Rethinking Philadelphia Taxes to Fund Education

By Marc Stier
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Last year, Mayor Jim Kenny boldly called for the School Reform Commission (SRC) to be disbanded and for control over our schools to be returned to the city. In doing so, he took on the responsibility to pay for schools at a time when growing deficits are expected over the next five years.

We at PBPC have long argued that the education of Philadelphians shouldn't be a responsibility of the city alone. Not just Philadelphia but the entire commonwealth suffers because the state share of education funding has fallen from almost 50% to less than 35% of total funding.

But while we struggle to encourage Harrisburg to meet its responsibilities to the children of this state, Mayor Kenny is right to prepare the city to increase its spending on education. Indeed, we are so far from providing an adequate education to so many of our kids that even if state funding increases to a more appropriate level, we would encourage the city to supplement it.

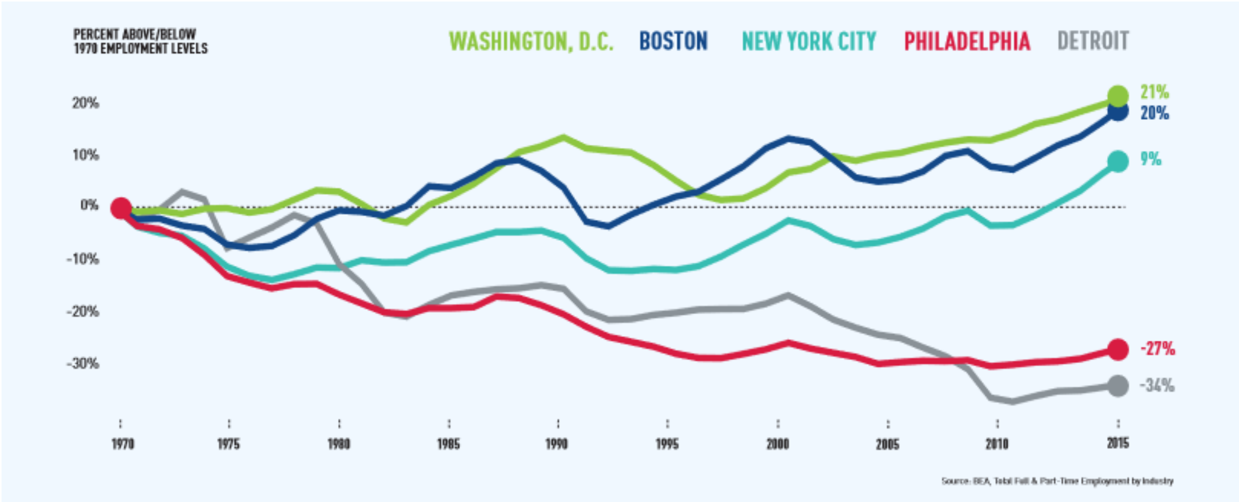
So, what are the best options for the city to pay for K-12 education?

This is a question we intend to look in more detail over the next few months.

We want to start today by suggesting one possibility: delaying the reductions in the city wage tax and business taxes built into the five-year plan.

We won't present a complete analysis of this option here, but we want to start a conversation about this option by challenging what has been accepted wisdom too long: that Philadelphia should make a radical change to its unusual tax system, in which relatively more revenue comes from wage and business taxes and relatively less from property taxes than other large cities and suburban communities

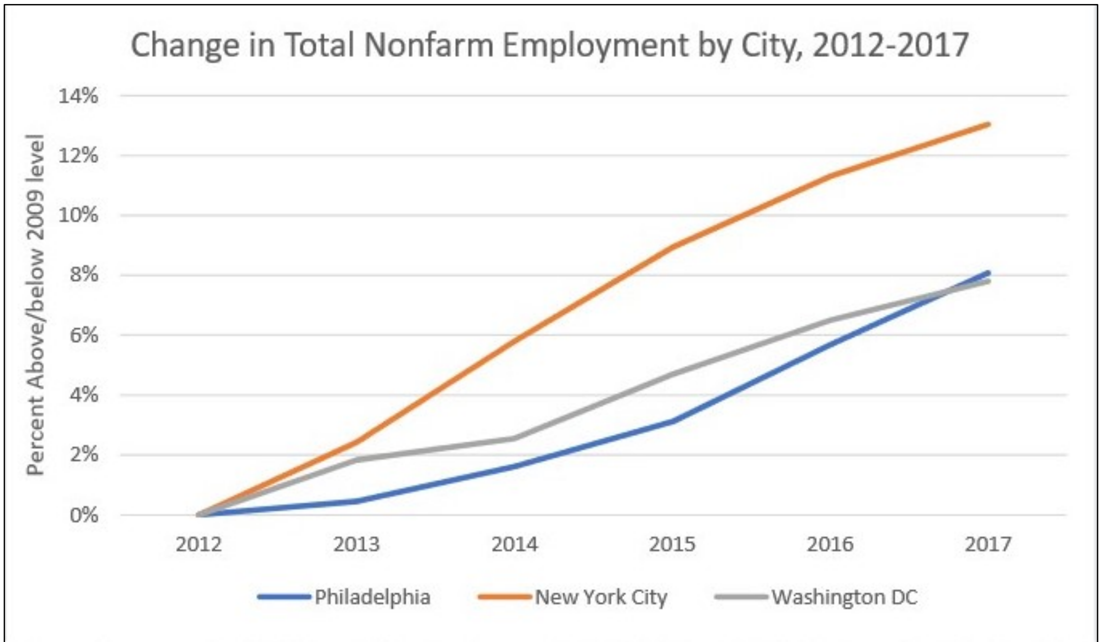
At a time when the city was losing both population and jobs, everyone was looking for an explanation of the city's troubles and a plan to turn things around. And variants of the following chart, which has appeared in one document after another calling for tax cuts in the city, suggested that the city was doing something wrong because a number of other cities have been doing better than Philadelphia when it comes to job creation.



In a political climate when even Democrats were often echoing the voices of Republicans and the business community about the dangers of over taxation, the unique features of the city's tax system seemed, to many, a plausible explanation of why job growth was so slow in the city. So the Tax Reform Commission concluded that it made sense to reduce wage and business taxes in the city. This policy, the commission argued, would lead to more business and workers coming into the city which, in turn, would lead to rising property values. In part through this mechanism, and in part through increasing property taxes, the revenue the city would lose by cutting wage and business taxes would be recovered.

There were always some voices, including ours at the Pennsylvania Budget and Policy Center, calling that analysis into question.

Given the evidence of chart 2, which shows that employment has been growing faster in Philadelphia in recent years, despite the city's basically unchanged tax structure, perhaps it is time to challenge the accepted wisdom about the burdens of Philadelphia's tax structure on economic growth.



Source: Pennsylvania Budget and Policy Center analysis of BLS data, http://data.bls.gov/cgi-bin/dsrv?sm

So consider four reasons to cast doubt on the claim that Philadelphia should keep reducing wage and business taxes in the city to keep our economy humming.

First, there is an enormous body of empirical evidence that casts doubt on the impact of relatively small variations in tax policy on the decisions of businesses to locate in one jurisdiction or another.[1]

This conclusion may seem counter-intuitive, as everyone seems to know that taxes are an important consideration in the decisions of business. Yet, that "intuitive" conclusion forgets some key features of our economic life that, once one stops and thinks about it, should also seem intuitive.

Taxes are a cost of doing business. Businesses pay some taxes no matter where they locate. And, for most businesses, they are a much smaller cost of doing business than labor costs and, for manufacturers, the costs of raw materials and energy. Access to low-cost energy and raw materials are determined by such things as geographic location and the costs of transportation, while access to plentiful skilled labor is determined by the quality of training and education found in a geographic location and the costs of regional transportation for educated and trained workers. The best research we have suggests that all state and local taxes together account for only 1.9% of total costs. Corporate income taxes at the state and local level amount to only about 8.6% of that 1.9%,

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[1] See Peter Fisher, State and Local Taxes are Not Significant Determinants of Growth," http://www.gradingstates.org/the-problem-with-tax-cutting-as-economic-policy/, which is an accessible overview and one-stop resource on the impact of tax policy on economic development.

or 0.16%, according to one estimate.[2] The very small reduction in business taxes planned by the city thus amounts to a tiny fraction of the cost to businesses that operate in the city.

Of course, the city's wage tax might also affect business investment decisions because businesses might have to pay employees more in Philadelphia than in other locations to compensate for higher taxes. Yet, here, too, the empirical evidence about the impact of differential tax rates on employees on business location is fragile. Moreover, there has always been something disingenuous about the argument for wage tax reductions in the city in that they have been put forward not so much as a way to reduce the overall burden of taxation but as a way of shifting taxation from wages to property taxes – that is, again to make Philadelphia a city with a more "normal" tax structure. There is little reason to think that trading lower wage taxes for higher property values and property taxes will reduce the wages that employers have to offer employees to come to Philadelphia.

Second, as we pointed out 15 years ago, the econometric study most often cited in support of the presumed relationship between Philadelphia's wage and business taxes and employment in the city, was always deeply flawed, as were many others.[3] As Stephen Herzenberg, the Executive Director of the Keystone Research Center, wrote in 2002,

> "The flaw is that, in seeking to explain what drives changes in the tax base, Econsult does not consider any other factors — besides tax changes — that might be expected to impact the tax base. Such other factors might include crime, school quality, the relative well-being of cities (e.g., cities doing badly as a group in the 1980s, cities doing somewhat better in the 1990s), or a one-time psychological effect (e.g., associated with a change in Mayoral administration). If these excluded factors are correlated with changes in taxes, excluding them from the model can result in tax changes appearing to have a bigger impact than they actually do."[4]

There is little reason to doubt that many of these factors affected Philadelphia's economic growth during the time that wage and business taxes were increasing. Some of them are Philadelphia specific, including Philadelphia's greater dependence on manufacturing jobs relative to other cities; the racial strife created by Mayor Rizzo; and the historically high rate of crime in

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[2] These conclusions are draw from the paper cited in the previous notes. It is "based on data from 2001 through 2012 from two sources: U.S. Internal Revenue Service, Statistics of Income, Integrated Business Data for all U.S. Corporations, partnerships, and non-farm proprietorships, showing total deductions for business costs on tax returns, at https://www.irs.gov/statistics/soi-tax-stats-integrated-business-data ; and the Council on State Taxation's annual reports *Total State and Local Business Taxes* (the 2016 edition is available at http://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/cost-studies-articles-reports/fy16-state-and-local-business-tax-burden-study.pdf)."

[3] Econsult Corporation, *Philadelphia Tax Rates and Their Relationship To Tax Bases and Tax Revenues*, report submitted to the Pennsylvania Economy League Eastern Division, February 2002.

[4] Stephen Herzenberg, Testimony Before the Pennsylvania Senate Urban Affairs and Housing Committee Public Hearing on the Philadelphia Wage Tax, April 17, 2002

Philadelphia compared to other cities.[5] Others are general and affect all urban areas to one degree or another, including the redlining that undermined black neighborhoods; white flight from cities; the decline of federal investment in cities; and the rise of investment in suburbs, including the Interstate Highway system that encouraged suburbanization. All of these factors no doubt helped create a cultural mood in America that held up suburban life as an ideal. This ideal itself became a further barrier to economic growth in cities like Philadelphia.

In recent years, however, that ideal has been overcome by another cultural shift. Especially among millennials and retiring baby boomers, the arts, culture, restaurants, and streetscapes of our cities have taken on a whole new appeal. And all the attractions of urban life have been multiplied as the populations of our urban areas – including Center City Philadelphia and surrounding neighborhoods – take off. There seems to be no end to the proliferation of high-end coffee shops, restaurants, and art spaces of many kinds. There is an underlying economic basis to this new trend. The health care, education, and technology sectors have been growing due to technological advances and public policies that have stimulated the demand for health care and supported research in the field. These fields require the kinds of intense daily interaction among and between teachers, researchers, practitioners, and executives and providers of legal and other business services that, in an era of digital communication, is best conducted face to face. And that in turn has made central cities far more economically attractive. Philadelphia has very much benefitted from the growth in its "eds and meds" sectors. And that growth in employment has helped create an urban environment and the cultural excitement that has made urban life far more attractive now than it was forty years ago and that has, in turn, encouraged more people to move to the city.

None of the repeated econometric studies that singled out the harms of rising city taxes took into account the other factors that undermined the economic growth of Philadelphia. That Philadelphia has been growing much faster in recent years despite not reducing its taxes by much is further reason to doubt that taxes play the important role in shaping the economic life of the city claimed by the proponents of tax cuts.

Third, there is some reason to believe that the proponents of making Philadelphia's tax structure more "normal" may have had it totally backwards. To the extent that taxes play a role in stimulating or stifling job growth, Philadelphia's relatively low property taxes may be an advantage, not a disadvantage. This is true for two reasons.

First, property taxes are likely to be as great or greater a burden on economic development than business taxes or wage taxes because most new job growth comes from start-ups that do not make any profits and do not pay business profit taxes, but do pay property taxes.

This claim is supported by a fascinating report last year by Michael Mazerov and Michael Leachmen of the Center for Budget and Policy Priorities, which reached two key conclusions about the source of new jobs:

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[5] It is striking that the cities in chart 1 to which Philadelphia is compared are ones that had historically had vibrant services, including Boston with its insurance, investment, and health and education sectors; New York with its dominant financial sector, and Washington the seat of our national government at a time when it was expanding.

The vast majority of jobs are created by businesses that start up or are already present in a state — not by the relocation or branching into a state by out-of-state firms. Jobs that move into one state from another typically represent only 1 to 4 percent of total job creation each year, depending on the state. Jobs created by out-of-state businesses expanding into a state through the opening of new branches represent less than one-sixth of total job creation. In other words, "home-grown" jobs contribute more than 80 percent of total job creation in every state.

During periods of healthy economic growth, startups and young, fast-growing companies are responsible for most new jobs. During the Internet-driven boom of the late 1990s and early 2000s, for example, startup firms (those less than one year old) and high-growth firms — which are likely to be young — accounted for about 70 percent of all new jobs in the U.S. economy.[6]

These conclusions give us more reason to doubt that business tax cuts in general are a useful tool to stimulate economic growth and job creation. Taxes on business profits are likely to have little impact on where jobs are created because new start-ups typically do not show any profits for their first few years in business. They also call into question the whole strategy proposed by the Tax Reform Commission – that is, to make Philadelphia a more normal city by reducing our reliance on business taxes and, instead, increasing the share of Philadelphia taxes that fall on real estate. After all, property taxes, unlike business profit taxes, do fall on start-up businesses because they pay them no matter whether they are profitable or not.

While a proponent of tax cuts might argue that taxes like Philadelphia's wage tax and gross receipts tax makes Philadelphia less attractive than other cities, keep in mind that Philadelphia has provided some protection to start-up businesses by exempting the first $100,000 of receipts from its gross receipts tax. And, of course, some startups, especially in the technology sector, pay employees, in some part, in stock options rather than wages, which reduces the impact of Philadelphia's wage tax.

Without a more detailed analysis, we can't defend the claim that reducing Philadelphia's wage and business taxes—which, according to the Tax Reform Commission, would lead to increased property values and property taxes—would undermine economic and population growth in Philadelphia. But we can say, first, that this is at least a possibility. And we can say, second, that this new analysis of the source of business and job growth undermines the claim that reducing wage and business taxes is the most important policy the city can adopt to spur economic development.

Not only do low property values and taxes contribute directly to job growth. They also account for one of the other widely recognized factors that makes Philadelphia an attractive place to live, especially for the millennials who have been coming here in large numbers—the lower cost of housing than in New York, Boston, and Washington, D.C..

[6] Michael Mazerov and Michael Leachman, State Job Creation Strategies Off-Base, Center on Budget and Policy Priorities, February 3, 2016, https://www.cbpp.org/sites/default/files/atoms/files/2-3-16sfp.pdf

It may well be that Philadelphia's unique tax structure, which many have blamed for the decline in manufacturing and other jobs, turned out to make our city well suited for taking advantage of the cultural shift back to cities, especially among young professionals. It would be a terrible irony of history if, at this moment, a continuing effort to cut wage and business taxes and raise property taxes as a source of revenue for the city undermined rather than stimulated economic growth in the city.

Finally, fourth, while the research that attributes variations in economic growth to small changes in taxes is very shaky, the research that points to the close connection between levels of public investment in education and infrastructure and economic growth is very strong.[7] There is substantial evidence of a strong relationship between the percentage of the population with a college degree and the pace of economic growth. That this is a causal relationship is fairly clear as well. The sectors of the economy that are growing fastest, and that have the highest wages, are those that rely on highly-educated and trained labor. That includes not just "eds and meds" but also in manufacturing and building, where advanced skills have become more important. Business are likely to start up, grow, and move to areas of the country where highly-educated and skilled labor is available.

Thus, Mayor Kenny's inclination to emphasize the importance of education to the future of the city is entirely appropriate. Investment in education is critical to our economic future. And it is also critical to creating the equality of opportunity for low-income and working-class Philadelphians who, too often, are cut off from the growing economic opportunity in our city. Investment in education, far more than cuts to wage and business taxes, is the path we should follow if want to create an economy the works for all Philadelphians, one that leads the entire commonwealth toward shared prosperity.

[7] On the importance of higher education to economic growth see, Enrico Moretti, "Estimating the Social Return to Higher Education: Evidence from Longitudinal and Repeated Cross-Sectional Data," Journal of Econometrics, Vol. 121, 2004, pp. 175-212. The city can best increase the proportion of Philadelphia residents with college degrees by investing in Pre-K programs the K-12 schools which make it possible for Philadelphians to secure a higher education.