Independent Fiscal Office

ANALYSIS OF REVENUE PROPOSALS

April 2022

FY 2022-23 Executive Budget

Independent Fiscal Office
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INDEPENDENT FISCAL OFFICE

April 8, 2022

The Honorable Members of the Pennsylvania General Assembly:

This report provides an analysis of the tax and revenue proposals included in the *2022-23 Executive Budget* released in February 2022. The Independent Fiscal Office (IFO) publishes this report to fulfill its statutory duties as provided under Section 604-B (a)(4) of the Administrative Code of 1929. The statute requires that the IFO "provide an analysis, including economic impact, of all tax and revenue proposals submitted by the Governor or the Office of the Budget."

This report uses various data sources to derive estimates of the revenue proposals included in the budget. All data sources and methodologies used to derive those estimates are noted in the relevant sections of this document.

The IFO would like to thank the various agencies and organizations that provided data or input for this report. Questions or comments regarding the contents of this report can be submitted to contact@ifo.state.pa.us.

Sincerely,

Matthew J. Knittel

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Introduction

This report provides revenue estimates for the tax and revenue proposals contained in the *2022-23 Executive Budget* released February 2022. The Independent Fiscal Office (IFO) publishes this report to fulfill its statutory duties as provided under Section 604-B (a)(4) of the Administrative Code of 1929. The statute requires that the IFO "provide an analysis, including economic impact, of all tax and revenue proposals submitted by the Governor or the Office of the Budget."

The report contains two sections. The first section analyzes general tax and revenue proposals, including the proposed expansion of the corporate net income tax base and the lowering of the tax rate. The second section analyzes the proposal to increase the state minimum wage.

The analyses contained in this report are based on descriptions from the *2022-23 Executive Budget* and, where applicable, legislative language provided by the administration. As necessary, assumptions to assess the potential revenue implications of the proposals are noted in the text.

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Tax and Revenue Proposals

Corporate Net Income Tax

The Executive Budget includes four proposals that impact the corporate net income tax (CNIT). For the first three, the IFO met with the Department of Revenue (DOR) and reviewed their estimate methodology. The IFO relied on DOR estimates due to the office's lack of data (e.g., detail on types of transactions) and legal staff to assist in the interpretation regarding the application of technical language. **Table 1.1** presents the proposals in the order in which they were scored. All proposals are effective for tax years beginning on or after January 1, 2023. Combined, the proposals are projected to reduce CNIT revenues by $67 million in fiscal year (FY) 2022-23 and by $967 million in FY 2026-27.

Broaden the Current Addback Provision: The proposal expands the original addback provision enacted by Act 52 of 2013. Regarding the current addback, Information Notice Corporation Taxes 2016-1 states the following:

> The Add-Back disallows deductions for royalties, licensing, or other fees paid, accrued, or incurred by a corporation subject to Pennsylvania Corporate Net Income Tax ("CNIT") to an affiliated entity for tax years beginning after December 31, 2014. The Add-Back disallows all intangible costs or expenses paid by a PA Corporate Taxpayer to an affiliated entity unless an express statutory exception applies. While the relevant statutory language and this notice describe the Add-Back and its exceptions, the Add-Back does not limit the Department of Revenue's authority to deny deductions resulting from fraudulent or sham transactions.
>
> The Add-Back refers to direct or indirect costs or expense deductions claimed by a PA Corporate Taxpayer as a result of transactions with an affiliated entity (the definition of which is set forth in the statute) and expressly disallows costs or expense deductions incurred by a PA Corporate Taxpayer in connection with the following intangible assets: patents, patent applications, trade names, trademarks, service marks, copyrights and mask works.
>
> The list of intangible assets is not exhaustive. The Add-Back also applies to "other similar expenses or costs." Furthermore, the classification or label of a transaction is not determinative—whether it be called a royalty, license, lease, franchise right, know how, trade secret, contract right, management fee, or otherwise. Rather, the substance of a transaction is determinative. The Add-Back applies whenever a PA Corporate Taxpayer pays an intangible expense to an affiliated entity to acquire, use, maintain, manage, sell, exchange, or otherwise acquire or dispose of an intangible asset.

The proposal adds intercompany management fees and broadens the applicability of the current addback on intercompany royalty and interest payments. DOR estimates that this proposal will generate roughly $500 million per annum once fully phased in (FY 2024-25). As noted, the additional revenue is scored under the current tax rate of 9.99%.

Codify Economic Nexus: The proposal codifies Corporation Tax Bulletin 2019-04.[1] The notice states that "the Department will deem there to be a rebuttable presumption that corporations without physical presence in the state but having $500,000 or more of gross receipts sourced to Pennsylvania per year pursuant to the sales factor rules contained in 72 P.S. Section 7401, have a filing requirement with the Commonwealth for purposes of the Corporate Net Income Tax." Due to potentially significant overlap, this proposal is scored with the one that follows. While the department believes that most passive investment companies are currently subject to CNIT under existing U.S. Supreme Court case law and existing statutory authority, passive investment companies have not generally begun filing CNIT returns as they may disagree with the department's interpretation of current authority. To the extent economic nexus is codified in Pennsylvania law, passive investment companies will need to become compliant and begin filing Pennsylvania CNIT returns.

Adopt Market-Based Sourcing for Intangibles: The proposal adopts rules most reflective of the market for sourcing of intangible property (e.g., copyrights, trademarks), similar to the rules previously adopted for tax years 2014 and later in regard to the sourcing of services. Market-based sourcing generally attributes receipts based on the location where the benefits are delivered to the customer. When combined with the codification of economic nexus, the department estimates it will generate $168 million in FY 2023-24 and grow to $194 million by FY 2026-27. The estimate assumes that both proposals are effective for tax years that begin on or after January 1, 2023.

Reduce the CNIT Rate: The proposal reduces the tax rate from 9.99% to 7.99% for tax years 2023 to 2025, 6.99% for tax year 2026 and 5.99% for tax year 2027 and later. This proposal is stacked after the three provisions that broaden the tax base and uses the latest IFO CNIT baseline (January 2022). The proposal reduces revenues by $243 million in FY 2022-23 and $1.67 billion by FY 2026-27.[2]

Table 1.1
Corporate Net Income Tax

	2022-23	2023-24	2024-25	2025-26	2026-27
Broaden Addback Provision	$136	$461	$504	$514	$513
Codify Nexus and Market Sourcing	40	168	191	195	194
Reduce CNIT Rate	-243	-975	-987	-1,138	-1,674
Total	**-67**	**-346**	**-292**	**-429**	**-967**

Note: Millions of dollars.

[1] Largely due to the bulletin, the department notes that 1,700 new firms filed a CNIT return in tax year 2020 with roughly $50 million in total liability.

[2] The estimate includes an offset that reduces the revenue loss from rate reduction to reflect dynamic effects (i.e., allowing the economy to expand or contract in response to the policy). For the Tax Cuts and Jobs Act of 2017, most studies using dynamic models found that dynamic effects reduced the static revenue loss by 10% to 20%. See https://www.brookings.edu/blog/up-front/2019/03/15/did-the-tax-cuts-and-jobs-act-pay-for-itself-in-2018/.

Cigarette Tax

Transfer to Tobacco Settlement Fund

The administration's proposal creates a cigarette tax transfer to the Tobacco Settlement Fund for debt service payments. This provision is expected to reduce FY 2022-23 cigarette tax revenues by $115 million. See **Table 1.2** for this transfer and the transfers that follow.

If not provided for from cigarette tax collections, the Tobacco Settlement Fund debt service payments are transferred from sales and use tax. Therefore, the most recent IFO revenue estimates already incorporate this transfer from cigarette tax.

Personal Income Tax

Transfer to Environmental Stewardship Fund

The administration's proposal creates a personal income tax (PIT) transfer to the Environmental Stewardship Fund for Growing Greener debt service payments. This provision is expected to reduce FY 2022-23 PIT withholding revenues by $12 million.

Transfer to School Safety and Security Fund

The administration's proposal creates a PIT transfer to the School Safety and Security Fund. This transfer will reduce FY 2022-23 PIT withholding revenues by $45 million.

Gaming Taxes

Transfer to Property Tax Relief Fund

The administration's proposal eliminates the requirement that table games taxes be deposited into the Property Tax Relief Fund once the Budget Stabilization Reserve Fund exceeds $750 million on the last day of the fiscal year. This provision is expected to increase FY 2022-23 gaming revenues by $129 million. The most recent IFO revenue estimate assumes these revenues remain in the General Fund.

Nontax Revenues

Transfer from the Medical Marijuana Program Fund

The administration's proposal transfers the unexpended fund balance of the Medical Marijuana Program Fund to the General Fund to offset Department of Health operations (as authorized under Act 16 of 2016). This provision is expected to increase FY 2022-23 nontax revenues by $37 million.

Table 1.2
General Fund Transfer Detail

	2022-23	2023-24	2024-25	2025-26	2026-27
Table Games Taxes	$129	$144	$158	$171	$183
Tobacco Settlement Fund	-115	--	--	--	--
Environmental Stewardship Fund	-12	--	--	--	--
School Safety and Security Fund	-45	--	--	--	--
Medical Marijuana Program Fund	37	--	--	--	--
Total	**-7**	**144**	**158**	**171**	**183**

Note: Millions of dollars.

Raising the Minimum Wage

The administration proposes to raise the state minimum wage from the federal minimum of $7.25 to $12.00 per hour on July 1, 2022 and increase the wage by 50 cents every year until the minimum wage is $15.00 beginning on July 1, 2028. Every July 1 thereafter, the minimum wage would increase by an annual cost-of-living adjustment based on the regional Consumer Price Index for All Urban Consumers (CPI-U), rounded to the nearest 5 cents. For tipped workers, employers must also pay the state minimum, regardless of tip income.[3]

The administration has made similar proposals in prior years that were reviewed by the IFO. The last review was released in April 2021. Where possible, this year's analysis updates the April 2021 analysis if new data exist.

Comparison to Other States

As of January 1, 2022, Pennsylvania and 19 other states do not require employers to pay a wage that exceeds the federal minimum of $7.25 per hour. (See **Table 2.1**.) By contrast, 14 states and the District of Columbia require employers to pay an hourly wage of $12.00 or more. By January 1, 2028, it is projected that 19 states and the District of Columbia will require employers to pay an hourly wage of $12.00 or more under current law.

The federal minimum wage was last raised to $7.25 per hour in 2009. Due to inflation, the real value of the wage rate has eroded over time. From 2009 through 2022, the Philadelphia CPI-U increased by an estimated 27.8%, an average rate of 1.9% per annum. If the minimum wage had been adjusted for inflation through the current year, then the wage rate would be $9.26 in 2022.

Currently, all border states have a minimum wage that exceeds Pennsylvania by at least $1.50 per hour, and four states (New York, Maryland, New Jersey and Delaware) have a minimum wage that is at least $2.00 higher. If Pennsylvania increases the minimum wage to $12.00 in 2022, 13 states and the District of Columbia would remain higher and the state would be tied with Illinois for the 15th highest minimum wage. If Pennsylvania continues to increase the minimum wage to $15.00 over the subsequent six years, then on January 1, 2028, it would join 13 other states and the District of Columbia with a minimum wage that meets or exceeds $15.00.

[3] For tipped workers, the proposal increases the cash minimum wage from $2.83 per hour to $12.00 per hour in one adjustment. Due to the dramatic increase in wage rates at one time and the lack of data and research related to income received by tipped workers, this report provides limited analysis of the impact of that proposed change. (See Table 2.3.)

Table 2.1
Minimum Wage Rates by State (As of January 1st)

State/Territory	2022 Rank	2022	2025	2028
Washington D.C.	1	$15.20	$16.25	$17.40
California	2	15.00	16.07	17.21
Washington	3	14.49	15.53	16.62
Massachusetts	4	14.25	15.00	15.00
New York	5	13.20	14.15	15.14
New Jersey	6	13.00	15.35	16.43
Connecticut	6	13.00	14.65	15.69
Arizona	8	12.80	13.70	14.65
Oregon	9	12.75	14.10	15.10
Maine	9	12.75	13.65	14.60
Colorado	11	12.56	13.46	14.41
Vermont	12	12.55	13.45	14.40
Maryland	13	12.50	15.00	15.00
Rhode Island	14	12.25	15.00	15.00
Illinois	15	12.00	15.00	15.00
New Mexico	16	11.50	11.50	11.50
Missouri	17	11.15	12.60	13.50
Virginia	18	11.00	15.00	16.06
Arkansas	18	11.00	11.00	11.00
Delaware	20	10.50	15.00	15.00
Alaska	21	10.34	11.08	11.86
Minnesota	22	10.33	11.07	11.85
Hawaii	23	10.10	10.10	10.10
Florida	24	10.00	13.00	15.35
South Dakota	25	9.95	10.70	11.45
Michigan	26	9.87	10.56	11.29
Nevada	27	9.75	12.00	12.00
Ohio	28	9.30	9.90	10.65
Montana	29	9.20	9.80	10.50
Nebraska	30	9.00	9.00	9.00
West Virginia	31	8.75	8.75	8.75
Pennsylvania	**32**	**7.25**	**7.25**	**7.25**
Other	32	7.25	7.25	7.25

Note: Over 50 localities have adopted a minimum wage above their state's minimum wage.
1 Inflation adjustments based on an estimated 2.4% for 2023 and 2.3% for 2024 to 2028.
Source: The Economic Policy Institute. Minimum Wage Tracker (as of January 1, 2022).

Recent Minimum Wage Studies

The text that follows provides the main findings and results from recent minimum wage studies.[4] To interpret results, it is necessary to define the term "employment elasticity." The employment elasticity is the percentage change in employment divided by the percentage change in the statutory minimum wage. For example, an elasticity of -0.1 implies that a 10.0% increase in the minimum wage would reduce employment by 1.0% (-1.0 / 10.0).

Manning (2021)[5]

The study illustrates the uncertainty of minimum wage sector employment elasticities through an analysis that estimates the impact of a minimum wage increase on the teen labor market. The analysis uses seven different models that incorporate quarterly state-level data from 1979 to 2019. Each model resulted in significantly different employment elasticities, yielding an inconclusive outcome. The author primarily credits this to the relatively small size of the teen labor market. Other factors cited were (1) the added labor costs from the higher minimum wage may be offset by reductions in other costs (e.g., labor turnover) and improved productivity, (2) the elasticity of labor demand is low (i.e., minimum wage workers are not perfect substitutes for other inputs like capital and materials) and (3) the labor market for workers impacted by the minimum wage is not perfectly competitive.

Long (2021)[6]

The study evaluates whether the $15.00 minimum wage ordinance in Seattle, Washington reduced income inequality in the city. Using a constructed counterfactual scenario of what would have likely happened in the absence of the policy change, the results suggest that income inequality for workers paid less than the median wage was reduced. However, the analysis also found a large increase in inequality for all workers in 2016 and 2017. The author offers several possible explanations for this secondary outcome, including an unrelated shock to demand for very high-skilled labor due to a strong U.S. economy.

Yu, Mankad and Shunko (2021)[7]

The study examines the impact of the minimum wage on firms' scheduling practices in the retail industry. Using private data from a chain of retail fashion stores, the analysis showed that a $1.00 increase in the minimum wage leads to a 27.7% increase in the number of workers scheduled per week, but a 20.8% reduction in weekly hours per worker. Fewer hours worked not only reduced total wage compensation but also eligibility for certain fringe benefits (e.g., health insurance), even when net employment at the stores was unchanged. The results suggest that the combination of reduced hours, lower eligibility for benefits and less consistent schedules results in a net loss in worker welfare. The authors advocate for the consideration of operational trade-offs firms face when making scheduling decisions and to take those into account when designing minimum wage policy.

[4] Prominent studies prior to 2021 can be found in the IFO analyses from prior years.
[5] Manning, A. "The Elusive Employment Effect of the Minimum Wage," Journal of Economic Perspectives, 35(1), 3-26 (February 2021).
[6] Long, M. C. "Seattle's local minimum wage and earnings inequality," Economic Inquiry (April 2021).
[7] Yu et al. "Evidence of the Unintended Labor Scheduling Implications of the Minimum Wage," Harvard Business Review (June 2021).

Border County Comparison

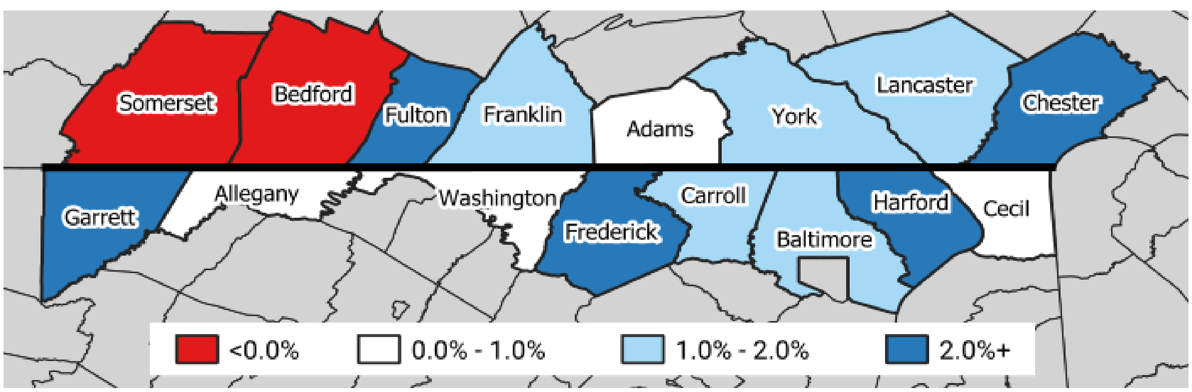
Many minimum wage studies compare employment trends for border counties in states that do and do not raise the minimum wage. Because economic and demographic conditions are generally similar in the border counties, the higher minimum wage offers researchers a "natural experiment" that allows them to isolate the impact of the higher minimum wage. In nearly all cases, these comparisons focus on the food service sector, because that sector has a relatively large share of workers that would be directly affected by a higher minimum wage.

For the FY 2020-21 analysis of revenue proposals, the IFO reproduced the methodology used by a Federal Reserve Bank of New York article that compared employment trends in the border counties of Pennsylvania and New York.[8,9] For this report, the IFO utilizes a similar methodology for counties along the Maryland border. Starting in 2015, Maryland started to phase in a higher minimum wage for all non-tipped workers.[10] The schedule was as follows: $8.00 (January 2015), $8.25 (July 2015), $8.75 (July 2016), $9.25 (July 2017) and $10.10 (July 2018).

In January 2020, Maryland again raised its minimum wage to $11.00. However, due to widespread employment reductions in the leisure-hospitality sector related to the COVID-19 pandemic, this analysis only uses data through 2019. **Figure 2.1** displays the average annual employment growth of the food services and drinking places sub-sector (NAICS 722) for 2014 through 2019 in the border counties of Pennsylvania and Maryland. Overall, employment in Maryland counties grew at an average rate of 1.8% per annum, while Pennsylvania counties grew at a slightly slower rate (1.6%). Across both states, Fulton (PA, 5.9%), Garrett (MD, 4.8%) and Frederick (MD, 3.7%) counties recorded the strongest employment growth.

Figure 2.1

Food Service Employment AAGR for PA and MD Border Counties: 2014-2019



Note: AAGR is average annual growth rate.

[8] See http://www.ifo.state.pa.us/releases/364/Analysis-of-Revenue-Proposals-in-the-2020-21-Executive-Budget/.
[9] Bram et al. "Minimum Wage Impacts Along the New York-Pennsylvania Border," Liberty Street Economics Blog (September 25, 2019).
[10] The rate for tipped employees did not change.

Table 2.2 displays the average annual growth rates for population, personal income, food service employment and average wages for the relevant counties in both states. These data illustrate the similar general economic and demographic conditions in the two sets of border counties. For both sets of counties, population growth was relatively flat, while (nominal) personal income increased at an average annual rate of 3.6% for Maryland and 4.2% for Pennsylvania. The rate for Pennsylvania's counties is higher due to strong growth (4.9%) in non-wage income (e.g., dividends, transfer receipts).

Due in part to the higher minimum wage, average weekly wages for food service employees in Maryland grew at a slightly faster rate than Pennsylvania. At the same time, average annual employment growth in the industry was comparable to Pennsylvania, which suggests the minimum wage increase did not have a material negative impact on employment. However, it should be noted that these data do not capture other potential employment outcomes, such as a reduction in hours worked per employee. It is also noted that the higher hourly wage was phased in to $10.10 over several years, whereas Pennsylvania will move directly to $12.00 and under much different labor market conditions.[11]

Table 2.2
Average Annual Growth Rates: 2014 to 2019

	County Population	Personal Income	NAICS 722 Employment	Wage (NAICS 722)
Maryland	0.3%	3.6%	1.8%	3.8%
Pennsylvania	0.4%	4.2%	1.6%	3.4%

Note: NAICS 722 is the food services and drinking places industry.

Source: U.S. Bureau of Economic Analysis and U.S. Bureau of Labor Statistics, Quarterly Census of Employment and Wages.

[11] From 2014 to 2019, the average weekly wage (AWW) grew by 20.7% and 18.2% for Maryland and Pennsylvania, respectively. Using Pennsylvania as a control state, this implies that the higher Maryland minimum wage increased the AWW by 2.5% (actual increase of 20.7% less control growth of 18.2%). Based on a 2014 AWW of $314 in Maryland, it implies that the higher minimum wage increased weekly pay for the average worker by roughly $8, or $410 per year by 2019.

Economic and Revenue Impact

To estimate the impact of the higher minimum wage on Pennsylvania employment, the analysis uses data from the 2019 Occupational Employment Statistics (OES) dataset from the U.S. Bureau of Labor Statistics. The OES is a semi-annual survey sent to a sample of non-farm establishments across all industries and includes estimates for employment and wages for specified occupations by state. For 2019, the OES dataset for Pennsylvania represents 5.90 million jobs, including secondary jobs. The dataset also includes workers employed in occupations that typically receive tips, though these workers are excluded from the analysis.

In April 2021, the IFO published a detailed analysis of a minimum wage increase to $12.00 per hour effective July 1, 2021.[12] The results from the prior analysis for the first full year are as follows:

- An estimated 749,000 directly affected workers (earning less than $12.00 per hour) and 696,000 indirectly affected workers (earning $12.00 to $14.99 per hour) received higher wages.
- An estimated employment reduction of 16,000.
- A net income gain for all directly and indirectly affected workers of $2.44 billion.
- A net increase in state General Fund revenues of $61 million as follows: (1) +$40 million for sales and use tax, (2) +$58 million for personal income tax and (3) -$37 million for corporate net income tax.

Since the prior analysis, there has been minimal data that would materially change the results. Therefore, this analysis provides only a general update to the more detailed analysis published in April 2021. This analysis does update the assumptions related to job loss and wage gains since 2019. The assumptions in the current analysis differ from the prior analysis as follows:

- The prior analysis assumed that there would be 230,000 fewer jobs in 2022 than 2019. Based on more recently published data, that figure is revised to 190,000.
- Based on sector data, the prior analysis reduced employment in certain sectors and then assumed the entire wage distribution shifted to the right by roughly 2% per annum from 2019 to 2022. However, statewide wage data show average wage gains of roughly 5.8% per annum (across all payroll workers) and this analysis assumes that the entire wage distribution from 2019 shifted right by roughly 4% per annum.
- For 2022, the total number of non-tipped workers earning less than $10.00 per hour is estimated at 176,000 due to the loss of jobs in lower-paying sectors during the COVID-19 pandemic as well as larger than expected hourly wage gains for those workers. The prior analysis assumed that 310,000 workers earned less than $10.00 per hour. Moreover, the current analysis assumes that all workers earn at least $9.50 per hour. The prior analysis had assumed $8.00 per hour.

[12] See Revenue Proposal Analysis, April 2021. http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/Revenue_Proposal_Analysis_2021_04.pdf.

Table 2.3 provides a breakdown based on wage rate for all non-tipped payroll jobs for 2019 (actual based on sample) and 2022 (projected, excludes self-employed). For 2022, the analysis assumes that there are 1.324 million directly (earning less than $12.00 per hour) and indirectly affected ($12.00 to $14.99 per hour) workers.

Table 2.3
Pennsylvania Worker Distribution by Hourly Wage Rates

	Number of Payroll Employees (000s)		
	CY 2019	CY 2022	Change
Non-Tipped Workers			
$7.25 to $9.99	506	176	-330
$10.00 to $10.99	260	264	4
$11.00 to $11.99	278	201	-77
$12.00 to $14.99	764	684	-80
$15.00 or more	3,916	4,234	317
Total Non-Tipped Workers	**5,725**	**5,558**	**-167**
Tipped Workers	177	157	-20
Total All Workers	**5,902**	**5,715**	**-187**
Directly Affected by $12 Minimum Wage			
Non-Tipped Workers	1,044	640	-404
Tipped Workers	119	105	-14

Note: Excludes self-employed. Thousands of full- and part-time jobs.

Source: Occupational Employment Statistics (OES), 2019. Projection for 2022 by IFO.

The analysis estimates the following impacts for a minimum wage increase to $12.00 per hour:

- An estimated 635,000 directly affected workers (640,000 if job losses included) and 684,000 indirectly affected workers receive wage increases.
- An estimated employment reduction of 5,000. Most of the employment reduction would likely be due to firms not filling vacant positions or not replacing workers who depart or retire.
- A net wage increase for directly and indirectly affected workers of $1.93 billion (full year amount). Directly affected workers receive an annual gain of $1,700 per worker.
- A net gain in state General Fund revenues of $40 million to $45 million per annum.
- According to the FY 2022-23 Executive Budget, the Department of Human Services expenditures are impacted by savings in the Medical Assistance Capitation line item (-$7.4 million) and higher costs in the Children's Health Insurance Program (CHIP) (+$2.6 million); County Child Welfare (+$2.1 million); and Child Care Assistance (+$38,000) line items.