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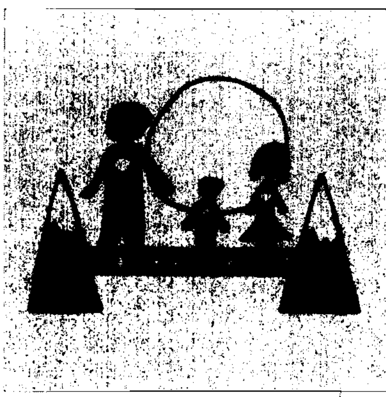
ABSTRACT

Noting that a state's tax policies have direct impact on a family's ability to feed, clothe, house, educate, and care for its children, this report presents an overview of taxes in the state of Pennsylvania. The report is presented in five sections. Section 1 presents the argument that it is necessary to understand the rule driving the revenue system in a state in order to make the system work for Pennsylvania families and their children. Section 2 contains a glossary of tax terms and concepts used throughout the paper. Section 3 introduces Pennsylvania's major taxes and revenue generators: (1) property (the primary funding source for Pennsylvania schools) and other local taxes; (2) personal income tax; (3) sales and excise taxes; (4) corporate net income and other business taxes; and (5) lottery and motor license funds. Section 4 evaluates the entire system's effectiveness and quality, based on criteria developed by the National Conference of State Legislatures. Section 5 presents proposals for 3 new family-friendly tax strategies: (1) increase tax forgiveness thresholds; (2) establish a general fund property-tax/rent rebate program for low-income families with dependent children; and (3) create a dependent care tax credit. The report concludes by asserting that although taxes are at the heart of a functioning government, it is important to evaluate the allocation of tax dollars and to inject a family perspective into the tax system. (Contains 20 references.) (KB)

TAXING PENNSYLVANIA:

A Family-Focused Overview of Pennsylvania Taxes



Pennsylvania
Partnerships
for Children

State Fiscal Analysis Initiative

October 1999

State Fiscal Analysis Initiative

The State Fiscal Analysis Initiative is designed to broaden public understanding of taxes and budgeting so more citizens can comfortably participate in policy-making. As funding and management of social programs devolve to states, SFAI focuses on helping policymakers and citizens grasp the increasing opportunities and responsibilities facing them. Pennsylvania Partnerships for Children is pleased to be one of 22 state-based organizations chosen to participate in this initiative.

Pennsylvania Partnerships for Children is an independent, nonpartisan advocacy organization promoting public policies that benefit children's well-being. The SFAI project is funded by the Ford Foundation, the Charles Stewart Mott Foundation, the Annie E. Casey Foundation and the Open Society Institute.

Throughout this paper are estimates of family spending on children's needs. These are derived from the U.S. Agriculture Department's Center for Nutrition Policy and Promotion's 1998 Annual Report, *Expenditures on Children by Families*. They represent two-adult families with children in the lowest income range, averaging $22,500 in before-tax income. Elsewhere, in the introduction, the vertical equity evaluation, and strategy recommendations, citations of households' tax burdens represent non-elderly married couples with and without children. These figures are derived from *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States,* published by Citizens for Tax Justice and The Institute on Taxation & Economic Policy. This indicator has been used because of the absence of reliable information pertaining exclusively to families, married or unmarried, with children.

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Taxing Pennsylvania: Introduction

Families pay taxes. Businesses pay taxes. Their taxes fund government services that, in turn, support families, businesses, organizations, and communities.

But to paraphrase an old baseball saying, you can't tell the taxes without a scorecard. Pennsylvania's tax system, like all others, is built on a mystifying set of principles and interrelationships. Even a straightforward tax like the sales tax has exemptions and exceptions and special circumstances. How these circumstances play out - whether taxes are applied in relation to the taxpayer's ability to pay and at the right level to fund needed services now and in the future - is difficult to gauge objectively.

A low-income family spends an average of $6,000 annually on each child's food, clothing, housing, transportation, education, health care and other expenses. These families pay a substantial percentage of their income in state and local taxes.

And yet, objective review is critical to understanding this unavoidable part of our daily lives. For a household in the lowest 20 percent of income, those among the group averaging $17,800 in earnings, these questions are particularly relevant because they pay 13.3 percent of their scarce income in taxes. The state's tax policies impact directly on that household's ability to feed, clothe, house, educate and care for children. In this atmosphere, children's needs for adequate health care and nutrition, a safe home with a quiet place to study, and time for interaction with caring, nurturing adults aren't always met.

To increase understanding of the state's tax system and its impact on children and their families, Pennsylvania Partnerships for Children has prepared this basic tax overview. It begins with a glossary of tax terms and concepts used throughout this paper, followed by a bird's-eye view of Pennsylvania's revenue structure.

The third section introduces Pennsylvania's major taxes and revenue generators:

- Property and other local taxes
- Personal income tax
- Sales and excise taxes
- Corporate net income and other business taxes
- Lottery and Motor License funds

The fourth section evaluates the entire system's effectiveness and quality, based on criteria developed by the National Conference of State Legislatures. And finally, PPC proposes three new family-friendly tax strategies.

Understanding the rules that drive the system that imposes the taxes is a first step in making that system work for Pennsylvania families and their children.

Concepts and Terms in Pennsylvania Taxation

Tax systems are based on a set of concepts, and Pennsylvania's tax laws contain definitions, formulas, and exceptions that shape their application to millions of individuals and businesses. These concepts determine how much taxpayers pay and how much is left for personal or corporate priorities. Some of the concepts that impact most directly on families, plus important tax terms and types, are defined here.

Assessment: A valuation of a piece of property (land and buildings) at its market value or the dollar amount at which it could be sold. Many jurisdictions assess property at a specified percentage of its estimated true market value, establishing "assessed value."

Base: The amount of income or property or selling price to which a tax rate is applied. Common tax bases are income, property, sales price, gross receipts, or volume, such as a gallon of gasoline.

Benefit principle: Paying taxes in relation to government services received. Example: Motorists who drive long distances will pay more in gasoline tax.

Business cycle: An economic period encompassing recession, recovery and growth. An economy is considered in recession when total production declines for at least two straight three-month periods. It often takes a year or two or more to regain previous levels, and then it may continue growing for three, five, or more years before the next recession.

Capital stock: Ownership shares of a company or corporation.

Capital stock and franchise tax: In-state corporations pay the capital stock tax, while out-of-state corporations pay the foreign franchise tax on capital stock apportioned to Pennsylvania. Family farm corporations are exempt. Manufacturing and processing, computer software development, research and development, and air or water pollution control are also exempt. The tax rate is currently is 10.99 mills (about 1.1 percent) with a minimum tax of $200.

Corporate net income tax: A tax on in-state taxable profits. Multi-state corporations use an apportionment formula to determine the portion of profit allocable to a particular state. Corporations doing business in Pennsylvania pay a corporate net income tax of 9.99 percent. Some smaller businesses known as "S" corporations and limited liability companies pay the lower personal income tax, instead of the corporate income tax. Building and loan associations, insurance companies and banks aren't subject to the corporate net income tax, but they may pay other, industry-specific taxes. Non-profit corporations are exempt.

Credits: Subtractions from the tax amount that would otherwise be owed.

Deduction: A specified amount deducted from the tax base to fund various activities. Also called "exemption."

Earned income tax: In Pennsylvania, a local tax extracted from a narrow definition of income. For earned income tax purposes, wages, salaries, tips, commissions, and bonuses are income, but interest and dividends are not.

Excise taxes: Similar to sales taxes, but imposed on a narrow range of goods. When levied with the hope of discouraging consumption, some excise taxes are called "sin taxes." Usually expressed per unit or volume of the good, rather than as a percentage of the sales price.

Exclusion: Income which would normally be considered part of the tax base but which is partially or completely excluded from it.

Exemption: A specified amount deducted from the tax base to fund various activities. Also called "deduction."

Factor weighting: Corporations are taxed on the amount of business they do in Pennsylvania. The figure is calculated with an apportionment formula based on three factors: property, payroll, and sales attributable to Pennsylvania. Until 1995, Pennsylvania weighted each of these three factors equally, but by 1999, the state had adopted "triple-weighting," weighting sales 60 percent and property and payroll each 20 percent.

Federal adjusted gross income: All sources of income minus a limited list of items, including long-distance moving expenses for a new job, half of self-employment tax, and alimony paid.

Federal taxable income: Adjusted gross income minus exemptions for each family member and allowable deductions.

Financial institutions taxes: Banks, trusts and title insurance companies are taxed 1.25 percent of their capital stock, and mutual thrift institutions 11.5 percent of their net income.

General Fund: The fund into which the state's general ("non-earmarked") revenues are deposited and from which monies are appropriated to pay general expenses.

Gross receipts tax: A tax on a business' gross sales. Similar to a sales tax but usually on a narrower base or range of goods or services. In contrast to a sales tax, gross receipts taxes are not necessarily itemized on customer bills.

Horizontal equity: A tax or tax system has horizontal equity when people with the same ability to pay taxes, pay close to the same amounts. For example, tax provisions that recognize the costs of raising additional children have horizontal equity. Another example would be taxing jurisdictions that give similar assessed valuations to homes of similar value.

Incidence: See **Tax incidence**

Inheritance tax: Direct descendants - children, parents and grandparents - pay a 6 percent inheritance tax, and other heirs pay 15 percent, based on the federal estate tax base. Transfers of money and property to a spouse are not taxed.

Insurance premiums tax: Insurance sales aren't subject to the 6 percent sales tax, but insurance companies must pay 2 percent of their premium amounts in taxes. The base is gross premiums from all business transacted in Pennsylvania by in-state and out-of-state companies.

Mills: One one-thousandth of a dollar or one-tenth of a cent. A 10-mill tax equates to $10 for every $1,000.

Personal income: A measure of a whole economy totaling all income in a year. The figure, which totaled $323 billion in Pennsylvania in 1998, includes not only wages but also fringe benefits, interest, rent received, dividends, unincorporated businesses' profits, government cash payments, and indirect business taxes.

Personal income tax: In Pennsylvania, a 2.8 percent income tax paid on compensation, net profits, interest, dividends, capital gains, rents and royalties, gambling and Lottery winnings before July 20, 1983, and income from estates and trusts.

Progressive: A tax or tax system is progressive when higher-income people pay a higher percentage of their income in taxes than lower-income people.

Proportional: A tax or tax system is proportional when it takes the same percentage of income from all families, regardless of income.

Public utility realty tax: In Pennsylvania, a tax levied on the value of property owned by regulated public utilities.

Rate: A percentage, millage, or cents or dollars per unit, which is multiplied by the tax base to determine the tax owed.

Refundable/nonrefundable credit: When some tax credits exceed the tax liability (taxes owed before withholdings), the taxpayer gets a refund of the excess. These are called "refundable" credits. An excess credit that is not refunded - meaning that the tax liability is reduced to zero and no less - is called a nonrefundable credit.

Regressive: A tax or tax system is considered regressive when lower-income people pay a higher percentage of their income in taxes than higher-income people.

Reliability: A tax's ability to remain relatively constant over time, minimize fluctuations in revenue, and grow with the economy or personal income to provide for population growth, salary increases and inflation, and changing policies or needs. Also called "adequacy."

Revenue: Monies received from taxes, fees, fines, and other sources deposited in the state treasury and available as a source of state government funds. This paper does not include federal grants in revenue amounts.

Sales tax: Pennsylvania's 6 percent sales tax is levied on retail purchases and rentals. However, the tax isn't imposed on some items considered essential to daily life — food, clothing (including footwear), prescription and non-prescription drugs, and residential utilities. Also exempt are most business services, although premium cable television, repairs to taxable items such as vehicles and appliances, and hotel room rentals are taxed. Restaurant food, cigarettes, beer, wine, and liquor are taxed at 6 percent, while a distinct excise tax is imposed on cigarettes, beer, wine, and liquor. An additional 1 percent sales tax is levied in Philadelphia and Allegheny County.

Special fund: An independent fiscal source of money set aside ("earmarked") by law to carry out specific activities. Pennsylvania examples include the Lottery Fund and the Motor License Fund.

Stability: A tax system's ability to remain relatively constant over time, minimizing revenue fluctuations as the economy rises and falls.

Sufficiency: A tax system's ability to provide revenue in appropriate amounts, including the revenue growth needed to finance the desired rate of growth of spending.

Tax incidence: The people who ultimately bear the financial burden of a tax. For example, a business may pass some of a tax on to consumers, shareholders, or workers, and a landlord may pass part of the property tax on to renters.

Tax expenditures: A reduction in revenue that would otherwise be collected by the state as the result of an exemption, deduction, exclusion, tax deferral, discount, refund, commission, credit, special rate or special treatment. Also sometimes known as "tax breaks" or "loopholes." Though tax expenditures reduce the amount of taxes collected, they can also be an alternative to government funding for a social good. For example, if Pennsylvania taxed scholarships - which it doesn't - the revenue could fund a financial aid program for more students.

Tax forgiveness: A poverty-based exemption from paying a tax. In Pennsylvania, the personal income tax is not levied on the lowest-income families - families of three with annual incomes up to $19,500, families of four with annual incomes up to $26,000, and so on - and is reduced for families within the next $2,250 of income. Also known as the "Special Provision," participants meeting eligibility criteria can get a refund. After one full tax year of participating, eligible citizens can also stop automatic withholding of the state income tax from their paychecks.

Uniformity Clause: The uniformity clause, a fixture in the Pennsylvania Constitution since the 19th century, is currently Article VII, Section 1: *"All taxes shall be uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax, and shall be levied and collected under general laws."* Notably, the clause allows exceptions for "age, disability, infirmity, or poverty," making tax forgiveness possible for low-income citizens.

User fees: Fees applied for the use of a public service, such as highway tolls and park admission.

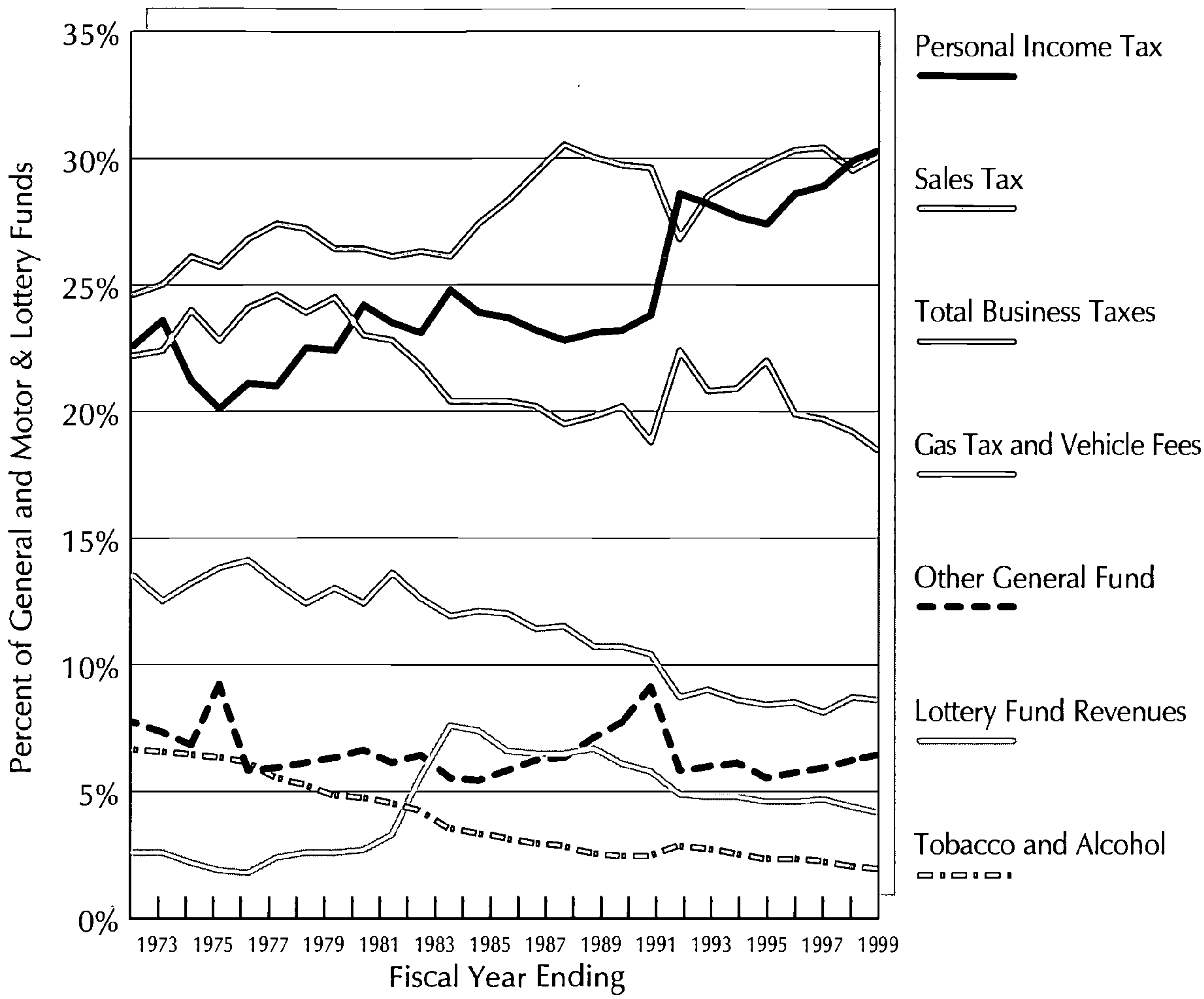
Utility gross receipts tax: A tax levied on the gross receipts of business transacted wholly within Pennsylvania by utilities such as gas, electric, and telephone companies. Municipally owned public utilities and electrical co-ops are exempt. The rate is 50 mills for gas and phone companies and 44 mills for electric. Beginning January 1, 2000, regulated gas companies' gross receipts from the sale of natural and artificial gas will be exempted. The incidence of the tax is on families and businesses, which purchase electricity and telephone services from Pennsylvania-based utilities, and also on shareholders and employees.

Vertical equity: A tax or tax system has vertical equity when people with different incomes pay different amounts. The term explains how a tax affects different families from the top of the income spectrum to the bottom, from rich to poor. Within the definition of vertical equity, taxes may be:

- *Progressive:* Taking a higher percentage of income from higher-income people.
- *Regressive:* Taking a higher percentage of income from lower-income people.
- *Proportional:* Taking the same percentage of income from all families, regardless of income.

Pennsylvania Revenue Structure

Trends from 1972-73 through 1998-99: Major Taxes' Share of Overall State Spending Needs

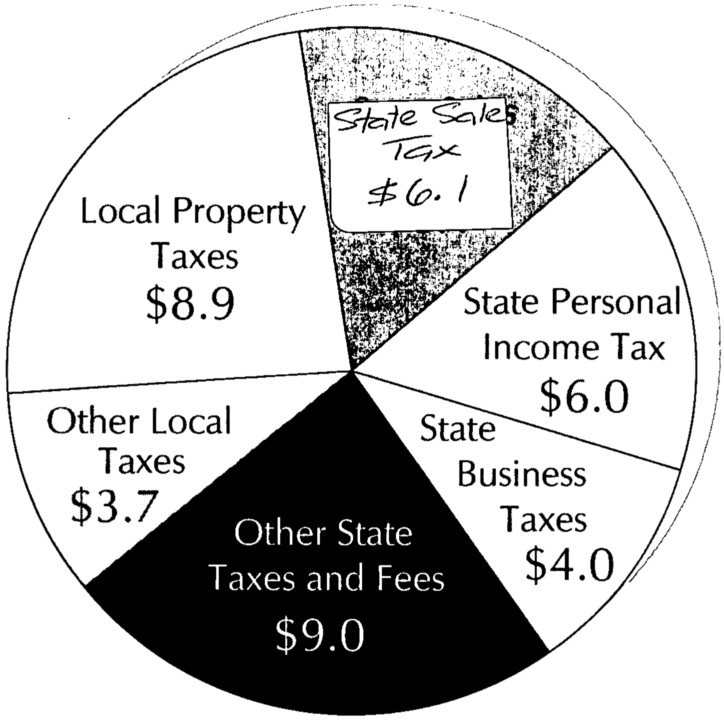


Source: Pennsylvania Partnerships for Children

- The sales tax was traditionally the state's largest tax source, but the personal income tax has risen to equal it. Since the sales tax rate has stayed at 6 percent for more than 30 years, the peaks and valleys of the sales tax reflect instability over the ups and downs of a normal economic cycle.
- The income tax rate is more often raised and lowered to counterbalance changing revenue intake as the economy rises and falls. Therefore, its major bumps reflect rate changes, and its growth over the entire period represents rate increases and the economic growth of its base.
- Business taxes show a long-term decline, but their rates also rise during economic downturns.
- Sales, personal income, and total business taxes are the big three contributors to state revenue.
- The gas tax and vehicle registrations and fees (Motor License Fund) have declined over the 25 years, as have excise taxes on cigarettes, beer, wine and liquor.
- The Lottery Fund's share of overall revenues has been declining since 1984.

Size and Role of State Taxes and Fees and Local Taxes in Pennsylvania's Overall Economy, 1997

— BILLIONS OF DOLLARS —



1997	In billions of $	$ per capita	% of PA personal income
State Sales Tax	$6.1	$507	2.0%
State Personal Income Tax	$6.0	$498	1.9%
State Business Taxes	$4.0	$329	1.3%
Other State Taxes and Fees	$9.0	$746	2.9%
Other Local Taxes	$3.7	$312	1.2%
Local Property Taxes	$8.9	$743	2.9%
Total	**$37.7**	**$3,135**	**12.2%**

Source: Pennsylvania Partnerships for Children

In 1997, the $37.7 billion collected in state and local taxes totaled 12.2 percent of the state's $308 billion in "personal income," a term used as a comprehensive measure of an economy. A state's personal income includes a much larger swath of earnings than just the personal income declared on tax forms.

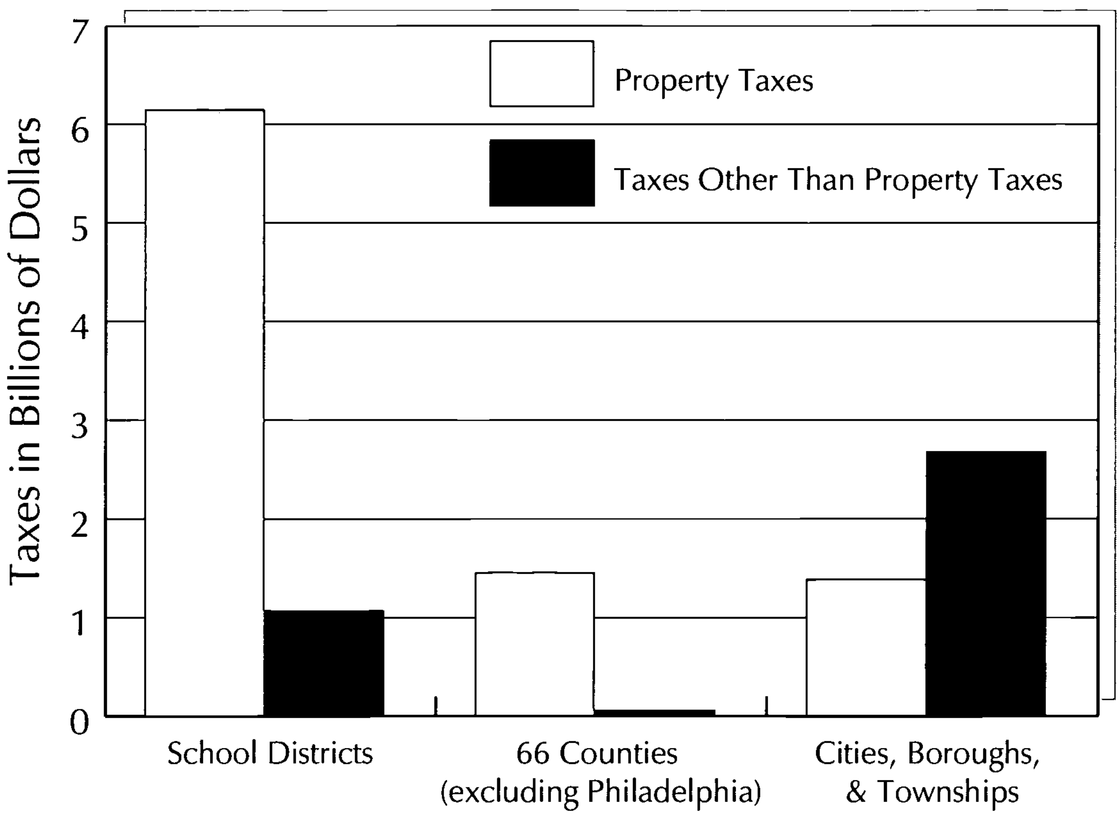
Pennsylvania ranks 42nd lowest among states in state and local revenue as a percentage of personal income and 26th lowest on a per capita basis. Overall, Pennsylvania is not a high tax state.

Local and Property Taxes

The primary tax for Pennsylvania local governments and school districts is the property tax, amounting to $8.9 billion, or almost $750 per capita. In 1997, property taxes comprised 85 percent of school districts' revenues and 94 percent of county revenues.

- Of the $3.7 billion non-real estate local tax dollars, $2.4 billion comes from the local earned income tax.

Size and Role of Property Taxes for School Districts and Local Governments in Pennsylvania, 1997



Source: Pennsylvania Partnerships for Children

- School taxes dominate local taxes.
- Like schools, counties rely heavily on the property tax for revenue.
- Property taxes comprise 70 percent of all local taxes collected.

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Personal Income Tax

In 1997, the state's 2.8 percent personal income tax collected $6 billion in revenue. The total collected represented 1.9 percent of state personal income or $498 per capita. **Pennsylvania is the only state whose personal income taxes aren't tied to the federal income tax.** Other states begin their tax forms with federal adjusted gross income or federal taxable income, or they make their state's tax a percentage of the federal tax amount.

TAX FORGIVENESS

Under the Uniformity Clause's poverty exemption, the state's lowest-income families don't pay the personal income tax. For the 1999 tax year, families of four with annual incomes up to $26,000, families of three with annual incomes up to $19,500, and so on owe no tax. Tax liability is phased in to the full 2.8 percent over the next $2,250 of income.

TAX EXPENDITURES

Pennsylvania's personal income tax has two major tax expenditures:

- More than $1.2 billion not collected because retirement income - Social Security and most pensions - is not considered income.
- More than $1.2 billion not collected because employers' contributions to current employees' retirement plans and health plans aren't taxed.

Other tax expenditures include home sale proceeds, welfare benefits, and payments to foster parents.

Sales and Excise Taxes

SALES TAX

Pennsylvanians pay the sales tax, set at 6 percent since 1968, on retail purchases and rentals. However, the tax isn't imposed on some items considered essential to daily life — food, clothing (including footwear), prescription and non-prescription drugs, and residential utilities. Also exempt are most business services, although premium cable television, repairs to taxable items such as vehicles and appliances, and hotel room rentals are taxed. Restaurant food, cigarettes, beer, wine, and liquor are taxed at 6 percent, while a distinct excise tax (see page 9) is imposed on cigarettes, beer, wine, and liquor. An additional 1 percent sales tax is levied in Philadelphia and Allegheny County.

A low-income family spends a rising amount on clothes for growing children, from $390 annually for a newborn, to $470 for a preteen, to an average of $735 for a teenager. Pennsylvania families do not pay sales tax on their clothing purchases, enhancing their buying power. Families in some neighboring states, like Maryland, pay sales taxes on clothing, making it even harder for low-income families to make ends meet.

TAX EXPENDITURES

Major tax expenditures include:

- More than $1 billion not collected on food in 1999-2000. Not taxed as a basic necessity of life, food takes a larger share of low-income families' earnings than those earning higher incomes.
- $900 million not collected on clothing. The Pennsylvania Revenue Department has concluded that any clothing tax would be very regressive, because families earning between $10,000 and $20,000 spend an average of 11 percent of their income on clothes, while families earning between $50,000 and $75,000 spend 4 percent on clothing.

- $1 billion not collected on retail purchases by governments, non-profits, and religious organizations.
- Nearly $1 billion not collected on manufacturing, processing, and agriculture.
- More than $415 million not collected on residential utilities and water.

A low-income family spends an average of $1,270 a year on each child's food costs. Essential food purchases are exempt from sales tax in 25 states, including Pennsylvania - allowing low-income families to stretch their resources further.

EXCISE TAXES

Excise taxes, similar to sales taxes, are imposed on a narrow range of goods. Some are also known as "sin taxes," because they're sometimes imposed with the hope of discouraging consumption.

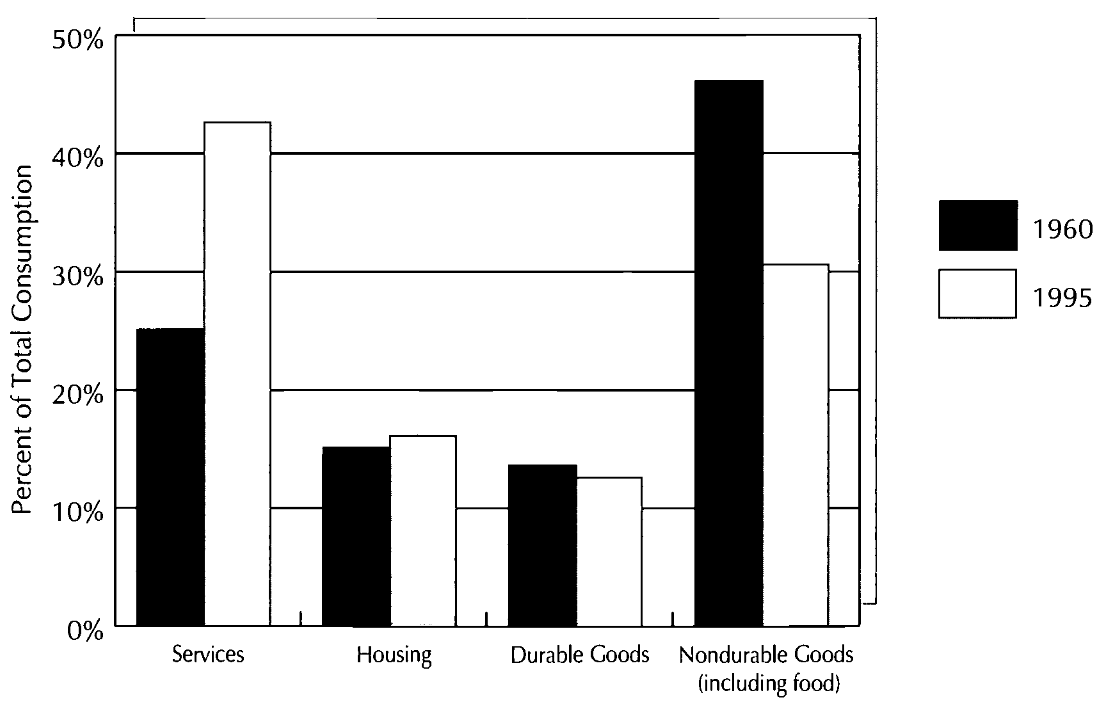
Cigarettes: Pennsylvania's excise tax is 31 cents a pack — 29th highest in the nation. States' rates range from 2.5 cents to $1 per pack. Three cents of Pennsylvania's tax is transferred to the Children's Health Insurance Program (CHIP) and 2 cents to the Agricultural Conservation Easement Fund. The remaining 26 cents goes to the General Fund.

Beer: 1 cent per can or bottle or 1 cent per pint on larger quantities.

Liquor: 18 percent, including all wine and spirits sold by the Liquor Control Board at State Stores and to restaurants and bars.

Gasoline: 12 cents per gallon, plus an additional 14 cents in oil company franchise tax is levied on a per-gallon basis (19 cents for diesel). Most of this revenue source goes into the Motor License Fund.

Personal Consumption Has Shifted Away from Goods and Towards Services
United States



Source: Center on Budget and Policy Priorities using data from the U.S. Bureau of Economic Analysis.

Since 1960, the United States economy has shifted dramatically, away from a reliance on the sale of goods and toward the sale of services. Because many services aren't taxed in Pennsylvania, the economic change has affected sales tax revenue.

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Business Taxes

In evaluating the impact of business taxes on Pennsylvania families, the question becomes: Who pays a tax initially, and who pays it ultimately? If a business tacks the tax onto the price of its products, then consumers bear some of the burden. If profits and dividends are lowered, then owners and shareholders bear some of the burden. And if salaries stagnate or decline to make up for a tax, then employees bear some of the burden. Thus, the ultimate incidence of a tax on businesses is some combination of consumers, owners, and workers.

CORPORATE NET INCOME TAX

Pennsylvania's corporate net income tax rate changes more frequently than many other taxes. The rate rose from 8.5 percent to 12.25 percent after the 1990 recession, but fell to 9.99 percent in 1995. **The corporate net income tax rate is still one of the nation's three highest, and its share of overall state revenues is the 12th highest among states.** Thus, Pennsylvania relies more heavily on the corporate net income tax than most other states.

CAPITAL STOCK AND FRANCHISE TAX

The capital stock and franchise tax rate is currently 10.99 mills (about 1.1 percent) with a minimum tax of $200. Like the corporate net income tax, the capital stock and franchise tax rose from 9.5 mills to 13 mills in 1991, then fell to 10.99 mills in 1999. Stockholders bear most of the burden of federal and state corporate income and capital stock taxes.

UTILITY GROSS RECEIPTS TAX

The utility gross receipts tax's incidence is on families and businesses, which purchase electricity and telephone services from Pennsylvania-based utilities, and also on shareholders and employees.

OTHER BUSINESS TAXES

Other major Pennsylvania business tax contributors include public utility realty, the insurance premiums, and financial institutions taxes.

TAX EXPENDITURES

Business tax expenditures include:

- Almost $600 million not collected from exemptions on manufacturing and processing, and research and development.
- About $30 million not collected for the air and water pollution control exemption.
- Nearly $200 million not collected from mutual insurance associations and from non-profit hospital and medical organizations, such as Blue Cross/Blue Shield.

Funds and Credits

LOTTERY FUND

About half of state Lottery revenues finance prizes, and the other half fund spending programs. The Lottery isn't a tax, but it is considered a regressive way to raise revenue because low-income people, on average, spend a decidedly higher percentage of their income on lotteries.

Lottery funds are earmarked for programs for the elderly and disabled, easing the demand for services that might otherwise be placed on the General Fund. Most notably:

- The Property Tax and Rent Rebate program reduces the property tax burden for low-income elderly and disabled citizens, rebating $80 million to about 300,000 households in 1998.
- The $260 million Pharmaceutical Assistance Contract for the Elderly, or PACE, covers some prescription drug costs for 240,000 elderly, low-income Pennsylvanians.

> *A low-income family spends an average of $2,096 a year on each child's housing costs. Low-income families who rent or own their homes are further burdened by local property taxes.*

MOTOR LICENSE FUND

The largest of the special funds, the Motor License Fund is fueled by vehicle registrations, fuel taxes, drivers licenses, inspection stickers, and vehicle title fees. Most of it finances highway construction and maintenance and State Police highway patrol operations.

> *A low-income family spends an average of $903 a year on each child's transportation costs. Adding to the cost of transportation, many Pennsylvania low-income families pay sales tax on the purchase of a used or new car, title fees, annual registration and inspection sticker fees, and gas tax.*

TAX CREDITS

Pennsylvania has several tax credit programs, reducing the amounts that individuals and businesses pay for specific taxes. All impact on families' job prospects and quality of life: Neighborhood Assistance Program, Job Creation Tax Credit, Waste Tire Recycling Tax Credit, Employment Incentive Payments Program, Research and Development Tax Credits, and the new Keystone Opportunity Zone, which exempts residents and businesses in certain blighted areas from income, property, and business sales taxes until 2011.

Evaluating Pennsylvania's Tax Sources

States adopt taxes to meet the needs of their citizens, but how do you gauge success? One way is to apply a set of criteria developed by the National Conference of State Legislatures. The criteria's six principles can be used to evaluate an individual tax's impact within a state's overall revenue mix. The six principles are:

- Reliability
- Equity
- Compliance and administration
- Responsiveness to interstate and international competition
- Economic neutrality
- Accountability

Applied to Pennsylvania, these principles can reveal the quality and effectiveness of the taxes that Pennsylvania families pay.

RELIABILITY

Reliability has two primary components:

- *Stability* — The tax remains relatively constant over time, not fluctuating unpredictably, and minimizing ups and downs with the business cycle.
- *Sufficiency* — The tax provides enough revenue to keep up with the desired rate of spending growth.

Stability

- Pennsylvania's property, excise, and sales taxes are the most stable.
- The personal income tax is not stable.

  From a family's perspective, instability isn't a bad thing. Parents who lose their jobs in a recession wouldn't want to pay income tax when no income is coming in.

- The corporate income tax is the least stable, because it derives from volatile profits.
- Pennsylvania is well-balanced, with both a sales and personal income tax contributing proportional shares to overall revenue, but the sales tax exemptions on food and clothing can be destabilizing.

  Again, families benefit from this instability factor by not paying taxes on everyday necessities.

- No state achieves full stability. In the recession of the early 1990s, Pennsylvania - like virtually every other state - was forced to:

  ~ Raise tax rates, especially on personal and corporate income taxes. Personal income tax rates have yet to return to their pre-1991 level of 2.1 percent. Income eligibility thresholds for personal income tax forgiveness remained level from 1988 to 1994.

  ~ Expand tax bases.

  ~ Raise fees. When other tax bases are eroding, states often raise fees to help make up the difference. In 1991, for instance, the fee for a copy of a birth certificate rose from $2 to $4.

~ Spend reserve funds.

~ Cut program expenditures.

~ Delay payments.

- Pennsylvania's Rainy Day Fund, where revenue is saved as a hedge against economic downturns, is now at 5 percent of the General Fund. But in a recent study on budget reserves, the Center on Budget and Policy Priorities estimated that Pennsylvania would need reserves as high as 18 percent to close the gap between revenues and expenditures for three years without tax hikes, substantial spending cuts, or fiscal "gimmickry."

BOTTOM LINE: Pennsylvania is not stable, because it would be forced to raise taxes or cut programs in a recession.

Sufficiency

- The personal and corporate net income taxes are sufficient, usually growing as fast as the economy and personal income.
- Property taxes may or may not grow as fast as the economy.
- Sales taxes do not grow as fast, and excise tax revenues can decrease over time.
- Pennsylvania does not have one of the strongest tools for achieving sufficiency — a progressive income tax.

  However, Pennsylvania's very large income tax base bolsters sufficiency and allows a relatively low personal income tax rate of 2.8 percent.

- Most states' revenue systems are insufficient, so they occasionally add new taxes or dramatically change existing tax bases or rates to fund desired government services.

  Pennsylvania adopted the income tax and introduced Lottery games in the early 1970s. Since then, the state hasn't introduced any major new taxes, but it never lowered the personal income tax rate after hiking it up from 2.1 percent in the late 1980s, either.

- Excluding Social Security, other retirement pension income and employment-based health benefits from income takes away from sufficiency, as the population ages and their excluded income grows faster than included income.

  Again, a policy that makes a tax lack sufficiency benefits individual taxpayers.

- Sales taxes are insufficient because Pennsylvania's economy, like the nation's, is shifting dramatically from reliance on taxable goods to reliance on untaxed services, such as health care, retail trade, and banking and finance.
- Excise taxes on cigarettes and alcohol are very insufficient and may actually decline as consumption falls. Pennsylvania cigarette revenues have declined since the increase from 18 cents to 31 cents a pack in August 1991.

  Two cents of the 1991 increase was for the Children's Health Insurance Program. To expand CHIP, an additional cent of the cigarette tax was dedicated to CHIP in 1997.

BOTTOM LINE: Pennsylvania taxes are not sufficient, occasionally requiring new taxes or rate increases.

EQUITY

Equity relates to ability to pay. It can be *horizontal* or *vertical.*

- *Horizontal equity* means that people with the same ability to pay, pay nearly the same amounts.
- *Vertical equity* means that people with different incomes pay different rates. The tax is "progressive" if higher-income people pay a higher share of their income in taxes, "regressive" if lower-income people pay higher shares.

Horizontal Equity

- Pennsylvania's tax forgiveness program has horizontal equity.

  Tax forgiveness recognizes the additional costs of raising a family with each additional dependent child, increasing the eligibility threshold by $6,500 for each child.

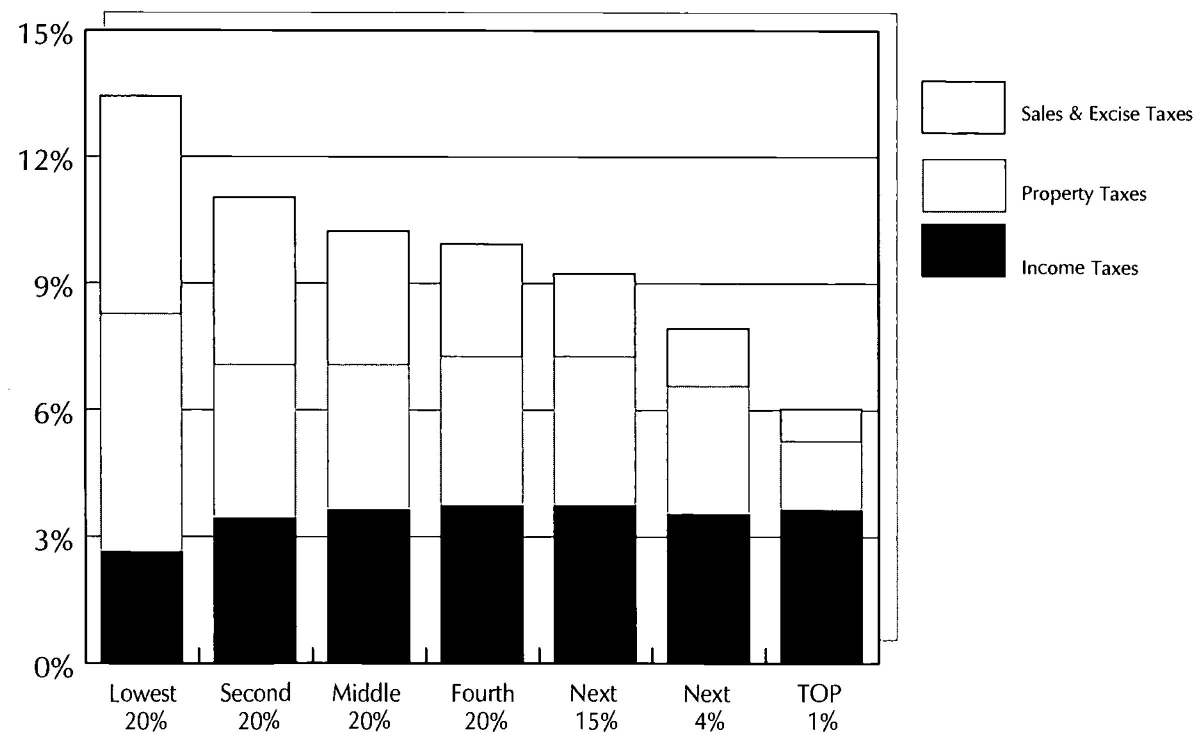
- The personal income tax does not have horizontal equity.

  Two single-parent families, each earning $30,000, pay the same 2.8 percent in the PIT, even though one family is raising one child, spending about $7,000 annually on housing, food, transportation, health care and other necessities, and the other is raising three and spending more than $13,000 every year.

Vertical Equity (regressive/progressive)

Covering the income spectrum from poorest to wealthiest, the following charts show the percentage of income that state and local taxes take from households.

Pennsylvania State & Local Taxes in 1995
Shares of family income for non-elderly married couples



Income Group	Lowest 20%	Second 20%	Middle 20%	Fourth 20%	Top 20% Next 15%	Top 20% Next 4%	Top 20% TOP 1%
Income Range	Less than $29,000	$29,000- $42,000	$42,000- $55,000	$55,000- $73,000	$73,000- $128,000	$128,000- $405,000	$405,000 or more
Average Income in Group	$17,800	$35,400	$48,400	$62,500	$90,700	$179,000	$728,000
Sales & Excise Taxes	**5.2%**	**4.0%**	**3.2%**	**2.7%**	**2.0%**	**1.4%**	**0.8%**
General Sales — Individuals	2.6%	2.1%	1.8%	1.5%	1.1%	0.8%	0.5%
Other Sales & Excise — Indiv.	1.3%	0.9%	0.7%	0.5%	0.4%	0.2%	0.1%
Sales & Excise on Business	1.3%	1.0%	0.8%	0.7%	0.5%	0.3%	0.2%
Property Taxes	**5.6%**	**3.6%**	**3.4%**	**3.5%**	**3.5%**	**3.0%**	**1.6%**
Property Taxes on Familes	5.4%	3.5%	3.3%	3.4%	3.3%	2.8%	1.0%
Other Property Taxes	0.2%	0.1%	0.1%	0.1%	0.1%	0.2%	0.6%
Income Taxes	**2.6%**	**3.4%**	**3.6%**	**3.7%**	**3.7%**	**3.5%**	**3.6%**
Personal Income Tax	2.4%	3.3%	3.5%	3.6%	3.5%	3.3%	3.0%
Corporate Income Tax	0.2%	0.1%	01%	0.1%	0.2%	0.3%	0.6%
TOTAL TAXES	**13.3%**	**11.0%**	**10.2%**	**9.9%**	**9.2%**	**7.9%**	**6.1%**

Source: Who Pays? A Distributional Analysis of the Tax Systems in All 50 States. Citizens for Tax Justice and The Institute on Taxation & Economic Policy, June 1996

- Pennsylvania's state personal income tax is progressive at the low-income range, because of tax forgiveness. In the middle- and upper-income ranges, the personal income tax is proportional.
- The corporate income tax is progressive. Although most households pay small percentages of their incomes, households in the top 20 percent of income pay a higher percentage.
- Sales and excise taxes are regressive, despite the tax exemptions for necessities.

  In 1995, the lowest 20 percent of Pennsylvania households paid 5.2 percent of their income in sales and excise taxes, while the top 20 percent paid less than 2 percent of income.

- Property taxes are regressive.

  In 1995, the lowest 20 percent of Pennsylvania households paid 5.4 percent of their income in property taxes, while the top income groups paid 3.3 percent or less.

- Pennsylvania's tax system is regressive overall.

  In 1995, the poorest one-fifth of households paid 13.3 percent of their income in state and local taxes, making Pennsylvania 10th highest among states. The top income groups paid in the range of 6 percent to 9 percent.

BOTTOM LINE: Pennsylvania does not have equity, because the poorest citizens pay a higher share of their income in taxes.

COMPLIANCE AND ADMINISTRATION

A quality tax minimizes the time and effort of citizens to comply. It's also collected efficiently, with little waste of taxpayer dollars.

- Pennsylvania's personal income tax and tax forgiveness are understandable, and compliance takes little time and effort.

  Including tax forgiveness on all state income tax forms helps spread the word. Out of 5.2 million tax returns filed in 1996, 1 million qualified for tax forgiveness.

Pennsylvania's sales taxes are levied on a uniform base in all counties (although the rate may be higher in some), making compliance and administration of these local sales taxes efficient.

There is an important exception to the understandability of Pennsylvania's personal income tax. Families eligible to stop withholding of the PIT from their paychecks often don't know about the program, must participate in tax forgiveness for a full tax year to qualify, and must file a little-known form with employers to participate.

- Despite relying on federal law to determine the Pennsylvania corporate net income base, apportioning income across states brings new complexities and increased costs of compliance for multi-state corporations. In a similar vein, Pennsylvania's capital stock and franchise tax requires a unique calculation for multi-state corporations. No other state uses the same formula for net worth or even includes income in a capital stock tax formula.
- The cost of administering property taxes in relation to revenue collected is higher than many taxes due to the resources needed to maintain accurate assessed valuations.

BOTTOM LINE: Some complexity and expense in tax collections cannot be avoided. Pennsylvania has reasonably simple compliance and reasonably efficient administration.

RESPONSIVENESS TO INTERSTATE AND INTERNATIONAL COMPETITION

State tax systems must recognize the state's marketplace, in surrounding states and around the world. Taxes that vary widely from neighboring and competing states can affect economic activity.

- Pennsylvania clothing retailers may benefit from the sales tax exemption because clothing is taxed in New York and Maryland. However, neighboring New Jersey doesn't tax clothes, and Delaware has no sales tax.
- Pennsylvania's recent adoption of "triple-weighting" could attract business and the jobs they create to Pennsylvania. However, at least 29 other states have also changed their factor weighting.
- Pennsylvania's corporate tax rates increased steeply in the 1991 recession. Despite sharp cutbacks in 1995, Pennsylvania still has the nation's third highest corporate income tax rate.

BOTTOM LINE: Pennsylvania is responding to interstate and international competition but may still be at the upper end among states in overall business taxes.

ECONOMIC NEUTRALITY

Though taxes can never be economically neutral, they can be designed to minimize their effect on the allocation of resources in the economy and reduce their impact on economic decisions.

- In a two-parent, moderate-income family, the second parent's decision whether to get a job is not likely to be influenced by the minimal tax bite taken by the state's 2.8 percent personal income tax. However, federal Social Security and income taxes, combined with the possible addition of higher child care costs, probably do enter into the decision.
- Like the federal government and most other states, Pennsylvania taxes the income of small and large businesses at different rates. In this case, economic neutrality is ignored as a means of boosting small businesses' viability.
- Economic neutrality can also be ignored to encourage an activity with a social benefit.

  The state's Tuition Account Program, exempt from the personal income tax, encourages families to save for their children's college education.

BOTTOM LINE: Although difficult to measure objectively, Pennsylvania appears to maintain a reasonable degree of economic neutrality or, when needed, to defer for valid reasons.

ACCOUNTABILITY

Accountability refers to three aspects of a tax's visibility:

~ Credits and exemptions should be reviewed frequently and shouldn't unfairly benefit some taxpayers at the expense of others.

~ Taxes can be paid openly, or they can be passed through to the final consumer as part of the price paid.

~ The public should have access to budget and tax information.

- In Pennsylvania, some taxes are visible, and some are hidden.

  A motorist pumping 10 gallons of gas doesn't think about the $2.60 in state taxes embedded in the cost. That same motorist picking up a 99-cent, taxable bottle of soda (carbonated beverages are considered a non-food item) knows that the transaction will require another 6 cents in sales tax.

- Pennsylvania's annual revenue, allocations, and extent of tax expenditures from past years can be reviewed in the comprehensive, annual *Governor's Executive Budget.*

  The budget book does not analyze the economic impact of significant tax proposals beyond their first year.

  Only 1,400 copies of the book are printed and distributed, largely to public officials. Citizens can't buy it or borrow it from local libraries. It is not on the Internet, but the state is exploring electronic publication on the Web and on CD-ROM.

BOTTOM LINE: Pennsylvania's income and sales taxes and budget execution are visible but show room for improvement.

Family-Friendly Strategies

Under Pennsylvania's regressive tax system, the poorest one-fifth of households pay 13.3 percent of their scarce income in state and local taxes, while the highest earners pay in the 6 percent to 9 percent range. Even middle-income earners bear a lower state and local tax burden than their poorer neighbors.

But regressivity can be countered. To become more tax-friendly for families with children, Pennsylvania can adopt strategies that ease the burdens on families' household budgets. With less of their earnings going toward taxes, parents can invest more in children's necessities, such as nutrition, housing, recreation, clothing, and health care.

Recommended strategies are:

- Increase tax forgiveness thresholds
- Establish a property tax/rent rebate program from the General Fund
- Create a dependent care tax credit

With these three changes, more Pennsylvanians could give their children a better start in life.

1. INCREASE TAX FORGIVENESS THRESHOLDS

For 1999, Pennsylvania's full tax forgiveness thresholds correspond, for example, to 141 percent of the Federal Poverty Income Guidelines for a family of three, $19,500, and 156 percent for a family of four, $26,000.

To reduce the disproportionate tax burden on working poor individuals and families and lower-income retirees, Pennsylvania can raise the threshold for full tax forgiveness from $6,500 to $7,000 for each qualifying claimant and dependent, which would cost about $24 million in reduced personal income taxes.

2. ESTABLISH A GENERAL FUND PROPERTY TAX/RENT REBATE PROGRAM FOR LOW-INCOME FAMILIES WITH DEPENDENT CHILDREN

The property tax is one of Pennsylvania's most regressive elements for all low-income individuals and families. To ease the tax bite that property taxes take from low-income households, Pennsylvania could use General Fund money to establish a property tax/rent rebate program, similar to the existing program for the elderly and the disabled.

Several other states see the benefit in reducing property tax burdens for low-income households. In Kansas, low-income people 55 and older, and under 55 if they have a dependent under 18 years old, are eligible for property tax relief. Other states, including Maine, Maryland, Michigan, Minnesota, New York, Vermont and Wisconsin, all have similar relief for elderly and low-income citizens, with even broader eligibility criteria than Kansas.

To ease the tax burden on families with children, Pennsylvania could extend the property tax/rent rebate program to all households with incomes below $15,000 and dependent children under 18 years old. Like the existing program for the elderly and disabled, the maximum rebate would be $500. An estimated 160,000 households would be eligible for the rebates, which would average about $300.

3. CREATE A DEPENDENT CARE TAX CREDIT

Pennsylvania could develop a nonrefundable tax credit for the expenses families incur for child care and the care of elderly or disabled dependent family members. Eligible families would receive credits based on their family income, expenses incurred, and the number of children, disabled or elderly dependents receiving care.

The state should then take the next step to make this credit refundable. Though this could be seen as contrary to the Uniformity Clause, the Constitution's explicit exception for age and disability, as well as poverty, opens up possibilities. A program could be designed that may pass constitutional muster by combining youth, aging and disability with poverty into one basic need factor. The significant portion of family earnings that are spent on care for children, seniors and the disabled, plus the need to provide for these basic necessities for our most vulnerable populations, argue for a special provision.

Taxing Pennsylvania: Conclusion

Taxes are at the heart of a functioning government. They provide the funds to educate children, pave highways, pass laws, and build parks. With tax-funded projects, families and communities can thrive, public safety can be assured, and businesses can grow on an efficient infrastructure.

The allocation of Pennsylvania's tax dollars - whether they are, in fact, used at top efficiency and for the best array of public investments - is another subject. This paper simply reviews who pays what, and how each element of Pennsylvania's tax structure blends into the whole. As part of the State Fiscal Analysis Initiative, it injects a family perspective into a system that went about its business collecting $38 billion in state and local taxes in 1997.

In the coming year, Pennsylvania Partnerships for Children will delve further into the impact of taxes on Pennsylvania families. It is one more avenue in the effort to ensure that, when public policy is made, we remember the children.

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Pennsylvania Partnerships for Children

20 North Market Square, Suite 300
Harrisburg, PA 17101-1632

(717) 236-5680 • 1 (800) 257-2030

Fax (717) 236-7745

e-mail: info@papartnerships.org

www.papartnerships.org

Joan L. Benso, *Executive Director*
Martha C. Bergsten, *Director of Research and Analysis*
M. Diane McCormick, *Director of Communications*

Founded in 1990, PPC works with individuals and organizations in the public and private sectors to develop common agendas and strategies that promote the well-being of Pennsylvania's children.

PPC advocates for children and their families through government relations, research and analysis, community organizing, public awareness, training and technical assistance. PPC is statewide, independent and nonpartisan.

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