Testimony on the FY2005 Tax Measures

Presented By

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Good morning, President Verna and members of City Council. I am Joyce Wilkerson, Chief of Staff for the City of Philadelphia. Thank you for this opportunity to present testimony on FY05 tax measures that are currently before Council.

No one has done more to provide tax relief in Philadelphia over the past nine years, year in and year out, than Mayor John F. Street has. As Council President, he joined with Mayor Rendell to initiate the City's unprecedented program of tax cuts after a half-century of steadily rising tax burdens. As Mayor, he has not only continued this program through a ninth consecutive year, returning $244 million in tax relief to taxpayers, he has proposed and implemented accelerated rate reductions. The $375 million in tax relief proposed in the FY05-FY09 Five-Year Financial Plan would extend the tax reduction program to a fourteenth year and provide the largest amount of relief yet in any Five-Year Plan. Although the Mayor has warned of the challenges and choices involved in making these changes, he has proposed tax relief in each of his budgets, because it is one of the key investments that is necessary to our city's future.

You have heard about the $670 million deficit that loomed when we began to prepare the Plan. You have learned about the steps we propose to head off that deficit and avert another fiscal crisis. In spite of the palpable risk in our future, this Administration maintained its commitment to tax reductions, and not only maintained the existing tax reduction program, but also provided another $65 million in tax relief proposed by the Tax Reform Commission. The annual reductions in the wage tax would leave the resident rate 15 percent lower in FY09 than before the tax cuts began, and annual reductions in the gross receipts rate would cut the FY09 rate to less than half what the rate was when the cuts began.

After three straight years of declining fund balances, after a prolonged national slump that has caused local governments in New York, Los Angeles, Detroit, Washington, D.C., Atlanta, and Baltimore to raise tax rates or halt tax reductions, we found a way to continue to cut taxes. As you well know, our neighbors in Pittsburgh, on the brink of bankruptcy, sought and received the designation of fiscal distress in order to obtain the authority to increase their taxes. Here in Philadelphia, we do things a little differently. No other major city has continued to cut taxes every year as we have. We are unique. We make tax relief a priority because it is one of our strategic investments, but there is a limit. There is a limit to what is affordable and fiscally responsible.

We are faced with the daunting task of balancing the many strategic investments that Philadelphia needs to grow in the midst of our most serious fiscal challenge in a decade. For the past month, you have been diligently learning about the difficult choices that must be made on the expenditure side of our budget. In order to offset a $119 million increase in our pension and health benefits costs in FY05, as well as increases in our mandated subsidies to state authorities and key investments in a few departments, we have proposed cutting a total of $107 million from the rest of the City budget, or 5.4 percent. You have heard about the impacts that these cuts may have on services, even though in our proposed budget we attempted to limit the impact on service as much as possible through innovation, restructuring, and productivity improvements. The proposed budget you are considering makes no allowance for wage increases or public emergencies.

We have been cutting our expenditures and our greatest expense item, personnel costs, consistently for the past several years, until there is very little opportunity to reduce the size of our workforce further without disrupting services. Since October 2003, the size of our workforce has dropped by 3.5 percent. Prior to that date, the hiring freeze we implemented in 2001 had already resulted in the reduction of over 600 positions in the departments that were not exempt from the freeze. The hiring freeze will remain in place, and we will fill positions only when absolutely necessary. We will continue to replace only one-half of the positions that leave through the DROP, as we budgeted for in this year's proposed Plan and last year's. Further reductions in staffing will likely lead to service reductions. It will become more and more difficult to pick up the trash on time, replace and restore our roads on the proper cycle, keep libraries open, fight homelessness, child abuse, and the spread of disease, maintain our parks and recreation centers, and make Philadelphia a safer city, with ever-dwindling staffing.

Although the Mayor in his budget message signaled a willingness to compromise on his proposed budget, he was clear that for every recommended restoration there must be a correction through new and offsetting cuts. Similarly, for every dollar of revenue that we forego, there must be an adjustment in expenditures. We are not the federal government. We can not print money, or borrow against our future to avoid the difficult choices of today. Yet we all agree that tax reductions are valuable and necessary for our city to become more competitive and grow.

Unfortunately, as we sit here today, we start from less than zero. Many of you would like to see funding restored to programs or departments you support. The reality is that we must first find the funding to make the Plan balanced again. The Pennsylvania Intergovernmental Cooperation Authority sent a letter to the Mayor and City Council indicating that it would not approve certain revenue projections. Subsequent to that letter, the Administration determined that we needed to forgive the annual payments from the Philadelphia Gas Works in order to ease PGW's cash flow crisis and avoid a devastating ratings downgrade. Instead of projecting a positive fund balance of $11.5 million in FY09, we must now address a negative fund balance of almost $90 million, before we can even think of restoring spending cuts or funding tax relief beyond the $440 million already included in our proposed Plan.

The Philadelphia Tax Reform Commission was charged with studying our taxes and making recommendations on how they should be reduced and simplified in a "fiscally and socially responsible manner." I would like to take this opportunity to thank the members of the Tax Reform Commission for their volunteer service, and their contribution to the discussion of our tax structure. The report of the Commission brought many potentially fruitful ideas to light and provided informative data on which to base decisions, data which, in part, was developed in conjunction with members of City government. Our proposed Five-Year Plan endorsed and incorporated fifteen of the Commission's recommendations. These recommendations are detailed in the Plan, but the key changes the City is proposing for the next fiscal year, which are incorporated into the proposed FY05 budget, include:

- *Establish Accurate Land and Structure Values for All Property Parcels.* This will provide more comprehensive and accurate data collection for the real estate tax assessment process. The FY05 budget includes $5 million in funding for the Board of Revision of Taxes to carry out this recommendation.

– *Eliminate Fractional Assessments*. The BRT will attempt to value all properties at 100 percent of market value. The Administration supports the BRT's proposal to implement this recommendation in FY06, following a pilot and the establishment of more accurate land and structure values. This proposal would entail adjusting real estate tax millage rates in the future.

– *Phase-in Land Value Taxation*. The Commission's recommendation is to increase the percentage of real estate tax revenues from taxing the value of land from its current 22.5 to 50 percent by 2014. This change would begin in FY06 after the BRT has established accurate values.

– *Single-Sales Factor Apportionment.* Instead of basing the net income portion of the business privilege tax on property, payroll and a double weighting of sales in Philadelphia, the City would base this tax solely on sales in Philadelphia. Although this change is projected to cost the City $13 million annually, it will eliminate the current penalty for businesses that operate and invest within Philadelphia. This change is proposed for FY05 in conjunction with a proposed increase in the parking tax from 15 percent to 20 percent to help offset the cost.

– *Shift to January 1st Implementation of Changes in Wage and Earnings Tax Rates*. Changing the effective date of reductions in the wage and earnings tax rates from July 1st to January 1st beginning in FY05 would conform those changes to the federal tax year, and remove a compliance burden for businesses so that they need only adjust their withholding rates once each year.

These recommendations will reduce the City's revenue by approximately $65 million and cost at least $5 million to implement and administer over the life of the Plan, in addition to the $375 million in tax relief from our proposed rate reductions.

The Tax Reform Commission made other recommendations that, unfortunately, we determined we could not responsibly adopt. The recommendations that require your approval have been introduced as legislation. Exhibit A, attached to my testimony, indicates which bills we do not support because of the potential negative effects they would cause, including:

- Unaffordable revenue losses;
- Changes in timing that would significantly impair our budget or cash flows, or cause taxpayers to pay their bills twice in one year; or
- Unduly restrictive legal constraints.

The recommendations we do not support were projected by the Commission to reduce the City's revenue by $285 million over the life of the FY05-FY09 Plan, although this revenue projection has since increased to over $290 million due to increased growth assumptions in the Plan. However, the loss of revenues resulting from the Commission's recommendations do not end with this Plan. The bills before you today include schedules for mandated wage tax reductions through 2014, and the elimination of the business privilege tax by 2015. Yet, despite its charge to provide a fiscal impact statement along with any required ordinances, the Commission made no estimate of the cost of its recommendations beyond FY09, even as the magnitude of the wage tax reductions increase in FY10, and the gross receipts reductions accelerate in FY09.

Put another way, in order to pay for the wage and business privilege tax reductions and changes proposed by the Tax Reform Commission, in FY09 the City would have to increase the real estate tax by 37 percent, or find an alternative source for the $146 million cost in that single year. To pay for the elimination of the business privilege tax, whether by 2015 as recommended by the Tax Reform Commission, or by 2009 in an alternate Bill, the City would have to increase the real estate tax by 75 percent or find alternative sources to replace this funding.

In addition, the recommendations we do not support would possibly even worsen the tax burden for a significant portion of our taxpayers, particularly our most vulnerable taxpayers. The Tax Reform Commission hired Econsult to produce an econometric model on tax rates and their effects in Philadelphia, similar to the model they were hired to produce for the Pennsylvania Economy League in 2002. In their report to the Commission, Econsult produced estimates of the supply side effects of tax reductions. The Econsult report estimates that by FY09, the City's real estate tax revenues would increase by $92 million. That amount represents a 23.5 percent increase from our Plan projection. In other words, within the length of this Plan, a typical resident might pay 23.5 percent more in real estate taxes due to the Tax Reform Commission's package of recommendations. The Econsult report also projects that by 2017 the median home value in Philadelphia would increase by 29 percent in "real" or inflation-adjusted dollars, or 40 percent after inflation.

To many, this would be great news. To others, it would represent a difficult burden and a damaging blow to one of Philadelphia's historical strengths, its relatively high home-ownership rate among northeastern cities. To the Tax Reform Commission, the increased real estate taxes represent an opportunity for the City to replace some of the revenue lost by tax cuts. However, Econsult itself addressed these concerns in its 2002 report to PEL:

> "*The increase in property tax revenue from the increased value of properties is unlikely to be politically feasible. It would imply large increases in property tax payments by Philadelphia property owners, many of whom have little ability to pay the increased property taxes resulting [from] the higher value of their properties*."
> [Econsult report submitted to PEL February 2002, page 24]

You haven't heard much about this, but it's a critical issue. If real estate taxes did increase by as much as Econsult estimates, many Philadelphians would suffer; if elected officials prevented real estate taxes from increasing as much as Econsult estimates, then the supply side effect touted by the Tax Reform Commission would be illusory.

It's also important to point out what Econsult modeled. Econsult modeled the effects of the tax rate changes recommended by the Tax Reform Commission by comparing them to our current tax rates. In other words, the supply side effects they estimate include the effects of both the tax reductions in our proposed Plan *and* the Commission's additional reductions. Whenever you see the costs of the Tax Reform Commission's proposals, however, they are always calculated by subtracting the cost of the tax reductions included in the Administration's proposed Plan. If anyone shows you a comparison of Tax Reform Commission tax cut costs and supply side benefits where the supply side benefits are greater than the costs between FY05 and FY09, they are comparing apples and oranges, and they are wrong. Under the most optimistic supply side scenario, which is essentially what Econsult has given us, tax cuts mean less revenue for the City during this Plan.

Since Econsult modeled the impact of both the cuts proposed in the Plan as well as the additional cuts proposed by the Tax Reform Commission, we can identify the potential impact of the cuts proposed in our Plan. The cuts proposed in the Plan represent 66 percent of the value of tax cuts modeled by Econsult through FY09. Based on that proportion, their model indicates that the Plan's tax cuts alone would result in an increase of over 31,300 jobs by 2010, although we do not have enough confidence in that figure to build it into our budget.

Supply side effects, or "voodoo economics," as they were once described by George Herbert Walker Bush, have a very limited role in government forecasting. Some state governments, and very recently the federal government, look at supply side effects as part of their budget analysis, but they do not include them in the budget itself, despite years of pressure from far-right Republicans. As recently as 2002 the nonpartisan Congressional Budget Office believed that using supply side effects in the budget process "would pose intractable problems." We all believe that tax reductions have a beneficial effect on our economy, or we wouldn't be discussing these measures today. What we don't know with any certainty is how great those effects are and when they would take place. For this reason, in 1998 the District of Columbia Tax Revision Commission refused to recommend the use of any supply side effects as a means of funding tax reductions following their two-year-long study. Consider that after years of pressure from Republican legislators, the State of California developed a supply-side model with the assistance of the University of California-Berkeley Economics Department. This model projected no more than a twenty percent supply-side return to state tax cuts. Other models for the Connecticut and Massachusetts state governments had similar returns, as did a study on New York City tax cuts by a private think-tank. The conservative Heritage Foundation projected no more than a 50 percent supply side return to federal tax cuts, although *even the Bush White House continues to avoid using supply side effects to justify tax cuts*. The Econsult model projects far higher returns than any of these models – more than five times as great as the model developed for the country's largest state by one of the leading economics departments in the world.

To our knowledge, no other federal, state, or local government explicitly budgets for a supply side effect, and this Administration does not intend for Philadelphia to be the first. Even those cities that have multi-year budgets, and have made tax reductions in the last five to ten years, like New York City and Washington, D.C., do not budget for a supply side effect. We do not believe that being the first would be bold and innovative. We believe it would be unreasonably risky, desperate, and fiscally irresponsible.

While we are discussing tax measures here today, it is appropriate to touch on the issue of tax collection rates and receivables. There has been some discussion recently of our outstanding tax receivables. The Tax Reform Commission recommended that the City could improve tax collection rates by one percent, although it provided no benchmarking or other support for that contention. The Administration does agree that tax collections could improve, and accordingly proposed a small investment in staffing for FY05 in the hopes of generating additional revenue.

Based on some preliminary analysis of other cities and their real estate tax collections, while there is room for improvement, it is not a dramatic amount of room. For fiscal year 2002 our real estate tax collection rate of 93.7 percent was superior to that of New York City and Washington, D.C., and only slightly lower than Pittsburgh, while a four-year average rate produced similar results. The majority of our tax revenues are of course from the wage tax, and due to state laws mandating employer filing, our improved databases, and our cross-matching against Internal Revenue Service files, we are confident that our collections of this tax are strong. As City Solicitor Ramos detailed in his budget testimony, we can and will do better, but I assure you that this is not the magic wand that will provide the funding for budget restorations and additional tax cuts.

The Administration supports several bills that were not part of the Tax Reform Commission package, including Bill no. 040261 and Bill no. 040256. Bill no. 040261 would allow the adoption of the Tax Reform Commission's recommendation to shift the effective date of future wage tax reductions from July 1st to January 1st to ease compliance burdens for businesses. This Bill would also modify the trigger for reductions in wage taxes that by Bill 030073 must be implemented in response to real estate tax collections growth of more than two percent per year. The Bill would increase this threshold to four percent, which would continue to provide residents relief and protection against surges in real estate values, while allowing the City to benefit from reasonable levels of inflationary growth in our second-largest tax source. Bill no. 040256 would raise the parking tax rate in order to provide additional revenue necessary to balance the Plan. The Tax Reform Commission commented that "When compared to other Philadelphia taxes, the burden created by the Parking Tax is relatively small." The Administration agrees. This change would provide much-needed revenue while protecting Philadelphia residents.

Just as we all believe that tax reductions provide an economic benefit, or we wouldn't support them, we all recognize that maintaining our core public services is also necessary, or else we would cut the wage tax rate to 0. Professor Robert Inman of Wharton has conducted groundbreaking and extensive work on the effect of taxes on our city, and while he was the first to estimate the negative effects of taxation, he has also always stressed the need to maintain public services in order to gain economic benefits from tax cuts. The Tax Reform Commission, in its hard and valuable work, identified numerous reforms and some key tax cutting goals: the elimination of the business privilege tax and the reduction of the wage tax rate to an arbitrary 3.25 percent. The Commission then concluded that these recommendations were "fiscally and socially responsible." Each year, this Administration, and this Mayor, apply decades of collective expertise in the City's finances in order to determine what tax reductions are affordable, and then make them work within the City's budget by trimming expenditures. This year, we are facing the biggest fiscal challenge in a decade. The tax reductions included in the proposed Plan provide an investment in our future while protecting our services and fiscal health. The cost of any tax reductions beyond those in the proposed Plan must be paid for with offsetting revenue increases or expenditure reductions. Those who support additional tax reductions should be prepared to identify the corresponding budget cuts. We have gone as far as we can go.

Thank you for the opportunity to present this testimony regarding the FY05 tax measures. We would be happy to answer any questions that you have at this time.

Exhibit A

Tax Measures Currently before City Council

Bill Number	**Administration Position**
040009	*Opposed*
040010	*Opposed*
040011	*Neutral, if the Bill does not increase the City's administrative costs*
040012	*Opposed*
040013	*Opposed*
040014	*Opposed*
040015	*Support*
040016	*Support*
040017	*Opposed*
040018	*Opposed*
040019	*Support*
040020	*Opposed*
040021	*Support, with amendment*
040022	*Opposed*
040023	*Opposed*
040256	*Support*
040261	*Support*
040313	*Bill requires further study and impact analysis*