

INDEPENDENT FISCAL OFFICE
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Testimony Before the Senate Finance Committee
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Chairmen Eichelberger and Blake, members of the committee, thank you for the opportunity to testify before you today. For my testimony, I would like to focus on the four tables that have been submitted for your review. The tables provide an overview of the Administration's proposed changes to the personal income tax (PIT) and sales and use tax (SUT).

The attached **Table 1** lists the Independent Fiscal Office's (IFO) revenue estimates for PIT changes and the SUT rate increase and base expansion. When fully phased-in by FY 2017-18, the IFO estimates that the PIT changes will generate \$2.5 billion, the SUT rate increase will generate \$1.0 billion, and the SUT base expansion will generate \$3.2 billion. Relative to the Administration's estimates, our revenue estimates are roughly 3 percent lower for next fiscal year, and 7 percent lower by FY 2019-20.

The attached **Table 2** provides additional detail regarding the impact of the PIT rate change. The table illustrates the impact of a hypothetical \$100 million PIT increase for 2012. Tax data show that 77 percent of new revenues would come from wage earners, 12 percent from capital income such as capital gains, interest, dividend and rental income, and 11 percent from the net business profits of S corporations, partnerships and sole proprietorships. The data suggest that \$6.1 million would be remitted by non-residents. The net tax burden of Pennsylvania residents would be reduced further because state income taxes can be deducted on the federal income tax return, which reduces federal income tax. This deduction can be significant, and could offset more than one-third of the PIT rate increase for certain high-income residents. Overall, exporting and deductibility reduce the net PIT tax burden of residents by more than 20 percent.

The middle portion of **Table 2** displays the impact by taxable income class. Higher-income residents receive more federal tax relief because they are more likely to itemize and the tax deduction is worth more to them. By itself, that outcome makes the PIT rate increase appear regressive. However, all Social Security (\$38.1 billion in 2012) and pension (\$38.6 billion) income is exempt from PIT. As shown at the bottom of **Table 2**, roughly half of that income accrues to the lower end of the income distribution. Those exemptions may imply that a PIT rate increase could be slightly progressive across income groups if the base of comparison is all income, and not just income subject to tax.

Table 3 displays the distribution for new SUT revenues across income groups used by the IFO in a recent analysis of the Administration's revenue proposals. The analysis assumed that a little more than one-quarter of the SUT rate increase would be borne by households with incomes under \$50,000, and a bit less than one quarter for the SUT base expansion. It is well known that sales taxes are regressive because lower-income individuals tend to spend all, or more than all (due to depletion of savings or borrowing) of their income. The assumed tax incidence of the SUT is confirmed by two other studies shown in **Table 3**:

- A recent study by The Institute on Taxation and Economic Policy (ITEP) found that Pennsylvania has the sixth most regressive tax system in the U.S. Compared to the IFO analysis, their results suggest that more of the SUT increase would be borne by low-income households, and less by high-income households.
- The Minnesota Department of Revenue publishes a respected incidence analysis every two years. The tax incidence results are very similar to those assumed for Pennsylvania.

Unlike the PIT, sales tax cannot be deducted on the federal income return under current law. Therefore, the federal government does not effectively subsidize state sales tax systems.

Table 4 compares an SUT or PIT rate increase to the proposed SUT base expansion. As shown, a 0.1 percentage point increase in the tax rate is worth roughly \$430 million for the PIT and \$180 million for the SUT. If new revenues must be generated, policymakers may want to consider the inherent tradeoffs between rate increases and an SUT base expansion. **Table 4** shows that proposed SUT base expansion revenues are very concentrated. The IFO itemized 33 base expansion categories, and the top five comprise almost half (46 percent) of total SUT base expansion revenues, while the bottom 15 comprise only one-eighth. In terms of revenues, the bottom 15 items are roughly equivalent to a 0.1 percentage point increase in the PIT rate. It is likely that those SUT revenues will require more compliance outlays by businesses and enforcement by the Department of Revenue, compared to an equivalent PIT rate increase. Moreover, the higher sales tax will likely make the overall tax system more regressive.

Finally, policymakers may want to consider enforceability and ease of administration when weighing various SUT base expansion items. Certain items such as basic cable, many goods (which are sold through larger retailers that already collect tax) and services provided by licensed practitioners will be easier to bring into the expanded SUT base. Conversely, there may be significant compliance and enforcement concerns for many service sectors due to the proliferation of very small service providers. In particular, Census data show a very high proportion of such providers in the personal care and other personal service sectors. In order to achieve desired rates of compliance, businesses and the Department of Revenue may incur significant costs.

Table 1
Personal Income and Sales and Use Tax Revenue Estimates

	Fiscal Year (\$ millions)				
	2015-16	2016-17	2017-18	2018-19	2019-20
Personal Income	\$2,243	\$2,396	\$2,509	\$2,631	\$2,759
1 Rate Change (3.07% to 3.70%)	2,317	2,476	2,589	2,711	2,839
2 Higher Tax Forgiveness Thresholds	-89	-98	-99	-100	-102
3 Tax Lottery Winnings	15	18	19	20	22
Sales and Use – Rate Increase (6.0% to 6.6%)	\$399	\$991	\$1,024	\$1,058	\$1,093
Sales and Use – Base Expansion	\$1,172	\$2,979	\$3,206	\$3,423	\$3,599
1 Recreational Services	292	738	790	840	882
2 Health Services	248	640	699	755	800
3 Professional Services	224	570	618	663	697
4 Various Goods	157	395	419	443	463
5 Personal Services	113	287	311	334	351
6 Miscellaneous Services	105	265	281	297	311
7 All Other ¹	33	83	88	92	96
TOTAL	\$3,814	\$6,366	\$6,740	\$7,112	\$7,451

Notes

1 Includes cap on vendor discount and bracket rounding.

Table 2
Incidence of a Hypothetical \$100 Million PIT Increase (2012)

By Income Source	Total Tax	Non-Residents	Paid by PA Residents			% Total
			Gross	Offset ¹	Net	
Wages and Salaries	\$77.5	\$3.5	\$74.0	-\$11.5	\$62.5	80.7%
Capital Income ²	\$11.7	\$1.0	\$10.7	-\$2.7	\$8.0	67.9%
Net Business Profits	<u>\$10.8</u>	<u>\$1.6</u>	<u>\$9.2</u>	<u>-\$2.3</u>	<u>\$6.9</u>	<u>63.8%</u>
Total	\$100.0	\$6.1	\$93.9	-\$16.6	\$77.3	77.3%

By Taxable Income		Total Tax	Non-Residents	Paid by PA Residents			% Total
				Gross	Offset ¹	Net	
\$0	\$50,000	\$20.1	\$1.2	\$18.9	-\$0.4	\$18.6	92.2%
\$50,001	\$100,000	\$23.8	\$1.0	\$22.8	-\$1.9	\$20.9	87.7%
\$100,001	or more	<u>\$56.1</u>	<u>\$3.9</u>	<u>\$52.2</u>	<u>-\$14.3</u>	<u>\$37.9</u>	<u>67.6%</u>
Total		\$100.0	\$6.1	\$93.9	-\$16.6	\$77.3	77.3%

Distribution of Exempt Social Security and Pension Income		
By Federal Adjusted Gross Income		Share
\$0	\$50,000	49.1%
\$50,001	\$100,000	25.4%
\$100,001	or more	<u>25.6%</u>
Total		100.0%

Notes and Sources

- 1 Reduction in federal income tax due to higher deduction of state personal income taxes.
- 2 Includes capital gains, interest, dividends, rental and estate income.
- 3 Sources: Income tax data are from PA Department of Revenue tabulations as published in the 2012 Personal Income Tax Statistics. Social Security data are from the Social Security Administration. U.S. Pension data are from the U.S. Bureau of Economic Analysis (Table 6.11) and IRS state tax return data. Distributions across taxpayer groups based on IRS tax return data and are estimates by the IFO.

Table 3
Distribution of the Pennsylvania and Minnesota Sales and Use Tax

Independent Fiscal Office (2018)¹		Share PA	Share Base
Lower	Upper	Sales Tax	Expansion
\$0	\$50,000	26.8%	23.2%
\$50,001	\$100,000	27.4%	27.2%
\$100,001	or more	45.8%	49.6%

Institute on Taxation and Economic Policy (2015)²		Share PA
Lower	Upper	Sales Tax
\$0	\$50,000	28.4%
\$50,001	\$100,000	35.5%
\$100,001	or more	36.1%

Minnesota Tax Incidence Study (2017)³		Share MN
Lower	Upper	Sales Tax
\$0	\$50,000	26.8%
\$50,001	\$100,000	24.4%
\$100,001	or more	48.7%

Notes and Sources

- 1 IFO analysis based on U.S. Consumer Expenditure Survey. Analysis assumes that PA consumer spending patterns are similar to U.S. for 2013. Census data show similar distribution of households by income group (U.S. slightly weighted more towards higher income).
- 2 See "Who Pays? A Distributional Analysis of Tax Systems in All Fifty States" Institute on Taxation and Economic Policy (January 2015). Data apply to non-elderly taxpayers only and general sales tax for individuals. Census data show that distribution of elderly PA households is more weighted towards lower income groups compared to households under age 65.
- 3 See Table 3.2 in "2015 Minnesota Tax Incidence Study" MN Department of Revenue (March 2015). Like PA, the MN sales tax base excludes food for home consumption and clothing, but taxes certain residential utilities. Census data for 2009-13 (five-year estimate) show a higher income distribution for MN households than PA. For 2009-13, MN households with less than \$50,000 of income comprised 41.9 percent of households and 13.4 percent of total household income. For PA, the respective figures are 47.8 and 16.1 percent. This difference suggests that lower income households in PA would bear a higher share of a similar sales tax.

Table 4
SUT or PIT Rate Increase Versus SUT Base Expansion

Revenue Impact from 0.1% Rate Increase	Fiscal Year (\$ millions)			
	2016-17	2017-18	2018-19	2019-20
Personal Income Tax	\$400	\$420	\$440	\$460
Sales and Use Tax	\$170	\$180	\$180	\$190
SUT Base Expansion Items Ranked by Revenue Potential¹				
Top 5 Items	\$1,368	\$1,478	\$1,582	\$1,667
Next 5 Items	\$684	\$730	\$774	\$812
Next 8 Items	\$583	\$626	\$667	\$700
Next 15 Items	<u>\$384</u>	<u>\$415</u>	<u>\$444</u>	<u>\$465</u>
Total	\$3,020	\$3,249	\$3,467	\$3,644
Higher Compliance, Lower Enforcement and Administrative Burden				
All Goods	\$395	\$419	\$443	\$463
Basic Cable	\$239	\$248	\$258	\$270
Waste Remediation	\$112	\$122	\$130	\$137
Vendor Cap	\$70	\$73	\$75	\$78
Veterinary Fees	\$63	\$69	\$74	\$77
Lower Compliance, Higher Enforcement and Administrative Burden				
Personal Care Services	\$108	\$118	\$126	\$133
Other Personal Services	\$47	\$51	\$54	\$57
Other Professional Services	\$44	\$48	\$51	\$54

Notes

1 Excludes proposed change from bracket rounding.