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Tax Foundation Testimony on the Impacts of the Governor's Budget Plan

February 24, 2021

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Chairman Causer and Members of the Committee:

Thank you for the opportunity to testify before you today regarding the revenue proposals in the governor's budget and their impact on working class Pennsylvanians. State tax revenues only declined 1 percent in 2020, but the governor's budget proposes a tax increase of more than $6 billion, which would increase income tax collections by more than a third. These tax increases are not in response to needs arising from the pandemic; they are intended to provide funding for new spending priorities identified in the governor's budget. My focus is on tax policy, so I defer to this body, and to the governor, on any debate about these proposed expenditures. I do, however, appreciate the opportunity to speak with you about the tax implications.

Pennsylvania's flat-rate personal income tax currently has the second lowest top—or in this case, only—rate of any individual income tax in the country, trailing only North Dakota, which has a single 2.9 percent rate. The low, flat rate—flat not only because it lacks a graduated rate schedule, but also because it applies to a broad base of income—is highly competitive and a genuine selling point for the Commonwealth, in contrast to its unusually high and poorly structured corporate net income tax, with a 9.99 percent rate. At first glance, a proposed increase to a 4.49 percent individual income tax, while certainly large in percentage terms, still seems modest. It is, after all, a lower-than-average state rate, and lower than the state rate in any neighboring jurisdiction. Ohio comes the closest with a top rate of 4.797 percent.

This, however, is misleading, for two reasons. First, Pennsylvania's income tax applies to a broader definition of income than is found in any other state, and has a design quirk, unique to the Commonwealth, that allows taxpayers to be taxed on more income than they actually netted in a year. And two, Pennsylvania is highly atypical in the heavy local government reliance on earned income taxes, which are imposed by municipalities and school boards alike. Because neighboring Ohio and Maryland also have local income taxes, it is easy to think that this is typical, but in fact, Pennsylvania alone accounts for 60 percent of all local income taxes in the country, and Ohio is responsible for another 17 percent. Pennsylvania's local income tax rates, moreover, are high—very high. Philadelphia's rate is higher than the current state rate. It is higher than New York City's rate, barely. It is the highest local income tax rate in the country, and if you added it to the governor's proposed state income tax rate of 4.49 percent, the result is the highest flat-rate subnational income tax in the country at 8.37 percent. It's not even particularly close: right now, the highest such rate is in Detroit, at 6.65 percent.

These rates would be offset for many taxpayers by a dramatic increase in the poverty credit, taking it far beyond its stated objective of addressing poverty and turning it into the mechanism for creating a backdoor graduated income tax, something forbidden by Pennsylvania's constitution. But these offsets would not be of much comfort to small businesses in the Commonwealth, who employ nearly half of all Pennsylvanians. A dramatic tax increase on small businesses is a risky bet as employers continue to struggle with the effects of the pandemic.

The governor's proposal would also reduce the state's anomalously high corporate income tax rate, long a bipartisan priority, paid for by the adoption of combined reporting. Curiously, however, while the rate would ultimately be scheduled to decline from 9.99 to 5.99 percent, the initial rate cut is only to 8.99 percent, even though the pay-for is fully implemented at that time. If the proposal is to trade combined reporting for a more competitive rate, why fully implement combined reporting in 2022 but wait until 2026 to implement the promised rate reduction?

Taken together, these income tax changes would increase revenue by an estimated $3.17 billion in Fiscal Year 2022, which only represents six months of adjusted rates. In calendar year 2022, therefore, personal income tax collections would rise a projected $5.92 billion while corporate income tax receipts would rise by $395 million, a combined $6.32 billion a year tax increase that would represent a 33 percent increase in total income tax collections.

Pennsylvania's constitution requires that taxes be imposed uniformly, which prohibits the state from adopting a graduated-rate income tax and has been understood to preclude such provisions as a standard deduction. However, policymakers have been able to get away with modest adjustments, including, for decades, a poverty credit designed to reduce or eliminate liability for the lowest income taxpayers. Currently, an unmarried taxpayer has no liability if their income is lower than $6,500, and the benefit of the credit phases out by the time they reach $9,000 in income. For married taxpayers, the full benefit is available through $13,000 in income, with an additional $9,500 allowance for each child.

A married family with two children, therefore, currently has no liability in Pennsylvania if their income is below $32,000, though the benefit quickly phases out, and they get no benefit of it at all above $34,250 in income. The credit works by offsetting a certain percentage of tax liability: 100 percent under the threshold, reduced by 10 percent for every $250 in additional income. For a single filer, therefore, 100 percent of tax liability is abated at $6,500 in taxable income, then 90 percent at $6,750, and 50 percent at $7,750, down to 10 percent at $8,750, before the benefit is eliminated at $9,000.

Under Governor Wolf's proposal, the fully excluded amounts would rise to $15,000 for single filers and $30,000 for married couples, plus $10,000 per dependent. Even more significantly, however, instead of the credit's value declining by 10 percent for every $250, it would only decline by 1 percent for every $500 in additional income. Previously, a married couple with two children would see the credit go from fully available at or under $32,000 to fully phased out at $34,250. Under the budget proposal, that same couple would see the benefit phase out between $50,000 and $100,000 of income, with a family of four entitled to fill out paperwork claiming a poverty credit with as much as $99,999 in taxable income. This certainly violates the spirit, and quite possibly the letter, of the uniformity clause in the Commonwealth's constitution.

Even though Pennsylvania's individual income tax is low at 3.07 percent, and would remain low at 4.49 percent, the Commonwealth is unique in establishing eight classes of income and not allowing taxpayers to apply losses in one class against gains in another, or to carry losses from one spouse to another on a joint return. Imagine, for instance, that a Pennsylvania resident quits her job to open her own business. Before she quits, she has earned $80,000 in taxable wages that year, but her new business is not profitable yet, and she posts $20,000 in losses. In any other states, the $20,000 in business losses would offset the $80,000 in wages, yielding $60,000 in taxable income. In Pennsylvania, taxable income would be $80,000, because the business losses cannot offset losses from compensation. Other classes of income include interest, dividends, and income from the sale of property.

Crucially, the business owner is also prohibited from carrying losses into future years, so not only does that $20,000 business loss not offset wages in the current year, but it cannot be deducted from business gains in a future year, either. And even in a situation where spouses had offsetting gains and losses in the same income class, and the couple files jointly, these gains and losses cannot offset.

The rate, therefore, may seem low—but Pennsylvania's anomalous income tax structure creates a base that is potentially much broader than actual net income. To this, Governor Wolf proposes a 46 percent rate increase, from 3.07 to 4.49 percent. This would undermine regional competitiveness, with the average effective rate on income in the state exceeding neighboring Ohio's, and the impact on small businesses in particular could be substantial.

And as I mentioned, Pennsylvania has more local income taxes than the rest of the country combined. Local income taxes in Pennsylvania are only imposed on earned income, but the average effective rate on that income is 1.76 percent, bringing the average combined rate to 6.25 percent under the governor's proposal. Earned income taxes can be imposed by both municipal governments and school districts, though in most cases, they have a combined cap, and there may be sharing requirements within that cap. Pennsylvania's average rate would be higher than combined state-local flat rate income tax rates in all but four municipalities nationwide, led by Detroit.

In Philadelphia, a rate of 3.8809 percent would yield an 8.37 percent flat income tax rate, a higher flat income tax rate than currently exists anywhere in the country. In Chester and Reading, the rates would reach 8.24 and 8.09 percent, respectively, while Scranton's combined rate would be 7.89 percent. Pittsburgh's flat rate would be 7.49 percent. Each of these is higher than any combined state and local flat-rate tax rate anywhere in the country at present. Very few places would be spared; while it seems almost reasonable compared to rates in Philadelphia, Pittsburgh, or certain other cities, those living in, say, Allentown might find it getting hard to stay at a flat rate of 6.47 percent, nearly matching Detroit rates.

With the Commonwealth's finances largely in order, such rates may prove hard to justify. For Pennsylvania's small businesses, still struggling due to the pandemic, they could be devastating.

Meanwhile, the governor's proposal fails to tackle major issues in the tax code, like the Commonwealth's extremely stingy treatment of net operating losses, which are capped at 40 percent of liability in any given year. No other state is below 80 percent. This is highly uncompetitive in any year, especially given the Commonwealth's extremely high corporate rate, but will be particularly economically harmful as we emerge from the pandemic with businesses having taken considerable losses. The long phase-down of the corporate rate, moreover, long after the pay-for has been adopted, gives rise to fears that the rate cuts may never reach their target, while the pay-for remains in place. Pennsylvania could have an unusually high rate *and* combined reporting *and* some of the nation's worst treatment of net operating losses.

The governor's budget touts tax cuts for some working families under the proposal, and that's true enough due to the dramatic expansion of the poverty credit, assuming it withstands legal scrutiny. But middle class families getting access to a poverty relief tax credit is a poor trade for policies which would significantly increase the cost of doing business, particularly for the state's small businesses. Once the pandemic is in the rearview mirror, job creation will be the order of the day. A $6 billion tax increase certainly won't help.

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