INDEPENDENT FISCAL OFFICE

August 24, 2018

The Honorable Seth Grove
Pennsylvania House of Representatives
7 East Wing, Main Capitol Building
Harrisburg, PA 17120

Dear Representative Grove:

Thank you for the invitation to submit material for the upcoming hearing regarding the implications of recent federal tax law changes for Pennsylvania residents and General Fund tax revenues. The Tax Cuts and Jobs Act (TCJA) of 2017 enacted numerous changes to the federal tax code, and many provisions will impact the national and Pennsylvania economies, as well as General Fund revenues for fiscal year (FY) 2018-19. This letter provides a brief discussion of major provisions of the TCJA and how they might impact the state economy and General Fund tax revenues. The discussion in this letter proceeds based on the three major tax types affected: personal income, corporate net income and sales and use taxes. Other tax revenue sources will be impacted as well (e.g., gross receipts tax will decline due to lower utility rates), but those impacts are not included in this letter.

Personal Income Tax

The TCJA of 2017 enacted numerous changes to the federal individual income tax code. Substantive changes include the following:

- Reduced tax rates and raised tax bracket thresholds. For example, the former 15 percent federal tax rate was reduced to 12 percent beginning with tax year 2018 and the former 39.6 percent rate was reduced to 37 percent (and the bracket thresholds were raised).
- Repealed all personal exemptions and increased the standard deduction to $12,000 (single) and $24,000 (married filing joint).
- Implemented a limit of $10,000 for all state and local taxes (property, income or sales) for filers that itemize deductions.
- Implemented a new 20 percent deduction for qualified business income if filers meet certain criteria.
- Increased the child tax credit to $2,000 (refundable portion is $1,400).

Table 1 provides data on the number of Pennsylvania filers that could be impacted by these provisions. The data are for tax year 2015 and are published by the Internal Revenue Service. Without access to the federal income tax returns filed by Pennsylvania residents, the Independent Fiscal Office (IFO) is unable to simulate the number of taxpayers that would be affected and the potential increase in after-tax income due to the federal tax cut. Therefore, the data from Table 1 represent the upper limit on the number of taxpayers that could be impacted by the provisions noted above. The data show that:

- Over 6.2 million Pennsylvania residents filed a federal return and the majority (83.4 percent) reported adjusted gross income under $100,000.
- Over 1.1 million filers reported business income on Schedule C, partnership income or a distribution from an S corporation. Many filers report income from two or all three of those sources, so that the number of unique filers is smaller.
- Roughly 1.6 million filers reported a state and local income tax deduction ($11.3 billion) and the same number reported a local property tax deduction ($8.2 billion). Nearly all filers that claim one of those deductions will claim both. The majority of both deductions was claimed by filers that reported more than $100,000 of adjusted gross income.
- More than 1.4 million filers claimed the regular child tax credit ($1.05 billion) and/or the refundable child tax credit ($741 million). A small number of filers may claim both, so that the number of unique filers is somewhat smaller.

Several national organizations have access to samples of federal income tax returns and have performed simulations that provide insights into the potential impact of the TCJA on the federal income tax remitted by Pennsylvania residents. For example, the U.S. Joint Committee on Taxation estimates that the TCJA will reduce total federal income taxes by $189 billion for federal fiscal year (FFY) 2018-19, while the UPenn Wharton School estimates a reduction of $169 billion.[1] Based on other federal tax data, the IFO estimates that the Pennsylvania share of the federal individual income tax cut is roughly 3.5 percent. If those estimates are accurate, then it implies a federal tax cut for Pennsylvania residents of $5.9 to $6.6 billion for FFY 2018-19.

Other national organizations have published state-level estimates of the federal income tax cut. The Tax Policy Center estimates that 63.2 percent of Pennsylvania "tax units" would receive an average tax cut of $2,180 for tax year 2018, while 5.1 percent would receive an average tax increase of $1,190. The average across all tax units is a tax cut of $1,330.[2] The Tax Foundation finds a similar impact, with an average tax cut that ranges from $1,350 to $1,500 based on the congressional district of the taxpayer.[3]

The federal income tax changes do not directly impact state personal income tax (PIT) collections because Pennsylvania does not conform to the federal tax base. The IFO assumed that state PIT

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[1] See https://www.jct.gov/publications.html?func=startdown&id=5053 and http://budgetmodel.wharton.upenn.edu/issues/2017/12/18/the-tax-cuts-and-jobs-act-reported-by-conference-committee-121517-preliminary-static-and-dynamic-effects-on-the-budget-and-the-economy.

[2] See https://www.taxpolicycenter.org/publications/effect-tcja-individual-income-tax-provisions-across-income-groups-and-across-states/full.

[3] See https://taxfoundation.org/tcja-job-impact-2018/.

collections would increase due to (1) higher levels of capital gains, dividends and wages from the corporate income tax rate cut (see next subsection) and (2) higher business and wage income as residents spend much of their higher after-tax income. The impact for FY 2018-19 is difficult to estimate as some of these impacts will not immediately manifest themselves. The IFO believes that a reasonable estimate for the PIT impact for FY 2018-19 could range from $30 to $60 million.

Corporate Net Income Tax

The TCJA of 2017 enacted many changes to the federal corporate net income tax (CNIT). Major changes include:

- Reduced the tax rate from 35 to 21 percent starting with tax year 2018.
- Eliminated the former Section 199 deduction for certain domestic production activities.
- Increased the Section 179 expensing deduction limit to $1 million.
- Limited net interest deductions for certain firms based on earnings before interest, taxes, depreciation and amortization (EBITDA).
- Increased bonus deprecation for equipment purchases to 100 percent through tax year 2022, which then declines by 20 percentage points each year.
- Changed the treatment of foreign source income to a territorial based regime.
- Required research and development expenses to be amortized after tax year 2021.

Pennsylvania largely conforms to federal tax treatment for CNIT. However, the state did not conform to the federal 100 percent bonus depreciation provision.

The federal tax law changes will have two main impacts related to Pennsylvania CNIT:

- The value of the state CNIT deduction at the federal level will fall due to the rate reduction. For example, a $100 state CNIT deduction could previously reduce federal CNIT by 0.35 * $100 = $35. The new deduction will be worth 0.21 * $100 = $21. Effectively, the federal government provides less of a subsidy to the state tax structure.
- The various provisions will, on net, expand the state CNIT base. At the January 2018 Mid-Year Update, the IFO estimated that the base expansion and profit shifting out of tax year 2017 could increase revenues in FY 2018-19 by roughly $160 million.

The IFO does not have new information that could be used to update that estimate. Estimated CNIT payments for March through July (i.e., tax year 2018) are up 8.1 percent versus the prior year, which likely reflects both economic growth and base expansion aspects. The IFO projects continued robust CNIT gains through the rest of the fiscal year.

In terms of the impact on Pennsylvania residents, the U.S. Joint Committee on Taxation and UPenn Wharton estimate that the TCJA will reduce federal CNIT revenues by roughly $90 billion for FFY 2018-19, largely due to the tax rate reduction from 35 to 21 percent. However, it is not clear how much of that tax cut would flow through to shareholders (in the form of higher capital gains or dividends) and workers (in the form of higher salaries, wages or bonuses). The IFO assumed that one-third of the net tax cut would flow through to those individuals, and if that assumption holds, then roughly $1.0 billion could flow through to Pennsylvania residents in the form of higher capital gains, dividends or wages/salaries (using the 3.5 percent share of the national tax cut). Those monies increase the total potential impact on Pennsylvania disposable income to $6.9 to $7.6 billion. It is emphasized there is a high degree of uncertainty regarding the CNIT impact on Pennsylvania after-tax income.

Sales and Use Tax

The main impact of the TCJA on sales and use tax (SUT) is through higher after-tax income, much of which will be spent in the Pennsylvania economy. At the January 2018 Mid-Year Update, the IFO estimated that the impact could increase FY 2018-19 SUT revenues by $60 to $80 million. Based on recent strength in SUT collections, the IFO would increase the impact for this fiscal year to $80 to $100 million.

General Economic Impact

The IFO has not attempted to simulate the impact of the federal tax cut on the state economy. For the U.S. economy, most forecasters project that the tax cut will boost real GDP by roughly 0.3 to 0.8 percent for 2018. After that year, the GDP impact fades because (1) many of the tax provisions are temporary (e.g., bonus depreciation), (2) other tax increases take effect (e.g., amortization of research and development expenditures) and (3) higher federal deficits will increase interest rates and constrain growth. By 2027, researchers project that the level (as opposed to growth rate) of U.S. real GDP will be higher by the following percentages: Joint Committee on Taxation (0.7 percent), UPenn Wharton (0.8 percent), IHS Markit (0.6 percent), Tax Policy Center (0.0 percent) and Tax Foundation (3.4 percent).

Regarding the impact of the TCJA on federal revenues, deficits and interest rates, Table 2 provides the latest forecasts from the Joint Committee on Taxation (TCJA revenue impact only) and Congressional Budget Office (CBO). The federal revenue impact estimate shows that the tax cut impact peaks in FFY 2019 and declines every year thereafter. The CBO projects that the federal deficit will grow quickly through that year, but at a much more moderate pace through FFY 2027. The federal deficit projections peak in FFY 2022 at $1.18 trillion.

I hope you find this information useful. If you have any additional questions regarding this material, please do not hesitate to contact my office (717-230-8293).

Sincerely,

Matthew J. Knittel

Matthew Knittel
Director, Independent Fiscal Office

Enclosures

Table 1: Federal Returns Filed by Pennsylvania Residents - Tax Year 2015

	Federal Adjusted Gross Income Range								
	Less than $0	$1 to $24,999	$25,000 $49,999	$50,000 $99,999	$100,000 $199,999	$200,000 $499,999	$500,000 $999,999	$1,000,000 or more	TOTAL
Adjusted Gross Income									
Number (000s)	70.2	2,234.3	1,428.2	1,437.3	776.8	207.4	32.2	14.3	6,200.6
Amount (millions)	-$4,832	$25,883	$51,938	$102,872	$104,313	$59,138	$21,559	$44,271	$405,142
Schedule C, Partnership or S Corporation									
Number (000s)	30.9	275.5	181.0	265.9	220.5	108.4	26.8	14.4	1,123.4
Amount (millions)	-$1,293	$1,779	$1,827	$3,333	$5,015	$7,307	$4,844	$9,774	$32,586
State and Local Income Tax Deduction									
Number (000s)	0.0	58.0	195.1	528.6	551.1	193.3	31.1	13.6	1,570.7
Amount (millions)	$0	$81	$416	$1,898	$3,531	$2,582	$987	$1,827	$11,323
Real Estate Tax Deduction									
Number (000s)	0.0	84.4	195.1	530.5	552.0	188.4	30.2	13.2	1,593.8
Amount (millions)	$0	$331	$687	$2,088	$2,895	$1,535	$396	$296	$8,228
Child Tax Credit (includes refundable portion)									
Number (000s)	2.0	419.3	454.6	386.5	165.3	0.1	0.0	0.0	1,427.8
Amount (millions)	$3	$439	$517	$608	$223	$0	$0	$0	$1,790

Source: IRS Statistics of Income Division.

Table 2: Federal Tax Revenue, Debt and Interest Rate Projections

	Federal Fiscal or Calendar Years ($ billions)										
	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
TCJA Net Revenue Impact	0	-136	-280	-259	-221	-178	-138	-120	-115	-41	33
Federal Deficit	-715	-811	-965	-969	-1,056	-1,178	-1,139	-1,076	-1,144	-1,076	-1,026
Debt Held by Public	14,665	15,688	16,762	17,827	18,998	20,319	21,638	22,932	24,338	25,715	27,087
Nominal GDP	19,178	20,103	21,136	22,034	22,872	23,716	24,621	25,583	26,595	27,608	28,677
Debt / GDP Ratio	0.765	0.780	0.793	0.809	0.831	0.857	0.879	0.896	0.915	0.931	0.945
10-Year Treasury Note	2.33	3.02	3.60	3.88	3.95	3.89	3.76	3.68	3.68	3.69	3.72
3-Month Treasury Bill	0.93	1.93	2.75	3.15	3.24	3.20	3.01	2.81	2.72	2.73	2.79

Notes: Federal deficit is "on-budget" deficit only and excludes any deficit from Social Security Trust Funds.
TCJA Net Revenue Impact includes budget savings from the elimination of the individual shared responsibility payment.
Sources: U.S. Congressional Budget Office, "The Budget and Economic Outlook: 2018 to 2028" (April 2018) and "An Update to the Economic Outlook: 2018 to 2028" (August 2018).
U.S. Joint Committee on Taxation, "Estimated Budget Effects of the Conference Agreement for H.R. 1" (December 2017).