KEYSTONE RESEARCH CENTER

A Real Tax Cut for Pennsylvania's Middle Class

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Howard Wial

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Keystone Research Center • 412 North Third Street • Harrisburg, Pennsylvania 17101
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Keystone Research Center

The Keystone Research Center (KRC), a non-partisan think tank with offices in Harrisburg and the Philadelphia area, conducts research on the Pennsylvania economy and labor market. This research documents current conditions and seeks to develop innovative policy proposals to improve state economic, labor market, and social performance.

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About the Author

Howard Wial is a Senior Fellow of the Keystone Research Center and adjunct professor of law at Rutgers University, Camden, New Jersey. He holds a Ph.D. in economics from the Massachusetts Institute of Technology and a law degree from Yale University. Howard is co-author of the 1998 Cornell University Press book *New Rules for a New Economy: Employment and Opportunity in Postindustrial America*.

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Overview

State income tax relief for the middle class is on the agenda in Pennsylvania. In the first half of March, the state House of Representatives voted to cut the state personal income tax rate from 2.8 to 2.7 percent. This reduction would put very little cash back in the pockets of middle-class Pennsylvanians. A family making $30,000 would have only $30 more to spend, a family making $50,000 an extra $50. The meager benefit for working families from a 0.1 percentage point reduction in the state income tax is one reason that the reduction is not currently expected to become law.

To achieve a more substantial middle-class tax cut, this briefing paper proposes that the Legislature introduce a personal exemption into the state income tax. This would eliminate taxes on part of each taxpayer's income. Under our proposal, a two-adult, two-child family with an income of $30,000 would pay taxes on only a very small fraction of its income. Its take-home income would increase by more than $700.

So that our proposal is "revenue neutral," i.e., does not reduce the total revenue raised by the state's personal income tax, we propose combining the introduction of personal exemptions with an increase in the state income tax rate to 3.8 percent. Families that make enough to pay taxes would pay a higher tax rate on a smaller part of their income. Even with this rate increase, any two-adult/two-child family with an income below $104,120 would be as well or better off under our proposal.

In sum, our proposal would help those families that have shared little or not at all in the fruits of economic growth in Pennsylvania in the last two decades. Implementing this proposal would send a clear signal that lawmakers have the interests of the state's middle class uppermost in their minds.

What's Wrong with Pennsylvania's Tax System?

In Pennsylvania and throughout the nation, the wages of middle- and low-income workers have stagnated in the past two decades. Even in 1998, after several years of modest wage increases, median and low-wage earners in Pennsylvania made about 50 cents per hour less in inflation-adjusted dollars than in 1979 — $1,000 dollars less per year for a full-time, full-year worker.[1] In part because of rising wage inequality, the before-tax income gaps between the rich and poor and between the rich and middle class are wider today than in the 1980s or 1970s.[2] State and local taxes could have been used to cushion the impact of rising wage inequality on working and low-income families. But state and local taxes in every state place a higher tax burden on the middle and bottom fifths of income earners than on the top 1 percent (Table 1).

Table 1
State and Local Taxes in 1995: Effective Rates* for Each Fifth of the Income Distribution (in order of rate paid by bottom fifth)

	Bottom Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Next 15%	Next 4%	Top 1%
Washington	17.0%	12.2%	10.4%	8.9%	7.2%	5.4%	3.6%
New York	16.1%	13.9%	13.5%	12.6%	11.4%	9.8%	8.9%
New Jersey	15.6%	10.0%	9.1%	8.4%	8.0%	7.0%	6.2%
New Mexico	15.0%	12.6%	11.0%	10.0%	8.9%	7.5%	6.7%
Florida	14.0%	9.8%	7.6%	6.4%	5.3%	4.1%	3.2%
Texas	13.8%	10.4%	8.5%	7.3%	6.1%	4.9%	4.0%
Wisconsin	13.6%	12.1%	12.0%	11.1%	9.8%	8.1%	6.4%
Illinois	13.5%	10.3%	9.4%	8.3%	7.3%	5.7%	4.9%
Louisiana	13.4%	11.2%	10.4%	8.8%	7.4%	5.6%	4.8%
PENNSYLVANIA (1995 tax system)	13.2%	10.7%	9.8%	8.9%	7.7%	6.2%	4.5%
Michigan	13.2%	11.4%	10.2%	9.1%	7.8%	6.5%	5.0%
Rhode Island	12.8%	10.9%	9.9%	9.4%	8.7%	7.5%	7.5%
Indiana	12.6%	10.3%	9.4%	8.3%	7.3%	6.0%	4.9%
PENNSYLVANIA (1995 tax system with 1998 tax forgiveness credit)**	12.5%	10.6%	9.8%	8.9%	7.7%	6.2%	4.5%
Iowa	12.3%	11.0%	10.2%	9.7%	8.7%	7.5%	6.1%
Tennessee	12.3%	9.3%	7.6%	6.4%	5.3%	3.9%	3.2%
Mississippi	12.1%	9.7%	9.6%	9.1%	7.7%	6.4%	5.4%
Arkansas	12.0%	10.5%	9.6%	9.0%	8.1%	6.8%	5.7%
California	12.0%	9.0%	8.5%	8.1%	7.8%	7.4%	8.1%
Utah	12.0%	11.2%	10.6%	9.8%	8.4%	7.0%	5.7%
South Dakota	11.7%	8.9%	7.8%	6.6%	5.7%	4.0%	2.6%
Maine	11.6%	9.7%	9.9%	10.1%	9.4%	8.2%	7.2%
Ohio	11.6%	10.0%	9.6%	9.1%	8.1%	7.2%	6.3%
Alabama	11.5%	10.3%	9.0%	7.8%	6.5%	5.2%	3.6%
Missouri	11.5%	10.2%	9.6%	8.8%	7.7%	6.5%	5.5%
Massachusetts	11.4%	10.2%	9.6%	8.7%	8.0%	7.0%	6.0%
Arizona	11.3%	9.5%	8.5%	7.7%	6.5%	5.7%	5.3%
Connecticut	11.3%	9.5%	9.5%	8.8%	7.8%	6.1%	4.9%
Georgia	11.1%	9.9%	9.3%	8.4%	7.4%	6.3%	5.7%
Hawaii	11.0%	10.1%	9.7%	8.6%	7.9%	6.9%	6.2%
Kansas	10.9%	9.7%	9.3%	8.8%	7.8%	6.6%	5.9%
Minnesota	10.9%	10.9%	10.4%	9.7%	8.7%	8.0%	7.8%
Maryland	10.8%	10.7%	9.8%	9.0%	8.2%	6.7%	5.6%
Nebraska	10.8%	10.1%	9.7%	9.1%	8.3%	7.2%	6.4%
Oregon	10.8%	9.1%	9.2%	9.2%	8.5%	7.6%	7.0%
North Dakota	10.6%	8.7%	7.8%	7.3%	6.5%	5.7%	5.2%
West Virginia	10.6%	9.4%	8.6%	8.2%	7.8%	6.9%	5.7%
Washington, D.C.	10.5%	10.0%	9.5%	9.1%	8.0%	6.4%	6.4%
Kentucky	10.4%	10.5%	10.2%	9.9%	8.7%	7.4%	5.7%
Colorado	9.9%	9.0%	8.4%	7.7%	6.6%	5.6%	5.1%
Oklahoma	9.9%	10.0%	9.4%	8.9%	7.6%	6.1%	5.0%
North Carolina	9.6%	9.7%	9.1%	8.7%	7.7%	6.7%	6.0%
Virginia	9.6%	8.8%	8.3%	7.6%	6.8%	5.9%	5.0%
Vermont	9.4%	8.5%	9.6%	8.4%	8.0%	7.0%	6.9%
Idaho	9.2%	9.2%	9.0%	8.8%	8.2%	7.1%	6.8%
New Hampshire	9.0%	6.7%	5.7%	5.6%	4.7%	3.8%	3.2%
Nevada	8.9%	5.6%	4.7%	4.1%	3.4%	2.5%	1.6%
Wyoming	8.2%	6.5%	5.7%	4.7%	3.8%	3.0%	2.7%
South Carolina	8.0%	7.0%	7.8%	7.8%	7.0%	6.3%	5.6%
Montana	7.6%	6.5%	6.6%	6.9%	6.6%	5.9%	5.5%
Alaska	6.9%	3.7%	2.7%	2.4%	2.0%	2.0%	2.1%
Delaware	6.3%	6.5%	6.2%	6.0%	5.8%	5.2%	4.9%

*Effective rates are the ratio of average tax liability to pretax family income for each income grouping, after deducting the federal offset from state tax liability (since taxpayers can deduct state and local income and property taxes from their federal income tax liability).
**These estimates assume that, except for the tax forgiveness credit, the Pennsylvania tax system has not changed since 1995.

Source: Institute on Taxation and Economic Policy.

Compared to other states, Pennsylvania's tax system places an unusually high tax burden on low-income people and contributes more to widening the income gap between rich and poor. (In Pennsylvania, the major state and local taxes include local property, occupational privilege, and wage taxes, and the state personal income and sales taxes.) Table 1 shows that in 1995, the last year for which it is possible to compare all states, Pennsylvania's effective tax rate on the bottom fifth of income earners (13.2 percent) was tenth-highest among all states. On the middle fifth of income earners it was thirteenth-highest (9.8 percent). But on the top 1 percent it was eleventh-lowest (4.5 percent). Only three states, Washington, Florida, and Texas, both taxed the bottom fifth at a higher rate and taxed the top 1 percent at a lower rate than Pennsylvania.

In the last several years, Pennsylvania has reduced the tax burden on some working poor families by expanding eligibility for its low-income tax forgiveness credit. Under this program, taxpayers below specified income levels need pay no tax. (These levels equal $6,500 times the number of family members up to two, plus $6,000 times the remaining number of family members.) A married taxpayer with two dependents, for example, now owes no tax if her income is $25,000 or less (and owes less than 2.8 percent if her income is between $25,000 and $27,250). In his 1999 budget, the Governor proposed raising the income below which this family pays no tax to $26,000. Governor Ridge and the state Legislature deserve credit for expanding the state's income tax forgiveness credit. But Pennsylvania needs to go further. According to calculations by the Institute on Taxation and Economic Policy, the tax forgiveness changes through 1998 only lowered Pennsylvania's tax rate on the bottom fifth from tenth-highest to thirteenth-highest (Table 1).

The expanded low-income tax forgiveness credit has two major drawbacks. First, the income limits are still too low, so that the state income tax continues to be a major burden to some low-income working families. In all but two Pennsylvania counties, a family of two adults, an infant, and a preschooler needs more than $27,250 (the income at which the tax credit is now phased out completely for this family) to pay for minimally adequate food, rent, transportation, and other basic necessities.[3]

Second, if a family's income rises by only $2,250, then that family can go from paying no tax to paying a 2.8 percent tax on all of its income. For a two-adult, two-child family whose income rises from $25,000 to $27,250, the state income tax goes from zero to $763 per year though such a family cannot afford basic necessities in most counties even after its income goes up.

The Solution: Introduce Personal Exemptions

Introducing personal exemptions into the Pennsylvania state personal income tax, similar to that used in most other states and the federal tax system, would solve both problems. Instead of taxing all income above a certain threshold at 2.8 percent from the first dollar, only the dollars above the threshold would be taxed. In order to keep total state revenues from the personal income tax the same, the tax rate would have to be increased. But most taxpayers above the threshold would still see their taxes fall. Low- and middle-income people with incomes above the threshold would receive tax cuts because they would pay a higher tax on a much smaller portion of their income. High-income people would pay more in taxes than they now do. The benefits of the personal exemption would fall gradually as income rose (but would never be completely wiped out, even for the very rich), eliminating the quick phase-out problem in the current tax forgiveness credit.

If the Pennsylvania income tax had a **personal exemption of $8,000 per adult and $5,700 per dependent and a tax rate of 3.8 percent instead of the current 2.8 percent**:

- The state would collect approximately the same amount of tax revenue as it currently does.
- A family of two adults and two children would pay no tax if its income were $27,400 or less.
- All two-adult, two-child families with annual incomes below $104,120 would see their income taxes fall, while those with higher incomes would pay higher taxes. (Only about 8 percent of all Pennsylvania households have incomes greater than $104,120.)
- A two-adult, two-child family with an annual income of $30,000 would pay $99 in tax instead of the current $840, for a tax saving of $741.
- A two-adult, two-child family with an annual income of $50,000 would pay $859 in tax instead of the current $1400, for a tax saving of $541.
- 94.5 percent of the tax cut would go to households in the bottom 80 percent of the income distribution—households with incomes of $61,000 or less.

Table 2
Comparison of Keystone Research Center and House of Representatives Income Tax Proposals for a Family of Two Adults and Two Children

Income	**$25,000**	**$30,000**	**$50,000**	**$75,000**	**$100,000**	**$150,000**
1999 Income Tax	0	$840	$1,400	$2,100	$2,800	$4,200
1999 Income Tax, Keystone Research Center Proposal*	0	$99	$859	$1,809	$2,759	$4,659
Tax Change in Dollars, Keystone Research Center Proposal*	0	-$741	-$541	-$291	-$41	+$459
Tax Change in Dollars, Bill Passed by PA House of Representatives**	0	-$30	-$50	-$75	-$100	-$150

*Introduce personal exemption of $8,000 per adult and $5,700 per dependent, raise tax rate from 2.8 percent to 3.8 percent, and eliminate low-income tax forgiveness credit.
**Reduce tax rate from 2.8 percent to 2.7 percent. Maximum income for low-income tax forgiveness credit remains at $25,000.
Source: KRC calculations.

Table 3
Effects of a Personal Exemption ($8,000 per Adult, $5,700 Per Dependent) and a 3.8 Percent Income Tax Rate

					Top 20%		
Household Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Average Income in Group	$8,000	$18,800	$30,900	$48,700	$79,500	$161,000	$734,000
Income Range	Less than $13,500	$13,500-$24,000	$24,000-$38,800	$38,800-$61,000	$61,000-$114,000	$114,000-$266,000	$266,000 or more
Average Tax Change as Percent of 1999 Income	-0.5%	-0.5%	-0.4%	-0.4%	0.0%	+0.4%	+0.8%
Average Tax Change, in Dollars	- $41	- $94	- $126	- $178	- $34	+ $618	+ $5641
Percent of Total Tax Cut Received by Income Group	8.9%	20.2%	27.1%	38.3%	5.6%	—	—

Source: Institute on Taxation and Economic Policy, 1999.

- The effective tax rate (defined in the notes to Table 1) on the richest 1 percent of Pennsylvania families would still be less than in all surrounding states except Delaware (assuming other states' tax systems remain as they were in 1995). Delaware and Pennsylvania would have similar effective tax rates on the richest households.

Table 2 summarizes the consequences of our proposal for Pennsylvania families with two adults and two children. Table 3 summarizes the consequences for households at different income levels. (When households have only one, two, or three people, our proposal reduces their taxable income by less than in four-person or larger families. The existence of large numbers of small households is the main reason that the *average* tax changes for less affluent households are not as large as they are for a family of four.)

Our Proposal Compared with a Cut in the State Income Tax from 2.8 to 2.7 Percent

A cut in the state income tax rate from 2.8 percent to 2.7 percent helps middle-class taxpayers, but not as much as our proposal. It delivers greater benefits to the rich than to the middle class. Holding constant the number of adults and children in a family, the benefits of this proposal go up as income rises, while the benefits of our proposal go up as income falls (until the income tax forgiveness threshold is reached).

Table 4 summarizes the consequences of a 0.1 percentage point reduction in the Pennsylvania personal income tax rate proposal for households at different income levels. The last row of Table 2 does the same for four-person households with two children.

Table 4
Effects of Reducing Pennsylvania's Income Tax Rate from 2.8 Percent to 2.7 Percent

					Top 20%		
Household Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Average Income in Group	$8,000	$18,800	$30,900	$48,700	$79,500	$161,000	$734,000
Income Range	Less than $13,500	$13,500-$24,000	$24,000-$38,800	$38,800-$61,000	$61,000-$114,000	$114,000-$266,000	$266,000 or more
Average Tax Change as Percent of 1999 Income	-0.03%	-0.05%	-0.06%	-0.08%	-0.09%	-0.09%	-0.09%
Average Tax Cut, in Dollars	-$2	-$10	-$19	-$37	-$70	-$141	-$649
Percent of Total Tax Cut Received by Income Group	1.2%	5.5%	10.6%	20.3%	28.6%	15.4%	18.4%

Source: Institute on Taxation and Economic Policy, 1999.

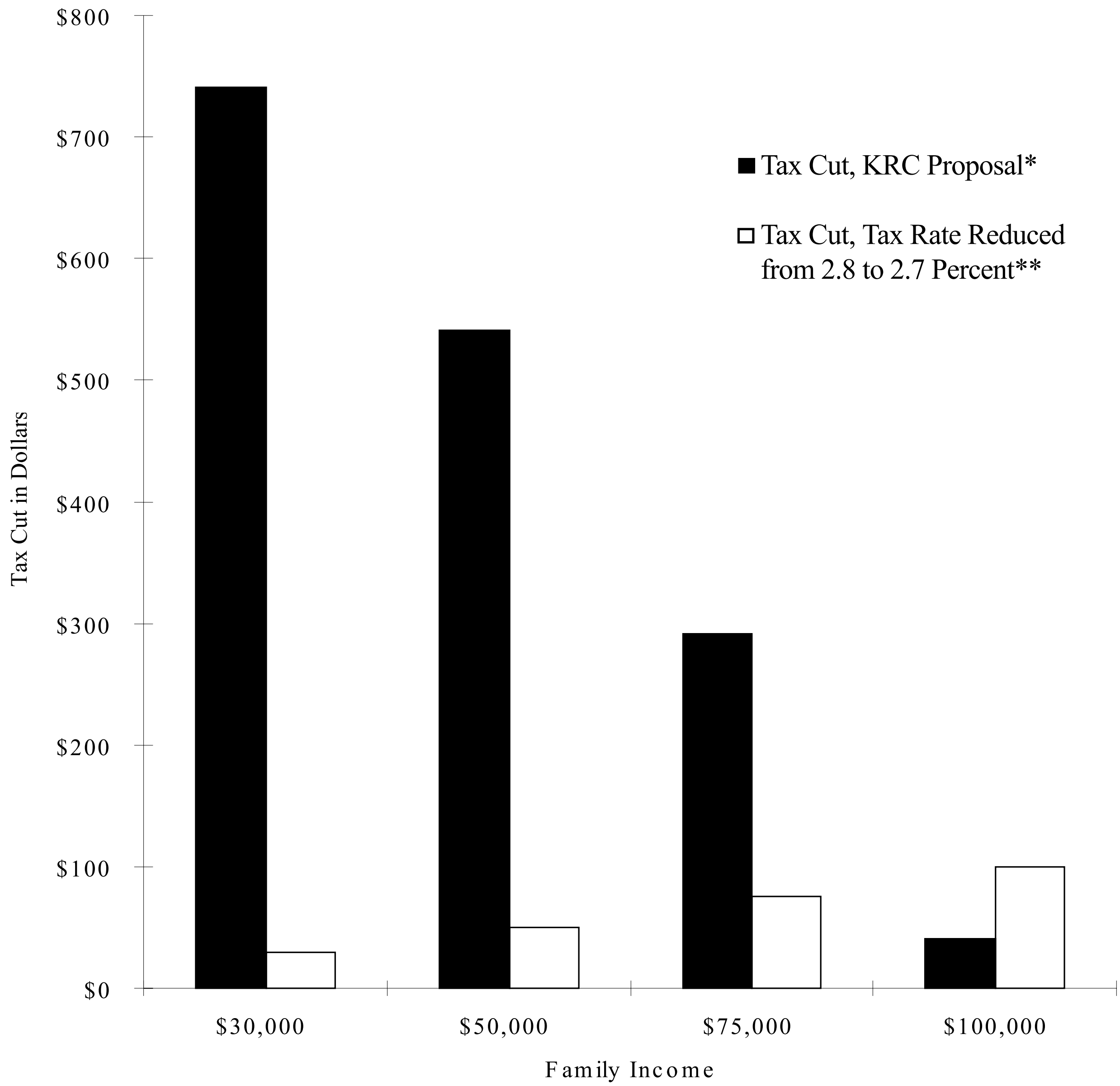
Table 4 shows that:

- the richest 1 percent of households would garner 18 percent of the benefits of a cut in the state income tax from 2.8 to 2.7 percent, compared with none of the benefits under our proposal;
- the richest 20 percent of households would receive 62 percent of the benefits, compared with 6 percent under our proposal;
- the middle 60 percent of the household income distribution would receive 36 percent of the benefits, compared with 86 percent of the benefits under our proposal.

For two-adult, two-child families at different income levels, Figure 1 compares the benefits of a 0.1 percentage point cut in the state income tax rate with the benefits from introducing personal exemptions into the state income tax.

Our proposal helps the middle class without reducing the amount of tax revenue that the state collects. If the Legislature decides to use part of the state budget surplus to reduce middle-class taxes, then our plan can be made more generous to taxpayers through a higher personal exemption and/or a smaller increase in the tax rate. If the Governor and Legislature truly want to provide income tax relief to the middle class, a plan similar to ours is the only option under Pennsylvania's flat-rate personal income tax.[4]

Figure 1
Middle-Class Four-Person Families Gain More from Personal Exemptions in State Income Tax than from a Small Tax Rate Reduction



Note: Figure 1 shows tax changes for a family of two adults and two children.
*Introduce personal exemption of $8,000 per adult and $5,700 per dependent, raise tax rate from 2.8 percent to 3.8 percent, and eliminate low-income tax forgiveness credit.
**Reduce tax rate from 2.8 percent to 2.7 percent. Maximum income for low-income tax forgiveness credit remains at $25,000.
Source: Table 2.

FOOTNOTES

[1] Median wage workers earn more than half of the state's wage earners and less than the other half of the state's wage earners. By a low-wage earner we mean a worker who makes more than 20 percent of workers and less than the remaining 80 percent. Data on wages over time come from the Current Population Survey and were provided by Larry Mishel of the Economic Policy Institute.

[2] Howard Wial, *Pulling Apart in Pennsylvania: The Incomes of Pennsylvania Families Since the 1970s*, Keystone Research Center Briefing Paper 98/3.

[3] The two counties in which a basic needs budget (or "minimum annual self-sufficiency income") is below $27,250 are Fulton and Sullivan. Across the state, this basic needs budget in 1996 ranged from $23,831 in Sullivan County and $26,211 in Fulton County to $40,738 in Montgomery County and $41,082 in Chester County. Adjusting these figures for inflation since 1996 would produce even higher basic needs requirements. Calculated from data in Diana Pearce and Jennifer Brooks, *The Self-Sufficiency Standard for Pennsylvania* (Swarthmore: Women's Association for Women's Alternatives, 1997).

[4] The Pennsylvania Constitution, Article 8, Section 1, requires all taxes to be "uniform, upon the same class of subjects, within the territorial limits of the authority levying the tax. . . ." The case law interpreting this constitutional provision is complex. If the precise proposal in the text is determined to be inconsistent with the constitutional requirement, it may be possible to modify it so that it is constitutional under the relevant case law. If such a modification is not possible, Pennsylvanians who want a meaningful income-tax cut for the middle class will favor a constitutional amendment to permit a proposal like ours to take effect. If the Governor and House proponents of a middle-class tax cut supported a constitutional amendment permitting the introduction of personal exemptions (while otherwise maintaining the flat state income tax rate), such a proposal would likely pass both houses of the Legislature with bipartisan support in both this legislative session and the next. A referendum of the state's voters would then be necessary to finalize the constitutional change.

Available from the Keystone Research Center

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- Stephen A. Herzenberg and Howard Wial, Testimony before the Senate Majority Policy Committee Forum, "A Better Agenda for Pennsylvania: Legislative Priorities for 1998," February 11, 1998, $2.00.

<u>*Education*</u>

- Alex Molnar, *Smaller Classes—Not Vouchers—Increase Student Achievement*, January 1998, $12.00.

<u>*Employment and Wages*</u>

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- Keystone Research Center, *Technology and Industrial Performance in the Service Sector*, report to the U.S. Department of Commerce under contract #50SBTK6C9281, $20.00.
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Philadelphia Office:

314 Springton Road • Upper Darby, Pennsylvania 19082
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