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Tax Fairness: What Does It Mean?

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Many people have strong opinions about local taxes. They might believe that some local taxes are fair while others are unfair. Being able to describe why they view these taxes this way is important, particularly as Pennsylvania considers reforming its local tax structure.

An Introduction To Tax Fairness Principles

Two main principles typically are used to evaluate the fairness of taxes: the “ability-to-pay principle” and the “benefits principle.” The two provide a useful way to think about how the tax burden is distributed. These principles are extremely helpful to understand because they are the underlying themes to much of the public debate about taxes.

Ability-to-pay principle

The ability-to-pay principle states that the tax burden should be distributed on the basis of people’s ability to pay those taxes. People with lower ability to pay should pay less than people with greater ability to pay.

The ability-to-pay principle applies 1) across all income classes and 2) among people with the same income. The former, called “vertical equity,” is exemplified by the statement, “Poor people shouldn’t pay a larger share of their income in taxes than do wealthy people.” The latter, called “horizontal equity,” is best expressed by the sentiment that “All people with the same ability to pay should pay the same amount in taxes.” According to the ability-to-pay principle, it would not be fair for some individuals to pay more than others would who have the same ability to pay—a situation that can occur if taxes discriminate between types of income or wealth.

The most difficult and controversial aspect of the ability-to-pay principle is deciding how ability to pay should be measured. Should it be by annual income? By lifetime income? By net wealth? By consumption? The choice has major implications for what appears fair and unfair.

Benefits principle

The second common tax fairness principle, the benefits principle, states that people should pay taxes in direct relation to the benefits they receive. In other words, people who receive more local services or benefits should pay more in taxes than those who receive less.

The principle can work well when benefits are readily identifiable and easily quantified. The amount of public water a household uses, for example, usually is easy to determine. The benefits of most local services are not so easily assigned to specific taxpayers. How, for example, do you accurately measure and compare the benefits different families receive from the local police force, from snowplowing of public streets, or from their children attending good schools?

In addition, relying purely upon the benefits principle can ignore the public good or welfare justification for local services; we don't pay for Medicaid entirely through taxes on Medicaid recipients, for example, or ask low-income people receiving winter heating assistance to pay the entire cost of the program.

How Useful Are These Principles In Practice?

The ability-to-pay and benefits principles sometimes are inconsistent with each other, but they are important to understand because many opinions expressed about local taxes arise directly from their concepts. Having a basic grasp of these principles can provide you with a language for understanding and comparing peoples' opinions about tax fairness, and can help you identify some of the reasons people might disagree about these issues.

Other Important Criteria Used To Evaluate Taxes

Tax fairness is only one of several criteria that local government experts recommend for evaluating the appropriateness of specific local taxes. Other criteria include adequacy, adaptability, administrative ease and economy, economic effects, and social acceptability. Local officials and communities must balance fairness concerns with these other criteria. The fairest tax might not be viable in your community, for example, if it fails to produce sufficient tax revenues for your school district, county, or municipality to operate, or if it is too difficult to administer.

How Do Pennsylvania Taxes Measure Up?

How do Pennsylvania's most important local taxes and tax reform alternatives measure up to these criteria? What are the advantages and disadvantages that people identify with each?

The Real Property Tax taxes the value of real property (land, buildings, and other improvements) owned by a taxpayer. This is often called the "Real Estate" tax.

Advantages:

- The real property tax is the only local tax that local businesses (such as gas stations, factories, and department stores) and non-resident property owners (such as hunting camps and vacation homes) pay in most jurisdictions.
- It is a stable revenue source, so it allows a government to be more accurate in budget planning. It is more insulated from economic downturns than an income or sales tax.
- It is relatively difficult to cheat on the real property tax compared to other taxes (e.g., you cannot pretend not to own the property or that it doesn't have a house on it), which means people can't easily evade it.

Disadvantages:

- The amount someone pays is based upon the value of their property, not their income and thus their ability to pay the tax. However, some economists argue the fairness of this depends upon whether one considers annual- or lifetime-income.
- Unfairness also exists across county, municipal, and school district boundaries, because tax rates have to be higher in poorer jurisdictions to generate the same amount of revenue per capita.
- The tax can create special burdens on farmers and other land-intensive businesses.
- The tax is only as fair as the assessments that set the property values— and yet these assessments are out of date in many Pennsylvania counties.
- The real property tax is costly and complex to administer.
- The real property tax discourages investment in property improvements, and some argue it contributes to urban sprawl.

Earned Income Tax taxes residents' earned income, such as wages, salaries, and other reimbursements for work. Unearned income, such as interest, dividends, pensions, and social security, are exempt from the tax. The EIT is commonly used by Pennsylvania municipalities and school districts.

Advantages:

- Some argue the EIT is a better reflection of ability-to-pay than real property tax.
- Pennsylvania taxpayers are familiar with the tax. For most taxpayers, it is collected from each paycheck, making it relatively easy to pay. Tax collections naturally grow over time as peoples' incomes increase because it is collected as a flat percentage of earnings.
- Pennsylvania local tax collectors are familiar with how to collect the tax.

Disadvantages:

- The amount collected fluctuates widely, depending upon the economy, making it difficult for local officials to budget.
- It is not paid by local businesses or nonresident property owners, even though they require public services paid for with tax dollars.
- The EIT only taxes earned income, so it primarily affects working age residents. Income from interest and investments is exempt, though these types of income are often the main income sources for higher income professionals.
- Working age taxpayers are becoming an increasingly smaller proportion of the population in Pennsylvania, so the tax burden would shift to a smaller proportion of the community.
- Pennsylvania residents who work and pay income taxes in New Jersey or New York get a tax credit on their local EIT, which means they pay no local income tax. This disproportionately affects counties, municipalities, and school districts in border counties where a large number of residents commute to these states to work. The Sterling Act similarly affects taxpayers who work in Philadelphia but live elsewhere in Pennsylvania.
- It is easier to cheat on this tax than other taxes, which means dishonest residents can avoid or reduce their tax obligation, shifting the tax burden to honest residents.

Personal Income Tax taxes residents' personal income, which includes earned income (such as wages, salaries, and other reimbursements for work), and interest and dividends. Social security and pensions are exempt from the tax. This is identical to the Commonwealth of Pennsylvania's state income tax, and recently became an option for school districts via Act 72 of 2004 and Special Session Act 1 of 2006.

Advantages:

- The PIT is a better reflection of ability to pay than real property tax, or the earned income tax because it doesn't ignore interest and investment income.
- Pennsylvania taxpayers are familiar with the state personal income tax, which is identical to the local version authorized for school districts. For most taxpayers, it is collected from each paycheck, making it relatively easy to pay.
- Tax collections naturally grow over time as peoples' incomes go up.

Disadvantages

- The amount collected fluctuates widely, depending upon the economy, making it difficult for local officials to budget.
- The PIT is not paid by local businesses or nonresident property owners, even though they require public services paid for with tax dollars.
- Pennsylvania residents who work and pay income taxes in New Jersey or New York get a tax credit on their local PIT, which means they pay no local income tax. This disproportionately affects counties, municipalities and school districts in border counties where a large number of residents commute to these states to work.
- PIT tax rates are not very flexible, which would make it difficult for jurisdictions to adjust the tax rate as needed.
- It is easier to cheat on this tax than other taxes.
- Pennsylvania local tax collectors have no familiarity with how to collect the tax.

Local Sales Tax taxes the retail price of items purchased by consumers, and is collected by the retailer who sells the item. The sales tax is currently used by the Commonwealth of Pennsylvania and in Philadelphia and Allegheny counties. Purchases of food, clothing, drugs, and other selected items currently are exempt from the sales tax.

Advantages:

- The sales tax is based upon taxpayers' ability to pay, as measured by their consumption of goods and some services.
- It is collected from taxpayers at point of sale, in small increments, rather than in large lump sums.
- Tax collections naturally grow over time as peoples' incomes (and thus spending) go up.
- If many customers at local businesses come from outside the jurisdiction, a share of the local tax burden will be paid by non-residents.

Disadvantages:

- The amount of sales tax collected fluctuates widely, depending upon the economy, making it difficult for local officials to budget.
- The amount that can be collected depends, in part, upon where residents go to shop. Jurisdictions with many “magnet” businesses that attract customers from miles away can do quite well. Those without many businesses will not do well.
- It is not paid by local businesses, even though they require public services paid for with tax dollars. Businesses collect the sales tax from customers, rather than paying it directly out of their own profits or sales.
- If sales tax rates vary across counties, it could make some businesses less competitive as customers go to shop where the tax rate is lower.
- Low income residents spend higher portions of their income than do higher income residents, although exemptions for “necessities” such as food and clothing are intended to reduce the unfairness of the sales tax.
- Sales tax rates are not very flexible, which would make it difficult for jurisdictions to adjust the tax rate as needed.
- Sales tax is not as easily deducted from federal income tax as either the real property or local income tax.

For More Information

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