PENNSYLVANIA
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INCOME TAX REFORM IN PENNSYLVANIA

The Best Way to Solve the 2009 Budget Crisis and the Best Choice for the Long Term

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In Pennsylvania, as in the United States, the current economic recession comes on the heels of a period of economic growth that did little to raise the wages of middle-income Pennsylvanians. The economic expansion following the 2001 recession to the current one was one of stunning growth in economic inequality, with 79% of the total increase in income in Pennsylvania going to the richest 1% of Pennsylvania taxpayers.[1] In this period, the richest 1% of Pennsylvanians enjoyed income increases that *averaged* at least $60,000 and rose to $7 million dollars for the very richest Pennsylvanians (1 out of every 10,000 taxpayers). During the same economic expansion, the inflation-adjusted average incomes for 90% of Pennsylvanians fell by 4%.

Stagnating wages and income thus came, for most Pennsylvanians even before the economic recession began in December 2007, bringing with it plummeting home values, rising joblessness, and fears of more rapid wage and income decline.

This economic context explains why Pennsylvania families—and their legislators—might be nervous about any increase in tax rates enacted to forestall deep cuts in state spending—even when that spending maintains services for working families and can help kick-start an economic recovery.

The unequal growth of the last decade also suggests that state legislators should target tax changes, to the extent possible, to affluent families that can most afford to pay and that have seen large increases in income in recent times.

Pennsylvania's state and local tax system does not currently tax top earners adequately—in fact, just the opposite. The richest 1% of Pennsylvania non-elderly taxpayers currently pay only 5.2% of their income in state and local taxes—below national norms—while the middle class pays twice as much (10.8%) and the poorest fifth pay12.6%.

This briefing paper outlines three changes to the Pennsylvania personal income tax (PIT) that would help plug the state's multi-billion dollar revenue hole in the least painful way possible

[1] All wage and income figures are adjusted for inflation. Income figures are for the period 2001 to 2005, 2005 being the most recent data analyzed. Wage figures are for the period 2001-2007. For sources and full details on all of the figures in this and the next paragraph, see Mark Price and Stephen Herzenberg, *The State of Working Pennsylvania 2008* (Harrisburg: Keystone Research Center, 2008), online at www.keystoneresearch.org.

for working families. The revenue changes proposed here would have two critical benefits compared to most other approaches to resolving the state budget stalemate:

- The increases in income taxes would be paid in large part by taxpayers at the very top that have enjoyed very rapid recent increases in income. Lower-income rural regions and city neighborhoods would pay relatively little. Tens of thousands of working families would receive an income tax decrease.

- The PIT changes proposed here would boost job growth substantially, in contrast to two other alternatives: deep cuts in spending without increasing state taxes, or increasing revenues through a sales tax increase. There are two reasons the tax changes considered here would boost job growth relative to sales taxes:
    - Pennsylvanians would enjoy offsetting reductions in federal income taxes equal to 20 cents for every $1 increase in Pennsylvania income taxes. (Sales taxes by contrast are not deductible on federal income tax forms.) Another 7 cents of the increase would be paid by out-of-state taxpayers. Taking these two facts together, the state would receive a dollar increase in revenue for every 73 cents that Pennsylvanians pay in increased net taxes. Since upper-income Pennsylvanians save more of their income than middle-income families, an income tax increase that focuses on higher-income families will have a smaller impact on consumer demand than tax increases paid more heavily by middle-class and lower-income taxpayers, as with a sales tax increase.

This paper proposes to reform Pennsylvania's Personal Income Tax (PIT) and raise additional revenue to prevent service cuts through three interrelated changes:

1. An increase in the PIT on earned income (wages and salaries) and interest income from the current 3.07% to 3.4%.
2. A higher income tax rate on investment income (dividends, capital gains, net profits but not interest) to 4%, still far below the top income tax rate of any of our neighboring states.
3. An expansion of the state's tax forgiveness program that exempts families from paying all or part of their income tax. We propose that one-adult, two-child families earning up to $27,500 would pay no state income tax. For a family of three, the current threshold for complete tax forgiveness is $25,500. A family of three earning $27,500 would enjoy an $844 tax reduction under this proposal.

A higher tax rate on investment income would be permissible in Pennsylvania despite the state's constitutional uniformity clause, because Pennsylvania law recognizes interest, dividends, and other unearned income as different income "classes."

The next section of this briefing paper contains a primer on earned income and investment income in Pennsylvania, showing how much more concentrated investment income is among the top earning groups. The remainder of the brief analyzes the revenue impact of the three proposed PIT tax reforms and their impact on (a) low-, middle-, and upper-income families, and (b) by county.

The paper closes with a proposal that our three proposed tax changes be phased out automatically as soon as the state's uniformity clause is repealed. Repeal requires that legislators' vote in favor of eliminating the uniformity clause in two consecutive legislative sessions and then that voters approve the repeal. Repeal could happen less than two years from now, on the spring 2011 primary election day in Pennsylvania.

Earned and Unearned Income in Pennsylvania

Eight classes of income are subject to the Pennsylvania PIT: gross compensation (mostly wages, salaries, and tips); interest; dividends; net profits (from a business, profession, or farm); capital gains; net income from rents, royalties, patents, and copyrights; gambling and lottery winnings; and income estates or trusts.[2]

In 2004, 82% of total Pennsylvania taxable income was in the form of compensation or interest. The other 18% of income was in dividends, net profits, rent, royalties, and sale of property, defined here as "investment income."

These types of income—investment income vs. compensation and interest—are not distributed equally across income groups. Figures 1 and 2 show how the two broad categories of income are distributed among families by income level.

Families earning more than $150,000 accounted for only 22% of compensation and interest income. Families with incomes up to $50,000 accounted for nearly a third of taxable compensation and interest, and families earning between $50,000 and $100,000 took home another third.[3]

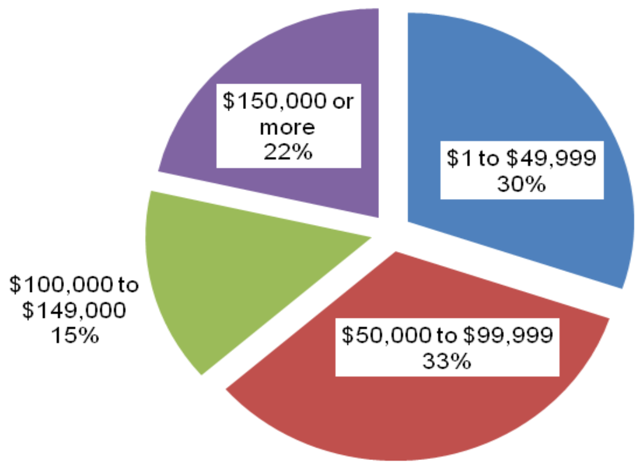
By contrast families earning $150,000 or more took home nearly two-thirds of investment income in 2004. Middle-income families with $50,000 to $99,999 in income had only 12% of investment income.

This basic information makes clear that the way to target a tax increase towards families that can afford to pay in Pennsylvania is by raising the tax rate more on investment income than on compensation and interest.

[2] For additional detail, see http://www.revenue.state.pa.us/revenue/lib/revenue/pitguide_chapter_06.pdf.

[3] Figures 1 and 2 are based on 2004 data. Today, these two groups combined would account for somewhat less of investment income and of compensation plus interest because inflation has taken more families into higher-earning groups.

Figure 1. Distribution of Compensation Income Plus Interest Income in Pennsylvania, by Income Group, 2004

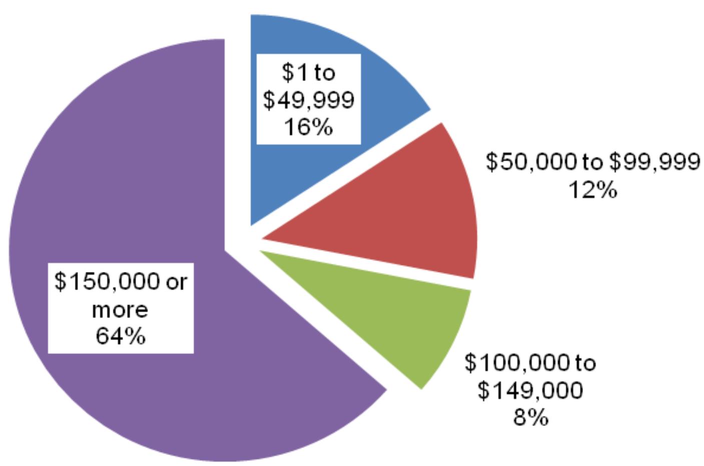


Note: In 2004, there were 4,028,674 taxpayers with taxable incomes ranging from $1 to $49,999; 1,108,377 taxpayers with taxable incomes between $50,000 and $99,999; 340,387 with taxable incomes between $100,000 and $149,000; and 261,422 taxpayers with incomes of $150,000 or greater.

Source. Keystone Research Center (KRC) based on 2004 Pennsylvania Depatment of Revenue (DOR) data estimates

Figure 2. Distribution of Investment Income in Pennsylvania in 2004, by Income Group

(investment income = net profits plus dividends plus capital gains plus other income other than compensation and interest)



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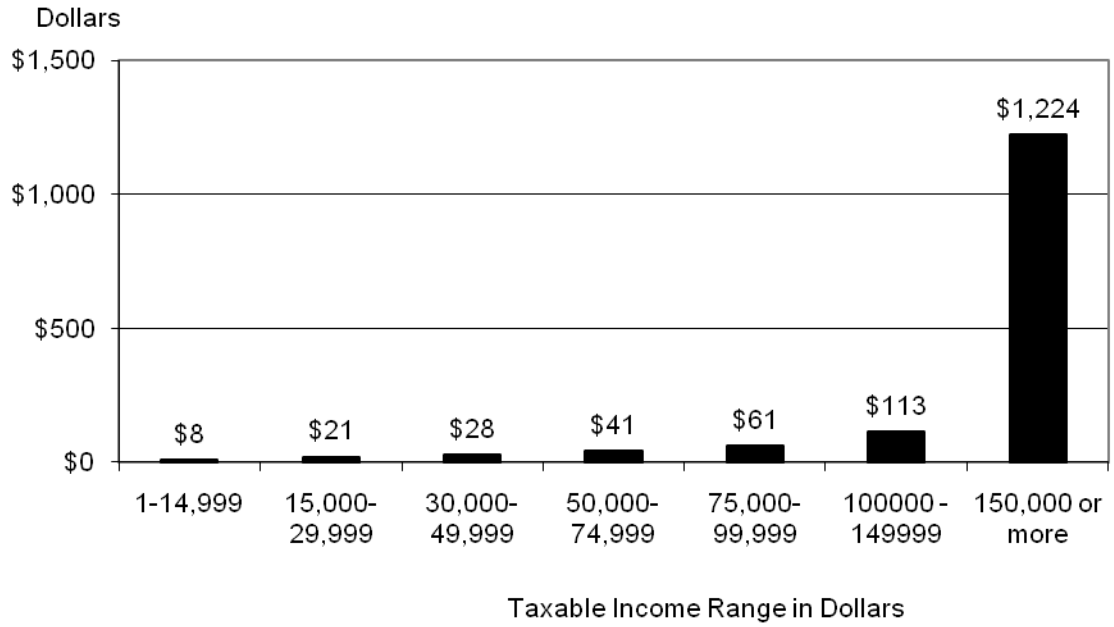
Source. KRC based on PA DOR estimates

This tax change would have little impact on most Pennsylvania families. Figure 3 shows, by income group, the average increase in taxes that results from an increase in the tax rate on investment income (but not compensation and interest) to 4%. All taxpayers earning less than $100,000—roughly 85% of Pennsylvania taxpayers—would pay a tax increase of $61 per year, or $1.18 per week. Taxpayers earning more than $150,000 would pay on average $1,224, well under 1% of their average income.

Figure 3. Average Increase in Taxes by Income Bracket Based on Increasing Tax Rate on Investment Income to 4%



Source. KRC analysis of PA Department of Revenue Personal Income Tax Statistics 2006, Table 4, All Returns, Page 6

The Revenue Impact of Three Proposed Changes in the State Income Tax

Table 1 shows the combined impact of our three proposed income tax reforms.[4] These proposals would increase state revenues by nearly $1.4 billion in FY 2009-10 and about $1.65 billion in FY 2011-12.

[4] The estimates in the text are based on a Pennsylvania Department of Revenue analysis of three tax changes three times as large as those discussed in the text—i.e., increases in the tax rate on investment income to 5.5%, in the tax rate on earned income and interest to 4.07%, and in the state's income tax forgiveness thresholds by $2,000 per person rather than by $667. DOR's analysis enables us to estimate the smaller changes considered here because the revenue impact of income tax rate changes is proportional to the size of the tax rate change; and because the distributional impacts of the tax changes will be the same as long as the ratio of the tax rate increase on investment income to the tax rate increase on earned income and interest remains the same. The one simplifying assumption necessary to scale down PA DOR's estimates as we have done is that raising the income tax thresholds by $667 will have one-third the impact of a $2,000 increase and also that it won't affect the distributional analysis. While this simplifying assumption is not precisely accurate, the overall estimates here will nonetheless closely approximate the results if DOR re-ran the numbers at one-third the original levels.

TABLE 1. REVENUE IMPACT OF THREE CHANGES TO THE PENNSYLVANIA PERSONAL INCOME TAX					
Tax Changes			Revenue Increase by Fiscal Year *($ millions)*		
Increase tax rate on earned income and interest to	Increase tax rate on other income to	Increase tax forgiveness to	2009-10	2010-11	2011-12
3.40%	4%	$7,167/adult $10,167/dependent	1,390	1,490	1,650

Note: See foonote 3 for additional information on the source of these estimates.

Source. Keystone Research Center (KRC), based on PA Department of Revenue (DOR) estimates.

The Impact of the Proposed Changes Based on Family Income

Table 2 and Figure 4 show what different groups of Pennsylvanians pay based on income level. This figure separates all Pennsylvania taxpayers into income quintiles, with each group including 20% of all taxpayers.The lowest-income 60% of taxpayers would pay less than $100 on average per year and the top 1% would pay $5,263. Even the top 1% would see only a 0.59% increase in its average tax rate.

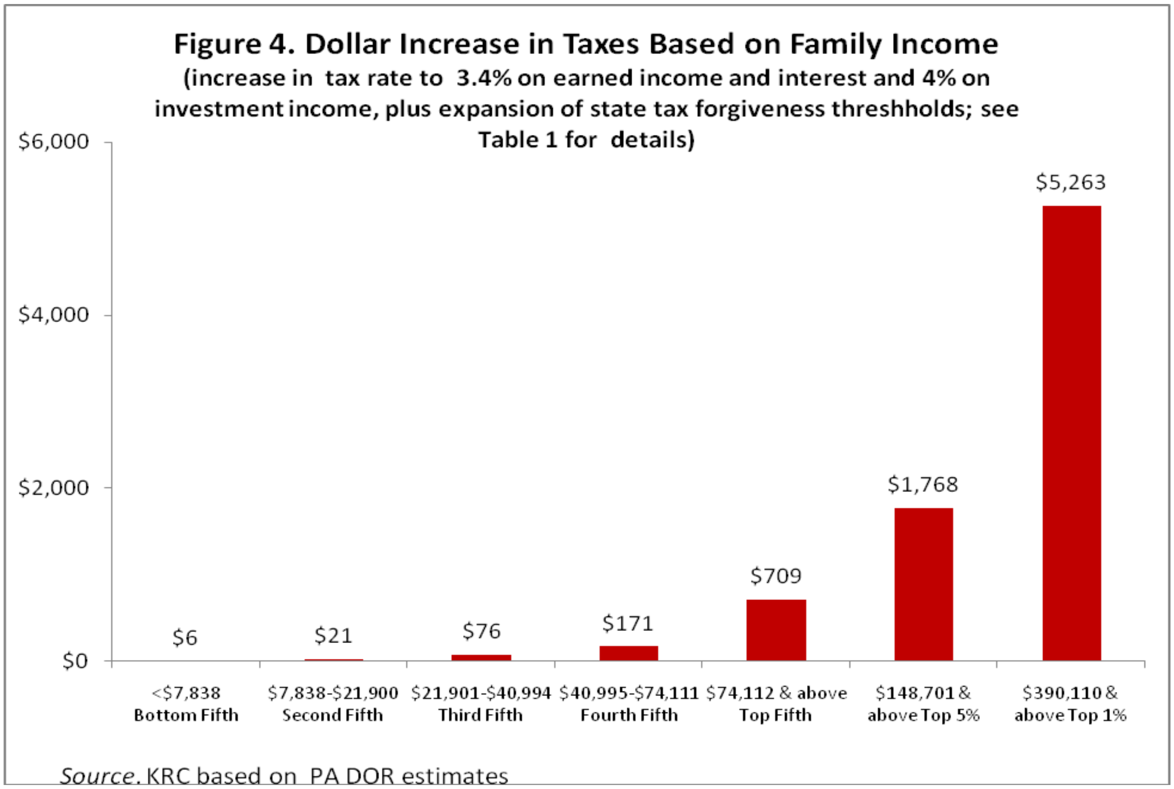
Figure 5 shows the share of the increase in taxes that would be paid by different income groups. A total of about 28% of the increase would be paid by families earning less than $74,000. Families earning more than $148,000 would pay 45% of the increase.

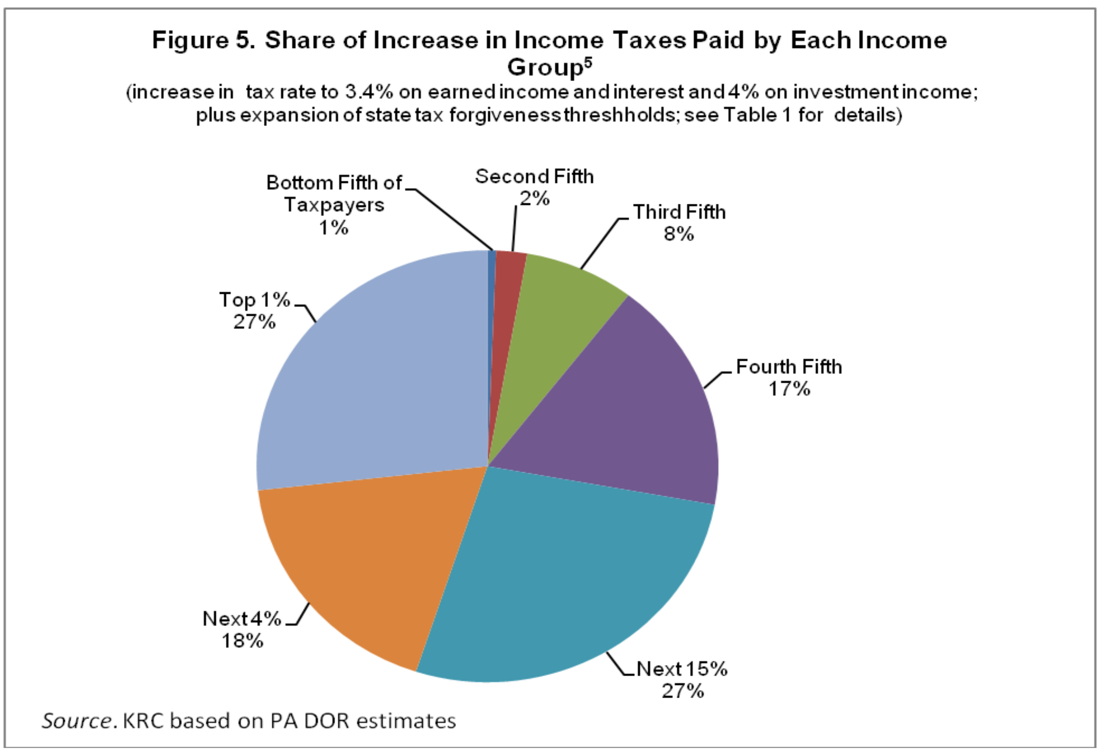
TABLE 2. IMPACT ON TAX RATES BY INCOME OF THREE CHANGES TO THE STATE'S INCOME TAX

(increase in tax rate on earned income and interest to 3.4%; increase in tax rate on other income to 4%; increase in income tax forgiveness thresholds to $7,167 for adults and $10,167 for dependents)

Percentile	Income Range	$ Increase in Taxes	Effective Tax Rate Current Law	Effective Tax Rate Proposed Law	Tax Rate Change
Bottom Fifth	<$7,838	$6	1.42%	1.57%	0.15%
Second Fifth	$7,838-$21,900	$21	2.27%	2.45%	0.18%
Third Fifth	$21,901-$40,994	$76	2.77%	3.05%	0.28%
Fourth Fifth	$40,995-$74,111	$171	3.01%	3.35%	0.34%
Top Fifth	$74,112 & above	$709	3.07%	3.52%	0.45%
	TOTAL	$197	2.96%	3.35%	0.39%
TOP 5%	$148,701 & above	$1,768	3.07%	3.58%	0.51%
TOP 1%	$390,110 & above	$5,263	3.07%	3.66%	0.59%

Source. Keystone Research Center (KRC) based on Pennsylvania Department of Revenue estimates





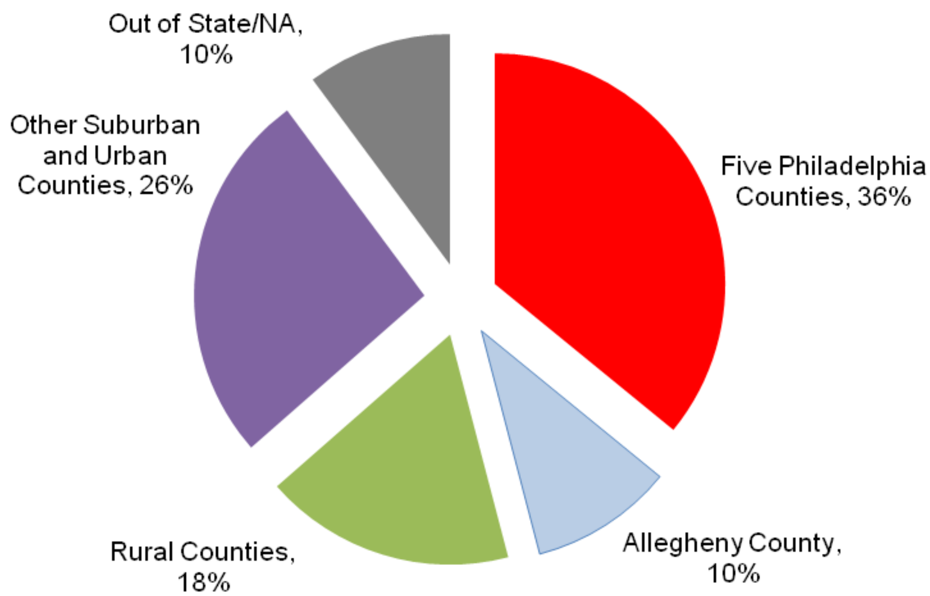
[5] Income fifth ranges omitted for clarity in Figure 5. Income groupings are as follows: Bottom Fifth (less than $7,838), Second Fifth ($7,838 to $21,900), Third Fifth ($21,901 to $40,994), Forth Fifth ($40,995 to $74,111), Next 15% ($74,112 to $148,700), Next 4% ($148,701 to $390,109), an Top 1% ($390,110 and above).

The Impact of the Proposed Changes by County

The greatest share of the increased revenue under this proposal would come from the five-county Philadelphia region. Figure 6 considers the combined impact of our tax changes by region. The Philadelphia region pays 36% of the increase while Allegheny County pays 10%, reflecting the fact that it includes both the city itself and some affluent suburbs. The 48 counties of rural Pennsylvania, which account for 28% of the state's population, would pay 18% of the tax increase.[6]

Increasing revenue by raising the state's sales tax would require rural and lower-income urban communities to pay a larger share of the revenue increase. Similarly, if the state does not raise revenue but cuts spending on education and services, leading to local property tax hikes, those increases would fall more heavily on lower-income rural and urban areas than would our proposed income tax changes.

Figure 6. Share of Revenue Increase by County Group



Note. Rural counties are the 48 designated as rural by the Center for Rural Pennsylvania. The "other suburban and urban counties" group consists of those counties that are not in the rural, Philadelphia, and Allegheny groups.
Source. KRC based on PA DOR estimates

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CONCLUSION

Despite Pennsylvania's constitutional uniformity clause, the analysis above shows that it is possible to enact changes to Pennsylvania's personal income tax that will allow the state to collect a large part of the increased revenue from people and places that have a greater ability to pay. The options of raising income tax rates higher on investment income and increasing the state's income-tax forgiveness thresholds enable tax increases targeting more affluent taxpayers.

In addition to tax fairness, a targeted income tax increase represents the best way to achieve a state budget agreement without worsening the state's job loss during this recession.

One reason for this is that, unlike with higher sales taxes, higher state income taxes lower federal income taxes for those Pennsylvania taxpayers who itemize deductions on their federal tax form. On average, 20 cents of every dollar paid by Pennsylvanians in higher income taxes comes back to the state in the form of lower federal income taxes. As a result, the state gets a dollar in increased revenue to spend, while Pennsylvania taxpayers only lose 80 cents in after-tax income.

A second reason that targeted tax increases minimize job loss is that more affluent taxpayers consume less of their income. Moreover, investment income is particularly likely to be saved—because investors are concerned currently about the lack of consumer demand.

In sum, maintaining state spending through an income tax increase targeted at higher-income taxpayers and at investment income boosts the economy substantially compared to either cutting spending and not increasing taxes or raising revenue with a sales tax.

While the state's uniformity clause permits the three PIT changes analyzed here, it does constrain lawmakers' ability to give more middle-income families (those above the income-tax forgiveness threshold) a break on their income tax. Simultaneously, it restricts lawmakers' ability to shift state taxes away from lower-income rural regions and urban neighborhoods. Indeed, even with the changes proposed here, the state's overall state and local tax system would remain highly regressive *overall* because middle- and lower-income families pay a much higher fraction of their income in state sales and local property taxes than do upper-income families.

To gain further flexibility to target income tax increases to those with a greater ability to pay, the state needs to repeal the uniformity clause. Repeal is overdue in an era in which inequalities in income and wealth have grown to levels of the 1920s.

Lawmakers could take the first step towards eliminating the uniformity clause by linking the proposed tax changes outlined here to a commitment to eliminate those tax changes as soon as the uniformity clause is repealed. If the legislature itself approves elimination of the uniformity clause in this legislative session and the beginning of the next, repeal is possible through a voter referendum held in the spring 2011 primary.