SENATE ECONOMIC STIMULUS PACKAGE:

The Wrong Solution for Pennsylvania's Economy

June 16, 2008

Overview

In the context of a slowing economy, the Governor's budget address in February proposed an economic stimulus plan that included increased infrastructure investments and tax rebates to low-income families. On June 11, the Senate (in SB2) passed a bill that provides some funds for infrastructure, but has not acted on the rebates, which failed to generate significant political support despite growing need. Recently, Senate leaders put forward their own plan for "economic stimulus" via a series of tax reductions. Senate Bills 1385, 1386, 1387, and 1388, would reduce or shift taxes for certain corporations, increase the amount small businesses can write-off for certain equipment purchases, and increase the income limits for the state's Tax Forgiveness program through which low-income families receive a complete rebate of what they pay in state income tax.

Collectively, the Senate stimulus bills are estimated to cost $96 million in 2008-09 and grow to $254 million per year by the third year. No offsetting funding sources or spending reductions were proposed to pay for these ongoing tax reductions.

This briefing paper considers whether these proposed tax changes would achieve the outcome that their sponsors put forward. We evaluate the plans based on two criteria (1) do the proposed tax cuts represent effective "economic stimulus" and (2) does the package benefit the families that most need help in our lagging economy. **We rely upon the consensus opinion of economists that effective stimulus should be targeted, temporary, and timely. The federal stimulus plan approved by Congress and the President in February 2008 stuck closely to this prescription.**

- ***Targeted stimulus* should help jump start a faltering economy by reaching people and businesses that will use it and by generating the greatest spending or investment for each dollar spent.**
- ***Temporary stimulus* should not be permanent and should phase out once the economy recovers.**
- ***Timely stimulus* must impact the economy quickly—when the economy needs a boost not after it has recovered.**

The proposed Senate tax cuts do not meet these three criteria for effective stimulus.

- Taken as a whole, the proposed cuts are poorly targeted and would be permanent, not temporary.
- The cuts will not help those most in need of help in our lagging economy.
- The proposals will not generate significant economic activity. Research on the effect of previous federal stimulus programs show that tax rebates to individuals returned $1.02 to $1.26 for every dollar spent, while business tax cuts generated less than 30 cents for every dollar spent.

- The tax cuts are not paid for. To the extent that the tax cuts lead to a corresponding cut in state spending—likely because of the requirement that the state not run a deficit—the tax cuts would actually contribute to further slowing down the economy.

In sum, the Senate stimulus plan is unlikely to do much to stimulate Pennsylvania's economy and could do more harm than good. Unlike the federal government, which can deficit spend in an economic downturn; the state must balance its budget. Without offsetting sources of revenue, these tax cuts threaten to drive the state into a deficit and force some combination of immediate cuts in services and future increases in taxes.

The proposed tax cuts are particularly ill-timed because even without changes to the tax code state tax collections are slowing. Tax revenue in Pennsylvania was lower than projected in March and May, and the surplus anticipated in the Governor's 2008 budget address has dwindled. Cuts in taxes that are not offset with other tax increases will lead to significant cuts in social services such as health care at precisely the time the need for these services is increasing. Declining state revenues have already led 27 states to project budget deficits for 2009 and 18 states to propose cuts in spending to close those deficits.[1] Rarely have states facing a fiscal deficit been able restore budget balance without raising taxes.

The business tax cuts would provide a windfall for certain businesses without any expectation that these businesses would in turn create new jobs or expand operations in the state. The tax forgiveness for lower income working families is limited to a very small group of taxpayers and offers nothing to help the broad cross-section of families burdened with higher health care, food, and gasoline prices.

There are better ways to help Pennsylvania's working families during an economic slowdown. The tax rebate proposal would do the most to stimulate the economy but it has not been embraced by policymakers in either the House or the Senate. A second approach that would put money in the pockets working families would be to enact a state earned income tax credit.[2] Since eligible families—whose incomes range from a few thousand dollars to almost $38,000 for a family of four—are typically cash strapped they would likely spend all of the money they get through a state credit, while tax cuts to businesses may be retained or returned to out-of-state shareholders, and to higher-income families are more likely to be saved. Second, the state could enact a health insurance coverage expansion program for adults, like that proposed in Senate Bill 1137.

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[1] Iris Lav and Elizabeth Hudgins, "Facing Deficits, Many States are Imposing Cuts that Hurt Vulnerable Citizens," Center on Budget and Policy Priorities, June 2, 2008 <http://www.cbpp.org/3-13-08sfp.htm>.

[2] A state earned income tax credit is a tax credit given at the state level to people who receive the federal earned income tax credit. The state issues a credit equal to a set percentage of federal credit, for example 30%. This could be done as a stand-alone program or as an optional alternative to the existing Tax Forgiveness program.

The Senate "Stimulus" Plan

The Senate Stimulus Plan includes four elements. Two of the bills incorporate changes long advocated by certain segments of the Pennsylvania business community and would result in lower corporate income tax payments for a select set of businesses. Two other proposals are being advanced simply as ways to stimulate spending in a recession.

Net operating losses. Companies that incur an operating loss in one year are able to carry that loss forward to reduce their taxable income in future years, and pay taxes only on the reduced income. **Senate Bill 1385** would increase the amount of net operating losses (NOLs) that can be carried forward, from $3 million or 12.5% of taxable income to $5 million or 20% of taxable income. In general, larger businesses with larger losses and significant tax liability would benefit from this change, while other businesses would not.

Sales factor apportionment. Senate Bill 1388 changes the way corporate taxes are calculated for some multi-state corporations. Corporations doing business in multiple states (such as Wal-Mart or Hershey) use a three-factor formula—sales, payroll and property—to determine how much of their income is allocated to Pennsylvania for tax purposes. SB 1388 would count sales more heavily than payroll and property, reducing the tax liability of corporations who have facilities in Pennsylvania but few sales, and increasing the tax liability of corporations with sales but little in the way of payroll or property.

Tax Forgiveness. Senate Bill 1386 increases eligibility income limits for the state's Tax Forgiveness program from $6500 to $7500 for individuals and $34,000 to $37,000 for a family of four. The Tax Forgiveness program provides a refund of state income taxes paid by low income individuals and families. The Commonwealth has not increased income eligibility for this program since 2004.

Equipment expensing. Currently, business owners can deduct the cost of certain equipment investments in the year of purchase rather than depreciating the asset over time. **Senate Bill 1387** would double the write off amount from $25,000 to $50,000.

Grading Proposals for Economic Stimulus

One of the few topics on which the economic profession has a broad consensus is the criteria for evaluating an economic stimulus package: effective stimulus policies should be timely, targeted and temporary.[3]

Timely stimulus reaches the intended recipients when it is most needed to spur the economy. If stimulus comes too late in the economic cycle, it will impact the economy after it is already well on its way to recovery.

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[3] Douglas Elmendorf and Jason Furman, *If, When, How: A Primer on Fiscal Stimulus*, The Brookings Institution, January 10, 2008.

Targeted stimulus produces the best return on investment—that is, the greatest economic activity for the dollar cost to the government budget. The most powerful, and in that sense "targeted," stimulus is increased government spending itself. The second most targeted approach is to help those most adversely affected by the worsening economy and most likely to spend any additional money they receive. Research buttresses the common-sense idea that those most likely to spend additional money are lower-income working families.

Temporary stimulus recognizes that the federal government often has to borrow the money for the stimulus but must, in the long run, run a balanced budget (or, at the federal level, achieve a level of debt that is manageable as a share of economic output). For a state, stimulus in the form of permanent tax cuts can create or worsen a long-run "structural deficit"—a long-run gap between state tax revenues and state needs to finance critical investments and services. Fixing a future structural deficit requires tax hikes or spending cuts.

The Proposals Get Near Failing Grades on All Three Counts.

The Senate plan is not timely: The proposed tax cuts are intended to take effect in beginning in 2009 for the 2008 Tax Year. Most of the cuts are back loaded to the third year. Even if the recession is a long one, the biggest financial impact will occur after it would do the most good.

The plan is not temporary: The stimulus proposals would make permanent tax changes that will create a $254 million annual drain on the Treasury.

The plan is not well- targeted: Consumer spending generates vastly more economic return that broad – based business tax cuts. Estimates based the impact of previous stimulus packages, including those enacted in 2001, found that direct rebates to consumers generated significant economic activity, returning $1.02 to $1.26 for every dollar reduction. By contrast, tax cuts for business (accelerated depreciation, a cut in the corporate tax rate) generated less than 30 cents in terms of increased spending and investment.[4] Tax cuts aimed at businesses are ineffective in stimulating increased spending during a recession because businesses investments respond most to changes in demand for their goods and services not changes in their tax liability. Businesses would be most helped by stimulus package which put more money in their customers' pockets. Early results from the federal stimulus seem to bear this out, as retail sales have climbed since the stimulus checks were issued to individuals.[5]

Ignoring the empirical evidence, the Senate stimulus proposal is skewed heavily to business tax cuts that have not proven to be effective at generating new economic activity. The weighted sales factor will reduce corporate net income tax liability for some companies, but will actually increase income taxes for others. There is no requirement that any company receiving a tax break would have to increase jobs or i

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[4] Moody's Economy.com, "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," Moody's Economy.com, January 2008

[5] Michael Grynbaum, "Retail Sales Rise Above Forecasts," New York Times, June 13, 2008 <http://www.nytimes.com/2008/06/13/business/13econ.html?ref=business>.

investment in the state. There is no evidence that a weighted sales factor has had a favorable impact on manufacturing employment. In fact equally weighted sales factor states have done better at retaining manufacturing jobs between 2001 and 2007. The NOL changes will not impact the bulk of PA corporations who do not have a bank of losses over $3 million.

Consistent with evidence that tax cuts for individuals stimulate the economy more than cuts for businesses, $117 million of the $168 billion federal stimulus package, or 69% of the total, went directly to individuals in the form of rebate checks delivered this spring.[6] In contrast, the Pennsylvania Senate plan devotes only 47% to individual spending in the first year, declining to 32% in the second and third year.

Expanding tax forgiveness allows policymakers to target relief to individuals who are likely to suffer the effects of a recession; job loss, housing foreclosure, loss of health insurance coverage. But SB 1386 is extremely limited in its assistance for such families. It does nothing for any of the 1.2 million lowest-income Pennsylvanians who are currently enrolled in tax forgiveness. It expands the program to a sliver of new beneficiaries over three years.

Past Recessions Triggered Declining Tax Revenues in Pennsylvania

While every recession is different and affects different parts of the economy, the results of the last two recessions have meant the same thing for Pennsylvania – lower tax collections. A review of Pennsylvania tax collections shows that corporate and personal income taxes (particularly related to capital gains) declined in the year <u>after</u> the recession, as final tax balances are settled in the year after they occur. In 1991, the state had a $450 million budget deficit and raised taxes $3 billion to balance the budget the next fiscal years.[7] In 2002, following a relatively mild recession, the state drained over $1 billion from a reserve fund and raised cigarette taxes, increased the Personal Income Tax rate and made other changes to cover the shortfall and avoid further deficits.

The lesson to learn from this is that the state needs to be cautious in 2008-09 and in 2009-10. Cuts in taxes that aren't likely to be reinvested in the economy could lead to a severe budget crisis which will have to be solved with some combination of program cuts and tax increases.

Conclusion

The Senate stimulus plan is not serious stimulus. The plan capitalizes on the idea that the government should jump start the economy but does so with a series of business tax cuts that have been shown at the federal level to be of little impact on the economy. The four proposals fail to follow the three pillars of effective stimulus –that it be temporary, timely, or targeted. Collectively, the bills will permanently

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[6] OMB Watch, *Assessing the Fiscal Stimulus Program*, February 20, 2008 <http://www.ombwatch.org/article/articleview/4170/1/82/?TopicID=2>.

[7] National Association of State Budget Officers, *The Fiscal Survey of States*, October 1991 and October 1992 editions.

blast a $250 million hole in the state budget – at a time when the revenue is likely most needed (the fiscal year following a recession). While modestly increasing the state's Tax Forgiveness program will help a few lower-income Pennsylvanians, the efforts to do so should not be accompanied by business tax cuts that will be more than double the cost of the tax forgiveness changes in three years. Due to the limits placed on the state in terms of deficit spending, the prudent course is to leave further action on non-infrastructure economic stimulus in the hands of federal lawmakers, and do those things that can be paid for in the current economic climate, a health insurance expansion and a modest state Earned Income Tax Credit.