Prepared Testimony of

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to the

House Finance Subcommittee on Tax Modernization and Reform

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Introduction

Chair Rabb and Chair Fritz,

As you may know, I am the author of a paper introducing the Fair Share Tax, which was published on December 20, 2016, by my former employer the Pennsylvania Budget and Policy Center.¹ That plan has been introduced in the House and Senate a number of times since then. And I and others have refined the plan and developed variants of it in the years since.

But this is the first time the plan has been considered in a committee hearing. So, I’m very grateful to you for providing this opportunity.

After a brief consideration of the two reasons, I believe something like the Fair Share Tax is necessary, I’m going to present the fundamentals of one version of the plan and then respond to some common misunderstandings and criticism of the plan.

¹ Marc Stier, “The Fair Share Tax to Support Public Investment in Pennsylvania,” Pennsylvania Budget and Policy Center, December 20, 2016; revised version March 22, 2017, https://marcstier.com/blog2/?p=10702. While I wrote the text of the paper, Stephen Herzenberg and Mark Price contributed to the development of the Fair Share Tax plan. Diana Polson contributed to updates of that plan released in 2018 and 2023. We are indebted to Aidan Davis, Kamolika Das, and Miles Trinidad of the Institute on Taxation and Economic Policy (ITEP) for their ideas and for giving us the estimates of the Fair Share tax they generated with ITEP’s model of Pennsylvania’s economic and tax system.
Two Issues with Taxes in Pennsylvania

There were two reasons we presented the Fair Share Tax plan in 2016. Both of those reasons remain compelling.
I will not address the first reason in detail as others are speaking to it today: our state and local tax system is horribly unfair as others have testified about that today. You can see in figure 1 that state and local taxes in Pennsylvania are upside-down. Those with the lowest incomes pay a far higher share of their income in state and local taxes than those with the highest incomes. We call such a system “regressive” while a tax system in which the share of income taken by taxes rises as income rises is called progressive. We have the fourth most regressive state and local tax system in the country. And we have the highest tax rate in the country for those in the bottom 20% of households.

Figure 1

Total State and Local Taxes Paid
As a % of family income

Our tax system is so upside-down because of the current interpretation of the Pennsylvania Constitution’s “uniformity clause.” However, that clause was introduced in the “Reform Constitution” of 1874 not to protect the wealthy but to limit the General Assembly’s ability to enact “corrupt legislation” that would give preferential treatment to “favored industries and individuals.” That is, the uniformity clause was designed to protect everyday Pennsylvanians from tax policies that favored wealthy corporations and individuals.

Many states have similar clauses. Despite the original intent, the uniformity clause has been interpreted as requiring that there be only one tax rate on any class of income, prohibiting Pennsylvania from enacting a graduated income tax. In all states, sales and property taxes tend to take a higher share of income from those with low incomes than those with high incomes. But in a majority of states, a graduated income tax provides a countervailing force that make the overall state and local tax system flat or slightly progressive. Thanks to the current interpretation of the uniformity clause, that is impossible in Pennsylvania. As a result, our tax system is horribly unfair.

**Insufficient Revenues**

That unfairness is not the only problem with our tax system. A regressive tax system also has difficulty raising sufficient revenues to fund the government services the people of the state desire and need. When asked why he robbed banks, the bank robber Willie Sutton once answered, “because that’s where the money is.” Most states tax the rich at a high or higher rate than the poor because that’s where the money is.

Our failure to tax the rich is responsible for the long-standing structural deficit Pennsylvania faces. I won’t rehearse in detail the story of our need for new, recurring revenues. For a decade up until the start of the pandemic, the state government started each budget year with a structural deficit: the projected revenues for each year were less than the projected expenditures needed just to maintain the current level of state services adjusted for inflation and the need to meet contractual and constitutional obligations to state workers, debt service, and actuarially required pension contributions. Year after year, structural deficits were met with short-term revenues such as selling licenses to new forms of gaming and budget gimmicks that included shifting revenues forward from future years to the current year, shifting expenditures back from the current year to future years, and borrowing from special funds. One especially effective budget dodge was underestimating Medical Assistance caseloads, which practically became an art form. At one point the state had created a $600 million and growing long-term Medical Assistance deficit which was rolled over from year to year. And one year, the General Assembly’s failure to enact legislation for revenues to meet the expenditures it had already approved was met by floating a $1.3 billion bond secured by yearly tobacco settlement revenues.

Thanks to federal COVID-19 assistance and the very fast recovery from the COVID recession, the state now has a $13 billion dollar surplus. That surplus is now papering over a structural deficit in which current year revenues do not cover current year expenses. Governor Shapiro’s proposed budget plan for FY 2025 calls for using $3.6 billion of the surplus to pay for current-year operations. And after one year in which the current revenues meet current expenses, the seven-year financial statement calls for using $2 billion and $2.9 billion of the surplus to cover operating expense in fiscal years 27, 28 and 29, and, presumably, in subsequent years. IFO budget projections are somewhat more pessimistic than the Governor’s. And the Governor’s long-term projection does not include more than the first year of the seven-year plan adopted by the Basic Education Funding Commission, which is required to meet our moral and constitutional obligations to fund K-12 public education fully and fairly. Nor does it include necessary expenditures to meet other parts of what I call our public investment deficit, including the funds necessary to provide an opportunity for every high school graduate to receive at least some post-secondary education or workforce training; to deal with crises in mental health and rural health; to ensure that housing remains affordable; or to meet other public needs.

I say all this not to question a plan to spend down our $13 billion surplus—we should spend down most of it. It is the taxpayers’ money, and it should be spent on the public goods taxpayers clearly support. But
eventually the surplus will run out. The forward-looking thing to do is to create a new revenue stream that both extends the life of the surplus and will grow sufficiently to cover state expenditures when the surplus finally is reduced to the minimum level we should keep in the Rainy Day Fund.

The Fair Share Tax

The Fair Share Tax has been designed to address both problems: the unfairness of our tax system and the need to raise new, recurring revenues.

The Basic Idea

The basic idea of the Fair Share Tax is to repeal the current personal income tax and create two new taxes. Currently, eight classes of income, which are defined under federal law, are subject to the Pennsylvania Personal Income Tax: gross compensation (mostly wages, salaries, and tips); interest; dividends; net income from a business, profession, or farm; capital gains; net income from rents, royalties, patents, and copyrights; gambling and lottery winnings; and income from estates or trusts.\(^3\) We propose creating two new taxes to replace the Personal Income Tax. The first would be a tax on what we call income from work (or earned income), which includes two classes of income: wages and salaries, and bank interest. It would be set below the current Personal Income Tax rate. The second would be a tax on the other six classes which would be set higher than the current Personal Income Tax rate. We call those other seven categories “income from wealth,” “unearned income,” or “passive income” because they mostly include income that is earned from the ownership of some kind of wealth (including, among other things, intangible and real property) as opposed to income from work.

Most people under the age of retirement have income from compensation, that is, wages, salaries, tips, and interest. But the majority of total “income from wealth” is earned by those with higher incomes. Thus, by taxing income from wealth at a higher rate we could generate more tax revenue from those whose overall incomes are high and have been growing fast.

The Fair Share Tax can be instituted with different rates on income from work and incomes from wealth. Today I will be reporting primarily on the plan we initially introduced, which sets the tax rate on income from work at 2.8% down from the current 3.07% and raises the tax rate on income from wealth from the current 3.07% to 6.5%. I will also present some data about a more aggressive variant of the plan in which the tax rate on income from work is set at 1.9% and the tax rate on income from wealth is set at 12%. The rates on both parts of the Fair Share Tax can be set at any level. Higher rates raise far more revenue while lower rates raise less. Increasing the gap between the rate on income from work and income from wealth makes the combination of the two taxes more progressive. In a forthcoming paper we will present data on the impact of other variants of the Fair Share Tax.

Complications

I want to mention one complicating factor: how to treat self-employment income, which is included on schedule C of federal tax returns. There are two broad kinds of schedule C income. The first includes self-
employment income earned by gig workers, such as drivers for Uber and Lyft; contract workers such as consultants for businesses, including many of those who work for long periods of time with a business in this capacity; and sole proprietors in a small business or a profession, such as the owners of corner shops in urban areas or lawyers. We believe this kind of income should be treated similarly to wage income and taxed at the lower rate since it is almost entirely earned by the labor of the self-employed.

Schedule C income also includes self-employment income that is passed through a subchapter S corporation, limited liability company, partnership, or other artificial entity. These entities are able to enter capital markets to secure funds that then enable them to earn some income from wealth—that is investments of various kinds: facilities, stock, tools and machinery, offices, and much more advertising than is typically carried out by small proprietors. These enterprises typically have more employees than small proprietors and solo practitioners and thus earn income from the work of others. Limited liability entities, such as subchapter S corporations; limited liability companies (LLCs); and limited liability partnerships (LLPs) also protect their owners by limiting their liability to creditors. Partnerships, whether they are organized as LLPs or not, have the structural advantages of allowing the members to raise capital more readily and extensively. They are also able to pool their talents and resources—including capital resources—more efficiently, share and spread out costs, and provide for business continuity upon departure of a member. We propose to tax these kinds of schedule C income as income from wealth. Note, however, that due to the limitations of the data we receive from the Institute on Tax and Economic Policy, much of this income is taxed at the lower rate. So, the data I present understates both the amount of revenue raised and the progressivity of the Fair Share Tax.

Impact of The Fair Share Tax

How Much It Raises

What we call the standard Fair Share Tax would raise $2.45 billion in the current fiscal year by increasing the tax on income from wealth to 6.5% and decreasing the tax on income from wages, interest, and self-employment income to 2.8%. A more aggressive version of the Fair Share Tax, with the tax rate on income from wealth set at 12% and the tax rate on income from work set at 1.9% would raise $4.23 billion.4

Who Would Pay the Fair Share Tax Statewide

As table 1a shows, only 17% of Pennsylvania taxpayers would pay more under the Fair Share Tax. The vast majority of taxpayers, 83%, would see their taxes go down (61%) or remain unchanged (22%). Table 1b gives the results for the more aggressive version of the Fair Share Tax. Under it, only 13% of taxpayers would see their taxes go up. About 77% of taxpayers would see their taxes go down (65%) or remain unchanged (22%).

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4 We have examined a number of other variants of the Fair Share Tax. If the rate on income from work were set at 2.8% and the rate on income from wealth were set at 7.5%, the Fair Share Tax would raise about $3.53 billion. If the rates were set to 2.4% and 10%, the total increase in revenue would be $4.385 billion.
Table 1a

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<thead>
<tr>
<th>Impact of Fair Share Tax on Pennsylvania Taxpayers 2.8% / 6.5% rates</th>
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<tbody>
<tr>
<td>Taxes are reduced</td>
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<td>Taxes are increased</td>
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<td>Source: Pennsylvania Policy Center analysis of data</td>
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<td>from the Institute of Taxation and Economic Policy (ITEP).</td>
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Table 1b

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<tr>
<th>Impact of Fair Share Tax on Pennsylvania Taxpayers 1.9 / 12% rates</th>
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<tr>
<td>Taxes are reduced</td>
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Who Pays More and Who Pays Less

Figures 2 and 3 show whose taxes would increase under the Fair Share Tax but only among Pennsylvanians. This analysis excludes non-residents who pay income tax to Pennsylvania, and our previous estimates suggested that between 16% and 18% of the $2.45 billion raised by the Fair Share Tax would be paid by residents of other states and countries.
Given what we said about the distribution of income from wealth, it should come as no surprise that most of the increase in taxes would be on taxpayers with the greatest incomes. Figure 1 shows that a bit more than 54% of the revenue raised from Pennsylvanians by the Fair Share Tax would be raised from taxpayers in the top 1% of income with incomes above $773,000 and an average income of $1.93 million. Almost 24% of revenue raised by the plan from Pennsylvanians would come from taxpayers in the next 4%, from the 95th to 99th percentile, with incomes between $312,000 to $771,200. Thus, taken together, 78% of the additional revenue would come from families with incomes in the top 5%, earning more than $312,000 per year. Just 10.5% of revenues raised from Pennsylvanians would come from taxpayers from the 80th to 95th percentile with incomes between $143,600 and $312,000. And only 11% of revenues would come from the bottom 80% of families.

The distribution of the tax increase under the more aggressive Fair Share Tax is roughly the same as under the standard Fair Share Tax.

As we shall see in a moment, the average family in the bottom 20% would see their taxes go down, not up, if the Fair Share Tax were enacted. Only .41% of the bottom quintile of taxpayers, 1.16% of the second quintile, 1.68% of the third quintile, and 5.28% of the fourth quintile would see an increase in taxes. We
believe that the very small percentage of those in the bottom 60% of taxpayers who would see their taxes go up are individuals with little income from a small amount of inherited wealth—"trust fund kids" if you will. The 5.28% of the fourth quintile, those with an average annual income of $112,800, are most likely families who have some investment income that is not contained in a pension or retirement account, such as a 401k, which is not taxed in Pennsylvania.

What Each Income Group Pays with the Fair Share Tax

Figure 3a gives details on how much the average family in each category would pay or save under the standard Fair Share Tax.

**Figure 3a**

<table>
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<tr>
<th>Income Category and Average Income in Category</th>
<th>Change in Taxes Paid</th>
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<tr>
<td>Top 1% -- $1,980,000</td>
<td>$25,605</td>
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<tr>
<td>Next 4% -- $451,400</td>
<td>$2,444</td>
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<tr>
<td>Next 15% -- $195,500</td>
<td>$133</td>
</tr>
<tr>
<td>Fourth 20% -- $112,800</td>
<td>-$4</td>
</tr>
<tr>
<td>Third 20% -- $67,100</td>
<td>-$59</td>
</tr>
<tr>
<td>Second 20% -- $38,200</td>
<td>-$32</td>
</tr>
<tr>
<td>Bottom 20% -- $13,900</td>
<td>-$4</td>
</tr>
</tbody>
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*Source: Pennsylvania Policy Center analysis of Institute on Taxation and Economic Policy Data*

Under the standard Fair Share Tax the top 1% of taxpayers would pay, on average, $25,065 more than they do today. Yet this increase is relatively small considering that the average income in this group is more than $1.98 million. The Fair Share Tax only takes another 1.46% of the income of this group of households. For the next group, those from the 95th to the 99th percentile, with incomes between $312,000 and $771,200 and an average income of $451,000, the additional tax averages $2,444 per year. This only increases the tax rate they pay by 1.36%. In the group with incomes between $143,600 and $312,000, from the 80th to the 94th percentile, the average tax increase would be $133. This is only an increase of .46% in their tax rate. Below the top 20%, the average family would see its taxes decline. Families in the middle quintile, with incomes from $52,100 to $85,000 and with an average income of $67,100, would on average receive a tax cut of $59. Because families in the lowest quintile benefit from income tax forgiveness they would see little change in their taxes.
As shown in figure 3b, under the more aggressive Fair Share Tax, taxpayers in the top 1% would pay annually, on average, $63,065 more than they do today. Though larger than under the standard plan, this increase is not that large considering that the average income in this group is more than $1.98 million. This version of the Fair Share Tax only takes another 3.67% of the income of this group of households. In the next group, those from the 95th to the 99th percentile with incomes between $312,000 and $771,200 and an average income of $451,000, the additional tax averages $5,109 per year. For all other taxpayers—that is all taxpayers below the top 5%—the aggressive Fair Share Tax substantially reduces taxes by an average of $38 in the bottom quintile, $196 in the second quintile, $355 in the third quintile, $362 in the fourth quintile, and $280 for taxpayers from the 81st to the 95th percentiles. Again, families in the lowest quintile benefit less from the Fair Share Tax because they currently benefit from tax forgiveness.

Responses to Possible Objections to the Fair Share Tax

Impact on Pennsylvania’s Economy

The tax does not place Pennsylvania at a competitive disadvantage to neighboring states. After it is instituted, the effective tax rate on all forms of income on the top 1% of taxpayer would only be 4.7%, which is lower than all of our neighboring states except West Virginia and Ohio and is far below New York, New Jersey, Maryland, and Washington, DC, which all have an effective tax rate at or above 6.5% (figure 4).

We estimate that even the more aggressive version of the Fair Share Tax would put the effective tax rate on the top 1% in Pennsylvania at 6.14%, which remains lower than four of our neighbors.
There is almost no evidence that tax rates at the level we propose harm economic growth—and there is evidence that cutting taxes for people with low incomes helps their communities economically. Indeed, reducing the tax burden on work and those with low incomes, who must spend almost all their income, while raising it on the rich, who save much of their income, is likely to increase consumption benefiting our economy, especially in low-income communities.

Two other concerns are often raised about the Fair Share Tax, so let me answer them now.

**Seniors Are Protected**

First, the Fair Share Tax does not put an unfair burden on retired Pennsylvanians. Pennsylvania is one of the best places to retire from a tax perspective. Social security, pension withdrawals, and 401k withdrawals are not taxed at all. The Fair Share Tax would raise more only from retired Pennsylvanians who have substantial financial holdings beyond these protected categories and who are almost entirely in the top 5% of households. We will have more detailed data to support this claim in our forthcoming paper.

**Small Businesses Receive a Tax Cut**

The tax also does not put an unfair burden on small, family-owned businesses or farms. In fact, our plan includes a built-in loophole for very small businesses. Those businesses could avoid the tax increase by taking the income from their business as wages instead of business profits. Since the tax rate on wage income would decline under the Fair Share Tax, these small businesses would see a reduction in their taxes.

Larger businesses would not be able to take advantage of this loophole because they would need to show a profit to secure loans. Typically, loans to family-owned businesses are secured by the assets of members of the family.

**The Impact of the Fair Share Tax on our Upside-Down Tax System**

The two versions of the Fair Share Tax go part-way to making state and local taxes in Pennsylvania more progressive as seen in figure 5, which brings the data in figure 1 together with estimates of the impact of
both the standard and aggressive version of the Fair Share Tax. Both versions of the Fair Share Tax make major reductions in the tax rates of the second, third, and fourth quintile—or broadly speaking, Pennsylvania’s middle class. Both versions raise tax rates on the top 1% and next 4% of households. The more aggressive version of the Fair Share Tax does better than the standard version. But neither of them gives us a flat, let alone progressive, tax. We could find a variant of the Fair Share Tax that would come closer to a flat tax. But true progressivity for all but the first quintile would require other measures, including a repeal (or reinterpretation) of the uniformity clause to allow graduate tax rates, reform of the corporate net income tax to require combined reporting, a severance tax on natural gas drilling, or some form of direct tax on wealth.⁵

Figure 5

Impact of Two Versions of the Fair Share Tax on Tax Fairness in PA

Source: Pennsylvania Policy Center analysis of Institute on Taxation and Economic Policy Data.

I would suggest, however, that even if we could overcome the uniformity clause, the basic principle of the Fair Share Tax remains a good idea. As we saw above, there is a very strong case to be made for taxing income from wealth at a higher rate than income from work, especially when our economic system has become tilted heavily in favor of the owners of capital and against working people.

The standard version of the Fair Share Tax does little to reduce our highest-in-the-nation tax rate on families in the lowest quintile of income. The more aggressive version does a bit better. But because the tax forgiveness program excludes many families with low incomes from paying the Personal Income Tax, the Fair Share Tax does little to reduce their tax rate. To make a larger dent in the overly high taxes paid by the

⁵ A version of corporate tax reform, sponsored by Representatives Samuelson and Fiedler, passed the House in 2023.
lowest 20% of Pennsylvania families, we need to enact other policies such as the Working Families Tax Credit (also known as the state Earned Income Tax Credit) which provides a state refundable tax credit that piggybacks on the federal Earned Income Tax Credit.\textsuperscript{6}

**The Constitutionality Issue**

I want to conclude my remarks by addressing the constitutionality of the Fair Share Tax. What I say here only skims the surface of the issue; I also refer you to the legal brief we commissioned from the noted tax attorney Richard Feder.

To some extent, the impact of a Fair Share Tax simulates the pattern of tax distribution that would result from Pennsylvania having a graduated income tax by raising taxes on households with higher overall incomes and cutting taxes for households with lower overall incomes. But it is not a graduated income tax. That is why the Fair Share Tax is not inconsistent with the uniformity clause of the Pennsylvania Constitution.

The uniformity clause requires that a tax must be “uniform upon the same class of subjects.” The different classes we apportion to the two replacements for the Personal Income Tax are well-defined in both federal and state law. Under the Fair Share Tax, each class of income is taxed at a single rate. And variations in the tax rate on different classes of income is a long-standing tradition in federal tax law and that of many states.

As shown in a large body of case law, the usual interpretation of the uniformity clause—and many examples of taxes that are similar to the Fair Share Tax in one way or another—would not stand in the way of the General Assembly enacting our proposal.\textsuperscript{7} Perhaps most importantly, Pennsylvania’s courts have long allowed for different tax rates on different “readily recognizable, well-established” classes or categories of income that are “regularly subject to differential treatment in the business world, the financial world, and/or the regulatory world.” As our brief shows, the distinction between active and passive income—or earned and unearned income—is long established in all these areas.

In addition, as the appendix to Mr. Feder’s brief shows, any decision declaring the Fair Share Tax unconstitutional would also have to declare many other taxes unconstitutional, including the earned income tax levied by municipalities and school districts and the Philadelphia wage tax. All of these taxes have a single rate but do not tax all classes of income.

Pennsylvania case law holds that a policy rationale for taxing different categories of income at different tax rates is not required under uniformity clause case law so long as the different rates apply to well-established categories of income. And there are a number of sound rationales for taxing income from work and income from wealth differently.

\textsuperscript{6} A version of such legislation, sponsored by Representative Fiedler, passed the House in 2023.

First, higher taxes on labor tend to reduce the economic incentive to seek employment or to work longer hours. By enacting the Fair Share Tax, the General Assembly would be creating a strong incentive for Pennsylvanians to work and to work more by rewarding those who do.

Second, Pennsylvanians need to produce active income in order to meet their daily living expenses; thus, the Legislature has good reasons to ease the burdens on workers, as the tax burden simply takes money off the table from people who really need it. In contrast, passive income, or income from property or wealth, is generally received by those with greater means, who can more easily afford a higher tax burden.

Third, income from wealth also involves some measure of speculative activity; taxpayers use their wealth to purchase and maintain some income-producing property. The Legislature could conclude rationally that those who can afford to take such risks can also afford to absorb a slightly higher tax burden.

Fourth, the huge expansion of inequality in America in the last 35 years is the result of the returns to labor declining relative to the returns to capital or wealth. This is, first, contrary to the basic premise of our country and our state. America and Pennsylvania have always been dedicated to the proposition that hard work should be rewarded. As wages have stagnated, that has become increasingly untrue. We can partly compensate for the tilt in our economy from labor to wealth by creating a tax system that taxes the latter at higher rates than the former.

Fifth, increasing wealth is also dangerous to our democracy as both our Founders and later advocates for preserving our democracy from huge accumulations of wealth, such as Theodore Roosevelt and Louis Brandeis, warned. Wealth can too easily be translated into political power. Increasing the tax on wealth is one way to limit the kinds of wealth accumulation that threaten our democracy.

And sixth, racial justice demands that we tilt our tax system from taxing wages to taxing income from wealth. The consequences of slavery, Reconstruction-era policies and practices, economic and residential segregation, government policies such as redlining, the impact of segregation, and the impact of racism on housing values in Black communities have made it more difficult for people of color to accumulate wealth relative to white people. Taxing income from wealth more than wages is one way to right the balance.

Conclusion

In conclusion, enactment of a Fair Share Tax could help us both raise the revenues we need to close our public investment deficit, especially in education, and fix our horribly unfair tax system.

Thank you, again, for allowing me to testify today. I would be happy to answer any questions.