POLICY MEMO
FROM THE COMMONWEALTH FOUNDATION

November 2018

Pennsylvania's Path to Tax Relief

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Why Pennsylvania Needs Tax Reform Now

Rising tax burden. Pennsylvania's state and local tax burden is hindering job growth, suppressing wages, and enabling wasteful government spending. Our state's tax bill, which amounts to $4,589 per person, is one of the highest in the country. The Tax Foundation estimates a total of 10.2 percent of Pennsylvania's income is siphoned off to pay state and local taxes.

Economic stagnation. Since 1991, Pennsylvania has ranked 46th in job growth, and 45th in income growth. Additionally, our state's unemployment rate has been higher than the national average since July of 2015. The failure to compete for high-paying jobs in a global market has hampered population growth, which has been the fifth slowest in the nation since 1991. An average of 36 college graduates left our state every day in 2015, according to the Independent Fiscal Office. These troubling demographic trends show no sign of slowing down absent pro-growth policy changes.

Imminent difficult budget decisions. A series of poor political choices have pushed necessary fiscal decisions down the road. Over the next several years, lawmakers will need to decide how to cover mounting debt service costs and transportation expenses—a task made more difficult due to our state's historically slow growth economy.

As the Tax Foundation makes clear in a recent report, our state's tax code is broken. The assortment of onerous and obscure taxes coupled with an archaic administration system diverts resources away from taxpayers, job creators and ultimately efforts to improve the economy for all Pennsylvanians.

Principles of Good Tax Reform

Any comprehensive tax reform plan must adhere to four guiding principles to create a fair and competitive tax structure.

1. *Simplicity*. Pennsylvania's state and local tax codes are far too complex and burdensome. A comprehensive tax reform plan should move Pennsylvania in the direction of a simpler, more transparent tax code. This will reduce compliance costs and allow Pennsylvanians to allocate their time and money to pursuits more productive than bureaucratic paperwork.

2. *Fairness*. Tax codes should avoid conferring special privileges to well-connected interest groups to the maximum extent possible. A true reform plan will treat people equally no matter their income or political connections.

3. *Certainty*. Entrepreneurs need to know the government will not arbitrarily impose new rules on their businesses. Likewise, temporary tax increases or tax breaks provide a level of uncertainty that discourages long-term investment. Policymakers should provide a predictable tax structure to facilitate long-term economic growth.

4. *Relief*. Pennsylvania should not pursue tax reform just to raise revenue. Our state's total revenue collections are already at an all-time high. Instead, the purpose of reform to the state and local tax codes must be to provide real financial relief to people of all income levels—not to increase the wealth and scope of state and local governments. While raising revenue shouldn't be the primary purpose of tax reform, it will likely be one consequence of increased economic vitality and a broader tax base.

The Benefits of Good Tax Reform

Decrease the cost of living. Every dollar taxed by local or state government is a dollar people can't use to meet their own needs. In 2018 Americans will spend more on taxes—federal, state, and local—than they will on food, housing, and clothing *combined*.

Yet, taxation isn't the only way government increases the cost of living. It also imposes countless regulations on families and businesses, which act effectively as taxes. A Heritage Foundation analysis quantified a portion of these costs per household for just 12 regulations. They found the cost to each household was **$4,440 per year**. These hidden taxes makes reform even more urgent, considering the burden government places on working people is significantly underestimated.

Reduce out-migration. Pennsylvania continues to lose residents—with a net 25,793 people moving to other states last year. There is no doubt that taxes contribute to this out-migration. Between 2010-2016, the 10 highest-tax states (Pennsylvania fell .1 percent outside the top ten.) lost more than 2.3 million residents. In contrast, the 10 lowest-tax states gained more than 1.2 million residents.

A Cato Institute bulletin documented the domestic moving patterns of Americans in 2016. According to the author Chris Edwards, a net 600,000 people with an aggregate income of $33 billion moved from the 25 highest-tax states to the 25 lowest-tax states. Of the 25 highest-tax states, 24 lost a net number of people via interstate migration. Of the 25 lowest-tax states, 17 saw a net increase.

Increase economic growth. A wealth of evidence exists tying taxes to economic growth. Dr. William McBride conducted a review of the literature on this issue, which included 26 different studies dating back to 1983. Twenty-three of the studies found taxes negatively impacted economic growth. The other three found no relationship.

A 2010 study co-authored by Christina Romer, the former head of the Council of Economic Advisers for President Obama, found a tax increase of one percent of gross domestic product (GDP) lowered real GDP by about three percent. Another study found reducing marginal tax rates by five percentage points could increase growth rates by 0.2-0.3 percent.

These studies provide just a small sample of the evidence demonstrating lowering taxes leads to a healthier economy. A comparison of low-tax and high-tax states tells the same story. As the table below illustrates, the states with the lowest tax burdens outperform states with the highest tax burdens in both job and income growth. For Pennsylvania to spur income and job growth, we must lower our state and local tax burden.

THE EFFECT OF TAXES ON ECONOMIC GROWTH

States with the 5 Lowest Tax Burdens	State and Local Tax Burden as % of Income	Personal Income Growth Rate (2007-2017)	Non-Farm Payroll Employment Growth (2007-2017)
Alaska	6.50%	42.37%	2.53%
South Dakota	7.10%	39.02%	6.77%
Wyoming	7.10%	38.32%	-4.43%
Tennessee	7.30%	44.83%	7.93%
Texas	7.60%	53.76%	16.77%
Average	7.12%	43.66%	5.91%

States with the 5 Highest Tax Burdens	State and Local Tax Burden as % of Income	Personal Income Growth Rate (2007-2017)	Non-Farm Payroll Employment Growth (2007-2017)
Illinois	11.00%	28.84%	1.38%
Wisconsin	11.00%	33.86%	2.08%
New Jersey	12.20%	31.83%	1.47%
Connecticut	12.60%	25.71%	-1.78%
New York	12.70%	40.61%	8.47%
Average	11.90%	32.17%	2.32%

Sources: Tax Foundation, U.S. Bureau of Economic Analysis & U.S. Bureau of Labor Statistics

Tax Reform Options

1. *Lower the personal income tax rate*. Lawmakers should reduce Pennsylvania's Personal Income Tax (PIT) rate to its 2003 level—before Gov. Ed Rendell's income tax increase of nearly 10 percent.

2. *Reduce the corporate tax rate*. At 9.99 percent, Pennsylvania's Corporate Net Income Tax (CNIT) is third highest statutory rate. The Tax Foundation recommends reducing the rate to 6.99 percent to make our state more competitive. One way to offset a loss of revenue is by eliminating corporate welfare, which will cost Pennsylvania taxpayers approximately $847 million this year. Ending corporate welfare would enable a reduction of the CNIT to 7.04 percent.

3. *Normalize the treatment of operating losses*. Pennsylvania is just one of two states to cap the amount of net operating losses (NOL) that can be claimed in a given year. This harms entrepreneurs who are unable to use NOL deductions to mitigate tax obligations over time. This is especially problematic for businesses—like those in heavy industry and manufacturing—with "cyclical income,"—as they're required to pay more—relative to other businesses—in the absence of a NOL deduction. Gradually increasing the NOL cap would help businesses weather difficult times and protect the jobs so many depend on.

4. *Eliminate classes of income.* Pennsylvania is the only state that separates income into distinct classes and taxes each class without allowing for losses to carry over from class to class. This arbitrary penalty for small business owners, investors and others raises questions about the constitutionality of these distinctions, as the state's Constitution requires uniform taxation.

5. *Broaden the sales tax base to lower sales tax rates.* The Tax Foundation identifies at least 23 different goods or services exempted from Pennsylvania's sales taxes. Some of these services—specifically those related to health care—should remain exempted. However, other goods and services—like candy, spectator sports admission tickets, and parking—could be taxed to lower Pennsylvania's six percent sales tax rate. Eliminating these and other sales tax exemptions should **not be used as a tool to raise revenue**.

6. *Streamline tax administration.* Pennsylvania's dizzying number of tax authorities is unnecessarily expensive. Consolidation can reduce these costs. Act 32 of 2008 consolidated the collection of the earned income tax at the county level. It reduced the number of tax collection jurisdictions by 2,831 and tax collectors by 543. Policymakers should expand consolidation of tax collection to include property taxes, which are collected by numerous governmental bodies.

Case Study: Kansas vs North Carolina's Tax Reform Efforts

Kansas and North Carolina provide valuable lessons for tax reformers. However, Kansas's *tax relief package was not tied to spending restraint*. General Fund spending in Kansas rose by 55 percent from 1995 to 2017. This large increase, along with tax rate reductions, triggered serious fiscal problems. As Jonathan Williams and Joel Griffith point out, if Kansas kept spending growth to the rate of inflation, the state would not have faced a budget deficit.

In contrast, North Carolina *reduced taxes and controlled spending*, greatly benefitting the state's economy. North Carolina's job and income growth has exceeded the national average over the last five years. Today, North Carolinians have saved approximately $7 billion in taxes since 2013, according to Joseph Coletti of the John Locke Foundation. Plus, the state's reserve fund is more than $2 billion, and the state projects a surplus for the 2019-2020 fiscal year.

As North Carolina demonstrates, tax reform—coupled with spending restraint—is essential to improving Pennsylvania's fiscal and economic health. Now is the time to act. Pennsylvanians deserve no less.