POLICY BRIEF
FROM THE COMMONWEALTH FOUNDATION

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Three Steps to an Honest State Budget

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Executive Summary

Pennsylvania is a high tax state with a large public debt from chronic overspending. The complexity of the problem has for too long discouraged serious reform. Instead, fiscal patches and gimmicks have multiplied in each budget season. They include cost and revenue shifts, temporary revenue, and the use of special funds outside the General Fund budget.

The Commonwealth Foundation sees a better way forward. Our budget plan puts guardrails on spending, increases accountability, and stabilizes debt while maintaining core services. This report reviews the state's fiscal problems and presents legislative proposals to advance three priorities:

1. **<u>Enact a balanced budget without tax hikes</u>**

    - Expenditures should match existing revenues.
    - There should be no new taxes or one-time revenue sources.
    - The revenue base can be broadened and simplified through tax reform. Elimination of breaks and exemptions can create room to affordably lower rates.

2. **<u>Limit state spending growth</u>**

    - The Taxpayer Protection Act would limit spending growth to the combined rate of inflation and population growth.
    - The Act commits the state government to long-term sustainability, thus helping to prevent harmful tax increases and risky borrowing in the future.

3. **<u>Adopt transparency in budgeting</u>**

    - Restore legislative control by consolidating government accounts. End the diversion of revenue out of the General Fund into special funds.
    - Cleanse the fiscal code of earmarks, which unconstitutionally direct state funds to private parties outside of the regular legislative process.
    - Increase oversight and transparency with respect to supplemental appropriations, which currently allow the administration to overspend with little scrutiny.
    - Prohibit new borrowing by the Commonwealth Financing Authority and PENNVEST, two state agencies with a history of funding subsidies and handouts to business.

Background

The debt problem

Pennsylvania is home to 13 million people. It has vast natural resources and economic output equivalent to that of Turkey. Sadly, Pennsylvania also ranks 39th in the United States for fiscal health according to Truth in Accounting, a non-partisan monitoring group. Bonded debts of the state government are about $24 billion, or $1,800 per person.[1] Adding the debts of other public entities and counting unfunded pension liabilities increases the total to more than $120 billion or $9,000 per person.[2]

The spending problem

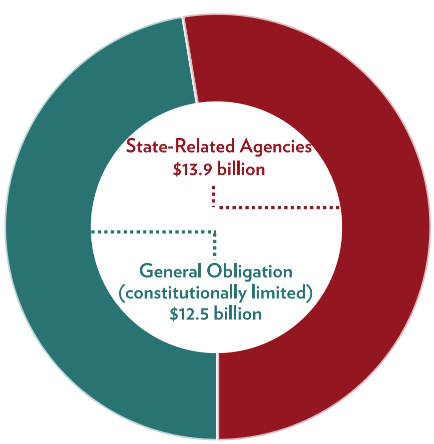
Pennsylvania's excessive debt is the result of chronic overspending. State spending has grown 70% since 2000, exceeding the rate of personal income growth over the same period. Population grew only by only 4%. Since the 1970s the Pennsylvania state government has tripled in size, adjusting for inflation.

The tax problem

Tax revenue is tapped out. The state already collects about $3,000 per person on top of a high local tax burden. The state has increased taxes five times in the past eleven years. Pennsylvania's overall tax burden ranks in the middle among states according to the Tax Foundation, but the 9.99% corporate income tax and high local property taxes are especially harmful to business and household formation. Pennsylvanians aged 20-34 are leaving the state on net.[3] A 4.5% inheritance tax encourages wealthy older taxpayers to establish residency elsewhere. More taxation will only increase Pennsylvania's problems in the long term.

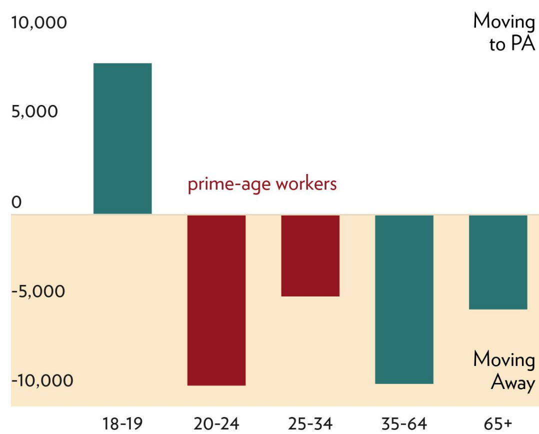
Pennsylvania State Debt

The government has a debt limit, but it can borrow through affiliated bodies without limit.



Net Migration by Age Group

From 2013 to 2017 Pennsylvania lost an average of 14,000 working aged adults per year.



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[1] General obligation bonds are about $12.5bn. Debts of the Commonwealth Financing Authority, Economic Development Financing Authority and Public School Building Authority are about $11.4bn.
[2] Unfunded pension liability at least $70bn, Turnpike debt $12.8bn, other debt $14.6bn
[3] PA Independent Fiscal Office. "Migration Data by Age Group and Educational Attainment." July 2, 2019 http://www.ifo.state.pa.us/Releases.cfm?id=282

Gimmicks in place of solutions

Because spending is not properly sized to available revenue, budget gimmicks have become routine. Lawmakers have relied on the following in recent years:

- **Backfilling:** In five of the last six fiscal years the Wolf administration overspent the ostensibly balanced budget approved by lawmakers and then obtained the extra money at year end via a supplemental appropriation. Current estimates are that overspending will be close to extra $600 million for fiscal 2019-20, equivalent to $46 per resident.

- **Temporary revenue:** The Pennsylvania Constitution[4] requires all operating expenditures to have matching revenue available in the same fiscal year, but such revenue need not be sustainable or recurring. With no discipline on the expense side, every new fiscal year brings a scramble for cash. Recent short-term and one-time revenue measures have included casino licensing, transfers from the Pennsylvania Turnpike ($450 million per year through 2022), use of segregated transportation monies for the state police ($50 million per year), and repeated attempts to expropriate $200 million from the Joint Underwriting Association, a quasi-public insurance company.

- **Shadow budgeting:** The legislature votes on less than half of annual spending. The last enacted General Fund budget was $34 billion, but all government entities together collect and spend about $86 billion. [5] It is unwise and unconstitutional that so much spending be either automatic or hidden.

- **Handouts and earmarks:** Instead of making reforms to improve business conditions for all, the government has been handing taxpayer money to businesses and organizations it favors. The 2019-2020 budget included over $700 million in grants and tax credits for businesses sufficiently well-connected to get them.[6] The money at risk on subsidized loans and loan guarantees is far more: the entities that make such loans have debts of about $10 billion.[7] The practice of "earmarking" involves smaller dollar amounts but is more flagrant. An earmark is a direct appropriation to a specific private party.

[4] Section 13a
[5] Excluding certain self-sustaining entities like the Turnpike
[6] "Corporate Welfare is the Gift that Just Keeps Taking." Commonwealth Foundation Policy Blog. August 9, 2019. https://www.commonwealthfoundation.org/policyblog/detail/corporate-welfare-is-the-gift-that-just-keeps-taking
[7] Combined debts of Economic Development Financing Authority, Infrastructure Investment Authority (PENNVEST), Commonwealth Financing Authority and Industrial Development Authority.

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Proposals for Fiscal Year 2020-2021

Enact a truly balanced budget

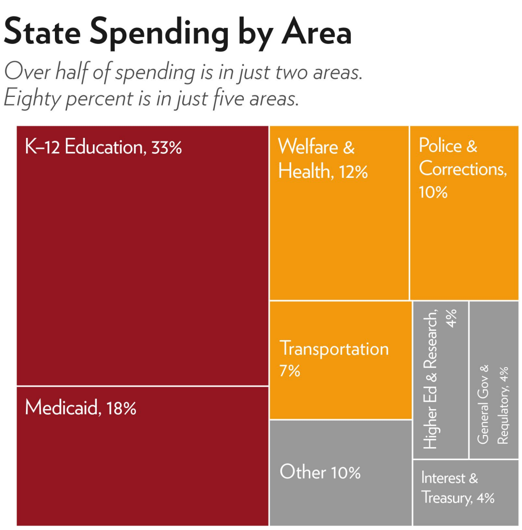
True budget balance is not simply current year equality between expenses and revenue, but a sustainable rate of budget growth. If spending growth can be held in line with the growth of available resources, fiscal gimmicks will become unnecessary and the commonwealth's debt and tax problems will become manageable. In contrast, a budget that spends beyond the state's means will increase the financial burden on families and businesses.

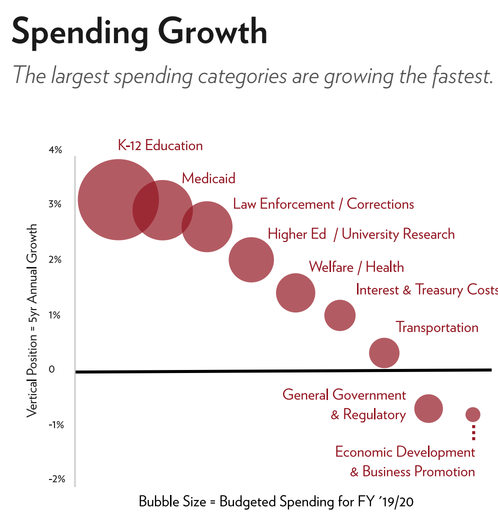
The 2020-21 budget should spend no more than $34.7 billion from the General Fund, a 2.1% increase to the state's enacted 2019-20 budget. This rate of increase equals the state's three-year average population growth rate plus the three-year average rate of inflation. Expenditure should match existing revenue: there should be no new taxes or use of one-time revenue sources.

The only way for the legislature to maintain budgetary balance is by addressing the main cost drivers. Over the past five years, the dollar growth in K-12 and Medicaid alone were greater than the growth in everything else combined. The next largest spending areas were corrections, law enforcement, and higher education. Both of these areas grew in excess of the estimated sustainable rate.

In addition to being concentrated in just a few programs, spending is also highly concentrated among individual line items. Just seven items line make up half the budget. The single largest item, Basic Education, takes up 17% of the budget. The only item in the top seven not related to K-12 education or social programs is the prison system. To consistently balance the books, lawmakers must start defining the success of the education, welfare and corrections systems in terms of results rather than dollars spent.

Budgeting in the health and welfare area has stood out in recent years as opaque and manipulated. In the 2019-20 fiscal year the government pulled $150 million of revenue for the Department of Human Services from sources outside the General Fund while pushing $348 million of costs out of the General Fund into the Lottery Fund and elsewhere.





Broaden and simplify the revenue base through tax reform

Three parts of the tax code can be reformed with relative ease: the corporate income tax can be lowered, the personal income tax can be simplified and the sales tax can be modernized.

Lowering the corporate tax rate will encourage businesses to locate in Pennsylvania. The commonwealth's 9.99% rate is the second highest single-rate corporate income tax the country, making Pennsylvania an uncompetitive business location. Instead of addressing the problem, state government has been handing taxpayer money to businesses and organizations it favors. The 2019-20 budget includes over $700 million in grants and tax credits for private businesses. Eliminating them could pay for a corporate rate cut down to 6.99%. In addition to lowering the rates, the state should allow more use of net operating losses (NOLs) to offset tax liability. Limiting the use of NOLs harms the kind of capital-intensive industrial firms whose plants have historically anchored small communities.

Personal income taxation can be simplified by unifying the eight categories of personal income. The state's flat personal income tax rate of 3.07% is not as low as it looks. This is because Pennsylvania specifies eight different classes of income depending on source. Losses in one area cannot be used reduce liability in another. This is deeply harmful to small businesses. Consider a family in which the husband holds a salaried position and the wife operates a sole proprietorship which has yet to become profitable. In other states the wife's business losses can be offset against the husband's salary. In addition to unifying income categories, lawmakers should cut the rate to 2.8% which is where it was before the last hike.

Sales tax can be modernized by eliminating exemptions. Pennsylvania has an average combined state and local sales tax rate of 6.34%, near the median among the 50 states. The rate could plausibly be reduced if the base were broader. Sales tax base-broadening options and their probable revenue impact are as follows, according to a Tax Foundation study:

- Expanding the sales tax to personal services, amusements, confections, and similar items would raise $900 million.
- Adding clothing, nonprescription drugs, utilities, and fuels to the above would raise $3.58 billion.
- Including nearly all final consumer transactions could raise $11 billion.

Tax reform can help address Pennsylvania's outmigration problem. The reasons why people move are many and complex, but the statistical link between low taxes and interstate migration is well established. A 2018 study from the Cato Institute, *Tax Reform and Interstate Migration,* shows a definite flow of people from high-tax states to low-tax states.

It is important to act now on personal taxation because a change in the federal treatment of state and local taxes (no longer fully deductible at the federal level) has many high earners in states like New York, New Jersey, and Connecticut re-evaluating their place of residence. If Pennsylvania lowers and simplifies its own tax burden, it has a once-in-a-generation chance to pull a tremendous amount of wealth and investment capital into the commonwealth.

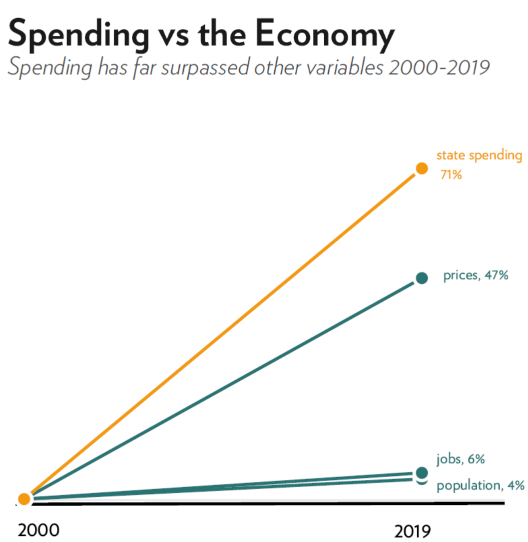
Commit to long-term sustainability by passing the Taxpayer Protection Act

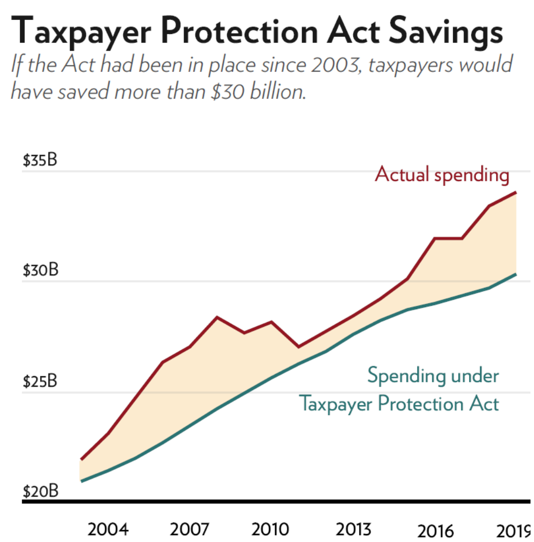
The Taxpayer Protection Act would limit annual General Fund budget growth to the three year average sum of population growth and inflation. The Act is currently embodied in House Bill 1316 (Rep. Warner) and Senate Bill 116 (Sen. Bartolotta). Because the bills propose a constitutional amendment, the same proposal must be approved by the General Assembly in two consecutive legislative sessions and then be approved via referendum in order to become law.

The Act would encode the principle that government spending must only grow in line with available resources. It would also bring Pennsylvania in line with other states. Twenty-eight states already have some form of tax or spending limit, according to the Urban Institute.[8] The Taxpayer Protection Act does not mandate cuts to government services. In fact, the Act would permit the legislature to spend $700 million more this year than last year. In an emergency the spending limit may be exceeded if approved by a supermajority of the General Assembly.

With the Act in place, legislators will be free to make thoughtful trade-offs about where taxpayer dollars are spent, just as every citizen does in his own household or business. If the Act had applied to General Fund spending from fiscal 2003-04 through fiscal 2018-19, a cumulative $35 billion, or $2,700 per person, would have remained in taxpayers' hands.

The Act is popular and bipartisan. In a 2019 poll more than 2/3rds of respondents favored the Taxpayer Protection Act when it was described to them. Only 16% were opposed and 16% were undecided.[9] A 2015 poll by the same firm using the same question found that 71% of Republicans, 61% of Democrats and 59% of independents supported the Act.





[8] https://www.urban.org/research/publication/tax-and-expenditure-limits
[9] Susquehanna Polling and Research, survey of 700 registered voters, October 2019. "Lawmakers are considering a law that would limit increases in government spending to the rate of inflation plus the rate of population growth. For example, if we had three percent inflation and one percent population growth, government spending could increase no more than four percent for that year. The limit could only be exceeded by a two-thirds votes of both houses of the General Assembly or by a declared emergency. Generally speaking would you (support/oppose/undecided)?"

Restore legislative control and consolidate government accounts

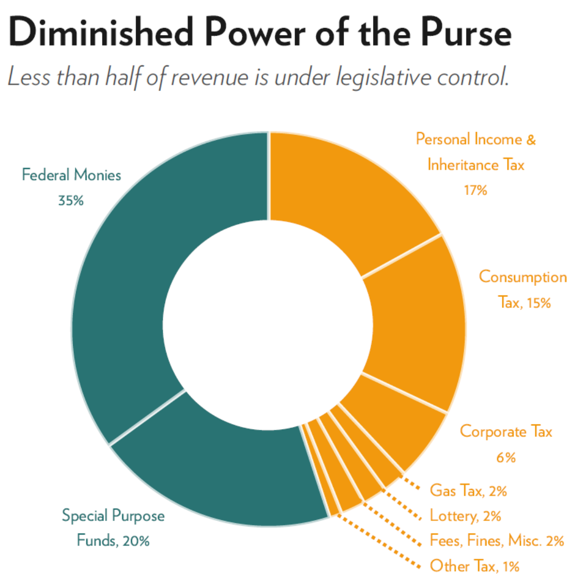
The state constitution[10] tasks the legislature with both raising and spending revenue, but a large and growing amount of state spending is conducted outside of the General Fund budget, denying the legislature its proper role. The Pennsylvania government will raise and spend about $86 billion in the 2019-2020 fiscal year but the legislature only voted on $34 billion. The difference between those figures, $52 billion, is often called the "shadow budget."

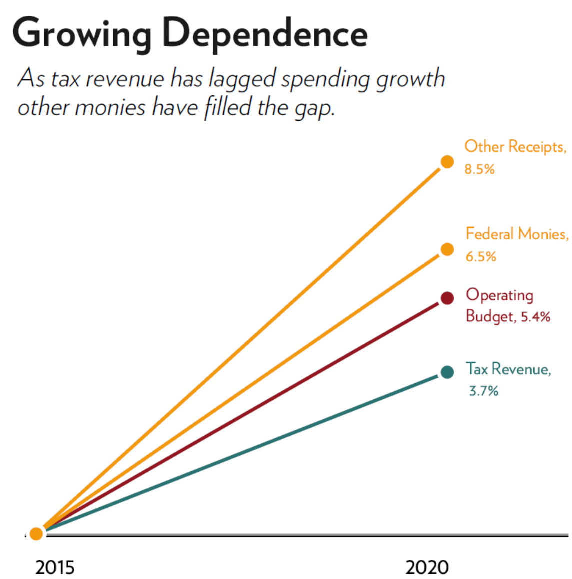
Dependence on the shadow budget has been growing: tax revenue growth has averaged about 3.5% over the past five years while expenditures from special funds, many of which have their own revenue streams, have grown at an 8.5% annual rate.

Shifting revenue and expenses from the General Fund to the shadow budget has served to hide deficits and place programs on autopilot outside of legislative control. The 2019-2020 budget diverted at least $49 million of revenue and costs into special funds. Permanent diversions by statute include the following:

- 0.95% of sales tax receipts go to the Public Transportation Assistance Fund
- 4.4% of sales tax receipts go to the Public Transportation Trust Fund
- $31 million of cigarette taxes go to the Children's Health Insurance Fund and $23 million go to the Agricultural Conservation Easement Purchase Fund
- Sales taxes are transferred automatically to pay the debts of the Commonwealth Financing Authority, which received $201 million in debt service monies overall, according to its most recent financial report

Two bills to address the situation are now before the General Assembly. The General Fund Stabilization Act (HB 1988, Rep. Grove), would consolidate numerous so-called special funds into the general government. A proposed amendment to the state constitution (HB 1991, Rep. Keefer) would prohibit the diversion of General Fund revenue into special funds.





[10] Article III

Improve public trust by cleansing the fiscal code of earmarks

The annual budget appropriates monies to various programs and departments. Along with the budget, the legislature passes a fiscal code containing more specific instructions about how to use the money. That bill typically directs public money to scores of private parties in direct breach of the state constitution.

Article III, Section 11 of the Pennsylvania Constitution states the following:

> ***"The general appropriation bill shall embrace nothing but appropriations for the executive, legislative and judicial departments of the Commonwealth, for the public debt and for public schools. All other appropriations shall be made by separate bills, each embracing but one subject."***

Article III, Section 30 states:

> ***"No appropriation shall be made to any charitable or educational institution not under the absolute control of the Commonwealth, other than normal schools established by law for the professional training of teachers for the public schools of the State, except by a vote of two thirds of all the members elected to each House."***

In other words, the legislature may direct funds to a specific recipient, but it must follow certain rules. A separate bill is supposed to be brought forward for each purpose and the bill should clearly name the recipient of the money. If the proposed spending is for a private institution, a supermajority vote is required. Examples of the process include the annual bills funding Penn State, Pittsburgh, and Temple Universities.

What happens instead is that sentences like the following are slipped into the fiscal code bill just before passage:

> ***"$5,000,000 shall be distributed to a hospital in a city of the third class in a home rule county that was formerly a county of the second class A."***
>
> ***"At least $800,000 shall be used to support a manufacturing technology development effort in a county of the fourth class with a population of at least 143,679, but not more than 144,200, under the most recent Federal decennial census."***

These are earmarks: direct instructions to spend public funds on a specific recipient. The 2019-2020 fiscal code contained more than 80 earmarks totaling $61 million. Not all earmarked purposes are unworthy. For example, the last fiscal code reserved $400,000 for a police information-sharing computer system. However, ordinary procedures ought to be followed.

Also worth noting is that most earmarked funds went to the Philadelphia and Pittsburgh areas, where abundant philanthropic money is already available for community projects. The earmark process disadvantages rural taxpayers with less access to community resources.

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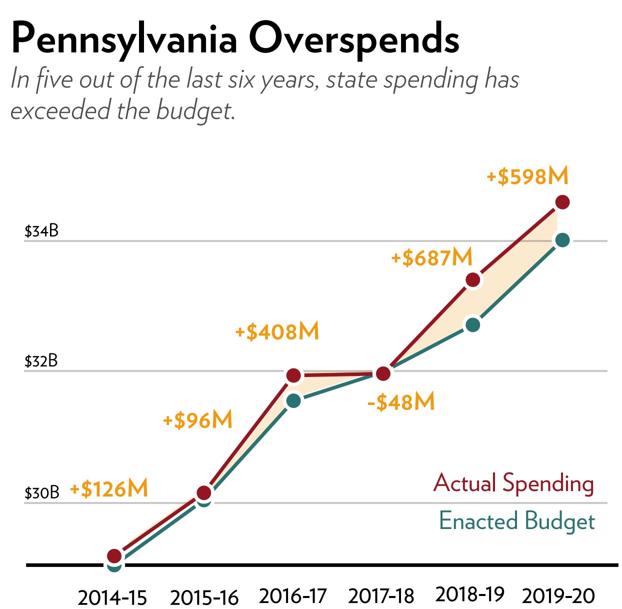
Increase oversight and transparency with respect to appropriations

In five of the past six fiscal years the Wolf administration overspent what they were appropriated by the legislature and then obtained the extra money at year end via a supplemental appropriation. These overruns, including the projected result for fiscal 2019-20, total $1.9 billion. The amount is far too large to be plausibly accidental. Rather, it is strong evidence that the Wolf administration is purposefully under-budgeting up front and backfilling at year end. This is a clear work-around of the constitutional requirement for a balanced budget.[11]

The trend toward overspending is accelerating. Last year the state overspent by $673 million and, as of this writing, official estimates are that it will overspend by $600 million this year, which is the equivalent of $46 for every state resident.

The legislature has been providing the supplemental appropriations as a line item in the following year's budget. For example, the 2019-20 budget enacted on June 30, 2019, contained not just appropriations for the coming twelve months but also a line item for $673 million of funds already spent.

House Bill 1861 (Rep. Grove) and Senate Bill 885 (Sen. Phillips-Hill) propose a constitutional amendment that will require supplemental spending to be voted on in a standalone bill, not tucked into the spending bill for the next year. The amendment would make budget overruns more visible and would put legislators on record as explicitly assenting to them.



11 Article VIII, Section 13

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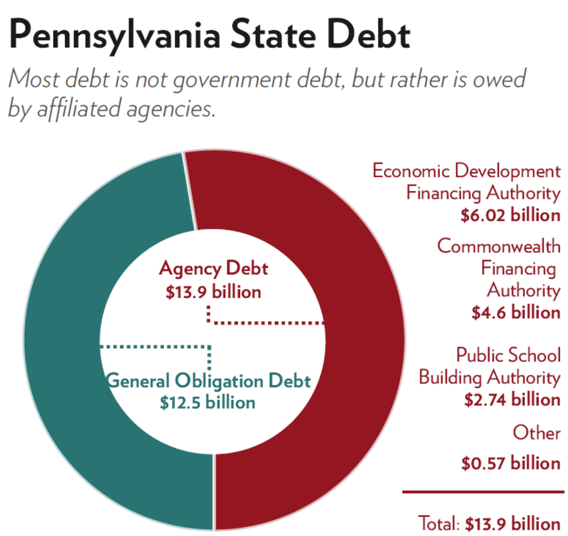
Stop borrowing for private subsidies

Pennsylvania has a constitutional debt limit but only $12.5 billion of debt, the so-called "general obligation" bonds secured by state taxing power, are subject to it. [12] Other debts are owed by a group of bodies that do not have taxing power but which benefit in varying degrees from a connection to the government. Their names are an alphabet soup of acronyms: CFA, PENNVEST, PHEFA, SSHE, PRPA, PHEAA, PHFA, PEDFA, PSBA, PIDA. Together they owe more than $26 billion (only three agencies are included in the graph below). The Pennsylvania Turnpike owes a further $13 billion of debt. If estimated retirement liabilities are included the public debt burden is more than $120 billion, or $9,000 per person.[13]

As a first step toward reducing the public debt we recommend a debt moratorium at CFA and PENNVEST, which make loans and grants to private businesses and other parties. The agencies should be prohibited from new borrowing, and their asset portfolios should be allowed to wind down as their combined $5 billion of debt matures.

The CFA has the vague purpose of funding economic development. In the 2017-2018 fiscal year it received $319 million from the government through at least six different government funds, including diversions of sales tax money from the General Fund. The CFA does fund local infrastructure projects, but other programs include real estate development and business funding. The CFA's board meets infrequently and little substantive deliberation is made public.

PENNVEST primarily funds local water and sewer projects, but it also has authority to lend to private companies. According to the agency website, "Funding also assists businesses to locate and expand their operations in Pennsylvania to create permanent well-paying jobs for our workers." In 2018 PENNVEST lent $50 million to Lyme Timber, an out-of-state investment firm, for the purchase of land on which Lyme Timber committed to just $750,000 of relevant water projects. The deal was suspicious enough that House lawmakers passed a resolution calling on the auditor general to review the deal. To date he has not.



[12] 1.75 times the last five years average tax revenue, as specified in Article VIII, Section 7
[13] Unfunded pension liability is official reported as about $70bn, allowing for very optimistic investment return assumptions. Other Post-Employment Benefits (OBEB) are tens of billions of dollars more.