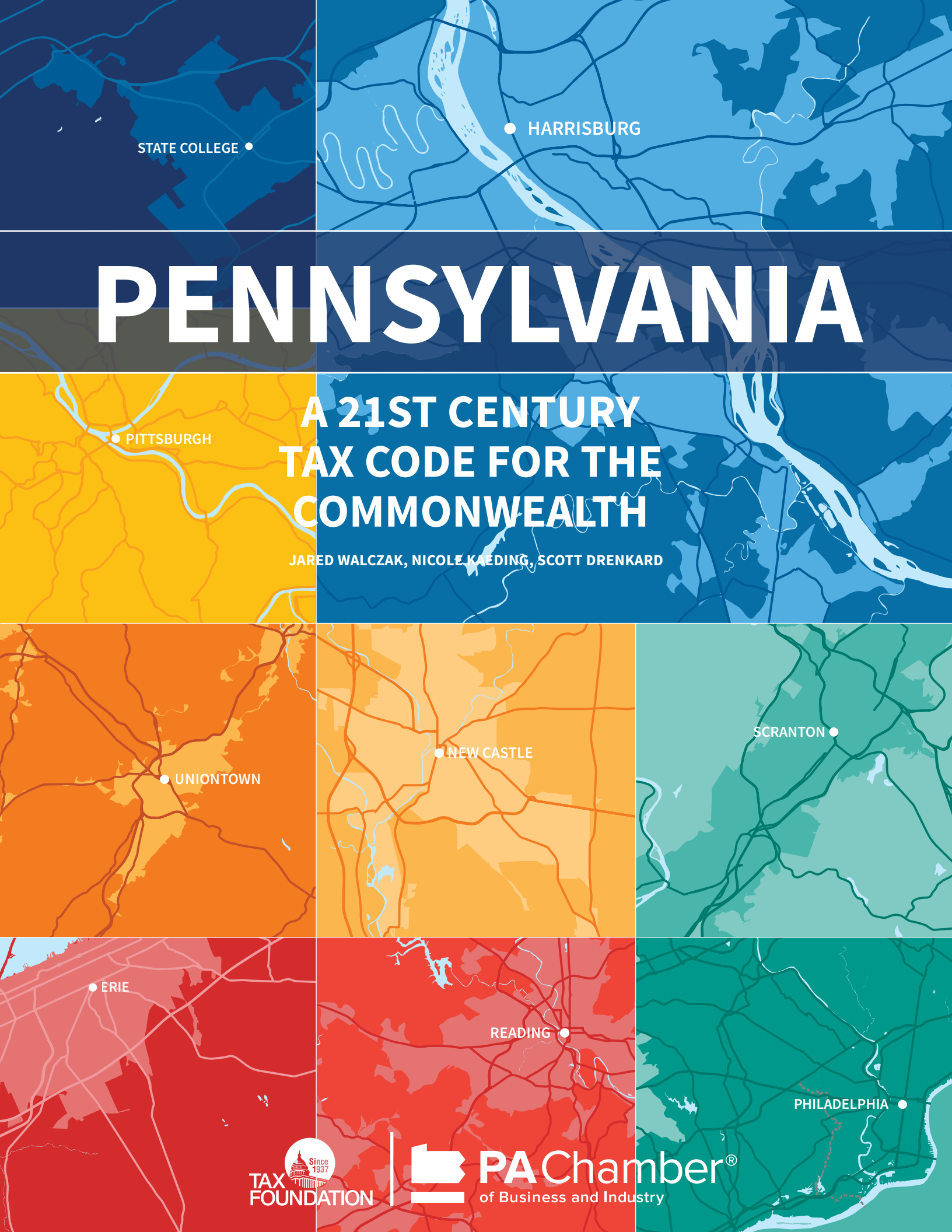

STATE COLLEGE
HARRISBURG
PENNSYLVANIA
A 21ST CENTURY TAX CODE FOR THE COMMONWEALTH
JARED WALCZAK, NICOLE KAEDING, SCOTT DRENKARD
PITTSBURGH
UNIONTOWN
NEW CASTLE
SCRANTON
ERIE
READING
PHILADELPHIA
TAX FOUNDATION
Since 1937
PA Chamber®
of Business and Industry

ISBN: 978-1-942768-21-0

© 2018 Tax Foundation
1325 G Street, NW, Suite 950
Washington, D.C. 20005
202.464.6200
taxfoundation.org

PENNSYLVANIA

A 21ST CENTURY TAX CODE FOR THE COMMONWEALTH

TABLE OF CONTENTS

Executive Summary

Introduction 1
A Menu of Tax Reform Solutions 2

ECONOMY AND BUDGET

CHAPTER 1: Pennsylvania's Economy 9

Introduction 10
State Gross Domestic Product (GDP) 10
Personal Income 12
Major Industries 16
Employment 18
Migration Patterns 20

CHAPTER 2: Pennsylvania's Tax and Budget Structure 23

Introduction 24
Tax and Spending Policies in the 2000s 24
Measures of State Tax Competitiveness 28

STATE TAXES

CHAPTER 3: Corporate Net Income Taxes 33

Introduction 34
Overview of Pennsylvania Corporate Income Taxation 35
Comparing Pennsylvania's Corporate Income Taxes Regionally and Nationally 38
Corporate Net Income Tax Collections 38
Structural Elements 40
Corporate Income Tax Reform Solutions 55

CHAPTER 4: Personal Income Taxes 57

Introduction 58
A Short History of the Personal Income Tax 59
Tax Expenditures: Deductions, Exemptions, and Credits 65

CHAPTER 5: State Sales Taxes 71

Introduction 72
Sales Tax Collections 73
Sales Tax Rate Composition 74
Sales Tax Base Composition 75
Sales Tax Solutions 86

CHAPTER 6: Other State Taxes 89
Introduction 90
Environmental Impact Fee 90
Motor Fuel Tax 94
Unemployment Compensation Taxes 96

LOCAL TAXES

CHAPTER 7: Earned Income, Occupational, and Nuisance Taxes 99
Introduction 100
Pennsylvania's Multitiered System of Local Government 101
Earned Income and Wage Taxes 103
Occupational and Local Services Taxes 110
Mercantile and Business Privilege Taxes 113
Per Capita Taxes 118
Local Taxing Authority 119
Local Tax Solutions 122

CHAPTER 8: Property and Related Taxes 125
Introduction 126
A General Overview of Pennsylvania Property Taxes 127
Property Tax Assessments 131
Rate and Levy Limitations 137
Property Tax Exemptions and Rebates 138
Other Property Taxes 140
Property Tax Administration 142
Property Tax Solutions 143

CHAPTER 9: Local Sales and Excise Taxes 147
Introduction 148
Local Sales Taxes 148
Philadelphia Beverage Tax 148

Introduction

Today, Pittsburgh and Philadelphia are thriving cities, but in the early colonial era, Pittsburgh was a western outpost on the Forks of the Ohio. Life on the frontier was beset by strife, violence, and occasional open warfare, yet for years the region's security was outsourced to volunteers from Virginia, since the colonial assembly would not appropriate funds for garrisons or defense.

Partly this was borne of religious compulsion, but increasingly it transformed into a dispute over taxes.[1] Pennsylvania was, after all, a proprietary colony headed by dual proprietors, Thomas and Richard Penn. Outside of Philadelphia and the surrounding counties, vast tracts of land were held in fief, and since much of the land was forested and unproductive, the colonial charter afforded tax exemptions for this land, held by the colony's richest landowners.

To Benjamin Franklin, this was an affront to the liberty of the colony to govern its own affairs and levy its own taxes in an equitable manner. Decades before Pennsylvania's most honored son observed that nothing in life is certain except death and taxes, Franklin penned a petition to the Deputy Governor outlining the assembly's bargaining position: the safety of the western frontier could not be provided for until the assembly enjoyed the liberty to tax. Or, in words now familiar to many: "Those who would give up essential Liberty, to purchase a little temporary Safety, deserve neither Liberty nor Safety."[2]

Today it may seem peculiar to regard the authority to impose such a tax an "essential liberty," but from that early fight over tax powers, through the Whiskey Rebellion, to the fitful efforts to tax income,[3] to the 1991 income tax vote that sparked a literal scuffle in the lower house,[4] and on to the present day, debates over taxes are interwoven in the fabric of Pennsylvania's history.

The vision of a tax system that looks like someone designed it on purpose has proved elusive, here even more than in other states. Governing structures look different in Pennsylvania than they do elsewhere, and that is part of the Commonwealth's charm. Unfortunately, it has also helped yield a tax code patched together over the years, overlaid on a system that has been evolving–not always in one direction–since William Penn affixed his name to a treaty under that ancient elm.

Policymakers from across the spectrum recognize that the Commonwealth's tax code has not kept up with a 21st century economy, even if they cannot always agree on a course of action. This book is intended to help fill in the gaps.

In the following pages, we examine Pennsylvania's economy, outline the existing tax structure, and offer recommendations for reforming the tax code. We seek to identify

1 Alvin Rabushka, *Taxation in Colonial America* (Princeton, NJ: Princeton University Press, 2008), 797.
2 Francis Parkman, *Montcalm and Wolfe* (Boston: Little, Brown and Company, 1884), Vol. 1, 345.
3 William J. McKenna, "The Income Tax in Pennsylvania," *Pennsylvania History: A Journal of Mid-Atlantic Studies* 27:3 (July 1960), https://www.jstor.org/stable/27769968.
4 Karen Langley, "Pennsylvania Has History of Contentious Tax-Hike Efforts," *Pittsburgh Post-Gazette*, Oct. 12, 2015, http://www.post-gazette.com/local/region/2015/10/12/Pa-has-history-of-contentious-tax-hike-efforts/stories/201510120017.

what the Commonwealth does well and to point out opportunities for improvement. Underlying our analysis is the goal of enhancing Pennsylvania's competitive standing and a commitment to the principles of sound tax policy—that, to the greatest extent possible, taxes should be simple, transparent, neutral, and stable, and that the best tax structures are those with broad bases and low rates.

In the course of our research, we pored over Pennsylvania's tax code, dusted off old tax studies, reviewed the economic literature, and examined successful reforms implemented by other states. First and foremost, however, we talked to Pennsylvanians—state and local government officials, business leaders, and everyday taxpayers alike. The insights and perspectives of those who actually interact with Pennsylvania's tax system inform every page of this book.

The Pennsylvania Chamber of Business and Industry commissioned the Tax Foundation to prepare a review of the Pennsylvania tax system and recommend possible solutions, and this book is the result. While they supported our study, they did not direct our study or any of our recommendations. We offer our thanks to the many Pennsylvanians of all walks of life who met with us as we worked on this book. It is our hope that this book will help reform a robust and much-needed debate about the future of the state's tax code.

A Menu of Tax Reform Solutions

Corporate Net Income Tax

Pennsylvania's 9.99 percent Corporate Net Income Tax rate is the second-highest in the country, and the tax is beset by structural shortcomings which impose particularly high burdens on certain industries. Our corporate tax solutions would make Pennsylvania more competitive by moving to a lower rate and broader base while reducing disincentives for corporate investment.

Improving the treatment of net operating losses. Pennsylvania is one of only two states to cap the amount of net operating losses which can be claimed in a given year. This policy undermines tax neutrality and results in particularly heavy tax burdens for companies with longer business cycles. We propose the prioritizing of continued increases in the percentages of net operating losses businesses may carry forward.

Making the corporate rate more competitive. While many companies only pay a fraction of the statutory tax rate, for others, Pennsylvania's 9.99 percent Corporate Net Income Tax rate, combined with structural shortcomings which increase their overall liability, can result in prohibitively high tax burdens. We recommend targeting a rate reduction to 6.99 percent or lower, bringing the Commonwealth more in line with its peers, with reductions funded by tax credit reform and base broadening elsewhere.

Reforming corporate tax credits. Pennsylvania does better than most peer states in avoiding substantial carveouts of its corporate income tax base through targeted credits, but the state still forgoes an estimated $265 million a year due to Corporate Net Income Tax credits. The state should enhance its review of these credits and consider paring them back.

Personal Income Tax

Our individual income tax solutions begin with the recognition that there is already much to commend the state's Personal Income Tax, which is levied at a low, flat rate on a broad definition of income. Where the Personal Income Tax falls short, however, is its substantial carveout for retirement income, its use of distinct classes of personal income, and the large rate differential between individual and corporate income taxes owing to Pennsylvania's anomalously high corporate rate. Our solutions seek to address these concerns.

Taxing retirement income. Though difficult politically, any long-term rebalancing of Pennsylvania's tax code cannot ignore the complete exemption from taxation of all retirement income, an exemption that is far more generous than the tax treatment in peer states. As the Commonwealth's population continues to age, a policy which already turns away $3.4 billion in annual revenue cannot go unexamined forever.

Eliminating distinct classes of income. Pennsylvania divides income into eight classes and does not allow taxpayers to carry losses over from one class to another, or from one spouse to another. This outmoded tax structure introduces complexity into an otherwise straightforward income tax code and penalizes some taxpayers on a largely arbitrary basis. We recommend its elimination.

Rolling back business incentives. Policymakers should eliminate most or all business credits (which can be claimed by pass-through businesses against Personal Income Tax liability), using them to pay down reforms which benefit Pennsylvanians more broadly. Fortunately for taxpayers, Pennsylvania's reliance on incentives is already modest.

Sales Taxes

Pennsylvania's sales tax is an important source of revenue for both the state and for Allegheny County and Philadelphia, but it has one of the narrowest tax bases in the country. Currently, many goods and services are unnecessarily exempted, while some business inputs are subject to tax, which can lead to multiple layers of taxation being imposed on the same final product at different points along the production process. We urge that steps be taken to avoid the taxation of business inputs and offer a range of base-broadening options.

Broadening the sales tax base. A well-structured sales tax applies to all final consumer transactions, both goods and services, but Pennsylvania's tax code exempts many goods and most services. Accordingly, we offer a range of options for expansion to services. Any base broadening provides an opportunity to pay down reductions in the rate of the sales tax or other taxes.

Our base-broadening options are as follows:

- Modest expansion to personal services, amusements, candy and gum, and similar goods and services ($900 million);
- Broader expansion to also include clothing, nonprescription drugs, household utilities, and motor fuels, and similar goods and services ($3.58 billion);
- Broad-based expansion to further include groceries and personal use of legal and accounting services ($5.39 billion); and
- Inclusion of nearly all final consumer transactions in the sales tax base, including medical services, financial institution fees, and private educational expenditures ($11 billion).

Revenue projections are given for each line item considered, allowing policymakers to design their own base expansion options, modernizing the state's sales tax code while generating revenues which can help offset improvements elsewhere.

Exempting business inputs. Pennsylvania taxes relatively few services. Nevertheless, it does manage to tax 27 categories of services (as defined by the Federation of Tax Administrators) which count as business inputs and lead to tax pyramiding. We offer suggestions for removing business inputs from the sales tax base.

Local Earned Income, Occupational, and Nuisance Taxes

Pennsylvania's earned income, occupational, and nuisance taxes receive extensive treatment because they play an outsized role, not only in local finances, but also in overall tax complexity in the Commonwealth. The challenges begin with Pennsylvania's patchwork approach to local government, which yields multiple layers of local tax authority and extends different degrees of taxing power to local governments based on population and other factors.

The Commonwealth's fractured approach to local governance–and both the powers and constraints imposed by the state–has serious consequences for local tax policy. The resultant complexity, administrative duplication, and local reluctance or inability to shed deeply outmoded taxes imposes real costs on government and taxpayers alike. Our recommendations favor simplicity and consolidation.

Broadening the local income tax base. Pennsylvania's local earned income taxes have a narrower base than the state income tax. While there are arguments in favor of the chosen local base, local taxation would be simplified by sharing the state income tax base. Additional revenue associated with base broadening could help pay for reduced reliance on, or even elimination of, business gross receipts and nuisance taxes, which impose significant compliance burdens to collect a modest amount of revenue.

Repealing gross receipts and nuisance taxes. Pennsylvania's remaining mercantile and business privilege taxes are nonneutral and both economically and administratively inefficient. Other legacy taxes, like head taxes and the extraordinarily arbitrary assessed occupation tax, are generally small but contribute substantially to taxpayer frustration with an outdated tax code. They should be phased out entirely with the assistance of new state grants of tax authority like an expansion of the local income tax base.

Consolidating collections at the county level. Policymakers should build on the success of Act 32 to reduce the number of tax authorities with which the average taxpayer must interact. Consolidating local tax collections at the county rather than the state level should help ameliorate concerns local governments have about local autonomy and revenue certainty.

Simplifying statutory tax authority. Pennsylvania has eight classes of counties, four classes of cities, two classes of townships, and boroughs, many of them operating under separate tax codes. Policymakers should begin consolidating the different tax codes into the primary authorization statute, eliminating as many distinctions as possible along the way.

Property and Related Taxes

Real property taxes are an uncommonly contentious topic in Pennsylvania, with popular contempt for property taxes arguably driven in significant part by the highly visible inequities and complexities of the Commonwealth's approach. Our solutions emphasize fairness, uniformity, and simplicity.

Adopting mandatory assessment cycles. The infrequency and inconsistency of countywide property tax reassessments results in significant inequities and actively discourages improvement to properties. Counties are understandably reticent to initiate reassessments on their own. State government should address the serious distortions created by this anomalous approach, mandating countywide reassessments at regular intervals.

Consolidating property tax administration. Pennsylvanians receive separate property tax bills from counties, municipalities, and school districts, and the state lacks a uniform filing deadline. The state legislature should consolidate collections at the county level and adopt a uniform filing deadline statewide. Policymakers should also explore ways to consolidate the property tax codes under which different jurisdictions operate.

Repealing the inheritance tax. Inheritance and estate taxes are becoming less and less common nationwide, as they promote costly tax avoidance strategies and can be uniquely burdensome to small businesses, which may have to be broken up to pay the resulting tax bill. Pennsylvania's inheritance tax is unusually broad, which makes it uniquely burdensome but also makes it harder to replace, or do without, the revenue it brings in, but policymakers should at least explore rate reductions or exemptions to mitigate its adverse economic effects.

Comprehensive Reform

Most of our proposals are intended to stand on their own, providing policymakers with discrete ways of improving the competitiveness of each element of the state's tax code. Often, however, successful tax reform is more comprehensive in nature, which is not only good policy but often good politics, including additional stakeholders and facilitating a broader rebalancing of the code.

In some cases, moreover, it may be strictly necessary: reduced reliance on a counterproductive tax may require offsets elsewhere in the system. Therefore, while we intend this book to facilitate important conversations about priorities within each tax type, it is also important to illustrate the ways that they can complement each other.

Local governments, for instance, could be empowered to eliminate nuisance taxes through a broader local income tax base and, in the two counties with local option sales taxes, a broader sales tax base which extends to more services and perhaps captures additional remote sales. Modernizing the property tax would also help alleviate local revenue pressures. At the state level, broadening the sales tax base, coupled with scaling back exemptions in the Personal Income Tax, could facilitate structural improvements to, and reduced rates in, both taxes, and pay down important corporate tax reforms.

For illustrative purposes, consider the following package of comprehensive reforms. Because Pennsylvania's tax code is highly anomalous, some of its less competitive features are not captured in our *State Business Tax Climate Index*. Nevertheless, we offer a projection of how the Commonwealth would improve on the *Index* for those elements which contribute to the state's rank. The illustrative comprehensive reform package includes:

- A reduction in the Corporate Net Income Tax rate to 6.99 percent, coupled with the repeal of the state's job creation and research and development credits;
- Moving to federal treatment of net operating losses;
- Modest expansion of the sales tax base to include personal services, amusements, candy and gum, and similar goods and services;
- Broadening the local income tax base to match the state base and phasing out local gross receipts and nuisance taxes; and
- Adopting mandatory assessment cycles for real property taxes.

A much more aggressive reform package might also contemplate building upon the above by adding the following:

- The inclusion of retirement income in the income tax base coupled with a Personal Income Tax rate reduction to 2.5 percent;
- Eliminating the eight distinct classes of income in the Personal Income Tax;
- Repealing the Inheritance Tax; and
- Cutting the Corporate Net Income Tax rate to 5.99 percent.

Alternatively, the state might focus on broader sales tax base broadening for further reforms, rather than taxing retirement income or making other modifications to the Personal Income Tax:

- Further broadening the sales tax base to include clothing, household utilities, nonprescription drugs, motor fuels, and burial services;
- Reducing the state sales tax rate to 5.6 percent;
- Repealing the Inheritance Tax; and
- Cutting the Corporate Net Income Tax rate to 5.99 percent.

These more aggressive packages, while politically difficult, are intended as illustrative, to show how much could change if the state adjusted its overall tax environment. The analysis and individual recommendations contained within this book are intended to help lawmakers develop comprehensive packages consistent with their policy priorities and the goal of creating a simpler, more neutral, and more competitive tax code.

	Total	Corporate	Individual	Sales	Unemployment Insurance Tax	Property
Current System (2018)	26	44	17	21	50	33
Reform Package A	18	8	17	20	50	33
Reform Package B	15	5	17	20	50	21
Reform Package C	13	5	17	12	50	21

Our Objective

We hope these solutions contribute to the tax conversation in Pennsylvania by providing a framework upon which legislators and citizens can base future decisions. The menu of options we present all ensure that the state builds a tax system for a diversified economy and positions itself as a destination for investment, entrepreneurs, and talented individuals in the years ahead.

CHAPTER 1

PENNSYLVANIA'S ECONOMY

Introduction

Pennsylvania is one of the most populous states in the country and boasts one of the nation's largest economies. However, the Commonwealth has historically lagged behind the majority of its regional neighbors in a number of key metrics, such as gross domestic product per person and personal income per person. Pennsylvania's economic indicators closely track the national averages.

The Commonwealth's economy tends to remain more stable during recessionary periods than other states, yet more stagnant during expansionary phases, producing relatively steady growth over the business cycle. Following the Great Recession, the state experienced a quick recovery; however, it continues to have a high unemployment rate. The Commonwealth has also experienced slow population growth in recent years, stemming from significant outbound migration.

The following pages provide an overview of the Pennsylvania economy and the necessary context that informs the tax analysis throughout this publication.

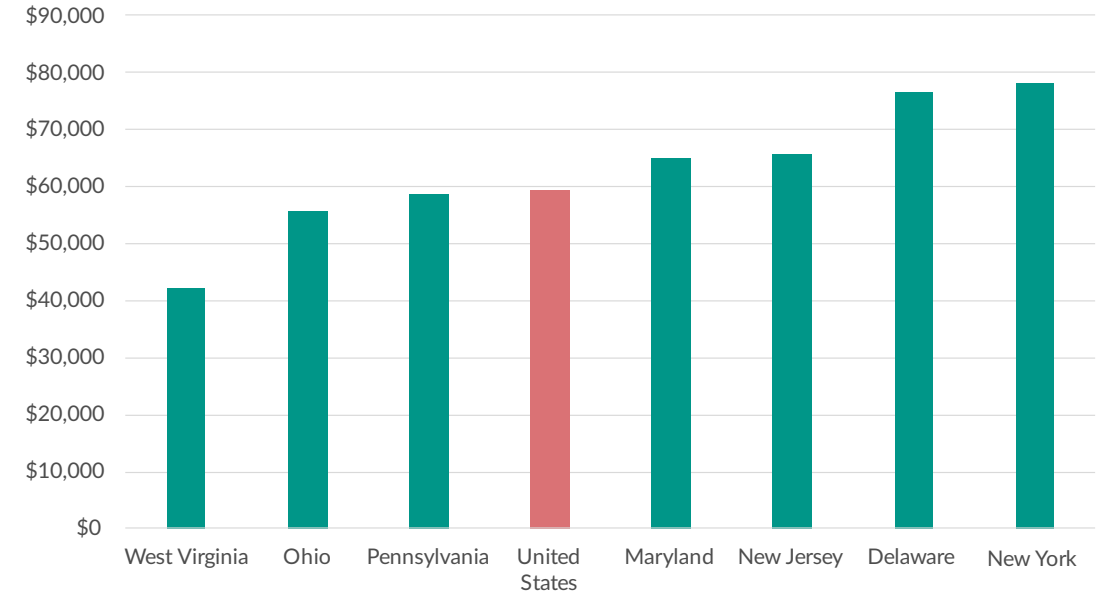
State Gross Domestic Product (GDP)

Pennsylvania had the sixth largest state economy in the U.S. in 2017, based on total production.[5] When compared to its regional competitors, Pennsylvania's economy is of comparable magnitude to Ohio (seventh) and New Jersey (eighth) and is almost double the size of Maryland's (15th). The state's economy is substantially larger than those of West Virginia (40th) and Delaware (41st), but has less than half the total production of New York (third).[6] The comparative sizes of these economies are driven in large part by population. New York, for example, is the fourth most populous state in the nation and consequently ranks very high in total production.[7]

After adjusting for population, Pennsylvania ranks worse when compared to its regional peers. In 2017, Pennsylvania's inflation-adjusted, per capita state gross domestic product (GDP) ranked 21st nationally, and lagged behind the majority of its neighboring states, leading only Ohio (26th) and West Virginia (47th).[8] At $58,730, Pennsylvania only slightly trailed the national GDP per capita of $59,141. Figure 1.1 compares Pennsylvania's real state GDP per capita to select regional competitors' and the U.S. average.

5 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*, "Gross Domestic Product (GDP) by state (millions of current dollars)."
6 Id.
7 Bureau of Economic Analysis, Regional Economic Accounts, *Population (number of persons)*, "SQ1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income."
8 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*, "Gross Domestic Product (GDP) by state (millions of current dollars)."

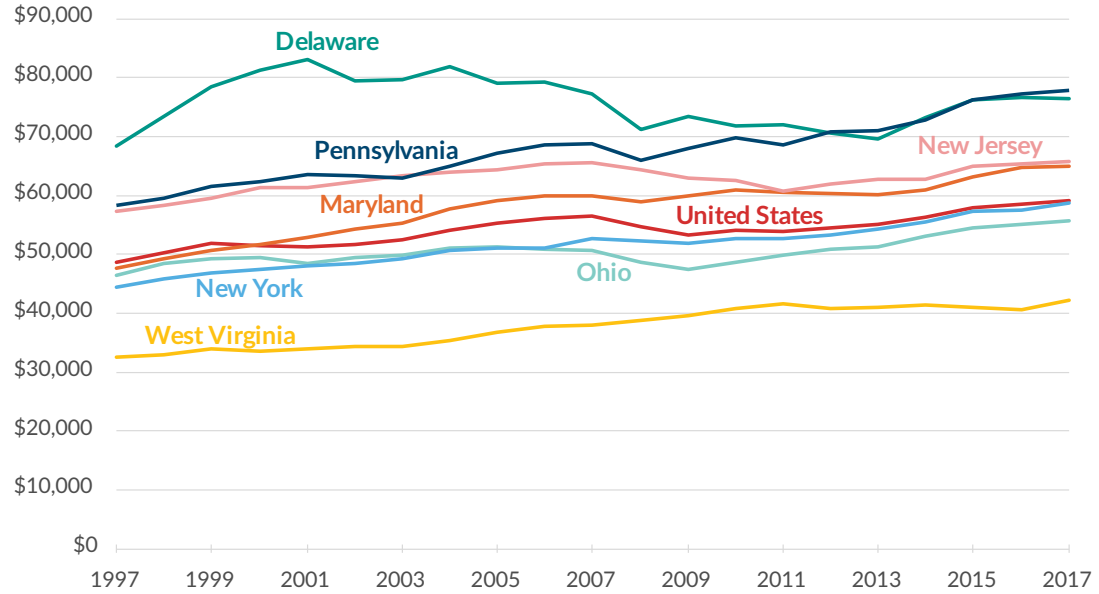
FIGURE 1.1.
State Gross Domestic Product per Capita (2017)



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*

Figure 1.2 shows the inflation-adjusted, per capita state GDP over time for these same geographies.[9] Pennsylvania has shown steady growth over the past two decades, though still lags behind the majority of its neighboring states. Pennsylvania's GDP per capita has largely paralleled the trends of the national figure, and has almost matched the U.S. as a whole over the past decade.

FIGURE 1.2.
State Gross Domestic Product per Capita 1997-2017 (2017 dollars)



Note: Dollar amounts are adjusted for inflation and expressed in 2017 dollars using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics. Inflation calculated by using the annual average of monthly CPI values.

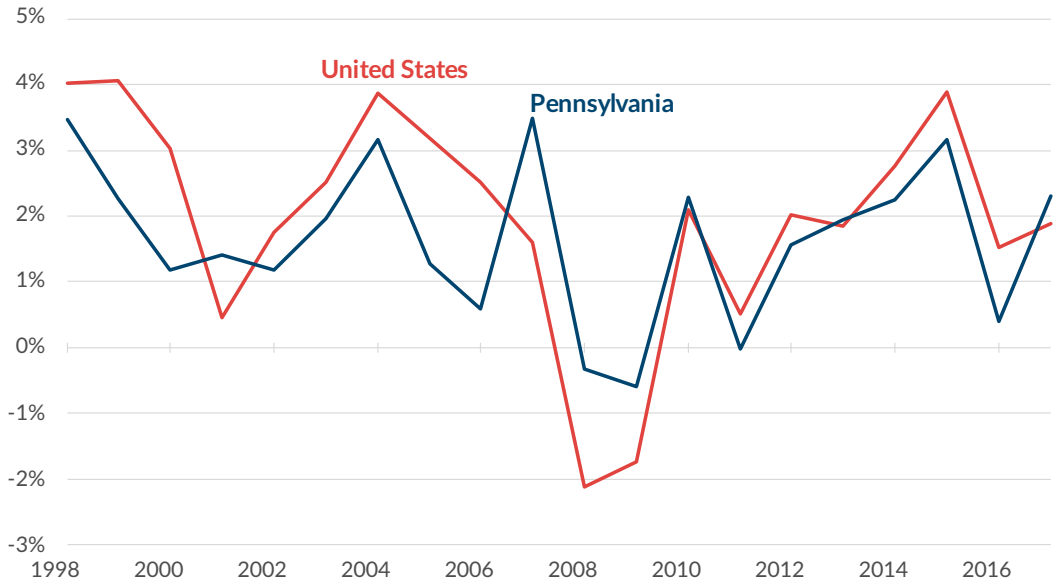
Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers); U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico."

9 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers); U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico" (Series Id: NST-EST2017-01).

Pennsylvania's real state GDP generally follows the broader national trends, but as Figure 1.3 illustrates, Pennsylvania does not experience the same economic highs at the peak of the business cycle as the national average. However, Pennsylvania's trough during the Great Recession was also not as severe as the national average.[10]

FIGURE 1.3.

Annual Percent Change in Real GDP (1998-2017)



Note: Dollar amounts were adjusted for inflation and expressed in 2017 dollars prior to calculating percentage changes using the Consumer Price Index for All Urban Consumers (CPI-U) from the Bureau of Labor Statistics.

Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*; Bureau of Labor Statistics, *Consumer Price Indexes (All Urban* Consumers).

Personal Income

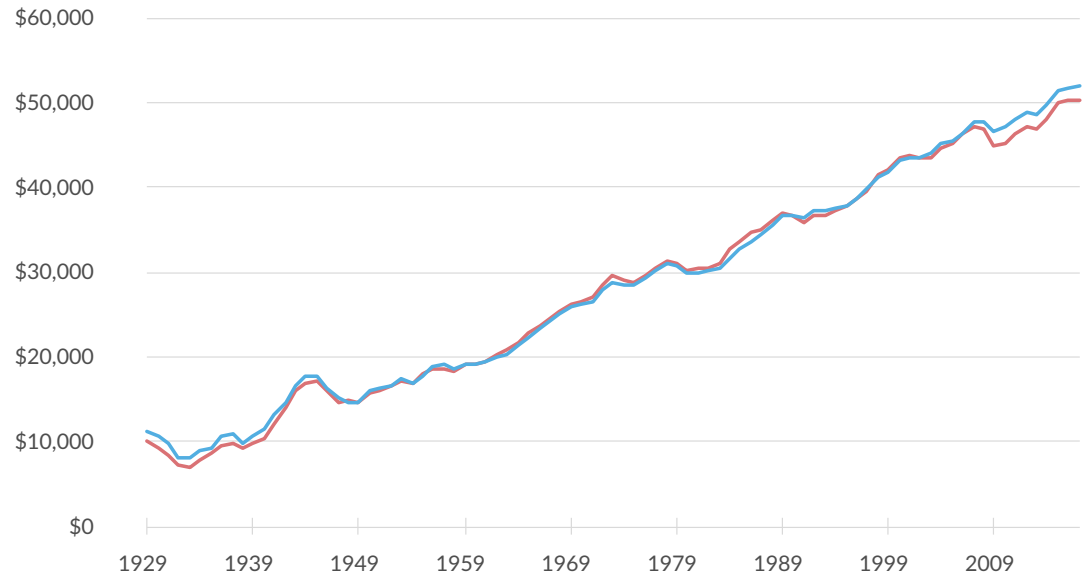
In 1929, the average inflation-adjusted personal income of a Pennsylvania resident was $11,107—above the U.S. average of $10,005.[11] Since that time, the Pennsylvania and U.S. personal income amounts have roughly converged on each other (see Figure 1.4).

10 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*, "Gross Domestic product (GDP) by state (millions of current dollars)."

11 Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income (Table SA1)*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers); U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico."

FIGURE 1.4.

Personal Income per Capita 1929-2017 (2017 dollars)



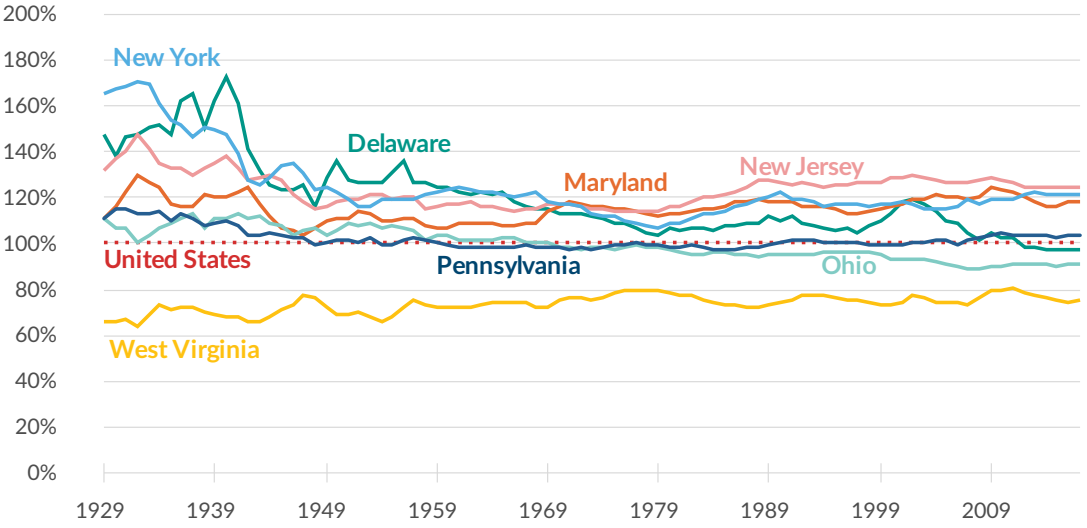
Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2017 base year.

Source: Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income* (Table SA1); Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers); U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico."

The Commonwealth has largely been outpaced by its neighbors since 1929. In the last decade, Pennsylvania has overtaken Delaware and the national average.[12] Figure 1.5 illustrates the personal income per capita, expressed as a percent of the U.S. level, for Pennsylvania and its bordering states.

FIGURE 1.5.

Personal Income per Capita as Percent of U.S. Level (1929-2017)



lote: Dollar amounts were adjusted for inflation and expressed in 2017 dollars prior to calculating percentage changes using the Consumer Price Index for All rban Consumers (CPI-U) from the Bureau of Labor Statistics.

ource: Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income* (Table A1); Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers); U.S. Census Bureau, Population Division, "Annual Estimates of the Resident opulation for the United States, Regions, States, and Puerto Rico."

12 Bureau of Economic Analysis, Regional Economic Accounts, *Personal Income Summary: Personal Income, Population, Per Capita Personal Income (Table SA1)*; Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers). U.S. Census Bureau, Population Division, "Annual Estimates of the Resident Population for the United States, Regions, States, and Puerto Rico."

It's also valuable to go beyond the state-by-state comparisons to examine intrastate incomes, since state economic composition varies by area. While both metropolitan and nonmetropolitan area personal incomes per capita have increased over time (controlling for inflation), nonmetro tends to be much lower than income in metro-area Pennsylvania (see Figure 1.6).[13] This disparity has grown increasingly larger over time.

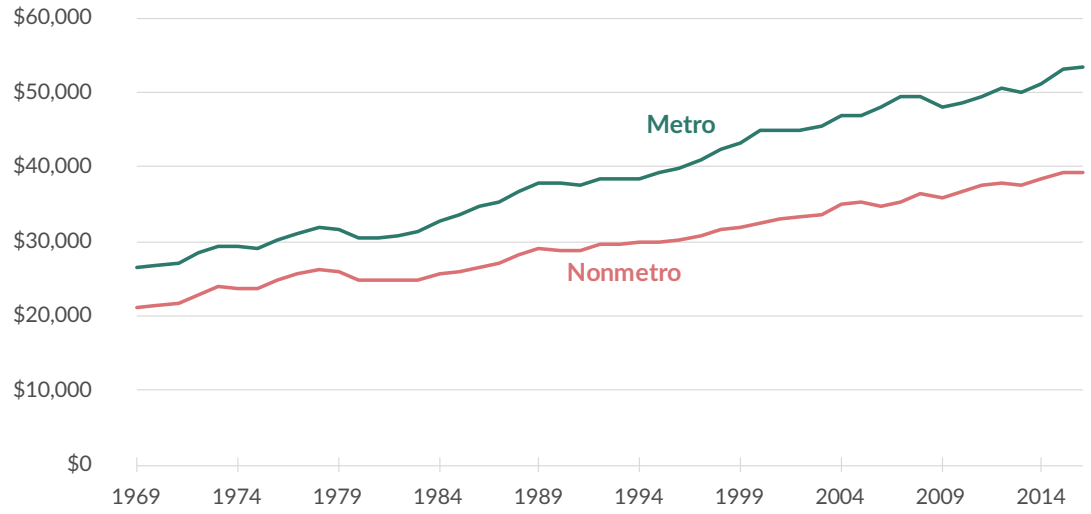
The differences in economic activity among Pennsylvania's regions go further than just the differences between metro and nonmetro areas, as even the various Metropolitan Statistical Areas (MSA) of Pennsylvania vary to a large degree.[14] Figure 1.7 illustrates the differences in GDP per capita of some of the most populated metro areas in Pennsylvania.[15] The larger cities in Pennsylvania, such as Pittsburgh and Philadelphia, dwarf the per capita GDP of the smaller cities. For example, the Pittsburgh, Harrisburg, and Philadelphia MSAs have more than $20,000 of GDP per capita more than the Scranton MSA.

When looking at these per capita GDPs by MSA over time (Figure 1.8), their comparative differences have evolved since 2001.[16] During this time period, the Philadelphia MSA grew by 21 percent, and the Pittsburgh MSA grew by 22 percent, both exceeding the national average of 12 percent.[17] However, other areas of the state have struggled. The Allentown, Harrisburg, Lancaster, and Scranton MSAs have only grown between 8 and 10 percent during this time period. If this trend continues, the gap between Pittsburgh and Philadelphia and the rest of the state, both in terms of GDP and personal income, will present significant challenges for policymakers. Allowing those areas to continue their rapid growth, while balancing the sluggish economies in the rest of the state, is not an easy task.

13 Bureau of Economic Analysis, Regional Data, Local Area Personal Income and Employment, *by Major Component* (Table CA4).
14 Bureau of Economic Analysis, Regional Economic Accounts, *Gross domestic product (GDP) by metropoltan area*.
15 Several of the MSAs in Pennsylvania, such as the Philadelphia MSA, cross state lines. This data limitation, however, does not impact the broader analysis above that economic production tends to be concentrated in the Harrisburg, Pittsburgh, and Philadelphia metropolitan areas.
16 Bureau of Economic Analysis, Regional Economic Accounts, *Gross domestic product (GDP) by metropoltan area*.
17 Id.

FIGURE 1.6.

Personal Income per Capita of Metropolitan and Nonmetropolitan area of Pennsylvania 1969-2016 (2017 dollars)

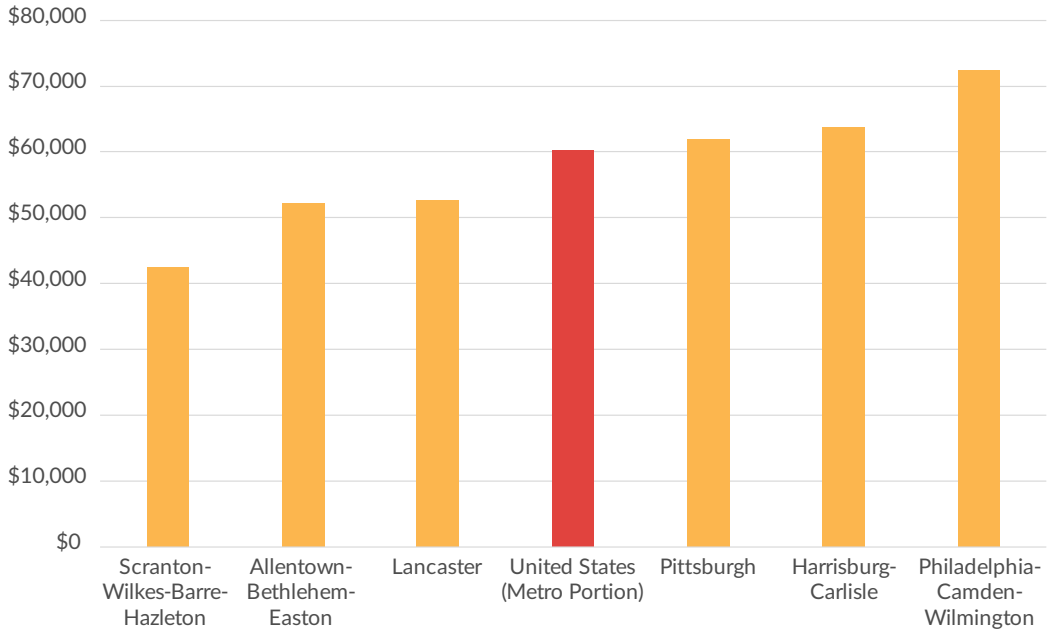


Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2017 base year.

Source: Bureau of Economic Analysis, Regional Data, Local Area Personal Income and Employment, by *Major Component* (Table CA4); Bureau of Labor Statistics, *Consumer Price Indexes* (All Urban Consumers).

FIGURE 1.7.

GDP per Capita by Metropolitan Statistical Area 2016 (2017 dollars)

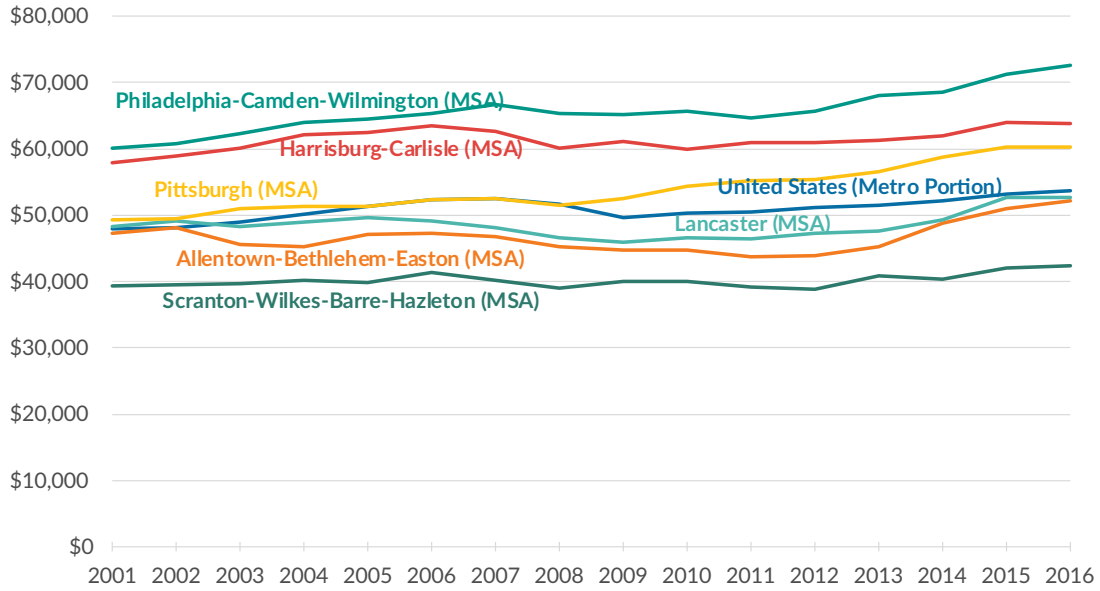


Note: 2016 is the most recent year of data available.

Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross domestic product (GDP) by metropoltan area.*

FIGURE 1.8.

GDP per Capita by MSA over Time 2001-2016 (2017 dollars)



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross domestic product (GDP) by metropoltan area.*

Major Industries

Pennsylvania's largest industry sectors in 2017 were professional and business services (12.6 percent), real estate and rental leasing (12.4 percent), manufacturing (11.7 percent), government (9.7 percent), and the health care and social assistance sector (9.4 percent).[18] Figure 1.9 illustrates the full composition of Pennsylvania's economy by industry, compared to the U.S. The Commonwealth exceeds the national averages in several areas, particularly health and social assistance, information, and mining. Pennsylvania does, however, lag the national average on government, largely due to the lack of major federal facilities in the state.

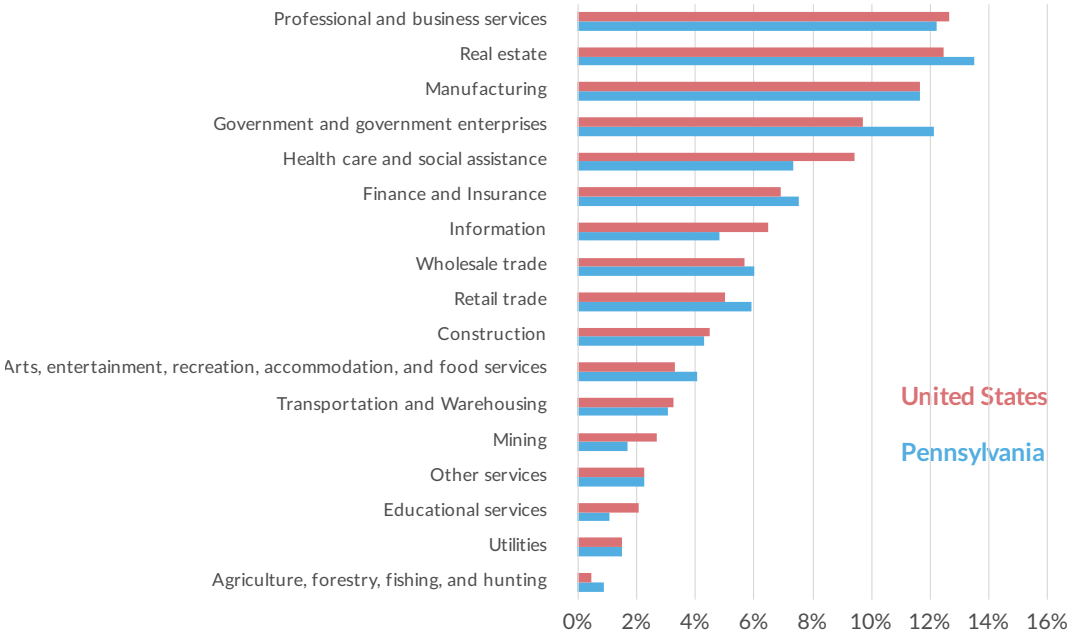
The Pennsylvania economy broadly reflects the United States overall but deviates in a few subtle ways. Pennsylvania trails the U.S. in several industries, such as the finance and insurance sector. The state has a much greater health care and social assistance industry, and a larger information sector, when compared to the United States overall.

When analyzing how the state's economy has evolved over the past two decades, several distinct changes have occurred. From 1997 to 2017, the size of the manufacturing industry has dramatically decreased from 20 percent of the state's total GDP to just 12 percent.[19] In its place a larger professional and business services industry has emerged, growing from 9 percent to 13 percent. The real estate sector has also grown considerably, as well as the health care and social assistance service industry (Figure 1.10).

18 Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*.
19 Id.

FIGURE 1.9.

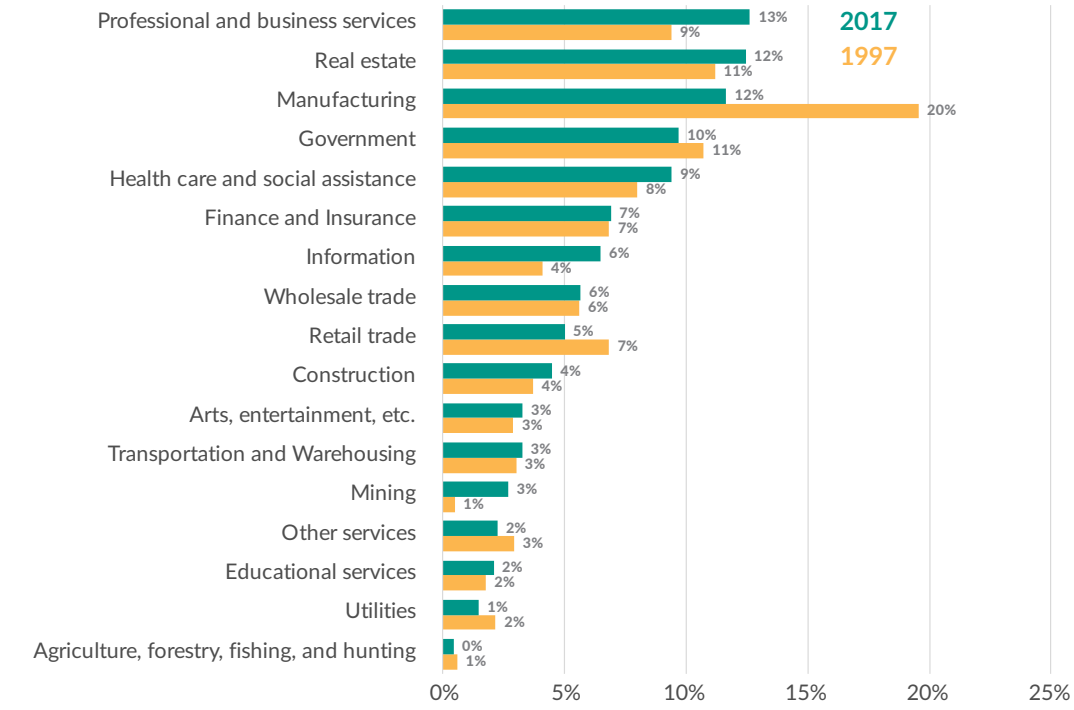
Percent of Total State GDP by Industry (2017)



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*

FIGURE 1.10.

Percent of Total State GDP by Industry (2017)



Source: Bureau of Economic Analysis, Regional Economic Accounts, *Gross Domestic Product (GDP) by State*

Employment

Employment in Pennsylvania has risen 15.9 percent since 1990, but only 6.4 percent since 2000. [20] Pennsylvania lost an estimated 258,100 jobs during the Great Recession, and total employment remained below its prerecession high until April 2015. March 2018 represented a high-water mark for the Commonwealth, as it had its highest level of nonfarm employment on record at 6 million employees (Figure 1.11).

While the national unemployment peaked at 10 percent, in the aftermath of the Great Recession, the Commonwealth only sustained a peak rate of 8.8 percent.[21] However, Pennsylvania was tied for the sixth highest unemployment rate in the nation as of April 2018, with a rate of 4.7 percent.[22] Similar to other economic indicators, Pennsylvania experiences somewhat less volatility than the national average, but also tends to underperform.

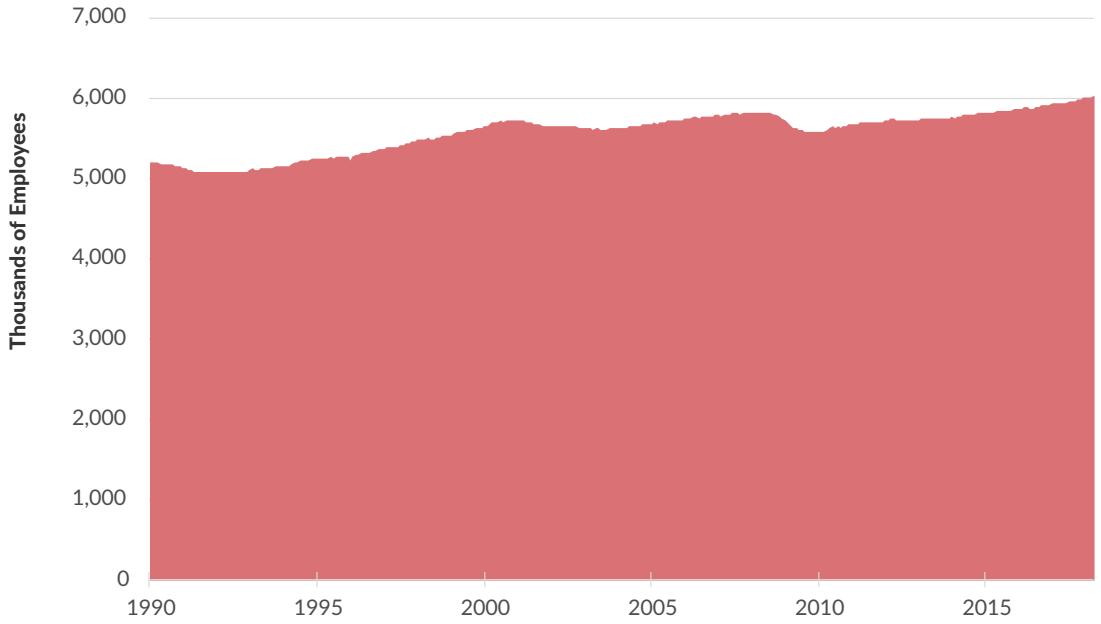
The educational and health service sector is the largest employer in the Commonwealth, comprising 21.2 percent of total state nonfarm employment, as of April 2018. The next largest industry is trade, transportation, and utilities at 18.8 percent, followed by professional and business services (13.6 percent), government (11.6 percent), and leisure and hospitality (9.5 percent). Figure 1.12 shows the breakdown of nonfarm employment within the Commonwealth, organized by broad sector categories provided by the Bureau of Labor Statistics.[23]

Each of these industries has fared differently over time (See Figure 1.13), with some sectors' employment levels being more volatile than others.[24] Many industries saw a large dip in employment following the Great Recession, especially in the construction and manufacturing sectors, though manufacturing's decline well preceded the recession.

While some sectors have struggled in recent years, others such as the leisure and hospitality industry have increased steadily. The transportation and warehousing sector is also increasing. The mining sector saw a large spike in employment around 2009. The growth can be attributed to the advent of new hydraulic fracturing "fracking" technologies coupled with surges in natural gas prices that allowed Pennsylvania to extract natural gas at a lower cost in the Marcellus Shale layer.[25] However, natural gas price volatility has nearly erased the gains made in mining employment, as many wells have been idled.

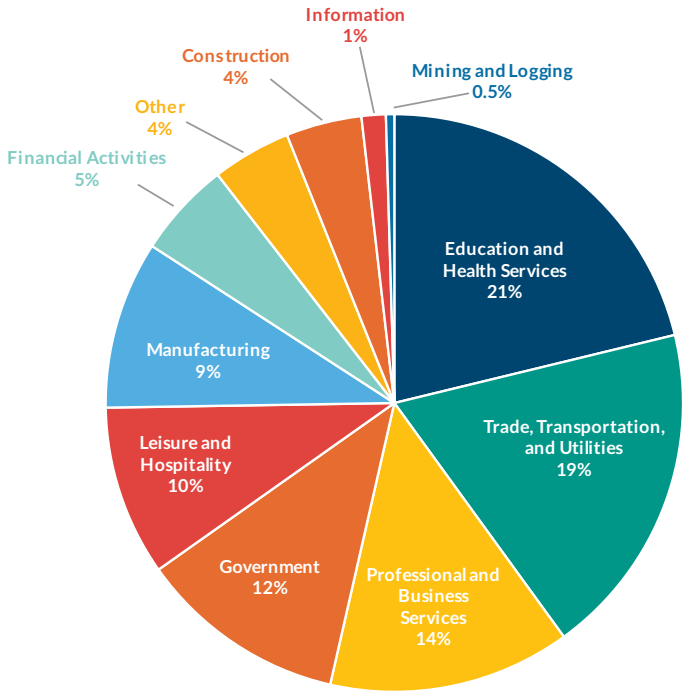
20 U.S. Bureau of Labor Statistics (BLS), "All Employees: Total Nonfarm in Pennsylvania."
21 BLS, "Labor Force Statistics for Current Population, Unemployment Rate" (Series Id. LNS14000000).
22 BLS, "Local Area Unemployment Statistics, Unemployment Rates for States, Seasonally Adjusted," https://www.bls.gov/web/laus/laumstrk.htm.
23 BLS, "State and Area Employment, Hours, and Earnings" (SMS42000000000000001).
24 BLS, "State Employment and Unemployment, Hours, and Earnings."
25 Daniel J. Soeder and William M. Kappel, "Water Resources and Natural Gas Production from the Marcellus Shale," U.S. Geological Survey (Fact Sheet 2009–3032), 6, https://pubs.usgs.gov/fs/2009/3032/pdf/FS2009-3032.pdf.

FIGURE 1.11.
Total Nonfarm Monthly Employment 1990-2018



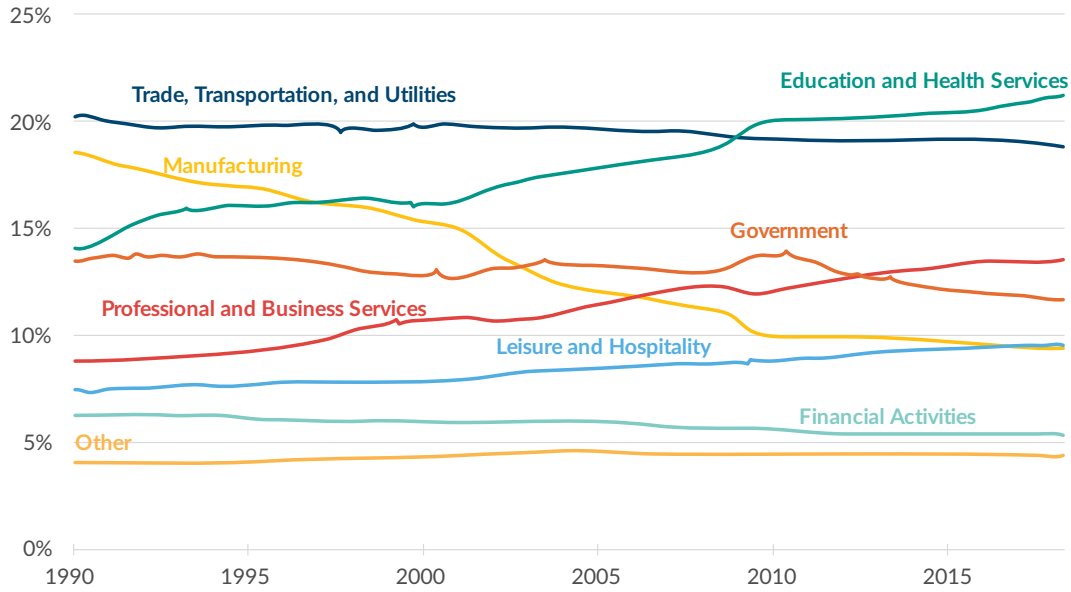
Source: U.S. Bureau of Labor Statistics, All Employees: Total Nonfarm in Pennsylvania.

FIGURE 1.12.
Percent of Total Nonfarm Employment by Industry (April 2018)



Source: Bureau of Labor Statistics, "State and Area Employment, Hours, and Earnings."

FIGURE 1.13.
Percent of Total Nonfarm Employment by Industry over Time 1990-2018



Source: Bureau of Labor Statistics, "State and Area Employment, Hours, and Earnings."

Migration Patterns

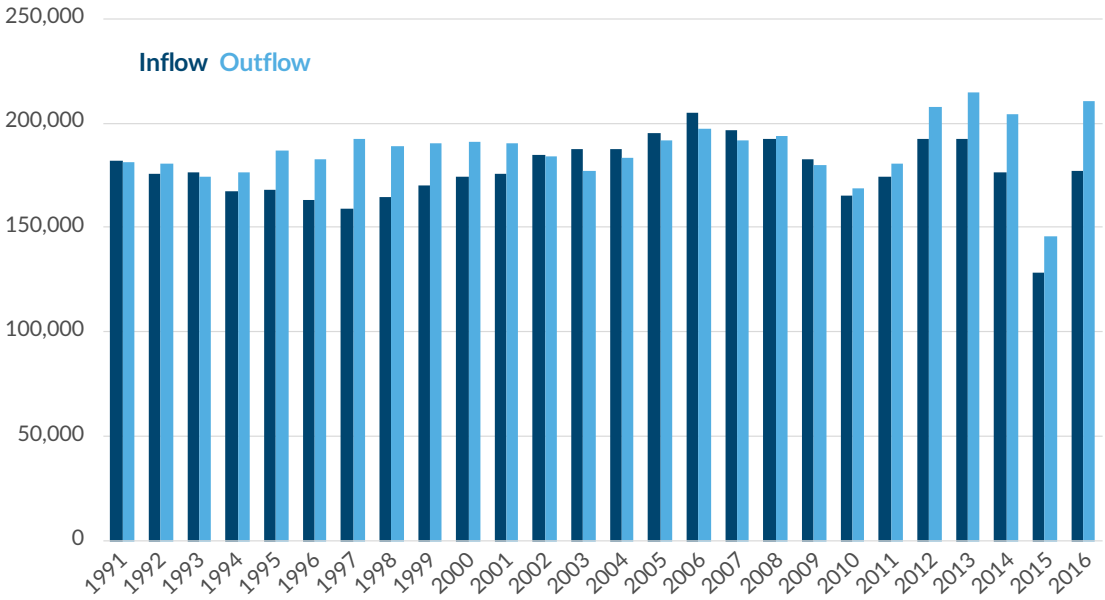
There are many ways to measure interstate migrations, but one way is to compare the movement of individual federal income tax returns, and the corresponding exemptions, between states and abroad, over time. The Internal Revenue Service's State Migration Data shows the inbound and outbound number of federal tax exemptions, which serves as our measure of "people."

Since 1991, Pennsylvania has had an outflow of residents during most years and seen a net total of 251,932 people leave the state.[26] From 2002 to 2007, the Commonwealth saw a small net inflow of residents, but in recent years, outflow has greatly exceeded inflow, with 2016 having the second highest net outflow since 1991. Figure 1.14 illustrates these migration trends over time.

26 Internal Revenue Service, *Statistics of Income Tax Stats – Migration Data*, "U.S. Population Migration Data."

FIGURE 1.14.

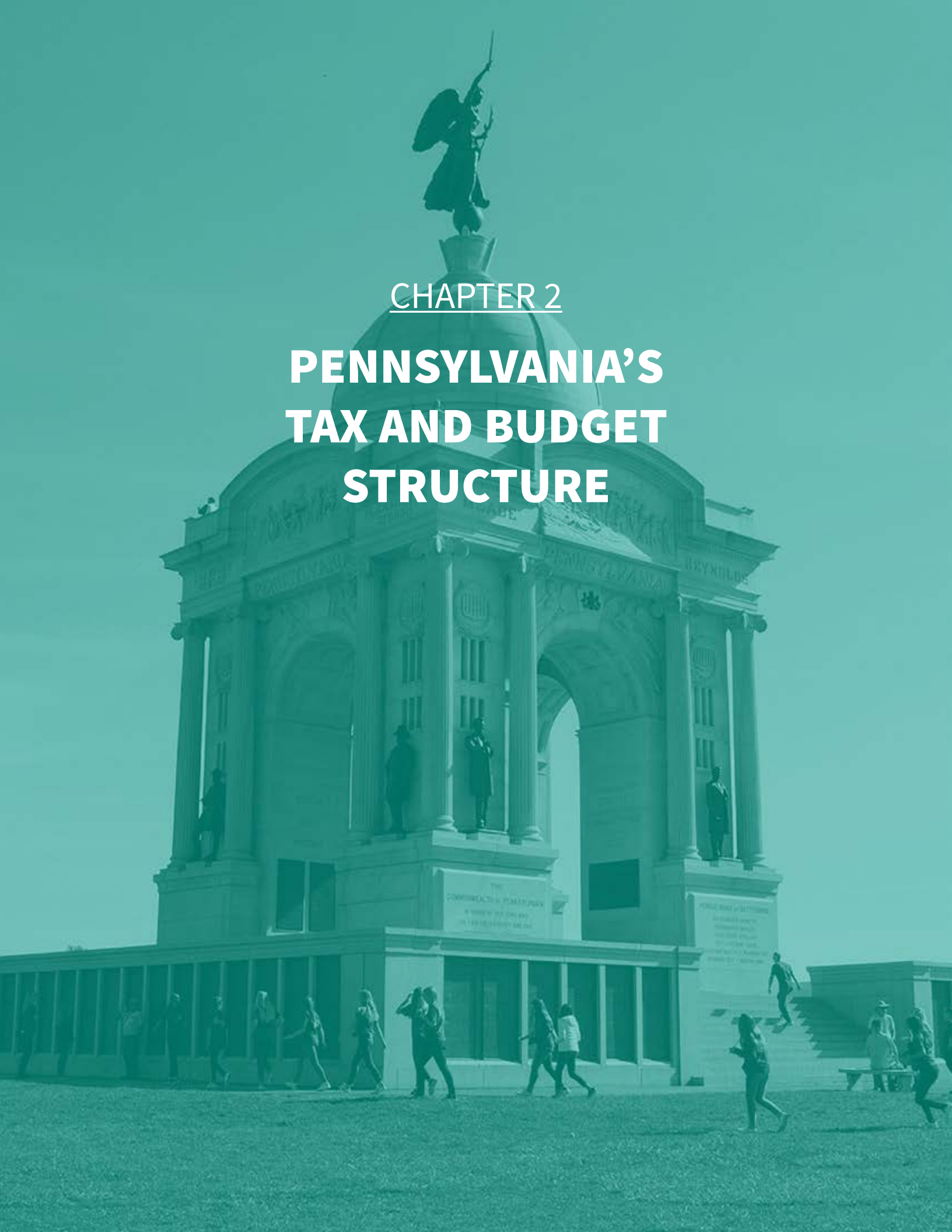
Migration In and Out of Pennsylvania 1991-2016



Source: Internal Revenue Department: *Statistics of Income Tax Stats*–Migration Data, "U.S. Population Migration Data."

Between 1991 and 2016, Pennsylvanians moved throughout the country, with the largest outbound migration to New Jersey (567,956), Florida (540,159), New York (423,800), Maryland (298,274), and Virginia (270,464). Other states which Pennsylvania lost considerable individuals to were North Carolina, Ohio, California, Texas, and Delaware. Over the same period, Pennsylvania gained the most individuals from New York (647,002), New Jersey (627,083), Maryland (354,989), Florida (328,604), and Virginia (227,570), with other notable inflows coming from Ohio, California, North Carolina, Texas, and Delaware.

Pennsylvania's migration data is of particular significance due to the state's stagnant population growth in recent years. Between 2008 and 2017, population grew by a mere 1.5 percent, and in 2016, the state actually experienced a net decrease in population. The overall net migration outflow has surely contributed to this slow growth.



CHAPTER 2

PENNSYLVANIA'S TAX AND BUDGET STRUCTURE

Introduction

Spending in Pennsylvania has grown rapidly over the last two decades. Total state spending, including funding from the federal government, has increased by more than 50 percent. Spending growth in recent years has been driven by increases in transportation, education, and health and human services. By the end of the decade, moreover, the Commonwealth will be required to pay a share of the cost of Medicaid expansion, which is currently financed fully by the federal government.

Individual income tax and sales tax revenues generate approximately 70 percent of state tax collections. While these two taxes provide relative stability to Pennsylvania's revenue collections, other taxes introduce both volatility and complexity. The Commonwealth's Corporate Net Income Tax, in particular, is quite volatile, with some year-over-year fluctuations in excess of 35 percent. Pennsylvania has one of the highest corporate income tax rates in the country, and ranks last out of all states on our *State Business Tax Climate Index* for its unemployment insurance tax structure. This tax structure hinders Pennsylvania's competitiveness, both regionally and nationally.

This chapter provides an overview of Pennsylvania's tax and budget structure.

Tax and Spending Policies in the 2000s

Pennsylvania inflation-adjusted state spending increased 56 percent between 1996 and 2017. From 2008 to 2011, inflation-adjusted expenditures increased 11 percent, chiefly stemming from the Federal American Recovery and Reinvestment Act (stimulus) of 2009. Over the next three years, spending remained relatively unchanged, but it has increased quickly over the last several years, growing 15 percent between 2014 and 2017. Figure 2.1 details Pennsylvania's inflation-adjusted total expenditures from 1996 to 2017.[27] Total expenditures include both state general funds and federal funds.

Several key areas are driving the recent increase in spending. Transportation expenditures increased 30 percent between 2014 and 2017, while education spending rose 16 percent over the same period. Expenditures for health and human services have also increased substantially, rising from an inflation-adjusted $32.9 billion in 2014 to $40.4 billion in 2017 (a 23 percent increase). A large contributor to the rise in health and human services expenditures is the Medicaid expansion program, which was first implemented in January of 2015. In calendar year 2015 alone, Medicaid expansion cost $2.8 billion.[28] While federal funds initially covered all the costs associated with the expansion during 2015 and 2016, the Commonwealth began paying 5 percent of the total costs in 2017, and will pay an increasingly larger percentage until reaching 10 percent for calendar year 2020 and subsequent years.[29]

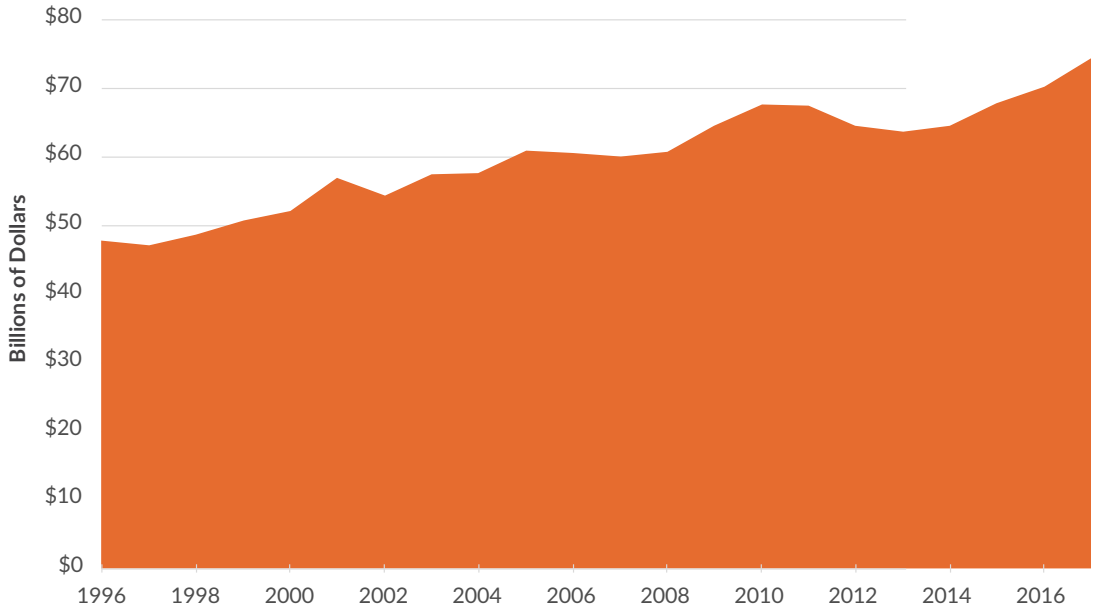
27 Commonwealth of Pennsylvania, *Comprehensive Annual Financial Report For the Fiscal Year Ended June 30, 2017*, http://www.budget.pa.gov/PublicationsAndReports/AnnualFinancialReport/Documents/june-30-2017-cafr.pdf.

28 PA Department of Human Services, *Medicaid Expansion Report*, Jan. 27, 2017, 33, http://www.dhs.pa.gov/cs/groups/webcontent/documents/document/c_257436.pdf.

29 Id.

FIGURE 2.1.

Total State Expenditures, 1996-2017 (2017 dollars)

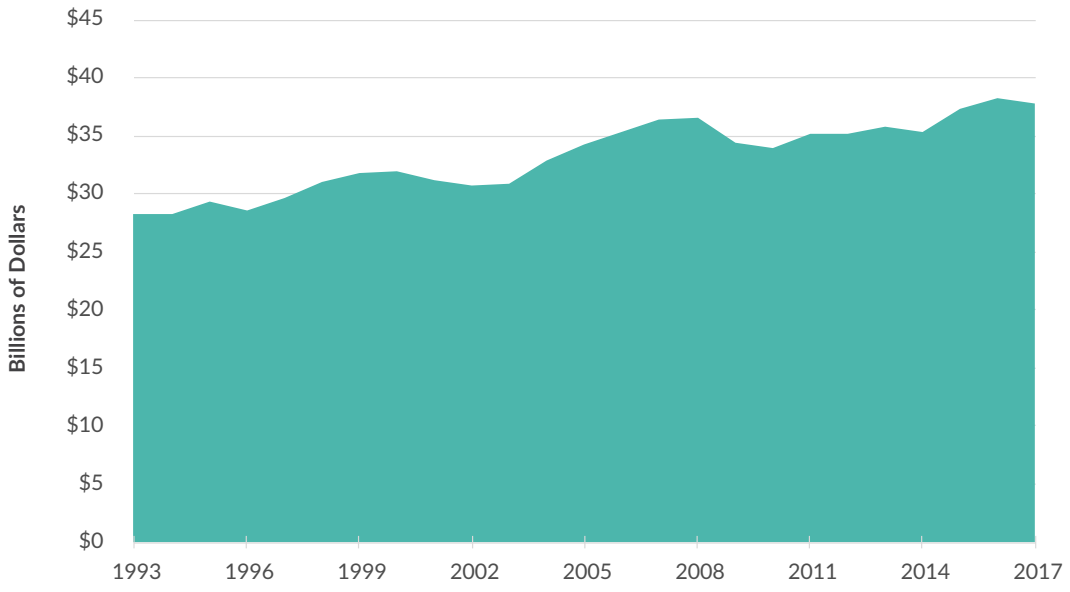


Source: Pennsylvania Office of the Budget, *Comprehensive Annual Financial Report 2008 and 2017*

Between 1993 and 2017, state tax collections increased by 34 percent, even after adjusting for inflation.[30] Collections grew with a particularly fast pace during the strong economy in the years between 2003 and 2008, prior to the recession. Following the recession, state tax collections decreased by 7 percent and did not return to prerecession levels until 2015. Figure 2.2 shows Pennsylvania's tax collections over the past couple decades.

FIGURE 2.2.

Total Tax Collections 1993-2017 (2017 dollars)



Source: U.S. Census Bureau, "State Government Tax Collections"

30 U.S. Census Bureau, "Survey of State Government Tax Collections," https://factfinder.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=COG_2012_COG001&prodType=table.

Pennsylvania's soaring pension liabilities are also part of the puzzle. As researchers from the Pew Charitable Trusts noted, liabilities on the Commonwealth's two pension funds–the Pennsylvania School Employee Retirement System (PSERS) and State Employees' Retirement System (SERS)–swung from a $20 billion surplus in 2001 to a $61 billion deficit by 2015.[31] In 2017, Pennsylvania had an official unfunded liability of $74 billion, but actuaries have suggested that the real liabilities may eclipse $100 billion.[32] Pension reform undertaken in 2017 will bring down future costs substantially, but the state must still grapple with the liabilities incurred during years of mismanagement and inconsistent funding.

Pennsylvania's Current Budget Makeup

In fiscal year 2017, Pennsylvania derived around 56 percent of its total revenue from state sources, while the other 44 percent came from federal funds (Figure 2.3).[33] Between 2014 and 2017, intergovernmental revenue increased 35 percent, while total revenue increased 23 percent.[34]

Within Pennsylvania's tax system (excluding federal revenue transfers), the personal income tax has been the largest source of revenue since 2006, comprising around 41 percent of the state's total tax collection in fiscal year 2017 (Figure 2.4).[35] The sales tax generates 33 percent of the state's total tax collections, making the individual income and sales taxes the workhorses of the Commonwealth's revenue streams.

While the bulk of Pennsylvania's revenue is generated from the individual income and sales taxes, the Commonwealth does receive a sizable share from the Corporate Net Income Tax. Many states rely on corporate income taxes for a portion of their revenues, but Pennsylvania has a larger reliance than most. According to the U.S. Census Bureau, 4.7 percent of Pennsylvania's state and local tax collections came from the corporate income tax, compared to 3.7 percent nationally.[36] This can be problematic, because corporate income taxes, both in Pennsylvania and other states, tend to be quite volatile. This uncertainty makes budgeting more difficult, and is exacerbated by Pennsylvania's restrictive treatment of net operating losses (discussed at length in Chapter 3).

Figure 2.5 compares year-over-year changes in revenue collections for the Commonwealth's three largest revenue streams–individual income, sales, and corporate income–since 1973.[37] The volatility of the corporate income tax is apparent immediately. While all taxes can be volatile, the Corporate Net Income Tax is particularly so.

31 Greg Mennis, "Pennsylvania's Historic Pension Reform," The Pew Charitable Trusts, Dec. 14, 2017, http://www.pewtrusts.org/en/research-and-analysis/articles/2017/12/14/pennsylvanias-historic-pension-reforms.

32 Jerry Shenk, "Pennsylvania's Looming Pension Crisis," Lebanon Daily News, May 16, 2018, https://ldnews.com/story/opinion/2018/05/16/pennsylvanias-looming-pension-crisis/615097002/.

33 U.S. Census Bureau, "State & Local Government Finance," 2015.

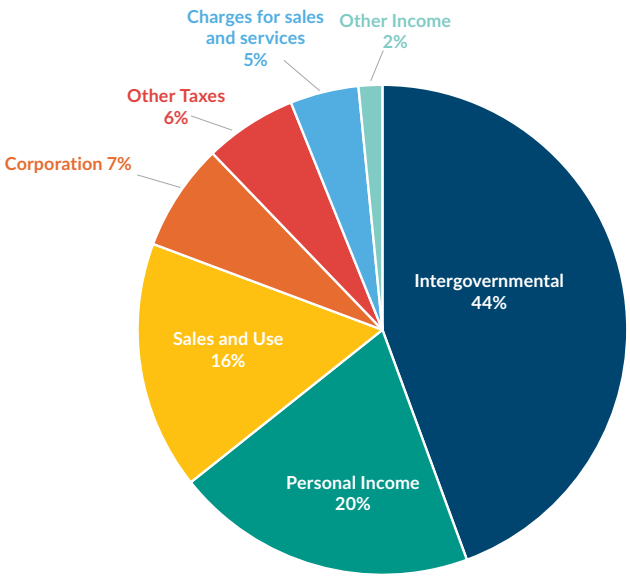
34 Commonwealth of Pennsylvania, *Comprehensive Annual Financial Report: For the Fiscal Year Ended June 30, 2015*, http://www.budget.pa.gov/PublicationsAndReports/AnnualFinancialReport/Documents/2015/june-30-2015-cafr.pdf.

35 Pennsylvania Department of Revenue, *The Statistical Supplement for the Pennsylvania Tax Compendium, Fiscal Year 2016-17*, November 2017, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/Documents/2016-17_stat_supp.PDF.

36 Tax Foundation, *Facts and Figures 2018: How Does Your State Compare?* Table 8, https://taxfoundation.org/publications/facts-and-figures/.

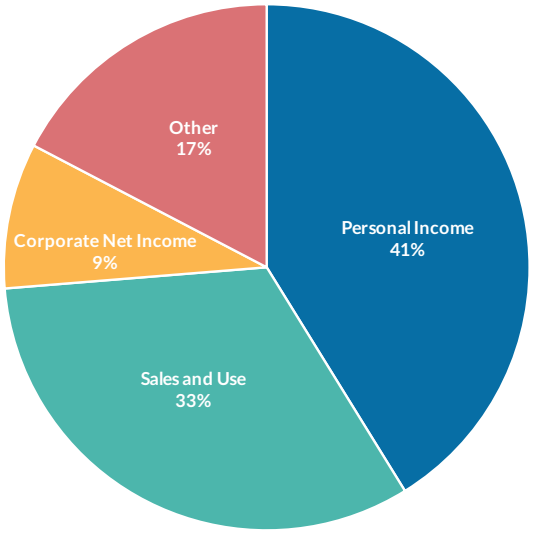
37 U.S. Census Bureau, "Annual Survey of State Government Finance."

FIGURE 2.3.
General Fund Revenue by Source (2017)



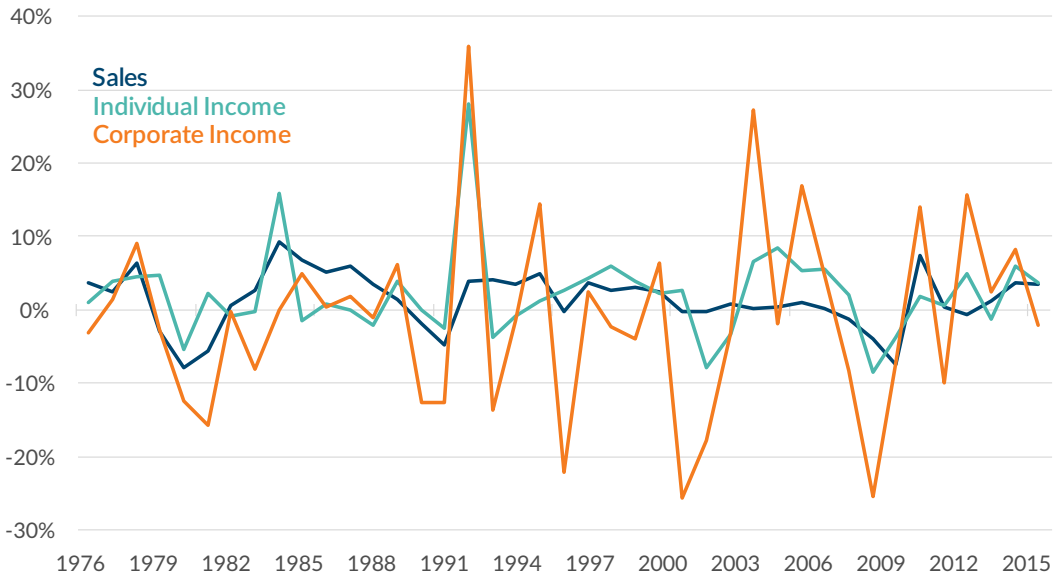
Source: Pennsylvania Office of the Budget, *Comprehensive Annual Financial Report 2017*

FIGURE 2.4.
Total Tax Revenue by Source (2017)



Source: Pennsylvania Department of Revenue, *The Statistical Supplement for the Pennsylvania Tax Compendium, Fiscal Year 2016-2017*

FIGURE 2.5.
Tax Collection Volatility



Source: U.S. Census Bureau, State & Local Government Finance

Measures of State Tax Competitiveness

Tax reform can improve the budgeting process, making it easier and more consistent, and can reduce compliance costs for both individuals and businesses. Most importantly, though, tax reform can improve a state's competitiveness.

Two Tax Foundation publications, *State-Local Tax Burden Rankings* and the *State Business Tax Climate Index*, provide different perspectives on each state's tax competitiveness. The *State-Local Tax Burden Rankings* estimates the combined state and local tax burden as a percentage of state income, essentially showing how much a resident of each state pays in state and local taxes. Conversely, the *State Business Tax Climate Index* compares each state's tax structure across 114 variables.

The *State-Local Tax Burden Rankings* report seeks to answer "how much does a state collect in revenue?" while the *State Business Tax Climate Index* answers "how complex is a state's tax code?" Combined, these two reports serve as diagnostic for a state's tax code to determine how competitive a state is compared to its regional and national peers.

State and Local Tax Burdens

Many people are familiar with tax collections measures, which tally the amount of taxes collected by state and local governments. Tax burdens, however, measure the impact of those collections on taxpayers.

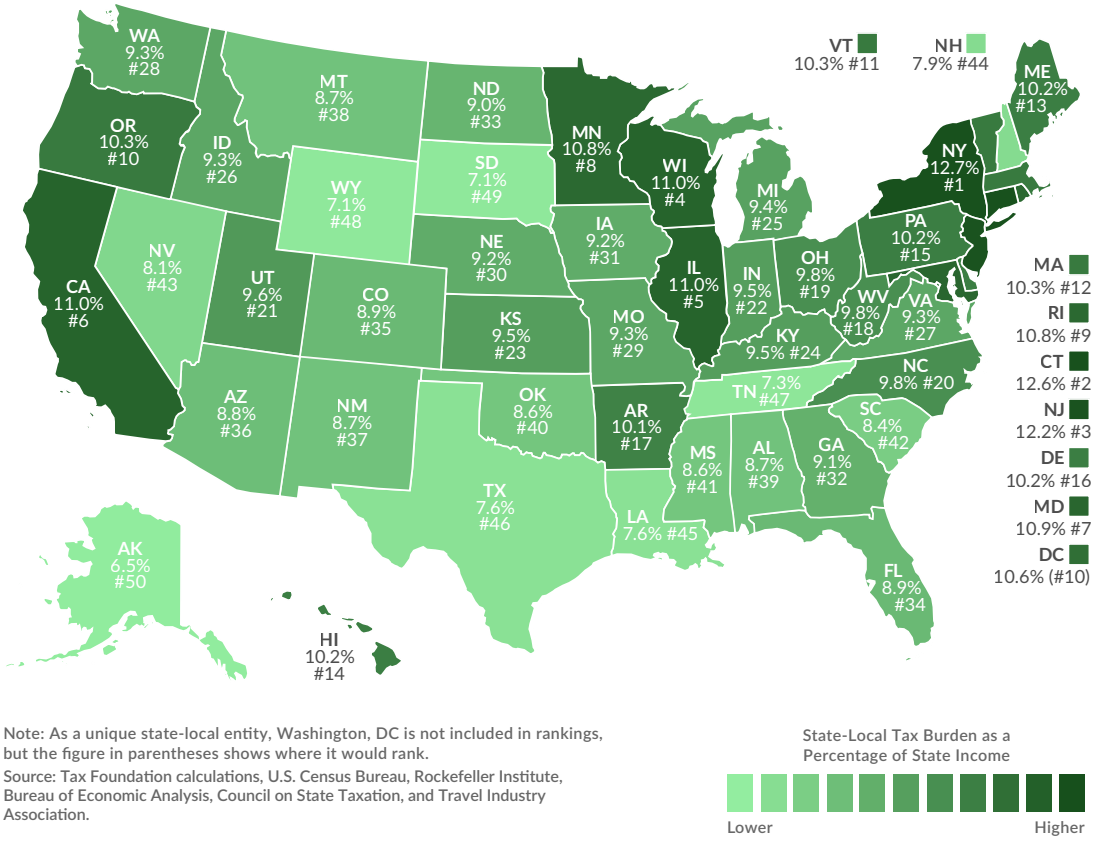
In the Tax Foundation's *State-Local Tax Burden Rankings*, collections data are adjusted for tax importation and tax exportation to reflect the economic–not legal–incidence of taxation. State taxes are not just paid by state residents, but rather are borne by individuals across the country. For example, while Alaska's state and local tax collections are among the highest in the country, its burden is the lowest (6.5 percent of personal income in fiscal year 2012). This is because Alaska generates the bulk of its revenue from its oil and natural gas severance taxes, which are not paid by Alaskans but rather the rest of the country when they put fuel into their automobiles or buy other petroleum-based products. The *State-Local Tax Burden Rankings* report allows us to capture the impact of tax exporting.

In fiscal year 2012 (the most recent year in which data are available), New Yorkers paid the most in state and local taxes (12.7 percent of total state income), while Alaskans paid the least (6.5 percent).[38] Pennsylvania experiences above-average state and local tax burdens, ranking 15th nationally. In fiscal year 2012, residents of the state paid $4,589 in state and local taxes per capita, including $1,204 in taxes to other states, or 10.2 percent of total state income. Figure 2.6. shows the total state and local tax burden for each state in the 2012 fiscal year.

FIGURE 2.6.

State-Local Tax Burdens by State

State-Local Tax Burdens as a Percentage of State Income, FY 2012



Note: As a unique state-local entity, Washington, DC is not included in rankings, but the figure in parentheses shows where it would rank.

Source: Tax Foundation calculations, U.S. Census Bureau, Rockefeller Institute, Bureau of Economic Analysis, Council on State Taxation, and Travel Industry Association.

38 Liz Malm and Gerald Prante, "State-Local Tax Burden Rankings: Methodology," Tax Foundation, Jan. 20, 2016, https://taxfoundation.org/state-local-tax-burden-rankings-methodology/.

Business Tax Climate

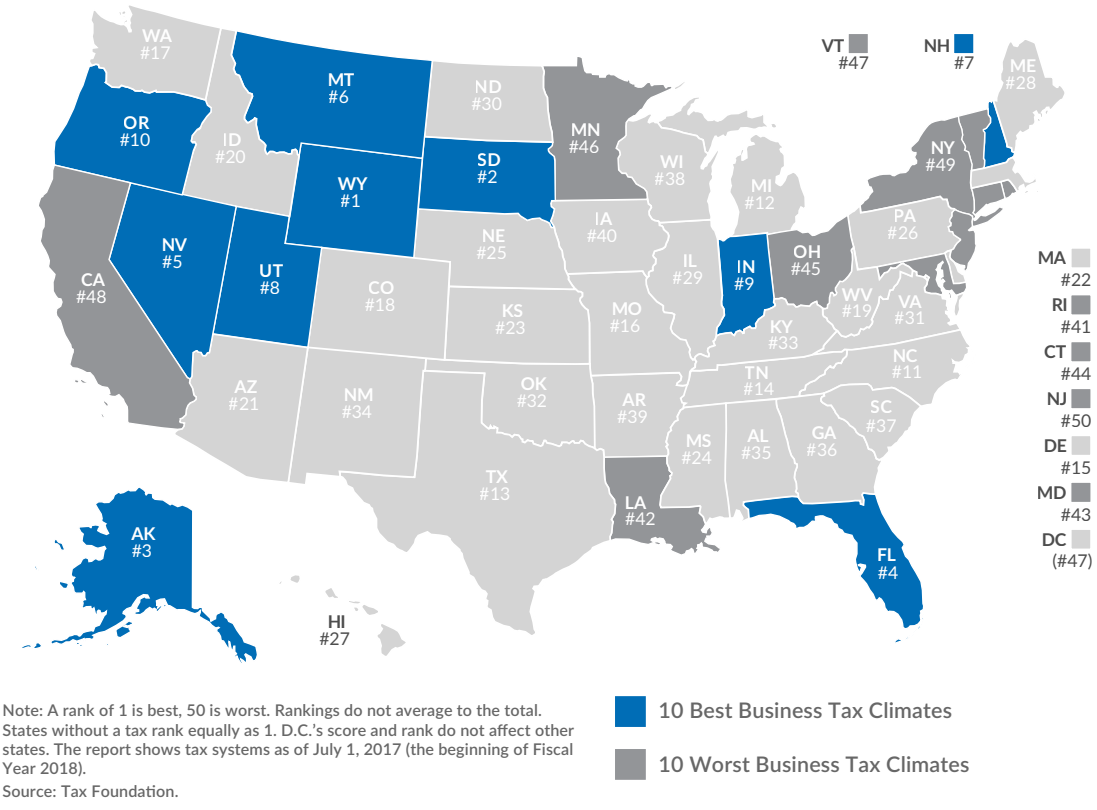
While how much is paid in taxes each year is an important consideration for competitiveness, equally important is *how* those taxes are imposed. Taxes vary significantly, with certain levies being more harmful to growth than others or imposing high compliance costs.

Each year, the Tax Foundation produces the *State Business Tax Climate Index* to enable business leaders, state policymakers, and taxpayers to gauge how these structural elements compare. The *Index* examines 114 variables in individual income tax, corporate income tax, sales tax, unemployment insurance tax, and property tax categories to reduce these many complex considerations into a ranking.

In the recent 2018 edition, which evaluates state tax codes as of July 1, 2017, the states with the best tax systems are Wyoming, South Dakota, Alaska, Florida, Nevada, Montana, New Hampshire, Utah, Indiana, and Oregon. The states with the worst tax systems are New Jersey, New York, California, Vermont, Minnesota, Ohio, Connecticut, Maryland, Louisiana, and Rhode Island. Figure 2.7 highlights each state's overall ranking.

FIGURE 2.7.

2018 State Business Tax Climate Index



Note: A rank of 1 is best, 50 is worst. Rankings do not average to the total. States without a tax rank equally as 1. D.C.'s score and rank do not affect other states. The report shows tax systems as of July 1, 2017 (the beginning of Fiscal Year 2018).

Source: Tax Foundation.

10 Best Business Tax Climates

10 Worst Business Tax Climates

Pennsylvania's overall tax structure ranking of 26th among states leaves much to be desired. The state's corporate income tax rate of 9.99 percent is the second highest in the nation, and its unemployment insurance tax structure ranks 50th in the country. Another component that ranks in the bottom half of states is the Commonwealth's overall property tax ranking (33rd), which is impacted by the state's inheritance tax.

Fundamental tax reform is about improving these shortcomings so that Pennsylvania can collect the revenue necessary for government services while still maintaining a competitive position that allows the state's economy to grow. By broadening tax bases and lowering tax rates, the state can have a meaningful impact on the quality of life for Pennsylvania residents.

Throughout this book, we will use the *State Tax Business Climate Index* as a way to compare Pennsylvania's taxes to states that are regional competitors and to the country as a whole. The states we have chosen for comparison are the bordering states of Delaware, Maryland, New Jersey, New York, Ohio, and West Virginia.

CHAPTER 3

CORPORATE NET INCOME TAXES

Introduction

With a rate of 9.99 percent, Pennsylvania has the highest single-rate corporate income tax in the country. Only Iowa, with a top marginal rate of 12 percent, and New Jersey, with a newly-adopted 11.5 percent top rate, impose a higher rate on any amount of corporate income (though newly enacted legislation is intended to reduce Iowa's top marginal rate to 9.8 percent in a few years, and New Jersey's rate is slated to decline slightly, to 10.5 percent, after two years).[39]

Pennsylvania's unusually high corporate rate is a particularly heavy burden for industries with long or uneven business cycles, since the Commonwealth is notoriously stingy with its net operating loss provisions. This imposes substantial costs on legacy industries, like steel and aluminum, but some emerging industries, like natural gas, are also hard-hit.

In this chapter, we provide a broad overview of Pennsylvania's corporate income tax, outline issues to consider regarding the current system, and provide options for reform.

39 Jared Walczak, "What's in the Iowa Tax Reform Package," Tax Foundation, May 9, 2018, https://taxfoundation.org/whats-iowa-tax-reform-package/; Ben Strachman and Scott Drenkard, "Business and Individual Taxpayers See No Reprieve in New Jersey Tax Package," Tax Foundation, July 3, 2018, https://taxfoundation.org/individual-income-tax-corporate-tax-hike-new-jersey/.

Overview of Pennsylvania Corporate Income Taxation

Corporate income taxation came to Pennsylvania in fits and starts—first with 3 percent tax to pay down Civil War debt, and then with a half-percent emergency corporate profits tax adopted in 1923.[40] The modern era of corporate taxation in Pennsylvania, however, began in 1935, when a new corporate net income tax (CNIT) of 6 percent was adopted in tandem with an individual income tax. The individual income tax was struck down as unconstitutionally structured, but the corporate tax survived, even though it was only imposed one year at a time until 1956, when it was finally made permanent.[41]

Thus, Pennsylvania became the 29th state to adopt a corporate income tax, part of a wave of such taxes adopted during the decade of the 1930s.[42] The rate has been adjusted many times, reaching its current rate of 9.99 percent in 1995. Throughout its history, it has always been a single-rate tax, consistent with the uniformity clause in the state constitution.[43]

The Commonwealth taxed capital stock from 1844 until 2016, when the Capital Stock and Franchise Tax was repealed following a lengthy, and occasionally suspended, phaseout which began in 2002. Table 3.1 shows historical corporate net income tax rates.

TABLE 3.1.
Historical Corporate Net Income Tax Rates[6]

Year	Tax Rate	Year	Tax Rate
1935	6.00%	1972	11.00%
1936	10.00%	1974	9.50%
1937	7.00%	1977	10.50%
1943	4.00%	1985	9.50%
1951	5.00%	1987	8.50%
1956	6.00%	1991	12.25%
1967	7.00%	1994	11.99%
1969	12.00%	1995	9.99%

Source: Pennsylvania Department of Revenue

Like most states, Pennsylvania carves out its corporate base with a range of targeted tax incentives, which contribute to a higher rate overall to maintain collections. Unlike most states, Pennsylvania is uncommonly stingy in its treatment of net operating losses, which makes the tax particularly onerous for industries with irregular business cycles. Finally, state policy discriminates against capital investment, not only failing to conform to federal treatment, but, most recently, adopting easily the nation's most punitive policies toward investment.

40 William J. McKenna, "The Income Tax in Pennsylvania," *Pennsylvania History: A Journal of Mid-Atlantic Studies* 27:3 (July 1960), 295, https://www.jstor.org/stable/27769968.
41 Id.
42 Fifteen states adopted corporate income taxes in the 1930s, beginning with Idaho in 1931 and ending with Maryland in 1937. It took another decade, until 1947, for another state to do so. See U.S. Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism Volume 1, Budget and Tax Processes*, 34, http://www.library.unt.edu/gpo/acir/SFFF/SFFF-1994-Vol-1.pdf.
43 PA CONST Art. 8, § 1.
44 Pennsylvania Department of Revenue, *The Tax Compendium*, March 2017, 3, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/Documents/2017_tax_compendium.pdf.

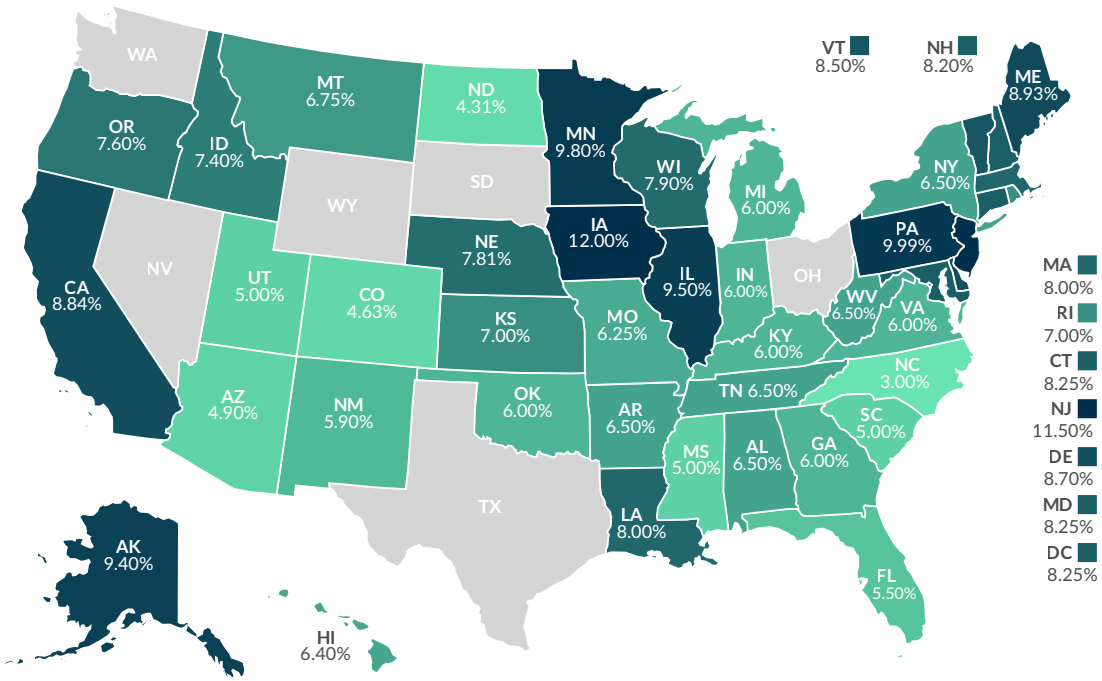
Pennsylvania's high-rate corporate income tax, combined with these structural deficiencies, yield a corporate tax code which holds the state back.

Among Pennsylvania's neighboring states, five impose single-rate corporate income taxes and one, Ohio, forgoes a corporate income tax and instead levies a 0.26 percent gross receipts tax, called the Commercial Activity Tax (CAT). New York and West Virginia have the lowest corporate rates among bordering states, at 6.5 percent, while Maryland's rate is 8.25 percent and Delaware's is 8.7 percent.[45]

New Jersey's code stands apart, as it is usually deemed to levy a flat tax, but the rate varies based on taxable income. New Jersey has no income brackets. Instead, corporations with net income greater than $1 million pay 11.5 percent on all taxable income, those earning more than $100,000 but less than $1 million pay 9 percent on all income, those with greater than $50,000 and less than $100,000 in net income remit 7.5 percent on all income, and those with less than $50,000 pay 6.5 percent on all taxable income. Figure 3.1 shows top marginal corporate income tax rates for all 50 states and the District of Columbia.

FIGURE 3.1.

Top State Marginal Corporate Income Tax Rates in 2018



Note: Connecticut's rate includes a 10 percent surtax. Illinois' rate includes two separate corporate income tax rates. Delaware, Ohio, Texas, Virginia, and Washington have gross receipts taxes with rates not strictly comparable to corporate income taxes.

Source: Tax Foundation, State Corporate Income Tax Rates and Brackets for 2018.

45 Morgan Scarboro, "State Corporate Income Tax Rates and Brackets for 2018," Tax Foundation, Feb. 7, 2018, https://taxfoundation.org/state-corporate-income-tax-rates-brackets-2018/.

Pennsylvania's corporate net income tax is imposed at a single rate due to the constitutional requirement that "[a]ll taxes shall be uniform, upon the same class of subjects," a clause which has generated no small amount of controversy over the years and spawned multiple campaigns to repeal the requirement. Even absent a constitutional imperative, however, there are sound policy reasons for choosing a single-rate tax, like Pennsylvania and its neighbors do.[46]

Forty-four states levy a corporate income tax, and of those, 27 have a single tax rate. Single-rate systems are more consistent with the principles of simplicity and neutrality. In contrast to the individual income tax, there is no meaningful "ability to pay" concept in corporate taxation. Jeffery Kwall, a professor at Loyola University Chicago School of Law, notes that

> graduated corporate rates are inequitable—that is, the size of a corporation bears no necessary relation to the income levels of the owners. Indeed, low-income corporations may be owned by individuals with high incomes, and high-income corporations may be owned by individuals with low incomes.[47]

A single-rate system minimizes the incentive for firms to engage in expensive, counterproductive tax planning to mitigate the damage of higher marginal tax rates that some states levy as taxable income rises. In this regard, at least, Pennsylvania does well—though its 9.99 percent rate subjects all corporate taxable income to a rate higher than the top marginal rate in all but one other state.

Since 2008, 15 states and the District of Columbia have cut corporate income taxes, and Michigan shifted from a gross receipts tax to a traditional corporate income tax.[48] In Pennsylvania, by contrast, there has not been a rate cut since 1995, and the current rate–imposed on the first dollar of taxable income–is the second-highest in the nation, after only Iowa, which allows corporate taxpayers to deduct half of their federal tax liability.[49]

Reductions in corporate rates elsewhere reflect a trend toward reduced reliance on a highly volatile tax imposed on a declining amount of taxable income, and, in some instances, an effort to simplify the tax structure by broadening the base and lowering the rate. Corporate income tax revenue as a share of total revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common, and states give away more of their tax base in special credits and deductions.[50]

46 Excepting the curious case of New Jersey, explained above.
47 Jeffrey L. Kwall, "The Repeal of Graduated Corporate Tax Rates," *Tax Notes*, June 27, 2011, 1395.
48 See Joseph Bishop-Henchman, "Trend #3: Corporate Tax Reductions, Top 10 State Tax Trends in Recession and Recovery, 2008 to 2012," Tax Foundation, June 13, 2012, http://taxfoundation.org/article/trend-3-corporate-tax-reductions; and Tax Foundation, *Facts & Figures: How Does Your State Compare?* multiple years.
49 Federal deductibility is set to be eliminated once the rate is phased down to 9.8 percent. Jared Walczak, "What's in the Iowa Tax Reform Package."
50 Scott Greenberg, "Pass-Through Businesses: Data and Policy," Tax Foundation, Jan. 17, 2017, https://taxfoundation.org/pass-through-businesses-data-and-policy/.

Corporate income taxes also tend to be complex and impose substantial administrative burdens for both payers and the government, and this complexity has not abated as the tax base has eroded. Finally, revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus lack any exposure to a corporate income tax.

Comparing Pennsylvania's Corporate Income Taxes Regionally and Nationally

Pennsylvania has the seventh-worst corporate income tax structure in the nation according to our *2018 State Business Tax Climate Index*, owing to the state's high tax rate, reliance on tax incentives, and poor treatment of net operating losses. Perhaps surprisingly, New York, which has a high overall tax burden and performs poorly on the structure of its other major tax categories, has a well-structured corporate tax code following reforms inaugurated in 2014, which improved its corporate income tax component ranking to seventh, compared to Pennsylvania's 44th. The *Index* measures tax structure, not collections.

TABLE 3.2.

State Business Tax Climate Index Corporate Income Tax Component Rankings

Pennsylvania and Regional Competitors (2018)

State	Component Ranking
Pennsylvania	44th
Delaware	50th
Maryland	20th
New Jersey	42nd
New York	7th
Ohio	47th
West Virginia	17th

Source: Tax Foundation, *2018 State Business Tax Climate Index*.

Corporate Net Income Tax Collections

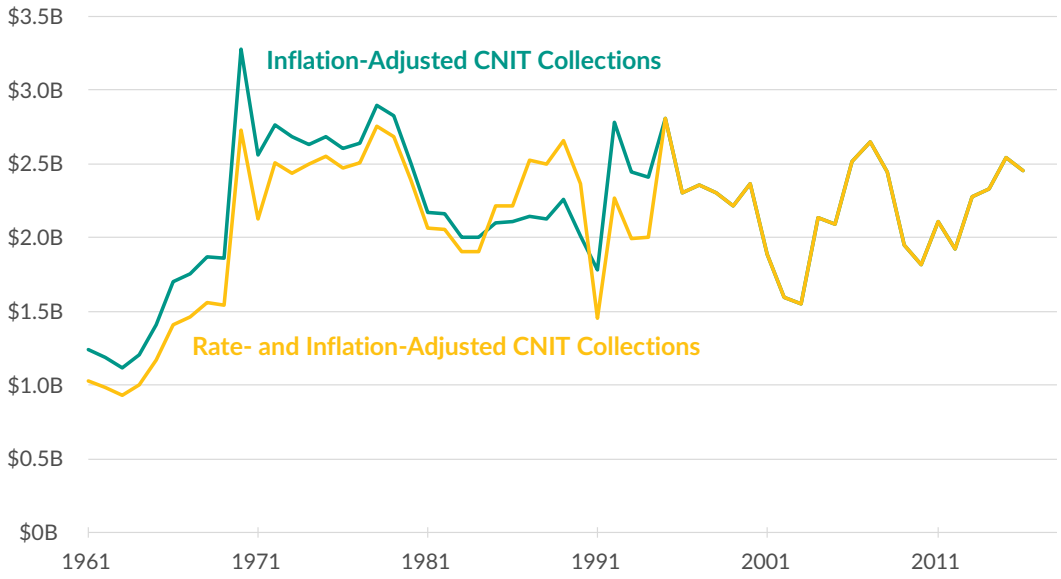
Corporate income taxes are among the most volatile sources of state revenue, since many companies may generate little or no net income during economic downturns. While practically all revenue streams are cyclical, with collections lower during periods of economic distress, corporate income taxes experience particularly deep troughs. Property values may decline during a recession, but they are rarely wiped out, limiting how low property tax collections can go. Similarly, consumption patterns may decline, leading to lower sales tax revenues than when the economy is booming, but sales can only drop so far. Many companies' net income, by contrast, can bottom out or even go into negative territory. As such, collections tend to be highly volatile, spiking sharply in good years and collapsing in bad ones.

As demonstrated in Figure 3.2, corporate net income tax collections took a significant hit during the Great Recession, just at the time when Pennsylvania most needed revenue stability. In fiscal year 2015, the corporate income net tax brought in $2.46 billion,[51] accounting for 6.6 percent of state tax collections and 2.5 percent of state expenditures.[52] The Department of Revenue is counting on higher revenues in fiscal year 2018, with a midyear estimate showing a projected $3.07 billion in corporate net income tax collections for the year.[53]

Pennsylvania leans far more heavily on corporate taxation than most states do, with the fourth highest collections in the nation, and the 12th highest per capita.[54] The following figure illustrates the volatility of Pennsylvania's Corporate Net Income Tax collections, with and without adjustments for rate changes. In both cases, revenues are adjusted for inflation.

FIGURE 3.2.

Inflation-Adjusted Corporate Net Income Tax Collections



Note: Dollar amounts are inflation-adjusted based on the annual average Consumer Price Index for All Urban Consumers (CPI-U) with a 2016 base year.

Source: Census Bureau, State and Local Government Finances; Bureau of Labor Statistics, Consumer Price Indexes (All Urban Consumers).

51 Pennsylvania Office of the Budget, "Comprehensive Annual Financial Report FY 2015," http://budget.pa.gov/PublicationsAndReports/AnnualFinancialReport/Documents/2015/june-30-2015-cafr.pdf.

52 State expenditures ran $21.8 billion in FY 2015. The difference between state expenditures and state tax collections is largely accounted for by intergovernmental transfers, but also includes fees and miscellaneous other revenue sources. See National Association of State Budget Officers, *State Expenditure Report: Examining Fiscal 2013-2015 State Spending*, 2015, 8, https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/SER%20Archive/State%20Expenditure%20Report%20(Fiscal%202013-2015)S.pdf.

53 Pennsylvania Bureau of Research, *2018–2019 Estimate Documentation*, Feb. 20, 2018, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/EstimateDoc/Documents/2018_19_est_doc.pdf.

54 Morgan Scarboro, *Facts & Figures 2018: How Does Your State Compare?* Tax Foundation, March 21, 2018, Tables 16-17, https://taxfoundation.org/facts-figures-2018,

Structural Elements

Net Operating Loss Carrybacks and Carryforwards

The corporate income tax is designed to tax only the profits of a corporation. However, a yearly profit snapshot may not fully capture a corporation's true profitability. For example, a corporation in a highly cyclical industry may look very profitable during boom years but post substantial losses during bust years. When examined over the entire business cycle, the corporation may actually have an average profit margin, or even a poor one.

Although corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. This can be problematic for corporations with cyclical income, enjoying high profitability one year and losses the next. To mitigate this reality, states (along with the federal government) allow corporations to deduct losses from previous years and future years to offset current taxes owed. These net operating loss (NOL) "carrybacks" and "carryforwards" smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

Under a well-designed system of net operating losses, businesses which experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxable income. The NOL deduction helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed up to the entirety of current year taxable income). Among the states that allow carrybacks, the most common time span is two years with no cap.

Prior to the adoption of the new federal tax reform law, the maximum carryforward given in any state was 20 years, again with no cap (most states allow either 15 or 20 years, though 20 is more desirable). The new federal law provides for unlimited years but caps the amount that can be deducted in any given year at 80 percent of tax liability, a convention some states will now follow. The longer the overall time span, the higher the probability that the corporate income tax is being levied on the corporation's average profitability.

Currently, Pennsylvania disallows carrybacks and places strict limitations on carryforwards. While the Commonwealth offers a 20-year carryforward period, it is unusual among states by capping the amount of prior years' losses that can be claimed in any year. Until 2017, Pennsylvania allowed businesses to apply past losses to their current

year's tax liability up to 30 percent of their liability or $5 million, whichever was greater,[55] but the state supreme court held that this bifurcated system violates the uniformity clause.[56] Because some taxpayers (those carrying forward losses worth less than $5 million) were able to eliminate their tax liability, and others–despite having sufficient losses to do so–were still required to make payments, the courts held that the law effectively established two classes of taxpayers according to taxable income.[57]

The temporary remedy imposed by the state supreme court, unfortunately, was to make the system worse: capping NOLs at 30 percent, without the $5 million minimum allowance.[58] A revenue bill signed in October 2017 increased the deduction to 35 percent in tax year 2018 and 40 percent thereafter to offset some of these losses to businesses,[59] though this still leaves the net operating loss deduction smaller than it was before the court decision, and far stingier than the treatment provided in other states.

Amazingly, the current limitation, as restrictive as it is, represents progress of a sort: as recently as 2007, the caps stood at the greater of 12.5 percent or $3 million.[60] The following examples illustrate how Pennsylvania's current NOL limitations can result in widely disparate liabilities for businesses with the same long-term net revenue.

TABLE 3.3.

The Effect of Cyclical Income on Pennsylvania Corporate Net Income Tax Liability

Business No. 1	2017	2018	2019	2020
PA Taxable Income (Loss)	($100M)	$130M	($50M)	$100M
Carryforward Available	($100M)	($55M)	($105M)	($65M)
Carryforward Allowed	-	($46M)	-	($40M)
Taxable Income After Carryforward	-	$84.50M	-	$60.00M
Tax Liability at 9.99% CNIT	-	$9.09M	-	$6.99M
Total Revenue (4-year)				$80.00M
Total Tax Liability (4-year)				**$14.44M**
Effective Rate on Taxable Income				**18.04%**

Business No. 2	Year 1	Year 2	Year 3	Year 4
PA Taxable Income (Loss)	$20M	$20M	$20M	$20M
Carryforward Available	-	-	-	-
Carryforward Allowed	-	-	-	-
Taxable Income After Carryforward	$20M	$20M	$20M	$20M
Tax Liability at 9.99% CNIT	$2.00M	$2.00M	$2.00M	$2.00M
Total Revenue (4-year)				$80M
Total Tax Liability (4-year)				**$7.99M**
Effective Rate on Taxable Income				**9.99%**

Source: Tax Foundation calculations

55 72 P.S. § 7401(3)4.
56 *Nextel Communications of the Mid-Atlantic, Inc., v. Commonwealth Department of Revenue*, Supreme Court of Pennsylvania, Docket No. 6 EAP 2016, slip op. (Oct. 18, 2017).
57 KPMG, "Pennsylvania NOL Flat-Dollar Cap Violates Uniformity Clause; Taxpayer Not Allowed an Uncapped NOL," *SALT Alert!* 2017-27, 1, https://home.kpmg.com/content/dam/kpmg/us/pdf/2017/10/tnf-salt-oct18-2017.pdf.
58 *Nextel Communications of the Mid-Atlantic, Inc. v. Commonwealth*, No. 6 EAP 2016 (Pa. S. Ct. Oct. 18, 2017).
59 2017 Pa. Legis. Serv. Act 2017-43 (H.B. 542).
60 Pennsylvania Department of Revenue, "Corporation Tax Bulletin 2017-01, Net Operating Loss Deduction (NOL)," Nov. 16, 2017, http://revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/TaxBulletins/CT/Documents/ct_bulletin_2017-01.pdf.

Over the course of four years, both businesses have netted $80 million, but they experience radically different tax liability, with the first business paying 80 percent more in taxes than the second.[61] Historically, heavy industry and manufacturing have been highly sensitive to business cycles. In a state where manufacturing is responsible for more than half a million jobs,[62] and where the fabrication of steel and extraction of natural gas are important pieces of the economic puzzle, this disparate treatment can put major–and in some cases struggling–employers on an uncompetitive footing.

Every state with a corporate income tax offers a carryforward provision. Thirty-one states and the District of Columbia offer carryforward periods of at least 20 years. Of these, 17 states and the District of Columbia follow the number of years offered by the federal government and are positioned to offer unlimited year carryforwards absent an effort to decouple from the provision.[63] Six states limit carryforwards to 15 years, and the remaining eight states with corporate income taxes offer more limited carryforward periods. Seventeen states permit net operating loss carrybacks. Other than Pennsylvania, only New Hampshire currently caps net operating loss carryforwards, imposing a $10 million cap.[64]

Table 3.4 shows the treatment of net operating losses in Pennsylvania and regional competitor states. None of Pennsylvania's neighbors cap carryforward amounts, and four neighboring states offer NOL carrybacks, which Pennsylvania neglects.

TABLE 3.4.

Treatment of Net Operating Losses

Pennsylvania and Select Regional Competitors (2018)

	Carrybacks		Carryforwards	
State	Years	Cap	Years	Cap
Pennsylvania	0	$0	20	35% of liability *(40% in 2019)*
Delaware	2	$30,000	20	Unlimited
Maryland	2	Unlimited	20	Unlimited
New Jersey	0	$0	20	Unlimited
New York	3	Unlimited	20	Unlimited
Ohio	*not applicable (no CIT)*			
West Virginia	2	$300,000	20	Unlimited

Source: Tax Foundation, *2018 State Business Tax Climate Index*. Assumes no changes due to federal tax reform. Under tax conformity, Delaware, Maryland, and West Virginia could implement an unlimited carryforward period, a change which–at least for Maryland and West Virginia–could be accompanied by a cap of 80 percent of tax liability.

61 At a 30 percent cap, the first business would pay twice as much as the second. This example applies current law treatment, with a 35 percent cap in tax year 2018 and a 40 percent cap in 2019 and 2020.

62 U.S. Department of Labor, Bureau of Labor Statistics, "Economy at a Glance–Pennsylvania," December 2017, https://www.bls.gov/eag/eag.pa.htm.

63 Jared Walczak, "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform," Tax Foundation, Jan. 31, 2018, 28, https://taxfoundation.org/state-conformity-federal-tax-reform/.

64 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, *2018 State Business Tax Climate Index*, Tax Foundation, 61, https://taxfoundation.org/publications/state-business-tax-climate-index/.

The state supreme court's elimination of the $5 million minimum allowance would have increased state revenues by an estimated $215 million a year,[65] though the increased percentages (35 percent in tax year 2018 and 40 percent thereafter) reduce the size of the state's windfall to an estimated $52.6 million in fiscal year 2017 (which includes the first six months of 2018) and $80.3 million in fiscal year 2019 (which includes six months at 35 percent and six months at 40 percent).[66]

Expensing of Capital Investments

Pennsylvania has been charting its own path on depreciation for some time, but in 2018, that alternative pathway briefly went from detour to U-turn.[67] The Commonwealth upended its tax treatment of business investment, adopting the most restrictive policy in the country not by law or even by regulation, but through the mere issuance of a tax bulletin.[68] In every other state, the ability to deduct the cost of investment in calculating taxable income is a question of *when*, not *if*. In Pennsylvania, the Department of Taxation briefly required the full cost of investment to be subjected to the state's high 9.99 percent corporate income tax, without any option for recovering those costs until an asset is sold, before that determination was reversed by the legislature.

Broadly speaking, corporate income taxes are imposed on net income (essentially profits), meaning that businesses deduct compensation and other costs in arriving at taxable income. Generally, however, they are not able to deduct the cost of investment in the first year, which creates a bias against investment. Instead of claiming the full deduction immediately, businesses "recover" the cost across the depreciable life of the asset, which can run many years, deducting a portion of it each year.

Various federal policies have sought to attenuate this disincentive. The Modified Accelerated Cost Recovery System (MACRS) frontloads the deductions somewhat,[69] and a policy called bonus expensing–initially at 30 percent, later at 50 percent, and briefly at 100 percent–allowed a greater share of the deduction to be taken in the first year, with the remainder amortized over the rest of the depreciation schedule. Classes of assets are assigned different asset lives, with recovery periods for tangible property ranging from three to 20 years.

65 Pennsylvania Independent Fiscal Office, "Mid-Year Revenue Update," Jan. 29, 2018, 24, http://www.ifo.state.pa.us/download.cfm?file=/Resources/Documents/2018_Mid-Year_Update.pdf.

66 Pennsylvania House Committee on Appropriations, "Fiscal Note, H.B. 542 (2017)," Printers No. 2598, 3, https://www.legis.state.pa.us/WU01/LI/BI/FN/2017/0/HB0542P2598.pdf.

67 This section previously appeared, in slightly different form, as Jared Walczak, "How an Unexpected Revenue Ruling Penalizes Capital Investment in Pennsylvania, and How Lawmakers Can Fix It," Tax Foundation, March 19, 2018, https://taxfoundation.org/ruling-penalizes-capital-investment-pennsylvania/.

68 Pennsylvania Department of Revenue, "Corporation Tax Bulletin 2017-02," Dec. 22, 2017, http://revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/TaxBulletins/CT/Documents/ct_bulletin_2017-02.pdf.

69 U.S. Department of the Treasury, Internal Revenue Service, "How to Depreciate Property," Publication 946, 2017, https://www.irs.gov/publications/p946.

As part of the federal tax overhaul adopted in late 2017, machinery and equipment purchases are now subject to a policy called full expensing, meaning that the full cost can be deducted in the first year. While this dramatically improves the treatment of capital investment at the federal level, the Pennsylvania Department of Revenue's interpretation of an idiosyncratic state statute meant that Pennsylvania's initial response was an extreme one, disallowing any deduction whatsoever until the asset is sold.

To understand how this came about, it helps to walk through the contemporary history of Pennsylvania's treatment of capital investment. When the first round of Section 168(k) bonus depreciation was adopted in 2001, Pennsylvania adopted the 3/7 formula,[70] by which the first-year "bonus" (at the time, 30 percent) was disallowed, but the taxpayer was allowed to take the allowable non-bonus depreciation for each year plus an additional 3/7ths of that amount, thus ensuring that the entire value of the asset could be deducted for Pennsylvania tax purposes over the same number of years, albeit without the frontloaded "bonus."[71]

Accelerated cost recovery differs from straight-line depreciation, where the same percentage of an asset's value is depreciated each year, but to illustrate how Pennsylvania's 3/7 formula functions, imagine a simplified example of a seven-year straight-line depreciation schedule with a first-year 30 percent "bonus" expensing regime and no residual value after depreciation.[72] At the federal level, the taxpayer would deduct 40 percent of the cost of the capital investment in the first year (the 30 percent bonus plus one-seventh of the remaining value of the asset), then an additional 10 percent of its cost each of the six years thereafter, until the entire cost has been deducted over the course of seven years.

In Pennsylvania, the first year's 30 percent bonus expensing would have been disallowed (added back into taxable income), but for each year, in addition to the normal amount of depreciation permitted, the taxpayer could deduct a further 3/7ths of the federal deduction. Pennsylvania's depreciation schedule would have caught up with the federal schedule in the final year, and the entirety of the asset's cost would be depreciated (see Table 3.5).

When, however, the federal government adopted 50 percent bonus depreciation, meaning that 50 percent of an asset's cost could be written down in the first year, Pennsylvania did not update its 3/7ths formulation. The result was that the totals no longer matched; Pennsylvania not only lagged federal depreciation schedules, but only allowed 71.43 percent of the total cost of an asset to be depreciated.

70 GrantThornton.com, "Pennsylvania Disallows Bonus Depreciation on Certain Assets," Feb. 2, 2018, https://www.grantthornton.com/library/alerts/tax/2018/SALT/P-T/PA-disallows-bonus-depreciation-assets-02-02.aspx.

71 72 P.S. § 7401(3)1.(r).

72 Most assets have some salvage value at the end of their useful life. A piece of machinery purchased for $25,000 and depreciated over five years might have $3,000 in salvage value after five years, in which case the amount subject to cost recovery would be $22,000, not $25,000.

TABLE 3.5.

Pennsylvania's 3/7 Formula Under a Hypothetical Straight-Line Depreciation Scenario

	30 Percent Bonus Depreciation		50 Percent Bonus Depreciation	
Year	State	Federal	State	Federal
Year 1	14.29%	40.00%	10.20%	57.14%
Year 2	28.57%	50.00%	20.41%	64.29%
Year 3	42.86%	60.00%	30.61%	71.43%
Year 4	57.14%	70.00%	40.82%	78.57%
Year 5	71.43%	80.00%	51.02%	85.71%
Year 6	85.71%	90.00%	61.22%	92.86%
Year 7	100.00%	100.00%	71.43%	100.00%

Source: Author's calculations

While straight-line depreciation does not capture the reality of cost recovery for many companies, the table above helps illustrate the concept of Pennsylvania's 3/7 formula, and the percentage of the total asset cost that can be recovered in Pennsylvania (71.43 percent under 50 percent bonus) is the same whether straight-line or declining balance depreciation is used.

The following scenario accounts for a 10-year cost recovery schedule using the half-year convention (meaning that the property was placed into service halfway through the first year) and which uses what is called 200 percent declining balance depreciation under MACRS,[73] coupled with a 50 percent first-year "bonus" as was in effect until the end of 2017.[74] Note that here too, Pennsylvania's cost recovery regime only allowed 71.43 percent of the total cost of the investment to be written down.

TABLE 3.6.

Pennsylvania's 3/7 Formula Under a Declining Balance Method with 50 Percent Bonus Depreciation

Year	State	Federal
Year 1	7.14%	55.00%
Year 2	20.00%	64.00%
Year 3	30.29%	71.20%
Year 4	38.51%	76.96%
Year 5	45.10%	81.57%
Year 6	50.36%	85.26%
Year 7	55.04%	88.53%
Year 8	59.72%	91.81%
Year 9	64.41%	95.09%
Year 10	69.09%	98.36%
Year 11	71.43%	100.00%

Source: Author's calculations

Once the federal government provided for full and immediate expensing of purchases of machinery and equipment, the Pennsylvania Department of Revenue took the counterintuitive position that the 3/7 formula now serves to eliminate all cost

73 MACRS changes from the declining balance to straight-line method when that method provides an equal or greater deduction. Short-lived assets use 200 percent declining balance depreciation converting to straight-line.

74 For other examples, see Pennsylvania Department of Revenue, "Acquisition & Depreciation of 168k Property," REV-799CT, June 2011, http://www.revenue.pa.gov/FormsandPublications/FormsforBusinesses/CorporationTax/Documents/corptax_168k_example.pdf.

recovery whatsoever until a company sells or otherwise disposes of the property.[75] The Department reached this position on the grounds that, if the entire amount of the deduction is essentially "bonus," then the remaining amount to be claimed, at the standard amount plus 3/7ths, is $0.

This was a reversal from the last time first-year expensing stood at 100 percent, when the Department took the position that state law required that Pennsylvania provide full first-year expensing as well. The difference comes down to two very different readings of the same statutory text:

> "… if a deduction for depreciation of qualified property was included in taxable income in accordance with paragraph (q) [the addback of bonus depreciation], an additional deduction for depreciation of the qualified property shall be allowed from taxable income until the total amount included as taxable income under paragraph (q) has been claimed. The additional deduction shall be equal to the product of taking three sevenths of the amount of the deduction for depreciation of the qualified property allowable under section 167 of the Internal Revenue Code of 1986 (26 U.S.C. § 167)…"[76]

In 2011, the last time the federal government (briefly) adopted a policy of full expensing,[77] the Pennsylvania Department of Revenue concluded that the requirement that an additional deduction be allowed until the total amount matches the amount claimed at the federal level meant that the code permitted recovery of any disallowed bonus depreciation claimed federally by the time the property had been fully depreciated for tax purposes.[78] If the property was fully depreciated in the first year, then Pennsylvania had to follow. If, as in other years, depreciation was accelerated in the first year, Pennsylvania was not obligated to mirror that so long as the asset was fully depreciated at both the state and federal levels simultaneously.

In late 2017, the Department took the opposite view, focusing on the mechanism and concluding that the general requirement only applies after the asset has been sold or otherwise disposed.[79] There is no doubt that the statute's wording failed to anticipate full expensing, but there could also be little doubt that lawmakers did not intend to eliminate the deduction altogether.

Every other state in the nation allowed some form of depreciation, as Pennsylvania lawmakers were acutely aware. Some conform to bonus depreciation and will now follow the federal full expensing regime. At the opposite end of the spectrum, California does not conform to MACRS, but Pennsylvania's policy went much farther, prohibiting

75 Pennsylvania Department of Revenue, "Corporation Tax Bulletin 2017-02, Disallowance and Recovery of 100 Percent Depreciation Under IRC Section 168(k)," Dec. 22, 2017.
76 72 P.S. § 7401(3)1(r).
77 This policy lasted from September 2010 to December 2011, before again returning to 50 percent.
78 Pennsylvania Department of Revenue, "Corporation Tax Bulletin 2011-01," Feb. 24, 2011, http://revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/TaxBulletins/CT/Documents/ct_bulletin_2011-01.pdf.
79 Pennsylvania Department of Revenue, "Corporation Tax Bulletin 2017-02."

any deduction at all until the asset is sold. Recognizing that this new policy provided the most unfavorable treatment of capital investment found anywhere in the United States and dramatically increased the cost of doing business in Pennsylvania, legislators responded, and the governor signed Senate Bill 1056 into law in late June 2018, placing the Commonwealth back on MACRS.[80]

This represents a marked improvement from the policy of fully disallowing the depreciation of machinery and equipment, which had the potential to make Pennsylvania corporate taxable income significantly higher than federal taxable income, but at the same time, it is a substantial retreat from the prior law's interpretation in 2011, which–if followed here–would have resulted in mirroring the new federal policy of full expensing. Reversing the Bulletin is a welcome first step, but policymakers should prioritize further improvements to the treatment of capital investment in Pennsylvania.

Apportionment and Sourcing

When businesses operate in more than one state, income must be apportioned among those states for tax purposes. The legal term for whether a state has the power to tax is *nexus*–which typically requires a business to have some physical presence, either property or employees, in a state–and the determination of the amount of that business's income subject to a given state's corporate income tax is known as *apportionment*. States apportion business profits based on some combination of the percentage of company property, payroll, and sales located within their borders.

Since 2013, Pennsylvania has used single sales factor apportionment, meaning that only sales are taken into account in determining income apportionment.[81] If, hypothetically, a business owned all its property and employed all its personnel in Pennsylvania, but only sold 10 percent of its sales in the state, then 10 percent of its net income would be subject to Pennsylvania's corporate net income tax. Pennsylvania's embrace of single sales factor is relatively new, but it is part of a broader national trend. For decades, most states adopted an evenly weighted three-factor apportionment formula of property, payroll, and sales, but now 20 states, including Pennsylvania, use single sales factor apportionment.

Among Pennsylvania's neighbors, Maryland, New York, and New Jersey have also adopted single sales factor apportionment, while Delaware and West Virginia use three-factor apportionment which more heavily weights sales than the other factors (double-weight in West Virginia and triple-weight in Delaware). Beneficially, Pennsylvania forgoes a throwback rule, which some states utilize in an attempt to capture and tax so-called "nowhere income" that is earned out of state in jurisdictions where it is not subject to foreign taxation.[82]

80 2018 Pa. Legis. Serv. Act 2018-72 (S.B. 1056).
81 2013 Pa. Legis. Serv. Act 2013-52 (H.B. 465).
82 Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, *2018 State Business Tax Climate Index*, 62.

Consistent with its approach on apportionment, Pennsylvania also sources service income to the location where the benefit of a service is received. Nineteen states emphasize, in varying ways, the location where a service is performed or its benefit is received, which is known as market or benefit sourcing and stands in contrast to sourcing rules emphasizing the location of the greater proportion of income-producing activity (IPA sourcing).[83]

Pennsylvania's approach to market sourcing, which emphasizes delivery of service to a location in a state,[84] has been adopted in three other states (Alabama, Massachusetts, and Nebraska). The Department of Revenue, taking notice of legislative intent to enact 100 percent market sourcing of services, has concluded that "delivery to a location not representative of where the customer for the service is located does not represent completed delivery of the service," giving priority to the location of the customer where the point of delivery would yield an anomalous result.[85]

Service income is "sourced" to facilitate apportionment. As noted previously, the three factors that can be considered in apportionment are payroll, property, and sales, with Pennsylvania focusing exclusively on sales. For income derived from the sale of goods, all states emphasize the location of the sale, or the destination if the good is shipped to the customer. Service income imposes an added wrinkle. If a company based in Pennsylvania performs a service for a company in New Jersey, and those performing the service never leave Pennsylvania while those receiving the benefit of the service remain in New Jersey, sourcing rules are necessary to determine whether the sales income is apportioned to Pennsylvania.

Under Pennsylvania's system of market sourcing, when a Pennsylvania firm performs a service which is enjoyed in another state, that income is not sourced to Pennsylvania for apportionment purposes. Conversely, when an out-of-state firm provides a service, the benefit of which is enjoyed in Pennsylvania, the portion of the foreign corporation's income represented by that sale is apportioned to Pennsylvania. The state's single sales factor apportionment rule and its sourcing method both result in a significant measure of tax exporting, limiting liability for firms based in Pennsylvania while increasing liability for firms located outside the state.[86]

Separate Reporting

Pennsylvania's corporate net income tax uses separate, rather than combined, reporting, meaning that each corporate entity files a return based on its own taxable income, rather than combining all affiliated businesses into a "unitary group" and taxing them as if they constituted a single legal entity. Proponents of combined reporting see it as a way to undermine tax planning, where companies shift income to some subsidiaries and park

83 Jared Walczak, *Location Matters: The State Tax Costs of Doing Business*, Tax Foundation, 2015, 114, http://taxfoundation.org/sites/taxfoundation.org/files/docs/TF_LocationMatters_2015.pdf.

84 72 P.S. § 7401(3)2.(a)(16.1)(C).

85 Pennsylvania Department of Revenue, "Information Notice Corporation Taxes 2014-01," Dec. 12, 2014, 2, http://revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/InformationalNotices/Documents/info_notice_ct_2014-01.pdf.

86 States' disparate apportionment rules can result in more than 100 percent of a firm's income being subject to corporate taxation. However, the courts have adopted an "internal consistency" rule which provides that no state may adopt an apportionment rule which, if uniformly adopted in all states, would result in taxation of more than 100 percent of income. See *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977).

losses in others to minimize tax exposure. Opponents point to high compliance costs, increased complexity, and taxation of legitimate business activity in no way associated with the state. For every business structuring royalty income to reduce tax liability, how many others would pay Pennsylvania taxes on normal business activity carried out by an affiliated entity wholly outside the Commonwealth, and from which the Pennsylvania business obtains no benefit?

Twenty-five states and the District of Columbia have combined reporting, but it has been a bumpy road to get there. Nine states have shifted from separate to combined reporting since 2006; before that, it had been three decades since a state last took the leap.[87] (Two of Pennsylvania's neighbors have combined reporting, while three use separate reporting.) Nor has the transition always gone as planned: while states implementing combined reporting typically intend it as a revenue-raiser, sometimes it proves the opposite.

TABLE 3.7.

Reporting Units for Purpose of Corporate Taxation

Pennsylvania and Neighboring States

State	Reporting Requirement
Pennsylvania	Separate Reporting
Delaware	Separate Reporting
Maryland	Separate Reporting
New Jersey	Separate Reporting
New York	Combined Reporting
Ohio	n/a
West Virginia	Combined Reporting

Source: Bloomberg BNA

This should not be altogether surprising. In a hypothetical scenario where all net income, wherever taxed, was subject to the same tax rate, the total tax liability of any group of companies would be identical under combined or separate reporting. If a shift to combined reporting raised revenue in one state, it would have to reduce tax collections in others. The real world is considerably messier, but the fact remains that changing the method by which income and losses are tallied can only be guaranteed to yield a *different* total, not necessarily a *higher* one.

Minnesota reviewed its projections in light of actual revenue after the shift to combined reporting, and actually discovered that combined reporting reduced corporate income tax collections.[88] Studies of revenue effects in other states have yielded equivocal results, with the authors of a leading study concluding that "combined reporting probably increases tax revenues, but by a relatively small amount and perhaps only for a short period as firms develop alternative planning arrangements or further change their operating behavior."[89]

87 William Fox and LeAnn Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," NCSL Task Force on State & Local Taxation of Communications and Interstate Commerce, November. 2010, https://www.ncsl.org/documents/standcomm/sccomfc/CombinedReportingFinalDraft.pdf.

88 Robert Cline, "Understanding the Revenue and Competitive Effects of Combined Reporting," Council on State Taxation, May 2008, 2, http://motaxpayers.com/finalcombinedreportingstudy.pdf.

89 William F. Fox, LeAnn Luna, Rebekah McCarty, Ann Boyd Davis, and Zhou Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," Report to the Tennessee Comptroller of the Treasury, Oct. 30, 2009, 35, http://cber.haslam.utk.edu/pubs/combrpt.pdf.

Imagine two different companies. One parks its intellectual property in a Delaware subsidiary, with the Pennsylvania parent company paying royalties to that subsidiary and posting losses in Pennsylvania, even though the two companies are profitable taken together. This is the sort of tax avoidance activity understandably targeted by proponents of combined reporting.

The second company, by contrast, is profitable and has significant sales in Pennsylvania. It has an affiliate located in Massachusetts, which has no activity–including sales–in the Commonwealth. Under combined reporting, the net income of the Massachusetts company is included in the potential taxable base for Pennsylvania, apportioned on the basis of the percentage of sales made into Pennsylvania by the unitary group as a whole. In this case, the justification is less apparent, as is the revenue implication. It is possible that the Massachusetts affiliate is highly profitable, and its inclusion will increase Pennsylvania tax collections. It is also possible that the Massachusetts entity is in worse shape than the Pennsylvania company, and its inclusion will reduce overall state tax liability.

Combined reporting, moreover, shifts tax liability among related firms in ways that have no connection to ability to pay. It assumes that all member companies have the same level of profitability per dollar of sales (under Pennsylvania's single sales factor apportionment), an assumption which cannot be borne out in the real world. Just because two companies are affiliated does not mean that each entity is in similar shape financially; increasing the tax burden on one company, which may be struggling, because a related company elsewhere is doing well, can be economically devastating.

Where differences in profitability are the result of tax planning, those strategies can be adjusted; where, as is more often the case, they represent the actual financial standing of each company, splitting tax liability this way–much like a group of friends splitting a restaurant bill equally, regardless of what they ordered–can be uniquely burdensome for some operations.

The challenges associated with combined reporting do not end–or even begin–with an inequitable distribution of tax burdens. The first step is calculating that tax liability, which can be complex, costly, and controversial under combined reporting. There is often no easy answer to the question of which affiliated businesses should be considered as part of the unitary group; in fact, answers to this definitional question can vary from state to state and even year to year.[90] Disputes can take years or even decades to untangle. In 2010, California (which used combined reporting) was still processing tax cases from the 1970s, and General Electric had just closed its 1982 California tax return.[91]

Combined reporting increases complexity and can misallocate tax burdens. Little wonder, then, that statistical analyses demonstrate that combined reporting reduces gross state product.[92]

90 William F. Fox and LeAnn Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," Center for Business and Economic Research, University of Tennessee, November 2010, iv.
91 Commonwealth Foundation, "Pennsylvania Budget Facts 2010: Corporate Taxes," June 29, 2010, https://www.commonwealthfoundation.org/research/detail/pennsylvania-budget-facts-2010-corporate-taxes.
92 Fox and Luna, "Combined Reporting with the Corporate Income Tax: Issues for State Legislatures," 36-40.

Combined reporting has been under intermittent consideration in Pennsylvania since the Rendell administration, when a Department of Revenue study estimated that the different reporting method would increase statewide Corporate Net Income Tax liability by 24 percent.[93] There are, however, reasons to treat this estimate with skepticism. At the time, nearly 75,000 C corporations paying Pennsylvania taxes were deemed to have the potential to be affected by combined reporting. Working with the Minnesota Department of Revenue, officials in Pennsylvania evaluated 107 combined groups where income reported exceeded Pennsylvania taxable income by at least $1 billion. Another 123 combined groups with lower income differentials were also added to the sample.[94]

By selecting for high-revenue companies with large income differentials, however, officials almost certainly skewed the sample, resulting in an overestimate. There is no reason to believe that a small number of high-income firms with liability in both Pennsylvania and Minnesota are representative of the typical Pennsylvania business group. The Commonwealth did its best with the data available, but it could be a mistake to rely too heavily on projections based on a small and perhaps unrepresentative sample.

Pennsylvania has already implemented an "addback" provision in an attempt to thwart tax avoidance, and thus may have already captured much of the additional revenue sought with combined reporting. This is especially pertinent because the addback, while not as comprehensive as combined reporting, is a pure base broadener—it can only increase state revenue. Conversely, combined reporting can cut in either direction, a risk that is enhanced if the addback is already capturing a substantial share of the additional revenue from businesses with greater tax liability under combined reporting.

International Income

The enactment of the Tax Cuts and Jobs Act altered the tax landscape in many ways, but nowhere were the changes more significant than in the treatment of international income. Under the new law, the United States shifts from a worldwide system of taxation which taxed global earnings of U.S.-based companies (with a credit for taxes paid to foreign governments) to a mostly territorial one, which taxes income where it is sourced.

The old worldwide system discouraged the repatriation of foreign profits, which could be deferred almost indefinitely, and spurred corporate inversions, two outcomes policymakers almost universally regarded as undesirable. Policymakers also feared, however, that a "pure" territorial system would encourage shifting earnings activity to lower-tax countries—particularly intellectual property, which is inherently mobile. Consequently, the new international tax regime contains several anti-base erosion provisions targeted at high-return foreign profits, intangible income, and income stripped out of the United States.[95]

93 Pennsylvania Department of Revenue, "The Revenue Impact of Combined Reporting on the Corporate Net Income Tax," Feb. 25, 2005, https://www.taxadmin.org/assets/docs/Meetings/05rev_est/pa_award_report.pdf.
94 Fox, Luna, McCarty, Davis, and Yang, "An Evaluation of Combined Reporting in the Tennessee Corporate Franchise and Excise Taxes," 56-57.
95 Kyle Pomerleau, "A Hybrid Approach: The Treatment of Foreign Profits Under the Tax Cuts and Jobs Act," Tax Foundation, May 3, 2018, https://taxfoundation.org/treatment-foreign-profits-tax-cuts-jobs-act/.

There are four main components of the overhaul of the international tax regime, and some states are actively exploring what they could mean for state finances. Accordingly, they are worthy of at least a brief review.

The first provision is the "participation exemption," which exempts from domestic taxation any foreign profits paid back into the United States. This is the heart of territorial taxation; the other provisions set limits on it. The second provision is a new 21 percent tax on Global Intangible Low Tax Income (GILTI), and the third a deduction for Foreign Derived Intangible Income (FDII), essentially taxing that income, but at a lower rate. Finally, there is a minimum tax, the Base Erosion Anti-Abuse Tax (BEAT), targeted at discouraging "income stripping," where multinational firms make excessive payments to foreign-affiliated corporations to shift profits into lower-tax countries.[96]

When the federal government used a worldwide taxation regime, states did not include foreign income in their tax bases. Now, under what is intended to be closer to a territorial system, some states are contemplating the taxation of GILTI to raise additional revenue. This would not only constitute a reversal of longstanding approaches in state taxation, but would involve a much larger base than is intended at the federal level. The provision is only intended to apply to income attributable to low-tax foreign jurisdictions, an outcome accomplished through the application of foreign tax credits. States, however, do not have foreign tax credits, so adding GILTI to a state tax base would transform the provision from an anti-abuse tax into a much broader tax on foreign-derived income.[97]

At the federal level, GILTI and FDII are intended to work together. Placed in the context of state tax codes, the intended linkages easily break down. If multiple states sought to take GILTI, moreover, the same income could be taxed multiple times over.

The Base Erosion Anti-Abuse Tax (BEAT) has also drawn interest in some state capitals, but again, it involves the taxation of income states have not sought to reach in the past, and which is inconsistent with how income is traditionally apportioned to states. Adoption of these provisions could even raise constitutional questions, as states are prohibited from discriminating against foreign (out-of-state and out-of-country) activity and cannot tax it differently than they do income from their own state. States would be well-advised not to attempt the creation of their own international tax regime, avoiding aggressive approaches designed to tax repatriated or foreign-derived income.

96 Id., 4-5.
97 PricewaterhouseCoopers, "State Tax Implications of Federal Tax Reform: Taxation of International Business Operations," Jan. 8, 2018, https://www.pwc.com/us/en/state-local-tax/newsletters/salt-insights/state-implications-of-federal-tax-reform-international-business.html.

Corporate Income Tax Expenditures

Pennsylvania offers a range of deductions, exemptions, and credits against corporate income tax liability. These tax expenditures function as incentives for select industries and favored business activities, and for funneling growth into particular regions.

Incentives can be effective, but they are not efficient. By lowering tax costs for targeted industries or rewarding specific business activities, they can yield higher employment or greater investment in those sectors. Unfortunately, the cost of these incentives must be borne by other, non-favored businesses which bear a correspondingly higher tax burden. Ultimately, incentives involve picking winners and losers, and seek to guide the economy in keeping with policymakers' (often competing) visions. A well-structured tax code with a broader base-eliminating many of the incentives-and a lower rate would do far more to encourage job creation and economic growth.

All states rely on incentives to some degree, and Pennsylvania does so in part to help offset the state's high corporate rate. Tax preferences, however, represent a poor approach to reducing burdens. In many cases, companies must navigate an application process to be approved for such incentives, and of course, some companies fail to qualify. This uncertainty can make Pennsylvania less attractive than a state with a lower overall rate but fewer incentives, even though firms that do decide to locate in Pennsylvania may obtain approval for a number of credits and other incentives which reduce their overall tax burden.

Deductions, exemptions, and credits all serve to reduce tax liability, but they do so in distinct ways that are important to bear in mind while attempting any comparison. Deductions reduce taxable income by a given amount, whereas credits are a subtraction against tax liability. Imagine, for instance, a corporate taxpayer with $50,000 in Pennsylvania corporate income tax liability. A $5,000 credit will reduce tax liability to $45,000, whereas a $5,000 deduction would reduce tax liability by less than $500, as the reduction in liability will be equal to the tax on that $5,000. An exemption, meanwhile, excludes certain revenue from the tax rolls altogether.

All states should scrutinize their incentives programs with a critical eye, as such programs routinely fail to meet their stated objectives. It is worth noting, however, that Pennsylvania's tax preferences are quite modest compared to many of the state's peers. Only four credits have projected utilization north of $50 million in fiscal year 2019, with Keystone Opportunity Zones–designed to encourage investment in economically depressed areas–the costliest at an estimated $70 million.[98]

98 We are grateful to the Pennsylvania Department of Revenue for providing data on the proportion of these tax credits taken against liability for each tax type.

TABLE 3.8.

Corporate Net Income Tax Credits in Millions, FY 2019

Tax Expenditure	Tax Cost
Keystone Opportunity Zones	$70
Educational Improvement Tax Credit	$62
Film Production Tax Credit	$59
Research and Development Tax Credit	$52
Tax Credit for New Jobs	$9
Educational Opportunity Scholarship Tax Credit	$4
Concert Rehearsal and Tour Tax Credit	$4
Neighborhood Assistance Programs	$2
Keystone Innovation Zone	$1
Video Game Production Tax Credit	$1
Total	$265

Source: 2018–2019 Governor's Executive Budget; Tax Foundation calculations based on Pennsylvania Department of Revenue data.

Corporate Income Tax Reform Solutions

Make the Corporate Rate More Competitive

At 9.99 percent, Pennsylvania's corporate rate is the second highest in the country and will be the nation's highest if Iowa reduces its top rate as scheduled. For many companies, effective rates are only a fraction of the statutory tax rate, but some companies–particularly smaller companies which operate chiefly in-state–are forced to pay full freight. Combined with the Pennsylvania tax code's structural shortcomings, the resulting tax burden can be very high, even prohibitively high for some businesses. Each percentage point on the rate is worth over $300 million in tax collections in fiscal year 2018, so the costs of rate reductions are hardly trivial and would require offsets elsewhere, but policymakers should prioritize rate reductions to make the corporate tax more competitive both regionally and nationally.

Reform Corporate Tax Credits

Pennsylvania already does better than most peer states in avoiding substantial carveouts of its corporate income tax base through targeted tax credits. Tax credits reduce the corporate tax base by about 8 percent, which is modest by national standards, but far from insignificant. Economic development incentives rarely achieve their economic objectives, so scrutiny is warranted.

Film tax credits have a particularly poor track record; in Massachusetts, for instance, the state's Department of Revenue found that the state spent more on credits than the film industry actually spent in the state, with Massachusetts only recouping 11 cents on the dollar in tax revenue.[99] In Michigan, lawmakers discovered that the new jobs created were ephemeral, with the average job lasting a mere 23 days. Pennsylvania is slated to lose $59 million to film tax credits in fiscal year 2019.

Regional incentives like those for Keystone Opportunity Zones, meanwhile, are unlikely to improve gross state product–often the incentive is simply to relocate economic activity within the state–but may serve the narrower purpose of channeling investments to economically depressed areas. Similarly, credits for education programs and neighborhood assistance programs do not grow the state's economy but have been advocated on other grounds.

Pennsylvania would do well to scrutinize and scale back its economic development tax credits.

99 Jared Walczak, "The Poor Economics of Florida's Film Incentives," Tax Foundation, April 27, 2015, https://taxfoundation.org/poor-economics-floridas-film-incentives/.

Improve the Treatment of Net Operating Losses

The Commonwealth is a marked outlier in its treatment of net operating losses. The state is scheduled to allow a 40 percent net operating loss carryforward in 2019; only one other state imposes any such cap. Allowing a full net operating loss carryforward is likely unaffordable in the short term, but Pennsylvania should prioritize continued increases in the percentages to curtail the inequitable and counterproductive treatment of employers with longer business cycles.

Improve Treatment of Capital Investment

An ideal tax code would provide for the full expensing of all capital investment, since a corporate net income tax–as the very name implies–should fall upon net income, after expenses (including investment expenses). Most states fall short of this goal, but even after the reversal of the Department of Revenue's disallowance of all depreciation, there is more work to be done to improve the state's treatment of capital investment. Even if full expensing is not possible, the Commonwealth might explore some acceleration of depreciation schedules for machinery and equipment purchases.

CHAPTER 4

PERSONAL INCOME TAXES

Introduction

Pennsylvania's personal income tax is imposed at a flat rate of 3.07 percent on a broad income base. Alone among the 41 states which tax wage income, Pennsylvania offers neither a standard deduction nor a personal exemption. Partly because of the broad tax base, the Commonwealth also boasts one of the lowest income tax rates in the nation; only North Dakota's 2.9 percent single-rate tax is lower. Indiana, with a flat rate of 3.23 percent, has the next-lowest income tax rate after Pennsylvania, while seven states forgo all income taxation (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) and another two (New Hampshire and Tennessee) only tax interest and dividend income.[100]

The personal income tax is undoubtedly the best feature of Pennsylvania's tax code, with its low rate and relatively simple and neutral structure. It is, however, beset by a highly unusual feature: the tax is imposed on eight separate classes of income. Taxpayers lack the ability to carry losses from one category to another or, in the case of joint filers, from one spouse's income to another's. Furthermore, losses cannot be carried forward or backward.[101] Thus, a small business owner who posts a business loss but still has compensation or investment income cannot use her business losses to reduce tax liability on her other gains.

Individual income taxes are not, of course, exclusively of interest to individual taxpayers, as many businesses (known as pass-through businesses, and including S corporations, LLCs, partnerships, and sole proprietorships) pay individual income taxes as well. Since these taxes impact Pennsylvania employers, it is important to consider business as well as individual payers when contemplating changes to the individual tax code.

Pennsylvania also allows municipalities to levy income taxes on a different, narrower tax base. These local earned income taxes (EITs) and wage taxes are discussed separately in our consideration of local taxes, but the relatively high local income tax rates are relevant here inasmuch as they can increase the overall income tax burden in the state dramatically. Philadelphia's wage tax is the Commonwealth's highest. At 3.8907 percent, it has a higher rate than the state's income tax, albeit on a narrower tax base.

In this chapter we provide a broad overview of the state's personal income tax, identify issues with the current system, and discuss potential reform options.

100 Tennessee is in the process of phasing out its interest and dividends tax, called the Hall Income Tax.
101 Pennsylvania Department of Revenue, "Pennsylvania Personal Income Tax Guide, Chapter 6: Brief Overview of Pennsylvania Personal Income Tax," 2, http://www.revenue.pa.gov/FormsandPublications/PAPersonalIncomeTaxGuide/Documents/pitguide_chapter_06.pdf.

A Short History of the Personal Income Tax

The state's current income tax is the newest of Pennsylvania's major taxes, a product of the 1970s. The prominence of income taxes, and their continuous federal existence since 1913, often makes the tax seem considerably older than it is in many of the states, Pennsylvania included.

There were precursors, of course. In the early days of the American republic, Pennsylvania adopted a "faculty tax" upon the assumed income of property, with occupations and professions "rated at the discretion" of local government officials, "having due regard to the profits arising from them."[102] Rather than ascertaining the actual income of taxpayers, the state assessed them according to their professions, with the faculty tax ultimately evolving into an occupation tax which continues in Pennsylvania to this day.[103]

A tax approaching the modern form was imposed in 1840, when the Commonwealth levied a 1 percent tax on the income of salaried employees and 1 mill (0.1 percent) on other income received from trades, professions, and occupations. The next year, the salaried rate rose to 2 percent, while the tax on other occupational income increased to 1 percent. There were nods toward the future here, with the creation of an exemption in 1841, and even a withholding provision for the salaried professions. The tax was repealed in 1871, after the debt crisis that had precipitated it (and a subsequent one, the product of the Civil War) had passed.

The General Assembly created a classified income tax in 1935, only to see it struck down by the state supreme court as violative of the uniformity clause of the state constitution, which requires that similar classes of taxpayers be taxed similarly.[104] Classified income taxes, now almost extinct, were an ungainly forerunner of modern-day graduated rate taxation, in some cases imposed with different rates not only on different income levels, but also on different professions or sources of income.

The Pennsylvania classified income tax had rates ranging from 2 to 8 percent, and one's rate applied to the entirety of taxable income, not just on marginal income above a certain threshold, thus resulting in substantial tax cliffs. It also included a system of personal exemptions for filers, spouses, and dependents.[105] The court's rejection of the tax in light of state uniformity requirements was unsurprising, and the court did not spare legislators in its excoriation of the tax, with its "pretended classification[s]" resulting in an "unjust, arbitrary, and illegal" tax.[106]

102 Edwin R. A. Seligman, "The Income Tax in the American Colonies and States," *Political Science Quarterly* 10:2 (June 1895): 231, http://www.jstor.org/stable/2139730.
103 William J. McKenna, "The Income Tax in Pennsylvania," *Pennsylvania History: A Journal of Mid-Atlantic Studies* 27:3 (July 1960), 293, https://www.jstor.org/stable/27769968.
104 Id., 299.
105 Id., 303.
106 *Kelly v. Kalonder*, 220 Pa. 180 (1935).

Even today, the uniformity clause drives the structure of the state's income tax, most notably by prohibiting a graduated-rate tax. Voters rejected constitutional conventions in 1921, 1924, 1935, and 1953, largely due to organized opposition to graduated-rate taxation. In 1913 and 1937, amendments repealing the uniformity clause were submitted directly to the voters; both failed.[107]

The modern income tax was first imposed in 1971 at a rate of 2.3 percent. Since then, the rate has been cut six times, going as low as 2.0 percent, and increased five times, culminating in the 3.07 percent rate that has been in effect since 2004.

TABLE 4.1.

Personal Income Tax Rate History[108]

Year	Rate	Year	Rate
1971	2.30%	1986	2.16%
1974	2.00%	1987	2.10%
1978	2.20%	1991	2.60%
1983	2.45%	1992	2.95%
1984	2.40%	1993	2.80%
1985	2.35%	2004	3.07%

Source: Pennsylvania Department of Revenue

Comparing Pennsylvania's Individual Income Taxes Regionally and Nationally

Compared to other state individual income tax systems, Pennsylvania's does better than average on our *State Business Tax Climate Index*, and easily bests the individual income tax codes of most of its regional competitors, which include four of the five least competitive systems in the nation as measured on the *Index*'s individual income tax subcomponent. The *Index* provides a measure of a state's tax structure, not its collections, where Pennsylvania is closer to the middle of the pack, with the 28th highest collections per capita in the country.

TABLE 4.2.

***State Business Tax Climate Index* Individual Income Tax Component Rankings**

Pennsylvania and Regional Competitors (2018)

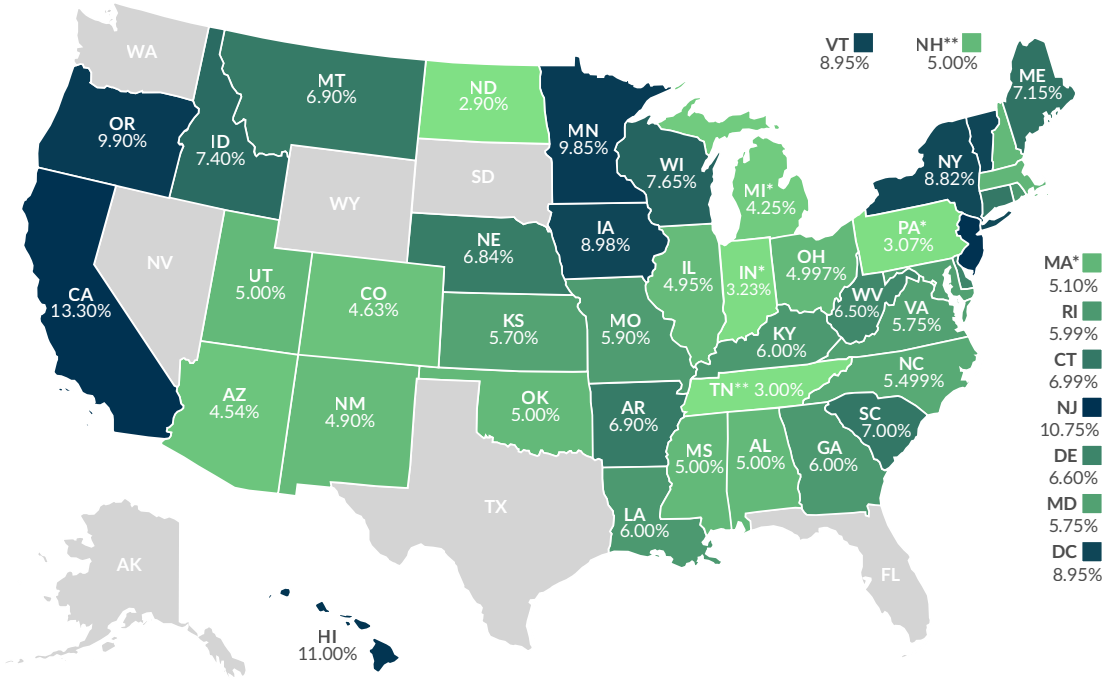
State	Component Ranking
Pennsylvania	17
Delaware	34
Maryland	46
New Jersey	48
New York	49
Ohio	47
West Virginia	25

Source: Tax Foundation, *2018 State Business Tax Climate Index*.

107 William J. McKenna, "The Income Tax in Pennsylvania," 296-299.
108 Pennsylvania Department of Revenue, *The Tax Compendium*, March 2017, 17, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/Documents/2017_tax_compendium.pdf.

Pennsylvania stands out as the only Mid-Atlantic state to levy a single-rate income tax, and its 3.07 percent rate is the lowest top rate in the region. The most geographically proximate states with single-rate income taxes are Massachusetts (5.1 percent), Michigan (4.25 percent), Indiana (3.23 percent), Illinois (4.95 percent), and North Carolina (5.499 percent).

FIGURE 4.1.
Top State Marginal Individual Income Tax Rates, 2018



Note: (*) State has a flat income tax. (**) State only taxes interest and dividends income. Map shows top marginal rates: the maximum statutory rate in each state. This map does not show effective marginal tax rates, which would include the effects of phase-outs of various tax preferences. Local income taxes are not included.
Source: Tax Foundation; state tax statutes, forms, and instructions; Bloomberg BNA.

Excessive taxes on income are generally less desirable than taxes on consumption because they discourage wealth creation. In a comprehensive review of international econometric tax studies, Arnold et al. (2011) found that individual income taxes are among the most detrimental to economic growth, outstripped only by corporate income taxes. The authors found that consumption and property taxes are the least harmful.[109]

The economic literature on graduated-rate income taxes is particularly unfavorable.[110] The Arnold et al. study concluded that reductions in top marginal rates would be beneficial to long-term growth, and Mullen and Williams (1994) found that higher marginal tax rates reduce gross state product growth. This finding even adjusts for the overall tax burden of the state, lending credence to the precept of broad bases and low rates.[111]

109 Jens Arnold, Bert Brys, Christopher Heady, Åsa Johannsson, Cyrille Schwellnus, and Laura Vartia, "Tax Policy for Economic Recovery and Growth," *The Economic Journal* 121:550 (February 2011).
110 See William McBride, "What is the Evidence on Taxes and Growth?" Tax Foundation, Dec. 18, 2012, http://taxfoundation.org/article/what-evidence-taxes-and-growth.
111 John K. Mullen and Martin Williams, "Marginal Tax Rates and State Economic Growth," *Regional Science and Urban Economics* 24:6 (December 1994).

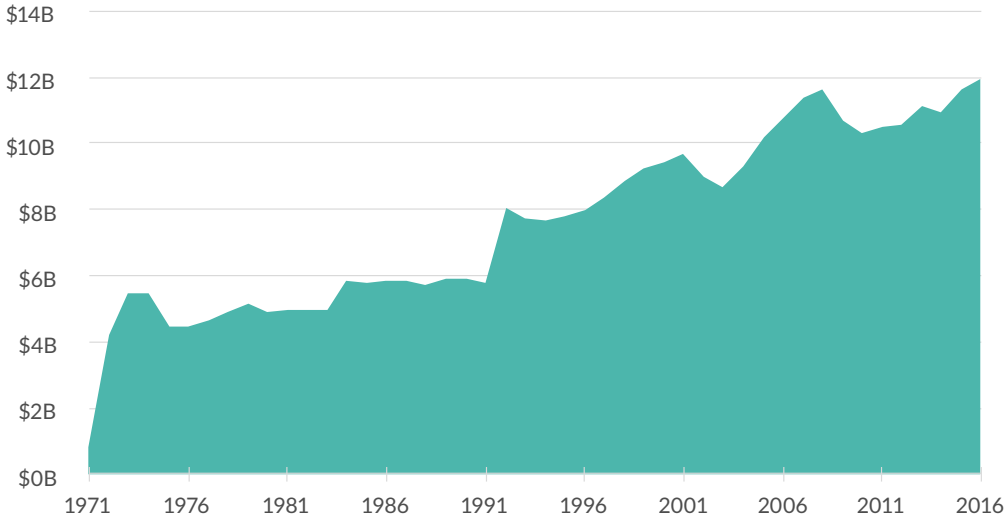
Personal Income Tax Collections

Personal income tax collections have grown significantly through the years, but have seen sizable swings, dipping notably during recessionary periods. Interestingly, collections were nearly flat (in inflation-adjusted terms) from 1984 through 1987, during a period of yearly rate reductions which reduced the income tax rate from 2.45 to 2.1 percent following a tax increase in 1983.

Personal income taxes accounted for 32 percent of state tax collections in fiscal year 2016, edging out general sales taxes at 27 percent to represent the largest single source of state tax revenue.[112]

FIGURE 4.2.

Pennsylvania Personal Income Tax Collections (1971-2016, in 2017 Dollars)



Source: U.S. Census Bureau, State Government Tax Collections

Even under a single-rate tax code, high earners are, predictably, responsible for much of the state's personal income tax collections. Filers earning more than $100,000 per year comprise 14 percent of households but are responsible for more than half of all collections, with those pulling in $250,000 or more (2.63 percent of filers) incurring more than 19 percent of the state's total income tax liability.[113]

112 U.S. Census Bureau, "Annual Survey of State Government Finances (FY 2016)," https://www.census.gov/programs-surveys/state.html.
113 Commonwealth of Pennsylvania, *Comprehensive Annual Financial Report*, Fiscal Year 2017, 268, http://www.budget.pa.gov/PublicationsAndReports/AnnualFinancialReport/Documents/june-30-2017-cafr.pdf.

TABLE 4.3.
Percentage of Personal Income Tax Liability by Income Range

	By Income Range		Cumulative Totals	
Income Range	% of Filers	% of Liability	% of Filers	% of Liability
Less than $25,000	46.8%	7.1%	46.8%	7.1%
$25,000 - $49,999	20.0%	14.4%	66.8%	21.5%
$50,000 - $99,999	18.8%	26.9%	85.7%	48.3%
$100,000 - $249,999	11.7%	32.4%	97.4%	80.7%
$100,000 - $249,999	2.6%	19.3%	100.0%	100.0%

Source: Commonwealth of Pennsylvania, *Comprehensive Annual Financial Report*

Structural Elements

The chief impediment to a well-structured income tax in Pennsylvania is the division of taxable income into eight distinct classes, without the ability to use a loss in one class of income to offset gains in another class, or even against the same class of income attributable to a spouse. The eight classes are:

1. Compensation;
2. Interest;
3. Dividends;
4. Net profits from the operation of a business, profession, or farm;
5. Net gains or income from the dispositions of property;
6. Net gains or income from rents, royalties, patents, and copyrights;
7. Income derived through estates or trusts; and
8. Gambling and lottery winnings other than Pennsylvania lottery winnings.[114]

Imagine a married couple in which one spouse holds a salaried position with salary and other taxable compensation of $90,000, while the other has just started a small business which has yet to become profitable, accumulating annual losses of $20,000. Due to a stock market contraction, the couple decides to take their losses, and posts a net capital loss of $10,000. They do, however, receive $5,000 in dividend distributions on their investments. In most states, the couple's resulting taxable income would be $65,000, neglecting any further adjustments (including deductions and exemptions). In Pennsylvania, by contrast, the $90,000 in compensation and $5,000 in dividends would not be offset by the losses in any other class of income, or accruing to the other spouse, making their taxable income $30,000 higher than it would be elsewhere.

114 Pennsylvania Department of Revenue, "Pennsylvania Personal Income Tax Guide," Chapter 6.

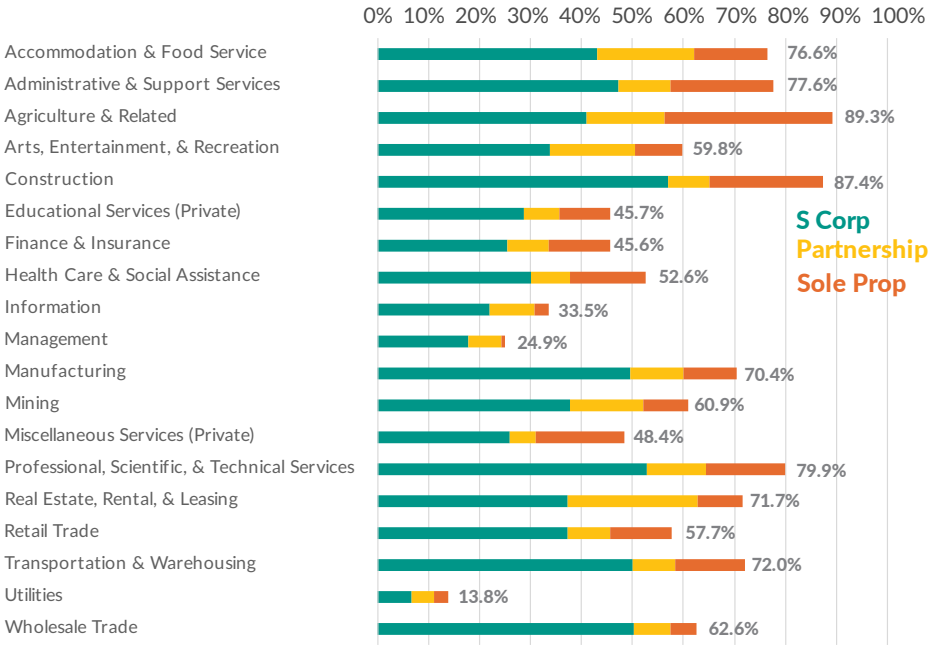
The more sources of income a filer has, the more distortive the effects can be. Capital losses cannot be offset by dividend income, let alone rental income. The business gains of one spouse cannot be offset by the business losses of the other. This not only has the effect of increasing tax liability above and beyond what would be anticipated by the state's low 3.07 percent rate, but doing so in a way that is decidedly nonneutral, penalizing filers with less typical income streams. The disincentives are particularly strong for those starting pass-through businesses.

Impact of the Personal Income Tax on Businesses

Individual income taxes are of considerable importance to pass-through entities, businesses that pay the individual income tax in lieu of the corporate income tax because the earnings "pass through" to the income tax form of the owners or shareholders rather than being remitted by the business entity itself. Because S corporations, partnerships, sole proprietorships, and limited liability corporations (LLCs) remit their income tax payments through the individual income tax, the individual code is a significant policy issue for the majority of Pennsylvania businesses. Figure 4.3 shows the share of employer firms in each sector that pay personal income taxes in Pennsylvania (separated by type).[115]

FIGURE 4.3.

Share of Employer Firms Paying the Personal Income Tax, By Sector



Note: This does not include non-employer firms.

Source: Census Bureau, "County Business Patterns"

115 U.S. Census Bureau, "Geography Area Series: County Business Patterns by Legal Form of Organization," 2013.

Traditional C corporations care about individual income tax rates as well, since high rates can impede their ability to attract and retain talented employees. Pennsylvania's attractive individual income tax rate structure helps countervail its high corporate taxes.

Limited Internal Revenue Code Conformity

For reasons of administrative simplicity, states frequently seek to conform many, though rarely all, elements of their state tax codes to the federal tax code. This harmonization of definitions and policies reduces compliance costs for individuals and businesses with liability in multiple states and limits the potential for double taxation of income.[116] No state conforms to the federal code in all respects, and not all provisions of the federal code make for good tax policy, but greater conformity substantially reduces tax complexity and has significant value.

Pennsylvania is one of only four states with a state-defined calculation of taxable income. All other income tax states begin with either federal adjusted gross income (AGI) or federal taxable income as their income starting point, then make various adjustments, adding to and subtracting from a federally-defined tax base.[117] Because it forgoes both a standard deduction and a personal exemption, Pennsylvania's income tax is unusually broad, capturing virtually all income other than retirement income. It does not conform, for instance, to federal deductions for mortgage interest, medical expenses, or property taxes paid.

The only significant point of Internal Revenue Code conformity within Pennsylvania's personal income tax is for Section 179 small business expensing, under which pass-through businesses are permitted to deduct the full cost of certain capital investments in the first year, subject to income and cost limitations, rather than depreciating it over multiple years. The Tax Cuts and Jobs Act of 2017 raised the cap on first-year "expensing" from $500,000 to $1 million, while increasing the provision's phaseout threshold from $2 million to $2.5 million in income.[118]

Tax Expenditures: Deductions, Exemptions, and Credits

Pennsylvania offers extremely few tax deductions, either above- or below-the-line. At the federal level and in most states, above-the-line deductions are available to all taxpayers, regardless of whether they choose to itemize. They include deductions for student loan interest, contributions to qualified retirement funds, and alimony, among others. Below-the-line deductions are those which can be taken if one itemizes, but not if one takes the standard deduction. These include medical expenses, state and local taxes paid, charitable contributions, interest, unreimbursed business expenses, and others.

116 Ruth Mason, "Delegating Up: State Conformity with the Federal Tax Base," *Duke Law Journal* 62:7 (April 2013), 1269–1270.
117 Jared Walczak, "Tax Reform Moves to the States: State Revenue Implications and Reform Opportunities Following Federal Tax Reform," Tax Foundation, Jan. 31, 2018, https://taxfoundation.org/state-conformity-federal-tax-reform/.
118 Jared Walczak, Joseph Bishop-Henchman, and Nicole Kaeding, "Details of the Conference Report for the Tax Cuts and Jobs Act," Tax Foundation, Dec. 15, 2017, 8, https://taxfoundation.org/conference-report-tax-cuts-and-jobs-act/.

Pennsylvania disallows all above-the-line deductions and, among the major below-the-line deductions, only offers a deduction for unreimbursed business expenses.[119] Moreover, the state does not have adoption credits, child tax credits, or child and dependent care credits. All this serves to create a broad tax base with few policy carveouts, consistent with principles of sound tax policy.

Tax deductions reduce taxable income; exemptions exclude specific income from taxation; and tax credits, the most generous form of tax preference, directly reduce tax liability. At a 3.07 percent personal income tax rate, a $1,000 deduction or exemption reduces tax liability by $30.70, while a $1,000 credit reduces tax liability by $1,000.

In Pennsylvania, some policies preferentially treat retirement income, insurance proceeds, public assistance, scholarships, and other sources of income rarely subject to tax. A few benefit certain charitable contributions, including to educational scholarship organizations. Most of the remainder are intended to promote economic development. Deductions and exemptions are specifically provided against the personal income tax, whereas the state's tax credits–frequently oriented toward economic development–can be applied against corporate and personal income tax liability, among other taxes. Figures given in this chapter pertain to claims against the personal income tax, excluding claims of those same credits against the corporate net income tax and other state taxes.[120]

Income tax-specific exemptions will reduce statewide personal income tax liability by an estimated $6.5 billion in fiscal year 2019, a highly significant amount given that income tax collections that year are projected at $14.8 billion. Tax credits taken against the personal income tax cost an additional $152 million. Some of the exemptions represent policy preferences, as do nearly all of the tax credits; many others, however, are structural provisions which are necessary to come to a proper definition of taxable income—for instance, to avoid double taxation. While personal income tax expenditures for fiscal year 2019 will approach $6.7 billion, therefore, it would be inaccurate to state that this amount of revenue is available by eliminating tax preferences.

Nevertheless, while Pennsylvania's income tax has a larger-than-average tax base, it does feature costly carveouts, and none are costlier than its preferential treatment of retirement income. Pennsylvania not only offers deductions for contributions to qualified retirement accounts (which is typical), but also exempts retirement income—excluding the income when it is put in and when it is taken out (including any investment returns).

Contributions to retirement and benefit programs are usually excluded from taxable income, so it is unsurprising that retirement contributions by employers ($938 million in fiscal year 2019), employee benefit program employer contributions ($1.1 billion), and contributions to health savings accounts and ARCHER MSAs ($23.4 million) are exempt. Uniquely, however, all retirement income-at a cost of $3.4 billion in forgone tax revenue-is exempt from state taxation.

119 Pennsylvania Department of Revenue, "Pennsylvania Personal Income Tax Guide, Chapter 6"
120 We are grateful to the Pennsylvania Department of Revenue for providing data on the proportion of these tax credits taken against liability for each tax type.

Of the 41 states with a wage income tax, Pennsylvania is the only state to exempt retirement income fully, which is to say that Social Security, private pensions, state and local pensions, federal civil service pensions, and military pensions are all exempt from taxation. Four other states–Alabama, Hawaii, Illinois, and Mississippi–exempt all governmental retirement income, including Social Security, but tax at least some private pension income. Many states tax all classes of retirement income, though they frequently offer deductions or cap the taxable amount.[121]

TABLE 4.4.

Personal Income Tax Deductions and Exemptions, Fiscal Year 2019
Tax Costs in Millions

Tax Expenditure	Tax Cost
Retirement Income	$3,404
Employee Benefit Program Employer Contributions	$1,051
Retirement Contributions by Employers	$938
Scholarships, Grants, Fellowships, and Stipends	$207
Sale of a Principal Residence	$165
Life Insurance Proceeds	$159
Compensation for Military Service	$114
Cafeteria Plans	$111
Unreimbursed Expenses	$107
Workers' Compensation	$91
Unemployment and Supplemental Unemployment Compensation	$68
Nonqualified Deferred Compensation	$50
Qualified Tuition Programs	$33
HSAs/ARCHER MSAs	$23
Public Assistance	$5
Reimbursements for Actual Expenses	$3
Exemption for Elected Officials	$1
Total	**$6,533**

Source: Commonwealth of Pennsylvania, *Governor's Executive Budget*

Credits available to C corporations are also available to pass-through businesses, which pay through the personal income tax. Most tax credits, particularly those with an economic development focus, are utilized disproportionately by C corporations, but the state also offers educational tax credits–an Educational Improvement Tax Credit for contributions to public school programming and an Educational Opportunity Scholarship Tax Credit for contributions to private school scholarships–which are claimed almost equally against personal and corporate income tax liability.[122] The following table shows the estimated tax cost of tax credits against the personal income tax.[123] Nearly all states carve out their tax codes with various incentives; Pennsylvania does this less than most.

121 National Conference of State Legislatures, "State Personal Income Taxes on Pensions and Retirement Income: Tax Year 2014," April 3, 2015, http://www.ncsl.org/documents/fiscal/StateTaxOnPensions2015update.pdf.

122 Commonwealth of Pennsylvania, *2018 - 2019 Governor's Executive Budget*, D72-D85, http://www.budget.pa.gov/PublicationsAndReports/CommonwealthBudget/Documents/2018-19%20Proposed%20Budget/2018-19%20Governor%27s%20Executive%20Budget%20-%20Web.pdf.

123 Id., D5-D30.

TABLE 4.5.

Personal Income Tax Credits, Fiscal Year 2019
Tax Costs in Millions

Tax Expenditure	Tax Cost
Educational Improvement Tax Credit	$47
Educational Opportunity Scholarship Tax Credit	$46
Keystone Opportunity Zone	$17
Neighborhood Assistance Programs	$13
Keystone Innovation Zone	$10
Resource Enhancement and Protection Tax Credit	$8
Entertainment Production Tax Credits	$6
Research and Development Tax Credit	$3
Tax Credit for New Jobs	$1
Total	**$152**

Source: Commonwealth of Pennsylvania, *Governor's Executive Budget*

Personal Income Tax Reform Solutions

Pennsylvania's personal income tax stands out as one of the best features of the state's tax code, with its low, flat rate on a broad definition of income. Policymakers should be wary of making too many changes to a tax that is largely working. The areas where the income tax can be found wanting are (1) the substantial carveout for retirement income, (2) the use of distinct classes of income, and (3) the large rate differential between individual and corporate income taxes, which owes chiefly to the state's anomalously high corporate rate. The use of targeted tax incentives also diverges from principles of sound taxation, though Pennsylvania utilizes credits far less than many of its competitors.

Tax Retirement Income

Many states provide tax preferences for retirees, but Pennsylvania's complete exemption of all retirement income stands out. Because retirement savings are also tax-advantaged, this policy means that, at the state level, income saved for retirement is untaxed going in (when invested) *and* coming out (when expended). Optimal treatment only offers an exclusion on one side of the investment.

Consider, for instance, Individual Retirement Accounts, which are offered in traditional (exempt on investment but taxed on realization) and Roth (taxed on investment but exempt on realization) form. If all else held constant, these two approaches would be identical. In both cases, the income is taxed—but only once. Under Pennsylvania's income tax, however, retirement savings and retirement income are both exempt, which badly skews the tax system and forgoes $3.4 billion in revenue.

Pennsylvania's uniformity clause makes it more difficult to pursue compromise solutions, like exempting retirement income up to a certain threshold, but the taxation of retirement income should be on the table as part of broader tax reform efforts. Taxing retirement income would allow the personal income tax rate to be reduced to 2.5 percent on a revenue-neutral basis, though it would be better used as a pay-for to reduce less competitive tax rates elsewhere. Support for low-income retirees could be maintained, consistent with the constitutional uniformity clause, by using part of the additional revenue to offer far more generous property tax and rent "circuit breakers" for senior citizens.

Eliminate Distinct Classes of Income

Pennsylvania's income classes have always existed in tension with the uniformity clause. They are also highly unusual; the authors are not aware of a similar system in any other state. Separately taxing each class of income, without the ability to carry losses over from one class to another, penalizes some taxpayers—and does so on a largely arbitrary basis. There is no good reason why interest income should constitute a class distinct from dividend income, or why neither of them are permitted to offset losses in business or rental income. Policymakers should explore the repeal of this outmoded structure, which harkens to the virtually extinct concept of a "classified income tax."

Roll Back Business Incentives

Tax credits are projected to reduce personal income tax collections by $152 million in fiscal year 2019, of which $46 million is set aside for pure economic development purposes. For reasons discussed at greater length in Chapter 3, there is little reason to believe that these credits induce significant investment or promote meaningful economic growth. Benefits accrue to industries and activities favored by the legislature, a state of affairs which is likely to encourage economic decision-making different from the choices that would be made under a more neutral regime.

Pennsylvania policymakers should eliminate most or all business credits, using them to pay down reforms which benefit Pennsylvanians more broadly. To the state's credit, however, existing credits are extremely modest in the context of overall personal income tax collections.

CHAPTER 5

STATE SALES TAXES

Introduction

Until 1953, Pennsylvania taxed neither income nor sales. In fact, the sales tax came into being as the result of a failed attempt to tax income. After voters rejected a referendum for a constitutional convention intended to consider authorizing a graduated-rate income tax, the legislature considered, but ultimately rejected, a 0.5 percent flat income tax. After that setback, policymakers came back with an alternative: a 1 percent sales tax for education.[124]

The original sales tax expired in 1955,[125] but was restored at a 3 percent rate in 1956. Further rate increases were implemented in 1959 (twice), 1963, and finally in 1968, when the state settled upon the 6 percent rate which remains to this day.[126] Philadelphia and Allegheny County are statutorily authorized to levy their own local sales taxes at rates of 2 and 1 percent respectively. These are briefly considered separately, as a part of the local tax code.

TABLE 5.1.
Sales Tax Rate History[125]

Year	Rate	Year	Rate
1954	1.0%	1959	4.0%
1956	3.0%	1963	5.0%
1959	3.5%	1968	6.0%

Source: Pennsylvania Department of Revenue

Pennsylvania's sales tax faces challenges common to many of its regional competitors: a shrinking tax base, limited taxation of the service sector, constraints on collecting taxes on remote transactions, and uncertainty over tax definitions and administration. In recent years, both Governor Tom Wolf (D) and House Republicans have touted plans to broaden the sales tax base. These plans, constituent parts of competing tax reform and budget packages, went nowhere.

In Pennsylvania as elsewhere, a narrow sales tax base is the subject of bipartisan frustration, vexation, and, ultimately, resignation. There is widespread recognition that the sales tax has not kept up with contemporary economic conditions but little appetite for taking on the burden of modernization. The sales tax code thus remains, essentially, in stasis. It has often been tinkered with, but its basic structure–and particularly its tax base–is frozen in time, barely changed since first enacted in 1953.

In this chapter, we provide a general overview of Pennsylvania's state sales tax system and offer recommendations for modernizing the sales tax. We explore the state's current sales tax structure, place Pennsylvania's sales tax in both a regional and national context, consider the state's treatment of business inputs, explore options for expanding the base to include additional services, and review requirements incumbent upon states wishing to participate in prospective future federal remote seller regimes. We conclude the chapter by outlining proposals for reform, including a menu of base expansion options.

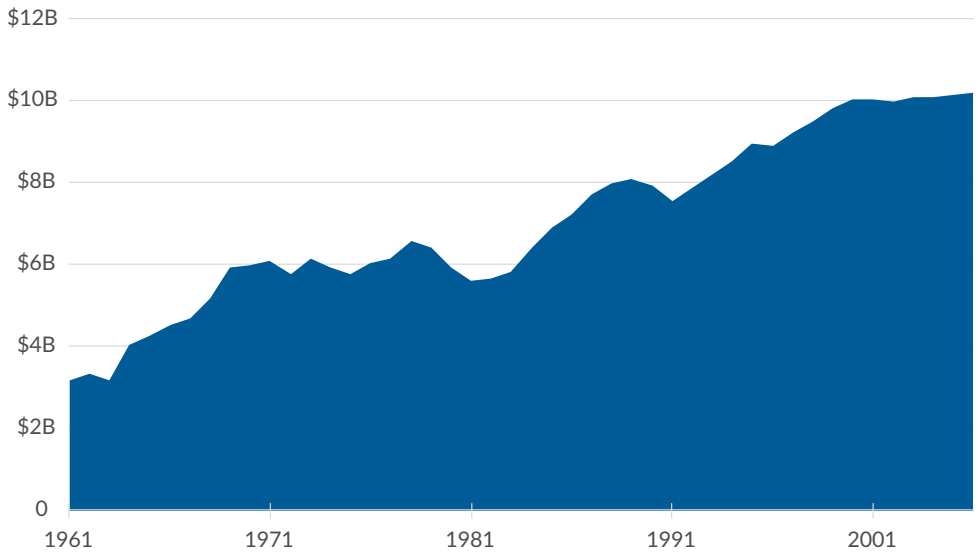
124 Philip S. Klein and Ari Hoogenboom, *A History of Pennsylvania* (State College, PA: Pennsylvania State University Press, 1980), 478.
125 Id., 502.
126 Pennsylvania Department of Revenue, *The Tax Compendium*, March 2017, 11, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/Documents/2017_tax_compendium.pdf.
127 Id., 17.

Sales Tax Collections

Sales taxes are a significant driver of state revenue but only a modest source of local government revenue in Pennsylvania, accounting for 27.3 percent of total state tax collections but a mere 3.1 percent of local tax collections.[128] In fiscal year 2015, Pennsylvania state and local governments raised $10.7 billion in state and local sales taxes, $9.9 billion of which went to state coffers.[129] In fiscal year 2017, for which only state figures are available at the time of writing, $10.5 billion flowed to the state's coffers.[130]

Although collections dipped sharply in 2010, during the Great Recession, they have otherwise proven remarkably stable in recent years. Between 1999 and 2017, inflation-adjusted collections only diverged from the overall period's average by more than 3 percent three times: once, when collections dropped in 2010, and again in 2016 and 2017, when collections comfortably exceeded the average. Although, like all taxes, it is subject to the vicissitudes of the broader economy, it has proven far more stable than the state's other major sources of tax revenue, the personal income tax and the corporate net income tax.

FIGURE 5.1.
Inflation-Adjusted Sales Tax Collections, 1961-2017



Source: U.S. Census Bureau, State Government Tax Collections

128 This does not include selective sales (excise) taxes like the gas tax or cigarette tax.
129 U.S. Census Bureau, "State & Local Government Finance (FY 2015)," https://www.census.gov/govs/local/.
130 U.S. Census Bureau, "Annual Survey of State Government Tax Collections," https://www.census.gov/programs-surveys/stc.html.

Sales Tax Rate Composition

As of January 2018, Pennsylvania had an average combined state and local sales tax rate of 6.34 percent, placing the state squarely in the middle of the pack on combined rates, and virtually on par with neighboring West Virginia (6.37 percent) and Massachusetts (6.25 percent). Maryland (6 percent) has a lower rate, and Delaware forgoes a sales tax altogether. Combined rates in New Jersey (6.6 percent), Ohio (7.15 percent), and New York (8.49 percent) exceed the rate in Pennsylvania.[131] The Commonwealth's weighted combined rate is driven by a 7 percent combined sales tax rate in Allegheny County and an 8 percent combined rate in Philadelphia; all other jurisdictions only levy the state rate of 6 percent.

TABLE 5.2.

Average Combined State and Local Sales Tax Rates Pennsylvania and Select Regional Competitors

State	State Rate	Average Local Rate	Combined Rate
Pennsylvania	6.00%	0.34%	6.34%
Delaware	n/a	n/a	n/a
New Jersey	6.625%	-0.03%*	6.60%
New York	4.0%	4.49%	8.49%
Ohio	5.75%	1.40%	7.15%
West Virginia	6.00%	0.37%	6.37%

* Select jurisdictions in New Jersey are authorized to impose the state sales tax at half the normal rate. This is represented as a negative local rate in those jurisdictions.
Note: Average local rates are population-weighted.
Sources: Sales Tax Clearinghouse; Tax Foundation calculations

Most states–Pennsylvania's regional competitors among them–have a two-part sales tax: a state-level rate that is levied throughout the entire state, and local option sales taxes that are levied in specific jurisdictions or tax districts. Pennsylvania's sales tax consists of a 6 percent general state sales tax plus local sales taxes in two jurisdictions: a 1 percent levy in Allegheny County and a 2 percent local sales tax in Philadelphia. The state-level sales tax has been levied at a 6 percent rate since 1968, while the two local sales taxes have been in effect since the early 1990s.

Some of Pennsylvania's sales tax revenue is dedicated to specific spending purposes. In 2013, the state began depositing 0.947 percent of sales and use tax receipts into the Public Transportation Assistance Fund.[132] This is on top of an existing transfer of 4.4 percent of total sales tax receipts into the separate Public Transportation Transfer Fund, which commenced in 2007.[133]

131 Jared Walczak and Scott Drenkard, "State and Local Sales Tax Rates 2018," Tax Foundation, Feb. 13, 2018, https://taxfoundation.org/state-and-local-sales-tax-rates-2018/.
132 Pennsylvania Department of Revenue, *The Tax Compendium*, 12.
133 Id.

Sales Tax Base Composition

Like most states, Pennsylvania imposes its sales tax on a base that consists of the majority of goods–with economically significant policy carveouts–and relatively few services. Most state sales tax bases are narrower than economists would recommend, but Pennsylvania's is particularly limited.

Pennsylvania, under its state sales tax, does not tax food, candy, and gum; prescription and nonprescription drugs; or most apparel. It thus exempts a sizable and stable portion of consumer spending.[134] In 2016, 9.6 percent of personal consumption expenditures in Pennsylvania were spent on off-premise food and beverage consumption, clothing, and footwear.[135] The state also exempts many, though not all, services and select other goods. By law, tangible personal property is included in the sales tax base unless expressly exempted, whereas services are only subject to tax if specifically enumerated.

Apples-to-apples comparisons of state sales tax bases are difficult, but one method is to calculate the value of taxed transactions as a percentage of personal income. Hawaii, for instance, has a sales tax breadth of 107 percent of state income.[136] The state exempts some transactions which arguably should be taxed, but double-taxes others. Pennsylvania also exposes some transactions to multiple levels of taxation but omits far more transactions altogether. The state's sales tax breadth, as a percentage of state income, is an anemic 26 percent. A robust sales tax base would not reach 100 percent, as not all income is consumed in any given year, but could tax as much as 75 percent of state income.

Much of Pennsylvania's narrow base owes to the inclusion of relatively few services in the state's sales tax base. Services comprise an ever-larger share of consumer transactions. Combined with pressure to exempt certain other goods from time to time, base erosion is inevitable. As the tax base shrinks, lawmakers may look to rate increases for additional revenue. A better option is to broaden the tax base, which can permit rate reductions even in revenue positive scenarios.

Taxation of Business Inputs

When contemplating broadening the sales tax base, it is important to maintain proper treatment of business inputs. A well-structured sales tax is imposed on all final consumer goods and services while exempting all purchases made by businesses that will be used as inputs in the production process. This is not because businesses deserve special treatment under the tax code, but because applying the sales tax to business inputs results in multiple layers of taxation embedded in the price of goods once they reach final consumers, a process known as "tax pyramiding." The result is higher and inequitable effective tax rates for different industries and products, which is both nonneutral and nontransparent.

134 Id, 11.
135 Bureau of Economic Analysis, "Total personal consumption expenditures (PCE) by state (millions of dollars)," GDP & Personal Income series, 2016.
136 Calculation by Prof. John Mikesell, Indiana University, FY 2016.

Ideally, business inputs would be exempted based upon the identity of the purchaser. In practice, however, states must generally make binary choices which are not always entirely clear-cut, as there are many goods and services which are consumed by businesses and individuals alike. For instance, when a business retains an outside accounting firm, that is clearly a business input, but individuals sometimes hire accountants as well.

Sometimes this conundrum can be resolved, if only imperfectly, by considering typical use. It is true, for instance, that a select few individuals might occasionally rent a cold storage facility or take out advertising, but these services are overwhelmingly purchased by businesses, and the rare exception should not guide policy. A more interesting case arises with goods which are consumed by both businesses and individuals but which, when used by businesses, are not a direct part of the production process.

Businesses and individuals both buy desk chairs and both procure landscaping service. In such cases, exemption certificates are optimal, as they can address the use case of the company ordering a thousand desk chairs. If, however, a sales tax fails to distinguish the ultimate purchaser for goods which are *consumed* by the business rather than used in the course of production and sale (equipment, machinery, raw materials, packaging, advertising, etc.), the consequent tax pyramiding may still be modest.

Nonprofits and agricultural purchasers are often granted exemption certificates which exempt transactions from tax based on the purchaser's identity rather than a determination of whether the good or service is most likely to be purchased by a business or a consumer. The chief shortcoming of exemption certificates is the administrative hassle they create for the state, the seller, and the purchaser alike. A policy of exempting transactions which are overwhelmingly or exclusively business inputs, while allowing exemption certificates to be used to avoid tax on mixed-use goods and services when the purchaser is a business, represents the best available policy option.

While most states make some effort to exclude business inputs from taxation, few do so consistently or uniformly. It has been estimated that 13.7 percent of total business taxes paid in Pennsylvania are general sales taxes, below the national average of 19.5 percent.[137] In a perfectly structured tax code, that share would be zero. The state has taken steps to address the taxation of business, exempting machinery, equipment, and supplies from the sales tax. Nevertheless, other inputs continue to be subject to the tax, undermining tax neutrality and allowing tax costs to be embedded in the final price of goods several times over.

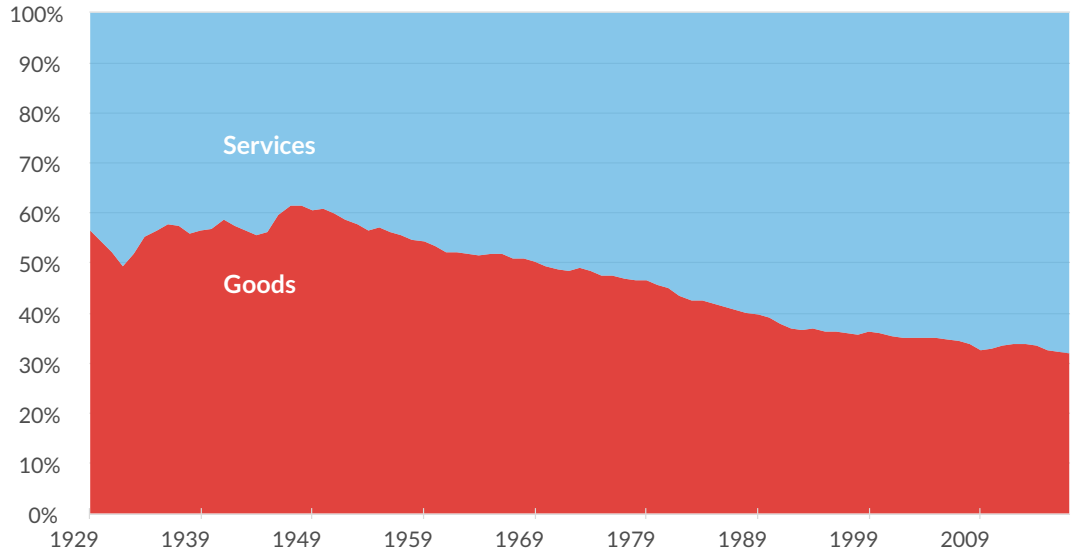
137 Jason Horwitz and Brian Peterson, "2017 State Business Tax Burden Rankings," Anderson Economic Group, April 17, 2017, www.andersoneconomicgroup.com/Portals/0/AEG%20Tax%20Burden%20Study_2017_FINAL.pdf.

Taxation of Services

Another major contributing factor to the shrinking sales tax base over time–in Pennsylvania and elsewhere–is that American consumption habits have shifted over the years. Whereas the U.S. economy was heavily weighted towards goods when sales taxes were first imposed, today the economy is increasingly service-oriented. Figure 5.2 shows national goods and services consumption shares since 1929.

FIGURE 5.2.

Percentage of Personal Consumption Expenditures on Goods and Services



Source: Bureau of Economic Analysis, Regional Economic Accounts

As mentioned previously, Pennsylvania's sales tax breadth, at 26 percent of state income in fiscal year 2016, is well below the U.S. median rate of 36 percent.[138] Of neighboring states with a sales tax, only New Jersey has a narrower base. Failure to modernize the state sales tax base presages continued erosion and commensurate pressure to raise rates. Unsurprisingly, sales tax base broadening has been considered by several of the state's tax reform commissions through the years.

138 Morgan Scarboro, *Facts and Figures 2018: How Does Your State Compare?* Table 22.

TABLE 5.3.

Sales Tax Breadth

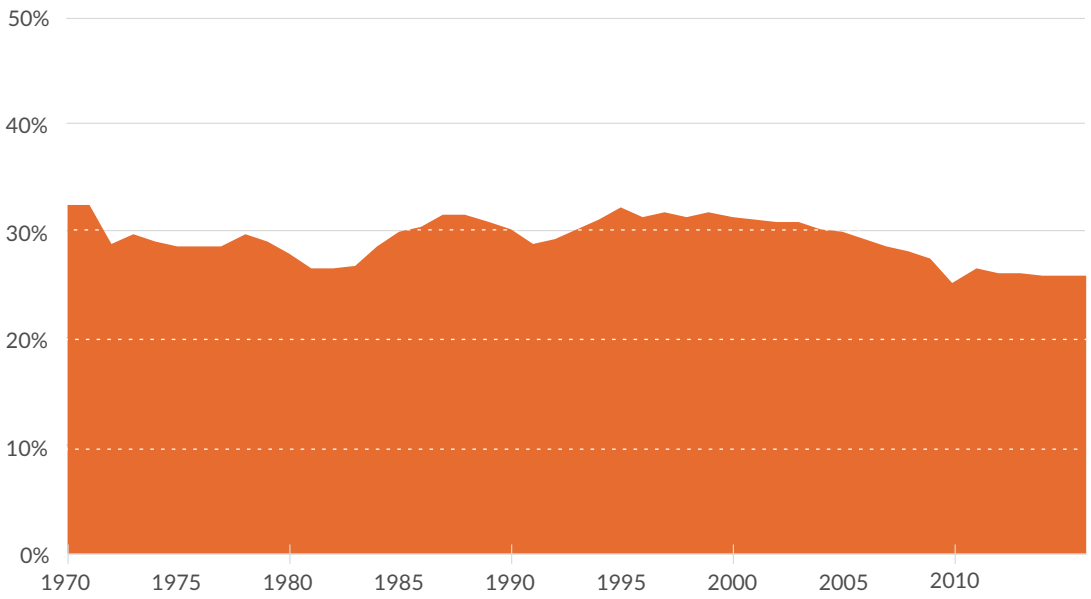
Pennsylvania and Regional Competitors

State	Breadth
Pennsylvania	26.0%
Delaware	n/a
Maryland	25.7%
New Jersey	23.9%
New York	27.0%
Ohio	35.3%
West Virginia	36.4%

Sources: Prof. John Mikesell, Indiana University; Tax Foundation, *Facts & Figures* 2018

FIGURE 5.3.

Pennsylvania's Sales Tax Breadth, 1970-2016



Source: Prof. John Mikesell, Indiana University

The Federation of Tax Administrators (FTA) periodically publishes a survey of services taxable under each state's general sales tax, with the most recent data compiled in 2010. The survey includes both business-to-business services (which should be exempted under a well-structured sales tax) and final consumer services. As of 2010, Pennsylvania taxed 67 of the 183 services enumerated in the FTA survey under the general sales tax. Of those, at least 27 should be exempted because they are business inputs, while 49 final consumer service transactions went untaxed, as did 30 services that could represent business inputs or final purchases depending on the identity of the purchaser.

Existing Sales Tax Exemptions

Although Pennsylvania does not publish a standalone tax expenditure report, one is contained within each year's executive budget, with the present budget containing projections through fiscal year 2021. A tax expenditure is something that would have been taxed but was specifically exempted or abated, or a subtraction, credit, deduction, or exclusion that was implemented to reduce or completely eliminate an entity or individual's tax liability. The report cites 101 sales tax exclusions which carve out billions of dollars from the sales tax base. Not all these expenditures are created equal, however, and different starting definitions of the sales tax base make comparison across states difficult.

For instance, one of the largest sales tax exemptions–worth an estimated $1.3 billion–is for the purchase of machinery, equipment, parts and supplies, or the use of services or utilities used directly in manufacturing and processing. There are many ways that sales taxes can pyramid, hence efforts like this to exclude business inputs from the sales tax base are proper.

The policy rationales for many of these exemptions are understandable. They do, however, carve away the sales tax base, forcing the rate to be higher in order to raise the same revenue on a smaller base of transactions. The following tables attempt to classify existing tax expenditures for which cost estimates are available.

In a very broad, ideal sales tax, all final consumer transactions, both goods and services (Table 5.4), would be subject to the sales tax, while business inputs (Table 5.5) would be exempt. However, since sales tax breadth is not the only policy consideration facing lawmakers, certain services are sometimes exempted for other reasons.

Taxing the services enumerated in Table 5.6 requires provisions to ensure that when purchased by consumers these service transactions are taxed, but when purchased by businesses they are not. One option is to grant businesses a business identification number registered with the Pennsylvania Department of Revenue. The firm would then present this number upon purchase of any goods or services used in the production process and be exempt from paying sales tax on those purchases. This is similar to how some states identify nonprofit organizations for purposes of exempting them from taxation.

TABLE 5.4.

Pennsylvania's Tax Treatment of Final Consumer Transactions

Exemption	Value in Millions
Food	$1,524.6
Physician & Dental Services	$1,454.8
Hospitals	$1,241.1
Prescription Drugs & Orthopedic Equipment	$1,034.6
Gasoline & Motor Fuels	$951.8
Tuition (College, Vocational Training, & Instruction)	$902.0
Clothing & Footwear	$844.1
Home Health Care, Nursing Care, & Other Ambulatory Health Care Services	$490.3
Residential Utilities Electric	$458.4
Amusement & Recreation Industries	$378.4
Basic Television	$243.9
Personal Care Services	$208.2
Liquor or Malt Beverage Purchased from Retail Dispenser	$168.8
Residential Utilities Fuel Oil/Gas	$168.2
Social Assistance Including Day Care	$167.8
Health & Social Assistance Organizations	$164.6
Nonprescription Drugs	$143.5
Water & Sewage Services	$137.7
Theater, Dance, Music, & Performing Arts Admissions	$102.6
Nonprofit Educational Institutions	$87.3
Spectator Sports Admissions (Excludes Schools)	$79.0
Candy & Gum	$70.9
Funeral Parlors, Crematories, & Death Care Services	$64.2
Residential Utilities Telephone	$58.1
Parking Lots & Garages	$55.7
Other Personal Services	$55.6
Personal Hygiene Products	$52.7
Dry Cleaning & Laundry Services	$39.3
Transit & Ground Transportation	$31.1
Museums, Historical Sites, Zoos, & Parks	$29.7
Caskets & Burial Vaults	$22.1
Volunteer Firemen's Organizations	$16.6
Newspapers	$15.3
Recreational Parks, Camps, & Campgrounds	$14.6
Charitable Organizations	$12.9
Textbooks	$11.9
Firewood	$8.8
Religious Organizations	$8.7
Hotel Permanent Resident	$6.7
Magazines	$6.5
Horses	$2.6
Flags	$1.6
Stair Lift Devices	$0.4
Construction of Memorials	$0.1
Total	**$11,537.8**

Source: Commonwealth of Pennsylvania, Governor's Executive Budget

TABLE 5.5.

Pennsylvania's Tax Treatment of Business Inputs

Exemption	Value in Millions
Manufacturing Exemption	$1,286.7
Advertising, Public Relations, & Related Services	$805.5
Administrative Services	$524.8
Custom Programming, Design, & Data Processing	$398.6
Consulting (Scientific, Environmental, & Technical)	$363.9
Services to Buildings & Dwellings	$257.4
Coal	$127.2
Manufacturing Exemption (Public Utility)	$97.5
Scientific Research & Development Services	$84.0
Specialized Design	$71.8
Information Services	$58.2
Common Carriers	$54.7
Contract Farming	$54.6
Manufacturing Exemption (Agriculture)	$37.6
Rental of Films for Commercial Exhibition	$23.6
Truck Transportation	$19.6
Commercial Vessels (Construction & Repair)	$18.0
Rail Transportation Equipment	$11.4
Commercial Vessels (Equipment & Maintenance)	$5.8
Catalogs & Direct Mail Advertising	$3.5
Manufacturing Exemption (Foundations for Machinery & Equipment)	$2.4
Airline Catering	$0.9
Total	**$4,307.7**

Source: Commonwealth of Pennsylvania, Governor's Executive Budget

TABLE 5.6.

Pennsylvania's Tax Treatment of Transactions Which Can Be Either Business Inputs or Final Consumer Transactions Based on the Identity of the Purchaser

Exemption	Value in Millions
Legal	$677.4
Accounting, Auditing, & Bookkeeping Services	$305.8
Architectural, Engineering, & Related Services	$292.6
Financial Institution Fees	$237.4
Storage	$193.9
All Other Professional & Technical Services	$173.5
Waste Management & Remediation Services	$171.6
Veterinary Fees	$72.5
Other Transportation	$14.3
Aircraft	$5.8
Air Transportation	$3.6
Total	$2,148.4

Source: Commonwealth of Pennsylvania, "Governor's Executive Budget"

Taxation of E-Commerce

The rise of e-commerce also plays a role in the erosion of state sales tax bases. Prior to the U.S. Supreme Court's ruling in *South Dakota v. Wayfair*,[139] retailers were only obligated to collect and remit sales taxes in states in which they had a physical presence, defined as having property or employees within the state. That geographic limitation on the scope of state sales tax authority, defined by the Supreme Court in *Quill v. North Dakota*,[140] became increasingly important as online transactions drove remote sales upward.

The *Quill* decision was handed down in 1992, at what was very nearly the low ebb of consumer remote sales. The great mail order businesses of the twentieth century, like Sears Roebuck, Montgomery Ward, and Bella Hess (itself the subject of a prior Supreme Court ruling on the taxation of remote sales), were either gone or on their last legs, victims of the discount department store chains, while e-commerce was still largely in the future, not yet a meaningful presence on the fledgling World Wide Web. Today, online sales account for nearly 10 percent of all consumer transactions by value—this despite the fact that e-commerce has only begun to make a dent in some of our costliest consumer markets, like the automobile market.[141]

Consumers are, as a point of law, required to pay a compensating use tax on any goods they purchase for which sales tax is not collected. In practice, this requirement is generally observed by businesses but only practiced in the breach by individual taxpayers, few of whom track or pay use tax on transactions where tax was not collected at the point of sale. This creates a disparity in the practical, if not legal, tax treatment of goods purchased online and those purchased in brick-and-mortar stores, and it erodes the sales tax base as

139 *South Dakota v. Wayfair, Inc.*, 585 U.S. ___, slip op. (2018).
140 *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992).
141 Statistics are for sales of personal, not real, property, and thus exclude real estate transactions.

an ever-greater share of purchases are shifted to online retailers.

Keeping the sales tax aligned with the modern economy is important, therefore, both for tax neutrality and tax collections. At the same time, with more than 10,000 sales taxing authorities across the country with widely disparate rates, bases, and collection regimes, the prospect of remitting sales tax in every jurisdiction nationwide is understandably daunting for many businesses, and without some degree of uniformity, perhaps even prohibitive. States, then, were not only constrained by law, but also by the need to avoid imposing incredibly high compliance costs on retailers.

Limits of the Use Tax

Use taxes were enacted as complements to sales taxes not long after the introduction of the latter. While the sales tax is collected at point of sale, the use tax is a liability incurred for consumption of a good or service on which sales tax has not been collected. Use taxes were introduced in large part to address the concern that taxpayers would avoid state sales taxes by purchasing goods in states with lower sales tax rates, or none at all. The obligation to remit use taxes eliminates any advantage of cross-border (or online) shopping, at least in theory.

However, because the use tax is self-reported, use tax compliance remains very low except for large purchases or business purchases potentially subject to a state audit. Efforts in many states–including Pennsylvania–to enhance collections by including a use tax payment line on income tax forms have increased collections only modestly, if at all.[142] While a growing number of large retailers now collect sales taxes in most or all states, increasing overall collections, self-reporting of untaxed transactions is not a viable solution for collecting the remaining use tax owed.

An Increased Push to Tax Internet Services

Americans spent about $453.5 billion in internet retail purchases in 2017, representing a 16 percent increase over the previous year and comprising about 8.9 percent of total retail sales.[143] This growth rate has been fairly steady, and it is likely that e-commerce will continue to grow as a share of national retail sales. In the aftermath of the *South Dakota v. Wayfair* decision, moreover, it is economic activity that states are increasingly likely to tax.

While revenue is undoubtedly the single largest reason for state interest in taxing internet sales, tax neutrality is also an important consideration. There is no good reason why the same good or service should be untaxed if purchased online but taxed if purchased in a brick-and-mortar store. The tax, moreover, should be based on the consumer's

142 About half the states now include a use tax payment line on their income tax form, with some states offering an exclusion for purchases under a certain threshold or a lookup table where taxpayers can remit an amount based on their income rather than tracking all purchases throughout the year. See Nina Manzi, "Use Tax Collection on Income Tax Returns in Other States," Minnesota House of Representatives Research Department Policy Brief, April 2015, http://www.house.leg.state.mn.us/hrd/pubs/usetax.pdf.

143 U.S. Census Bureau, "Quarterly Retail E-Commerce Sales 1st Quarter 2018," May 17, 2018, https://www.census.gov/retail/mrts/www/data/pdf/ec_current.pdf. This percentage continues to rise, and hit 9.5 percent of total sales in the first quarter of 2018, compared to 8.5 percent in the first quarter of 2017.

location, not the seller's. The sales tax is not intended as a tax on business utilization of state or local services; that is the role of property and other taxes levied on business facilities. Sales taxes, rather, are collected on consumption, and are intended to be levied where a good or service is consumed—regardless of where the transacting company is located. In public finance parlance, sales taxes are *destination-based*, not *origin-based*. The discrepancies resulting from the current system improperly favor online purchases over purchases made at traditional retail establishments.

Prior to the *Wayfair* decision, state sales taxing authority was generally limited to individuals and businesses within the state's borders. States have become increasingly creative, not to say aggressive, in their efforts to increase the share of taxed transactions. Some probed the limits of the *Quill* decision, while others have effectively ignored it, inviting challenges.

Some have adopted "click-through nexus" or "cookie nexus" statutes, which assert that when a retailer's website deposits a "cookie" (locally-stored data with information about the user) on a consumer's computer, the presence of that file on an in-state computer establishes physical presence. Others have adopted "affiliate nexus," requiring out-of-state retailers to collect sales tax if any of their affiliates–including individuals compensated for "referral" links–have a physical presence in the state.[144] And still others have pursued "marketplace sales," obligating any company which itself has nexus to collect and remit sales tax for any businesses that use its sales platform, even if those businesses would not have physical presence in the state on their own.

Then there are states which dispensed with physical presence altogether, even while *Quill* was still good law, adopting what is known as "factor presence," by which a retailer must collect sales taxes if it meets certain thresholds, even in the absence of any physical presence in the state. Under *Wayfair*, substantial nexus can be achieved without a physical presence in the state, provided that the state's approach to collecting tax on remote sales does not impermissibly burden interstate commerce.

Finally, several states, led by Colorado, have begun requiring remote sellers to notify both purchasers and the state of any in-state sales. The retailer is not obliged to collect the tax, but must expend time and resources notifying customers of their obligation, and to report that transaction to state tax authorities, who may act on it. Because this approach ties a particular taxpayer to specific transactions, it also raises privacy concerns. The state may not know the specific good or service purchased, but it would be apprised of the fact that a taxpayer made purchases of a certain amount at a specific, named retailer—information which some may prefer not to have disclosed.

These types of laws are problematic because they're nonneutral, only applying to certain online retailers. Further, they can discourage companies from locating distribution facilities or other operations in states with such laws, and in some cases can be triggered by *de minimis* contact with a state (e.g., the presence of an affiliate, or even of a website visitor).

144 Joseph Bishop-Henchman, "The Marketplace Fairness Act: A Primer," Tax Foundation, July 14, 2014, http://taxfoundation.org/article/marketplace-fairness-act-primer.

Even in the new, post-*Wayfair* environment, not all state laws are likely to make the cut. The Supreme Court established that a business can have substantial nexus in a state without establishing a presence there, with the majority commenting favorably upon safeguards built into the South Dakota statute. It is not necessarily the case that depositing a cookie on a shopper's computer constitutes substantial nexus, or that marketplace sales are automatically covered if the marketplace facilitator is within the state's taxing jurisdiction, for instance. These issues and others may yet be litigated.[145]

In Pennsylvania, Act 43 of 2017 requires certain marketplace facilitators, remote sellers, and referrers to either collect and remit the sales tax that is due on taxable sales within the state, or elect to notify their customers that use tax may be due and report certain customer information to the state.[146] The requirements apply to those businesses which have no place of business within the state and have had aggregate taxable sales in Pennsylvania worth at least $10,000 in the prior 12 months. Effectively, this gives retailers a choice of abiding by factor presence or taking on the expense of reporting. Both options burden e-commerce, and while reporting requirements have yet to be litigated, their constitutionality is somewhat murky.

Fortunately for retailers electing to collect Pennsylvania sales taxes, the state sales tax regime is a relatively simple one for compliance purposes, with only two local rates and a uniform statewide base. With the Court's decision in *Wayfair*, Pennsylvania has a clear opportunity to expand its sales tax collections, though the success of Act 43 remains a matter of some uncertainty. Pennsylvania starts in a good place, with few local option sales taxes and a uniform tax base, but additional steps–including joining the Streamlined Sales and Use Tax Agreement and establishing a *de minimis* threshold under which sellers need not remit–could bolster the state's case.

145 *South Dakota v. Wayfair, Inc.*
146 Pennsylvania Department of Revenue, "Sales and Use Tax Bulletin 2018-01," Jan. 26, 2018, http://revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/TaxBulletins/SUT/Documents/st_bulletin_2018-01.pdf.

Sales Tax Solutions

A well-structured sales tax applies to all final consumer purchases, both goods and services, while exempting business inputs. Currently, the Pennsylvania sales tax specifically exempts a significant number of consumer transactions which, if included in the base, would permit substantial rate reductions.

Among existing exemptions of consumer goods, the groceries exemption is the largest, worth $1.5 billion in fiscal year 2019. If food for home consumption were included in the sales tax base, the state sales tax rate could decline from 6.0 to 5.25 percent, retaining revenue neutrality. Many other exemptions also contribute to the erosion of the sales tax base, yielding higher rates than would otherwise be necessary.

Lawmakers should also consider expanding the sales tax base to include additional consumer goods and services, while exempting business inputs. Table 5.7 shows four options for base broadening, where Option A adds a few additional consumer transactions to the sales tax base, and Option D is the broadest, adding a wide range of goods and services.

When services could constitute either a final consumer transaction or a business input, depending on the identity of the final purchasers, the state should either define the categories in such a way as to exclude business inputs or, preferably, provide a mechanism by which business purchases are exempted, in much the same way as purchases by nonprofits are exempted in many states. For purposes of these calculations, services which frequently constitute business-to-business transactions have their value prorated based on estimates of the business share of purchases in given industry categories.[147] For instance, the exemption for legal services forgoes an estimated $677 million, but only 29 percent of that value is associated with final transactions, yielding $196 million potentially available under sales tax base broadening.

In outlining these options, we do not attempt to quantify the political considerations that are bound to accompany any discussion of base broadening. Providing a few base-broadening options allows lawmakers to decide how broad they would like to make the sales tax base, while still accounting for other policy considerations.

147 Robert Cline, John Mikesell, Tom Neubig, and Andrew Phillips, *Sales Taxation of Business Inputs: Existing Tax Distortions and the Consequences of Extending the Sales Tax to Business Inputs*, Council on State Taxation, Jan. 25, 2005, 10, http://www.ncsl.org/documents/standcomm/sccomfc/Business-Inputs-Study.pdf.

TABLE 5.7.

Sales Tax Base Expansion Options

Good or Service	Revenue	Option A	Option B	Option C	Option D
Amusements & Recreation	$378.4M	✓	✓	✓	✓
Personal Care Services	$208.2M	✓	✓	✓	✓
Spectator Sports Admissions (Excludes Schools)	$79.0M	✓	✓	✓	✓
Veterinary Services	$72.5M	✓	✓	✓	✓
Candy & Gum	$70.9M	✓	✓	✓	✓
Parking Lots & Garages	$55.7M	✓	✓	✓	✓
Dry Cleaning & Laundry Services	$39.3M	✓	✓	✓	✓
Gasoline & Motor Fuels	$951.8M		✓	✓	✓
Clothing & Footwear	$844.1M		✓	✓	✓
Household Utilities	$654.2M		✓	✓	✓
Nonprescription Drugs	$143.5M		✓	✓	✓
Funeral & Burial Services	$86.3M		✓	✓	✓
Food	$1,524.6M			✓	✓
Legal Services	$196.4M			✓	✓
Accounting Services	$88.7M			✓	✓
Physician & Dental Services	$1,454.8M				✓
Hospitals	$1,241.1M				✓
Prescription Drugs & Orthopedic Equipment	$1,034.6M				✓
Tuition (College, Vocational Training, & Instruction)	$902.0M				✓
Home Health & Nursing Care	$490.3M				✓
Financial Institution Fees	$237.4M				✓
Health & Social Assistance Organizations	$164.6M				✓
Nonprofit Educational Institutions	$87.3M				✓
Total Revenue Increase		**$0.90B**	**$3.58B**	**$5.39B**	**$11.00B**

Sales tax base broadening could be used to pay down sales tax rate reductions or other reforms elsewhere in the tax code, or both. If the base broadeners in Option A were used to pay down a roughly revenue-neutral state sales tax rate reduction from 6.0 to 5.5 percent, Pennsylvania would improve from 26th to 24th overall on our *State Business Tax Climate Index*, and from 21st to 19th on the sales tax component. A revenue-neutral implementation of Option B, which would yield a state rate of 4.5 percent, would yield an overall rank of 20th and a rank of eighth on the sales tax component, third-best among states with a statewide sales tax. Using the revenue to pay down other reforms could yield even more dramatic results on the *Index*.

Business Input Exclusion

Pennsylvania policymakers have long recognized the importance of excluding business inputs from the sales tax base to avoid tax pyramiding, but little progress has been made in expanding the scope of these important exemptions. At least 27 categories of services currently taxed in the Commonwealth as classified by the Federation of Tax Administrators, ranging from welding to industrial utilities, are business inputs.

Either specific exemptions should be written for goods and services likely to constitute business inputs, or businesses should be granted the ability to claim an exemption from the sales tax for all business purchases. Many states allow nonprofit organizations to make sales tax-exempt purchases. Similar provision could be made for business purchases to avoid taxation of business inputs without attempting to ascertain which goods and services are likely to constitute business-to-business transactions.

CHAPTER 6

OTHER STATE TAXES

Introduction

In this short chapter, we review three other smaller yet still important taxes in Pennsylvania: unemployment compensation taxes, environmental impact fees, and the motor fuel tax. The state's impact fee is imposed on Pennsylvania's burgeoning natural gas industry. We classify it as a state revenue source as it is primarily levied and collected by state government, but most of the revenue is disbursed to local governments. We consider it a tax, despite its "fee" nomenclature, because its formula relies on natural gas prices, a consideration which would be irrelevant for a true fee. Properly speaking, fees pay for specific services or offset specified costs, while taxes have a more general goal of revenue generation. A true fee would not vary based on the price of natural gas.

Pennsylvania's motor fuel tax is, at present, the highest gas tax in the country, though recent developments in California give it serious competition. And the state's unemployment compensation taxes have anomalously high rates and score worst in the country on our *State Business Tax Climate Index*.

Environmental Impact Fee

In the Devonian epoch, a layer of dense black rock shale formed beneath a primordial ocean. In a rather more recent epoch, innovations in the oil and gas industry permitted the economical extraction of natural gas in this low-permeability Marcellus Shale layer, which stretches from New York to West Virginia, and includes over half of Pennsylvania. Suddenly, the state which boasted the first commercial oil well is back on the map for resource extraction as hydraulic fracturing ("fracking") opened the Commonwealth's vast natural gas fields.

By 2016, Pennsylvania was producing 5.3 trillion cubic feet of natural gas a year, with production behind only Texas (at 7.2 trillion cubic feet a year), more than doubling the production of the third-largest natural gas state, Oklahoma.[148] Almost overnight, Pennsylvania became a major energy state.

In 2017, Pennsylvania accounted for 19 percent of total U.S. marketed natural gas production, this from an industry that was almost nonexistent in the Commonwealth until 2009.[149] A later decline in natural gas prices idled many wells, and the Commonwealth's industry, based on a comparatively high-cost extraction method, can be quite volatile. However, there can be little question that access to the Marcellus changes Pennsylvania's energy profile for the long term.

If fracking technology opened new natural gas pools, it also opened a new political conversation, as at the time, the new industry made Pennsylvania the only state with meaningful oil or natural gas production which lacked a severance tax.[150] Critics of

148 U.S. Energy Information Administration, "Rankings: Natural Gas Marketed Production, 2016," https://eia.gov/state/rankings/?sid=PA#series/47.

149 U.S. Energy Information Administration, "Pennsylvania's Natural Gas Production Continues to Increase," April 23, 2018, https://eia.gov/todayinenergy/detail.php?id=35892.

150 The Council of State Governments, "The Book of the States 2017," 371, http://knowledgecenter.csg.org/kc/system/files/7.15.2017.pdf.

Pennsylvania's approach to taxing the emergent natural gas industry argue that this is still the case, though important to any such analysis is the implementation, in 2012, of an environmental impact fee on natural gas production, which is economically quite similar to a severance tax.[151]

The traditional justification for severance taxes is the need to offset the costs of resource extraction, from infrastructure to environmental reclamation. In practice, however, such taxes are rarely calibrated to the externalities of resource extraction, tending to have a general revenue component as well.[152] From a public finance standpoint, there can be compelling arguments for addressing unique costs associated with specific industries, but once those costs have been covered, there is little justification for additional nonneutral taxation of targeted industries above and beyond the taxes imposed on other industries.

Severance taxes come in all shapes and sizes. Many are volume-based, assessed based on the amount of oil or gas extracted. Others are based on gross or net income, wellhead prices, or spot prices on a specified futures market (like Henry Hub for natural gas). They can encompass such factors as the age, type, and productivity of wells, called "spuds." Often, revenues flow to state government; sometimes they are shared with local governments.

In Pennsylvania, the environmental impact fee is imposed on unconventional natural gas wells, which captures the vast majority of natural gas production in Pennsylvania. It is calculated on the basis of two factors: the average natural gas price (determined annually) and the age of each well. Fees rise with ability to pay, based on higher natural gas prices, and are reduced according to the life of the spud.[153] This is because the cost of extraction tends to rise as a well gets older, and the state has an interest in seeing spuds exhausted rather than promoting drilling a spate of new ones while further recovery is possible in existing wells. Fees are suspended for marginal wells, often called "stripper wells," after three years.

Every state has a different approach to taxing oil and natural gas production, but Pennsylvania's structure, though styled an impact fee, falls largely within the parameters of what other states call a severance tax. Where it differs from a traditional severance tax, if such a thing can be said to exist, is that it is imposed on a per-well basis, using a fee schedule intended to approximate extraction volume and revenue, rather than falling on the extraction itself. The distinction is not inconsequential, but severance tax proposals percolating in Pennsylvania represent an effort to double-tax the industry, layering a severance tax atop an existing tax on natural gas production.

151 58 Pa.C.S.A. § 2302.
152 Jacquelyn Pless, "Oil and Gas Severance Taxes: States Work to Alleviate Fiscal Pressures Amid the Natural Gas Boom," National Conference of State Legislatures, February 2012, http://ncsl.org/research/energy/oil-and-gas-severance-taxes.aspx.
153 Angela Pachon and Dillon Weber, "A Tale of Two Taxes: Impact Fee and the Severance Tax in Pennsylvania," Kleinman Center for Energy Policy, Sept. 2, 2015, https://kleinmanenergy.upenn.edu/policy-digests/tale-two-taxes.

TABLE 6.1.
Impact Fee by Natural Gas Price and Spud Age

Year(s)	$0.00 - $2.25	$2.26 - $2.99	$3.00 - $4.99	$5.00 - $5.99	$6.00 and up
1	$40,000	$45,000	$50,000	$55,000	$60,000
2	$30,000	$35,000	$40,000	$45,000	$55,000
3	$25,000	$30,000	$30,000	$40,000	$50,000
4 - 10	$10,000	$15,000	$20,000	$20,000	$20,000
11 - 15	$5,000	$50,000	$10,000	$10,000	$10,000

Source: Act 13 of 2012

Pennsylvania's impact fees are collected at the state level, but overwhelmingly benefit local governments. A little over $25 million is taken "off the top" and allocated to state agencies with costs associated with fracking,[154] with the remaining funds divided between an Unconventional Gas Well Fund and a Marcellus Legacy Fund, both of which are distributed to counties and municipalities with natural gas wells.[155] Local governments also have the right to adopt local option impact fees.

Sixty percent of collections after the moneys earmarked for state agencies are deposited into the Unconventional Gas Well Fund, with revenues to be used by counties for designated purposes like infrastructure, storm water management, public safety, environmental programs, delivery of social services, and tax reductions, among other qualifying purposes.[156] The list is not unlimited, but it is broad enough to be functionally unrestricted, since localities will always have enough expenditures in these areas to which impact fee revenues can be applied. The remaining 40 percent is deposited into the Marcellus Legacy Fund, which goes toward highway bridge improvement and certain environmental initiatives.[157] A portion of the fund's distributions are to counties without wells within their borders.[158]

Because they are imposed on wells rather than extraction, impact fees can over-collect in years when producers drill new wells, even though these wells may not all be producing at scale, while under-collecting when producers focus on their existing wells, even if production is high. For instance, Pennsylvania collected $173.3 million in impact fees in 2016, which represented a decline from the prior year even though production increased by 11 percent, the product of lower prices and a decline in the number of new wells drilled.[159] Collections increased to $209.6 million in 2017.[160] However, this system has also resulted in less volatility than might have been experienced under a traditional severance tax regime.

154 Designated agencies include the Department of Environmental Protection, the State Conservation Commission, the Public Utility Commission, the Emergency Management Agency, and the Office of the State Fire Commissioner, among others.
155 Pennsylvania Public Utility Commission, "Impact Fee Distributions to State & Local Governments," http://www.puc.state.pa.us/filing_resources/issues_laws_regulations/impact_fee_collection/impact_fee_distribution_state_local_gov.aspx.
156 Pennsylvania Public Utility Commission, "Unconventional Gas Well Fund Usage Report," http://www.puc.state.pa.us/NaturalGas/doc/Act13/Act13_Usage_Report.docx.
157 Pennsylvania Department of Community & Economic Development, "Act 13 Programs: Marcellus Legacy Fund," https://dced.pa.gov/programs-funding/commonwealth-financing-authority-cfa/act-13-programs/.
158 Pennsylvania Public Utility Commission, "Impact Fee Distributions to State & Local Governments."
159 Jamison Cocklin, "Pennsylvania Impact Fees Forecast to Increase for First Time in Three Years," *NGI's Shale Daily*, July 21, 2017, http://naturalgasintel.com/articles/111168-pennsylvania-impact-fees-forecast-to-increase-for-first-time-in-three-years.
160 Public Utility Commission, "Act 13 Disbursements and Impact Fees," https://www.act13-reporting.puc.pa.gov/Modules/PublicReporting/Overview.aspx.

TABLE 6.2.
Impact Fee Revenue Distributions by Year[161]

Year	Amount
2012	$204.2 million
2013	$202.5 million
2014	$225.8 million
2015	$223.5 million
2016	$187.7 million
2017	$173.3 million
Total	$1.22 billion

Source: Pennsylvania Public Utility Commission, "Act 13 Impact Fee Distribution"

Proponents of severance taxes have sometimes sold them as a solution to declining collections, but that has not been the reality for states with those taxes. In Pennsylvania, impact fee revenues declined 22.5 percent between 2014 to 2016, while in neighboring West Virginia, the state's collections from natural gas severance taxes decreased by 38.8 percent.[162] Declining prices hit West Virginia's severance tax much harder than Pennsylvania's impact fee.

Relatedly, state projections of revenue from a proposed severance tax come with significant caveats, because proposals have been based on gross revenue, not volume. By definition, revenue is harder to calculate, as it requires estimates of production *and* natural gas prices in the out years. This is easier said than done. In April 2017, the governor's office estimated a 2017 Henry Hub spot price of $3.42 per thousand cubic feet, which formed the basis for their revenue projections. The actual price that year was $2.99.[163] For 2018, they estimated $3.43, but at the time of this writing, actual prices are lower than they were at the same point in 2017.[164]

If Pennsylvania's impact fee differs from the approach of other states, so does the impact of the rest of the state's tax structure on the natural gas industry. Texas, the state with the largest natural gas industry, forgoes individual and corporate income taxes.[165] Pennsylvania, by contrast, has the second-highest corporate income tax rate in the country, and by far the highest among oil or natural gas states. The state's punitive treatment of capital investment and stingy approach to net operating losses excessively burdens a highly volatile and capital-intensive industry.

In short, while the impact fee is not as aggressive as the severance taxes imposed by some peer states, it exists within an unusually unattractive tax environment for extractive industries. Imposing a new tax or converting the existing tax into a more aggressive severance tax could be a serious hindrance to an important new industry.

161 Pennsylvania Public Utility Commission, "Act 13 Impact Fee Distribution," multiple years, https://www.act13-reporting.puc.pa.gov/Modules/Reports/ReportViewer.aspx?rptPath=/Act%2013/DisbursementsReport.
162 West Virginia Department of Revenue, "Severance Taxes: Tax Data, Fiscal Years 2004 Through 2016," https://tax.wv.gov/Documents/Reports/SeveranceTaxes.TaxData.FiscalYears.2004-2016.pdf.
163 Federal Reserve Bank of St. Louis, "Henry Hub Natural Gas Spot Price," May 31, 2018, https://fred.stlouisfed.org/series/AHHNGSP.
164 U.S. Energy Information Administration, "Henry Hub Natural Gas Spot Price," https://eia.gov/dnav/ng/hist/rngwhhdM.htm.
165 The state does levy the Franchise (or Margins) Tax, a gross receipts tax, but its impact on resource industries is modest.

Motor Fuel Tax

Pennsylvania's gas tax was overhauled in 2013, with structural changes yielding substantial rate increases. Today, Pennsylvania's tax is the highest in the nation at 58.7 cents per gallon, with only California (54.73 cents per gallon) coming close to matching it. It is nearly 75 percent higher than the national average of 33.72 cents.[166] Pennsylvania is one of three states (with Kentucky and Virginia) to calculate its gas tax as a percentage of the wholesale price of gasoline.[167]

Until 2014, the Commonwealth's motor fuel tax consisted of three components: (1) a flat per-gallon levy under the Liquid Fuels Tax Act (LFTA); (2) an Oil Company Franchise Tax (OCFT), calculated as a percentage of the wholesale price of gasoline (with a fuel price ceiling of $1.87 per gallon); and an Underground Storage Tank Indemnification Fund (USTIF) fee, intended to cover environmental mitigation costs for leaking underground tanks.[168] In the final year of the old system, the aggregate gas tax stood at 32.3 cents per gallon (or 34.6 cents in inflation-adjusted terms).

TABLE 6.3.

Pennsylvania Gas Tax Rate History (in cents per gallon)

Year	LFTA	OCFT	USTIF	Total	Year	LFTA	OCFT	USTIF	Total
1921	1.00	0.00	0.00	1.00	1994	12.00	10.35	2.00	24.35
1923	2.00	0.00	0.00	2.00	1996	12.00	10.35	1.00	23.35
1927	3.00	0.00	0.00	3.00	1998	12.00	13.90	0.50	26.40
1929	4.00	0.00	0.00	4.00	1999	12.00	13.90	0.10	26.00
1930	3.00	0.00	0.00	3.00	2000	12.00	13.90	0.05	25.95
1935	4.00	0.00	0.00	4.00	2001	12.00	14.00	0.05	26.05
1949	5.00	0.00	0.00	5.00	2002	12.00	14.60	0.10	26.70
1955	6.00	0.00	0.00	6.00	2003	12.00	13.90	1.00	26.90
1957	5.00	0.00	0.00	5.00	2004	12.00	14.20	1.10	27.30
1961	7.00	0.00	0.00	7.00	2005	12.00	18.00	1.10	31.10
1970	8.00	0.00	0.00	8.00	2006	12.00	19.20	1.10	32.30
1974	9.00	0.00	0.00	9.00	2014	0.00	40.70	1.10	41.80
1979	11.00	0.00	0.00	11.00	2015	0.00	50.40	1.10	51.50
1981	11.00	3.15	0.00	14.15	2016	0.00	50.40	1.10	51.50
1983	12.00	5.40	0.00	17.40	2017	0.00	58.20	1.10	59.30
1991	12.00	10.35	0.00	22.35	2018	0.00	57.60	1.10	58.70

Sources: U.S. Highway Administration; Pennsylvania Department of Revenue; Tax Foundation research

Since then, the Liquid Fuels Tax Act levy has been eliminated and the Oil Company Franchise Tax's ceiling was phased out, replaced with a floor of $2.99 a gallon.[169] The USTIF, currently at 1.1 cents per gallon, is unchanged. Combined with the calculated Oil Company Franchise Tax rate of 57.6 cents in 2018, the overall rate now stands at 58.7 cents per gallon.

166 American Petroleum Institute, "State Motor Fuel Tax Rates," April 1, 2018, http://www.api.org/~/media/Files/Statistics/State-Motor-Fuel-Notes-Summary-Apr-18.pdf.

167 Transportation Investment Advocacy Center, *Variable-Rate State Gas Taxes: A Resource Guide of Current Laws*, February 2015, 2, https://artba.org/wp-content/uploads/2015/02/Variable-Rate-State-Gas-Tax-Report.pdf.

168 Id., 12.

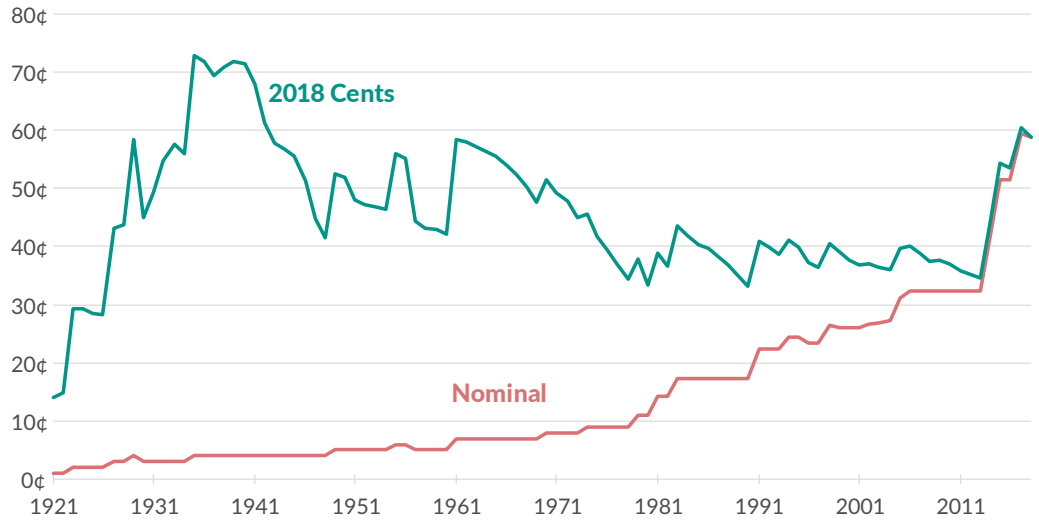
169 Even if gas prices fall below $2.99 per gallon, that price is used to determine Pennsylvania's rate.

In most states, tax collections decline in real terms over time. This is because state motor fuel taxes are typically imposed as an excise of a given amount per gallon and tend not to be indexed for inflation. Because Pennsylvania's gas tax is tied to the average annual wholesale price, it does not suffer from that shortcoming. Since 2014, the entirety of Pennsylvania's gas tax (less the 1.1 cent per gallon underground storage tank fee) is indexed to inflation.

FIGURE 6.1.

Pennsylvania Motor Fuel Tax Rates

Nominal and Real Rates, 1921-2018



Source: Pennsylvania Department of Revenue.

Unemployment Compensation Taxes

Pennsylvania's unemployment compensation tax regime ranks worst in the nation on our *State Business Tax Climate Index*, reflecting high rates and an uncompetitive structure. By contrast, two neighboring states rank in the top 10. Unemployment compensation taxes are unique, as rates are computed for each company based on their characteristics, rather than being applied at a uniform rate (or rate schedule) against all businesses.

TABLE 6.4.

State Business Tax Climate Index Unemployment Insurance Tax Component Rankings

Pennsylvania and Regional Competitors (2018)

State	Component Ranking
Pennsylvania	50th
Delaware	3rd
Maryland	24th
New Jersey	36th
New York	30th
Ohio	8th
West Virginia	28th

Source: Tax Foundation, *2018 State Business Tax Climate Index*.

Every year, a contribution tax rate is computed for each employer. The tax is not levied on all compensation, but on the taxable wage base—presently $10,000. The use of a taxable wage base is a standard part of unemployment compensation tax structures, since unemployment benefits are capped and do not rise indefinitely with wages.

For new employers, a basic contribution rate is applied—3.6890 percent at the time of this writing, except in the construction industry, where the rate is 10.2238 percent. These rates include a surcharge adjustment which is currently in effect.[170] After a company has an established employment history, the contribution rate is adjusted based on six components.[171] If a company only has a sporadic employment record, it is moved to a "standard rate," currently set at 7.2916 percent for employers with positive reserve account balances and 11.2968 percent for those with negative reserve account balances.

170 Pennsylvania Department of Labor & Industry, "Types of Rates," Employer UC Services/UC Tax, http://www.uc.pa.gov/employers-uc-services-uc-tax/uc-tax-rates/Pages/Types-of-Rates.aspx.

171 The six components are the reserve ratio, benefit ratio, state adjustment, additional contributions, interest factors, and the surcharge adjustment.

All this needs to be unpacked.

A company subject to a calculated rate is said to be "experience rated," and since this yields a better calibration of taxes and benefits, states with shorter periods before new companies are experience rated are generally seen as having superior tax structures. In Pennsylvania, the time period before a company can be experience rated is 18 months.

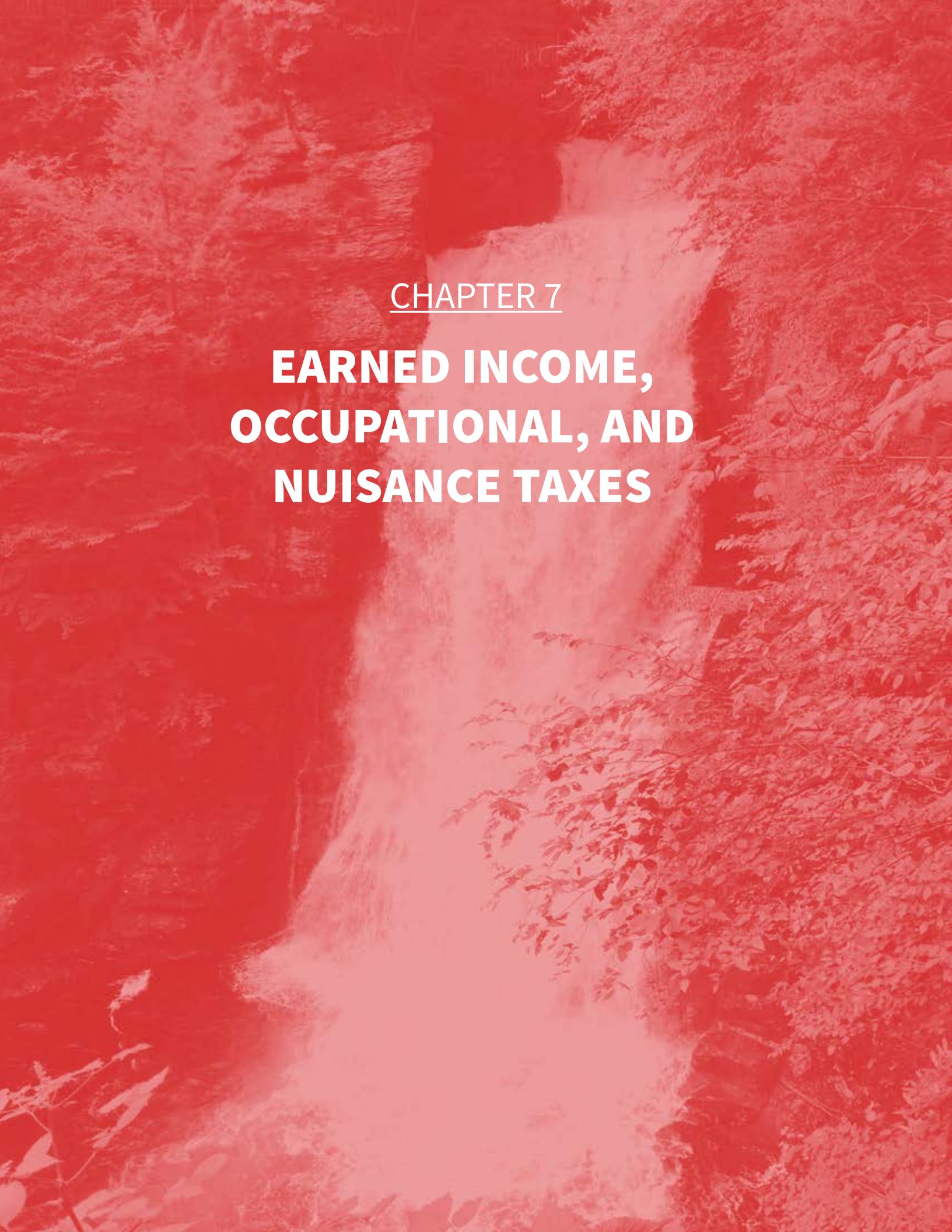
A company's lifetime risk with unemployment is indicated by its reserve ratio, calculated by dividing its reserve account balance (the total lifetime contributions less benefits charged to the employer's account) by its average annual taxable payroll for the prior three fiscal years. Companies with higher (better) reserve ratios face lower tax rates. The benefit ratio, meanwhile, is a shorter-term comparison of an employer's taxable payroll to the benefits charged against the employer's account.[172]

Other factors serve to ratchet up liability–even for employers with solid track records–based on the state of the economy and the solvency of the unemployment compensation fund. If the Commonwealth is forced to borrow from the federal government to make payments, moreover, businesses in Pennsylvania are responsible for an additional "interest factor." Surcharges and solvency measures are understandable, but they are also an admission of a program's shortcomings. It would be far better if states accumulated reserves in prosperous years than if they relied on hiking rates just as businesses are struggling to make payroll.

Pennsylvania's maximum weekly benefit amount is 40 percent higher than New York's,[173] and to pay for it, the Commonwealth's average effective rate on wages–not just on the taxable wage base–is third-highest in the country, at 1.17 percent of total wages.[174] Pennsylvania's minimum rates are the highest in the country, and the maximum rates are among the highest.

A well-structured unemployment compensation system prioritizes stability; by contrast, with its solvency tax layered atop a surtax, Pennsylvania's system follows, rather than anticipates, the business cycle. The Commonwealth's rates are high enough during an up economy; during a downturn, the even higher rates impose heavy burdens on the very businesses that are struggling to avoid layoffs. Policymakers would do well to rebalance rates, benefits, and structure to make the system more competitive.

172 Pennsylvania Department of Labor & Industry, "Computation of Rates," http://www.uc.pa.gov/employers-uc-services-uc-tax/uc-tax-rates/Pages/Computation-of-Rates.aspx.
173 National Foundation for Unemployment Compensation & Workers' Compensation, *Highlights of State Unemployment Compensation Laws*, 2018, 54.
174 Id., 36.



CHAPTER 7

EARNED INCOME, OCCUPATIONAL, AND NUISANCE TAXES

Introduction

No review of Pennsylvania's tax code is complete without diving into the complexities of local taxation. The Commonwealth's mosaic of taxing jurisdictions, its elected local tax collectors, its heavy reliance on not one but three different taxes on real property, its panoply of outmoded taxes, and the degree to which many of the least competitive features of local taxation are steered by the state legislature make local taxes a fitting subject of exploration.

Broadly speaking, there are three sources of statutory authority for local taxes in Pennsylvania: codes specifically written for a specific level of government (the county, municipal, and school codes), general enabling acts (like the Local Tax Enabling Act and the Sterling Act), and single-purpose statutes authorizing a particular tax (like the Municipalities Financial Recovery Act).[175]

These three sources of tax authority, however, only scratch the surface of local tax complexity, driven in substantial degree by the structure of local government in Pennsylvania. The Commonwealth's 67 counties host a veritable salmagundi of 2,560 "municipal corporations"[176]–cities, townships, and boroughs–which are further subdivided into classes, each with a unique grant of authority. A municipality's class is largely dependent upon its population, but its form is not: the smallest city, Parker, has a population of 820,[177] while Upper Darby Township is Pennsylvania's sixth most populous municipality, with a population of 82,629.[178]

Adding to what even state documents refer to as a "mosaic" of local governing bodies are 500 school districts and 1,546 active authorities.[179] Counties, school districts, and municipal corporations possess tax authority, while local authorities are limited to imposing user fees and special assessments.[180] These special assessments, which can take the form of a lien against real estate based on an assessment of benefit derived from a public improvement,[181] are legally distinct from property taxes, but that distinction may be lost on those obligated to pay them.

175 Pennsylvania Department of Community and Economic Development, "Taxation Manual," June 19, 2018, 2, https://dced.pa.gov/download/taxation-manual/.
176 As of 2016. Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 5th ed. (Harrisburg, PA: General Assembly of the Commonwealth of Pennsylvania, 2017), 7-8, http://www.lgc.state.pa.us/deskBook.cfm.
177 U.S. Census Bureau, "City and Town Population Totals: 2010-2016," April 2018, https://www.census.gov/data/tables/2016/demo/popest/total-cities-and-towns.html.
178 Id.
179 Pennsylvania Department of Community and Economic Development, "Citizen's Guide to Pennsylvania Local Government," 11th ed., March 23, 2018, 1, https://dced.pa.gov/download/citizens-guide-to-pennsylvania-local-government-pdf/.
180 Pennsylvania Department of Community and Economic Development, "Municipal Authorities in Pennsylvania," 10th ed., June 4, 2018, 2, https://dced.pa.gov/download/municipal-authorities-in-pennsylvania/.
181 Pennsylvania Department of Community and Economic Development, "Special Assessments," Presentation to the Pennsylvania CD&H Practitioners Annual Conference, March 21, 2017, 4, https://dced.pa.gov/download/special-assessments/?wpdmdl=72097.

Pennsylvania's Multitiered System of Local Government

Counties are divided into nine subgroupings on the basis of population. Only Philadelphia, a consolidated city-county, is a county of the first class (population of 1.5 million or more), while counties of the eighth class are those with populations less than 20,000. Adding to the complexity, second class counties are broken out into those of the Second Class (800,000 to 1,499,999) and the Second Class A (500,000 to 799,999), and some counties which, on the basis of population alone, should be of the seventh class may, by ordinance or resolution, self-designate into the sixth class. To change classes based on population change, the population change must persist across two censuses and be certified by the governor.[182]

Different classes confer different tax authority, with Philadelphia in particular, as the sole city and county of the first class, granted unique tax powers under the Sterling Act.[183] Allegheny County, in which the city of Pittsburgh is located, is the only county of the Second Class, though three others (Bucks, Delaware, and Montgomery) are counties of the Second Class A.

Cities are divided into four groups based on total population–three classes, again with two tiers in the second class–while there are two classes of township, based not on total population but rather on population density and voter approval.[184] Boroughs are not segregated into classes, though they can adjust the number of council members on the basis of population.[185]

This unique patchwork matters because taxation in Pennsylvania is significantly a local affair, and each form and class of municipal government is entitled to different forms of government and divergent legal authority, including tax authority. Tax collectors are elected and are responsible for municipal and school district property taxes–often county property taxes as well–along with certain other business and personal taxes.[186] They are not, however, responsible for earned income or net profits taxes, which are under the purview of a tax collection committee.[187]

182 "Pennsylvania Municipalities: In a Class by Themselves," *Pennsylvania Township News*, March 2007, 2-3, http://www.psats.org/ckfinder/userfiles/files/today_About_PA_Municipalites[1].pdf.
183 53 P.S. § 15971 et seq.
184 *Pennsylvania Township News*, 4.
185 Id., 5.
186 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 151.
187 Id., 148

Home Rule vs. Dillon's Rule

Local governments have the authority to break out of some of these constraints by adopting home rule. Under home rule, they are relieved of the requirements of the municipal code and may instead adopt their own charter with voter approval, subject only to the restrictions imposed by state law generally. Alternatively, localities may embrace an "optional plan" under which the jurisdiction is still subject to the municipal code pertinent to its form, but with certain alterations.[188]

Local taxation in Pennsylvania consists of real and personal property taxes (imposed at three levels), earned income and net profits taxes, business privilege taxes, per capita taxes, real estate transfer taxes, local services taxes, and more.

Outside of home rule jurisdictions, Dillon's Rule prevails. The rule, named after Judge John Dillon, narrowly proscribes the power of local governments. According to Judge Dillon, "Municipal corporations owe their origin to, and derive their powers and rights wholly from, the legislature. It breathes into them the breath of life, without which they cannot exist. As it creates, so may it destroy. If it may destroy, it may abridge and control."[189] And if municipalities are creations of the state, they operate at the state's pleasure.

In 1870, in the cased of *Philadelphia v. Fox*, the Supreme Court of Pennsylvania adopted Dillon's Rule as operative in the Commonwealth,[190] and it remains so in the "code" jurisdictions. Unless a local government adopts home rule (an innovation that came to Pennsylvania after the court's ruling[191]) or operates under an optional form of government, it may only act where the state makes an express grant of authority to do so. By contrast, home rule jurisdictions may generally act unless otherwise constrained by law, though they may only impose taxes on subjects of taxation delineated in the grant of municipal powers for its class of municipality.[192] Home rule offers expanded authority, but it is not unlimited.

Financially distressed municipalities, moreover, operate under a separate framework. In exchange for ceding oversight authority to the state government, municipalities receive enhanced earned income and local services tax authority which they are often loath to relinquish.[193] Permitting a phase out of these revenue enhancements, rather than eliminating them when a municipality exits its Act 47 plan, might permit localities to exit receivership earlier and adjust more effectively.

188 Pennsylvania Department of Community and Economic Development, "Citizen's Guide to Pennsylvania Local Government," 3.
189 *Clinton v. Cedar Rapids & Missouri River R.R. Co.*, 24 Iowa 455 (1868)
190 *Philadelphia v. Fox*, 64 Pa. 169.
191 Teri Ooms, Sherry Tracewski, and Pilar Lizasoain, "A Primer on Home Rule," The Institute for Public Policy & Economic Development, August 2009, 4, http://www.institutepa.org/PDF/Research/APrimeronHomeRule0809.pdf.
192 53 Pa.C.S.A. § 2962(b).
193 Steve Marroni, "Harrisburg needs to keep $12M coming in from Act 47 or hike taxes: report," July 10, 2018, *The* [Harrisburg] *Patriot-News*, https://www.pennlive.com/news/2018/07/harrisburg_needs_to_keep_12_mi.html.

The Local Tax Enabling Act and the Sterling Act

Still, the list of allowable taxes is broad. Not for nothing was a 1947 legislative grant of local tax authority dubbed the "Tax Anything Act" (it was broadly unpopular),[194] and while subsequent emendations, most notably the Local Tax Enabling Act of 1965 and as amended in 2008, did not go quite so far, they left in place a system of substantial local tax authority.[195]

The Sterling Act (1932), which governs only Philadelphia, is even more generous: whereas the Local Enabling Act promulgates a long list of restrictions on other local governments' tax authority, Philadelphia's power to tax is quite broad. However, the Sterling Act does prohibit the city from taxing anything also taxed at the state level, so should state government impose a tax on anything subject to tax in Philadelphia, the Philadelphia tax would be voided.[196]

Earned Income and Wage Taxes

Pennsylvania was a pioneer in local income taxation. Philadelphia's tax, implemented in 1939 after a failed effort the previous year, was the first local income tax in the nation and became a model for other such municipal income taxes across the country.

Authority for local income taxes dates to 1932, when the Sterling Act granted Philadelphia and Pittsburgh the right to levy income and other taxes until such time as similar taxes were adopted at the state level, at which point local taxation would be vacated.[197] A state income tax was still nearly four decades off, so the state's two largest cities were free to experiment with their own income taxes. The bill's House sponsor, Representative Philip Sterling, hailed the new authority as "the salvation of Philadelphia."[198]

The city's first attempt at a municipal income tax, adopted in 1938, was struck down by the courts because it included exemptions deemed impermissible under the constitution's uniformity clause.[199] The 1939 ordinance, which imposed a 1.5 percent wage tax on residents and nonresidents alike, was upheld and survives to this day.[200] It remained the nation's only local income tax until the adoption of a similar ordinance in Toledo, Ohio, in 1946.[201]

194 Pennsylvania Economy League, "The Sterling Act: A Brief History," March 1999, 4, http://economyleague.org/uploads/files/783716581668902685-the-sterling-act-a-brief-history.pdf.
195 Richard M. Cyert et al., "Final Report of the Pennsylvania Tax Commission" (1981 Tax Commission Report), March 1981, 1.
196 53 P.S. § 15971 *et seq*. This is why, for instance, opponents of Philadelphia's tax on sugar-sweetened beverages argued that the tax is illegal (because, they said, it essentially functions as a second sales tax), and a similar tax would certainly be impermissible elsewhere (because other jurisdictions would have no inherent authority to tax soda). Being governed under the Sterling Act rather than the Local Tax Enabling Act is also why Philadelphia's earned income tax can be more aggressive than similar taxes in other jurisdictions.
197 William J. McKenna, "The Income Tax in Pennsylvania," *Pennsylvania History: A Journal of Mid-Atlantic Studies* 27:3 (July 1960), 304, https://www.jstor.org/stable/27769968.
198 Pennsylvania Economy League, "The Sterling Act: A Brief History," 2.
199 Milton C. Taylor, "Local Income Taxes After Twenty-One Years," *National Tax Journal* 15:2 (June 1962), 113-114, http://www.jstor.org/stable/41790884.
200 City of Philadelphia, "Income Tax Regulations," iv, http://www.phila.gov/trb/PDF/income_tax_regs.pdf.
201 Milton C. Taylor, "Local Income Taxes After Twenty-One Years," 114.

Pittsburgh never took advantage of its original authority to enact an income tax under the Sterling Act, authority which sunset after three years.[202] In 1947, however, power to enact an income or wage tax was dramatically expanded, and Pittsburgh joined Philadelphia in implementing its own income tax in 1954 at a rate of 1 percent, increased to 1.5 percent the next year.[203] After that, similar taxes proliferated around the Commonwealth. When Pennsylvania adopted a state income tax in 1971, legislators inserted a "saving clause" preventing the new tax from preempting local earned income taxes.[204]

Today, municipal income taxes in Pennsylvania bear several names: earned income taxes, wage taxes, and net profits taxes. Localities frequently levy both an earned income (or wage) tax and a net profits tax, with the former falling on compensation and the latter capturing pass-through business income, though the two taxes are imposed at the same rates. As a shorthand, these taxes are often referred to collectively, even though technically they may be separate.

In each case, these taxes are imposed at a single rate on a base which excludes unearned income but, like the state income tax, is free of deductions and exemptions. Using a different tax base for state and local income taxes has become less common, but was a feature of early local taxes, which were intentionally kept as simple as possible by taxing only the most easily tracked forms of income.[205] Ironically, for present-day purposes this actually adds an extra step, as it would be easier to apply the local rate to state taxable income.

Earned Income Tax Bases

Local income taxes in Pennsylvania are imposed on salaries, wages, commissions, bonuses and incentive payments, tips, and other earned income, as well as on the net profits of pass-through businesses. The tax base excludes interest, dividends, capital gains, retirement income, unemployment income, insurance proceeds, gifts and inheritances, and other forms of unearned income. Similarly, the tax does not extend to traditional C corporations.

By exempting unearned income, Pennsylvania law reduces the taxable base for in-state filers by about 11 percent, worth about $210 million in fiscal year 2016.[206]

Both school districts and municipalities may levy the tax, but their taxpayer bases are not coterminous. Municipalities may tax both resident and nonresident wage earners, while school districts' income taxes only extend to those domiciled within the district.[207] This distinction follows a certain logic: a nonresident commuting into a central city for work imposes additional costs by his use of city infrastructure but does not further burden the city's schools.

202 Pennsylvania Economy League, "The Sterling Act: A Brief History," 2.
203 William J. McKenna, "The Income Tax in Pennsylvania," 304-305.
204 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 30.
205 Milton C. Taylor, "Local Income Taxes After Twenty-One Years," 115.
206 Pennsylvania Department of Revenue, "Revenue and Receipts Reports," http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/RevenueReceipts/Pages/default.aspx.
207 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 148.

When a municipality taxes nonresidents, however, it must provide a credit for taxes levied at the taxpayer's place of residence to avoid double taxation. Under Pennsylvania's earned income tax system, a taxpayer's domicile takes precedence over her place of employment when both levy the tax.[208] There is one important exception to this rule: Philadelphia. Under the Sterling Act, places of residence must provide credits against taxes their commuters pay under the Philadelphia Wage Tax, and not the other way around.[209] As a consequence, while earned income taxes are ubiquitous throughout most of Pennsylvania, they are rare in the Philadelphia suburbs, where credits wipe out much of their potential revenue.[210]

Philadelphia's unique arrangement, at least as it pertained to those commuting out of state, had been subject to criticism on constitutional grounds,[211] and following the U.S. Supreme Court's 2015 ruling on a related matter in *Comptroller of the Treasury of Maryland v. Wynne*, the city was forced to provide tax credits for Philadelphia residents working in other states.[212] The relevant point of law, the dormant commerce clause, does not apply to discrimination in intrastate commerce, however, so the Court's jurisprudence in *Wynne* does not invalidate the city's suppression of earned income taxes from surrounding in-state jurisdictions.

Philadelphia is an outlier in another way as well, using unique authority to impose a school income tax on unearned income, the income not subject to its wage tax. This tax is imposed at the same rate as the city's wage tax, currently 3.8907 percent.[213]

Because taxes can be levied on residents and nonresidents alike, but (excepting Philadelphia) the employing jurisdiction must credit back taxes paid to the domiciliary jurisdiction, the tax has a built-in tendency to proliferate. Once a city adopts a wage tax, there are strong incentives for neighboring jurisdictions to match it, since many of their residents will be liable for the tax either way. By implementing a tax of their own, local government officials can redirect their residents' payments from a central city to their own coffers. Governments can thus raise revenue with little additional taxpayer cost.[214]

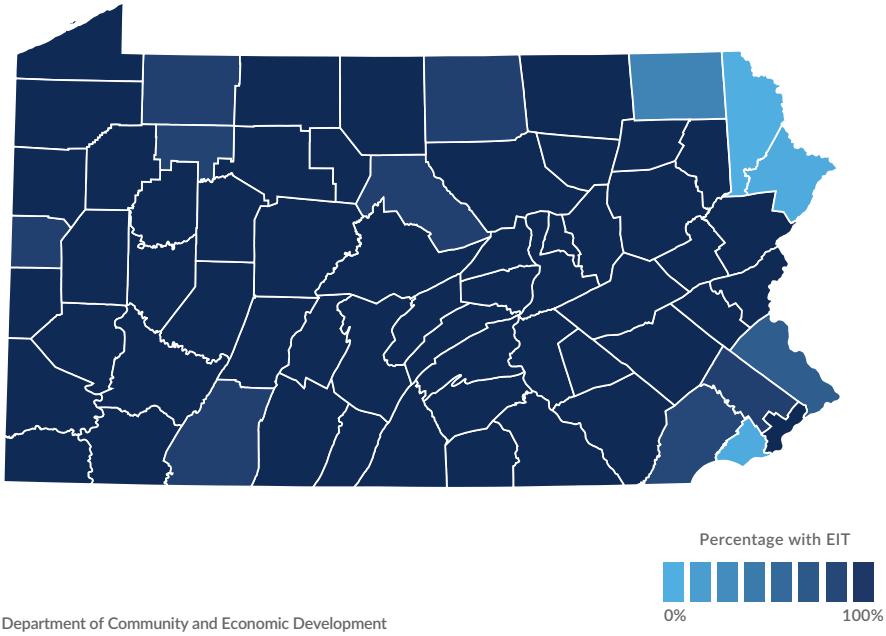
The adoption of Pittsburgh's municipal income tax in March 1954 set off a wave of similar policies in the surrounding communities; for instance, by year's end, three-quarters of communities in the Pittsburgh metropolitan area had their own tax, and the remainder soon followed. Similar patterns emerged in other areas, cascading across the state. By the early 1960s, earned income taxes were almost everywhere—except the communities bordering Philadelphia.[215]

208 53 P.S. § 6924.317.
209 Koleman S. Strumpf, "Government Credibility and Policy Choice: Evidence from the Pennsylvania Earned Income Tax," *Journal of Public Economics* 80 (2001), September 1999, 145, https://pdfs.semanticscholar.org/2ca0/80d24747639ec050c15b8f39bac31d357fb4.pdf.
210 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 30.
211 Michael S. Knoll and Ruth Mason, "Is the Philadelphia Wage Tax Unconstituional? And If It Is, What Can and Should the City Do?" University of Pennsylvania Law School, April 20, 2016, 167, https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1166&context=penn_law_review_online.
212 Chris Catarino and Rosalind W. Sutch, "Commuters Rejoice! Philadelphia Residents Working Outside Pa. Now Eligible for Wage Tax Refunds," *Philadelphia Business Journal*, March 30, 2017, https://www.bizjournals.com/philadelphia/news/2017/03/30/commuters-rejoice-philadelphia-residents-working.html.
213 Laura McCrystal, "Philly Officials: Don't Forget to Pay Your City Taxes," *The Philadelphia Inquirer*, Dec. 22, 2017, http://www.philly.com/philly/news/pennsylvania/philadelphia-tax-collection-delinquent-20171222.html.
214 James R. Hines Jr. and Richard H. Thaler, "Anomalies: The Flypaper Effect," *Journal of Economic Perspectives* 9:4 (Fall 1995), 220, https://pubs.aeaweb.org/doi/pdf/10.1257%2Fjep.9.4.217.
215 Koleman Strumpf, "Government Credibility and Policy Choice: Evidence from the Pennsylvania Earned Income Tax," 145.

Today, earned income taxes are levied by 2,374 of Pennsylvania's 2,475 municipalities and 467 of the 500 school districts, for a total of 2,841 jurisdictions levying an earned income tax.[216] With the exception of school districts in Clinton and Forest counties, all taxing jurisdictions currently forgoing an earned income tax are either located in the Philadelphia metropolitan area or along a state border.[217]

FIGURE 7.1.

Percentage of Jurisdictions Levying Earned Income Taxes by County



Source: Pennsylvania Department of Community and Economic Development

Localities are permitted to exempt extremely low-income taxpayers from the earned income tax altogether–the threshold is higher if the tax rate exceeds 1 percent–but cannot offer any further deductions, exemptions, or exclusions. The tax does, however, fall on net pass-through business income, not gross income, and taxpayers may deduct business losses from wage and salary income, though losses accruing from one business may not offset gains from another.[218]

216 Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools," 2016-2017, http://www.education.pa.gov/Teachers%20-%20Administrators/School%20Finances/Finances/AFR%20Data%20Summary/Pages/AFR-Data-Summary-Level.aspx; Pennsylvania Department of Community and Economic Development, "EIT / PIT / LST Tax Registers," June 15, 2018, https://munstats.pa.gov/Reports/ReportInformation2.aspx?report=EitWithCollector_Dyn_Excel&type=O; author's calculations.

217 In one case, however, the location near a state border is mere coincidence. S.N.P.J. Borough in Lawrence County encompasses 500 acres owned and operated by a benevolent society, incorporated to obtain a liquor license unencumbered by the county's blue laws. The lack of an earned income tax is almost certainly due to a population of fewer than 20 people, and not to its proximity to Ohio.

218 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 32.

Earned Income Tax Rates

Earned income tax rates are generally capped at 1 percent, though state law enumerates several circumstances under which localities can exceed this rate. In practice, very few municipal governments levy the tax at rates lower than 1 percent, in part because there is an incentive to match the rates of neighboring communities to the extent that some residents work elsewhere. The 1 percent cap is an aggregate cap, so if municipal governments and school districts both choose to levy the tax–which is almost invariably the case–then they must split their rates, each imposing an 0.5 percent tax unless they can agree on another division.[219]

Of jurisdictions levying an earned income tax, only 17 levy one at a combined rate below 1 percent.[220] By contrast, 689 jurisdictions take advantage of provisions permitting them to exceed the standard 1 percent cap, led by Philadelphia at 3.8907 percent and Reading at 3.6 percent.[221]

Philadelphia's rates are uncapped, though above a certain threshold the nonresident rate cannot exceed 75 percent of the resident rate.[222] Pittsburgh's school district has the right to impose an unshared earned income tax at 2 percent, in addition to the 1 percent municipal rate, and Scranton's school district may levy a 1 percent rate without a sharing requirement.[223] For all other jurisdictions, exceeding a 1 percent combined rate requires meeting one or more prove-out standards.

The most far-reaching exception is for home rule localities, which are exempt from the cap. Whatever their resident rate, however, they may not tax nonresidents more than 1 percent. Financially distressed municipalities (acting under Act 47) or those with financially distressed pension systems (subject to Act 205) may also levy higher earned income taxes as part of their recovery package, applying to residents and nonresidents alike.[224]

Taxing authorities are also permitted to levy higher rates to offset the repeal of other taxes. Under Act 24, school districts and municipalities may increase the rate commensurate to the revenue forgone in repealing occupational taxes. Similarly, under Act 50, school districts may adopt a 1.5 percent rate in exchange for repealing their occupation, occupational privilege, and per capita taxes, and reducing real property taxes. (Each of these taxes is discussed later.) The latter option, which requires more aggressive action, has proven significantly less popular than the occupational tax swap.[225] Other circumstances in which rates may exceed 1 percent include obtaining voter approval to raise additional revenue to purchase open lands, and as part of a package to use higher earned income tax rates and table gaming revenue to lower residential property taxes.[226]

219 Milton C. Taylor, "Local Income Taxes After Twenty-One Years," 31.
220 Pennsylvania Department of Community and Economic Development, "EIT / PIT / LST Tax Registers."
221 Id.
222 72 P.S. § 7359(b).
223 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 147.
224 Id.
225 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 32.
226 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 147.

TABLE 7.1.

Municipalities with Highest Earned Income Tax Rates[227]

Municipality	Municipal Rate	School Rate	Combined Rate
Philadelphia City	3.8907%	0%	3.8907%
Reading City	2.1%	1.5%	3.6%
Scranton City	2.4%	1%	3.4%
Mount Oliver Borough	1%	2%	3%
Pittsburgh City	1%	2%	3%
Wilkes Barre City	2.5%	0.5%	3%

Source: Pennsylvania Department of Community and Economic Development, "EIT / PIT / LST Tax Registers"

As a tax authorized by Pennsylvania's Local Tax Enabling Act, the earned income tax is also subject to an aggregate revenue cap. All taxes collected under the Local Tax Enabling Act, which include per capita, realty transfer, business gross receipts, occupational privilege and occupation taxes, and amusement taxes, in addition to the earned income tax, may not combine to exceed 1.2 percent of the market valuation of all real property in the jurisdiction.[228] This constraint does not apply to the city of Philadelphia, which derives its wage tax authority from the Sterling Act instead.

Earned Income Tax Collections

Earned income, net profits, and wage taxes raised about $1.67 billion in fiscal year 2016, with $346 million raised by municipal governments and $1.3 billion collected by school districts.[229] If imposed on the same base as the state income tax, local governments would have raised about $210 million more that year.

Since the enactment of Act 32 in 2008, collections have been consolidated at the county level.[230] (Allegheny County remains an exception, with four tax collection districts.[231]) Before that, collection of the earned income tax, like other local taxes, was the responsibility of myriad local tax collectors.

This consolidation dramatically reduced compliance costs for businesses (subject to withholding requirements) and individuals alike. In our conversations with taxpayers, many recalled the hassle of remitting local earned income taxes to borough or township tax collectors, many of whom did not prominently publish rates and had limited capacity to handle issues that might arise. As such, the creation of consolidated tax collection districts for earned income tax collections could serve as a model for consolidating the administration and collection of other local taxes as well.

227 Pennsylvania Department of Community and Economic Development, "EIT / PIT / LST Tax Registers."
228 53 P.S. § 6924.320; expressed as the latest market value of all assessed property multiplied by 12 mills.
229 Pennsylvania Department of Revenue, "Personal Income Tax Statistics," http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/PIT/Pages/default.aspx.
230 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 149.
231 53 P.S. § 6924.504.

Consequences of the Earned Income Tax

Local income taxes are inferior to property taxes, as labor and capital are mobile, while land and structures are not. Income taxes can encourage out-migration, particularly if it is not necessary to move far. Philadelphia, with its high rates, serves as a cautionary tale. According to one study, taxes alone make it 19 percent more expensive to run a business in Philadelphia than in the outlying suburbs,[232] and about half of the 300,000 jobs the city lost between the 1960s and 1990s have been estimated to be casualties of Philadelphia's high taxes.[233]

Philadelphia's income tax collections first exceeded property tax collections in the late 1960s, and since then, the city has diverged sharply from its peers.[234] Due to its unique authority, Philadelphia relies heavily on the wage tax, and according to one estimate, 66 percent of the city's tax revenues now come from taxing mobile wages and profits, nearly double the amount in cities like New York or Washington, D.C.[235] While employment in New York City, Boston, and Washington, D.C. has grown rapidly since 1970, Philadelphia has lost a quarter of its jobs during the same period.[236]

Purely from the perspective of economic growth, the earned income tax is inferior to real property taxes but preferable to nuisance taxes like occupation or per capita taxes, or highly nonneutral business taxes like the mercantile and business privilege taxes. Given the state's low 3.07 percent individual income tax rate, local income taxes are sustainable at modest rates, but create competitive disadvantages at higher rates, particularly those seen in Philadelphia and Pittsburgh.

232 Michael S. Knoll and Ruth Mason, "Is the Philadelphia Wage Tax Unconstitutional? And If It Is, What Can and Should the City Do?" 163, citing Robert Inman, "Local Taxes and the Economic Future of Philadelphia: 2008 Report" (2009).
233 Id.
234 Christopher Wink, "Philly's City Wage Tax Just Turned 75. Here's Its Dubious Legacy," Technical.ly Philly, Dec. 12, 2014, https://technical.ly/philly/2014/12/12/Philadelphia-city-wage-tax/.
235 "Center City Reports: Pathways to Job Growth," CenterCityPhila.org, January 2014, 15, http://2h7qju2c3qvcc3s86ekn8n0-wpengine.netdna-ssl.com/philly/wp-content/uploads/sites/2/2014/12/Pathways-to-Job-Growth-2014.pdf.
236 Christopher Wink, "Since 1970 Philly lost 25% of its jobs; Boston, NYC, DC grew: fix taxes," Technical.ly Philly, May 6, 2013, https://technical.ly/philly/2013/05/06/pew-taxes/.

Occupational and Local Services Taxes

Pennsylvania's colonial-era faculty tax, imposed on the assumed income of occupations and professions, gradually evolved into the occupation and local services taxes, two locally-imposed taxes which survive to the present day. In 1960, one scholar declared that the occupation tax "is arbitrary in assessment; it is unlimited in millage rate; its yield is not great; its collection cost is high; it is difficult to collect[;] and the delinquency rate is high."[237] Nothing much has changed in the intervening years.

Local Services Tax

The local services tax is far and away the more significant of the two taxes. The local services tax is imposed as a lump sum for the privilege of being employed in a given jurisdiction. Through 2004, it was capped at a maximum rate of $10 per year,[238] though it may now be levied at amounts up to $52 per year (higher for distressed cities). If, however, the tax exceeds $10 a year, the taxing jurisdiction must exempt taxpayers earning less than $12,000.[239]

Currently, 1,210 municipalities levy a local services tax at the standard top rate of $52, while four distressed cities (Harrisburg, Johnstown, and Scranton at $156, and Beaver at $104) have authority to impose higher lump sum taxes while in receivership under Act 47. Another 694 municipalities levy the tax in amounts ranging from $5 to $50 per year, while the remaining tax jurisdictions elect not to levy a local services tax.[240]

This tax has the distinction of being the only local non-real estate tax outside Philadelphia to be levied on nonresidents without recourse to a countervailing tax credit, creating possibilities for double taxation.[241] Both municipalities and school districts may impose the tax, which is levied on employment, but the proceeds must be shared by them.

Under prior law, the amount was shared equally unless the two tax authorities came to a separate agreement; now, however, school districts are limited to $5 (half of the old maximum rate) and municipalities may claim the remainder, up to $47. When school districts decline to levy a local services tax, their municipalities are free to claim the full $52. If an individual is employed in two or more jurisdictions with local services taxes, state law establishes a system of prioritization.[242]

237 William J. McKenna, "The Income Tax in Pennsylvania," 294.
238 Christine Vendel, "It Will Cost More to Work in Harrisburg: 5 Things You Need to Know about the Local Services Tax," *The* (Harrisburg, PA) *Patriot-News*, April 29, 2016, http://www.pennlive.com/news/2016/04/cost_more_work_in_harrisburg_l.html.
239 Pennsylvania Department of Community and Economic Development, "Local Services Tax," https://dced.pa.gov/local-government/local-income-tax-information/local-services-tax/.
240 Pennsylvania Department of Community and Economic Development, "EIT / PIT / LST Tax Registers."
241 Local sales taxes in both Allegheny County and Philadelphia are clearly borne by nonresidents in terms of their economic, but not their legal, incidence. Philadelphia's earned income tax may be levied on nonresidents who work in the city; this option is not available to other jurisdictions.
242 Richard M. Cyert et al., "Final Report of the Pennsylvania Tax Commission" (1981 Tax Commission Report), 36.

A dollar-denominated local services tax is clearly unconnected to ability to pay and is insufficiently nuanced to capture different burdens on local infrastructure. It is, moreover, a highly inefficient tax, as its complexity is disproportionate to the amount it raises. In 1973, a state tax commission recommended its repeal,[243] and future studies called further attention to it as an anachronism in the state tax code. It is often deemed a "nuisance tax," inasmuch as it is one of a multiplicity of local taxes, all relatively modest in their own right, which are often seen as nickel-and-diming taxpayers.

Nevertheless, the local services tax survives and even thrives because it enables local governments to collect some tax other than the sales tax on nonresident workers. In 2016, the tax generated $214 million for municipalities statewide, representing just under 2.6 percent of aggregate local tax collections.[244] Because school districts can claim no more than $5 per taxpayer, it plays a much more modest role in school finance, raising a further $15 million, or a little less than 0.7 percent of school tax revenue in Pennsylvania.[245]

Occupation Tax

The occupation tax can be imposed in one of three ways: as lump sum of $10 or less, by unlimited millage against the value of all occupations, or by millage against the assessed value of each occupation with a maximum rate equal to the rate on real property.[246] This latter approach renders the tax arbitrary almost to the point of caprice and asks the impossible of local officials. Local governments in Pennsylvania have the earned income tax, based on the actual compensation each taxpayer receives for their labor. The occupation tax, by contrast, attempts a haphazard approximation of the same figure, based on broad generalizations and accountable to no set standard. The assessed value of an attorney, for instance, is the same whether that attorney is a corporate litigator or a public defender.

Occupational taxes harken to an earlier era when occupations could be understood as a form of transferable property, created by grant or letter of appointment, and transferred or passed down through generations. While some professions still require licensing, the era of letters patent is long gone, and occupations are no longer transferable or heritable property.[247]

Each county is responsible for devising a list of occupational titles and setting their corresponding assessments. Local assessors generally have no particular competency in this field, nor should they be expected to, but even with perfect data, inequities are inherent in the very structure of the tax. By design, the tax base is potential (not actual) income, and not income at any given point in time, but expected lifetime earnings.

243 Albert Hydeman, Jr., et al., "Report of the Governor's Tax Reform Subcommittee on Local Taxes" (1973 Tax Reform Subcommittee Report), March 1, 1973, 34.
244 Pennsylvania Department of Community and Economic Development, "Statewide Municipal Annual Financial Reports," 2016, http://munstats.pa.gov/Reports/ReportInformation2.aspx?report=StatewideMuniAfr.
245 Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools."
246 Edmund W. Appleton, "The Commonwealth of Pennsylvania's Antiquated and Oft-Abused Occupation Tax: A Call for Abolition," *University of Michigan Journal of Law Reform Caveat 46:1* (2012), 18.
247 With limited exceptions, perhaps, where government still plays an outsized role; cf. taxi medallions.

Tax assessors can take experience, skills, and business size into account, but this creates its own set of problems. Even if we assume that assessors are able to determine, say, the approximate skill level of an engineer, the owner of a small boutique engineering firm may have far higher income–both potential and actual–than a talented but mid-level engineer in a large firm. A teacher may choose to accept lower compensation to teach at a particular school, thus failing to realize the profession's "potential" income. An orthopedic surgeon might eventually abandon a lucrative career to work in medical missions abroad, bearing the burden of taxation based on an assumption of high lifetime earnings during the early years–while paying off student loans–without ever enjoying the years of high, unencumbered earnings.

All of which is to say that the best measure of income is income, not a tax assessor's best guess of what that income would be assuming that a given taxpayer hewed to the median for his or her profession. Income taxes have their own drawbacks by neglecting the concept of lifetime earnings, particularly in states where high top marginal rates interact with an unequal distribution of lifetime compensation. Pennsylvania's broad-based, single-rate income tax, however, avoids most of the drawbacks, making it particularly odd that the state maintains an antiquated tax that inelegantly backs into some approximation of income.

Any list of occupations, moreover, is destined to be incomplete, placing wage earners into categories which may be a poor representation of their actual career or income potential. These lists are rarely updated, and most classifications are based on self-reporting, giving taxpayers the opportunity to select a plausible classification with the lowest tax burden. As has been frequently noted, the correlation between assessed values and potential–to say nothing of actual–incomes is necessarily crude.[248] The assessed occupation tax is, moreover, regressive within each occupational classification, as those with the lowest incomes in any given field face the highest effective rates.[249]

The Current State of Occupation and Local Services Taxes

As of fiscal year 2016, 51 school districts (out of 500) imposed flat occupation taxes of $10 or less, while 46 imposed assessed occupation taxes.[250] That same year, 229 of the Commonwealth's 2,475 municipal governments imposed occupation taxes in either form. Occupation taxes only raised more than $1 million in a single municipality (Derry Township in Dauphin County), and more than $100,000 in eight. The tax raises less than $10,000 a year in 172 of the 229 municipalities in which it is imposed, the very definition of a nuisance tax.

Reforms undertaken in 2001 and 2008 helped reduce reliance on occupation taxes. The Optional Occupational Tax Elimination Act permits localities to repeal the occupation tax and replace the revenue with higher Earned Income Taxes.[251] The revenue replacement

248 Diane Lim Rogers and Judy A. Temple, "Taxing Human Wealth: Pennsylvania's Experience with the Local Occupational-Assessment Tax," *Proceedings of the Annual Conference on Taxation Held under the Auspices of the National Tax Association-Tax Institute of America* 88 (1995), 290-291.
249 Richard M. Cyert et al., "Final Report of the Pennsylvania Tax Commission" (1981 Tax Commission Report), 36.
250 Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools."
251 Edmund W. Appleton, "The Commonwealth of Pennsylvania's Antiquated and Oft-Abused Occupation Tax: A Call for Abolition," 20-21.

is intended to function on a revenue neutral basis, and while the tax swap must be initiated by the municipal governing body, it requires voter approval to go into effect.[252] Yet while the majority of jurisdictions have eliminated the occupation tax, a smattering of jurisdictions continue to hold out.

These taxes, routinely decried as arbitrary and inequitable, survive out of inertia and lack of ability or motivation to replace them with superior modes of taxation. Nudges have only accomplished so much; meaningful local tax reform would put these antiquated taxes on the chopping block.

Mercantile and Business Privilege Taxes

Pennsylvania law provides for two types of local business gross receipts taxes, though their distinctions have blurred over the years. The older of the two, the mercantile tax, may only be levied on wholesale, retail, and restaurants, while the business privilege tax (BPT) may be imposed on all classes of business. Taxes on retail, wholesale, and dining establishments are subject to rate caps, whether taxed under the mercantile tax or the BPT, while gross receipts taxes on other establishments are only subject to the aggregate limitation for a broader class of local taxes.

As gross receipts taxes, both the mercantile tax and the BPT represent throwbacks to a far earlier era; the mercantile tax itself is an outgrowth of mercantile license taxes, and these can be traced to Pennsylvania's colonial history. Once common, gross receipts taxes have fallen out of favor nationwide, largely done in by a consensus that levying taxes on the basis of gross revenues is inequitable, promotes otherwise inefficient economic decision-making, and impedes growth.[253]

As far back as 1925, a state tax commission observed that a precursor tax, the mercantile license tax, was anachronistic and uncompetitive, with the commission report concluding, "It is an unusual tax in the fiscal plan of the States of the Union, and has been the subject of great criticism before the Commission."[254] Today, no jurisdiction may impose a new business gross receipts tax, though preexisting taxes are grandfathered in.

Only five states have statewide gross receipts taxes, and just a small smattering of states authorize local gross receipts taxes. These taxes, however, are concentrated in the Mid-Atlantic: Delaware and Ohio both levy statewide gross receipts taxes,[255] while Virginia and West Virginia join Pennsylvania in authorizing them at the local level.

252 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 144-145.
253 Justin Ross, "Gross Receipts Taxes: Theory and Recent Evidence," Tax Foundation, Oct. 6, 2016, https://taxfoundation.org/gross-receipts-taxes-theory-and-recent-evidence/.
254 Franklin S. Edmonds et al., "Report of the Tax Commission of the Commonwealth of Pennsylvania" (1925 Tax Commission Report), 1925, 17.
255 Of the five states with a statewide gross receipts tax, only Delaware imposes the tax in addition to a corporate income tax.

Structure of Pennsylvania's Local Gross Receipts Taxes

Pennsylvania's local business gross receipts taxes can be imposed at rates of up to 1 mill (0.1 percent) on wholesale and 1.5 mills (0.15 percent) on retail, with no cap on the rates on other businesses. If localities adopt both forms of gross receipts tax, the two cannot overlap: the mercantile tax falls on wholesale, retail, and restaurants, while the business privilege tax is applied to all remaining businesses. Since, in the absence of a mercantile tax, the business privilege tax can also apply to wholesalers, retailers, and restaurants, jurisdictions first adopting a gross receipts tax after the creation of the BPT have tended to levy it in lieu of, rather than in concert with, a mercantile tax.[256] Alternatively, business privilege taxes may be imposed as lump sum taxes.

The Local Tax Enabling Act, which places rate limits on the mercantile tax, also requires that revenues from the three industries covered under the mercantile tax be shared between municipalities and school districts, if they both tax those industries, whereas gross receipts tax revenues from other industries need not be shared.[257] The Pittsburgh School District is permitted to levy a 0.5 mill wholesale and 1 mill retail mercantile tax without sharing, while the Philadelphia School District may levy the tax as a special rate of 2 mills, subject to a cap of 2 percent of business income.[258] The city of Philadelphia itself, moreover, is free from the mercantile tax's rate limitations, as its tax is levied under the Sterling Act rather than the Local Tax Enabling Act.[259]

In 1987, a state-initiated commission on local tax reform recommended sweeping changes to Pennsylvania's system of local taxation, including banning any locality from imposing a new mercantile or business privilege tax going forward.[260] Voters rejected a constitutional amendment on which many of the proposed changes were conditioned, but the prohibition on new gross receipts taxes went into effect while grandfathering in those imposed as of November 30, 1988.[261]

Because of the freeze, the vast majority of jurisdictions go without a gross receipts tax, but 271 municipalities still impose one, of which 52 municipalities generate more than $1 million a year from the tax.[262] Philadelphia's municipal gross receipts taxes raise nearly 3.5 times as much as the other 270 jurisdictions' municipal gross receipts taxes do combined.[263]

256 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 47.
257 Id, 48.
258 Richard M. Cyert et al., "Final Report of the Pennsylvania Tax Commission" (1981 Tax Commission Report), 39.
259 Robert J. Butera and Loenard C. Staisey, et al., "The Final Report and Recommendations of the Pennsylvania Local Tax Reform Commission as Presented to Robert P. Casey, Governor of Pennsylvania" (1987 Local Tax Reform Commission Report), Oct. 30, 1987, 39.
260 Id., 30.
261 72 P.S. § 4750.533.
262 Pennsylvania Department of Community and Economic Development, "Statewide Municipal Annual Financial Reports."
263 Id.

Similarly, 59 of the state's 500 school districts currently impose business privilege or mercantile taxes, though reliance is limited. Only 12 school districts derive more than 2 percent of their revenue from gross receipts taxation.[264] Fifty-six of the 59 school district gross receipts taxes are imposed on a proportional (rate) basis, while three are dollar-denominated.[265]

TABLE 7.2.

Reliance on Business Gross Receipts Taxes

Gross Receipts Taxes as Percentage of Municipal Revenue

Percentage Range	Number of Municipalities	School Districts
More than 20% but less than 30%	6	0
More than 10% but less than 20%	24	0
More than 5% but less than 10%	51	0
More than 0% but less than 5%	190	59
No gross receipts tax	2,204	441

Sources: Pennsylvania Department of Education; Pennsylvania Department of Community and Economic Development

Most business privilege taxes are imposed at a single rate, but the courts have upheld industry-specific rates. In fact, though, jurisprudence on Pennsylvania's local gross receipts taxes is complex and sometimes contradictory: the Commonwealth Court has held that not applying the business privilege tax to services can violate the uniformity clause, but has also upheld setting separate rates for sales and services within the BPT (and not just split out between the BPT and the mercantile tax).[266] There is also considerable uncertainty about what changes are possible to grandfathered GRTs.[267]

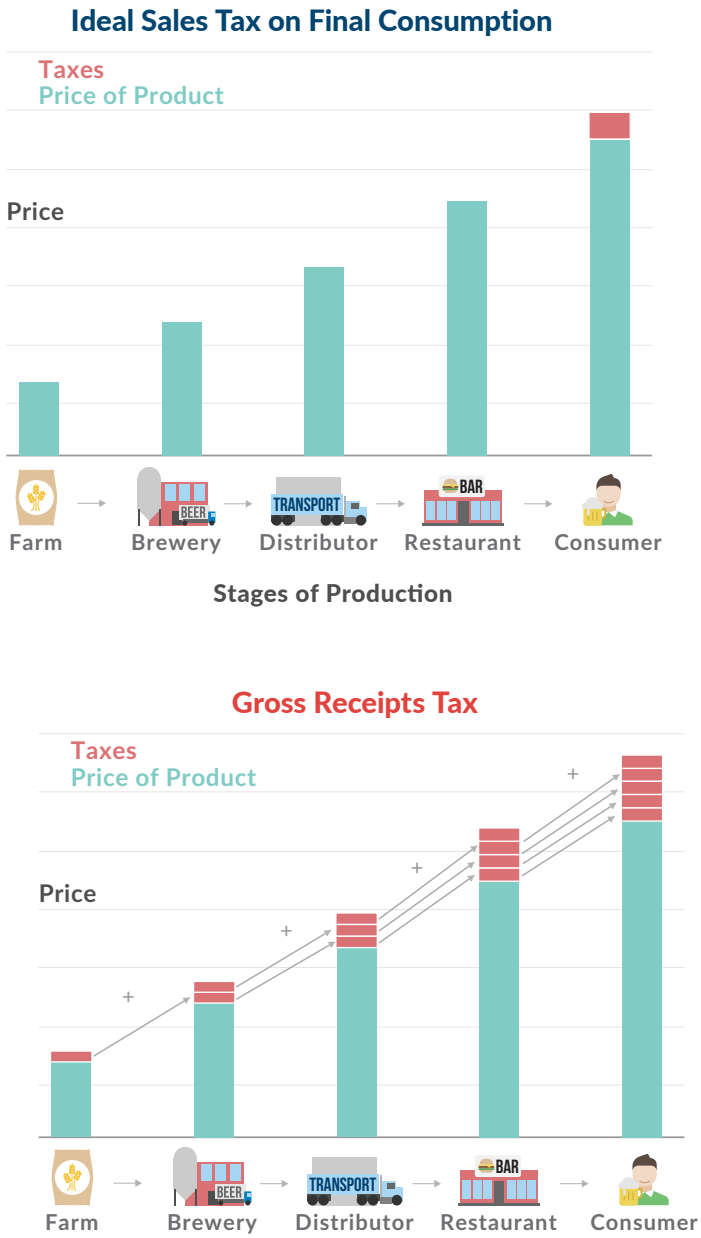
Because they are levied on gross rather than net income, and can be embedded in the same final good or service multiple times over (a process known as "tax pyramiding"), gross receipts taxes lead to arbitrary and inconsistent tax burdens, are indifferent to ability to pay, and often have effective rates many multiples of the statutory tax rate. All these things are true of Pennsylvania's gross receipts taxes, and are discussed at greater length below, though under the mercantile and business privilege tax structures, pyramiding is ameliorated somewhat by a manufacturing exclusion.[268]

The tax does not fall upon all stages of production–at least provided that each stage qualifies as manufacturing under state law–but still pyramids. For instance, a good's actual production process might not be taxed, but its packaging, marketing, distribution, wholesale, and retail may all be taxed separately, along with any business services the manufacturer outsources, like human resources or accounting. The result is a tax which is imposed on multiples of the final retail price of a good or service.

264 Pennsylvania Department of Education, "Act 1 / Act 511 / 1st Class SD Taxes for School Districts," http://www.education.pa.gov/Teachers%20-%20Administrators/School%20Finances/Finances/AFR%20Data%20Summary/Pages/AFR-Data-Summary-Level.aspx.
265 Id.
266 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 49.
267 See generally, Pamela Millard, "Public Enemy Number One: Business Privilege Taxes and the Court's Flawed Reasoning in Applied Tech Products Corporation v. Radnor Township," *The State and Local Tax Lawyer* 11:2 (2006), http://www.jstor.org/stable/42721361.
268 Pennsylvania Department of Community and Economic Development, "Taxation Manual," 51-53.

FIGURE 7.2.

Illustration of Tax Pyramiding Under a Gross Receipts Tax



Economic Ramifications of Gross Receipts Taxation

By their very design, gross receipts taxes lack transparency. With the tax embedded in the price of goods and services, often several times over, it is difficult if not impossible to determine the total tax cost associated with a final transaction. Furthermore, because gross receipts taxes are indifferent to ability to pay, they impose especially harsh burdens on low-margin firms or those posting losses. Such burdens can be particularly problematic for startups, which often lose money in their first few years of operations.[269]

In producing a good or delivering a service, businesses must make economic decisions about whether to handle processes in-house or to contract out to other providers. Ideally, this decision would be rendered based solely on the economic merits and without regard to tax planning, but under a gross receipts tax regime, a company able to bring more of the production process in-house receives an advantage over one that is not, which must bear the cost of the tax being imposed again at each external production stage.

This introduces inefficiency, to the extent that businesses make economic decisions hinging on tax arbitrage and avoidance strategies and inequity, to the extent that businesses are unable to respond in this manner. As noted previously, when taxes fall on intermediate business-to-business transactions, the result is tax pyramiding, with the cost of multiple levels of taxation ultimately passed along to the consumer.[270]

The figure below provides a stylized illustration of how the imposition of gross receipts taxes at each step of the production process leads to tax pyramiding. This results in an effective tax rate on the final transaction that can be multiples of the statutory tax rate.

As far back as 1925, Dr. Edwin Seligman, a prominent economist, could write that "[t]axes on output or gross receipts which make no allowance for the expenses constitute a rough and ready system, suitable only for the more primitive stages of economic life." He continued by noting that "in modern times … the tax on gross receipts is everywhere giving way to the tax on profits or net receipts" and terming gross receipts taxes "exceedingly inequitable as between various classes of business, or as between different individuals in the same class," observing that in some cases, the gross receipts taxes of the era could be equivalent to a net income tax levied at 30 times the rate.[271] If anything, his case is even more compelling in the 21st century.

Governments sometimes favor gross receipts taxes for their deceptively low rates (since they are imposed on an overly broad base) and their ability to generate large and stable amounts of revenue. This revenue stability, however, does not outweigh the tax's economic harm.

269 April L. Butler, "A Look at What the CAT Dragged In: The Problems Inherent in Ohio's Commercial Activity Tax," *University of Dayton Law Review* 32:1 (Fall 2006), 122.
270 Justin Ross, "Gross Receipts Taxes: Theory and Recent Evidence," Tax Foundation, Oct. 6, 2016, 6-7. https://taxfoundation.org/gross-receipts-taxes-theory-and-recent-evidence/.
271 Edwin R.A. Seligman, *Studies in Public Finance* (New York: The Macmillan Company, 1925), 134-135.

The second-oldest surviving gross receipts tax in the United States, Washington's Business & Occupation (B&O) Tax,[272] comes in for routine criticism even from state government sources. A tax reform commission appointed by the state legislature in 2002 concluded that the tax system created substantial nonneutralities, that the tax pyramided an average of 2.5 times, and that it caused pyramiding of up to 6.7 times on some manufacturing industries, creating significant economic distortions.[273] Similar findings accompany other gross receipts taxes.

A gross receipts tax in some municipalities but not others can also disadvantage local activity by incentivizing companies to work with outside vendors, not subject to a gross receipts tax regime, to avoid pyramiding on those business inputs.

Per Capita Taxes

A major and often deeply unpopular source of revenue in the colonial era, the per capita tax is now an afterthought in Pennsylvania's municipal tax system. Head taxes were once the stuff of rebellion; in medieval England, attempts to collect a four pence capitation tax sparked a Peasants' Revolt which shook the whole country and threatened its traditional institutions.[274] Today in Polk Township, Pennsylvania, you can save 10 cents off your $5 head tax if you pay early, though you might get slapped with a 50-cent penalty if you postpone filing for too long.[275]

In 1973, a state-commissioned study on local taxes said that per capita taxes earned the distinction of being a "true 'nuisance tax,'" noting that it was possible for a taxpayer residing in a third class city to face five different per capita levies.[276]

Though Pennsylvania taxpayers have a hard time getting worked up over a few dollars, we did hear in our meetings with taxpayers that per capita taxes contribute to the general perception that there is nothing that Pennsylvania localities will not tax—not even life itself.

More than half (262) of the state's 500 school districts levy per capita taxes, but the resulting revenue was less than $25,000 in 108 of them and only eclipsed $100,000 in 17. Statewide, school districts generated $10.4 million from per capita taxes in fiscal year 2016, accounting for a trifling 0.03 percent of their total revenue, at great administrative cost.[277]

272 The persistence of Washington's B&O is likely due to constitutional constraints which have prevented the state from levying taxes on income, including corporate income.

273 See generally, Washington State Tax Structure Study Committee, *Tax Alternatives for Washington State: A Report to the Legislature*, Vols. 1 and 2 (November 2002).

274 Led by Wat Tyler–the uprising is often called Wat Tyler's Rebellion–and the dissenting clergyman John Ball, the Peasants' Rebellion started as a tax revolt but evolved into an attack on the aristocracy and the system of monarchical government.

275 David Pierce, "Is There a Tax That Everyone Has to Pay?" *The Pocono Record* (Stroudsburg, PA), Jan 12, 2003, http://www.poconorecord.com/article/99999999/NEWS090106/51216024.

276 Albert Hydeman, Jr., et al., "Report of the Governor's Tax Reform Subcommittee on Local Taxes" (1973 Tax Reform Subcommittee Report), 35.

277 Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools."

Similarly, more than half (1,299) the municipalities impose a per capita tax, but here too, collections are quite modest. Revenue is less than $10,000 in 1,034 of them and less than $25,000 in all but 80. Only 11 of the state's 2,475 municipalities derive more than $100,000 from per capita taxes, and the $11.2 million that municipal head taxes raise statewide is less than 0.06 percent of total revenue—$1 in every $1,755.[278]

Local Taxing Authority

For many taxpayers across the country, local tax compliance is limited to the property tax, with most other local taxes–especially for nonbusiness taxpayers–administered by the state. In a state which permits local income taxes, for instance, those taxes might function as an additional percentage reported on state income tax forms, collected by the state, and remitted by the state to one's locality.

In Pennsylvania, property taxes, earned income taxes, occupation taxes, local services taxes, mercantile and business privilege taxes, per capita taxes, amusement taxes, and more are administered by political subdivisions of the Commonwealth—frequently multiple. Taxpayers are responsible for complying with taxes imposed by their county, municipality, and school district, without any streamlined process for doing so. It has been said that Pennsylvania's local taxes are administered by more local collectors than existed in the rest of the country combined.[279]

In Pennsylvania, tax collector and tax assessor are elected offices—a feature of local government which must come as a surprise to transplants from other states, generally accustomed to such functions being vested in appointed officials or permanent staff. Even those from states with elected county revenue officers would no doubt be astonished by a system in which, in many counties, provision is made for the election of assessors in each ward of a borough or township, and sometimes for the election of an assistant assessor as well.[280]

These elected assessors, among their other duties, are responsible for assessing the earning potential of occupations for purposes of levying the occupation tax, a job which would keep the professional staff of the federal Bureau of Labor Statistics up at night, but which in Pennsylvania is entrusted to officials elected, not infrequently, on the strength of a few votes, in wards with populations that may not rise out of the hundreds.

278 Pennsylvania Department of Community and Economic Development, "Statewide County Annual Financial Reports," 2015, http://munstats.pa.gov/Reports/ReportInformation2.aspx?report=StatewideCountyAfr.

279 Pamela Millard, "Public Enemy Number One: Business Privilege Taxes and the Court's Flawed Reasoning in Applied Tech Products Corporation v. Radnor Township," 173, quoting James G. Newhard, "Member Perspectives: Issues that Need Attention," *Pennsylvania CPA Journal* 76 (Oct. 1, 2005), 50.

280 Local Government Commission of the Pennsylvania General Assembly, "Real Estate Assessment Task Force Final Report," October 1988.

It is a system set up for failure. When we spoke with business owners, they told us about many of the frustrations they experienced in dealing with this incredibly devolved system of tax authority. Some spoke of elected tax collectors who kept records on yellow legal pads, while others complained that determining the rate and base of local business privilege taxes sometimes required direct calls to local officials. One tax professional talked about obtaining the documents he needed for his clients' returns by requesting that municipal tax collectors fax them to him.

Real property taxes are taxpayer passive, meaning that the government determines the taxpayer's liability and sends a bill. Many other levies are taxpayer active, requiring the taxpayer to make a determination of liability. If that requires pestering local officials with calls and emails just to figure out what taxes are imposed, however, the system is broken. And if it requires filing returns for a panoply of nuisance taxes to three different levels of local government, something has gone wrong.

In 2008, Act 32 consolidated collection of the earned income tax at the county level, with municipal and school district shares disbursed by the county.[281] That measure has proven a success, dramatically simplifying compliance burdens and reducing duplication of administrative efforts. Thus far, however, localities have resisted further consolidation, even though it would be equally possible for counties to take over the administration of remaining local taxes. In much of the country, after all, something like a local income tax would be collected by the state, so locating the function in county government is hardly a radical step.

Local officials with whom we spoke to expressed opposition to relinquishing control of local tax collections to Harrisburg, citing delays in receiving the revenue or, in extreme cases, the possibility that state government might "sweep" the funds into state accounts to cover a state-level revenue shortfall, depriving local governments of needed revenue. The experience of other states offers little to buttress such fears, but each state is different, and county-level consolidation would accomplish many of the same purposes without the attendant risk.

Consolidation could accommodate varying municipal tax bases, but it would also present a valuable opportunity to streamline the entire taxpayer experience. If taxpayers remitted all local taxes–county, municipal, and school district–to a single tax collection authority, costs would be greatly reduced for taxpayers and government alike, and appeals would likely be fewer and more straightforward.

But it is not merely the number of taxing authorities, but also their nature, that requires consolidation. Philadelphia, the state's only first class city, derives unique sales tax authority from the Intergovernmental Cooperation Authority Act, while Allegheny County's sales tax authority derives from the Second Class County Code, which grants it privileges unavailable to the remaining counties.[282] Philadelphia can tax nonresidents with impunity; the rest of the state cannot.

281 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 149.
282 Pennsylvania Department of Revenue, "The Tax Compendium," March 2017, 11, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/Documents/2017_tax_compendium.pdf.

Pittsburgh and Scranton have unique authority with regard to their business privilege tax levies, while the code for cities of the third class diverges from the authority granted other jurisdictions levying the business privilege tax.[283] As will be discussed further in the subsequent chapter on property taxes, the entire structure of property tax assessment organizations varies based on the class of county. Some cities of the third class assess real property independently of the county, a power not available to other cities.[284] And the list goes on.

The multiplicity of municipal and county codes serves only to complicate local taxes. Consolidation of these various tax schemes into a uniform local tax code would represent a profound improvement. It would greatly simplify compliance for those with tax liability in multiple jurisdictions, of course, and eliminate inequities with rationales lost to history. If jurisdictions were subject to a uniform set of provisions, moreover, there might well be fewer tax appeals, as each question would only have to be settled once, whereas under the current system, the courts' answer might be different for a county of the fourth class than it is for a county of the third class, and the underlying question might not even be pertinent to a city, township, or borough, where taxpayers wrestle with completely different sets of issues.

283 Richard M. Cyert et al., "Final Report of the Pennsylvania Tax Commission" (1981 Tax Commission Report), 39.
284 Local Government Commission, "Real Estate Assessment Task Force Final Report," 3.

Local Tax Solutions

An ancillary consideration in many other states, improving the Commonwealth's system of local taxation is at the heart of any tax reform project in Pennsylvania. Local taxes represent a significant share of overall tax burdens and are responsible for outsized compliance costs. Worse still, they frequently create perverse incentives acknowledged by local government officials, who often lament their modes of taxation but believe they lack viable alternatives.

The state should give them alternatives.

Reforming local taxation is an ambitious project, as each taxing jurisdiction has different concerns, priorities, and economic and revenue profiles. This is particularly true in Pennsylvania, with its patchwork approach to local tax authority. But most things worth doing are hard, and the experience of Act 32 shows that local tax reform is possible—and desirable.

The following local tax solutions, adopted in whole or in part, would improve the competitiveness of Pennsylvania's local tax structure.

Broaden the Local Income Tax Base

There are legitimate theoretical justifications for limiting the income tax to earned income, and particularly for exempting investment income. Such efforts, however, are best accomplished at the federal and state, not the local, level. Local income taxes would be simplified by sharing the state income tax base, and the additional revenue associated with such base broadening could help pay for reduced reliance on, or even elimination of, business gross receipts and nuisance taxes which impose significant compliance burdens to collect a modest amount of revenue.

Repeal Gross Receipts and Nuisance Taxes

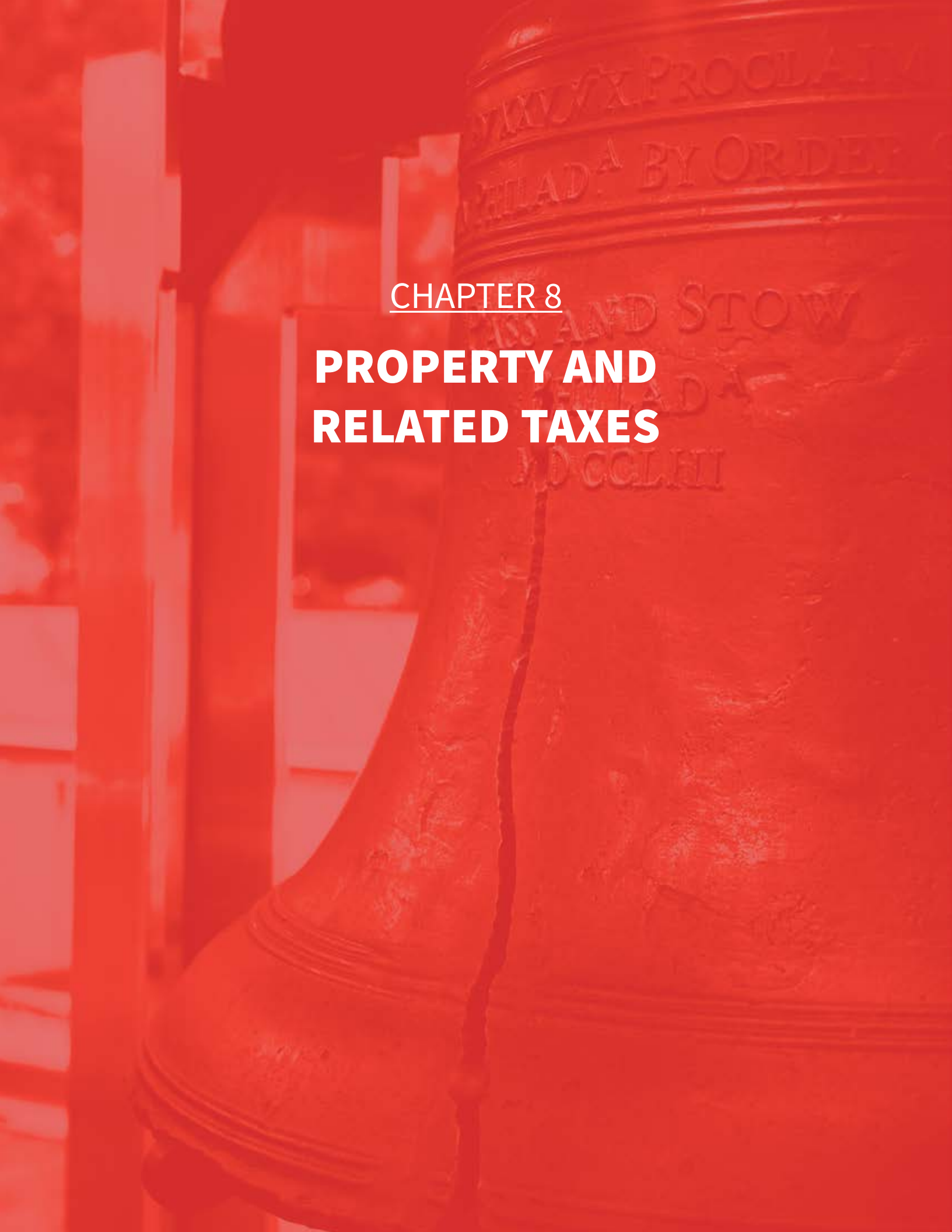
Pennsylvania's business gross receipts taxes and nuisance taxes all deserve intense scrutiny, but the two gross receipts taxes and the assessed occupation tax stand out as particularly counterproductive. In the past, Pennsylvania has provided incentives for localities to replace these taxes. Now, three decades after the Commonwealth froze gross receipts taxes, the time has come to eliminate them altogether, requiring local governments to phase them out while granting greater local income tax rate authority, combined with the additional revenue from broadening the base of the earned income tax, transforming it into a local tax on all income subject to the state income tax.

Consolidate Collections at the County Level

Act 32 provides a model for how local tax authority can be consolidated. Whatever local taxes remain should be collected at the county level and disbursed to municipalities and school districts, eliminating the need for separate tax collectors. The current system is needlessly complex, highly duplicative, and unnecessarily costly for small jurisdictions.

Simplify Statutory Tax Authority

It may be politically difficult to eliminate all differences in local tax authority, especially for Philadelphia and Pittsburgh, but there is no justification for having such a long list of separate tax codes. Policymakers should begin consolidating the different tax codes into the primary authorization statute, eliminating as many distinctions as possible along the way.



CHAPTER 8

PROPERTY AND RELATED TAXES

Introduction

Pennsylvanians have their share of disagreements: Steelers or Eagles, Sheetz or Wawa, Penn State or Pitt, Philly cheesesteaks or Primanti Brothers sandwiches, Yuengling or Rolling Rock. But if there is one thing that can unite Pennsylvanians, it is a shared contempt for property taxes.

Taxes are never exactly popular, and the residents of other states grumble about property taxes as well. In Pennsylvania, however, property taxes are the object of unusual contempt. Each year, state legislators introduce bills to abolish school property taxes, far and away the largest component of local property tax collections. These efforts, moreover, gain more traction than one would generally expect. In 2017, 20 state senators (in a body of 50) cosponsored Senate Bill 76, the Property Tax Independence Act, which would have eliminated school property taxes. It is hard to imagine such efforts gaining anywhere near that much support in other states.

There may be no single explanation for Pennsylvanians' antipathy toward property taxes, but the Commonwealth's approach to property taxation cannot be helping. For all practical purposes, Pennsylvania does not have one property tax but three, levied by counties, municipalities, and school districts respectively. The result is that property owners get hit with three different tax bills. The absence of a system of mandatory assessment, moreover, results in similarly situated properties experiencing dramatically different tax burdens. This cuts against fairness. It also holds back the state's economy by distorting incentives.

Tax increment financing is used to abate property tax burdens for some commercial landowners, providing relief for select businesses at the cost of higher burdens on those unable to secure beneficial treatment. In some jurisdictions, realty transfer taxes, imposed when property changes ownership, can be substantial. The state also imposes an inheritance tax.

In this chapter, we provide an overview of the property tax system in Pennsylvania and then provide four ideas for improvement.

A General Overview of Pennsylvania Property Taxes

Property taxes are among the oldest forms of taxation and remain the most significant source of local government revenue in many states, Pennsylvania included. Imposed from the outset of the colonial era, when William Penn and the members of the Provincial Council unanimously voted "that a Publick Tax upon Land ought to be Raised, to dray the Publick Charge,"[285] Pennsylvania's first property taxes were a continuation of the Property and Income Tax regime under which England already operated. (The income portion was incorporated into early Pennsylvania law in the form of faculty and occupation taxes, considered elsewhere.)

Once a significant state as well as local revenue tool, the property tax's current form is the product of many decades of evolution. Today, the property tax, primarily levied on land and improvements, serves as the single largest source of revenue for Pennsylvania's local governments overall, operating as the primary tax for counties and school districts and as a major revenue stream for municipalities.

Property taxes tend to be justified on both economic and practical grounds: economically, as a generally efficient form of taxation which raises revenue with a minimal effect on economic decision-making and consistent with widely accepted principles of taxation, and practically, as a well-established source of funding that is both familiar and not easily replaced.

Because real property is an immobile asset, tax competition and tax avoidance activities arising from its taxation are less pronounced than they would be from other available tax options.[286] At the margin, income taxes discourage labor and investment and may induce inefficient efforts at avoidance. Many other taxes pick winners and losers by favoring or disfavoring a range of economic activities. Property taxes, by contrast, tend to be more economically neutral.[287]

Property taxes also come closer than most taxes to passing the benefit test, whereby taxes paid roughly correlates with benefits received. However imperfect, the value of one's property is a better proxy for the value of local services received than most alternative tax bases. More than at other levels of government, local services often align closely with property and property values. Roads, utilities, police and fire protection, and local public amenities all increase or preserve the value of property, and, if supplied privately, would likely increase in worth with higher property values.[288] If, therefore, aggressive property tax limitations drive localities to shift to alternative revenue options, the net economic effect may be negative.

285 Jeffrey A. Weber et al., "Pennsylvania County Property Reassessment: Impact on Local Government Finances and the Local Economy," The Center for Rural Pennsylvania, November 2010, 5, http://www.rural.palegislature.us/county_reassessment_2010.pdf.

286 For a discussion of strategic competition in property tax regimes, see Jan K. Brueckner and Luz A. Saavedra, "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal* 54:2 (June 2001), https://www.ntanet.org/NTJ/54/2/ntj-v54n02p203-30-local-governments-engage-strategic.pdf?v=%CE%B1&r=03589733876287937.

287 Bruce Wallin and Jeffrey Zabel, "Property Tax Limitations and Local Fiscal Conditions: The Impact of Proposition 2½ in Massachusetts," Lincoln Institute of Land Policy Working Paper, 2010, 4, http://www.lincolninst.edu/sites/default/files/pubfiles/1885_1200_wallin_zabel_wp11bw1.pdf.

288 Id., 4-5.

Due to the state constitution's uniformity clause, property taxes do not vary by type or use, unlike in some other states, where different classes of property are assessed or taxed at different rates or assessment ratios (called split roll). This preliminary nod to simplicity, however, is quickly eclipsed by the quirks of the system, from the tripartite taxing authorities to an absence of central administration and, perhaps most notably, the lack of any mandatory reassessment cycle, which has led to vast disparities in effective tax rates on similarly-situated properties.

Property taxation in Pennsylvania is also characterized by a distinct lack of comparability. The same millage rate in two jurisdictions can produce radically different burdens, both for similar properties and on the aggregate of all properties within each jurisdiction. Different jurisdictions use different "base years" (discussed later) in assigning assessed values; they reassess at different intervals, if at all; they utilize different assessment ratios; and in some cases, they even tax land and improvements at different rates.

Even something seemingly as routine as a homestead exclusion takes on additional wrinkles in the Commonwealth, where each eligible property is potentially subject to three different homestead exclusions, which must be applied for with the county assessor, and with exclusion values which vary from year to year.

The composition of the assessment board varies by form of local government; in Philadelphia, the board is appointed by judges, while in many jurisdictions, the county commissioners take on these duties themselves. Frequently, assessment appeals are heard by the same officers responsible for the initial assessment. The absence of a regular assessment cycle undercuts uniformity in taxation and has emerged as a fraught legal issue—not inherently unconstitutional, but often unconstitutional in its effects. With judicial oversight undertaken on a case-by-case basis, the system is imbued with even greater uncertainty.

A state equalization board exists, but its determinations (embodied in something called the Common Level Ratio, which measures how far assessed values in a jurisdiction, in aggregate, diverge from actual value) are only binding for school funding formulas and as part of the record in appeals of individual assessments. Meanwhile, both state and local governments tax the transfer of real estate, sometimes at unusually high rates. A property tax and rent rebate program serves as a "circuit breaker" for elderly residents and select others, funded by gaming (both lottery and slots).[289] The state imposes rate limitations, but they are easily circumvented and thus largely ineffectual.

The result is a complex, inequitable, and often unpredictable system which is, for most taxpayers, a black box. It is little wonder that property taxes are so unpopular in Pennsylvania, an unpopularity rendered all the more significant due to their crucial role in funding the services closest to the public: local government and the school system.

289 Pennsylvania Department of Revenue, "Property Tax/Rent Rebate Program," http://www.revenue.pa.gov/GeneralTaxInformation/PropertyTaxRentRebateProgram/Pages/default.aspx.

"Pennsylvania is the Wild West of local school taxes," declared the head of one education nonprofit,[290] discussing a report labeling Pennsylvania's property tax landscape as one "that mirrors the state's anything-goes policy environment."[291] Pittsburgh was once considered the Gateway to the West—but it was meant to be a gateway, and no more.

Compared to other states' property tax systems, Pennsylvania ranks worse than average. On our *2018 State Business Tax Climate Index*, Pennsylvania ranks 33rd, better than three of its neighbors (Maryland, New Jersey, and New York) which place in the bottom 10 nationwide, but significantly worse than its other three neighboring states (Delaware, Ohio, and West Virginia), which all rank in the top 20.

Table 8.1 shows Pennsylvania's *2018 State Business Tax Climate Index* property tax component ranking, in addition to rankings from neighboring states. Although the state's above-average property tax burden contributes to these results, Pennsylvania's ranking is primarily driven by broader structural issues, including its continued reliance on inheritance and real estate transfer taxes. The *Index*, moreover, does not capture the inequities created by Pennsylvania's inconsistent assessments, which radically increase burdens for some taxpayers and lead to considerable disparities in effective rates.

TABLE 8.1.
State Business Tax Climate Index Property Tax Component Rankings

Pennsylvania and Neighboring States

State	Component Ranking
Pennsylvania	33rd
Delaware	20th
Maryland	42nd
New Jersey	50th
New York	47th
Ohio	11th
West Virginia	17th

Source: Tax Foundation, *2018 State Business Tax Climate Index*

290 Dale Mezzacappa, "Study: Pa. is 'Wild West' of Property Taxes," *Philadelphia Public School Notebook*, March 2, 2017, http://thenotebook.org/articles/2017/03/02/study-pa-is-wild-west-of-property-taxes.
291 EdBuild, "Building Equity: Fairness in Property Tax Effort for Education," February 2017, 53, https://edbuild.org/content/building-equity/report.pdf.

Property Tax Rates and Collections

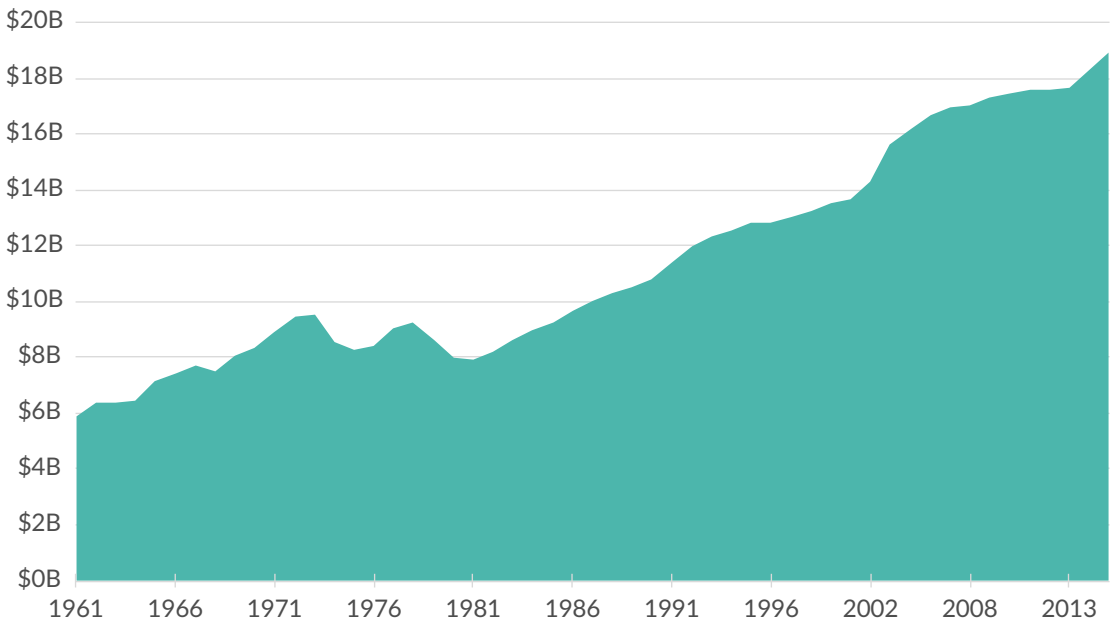
Property taxes are the primary revenue source for local governments in Pennsylvania, responsible for 69 percent of tax collections in fiscal year 2015.[292] They are particularly vital to counties,[293] where they generated 85 percent of all tax revenue that year, and to school districts, for which property taxes supplied 81 percent of tax revenue.[294] However, even municipalities, which also possess the authority to levy wage or earned income taxes, lean on property taxes, which account for about 33 percent of their tax collections in aggregate.[295] Over 70 percent of all property tax collections are by school districts.[296]

Property taxes have been rising steadily for decades. Pennsylvanians paid a grand total of $18.9 billion in property taxes in fiscal year 2015, more than double the amount paid four decades earlier, even after adjusting for inflation. Figure 8.1 shows increases in property tax collections in real (inflation-adjusted) terms since 1961.

FIGURE 8.1.

Pennsylvania Property Tax Collections (1961-2015)

Inflation-Adjusted



Source: U.S. Census Bureau, "State Government Tax Collections"

292 U.S. Census Bureau, "Annual Survey of State and Local Government Finances (FY 2015)", https://www.census.gov/govs/local/.
293 Pennsylvania Department of Community & Economic Development, "Statewide County Annual Financial Reports," 2015, http://munstats.pa.gov/Reports/ReportInformation2.aspx?report=StatewideCountyAfr.
294 Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools," 2016-2017, http://www.education.pa.gov/Teachers%20-%20Administrators/School%20Finances/Finances/AFR%20Data%20Summary/Pages/AFR-Data-Summary-Level.aspx. Note, however, that local school district taxes are only responsible for about 55 percent of school district revenue, with federal, state, and local governments providing most of the remainder.
295 Pennsylvania Department of Community & Economic Development, "Statewide County Annual Financial Reports."
296 U.S. Census Bureau, "2012 Census of Governments," https://www.census.gov/programs-surveys/cog.html.

Stripping away millages, ratios, base years, and outdated assessments, the effective rate of taxation on owner-occupied housing across the Commonwealth is 1.48 percent of housing value, the 12th highest effective rate in the country, and substantially above the national average of 1.13 percent.[297] Of regional competitors, only New Jersey has a higher effective rate—in fact, the highest in the nation.

Pennsylvania's high effective rates reflect high reliance on property taxes to fund schools and local governments in Pennsylvania, both due to the menu of available local revenue options and the degree to which education is locally–and specifically–funded. Property tax collections ran $1,481 per capita in fiscal year 2015, which is actually somewhat lower than the national average ($1,518).[298]

TABLE 8.2.

Property Taxes Paid as a Percentage of Owner-Occupied Housing Value

Pennsylvania and Neighboring States (Calendar Year 2016)

State	Effective Rate
Pennsylvania	1.48%
Delaware	0.56%
Maryland	1.03%
New Jersey	2.16%
New York	1.40%
Ohio	1.60%
West Virginia	0.53%

Source: Tax Foundation, *2018 Facts & Figures*

Property Tax Assessments

When Blair County, Pennsylvania, mailed new assessed values to homeowners in 2016,[299] it was a momentous occasion. Dwight D. Eisenhower retired to a farm just outside Gettysburg in 1961, but he was still taking up residence in the White House when Blair County conducted its previous countywide assessment. That assessment, undertaken in 1958, took place in the first decade in which more than half of Americans owned their home.[300]

That year, the average home price was $15,000; today it stands at nearly $200,000. Partly this is because homes have become larger; mostly it is because of inflation, with the real cost of housing rising far less dramatically.

297 Morgan Scarboro, *Facts & Figures 2018: How Does Your State Compare?* Table 34.
298 Id., Table 35.
299 William Kibler, "New Blair County Tax Values Hitting Home," *Altoona* (PA) *Mirror*, July 3, 2016, http://www.altoonamirror.com/news/local-news/2016/07/new-blair-county-tax-values-hitting-home/.
300 U.S. Census Bureau, "Homeownership Rate for the United States," 1965-2018.

For nearly six decades, however, Blair County was stuck in an earlier era, using assessments harkening to a time when tuition at the University of Pennsylvania set a student back $900[301] and the brand-new Buick LeSabre ran $1,495.[302] The previous time Blair County sent assessors on their rounds, the median household income in this country was $5,100.[303] Some of those who would watch their housing values soar in the early 2000s and then collapse when the housing bubble popped amid the subprime mortgage crisis had yet to be born.

Blair County was not alone. With reassessment finally undertaken there, Franklin County now has the dubious honor of going the longest without a countywide reassessment. In Franklin, the last reassessment was in 1961; in Lackawanna, 1968; and in Butler and Crawford, 1969. While most other jurisdictions do not lag quite as badly,[304] Pennsylvania's system of property tax assessment is out of line with national norms, the resulting administration is confusing to taxpayers, and the system's peculiarities create serious inequities and inefficiencies.

Pennsylvania's Assessments Are Inequitable and Badly Out of Date

Property tax assessments are undertaken at the county level, though not according to any state-ordained schedule. Absent a judicial order, counties are free to operate under a given assessment for as long as they wish, and many have retained dated assessments for years or even decades, periodically raising rates to keep ahead of inflation.

In 2016, 15 counties had assessed values of less than one-quarter of the market value of their taxable property. Washington County fared worst, with assessed value at a mere 10.0 percent of the state's estimate of current market value, closely followed by Blair (10.6 percent), Butler (10.8 percent), and Bucks (10.9 percent) counties.[305] Blair County has since implemented a countywide reassessment.

Properties are typically valued according to a base year (the year of the last assessment), and millages tend to reflect how far behind the county has fallen. In the city of Butler (the county seat of Butler County), where assessed value is 10.8 percent of market value, the total millage rate is 171.876,[306] while in Gettysburg (the county seat of Adams County), where assessments actually overstate market value (115.8 percent), the total millage is 18.7563.[307] The effective property tax rate in Butler is only about 14 percent higher than the one in Gettysburg, even though the statutory rate is 816 percent higher, reflecting the fact that Adams County reassessed in 2010, while Butler has not done so since 1969.

301 University of Pennsylvania, "University History: Tuition and Mandated Fees, Room and Board and Other Educational Costs at Penn Since 1900: 1950-1959," http://www.archives.upenn.edu/histy/features/tuition/1950.html. It was $32,286 in 2016.
302 The People History, "1950's Collector Cars Including Prices," http://www.thepeoplehistory.com/50scars.html.
303 U.S. Census Bureau, "Income of Families and Persons in the United States: 1958," https://www2.census.gov/prod2/popscan/p60-033.pdf.
304 Another four–Forest, Huntingdon, Washington, and Westmoreland–have not reassessed in more than three decades.
305 Pennsylvania Department of Community & Economic Development, "2016 Common Level Ratios," 2, https://dced.pa.gov/download/2016%20Common%20Level%20Ratio/?wpdmdl=74337.
306 County of Butler (PA), "Butler County Millage Rates," http://www2.co.butler.pa.us/proprev/mills.pdf.
307 County of Adams (PA), "County of Adams Millage Rate Chart," http://www.adamscounty.us/Dept/TaxServices/AssessmentAppraising/Documents/2017MillageChart.pdf.

Apart from a countywide reassessment, properties can only be reassessed under limited conditions:

1. when the property is subdivided;
2. when physical changes have been made to the property, like improvements valued at $2,500 or more;
3. when a catastrophic loss has occurred;
4. when the property's use has changed (for instance, if it gains or loses tax-exempt status); or
5. when the assessment is successfully appealed by the taxpayer or a taxing authority.[308]

Notably, the sale of a property does not trigger a reassessment, as it would in many states, nor is it relevant what a property may sell for, even though such "comparables" often form the basis for assessments elsewhere. Since improvements to the property can bring about a reassessment, however, owners are discouraged from maintaining and improving properties in areas where values have risen dramatically.

The issue is not, primarily, one of revenue. Under state law, outside of Philadelphia, an assessment cannot raise taxes in and of itself,[309] and there is little correlation between the years since reassessment and the per capita level of county taxes.[310] When conducting a countywide reassessment, local officials must adjust millage rates to ensure that the three taxing jurisdictions–county, municipality, and school board–do not increase revenue collections over the previous year due to the assessment. Upon completing this process, the local governing body may implement a simultaneous increase by a separate vote, though this vote cannot increase tax assessments by more than 10 percent overall.[311]

Rather, reassessments are about equity and efficiency. Governments can keep revenues flowing by ratcheting up millages on ever-less-accurate assessments, but over time, the amount that each individual property owner pays comes to have very little connection with the true value of her property.

In the half-century since Lackawanna County last reassessed, it is doubtless true that practically all properties increased in nominal value, but some would have seen greater increases than others. Without a countywide reassessment, tax bills in the county cannot reflect these changes, leading to inequitable tax burdens and reducing productivity, since there is less of an incentive to put property toward its most highly valued use, or in some cases even to maintain it.

308 Local Government Commission of the Pennsylvania General Assembly, *Pennsylvania Legislators' Municipal Deskbook*, 5th ed. (Harrisburg, PA: General Assembly Commonwealth of Pennsylvania, 2017), 125, http://www.lgc.state.pa.us/deskBook.cfm.
309 53 Pa.C.S. § 8823(b).
310 Eric Montarti and Elizabeth Weaver, "Pennsylvania's Property Assessment System Needs Change," Allegheny Institute for Public Policy, September 2007, 4, http://www.alleghenyinstitute.org/wp-content/uploads/components/com_reports/uploads/07_07.pdf.
311 16 P.S. § 4980.2. The limit is 5 percent in Allegheny County, and the anti-windfall provisions for school districts may diverge from those for county and municipal governments; but outside the consolidated city-county of Philadelphia, the limit is always 10 percent or less.

The system also creates sticker shock and makes it nearly impossible to compare tax burdens. In 2014, when Philadelphia implemented its Actual Value Initiative (AVI), which relies on contemporary market values as an assessment standard,[312] the combined rate fell from 97.71 to 13.4 mills even as revenue was held constant.[313] Philadelphia's property taxes appear incredibly modest compared to Butler's, but this is, of course, an illusion.

The lack of any semblance of comparability in property tax rates is itself a mark against Pennsylvania's approach. Transparency is an important principle of tax policy, yet the average taxpayer is likely to be at a loss when comparing property taxes in different jurisdictions. Nearly indecipherable and seemingly astronomical rates lead to discontent above and beyond what is justified by the effective rates of taxation. And the system's inequities can create a strong sense of unfairness as market values diverge from assessed values over the years or decades, requiring newer or more recently renovated properties to bear added burdens, or overtaxing communities which declined long ago–further depressing their chances of recovery–while effectively subsidizing areas which boomed after the last assessment.

Unsurprisingly, the longer a county has gone without a reassessment, the less revenue generated per mill. More interestingly, research indicates that long stretches without reassessment correlate with higher unemployment rates and declining average personal incomes.[314] Inequities have real costs, disincentivizing activity. Improving a property can dramatically increase its tax exposure, so property renovations may be postponed or higher uses forsworn. The unfairness of the system is readily apparent; its impact on economic development is similarly important.

According to one study, for each year since the last countywide reassessment, the amount of revenue raised per mill declined by 0.9 percent in rural counties and 0.6 percent in urban counties.[315] If this decline were uniform, it could be offset by raising rates every few years. In practice, however, new property, which has been assessed more recently, experiences higher effective rates, as do properties which have declined in value over the years, while properties which have appreciated markedly may experience unjustifiably low levels of taxation, subsidized by less fortunate neighbors.

There is a measure of inequity in property assessment, called the coefficient of dispersion (COD). Essentially, it records the average percentage deviation of individual property assessments from actual value compared to the median ratio of actual value. This differs from the Common Level Ratio, which compares the average assessed value of all properties in a county to their actual (market) value.

312 Claudia Vargas and Tricia L. Nadolny, "Philly to Rake in $118 Million in New Taxes After Reassessing Commercial Properties," *The Philadelphia Inquirer*, April 1, 2017, http://www.philly.com/philly/news/politics/City-to-collect-54-million-more-in-property-taxes-thanks-to-increase-in-commercial-property-values.html.

313 City of Philadelphia, "Summary Schedule of Tax Rates Since 1952," July 12, 2017, https://beta.phila.gov/media/20170727154558/Summary-Schedule-of-Tax-Rates-since-1952-Revised-July-12-2017.pdf.

314 Jeffrey A. Weber et al., "Pennsylvania County Property Reassessment: Impact on Local Government Finances and the Local Economy," 12.

315 Id., 10

Imagine two clusters of four properties. In the first, the properties are assessed at 10, 20, 70, and 100 percent of actual value, respectively. In the second, all four properties are assessed at 50 percent of actual value. In both cases, the median ratio is 50 percent of actual value, but the first set of properties creates equity issues not present in the second. The coefficient of dispersion measures the degree to which properties in a county are assessed more akin to the first than the second group.

Pennsylvania's State Tax Equalization Board considers a COD of 15 or less to be acceptable. In a 2006 study, only 4 percent of jurisdictions met that standard. The average COD was 33.15 in 2006, with 11 counties posting CODs more than three times the acceptable level.[316]

This is no way to operate a major system of taxation.

How Property Tax Assessments Work in Pennsylvania

Pennsylvania has six assessment laws, only slightly revised since their adoption in 1933.[317] There is a general assessment law which applies to all jurisdictions, but there are also discrete laws for different classes of county, with provisions that override the general law. Under state law, Philadelphia's assessment process is run by a Board of Revision of Taxes comprised of seven members appointed by the judges of the Philadelphia Court of Common Pleas. Elsewhere, appointments are made by county commissioners—or the posts are held by the commissioners themselves.[318]

Some classes of counties are also authorized to provide for the election of assessors in each township or ward, though these elected assessors only rarely play a role in assessing the value of real property.[319] Third class cities, if they so choose, can assess property independently from their counties, and all cities can set their own predetermined ratios (discussed below).[320] Home rule counties operate under a different set of rules and procedures than code counties.[321]

It is not necessary to recite the myriad variations, which deal with the composition of the assessing body, the functions delegated to it and whether they are divided among multiple entities, and the authority granted it. The real issue is not whether a jurisdiction is entitled to a Property Assessment Oversight Board or a Board of Assessment Appeals. It is that Pennsylvania needlessly multiplies methods and, more importantly, permits most localities to combine assessments and appeals in a single entity, such that the same officers responsible for assessing a property also hear any appeals of their assessment.

316 Id., 11.
317 Id., 12
318 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 6.
319 They may conduct assessments for occupation taxes, and in the past often had responsibility for assessing tangible personal property for taxation.
320 Local Government Commission of the Pennsylvania General Assembly, "Real Estate Assessment Task Force Final Report," October 1988, 2-3.
321 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 6.

Separating the assessment and appeals functions has been a common refrain of tax commissions for decades,[322] but in most jurisdictions both processes remain entwined. Even if one assumes the highest probity from assessors, the officials responsible for an assessment are unlikely to be best suited to recognizing its flaws. Although their decisions may be appealed to the county court of common pleas,[323] this process is expensive, time-consuming, and ill-suited to bringing about favorable results for taxpayers. In other states, the system tends to embody greater objectivity and disinterestedness from the start.

Assessments can be based on current-year market value or value in a base year, that in which the last countywide assessment was conducted.[324] When taxing authorities choose the latter approach, then if new construction takes place in 2018, assessors in many counties must determine what the value of the improvement would have been years or even decades prior. When they select the former, some properties will be assessed at values which capture years or even decades of inflation, while others are not. There is no good option—other than to reassess regularly.

The state supreme court struck down Allegheny County's base year system in 2009, concluding that it violated the uniformity clause of the state constitution. The court did not, however, reject a base year system in its entirety, but rather insisted that such a system must have regular adjustments or reassessments to pass constitutional muster.[325] How frequently those assessments must take place was left unspecified, and opened the door to litigation in other counties.[326]

Each county (and sometimes each city within a county) also has its own "predetermined ratio," which is the percentage of actual value captured by assessed value. Even when a property is newly assessed, if the predetermined ratio is 50 percent, then its assessed value will be 50 percent of its actual value, whereas at 100 percent, it would be equivalent to its market value as determined by the assessor.[327]

Actual value itself is not wholly defined in state law.[328] It is generally understood to imply fair market value; in Pennsylvania, however, assessors use some combination of three approaches to determine that value: income, cost, and comparative sales.[329] Which methods are used varies based on the property and the assessor's discretion, and the actual purchase price of a given property is not determinative.

When a homeowner challenges her assessment, the predetermined ratio (PDR) is switched to the Common Level Ratio (CLR), but only if the PDR and CLR differ by more than 15 percent.[330] At that point, the appeal is considered using the CLR and a recent

322 See Albert Hydeman, Jr., et al., "Report of the Governor's Tax Reform Subcommittee on Local Taxes," March 1, 1973, 27; Richard Cyert et al., "Final Report of the Pennsylvania Tax Commission," March 1981, 2; and Local Government Commission of the Pennsylvania General Assembly, "Real Estate Assessment Task Force Final Report," October 1988, 8.
323 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 10.
324 Jeffrey A. Weber et al., "Pennsylvania County Property Reassessment: Impact on Local Government Finances and the Local Economy," 13.
325 *Clifton v. Allegheny County, 600 Pa. 662, 969 A.2d 1197 (2009).*
326 Weiss Burkardt Kramer, LLC, "Property Assessment Study for Blair County," March 2014, 29, http://fanwil.com/wp-content/uploads/2014/03/Reassessment-Study-BLAIR-COUNTY-Final.pdf.
327 Local Government Commission of the Pennsylvania General Assembly, "Real Estate Assessment Task Force Final Report," 4.
328 Commonwealth of Pennsylvania, "Preliminary Evaluation of Real Property Tax Reform Opportunities," September 1972, 1-3.
329 Penn State College of Agricultural Sciences Cooperative Extension, "Reassessment: What Property Owners Need to Know," 1996, 3, http://www.lackawannacounty.org/uploads/Reassessment.pdf.
330 Pennsylvania Department of Community &d Economic Development, "Taxation Manual," 10.

assessment of market value; otherwise, the county is entitled to rely on its base-year assessment ratio. As a measure to increase uniformity, the CLR is weak and (because it is only pertinent on appeal) highly inefficient.

Rate and Levy Limitations

By far the most meaningful property tax limitation is an incidental one: the degree to which a lack of regular assessments can shield owners of incumbent properties from some burdens which are borne disproportionately from those who develop or improve property. However, Pennsylvania law also includes both rate and levy limitations, albeit largely ineffectual ones.

Local governments in Pennsylvania face an aggregate tax cap, though not one specifically limited to taxes on real property. The aggregate of all taxes in a locality is not permitted to exceed the value of 12 mills on the total market value of all real estate in the jurisdiction.[331] Outside of Philadelphia, which is governed by the Sterling Act, a reassessment may not result in a net tax increase; rates must be adjusted downward to avoid such an eventuality.[332]

School districts face a further restriction. Absent voter approval through the referendum process, they may not increase school property tax millages above the amount specified in a state-defined inflation index. This index is calculated with reference to percentage increases in statewide average weekly wage and the federal employment cost index for elementary and secondary schools. Three localities ineligible for certain elements of a property tax relief bill which passed in 2004–Philadelphia, Pittsburgh, and Scranton–are permitted somewhat higher rate increases.[333] State law governs the circumstances under which school districts can pursue larger rate increases by referendum.[334]

The referendum provision is a relatively recent development, first adopted in 1998 and reinstituted as part of Act 1 of 2006, commonly known as the Property Tax Relief Act.[335] That legislation represents the latest of several attempts to limit property tax increases and reduce property tax burdens by shifting toward other taxes.

The practical effects of these constraints, however, are relatively limited, since the overall cap is quite high and other limitations are often easily circumvented by adjusting assessment ratios or base years, or even conducting a reassessment—all of which can enhance local revenues without running afoul of the state's rate or levy limitations.

331 53 P.S. § 6924.320.
332 53 P.S. § 6926.327.
333 Jaime S. Bumbarger, "Pennsylvania's Taxpayer Relief Act: Big Gamble Pays Off for Some, But Most Lose Their Shirt," *Penn State Law Review* 114:3 (Winter 2010), 1010-1011, (http://www.pennstatelawreview.org/articles/114/114%20Penn%20St.%20L.%20Rev.%201003.pdf.
334 53 P.S. § 6926.333.
335 Jaime S. Bumbarger, "Pennsylvania's Taxpayer Relief Act: Big Gamble Pays Off for Some, But Most Lose Their Shirt," 1011.

Property Tax Exemptions and Rebates

Homestead Exclusion

A homestead exclusion exempts a portion of a taxpayer's primary residency from property taxation, meaning that the property tax is levied on a lesser taxable value than it would have been absent the exclusion. Such exclusions or exemptions are found in many states, and vary in their implementation, but Pennsylvania's approach is unique and unpredictable. Whereas most states' homestead exclusions provide an exemption of a fixed dollar amount for all qualifying owner-occupied housing statewide, Pennsylvania's exclusions are optional to each taxing authority, with the exclusion amount routinely adjusted and varying across jurisdictions. They can only be created under defined circumstances, moreover, and property tax rates cannot be increased to fund them.

Since property taxes in Pennsylvania are levied by three different taxing authorities–county, municipality, and school district–it is entirely possible for a single property to be granted an exclusion by one tax authority but not the others, or to have different exclusion amounts with each authority.[336] Taxpayers must apply for the exclusion, which is fairly routine, but taxpayers told us that the process can be particularly uncertain in Pennsylvania, whereas in most states the application process is largely *pro forma*.

Local governments may, subject to a voter referendum, increase earned income tax rates above the normal cap to provide a homestead exclusion. State revenues are also available for this purpose, and the amount of the exclusion can vary from year to year based on revenue and the number of claimants.[337] The exclusion, first offered in 1999, required a constitutional amendment to supersede the uniformity clause, which would otherwise require the preference to be offered to businesses as well.[338]

Circuit Breaker for Senior Citizens and Disabled Adults

Pennsylvania offers a lottery-funded property tax and rent rebate program for low-income senior citizens, older widows and widowers, and permanently disabled adults. The program is funded and administered by state (not local) government, and issued in the form of rebates based on ownership status and income range.[339]

336 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 18.
337 Pennsylvania Department of Community & Economic Development, "Homestead Tax Exemption," https://dced.pa.gov/local-government/property-tax-relief-homestead-exclusion/.
338 Grant R. Gulibon, "Taxpayers' Guide to the Rendell Property Tax Relief Act," *Commonwealth Policy Brief* of the Commonwealth Foundation for Public Policy Alternatives 19:1 (February 2007), 10-11, https://www.commonwealthfoundation.org/docLib/20090904_Act1PB.pdf.
339 Pennsylvania Department of Revenue, *The Tax Compendium*, 38.

Rent reimbursements are offered in acknowledgment that the economic incidence of property taxes on residential structures is borne by the occupants and not by the owners of a given property. The latter element is particularly pertinent given that rental properties–whether apartment complexes or single-family dwellings–do not receive the benefit of the homestead exemption. However, rent rebates cut off at a lower income level than do owner rebates.

Under most circumstances, the maximum Senior Citizen Property and Rent Rebate is $650. However, supplemental rebates are available for seniors living in Philadelphia, Pittsburgh, and Scranton (which have greater taxing authority), and for qualifying homeowners with property tax bills which exceed 15 percent of income.[340] Philadelphia and Allegheny County (of which Pittsburgh is the county seat) are also authorized to provide their own tax rebate programs, and Allegheny County and its municipal governments may use tax-neutral assessments for qualifying homesteads following a countywide reassessment.[341]

Pennsylvania paid 542,657 claims for the 2016 tax year, totaling about $259 million. Of this, just under $153 million flowed to qualifying homeowners, while the remaining $106 million was claimed by renters.[342] The rebate amounts are as follows.

TABLE 8.3.
Senior Citizen Property Tax and Rent Rebate Amounts

Income Range	Owner	Renter
$0 - $7,999	$650	$650
$8,000 - $14,999	$500	$500
$15,000 - $17,999	$300	--
$18,000 - $34,999	$250	--

Source: Pennsylvania Department of Revenue

Other Provisions

Since 1984, Pennsylvania has authorized Philadelphia and Allegheny Counties to grant tax deferrals or exemptions to increased property taxes resulting from substantial neighborhood improvements. Allegheny County's school districts and municipalities also have the option of participating. All local tax authorities, meanwhile, are authorized to grant tax abatements to residences built on unimproved land in designated areas, if they so choose. Additional tax preferences exist for "deteriorated property" and farm and forestland preservation.[343]

340 Id.
341 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 19.
342 Pennsylvania Department of Revenue, Bureau of Research, "Report to the Pennsylvania General Assembly on the Property Tax Rent Rebate (PTRR) Program for Property Taxes or Rent Paid in 2016," Sept. 29, 2017, 6, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/PTRR/GenAssembly/Documents/2017_ptrr_report.pdf.
343 Pennsylvania Department of Community & Economic Development, "Taxation Manual," 19-20.

Other Property Taxes

Inheritance Tax

Pennsylvania is one of only six states to impose an inheritance tax, levied at rates ranging from 4.5 to 15 percent. One state with an inheritance tax (Maryland) also imposes an estate tax, while another 13 states and the District of Columbia levy an estate tax but not an inheritance tax.[344]

Inheritance and estate taxes are similar, but not identical. Estate taxes are imposed on the entirety of a decedent's bequests, while inheritance taxes are owed on the receipt of an estate's proceeds. While state taxes are imposed on the estate itself before assets are distributed to heirs, inheritance taxes are paid by legatees based on their share of the inheritance and relationship to the deceased. Inheritance taxes are the older of the two approaches to taxing transfers of property at death, with many states shifting to estate taxes after the federal government adopted one in 1916.[345] Pennsylvania's inheritance tax, however, far predates that.

When Pennsylvania first began taxing inheritances, it did so as an innovator. Its original inheritance tax, imposed at a rate of 2.5 percent on the inheritances of collateral heirs (those who are not direct descendants of the decedent), was imposed in 1826 to help finance a canal connecting Lake Erie to the Ohio and Susquehanna Rivers, to compete with New York's recently-completed Erie Canal.[346] In time, the Pennsylvania Canal would give way to railroads, but the tax it inspired lives on.

Today, the tax is imposed at separate flat rates on lineal heirs, siblings, and other beneficiaries. Lineal heirs (like children and grandchildren) are taxed at 4.5 percent, siblings at 12 percent, and any other taxable beneficiary at 15 percent. Surviving spouses and children aged 21 or younger are not subject to the inheritance tax. Charitable bequests are tax-exempt, as are some transfers of agricultural property.[347]

Inheritance taxes can be particularly harmful to small, family-owned businesses–including farms–if they do not possess the liquid assets necessary to cover the tax liability. To this end, lawmakers have taken steps to mitigate taxes on the inheritance of small businesses which remain in the family.[348] Absent such protections, an inheritor may be forced to downsize the business, or sell part or all of it, to pay the inheritance tax.[349]

The state's inheritance tax has long come in for criticism. In 1981, a state tax commission

344 See generally, Jared Walczak, "State Inheritance and Estate Taxes: Rates, Economic Implications, and the Return of Interstate Competition," Tax Foundation, July 17, 2017, https://taxfoundation.org/state-inheritance-estate-taxes-economic-implications/. Since the publication of this paper, New Jersey has completed the then-pending phaseout of its estate tax but continues to levy an inheritance tax.

345 Joint Economic Committee, "The Economics of the Estate Tax," December 1998, 6-7, https://www.jec.senate.gov/reports/105th%20Congress/The%20Economics%20of%20the%20Estate%20Tax%20(1708).pdf. There were several previous, short-lived estate taxes before 1916.

346 Eugene E. Oakes, "Development of American State Death Taxes," *Iowa Law Review* 26:451 (1940-1941), 452-453.

347 Pennsylvania Department of Revenue, "Informational Notice Inheritance Tax 2012-01," Sept. 6, 2012, http://www.revenue.pa.gov/GeneralTaxInformation/TaxLawPoliciesBulletinsNotices/InformationalNotices/Documents/info_notice_inh_2012-01.pdf.

348 2013 Pa. Legis. Serv. Act 2013-52 (H.B. 465).

349 See Jared Walczak, Scott Drenkard, and Joseph Bishop-Henchman, *2018 State Business Tax Climate Index*, 26.

found that the state inheritance tax "imposes an undue burden on small estates, and in certain instances adversely affects the continued ownership of family farms and businesses."[350] They lamented the effects on family farms–somewhat mitigated by later enactments–and noted "increasing evidence" of costly tax arbitrage, observing that "corporate forms are being sought out in order to avoid the adverse tax consequences of inheritance taxes."[351]

Amounts remitted under inheritance taxes represent only a portion of their cost. Many individuals who expect to leave sizable legacies employ sophisticated estate planning techniques to limit future liability. These avoidance strategies impose their own costs, both in terms of time and resources spent on estate planning and in economic opportunities forgone to reduce future tax exposure. These costs can be substantial, and they are economically inefficient, as they reduce wealth without increasing government revenues.

Wealthy individuals frequently take advantage of tax-advantaged gifts and transfers, or shift assets and investments to limit future liability, for instance by arranging for the purchase of a business subsequent to death. These strategies are expensive, inefficient, and may involve a loss of control of one's assets, but they are pursued to limit estate and inheritance tax liability. With the federal estate tax exclusion now set at $11 million, Pennsylvania's inheritance tax falls on a great many beneficiaries who are unaffected by federal death duties.

Realty Transfer Tax

Another, more common form of asset transfer tax is the realty transfer tax. Pennsylvania imposes a realty transfer tax at a rate of 1 percent of the consideration paid in the sale of property. Both the grantor and the grantee are jointly and severally liable for the tax, which is somewhat unusual.[352] Typically in Pennsylvania the payment is split evenly between the parties, but this is a matter of contract and not law.[353]

In addition to the state-imposed tax of 1 percent,[354] both municipalities and school districts are entitled to their own levy, typically not to exceed an additional 1 percent in aggregate. However, certain home rule municipalities are permitted to impose higher rates, led by Philadelphia at 3.1 percent[355] and Pittsburgh at 3 percent, for a total combined state and local rate of 4 percent or more in those jurisdictions.[356]

The tax is generally collected by the County Recorder of Deeds, with proceeds remitted

350 Richard Cyert et al., "Final Report of the Pennsylvania Tax Commission," 3.
351 Id, 53.
352 Pennsylvania Department of Revenue, *The Tax Compendium*, 18.
353 Pennsylvania Department of Revenue, "Who Pays the One Percent Realty Transfer Tax: The Seller or the Buyer?" April 11, 2015, https://revenue-pa.custhelp.com/app/answers/detail/a_id/1260/~/who-pays-the-one-percent-realty-transfer-tax%3A-the-seller-or-the-buyer%3F.
354 72 P.S. § 8102-C.
355 W. Roderick Gagné and Morgan Klinzing, "Philadelphia Real Estate Transfer Taxes Rising in 2017," Pepper Hamilton LLP, Nov. 8, 2016, http://www.pepperlaw.com/publications/philadelphia-real-estate-transfer-taxes-rising-in-2017-2016-11-08/.
356 Kirkpatrick & Lockhart Nicholson Graham LLP, "Pennsylvania Real Estate: New Developments in Pennsylvania's Local Transfer Taxes," K&LNG Alert, October 2005, http://www.klgates.com/files/Publication/ca356a59-eedd-450b-be9a-97c70aec0585/Presentation/PublicationAttachment/5889f489-3ff4-4a94-8412-9b8eba567f74/rea1005.pdf.

to the state, municipality, and school districts, as applicable.[357] In 2016, Philadelphia derived $237 million from realty transfer taxes, over eight times the amount collected in Pittsburgh ($30 million). Collectively, these two cities collect more in realty transfer taxes than the rest of the state's municipal governments combined. Statewide, school districts derive about half as much revenue from the tax as municipalities do.[358]

Property Tax Administration

The Council on State Taxation (COST) releases a report detailing the property tax administration practices of the 50 states, in addition to giving each state's system a letter grade based on its practices. According to COST,

> [I]t is essential for state legislators and tax administrators to ensure the tax is administered fairly and without perceptions of bias or undue administrative burdens. Taxpayers are much more willing to fairly and fully comply with a property tax system perceived as unbiased, equitable and efficient.[359]

States are evaluated based upon whether they have a uniform tax base and rates, adopt efficient filing procedures, centralize review and uniform appeal procedures, and limit payment requirements to the uncontested portion of valuations.[360]

Based on these criteria, Pennsylvania receives a grade of D and ranks worst in the nation. A range of factors contributes to this score, including the absence of property valuation cycles, the lack of standardized forms and oversight, lack of standardization of when reports are due to local assessors, unequal interest rates for under- and overpayments, the lack of an exclusion for *de minimis* values, disparate due dates, high taxpayer burdens of proof in tax appeals, and large homestead exemptions.[361]

357 Pennsylvania Department of Revenue, *The Tax Compendium*, 18.
358 Pennsylvania Department of Community & Economic Development, "Statewide County Annual Financial Reports"; and Pennsylvania Department of Education, "Revenue Data for School Districts, Career and Technology Centers, and Charter Schools."
359 Council on State Taxation, "The Best and Worst in Property Tax Administration," May 2011, 1.
360 Id., 2.
361 Id., 10-45.

Property Tax Solutions

A well-designed property tax system has certain advantages over other forms of taxation, which tend to have a larger adverse impact on economic decision-making. Commendably, Pennsylvania exempts personal property from taxation, properly circumscribing the tax base to land and improvements. The state does, however, have a highly convoluted and nonneutral system of taxes on real property, and imposes an economically harmful inheritance tax.

The following property tax solutions are designed to be severable, to be considered individually or in concert with each other. Each solution would improve the competitiveness of the Commonwealth's property tax structure.

Mandatory Assessment Cycles

Pennsylvania's haphazard approach to property tax assessment results in significant inequities which cry out for redress. Similarly situated properties are taxed at markedly different effective rates, while the tax code actively discourages improvements which would increase a property's value and productivity, particularly in cases where the underlying property and structures have appreciated rapidly since their last assessment. Millage rates convey almost nothing about actual property tax burdens, since the tax base can vary so dramatically across jurisdictions.

County governments have shied away from regular reassessments due to costs and potential political ramifications. While the process would not be painless, state government can address both concerns by mandating reassessment on a regular cycle, using state-defined standards and assistance which can help cut down on costs. Requiring assessments every five years, at full market value, would represent a vast improvement in equity and comprehensibility. Existing law prohibits a reassessment from triggering a net tax increase, so jurisdictions would be obligated to adjust their rates following each mandated reassessment.

Properties which have benefited from the current system will see higher taxes under a system made more equitable, while those which have borne the brunt of the current system will see a reduction in liability. Such distributional changes are unavoidable in a system which has long operated with substantial distortions, and the longer the Commonwealth waits, the worse the problem will become. The current system, under which counties face individual legal challenges, is untenable as a long-term solution. Localities in nearly every other state conduct assessments on a regular basis, either by law or common practice. Pennsylvania's outlier status is unfair, economically inefficient, and one of the primary reasons why the property tax is so burdensome in the state.

Consolidated Property Tax Administration

Pennsylvanians receive three different property tax bills for each parcel: one from the county, one from the municipality, and one from their school district. The state lacks a uniform filing deadline, moreover, so those with property in multiple jurisdictions can see bills arrive at different times of the year. It would require very little loss of local autonomy for the legislature to mandate a uniform filing deadline statewide, or even to stipulate that property tax collections should be consolidated at the county level, with a single collector disbursing the appropriate sums to the county, municipal, and school district funds.

Uniform Property Tax Codes

As with the rest of local taxation, Pennsylvania's property tax codes are a potpourri of provisions which vary from one class of county to the next, or from which particular jurisdictions are exempt. This sort of complexity is less problematic in real property taxes, which are taxpayer passive–which is to say, the taxing authorities prepare the bill–than in other taxes, where the taxpayer is required to ascertain tax liability, but it is still needlessly complex and results in a web of case law of uncertain applicability across the state. Policymakers should look to consolidate the discrete codes wherever possible, and to phase out special carveouts for select jurisdictions.

Inheritance Tax Repeal

Pennsylvania's inheritance tax disadvantages some bequests more than others, favoring lineal heirs over other relatives, and treating anyone other than a lineal heir or sibling the same as an unrelated beneficiary, with a tax rate of 15 percent. The tax can prove uniquely burdensome to small businesses, potentially requiring them to be broken up to pay the tax bill.

Under the current system, some Pennsylvanians may elect to adopt tax avoidance strategies such as making lifetime gifts, even if they would otherwise prefer to retain ownership throughout their life. Such arrangements are suboptimal for the individuals involved without conferring any revenue advantage to the state.

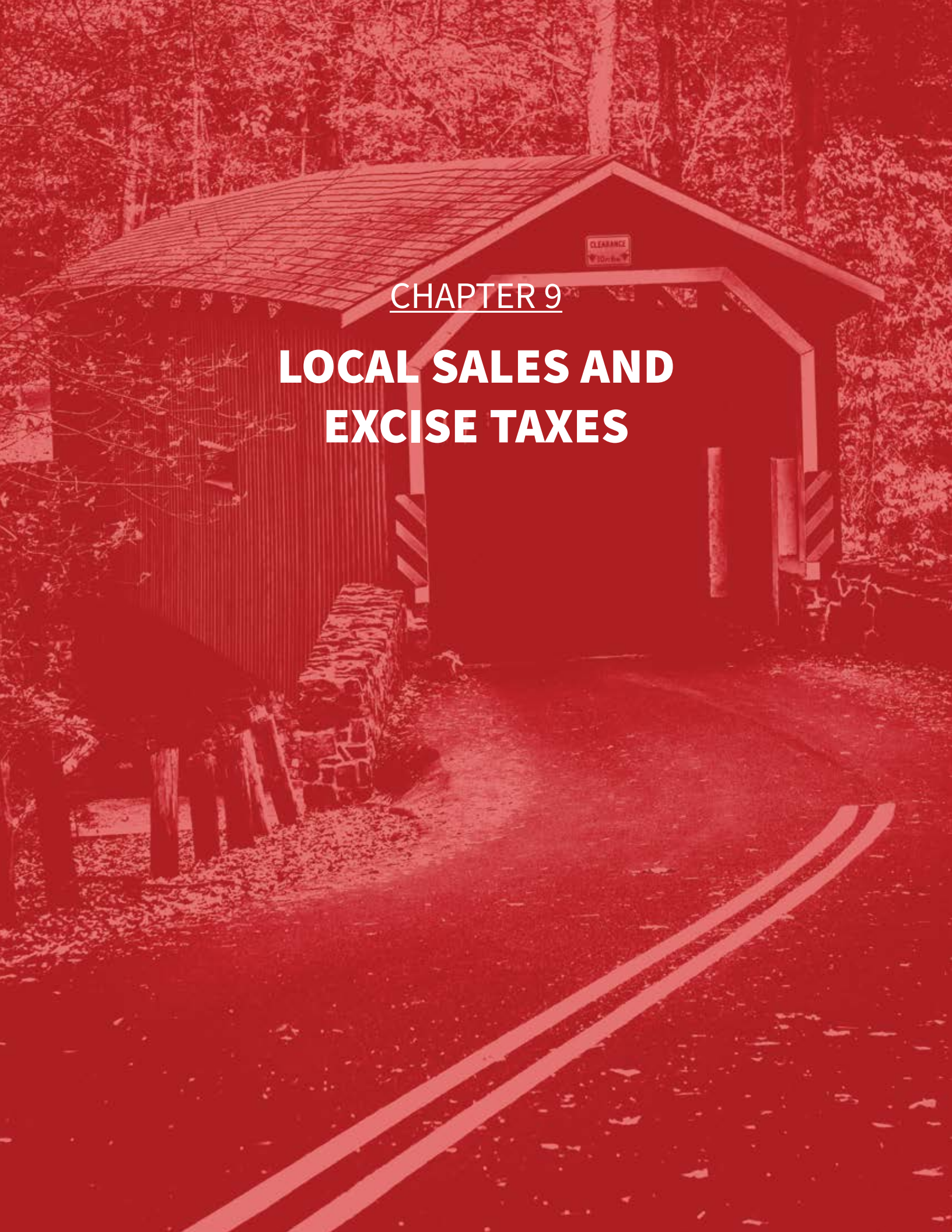
Because Pennsylvania's inheritance tax applies so broadly, without the substantial income exclusions which exist in other states, it raises a substantial amount of revenue—$978 million, or 3.2 percent of state tax revenue, in fiscal year 2017.[362] Pennsylvania policymakers should consider putting the state on the path of repealing the inheritance tax, increasingly a relic of a bygone era. In 2008, the House of Representatives unanimously supported an amendment phasing out the inheritance tax, though it was stripped out in the Senate.[363]

362 Pennsylvania Department of Revenue, "Statistical Supplement for the Tax Compendium," 2016-2017, http://www.revenue.pa.gov/GeneralTaxInformation/News%20and%20Statistics/ReportsStats/TaxCompendium/StatSupplement/Pages/default.aspx.

363 Timothy J. Witt, "Individuals and Inheritance Taxes: A Praxeological Examination of Pennsylvania's Inheritance Tax," *Penn State Law Review* 114:3 (Winter 2010), 1115, http://www.pennstatelawreview.org/articles/114/114%20Penn%20St.%20L.%20Rev.%201105.pdf.

If a revenue loss of this scale cannot be absorbed within the context of broader tax reform, legislators might explore rate reductions or exemptions, to the degree that they are permitted under the state's uniformity clause. Some of the loss may be offset, in the long run, through additional tax receipts from individuals who might otherwise leave the state, but such revenues cannot be predicted and should not be relied upon as a significant offset.

	Pennsylvania's Current Ranking	Ranking with Full Implementation of Property Tax Reform Recommendations
Overall *Index* Ranking	26	23
Property Tax *Index* Component Ranking	33	21



CHAPTER 9

LOCAL SALES AND EXCISE TAXES

Introduction

Only Philadelphia and Allegheny County have the authority to impose local sales taxes. Counties receive a share of the hotel occupancy tax, levied by the state, but it is Philadelphia, with its beverage tax, that stands out on the local excise tax front. Because state sales taxes were considered at length in Chapter 5, this short chapter provides only the briefest of reviews of local sales and excise taxes.

Local Sales Taxes

States vary in their grant of local sales tax authority. Some prohibit local sales taxes outright; others permit them to some political subdivisions but not others; and still others grant them to every taxing authority. In Pennsylvania, only Philadelphia and Allegheny County are authorized to levy local sales taxes, at 1 percent in Allegheny County and 2 percent in Philadelphia.

Because sales taxes were treated separately in Chapter 5, there is little else to be written here. However, should the state expand the sales tax base to services, or take full advantage of the Supreme Court's recent decision in *Wayfair v. South Dakota* to capture revenue from remote sales, these jurisdictions would receive additional revenue that could be used to limit or eliminate local nuisance taxes.

Philadelphia Beverage Tax

Long ago, Philadelphia was the first city in the country to impose a municipal income tax. It would prove far from the last time that the city pushed the envelope on local taxation. Most recently, Philadelphia became the second city in the country–after only Berkeley, California–to levy a beverage tax. Since then, it has been joined by Boulder, Colorado; Seattle, Washington; and several other cities in California, including San Francisco.

Commonly called the soda tax and officially termed a sugar-sweetened beverage tax, it is actually broader than either term implies. The 1.5-cent per ounce tax is imposed on beverages other than soda, like sweetened juices and sports drinks, and on diet sodas with artificial sweeteners, not just beverages sweetened with sugar or high fructose corn syrup. The ordnance delineates 38 sweeteners, from sugar to agave to dried raisin sweetener, which subject a beverage to taxation, and the list is not intended to be exhaustive.[364]

While similar taxes elsewhere have been presented as public health measures designed to reduce liquid calorie consumption, Philadelphia Mayor Jim Kenney (D) and other proponents of Philadelphia's beverage tax were unequivocal in billing the tax as a revenue-raiser first and foremost. The tax adds just over a dollar to the price of a two-liter

364 City of Philadelphia Department of Revenue, "Sugar-Sweetened Beverage Tax ('SBT') Regulations," Aug. 4 2017, http://phillybevtax.com/Content/Documents/Philadelphia-Beverage-Tax-Regulations.pdf.

bottle of soda, and $4.32 to a 24-pack case, tax costs which rival the regular retail prices of these products.

The beverage tax is imposed on distribution to dealers selling soft drinks at retail in Philadelphia. Remittance is generally made by the distributors themselves, though contracts can be structured for payment by dealers instead.[365] That, at least, is the legal incidence; the economic incidence falls upon consumers, who now pay considerably more for sweetened beverages purchased in the city. Avoidance of the tax, either by purchasing soda across the city line or by reducing consumption, imposes costs as well.

Thus far, soda tax revenues have failed to meet expectations. It is a given that a high excise tax on sweetened beverages will change consumption patterns, but estimating that effect can be quite difficult. Consumers will reduce their consumption of taxed beverages, substituting other goods. (In many cases, they may consume just as many calories, but get them elsewhere.) Or they may shift their purchases, buying cases of soda outside city limits. They may consume more alcoholic beverages, which are taxed at a small fraction of the rate imposed on soft drinks.[366]

As a source of funding for pre-K and other early childhood expenditures, moreover, the tax has clear flaws. Imposed on a narrow and declining base, one further carved away by the tax itself, revenues can only decrease. Soft drink consumption is down more than 25 percent since 1997, and that trajectory will only be enhanced by taxes which can nearly double their price.[367]

Finally, taxes on sugar-sweetened beverages are regressive. The share of household income devoted to expenditures on soft drinks decreases as income rises. In Pennsylvania, the average household purchases 3,830 ounces of sugar-sweetened beverages a year. If that held true for Philadelphia in particular–and cities usually have higher consumption patterns–then the average Philadelphia household would pay $57.45 a year in soda taxes.[368]

Nationally, households earning $25,000 to $30,000 in income consume 4,226 ounces a year, on average. Households with income above $100,000 consume 3,949 ounces per year. Not only do lower-income households consume slightly more soda than their higher-income counterparts, but the purchases also represent a significantly larger share of their total income.[369]

For its revenue instability, nonneutrality, and regressivity, the Philadelphia soda tax is an experiment to avoid, not one to emulate.

365 City of Philadelphia Department of Revenue, "Philadelphia Beverage Tax Frequently Asked Questions," http://phillybevtax.com/Consumers/Frequently-Asked-Questions.
366 Courtney Shupert and Scott Drenkard, "Soda Tax Experiment Failing in Philadelphia Amid Consumer Angst and Revenue Shortfalls," Tax Foundation, Aug. 3, 2017, https://taxfoundation.org/philadelphia-soda-tax-failing/.
367 John Buhl, "The Case Against Soda Taxes," Tax Foundation, March 15, 2017, https://taxfoundation.org/case-against-soda-taxes/.
368 Justin Ross and Felipe Lozano-Rojas, "Are Sugar-Sweetened Beverage Taxes Regressive? Evidence from Household Retail Purchases," Tax Foundation, June 19, 2018, 7, https://taxfoundation.org/soda-taxes-regressive/.
369 Id., 8.

ABOUT THE TAX FOUNDATION

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. Our Center for State Tax Policy uses research to foster competition among the states and advises policymakers on how to improve their tax systems.

Center for State Tax Policy

Joseph Bishop-Henchman
Excutive Vice President, Legal & State Projects

Scott Drenkard
Director of State Projects

Nicole Kaeding
Economist & Director of Federal Projects

Jared Walczak
Senior Policy Analyst

Katherine Loughead
Policy Analyst

Morgan Scarboro
Policy Analyst

Publications

Rachel Shuster
Editor

Dan Carvajal
Designer

Special thanks to Erica York and Colin Cook for their research assistance.

ABOUT THE PENNSYLVANIA CHAMBER OF BUSINESS AND INDUSTRY

Founded in 1916, the Pennsylvania Chamber of Business and Industry is the largest broad-based business advocacy association in the Commonwealth. As the Statewide Voice of Business™ the PA Chamber's mission is to articulate and advocate on public policy issues that will expand private sector job creation and lead to a more prosperous Pennsylvania for all its citizens. With close to 10,000 member businesses of all sizes and industry sectors throughout the state–from sole proprietors to Fortune 100 companies–representing nearly 50 percent of the private workforce in the Commonwealth, the PA Chamber serves as the frontline advocate for business growth in the state capitol. The United States Chamber of Commerce awarded the PA Chamber with a rating of Accredited with Distinction–one of only three state chambers to reach this achievement.

From the colonial era through the Whiskey Rebellion, to the fitful efforts to tax income, to the 1991 income tax vote that sparked a literal scuffle in the lower house, and on to the present day, debates over taxes are interwoven in the fabric of Pennsylvania's history. The vision of a tax system that looks like someone designed it on purpose has proved elusive, here even more than in other states.

Governing structures look different in Pennsylvania than they do elsewhere, and that is part of the Commonwealth's charm. Unfortunately, it has also helped yield a tax code patched together over the years, overlaid on a system that has been evolving–not always in one direction–since the days of William Penn.

Policymakers from across the spectrum recognize that the Commonwealth's tax code has not kept up with a 21st century economy. This book seeks to identify what the Commonwealth does well and to point out opportunities for improvement. It is our hope that this book will help reform a robust and much-needed debate about the future of the state's tax code.

TAX FOUNDATION | Since 1937

PRINCIPLED
INSIGHTFUL
ENGAGED

The Tax Foundation is the nation's leading independent tax policy research organization. Since 1937, our research, analysis, and experts have informed smarter tax policy at the federal, state, and local levels. We are a 501(c)(3) non-profit organization.

©2018 Tax Foundation

Tax Foundation
1325 G Street, N.W. Suite 950
Washington, D.C. 20005
202.464.6200

taxfoundation.org

ISBN 978-1-942768-21-0
90000>
9 781942 768210