4. Reform Pennsylvania's Taxes for the 21st Century

Box 1 contains the part of the *Prescription for Prosperity: An Economic Agenda for Pennsylvania's Future* that addresses taxes. The rest of this section elaborates the rationale for that part of the agenda and includes more detailed policy options that could accomplish the goals in section 4 of the agenda. As with all sections of this "discussion draft," we welcome feedback. (Comments may be sent to agenda@keystoneresearch.org.)

Pennsylvania needs a tax system that will generate sufficient revenues to support the public investments detailed throughout this agenda. As with private investments, tax revenue once invested is a down payment that will generate a stream of future returns—better educated children, a healthier population, shorter spells of unemployment thanks to stronger supports for job and career changes over a lifetime, higher quality jobs, a growing economy, and a better quality of life. Pennsylvanians can elect to stop spending, to roll up the sidewalk and pull the plug on lighting the streets at night. But for the state, as with any business, the failure to invest will be a prescription for stagnation and ultimately for failure. Other states, those states with greater wherewithal or greater vision will continue to grow, innovate, and respond to our changing and challenging world and leave Pennsylvania behind.

Box 1. *The Prescription for Prosperity Excerpt on Taxes*
Reform Pennsylvania's Taxes for the 21st Century

Pennsylvania's state and local tax systems are inequitable and unable to meet the needs of its aging population or to invest in its economic future. More state funding is necessary, as is a plan to raise it from those who can most afford to pay. The Commonwealth should support comprehensive tax reform that would:

i. Reduce taxes on the middle class
   a. By modifying Pennsylvania's constitutional uniformity clause to permit two tax rates, with the higher of the two rates imposed on individuals and businesses with greater ability to pay
   b. By introducing personal exemptions to eliminate taxes on the first part of income
   c. By setting a higher tax rate on dividends and capital gains than on wage income
   d. By allowing localities to similarly restructure their taxes and to include all forms of income, earned and unearned, in their tax base

ii. Ensure that everyone pays a fair share of taxes
   a. By closing tax loopholes that allow corporations to artificially shift their profits to states with lower or no income tax, so that all profitable corporations pay state income tax
   b. By expanding the sales tax to include all tobacco and others goods and services not currently taxed, excluding necessities
   c. By taxing businesses that do not provide health care to help fund comprehensive health care reform
   d. By authorizing local business taxes to be imposed on all classes of businesses

iii. Increase the state share of education funding to reduce reliance on the property tax
   a. By shifting funding for education from local property taxes to state income taxes
   b. By targeting additional property tax relief, to low- and middle-income families whose property taxes have grown to a high share of their income

iv. Ensure that all localities have a tax base adequate to fund schools and other services by shifting the collection of local taxes to the regional level

A major obstacle to an investment strategy is Pennsylvania's tax system itself, which is structured in a way that places too much of the tax effort on those less able to pay, the poor and the middle class. A revitalized and restructured tax system will be more sensitive to ability to pay, and draw more funds from those most able to invest in our collective future. This system will not only be more fair but will also accrue benefits across the income spectrum, including to those whose taxes rise.

Pennsylvania is not a high tax state. In 2005, the Commonwealth ranked 6th in the nation in population, but rank 22nd among all states for per capita state and local taxes, 29th for property taxes, 36th for sales taxes and 19th for income taxes. Our total tax collections per capita are almost $100 below the national average, and if we moved just to the national average would raise an addition $1.17 billion. Even our corporate taxes, which rank 14th , are below the national average in per capita terms.

Make the Tax System More Equitable

The Commonwealth does have the dubious distinction of being one of what the Institute for Taxation and Economic Policy calls the Terrible Ten—i.e., one of the 10 states with the most regressive tax systems. The main reason for this is that Pennsylvania is one of only six states with a flat tax rate. This means that individuals with low incomes pay the same share of each dollar (3.07 cents to be exact) in state income tax as do high income individuals. In the other 36 of the 42 states that have an income tax, the income tax rate increases for higher-income individuals. Many municipalities impose a flat local income tax as well. (As discussed below, Pennsylvania's flat tax structure stems from the uniformity clause of the state's Constitution, which requires that all taxpayers in a given class be taxed at the same rate.) Municipalities in many cases also impose their flat income tax only on "earned" income (wages) and not on "unearned" income (including interest, dividends, and capital gains). Since higher-income taxpayers receive a higher share of unearned than earned income, the exclusion of unearned income from the local income tax base makes the tax even more regressive.

Sales and property taxes, the other two main types of tax besides income taxes, are even more regressive than flat income taxes. That is, lower-income taxpayers pay a *higher* share of their income in sales and property taxes than higher-income taxpayers. When you combine a flat income taxes with a regressive sales and property taxes you get an overall tax system in which the poor pay more of each dollar in taxes than the middle class and the middle class pays more than affluent taxpayers. Overall, the poorest 20% of Pennsylvanians pay 11% of their income in state and local taxes, while the top 1% pays only 3.4%. In 2002, Pennsylvania's tax effective tax rate was 19th highest in the nation for the lowest 20% of earners, but ranked 42nd for the top 1%.

Pennsylvania's state Tax Forgiveness program helps to reduce the regressivity of the income tax, and the overall tax system, by allowing lower-income individuals and families to receive a rebate of state income taxes that they have paid. Under this program, for example, a family of four qualifies for a 100% rebate of all taxes up to an income of $32,000.[1] This program, however, does not

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[1] Each adult in a family qualifies for complete tax forgiveness up to an income of $6,500 and each child for tax forgiveness up to an income of $9,500. Therefore, with two adults and two children in a family, the complete tax

apply to local earned income taxes. Moreover, only $2,250 above the threshold for complete tax forgiveness, families must pay taxes on every dollar of their income. As a result, a family of four that sees its income rise from $32,000 to $34,250, sees its income tax rise from zero to $1051. (Thus, 47% of the increase in income over this range is paid in state income taxes.)

In principle, a variety of methods could be used to introduce greater progressivity into the state and local income tax systems. At minimum a second, higher tax rate should be established for higher-income individuals. For those businesses (so-called pass-through entities) that pay the personal income tax on profits "passed through" to their owners, having two income tax rates would also make it possible for genuinely small businesses to pay the lower rate while larger and more profitable ones pay a higher rate.

A second way to increase the progressivity of state and local income taxes would be to introduce personal exemptions. Personal exemptions comparable to those permitted in the federal income tax structure would exempt the first part of income from tax for all taxpayers, not just for families below the Tax Forgiveness thresholds. If these personal exemptions mirrored the provisions of Tax Forgiveness, eliminating tax on the first $32,000 of income for a family of four, then a family earning $34,250 would pay taxes only on $2,250 of income ($68 with the current tax rate instead of $1051). Thus personal exemptions would reduce taxes especially on middle-class families.

Taxing unearned income, including interest, dividends, income from trusts at a higher rate than ordinary compensation could also make the tax structure vastly more progressive. Recent analysis by KRC based on Department of Revenue data suggests that 4% of taxpayers would account for almost two-thirds all revenue from a higher rate tax on interest, dividends and non-compensation income. At the local level in many cases, simply taxing unearned income at all, and including unearned income in the tax base, would make income taxes more progressive.

Of the changes above, the introduction of two tax rates, and possibly the introduction of personal exemptions, would require a Constitutional change to become effective.[2]

Make Business Taxes More Fair

In Pennsylvania, and across the nation, corporate income taxes are declining source of funds for state services. Corporate taxes are declining in Pennsylvania for several reasons. In 1998 legislation was passed to phase out Pennsylvania's Capital Stock and Franchise tax, which raises more than $1 billion annually. The yearly one mill reduction of the tax rate removes about $200 million in state revenue and the tax is scheduled to be eliminated in 2012.

The difference in the Corporate Net Income tax (CNIT) rate, at 9.99% and the (PIT) Personal Income Tax rate, at 3.07% make it very attractive for businesses to incorporate under subchapter S of the Internal Revenue code. Rather than paying the CNI tax on profits, Subchapter S

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forgiveness ceiling is $32,000. See the 2006 PA Schedule SP Eligibility Income Tables at http://www.revenue.state.pa.us/revenue/cwp/view.asp?a=3&q=237877

[2] We say probably with respect to personal exemptions because this change might be possible with the current constitution if people first paid taxes but then received a rebate of those taxes.

corporations (and other pass-through entities, such as limited liability partnerships) pay the personal income tax when profits are passed through to shareholders.

Aggressive use of tax avoidance strategies are a significant cause of corporate tax decline. Businesses avoid paying taxes through a variety of loopholes that reduce the tax liability in a particular state. For example, some businesses create holding companies in states like Delaware and Nevada that have no employees and no payroll but hold valuable assets, including trademarks and patents. These holding companies then charge the company operations in other states, including Pennsylvania, for use of the trademark. This shifs income to the holding company and reduces taxable income in the other states.

Whether because they made no money or because of income shifting, in 2004 (the last year for which we have data) only 23% of Pennsylvania (C) corporations paid any corporate income tax and 96% paid less than $10,000.[3]

In order to ensure that tax liability falls fairly across all companies and to limit tax avoidance and income-shifting, many states have adopted mandatory unitary combined reporting. The intuition behind combined reporting is that it is artificial to treat legally interconnected subsidiaries as meaningfully separate. It is also very difficult to determine in any objective way the "profits" associated with one subsidiary. Instead of attempting this, mandatory unitary combined reported requires businesses with multiple subsidiaries to file taxes as a single company. Once the profits in the entire United States (or entire world) of the single entity are calculated, the share of these profits attributable (or apportionable) to Pennsylvania is determined based on the companies property, payroll, and sales in Pennsylvania compared to its property, payroll, and sales in the entire country (or world). 17 states have adopted combined reporting and Governors in three additional states, New York, Massachusetts and Iowa have included combined reporting proposals in their 2007 budget addresses.

In addition to being much more fair, using combined reporting can raise substantial revenue. Governor Rendell's budget address illustrates this in a dramatic way. Today, the state's 7 oil companies pay $71 million in corporate net income tax. Under the Governor's proposed oil gross profits tax, which would tax these gross profits at a lower rate than the CNIT, using combined reporting instead of separate company reporting would increase tax receipts to $765 million.

A business tax reform commission convened by Governor Rendell recommended a revenue neutral approach to introducing combined reporting as the method used to calculate corporate net income taxes due under the CNIT. Under this revenue neutral approach, additional revenues from combined reporting would be offset by a reduction in the corporate income tax rate.

Under a switch that is revenue neutral or one that generates additional revenue, enacting combined reporting would remove a competitive advantage available to some large, multi-state corporations but not available to C corporations that have operations only in Pennsylvania.

[3] Some portion of the corporations that pay no tax are inactive but have not taken the extra step of legally going out of existence.

Update the Sales Tax and Tobacco Tax

In 2006, the Pennsylvania House of Representatives passed legislation that would have expanded the state sales tax to products that are currently exempt and to a wide variety of services. The legislation implicitly recognized that the sales tax has not been updated to reflect the growth of the service economy and that there are products, such as candy and gum that are not subject to the tax, although the reason for the exemption may not be particularly relevant today, if it ever was.

There is ample room to broaden the Pennsylvania sales tax. Pennsylvania taxes only 66 of 168 possible services, and many states apply their sales tax much more uniformly across products and services. One way to keep the sales tax rate down is to expand the base. When the tax is expanded to services that are a growing part of consumption, revenue from the sales grows naturally over time, reducing the need for a higher rate.

The 2007-08 Governor's Executive Budget estimates that the exemption of services from sales taxation, from dry cleaning to hospital fees, costs the Commonwealth $9.7 billion in 2007-08. This is roughly equal to what is expected to be collected from the current sales tax base. Thus a substantial broadening of the sales tax base could allow for significant *reductions* in the sales tax rate.[4]

The sales tax, although a regressive tax, is an important source of revenue for the state. Pennsylvania exempts food and clothing from the tax, which reduces the burden on lower income individuals, but efforts to apply the tax more broadly and uniformly should be adopted.

Pennsylvania is the only state in the nation that does not tax smokeless tobacco products, including cigars, chewing tobacco and pipe tobacco. Such a tax would help to discourage tobacco use, especially among young people, a worthwhile goal in and of itself. It addition, the tax would create parity between different types of tobacco and would contribute to the goal of expanding the tax base to allow for sufficient natural growth to limit the need for rates to increase.

[4] It is possible that imposing the sales tax on some services consumed primarily by high-income taxpayers would also reduce the regressiveness of the sales tax. This is a difficult issue to analyze because of a lack of good data on consumption by income level of specific (narrow) services. In addition, it is not simple to determine in many cases who ultimately pays services imposed on business inputs.

Targeted, not General, Property-Tax Relief

In Pennsylvania and across the country, the property tax has come under increasing scrutiny as a source of school funding. Pennsylvania relies more on local property taxes to fund basic education that the national average. Since the mid-1970s, the state share of school instructional expenses has declined from a peak of 55% in 1973-74 to 37% today.

While regressive, the property tax, which is based on the value of property, is less regressive than the sales tax because property wealth grows more with income than consumption of goods and services subject to the sales tax. Nonetheless, because the property tax is not based on the taxpayer's ability to pay, it can be a difficult tax for many seniors and lower-income individuals to pay.

While Pennsylvania's property taxes are not that high on average compared to tax rates in other states, they are high in some communities. In lower-income and declining communities which are losing jobs, population, and more affluent individuals, a declining tax base tends to go along with increases in rates on those businesses and individuals left behind. This problem has been exacerbated by the heavy reliance on local funding for schools. This pattern of high property taxes in struggling cities, older suburbs, and some rural areas will be documented in a forthcoming Pennsylvania Economy League study. These communities have relatively high millage rates which strain the ability of the residents to pay. Property taxes can also become burdensome for long-time residents in places where property values are escalating rapidly (e.g., due to gentrification) and/or where assessments are updated to accurately reflect past increases in value.

The General Assembly has enacted a variety of measures over the past four years to stem the growth in local property taxes. In 2004, the state passed gaming legislation, creating four race track based and five freestanding slot machine parlors. These are expected to generate about $1 billion in income for the state to pay for tax rebates that will be distributed to individuals through a school-district based formula. In 2006, the legislature once again grappled with the issue, allocating funds to increase the state's income-based property tax and rental rebate program for eligible low-income seniors and disabled property owners and renters. Act 1 of 2006 also authorized school districts to raise local income taxes by up to 1% and use those funds to replace, dollar for dollar, local property tax revenue.

In 2007, Governor Rendell proposed increasing the state's sales tax from 6% to 7% and using part of the additional proceeds, about 1/3 in 2007 and ½ in subsequent years, to fund additional property tax reduction.

The principle problem in Pennsylvania is not a property tax problem, but a school funding problem. The Commonwealth has not raised sufficient funds to allow for an adequate level of funding for each school district, and the costs have shifted to local taxpayers. A school funding system should be established that provide an adequate level of funding to allow districts to meet achievement standards, and new dollars should be distributed to school districts that are unable to raise them locally. The costing out study recently approved by the Pennsylvania Department of Education will for the first time assess the cost of meeting standards and establish the system wide funding need. A funding system could then be developed that raised the necessary fund from sources that are more sensitive to taxpayer's ability to pay. This is a more comprehensive and ultimately better and more long-term solution to the problem.

If additional property tax relief is on the table, then a new distribution system should be established. In order to distribute limited funds to those most in need, and allow for more significant reductions, the Commonwealth should move away from a policy of across-the-board tax relief and enact instead the type of income-based program in use in many other states, the so-called circuit breaker. In this program, lower- and sometimes middle-income taxpayers are eligible for rebates when their property taxes exceed a fixed percentage of their income (property tax exceeding this percentage "trips" the circuit and the rebate flows to the taxpayer).

Regional Tax-base Sharing

Another way to reduce property taxes in some low-income school districts and also to ensure more adequate school funding would be to collect revenues for schools, or services more generally, at the regional level rather than the municipal and school district level.

Under one version of regional tax-base sharing, municipalities within each county or metropolitan area would be required to contribute part of the growth in their commercial and industrial property tax bases to a regional pool distributed in ways that alleviate intra-regional disparities. Municipalities with rapid commercial or industrial growth would, therefore, contribute some of the fruits of that growth to their slower growing or declining neighbors. The latter, typically urban centers or older suburbs, would gain extra revenues that they could use to improve services, cut taxes, or both. By improving services and/or cutting taxes in urban and older suburban areas, regional tax base sharing could help stem the vicious circle of decline that depopulates older communities.

Consolidating contiguous school districts that are above and below state income and property wealth averages could also reduce the tax burden in lower-income areas and ensure more adequate funding of their schools.