

Testimony of Stephen Herzenberg, Keystone Research Center
Senate Finance Committee
Public Hearing on Proposals to Increase the Personal Income and the Sales/Use Tax
Wednesday, June 10, 2015

Chairman Eichelberger and members of the committee, thank you for the opportunity to testify before you today. I hold a Ph.D. in economics from MIT and am the Executive Director of the Keystone Research Center (www.keystoneresearch.org). KRC is an independent non-partisan policy and research organization, the mission of which is to promote a more prosperous and equitable Pennsylvania. Most of our budget and tax analysis has been for the past decade under the banner of the Pennsylvania Budget and Policy Center (www.pennbpc.org), which is a project of KRC. I am speaking to you myself today because PBPC is short-staffed at the moment. So if any of you know a great potential director or senior researcher for our PBPC, please send them our way.

Before providing our perspective on current income and sales taxes, including Gov. Wolf's proposal and the Saylor property tax relief proposal which passed the House HB 504, let me take a minute to explain the values and tax principles that inform our position on tax proposals generally.

Sound Tax Principles

One critical value that should guide tax policy in our view is "revenue adequacy" – having enough revenue to invest in essential public goods, starting with education, and in services critical to quality of life for middle- and low-income families.

A second value important to us is "tax fairness" or tax progressivity. We favor collecting the same or more revenue as a share of income from those with greater ability to pay.

While we may place more emphasis on these two values than others, they are widely shared goals of tax policy and principles of public finance. For example, a Pennsylvania business-labor tax project a decade ago grounded its negotiation of a consensus tax reform proposal in a set of principles that included tax fairness and revenue adequacy as objectives (albeit using tax jargon to describe these principles – "vertical equity" and "long-run revenue sufficiency"; see Appendix A).¹ The "PA 21" tax project also included as tax objectives other sound principles, including "tax neutrality" (broader bases, lower rates) and "exportability" (enact taxes that people outside your jurisdiction pay, such as a severance tax).

Specific tax proposals may, of course, satisfy one tax objective or principle better than others. Therefore, you have to weigh the trade-offs among different objectives, including tax fairness and revenue adequacy.

¹ This project included, at the end, the Pennsylvania Business Roundtable and the Allegheny Conference as well as several labor organizations. The Pennsylvania Chamber of Business and Industry dropped out of the project part way through.) See *Pennsylvania's 21st Century Tax Policy Project: Moving Pennsylvania's Tax System Into the 21st Century*, prepared by Pennsylvania 21st Century Consultants (Ernst & Young, Keystone Research Center, and the Pennsylvania Economy League, December 2003.

How Well Does the Current Pennsylvania Tax System Meet Sound Tax Principles?

Currently, the Pennsylvania tax system does not meet sound tax principles.

For example, recent budgets in Pennsylvania pay inadequate attention to revenue adequacy, which explains why we have a structural deficit. Pennsylvania needs to raise revenues sufficient to meet its needs and to eliminate its structural deficit.

Second, Pennsylvania's overall state and local tax system is highly regressive – the sixth most regressive state and local tax system in the country (<http://www.itep.org/whopays/states/pennsylvania.php>). The highest-income one percent pay only 4.2% of their income in state and local taxes, compared to 10.3% for middle-income families and 12% for low-income families.

Third, Pennsylvania's tax system ranks poorly when it comes to "revenue neutrality" – it is rife with loopholes. This is true of our corporate tax system and it also true of our existing sales tax, which has a relatively narrow base.

Given these flaws of the current Pennsylvania tax system, we see a critical need to bolster revenue adequacy and tax fairness. Earlier this year, we released a tax fairness platform with other groups that included 19 ways to increase tax fairness (see <http://betterchoicesforpa.com/>). We also see a need to eliminate tax loopholes, which is why we should adopt Governor Wolf's combined reporting proposal (following in the footsteps of 23 other states);² and also why we have favored broadening the base of the sales tax³ but not raising more revenue from sales taxes. Given the highly regressive Pennsylvania tax system, we tend to favor raising more revenue from the PIT, which is the least regressive of our three main taxes (sales, property, and income). We also included in our 19 tax fairness proposals ideas for making the income tax itself more progressive, with or without a constitutional amendment to eliminate or modify our constitutional uniformity clause.

Current Sales and Income Tax Proposals

Consider now current sales and income tax proposals, starting with the Governor's budget proposal. First, the Governor's proposal is the only one under discussion that addresses revenue adequacy. Together with his severance tax proposal, the Governor's sales and income tax proposals would provide revenue to reinvest in education, in communities, and in job creation. These investments would reverse the cuts and austerity within the 2011-12 budget, which contributed to the layoff of 27,000 public school employees and help explain the states low-job growth ranking. The Governor's proposal would also solve the state's structural budget deficit, not only this year but going forward, reassuring bond rating agencies.

² For a comprehensive analysis of the case for combined reporting, see <http://www.cbpp.org/research/state-corporate-tax-shelters-and-the-need-for-combined-reporting>; for a two-page recent summary of why combined reporting makes sense, see <http://itepnet.org/pdf/pb24comb.pdf>; for a refutation of business arguments that combined reporting is "too confusing" for businesses that operate across the country (and often around the globe), see <http://pennbpc.org/97-top-pennsylvania-companies-use-combined-reporting>. While Pennsylvania's addback law is a step forward it is much weaker than combined reporting and fails to prevent many creative corporate accounting schemes that low taxable corporate income in a state below a level commensurate with the scale of corporate operations.

³ On the case for broadening Pennsylvania's sales tax, see <http://pennbpc.org/modernizing-sales-tax-match-todays-economy>.

When it comes to tax fairness, the Governor's proposal includes one proposal that we would oppose if it were a stand-alone proposal: it raises substantially more money from the sales tax. It does this through a combination of a base broadening – in principle, a positive step – and a higher sales tax rate. This sales tax proposal, however, is not a stand-alone proposal. As well as being part of a revenue adequacy package, the Governor's sales tax proposal is coupled with income tax changes that are used for property tax relief that is distributed in a progressive way. This relief is distributed primarily through the state's homestead exemption which means median-value homesteads get exactly as much relief as families with the most expensive homes in a school district. In addition, this relief is targeted to areas which have the highest property taxes relative to income – including predominantly Republican areas in the Poconos, southern York, and parts of southern Chester County. According to analysis done for us by ITEP, low-income Pennsylvanians would pay less in overall taxes under the Governor's proposal. ITEP's analysis also shows that the revenue from the Governor's proposal is collected in a much more progressive way than the status quo Pennsylvania tax system.

Ignoring political constraints, would we have preferred to collect less revenue than the Governor proposes from the sales tax? Yes. But we understand why he made the choice to incorporate revenue proposals from recent legislative proposals. If budget negotiators revisit the details of how revenue is raised, we would be fine with reducing the Corporate Net Income (CNI) tax rate by less than the Governor proposes or with a higher PIT increase (overall or just on non-wage income). This additional revenue then allowing less increase in the sales tax rate.

Turning briefly to HB504, a key difference with the Governor's proposal is that the Saylor bill does not address revenue adequacy. It uses all the revenue raised for property tax relief. What about the distribution of the property tax relief in the Saylor proposal? We are just completing a comparison of this with the Wolf property tax distribution, which we will release in the next few days. But here are the basic findings. More of the relief in the Saylor proposal goes for general rate reduction rather than being funneled through the homestead exemption; general rate reduction benefits commercial property owners and people with expensive homes more relative to people who have a home worth in the middle or at the low end.⁴ In addition, more of the relief under the Saylor proposal goes to wealthier school districts. You put these two factors together and the Saylor proposal rates less well on tax fairness than the Wolf proposal.

Let me close with two points. Our preliminary analysis indicates that some of the areas where Republican lawmakers' have been champions for property tax relief do well under Gov. Wolf's proposal, better than under the Saylor proposal. If this result holds up, representatives in these areas should embrace Governor Wolf's budget or a compromise shaped by it. Not doing that would seem to reject a once-in-a-generation chance to achieve progress on property taxes for their constituents – and would seem to be an example of cutting off your nose to spite your face.

Finally, looking beyond this budget, it is worth noting which geographical areas are hurt by Pennsylvania's highly regressive tax system: low-income areas. Many of these are rural Republican areas. Those areas have as much interest as central cities in structural change to achieve a fairer tax system. So we look forward to working with those of you from those rural areas to make more progress on tax fairness in future budgets.

⁴ For more on the greater progressivity of distributing property tax relief through the homestead exemption compared to rate reduction, see <https://pennbpc.org/property-tax-relief-pennsylvania>.

Appendix A

State and Local Tax Policy Objectives from the Business-Labor 21st Century Tax Policy Project

A. Equity Objectives

- *Benefit Principle*—taxes are distributed in line with the value of public goods and services received by taxpayers
- *Ability-to-Pay Principle*
 - Horizontal equity—taxpayers with equal ability to pay the same amount in taxes
 - Vertical equity—effective tax rates rise with income or ability to pay

B. Efficiency Objectives

- *Competitiveness*
 - Support retention and expansion of jobs and investment
 - Support long-run growth in income
 - Consider combined state and local tax impact
- *Revenue Productivity*
 - Long-run revenue sufficiency
 - Revenue stability over the economic cycle
 - Balanced use of income, consumption and wealth taxes
 - Predictable
 - Exportability
- *Tax Neutrality*
 - Broad bases, minimum rates
 - Apply uniformly to similarly situated taxpayers
- *Accountability/Understandable to Taxpayers*
 - Visible taxes, understandable to taxpayers
 - Clear and predictable
 - Minimize complexity

C. Administrative Objectives

- *Accountability/Understandable to Taxpayers*
- *Clear and Timely Administrative Guidance*
- *High Voluntary Compliance*
- *Low Compliance Costs—Taxpayer and Tax Agencies*
- *Stability in Tax Laws*
- *Certainty of Tax Liabilities*
- *Timely and Impartial Tax Appeals Process and Resolution of Controversies*³