COMMONWEALTH OF PENNSYLVANIA
HOUSE OF REPRESENTATIVES

APPROPRIATIONS COMMITTEE
FISCAL POLICY SUBCOMMITTEE
PUBLIC HEARING

STATE CAPITOL
HARRISBURG, PA

MAIN CAPITOL BUILDING
ROOM 140, MAJORITY CAUCUS ROOM

THURSDAY, JANUARY 18, 2018
9:10 A.M.

PRESENTATION ON
PENNSYLVANIA'S TAX STRUCTURE, CLIMATE, AND COMPETITIVENESS;
AND THE IMPACT OF FEDERAL TAX LAW CHANGES

BEFORE:
HONORABLE WARREN KAMPF, MAJORITY SUBCOMMITTEE CHAIRMAN
HONORABLE FRED KELLER
HONORABLE JASON ORTITAY
HONORABLE JAMES R. SANTORA
HONORABLE STAN SAYLOR, MAJORITY COMMITTEE CHAIRMAN
HONORABLE PETER SCHWEYER, DEMOCRATIC SUBCOMMITTEE CHAIRMAN
HONORABLE MADELEINE DEAN
HONORABLE JOSEPH F. MARKOSEK, DEMOCRATIC COMMITTEE CHAIRMAN

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ALSO PRESENT:

REPRESENTATIVE GEORGE DUNBAR
REPRESENTATIVE SUSAN C. HELM
REPRESENTATIVE MICHAEL PEIFER
REPRESENTATIVE STEPHEN KINSEY

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SUBMITTED WRITTEN TESTIMONY

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P R O C E E D I N G S

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MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. We'll get started. Good morning. My name's Warren Kampf. I'm the Majority Chairman of the Fiscal Policy Subcommittee of the Appropriations Committee of the House. And my counterpart, Representative Schweyer, is the Minority Chair. And we have several Members of our Committee, plus some other Members of the General Assembly here as well.

Just a couple of quick comments before I turn it over to Pete if he'd like to make some comments and then to have the three of you testify. So the Fiscal Policy Subcommittee in my mind is really just about fiscal policy. And, you know, my layman's understanding of that is it's essentially tax and spending policies that could impact the economy of a State or a country. I might be wrong about that, but that's what I think the definition of the term is.

This is our first hearing in this session. You know, we went through a lengthy budget process, but we're here between that ending and the next budget process about to begin, so it makes sense to hold a hearing.

The purpose of this hearing -- and I think there will be others -- is to examine, first off, just what our fiscal policy is, what our tax structure is, and that'll educate the Members so that if you all recommend some things we might do or might not do, we can digest those and perhaps make some proposals going forward.

So with that as an introduction, we are being recorded here just as a reminder to everybody. Pete, I don't know if you have anything you'd like to say?

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: Yes. Thank you, Mr. Chairman.

Good morning, everyone. As I said to the Chairman earlier, I apologize for being a minute or two late. I got caught up in traffic. That traffic was for a very unfortunate incident and very tragic incident. There were apparently two Harrisburg police officers from early reports who were injured and perhaps shot, according to the Dauphin County D.A., over on the eastern part of the city, and so I'm sure I stand with all my colleagues in thinking about them and their families and hoping the very best for them and for a resolution to the criminal activity that preceded that. And so I, you know, just want to make sure that we acknowledge that there was a pretty tragic incident here in Harrisburg just I guess a few hours ago.

So with that, more to the point, Chairman, I think it's fair to say that you and I agree on the overall concept of what we should be moving towards in terms of examining our tax policies in the Commonwealth of

Pennsylvania. I think, you know, you allude to the fact that we've had one bruising budget. Well, my first budget as a Member was the 2015 budget, which of course was completed in 2016, so perhaps it's all my fault as the rookie. But, like you, I'm always interested in hearing ideas about ways that we can fund our government more effectively. Hopefully, we can find ways that are in a manner that is less reliant on one-time funding, that is less reliant on borrowing from things like the tobacco fund or possibly monetizing the State liquor funds. And so we're all ears, and the House Democrats are willing to listen to experts in the field from across the Commonwealth and see if there's a way that we can do things better.

Thank you, Mr. Chairman.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay, Pete. Thank you. All right. So as the Members can see, we have three individuals who are going to testify, Jared Walczak, who's a Senior Policy Analyst at the Tax Foundation; Pavel Yakovlev, who's Associate Professor Economics at Duquesne; and Robert Strauss, who's a Professor of Economics and Public Policy at Carnegie Mellon. We'll go in that order. And my plan is to have each of you talk to us for, you know, about 10 or 15 minutes, and then after that, we'll open up for questions from the Members.

So with that, Jared, tell us a little bit about yourself and what you came here to say.

MR. WALCZAK: Thank you, Chairman Kampf, Chairman Schweyer. Thank you for the opportunity to testify here today to speak about some challenges and opportunities for Pennsylvania as you review the State's tax code. Of course, this is something that has been discussed here in the State for years, and there are some difficult challenges that the State has faced while addressing these things. But it's a privilege to be able to provide a quick review.

I am with the Tax Foundation. We're a nonpartisan, nonprofit research organization devoted to tax policy based out of Washington, D.C., but we work with State Legislatures across the country to help them identify opportunities to make their tax codes simpler, more neutral, more transparent, and more pro-growth.

I always enjoy coming back here because I am a native Pennsylvanian. I grew up in Butler County. It's always good to be back here. And it's actually good to be somewhere warm because I just came from Wisconsin, so it feels really warm here today, and I appreciate that.

My goal this morning, as I understand it, is in some ways a broad overview to just go through a number of the areas where there could be room for improvement in the tax code and, you know, maybe bring up some things that you've heard a dozen times before, maybe a few that haven't been discussed as much, but to give you the lay of the land as we see it. And then there are some distinguished gentlemen here who I think have some more detailed recommendations that they have put together, but I of course am happy to take any questions or go into further detail about the points that I raise.

I think any conversation about Pennsylvania's tax code probably begins with the corporate net income tax simply because that 9.99 percent rate is the second-highest rate in the country after Iowa, but there's a big asterisk there because Iowa has something called Federal deductibility, meaning that you actually get to deduct the amount you pay in Federal taxes from your definition of income when you pay that tax, which realistically brings it down to an effective rate that is lower than Pennsylvania. This is not a great policy. I don't recommend what Iowa is doing, but it does in fact mean that Pennsylvania's rate is functionally the highest in the country. And that of course has been an issue for years and I think something that has been recognized on a bipartisan basis as a challenge the State faces.

Of course, the solutions are often more difficult. Part of that is because Pennsylvania gets much more revenue from its corporate income tax than the average State. It's still a relatively small share of State revenue, but in many cases the corporate income tax is now bringing 2 or 3 percent in to the budget, and it's often just a few hundred million dollars in some States, so solutions to rates are sometimes much easier. Pennsylvania does rely more heavily on the corporate income tax, and of course then this is a good thing, but the franchise tax has been phased out. That took quite some time, but I think that has pushed more reliance on the corporate income tax.

The move some years ago to single sales factor was intended at least in part to reduce the burden on businesses located in Pennsylvania because to the degree that they're selling outside of the State, especially your manufacturing industry, they're not being taxed on that. And that certainly does have the effect of reducing burdens, especially for your manufacturing interests and some of the larger firms. But you have a lot of C corporations that aren't able to take advantage of that, and some of them are facing the brunt of that 9.99 rate.

Now, a lot of States I want to start out by saying, well, you can pay down this rate reduction by looking at tax credits. And to a modest degree, that's true here. But to the State's credit, there aren't as many corporate tax credits in the code here as there are in other States. I took a look at some of the numbers last night. Keystone Opportunity Zones are about $79 million a year, Innovation Zones are $15 million a year; the research and development credit costs about $55 million; the entertainment production credits sets the Commonwealth back about $65 million. These aren't a drop in the bucket, but they are relatively modest. They're less than 10 percent of the collections within the corporate income tax.

Now, it's still worth reviewing these things. Some of them probably are not bringing that much activity to the State, and some of them are shuffling it around. Sometimes, it's a legitimate purpose. The Opportunity Zones to some degree are about regional economic development, not necessary State product, and they may be more successful on that measure, but they're probably not actually increasing gross State product very much. And generally speaking, a more neutral tax code that doesn't pick winners and losers is the best way to incentivize economic activity, not these credits. So they're certainly something to look at, but I will be the first to acknowledge that while in some States you could make rate reductions of several points just by eliminating targeted incentives, there's not that much here because in some ways Pennsylvania is closer to where you want to be on credits by having a relatively limited number.

The other approach is of course looking for pay-fors elsewhere. Back in 2015, both Governor Wolf and separately in a very different proposal, some House Republicans had looked at sales tax base broadening. And this of course gets into very controversial territory because, typically, as with most States, Pennsylvania does not tax most of the service sector. And this is in some ways a historic accident. When sales taxes were first imposed in this country -- they began roughly in the Great Depression era -- it was simpler to just look at goods. There weren't that many services being sold, and they were hard to track. So the first State to do it, Mississippi, just did goods and most States simply followed in that path.

There's not really an economic reason why we don't tax services, but now this has become the shibboleth where there's not often a lot of appetite to do so, but there is a lot of revenue there. And if there was a desire to have more neutral tax code but there's no reason why you should be singling out services for a particularly special treatment, you could do a lot with your tax code, not just lowering the corporate rate -- you could easily do that -- but lowering the sales tax rate and having a more equitable sales tax because when we think about the sales tax, one of the first things you often here is that it's regressive.

And the biggest reason that that's true is because it predominantly falls on goods.

Now, Pennsylvania, like a lot of States, the Commonwealth exempts certain necessities so, you know, groceries and things like this. But still, it falls predominantly on goods. And if you think about consumption of goods as a percentage of income, consumption of services as a percentage of income, services tend to be consumed much more by higher-income individuals, and that is currently being exempted for no good reason.

Now, when you think about the taxation of businesses being relatively high, now you're thinking about services the people are consuming from those businesses not being taxed, there's a way perhaps to massage and address these two issues in tandem. The goal would be to tax only final consumer transactions, not business inputs because you want to avoid pyramiding where the same tax is imposed multiple times across the production process, whether that be the production of goods or services. But there's no reason why more transactions shouldn't be taxed. I recognize that is often a very hot-button issue, but Pennsylvania took a pretty good look at that in 2015, and I do think that that should still be on the table. The Governor has also proposed combined reporting or severances taxes, other ways of reducing the corporate rate, which have also met with significant resistance.

I would only note on the severance tax, Pennsylvania is unique as a resource State in not having one, but the State does have the environmental impact fee, which operates very similarly to a severance tax, so of course when severance taxes have been considered, it's very important to know that there already is something and you may not want to double -- whether you shift or whether you keep the current system, you know, you do have something that is operating in many ways like a severance tax.

Net operating losses have been a point of consideration in the last year due to litigation based on the uniformity clause. Ideally, a long-term goal would be to conform to Federal treatment, which has changed under the new law. It's now 80 percent a tax liability is the most that you can apply, but it carries forward indefinitely, either applying Federal law or creating a State-specific system that doesn't limit the amount of losses that can be carried forward.

The limitations that Pennsylvania has now are fine for many businesses that don't rely on them regularly, but some businesses with pro-cyclical, you know, business cycles that don't follow a calendar year can be hit very hard because they may have significant losses in one year, significant gains in another year, and they're not able to, you know, smooth those out in the way that ideally you would want to. We choose a year for tax purposes because we have to choose some period. It makes perfect sense. But of course businesses don't actually operate, you know, within a calendar year. You know, business income is over the long term, and, ideally, net operating losses are supposed to smooth this out to ensure that there isn't overpayment or that some industries that have these longer business cycles aren't adversely affected.

Pennsylvania's NOLs are some of the most restrictive in the country. There's only one other State I think that has anything near this restrictive of an NOL treatment, and I think that is something that does have to be addressed even beyond what the litigation has required.

Pennsylvania finally also decouples on the corporate income tax from Federal expensing provisions meaning that while businesses can deduct the full cost of labor and many of their other expenses, they cannot deduct the costs of capital investment in the first year. They can do it across the depreciation cycle, you know, over the asset life. At the Federal level, since 2002, there has been what was called bonus depreciation. It's a terribly unnecessarily confusing name for basically accelerating depreciation of machinery and equipment. Pennsylvania did not conform to that. Now, that's in some ways a pattern.

Pennsylvania has a very different tax code that conforms less to the Federal code than almost any other State, but Pennsylvania did not conform to bonus depreciation and therefore will also not conform to the full expensing for machinery and equipment that is being offered under the new Federal tax law.

As we analyze the tax law, there are elements that are very pro-growth. There are some elements that probably are a drag on growth. But the full expensing provision is, I think, the most pro-growth element of the provision. It is what encourages businesses not just to take their tax cut and run with it but to actually reinvest it in the economy, expanding their business. And you want that to happen here in Pennsylvania, too. Pennsylvania does not conform on that provision. That is something I think worth looking at.

The personal income tax is a bright spot in Pennsylvania's tax structure, low flat rate. It has a broad base to go along with that, again, not conforming with the Federal system, so no standard deduction, no personal exemption, none of the normal features that you often see. Pennsylvania does conform to a few miscellaneous provisions, some of the deductions that are available, but not to a great degree.

But what is unique here and perhaps surprising given the relatively strict uniformity clause jurisprudence in the State is the five different classes of income and the fact that you report these separately and they cannot be carried against each other. So if you have a loss on one class of income, say, your capital gains or business income, you cannot carry that against other income. So if you have wage income, if you have business income, if you have capital gains income -- you have five different classes of income -- you can't take a loss against any other category. It's capped within each. Pennsylvania is the only State that does this. These classes of income do not exist anywhere else. There are a few other States that have special treatment of capital gains income, but that's the extent of it.

And I'm actually to some degree surprised that this works under a uniformity clause as strict as Pennsylvania's, but certainly it is inequitable for certain classes of taxpayers who are seeing something very different than the advertised low rate. So that is something anomalous worth addressing.

You know, every time I talk to Pennsylvania legislators, I always get questions about the property tax even though that's a local issue, but there are some State things that can be done, so I want to address that. At times, there have been proposals to increase the State share of public education funding or provide offsets or credits or different ways to try to reduce local property tax burdens. The problem with these shifts is that usually there's a lot of flexibility for localities to actually potentially raise rates again or, you know, actually raise them further to offset the relief that the State Government is providing. There are some perverse incentives that in other States have often meant that intended relief doesn't actually materialize, and people don't in the long term get lower property tax burdens, though the State suddenly has new obligations.

But there are some things that the State can do to improve the property tax structure. For instance, Pennsylvania does not have one property tax but three. Of course, you know, there's collections by the county, municipality, and school districts. Generally, frequently, each of those impose their own millage, but usually, they're collected all at once. And often, there's unified control. Now, I'm not suggesting Pennsylvania completely overhaul how it does municipal government, but three separate bills sometimes on different schedules and of course definitely in different schedules across different counties creates confusion, especially for those who own property in multiple counties. They're paying seemingly property taxes constantly. It's I think a needless effort.

It also means spending priorities don't compete within a single budget.

In addition to these overlapping property tax authority, there's a unique lack of mandatory assessments. And all of you know this. But, you know, I grew up in Butler County. If I recall correctly, the last assessment there was in 1968. That was a long time ago. A lot of things have changed in Butler County. It doesn't make a whole lot of sense that the assessment that they're operating under is still from 1968.

Now, occasionally, we've seen, you know, court-mandated reassessments. On a handful of occasions, counties have just gone forward with it. But there is a patchwork here, and that can be very unfair and it can have some real like dangerous inequities.

Massachusetts for a long time did not address this, and what they found over time is that in the Boston area minority communities were paying sometimes 10 or 20 times as much in property taxes per the value of their property than some of the old monied, you know, white communities because those had been there for a very long time, and the minority communities were more recent, and they were really getting hit incredibly hard. And I don't think that was Boston's intention, but that's what the tax code did because there hadn't been a reassessment.

I do think that there are some serious inequities that should be addressed, but counties are nervous about doing this. But when I talk to counties, they often say, "We wish the State gave us an assessment window. We wish that there was a schedule, if we could be told we have to reassess every four years, every five years, whatever the case may be, anything would be an improvement on there."

Meanwhile, local governments have a range of what foes call nuisance taxes, and I think the phrase is fairly apt because they don't collect much money, but they can be tedious to comply with. The local services tax, which is an antiquated gross receipts tax, is one of those that's not neutral. It results in tax pyramiding. It imposes compliance costs outsized compared to the revenue that it gains. And because of the local structure here where often you have local tax collectors even at the township level, I've talked to businesses where they say, "We had to call someone up and ask them to fax us the instructions for how the LST operates in our township." And if you work in a lot of places, that's a really tedious way. And sometimes, these are being done on, you know, notepads like legal pads. Some of these taxes, I think there are some issues that are raising very little revenue.

The Commonwealth has made admirable progress in consolidating earned income tax collections at the county level, but there are significant administrative and compliance gains that could be made by even consolidating some of taxes further or at least giving more of an option for municipalities to work with the county or work with surrounding governments on unified collection of some of these very small taxes, especially if you keep the nuisance taxes in place.

I mentioned that the Commonwealth is a bit of a patchwork quilt, and I grew up here and I kind of love that because it's unique. It's nice in some ways, but, you know, eight classes of counties, four classes of cities, two classes of townships, boroughs, unincorporated communities, tax authority is different for each one of them. And then it's of course different whether or not you have home rule, and what home rule is differs according to each class as well. It's not even just one category of home rule. That's probably too much. You know, there's probably room for the Commonwealth to simplify what the tax authority is for localities. And this doesn't mean less; it could mean more. You know, the balance could be whatever this Committee, whatever the Legislature wants but having potentially like 33 different variations on what tax authority can look like in jurisdictions is probably unnecessary. It's not an easy lift, but streamlining that authority might be worth doing.

And I will try to wrap this up in just a moment.

Pennsylvania's unemployment insurance taxes include reserve taxes, taxes for negative balance employers, and an 18-month experience rating. All of this, what it really means is that the taxes fall a little more heavily -- it ratchets up the cost for new firms and struggling firms. And this makes sense to some degree. The new firms haven't proven themselves; we don't know if they have a good record. Struggling firms probably don't have a good record. But what it also means is that firms that are just trying to make payroll are being hit the hardest. And there are sometimes opportunities to allow the system to be a little smoother so that you're collecting more in the good times, that you have the reserves so that in the toughest times businesses aren't being hit with a significantly ratcheted up unemployment insurance tax when they can't pay. Pennsylvania has some features like that but probably few than most.

If there is a desire to pursue tax reform, there are plenty of opportunities to improve the State's tax code and to do so in a revenue-neutral, revenue-negative, or revenue-positive way. With some changes, there's also the possibility of phase-ins or the use of contingent revenue triggers to smooth and facilitate a transition.

Tax structure matters. In particular, neutrality and simplicity matter. To the greatest degree possible, economic decisions should not be influenced by tax policy. Complexity, moreover, produces deadweight losses. It increases cost for job creators without actually increasing State revenue.

For today, I was just asked to provide this overview of areas where Pennsylvania diverges from many of its peers, but I am of course more than happy to field any questions. And my colleagues and I at the Tax Foundation want to be a resource to this Subcommittee, to any of you who have questions going forward.

In the aftermath of Federal tax reform in particular, States are looking to overhaul their tax codes. Some of them are seeing additional revenue due to these changes and they're even more likely to do this. While that happens, Pennsylvania cannot afford to fall further behind. Thank you.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay, Jared. Thank you. I realize putting all you know in 15 minutes is difficult.

Doctor, if you would introduce yourself to us, and the floor is yours.

DR. YAKOVLEV: Thank you, Chairman.

Dear Chairman Kampf and distinguished members of the Appropriations Subcommittee, thank you for accepting my testimony on the features of the Pennsylvania tax system and how it compares to other States in the Nation. My name is Pavel Yakovlev, and I am a Professor of Economics at Duquesne University in Pittsburgh, and I'm also a scholar affiliated with the Mercatus Center at George Mason University.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Professor, could you move your mike a little bit closer to you?

DR. YAKOVLEV: Right. I will.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Thanks.

DR. YAKOVLEV: How about this? Is this better?

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: Yes.

DR. YAKOVLEV: Okay. So my basic message today is very simple. We can improve our tax system in Pennsylvania with just two very basic tweaks to our tax system, okay? And the basic tweaks are these: Number one, widening the tax base. As Jared already mentioned, a wider tax base can tap into previously untaxed sources of revenue providing State with additional revenue that we sometimes need to finance our public services. A wider tax base that includes a variety of services, as well as goods, would also allow us to spread revenues or taxes across a wider segment of our economy, across essentially all sectors and all people, making the tax burden more equally shared across our State.

A wider tax base would also make our revenues more stable over the business cycle because some taxes go up, some taxes go down as the economy grows and slows down. But distributing the tax burden across as many goods as possible and across as many services as possible would effectively diversify us against shocks to any particular sector of the economy, so that would certainly help, right?

And finally, a wider tax base would effectively allow us to do the second tweak to our system, and that is to lower the tax rate without jeopardizing our tax revenue. A wider tax base would allow us to raise more revenues at a lower tax rate. A lower tax rate is very beneficial for our economy because it limits the number of distortions and lowers the burden on businesses and individuals, allowing the State to grow faster, allow us to create more jobs, and at the same time allow us to finance valuable public services.

So only two simple tweaks, wider tax base and lower tax rate would enable us to achieve quite a lot of what we hope to achieve with a sound tax policy, namely more efficiency, more equity, more revenue stability over the business cycle. It sounds almost too good to be true, right? I tell my students, "If you hear a story or somebody is trying to sell you something that sounds too good to be true, it probably is," but in this case, you know, I think the message is pretty on target. With just two minor tweaks, you know, we can accomplish quite a lot, a lot of good objectives for a tax policy that can make our State more prosperous and raise enough revenue in a very efficient fashion.

Now, what are some of the challenges and what are some of the opportunities? Let me start with the bad news. As you probably have read in the news and as you are probably aware, the State of Pennsylvania is facing some fiscal challenges. We have difficulty finding sufficient revenue to finance our spending and to balance our budget. These findings are echoed by a recent study done by the Mercatus Center where the researchers actually ranked every State in the Nation according to their budget solvency, and the numbers are not very good for Pennsylvania. We rank number 45 in budget solvency, near the bottom. States like Massachusetts or New Jersey or Illinois or Maryland, we are in the company or in a group of States that have similar problems to us, and that is finding enough revenue to finance a rather high level of government spending. It's difficult. It's a serious challenge, and I'm sure you're aware of that.

So how do we solve that problem? How do we address those issues? I think a comprehensive solution is necessary. There's just no other way. So a comprehensive solution would look at where we can gain efficiency on the tax side but also look at where we can gain some efficiency on the spending side. So a combination of tax tweaks and spending tweaks are necessary.

I already mentioned the good, simple tax tweaks we can look at in order to make our tax system more efficient, equitable, and resilient over the business cycle. Again, widening the tax base and lowering the rate would accomplish quite a lot for us overall, right? And, specifically, where this really works well, as Jared has already mentioned, is looking at the consumption side of the economy, looking at taxing consumption of goods and services with a very broad-based sales tax or something like that, which will help us to widen the tax base, distribute the burden more equitably, lower the tax rate, and make the State actually a lot more competitive, a lot more efficient in raising revenue.

And we already do that quite a bit in terms of taxing consumption law. We have one of the lower sales tax rates in the Nation, which compares us favorably to other States. At about 6.3 percent on average of the sales tax rate in the State, we do pretty well in comparison to many neighbors. But you can make it better. I think we can lower the rate even more, widen the tax base. We'll probably even raise more revenue with lowering the rate and widening the tax base than we currently do, so we might want to consider taxing previously untapped sources of revenue, which are large, such as, you know, clothing or groceries or many services that currently are untaxed.

And if you're concerned about regressivity of those taxes, I think they can be addressed. We can lower the tax rate on food, you know, below the average so that the burden on the low-income individuals is not as high. We can lower the tax rate on clothing to, you know, a pretty low rate, make sure the burden is not too high but at the same time still tap those sources of revenue, which will be very helpful. So we compare really well across the Nation in terms of our sales tax rate, but again, we can improve that. We can make our tax on consumption, you know, wider, increase the base.

We also compare favorably to other States in terms of our flat income tax. A flat income tax of 3 percent is relatively competitive. You know, it's relatively a decent rate in comparison to many other neighboring States on the East Coast, and that makes us very competitive. And what's more important, the flat rate is very efficient. It doesn't discourage investment in the business or it doesn't encourage income creation as much as a progressive income tax rate, which we don't have. So I think we compare really well in that respect to the other

States.

Where we don't compare very well is a very high corporate income tax rate, which Jared already mentioned, and very high unemployment insurance tax, so these two taxes make it very expensive to do business in Pennsylvania for many firms. And, you know, to be frank, I think when it comes to those two taxes, we kind of stick out like a sore thumb in Pennsylvania because having the highest corporate tax rate of 10 percent essentially in the Nation in terms of flat rates, it's pretty out there, you know, a huge outlier, especially in comparison to States like Iowa, which has the highest corporate tax rate of 12 percent, but it's a graduated rate. So they start at a low rate and eventually they build it up to 12 percent. We immediately start with 10 percent. And again, this is the highest flat rate in the Nation, which I think puts us as a significant disadvantage, competitive disadvantage. When firms look around where they want to start their business or where they want to invest their capital and when they look at, let's say, nearby States like Ohio, West Virginia, they see a much more favorable tax rate.

And I think that echoes what's happening at the Federal level. As you're aware, you know, there have been substantial changes to the tax code made at the Federal level, namely significant reductions in the Federal corporate income tax rate. And we kind of mirror the same problem they have had at the Federal level. The corporate tax rate at the Federal level is one of the highest in the world -- used to be up until recently -- and the Federal Government didn't really raise all that much revenue considering that they taxed corporate profits quite a lot. They didn't really raise all that much revenue as corporations try to, you know, hide their income, try to use inversion and whatever means possible to avoid paying the tax, so the Federal Government actually didn't raise much revenue.

A similar problem in Pennsylvania, having the highest flat rate in the Nation, we actually raise about 7 percent of total tax revenue in terms of corporate income tax according to my calculations. It's about average. When I looked at the average corporate tax revenue, the share of total State income across the Nation, it's about the same amount, yet we have one of the highest corporate taxes in the Nation. So having high tax and relatively, you know, small share of revenue coming from corporate taxes, that just doesn't add up very well. And the reason it doesn't add up is because I think we're just creating a perverse incentive, you know, not to do business in Pennsylvania. We are not encouraging corporations to invest in this economy as much as they would have under a more competitive tax rate. And, you know, that's not helping us.

So I think it is possible to broaden the tax base, similar with corporate taxes, lower the rate, encourage more investment in the economy, and potentially, we might actually raise just as much revenue with a lower corporate income tax rate and at the same time growing our economy faster. I think it would help, you know, virtually everybody.

And we shouldn't forget that a lot of the corporate taxes fall not only on the investors in the corporations but they also fall on consumers in terms of higher prices for the products that they buy, and they also fall on workers in terms of lower wages for the workers who work for those corporations, or sometimes actually no employment whatsoever. You know, as we could probably see in the news recently, just driving here this morning and heard on NPR that Apple decided to bring a lot of cash from abroad and invest it in the United States, and the timing makes me think that maybe it has something to do with the recent decreases in the Federal corporate income tax. So I think there might be something going on there, and you should take a look at our corporate tax rate and consider doing something about it to make our State economy more competitive in the Nation.

So that's where I would put a lot of the focus on in terms of reforming our tax code. Some additional things we might want to consider is to look at maybe using more user fees and charges. One of the benefits of user fees and charges is that they are relatively efficient sources of tax revenue because they work like market prices where people who use certain services pay for them, and they pay in proportion to the usage. And so these sources of revenue tend to have, you know, economic consensus in terms of, you know, being some of the most efficient ways to finance government.

Another source of revenue I would like you to consider is taxing what we call negative externalities, things like pollution, things like carbon emissions. Economists argue that these are some of the best taxes you can have. You know, there is such a thing as a good tax, that would be a tax on carbon emissions or some other forms of pollution and environmental damage because, on the one hand, we would want to incentivize firms to limit their pollutants, limit their emissions of pollutants, and limit their damage to the environment and people's health. And so putting a tax on that would force them to be more cognizant or more aware of the damage they might be causing and give them incentives to undertake or adapt cleaner methods of production.

On the other hand, it would also raise revenues. You know, what's not to like, right? You have revenues and you have, you know, a more sort of healthy economy, right? So when it comes to carbon taxes or taxes on natural resources extraction like natural gas, this is something we might want to consider, you know, structuring a corrective tax in proportion to the amount of emissions or the environmental damage done so that firms have a strong incentive to extract energy in as clean of a way as possible but at the same time still have incentives to do business here in Pennsylvania and benefit our economy.

So in conclusion, to sum it up, two very basic tweaks that we can do to our economy that would benefit a wide distribution of individuals, a wide proportion of individuals and at the same time grow our economy, those two simple tweaks would be using a wider tax base, as wide as possible to include, you know, services as well as all kinds of goods that we sell here in Pennsylvania. And at the same time widening the tax base would allow us to reduce the tax rates, which would make our economy more competitive, more efficient, would give us sufficient revenue to finance valuable public services without slowing down our economic growth, without forcing businesses to leave the State.

You know, it sounds like too good to be true, but

I believe, you know, there is a reason why economists talk about a wide tax base and a low rate in virtually every public finance tax book that I know, because, you know, it works. It's a policy that works. It's a policy that most States should look at, and it's relatively easy to do. And I think Jared mentioned that already several times. It's one of the easiest tweaks to do. You know, what's not to like about it? So I would very much endorse looking at a combination of tax rate decreases and tax base widening, as well as maybe looking at ways where we can gain more efficiency out of our spending, see if we can make the provision of public services more efficient so that the taxpayers get a good deal for their tax payments.

Thank you very much.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. Thank you, Professor.

Professor Strauss, you're on.

DR. STRAUSS: Good morning. Well, while Jenny gets me operational with the overheads, I was sitting here thinking, listening of course, but sitting in front of a dias reminded me of when I broke the news to the Ways and Means Committee in Congress that the Banking Committee had violated their jurisdiction. And I became a hero to a guy named Al Ullman. That was a long time ago. Anyway --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: So, wait, are you saying that you're about to do something similar here?

DR. STRAUSS: Well, you've read my testimony --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Yes, I did.

DR. STRAUSS: -- Mr. Kampf, so --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Go right ahead.

DR. STRAUSS: Yes. So you wanted to know about me, and you've got three documents. You've got a one-pager at the bottom, okay? Now, this you should not lose because it's the official Tax Cuts and Jobs Act of 2017, okay? So that's from -- this is what Congress says they did, and so this will be with you all year. And I'm going to get back to it, but don't lose this; put it aside. Then, you've got the PowerPoints, which are too long. I gave this talk the first day of class yesterday, and I had fun with my students.

And then you've got my written testimony, which is 62 pages, including appendices. It includes stuff I gave in November to another Subcommittee of the House, Eli Evankovich. He gave me five minutes. I think I have 10, maybe 15, but you're more generous. And what I've tried to do in the written remarks, which I really hope you read, is to be very more concrete. And I could be a lot more concrete about what I've heard, but let's get started.

First, let me give you the gist of my remarks. I really think you ought to read. I've given you homework on page 11, and I did that because I know that you are both a tax and spending committee. Most of the appropriations Committees around the country, when things got bad in the '90s, took on substantial tax rolls. So this is really where stuff gets started. It's in the Appropriations Committee.

And I guess if you read my credentials and you ask Miriam because she knows me, I have a lot of former students here, Dan Hassell, who's Secretary of Revenue, was my student; John Raymond, who works for Senator Hughes, so I know a lot of people. You may not me but I know a lot of young people who've been committed to public service, and so I'm here even though you don't know it. Randy Albright, the Executive Assistant, was a public finance student a couple of years ago, so I'm bipartisan. Billy Joraskie works for Senate leadership on the R side.

Okay. So I've been around. I've done a lot of things. I've changed current law. Changing tax law has been in my DNI at the Federal, State, and local level forever, and I've been involved in two commissions here and actually was on a voting one when Jack Stauffer had a heart attack. When Governor Casey had a heart attack, Jack asked me to take his place, and I said, "So what do you want me to do?" And he says, "Do what you think is right." And that's kind of the way I proceed.

So do read -- get to 11. I think you're in a pickle, and I want to give you an intellectual, rhetorical, and political standard by which you judge everything that you hear and consider even today from anybody, which is does it get you closer or farther away from the pickle that Illinois is in? Because that's where you don't want to be. And one of the things that Jenny told me when we talked on the phone was that you folks don't go to NCSL conferences anymore. It's not approved travel. But I think you and your staffs better start talking to people in Illinois because they turned the corner, and I think you need to learn how to turn the corner, okay? That's a big deal. They got the same kind of politics that we have. They've got Chicago; we've got Philadelphia, down State, all that.

The third thing is you may be excited about the Federal changes, but some of the real excitement could be when this one-pager doesn't happen, okay? And Title 3 is really far out there in no-man's land, which is the international stuff. Nobody knows if companies are really going to repatriate and keep doing it, and that has effects on the economy, on the Federal deficit, and maybe on Pennsylvania.

You asked me to opine on a couple of things. Where are we among the States? You've heard some of that, and I'll give you my own views. And then second, what does Federal tax change or reform mean to Pennsylvania? And the answer is in the short run because we're decoupled not much, which means that what you're going to be facing this spring and summer is the budget again and the revenue and expenditure fights that you've been going through, complicated by other kinds of politics. So because you're decoupled, that's a blessing and a curse. It means it's not going to affect you automatically. The expensing provisions that were out there to eliminate depreciation -- Dan issued a January 9th guidance, so depreciation's off the table as far as Department of Revenue is concerned. Whether that's a good thing or a bad thing, you won't take the revenue hit, so you'll just have that part of the corporate base in place.

Okay. So let me try to go through as fast as I can my remarks, and on some occasions I'll tell you where you can find substantiating material in my written remarks. I've told you about myself. I've been at CMU since '79. I have two presidential pins. I play tennis. I do lots of things.

I want to focus for a moment on equation 3, which is what you do every year. And on the left side it says "taxes to levy," and then it says on the right "expenditures," but that's really expenditures you want to spend. And then from that you say, "Well, if we can charge fees or if we can get money from other governments, e.g., the Feds, that's a good thing because then taxes don't have to be as high." And then there's this change in net work item, which is really what you're doing in the bond market and/or selling off assets of Pennsylvania. So the net proceeds of the bond activity are that net worth thing.

Okay. There are in any public finance textbook and in the 1981 Tax Commission Reform Report, the Thornburgh Report that I wrote, six goals, and they are: adequate revenues, simplicity, certainty, economy, equity, and economic neutrality. You've heard about some of these already. We can go into discussion about what they mean, but what I want to bring to your attention is four additional goals that are particularly relevant to State and local governments.

And first is that redistributed spending should be financed by ability to pay or income or broad-based sales taxes, so you don't want to ask poor people to pay taxes to pay for their transfers, right? You want to ask people with incomes above the poverty line when you have a little poverty threshold, right? So if you're going to engage in income redistribution, which you do through spending, then you ought to look at where it's financed. And this is called solving the alignment problem, and that's what I want you to fill out on page 11, your homework.

Second, if the public service is narrow in benefit, you ought to try to price it. You've heard that.

Third, goal 9, which makes you uncomfortable, is that the benefit period of public services should match the financing period. Now, there are a couple of corollaries to that. First of all, if you're going to build a 30-year road, you shouldn't try to pay it off in two years or pay it off in 60 years. Every generation should pay for their own public services. That's called generational equity. And so that's something to ponder and think about if you want to reach for debt finance again this coming year to pay for operations. That's a pyramid scheme. I bailed out New York City a long time ago. It was a very fun game when I was on the Hill. But if you keep pyramiding, you'll do what you did in the 1840s, which you don't remember. You defaulted on your debt, and you issued script. Now, that's in the longer testimony.

So here's a question for you: Can Illinois issue script? And the answer is no. There's only one State in the union that issues script. Who is it? It's California. Why? Because they're rich. Do you think you can issue script if you really get into a pickle? I think not. And let me tell you something else that you may not hear anywhere else. Domestic banks, if they take on your paper and it's deemed to be risky, that affects the risk analysis of their balance sheets by the Board of Governors, okay? So you may be driven to foreign banks if you have a couple more bad years, and they're going to charge you up the kazoo, right, high interest rates, okay? So this business about borrowing for operating purposes is not a good idea.

Spending responsibility should match revenue authority by level of government, and this is a big issue in Pennsylvania because the locals always come and say, "Give us the taxing authority," and you say to your constitutional children, "Well, then, you're just going to tax and spend" or "Come ask us for an intergovernmental transfer." But there are ways to get this right, and I would tell you that in the coming years with the kind of long-term expenditures that are going to come to your doorstep, you're better served by giving local government the right kind of spending authority and the right kind of accounting responsibility and sort of keeps them out of this hearing room, okay?

Now, I have lots of friends in local government, and I know the unions and I know all about intergovernmental relations, which sometime can be described as pandering, but I think in the coming years with the elderly problem I'm going to emphasize you just don't need that kind of headache, okay? So if you can try to get things right and have a clear future, you've got to control the way local government raises and spends money and make it consistent with what our needs are.

Let me tell you about local government in Pennsylvania. I moved here in '79. We are third largest in terms of the number of governments that we have. And you know that public authorities are just rampant, right? Pennsylvania's public authorities raise more local debt -- which means without a vote -- than any other State in the union, okay? Now, what does that mean? Well, we could go on and on and on about what it gets into, but you may want to ask me, but that's not a terrific thing in terms of transparency, which is my last goal.

Now, we have two kinds of problems that I'm going to show you graphs on, and the first one is not going to make you comfortable. I saw this a couple years ago. On the horizontal axis, if you look closely, it's time, okay? Those are years. And it starts about 1971 and then I projected it to 1990. And you know and the public thinks that your budget is subject to a balanced budget requirement, but that in fact is not quite the case under law because only the General Fund is what matters. So I asked myself the question a couple years ago, "What percentage of your total spending" -- think of it as a consolidated annual financial activity of the State of Pennsylvania is measured by the Census Bureau, which does this. So you take the General Fund and you divide it by the CAFR, and what do you get? Well, what you get is about 1972 it was 51 percent, so you were really subjecting yourself to a discipline of balancing the budget for really half of the budget because the CAFR is really what you do, okay?

And then what's happened? Through every recession it's ratcheted down, right? And why is Randy grayer than he was 10 years ago? Because you're down at 30 percent. So you're only balancing the budget in a constitutional sense -- and I know you fight like hell over it, right? But it's only for about 32, 33 percent of the money. So if you said to yourself you want to get financial and fiscal religion and we want everybody to trust us and we want to be financially transparent, then what you would say is, "Well, we're going to balance the budget every year, but the budget is the CAFR. We're going to look at consolidated spending and consolidated revenues so the lottery is in, all the off-budget stuff gets in and we're going to start dealing with ourselves financially the way publicly traded corporations have to for SEC purposes," okay? That's a whole different world.

So if you want to think about how to convince the rest of the country and the bond market Pennsylvania's getting serious, then think through what it is to get up above 50 percent, and then the processes, both informational and political that you're going to have to do. And one of the advantages of this -- and I know that Congress sometimes understands this and you guys and gals know it, too -- is when you constrain yourself to do things because of a different kind of budgeting statute, what you're saying is "Our hands are tied; this is the way it's got to be." And it may get you to talk to each other more.

Now, one of the things I have on page 11 when you do your homework is that I would suggest you try to figure out the allocation of spending and tax responsibilities by level of government in Pennsylvania and how much you want to finance different kinds of services by which taxes. And then talk about it, Republicans among yourselves, Democrats, and what have you. I think it'll be educational. And if you need somebody to lead the discussion, you want to do a retreat, welcome to Carnegie Mellon or I'll come here.

Okay. The second thing I want to tell you about it -- and I'm going to tell you in a somewhat different way than previous folks have -- is that you've got a very narrow tax base in sales and income and in some respects even in the CNI. And in November, Members sort of chuckled when I said to them, "Do you know how much money you're giving up by not taxing retirement income?" And they said, "Well, we can't tax the elderly." But let me talk to you about what's going on demographically. It's in my remarks, the written story. By 2025 compared to 2014 there's going to be a million more people over 65 and a million less people working, okay? And the population is going to be constant, about 12.8 million, okay? That's a demographic tsunami.

Medicaid -- I just saw a Keiser report, and I can email it to you if somebody wants it. Over the last 10 years, Medicare expenditures have gone up about 10.1 percent in Pennsylvania. Now, you know because you look at the tax numbers every year you're not seeing any kind of revenue growth like that, so you'd say to yourself, "Gee, there's a mismatch." Well, what I'm telling you is by 2025, you're going to have to find between $5-7 billion more because you're not taxing public and private retirement income. It's zero. It's a tax expenditure. And the spending on the elderly are going to go up from what I figured out in '13 with the help of House and Senate Budget staff of something like maybe $3-4 billion, it's going to double or more. And when you start seeing the budget projections when you hear Aging come up to you, you're going to say, "Oh, my God."

When I testified in November, one of the Members -- I'm not going to name him or her -- said, "Well, I was on the Aging Committee and, you know, Bob, I read your testimony and that's why I got off. There are no good votes," okay? So I'm just telling you that the demographics of this State, which you can't turn around quickly, are going to create a revenue problem the likes of which you haven't seen. And that's without anything else happening, okay? And that's been part of Illinois' problem, but we're actually older than they are.

Okay. So I've used up a lot of time. I've gotten to my main points. Let me turn to when you start talking about tax reform and changing the tax laws, some of you will say, "Well, let's get rid of the uniformity requirement because that means we can't have progression." Progression is a two-edged sword. When things grow, you get disproportionate increases in revenues, but when things slide, you start having disproportionate reductions in monies, okay?

When I read the history all the way back into the 1800s for my November testimony -- and it's buried in my written remarks -- changing the uniformity clause, which was from the 19th century, failed 12 times, okay? So my advice to you is forget it. Take it off the table. Now, that means you're going to have a proportional tax system that will only grow proportionally with the economy, but I think you're better off over the business cycle with that than trying to say we're going to have a rainy day fund and then make it negative. I mean, you're basically out of reserves, as I understand it, now. So -- and reserves, by the way, should be 10 percent of your operating budget. That's kind of a good number from MFOA. And where are you going to find 10 percent? I mean, even if you look at the General Fund, that's $3 billion, right? And if you believe that I do that your budget is $88 billion, that's $8 billion. Well, you don't have reserves of $8 billion. If you had, you would have been able to adjust things in the last couple of years.

Okay. And the second thing is that I wouldn't let the locals convince you that because we're a Commonwealth you can't tell them what to do. If your staff doesn't know how to draft legislation that will fly constitutionally to tell local governments how to tax and spend, I'll volunteer to help you, okay? If you give them money and say, "If you don't want the money, you don't have to take it," they'll just line up. I did that with revenue-sharing. That's how I got my first presidential pin, okay, from a guy who you may have heard of, Nixon, resurrected.

Okay. The history of the taxes in Pennsylvania in the 19th century was that you wanted to tax business by their balance sheet, and you did. You went from 3 to 5 mills. And then in the 20th century you discovered the income tax in '71. You discovered the corporate net income tax. There's some people in the room who may remember when you got it to 12 percent, which was not a good thing. And you've had a sales tax of 6 percent. The business community convinced you that the capital stock and franchise tax was a bad idea because it's not based on ability to pay, so you said, "Okay. We're going to gid rid of it." And that's the declining line.

Now, I agree with the previous speakers that the CNI rate, at least initially, is too high, but they forgot to mention a few things, and so let me tell you how it really works. If you're a big company and you file under separate accounting, you can plan your way around this by putting things in Delaware and receiving dividends that are 100 percent excluded. This is not rocket science. Undergraduate accountants learn how to do this in any decent business school in Pennsylvania, and I teach it in public finance to my master's students. The real question is who's paying 9.9 percent? And it's the small companies because they can't fool around. They can't afford to. So in my perfect world I think you should consider lowering the CNI because that's the advertised rate and think about base-broadening perhaps in the CNI but also especially in other parts of our tax system.

Let me give you a number that gets Dan Hassell very -- he's your Revenue Secretary, you know, so I call him Dan because he's younger than me. So I added up all the tax expenditures in the budget. I don't know if you've looked at the Governor's budget. You should, but it's there -- it's Section D every year -- and all the tax expenditures are there. And it's in my written remarks. So I did something that nobody has evidently ever done before. I added them up. And you say, "Well, how much are we giving away in the base?" Well, the answer is, compared to the General Fund, which is one denominator over 100 percent.

And you say, "Professor Strauss, what are you talking about?" I'm saying that, you know, when you start excluding income of the elderly, you exclude food, and you go through all of your taxes, you've narrowed your tax base. In the '90s it was the size of the General Fund, $20 billion. Now, it's in the 30s, and the projections are it'll be in the 50s or 60s. So that's another way of saying if you want to keep our rates the way they are and you need to balance the budget and you don't want to start looking hard at expenditures -- and believe me, I know how to look at expenditures, but that's a different hearing. You just start broadening the base. And unlike my colleagues over here, I know what's going to happen. People are going to get mad.

How many of you know David Sweet? He was in the House for a long time. So David's a friend, and I went over to see Speaker Reed some months ago trying to get him to adopt a policy of fixing assessments, and he's got a problem in Indiana County, as you know, a pretty severe one. And then afterwards, David and I had lunch and he said, "Look, Bob, this business of putting elderly retirement income into the base is not something that you just thought up. We did it in '91. It lasted three months. The Gray Panthers came here, rioted, and we repealed it."

That was in the '90s, and so you ask yourself, well, are the politics the same? In some respects they're worse, but also the argument in favor of it is better because I don't think you've got a choice. I mean, if we all are over age 65, then what is your tax base going to be, right? It's going to be retirement income. There won't be any wages. People in their 70s don't work except me.

So you really need to look through your tax expenditure list. Representative Dean was at the earlier hearing in November. She started saying, "You know, I started looking at that when we were fishing around, but there was no appetite to put clothing." Clothing is close to $1 billion. It's progressive. Now, $1 billion on the General Fund, you say, "Hey, wait a second; maybe there's something there." So I hope I've gotten your attention.

Okay. So your problem is to figure out rates and base and what it's going to be in the next couple of years. And the tax expenditure budget in the Governor's budget, Section D, is a place to start. So here's the numbers. Twenty billion, tax expenditures '94, '95; $33 billion in '15, '16; $54.3 billion projected '21, '22. Now, Secretary Hassell -- Dan -- complains to me that you can't -- conceptually, there's some double-counting. But even if the double-counting is 50 percent, would you like to have $10 billion more in '94 or $25 billion more in 2021? Now you're excited. "Hey, we could solve the budget problem. We might even spend something," you know. So the money's there, but those are tough votes, okay?

All right. Let's turn last to what's the Federal law going to do? This is a comparative table. For those of you in the southeast, you know that shopping in Delaware is good, right, because they have zero sales tax. I gave this yesterday, and one of my students, Cheryl, is from

Philly. She says, "Oh, yeah, whenever Mom and Dad would take me when I was in junior high school shopping for clothes for school, we hopped in the car and went over to Delaware." Okay. And so when Philly was told they could go from 6 to 8 percent, what do you think happened to retain sales in Philadelphia? They slowed down, right? They took it in the ear.

Over in the southwest, we have competition. Our taxes are higher on average than Ohio and West Virginia, so we've got to be careful. Now, if you want to compare us to New Jersey and New York, we're a low-tax State. Just look at these per-capita amounts, right? So it all depends who you want to compare yourself to. But it also means that when you go to look for votes, your Members from those parts of the State are going to say, "Hey, wait a second." Okay? So people in the southeast think there's room. Maybe we could go to a CNI of 4 percent -- I mean, a PIT of 4 or 5 percent because look at where New York is, especially if you throw in New York City.

But I would be very careful about saying that we can take another point on the PIT next year. You're better off thinking about tax expenditures because that elderly tsunami is going to hit you, and if you don't go for generational equity, you're going to chase working-age people and their employers out of this State. It's that simple.

All right. So let me just catch up with myself. All right. Let's talk a little bit -- okay. So here's the eight buckets in your PIT. It's not linked to AGI, so the changes that the Feds made, the reforms or the -- you know, they called it tax cuts; they didn't call it reform. I don't know if you noticed. It's the Tax Cuts and Jobs Act of 2017. So the dynamic effects are revenue loss of $1.4 trillion, and there are effects on AGI, but they're not going to affect us because we are decoupled from that. And so before you jump into AGI, you should go to an NCSL meeting and talk to your counterparts who are struggling with how that's going to affect them. I think we're better to be immunized to be unconnected to the Internal Revenue Code right now.

Okay. So that's what we do. We tax capital gains as ordinary income, and there's an intellectual argument for it. I can give you the arguments both ways. It's a final exam question that I give my kids. That's what we do, and it's true that the losses in one can't offset the positives in another. That has the effect of keeping the rate low by the way, right?

And then if you look at the CNI base, I've got arrows where there may be some effects. On line 5 of the CNI, there could be an interest rate deduction effect because the Federal law puts a 30 percent limitation on interest deductions, and that's to stop the leverage that was part of earnings strippings around the world. So if interest deductions are actually capped at the Federal level, because you start at line 28, that'll flow through and you may see a little revenue bump. My advice is that you ask Secretary Hassell to try to get the big returns from the big companies and do some calculations. I don't know if they're doing it or not, but that's a good thing to do.

The other thing is that there may be a dividend bump at the national level on the corporate 1120, but because you exclude dividends received 100 percent, it's not going to affect you at all, okay?

Okay. Then depreciation, line 20, expensing was nullified by a clarification on January 9th by the Department of Revenue. The Federal law also eliminated at the Federal level the deduction for domestic production activity, so that could cause you a little bump, but that stuff is mostly old, and I don't think there's much left in the system.

So the story with respect to the impact of the Tax Cuts and Jobs Act on Pennsylvania's base is holding constant changes in economic behavior probably not very much, okay? So when you start thinking about the budget this spring, you don't have to worry about fooling around with conformity.

Okay. So I wind up where I started in a couple of different ways, but mostly, your problems are budget problems. That is, you've got to find money to convince the capital markets to fund you at reasonable interest rates for capital expenditures. And if you want to do something dramatic that'll be noticed around the country, then think about looking at your CAFR as what you want to balance. And it may be something you say, "Okay. We're going to take that seriously. We can't do it this year, but it's our goal within four years to phase this in." And all of a sudden people will say, "Gee, Pennsylvania's more transparent." And if you go that route, then, oh, by the way, require local governments to follow generally accepted accounting principles. You have no idea what's going on locally and neither do they, okay? It's really -- when I came here in '79, I was amused frankly.

Okay. I'll stop, and we're ready.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. Thank you, Dr. Strauss.

So I think what we'll do at this time is I've got a question or two just to start things off, and then Representative Schweyer, and then I'll turn it over to our side and alternate back and forth if that's okay with everybody.

So just so I'm clear, Dr. Strauss, the term "tax expenditures" I have to say that was the first time I heard it, not an economics major. That is you have various taxes, but there are sectors of the economy or elements that might be subject to the tax, which are not. For example, you said retirement income is not taxed by the PIT, and so that is a tax expenditure.

DR. STRAUSS: Right.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Manufacturing activity to some extent gets --

DR. STRAUSS: Favorable treatment.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: -- under CNI --

DR. STRAUSS: Right.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: -- and so that is a tax expenditure. I just wanted --

DR. STRAUSS: It's --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: -- the Committee to know what that term is.

DR. STRAUSS: Right. It's an exclusion, a deduction, or exemption in any tax base that's not general in impact, and so, you know, it could be for lots of different reasons, okay?

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. But as opposed to Jared had mentioned, you know, tax credits, right? We give a tax credit for --

DR. STRAUSS: Well, that's an expenditure.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: So that is an expenditure.

DR. STRAUSS: Yes, sure.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: But tax credits themselves relatively small in the list of all of the tax expenditures?

DR. STRAUSS: Right. And one of the reasons is you've got the uniformity clause looking over your shoulder, and, you know, the NOL was recently litigated and I don't know if the Supreme Court decided, but they could have severed the whole thing and gotten rid of it. You know, they had two ways to go. And so I'm not raising the issue of whether an NOL is on other grounds a good idea or a bad idea. I can give you arguments both ways, but from a constitutional perspective, it's a non-neutrality, right, because not everybody loses money.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Right.

DR. STRAUSS: And so that's why the -- I actually was -- I was invited to be an expert in the case, and I gave them the theory of the case but decided not to follow through. But anyway, yes --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay.

DR. STRAUSS: -- so that's it.

MR. WALCZAK: And --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Jared, go ahead. I do have a question for the panel, but that was a question of clarification really.

MR. WALCZAK: Okay. Well, I will defer then. I'm sorry.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. So we talked a little bit about -- well, we talked quite a bit about -- or you talked quite a bit about broadening the base in various taxes. So, for example, taxing services, I guess my question is when we do something like that, does that have an impact on the economy, which we need to be concerned about or tax clothing or perhaps broaden the base on the CNI? I guess that's the general question to each of you.

MR. WALCZAK: Mr. Chairman, thank you for the question. And certainly, it does have an impact, but I would encourage you to consider that it has an impact now because we are favoring or preferencing certain economic activities and certain purchases over others. This means of course that, all things being equal, there have to be higher rates and higher levies on the activities that are taxed to make up for the fact that so many things are out of the base.

Now, every single State in the country taxes at least some services. The Federation of Tax Administrators has broken out the possible range of services out there. They have, I believe, 168 categories. You could break it up a different way, but they have 168 possible categories of services the States could tax. And the range goes from -- the States at the lowest end tax 19 of them. The State at the highest end taxes 157. So there's a broad range here. There are three States that tax practically all services, another three or four that tax a pretty significant range of them. And then most States are like Pennsylvania, toward the lower end of taxing relatively few.

Will there be economic impacts? I think that that's undoubtedly the case but in both ways. Yes, you're taxing some services. You're making those more expensive. At the same time you're making a lot of things less expensive that have been disproportionately hit.

And neutrality is an important principle because, as much wisdom as I think there is in any legislature, there is not the ability to actually make all the economic decisions about what your economy should look like. I don't think any legislature wants to do that. And economic decisions should be primarily made by the market. Legislatures step in to achieve certain target goals, and that may be fine, but the goal shouldn't be to decide which industry is the growth sector that you want to, you know, place, you know, all of your chips on. You should probably have a more neutral tax treatment that let's those decisions be made in the market.

Now, with the tax expenditure report, which is very important -- I do encourage everyone to look at that -- but you were assigned some homework. The Tax Foundation doesn't give homework but we love to help with homework, so I would note the double-counting is important. Take, for example, on the sales tax. Let's say you're in a hospital and they give you a prescription drug. Well, that particular transaction is being included on the prescription drug exemption, it's included under the heath care services exemption, and under the nonprofit exemption. It's being counted in all three of them, so just adding up that list, as Professor Strauss mentioned, there's some double-counting. It can be a lot of double-counting. These are all very valuable things to look at, but be aware of that double-counting.

Be aware also that expenditure is any change from the starting point calculation. That doesn't mean a tax preference. It can mean structural changes. So, you know, when, for instance -- well, NOLs were mentioned, but any sort of business deduction. I mean, you obviously don't pay taxes on the amount you give in compensation to employees because that's a net income tax. It's in the name, corporate net income tax. But the line on the Federal code it starts with still has that in there, so of course there is a subtraction out for salaries and wages. I don't think anyone thinks that the corporate net income tax should be taxing salaries and wages, but that's a tax expenditure. That's a good tax expenditure. That's necessary. It's a structural one, same way that business inputs on the sales tax. There's almost universal agreement in the public finance realm that you shouldn't be taxing business inputs, but because the sales tax starts out on every transaction, it's a tax expenditure when you include those.

And I would disagree with Professor Strauss on the net operating -- well, he said he could go either way on whether that is like a policy change or a structural change. The goal is to tax net income, not net income in a given year but net income. And therefore, you know, every single State has net operating losses. The Federal Government has net operating loss treatment because the sense is that there should be equilibrium. It should be on your long-term net gains. That's pretty universally accepted. I mean, I'm sure there's good arguments on the other side, but every single State has operated on the assumption and all of the developed world operates on the assumption that net operating losses are a structural matter.

DR. STRAUSS: All right. Let me give you --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Wait, gentlemen.

DR. STRAUSS: Yes.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: So my question to you was services, expanding the base on CNI, does that have a negative economic impact? That was my question, so if you would --

DR. STRAUSS: Sorry.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: -- address that one, and there'll be other questions, I'm sure.

DR. STRAUSS: Sure. So when you raise a tax on something that wasn't taxed, it's going to cause a behavioral adjustment, okay? And I mentioned already that the people in that line of business, they come here. They want exemption. Why do they want exemption? Because they'll sell more, right? It's just common sense. Why is Amazon rich? Because they were able to arbitrage and not collect sales and use tax. And, you know, the margins in retail are like 2 or 3 percent, and they were arbitraging on sales tax, which are like 5, 6, 7 percent. So it will cause some behavioral reaction.

But what I wanted to say, if you want a shopping list, look on page 44, 45, and 46. I just abstracted from the Governor's budget. You'll see what the items are and you can decide whether there's double-counting or not. And so what you've got is exempting food in the grocery store costs $3.6 billion a year. Okay. So you can say I don't want to tax all of food, and you'll say, "It's because the poor. And I say, "Well, they're on food stamps, and the Federal Government already told you that if you try to tax food stamps, food stamps don't come into your State." You probably didn't know that, right? That's the law. So then you can say, "Well, all right, so maybe we want to tax some of these things more than zero but less than 6 percent." So that's a way to think about it.

So you go down this list, and they're sorted from highest to lowest, and then you can go over from page 44 to 45. You can see what manufacturing gets separately, what Dan thinks it is, and you go at 45 and you can see what it is, retirement income and so forth. And some of these you can say we don't want to touch, and then some of them you'll say, "Well, these are pretty big numbers, you know. Do I want to cut spending or do I want to broaden the base?" Okay. But don't kid yourself. If you broaden the base on services and you include legal services in Philadelphia, what do you think you're going to hear? The lawyers are going to move, right?

So it's not an easy thing to do. I've seen this. But you are not in a favorable position. You have tough choices. That's my point. And I think broadening the base rather than raising the rate is a better economic efficiency argument overall because it's neutral. You're getting to a point where you're not making distinctions among lines of business.

Now, let me give you a number about the sales tax and taxing inputs because if you really want to become popular among the States, 35 percent of our revenue in the sales tax comes from taxing inputs. That's a double-counting number, okay? So if you wanted to have a pure consumption tax, you'd have to find 35 percent of the sales and use tax from somewhere else, okay? An economist, textbooks, everybody will say "We shouldn't tax business inputs," but it's not a small number.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Doctor, you have something to add?

DR. YAKOVLEV: Yes, I'd like to add a couple of small things. One of my favorite quotes in economics is that "There are no perfect solutions, just tradeoffs," okay? So every tax policy will produce the winners and losers. The question we should be looking at on that, you know, do we grow our economy or not? You know, do we have a more efficient tax system or less efficient tax system? I believe that every economist probably would agree that a wider tax base and a lower tax rate is the lesser of two evils. It's a more efficient way of going forward. You just can't beat that. A narrow tax base and a high rate creates a lot of distortions. On that, the effect is worse, so --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: All right.

DR. YAKOVLEV: -- you just can't beat the wider tax base and a lower tax rate.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: All right. Representative Schweyer?

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: Thank you, Chairman.

A couple of specific questions and then a broader point if I could. Jared, if you could, you had mentioned in your testimony that there were classes of income that may be fairer to certain classes. Can you expand upon that a little bit?

MR. WALCZAK: Mr. Chairman, there are different classes of income in Pennsylvania based on different receipts of income, so wage income is treated differently than capital gains income is treated differently than business income or interest income or retirement income and go down the line. So an individual who only has one source of income or has their losses and gains in the same class of income is treated favorably and gets the full advantage of that 3.07 percent rate. A person whose income is split among different sources of income doesn't necessarily get that advantage. You know, so take, for instance, an individual who, you know, has some investment losses in a given year, it's just a bad year in the market, you know, middle class family, they have their wage income, they probably don't have many of the other categories. They're not retired, they don't have a lot of things, but they have some investment losses.

In any other State, you know, you'd be able to take a least some of the capital gains against your ordinary income. In most States, you can take all of it because you treat them the same way. At the Federal Government level, you can only take $3,000 of losses, and then you carry the rest forward. A State, because you treat them the same way, you just deduct the losses. In Pennsylvania, that would be disallowed. If you had only losses in the market, there's nothing to take them against because your wage income is in a completely separate bucket.

This would also be an issue if and when -- two other points -- if retirement income was ever taxed, and it's currently not, so this is not a concern, but your retirement income, which would of course all be in the black, if you have losses in any other area, you would not be able to take it against them. So I think it's especially something to consider if there was ever an expansion into retirement income because now you had a fixed income individuals where losses anywhere else, you know, if they're trying to consolidate some of their investments for instance, it would be treated differently. And then businesses because small businesses do operate through generally the individual income tax because most of them are passed through businesses. They can have losses in one area, gains in another, and if they fall into different buckets, they can't actually use them against each other.

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: Okay. Thank you.

The broader statement I have, and that plays right to it, was something that has been said, which is our tax policy really is supposed to focus on -- or also focuses on a question of who's benefiting based on a tax structure? So right now, in Pennsylvania what we're hearing is senior citizens are benefiting --

MR. WALCZAK: Yes.

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: -- from our tax structure and perhaps corporations that are unable to take advantage of what is affectionately known as the Delaware loophole are the most penalized in our tax code or at least the ones most exposed in our tax code. I don't know that I would necessarily say that is penalized.

So the challenge that we have is how do we make sure that at-risk constituencies -- senior citizens, people on fixed income, people at or near the poverty line -- and I would argue that the poverty line is set arbitrarily low since it doesn't include housing, neither here nor there -- when we're trying to make sure that their particular interests are being taken care of, that at the same time our tax policy has to reflect some of those key goals that we have.

And so when we're looking at broadening the tax base outside of -- the biggest issue of course is could we or should we or shouldn't we tax retirement income, but in addition to that, you're looking at the list that Dr. Strauss provided us on page 44, et al. of different options. So one of the major concerns that we have is, you know, those impacts on I'm not going to say industries but I'm going to say individuals and any of those tax changes, how does it impact those people most at risk.

And then lastly, any of these changes have to at the very least be revenue-neutral, but, quite frankly, I would argue actually have to go the other way without any additional spending. I find it interesting when we were talking about tax credits, things like the EITC aren't brought up, but I'm assuming that things like the educational improvement tax credit is also considered --

MR. WALCZAK: Yes.

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: -- in your testimony even if it wasn't --

MR. WALCZAK: Yes.

DEMOCRATIC SUBCOMMITTEE CHAIRMAN SCHWEYER: -- specifically spelled out. So as we continue to look at tax policy, we are required to keep in mind impacts on individuals, not just sectors of our economy, but the actual individuals that are being impacted on this.

Very interesting stuff, gentlemen. I really appreciate your input on this, and thank you, Mr. Chairman.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Representative Keller?

REPRESENTATIVE KELLER: Thank you, Mr. Chairman, and thank you, gentlemen, for your testimony today.

Just a couple things, and if I get your name wrong, Mr. Walczak, is that correct?

MR. WALCZAK: That's correct.

REPRESENTATIVE KELLER: Okay. Sometimes my Pennsylvania Dutch gets in the middle of how I pronounce things. You mentioned about the categories of services that were not taxed, and you said that Pennsylvania is among one of the States that taxes the fewest. Are there other States that tax in a similar range as Pennsylvania, and how are they doing -- how do they rank as far as their economies in growth?

MR. WALCZAK: Sure. Representative, thank you for the question. The reality is that the distribution -- most States tax relatively few services, and then there are a handful that tax significantly more. So Pennsylvania is with the majority of States in taxing relatively few services. This especially is true in the older line States because they adopted sales taxes earlier and therefore didn't make some of the modifications that came later. So most of the East Coast particular operates --

REPRESENTATIVE KELLER: But are there any States that are doing relatively well? And I guess maybe Dr. Strauss could say that because you've ranked Pennsylvania for potential -- you know, you did that ranking.

DR. STRAUSS: Yes.

REPRESENTATIVE KELLER: Are there States that have a low amount of services that are taxed that are up near the high end of your rank? And excuse me for shifting but --

DR. STRAUSS: It's knowable, but I don't have those figures right at my hand. I'll get back to you.

REPRESENTATIVE KELLER: I think that would be interesting to make sure when we're looking at policy, you know, we don't just look at one sector but we try to see how States that are doing well and sort of benchmark ourselves against people that -- you know, we look at the whole picture.

DR. STRAUSS: Yes. I think being careful about this is important because let's suppose that you decide that you want to tax the retail sale of legal and accounting services just for openers. The State Society of Accountants and the bar will be in here yelling and screaming, and those of you who are members of the bar will be threatened with excommunication from the bar. I mean, that's the way it's going to work.

REPRESENTATIVE KELLER: Well, actually, again, we should lay that aside if we're looking at good policy --

DR. STRAUSS: No, I understand, but --

REPRESENTATIVE KELLER: -- for our Commonwealth and --

DR. STRAUSS: -- the way that the exemptions in the sales tax work, it's like a searchlight. And during recessions, what legislatures do is they look for areas that have not been taxed. And what I think you'll find is that most of the States have wound up staying away from services even though the economic argument is very, very strong, okay? But I'll do some more homework.

REPRESENTATIVE KELLER: Yes --

DR. STRAUSS: I'll do homework if you promise to do some homework.

REPRESENTATIVE KELLER: Well, I'm sure. We've got a lot of homework over the next few months here in this Committee, not just limited to what you're distributing.

DR. STRAUSS: I understand. You get to vote.

REPRESENTATIVE KELLER: The next question I guess I would have, you know, in looking at anything we do in tax reforms, and if we look at Pennsylvania's, I mean, we need to make sure that we're competitive, that we're doing the right thing to attract business and be fair with our tax system. But along with this, would you say it's fair to say that we need to look at the growth rate of our spending? And the reason I'm going to say that is if you look at what we've done historically in Pennsylvania, I mean, I'm just going to go over three years, you know, our spending has grown pretty close to 10 percent when you look at what we approved each year. And then you go to the Federal Reserve and our CPI, which is the growth of our economy, is about 3 percent. I mean, I see you shaking your head, Dr. Strauss. I think --

DR. STRAUSS: I agree with you.

REPRESENTATIVE KELLER: -- my numbers are pretty much --

DR. STRAUSS: Yes.

REPRESENTATIVE KELLER: You know, it's right from the Office of Budget and the Federal Reserve. So we can do all this stuff, but would you agree that we also have to look at the spending side? Otherwise, if we're just doing this to spend more money, we might find ourselves back --

DR. STRAUSS: Yes, so --

REPRESENTATIVE KELLER: -- looking at tax policy again.

DR. STRAUSS: Right. So education is a big driver, and we're one of the few States that teachers have the right to strike. I presume you're aware of that, correct?

REPRESENTATIVE KELLER: Yes.

DR. STRAUSS: And you may not be aware the rest of organized labor tends to walk away from where the teachers' unions stand because they've done so much better at the local collective bargaining table. And let me just give you an analysis of those dynamics. You don't supervise collective bargaining decisions. Only the State of Washington tried to do it centrally. And so there's something called pattern bargaining. And so a rich district is hit first, and so they give 6 percent. And then the union goes to the next district and said, "Well, you know, maybe 5-1/2." But the point is compound interest in especially pensions drives things. So getting control of education spending in a constructive way would be a big first.

REPRESENTATIVE KELLER: Yes, but in all fairness, if you followed Pennsylvania, we didn't do well in our negotiations when you're talking about increases with our higher education and some of our other State contracts, so I wouldn't put it solely just to the local district. But I guess my point just is -- and I think we agree and I don't want to --

DR. STRAUSS: Yes.

REPRESENTATIVE KELLER: -- belabor that, that the fact is that if we don't control our spending, we could be back at the table looking for different tax policy to support that level of spending.

DR. STRAUSS: Especially of the elderly. Here's a number. Do a calculation. If you put somebody in a nursing home -- and we're not doing that so much anymore because it's so expensive -- it's at least $60,000 a year, right? Okay. And let's suppose just as a characteristic calculation you say, "Well, those one million people that Bob was talking about, they all go into a nursing home because you all love the elderly," okay? All right. So if you take those two numbers and you multiply them and that's on an annual basis, you get $60 billion. That's a very big number, okay? You can't afford that.

REPRESENTATIVE KELLER: Right.

DR. STRAUSS: Okay. So then the question becomes what can you afford? And then you get into the guts of the budget.

REPRESENTATIVE KELLER: Right.

DR. STRAUSS: And I think you have to work it backwards.

REPRESENTATIVE KELLER: Okay. The other thing I guess I would say -- and this is for you, Dr. Strauss -- you did the ranking of Pennsylvania and you said that we're in the bottom -- you know, we're like #45. We're in the bottom end of the range when you're looking. And you looked at everything from the amount of money we have on hand to how we do our budget and those other things. Did you take into account -- and I know there's been a lot of discussion about the other special funds that are contained in our treasury.

DR. STRAUSS: Yes.

REPRESENTATIVE KELLER: And, you know, if I can just make a statement on this and see if you agree with that. If we're accumulating and growing the pot of dollars in those funds, we're likely overcharging for some of those services that fund that, and we should probably look at either reducing that amount so that the fund is stable to fund what we need based upon what I'm hearing in our testimony today, and/or we have the opportunity to take some of that money and use it for other areas rather than borrowing.

DR. STRAUSS: Absolutely. And if you view your financial activities on a consolidated basis, then you're going to see all that money and you're going to say, "Okay, what do we need in terms of a rainy day fund? What balance do we have to carry to pay our bills?" And if there's money left over, then you can use it to borrow less or to reduce taxes, but I don't know those numbers carefully enough to give you an answer. But you're right; you've got to look at all the cash.

REPRESENTATIVE KELLER: The Chairman just whispered in my ear "Other people need to ask questions." If I can just say one thing --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: No, no, no --

REPRESENTATIVE KELLER: No, I just --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: It's good. Go ahead.

REPRESENTATIVE KELLER: I don't want to take up all the time, but in your analysis, what were those other special funds included or --

DR. STRAUSS: The CAFR is supposed to be everything, so --

REPRESENTATIVE KELLER: Okay.

DR. STRAUSS: And I trust the Census Bureau because when they do that, they look at all the States.

REPRESENTATIVE KELLER: Okay.

DR. STRAUSS: So they have a classification system.

REPRESENTATIVE KELLER: So the answer's yes?

DR. STRAUSS: Yes.

REPRESENTATIVE KELLER: Thank you.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Representative Kinsey.

REPRESENTATIVE KINSEY: Thank you, Mr. Chairman.

Good morning, gentlemen. I want to start with -- I just have basically two questions. And excuse me if I get the name wrong also. Professor Yakovlev?

DR. YAKOVLEV: That's fine.

REPRESENTATIVE KINSEY: Oh, thank you.

DR. YAKOVLEV: Yakovlev, yes.

REPRESENTATIVE KINSEY: Okay. Great, first try. You know, in your testimony you talk about two basic messages, one was to lower the tax rate and then also to widen the tax base.

DR. YAKOVLEV: Yes.

REPRESENTATIVE KINSEY: When I think about the State of Pennsylvania, the general sales tax is at 6 percent. However, Allegheny County has a 7 percent, and then there's an 8 percent with the City of Philadelphia, which I represent. So I guess what I'm trying to understand is when we talk about lowering the tax rate, the municipalities, the local municipalities such as the City of Philadelphia, the impact that something like that would have on it -- I mean, I understand the concept, okay, well, let's broaden the tax base, but by the same token, I think Professor Strauss talked about, you know, it is a tough -- you know, you're going to have a lot of folks who are going to be impacted by doing that, so how would you go about -- you know, the conceptual ideal I understand, but again, when I look at the City of Philadelphia that has, in addition to the 8 percent sales tax, you know, we also have an additional cigarette tax, as well as a recently enacted soda tax. How do you sort of bring those things back in?

DR. YAKOVLEV: Great question, by the way. Thank you for asking that. As Professor Strauss mentioned, I think it's very easy for economists to say things that people don't want to hear and upset them. I do that all the time, too. And especially, you know, I understand the predicament that you're in as a public servant or as a politician. You have to tell people that sometimes the things we recommend or advocate might hurt, you know, and they might be tough. They might be tough to endure. But I think we have actually a very good message here with a wide tax base and a low rate because you can tell people, you know what, you don't have to pay higher taxes anymore. Even if we tax food, that means we can lower taxes elsewhere. So while a tax on food or clothing might rise, at the same time we might lower the rate on something else that we tax in the economy, which will offset the tax burdens that they pay on food or some other items.

A wider tax base essentially means we don't have to squeeze the economic activity out of certain sectors. A wider tax base allows us to create fewer distortions, so we're not forcing people to look for better deals elsewhere. It actually means we can lower the overall tax burden on people in the economy by encouraging people to do more economic activity, which would benefit everybody. And so I think it's really about sending the right message. Lowering the rates across the board will benefit not just the wealthy individuals but also the poor individuals who might be reluctant to accept a higher tax or in general a new tax on food.

But we need to convince them. We need to tell them, "Look, you know, by widening the tax base, okay, what we're doing is we are tapping into previously untapped revenue sources. We are creating a more equally shared tax burden, and at the same time, widening the tax base allows us to lower the rates, which is a good thing for the poor individuals as well.

And I think there's actually quite a lot of exaggeration of the regressivity of the sales tax. If the sales tax is very broad just like Jared mentioned, we'll be able to tax services. And many of the services are rather expensive and they're consumed by people with higher incomes. So the people with higher incomes will actually bear quite a bit of a burden. And so I think we can probably convince a lot of people that a wider tax base and a lower tax rate is in the interest of everybody, not just, you know, the high-income individuals, not just in the interest of the State but also in the interest of the low-income individual.

REPRESENTATIVE KINSEY: Okay. Professor Strauss?

DR. STRAUSS: Yes. Let me comment about Philadelphia because I want to give you a longer view that reinforces the economics argument for good tax policy. When I came into Pennsylvania and I did the Thornburgh/Cyert Report, I got to understand Philadelphia's finances dramatically because you're such an important population. So you had this commuter tax, right? And so you ask yourself, "How did Ed Rendell become Governor of Pennsylvania?" And the answer is he lowered the commuter tax and found out how to make Philadelphia's budget balance. And you've been able to grow jobs and stabilize your population loss because the economic incentives, the tax incentives to work and live in Philadelphia got better.

And you just look at the numbers. I have a friend at Wharton, Bob Inman, and he wrote this wonderful paper demonstrating that the commuter tax, when it was at its highest rate, cost something like 300,000 jobs to leave the city to go to the suburbs. And it wasn't the KYZ zone in my judgment. It was the fact that the commuter tax was lowered. And slowly but surely, Philadelphia has fixed its property tax. You went through a reassessment. And if you watch TV, you know I was there talking about just how fair and equitable it was. But Philadelphia is getting its finances straight, and it's made a market impact on your population numbers.

You look at Allegheny County, and we're losing population because we don't get our local taxes where we have discretion straight. So I think you can see within Pennsylvania in the last 10, 15 years that getting things aligned on principles can actually lead to economic growth and economic efficiency. And so I think you only have to look where you represent to see that effect.

REPRESENTATIVE KINSEY: Thank you both, gentlemen.

And, Professor Strauss, I keep hearing -- as we talk about the widening tax base and we talk about taxing other services, you may have mentioned earlier that you're going to come back with information as to what --

DR. STRAUSS: Yes, there are papers on this that look -- I mean, yes, I just don't have them at my fingertips --

REPRESENTATIVE KINSEY: Sure.

DR. STRAUSS: -- but, yes, I'll --

REPRESENTATIVE KINSEY: Sure.

DR. STRAUSS: -- send them -- Jenny, she'll distribute it, yes.

REPRESENTATIVE KINSEY: Okay. And I think the other thing -- and I was trying to go through --

DR. STRAUSS: Right.

REPRESENTATIVE KINSEY: -- your slide presentation real quick, and I can't count to it, but as we talk about spending throughout the Commonwealth of Pennsylvania and maybe trying to, you know, reel in some of the spending -- I mean, on the flip side of that, you know, the State has certain mandates where we're responsible to make certain payment. I mean, as we talk about, you know, with some of the Fed dollars coming down --

DR. STRAUSS: Right.

REPRESENTATIVE KINSEY: -- you know, there are some expenditures. So how do we sort of reel that in? I mean, I thought that's where you were sort of leading to.

DR. STRAUSS: Okay. So this is like a big thing, and it's like you should think about getting some other budget experts. I can talk about education. But, first of all, a lot of your plans that go to the Feds are State plans that have to be accepted, right? And so you got to think to yourself, "What are we going to approve and what it's going to cost ahead of time," okay?

Second, you got to start asking, "Can you differentiate between urban and rural in trying to find some cost savings there," okay? Now, in some parts of the Commonwealth student-teacher ratios have collapsed, and they're disparate between elementary, middle, and high school. Fifty thousand high school kids aren't there anymore if you look at the demographics. The school districts don't have the right kind of flexibility to lay off or force teachers to teach kids of the right age. In the business community, that would be unacceptable because you're basically subsidizing an activity that you can't afford, okay?

So I think you start to ask yourself the question on page 11, "What do we want to do in education? Where do we want to be?" And then you take your goals that you can accomplish and then work backwards, okay? And maybe it is State supervision of the collective bargaining process. It's not a crazy idea. Other States have tried it. It's been somewhat successful in Washington, but then they backed off. But you can be in favor of public education, but you know what those numbers look like for retirement benefits in a defined contribution plan. I mean, it's really excessive.

Okay. And teacher salaries in some parts of the State are too low, so you start looking at the formula, okay, and you have some hard private discussions. What do we want to do and how are we going to get there? And if you set a budget target number and work backwards, then you're all going to feel some pain, okay?

What's happened in Philadelphia frankly is because you've been told financially by the Legislature you're on your own, Philadelphia is getting its finances in order. You got rid of the School Reform Commission. You've gone back to, right, appointed members of the school board.

REPRESENTATIVE KINSEY: We're working on it.

DR. STRAUSS: The Mayor is making some tough decisions. There's probably about $3-400 million lying around that you could get. I mean, I have friends in

Philadelphia who can advise on how to fix the energy use. I mean, there's all kinds of things you can do to save money because government is habitual, all right?

MR. WALCZAK: Representative Kinsey, you had a question that maybe wasn't answered. Would it be okay if I spoke very briefly on -- Mr. Chairman?

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Yes, could we -- yes, maybe just a couple more minutes, Steve.

REPRESENTATIVE KINSEY: Sure.

MR. WALCZAK: I've got an answer in just one minute, but you spoke specifically about Philadelphia, and of course under the Sterling Act there is the 2 percent sales tax add-on available there. And you asked, "What would sales tax base broadening and rate reductions do for Philadelphia?" Well, if you didn't amend the Sterling Act, Philadelphia would still have up to 2 percent that it could tax on a much broader base. You wouldn't be ratcheting down that; you'd be ratcheting down the State rate. So this would mean more revenue for Philadelphia. Philadelphia would have a number of options. They could choose to tax at lower than 2 percent if they didn't want to bring in that additional revenue.

If they did choose to bring it, that could be a windfall, but there would also be opportunities. You mentioned the cigarette tax; you mentioned the soda tax.

Both of these of course have public health purposes, but they also very clearly have revenue purposes that tend to be very regressive. Both the soda tax and the cigarette tax are pretty regressive. So if the State does sales tax base broadening to include some services that would be more progressive, the City and the County of Philadelphia could actually if it chose take some of that additional revenue it's getting because the base broadened and its rate stayed the same to perhaps reduce taxes, not just those excise taxes, maybe other taxes as well that have impacts that Philadelphia would prefer not to if it could get revenue from another source.

REPRESENTATIVE KINSEY: Thank you very much.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Representative Ortitay.

REPRESENTATIVE ORTITAY: Thank you, Mr. Chairman.

As probably the person who's been out of college the least, homework doesn't bother me quite as much, so I appreciate that.

DR. STRAUSS: Go for it.

REPRESENTATIVE ORTITAY: No, we've talked a lot about broadening the sales tax. I'll be more pointed with my questions, and any three of you or all three of you are more than welcome to answer. But if we were to tax all goods and services, what would we be able to lower the rate to if you have any general guesses or estimates from the 6 percent.

DR. STRAUSS: What are you going to do about business? Are you going to get rid of the 35 percent cascading or not? Because --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Now, wait. Now, he asked the question, and you --

DR. STRAUSS: Well, no, but I --

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: -- need to give the answers.

REPRESENTATIVE ORTITAY: You can answer with both. How about that? With or without, you can answer both and we can see where that goes because we've had several I guess proposals that lower the rate to, what, 2 percent from where it's at now and you tax all goods and services. I don't think the --

DR. STRAUSS: Yes, but I think that would cascade if I had to make a guess. I would look at the tax expenditure table, and that's going to give you a start. But then you've got to find the 35 percent.

MR. WALCZAK: Representative, if you were to accept the business inputs that are currently in the code but expand to not include any further, include all other final consumer transactions but not expand, you could probably get in the ballpark, on a first-order approximation, 2 or 2-1/2 percent. If you were to eliminate those business inputs while you were doing so, so that you had -- you know, economists would want as an ideal sales tax, you would probably be somewhere in the low 3's. These are first-order approximations just based on the fact that most States that exclude services are excluding more than half of their base. Two-thirds of our economy is now services, and Pennsylvania taxes only a small sliver of those. So somewhere between 2 and 3 percent is the right answer, and if you're doing all business inputs out, probably closer to 3, keeping in some in, closer to 2.

DR. YAKOVLEV: If I might add, my estimate would be a lot more conservative, maybe 4 percent I would say for the wide, you know, tax base on consumption. And the reason I'm saying that is because I think we should look at Hawaii as a realistic model. They have their tax rate in the low 4 percent, and they do tax quite a lot of goods and maybe some services I believe. So I think it's a reasonable approximation.

MR. WALCZAK: Yes, they wouldn't be everything, but they'd be as close as you can get.

REPRESENTATIVE ORTITAY: Okay. And that's good. That's what I was looking for because if you did it uniform across the board or if you did it uniform across the board, some would see a tax decrease, some would see a tax increase obviously. And, you know, in this line of work, you usually make half the people happy and half the people upset no matter what you do anyway. So I just wanted to try to get some sort of a number on that.

The other part I wanted to ask about was transparency. That was one of the issues that you had discussed. And, you know, we have quite large I'll call it the shadow budget, which can be upwards of $50 billion whether it's in special funds --

DR. STRAUSS: Well, yes, that's my graph.

REPRESENTATIVE ORTITAY: Exactly.

DR. STRAUSS: Yes.

REPRESENTATIVE ORTITAY: Do you think it would be beneficial for us to bring that back in line with our annual budgets and put it back in the General Fund every year?

DR. STRAUSS: Yes, it would because you don't know what you're dealing with in a -- you're not seeing the tradeoffs, and basically, you're kiting checks. I mean, that's -- between the funds. That's what's going on. And if you want to control your future more systematically, you've got to see the overall financial picture. That's why the private sector uses consolidated accounting, right? Yes. I mean, this would be such a cold-water shock that you've got to phase it in, you know? And you've got to get agreement. And frankly, I think looking at those numbers will bring you much closer together politically because it's such a change, you know, people from various parts of the State and so on and so forth. Yes.

But don't forget you've got to do that for the locals. You've got to be gap audited and they've got to be gap audited, and they're not. And that's, you know -- that will change the politics in Pennsylvania constructively I think, but it's going to change the politics. It has to because -- I'll tell you a funny story. I'm up in Minnesota talking to the State Budget Director, and I give him an example from Allegheny County. And in Allegheny County, we had a guy who was a county judge who was doing bond counsel out of his law office and it was not a conflict of interest. Okay? The guy in Minnesota burst out laughing. He said, "If I did that, I'd go to jail." So we're talking about transparency. We're also talking about what's reasonable practice in the division between the public and the private sector, and how do our citizens understand and know what's going on so they have confidence?

You want to see something funny, go to Pittsburgh and look at the streets, okay? The city's in an uproar because the snow is on the streets. It's been on the streets in the winter forever because no Mayor has had the guts to face up to it. And what I'm talking about in terms of looking at things on a consolidated basis for State and local purposes is just to change the way you do government. But I think you'll wind up making easier and better decisions, but getting there will not -- you can't do it in one year.

REPRESENTATIVE ORTITAY: And then that's what I wanted to get to is, you know, you had mentioned that we have some really tough decisions to make, and I don't doubt that we do, but doing something like this may certainly make it a little more palatable.

DR. STRAUSS: Well, then everybody's got to agree. You know, the present value of your liabilities are on the balance sheet. You can see it, you know, and you say, "Now, wait a second. We've got this pension problem, you know," and the locals, you know, you start looking at them and you say, "Okay, well, we're going to try to address this by looking at our consolidated financial position and we're going to try to do it in a businesslike way. We're not going to try to do it in one year. And you would be surprised what the rest of the country's going to think of you. You'll get A-plusses, and it'll be a better place to do business.

REPRESENTATIVE ORTITAY: Hey, I like A-plusses. One more question -- and if the Chairman will indulge me --

about tax credits. Earlier today, I was reading that both Pittsburgh and Philly are in the final 20 to get an Amazon headquarters here, and I'm sure Apple won't be far behind in putting their bids out. Overall when we talk about tax credits and tax incentives, do they actually benefit the State from a revenue -- I guess a plus-revenue standpoint compared to the amount of money that we actually give them in incentives to come here? Because when you factor in the thousands of jobs that they bring here, are we going to collect enough in PIT and sales tax and the other taxes we collect because I think that we already have $100-plus-million in tax credits right now. And I'm not sure what both Philly and Pittsburgh offered, but I'm sure it was something substantial.

MR. WALCZAK: The qualified answer would be generally no. Generally speaking, the best economic development incentive you can have is low and neutral tax rates that aren't picking winners and losers. This isn't to say that sometimes an economic development package may not bring in a company that turns out to do great things for a State, but the problem is you get one of those white whales occasionally. Usually, you're ending up subsidizing things that either already would have happened or at a cost of missing other opportunities because your rates on other businesses were too high.

We look at States like North Carolina. I think it's a good example because they did tax reform and they did a lot of things that some of you may like, some of you may dislike, but the one thing that I think there was strong agreement on, their old code was based on pretty high rates with huge exemptions for targeted industries that at one time were their growth industries: textile manufacturing and tobacco. If you were in those industries, you paid almost no taxes. If you were in anything else, you paid pretty high taxes. Well, that hasn't been their economy for a while and is certainly not their future, and they've got the research triangle, they have everything else, and they were taxing it way too high. So trying to equalize those rates, not having new targeted incentives for the new businesses but having more equitable rates I think has been very beneficial to them.

You know, you look at, you know, Pittsburgh and the tech clustering that is already going on there, I mean, Google has a significant facility there. CMU is there attracting a lot of activity. Would bringing Amazon in be a great thing for the Commonwealth? I mean, no doubt, but every time you go after one of these white whales, you spend a lot of time, resources, money. There are other things you could be doing with that, and most of them probably lose money.

DR. STRAUSS: I can give you examples.

REPRESENTATIVE ORTITAY: Please.

DR. STRAUSS: Okay. I live in -- anybody here from Westmoreland County?

MALE SPEAKER: I am.

DR. STRAUSS: Okay. Well, then you know the story of the VW plan. Okay. We put in a couple hundred million dollars, and there was local money. And all the present value calculations ahead of time were that it would be a revenue-raiser, a job-creator, but VW left. It was empty, and to fill it up, more subsidies had to have been provided. So the net economic effect of that compared to what we might have otherwise done with the money has been negative, okay? And you agree.

Nobody's mentioned the quality of public service competition, okay? And that's something that, as you start to do your homework, you start to think about. If we're really good in a particular area of K through 12, STEM education, vocational education, I challenge you to go look at what Kasich did in Ohio. That's what turned around that economy, not only lower taxes but vocational education works.

And so there has to be a value proposition when you're extracting taxes from people and companies. What are they getting in return, okay? There are potholes on the Pennsylvania turnpike because I drove it last night.

DR. YAKOVLEV: I drove it this morning. And I'd like to add that I completely agree. I think I'm very skeptical as well of the targeted tax incentives. It's just a very politically charged game most of the time.

May I add one more comment? I'd like to respond to Representative Keller's question about government spending and its impact on State economic growth. In one of my studies for the Mercatus Center, I actually estimated the effect of raising the average tax rate across the Nation at the State level, and I found that a 1 percent increase in the average tax burden leads to a 2 percentage point decrease in State economic growth, which suggests, because of the balanced budget requirements, that the average level of government spending across the Nation is relatively high, and it's stifling economic growth.

MR. WALCZAK: And I'll just finish up on the tax credits. When we look at this and when we see the aggressiveness that goes after an Amazon, a multibillion dollar company -- I think Jeff Bezos is now the richest man in the history of the world at $105, what, billion that he's worth now. Yet on the opposite side of that we're looking at taxing energy in this -- we're giving a $1 billion industry tax credits and tax breaks, but we're trying to tax another industry. So the idea of picking winners and loses never seems like a good idea, so I'll close with that. Thank you, Mr. Chairman.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Representative Helm.

REPRESENTATIVE HELM: Thank you, Mr. Chairman.

And I have a question on tax credits. I know we've kind of talked about that a lot. Jared, you made the statement that Pennsylvania does not have as many tax credits as other States, and, Professor Strauss, you said tax credits are a tax expenditure. But I'm on the Tourism Committee, and also every year on the budget we talk about film tax credits. And that's always the controversy. I just wonder if you have any facts and figures specifically on film tax credits.

MR. WALCZAK: Yes, ma'am. Oh, sorry.

DR. YAKOVLEV: I actually wrote a study on that for Pennsylvania, and I am not in favor of it in general. The conclusion is I think just like with many other tax credits, the companies would have come here regardless and it just ends up being a tax giveaway most of the time.

MR. WALCZAK: I would add that sometimes certainly films take place because of tax credits. I don't think there's much doubt that, I mean, Georgia wouldn't have as many as they have. Pennsylvania's had a lot, and the tax credits have brought them in. But you have to ask what are you obtaining? Because Massachusetts and Michigan both did studies of their film tax credits, and they both concluded that the average job created lasted 28 days or I think one of them was 31, one was 28 days. I forget which is which. But that's not a particularly long-term job.

A lot of counting is double-counting so, you know, when you've seen perhaps States put out their, you know, economic analysis, sometimes it's been, well, we created a job in catering. Well, the caterer already existed. It wasn't a new job. Most of these have very limited actual benefits because it all goes away very quickly. A new film comes in, takes very generous credits. Most of the compensation is going to people who are out of State and very little if any of what they're earning is going to Pennsylvania income taxes. You get a small share.

You know, States have done estimates. There have been about eight or nine States that have done revenue office estimates, and they varied on their impact, but they have varied between getting back between 6 and 24 cents on the dollar that you put in. No one has gone over a quarter thus far that I know of.

REPRESENTATIVE HELM: Interesting, because it sounds like I'm the General Assembly. That's exactly what we say. One person agrees and one person -- anyway. There was another statement made about reassessment, statewide reassessment. I've talked about this. I've been in the Legislature now my 12th year, and I have a real estate background 20 years before this. And I just would love to see legislation that we reassess every five years, but every time I talk about it in here, I just don't like the way that the people want to do it. Could you just talk a little bit more about that? Because you said the different municipalities actually were asking why we don't have it.

MR. WALCZAK: Yes, Representative. As I've been speaking, you know, the Tax Foundation, we're actually doing some research to ultimately put together some recommendations for Pennsylvania, so we've spoken to some local government officials. And that's something I've heard almost everywhere, that a lot of local governments would love to reassess, but of course they're concerned about the political consequences and the cost if they're the only ones doing so. They would like this to be uniform.

Now, different States handle this in different ways. Some States requirement complete reassessment every single year. I personally think that's too expensive, probably too wasteful. Some States do it every three, four, or five years. Sometimes they require some rough adjustments in the interim years that aren't full reassessments but, you know, try to catch up. I think somewhere between a three- and five-year cycle -- given that Pennsylvania doesn't it do it much at all now, five is probably a reasonable number where you would do a proper full reassessment every five years, and in the interim you would be bringing in, you know, obviously improvements like you do now and also on sale. That would presumably reset, but not every State does that, but resetting. But I think that would be very valuable.

I don't know if I'm particularly answering your question. I might be missing your question. But I do think having a system where every five years there's a true reappraisal and then it is also reassessed. The improvement portion is added immediately, and on sale, the sale price goes in because usually you use comparables but you can use actual sales price of course if it was just sold. That would put Pennsylvania probably at a much more equitable position because some properties are paying next to nothing. Some are bearing the brunt of the fact that they have to pay much more. And the localities are kind of -- they have their hands tied, I think.

REPRESENTATIVE HELM: Well, I would love to see every five years. Anybody else have --

DR. STRAUSS: Yes. So if you take my -- you have the long document?

REPRESENTATIVE HELM: Yes.

DR. STRAUSS: Way in the back on page 60, county by county I calculated the median assessed price ratio and compared it to what the Tax Equalization Board says and it's very different. So there's a STEB problem, which you've probably heard about if you follow the property tax. But then I've got the coefficient of dispersion, and it's out of sight. And they stopped reporting it on the State website because the disparities in assessment are so bad.

So let me try to give you a good government fixe assessment economic development argument. And I don't know if anybody was here, but years ago -- have any of you heard of the company AT&T? Okay. So AT&T's principally in New Jersey, and New Jersey's a high-tax State. And so they went and they wanted to move some of their facilities to Pennsylvania, capital, big stuff. And they said to the Governor at the time -- and I frankly don't remember who it was, maybe some of the legislative leadership -- if you fix assessments by going to cyclical assessments as he suggested, three or five years, and you put some money into -- now, let me give you a number that you haven't seen. It's in the testimony.

We spend about $11 on average per parcel in the State for reassessing -- for assessing, not reassessing. In other words, the normal expenditure of an assessing office is 11 bucks per parcel, and we get very crummy results. The national average is about $20 per parcel, okay? So if you want to force them to reassess and get things lined up because the Supreme Court, you know, chickened out and said Allegheny County was the mischief county but the rest of the State was okay. So you got these lawsuits like popcorn popping up.

You might think about with some of this money that you're somehow going to find to put some State money with some oversight, some rewards and penalties to get the assessments straightened out. And that is an economic development thing. If the rest of the country knows that Pennsylvania's coefficient of dispersion is going to be 20 percent instead of 60 percent, business is going to say, "Well, maybe we can locate some capital-intensive facilities and maybe they won't try to extort from local government. We want a 10-year tax haven, you know, no taxes," which I think we all think is not a good idea. So facing up to this by putting some money, recognizing how bad it is and getting the staff at STEB from 3 to 10, which it used to be and it needs to be 15 so it's like Ohio would be a very wise use of money.

And so there are things that you can spend more money on and get some results on, but it's on the service-quality side, okay? And as I said, I could go on and on and on, but this I've studied. Local government is spending $11 per parcel, the national average is $20, and we've got a coefficient of dispersion that's 60 percent; it's supposed to be 15. Those are good numbers to remember.

REPRESENTATIVE HELM: Well, thank you. This is something I would like to -- I have just one other quick question because I had a constituent call yesterday. This is really Federal. I know we're talking about Pennsylvania, but Professor Strauss, you might be able to answer this for me. I had a constituent call who is back, he doesn't have his like 2016 income tax done. He's also a business owner. And he wanted to know the new tax law, which law would apply, if he'd have done his income tax on time or the current law?

DR. STRAUSS: Oh, it's the old law. There may be penalties but he's under the -- the results and the activity for 2016 are subject to, you know, 2016 law.

REPRESENTATIVE HELM: Thank you.

DR. STRAUSS: Yes. That was easy.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Representative Dunbar for the final questions.

REPRESENTATIVE DUNBAR: Thank you, Mr. Chairman. Wow, this microphone is really short. Steve, how do you live up here all year long? Sorry about that.

But we've had a lot of discussions about maybe some long-term tax policy changes, and there are some short-term tax policy changes I think we all have to be aware of, especially based upon the Tax Cuts and Jobs Act, which we talked about. I understand most of those changes there don't affect Pennsylvania directly because Pennsylvania doesn't start with Federal income tax, so the decoupling that had been mentioned.

But Dr. Strauss had mentioned bonus depreciation, and it is a big issue and I think it is an issue that Pennsylvania's going to have to address almost immediately when we get back into session. Dr. Strauss had mentioned the Department of Revenue --

DR. STRAUSS: They issued a guidance.

REPRESENTATIVE DUNBAR: They issued a guidance in December I believe it was --

DR. STRAUSS: Yes.

REPRESENTATIVE DUNBAR: -- and you had said that that guidance would have no effect. I respectfully --

DR. STRAUSS: No, I didn't say that.

REPRESENTATIVE DUNBAR: Okay. You said it would have no revenue effect.

DR. STRAUSS: Oh, yes, that's true.

REPRESENTATIVE DUNBAR: Okay. And I disagree with that, at least my interpretation, which may be incorrect. My interpretation, which is also the interpretation of the Certified Public Accountants, as well as the Manufacturers Association is that that tax bulletin essentially says that if you as a corporation take bonus depreciation for Federal purposes, you would not be able to depreciate those assets at all for State purposes until those assets are disposed, which essentially could mean a great deal of additional revenue for Pennsylvania in the short term. In the long term it would all balance out as those assets are disposed eventually at disposition, but that could be a decade or so down the road.

So my question -- it may have been a long explanation but --

DR. STRAUSS: No, no, I understand. Yes --

REPRESENTATIVE DUNBAR: But my question for the whole panel is what would good sound tax policy be? Adoption of the bonus depreciation that they've offered at the Federal level because then it will make supposedly Pennsylvania more business-friendly or continued status quo, which has been not allowing bonus depreciation in Pennsylvania but still allowing you to depreciate the assets?

DR. STRAUSS: Okay. So --

REPRESENTATIVE DUNBAR: Or the third option, which is the way I take the bulletin to be saying that no depreciation whatsoever if you elect bonus depreciation.

DR. STRAUSS: Yes. Okay. So not revealing my source but you remember who one of my students was, right?

REPRESENTATIVE DUNBAR: And I have a great deal of respect.

DR. STRAUSS: Okay. So I think that there's confusing statutory language here in Pennsylvania.

REPRESENTATIVE DUNBAR: I agree.

DR. STRAUSS: And I think it's going to be a food fight before you.

REPRESENTATIVE DUNBAR: I agree.

DR. STRAUSS: But here's --

REPRESENTATIVE DUNBAR: And I think it's going to happen --

DR. STRAUSS: Okay.

REPRESENTATIVE DUNBAR: -- almost immediately.

DR. STRAUSS: Number two, the expensing that starts in 2018 gets phased out over 10 years because that's the way Congress put the sweetener up front. In my perfect world, I think capital should be depreciated. I understand the value of expensing and what it does to investment, but if you want to go to a consumption tax, which is really what is going to happen in 2018 and 2019 by expensing advancement nationally, the States don't have to go along and they can follow financial accounting standards and just depreciate the stuff over time.

But let me say this. There should be clarity. If the situation is confused right now statutorily and the bulletin is in conflict with the linkage to line 28, which is in effect what you're saying, then whatever you do, you should not leave it confused by the close of this calendar year, okay?

REPRESENTATIVE DUNBAR: Agreed.

DR. STRAUSS: And I would say just depreciate. That'd be my simple answer.

REPRESENTATIVE DUNBAR: And also for the other members of the panel, if you know of anything that other States are doing in regards to this, I'd appreciate that, too.

MR. WALCZAK: Yes. Representative, when bonus depreciation was first offered in 2002, 29 States immediately decoupled from that provision. Since then, a few have recoupled, so there are about, you know, 25 States I believe that are still decoupled, Pennsylvania being one of them. And right now, it appears that most States that are still coupled to the provision are probably going to go along with full expensing, not all but most. They are in a bit of a different position than Pennsylvania because the majority of these States conform on Federal AGI and bring in some of the changes on standard deduction, personal exemption, and other changes, which on the whole if you conform to all of them, you're going to see a broader tax base. There are difference in different States and how they conform, but most States will see a broader tax base due to Federal tax reform.

Since Pennsylvania uses State-specific calculations on most things, as Professor Strauss mentioned, very few of those actually flow through to broaden the base. So a lot of States are looking at this as this is a cost, but we think it's good tax policy and, more importantly, we're also getting additional revenue elsewhere, so we'll accept it. Pennsylvania doesn't have that.

The rationale behind full expensing is that it's the one thing that you can do in a business that's a cost that isn't immediately written off, so it is essentially a penalty on investment compared to other economic activity. There is disagreement among economists on this but some, as Professor Strauss would say, would just use the, you know, accounting principles of depreciation, others, you know, more full expensing, full disclosure. I and my organization believe full expensing is good policy. But it is a cost for Pennsylvania, particularly because you don't get the other revenue gains.

What I would say to the memo -- I mean, I'm sorry, the guidance that's been issued by the Department, I do agree. I think it is actually in tension with Pennsylvania law. I do not agree with the interpretation. I'm not a lawyer, but as I look at that, I do not believe that it should be disallowing the current depreciation schedules. And I worry about that, and I think that's bad policy.

Ideally, full expensing is great, but that's a revenue cost, but I would think that the status quo is far superior to not allowing any of that to be taken until an asset is sold or disposed of, which has a huge time penalty because time value of money matters. It changes cashflows dramatically, and I don't see adequate defense of that in law. It's a major change to come through, you know, some sort of guidance.

REPRESENTATIVE DUNBAR: Thank you.

DR. YAKOVLEV: I concur.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay.

DR. YAKOVLEV: I concur with Jared.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Sorry. I made a mistake. Representative Santora also has questions.

REPRESENTATIVE SANTORA: It's more following up on Dr. Strauss' point of the aging population of Pennsylvania and the concern that we are not doing an effective enough job keeping the youth here when they are finished. They're coming to our schools and they're leaving.

And then I'm very concerned about the income-producing families seem to be reducing in Pennsylvania. Our population is reducing, but our elder population is growing.

DR. STRAUSS: Right.

REPRESENTATIVE SANTORA: When I look at your numbers down the road, yes, I believe those numbers of the $4.5 billion to $5.5 billion, I actually think they may be higher.

DR. STRAUSS: I agree with that actually, yes.

REPRESENTATIVE SANTORA: We've got to start looking at alternatives because the seniors, quite frankly, they can't afford with our property tax system the way it is and then getting hit with an income tax locally -- or in Pennsylvania. It's going to put them at a disadvantage that is ultimately going to become a burden of the State and the smaller population to have to make up the difference. So we truly do have to look at some of these things now versus five years from now.

DR. STRAUSS: So, yes. In my November testimony -- and it may be buried in here -- I tried to answer the following question because some friends -- I mean, I'm over 65 if you don't know, and I think I'm undertaxed. So the question is for people who did their financial planning, how are you going to accomplish this? And so there are some simple ways to do it. One is you say, "Well, we'll treat it like Social Security." Our goal is to get to 50 percent of retirement income is taxable. If that's the value judgment that Congress has made, we can make that value judgment as well, okay? But we're not going to get there right away. We're going to have an exclusion that gets us -- we're going to exclude 95 percent, then 90, and then you phase it in. So you look at the time that a person's retired, 65 to 80. You look at the life tables and you say, "Well, let's phase it in." And that's going to be our long-run strategy, that we're going to take our time on that, okay?

And then, by the way, you're going to be fighting over Medicaid, Medicaid expansion. You're going to be fighting over home care. And it'll be right here in the Committee. And I can go on about the fact the State has a database, the SAM database, but they don't keep track of the service spending levels and the fees. You need to be monitoring this stuff because when you have a million more people and lots more over age 75 -- and those are the people who get dementia and Alzheimer's -- you've got to start figuring out and being sympathetic to the county aging organizations. What the hell are they going to do?

And you want to find some stressed people? Talk to the Allegheny County lady who's in charge of aging or the one in Philadelphia. And I did talk to both of them, and they say no Governor understands what's coming, and by implication that's you folks, okay?

And have you noticed the turnover in the leadership of the Department of Aging? Why is that? Because the people who come and say they have an impossible task. So there has to be agreement on the numbers, first, how many are we going to have. And Penn State's got a wonderful group of demographers in their soc. department. They can be very helpful. Get them. They know about elder numbers better than I do and give you the high and the low ranges.

And then you've got to start saying, "Well, what are we going to spend and how are those services going to be delivered? What's going to make home care work," okay, and "What's the problem in the rural areas because there's no transportation?" And the rural areas with unemployment is where the kids live, so you can't count on an extended family, and it gets very complicated very quickly and there are no good decisions.

But if you don't deal with this, it's going to be like the opioid crisis, right? It's going to be in all the newspapers, and it's going to be very, very difficult politically. So getting hold of it, you know, what are the numbers going to look like? What can we afford? Talk to the nonprofits because they're the ones that support a lot of the human services. I mean, it's very detailed stuff, and it means keeping an eye on the executive branch more than in the past. And frankly, I think they'll be welcome because they'll understand that there's the beginnings of a dialogue. And they're going to be up here with their budgets, right, next month, so getting that going I think is very healthy.

REPRESENTATIVE SANTORA: Thank you.

MAJORITY SUBCOMMITTEE CHAIRMAN KAMPF: Okay. Just one quick comment. I have to give a shout-out to my dad who just went into sort of a longer-term rehab nursing home setting. And he had to close his business at the age of 86 on December 31st, so like many elder Pennsylvanians, he still worked, still paid taxes long after some of the numbers we've been talking about, so thanks, Dad.

And just to everybody, I thought this was a great discussion. I thought you gentlemen are, you know, obviously experts in your field and you've really helped us, so thank you very much.

And okay if we adjourn the meeting? All right. Meeting adjourned.

(The hearing concluded at 11:30 a.m.)

I hereby certify that the foregoing proceedings are a true and accurate transcription produced from audio on the said proceedings and that this is a correct transcript of the same.

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Transcriptionist

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