Budget Hearing for the Independent Fiscal Office
House and Senate Appropriations Committees
February 20, 2018

Good morning/afternoon Chairmen and members of the committee. I appreciate the opportunity to testify before you today. To provide some context for the packet that has been submitted for this budget hearing, I would like to briefly discuss recent economic and revenue trends, as well the potential impact of the federal Tax Cuts and Jobs Act (TCJA).

Revenue Update

Through January, the IFO revenue estimate is holding up well, and actual revenues are up roughly $190 million over estimate once we account for earlier-than-anticipated monies from the lease of the Farm Show complex and non-recurring monies from casino license auctions. If we also control for what appears to be accelerated personal income tax payments (~$150 million), then the overage is roughly $40 million, and it is largely attributable to inheritance tax ($30 million). At our mid-year revenue update (January 2018), we added $35 million to our official revenue estimate originally released June 2017. For this fiscal year, we are very close to the projection carried in the Executive Budget ($34.75 billion).

However, there are risks this year, and they lean to the downside. First, the IFO revenue estimate includes the receipt of the $200 million JUA transfer. We included that transfer in our official revenue estimate, and despite the current legal challenge, we have not removed it because the final outcome is not clear. Second, federal tax law changes make it difficult to discern underlying trends in corporate net income and personal non-withholding taxes because we believe that significant payment and income shifting has occurred, which will also impact the final payments received in March to May. At this point, we cannot be certain regarding the magnitude of any shift. Finally, we have assumed that recent changes to the NOL thresholds will provide a $200 million boost to corporate net income tax revenues, and nearly all of that impact should manifest itself in the final payments over the coming months.

Pennsylvania Economy

The state economy seems to be in a good position, with the latest Philadelphia CPI-U reading running low (0.8% in December), jobs growth strong (roughly 60,000 net new jobs last year) and wages increasing at a solid pace (4.2% in latest quarter). Moreover, median existing home values increased by 4.4% last year, while total mortgage debt of Pennsylvania consumers was flat (includes home equity loans). Overall, these data suggest sound economic fundamentals and potential for further expansion into next fiscal year.

There are three concerns which temper this optimistic outlook. First, sales tax collections were weak in January, and nearly flat from the prior year. Many states experienced similar weakness in sales tax revenues. At the national level, there is concern regarding the impact of federal deficits on interest rates. Any impact will likely be exacerbated by the Federal Reserve winding down its unusually large portfolio of US Treasury securities (and other debt) as well as the new corporate territorial tax regime (allowing for repatriation of certain deferred foreign income), which will motivate certain firms to sell US debt and distribute those proceeds to shareholders through dividends or share buy backs. If interest rates climb significantly, it will have a negative impact on the national and state economies, especially if rates rise quickly. Finally, some analysts have raised concerns about inflation and inflated asset values, but it is too soon to know whether either could have a material impact on short-term economic growth.

Federal Tax Law Changes

The Tax Cuts and Jobs Act will have important implications for General Fund revenues and the overall budget. In the short term, the IFO projects a modest economic boost due to the act. We project higher real GDP and wage growth, and strong growth for dividends and capital gains due to the significant reduction in the federal corporate income tax rate from 35 to 21 percent. We have built these impacts into our economic forecast and therefore, our revenue projections as well.

The federal tax law changes will impact General Fund revenues via three routes. First, the tax cut will increase disposable income. For Pennsylvania residents, the IFO estimates that disposable income could increase by $6 to $8 billion next fiscal year. Much of that income will be spent and will enhance tax revenues. The size of the impact will depend upon (1) the share that is spent and not saved, (2) the share spent on taxable items, and (3) how quickly individuals respond to the tax cut. Some forecasting firms believe the response will be immediate, while others believe there will be a six to nine-month lag.

The second way the TCJA will impact revenues is through the corporate tax rate cut. This impact is much less clear because it is not known what corporations will do with the tax cut. Corporations could do any or all of the following: (1) raise worker wages, (2) pay down debt, (3) reduce prices, (4) pay dividends, (5) buy back shares, (6) purchase machinery, equipment or expand and (7) retain the funds as cash or liquid investments. This outcome is important because the U.S. Joint Committee on Taxation estimates that the corporate rate cut and base changes are a $134 billion tax cut in the first full fiscal year they are effective.

In addition to the rate cut, the TCJA broadens the corporate income tax base, and the IFO has included that impact in the revenue forecast. The office also assumes that some pass through businesses will convert to C corporation status due to the rate cut. If that occurs, it will be a net revenue pickup for the state due to the large differential between the pass through (3.07%) and corporate (9.99%) income tax rates. I should also note that we have not included any revenue impact from Corporate Tax Bulletin 2017-02, which decouples from federal bonus depreciation. We will revisit that assumption at our May 1 revenue release.

The final way the federal tax cut will impact the economy and General Fund revenues is through indirect and induced effects. These are also known as dynamic effects that occur after the first round of spending from gains in disposable income. This impact expands the state economy, and therefore, will enhance revenues. The IFO has not included this impact in revenue projections because these effects take time to fully manifest themselves. Most researchers believe that dynamic effects will offset one-eighth to one-quarter of the projected reduction in tax revenues.

That concludes my opening remarks and I would be happy to address any questions that you may have. Thank you.

INDEPENDENT FISCAL OFFICE

February 12, 2018

The Honorable Patrick M. Browne
Majority Chairman
Senate Appropriations Committee
281 Main Capitol Building
Harrisburg, PA 17120

The Honorable Stan Saylor
Majority Chairman
House Appropriations Committee
245 Main Capitol Building
Harrisburg, PA 17120

The Honorable Vincent J. Hughes
Democratic Chairman
Senate Appropriations Committee
545 Main Capitol Building
Harrisburg, PA 17120

The Honorable Joseph F. Markosek
Democratic Chairman
House Appropriations Committee
512E Main Capitol Building
Harrisburg, PA 17120

Dear Sirs:

The Independent Fiscal Office submits this document for the purpose of the budget hearings before the House and Senate Appropriations Committees on February 20, 2018. In addition, per the request of Chairman Saylor, an attachment to this letter contains a history of spending by the office on information technology. If you require additional data or materials, please do not hesitate to contact me (717-230-8293).

Sincerely,

Matthew Knittel
Director, Independent Fiscal Office

Attachment

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Summary of IFO Information Technology Expenditures

	Actual 2011-12	Actual 2012-13	Actual 2013-14	Actual 2014-15	Actual 2015-16	Actual 2016-17	Available 2017-18	Estimate 2018-19
Personnel Costs	$0	$0	$0	$0	$0	$0	$0	$0
Hardware Costs	$50,453	$7,575	$646	$824	$9,682	$20,800	$1,000	$4,000
Software Costs	$33,183	$24,867	$11,566	$11,961	$11,150	$23,000	$12,000	$15,000
Consultant Costs	$0	$0	$0	$0	$0	$0	$0	$0
Total Expenditures	**$83,636**	**$32,442**	**$12,212**	**$12,785**	**$20,832**	**$43,800**	**$13,000**	**$19,000**