PA Should Raise Needed Revenues in Fair Ways:

Short- and Long-term Approaches to Fixing Pennsylvania's Unfair Tax System

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Executive Summary

This briefing paper analyzes several options for raising revenue for the Pennsylvania state budget which would fall much less on middle- and low-income families than the existing Pennsylvania state and local tax system.

We first analyze the income tax increase (from 3.07% to 3.4%) and expansion of income tax forgiveness and sales tax base broadening proposed by Governor Wolf in his 2016-17 budget. This reveals that the governor's revenue increases would be substantially less regressive than the current Pennsylvania state and local tax system.

Our second set of analyses compare the governor's 2016-17 income tax proposal with two other ways of modifying the state's single flat income tax that would raise the same amount of revenue. Both of these options would fall even less on middle and low-income taxpayers than the governor's proposal and one of them – elimination of taxes on the first $30,000 of income – would reduce the average taxes paid by the bottom 80% of taxpayers by nearly $500 per taxpayer.

Based on this analysis, PBPC recommends that lawmakers use a two-step process to achieve fairer taxation and raise the revenue Pennsylvania needs.

The first step, which could be taken without a change to the constitution, would include a smaller increase in the tax rate on middle-class income than proposed by Governor Wolf, but a larger increase in the tax rate on income from wealth. The second step would begin this legislative session the process of eliminating the constitutional uniformity clause, which removes any uncertainty regarding the constitutionality of an exemption on the first part of income from state income taxes.

The analysis in this paper underscores that Pennsylvania can raise the critical revenues needed to address the state's structural deficit and invest in education and vital services without raising taxes substantially on the middle class – and could, in fact, raise more revenue while cutting middle-class taxes.

NOTE: For reasons of simplicity, and to focus on taxes paid directly by individuals, this brief does not address the issue of the severance tax. Any comprehensive approach to raising revenue in a fair way, however, should include a severance tax so that Pennsylvania does not remain the only state with significant natural gas extraction that does not have such a tax.

Introduction

While the 2015-16 state budget has finally been completed, legislators remain unwilling to raise needed revenues going forward. As a result, Pennsylvania continues to face a nearly $2 billion structural deficit by the end of fiscal year 2016-17, which could lead to a further downgrade of state debt by rating agencies.

Part of lawmakers' resistance to raising taxes stems from the fact that Pennsylvania's existing state and local tax system falls more heavily on middle- and low-income households than it does in most states. Middle- and low-income Pennsylvania taxpayers pay two-and-a-half to three times as big a share of their income in taxes, on average, as the top 1%. The main reasons: sales and property taxes fall more heavily on lower-income groups, and the state's flat income tax falls nearly equally on all income groups (unlike "graduated" income taxes, which impose higher tax rates as income increases).

While the existing tax system does fall heavily on the broad middle class, lawmakers have options for raising additional revenue which would fall less on middle- and low-income families. This briefing paper analyzes the change in taxes for different income groups under several such revenue-raising options.

We first analyze Governor Wolf's proposal revenue increases in his 2016-17 budget (leaving out changes in corporation taxes and tobacco taxes). This consisted of an income tax increase (from 3.07% to 3.4%), an expansion of income tax forgiveness, and a modest sales tax base broadening. This reveals that the Governor's revenue increases would be substantially less regressive than the current Pennsylvania state and local tax system:

- The increase in taxes for a typical, non-smoking middle-income taxpayer would be $3 per week; for the lowest-income 40% of taxpayers as a group, it would be less than $1 per week.
- The increase in taxes would be a small share of income for every group, on average – a third of one percent of income or less for most groups and close to zero for the bottom fifth due to the expansion of income tax forgiveness.

Our second set of analyses compares with the governor's proposed income tax changes two other ways of raising the same amount of revenue (roughly $1.08 billion) through modifications to the state's single flat income tax, currently imposed (at the 3.07% rate) on all sources – or "classes" – of income.

- One of these alternative options would be a smaller increase (to 3.25%) than the governor proposed in the tax rate on "middle-class income" (i.e., income from compensation and interest), plus the same expansion of income tax forgiveness as Governor Wolf proposed, and a higher increase (to 4%) in the tax rate on six other kinds of income that go most to the wealthy ("income from wealth"). (See Box 1.)

- The second alternative option examines a variant of a 2014 campaign proposal of Governor Wolf's – eliminating taxes on the first $30,000 dollars of income for each taxpayer (so $60,000 for married people filing jointly) and then raising the personal income tax (PIT) rate on income above this level (to 6.62%) to make up the lost revenue.

Box 1. Pennsylvania's Eight Classes of Income and the Definition of "Income from Wealth"

Eight classes of income are subject to the current Pennsylvania personal income tax: gross compensation (mostly wages, salaries, and tips); interest; dividends; net income (from a business, profession, or farm); capital gains; net income from rents, royalties, patents, and copyrights; gambling and lottery winnings; and income from estates or trusts.[1]

The Pennsylvania constitution requires uniformity of tax rates within each class of income[2] but is generally understood to permit different rates on different classes. Thus one of the policy options considered in the text would tax two classes of income relied on by the middle class at 3.25% – compensation (79% of all state income subject to the PIT in 2013) and interest (4% of all PIT-taxable income in 2013).[3] This option would tax the other six classes of income (including dividends, capital gains, net profits, and net income from rents, etc., and income from estates and trusts) – what we call "income from wealth" – at the higher rate of 4 %.

Under current Pennsylvania law and regulations, if owners of small businesses classified as "S" corporations are employees of the corporations they can receive "compensation" income that would be taxed at the lower rate of 3.25% in the example above. "Sole proprietors," and owners of LLCs (limited liability corporations) and partnerships are not employees and their income would ordinarily be taxed at the higher rate. It may be possible to accompany the establishment of separate taxes on income from wealth and middle-class income (from compensation and interest) with a regulatory change that allows sole proprietors to report a reasonable portion of their income as compensation, with "reasonable" defined by reference to average salaries of a comparable managerial occupation.

The two alternative options would both raise total taxes on all the income of middle- and low-income families substantially less than would an increase in the PIT rate to 3.4%.

- With a tax on middle-class income of 3.25%, but a higher 4% tax on income from wealth, the annual increase in taxes for the bottom three fifths of taxpayers would be $60 or less on average and only about $21 per taxpayer across the three groups as a whole – about 40 cents per week.
- With a uniform exemption of $30,000 for each taxpayer:

[1] Pennsylvania Department of Revenue, *Pennsylvania Personal Income Tax Guide*, revised March 7, 2014, p. 9 of 53; online at http://www.revenue.pa.gov/FormsandPublications/PAPersonalIncomeTaxGuide/Pages/default.aspx

[2] "All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws." Pa. Const., Art. VIII, sec. 1.

[2] The constitution allows the legislature to depart from uniformity in the cases of age, disability, infirmity, and poverty. Pa. Const., Art. VIII, sec. 2(b)(ii).

[3] Pennsylvania Budget and Policy Center (PBPC) estimate based on 2013 data online at http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/Pages/Reports%20and%20Statistics/PIT%20Stats.aspx#.Vv1qGHqAsms

- On average, each of the bottom four fifths of taxpayers would pay less in taxes, $552 to $687 less annually for the middle 60 percent of taxpayers.
- Even those in the 80th to 95th income percentile, with incomes from $101,000 to $201,000, would see an annual tax increase of only $465 on average, about $9 per week.

Most legal experts on the Pennsylvania tax system agree that the second option above, which imposes a tax on income from wealth that has a higher rate than the tax on middle-class income, is constitutional. Legal observers are less sure that a uniform exemption of the first part of income from taxes would be ruled constitutional – this precise concept has not been considered in any prior legal case.

Based on this analysis, PBPC recommends that lawmakers use a two-step process to achieve fairer taxation and raise the revenue Pennsylvania needs.

The first step would include a smaller increase in the tax rate on middle-class income than proposed by Governor Wolf, but a larger increase in the tax rate on income from wealth.

The second step would begin this legislative session the process of eliminating the constitutional uniformity clause, which removes any uncertainty regarding the constitutionality of a uniform exemption on the first part of income. Enacting a constitutional change requires passing legislation in two consecutive legislative sessions, and then having a voter referendum to approve the change. If legislation eliminating the uniformity clause passed this year and early next year, voters could potentially approve it in time for a substantial middle-class tax cut to be part of the 2017-18 budget. It is worth underscoring that changing the constitution to make explicit that exemptions are permitted is hardly a radical idea. The 21st Century Tax Policy Project ("PA 21") in which the Business Roundtable and Allegheny Conference partnered made this proposal in a 2003 report as part of a package that also included a variety of corporate tax reductions.[4] By now, most of the corporate tax reductions recommended by PA21 have already been implemented, which, by themselves, have made the Pennsylvania tax system *less equitable* than it was in 2003. It's time to make exemptions permissible.

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[4] On p. 7, the business-labor tax report said "To make Pennsylvania taxes on families and individuals more equitable, the PA21 tax reform package…recommends a change to the Pennsylvania constitution allowing the General Assembly to enact an across-the-board exemption on the first part of income under Pennsylvania's constitutionally mandated flat personal income and wage taxes." See Pennsylvania 21st Century Tax Policy Project, *Moving Pennsylvania's Tax System Into the 21st Century*, December 2003, p. 7.

Pennsylvania's Existing Regressive Tax System

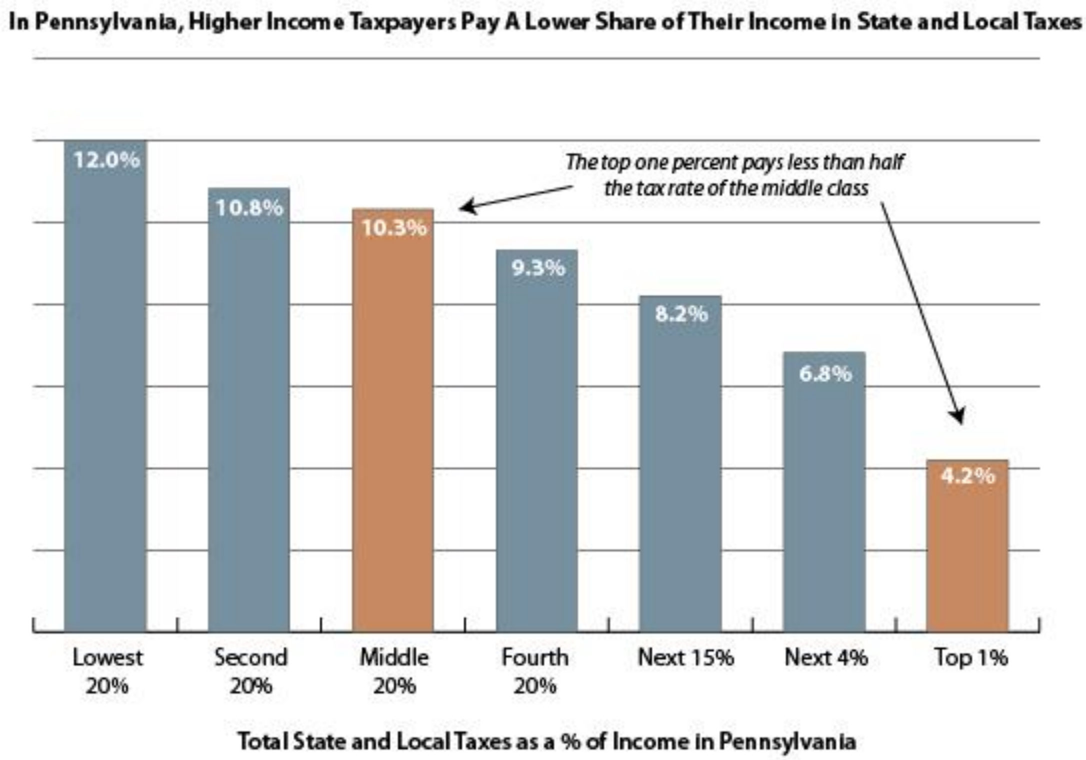
U.S. states rely on three primary taxes paid by individuals to raise needed revenues: the sales tax, the property tax and the income tax. As shown in tax models for each state built by the Institute on Taxation and Economic Policy (ITEP), sales and property taxes are both regressive: this means that each of these taxes garners a larger share of the income of middle- and low-income taxpayers than it does of the income of high-income taxpayers. In states with a progressive income tax – through a combination of graduated rates (tax rates that rise as income increases) and exempting the first part of income from the state income tax – the fairness of the progressive income tax offsets the unfairness of the sales and property taxes. As a result, in the few states that rely heavily on a highly-progressive state income tax, the top fifth and top 1% pay nearly as big a share of their income in state and local taxes as do the middle and bottom fifth.

In Pennsylvania, however, a constitutional requirement that every tax be uniform on the same class of subjects (see footnote 2 above) presents an obstacle to graduated income tax rates and may present an obstacle to exempting the first part of income from taxes. Partly as a result, Pennsylvania currently has a flat income tax, which takes exactly the same percentage of income from middle- and low-income families as from millionaires and billionaires – currently 3.07%. In addition, Pennsylvania taxes every single dollar of income earned, so a family with an income of $50,000 pays 3.07% on every penny, for a total state income tax of $1,535. Using constitutional departures from uniformity permitted for poverty and for seniors,[5] Pennsylvania does not tax retirement income or and does not tax other income below a specified ("income tax forgiveness") threshold (a family of four with two adult pays no income tax up to an income of $32,000).

Since, for most taxpayers, the income tax rate is uniform and falls on every dollar of income, the Pennsylvania income tax does not offset the regressivity of the state's sales and property taxes, and the Pennsylvania state and local tax system as a whole imposes an overall tax rate as a share of income that is two-and-a-half times higher for the middle fifth than the top 1% and nearly three times higher for the bottom fifth (Figure 1).

[5] The constitution allows departure from uniformity in the cases of age, disability, infirmity, and poverty. Pa. Const., Art. VIII, sec. 2(b)(ii).

Figure 1.



Source. Institute on Taxation and Economic Policy, Who Pays? http://www.itep.org/whopays/

Pennsylvania's unfair state and local tax system also has a geographic dimension. It means that lower-income parts of the state, primarily rural areas, poor city neighborhoods, and some inner suburbs, pay more of their income in taxes, while affluent suburban areas pay less. As a result of this geographic dimension, elected officials from low-income rural and urban areas who want to represent the economic self-interest of their constituents should be leading advocates for tax fairness.

Estimating the Tax Incidence of Alternative Revenue Proposals

The unfair existing Pennsylvania state and local tax system tends to reinforce anti-tax sentiment and make lawmakers less willing to raise revenues. This tendency makes it important to find revenue-raising options that are less regressive than the current tax system.

In the rest of this brief, we examine a range of different tax options.

We first analyze the income tax increase (from 3.07% to 3.4%), expansion of income-tax forgiveness, and sales tax base broadening proposed by Governor Wolf in his 2016-17 budget address and compare its impact on different income groups with the status quo Pennsylvania state and local tax system.

Our second set of analyses hone in on three different ways of raising the same amount of revenue through changes to the state income tax.

- The first income tax option is Governor Wolf's proposed increase in the income tax from 3.07% to 3.4% combined with expanding income tax forgiveness by increasing the income per taxpayer that qualifies for such forgiveness from $6,500 to $8,700 (increasing the income tax threshold for a family of four by $4,400, to $38,650.)
- The second income tax option would increase the income tax rate on wage (and interest) income to 3.25% instead of 3.4%, but then increases the tax rate on non-wage (and non-interest) income sufficiently (to 4%) to make up the lost income. (Under the uniformity clause, as noted, most tax experts believe tax rates may be different on different kinds – or "classes" – of income.)
- The third option examines a variant of a 2014 campaign proposal of Governor Wolf's – to eliminate taxes on the first $30,000 dollars of income for each taxpayer and then raise the overall tax rate to 6.62% — enough to compensate for the lost revenue.

In what follows, we present estimates from the Institute on Taxation and Economic Policy (ITEP) on the increased taxes paid under these options.

The Governor's Revenue Proposal

Table 1 presents ITEP's findings on the incidence of the Governor's proposed income tax increase to 3.4%, expansion of income tax forgiveness, and broadening of the sales tax to basic cable, movie tickets and digital downloads. (Table 1 does not include the broadening of the tobacco tax or the increase in the cigarette tax – this analysis thus applies to taxpayers that do not consume tobacco products). These changes would raise, ITEP estimates, $1.46 billion.

Table 1 shows that:

- For most people, the annual increase in taxes will be modest: an average of $5 for the bottom fifth, $82 for the next fifth, $156 for the middle fifth, and $255 for the fourth fifth. Even the largest of these annual amounts is only about $5 per week.
- Second, the increase in taxes is a small share of income for every group on average – a third of one percent of income or less for most groups and close to zero for the bottom fifth because the expansion of income tax forgiveness offsets the increase in the income tax and broadening of the sales tax.
- Third, the increase in taxes as a share of income is almost as high for upper-income groups as for middle-income groups, making the collection of the additional revenue much more equitable than the status quo Pennsylvania state and local tax system.
- Fourth, because the effective increase in tax rates is almost as high for top-income groups, these groups account for most of the total tax increase: the top 1% pay 15% of the total increase in taxes, and the top fifth pay nearly 60% of the total increase.

In sum, because the Governor's proposal relies mostly on the state income tax, and also includes an expansion in income tax forgiveness, it falls less heavily on middle- and low-income groups relative to upper-income groups than the existing state and local tax systems.

Table 1. Increase in Taxes by Income of Governor Wolf's Proposed 3.4% PIT Increase, Expansion of Income Tax Forgiveness, and Broadening of Sales Tax to Basic Cable, Movie Tickets and Digital Downloads				
Income Fifth	*Income Range*	*Average Tax Increase*	*% of Total Tax Change*	*Increase in Taxes as % of Income*
Lowest 20%	Less than $22,000	$5	0.5%	0.04%
Second 20%	$22,000 - $41,000	$82	6.9%	0.26%
Middle 20%	$41,000 - $65,000	$156	13.3%	0.29%
Fourth 20%	$65,000 - $101,000	$255	21.6%	0.31%
Next 15%	$101,000 - $201,000	$443	28.2%	0.33%
Next 4%	$201,000 - $463,000	$831	14.1%	0.29%
Top 1%	$463,000 or More	$3,639	15.4%	0.27%
Source. Institute on Taxation and Economic Policy (ITEP)				

Comparing Alternative Ways of Raising Revenue from Taxes on Income

The rest of this report focuses exclusively on changes to the state's income tax, honing in on that tax alone so that the impact of alternative approaches to changing it can be compared cleanly, without simultaneously changing the state's sales tax. Specifically, Tables 2 and 3 compare Governor Wolf's proposed income tax increase from 3.07% to 3.4% and expansion of income tax forgiveness (so, unlike above, we now do NOT include the governor's proposed sales tax broadening) with two other ways of changing the state's income tax. All three approaches to changing the state's income tax raise roughly $1.08 billion in additional state revenue.

- The first alternative to the governor's income tax proposal would increase the income tax rate on wage (and interest) income to 3.25% instead of 3.4%, expand income tax forgiveness as proposed by the governor, and also raise the tax rate on non-wage (and non-interest) income to 4%.
- The second alternative is a variant of Governor Wolf's 2014 campaign proposal – it would eliminate taxes on the first $30,000 dollars of income for each taxpayer and then raise the overall tax rate to 6.62%. (This option doesn't explicitly include income tax forgiveness because the overwhelming majority of families currently eligible for income tax forgiveness would already pay no taxes because of the $30,000 exemptions – thus, income tax forgiveness would be largely superfluous or redundant.)

Table 2 shows that the second and third option shift the increase in taxes more towards upper-income taxpayers with the greatest ability to pay. The $30,000 exemption would have the most powerful and profound impact on the Pennsylvania tax system.

- With a lower increase in the PIT rate on wage (and interest) income, the annual increase in taxes for the bottom 60 percent of taxpayers would be $21 on average across the three groups as a whole, about 40 cents per taxpayer per week.
- With the uniform $30,000 exemption, the average taxpayer in the three middle fifths receives an annual $552 to $687 **tax cut**. Those in the 80th to 95th income percentile, with incomes from $101,000 to $201,000, would see a tax increase of $465 on average.

Table 2. Change in Taxes by Income Group Under Three Income Tax Proposals That Each Raise $1.28 Billion

		Increase in Personal Income Tax (PIT) Rate to 3.4% and Expand Income Tax Forgiveness	*Tax Wage and Interest Income at 3.25%, Expand Tax Forgiveness, and Tax Income from Wealth at 4%*	*Uniform Exemption of $30,000 for Each Taxpayer and Increase Tax Rate on All Income Greater than Exemption to 6.62%*
Income Group	*Income Range*	*Average Tax Change*		
Lowest 20%	Less than $22,000	-$13	-$17	-$150
Second 20%	$22,000 - $41,000	$39	$19	-$552
Middle 20%	$41,000 - $65,000	$91	$60	-$582
Fourth 20%	$65,000 - $101,000	$184	$139	-$687
Next 15%	$101,000 - $201,000	$359	$289	$465
Next 4%	$201,000 - $463,000	$738	$900	$4,368
Top 1%	$463,000 or More	$3,415	$6,141	$33,087

Source. Institute on Taxation and Economic Policy (ITEP)

Table 3 and Figures 2 and 3 evaluate the impact of these three income tax proposals based on the change in taxes as a percent of income. In Figure 2, the blue bars show the flat nature of a straight PIT increase to 3.4% plus expanded income tax forgiveness, with taxes going up less (as a share of income) for the bottom two fifths because more taxpayers in these groups qualify for income tax forgiveness. The orange bars in Figure 2 show that combining a lower increase in the tax rate on middle-class (compensation and interest) income with a higher increase in the tax rate on income from wealth reduces taxes paid as a percent of income for 19 out of 20 taxpayers (i.e., for the bottom 95% of taxpayers). Only the highest-income 5% of taxpayers – the two orange bars to on the right in Figure 2 – pay more in taxes with a higher tax rate on non-wage income. Moreover, keep in mind that the 4% tax rate on income from wealth is substantially *lower* than the top income tax rate in surrounding states, which ranges from 5.33% in Ohio to 8.97% in New York State.[6]

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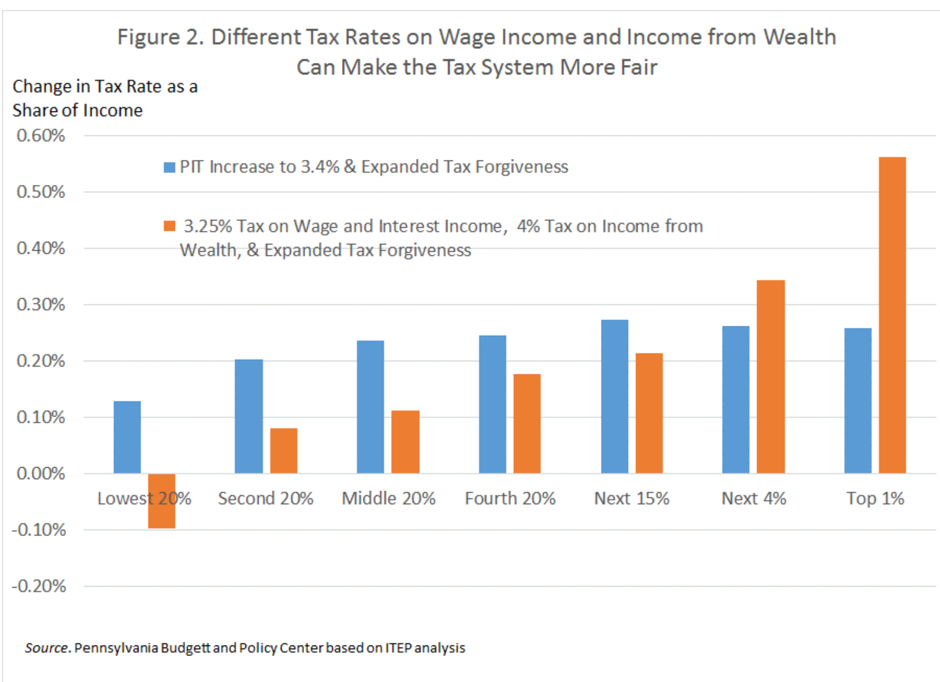
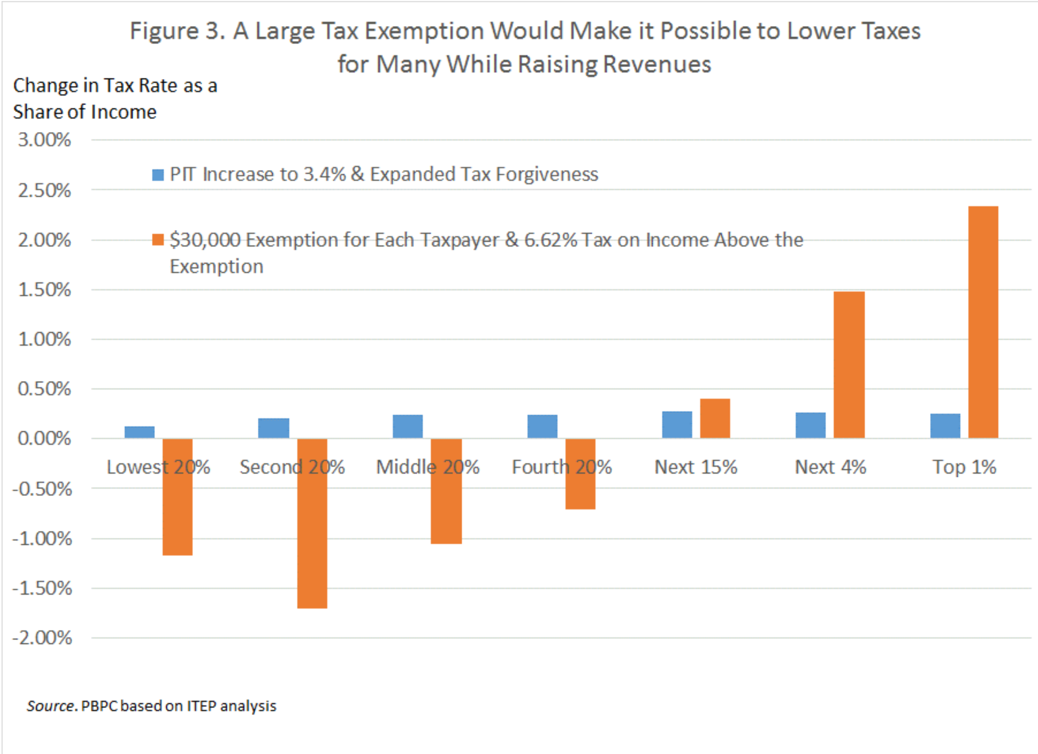
[6] According to the Tax Foundation (http://taxfoundation.org/article/state-individual-income-tax-rates-and-brackets-2015), the top income tax rate in neighboring states is NJ 8.97%; NY 8.82%; DE 6.6%; WV 6.5%; MD 5.75%; OH: 5.33%.

In Figure 3, the blue bars again show the flat nature of a straight PIT increase to 3.4% combined with expanded income tax forgiveness. The orange bars in Figure 3 show the impact that exempting the first part of income from any income tax has on taxes as a share of income. The figure shows the four left-most orange bars going DOWN (representing a tax reduction). By contrast the right-most two orange bars go up. A large personal exemption alone cannot eliminate the unfairness of the Pennsylvania tax system – the overall state and local tax system would still be regressive. The top 1%, however, would now pay two-thirds the share of income paid by the middle fifth and more than half the share of income paid by the bottom fifth.

Table 3. Change in Taxes by Income Group Under Three Income Tax Proposals That Each Raise $1.28 Billion				
		Increase in Personal Income Tax (PIT) Rate to 3.4% and Expand Income Tax Forgiveness	*Tax Wage and Interest Income at 3.25%, Expand Tax Forgiveness, and Tax Income from Wealth at 4%*	*Uniform Exemption of $30,000 for Each Taxpayer and Increase Tax Rate on All Income Greater than Exemption to 6.62%*
Income Group	*Income Range*	*Change in Taxes as a % of Income*		
Lowest 20%	Less than $22,000	-0.10%	-0.13%	-1.14%
Second 20%	$22,000 - $41,000	0.12%	0.06%	-1.77%
Middle 20%	$41,000 - $65,000	0.17%	0.11%	-1.11%
Fourth 20%	$65,000 - $101,000	0.23%	0.17%	-0.84%
Next 15%	$101,000 - $201,000	0.27%	0.21%	0.34%
Next 4%	$201,000 - $463,000	0.26%	0.32%	1.54%
Top 1%	$463,000 or More	0.26%	0.46%	2.48%
Source. Institute on Taxation and Economic Policy (ITEP)				





Conclusion

The analysis in this paper underscores that Pennsylvania can raise the critical revenues needed to address the state's structural deficit and invest in education and vital services without raising taxes substantially on the middle class – and could, in fact, raise more revenue while actually cutting middle-class taxes.

Gov. Wolf's 2016-17 budget proposal represents a good starting point for those who want to limit tax hikes on middle and low-income taxpayers because it relies on the personal income tax for most of the additional revenue raised, and it also expands income tax forgiveness.

For those who want to go beyond what Gov. Wolf proposed in efforts to limit the increase in taxes on middle- and low-income families, this brief provides good news: doing so is possible even without a change to the state constitution. Capitalizing on the fact that tax rates need only be uniform on each type (or "class") of income, the state can raise the tax rate less on wage income and more on income from wealth held mostly by the richest Pennsylvanians. Although it is not addressed in this brief, the state could also raise revenues from groups other than Pennsylvania's middle class through a severance tax on natural gas.

To fundamentally and permanently relieve the tension between raising adequate revenues to meet state needs and the tax rate on the middle class, Pennsylvania would be best served by eliminating its anachronistic uniformity clause. Doing that would make clear that Gov. Wolf's campaign proposal to establish a uniform exemption in Pennsylvania's income tax is constitutional. This simple proposal, even with retention of a single tax rate on all income above the exemption (i.e., without progressive tax rates that increase with income) would make it possible to raise over a billion dollars more from taxes on income while lowering taxes on average for the bottom four fifths of the Pennsylvania income distribution.

For those lawmakers who articulate their positions in terms of what best serves the hard-working middle class, the way forward is clear. Pennsylvania should meet its revenue needs this year in part by raising the tax rate more on income from wealth than wage income. Pennsylvania should also begin the constitutional process of eliminating the uniformity clause to make it entirely possible to *lower* taxes on the broad middle class while solving the state's structural deficit and investing more adequately and equitably in education, other public goods, and essential services.