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May 8, 2007

Dennis Yablonsky  
Secretary, Office of Community Affairs & Development  
Department of Community and Economic Development  
400 North Street, 4th Floor  
Commonwealth Keystone Building  
Harrisburg, PA 17120-0225

Dear Secretary Yablonsky:

As you know, in 2004 the Governor's Center for Local Government Services estimated that, based on FY 2000-01 data, at least \$100 million annually in school district and municipal earned income tax revenues went uncollected. Among the reasons the Governor's Center cited for this large amount of uncollected revenue were the lack of uniform tax withholding and the general fragmentation of earned income tax collection at the local level.

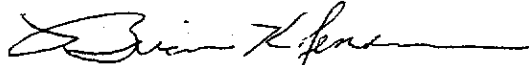
In anticipation of the introduction of legislation that would consolidate, modernize and introduce uniformity to the earned income tax collection process, the Pennsylvania Economy League of Southwestern Pa. (PELSW) reviewed the Governor's Center estimate. PELSW judged the methodology to be thorough and sound. It generally tended to underestimate, rather than overestimate, the total amount of earned income tax revenue lost under the current fragmented system.

PELSW went on to develop its own estimate of "lost" earned income tax revenue. We applied the Governor's Center basic methodology using FY 2004-05 data. The result of PELSW's analysis shows that **\$237 million** annually in lost school district and municipal earned income tax revenue was potentially recoverable for collection under a more efficient, thorough tax collection system. The increase over the Governor's Center estimate can be explained by the poor state of the national economy during the original study period (just prior to and following the

9/11 terrorist attacks) and the substantial economic recovery underway during FY 2004-05.

I have attached a detailed explanation of PELSW's results and methodology. Please feel free to call me if you have any questions.

Sincerely,



Brian K. Jensen, Ph.D.  
Senior Vice President  
Local Government Function and Structure Program

cc: Steve Crawford, Secretary for Legislative Affairs  
Office of the Governor  
Donna Cooper, Secretary of Policy and Planning  
Office of the Governor  
Kenneth Klothen, Deputy Secretary  
Office of Community Affairs & Development  
Christian Muniz, Director, Legislative Affairs  
Department of Community and Economic Development  
Michael Langley, Chief Executive Officer  
Kathryn Z. Klaber, Executive Director

attachment

## **Earned Income Tax Revenue Loss Analysis: Results and Methodology Pennsylvania Economy League of Southwestern Pa.**

### Issue Background

Under existing earned income taxes (EIT) collection processes in Pennsylvania, income is typically self-reported and paid to local EIT collectors. It is suspected that income is underreported and the full amount of EIT owed is goes uncollected under this self-reported, decentralized collection system.

### Finding Summary

The Pennsylvania Economy League of Southwestern Pa. (PELSW) undertook an analysis to estimate the gap between the collections of EIT at the local level and potential collections under a consolidated collection system. PELSW compared actual 2004-05 EIT collections reported by school districts to the Pennsylvania Department of Education to the earned income reported on state personal income tax (PIT) returns for the same school districts in 2004 and the resulting EIT revenue that was potentially available for collection. The analysis suggests that **\$127 million** more EIT revenue was potentially available for collection statewide than was collected by school districts (this includes over **\$37 million** for southwestern Pennsylvania). Extrapolating from this finding to include municipal EIT shows that **\$109 million** more revenue was potentially available for collection statewide than was collected by municipalities (**\$38 million** in southwestern Pennsylvania). A combined **\$237 million** more school district and municipal EIT revenue was potentially available for collection statewide (**\$75 million** in southwestern Pennsylvania) than was reported collected at the local level.

### Data Sources

Local EIT collections by school district for 2004-05 were obtained from the Pennsylvania Department of Education<sup>1</sup>. School district and municipal tax rates for 2004 were obtained from the Governor's Center for Local Government Services<sup>2</sup>. PIT data for 2004 were obtained from the Pennsylvania Department of Revenue<sup>3</sup>.

Adjustment factors were calculated based on historical data from the Pennsylvania Department of Revenue, total state wage data from the Bureau of Labor Statistics and commuter data from the 2000 Census. The Pennsylvania Department of Community and Economic Development provided additional adjustment factors.

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<sup>1</sup> 'Earned Income 6151' from *Act 511 taxes for school districts* accessed from: [http://www.pde.state.pa.us/k12\\_finances/cwp/view.asp?a=3&Q=50949](http://www.pde.state.pa.us/k12_finances/cwp/view.asp?a=3&Q=50949)

<sup>2</sup> *Earned Income Rates and Collectors* (2004 historical data) accessed from: <http://munstatspa.dced.state.pa.us/Registers.aspx?H=1>

<sup>3</sup> School District Totals from *Personal Income Tax Statistics* accessed from: <http://www.revenue.state.pa.us/revenue/cwp/view.asp?A=246&Q=261530>

### Method

Taxable Compensation was added to Net Profits for each school district to create an income base comparable to the local EIT base reported in the PIT earnings data.

Both Taxable Compensation and Net Profits were increased to reflect a share of Invalid Returns and Out-of-State returns (the share was assigned based on each school district's proportion of total state Taxable Compensation or Net Profits). This accounts for revenue from filers who did not specify the correct school district code and from taxes withheld for out-of-state filers at the state level.

Since the data for local EIT collections were for the school districts' fiscal year 2004-05, and the PIT earnings data was for calendar year 2004, an adjustment was necessary for both Taxable Compensation and Net Profits. Using data from the Bureau of Labor Statistics on Pennsylvania total wages in 2005 and 2004, half of the annual growth was used to adjust the 2004 PIT Taxable Compensation to the 2004-05 period. To adjust Net Profits, the average annual increase in PIT reported Net Profits over the 2000 – 2004 period was halved and applied to the 2004 PIT Net Profits data to adjust it to the 2004-05 period.

As some Pennsylvania employees have their PIT payments withheld from their income, but fail to file their taxes at the end of the year, some income is not captured by the PIT data source used. The Pennsylvania Department of Community and Economic Development supplied the 2000 ratio of these 'nonfilers' to filed returns. This was then used to increase the PIT Taxable Compensation in each school district.

Adjustments were also made to reflect Pennsylvania residents who work either in Philadelphia or Ohio. Estimates of these commuters were calculated for Philadelphia's surrounding counties and for the whole state with regards to Ohio based on data from the 2000 Census. PIT Taxable Income was reduced by the proportion of commuters to reflect the smaller EIT base in these areas.

The PIT taxable base for Net Profits is broader than for the EIT. To account for the income distributed from S corporations (taxable at the state, but not the local level), Net Profits was reduced by 30 percent<sup>4</sup>.

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<sup>4</sup> The percentage was supplied by the Pennsylvania Department of Revenue based on the proportion of S corporations to other types of business entities reporting net profits on their 2004 federal tax returns.

To summarize, the data was adjusted as follows:

To get the Adjusted Taxable Compensation for each school district:

$$\left[ \begin{array}{l} 2004 \text{ Taxable} \\ \text{Compensation +} \\ \text{apportioned Out-of-state} \\ \text{and Invalid Returns} \end{array} \right] * \left[ \begin{array}{l} 1 + 2004- \\ 05 \text{ Growth} \\ \text{Adjustment} \end{array} \right] * \left[ \begin{array}{l} 1 + \text{Non-} \\ \text{filers} \\ \text{Adjustment} \end{array} \right] * \left[ \begin{array}{l} 1 - \% \text{ Ohio} \\ \text{Commuters - \%} \\ \text{Philadelphia} \\ \text{Commuters} \end{array} \right]$$

To get the Adjusted Net Profits for each school district:

$$\left[ \begin{array}{l} 2004 \text{ Net Profits +} \\ \text{apportioned Out-of-} \\ \text{-state and Invalid} \\ \text{Returns} \end{array} \right] * \left[ \begin{array}{l} 1 + 2004- \\ 05 \text{ Growth} \\ \text{Adjustment} \end{array} \right] * \left[ \begin{array}{l} 1 - \text{S-corp} \\ \text{Adjustment} \end{array} \right]$$

The EIT rate for each school district was then applied to this adjusted PIT base, to produce an estimate of the EIT revenue that could have been collected based on the state data.

The loss of school district tax revenues was calculated as the difference between this PIT based EIT revenue and the EIT revenue actually reported by school districts. This loss came to over \$127 million in aggregate across the state with \$37 million of the total attributable to the 10-county region of southwestern Pennsylvania.

The loss of municipal tax revenues was calculated by using the ratio of the lowest municipal EIT rate in each school district to the school district EIT rate and applying this to the previously calculated loss of school district tax revenues. This came to \$109 million foregone municipal EIT revenue across Pennsylvania with \$38 million of this amount attributable to southwestern Pennsylvania.