



March 8, 2012

Policy Brief: Volume 12, Number 14

Pennsylvania Hits Bottom in New Business Tax Ranking

Every year the Washington DC based Tax Foundation releases its *State Business Tax Climate* ranking report. For the past several years Pennsylvania has done reasonably well according to the Foundation ranking among the top half of all states. These favorable rankings have been a source of consternation inasmuch as they are inconsistent with the widely held view among Pennsylvania businesses that the tax burden on business is an impediment to growth and expansion. Back in 2006, an Institute report ([06-03](#)) called attention to problems with the rankings and in 2009 we noted in an [Issue Summary](#) our misgivings about the Tax Foundation ranking scheme.

In early 2012 the Tax Foundation released its annual update of the *Tax Climate* index, in which Pennsylvania ranked 19th best among the 50 states. Recently, the Foundation also released a new publication called *Location Matters: A Comparative Analysis of State Tax Costs on Business*. The latter publication provides a far superior ranking scheme for the tax burdens actually faced by businesses across the 50 states. As the Foundation says, the tax rankings are based on apples-to-apples comparisons. According to this new ranking Pennsylvania comes in at 50th. Quite a difference and certainly more compatible with views expressed in surveys of Commonwealth businesses.

In the traditional *Tax Climate* rankings, Pennsylvania fared well because the construction of the ranking index used a weighting methodology that failed to capture real world experience. The index looks at five different taxes that are deemed important to business decision making. These taxes, with their assigned weights, are as follows: individual income tax (33.1 percent); sales tax (21.4 percent); the corporate income tax (20.3 percent); property tax (14.1 percent); and the unemployment insurance tax (11.1 percent). The weights are based on the variability of the 50 states' tax rates calculated as deviations from the mean with heavier weights assigned to taxes with greater variability.

The *Climate* rankings methodology places higher weight on Pennsylvania's lower and flatter taxes while giving lower weight to its higher taxes. This combination of circumstances causes Pennsylvania to rank reasonably well among states according to the Tax Foundation's traditional weighting system. Further, the Tax Foundation rewards Pennsylvania for having flat, single rate taxes (personal income and corporate income) that are "simple and neutral". When all of these factors are taken into account, the resulting Pennsylvania tax ranking is not a useful measure of the state's true business tax climate.

And of course the problem with the *Tax Climate* index is that it is based on this variability from the mean instead of looking at the actual tax burden faced by businesses. The *Location Matters* paper provides a better analysis of the actual tax burden faced by businesses.

In the *Location Matters* analysis, the Tax Foundation attempts to look at what hypothetical businesses would pay in taxes in each state. The taxes studied are corporate income taxes, property taxes, sales taxes, unemployment insurance taxes, capital stock taxes, inventory taxes, and gross receipt taxes. Instead of constructing a weighted average, the index uses the national average burden for each tax as a benchmark (100) and looks at how far a state's burden is from that average for each tax to come up with the score. For example, Pennsylvania's overall score is 145.1 (50th). This implies that the effective business tax rate in Pennsylvania is 45.1 percent greater than the national average.

The Tax Foundation then constructed seven hypothetical business operations (new and mature) in the following categories: corporate headquarters, R&D facility, retail, call center, distribution center, capital-intensive manufacturing, and labor-intensive manufacturing. They chose two locations in each state to measure the tax burden for these firms, one major urban and one mid-sized city, in all states except Rhode Island. For Pennsylvania they chose Philadelphia as the major urban and the Reading area as the mid-sized city. Since both cities are in the Southeastern part of the state, it might have been better to have chosen a mid-sized city in the western half such as Erie—or perhaps Pittsburgh rather than Philadelphia as the large city.

This new approach by the Tax Foundation is far more appropriate, looking at comparative tax burdens using the U.S. average as the benchmark instead of weighting tax rates by variability of rates across the country. Pennsylvania does not fare well. In addition to ranking last in the overall rankings for mature businesses, the Commonwealth finished last with the following firm types: corporate headquarters (both new and mature), R&D facility (both), and retail store (mature). The Commonwealth was ranked 48th for a call center (mature) and 49th for a distribution center (mature). The only areas in which Pennsylvania scored well occurred in capital-intensive manufacturing (9th for new and 5th for mature) and labor-intensive manufacturing (26th for new and 15th for mature).

As mentioned above, the Commonwealth's overall score for mature firms came in at 145.1 (50th) and for newly established firms 145.9 (49th, ahead of only Hawaii). The Tax Foundation claims that the *Location Matters* study is a true “apples-to-apples” comparison of state tax burdens facing firms. While there may still be flaws, such as not picking a city from the western part of the state, the new rankings are a vast improvement over the *Business Tax Climate* study and the weighting system of that study. It puts Pennsylvania's business tax burden in the proper focus and reminds legislators that plenty of work needs to be done to make the Commonwealth more competitive for businesses.

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