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Making Pennsylvania's Business Tax Climate Competitive

Recent surveys of business people, both inside and outside Pennsylvania, confirm that the state's business tax climate continues to be perceived as uncompetitive and unfair. In particular, the rates and/or structure of a number of Pennsylvania's state business taxes—most prominently its Corporate Net Income (CNIT) and Capital Stock and Franchise (CSFT) taxes—continue to be cited as major 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 especially weak on the types of taxes that most heavily impact the creation and survival of newer and smaller businesses.

Nevertheless, the Governor 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 Tax Foundation 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.

Fortunately, there are a number of business tax reform options available to Pennsylvania policymakers truly interested in improving the state's competitiveness. They should begin by acting to reduce the state's CNIT rate (currently the 4th-highest effective rate among states with such a tax) and at the same time accelerate the scheduled phase-out of the CSFT. Doing so would allow Pennsylvania to quickly shed its distinction as one of the only states that taxes both corporate income and assets.

At the same time, there are a number of other facets of Pennsylvania's business tax system that have been regularly cited as uncompetitive. These business tax policy areas have not received the attention that issues such as Pennsylvania's high CNIT rate and continued imposition of the CSFT have garnered, but they represent particularly onerous burdens on Pennsylvania businesses. To remedy these flaws, Pennsylvania policymakers should pursue the following reforms:

- *Remove the cap on net operating loss (NOL) carryforwards***.** Legislation enacted in July 2006 raised the annual cap on the amount of net operating losses that Pennsylvania businesses subject to the CNIT can carry forward 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 nationally by having an NOL cap in the first place. 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.

- *Institute a single sales factor (SSF) apportionment formula for corporate income.* Major manufacturing states have generally moved in the direction of SSF apportionment of corporate income in order to encourage corporate expansions within their borders. Pennsylvania's current apportionment formula, which has a sales factor of 70 percent, penalizes companies that expand in-state facilities and hiring. Lowering the effective tax rates faced by Pennsylvania's corporate employers—by taxing them only on what they sell in Pennsylvania—lowers their cost of doing business in the state and makes it more attractive as a destination for investment.

- *Uncap the state's Research & Development (R&D) Tax Credit.* Pennsylvania's 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.

Finally, with regard to 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 a burden to businesses of all sizes, but are particularly harmful to many smaller and less-established businesses, which often operate on thin to non-existent profit margins. 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 that of 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.

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