PENNSYLVANIA'S BUSINESS TAX CLIMATE: CURRENT COMPETITIVE ISSUES AND PROSPECTS FOR REFORM

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Key Findings

- Recent surveys of business people both inside and outside Pennsylvania have found that the state is perceived as having a poor business tax climate. The most significant issues identified by those responding were the state's high Corporate Net Income Tax (CNIT) rate, the state's practice of capping net operating loss (NOL) carryforwards, the lack of single sales factor (SSF) apportionment of corporate income, and the continued presence of the state's Capital Stock and Franchise Tax (CSFT). In addition, a general attitude exists among business people that Pennsylvania has fostered an unfair and unpredictable tax environment for businesses.
- Gov. Ed Rendell has attempted to claim that his administration has improved Pennsylvania's business tax climate, citing a recent study of state business tax systems by the Washington, D.C.-based Tax Foundation as evidence. His claims are unfounded. A closer look at the study reveals that the positive features it cites concerning Pennsylvania's business tax system largely predate Gov. Rendell's administration, and that the system includes several glaring anomalies, particularly in the areas of corporate and wealth taxes.
- Continuing to limit NOL carryforwards results in vastly different tax treatment for Pennsylvania businesses with the same net profitability over a multi-year time period, makes it more difficult for the state's struggling manufacturers to recover from difficult economic times, and makes it less likely that new companies will form and grow in Pennsylvania.
- Major manufacturing states have generally moved in the direction of SSF apportionment of corporate income in order to encourage corporate expansions within their borders. Lowering the effective tax rates faced by Pennsylvania's corporate employers lowers their cost of doing business in the state and makes Pennsylvania more attractive as a destination for investment.
- Pennsylvania's Research & Development (R&D) Tax Credit program has been capped (albeit at increased levels) since its inception. Pennsylvania small businesses have not been using all of the credits available to them, while there are not enough credits for all of the non-small businesses that want to use them. Given the historical levels of applications for the credit program, a better strategy would be to remove the cap, as Pennsylvania's neighboring state of New Jersey has done.
- Over the past 50 years, empirical research has begun to repeatedly demonstrate that taxes shape business location and investment decisions, and that lower-tax jurisdictions have a competitive advantage over their higher-taxed counterparts—especially in the area of property taxes. Future discussions of property tax reform in Pennsylvania should focus on how to reduce the burden faced by businesses, as well as that faced by residential property owners.
- Several areas of Pennsylvania have national reputations as high-cost business locations, and local business taxes are a major factor in the creation of those reputations.

Introduction

Pennsylvania has long had a reputation as a state with high levels of business taxes, and throughout the past several decades, under governors and legislative majorities of both major political parties, little has occurred to change that perception. At the same time that the impression of Pennsylvania as an unfriendly place to do business has been cemented in the minds of the owners of many of the state's existing firms and their counterparts across the United States, the Commonwealth has consistently failed to match both the national economy and those of many of its competitor states in terms of employment, population, and personal income growth.

However, as Gov. Ed Rendell campaigns for re-election, he has made a point of emphasizing his record as a business tax-cutter, claiming credit for more than $1 billion in tax cuts since taking office and touting the complimentary portions of a study of state business taxes by the Washington, D.C.-based Tax Foundation as evidence that his policies have made Pennsylvania's business tax climate friendlier to investment.

Nevertheless, the governor's claims that he has improved Pennsylvania's business tax climate, as well as his citation of evidence that supposedly supports his argument, are unpersuasive. In fact, efforts to discern the opinion of the business owners and investors who operate in Pennsylvania suggest that the reality is much different, and that they believe that despite some recent incremental improvements, the Commonwealth still has much to do to remedy some of the most obvious flaws in its business tax system. At the same time, a close reading of the Tax Foundation study reveals that it is far from a blanket endorsement of Gov. Rendell's business tax policies, and that Pennsylvania is still extremely uncompetitive in several key areas of taxation, including several of the types of taxes most burdensome to business owners.

The following analysis looks at how Pennsylvania's business tax climate is perceived by business people, both inside the state and around the United States, and presents information on some of the specific reforms sought by representatives of the Commonwealth's large and small businesses. It also examines the Tax Foundation's 2006 *Business Tax Climate Index* as it pertains to Pennsylvania in an attempt to discern exactly where the state's business tax climate compares favorably with other states, and where improvement is still needed. Finally, it reviews some of the academic literature on state and local business taxes and business location decisions, and looks briefly at how Pennsylvania's local business tax structure impacts the Commonwealth's competitive position.

What Do Business Owners Say
About Pennsylvania Business Taxes?

Several recent formal and informal surveys of the business community, both inside Pennsylvania and nationally, have been less than complimentary to the Commonwealth's business tax climate. These surveys also identify what many business people see as the major areas in which Pennsylvania continues to be a less than hospitable environment for existing companies to locate or expand, as well as for new businesses to form and begin to grow.

2004: CFO Magazine State Tax Survey

In 2004, *CFO Magazine* released the results of its 2004 State Tax Survey, in which corporate tax officials were asked their impressions of state tax environments. The survey was designed to measure opinion among its 130 respondents, rather than objective measures of state business tax climates such as tax rates, and one of its key findings was that "impressions of unfair treatment die hard."[1]

Pennsylvania's rankings in several categories clearly demonstrate that its reputation as a state with a punitive business tax system is intact. It was rated the 5th "least fair and predictable" tax environment among the 50 states, the 5th "least desirable state" with regard to how its revenue department's policies and systems influence companies' decisions to locate or expand within its borders, and the "least independent" of the 50 states in terms of how independent its administrative appeals process (tax board, law judge, or tax court) is from its audit department.[2] It is also important to note that this survey was conducted prior to the passage of the 2003-04 Pennsylvania budget, which included a 10 percent increase in the state's Personal Income Tax (PIT)—the tax paid by many of Pennsylvania's small businesses—and a retroactive increase in the state's Capital Stock and Franchise Tax (CSFT).

2005: Forward to Prosperity

The results of CFO's survey of nationwide business executives are mirrored by the perceptions of people who own and operate businesses in Pennsylvania. The 2005 study *Forward to Prosperity*, commissioned by the Pennsylvania Prosperity Coalition, found that in interviews with community, business and government leaders across the state, these individuals' "top-of-mind" impression was that high business taxes are "a major cause of weak economic development in Pennsylvania" and a "major obstacle to attracting out-of-state businesses."[3] The respondents identified the following major problems with Pennsylvania's business tax system:

[1] Tim Reason, "Stingers: The 2004 State Tax Survey," *CFO Magazine*, January 1, 2004.
[2] *Ibid.*
[3] Pennsylvania Prosperity Coalition, *Forward to Prosperity: Removing Obstacles to Pennsylvania's Economic Performance*, Michael Young Strategic Research, 2005.

- Pennsylvania has both a Corporate Net Income Tax (CNIT) and CSFT, while most states have one or the other, but not both.
- The state's high CNIT rate (9.99 percent, which is the second-highest among states with such a tax) is a "red flag" for businesses.
- Even though the CSFT is being phased out, its continued presence is a problem.
- Both the CNIT and the CSFT "are widely considered to be drags on Pennsylvania's competitive position versus other states seeking business development," and these taxes have hobbled business development for many years and continue to make Pennsylvania less attractive to potential employers.[4]

The findings of a survey of Pennsylvania citizens presented in *Forward to Prosperity* reveal that the general public has come to many of the same conclusions about the state's lack of a competitive business tax system as Pennsylvania's business and community leaders. Forty-one percent of those surveyed said that they believe high business taxes are "the main reason" that businesses leave Pennsylvania. In addition, 51 percent of Pennsylvanians believe that the "main reason" businesses leave the state is either high taxes or the cost of doing business in the Commonwealth, and the same percentage of those surveyed believe that high business taxes have contributed a great deal to Pennsylvania's weak job growth.[5]

2006: SMC Business Councils and Compete PA

In February 2006, SMC Business Councils, a Churchill-based statewide trade association of smaller Pennsylvania businesses, surveyed a cross-section of 150 small business owners in southwestern Pennsylvania on various tax issues. Four out of 5 of the business owners surveyed called Pennsylvania's high business taxes a "significant drag" on their businesses, and more than 90 percent stated that high taxes are "a significant drag on Pennsylvania's economic growth."[6]

With regard to specific Pennsylvania tax issues, survey respondents said that they would most like to see the 10 percent increase in the state PIT, enacted in 2003, repealed (not a surprising finding among a group of small business owners)—but they were also heavily critical of a number of other uncompetitive facets of the Commonwealth's business tax climate. First among these was Pennsylvania's "singularly high" CNIT, but a number of other, equally important changes were mentioned. Those included removing the state's cap on the amount of net operating losses (NOLs) that can be carried forward to by businesses, the state's cap on the amount of research and development (R&D) tax credits available to businesses, the "overly complex" sales and use tax rules businesses face, and complicated expensing and depreciation provisions.[7]

[4] Pennsylvania Prosperity Coalition, *Forward to Prosperity: Removing Obstacles to Pennsylvania's Economic Performance*, Michael Young Strategic Research, 2005.
[5] *Ibid.*
[6] SMC Business Councils, "SMC State Business Tax Survey Results," February 14, 2006.
[7] *Ibid.*

In concluding its report on its survey, SMC noted that 94 percent of those polled agreed that Pennsylvania's business climate needs to be "regionally, nationally and globally competitive"—not simply competitive, as Gov. Rendell stated in his 2006-07 budget address, with neighboring states, many of which currently struggle with uncompetitive business tax systems of their own.

Finally, the CompetePA Coalition—a statewide association of businesses and organizations dedicated to "working to solve the serious business tax competitiveness problems that are contributing to the low rate of job creation in Pennsylvania"—has announced two primary goals for the fall of 2006: to remove the cap on the carryforward of net operating losses, and to change the income apportionment formula used to calculate Pennsylvania businesses' CNIT liability to a "single sales factor."[8]

The 2006 Tax Foundation State Business Tax Climate Index and Pennsylvania: Gov. Rendell's Spin vs. What the Report Actually Says

In marked contrast to the views of Pennsylvania and nationwide business leaders, Gov. Ed Rendell has argued that his administration has improved Pennsylvania's business tax climate, and he has touted the findings of one particular research report as proof that the Commonwealth, under his leadership, ranks among the better business tax environments in the United States. The governor has embraced the 2006 edition of the Washington, D.C.-based Tax Foundation's *State Business Tax Climate Index* in an effort to argue that Pennsylvania's business tax climate is actually quite friendly, especially in comparison to its closest geographic neighbors.

At first glance, Pennsylvania's overall ranking of 16th among the 50 states seems to lend credibility to the governor's assertion that his administration's policies have contributed to the state's position in the Tax Foundation's index. However, a closer look at the methodology and assumptions underlying the Tax Foundation study reveals that it does not have unqualified praise for Pennsylvania. It turns out that the strengths of Pennsylvania's business tax climate, as identified by the Tax Foundation report, largely predate Gov. Rendell's administration and are generally related to the structure (mainly the design of tax rates and definitions of tax bases) of the state's business tax system. At the same time, Gov. Rendell's actions while in office have actually diluted some of the advantages that Pennsylvania's business tax climate enjoys with regard to its competitors, and he has both proposed changes that would make Pennsylvania less competitive with other states and delayed modest reforms that would reduce the burden actually felt by the state's remaining businesses.

The following section provides an overview of the key findings of the Tax Foundation study as they relate to Pennsylvania. It examines the design of the *State Business Tax Climate Index* and its key components, with the aim of painting a more complete picture of how it evaluated Pennsylvania's business tax climate and pointing out opportunities for reform.

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[8] CompetePA, "Our Goals for Fall 2006," http://www.competepa.org/.

Structure and Methodology

It is important to note at the outset that the Tax Foundation's *State Business Tax Climate Index* is just that—an examination of state business tax climates, and nothing else. It "does not attempt to measure economic opportunity or freedom, or even the broad business climate"[9]—and Pennsylvania has generally fared very poorly in such studies in the past, the most recent of which, the Pacific Research Institute's *U.S. Economic Freedom Index: 2004 Report*, ranked Pennsylvania 45th among the 50 states in economic freedom.

The Tax Foundation study begins with the commonly accepted assumptions that taxes do matter to businesses, that states do not enact tax changes "in a vacuum," and that "those places with the most competitive tax systems will reap the benefits of business friendly tax climates."[10] It also notes the danger of using economic development subsidy packages in an attempt to compensate for an uncompetitive state business climate—as Pennsylvania has done in the past and continues to do. To quote the study:

> "*Lawmakers create (subsidy) deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a woeful business climate plagued by bad tax policy. A far better approach is to systematically improve the business climate for the long term so as to improve the state's competitiveness as compared to other states."*[11]

The Tax Foundation also argues that ideal tax systems are those that are neutral to business activity, but since such systems do not exist, the goal should be to minimize the economic distortions taxes cause. For that reason, states with simple tax systems with broad bases and low rates score best on the Tax Foundation's index (and, as will be illustrated shortly, partially accounts for Pennsylvania's overall ranking on it). It further notes that the index is based not only on how much states take in taxes, but how those taxes are taken—meaning that states with "poor tax regimes" cannot "hide behind low tax burdens."[12] But this raises an important question: Can states with high tax burdens in key areas "hide behind" good tax regimes?

At any rate, the Tax Foundation uses the "good tax system" criteria of low tax rates, broad tax bases, and similar treatment of similar taxpayers to rate state tax systems in five categories or "component indexes." Each component index was assigned a weight according to the variability of the 50 states' scores from the mean, and indexes with greater variability are weighted more heavily. The index is a relative index (meaning that variables were ranked according to that variable's range in other states), and all final

[9] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[10] *Ibid.*
[11] *Ibid.*
[12] *Ibid.*

scores are normalized (the average score for each index is 5, and scores can be compared across indexes).[13] The five component indexes and their weights are as follows:

- Corporate Tax Index—19.98 percent.
- Individual Income Tax Index—28.09 percent.
- Sales and Gross Receipts Tax—22.36 percent.
- Unemployment Insurance Tax—13.91 percent.
- Wealth Tax—15.66 percent.[14]

The Tax Foundation notes that index areas with higher standard deviations are tax law areas "where some states have significant competitive advantages," and that businesses must give greater emphasis to tax climate where differences are large. It argues that in areas of its index in which state scores are clustered closely together, businesses are more likely to de-emphasize those tax factors. The study argues that small changes in state tax law can change a sub-index ranking dramatically where states are tightly clustered, but still tell businesses little about the total overall differential between states, such as with unemployment taxes.[15]

While this point is well taken, it must be pointed out that Pennsylvania's corporate and wealth taxes—two areas which are given relatively less weight in the Tax Foundation's index—are the two areas in which business people who operate (or have operated) in Pennsylvania's business tax climate consistently argue that the state is much less competitive than other states. Furthermore, many of those business people have indicated that relatively greater emphasis is being given to such taxes, specifically the CNIT and CSFT, in making decisions about whether or not to locate in Pennsylvania. At the same time, the area of the Tax Foundation study on which Pennsylvania scored highest—the index taking into account the state's relatively low personal income tax (PIT)—is not regularly cited as an advantage for businesses to locate in Pennsylvania to the degree that the state's corporate and wealth taxes are cited as deterrents. In fact, Pennsylvania's advantage in this area was diluted somewhat when the PIT was increased by 10 percent in 2003.

Corporate Tax Sub-Index

The Corporate Tax Sub-Index consists of two equally-weighted sub-indexes—one for rate structure and one for competitiveness of the business tax base. The rate sub-index includes the top business tax rate, the level of taxable income at which the rate kicks in, the number of brackets, and the average width of brackets. States with corporate taxes generally score well with low-rate systems, while states with complex, multi-rate systems generally score poorly. The business tax base sub-index includes two broad areas—treatment of net operating losses and how well the tax code conforms to uniform standards and protects companies from double taxation. States that score well on the tax

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[13] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[14] *Ibid.*
[15] *Ibid.*

base sub-index generally have generous carry-forward and carry-back deductions for net operating losses, and a system that conforms well to uniform standards and avoids double taxation.[16]

Pennsylvania ranked 32nd among the 50 states on the corporate tax sub-index in 2006, up from 35th in 2003 and 2004. The study notes that Pennsylvania has the 4th-highest effective corporate tax rate among states with such a tax, trailing only Michigan, Washington, and Iowa. However, despite its high rate, Pennsylvania scores well as one of 31 states with a flat, single-rate corporate tax system, consistent with, according to the study, "the sound tax principles of simplicity and neutrality."[17] Its flat corporate tax rate also causes Pennsylvania to score well because it does not further punish businesses as they become successful. It can be argued, however, that Pennsylvania's high corporate tax rate does not allow businesses a sufficient opportunity at success (or discourages businesses from locating in the state in the first place).

Pennsylvania is also one of 31 states with one corporate tax bracket, which, according to the Tax Foundation study, avoids the changes in incentives that occur when taxpayers reach the end of one bracket and move into the next-highest bracket. Pennsylvania was also rewarded for being one of 31 states with "zero bracket width" because of its flat corporate rate system.[18]

On the tax base sub-index, two criteria were weighted equally: the ability to deduct net operating losses (NOLs), and a collection of smaller tax base issues. The NOL component is important because it "helps to ensure that, over time, corporate income taxes tax average profitability" and "levels the playing field" between cyclical and non-cyclical industries.[19] There are two main variables involved with NOLs—carrybacks and carry-forwards—and Pennsylvania scores poorly with regard to both. Pennsylvania is one of 27 states with a zero-year carryback period (generally, longer carryback periods are associated with a greater probability that corporate income taxes are levied on a company's average profitability). Pennsylvania is the only state, according to the Tax Foundation study, to limit net operating loss carry-forwards.[20]

On the remaining issues considered in the corporate tax base sub-index, Pennsylvania scored well on each, with one exception. It was one of 48 states that conform to the federal definition of corporate income, which reduces the tax compliance burden. It was one of 47 states that substantially conform to federal depreciation schedules and one of 40 states that conform to federal depletion schedules, both of which reduce tax complexity. Pennsylvania and 41 other states do not have an alternative minimum tax (AMT) for corporations, and it is one of 33 states that index their corporate tax brackets

[16] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[17] *Ibid*.
[18] *Ibid.*
[19] *Ibid.*
[20] *Ibid.*

for inflation. Pennsylvania does score poorly as one of 23 states that do not allow deductions for federal and state taxes paid to other jurisdictions.[21]

Individual Income Tax Index

As noted previously, the Individual Income Tax Index is weighted the most heavily among the five component indexes in the Tax Foundation study. Its significance derives from the fact that much business activity is taxed this way (as in Pennsylvania), and less neutral individual income tax systems hurt entrepreneurship, and thus harm state business tax climates. The study also notes that individual income tax rates impact the cost of labor, influence the location decisions of individuals, and can change the quantity and quality of the labor pool in a given state.[22]

The Individual Income Tax Index is composed of two sub-indexes, one dealing with rate structure and the other with the tax base. The rate structure sub-index is assessed according to 4 areas—the states' top marginal tax rates, the starting point of the top rates, the number of brackets, and the average width of the brackets. States with no income taxes, or with a low, flat rate with few deductions and exemptions score best on this sub-index. The tax base sub-index is constructed according to how the tax code treats married couples, how far it goes to avoid double taxation, and whether the code is indexed for inflation.[23]

Pennsylvania was 12th on the Individual Income Tax Index in 2006, down from 11th in 2003 and 2004. It scored among the top 5 states with broad-based income taxes due to its single, low rate (one that is 10 percent higher than it was at the beginning of the Rendell Administration). In terms of rate structure, Pennsylvania was one of the 6 best states, scoring well for having a low top rate and a flat rate system, as well as for being just one of 4 states with only one bracket. Pennsylvania also has no personal exemption or standard deduction.[24]

On the income tax base sub-index, three equally weighted components—the "marriage penalty," double taxation of corporate income, and a number of other minor issues—determined state scores. Pennsylvania received positive marks for having no "marriage penalty" and for allowing married couples the option of filing separately. However, it scored poorly (as did 47 other states) for double-taxing interest, dividends and capital gains, and it was also one of just 7 states that were downgraded for adding complexity to their individual income tax systems by failing to conform to the federal definition of taxable income.[25]

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[21] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[22] *Ibid*.
[23] *Ibid.*
[24] *Ibid.*
[25] *Ibid.*

Pennsylvania did rate positively for being one of 38 states with no AMT for individuals, for recognizing S-corporations and limited liability companies (LLCs), and for indexing all aspects of its individual income tax system for inflation. As for deductibility of tax payments to other jurisdictions, Pennsylvania was rated positively for allowing deductions of taxes paid to foreign countries and to other states, but negatively for not allowing federal tax payments to be deducted.[26]

Sales and Gross Receipts Tax Index

The third component index of the Tax Foundation study dealt with state sales and gross receipts taxes. It was the second-most heavily weighted index among the 5 components examined, and it consisted of two equally-weighted indexes—one for the rate, and one for the base. The rate sub-index included the state-level and local rate, with states scoring well if they had no rate or a low combined state-local rate. The base sub-index rewarded states that tax all goods and services at the end user, thus reducing "tax pyramiding." The worst such state taxes were deemed to be gross receipts taxes with no exclusions.[27] Overall, Pennsylvania rated 19th in 2006, up from 24th in both 2003 and 2004—but it is difficult to tell how the state improved its ranking, given the following findings from the Tax Foundation study.

On the sales tax rate sub-index, Pennsylvania's rate was near the high end among states levying such a tax, but it is one of the states that does not allow localities to define the sales tax base. On the sales and gross receipts tax base index, Pennsylvania has business-to-business exemptions for every major category except office equipment, and has no gross receipts tax. However, Pennsylvania is less competitive when it comes to excise taxes, which, as the Tax Foundation study notes, are more problematic from a "tax pyramiding" standpoint. Pennsylvania imposes a gasoline tax, and its excise tax on diesel is the highest in the country. Pennsylvania has recently hiked its tobacco taxes on several occasions, but has one of the lowest beer taxes among the states.[28]

Unemployment Insurance Tax Index

The Unemployment Insurance Tax Index was the lowest-weighted among the five component indexes, at slightly less than 14 percent of the total, and it is composed of two equally weighted sub-indexes (rate structure and tax base). The rate structure index is based on a schedule ranging from a minimum rate to a maximum rate. The schedule for businesses differs according to "experience rating" and other base factors. The best systems, as judged by the Tax Foundation, have lower minimum and maximum rates, a wage base at the federal level, and simpler experience formulas and charging methods with no benefit add-ons.[29]

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[26] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[27] *Ibid.*
[28] *Ibid.*
[29] *Ibid.*

Pennsylvania ranked 16th on the Unemployment Insurance Tax Index in 2006, four spots lower than in 2004, and had one of the 5 worst maximum unemployment tax rates among the 50 states.

Wealth Tax Index

The Wealth Tax Index is the second-lowest weighted of the five component indexes, at 15.66 percent. It includes taxes imposed on the wealth of individuals and businesses, such as property, capital stock, inheritance, estate and gift taxes. The Wealth Tax Index consists of two equally-weighted sub-indexes, one devoted to their rates and one for their bases. The rate sub-index includes property taxes per capita, property tax collections as a percentage of state personal income, and capital stock tax rates and maximum payments. The base sub-index is composed of dummy variables showing whether or not each state levies a given wealth tax. (It is important to note that, especially in the case of Pennsylvania, where local property taxes are a contentious issue in many areas of the state, the Tax Foundation study does not attempt to collect data on property taxes for all local jurisdictions within a given state.)[30]

Pennsylvania posted it poorest performance on the five component indexes on the Wealth Tax Index, ranking 45th among the 50 states in 2006 (2 spots higher than in 2004). Its poor ranking is primarily due to the following factors:

- A high capital stock tax rate (despite the ongoing, twice-delayed—once under Gov. Mark Schweiker, and again under Gov. Rendell—phase-out of the state's capital stock and franchise tax (CSFT)) and the fact that Pennsylvania taxes both business income and capital.
- Pennsylvania is one of 33 states with a real estate transfer tax.
- Pennsylvania is one of 17 states that have decoupled from the federal system for estate taxes, which has increased tax complexity.
- Pennsylvania is one of just 10 states with an inheritance tax.[31]

Summary

The Tax Foundation's State Business Tax Climate Index, as currently designed, gives greater weight to two areas of Pennsylvania's business tax code that are relatively strong compared to the other 49 states (personal income and sales/gross receipts taxes), while its weakest points—its corporate and wealth taxes, which are consistently cited by business people as the most negative factors affecting the state's competitiveness—received relatively lower weight. The study's emphasis on the structure of state tax systems, as well as the tax burden for each state, also contributes to Pennsylvania's relatively high overall ranking.

[30] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.
[31] *Ibid.*

The preceding factors partially mask several of the reasons that continue to make Pennsylvania an uncompetitive location for business investment and employment growth. A closer look at the study reveals, however, that Pennsylvania's business tax system includes several glaring anomalies, and that Gov. Rendell's claims that his policies have contributed to improving the state's business tax climate are unfounded. In addition, an examination of the impact of local property and other taxes on a regional basis within Pennsylvania may reveal other factors that explain the state's lack of economic growth over the past several decades.

Pennsylvania's Business Tax Weaknesses: Opportunities for Reform

Given the information available about how Pennsylvania's business tax climate is perceived, the following sections of this analysis examine the features of the state's business tax system that have been regularly cited as uncompetitive, with special emphasis on areas that impose particularly onerous burdens on businesses in the state, but which have not received the attention that issues such as Pennsylvania's high CNIT rate and continued imposition of the CSFT have garnered. The issues examined are evaluated with an eye toward how they impact new business formation in Pennsylvania.

Net Operating Loss Carry-Forward

As discussed briefly in the previous section of this analysis, Pennsylvania businesses subject to the state's Corporate Net Income Tax (CNIT) are permitted to carry forward net losses for taxable years beginning on or after January 1, 1981. Losses carried forward to a tax year may be deducted from taxable income in that tax year to arrive at the firm's tax liability.[32] The ability to carry losses forward is important to businesses in that, as noted in the preceding section of this analysis, it "helps to ensure that, over time, corporate income taxes tax average profitability."[33]

Since the net operating loss (NOL) carryforward has been allowed in Pennsylvania, its structure, both in terms of how many years' losses can be carried forward and the amount of losses that can be carried forward has changed periodically. The schedule below shows, on a year-by-year basis, how many years' losses may be carried forward.

- 1981—losses can be carried forward 1 year.
- 1982—2 taxable years.
- 1983-1987—3 taxable years.
- 1988—2 taxable years, plus the 1995 taxable years.
- 1989—1 taxable year, plus the 1995 and 1996 taxable years.
- 1990-1993—1995 through 1997 taxable years.
- 1994—1995 taxable year.

[32] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.
[33] Curtis S. Dubay and Scott Hodge, "State Business Tax Climate Index: 2006 Edition," Tax Foundation *Background Paper*, February 2006, No. 51.

- 1995-1997—10 taxable years.
- 1998—20 taxable years.[34]

Between 1982 and 1990, net loss deductions were uncapped, but from 1991 to 1994, net loss deductions were suspended and no net loss deduction was allowed. The net loss deduction was reinstated in 1994, but it was no longer unlimited. For tax years 1995 through 1997, the net loss deduction was capped at $500,000, and 1995 legislation raised the cap to $1 million per year for tax years 1996 and thereafter.[35]

The 3-year net loss carryforward period was increased to 10 years in 1998, starting with losses realized in tax year 1995—meaning that 10 years of losses were first fully available to Pennsylvania businesses in 2005. Legislation passed in 1999 raised the NOL cap to $2 million in each of the 10 years following the loss, starting on January 1, 1999, and in 2002, the carryforward period was increased to 20 years, starting with losses realized in tax year 1998, making 2018 the first year in which 20 years of losses will be fully available.[36]

As noted in the preceding discussion of the Tax Foundation study, Pennsylvania is one of the least competitive states in the country in terms of its treatment of NOL deductibility. It is an anomaly in that it limits the amount of losses that can be carried forward, and this has led to very different tax liabilities for businesses with the same net profitability over a multi-year time period. This is so because of the difference between “cyclical” and “non-cyclical” businesses.

“Cyclical” businesses are defined as those businesses that may experience wide swings in profitability over a given time period, such as many traditional manufacturers (a still-sizable, but shrinking segment of Pennsylvania’s economy), as well as firms in “emerging” industries (including technology companies and many other start-up companies that are often unprofitable until they have been established for several years). Such firms are especially vulnerable to Pennsylvania’s restrictive treatment of NOL carryforwards, because it is then less attractive and more difficult for a business to invest in capital improvements and hire additional workers—or to start a business in Pennsylvania in the first place—if the amount of losses they can use to reduce future tax liabilities is limited.

Writing in June 2005 for the Pennsylvania Manufacturers Association *Bulletin*, John Surma, President and CEO of United States Steel Corp., presented an example illustrating the large difference in tax treatment that can result between Pennsylvania’s cyclical and non-cyclical businesses due to the cap on NOL carryforwards. He contrasted the performance of a cyclical company that lost $100 million in 2003 and earned $160 million in 2004 with a non-cyclical company that earned $30 million in both years—meaning that both companies had a two-year net profit of $60 million. However, under Pennsylvania’s corporate tax system as it existed at the time Surma wrote his article, the

[34] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.
[35] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.
[36] *Ibid.*

two-year tax burden faced by the cyclical company would have been nearly $10 million higher than that of the non-cyclical company.[37]

How could this occur? The cyclical company would pay no corporate income taxes in 2003, but would pay nearly $16 million in taxes in 2004 ($160 million profit less the $2 million NOL carryforward permitted at the time multiplied by the 9.99 percent Pennsylvania CNIT). For the 2003-2004 period, the cyclical company would have faced an effective tax rate of approximately 27 percent ($16 million CNIT liability divided by $60 million in net income). At the same time, however, the non-cyclical company's total tax liability would have been approximately $6 million, or slightly under $3 million per year ($30 million multiplied by 9.99 percent).[38]

Pennsylvania policymakers, recognizing the problems associated with the continued presence of the cap on NOL carryforwards, enacted legislation in July 2006 raising the annual cap from $2 million to $3 million (or 12.5 percent of tax liability, whichever is higher) for taxable years after December 31, 2006. Nevertheless, Pennsylvania remains at a disadvantage with virtually every one of its competitor states by having an NOL cap in the first place, as continuing to limit NOL carryforwards makes it more difficult for the state's struggling manufacturers—which continue to steadily shed jobs and facilities—to recover from difficult economic times. It also makes it less likely that new companies will form and grow in Pennsylvania, as it may take start-up firms years of future profits to make up for their initial losses (especially small businesses, which often operate on very thin profit margins even after becoming established).

Removing the cap on NOL carryforwards would likely be a much stronger "economic stimulus" than the billions of taxpayer dollars spent on Pennsylvania's economic development subsidy programs over the past several decades.

Single Sales Factor Apportionment of Corporate Income

For Pennsylvania purposes, corporations are taxed on a separate company basis, which means that corporations that file a consolidated federal return must start with the taxable income that would have been shown on separate federal returns to determine the Pennsylvania base. In effect, if a corporation does not do all of its business in Pennsylvania, its income base may be allocated and apportioned to determine Pennsylvania taxable income. Business income is therefore apportioned on the basis of property, payroll and sales factors within or without Pennsylvania.[39]

For tax years prior to 1999, the "sales factor" in Pennsylvania's corporate income apportionment formula was double-weighted, meaning that it comprised 50 percent of the taxable income base, while payroll and property comprised equal portions of the remaining 50 percent. Beginning with tax year 1999, the sales factor was raised to 60

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[37] John P. Surma, "Removing the Cap on Net Operating Loss Carryforward: An Opportunity to Improve Competitiveness," Pennsylvania Manufacturers Association *Bulletin*, June 15, 2005.
[38] *Ibid.*
[39] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.

percent, with payroll and property each accounting for 20 percent.[40] Legislation enacted in July 2006 raised the sales factor to 70 percent.[41] Under such a formula structure, the more heavily sales are weighted in apportioning corporate income, the more that Pennsylvania businesses with more payroll and property relative to sales in the state would see the apportionment formula lowered (as well as their Pennsylvania CNIT liability). One the other hand, the more heavily weighted property and payroll are in the formula, the more that Pennsylvania employers who expand in-state facilities and hiring are penalized with higher tax liabilities.

It is for this reason that a number of businesses and organizations have called for Pennsylvania to move to a Single Sales Factor (SSF) formula for determining Pennsylvania corporations' tax liability. Doing so would tax Pennsylvania companies on only what they sell in Pennsylvania, and also shifts the CNIT burden onto out-of-state companies that have little physical presence in Pennsylvania but do sell into the state. A SSF formula could therefore create an incentive for businesses (including multi-state businesses) to locate in Pennsylvania, as out-of-state sales would not be taxed, and in-state property and payroll would not be a consideration with regard to their CNIT liability. Finally, moving to a SSF approach would also encourage Pennsylvania businesses to actively seek out-of-state markets for their goods and services—a far superior way to promote exports by Pennsylvania companies than the state's current strategy, which relies heavily on state-run, taxpayer-funded export promotion programs.

A 2001 study from the Public Policy Institute of New York State, Inc. estimated the fiscal and economic impact to New York of switching to a SSF apportionment of corporate income. It examined the experiences of other states that modified their apportionment formulas over the preceding two decades and found that after controlling for other factors, increasing the weight of the sales factor had "significant positive effects" on in-state employment. Specifically, the study estimated that switching to SSF apportionment in New York would increase long-run manufacturing jobs by 3.5 percent (approximately 32,000 jobs), while employment in the non-manufacturing sector would increase by 1.3 percent (or about 101,000 jobs).[42]

All in all, these employment gains would be expected to result in long-term increases in New York personal income tax revenue of $184 million to $247 million annually. The study also argued that apportionment formulas have significant impacts on state employment, and that any resulting employment gains (and the related personal income tax revenues generated) can reduce or offset any losses in corporate income tax revenue.[43]

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[40] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.
[41] Pennsylvania Manufacturers Association, "Massive State Spending Hike Squeezes Business Tax Relief," July 17, 2006.
[42] Austan Goolsbee, "The Economic Impact of Single Sales Factor Apportionment for the State of New York," The Public Policy Institute of New York State, Inc., January 2001.
[43] *Ibid.*

Major manufacturing states have generally moved in the direction of SSF apportionment in order to encourage corporate expansions within their borders. Lowering the effective tax rates faced by Pennsylvania's corporate employers lowers their cost of doing business in the state and makes Pennsylvania more attractive as a destination for investment. It also helps to achieve the goal of simplifying Pennsylvania's corporate taxes, which would be a major step in overcoming the fact that, as noted in the Final Report of the Pennsylvania Business Tax Reform Commission, Pennsylvania is perceived as having "one of the most complex tax systems in the country."[44]

Research and Development Tax Credits

Pennsylvania's Research and Development (R&D) Tax Credit was created in 1997 with an initial cap of $15 million per fiscal year. In 2003, the credit was doubled to $30 million (effective December 2004), and July 2006 legislation increased the credit cap to $40 million. Twenty percent of the credits have been set aside for "small businesses"—defined as a "for-profit corporation, LLC, partnership or proprietorship with net book value of assets totaling…less than $5 million."[45]

R&D tax credit recipients can also sell unused tax credits to other taxpayers (this provision applies to credits awarded in December 2003 and forward). Credit recipients can apply to the Department of Community and Economic Development (DCED) to sell or assign an R&D credit if there has been no claim for allowance filed within one year from the date that DCED approved the credit. The purchaser or assignee must then use the credit during the year of purchase or assignment. Purchased or assigned tax credits cannot be used to offset more than 75 percent of a tax liability for a taxable year, and they also cannot be carried over, carried back, resold or refunded.[46]

The R&D tax credit can be claimed against the CSFT, CNIT or PIT, but those taxpayers claiming the credit were originally not allowed to reduce their tax liability for tax years 2004 and prior by more than 50 percent. This restriction was eliminated as of taxable year 2005, and the credit was therefore allowed to be used to eliminate up to 100 percent of a given tax liability. Unused credits can be carried over and used for up to 15 succeeding taxable years.[47]

The Pennsylvania R&D tax credit is calculated using the increase over the taxpayer's base year research expenses for qualified R&D conducted within Pennsylvania and generates a tentative credit at the rate of 10 percent.[48] Businesses wishing to apply for the credit must do so with DCED before September 15, and the credit is for "qualified" Pennsylvania R&D for the taxable year ending in the prior calendar year. DCED must notify taxpayers of their approved credit amount by December 15. DCED has also been

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[44] Pennsylvania Business Tax Reform Commission, "Final Report," November 30, 2004.
[45] Pennsylvania Department of Revenue, *Report to the Pennsylvania General Assembly on the Research and Development (R&D) Tax Credit*, March 15, 2006.
[46] *Ibid.*
[47] *Ibid.*
[48] The July 2006 legislation increasing the R&D tax credit cap from $30 million to $40 million also allowed small businesses to receive a credit equal to 20 percent of the qualified R&D expense.

required to report all taxpayers receiving the R&D credit annually to the General Assembly, beginning with 2004.[49]

Selling or Assigning Unused R&D Tax Credits

Act 46 of 2003 created the R&D Credit Assignment Program, which allows taxpayers with unused R&D credits to sell them for cash to other taxpayers who can use them. The goal of the program is to "assist in the growth and development of technology-oriented businesses, primarily small start-up technology businesses."[50] Many such businesses do not face significant tax liabilities in their early years of operation and can put the cash they receive from selling unused R&D credits to use. Unused credits, once purchased, can then be used to partially offset their tax liabilities, but they also must identify who they bought the credit from. R&D credits are considered unused and available for sale as long as they are not applied against a specific tax year liability and the taxpayer does not have a collectible tax liability. [51]

As of February 2006, about $34 million of the $60 million in R&D tax credits awarded in 2003 and 2004 was available for sale. Of the $30 million awarded in 2003, 8 taxpayers sold or assigned $663,502 in unused credits for $622,308, or 93.8 percent of their value, and of the $30 million awarded in 2004, 25 taxpayers sold or assigned $2.5 million in unused credits for $2.2 million, or 88 percent of their value. In 2005, 83 taxpayers filed for the R&D credit for the first time, representing the third-largest number of new filers since the inception of the program—possibly attributable to the increase in the credit cap and the ability to sell unused credits.[52]

Who Uses the R&D Credit?

For 2005, $66 million in R&D credits would have been awarded against qualified 2004 Pennsylvania R&D expenditures to 291 taxpayers if not for the $30 million cap. Approved credit amounts were pro-rationed to fit the cap. Approximately 75 percent of approved taxpayers received R&D credits of less than $50,000, representing just 8.9 percent of approved credits. The remaining 25 percent (73 applicants) received R&D credits of more than $50,000, and those credits were equal to approximately 91 percent of the total amount awarded.[53]

The number of applicants for the R&D tax credit has fluctuated since it was established. In 1997, 292 taxpayers applied, and while the number dropped to 270 in 1998, the number of applicants rose each year through 2001, when it reached a high of 293. After falling in 2002 and 2003, the number of applicants rose to 274 in 2004 and 291 in 2005. The credit amount tentatively awarded began at $66.371 million in 1997, fell to a low of

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[49] Pennsylvania Department of Revenue, *Report to the Pennsylvania General Assembly on the Research and Development (R&D) Tax Credit*, March 15, 2006.
[50] *Ibid.*
[51] *Ibid.*
[52] *Ibid.*
[53] *Ibid.*

$53.456 million in 1999, but then rose each year through 2002, in which year it peaked at $74.256 million. The tentative award amount dropped in 2003, rose slightly in 2004 to $70.983 million, before dropping to $65.806 million in 2005.[54]

55.7 percent of taxpayers receiving the R&D credit in 2005 were manufacturers, who received $18.788 million (62.6 percent of the actual credits awarded). 32 percent were service businesses, who received $10.112 million (33.7 percent of the actual credits awarded). Among the manufacturers, the largest share of tax credits went to pharmaceutical companies (24 companies received $10.4 million in credits), and computer-related firms accounted for the largest share of the credits awarded to service-sector businesses (26 companies received just over $900.000 in credits).[55]

Small businesses represented 37.1 percent of all applicants in 2005 (108 of the 291 total applicants) and received all of the $2.268 million in R&D credits they applied for—a total that represented 7.6 percent of the approved credits. This credit amount was less than 40 percent of the total small business set-aside, and this was not an atypical result. Only in 1999—at which time the set-aside cap was $3 million—did small businesses claim the entire amount of the R&D set-aside. Furthermore, 2005 was only the second year in which small businesses applied for as much as $2 million in credits.[56]

Non-small businesses accounted for the remaining 62.9 percent of 2005 R&D credit applicants (183 of 291). $63.538 million in credits were tentatively approved, but due to the $30 million cap, just $27.732 million in credits were awarded—43.6 percent of the requested amount, which was slightly above the 41.1 percent figure for 2004.[57]

Distribution of R&D Credits: 1997-2003

For the years 1997 to 2003, 78 percent of the $105 million in R&D credits awarded were applied to specific periods. Of the amount awarded and applied, 53 percent was applied against the CSFT, 44 percent was applied against the CNIT, and 3.7 percent was applied against the PIT. Some portions of the R&D credit—especially those awarded pre-2003—may never be used, but the 2003 change that allows taxpayers to claim credits against more than 50 percent of a tax liability, along with the 15-year carryover and the allowance for sale of unused credits, should minimize the amount of credits not utilized.[58]

Once the CSFT is completely phased out, the R&D credit cannot be used against it. S corporations and limited liability companies (LLCs) that are primarily subject to the CSFT, rather than the CNIT, can pass the credit along to shareholders who can claim it against the PIT.[59]

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[54] Pennsylvania Department of Revenue, *Report to the Pennsylvania General Assembly on the Research and Development (R&D) Tax Credit*, March 15, 2006.
[55] *Ibid.*
[56] *Ibid.*
[57] *Ibid.*
[58] *Ibid.*
[59] *Ibid.*

The Federal R&D Tax Credit

Beginning in 1981, the federal government has offered an R&D tax credit periodically over the past 25 years, but the credit has never been made permanent—it has been extended nine times, but was allowed to lapse on seven occasions and was set to expire on December 31, 2005. Unlike the Pennsylvania R&D credit, the federal credit was not capped. The goal of the program was to increase R&D spending, which would then stimulate economic growth by increasing productivity through the use of new technology.[60]

Economic theory holds that an R&D tax credit can alleviate instances of market failure that occur because firms may under-invest in R&D when they tend not to recoup all associated costs of R&D investment. Therefore, less R&D occurs than is economically optimal for the economy as a whole. R&D tax credits lower the cost of research to private firms and increase the return on investment, and more R&D is encouraged than if there were no credits available.[61]

Besides Pennsylvania, 38 other states have R&D tax credits, but some of those states, like New Jersey, follow the structure of the federal credit while not capping the amount of credit that can be awarded in a given year. In 2003, New Jersey had 252 returns filed claiming $45 million in credits.[62]

DCED Observations on Pennsylvania's R&D Tax Credit Program

Since many private sector R&D projects can be lengthy, encompassing as many as 10 to 15 years, it is difficult to quantify the impact of R&D credits until the time frame of credit programs reach a similar length. In the interim, DCED has made several observations about the program, which are recounted below.

- 909 different taxpayers have applied for the credit over its lifetime, and the number of qualifying taxpayers is expanding, despite year-to-year volatility in research expenditure amounts.
- Of the 291 taxpayers receiving credits in 2005, 117 were S corporations, LLCs or individuals, while 174 were C corporations. The former group received $1.9 million in credits, while the latter received $28.1 million.
- The 291 taxpayers receiving credits in 2005 had had taxable year 2004 Pennsylvania R&D expenditures of $3.008 billion—a 15 percent increase over the taxable year amount of $2.612 billion.
- Non-small businesses (183 in total) receiving R&D credits in 2005 increased their taxable year 2004 R&D expenditures by 14.4 percent over 2003, rising to $2.942 billion from $2.572 billion. 138 of those businesses increased R&D from 2003 to 2003, while 45 reduced it.

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[60] Pennsylvania Department of Revenue, *Report to the Pennsylvania General Assembly on the Research and Development (R&D) Tax Credit*, March 15, 2006.
[61] *Ibid.*
[62] *Ibid.*

- Small businesses (108 in total) receiving R&D credits in 2005 increased their taxable year 2004 R&D expenditures by 48.4 percent from 2003 ($39.6 million) to 2004 ($58.7 million). 90 of those businesses increased R&D spending from 2003 to 2004, while 18 reduced it.
- 83 taxpayers first claimed the R&D credit in 2005. Those taxpayers claimed $3 million in credit, with Pennsylvania R&D expenditures for taxable year 2004 of $174.8 million.
- 100 taxpayers that claimed the R&D credit in 2004 did not claim it in 2005. These taxpayers had 2003 Pennsylvania R&D expenditures of $505.2 million and claimed $4 million in credits in 2004.
- Of all 2005 Pennsylvania R&D credit claimants, 96 were incorporated after the R&D credit legislation was enacted in 1997. These companies were not all necessarily start-ups, as some could be newly formed subsidiaries of a parent incorporation. These taxpayers claimed about $6.8 million in credits in 2005 and had 2004 R&D expenditures of approximately $419.4 million.[63]

Summary

With regard to taxpayers receiving the R&D tax credit in 2005, small businesses had a larger increase in Pennsylvania research expenditures in taxable year 2004 than non-small businesses. However, small business R&D expenditures represented just 2 percent of the total for that year. The vast majority of Pennsylvania research expenditures were still made by non-small businesses.

The long-term tracking by DCED indicates that manufacturers have been the primary beneficiaries of the R&D credit. At its historical size, the credit is a very small percentage of Pennsylvania research expenditures, meaning that many other factors are likely to impact a firm's R&D spending decisions.

Finally, the experience has been that Pennsylvania small businesses have not been using all of the credits available to them, while there are not enough credits for all of the non-small businesses that want to use them (even after utilizing the unused portion of the small business set-aside). This may be, at least in part, a function of larger businesses having time, money and resources to apply for state programs—such as tax credits—that benefit them that smaller businesses do not. The same dynamic is at work with Pennsylvania's economic development subsidy programs. A better long-term strategy would be to emulate New Jersey's practice of keeping the amount of R&D tax credits available in a given year uncapped, thus allowing all businesses that could benefit from the credit an improved chance at receiving the full amount requested.

[63] Pennsylvania Department of Revenue, *Report to the Pennsylvania General Assembly on the Research and Development (R&D) Tax Credit*, March 15, 2006.

Taxes and Business Location Decisions

The perception of Pennsylvania's business tax climate by the state's business leaders—as well as the specific factors that those leaders see as hampering its efforts to compete with other states—provides valuable insight as to what the Commonwealth can do to attract and retain firms of all sizes. For policymakers, however, just as important as identifying areas for improving Pennsylvania's business tax climate is gaining an understanding of how the costs and benefits of taxes are perceived differently by businesses and individuals—and how that difference impacts firm location decisions.

In a little-reported section of its 2006 *State Business Tax Climate Index,* the Tax Foundation noted that in general, when considering the costs of benefits of tax policy, individuals tend to look for areas that have the level of taxes and public services that meet their preferences. This means that people with a high demand for public services—and by extension, the high levels of taxation required to pay for them—will choose communities that provide such amenities, while those who prefer a lower level of government services (and often, a lower tax burden) will locate in areas that meet those criteria. Businesses, however, can be and usually are more mobile than individuals, because they must earn a profit in order to remain operational. Since taxes reduce profitability, it therefore follows that firms will seek out lower-tax jurisdictions in order to maximize their opportunity to stay in business for the long term.[64]

This has not always been the prevailing view of the role that taxes play in business location decisions, and at present, a number of Pennsylvania policymakers still subscribe to the notion that taxes have little impact in this regard. But despite this continuing skepticism in some quarters, it is important to note that during the past 50 years, the economic research on this topic has evolved in the direction of those who argue that a state's business tax climate indeed has a great deal of influence on private sector economic growth.

During the period from the 1950s to the 1970s, the consensus among economists shifted from the idea that taxes have no impact on business location decisions, to an intuitive sense that taxes had some influence on such decisions (but without the sophisticated econometric analysis needed to test the hypothesis), and finally to initial evidence that taxes do influence business location decisions, but with a lower statistical significance than other factors (such as labor supply and agglomeration economies).[65]

By the early to mid-1980s—a time period which included the Reagan tax cuts of 1981 and the federal tax reform package of 1986—research on non-manufacturing sectors of the economy suggested that "Higher wages, utility prices, personal income tax rates, and an increase in the overall level of taxation discourage employment growth in several industries."[66] At the same time, other research seemed to indicate that "significant tax

[64] Curtis S. Dubay and Scott A. Hodge, "State Business Tax Climate Index," 2006 edition, Tax Foundation, February 2006, No. 51.
[65] *Ibid.*
[66] *Ibid.*

effects only emerged when models were carefully specified."[67] Nevertheless, as the decade of the 1980s came to an end, empirical research began to repeatedly demonstrate that taxes shape business decisions, as noted in the conclusions of the following studies referenced in the Tax Foundation report:

- *Helms (1985)* found that a state's ability to attract, retain and encourage business activity is significantly slowed by tax increases that are used to fund transfer payments (a policy that Pennsylvania, under the Rendell Administration, has embraced to a greater degree by increasing the state's welfare rolls and encouraging Pennsylvanians with higher and higher incomes to sign themselves and their children up for taxpayer-funded health care coverage).
- *Bartik (1986)* argued that the "conventional view" that state and local taxes have little effect on business is false.
- *Papke and Papke (1986)* found that "consistently high business taxes can represent a hindrance to the location of industry," and they also noted that "tax differences between locations may be an important location factor."[68]

Finally, for the period that encompasses the early 1990s through the present day, the Tax Foundation noted that additional academic research on taxes and business location decisions buttressed the conclusions reached during the 1980s. For instance, a 2001 study by Agostini and Tulayasathien examined the effects of corporate income taxes on foreign direct investment in U.S. states and found that such taxes are "the most relevant" tax influencing the investment decisions of foreign entities. Mark, McGuire and Papke (2000) found evidence that "taxes are a statistically significant factor in private sector job growth."[69] Harden and Hoyt (2003) contend that the corporate income tax has the "most significant negative effect on the annual growth of private employment," and Gupta and Hofmann (2003), using a regression model that incorporated 14 years of data, concluded that "firms tend to locate property in states where they are subject to lower income tax burdens."[70]

Local Property Taxes: A Less Obvious Burden for Pennsylvania Businesses

The conclusions of the bulk of the academic literature on the impact of various types of business taxes on business location decisions and economic growth mirror the attitudes expressed in recent years about state business taxes by Pennsylvania business owners and investors. However, still other research reports point to another, less publicized culprit that can significantly influence business formation and investment—property taxes.

As most Pennsylvanians know, property taxes have been a long-running source of contention in the Keystone State. State government does not levy property taxes in

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[67] *Ibid.*
[68] Curtis S. Dubay and Scott A. Hodge, "State Business Tax Climate Index," 2006 edition, Tax Foundation, February 2006, No. 51.
[69] *Ibid.*
[70] *Ibid.*

Pennsylvania, and the local property taxes that are imposed by counties, school districts and municipalities apply only to the appraised value of land and buildings owned by businesses and individuals.[71] County assessment offices establish market values for property and apply a pre-determined ratio of between 20 to 100 percent to calculate the assessed value of each property. Each taxing jurisdiction within a given county then applies a uniform millage rate against that assessed value.[72]

Due to differences in assessment practices among counties, millage rates are not comparable on a county-by-county basis, and the differences that do exist from county to county in how property taxes are assessed have led to much uncertainty and frustration among property owners in many regions of Pennsylvania.[73] Yet despite the widespread discontent with Pennsylvania's local property tax system as a whole, until now the debate has been largely centered on how to reduce the tax burden shouldered by residential property owners, with far less attention paid to that faced by businesses. The Tax Foundation's *2006 State Business Tax Climate Index* provides some insight as to why Pennsylvania policymakers would be well served to devote more attention to the impact of property taxes on businesses, as it noted that "Property taxes are a major concern to business because they constitute a considerable cost of doing business and significantly impact location decisions."[74]

One of the main arguments in favor of reducing or eliminating residential property taxes has been that such taxes often bear little relationship to a property owner's economic circumstances. While this is true, it is often forgotten that the same is true of businesses as well, as an increase in business property tax liability "is not always linked to a change in behavior" (such as increased earnings).[75] In other words, while a residential or business property owner may realize an increase in total wealth (in this case, the value of the property being taxed) over time, it does not necessarily follow that the "income stream" available to pay the taxes on that property will increase as well.[76]

This relationship may explain, in part, why Pennsylvania's economy has performed so poorly over the past several decades. The property tax, much in the same manner as the other wealth taxes that Pennsylvania levies on businesses, is particularly harmful to the types of firms that provide many of the new jobs and much of the dynamism in state economies—smaller and start-up businesses with low or non-existent profit margins. This is not to suggest that larger, more established Pennsylvania businesses are not harmed by wealth taxes such as the property tax, but merely that they are, relatively speaking, not as likely to be forced to re-locate or cease operations entirely as smaller, younger firms would be. In addition, the presence of such taxes means that many potential entrepreneurs may be discouraged from starting businesses in the first place.

[71] IssuesPA, "Taking a Closer Look at Government: Pennsylvania's Local Taxation 'System'," Pennsylvania Economy League, May 2006.
[72] *Ibid.*
[73] Curtis S. Dubay and Scott A. Hodge, "State Business Tax Climate Index," 2006 edition, Tax Foundation, February 2006, No. 51.
[74] *Ibid.*
[75] *Ibid.*
[76] *Ibid.*

The *State Business Tax Climate Index* notes that in 2004, businesses paid $447 billion in state and local taxes—$165 billion (or 37 percent) of which were property taxes (including real, personal and utility property). In addition, a March 2006 study by Ernst & Young (in conjunction with the Council on State Taxation) found that property taxes comprised the largest portion of state and local business taxes nationally in 2005, and that this was true of Pennsylvania as well (property taxes represented 31 percent of total state and local business taxes in that year). Several of the studies referenced by the Tax Foundation point to specific negative impacts that property taxes have on business location decisions:

- *Mark, McGuire and Papke (2000)* argued that "taxes which vary from one location to another within a region might be expected to be more important determinants of intraregional location decisions."[77] Their research also suggests that "states competing for business would be well-served to keep statewide property taxes low so as to be more attractive to business investment."[78] While property taxes in Pennsylvania are levied at the local, rather than the state level, this finding still has relevance to any analysis of the state's competitive position.
- *Bartik (1985)* found that property taxes are a "significant factor" in business location decisions and estimated that a 10 percent increase in business property taxes decreases the number of new plants opening in a state by between 1 and 2 percent.[79]
- *Bartik (1989)* reported "strong evidence" that taxes negatively impact business start-ups, especially property taxes. He argued that property taxes have the most negative impact on businesses because they must be paid regardless of profitability, and that since many small businesses are not profitable in their first few years of operation, property taxes are more important than profit-based taxes on the start-up decision. Bartik's econometric model also predicted that a 10 percent cut in tax rates will increase business activity by 1 to 5 percent (given tax elasticities of -.1 to -.5).[80]

All in all, the Tax Foundation study contends that given "the academic findings that property taxes are the most influential tax in terms of impacting location decisions by businesses, the evidence supports the conclusion that property taxes are a significant factor in a state's business tax climate."[81] Such findings should be of special concern to Pennsylvania policymakers, given that property taxes are a wealth tax—the very type of tax that Pennsylvania is weakest on at the state level, as evidenced by many of the concerns of state business leaders and by the state's poor ranking among its competitors on the *State Business Tax Climate Index.*

[77] Curtis S. Dubay and Scott A. Hodge, "State Business Tax Climate Index," 2006 edition, Tax Foundation, February 2006, No. 51.
[78] *Ibid.*
[79] *Ibid.*
[80] *Ibid.*
[81] *Ibid.*

Overview of Other Pennsylvania Local Business Taxes

While the property tax is a major component of the local tax burden faced by Pennsylvania businesses, other local taxes levied in some areas of the state can produce significant additional costs for businesses. Pennsylvania's non-real estate local taxes are authorized by a variety of sources, including the Public School Code, the codes governing various classes of counties and townships, the Borough Code, and special laws for Philadelphia, Pittsburgh and their school districts, and "general enabling legislation allows municipalities and school districts to tax subjects not prohibited or already taxed by the state."[82]

The following section of this analysis examines a number of the various local taxes affecting businesses that Pennsylvania counties, school districts and municipalities are permitted to impose, with a particular focus on local business taxes imposed in the state's 10 most populous counties (Philadelphia, Allegheny, Montgomery, Bucks, Delaware, Lancaster, Chester, York, Berks and Westmoreland). The data examined for this purpose are from the year 2004 (the latest available) as collected by the Pennsylvania Department of Community and Economic Development's Governor's Center for Local Government Services (for counties and municipalities) and the Pennsylvania Department of Education (for school districts). Data for 66 counties (Philadelphia is included with the municipal statistics) and approximately 95 percent of Pennsylvania municipalities are available.

Earned Income Tax (Local Wage Tax)

Pennsylvania school districts and municipalities are permitted to levy an earned income tax on wages, salaries, commissions, net profits and other compensation (excluding interest and dividends). The tax must be paid where levied by employed individuals, unincorporated businesses, partnerships and professional persons, and it usually applies only to residents of the jurisdictions levying the tax. The tax is capped at 1 percent in most cases (and the revenues generated are usually shared by the school district and its respective municipalities)[83], but there have been several exceptions to this limit, such as the cities of Philadelphia, Pittsburgh and Scranton, jurisdictions that have opted to eliminate the occupational assessment tax, some home rule charter municipalities, some municipalities with distressed pension systems, and school districts that operated under Act 50 or Act 24.[84]

As of 2004, only 134 Pennsylvania municipalities (5.3 percent of the statewide total of 2,518 municipalities reporting data for that year) did not report revenues from a local earned income tax, and just 36 of the state's 501 school districts (or 7.2 percent) did not report such revenues. Among the reporting municipalities in which no local earned

[82] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[83] IssuesPA, "Taking a Closer Look at Government: Pennsylvania's Local Taxation 'System'," Pennsylvania Economy League, May 2006.
[84] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.

income tax revenues were reported in 2004, 116 (or 86.6 percent) were located in 7 counties—the suburban Philadelphia counties of Bucks, Chester, Montgomery and Delaware (all of which are among the 10 most populous counties in Pennsylvania) and the northeastern counties of Pike, Susquehanna and Wayne. Just 2 of the 36 school districts reporting no earned income tax revenues in 2004 were located outside one of those seven counties.

As with the state personal income tax, a local earned income tax is burdensome to the many small businesses subject to it—not only in terms of its monetary impact, but also because of the administrative burdens that it imposes. Most states do not levy local income taxes, as Pennsylvania does, and this additional burden—especially in the cases of Philadelphia and to a lesser extent, Pittsburgh—is another competitive impediment for the state.

The Sterling Act and Philadelphia Local Taxes

The Sterling Act of 1932—described as "by far the most extensive grant of non-real estate taxing power to any political subdivision in Pennsylvania, and the earliest of this type"—authorized Philadelphia to "levy, assess and collect…such taxes on persons, transactions, occupations, privileges, subjects and personal property…as it shall determine."[85] The Act prohibited Philadelphia from taxing subjects pre-empted by state taxes or fees, but there are no other limits on what the city can tax, the rate at such taxes can be levied, or the amount of revenue those taxes can raise.[86] In 1939, Philadelphia used its authority under the Sterling Act to become the first municipality in the United States with a local earned income tax,[87] and this tax applies not only to residents, but to non-residents working in the city. While there is no statutory limit on Philadelphia's wage and net profits tax, its ability to tax commuters was limited in 1977.[88]

In 1963, a "little Sterling Act" was passed giving the Philadelphia School District the same taxing authority (except for the commuter tax) as the city. To date, Philadelphia has used its authority under the Sterling Act to enact taxes on "wages, earnings and net profits, admissions to amusements, real estate transfers, parking lot receipts, mechanical devices, bowling alleys and sound reproduction."[89] This vast array of local taxes has, over time, severely eroded both Philadelphia's economic position and reputation as a potential business location.

Despite efforts to improve Philadelphia's competitiveness that, over the past decade, have included business and other tax cuts estimated at more than $1 billion, it still has, according to the 2006 Kosmont-Rose Institute Cost of Doing Business Survey, the highest combined state and local business tax and fee burden in the United States.[90] At

[85] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[86] *Ibid.*
[87] *Ibid.*
[88] *Ibid.*
[89] *Ibid.*
[90] Larry Eichel, "Taxed to the Max," Philadelphia *Inquirer*, April 23, 2006.

the same time, suburban residents who work in Philadelphia "face the highest overall tax burden for commuters in the country" due to the city's non-resident wage tax.[91] All told, Philadelphia has experienced a net loss of more than 16,000 jobs since 1995, and it continues to lag the state and the nation in terms of economic growth.

Business Gross Receipts Taxes

One of the main reasons for Philadelphia's uncompetitive business tax climate is that it is one of the only large cities in the United States, along with Los Angeles, Memphis and Pittsburgh, that taxes business gross receipts. In Pennsylvania, local governments are allowed to impose a business gross receipts tax (alternatively known as a mercantile tax or a business privilege tax). This tax must be paid regardless of whether or not the business in question earns a profit (and while not a tax on wealth or assets, acts in a manner similar to that of the Capital Stock and Franchise Tax and the local property tax).

Mercantile taxes were generally levied first because they were "defined somewhat by the rate limits imposed on wholesale dealers, retail dealers and restaurants" under the Local Tax Enabling Act, and they "are generally understood as limited to those classes of businesses."[92] Business privilege taxes, as the name suggests, are levied on the privilege of doing business in a given jurisdiction and take two forms—one that applies to all businesses except those subject to a mercantile tax, and another that covers all businesses in jurisdictions that are not subject to a mercantile tax.

This pattern of establishing separate mercantile and business privilege taxes was established by Pittsburgh, as it first levied a mercantile tax and then enacted a business privilege tax.[93] In 2005, Pittsburgh's business gross receipts tax structure was significantly changed as a result of state legislation, as the city's mercantile tax was eliminated, the business privilege tax was reduced from 6 to 2 mills as the first step in a process that will see it eliminated by 2010, and a "payroll preparation tax" was levied on all for-profit employees in the city.[94]

Business gross receipts taxes are imposed on the actual gross receipts of a person engaged in business (excluding political subdivisions, employment for a wage or salary and businesses where the power to tax is withheld by law). All businesses, trades and professions in which a service is offered to the public must pay this tax, with two broad exemptions: for those businesses qualifying for the manufacturing exclusion, and for those subject to pre-empting state taxes or license fees (except in Philadelphia, the law governing which contains no such pre-emption clause).[95]

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[91] *Ibid*.
[92] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[93] *Ibid.*
[94] Eric Montarti and Jake Haulk, "Revenues from Pittsburgh's New Tax Structure," Allegheny Institute for Public Policy, *Policy Brief*, May 15, 2006, Vol. 6 No. 24.
[95] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.

Business gross receipts taxes are authorized under the Local Tax Enabling Act, subject to a limit of 1 mill on wholesale vendors and 1½ mills on retail dealers and restaurants. Gross receipts taxes on wholesale and retail businesses and restaurants must be shared by municipalities and school districts when levied under the Local Tax Enabling Act, but such taxes on other types of businesses (such as services) are not limited by the Act and do not have to be shared.[96]

The Public School Code authorizes the Pittsburgh School District to levy a mercantile tax that also includes amusement and recreation businesses and is limited to one-half mill on wholesale business and 1 mill on retail business, as well as a gross receipts tax under the Local Tax Enabling Act.[97] Philadelphia levies its business gross receipts tax, at 0.19 percent, on all business within the city (based on gross receipts and net income), under the authority of the First Class City Business Tax Reform Act, and it also taxes net profits at 6.5 percent.[98] Pennsylvania jurisdictions that did not levy this tax as of November 30, 1988 can not levy it in the future, and those that were levying it as of that date cannot raise the tax rate above that levied at that time.[99] In addition, second, second class A, and third class cities can levy business license taxes on a flat rate basis, with no limit for second and second class A cities and a $100 limit for third class cities.[100]

Of Pennsylvania's 2,518 municipalities reporting data to DCED in 2004, 272 (or 10.8 percent) reported revenues from business gross receipts taxes in 2004. Just over half of those municipalities—137 of 272—were in the 10 most populous Pennsylvania counties, with 53 of those 137 (38.7 percent) in Allegheny County, and Lancaster the only one of the 10 counties without a municipality levying a business privilege tax in 2004. Complete data on school districts levying gross receipts taxes for 2004 are not available.

Real Estate Transfer Taxes

Real estate transfer taxes can be imposed by municipalities and school districts on the selling price of real property (which can include transactions undertaken by businesses), with the tax being paid by the purchaser at the time of transfer. The real estate tax is jointly authorized by the Local Tax Enabling Act and the Tax Reform Code, to be levied at a maximum rate of 1 percent (with some exceptions). If the real estate transfer tax is levied jointly by a school district and a municipality, they must share it.[101] The state also imposes a 1 percent real estate transfer tax, which was enacted as a temporary tax in 1951 and made permanent in 1961.[102]

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[96] *Ibid.*
[97] *Ibid.*
[98] Larry Eichel, "Taxed to the Max," Philadelphia *Inquirer*, April 23, 2006; Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[99] Ernst & Young LLP et al., "Pennsylvania 21st Century Tax Project," December 2003.
[100] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[101] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[102] *The Tax Compendium*, Pennsylvania Department of Revenue, March 2004.

Of the 2,518 Pennsylvania's municipalities reporting revenue data to DCED for 2004, 120 (or 4.8 percent) did not report revenues from a real estate transfer tax in that year. Of those 120, just 8 (or 6.7 percent) were in the 10 most populous Pennsylvania counties. Similarly, only 12 of the 501 Pennsylvania school districts (2.4 percent) did not report revenues from a real estate transfer tax for 2004, with just 2 of the 12 in the 10 most populous Pennsylvania counties (one in Lancaster County, one in Montgomery County).

Mechanical Devices Taxes

Mechanical devices taxes are amusement taxes on the gross receipts of coin-operated mechanical devices, such as "jukeboxes, pinball machines, video games and coin operated pool tables."[103] This tax is authorized by the Local Tax Enabling Act, can be levied by municipalities and school districts, and must be shared by the two jurisdictions. The tax cannot exceed the sum of 10 percent of the individual price to operate a given machine.[104] Among the 2,518 Pennsylvania municipalities that reported financial data to DCED in 2004, 373 (or 14.8 percent) reported revenues from the mechanical devices tax. Of those 373 municipalities, 169 (or 45.3 percent) were in one of the 10 most populous counties, with 87 (or 51.5 percent) of those municipalities located in Allegheny County. There were no data on mechanical devices taxes by school district available for 2004.

Conclusion

As surveys of business people both inside and outside Pennsylvania confirm, the state's business tax climate continues to be perceived as uncompetitive and unfair. Despite claims by some Pennsylvania political leaders that recently enacted incremental reforms have significantly improved the situation, the rates and/or structure of a number of Pennsylvania's state business taxes—particularly its Corporate Net Income and Capital Stock and Franchise taxes—remain deterrents to business investment and expansion. Furthermore, the academic literature on the impact of business taxes on investment and location decisions leads one to infer that Pennsylvania is weak on the types of taxes—particularly wealth taxes—that most heavily impact the creation and survival of newer and smaller businesses.

There are solutions available to Pennsylvania policymakers interested in reforms that will truly improve the state's competitiveness. They should act to reduce the state's Corporate Net Income tax rate (currently the 4th-highest effective rate among states with such a tax), remove the cap on net operating loss "carryforwards," and moving to a single-sales factor apportionment of corporate income. Doing so would help to encourage new investment in Pennsylvania, ensure more similar tax treatment for "cyclical" and "non-cyclical" businesses, and provide incentives for Pennsylvania businesses to seek out-of-state markets for their products and services. At the same time, the scheduled phase-out of the

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[103] Pennsylvania Department of Community and Economic Development, Governor's Center for Local Government Services, "Taxation Manual," Eighth Edition, October 2002.
[104] *Ibid.*

Capital Stock and Franchise tax should be accelerated, so that Pennsylvania can shed its distinction as one of the only states that taxes both corporate income and assets as quickly as possible, and the state's research and development tax credit should be uncapped.

On the local component of Pennsylvania business taxes, it is critical that future discussions of local property tax reform and reduction focus on business, as well as residential, property taxes. Local property taxes are particularly harmful to many smaller and less-established businesses that may not have the type of income stream needed to absorb them. In addition, several areas of Pennsylvania—especially Philadelphia and to a somewhat lesser extent, Pittsburgh—have national reputations as high-cost business locations, and local taxes are a major factor in the creation of those reputations.

Pennsylvania's past and current economic development strategy of maintaining high tax rates on business and redistributing billions of taxpayer dollars to politically chosen firms and industries via subsidy programs has failed to generate growth comparable to many of its competitor states. It is time for a new approach that recognizes the importance of a competitive state and local business tax climate to long-term economic prosperity, and works aggressively to make the changes necessary to bring this about.