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Are Pennsylvania's Economy and Tax Collections Strengthening?

Summary: In the shadow of this year's budget crisis, the amount of total general fund revenues has quietly surpassed last year's total both on a calendar and current fiscal year basis. The three largest tax revenue collections, corporate net income, personal income, and sales and use are definitely improved from last year. Does this represent a turn-around for the state's economy? Too soon to say.

When the Legislature passed the spending plan for Pennsylvania's 2017-18 fiscal year, only half of the budget process had been completed. The second half, finding the revenue, including borrowing against future income, to pay for it all, was completed in late October when the governor signed the revenue bills. The latest budget crisis lasted nearly four months (see *Policy Brief Vol 17, No. 30*).

A $1.1 billion shortfall in FY 2016-17 revenue below projections, resulting in a carried over deficit, have compounded the funding search for FY 2017-18. The $31.8 billion in approved expenditures for the current fiscal year represents an increase of 1.5 percent over last fiscal year's $31.3 billion general fund budget. In total, the new revenue bill needed to raise an additional $2 billion, which the agreed-upon spending bill appears to do—on paper at least. Gaming options are being expanded along with substantial borrowing against future receipts from the tobacco settlement. Obviously, these borrowed funds will have to be repaid out of future tax revenues that will need to rise even further to cover those payments as well as to meet the likely shortfall in the next budget unless spending is curbed significantly. And that budget will be due in three months. Then, too, whether or not the gaming revenue projections will be achieved remains to be seen; after all, last year's gaming revenue enhancements were not attained.

And that raises a critical question: Is the commonwealth's economy growing fast enough to generate the level of general fund revenues that will be needed to cover expenditures this fiscal year and next? This *Policy Brief* looks at the recent revenue collections in comparison to last year's receipts using the Department of Revenue's monthly revenue reports as well as recent economic data.

In short, there has been some upturn in the pace of tax revenue flowing to the treasury. Note that for calendar year 2017, January through September, total general fund revenues are up $1.03 billion (4.3 percent) over the same period in 2016. However, over half of the gain is a result of a jump of $637 million in May. By comparison, revenue collection during calendar 2016 through September was just slightly above 2015's collection $86.9 million (0.4 percent).

For the first quarter of the current fiscal year (July, August and September), general fund revenues are up $318.6 million (4.8 percent) over last fiscal year's first quarter. Bear in mind, however, that revenue in the first quarter of the current fiscal year was only 4.8 percent above the same period of 2014. And that means there was no net growth in the July to September quarter collections from 2014 to 2016.

Still, if the 2017 July-September quarter gain compared to the year earlier collection is sustained for three more quarters, the treasury would see an increase of $1.2 billion in general fund revenue for the 2017-18 fiscal year—a far cry from the shortfall in the last fiscal year. But will the gains be sustained? That is the question.

The three largest sources of general fund revenue are the taxes on corporate net income, personal income taxes and sales and use taxes. Through the first nine months of calendar 2017 the corporate net income tax was up a slight one percent over the same period last year. By comparison for the first nine months of 2016, corporate net income tax revenue was down 1.1 percent compared to the first nine months of 2015.

Fortunately, while the beginning of this calendar year was weak for corporate net income tax collections, they showed significant strength from May through September. For July, August and September combined (the first quarter of the fiscal year) corporate net income tax revenue was 10.9 percent above the first quarter of fiscal 2016-17.

Meanwhile, personal income tax collections have been much stronger through the first nine months of calendar 2017. Collections have topped $10 billion through September, a rise of 3 percent over 2016's first nine months' collections. By comparison, 2016's collections were only slightly higher than in 2015 (0.8 percent). The much improved performance in the first nine months of 2017 was even stronger in the first quarter of the current fiscal year as personal income tax collections rose 3.8 percent ($104.9 million) compared to the year-earlier pace. While this is just one quarter and not necessarily an assurance of future gains, clearly FY 2017-18 is off to a much better start than a year ago.

Following the pattern of personal income tax revenue for the first nine months of this calendar year, the pace of sales and use tax collections is up from the year-earlier pace, rising 3.6 percent or $265.5 million. This is a significant improvement over last year when the collections of the sales and use tax were up only 2.4 percent ($169.5 million) for the first nine months over the same time frame in 2015. Moreover, the faster 2017 pace strengthened further in the July to September period climbing 3.9 percent above the year ago level.

Normally, one expects growth in sales and use tax and personal income tax to track reasonably closely with gains in employment and employee earnings. And while growth in employee earnings should track reasonably well over time with sales and use taxes revenue and personal income tax revenue, it may not track perfectly because personal income is also derived from other sources such as rent, interest and dividends and government transfer payments. To see if the 2017 tax collection gains in Pennsylvania are a reflection of an improving economy, the analysis reviews statewide employment and weekly earnings using data from the U.S. Bureau of Labor Statistics (BLS).

The BLS provides monthly data on average weekly earnings for the private sector (for some reason the BLS does not provide earnings for government workers) and private-sector employment. By multiplying the number of workers in the private sector by the weekly earnings

for each month, the trend in earnings of all private employees can be calculated. Total private-employee earnings should be a reasonable predictor of trends in income tax paid and sales and use tax revenue.

Total weekly earnings for Pennsylvania private sector employees in the first nine months of 2017 rose 3.03 percent compared to the first nine months of 2016. Interestingly, personal income tax revenue was up 3.01 percent for the same period comparison. Meanwhile, sales and use tax revenue was up 3.6 percent in the first nine months of 2017 over the first nine months of 2016. For 2017 the weekly earnings gains have tracked fairly closely with gains in income and sales taxes.

Corporate income tax collections will depend on profits of the companies and will not necessarily track closely with employment and earnings in the commonwealth. Over the longer term the relationship might be closer but in the short run there are many national and international factors that can affect corporate profits.

Then, too, it is important to bear in mind that spending of disposable income can be affected by expectations about the future health of employment prospects and the economy. And there is also a wealth effect that can come into play when real estate values are rising or the stock market is adding value to investor portfolios.

Given the enormous gains in share prices this year and the strengthening of home prices, consumer confidence has climbed in response nationally and almost certainly to some extent in Pennsylvania as well.

If the economy and jobs continue to improve, tax collections will almost certainly pick up as well. Thus, the revenue picture should look a little brighter next year. However, given the missteps of the past two years it will be absolutely necessary to hold spending in check until revenues can cover future spending and cover the payments on the debt incurred to cover this year's shortfall.

This means that even though the employment and income picture has brightened somewhat, the state continues to face the seemingly intractable problems of corralling spending growth and balancing the budget without relying on gimmicks and the poor practice of borrowing to fund current spending.

At some point, the commonwealth must shed its image as having a poor business climate if it wants to match national economic growth and have the wherewithal to deal with the enormous legacy costs it faces.

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