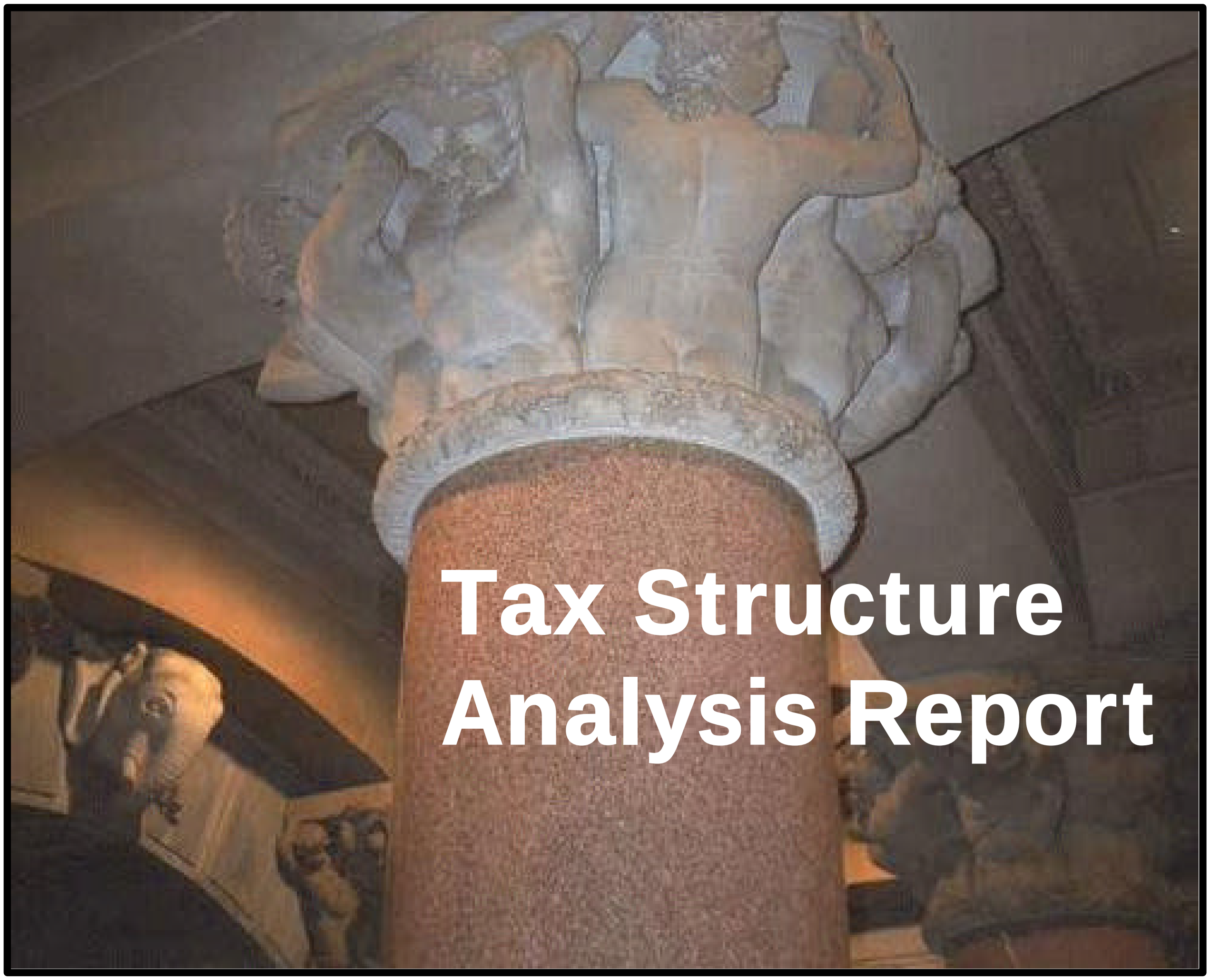

Tax Structure Analysis Report

Office of the City Controller
City of Philadelphia

Jonathan A. Saidel
City Controller

November 26, 2001

To the People of the City of Philadelphia
And the Commonwealth of Pennsylvania

Dear Friends:

Philadelphia's City Hall is adorned with ornamental and allegorical statuary that makes the remarkable building both whimsical and profound. In the building's crypt, four great columns form the base of the City Hall tower. The top of each column is crowned with carvings of the peoples of the world; pillars representing Africa, Asia, Europe, and America hold up the massive tower's weight. The statues can be seen as representing the people propping up their government — or being crushed by its oppressive heaviness. That stony metaphor could apply rather easily to the city's tax structure.

In recent years, the combined effects of modest tax reduction at the local level and momentum generated by an expanding national economy have created some economic growth in the City of Philadelphia. However, that growth still lags behind the nation as a whole, competitor cities, and neighboring jurisdictions. Similarly, despite some increase in the number of jobs in the city in recent years, the city's longtime population decline continues. These are clear signals that efforts to alter the local tax burden must be more substantial if the city's competitive position is to improve.

I am, therefore, pleased to present the City Controller's *Tax Structure Analysis Report*, an examination of the City of Philadelphia's current system of taxation and a series of proposed reforms designed to alter this competitive disadvantage and retain and attract businesses and residents. I can think of few topics more critical to the ongoing effort to make Philadelphia a preferred place to live, work, and visit.

City government cannot alter international events or change federal initiatives, but it can create a tax structure that encourages smart growth. By creating a tax structure that improves the city's overall competitiveness, the craft that is our city will be best able to find favorable currents in our international economic ocean and Philadelphia will be better positioned to move into the future.

I look forward to working with the mayor, city council, city officials, and citizens to create a new tax structure for Philadelphia that will fund our city's needs, be fair to taxpayers, and further the city's goals of economic development and neighborhood transformation.

Sincerely,

JONATHAN A. SAIDEL
City Controller

OFFICE OF THE CITY CONTROLLER
TAX STRUCTURE ANALYSIS REPORT

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Acknowledgements

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Additionally, we are deeply indebted to the individuals and organizations that helped to set up and hosted roundtable discussions on taxation in Philadelphia (a list of these groups is provided as Appendix D). Finally, the Controller's Office acknowledges the advice and aid of numerous city officials from the Revenue Department, Board of Revision of Taxes, Law Department, and other agencies whose contributions are evident throughout this document.

REPORT IN BRIEF

REPORT IN BRIEF

Just a decade ago, the City of Philadelphia teetered on the verge of fiscal collapse. The city had to rely on its newly established fiscal oversight board, the Pennsylvania Intergovernmental Cooperation Authority (PICA), to gain access to capital markets and to refinance city debt. With PICA's assistance, the city was able to make strides toward reducing the cost of government and actually make marginal reductions in tax rates. But, despite moving from fiscal crisis to regular budgetary surpluses and even with small-scale tax reductions and some job expansion, Philadelphia has continuously lagged behind the nation, the Greater Philadelphia region, and competitor cities in terms of economic growth. More important, Philadelphia's population loss continued throughout the 1990s.

Now, years removed from fiscal crisis and buoyed by recent economic growth, the city is in a position to address the underlying structural issues that contributed to its decline in past decades and prevented it from enjoying more robust economic gains in recent years. Unfortunately, issues such as improving schools and reducing crime involve cooperative efforts of many levels of government. Issues such as rightsizing city government or linking governmental performance to agency budgets involve complex interactions of various governmental entities and actors. However, the city can create a tax structure that encourages smart growth through local legislative action and, in a relatively short period of time, could positively affect every single business and resident in Philadelphia and dramatically improve the city's overall competitiveness. The city can cut taxes and change how the city taxes to encourage businesses to locate and expand in Philadelphia so that the tax reductions and modifications will actually result in a larger tax base and increased tax collections in the future.

During the past several months, the Controller's Office has reviewed the role the local tax structure has played in driving so many residents and employers from Philadelphia. Staff directed roundtable discussions with groups comprising representatives from the various sectors of the Philadelphia economy and the City Controller conducted a listening tour where he heard perspectives from citizens throughout the city. The office studied theoretical and empirical perspectives on taxation, evaluated the city's taxes and tax rates in comparison with rival cities and surrounding jurisdictions, and modeled the revenue implications of alternative tax rates and structures. As a product, this document reviews the findings of the Controller's Office and proposes the elements of a new tax structure for Philadelphia designed to attract and retain jobs and residents.

The Tax Structure Analysis Report

This *Tax Structure Analysis Report* begins with the assumption that tax reform in Philadelphia is desirable and necessary and concludes with recommendations designed to improve the city's competitive position. The city has many competitive advantages, from its geographic location at the center of the nation's East Coast to its prominence as the home of some of the nation's finest historical and cultural attractions. Nevertheless, the pull exerted by all that the city has to offer contrasts with the push of reasons not to locate within its borders. A fertile marketplace of millions of consumers may pull a business to Philadelphia, but a burdensome tax structure may push that business to consider locating in another city. High-quality universities may attract firms to Philadelphia, but high taxes may push those firms to locations outside the city limits. If recommendations to change how Philadelphia taxes can eliminate or mitigate that push, the city will be able to better capitalize on its pull.

In general, the Controller's Office focused its analyses on potential solutions to the city's tax woes rather than on academic exercises to catalogue the severity of those woes. While the effort concentrates significant attention on tax and economic theory, it is not a search for an unachievable perfect taxation system. Instead, the research products and analyses were designed to yield practical suggestions for making specific, achievable changes to Philadelphia's system of taxation. We attempted to focus our tax reforms on changes that would have the broadest and most positive effects and tried to avoid second-guessing the market by picking specific winners in favor of recommendations that could create a more favorable marketplace in general. While one may be tempted to try to attract or retain a specific growing industry, the growing business of today could be the bursting bubble of tomorrow. In the same way, there are certainly growing businesses in dying industries that employ significant numbers of Philadelphians today. We recommend using tax policy to do the most good for the greatest number and reserve other economic tools — Tax Increment Financing, tax abatements, loans, grants, etc. — to help individual businesses or industries as part of a well-crafted overall economic development plan. If we expressed a bias, we erred on the side of incremental change due to the reality that while more dramatic change may be beneficial and desirable, legal, historical, budgetary, and political constraints hamper such efforts. Therefore, we examined what the city should do in theory and analyzed what it could do given legal and other barriers, but chose to craft our recommendations based on what the city ***can*** do within its current constraints.

Finally, in considering the city's tax structure, the Controller's Office avoided confusing issues surrounding the need to reduce the city's high tax burden by discussing areas where the city should consider increasing spending. The Controller's Office certainly believes that additional resources could help to improve schools, reduce crime, and raise the quality of life in city neighborhoods, and the demand from the citizenry to improve services in the city is clear. But given the oppressive nature of the city's current mix of taxes, we believe that reducing the high tax burden of city residents and employers is a desirable primary goal that is necessary to help stop the ongoing exodus of residents and improve the city's long-term economic prospects. Any changes in the city's spending priorities should be pursued within the current budgetary structure and made possible by expanded use of technology, productivity gains, and other efficiency-generating measures.

The Need To Reduce Taxes Is Clear

The need to reduce taxes is abundantly clear and it is equally clear that tax cuts can work to improve economic conditions in the city without compromising budgetary priorities. Philadelphia's experience in recent years provides compelling evidence that a tax cut does not necessarily threaten revenues. Despite positive growth in the U.S. economy since 1992 and positive growth in the regional economy since 1993, it was not until after the city reduced taxes that it experienced job growth. Even with a cumulative 8.0-percent decrease in the Wage Tax rate, total Wage Tax collections actually increased by 18.8 percent between fiscal year 1995 and fiscal year 2001.

It should be no surprise that the Controller's Office discovered that the city's overall tax burden, and many individual taxes, are high; that the city's tax structure places it at a competitive disadvantage in relation to other cities and surrounding jurisdictions. This weakness blunts the city's natural advantages and frustrates attraction and retention efforts. While big cities in general present higher taxes than surrounding jurisdictions, many Philadelphia residents and employers question whether the service they receive and the market they access by being in Philadelphia are worth the high price they pay. Beyond tax rates, Philadelphia's tax structure is overly complex and confusing. Because of this complexity, complying with the city's tax laws adds costs and frustrations to residents and employers and creates a powerful negative feeling about doing business within the city.

In crafting recommendations for change, the Controller's Office concluded that, given budgetary constraints, business tax cuts can create a more significant, positive economic effect than reductions of the Wage Tax. Resulting growth can create opportunity for more aggressive Wage Tax cuts in the near future. Additionally, tax shifts that will alter taxation but maintain current tax revenues, and small-scale changes to individual taxes, can improve the city's structure and make a difference to many taxpayers. But, despite any change at the local level, the Controller's Office is convinced that the city must continue to pursue tax reform at the state level to address issues that cross the city's borders and add to the city's competitive disadvantage.

Recommendations For Change

Specifically, the Controller's Office recommends that the city:

Significantly reduce business taxes in Philadelphia in the near term

- Reduce the Net Income portion of the Business Privilege Tax from 6.5 percent to 4.0 percent beginning fiscal year 2003.
- Reduce the Gross Receipts portion of the Business Privilege Tax from .24 percent to .20 percent beginning fiscal year 2003.
- Eliminate the city Net Profits Tax beginning fiscal year 2003.

Shift tax burden to reduce resident Wage Tax and encourage development

- Institute a Land Tax, changing the way property is taxed in Philadelphia from the current system (where the amount of tax from structures and improvements generates approximately 77.5 percent of Real Estate Tax revenues) to a system where the tax on land and the tax on structures/improvements each generate an equal amount of revenue beginning fiscal year 2003.
- Reduce the city Wage Tax from 4.5385 percent to 4.0 percent for city residents and increase the city Real Estate Tax accordingly to create a budget-neutral first-year shift beginning fiscal year 2003.

Take advantage of improved business climate to accelerate the pace of Wage Tax reductions

- Reduce the city Wage Tax from 4.5385 percent for city residents and 3.9462 percent for non-residents to 3.5 percent and 3.375 percent, respectively, by fiscal year 2007.

Eliminate confusing and arguably unfair elements of the city's tax structure

- Advocate for the Pennsylvania General Assembly to make a technical amendment to the enabling legislation for the city's Business Privilege Tax to make it a retrospective tax instead of a prospective tax and eliminate the need for businesses to double-pay their Business Privilege Tax in the second year of operations beginning fiscal year 2003.
- Change the current multi-factor apportionment formula for determining tax liability for the Net Income portion of the Business Privilege Tax to a single-factor apportionment formula beginning fiscal year 2003.
- Simplify the process for paying Business Privilege Taxes and redesign Business Privilege Tax forms accordingly beginning fiscal year 2003.

Pursue additional solutions to improve the city's tax competitiveness and fiscal stability

- Implement a Philadelphia New Jobs Tax Deduction based on the Commonwealth of Pennsylvania's existing Job Creation Tax Credit program to encourage Philadelphia companies to create new jobs in the city and to offset increased costs they must bear due to Philadelphia's Wage Tax.
- Enhance the ability of neighborhood-based tax incentives to encourage growth in development-starved areas of the city.
- Utilize technology and establish a Taxpayers' Ombudsperson to facilitate improved interactions between taxpayers and the city's revenue-collection bureaucracy.
- Improve tax collection efforts.

- Continue to make every effort to reduce the cost of government and use savings to drive down the city's need for taxes.
- Continue to advocate for regional and statewide tax reform to alter the way the Commonwealth of Pennsylvania and local jurisdictions fund public education and local government services.
- Continue to push for the Commonwealth of Pennsylvania to fund Pennsylvania's courts at the state level and remove the burden of court funding from Philadelphia and other counties so the city can use those funds to reduce taxes.
- Complement efforts to make the tax structure business- and resident-friendly by improving the city's regulatory processes.
- Set the city budget in structural balance to maintain fiscal stability.
- Establish a rainy-day fund to aid efforts to achieve structural balance.
- Expand non-tax-revenue collections with entrepreneurial efforts to fund additional tax cuts or expansion of services.
- Create an overall economic development plan for the city to ensure that tax subsidies are justified by utilizing criteria and clawbacks when considering subsidy efforts.

To fund tax-reform proposals, the Controller's Office has identified anticipated increased revenue based on Five-Year Plan growth projections applied to actual fiscal year 2001 collections; specific savings within the city budget; a higher-than-anticipated accumulated city surplus; and a significant supply-side reaction to tax cuts. By identifying more than 130 percent of revenues necessary to fund these reform proposals, the Controller's Office provides a cushion of more than 30 percent against any future contingencies such as declining revenue collections or unanticipated expenditures. This means that the Controller's Office's analysis of the city's revenue and expenditure estimates provides more than 30 percent additional funding than would be necessary to implement the proposed recommendations as well as meet the revenue estimates and spending priorities in the city's current Five-Year Plan.

In Conclusion…

No longer threatened with the immediate pressure of fiscal collapse, the City of Philadelphia has a unique opportunity to fundamentally alter its overly burdensome and confusing tax structure in a way that will allow the city to capitalize on its competitive advantages and expand its tax base. This major step can finally create the kind of significant reform necessary to reverse decades of population loss and lagging job growth. Even presented with a declining economy, the imperative remains to reduce taxes and better position the city among international, national, and regional competitors.

There may be a cost to reducing taxes, but there is certainly a cost to not reducing taxes. The Controller's Office asserts that, without significant change to the city's tax structure, Philadelphia will continue to grow more slowly than competitor cities and surrounding jurisdictions and that population decline will continue unchecked. By reducing the overall cost of living and doing business in Philadelphia, and improving a tax structure that impedes smart growth, the city's elected and appointed leadership can make an important stride toward making Philadelphia a preferred place to live, work, and visit.

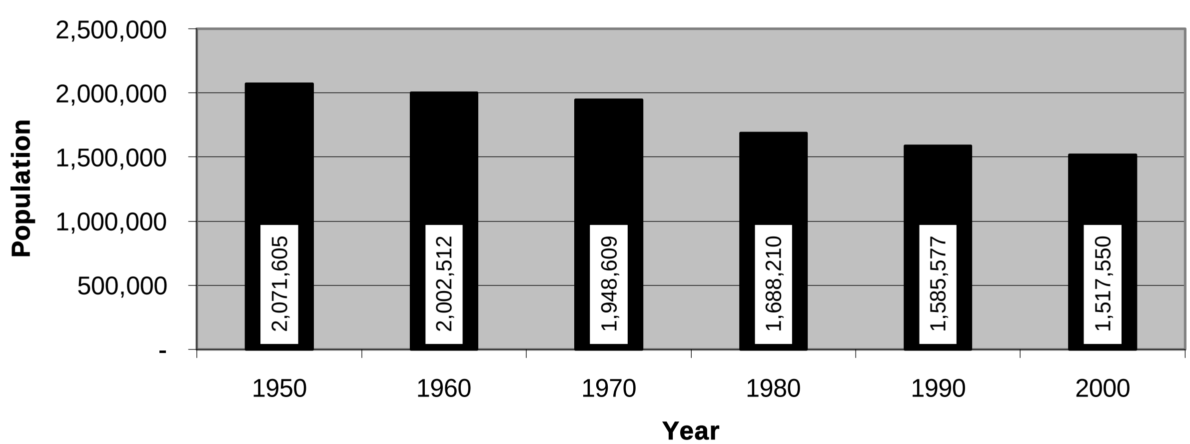
1. The Imperative to Change Philadelphia's Tax Structure

A decade ago, the City of Philadelphia teetered on the verge of fiscal collapse. With the assistance of the Pennsylvania Intergovernmental Cooperation Authority, sound fiscal management, and unprecedented expansion in the national economy, the city experienced some growth and was able to actually make marginal reductions in tax rates. But economic growth in Philadelphia has continuously lagged behind growth at the national level, in the region, and in competitor cities, and the city's well-documented population loss continued throughout the 1990s. The lackluster economic performance and population loss have complex causes, including international economic shifts, changing national policies, and individual preferences. Locally, underperforming schools, declining neighborhood quality, and a high tax burden have pushed residents and employers from Philadelphia. While issues such as improving schools and reducing crime involve cooperative efforts of many levels of government, the city can create a tax structure that encourages smart growth through local legislative action. In a relatively short period of time, such an action could positively affect every single business and resident in Philadelphia and dramatically improve the city's overall competitiveness.

The Need For Significant Tax Reform To Foster Sustainable Growth

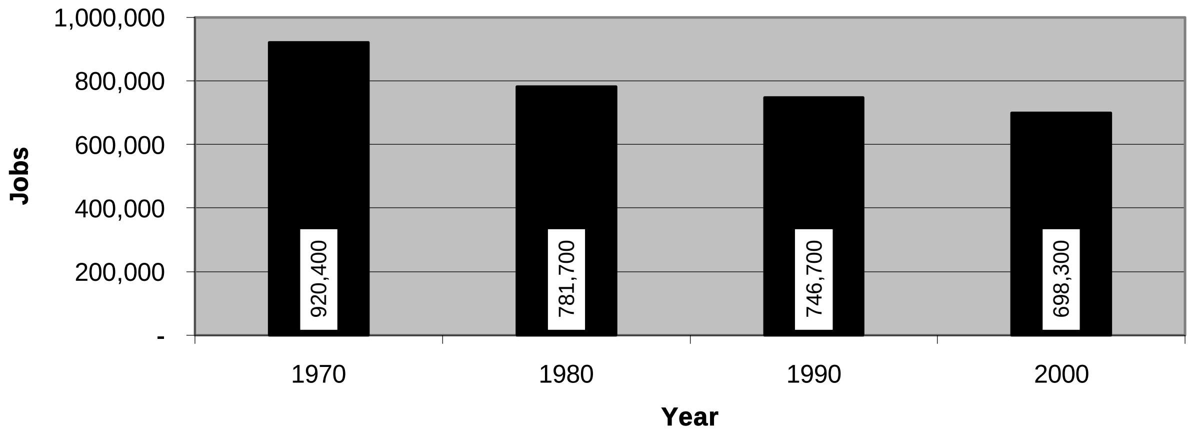
In the last 50 years, hundreds of thousands of Philadelphia residents and jobs have left the city. Shifting demographics have altered the city's residential makeup, leaving the city's population older and poorer with fewer people contributing to the tax base. Where factories once produced goods for familiar brands like *Stetson* and *Atwater Kent*, abandoned buildings remain as an eerie reminder of Philadelphia's former industrial glory. Neighborhoods and industrial areas once teeming with activity exist as virtual urban ghost towns. Blight and abandonment represent an epidemic problem for a city that lost about one quarter of its population and employment base in the recent decades. (See Figures 1.1 and 1.2.)

Figure 1.1 — Total Population In Philadelphia Has Declined In Recent Decades



Source: United States Census Bureau

Figure 1.2 — Total Employment In Philadelphia Has Declined In Recent Decades

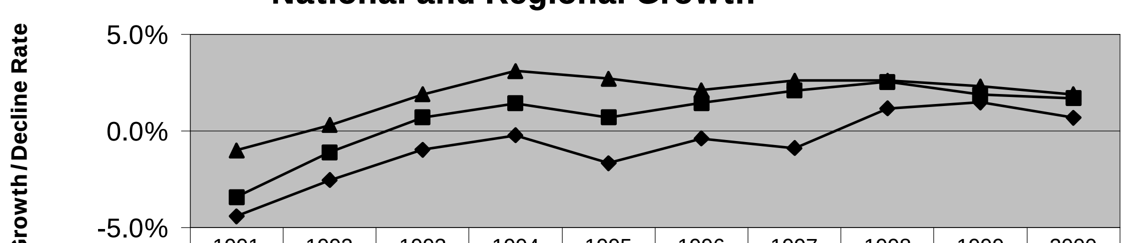


Source: Bureau of Labor Statistics

While some Philadelphia neighborhoods are attracting new residents, and while the city has enjoyed some modest economic growth in recent years, population and economic growth have lagged behind national and regional growth, as well as growth in other cities. (See Figure 1.3.) As detailed by the Federal Reserve Bank of Philadelphia in *A Philadelphia Report Card* (January 2001):

> "The area has not done as well as the nation in terms of either job growth or income growth, but it seldom does. Even by other measures, however, this was a relatively weak expansion for the Philadelphia metropolitan area. Payrolls and real personal income in the region have grown more slowly during the 1990s than in the long expansion in the 1980s. Moreover, among the 50 largest metropolitan areas in the country, Philadelphia ranks near the bottom in terms of job growth over this expansion."

Figure 1.3 — Philadelphia Employment Growth Lags Behind National and Regional Growth



	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Growth in Philadelphia	-4.4%	-2.5%	-1.0%	-0.2%	-1.7%	-0.4%	-0.9%	1.2%	1.5%	0.7%
Growth in Phila. PMSA	-3.4%	-1.1%	0.7%	1.4%	0.7%	1.4%	2.1%	2.5%	1.9%	1.7%
Growth in USA	-1.0%	0.3%	1.9%	3.1%	2.7%	2.1%	2.6%	2.6%	2.3%	1.9%

Source: Bureau of Labor Statistics

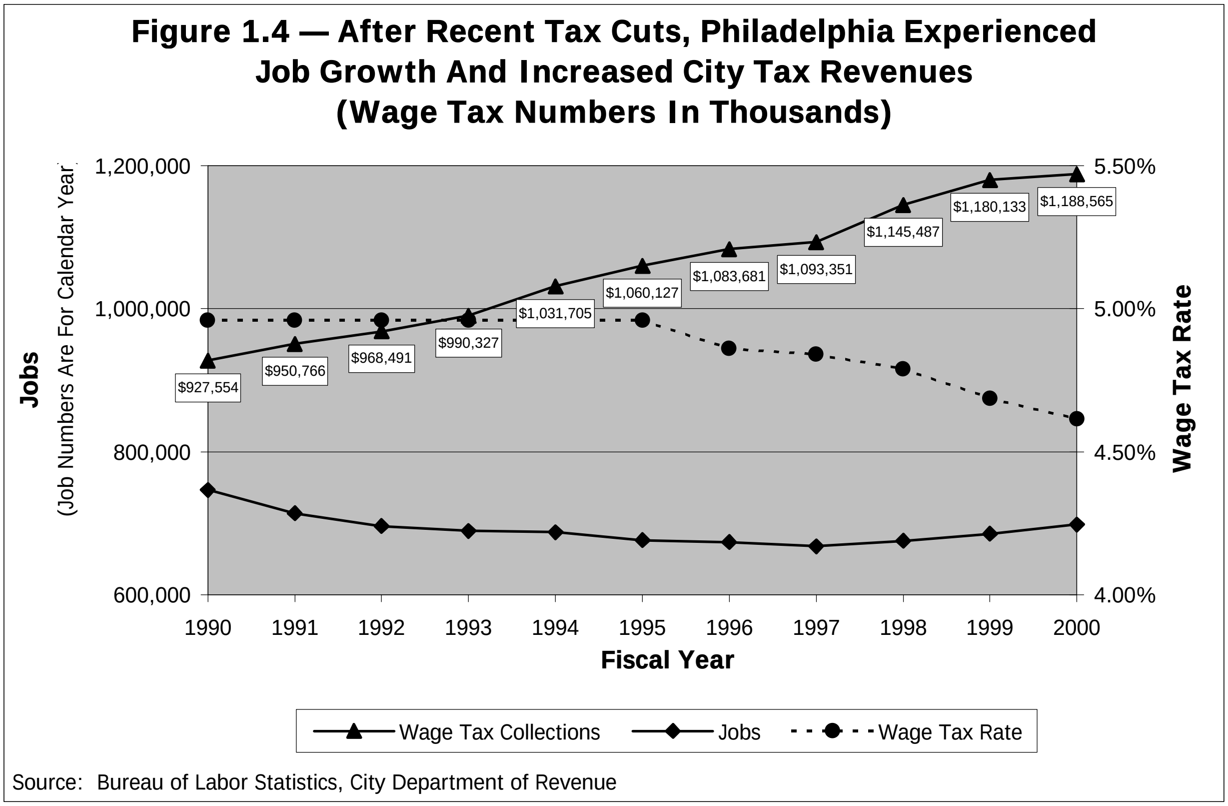
This downward cycle threatens the city's long-term fiscal stability. Every lost resident and job represents erosion of the tax base and creates pressure on the remaining residents and employers to continue to support the city's revenue demands. Those residents and employers that left Philadelphia departed for many reasons. Some were motivated by racial prejudice, forced by economic conditions, or encouraged by federal and state policy, but many left due to the direct action or inaction of Philadelphia's government. Racial prejudice motivated many former residents to move away from increasing minority populations, but government's inability to provide quality schools or fight the spread of crime encouraged them to settle in suburbia. Economic conditions forced employers to consider taking their jobs elsewhere, but the city's failure to capitalize on its competitive advantage and give employers an economic rationale to remain in Philadelphia made their relocation decisions easy. Federal and state policies created thousands of miles of expressways and mortgage-assistance programs, allowing former city residents to move out, but by raising taxes instead of better managing spending, local government helped chase them beyond the city limits.

The city government cannot directly alter federal policy or global economic trends to reverse the population and job loss of recent decades. But even in areas where the city can affect the location decisions of residents and employers, it will only have a limited ability to make large-scale change in the short run. Initiatives like creating an excellent school system, radically reducing crime, or dramatically improving the quality of life in city neighborhoods require considerable resources, substantial effort, and a significant amount of time to make a real impact.

There is, however, one area where limited action at the city level can have profound and far-reaching effects. Local legislative action can alter Philadelphia's tax structure to change *what* the city taxes and *how* the city taxes to improve its fundamental competitiveness and transform the city into a magnet for residents, businesses, and visitors. By altering tax rates, changing tax procedures, and reforming the overall tax structure, the City of Philadelphia's elected leadership can act in the very near term to dramatically improve the city's competitive position for the immediate and long-term future.

Changing The Tax Structure Can Make A Difference

One needs to look no further than the City of Philadelphia's experience in recent years to see evidence of a favorable response to a cut in taxes. Despite positive growth in the U.S. economy since 1992, and positive growth in the regional economy since 1993, it was not until after the city reduced taxes that it experienced job growth. In fiscal year 1996, the city began a series of cuts to the Wage Tax and the Gross Receipts portion of the Business Privilege Tax. Since that time, the Wage Tax has been reduced by a total of 8.5 percent and the Gross Receipts portion of the Business Privilege Tax has been reduced by 26.15 percent. According to the Bureau of Labor Statistics, employment in Philadelphia finally increased — after nine straight years of decline — between 1997 and 2000 by more than 30,000 jobs. More important, city tax revenue increased significantly even after the tax cuts. Despite the cut in the Wage Tax rate, total Wage Tax collections increased by 18.8 percent between fiscal year 1995 and fiscal year 2001 (an increase greater than the rate of inflation). Similarly, despite the fact that cuts in the Gross Receipts portion of the Business Privilege Tax represented a 10.7-percent cut to the overall Business Privilege Tax rate between fiscal year 1995 and fiscal year 2001, total Business Privilege Tax collections increased by 33.2 percent during the same period (also greater than the rate of inflation). (See Figure 1.4.)



Taxes in the City of Philadelphia are criticized for being high, confusing, and inequitable. The city's tax collection bureaucracy is criticized for collecting taxes in a manner that is lax, unfair, and unfriendly. Because issues surrounding taxation generate strong visceral responses, some of this criticism can be attributed to problems of perception or exaggeration. Unfortunately for the city, much of this condemnation is accurate. Taxes place Philadelphia at a competitive disadvantage in comparison with other cities and surrounding jurisdictions for residents and employers. Because the push of taxes and the tax structure is often more powerful than the pull of the city's natural attractiveness and lucrative marketplace, Philadelphia's tax structure blunts its advantages and chases firms and families beyond the city limits.

The imperative to address the tax system is compounded by likely trends for Philadelphia's future. If, in the future, Philadelphia is to experience continued population loss, particularly among wage earners, Wage Tax collections will suffer. If growth in the non-profit sector outpaces growth in other sectors, Real Estate Tax collections may fall since such institutions pay no Real Estate Taxes.

By definition, any tax-relief plan that does not compromise services has a positive effect since it represents an injection of money into the local economy. Put another way, reducing the cost of living and doing business while maintaining service levels should always generate a beneficial response. In response to a tax cut, all other things being equal, individuals should place more money into the economy by spending newfound tax savings. Businesses should similarly expand and re-spend newfound savings and profits, generating increased economic activity. Some, who may have otherwise moved away, would stay, and others, who may have otherwise stayed away, would relocate to the city. All of this increased economic activity should translate into increased tax income for the city so that a dollar of tax cut should equal less than a dollar of reduced revenue for the city.

In the past, most of the literature on firm location decisions showed that tax differentials were an insignificant variable in influencing business location to a particular region. However, once a business committed to a region, tax differentials played a vital role in the specific location decision within that region. Household location decisions were quite similar, since people have a propensity to follow jobs. More contemporary literature describes a stronger relationship between business location and inter-regional tax differentials. During the past two decades, profound technological changes have enhanced the geographic mobility of employers. This new flexibility has intensified interregional competition and placed a greater premium on savings from locating in lower-tax regions. Few businesses will move their entire operation in an effort to lower their tax liability, but when locating a new plant or branch, tax differentials are likely to become a more important factor.

Tax reduction is most effective when it is steep enough to influence household and business location decisions. In research conducted for the book Philadelphia: A New Urban Direction, (Saint Joseph's University Press, 1999) the City Controller's Office employed regression estimates to derive the relationship between effective tax rates and economic activity. When the economy is weak, any tax reduction will help stimulate growth and tax reduction in its own right is a very effective means of generating revenues, but when the economy is strong, tax reduction must also be steep to create a market response that will maintain revenue levels.

In its January 2001 *A Philadelphia Report Card*, the Federal Reserve Bank of Philadelphia suggested:

> "The city is near its peak of revenue-generating capacity — that is, raising taxes shrinks the city's economy and tax base so much that revenue will not rise significantly. On the positive side, this implies that while lowering taxes will reduce the city's tax revenues, it will *increase* economic activity in the city. Thus, in the long run, the annual revenue loss will be less than the initial loss in taxes."

This analysis suggests that, as the economy worsens, the ability of a given tax cut to stimulate growth increases and that while tax cuts must be robust to encourage growth during times of expansion, those tax cuts do not have to be as substantial to generate a response during times of slower growth or contraction. It follows that in good times, firms are not as worried about tax costs and not as responsive to the idea of relocation to minimize tax burdens. However, when conditions worsen and profits wane, firms would be more inclined to consider relocation as a way to reduce costs. One could then expect tax cuts to generate a more substantial supply-side response when economic conditions are less favorable and a less substantial supply-side response when the economy is performing well. A dollar's worth of tax cuts should generate very little revenue during peak economic conditions, but a more significant revenue return during periods of slow growth or decline. Thus, it could be that in declining economic conditions, the need to reduce taxes becomes more pronounced, as it can prevent high taxes from being a reason to relocate just as it could attract firms and families who are looking to save money by relocating to areas with low taxes.

Some may argue that by reducing government revenue, steep tax reductions could cause government to reduce services or the quality of service delivery. However, it is clear from numerous examples in the private sector, from model efforts of other governments, and even from noteworthy successes here in Philadelphia, that reduced costs do not have to mean reduced services or quality. Business and government consistently show that by using technology and by working with the labor force to achieve savings, it is possible to decrease costs while increasing overall productivity and quality. Setting aside the question of whether government can reduce costs while maintaining service delivery, it is possible to demonstrate that reducing taxes or altering the tax structure to encourage smart growth can have positive results that can help partially pay for tax reduction.

There is clearly a relationship between growth in the city economy and the need to fund services so reducing taxes could actually help reduce city service-related expenditures. If tax reduction and other economic development efforts are successful at stimulating the economy, there should be less of a need to subsidize businesses in an effort to compensate for the burden of the tax. Similarly, there is a close association between city spending and economic performance in other areas as well. For example, the Controller's Office found a positive relationship between city Fire Department expenditures and the local unemployment rate between fiscal years 1980 and 1997. This positive relationship is also consistent with the findings of a recent Controller's Office audit of the city's Fire Department, which presented evidence showing that there was a high correlation between the incidence of fire emergencies and the economic state of city neighborhoods. Economic growth, therefore, should reduce service costs to the city and enable the city to free increased resources that could be used to fund service expansion or further tax reductions.

The inverse relationship between city-agency expenditures and the city's economic performance shows that expenditures are directly related to the state of the economy. This should offer some evidence that steeper tax reduction, combined with other policies to promote growth, may not present a significant amount of risk to the city budget. Indeed, if city officials do not reduce taxes to be more in line with competing regions, the city will necessarily forego a substantial amount of revenue and incur additional costs associated with a weaker local economy.

One indication that a significant tax cut could generate a positive economic response is the success of Tax Increment Financing, Keystone Opportunity Zones, and tax abatements in attracting and retaining businesses. Even if one suggests that companies taking advantage of these tax breaks would have come to Philadelphia without these incentives or questions whether these incentives are offered at a higher level than needed, it is hard to argue that they have not generated a response from businesses. Perhaps this need for extraordinary measures to compensate for the disadvantages of the city's tax structure are the best argument that tax structure reform is sorely needed. Where the city's tax structure presents high costs, these incentives have eliminated the push of high taxes so the pull of the Philadelphia marketplace can bring in new employers. Tax Increment Financing has helped lure numerous hotel projects and hundreds of new hotel rooms. The tax advantages of locating in one of the city's Keystone Opportunity Zones have encouraged dozens of businesses to move to Philadelphia. Tax abatements such as the ten-year Real Estate Tax abatement for buildings that are converted from office and industrial uses into residences have enabled many exciting projects to move forward.

Perhaps the most visible example of how a change in tax policy has altered market conditions and encouraged growth, the residential-conversion tax abatement allows developers to freeze the amount of tax they pay for an industrial or commercial building (despite the fact that the conversion to residential use dramatically increases the value of the property). This freeze remains in place for ten years. By eliminating a major reason why such conversions would not move forward — the fact that increased taxes would make the project less desirable — the abatement has encouraged developers to build to meet increasing demand for apartment dwelling in Center City and surrounding neighborhoods. With their costs reduced, developers have found that projects that had previously been unfeasible have become attractive. Where few former industrial or commercial buildings were being converted to residences just a few years ago, now many exciting conversions are turning mostly empty spaces into vibrant homes that attract new city residents.

Initiatives such as those listed above have generated a response in specific, targeted areas, but most current or potential city taxpayers remain unaffected by the incentives. Some individual businesses or sectors of the local economy may see a benefit, but the vast majority of employers continue to be burdened by the city's high taxes. Tax incentives are the municipal equivalent of a retail sale. Often, when businesses have excess inventory or need to move product quickly to generate cash, they will have a sale to encourage shoppers to buy. Stores that enjoy robust and steady business generally do not have as many sales because they do not need to — their cash flow is strong and they have little difficulty selling their inventory. Unless the city significantly changes its tax structure, it will be forced to continue to offer these sales because many of its consumers refuse to pay full retail price.

2. Taxes In Theory — And In Practice

More than 200 years ago, Benjamin Franklin admonished that "in this world nothing is certain but death and taxes." As much as anyone might like to totally do away with the latter, it does appear as if Franklin is correct. In general, societies and jurisdictions tax themselves for two reasons, to alter behavior or to raise funds to pay for services that the private marketplace would not or cannot otherwise provide. Thus, a jurisdiction may raise a liquor tax to increase the price of alcohol and discourage drinking. Alternatively, a jurisdiction may levy a tax to fund fire-protection services if its residents will not or cannot privately fund efforts to prevent and extinguish fires. Questions of whether a jurisdiction should discourage a given activity, or whether a jurisdiction should provide a certain service, are likely to be answered within a political arena. Of course, the impact will always be reflected on employers' bottom lines and residents' wallets. If taxes are levied in an overly burdensome way, those taxes designed to raise revenue will certainly end up altering behavior — they will encourage residents and employers to flee.

Taxation Theory As Background

Government has a variety of tools at its disposal that can be used to generate policy responses. Those tools can be grouped into command and control approaches, including various laws, and rules designed to regulate the conduct of individuals, and fiscal approaches including decisions regarding how to tax and spend, which then generate market responses. Because questions about how to levy taxes will generate sweeping market responses and affect everyone who lives and does business in Philadelphia, decisions about what to tax and how to tax are crucial to the city's future.

While, in general, taxes are levied to generate revenues or change behavior, there are many different ways to levy those taxes. Questions of how to tax will become as important as or more important than questions of how much to tax when judging a given tax structure. Some taxes will be linked to the services those taxes help fund, as in the case of Philadelphia's Hotel Tax, which generates revenues to pay for the Convention Center and tourism-promotion activities. Other taxes will be levied on general activities to fund general services as in the case of Philadelphia's Business Privilege Tax on business activity that generates money to fund general government expenditures to support and improve the marketplace. Still other taxes will be levied on certain activities that are not at all connected to the ultimate expenditure of that tax revenue, as in the case of a Philadelphia's Liquor Sales Tax, which taxes liquor sold by the drink to help fund the School District of Philadelphia.

Even if the ultimate decisions surrounding taxation are political ones, sound theory can inform those political decisions. According to classical economic theory, the canons of taxation suggest that taxes should be:

- Fair — equals should pay equally according to benefits received,
- Certain — the time, manner, and amount of payment should be clear to payers,
- Convenient — the means and timing of payment must be convenient to payers, and
- Efficient — the cost of collection must be low relative to the yield.

All things being equal, two individuals who purchase the same item or earn the same salary should pay the same amount in taxes associated with those purchases or salaries. Those individuals should pay their taxes at a fixed time and with a fixed procedure so that they can make decisions based on how and when the tax is levied without surprises or ambiguity. The process for paying taxes should not be problematic for the taxpayer or overly costly for the taxing jurisdiction. Thus, a tax that must be paid in person in precious jewels in the middle of the night will make little sense as would a tax that costs more to collect than it brings in.

Taxes differ based on how they affect those taxed and can be categorized as regressive, proportional, or progressive. A *regressive* tax takes a larger percentage of the income of lower-income people than of higher-income people. In Philadelphia, the Amusement Tax could be considered a regressive tax since low- to moderate-income individuals pay a higher percentage of their income than high-income individuals to enjoy taxed events such as concerts and sporting events. A *proportional* tax is levied at a single flat percentage rate for all individuals regardless of how much or how little they earn. A proportional tax could have regressive effects because each dollar is more precious to a low-income family than a high-income family so a flat tax may exact a greater toll on low-income individuals. In Philadelphia, the city Wage Tax is a proportional tax levied at the same rate (although at a separate rate for residents and non-residents) for wage earners, regardless of how much income they receive. Finally, a *progressive* tax takes a higher percentage of income from high-income people than from low-income people. In other words, the more one earns, the higher percentage one pays. In the United States, the federal Income Tax is an example of a progressive tax because individuals who earn more money pay a higher percentage of their income than those who earn less money.

Additionally, taxes have a strategic element. All taxpayers do not have the same ability to avoid taxes by leaving a given jurisdiction. Depending on tax disparities in competitor locations, taxpayers may or may not be tempted to move. Therefore, decisions surrounding whom to tax can be influenced by how competitors tax as well as who must pay taxes. For example, there will be little strategic advantage to raising or lowering taxes if all competitor locations are raising or lowering their taxes at the same time. Conversely, there is a clear strategic disadvantage to raising taxes or maintaining high taxes when competitors have low taxes or are lowering their taxes. Considering the likelihood that taxpayers would move to a competitor location involves the amenity package offered by competing jurisdictions, but also involves those taxpayers' ability to move. Firms with large capital investments in a given area, firms that capitalize on their particular location, and firms that depend on a local resource will be less likely to leave than firms with no capital investments or no particular attachment to a location or local resource. So, all things being equal, a jurisdiction might have greater success taxing those firms that are more attached to that jurisdiction than firms that have greater mobility. Similarly, it may make more sense to tax individuals in the same manner because a tax that affects residents may drive individuals to move but a tax that affects visitors may not discourage tourists from visiting popular vacation spots. While such strategic elements are not necessarily fair or justified in a larger theoretical framework, they represent real factors that must be considered within a political environment.

Tax Theory Meets Tax Practice

It is possible to merge tax theory with tax practice to create a framework to evaluate the city's current mix of taxes and any future recommendations. Because taxation decisions will create winners and losers, theory can only provide ammunition for political debate. Elected officials will be mindful of how tax policy affects their core constituencies. Interest groups will lobby for changes that benefit their members. Immediate needs may crowd out considerations for long-term consequences. Party and personal politics will further complicate efforts to create alternative policies. Examining how tax theory meets tax practice can help set issues in context.

Government does not steal money from hard-working individuals and entrepreneurs through oppressive taxes. Government creates the conditions under which money can be made and establishes the infrastructure for wealth creation and protection. By establishing a system of laws and mechanisms to enforce agreements, government creates the foundation for exchanges of goods and services. By building the physical environment in roads, bridges, sewers, etc., government establishes nodes of commerce. By providing services to a given physical area, government creates a place where people choose to live and establish a marketplace where buying and selling can take place. If government and taxes are necessary to create and sustain the marketplace, then the question “Should the city tax?” must be answered affirmatively and the questions of “What should the city tax?” “How much should the city tax?” and “What level of service should the city return in exchange for those taxes?” become the important variables.

To answer the question, “What should the city tax?” one must consider the very nature of a city. To survive and thrive, cities must export goods and services and bring outside money into the city. A city that is inhabited only by businesses and employees that serve the other businesses and residents of the city will simply recirculate the same money around and around without allowing anyone to accumulate the wealth necessary to expand the local economy. Businesses that bring outside money into the city create a need for additional businesses that support the work of the first business. The firm that exports widgets to the global market brings money into the local economy and uses that money to pay widget-makers and purchase widget-making supplies. Widget-making-supply companies then emerge to meet the new demand, while grocery stores, furniture dealers, and clothing shops open to meet the needs of the widget-makers. If the firm serving local market demand goes out of business or leaves the city, another firm will take its place so long as that market demand remains, but if the firm that brings money into the city leaves the city, some of that market demand will disappear. Therefore, one way to answer to the question, “What should the city tax?” is that the city should avoid overtaxing firms that bring outside money into the local economy and focus on taxing firms that serve local market demand.

Similarly, as noted in the maxim, “if one wants less of something, one should tax it,” taxation discourages activities. If a city taxes sales, profits, or income, the action increases the cost of (respectively) goods, doing business, and employing individuals and — if those taxes are too burdensome — forces employers and individuals to consider choosing another jurisdiction in which to start a business or live. If one taxes businesses, businesses may leave. If one taxes people, people may leave. Thus, another answer to the question “What should the city tax?” is the city should avoid taxing that which is exceedingly mobile.

Considering the question of “How much should the city tax?” one must be wary of unfair comparisons. For example, if taxes represented the only factor driving location decisions, then firms and families would never consider moving to high-tax locations. Firms also look for access to markets, labor quality, natural resources, and a host of other factors when choosing locations. Families look for job opportunities, good schools, nice neighborhoods, and other amenities when making relocation decisions. Simple inertia keeps businesses and residents from moving as well. Therefore, the answer to “How much should the city tax?” does not have to be “less than any other locality” or even “less than most other cities” so long as a city is able to offer benefits — high-quality labor and municipal services, a thriving marketplace and good neighborhoods — to attract and retain employers and residents. Alternatively, the best way to answer the question “How much should the city tax?” could be to rephrase the question as, “How much does the city offer in return for the tax in relation to competitor cities and surrounding jurisdictions?” If the city is not able to offer firms and families as much as competitors, then it must offer lower taxes to compensate. If the city is able to offer more, then taxes may not discourage residents and employers from coming to and remaining in the city.

In roundtable discussions with local employers, Controller’s Office staff heard complaints about high taxes and also heard that the city does not offer enough in the way of services to justify such a high tax burden. With the recent proliferation of business improvement districts in Philadelphia, business owners have actually decided to effectively raise taxes on themselves to fund additional services. When businesses and residents wonder if they are getting worth for those high taxes, they may reconsider location decisions.

Perception becomes a significant factor when considering service-delivery efforts and the taxes that pay for them. In Philadelphia, despite the fact that the city has actually reduced taxes and improved services in recent years, residents and business owners (some of whom still complain about old tax rates without knowledge that they have been decreased) take issue with both subjects. If taxes are high, people expect excellent services. If those services are not excellent, people will complain about the amount of the taxes. In considering the question “What level of service should the city provide in exchange for those taxes?” one must be mindful of both reality and perception. If services are not superior, high taxes will cause people to dismiss the quality of services and criticize service efforts, and if services are poor, people will bemoan the fact that their taxes are too high.

3. Taxation In Philadelphia And The Framework For Change

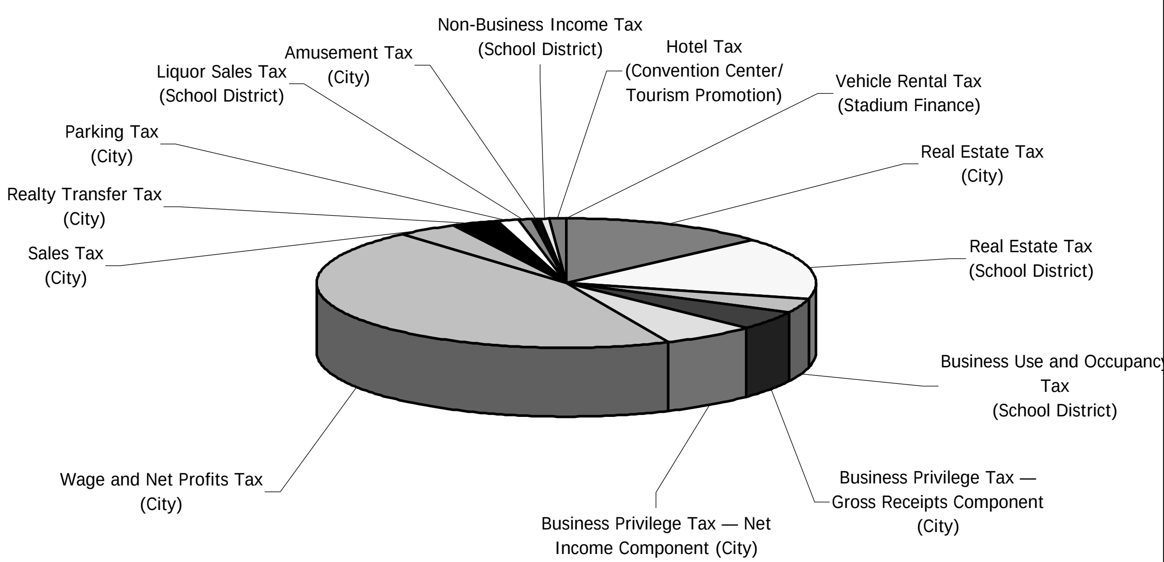
Local taxes in Philadelphia fund both city and school district operations. Certain taxes are dedicated to fund specific activities outside the general operations of the city and school district. These local taxes affect nearly everyone who lives, works, operates a business, owns property, or consumes goods and services within the City of Philadelphia. An examination of what the city taxes and how the city taxes helps illustrate how Philadelphia's tax structure places the city at a competitive disadvantage.

Significant City of Philadelphia Taxes

Locally generated taxes in Philadelphia currently produce more than $2.6 billion to help fund more than $4 billion in annual general and educational services. In fiscal year 2000 (July 1, 1999-June 30, 2000), the City of Philadelphia spent more than $2.7 billion dollars to meet general fund obligations. During the 1999-2000 school year, the School District of Philadelphia spent more than $1.4 billion dollars from the general fund portion of its operating budget. Locally generated taxes in Philadelphia raised more than $1.8 billion (approximately 67 percent of the city's general fund) to fund city operations and more than $551 million in locally generated tax revenues (approximately 39 percent of the district's general fund) to fund district operations. Additional local taxes levied pursuant to the legislation that helped the city extricate itself from its recent fiscal crisis raised $256.6 million, some of which went to pay off PICA bonds and the remainder was returned to the city as revenue. Other levies support the Pennsylvania Convention Center and the construction of a new ballpark and a new football stadium.

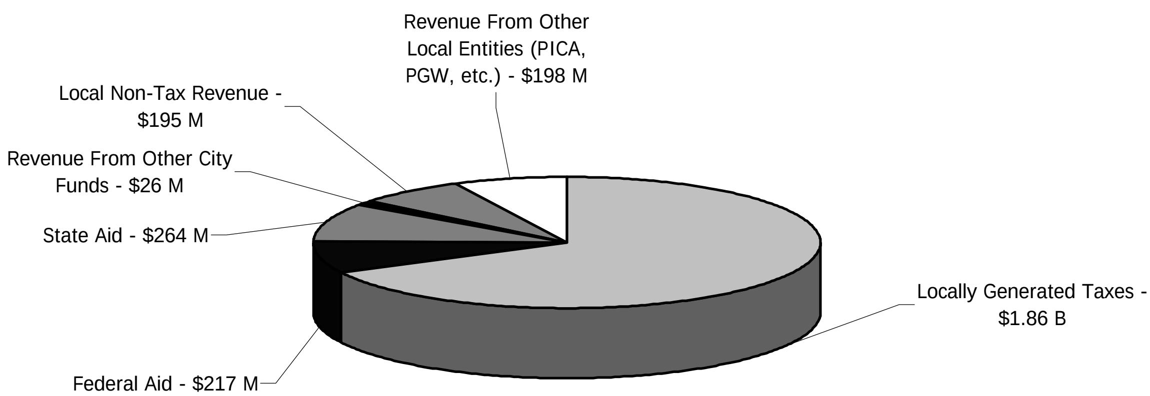
The figures below show estimated revenues and revenue sources for the city and school district. Taxes are first presented as a sum of all taxes from a taxpayer's perspective: what comes out of the collective taxpaying pocket. (See Figure 3.1.) Local taxes are then placed in the perspective of the city and school district budget. (See Figures 3.2 and 3.3.) Below the figures, each tax is discussed in more detail. Appendix C presents an outline of taxation in Philadelphia.

Figure 3.1 — A Variety Of Local Taxes In Philadelphia Combine To Generate More Than $2.6 Billion In Local Tax Revenues (FY 2000)



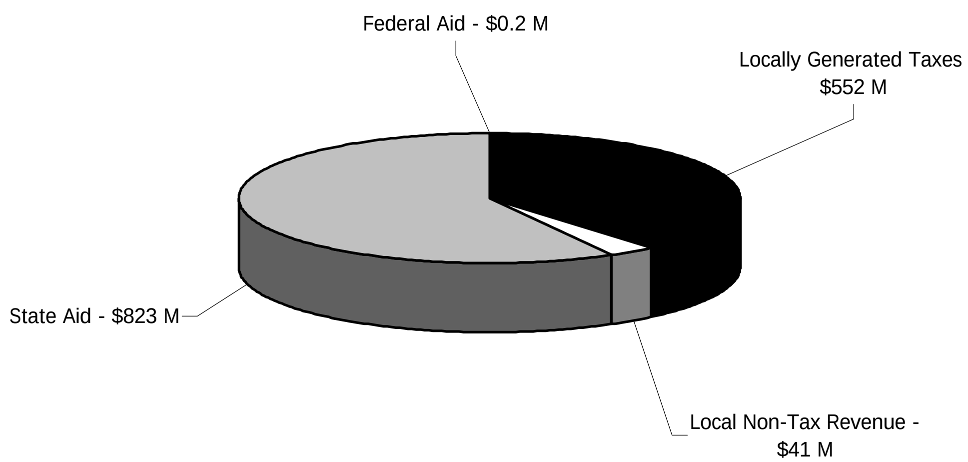
Source: City Controller's Office

Figure 3.2 — Locally Generated Taxes Comprise The Largest Portion Of The City Of Philadelphia's $2.76 Billion Fiscal Year 2000 General Fund



Source: City Controller's Office

Figure 3.3 — Locally Generated Taxes Comprise Less Than Half Of The School District Of Philadelphia's $1.4 Billion 1999-2000 General Fund



Source: City Controller's Office

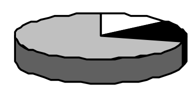
Taxes Based on Real Estate Assessments

Real Estate Tax (City and School)

Rate as of July 1, 2001 = 8.264 percent of assessed value of Philadelphia real estate

- City — $353.6 million in fiscal year 2000, 12.8 percent of city's fiscal year 2000 general fund (includes $8 million in proceeds from June 1997 Tax Lien Sale)
- School District — $414.8 million in school year 1999-2000, 30.6 percent of the general fund portion of the School District's school year 1999-2000 operating budget

Real Estate Tax As a Percentage of All Locally Generated Taxes In Philadelphia (FY 2000)



Source: City Controller's Office

The Real Estate Tax is levied on the assessed value (typically 32 percent of fair market value) as certified by the city's Board of Revision of Taxes. The city rate of taxation is 37.45 mills[1] on assessed value. For the school district, the tax on real estate is currently 45.19 mills on assessed value. The total rate of taxation, including both the city and school district portions of the Real Estate Tax is 82.64 mills on assessed value with the larger share (approximately 55 percent of proceeds) going to the school district.

<u>*Notable from a taxpayer's perspective*</u> — Approximately 25 percent of the 135 square miles of land in the City of Philadelphia is tax exempt, including parkland, government facilities (including property of the city, state, and federal governments; school district; and quasi-governmental agencies), and other tax-exempt owners such as religious institutions, colleges, universities, and hospitals. If aggregated in one concentrated area, this land would represent all of Philadelphia west of the Schuylkill River. However, properties owned by tax-exempt entities do pay Real Estate Taxes on the portion of the their properties occupied by for-profit operations. For example, a university must pay Real Estate Taxes on the portion of a university building leased by a fast-foot restaurant.

In Philadelphia, approximately 54 percent of Real Estate Tax revenue is generated from residential property, while approximately 23 percent of revenue comes from commercial property and approximately 15 percent comes from hotels and apartments. Breaking that amount down geographically, approximately 23 percent of Real Estate Tax revenue in Philadelphia is generated by Center City properties. (See Tables 3.1 and 3.2.)

Table 3.1 — Philadelphia Real Estate Tax Assessments By Building Type (FY 2000)

Building Type	Total Taxable Assessments	Percentage of Assessments
Commercial	$2,191,001,393	23%
Hotels & Apartments	$1,378,580,782	15%
Industrial	$447,535,401	5%
Residential	$5,039,654,630	54%
Store w/ Dwelling	$214,902,488	2%
Vacant Land	$84,228,415	1%
Total	**$9,355,903,109**	**100%**

Source: Board of Revision of Taxes

[1] One mill is equal to 0.1 percent or one over one thousand.

Table 3.2 — Philadelphia Real Estate Tax Assessments By City Planning Commission Planning District (FY 2000)		
Building Location	**Total Taxable Assessments**	**Percentage of Assessments**
Center City	$2,174,605,471	23%
Upper North Philadelphia	$195,198,558	2%
Lower North Philadelphia	$427,353,265	5%
Olney-Oak Lane	$615,143,502	7%
Near Northeast Philadelphia	$1,432,490,949	15%
Far Northeast Philadelphia	$1,311,525,482	14%
Bridesburg Kensington Port Richmond	$373,673,971	4%
Roxborough Manayunk	$353,160,592	4%
Germantown Chestnut Hill	$635,166,990	7%
South Philadelphia	$767,217,816	8%
Southwest Philadelphia	$306,087,391	3%
West Philadelphia	$760,363,826	8%
Undesignated	$3,915,296	0%
Total	**$9,355,903,109**	**100%**
Source: Board of Revision of Taxes		

The Commonwealth of Pennsylvania's Constitution allows for localities including Philadelphia to grant Real Estate Tax exemptions and rebates to elderly, poor, and infirm taxpayers. In Philadelphia, the Senior Citizen Low Income Special Tax Provisions (or Senior Citizen Tax Freeze) permits seniors who meet income eligibility under Pennsylvania's Pharmaceutical Assistance Contract for the Elderly (PACE) program to freeze their Real Estate Tax assessments so that they are not affected by increases in assessments. To be eligible, a taxpayer must be over 65 years of age or be the spouse or widow/er of such a person and must earn less than $14,000 per year if single and less than $17,200 per year if married. According to the Revenue Department, more than 10,800 senior citizens currently benefit from this freeze and their total tax credit equals more than $593,000.

In general, mortgage-debt institutions escrow Real Estate Tax payments for mortgagees. Most taxpayers with mortgages never actually write a check to pay this tax. The Real Estate Tax is paid as a lump sum, due by March 31st each year.

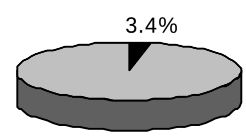
❖

Business Use and Occupancy Tax

Rate as of July 1, 2001 = 4.62 percent of assessed value of Philadelphia real estate

- School District — $90.6 million in school year 1999-00, 6.4 percent of the general fund portion of the School District's school year 1999-2000 operating budget

Business Use & Occupancy Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

Originally authorized in 1970, this tax is levied on the use or occupancy of real estate within Philadelphia for the purpose of conducting any business, trade, occupation, profession, vocation, or any other commercial or industrial activity.

Notable from a taxpayer's perspective — The tax is paid by landlords who rent their properties to business owners. This tax is based upon the assessed value of the property. There are two ways to reduce the maximum tax due on a property. The landlord may take a reduction for vacant floors or vacant or empty parts of the building. Alternatively, if a part of the building is rented as living space, then no Use and Occupancy Tax is due on that portion of the building. Major corporations or developers who rent their entire building as office space have a tax due on the entire assessed value of the building. Legally, the landlord can pass this tax off to the tenant.

This tax is not paid by non-profit entities, but if a non-profit organization owns a building and uses three of the four floors for its own purpose but rents the other floor to a for-profit entity then a Use and Occupancy Tax payment is due on one-fourth of the building.

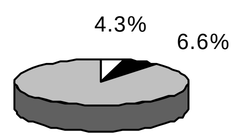
Taxes Based On Business Activity

Business Privilege Tax
(City Gross Receipts and Net Income Components)

Rate as of July 1, 2001 = .24 percent of gross receipts and 6.5 percent of net income of businesses conducting commercial activity in Philadelphia

- City — $289.1 million (approximately 60 percent from the Net Income Component) in fiscal year 2000, 10.7 percent of city's fiscal year 2000 general fund

Business Privilege Tax As a Percentage of All Locally Generated Taxes In Philadelphia (FY 2000)



Source: City Controller's Office

The Business Privilege Tax has two components: gross receipts and net income. The first is levied on gross receipts of businesses conducting for profit any trade, business, profession, vocation, or commercial activity in Philadelphia. In fiscal year 1995, the Gross Receipts portion was .3250 percent, but it has been reduced in each of the fiscal years from 1996 to 2001. By fiscal year 2002, the Gross Receipts portion had been reduced by more than 26 percent to .24 percent.

The second component is a tax levied on net income of the same business activity. In order to mitigate potential double taxation of non-corporate net income under both the Net Income component of this tax and the Net Profits Tax (discussed below), 60 percent of the Net Income component of the Business Privilege Tax is deductible from the Net Profits Tax.

Notable from a taxpayer's perspective — The Business Privilege Tax (BPT) is essentially paid in advance. Unlike most taxes where taxpayers pay their liability based on last year's activities, for the BPT, taxpayers pay their liability for the current year's activities. While the BPT is levied on an annual basis, because a business pays the BPT a year in advance — that is, a 2001 BPT return based on 2000 calendar year activity instead of a 2000 return based on 2000 calendar year — in the second year of operation, a business must pay two years of BPT taxes. The logic is that this double-payment should be postponed to the second year to avoid overburdening businesses in their first year of operations. As a result, when a firm goes out of business, there is no BPT due for that year (their last year of operations). If the firm goes out of business before the calendar year is completed, it may be entitled to a refund of part of the advance payment. Because the city receives its double-payment in the second year of operations, but foregoes a payment in the final year of business, the city could be losing tax revenues in the long run. The city loses tax revenue when businesses locate beyond the city limits since they are probably more profitable the year they leave than they were in their second year of operations. Additionally, the city loses potential revenues since it foregoes the ability to tax asset sales associated with firms that are going out of business or leaving the city.

All businesses located in or doing business in the City of Philadelphia are subject to the BPT. However, there are some basic differences among the various entities. Corporations pay the Gross Receipts and the Net Income portions of the BPT. Sole Proprietorships and Partnerships pay an additional tier of taxes, the Net Profits Tax. Not-for or non-profit organizations do not pay the BPT tax or the Net Profits Tax whether incorporated or not. Any business engaged in a port-related activity is exempt from payment of the BPT. Public utilities and insurance companies are also exempt from the BPT. Information technology companies are exempted from paying taxes on their gross receipts from tax year 2001 through tax year 2006.

Manufacturers, wholesalers, and retailers may utilize an alternate method to compute their gross receipts liability, which allows them to substitute a higher tax on sales in lieu of the tax on gross receipts. However, most businesses simply pay the tax on gross receipts in the conventional manner.

As of July 1, 2001, taxable businesses pay BPT at the rate of .24 percent on their gross receipts and 6.5 percent on net profits. Corporations, as well as sole proprietors and partnerships, all pay the BPT. In addition, sole proprietors and partnerships pay an additional 4.5385 percent, a rate equal to the Wage Tax, on net profits. However, these entities may take a 60-percent credit of their BPT Net Income portion against this additional tier of taxes. Despite this credit, because they are subject to both the Business Privilege and the Net Profits Taxes, sole proprietors and partnerships pay a higher business tax burden than their corporate competitors.

The city considers most landlords to be in the rental property business. As a result, all landlords are subject to the BPT and, if not incorporated, the Net Profits Tax. However, if the landlord owns a duplex and lives in one apartment and rents the other, no BPT or Net Profits Tax is due, but he or she would pay School Income Tax on the rental income. If the landlord owns a triplex and lives in one unit and rents the other two units, the rental income is subject to the BPT. If the landlord owns a single-family dwelling and rents it out, BPT is due.

Entities that are not located within the city may apportion their gross receipts and net profits between earned within the city and earned outside the city, thus reducing their total BPT tax burden. For the Gross Receipts portion, entities simply pay BPT based on the percentage of receipts generated within the city. The city uses multiple weighting factors to determine tax liability for the Net Income portion of the BPT based on the percentage of a firm's Philadelphia property, payroll, and receipts (which are double-counted).

The BPT is criticized for being overly complex and confusing. The apportionment schedule (discussed below) is difficult to understand. As a prospective tax, the BPT confuses many taxpayers and preparers who are used to filing taxes for past activities instead of current or future activities. For instance, the BPT form asks businesses for information from business conducted during the first calendar year in business and the first 12 months of operations. In many cases the accountants use the same amounts for both, but some actually try to figure this out and usually don't get it right. (The probability that data will overlap causes most to just use the same numbers twice.)

The Gross Receipts component is also criticized for being unfair because a business that doesn't make any profit still must pay a tax based on gross sales. This tax is not unique to Philadelphia. In fact, some other jurisdictions levy the tax on all gross receipts. The City of Philadelphia only levies the tax on sales considered generated within the city and not on sales considered generated outside the city. Therefore, a Philadelphia candlestick-maker must pay the tax on receipts from an over-the-counter sale, but does not pay the tax on a sale shipped overseas.

While some may criticize the tax, it may not be as burdensome as some believe. The BPT payment can be taken as a Schedule C deduction on a self-employed taxpayer's federal returns. Similarly, BPT payments can be claimed as deductions by corporations on both state and federal annual tax returns.

Obtaining a business-privilege license is a two-step process. A new business owner can download the forms to apply for the business-privilege license but cannot apply on-line. They must complete the form and then mail it in along with a check for $200. Applications are not accepted on-line because the city does not yet accept credit card payments. When a taxpayer appears in person for his or her license, the taxpayer must fill out the application and be interviewed by a Revenue Department customer service representative who will assign a revenue account number. The taxpayer then must wait in line again at the License and Inspection counter to obtain their license, which has a different number than the revenue account.

The BPT must be paid on an annual basis, by April 15th of each year.

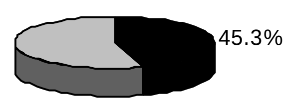
Taxes Based On Wages and Earnings

City Wage and Net Profits Tax

Rate as of July 1, 2001 = 4.5385 percent of Philadelphia residents' wages and net profits; 3.9462 percent of the wages and net profits of non-residents who earn wages or profits in Philadelphia

- City — $1.2 billion in fiscal year 2000 ($1.2 billion on wages, $20 million on net profits — $778 million from residents and $466 million from non-residents), 45.0 percent of city's fiscal year 2000 general fund

City Wage/Net Profits Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

Originally authorized as a short-term measure in 1932 and first imposed in 1939, this tax is still levied on salaries, wages, commissions, and other compensation earned by residents of Philadelphia; on salaries, wages, commissions, and other compensation earned by non-residents of Philadelphia for work done or services performed or rendered in Philadelphia; on net profits attributable to business conducted in the City of Philadelphia; and on net profits earned by Philadelphia residents for business conducted in or outside Philadelphia. (Persons and entities subject to the Net Profits Tax are entitled to deduct 60 percent of their Net Income portion of the Business Privilege Tax from their Net Profits Tax). In fiscal year 1995, the Wage Tax was 4.96 percent for residents and 4.3125 percent for non-residents, but the tax has been reduced in each of the fiscal years from 1996 to 2001. By fiscal year 2002, the tax had been reduced by 8.5 percent to 4.5385 percent for residents and 3.9462 percent for non-residents.

A portion of the Wage Tax and Net Profits Tax is collected directly by PICA to repay debt incurred on behalf of the city during the city's early 1990s fiscal crisis. Specifically, PICA collects a 1.5-percent tax on the wages and net profits of Philadelphia residents (this is a portion of — not an addition to — the city's tax) for the purposes of servicing the debt. However, PICA's collection has regularly exceeded the debt repayment obligation and, as a result, the excess has been refunded to the city's general fund annually as "revenue from other governments." In fiscal year 2000, PICA's collected portion totaled $247 million in Wage Tax and $9 million in Net Profits Tax (PICA kept $98 million for debt service and returned $158 million to the city).

<u>*Notable from a taxpayer's perspective*</u> — Possibly the most vilified of all Philadelphia's taxes, the Wage Tax is definitely burdensome, but it also suffers from misperception. Despite the fact that the tax has been decreased in recent years, because the individual tax cuts that have contributed to a total 8.5-percent cut have been marginal, many taxpayers have not noticed that the tax has been lowered. Some still associate the tax with its highest rate. Because the impact of the city's actual cutting of this tax has worn off, any future changes would have to be significant indeed to make employers and wage earners take notice.

Another perception problem dogs this tax: employees and employers both claim that they pay the tax. Employees complain that the tax takes a significant percentage of their wages while employers claim that, because of the tax, they must increase salaries to offset the tax if they are to be able to attract workers.

While the tax is definitely burdensome, individuals may actually believe that the Wage Tax takes a bigger bite out of disposable income than it does. If taxpayers itemize their deductions on their federal tax returns, they are able to deduct state and local income taxes. New Jersey residents employed in Philadelphia can take a credit on their state income tax return for Wage Taxes paid to Philadelphia.

Non-residents whose principal place of work is in the city pay the non-resident rate. If a non-resident individual works at any time outside the city, even though their main office is in the city, he or she is not subject to the Wage Tax for that amount of time. If the tax is withheld, that individual may petition for a refund of Wage Tax withheld for the time they worked outside the city.

Since September 2000, stock options that are received as compensation but do not have a readily ascertainable value on the date they are granted are exempted from the tax on wages. This exemption was created to retain and attract emerging firms that may offer significant stock options instead of increased salaries. Because these stock options have no real value at the time of issuance but could become valuable depending on a company's success, critics contended that growing firms were not able to attract top talent because their stock options would be subject to the Wage Tax. The federal and state governments still tax these stock options.

Professional athletes are subject to the tax on wages, but they pay Wage Taxes only on what the city has labeled duty days. For most athletes on the Philadelphia teams, duty days are game days and practice time. The city collects Wage Taxes based on a derived formula for visiting players.

Unincorporated businesses including sole proprietorships and partnerships doing business in Philadelphia are subject to the Net Profits Tax. But there is a second level to the Net Profits Tax. Net profits include income from rentals and the sale of rental properties. The full amount of the gain or profit from the sale of this real estate is taxable. If a Philadelphia resident owns a rental property even if the property is outside the city limits, the net rent or net profit from the rental activity is subject to the Net Profits Tax.

In Pennsylvania, by law most employees' Wage Tax is automatically deducted from their paychecks and submitted to the City of Philadelphia by their employers. However, in violation of the law, some suburban Pennsylvania employers are not withholding Philadelphia residents' city Wage Taxes. In addition, city residents who work outside the Commonwealth of Pennsylvania may not have Wage Tax deducted. In both cases, resident taxpayers must register for an Earnings Tax Account and file a Wage Tax return on their own behalf.

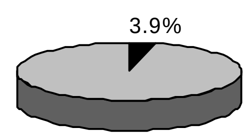
Other Taxes

City Sales Tax

Rate as of July 1, 2001 = 1.0 percent of applicable purchases made in Philadelphia or by Philadelphians

- City — $103.7 million in fiscal year 2000, 3.8 percent of city's fiscal year 2000 general fund

Sales Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

Originally authorized in 1991, this tax is levied on the sale at retail of tangible personal property or services (clothing, non-takeout food, medicines, and certain other items are exempted). The current rate of taxation is 1.0 percent of the retail purchase price on top of a 6.0-percent state Sales Tax. Unlike most city taxes, which are paid directly to the city, this tax is collected by the vendor from the purchaser and paid to the Commonwealth of Pennsylvania. The Commonwealth of Pennsylvania then remits the city's portion to the city.

Notable from a taxpayer's perspective — For purposes of this tax, sales are deemed consummated at the place of business of the retailer, and therefore taxed if consummated in Philadelphia, unless the purchases are shipped outside of Pennsylvania. If the retailer has additional places of business within Pennsylvania, the purchase is deemed consummated where the initial order is taken. Sales of any Philadelphia firm that are shipped to a location within Pennsylvania are subject to the tax even if the order is forwarded to an alternate location for shipping or billing. The city is prohibited from collecting Sales Tax on concrete and asphalt that is sold in Philadelphia but delivered outside the city.

In the case of purchases of vehicles, aircraft, or motorcraft, the purchase is considered consummated at the purchaser's address. Thus, a Philadelphia resident must pay the additional 1.0-percent tax when purchasing a vehicle, aircraft, or motorcraft outside of Philadelphia, while a non-Philadelphia resident purchasing a vehicle, aircraft, or motorcraft in Philadelphia does not pay the additional 1.0-percent tax.

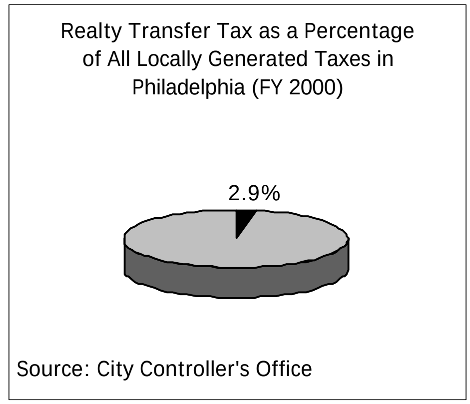
For utility sales, purchases are taxed based on where the utility meter or telephone connection is located.

❖

City Realty Transfer Tax

Rate as of July 1, 2001 = 3.0 percent of the value of real estate sold in Philadelphia

- City — $77.7 million in fiscal year 2000, 2.8 percent of city's fiscal year 2000 general fund



This tax is levied on the value of real estate sold in Philadelphia. The current rate of taxation is 3.0 percent on top of a 1.0-percent state Realty Transfer Tax.

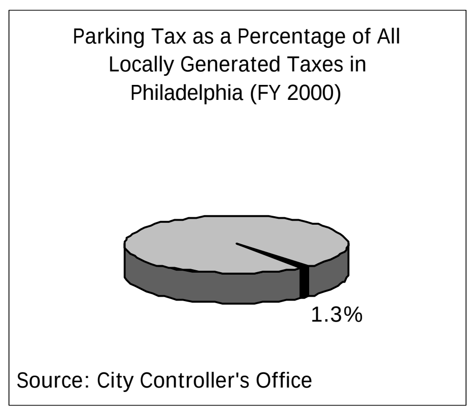
Notable from a taxpayer's perspective — The city's portion of the Realty Transfer Tax is paid when the deed is filed with the city's Records Department. Mechanically, the title company that is responsible for the transfer of ownership and recording of the transaction is responsible for submitting payment for the Realty Transfer Tax. For most residential sales, the tax is split by gentlemen's agreement between the seller and buyer. In most cases, the transfer of real estate between family members and property received as per a will are exempt from taxation.

❖

City Parking Tax

Rate as of July 1, 2001 = 15.0 percent of the amount charged for parking in Philadelphia

- City — $34.1 million in fiscal year 2000, 1.2 percent of city's fiscal year 2000 general fund



This tax is levied on every individual parking or storing a motor vehicle in or on any parking facility in the city of Philadelphia.

Notable from a taxpayer's perspective — Parking facility operators are responsible for collecting and paying the tax to the city. No parking taxes are due in cases where a tenant or owner is entitled to parking privileges as part of a lease or ownership of a living facility where no additional consideration is paid for the parking privilege.

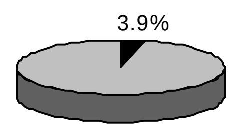
❖

Liquor Sales Tax

Rate as of July 1, 2001 = 10.0 percent of the retail sale price of alcoholic beverages in Philadelphia

- School District — $25.0 million in school year 1999-00, 1.8 percent of the general fund portion of the School District's school year 1999-2000 operating budget

Sales Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

Originally authorized in 1995, this tax is levied on the retail sale of liquor, malt, and brewed beverages.

Notable from a taxpayer's perspective — Because this tax is largely self-assessed, owners of establishments selling liquor have to calculate what is owed. Since smaller bars and restaurants have limited capacity to be precise about the amount of taxes owed, owners or managers have to count the number and cost of drinks to arrive at a gross sales number to derive their tax obligation. This tax is a monthly tax but tax filers are required to provide an additional quarterly reconciliation.

There are approximately 2,200 liquor licenses in Philadelphia but, invariably, monthly collections reflect between 1,300 and 1,500 returns received by the city. It is possible that some of the 2,200 licenses are not currently active which would preclude that entity from filing a monthly return. Sales by Pennsylvania Liquor Stores and malt beverage distributors are excluded from the tax.

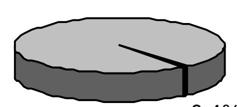
❖

City Amusement Tax

Rate as of July 1, 2001 = 5.0 percent of the price of applicable event admission in Philadelphia

- City — $11.7 million in fiscal year 2000, 0.4 percent of city's fiscal year 2000 general fund

Amusement Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

This tax is levied on the admission charges to concerts, movies, performances, sporting events, and nightclubs. Legitimate theater shows — defined as presentations of traditional forms of drama, comedy, musical comedy, tragedy, repertoire works, dramatic recitation of recognized works of literary art of the kind and in the nature normally associated with traditional and contemporary American theater — are exempted from the Amusement Tax.

Notable from a taxpayer's perspective — The operator or provider of any amusement is responsible for collecting and remitting the tax on a monthly basis.

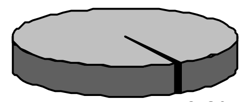
❖

School (Non-Business) Income Tax

Rate as of July 1, 2001 = 4.5385 of non-business income of Philadelphia residents

- School District — $21.5 million in school year 1999-00, 1.5 percent of the general fund portion of the School District's school year 1999-2000 operating budget

School Income Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

Originally authorized in 1967, this tax is levied on the non-business income of Philadelphia residents. The tax is applied to income such as dividends or interest on securities. By law, the tax rate cannot be higher than the Wage Tax rate.

<u>*Notable from a taxpayer's perspective*</u> — In addition to other non-business income, this tax is due on all dividends, royalties, prizes and awards, rents received from an owner-occupied duplexes (larger facilities such as owner-occupied triplexes are subject to the BPT), and interest received from institutions other than banking institutions. Taxpayers can reduce the amount of tax owed by subtracting the investment expenses from the total dividends received. Interest on bonds issued by the Commonwealth of Pennsylvania or its political subdivisions or the Federal Government are exempt from the tax.

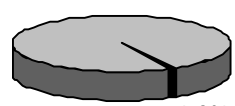
Additional Taxes For Special Purposes

Hotel Tax

Rate as of July 1, 2001 = 7.0 percent of the cost of the rental of hotel rooms in Philadelphia

- City — $25.9 million in fiscal year 2000, would equal about 0.9 percent of city's fiscal year 2000 general fund but is paid into a special fund for spending related to the Convention Center and tourism promotion

Hotel Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

This tax is levied on the rental of hotel rooms in the city. The current rate is 7.0 percent of the cost to rent a hotel room on top of a 6.0-percent state hotel tax and a 1.0-percent Hotel Occupancy Tax imposed by the city (analogous to the 1.0-percent increase in the city Sales Tax). The city rate comprises a 6.0-percent tax to support debt service related to the Pennsylvania Convention Center and a 1.0-percent tax to support tourism and marketing spending.

<u>*Notable from a taxpayer's perspective*</u> — Occupants of hotel rooms pay this tax to the hotel operator. The tax is paid to the city by the hotel operator on a monthly basis.

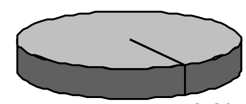
❖

Vehicle Rental Tax

Rate as of July 1, 2001 = 2.0 percent of the cost of vehicle rental in Philadelphia

- City — $0 million in fiscal year 2000, would equal 0.0 percent of city's fiscal year 2000 general fund (the tax, enacted in 2000, will be paid into a special fund for capital — new-stadium-related — spending)

Vehicle Rental Tax as a Percentage of All Locally Generated Taxes in Philadelphia (FY 2000)



Source: City Controller's Office

This tax, levied on rental of vehicles in Philadelphia, went into effect in July 2000 and generated approximately $3.75 million in fiscal year 2001.

<u>*Notable from a taxpayer's perspective*</u> — This tax is applied whenever a renter takes possession of rental vehicle in Philadelphia. The tax is collected by rental companies and paid to the city on a monthly basis.

City Tax-Related Exceptions

Residents and employers located within certain geographic areas or meeting certain conditions may have higher or lower tax burdens. The following cases represent some taxation exemptions in Philadelphia.

Tax Increment Financing

Pursuant to state legislation, the city has the authority to designate defined portions of Philadelphia as Tax Increment Financing (TIF) districts. Projects within such districts may be financed with bonds or notes that are repaid using the increased tax revenues resulting from enhanced property values and business activity within the district. Essentially, Tax Increment Financing freezes the taxes (usually Real Estate Taxes) owed[2] to the city by property owners for up to 20 years, during which the city collects all other applicable taxes at their full rate.

Tax Abatements

Pursuant to state legislation, the city has enacted several ordinances that, subject to certain conditions and limitations, exempt selected properties from Real Estate Tax assessments or increases in those assessments. For new residential construction, property owners who apply and qualify pay no Real Estate Taxes for ten years from the date the certificate of occupancy is issued. For improvements to residential properties, property owners who apply and qualify pay no increase in Real Estate Taxes on those improvements for ten years from the first year in which the improvements would otherwise be taxable. For repair, construction, or reconstruction of deteriorated industrial, commercial, or other business properties, property owners who apply and qualify pay no increase in Real Estate Taxes on those improvements for ten years from the date the certificate of occupancy is issued. For improvements to convert deteriorated industrial, commercial, or other business properties to residential properties, property owners who apply and qualify pay no increase in Real Estate Taxes on the improvements for ten years from the date the certificate of occupancy is issued.

[2] The abatement is typically granted for capital improvements to a property, but generally does not extend to any increase in the value of the land.

Keystone Opportunity Zones

Pursuant to state legislation, certain areas in Philadelphia have been designated as Keystone Opportunity Zones (KOZ) or Keystone Opportunity Expansion Zones (KOEZ). These KOZs (1,503 acres in Philadelphia) and KOEZs (1,146 acres) are designated areas throughout the city. Companies that move to one of the zones and either increase full-time employment by at least 20 percent in the first year of operation in the zone, or make a capital investment in the property located within a zone equivalent to 10.0 percent of the gross revenues for that business in the preceding year pay virtually no city or state business taxes until 2011 for KOZs, 2013 for KOEZs. Specifically, qualified companies moving into KOZs or KOEZs pay no:

- Pennsylvania Taxes: Sales & Use Tax, Personal Income Tax, Corporate Net Income Taxes, Capital Stock & Foreign Franchise Tax;
- Philadelphia Taxes: Real Estate Tax, Use and Occupancy Tax, Business Privilege Tax, Net Profits Tax, or Sales Tax.

Business Improvement Districts

The city has created Special Services Districts or Business Improvement Districts (BIDs) — independent municipal authorities created pursuant to state law and authorized by local government — throughout Philadelphia. The BIDs are commercial areas in which businesses may be subject to an additional charge to fund expanded service within the district. If property owners within a duly constituted district choose to do so, they may approve a supplementary assessment to fund service delivery, which is paid directly to the BID.

4. Problems With Taxation In Philadelphia — In Theory And Practice

If, according to economic theory, taxes should be fair, certain, convenient, and efficient, and if, strategically, taxation decisions should take into account competitors' tax rates and taxpayer mobility issues, taxation in Philadelphia clearly does not fit an ideal model. In many cases, it is not clear at all that equals are paying taxes equally. Confusing and confounding aspects of the tax system make city taxes uncertain, inconvenient, and inefficient. It is objectively clear that Philadelphia's taxes are high compared to competitors, including other large cities and surrounding jurisdictions. The heavy burden imposed by taxes, the frustrating nature of those taxes, and the city's particular mix of taxes combine to hamper efforts to attract and retain residents and businesses.

Philadelphia Taxes Are Too High

Despite an increase in city employment in recent years, Philadelphia's economic growth still lags behind growth in competitor locations and the nation as a whole — a signal that efforts to improve the city's competitive position and reduce the local tax burden must be increased. Placing Philadelphia's tax structure in some perspective can help illustrate how the tax structure contributes to an inhospitable environment for businesses and residents.

Any effort to make rational comparisons between tax systems in different locations will be less than satisfactory because taxes differ from city to city and from jurisdiction to jurisdiction. This is only logical. Location influences taxation decisions and, therefore, localities with significant natural resources may tax those that capitalize on those resources and tourist destinations will be able to tax visitors more than other destinations. Similarly, location will also influence demand for taxes as colder jurisdictions will require costly snow-removal services that are unnecessary in other cities, and cities where wages or utility costs tend to be higher will have to spend more to provide the same services that cost less in other cities. Historical choices will also play a role in determining elements of the tax structure as well as the demand for taxes. As change tends to be incremental, taxation decisions of a century ago may continue to influence today's tax policy just as yesterday's decisions to provide certain municipal services or contract-out services will influence today's spending priorities. Finally, because different cities and jurisdictions exist within different states, it is clear that differences from state to state will influence local taxation decisions. Thus, legal constraints may inhibit one city in one state, but not other cities in other states, and a more generous state may provide more funds to a given city than another state, alleviating the need for taxes. While comparisons are, therefore, instructive but limited in their general usefulness, the following paragraphs, charts, and tables do not paint a pretty picture for Philadelphia.

Philadelphia presents high tax rates compared to competitor cities. It is one of only a handful of jurisdictions that taxes business receipts. (See Table 4.1.) Only businesses in New York City face higher income taxes than businesses in Philadelphia. (See Table 4.2.) While Philadelphia's business income tax rate is clearly higher than rates in competitor cities, it is interesting to note that the Commonwealth of Pennsylvania's 9.99-percent Corporate Net Income Tax significantly increases business tax burdens for city firms. Similarly, considering taxes on sales (See Table 4.3.), it is the Commonwealth of Pennsylvania's 6.0-percent tax that is onerous while the city's 1.0-percent tax helps keep Philadelphia's total Sales Tax burden lower than most other large cities. Finally, Philadelphia's Wage Tax is overly burdensome in comparison with other large cities. (See Table 4.4) First, Philadelphia is joined by only a handful of other large cities in imposing such a tax. Second, because Pennsylvania's Personal Income Tax is relatively low compared with similar taxes in other states, Philadelphia's high tax on wages is clearly the factor that causes it to rank so high among the nation's largest cities in terms of income tax rate.

Table 4.1 — General Business Gross Receipts Tax Rates For Major U.S. Cities (2001)						
City	**State**	**City Tax**	**County Tax**	**State Tax**	**Total**	**Rank**
New York City	NY	0.00%	0.00%	0.00%	0.00%	6
Los Angeles	CA	0.59%	0.00%	0.00%	0.59%	2
Chicago	IL	0.00%	0.00%	0.00%	0.00%	6
Houston	TX	0.00%	0.00%	0.00%	0.00%	6
Philadelphia	**PA**	**0.24%**	**0.00%**	**0.00%**	**0.24%**	**5**
Phoenix	AZ	0.00%	0.00%	0.00%	0.00%	6
San Diego	CA	0.00%	0.00%	0.00%	0.00%	6
Dallas	TX	0.00%	0.00%	0.00%	0.00%	6
San Antonio	TX	0.00%	0.00%	0.00%	0.00%	6
Detroit	MI	0.00%	0.00%	0.00%	0.00%	6
San Jose	CA	0.00%	0.00%	0.00%	0.00%	6
Indianapolis	IN	0.00%	0.00%	1.20%	1.20%	1
San Francisco	CA	0.00%	0.00%	0.00%	0.00%	6
Jacksonville	FL	0.00%	0.00%	0.00%	0.00%	6
Columbus	OH	0.00%	0.00%	0.00%	0.00%	6
Austin	TX	0.00%	0.00%	0.00%	0.00%	6
Baltimore	MD	0.00%	0.00%	0.00%	0.00%	6
Memphis	TN	0.20%	0.00%	0.20%	0.40%	4
Milwaukee	WI	0.00%	0.00%	0.00%	0.00%	6
Boston	MA	0.00%	0.00%	0.00%	0.00%	6
Atlanta	GA	0.22%	0.00%	0.25%	0.47%	3
Washington, DC	-	0.00%	-	-	0.00%	6
Minneapolis	MN	0.00%	0.00%	0.00%	0.00%	6
Denver	CO	0.00%	0.00%	0.00%	0.00%	6

Note: In cases where cities use a variable tax rate, the highest rate is displayed.

Source: City Controller's Office with assistance from Andersen

Table 4.2 — General Business Income Tax Rates For Major U.S. Cities (2001)						
City	**State**	**City Tax**	**County Tax**	**State Tax**	**Total**	**Rank**
New York City	NY	8.85%	0.00%	8.00%	16.85%	1
Los Angeles	CA	0.00%	0.00%	8.84%	8.84%	7
Chicago	IL	0.00%	0.00%	7.30%	7.30%	13
Houston	TX	0.00%	0.00%	4.50%	4.50%	20
Philadelphia	**PA**	**6.50%**	**0.00%**	**9.99%**	**16.49%**	**2**
Phoenix	AZ	0.00%	0.00%	6.97%	6.97%	15
San Diego*	CA	0.00%	0.00%	8.84%	8.84%	7
Dallas	TX	0.00%	0.00%	4.50%	4.50%	20
San Antonio	TX	0.00%	0.00%	4.50%	4.50%	20
Detroit	MI	1.60%	0.00%	2.00%	3.60%	24
San Jose*	CA	0.00%	0.00%	8.84%	8.84%	7
Indianapolis	IN	0.00%	0.00%	7.90%	7.90%	11
San Francisco**	CA	0.00%	0.00%	8.84%	8.84%	7
Jacksonville	FL	0.00%	0.00%	5.50%	5.50%	18
Columbus	OH	2.00%	0.00%	8.50%	10.50%	3
Austin	TX	0.00%	0.00%	4.50%	4.50%	20
Baltimore	MD	0.00%	0.00%	7.00%	7.00%	14
Memphis	TN	0.00%	0.00%	6.00%	6.00%	16
Milwaukee	WI	0.00%	0.00%	7.90%	7.90%	11
Boston	MA	0.00%	0.00%	9.50%	9.50%	6
Atlanta*	GA	0.00%	0.00%	6.00%	6.00%	16
Washington, DC	-	9.98%	-	-	9.98%	4
Minneapolis	MN	0.00%	0.00%	9.80%	9.80%	5
Denver	CO	0.00%	0.00%	4.63%	4.63%	19

Note: In cases where cities use a variable tax rate, the highest rate is displayed.

*San Diego, San Jose, and Atlanta impose a tax on businesses based on the number of employees.

**San Francisco imposes a tax on payroll expenses.

Source: City Controller's Office with assistance from Andersen

Table 4.3 — General Sales Tax Rates For Major U.S. Cities (2001)							
City	**State**	**City Tax**	**County Tax**	**District Tax**	**State Tax**	**Total**	**Rank**
New York City	NY	4.00%	0.00%	0.25%	4.00%	8.25%	2
Los Angeles	CA	0.00%	1.25%	1.00%	5.75%	8.00%	9
Chicago	IL	1.00%	0.75%	0.75%	6.25%	8.75%	1
Houston	TX	1.00%	0.00%	1.00%	6.25%	8.25%	2
Philadelphia	**PA**	**1.00%**	**0.00%**	**0.00%**	**6.00%**	**7.00%**	**16**
Phoenix	AZ	1.80%	0.70%	0.00%	5.60%	8.10%	8
San Diego	CA	0.00%	1.25%	0.50%	5.75%	7.50%	12
Dallas	TX	1.00%	0.00%	1.00%	6.25%	8.25%	2
San Antonio	TX	1.13%	0.00%	0.50%	6.25%	7.88%	11
Detroit	MI	0.00%	0.00%	0.00%	6.00%	6.00%	19
San Jose	CA	0.00%	1.25%	1.00%	5.75%	8.00%	9
Indianapolis	IN	0.00%	0.00%	0.00%	5.00%	5.00%	22
San Francisco	CA	0.00%	1.25%	1.25%	5.75%	8.25%	2
Jacksonville	FL	0.00%	1.00%	0.00%	6.00%	7.00%	16
Columbus	OH	0.00%	1.25%	0.25%	5.00%	6.50%	18
Austin	TX	1.00%	0.00%	1.00%	6.25%	8.25%	2
Baltimore	MD	0.00%	0.00%	0.00%	5.00%	5.00%	22
Memphis	TN	0.00%	2.25%	0.00%	6.00%	8.25%	7
Milwaukee	WI	0.00%	0.60%	0.00%	5.00%	5.60%	21
Boston	MA	0.00%	0.00%	0.00%	5.00%	5.00%	22
Atlanta	GA	0.00%	2.00%	1.00%	4.00%	7.00%	14
Washington, DC	-	0.00%	-	-	5.75%	5.75%	20
Minneapolis	MN	0.50%	0.00%	0.00%	6.50%	7.00%	-
Denver	CO	3.50%	0.00%	0.80%	2.90%	7.20%	13

Note: In cases where cities use a variable tax rate, the highest rate is displayed.
Source: City Controller's Office with assistance from Andersen

Table 4.4 — General Resident Income Tax Rates For Major U.S. Cities (2001)						
City	**State**	**City Tax**	**County Tax**	**State Tax**	**Total**	**Rank**
New York City	NY	3.65%	0.00%	6.85%	10.50%	1
Los Angeles	CA	0.00%	0.00%	9.30%	9.30%	3
Chicago	IL	0.00%	0.00%	3.00%	3.00%	18
Houston	TX	0.00%	0.00%	0.00%	0.00%	19
Philadelphia	**PA**	**4.54%**	**0.00%**	**2.80%**	**7.34%**	**10**
Phoenix	AZ	0.00%	0.00%	5.04%	5.04%	15
San Diego	CA	0.00%	0.00%	9.30%	9.30%	3
Dallas	TX	0.00%	0.00%	0.00%	0.00%	19
San Antonio	TX	0.00%	0.00%	0.00%	0.00%	19
Detroit	MI	2.75%	0.00%	4.20%	6.95%	11
San Jose	CA	0.00%	0.00%	9.30%	9.30%	3
Indianapolis	IN	0.70%	0.00%	3.40%	4.10%	17
San Francisco	CA	0.00%	0.00%	9.30%	9.30%	3
Jacksonville	FL	0.00%	0.00%	0.00%	0.00%	19
Columbus	OH	2.00%	0.00%	6.98%	8.98%	8
Austin	TX	0.00%	0.00%	0.00%	0.00%	19
Baltimore	MD	2.51%	2.79%	4.80%	10.10%	2
Memphis	TN	0.00%	0.00%	0.00%	0.00%	19
Milwaukee	WI	0.00%	0.00%	6.75%	6.75%	12
Boston	MA	0.00%	0.00%	5.60%	5.60%	14
Atlanta	GA	0.00%	0.00%	6.00%	6.00%	-
Washington, DC	-	9.00%	-	-	9.00%	7
Minneapolis	MN	0.00%	0.00%	7.85%	7.85%	9
Denver	CO	0.00%	0.00%	4.63%	4.63%	16

Note: In cases where cities use a variable tax rate, the highest rate is displayed.
Source: City Controller's Office with assistance from Andersen

When examining effective property taxes rates (the nominal tax rate per $100 multiplied by the assessment level — for example, Philadelphia's Real Estate Tax rate is 8.264 percent of 32 percent of a property's fair market value, or an effective rate of 2.64 percent), Philadelphia does not rate as poorly. Many other large cities present higher overall property tax rates than Philadelphia. (See Table 4.5.)

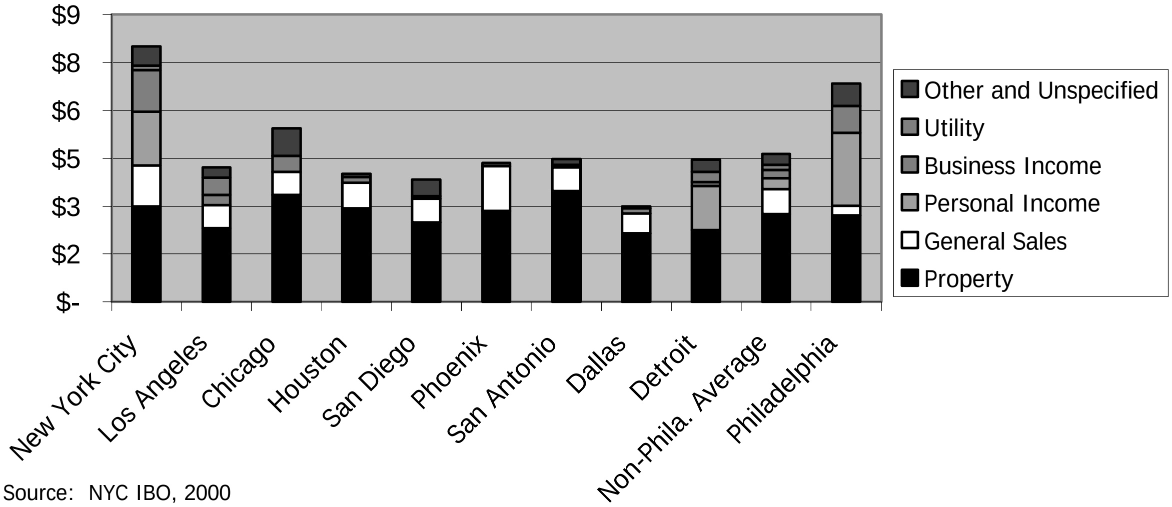
Table 4.5 — Residential Property Tax Rates For Major U.S. Cities (2001)

	City Tax			District Tax			County Tax			State Tax				
City	Nominal Rate	Assmnt. Level	Effective Rate	Nominal Rate	Assmnt. Level	Effective Rate	Nominal Rate	Assmnt. Level	Effective Rate	Nominal Rate	Assmnt. Level	Effective Rate	Total	Rank
New York City	11.255%	8.00%	0.90%	-	-	0.00%	-	-	0.00%	-	-	0.00%	**0.90%**	18
Los Angeles	0.000%	-	0.00%	0.000%	-	0.00%	1.068%	75.00%	0.80%	0.000%	-	0.00%	**0.80%**	21
Chicago	1.500%	16.00%	0.24%	0.000%	-	0.00%	8.536%	16.00%	1.37%	0.000%	-	0.00%	**1.61%**	15
Houston	0.655%	100.00%	0.66%	1.519%	100.00%	1.52%	0.359%	100.00%	0.36%	0.000%	-	0.00%	**2.53%**	8
Philadelphia	**3.745%**	**32.00%**	**1.20%**	**4.519%**	**32.00%**	**1.45%**	**0.000%**	**-**	**0.00%**	**0.000%**	**-**	**0.00%**	**2.64%**	**7**
Phoenix	0.000%	-	0.00%	0.000%	-	0.00%	14.204%	10.00%	1.42%	0.000%	-	0.00%	**1.42%**	16
San Diego	0.000%	-	0.00%	0.000%	-	0.00%	1.062%	75.00%	0.80%	0.000%	-	0.00%	**0.80%**	22
Dallas	0.667%	100.00%	0.67%	1.548%	100.00%	1.55%	0.196%	100.00%	0.20%	0.000%	-	0.00%	**2.41%**	11
San Antonio	0.580%	100.00%	0.58%	1.722%	100.00%	1.72%	0.358%	100.00%	0.36%	0.000%	-	0.00%	**2.66%**	6
Detroit	3.531%	50.00%	1.77%	2.500%	50.00%	1.25%	1.106%	50.00%	0.55%	0.600%	50.00%	0.30%	**3.87%**	3
San Jose	0.000%	-	0.00%	0.000%	-	0.00%	1.091%	75.00%	0.82%	0.000%	-	0.00%	**0.82%**	20
Indianapolis	3.767%	33.33%	1.26%	5.981%	33.33%	1.99%	1.060%	33.33%	0.35%	0.000%	-	0.00%	**3.60%**	4
San Francisco	0.000%	-	0.00%	0.000%	-	0.00%	1.132%	75.00%	0.85%	0.000%	-	0.00%	**0.85%**	19
Jacksonville	0.000%	100.00%	0.00%	0.926%	100.00%	0.93%	1.057%	100.00%	1.06%	0.000%	-	0.00%	**1.98%**	13
Columbus	0.534%	29.70%	0.16%	5.737%	29.70%	1.70%	1.764%	29.70%	0.52%	5.308%	35.00%	1.86%	**4.24%**	2
Austin	0.466%	100.00%	0.47%	1.549%	100.00%	1.55%	0.467%	100.00%	0.47%	0.000%	-	0.00%	**2.48%**	9
Baltimore	5.820%	40.00%	2.33%	0.000%	-	0.00%	2.788%	40.00%	1.12%	0.210%	40.00%	0.08%	**3.53%**	5
Memphis	3.230%	25.00%	0.81%	0.000%	-	0.00%	3.790%	25.00%	0.95%	0.000%	-	0.00%	**1.76%**	14
Milwaukee	1.417%	101.10%	1.43%	0.987%	101.10%	1.00%	0.566%	101.10%	0.57%	2.262%	100.00%	2.26%	**5.26%**	1
Boston	1.058%	100.00%	1.06%	0.000%	-	0.00%	0.000%	-	0.00%	0.000%	-	0.00%	**1.06%**	17
Atlanta	4.677%	40.00%	1.87%	0.000%	-	0.00%	1.334%	40.00%	0.53%	0.025%	40.00%	0.01%	**2.41%**	10
Washington, D.C.	2.050%	100.00%	2.05%	0.000%	-	0.00%	0.000%	-	0.00%		-	0.00%	**2.05%**	12
Minneapolis*	-	-	-	-	-	-	-	-	-	-	-	-	**-**	-
Denver	6.732%	9.15%	0.62%	0.000%	-	0.00%	0.000%	-	0.00%	0.000%	-	0.00%	**0.62%**	23

Note: In cases where cities use a variable tax rate, the highest rate is displayed.
*Minneapolis Property Tax rates are not readily comparable on this basis.
Source: City Controller's Office

Examining rates only tells a part of the story. With regard to tax burdens, it is clear that Philadelphia's tax rates translate into high tax obligations for city businesses, residents, and workers. In February 2000, New York City's Independent Budget Office released *TAXING METROPOLIS: Tax Effort and Tax Capacity in Large U.S. Cities*. This thoughtful and rigorous survey concluded that in 1997, Philadelphia's local tax effort (amount of local taxation per $100 of a combination of resident household income and local business net income) was second only to New York City among the nation's largest ten cities. (See Figure 4.1.) By measuring tax effort, the study attempted to measure the capacity of a city's residents and employers to pay its tax burden. As Figure 4.1 illustrates, while Philadelphia's sales and utility tax efforts are lower than those of other large U.S. cities, personal income tax and business income tax efforts dramatically increase the overall tax burden and weigh heavily on taxable resources. Parenthetically, it is interesting to note that the study includes only city resident income tax in its measurement — Philadelphia's non-resident Wage Tax and commuter taxes in New York and Detroit are not included in the calculation of tax effort. (They are treated as if they were intergovernmental transfers.)

Figure 4.1 — Philadelphia's Local Tax Effort
(Taxes per $100 Of City Taxable Resources, 1997)
Ranked Higher Than All Other Large U.S. Cities Except New York City



Source: NYC IBO, 2000

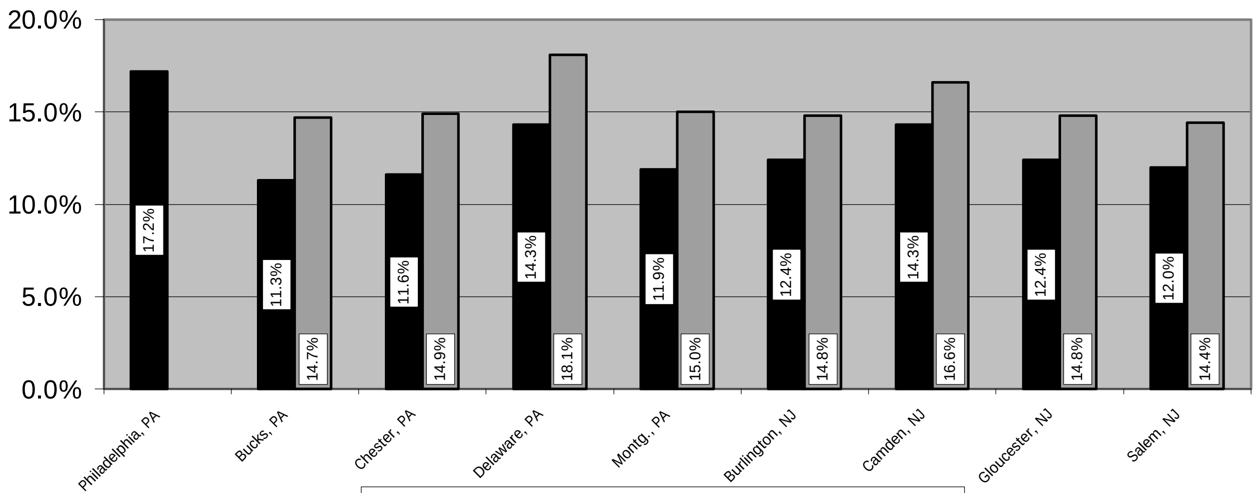
In July 2000, the Washington, D.C. Chief Financial Officer published *Tax Rates and Tax Burdens In The District of Columbia — A Nationwide Comparison*, which compared the 1999 estimated tax burden including state and local income, property, sales, and automobile taxes for the largest city in each state plus the nation's capital. For a hypothetical family of four with an annual income of $25,000, Philadelphia presented the third-highest tax burden among comparison cities. For a hypothetical family of four with an annual income of $150,000, Philadelphia presented the eighth-highest tax burden. (See Table 4.6.)

Table 4.6 — Estimated Burden Of Major Taxes For A Family Of Four In The Largest City In Each State						
Annual Income of $25,000				Annual Income of $150,000		
City	State	Percent Burden		City	State	Percent Burden
Bridgeport	CT	22.8%		Bridgeport	CT	22.9%
Newark	NJ	14.5%		Portland	ME	14.4%
Philadelphia	**PA**	**13.4%**		Newark	NJ	14.3%
Providence	RI	11.6%		New York City	NY	14.2%
Portland	ME	11.2%		Providence	RI	13.7%
Manchester	NH	10.7%		Los Angeles	CA	11.8%
Louisville	KY	10.5%		Minneapolis	MN	11.7%
Virginia Beach	VA	9.7%		**Philadelphia**	**PA**	**11.7%**
Milwaukee	WI	9.0%		Washington	D.C.	11.4%
Detroit	MI	8.9%		Boston	MA	11.2%
Seattle	WA	8.8%		Louisville	KY	11.1%
Honolulu	HI	8.7%		Milwaukee	WI	10.9%
Washington	D.C.	8.6%		Baltimore	MD	10.8%
Chicago	IL	8.4%		Columbus	OH	10.6%
Columbus	OH	8.3%		Des Moines	IA	10.6%
Salt Lake City	UT	8.2%		Columbia	SC	10.5%
Little Rock	AR	8.2%		Boise	ID	10.3%
Jackson	MS	8.1%		Honolulu	HI	10.3%
Boston	MA	8.1%		Atlanta	GA	10.3%
Des Moines	IA	8.0%		Detroit	MI	10.3%
New York City	NY	7.9%		Omaha	NE	10.1%
Oklahoma City	OK	7.9%		Billings	MT	10.1%
Charleston	WV	7.9%		Charlotte	NC	10.1%
Los Angeles	CA	7.9%		Burlington	VT	10.0%
Sioux Falls	SD	7.9%		Jackson	MS	9.8%
Kansas City	MO	7.8%		Little Rock	AR	9.7%
Birmingham	AL	7.7%		Virginia Beach	VA	9.6%
Charlotte	NC	7.5%		Charleston	WV	9.5%
Phoenix	AZ	7.5%		Salt Lake City	UT	9.4%
Omaha	NE	7.5%		Portland	OR	9.4%
Wichita	KS	7.4%		Albuquerque	NM	9.3%
Indianapolis	IN	7.4%		Wichita	KS	9.3%
Portland	OR	7.4%		Kansas City	MO	9.1%
Fargo	ND	7.0%		Oklahoma City	OK	9.1%
Atlanta	GA	6.9%		Manchester	NH	8.9%
Columbia	SC	6.9%		Phoenix	AZ	8.8%
Minneapolis	MN	6.6%		Chicago	IL	8.8%
Billings	MT	6.4%		Birmingham	AL	8.3%
Burlington	VT	6.3%		New Orleans	LA	8.0%
Memphis	TN	6.3%		Wilmington	DE	7.6%
Baltimore	MD	6.3%		Fargo	ND	7.5%
Houston	TX	6.3%		Indianapolis	IN	7.3%
Albuquerque	NM	6.2%		Denver	CO	6.9%
Las Vegas	NV	5.9%		Seattle	WA	6.9%
Denver	CO	5.6%		Sioux Falls	SD	6.0%
Boise	ID	5.6%		Houston	TX	5.3%
New Orleans	LA	5.5%		Memphis	TN	5.2%
Wilmington	DE	5.5%		Jacksonville	FL	5.1%
Cheyenne	WY	5.2%		Las Vegas	NV	4.3%
Jacksonville	FL	4.9%		Cheyenne	WY	3.8%
Anchorage	AK	3.9%		Anchorage	AK	3.1%
Median		**7.8%**		**Median**		**9.7%**

Source: Washington, D.C. Chief Financial Officer: *Tax Rates and Tax Burdens In The District of Columbia — A Nationwide Comparison*, 1999

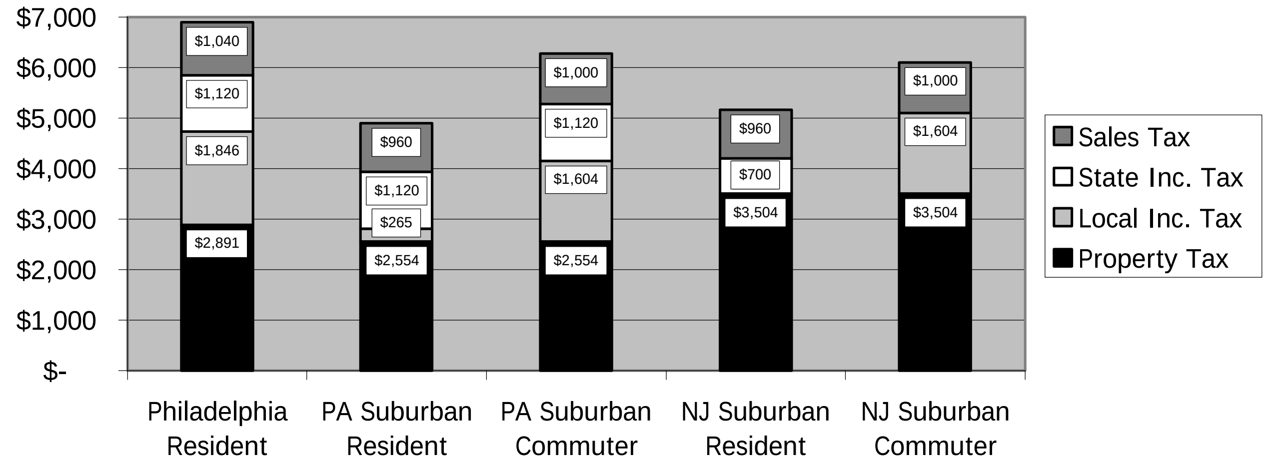
Even when firms and families commit to the Greater Philadelphia Region, their location decisions are often stacked against the city due to its high tax rates. In 2001, the Pennsylvania Economy League (PEL) updated an analysis of local tax burdens in the Greater Philadelphia Region. Not surprisingly, the Economy League's research showed that Philadelphia presents a higher tax burden for residents than the average suburban jurisdiction. (See Figure 4.2.) For persons who work in Philadelphia but live in its suburbs, the disparity is not as great. In fact, examining the tax burdens for suburban residents who commute to Philadelphia, one should note that the typical Delaware County commuter could actually save money by moving to the city. Breaking down the components of that tax burden, it is clear that the city's Wage Tax for residents and commuters is what drives most of the disparity. (See Figure 4.3.) In New Jersey, residents are able to deduct local income tax payments from state income tax obligations, so a New Jersey resident who works in Philadelphia could effectively pay little or even no state income tax. The PEL study does note that the disparity between the city and median suburban residential tax burden continues to go down as Philadelphia lowers taxes and suburban jurisdictions increase taxes to pay for increasing service demands, but concludes that at the current rate of change, the gap would not be eliminated until 2025.

Figure 4.2 — Philadelphia Residents Face A Higher Percentage Tax Burden Than Residents Of Suburban Jurisdictions



Source: PEL, 2001

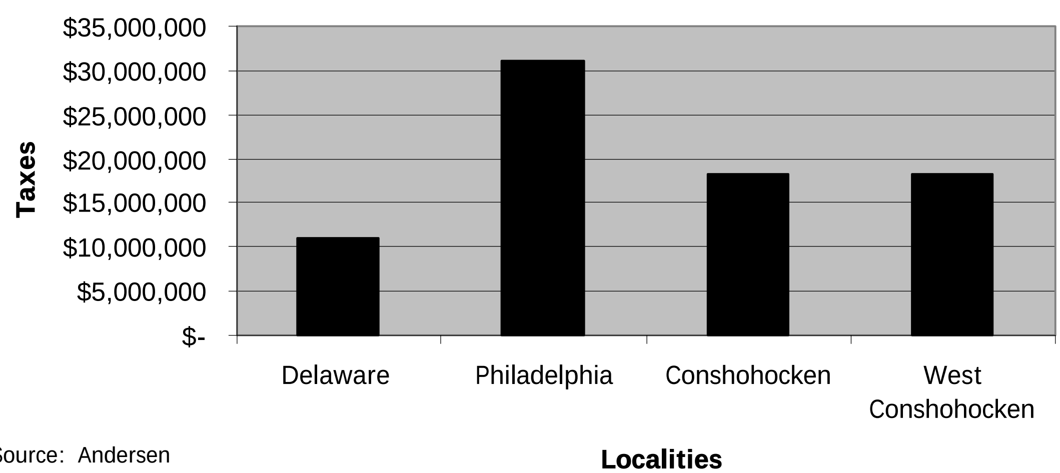
Figure 4.3 — Comparing Median Households In The Region, Philadelphia Residents Bear The Highest Tax Burden



Source: PEL, 2001

Examining local business tax burdens presents similar conclusions. According to a variety of site analyses performed by Andersen in recent years, the net present value of tax liability for model firms is much higher in Philadelphia than competitor locations. For example, as illustrated in Figure 4.4, Andersen found that when examining likely tax burdens for the next ten years, taxes in Philadelphia for a services firm are much higher than they would be in competitor locations.

Figure 4.4 — High Taxes Make Philadelphia Unattractive For A Model Services Firm (Net Present Value Over Ten Years)



Source: Andersen

With high business taxes blunting the city's natural competitive advantages and with a high personal income tax that both increases personnel expenses for companies trying to attract talent and erodes employees' take-home pay, Philadelphia discourages firms and families from locating within the city limits. This push must be alleviated if the pull of the city's marketplace and neighborhoods are to help reverse the trends of an outward flow of residents and a city economy that lags the region and nation in terms of growth. But the rate of its taxes is not Philadelphia's only tax-related obstacle. The city's particular mix of taxes is also problematic.

Philadelphia's Mix Of Taxes Presents Problems

Examining Wage Tax revenues helps illustrate a salient fact about the city economy. Government and non-profit entities generate the most Wage Tax dollars. (See Table 4.7.) Because they are not subject to business or property taxes, non-profit entities do not feel the full impact of the city's high tax burden. For-profit firms cannot avoid city taxes — but they can avoid the city.

Table 4.7 — Top Ten Industry Classifications By Wage Tax Remittance (Calendar Year 2000)

Description	Total Amount of Wage Tax Collection	Percentage of Total Collections
City Government/School District	$111,065,493	9.0%
Hospitals	$108,756,617	8.8%
Federal Government/U.S. Post Office	$71,295,713	5.8%
College And Universities	$62,658,808	5.1%
Attorneys/Legal Services	$50,797,492	4.1%
Restaurants and Bars	$26,168,318	2.1%
Doctors	$22,623,972	1.8%
Commercial Banks	$21,570,687	1.8%
Security Brokers And Dealers	$21,123,950	1.7%
Management And Public Relations	$20,925,259	1.7%

Source: Revenue Department

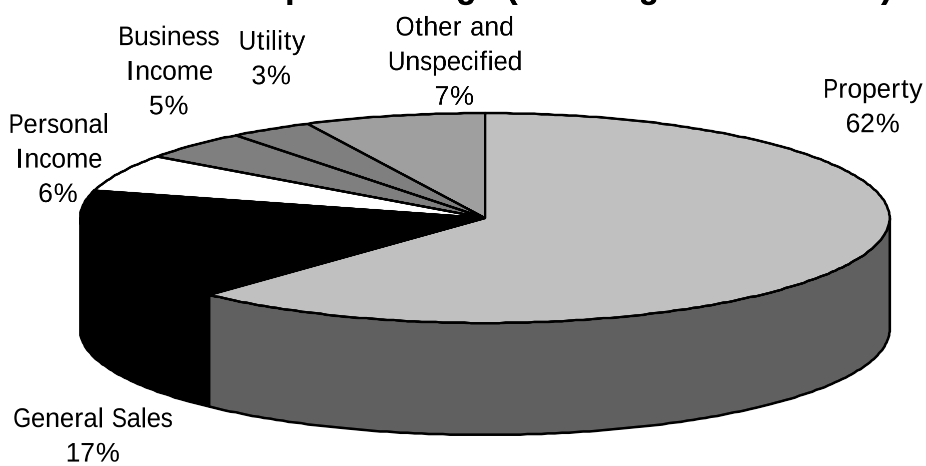
As the power to tax is truly the power to destroy, the decision of what to actually tax is a decision that will help or harm. The decision to place a local tax on an individual industry or a given interaction is a decision to make it more costly to operate a business within that particular industry or make it more costly to accomplish that particular interaction within that local jurisdiction. Thus, a tax on petroleum manufacturing will influence the location decisions of petroleum manufacturers just as a tax on cigarettes may alter local consumer behavior. Perhaps fewer petroleum manufacturers will locate within that locality. Perhaps cigarette smokers will travel to a different locality to make their purchases. In considering taxation, therefore, it is important to not only ask "How high are tax rates?" it is crucial to question how taxes are imposed in the first place.

To help raise revenues in Philadelphia, the Pennsylvania General Assembly authorized the city to impose taxes on personal income in 1932. In what was intended to be a temporary measure, the City of Philadelphia first imposed its tax on wages in 1939. That tax grew from a 1.5-percent levy to its peak of 4.96 percent for city residents, before recent reductions. The decision to impose a local tax on personal income, and the subsequent decisions to increase that tax may have made more sense in a time when the city was the region's only real economic engine and when limited transportation and homeownership options effectively kept workers close to their city jobs. However, as economic growth in the suburbs has made it more attractive for businesses to locate outside the city, and as individuals benefited from increased mobility and mortgage policies that made suburban homeownership more attractive, the Wage Tax has been transformed from a way to tax a captive audience to a primary reason why that once-captive audience continues to leave.

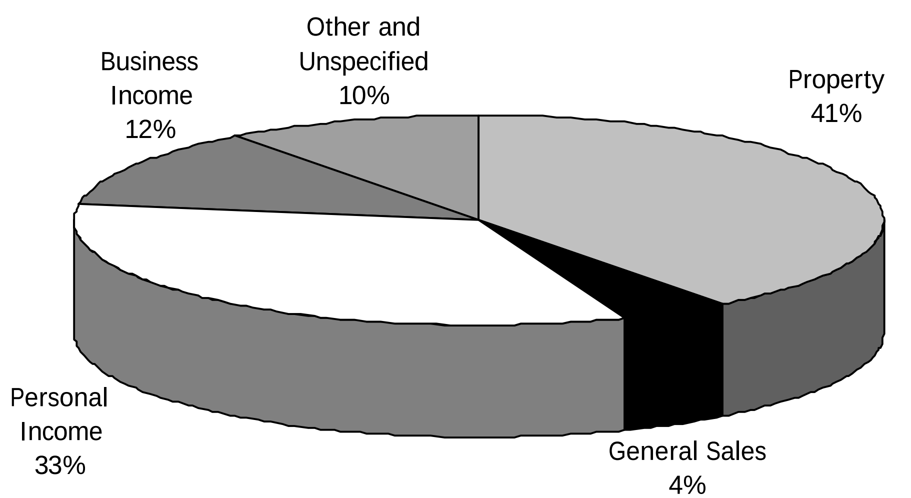
Looking again at the New York City Independent Budget Office's *TAXING METROPOLIS: Tax Effort and Tax Capacity in Large U.S. Cities*, it is evident that the mix of local government taxes in Philadelphia (including city, county, school, and other jurisdictional taxes, but not including commuter taxes) is much different from other large cities. Where most other large U.S. cities collect most locally generated tax income from property taxes, and a significant portion from general sales taxes, Philadelphia generates most of its revenue from taxes on personal and business income. (See Figure 4.5.)

Figure 4.5 — The Mix Of Taxes Collected In Philadelphia Is Much Different From The Average Mix Of Taxes Collected In Other Large U.S. Cities

Non-Philadelphia Average (Ten Largest U.S. Cities)



Philadelphia



Source: NYC IBO, 2000

This over-reliance on Wage Tax is harmful to the city in a number of ways. First, the Wage Tax tends to vary a great deal based on economic conditions. Unlike a tax on property, which tends to be more stable, collections from a tax on income will increase substantially during an economic expansion and then decrease during an economic contraction. In combination, the natural volatility of the tax on income and the city's over-reliance on Wage Tax collections leave city revenue collections particularly vulnerable to economic downturns.

Additionally, the Wage Tax is troublesome due to the significant cost it adds for employees, employers, or both. This cost is compounded when it is presented as a comparative choice. As noted above, when factoring in state and local income taxes, Philadelphia presents high, but not outrageously disparate rates compared with other large cities. Considering both state and local taxes, residents of New York City would pay a lower tax on personal income in Philadelphia while residents of Boston would pay a personal income tax that is only 1.74 percentage points — 31 percent — higher. However, examining what local commuters pay in taxes on personal income, one can see that there is a much more substantial difference depending on a given worker's residence. While the state of New Jersey allows workers to offset Wage Taxes paid to Philadelphia against the New Jersey State Income Tax, the Commonwealth of Pennsylvania and the State of Delaware do not. The high Wage Tax creates its most disparate gap in tax burdens between Philadelphia residents and the commuters from and residents of the city's Pennsylvania and Delaware suburbs. (See Table 4.8.)

Table 4.8 — Combined State And Local Tax Burden For A Family Of Four With An Earned Annual Income Of $50,000 (Calendar Year 2001)

	Wage Tax	State Income Tax	Total Income Tax Burden
Live in Philadelphia / Work in Philadelphia	$2,275.50	$1,400.00	$3,675.50
Live in Pennsylvania / Work in Philadelphia	$1,978.35	$1,400.00	$3,378.35
Live in Pennsylvania / Work in Pennsylvania	-	$1,400.00	$1,400.00
Cost of commuting to Philadelphia from Elsewhere in Pennsylvania			$1,978.35
Live in New Jersey / Work in Philadelphia	$1,978.35	-	$1,978.35
Live in New Jersey / Work in New Jersey	-	$806.00	$806.00
Cost of commuting to Philadelphia from New Jersey			$1,172.35
Live in Delaware / Work In Philadelphia	$1,978.35	$1,770.00	$3,748.35
Live In Delaware / Work in Delaware	-	$1,770.00	$1,770.00
Cost of commuting to Philadelphia from Delaware			$1,978.35

*Some Pennsylvania jurisdictions levy a tax of up to 1.0 percent on income, but for comparison purposes in this table, the hypothetical family of four is assumed to live in a suburban-Philadelphia community without a tax on income.
Source: City Controller's Office

This disparity can become particularly troublesome as the city attempts to attract and retain businesses in services and technology sectors. These firms tend to hire highly mobile workers who command high salaries. The Wage Tax will continue to be an impediment to attraction and retention efforts if firms are tempted to relocate outside the city to be able to attract these demanded workers.

The fact that the Wage Tax generates such a significant portion of city revenue effectively prohibits significant reductions since even minor cuts would have a major effect on the city budget. Where a 10.0-percent cut in the Sales Tax would only represent approximately $10 million to the city budget, a 10.0-percent cut in the Wage Tax would represent more than $120 million. Because the city is so reliant on its revenues, the high Wage Tax is not only difficult to cut and almost impossible to eliminate, the Wage Tax effectively dictates tax policy in many ways.

City policy-makers are often willing to abate other taxes as a way to encourage economic development, knowing that any job growth is likely to generate enough money in Wage Taxes to justify the subsidy. Therefore, Tax Increment Financing may reduce Real Estate Tax revenue, but may generate Wage Tax revenue. Similarly, while the city foregoes many taxes from businesses that locate within a Keystone Opportunity Zone, because they continue to generate Wage Tax revenue, foregoing the other taxes could still make fiscal and budgetary sense. The Wage Tax may be loathed by those who pay it and it may be so high that it discourages firms and families from locating in Philadelphia, but because it is such a major source of revenue, efforts to reduce the tax present significant budgetary risks.

High taxes on business do little to help efforts to attract firms to Philadelphia, but the way the city taxes business also contributes to the perception that the city is not business-friendly. While the city formerly taxed receipts exclusively, the move to reduce the burden on receipts and increase the burden on profits was popular when enacted in 1984. However, this particular mix of business taxes places a burden on all businesses that earn receipts in the city regardless of whether they turn a profit, and — because the Business Privilege Tax is a prospective tax — doubles business tax burdens in the second year of operations.

While many criticize a tax on gross receipts because it taxes unprofitable businesses, the tax is not uncommon in other local jurisdictions. As a tax on receipts generated within Philadelphia, it represents a way to generate revenue from companies that capitalize on the local marketplace. This is especially attractive since it taxes companies that locate just outside the city limits but still capitalize on the city market for sales. Because it affects those firms that cater to individuals and businesses within the city, the tax does not necessarily threaten to chase businesses out of the city. If one firm cannot operate profitably because of the tax (which is a not-so-burdensome 24 cents on every hundred dollars of receipts), so long as there is demand to fill within the city, some business should emerge to meet that demand. One area where the tax on receipts may be more troublesome is in the case of service firms that may conduct business via telephone, teleconference, or Internet. These firms may serve clients located across the globe, but, depending on how that service is provided, may have their receipts taxed because they are recorded as being generated in the city.

From the city's point of view, a tax on gross receipts is more recession proof than a tax on profits. Receipts are more certain than profits, especially when creative accounting can turn gains into losses on paper. Even when profits wane, as long as there is economic activity in the marketplace, receipts will always be generated. This is not the case for businesses that pay taxes on their net income. If these businesses do not generate significant receipts from activity within Philadelphia, they may only be located in the city because of a historical accident or inertia. It is clear that the tax on net income can be a powerful reason to locate outside the city. Philadelphia currently uses multiple weighting factors to determine tax liability for the Net Income portion of the Business Privilege Tax: property, payroll, and double-counting of receipts. Under this multi-factor apportionment formula, a business located wholly in Philadelphia with 50 percent of its receipts in the city would factor 100 percent of its property, 100 percent of its payroll, and 100 percent of receipts (50 percent double-counted). It would have the percentage of taxable receipts determined by a formula dividing the apportionment total of 300 by the number of factors (four) or 75 percent. A business that is located outside the city but establishes a presence within Philadelphia by doing more than simply soliciting business would have no payroll and no property included in the apportionment, would have a factor of 25 (two times 50 percent of receipts divided by four), and would only pay taxes on 25 percent of its receipts. (See Table 4.9.) The city business in this example pays three times as much as the suburban competitor fighting for the same city business.

Table 4.9 — Effect Of Multi-Factor Apportionment On A Suburban Business That Competes With A City Firm When Both Have An Equal Sales Presence In Philadelphia					
Type of Business	Percentage Of Payroll Based In Philadelphia	Percentage Of Property Located In Philadelphia	Percentage Of Taxable Receipts Generated In Philadelphia (Double-Weighted)	Total Of Apportionment Factors	Apportionment Factors Divided By Four To Generate Tax Liability
City Business	100%	100%	100%	300%	75%
Suburban Competitor	0%	0%	100%	100%	25%
Source: City Controller's Office					

Businesses that are physically located in Philadelphia but generate little or no sales in the city face a significant net income burden despite the fact that they may have no business reason to maintain their actual location within the city. Because these businesses bring outside money into the economy and do not capitalize on local demand, they are important to the city's economic health, but, while some of these businesses find a competitive advantage in the city's work force or physical location, most could find those same advantages in locations just outside the city or in other regions. Many industry sector representatives confess that the majority of manufacturing firms no longer have a business reason to remain in Philadelphia. Technology firm representatives report that many technology-related businesses may incubate or grow in the city, attracted by proximity to world-class university or entrepreneurial centers, but when they become profitable, executives and investors find little reason to remain in Philadelphia.

To illustrate how the city's mix of business taxes affects the various sectors of the economy, it is instructive to break the Business Privilege Tax down into its component portions and then sort the city's business taxpayers into industry sectors for comparison purposes. When sorted, it is clear that businesses that serve local demand — businesses within the Retail Trade, Wholesale Trade, and Construction classifications — pay more taxes on their gross receipts than on net income, while businesses that may have much less connection to the local market — businesses within the Services, Finance, Insurance, and Real Estate, and Manufacturing classifications — pay more taxes on net income than on gross receipts. For example, firms within the Services industry pay more than two-and-a-half times as much in the Net Income portion of the Business Privilege Tax as they pay in the Gross Receipts portion. Interestingly, the city recently acted to exempt certain technology firms from the Gross Receipts portion of the Business Privilege Tax, but, because those firms all fall within the industry sector Business Services, those firms would seem to benefit more from a move to reduce the Net Income portion of the tax. (See Table 4.10.)

Table 4.10 — Business Privilege Tax Net Income Payment As A Percentage Of Business Privilege Tax Gross Receipts Payment By Industry For Calendar Year 2000	
Industry Description	Percentage
Services	268%
Agriculture, Fishing, Forestry	184%
Finance, Insurance, and Real Estate	140%
Transportation, Public Utilities	115%
Manufacturing	113%
Construction	76%
Retail Trade	69%
Wholesale Trade	62%
Source: Revenue Department	

Raising or lowering different portions of the Business Privilege Tax will have different effects on firms in different industries and a different effect on the city economy. For example, businesses within the Services and Finance, Insurance, and Real Estate sectors pay nearly 70 percent of the total net income burden and would benefit greatly from a cut on the Net Income portion. (See Table 4.11.)

Table 4.11 — Business Privilege Tax Component Burdens By Industry For Calendar Year 2000

Industry Description	Net Income	Gross Receipts
Agriculture, Fishing, Forestry	0%	0%
Construction	4%	8%
Finance, Insurance, and Real Estate	19%	20%
Manufacturing	6%	8%
Retail Trade	9%	20%
Services	49%	27%
Transportation, Public Utilities	3%	4%
Wholesale Trade	5%	12%
Unclassified	4%	2%

Note: Figures may not add to 100% due to rounding.
Source: Revenue Department

While other large cities rely heavily on a Sales Tax to raise revenues, Philadelphia does not benefit as much from the transactions that take place in its marketplace. The city is only enabled by state law to collect a 1.0-percent Sales Tax. Even though the Commonwealth of Pennsylvania's Sales Tax is high compared to other states, the overall Sales Tax on purchases in Philadelphia is lower than other big cities. However, the Sales Tax in Philadelphia is still a percentage point higher than it is in the city's Pennsylvania and New Jersey suburbs and increasing that disparity by raising the city's Sales Tax is not a very attractive option.

Philadelphia's Real Estate Tax Distorts Incentives To Develop

Most local jurisdictions levy some form of tax on real estate. In fact, in most local jurisdictions including counties, cities, and school districts, the tax on real estate comprises — by far — the largest share of locally generated revenues. Only a handful of states levy a Real Estate Tax. The Commonwealth of Pennsylvania does not. Despite the fact that the tax may be widely levied, the effect of an indiscriminate tax on real estate may discourage development.

Because it increases the cost of owning or improving a building, a tax on buildings discourages individuals from constructing or improving their structures. Alternatively, a tax on land discourages speculation by raising the cost of holding land unused and increasing the likelihood that the owners would do something with the land to generate revenue. Economic theory would therefore suggest that removing a tax from buildings would encourage people to build more valuable buildings, just as placing a tax on land would drive land into production and encourage people to make that land more productive.

The traditional property tax is levied on both the land and the structures on it at the same rate. To encourage development and discourage speculation, many jurisdictions have altered their tax structure to place a higher tax on land than property. Pennsylvania law allows localities to introduce land-value taxation or to implement a split-rate tax that levies one tax on land and another tax on the structures and buildings upon that land. Many Pennsylvania cities including Allentown and Harrisburg employ such a split-rate tax. Under such a system, owners of vacant lots and blighted buildings pay substantially higher taxes because the system places a premium on the value of the location. Essentially, any property owner whose land is worth much more than the structure upon it would pay more under a split-rate system than under a single-rate system. By shifting the tax burden from buildings to land by taxing land assessments at a higher percentage rate than building assessments, jurisdictions like Allentown and Harrisburg have changed incentives for property usage.

Because a conventional property tax penalizes property owners who improve their properties (if the value of the property increases, the amount of taxes owed increases), speculators have an incentive to allow buildings to deteriorate and then ask for a lower property assessment. A two-rate property tax system that taxes land at a high rate and buildings/improvements at a lower rate encourages property owners to develop their properties more fully since the actual value of the improvements to the properties are taxed at a lower rate than the land upon which they sit. Because the value of the land, not the deteriorated condition of the property, would determine tax liability, owners of vacant properties would have an incentive to do something productive with that property — or sell it to someone else who will.

Theoretically, land-value taxation is more efficient than traditional property taxation. Land-value taxation does not impact production since land is already produced. If properly administered and implemented, land values are transparent to all involved parties. They can be monitored regularly so that market values can easily be reassessed. The value of land is assessed by consideration of three factors: the land's natural setting and landscape, the public infrastructure and policies (including zoning considerations) of the land's larger political jurisdiction, and the private investments and activity that surround the land. This underscores the maxim that the three most important factors when considering purchasing property are "location, location, location." For example, a piece of land located close to a good school, public transportation, and business opportunities, would be worth more than a similar land parcel next to a vacant, garbage-strewn lot in a depressed area of the city. Similarly, because of the value of land, two otherwise identical houses will have dramatically different values depending upon where they are located. In Center City, the house may sell for hundreds of thousands of dollars while the same house located in a distressed neighborhood may command only a few thousand dollars.

The success of the city's program of Real Estate Tax abatements provides additional evidence that a shift away from high taxes on improved buildings can encourage development. Since the tax abatement for conversion of commercial and industrial buildings into residential properties freezes the tax developers pay, the developers are able to increase the value of the property without incurring a greater Real Estate Tax burden. By taxing land more heavily than improvements, the city would similarly reduce the tax increase for any improvement and move projects forward which may currently be unfeasible.

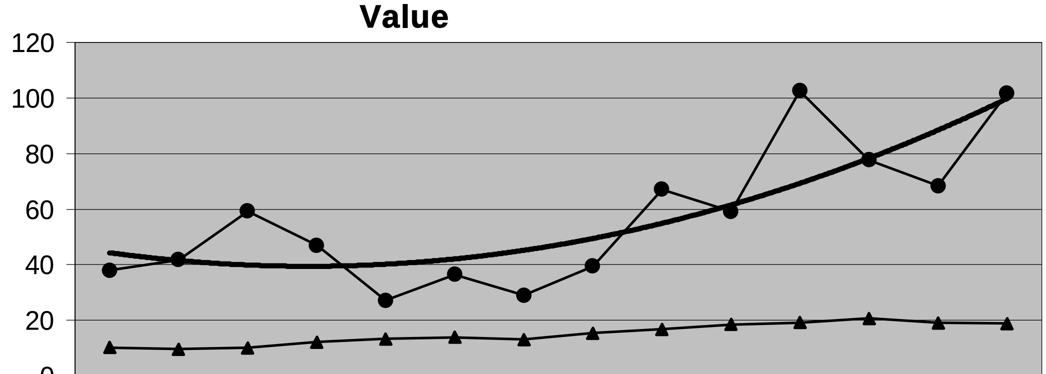
While evaluations of land-value taxation in the United States are limited, empirical evidence exists to support its theoretical attractiveness. Studying the effect of two-rate property taxes on construction in Pennsylvania in 1997, Virginia Polytechnic Institute and State University Economics Professors Florenz Plassmann and T. Nicolaus Tideman show that cities that have adopted a two-rate property tax actually enjoy significantly higher levels of construction activity than they would with single-rate taxes. Also in 1997, University of Maryland economists Wallace Oates and Robert Schwab took on the subject in *The Impact of Urban Land Taxation: The Pittsburgh Experience*. While pointing out that it is generally difficult to separate the effects of a tax reform from other economic events, Oates and Schwab concluded that "the reliance on increased land taxation played an important supporting role by enabling the city to avoid rate increases in other taxes that could have impeded development."

These findings were echoed in the testimony given before Pittsburgh's city council nearly two decades earlier by Carnegie Mellon University Professor and Nobel Prize Laureate Herbert Simon. When the legislative body was investigating the possible benefits of an increase in land tax rates, Simon said:

> "Assuming that a tax increase is necessary, it is clearly preferable to impose the additional cost on land by increasing the Land Tax, rather than to increase the Wage Tax — the two alternatives open to the city. It is the use and occupancy of property that creates the need for the municipal services that appear as the largest item in the budget — fire and police protection, waste removal, and public works. The average increase in tax bills of city residents will be about twice as great with a Wage Tax increase than with a Land Tax increase."

The Controller's Office investigated two cities with land-value taxation, Allentown and Harrisburg, to determine the development response to the shift in property taxation. Harrisburg has employed a higher tax rate on land than on buildings since 1974. Figure 4.6 shows that when the city increased the ratio of its tax on land to its tax on buildings (Harrisburg has almost doubled the ratio of the tax on land to the tax on buildings over the last 14 years) an increased number of building permits were issued and the total value of permits filed increased. According to Harrisburg Mayor Stephen Reed, the city has managed to reduce its vacant building stock from more than 4,000 to fewer than 500 during the past two decades — a drop of approximately 90 percent.

Figure 4.6 — Building Permits And Total Building Permit Value Increased In Harrisburg With Each Tax Increase On Land Value



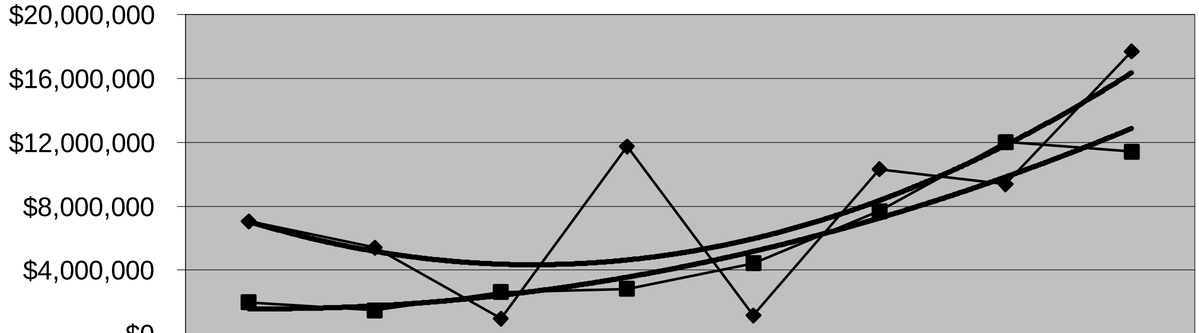
	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Tax Ratio Land/Building	2.6	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	4.0	4.0	4.0	5.0
Value of Bldg Permits ($m)	37.91	41.68	59.19	46.96	27.05	36.42	28.99	39.44	67.04	59.08	102.65	77.74	68.40	101.76
Number of Permits (100)	10.13	9.54	10.02	12.13	13.24	13.85	13.06	15.34	16.75	18.43	19.14	20.64	18.99	18.82

Source: Harrisburg Building Permit Database

Reassessment Years: 1973, 1985, 2001

Allentown shows similar positive trends. In 1996, Allentown adopted a land-value tax system by popular vote. The enabling legislation embedded in the new Home Rule Charter prohibits city council from levying any other tax than a tax on land values to generate new tax revenue. Figure 4.7 shows that both the value for new commercial construction and the value for new residential construction are up significantly.

Figure 4.7 — The Value Of New Residential And Commercial Construction In Allentown Increased After The Adoption of Land-Value Taxation



	1993	1994	1995	1996	1997	1998	1999	2000
Land/Building Ratio	1.0	1.0	1.0	1.0	1.6	2.0	2.8	3.6
Value New Commercial	$7,062,495	$5,415,200	$969,107	$11,751,250	$1,159,620	$10,330,070	$9,382,258	$17,688,453
Value New Residential	$1,983,000	$1,490,900	$2,619,000	$2,829,000	$4,424,164	$7,693,758	$12,020,428	$11,416,305

Source: Bureau of Code Enforcement, Allentown

Such empirical evidence supports the strong theoretical basis for land-value taxation. By altering the way property is taxed, jurisdictions can alter the way property owners maintain their real estate holdings. By taxing land, local jurisdictions can encourage property owners to best utilize their properties, discourage speculators from holding land vacant and allowing buildings to decay, and — where market demand exists — encourage development. Of course, such a shift in taxation should be complemented with efforts to enforce the city's licensing laws and building regulations to further encourage owners of run-down properties to maintain their properties or sell them to someone who would. But even if taxing land would fail to change market conditions enough to drive land into production, at the very least such a move would alter the incentives presented by the tax on property to make those who own vacant and underutilized land pay more to support the city expenditures necessary to serve their properties and deal with the often-dangerous externalities associated with vacant buildings and land.

Philadelphia Taxes Are Confusing And Unfair

Specific features of Philadelphia's tax structure make it particularly confusing — and, therefore, particularly frustrating — to taxpayers and tax preparers. More troublesome, many contend that specific aspects of the tax structure are blatantly unfair to certain groups and individuals.

Business Taxes

The Business Privilege Tax is particularly confusing to most taxpayers. Some wonder whether paying the tax is a privilege at all. Most people are confused by the fact that the tax is basically paid in advance and taxpayers and preparers routinely confuse the time periods for which they are filing. Additionally, the multi-factor apportionment — which demands that taxpayers that do not conduct business solely within the City of Philadelphia apportion their taxes based on the amount of property, employees, and sales within the city — can be cumbersome.

Many believe that this tax is also unfair because it essentially taxes businesses twice during their second year of business. Since it is a prospective tax, businesses open already owing a year's worth of taxes.

Even though this double payment is put off to the second year to avoid overburdening businesses in their first year of operations, few appreciate the delay and instead focus on the fact that they are paying twice their tax liability in a single year. Similarly, even though the Gross Receipts portion of the tax is a tax on business activity, many complain that the tax is levied even if a firm is not profitable. Finally, many taxpayers resent the fact that certain industries receive a tax break or pay no Business Privilege Tax.

Examining the interplay between the Net Profits Tax and the Business Privilege Tax highlights another common area where fairness is questioned. Corporations pay only the Business Privilege Tax, but sole proprietors and partnerships pay both the Net Income portion of the Business Privilege Tax and the Net Profits Tax. While they are entitled to take a credit equal to 60 percent of the Net Income portion of the Business Privilege Tax against their Net Profits liability, sole proprietors and partnerships pay a higher tax burden than their corporate competitors. (See Table 4.12.)

Table 4.12 — Tax Liability For Model Businesses With $10,000 In Net Income And $50,000 In Gross Receipts

Type of Business	Gross Receipts Liability (receipts x .0024)	Net Income Liability (income x .065)	Net Profits Liability (profits x .045385	Deduction (Net Income Liability x .6)	Total Tax Liability
Sole Proprietorship	$120	$650	$453.80	($390)	$833.80
Corporation	$120	$650	-	-	$770.00

Source: City Controller's Office

Property Taxes

One essential element of fairness in any system is that likes should be treated alike. That may not be the case in one particular area of the city's tax structure. The tax burden of a given property should equal the tax rate applied to 32 percent of the property's fair market value as determined by the city's Board of Revision of Taxes. However, the relationship between the determined fair market value and the true value of a given property in the marketplace varies from neighborhood to neighborhood, block to block, and house to house. Any Real Estate Tax system will exhibit natural lags trying to keep up with the changes in property values, but the fair market value for tax purposes should reflect a property's true value. If all properties are equally undervalued, then the city may not be collecting what it should be (which may be bad for city revenue collections), but if some properties that should be equally valued are effectively taxed at different rates, the city could be maintaining a system with serious fairness problems.

Discussing the most recent reassessment process in a document titled *Equalization 2002*, the Board of Revision of Taxes wrote:

> "The basis of fair market value for any residential property is the sale of a similar property. When sale prices for a given type of property are increasing the market is said to be appreciating. When the real estate market rises and the BRT does not adjust market values to keep pace with a rising market, therefore equity, fairness, and uniformity are diminished. The resulting inequity in the valuation process then becomes an inequity in the real estate taxation system."

Examining the Year 2000 Board of Revision of Taxes Data File, the Controller's Office found that the average variance between actual 1999 sales price and the assessed 2000 fair market value for Philadelphia residential properties exceeded 35 percent. (According to the Pennsylvania State Tax Equalization Board, the disparity between sales figures and assessed value was 35.3 percent in 2000 —

the International Association of Assessing Officers recommends this amount be less than 15 percent.) More troubling is the fact that the variance is significantly different from neighborhood to neighborhood. This not only suggests that the city may not be collecting what it should generate in Real Estate Taxes, it points out that equals may not be paying Philadelphia Real Estate Taxes equally. (See Table 4.13.)

Table 4.13 — Variance Between 2000 Fair Market Value And 1999 Sales Price For Arm's Length Transactions

City Neighborhood	Average Percentage Variance
Center City	80.9%
Upper North Philadelphia	3.2%
Lower North Philadelphia	45.3%
Olney-Oak Lane	43.3%
Near Northeast Philadelphia	30.7%
Far Northeast Philadelphia	44.0%
Bridesburg/Kensington/Port Richmond	23.5%
Roxborough/Manayunk	41.9%
Germantown/Chestnut Hill	39.2%
South Philadelphia	30.8%
Southwest Philadelphia	34.7%
West Philadelphia	42.3%
Total	**35.9%**

Source: City Controller's Office Analysis of Year 2000 Board of Revision of Taxes Data File

Recent increases in Philadelphia real estate assessments have lagged behind the increase in the rate of inflation. Because real estate values are a component of the market basket that is used to define the rate of inflation, the change in real estate values influences the rate of inflation. Between 1990 and 2000 inflation increased by 31.8 percent but real estate assessments in Philadelphia grew by a mere 3.2 percent over the same period. The median sale price for a house in the United States increased by 39.6 percent and the median sale price for a house in Philadelphia increased by 37.7 percent between 1990 and 1999. (See Table 4.14.)

Table 4.14 — Percentage Increase Of Inflation, Median Sale Prices For U.S. Houses, Median Sale Prices For Philadelphia Houses, And City Real Estate Assessments (1990-2000)

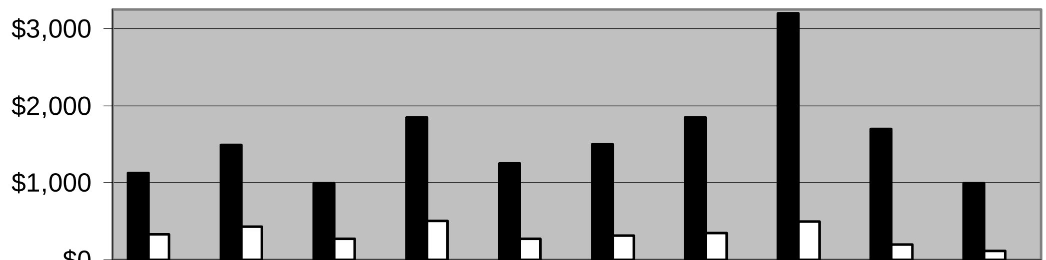
	Inflation	Median Sale Price For U.S. Houses*	Median Sale Price For Philadelphia Houses*	Philadelphia Real Estate Assessments
Rate Of Change	31.8%	39.6%	37.7%	3.2%

*Rate of U.S. and Philadelphia House Sale Price change is expressed from 1990-1999.
Source: Bureau of Labor Statistics, National Association of Realtors, City Planning Commission, Board of Revision of Taxes

If the city's fair market values more closely mirrored current market conditions, the city would be due a substantial amount of additional tax revenue. Below-market-price assessments reduce the amount of revenue the city can collect from Real Estate Taxes, forcing the city to maintain higher-than-necessary Real Estate Tax rates. This condition also affects housing costs, since lower assessments cause sales prices to inflate artificially because low property taxes are immediately capitalized into sales prices. This artificial inflation of housing costs makes it more difficult for low-income families to find affordable housing.

Sharpening that focus to examine actual sales compared to fair market values for tax purposes, the question of fairness becomes more salient. The disparity between current real estate offerings throughout the city and the Board of Revision of Taxes' assessment data is striking. Figure 4.8 shows that ten randomly selected residential properties currently offered for sale for approximately $1 million and more have fair market values for tax purposes that range from 11.1 percent to 29.3 percent of the asking price. This suggests that the city may be losing significant revenues due to inaccurate or low assessments and that owners of properties with approximately equal value could be paying significantly different Real Estate Tax bills.

Figure 4.8 — Philadelphia Properties Currently Offered For Approximately $1 Million And More Are Taxed As If They Were Worth Substantially Less



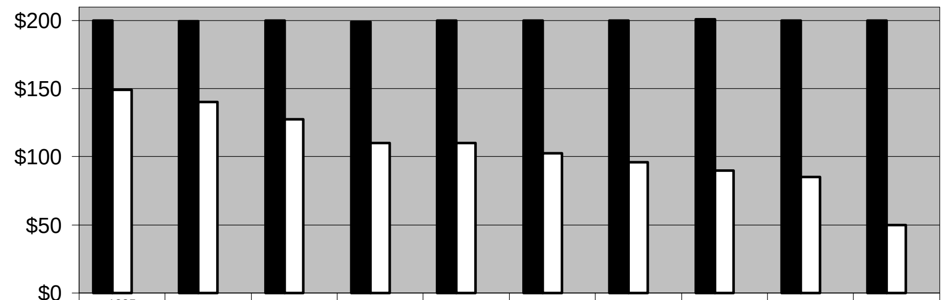
	2109 Delancey 19103	1911 Spruce 19103	114 Bainbridge 19147	2128 Locust 19103	2104 Delancey 19103	1822 Pine 19103	2026 Delancey 19103	1912 Rittenhouse 19103	716 Pine 19106	109-13 N Orianna 19106
■ Current Value as Advertised ($1,000)	$1,125	$1,490	$995	$1,850	$1,250	$1,495	$1,850	$3,200	$1,700	$995
□ BRT 2000 Fair Market Value ($1,000)	$330	$425	$275	$500	$270	$310	$350	$495	$200	$110
BRT 2000 Fair Market Value as % of Advertised Price	29.3	28.5	27.6	27.0	21.6	20.7	18.9	15.5	11.8	11.1

Source: Reallist.com, Board of Revision of Taxes

The city is required by state law to annually review its real estate values. While it is natural for sales prices to increase before fair market values catch up, fair market values in Philadelphia continue to lag seriously behind even after several years of reviews. A review of ten randomly selected Philadelphia residential properties that sold for approximately $200,000 in 1999 shows that these properties have current fair market values that range from 24.0 percent to 74.5 percent of their actual 1999 sale price. Looking at residential properties that sold in 1999 for approximately $80,000 in neighborhoods from across the city, fair market values range from 33.3 percent to 78.7 percent of their actual 1999 sale prices.[3] (See Figures 4.9 and 4.10.)

[3] It is interesting to note that the residential properties for sale in 2001 for $1 million have fair market values that are a much lower percentage than their sale prices when compared to the houses that sold in 1999 for $80,000. Anecdotally, this suggests that the owners of expensive properties may be actually paying proportionally less Real Estate Tax (as a percentage of actual property value) than owners of less expensive properties. Put another way, it could be that owners of expensive properties are paying less than their fair share of Real Estate Taxes while owners of less expensive properties are paying more than their fair share, causing the Real Estate Tax in Philadelphia to be significantly regressive.

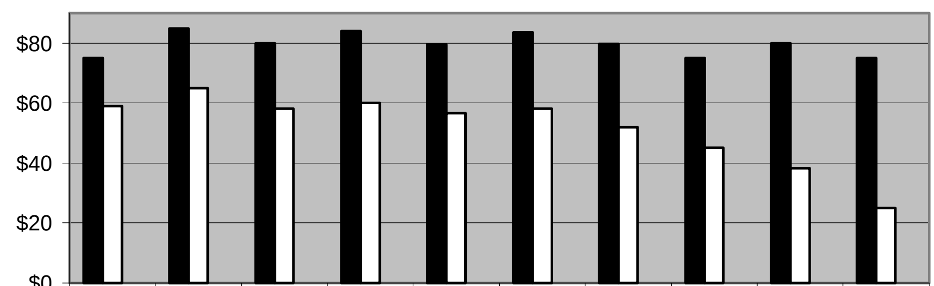
Figure 4.9 — Philadelphia Residential Properties That Sold For Approximately $200,000 In 1999 Are Not Valued At The Same Level For Tax Purposes



	1825 Delancey 19103	1228 Rodman 19147	1723 Lombard 19146	2023 Waverly 19146	600 E Luzerne 19124	2025 Sansom 19103	223 Rex 19118	762 N 26th 19130	621 Lombard 19147	146 Richmond 19126
■ 1999 Actual Sales Price ($1,000)	$200	$200	$200	$199	$200	$200	$200	$201	$200	$200
□ BRT 2000 Fair Market Value ($1,000)	$149	$140	$127	$110	$110	$103	$96	$90	$85	$50
BRT 2000 Fair Market Value as % of Actual Sale Price	74.5%	70.2%	63.7%	55.2%	55.0%	51.3%	48.0%	44.8%	42.5%	25.0%

Source: Board of Revision of Taxes

Figure 4.10 — There Is Currently Great Disparity In The Tax Burdens Of Philadelphia Properties That Sold For $75,000-85,000 In 1999

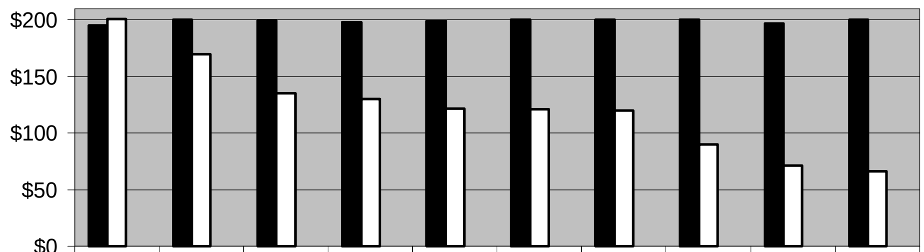


	7348 Dungan 19111	332 Poplar 19123	2005 Murray 19115	10029 Westbourne 19114	12008 Medford 19154	3108 Teesdale 19152	7524 Woodbine 19151	6736 Emlen 19119	2639 Dudley 19145	1807 Fairmount 19130
■ 1999 Actual Sales Price ($1,000)	$75.0	$84.9	$79.8	$83.9	$79.5	$83.5	$79.7	$75.0	$79.8	$75.0
□ BRT 2000 Fair Market Value ($1,000)	$59.0	$65.0	$58.0	$60.0	$56.7	$58.0	$51.8	$45.0	$38.2	$25.0
BRT 2000 Fair Market Value as % of Actual Sale Price	78.7%	76.6%	72.7%	71.5%	71.3%	69.5%	65.0%	60.0%	47.9%	33.3%

Source: Board of Revision of Taxes

Focusing on Philadelphia residential property sales data from 1995 illustrates that this fairness question lingers — and perhaps becomes more substantial over time. The current fair market values of properties that sold for approximately $200,000 in 1995 range from 33.0 percent to 103.0 percent of their 1995 sale price. But, given inflation and increasing home values, these properties should be worth more than $200,000 today. Nearly all of the randomly sampled properties in Figure 4.11 show a current fair market value below the 1995 sales price. Considering that the last five years were extremely strong in terms of increasing real estate values, it appears that fair market values do not come close to reflecting the true value of properties in the marketplace. (See Figure 4.11.)

Figure 4.11 — Most Properties Sold In 1995 For Approximately $200,000 Are Still Valued Below Their Sales Prices Even After Years Of Inflation And A General Appreciation Of Philadelphia Housing Values



	8740 Stenton 19118	4012 Lancaster 19104	229 S Bonsall 19103	942 Clyde 19128	3314 W Coulter 19129	4027 Fitler 19114	2226 Cottman 19149	1319 Spruce 19107	8607 Prospect 19118	7350 Frankford 19136
1995 Actual Sales Price ($1,000)	$195	$200	$200	$198	$199	$200	$200	$200	$197	$200
BRT 2000 Fair Market Value ($1,000)	$201	$170	$135	$130	$122	$121	$120	$90	$72	$66
BRT 2000 Fair Market Value as % of Actual Sale Price	103.0%	85.0%	67.7%	65.7%	61.1%	60.7%	60.0%	45.0%	36.3%	33.0%

Source: Board of Revision of Taxes

Any process to equalize real estate values is likely to generate concerns from citizens and complaints from those who may see their tax bills increase. However, in a letter describing efforts to reassess property values in the city, the Chairman of the Board of Revision of Taxes expressed the need for fairness quite well:

> “We realize that property value increases, with concomitant increases in property tax, will never be popular activities, however, if the process is fair, equitable and uniform, while striving to be as ‘transparent’ as possible, the level of trust in and respect for the government will increase throughout our citizenry.”

This fall, as part of its ongoing efforts to properly value the city’s real property, the Board of Revision of Taxes will notify owners of approximately 190,000 properties (about 40 percent of the total number of residential properties) that increased property value has increased the assessed value of their homes — and increased their tax bills. This reassessment will lessen the problem of the general undervaluing of city properties, but more work remains to ensure that the city is properly assessing real estate and guaranteeing that owners of similar properties pay similar tax bills.

Other Taxes

In specific cases where the city targets a single industry for taxation, representatives from those industries feel unfairly burdened by taxes that are used to generate revenues for purposes that do not directly benefit them. Unlike a tax on gasoline that is used to support road construction, Philadelphia’s Vehicle Rental Tax (which is used to help fund new sports stadia) and Liquor Sales Tax (which is used to help fund the school district) levy taxes on industries that do not directly benefit from the expenditure of generated tax revenues. While these taxes may or may not discourage firms in those industries from locating or remaining in Philadelphia, the taxes do create a sense among business owners in those industries that the city is a less-than-friendly place to do business. Similarly, the tax on non-business income that supports school district operations generates resentment as it gives many people who can afford to move one more reason to leave the city.

In some ways, the manner in which that the city administers its tax-collection efforts contributes to a perception that taxation is unfair. As documented above, the Real Estate Tax may generate less than it should. Tax-collection efforts for certain taxes have been criticized as lax. A recent Controller's Office audit found that the City of Philadelphia does not collect Liquor Sales Tax from approximately one-third of the total number of establishments subject to the 10.0-percent tax on the sale of liquor, malt, and brewed beverages. The Controller's Office has long recommended expanding efforts to ensure that city and school district vendors settle any tax bills before they receive payment for goods and services, and has suggested avenues of cooperation between the City of Philadelphia and Commonwealth of Pennsylvania to improve collections efforts.

Taxpayers who note lax collection efforts question why it is that they pay taxes when others do not or why they pay high taxes when others pay little. Business owners who must pay high taxes but compete with newcomers to the marketplace who benefit from abatements or other tax breaks express frustration over the inequities created by such a dynamic. Even those who pay taxes without comment are often aggravated by a revenue-collection bureaucracy that is often described as unhelpful or even hostile. Anecdotal horror stories involving dealing with the city's revenue-collection bureaucracy range from the annoying (taxpayers receiving legal notices of code complaints when they were in compliance with all relevant filing requirements) to the exasperating (taxpayers having to pay fees for errors found on tax returns that had been prepared by Revenue Department personnel).

Into A New Reality

The national and local economies have experienced revolutionary change during the past twenty years. The old manufacturing economy was eclipsed by a new economy built upon the service and high technology sectors. Jobs shifted from manufacturing to services, and new businesses in the fields of communications, computers, life sciences, and the Internet outpaced the traditional economic sectors. Firms in these new industries are less dependent upon the city's heavy infrastructure and large pools of unskilled workers and, instead, require a highly trained workforce. The Internet created a virtual marketplace accessible by anyone from anywhere and this further undermined the importance of the city's physical infrastructure and market. In sum, some of the city's traditional competitive advantages have become less important in the new economy.

The city must re-think its tax structure to adapt it to the new economy. First and foremost, the city must be able to compete for firms that are more mobile than ever. The city retains significant advantages, but the ongoing flight of companies from the city indicates that its pull on commerce is now offset by the push of other factors, including high taxes. With employers and employees both in high demand, taxes on workers or businesses could reduce the city's appeal to employers. The city can instantly improve its competitiveness by lowering the cost of doing business within its borders by reducing taxes.

The city must also review the interplay between its tax structure and revolutionary features of the new economy to maximize revenue while minimizing harm to local businesses. For instance, the Internet has created a virtual marketplace that instantaneously hosts transactions among buyers and sellers located in different places anywhere in the world. While this technology provides companies with access to new markets, the city may not see increased tax revenues that might otherwise be associated with increased sales. The city benefits if a shop in the Italian Market is able to generate new business by selling wares to customers around the world, but, depending on how those sales can be taxed, the city may not realize new revenues.

In 1998, the federal government, in its own effort to come to grips with new economy tax issues, imposed a three year moratorium on localities, prohibiting them from levying "multiple or discriminatory taxes on electronic commerce." This provision, which is under review for extension, limits local jurisdictions' ability to collect Sales Tax on Internet transactions. Philadelphia, as a comparatively low Sales Tax jurisdiction, probably has not suffered a significant loss of revenue from this prohibition, but if the ban is repealed, the city will need to consider whether taxation of Internet transactions will encourage retailers to locate elsewhere.

Additionally, the city must also consider the impact of its tax structure on companies that sell digital products and services directly through the Internet. These products and services include software, music, video, games, chat, and other application services and products that consist entirely of electronic digital code. The sellers of these products are typical of the new economy in that they can locate anywhere. They do not need a large labor force or physical plant, and they do not require a heavy transportation system. They simply need a trained workforce, a server to host their systems, and a high-speed Internet connection to export their products instantaneously throughout the world. In order to capture its share of this growing industry sector, the city should reevaluate the factors it utilizes to establish business tax liability so as not to punish businesses that locate in Philadelphia. By taxing firms' profits based on where workers and offices are located, the city discourages information technology firms from locating in Philadelphia, but by taxing firms' profits based on local sales alone, the city could be an attractive tax haven.

After more than three centuries of history that shaped its tax structure, Philadelphia is poised to enter a new century at a time when the world economy is being reinvented. How the city's tax structure affects firms and families could very well determine the future of the city itself.

Legal Issues Surrounding Altering Taxation In Philadelphia

In evaluating the problems associated with taxation in Philadelphia, the imperative to reduce Philadelphia's oppressive tax burden, and the need to alter the city's tax structure, thoughtful individuals differ on recommendations for change. In crafting tax-reform proposals, one must not only be mindful of fiscal and budgetary issues that hamper efforts to alter the city's current mix of taxes, one must also understand legal obstacles to certain otherwise worthy proposals.

Philadelphia is a home-rule city and the city's elected and appointed officials have tremendous latitude to set policy directions, enact legislation, and promulgate regulations. But in many matters, including taxation, the city is limited by state and federal laws and prohibitions. The City of Philadelphia's taxing authority is limited by state statute, the preemption doctrine, and by the Pennsylvania and U.S. Constitutions. In many cases, the city can enact, repeal, alter, or raise and lower taxes through legislative action at the local level. In other cases, however, the city cannot change how or how much the city taxes without action at the state or federal level.

The Pennsylvania Constitution vests all taxing authority with the state government. In fact, the legislation that defines the city's ability to govern itself specifically denies it the ability to impose a tax without state authorization. The state government has enacted a series of enabling statutes defining the scope of Philadelphia's taxing authority. These enabling statutes, while granting Philadelphia expansive taxing powers, impose significant limitations.

In general, the city's taxing power is created and defined by two significant pieces of state legislation. The Sterling Act of 1932 authorizes Philadelphia to assess taxes on "persons, transactions, occupations, privileges, subjects and personal property" within the city limits. The Sterling Act also imposes significant limitations on these powers. First, it prohibits Philadelphia, absent special permission from the state, from levying a tax that the state already collects. Second, the Sterling Act places a geographic restriction on Philadelphia's taxing authority. It limits Philadelphia's taxing authority to persons and transactions within Philadelphia's city limits, which courts have interpreted to allow the city to tax all resident income regardless of where it is earned while limiting tax on non-residents to income they earn within Philadelphia city limits. The Little Sterling Act of 1963 authorizes the City of Philadelphia to grant its school district the power to impose taxes on anything that the city can tax under the Sterling Act (except the wages or net income of non-residents) and unearned income of residents at a rate equal to or lower than the Wage Tax.

Additional state legislation has altered the way the city may tax. For example, the First Class City Business Tax Reform Act of 1984 authorizes Philadelphia to tax the net income and gross receipts of individuals and corporations engaged in business within the city. This legislation allows the city to alter the rates of these levies, but requires the Pennsylvania General Assembly to act to implement certain other changes to the city's Business Privilege Tax.

Pursuant to the legislation that created the Pennsylvania Intergovernmental Cooperation Authority, the city enacted a 1.5-percent Wage Tax and a 1.5-percent Net Profits Tax on residents and pledged the revenue generated by the tax as security for PICA bonds. The city reduced its existing Wage Tax and Net Profits Tax by 1.5 percent, thus preventing any tax increase for residents. Until those PICA bonds are paid off in 2023, or until bondholders agree to another arrangement, the city must at least maintain a 1.5-percent tax on residents' wages and net profits.

Pursuant to state law, the city may not increase the non-resident Wage Tax rate beyond 4.3125 percent unless the city raises the resident rate to 5.75 percent or greater. If the resident rate is increased beyond 5.75 percent, the non-resident rate can also be increased, but not to a rate that is greater than 75 percent of the resident rate (the city may reduce the Wage Tax on residents without reducing the tax on non-residents). However, with other taxes such as the Sales Tax, Hotel Tax, and Vehicle Rental Tax, the city must obtain authority from the Pennsylvania General Assembly before it increases the amount of the tax.

The Commonwealth of Pennsylvania has issued a series of exemptions from taxation and special taxation provisions that must be abided by the city. Public property, places of religious worship, property owned by veterans' groups, and institutions of pure public charity are exempt from city taxation. Similarly, the city may not levy certain taxes on businesses located within Keystone Opportunity Zones.

The city is also barred by what is termed the "preemption doctrine" from taxing any industry that is already pervasively regulated by the state or federal government. For example, courts have barred Pennsylvania municipalities from taxing banks, horse racing tracks, or malt and brewed beverage importers because these businesses are heavily regulated by the commonwealth.

Additionally, the Pennsylvania Constitution's uniformity clause requires that all taxes in Pennsylvania apply equally to similarly situated taxpayers. It states, "All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws." Jurisdictions, including Philadelphia, have struggled to work around the uniformity clause by creating distinct taxpayer and revenue classifications that could be targeted by different taxes. For instance, various city and state taxes distinguish between corporations and individuals, non-profits and for-profits, and commercial rental property and residential rental property, among other distinctions.

However, any disparate treatment among taxpayer groups or classes must have a rational purpose or the courts will prohibit the tax as a violation of the uniformity clause. For example, the state courts have ruled that the uniformity clause bars the state and its municipalities from levying graduated or progressive taxes on the grounds that they provide different treatment of income levels without proper justification. As a result, all taxes in Pennsylvania are proportional or flat taxes.

The U.S. Constitution places additional restrictions on the city's taxing authority. First, the equal protection clause restricts Philadelphia's taxes in a manner similar to the Pennsylvania Constitution's uniformity clause. Federal law demands that the city treat similarly situated taxpayers equally (but this provision is generally less restrictive than Pennsylvania's uniformity clause). Second, the due process clause requires that there must be sufficient nexus between the city and the taxpayer to justify taxation. Therefore, the city must have a justifiable connection with a taxpayer if it is to impose a tax upon that taxpayer. Finally, the commerce clause prohibits taxes on interstate commerce unless the tax is on activity that has a sufficient nexus to the state, is fairly apportioned, is related to the services provided by the state, and does not discriminate against interstate commerce.

5. Recommendations For Tax Reform In Philadelphia

It should be no surprise that the Controller's Office concludes that the city's overall tax burden and many individual taxes are high, and that the city's tax structure places Philadelphia at a competitive disadvantage in relation to other cities as well as surrounding jurisdictions. This weakness blunts the city's natural advantages and frustrates attraction and retention efforts. Significant change must occur if Philadelphia's tax structure is to help the city retain and attract businesses and residents.

Recommendations For Change

The following assumptions helped guide the Controller's Office in its work. Given budgetary and fiscal restraints, the Controller's Office focused on reforms that could do the most good for the most residents and employers and recommended changes that should create significant positive reactions in the local economy. Similarly, the Controller's Office avoided picking specific winners in favor of recommendations that could create a more favorable marketplace in general. With a more favorable marketplace, growth should occur across the board, not just in one industry and the city could attract and retain the growing businesses of tomorrow, not just chase after the grown businesses of today.

In considering the city's tax structure, the Controller's Office focused on the city's overall tax burden and avoided confusing issues by discussing areas where the city should consider increasing spending. It is clear that additional resources could help improve underperforming schools, reduce crime, and improve the quality of life across Philadelphia. But it is equally clear that reducing the high tax burden of city residents and employers is a desirable primary goal that is necessary to help stop the ongoing exodus of city residents and improve the city's long-term economic prospects. A tax structure that helps attract and retain firms and families will improve the city and each of its neighborhoods — and generate additional resources that could be targeted toward solving specific problems within the city.

The Controller's Office did not craft its recommendations within a vacuum. Additional concerns beyond tax or economic theory played a major role in the process to generate reform recommendations. First, in examining the budgetary and fiscal framework for change, the Controller's Office respected the city's current spending priorities and avoided suggestions that would make change at the expense of currently funded city programs and projects. Furthermore, the Controller's Office attempted to generate recommendations that would complement city initiatives so that programs like the Neighborhood Transformation Initiative and the tax-reform recommendations become parts of a greater whole. In addition, we exhibited conservatism in light of current economic and budgetary uncertainty. In sections ahead that address the financial impact of proposed recommendations, readers will note that the Controller's Office believes that it is possible to identify more than enough funding to support its reforms.

Because the Controller's Office worked to establish tax recommendations that represent sound policy that is politically achievable in the current fiscal environment, the following recommendations are directly related to what we believe can be done. If we believed the city budget could withstand a $1 billion tax cut, we may have chosen alternate recommendations, just as we may have altered our proposals if we believed the city budget could only withstand a $1 million tax cut.

As a final notion, this package of recommendations is drafted with severability in mind so that the recommendations make sense as a package or individually. While it may be impossible to please all of the people all of the time, we believe that the following recommendations will please most. However, if most are not pleased, each of the various recommendations could be modified, eliminated, or augmented with additional ideas without compromising the beneficial effects of the other proposals. (See Appendix E for examples of how recommendations would affect Philadelphia taxpayers.)

Significantly Reduce Business Taxes In Philadelphia In The Near Term

Given the city's restricted ability to cut taxes dramatically, it is crucial to maximize the impact of any proposed reductions. As the next section details, the City Controller's Office sees flexibility within the city's budgetary structure to increase the magnitude of tax cuts. The key is to choose the right tax or taxes to cut and to make that cut significant enough to influence residents and employers who would look to enter or leave the city.

The city has the choice to eliminate one or more of the taxes that generate a limited amount of revenue (such as the Amusement Tax) or marginally reduce one or more of the taxes that generate considerable revenues (such as the Wage Tax). Similarly, the choice extends to addressing a tax or taxes that affect employers in general (such as the Business Use and Occupancy Tax), specific employers (such as the Liquor Sales Tax), residents in general (such as the Real Estate Tax), or specific residents (such as the School Income Tax).

In deciding the second question first, the Controller's Office believes the city must do everything in its power to encourage individuals to move to and remain in Philadelphia. However, given the substantial role that issues like school quality and neighborhood safety play in determining residential decisions, the city will always have only a limited ability to influence residential location decisions with tax policy. Businesses will be more likely to respond to tax cuts, which affect overall profitability. To make Philadelphia more attractive to employers will create jobs and, therefore, attract more residents.

If the city is to address business taxes, it must choose between the Wage Tax, which affects salaries, and the Net Income and Gross Receipts portions of the Business Privilege Tax, which affect profits. In 1999, as part of Philadelphia: A New Urban Direction, the City Controller addressed this issue to determine how equal cuts to these taxes would encourage job growth.

The City Controller's Office ran through three separate simulation exercises to compare the employment effects stemming from a dollar of reduction in tax liability.[4] The data show that a dollar of tax reduction affecting the Business Privilege Tax generates larger employment effects compared to a similar reduction in the Wage Tax. In particular, reducing the Gross Receipts portion of the tax would offer the greatest benefit. Although reducing the Net Income portion of the tax would offer a slightly lower return from a dollar of tax reduction, it would generate significant growth in the for-profit sectors and would be consistent with a strategy of targeting for-profit industries for economic development. Furthermore, in analysis performed to estimate the effect of proposed tax changes, the Controller's Office estimates that a reduction of the Net Income portion of the Business Privilege Tax would generate a more substantial supply-side effect than a reduction of the Gross Receipts portion. (See Appendix B.)

After years of reductions, the Gross Receipts portion of the Business Privilege Tax has been reduced by more than 26 percent, but the Net Income portion has remained unchanged. As discussed above, it is clear that retailers and wholesalers would benefit from cuts in the Gross Receipts portion, while service firms and manufacturers would benefit from cuts in the Net Income portion.

In Philadelphia, businesses with a higher net income liability than gross receipts liability serve an export demand, while businesses with a higher gross receipts liability than net income liability serve a local demand. As long as that local demand remains, firms will enter the marketplace to meet that demand, but firms that meet a demand that is not local may not remain in the local marketplace if it is not in their business interest to do so.

[4] For more information about this analysis, see Philadelphia: A New Urban Direction (Saint Joseph's University Press), 1999: pp. 115-118.

If the city wants to stimulate attraction and retention efforts for businesses that capitalize on local demand like restaurants or retail stores, the city should focus its tax-reduction efforts on the Gross Receipts portion of the Business Privilege Tax. To encourage attraction and retention of businesses that export goods and services across the globe — and serve to bring money into the city economy instead of simply shifting income around the city economy — the city should focus its tax-reduction efforts on the Net Income portion of the Business Privilege Tax. Additionally, by eliminating the Net Profits Tax, the city can encourage business expansion and eliminate a confusing and unfair element of the tax structure.

<u>Recommendation: Reduce the Net Income portion of the Business Privilege Tax from 6.5 percent to 4.0 percent beginning fiscal year 2003 (July 1, 2002).</u>
While the city has reduced the Gross Receipts portion of the Business Privilege Tax in recent years, this reduction has only affected corporations that generate receipts in Philadelphia. For corporations that sell products and services outside Philadelphia, none of the recent tax cuts has reduced the city's onerous tax burden. To attract and retain these businesses — that do not necessarily serve the local marketplace and therefore can and often do locate or relocate outside of Philadelphia — the city must address the Net Income portion of the Business Privilege Tax. This cut represents a 38.5-percent reduction, and would represent a worst-case scenario, first-year net loss to the city budget of approximately $62.0 million.

<u>Recommendation: Reduce the Gross Receipts portion of the Business Privilege Tax from .24 percent to .20 percent beginning fiscal year 2003 (July 1, 2002).</u>
While the Gross Receipts portion is often criticized as unfair because even unprofitable businesses must pay the tax, it represents a way to generate revenue from companies that capitalize on the local marketplace. In recent years, this tax has been reduced from .3250 percent to .2400 percent — more than 26 percent — but it continues to be a source of frustration for business owners and a disincentive to enter the marketplace. The suggested cut from .24 percent to .2 percent represents a 16.7-percent cut, and would represent a worst-case scenario, first-year net loss to the city budget of about $13.9 million.[5]

<u>Recommendation: Eliminate the city Net Profits Tax beginning fiscal year 2003 (July 1, 2002).</u>
Currently, non-corporate business income generated within the city is subject to both the Net Profits Tax (4.5385 percent for residents and 3.9462 percent for non-residents) and the Net Income portion of the Business Privilege Tax (6.5 percent). These taxpayers are entitled to a credit equal to 60 percent of their Net Income liability against their Net Profits Tax liability. However, they still pay higher rates than corporations and face effective business net income tax rates of 7.1385 percent for residents and 6.5462 percent for non-residents. Additionally, Philadelphians self-employed outside the city are subject to the 4.5385 percent tax on their net profits even though they are earned outside the city. Eliminating the Net Profits Tax would both simplify the tax system and reduce taxes for non-corporate businesses operating in Philadelphia, thereby encouraging business activity and growth within the city. By doing away with the Net Profits Tax, the city could eliminate this confusing (the deduction and distinctions between net income and net profits are cumbersome and most taxpayers do not understand why they are subject to two taxes on their income), and unfair (individuals pay a higher tax on business profits than corporations) element of Philadelphia's tax structure. Similarly, such a move could encourage Philadelphians self-employed outside the city to remain in Philadelphia and might encourage self-employed residents outside Philadelphia to move to the city since the Net Profits Tax would no longer be a factor in their location decisions. Because the legislation establishing the Pennsylvania Intergovernmental Cooperation Authority requires a 1.5-percent city Net Profits Tax to be used to help pay the debt service on PICA-issued bonds, the city would need PICA bond-holder approval to implement this reform. Since that debt service is also supported by a 1.5-percent city Wage Tax, the much smaller amount generated by the Net Profits Tax is currently not necessary to meet bond debt obligations. This change would represent a worst-case scenario, first-year net loss to the city budget of approximately $19.8 million.

[5] The administration currently plans to reduce this tax gradually to .215 percent for fiscal year 2006.

Shift Tax Burden To Reduce Resident Wage Tax And Encourage Development

Even though cutting the Wage Tax is difficult due to the significant effect such cuts would have on the city's budget, it should be possible to reduce the rate of the Wage Tax by shifting tax burden from wages to real estate. Similarly, by altering the way the city taxes real estate — placing a higher tax on the value of land than the value of buildings — the city should be able to reduce Real Estate Tax bills for the vast majority of residents, while attacking blight and encouraging development.

By utilizing a higher tax on land than on improvements, the city can discourage speculation and reduce disincentives to build, thus promoting responsible development and property maintenance. By reducing the Wage Tax through a shift of tax burden to the Real Estate Tax, the city could reduce pressure on employers to increase salaries to compensate for a high Wage Tax. In addition to reducing the tax burden for most city residents, this move would shift tax burden from income to real estate, a reorientation that economic theory suggests would improve the city's business and residential climate. Even if these shifts increase taxes on businesses, the Controller's Office estimates that the vast majority of employers would save money if the proposed reductions to the Business Privilege Tax are adopted.

<u>Recommendation: Institute a Land Tax, changing the way property is taxed in Philadelphia from the current system (where the tax from structures and improvements generates approximately 77.5 percent of Real Estate Tax revenues) to a system where the tax on land and the tax on structures/improvements each generate an equal amount of revenue beginning fiscal year 2003 (July 1, 2002).</u>
This shift would capitalize on the real estate maxim that location is the most important factor in determining the worth of a property and create a system where land is taxed at 3.44 times the rate of structures/improvements. (Such a ratio would generate half of Real Estate Tax revenue from land and half from buildings.) Modeling by the Controller's Office using data from the Board of Revision of Taxes shows that approximately 78 percent of residential taxpayers would see their Real Estate Taxes reduced with this shift, while approximately two-thirds of those whose taxes might increase would see increases of less than $100 per year. Such a shift could aid blight-removal and neighborhood-transformation efforts. By taxing the value of land more than the value of the structures/improvements that exist on it, this split-rate taxation discourages speculation and encourages development and neighborhood revitalization. Owners of vacant and underutilized land and properties would find it more costly to continue to maintain their holdings in an underdeveloped state. Those who want to construct or improve homes and buildings would pay less in the short and long run instead of being punished with significantly higher taxes on their investments. (An 18-month moratorium on reassessment of recently sold land and property could be established to give developers an opportunity to assemble land for new construction.) This shift would be budget neutral[6] in the first year — with the potential to generate additional future revenues as additional development takes place in Philadelphia — as the increased taxes on land will generate enough revenue to offset the reduction of the taxes on real property. (For more detailed information on how such a proposed shift would affect properties in Philadelphia, see Appendix A.) While this shift could be accomplished in a budget-neutral manner, implementing a system to properly value land, and then support and defend those values for assessment purposes, could generate one-time and ongoing costs for the city's Board of Revision of Taxes.[7] Ongoing reassessments will then be crucial to maintaining fairness in the system and making the incentives of land-value taxation work.

[6] By budget neutral, the Controller's Office means that, in this case, revenues generated by the higher tax on land and lower tax on structures will be sufficient to meet the current budgeted revenue projections for the Real Estate Tax.

[7] An estimate by the Board of Revision of Taxes suggests that the cost to establish fair, defendable, and supportable land values could be between $6.2-6.7 million per year. The Controller's Office notes that this estimate would nearly double the budget of the Board of Revision of Taxes and, therefore, may be seen as somewhat liberal.

Recommendation: Reduce the city Wage Tax from 4.5385 percent to 4.0 percent for city residents and increase the city Real Estate Tax accordingly to create a budget-neutral first-year shift beginning fiscal year 2003 (July 1, 2002).

This change would lower the city Wage Tax by more than 11.0 percent. The majority of employed Philadelphia homeowners would actually see their taxes decrease under this change. (Only individuals whose homes have a resale value of more than three times their annual household income might see an increase in taxes in this scenario.) For example, a household earning a total of $50,000 per year, living in a home with a resale value of $150,000 would save $269 each year from the Wage Tax cut and might only see an increase of approximately $222 per year from the Real Estate Tax increase. This shift would increase the overall Real Estate Tax (including taxes dedicated to fund school district operations) from 82.64 mills to 91.89 mills. Because, by law, the School (Non-Business) Income Tax cannot be higher than the Wage Tax, any change to the Wage Tax would reduce the rate and the amount of revenue generated by the School (Non-Business) Income Tax. The city would have to compensate the school district for any lost revenues (in this case, approximately $1.4 million annually). This shift would be budget neutral[8] in the first year — with the potential to generate additional future revenues by improving employer- and resident-attraction and retention efforts — as the additional Real Estate Tax revenues will generate enough revenue to offset the city Wage Tax reduction. Low-income seniors in Philadelphia would not have to worry about tax increases due to this shift because they are protected by the Senior Citizen Low Income Special Tax Provisions. This program permits taxpayers that meet income eligibility to freeze their Real Estate Tax assessments so that they are not affected by increases in assessments. Furthermore, the city could consider increasing the income eligibility for the tax freeze program or create a special fund as it did during the 1997 Tax Lien Sale to assist seniors or low-income residents who may be adversely affected by this recommendation.

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To demonstrate how these shifts would affect taxpayers, the Controller's Office has created a Tax Shift Calculator. This Tax Shift Calculator can be found on the Internet at the City Controller's On-Line Office at www.philadelphiacontroller.org/calculator.htm. Alternatively, readers can utilize the directions on the following page to calculate how these shifts would affect their annual tax bills.

[8] By budget neutral, the Controller's Office means that, in this case, revenues generated by the Wage Tax plus the Real Estate Tax after the proposed shift will be sufficient to meet the current budgeted revenue projections for those taxes. By basing future revenues on fiscal year 2001 actual tax collections, the Controller's Office is able to offset an 11.1-percent cut in the residential Wage Tax with only a 11.19-percent increase in the Real Estate Tax. If one were to use the inherently conservative revenue-collection estimates of the current Five-Year Plan, the above-proposed rates would have to be altered to maintain revenue neutrality.

Tax Shift Calculator

www.philadelphiacontroller.org/calculator.htm

By following the steps below, taxpayers will be able to determine how their tax burdens would change if the tax shifts recommended by the City Controller's Office were to be enacted. The calculations below are based on the City Controller's Office's modeling of data supplied by the Board of Revision of Taxes and Revenue Department. Any errors in the data would naturally alter results. Similarly, results could change depending on how the shifts would be implemented in practice.

Calculating The Effect Of A Proposed Shift Of Tax Burden From Property To Land

1. Contact the Board of Revision of Taxes at 215.686.4334 to determine:

   your total annual Real Estate Tax bill (here) __________ (a)

   your Assessed Taxable Land; (here) and __________ (b)

   your Assessed Taxable Building (here) __________ (c)

2. Multiply (b) by .1833 to generate your proposed tax on your land and enter here __________ (d)
3. Multiply (c) by .0533 to generate your proposed tax on your building(s) here __________ (e)
4. Add (d) plus (e) to generate your total new Real Estate Tax burden here __________ (f)

If (a) is larger than (f), you will pay less under this proposed shift.

Note: If your building is worth much more than your land, you should see a tax reduction in this scenario. If you do not, you may want to contact the Board of Revision of Taxes regarding any questions about your assessments.

Calculating The Effect Of A Proposed Tax Shift From Income To Property

5. Enter your total annual Real Estate Tax bill (a) here __________ (g)
6. Enter your total annual household income (your wage or salary income) here __________ (h)
7. Multiply that total (h) by .045385 to generate your annual Wage Tax burden here __________ (i)
8. Add (g) plus (i) to generate a total annual Wage and Real Estate Tax burden here __________ (j)
9. Multiply (g) by 1.1119 to generate the proposed Real Estate Tax burden here __________ (k)
10. Multiply (h) by .04 to generate the proposed annual Wage Tax burden here __________ (l)
11. Add (k) plus (l) to generate a proposed total Wage and Real Estate Tax burden here __________ (m)

If (j) is larger than (m), you will pay less under this proposed shift.

Note: If your annual household income is less than one-third of the value of your home, you should see a tax reduction in this scenario. If you do not, you may want to contact the Board of Revision of Taxes regarding any questions about your assessments.

Calculating The Combined Effect Of Both Shifts

12. Enter the proposed annual Wage Tax burden (l) here __________ (n)
13. Multiply your proposed new Real Estate Tax burden (f) by 1.1119 and enter here __________ (o)
14. Add (n) plus (o) to generate your total new combined tax burden here __________ (p)

If (p) is larger than (j), you will pay less under the combined effects of both proposed shifts.

Note: If your building is worth much more than your land, you should see a tax reduction in this scenario. If you do not, you may want to contact the Board of Revision of Taxes at 215.686.4334 regarding any questions about your assessments. If you believe your assessment information is incorrect, you can appeal and if you are right, your bill will be lowered.

Take Advantage Of Improved Business Climate To Accelerate The Pace Of Wage Tax Reductions

Econometric evaluations show that the proposed changes to the tax structure will create sustained and positive growth in the marketplace. (See Appendix B.) If that is the case, the city should be able to increase the pace of its current Wage Tax reductions and decrease the burden of this tax on city residents and workers. In the *1997 Mid-Year Economic and Financial Report*, the City Controller's Office estimated the impact of recently enacted and proposed Wage and Net Profits Tax cuts on the number of city jobs and found that anticipated cuts should create more than 18,000 jobs. According to the Bureau of Labor Statistics, the city realized a net job increase of more than 22,000 between 1995 and 2000. While some of this growth may be attributable to growth in the national economy, as discussed above, Philadelphia did not experience job growth until after the city reduced its taxes — years after the national expansion began and years after regional employment showed a corresponding increase. It follows that increasing the pace of tax reductions should increase the pace of job growth (or slow the pace of job decline during recessionary times).

<u>Recommendation: Reduce the city Wage Tax from 4.5385 percent for city residents and 3.9462 percent for non-residents to 3.5 percent and 3.375 percent, respectively, by fiscal year 2007 (July 1, 2006).</u> These cuts would come as increments and could be implemented in combination with the recommendation to reduce the resident Wage Tax to 4.0 percent by shifting some of the tax burden from income to property. A five-year reduction schedule could create the following reductions: 4.0/3.875 percent for fiscal year 2003, 3.875/3.750 percent for fiscal year 2004, 3.750/3.625 percent for fiscal year 2005, 3.625/3.50 percent for fiscal year 2006, and 3.50/3.375 percent for fiscal year 2007[9]. Even though the Wage Tax has been reduced in recent years for both residents and non-residents, significant additional reductions are required to attract and retain families and businesses. The reductions would represent cuts of about 3.25 percent per year. Assuming the city implements the recommendation to reduce the resident Wage Tax to 4.0 percent by shifting a portion of the Wage Tax burden to the Real Estate Tax, these proposed cuts would represent a worst-case scenario, first-year net loss to the city budget of approximately $4.6 million and a yearly net loss to the city budget of approximately $40 million in the immediate following years. If possible, these cuts should extend into the future beyond fiscal year 2007. Alternatively, if the city is worried that the budget will not be able to withstand these additional cuts, these Wage Tax reductions could be trimmed back or they could be shifted to increases in the tax on land to maintain budget neutrality while reducing the tax burden for most residents and further encouraging development. Because, by law, the School (Non-Business) Income Tax cannot be higher than the Wage Tax, any change to the Wage Tax would reduce the amount of revenue generated by the School (Non-Business) Income Tax. The city would have to compensate the school district for any lost revenues (in this case, approximately $600,000 each year beginning in fiscal year 2004).

Table 5.1 — Budgetary Impact Of Major City Controller Tax-Reform Recommendations

Recommendation	**Worst-Case FY 2003 Tax Loss**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$62.0 million
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$13.9 million
Eliminate The City Net Profits Tax In FY 2003	$19.8 million
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-
Shift A Portion Of The Resident Wage Tax To Real Estate Tax In FY 2003	-
Reduce The Wage Tax To 3.5% (Residents)/3.375% (Non-Residents) By FY 2007	$4.6 million
Total	**$100.3 million**

Source: City Controller's Office based on FY 2002-2006 Five-Year Financial Plan forecasted tax collections approved May 15, 2001

[9] The administration currently plans to gradually reduce this tax to 4.3850/3.8127 percent for fiscal year 2006.

Eliminate Confusing And Arguably Unfair Elements Of The City's Tax Structure

While tax cuts and shifts may improve the city's competitiveness for current or prospective residents and employers, the city must take steps to improve the clarity and fairness of its tax structure. Actions outlined below can make paying taxes in Philadelphia a much more user-friendly activity, while at the same time making the tax structure much more business friendly. Eliminating the double-payment of the Business Privilege Tax during the second year of business operations, altering the multi-factor apportionment formula for determining net income tax liability, and utilizing new flexibility gained by proposed tax changes to reduce the complexity of Business Privilege Tax paperwork will be important steps toward improving the city's tax structure.

<u>Recommendation: Advocate for the Pennsylvania General Assembly to make a technical amendment to the enabling legislation for the city's Business Privilege Tax to make it a retrospective tax instead of a prospective tax and eliminate the need for businesses to double-pay their Business Privilege Tax in the second year of operations beginning fiscal year 2003 (July 1, 2002).</u>
The Business Privilege Tax is essentially paid in advance. While the BPT is levied on an annual basis, because a business pays the BPT a year in advance, in the second year of operation a business must pay two years of BPT taxes. The logic is that this double-payment should be postponed to the second year to avoid overburdening businesses in their first year of operations. For many new start-ups, paying this double-payment in their second year of operations is still overly burdensome. Regardless of the burden, the fact that the BPT is basically paid in advance causes a great deal of confusion for tax payers and tax preparers. Additionally, from the city's perspective, double-taxing a business in its early years and foregoing tax revenues from its final year in the city when the business is either more profitable (and leaving the city) or generating significant income (from disposal of its assets) causes the city to lose revenue over the long term. The city's Revenue Department has proposed a technical amendment to the BPT's enabling legislation to accomplish this change, which, according to Revenue Department officials, could change the BPT from a prospective tax to a retrospective tax in a manner that would be budget neutral.

<u>Recommendation: Change the current multi-factor apportionment formula for determining tax liability for the Net Income portion of the Business Privilege Tax to a single-factor apportionment formula beginning fiscal year 2003 (July 1, 2002).</u>
The city currently uses multiple weighting factors to determine tax liability for the Net Income portion of the Business Privilege Tax: property, payroll and double-counting of receipts. As noted in previous sections of this report (See Page 42), because of this apportionment formula, a city business pays a higher tax burden than a suburban business when both businesses have an equal sales presence in Philadelphia. Under single-factor apportionment, the system would be dramatically simplified as all businesses would be taxed on the percentage of gross receipts generated within the city. The apportionment factors of property and payroll would be eliminated from the formula. The city-based business would see a significant tax reduction while the business located outside the city would face a larger tax bill. As a result, businesses located outside the city might consider moving into the city or they might consider not serving the city demand — allowing their city competitors to expand operations and capitalize on the opportunity. From another perspective, this change would reduce the taxes for Philadelphia businesses and encourage them to remain and expand in the city. At the same time, the recommendation would increase taxes on businesses that take advantage of the Philadelphia market without paying as much as their city competitors to support the marketplace. Additionally, as technology and business practices make location less important to firms, it is increasingly difficult to assign an exact percentage to what portion of payroll many businesses (especially those in the services sector) maintain in the city. Employees may be headquartered in Philadelphia, but spend little time at the actual home

office. The change to single-factor apportionment would bring taxation policies more into line with modern business practices and eliminate the need for businesses to maintain complex sales and payroll records to meet the city's reporting requirements. Similarly, businesses that are physically located in Philadelphia but generate little or no sales in the city face a significant net income burden despite the fact that those businesses may have no business reason to maintain their actual location within the city. Thus, while some businesses find a competitive advantage in the city's work force or physical location, other businesses can find those same advantages in locations just outside the city or in other regions. Many industry sector representatives confess that few manufacturing firms have a business reason to remain in Philadelphia. Technology firm representatives report that many technology-related businesses may incubate or grow in the city, attracted by proximity to world-class university or entrepreneurial centers, but when they become profitable, executives and investors find high taxes are a reason to leave Philadelphia. Changing to single-factor apportionment would make Philadelphia a tax haven for these businesses which bring outside dollars into the city, but have few real business reasons to remain in Philadelphia. According to the Revenue Department, this change would represent a worst-case scenario, first-year net loss to the city budget of approximately $11 million.

Recommendation: Simplify the process for paying Business Privilege Taxes and redesign Business Privilege Tax forms accordingly beginning fiscal year 2003 (July 1, 2002).

Currently, for a corporation located wholly in the city with sales entirely inside the city, the filing of the Business Privilege Tax return is relatively simple. The city has designed a BPT-EZ form to facilitate filing for an entity of this nature. First, the tax preparer takes the entity's net income or net profit and multiplies it by the current rate and enters that amount on Line 1 of the BPT form. Then, the tax preparer multiplies the total gross receipts by the current tax rate and enters this amount on Line 2 of the form. However, non-corporate entities or partnerships must additionally file a Net Profits Tax return. To do so, the tax preparer takes the already calculated net income and multiplies that amount by the current rate and enters that amount on Line 1 of form NPT-3. This becomes complicated when the preparer must calculate the Net Income credit. Each non-incorporated entity is entitled to a credit equal to 60 percent of the Net Income liability. This amount is moved forward to Line 5 of the Net Profits Tax return and then subtracted from the Net Profits Tax liability (Line 1) to arrive at a net Net Profits Tax liability. The Business Privilege Tax returns become even more confusing and much more complicated when the filing entity has sales or deliveries outside of the city. This is when the apportionment formula and apportionment factors of payroll, property, and receipts enter the equation. The city uses these factors (with double-weighting of the receipts) to calculate the apportionment ratio which is used to determine Net Income liability. As described above, this formula penalizes city businesses while providing an advantage to businesses located outside the city that have more than an active presence in the city. If the city were to eliminate the Net Profits Tax and change the apportionment formula to single-factor apportionment, the Business Privilege Tax would be streamlined and the forms related to the tax could be simplified. Without the Net Profits Tax, the city could eliminate the 60-percent credit calculation and the confusion it creates. Without the apportionment-weighting-factor calculation, the city could eliminate an entire page (Schedule C-1) from the Business Privilege Tax return. These changes could reduce the number of pages of forms that must be filled out by those who pay Business Privilege Tax from as many as six pages to a redesigned single-page form.

Pursue Additional Solutions To Improve The City's Tax Competitiveness And Fiscal Stability

Even if the city would implement each of the preceding recommendations, much work would remain in the ongoing effort to make Philadelphia a preferred place to live, work, and visit. The recommendations listed below would complement the tax-reform proposals outlined above.

<u>Recommendation: Implement a Philadelphia New Jobs Tax Deduction based on the Commonwealth of Pennsylvania's existing Job Creation Tax Credit program to encourage Philadelphia companies to create new jobs in the city and to offset increased costs they must bear due to Philadelphia's Wage Tax.</u>
While the Controller's Office initially explored the notion of eliminating the Wage Tax for new residents or employees, concerns about the legality of such moves shifted the focus toward a recommendation to encourage firms to expand employment. The commonwealth's program provides companies that meet certain criteria with a $1,000 tax credit for each new job they create. The credit applies to approved companies that either add 25 new jobs or increase their employment by 20 percent within three years. The city program can piggyback administratively on the commonwealth program by offering a $1,000 city tax credit against a firm's Business Privilege Tax liability for any new job in the city that receives a credit from the commonwealth under its program. By offering a $1,000 credit per new job (the same credit awarded by the commonwealth) against the Business Privilege Tax, the city can partially offset the cost employers must bear due to the Wage Tax.

<u>Recommendation: Enhance the ability of neighborhood-based tax incentives to encourage growth in development-starved areas of the city.</u>
In recent years, federal and state initiatives have designated certain areas of Philadelphia as an Enterprise Zone, Empowerment Zone, Keystone Opportunity Zone, or Keystone Opportunity Expansion Zone. Businesses within these zones receive tax benefits designed to offset disamenities associated with the areas. The city can pursue a number of strategies to capitalize on the attractiveness of these tax benefits (which, in the case of the Keystone Opportunity and Keystone Opportunity Expansion Zones, can be as significant as the near-complete elimination of state and local tax liability). First, the city can work to improve services to reduce the unattractiveness of these areas as places to do business. Second, the city can coordinate other initiatives like the Neighborhood Transformation Initiative and capital spending to improve the physical environment in these areas. Finally, the city can continue to push at the state and federal levels for changes in tax policy — like the elimination of capital gains taxes for those who locate in big cities in general or in depressed urban areas specifically — to complement local business-attraction efforts.

<u>Recommendation: Utilize technology and establish a Taxpayers' Ombudsperson to facilitate improved interactions between taxpayers and the city's revenue-collection bureaucracy.</u>
Taxes are an annual source of frustration for most residents and employers, but the city should do all it can to make the taxpaying experience less inaccessible and antagonistic.

- The city should invest in the technology necessary to make it easier for taxpayers to pay their obligations. The city could use telecommunications technology to make paying taxes more customer-friendly and collections more certain. Like the Internal Revenue Service, the city could allow residents and businesses to pay taxes with credit cards. Like the Commonwealth of Massachusetts, the city could allow taxpayers to file tax returns by phone. Like the Commonwealth of Pennsylvania, the city could develop an information data exchange system to allow businesses to use Electronic Data Interchange and Electronic Funds Transfers to pay taxes.
- The city should follow the lead of other local jurisdictions and make all public tax-related real estate data available on-line to improve the overall transparency of property taxation in Philadelphia. Jurisdictions like Allegheny County, Pennsylvania and Cook County, Illinois have made tax data

available on the Internet and even include images of properties or floor plans so that citizens can have ready access to all public information about real estate taxation in those counties.[10]

- Taxpayers continually express frustration over the city bureaucracy's inability to answer tax questions, the city's inefficiency in rectifying disputes, and a general dissatisfaction with the taxpaying process. While the city's Revenue Department is constantly trying to improve customer relations, an intermediary office established to represent taxpayers could do much to ease the perception that the city/taxpayer relationship is an antagonistic one. The Taxpayers' Ombudsperson could field tax inquiries and work with taxpayers and the revenue-collection bureaucracy to resolve issues in a way that would meet the city's goal of collecting from those who owe, as well as ensuring that taxpayers' concerns are considered by a fair and responsive advocate. This new official could even coordinate sensitivity training for revenue-collection personnel to improve the nature of contact between the city and its taxpayers. Additionally, the Ombudsperson could help improve efforts to educate new taxpayers and ensure that new employers and residents understand the nuances of the Philadelphia tax structure.
- To demonstrate to taxpayers the city's desire to be fair, the city can change the law relating to record-keeping requirements to equalize the rights of taxpayers with the rights of the city. Currently, the law requires taxpayers to maintain records for six years and allows the city to sue to recover certain unpaid taxes for six years, but taxpayers who overpaid city taxes may only claim a refund for the tax overpayments for three years after the date of payment. To improve the fairness of the system, the city should enact legislation to limit the city's audit power (other than in cases of fraud or non-filing) and reduce the city record-keeping requirements to three years.

<u>Recommendation: Improve tax collection efforts.</u>
Tax avoiders and evaders generally do not pay taxes for one of two reasons: they cannot afford to pay taxes or they can afford to not pay taxes. While some individuals find that their tax burden outweighs their ability to pay, others are able to rationalize that the city's collection efforts are lax enough to provide an incentive to avoid paying taxes.

- A recent City Controller's Office audit found that the City of Philadelphia does not collect Liquor Sales Tax from approximately one-third of the total number of establishments subject to the 10.0-percent tax on the sale of alcoholic beverages. Additionally, the Controller's Office has long recommended that the school district employ a vendor tax match similar to that employed by the city to ensure that vendors settle any tax bills before they receive payment for goods and services.
- In the weeks before the city's 1997 Tax Lien Sale, thousands of property owners came forward to settle delinquent Real Estate Tax bills. In total, the city generated approximately $30 million in Real Estate Tax revenues just before the sale as owners suddenly took seriously the notion that they could lose their properties if they did not pay their taxes. The city should encourage owners of tax-delinquent properties to pay their taxes by more aggressively utilizing its property-acquisition tools and making real the threat that if property owners do not pay their taxes, they could lose their properties.
- Philadelphia Real Estate Taxes are derived through a formula that applies the tax rate to 32 percent of the city-determined fair market value of a given property, but in many cases that market value is significantly less than the true value of that property — or significantly different from the market value of a similar property elsewhere in the city. Any Real Estate Tax system will exhibit natural lags trying to keep up with the increases in property values, but many properties in Philadelphia should be equalized to reflect their true value. The city should consider a full city real estate reassessment or step up efforts to equalize all Philadelphia properties so that similar properties have similar city-determined market values and equal Real Estate Tax bills.

[10] See: <http://www2.county.allegheny.pa.us/RealEstate/Search.asp> & <http://www.cookcountyassessor.com/startsearch.html>

Recommendation: Continue to make every effort to reduce the cost of government and use savings to drive down the city's need for taxes.

The Controller's Office continues to advocate for efforts to rightsize government to reduce the cost of city government, consolidate government functions to eliminate needless duplication of effort, utilize technology to reduce service-delivery costs, and engage the municipal workforce in labor-management cooperatives to improve service to the citizenry at all levels. By lowering the cost of government, the city can free funds that could be used to further reduce the tax burden.

Recommendation: Continue to advocate for regional and statewide tax reform to alter the way the Commonwealth of Pennsylvania and local jurisdictions fund public education and local government services.

Philadelphia can alter its tax structure, but only the commonwealth can address larger issues of tax fairness and regional tax disparities. Such a move could be combined with an effort that would require General Assembly action to redefine the entire Philadelphia tax structure.

- If, as in Minnesota's Minneapolis-St. Paul region, the jurisdictions of the Greater Philadelphia region could agree on a property tax-base sharing plan, the region could redistribute resources from growing communities toward communities with additional needs and discourage inter-jurisdictional competition since any regional growth would benefit the entire region instead of just one community. Any additional income flowing into Philadelphia as part of such a system could be used to reduce the city's Wage Tax.
- If, as in other states like Michigan and Vermont, the Commonwealth of Pennsylvania would establish a new system of school funding that removed most of the pressure from local jurisdictions to fund schools, the City of Philadelphia could address some of its more reviled taxes. If the Commonwealth of Pennsylvania would meet its constitutional mandate to "provide for the maintenance and support of a thorough and efficient system of public education" by fully funding local schools, the City of Philadelphia could eliminate the Business Use and Occupancy Tax, the Liquor Sales Tax, and the School (Non-Business) Income Tax, and then use Real Estate Taxes that would have otherwise gone to the school district to reduce the Wage Tax. Such actions could allow the city to reduce the city's tax burden by eliminating the Business Use and Occupancy Tax (approximately $91 million), the Liquor Sales Tax (approximately $25 million), and the School (Non-Business) Income Tax (approximately $22 million). Such a move would free approximately $415 million in Real Estate Taxes currently pledged to fund the school district, which could be redirected to the city's general fund and allow the city to reduce the Wage Tax by approximately 35 percent.

Recommendation: Continue to push for the Commonwealth of Pennsylvania to fund Pennsylvania's courts at the state level and remove the burden of court funding from Philadelphia and other counties so the city can use those funds to reduce taxes.

In 1987, the Pennsylvania Supreme Court voided county funding of local courts. Subsequent legal activity and Supreme Court pronouncements established guidelines for the commonwealth to implement a unified court funding scheme, but full commonwealth assumption of these funding obligations remains elusive. If the Commonwealth of Pennsylvania would provide funding for court operations, the City of Philadelphia could free at least $111 million (this amount could be reduced by about $37 million in court-related revenue streams, but could be increased by state assumption of costs related to personnel in court-related offices, space rental, utility expenses, and other support costs), which could be used to reduce the Wage Tax by as much as 10.0 percent.

Recommendation: Complement efforts to make the tax structure business- and resident-friendly by improving the city's regulatory processes.

The city should establish a Regulatory Study Commission to evaluate the relevance, necessity, and cost of any new city regulations, and serve as a filter agency through which regulations are passed on to City Council. Concurrently, a Code Task Force could review, revise, and rightsize the existing Regulatory Code to eliminate or consolidate regulations that are outdated, costly, and counterproductive. The city should swiftly embrace e-commerce technology to expedite the application and approval processes and to cut back on the amount of personal and telephone contacts to city agencies. Payments for licenses and permits should be accepted on-line by credit card and customers should be able to check the status of their applications and access code and payment requirements on-line. Inter-agency databases must be expanded and agency personnel should be cross-trained to improve coordination among the multiple agencies involved in the regulatory process and allow caseworkers to address concerns raised by customers. Such actions would improve the way the city interacts with residents and business owners and could help eliminate the perception that the city is not responsive or welcoming.

Recommendation: Set the city budget in structural balance to maintain fiscal stability.

The city must ensure that its budget is in structural balance — that projected increases in expenditures are no greater than projected increases in revenue growth. The city should justify any expansion of spending with a corresponding increase in revenue or decrease in spending elsewhere in the budget. Agencies should face similar choices and should have opportunities to keep a percentage of agency revenues and retain savings to enable them to expand services. Unless the city budget is in structural balance, another fiscal crisis is only a downturn in the economy away, but with structural balance the city can plan for a sound financial future.

Recommendation: Establish a rainy-day fund to aid efforts to achieve structural balance.

Financial mechanisms can be employed to hold down spending that may accompany the rapid revenue growth characteristic of economic upswings and to stabilize spending during periods of revenue contraction. Such mechanisms may include legally obligated triggers for fund contributions and formulaic methods to determine the amounts of fund withdrawals to improve long-term governmental financial conditions. With such a mechanism, the city could curtail its ability to spend recklessly when the economy booms and revenues soar. By creating a rainy-day fund or a similar mechanism designed to hold expenditures down in good times and save for hard times, Philadelphia can increase the likelihood that it will be able to meet service demands over the long run without budgetary stress.

Recommendation: Expand non-tax-revenue collections with entrepreneurial efforts to fund additional tax cuts or expansion of services.

The city can meet the constant pressure to reduce the cost of government as well as expand government services by finding new sources of revenue that would neither increase the cost of living and doing business in the city nor threaten service-delivery levels. As detailed in numerous City Controller's Office reports, the city can enhance non-tax revenue collections by: pursuing entrepreneurial activities such as leasing rooftop space to telecommunications companies, selling advertising on city-owned property, charging appropriate rates for the use of city rights of way, and marketing exclusive rights to concessionaires.

Recommendation: Create an overall economic development plan for the city to ensure that tax subsidies are justified by utilizing criteria and clawbacks when considering subsidy efforts.

While many argue that any city subsidy to a particular business runs the risk of giving one firm an unfair advantage over other competing local firms or that efforts to support a given business may not be cost effective, others contend that tools like Tax Increment Financing, low-interest loans, and tax abatements are necessary to continue to grow the local economy. To maximize the impact of its economic development efforts, the city should develop an overall economic development plan that targets activities toward industries that are able to stimulate local economic growth, exhibit a competitive advantage, and have significant prospects for growth. Such a strategy would create the best possible return for the city's limited economic development resources. Looking to the future, the city can use clawback mechanisms to recover public expenditures if private development does not meet promised economic impact or job-creation goals.

Fitting Recommendations Into The City's Fiscal Framework

The Controller's Office believes that these proposed changes to the local tax structure can dramatically improve the city's competitiveness in efforts to retain and attract residents and employers. More important, the Controller's Office believes that the collection of recommendations outlined in this document represent achievable reforms within the city's current budgetary and fiscal framework.

Designed to be bold enough to change market conditions, the Controller's Office's recommendations will change economic conditions in Philadelphia. The tax cuts and related changes outlined above will also have an impact upon the city budget. Tax cuts will reduce revenues in the short term. Tax shifts will change the sources of city revenues. Bureaucratic reforms may require the city to spend money or commit administrative resources to make change. But, tax reform will also have a positive impact. Perhaps most significant, these improvements will help transform the perception of Philadelphia from a high-tax city to a business-friendly location. Tax cuts will infuse additional money into the local economy, which will then be spent and re-spent, creating jobs and expanding development. Improvements to the tax structure will encourage some residents and employers who may be considering leaving the city to remain in Philadelphia, or encourage others to consider relocating to the city.

These positive changes will only reduce the negative impact of tax reform on the Philadelphia budget. To fund the remaining costs, the city can take advantage of the conservatism of current and future revenue and expenditure estimates. In the following section, the Controller's Office will set the cost of tax-reform proposals in perspective by showing how the recommendations would affect Philadelphia's economic condition. Specifically, econometric modeling will illustrate the economic benefits of proposed tax reforms, while budgetary analysis will demonstrate that the recommendations can fit within the revenue and expenditure projections of the city's Five-Year Financial Plan.

6. Funding Tax Reform In Philadelphia

If the City Controller's tax-reform recommendations are to truly represent sound policies as well as smart politics, those recommendations will have to respect mayoral and city council spending priorities and fit within the budgetary framework of the city's Five-Year Financial Plan. As mandated pursuant to the Pennsylvania Intergovernmental Cooperation Act, the Five-Year Financial Plan is the city's multi-year budgetary blueprint, which articulates revenue-generation and expenditure forecasts for the coming years. While no forecast is likely to be exactly accurate given new developments and shifting conditions, the Five-Year Plan is the base estimate for city spending and, therefore, must be the origin for any financial-impact estimations. Although the Controller's Office is confident that the tax-reform proposals will expand the tax base and increase tax revenues in the long term, it is unlikely that the economic growth encouraged by changes in tax policy will generate enough revenue to fund those changes in the short term. Therefore, the City Controller's Office analyzed the city's revenue and expenditure estimates to illustrate conservatism within the Five-Year Plan that creates more than enough flexibility within the city budgetary structure to fund tax-reform proposals and also all of the city's other budgeted priorities.

Fitting Tax Reform Into The Five-Year Plan

To fund tax-reform proposals the Controller's Office has identified anticipated increased revenue based on Five-Year Plan growth projections applied to actual fiscal year 2001 collections; specific savings within the city budget; a higher-than-anticipated accumulated city surplus; and a significant supply-side reaction to tax cuts. The table and notes below illustrate how the City Controller's Office's recommendations would affect the fiscal year 2002-2006 Five-Year Plan. (See Table 6.1.)

Table 6.1 — Impact Of Major City Controller Tax-Reform Recommendations On The FY 2002-2006 Five-Year Financial Plan (Approved By PICA May 15, 2001)

FY	*Worst-Case Scenario Impact of City Controller's Tax-Reform Proposals on Current Five-Year Plan (1)*	Increased Revenue Projections Based on Actual FY 2001 Collections (Taxes Affected by Proposals) (2)	Increased Revenue Projections Based on Actual FY 2001 Collections (Prior-Year Collections and Other Taxes) (3)	Specific Expenditure Savings Opportunities (4)	Increased Cumulative Surplus (5)	Supply-Side Effect of Tax Cuts (6)	*Total Amount Identified to Fund Tax-Reform Proposals (7)*	Projected Surplus Combining Worst-Case Scenario Impact and Amounts Identified to Fund Tax Reform (8)
2003	$(110,349,232)	$6,817,967	$36,458,420	$51,580,000	$30,267,501	$18,650,588	$143,774,476	$33,425,244
2004	$(140,568,088)	$6,711,758	$37,132,421	$67,680,000	$30,267,501	$50,852,316	$192,643,997	$52,075,909
2005	$(172,318,724)	$6,596,752	$37,834,211	$73,690,000	$30,267,501	$82,774,626	$231,163,090	$58,844,366
2006	$(206,312,490)	$6,465,351	$38,556,198	$95,800,000	$30,267,501	$103,989,970	$275,079,021	$68,766,530
Total	$(629,548,535)	$26,591,827	$149,981,250	$288,750,000	$121,070,006	$256,267,501	$842,660,584	$213,112,049

Note: The following recommendations are included:

- Reduce the Net Income portion of the Business Privilege Tax from 6.5 percent to 4.0 percent beginning fiscal year 2003.
- Reduce the Gross Receipts portion of the Business Privilege Tax from .24 percent to .20 percent beginning fiscal year 2003.
- Eliminate the city Net Profits Tax beginning fiscal year 2003.
- Change the way property is taxed in Philadelphia from the current system to a system where the tax on land and the tax on structures/ improvements each generate an equal amount of revenue in the first year beginning fiscal year 2003.
- Reduce the city Wage Tax from 4.5385 percent for city residents to 4.0 percent for city residents and increase the city Real Estate Tax accordingly to create a budget-neutral-first-year shift beginning fiscal year 2003.
- Reduce the city Wage Tax from 4.5385 percent for city residents and 3.9462 percent for non-residents to 3.5 percent and 3.375 percent, respectively, by fiscal year 2007.

Source: City of Philadelphia FY 2002-2006 Five-Year Financial Plan, City Controller's Office

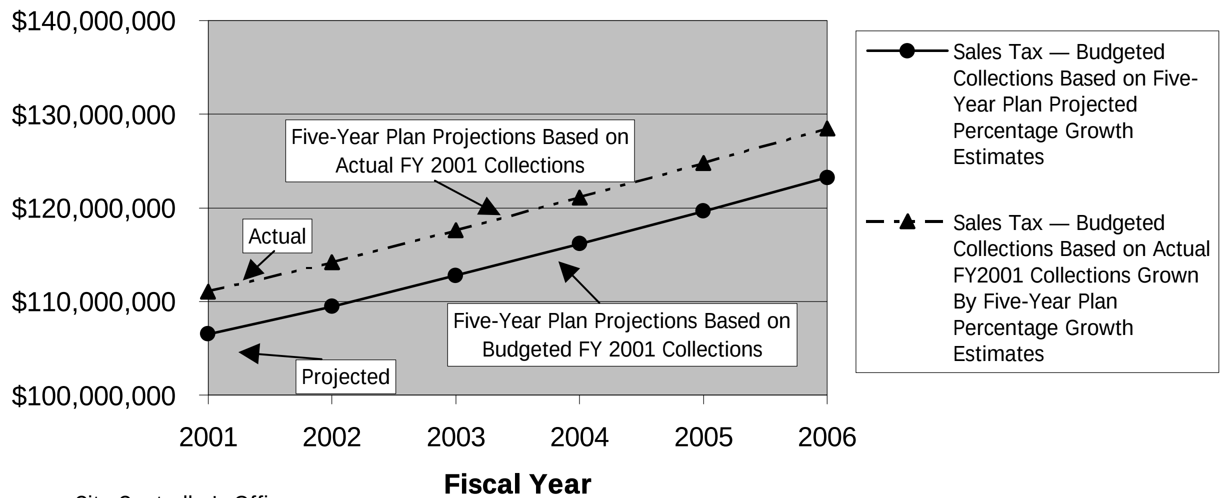
(1) Column 1 of the chart above represents the anticipated impact of the major City Controller's Office tax-reform proposals based solely on current Five-Year Plan revenue projections. Column 1 does not factor in any supply-side reaction or budgetary conservatism. To make this calculation, the Controller's Office assumed the same tax base and revenue collections as budgeted in the current Five-Year Plan. These numbers were then reduced in direct proportion to the reduction in tax rates. For example, in calculating the impact of the proposed 38.5-percent reduction of the fiscal year 2003 Net Income portion of the Business Privilege Tax rate, the Controller's Office reduced the city's estimated collections of $161.2 million by 38.5 percent, or $62.0 million. The same method was used for all proposed reductions, and the total is presented by year in the chart above. For those Controller's Office recommendations calling for budget-neutral shifts in taxes, the Controller's Office utilized estimated amounts based on the higher tax bases (discussed in note 2 below), which would be budget neutral based on the Controller's Office's estimates, but would become a cost based on current Five-Year Plan revenue projections. Thus, the number in Column 1 is larger than the total of the anticipated worst-case scenario, first-year net loss to the city budget of the Controller's Office's recommendations as expressed in Table 5.1.

(2) The Controller's Office believes that Column 1 underestimates tax revenues because its tax base assumptions, derived from the Five-Year Plan, are significantly lower than actual collections. Using the tax base reflected by actual collections, multiplying it by the proposed tax rates, and comparing the resultant amount with the budgeted collections in the Five-Year Plan, the Controller's Office estimates that revenue impacts relative to the city's budget will be much smaller than those reported in Column 1. Column 2 indicates the difference between the two methods of calculation.

More specifically, using the fiscal year 2001 tax rates and the actual collections reported in the city's July 2001 Comparative Report, the Controller's Office derived the real fiscal year 2001 tax base for each tax. For all subsequent years, the Controller's Office then increased the fiscal year 2001 tax base at the same rate assumed in the city's Fiscal Year 2002-Fiscal Year 2006 Five-Year Financial Plan. These more realistic tax bases are multiplied by the proposed tax rates to determine likely collections. To avoid any accusation that revenue estimates are unrealistic, growth estimates for the future are not increased. Instead, the calculated growth rates from the Five-Year Plan are applied to the new base as established by the actual fiscal year 2001 collections. The difference between this result and the numbers in Column 1 are entered in Column 2.

For example, examining projections for Sales Tax collections, one can see that higher-than-budgeted collections generated approximately $4.6 million more revenue than was budgeted in the Five-Year Plan for fiscal year 2001. When the exact same growth estimates for the Sales Tax as used in the Five-Year Plan (3.0 percent through fiscal year 2006) are applied to this higher base — without altering the rate of growth at all — future projections for Sales Tax revenue increase by about $5 million per year. While the current Five-Year Plan anticipates approximately $109.5 million in Sales Tax revenues for fiscal year 2002, the Sales Tax generated more than $111.0 million in the previous year, fiscal year 2001. Applying the Five-Year Plan's 3.0-percent growth estimate, to this higher base the Sales Tax should generate approximately $114.3 million in fiscal year 2002, or $4.8 million in additional revenues. (See Figure 6.1.)

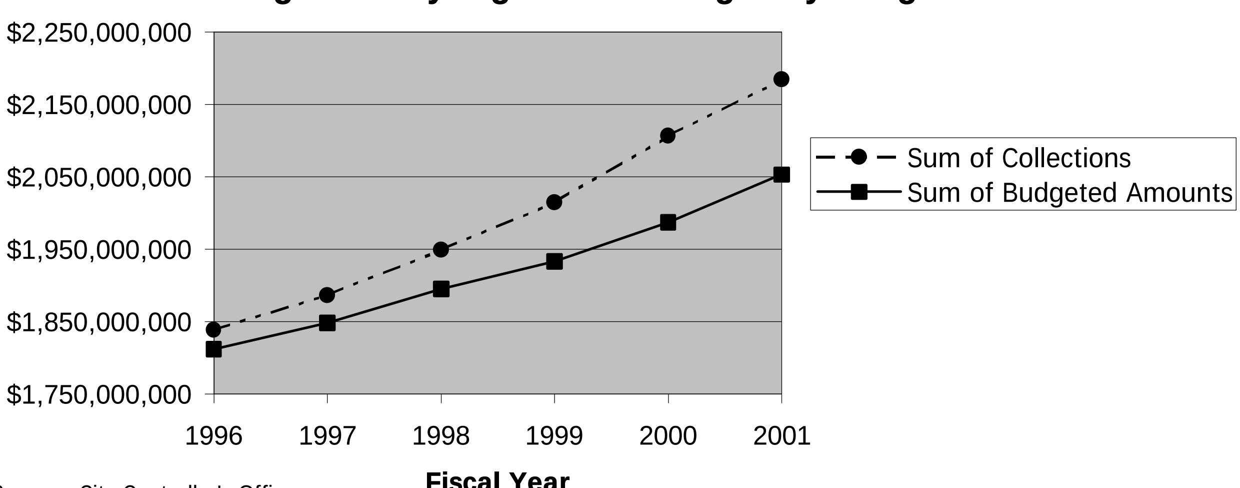
Figure 6.1 — Actual And Projected Sales Tax Revenues Show That Current Projected Growth Rates Will Yield Increased Collections When Applied To Actual FY2001 Tax Collections



Source: City Controller's Office

It should not be surprising that the Five-Year Plan is conservative in its future projections. In fact, in a city only years removed from the brink of fiscal insolvency, it is wise to be more cautious than aggressive in budgeting matters. But when comparing budgeted to actual collections, evidence of irrational conservatism emerges. In recent years, the gap between the city's conservative tax-collection projections and the actual collections has grown substantially. (See Figure 6.2.)

Figure 6.2 — Evidence Of Irrational Conservatism? In Recent Years, The City Has Generated Tax Collections In Amounts Significantly Higher Than Originally Budgeted



Source: City Controller's Office

Purely as a result of using tax base numbers that correspond to real reported collections, Column 2 in Table 6.1 suggests that the negative impact of the City Controller's Office's proposed tax reforms would be $6.8 million better than the $110.3 million assumed in the fiscal year 2003 Column 1 number. Since the Controller's Office uses the same growth estimates as the Five-Year Plan, the entire effect measured by Column 2 can be attributed to the difference in tax bases.

The tax base and growth rate amounts assumed in making Column 2 calculations are the same numbers used to calculate the initial budget neutrality of the Controller's Wage Tax/Real Estate Tax shift. As discussed above, the Controller's Office's tax shifts are budget neutral using the tax collections implied by the actual fiscal year 2001 collections, but not budget neutral when using the projected tax collections of the Five-Year Plan. One would have to simply alter the amounts of taxes shifted to make the shifts budget neutral according to the projected tax collections of the Five-Year Plan.

If, due to a weakening economy, the administration's growth estimates turn out to be overly optimistic, these tax revenue estimates will need to be adjusted downward. However, a weakening economy signals an imperative to reduce taxes. Like any business facing a downturn, the city should not only reduce expenditures to save, but slash "prices" to maintain revenues. One need only look at the automobile manufacturers currently offering zero-percent financing as a way to stimulate sales to see evidence of how businesses adjust pricing policies to fight slack demand. It is clear that firms and families have downward-sloping demand curves when it comes to moving or remaining in Philadelphia. By decreasing the overly oppressive cost of taxes, the city would then increase demand and encourage residents and employers to stay in Philadelphia, or move in.

(3) In calculating the first two columns, the Controller's Office excluded the taxes about which the Controller's Office's tax-reform proposals are silent (such as the Amusement Tax or the Realty Transfer Tax). The Controller's Office believes that the city's Five-Year Plan underestimates revenue in these categories as well. By comparing actual recent collections to budgeted amounts, the Controller's Office derived an average underestimation factor and multiplied it by the budgeted amounts to estimate the collections that are likely to prevail over the life of the Five-Year Plan. Column 3 indicates the amount by which the Controller's Office expects collections to exceed the budgeted amount.

(4) The city's conservative budgeting strategy extends to the expenditure side of the budgeting process where, in many cases, the city budgets expenditures that will probably never be spent. Column 4 aggregates these opportunities to reduce expenditures — without reducing service-delivery efforts — for each year of the Five-Year Plan. These funds are currently budgeted but should be available to fund tax cuts or other city expenditures. These budgeted expenditures could be freed for other purposes without any change in the way government works. (See Appendix F.)

(5) At the end of a fiscal year, there are two potential sources for an operating surplus: revenue can be collected in excess of the budgeted amount or spending can be less than the budgeted amount. The sum of these two numbers represents the city's contribution to the cumulative fund balance, an account which, like a savings account, can be drawn on to fund municipal activities in future fiscal years. By projecting excess revenues and overbudgeting of expenditures for fiscal years 2003-2006, the Controller's Office's has already identified some of the money that would have been placed in the cumulative fund balance for these years. However, for fiscal year 2001, a year that is not included in the Controller's Office's estimates, the city is currently projecting that the cumulative fund balance will be $73.5 million larger than that projected in the budget.

Specifically, instead of finishing fiscal year 2001 with the $152.8 million projected in the Five-Year Plan, the August 15, 2001 Quarterly City Managers Report estimates the city's fiscal year 2001 fund balance at $226.2 million — a 48-percent increase. In adopting its fiscal year 2001 budget, the city implied that it would be able to meet all of its fiscal year 2001 obligations, responsibly enter fiscal year 2002, and maintain $152.8 million in the bank. The Controller's Office agrees and believes that any additional surplus should be allocated toward tax reform.

To this additional surplus, the Controller's Office adds budgeted-but-available funding from FY 2002 as well as anticipated-but-unbudgeted FY 2002 tax revenues due to tax-base growth. In Column 5, the Controller's Office spreads the $121.1 million over the last four years of the Five-Year Plan to help fund tax cuts while retaining $152.8 million in the cumulative fund balance as budgeted.

(6) Economic theory suggests that, all else equal, there will be a positive supply-side economic response to tax reductions. The city's experience during the tax cuts that began in fiscal year 1996 bears witness to this premise. Despite a cumulative 8.0-percent decrease in the Wage Tax rate, total Wage Tax collections actually increased by 18.8 percent between fiscal year 1995 and fiscal year 2001. To estimate the likely supply-side effect of its tax proposals, the Controller's Office worked with a model specifically tailored to Philadelphia by University of Pennsylvania Wharton School Professor Robert Inman to estimate the revenue growth that would likely be generated by proposed tax cuts. Specifically, the Controller's Office estimated that, depending on the tax, between 22 and 56 percent of the tax revenues lost from the cut in tax rates would be returned to the city as increased tax revenues generated by business and employment expansion. In cases where the City Controller's Office recommends a shift in taxation, the supply-side estimations take into account both the revenue generated by a tax cut and the revenue lost from the tax increase. Column 6 totals the likely return on the tax cut investment. (See Appendix B for more detail on the supply-side reaction.)

(7) Because it neglects revenue surpluses as well as the positive response historically associated with tax cuts, the first column of the chart represents the absolute worst-case scenario associated with the City Controller's proposed tax cuts. Each subsequent column illustrates another reliable source of revenue that can mitigate the negative effect implied by the worst-case scenario. Column 7 is a sum of all of these reliable sources of funding and, in comparison to Column 1, demonstrates the difference between an unrealistic worst-case assumption and a responsible evaluation of the real affordability of the proposed tax changes.

(8) Column 1 plus Column 7 equals the combination of worst-case scenario amounts added to the positive effects of the City Controller's Office's tax-reform proposals and the additional revenues and saved expenditures identified to fund tax reform. Unlike the negative worst-case scenario numbers of Column 1, these numbers are positive, indicating that the Controller's Office's recommendations can fit within the current budgetary environment. Conservatism in the Controller's Office's analysis yields coverage rates that more than pay for tax-reform recommendations. (See Table 6.2.)

Table 6.2 — Coverage Ratio: Identified Funding Sources To Worst-Case Scenario Impact

	FY 2003	FY 2004	FY 2005	FY 2006	TOTAL
Coverage Ratio	1.30	1.37	1.34	1.33	1.34

Source: City Controller's Office

By dividing Column 7 by the absolute value of Column 1, the table above shows the degree of conservatism in the Controller's Office's claim that the proposed tax cuts are feasible. Any value above 1.00 indicates that the Controller's Office's plan would provide more money than that necessary to fund even the worst-case scenario assumptions. With coverage ratios of 1.30 and above for each of the years of the Five-Year Plan, the table suggests that there is at least a 30-percent cushion to fund the proposed recommendations. By identifying more than 130 percent of revenues necessary to fund these reform proposals, the Controller's Office provides a cushion against any future contingencies such as declining revenue collections or unanticipated expenditures. This means that the Controller's Office's analysis of the city's revenue and expenditure estimates provides more than 30 percent more funding than would be necessary to implement the proposed recommendations as well as meet the revenue estimates and spending priorities in the city's current Five-Year Plan.

In Conclusion…

The recommendations outlined in the City Controller's *Tax Structure Analysis Report* represent a series of tax reforms that reduce the city's high taxes and significantly improve its tax structure, but — perhaps more important — the recommendations represent sound policies that can be accomplished in the current fiscal and budgetary environment. Because tax policies, like all city policies, are matters of political choice, the question of whether to implement these proposals will clash with other proposals within the political arena. The City of Philadelphia will not transform from a high-tax jurisdiction to a tax haven overnight. Even if these recommendations are implemented, the city should continue to work toward government efficiencies that will allow for further tax reductions, and push for statewide tax reform to address issues that extend beyond the city limits. These recommendations create a choice to do what is possible to reduce the burden presented by the city tax structure. The city's elected and appointed leadership should embrace the choice presented by these reforms as a primary goal in the ongoing effort to continue the city's forward progress.

In discussions above, the term worst-case scenario is used to describe the negative effect of cuts in tax rates on the city budget as in "the worst-case scenario of reducing tax X by 10.0 percent is $10 million per year." In truth, the worst-case scenario is not a loss of revenue. The worst-case scenario is that Philadelphia continues to maintain its high tax burden, continues to lag economically, and continues to experience population loss. There may be a cost to reducing taxes, but there is certainly a cost to not reducing taxes. The City Controller's Office asserts that, without significant change to its tax structure, the city will continue to experience slower growth than competitor cities and surrounding jurisdictions and that the population decline of recent decades will remain unchecked. Therefore, the Controller's Office submits its package of tax-reform recommendations designed to represent significant reform that can be realistically implemented. The worst-case scenario is not implementing these recommendations and figuring out the fiscal ramifications. The worst-case scenario is maintaining the status quo and watching the continuing decline of the City of Philadelphia.

Appendix A: Likely Effects Of A Shift To Land-Value Taxation

By examining the Year 2000 Board of Revision of Taxes Data File, the Controller's Office analyzed how a budget-neutral shift from the traditional property tax to a system where land and buildings generate equal amounts of tax revenue would affect city taxpayers. On average, by implementing a system that taxes land at 3.44 times the rate of structures/improvements, the city would only raise the tax burden of properties which have assessed land values that are more than 22.5 percent of total assessed value.

Based on the Controller's Office analysis, such a shift would reduce the annual tax burden on 71.6 percent of all city properties. An additional 18.0 percent would have a new annual tax burden that would increase by less than $100. As Table A-1 illustrates, the properties that would have the greatest savings are residential properties. In total, nearly eight in ten residential properties would realize savings. Two-thirds of those property owners who would pay more would pay less than $100 more per year. Tax bills for more than 99 percent of properties identified as vacant land would increase. (See Table A-1.)

Table A-1 — Effect Of City Controller's Office's Proposed Shift To Land-Value Taxation On The Annual Tax Burden Of Philadelphia Properties

Building Type	Properties With Taxes Reduced	Properties With Taxes Increased Up To $100	Properties With Taxes Increased > $100
Residential	78.2%	14.7%	7.0%
Hotels & Apartments	72.3%	15.9%	11.8%
Commercial	28.0%	20.6%	51.4%
Industrial	35.1%	15.0%	49.8%
Store With Dwelling	54.3%	25.2%	20.5%
Vacant Land	0.7%	70.5%	28.9%
Total	**71.6%**	**18.0%**	**10.4%**

Source: City Controller's Office Analysis of Year 2000 Board of Revision of Taxes Data File

While many industrial and commercial property owners would face higher Real Estate Tax bills, they would see their business taxes greatly reduced by the Controller's Office's recommendations to cut the Net Income and Gross Receipts portions of the BPT. In nearly all cases, these cuts will result in overall savings for industrial and commercial property owners despite the shift in Real Estate Tax burden. Similarly, most individuals who would see their Real Estate Tax bills increased would see overall savings due to cuts in the Wage Tax.

Consider the case of the North side of the 1900 block of Market Street. The block is occupied by two properties: the Independence Blue Cross building and a vacant grass lot. According to the Year 2000 Board of Revision of Taxes Data File, the Independence Blue Cross building had a total assessed value of $31,624,512 ($5,080,600 on the land and $26,543,912 on the building) and the vacant lot had a total assessed value of $1,951,680 (all on the land). Setting aside questions about the stark difference between the land values (both parcels are of near-equal size but the land under the Independence Blue Cross building is valued at more than 2.7 times the neighboring vacant land), the two properties provide an excellent extreme example of how the proposed shift to land-value taxation would affect Philadelphia real estate. Under the proposed shift, the Real Estate Taxes on the Independence Blue Cross building would be reduced by $267,385 (10.2 percent), while the Real Estate Taxes on the vacant lot would be increased by $196,456 (121.8 percent). As a result, the owners of the Independence Blue Cross building would see their overall operating costs reduced and would be able to lower rents for tenants. The owners of the vacant lot would face higher tax bills and would be encouraged to do something productive with the valuable Center City land, or sell it to another party that would.

Examining the properties that would incur higher taxes under the proposed shift demonstrates how crucial it is to properly value land to make land-value taxation work well. For instance, one property that would face a significantly increased Real Estate Tax bill is the landmark Union League building at Broad and Sansom Streets. Even though the historically and architecturally significant building is sited on land that would otherwise have a high value, the site cannot generate the kind of revenue a skyscraper could at the same location without destroying the current historic building. Because the Union League is effectively permanently foregoing the ability to generate high rent by maintaining the historic building, its otherwise-valuable land must be correctly reassessed at a much lower rate than surrounding land. Any property that has a historic or environmental easement essentially forsakes the right to build and therefore should have a lower land assessment. Similarly, because a property's zoning will affect its ability to generate revenue, zoning becomes a key component of land value. A property's land value must increase if its zoning changes from residential to commercial or from a designation that only permits low-rise buildings to a designation that permits high-rises. Incorporating property zoning and historic or environmental easements into the assessment of land values should ensure that historic properties and other properties that unable to generate maximum revenues do not see their taxes increased unfairly.

Examining residential properties in city neighborhoods, it is clear that the proposed shift benefits homes across the city. A majority of residents in neighborhoods (defined by the City Planning Commission) from Southwest to Northeast Philadelphia would see savings. (See Table A.2.) To inspect the impact the shift would have on individual properties, individuals should follow the instructions on the Controller's Office's Tax Shift Calculator (See www.philadelphiacontroller.org/calculator.htm or Page 62 of this report.)

Table A.2 — Effect Of City Controller's Office's Proposed Shift To Land-Value Taxation On The Annual Tax Burden Of Residential Properties In Philadelphia

City Neighborhood	Properties With Taxes Reduced	Properties With Taxes Increased Up To $100	Properties With Taxes Increased By > $100
Center City	80.4%	5.3%	14.3%
Upper North Philadelphia	72.2%	26.3%	1.5%
Lower North Philadelphia	56.6%	32.9%	10.5%
Olney-Oak Lane	85.1%	10.7%	4.3%
Near Northeast Philadelphia	89.5%	4.8%	5.7%
Far Northeast Philadelphia	76.9%	8.2%	14.9%
Bridesburg/Kensington/Port Richmond	91.1%	7.3%	1.6%
Roxborough/Manayunk	76.8%	9.1%	14.1%
Germantown/Chestnut Hill	66.5%	15.5%	18.0%
South Philadelphia	80.1%	16.3%	3.6%
Southwest Philadelphia	85.6%	12.0%	2.4%
West Philadelphia	65.4%	27.9%	6.6%
Total	**78.2%**	**14.7%**	**7.0%**

Source: City Controller's Office Analysis of Year 2000 Board of Revision of Taxes Data File

There are only three city neighborhoods where fewer than 70 percent of residential property owners would save money in the shift. In West and Lower North Philadelphia, a high number of vacant properties and lots (where the value of land is a high percentage of total property value) account for the fact that more than 30 percent of properties in these neighborhoods will have a higher tax burden. In Germantown/Chestnut Hill, some vacant properties and lots in part of the neighborhood and large lots in other parts of the neighborhood account for the fact that there is a lower percentage of properties that would carry reduced tax burdens.

To ensure that the proposed tax shift is not merely a shift of tax burden from the rich to the poor, the Controller's Office examined how the shift would affect residential properties in census tracts in Philadelphia. Table A.3 shows that 74.7 percent of census tracts with household income below median would experience savings and 80.2 percent of census tracts with household income above median would experience savings. Census tracts with household income above median income are three times as likely to face tax increases of more than $100 per year than tracts below median income.

Table A.3 — Effect Of City Controller's Office's Proposed Shift To Land-Value Taxation On The Annual Tax Burden Of Residential Properties In Philadelphia (Sorted By Median Income Of Census Tract)

Census Tracts	Properties With Taxes Reduced	Properties With Taxes Increased Up To $100	Properties With Taxes Increased By > $100
Household Income Above Median	80.2%	8.0%	10.5%
Household Income Below Median	74.7%	22.1%	3.3%
Total	**78.2%**	**14.7%**	**7.0%**

Source: City Controller's Office Analysis of Year 2000 Board of Revision of Taxes Data File, U.S. Census

Appendix B: The Supply-Side Effects Of Tax-Reform Recommendations

All communities impose taxes to generate revenue to pay for the desired public services of residents. Whenever a community levies a tax, however, it creates incentives for businesses and households to avoid the tax. At the national level, a very high marginal income tax may cause some people to work less while a high tax on business profits may result in less investment. At the state level, households and firms have an additional way to avoid taxes — they can move to another state with lower taxes. Still, moving from state to state can be very costly to a business; it may involve greater distances to the primary market for its goods or increased costs of obtaining the necessary supplies for making its product. At the local level however — whether municipality or county — it is much easier for both firms and households to move to avoid taxes, and the easier it is to avoid taxes, the greater the negative impact a tax will have on economic activity and tax base. Thus, a local tax increase is likely to generate less revenue than one would expect had there been no impact on the tax base. Similarly, a tax reduction will reduce tax revenues by less than expected. The impact of tax rate changes on economic activity is commonly referred to as a supply-side effect.

Cutting local taxes by a dollar does not mean that local government will forego a dollar of revenue. If all else remains the same, tax reduction in Philadelphia should encourage some employers and residents, who otherwise would have left Philadelphia, to remain. Similarly, because of the attractiveness of lower taxes, some employers and individuals will decide to relocate into the city. In combination, these responses will retain some economic activity that would have otherwise departed and attract new economic activity that would have otherwise remained outside the city. This economic activity will generate increased tax revenue that will reduce the effect of a dollar's worth of tax cut so that the true effect on the city budget is actually much less than a dollar.

The effect of local taxes on economic activity, tax base, and tax revenue depends on the competitive position of the local jurisdiction relative to its neighbors — which, in turn, depends not only on tax rates, but also on the public services financed by those taxes. It is possible, for example, for a community to have taxes that are too low and public services that are inadequate so that an increase in taxes — and public services — would result in greater economic activity and a greater tax base. On the other hand, a community with much higher taxes than its neighbor (without significantly better public services) is likely suffer relatively large adverse effects on its economy and tax base as firms and households relocate to nearby communities to avoid the tax.

As documented elsewhere in this report, Philadelphia's tax rates are high relative to its suburban neighbors and relative to other large American cities. Therefore, one would expect that tax rate changes would have relatively large effects on economic activity in the city and on the city's tax base. During the last ten years, Robert Inman, Professor of Finance at The University of Pennsylvania's Wharton School, along with his colleagues, has undertaken several analyses of the effect of Philadelphia's tax rates on employment and tax bases. These analyses examine the statistical relationship between changes in employment in Philadelphia and changes in the Wage Tax; changes in the Real Estate Tax base and changes in effective Real Estate Tax rates; and changes in Philadelphia's business tax rates — the Net Income and Gross Receipts portions of the Business Privilege Tax — and the bases for those taxes. These analyses looked at data from the early 1970s through 1998 and generally found that increases in tax rates significantly reduced either employment or tax bases.

Professor Inman's estimates of the impact of tax rate changes on employment and tax bases can be used to make an educated guess as to how much revenue a tax cut will cost the city treasury. Of course, reducing taxes will reduce tax revenue — but *some* of the lost revenue associated with the lower rate will be offset by increases in employment or increases in the size of the property and business tax bases.

One way to think of this is to ask how much of every dollar the city will lose with a tax rate cut of one dollar, after taking into account tax-change induced changes in the tax base. Or, on the other hand, what fraction of a dollar of new revenue can the city anticipate from a tax rate increase that would generate one dollar of new revenue, again after taking into account tax-change induced changes in the tax base.

Using the findings of Inman and his colleagues in his study done in 2000, the Controller's Office estimates that a Wage Tax reduction will have a supply-side effect that will initially increase employment enough so that nearly 25 percent of the tax reduction will be offset by increased Wage Tax revenues associated with increased employment.[11] The supply-side effect increases to about 55 percent over three years. About 35 percent of the Net Income portion of the Business Privilege Tax reduction is offset by increased tax base growth (based on results from Inman's 1998 study) while 22 percent of the reduction of the tax on gross receipts is offset by tax base growth (based on Inman's 2000 study). The full effects of the business tax changes occur in the first year. Finally, the revenues from the Real Estate Tax increase are *reduced* by 40 percent, again the impact occurs in the first year. (See Table B.1.)

Table B.1 — Estimation Of The Supply-Side Effect For The City Controller's Office's Tax-Reform Proposals

Fiscal Year	Supply-Side Revenue
2003	$18.7 million
2004	$50.9 million
2005	$82.8 million
2006	$104.0 million

Source: City Controller's Office based on Econsult Corporation analysis

While the numbers above reflect the implications of the best work estimating the relationship between Philadelphia's taxes and its tax bases, they should be interpreted with caution. Although all of the evidence points toward significant supply-side effects, uncertainty remains with respect to the actual magnitudes of the effects, even when one looks across Inman's studies. Arguments can be made suggesting that the impacts are smaller or larger than the ones presented. Moreover, the research supporting these estimates was not originally intended as a revenue-forecasting tool, so additional research would be needed to obtain more precise, more certain estimates. Given those words of caution, however, economic theory suggests that the supply-side effects of Philadelphia's taxes will be relatively large, because taxes in the city are at such a wide variance with taxes in neighboring jurisdictions.

[11] Estimates of the impacts of wage tax cuts are based on research by Andrew Haughwout and Robert Inman. Using an estimated equation relating Philadelphia's national share of employment, S, to changes in current and two lags of Wage Tax changes, dt, dt1, dt2, respectively, they estimated the impact of changes in Wage Taxes on Philadelphia's national share, DS, which is given by DS = .00033*dt + .00037*dt1 + .00025*dt2. To get the employment impact, multiply the change in share, DS, times the total national employment. To calculate supply-side revenue effects, multiply the Philadelphia change in employment times the average Wage Taxes generated by a job in Philadelphia. Note that for a series of Wage Tax cuts over time, the calculation of the total impacts of changes in Wage Taxes for a given year is somewhat complicated because one must account for supply-side responses that occur with a lag. The calculations of the supply-side impacts for other taxes are similar in nature, but simpler in two regards. There are no lagged effects and the effects of changes in taxes are calculated as impacts on the tax base per capita, so that the revenue effects can be calculated directly from the change in the size of the base since the total population in Philadelphia is known. On the other hand, some of the issues regarding the business tax base is further complicated because of the two components of the business tax base in Philadelphia.

Appendix C: A Brief Description Of Taxation In Philadelphia

Tax	Rate 7/1/01	What is Taxed?	Budgetary Impact	Notable
Taxes Based on Real Estate Assessments				
Real Estate Tax (City and School)	8.264%	assessed value of city real estate	City: $353.6 million, 12.8% of city's fiscal year 2000 general fund (including $8 million in proceeds from the city's June 1997 Tax Lien Sale) School District: $414.8 million, 30.6% of the general fund portion of the School District's school year 1999-2000 operating budget	The Real Estate Tax is levied on the assessed value (typically 32 percent of fair market value) as certified by the Board of Revision of Taxes. The tax is levied at the same rate on land and structures. The current rate of taxation is 37.45 mills on assessed value. For the School District, the tax on real estate in Philadelphia is currently 45.19 mills on assessed value. The total rate of taxation, including both the City and School District portions of the Real Estate Tax is 82.64 mills on assessed value.
Business Use and Occupancy Tax	4.62%	assessed value of city real estate	School District: $90.6 million, 6.4% of the general fund portion of the School District's school year 1999-2000 operating budget	Originally authorized in 1970, this tax is levied on the use or occupancy of real estate within Philadelphia for the purpose of carrying on any business, trade, occupation, profession, vocation, or any other commercial or industrial activity.
Taxes Based On Business Activity				
Business Privilege Tax (Gross Receipts Component)	.24%	gross receipts of businesses conducting commercial activity in Philadelphia	City: ≈$115.0 million, 4.3% of city's fiscal year 2000 general fund	This tax is levied on gross receipts of businesses carrying on or exercising for profit any trade, business, profession, vocation, or commercial activity in Philadelphia. The gross receipts portion has been reduced in each of the fiscal years from 1996 to 2001. Non–profit organizations, businesses engaged in port-related activities, public utilities and insurance companies are also exempt from the BPT. Information technology companies are exempted from paying taxes on their gross receipts.
Business Privilege Tax (Net Income Component)	6.5%	net income of businesses conducting commercial activity in Philadelphia	City: ≈$174.2 million, 6.5% of city's fiscal year 2000 general fund	This tax is levied on net income of the same business activity. In order to mitigate potential double taxation of non-corporate net income under both the Net Income component of this tax and the Net Profits Tax (discussed below), 60 percent of the Net Income portion of the BPT is deductible from the Net Profits Tax. Non-profit organizations, businesses engaged in port-related activities, public utilities, and insurance companies are also exempt from the BPT.
Taxes Based On Wages and Earnings				
City Wage and Net Profits Tax	4.5385% (Resident Portion) 3.9462% (Non-Resident Portion)	city residents' wages and net profits the wages and net profits of non-residents who earn wages or profits in Philadelphia	City: $1.2 billion, 45.0% of city's fiscal year 2000 general fund ($1.2 billion on wages/$20 million on net profits; $778 million from residents/$466 million from non-residents)	Originally authorized as a short-term measure in 1932, this tax continues today. It is levied on salaries, wages, commissions, and other compensation earned by city residents; on salaries, wages, commissions, and other compensation earned by non-residents for work done or services performed or rendered in Philadelphia; on net profits attributable to business conducted in Philadelphia; and on net profits earned by city residents from business conducted in or outside Philadelphia. (Corporations pay BPT; persons and entities subject to the Net

				Profits Tax can deduct 60 percent of the Net Income portion of the BPT from their Net Profits Tax.) The tax has been reduced in each of the fiscal years from 1996 to 2001. PICA collects a 1.5-percent tax on the wages and net profits of Philadelphia residents (this is a portion of — not an addition to — the city's tax) for the purposes of servicing debt authorized by PICA during the city's early 1990s fiscal crisis.
Other Taxes				
City Sales Tax	1.0%	applicable purchases made in Philadelphia or by Philadelphians	City: $103.7 million, 3.8% of city's fiscal year 2000 general fund	Originally authorized in 1991, this tax is levied on the sale at retail of tangible personal property or services. The current rate of taxation is 1.0 percent of the retail purchase price on top of a 6.0-percent state Sales Tax.
City Realty Transfer Tax	3.0%	the value of real estate sold in Philadelphia	City: $77.7 million, 2.8% of city's fiscal year 2000 general fund	This tax is levied on the value of real estate sold in Philadelphia. The current rate of taxation is on top of a 1.0-percent state Realty Transfer Tax.
City Parking Tax	15.0%	the amount charged for parking in Philadelphia	City: $34.1 million, 1.2% of city's fiscal year 2000 general fund	This tax is levied on every individual parking or storing a motor vehicle in or on any parking facility in the city.
Liquor Sales Tax	10.0%	the retail sale price of alcoholic beverages in Philadelphia	School District: $25.0 million, 1.8% of the general fund portion of the School District's school year 1999-2000 operating budget	Originally authorized in 1995, this tax is levied on the sale — at retail — of liquor, malt, and brewed beverages.
City Amusement Tax	5.0%	the price of applicable event admission in Philadelphia	City: $11.7 million, 0.4% of city's fiscal year 2000 general fund	This tax is levied on the admission charges to concerts, movies, performances, sporting events, and nightclubs.
School (Non-Business) Income Tax	4.5385%	non-business income of city residents	School District: $21.5 million, 1.5% of the general fund portion of the School District's school year 1999-2000 operating budget	Originally authorized in 1967, this tax is levied on the non-business income of city residents including income from rents received from an owner-occupied duplex. The tax is applied to income such as the income from dividends or the interest on securities.
Additional Taxes For Special Purposes				
Hotel Tax	7.0%	the cost of the rental of hotel rooms in Philadelphia	City: $25.9 million, would equal about 0.9% of city's fiscal year 2000 general fund but is paid into a special fund for spending related to the Convention Center and tourism-promotion	This tax is levied on hotel room rentals in the city. The current rate of taxation is 7.0 percent of the cost to rent a hotel room in Philadelphia on top of a 6.0-percent state hotel tax and a 1.0-percent Hotel Occupancy Tax imposed by the city in a move analogous to the 1.0-percent increase in the City Sales Tax. The city rate comprises a 6.0-percent tax to support debt service related to the PA Convention Center and a 1.0-percent tax to support tourism and marketing spending.
Vehicle Rental Tax	2.0%	the cost of the rental of vehicles in Philadelphia	City: $0 million, would equal 0.0% of city's fiscal year 2000 general fund (the tax, enacted in 2000, will be paid into a special fund for capital (stadium-related) spending	This tax, levied on rental of vehicles in Philadelphia, went into effect in July 2000 and generated an estimated $3.75 million in fiscal year 2001.

Appendix D: Roundtable Discussion Hosts

During the spring and summer of 2001, staff from the Controller's Office conducted roundtable discussions with a number of organizations representing a variety of perspectives on taxation in Philadelphia. The following organizations hosted roundtable discussions with organization members to help the City Controller's Office in its efforts to examine issues surrounding taxation in Philadelphia:

- African American Chamber of Commerce
- Ben Franklin Technology Partners of Southeastern Pennsylvania
- Center City District
- Center City Proprietors Association
- Chestnut Hill Business Association
- Delaware Valley Industrial Resource Center
- Germantown Special Services District
- Greater Philadelphia Association of REALTORS
- Greater Philadelphia Chamber of Commerce
- Greater Philadelphia Hotel Association
- Greater Philadelphia Restaurant and Purveyor Association
- Midlantic Business Alliance
- Pennsylvania Food Merchants Association
- Pennsylvania Institute of Certified Public Accountants
- Philadelphia Bar Association State and Local Tax Committee
- Regional President's Council Colleges and Universities
- University City District
- University City Science Center
- Urban Industry Initiative

Appendix E: Examples Of How Recommendations Would Affect Taxpayers

The following tables provide examples of how the City Controller's tax-reform recommendations would affect Philadelphia taxpayers. Selected taxpayer profiles are described below along with the estimated annual impact of major tax-reform recommendations comparing current and proposed tax burdens.

Individuals

Table E.1 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Philadelphia Family Of Four With An Annual Household Income Of $45,000 And A Home With A Market Value Of $80,000 (Assessed Taxable Land $5,120 / Assessed Taxable Building $20,480)

Recommendation	First Year Savings
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	-
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	-
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	$85.50
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	$5.59
Additional Impact From Implementing Both Shifts*	$9.57
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**100.66**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.2 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A New College Graduate With An Annual Income Of $35,000 Who Rents An Apartment In Philadelphia

Recommendation	First Year Savings
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	-
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	-
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	$188.47
Additional Impact From Implementing Both Shifts*	-
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**$188.47**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.3 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Philadelphia Low-Income Senior Citizen With An Annual Unearned Income Of $12,000 And A Home With A Market Value Of $18,000 (Assessed Taxable Land $1,223/Assessed Taxable Building $4,537)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	-
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	-
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	$10.01
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-$53.27
Additional Impact From Implementing Both Shifts*	1.12
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**(see note) $0.00**

Note: This individual's Real Estate Tax assessments would be frozen under the city's Senior Citizen Tax Freeze which permits seniors who meet income eligibility under Pennsylvania's Pharmaceutical Assistance Contract for the Elderly program to freeze their real estate tax assessments so that they are not affected by increases in assessments.
*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.4 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Self-Employed Philadelphian With Annual Gross Receipts Of $200,000 And Annual Net Income Of $42,000 And A Home With A Market Value Of $84,600 (Assessed Taxable Land $6,691/Assessed Taxable Building $20,381)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$1,050.00
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$800.00
Eliminate The City Net Profits Tax In FY 2003	$1,906.17
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-$75.54
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-$250.35
Additional Impact From Implementing Both Shifts*	-$8.45
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**$3,421.83**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.5 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Non-Resident Property Owner Who Owns A Vacant Lot In Philadelphia With A Market Value Of $3,500 (Assessed Taxable Land $1,120 / Assessed Taxable Building $0)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	-
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	-
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-$112.74
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-$10.36
Additional Impact From Implementing Both Shifts*	-$12.62
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**-$135.72**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

Businesses

Table E.6 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Philadelphia Corner Store With Annual Gross Receipts Of $300,000 And Annual Net Income Of $35,000 (All Sales Generated In Philadelphia, 100% Of Personnel And Real Estate In Philadelphia) And A Property With A Market Value Of $50,000 (Assessed Taxable Land $1,787 / Assessed Taxable Building $14,213)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$875.00
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$1,200.00
Eliminate The City Net Profits Tax In FY 2003	$1,588.48
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	$237.13
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-$147.96
Additional Impact From Implementing Both Shifts*	$26.53
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**$3,779.18**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.7 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Philadelphia Manufacturer With Annual Gross Receipts Of $2,000,000 And Annual Net Income Of $250,000 (No Sales Generated In Philadelphia, 100% Of Personnel And Real Estate In Philadelphia) And A Property With A Market Value Of $54,100 (Assessed Taxable Land $15,000/Assessed Taxable Building $2,312)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$6,250.00
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	-
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-$1,442.07
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-$160.09
Additional Impact From Implementing Both Shifts*	-$161.37
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**$4,486.47**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.8 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Philadelphia Services Corporation With Annual Gross Receipts Of $10,000,000 And Annual Net Income Of $1,000,000 (25% Of Sales Generated In Philadelphia, 100% Of Personnel In Philadelphia) Renting Space In A Center City Building	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$9,375.00
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$10,000.00
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-
Additional Impact From Implementing Both Shifts*	-
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	$5,000.00
Total	**$24,375.00**

Note: If single-factor apportionment is implemented and the Net Income rate remains the same, the savings would only be $18,125.00. If the rate changes, but single-factor apportionment is not implemented, the savings would only be $19,375.00.
*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.9 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A New Philadelphia Business In Its Second Year Of Operations With Annual Gross Receipts Of $100,000 And No Annual Net Income (The Business Is Not Yet Profitable) (100% Of Sales Generated In Philadelphia, 100% Of Personnel In Philadelphia) Renting Space In A Neighborhood Building	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	-
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$400.00
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-
Additional Impact From Implementing Both Shifts*	-
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	$400.00
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-
Total	**$800.00**

*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

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Table E.10 — Annual Impact Of Major City Controller Tax-Reform Recommendations For A Suburban Philadelphia Business With A Presence In The City Beyond Just Soliciting Business With Annual Gross Receipts Of $500,000 And Annual Net Income Of $100,000 (50% Of Sales Generated In Philadelphia)	
Recommendation	**First Year Savings**
Reduce The Net Income Portion Of The Business Privilege Tax To 4.0% In FY 2003	$3,125.00
Reduce The Gross Receipts Portion Of The Business Privilege Tax To .20% In FY 2003	$1,000.00
Eliminate The City Net Profits Tax In FY 2003	-
Shift Real Estate Taxes So Half Of Revenues Derive From A Tax On Land In FY 2003	-
Reduce The Resident Wage Tax To 4.0% By Shifting Burden To Real Estate Tax In FY 2003	-
Reduce The Wage Tax To 3.5% (Residents)/3.375% (Non-Residents) By FY 2007	-
Additional Impact From Implementing Both Shifts*	-
Eliminate Double-Payment Of BPT In The Second Year Of Operations In FY 2003	-
Adopt Single-Factor Apportionment For Determining BPT Net Income Liability In FY 2003	-$5,000.00
Total	**-$875.00**

Note: If single-factor apportionment is implemented and the Net Income rate remains the same, the cost would be -$7,125.00. If the rate changes, but single-factor apportionment is not implemented, the cost would become a savings of $4,125.00.
*Since the two shifts would affect each other if both are implemented, the total impact is not simply a sum of the two impacts.
Source: City Controller's Office

Appendix F: Illustrating Conservatism In Expenditure Estimates

The City Controller's Office has regularly and consistently suggested ways for the city government to become more efficient. In recent years, the Controller's Office has put forth suggestions that could, if implemented, save hundreds of millions of dollars. Reviewing the recommendations of agency audits from the past four years, the Controller's Office can document an impact of more than $241 million from proposed recommendations. To date, fewer than half of the Controller's Office's recommendations have been implemented. Beyond these departmental audits, the Controller's Office can document that recommendations from its 11 most recent performance audits have resulted in approximately $22 million in annual recurring cost savings for the city and the school district. Many of the Controller's Office's performance audit recommendations remain unimplemented.

Many of the recommendations from the Controller's Office would require administrative reform, investment in technology, or procedural changes. But it is possible to find significant budgetary savings within the city's current Five-Year Plan that could be freed for other purposes without any change in the way government works. These funds are currently budgeted, but should be available to fund tax cuts or other city expenditures. The table and notes below illustrate major sources of budgetary savings identified by the City Controller's Office. (See Table F.1.)

Table F.1 — Significant Savings Exist Within The City's FY 2002-2006 Five-Year Plan

	FY 2002 (millions)	FY 2003 (millions)	FY 2004 (millions)	FY 2005 (millions)	FY 2006 (millions)
Debt Service					
Anticipated New Debt (1)	$3.40	$4.10	$7.60	$12.70	$27.30
Arbitrage Payments (2)	$0.85	$0.85	$0.85	$0.85	$0.85
SF Reserve For Gallery II (3)	$1.26	$1.26	$1.26	$1.27	$1.27
Commitment Fees (4)	$0.60	$0.60	$0.60	$0.60	$0.60
Parking Authority Series 1999A (5)	$1.40	$1.40	$1.40	$1.40	$1.40
Over-budgeting in JLR Bonds (6)	$0.50	$0.50	$0.50	$0.50	$0.50
Fringe Benefits					
Health Care (7)	$2.10	$6.30	$17.50	$16.80	$23.20
Other Costs					
Materials, Supplies & Equipment (8)	$2.00	$2.00	$2.50	$3.50	$4.00
Utilities (9)	$1.21	$1.22	$1.22	$1.22	$1.23
Economic Stimulus (10)	$5.00	$5.00	$5.00	$5.00	$5.00
One-Time Sources					
Act 71 Funds (11)	-	$10.50	$10.50	$10.50	$10.50
Day Backward/Day Forward Funds (12)	-	$3.00	$3.00	$3.00	$3.00
Economic Stimulus Funds (13)	-	$4.55	$4.55	$4.55	$4.55
Budget Conservatism					
Year-End Unobligated Funds (14)	$9.40	$10.30	$11.20	$11.80	$12.40
Total	**$ 27.72**	**$ 51.58**	**$ 67.68**	**$ 73.69**	**$ 95.80**

Source: City Controller's Office

(1) The administration currently budgets debt service payments as if the city were going to borrow an estimated $125 million every year during the life of the Five-Year Plan. However, the capital program estimates that the capital budget during the next six years will be under $100 million in each year. (See Table F.2.) While the city may seek voter authorization for every year of the capital program, it is highly unlikely the city will seek to borrow money each year for the next five years. It may be that the city will borrow one or two years' worth of voter-authorized debt in one year. However, due to the constraints of the current debt limit, the city will not be in a position to seek voter approval for the entire amount of proposed new debt contained in the Plan. Therefore, while the administration could decide to use quasi-governmental institutions to borrow funds as a way to avoid the city's debt limit, there are no budgeted plans to do so and the Controller's Office considers this line item to be over-budgeted in each year.

Table F.2 — Debt Limit Calculation (all figures in thousands)

	FY 2002	FY 2003	FY 2004	FY 2005	FY 2006
Beginning Debt Limit Margin*	$109,265	$151,365	$105,965	$63,165	$3,065
Proposed Capital Budget**	-	$(90,000)	$(86,000)	$(88,000)	$(46,000)
Debt Retired	$42,100	$44,600	$43,200	$27,900	$17,000
Adjusted Debt Limit Margin***	$151,365	$105,965	$63,165	$3,065	$(25,935)

* Beginning Debt Limit Margin is as of the beginning of FY 2002. It takes into consideration the amount of debt retired during FY 2001 as well as the newly authorized capital budget for FY 2002 of $91,230,000.

**If the city continues to budget capital projects as presented in the 2002-2006 capital program, it will be unable to seek voter authorization for the 2006 capital budget. The city will, at that point, have surpassed its legal debt limit. Historically, the city has needed voter authorization to fund the capital budget. Even though the amount of the capital budget is usually much more than the voter request (many projects are financed with other funding sources such as operating revenues and state and federal contributions), voter authorization is needed to borrow any new money to fund the projects. In recent years, the city has refrained from borrowing immediately, putting off bond sales until the city became low on capital cash. When it does this, the city may borrow for an amount equal to several years of capital authorization. Regardless of such a maneuver, the debt limit is calculated on bond authorization, not bond issuance.

***In the Five-Year Plan, the administration budgeted for $125 million in new debt for each year of the plan beginning with FY 2003. However, the capital program calls for new borrowings of only $90 million in FY 2002 and FY 2003, with this amount decreasing to $86 and $88 million in FY 2004 and FY 2005, respectively. In FY 2006, the capital program requests a mere $46 million in new money, for a total of $400 million in new projects. However, as noted above, by FY 2006 the city will have exhausted its debt limit and will be unable to put a ballot question seeking authorization for capital borrowing before the voters.

Source: City Controller's Office

(2) For at least the last five years, the city budgeted $850,000 for arbitrage payments — tax payments in cases where the city earns excessive funds from tax-free borrowings — without incurring any arbitrage costs. The Controller's Office believes that the city will not make any arbitrage payment in the near future.

(3) In 1982, the city, through the Philadelphia Authority for Industrial Development (PAID), borrowed $15.5 million to fund the construction of the Gallery II garage. These 1982 bonds are further secured under the terms of a contract between the city and PAID under which the city covenants with the authority to budget and annually appropriate amounts necessary to restore any deficiency in the debt service reserve fund. While the bonds' official statement requires this appropriation to be included in the city's annual operating budget, the amount of subsidy has steadily decreased since 1982. For the last two years, there has been no cost to the city. The Controller's Office believes that more than $1.2 million budgeted each year in this line item will not be needed in the future.

(4) When the city teetered on the brink of bankruptcy, it needed credit enhancements to market its short-term notes. With the improvement of the city's fiscal health over the last nine years, credit enhancements are no longer needed, yet the city continues to budget this line item. The Controller's Office believes there is approximately $600,000 available in this line item in each year of the Five-Year Plan.

(5) In 1999, the Philadelphia Parking Authority issued bonds for the repair of existing garage facilities, as well as to finance the construction of two new garages. The debt service on the bonds used for the repairs is paid from the operating revenues of the garages. The debt service for the new construction projects must be paid by the city until the garages are open for business and generating enough income to cover the debt service costs. The city currently budgets the total debt service from the 1999 bond issue despite the fact that, according to information provided by the Parking Authority, approximately $1.4 million of the debt service payments on the 1999 issue will be paid from the operating revenues of existing garages. As a result, there appears to be $1.4 million of additional appropriation in this line item throughout the life of the Five-Year Plan.

(6) Justice Lease Revenue (JLR) bonds financed the Criminal Justice Center and the Curran-Fromhold Correctional Facility. According to the debt service schedules related to these bonds, the city has over-budgeted by approximately $500,000 in each of the next five years.

(7) Health and welfare costs for the city's unionized and non-unionized employees are over-budgeted. The administration is growing these costs by approximately 9.0 percent annually over the life of the Five-Year Plan. However, the current contracts between the city and the unions representing city workers provide for a 7.0-percent increase in health care benefits annually for non-uniformed employees over the four-year term of the contract that expires June 30, 2004. Uniformed employees agreed to two-year contracts with similar benefits increases. Using the fiscal year 2001 costs of $187.2 million as the base, and applying the negotiated increase, the Controller's Office estimates that health care costs for city employees may be over-budgeted by as much as $65.9 million over the life of the Five-Year Plan.

(8) The city never spends all that is appropriated for materials, supplies, and equipment. The Controller's Office conservatively estimates that there is $14 million over-budgeted in these line items over the life of the Five-Year Plan.

(9) The city has consistently over-budgeted for utility expenses — an average of 9.0 percent or $2.7 million each year for the past five years. The Controller's Office conservatively estimates that utilities are over-budgeted by 4.5 percent or $6.1 million over the life of the Five-Year Plan.

(10) The Five-Year Plan budgets $5 million in each of the next five fiscal years for "Economic Stimulus." This funding is deemed necessary to compensate for the city's overly burdensome tax structure. The Controller's Office utilizes these funds to reduce the burdensome nature of city taxes.

(11) During the construction of the Criminal Justice Center and the new Curran-Fromhold Prison, the Commonwealth of Pennsylvania enacted legislation that granted back to the counties reimbursements for costs incurred for such new facilities. This legislation, known as Act 71, partially reimbursed the city as well the Philadelphia Municipal Authority for costs incurred. The reimbursement came with no restriction as to how the funds could be spent. According to the administration, there is approximately $42 million of this reimbursement available for reuse. However, some of this funding is apparently earmarked for construction of a new Youth Study Center and some has been used as an advance (that should be repaid) for land acquisition for new stadium construction. While building a new youth detention facility may be desirable, no plan exists to do so, no site exists upon which to build, and no design exists for a new structure. The Controller's Office believes that all or part of the Act 71 money may be available for use as one-time funding to reduce city taxes. The Controller's Office apportions this one-time savings over the final four years of the Five-Year Plan, which coincides with the first four years of its tax-reform proposal.

(12) In fiscal year 1994, the Pennsylvania Intergovernmental Cooperation Authority (PICA) granted approximately $23 million of bond proceeds to the city to be used to reduce the huge backlog of lawsuits filed against the city that amassed during Philadelphia's fiscal crisis. Many of these cases were settled as part of this Day Backward/Day Forward Program. In fiscal year 1995, PICA granted the city an additional $7.8 million to continue the backlog reduction. As of June 2001, there was more than $1.3 million of the fiscal year 1994 grant and all of the fiscal year 1995 grant still available to pay Day Backward/Day Forward costs. According to PICA officials, with interest earnings, the total available in the PICA Special Indemnity Fund is in excess of $12 million. These same officials stated that they have not received a request for use of these funds since April 1995. Should the current administration use these funds as they were originally intended, $12 million now earmarked for lawsuit settlements would be available for other uses, such as tax cuts. The Controller's Office apportions this one-time savings over the final four years of the Five-Year Plan, which coincides with the first four years of its tax-reform proposal.

(13) In recent years, the city has forwarded significant sums of money to the Philadelphia Industrial Development Corporation for economic stimulus purposes. This money has been used for grants and loans to various organizations and businesses as part of the city's business retention efforts. For example, the city extended a $200,000 loan to an Ogontz-area restaurant and granted $7 million to help fund the Philadelphia Eagles' practice facility. Currently, the economic stimulus program has more than $31 million obligated to additional projects. While this money is pledged to many organizations and businesses that have already received economic stimulus funding, some of these projects have yet to receive a penny as of March 31, 2001. If the city would reprogram only the funding for projects that have received no funding to date, it could free $18.2 million to fund tax reductions. The Controller's Office apportions this one-time savings over the final four years of the Five-Year Plan, which coincides with the first four years of its tax-reform proposal.

(14) During the last five fiscal years, the city has budgeted more than it has spent and, on average, has obligated only 98.9 percent of its total general fund budget. (See Table F.3.) The remaining 1.1 percent represents unencumbered obligations — budget money that was not spent — which contributed to the city's budget surplus. These unencumbered obligations included budgeted-but-unfilled personnel positions, funding for professional service contracts that were never let, savings incurred due to job turnover, and budgetary efficiencies. If the city continues to exhibit similar obligation patterns — and the Controller's Office has no reason to believe that the city will change this past practice and over-spend its budgets in the future — the city should save an average of 1.1 percent of its total general fund budget in coming years. For example, the city would avoid spending $32.4 million of its fiscal year 2002 budget of $2.95 billion. Subtracting from that figure, an amount equal to the city's "canceled commitments" ($23 million in each of the years of the Five-Year Plan), yields a total amount of approximately $10 million each year that should be available to help fund tax reductions.

Table F.3 — Unobligated General Fund Dollars

	FY 2000	FY 1999	FY 1998	FY 1997	FY 1996
Percentage of Budget Spent	98.25%	98.74%	98.79%	99.99%	99.75%
Amount of Budget Unobligated (in millions)	$48.3	$33.5	$30.5	$0.2	$5.9

Source: City Supplemental Revenue and Obligation Report