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The Capital Stock and Franchise Tax Issue: It's All About Attitudes

A contentious election year issue has erupted in Harrisburg. To deal with the state's revenue shortfall, the Governor has proposed slowing the implementation of the currently legislated phase out of the Capital Stock and Franchise Tax (CSFT). Changing the pace or timing of the phase out will require an act of the legislature. To further complicate the picture, since the CSFT rate was already lowered by one mill to 6.49 mills on January 1, 2002 as required by current law, the proposed increase to 6.99 mills retroactive to the beginning of the year would actually represent a tax increase from the rate companies are now paying. Needless to say, how the legislature deals with this issue is crucial for Pennsylvania's future

What will they decide? That depends on the type of future they want to see and the prevailing attitudes in the General Assembly.

By way of background, Pennsylvania is the only state to tax both business capital, through the CSFT, and income, by the Corporate Net Income tax. The resulting combined tax burden on business in Pennsylvania ranks among the highest in the nation.

There is an old truism in economics and public finance: government should tax what it wants less of and subsidize what it wants more of. There is an additional newer truth that has been developing over the past two decades: economic growth and prosperity are closely correlated with economic freedom. Economic freedom goes down when taxes go up.

High taxes on wealth and income will slow wealth formation, income and jobs. As nature abhors a vacuum, capital abhors high taxes.

Pennsylvania has a long history of trying to offset the high taxes on capital and business income with a raft of programs to assist economic development through a mind boggling array of subsidies, grants, low cost loans, etc., thinking this reflects a more sophisticated pro-business, pro-free enterprise attitude. Wrong. In fact, most of these assistance programs reflect a big government control attitude wherein politicians and bureaucrats get to decide which individuals, which companies or even which industries will be favored with taxpayers' largesse.

The one notable and successful exception has been the Keystone Opportunity Zone Program, which creates tax free zones and offers a level playing field for any business that wishes to take advantage. This is a proven better way to foster growth.

In large measure, subsidies and handouts to this or that business are far less effective at creating investment and sustained growth than are low business taxes. The point is, Pennsylvania should move away from trying to direct development and instead use that money to roll back taxes and provide a business friendly climate that will launch the state onto a much better economic trajectory.

And that brings us to the Capital Stock and Franchise Tax. What's the harm in delaying the promised full implementation? The damage would be to the Commonwealth's credibility as a state that is trying to change it's image as being hostile to business. Unfortunately, the overtaxed business sector, which is, after all, the horse that pulls the economic wagon, is targeted because that's where the supposed easy votes are. But it makes no sense to hobble the horse further at a time when every possible opportunity to improve the business climate should be seized upon to encourage investment and job creation.

Look at it this way. What is the possibility the state would renege on promised pay increases for state employees or not meet required pension plan contributions for legislators? Just asking the question is likely to be met with snide comments. How many school administrators, teachers or other school employees have volunteered to accept a pay freeze for a year to help their districts and the state get through a tough period? Not many is a safe guess. How many legislators will even entertain the possibility of asking school employees and state employees to help the overburdened taxpayers for a year until the economy can turn around? Not many.

Obviously, there are many opportunities for the state to cope with the projected revenue shortfall that do not involve reneging on a promise to the business community. Unfortunately, the legislature will instead be spending a lot of time debating whether to slow much needed business tax reduction. What a shame.

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