



Testimony of Susan R Hileman, District Manager, Northwest IRC

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“The Cost of Doing Business in PA”
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Good afternoon. My name is Susan Hileman and I am the District Manager for the Northwest Pennsylvania Industrial Resource Center (NWIRC)—one of 59 Manufacturing Extension Partnerships (MEPs) in the country and one of seven regional IRCs. I would like to thank the House Majority Policy Committee for the opportunity to provide testimony on “The Cost of Doing Business in PA.”

The IRC Network was established in 1988 under Governor Casey’s administration to assist manufacturing performance and competitive position. In 1994 we were awarded the federal MEP contract through the United States Department of Commerce, National Institute of Standards and Technology (NIST). With 9 employees, a \$2.1 million annual budget, and offices in Erie, Meadville and DuBois, our organization works with manufacturers in these 13 counties of Northwest Pennsylvania: Erie, Crawford, Mercer, Forest, Warren, Venango, Clarion, Clearfield, Jefferson, Potter, McKean, Cameron and Elk Counties.

Pennsylvania’s manufacturing sector is central to the state’s economy. It is the largest sector in terms of the generation of Gross State Product (GSP); it is the state’s fourth-largest source of jobs; it has the highest productivity of any sector; and it has the highest employment, income, and value added multipliers of any economic sector in the state.

As companies struggle to keep pace with accelerating changes, the IRC’s mission has become more critical than ever to assist individual manufacturing firms through the implementation of strategies for top line growth and profitability, and tools for bottom line cost reduction. By advancing the performance of manufacturing in northwest Pennsylvania through outreach, training and consulting services, individual companies grow and improve, and collectively, they impact our regional economy by creating family-sustaining wage jobs and re-investing in their businesses.

Changing state priorities and economic uncertainties provide both challenges and opportunities that further emphasize the need to leverage resources and strengthen partnerships. In addition to being a service provider, Northwest IRC often plays a liaison role between the business community, economic development partners, elected officials, and manufacturing leaders and policy-makers. We value being able to provide insight into the daily challenges faced by manufacturers and serving as a conduit for public and private available resources.

PA Manufacturers, particularly small and mid-sized manufacturing firms, are facing new and significant challenges. The “cost of doing business” in Pennsylvania includes constant pressures to reduce costs, improve quality, meet environmental and international standards, and get to market faster with new and improved products, all in a larger, more competitive, global market. We recognize there is no “silver bullet”—no one individual answer to increasing manufacturing’s competitiveness. Rather, it takes a comprehensive approach across multiple areas to provide the business growth and cost savings impacts to spur job creation and allow Pennsylvania manufacturers the ability to compete in the global economy.

Like other areas of the Commonwealth, in order for the Northwest Pennsylvania region to successfully attract and retain businesses, it must create a competitive business climate that enables companies to grow. While efficient shop floor operations of a firm represent a large part of manufacturing’s financial health, efficiency alone is not sufficient. Manufacturers must position themselves to manage a variety of challenges in concert in order to compete long term. While managing programs of continuous improvement, technology acceleration and supplier development, they must also be responsive to business taxes, various regulatory issues, and the significant challenges of workforce development.

BUSINESS TAXES

One of the key mantras the IRCs promote is the necessity for continuous improvement. It will come as no surprise that when employers were asked what keeps them up at night, a dominant response was ‘taxes’. While the 2010-2011 budget provided some relief to companies, each year brings new opportunity for budget improvements—particularly when it comes to business taxes. One of the most

commonly used indicators of a state's business climate is its Corporate Net Income (CNI) tax. Pennsylvania's Corporate Net Income tax of 9.99% is the second highest in the country—and the highest of any major state. Pennsylvania's high tax, and complexity of the tax code itself (compliance and navigation), guarantees low ranking on many business climate indexes presenting a difficulty in attracting new business from outside the region as well as placing a burden on current employers. From a global perspective, this current tax structure is certainly a deterrent to economic development and job creation. From a regional perspective, a system that is flatter and easier to comply with would relieve some of the burden on current employers.

In addition, Pennsylvania continues to be one of only two states with a cap on Net Operating Loss (NOL) carry-forwards. Every state recognizes that if a business loses money one year, and makes money the next year, it is unfair to base its tax just on the year in which it is generating income. So, states allow business to carry forward their net operating losses from one year into future years. However, Pennsylvania limits the amount of losses a business can carry forward. While the 2010-11 Pennsylvania budget continued its improvement plan of increasing the cap from \$2 million to \$3 million (or 20%), every other major state puts *no* limit on the carry-forwards. This cap makes many manufacturers as well as fast-growing technology startup firms uncompetitive with similar firms. It also means that cyclical manufacturers and high-growth start-up companies face effective tax rates that are several times higher than what they would pay in any other state.

Additionally, while the Pennsylvania Corporate Net Income tax apportionment formula now has a sales factor weight of 90% (a significant and welcome increase from the 60% of previous years), it is still behind other competitor states. Compared to states with a 100% weight on sales – a “single sales factor” – firms in Pennsylvania pay a higher effective tax rate. This continues to make it more difficult for companies that employ large numbers of Pennsylvanians to compete. Pennsylvania's current formula is based on three factors – property, payroll and sales. A single sales factor (SSF) formula, on the other hand, has no property or payroll factors, thereby eliminating the inherent penalty on companies with significant operations and jobs in the state. Under a single sales factor, more than 90% of companies doing business in

Pennsylvania would either benefit from, or see no change in their taxes allowing those who would be able to hire and expand operations to do so without incurring a substantial tax penalty.

Finally, while manufacturing is exempt, Pennsylvania is one of a minority of states to impose a Capital Stock and Franchise Tax in addition to the Corporate Net Income Tax. We applaud the fact that this tax is currently being phased out by 1 mill per year. This will be a major improvement in the state's competitiveness for those firms that pay the tax, especially business service firms that do not qualify for exemptions. However, full elimination was last slated for 2011. The phase-out has already been delayed twice from the original schedule and is currently frozen for two more years at the rate of 2.89 mills. This may cause potential businesses considering Pennsylvania to see the tax structure as unpredictable as well as uncompetitive.

Looking at each issue independently, we acknowledge there have been recent improvements. The 2010-11 budget allowed for an increase in the Net Operating Loss (NOL) cap from \$2 million to \$3 million and also in the state apportionment formula base from 60% sales tax for multi-state company's income to 90% sales tax. But local areas have little choice over the high Corporate Net Tax rate of 9.99%.

Pennsylvania should consider reducing the Corporate Net Income tax to at least the 8.5% level that existed in 1987-1990—or support the ideas proposed in Senate Bill 206 which intended to reduce the Corporate Net Income (CNI) tax rate to 8.99 percent in Fiscal Year 2010-11, 7.99 percent in FY 2011-12, and 6.99 percent thereafter. Phasing a reduction in over a three-year period would reduce the impact on the state budget, and would bring the rate into a range that would be competitive with many other states. Finally, Pennsylvania should join all of its competitor states by complete elimination of the \$3 million cap on the amount of net operating losses (NOLs) that can be carried forward to future tax years.

REGULATORY ISSUES

Many of the CEOs we work with tell us how difficult it is to keep up with the challenges of their global markets, new innovations in products and processes, and a more diverse workforce, as well as the changing landscape of government resources and regulations. They value the services of the IRC program to help them stay current on the opportunities available to them as well as the industry best practices that can help them stay competitive in difficult economic times.

One of the current challenges we find manufacturers facing relates to ongoing and increasing regulatory and compliance issues within their respective industry sectors, especially as concerns regarding the health and well-being of the environment become more pressing. From the American Clean Energy and Security Act of 2009, the Family Medical Leave Act , and OSHA compliance regulations which cover *all* industries, to the Oil and Gas Act regulations overseeing the Marcellus Shale industry, FDA regulations overseeing the Food Processing and Pharmaceutical industries, and RoHS and WEEE regulations governing hazardous substance and waste specific to the electrical equipment and electronic components industry. Companies face ever-increasing pressure—and costs—associated with regulations as well as certifications mandated for manufacturing. Forest Stewardship Certification (FSC) now governs sustainability issues within the Wood and Lumber industry. ISO 9001:2008 and ISO14001 certifications are increasingly mandated by automotive, aerospace and defense industries...not to mention the ITAR building security regulations and the new ISO50001 Energy standard which is being encouraged for all major companies.

By providing the latest industry best practices, translated to meet the needs of the small and medium-sized establishments that dominate our region's manufacturing sector, the Northwest IRC is able to help many manufacturing companies stay current with the ever-changing regulatory and certification requirements. However these regulations affect many diverse aspects of the manufacturing business and process—and costs required to insure compliance

often inhibits their ability to be competitive. Government regulations are not intended to stifle the production abilities of the manufacturer, and yet, that is too often the case. Job loss is unfortunately a common coincidence to regulations that require significant monetary input to reach compliance.

One recent example can be seen in the federal Corporate Average Fuel Economy (CAFE) standards whose amendments related to this legislation, as it applies to manufacturing specifically, are currently being debated. The manufacturing industry is anxious to see how new and potentially costly regulations will affect the number of manufacturing jobs available and are hopeful to minimize any job loss. The 10,700 jobs currently in Northwest Pennsylvania's transportation industry will likely be affected first. In addition, ensuring green manufacturing processes (ISO 14001) and implementing a green supply chain will be even more important than it is today as the increased awareness for environmental concerns and push from customers to be more sustainable becomes evident. As one professional stated, greening the supply chain is "not optional, it's becoming the standard."

Information technology (IT) software and hardware systems can assist with implementing tracking mechanisms, compliance and data storage. For example, enterprise resource planning (ERP) systems are now available which offer an embedded environmental footprint management tool and yet the cost for investing in such technology can be high. This is especially true when considering new versions and updates for software and hardware technology are available on an on-going basis, making "current technology" practically obsolete within a short time of purchase. While small to midsized manufacturers are recognizing the need for upgraded information technology, they often struggle with selection and investment criteria. Among focus group participants surveyed in a recent IRC report, more than 20 percent of manufacturers estimate their companies' IT investment as more than 5 percent of annual sales.

Regulatory issues are intended to support and protect—the company, the employee, the consumer and the environment. Too often the cost of attaining and maintaining regulatory

compliance significantly affects a manufacturer's bottom line which is already stretched trying to remain competitive with rising costs of materials, transportation, energy and labor. While larger companies have the human capital and resources to dedicate putting best practices in place, small to medium manufacturers struggle with wearing multiple hats and often are focused on survival, or certainly business growth. Pennsylvania could consider putting funding opportunities and tax credits in place so that when mandates are legislated, or increases in technology are required, companies are assured that their ability to meet compliance is not at the cost of being regionally or globally competitive.

WORKFORCE DEVELOPMENT

In order to be competitive in the global marketplace, businesses need workers who are proficient in basic skills and knowledgeable about technical skills in order to obtain and keep good quality jobs. Despite losing nearly 230,000 jobs between 1998 and 2008, manufacturing still employs over 500,000—more Pennsylvania workers than nearly all other industry sectors. However one of the single largest issues manufacturers face impacting their day-to-day business is the challenges associated with the ability to find skilled workers. Among recent focus group participants surveyed, 94% rated "human-capital acquisition, development and retention" as important to their company's success over the next five years; 60% described it as highly important. Workforce issues hurt their ability to grow.

Some economists have suggested that U.S. employment is taking on the shape of a barbell, with growth concentrated among either low-skill jobs or high-skill jobs. Low-skill jobs are those accessible to high school graduates with limited on-the-job training. High-skill jobs are those requiring a bachelor's degree frequently coupled with large amounts of on-the-job training. Other economists say retirements will create many job openings in the middle of the skills distribution.

Regardless, Pennsylvania manufacturers don't see a shortage of the middle-skill *jobs*; they worry about a scarcity of workers with skills sets critical to manufacturing activities and

including work ethic, attitude and interest. As one manufacturer noted, “We can’t find machinists, welders, hands-on guys who used to be the backbone of this country. We have the opportunity to grow. But we can’t find the people.” And it is anticipated to get worse. According to the U.S. Census Bureau Center for Economic Studies, 19.8% of all manufacturing workers in the Northwest Pennsylvania region are between 55- and 64-years old; and within the next 10 years they will be eligible to retire. The fate of middle-skill jobs is also an important long-term policy issue in Pennsylvania because, according to the American Community Survey of 2010, over 38% of the state’s adult workers have a high school education or less.

An educated and skilled labor force drives innovation and production and can grow jobs in high-value industries. According to the report “Pennsylvania’s True Commonwealth - The State of Manufacturing Challenges and Opportunities” completed in April of 2011, employment growth in the state is polarizing, with the growth in new jobs concentrated in relatively high-skill, high-wage jobs and low-skill, low-wage jobs. The widely accepted definition of a *middle-skill* occupation is one that generally some combination of postsecondary schooling that is industry-recognized, substantial amounts of on-the-job training, or, less frequently, a specialized associate's degree. In 2008, middle-skill manufacturing jobs accounted for 10.8% of all middle-skill positions in Pennsylvania and 2.9% of *all jobs* in the Commonwealth. The U.S. Bureau of Labor Statistics projected that 45% of all *job openings* across the United States between 2004 and 2014 would be in middle-skill occupations, compared to 33% for high-skill and 22 percent for low-skill occupations. While these projections were made before the Great Recession, the trend is expected to resume once the economic recovery gets further underway.

Half of these middle-skill manufacturing jobs are in production. The next-largest occupational grouping for middle-skill jobs is in the skilled trades and industrial maintenance. As productivity increases and production jobs slowly come back, created mostly through turn over, we expect to see increased demand for workers with mid-level skills. Building career ladders by providing access to middle-skill positions, particularly production occupations, will be critical to both the

success of the manufacturing sector and to the economic success of these Pennsylvania workers.

Government at all levels needs to invest in basic skills training and development and workforce needs. A sustained commitment to workforce development—through support for internships and apprenticeship programs—would improve the preparedness of our labor force and provide a path for unskilled workers to increase their productivity. In a future where middle-skill manufacturing jobs will be at the top of the job ladders many workers climb, the IRCs can be an effective tool to bridge the gap between these supply and demand sides of the labor market.

One way to assist would be to provide a Career Development Tax Credit program to credit a percentage of qualified employer costs for training employees and upgrading their skills against their Pennsylvania corporate and income tax liability. The program could be capped at \$20 million per year and funded through state dollars already being spent on workforce development in the Commonwealth. Eighteen other states offer such a job training tax credit.

SUMMARY

Employing over 500,000 Pennsylvanians state-wide, manufacturing is the state's fourth-largest employment sector with family-sustaining average wages in 2008 of over \$52,000 annually. Manufacturing remains a key part of Pennsylvania's innovation infrastructure and is present in all parts of the state, from city to suburb to rural counties. The Industrial Resource Center program is a tested tool in the state's economic development toolbox. In return, small to midsized manufacturing companies are able to improve their competitiveness thereby strengthening our regional and state economy.

While the reduction of the Corporate Net Income tax and simplification of the tax code, improved support for compliance to regulatory requirements and IT costs, or focused workforce development programs to train middle skill occupations are necessary, there is no one silver bullet to improving the cost of doing business in Pennsylvania. Our experience with

Pennsylvania's manufacturers shows a clear ability to compete when firms engage in 5 basic business transformations. Such transformation:

- * Is built on the foundation of a strong objective strategic plan;
- * Is followed by the systematic elimination of waste in the production process, improving quality, and shortening the time it takes to get product to market (these actions are frequently put under the label of what is known as lean manufacturing techniques);
- * Measures what is important and establishes a culture of continuous improvement;
- * Empowers the core workforce and frees senior management to work on the business;
- * Engages in product development in a niche market, coupled with an effective sales and marketing strategy.

This is a recipe that is easy to recite, challenging to implement, and hard to stick with unless it is a part of a company's core operations. That's where the IRC can help the best-of-the-best manufacturers in Pennsylvania succeed. These manufacturers, who have survived the difficult environment of the recession by retooling and repositioning, tell the IRCs that they are poised for growth. That positioning can, and should, be enhanced with selective changes in public policy. It is an industry sector that deserves continued public support and investment in the form of state tax and regulatory reform, and employer-responsive workforce development programs—along with an industrial resource that can transfer knowledge about business growth strategies and management practices that fit the demands of small and mid-sized firms. At 13.6%, manufacturing provides Pennsylvania's largest source of Gross State Product (GSP). Every \$1 increase in final demand for products manufactured in Pennsylvania leads to a total increase in gross value added by all industries of \$2.52. No other industry in the state comes close to rivaling this kind of impact. As one focus group participant succinctly put it: "Government should make it easy to do business in Pennsylvania. Reasonable red tape and taxes. Support bringing business back domestically from overseas as much as possible. Encourage investment in Pennsylvania – low taxes, good business environment promotion."

Thank you for providing the opportunity to testify and share the IRCs perspective on the Cost of Doing Business for manufacturers in Pennsylvania.

