Preliminary Recommendations for Public Comment
August 2009

Mayor's Task Force on Tax Policy & Economic Competitiveness

The task force welcomes and encourages public comment on the preliminary proposals on Philadelphia's tax structure and real estate development environment which are outlined in this document. More detailed recommendations (ex. specific tax rates) will be developed. To provide your comments, please attend the Task Force's final public hearing on Thursday, August 13 in City Hall, Room 400 from 4:00pm to 6:30pm or submit comments in writing to CompetitivePhilly@phila.gov.

Those who wish to testify at the public meeting should email CompetitivePhilly@phila.gov or call (215) 686-6569 to be placed on the speakers list. Attendees are asked to bring copies of their testimony or email them in advance. A photo ID is required for building access.

MAYOR'S TASK FORCE ON TAX POLICY & ECONOMIC COMPETITIVENESS IN PHILADELPHIA

"A thorough review of our tax policy and barriers to development is needed in order to best position the City for growth and economic competitiveness... The Task Force shall provide a report to the Mayor and the President of City Council setting forth its recommendations regarding the City's tax policy and economic competitiveness."

Excerpt from Mayor Michael Nutter's Executive Order 3-09, signed February 11, 2009.

The Task Force's mission is to evaluate the City's real estate development environment and its tax policies and structure and to determine how these compare to neighboring jurisdictions and peer cities. The Task Force is charged with providing recommendations and accompanying legislation by September 2009.

The Task Force on Tax Policy & Economic Competitiveness has focused on what it believes the City must do to foster a favorable climate to create more opportunities and wealth for Philadelphia residents and for sustainable business formation and growth. Although education is not part of the Task Force's mission, the Task Force stresses that improving levels of educational attainment for the working population of the City is essential to achieving the goal of sustainable business development.

Despite the temporary infusion of stimulus dollars from the Obama Administration, 74% of the financial support for municipal government is generated locally by taxing people, jobs, real estate and business activity. While the City must continue to press for the Commonwealth of Pennsylvania to assume more of its share of Philadelphia's county-related costs, the economic conditions at the state and federal levels places a severe limit on these efforts. Therefore, Philadelphia must create an environment of job and population growth to broaden the tax base of the City.

CREATING OPPORTUNITIES FOR RECOVERY IN THE FUTURE

Philadelphia is an extraordinary city with incredible assets, yet it has lost jobs and population for decades. This is, in part, the consequence of a long-term and ongoing transition from an industrial to a service economy and the improvement of technology that allows for a mobile workforce. However, Philadelphia's tax structure and development environment have exacerbated and accelerated the city's decline.

Today, despite the global recession which presents immediate challenges to Philadelphia's municipal budget, real estate, demographic and cultural trends are tilting in Philadelphia's favor. Philadelphia has a strong base of educational and medical institutions that provide intellectual capital and a diversified economy with industry-leading companies across a wide variety of sectors, including telecommunications, life sciences, professional and financial services, and tourism and hospitality. The city is highly accessible via public transportation and highways to a huge regional market with a well-educated workforce and is connected to the global economy by an expanding airport. Municipal government has a significant opportunity to reposition the city for renewed growth once recovery takes hold, making Philadelphia more competitive with its suburbs and other East Coast centers as a business location, while expanding economic opportunities for all citizens and restoring the central city's role as a leader of regional growth.

The Task Force's recommendations have been constructed as a package that if fully implemented will create jobs, build wealth, expand business activity, and generate sufficient revenue to provide quality public services to all Philadelphians. To create these new opportunities, Philadelphia must have:

Accurate, Easy and Transparent Government Interactions— Today, Philadelphia's tax structure and real estate development environment can be complex and unpredictable, allowing those in-the-know to gain an advantage, driving others to leave, and scaring off potential residents, investors, and entrepreneurs.

A Tax Structure and Development Environment That Encourages Growth Opportunities — Philadelphia now heavily taxes things that can pick up and leave, such as residents, employees, and businesses, with its Wage and Business Privilege Taxes. As technology developments and globalization have made it possible for people to work anywhere, these taxes chase residents, companies, and jobs out of Philadelphia into the suburbs and to other cities.

A Lower Overall Tax Burden— Changing Philadelphia's mix of taxes and making interactions with government easier and more predictable can create opportunities for job seekers, businesspeople, entrepreneurs, and homeowners. But Philadelphia has no chance of reaching its potential if it continues to place one of the largest tax burdens in the nation on its firms and families. In order to be competitive with our neighboring suburbs, the City needs to reduce the overall tax burden on residents and businesses through reductions in spending, growth in non-tax revenues and, where possible, additional support from the state and federal government.

Guiding Principles for Reform

Over the course of its work, the Task Force developed guiding principles based on widely accepted tax theory, prior studies of Philadelphia's tax structure and economy, credible data sources, insights from local and national experts, public input, and Task Force members' personal and professional experiences from living and doing business in Philadelphia. These principles have helped form the preliminary recommendations:

- Since 1970, Philadelphia has lost 500,000 residents and 200,000 private sector jobs. In the last decade many comparable cities have been adding people and jobs. To change this path of decline, municipal government must make fundamental changes in the way it does business and how it taxes.
- Changing Philadelphia's tax structure and development process is not enough to overcome the City's many challenges, but it is an essential step towards renewed growth that can be undertaken immediately and with little outside help.
- Philadelphia's mix and level of taxes hinder the city's competitiveness. The tax mix should shift from taxes on things that are mobile (people and businesses) to assets that are fixed (land and buildings). The tax level should be lowered to reduce the overall tax burden on residents and businesses.
- The cost of doing business in Philadelphia must be competitive regionally and nationally. When existing firms are planning growth and potential employees, suppliers, and customers are choosing between locations, taxes and administrative costs influence decisions.
- To close the gap between real estate construction costs and sales and rental rates, government subsidies are not enough; a growing population and a healthy thriving economy are needed to create demand, and that requires a competitive tax structure.
- Predictable and streamlined procedures are needed to eliminate real and perceived barriers to doing business in Philadelphia.

SHORT-TERM RECOMMENDATIONS (0-24 MONTHS): ACCURATE, EASY, & TRANSPARENT GOVERNMENT INTERACTIONS

Taxpayer compliance and the desire to locate a business within the City improves if the taxpayers and decision makers believe that taxes are levied in a rational, fair, transparent, and equitable manner, if they receive high quality services, and if they can interact with personnel at City agencies governed by a strong ethic of customer service who are both capable of and appear happy to assist and answer questions. The Task Force will recommend changes to the City's tax structure but as a first step, even within the existing tax structure, the Commission recommends:

- Upgrading Property Information and Tax Administration Technology & Human Capital — To efficiently collect all taxes due to the city and analyze tax information, the City of Philadelphia needs to provide appropriate resources for the Department of Revenue and other departments engaged in tax administration. This includes ensuring that all departments involved in recording the transfer of real estate and the collection of real estate taxes can share the same information and have timely access to that information. The Task Force believes that the City should have a state-of-the-art, networked property information and tax databases with adequate professional staffing to make collection of all tax types more efficient, to monitor trends and to measure, over time, the impact of the entire Philadelphia tax structure and development policies on job creation and income growth. Investments also should be made in the professional development of Department of Revenue staff to maintain and expand expertise and institutional knowledge.

- Reducing the City's Need for Taxes By Reducing the Cost of Government — The Task Force believes that the City must reduce its spending to be more closely in line with neighboring jurisdictions and peer cities. At the same time, the Task Force recognizes that the City is required to supply greater services than some neighboring jurisdictions because of the higher poverty rates in Philadelphia and the City's obligation to fund county functions like human services and courts, a situation unique in Pennsylvania and rather unusual throughout the nation. To cut these costs. The Task Force believes that the City must focus on efficiencies, productivity, and expenditures that are out of line with peer and comparable cities and the private sector.

- Improving Real Estate Assessment — Philadelphia's real estate taxes should reflect the actual market value of property. At the current time, a move to actual value will increase the assessed value of Philadelphia real estate. This increase will be spread among residential and commercial properties and, on average, will more fairly tax properties that have increased in value. The biggest beneficiaries of moving to actual values will be those property owners whose property values are at the lower ends of the spectrum, have been relatively stable, but that have been assessed at a much higher percent of their market value than properties in appreciating neighborhoods. The implementation of the Actual Value Initiative however, is not a one time event and to assure that the assessed values keep up with the market, assessments should be updated routinely through both city-wide computer analyses and individualized, professional appraisals. Complete re-valuation of properties should be mandated at set intervals. As part of the move to actual value, which will create a large net increase in assessed values, City Council must approve a new, reduced tax millage rate to take into account the increase in real estate assessed values. The City should create programs to protect those on fixed and limited income if existing state and local programs are found to be insufficient and assist homeowners who would otherwise experience sudden and dramatic increases in assessment with a homestead exemption (for which state legislation may be necessary). Also, the Task Force believes that separating the real estate assessment process from the real estate value appeals functions would increase property owners' confidence in the integrity of the process.

- Providing Predictable, Streamlined Procedures — The Task Force believes that the City must continue to make citizens' and businesses' interactions with government easier. Improvements may include the planned new zoning code that could minimize the need for variances; less onerous, simple paperwork and requirements for small businesses and start-ups; and dedicating a case worker to each business to help them navigate through the various interactions with the City. The City should make it a priority to complete and implement improvement efforts already underway, such as the work of the Zoning Code Commission and the Reform Team reviewing the development process.

- Lowering Interest & Penalty on Tax Underpayments & Offering a Tax Amnesty — Philadelphia has unusually high and uncapped interest (12% annually) and penalties (30% in the first 12 months and 15% each year thereafter) on tax underpayments. In peer jurisdictions, interest on underpayments is at a rate somewhat over the prime rate and typical penalties are capped at 25-50% in non-fraud situations. Philadelphia's interest and penalties often overwhelm and frighten struggling taxpayers, and create circumstances where taxpayers who otherwise might step forward to work out underpaid or unpaid taxes do not pay at all. If the interest and penalties were more in line with peers, both the abnormally high interest and penalty rates as well as the systematic unfairness that arises because more sophisticated taxpayers often are able to negotiate settlements that minimize the high interest and penalties and less sophisticated taxpayers with fewer resources wind up paying more would be addressed. By offering a tax amnesty, delinquents and non-filers would have the opportunity to come into compliance. This would also expand the tax base, growing revenues on a continuing basis. Following the tax amnesty, those current delinquents who failed to come forward would continue to face the high interest and penalties currently in place, while a new, more equitable interest and penalty rate structure should be implemented for future tax underpayments. The revenues raised through the amnesty in the short-term could provide the resources needed to provide 21st century data systems and information technology for tax administration, as well as fund staffing and professional development for the Department of Revenue.

- Creating a Tax Ombudsman — It is inevitable that not every tax-related transaction will go smoothly. The Task Force believes that the City should offer accessible and fair assistance to taxpayers who have issues that remain unresolved after taking the normal steps.

- Making Business Taxes More Hometown Friendly & Attractive to New Firms - The rules that the City currently uses to determine the share of a business's income that is subject to the Business Privilege Tax (BPT) and Net Profits Tax (NPT) are based on the Uniform Division of Income for Tax Purposes Act (UDIPTA), created in 1957 at a time when the economy was more dominated by manufacturing and when local property and payroll investments were necessary to generate revenue. With technological advancements and the overall shift to a services-based economy, that model does not reflect the current business environment. As the global economy evolves, the City's tax structure needs to change with it. The current apportionment methodology favors multi-jurisdictional businesses that do not invest locally and creates a disincentive for companies with large numbers of employees to locate in the City. The Task Force recommends two mechanisms (either separately or in combination) to modernize the City's apportionment formula for the BPT and NPT:

    - Single Sales Factor Apportionment – To calculate what percentage of a business's income is subject to the BPT and NPT, Philadelphia considers not only the firm's sales inside the City, but also whether its employees and property are located here. For example, imagine two firms, one in Manayunk and the other with offices in both Manayunk and Conshohocken, with the same amount of income from sales in Philadelphia. The firm only in Manayunk would pay more than the firm with employees in Conshohocken, since the Manayunk firm has all its employees and property in the City even though both firms do the same amount of business in Philadelphia. This situation may push the Manayunk firm to move to a suburban location and prevent the Conshohocken firm from expanding in Philadelphia. The implementation of a single factor sales formula for business tax apportionment, which would eliminate the property and payroll factors, would appropriately align incentives that encourage businesses to start-up, locate, and expand here.

    - Market-based Sourcing — To estimate what percentage of a firm's income is taxable in Philadelphia; the current system treats manufacturers and service providers differently. For manufacturers, a sale is taxable only if the purchaser of the product is in the City. Sales of manufactured goods by Philadelphia-based businesses to purchasers outside the city limits are not subject to BPT and NPT. For services companies, the City employs a cost of production (COP) rule, whereby sales of services are attributed to where the income producing activity is performed. The original intent for including the sales-factor in the multi-factor apportionment formula was as a measure of the economic value derived from the local marketplace. In today's economy, where exports of services, like graphic design or legal services, are as common as exports of tangible property, like hats or trains, the COP rule no longer provides a measure of the economic value that a service company derives from the local marketplace. A market-based rule would reduce the tax burden on businesses located in Philadelphia that provide services to customers outside the City, and it would shift the tax burden to businesses outside the City that provide services to residents and businesses located within Philadelphia. Market-based sourcing taxes revenues of services firms based upon physical location of the customers.

Single-sales factor apportionment and market-based sourcing are economic development tools that can encourage regional and national companies to locate facilities and expand their workforces in Philadelphia. Services account for virtually every new job created in America since the 1970s. To have any chance of reaching its potential, Philadelphia cannot maintain a tax structure that is unfriendly to local companies. Many states have already adopted a single-factor sales-only apportionment formula and/or the market-based approach for sales of services. As other jurisdictions take steps to modernize their tax structure, Philadelphia must not let itself be left behind.

MID-TERM RECOMMENDATIONS (2-4 YEARS): A TAX STRUCTURE AND DEVELOPMENT ENVIRONMENT THAT ENCOURAGES GROWTH & OPPORTUNITIES

Philadelphia's taxpayers are subject to the highest tax burden in the region. While taxes are certainly not the only factor that a taxpayer considers when making a location decision, the Task Force believes that reducing Philadelphia's tax burden and altering the mix of taxes that support local government will help retain existing taxpayers, expand residents; opportunities and wealth, increase small and minority business formation, and attract new people and investment to the City. Making Philadelphia competitive involves:

- Restoring Phased Tax Reductions – Current law states a return to phased reductions in the Wage and Business Privilege Taxes by 2015. The Task Force believes that as soon as the local economy shows signs of recovery, but no later than 2012, the City should reinstate the phased reductions in Wage and Business Privilege Taxes that have improved Philadelphia's regional competitiveness and saved the City 23,000 jobs in the last thirteen years.

- Using Public-Owned Property to Spur Development — In addition to subsidies and tax incentives, the City and other agencies should use publicly-owned property as a tool for reducing Philadelphia's high cost of development and to focus activity in areas that have significant development potential.

- Shifting the tax burden from things that are mobile (wages and businesses) to assets that are fixed (land and property) — There is substantial evidence that Philadelphia's high Wage and Business Taxes, which account for more than two-thirds of locally generated tax revenues, chase businesses and jobs out of the City. Since 1970, Philadelphia has lost more than 200,000 private sector jobs, leaving residents with fewer employment opportunities, depressing the demand for real estate, and reducing the tax base that the City needs to provide quality services. By significantly decreasing Wage and Business Privilege Taxes, Philadelphia can retain and attract more residents and businesses, begin to generate more demand for real estate and, correspondingly, more revenue generation from real estate taxes. Consequently, the Task Force recommends that within the context of a rational budget for the City, the City shift its tax revenue base, in part, by reducing Wage and Business Privilege Taxes and increasing real estate taxes once actual value assessments are in place. If the City were to rely more on real estate taxes for its revenue, such reliance does not need to fall primarily on homeowners. High taxes on wages and business have depressed demand for commercial real estate in Philadelphia and increased the share of real estate taxes that are paid by homeowners. Only 27% of assessed real estate value in 2008 was attributed to commercial and industrial property, while 53.6% came from single-family residential properties. Creating a favorable climate for business would allow the commercial real estate tax base of the City to grow relative to the residential real estate base and provide a more stable and predictable revenue source for local government. With state approval of Homestead Exemption legislation, Philadelphia should also reduce some of the burden on homeowners by exempting a portion of a home's value from the Real Estate Tax.

- Making Tax Incentives Accessible and User-Friendly — In the long term, improvements to the City of Philadelphia tax structure and governance should eliminate the need to use tax incentives to encourage real estate development and job creation, but reality requires that incentives continue for the time being. Currently available tax incentive programs should be more widely promoted by the City and requirements should be streamlined so that the programs are broad-based rather than targeted, as well as easier to access and administer. Future tax incentive programs should be modeled on the successful 10 year real estate tax abatement for new construction and substantial renovations, which is available as-of-right with a simple application.

IDEAS FOR FURTHER STUDY

The Task Force has identified several additional areas to explore and plans to continue its analysis before formulating recommendations. These ideas include:

- Reducing the Overall Number of Taxes — Philadelphia has 19 different taxes. In many cases, individuals or businesses have to file and pay more than one tax to the City of Philadelphia, creating administrative burdens and unnecessary complexity for both taxpayers and the City. The Task Force will be exploring the potential benefits of eliminating some of these taxes. What if Philadelphia had a single business tax rather than taxes on gross receipts, net income, and net profits or if the Use & Occupancy Tax were combined with the Real Estate Tax?
- Making Rules and Regulations in Philadelphia Normal — Philadelphia not only has a high tax burden compared to its peers, but also sets itself apart in some instances by taking administrative positions and promulgating regulations that are substantially different from what is standard in most other jurisdictions. This adds complexity for firms operating in multiple jurisdictions and makes Philadelphia a more difficult place to do business. Should the City avoid taking these unique positions in the future and reform existing regulations and positions to improve conformity?
- Cutting the Realty Transfer Tax Rate to Increase Collections — Philadelphia's Realty Transfer Tax of 3% is paid by buyers and sellers of residential properties, but many commercial property owners hire lawyers to structure land and building sales in a manner that avoids the tax. Would lowering the rate to a more competitive level encourage enough commercial property owners not to avoid the tax that the City would still collect as much revenue, if not more?

MAYOR'S TASK FORCE ON TAX POLICY & ECONOMIC COMPETITIVENESS

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