INDEPENDENT FISCAL OFFICE
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The Independent Fiscal Office (IFO) provided background materials to the committee regarding the office, the economy and major General Fund revenue sources. I will not review that material in the limited time for opening remarks. Rather, I would like to summarize the IFO's economic and revenue outlook for the current and next fiscal year.

A core function of the IFO is the provision of revenue estimates for consideration by the General Assembly. Our next formal release will be on May 1, when our preliminary revenue estimate is due. By June 15, the office will release its official, or final, estimate for FY 2014-15.

Although the office will not provide a formal estimate until May 1st, I would like to take this opportunity to outline our current thinking about the revenue outlook and the economy.

<u>FY 2013-14 Revenue Outlook</u>

The IFO recently published a mid-year update of its revenue estimate for the current fiscal year and concluded that a $150 million reduction to the estimate was warranted. (For comparison, our revised estimate is about $112 million lower than the estimate certified by the Governor for the current fiscal year. The recent Executive Budget did not change the certified number.) The IFO's reduction was based on two factors:

- At the mid-point in the fiscal year, growth rates for the General Fund and its key revenue sources were below the IFO's expectations.
- For the remainder of the fiscal year, it is unlikely that growth will reach the levels necessary to meet the IFO's original estimate.

Although we have reduced our estimate, it still relies on stronger growth in the second half of the fiscal year. Factors that likely affected economic growth and tax revenues in 2013, such as the expiration of the federal payroll tax cut and the federal budget sequester, should be fully absorbed at this point. However, recent wage growth and consumer spending does not appear to be strong enough to meet our original estimate.

For the first half of the fiscal year, General Fund revenues grew by 0.5 percent. The second-half growth rate necessary to meet our revised estimate is 1.8 percent. The January through June growth rates for major General Fund revenue sources are as follows:

- Corporate net income tax: 1.7 percent (vs. 1.3 percent in the first half).
- Sales and use tax: 3.9 percent (vs. 2.3 percent in the first half).
- Personal income tax withholding: 3.6 percent (vs. 2.2 percent in the first half).

Unlike last year, we do not expect strong growth in the final payment for personal income tax this April. April 2013 revenues were artificially inflated because taxpayers accelerated the receipt or recognition of certain income at the end of 2012 to avoid federal tax increases that took effect in 2013. With this behavioral effect now removed, we expect annual personal income tax payments in the spring of 2014 to return to a more normal pattern. Therefore, our estimate anticipates a 3 percent reduction in annual payments received during the second half of the fiscal year.

2014 Economic Outlook

Economic data released at the end of 2013 suggest that conditions are favorable to facilitate stronger growth in the U.S. economy in 2014. Businesses have cash balances available to expand hiring and investment. Households are in better financial shape to increase spending because they have paid down debt, especially credit card debt. Gains in the stock market and housing markets for 2013 may bolster consumer confidence and give rise to a “wealth effect” that facilitates more consumer spending. However, recent revenue data suggest that these conditions have not yet translated into higher spending levels.

We believe that the key to tax revenue growth in 2014 will be the labor market. Wages are highly correlated with overall economic growth, personal income and sales and use tax revenues. An increase in consumer spending is not sustainable without growth in wages. For 2013, wage growth was modest due to low inflation and significant slack in the labor market, which reduces worker leverage. In order for workers to realize wage gains, the slack must be removed from the labor market. Hiring must increase for an extended period of time before that can occur.

For 2014, the IFO projects Pennsylvania wage growth of 3.6 percent, compared to 2.6 percent for 2013. The growth rate can be decomposed into two parts: (1) 1.0 percent for job growth (about 57,000 new jobs) and (2) 2.6 percent for wage inflation, mostly pay raises to current workers. An improvement in the labor market would support stronger sales and use tax and employer withholding collections.

FY 2014-15 Revenue Outlook

Stable federal tax policy and the resolution of federal budget issues remove some of the sources of uncertainty that have affected the economic and revenue outlooks in recent years. The IFO's preliminary look at FY 2014-15 revenues indicates an increase of about 3 percent over the current year. This growth rate does not include any additional revenues that might be received due to:

- The expansion of small games of chance to bars, restaurants and taverns.
- Proposed legislative changes to reduce the holding period for unclaimed property or to transfer monies from the Oil and Gas Lease Fund.
- Additional slots or table games fees from new casino openings

Thank you. I would be happy to answer any questions that you might have.