

Possible Avenues for Tax Reform in Pennsylvania: Opportunities and Challenges in the Tax Code

*Prepared Testimony for the Pennsylvania House
Appropriations Subcommittee on Fiscal Policy*

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January 18, 2018

Chairman Kampf, Chairman Schweyer, and members of the Subcommittee:

Thank you for the opportunity to speak with you today about both challenges and opportunities in Pennsylvania's tax code. I am a senior policy analyst with the Tax Foundation, a nonpartisan tax policy organization based in Washington, D.C., but I'm also a native of the Commonwealth of Pennsylvania, having grown up and attended college here, so I always appreciate the opportunity to come back home.

My hope this morning is to highlight a few of the ways in which Pennsylvania's tax code stands out, for good and for ill, and to provide a brief sketch of possible avenues for reform. I was given a broad remit today, so the level of detail is necessarily limited, but I am of course more than happy to entertain questions at any time during my testimony, or to discuss these matters further afterward. My hope is that by outlining some of the key issues, this review can contribute to a necessary conversation about which matters are of the greatest importance to this committee and, ultimately, to the Commonwealth.

Any consideration of tax reform in Pennsylvania has to begin with the Commonwealth's 9.99 percent Corporate Net Income Tax (CNIT), the second-highest state corporate income tax in the nation after Iowa, where businesses are able to deduct their federal taxes. A reduction in the corporate income tax is long overdue, and important to Pennsylvania's ability to compete with other states.

Moving to single sales factor apportionment some years ago was intended to dampen incentives to relocate out of the state due to the high rate, and no doubt it does that to some extent, but even if a company sells its products entirely out-of-state, it is likely to rely on a local supply chain hit by the tax. There has long been a bipartisan recognition that the corporate net

income tax rate is too high, and any effort at tax reform would likely take a long look at ways to reduce that rate.

One partial approach to doing so is to pay down rate reductions by curtailing targeted incentives. To its credit, Pennsylvania does not offer as many tax incentives as some of its peers, but several tax preferences in the code do add up. The Keystone Opportunity Zones credit forgoes \$79 million each year, while Innovation Zones add another \$15 million. The Research and Development credit costs \$55 million, and the Entertainment Production credit sets the Commonwealth back \$65 million. Those credits are collectively worth about 8 percent of CNIT collections—not an enormous amount, but not a drop in the bucket, either.

Another approach, of course, is to look for pay-fors elsewhere. Sales tax base broadening has proven a source of significant contention here in Pennsylvania, but since 2015, there have been serious proposals for base broadening coming from both sides of the aisle. Expanding the sales tax to include final consumption of select services would create greater tax neutrality while also providing an opportunity to pay down rate reductions, possibly across several taxes depending on the degree to which the sales tax base is expanded. The Governor has alternatively proposed combined reporting and severance taxes in exchange for reducing corporate rates.

Net operating losses have been a point of consideration over the last year, due to uniformity clause litigation. Ideally, a long-term goal would be to conform to federal treatment—which has changed under the new tax law—or create a state-specific system which does not limit the amount of losses which can be carried forward. Pennsylvania’s tax code discriminates against businesses with procyclical income that does not mirror the calendar year.

Pennsylvania also decouples from federal expensing provisions, meaning that, while businesses can deduct the full cost of labor and other expenses, the cost of capital investments can only be recovered over many years, across asset life depreciation schedules. Many states coupled to what was called “bonus depreciation,” which accelerated the expensing of machinery and equipment purchases. Those states will also conform to the full expensing provisions available under the new tax law. Pennsylvania will not, making the competitive gulf with many of its peers that much wider.

The Personal Income Tax is one of the bright spots in Pennsylvania’s tax structure, with its low, flat tax rate. It also has a broad base to go along with that low rate; most states have either a standard deduction, a personal exemption, or both, but Pennsylvania forgoes them. The Commonwealth is, however, unusually generous in its treatment of retirement income.

One particularly anomalous provision of the income tax, particularly in a state with a strict uniformity clause, is that there are five different classes of income, and losses in one class cannot carry over to offset gains in another. Pennsylvania is the only state which compartmentalizes income like this, and the system creates inequities for some taxpayers.

Property tax relief is a perennial subject in Harrisburg, and a worthy goal, but one that is difficult to implement at the state level. At times, policymakers have contemplated increasing the state's share of public education funding to reduce the pressure on localities to raise revenues through local property taxes, or providing offsets or rebates.

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

There are, however, ways that the state legislature can improve Pennsylvania's property tax system. In some respects, Pennsylvania does not have one property tax but three. In most states, there is only one property tax authority. Multiple jurisdictions may impose millages, but they are aggregated and collected by one political subdivision, typically the county. In Pennsylvania, county, municipal, and school districts each levy their own property taxes, and often on different schedules. This means that spending priorities do not compete with each other in a single budget, but instead are considered separately.

In addition to overlapping property tax authorities, Pennsylvania is also unique in its lack of mandatory assessments. In most states, assessments are required on a certain schedule—sometimes annually, more often every few years—to ensure that property tax burdens are equitably distributed. In Pennsylvania, however, counties vary their appraisal cycles, if they have one at all, and can use either market value or a base year as the basis for determining assessed values. My home county of Butler has not done a reassessment for nearly fifty years. Localities are wary of instituting assessment cycles on their own; the state could help by establishing a statutory cycle.

Meanwhile, local government pose a range of what foes call “nuisance taxes”—and the phrase seems apt. The local services tax is probably the most prominent, and localities have not been able to adopt new ones for decades. This antiquated gross receipts tax is, however, grandfathered in for some jurisdictions. It is non-neutral, results in tax pyramiding, and imposes compliance costs which are outsized compared to the revenue it generates. Putting an end to nuisance taxes would make Pennsylvania a more friendly place for economic activity.

The Commonwealth has made admirable progress in consolidating earned income tax collections at the county level, but significant administrative and compliance gains would be made by consolidating additional state and local levies, including nuisance taxes if they are retained.

Unfortunately, the Commonwealth is a patchwork quilt when it comes to tax authority. With eight classes of counties, four classes of cities, and two classes of townships, along with boroughs and unincorporated communities, taxing authority is diffused and varies greatly.

While it is not an easy lift, legislators should consider ways to streamline tax authority and tax collections, reducing these burdens and limiting duplication of effort for both individuals and governments.

Pennsylvania's system of unemployment insurance taxes includes both a reserve tax and taxes for negative balance employers. It also features an 18-month experience rating for new firms, whereas many states allow a company to get off the less favorable schedules after a year. Essentially, the system ratchets up the costs for new and struggling firms, which is understandable but also means that the tax burden is the highest precisely when businesses are trying to avoid layoffs.

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 even revenue positive way. With some changes, there would also be the possibility of phase-ins or the use of contingent revenue triggers to smooth the 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 dead weight losses, increasing costs for job creators without actually increasing state revenue.

For today, I was simply asked to provide an overview of areas where Pennsylvania diverges from many of its peers. 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 going forward. In the aftermath of federal tax reform, states are looking to overhaul their own tax codes. Pennsylvania cannot afford to fall further behind.

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