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Income and Sales Tax Increases in Context

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Introduction

Chairman Eichelberger and members of the Committee, thank you for the opportunity to testify before you today on proposals to increase the personal income tax and the sales and use tax. I'd like to start with a very brief overview of the state's broader tax structure, then return to those two proposed tax increases, contrasted with tax reductions they are intended to fund, bearing in mind that even after that tax shifting, the plan is projected to increase overall revenue by $4.6 billion.

Overview of Pennsylvania's Tax Structure

Pennsylvania's tax climate is at best uneven, combining a relatively modest individual income tax burden and middle-of-the-road sales tax with high corporate and property tax burdens. Pennsylvania's tax competitiveness, however, is as much a matter of structure as it is of rates.

At 9.99 percent, Pennsylvania's Corporate Net Income Tax (CNIT) is the second-highest state corporate income tax in the nation, and it's a significant factor in the Commonwealth's 46th place ranking on the corporate tax component of our 2015 State Business Tax Climate Index, which looks at rates and structure. Moreover, businesses are also hit with an antiquated capital stock and franchise tax which has been phasing out, in fits and starts, for years.

With property taxes, the story is far more complex. Property tax collections are right at the median point, but the distribution is skewed by an inheritance tax and the aforementioned capital stock tax. Millages are of course assessed by counties, municipalities, and school boards, and in many counties, decades have passed between reassessments.

Although I now work in D.C., I'm originally from Butler County, where the last reassessment took place in 1969. Forty-six years is a long time to go without a reassessment, and it introduces substantial inequities into the tax system. Millages may be adjusted from time to time to keep collections on target, but for many properties, the relative tax burden is determined by an assessment that is decades out of date.

The state's unemployment insurance taxes are among the highest in the country, and on our Index, which also takes structure into account, we rank the state's UI taxes the worst in the nation. The personal income tax (PIT), by contrast, is both low and simple—a 3.07 percent flat-rate income tax on individual income. There are, however, local income taxes as well with widely disparate rates which can increase overall liability substantially.

Governor Wolf's Plan

Much like Pennsylvania's overall tax structure, from our perspective Governor Wolf's proposal is a mixed bag. We do not take positions on legislation, but we do seek to analyze pros and cons, and today I'd like to discuss tradeoffs between the PIT and sales tax proposals and other elements of the plan. The Governor's budget advances some creditable structural reforms, like broadening the sales tax base, reducing reliance on the corporate net income tax, and finally eliminating the franchise tax. However, it also increases the sales tax rate, hikes the PIT, and imposes a severance tax for the first time, while providing property tax offsets that may not work as well as desired.

Sales tax base broadening can be good policy, as it increases tax neutrality. The government should not pick winners and losers through the tax code. Increasingly, moreover, we live in a service-oriented economy, and it is important for the sales tax base to reflect that reality.

Rather than using base broadening to pay down the rate, however, the budget includes a substantial increase in the overall rate, from 6.0 to 6.6 percent. From a structural standpoint, it is also worth noting that some of the sales categories subject to expansion are clearly business inputs (for instance, advertising/research and business administrative), and others have the potential to be (e.g., legal and accounting services).

A well-structured expansion would seek to exclude business inputs to avoid tax pyramiding, which is when a single good or service is subject to multiple points of taxation along the production chain, and instead imposes the tax on all final consumer transactions. Combined, sales tax changes are estimated to bring in additional $4 billion a year by Fiscal Year 2018, and a significant portion of that will be in taxes embedded in the cost of goods and services several times over.

The Personal Income Tax (PIT) is currently one of the bright spots in Pennsylvania's tax structure, with its low, flat tax rate. Even after the proposed 20.5 percent increase, the rate would still be below average, but the Commonwealth would be giving up much of the advantage conferred by the rate, particularly for small businesses which pay through the individual tax code. By Fiscal Year 2017, this increase is estimated to bring in a sizable $2.5 billion a year in increased revenue.

Since a significant portion of the revenue generated by these proposals would help pay down property tax relief and reductions in corporate income tax reliability, I feel

compelled to discuss these matters in the context of the tradeoffs with income and sales tax expansion.

Property tax relief is a worthy goal, but one that is often difficult to implement at the state level. It would be more accurate to say that the Governor has proposed increasing the state's share of public education funding to reduce the pressure on localities to raise revenues through local property taxes, with different impacts across the Commonwealth. In Philadelphia, for instance, most of the reduction would actually come through the city's wage tax, not property taxes as such.

Although school districts would be prohibited from increasing their property tax millage rate if their unassigned fund balance is greater than four percent of total expenditures, the unfortunate reality is that there is nothing to ensure that the non-homestead exemption share of property tax relief actually materializes, as local taxing authorities necessarily remain free to set their own millage rates, and are not obligated to reduce them in proportion to their lesser school funding obligations, nor to keep them at whatever rates they set.

All of that is to say that state-level property tax relief can introduce an element of moral hazard: some localities may consider themselves freed up to raise property taxes further due to the existence of an offset, resulting in higher taxes across the board. Since this plan is predicated on tax shifting, it can also raise equity issues: should income and other state-level tax dollars be used to provide rebates to property owners, who are paying, at least in part, for services associated with property ownership?

Far more than income taxes, property taxes also conform reasonably well to the benefits test, as they help to pay for services tied to property ownership—local road maintenance, law enforcement and emergency services, and the like—and the value of the property is a reasonable, if imperfect, proxy for the value of those services. Many economists also favor property taxes over many alternative forms of taxation, like income and sales taxes, because have a relatively limited impact on economic growth and development.

On the other hand, a reduction in the **Corporate Net Income Tax** is long overdue, and important to Pennsylvania's ability to compete with other states. At 9.99 percent, Pennsylvania's corporate tax rate is the second-highest in the nation, and—especially combined with the franchise tax—is holding the Commonwealth back.

People sometimes doubt whether taxes really matter, whether businesses really decide where to locate or relocate due to tax liability. And while it's hardly the only consideration, and may often be some ways down the list, the truth is that yes, taxes do matter. I think we all intuitively believe this: otherwise, states would not jockey to offer tax incentives packages in an effort to attract businesses. Of course, states are better off in the long run if they compete not with targeted incentives but with competitive rates and good tax structure, but clearly, taxes matter.

Just last week, the Connecticut legislature passed a budget that will increase business taxes by $500 million over the biennium. It's now sitting on the Governor's desk, and GE and Aetna are threatening to leave the state if the increases become law. Taxes matter. A few years ago, Illinois ramped up its corporate tax, and several Fortune 500 corporations, including Sears and the Mercantile Exchange, prepared to leave for greener pastures. The state blinked, not by abandoning the tax increases, but by exempting those companies from them, an avoidable crisis. Taxes matter.

Phasing the corporate net income tax down to 4.99 percent, therefore, has the potential to be highly significant for Pennsylvania. Corporate income taxes tend to distort economic decision-making far more than individual income taxes and sales taxes. Corporate income taxes also represent an ever-declining source of revenue for states as more and more of the economy is represented by pass-through corporations (which pay through the individual income tax), but CNIT rates can be hugely important to many companies, and such a reduction is well worth pursuing. In the long run, it's a fair guess that states will work to further reduce their reliance on corporate income taxes due to their inherent revenue volatility and declining collections. It makes sense for Pennsylvania to get a head start on that process.

Conclusion

Still, the question remains: at what cost? All told, the package is worth about $4.7 billion a year in tax increases for FY 2015, exceeding $5 billion by FY 2019.

The Governor's budget has positive elements. Expanding the sales tax base is good policy; so is reducing the corporate income tax and eliminating the outmoded capital stock tax. A $4.7 billion tax increase, however, is a bitter pill to swallow, and several of the Governor's proposals increase tax complexity and further burden economic activity. The chamber across the hall evidently has some misgivings about a 16 percent increase in the state budget. Whatever this chamber decides, I would urge the members to weigh all aspects of the plan against the principles of sound tax policy—that, as best as possible, taxes should be simple, transparent, neutral, and stable, with broad bases and low rates.
