



Who Pays For An Increase in the Sales Tax: Analysis of the Tax Incidence of an Increase in the Sales Tax from 6% to 7.25%

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Summary

Gov. Wolf and legislative leaders are currently negotiating over the terms of a plan to cut property taxes which would be financed by an increase in the state sales tax rate from 6% to 7.25%. This brief analyzes the size of the sales tax rate increase by income. It also compares that impact to how much different income groups would pay with an increase in the state personal income tax rate from 3.07% to 3.57%, as proposed by Gov. Wolf in October and rejected by the Republican legislative majority and nine Western Pennsylvania Democrats. We find:

- The bottom 60% of families, those earning less than \$65,000 per year, would pay 39% of the increase in the sales tax. In contrast, these families would pay just 19% of Gov. Wolf's proposed increase in the personal income tax via a rate hike to 3.57%.
- The top 20% of families, or those earning \$102,000 or more per year, would pay 37% of the sales tax increase. In contrast, families with annual incomes over \$102,000 would pay 61% of the tax increase resulting from a higher personal income tax rate.
- The average taxpayer in the bottom 80% of taxpayers would pay higher taxes under the proposed sales tax rate increase than under an increase in the personal income tax rate to 3.57%.
- The average taxpayer in the top 20% of taxpayers, on the other hand, would pay substantially less in new taxes with a higher sales tax rate than a higher personal income tax rate.
- By far, the biggest beneficiaries of relying on the sales tax to fund cuts in property taxes are the top 1% of taxpayers, who would see an average tax increase of \$1,200 under the sales tax plan, less than a quarter of the average increase of \$5,300 under the governor's proposed higher income tax rate.

From a tax fairness perspective, these findings show, even an increase in the state's flat personal income tax is far superior to a sales tax rate increase. If the General Assembly and Gov. Wolf must finance property tax cuts we urge them to do it with a higher personal income tax rate rather than with a higher sales tax rate. (They could also finance property tax cuts with a severance tax which, according to the conservative Tax Foundation, would be paid mostly by people from out of state.)

If a sales tax rate increase remains the vehicle for reducing property taxes, it is imperative that the property tax cut in the final budget not further amplify the regressive nature of the tax increase by distributing a high share of property tax cuts to affluent property taxpayers. To this end, the final plan to cut property taxes should:

- include a rebate for renters;
- target property tax cuts to low- and middle-income homesteads; and

- increase the minimum wage to \$10.10 per hour to boost the wages of low-income taxpayers who already bear the greatest relative burden of sales taxes.

In addition, lawmakers should take up Gov. Wolf's proposal (made first in March and again in October) to expand personal income tax forgiveness to more low-income households.

Higher Taxes in the Budget Framework

The governor and legislative leaders are currently negotiating the terms of a plan to cut property taxes that would be financed by an increase in the sales tax rate from 6% to 7.25%. This would raise about \$2 billion per year to replace existing funds dedicated to reducing property taxes derived from gaming monies (which is distributed in a fair way) and to provide \$1.4 billion in additional property tax cuts. As we pointed out in January of this year (<http://goo.gl/a0Eri9>), sales taxes impose a greater tax burden on low- and middle-income families than they do on affluent families and are a key contributor to Pennsylvania having one of the 10 most regressive tax systems in the country (<http://goo.gl/FrkpP5>).

In this briefing paper we analyze the distribution of the tax burden from the proposed sales tax rate increase and compare that burden to Gov. Wolf's proposal in October to raise the personal income tax rate from 3.07% to 3.57%, which would have generated \$1.8 billion in revenue while also expanding tax forgiveness for low-income families.

Estimating Tax Incidence

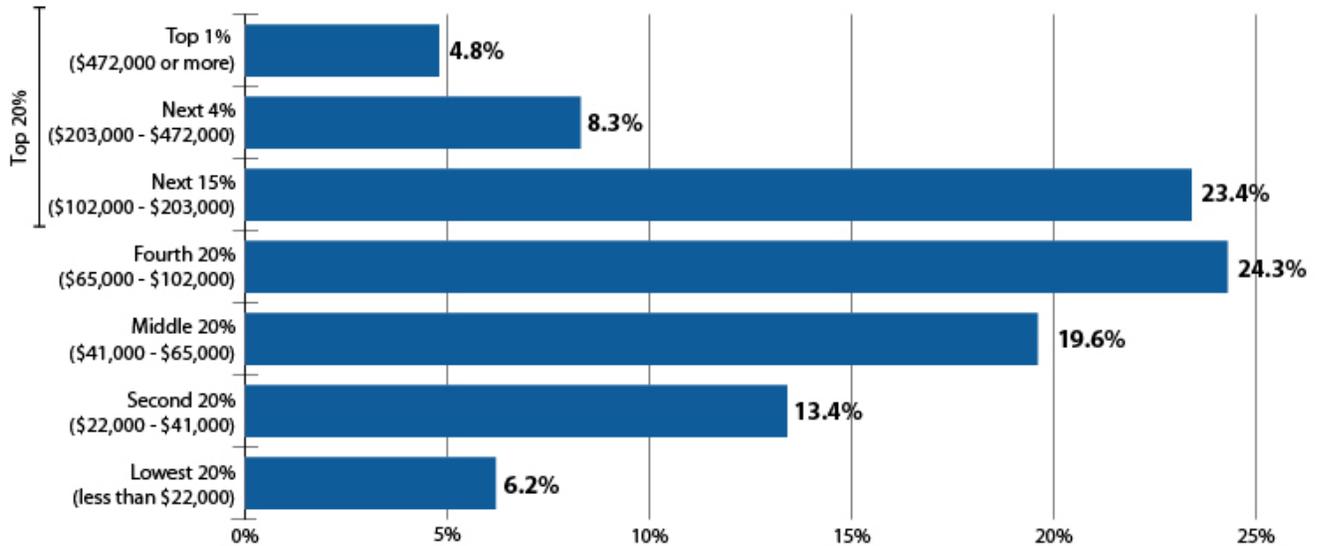
In what follows, we present estimates from the Institute on Taxation and Economic Policy (ITEP) on the increased taxes paid when raising the sales tax rate from 6% to 7.25% and, by way of comparison, when raising the personal income tax rate from 3.07% to 3.57%.¹ The average increase in taxes for all taxpayers between a sales and income tax rate increase is comparable, with families paying, on average, an additional \$250 in sales taxes compared to an average increase in income taxes of \$282.² However, these averages obscure a starkly different distribution of the tax increases on low-, middle- and high-income families under these two approaches.³

In order to illustrate the impact of these alternative tax increases by income level, we report the average increase in taxes by income quintile (five equal groups) with the top quintile, or top 20% of families, divided further into three smaller groups.⁴ Specifically:

- The bottom 60% of families, those earning less than \$65,000 per year, would pay 39% of the increase in sales taxes paid by all Pennsylvania taxpayers. In contrast, the bottom 60% of families would pay just 19% of the higher taxes under Gov. Wolf's proposal to increase the personal income tax.
- Families making between \$65,000 and \$102,000 per year would account for 24% of the increased sales tax revenue from Pennsylvania taxpayers. Under an income tax rate increase to 3.57%, families in this income range would pay 20% of the increase in taxes.
- The top 20% of families, or those earning \$102,000 or more per year, would account for just 37% of the increased sales tax revenue from Pennsylvania taxpayers. In contrast, affluent families making more than \$102,000 per year would account for 61% of the revenue raised from an increase in the PIT.

The Top 20% of Families or Those Earning \$102,000 or More Account for Just 37% of the Revenue Raised from a Sales Tax Increase

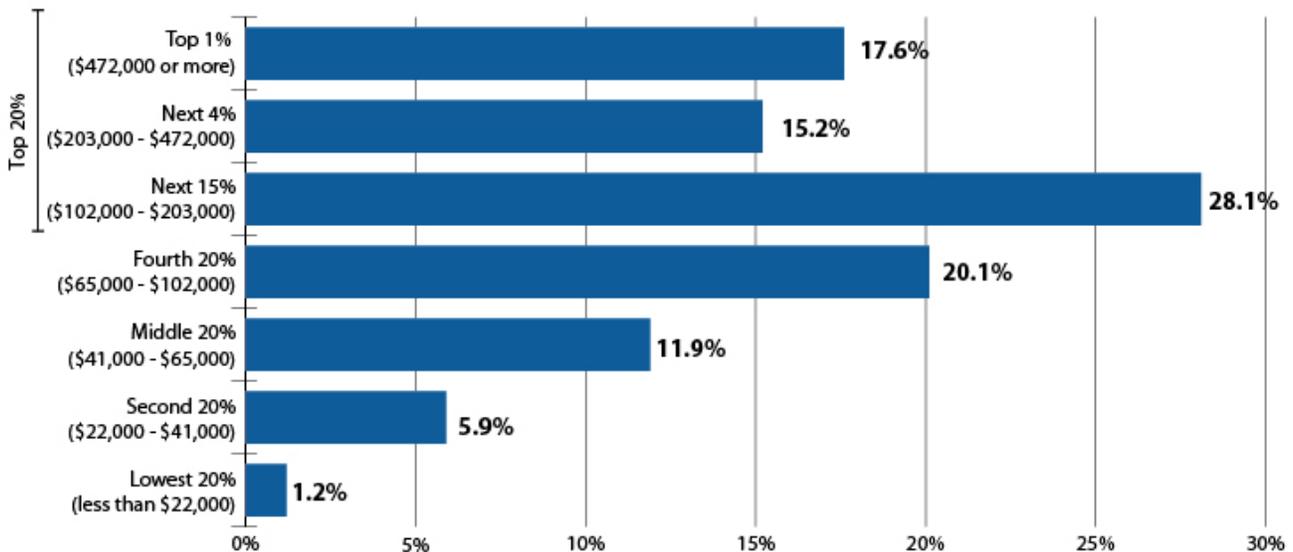
Share of tax increase by income group from a Personal Income Tax increase from 3.07% to 3.57%



Source: Institute on Taxation and Economic Policy, October 2015

The Top 20% of Families or Those Earning \$102,000 or More Account for 61% of the Revenue Raised from a PIT increase to 3.57%

Share of tax increase by income group from a Personal Income Tax increase from 3.07% to 3.57%



Source: Institute on Taxation and Economic Policy, October 2015

Table 1.

Increase in average taxes by income fifth for Pennsylvania taxpayers						
Income Fifth	Income Range	Sales tax rate increase from 6 to 7.25%		Personal income tax rate increase from 3.07 to 3.57%		
		Average tax increase	% of Total Tax Change	Average tax increase	% of Total Tax Change	
Lowest 20%	Less than \$22,000	\$78	6.2%	-\$4	1.2%	
Second 20%	\$22,000 - \$41,000	\$170	13.4%	\$70	5.9%	
Middle 20%	\$41,000 - \$65,000	\$248	19.6%	\$151	11.9%	
Fourth 20%	\$65,000-\$102,000	\$308	24.3%	\$297	20.1%	
	Next 15%	\$102,000 - \$203,000	\$395	23.4%	\$561	28.1%
Top 20%	Next 4%	\$203,000 - \$472,000	\$527	8.3%	\$1,147	15.2%
	Top 1%	\$472,000 - Or More	\$1,205	4.8%	\$5,306	17.6%

Note. Sales tax estimates are for Pennsylvania residents. Personal income tax increase assumes expanded eligibility for personal income tax forgiveness as proposed by Gov. Wolf in October of this year.

Source. Institute on Taxation on Economic Policy

Table 1 above details the average increase in taxes by income fifth under the proposed sales tax rate increase and under Gov. Wolf's October proposal to increase the personal income tax rate to 3.57%.

- The average tax bill for the bottom 20% of families, with annual incomes below \$22,000, would rise by \$78 per year from a sales tax rate increase. Under Gov. Wolf's October proposal, which included expanded income tax forgiveness, these low-income families would see their average income tax payment fall by \$4.
- Under a sales tax rate increase the next 20% of families, those earning between \$22,000 and \$41,000 annually, would, on average, see their tax bill rise \$170 per year. Under an increase in the personal income tax rate, these families would see their average tax bill climb by just \$70 per year.
- Families in the middle fifth, those earning between \$41,000 and \$65,000 per year, would see their average annual income tax bill rise by \$248 as a result of a sales tax rate increase, compared to an average annual increase of \$151 under a personal income tax rate increase.
- Families earning between \$65,000 and \$102,000 per year, the fourth 20%, would see their average tax bill rise by \$308 per year under a higher sales tax rate and by \$297 per year under a higher personal income tax rate.
- The bottom 80% of families, on average, would pay higher taxes under a sales tax rate increase than under a personal income tax rate increase. The primary beneficiaries of a switch to a sales tax rate increase are the highest-income 20% of taxpayers. Breaking up the top 20% of families into three groups, we find that:
 - The first 15% of this group – those earning between \$102,000 and \$208,000 annually -- would see their tax bill rise, on average, by \$395 per year under a higher sales tax rate, and, on average, by \$561 per year under a higher income tax rate.

- The next 4% of this group – those earning between \$208,000 and \$472,000 per year – would see their tax bill rise annually by an average \$527 under a higher sales tax rate, a figure which is less than half the average additional amount this group would pay under a higher personal income tax rate (\$1,147).
- Far and away, the biggest beneficiaries of the switch to a higher sales tax rather than a higher personal income tax would be the top 1% of taxpayers. An increase in the sales tax rate to 7.25% would raise taxes for the top 1% by an average of \$1,205 per year, less than a quarter the average additional amount this group would pay (\$5,306) under an increase in the personal income tax rate to 3.57%.

Conclusion

In the past two legislative sessions, Republican lawmakers and, in this session, Gov. Wolf have advanced ambitious proposals to cut property taxes using a combination of income and sales tax increases.⁵ Analysis of the tax incidence of sales and income tax increases shows that budget negotiators picked the wrong path, from the perspective of tax fairness, when they chose to finance a yet-to-be-fully described property tax cut proposal with just one of these two options.

A personal income tax rate increase would be far superior and fairer to the average Pennsylvanian than a sales tax rate increase. Therefore, we urge the General Assembly and Gov. Wolf to finance property tax cuts more with higher personal income taxes than with higher sales taxes. Another fair way to analyze property tax cuts, not included here, would be a severance tax.

If the sales tax rate increase is going to remain the vehicle for cutting property taxes, it is critically important that the plan to cut property taxes not further amplify the regressive nature of the sales tax by distributing the bulk of the tax cuts upward to affluent taxpayers. The final budget agreement should:

- include a rebate for renters;
- target property tax cuts at low- and middle-income homesteads;
- expand personal income tax forgiveness to more low-income households, as Gov. Wolf proposed again in October; and
- include an increase in the minimum wage to \$10.10 per hour to boost the wages of low-income taxpayers who bear the greatest burden of sales taxes.

Addendum: Improving Pennsylvania's Personal Income Tax

When considering all state and local taxes, Pennsylvania has a highly unequal tax burden with middle-income Pennsylvanians paying two times more in taxes, as a share of income, than the highest-income earners, and the lowest-income earners paying nearly three times more.⁶ A progressive, rather than flat, personal income tax would correct this inequity. But as yet no elected official we know of has advanced a plan for a campaign to amend the state constitution to permit high-income Pennsylvanians to be taxed at a higher rate. Nor have the options that exist to increase tax rates on upper-income Pennsylvanians without a constitutional change gained significant traction.⁷ In March of this year, we estimated that

taxing the highest-income one percent of Pennsylvania taxpayers at the same rate as the middle 20 percent would raise \$3.75 billion per year.⁸ That modest increase in tax fairness would, by itself, solve the state's structural deficit and finance adequate investment in education, human services, communities and jobs – with some money left over for property tax cuts.

END NOTES

¹ These estimates include the impact of expanded tax forgiveness but do not include the impact of increased expanded property tax rebates.

² While the income tax increase raises less money than the sales tax increase (about \$1.8 billion versus \$2 billion), the former translates into a higher average tax increase for Pennsylvania taxpayers primarily because people from out of state pay 24% of the sales tax increase and a small portion of the income tax increase. As a result, instead of paying 11% more on average with the sales tax increase, Pennsylvania taxpayers pay 11% less. But as emphasized in the text, these averages obscure the wide variation in the impact of the sales and income tax rate increases on different parts of the income distribution.

³ The Commonwealth Foundation estimates that a personal income tax rate increase to 3.57% would increase taxes for a family of four by \$657. The procedure the Commonwealth Foundation employs for estimating the increase in taxes divides the total amount of revenue raised from a tax increase by one-fourth of the state population. This procedure is not a conventional means of estimating tax incidence and is highly inaccurate. For a 0.50 percentage point increase in the personal income tax to cost a four-person family \$657, that family must have an annual income of \$131,500. In fact, the median four-person family income in Pennsylvania is \$84,060 (<http://goo.gl/vHGMkV>), putting the actual tax increase closer to \$420 for a family of four. The Commonwealth Foundation procedure overstates the tax increase for a four-person family by 56% and is 133% higher than the average increase for all families.

⁴ The percentages of the increased sales taxes paid by each Pennsylvania income group reported in these bullets are shares of the total increase in sales tax paid by all Pennsylvania taxpayers. They are not shares of the total sales tax increase, which would also take into account the 24 percent of the sales tax paid by people from out of state. Shares of the total sales tax revenue paid by each Pennsylvania income group would be roughly three-quarters as large as the shares reported in these bullets.

⁵ For a detailed comparison of the proposals advanced this year by House Republicans and Gov. Wolf, see Pennsylvania Budget and Policy Center, *Follow the Property Tax Money: The Wolf Plan and HB 504 Compared*, July 28 2015, online at <https://pennbpc.org/follow-property-tax-money-wolf-plan-and-hb-504-compared>

⁶ The Institute on Taxation and Economic Policy. 2015. "Who Pays?: A Distributional Analysis of the Tax Systems in All Fifty States" <http://www.whopays.org/>

⁷ These options include taxing income from wealth (non-wage income) at a higher rate than wage income and a flat wealth tax. See Better Choices for Pennsylvania, "2015 Pennsylvania Tax Fairness Campaign Platform: Nineteen ideas to make Pennsylvania's tax system fairer," February 18, 2015, online at <https://pennbpc.org/sites/pennbpc.org/files/2015PennsylvaniaTaxFairnessCampaignPlatform.pdf>

⁸ Pennsylvania Budget and Policy Center. 2015. "Tax Fairness: An Answer to Pennsylvania's Budget Problems." http://keystoneresearch.org/sites/default/files/PA_TaxFairness_0.pdf