Inflation's Impact on the Pennsylvania Economy, Budget and Pensions
House Majority Policy Committee Hearing on Inflation
June 8, 2022
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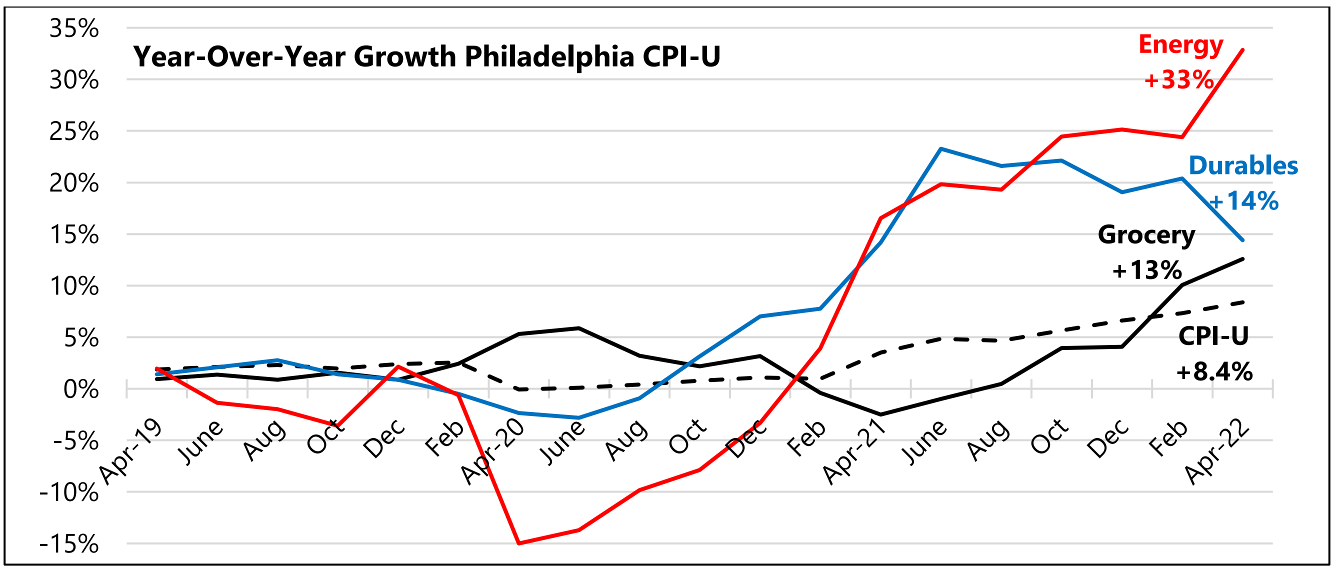
Good morning committee members. For my testimony, I will note some brief highlights from the tables and graphs that appear below.

Philadelphia CPI-U

The latest data for the Philadelphia CPI-U is for April 2022. The year-over-year growth rates show that:

- The **All Items CPI-U or overall rate was 8.4%**, the highest rate since December 1981.
- Excluding shelter (largely imputed rent to homeowners) the rate is 9.6% (not shown).
- Energy prices (gasoline and utility bills) are a clear driver of inflation. Energy prices were up 33% from the prior year and comprise 7.0% of the CPI-U basket.
- Durable goods purchases (new and used cars, appliances, furniture) were up 14% (10.9% of CPI-U).
- Grocery prices are now increasing rapidly, up 13% (7.1% of CPI-U).
- The IFO projects overall inflation to average 7.0% for 2022 and decelerate to 4.5% for 2023.



Real Average Hourly Earnings

Due to inflation, the real value of average hourly earnings for Pennsylvania payroll workers **contracted by 3.8%** in April 2022 relative to the prior year (see next page). (For the U.S. (not shown in table), real hourly earnings contracted by 2.6%.) In December 2021, real hourly earnings for workers in the leisure-hospitality sector increased by 8.2%, but gains were eroded to 2.5% by April 2022. All other sectors recorded real earnings contraction, and strong contraction for the retail-wholesale trade and transportation sector.

Growth of Pennsylvania Real Average Hourly Earnings	Dec	Jan	Feb	Mar	Apr
All Private Workers	**-1.8%**	**-0.1%**	**-3.3%**	**-2.6%**	**-3.8%**
Leisure and Hospitality	8.2%	7.0%	4.8%	6.0%	2.5%
Construction	1.2%	2.4%	-0.2%	0.3%	-3.2%
Manufacturing	-2.2%	-2.7%	-3.2%	-2.0%	-2.0%
Trade and Transportation	-6.1%	-2.4%	-4.8%	-4.5%	-6.6%
Professional-Business Services	2.5%	1.5%	-1.5%	-1.1%	-1.2%

Note: Growth is year-over-year. Average hourly earnings deflated by Philadelphia CPI-U. Excludes self-employed and government.

Source: U.S. Bureau of Labor Statistics (data and methodology).

General Fund Revenues

A massive infusion of federal funds, inflation and changes in consumer purchase patterns caused a surge in General Fund tax revenues in FY 2021-22 relative to (1) FY 2018-19 (latest pre-pandemic year) and (2) the overall state economy.

- Revenue sources tied to business profits or stock markets (i.e, dividends and capital gains) are shaded red and recorded very strong growth due to inflated asset markets and unusually high profit margins.
- Sales and use taxes easily outperformed the overall growth of the Pennsylvania economy (nominal GDP).
- Withholding tax revenues (wages) increased at roughly the same rate as the state economy.
- Real output or Real GDP increased despite 155,000 fewer payroll jobs.

The IFO revenue forecast assumes that the surge in business profits, dividends and capital gains cannot be maintained in FY 2022-23 and will begin to revert to historical levels and trends as the Federal Reserve raises interest rates and reduces the money supply.

General Fund Tax Revenues Surge Relative to PA Economy

	Amounts or Levels		Growth Rates	
	2018-19	2021-22	Cumulative	Avg Ann
All Tax Revenues (millions)	**$34,056**	**$43,073**	**26.5%**	**8.1%**
Personal Income - Non-Wage	$3,652	$5,992	64.1%	17.9%
Corporate Net Income	$3,398	$5,057	48.8%	14.2%
Inheritance	$1,054	$1,576	49.6%	14.4%
Sales and Use	$11,100	$13,835	24.6%	7.6%
Personal Income - Wages	$10,444	$12,054	15.4%	4.9%
All Other	$4,410	$4,559	3.4%	1.1%
PA Macro Variables	**2019.2**	**2022.2**	**Cumulative**	**Avg Ann**
Nominal GDP (billions)	$797.4	$911.8	14.3%	4.6%
Real GDP (billions)	$714.9	$728.6	1.9%	0.6%
Philadelphia CPI-U	257.7	293.5	13.9%	4.4%
Payroll Jobs (000s)	6,082	5,927	-155	n.a.

General Fund Expenditures

For FY 2022-23, the IFO had projected $41.3 billion in General Fund expenditures in its latest five-year outlook report (November 2021). That amount is for illustrative purposes only and will change based on current budget negotiations. However, a few points can be noted:

- Wage costs (and related taxes) will total roughly $3.0 billion for FY 2022-23 based on existing contracts (4.2% growth for next fiscal year). Negotiated wage contracts expire in June 2023 and non-union workers will typically receive similar pay adjustments.
- Inflationary pressures will factor into negotiated rates for wage increases and healthcare.
- State and local programs that rely on state or federal funds will experience an erosion in purchasing power if discretionary subsidies, grants and other funding increase less than the rate of inflation. In some cases, this will increase the need for additional funds at the local level for school and county programs.
- Any inflationary increase in FY 2022-23 and later will likely become a permanent part of future budgets and the impact will compound. The columns below depict the impact in FY 2022-23 if (1) growth rates are 1 percentage point higher than assumed in FY 2022-23 and (2) the impact in the third year if growth rates are 1 percentage point higher across all three years. The amount is more than three times larger due to compounding.

General Fund Expenditures

	Amount FY 22-23	1 ppt extra growth	Over 3 years	Notes
Personnel Costs				
Wages	$2,988	$29	$93	Wage contracts expire June 2023
SERS and PSERS	$3,980			S&P 500 down 13% for YTD
Healthcare	$999	$9	$31	
Program Costs				
K-12 Education	$11,111	$108	$343	Discretionary, but costs passed to locals
Human Services	$17,200	$154	$527	Excludes enhanced FMAP offset
Debt Service	$1,208			
Higher Education	$1,816	$18	$56	Includes PHEAA
Corrections	$648	$6	$20	Operating, meals, inmate healthcare
All Other	$1,369	$13	$42	Operating, contracting and grants
Total	**$41,320**	**$337**	**$1,112**	

Note: Million of dollars. Value of Extra 1 ppt column increases growth rate by 1 ppt more than assumed. The Over 3 Years column increases assumed growth rate by 1 ppt each year over 3 years. Amount is extra spending in third year. SERS-PSERS and Debt Service are excluded because the short-term impact of higher inflation is less clear.

Inflation Erodes Real Pension Benefits

Because SERS and PSERS benefits are not indexed to inflation, current retirees lose significant purchasing power due to high inflation that will not be recovered. The table below illustrates the impact for the average SERS or PSERS beneficiary who was retired in 2020 after achieving full benefits. The average annual benefit earned was $30,050 for SERS and $29,600 for PSERS.[1] The analysis uses an average benefit amount ($29,820) for the two systems. The table displays nominal payments over the next 10 years at five-year increments and outcomes under two inflation scenarios. The first scenario assumes inflation of 2.0% per annum, which reflects the Federal Reserve's original target rate. The second scenario uses higher inflation for 2021 (4.0%, actual), 2022 (7.0%, based on data through April), 2023 (4.5%) and 2024 (2.8%) prior to reversion to an annual rate of 2.0%.

Constant inflation of 2.0% per annum erodes the real value of annual pension benefits by $2,810 for 2025 (-9.4%), $5,350 (-17.9%) for 2030 and $30,310 (-10.2%) over the entire 10-year period. Under higher inflation, the erosion increases to $5,360 for 2025 (-18.0%), $7,670 for 2030 (-25.7%), and $52,390 (-17.6%) over the entire 10-year period. The difference between the two scenarios is **$22,080 of reduced real purchasing power** over the entire 10-year period, or -$2,208 per annum on average. This example illustrates how inflation redistributes fixed wealth from certain residents to others who may benefit from higher prices.

Higher Inflation Erodes Real Value of Public Pensions

				Total 2021-30	
	2020	**2025**	**2030**	**Dollar**	**Percent**
Real Value of Average Benefit					
No Inflation	$29,820	$29,820	$29,820	$298,200	n.a
With 2% Inflation All Years	$29,820	$27,010	$24,470	$267,890	n.a
With Higher Inflation	$29,820	$24,460	$22,150	$245,810	n.a
Reduction in Real Value					
No Inflation vs 2% Inflation	$0	-$2,810	-$5,350	-$30,310	-10.2%
No Inflation vs Higher Inflation	$0	-$5,360	-$7,670	-$52,390	-17.6%
Difference: Additional Erosion	$0	-$2,550	-$2,320	-$22,080	n.a

Note: Higher Inflation uses 4.0% (2021), 7.0% (2022), 4.5% (2023), 2.8% (2024) and 2.0% in all future years.

[1] These figures reflect an average beneficiary who achieves superannuation (i.e., maximum benefits). Upon retirement, most members (70% to 80%) withdraw their employee contributions to use for investment or other purposes. The figures represent a weighted average for a member who withdraws and does not withdraw employee contributions.