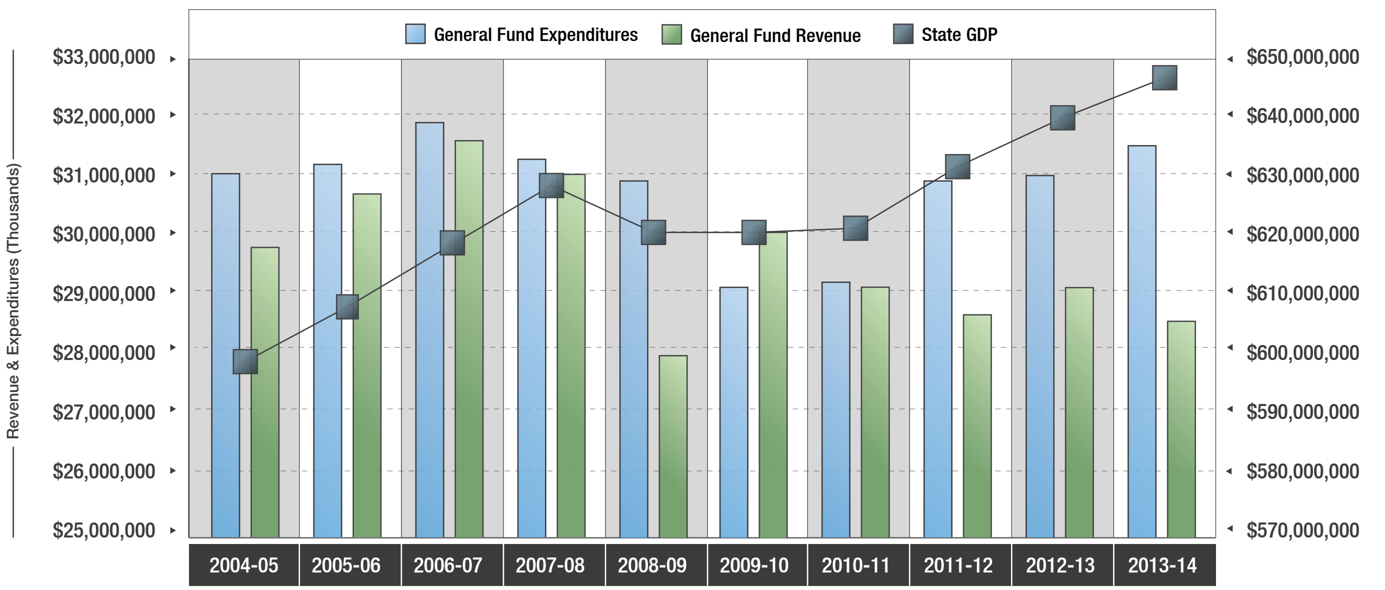
Treasury Notes

March 09, 2015

General Fund Revenues & Expenditures Compared to State GDP (2014 dollars)

Pennsylvania's economy continues to recover from the great recession of 2008, as reflected by Pennsylvania's increasing Gross Domestic Product – a measure of the state's output of goods and services. General Fund revenues, however, still remain substantially below their pre-recession peak. The chart below also shows that, on an inflation-adjusted basis, General Fund revenues have not increased at a pace that reflects economic growth or is necessary to meet General Fund expenditures, which have yet to fully return to pre-recession levels.

On an inflation-adjusted basis, General Fund revenues are nearly $1.2 billion less than they were ten years ago – from $29.8 billion in 2004-05 to $28.6 billion in FY 2014-15 – largely led by a nearly $940 million drop in collections of the Capital Stock and Franchise Tax. Additionally, the relative contributions to General Fund revenue from the Personal Income Tax and from the Capital Stock and Franchise tax have shifted in opposite directions over the past ten fiscal years, with the former increasing by almost 6.7% while the latter contracted by 74%.



Sources: PA Department of Revenue, U.S. Dept. of Commerce: Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Pennsylvania Treasury

* Note: General Fund revenues do not include augmentations or one-time transfers.

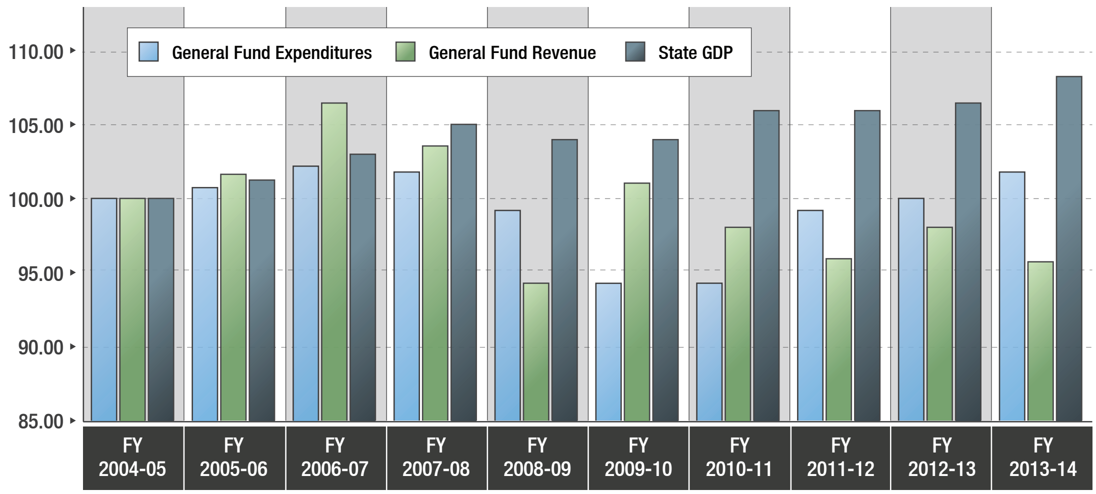
In this Edition of Treasury Notes

Although there has been much talk of late about Pennsylvania's structural budget deficit, the term can mean different things to different people. Accordingly, it is hoped this issue of *Treasury Notes* will at least help to identify the genesis of Pennsylvania's existing structural deficit. Reductions in existing sources of taxes – without identifying compensating revenues – and changes in tax policies that fail to track changes in Pennsylvania's economic base can result in growing revenue shortfalls. As the figures in this issue depict, reducing the Capital Stock and Franchise Tax and many businesses filing at personal income tax rates may be responsible for annual tax revenues coming in $1.9 billion lower than they otherwise would be.

The content in *Treasury Notes* is not intended to advocate any particular public policy position or legislative proposal. Rather, it is the intention of *Treasury Notes* to provide statistical context, through graphical illustrations, for current state fiscal policy discussions and to facilitate a better understanding of the financial condition of the Commonwealth.

Policy topic suggestions for future *Treasury Notes* are welcome and should be sent to TreasuryNotes@patreasury.gov.

General Fund Revenue and Expenditures Compared to State GDP (indexed)



The chart to the left indexes the inflation-adjusted revenue, expenditures and GDP based upon 2005 levels. It shows that GDP increased 8.11% and General Fund expenditures increased 1.78% over the past 10 years, yet General Fund revenues decreased 3.99% during the same period.

* Note: General Fund revenues do not include augmentations or one-time transfers.

Sources: Pennsylvania Department of Revenue, U.S. Dept. of Commerce: Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Pennsylvania Treasury

Increases and Decreases of Contributors to General Fund Revenue

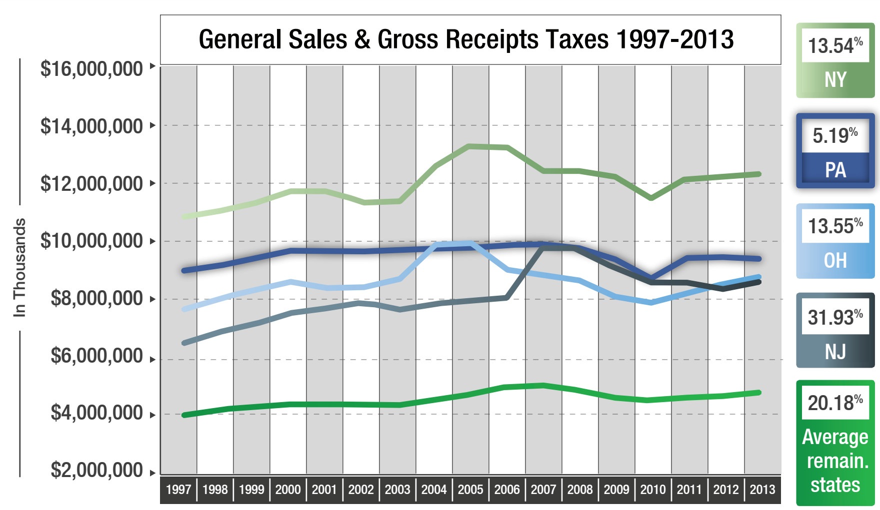
The table below lists the revenue categories with the largest increases and decreases in contributions to General Fund revenues (expressed in thousands of dollars), as compared on an inflation-adjusted basis from FY 2004–05 to FY 2013–14.

Top 6 Categories of Revenue Increases		Top 6 Categories of Revenue Decreases	
Personal Income Tax - Withholding	$485,016	Corporate - Capital Stock & Franchise	($937,310)
Personal Income Tax - Quarterly	$154,113	Sales Tax – Nonmotor	($405,894)
Corporate Net Income Tax	$146,430	Sales Tax - Motor Vehicle	($270,593)
Table Games	$90,450	Realty Transfer	($203,815)
Personal Income Tax - Annual	$76,603	Treasury (investment earning, uncashed checks, and some escheats)	($154,706)
Financial Institution	$61,781	Corporate Tax - Gross Receipts (imposed on a variety of transportation and communications activities)	($100,882)

Sources: Pennsylvania Department of Revenue, U.S. Dept. of Commerce: Bureau of Economic Analysis, Pennsylvania Treasury

Comparison of State Sales Tax Revenues

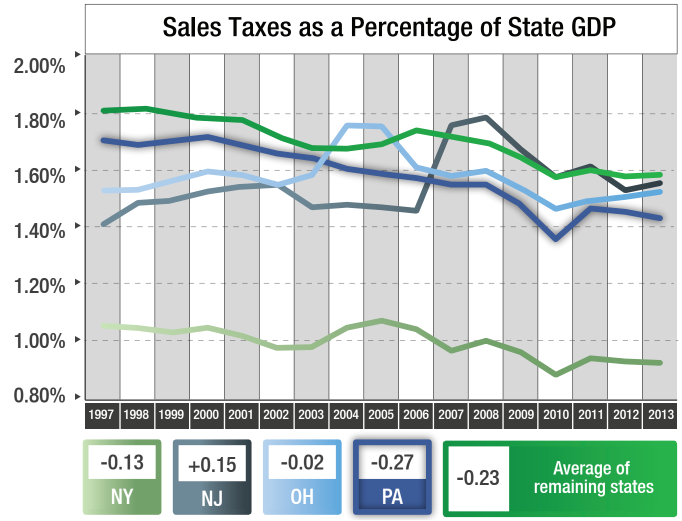
As the chart to the right shows, Pennsylvania's non-motor and motor vehicle sales tax revenues are down over $676 million on an inflation-adjusted basis over the past ten years. The chart utilizes data from the U.S. Census Bureau in order to provide an apples-to-apples comparison of General Sales & Gross Receipts Taxes (or simply, sales tax) between Pennsylvania, its neighboring peer states, and the average of the remaining states since 1997. On an inflation-adjusted basis, Pennsylvania sales tax revenue increased 5.19% since 1997, as contrasted to notably higher levels for our neighboring peer states and 20.18% for the rest of the U.S.

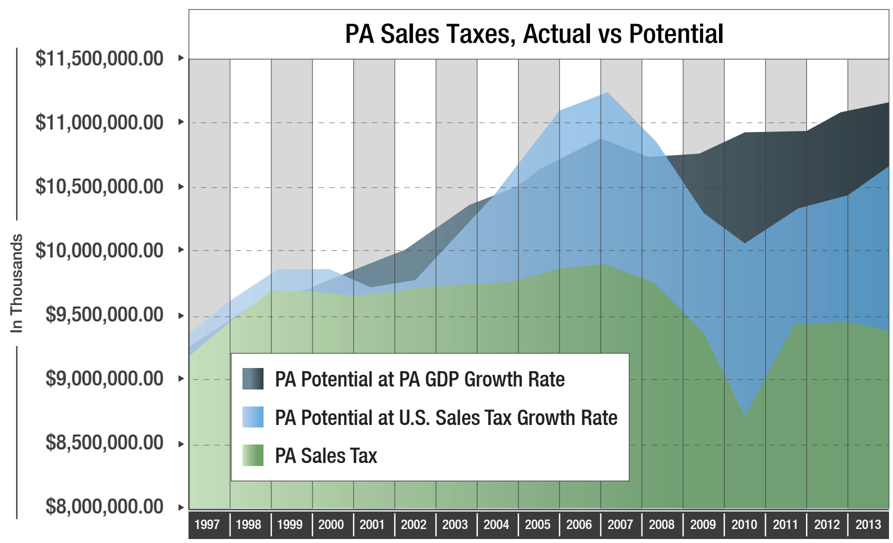


Sources: U.S. Census Bureau., U.S. Dept. of Commerce: Bureau of Economic Analysis, Pennsylvania Treasury

Comparison of State Sales Tax Revenues (continued)

One way that economists normalize data to evaluate changes in a particular variable over a period of time is to consider the variable as a percentage of GDP. Sales tax revenue changes, other things being equal, can be expected to track closely with changes in GDP. Thus, increases in the sales tax percentage of GDP could reflect increased tax rates or that sectors not subject to the tax are under-performing the taxable sectors (or vice-versa). Conversely, a decrease in this measure over time could indicate over-performance of those sectors not subject to the tax. As the chart to the right shows, sales taxes as a percentage of GDP decreased in Pennsylvania from 1.71% in 1998 to 1.43% in 2013 – a difference of 0.27 percentage points, the largest decrease among Pennsylvania's neighboring peer states and larger than the 0.23 percentage point decrease experienced by all other states.





The lag in Pennsylvania's sales tax revenue has had a significant impact upon General Fund revenue. Had Pennsylvania's sales tax revenue increased at the rate experienced by other states since 1998, the difference would have been an additional $1.3 billion in General Fund revenue in 2013. Had Pennsylvania's sales tax revenue simply continued at the same percentage of Pennsylvania's GDP (rather than declining by .27 percent), the growth in economic output since 1998 would have resulted in an additional $1.79 billion in sales tax collections in 2013.

Sources: U.S. Census Bureau., U.S. Dept. of Commerce: Bureau of Economic Analysis, Pennsylvania Treasury

Top Income and Corporate Tax Rates

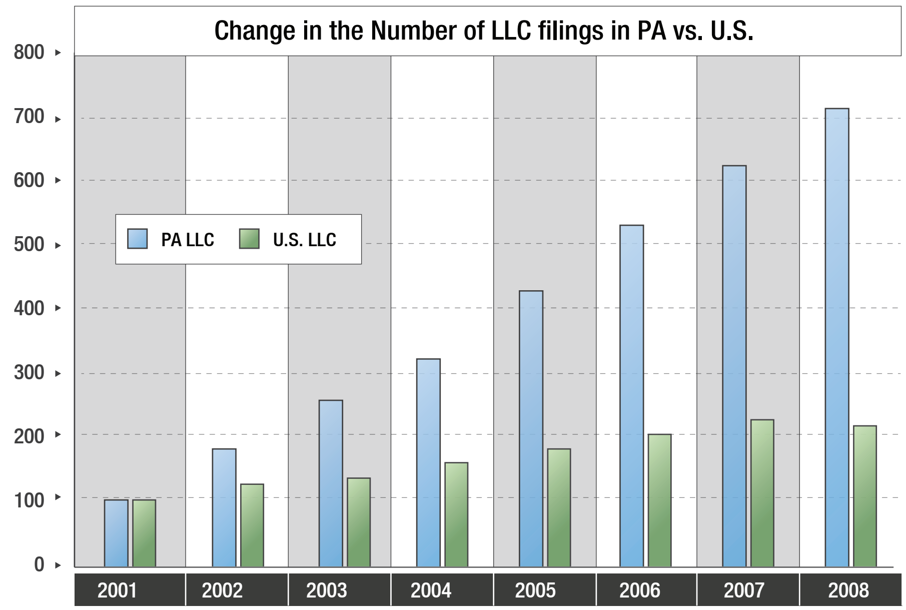
Along with partnerships and so-called "S" corporations, limited liability companies (LLCs) are business structures that Pennsylvania (and federal) law allows to pass through earnings directly to their owners, enabling them to be taxed only once, and at applicable individual tax rates. These tables illustrate the comparative value of these different forms of tax treatment of earnings in Pennsylvania and neighboring states at the highest marginal tax brackets. Pennsylvania's flat tax rates for both corporate and personal income taxes create a far greater incentive for companies to seek personal income tax treatment than can be found in neighboring jurisdictions, where upper personal income brackets are taxed at rates that more closely approximate (and, in New York's case, exceed) the highest corporate tax rates.

State	Income Bracket	Rates	Income Bracket	Rates
	- CORPORATE NET INCOME -		- PERSONAL INCOME -	
Delaware	> $0	8.70%	> $60,000	6.60%
Maryland	> $0	8.25%	> $250,000	5.75%
New Jersey	> $100,000	9.00%	> $500,000	8.97%
New York	> $0	7.10%	> $1,029,250	8.82%
Ohio	N/A	N/A	> $208,500	5.392%
Pennsylvania	> $0	9.99%	> $0	3.07%
West Virginia	> $0	6.50%	> $60,000	6.5%

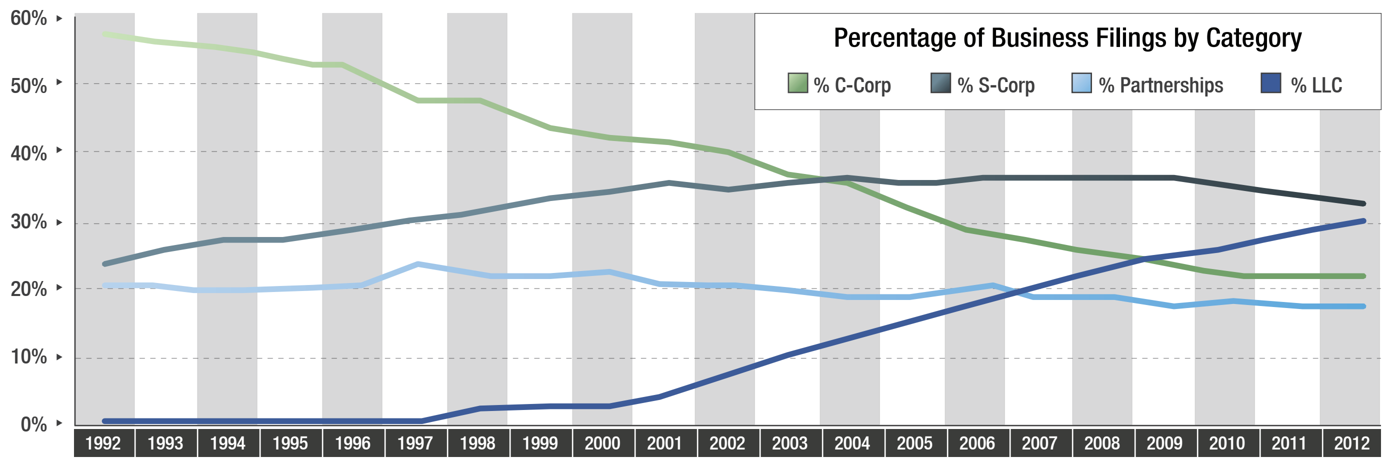
* Note: Ohio imposes a gross receipts tax.

Source: The Tax Foundation

Evolution of Business Returns by Category



These two figures illustrate the dramatic increases in the number and proportion of new Pennsylvania businesses benefiting from the 3.07% Personal Income Tax rate as LLCs rather than pay the far higher 9.99% Corporate Net Income Tax rate following the General Assembly's enactment of the Limited Liability Company Act of 1994. The graph to the left shows that LLC filings have grown at a significantly more rapid pace in Pennsylvania than they have across the U.S. The graph below depicts the dramatic increase in the share of LLC filings among Pennsylvania businesses.

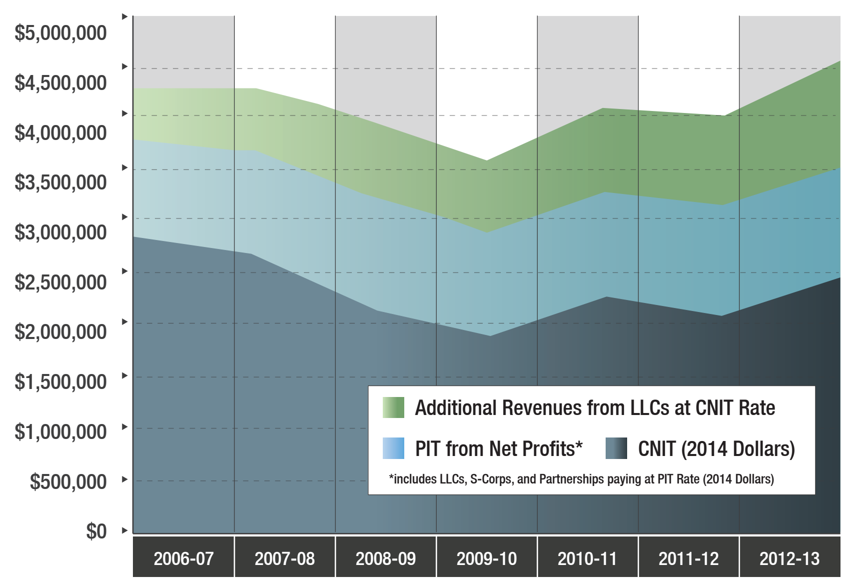


Sources: Pennsylvania Treasury, Pennsylvania Department of Revenue, Internal Revenue Service

PIT and CNIT Collections in Pennsylvania

A small change in behavior might not be immediately noticeable, but it can grow over time to be significant. The chart to the right shows PIT and CNIT collections, on an inflation- adjusted basis, from FY 2006-07 to FY 2012-13, as well as lost revenue from filing behavior associated with the noted increase in registrations of LLCs. If LLCs had paid at the CNIT rate of 9.99%, the additional revenues generated would have been over $500 million in FY 2006-07 and reached nearly $975 million in FY 2012-13*.

* Note: The estimated lost tax revenue figure is illustrative only since it assumes an equal distribution of income between the various business entities paying at the PIT rate (S Corporations, LLCs, and Partnerships). While such a distribution is unlikely to exist in reality, the assumption allows a sense of the possible range of the tax revenues to be inferred. More accurate estimates of the lost revenue involved are not possible based upon publicly available information.



Source: Pennsylvania Treasury, Department of Revenue