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March 19, 1981

Governor Richard Thornburgh
225 Main Capitol Building
Harrisburg, Pennsylvania 17120

Dear Governor Thornburgh:

On behalf of the Pennsylvania Tax Commission, we are transmitting our Final Report which contains recommendations concerning how Pennsylvania can improve its overall tax structure. This Final Report represents the culmination of some 17 months of work by the Commission. In the first phase of its work, the Commission held public hearings throughout the state, resulting in some 2,000 pages of testimony which the Commission published and transmitted to you and to the General Assembly on June 20, 1980.

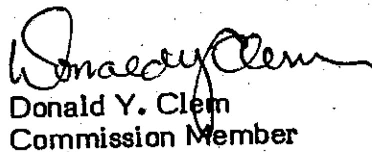
In the second phase of its work, the Commission subdivided into Task Forces to gather factual and analytical information about the Commonwealth's state and local taxes for subsequent use by the entire Commission. Each Task Force was chaired by a Commission member and was composed of experts in the particular area of taxation. The resultant Task Force Reports, which are in press, provided important background materials to the Commission which it considered when making the final recommendations.

Throughout the Commission's deliberations, we have sought and generally arrived at our recommendations by concensus. Thus, the recommendations contained in the Final Report reflect the general consensus of the Commission's members, although in some instances the recommendations reflect a majority of their views rather than unanimity. With respect to the ex-officio members of the Commission, they have asked us to indicate that they do not necessarily endorse the recommendations in the report, although they expressed their appreciation for the opportunity to comment and observe the work of the Commission.

As you know, the Commission has not recommended an increase in tax revenue for the General Fund, and thus have been true to your charge in this respect. We have also kept the proportion of tax revenue raised from business and the proportion raised from individuals the same as it has been. We have, however, recommended certain changes in transportation taxes for the Motor License fund, taking into account the effects of inflation, in order to insure that revenues are adequate to meet maintenance and repair needs. The Commission believes these changes are essential for the restoration of our transportation system.

We believe that the recommendations below represent a realistic set of reforms for Pennsylvania which, if adopted over a period of time, will materially improve the equity and efficiency of our tax system, encourage the creation of new jobs, and be an excellent example for other states in the nation.

Richard M. Cyert
Chairman



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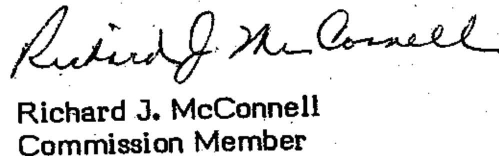

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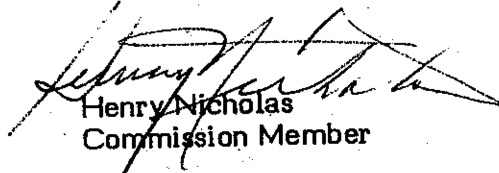

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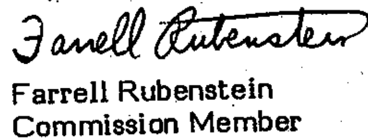

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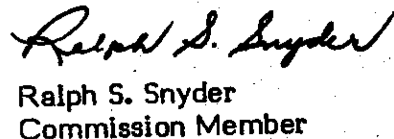

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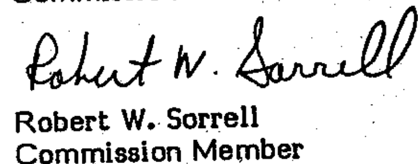

Robert W. Sorrell
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W. Bruce Thomas
Commission Member

Final Report of the Pennsylvania Tax Commission

March, 1981

Commonwealth of Pennsylvania
Dick Thornburgh, Governor

Richard M. Cyert
Chairman

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Executive Summary

Final Report of the Pennsylvania Tax Commission

Objectives of the Report

This *Report* represents the recommendations of the Pennsylvania Tax Commission which was created by Governor Thornburgh on October 18, 1979. The charge[1] to the Commission was to review the entire structure of state and local taxes in the Commonwealth and make a comprehensive assessment of the tax system. This in turn led to recommendations to improve the equity and economic neutrality of the system. This was to be and has been done within a framework of overall taxation which would keep the burden of state and local taxes, expressed as a percentage of personal income in the state, at the same level as current law. In addition, the *Report* contains recommendations and analysis which relate to a number of specific areas which the Governor asked the Commission to investigate: the administration of the local property tax and its use to finance public education, the impact of taxation on economic development and job creation, and the impact of taxation on local communities and on the state's transportation and energy problems.

I. The Goals and Criteria for Pennsylvania's Tax System

In order to evaluate the current tax structure, the Commission developed six goals for use in evaluating the system and recommending reforms, and also two criteria, in terms of the principle of taxation which was implied by a particular tax. The Commission recommends that Pennsylvania's system of state and local taxation should seek to achieve the following goals:

A. Simplicity: taxes should be readily understood by taxpayers and tax administrators.

B. Certainty: taxes should have known and predictable liabilities over time, and not be the subject of constant debate and appeal by taxpayers and administrators.

C. Equity: taxes should treat taxpayers in the same economic circumstance in the same way, and provide that taxpayers with differing abilities to pay should pay different amounts consistent with the distributional objectives of the state.

D. Economy of Administration: taxes should be inexpensive to administer for taxpayers and tax collectors and not cost more than 3% of net tax receipts.

E. Economic Neutrality: taxes should not unintentionally alter consumer, worker, or producer choices. To the extent possible, social and economic policy objectives should be met through explicit expenditure policies rather than through the use of tax expenditures. When tax expenditures are socially desirable, they should be justified in relation to their benefits and costs, and periodically reviewed and evaluated.

F. Revenue Adequacy: the overall tax system should provide reasonable growth in revenues so that a constant set of tax rates are adequate to finance expenditure needs of state and local government.

In addition to these six goals, a tax must be justified by either one of two criteria: the benefit principle of taxation or the ability to pay principle of taxation.

Recommendations

The recommendations contained in the *Final Report* are summarized below by major type of tax. A separate section summarizes recommendations with regard to tax administration.

II. Local Taxation

The Commission finds the current local tax system to contain several structural defects. First, the property tax is unfairly administered in terms of assessment, and regressive for elderly homeowners. Second, due to certain current limitations on local taxing authority, jurisdictions are forced to rely on nuisance taxes to meet their revenue needs, or are forced to rely heavily either on the property tax or the local wage tax. As a result, migration in terms of individuals and business has been induced with adverse economic effects. Also, this lack of flexibility has had adverse distributional effects.

The Commission believes that systematic reform of the property tax coupled with greater access for localities to broader and more elastic revenue sources will provide a structure of local taxation that is not only more coherent, but also reduces the need for special rules for particular jurisdictions. Such a reformed system of local taxation will be more equitable and more flexible than the current system. Important additional ingredients of a reformed local tax structure are a co-

[1] Executive Order, 1979-14.

herent policy toward non-residents, and the principle of regional taxation for the provision of regional services.

The recommendations are grouped below in terms of the local property tax, and the local non-property taxes.

A. The Property Tax

The Commission reviewed both the assessment of real property throughout the state and the use of the local property tax as a major source of revenue for local school districts. The Commission finds that assessment of property is non-uniform, and therefore, inequitable throughout the state. In addition, it finds that local school districts, compared to those in other states, generally do not excessively rely on the property tax. The Commission recommends that legislative action be taken to improve the assessment of all property and to provide additional property tax relief to low income, elderly homeowners. The Commission makes the following specific recommendations:

1. Assessment Reform

a) Consolidation and codification of various local assessment statutes into one uniform statute.
b) Retention of assessment function at the county level.
c) Collection of uniform data on property attributes statewide.
d) Modernization of data collection, recording, and reporting procedures making maximum use of computerized data processing.
e) Assessments be valued at 100% of market value. The increase in the assessment ratio must be coupled with the provision that millage rates be decreased to insure that tax revenues do not increase more than a stated percentage over the previous year.
f) Separation of the appeals process from the assessment process in counties.
g) State certification of local assessors.
h) State provision of technical assistance and training.
i) State standards for assessment performance. State evaluation of assessment practice and sanctions for poor performance after a grace period.
j) Mandatory reassessment when the coefficient of dispersion in assessment ratio exceeds 20.0.
k) State grants of $4.25 per taxable parcel to each county assessment office to finance initial data collection.
l) Availability of state computer service to aid in the management of assessment for counties which choose the service.
m) Recertification and publication of tax exempt property.

B. Reform of the Property Tax/Rent Rebate Program to Provide Additional Relief

The Commission finds that the regressivity of the property tax is most severe for low income, elderly homeowners and recommends, to the extent new lottery funds can be made available, the expansion of the Property Tax/Rent Rebate Program as the most direct and least expensive method of alleviating the burden that the property tax places on low income elderly households. The Commission recommends that the income level for eligibility be increased from $9,000 to $12,000 and that the rebate schedule be modified to reflect this increase.

C. Local Non-Property Taxation

The Commission finds that the current system of local non-property taxation is in urgent need of simplification. The Commission recommends that a number of current local taxes be eliminated, and the revenue foregone be replaced through the increased use of a more broadly defined income tax.

With respect to all jurisdictions, except Philadelphia, the Commission recommends the elimination of the following taxes:

1. The assessed occupation taxes levied under Act 511, and under municipal and county codes.
2. The flat rate occupation tax levied under Act 511.
3. All per capita, residence and poll taxes levied under county, municipal, and school district codes, and the per capita tax levied under Act 511.
4. The intangible personal property tax levied under county and municipal codes.
5. The residential construction tax.
6. The earned income tax as presently structured, including all non-resident provisions.

The Commission recommends for all jurisdictions, except Philadelphia, the following structure of local taxation to replace lost revenues:

1. For local governments within counties and school districts other than in Philadelphia county, a tax on income as defined under the state's personal income tax with the state's special provisions for low income taxpayers.
2. School districts other than in Philadelphia county could levy up to a maximum rate of 1.5% and local governments within counties could levy up to 1.0%. Home rule jurisdictions would continue to be able to levy higher rates. Transition rules would limit the extent of revenue growth in the first three years.
3. For jurisdictions which levy the income tax, the state would piggyback the local tax on the state tax through the state withholding system. In local governments within counties other than Philadelphia, non-residents would pay .25% of earnings to the jurisdiction of the workplace.
4. In order to provide county governments revenues sufficient to replace revenues lost from the elimination of the personal property tax, to provide greater flexibility, and to finance assessment reform, the Commission recommends that the local portion of the realty transfer tax, currently available to municipalities and school districts, be available only to counties. A portion of the proceeds of the local realty transfer tax would be distributed by the state to county assessment offices to finance assessment reform for a limited period of time, and the balance would be distributed in proportion to realty transfer tax receipts. Thus, the majority of the realty transfer

tax would remain with the county in which it was generated.

With respect to Philadelphia, the Commission recommends the following changes in Philadelphia's taxing authority:

1. The elimination of the personal property tax.
2. The elimination of the School District's tax on unearned income.
3. The elimination of the tax on residents' and non-residents' earnings, and the elimination of Philadelphia's first claim on suburban commuter's wage taxes.
4. The elimination of Philadelphia's and other counties' contribution to the Southeastern Pennsylvania Transit Authority (SEPTA).

Lost revenues for Philadelphia are to be replaced through the following structure of taxation:

1. A tax on residents' income as defined under the state's personal income tax, with the state's special provisions for low income taxpayers. No change is recommended in the 4-5/16% rate now levied on residents.
2. A tax on non-resident earnings which would take into account the elimination of the city's SEPTA contribution, and take into account the increased revenues generated from the resident tax on unearned income. The Commission estimates that the non-resident tax rate would be approximately 2.9% compared to the current rate of 4-5/16%.
3. Administration of the resident income and non-resident tax would be piggybacked onto the state tax through the state withholding system.

With respect to the 5 county area of Bucks, Chester, Delaware, Montgomery, and Philadelphia counties, the Commission recommends that a uniform tax of up to 0.2% on resident income in the area be imposed to finance SEPTA and urban and rural mass transit authorities in the area.

As a result of these structural reforms, all local governments will be accorded the same tax bases, and disparities in structure throughout the state will be materially reduced. In the Philadelphia area, surrounding jurisdictions will have greater opportunity to use the income tax, in lieu of property taxes if they so choose. Moreover, throughout the state there will be the coherent principle that non-resident earnings should be taxed at a lower rate than for residents. In addition to these local non-property tax reforms local governments will also benefit from changes in transportation taxation suggested below.

With respect to local non-property taxation of business, the Commission was hampered in its analysis by a lack of comprehensive data. Accordingly, the Commission recommends that more complete data on such taxes be collected in conjunction with consideration of possible limitations on the Business Privilege Tax in line with current limitations on the Mercantile Tax.

III. State Taxation of Individuals

A. State Personal Income Tax

The Commission finds the state personal income tax to be a relatively simple, widely understood form of tax with relatively few administrative problems. The Commission, however, recommends that certain improvements can be achieved as follows:

1. Simplification of the SP provisions by basing eligibility only on taxable income and exempt interest. Raising the income and exempt interest eligibility levels to reflect the inflation from 1974 to 1980.
2. Adoption of federal tax treatment of gains from sales and purchases of principle residences and the $100,000 exclusion for those over 55 years of age.
3. Adoption of federal rules for adjustment of gross income for uncompensated employee business expenses, and for tax treatment of income from installment sales.

B. State Sales Tax

The Commission reviewed the operation of the state sales tax and considered the possibility of including clothing in the tax base. While such a broadening of the base would significantly increase revenues and not materially alter the incidence of the tax, the Commission concluded that such a change could adversely affect clothing purchases in certain parts of the state, and was not justified at this time. The Commission believes that current exemption policies should be periodically reviewed.

C. Inheritance and Estate Taxes

The Commission finds that the state inheritance tax poses an undue burden on small estates, and in certain instances adversely affects the continued ownership of family farms and businesses. The Commission therefore recommends —

1. the exclusion from the clear value of the estate the first $15,000 of clear value;
2. the valuation of family farms and property used in closely held businesses at current use rather than at best use;
3. various technical amendments for the tax related to the valuation of income with respect to a decedent, the appropriate interest rate and life tables for valuation of a life interest, and the denial of the deduction of medical expenses which are reimbursed under third party insurance programs (principally Medicare).

D. Substitute Revenues

To finance the above tax reforms, the Commission recommends that the personal income tax rate be increased from 2.2% to 2.28%. The increased rate will generate sufficiently higher personal taxes to offset declines in revenue from the personal tax and inheritance tax reforms.

IV. Transportation Taxation

A. General

The Commission finds that the primary guideline for financing transportation should be the user principle. The Department of Transportation is urged to study the costs imposed on facilities by users so that taxes paid and usage can be more closely related. To maintain this linkage between finance and usage, the Commission finds that the receipts from transportation taxes should continue to be kept separate from the General Fund and placed in a special fund to be used solely for transportation purposes.

The Commission finds that the financial problems of transportation facilities in Pennsylvania are severe, and predicts a growing gap between future transportation taxes and expenditure needs: the flow of revenues for transportation from a variety of sources is stagnating while costs, due primarily to increases in materials prices and labor, are rising at an average annual rate of about 9% a year.

In order to provide a predictable and adequate level of funding transportation, the Commission recommends TRIP, a Transportation Rehabilitation and Improvement Program. This program includes several major changes in the structure and rate of transportation taxation and expenditures, and the structure of responsibilities between state and local governments.

B. Highways and Bridges

The Commission recommends that for the financing of road maintenance and reconstruction of highways and bridges —

1. fuel taxes should be raised 2 cents a gallon and various user fees increased 20%; Motor License Fund revenues would increase $170 million as a result;
2. all taxes and fees should be indexed to maintain a constant volume of road maintenance and reconstruction expenditures. The index should consist of two parts, the first based on the federal cost index of highway construction and maintenance, the second based on the deviation of predicted and actual funds flowing into the Motor License Fund;
3. vehicles should be taxed in relation to an estimation of the damage they cause to roads and bridges to be determined by a detailed cost allocation study by the Pennsylvania Department of Transportation taking weight of vehicles into account; this part of TRIP would take several years to implement;
4. the system for auditing out-of-state trucks should be strengthened and consideration given to replacing the present system of bilateral taxation agreements with particular states with a more multistate system of truck taxation;
5. most exemptions from fuel taxes and registration fees of organizations and classes of individuals should be phased out over five years; a more effective monitoring system for off-highway farm vehicles should be established;
6. the employment of other types of user fees for financing transportation should be seriously investigated by the state.

With respect to the state-local balance of transportation responsibility, the Commission finds that local roads should be administered whenever possible on a local basis. Because local governments do not currently have the funds to rehabilitate and to properly maintain local roads which might be turned over to them by the state, the Commission recommends that a new formula for allocating transportation taxes from the Motor License Fund back to the local governments be created and this formula should be based on the mileage, cost, condition, and type of roads administered by each and the costs of such maintenance.

The road turnback formula should provide local governments with an additional $85 million from the augmented Motor License Fund. The Commission also recommends a road and bridge census, as well as the generation of relevant cost information, to implement this proposal in a proper manner, and that turnback of local roads be conditioned upon localities entering into a contract with the state to assure that rehabilitation, maintenance, and repair will take place.

C. Mass Transit

The Commission finds that the historical state subsidy to mass transit is inefficient and that the recently enacted subsidy formula continues to encourage mass transit authorities to run deficits. The Commission recommends the following changes in mass transit finance:

1. The current subsidy formula should be replaced with a lump-sum-per-passenger subsidy so that the combined federal and state subsidy would equal 48 cents.
2. The Commission recommends that SEPTA be provided the receipts from a regional income tax as a first step toward providing uniform regional taxation to support regional services. Although the Commission favors a regional income tax that would be piggybacked to the state income tax as a new source of finance, it also sees merit in using a regional sales tax piggybacked to the state sales tax instead. For the 5 counties in southeast Pennsylvania that are served by SEPTA, Colonial, and TPC, an income tax piggybacked on the state personal tax with a rate of 0.2% would be sufficient to replace current contributions from the counties.
3. Transportation subsidies for low income ridership should be via transfers to the individuals. The Commission recommends experimental mass transit stamps (based on Food Stamp eligibility) to determine the practicality of such direct support.

D. Other Transportation Taxes

The Commission finds that taxation in other areas of transportation does not follow the benefit principle. It recommends that several long range measures be taken to more carefully relate taxes to benefits:

1. Airplane fuel taxes should be raised; such additional revenues should replace the current state and local

subsidies to airports that come from the general fund; a full scale study of all subsidies to airports should be made.
2. A study should be made on all costs associated with construction and maintenance of waterways and docks in the Commonwealth as well as on the usage of such facilities by various classes of boats and ships. This would allow changes in the taxation system financing these facilities to be made so that the user principle can be followed more consistently.

V. Taxation of Business

The Commission reviewed various state business taxes and finds Pennsylvania's state and local tax burden on business to be competitive with other major industrial states. Also, the Commission finds that taxes, while important in business location decisions, are not the most important factor in such decisions. The certainty and simplicity of taxes coupled with low compliance costs are more important to a reformed business tax structure than the provision of tax incentives. However, the Commission believes that the current high rate of tax on corporate net profits (10.5%) is a psychological barrier to many firms considering Pennsylvania as a place to expand. Consideration should be given, as revenues become available in the future, to lower the tax rate to one more competitive with other major industrial states.

Also, the Commission finds the current state taxes on profits, business wealth, and gross receipts to be unduly complicated and the source of substantial uncertainty. The Commission recommends as a long-run objective for the state's tax structure that the taxation of business be on the basis of profits, and not on the basis of gross receipts or capital stock value. However, in light of the importance of these taxes now, the Commission recommends that certain reforms be made within each type of tax, as a first step toward achieving a uniform business tax which will ultimately be based solely on profits.

A. Recommendations with Regard to Taxation of Small Business and Large Business

The Commission recommends a series of small business tax reforms:

1. Provide full federal net operating loss carryback and carryforward[2];
2. Provide small corporations (with 15 or fewer shareholders) federal Subchapter-S tax treatment;
3. Exempt new businesses from the Capital Stock and Franchise taxes until the third year of operation.

In addition, the Commission recommends that the current, negotiated valuation practices in relation to the Capital Stock and Franchise Tax be replaced with a fixed valuation formula which would value the capital stock of a firm on the basis of a 6 year average of earnings capitalized at 9.5%.

With respect to the Corporate Net Income Tax (CNI), the Commission recommends that business income, suitably defined, be apportioned rather than allocated.

The Commission recommends abolition of the Corporate Loans Tax. The Commission estimates that the revenue losses and gains from these recommendations will balance out evenly. Finally, the Commission has a series of additional business tax reform recommendations which should be considered later when better revenue estimates and/or revenue loss offsets become available.

B. Taxes Levied on Banks, Insurance Companies, and Utilities

The Commission finds that the various taxes imposed on banks, insurance companies, and public utilities violate the principles and objectives of a good tax system. However, due to the significant nature of the revenues generated by these industries, only a limited number of reforms are recommended at this time. With respect to banks, the Commission recommends —

1. that all financial institutions be taxed at 10.5% on an excise-income basis including federal, state and Pennsylvania interest;
2. that transition rules be provided;
3. that the Commonwealth review the operation of the Public Utility Realty Tax (PURTA) in terms of reforming the sharing formula.

VI. Tax Administration

The Commission reviewed the administration of various state and local taxes and found that significant improvements in the tax climate can be achieved through the clarification and standardization of various administrative procedures. The Commission recommends a series of legislative and administrative changes outlined as follows:

A. General Administrative Reforms Requiring Legislation

Administrative reform can be generally achieved if legislation is enacted which —

1. codifies all state and local tax law, administration and procedure in one Pennsylvania Tax Code (Pennsylvania is unique among major states in not having a code of tax law); and that administrative and procedural aspects of the code be as uniform among taxes as possible;
2. provides cash refunds without requiring petitions for refunds in line with current federal practices and those of other states;
3. ties interest rates on underpayments and penalties to the more realistic interest rates used by the IRS, makes the interest rates the same for all taxes, and provides for interest on determined refunds;
4. permits the Department of Revenue to purge uncollectable accounts with adequate oversight by the Department of Justice and the Auditor General;
5. clarifies the responsibility for collection activities between the Departments of Revenue and Justice.

[2] On December 8, 1980 Governor Thornburgh signed legislation providing up to 3 years carryforward of net operating losses.

B. General Reforms Achievable through Administrative Regulation

1. Personnel Reforms

The Commission finds that the Department of Revenue operations can be made significantly more effective if the Department of Revenue —

a) and the Department of the Auditor General in cooperation with the accounting profession accord to Department of Revenue accountants the same status to work experience in the Department of Revenue which the IRS does vis-a-vis CPA qualifying exams;

b) is permitted, through changes in the state personnel system, to pay competitive salaries for attorneys, accountants, and computer specialists;

c) generally increases its taxing and audit staffs and allocates them in relation to the additional revenue which would result;

d) increases the number and quality of its field valuation staff for the inheritance tax.

2. Enhanced Information for Taxpayers and the Department of Revenue

The Commission finds that taxpayer compliance costs and departmental costs can be significantly reduced if greater information is made available about pending and actual changes in the state tax system. Accordingly, the Commission recommends —

a) that public hearings be held at the discretion of the Department of Revenue on proposed tax regulations before promulgation;

b) that a monthly or bimonthly publication describing statutory changes, court decisions, regulations, public hearings, and decisions of the Boards of Appeals and Finance and Revenue be provided by the Department free to state libraries and to the public at cost;

c) that the Department of Revenue annually update various information booklets describing all state taxes for the public;

d) the Department of Community Affairs, with additional staff as needed, update and publish annually the *Taxation Manual* which would be the companion document describing local taxes in the state.

3. Systematic Review of Tax Forms

The Commission recommends that the Department of Revenue undertake a program of systematic review of all of its tax forms, including the inheritance tax forms, with the objective of eliminating designs which continue to cause the taxpayer and the Department of Revenue problems. Special attention should be paid to the PA-40ES, SP schedule, 2106,1065 and K-1. It is further recommended that modern forms design techniques be utilized (i.e., examination of the readability and implied educational levels of forms) through outside experts as the IRS is currently doing.

4. Internal Information Flows in the Department of Revenue

Improved internal management can be achieved in the Department of Revenue in the view of the Commission if —

a) the Department of Revenue routinely collects and classifies data on taxpayer inquiries by purpose, and analyzes this data to devise improved forms, instructions and procedures to forestall such inquiries;

b) the Department of Revenue revises its information storage and retrieval capabilities so that information on prior reports and returns can be easily obtained and provided to outside agencies such as the Board of Finance and Revenue;

c) the Boards of Appeal and Finance and Revenue develop procedures for routinely collecting and analyzing data on issues generating appeals and provide the data to the Board, Secretary of Revenue, and the Governor.

5. Other Recommendations

The Commission further recommends —

a) that the current pre-payment procedure be reviewed with the purpose of making it easier for the taxpayer to comply;

b) that by regulation, the duties reflecting current procedures of what was the Resettlement Board on Petitions for Resettlements of Corporate Taxes be integrated with the current activities of the Board of Appeals;

c) that local governments utilize uniform accounting standards.

C. Specific Reforms Requiring Legislation

Administration of business taxes can be improved if legislation is enacted which —

1. requires the Department of Revenue to issue corporate tax settlements within 12 months from the final submittal of the return;
2. provides 60 instead of 30 days for reporting federal changes which affect the corporate net income liability;
3. grants automatic extensions of the due date for filing tax reports to 1 month beyond the period including extensions, when the taxpayer may file the federal return; payment should be due on the original filing date regardless of extension.

Administration of the Sales and Use Tax can be improved if legislation is enacted which —

1. makes all sales and use tax refund petition dates uniform;
2. requires the filing and payment periods be extended to the last day of the succeeding month.

Administration of the Inheritance and Estate Tax can be improved if legislation is enacted which —

1. redefines the responsibility of the Register of Wills to be limited to the collection of the tax for the Commonwealth;
2. requires that the representative of the estate docu-

ment all debts and deductions and valuations, and provide those for review by the Harrisburg office of the Department of Revenue in line with other taxes.

D. The Appeals Process: Recommendations for Reform and Further Study

The Commission finds the current appeals process to be in need of reform. The Commission recommends, as interim measures, that taxpayers be informed that an informal presettlement procedure is available, that the Board of Finance and Revenue inform the taxpayer prior to the hearing as to what issues are in dispute, and that a small claims procedure be provided.

The Commission finds that a sound appeals process should reflect the principles of timeliness of adjudication, independence and non-political nature of the review board, provide for precedent and written record where appropriate, and contain an expedited process for small taxpayers. The appeals process should also be consistent with the general principles of a good tax system.

The Commission further recommends that the Governor appoint a study committee to review the current appeals process in light of these principles and report back by the close of 1981 on whether, among other things, a tax court along the lines of those in New Jersey and Michigan would be an appropriate reform of the current appeals process in Pennsylvania.

Executive Summary Table 1

Summary of Current Law Receipts to State and Local Governments and the Impact of Commission Recommendations ($ millions at 1980 levels)

Panel A: General Fund

Source of Revenue	*Current Law*	*Commission Recommendations*
Corporate Net Income Tax	$ 720[1]	$ 694[1]
Capital Stock and Franchise Tax	289[1]	322[1]
Utility Gross Receipts Tax	308	308
Insurance Gross Receipts Tax	97	97
Financial Institutions Tax	62	62[2]
Utility Property Tax	171	171
Corporate Loans Tax	5	0
Corporate Income Tax	[3]	[3]
Sales and Use Tax	1,996	1,996
Cigarette Tax	252	252
Liquor Sales Tax	93	93
Liquor Store Profits	30	30
Personal Tax	1,696	1,704[4]
Inheritance and Estate Tax	173	164
Realty Transfer Tax	84	84
Other General Fund Revenues	185	185
General Fund Total	6,161	6,162

Panel B: Motor License Fund

Liquid Fuel Taxes	468	568
Licenses and Fees	326	396
Other	186	186
Motor License Fund Total	980	1,150

Note: Current law figures are from the Department of Revenue, *1980 Compendium of Finances* unless otherwise noted.

[1] Figures are at 1977 levels and reflect final, settled taxes rather than calendar year initial collections, based on analysis with Pennsylvania Corporate Tax Model. Settled taxes were used to insure comparability in the analysis of the impact of Commission recommendations with current law.

[2] Reflects transition period rules.

[3] Less than $.5 million.

[4] Reflects Subchapter S tax reduction.

Executive Summary Table 1
Panel C

Revenue Changes Resulting from the Commission's Recommendations by Type of Local Government (Excluding the City of Philadelphia and Philadelphia School District) at 1977 Tax Levels

Type of Tax	*1977 Tax Revenue (in $000)* (% of total tax revenue in parenthesis)		
	Counties	*Municipalities*	*School Districts*
I. Aggregate Revenue Losses			
Earned Income	—	187,459(29.3)	190,487[1](10.4)
Occupation Taxes			
(i) Occupation Millage (code)	502(0.1)	846(0.1)	—
(ii) Occupation Millage and Flat Rate (Act 511)	—	1,232(0.2)	42,213 (2.3)
(iii) Occupation Privilege (Act 511)	—	20,412(3.2)	9,500 (0.5)
Per Capita Taxes			
(i) Per Capita (code)	5,145(1.3)	1,200(0.2)	16,974 (0.9)
(ii) Per Capita (Act 511)	—	14,005(2.2)	19,155 (1.0)
Intangible Personal Property	21,366(5.2)	1,087(0.2)	971 (0.0)
Realty Transfer Tax	—	32,558(5.1)	38,148 (2.1)
Total Lost Revenue	27,013(6.6)	258,799(40.5)	317,448 (17.4)
II. Aggregate Revenue Gains			
Transfer of Realty Transfer Tax to Counties	76,658	—	—
Resident Income Tax[1] to Replace All Revenues Lost (average % rate)	—	258,799(0.68)	317,448(0.79)
Non-Resident Earnings Tax[2]	—	—	—
III. Net Aggregate Gains or Losses[3]			
	49,645	0	0

[1] This is a rough estimate obtained by estimating the 1977 earnings tax base using actual taxes collected, and augmenting this base by 10% (the ratio of total taxable income to the sum of compensation and net profits as reported to the state in 1977 on individual tax returns) to take account of broadening the tax base to include unearned income. The earnings tax base was estimated by dividing total collections (excluding Pittsburgh and Scranton) by 0.005. The base in the latter two cities was then added in after computation using the higher tax rates imposed in those cities. There is still a slight overestimate of the base due to other home rule jurisdictions that had a rate higher than 0.005. However, against this upward bias must be offset the enlargement of the total income base because of the probable increase in the number of school districts and municipalities (especially near Philadelphia) that will probably begin to levy the income tax should the Commission's recommendations be put into effect.

The base for municipalities produced by this procedure is $38,079,600,000 and that for school districts is $40,155,060,000.

[2] Estimated revenues from this tax (.25%) are not available because of the size the flows of non-resident workers into municipalities and the incomes they earn there are not known.

[3] In addition, under the Commission's transportation proposal, when fully implemented municipalities would receive $58.7 million, counties would receive $17 million, and Philadelphia would receive $9 million at 1980 levels.

Executive Summary Table 1
Panel D

Revenue Losses and Gains to Philadelphia City and the Philadelphia School District 1981 Revenue Estimates

Type of Tax	Estimated 1981 Revenue Estimates ($000) City	School Districts
I. Aggregate Revenue Losses		
Earned Income	553,000	—
Intangible Personal Property	7,000	—
Unearned Income	—	7,000
Total Revenue Loss	560,000	7,000
II. Aggregate Revenue Gains		
Income Tax on Residents at 4.3125% (Resident receipts of 376,000 augmented by 10%)	414,000	
Income Tax on Non-Residents at 2.9%	118,000	
Funding of Philadelphia SEPTA contribution from 0.2% Regional Income Tax	35,000	
Less Block Grant to Cover School District Loss	(7,000)	7,000
Total Gain	560,000	7,000
III. Net Revenue Change[1]	0	0

IV. Computation of Required Rate for Non-Resident Earnings Tax:

Exclusive of the non-resident income tax, Philadelphia experiences net revenue losses under the Commissions recommendations of $118 million. A non-resident income tax rate was calculated to raise the $118 million as follows:

Non-Resident Base = 177,000/0.043125 = 4,104,348
Non-Resident Rate = 118,000/4,104,348 = 0.028750

Hence, the non-resident rate can be cut from 0.043125 to 0.028750, or by 0.014375.

[1] In addition, under the Commission's transportation proposal when fully implemented, Philadelphia would receive $9 million at 1980 levels.

Pennsylvania Tax Commission Publications

Public Hearings Before the Pennsylvania Tax Commission: Philadelphia, Pittsburgh, Harrisburg, Erie, and Scranton; June, 1980.

Executive Summary: Final Report of the Pennsylvania Tax Commission; March, 1981.

Final Report of the Pennsylvania Tax Commission; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Business Taxation and Business Taxation with Special Reference to the Problems of Small Business; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Non-Property Taxation; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Non-Property Taxation with Special Reference to the Problems of the Delaware Valley; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Local Property Taxation; December, 1980.

A Task Force Report to the Pennsylvania Tax Commission: Personal Taxation; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Sales, Cigarette, and Liquor Taxation; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Tax Administration; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Taxation of Financial Institutions and Insurance and Utility Companies; March, 1981.

A Task Force Report to the Pennsylvania Tax Commission: Transportation Taxation; March, 1981.

Section I.
Overall Considerations: Goals for Pennsylvania's Tax System

The objective of this Commission has been to examine the totality of the Pennsylvania Tax System. While total tax revenue collected and the number of taxes levied have grown significantly over the last 100 years, the tendency has been to meet the revenue needs of the moment with *ad hoc* taxes. As a result, the system has too many taxes which lack a clear rationale. The system lacks a clear set of objectives and fails to display a set of criteria which are met by the various taxes.

In this *Report*, we will specify objectives for the tax system and attempt to develop a system that will meet these objectives. In addition, we will articulate the criteria that individual taxes should meet in order to be used as part of the system. Our long-run objective is to establish a model tax system for state and local governments with the hope that such an accomplishment will influence tax policy throughout the country.

A. Goals

It is common to state goals to achieve unanimous approval by reducing the content within them. That is not our desire. The goals we state are to be used as standards that will aid in the reform of the system. We also recommend that these goals be utilized in any future examination of the tax system.

1. Simplicity

In order for a tax to be accepted, the individual paying the tax must understand it. As the complexity of a tax increases, understanding decreases and, as a result, resistance to the tax increases. The Federal Individual Income Tax is an excellent example of this proposition. As Congress has tried to influence taxpayer behavior with respect to certain economic and social objectives, it has created a myriad of provisions that define income, taxpayers, and tax rates, and provided many exceptions from the general rules. The Pennsylvania Personal Income Tax, on the other hand, has been kept simple and is much better understood. Simplicity of structure is important in the long-run in a democratic society to maintain positive attitudes by the electorate toward government.

2. Certainty

The tax system should be stable, predictable, and relatively permanent so that the taxpayer, whether an individual or a corporation, can determine his tax bill at any time. This characteristic also serves the Commonwealth since budgeting is facilitated when revenue estimates are accurate. Uncertainty leads to different opinions as to taxpayer liability and such differences lead to litigation. In turn, litigation increases the cost of collection and also increases hostility toward government. For individuals and businesses considering the decision to move to Pennsylvania, or to stay in Pennsylvania, certainty can be an important ingredient in the final decision, and thus indirectly affect Pennsylvania's potential for economic growth. When state and local taxes are uncertain or ambiguous in application, individuals and firms may find other states more attractive.

3. Equity

The tax system and the individual taxes must be viewed as fair and equitable if taxpayers are to comply voluntarily with it. Attempts to evade and avoid the payment of taxes increase when the system is perceived to be inequitable. A system that is fair is one in which all persons (or firms) with the same economic situation are treated equally. Also, a system that is fair is one in which all persons or firms in different economic situations contribute resources through the tax system in a manner that the electorate finds consistent with its social values. Balanced against the need to redistribute income to achieve social justice must be a concern for the impact such sacrifices have on various segments of society. As we will show later, the property tax, as currently assessed in Pennsylvania, does not meet the equity standard. The large amount of subjective judgment involved in property appraisal leads to differential taxes for taxpayers with property of equal market value in the same jurisdiction. As the lack of equity becomes apparent in a tax, taxpayers become disillusioned with their government.

4. Economy of Administration

Different taxes may require different collection systems and costs. In general, a tax system should contain taxes that can be collected as inexpensively as possible. When the cost of collection, including costs to the taxpayer, is a high percentage of the revenue (3% or more), the desirability of the tax must be questioned.

5. Impact of Taxes on Economic Efficiency

From the standpoint of resource allocation, the goal of economic efficiency is central. The objective of neutrality, which enhances economic efficiency, is to avoid distortions of economic choices which can be induced by taxes. When price and output decisions by firms or the decision to work or not to work by individuals are modified as a result of a tax, the tax is not economically efficient. For example, a specific sales or excise tax can have the effect of a price increase. As a result, for those products being taxed, there will be a reduction in demand for the commodity. Consumers will make new sets of decisions with respect to their expenditures as a result of the changes in price due to the sales tax. In this sense, then, such a specific sales tax is not economically efficient because it affects economic decisions. Similarly, relatively high rates of taxation on personal income can dissuade individuals from working, and relatively high rates of taxation on the wealth of business can discourage necessary capital accumulation by business. A tax system should be neutral with respect to the allocation of resources.

6. Revenue Adequacy

The Commission is committed to the principle that the overall burden of state and local taxes should not increase over time as a percent of personal income. As a corollary, it believes that public expenditures should be financed with a system of taxation that meets these needs with a minimum of change from year to year. To the extent that tax receipts at given tax rates fail to grow in relation to economic growth, legislators are forced constantly at the state and local level to revise tax rates and in turn cause uncertainty about the future course of tax policy. This revenue adequacy, generally determined by the level of growth elasticity, is most problematical at the local level where such taxes as the property tax and various per capita taxes grow much more slowly than the economy.

7. Efficiency and Effectiveness of Tax Expenditures

Despite a preference for neutrality, it is sometimes necessary to use the tax system to achieve social goals. The use of the tax system to subsidize or support various types of activities is usually referred to as tax expenditure policy. The Commission recognizes the utility of tax expenditures, especially in light of the efficiency of tax expenditures in establishing automatic incentives which affect individuals or businesses with a minimum of governmental interference. When the General Assembly appropriates public funds through tax expenditures, however, the same caution should be applied which is customarily employed in making direct appropriations from the public treasury. Tax expenditures should be clearly tied to socially desirable new activities and should not subsidize activities which would occur regardless of tax expenditures. Such tax expenditures should be made for a fixed period of time, following which a detailed evaluation of the efficiency and effectiveness of the tax expenditure should be carefully conducted prior to continuing authorization for the tax expenditure. All too often millions of dollars of potential public funds are lost because of ineffective tax expenditures which continue far beyond their initial rationale.

B. Implications of Goals

There are certain important inferences that can be drawn from the goals discussed above for the type of tax system we recommend for Pennsylvania. It should be clear that we cannot develop a tax system in which each tax meets each goal. Moreover, Pennsylvania already has a tax system in place which must be taken into account in making recommendations for change. We do not propose to eliminate every tax in existence and develop an entirely new system. Many taxes that do not meet all the goals are functioning effectively and meet certain goals successfully. They compensate for their weakness vis-a-vis other goals. Thus, the sales tax, as applied in Pennsylvania, has much to recommend it even though it may not meet the economic efficiency criterion. On the other hand, taxes which do not achieve any of these goals are candidates for elimination in the view of the Commission. Resultant revenue losses must be made up by greater reliance on taxes that are successful in achieving these goals.

It is also clear that the more broadly based the tax is, the better it is. By broadly based, we mean that the tax base permits few exemptions in the definition of income or in the definition of taxpayer and does not easily permit avoidance. Pennsylvania's personal income tax is a good example. Broadly based taxes are generally simple to understand and calculate and are also stable and predictable. Such broadly based taxes are often viewed as most fair by taxpayers.

In applying these goals, it is also clear that a number of taxes fail to meet them satisfactorily. The property tax, as noted, contains arbitrary and unpredictable elements and, as a result, is viewed as unfair. The Capital Stock Tax and Franchise Tax on business also contains many arbitrary and *ad hoc* approaches to valuation of the corporation. The Pennsylvania State Supreme Court, in a 1976 decision, indicated that the Capital Stock Tax is really a tax on the properties and assets of the corporation and that the valuation of the capital stock is a judgmental factor.

Looking at the total system in terms of these goals, it seems reasonable to question the differential taxation Pennsylvania imposes on various industries. In particular, the banking and insurance industries are both exempt from the Corporate Net Income Tax (CNI). Other taxes have been devised to tax the firms in those industries. Uniform taxation for business as a whole on the basis of net income would increase the fairness of the system, contribute to simplification, and result in lower costs.

We believe application of these goals can be effective in insuring that Pennsylvania improves its tax system over time, eliminates the tendency to pass new taxes on an *ad hoc* basis to meet pressing revenue problems

of the moment, and adequately finances government. Any proposed new taxes should be analyzed in relation to these goals to see how well they meet the goals before being admitted to the system.

C. Criteria for a Tax

One of the striking features of Pennsylvania's current system of taxation is the tremendous range of taxes that compose the system. The justification for many of the taxes comes from the necessity of meeting a particular revenue deficiency at a point in time rather than from a well-defined criterion. We have attempted to solve this problem by emphasizing the importance of goals that should be met by the various taxes. Nothing has yet been said, however, about the basic criteria justifying particular taxes.

The literature on public finance is replete with discussions on the criteria justifying a particular tax. The two basic criteria are the ability to pay and the benefit received. Thus, an income tax is justified on the basis of ability to pay. The federal income tax with its progressive features is justified by that criterion, as is an income tax, such as Pennsylvania's, that uses proportional taxation. On the other hand, property taxes and gasoline taxes are justified on the benefits-received criterion. Property owners receive police and fire protection, rubbish collection, and other services of local governments; it is widely believed that the benefits of many municipal services are in proportion to the property they serve. The gasoline tax is paid by automobile owners and the revenue is channeled into road maintenance and improvement. Again, the benefit criterion justifies the tax. We propose to justify every tax in the system that we propose on the basis of one of these two criteria. Where the tax cannot meet one of these two criteria, it will be rejected as a candidate for the system.

Thus, we are proposing to use two screening mechanisms for the admission of any tax to the system. The first is the set of goals we described above. Each tax must be analyzed in terms of the six goals specified. When a tax does not meet a particular goal, it must be scrutinized carefully and can be admitted only if its evaluation in comparison with another goal compensates for its deficiencies. The second is the set of criteria we have specified. Each tax in the system must be justified on the basis of one of the two criteria or it will be rejected for admission to the system. Table I.1 summarizes the goals and criteria used by the Commission in examining Pennsylvania's tax system.

Table I.1

Goals and Criteria Used by the Pennsylvania Tax Commission in Examining Pennsylvania's Tax System

	Criteria	
Goals	*Ability to Pay Principle*	*Benefit Principle*
Simplicity	x	x
Certainty	x	x
Equity	x	x
Economic Efficiency	x	x
Economy of Administration	x	x
Revenue Adequacy	x	x

D. Characteristics of the System

It can be argued that the ideal tax structure would be one in which there was a single tax, and that tax would be on income. The income tax could meet the goals that we have established and could be justified on the ability to pay criterion. Since income, broadly defined, is the ultimate objective of the economic system, a good argument could be made for such a tax system.

However, even if one accepted that argument intellectually, it does not make sense operationally. The interdependence among states is an important factor to be taken into account when developing a tax system. The ease with which capital and human resources can move to other states means that states must have tax systems that are roughly comparable both in types of taxes in the system and in the level of rates applied by each tax. Obviously, no two systems are exactly the same, but there will be difficulties if one state attempts to establish a radically different system. Thus, we conclude that one characteristic of the system is that it must be a portfolio of taxes rather than a single tax system.

A second characteristic relates to the social justice or the distributive effects of a tax. At the federal level, the personal income tax and gift and estate taxes are strongly progressive and materially affect the distribution of income and wealth. The federal system attempts to reduce the inequality in income both by applying a progressive tax rate structure to income and wealth and by using transfer payments. Because of the mobility of human and physical resources, and in view of the Commonwealth's constitutional impediments to progressivity, the Commission believes that major income redistribution across all income classes through the tax system must be obtained at the federal level.

However, the Commission also believes that the state should seek to achieve through its tax system certain distributional objectives which are consistent with the constitutional framework. Within the current constitutional framework, this means that the tax system should seek to alleviate tax burdens on the poor, elderly, and infirm, and as such, should seek progressivity in the tax system for these groups of persons. Also, in viewing the state's role in achieving progres-

sivity, the Commission believes that both state and local taxes, to the extent possible, should be taken into account.

There are, in addition, other objectives of the system that we want the system to achieve. We want a tax system that is consistent with economic development in the state. There is increasing evidence that the tax structure is not the crucial factor in determining the location of new business. Many other factors, such as the labor climate and other intangible factors relating to the physical and economic conditions of the area, seem to be more important to the location decision than the tax system. Nevertheless, it is still important to make certain that the tax system keeps Pennsylvania competitive with its neighboring states.

E. Assumptions and Additional Considerations in the Report

1. Overall Tax Burden

In reviewing Pennsylvania's current tax system, certain assumptions about the overall revenue needs of the Commonwealth and the constitutional framework had to be made. The Governor charged the Commission to devise tax reform proposals which do not increase the level of overall taxation. To implement this, the Commission presents in this *Report* a set of recommendations which do not increase or decrease materially the percent of total Pennsylvania personal income dedicated to the public sector. Only in this manner can proper attention be focused on the effective rate of taxation.

The effective tax rate measures taxes as a percent of an indicator of resources available to pay taxes, usually personal income. These rates measure the true "burden" of taxes on the economy, in contrast to nominal or statutory rates which may fail to be responsive to economic activity. For example, the Commission finds that the flat cent-per-gallon motor fuel tax is really a tax with a decreasing effective rate despite a fixed nominal rate, because the price of motor fuel has risen so much over the past few years. Moreover, higher fuel prices and more fuel-efficient vehicles have meant that total motor fuel taxes have not kept pace with the increasing cost of road repair. Therefore, the Commission recommends changes in the structure of motor fuels taxes which will increase nominal tax rates, but which will not lead to any long term growth in the size of the public sector. In the short-run, Motor License Fund revenues will increase to finance the needed restoration of our roads and bridges.

Table I.2 shows the pattern of overall effective tax rates in Pennsylvania, U.S. average, and several other major states. While per capita taxes have risen since 1968-9, the effective tax rate in Pennsylvania has generally been below the U.S. average, below that of New York, about the same as New Jersey, and somewhat higher than Ohio. The Commission has sought to keep the overall effective rate of taxation at about 11.9% of personal income in connection with its recommendations.

2. Balance of Taxes between Business and Personal Sectors, Capital and Labor

In testimony before the Commission, reference was made repeatedly to the importance of maintaining a balance between business and personal taxes. The 1968 Tax Study and Revision Commission recommended that 70% of taxes be derived from personal taxation and 30% from business; these figures were cited before this Commission by public witnesses and representatives of industry and organized labor. This Commission believes its recommendations have not materially altered the current balance; in main, recommendations have substituted personal income taxes for occupation taxes and business income taxes for other types of business taxes.

While the Commission has observed the importance of this dichotomy, it also believes that such distinctions can be somewhat mechanical and misleading for a number of reasons. First, the Commission believes that the issue of balance is more properly the issue of the taxation of labor income vis-a-vis the taxation of income from capital. Business per se does not pay tax, but does so on behalf of the individuals who own the firm or its capital. By the same token, the local property tax, while collected from individuals is, in fact a tax on the ownership of capital. The local wage tax is, on the other hand, clearly a tax on labor income. Second, in trying to ascertain what the "balance" of taxation is between labor and capital income, it is important to examine the actual incidence of the tax as contrasted with the nominal impact of the tax. Thus, while the utilities literally write a check to the Department of Revenue for the gross-receipts tax, it is clear that consumers pay the tax through higher prices that include the tax. Unfortunately, the limitations of time and resources prevented the Commission from performing such incidence analysis and from measuring the current balance of taxes on labor and capital under current law and under its recommendations. The Commission believes that this is an important topic for future analysis.

With regard to overall revenue needs, the Commission assumed that the current expenditures financed by the Personal and Corporate Net Income taxes would be continued although their rates are scheduled to decline in 1982 from 2.2% to 2.0% and 10.5% to 9.5% respectively. Thus, the Commission has assumed that the current personal and corporate tax rates would be continued.

3. Tax Reform in Pennsylvania vs. Tax Reform in Other States

In reviewing the history of effective Pennsylvania tax rates, the Commission feels an obligation to caution the public and the General Assembly that tax reform in Pennsylvania has a different meaning than the term has generally been given in other states in recent years. Nationally, state and local governments have been experiencing overall budget surpluses of better than $20 billion as reflected in the U.S. Department

Table I.2

State and Local Tax Burden: 1968-1979 In Pennsylvania and Other States

Year	*Pennsylvania State and Local Taxes as a % of Personal Income*	*U.S. Average*	*California*	*Illinois*	*Michigan*	*New Jersey*	*New York*	*Ohio*
1968-1969	9.992%	11.220%	11.341%	9.411%	11.688%	10.349%	14.049%	8.839%
1969-1970	10.963	11.658	13.480	11.428	11.547	10.576	14.260	9.107
1970-1971	11.394	11.887	13.733	11.467	12.237	11.000	14.538	9.253
1971-1972	12.710	12.694	14.942	12.118	12.976	11.617	15.788	10.071
1972-1973	12.994	12.947	14.909	11.911	12.960	12.042	16.952	10.436
1973-1974	12.247	12.358	14.010	12.002	12.308	11.639	16.552	9.790
1974-1975	11.675	12.284	14.591	11.728	11.665	11.591	16.653	9.694
1975-1976	11.540	12.472	14.892	11.418	12.064	11.826	17.329	10.017
1976-1977	11.880	12.805	15.493	11.726	13.039	12.606	17.683	10.004
1977-1978	12.254	12.753	15.799	11.803	12.668	12.419	17.188	9.933
1978-1979	11.887	12.031	12.042	11.261	12.395	12.095	16.697	9.768

Year	*Per Capita Pennsylvania State and Local Taxes*	*U.S. Average*	*California*	*Illinois*	*Michigan*	*New Jersey*	*New York*	*Ohio*
1968-1969	$339.52	$379.94	$ 539.99	$ 372.80	$ 428.26	$ 406.06	$ 575.51	$305.77
1969-1970	401.40	427.14	559.33	486.78	455.54	447.25	652.32	343.24
1970-1971	444.37	460.47	603.22	513.48	491.33	498.55	688.60	363.87
1971-1972	525.93	522.49	687.11	575.19	569.36	554.25	788.68	418.76
1972-1973	581.34	577.08	738.84	613.03	635.11	630.51	893.61	475.42
1973-1974	614.95	618.39	762.25	699.03	679.15	683.19	952.29	496.70
1974-1975	636.43	663.77	868.62	730.27	681.77	725.48	1025.09	533.82
1975-1976	683.91	730.52	964.20	769.42	749.04	792.83	1139.94	585.79
1976-1977	770.01	813.01	1088.92	860.29	878.17	931.45	1252.22	640.74
1977-1978	861.77	888.00	1227.47	916.99	958.84	993.06	1308.28	700.52
1978-1979	921.47	933.93	1379.80	1003.75	1049.32	1060.37	1372.71	768.55

Source: U.S. Bureau of the Census, Governmental Finances (1968-1979). Series GF78, U.S. Government Printing Office, Washington, D.C.

of Commerce's national income accounts. These surpluses arise because of the inflation dividends generated by progressive income taxes, or because of the fortuitous location of certain energy resources.

Higher wages and prices have placed taxpayers into higher tax brackets despite relatively stable real personal income. As a result, in other states a type of tax reform has been possible in which across-the-board rate reductions were achieved. Because the Uniformity Clause of Pennsylvania's Constitution prohibits progressive nominal tax rates, Pennsylvania has not experienced the budget surpluses of other states. Because of Pennsylvania's tax structure, Pennsylvania cannot approach tax reform with a tax-reduction perspective, but must use a balanced budget approach. Any tax reductions in one area must be counterbalanced by revenue generating proposals in some other area. The Commission has sought to achieve this balance in its recommendations.

4. Outline of the Report

In the sections below, we outline our recommendations and the basis for these recommendations for a system of taxation in Pennsylvania which strikes a reasonable balance among the goals discussed above, and which the Commission believes the General Assembly will find achievable. Some of these recommendations can be achieved without new law through administrative regulation or through administrative clarification of existing law without materially altering it.

The recommendations and discussion below are grouped into four major headings: Local Taxation, State Taxation of Individuals, Taxation of Transportation, and State Taxation of Business. In addition to considering the major substantive areas of taxation in the state, the Commission reviewed the administration of a number of the state's taxes and made recommendations in the area of tax administration. The recommendations are contained in the section entitled Tax Administration.

Section II.
Local Taxation

A. The Local Property Tax

1. Background

In Pennsylvania in 1976-77, the property tax provided 26% of total state and local tax revenue and 66% of total local tax revenue.[1] For school districts in Pennsylvania, property taxes comprised 36% of total revenues, 68% of revenues from own sources, and 78% of total taxes.[2] Throughout the public hearings, the use of the property tax as a major source of local revenues, especially to finance schools, was frequently criticized. Three issues were raised in relation to the property tax: (1) excessive reliance on the property tax for funding public education, (2) poor property assessment practices, and (3) the regressive impact of the tax on low income homeowners, especially the elderly. These matters are discussed below.

2. Reliance

a) The Property Tax as a Source of School Finance

One of the fundamental objectives of the Commission was to examine the desirability of reducing reliance on the property tax for the funding of public education. Irrespective of assessment practices, there are a number of reasons why one may question the use of the property tax for school finance.

First, one of the fundamental principles of taxation discussed in Section I., is that there should be some relationship between those who reap the benefits of the activity and those who bear the taxes to support that activity. This is the benefit principle of taxation. Thus, it is argued that general purpose local governments should depend heavily upon the property tax since many of their activities such as the provision of police and fire services, the collection of garbage, and many other functions, basically relate to property. It is difficult to argue, however, that there is or should be any relationship between the holding of real estate and the provision of education. The benefit principle simply does not appear to apply to this situation. If there is any such relationship, there may be an association between the provision of educational services and the production of future income. Hence, one might argue that the benefit principle implies that our schools should be financed through income taxes.

On the other hand, funding public education from just the income tax may conflict with another objective of a good tax system discussed in Section I. — revenue adequacy. The Commission notes that there are circumstances currently in Pennsylvania where either the income or the property tax base is inadequate by itself to fund public education. In these situations, restricting jurisdictions to one tax source runs the risk of not permitting jurisdictions to finance adequately their local needs. Also, to the extent that the growth elasticities differ markedly over the business cycle between, say, the property tax and the local income tax, restricting jurisdictions to one tax source can adversely affect them over time. Accordingly, the Commission believes that, with respect to the objective of revenue adequacy, that local school districts should have access to both the property tax and the local income tax.

In terms of the *relative* access school districts should have to the income tax vis-a-vis other local governments, the Commission finds that school districts should have greater access to the income tax than other local governments, because the ability to pay principle is more appropriate than the benefit principle in the case of education. Generally, the Commission finds that the local governments should have considerable flexibility in relying upon various tax bases.[3]

A second argument regarding the use of the property tax as a source of school finance relates to national concerns about local taxation. At the time Governor Thornburgh formed the Tax Commission, Proposition 13 had just passed in California, and the property tax appeared to be under attack in many other parts of the nation. Given that the state is obligated to provide public education for its citizens, there was reason to examine alternative ways of financing public education so that the reliance upon the property tax might be examined and possibly reduced.

Third, it is often said that the property tax is a regressive form of finance, and, because of this regressivity, alternative, less regressive sources of school finance should be examined. It is believed that those who are poor, and especially the elderly tend to spend a disproportionate share of their income on the property tax.

[1] U.S.Department of Commerce, Bureau of the Census, 1977 Census of Governments, Compendium of Government Finances, Vol. 4, No. 5, Table 47, p. 121. It should be noted that the definition of property taxes in the Census of Governments includes taxes on real and personal, tangible or intangible property.

[2] U.S. Department of Commerce, Bureau of the Census, *1977 Census of Governments, Finances of School Districts*, Vol. 4, No. 1, Table 4, pp. 14-15.

[3] For a related perspective, see Joint State Government Commission, *Local School Tax Reform: A Proposal to Reduce Property and Nuisance Taxes* (Harrisburg, General Assembly, April 1980) which provides a series of proposals for a mandatory reduction in reliance on the property tax and increased reliance on the local income tax.

However, the regressivity of the tax is not inevitable, and in Pennsylvania the regressivity is substantially reduced by the current property tax/rent rebate program.

b) Empirical Evidence on Reliance on Property Tax for School Finance

If Pennsylvania is compared to other states, it does not appear that Pennsylvania school districts obtain a disproportionate share of their revenues from the property tax. As is shown in Table II.1, the property tax accounted for 36.41% of total revenues for school districts in Pennsylvania. Of the 41 states whose independent school districts have separate taxing authority from municipalities, Pennsylvania's property tax was a smaller proportion of total revenues than 22 states and a larger proportion than for 18 other states. Vermont, where 63.65% of total revenues come from the property tax, represented the state with greatest reliance, while Alabama, with 10.18% , represented the state with the least reliance on the local property tax. The mean reliance for the 41 states is 36.54%. Hence, compared with other states, Pennsylvania is about average in terms of proportion of revenues for school districts that is derived from the property tax.

The other columns in Table II.1 indicate that Pennsylvania does not appear to rely upon the property tax vis-a-vis other local taxes and total local revenues as heavily as do the school districts in other states. For example, the property tax, on average, accounts for 77.26% of total revenue for independent school districts derived from their own sources. In Pennsylvania, however, property taxes account for only 66.68% of own-source revenues. Of the 41 states shown on Table II.1, 35 states rely more heavily on property taxes to finance education at the local level than Pennsylvania, and only 5 states rely less on property than do Pennsylvania. Hence, in a comparative sense, Pennsylvania does not unduly rely upon the property tax for funding education.

The Commission also notes that in many other states, the tax revolt signalled by Proposition 13 in California has not materialized.

c) The State Role in School Finance

Pennsylvania, like many other states, provides considerable financial assistance to local school districts. Under the School Code,[4] the state is committed to finance 50% of total instructional expenditures each year, based on the previous year's expenditures. As a practical matter, however, the state's basic instructional subsidy has amounted to less than 50% of the prior year's expenditures. In 1980-81, the subsidy appropriated for 505 local school districts accounted for 43.1% of total state-wide instructional expenditures.

To achieve the 50% goal would require an increase in the basic instruction subsidy of $226.8 million, or a 15.2% increase over current appropriations. The Commission understands that a funding increase of this magnitude would utilize virtually all of the available revenue growth from state taxes.

While additional state assistance to school districts has been actively discussed from time to time in the state, the Commission believes that there are additional, competing concerns which militate against a significant increase in the state's role. The Commission believes that to the extent that financing of education derives from local sources, there will be greater local control of the use of the funds and greater local interest in the outcomes of their expenditure. Such local control and interest helps insure greater economy in the provision of public services.

d) Summary

In view of these considerations, the Commission believes that it is appropriate to finance, in part, local education through the local property tax. Pennsylvania does not, in comparison with other states, unduly rely on the property tax. The Commission finds that the principle difficulties with the property tax both as a source of school finance and as a source to other units of local government involve the issues of assessment, and the enhancement of the property tax/rent rebate programs to reduce the regressivity of the tax on elderly homeowners. These issues are discussed below. With respect to the manner in which greater access to the local income tax should be provided, this matter is discussed in Section II.B, *Local Non-Property Taxation.*

3. Property Assessment

Uniform property assessment requires that all properties within a taxing jurisdiction be assessed at a common ratio of assessed value to market value. The coefficient of dispersion, which measures how much variation there is across properties in their ratio of assessed to market value, is a common measure of assessment uniformity. If assessments are uniform, the observed distribution of assessments to sales ratios will cluster closely about the mean ratio. Smaller coefficients of dispersion indicate less variability among assessment ratios and, therefore, more uniform assessments. According to a recent study, the coefficients of dispersion for Pennsylvania counties, computed for 1976 data, ranged from a low of 13.6% to a high of 57.9%. The International Association of Assessing Officers recommends a coefficient of 20% as a reasonable limit on the coefficient of dispersion. If this standard is accepted, only 5 of the 67 counties in Pennsylvania would have satisfied this standard in 1976. The *1977 Census of Governments* ranked Pennsylvania 49 among the 50 states in terms of assessment uniformity as evidenced by the coefficient of dispersion computed for single family units.[5] Based upon this and other evidence, the Commission believes there is a problem in the administration of the property tax within the Commonwealth.

The poor quality of property assessment in

[4] According to Section 2501, Subsection 12 of the School Code of 1949, the state share is defined to be 50% of total instructional expenditures in the previous year. However, in practice, the program is not funded at 50%.

[5] U.S. Department of Commerce, Bureau of the Census, *1977 Census of Governments, Taxable Property Values and Assessment/Sales Price Ratios*, Vol. 2, Table 15, (Washington, D.C.: 1978), p. 91.

Table II.1

General Revenue of Independent School Systems by State: 1976-1977[1]

State	*Property Taxes as a % of Total Revenue*	*Property Taxes as a % of Revenue From Own Sources*	*Property Taxes as a % of Total Taxes*
Alabama	10.18%	45.04%	100.00%
Alaska	—	—	—
Arizona	39.66	84.32	100.00
Arkansas	33.44	85.07	100.00
California	49.62	91.14	100.00
Colorado	49.97	87.58	100.00
Connecticut[2]	—	—	—
Delaware	18.11	67.88	100.00
District of Columbia[2]	—	—	—
Florida	27.25	74.53	100.00
Georgia	34.27	82.06	100.00
Hawaii[2]	—	—	—
Idaho	34.32	86.26	100.00
Illinois	48.76	87.44	99.90
Indiana	43.16	88.57	100.00
Iowa	40.74	81.54	97.86
Kansas	43.63	78.54	100.00
Kentucky	25.17	64.49	84.50
Louisiana	13.08	39.10	46.51
Maine	15.40	33.25	100.00
Maryland[2]	—	—	—
Massachusetts[2]	—	—	—
Michigan	49.16	85.89	99.62
Minnesota	33.13	84.00	99.37
Mississippi	20.11	70.14	99.96
Missouri	41.65	80.89	100.00
Montana	27.05	84.51	100.00
Nebraska	63.81	85.76	99.82
Nevada	33.40	84.91	99.53
New Hampshire	59.00	68.16	99.98
New Jersey	49.09	77.75	100.00
New Mexico	14.89	77.10	100.00
New York	27.68	49.13	98.25
North Carolina[2]	—	—	—
North Dakota	30.82	73.54	100.00
Ohio	45.12	82.61	100.00
Oklahoma	32.04	83.34	98.76
Oregon	57.14	88.40	100.00
Pennsylvania	36.41	67.68	77.74
Rhode Island[2]	—	—	—
South Carolina	30.47	83.30	98.64
South Dakota	61.99	88.60	99.54
Tennessee[2]	—	—	—
Texas	40.45	85.87	100.00
Utah	32.01	81.14	100.00
Vermont	63.65	92.28	100.00
Virginia[2]	—	—	—
Washington	25.19	83.60	99.96
West Virginia	24.96	83.85	100.00
Wisconsin	31.59	63.06	100.00
Wyoming	40.83	85.34	100.00

[1]Source: U.S. Department of Commerce, Bureau of the Census, *1977 Census of Governments, Finances of School Districts*, Vol. 4, No. 1, Table 4, pp. 10-15, U.S. Government Printing Office, Washington, D.C.

[2]All school districts are dependent units of governments.

Pennsylvania is not a new phenomenon. In fact, it has been noted by virtually every other tax commission which has looked at the subject matter in both this century and the nineteenth century. In several counties the Commission was distressed to find that non-uniform assessments have led to litigation resulting in court decisions which, in effect, substitute judicial authority for the local assessment officials in order to protect property owners' rights to uniform assessments. The replacement of the tax administration responsibility which is lodged in the executive branch by the judicial process is symptomatic of the need for property tax reform in Pennsylvania. The Commission strongly believes that the imperative for property tax reform is compelling, and that the citizens of the Commonwealth demand it.

a) Issues

While the local property tax is used to finance local government, the Commission believes that the Commonwealth has an interest in assuring a more uniform local application of the tax than currently exists. In reviewing the operation of local property taxes throughout the state, the Commission observed that the non-uniformity which has plagued the system involves the following problems: (1) the lack of objective standards and performance criteria in the assessment process; (2) the absence of incentives and penalties which encourage county assessment offices to do a better job; (3) the disparity between resources available to county assessment offices and the requirements of the assessment task, especially in terms of the amount of information which must be processed to do a good job of assessment.

Historically, the property tax has been administered by the 67 county governments on behalf of the more than 3,000 local governments throughout the state. The assessment service which county assessment offices provide to local governments throughout the state has been without charge. The Commission believes that to improve the assessment in the counties, either greater resources need to be obtained by county assessment offices from the jurisdictions to which they provide services, or the state must, through requirements and financial assistance, insure that improved assessment takes place. The Commission believes that if improved property assessment is to be achieved at the lowest possible cost statewide, then assessment must remain the function of county government. However, current practice must be improved and this can be achieved through the exercise of state oversight and the commitment of resources to county assessment offices.

Disparities in assessments are well-documented and described in *A Task Force Report to the Pennsylvania Tax Commission: Local Property Taxation.* As noted in our introduction to this *Report*, the Commission believes that equity and uniformity are among the most important goals of our tax system. Currently, local assessment offices have little incentive and are under no requirement which insures that assessments in jurisdictions or among jurisdictions are equitable and uniform. Counties may delay reassessment several and in some cases many years. Even after reassessment, inequities may still exist. For example, some property may be assessed at 5% of its market value while other property in the same area may be assessed at 50% of market value. It then becomes very difficult for the individual taxpayer to have any confidence in the assessment procedure or even determine if he is under or over assessed.

b) Computer Aid for Assessment

The use of computer technology in the assessment process may range from simple record keeping operations to complex applications of statistical procedures which internally generate estimates of market value for selected types of property. At a minimum, computers can aid in the managing and processing of information. A computer system having the capacity to store and retrieve data files, update records, and generate reports can greatly ease the burden on the assessor.

(1) Computerized Mass Appraisal

Some states, such as California, Ohio, and Utah, and some counties in Pennsylvania have begun to utilize computers for more than the management of assessment information and generation of necessary reports. In these areas, computer programs have been used to perform automated mass appraisal.

The primary purpose of an automated mass appraisal system is the generation of a valuation comparison formula which accurately establishes the fair market value of any parcel as a function of certain observable property characteristics. The actual structural form depends upon the choice of statistical model.[6]

Currently, computerized mass appraisal techniques have been more readily applied to residential properties since, as already described, the market approach (comparable sales analysis) is more appropriate for this type of property. However, there is growing application of automated techniques for valuing commercial and industrial property as well. In cases where the income approach is used to value commercial and industrial property, income data must be collected for these properties.

(2) Equity and Computerized Mass Appraisal

A mass appraisal system is not necessarily an immediate panacea to all assessment problems. However, the basic intention of automation is to provide more equitable assessments at lower costs than through traditional techniques. Each property is evaluated on a similar set of characteristics which are determined by an objective (mechanical) statistical procedure which, in turn, weights the relevant characteristics appropriately. Not only should the taxpayer perceive even-

[6] Multiple regression analysis, cluster analysis, discriminant analysis, and a recently developed feedback approach are the kinds of statistical methods which have been used for computerized valuation. The appropriate weights for each of the property characteristics in the determination of market value is estimated by an analysis of current sales data. The model, therefore, represents an objective relationship stating precisely how property characteristics determine sales value. To estimate current year selling price, such a model may be applied to all properties within a similar property class where market values are unknown.

handed treatment, but as

> "experience suggests . . . [computer mass appraisal] . . . can produce appraisals with an average deviation of far less than 10% from the market price, a level which is recognized as good and which is not frequently achieved."[7]

As stated earlier, in Pennsylvania, the deviations within counties range from 13.6% to 57.9% from the market price (or some set fraction of the market price) with only 5 counties within the standard of 20% set by the International Association of Assessing Officers.

Second, computerized mass appraisal allows the assessing authority the capability of keeping pace with rapidly appreciating or depreciating values. County assessors stressed the importance of frequent reassessments, especially during periods of high inflation, to those associated with the Commission. Despite the widespread view that frequent reassessment is important, a survey of county assessment offices conducted by the Local Property Taxation Task Force indicated that the median number of years since the last county-wide reassessment was almost eight. Two counties had not reassessed in twenty-five years; two counties indicated there had never been a reassessment.

Many county assessors recognized that frequent reassessments were not possible without the aid of computer technology. Given the cost and time requirements of a conventional county-wide reassessment, it is unlikely that annual reassessments can occur using conventional methods. Yet, one significant variable found to increase assessment error is the amount of time since the last reassessment. This phenomenon adds to the non-uniformity of the property tax.

The performance of any statistical model depends upon the reliability, accuracy, and consistency of the data. Inaccuracies or inconsistent measurements in the data will lead to inaccurate or biased results. Computer mass appraisal requires that property attribute data be maintained and updated for every parcel. Furthermore, if considerable variability exists among properties in terms of property characteristics, statistical procedures which emphasize mean values will be less effective.

(3) The Benefits of Computerization

Computerization may be the most efficient and effective method of doing property assessment. There are several benefits to computerized assessment. Computers can manage data effectively at a relatively low cost. Properly constituted computer systems can easily retrieve, update and add information to the data base. Computer systems can generate a wide variety of reports which can evaluate the performance of the county assessment office as well as the performance of individual assessors. Computerized mass appraisal can allow counties to use sales data to produce yearly reassessments for the county. Thus, the assessment rolls can be updated more frequently and will therefore more accurately reflect the property market.

[7] Albert M. Church and Robert H. Gustafson, *Statistics and Computers in Appraisal Process*, International Association of Assessing Officers, (Chicago: 1976), p.2.

c) Recommendations on Property Assessment

The specific recommendations for assessment reform of the Commission are outlined below. Under the proposed reforms, the responsibility for assessment would remain with the county subject to provisions for not meeting proposed standards. The state would be required to set minimum uniformity standards and to determine sanctions for those counties not meeting the standards. In addition, the state would provide technical advice and assistance on the assessment process to counties. All counties would be required to collect a minimum set of data on each parcel within its boundaries. Under the proposed reforms, counties would be strongly encouraged to use computer mass appraisal techiques in the assessment process. The state would maintain a computer service to provide computer mass appraisals to counties.[8] The use of this service would be optional.

(1) County Assessment Law

The Commission recommends recodification of the various assessment laws into one county assessment law with statewide application. The current system has both a general assessment law and a separate set of laws for each class of county. This structure is very confusing as different counties follow different sets of law.

(2) Professional Assessors

The state would require that all assessors be certified. The state certification program would require that assessors successfully complete a state sponsored training program or receive a passing grade on an assessment exam administered by the state.

(3) Certification and Publication of Tax Exempt Property

Each county would be required to certify and list each tax exempt parcel every five years. This certification would insure that the current use of the property merits tax exempt status. Currently, there is no systematic check of current use. As a result, a property which was given tax exempt status twenty years ago may still be considered tax exempt even though it should be taxed given its current use.

(4) Technical Advisors

For all counties, the state would provide an information service through the Department of Community Affairs. Through this service, the state would offer assistance and training in "state of the art" valuation methods for different types of property, particularly those types of properties which are difficult to assess (e.g., industrial properties). This service would also provide information on the uses of computer technology in assessment.

(5) Data Collection

Under the proposed reforms, each county would be required to collect a minimum set of attribute data on each property within its boundaries. This required set of data would include factors such as type of construction, present condition, size of lot, age, location, sell-

[8] Estimates of state training and computer costs may be found in *A Task Force Report to the Pennsylvania Tax Commission: Local Property Taxation* (1980).

Table II.2

Number of Taxable Parcels by County in Pennsylvania

County	Number of Taxable Parcels	State Assessment Aid ($4.25 Per Parcel)
Adams	55,698	$ 236,716.50
Allegheny	465,941	1,980,249.25
Armstrong	35,006	148,775.50
Beaver	79,647	338,499.75
Bedford	24,085	102,361.25
Berks	14,683	62,402.75
Blair	58,000	246,500.00
Bradford	29,705	126,246.25
Bucks	62,879	267,235.75
Butler	160,475	682,018.75
Cambria	84,366	358,555.50
Cameron	5,011	21,296.75
Carbon	32,269	137,143.25
Centre	35,322	150,118.50
Chester	94,535	401,773.75
Clarion	22,407	95,229.75
Clearfield	38,131	162,056.75
Clinton	19,000	80,750.00
Columbia	32,000	136,000.00
Crawford	49,902	212,083.50
Cumberland	61,168	259,964.00
Dauphin	90,000	382,500.00
Delaware	175,000	743,750.00
Elk	20,207	85,879.75
Erie	105,618	448,876.50
Fayette	72,290	307,232.50
Forest	12,600	53,550.00
Franklin	44,980	191,165.00
Fulton	6,742	28,653.50
Greene	30,029	127,623.25
Huntington	22,500	95,625.00
Indiana	39,086	166,115.50
Jefferson	27,505	116,896.25
Juniata	10,050	42,712.50
Lackawana	73,000	31,025.00
Lancaster	122,605	521,071.25
Lawrence	49,463	210,217.75
Lebanon	38,134	162,069.50
Lehigh	98,944	420,512.00
Luzerne	134,996	573,733.00
Lycoming	46,005	195,521.25
McKean	29,540	125,545.00
Mercer	52,328	222,394.00
Mifflin	19,791	84,111.75
Monroe	66,633	283,190.25
Montgomery	203,279	863,935.75
Montour	62,000	263,500.00
Northampton	85,000	361,250.00
Northumberland	42,467	180,484.75
Perry	16,508	70,159.00
Philadelphia	560,000	2,380,000.00
Pike	45,838	194,811.50
Potter	15,515	65,938.75
Schuylkill	76,000	323,000.00
Snyder	15,801	67,154.25
Somerset	46,525	197,731.25
Sullivan	6,465	27,476.25
Susquehanna	22,819	96,980.75
Tioga	20,392	86,666.00
Union	12,291	52,236.75
Venango	33,719	143,305.75
Warren	27,366	116,305.50
Washington	100,000	425,000.00
Wayne	43,085	183,111.25
Westmoreland	160,000	680,000.00
Wyoming	12,439	52,865.75
York	116,480	495,040.00
State Total	4,572,265	$19,432,126.25

Source: Carnegie-Mellon University, School of Urban and Public Affairs, *Property Assessment in Pennsylvania: A Background Report Prepared for the Local Property Task Force of the Pennsylvania Tax Commission*, Appendix A, pp. 127-130.

ing price, improvements, etc. In addition, owners of income producing property would be required to provide income data (e.g., rental income). These income data permit the use of the income approach to valuing commercial property. Counties electing to use the state computer service might be required to collect information in addition to this minimum set.

In those counties that do not currently collect the required information, data collection costs under the Commission's recommendations are estimated to be approximately $4.25 per parcel. This figure assumes that the property attribute data are collected by sending out questionnaires to property owners. The $4.25 per parcel includes initial printing and mailing of the questionnaires to each property owner, audits with site visits, and recording data collected onto permanent file cards or computer disk storage.

As stated earlier, one of the major problems in the current system of property assessment is the large disparity between the resources available to county assessment offices and the requirements of the assessment task. Given this lack of resources and the importance of an updated data base in the assessment process, the Commission recommends that the state provide the financial resources necessary for this effort. In this way, the state can insure that the resource constraints on the county assessment office do not determine the quality of assessments. The funds required for each county for this data collection effort are presented in Table II.2.

(6) State Standards, Evaluations, and Sanctions

Under the proposed reforms, the state would set an upper bound on assessment error as measured by the coefficient of dispersion. Currently, the data necessary to compute the coefficient of dispersion is available in every county and is sent to the State Tax Equalization Board (STEB) each month. In some cases, the number of sales transactions is insufficient to calculate the coefficient of dispersion. In such cases, an alternative method to measure dispersion would be used. As stated earlier in this *Report*, the International Association of Assessing Officers recommends an upper bound of 20 on the coefficient of dispersion. The Com-

mission considers this a reasonable limit and recommends that this limit be adopted as the state standard. The state would also be responsible for publicizing county performance records. With this information, the public would have information with which to demand better assessments.

After enactment of a state standard, counties would be given three years to comply with the standard. After three years, those counties which fail to meet the standard would be given an additional two year probation period in which to comply. If after five years a county still does not comply with the state standard, the matter would be turned over to the Attorney General for appropriate action.

This component of the recommendations would require either an expansion of the role of the State Tax Equalization Board or the creation of a new agency to monitor and evaluate county performance.

(7) Reassessment

When a county is found to have a coefficient of dispersion above the state standard, the county will be required to reassess. As already stated, in the initial period after enactment of the state standard, counties will have three years to comply. After the initial period, counties must comply with the standard annually.

The Commission recommends that reassessment be done at 100% of market value in the reassessment year. Following a reassessment, all additions or alterations to the assessment rolls will be valued at 100% of market value in the last reassessment year. In other words, the reassessment year serves as the base year until the next reassessment. Given that counties currently assess at some fraction of market value, property tax revenues could substantially increase when assessments are made at 100% of market value if the millage rate were unchanged. Therefore, the increase of the assessment rate to 100% of market value must be coupled with a provision that millage rates be decreased to insure that tax revenues do not rise more than a stated percentage over the previous year. In this way, 100% valuation will not result in the large surpluses which preceded the Proposition 13 movement in California.

After enactment of the state standard, it is expected that many counties will have to reassess. For example, with a limit on the coefficient of dispersion of 20 as the state standard, 62 of the 67 counties would have to reassess.

(8) Appeals

Appeal of individual property assessments should continue to be heard at the county level. However, there should be a separation between the assessment and appeals function so taxpayers do not find themselves appealing assessments to the same body which issued the assessment.

The Commission also recommends that Section 17 of P. L. 1046, which prohibits use of the State Tax Equalization Board's information "to affect the validity of the assessed valuation of any real property", be repealed. Such action will permit taxpayers to use this information in the appeals process.

(9) State Computer Service

The Commission recommends that counties be strongly encouraged to use computer mass appraisal to determine assessed values. The benefits of such a system have already been discussed. As an incentive to counties to use computer mass appraisal, the state would offer a computer service. The state computer service would be equipped with sufficient computer hardware, software, and manpower to provide statistical mass appraisal to all counties in the state. The cost of the state providing computer service is expected to be lower than the cost of securing computer services from a commercial vendor.

4. The Distributional Burden of the Property Tax and the Property Tax/Rent Rebate Program

a) Background

As noted above, a major concern with relying on the property tax for a large portion of local revenue is the unequal burden the tax places on low income households, and, in particular, on the elderly. It is frequently argued that the elderly and other households on fixed incomes cannot keep up with increasing property taxes. These households find a growing portion of their annual incomes going to pay property taxes.

In 1971, Pennsylvania instituted the Property Tax/Rent Rebate Program to alleviate part of the burden on the elderly, widows, widowers, and permanently disabled citizens. In order to qualify for the program, an individual must have owned and occupied or rented and occupied a dwelling unit in Pennsylvania; the individual or spouse must be 65 years of age or older, or if the individual is a widow or widower, he/she must be 50 or older. Any permanently disabled individual is eligible. In 1979, any individual or family meeting the above requirement was eligible for the program provided that the total annual income was less than $9,000. A household meeting these eligibility requirements may file an application with the Pennsylvania Department of Revenue for a property tax or rent rebate. The percentage of property taxes or rent rebated is determined by the schedule provided in Table II.3. In 1979, the program set a ceiling on rebates of $400.

Table II.3

Current Law Rebate Schedules

Total Income	*Percent of Property Taxes Rebated (up to $400 maximum)*	*Percent of Rent Rebated*
0-$4,499	100%	20%
$4,500-$4,999	90%	18%
$5,000-$5,499	80%	16%
$5,500-$5,999	70%	16%
$6,000-$6,499	60%	12%
$6,500-$6,999	50%	10%
$7,000-$7,499	40%	8%
$7,500-$7,999	30%	6%
$8,000-$8,499	20%	4%
$8,500-$8,999	10%	2%
$9,000 or over	Not eligible	Not eligible

Table II.4

Estimated Burden of the Property Tax and Rent Under Current Law and Commission Proposal*

	Burden Without Rebate Program		**Burden With Current Rebate Program**		**Commission Proposal**	
Income Group	*(1) H:[1] Mean Tax/Income*	*(2) R:[2] Mean Rent/Income*	*(3) H:[1] Mean[2] Tax/Income*	*(4) R:[2] Mean Rent/Income*	*(5) H:[1] Mean Tax/Income*	*(6) R:[2] Mean Rent/Income*
$0 - 3,000	0.2473 (0.2077)	0.5009 (0.2627)	0.1372 (0.2118)	0.4431 (0.2416)	0.1372 (0.2118)	0.4431 (0.2416)
3,000 - 5,000	0.1110 (0.0792)	0.4321 (0.2101)	0.0465 (0.0765)	0.3934 (0.2042)	0.0459 (0.0769)	0.3931 (0.2044)
5,000 - 7,000	0.0821 (0.0519)	0.3531 (0.1786)	0.0480 (0.0458)	0.3374 (0.1727)	0.0467 (0.0465)	0.3367 (0.1729)
7,000 - 9,000	0.0648 (0.0376)	0.2783 (0.1331)	0.0535 (0.0320)	0.2737 (0.1309)	0.0516 (0.0309)	0.2728 (0.1305)
9,000 - 11,000	0.0518 (0.0278)	0.2473 (0.1235)	0.0518 (0.0278)	0.2473 (0.1235)	0.0492 (0.0262)	0.2462 (0.1224)
11,000 - 13,000	0.0477 (0.0267)	0.2150 (0.0980)	0.0477 (0.0267)	0.2150 (0.0980)	0.0467 (0.0261)	0.2145 (0.0977)
13,000 - 15,000	0.0420 (0.0235)	0.1905 (0.0825)				
15,000 - 20,000	0.0358 (0.0196)	0.1704 (0.0665)				
20,000 - 25,000	0.0315 (0.0161)	0.1401 (0.0611)	SAME AS UNDER BURDEN WITHOUT REBATE PROGRAM			
25,000 - 30,000	0.0294 (0.0157)	0.1193 (0.0492)				
30,000 - 50,000	0.0249 (0.0127)	0.1069 (0.0422)				
> 50,000	0.0209 (0.0102)	0.0722 (0.0366)				

Note: (Standard Deviation in Parenthesis)

* This analysis is based on 1,094,021 households which own their own property and 671,761 households which rent. These observations were taken from the U.S. Bureau of the Census, *Annual Housing Survey* for the Allentown SMSA (1976), Philadelphia SMSA (1975), and the Pittsburgh SMSA (1974). All data are in 1979 dollars.

[1] H = Homowners.

[2] R = Renters.

In order to assess the burden of the property tax on low income households and renters, the Commission examined the degree to which the current rebate program alleviates this burden and considered modifications to the program. Table II.4 displays the estimated statewide impact of the current property tax based on a large sample of households from the three largest metropolitan areas[9] in the state.

Column 1 of Table II.4 displays the average ratio of property tax to income, and Column 2 displays the average ratio of rent to income by income group. This represents the average burden of the property tax before the rebate program is provided to those eligible.[10] As is evident from Column (1), the fraction of income devoted to paying the property tax declines as income increases. That is, the property tax is regressive. Those with incomes under $3,000 paid 25% of their income in property taxes, while those with incomes of $25,000 to $30,000 paid 3% of their income in property taxes.

[9] This analysis is based on the U.S. Bureau of the Census Annual Housing Survey for the Allentown SMSA (1976), Philadelphia SMSA (1975) and the Pittsburgh SMSA (1974). All data are in 1979 dollars.

[10] Income is defined as total annual family income and includes social security, SSI payments, pensions and annuities, interest, dividends, capital gains, net rental income, net business income, wages, salaries, self-employment income, cash public assistance, and life insurance death benefits in excess of $5,000.

Table II.5

Estimated Costs of Current Property Tax/Rent Estate Program in Three SMSAs and State and Commission Proposal

Rebate Program:	Current 1979 Rebate Program *(age constraint, $9,000 income cutoff, $400 maximum rebate)*	Commission Proposal: Extended Rebate Program *(age constraint, $12,000 income cutoff, revised rebate schedule, $400 maximum rebate)*
Allentown, Philadelphia, & Pittsburgh SMSAs[1]		
Estimated Costs in 3 SMSAs		
Owners	$ 37,553,540	$ 41,478,426
Renters	$ 29,441,910	$ 31,408,217
Total	$ 66,995,450	$ 72,886,643
Number of Eligible Households		
Owners	150,139	190,824
Renters	125,261	145,083
Total	275,400	335,907
Statewide Costs		
Estimated Costs Statewide[2]	$158,779,217	$172,741,344
% Change in Costs Statewide Compared to Current Law	–	8.79
Dollar Increase over Actual Cost of Current Program in 1979[3]	–	$ 10,082,130

[1] Analysis is based on the U.S. Bureau of the Census, Annual Housing Survey for the Allentown SMSA (1976). Philadelphia SMSA (1975), and the Pittsburgh SMSA (1974) which provided 1,094,021 observations on homeowners and 671,761 observations on renters. All data are in 1979 dollars.

[2] Let n_i = number of eligible in SMSA
N = total population in SMSA
K_i = number of eligible in Pennsylvania
K = total population in Pennsylvania

Assuming that $\frac{n_i}{N} = \frac{K_i}{K}$

then statewide cost = SMSA costs $\times \frac{K}{N}$

$$\frac{\text{1978 Population of Pennsylvania*}}{\text{Population in 3 SMSAs}} = \frac{11{,}802{,}000}{4{,}975{,}871} = 2.37$$

* 1978 Population of Pennsylvania is taken from the 1979 Pennsylvania Abstract. Population in 3 SMSAs is estimated from Annual Housing Survey.

These estimated statewide costs assume 100% participation in the program and therefore overestimate total costs.

[3] In 1979, the actual costs of the Property Tax/Rent Rebate Program was $114.7 million. The figures provided in this column are calculated by applying the percent changes in the previous column to this figure.

With respect to renters, it is not known how much property tax they pay, although it is widely thought that part of their rent reflects the property tax passed on by landlords. As is evident from Column (2), total rent as a fraction of income declines as income rises. If property taxes are a constant fraction of rent, the property tax for renters is regressive as well.

The impact of the current rebate programs is shown in Column (3) and (4) of Table II.4. It is apparent that the current program significantly reduces the regressivity of the property tax for low income owners and renters. For homeowners with income under $3,000, the rebate program reduces the share of income used to pay property taxes from 24.7% to 13.7%; for renters in the same income bracket, total rent as a percent of income falls from 50% to 44% of income.

This improvement in the distributional impact of the property tax as a result of the rebate program is evident through a number of higher income brackets. However, for families with income between $7,000 and $13,000, the rebate program fails to stabilize or reduce the regressivity of the property tax.

b) Revision of Rebate Schedule, Extension to Elderly with Income of $12,000

Over the years, the lottery has proven more profitable than initially expected, and has permitted additional programs for the elderly. To the extent such unexpected funds become available, the Commission recommends such funds be used to improve the existing property tax/rent rebate program. The Commission considered a number of reforms to the program and concluded that an extension to the program to those with incomes of $12,000 and a revision of the rebate schedule would be the most effective way to improve the program at least cost. Columns (5) and (6) of Table II.4 display the estimated distributional impact of these reforms; Table II.5 displays the cost implications and numbers of families impacted, and Table II.6 displays the revised rebate schedule. The proposal would raise the cost of the rebate program by $10 million or 9% in 1979 and extend the program to an additional 143,000 households or an increase of 22%. The impact of eliminating the age requirement with other provisions is contained in Appendix D.

Table II.6

Extended Rebate Schedules

Total Income	*Percent of Property Taxes Rebated*	*Percent of Rent Rebated*
0-$4,999	100%	20%
$5,000-$5,999	80%	16%
$6,000-$6,999	60%	12%
$7,000-$7,999	40%	8%
$8,000-$8,999	20%	4%
$9,000-$12,000	10%	2%
over $12,000	Not eligible	Not eligible

B. Local Non-Property Taxation

1. Background

a) General

The local tax structure in Pennsylvania is complex. There are over 3000 local jurisdictions (counties, municipalities and school districts) with varying local economies and degrees of reliance on a variety of tax sources. The various state statutory sources of local taxing power have given municipalities and school districts an unusually broad range of local, non-real estate taxing authority. However, counties have a much narrower range of tax sources. The most commonly used local non-real estate taxes in Pennsylvania are the following: earned income, per capita, occupation, occupation privilege, mercantile, personal property, real estate transfer, amusement, mechanical devices, and business privilege taxes.

Some perspective on the overall role of these non-real estate taxes is obtained by comparing the reliance of local jurisdictions in Pennsylvania on such taxes with that of local jurisdictions nationwide. As Table II.7 indicates, revenues of all local governments in 1976-77 totalled over $196 billion or about $907 per person; revenues of Pennsylvania localities were about $8.4 billion or some $712 for each Pennsylvania resident. The most striking difference between the local revenue picture for Pennsylvania and the U.S. as a whole is in the composition of tax revenues. Local jurisdictions in Pennsylvania rely less on the property tax and more on income, license, and other taxes than localities do generally. However, the lesser reliance on the property tax in Pennsylvania is due chiefly to a lesser reliance on personal property taxes rather than on real estate taxes. For the real estate tax, Table II.7 suggests that the reliance in Pennsylvania (slightly less than 50.2% of local general revenues) is about the same as reliance nationwide (50.9%). Income taxes are more than four times as important in Pennsylvania than nationwide. Similarly, license and other taxes are more than three times as important. Aside from the personal property tax, the only major non-real estate tax used more heavily in local jurisdictions nationwide than in Pennsylvania is the local sales tax. This accounts for the vast difference between the percentage of local general revenue from sales and gross-receipts nationwide (8.1%) and the percentage for Pennsylvania (0.6%).

Table II.8 indicates per capita amounts for various revenue categories at both the state and local level, for the U.S. as a whole and for Pennsylvania. Local revenues and expenditures per capita in Pennsylvania in 1976-77 were almost $200 less than for local jurisdictions nationwide. The lower per capita amounts are evident throughout the entire list of local revenue sources with two notable exceptions. Local income taxes of $64 per capita in Pennsylvania were almost four times the national average of $17, and in the "other" category of taxes, Pennsylvania localities collected $33 per capita, more than three times the national average of $10. This collection of $70 per capita

Table II.7

Local Government Revenues From All Sources, 1976-77

U.S. Total of Local Government Revenue — All Sources 1976-77 (millions of dollars)

Total Revenue From Own Sources for U.S.

		General Revenue for U.S.	Taxes					Current Charges and Miscellaneous General Rev.					Inter-governmental	
Total	*Total Own Sources*	*Total General*	*Total*	*Property* (*Real* Estate* / *Personal**)	*Sales and Gross Receipts*	*Income*	*License and Other*	*Current Charges*	*Misc. Gen. Rev.*	*Utility*	*Liquor Stores*	*Insurance Trust*	*From States*	*From Federal*
$196,458	$119,626	$102,214	$74,852	$60,267	$8,278	$3,754	$2,552	$19,097	$8,265	$14,299	$306	$2,808	$60,277	$16,554
As a percentage of general revenue for U.S.														
								26.8%						
		100%	73.2%	59.0%	8.1%	3.7%	2.5%	18.7%	8.1%					
Total Revenue from own Sources for Pennsylvania Local Governments 1976-77														
$8,409	$5,050	$4,591	$3,480	$2,305**	$30	$759	$386	$701	$409	$333	—	$127	$2,487	$871
As a percentage of general revenue for Pennsylvania														
								24.2%						
		100%	75.8%	50.2%	0.6%	16.5%	8.4%	15.3%	8.9%					

Source: U.S. Department of Commerce, Bureau of the Census, *1977 Census of Governments, Governmental Finances, Compendium of Government Finances*, Vol. 4, No. 5, Table 47, Washington, D.C.: Government Printing Office, August 1979.

*Estimated: Real Estate, 52,006; Personal Property, 8,261.
**Less than one percent represent personal property taxes.

Table II.8

State and Local Revenue Per Capita, 1976-77, All U.S. and Pennsylvania

	U.S.			Pennsylvania		
	State and Local	*State*	*Local*	*State and Local*	*State*	*Local*
Revenue, Total	$1,561	$945	$907	$1,436	$940	$712
General Revenue	1,318	782	827	1,185	728	674
Intergovernment Revenue	289	225	355	264	196	285
From Federal Government	289	212	76	29	189	74
General Revenue Sharing	31	10	20	29	10	19
From State Government	—	—	278	—	—	211
From Local Government	—	13	—	—	6	—
Revenue from Own Sources	1,273	720	552	1,172	744	428
General Revenue from Own Sources	1,029	556	472	921	532	389
Taxes	813	467	345	769	474	295
Property	289	10	279	200	5	195
Sales & Gross Rec.	280	242	38	240	238	2
General	168	143	25	129	129	—
Selective	112	99	13	111	109	2
Motor Fuel	42	42	negligible	42	42	—
Alcoholic Bev.	10	10	negligible	9	9	—
Tobacco Prod.	17	16	1	21	21	—
Public Utility	19	11	8	25	24	1
Other	23	20	3	14	12	2
Motor Vehicle Lic.	21	19	2	23	23	negligible
Individual Income	135	118	17	164	100	64
Other	87	77	10	141	108	33
Charges and Misc.	216	90	126	152	58	94
Utility Revenue	69	3	66	28	—	28
Liquor Store Revenue	12	11	1	38	38	—
Expenditures, Total	1,493	595	898	1,427	715	712

Source: U.S. Department of Commerce, Bureau of the Census, *1977 Census of Governments, Governmental Finances, Compendium of Government Finances*, Vol. 4, No. 5, Tables 46, 47 and 48, Washington, D.C.: Government Printing Office, August 1979).

more in income and other local taxes was more than offset, however, by lower property tax collections which were $195 per capita in Pennsylvania compared to $279 per capita nationwide. Almost all the $195 in property taxes per capita in Pennsylvania was due to the real estate tax, whereas nationwide about $241 of the $279 was real estate taxes and $38 represented personal property taxes.

The tax structures of Pennsylvania counties, municipalities and school districts are determined by the tax sources provided under state law for use (most often with rate limits) by each type of local government. In addition, tax structures are affected by sharing provisions and the tax treatment of non-residents.

b) Tax Sources by Jurisdiction

Table II.9 indicates the tax sources in common use by type of local jurisdiction. The phrase "in common use" rather than the more definitive phrase "than can be levied" is required because under the two major pieces of state tax enabling legislation in Pennsylvania, the Sterling Act, which is a special tax enabling statute for Philadelphia, and the 1965 Local Tax Enabling or Act 511, which is a tax enabling statute for jurisdictions other than Philadelphia, localities are given the freedom to create taxes beyond those enumerated in Table II.9.

c) Revenue Sources

Information on the level and composition of tax revenues for Pennsylvania counties, municipalities and school districts is provided, respectively, in Tables II.10, II.11, and II.12 for 1977.

2. Issues

There are numerous related issues in non-real estate taxation in Pennsylvania. This discussion focuses on the shortcomings of several local taxes. Also discussed are the broader issues concerning non-resident taxation in Philadelphia and the rest of the state, rate limitations, and the appropriateness of reliance by particular jurisdictions on particular taxes.

a) Intangible Personal Property Tax

This tax is imposed by counties, the cities of Philadelphia and Pittsburgh, and the Pittsburgh School District. The maximum rate is 4 mills. Because of over-

Table II.9

Local Non-Real Estate Tax Sources Currently Used and Rate Limits by Type of Jurisdiction in Pennsylvania

Counties

General Purpose[1] Non-Real Estate Taxes	*Legal Limit[3]*
Personal Property	4 mills
Per Capita[2]	$5
Occupation[2]	20 mills

Philadelphia City

General Purpose[4] Non-Real Estate Taxes	*Legal Limit*	*1978-79 Rates*
Personal Property	4 mills	4 mills
Sterling Act Taxes[5]		
Earnings, Net Profits	No Limit[6]	4.3125%
Mercantile License	"	4 mills
Real Property Transfer	"	1%
Amusement	"	5%
Parking Lot	"	10% of Gross Receipts
Mechanical Devices	"	$25 per device
Sound Reproduction	"	4% of Gross Income
Business Occupancy	"	12.5 mills

Philadelphia School District

General Educational[4] Purpose Non-Real Estate Taxes	*Legal Limit*
General Business Gross Receipts	2 mills
Parimutuel Wagering	4%
Unearned Income	No Limit[7]
Business Occupancy	No Limit
Corporate Net Income	No Limit

Pittsburgh City

General Purpose[4] Non-Real Estate Taxes	*Legal Limit[8]*
Poll Tax	$1
License Taxes	No Limit
Dog Owners	No Limit
Act 511 Taxes	
Per Capita	$10
Occupation (Flat Rate)	$10
Occupation (Millage)	No Limit
Occupation Privilege	$10
Earnings, Net Profits	1%
Deed Transfer	1%
Mechanical Devices	No Limit
Parking	No Limit
Personal Property	No Limit
Amusement	10%
Mercantile License	1 mill wholesale 2 mills retail
Institution/Service Privilege	No Limit
Business Privilege	No Limit

Pittsburgh School District

General Educational[4] Purpose Non-Real Estate Taxes	*Legal Limit*
Earned Income	1%
Mercantile License	1/2 mill wholesale 1 mill retail
Personal Property	4 mills

Scranton

General Purpose[4] Non-Real Estate Taxes	*Legal Limit[9]*
Act 511 Taxes	
Per Capita	$10
Occupation (Flat Rate)	$10
Occupation (Millage)	No Limit
Occupation Privilege	$10
Earnings, Net Profits	1%
Deed Transfer	1%
Mechanical Devices	No Limit
Amusement	10%
Mercantile License	1 mill wholesale 1-1/2 mills retail
Business Privilege	No Limit

Third Class Cities

General Purpose[4] Non-Real Estate Taxes	*Legal Limit[10]*
Residence	$5
License	$100
Act 511 Taxes	
Per Capita	$10
Occupation (Flat Rate)	$10
Occupation (Millage)	No Limit
Occupation Privilege	$10
Earnings, Net Profits	1%
Deed Transfer	1%
Mechanical Devices	No Limit
Amusement	10%
Mercantile License	1 mill wholesale 1-1/2 mills retail
Business Privilege	No Limit

Boroughs, 1st and 2nd Class Townships

General Purpose[4] Non-Real Estate Taxes	*Legal Limit[11]*
Occupation	30 mills[12] (14 mills in 2nd class Twp.)
Act 511 Taxes	
Per Capita	$10
Occupation (Flat Rate)	$10
Occupation (Millage)	No Limit
Occupation Privilege	$10
Earnings, Net Profits	1%
Deed Transfer	1%
Mechanical Devices	No Limit
Amusement	10%
Mercantile License	1 mill wholesale 1-1/2 mills retail
Business Privilege	No Limit

2nd, 3rd and 4th Class School Districts

General Educational[4] Purpose Non-Real Estate Taxes	*Legal Limit*
Per Capita	$5
Act 511 Taxes	
Per Capita	$10
Occupation (Flat Rate)	$10
Occupation (Millage)	No Limit
Occupation Privilege	$10
Earnings, Net Profits	1%
Deed Transfer	1%
Mechanical Devices	No Limit
Amusement	10%
Mercantile License	1 mill wholesale 1-1/2 mills retail
Business Privilege	No Limit

Table II.9 cont'd.

Source: Taxation Manual, Information Services Center, Department of Community Affairs, Harrisburg, Pa., November 1979)

1. Counties may levy two types of special purpose non-real estate taxes. Second class counties only may levy a tax of 1% on hotel room rentals for use in financing a convention center. In addition, to support a community college, local sponsors may levy any tax supported by law, which, of course, includes non-real estate taxes. The revenues so raised for the support of a community college cannot exceed 5 mills of the market value of real estate, except in the Philadelphia and Pittsburgh School Districts, where it cannot exceed one mill of the market value of real estate. This is an aggregate limit for the jurisdiction rather than a limit on the tax paid by an individual taxpayer.

2. Can be levied by 4th to 8th class counties only. Levying the per capita tax precludes levying the occupation tax and *vice versa*.

3. Counties adopting home rule charters may set rates higher than the limits provided for in state law for property taxes and for personal taxes levied on residents. They may not create new subjects of taxation. Home rule counties as of January 1, 1979 are Delaware, Erie, Lackawanna, Lehigh, and Northampton.

4. To support a community college, local sponsors may levy any tax permitted by law. The tax cannot exceed 5 mills of the market value of real estate, except Philadelphia and the Philadelphia School District where it cannot exceed one mill of the market value of real estate. This is an aggregate limit rather than a limit on the tax paid by an individual taxpayer.

5. The Sterling Act gives Philadelphia the power to levy taxes on any privilige, transaction, subject or personal property not subject to a state tax or license. There are no limits on the rate of taxation under the Act. Taxes listed are those currently levied.

6. Effective in 1977, a restriction was placed on the taxation of non-residents above the current rate of 4.3125%. Nonresidents cannot be taxed at a higher rate than 4.3125% until the rate on residents goes above 5.75%. Hence, Philadelphia could raise the earnings tax rate to 5% but the 5% rate would apply only to residents of Philadelphia; non-residents would continue to pay 4.3125%. If, however, Philadelphia raised the earnings tax rate to 6%, non-residents would then pay 75% of 6% or 4.5%.

7. The tax rate on unearned income cannot exceed the rate of the city's earned income tax.

8. As a home rule municipality, Pittsburgh may set rates higher than the limits provided in state law for property taxes and for personal taxes levied on residents. It may not create new subjects of taxation.

9. Scranton is a home rule municipality and the same freedom from rate limits and restriction on new taxes mentioned in footnote 8 apply.

10. As of January 1, 1979, Carbondale, Farrell, Franklin, McKeesport, and Wilkes-Barre are home rule cities and footnote 8 applies.

11. Home rule boroughs (to which footnote 8 applies) as of January 1, 1979, are:

Bellevue
Bethel Park
Bradford Woods
Bryn Athyn
Cambridge Springs
Chalfont
Edinboro
Green Tree
Kingston
Monroeville
Murrysville
State College
Warren
Whitehall
Youngsville

Home rule first class townships, as of January 1, 1979, are:

Cheltenham
Haverford
Hermitage
McCandless
Middletown (Delaware Co.)
Mt. Lebanon
O'Hara
Penn Hills
Plymouth (Montgomery Co.)
Radnor
Upper Darby
Upper St. Clair
Whitehall (Lehigh Co.)

Home rule second class townships, as of January 1, 1979, are:

Elk (Chester Co.)
Ferguson (Centre Co.)
Hanover (Lehigh Co.)
Horsham
Kingston
Peters (Washington Co.)
Richland (Allegheny Co.)
Tredyffrin
Upper Providence (Delaware Co.)
West Deer

12. Five additional mills available with court approval.

Table II.10

Total Revenue and Tax Revenue of Pennsylvania Counties, 1977 (Excluding Philadelphia)

Total Revenue of All Counties (Excluding Philadelphia)

	($000)	%
Total Revenue	1,073,057	100.0
Own-Source Revenue	588,007	54.8
Tax Revenue	410,752	38.3
Charges and Miscellaneous	177,255	16.5
Intergovernmental	485,050	45.2

Total Tax Revenue of All Pennsylvania Counties (Excluding Philadelphia)

	($000)	%	*Number of Counties*	*Range of Reliance (High-Low in %)*
Total Tax Revenue	$410,752	100.0%	—	—
Real Estate	383,738	93.4	66	98.6-72.3%
Intangible Personal Property	21,366	5.2	66	19.2-0.2
Per Capita	5,145	1.3	34	15.7-0
Occupation	502	0.1	10	12.1-0

Source: Department of Community Affairs, *Local Governmental Financial Statistics.*

Table II.11

Total Revenue and Distribution of Tax Revenue by Type of Tax and by Class of Municipality, 1977

	(1) Total Revenue of Municipalities (2566 municipalities)		(2) Total Revenues All Municipalities Exclud. Philadelphia		(3) Total Revenues of First Class Cities (Philadelphia)		(4) Total Revenues of Second Class Cities (Pittsburgh)		(5) Total Revenues of Second Class A Cities (Scranton)	
	$000	%	$000	%	$000	%	$000	%	$000	%
Total Revenue	$2,761,796	100.0%	$1,435,748	100.0%	$1,326,048	100.0%	$157,526	100.0%	$23,406	100.0%
Own-Source Revenue	1,863,916	67.5	1,016,033	70.8	847,883	63.9	109,774	69.7	12,290	52.5
Tax Revenue	1,288,241	46.6	639,195	44.5	649,046	48.9	81,632	51.8	11,026	47.1
Charges and Misc.	575,675	20.8	376,838	26.2	198,837	15.0	28,142	17.9	1,264	5.4
Intergovernmental	897,880	32.5	419,715	29.2	478,165	36.1	47,752	30.3	11,116	47.5
Distribution of Tax Revenue										
Total Tax Revenue	$1,288,241	100.0%	$ 639,195	100.0%	$ 649,046	100.0%	$ 81,632	100.0%	$11,206	100.0%
Real Estate	514,859	40.0	346,126	54.2	168,733	26.0	41,973	51.4	4,266	38.7
Per Capita (code)	1,200	0.1	1,200	0.2						
Occupation (code)	846	0.1	846	0.1						
Intangible Personal Property (code)[1]	5,688	0.4			5,688	0.9				
Act 511 Taxes	291,022	22.6	291,022	45.5			39,659	48.6	6,760	61.3
Per Capita	14,005	1.1	14,005	2.2						
Occupation[2]	1,232	0.1	1,232	0.2						
Occupation Privilege	20,412	1.6	20,412	3.2			2,857	3.5	256	2.3
Earned Income	187,459	14.6	187,459	29.3			17,436	21.4	5,471	49.6
Real Property Transfer	32,588	2.5	32,588	5.1			2,151	2.6	233	2.1
Amusement	5,235	0.4	5,235	0.8			2,774	3.4	39	0.4
Mercantile License	12,602	1.0	12,602	2.0			2,425	3.0	596	5.4
Intangible Personal Property[3]	1,087	0.1	1,087	0.2			1,087	1.3		
Parking Lot Tax[4]	4,206	0.3	4,206	0.7			4,206	5.2		
Business Privilege[4]	6,592	0.5	6,592	1.0			6,592	8.1		
All Other	5,604	0.4	5,604	0.8			132	0.2	163	1.5
Sterling Act Taxes	474,625	36.8			474,625	73.1				
Earned Income	420,126	32.6			420,126	64.7				
Real Property Transfer	5,922	0.5			5,922	0.9				
Amusement	2,188	0.2			2,188	0.3				
Mercantile License	39,941	3.1			39,941	6.2				
Parking Lot Tax	943	0.1			943	0.1				
Mechanical Devices	127	*			127	*				
Petroleum Tax	5,380	0.4			5,380	0.8				

* Less than 1/10 of 1%.

[1] Levied by Philadelphia. All Philadelphia revenues for 1976-77 fiscal year.

[2] Millage and flat rate occupation taxes combined.

[3] Levied by the City of Pittsburgh only.

[4] Total is for Pittsburgh only. Other municipalities levy the tax.

[4] Total is for Pittsburgh only. Other municipalities levy the tax.

	(6) Total Revenue of Third Class Cities			(7) Total Revenue of Boroughs			(8) Total Revenue of First Class Townships			(9) Total Revenue of Second Class Townships		
	$000	%	(N = 49)	$000	%	(N = 963)	$000	%	(N = 92)	$000	%	(N = 1459)
Total Revenue	331,883	100.0		422,992	100.0		190,388	100.0		309,554	100.0	
Own-Source Revenue	214,176	64.5		317,807	75.1		154,762	81.3		207,226	66.9	
Tax Revenue	122,177	36.8		167,264	39.5		107,443	56.4		149,653	48.3	
Charges and Misc.	91,999	27.7		150,543	35.6		47,319	24.9		57,573	18.6	
Intergovernmental	117,707	35.5		105,185	24.9		35,626	18.7		102,328	33.1	

Distribution of Tax Revenue	(6) $000	%	N	Range of Reliance (High-Low)	(7) $000	%	N	Range of Reliance (High-Low)	(8) $000	%	N	Range of Reliance (High-Low)	(9) $000	%	N	Range of Reliance (High-Low)
Total Tax Revenue	122,177	100.0	—	—	167,264	100.0	—	—	107,443	100.0	—	—	149,653	100.0	—	—
Real Estate	75,877	62.1	49	81.2-28.3	92,626	55.3	959	100.0-0.0	72,054	67.1	91	93.0-0.0	59,331	39.6	1445	100.0-0.0
Per Capita (code)	1,200	1.0	22	4.6- 0.0												
Occupation (code)	14	*	4	8.0- 0.0	694	0.4	294	32.0-0.0					138	0.1	219	20.5-0.0
Intangible Personal Property (code)																
Act 511 Taxes	45,086	36.9	49	71.7-15.7	73,944	44.2	950	100.0-0.0	35,389	32.9	92	100.0-7.0	90,184	60.3	1418	100.0-0.0
Per Capita	1,303	1.1	25	5.9- 0.0	4,818	2.9	635	55.8-0.0	1,237	1.2	42	14.5-0.0	6,646	4.4	1008	100.0-0.0
Occupation	244	0.2	4	10.3- 0.0	763	0.5	50	26.8-0.0	128	0.1	4	12.6-0.0	97	0.1	17	15.8-0.0
Occupation Privilege	5,468	4.5	49	15.7- 1.2	5,534	3.3	427	63.0-0.0	2,972	2.8	63	20.3-0.0	3,324	2.2	296	77.7-0.0
Earned Income	29,507	24.2	47	46.7- 0.0	53,247	31.8	833	87.6-0.0	19,347	18.0	64	71.1-0.0	62,451	41.7	1198	100.0-0.0
Real Property Transfer	2,903	2.4	39	7.9- 0.0	6,706	4.0	591	51.0-0.0	6,759	6.3	86	33.9-0.0	13,836	9.2	837	71.1-0.0
Amusement	51	*	4	1.0- 0.0	545	0.3	9	50.9-0.0	533	0.5	19	11.3-0.0	1,292	0.8	71	61.1-0.0
Mercantile License	2,655	2.2	25	12.8- 0.0	1,485	0.9	51	30.3-0.0	3,310	3.1	24	16.9-0.0	2,131	1.4	25	32.2-0.0
Intangible Personal Property																
Parking Lot Tax																
Business Privilege																
All Other	2,955	2.4	28[5]	10.3- 0.0	845	0.5	196[6]	26.8-0.0	1,102	1.0	38[7]	17.4-0.0	407	0.3	54[8]	28.9-0.0

Note: Less than 1/10 of 1%.
[5] At least 24, at most 28.
[6] At least 146, at most 196.
[7] At least 34, at most 38.
[8] At least 37, at most 54.

Table II.12

School District Total Revenue and Distribution of Tax Revenue by Type of Tax and by Class of School District, Fiscal Year 1977-78

	(1)		(2)		(3)		(4)			
	Total Revenue of All School Districts		*Total Revenue of First Class School Districts (Philadelphia)*		*Total Revenue of First Class A School Districts (Pittsburgh)*		*Total Revenue of 2nd, 3rd and 4th Class School Districts*			
	($000)	%	*($000)*	%	*($000)*	%	*($000)*	% *N = 503*		
Total Revenue	3,967,205	100.0	592,978	100.0	134,999	100.0	3,239,228	100.0		
Local Sources	2,134,614	53.8	235,874	39.8	65,508	48.5	1,833,232	56.6		
Local Taxes	2,057,403	51.9	227,977	38.5	62,357	46.2	1,767,069	54.5		
Other Revenue	77,211	1.9	7,897	1.3	3,151	2.3	66,163	2.0		
Intergovernmental	1,832,591	46.2	357,104	60.2	69,491	51.5	1,405,996	43.4		
Federal Sources	226,326	5.7	87,428	14.7	17,720	13.1	121,178	3.7		
State Sources	1,606,265	40.5	269,676	45.5	51,770	38.3	1,284,819	39.7		
Distribution of Tax Revenue										
	($000)	%	*($000)*	%	*($000)*	%	*($000)*	%	*N*	*Range of Reliance (High-Low %)*
Total Tax Revenue	2,057,403	100.0	227,977	100.0	62,357	100.0	1,767,069	100.0	—	—
Real Estate	1,571,234	76.4	152,542	66.9	38,987	62.5	1,379,705	78.3	503	100.0 -35.0
Public Utility Realty	15,574	0.8	1,748	0.8	535	0.9	13,291	0.8	502	0.96- 0.0
Per Capita (code)	16,974	0.8					16,974	1.0	413	4.6 - 0.0
Payments in Lieu of Taxes	2,514	0.1	30	*	125	0.2	2,359	0.1	—	—
Act 511 Taxes	295,366	14.4					295,366	16.7	502	58.5 - 0.0
Per Capita	19,155	0.9					19,155	1.1	300	6.5 - 0.0
Occupation	42,213	2.1					42,213	2.4	328	27.5 - 0.0
Occupation Privilege	9,500	0.4					9,500	0.5		
Earned Income	177,559	8.6					177,559	10.0	448	40.1 - 0.0
Real Property Transfer	38,148	1.9					38,148	2.2	439	9.1 - 0.0
Amusement	1,773	0.1					1,773	0.1	48	3.2 - 0.0
Mercantile License	5,155	0.2					5,155	0.3	40	3.9 - 0.0
Business Privilege	1,523	0.1					1,523	0.1	—	—
All Other	340	*					340	*	—	—
Special Non-Real Estate Taxes (Phila. and Pgh. School Districts)	82,838	4.0								
Special Non-Real Estate Taxes (Philadelphia)			66,743	29.3						
General Business Gross Receipts			12,453	5.5						
Parimutual Wagering			4,378	1.9						
Unearned Income			6,883	3.0						
Business Occupancy			17,234	7.6						
Corporate Net Income			1,334	0.6						
Liquor			460	0.2						
City Block Grant			24,000	10.5						
Special Non-Real Estate Taxes (Pittsburgh)					16,095	25.8				
Earned Income					12,928	20.7				
Mercantile License					2,195	3.5				
Intangible Personal Property					971	1.6				
Delinquent	72,903	3.5	6,913	3.0	6,615	10.6	59,375	3.4	—	—

Source: Division of Education Statistics, Pa. Dept. of Education, *Our Schools Today, Public School Financial Statistics Report*, Vol. 18, No. 7, and *Act 511 Taxes, 1977-78*, plus correspondence with Pa. Dept. of Education.

lapping, residents of the City of Pittsburgh are subject to a rate of 12 mills (4 mills each at the county, city and school district levels) on taxable intangible personal property. The base of the tax is mortgages, other interest bearing obligations, public loans (except those of the federal government, Pennsylvania and its political subdivisions), corporate loans (not subject to the Pennsylvania corporate loans tax), and shares of stock (other than those subject to the capital stock or the bank shares tax). Savings accounts are exempt. Act 1978-26 amended the Intangible Personal Property Tax Law of 1913 to permit the county commissioners of each county and the city council of Philadelphia to choose not to levy the tax. In 1979, nine counties (Blair, Centre, Cumberland, Fayette, Jefferson, Pike, Potter, Union, and Wayne) did not levy the tax.

The intangible personal property tax raises problems from the standpoint of both equity and enforcement. Because the base of the tax has numerous exemptions, most notably for interest-bearing savings accounts and shares of stock subject to the Pennsylvania capital stock tax, it is possible for someone to have sizeable assets but to incur no liability for this tax. These exemptions violate the principles of horizontal and vertical equity: persons of equal ability to pay can easily have widely differing tax liabilities, and persons with very different abilities to pay can have the same tax liability.

These violations of equity are exacerbated by the difficulties of tax enforcement and valuation. Unlike the real estate tax, the intangibles tax is a personal tax, and no lien is attached to the intangible property if the taxpayer fails to declare and pay the tax. Enforcement requires a successful suit against the taxpayer. If the taxpayer fails to declare ownership of intangibles, such ownership may never be discovered unless it is a matter of public record (as would be true of mortgages, judgments, liens). Persons owning stocks and bonds are less likely to be discovered. This creates another source of inequity, since the ease with which the tax can be evaded depends upon what portfolio of assets is held by the taxpayer. In most jurisdictions, the only effective way to collect the tax is to review the assets of estates upon the demise of property owners. Although this technique, if pursued agggressively, can successfully collect the tax from estates, its effectiveness is limited by the statute of limitations which prohibits recovery of taxes to those due 5 years prior to death.

b) Per Capita Taxes

Counties as well as school districts and municipalities may levy per capita taxes. Some jurisdictions may levy both an Act 511 and a per capita tax. Although the tax is often only a $5 levy, taxpayers may be subject to several per capita taxes levied by overlapping jurisdictions.

In general, reliance on this tax is meager, although in 1977, one borough derived over half of its revenue from the Act 511 per capita tax, and one second class township relied exclusively on the per capita tax for its tax revenues.

The per capita tax is neutral with respect to economic decisions because it cannot be avoided by modifying spending, saving or work choices, and few taxpayers are motivated to move out of a taxing jurisdiction to escape paying a yearly $5 or $10 tax. In addition, the tax guarantees that all adults make a minimum direct contribution to the cost of government. Moreover, the yield of tax exhibits great stability, and it is visible, predictable and simple to report and pay.

However, the tax has a low yield relative to administration costs. A tax of $1 per capita (Pittsburgh's poll tax) would appear hardly worth collecting, and even a $5 levy may have collection costs of 25% to 30% of revenues. Over time, administrative expenses tend to rise with the general price level; however, the tax rate and the yield remain fairly constant, thus exacerbating this adverse relationship between collection costs and tax revenues. Also, if population falls, as has been typical of larger Pennsylvania municipalities, revenues can actually decline.

An additional difficulty with the per capita tax is its regressivity in relation to income. Some localities lessen regressivity by the practice of exempting all persons with annual incomes below $3,200, as permitted under Act 511. How widespread this practice is, is unknown, but in a survey conducted by the Pennsylvania Economy League, 20 of 36 jurisdictions surveyed did not grant exemptions.[11] Granting exemptions, while desirable from an equity standpoint, further adds to the overall cost of administering the tax.

While it is sometimes argued that the per capita tax assures that residents will make at least some minimal contribution to the cost of government, a resident taxpayer necessarily owns or rents a dwelling and will thus pay real estate taxes either on an owner-occupied home or as part of his or her rental payments. The state recognizes this relationship between one's rent and property taxes elsewhere in law by providing to poor, elderly renters a tax rebate from lottery proceeds.[12]

c) Occupation Taxes

The occupation taxes levied under codes of law pertaining to counties and municipalities are taxes based on assessments of occupations, and the maximum millage rate is the same as that for the real estate tax. Under Act 511, the occupation tax can also be levied as an assessed tax (for which there is no rate limit) or as a flat rate tax with a $10 limit. The occupation tax most often levied is the Assessed Occupation Tax under Act 511, with assessment done by the county assessing authorities. Most of this tax is collected by school districts. For example, in 1977, school districts collected about $42 million of the $44.6 million in occupation taxes raised in all local jurisdictions. According to the *Taxation Manual*[13] school districts have taken advantage of the lack of a limit for the assessed occupation

11 *An Administrative Analysis of the Per Capita Tax Collection in the Penn Hills District*, (Pittsburgh, PA.), The Economy League, May 1974, esp. pp. iv, 23-27, and Exhibit II, pp. 3 and 4.

12 Commission recommendations with regard to the property tax/rent rebate program are contained in Section II.A above.

13 Department of Community Affairs, *Taxation Manual*, p. 34.

tax levied under Act 511, and have levied taxes with extremely high rates that produce significant tax yields. There are tax rates on record as high as 1,100 mills, and some school districts raise as much as 25% of their local tax revenue from this tax.

Assessed occupation tax liabilities are typically much larger than either per capita or occupation privilege taxes. An illustrative occupational assessment schedule might be as follows:

judges, surgeons, superintendents	$1,000
accountants, attorneys, engineers	700
bank cashiers, draftsmen, government employees (unclassified)	500
welders, painters, masons	400
barbers, butchers	300
waitresses, township supervisors	200
housewives, invalids, students	100

If the taxing district has a millage rate of 160 mills, the actual tax liabilities would range from $16 to $160.

Pennsylvania law is not specific about what activities are or are not occupations or how the valuation of an occupation is to be made. Court cases have made it clear that factors other than income (social status, degree of training or education demanded, historical attributes, etc.) may be considered in the assessment of an occupation.[14] A ruling by the York County Court of Common Pleas held that the concept of an occupation is not solely limited to income-producing endeavors and upheld the occupation tax levied on housewives.[15] Courts in other jurisdictions (e.g., Dauphin County Court) have rendered the opposite opinion that the tax may not be levied on either housewives or on any retired person not employed or in business.[16] To complete the spectrum of rulings, the Centre County Court held that the State College Area School District has the power to exclude housewives, retirees and full-time students.[17]

Concerning the method of valuation, an 1885 ruling held that an occupation tax cannot be based on income earned by each person in an occupation because such a tax would violate a uniformity-in-taxation clause of the Pennsylvania Constitution. The courts have held that the tax must be assessed uniformly on all occupations, or occupations may be classified and uniform tax levied on each class.[18] Current law as specified in the Local Tax Enabling Act contains no requirement for classifying occupations, and a recent court case upheld an assessment by the Dauphin School District of $250 on all occupations.[19]

Aside from some comments about the relative stability of its yield, the assessed occupation tax has received widespread criticism. Because of arbitrary assessments, excessive millage rates, duplicate imposition of the tax by overlapping jurisdictions (e.g., by the county and school district or municipality), and the simultaneous existence of earnings, per capita, and occupation privilege taxes, the assessed occupation tax has generated more taxpayer resentment than any other local non-real estate tax in Pennsylvania.

The two most serious problems with the tax are its inequities and costs of administration. The inequities, based on ability to pay considerations, arise in several ways. First, since in a given jurisdiction all persons within an occupation are taxed at the same rate, regardless of the variation that may exist in actual earnings, the criterion of vertical equity is violated. The tax in fact has been found to be quite regressive in its incidence, that is, the ratio of assessed occupation tax paid to family income falls as family income rises.[20] Second, since there are variations in earnings among persons in a given occupation, persons in different occupations who happen to have the same annual income pay widely differing occupation taxes, which violates horizontal equity. Finally, wide variations exist among similar jurisdictions in the tax liabilities assessed on a given occupation.

Because it requires assessing occupations, the occupation tax is exposed to the same administrative problems that arise with the real estate tax, including unrealistic or inaccurate assessment schedules and wide variation in assessment practices among jurisdictions. Administration and enforcement are complicated further because the tax is not subject to withholding by employers, and taxpayers resent having to pay the tax in a single payment.[21]

d) The Occupational Privilege Tax

There are only two non-real estate taxes that localities are permitted to collect from non-residents regardless of where they live: the occupational privilege tax levied by municipalities and school districts under Act 511 and the earned income tax levied by Philadelphia under the Sterling Act.

The occupational privilege tax is limited to a maximum rate of $10 for the privilege of engaging in an occupation in the taxing jurisdiction. If both the municipality and the school district levy the tax, it must be equally shared between them (unless some other sharing arrangement is mutually agreeable). Act 511 clearly specifies that no one is to pay more than $10 in any calendar year and establishes priorities of collection in cases where a person is gainfully employed in more than one taxing jurisdiction.

Most of the criticisms levied against the per capita tax also apply to the occupational privilege tax. However, because the tax is withheld by employers, collection costs may be lower than for the per capita tax, even when the cost to employers is included in the

14 *Miller v. York Imperial School District*, 23 D.&C. 2d. 406, 417 (1960).

15 *Ibid.*

16 *Peifer v. Central Dauphin School District*, 97 Dauphin 199 (1975).

17 Petition of the State College Area School District, 9 Centre I. J. 417 (1974).

18 Banger's Appeal 109 Pa. 79 95 (1885).

19 Peifer, *op cit.*

20 See Rodger Downing "A Look at the Occupation (Assessed) Tax in Pennsylvania", Institute for Research on Land and Water Resources, The Pennsylvania State University, 1979.

21 Over ten years ago, the Pennsylvania Economy League recommended the abolition of the occupation tax. See Pennsylvania Economy League, *Where the Money Comes From: A Study of Financing Local Government in Pennsylvania*, Report No. 2, *Non-Real Estate Taxes*, prepared for the Local Government Commission and the Pennsylvania Department of Community Affairs, Harrisburg, Pa., 1969.

calculation. Still, collection costs as a percentage of revenues are likely to be higher than for many other taxes. Because of its flat rate, the tax is also an inelastic revenue source and has a regressive incidence.

The tax does have the advantage of being one of the few currently available that allow municipalities to collect revenue from non-resident workers who utilize municipal services (though $10 per year is hardly an adequate amount). There is little rationale, however, for allowing school districts to share the tax that municipalities impose on non-residents, since the children of non-residents do not attend school in the district that taxes their parents. Even for municipalities, however, there are other taxes that have more appeal than the occupational privilege tax as a vehicle for compensating municipalities for services supplied to non-residents. In particular, both equity and the benefit principle suggest that a better tax for this purpose would be one proportional to the earnings of non-residents in the municipality. Such a tax is more in keeping with taxation according to ability to pay than a flat rate tax of $10 or some higher fixed amount, and a proportional tax also takes into account that the greater one's earnings, the higher one is likely to value all kinds of goods and services including those provided by the local government where one works.

e) The Earned Income Tax

The major issues concerning the use of the earned income tax in local jurisdictions involve: (1) the failure to include property (sometimes called "unearned") income in the tax base; (2) a more efficient collection system; (3) provisions for exemption of those with a low income; and (4) the highly dissimilar treatment of non-residents under Act 511 on the one hand and under the Sterling Act on the other (the "Philadelphia problem").

(1) Act 511 provides for two kinds of income taxation: a tax on earned income without deductions and a tax on net profits with the deduction of expenses. Explicitly excluded from the base are all forms of "unearned", property income: interest, dividends, rental income, and capital gains.

Equity considerations provide perhaps the strongest argument for taxing property income. It is generally known that the ratio of property income to total income rises with total income; high income individuals tend to derive a larger fraction of their income from property than is the case for moderate and low income individuals. Accordingly, failure to include property income for local tax purposes will tend to make local taxation less fair under either the ability to pay or the benefit principle of taxation.

Including property income in the tax base means that the same total revenue can be collected with a lower tax rate. Lower rates are desirable per se because taxpayers have smaller incentives to modify their behavior solely for the purpose of reducing their tax liabilities. This greater neutrality reduces economic inefficiencies.

To collect property income, however, higher collection and enforcement costs would have to be incurred to administer effectively this part of the tax. The additional burden, especially for small localities, poses a significant hurdle since local funds for tax administration are limited. When the income tax is applied only to labor incomes, the bulk of the collection costs are borne by employers who withhold the tax. The incremental withholding costs to employers are small since federal and state income taxes are being withheld already. Since property income is not subject to withholding at the federal or state level, all incremental administrative costs of adding property income to the tax base would have to be borne by the local government. The average costs of collecting a dollar of tax on property income are several times as large as those of collecting a dollar of withheld tax on wages. Auditing efforts must be significantly expanded because of the greater discretion given to individual taxpayers in computing, reporting, and paying tax on property income.

(2) The inability or unwillingness of localities to bear the incremental administrative costs that must be incurred to tax property income effectively, taken together with the desirability of taxing property income, suggests that consideration be given to state administration of a local income tax or piggybacking. Rental income, interest, dividends, and capital gains could then be added to the tax base (since these types of income are included in the state tax base), and the added costs of duplicative local administration and taxpayer compliance (from having to complete a separate local tax return) would be avoided.

(3) As noted earlier, little is known about the extent to which localities grant the $3200 exemption permitted under Act 511. A tax on earnings alone has a regressive incidence pattern (assuming the tax is borne by those who are liable to pay it, which is likely). Widespread use of an exemption based on total family income, combined with the taxation of property income, would make the tax less regressive.

In connection with the exemption issue, it should be noted that another advantage of piggybacking would be the ability to apply the SP provisions of the state income tax to locally levied income taxes. Use of the SP provisions would make local income taxes less regressive and provide for uniform local treatment of low income persons — in contrast to the current situation of great variability in the use of exemptions and/or exonerations (whereby local tax collectors are exonerated from collecting the local earnings tax from persons meeting widely varying conditions).

f) Taxation of Non-Residents

The most significant aspect of the tax treatment of non-residents occurs with the earned income tax. Under Act 511, one treatment exists for Philadelphia and another for every other municipality. (School districts can levy the earned income tax only on residents.) Philadelphia has a prior claim to the earnings taxes it collects from non-residents, who are permitted to credit this tax against any tax levied where they live. Since other localities (except those with home rule) are limited to a 1% rate while Philadelphia currently sets a rate of 4.3125%, communities surrounding Philadel-

phia have a very meager tax base, and many choose not to levy an earnings tax since a substantial part of the tax base represented by their residents' earnings is taxed by Philadelphia.

Precisely the reverse crediting rule exists for all other localities who levy the earnings tax under Act 511. The locality of residence is given priority to the earnings tax, and a tax levied by the place of residence can be credited against any tax levied by the municipality of employment. Only if the place of residence does not levy the earnings tax (or levies it at a lower rate than the place of employment) is the municipality of employment entitled to collect the tax from non-resident workers.

New Jersey and Maryland do not currently permit municipal governments to levy an income tax, and residents of these states employed in Pennsylvania cannot escape the payment of the local earnings tax in Pennsylvania. The Maryland Attorney General has filed suits in the courts of Common Pleas of Franklin and York Counties claiming unequal treatment of Maryland residents because Act 511 requires that if a person pays earning's tax to a Pennsylvania municipality where that person resides, the municipality of employment *must* credit the payment to a Pennsylvania municipality but *may* credit the payment to non-Pennsylvania municipalities.

These crediting requirements of Act 511 explain the reaction of municipalities and school districts in areas surrounding the more heavily populated areas of the state (excluding the Philadelphia area). Suburban communities around these areas quickly enacted local earnings taxes following the adoption of such a tax in the city where many suburban residents work. For example, when Pittsburgh enacted a local income tax in March 1954, 130 local jurisdictions within 25 miles of Pittsburgh had responded by enacting their own tax by the end of the year.[22] Localities apparently found this means of capturing more local revenues without increasing the tax burden on their commuting citizens irresistible. Thus, while Philadelphia derives considerable revenues from non-residents, other jurisdictions in Pennsylvania generally collect very little, and almost all of what they do collect comes from the $10 occupation privilege tax.

This dissimilarity in the earnings tax treatment of non-residents produces a great disparity in the ratio of non-resident to total taxes in Philadelphia compared to the same ratio for all other municipalities. In 1980, Philadelphia will collect via the earnings tax an estimated $177 million dollars from non-residents or about 20% of all of its tax revenues. Most other municipalities, by contrast, can tax non-resident workers only through the Occupational Privilege Tax, and the amounts collected from non-residents using this tax are, at most, between 1% and 2% of tax revenues. One can grant that Philadelphia's situation is "unique" or "unusual" and still argue that Philadelphia is probably over-compensated for the services it provides to working commuters, while most other municipalities receive too little compensation from the commuters using their services.

In attempting to resolve the issue of non-resident taxation in general and the "Philadelphia problem" in particular, the Commission found the following guidelines appropriate. First, it should be recognized that the question of non-resident taxation relates to municipalities, not to school districts. Since the educational services provided by school districts are provided to residents, and since other benefits to non-residents of educating children are already being paid for by non-residents through the state subsidy to schools, school districts should not be permitted to tax non-residents. Second, any tax applied to the income of non-resident workers should have as a base only the earnings or compensation of the workers in the jurisdiction of employment. Thus, earnings received elsewhere or unearned income should not be in the non-resident tax base. The rationale for using this base is that only earnings in the jurisdiction reflect demands made by the worker on the jurisdiction's services.

Third, while many of the services that municipalities provide to non-residents are to non-resident working commuters, services may also be provided to other non-residents such as shoppers, theater-goers, and those attending sports events. Cities provide facilities and services which benefit a much wider area than the city itself. Large numbers of people, who live outside cities, use facilities such as museums and stadiums built by cities, as well as use transit systems, libraries, and many tax exempt facilities such as hospitals and colleges for which the cities provide services. The Commission believes that the burden of financing these services should not fall solely on city residents. Taxes levied on activities related to these services (amusement and parking lot taxes) are one method, albeit a limited one, of charging for services provided to non-residents. The Commission believes that a regional levy such as one tied to mass transit would in some measure recognize the services cities provide to those who neither live nor work in the city but enjoy facilities and services provided by cities.

Fourth, as regards Philadelphia, any move to reduce substantially the rate of taxation of non-resident workers in Philadelphia must realistically be accompanied by a plan to replace the lost revenues. Large revenue losses not made up by alternative revenues create serious adjustment problems, service cuts, and/or stop-gap taxes — none of which are desirable in the Commission's judgment.

g) The Residential Construction Tax

This is a relatively new tax levied on anyone applying for a building permit to construct a residence. The tax may be levied under the authority of Act 511 by both school districts and municipalities and provides an example of the "tax anything" authority granted by this act. As of June 1980, at least 15 school districts and 9 municipalities were levying the tax of from $300 to $1,000. The Southern York County School District in York County was the first local government to impose

[22] William B. Neenan, *Political Economy of Urban Areas*, (Chicago: Markham Publishing Co., 1972), pp. 291-92.

the tax. The rate there is $875 per residential unit. (Thus, a ten unit apartment building would incur a one-time tax of $8,750).

This tax was challenged in Commonwealth Court and was upheld. To quote the *Taxation Manual*:

> "The judge found the levy is actually a tax under state law, and met the requirements of the 'tax anything act', which he said, 'is an apt description'", p. 45.[23]

While the residential construction tax may be a permissable tax under Act 511, it does not meet the goals of taxation used by the Commission. The tax has a very narrow base (new construction) and runs afoul of the goals of efficiency and equity. Since property is already taxed through the real estate tax, the construction tax amounts to a surcharge on new construction. It is doubtful that the incremental educational services of school districts would warrant this type of surcharge.

The introduction of this new tax raises a serious question about the framework that Act 511 provides for local taxation in Pennsylvania. The latitude Act 511 provides for tax creation, while giving "flexibility" to local governments, may not be in the interests of all local governments and their citizens taken as a group. If such taxes are created because of limits on other revenue sources, this only provides a defensible argument for shifting reliance to taxes that are broader-based and more elastic, or for increasing tax rate limits on current taxes. Proliferation of new taxes only serves to add to the complexity of the maze already in existence — a maze the Commission is trying to untangle so that local taxation can be carried out using a more sensible, well-thought-out system.

h) Local Business Taxation

(1) Background

The two most important non-real estate taxes levied by school districts and municipalities under Act 511 on business are the Mercantile and Business Privilege taxes. The Mercantile Tax is imposed on the gross receipts of wholesale and retail businesses. This includes all wholesale and retail vendors and restaurants. Under Act 511, the tax may be imposed with a rate limit of 1 mill wholesale and 1-1/2 mills retail. Philadelphia is authorized to levy the tax by the Sterling Act and there is no rate limit. (In 1978-79, the rate imposed was 4 mills.) The Pittsburgh School District, under the School Code, can levy the tax at 1/2 mill wholesale and 1 mill retail; the City of Pittsburgh has 1 and 2 mill rate limits under Act 511 on wholesalers and retailers, respectively. The tax was used in 1977 by 125 municipalities and 41 school districts. In that year, municipalities collected about $12.6 million from the tax, or about 1% of total municipal taxes; school districts collected $5.2 million, or about 0.2% of their total tax revenues.

The Business Privilege Tax is levied on the privilege of doing business in the taxing jurisdiction. It may be imposed at a flat rate or on the basis of gross receipts. All businesses, trades, professions, and occupations are liable for payment of the tax. Hence, a much wider number of businesses are liable for paying the Business Privilege Tax than for the Mercantile Tax.

The Business Privilege Tax is levied under both the Sterling Act and Act 511. Neither act sets a rate limit. The Philadelphia School District also levies a gross-receipts tax under a special law at a rate (1979) of 2 mills, but the amount of tax payable under this law cannot exceed 2% of the net income of the business. Pittsburgh and Scranton can also levy business license taxes on a flat rate basis with no limit. Third class cities may levy the tax at a maximum rate of $100.

The number of municipalities using the Business Privilege Tax in 1976 was 41 according to the Department of Community Affairs. The number of school districts using the tax could not be determined because of the aggregation of various taxes together in school district data. Revenues from the tax were, on average, very small, that is, less than 1% of the tax revenues of municipalities, and less than 0.1% of revenues of school districts.

(2) Issues

The two most important issues relating to these two taxes are that (a) the business privilege tax has no rate limit, and (b) the application of these taxes to business gross receipts rather than to net business income has been disfavored by business firms.

The lack of a rate limit for the business privilege tax reflects an asymmetry of the treatment of businesses under this tax compared to the treatment under the Mercantile Tax. Since both taxes may be applied to wholesale and retail businesses, a rate limit applied to both would restore a degree of symmetry and avoid the possibility of having the rate of gross receipts taxation set at extremely high levels.

The second issue relates to the inequity of gross receipts taxation. Taxes based on gross receipts are generally opposed by business taxpayers, as compared to taxes on net income, because the tax liability is not necessarily proportional to the ability to pay. Hence both the Mercantile and Business Privilege taxes give rise to possible inequities. How extensive these inequities are, however, could not be determined due to a lack of data.

3. Recommendations

a) The Commission recommends that the following taxes be eliminated from the local tax structure:

(1) The assessed occupation taxes levied under Act 511.
(2) The assessed occupation taxes levied under all municipal and county codes.
(3) The flat rate occupation tax levied under Act 511.
(4) All per capita, residence and poll taxes levied under county, municipal and school district codes.
(5) The per capita tax levied under Act 511.
(6) The occupational privilege tax levied under Act 511.

[23] *Paul L. Smith, Inc., et al v. Southern York County School District*, 91 York 147 (1977).

(7) The intangible personal property tax levied under county and municipal codes.
(8) The earned income tax as presently structured, including provisions that determine whether a taxpayer is taxed at the place of residence or the place of employment. This includes the earned income tax levied under Act 511 and under the Sterling Act.
(9) The residential construction tax.

b) The Commission recommends the following taxes as sources of replacement revenues:

(1) For all municipalities (other than counties) and school districts, except Philadelphia and its school district, a local income tax on all income would be available, using the state income tax base. This local income tax with the same base as the state income tax would only be levied by school districts and municipalities on residents. Separate rate limits would apply to school districts and municipalities, and they would not share the tax. The rate limit recommended for the income tax levied by school districts is 1.5%; the rate limit recommended for municipalities is 1%. Such limits would not apply to jurisdictions that have adopted home rule,but again sharing would not be permitted.

Based on 1977 data, all but 103 of 2,543 municipalities would be able to raise sufficient revenue from the 1% income tax to offset the revenues lost from the occupation and realty transfer taxes. Some of these 103 jurisdictions are home rule, and some others currently tax non-residents more heavily than residents. As noted elsewhere, the Commission recommends that similar tabular analysis be performed with more recent data (i.e., from the 1980 Census) to ensure that the rate ceilings are adequate, as it is not the intention of the Commission to unduly restrict the revenue-raising flexibility of local government.

(2) In addition, the Commission recommends the administration of a local income tax through the administrative vehicle of the state personal income tax. All jurisdictions levying the income tax would be required to participate in the piggybacking system. As a first step to a piggyback system, the Commission recommends that the Department of Revenue require taxpayers for tax year 1981 to indicate their municipality of residence on the PA-40 form and that the information be a part of the the Department's computerized record system.

(3) For the city of Philadelphia, the Commission recommends there be provided a local income tax on all income, again using the state tax base (as would be available to all other municipalities and school districts under piggybacking). Philadelphia would participate in the piggybacking system in the same manner as all other jurisdictions that levy a resident income tax. However, no rate limit is suggested for the income tax levied by the city of Philadelphia on its residents. Also, since the base of the resident income tax is to be the same as the state base, the tax falls on unearned income, and, to avoid taxing this income twice, the Philadelphia School District would relinquish the tax it currently levies on unearned income. The revenues lost would be made up by a block grant from the city.

(4) Concerning non-resident taxation in Philadelphia, it is recommended that Philadelphia only tax earned income (wages, salaries, and net profits of unincorporated business as is currently permitted), and that the rate of the tax be reduced below its current level of 4.3125%. The amount by which the non-resident tax rate is reduced would be determined by the gain in revenues obtained from broadening the resident tax base to include unearned income and the amount Philadelphia currently contributes to the Southeastern Pennsylvania Transit Authority (SEPTA) and which would be replaced by the regional income tax.

(5) The Commission recommends eliminating the priority given to Philadelphia under Act 511, under which non-residents who pay the Philadelphia earnings tax are allowed to credit any tax paid Philadelphia toward any earnings tax levied where they live. Elimination of this, together with the reduction of the earnings tax rate Philadelphia levies on non-residents, is intended to give school districts and municipalities in the Delaware Valley region fuller access to the resident income tax as a revenue source as well as partially to reduce the extent to which Philadelphia finances its expenditures by taxing non-resident workers.

(6) The Commission recommends that eligible low-income residents be permitted to use the SP provisions now provided in the state income tax for the locally levied income tax as well.

(7) For all municipalities, excluding Philadelphia, the Commission recommends a non-resident earnings and net profits tax, covering wages, salaries and net profits of unincorporated businesses. All municipalities, if they so choose, are to be authorized to levy this tax on non-residents only, with a rate limit of 0.25%.

(8) The Commission recommends that the real estate transfer tax now levied by school districts and municipalities be transferred to counties. The tax itself would remain the same (the same base and same rate limit of 1%). The counties now collect this tax, and, instead of passing it on to municipalities and school districts, the counties would keep it as a new tax source. No county, however, would be permitted to reap large windfalls (see below), and

a portion of the revenues would be used to defray the cost of assessment reform, as detailed in the plan discussed in (9) below.

(9) The Commission recommends that a part of the windfall revenues which counties derive from recommendation (8) be used to finance the cost of assessment reform. A suggested plan for carrying out this funding is as follows. Using 1977 revenue estimates, counties as a group gain $80 million from the assignment to them of the real estate transfer tax. They lose $30 million as a result of eliminated taxes (per capita, occupation, personal property). The cost of assessment reform is estimated (1980 dollars) at $25 million. Several individual counties may be net losers when all tax changes and the cost of assessment reform are taken into account. Most, however, experience revenue increases.

The plan for funding assessment reform and making up the county deficits in the first year is as follows: (a) the state receives the local real estate transfer tax proceeds and puts the money in a special trust fund; (b) from this fund, the state distributes money to cover the cost of assessment reform (one year only); (c) the state then distributes money to each county, if there are any with a deficit (i.e., for which the new real estate transfer tax collections are less than the eliminated taxes); (d) the remainder is distributed to counties in proportion to real estate transfer tax collections. Any county experiencing a net loss of revenue would make up the loss by raising the real estate tax. Counties gaining revenue would have to either reduce the rate of the real estate transfer tax or reduce the rate of the real estate tax.

(10) The Commission recommends that the General Assembly levy a regional income tax on residents in SEPTA's service area of up to 0.2% to provide a predictable funding base for SEPTA. The income tax would have the same base as the state income tax and would be collected by the Department of Revenue under piggy-backing and returned to SEPTA. The tax would apply in the five county region served by SEPTA (Delaware, Bucks, Chester, Montgomery, and Philadelphia). The revenues would replace the funds the counties currently contribute to SEPTA and other operating rural and mass transit authorities. The Commission estimates that a rate of 0.2% is sufficient to cover the current contribution from the five counties ($36.7 million). Any revenue above this contribution would be placed in a fund for capital maintenance and improvement of the system. The Commission also believes that consideration should be given to permitting other urban and rural transit authorities elsewhere in the state to have access to analogous sources of finance.

(11) The Commission recommends that further study, including the collection of better data, be undertaken of the possible inequities arising from gross receipts taxation of business, with the possibility of limiting gross receipts taxation to a certain percentage of net business income.

(12) The recommended tax changes are likely to cause substantial revenue increases in some jurisdictions. This is most likely in the case of counties and in the case of school districts and municipalities which begin to levy the piggyback income tax where there was previously no tax on wage income. The Commission does not intend to have its proposals result in an increase in local taxation. The Commission recommends that the following limits be placed on revenue growth in all jurisdictions for the first three years after these proposals become effective:

   (a) The growth rate in tax revenues in each year for 3 years after these proposals become effective may not exceed the historical growth rate by 5% as represented by the average growth rate over the past 5 years. Thus, for the first year, if the 5 year average growth rate was 10%, the revenue increase in the first year under the recommendation could not exceed approximately 15%. More specifically, if g is the 5 year average of the growth rate in revenues, then the maximum permissable growth in the first year of piggybacking, m is $m=(1+g)\times(1.05)$, or 1.155 since $(1.1)\times(1.05)=1.155$. Thus a 15.5% increase would be permissable.

(13) The Commission recommends that Act 511 be rewritten specifying exactly what tax sources are available to each jurisdiction and eliminating the power to create new taxes. In the Commission's judgment, such freedom to create taxes in the past has reduced the equity and economic neutrality of local taxes over time. The Commission believes that before local government imposes a new type of tax, the Legislature should pass upon its merits and make a decision as to whether the tax should be added to the tax sources of local government.

(14) The Commission recommends that the aggregate 12 mill rate limit in Act 511 be abolished.

4. Revenue Consequences

Table II.13 indicates for all jurisdictions except for the city of Philadelphia and its school district, the aggregate revenue losses that would have resulted (in 1977) from eliminating the earnings tax, all occupation taxes, all per capita taxes, and the intangible personal property tax, and the reassignment of the realty transfer tax to counties. The table also shows the aggregate gains in revenue to counties and the average percen-

Table II.13

Revenue Changes Resulting from the Commission's Recommendations by Type of Local Government (Excluding the City of Philadelphia and Philadelphia School District) at 1977 Tax Levels

	1977 Tax Revenue (in $000) (% of total tax revenue in parenthesis)		
Type of Tax	*Counties*	*Municipalities*	*School Districts*
I. Aggregate Revenue Losses			
Earned Income	–	187,459(29.3)	190,487[1](10.4)
Occupation Taxes			
(i) Occupation Millage (code)	502(0.1)	846(0.1)	–
(ii) Occupation Millage and Flat Rate (Act 511)	–	1,232(0.2)	42,213 (2.3)
(iii) Occupation Privilege (Act 511)	–	20,412(3.2)	9,500 (0.5)
Per Capita Taxes			
(i) Per Capita (code)	5,145(1.3)	1,200(0.2)	16,974 (0.9)
(ii) Per Capita (Act 511)	–	14,005(2.2)	19,155 (1.0)
Intangible Personal Property	21,366(5.2)	1,087(0.2)	971 (0.0)
Realty Transfer Tax	–	32,558(5.1)	38,148 (2.1)
Total Lost Revenue	27,013(6.6)	258,799(40.5)	317,448 (17.4)
II. Aggregate Revenue Gains			
Transfer of Realty Transfer Tax to Counties	76,658	–	–
Resident Income Tax[1] to Replace All Revenues Lost (average % rate)	–	258,799(0.68)	317,448(0.79)
Non-Resident Earnings Tax[2]	–	–	–
III. Net Aggregate Gains or Losses[3]	49,645	0	0

[1] This is a rough estimate obtained by estimating the 1977 earnings tax base using actual taxes collected, and augmenting this base by 10% (the ratio of total taxable income to the sum of compensation and net profits as reported to the state in 1977 on individual tax returns) to take account of broadening the tax base to include unearned income. The earnings tax base was estimated by dividing total collections (excluding Pittsburgh and Scranton) by 0.005. The base in the latter two cities was then added in after computation using the higher tax rates imposed in those cities. There is still a slight overestimate of the base due to other home rule jurisdictions that had a rate higher than 0.005. However, against this upward bias must be offset the enlargement of the total income base because of the probable increase in the number of school districts and municipalities (especially near Philadelphia) that will probably begin to levy the income tax should the Commission's recommendations be put into effect.

The base for municipalities produced by this procedure is $38,079,600,000 and that for school districts is $40,155,060,000.

[2] Estimated revenues from this tax (.25%) are not available because of the size the flows of non-resident workers into municipalities and the incomes they earn there are not known.

[3] In addition, under the Commission's transportation proposal, when fully implemented municipalities would receive $58.7 million, counties would receive $17 million, and Philadelphia would receive $9 million at 1980 levels.

tage rate for an income tax on residents (with a base including property income) that would have been sufficient to replace all the revenues that were lost by municipalities and school districts.

Table II.14 shows average replacement tax rates and the distribution of tax rates for the income tax based on Commission estimates of state taxable personal income in each jurisdiction for 1977. A ceiling tax rate of 1.5% for school districts would accomodate all but four of the 504 districts, while a ceiling rate of 1.0% would accomodate all but 103 of 2,542 municipalities. Home rule municipalities would be able to continue to go above the 1% ceiling, and 6 of the 103 municipalities have home rule charters. The Commission found that many of the remaining 97 municipalities engage in significant exporting of the earned income tax, and in several cases, the non-resident tax rate exceeded resident tax rate. Revenues from the .25% non-resident earned income tax and from the increase in road maintenance funds will eliminate the revenue shortfall in many instances. It should be noted that over a period of time, disparities in rates among home rule municipalities and nearby jurisdictions may grow and influence location decisions.

The Commission recommends that this impact analysis be replicated with 1980 Census data, and that the Department of Revenue match its state personal income tax returns to the 1980 federal individual

Table II.14

Replacement Income Tax Rates for Individual Municipalities and School Districts — Mean Rates and Distribution of Rates

School Districts			Municipalities		
Number	*R*[1]	*R+E*[2]	*Number*	*R*[1]	*R+E*[2]
500	0.003602		2542	0.001407	
505		0.008710			0.005396
Standard Deviation	0.011231	0.034077	Standard Deviation	0.002437	0.005623
Minimum Value	0.00	0.00	Minimum Value	0.00	0.00
Maximum Value	0.011873	0.016846	Maximum Value	0.101164	0.2114

	School Districts Distribution of Rates			*Municipalities Distribution of Rates*	
	N	%	*R+E*	*N*	%
	39	7.7	Under — 0.002	314	12.4
	7	1.4	0.002 — 0.00299	170	6.7
	7	1.4	0.003 — 0.00399	305	12.0
	29	5.7	0.004 — 0.00499	410	16.1
	82	16.2	0.005 — 0.00599	464	18.3
	121	24.0	0.006 — 0.00699	326	12.8
	68	13.5	0.007 — 0.00799	240	9.4
	34	6.7	0.008 — 0.00899	140	5.5
	24	4.7	0.009 — 0.00999	70	2.8
	25	5.0	0.010 — 0.01099	36	1.4
	22	4.4	0.011 — 0.01199	18	0.7
	19	3.8	0.012 — 0.01299	16	0.6
	14	2.8	0.013 — 0.01399	7	0.3
	10	2.0	0.014 — 0.01499	4	0.2
	4	0.1	0.015 and over	22	0.8
Totals	505	100.0%		2542	100.0%

[1] R is computed as the ratio of revenues from all occupation taxes, the real estate transfer tax, all per capita taxes, the occupational privilege tax, and the intangible personal property tax, divided by the estimated size of state taxable income in each jurisdiction.

[2] R + E is computed in the same way as R except that the numerator also includes earnings taxes collected in 1977 under Act 511.

income tax returns, which will have the municipality of residence coded, in order to insure that the recommended ceilings are adequate, and to determine whether a phase-in period or other measures are warranted to avoid undue hardships.

Table II.15 displays the revenue source changes for Philadelphia for Fiscal Year 1980. Under the Commission recommendations, the non-resident tax rate can be reduced to 2.9% with Philadelphia's overall local tax revenues being maintained.

5. Elaboration on the Local Income Tax, Piggybacking, and Non-Resident Income Taxation

The recommendation of a local income tax (in contrast to the current local wage tax) contains the following provisions:

a) Base, Taxpayer, and Residence

The base for the local income tax on residents would be the recommended Pennsylvania taxable income of a taxable individual in his place of residence. Residence is defined to be the place of residence of the taxpayer at the close of the calendar year, and in terms of the customary place of abode where the taxpayer resides or intends to reside. The definition of a taxpayer for piggybacking follows the state definition (including exempt persons) for personal tax purposes and would include a resident trust or estate whose undistributed earnings are subject to tax. The jurisdiction of residence would be the municipality or school district within which the taxpayer resided.

b) Rate, Administration, and Withholding

The rate maximum would be 1% for municipalities and 1.5% for school districts. The rate must be con-

Table II.15

Revenue Losses and Gains to Philadelphia City and the Philadelphia School District 1981 Revenue Estimates

Type of Tax	*Estimated 1981 Revenue Estimates ($000)* City	*School Districts*
I. Aggregate Revenue Losses		
Earned Income	553,000	—
Intangible Personal Property	7,000	—
Unearned Income	—	7,000
Total Revenue Loss	560,000	7,000
II. Aggregate Revenue Gains		
Income Tax on Residents at 4.3125% (Resident receipts of 376,000 augmented by 10%)	414,000	
Income Tax on Non-Residents at 2.9%	118,000	
Funding of Philadelphia SEPTA contribution from 0.2% Regional Income Tax	35,000	
Less Block Grant to Cover School District Loss	(7,000)	7,000
Total Gain	560,000	7,000
III. Net Revenue Change[1]	0	0

IV. Computation of Required Rate for Non-Resident Earnings Tax:

Exclusive of the non-resident income tax, Philadelphia experiences net revenue losses under the Commissions recommendations of $118 million. A non-resident income tax rate was calculated to raise the $118 million as follows:

Non-Resident Base = 177,000/0.043125 = 4,104,348
Non-Resident Rate = 118,000/4,104,348 = 0.028750

Hence, the non-resident rate can be cut from 0.043125 to 0.028750, or by 0.014375.

[1] In addition, under the Commission's transportation proposal when fully implemented. Philadelphia would receive $9 million at 1980 levels.

veyed to the Department of Revenue four months before the beginning of the taxable year.

To implement the "piggyback" tax rate, the Department of Revenue would be notified by the jurisdiction of the planned withholding rate which could be promulgated to employers by the November preceeding the taxable year. Once set, the withholding rate could not be changed during the taxable year. The Department of Revenue would turn over the proceeds of the withholding on a quarterly basis, and on an estimated basis in the initial year of implementation. While the withholding rate would be conveyed to the Department of Revenue by no later than November of the preceeding taxable year, the initial entry into the system would require a conveyance of an "election to piggyback" which would have to be sent twelve months prior to the taxable year. Under this recommendation, a jurisdiction could not collect, or have collected by a party other than the Department of Revenue, a piggyback income tax, or have the authority to levy or collect a tax on income, or on a portion of income thereof.

Final resolution of the tax for under- or overpayment would be accomplished via the April 15 (following the taxable year) resolution for the state personal income tax liability, with net under-payments remitted by taxpayers being returned to the jurisdiction at the time of the succeeding quarterly payment, and net over-payments being remitted to the taxpayer directly through the normal PA-40 process.

Local governments expressed considerable concern about the reliability of the return of "piggyback" tax receipts, and the resultant management difficulties that would occur if payments were significantly late, or if they were in amounts that materially differed from those expected.

To address these cash-flow problems, it is recommended that a trust fund be established in the state accounts, and that withholding amounts obtained for the piggyback system by the Department of Revenue be deposited in the trust fund within three working days of receipt by the Department of Revenue. The trust fund would contain separate accounts within it for each piggyback jurisdiction, and would be subject to annual independent audit by an authorized certified public accountant. The results would be conveyed to the Governor, Legislature, and each piggyback jurisdiction.

Management of the trust fund would be through a panel consisting of the Secretary of Revenue, the Secretary of Budget, the Secretary of the Department of Community Affairs, and four representatives of piggyback governments appointed by the Governor. The trust fund would be permitted to invest on a short-term basis consistent with prudent, financial practices. A portion of the interest income would be used to

finance the additional staff necessary to prepare the estimates of payment amounts. The balance of the interest income would be paid out each quarter on a proportional basis. Procedures for adjustments between taxable years would be devised; however, in no event could the final payment to a jurisdiction remain open for more than three months after the close of the taxable year in question.

Withholding by the state would require modification of its current withholding practices. Employers would be required to solicit from employees the jurisdiction of residence of the employee, and any changes that might occur if the employee moved during the year. As a practical matter, this would entail identifying the local government (municipality or borough) and school district of residence. Hence, municipalities must be coded as school districts currently are. Employers would thus be required to provide additional information on the W-2 forms which they submit. It is contemplated that the employer would provide an aggregate withholding figure per jurisdiction rather than amounts per individual.

c) Penalties, Fines, Administrative and Judicial Review

Penalties and fines applicable to the state personal income tax would be required under the piggyback law, and 50% of such proceeds attributable to piggyback taxes would be remitted to the jurisdiction of residence of the taxpayer. Because the state would act as the local collection agent, appeals and adjudication would necessarily have to be through the same process available to taxpayers under the state personal income tax. To balance the local interest in continued review of the local personal income tax and the state interest in the effective administration of the state personal tax, the Commission recommends that the jurisdiction of residence and the taxing agency of jurisdiction(s) of non-residence would have access to relevant records and have the opportunity to audit, review, and recommend state tax treatment of taxpayers for piggyback purposes.

d) Non-Resident Tax

Under the piggyback tax, piggyback jurisdictions (other than school districts) may impose a tax on non-residents; however, there are certain differences in the recommendations with regard to the taxation of non-residents and of residents.

(1) Base

The definition of taxable income would be net profits plus wage and salary earnings only. Wages earned elsewhere and unearned income would be excluded.

(2) Geographical Definition of Non-Residents

In reviewing the current taxation of non-residents, the Commission was impressed by the difficulties localities have had in assuring non-resident's compliance with the wage taxation. Indeed, a principle argument for a state piggyback system is more uniform taxation of residents and non-residents. The underlying purpose of non-resident taxation is to finance their utilization or enjoyment of public services while a non-resident. Conceptually, such enjoyment would encompass not only time spent in a jurisdiction during periods of work (including commuting), but also time spent attending cultural activities, shopping, etc. As a practical matter, however, time spent working in a piggyback jurisdiction would seem to be the most common and readily measured activity by the state. Accordingly, the Commission recommends that non-residence be defined in terms of working days, and in the case of multiple places of employment during a working year, that liability be prorated on a days-worked as a proportion of total days-worked basis. To keep the attribution tractable, it is recommended that a work day not be divisible. In the case of traveling salesmen and other forms of employment which involve multiple places of work in a day, the situs of the employer should be used to determine the non-residence's place of taxation.

(3) Definition of Non-Resident Taxpayer

To ensure simplification of administration, it is suggested that the definition of non-resident taxpayer be limited to individuals and thus exclude non-resident earnings of trusts and estates.

(4) Rate of Tax

The Commission considered a number of alternative ways to determine the rate of tax on non-residents. After considerable discussion, it was thought that because the non-resident does not spend all of his time in the piggyback jurisdiction, he could not enjoy the benefits of the jurisdiction's services to the extent that a resident would. Equity would thus argue that the rate of tax should be lower for non-residents than for residents. Ultimately, it would be desirable to actually measure the benefits of the services enjoyed; however, as a practical matter, this cannot be done with any accuracy.

The Commission concluded that a rate of .25% fairly approximates non-resident utilization of such services.

Section III.
State Taxation of Individuals

A. The Personal Income Tax

1. Background

Pennsylvania currently imposes a personal income tax at 2.2% on a very broad definition of income. As shown in Column (4) of Table III.1, the tax is essentially flat[1] although there is some progressivity evident in the lower income classes. This contrasts with the rate structures in many other states which are progressive. In reviewing the personal income tax, the Commission identified several issues in the personal tax treatment of low income individuals, in the taxation of small estates under the inheritance and estate tax, as well as certain technical and administrative issues related to both the personal and inheritance taxes.

2. Issues

a) Tax Treatment of Low Income Individuals

The Special Provisions (or SP) provide to low income taxpayers a certain amount of tax relief based on their income level and relationship with other members in the household. As the number of dependents in the filing unit increases, the net income, at which taxes are due, rises. The SP provisions are broadly analogous in intent to both the exemptions and the zero bracket amount under the federal individual income tax.

While the basic equities of some kind of low income allowance or tax forgiveness are readily apparent, there are numerous ways to achieve it. The Commission found that the error rate associated with the current SP form is unusually high. This suggests that the form, or more directly the statutory provisions themselves, be examined with the aim of simplification. The Department of Revenue indicated to the Commission that as many as 18% of low income returns contain errors affecting their eligibility or amount of tax forgiveness under SP.

The errors which occur in the filing of the SP form are associated with two complexities in the law: first, the income concept used in determining eligibility for SP is broader in definition than that used for general individual income tax purposes. That is, income for SP purposes includes certain sources of income which are not taxed by the personal income tax itself. Making these distinctions may be especially difficult for low income individuals and may increase the likelihood of error. It may also discourage potentially eligible individuals from trying to take advantage of available tax relief.

Second, the relationship between spouses, in terms of the amount of income each contributes to the household, is extremely complicated. Essentially, their respective incomes are pooled and divided by the number of dependents in the household to obtain a per capita average. When one spouse files for the SP tax relief, the filer must consider the difference between the filer's income and the per capita average. Consider, for example, a couple without children. If the husband earned $4,000 and the wife earned $2,500, their combined income would be $6,500 and the per capita average $3,250. The wife is eligible for forgiveness; however, her income for the calculation is not $2,500 but $3,250 since the law assumes that the husband provided support in the amount of $750, the difference between the per capita average and the wife's earnings.

b) Inflation

The SP provisions tie tax forgiveness to certain dollar amounts which were enacted in 1974. They correspond broadly to 1974 poverty thresholds for various family sizes. Since 1974, however, prices and therefore the poverty threshholds have risen, although the SP income forgiveness levels have not. While revenue adequacy considerations might argue for not increasing the forgiveness levels, basic equity argues for accounting for such inflationary changes.

c) Taxation of Gains Realized in the Sale or Exchange of a Personal Residence

Under current law, gains resulting from the sale of an asset are taxable at 2.2% as personal income and are thus taxed at the same rate as compensation. Under federal law, such gains are more favorably taxed than compensation, and in the case of proceeds from the sale of a personal residence, such gains are not taxed if the net proceeds are reinvested in a personal residence within 18 months of the sale of the first residence. Moreover, the Congress recently accorded a once per lifetime exclusion from taxation of up to $100,000 of gain for those homeowners over age 55.

The Commission has been advised that enforcement of Pennsylvania's taxation of gains from the sale of personal residences has not been complete, owing in part to taxpayers' lack of familiarity with the provision, and in part to the federal provisions. The Commission is also concerned that in periods of rapid inflation, especially in the prices of personal residences, the taxa-

[1] Comparisons of Pennsylvania's personal tax in terms of structure, burden, and reliance as well as a detailed review of the uniformity issue as it relates to progressivity may be found in *A Task Force Report to the Pennsylvania Tax Commission: Personal Taxation.*

Table III.1

Distribution of Pennsylvania and Federal Personal Tax Burdens in 1977[1]

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
Pennsylvania Taxable Income Class	*% Pennsylvania Taxpayers*	*% Pennsylvania Taxes*	*Mean State Tax Per Unit*	*Mean Effective State Tax Rate %*	*Mean Effective Federal Tax Rate %*	*% of Federal Itemizers*	*Mean Effective State Tax Rate for Itemizers*	*% Federal Taxes*	*Cumulative % State Tax*	*Cumulative % Federal Tax*	*Mean Federal Taxes Per Unit*	*% Federal Itemizers in Income Class*
<$1000	12.0	.2	$ 4.42	—	—	4.2		3.5	.2	3.5	$ 541.44	7.6
1-1999	6.7	.7	28.29	1.97	2.81	.9	.65	.2	.9	3.7	44.51	2.9
2-2999	4.4	.9	49.31	1.99	.84	.02	.86	.05	1.8	3.75	19.81	.1
3-3999	4.2	1.2	69.18	1.98	4.36	.02	.97	.3	3.0	4.05	147.57	.1
4-4999	3.6	1.3	89.91	1.99	5.73	.8	1.73	.5	4.3	4.55	259.58	4.8
5-5999	2.7	1.2	109.22	1.99	5.36	1.0	1.75	.4	5.5	4.95	294.83	8.2
6-6999	4.2	2.1	129.14	2.00	8.12	.4	1.90	1.2	7.6	6.15	526.12	2.1
7-7999	3.6	2.1	148.98	2.00	7.32	1.8	1.83	1.1	9.7	7.25	549.00	10.5
8-8999	5.1	3.4	169.07	2.00	8.88	1.5	1.78	2.1	13.1	9.35	754.60	6.3
9-9999	3.4	2.5	189.49	2.00	9.27	1.0	1.81	1.6	15.6	10.95	981.35	6.3
10-14999	16.2	15.9	248.44	2.00	10.37	12.1	1.80	11.3	31.5	22.25	1,296.28	16.2
15-19999	14.3	19.6	346.47	2.00	12.04	19.1	1.78	16.2	51.1	38.45	2,093.31	28.7
20-24999	8.3	14.6	446.00	2.00	14.13	17.4	1.73	14.1	65.7	52.55	3,163.55	45.5
25-49999	9.8	24.4	628.43	2.00	16.40	33.7	1.68	28.0	90.1	80.55	5,279.72	74.2
50-99999	1.1	6.0	1,314.94	2.00	24.76	4.7	1.48	10.3	96.1	90.85	16,732.39	88.7
$100,000+	3.0	3.8	3,216.50	2.00	33.57	1.3	1.32	9.2	100.0	100.0	57,120.59	95.7
TOTALS	100.0	100.0	$ 253.03 $1,174,850,095[1]			100.0		100.0			$ 1,857.43	21.6%

[1]Universe estimate from sample. State reported collections equal $1,202,909,000 in 1977.

Source: Commission Simulations with Pennsylvania Personal Income Tax Model at 1977 Income Levels

tion of such gain can be unduly burdensome and conflict with the Commission's stated equity objective.

d) Tax Treatment of Installment Sales

Under current Pennsylvania law, the sales price in excess of the tax base in the case of the sale of an asset is entirely taxable in the year of the sale, even if the seller does not receive complete payment in that year, but rather receives payment over a number of years. The Commission understands that hardships arise in some of these cases.

e) *Staley* Decision Regarding Uncompensated Employee Business Deductions

Recently[2] the Pennsylvania Supreme Court held that certain uncompensated employee business expenses could be deducted from gross income for personal income tax purposes. The Department of Revenue has had considerable difficulty in administering the personal tax in light of the decision, and the Commission has been advised that there is a need for legislative remedy in this area.

3. Recommendations

a) Replace the SP Income Concept with Pennsylvania Taxable Income and Increase Table Amounts

As noted earlier, there are several different income concepts used to file the SP form and this has caused errors on the part of taxpayers. One simplification of the current provisions which the Commission recommends is to calculate the percentage of tax forgiveness on the basis of Pennsylvania taxable plus exempt interest income rather than on the basis of the sum of Pennsylvania taxable income, and the multitude of other tax exempt forms of income. This latter category is now composed primarily of tax exempt interest, alimony, life insurance proceeds, and certain gifts.

Another simplification the Commission recommends is to determine support, in allocating income of one spouse to another, on the basis of taxable income, plus tax exempt interest rather than the sum of taxable income, SP income, and certain other sources of income, which are tax exempt and not included in the SP income concept: social security payments, medicare benefits, AFDC and public assistance payments, workmen's compensation, unemployment compensation, and pensions and annuities.

The Commission also recommends that the tables which determine the point at which income becomes taxable be adjusted for the inflation between 1974 and 1980, and that the Legislature periodically review these income levels and adjust them in response to any subsequent inflation.

The effect of these proposed changes should be to make more persons eligible for tax forgiveness. The Commission estimates it would reduce revenues by $25 million at 1980 income levels. The Commission recommends that this reform be financed through an increase in the personal income tax rate (see Table III.2 which displays the impact of the proposal).

Table III.2

Impact of Proposed Changes in Special Provisions

	Current Law	Proposal
Pennsylvania Taxable Income Class	*1974 Pennsylvania Tax Law Average Effective Tax Rate*	*Replace SP and Support Income with Taxable Income*
$ 1,000	.5 %	–
1,000 – 1,999	1.2	–
2,000 – 2,999	1.2	–
3,000 – 3,999	1.35	.7 %
4,000 – 4,999	1.7	1.5
5,000 – 5,999	1.8	1.7
6,000 – 6,999	1.9	1.85
7,000 – 7,999	1.9	1.9
8,000 – 8,999	1.9	1.9
9,000 – 9,999	2.0	1.95
10,000 – 14,999	2.0	2.0
15,000 – 19,999	2.0	2.0
20,000 – 24,999	2.0	2.0
25,000 – 49,999	2.0	2.0
50,000 – 99,999	2.0	2.0
100,000 +	2.0	2.0
Revenue Loss/Gain	–	–$20.4 million
Revenue Change	–	– 2.3 %

b) Tax Consequence of Sale of Personal Residence

The Commission recommends that the federal tax treatment of the sale and exchange of personal residences be adopted by the Commonwealth. Under the recommendation, the taxpayer would have a tax-free roll-over if another residence was purchased within 18 months of the sale. Also, it is recommended that those homeowners over age 55 be accorded a once-per-lifetime exclusion of $100,000 of gain resulting from the sale of a personal residence. The Commission estimates that this will reduce revenues by $20.9 million at 1980 levels.

The Commission believes that federal law with regard to the taxation of capital gains on a personal residence can be adopted to conform with the Uniformity Clause of the Pennsylvania Constitution. The federal rules regarding the roll-over of gains until the individual no longer invests in a residence involve the issue of when to tax the gain rather than whether or not to tax the gain. The Commission believes it is reasonable to classify gains from the sale of personal residences as a separate class of income, and to determine that the gains are not realized for tax purposes until an individual uses the funds for purposes other than acquiring another residence.

The Commission also views it to be appropriate under the Uniformity Clause[3] to exempt for senior citizens, for one time only, the first $100,000 of gain

[2] *Commonwealth v. Staley*, 476 Pa. 171, 381 A 2nd 1280 (1978).

[3] Article VIII Paragraph 2(b) (ii) of the Pennsylvania Constitution allows as an exemption to the Uniformity Clause special tax forgiveness or exemptions for persons on the basis of age.

Table III.3

Analysis of Provision of Federal Adjustment for Employee Business Expenses for Pennsylvania Taxpayers, Adjustment for *Staley* Decision at 1977 Income Levels

Current Law[1]

Pennsylvania Taxable Income Class	*% Pennsylvania Taxpayers*	*% Pennsylvania Taxes*	*Mean State Taxes Per Unit*	*Mean State Tax Rate*	*% Affected by Proposal in Class*	*Average[2] Tax Reduction for Those Affected*
<$1000	12.0	.2	$ 4.42	–	.02	$ 2.99
1-1999	6.7	.7	28.29	1.97	0	–
2-2999	4.4	.9	49.31	1.99	.8	33.77
3-3999	4.2	1.2	69.18	1.98	.2	4.22
4-4999	3.6	1.3	89.91	1.99	.4	13.35
5-5999	2.7	1.2	109.22	1.99	0	–
6-6999	4.2	2.1	129.14	2.00	2.4	21.26
7-7999	3.6	2.1	148.98	2.00	2.2	76.00
8-8999	5.1	3.4	169.07	2.00	1.6	43.48
9-9999	3.4	2.5	189.49	2.00	4.0	41.76
10-14999	16.2	15.9	248.44	2.00	6.2	35.97
15-19999	14.3	19.6	346.47	2.00	8.9	29.49
20-24999	8.3	14.6	446.00	2.00	6.1	41.30
25-49999	9.8	24.4	628.43	2.00	14.4	42.34
50-99999	1.1	6.0	1,314.94	2.00	10.7	88.98
$100,000+	3.0	3.8	3,216.60	2.00	16.0	78.57

[1] In 1977, the Pennsylvania personal income tax rate was 2.0%.

[2] Total tax reduction, assuming 2.2% tax rate is $8.7 million at 1977 income levels.

Source: Commission Simulations of Pennsylvania Personal Income Tax Model at 1977 Income Levels.

realized from the sale of a residence when proceeds are not invested in another home. These gains are a vital source of capital needed by senior citizens to finance retirement. Since a home is the main financial asset of most individuals, it is appropriate for the General Assembly to direct special tax provisions to the elderly designed to keep these gains intact to finance retirement. At today's interest rates, it should be recognized that $100,000 is sufficient to purchase a lifetime annuity for an elderly person of only $10,000 per year without any protection against inflation.

c) Tax Treatment of Installment Sales

The Commission recommends that Pennsylvania adopt the federal tax treatment of installment sales which would permit taxpayers, who receive payments over a period of time from the disposition of real or personal property, to pay the personal income tax on a corresponding installment schedule. It is estimated that this will reduce revenues by approximately $200,000 based on 1980 statistics.

d) Tax Treatment of Uncompensated Employee Business Expenses

The Commission recommends the adoption of federal tax treatment of employee business expenses as a practical, but imperfect solution to the administrative difficulties caused by the *Staley* decision. In 1977, this would have reduced gross revenues by $8.7 million or $12.4 million in 1980 dollars. However, on a net basis, taking into account the fact that part of allowable federal adjustments are now being permitted by the Department of Revenue (estimated to be $6.9 million), there is a net revenue loss of $5.5 million resulting from the recommendation. The impact of this recommendation is displayed in Table III.3.

B. Consumption Taxes

1. Issues

Among states, Pennsylvania's sales tax base has three major forms of exemptions at the retail level: clothing, food, and medical supplies and services. The provision of these exemptions, particularly of food and prescription medicine, has materially reduced the regressivity, as measured by current income, of the sales tax. As shown in Table III.4, the burden of the tax is essentially proportional on incomes between $3,000 and $20,000, and then somewhat regressive on incomes beyond $20,000. At the same time, the rate of sales tax in Pennsylvania is higher than many neighboring and industrial states. Only Connecticut (7%) levies a higher rate of tax at the state level. For example, New York levies a 4% state tax as does Ohio, while New Jersey levies a 5% tax, and Delaware levies no sales tax whatsoever. Local sales taxes have been piggybacked on top of the state taxes in several states so that the overall rate is more comparable to Pennsylvania's 6% rate; in New York, localities can add on up to 4%, and in Ohio localities can add up to 2% on top of the state rate. Among the major exemptions currently provided by the Pennsylvania sales tax, the Commission found that clothing consumption is in

Table III.4

Pennsylvania Sales Tax Burden by Current Income Class Tax Paid as a Percentage of Current Income

%

	Selected Taxable Items					Sales Tax Burden for Exempt Items If They Are Taxed				
Income Class	*Current PA Law* (1)	*Food Consumed On-Premises* (2)	*Alcohol 18% Liquor & 6% Sales* (3)	*Furniture* (4)	*Auto Services* (5)	*All Non-Taxable Items* (6)	*Food Consumed Off-Premises* (7)	*Clothing* (8)	*Fuel* (9)	*Household Operations* (10)
0-3000	5.0	0.4	0.6	1.0	2.7	10.7	2.8	1.2	1.2	0.9
3001-6000	1.2	0.2	0.2	0.2	0.5	3.7	1.3	0.5	0.4	0.2
6001-9000	1.3	0.2	0.2	0.2	0.5	2.9	0.9	0.4	0.2	0.2
9001-12000	1.2	0.2	0.2	0.2	0.5	2.5	0.7	0.4	0.2	0.1
12001-15000	1.2	0.2	0.2	0.2	0.5	2.4	0.7	0.3	0.2	0.1
15001-20000	1.1	0.2	0.2	0.2	0.4	2.2	0.6	0.3	0.2	0.1
20001-30000	1.0	0.2	0.1	0.1	0.4	2.0	0.5	0.3	0.1	0.1
30001-50000	0.9	0.2	0.1	0.1	0.3	1.9	0.4	0.3	0.1	0.1
50000 and Over	0.6	0.1	0.1	0.1	0.2	1.5	0.2	0.2	0.07	0.1

Note: Housing expenditure, whether rental or owner-occupied, is not included in any of the calculations of sales tax burdens; specifically housing is excluded from the burden calculations in Column 6. The rationale for its exclusion is that housing is not likely to be subject to sales taxation since it is subject to property taxation.

Source: Commission simulations with Pennsylvania Sales Tax Model.

Table III.5

State Sales Tax Receipts with the Current Sales Base Plus Clothing at Various Tax Rates (in Millions of Dollars)

Tax Rates	*Tax Receipts 1979*	*Difference Between Actual 1979 Revenues Estimated Revenues under the New Tax Base*	*Percentage Change in Sales Revenues*
5.0 %	$1,843.5	−51.9	−2.7
5.25	1,935.7	40.2	2.1
5.5	2,027.9	132.3	7.0
6.0	2,212.2	316.7	16.7

Note: The estimate of the sales tax base for clothing used here is based on a U.S. average per capita clothing expenditure figure of $450 for 1979. This figure is compiled by the Bureau of Economic Analysis in the U.S. Department of Commerce. Figures for clothing consumption in individual states are not available.

the same proportion to income across income classes. Table III.5 shows the revenue implications of various sales tax rates and different tax bases.

Sales taxes are responsive to income growth. A 10% increase in Pennsylvania income results in a 9% increase in Pennsylvania sales tax revenues. Thus, the income elasticity of sales tax revenues is about 0.9.

2. Recommendations

a) Policies toward Exemption and Exclusions

The Commission does not recommend any immediate change in the state's complex exemptions and exclusions of transactions from the sales tax. It should be noted, however, that equivalent revenue could be generated by a comprehensive tax on all retail transactions of approximately 2%. Thus, the current sales tax contains over $4 billion in tax expenditures to benefit certain groups and subsidize various classes of transactions. The Commission believes that attention should be paid to eliminating many of these exemptions and exclusions, especially those of little revenue or distributional consequence but which encourage tax evasion and increase collection costs.

b) Non-Retail Transactions

Currently, Pennsylvania exempts from sales taxation agricultural, mining, manufacturing, processing, and research and development transactions, and provides a tax credit for items purchased for resale. Since these are not retail transactions, the exemptions are appropriate. When intermediate and wholesale transactions are taxed, sales taxes pyramid among the various stages of product creation, and the consumer pays far in excess of the nominal 6%.

Despite the presence of these desirable exemptions,

many non-retail transactions are taxed in Pennsylvania. Whenever a business purchases a taxable item for business use but cannot fit the transaction into one of the numerous pigeon holes of current exemption policies, the transaction is taxed.

The Commission finds sales taxation of any non-retail transactions undesirable. These taxes are most likely passed on to consumers in the form of pyramided sales taxes far in excess of the nominal 6% rate. Because of the revenue impact of eliminating all non-retail sales taxation, however, the Commission does not recommend immediate reform in this area. Instead, the Commission urges Governor Thornburgh and the General Assembly, after reviewing sales tax exemption policies, to channel part of the revenue realized from eliminating exemptions and exclusions to the task of eliminating non-retail sales taxation.

The Commission also recommends avoiding the creation of new sales tax exemptions and exclusions unless there is a compelling social justification. The narrower the sales tax base becomes, the more difficult enforcement, administration, and management of the system becomes. A narrow base forces high tax rates which encourage taxpayer resistance and fraud.

Prior to approving new sales tax exemptions or exclusions, the Commission urges the following steps be taken:

(1) A sales tax exemption or exclusion should not be granted for any activity for which a similar direct appropriation of public funds would not be justifiable; tax dollars not collected are equivalent to public funds appropriated.

(2) Sales tax exemptions should only be granted when measurable and significant public benefits are attained. The amount of revenue foregone should be clearly compared on a cost-benefit basis with objectives of the exemption or exclusion.

(3) Exemptions or exclusions should be narrowly targeted to affect primarily the incremental transactions found to be socially desirable.

(4) Like direct expenditures, sales tax expenditures should be granted only for a fixed period of time following which a thorough review should be conducted to determine whether the policy is worthy of continuation.

c) Liquor Sales in Pennsylvania

The Commission considered the revenue effects of a proposal to convert Pennsylvania liquor sales from a state operated monopoly system to a licensed private enterprise system. It concludes that if a state license system is adopted, competition among liquor stores would exert downward pressure on liquor prices. Liquor stores would be more numerous and be located more conveniently, and liquor sales are likely to increase.

The revenue impact of this conversion would be a modest loss in state liquor revenues of about $9.3 million, approximately 0.2% of general fund revenues. The $9.3 million loss results from two impacts of conversion. The Commission estimates modest increases in liquor sales after conversion and therefore, an increase in liquor tax revenues of $20.7 million at current liquor tax rates. However, $30.0 million in revenues from profits on state liquor store operations would be forgone as a result of conversion. To the extent that private liquor stores are profitable, they would pay the Corporate Net Income Tax and also would be subject to the Capital Stock Tax. Receipts from these taxes would then further reduce the extent of the $9.3 million revenue loss.

C. The Taxation of Inheritance

1. Background

The essential features of the current Pennsylvania inheritance tax are that it imposes a 6% rate on spouses, lineal ancestors and descendents and 15% on other beneficiaries. A flat $2,000 family allowance is available. Property held jointly passes free of a tax to a widow or widower. Gifts made prior to 2 years before death are tax-free and gifts made within 2 years of death are (unless shown to the contrary) deemed to be made in contemplation of death and are taxable transfers. The Pennsylvania estate tax is imposed if the federal tax credit for state death taxes exceeds the inheritance tax levied on the estate. The tax is limited to the difference between federal credit allowed for state death taxes and the actual state death taxes.

2. Issues

a) The Inheritance Tax in the Federal System

Historically, the federal government has provided a credit for state estate, gift, and inheritance taxes against the federal estate and gift tax to encourage the states to use this form of taxation, and in effect to provide a form of revenue sharing. Recent changes in federal statute have materially reduced the opportunity for states to benefit from this credit, as the tax-free level of estates for federal estate tax purposes has been materially increased. While it is beyond the scope of this *Report* to suggest recommendations at the federal level, the Commission believes that this issue should be raised by Governor Thornburgh and Legislature with their counterparts across the country so that the federal government is advised of the adverse impact on the states resulting from the 1976 Gift and Estate Tax Act amendments to the Internal Revenue Code.

Several states levy a tax up to the federal credit for state estate and inheritance taxes. The Commission finds merit in this approach as it would greatly simplify administration, and relieve the tax burden on small estates — something which the Commission finds to be of immediate importance. However, adoption of this form of estate taxation in lieu of the current inheritance and estate tax would entail a revenue loss in excess of $100 million which the Commission believes to be too large to entertain at this time.

b) Taxation of Lineal and Non-Lineal Beneficiaries

Under current Pennsylvania law, inheritances to cer-

Table III.6
Distribution of 1975 Pennsylvania Inheritance Tax Returns (Ordered by Total Taxes Paid)

Percentile	*Record #*	*Gross Value of Estate*	*Clear Value of Estate*	*Pennsylvania Inheritance Tax Due*	*Cumulative % of Taxpayers*
5th Percentile	22,722	$ 18,115	$ 14,121	$ 804	43.2%
10th Percentile	29,207	116,448	103,184	1,353	55.5
15th Percentile	33,502	35,533	32,415	1,883	63.6
20th Percentile	36,692	53,293	39,862	2,464	69.3
25th Percentile	39,193	22,943	21,329	3,080	74.4
30th Percentile	41,202	NA	NA	3,783	78.3
35th Percentile	42,864	100,915	79,218	4,515	81.4
40th Percentile	44,267	103,315	90,236	5,327	84.1
45th Percentile	45,465	120,890	107,635	6,176	86.4
50th Percentile	46,500	65,388	50,582	7,157	88.3
55th Percentile	47,394	59,925	54,251	8,264	90.0
60th Percentile	48,168	550,051	500,496	9,512	91.5
65th Percentile	48,843	106,671	76,196	10,936	92.7
70th Percentile	49,431	97,159	87,835	12,543	93.8
75th Percentile	49,941	281,184	254,854	14,554	94.9
80th Percentile	50,381	692,991	268,090	16,642	95.7
85th Percentile	50,766	474,147	320,209	19,236	96.4
90th Percentile	51,099	392,106	369,883	22,199	97.1
100th Percentile	51,634	358,319	320,736	29,999	98.1
Total	52,646	$3,414,965,835	$2,774,483,575	$137,426,893	

Source: Pennsylvania Department of Revenue.

tain blood relations[4] of the decedent are taxed at 6%, and inheritances to all other individuals, including brothers and sisters, are taxed at 15%. The Commission noted in its review of inheritance taxes that virtually every other state which levies an inheritance tax accords favorable tax rates for brothers and sisters vis-a-vis the tax rates for non-lineal beneficiaries.

c) Taxation of Family Farms and Closely Held Businesses

In reviewing the current inheritance tax in Pennsylvania, the Commission found increasing evidence that family farms are being sold at the time of death of the husband in order to pay inheritance taxes, or various corporate forms are being sought out in order to avoid the adverse tax consequences of inheritance taxes. The principle difficulty in many instances involves the valuation of the farm for agricultural versus other uses. The Commission believes these liquidations to be inconsistent with the objective of maintaining communities.

d) Taxation of Small Estates

In reviewing the burden of the inheritance tax, the Commission found that the majority of revenues generated by the tax are attributable to estates over $50,000 of clear value (see Table III.6). Put another way, 55% of the taxpayers paid only 10% of the inheritance taxes in 1975. Not only do small estates pay a small fraction of total taxes, they involve considerable administrative expense to the Commonwealth.

[4] Grandfathers, grandmothers, fathers, mothers, spouses, lineal descendants and wives or widows, and husbands or widowers of a descendant's child are taxed at 6%.

e) Certain Technical Matters

The Commission notes that the actuarial tables used to value life interests are better than 35 years old and do not reflect either realistic interest rates or realistic life expectancies. The Department of Revenue currently uses actuarial tables based on 3.5% to value life interests. The Commission found that a number of court decisions interpreting the 1961 Inheritance and Estate Act have complicated the administration of the tax, especially in the areas of allowable medical deductions, the valuation of income with respect to a decedent, and the determination of when an intervivos gift is made in contemplation of death. Also, the Commission is concerned that Pennsylvania does not currently accord to estates owning qualified businesses the opportunity to pay taxes on the installment basis as provided in Section 6166 of the Internal Revenue Code.

3. Recommendations

a) Taxation of Brothers and Sisters

The Commission recommends that inheritances to brothers and sisters be taxed at a 9% rate rather than a 15% rate as under current law. The Commission would actually prefer that the lower rate of 6% be applied; however, because of uncertainties as to the revenue consequences, a rate of 9% is suggested. Such an intermediate rate of taxation of siblings would provide Pennsylvania with a rate structure for siblings much more in line with those of other states.

b) Valuation of Family Farms

The Commission recommends that family farms and real estate used in closely-held businesses be valued at current use for inheritance tax purposes in the same manner as provided by 1976 Federal Gift and Estate Tax amendments to the Internal Revenue Code. Thus, if the use were to change within 10-15 years after transfer of property, an additional tax as a result of the farm having been put to a separate and new use vis-a-vis the use at the time of death, i.e., the federal recapture provisions would apply.

c) Taxation of Small Estates

The Commission recommends that estates with a clear value of less than $15,000 be tax free under the inheritance tax. The objective of this proposal is to alleviate the tax burden to many small estates. The Commission believes this recommendation will enhance the vertical equity of the inheritance tax, and significantly reduce the administrative burden on executors and the Department of Revenue. In particular, the Commission recommends an exclusion of $15,000 from the clear value of an estate.

To implement this recommendation, it is suggested that an abbreviated inheritance tax form and instructions be developed. The Commission does not believe it feasible to eliminate the filing for small estates, but does believe, due to the few assets usually involved and the absence of valuation problems of such estates, that it can be greatly simplified.

The Commission estimates that this proposal will reduce revenues by $9 million in 1980.

d) Actuarial Tables

The Commission recommends that the interest rates and life tables follow the interest rates and life tables currently being used at the federal level for estate tax purposes. The Commission understands that the revenue implications of this are negligible, since the higher interest rate being suggested is coupled with longer life expectancies embodied in the actuarial tables.

e) Income with Respect to a Decedent

The Commission recommends that income with respect to a decedent be valued without discount, and that the subsequent enjoyment of such benefits be without tax consequence to the beneficiary under the personal income tax. The Commission understands that this would require legislative action and has the effect of reversing the *Rose Estates* decision, in which the Pennsylvania Supreme Court held that income with respect to a decedent should be valued at discount, in part because the subsequent enjoyment of it by the beneficiary would be taxable under the federal income tax. The Commission observes that while valuation at discount is a theoretically appropriate technique for valuing a known, future stream of income, it has caused significant practical difficulties for administrators of trusts and the Department of Revenue. The recommendation addresses this problem.

f) Deduction of Certain Medical Expenses

The Commission recommends that medical expenses which are reimbursable not be allowed as deductions from the value of the gross estate. This recommendation relates to *Goldberg Estates* in which the Pennsylvania Supreme Court held that medical expenses, which were reimbursable under Medicare Part A, were properly deductible from the value of the estate without a corresponding increase in the value of the estate in the amount of the reimbursement.

g) Gifts in Contemplation of Death

The Commission recommends that the two-year rule currently available be amended to follow the three year federal rule. Under the federal rule, gifts made within three years would be treated as taxable.

D. Overall Revenue Implications

The Commission recommends that the personal income tax rate be increased from 2.2% to 2.28% to finance the reforms of the personal and inheritance taxes recommended above. This rate on the revised tax base will raise the additional $60.7 million needed to finance the reforms to the individual and inheritance taxes. Revenue estimates for some of the more technical changes to the inheritance tax were not available, although the Commission believes that they will balance out evenly overall.

Section IV.
Transportation Taxation

A. General

Unlike the personal and sales taxes, transportation taxes and fees may be readily related to an individual's utilization of the services that are provided by the public sector. Thus, the benefit principle can be applied to the financing of highways and other transportation facilities. The Commission believes that this principle is appropriate, and that the relationship between transportation services and finance should be strengthened. The Commission further believes that this principle should be maintained whether or not the transportation facilities are administered on a state or local level. Since user fees for most transportation facilities, especially highways, are easily collected at the state level, the Commission favors the maintenance of an identifiable fund of transportation tax receipts that is earmarked for transportation purposes and that is distributed between the state and local governments according to the facilities which they administer. It should be noted that the Motor License Fund (MLF) is limited by the Constitution to the financing of highways and bridges. Table IV.1 shows the current sources and uses of transportation finance.

Both the deterioration of our roads and bridges and the decline in receipts from major transportation taxes, at a time when repair and renovation costs are rising faster than the general price level, means that a revision of Pennsylvania's transportation taxes is imperative. The Commission also believes that the need to finance the restoration of our road system to an acceptable level provides an opportunity to strengthen the use of the benefit principle and to undertake some major reforms.

To insure that transportation expenditures and taxes are closely tied, the Commission proposes TRIP, a *T*ransportation *R*ehabilitation and *I*mprovement *P*rogram. TRIP contains a series of measures which are closely tied together and which deal with all the major modes of transportation in the state. Under this program, the major emphasis is placed on user financed programs and on revenue allocation systems to encourage the most efficient use of the state's transportation taxes. TRIP also assists in the decentralization of road and highway administration through a program of systematic turnback of roads and revenues to local governments.

B. Highway Taxation

1. Funding Adequacy

a) Issues

The Department of Transportation predicted in 1980 that its 1984/5 revenue would be $816 million, assuming that current transportation taxes are in place.

The Commission also made projections of likely expenditures in 1984/5, under the assumption that expenditures in constant dollars remain the same but that the wage and construction costs of building and maintaining highways rise at recent historical rates. The Commission's expenditure prediction for 1984/5 is $1,551 million in contrast to the Department's revenue estimate of $816 million. This estimate, based on current revenue projections, is 53% of the Commission's estimate; the Commission is seriously concerned that unless immediate steps are taken, real expenditures for maintaining and reconstructing state highways will fall considerably, with grave implications for the quality of our transportation system.

For the roads and bridges administered by the local governments, the situation is equally alarming and, in many ways, more intractable since over 3/4 of their expenditures on transportation facilities are financed from local property taxes and local general fund receipts (see Table IV.1). The problems of these revenue sources have been spelled out in other parts of this *Report.*

b) Recommendations

(1) Level of Tax Rates

The Commission recommends an increase in user charges to be collected by the state, and, as noted below, to be shared with the local governments. This would permit an increase in expenditures on roads and bridges, not only by state, but also by local governments. This part of TRIP can be implemented immediately.

A rate increase of 2 cents per gallon in the fuel taxes and a 20% increase in fees would be a necessary first step. A 1 cent increase in fuel taxes would yield about $50 million and a 10% increase in registration fees and other licenses fees would yield about $35 million. Thus, the program proposed by the Commission would

Table IV.1

Governmental Expenditures on Transportation and Sources of Finance in Pennsylvania in 1977 (Thousand dollars)

	Federal	*State*	*Local*	*Total*
Expenditures (in million dollars)				
Highways				
Capital	$ 682	$ 470,813	$ 75,189	$ 546,684
Maintenance	1,599	375,614	195,373	572,586
Administration	—	53,795	68,254	122,049
Traffic police	—	104,354	176,039	280,393
Interest, debt service	—	238,523	30,212	268,735
Intergovernmental transfers:				
to state	246,988	—	14,162	—
to local govts.	36,485	120,865	—	—
Total highway	285,704	1,363,964	559,229	1,790,448
Mass transit subsidies (to transit authorities)	59,013	74,749	39,448	173,210
Intercity bus *	n.a.	835	n.a.	n.a.
Railroads	n.a.	n.a.	n.a.	n.a.
Airports	n.a.	4,203	56,489	n.a.
Water transport	n.a.	—	3,910	n.a.
Pipelines	n.a.	n.a.	n.a.	n.a.
Receipts (in million dollars)				
Highways				
Retained user taxes	—	$ 679,324	—	$ 679,324
User tax intergovernmental transfers:				
Feds. to state	$226,205	226,205	—	226,205
State to locals	—	114,736	$114,736	114,736
Tolls	—	104,405	—	104,405
Parking fees	—	—	6,573	6,573
Fines	—	—	26,929	26,929
Property taxes	—	—	122,614	122,614
From general funds	2,281	45,007	245,210	292,498
Other fed. transfers	57,218	20,733	36,485	57,218
Other state transfers	—	—	6,129	—
Local transfers	—	14,162	—	—
Bond sales	—	45,000	14,587	59,587
Total highway	285,704	1,249,622	573,263	1,690,089
Mass transit	n.a.	n.a.	n.a.	n.a.
Intercity bus	n.a.	n.a.	n.a.	n.a.
Railroad	n.a.	n.a.	n.a.	n.a.
Airport	n.a.	2,857	49,703	n.a.
Water transport	n.a.	—	6,438	n.a.
Pipelines	n.a	n.a.	n.a.	n.a.

In the two halves of the table, intergovernmental expenditures are treated slightly differently. In the expenditure half, the transfers are noted but are not summed because they are included in the particular expenditure categories in the level of government receiving them. In the receipts half, the transfer is recorded twice — once by the level of government receiving the tax on which the subsidy is based and once by the receiver after the transfer is made; for this reason, the sum represents the single transfer.

The data for highway expenditures come from the U.S. Department of Transportation, Federal Highway Administration, *Highway Statistics, 1978*, pp. 66-7, 106-110, and 113-15; and from Federal Highway Administration, Highway Administration, *Highway Statistics, 1977*, pp. 138-43. These sources were not completely consistent; in cases of conflict, the later volume was used. The difference between receipts and expenditures is presumably financed by short term borrowing. The data on mass transit subsidies come from Pennsylvania Department of Transportation, Bureau of Mass Transit Systems and Bureau of Transportation Planning Statistics, *Pennsylvania Mass Transit Statistical Report, 1977-78*, Harrisburg, 1979; *Pennsylvania Mass Transit Statistical Report, 1976-77*, Harrisburg, 1978, pp. 21-22. The other data come from the U.S. Department of Commerce, Census Bureau, *1977 Census of Governments*, Volume 4, Number 5, Washington, D.C., G.P.O., 1979.

mean that roughly $170 million more would be available for highway and bridge maintenance and reconstruction. Although these taxes are slightly regressive, this regressivity is offset by progressive changes in other parts of the Commission's proposals. If a major portion of such increases was remitted to the local governments, this would reduce the share of local governmental financing from general funds and property taxes and would move the system closer to a user financed system.

(2) Indexation

The Commission recommends that all taxes and fees related to highway transportation be indexed, and that this index be arranged so as to maintain a constant volume of road maintenance and reconstruction for each year, despite cost increases attributable to higher energy and other prices. Such an index would have to be based on two factors: a cost index for highway maintenance and reconstruction, published by the Federal Highway Administration (FHA), and the actual level of highway taxes flowing into the Motor License Fund. Indexing both taxes and fees would permit the relative revenues flowing from each source to remain in alignment. This part of TRIP can be implemented immediately.

More specifically, in each quarter both fuel taxes and fees would be raised in percentage terms by the sum of the increase of the Federal Highway Administration highway cost index and the shortfalls in the projected MLF receipts. If the FHA index went up 3% and the shortfalls of the projected MLF funds were 1%, the current tax rates and fees would be multiplied by 1.04 (and rounded to the nearest tenth of a dollar if a flat fee is involved). On the other hand, if the FHA index went up 3% but the revenues flowing into the MLF in that quarter were 1% higher than projected, then the current tax rates and fees would be multiplied by 1.02. In this way, the MLF would never increase faster or slower than the amount of funds necessary to carry out the volume of expenditures for road construction and maintenance which were originally legislated. Or, to view the matter differently, no windfalls or shortfalls in revenue would occur to the Department of Transportation under such a system (assuming a constant level of maintenance and reconstruction) and, unlike a system of taxes indexed to the price of fuel, no floors or ceilings would have to be inserted.

Such a comprehensive indexing system requires that the information flowing between the Pennsylvania Department of Transportation and the Pennsylvania General Assembly be increased in terms of both quantity and quality so that the annual legislative review and revision of such rates be carried on with greater confidence. An important part of such reporting would be the results of a road and bridge census recording not only type of road and mileage but also road and bridge conditions, the changes from the previous year, and cost information about making such changes. As noted, the MLF funds remitted to the local governments would be based on such information as well. Indexation can be implemented immediately, although the paper flow of information might take several years to fully implement.

2. The Structure of Highway Taxation

a) Issues

Under the consistent application of the benefit principle, each user should pay the costs he imposes by using the roads. An important implication of this principle is that users who more heavily depreciate or damage the roads or who require special construction (e.g., special passing lanes or heavy bridges) should pay higher transportation taxes. In a preliminary cost allocation study using the rates in force in early 1980,[1] the Commission discovered that trucks in general, and medium trucks in particular, do not pay their appropriate share and that automobiles, conversely, pay more than their share of user costs. The change in fees in SB10 went a considerable way in reducing this imbalance. However, serious problems of equity still remain in the determination of the proper allocation of taxes between different classes of vehicles.

Pennsylvania also currently exempts a significant number of organizations and classes of individuals from particular taxes and fees. The Commission believes that many such exemptions violate both equity and uniformity objectives of our tax system and that some of these exemptions are also abused.

b) Recommendations

(1) Relative Taxation of Different Classes of Vehicles

The Commission recommends that the relative taxation on various classes of vehicles reflect the relative costs of highways and bridges imposed by these vehicles. The Commission believes that the relative weights of the vehicles have the most important role in the setting of these rates along with the mileage per year of each vehicle.

This part of TRIP will take some time to implement. As the first step, it will be necessary for the Pennsylvania Department of Transportation immediately to carry out a full scale cost allocation study, based on the costing model now being developed at the U.S. Department of Transportation. From the results of such a study, plus an estimate of the fuel tax paid by various classes of vehicles, a schedule of registration fees could be determined which would bring the total highway costs and the total taxes of each class of vehicles into alignment. Such a tax system would mean that weight classes for automobiles would be established in the same manner as for trucks. This system further implies that an adjustment in current registration fees of different vehicle classes would have to take place, especially for light and heavy trucks.

For a number of taxes and fees on such highway vehicles as motorcycles, mobile homes, etc., the Commission believes that the tax structure should be overhauled and brought into accord with the user principles

[1] See *A Task Force Report to the Pennsylvania Tax Commission: Transportation Taxation*, (1981).

discussed above. Along with other transportation taxes, these should be indexed. This aspect of TRIP can only be implemented in the long-run.

(2) Special Problems of Truck Taxation

More attention must be paid to better auditing methods for obtaining taxes due from out-of-state trucks. The possibilities of replacing the current system of bilateral taxation agreements with particular states with a more multilateral system of truck taxation (e.g., joining such regional truck taxation agreements as the International Registration Plan) should be seriously investigated. Implementation of this aspect of TRIP requires a long term administrative effort on the part of the Pennsylvania Department of Transportation, and the Department of Revenue.

(3) The Tax Exemption System

The Commission believes that most of the tax and fee exemptions accorded to various organizations and classes of individuals should be phased out over five years. If it is felt desirable to continue the subsidy to certain organizations which they now receive by means of a fuel tax exemption, then such subsidies should be made directly via public expenditures.

To prevent diversion of fuels destined for off-highway farm vehicles to highway vehicles, a more effective monitoring system is necessary. This system would require the tax to be paid to the Department and then remitted to the taxpayer upon request. The taxpayer would be required to provide information on his farm acreage in order for the Department to check the reasonableness of the refund. This aspect of TRIP can only be implemented in the long run.

(4) Greater Emphasis on User Fees in General

The Commission believes that primary emphasis in a reformed system of highway taxation should be on fuel taxes and registration fees. However, it also believes that several additional measures should be taken that would increase the use of toll financing. First, the excess of revenues over expenses of the Pennsylvania Turnpike should be used to repair and maintain access roads to the turnpike. This would require the legislation to designate officially such access roads, a feature of TRIP that can be implemented quickly. Second, the Pennsylvania Department of Transportation should seriously investigate the possibility of introducing toll financing of maintenance and interest expenditures on current interstates which do not have such toll booths. This proposal raises some considerable problems since certain special agreements would have to be negotiated with the federal government. Implementation, if it is possible at all, can only be carried out in the long run.

(5) Collection Method

For the various fuel taxes, the Commission believes that whenever possible, they should be collected at a wholesale, rather than at a retail level to simplify administration.

3. The Proper Roles of State and Local Governments in Transportation Finance

a) Issues

The road network administered by the state includes not only routes passing through the entire state but many roads and highways that are primarily of local significance. Construction, rehabilitation, and maintenance of the state road networks are presently financed almost completely through the Motor License Fund, whose revenues derive from various user taxes and federal grants. This state road network of local roads is quite extensive. Since the state highway authorities believe that such roads can be maintained less expensively if placed under local control, they have attempted to turn back a significant portion of this network to local governmental authorities. This effort has proceeded far too slowly.

A second network of local roads is administered by various levels of local governments. Although these local governments receive considerable funds from the Motor License Fund to finance their maintenance and rehabilitation, the Commission found that the local governments also contribute over $350 million of their own funds, derived from real property and other local taxes. The Commission believes that this represents a serious breach of the user principle. Since payments from the Motor License Funds are insufficient to cover costs, the lack of enthusiasm of local governments for accepting any mileage from the network of state administered roads is quite understandable.

On the other hand, the Commission does not suggest 100% financing of local roads using state collected revenues. Efficiency and effectiveness of local road maintenance, repair and construction activities requires a significant local financial commitment. Without a commitment of local funds, incentives to minimize costs and maximize output are often lacking. The appropriate approach, therefore, is to expand reliance on the user-principle of finance for local roads, but not to eliminate the significant local general fund contribution to the endeavor.

b) Recommendations

(1) A New Formula to Allocate MLF Funds Between Governmental Levels

The Commission recommends that local governments be allocated a significantly higher percentage of funds from the Motor License Fund, and that the allocation formula be changed to reflect more accurately relative highway maintenance expenditures.

There are a number of criteria on which such a formula could be based, e.g., population, road mileage, square footage of bridges, type of road, vehicular travel, vehicle registration, maintenance costs, income, and so forth. An equitable formula would require certain cost information that is not now available and which would have to be made available through a

road and bridge census for the entire state. Since the problem of local financing of transportation expenditures is pressing, TRIP envisions a two phase process.

In the first phase, the Commission recommends that the formula for allocating MLF funds between the state and local governments be revised and be proportional to a weighted average of the road mileage in each system. An example of the manner in which the formula would work is presented in Section F below. The allocation of funds between the various local governments would follow the current percentage allocation now used, with adjustments being made to take into account the roads and their characteristics accepted by the local governments in the turnback program.

In the second phase, a more comprehensive allocation formula, based on actual costs, would be instituted, and would be used both for dividing funds between the state and local governments on the one hand and between the various local governments on the other hand. An example of how such a formula might work is also presented in Section F below.

The necessary road and bridge census would have to follow guidelines drawn up by the Pennsylvania Department of Transportation. Receipt of the additional transportation funds by the various local governments would be conditioned on their to following such guidelines. This new method of allocating the MLF funds would reverse the recent trend of local governments receiving an ever-declining share of the MLF for maintenance expenditures, because state and local government receipts from the fund would grow together.

(2) Road Turnback

An essential part of TRIP is the streamlining of the work of the Pennsylvania Department of Transportation. An important step in this direction is turning back to local governments the local roads now under the jurisdiction of the Department. However, acceptance of such roads by local governments requires additional expenditures by the Department to bring the roads up to a proper standard.

Since TRIP forsees both higher MLF revenues and more revenues from the MLF flowing to the local governments, and since the formula for allocation between the state and local government is based on relative road mileage, for each mile of road accepted from the state, local governments would receive even higher revenues. It is planned (see Section F. below) that the amount received per additional mile of road (roughly $8000 per mile per year) would cover not only the cost of maintenance but also a good deal of the necessary rehabilitation work as well.

Local governments would be eligible for these additional revenues only after signing a contract with the Pennsylvania Department of Transportation specifying a schedule for receiving these roads. This provides an incentive for the local governments to accept the roads. To insure equity in situations where the roads currently administered by the Department of Transportation are in particularly bad condition, the contracts would specify road conditions for which the state would agree to provide to the local governments additional funds, over a period of time, to rehabilitate these roads. It is expected that the Department would, on a sample basis, examine local performance to insure that funds were used effectively.

C. Mass Transit Finance

1. Mass Transit Subsidies

a) Issues

Mass transit systems throughout the nation have historically failed to meet their expenses from fare receipts. In Pennsylvania, roughly half of the operating budgets of the various mass transit authorities come from federal, state, or local governmental subsidies. In 1979, the state financed up to 2/3 of deficits incurred by these authorities after federal subsidies were subtracted from the overall deficit.

The advisability of subsidizing mass transit systems from state funds, when the primary beneficiaries of the program are those living in the area in which the systems are located, can be questioned. Such a program deviates from the principle of user payments that has been advocated for the highways. The Commission believes that continually rising transit subsidies from the state do not represent a proper future direction.

The state subsidies also have very unfavorable incentive effects, for they do not encourage the various transit companies either to operate more efficiently or to align fares closer to costs. To attack this problem, the General Assembly, in its 1980 session, passed Act 101 which provides state financing for up to 3/4 of these deficits after the federal subsidies are subtracted. However, any funds provided by the state over 2/3 of the deficit would be conditional upon the transit authority meeting certain conditions (e.g., the revenue/cost ratio could not decrease more than two percentage points, ridership per vehicle hour would have to increase, operating revenue per vehicle hour would have to rise, and operating costs per vehicle hour adjusted for inflation would have to decrease).

The Commission examined considerable data for Pennsylvania for the 1970s and found evidence that any open-ended approach gives little incentive to the transit authorities for efficient operations. Although Act 101 is a step in the right direction, it is awkward to administer. Further, the incentive to the local transit authorities to reduce costs is not very great.

b) Recommendations

(1) Restructuring the State Subsidy Formula

As part of TRIP, the Commission recommends that the new subsidy formula be restructured to offer more incentives to local transit companies to operate more efficiently. Such a subsidy would be a simple lump sum amount per passenger trip such that the combined state and federal subsidy would equal a given amount per trip. If the limit were set at 25 cents per (revenue) passenger trip and the federal subsidy were less than this, the state would subsidize the local transit agency so that the 25 cents per passenger trip limit would be met. This particular limit should be indexed to a

national cost index. It could also be easily raised or lowered by the General Assembly. A 25 cent limit would require state subsidies of $52 million. Each additional penny that would be added to this limit would require additional state subsidies of about $3.9 million (so that a 48 cent limit would require state subsidies of about $142 million which is approximately the level of current state mass transit subsidies).

Such a lump sum subsidy would provide a much greater incentive for local transit authorities to operate in an efficient manner than under current legislation. It would be more easily and less capriciously administered. This aspect of TRIP could also be quickly implemented once the General Assembly set the subsidy per revenue passenger trip.

(2) New Sources of Revenue

If it is felt necessary to subsidize the mass transit system, then it should be done from local funds. More specifically, the Commission recommends that mass transit agencies become the recipient of a regional income tax piggybacked on the state income tax already collected. In particular, the Commission recommends up to a 0.2% income tax on residents of the five county area including the City of Philadelphia which would be enacted by the Legislature and the proceeds turned over to the Southeastern Pennsylvania Transit Authority (SEPTA) and certain other authorities in the five county area. The Commission also recommends that consideration be given to extending this revenue source to other regional transit authorities.

Formation of these special transit regions in other parts of the state to receive such revenues recommended by the Commission would require enabling legislation by the General Assembly. Implementation of this approach could, given the difficulties that would arise, take a considerable length of time. As a result, this does not represent a solution for the short-run financial problems now facing the local transit agencies.

2. Mass Transit and the Poor

a) Issues

An important aspect of mass transit is its implicit impact on the distribution of income. The poor use mass transit disproportionately more than other income groups. To the extent that mass transit fares must rise, the poor will be relatively more disadvantaged than other income groups unless contravailing measures are taken.

b) Recommendations

As part of TRIP, the Commission recommends a second subsidy to mass transit, namely a targeted welfare subsidy that would permit poor people to pay transit fares at reduced prices, in the same manner that food stamps allow the poor to purchase food at prices lower than the market level. If the subsidy was 50% of the current fares, and if all current transit riders with incomes below the poverty line obtained such assistance, this would amount to about $25 million. If each transit company raised its fare to obtain the additional $25 million in revenues, low income riders would end up with lower out-of-pocket expenditures on mass transit. Such a system would make it easier for mass transit companies to raise their fares to cover costs because a larger share of the burden would be shifted to middle and high income riders than would occur under the present system.

Such a system of targeted mass transit subsidies can be administered in several different ways. Determination of eligibility in programs designed to aid low income families is already carried out by those administering the food stamp program. This food stamp program could actually sell transit stamps along with food stamps, or the mass transit company could give reduced fares upon presentation of the card specifying eligibility to the program, as determined by the food stamp administrators. Such a system would take a certain time to establish. Further, cost projections are difficult to make since the percentage of those eligible who would actually take advantage of the program cannot be easily estimated.

In light of the administrative problems in instituting such a program, the Commission recommends that one transit system be selected for a demonstration project integrating the food stamp program and the transit stamp proposal. This program could take advantage of the results of similar programs that have been established in other U.S. cities, and could develop administrative procedures for other Pennsylvania transit systems could adopt.

D. Other Transportation Taxes

The Commission believes that the user principle should be implemented in other fields of transportation. Such a restructuring of taxes would be a long term project, for a considerable amount of data would have to be collected before an efficient and equitable program could be proposed. The discussion below is based on estimates that are quite rough but which are the best currently available.

1. Air Travel

For air travel, the Commission notes that airports receive a direct net subsidy of about $7 million equal to the difference between tax receipts from airports and governmental expenditures to airports from state and local governmental agencies. In addition, airports receive a number of free public services, such as police protection and access routes to airports which are financed from the Motor License Fund. The total subsidy to airports is probably in the range of $15 to $30 million. Certain user taxes do come from airplanes, primarily a 1 cent tax on jet fuel and a 1.5 cent tax on other fuels. This is considerably lower than fuel taxes in some contiguous states. Although other user fees are imposed currently, they are difficult to change: landing fees are often settled between airports and airlines on thirty year contracts, and airport taxes on passengers are not presently legal.

The Commission believes that the tax on air fuels should be significantly raised. If such tax rates were brought completely up to the same level as the taxes on automobile fuels, it would yield about $25 to $30 million. Taxes would be collected at the pump for locally based planes and on the basis of fuel used in traveling and landing in Pennsylvania by out-of-state commercial places (in the same manner as gasoline taxes and sticker fees are collected for out-of-state trucks). These funds would be remitted back to the airports. However, in return, airports would no longer receive state or local subsidies, and they would have to pay for the municipal services which they now receive without change. Further, building and repairing access roads to airports would also be financed from this fund. Such a change in the system would serve three purposes: it would move toward unifying all fuel taxes, it would put the airports on the same user-financed basis as the highways, and it would also act as a disincentive to the most fuel using mode of passenger transportation.

2. Water Transportation

The system of marine transportation taxes has many anomalies. The Commission believes it useful for a full scale study to be made to determine all of the costs associated with the construction and maintenance of our waterways and dock areas, and to determine the relative usage by various classes of boats and ships.

E. Administration of Taxes and Expenditures

The deliberations and analyses of the Commission were impeded by the paucity of data that would permit detailed recommendations on transportation taxes and expenditures. As part of TRIP, the Commission recommends that the state place more effort in its current (and laudable) drive to upgrade its statistical reporting system in the field of transportation. The Commission believes that the Pennsylvania Department of Transportation should carry out a number of detailed cost allocation studies for various transportation facilities (highways, airports, waterways), and keep such studies up-to-date so that the tax system can be adjusted in a systematic fashion when necessary. The Commission also believes that with a more adequate statistical reporting system, the transportation authorities can base their investment decisions on detailed benefit/cost analyses. Conclusive evidence is available that a number of highways currently planned by the Pennsylvania Department of Transportation, but which have not yet been constructed, have benefit/cost ratios considerably lower than unity. The Commission believes that compelling reasons must be demonstrated to justify building facilities with benefit/cost ratios less than unity.

F. Explanation of Alternative Methods of Allocating Motor License Fund Receipts between State and Local Governments

Under the present program, the local governments receive directly 1/2 cent per gallon of the taxed motor fuels sold. In addition, they receive from the Motor License Fund a specified amount per gallon of motor fuels sold from the funds sent to the Motor License Fund. The share of the total funds going to the local governments has declined steadily over the last five years.

The funds received by the local governments are divided according to a formula based 50% on the mileage of roads under the control of the local government and 50% on the population of the local unit.

The proposed allocation system under TRIP would change this system. During the transition period, state and local governments would divide all of the user fund revenues in proportion to the mileage of roads under their respective control, adjusted by a particular weighting factor. An illustration of this formula is presented in Table IV.2. It should be emphasized that this formula would be used only for the initial division of funds between state and local governments, and not between local governments during the transition period. The weighting in the proposed formula would take into account two considerations: recognition that maintenance costs of local governments for a given type of highway are lower because they do not need to meet certain standards, and recognition that the local governments are expected to meet certain expenditures for road maintenance and construction from local tax sources.

1. Phase I: TRIP during Transition Period

The amounts specified in TRIP are presented in Table IV.2. The proposed plan has the following features during its transition period:

a) All user fees collected by the state government should be placed in the MLF. This would include the taxes on motor fuels flowing directly to the state governments plus the additional $170 million of user charges which the Commission has proposed.

b) The basic division of the MLF should be made on the weighted average of road miles administered by the various levels of government (see Table IV.3). It is important to realize that with the road turnback program, the formula means that the local governments obtain a larger share of the MLF. Under TRIP, Table IV.3, the local governments receive $97 million ($8034 per mile) for the roads which are turned back. In addition to this, they receive $85 million from the additional taxes. These funds

Table IV.2

Projections for Fiscal 1980-81 (Million Dollars)[1] Under TRIP

	Governmental Level		
Current Situation	*State*	*Local*	*Total*
Current Situation			
Expenditures from MLF funds	$ 985	$103	$1088
Expenditures of motor fuel taxes going directly to local governments	0	27	27
Total	985	130	1115
Under TRIP			
MLF funds from current taxes			1088
Addition to MLF funds from funds previously going to local governments			27
Addition to MLF funds from new taxes of TRIP			170
Total			1285
Expenditures from MLF under TRIP formula (no road turnback)	1070	215	1285
Expenditures from MLF under TRIP formula (complete road turnback)	973	312	1285

[1] Data are based primarily on estimates in *Governor's Executive Budget 1980-81* (Harrisburg, 1980). Division between state and local government based on calculation made in Table IV.1.

Table IV.3

Examples of Sharing of Motor License Funds Using the Proposed Transition Formula[1]

Part A: No Road Turnback

Road Administrator	*Mileage*	*Weight*	*Adjusted Base*
Commonwealth:			
Interstate	1,154		
Arterial and ramps	13,265		
Collector	18,507		
Local	12,073		
Subtotal	44,999	1.0	44,999 (83.27%)
Local Government:			
Interstate	0		
Arterial	23		
Collector	2,896		
Local	68,602		
Subtotal	71,521	.1264	9,040 (16.73%)
Total	116,520		54,039 (100.0 %)

Part B: Road Turnback

Road Administrator	*Mileage*	*Weight*	*Adjusted Base*
Commonwealth:			
Interstate	1,154		
Arterial and ramps	13,265		
Collector	18,507		
Local	0		
Subtotal	32,926	1.0	32,926 (74.1 %)
Local Government:			
Interstate	0		
Arterial	23		
Collector	2,896		
Local	80,675		
Subtotal	83,594	.1264	10,566 (25.9 %)
Total	116,520		43,492 (100.0 %)

[1] The highway mileages were obtained from Pennsylvania Department of Transportation and differ somewhat from the data reported in Department of Transportation, *Highway Statistics 1978* (Washington, D.C., 1979). The weight is set by the General Assembly and is a crucial determinant of the share of the local governments in the MLF. The given weight of .1264 is consistent with the TRIP proposal discussed in the text. The adjusted base is the miles of road multiplied by the weight.

would be divided under the present percentage distribution. The local governments could use these funds from the MLF for maintenance, rehabilitation, or capital expenditures for highway construction.

c) Particular local governments would receive only 5% more than their present receipts from the MLF and the 1/2 cent per gallon tax, unless they would contract with the Pennsylvania Department of Transportation to the following conditions:

(1) They would conduct an inventory of the roads and bridges (and the quality of these facilities) under their administration following the guidelines set up by the Pennsylvania Department of Transportation.

(2) They would make estimates of the relative costs of maintaining lane/miles of the various types of roads and square yardage of bridge surface, to be used in the aggregate weighting formula to be developed.

(3) They would agree to accept the 12,073 miles of local roads presently the responsibility of state government, and to maintain that portion of these roads whose condition is above a standard set by the Department of Transportation. For those roads below this standard, the Department of Transportation would sign a long term contract to provide a portion of the funds for such rehabilitation.

Table IV.4

Two Illustrative Projections of Receipts from Motor License Funds (Million Dollars)[1]

Assumption A

	State	*Local*	*Total*
1980/81 No Turnback	$1070	$215	$1285
1985/86 No Turnback	1646	331	1977
1980/81 Turnback	973	312	1285
1985/86 Turnback	1497	480	1977

Assumption B

	State	*Local*	*Total*
1980/81 No Turnback	$1055	$160	$1215
1985/86 No Turnback	1623	246	1869
1980/81 Turnback	981	234	1215
1985/86 Turnback	1509	360	1869

[1] Assumption A: The full $170 million of TRIP is enacted and the revenues are split $85 million for the state and $85 million to the local governments. The weight in the formula for local road mileage is .1264.

Assumption B: Only $100 million of TRIP is enacted and the taxes are split $70 million to the state and $30 million to the local governments. The weight in the formula for local road mileage is .0954.

The 1985/86 projections were made by assuming a 9% annual increase in costs which are reflected in receipts. This is slightly lower than the more careful figure cited in the text in the revenue projections.

Table IV.5

Road and Revenue Turnback under TRIP: Final Phase

Road Administrator	*Mileage*	*Relative Costs*	*Weight*	*Adjusted Base*
State Government:				
Interstate	1,154	1.00	1.0	1,154
Arterial and ramps	13,265	.44	1.0	5,837
Collector	18,507	.38	1.0	7,033
Local	0	.16	1.0	0
Bridge Surface (1000 sq. yards)	3,000	.88	1.0	2,640
Subtotal			(75.72%)	16,664
Local Government:				
Interstate	0	1.00	.3586	0
Arterial	23	.44	.3586	4
Collector	2,896	.38	.3586	395
Local	80,675	.16	.3586	4,629
Bridge Surface (1000 sq. yards)	1,000	.88	.3586	315
Subtotal			(24.28%)	5,343
Total			(100.0 %)	22,007

Notes:

1. The exact amounts of square yardage of the bridges in the state are not known. The data in the table are merely for illustrative purposes. In the final formula, it would be useful to separate bridges of different lengths.

2. The relative cost includes maintenance and rehabilitation. An index similar to that used in Pennsylvania Statute 1980-68 (SB-10) which includes average maintenance costs per lane mile for that type of road or bridge, a snow index which influences maintenance expenditures in particular counties, a traffic volume index, and a relative pavement quality index. The importance of these various factors must be determined by means of a cost analysis carried out by the Department of Transportation. The relative pavement quality index would take into account both higher maintenance costs for poor quality roads plus rehabilitation costs. However, to receive the latter, a schedule for improvement would have to be approved by the Department of Transportation.

3. The weight plays the same role as the weight in Table IV.1. The end result of the weight is to determine the share of the MLF received by the various levels of government. When transition is made to the usage of this more complete formula, the weight will be set so that the local governments will be receiving the same share of the MLF that they did when the mileage criterion was used.

4. The adjusted base is calculated by multiplying the total mileage or square yardage of bridges times the relative costs time the weight.

2. Implications

In Table IV.4, certain projections are made of the MLF funds that can be used by the state and local governments under two assumptions about the tax package which is passed by the General Assembly and under two assumptions about whether local roads are turned back.

3. Phase II: Road and Revenue Turnback under TRIP

After the Department of Transportation has conducted a full cost study, the formula for distribution of funds can be made more equitable by taking into account the different mix of roads and bridges administered by local governments, the condition of these facilities, the amount of traffic on these facilities, and the snow fall in the county. An example is given in Table IV.5. Such a formula would be an elaboration of a formula in Act No. 1980-68.

Section V.
State Taxation of Business

A. General Issues Related to Pennsylvania Business Taxes

The taxation of business in Pennsylvania has evolved in a haphazard fashion over the years. Three types of major business taxes are levied at the state level: a profits tax, a series of property or wealth taxes, and several different taxes on the gross economic activity of certain businesses. In addition, there is a tax levied on the value of certain corporate indebtedness. The Commission believes that like individuals, business deserves to be treated on a predictable, equitable and uniform basis.

Several current business taxes, however, are seriously deficient in relation to these goals of a good tax system. For example, the taxation of the capital value of firms has been criticized by this and earlier tax commissions for a number of reasons.[1] Irrespective of the profitability of such firms (which is the analog to an individual's ability to pay), a tax liability can be incurred under the Capital Stock and Franchise Tax. For new firms or firms thinking about locating here, such taxation of their capital value is disadvantageous for they incur tax liabilities even though they lack the net income to pay such taxes. In periods of rapid inflation as experienced over the past decade, valuation becomes extremely problematical, and administration of it becomes very difficult. It is estimated, for example, that better than 60% of the Department of Revenue's legal staff work on issues related to the Capital Stock and Franchise Tax, yet the tax raises less than 10% of all revenues at the state level. Thus, such a tax violates the principles of administrative simplicity and certainty outlined earlier. Moreover, the tax does not directly relate to either the firm's ability to pay, nor to the benefits enjoyed by a firm in terms of state services.

The taxation of business in terms of the extent of its business activity or sales may be criticized on similar grounds. Gross activity without regard to profit or loss is at best an indirect measure of ability to pay and again bears little relation to benefits received from the state. The Commission believes that major improvements in the long range tax climate in the state can be achieved through adoption of the principle of income taxation rather than the taxation of business capital or taxation of the gross amount of economic activity undertaken by a business.

The recommendations for the taxation of business are described below in terms of the types of industries which are currently taxed differentially, but which, under the Commission's recommendations, would be taxed uniformly under a single business tax on income, to the extent possible, and consistent with the overall revenue needs of the Commonwealth to provide essential state services. The recommendations strive not only to provide greater fairness and certainty to Pennsylvania's business tax climate within the confines of an equitable tax system, but also strive to maintain the balance in taxation discussed in Section I.D.2 of this *Report.* The underlying purpose of the recommendations is to improve the capability of the Commonwealth to attract and retain business activity and thereby provide for more jobs while at the same time not changing the general level of business taxation.

B. Recommendations with Regard to Taxation of Small Business and Large Business

Throughout the Commission's public hearings, the Commission heard repeated testimony about the high statutory rate of tax imposed on corporate net income. Under current law, Pennsylvania's tax rate on net income of corporations is 10.5%, the third highest statutory tax rate of any state in the country.[2] For firms headquartered outside the state considering expansion in Pennsylvania or in competing states, this high statutory rate of taxation has frequently been cited as a major impediment, if not psychological barrier, to seriously considering Pennsylvania as a place to expand. For firms already in the state, the high rate and uncertainty over whether it would be retained permanently or not has also been cited as a disadvantage to the state's economic development. The Commission has found that this high statutory rate of tax is, to a considerable extent, offset by more favorable local tax treatment of business in Pennsylvania than in other states.

Of 12 major industrial states which compete with Pennsylvania for jobs and industry, based on state taxes alone, Pennsylvania has the second highest effec-

[1] See, for example, Tax Study Committee, *The Tax Problem* (1955), *Report of the Tax Policy Advisory Committee* (1956), Tax Study and Revision Commission, *Final Long Range Report* (1968), Task Force on Fiscal Policy, *Final Report* (1970).

[2] Minnesota imposes a 12% corporate income tax, and Massachusetts an effective rate of 10.83%.

tive *state* tax rate. Pennsylvania, however, was ranked 9th out of 12 states in the level of *local* taxes. *Combining* state and local taxes, Pennsylvania ranks 5th, in terms of effective tax rates, and is therefore more competitive than a simple comparison of state, statutory tax rates would suggest.

Also, Pennsylvania's corporate tax structure contains several tax advantages for various types of business. Manufacturers enjoy an exemption from the Capital Stock and Franchise Tax on assets used in the manufacturing process. Intercorporate dividends are exempt from taxation, and corporations are not required to report income on a consolidated basis. Without commenting on the wisdom of these features of current law, the Commission feels they nonetheless do make Pennsylvania attractive for many types of business.

Further, the Commission, through its investigations, has found that taxes are not the key determinant of industrial location. Many other factors such as labor costs, labor climate, unemployment and workmen's compensation costs, transportation and energy costs, also weigh heavily in the business decisions to expand or relocate. In fact, the Commission expressly rejected the option of injecting numerous incentives, preferences, and credits into the state tax structure to lure business to Pennsylvania. The state does not need tax "gimmicks" to attract and keep jobs. What is required is a stable and predictable basic tax structure which is fair and equitable, and encourages the formation of small and new business enterprises.

Nonetheless, the Commission believes that the current high statutory CNI rate is an important psychological barrier to economic development. Unfortunately, many firms considering location decisions do not look beyond the high statutory rate to Pennsylvania's other considerable attractions.

Under current law, the corporate net income tax rate is to revert from 10.5% to its previous rate of 9.5%, and the personal income tax is to revert from 2.2% to its previous rate of 2.0% after December 31, 1982. Thus, legislation which would continue the rates at 10.5% and 2.2% would amount to a statutory tax increase. While the Commission has assumed, for the purpose of its analysis of various business tax reforms below, that the rate is 10.5%, principally to insure that overall revenue needs of the Commonwealth and the current balance of taxation be retained, the Commission believes that an important long-run objective of business tax policy in Pennsylvania must be a reduction of the statutory corporate net income tax rate to one more in line with competing industrial states. Thus, to the extent that future growth in aggregate revenues in the state make reductions in statutory rates possible, the Commission believes that high priority be given to reducing the CNI tax rate in order to promote job creation through economic development.

With respect to the Capital Stock and Franchise Tax, the above criticisms argue ultimately for its abolition. However, the attending loss of revenue in excess of $250 million is too large to be financed realistically through other taxes on business, in light of the need to lower the corporate net income tax rate in the long run and the Commission's mandate to maintain the current overall balance of taxation.

The recommendations below are thus designed to reform the current Capital Stock and Franchise Tax and Corporate Net Income Tax and maintain the current levels of business tax revenues. In each of these taxes, the recommendations are designed to encourage the formation of small business and to improve the certainty and equity of the taxes.

1. Special Small Business Tax Reforms

The Commission recommends several changes to Pennsylvania's current business taxes which will be advantageous to small business.

First, the Commission recommends that federal tax treatment of net operating loss carryback and carryforward be made available to business in Pennsylvania.

In December 1980 the General Assembly adopted a phased-in 3 year carryforward deduction. Current federal law, however, allows a 7 year carryover and a 3 year carryback of net operating losses. The Commission recommends adoption of the full federal rule. Until the first year's corporate tax returns which show the schedule and history of deductions available to Pennsylvania corporations under the three year carryforward provision are filed, it is difficult to measure the cost of the Commission's recommendation. Based on historical data, it appears that the revenue cost of a 5 year carryover, in contrast to the legislated 3 year carryover, was $14 million at 1977 income levels.[3]

Second, the Commission recommends that small corporations be accorded federal Subchapter-S type tax treatment. Firms with 15 or fewer shareholders would be able to be taxed at the shareholder's individual income tax rate of 2.2% rather than at the corporate net income tax rate of 10.5% and otherwise follow federal rules. The Commission estimates that this will involve a reduction in revenue of $.5 million[4] at 1977 income levels.

Third, the Commission recommends that new firms not be taxable under the Capital Stock Tax until their third year of operation. It is recommended that rules be provided to properly define a new corporation to avoid abuse situations.

[3] Since prospective, three year carryforward is now a part of current Pennsylvania law, the Commission's estimate of the revenue loss of the full federal provision ($14 million) is an upper bound, since a part of the $14 million loss is now embodied in current law. Unfortunately, due to data limitations, the *incremental* cost of the recommendation could not be estimated. As a result, it would appear that the business tax reforms recommended could result in a net revenue gain, part of which could be used to offset other reforms suggested below for later consideration.

[4] In the opinion of practitioners, the current high corporate net income tax rate vis-a-vis the personal tax rate has probably encouraged most Subchapter-S firms to distribute income in the form of bonuses and wages prior to the determination of Corporate Net Income taxable income. The revenue estimate in the text is based on 1977 federal individual income tax returns which reported $5.6 million of small business income for Pennsylvania residents. On the other hand, if Pennsylvania's share of national Subchapter-S income is in proportion to Pennsylvania's share of total corporate income, then the revenue loss would be considerably higher. The estimate on this basis, which the Commission believes to be an upper bound, is $15 million.

2. The Capital Stock Tax

The Commission reviewed a number of alternative valuation methods for the Capital Stock Tax, and recommends that a fixed formula for the valuation of a firm's capital stock be adopted. Under the formula, the value of a firm would be determined on the basis of an average of apportioned historic earnings for six years, capitalized at 9.5% in conjunction with the current tax rate of 10 mills. The Commission believes that this formula will significantly reduce the controversy and uncertainty surrounding the tax, smooth out over the business cycle the tax burden for individual firms, and, in conjunction with forgiveness of any Capital Stock Tax for the first two years for new firms, encourage the creation of new firms in Pennsylvania.

3. The Corporate Net Income Tax[5]

Among the issues relating to the Corporate Net Income Tax, the Commission found the matter of clearly defining non-business income to be the most pressing. The Commission believes that the proper approach to the definition of income should be as broad a definition as possible in line with the trends in business taxation in other states. Therefore, the Commission recommends that the current distinctions between business and non-business income be altered. Under the recommendation, all income, after allowable deductions under current law of dividends and interest on federal securities, would be treated as business income, except gains from the sale or disposition of real or tangible personal property which is or has been used by the taxpayer in his normal line of business. Under this recommendation, certain gains (e.g., gains on the sale of intangible assets), and income attributable to net rents and royalties from real or tangible personal property, interest income (other than from U.S. securities) or royalties from patents and copyrights currently allocated, would be apportioned under the Corporate Net Income apportionment formula. Gains from the sale or disposition of real or tangible personal property which is or has been used by the taxpayer in his normal line of business would be allocated on a normal situs basis.

In the past decade, several states, most notably Massachusetts and New York, modified their apportionment formulas to double weight the sales factor. In contrast, under current law, the factors in the Pennsylvania apportionment procedures are given equal weight. The apparent objective of these actions was to increase the taxable income in the state of those, usually out-of-state firms which have a small physical presence in the state but significant sales activity.

The Commission believes that this practice of tax-exporting is objectionable, and recommends that the Commonwealth continue its current practice of giving equal weight to the apportionment factors in the formula. Moreover, to the extent possible, the Commission recommends that Pennsylvania encourage other states to adopt uniform apportionment procedures in order to prevent such inter-state tax competition.

[5] See also recommendations above under Special Small Business Tax Reforms.

4. The Corporate Loans Tax

The Corporate Loans Tax applies to all corporations doing business and having a resident treasurer or fiscal officer in Pennsylvania. It is a tax on obligations on which interest is paid if ownership or beneficial ownership is held by an individual Pennsylvania resident. The treasurer of the corporation assesses and withholds the tax from interest paid at a rate of 4 mills on each nominal value of script, bonds, certificates, and evidence of indebtedness. The tax imposes significant administrative burdens on both taxpayers and the Department of Revenue in relation to amounts collected (approximately $5 million). The Commission therefore recommends the elimination of the Corporate Loans Tax.

5. Revenue Implications and Transition Rules

The overall revenue implications of this series of recommendations for the Corporate Loans Tax, the Corporate Net Income Tax, Subchapter-S treatment, and the Capital Stock Tax are a net total balancing of revenue gains and losses at 1977 income levels.

At 1977 income levels, the total of final, settled Corporate Net Income Tax and Capital Stock and Franchise taxes was $1,009 million. Reforms to the Corporate Net Income Tax and Capital Stock and Franchise taxes, including full federal net operating loss carryover (see discussion above) yield $1,016 million. These reforms then permit the elimination of the Corporate Loans Tax ($5.0 million) and the provision of Subchapter-S treatment for small corporations ($.5 million).

The impact of the overall changes in the Corporate Net Income Tax and the Capital Stock and Franchise Tax are shown in Table V.1 at 1977 income levels. Based on data for 1977, the Commission finds that the overall industrial pattern of revenue changes is relatively smooth as a result of the changes in the Corporate Net Income and Capital Stock and Franchise taxes. Where changes are substantial, they result from the change in valuation technique for the Capital Stock and Franchise Tax. Earnings in the early 1970s, which are the averagable base which was capitalized, were less depressed than valuations accorded to firms as represented in the data base. With respect to the impact of the recommendations by tax payment class, the combination of recommendations provides tax decreases for small and large taxpayers, and modest tax changes throughout the remainder of the range of tax payment classes except for the $250,000-500,000 bracket, which experiences significant tax increases.

The Commission believes that it is essential that the reforms recommended adequately meet the overall revenue needs of the Commonwealth. Therefore, the Commission recommends that prior to adoption, more

Table V.1

Estimated Overall Impact of Commission Recommendations on Sum of Corporate Net Income and Capital Stock/Franchise Taxes by Industry and Tax Payment Class[3]

Industry[1]	*1977 CNI + CS/F*[2] *($ millions)*	*Commission Recommendations*[5] *($ millions)*
Chemicals	58	62
Construction and Wood	81	80
Food	37	40
Finance	57	57
Machinery	156	129
Mining and Metals	114	114
Miscellaneous	95	94
Retail	114	117
Services	82	83
Utilities	141	161
Wholesale	74	79
	1009	1016
Tax Class[4]		
Under $25,000	239	233
$25,000- 50,000	59	61
$50,000-100,000	79	77
100,000-250,000	113	118
250,000-500,000	94	135
500,000-1,000,000	95	86
1,000,000-2,000,000	73	78
Over $2,000,000	257	228
	1009	1016

[1] For exact Standard Industrial Code Groupings, see Appendix C.

[2] Figures are in millions of 1977 dollars. Current law, final, settled, Capital Stock/Franchise Tax payments totalled $289 million in 1977; current law, final, settled, Corporate Net Income Tax Payments totalled $720 million in 1977.

[3] Source: Commission Simulations of Pennsylvania Corporate Tax Model.

[4] Firms are classified on the basis of the sum of their final, settled Corporate Net Income Tax and Capital Stock/Franchise Tax payments with respect to 1977 estimates of current law liabilities.

[5] Recommendations shown are the simultaneous effects of providing federal tax treatment for net operating losses, apportioning non-business income except certain gains which are allocated, and provision of a fixed formula for the Capital Stock Tax. Resulting Capital Stock/Franchise Tax payments total $322 million; Corporate Net Income Tax payments total $694 million.

recent data be employed to test out the implications of these charges to both the Corporate Net Income and Capital Stock and Franchise taxes. In this connection, the Commission recommends that the data collection and computer modelling of business taxes in Pennsylvania, undertaken by the Department of Revenue for the Commission, be continued and become a permanent part of the Department's analytical effort.

To ease the impact of these recommendations, the Commission recommends that a transitional period of three years be provided for the implementation of the fixed formula of the Capital Stock Tax, during which the taxpayer would pay a weighted average of the taxes due under the old rules and new rules. In the first year, a 2/3 weight would be put on the estimated Capital Stock and Franchise Tax under the old rules. In the second year, 1/3 weight would be put on the tax determined under the old rules. In the third year, the new rules would be entirely in effect. In this way, the Commission believes that a reasonable transition can be achieved to the new, fixed formula.

6. Other Recommendations for Later Consideration

The above recommendations represent changes to the state's business taxes which will most readily improve the fairness of the system, encourage the development of business in the state, and reduce the uncertainty and administrative complexity for both the Department of Revenue and taxpayers. There are additional changes in business taxes which the Commission believes have significant merit and should be considered. However, because of the size and uncertainty of the revenue impact of the reforms, they are recommended for a second stage of business tax reform.

Recommended changes for the second stage of business tax reform would require the following:

a) Legislation to insure that the practice followed prior to the issuance of the Attorney General's opinion 78-0111 be continued; that any corporation (domestic or foreign), including one with all of its activities in Pennsylvania, be entitled to use the three-factor formula for computing its manufacturing, processing, and research and development activities for Capital Stock and Franchise tax purposes.
b) Legislation to indicate clearly that dividends and interest on U.S. securities are not to be included in the sales factor of the apportionment formula for the Capital Stock and Franchise taxes and therefore put it on the same basis as that for the Corporate Net Income Tax.
c) Legislation to require that all state and local taxes based on income be added back to Pennsylvania income prior to apportion in lieu of the current practice of adding Pennsylvania CNI after apportionment.
d) Legislation to eliminate the current throw out rule pertaining to the sales factor in the corporate net income apportionment fraction.
e) Legislation to eliminate the current addback of items of federal tax preference in defining the Pennsylvania Corporate Net Income tax base.

C. Recommendations with Regard to the Taxation of Financial Institutions, Insurance and Utility Companies

1. Financial Institutions

The Commission recommends that all financial institutions be taxed on their "excise income", without deduction for federal income taxes paid, rather than under the four special state-wide taxes presently imposed upon the various types of financial institutions. The four present taxes are the Bank Shares Tax imposed upon the shares of commercial banks, an almost identical tax imposed upon the shares of title insurance and trust companies known as the Title Insurance and Trust Companies Shares Tax, a gross-receipts tax imposed on private banks known as the Tax on Private Bankers, and the Mutual Thrift Institutions Tax imposed on the net income of savings banks and savings and loan associations. None of the institutions subject to these special taxes is subject to the Pennsylvania corporate taxes of general application — the Corporate Income Tax and the Capital Stock Tax. Under the Commission's recommendation, federal and state chartered credit unions would be exempt from the excise income tax because federal credit unions are exempt from virtually all state and federal taxes under federal statute. Any attempt to tax the income of only state chartered credit unions would result in those credit unions converting to federal charters.

The recommendation for an excise income tax is consistent with the overall goals of the Commission for Pennsylvania's tax system. A majority of states already subject banks to an income tax and most of these use an excise income tax. Pennsylvania already imposes an excise income tax on savings banks and savings and loan associations. However, under the present system, savings banks and savings and loan associations are permitted to deduct from taxable income federal taxes paid. This results in reverse revenue sharing, which the Commission believes is unwarranted, and lowers the effective rate levied on net income before taxes. For example, if an institution's federal tax is 30% of net income, and the state tax rate is 10%, the effective state rate is only 7% after deduction of federal taxes paid.

It is further recommended that the exise income tax include income from both federal and state obligations in its base. Excluding federal obligations would result in reverse revenue sharing. Excluding state and local obligations costs Pennsylvania far more in lost tax revenues than is saved through lower interest rates on tax-exempt obligations. The gain in revenue to Pennsylvania clearly would exceed the increase in interest costs because financial institutions pay federal income tax. In arriving at federal taxable income, financial institutions deduct state and local taxes paid. Imposition of state taxes on interest from state and local obligations reduces the federal tax base. For an institution facing the top bracket, 46% federal corporation income tax rate, payment of state taxes costs net only 54 cents on the dollar. Thus, a pretax yield of 7.4% on a state or local obligation taxed at 10% by the state would produce a net yield after both state and federal taxes of 7%. The bond income of $7.40 results in 74 cents of tax paid to the state. While the $7.40 of income is not taxed at the federal level, the 74 cents tax paid to the state is deductible from other income on the federal return, protecting 74 cents of other income from tax at 46%, and resulting in a tax savings of 34 cents. As a consequence, $7.40 of income less 74 cents of state tax plus 34 cents of tax saved results in an effective net income of $7.00 to the financial institution on the state or local obligation. Therefore, denial of state tax exemption for state and local obligations would raise the state's interest cost by only 40 cents per year per $100 of debt, while increasing tax revenues by 74 cents. In fact, the margin earned by the state in additional tax revenues may be even greater, because state and local obligations are widely held by non-corporate entities, such as individuals, estates and trusts. The proposed excise income tax would not reduce the effective after tax return to such entities. As a consequence, the rise in bond rates may be imperceptible.

In light of the above considerations, approximately 25 states provide for including in the taxable income of financial institutions interest on obligations of the taxing state and its subdivisions, as well as the obligations of all other states. At present, Pennsylvania taxes savings banks and savings and loan associations. Finally, it is neither equitable nor economically efficient to confer complete exemption to financial institutions that specialize in government securities when other financial

Table V.2

Historical Comparison Between Bank Shares Tax and Proposed Excise Income Tax
($ thousands)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Year	*Banks' Net Income*	*Bank Shares Tax Revenue*	*Equivalent[1] Excise Tax Percentage*	*Projected[2] Excise Income Tax Revenue*	*EIT[3] Marginal Increase in Revenue*	*Federal[4] Tax Saved by Marginal Increase*	*EIT[5] Increased Tax Cost to Banks*	*EIT[6] Percentage Increase of Tax Cost to Banks*
1973	$528,891	$47,737	9.02%	55,534	7,797	3,587	4,210	8.82
1974	524,335	49,729	9.48	55,055	5,326	2,450	2,876	5.78
1975	470,700	44,031	9.36	49,423	5,393	2,481	2,912	6.61
1976	491,111	43,681	8.89	51,567	7,886	3,627	4,259	9.75
1977	545,222	56,883	10.43	57,248	365	168	197	0.35
1978	691,770	58,707	8.49	72,636	13,929	6,407	7,522	12.81
1979	659,100	50,600	7.68	69,206	18,605	8,559	10,046	19.85

[1] Col. (1) ÷ Col. (2)
[2] Col. (1) x .105
[3] Col. (4) - Col. (2)
[4] Col. (5) x .46
[5] Col (5) - Col. (6)
[6] Col. (7) ÷ Col. (2)

institutions making substantial business, consumer, and mortgage loans pay substantial amounts of tax on earnings from those loans. Therefore, the excise income tax should be imposed on all sources of income.

In addition, the change to an excise tax system must provide a transition provision for taxation of such government obligations in order to protect the reasonable expectations that financial institutions had when they purchased their present portfolios of tax-exempt obligations. Such a transition provision could be on the basis of either providing a permanent exemption from income tax expressly limited to interest earned on state and local obligations held by financial institutions on a certain date, or a gradual phase-in over a period of years of taxation of the interest earned on such obligations. In order to insure the adequacy of state revenues, the transition provision should provide that an institution's tax, for so long as the transition provision is applicable, would not be less than the lesser of what would be due either under the Bank Shares Tax Act, or under the proposed excise income tax system including income from all state and local obligations without exemption. In the interest of uniformity, the transition provision should be available to all financial institutions.

Even though it is now possible for Pennsylvania to tax out-of-state financial institutions doing business in Pennsylvania, it is the recommendation of the Commission that such action not be taken. To do so requires an expansion of the standard concept of doing business, which, while constitutionally permissible, raises difficult questions of allocation of income among states. It is likely that this topic will be acted upon by Congress in the near future.

It is the further recommendation of the Commission that financial institutions be exempt from the capital stock tax. Tables V.2 and V.3 show that placing financial institutions on an excise income tax basis will, if enacted without a transition period, increase state revenues from financial institutions by about $20 million or 25%. If the Capital Stock Tax also were levied on financial institutions, revenues would increase by an additional $50-60 million per year for a total percentage increase for financial institutions of close to 100%. Even after taking into account the maximum possible federal taxes saved, the effective increase in state tax cost to financial institutions would exceed 50%.

2. Insurance Companies

With regard to the taxation of insurance companies, the Commission has seriously considered the elimination of the gross premiums tax, and the replacement of it with both the same generic excise income tax applied to financial institutions and the capital stock tax generally applied to business. Table V.4 shows that even with application of both general business taxes, the revenue loss to the Commonwealth would be in excess of $100 million, more than a 70% reduction of present insurance company taxes.

At present, insurance companies in Pennsylvania are subject to the insurance premiums tax imposed on gross premiums received. As with financial institutions, insurance companies are not subject to either the Capital Stock Tax or the Corporate Net Income Tax. The gross premiums tax is the most important and basic form of insurance company taxation in the United States. Pennsylvania has applied a gross premiums tax in various forms since 1873. Because of these considerations, as well as the substantial revenue loss that would result from application of an income tax, it is the recommendation of the Commission that the present gross premiums tax on insurance companies be retained.

Table V.3
Historical Comparison Between Mutual Thrift Institutions Tax and Proposed Excise Income Tax ($ thousands)

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Year	*Thrifts' Net Income*	*Mutual Thrift Institutions Tax Revenue*	*Equivalent*[1] *Excise Tax Percentage*	*Projected*[2] *Excise Income Tax Revenue*	*EIT*[3] *Marginal Increase in Revenue*	*Federal*[4] *Tax Saved by Marginal Increase*	*EIT*[5] *Increased Tax Cost to Thrifts*	*EIT*[6] *Percentage Increase of Tax Cost to Thrifts*
1973	157,921	12,900	8.17	16,582	3,682	1,694	1,988	15.41
1974	126,551	13,200	10.43	13,288	88	40	48	0.36
1975	121,960	8,100	6.64	12,806	4,706	2,165	2,541	31.37
1976	185,696	10,800	5.82	19,498	8,698	4,001	4,697	43.49
1977	259,727	19,100	7.35	27,271	8,171	3,759	4,412	23.10
1978	299,927	23,600	7.87	31,492	7,892	3,360	4,262	18.06
1979	255,137	25,400	9.96	26,789	1,389	639	750	2.95

[1] Col. (1) ÷ Col. (2)
[2] Col. (1) x .105
[3] Col. (4) - Col. (2)
[4] Col. (5) x .46
[5] Col (5) - Col. (6)
[6] Col. (7) ÷ Col. (2)

Consistent with the broader goals for Pennsylvania's tax system, the Commission reviewed the current exemption from taxation for Blue Cross, Blue Shield, health maintenance organizations and fraternal benefit organizations. The Commission finds that these non-taxed health plans and organizations compete with other insurance companies who are subject to taxation.

On the other hand, unlike other private health insurers, these non-taxed organizations provide insurance to individuals who may not be able to obtain coverage from the private sector, or provide coverage at preferential rates to low income or high risk individuals. Organizationally, they resemble the mutual insurance companies. Individuals subscribe to the various packages of insurance available on the basis of their preference for the various coverages and costs of those coverages. Taxation of only some of the direct competitors in the industry raises serious questions of tax equity unless the tax exemption is provided in tandem with public services which the taxable sector would not as a matter of course provide.

By taxing all competitors equally, the burden of taxation could be spread fairly among all competitors, and all consumers of insurance would bear the same indirect tax costs as their neighbors; however, it is likely that taxation of currently exempt forms of insurance would require, as a matter of equity, that they be freed of their current obligations, under law, which are not required of other health insurance carriers. While an increasing number of states have decided to tax Blue Cross/Blue Shield, the Commission does not recommend their taxation at this time. Table V.5 displays the impact of taxation of Blue Cross/Blue Shield, and indicates the overall gross premiums rate could be reduced to 1.6% and total revenues maintained.

Finally, it is the recommendation of the Commission that Pennsylvania eliminate the earmarking of taxes paid by foreign fire and casualty insurance companies for special use for firemen's and police pension, retirement and disability purposes, and that the Legislature fund such benefits from the general fund. Although it is no doubt important for firemen and police to have such benefits, sound fiscal practices dictate that the benefits be funded from general revenue funds instead of earmarked tax revenues. Such earmarking hampers effective budgetary control, leads to misallocation of total revenue, makes for an inflexible revenue structure and removes a portion of revenues from the control of the Commonwealth's legislative and executive branches. In addition, to the extent that the earmarked tax revenue becomes insufficient to provide the special benefits, pressure mounts to expand the earmarking of tax revenues and/or to increase the rate of the tax which provides the earmarked revenue. This is inconsistent with the fundamental goals of the Commission for Pennsylvania's tax system.

Table V.4

Historical Comparison Between Insurance Company Gross Premiums Tax and Proposed Excise Income Tax Plus Proposed Capital Stock Tax ($ thousands)

Year	(1) *Insurance Company Net Income Allocated to PA*	(2) *Gross Premiums Tax Revenue*	(3) *Equivalent[1] Excise Tax %*	(4) *Projected[2] Excise Income Tax Revenue*	(5) *Insurance Company Federal Tax Allocated to PA*	(6) *PA[3] Book Income*	(7) *Last 6 Years Average Income*	(8) *Projected Capital Stock Tax Revenue*	(9) *Projected[4] Total Revenue to PA*	(10) *Decrease[5] in Revenue to PA*
1968	$124,193				$ 61,410	$ 62,783				
1969	130,021				64,492	65,529				
1970	137,848				65,228	72,620				
1971	190,440				88,136	102,304				
1972	235,530				108,560	126,970				
1973	231,770	$ 79,949	34.50%	$24,336	106,628	125,142	$ 92,558	$ 9,256	$33,592	$ 46,357
1974	201,148	86,580	43.04	21,121	94,576	106,572	99,856	9,986	31,107	55,473
1975	198,644	91,923	46.28	20,858	93,104	105,540	106,542	10,653	31,511	60,412
1976	246,147	113,548	46.13	25,845	110,778	135,369	116,698	11,693	37,543	76,005
1977	260,582	132,342	50.79	27,361	117,275	143,307	123,817	12,382	39,743	92,599
1978	275,018	147,778	53.73	28,877	123,772	151,246	127,836	12,786	41,663	106,115
1979	289,453	161,101	55.66	30,393	130,268	159,185	133,537	13,354	43,747	117,354

Note:

The figures in Table V.4 have been difficult to compile because of difficulty in acquiring the amount of federally tax exempt income earned by insurance companies. Based on a very limited sampling an estimate of tax exempt income has been made resulting in United States Taxable Income reported by insurance companies being increased by 1.1%. The validity of this percentage is in question.

In any case, because of the federal definition of income differing for mutual as compared to stock life insurance companies, several mutual life insurance companies will pay more tax to Pennsylvania under the proposed system than under the current gross premiums tax.

[1] Col. (2) ÷ Col. (1)
[2] Col. (1) x .105
[3] Col. (5) - Col. (1)
[4] Col. (4) + Col. (8)
[5] Col. (2) - Col. (9)

Table V.5

Historical Comparison Between Present Insurance Company Gross Premiums Tax and Impact of Inclusion of Presently Exempt Organizations Under Gross Premiums Tax ($ thousands)

Year	(1) Gross Premiums Tax Revenue	(2) Gross Premiums Blue Cross/ Blue Shield	(3) Gross Premiums Fraternal Orgs.	(4) Gross Premiums Health Maint. Orgs.	(5) Gross[1] Premiums All Exempt Orgs.	(6) Projected[2] Increase in Revenue to Pennsylvania
1973	79,949	846,777	35,529		882,306	17,646
1974	86,580	941,584	36,454		978,038	19,560
1975	91,923	1,172,764	37,046		1,209,810	24,196
1976	113,548	1,449,549	40,408	5,346	1,495,303	29,906
1977	132,342	1,646,686	45,445	5,716	1,697,847	33,957
1978	147,778	1,828,677	47,343	19,951	1,895,971	37,919
1979	161,101	2,012,955	51,391	31,078	2,095,424	41,908

[1] Col. (2) + Col. (3) + Col. (4)
[2] Col. (5) x .02

3. Utilities

a) Background

(1) Overall Tax Burden

The public utilities in Pennsylvania provide a significant fraction of tax revenue to the state. Subject to the Corporate Net Income Tax, the Capital Stock Tax, the Gross-Receipts Tax, and the Public Utility Realty Tax (PURTA), utilities in 1980 paid $770 million out of $6,384 million of general fund receipts or 12.1%. Given these significant tax payments, the Commission inquired whether utilities in Pennsylvania are more onerously taxed than utilities in other states. Tables V.6 and V.7 display the effective tax rates (ratio of state and local taxes to pre-tax income) for large utilities in various states. Note that these rates do not take into account the deductability of state and local taxes for federal tax purposes. Viewed on this basis, electric and gas utilities in Pennsylvania are not taxed more heavily than in many other states; also, it would appear that telephone companies are taxed competitively with other states (see Table V.8). Not only are utilities taxed about the same as in other states, there does not appear to be any discernable trend.

(2) Utility Gross-Receipts Tax

The Pennsylvania Utility Gross-Receipts Tax imposes a 4.5 mill levy on all final sales of natural gas, electricity, and other utility services sold in Pennsylvania. The Public Utility Commission allows utilities to recover this tax by simply adding the tax to the total bill of each utility customer in the manner of a retail sales tax. Currently, receipts from the tax have been very rapidly increasing because of rapidly increasing energy prices.

(3) Public Utility Realty Tax

Pennsylvania's Public Utility Realty Tax Act (PURTA) imposes a 30 mill tax on the book value of utility property. PURTA was adopted in lieu of local real estate taxation by the General Assembly following the 1968 Constitutional Convention. In the 1968 Amendments to the Constitution, the General Assembly was empowered either to authorize local taxation of utility property, or to enact a state system of taxation which would redistribute to localities an amount of state revenue equivalent to revenues which would be collected if utilities were locally taxed. Under PURTA, an amount equal to total local property taxes on utility realty is distributed to localities based on the total revenue of municipalities rather than on the situs and value of individual parcels of utility property. The theory behind the tax is that since utilities serve the entire state, and all ratepayers contribute to maintaining utility investments, the tax revenue generated by utility property should benefit all municipalities.

Currently, the annual PURTA distributions are made pursuant to the following process:

(a) Utilities pay 30 mills on the book value of property into the Commonwealth's General Fund.
(b) Municipalities report the assessed value of all utility property, apply their current assessment ratio and millage to assessed value, and report to the state taxes which could be collected if the utilities were subject to the local property tax.
(c) The Commonwealth computes the total real estate tax equivalent for all municipalities and asks the General Assembly to appropriate this amount from the General Fund.
(d) The amount annually appropriated by the General Assembly is distributed to each local government unit with utility property within its boundaries using the ratio of total tax receipts for each municipality to total tax receipts of all municipalities containing utility property.

b) Issues

(1) Sales Tax vs. Gross-Receipts Tax

As noted in Section I., the Commission believes that taxes, to the extent possible, should not alter economic choices. The gross-receipts tax, when viewed in con-

Table V.6

Effective Tax Rates for Large Utilities in Selected States: 1976 (Gas and Electric)

	Non-Federal Taxes ($ millions)	*Net Income Before Federal, State and Local Taxes ($ millions)*	*Effective State and Local Tax Rate (%)*
California			
Pacific Gas and Electric Company	$154.3	$ 563.1	27.4%
Southern California Edison Company	118.1	451.5	26.2
Florida			
Florida Power and Light Company	97.0	372.8	26.0
Illinois			
Commonwealth Edison Company	255.2	757.2	33.7
Indiana			
Public Service Company of Indiana, Inc.	25.3	185.8	13.6
Massachusetts			
Boston Edison Company	75.6	189.3	39.9
Massachusetts Electric Company	25.5	62.2	41.0
New England Power Company	29.8	136.6	21.8
Michigan			
Consumers Power Company	74.5	366.6	20.3
Detroit Edison Company	93.9	326.3	28.8
New Jersey			
Public Service Electric and Gas Company	275.3	664.9	41.4
Jersey Central Power and Light Company	50.8	178.9	28.4
New York			
Consolidated Edison Company of New York, Inc.	525.9	1,099.5	47.8
Niagara Mohawk Power Corp.	130.9	309.7	42.3
North Carolina			
Duke Power Company	96.5	467.8	20.6
Ohio			
Cincinnati Gas and Electric Company	43.4	133.7	32.5
Cleveland Electric and Illuminating Company	51.9	170.4	30.5
Ohio Power Company	39.1	204.4	19.2
Pennsylvania			
Duquesne Light Company	34.4	156.5	22.0
Metropolitan Edison Company	22.6	103.3	21.9
Pennsylvania Electric Company	26.8	124.5	21.6
West Penn Power Company	24.1	111.7	21.6
Philadelphia Electric Company	92.6	385.3	24.0

Source: U.S. Department of Energy. *Energy Data Service — Statistics of Privately Owned Electric Utilities in the United States — 1976* (Washington, D.C. April 1978).

Table V.7

Effective Tax Rates for Large Utilities in Selected States: 1978 (Gas and Electric)

	Non-Federal Taxes ($ millions)	*Net Income Before Federal, State and Local Taxes ($ millions)*	*Effective State and Local Tax Rate (%)*
California			
Pacific Gas and Electric Company	$162.9	$ 715.4	22.7%
Southern California Edison Company	106.3	482.4	22.0
Florida			
Florida Power and Light Company	145.4	648.1	22.4
Illinois			
Commonwealth Edison Company	326.7	879.5	37.1
Indiana			
Public Service Company of Indiana, Inc.	30.3	187.2	16.2
Massachusetts			
Boston Edison Company	88.7	219.1	40.4
Massachusetts Electric Company	28.2	79.8	35.4
New England Power Company	31.4	127.8	24.6
Michigan			
Consumers Power Company	80.5	363.4	22.2
Detroit Edison Company	90.6	370.5	24.5
New Jersey			
Public Service Electric and Gas Company	328.2	795.6	41.3
Jersey Central Power and Light Company	72.0	213.7	33.7
New York			
Consolidated Edison Company of New York, Inc.	556.3	1,125.6	49.4
Niagara Mohawk Power Corp.	151.6	359.4	42.2
North Carolina			
Duke Power Company	115.5	479.7	24.1
Ohio			
Cincinnati Gas and Electric Company	53.6	184.5	29.1
Cleveland Electric and Illuminating Company	68.8	211.9	32.4
Ohio Power Company	58.9	190.5	30.9
Pennsylvania			
Duquesne Light Company	46.5	188.3	24.7
Metropolitan Edison Company	25.3	119.1	21.2
Pennsylvania Electric Company	34.3	138.9	24.7
West Penn Power Company	31.8	121.6	26.2
Philadelphia Electric Company	104.9	427.7	24.5

Source: U.S. Department of Energy. *Energy Data Service — Statistics of Privately Owned Electric Utilities in the United States — 1978* (Washington, D.C. October 1979).

Table V.8

Effective Tax Rates for Communications Common Carriers (Telephones) in Selected States

	1974			1976			1978		
	(A)	*(B)*	*(C)*	*(A)*	*(B)*	*(C)*	*(A)*	*(B)*	*(C)*
California Pacific Telephone and Telegraph Company	$201.5	$923.9	21.8%	$252.7	$1,111.9	22.7%	$241.6	$1,302.8	18.5%
Florida Southern Bell Telephone and Telegraph Company	128.7	648.4	18.8	177.4	957.2	18.5	210.5	1,239.9	17.0
Illinois Illinois Bell Telephone Company	174.6	628.8	27.8	198.5	684.1	29.0	219.6	768.6	28.6
Indiana Indiana Bell Telephone Company, Inc.	21.9	143.8	15.3	28.5	189.7	15.0	34.8	246.0	14.2
Massachusetts New England Telephone and Telegraph Company	113.3	436.5	25.9	146.6	621.7	23.6	170.5	719.2	23.7
Michigan Michigan Bell Telephone Company	63.7	303.1	21.0	55.9	369.7	15.1	67.9	496.9	13.7
New Jersey New Jersey Bell Telephone Company	87.7	402.5	21.8	108.9	488.7	22.3	114.2	541.5	21.1
New York New York Telephone Company	378.3	1,244.5	30.4	470.5	1,464.1	32.1	522.9	1,693.1	30.9
Ohio									
Cincinnati Bell Inc.	15.5	68.4	22.7	18.0	70.7	25.5	21.8	109.2	20.0
Ohio Bell Telephone Company	73.3	272.4	26.9	100.8	482.1	20.9	NA	NA	NA
Pennsylvania Bell Telephone Company of Pennsylvania	65.3	399.2	16.4	78.4	468.1	16.7	98.7	582.4	17.0

(A) Non-Federal Taxes ($ millions) (B) Net Income Before Federal, State and Local Taxes ($ millions) (C) Effective State and Local Tax Rate (%)

Sources: Federal Communications Commission. *Statistics of Communications Common Carriers* (Washington, D.C. 1974, 1976, 1978).

nection with the Pennsylvania sales tax, however, violates this principle. While the Pennsylvania sales tax is levied neither on residential uses of electricity and gas nor on the use by manufacturing entities of electricity and gas, it is levied on others, primarily commercial establishments. As a consequence, many users not eligible for the exemption from the retail sales tax pay both the retail sales tax and the gross-receipts tax on the same purchase. The Commission understands that this cascading is most pronounced for commercial establishments.

(2) Per Unit Tax vs. Percentage of Price Tax

Because of understandable concerns by consumers about high energy costs, it has been suggested to the Commission by both utility companies and their customers that the tax should be switched from millage rate based on gross receipts, an *ad valorem* tax, to a per unit tax (similar to motor fuel taxes) based on kilowatt-hours of electricity or on millions-of-cubic-feet of natural gas (an *in rem* tax). This proposal is advocated as a method of reducing rapidly escallating energy prices.

(3) Distribution of PURTA

Local governments have expressed two concerns about the operation of PURTA. First, since the state's 30 mill tax on utility property exceeds total local real estate tax equivalents, PURTA has generated net contributions to the state's General Fund. Local governments have argued that because PURTA is imposed in lieu of local property taxes, total receipts should be returned to local governments. Second, local governments have complained that the General Assembly chronically under-appropriates amounts to be used for PURTA distributions, thus delaying tax receipts until deficiency appropriations become available.

c) Recommendations

(1) Utility Gross-Receipts Tax

The Commission considered changing the tax to a per unit tax, and recommends that it remain an ad valorem tax at its current rate. Adopting per unit taxes rather than ad valorem taxes violates the criteria of revenue adequacy identified as a goal for the tax system. Since energy consumption is leveling off or actually falling because of rapidly rising prices, switching the Utility Gross-Receipts Tax to a per unit basis would mean a dramatic loss of revenue for the Commonwealth. A policy change of this type could create in the General Fund the same serious problems of revenue

inadequacy now faced in the Motor License Fund because motor fuel taxes are based on gallons consumed rather than some indicator (such as retail prices on the construction cost index) which is responsive to changes in economic activity.

In addition, the Commission notes that the problem of high energy prices is not, and should not be viewed as a product of the tax structure. In fact, by taxing energy at 4.5% and other sales at 6%, Pennsylvania currently has a tax system which gives a very significant preference to utility services. A number of other states currently tax utility services under their retail sales tax.

The Commission also considered the possibility of eliminating the gross-receipts tax (at 4.5%) and making the utility services taxable under the retail sales tax (as done in other states). However, in view of the fact that a considerable fraction of utility services are already taxable under the sales tax, a considerable net revenue loss (as much as 20%) would likely occur. Given aggregate budget needs, the likely adverse distributional impact of a higher tax on utility services for residential consumers, and the uncertainties with regard to the actual revenue implications, the Commission recommends no change in the utility gross-receipts tax.

(2) The PURTA Allocation Process

The Commission finds that the current system in which the legislature appropriates funds for PURTA distributions is excessively cumbersome and unfair to local governments. Total PURTA receipts should be placed in a restricted receipt account, local allocations paid out by executive authorization, and any balances deposited in the General Fund. This process will allow much greater accuracy in calculations, PURTA distributions, more rapid adjustment to changing conditions, and for fewer delays for local municipalities.

Section VI.
Tax Administration

Improving Pennsylvania's "climate" for retaining existing business and attracting new business is a major concern of the Pennsylvania Tax Commission. The Commission finds that the characteristics of state tax administration are an extremely important part of the business "climate". Indeed, for many, the characteristics of tax administration may be more important than the substantive level of taxation, absent very large differences, in determining Pennsylvania's competitive position with other states in attracting and retaining business.

Business looks to Pennsylvania for evidence of a desire to simplify the administration and procedures involved in its tax system, both state and local. It is particularly concerned about compliance costs, the predictability of tax burdens and liabilities, the speed of settlements, assessments, and determinations, and clarity in tax basis. It is concerned about compliance costs for the usual reasons of cost and profit consciousness. It needs to predict tax burdens and liabilities for a variety of planning purposes. It prefers speedy settlements so that it can close its books for planning and to lower compliance costs. It wants a clear basis of taxation to ensure against discriminatory taxing practices.

Yet the Governor's charge went beyond the Commission's striving for greater simplicity in administration only from the taxpayer's vantage point. He recognized that a reduction in the costs of collection and an improvement in the collections of accounts due and owing the Commonwealth are equally important if Pennsylvania is to have the kind of efficiency which will be of benefit to all of its citizens.

Thus, the Commission perceived its role to include recommendations to accomplish those purposes. We have set forth these recommendations first as to general matters and second as to specific taxes. The recommendations include, and are so designated, those which require legislation and those which the Commission believes can be accomplished through administrative regulation.

A. General Reforms

1. Those Requiring Legislation

a) Issues

(1) Codification of All State and Local Tax Laws

In reviewing the development of Pennsylvania tax law, the Commission found that the relevant legislation (both as to state and local taxes) was scattered making impossible the taxpayer's understanding of his tax liability and his reporting responsibilities. Pennsylvania is unique among major industrial states in not having a single, consistent set of tax laws and procedures. In 1970, the Pennsylvania Legislature enacted general legislation contemplating the codification of all state laws into major titles; however, to date the tax statutes have not been so consolidated and put in one place.

(2) Cash Refunds

Under federal law and in most other states, the business taxpayer who has paid estimated taxes during the year and has been withheld through the withholding system can obtain a refund at the end of the tax year for overpayment of taxes by simply indicating on the tax form whether there was a deficiency or a refund due and by signing the jurat on the form. However, Pennsylvania requires that a separate petition be filed by the taxpayer to obtain a cash refund. This requires additional paper work for the taxpayer and the Department, and creates greater chance of delay and error.

(3) Interest Rates

Until 1976, Pennsylvania charged a 6% interest rate on tax deficiencies for all taxes. Since 1976, several taxes provide for interest rates of 9% while others, including the corporate taxes, carry interest rates of 6% on such deficiencies. These interest rates contrast markedly with the prime rate of interest which has fluctuated between 5.7% and 16.4% throughout the period in question. Other states and the Internal Revenue Service have their interest rates for underpayments and penalties tied more closely to market rates of interest. The Commission finds that the present low rates of interest are inadequate, and that certain firms and individuals use the low rate of interest deliberately to postpone payment of their tax liabilities using the Commonwealth as a bank. However, the Commission also finds that it is unreasonable for the Commonwealth to refuse to pay interest on money to which it is neither legally nor equitably entitled. Finally, the Commission finds that fixed rates of interest both as to the deficiency or overpayment are neither practical nor proper in a volatile economic climate.

(4) Uncollectable Accounts

The Department of Revenue currently has no procedure for purging uncollectable accounts under the personal income tax and the sales and use tax. Since its inception in 1971, any account open under the personal income tax has remained open even though

some of these accounts are much too small and too old to justify any collection effort on the part of the Department. There have been reports in the press periodically that significant amounts of revenue remain uncollected in the Commonwealth; however, while some revenues could undoubtedly be collected by more vigorous collection activity, consideration must also be given to the cost of such collection. As a general matter, it would seem prudent in the view of the Commission to seek to collect only those accounts for which the prospective revenue yield exceeds the cost of collection.

(5) Centralization of Collection Activities in Department of Revenue

The Commission understands that there is currently ambiguity in the responsibility for collecting delinquent accounts. There may be some question under current law as to whether the Department of Revenue or the Office of the Attorney General is responsible for this activity. In other states and in the federal government, the initial collection responsibility rests with the authority charged with the responsibility of administering the tax. The Justice Department typically is not brought into the collection effort unless fraudulent behavior has been determined or changed.

b) Recommendations for General Administrative Reform Requiring Legislation

The Commission believes the administrative reform of the state's taxes can be generally achieved if legislation is enacted which addresses the issues outlined above.

(1) Codification of All State and Local Tax Laws

The Commission recommends that the Legislature enact a consolidated and uniform tax code for all state and local taxes including provisions for administration of taxes making administration and procedure in the state's tax laws as uniform as possible. Among major industrial states, Pennsylvania is unique in not having a uniform and consistent code of state tax law and administrative procedure. For the taxpayer, this means that he may have to consult various scattered acts of the legislature, or seek professional assistance at the outset. The absence of a uniform and consistent set of tax statutes relating to local taxation is even more problematical.

It is likely that such an undertaking would require a considerable period of time and expertise. The Commission therefore recommends that such resources of the Department of Revenue, the Department of Community Affairs and the Office of the Attorney General, as well as those of the General Assembly, be utilized to effect the codification. The Commission further recommends that the Pennsylvania Bar Association, which it understands is at work on such a project, and the accounting profession be consulted for their views and comments.

(2) Cash Refunds

The Commission recommends that the Commonwealth grant cash refunds to business taxpayers without requiring petitions for such refunds in line with current federal practice and that of other major states.

(3) Interest Rates

The Commission recommends that interest rates be tied to either some market rate of interest or to the rate of interest charged by the Internal Revenue Service in its administration of federal tax laws on deficiencies and that the rate of interest be uniform among taxes. Further, the Commission recommends that the Department of Revenue be required to pay interest on overpayments to taxpayers, a reform long overdue, which if adopted, will help restore confidence in Pennsylvania's system.

(4) Uncollectable Accounts

The Commission recommends that legislation be enacted which will permit the Department of Revenue to purge uncollectable accounts with adequate oversight by the Office of the Attorney General and the Department of the Auditor General. As already stated, there are storage and information processing problems associated with the current situation in which accounts remain open even though the taxpayers are no longer active. The Commission believes that such legislation can be enacted which would maintain the integrity of the system and at the same time reduce the administrative burden on the Department.

(5) Centralization of Collection Activities

The Commission recommends that the Office of the Attorney General and the Department of Revenue undertake the clear delineation of their respective responsibilities which will ensure the prompt and fair collection of taxes in a manner consistent with good tax administration practices as reflected in other states.

2. Administrative Reforms Achievable Through Administrative Regulation

a) Personnel Reforms

(1) Issues

(a) Status of Work Experience for Certified Public Accountant Examinations

The Commission found in reviewing the employment of accountants in the Department of Revenue and the Department of the Auditor General that there were some difficulties in attracting qualified tax accountants to join their staffs principally because the work experience which would be gained in, for example, the Department of Revenue does not currently count toward the Certified Public Accountant qualifying examinations. This contrasts with the status of work experience which accountants may enjoy when they work for the Internal Revenue Service.

(b) Salary Levels of Attorneys, Accountants, and Computer Specialists

Over the past several years, the salaries of professionals in the legal, accounting, and information processing professions have gone up dramatically in the private sector. On the other hand, the Commission notes that salaries in state government for such highly skilled professionals have not kept pace. As a result of

this situation, the Commission understands that the Department of Revenue is facing a critical shortage of computer specialists (that is, system analysts and programmers). The Commission understands that the situation with respect to accountants and attorneys is similar. If the Commonwealth is to have an efficient and effective tax system, the Commission believes it is essential that the Department of Revenue have qualified and highly motivated professionals on a continuing basis in order to insure that the taxes are collected and processed in a prompt and fair manner.

(c) Size of Audit Staff

In reviewing the amount of revenue which additional auditors can generate, the Commission was impressed with the finding that in each of the major tax areas, additional auditors would result in far more revenue being raised than they would cost in terms of their salary and overhead. The Commission further understands that the Department of Revenue, partly as a result of non-competitive salaries, has not continued to expand its audit staff especially in the sales and use tax area. The Commission believes that it is essential, if taxpayers are to have confidence in the tax system, that there should be a significant and productive audit effort throughout the Department of Revenue.

(d) Increased Valuation Staff for Inheritance Tax

The Commission understands that one of the most difficult tasks related to the inheritance tax, either in the origination of the return or in its audit, is the effective and fair evaluation of the assets of the estate. The Department of Revenue apparently does not have statewide standards of education for its valuation staff, and the Commission understands that in certain parts of the state with large volumes of inheritance tax work, staffs are not large enough to adequately handle the work load.

(2) Recommendations

(a) Status of Work Experience

The Commission recommends that the Department of Revenue and the Department of the Auditor General, in cooperation with the accounting profession, accord to the Department of Revenue accountants the same status of their work experience in the Department which the Internal Revenue Service currently accords their accountants in qualifying accountants for the CPA qualifying examinations. The Commission believes that implementation of this recommendation will make the Department of Revenue a more attractive place for young accountants to work.

(b) Salaries

The Commission recommends that the Department of Revenue be permitted through changes in the personnel system, to pay competitive salaries for attorneys, accountants, and computer programmers and systems analysts. The Commission believes that higher salaries will not only attract more qualified individuals and permit the Department to fill existing vacancies, but will also generate improvement in morale and in career employment.

(c) Increased Taxing Audit Staffs

The Commission recommends that the Department of Revenue generally increase its taxing and audit staffs, allocating on the basis of need in the area of greatest potential yield of additional revenue.

(d) Increased Valuation Staff for Inheritance Tax

The Commission recommends that the Department of Revenue decrease the number and quality of its field evaluation staff for the estate and inheritance tax. The Commission believes that training standards may be created for the evaluation staff and that additional field staff are justified. The Commission believes that the number of field staff should bear relation to the number of tax returns filed as among the various field officers in the state.

b) Enhanced Information for Taxpayers and the Department of Revenue

The Commission believes that much of the confusion and uncertainty about the various taxes in the Commonwealth can be eliminated if taxpayers are provided timely and accurate information about the various taxes for which they are liable, and about pending and actual recent changes that have taken place. The Commission therefore has a series of recommendations in this area of improved information which are as follows:

(1) Public Hearings on Regulations

The Commission recommends that public hearings be held at the discretion of the Department on proposed tax regulations before promulgation thus eliminating misunderstandings and improving the quality of the proposed regulation. Hearings currently may be held by the Department and in some instances the Commission understands that they are held. The Commission believes that this recommendation will enable the Department to forestall difficulties with compliance.

(2) The Pennsylvania Tax Register

The Commission recommends that a monthly or bimonthly publication (e.g., The Pennsylvania Tax Register) be published by the Department of Revenue, and that it include a description of statutory changes, court decisions, new regulations, notices of public hearings, and decisions of the Board of Appeals and the Board of Finance and Revenue. With such a regularly published document, which would be provided to state and county libraries free of charge and to the public by subscription and cost, the Commission believes that greater taxpayer compliance will be achieved.

(3) Information Booklets

The Commission recommends that the Department of Revenue publish and update a booklet dealing with all the state taxes. The Commission believes that a document analogous in purpose to *Your Federal Income Tax*, published by the Internal Revenue Service, will permit taxpayers, as well as those considering locating