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Legislative Budget and Finance Committee
Remarks to
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Thank you for inviting me to today's hearing on improving state government programs and expenditures. My name is Philip Durgin and I am the Executive Director of the Legislative Budget and Finance Committee. I've been asked to discuss with you a series of reports our Committee released in 2009 and 2010 with regard to the Commonwealth's tax credit programs.

At that time, we identified 18 different tax credit programs that were "on the books," although we later discovered that several of these were defunct or no longer active for one reason or another.

The Governor's Budget Office estimated that, in total, Pennsylvania's tax credit programs cost the Commonwealth about $450 million dollars in the last fiscal year, in terms of revenue foregone. It would take all morning to go through each one of the programs, so in the interest of time, I'll focus my remarks on the four largest programs, which together account for about $350 million, or almost 80 percent of all the tax credit spending. For information on the other programs, I would refer you to our reports, which are available on-line or by contacting our office.

The largest Commonwealth tax credit program is the Educational Tax Credit, a program that has increased over the past ten years from $45 million to $150 million. The Educational Improvement Tax Credit, the largest portion of the Education Tax Credit, is divided into two separate programs: one is for scholarships for low-to-moderate income families to send their children to a private school, and the other is the Educational Improvement Organization program, which allows businesses to take a tax credit for donations they make to organizations that provide programs to public schools. Most of our concerns focused on this second aspect of the EITC program, the Educational Improvement Organization program.

Under the law, Educational Improvement Organizations (EIOs) are to provide "an advanced academic or similar program that is not part of the regular academic program." However, when we reviewed the list of organizations and programs receiving these donation, it seemed unlikely that many of them would be offering "advanced academic" programs. Many of the organizations, for example, are institutions such as museums and zoos. When we read the descriptions of the programs they offered and spoke to representatives of the programs, it appeared that the programs were little more than the normal tours and programs routinely offered to the public. We also noted that a number of EIOs were approved to offer sports camps, theater groups, folk crafts, and what appeared to be essentially after-school programs.

In responding to our report, the Department of Community and Economic Development, the department responsible for determining which programs and organizations are eligible, said they discussed our concerns with officials in the Department of Education, who were satisfied that the DCED guidelines were appropriate. That is about as far as we felt we could take it. But it is difficult to look through the list of approved Educational Improvement Organizations, which starts with the Antique Automobile Club of America and ends with the York YMCA, and come away feeling comfortable that these organizations are likely to be offering "advanced academic or similar" programs.

The Research and Development Tax Credit is another large program, totaling $55 million annually. We had both conceptual and operational concerns about the R&D program. The Pennsylvania program is modeled largely off the federal research tax credit program, which most studies have found to have only marginal benefits. The California Legislative Analyst Office found that, while a reasonable case can be made for research subsidies at the federal level, at the state level, research tax credits are likely to be quite costly relative to the benefits they provide, and recommended to its legislature that their R&D tax credit program be cut back or terminated.

These broader issues aside, one of the problematic aspects we found with regard to Pennsylvania's Research and Development Tax Credit is that expenditures for product development are not eligible for the credit. I suspect what probably happened is that the program was named the Research and Development Tax Credit because that phrase flows so easily off the tongue. But the definition in the state enabling legislation of what constitutes "research and development" refers to the federal definition, which only includes research activities. So one of our report recommendations is that, if it is continued, the program be renamed to help avoid this confusion.

We were also concerned by how little the Department of Revenue did to verify that the credits are only awarded for qualified activities. For example, we found that nowhere on the original application were businesses asked to indicate whether their research expenses were incurred in Pennsylvania. And none of the 39 companies we spoke to that applied for the credit—including a small bakery in Reading that had received credits for "researching" new cake recipes—said that it had ever been audited by the Department of Revenue.

The Department of Revenue has since modified its application form to require companies applying for the R&D tax credit to indicate where the research took place. The Department also said that, if a company is selected for audit for other reasons, it would include the R&D tax credit as part of that audit. We recommended that the Department go a step further and specifically select for audit at least a few companies that have received substantial research and development tax credits, in hope that the word gets around that an audit is at least a possibility.

The third major tax credit program I'll talk about is the Keystone Opportunity Zone program. The Budget Office estimates the cost of this program in forgone state taxes to be $87.5 million, although that was a number we were never able to confirm or verify. The KOZ program began in 1998 with the goal of redeveloping blighted sites, such as abandoned industrial sites and strip mines, into productive properties by offering companies the opportunity to operate there free of state and local taxes, generally for a period of 10 to 15 years. The ability to operate free of such taxes proved very popular in the business community, and we found many examples where the program had successfully achieved its goals. The original program was so popular, in fact, that it was expanded and modified many times over the years, to the point that farm fields, woodlots, and other greenspaces were being designated as "deteriorated property" under the theory that they were not being used to their highest economic potential.

But our biggest concern about the KOZ program was that the original legislation placed no job creation or capital investment requirements on the participants.[1] When we reviewed the KOZ files, we found that fully two-thirds of all program participants reported not having created any jobs. And that's after we excluded all the

[1] There are job and capital investment requirements for existing Pennsylvania companies that move into a KOZ, but we found those requirements are not monitored or enforced.

residential participants, who live in homes that are in a KOZ and therefore do not have to pay any state or local income or property taxes.

Many KOZ participants also reported making no capital investments in their businesses. As you might suspect, many of these KOZ participants were not brick-and-mortar establishments, but rather some type of venture capital or investment fund that has a legal existence, but no real physical presence. One can understand why such "companies" would find it advantageous to be legally located in a KOZ as a way to avoid taxes, but I doubt this is really what the General Assembly had in mind when it created the KOZ program.

The last tax credit program I'll mention is the Film Production tax credit, which was estimated to cost $60 million in FY 2014-15. We contracted with an economic modeling firm to evaluate this program in 2009. That firm found that in FY 2007-08, the Commonwealth awarded $58.2 million in tax credits, which generated direct spending in Pennsylvania of $267.3 million. This direct spending in turn generated wages, both direct (e.g., working on the film set) and indirect (e.g., at the restaurants and hotels used by the film workers), of $146.5 million. All that economic activity itself generated additional state and local taxes of $17.9 million. So the question becomes, is a $40.3 million "investment" in tax credits ($58.2 million in credits minus $17.9 million in additional taxes) worth $146.5 million in additional wages. Or expressed in terms of jobs, the $40.3 million net investment in tax credits created an estimated 3,960 additional full- or part-time jobs for a year.

The numbers look much better if, as some argue, there would be virtually no film industry in Pennsylvania without a tax credit program. This argument rests on the idea that the tax credit attracts the critical mass of film activity needed to support the necessary infrastructure in terms of studios and other related businesses that, in turn, can then attract other film, video, and similar productions that do not receive tax credits. If you are willing to accept that argument, then the $58.2 million in tax credits can be said to have a net positive effect on state and local taxes of about $4.5 million, as the entire film production industry in Pennsylvania generated about $62.7 million in taxes, fees, and permits in FY 2007-08 ($62.7M - $58.2M = $4.5M).

In addition to the recommendations we make on specific programs, we also make a number of recommendations pertaining to tax credit programs more generally. One is that the Department of Community and Economic Development, which has responsibility for most of the tax credit programs, do a better job in monitoring these programs, both in terms of compliance and effectiveness. At one point DCED did have a monitoring unit with these responsibilities, but it was disbanded about 7 years ago, and I do not believe it has been re-established. We also recommended that when the General Assembly establishes a tax credit program, it does a better job in defining the purpose and objectives of the program, including identifying program measures against which the program's success can be measured.

I'll stop here and would be pleased to try to answer any questions you may have about our reports.