

SMC Business Councils

ADVANCING THE MANUFACTURING
AND SMALL BUSINESS COMMUNITIES



WHAT ARE THE IMPACTS OF INCREASED PERSONAL INCOME TAXES AND SALES TAXES ON SMALL BUSINESSES? INTERVIEWS WITH PENNSYLVANIA EXECUTIVES. SMC BUSINESS COUNCILS

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White Paper

About SMC Business Councils

SMC Business Councils is an organization that has served and represented the manufacturing and small business community since 1940. SMC has more than 800 member companies in western and central Pennsylvania who employ more than 20,000 workers. Businesses surveyed range in size from sole proprietors to manufacturers with several hundred employees. Their products and services are diverse and include such activities as environmental consulting for the oil and gas industry, the production of clothing for bicycling enthusiasts, the manufacture of steel rod for the tool industry and much more.

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What are the Impacts of Increased Personal Income Taxes and Sales Taxes on Small Businesses? **Interviews with Pennsylvania Executives:**

The cost of government as a percentage of economic activity is reaching a critical threshold within Pennsylvania. The private sector is always motivated to increase efficiency to survive in a competitive marketplace. The public sector in Pennsylvania has no such incentive. At a certain point, public sector cost in the form of taxes and inefficiency will choke the private sector and make it uncompetitive with surrounding states and in markets beyond our borders. Uncontrolled pension liabilities and increases in Personal Income Tax, Sales Tax and expansion of the Sales Tax base are major drivers of this as confirmed in the comments of the business executives in the following interview examples.

Small businesses are the backbone of the economy. Unfortunately they can't afford the voice or have the deep pockets of large, multinational corporations. Lawmakers must understand and consider the economics at this important level. Large companies depend on small companies for critical parts, supplies and services. Healthy small businesses are a critical component of a healthy state and national economy.

Pensions are the number one cost driver in Harrisburg and this problem must be solved first before Personal Income Taxes and Sales Taxes are increased for Pennsylvania's small employers and manufacturers. Increased taxes are the symptom of a disease; the disease is a flawed pension system with a massive unfunded liability. Unless that core problem is addressed there will never be adequate revenue. Without pension reform, more and more of the taxes collected by the government will be used to pay for an outdated and broken pension system.

Elected officials must recognize the indispensable role that small business and manufacturers play in generating revenue, taxes and jobs throughout the Commonwealth. They should understand that an increase in the Personal Income Tax (PIT) rate affects almost all small businesses and small manufacturers in PA. It is a tax increase on the growth sector of the economy.

Most small businesses, 80%, pay at the PIT rate because they are organized as pass-through entities such as sole proprietorships, limited liability corporations and S-Corporations. These are businesses whose owners report their business income on their individual tax returns for the year.

- *There are more than 225,382 small businesses with 1-499 employees in Pennsylvania.*
- *Of those businesses, 87% or 196,989, have LESS than 20 employees.*
- *In 2012 small businesses created 72,264 new jobs in Pennsylvania. (Jobs are created by economic demand, not by public officials).*

- *In 2012 small businesses employed 2,445,023 million employees who make up nearly 50% of Pennsylvania's private-sector labor force.*
- *Small businesses represent 98.2% of all employers in Pennsylvania.*
.....U.S. Small Business Office of Advocacy - most recent Pennsylvania profile.

The purpose of this paper is to show how the 20% increase in the Personal Income Taxes (PIT) and 10% increase in the Sales Tax and expansion of the sales tax base will impact small employers and manufactures. The comments were gathered by cold calling members and by email. All contributions were voluntary. It's apparent that there is a high level of frustration and distrust of government.

SMC SUPPORTS DELIBERATE and RESPONSIBLE ACTION BY STATE GOVERNMENT: When small businesses do not have sufficient income they cut expenses and look for ways to become more efficient with fewer resources. Government should do the same.

- **GET PA'S FINANCIAL HOUSE IN ORDER FIRST:** Focus on pension reform. Increased taxes are the symptom; the disease is the growth of mandated expenses. Defined benefit pensions for public employees are an unsustainable luxury we can no longer afford. To remain competitive nearly all private sector businesses have moved to defined contribution style plans. The public sector should do the same.
- **REDUCE GOVERNMENT SPENDING:** There has been very little discussion of how government economizes; instead it's about how can government raise revenue. Small businesses should not be expected to bear the burden of large tax increases to fund government without first having government do exactly what the Governor's proposal demands of us - do more with less.
- **INCREASE GOVERNMENT EFFICIENCY:** The Governor's plan should require state government to perform more efficiently or at a higher capacity.

****QUESTION POSED to EXECUTIVES:** *It would be helpful to know how the proposed 20% increase in the Personal Income Tax and the 10% increase in the Sales Tax, and expansion of the Sales Tax base will impact your business as a pass-through entity. Comments on pension reform are also needed.*

A Summary of the Key Impacts Identified by Pennsylvania Small Business Executives

- Businesses can and do move. Pennsylvania needs a friendly tax climate to prevent job loss and business migration to more business-friendly states.
- Increased sales tax places PA businesses and their products at an interstate competitive disadvantage.
- Numerous small businesses are organized as Subchapter S, LLC, and sole proprietorships and pay taxes on income at the personal rate which will be affected by the proposed increases.
- Many small businesses grow by reinvesting their profit. Profits that are taxed away cannot be reinvested in employees, equipment and R & D hurting their ability to grow and maintain a competitive edge.
- More and more is passed along to employees in the form of shared health care costs often resulting in decreased disposable income. Increases in personal income and sales taxes have the same effect. The impact ripples through the entire economy.
- Tax increases on businesses are not a boundless resource. Excess tax drains funds necessary for growth and in the extreme depresses economic activity across the board.
- A climate conducive to business growth is good for the economy and will produce the desired income to the state for needed public services without increasing the state's percentage share of the whole.

Case Studies

Product: Steel-structural manufacturers, construction-heavy grating

Number of Employees: 60

Respondent: President

Senate: Stefano Dist. # 32

House: Warner Dist. # 52

Impact of the 20% increase in the Personal Income Tax (PIT)

- **Relocation of company:** Taxes take away more money from the business. Companies will vote with their feet and move out of Pennsylvania. He constantly gets calls from Tennessee and South Carolina and other states where they have very active economic development programs. "The reason we are in PA now is because we were born here." "If PA doesn't want my company then we will go where we are wanted." The quality of the worker will be the same in another state but there are advantages:
 - Other states may have a better living climate.
 - Tax structures may be better allowing more investment to drive growth.
 - A move will bring him closer to his customer base.
 - Businesses go where they are wanted and are offered incentives.
 - He may have a better relationship with state environmental agencies.
- Other states are offering buildings and tax incentives. All he has to pay is moving expenses. His strategy will be to gradually make investments in new machinery and locate it in a building in another state. Once the new location is up and running he will close down the PA operation. An example of that strategy is Carpenter Specialty Steel. They are headquartered in Reading and are migrating to Alabama. They bought Latrobe Steel and will gradually phase out operations in PA and move the business. Any new investment dollars go into the new location.
- **Job loss:** Manufacturing has a minimum of a 2:1 multiplier meaning that for every job that leaves the state 2 others are no longer required. When he moves from PA he will no longer need the services of the oil supplier, the grease guy, and the hardware store, the lumber yard, his lawyers, his bankers, his machine shops and others. The money spent by employees and their taxes will be gone too.

Product: Metal specialties wholesale, metal spinning and forming

Number of Employees: 35

Respondent: Son of owner, family business

Senate: Costa Dist. # 43

House: Costa Dist. # 34

This commentary illustrates the unintended cumulative effects of tax increases and health care costs.

Background: His business is slower than he would like and they had to lay off several workers. The layoffs were caused by a combination of factors but escalating health care costs have the largest impact on their overall numbers. They don't see that situation getting any better in the future.

Their insurance renewal is September 1st; their premium increased by 68% which translates to more than \$90,000. With that money he could hire 2 employees or buy a new piece of machinery. They will go with a high deductible plan for the first time which reduces the increase to 28%.

- The company pays 70% of the premium and the employee pays 30%.
- Next year they will move to a 60%-40% split and eliminate spouse and dependent coverage.
- Eventually he anticipates moving to a 50%-50% split. He predicts at that point they will lose employees.
- Several business acquaintances have moved to employee-only coverage or stopped offering health coverage completely.

Impact of the 20% increase in the Personal Income Tax (PIT) and Sales Tax increase and expansion of the Sales Tax base:

- **Decreased employees' wages:** This compounds the burden on the employees pay check. Not only will they be hit with increased health premiums and high deductible costs, they will also pay increased personal income tax and sales tax.
- **Reduced ability to invest in company:** Taxes take away money from the business and reduces profit. His family is very strict about investing in their company. They have always gotten money to reinvest in the business from the business profits.
 - They just bought a new machine and hired someone to operate the equipment. It's a good move because it expands their reach into other markets. The total cost was around \$1,000,000. With increased PIT taxes, that type of investment could be out of the question in the future. There are other pieces of equipment that work in tandem to the new machine but it is out of the question to buy them now due to financial constraints.

General comments:

- They are paying more and more money and getting less in return. Health care is a good example of that. Increased expenses keep his company from making purchases for the company and from hiring more workers.
- This situation is from an accumulation of many issues. The result is they are losing the ability to innovate and their competitive edge.
- While his company is not in the city, he is concerned about the paid sick leave legislation just passed by the City of Pittsburgh.

Product: Importers, custom brokers, international freight forwarders, customs broker, air cargo

Number of Employees: 20

Respondent: President

House: Mustio Dist. # 44

Impact of the Sales Tax increase and expansion of the Sales Tax base: This will be devastating to his service company.

- **Decreased employee benefits:** With a new sales tax at an increased rate he estimated that he would pay \$220,000 during the first year of implementation. The only place he can find \$220,000 is by cutting employee profit sharing
- **Decreased competitiveness:** His customers are not willing to pay a lot for the service he provides and if he does pass the new sales tax along not only will he lose customers but he will be less competitive with similar companies who operate outside of Pennsylvania.
- **Increased compliance costs:** Collection of the tax would be a bookkeeping nightmare due to the nature of his business; sometimes he must advance \$10,000 in funds to make less than \$120.00.
- **Relocation of company:** He has offices in Cincinnati and Cleveland and can move his PA accounting office to Ohio.

Product: Refrigerating equipment-commercial, wholesale

Number of Employees: 52

Respondent: CFO

Senate: Vance Dist. # 31

House: Rothman Dist. # 87

Impact of the Sales Tax increase and expansion of the Sales Tax base: The 10% increase in sales tax is devastating.

- **Decreased competitiveness:** It makes it harder and harder for us to compete with internet sales where sales tax is not well regulated or enforced. It makes my price as a small business owner even more expensive when compared to internet sales which are having a substantial negative impact on my business.
- **Increased compliance costs:** If there are different tax rates for different areas or counties it makes administering the sales tax nearly impossible for my company which operates in 21 counties. Trying to keep track of where we performed services and collecting and remitting sales tax would become a full-time job. I don't have the funds to hire someone just to track sales tax.

Product: Engineers-mechanical, consulting, research and innovation

Number of Employees: 7

Respondent: Engineering Manager

Senate: Costa Dist. # 43

House: Costa Dist. # 34

Impact of the Sales Tax increase and expansion of the Sales Tax base: This will make his company less competitive because they compete nationally against firms in other states

Impact of the 20% increase in the Personal Income Tax (PIT):

- **Decreased talent competitiveness:** Tax increases restrict talent coming into an area. They hire from far-reaching regions. A potential employee may look at job options in a state with a lower or no income tax. The result is his company won't be able to hire the talent needed or will have to pay more to keep talent or he will lose existing talent. When companies pay more for talent they have less profit margin or they raise rates which makes the company less competitive.
- **Decreased employee benefits:** Employees in profit sharing will lose out if the company has to pay more to offset higher taxes.
- **Decreased innovation competitiveness and price competitiveness:** Increased taxes reduce the profit margin and margin dollars are what is used for innovation. His company has some regional manufacturers as clients. If the manufacturers are paying increased PIT and the company cannot raise prices they have less money to spend on innovation which results in less money to invest in his company's engineering services. The consequence is less research and innovation for the regional manufacturers. On a national level, Pennsylvania becomes less competitive because state companies are less competitive with national companies.
 - If they are paying increased PIT taxes and they can't raise prices on products a second consequence is that they are not price competitive with out of state firms.
- **Relocation of company:** When clients have less money to spend money on his services his company may move to another state. When companies leave PA that decreases the state's tax base

Product: Hydraulic components & systems, industrial/commercial machinery/equip

Number of Employees: 20

Respondent: Retired President

Senate: Bartolotta Dist. # 46

House: Christiana Dist. # 15

Impact of the 20% increase in the Personal Income Tax (PIT):

- **Decreased profits:** Small businesses that are “S” Corporations cannot bear one more tax burden. Owners take all of the risk and find it difficult to keep employees with an already stressed cash flow due to taxation. Government does not understand taxation on a pass-through. If the government cannot move in a direction to help small business by easing the tax burden, businesses will close when they are no longer profitable.
 - When in conversation with the head of a large international corporation, I stated that if their lobbying goals are to put small businesses out of business, they are succeeding because of taxes and regulatory burdens. When I asked him, “Who will you sell to once we are gone?” he was silent.
 - I and other owners that I know have sold our businesses because of the overwhelming tax burden that constantly drains income.
- **Relocation of company:** Is this state the most mismanaged of all in the U.S.A.? It is enough to make one want to relocate out of state.

Impact of the Sales Tax increase and expansion of the Sales Tax base:

Nursing homes and home care for the elderly: Most of my friends and I are now dealing with the aging of our parents. Modern medicine is a double edged sword. A person can live to be a hundred or more with current technology regardless of their mental capacity and quality of life.

- My mother is 87 years of age and she recently developed dementia. With a family of 6 living siblings, we thought we could take care of her at home, but quickly learned that none of us were able to care for the needs of a mentally unstable person. We investigated care facilities. The least expensive was about \$2,000 per month, the average cost is around \$4,000 per month and a home with extras costs \$7,000 per month or more. All of these costs will be increased with the new sales tax.
- Within less than 3 years all of her funds will be gone. This thought has put our family in turmoil because, the 6 of us, are trying to determine how we will be able to afford to keep her in a facility that best knows how to care for her once the money is gone.

Product: Manufacturer of precision springs/wire forms
Number of Employees: 51
Respondent: Owner
Senate: Fontana Dist. # 42
House: Deasy Dist. # 27

Sales have dropped dramatically over the past several months and we're struggling to survive. Now we are faced with a 27% increase in health care costs and the monies aren't there.

- When does it end?
 - How will these increases affect us and our employees?
 - It will be catastrophic!
 - It will be the end of many small businesses and cripple Pennsylvania overall.
 - It's got to stop!

Product: Manufacturers of switchgear/switchboard apparatus
Number of Employees: 30
Respondent: Co-Owner, General Manager, family business
Senate: Fontana Dist. # 42
House: Wheatley Dist. # 19

Impact of the 20% increase in the Personal Income Tax (PIT):

- **Decreased ability to invest in the business:** An increase in the PIT will affect the money we are capable of reinvesting into to the company in the future. We do not keep cash or investments inside the company. If we have excess cash and profits we pay it out to the shareholders as dividends or to employees at bonuses. Employees are also shareholders. When acquiring new product lines or when we have an immediate need for cash, the owners of the company know that they may be expected to "pay in" more money to keep their per cent of shares.
- **Decreased employee morale:** Our employees receive nice compensation and the tax increase may take away from their spending power resulting in the need for increased compensation which we may not be able to do. Having disgruntled employees or having employees who are distracted because of not being able to pay their bills will cause a decrease in productivity which results in a downward spiral.
- **Decreased ability to invest in start-up businesses:** The two start-up companies that I am a part of would suffer. Currently, in each company there are 3 to 6 of us who are investing money we make from our "full-time" jobs to launch these companies. The increase in personal tax would take away from our ability to develop our products, and hire employees.

Product: Janitorial services
Number of Employees: 8
Respondent: President
Senate: Vacant Dist. # 37
House: Ortitay Dist. # 46

Impact of the 20% increase in the Personal Income Tax (PIT) and the Sales Tax increase and expansion of the Sales Tax base:

- **Limited business income:** Tax increases raise expenses and that increases our costs. We try to pass on increased costs to our customers by raising prices but they may not go for it. The pot is only so big; the business gross revenue does not always increase. Those in government don't understand that concept.
- **Decreased employee compensation etc.:** When taxes dollars are taken out of our business income, we can't give raises, we can't give benefits, and we cut back on employees and hours.

General comments:

- **Property tax reform:** Where is the money from the lottery, cigarette tax and casinos that was earmarked for tax reform?
- **Unions:** What the government needs to do is simple but when the government is owned by the unions and only work to justify their own existence it is impossible to get anything done for the people.
 - Union benefits must be comparable to benefits of private business employees: Businesses have to be competitive. Their employees aren't guaranteed a job or a pension; employees have at-will arrangements with employers unless they are union members.

Product: Aviation fuel, heating oil, lubricants, heating oil, convenience stores/gas stations
Number of Employees: 50
Respondent: decision maker
Senate: Hutchinson Dist. # 21
House: Metcalfe Dist. # 12

Impact of the Sales Tax increase and expansion of the Sales Tax base: That lowers everyone's income. It is a consumption tax; if it keeps ratcheting up it impacts everyone especially the poor and the elderly. It is a totally regressive tax and it hits the poor right on the jaw.

General comments:

- **Pension reform:** Pensions are driving the budget and consuming all available revenue.
- **Property tax reform:** He is very skeptical that property tax reform will work. His father receives \$57.00 per year in a homestead exemption.

Product: Manufacturers of mechanical springs, wire forms

Number of Employees: 75

Respondent: President

Senate: Vulakovich Dist. # 38

House: English Dist. # 30

Impact of the 20% increase in the Personal Income Tax (PIT): This has an impact on any earnings which get passed along to individual shareholders who will ultimately pay the PIT. Cash flow is very important. More money sent to the government leaves less money to run the business and less money to pay bills.

Product: Strategic consulting, government relations, public relations

Number of Employees: 3

Respondent: Partner

Senate: Vance Dist. # 31

House: Regan Dist. # 92

Impact of the 20% increase in the Personal Income Tax (PIT): Any increase in the personal income tax is a whack on me as a Subchapter S corporation partner.

Impact of the Sales Tax increase and expansion of the Sales Tax base & property tax reform: The income tax increase is problematic unless it is tied to an equivalent decrease in my property tax. Paying additional tax for various business services is another tax on my company and me. If increased taxes go towards the reduction in my property taxes, that provides some relief but if there is no promise that the additional taxes would reduce and replace property tax liabilities, it's just more and more money out of my pocket.

Product: Educational and promotional content for websites, marketing videos, brochures, press releases

Number of Employees: self

Respondent: Owner

Senate: Hutchinson Dist. # 21

House: Metcalfe Dist. # 12

Impact of the 20% increase in the Personal Income Tax (PIT) on a new business: It is a daunting task to establish a new business and the added financial drain of tax increases could be the difference between success and failure. As a sole proprietor, I already make up the gap in FICA employer contribution.

Impact of the Sales Tax increase and expansion of the Sales Tax base: I don't have access to an employer supply closet or expense account for overhead and business development needs. As sales taxes expand and increase, my overhead will also increase. This is in addition to increasing health insurance and deductible expenses all of which are my sole responsibility and a growing financial strain.

General comments:

- **Spending:** Politicians seem convinced that it is their duty to collect more and more money from some in order to spend it on what they believe is most important. This approach minimizes the value of small businesses and the hard work and contributions of their owners.

Product: Precision machine shop, manufacturers
Number of Employees: 115
Respondent: President
Senate: Ward Dist. # 39
House: Dunbar Dist. # 56

Impact of the 20% increase in the Personal Income Tax (PIT):

- **Increased cost of employee wages:** If taxes are increased as proposed by the Governor all employees will be paying higher taxes regardless of your income level. When we negotiate our new labor agreement next spring the union is going to ask for additional wage increases over the norm due to employees take home pay being reduced.

Impact of delayed budget agreement: The availability of state training programs and dollars are in jeopardy since no budget is passed which delays our current plans to hire and train additional workers through state assisted training programs.

Product: Professional services company specializing in network engineering and network security engineering.
Number of Employees: 18
Respondent: CEO and President
Senate: Vacant Dist. # 37
House: Mustio Dist. # 44

General comments:

- **Impact of the 20% increase in the Personal Income Tax (PIT):** I thought “small businesses” were the “engine” of the economy? Obviously that is not true, since the increase in the PIT will affect most small businesses because of the pass-through to individual tax returns.
- **Spending:** As a small business owner, I want to understand when will the PA General Assembly and Governor start being fiscally responsible and cut expenses instead of spending MORE money?
- **Pension reform:** It is not 1950 and the life expectancy has increased by at least 15 years since then. When is someone going to get the courage to address the teacher’s unions and deal with the growing issue that will NOT go away? Large businesses dealt with this issue 20+ years ago. Yes, it is not easy. Change never is.....

Product: Welding equipment & supplies wholesale
Number of Employees: 30
Respondent: President
Senate: Vulakovich Dist. # 38
House: Dermody Dist. # 33

General comments:

- **Pension reform:** If new and current employees are brought into a 401 k plans then the unfunded liability must be paid off.
- **Spending:** Government must get spending and expenses under control.
- **Unions:** His small business has a union. “Unions are a disaster. PA must become a right-to-work state.”

Product: Electrical products manufacturers
Number of Employees: 25
Respondent: President
Senate: Vulakovich Dist. # 38
House: Costa Dist. # 21

General comments:

- **Spending:** The most critical concern is the high level of state spending.
- **Pension reform:** We must get pensions under control.

Product: Machine shops, manufacturers
Number of Employees: 8
Respondent: General Manager

General comments:

- He can't keep up with the actions of state government because he is short-handed. His brother, the co-owner, passed away last year.
- Government can't solve all peoples' problems.

Product: Insurance
Number of Employees: self
Respondent: Life and Health Manager
Senate: Costa Dist. # 43
House: Frankel Dist. # 23

Impact of the 20% increase in the Personal Income Tax (PIT) & Impact of the Sales Tax increase and expansion of the base: I have no employees so can only talk about my personal concerns and those of many of my clients. I can handle the increase, but it would impact my spending for the following:

- Goods and services
- What I have available for donations
- What I can put away for retirement

As for many of my clients with far less income, the proposed tax increases could severely impact their ability to feed and clothe themselves properly.

Product: Window cleaning
Number of Employees: 13
Respondent: Vice President
Senate: Vacant Dist. # 37
House: Saccone Dist. # 39

Impact of the 20% increase in the PIT & Impact of the Sales Tax increase and expansion of the base: That leaves his company with less to give out in wages. The employee in turn has less money to spend with increased Personal Income Tax and Sales Tax.

Product: Janitorial services
Number of Employees: 85
Respondent: Secretary/Treasurer
Senate: Vacant Dist. # 37
House: Saccone Dist. # 39

Impact of the 20% increase in the PIT & Impact of the Sales Tax increase and expansion of the base: That leaves his company with less to give out in wages. The employee in turn has less money to spend with increased Personal Income Tax and Sales Tax.