

Senate Appropriations Committee budget hearing with DOR/Lottery (BH)

3/5/18, 1:00 p.m., Hearing Room 1, North Office Building

The committee held a budget hearing with [Dan Hassell](#), secretary of the Department of Revenue (DOR), and [Drew Svitko](#), executive director of the Pennsylvania Lottery.

Sen. Hutchinson, chairman of the Finance Committee, discussed the technology and modernization process that is ongoing at DOR and was curious to hear how much has been spent total, how much more will be spent, and when it will be complete. He also remarked that it makes sense to use the best technology possible, but wondered if the department is seeing cost savings by having good technology. Sec. Hassell said the budget requests \$4.7 million to continue the modernization effort and explained the contract was awarded by (DGS) about a month ago and the department expects to begin work with the new vendor in the next month or two. This contract will cover a number of taxes, including personal income, inheritance and motor fuel taxes, and will bring efficiencies to the department, he added. He indicated the project dates back to a 2010 contract that was supposed to be a five-year effort that converted all tax systems, but that contract was cancelled after some of the business taxes were converted in part because the vendor was behind schedule and there were significant problems. [Christin Heidingsfelder](#), deputy secretary for administration, reported \$101 million has been spent to-date and the contract and other related costs are anticipated to be \$57 million over the next several years. Sen Hutchinson wondered if future costs will clean up the prior contract. Heidingsfelder replied in the negative, stating the "mess" has already been cleaned up. She also noted efficiencies that have been achieved, noting a decreased complement and a level budget while benefit costs increase. She confirmed there is a proposed 3.9 percent general government operations (GGO) increase in this budget to cover the increasing cost of personnel. Sec. Hassell noted the request is for 16 positions, which covers people at the lottery to roll out new games and also the gaming expansion.

Sen. Blake, minority chairman of the Finance Committee, asked if the tax recent amnesty program was successful. Sec. Hassell replied in the affirmative, stating the estimate was \$100 million but \$130 million in net revenue came in. He said the costs of running the program were about \$12.5 million.

Sen. Blake then asked about funding from the Enhanced Revenue Collection Account (ERCA). Sec. Hassell replied the bulk of that revenue goes to staff and explained those positions have created about \$360 million in revenue.

Sen. Blake also asked about changes to the appeal process. Sec. Hassell confirmed there have been a number of changes and the most recent was to reduce the appeal period to 60 days. He indicated none of the changes have reduced the numbers of appeals, which total almost 30,000 and is difficult to keep up with.

Sen. Blake raised concerns about the effect of gaming expansion on lottery programs and asked for an update. Svitko confirmed a number of competitors to the lottery have been introduced, but said correspondingly the lottery was given tools to compete, such as Keno, iLottery, and virtual sports. He indicated they will all be launching in the next few months and reported "we're doing wonderfully." Sen. Blake asked about lottery machines in state stores. Svitko replied machines are in about 300 state stores and are doing well, but they continue to look for opportunities to do better.

Sen. Blake asked if it is too soon for a year-end revenue estimate. Sec. Hassell reported "it looks good" and noted revenues are a bit ahead of estimates, but that might be temporary.

Sen. Costa wondered what type of success the department will have with the new games, worrying it will be like with tavern games where nobody signed up. Svitko anticipated success and said applicants will be subject to background checks, like all retailers. He did not think that will dramatically affect recruitment. Sen. Costa asked when the impact of the various forms of gaming on the Lottery Fund will be assessed. Svitko replied they are always trying to gauge the market and confirmed they will be watching closely.

Sen. Yaw noted potential problems with banks as medical marijuana comes online and asked how that has affected DOR. Sec. Hassell agreed that is a concern and said the department is continuing to work with the Department of Health and the licensees to find out if they will have banking problems. He was not aware of any such problems yet, but said if they run into an issue the department will be ready to have them make payments in cash which would be "frankly a little more expensive than having someone mail us a check." The first medical marijuana tax payments will come in next month.

Sen. Yaw also asked about taxes from fireworks and asked for a status update on ongoing litigation. Sec. Hassell was aware of the litigation, but did not know the details. The department is ready for the tax filings "and that's the extent of our involvement in it," he said.

Sen. Schwank requested an update on the Rainy Day Fund, which she said has an "appallingly low balance" at about \$200,000. Sec. Hassell agreed and said the governor's goal is to get back to the system in which a percentage of a budget surplus is allocated to that fund. He remarked on the importance of having a cushion for unforeseen events. He said the surplus will be allocated per the law, "unless that provision is suspended with the budget's passage."

Sen. Schwank was pleased to see the return of Gus the Groundhog in lottery marketing and asked about the plans for marketing the new games. Svitko agreed Gus has been effective and confirmed the new games will be advertised. He noted they work with an advertising agency out of Pittsburgh. Sen. Schwank asked how the program providing an opportunity to buy lottery tickets at gas pumps is working. Svitko replied it is going well, calling it a little bit of money but new points of distribution. He said the lottery is working with a third-party vendor on that effort and hopes to expand it.

Sen. Langerholc wondered about challenges and their effect on revenue of the changing demographics of the commonwealth. Sec. Hassell confirmed the senior population is growing and that will mean fewer wage earners paying income tax and there will be more pressure on programs that serve seniors and provide medical care. He did not have specific numbers, but said that is something the commonwealth will have to pay attention to.

Sen. Langerholc said the commonwealth spent \$48 million last year and another \$51 million is projected this year for advertising and he asked how the \$3 million increase this year will be used and what returns are projected. Sec. Hassell reiterated the new games are being rolled out and said the new dollars are to support those new gaming venues. Svitko explained the lottery does research to ensure they are affecting people's opinions of lottery and likelihood to pay, but does not do return on investment research because it is so expensive and affected by so many factors. "We are doing it to build and maintain a brand and protect those revenues for older Pennsylvanians," Svitko said. Sen. Langerholc

wondered if the advertising agency has any data on returns. Svitko assured him it is not a "blank check" to the agency and is monitored and said most of the money is used for media, like billboards or commercials.

Sen. Ward wondered about cash payments from medical marijuana and how that will be monitored. Sec. Hassell reiterated that at this point no cash payments are expected. Regarding monitoring, Heidingsfelder explained the Department of Health has a "seed to sale" system to monitor the industry. She said any cash payments would immediately be taken away by armored vehicles and not kept in a vault at the department. Sen. Ward quipped armored trucks picking up cash could be a whole industry by itself.

Sen. Ward then asked how the proposed natural gas tax would compare to other states. Sec. Hassell said the governor's proposal is on a cents-per-thousand-cubic-foot basis and starts at 4.2 cents per mcf and goes up from there, depending on the market price. He said that rate would put Pennsylvania below the average of the top ten gas producing states, and even when coupled with the impact fee it would be "in the middle of the pack."

Sen. Baker wondered about the federal bonus depreciation rules and a recent bulletin issued by the department on the subject. Sec. Hassell provided history on the subject, explaining that in 2003 Pennsylvania decoupled from the federal bonus depreciation and that law assumed the federal government's rate is 30 percent. As the federal government makes changes, he said, Pennsylvania's formula does not work very well. In his opinion, Pennsylvania statute does not allow the cost recovery and he did not believe he should be able to make such a policy decision to re-interpret the law. He recommended a legislative fix, but was not aware that the department has endorsed any specific plan yet. He merely cautioned that any proposal should be considered in the context of a balanced budget. Sen. Baker countered the legislature should also consider what is in the interest of businesses.

Chairman Browne asked how the department position on bonus depreciation affects the revenue estimate. Sec. Hassell replied the official estimate was signed in July and the change was made in December; the impact of the federal change is not in the official estimate. Chairman Browne wondered if an adjustment should be made. Sec. Hassell added DOR is still assessing the impact of federal changes and said they will come back to the legislature with a recommendation.

Sen. Street referenced suggestions that Pennsylvania shift to combined reporting and asked how that would affect commonwealth revenue. Sec. Hassell responded the governor's budget proposal contains a recommendation to phase down the tax rate of the corporate net income (CNI) tax from 9.99 percent to 7.99 percent and also to adopt combined reporting. Combined reporting would more accurately determine what is taxable from corporations and make it harder to avoid the tax by shifting profits out of state, he said. He added that the high rate of the CNI is a competitive problem for Pennsylvania and the governor's plan is to get Pennsylvania to place where it is no longer an outlier and everyone pays their fair share.

Sen. Scavello asked if the new employees for i-gaming will come from section 1401 accounts. Heidingsfelder replied i-Gaming and related new costs will come from the current 1401 accounts and there will be a separate 1401 account for VGTs (video gaming terminals) and for fantasy contests. Sen. Scavello asked if new vendors will be needed. Sec. Hassell replied the department is talking with potential vendors for VGTs and indicated the Gaming Control Board has not yet moved forward with applications for licenses. The existing system vendor will be handling iLottery, he added. Svitko noted \$162 million is projected over the

next five years for iLottery and \$40 million from monitor games. He added other states have seen sales increase in other products with the additional exposure and broadened player base.

Sen. Scavello wondered about future revenue projections. Sec. Hassell said the estimates in the budget are a little above the official estimates for this year and collections are going well. He mentioned a tobacco securitization transaction took place in February, which was expected in June, but even without that the growth rate is encouraging. Sen. Scavello questioned if federal changes have affected collections. Sec. Hassell said the department is projecting some of the strong income tax revenues are early payments on account of the federal changes, so that will "wash itself out," and he was less able to project business tax changes but said the department is closely watching those.

Sen. Argall returned to the modernization effort and mentioned prior testimony that this would help combat welfare fraud, wondering if that is still part of the effort. Sec. Hassell offered to get back to the committee with more information. Sen. Argall called this one of the main benefits of modernization and was eager to learn more.

Sen. Vogel asked what the department is doing to combat identity theft and cyber-attacks. Sec. Hassell replied, in short it can never be good enough, but assured the committee that the department has taken steps to address the problem. The department has a fraud investigation unit to help victims of identity theft, has procedures to detect problematic filings, and has implemented system changes to protect systems from intrusion including encryption. He was aware of the risk that the department faces as a prime target and said they are continually working to prevent that.

Sen. Vogel then asked about new positions at the lottery. Svitko confirmed initiatives like "play at the pump" are normal, everyday initiatives and are not included in the modern games like iLottery, which will bring in as many as 3,500 new venues.

Sen. Vogel questioned how the money from the Farm Show lease-leaseback was used. Sec. Hassell replied DOR was not involved in that and could not answer the question.

Sen. Vogel wondered about the effect of large Powerball jackpots on the lottery. Sec. Hassell confirmed a large jackpot recently resulted in an influx. Svitko added the multi-state games are as profitable as the other games, from a margin standpoint. He called the big jackpots "the difference between having a good year and a great year."

Sen. Vulakovich also asked about the modernization project. Sec. Hassell confirmed it began in 2010 and \$101 million has been spent so far, with another \$57 million to be spent over the next four years. He pointed out the upcoming costs will be for a different set of taxes; the 2010 system contains the business taxes and the remaining tax systems will be in the new system. Continuing, he said the original contract was suspended in early 2015. Sen. Vulakovich wondered if contracts have performance bond provisions. Sec. Hassell was not aware of a performance bond in the contracts, but offered to double check. He said this is not like the situation that occurred at the Department of Labor and Industry, pointing out the system is in use and working. Speaking to the issue of welfare fraud, Sen. Vulakovich said he cannot see a modernization that does not have provisions that can red flag potential fraud. Sec. Hassell responded the new system will be more secure than the current system for personal income taxes. Regarding a link to the Department of Human Services to suss out fraud, he was not sure of those provisions and offered to get more information.

Sen. Vulakovich requested the equivalent tax rate of the natural gas impact fee and how it would be coupled with a severance tax and other taxes the businesses are already paying. Sec. Hassell reiterated the figures he mentioned early, and said they are based on cents-per-mcf and are total revenue divided by production. He offered to get back to the committee with further details and noted the governor's proposal is a sliding scale.

Chairman Browne elaborated that the Independent Fiscal Office (IFO) has used a different platform to make tax calculations and suggested the two agencies should be making their calculations on the same platform for better comparisons. Sec. Hassell was familiar with this situation, and explained the IFO has constructed a theoretical model and tried to apply different state taxes to it. He opined that model is limited in usefulness because the department does not tax on present value and makes it difficult to discern what the tax is worth overall unless looking simply at revenue divided by production.

Sen. Hutchinson noted the budget requests \$30 million for the program to increase tax collections, which he conceded is laudable, but then pointed out that the rest of the department's role is to collect taxes. He wondered why those same procedures in ERCA aren't being applied across the board. Sec. Hassell explained the ERCA funded positions, by law, are supposed to be generating revenue and the intent is to add transparency to the system. He recognized Sen. Hutchinson's point, but said they are not ERCA-funded and not in direct revenue generating jobs.

Sen. Costa returned to the marketing contract with a Pittsburgh firm and wondered to what degree they work with women, veteran and minority-owned businesses. Svitko confirmed all contracts have a requirement for a percentage to be spent with disadvantaged businesses and that is monitored by DGS. He noted they also try to reach a diverse market and use a variety of media to do so. He confirmed the department receives reports from DGS and it is a topic of conversation occasionally with the vendor.

Sen. Street questioned how the governor's extract tax proposal compares with those in other states. Amy Gill, deputy secretary for tax policy, explained the tax bases vary quite a bit across the states and she confirmed Pennsylvania would be in the middle of the pack.

Sen. Yaw asked how many states have an impact fee. Sec. Hassell did not know. Sen. Yaw recalled that Pennsylvania ranks second in natural gas production, behind Texas which has a rate of 7.5 percent. He pointed out Texas has a number of exemptions. He also asked what hub is used to determine price in Pennsylvania. Sec. Hassell replied it is calculated based on futures contracts on the New York exchange, which had an average price of \$3.08 in 2017. Sen. Yaw wanted to know what other industry has come to Pennsylvania in the past few decades that has produced as much revenue overall as the new natural gas industry. Sec. Hassell referenced a number of "extraction type events," including oil and coal, but he could not think of any in the past two decades. Sen. Yaw commented no major industrial industry has come to Pennsylvania in recent years that is comparable to the natural gas industry "and we've done nothing to attract it." He compared this to the "hoops" Pennsylvania is jumping through to draw Amazon to Pennsylvania, yet the response to the natural gas industry is to levy a new tax. Sec. Hassell did not think it was fair to say the commonwealth has not done anything to support the development of natural gas, mentioning effort to streamline processes for the industry to develop. He also reiterated that the proposed natural gas tax would not put Pennsylvania out of line with other states, even when accounting for the nuances of each state's laws. Sen. Yaw commented the impact fee is different than severance taxes because it is paid irrespective of production. Sec. Hassell said

Gov. Wolf wants to see the industry develop and be a part of Pennsylvania, which includes contributing a reasonable tax.

Chairman Hughes pointed out natural gas drilling really kicked off around 2005 and asked when the impact fee was levied. Gill replied 2011. Chairman Hughes pointed out that means the industry had six years of not paying for extracting the gas, which he said belongs to the people of Pennsylvania. "So that's free drilling," he stated. He wondered about the missed opportunity that time meant. Sec. Hassell agreed to provide an exact figure, but guessed it would be billions of dollars. Chairman Hughes also wondered how the reduction in the CNI would help particular industries. Sec. Hassell offered to try to compile that information. Chairman Hughes explained he is trying to get a "true picture" of tax policy for industries in Pennsylvania.

Regarding modernization, Chairman Browne remarked on the need for ongoing dialogues about where that is going in the future and commented that the "leaps" that have been made for taxpayers are "extraordinary." Further, he said part of that is the advancement of e-filing and wondered what that has meant for the workforce. Sec. Hassell agreed it has been a tremendous change, noting some tax areas are approaching 100 percent in electronic filing. That transition and new technology has allowed the department to shrink over the past ten years, noting the head count is down about 300 people in that time.

Speaking to the federal tax bill, Chairman Browne said he has heard conversations about conversions from S-corporations to C-corporations for the first time. He added that all states are worried about the potential for higher taxes at the state level. He remarked this makes it more complicated for the department to determine its closing numbers and offered to be more proactive with the department to accommodate the changes and what they mean to budgets. He spoke to a projection in the budget and Sec. Hassell confirmed it is the positive impact of combined reporting. Chairman Browne asked about a potential legal challenge regarding interstate sales, which Sec. Hassell was not aware of. Further, Sec. Hassell explained companies affected by marketplace law had to file by March 1 and he confirmed one of those companies was Amazon, so they will be collecting sales tax on sales in their marketplace online. He called this positive news, and noted 163 forms were filed with the department and 70 of those were companies electing to file the sales tax. Chairman Browne asked if the department put out an extension on the nonresident withholding. Sec. Hassell replied in the affirmative, explaining the department recognized a lot of companies were having trouble complying and with hold off on collections until at least July 1.

Chairman Browne also asked how K-12 deductions will be handled. Sec. Hassell confirmed they will be handled the same as the other deductions.

Lastly, Chairman Browne spoke about programs that allow investments in low income areas and said the vast majority of the geography on those tracts are in communities that have drilling. The state tends to offer tax policies that encourage companies to invest, he said, as part of the "normal conversation." But if natural gas was part of the conversation, he continued, "Those two things would work counter to each other. He explained that has always been his concern and needs to be taken into account in any conversations on the severance tax.