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TESTIMONY

RECOMMENDATIONS FOR TAX REFORM IN PENNSYLVANIA

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Public Hearing on Pennsylvania Tax Structure, Climate and Competitiveness and Impact on Federal Tax Law Changes

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Chairman Kampf and distinguished members of the Appropriations Subcommittee:

Thank you for accepting my testimony on the features of Pennsylvania's tax system and how it compares to other states in the nation. My name is Pavel Yakovlev, and I am an affiliated scholar at the Mercatus Center at George Mason University and professor of economics at Duquesne University. My basic message today is that a sound tax policy that can promote both efficiency and equity has two important features: a low rate and a broad base with few exemptions or deductions. Unfortunately, some elements of Pennsylvania's state tax structure do not meet these basic requirements. Pennsylvania has one of the highest tax burdens in the nation and ranks near the bottom in business friendliness. While much good can be said about the state's flat personal income tax rate and relatively low sales tax rate, Pennsylvania's business taxes are inefficiently high. The state government took a step in the right direction by phasing out its archaic capital stock and foreign franchise tax, but Pennsylvania's economy is still being held back by its high corporate income and unemployment insurance taxes. Pennsylvania's 9.99 percent corporate income tax rate, second highest in the nation, puts the state at a significant competitive disadvantage. A combination of spending cuts, tax rate cuts, and tax base broadening could make Pennsylvania's economy grow faster without jeopardizing the state's ability to provide valuable public services.

POTENTIAL FOR TAX REFORM IN PENNSYLVANIA

A recent study by the Mercatus Center reveals that Pennsylvania's state government ranks 45th in the nation in terms of fiscal solvency,[1] placing it right next to the bottom five states: New Jersey, Illinois, Massachusetts, Kentucky, and Maryland. The Mercatus Center's state fiscal rankings consist of five dimensions of financial solvency (cash, budget, long-run, service-level, and trust fund) that assess total primary government activities as well as unfunded pension obligations and other post-employment benefit liabilities. Taken together, these five dimensions help capture a state's overall fiscal health, which looks poor in Pennsylvania.

[1] Eileen Norcross and Olivia Gonzalez, "Ranking the States by Fiscal Condition" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, 2017), 29.

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The main driver of the state's low fiscal score is its low (47th) rank on cash solvency. This dimension of fiscal health measures whether a state has enough cash to cover its short-term bills and it shows that Pennsylvania's ability to cover its short-term obligations is among the lowest in the country. Furthermore, Pennsylvania's negative net asset ratio of 0.27 and long-term liabilities of almost 60 percent of total assets point to the prevalence of debt and unfunded obligations in the state's budget. These fiscal pressures cause Pennsylvania to rank below the national average in budget (38th), long-run (36th), and trust fund (26th) solvency. Such low scores more than offset the state's relatively good service-level solvency rank of 21, resulting in the overall conclusion that the state government is living beyond its means.

One might argue that the root cause of the state's poor fiscal ranking is insufficient taxation of its people. This is simply not true, because Pennsylvania ranks above the national average in tax burdens. According to the Tax Foundation, in 2016 the average person in Pennsylvania had to work till April 22 to pay off his or her taxes, later than average citizen of 32 other states.[2] Pennsylvania has the 15th-highest tax burden in the nation, with a per capita tax burden of $4,589, or 10.2 percent of state income.[3]

Having a combined 6.34 percent average state and local sales tax rate, Pennsylvania ranks 20th nationally in sales tax burden and 17th nationally in personal income tax burden because of its single tax rate of 3.07 percent. However, the state's sales tax has too many exemptions and should be extended to include as many products and services as possible. This would allow the state to raise just as much revenue with a lower tax rate, which would increase efficiency and spread the tax burden more equitably across all sectors of the economy.

More importantly, Pennsylvania's 9.99 percent corporate income tax rate is the highest flat rate in the nation. This puts Pennsylvania at a significant competitive disadvantage compared to other states without generating much tax revenue. The US federal government has also had similar experience with its rather high corporate income tax rate. Despite having one of the highest corporate tax rates in the world, the federal government has raised relatively little revenue with this tax and it gave corporations ample incentive to hide their income through tax inversions and other means. This contributed to the Trump administration's motivation for lowering the federal corporate income tax rate.

To sum it up, Pennsylvania's low rankings on corporate income (44th) and unemployment insurance (45th) taxes more than offset its relatively favorable rankings on individual income and sales taxes, pushing the state toward the middle of the Tax Foundation's *2017 State Business Tax Climate Index*.[4]

At the same time, Pennsylvania has several options for improving its tax system. A sound tax system should strive to achieve efficiency, revenue stability, simplicity, and equity. Two very basic principles of taxation, a broad tax base and low tax rate, could satisfy a good portion of these objectives. A lower tax rate causes fewer distortions and reduces the strain on economic growth. A wide tax base that covers all forms of economic activity would allow the state to raise more revenue with lower tax rates. Another benefit of a wider tax base is that it can rely on multiples sources of revenue that fluctuate differently over the business cycle. This diversification helps to stabilize tax revenues. One more benefit of a broad-based tax system is greater horizontal equity, which is about equalizing tax burdens on individuals who have equal ability to pay. When a tax covers as many goods and services as possible, most individuals will bear the tax burden and do so proportionally regardless of how they earn or spend their money. To decrease the potential regressivity (i.e., burden on the poor) of broad-based consumption or sales taxes, the state could tax necessities at a lower rate.

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[2] Morgan Scarboro, *Facts and Figures: How Does Your State Compare?* (Washington, DC: Tax Foundation, 2017), 6.
[3] Scarboro, *Facts and Figures*, 8.
[4] Jared Walczak, Scott Drenkard, and Joseph Henchman, *2017 State Business Tax Climate Index* (Washington, DC: Tax Foundation, 2017), 3.

To offset possible revenue losses from the recommended tax cuts, state legislators may want to consider increasing state reliance on user fees and charges as well as corrective taxes on negative externalities like pollution and environmental degradation. User fees and charges have a twofold benefit: (1) they mimic market prices with all the associated implications for efficiency, and (2) they can be considered equitable because people who benefit from public services pay for them.

Corrective taxes on negative environmental externalities are also desirable from an efficiency standpoint because they force the market to internalize the costs that pollutants impose on society. However, the challenge with corrective taxes is that they should be set equal to the marginal damage, which is hard to estimate objectively in many cases. This is a particularly thorny issue when it comes to assessing what kind of taxes should be levied on natural gas extraction: a fixed impact fee per well or a severance tax per unit of gas extracted? From a societal perspective, if negative externalities are proportional to the number of wells drilled, then the tax should be structured more like a fixed impact fee per well. However, if externalities are proportional to the volume of gas extracted, then a severance-like tax per unit of natural gas might be more appropriate.

CONCLUSION

The evidence presented in this testimony suggests that state government spending is becoming more burdensome for the economy to sustain. The state could benefit from cutting some spending and squeezing more efficiency out of it, while also simplifying and lowering some of its taxes. As a general rule, a broad-based and low-rate tax system can reduce distortions, decrease compliance costs, and spread the tax burden more equitably across all taxpayers.

At 9.99 percent, Pennsylvania has the highest flat corporate income tax rate in the nation. This tax sticks out like a sore thumb, hampering the state's ability to attract investment. Reducing the corporate income tax rate, widening the overall tax base, and greatly simplifying tax rules would make the state tax system more equitable and efficient while making the state economy more prosperous. Pennsylvania could also benefit from lowering its rather high unemployment insurance tax. If revenue neutrality is a priority, policymakers should be prepared to offset potential revenue shortfalls from tax cuts by widening a sales tax base or increasing their reliance on user fees and charges. The state should also consider cutting spending and increasing its operational efficiency in order to improve its poor fiscal solvency, the primary cause of which is excessive spending.

Thank you for inviting me to speak with you today about Pennsylvania's tax policy. I look forward to answering any questions you may have concerning my testimony.

Sincerely,

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