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Testimony on Pennsylvania's Tax Climate before the Pennsylvania Senate Finance and Senate State Government Committees

August 20, 2015

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TESTIMONY AS PREPARED

Chairman Eichelberger, Chairman Folmer, and members of the Senate Finance and Senate State Government Committees, thank you for the opportunity to testify before you today regarding Pennsylvania's tax climate. My name is Jared Walczak and I'm a policy analyst with the Tax Foundation, a nonpartisan tax policy organization based in Washington, D.C. I'm also a native of the Commonwealth of Pennsylvania, having grown up and attended college here, so it's a privilege to be here today.

I spent the summer of 2007 in Harrisburg, and often spent the evenings wandering these halls, hanging out with the press gaggle and catching the press conferences and fevered activity during that year's overtime budget negotiations. So I feel right at home here today.

Three Ways of Evaluating State Tax Systems

At the Tax Foundation, we maintain three major studies looking at taxes in the fifty states: the *State Business Tax Climate Index*, our *State and Local Tax Burdens* report, and *Location Matters*. Each helps to quantify different aspects of state tax systems and, we hope, provide a blueprint for positive tax reform.

Each study represents a different way of looking at state taxes. The *Index* measures tax structure; it takes rates into account, but more than that, it reviews the neutrality, transparency, simplicity, and stability of each state's tax structure across more than one hundred variables. The *Index* is probably our best known publication, and is responsible for the rankings you often hear cited in the media—that a state's business climate ranks as such, or that it does this well (or poorly) for, say, the property tax component. We provide an overall ranking as well as rankings on five sub-indices: corporate, individual, sales, unemployment insurance, and property taxes.

But while we hope these rankings can help drive an important conversation about tax reform, they are the beginning, not the end, of the conversation the *Index* is intended to facilitate, because the *Index* enables state by state comparisons across a wide range of factors: whether a state imposes a franchise tax, or employs a throwback rule, or implements loan and interest repayment UI taxes, caps carryforwards, indexes brackets for inflation, and so on and so forth. And that, I think, is the real value of the *Index* for policymakers: it's a roadmap. It contributes to the tax reform discussion by allowing legislators to see how their state's tax structure compares to other states across a large range of variables. I'll return to how Pennsylvania does momentarily.

We also have our *Burdens* study, which looks at the total tax costs incurred by a state's residents, paid both in and out-of-state. Determining how much, in aggregate or on average, residents pay to their own state is a rather simple matter, answered by spending a couple of minutes with Census data or state revenue reports. This, however, is only part of the picture from a taxpayer's perspective, as differences in state economies and state tax structures can lead to significant differences in liability across state lines. *Burdens* seeks to fill that gap.

Finally, we have *Location Matters*, which we just released in its second edition on Tuesday. *Location Matters* is unique in the field: it's the only study out there that helps answer the bottom-line question asked by business executives: "How much will my company pay in taxes?" It is also intended to serve as a tool for policymakers, helping to illustrate the effects of a given tax structure on a range of firm types. The study takes seven model firms, largely representing those most sought after by state economic development agencies, and then runs their taxes in all fifty states, first as mature firms—thus ineligible for most incentives—and then again as new firms, able to take advantage of a range of tax incentives.

This allows us to see how not only tax rates, but also apportionment formulas, sourcing rules, throwback rules, and other structural aspects of the tax code impact effective tax rates for different types of firms, and also to get a better idea of *which* taxes are most significant for businesses, and how neutral—or more often, non-neutral—the tax system is across firm types.

State Business Tax Climate Index

Pennsylvania ranks 34th overall on the 2015 *State Business Tax Climate Index*. Most of the states bordering Pennsylvania do poorly on tax structure, so Pennsylvania does not stand out adversely in the region, but there's clearly significant room for improvement. On the sub-indices, Pennsylvania ranks 46th for corporate taxes, 17th for individual income taxes, 24th for sales taxes, 50th for unemployment insurance taxes, and 42nd for property taxes.

As I testified before the Senate Finance Committee back in May, Pennsylvania's tax climate is at best uneven, combining a relatively modest individual income tax burden and middle-of-the-road sales tax with high corporate and property tax burdens.

Pennsylvania's tax competitiveness, however, is as much a matter of structure as it is of rates.

Let's start with corporate taxes. At 9.99 percent, Pennsylvania's corporate net income tax is the second-highest state corporate income tax in the nation, and naturally it's a significant factor in the Commonwealth's ranking on the corporate tax component of our *Index*. Businesses are also hit with an antiquated franchise tax which has been phasing out, in fits and starts, for years. The result is a relatively uncompetitive corporate tax environment that limits the Commonwealth's ability to attract and grow businesses and foster job creation.

Pennsylvania has a fairly modest individual income tax burden, with a low 3.07 percent rate. I would note, though, that federal income is not used as the starting point for the state's income tax base, meaning that, while the rate is low, it is applied to more income than would be the case in many states.

The Commonwealth is middle-of-the-road both in terms of sales terms rate and structure. This legislative session has seen significant discussion about broadening the sales tax base, either to pay down rate reductions—to the sales tax or other taxes—or raise revenues, or both. I know there has also been a lot of discussion about if, and how, business inputs would be exempted should the base be broadened to a range of services, something we strongly encourage. For now, though, Pennsylvania is typical in taxing most goods and very few services. The state's gasoline and cigarette excise taxes are higher than average.

And then there's property taxes. Collections are right at the median point nationwide, but the distribution is skewed by an inheritance tax and the aforementioned capital stock tax. Millages are of course assessed by counties, municipalities, and school boards, and in many counties, decades have passed between reassessments. The state also imposes a real estate transfer tax. To the Commonwealth's great credit, however, Pennsylvania eliminated taxation of tangible personal property.

The state's unemployment insurance taxes are among the highest in the country, and on our *Index*, which also takes structure into account, we rank the state's UI taxes the worst in the nation.

State and Local Tax Burdens

Pennsylvania ranks 10th for overall state and local tax burden, with Pennsylvania residents making tax payments of $3,224 per capita to Pennsylvania and $1,150 to other states, for a per capita state and local tax burden of $4,374, or 10.3 percent of state income.

Location Matters

Finally, I'd like to take a few minutes to review the Pennsylvania findings of our just-released *Location Matters* study. As noted previously, we take seven model firms—a corporate headquarters, a research and development facility, a large retail store, a call center, a distribution center, and both a capital-intensive and a labor-intensive manufacturer—and, partnering with the international accounting firm KPMG, we run their taxes in all fifty states, first as a mature corporation, and then again as a new company eligible for more tax incentives.

Three of the firms—the corporate headquarters, R&D facility, and retail store—are located in a large city in each state, in this case Philadelphia. The other four firms are located in or around a smaller city, in this case Reading. In running the firms' taxes, we look at everything. So, for instance, Pennsylvania benefits from not imposing property taxes on inventory or equipment, but is disadvantaged by local income and gross receipts taxes. Our calculations yield an effective state and local tax rate on a company's net income.

Location Matters helps to explain why some firms experience moderate tax burdens in a state with a 9.99 percent corporate income tax, while others struggle. Due to the state's single sales factor apportionment, benefits sourcing, and the lack of a throwback rule, four of the seven mature firms in our study actually experience fairly low corporate income tax burdens.

Corporate headquarters, however, are not among those benefitting from these rules. Both the new and mature corporate headquarters experience the highest income tax burden for firms of their type in the nation, due to the state's high 9.99 percent tax on all corporate income. The effective tax rate on mature corporate headquarters is nearly 48 percent above the median.

The mature capital-intensive manufacturing operation, by contrast, ranks 4th in the nation with an effective rate of 4.2 percent due to the state's single sales factor apportionment and the lack of a throwback rule. Labor-intensive manufacturing facilities also experience significantly below-average tax costs.

High tax rates for the distribution center and call center are substantially driven by high property tax burdens, the second highest in the country for their firm types in both cases at 85 and 79 percent above the national average respectively. An incredibly high 56.8 percent effective rate on new distribution centers is 83.1 percent above the median. And although the state does offer research and development (R&D) incentives, they do little to offset the state's high tax burdens, and both the new and mature firms experience above-average taxes overall.

The distribution center, retail store, and corporate headquarters, in their mature iterations, rank 46th, 48th, and 49th overall. Only the two manufacturing firms in our study experience below-average tax burdens in Pennsylvania.

All of this speaks to the issue of tax neutrality as well as above-average tax incidence. Distribution centers are exposed to an effective tax rate about ten times that experienced by capital-intensive manufacturers and more than three times that of R&D facilities. And whereas the corporate net income tax alone exposes mature corporate headquarters and retail operations to an effective tax rate of about 15 percent—the majority of the overall burden on those firms—it only imposes a negligible burden on manufacturers, call centers, and distribution centers.

Some of this is due to different firm profiles: a call center is very labor-intensive, with much of its expenditures tied up in employee compensation, and thus unemployment insurance taxes play an unusually large role. Similarly, distribution centers are property-heavy, and thus property taxes outstrip everything else. Other times, some of the variance can be chalked up to tax incentives that may be available to some firms but not others. Either way, though, the end result is that some types of businesses experience much heavier tax burdens than others.

Conclusion

This year, you and your colleagues have grappled with the possibility of significant changes to the tax structure: reducing property tax burdens, broadening the sales tax base, cutting corporate income taxes, levying a severance tax, and eliminating the franchise tax, just to name some of the more notable. With Pennsylvania ranking 34th on our *State Business Tax Climate Index*, with state taxpayers experiencing the 10th highest overall tax burdens in the nation, and with frequently sought-after firms subject to high—and highly disparate—tax burdens, the time is ripe for reforms both large and small.

My colleagues and I at the Tax Foundation would be more than happy to work with these committees, and with any interested legislators, to identify possible avenues for tax reform, or to provide research and analysis as these discussions continue. Pennsylvania faces challenges but also an opportunity—the opportunity to reform the state's tax structure with an eye to the principle that, as best as possible, taxes should be simple, transparent, neutral, and stable, with broad bases and low rates.

Chart 1: State Business Tax Climate Index Ranks and Component Tax Ranks

	Overall Rank	Corporate Tax Rank	Individual Income Tax Rank	Sales Tax Rank	Unemployment Insurance Tax Rank	Property Tax Rank
Alabama	28	27	23	41	25	10
Alaska	4	30	1	5	24	32
Arizona	23	24	19	49	4	6
Arkansas	39	40	28	44	39	19
California	48	34	50	42	14	14
Colorado	20	12	16	43	35	22
Connecticut	42	32	34	31	20	49
Delaware	14	50	33	1	2	13
Florida	5	14	1	12	3	16
Georgia	36	8	42	17	36	30
Hawaii	30	9	37	15	28	12
Idaho	19	21	24	22	46	3
Illinois	31	47	11	34	38	44
Indiana	8	22	10	10	7	5
Iowa	41	49	32	23	33	38
Kansas	22	38	18	30	9	28
Kentucky	26	29	30	11	45	17
Louisiana	35	23	27	50	6	24
Maine	33	45	22	9	42	40
Maryland	40	16	45	8	21	41
Massachusetts	24	37	13	21	48	45
Michigan	13	10	14	7	47	27
Minnesota	47	44	46	37	29	34
Mississippi	18	11	21	28	8	33
Missouri	17	4	29	29	12	7
Montana	6	18	20	3	18	8
Nebraska	29	31	25	27	13	39
Nevada	3	1	1	39	43	9
New Hampshire	7	48	9	2	44	43
New Jersey	50	41	48	48	32	50
New Mexico	38	35	35	45	10	1
New York	49	20	49	40	31	46
North Carolina	16	25	15	33	11	29
North Dakota	25	19	36	20	16	2
Ohio	44	26	47	32	5	20
Oklahoma	32	7	40	38	1	11
Oregon	12	36	31	4	30	15
Pennsylvania	34	46	17	24	50	42
Rhode Island	45	43	38	26	49	47
South Carolina	37	13	41	18	40	21
South Dakota	2	1	1	35	41	18
Tennessee	15	15	8	47	26	37
Texas	10	39	6	36	15	36
Utah	9	5	12	19	22	4
Vermont	46	42	44	16	17	48
Virginia	27	6	39	6	37	26
Washington	11	28	6	46	19	23
West Virginia	21	17	26	25	23	25
Wisconsin	43	33	43	14	27	31
Wyoming	1	1	1	13	34	35
District of Columbia	45	38	35	42	27	44

Chart 2: Location Matters Effective Tax Rates