

CAPITAL PERSPECTIVE

CAPITAL DIVISION ● Pennsylvania Economy League, Inc. ● (717) 234-3151

A REPORT TO LEAGUE MEMBERS ON SIGNIFICANT STATE GOVERNMENT DEVELOPMENTS

April 1998

Local Tax Reform - Implications for Economic Development And Job Creation

Introduction

Local tax reform or restructuring is a “hot topic” in Harrisburg. As a service to the debate and the public, the Pennsylvania Economy League has issued a series of *Capital Perspectives* starting with “Local Tax Restructuring: Where Are We Headed?” followed by “Local Tax Reform: What Other States Can Tell Us” continuing with “Local Tax Restructuring: Technical, Procedural, and Related Policy Issues.” This *Capital Perspective* provides insight on the implications that proposed local tax changes could have for employers and job creation.

Economic development policy concerns continue to be the top priority for public officials at both the state and local levels. Therefore, every proposed major public policy change should be examined carefully for its potential effect on Pennsylvania’s economy. To date, little attention has been paid to the economic development effects of local tax restructuring proposals.

Pennsylvania’s economy has underperformed the rest of the country for many years. Public and private leadership throughout the state is working hard and with some success to improve the economy

and create jobs. Thus, it is natural and important to ask what the impact each aspect of local tax reform might be on employers and job creation.

This is of particular importance to Pennsylvania which has a reputation for having high state business taxes. Additional local business taxes would increase the cumulative burden of total state and local taxes.

This *Capital Perspective* raises seven issues for consideration:

1. The definition of homestead exemption and its intended effect.
2. The implications for employers who pay the personal income tax.
3. The potential for dealing with the local “nuisance” taxes on business.
4. The impact of increasing local sales taxes on employers.
5. The potential for increased administrative cost to employers.
6. The future potential for greater property taxes on commercial and industrial property.
7. The need for analytical modeling as part of the policy-making process.

Homestead Exemption

Local property taxes are imposed currently on residential, commercial and industrial property. The rate of taxation must be the same regardless of type. The “homestead exemption” to the Pennsylvania Constitution approved by voters on November 4, 1997, allows taxes paid by homeowners to be effectively lowered by exempting up to one-half of the median assessed value of all homestead property within the taxing jurisdiction. Non-homestead property remains taxable at full value. The General Assembly has yet to define “homestead property,” therefore it is not clear what properties will be eligible for the exemption. Issues such as defining what portion of a farm should be considered homestead and deciding how to handle property owned by small businesses, rental property, and property owned by people working out of their home remain under debate.

Obviously, such an exemption would lead to loss of revenue for local municipalities, schools and counties which rely on the

property tax for revenue. The amendment further provides that these local jurisdictions cannot make up the revenue by increasing property tax rates. At the same time, the homestead exemption will not provide a windfall of lower taxes for homestead property owners. Most proposals contain provisions to increase local income and/or sales taxes to make up for the loss.

The Constitutional amendment makes a homestead exemption legally possible. However, it cannot be implemented by local jurisdictions until enabling legislation is passed. Thus, the main objective of local tax reform legislation is to specify the ground rules under which local jurisdictions and, therefore, local taxpayers can take advantage of the homestead exemption. Key issues to be faced by public policy makers are how the definition of homestead and replacement sources of revenue will impact employers and job creation.

Unincorporated and Subchapter-S Employers

Many of our smaller employers are either proprietorships, partnerships, or Subchapter-S corporations. Current Pennsylvania law permits their income to be taxed at individual income rates rather than the significantly higher corporate net income tax rate. This advantage is particularly important for small businesses that are young and growing.

One of the substitutes under consideration to make up the lost property tax revenue from the homestead exemption is the personal income tax. A new local personal income tax would add to the tax burden of small business owners now subject to the individual income tax. However, these same

business owners would not experience any decrease in commercial and industrial property taxes, resulting in a net tax increase. Some legislators support the inclusion of property owned by these small business owners in the definition of homestead, thereby allowing an offset in reduced property taxes. Without this offset, the local tax burden on smaller businesses will rise. Many of these businesses already operate in the red in their early years and have little margin to absorb additional cost and still be competitive.

However, the inclusion of business property as part of a homestead definition would have

negative consequences as well. The ability to reduce property taxes for homeowners would be diminished due to the reductions in assessments for qualifying businesses. Also,

some question the fairness of reducing property taxes for some but not all businesses.

Business Privilege and Gross Receipts Taxes

State law allows local municipalities and school districts to levy mercantile taxes on wholesale and retail trade enterprises and business privilege taxes on other enterprises such as construction and service industries.

The tax provides, statewide, only about four percent of the school district Act 511 tax revenue. However, because of the large reliance in Philadelphia and Pittsburgh, it generates about ten percent of municipal tax revenue statewide.

With the exception of Philadelphia, these taxes are on the gross receipts of these enterprises, rather than their profitability. Therefore, they do not bear any uniform relationship to earnings produced by business. They may impose an excessive and discriminatory burden upon the enterprise having a normally low ratio of net profit to sales.

Selective imposition of these taxes may handicap businesses when compared to competing enterprises within the trading area. Since some jurisdictions apply it and

others do not, it can be a factor in business location decisions.

Several types of businesses are exempt. This means that its burden is unevenly borne by only a portion of employer taxpayers.

Compliance can be confusing and time consuming. Proper enforcement may involve complex and costly auditing to ensure accurate disclosure of taxable income.

For these reasons, the mercantile and business privilege tax is widely regarded as a “nuisance” tax. In certain circumstances, it is a factor in the location decisions of employers. Many of the problems associated with the tax could be alleviated as part of current efforts to “reform” local taxes. The solutions may include:

- lowering rates;
- expanding the base to cover all types of businesses;
- shifting from a gross to a net income tax base.

Local Sales Tax and the Effect on Business

One of the most widely instituted alternatives to the property tax in other states is the local option sales tax. A local option sales tax is authorized by 33 states for one or more local jurisdictions. These entities rely on the tax to differing degrees, from very small percentages of revenue to nearly 50% in some southern states, but there is no doubt

that it is widely used compared to other options.

Most state authorizations extend to cities and counties. A few states only give counties taxing authority, while others permit transit authorities, and in the case of Georgia and Louisiana, school districts to levy the sales tax. Unlike many states,

Pennsylvania's use of the sales tax is very limited - only Philadelphia and second class counties (Allegheny County) levy the tax at a rate of 1%.

Given the widespread use of the local option sales tax in other states and the fact that taxpayers find them more palatable than other tax options, it seems likely that local tax reform in Pennsylvania may well focus on this alternative revenue source. With this understanding, it becomes important to explore how such a tax will affect business.

Clearly, a local option sales tax will affect both individual and business purchases. According to the Consumption Tax Model developed for the pending Pennsylvania Tax Blueprint Project, Pennsylvania businesses pay about half of all state sales taxes. Further, particular classes of industry pay a greater portion of sales taxes than others. These include wholesale and retail trade, manufacturing, financial services, and business services. A reasonable assumption to make, then, is about half of an additional local sales tax burden would fall on business. Therefore, any local tax reform proposal which includes a sales tax as part of its menu of options has the potential to increase the overall levels of taxes paid by employers.

Further, those types of businesses listed above will pay a disproportionate share of that burden.

A local option sales tax could also increase the cost and complication of compliance for retailers, particularly if the local tax base is different from the state base. And, if rates are not consistent across the state, businesses with locations in different taxing jurisdictions will have added administrative costs.

While a local option sales tax will most certainly affect business, it may also contribute to the positive objectives of local tax reform. Broader authorization of local sales taxes would certainly widen the distribution of the local tax burden. Structured properly, as a county tax, for example, it could provide the means to address regional problems from a regional perspective. Finally, a sales tax, particularly at the county level represents a more rational allocation of tax sources than other local taxes would. Income, for example, is already taxed by the state, municipalities, and school districts. A county income tax would add a fourth layer of tax on the same source. Sales, on the other hand, are taxed only by the state at this time (except Philadelphia and Allegheny counties).

Collecting Taxes – A Cost of Doing Business

Employers already incur substantial costs as “collectors” of sales and earned income taxes. The cost of compliance and the consequences of not meeting every rule and regulation can be substantial. Local tax reform legislation should not unknowingly add yet another cost of doing business.

As noted above, having various sales tax rates as one crosses local jurisdictional lines is not only confusing and frustrating for the consumer, it is costly for employers who must collect and properly remit the taxes.

Special problems of note would occur. These may include:

- possible double taxation of purchases made by an employer in one county but used in another county;
- significant increases in compliance costs due to a multiplicity of taxing and collection jurisdictions, and;
- new and duplicative auditing agencies and procedures which would increase

costs for both the taxpayer and tax collector.

Using the state base, and the state Department of Revenue as the collecting agency would limit some of these additional costs of administration for employers and tax collectors.

In the case of the income tax, the greater the number of jurisdictions and rates that the employer becomes responsible for collecting, the greater the cost of compliance. Local jurisdictions are not currently enabled to levy a personal income tax, i.e. the same income tax individuals pay to the state. If local tax reform legislation gives local jurisdictions the ability to enact a personal income tax, it could create a huge additional compliance

cost on employers. This is due to the potential for a multiplicity of different rates. This burden could be mitigated somewhat by requiring these taxes to be “piggy-backed” on the state levy for collection and administrative purposes.

Finally, regardless of the specifics of local tax reform legislation, the property tax will continue to be a major source of revenue for local jurisdictions. The lack of an efficient and equitable assessment system causes not only homeowners, but owners of commercial and industrial property as well, to waste major time and effort on compliance. Assessment reform should be considered a fundamental element in local tax restructuring legislation.

Greater Property Taxes on Commercial/Industrial Property in the Future

The requirements of the Constitutional amendment ensure that the revenue loss from initiation of a homestead exemption cannot be made up by property tax rate increases. However, a homestead exemption could lead to higher rates on commercial and industrial property and shift a greater burden for this revenue source to commercial and residential property in the future. Here’s why.

Once the residential exemption goes into effect, the total property taxes paid go down because the property tax revenue loss must be either absorbed in budget cuts or made up through the jurisdiction adding or increasing another tax other than the property tax. However, the share of total property taxes paid by commercial and industrial property owners goes up. This means, in the future, if

local jurisdictions do increase property tax rates, a much higher proportion than is currently the case will be paid by owners of commercial and residential property.

Local officials have other options available such as:

- keeping operating expenses within the inflationary revenue growth under existing rates;
- reducing the cost of government;
- using or increasing municipal service fees;
- increasing the tax base through economic development growth strategies.

The Need for Analysis

Analytical tools such as the Pennsylvania Tax Blueprint Project should be used to help public officials determine the impacts and trade-offs of various policies as implementing legislation is crafted.

Assuming the enactment of local tax reform legislation, local jurisdictions will need local

tax model simulations that can apply to their situations. In order to make informed decisions on the various tax reform alternatives, local governments will need much more than “seat-of-the-pants” estimates of the effects of changes over the years.

Conclusion

None of the issues raised in *this Capital Perspective* is fatal to the objectives of local tax reform. But all should be considered and accommodated in the debate wherever possible.

Local tax reform should be not only neutral to local governments and their residential

property taxpayers, but also to employers, on whom the future of the economy and, therefore, the state rests. We cannot afford to ignore economic development and job creation as we address property tax relief. Otherwise, the solution could create another problem.

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