

How Pennsylvania's budget deficit could be worse

April 1, 2011

Flat income tax may have cushioned recession's blow

By Eric Boehm | PA Independent

HARRISBURG — One of only seven states with a flat personal income tax system may have spared Pennsylvania from some of the pain of the recent economic downturn.

It may be hard to believe with the state facing a \$4 billion budget deficit next year that is forcing difficult cuts to state government spending, but some experts argue it could have been worse.

Just look at Connecticut, California. Or New York and New Jersey.

In those states, and others with highly progressive tax systems, the top 1 percent of earners can end up paying more than 40 percent of the income tax burden. California tops the list, with 45 percent of personal income taxes paid by just 1 percent of the population, but Pennsylvania's neighbors New Jersey and New York are close behind. Both states collect 41 percent of its respective personal income taxes from the wealthiest 1 percent of the population, thanks to income tax rates of nearly 9 percent on anyone making more than \$500,000.

I

n Pennsylvania, the story is different. All earners in the state pay the same rate — 3.07 percent — regardless of how much income they make. The result is a personal income tax burden that is shared more evenly between the rich and the poor than in many places.

In Pennsylvania, the top 1 percent of earners pay 14 percent of the state's income taxes, according to the Institute on Taxation and Economic Policy, a nonpartisan tax research center known as ITEP. When property and sales taxes are added to the mix, the wealthiest 1 percent of the state's population pay 5 percent of state tax collections.

The top 20 percent of earners in Pennsylvania — which amounts to anyone making more than \$89,000 annually — cover 20.3 percent of the state's individual tax burden. By comparison, the bottom 20 percent of earners — anyone making less than \$19,000 annually — pay 11.3 percent of the state's taxes.

The flat income tax rate is one of the reasons Pennsylvania was named last year as one of the nation's 10 most regressive tax policies by the ITEP.

But a flat tax also can shield a state from the volatile ups and downs of an economy, said Scott Hodge, president of the Tax Foundation, a free market tax policy center based in Washington, D.C.

“By and large what we see are that flat tax systems are far more stable than more progressive systems, which rise and fall with the income of the wealthiest citizens,” Hodge said.

According to the IRS, the incomes of the top 1 percent of the nation's population fell 16 percent between 2007 and 2008, when the stock market tanked. By comparison, the average American earner saw a 4 percent decline in income during the same period.

The national budget also is heavily dependent on the highest earners. The top 1 percent of taxpayers paid 38 percent of federal income taxes in 2008, compared to only 25 percent in 1991. The highest federal income tax bracket — which applies to joint filers making more than \$379,000 annually — is 35 percent, though it's scheduled to increase to 39.6 percent in 2013. Since the income of the nation's richest people is generally more volatile than the middle and lower classes, states that tied their fiscal fortunes to their wealthiest residents were hit the hardest, Hodge said.

He said the flat tax also ensures all earners have "skin in the game" when it comes to government spending, rather than serving to redistribute wealth from the top earners.

Sharon Ward, executive director of the Pennsylvania Budget and Policy Center, a liberal think tank based in Harrisburg, disagreed. She said a fair tax system should be based on ability to pay, which is not part of Pennsylvania's income tax design.

"The flat tax violates the core principle about what makes a good tax system," Ward said. "It means that middle class people pay a higher share of their income."

Ward rejected the idea that a flat tax helped cushion Pennsylvania's tax revenues during the recession.

Income tax revenue in Pennsylvania peaked at more than \$10.9 billion in the fiscal year that ended in June 2008, just as the recession was beginning. At the end of fiscal year 2009-10, the state had collected more than \$9.9 billion in personal income taxes, a decline of 9 percent during a two year period.

But personal taxes do not tell the whole story in the Keystone State. Income tax revenues declined by about \$1 billion during the two years of the recession, yet the state finds itself with an expected budget deficit of more than \$4 billion.

Part of the reason is the state's appetite for spending. While tax revenues declined slightly, the state's budget continued to grow. Between fiscal year 2007-2008 and fiscal year 2009-2010, state spending climbed from \$27.2 billion to \$28.3 billion.

Another part of the answer is the sharp decline in corporate income taxes during the recession. Businesses operating in Pennsylvania are subject to a 9.99 percent income tax, the highest in the United States and among the top business tax rates in the world.

When combined with the federal corporate income tax — which ranges from 15 percent to 35 percent — Pennsylvania is one of the most hostile places to do business, said Nathan Benefield, research director for the Commonwealth Foundation, a free market public policy center in Harrisburg.

“Corporations don’t pay taxes, they pass the cost on to consumers in the form of higher prices or to workers in lower wages,” Benefield said.

Ward said the corporate income tax is high, but contains so many loopholes that most companies end up finding ways to avoid paying the state.