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What to expect from Pennsylvania's Corporate Net Income Tax cut

Summary: Act 53 of 2022 cuts Pennsylvania's Corporate Net Income Tax (CNIT) rate by five percentage points over the course of nine years, reducing the rate from 9.99 to 4.99 percent. This *Brief* compares Pennsylvania to other states and examines the likely impact on the state's economy and finances.

According to the state's Tax Compendium, the CNIT is "the tax paid by all domestic and foreign corporations for the privilege of doing business, carrying on activities, or employing or owning capital or property in Pennsylvania."

Pennsylvania's current CNIT rate is 9.99 percent. For fiscal years (FY) 2016-17 through 2020-21 the CNIT produced an average of $3.3 billion in revenue (10 percent of the $33.5 billion five-year average of total tax revenue). For FY2021-22, the Independent Fiscal Office (IFO) reports that the CNIT produced $5.3 billion in revenue, a significant increase from the average of $3.6 billion for FY2019-20 and FY2020-21, attributable to COVID recovery and inflation.

According to the Tax Foundation, Pennsylvania's rate does not stack up well against other states. Forty-four levy a corporate income tax, four (Nevada, Ohio, Texas, and Virginia) levy gross receipts taxes in lieu of a corporate income tax and two (South Dakota and Wyoming) levy neither. Of the states that tax corporate income, 29 levy the tax at a single rate while 15 have a marginal corporate income tax rate, which levies a different percentage tax for numerous income brackets. When compared to the single rate and the top marginal corporate tax rates for every state, Pennsylvania ranks highest of those with a single rate and second against those with a marginal rate. This puts Pennsylvania at a competitive disadvantage relative to other states.

Top 10 Highest Corporate Income Tax Rates

Rank	State	Rate	Type	Rank	State	Rate	Type
1	NJ	11.5	Marginal	6	AK	9.40	Marginal
2	PA	9.99	Single	7	ME	8.93	Marginal
3	MN	9.80	Single	8	CA	8.84	Single
4	IA	9.80	Marginal	9	DE	8.70	Single
5	IL	9.50	Single	10	VT	8.50	Marginal

Act 53 of 2022 phases the CNIT down from the current 9.99 percent to 4.99 percent in 2031. In the first decrease since 1995, there will be a full percentage point decrease in 2023 to 8.99 percent. Every year after through 2031 the rate will fall by half a percentage point until 2031.

Estimated revenue loss

Fiscal notes from the Pennsylvania House and Senate Appropriations Committees accompanying the legislation project that the CNIT rate cut in FY2022-23 with its additional provisions will result in a net revenue loss of $202.3 million (6.2 percent of the five-year average CNIT revenue) in FY2022-23 and a net loss of $225.3 million (6.9 percent of five-year average CNIT revenue) in FY2023-24.

Additionally, Act 53 codifies into law the regulations in the Pennsylvania Department of Revenue's Corporation Tax Bulletin 2019-04, which requires corporations that do not have a physical location in the state to pay corporate taxes if $500,000 or more of its receipts per year are sourced in Pennsylvania. According to an April 2022 IFO analysis, this will qualify certain firms that were not previously required to pay the CNIT, such as passive investment companies. The act also applies market sourcing rules to include multistate corporations that sell intangible products in source markets where the benefits of the product sold are derived by the consumers.

These two changes lessen the fiscal impact of the CNIT rate cut. According to the IFO's April 2022 report, the revenue increase attributable to these two changes is estimated at $40 million for FY2022-23 and an average of $187 million until FY2026-27. These estimated increases are taken into account in the estimated losses in revenue described above.

Importantly, simply looking at revenue from the CNIT does not give the whole picture. For example, the forecast reduction of CNIT revenue might be offset to some extent by increases in personal income taxes and sales taxes that result from corporations starting or expanding operations inside Pennsylvania. If companies choose to expand operations into Pennsylvania by employing more workers or selling more products in Pennsylvania due to the CNIT cut, sales tax and personal income tax revenue would increase.

Since the CNIT cuts are expected to boost Pennsylvania's economy, the state should try to offset any net loss in tax revenue by cutting government funding for economic development. The government should take the opportunity to reduce outlays for economic incentives that have been thought necessary. The CNIT rate cuts are a good first step—but by no means the only needed step—to make the state more economically competitive.

Potential Effects

This tax-cut legislation is very positive news. If implemented as scheduled, it may help stimulate Pennsylvania's lagging economy. Assuming other states leave CNIT rates unchanged, Pennsylvania's CNIT rate in 2031 will be eighth-lowest single rate in the country and second-lowest among the marginal rates by 2031, an enormous improvement. The final rate of 4.99 percent for Pennsylvania would be lower than New York and Maryland's rates (New York's top marginal rate: 7.25 percent and Maryland's single rate: 8.25 percent). At the end of the phase-down, Pennsylvania will have the lowest rate in the Northeastern region.

Business leaders and elected officials on both sides of the aisle applauded this reform. Both major party gubernatorial candidates also support this act but think that the tax should be lowered even more within a shorter timeframe. This view is welcome because if the state is to be competitive, cutting the CNIT rate substantially, along with eliminating other regulations that reduce the state's competiveness are a must.

Pennsylvania must continue making these changes if it is to keep up with other states.

For example, North Carolina plans to completely phaseout its corporate income tax by 2030. North Carolina has no gross receipts tax and is already ranked as one of the most economically competitive states in the nation. This will add to the strain on Pennsylvania's stagnant population given that North Carolina is one of the top five states for which Pennsylvanians are leaving.

Looking at inflows into and outflows from Pennsylvania from IRS migration data, North Carolina experienced a net gain of 4,086 people, coming in second to Florida, which experienced a net gain of 11,173 people. Despite Pennsylvania's tax cut, North Carolina may continue to be relatively more attractive, owing in large part to its far more favorable labor climate. Consider that from July 2012 to July 2022, Pennsylvania private-sector jobs rose 329,700 (6.6 percent) while those in North Carolina rose 787,500 (23.9 percent)—3.6 times as fast. Manufacturing jobs were down in Pennsylvania 1.2 percent in those years while North Carolina's were up 7.9 percent.

North Carolina is not alone; more states are starting to realize the benefits of lower corporate taxes. Among other states lowering them for 2022 are Arkansas, Louisiana, New Hampshire and Oklahoma. How these cuts make these states more competitive relative to Pennsylvania can only be speculated. But it is certain Pennsylvania's new-found momentum should be maintained and more changes should be made to the business climate. Some state lawmakers have echoed this sentiment stating that the CNIT cut timeline should be accelerated.

Regardless of the benefits, it is debatable whether this cut is sustainable. Was this tax cut made possible by the unprecedented Federal aid? In FY2021-22, COVID aid of $3.8 billion was transferred to the general fund with no specific description of how it would be used and a $2.6 billion general fund surplus was transferred to the rainy-day fund. In FY2022-23, an anticipated general fund surplus of $2.1 billion is to be transferred to the rainy-day fund.

State lawmakers are up front about the CNIT cut being made possible by a healthy rainy-day fund. What will they do when COVID aid expires? The rate cut schedule will certainly be called into question. The phase-down of the CNIT could possibly be delayed or canceled, similar to the phaseout of the capital stock and franchise tax, which was delayed and paused repeatedly for years.

Or will the corporate net income tax rate cut spark new investment and expansion in Pennsylvania and fill state tax coffers in other ways? And might the state Legislature finally muster the courage to pass a Right-to-Work measure (no small part of North Carolina's economic success story) that most certainly would help retain and expand current businesses and attract new companies to the Keystone State?

Ultimately, Pennsylvania must continue making policy decisions like this if it is to become a competitive state. Pennsylvania should adamantly commit to keep to the scheduled CNIT decreases and continue lowering its taxes in general.

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