



BUDGET WATCH

The End Game:

Finding The Funds To Balance The Budget

The General Assembly is in the final stages of negotiating the budget for Fiscal Year 2007–08. The House of Representatives adopted the Governor’s proposed \$27.3 billion spending plan on May 25, and on June 20th the Senate passed its version of the spending plan, reducing or eliminating funding for initiatives in health care, child nutrition, child care, education, and workforce development.

Governor Rendell’s February budget proposal was balanced through an increase in the state’s sales tax rate from 6 cents to 7 cents, with the roughly \$1.2 billion in revenue raised allocated to general fund spending (\$820 million) and property tax relief (\$420 million.) The sales tax increase has not been embraced by the legislature, even by members of the governor’s own party and the governor has acknowledged that it is likely a dead issue this year.

The Commonwealth will end the fiscal year with a surplus, as it has the last two years. In May, revenues were \$409 million ahead of projections and the surplus could reach \$500 million. Still, without additional funding, proposed initiatives in health care, education, transportation, and workforce development will be scaled back or eliminated.

There *are* ways to raise the revenue needed to support these and other important priorities, and to do so in a fair and sustainable way.

Polls suggest that Pennsylvanians are willing to raise taxes to pay for many of the Governor’s budget priorities, including some currently on the chopping block. The most recent Franklin & Marshall Keystone Poll, released on June 6, found that wide majorities support tax increases linked to improved transportation, health insurance and renewable energy.¹

While Pennsylvanians may be willing to pay higher taxes to support budget initiatives, the General Assembly is not willing to raise them. Philosophical opposition to higher state spending coupled with an uncertain political climate have stymied fact-based discussion about the need for spending on services and investment in the future.

This brief offers three approaches that could raise sufficient revenue to fully fund the programs in this year’s budget and at the same time make Pennsylvania’s tax system fall less heavily on low- and middle-income families:

1. Selectively **broaden the sales tax base** to include more goods and services, while preserving the current exemption from sales tax of basic necessities such as food and clothing.
2. Increase the **personal income tax rate on some nonwage income**, including dividends and business profits passed through to owners of types of corporate entities (that currently face very low tax rates). Rate changes as small as 1% on either of these categories of income could raise more than \$280 million per year.
3. **Close corporate tax loopholes** through the adoption of combined reporting, and retain some or all of the revenue in the general fund.

Three Options For Raising Revenue For 2007–08

Table 1 summarizes the revenue increases that would result from three non-sales tax options for raising revenue.

Table 1. Options for Raising Revenue for 2007–08	
Option	Increase in Revenue, 2007–08
Expand the sales tax base (1)	
Selected currently exempt goods	\$392 million
Selected currently exempt luxury services	\$275 million
Increase the personal income tax rate 1% on some classes of nonwage income (higher increases in the rate would raise more revenue) (2)	
Dividends and other taxable income (excluding interest)	\$302 million
Net profits	\$289 million
Close corporate tax loopholes/modernize tax system (3)	
Combined reporting (without rate reduction)	\$615 million
<i>Sources.</i> (1) PBPC calculations using tax expenditure data presented in the 2007–08 Governor’s Executive Budget. (2) PBPC calculations based on 2004 PIT data reported by the Pennsylvania Department of Revenue. (3) Pennsylvania Department of Revenue fiscal analysis of HB 1186, PN 1465.	

All three of these options would avoid making the Pennsylvania tax system even more unfair to low- and middle-income taxpayers, and the last two options would make the state tax system more equitable.

Pennsylvania’s top income tax rate, at 3.07, is the second lowest in the nation, higher only than Illinois (3.0), and significantly lower than Maryland (4.85%) Ohio (6.55%), West Virginia (6.5%), Delaware (5.95%), New Jersey (8.97%) and New York (6.85%).

It is important to note that most business tax filers in Pennsylvania pay taxes at the personal income tax rate of 3.07% rather than the corporate tax rate of 9.99%. Businesses incorporated under Subchapter S of the Internal Revenue Code and business partnerships, which together constitute 55% of all business tax filers, pay at the lower rate.

Pennsylvania is widely recognized for having one of the tax systems in the United States that falls most heavily on middle- and low-income families. In 2003, the Institute on Taxation & Economic Policy ranked Pennsylvania eighth in its “Terrible Ten” list of the most regressive tax systems.²

Non-elderly Pennsylvanians with the lowest fifth of income pay 11.4% of their income in state and local taxes, while the top 1% pays only 3.5%.³ This differential is among the highest in the nation. Sales taxes follow a similar pattern: the poorest Pennsylvanians pay 2.4% of their income in general sales taxes, while Pennsylvanians in the top 1% of income pay only 0.7% of their income in sales taxes.⁴

Much of this regressivity is due to the state’s flat personal income tax rates (at the local as well as state level) with no personal exemptions. Some of the regressivity of our tax system is due to Pennsylvania’s relatively narrow sales tax base.

Increasing the PIT on certain categories of nonwage income (such as dividends, but not including interest) is an especially effective way of shifting more of state taxes to upper-income taxpayers. Under the 1% increase in the PIT

on these categories proposed above, a taxpayer with taxable income between \$75,000 and \$99,999 would pay only \$40 additional in taxes. A taxpayer with taxable income of \$150,000 or more would pay \$957 more on average.

Conclusion

Pennsylvania general fund spending has been remarkably steady as a share of personal income, consuming about as much of the overall economy, 5.6%, as it did 15 years ago. Structural problems in Pennsylvania's tax system—its flat rate, loophole-rich corporate tax structure, and narrow sales tax base—reduce the natural growth in revenues that comes through normal economic activity, and increases the need to raise taxes to maintain service levels as well as to invest in the future.

Closing loopholes, broadening the tax base, and making the system more fair through slightly higher taxes on some forms of income would together provide needed revenue to fund services for Pennsylvania's children and seniors, and encourage economic growth, without increasing the tax burden on lower-income Pennsylvanians.

Endnotes

1. Franklin and Marshall College, Center for Opinion Research, June 6, 2007, www.fandm.edu/keystonepoll.xml
2. Institute on Taxation and Economic Policy, "State & Local Taxes Hit Poor & Middle Class Far Harder than the Wealthy," Jan. 7, 2003. <http://www.itepnet.org/wp2000/pr.pdf>
3. Institute for Taxation and Economic Policy (ITEP), *Who Pays? A Distributional Analysis of the Tax System in All 50 States*. Second Edition (Washington, D.C.: ITEP, January 2003). An updating of this analysis is expected shortly and Pennsylvania still has one of the 10 most regressive state and local tax systems in the nation. The figures in the text on the share of income paid in state and local taxes take into account the reduction in federal taxes that results when some taxpayers include state and local taxes among their itemized deductions.
4. Robert S. McIntyre et al., *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, 2nd Edition, (Washington: The Institute on Taxation & Economic Policy 2003).