

## Addressing Pennsylvania's Structural Budget Deficit

*In November 2016 Pennsylvania's Independent Fiscal Office released a five-year projection of the health of the Commonwealth's economy and budget. The long-term estimates were not promising, as increasing expenditures outstripped existing sources of revenues. Left unchanged, the status quo would result in a deficit of almost \$3 billion in fiscal year 2021–2022. Tackling this “structural deficit” is one of the most difficult issues facing the state of Pennsylvania. Given the current political climate it should come as no surprise that there is no consensus on resolving this problem. COMMONWEALTH invited representatives from two very different policy perspectives to provide their solutions to the structural deficit. We would like to thank Bob Dick of the Commonwealth Foundation and Marc Stier of the Pennsylvania Budget and Policy Center for addressing this important issue in the COMMONWEALTH Forum.*

## Revitalizing Pennsylvania through Government Reform

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Pennsylvania is in financial crisis. The growth in government spending, which has risen every year but one since 1970 (Commonwealth Foundation 2016), is at the heart of this crisis. As of July 2017, the Commonwealth's budget deficit is approximately \$2.2 billion (Levy 2017a)—a product of real and projected expenditures exceeding revenues in prior and current fiscal years. Pennsylvania's Independent Fiscal Office (IFO 2016) projects this trend will continue through the 2021–2022 fiscal year absent significant policy changes (Ryan 2017).

The IFO isn't the only organization with a bleak view of the state's budget situation. The Mercatus Center recently released a report on the fiscal health of all 50 states, ranking them based on key metrics used to analyze short- and long-term solvency (Norcross and Gonzalez 2016). Pennsylvania placed 46th, beating four other states and Puerto Rico, including Illinois and New Jersey—states beset with monumental financial challenges.

Standard & Poor's has also expressed concerns about Pennsylvania's fiscal condition, warning that unless the state passes a balanced budget and addresses the underlying causes of the structural budget deficit, it faces a possible credit rating downgrade (Braun 2017). These warnings concern most everyone, but policymakers are divided over the solution. Some believe raising taxes is necessary to fix Pennsylvania's finances. The most prominent and vocal advocate of this idea is Governor Tom Wolf, who has proposed eight different tax hike plans over the course of three years (Commonwealth Foundation 2017a). His last budget proposal would have raised taxes by \$1 billion while making modest reforms to control state spending (Pennsylvania Office of the Budget 2017).

In contrast, many fiscally conservative lawmakers prefer spending restraint in the General Fund budget—which makes up approximately 40% of the state's total operating budget—and reforms to bring about long-term fiscal stability. In April, House Republicans passed a General Fund budget that would have limited spending growth and required no tax hikes (Dick 2017a). The state Senate eventually amended the plan to include a larger spending increase. Governor Wolf allowed this plan to become law, despite lawmakers' inability to raise enough revenue to balance the budget as of July 2017 (Coulombis and Langley 2017). This is the second year in a row the state's budget

became law without sufficient revenues to pay for authorized spending (Meyer 2017), though the move appears to violate legal and constitutional balanced budget mandates.

How should lawmakers solve these intractable fiscal problems? First, they must reject tax increases, which stifle economic growth and destabilize the state's finances. Economic growth is key to turning the state's budget situation around. Any policies that could suppress this growth should be rejected.

In testimony before the U.S. House of Representatives Committee on Ways and Means, economist Jonathan Williams compared job growth from March 2007–March 2017 in states without an income tax to states with the highest income taxes. He found no-income-tax states grew 28% faster than the highest-income-tax states. Population also grew 111% faster in no-income-tax states (Williams 2017). These findings are not an aberration. Dr. William McBride authored a report on the effects of taxes on economic growth, which included a literature review of 26 studies on this topic—all but three of which concluded taxes negatively affect economic growth (2012).

Advocates of a more robust role for government see high taxes as a panacea, but a high tax burden can harm a state's finances and economy (Stansel, Torra, and McMahan 2016). Indeed, the 10 states in the best fiscal condition—per the above-noted Mercatus Center report—had an average tax burden of 8.48% compared to 10.12% for the 10 states in the worst fiscal condition (Tax Foundation 2012).

Some of the highest-taxed states in the country—Maryland, Illinois, and New Jersey—are in the worst fiscal shape, proof that high taxes won't bring budget relief and will likely exacerbate budget difficulties. Two recent examples illustrate this fact. The first is Connecticut. To deal with budget deficits, the state—over five years—enacted the two largest tax increases in its history (Fitch 2017). However, these increases could not keep up with spending growth, and lawmakers are now grappling with a \$5.1 billion deficit (De Avila 2017).

In Pennsylvania, lawmakers enacted a \$650 million tax increase package in July 2016 (Levy 2017b) to pay—in part—for a tremendous increase in government spending. It wasn't enough. The state ended the fiscal year with a \$1.5–\$1.6 billion deficit (Esack 2017). The tax not only failed to stabilize the Commonwealth's budget situation, it also closed dozens of small businesses (Gonzalez 2017). These regrettable examples of counterproductive fiscal policy should serve as a warning to policymakers as they grapple with the tough decisions needed to rescue Pennsylvania from financial ruin. Policymakers can either let the economy grow or grow government. They can't do both.

Since tax hikes aren't a viable solution, policymakers must focus on the spending side of Pennsylvania's balance sheet. Critics of this approach tend to assert state government is "cut to the bone," which means lawmakers have very few options—if any—to reduce government outlays. But a thorough review of the state's total operating budget reveals numerous cost-saving opportunities. The following six broad solutions are not exhaustive but represent some of the most transformative options available to lawmakers.

## **Reform Medicaid to Encourage Independence**

The Pennsylvania Department of Human Services (DHS), which houses most welfare programs, consumes approximately 39% of the General Fund budget (Pennsylvania House Republican Appropriations Committee 2017). It is the most expensive department in the total operating budget (which includes federal funds and other "off budget" funding). According to the IFO, welfare spending will grow at 5.8% annually. In contrast, personal income growth will be just 4.3% (2016). If these trends are left unchecked, DHS will continue to outgrow the economy, requiring additional resources from taxpayers, who already labor under the 15th-highest tax burden in the country (Tax Foundation 2016). Any effort to tackle the current fiscal crisis must focus on reducing poverty by redesigning the state's welfare programs—specifically Medicaid, the largest expense in the state budget.

Lawmakers can reform Medicaid—a program that consistently underserves the poor (HealthPocket 2015)—by converting it to a premium assistance support program. This would put Medicaid recipients in charge of purchasing their own health insurance with allotted funds. State lawmakers have also advanced work requirements and copays for able-bodied adults and wealthy families (Thompson 2017). Work requirements combined with time limits on Medicaid can help able-bodied adults transition away from government assistance and reduce lengthy waiting lists for those truly in need, without requiring new revenue.

## **Expand School Choice**

In 2015–2016, the latest year for which data is available, the typical Pennsylvania public school received approximately \$16,500 per student in local, state, and federal funding. This represents a 16.5% increase over the past five years. Pennsylvania ranks in the top 10 in education spending as of 2013–2014 (Commonwealth Foundation 2017c). Yet, lawmakers increase education spending year after year under the unproven assumption that more spending

improves academic achievement. Research, however, shows no correlation between academic achievement and education spending. Who spends these dollars, not simply how much is spent, is the real difference-maker. If dollars are placed in the hands of parents via school choice programs, educational outcomes improve, and taxpayers save (Forster 2016).

Pennsylvania's two private school choice programs—the Educational Improvement Tax Credit (EITC) and Opportunity Scholarship Tax Credit (OSTC)—spend a fraction of what traditional public schools spend on a per-student basis. In 2014–2015, average scholarship amounts for the EITC and OSTC were \$1,775 and \$2,300 respectively. Expanding these programs to more public school families would not only provide educational lifelines to thousands of students but also deliver cost savings for taxpayers. Of course, this requires a paradigm shift for those under the mistaken assumption that a large government bureaucracy is necessary to adequately educate students.

## Overhaul the Criminal Justice System

At more than \$2.3 billion, Pennsylvania's corrections system is the third largest expense in the General Fund budget. Although it has undergone significant changes over the last five years, more reforms are necessary. A recent report from Justice Reinvestment Initiative (JRI) Working Group (2017) notes the Commonwealth can save more than \$108 million over five years by reducing the prison population via several changes to the criminal justice system, including but not limited to the following:

*Release prisoners once their minimum sentence has been completed.* People inside the state's prison facilities are often held past their minimum sentence—by an average of 5.3 months. This extra prison time costs taxpayers tens of millions of dollars and does little to reduce recidivism. Releasing prisoners on time can save tax dollars without jeopardizing public safety.

*Increase guidance provided by sentencing guidelines.* Current guidelines permit a wide range of sentences for the same crime, meaning sentences can be counterproductive or punitive. Providing judges with more information on the efficacy of sentences (i.e., which sentences lower recidivism) should be a top priority. This way, judges can issue fair sentences based on all relevant information. The current system relegates too many to prison unfairly, making it more difficult for inmates to return to normal life.

*Improve parole supervision.* The JRI Working Group proposes adopting admission criteria for community corrections facilities (also known as half-way houses) based on risk and parolees' needs. The working group also suggests using short sanctions instead of incarceration for parole violators. The

former has proven effective in changing the behavior of violators and is a less expensive alternative to incarceration.

These recommendations focus on an important goal: transitioning people from prison back to society while keeping low-risk offenders out of prison. A criminal justice system that promotes independence will help the Commonwealth reduce incarceration costs while freeing resources to address more dangerous offenders who pose a threat to society.

## **Curtail State Borrowing**

Debt service is the fourth largest state expense behind welfare, education, and corrections. Since 2002, total outstanding state general obligation debt has increased by 97%, from \$6.8 billion to \$12.3 billion. Annual debt payments on general obligation bonds increased from \$349 million in FY 2002–2003 to more than \$1.1 billion in FY 2016–2017, a 218% jump (Commonwealth Foundation 2017c). This massive increase makes the Department of Treasury the fastest growing department over the last 15 years.

To avoid adding to taxpayers' debt load, lawmakers should limit or eliminate borrowing for some of the state's nonessential programs. Among these is the Redevelopment Assistance Capital Program (RACP), which authorizes wasteful "economic development" projects across the state. Some of the most infamous projects have included monuments to politicians, handouts to corporations, and subsidies for stadiums (Benefield 2010). There is no evidence of this program boosting overall economic growth in the Commonwealth. Moreover, the program tends to favor the largest Pennsylvania cities over smaller towns (Millsap 2015).

A cap on borrowing for Public Improvement Projects (PIP) is also critical. Together, these two programs represent about 43% of gross debt service. Eventually phasing out RACP and putting strict limits on PIP can help drive down the cost curve on state debt, freeing funds for other priorities such as law enforcement or tax relief.

## **Reduce or Eliminate Nonessential Spending**

The Commonwealth Foundation recently identified more than \$3 billion in available funds (Dick 2017b) that could be redirected to balance the state's General Fund budget. These "off-budget" programs generally operate outside legislative scrutiny. They include corporate welfare programs—like nearly \$250 million for the Race Horse Development Fund, which finances race

purses (prizes) for horse owners—and more than \$95 million for the Keystone Recreation, Park and Conservation Fund, which provides appropriations for recreational activities and facilities. This fund has financed projects such as an African Wild Dog Exhibit and an Athletic Fields Feasibility Study. This special interest spending is pervasive throughout the state budget and should be reduced or eliminated permanently. Redirecting these and other funds can provide a stable source of revenue to truly balance the state's General Fund budget.

## **Enact Budget Safeguards**

Too often, state spending is left unevaluated and grows without limit, to taxpayers' detriment. Lawmakers can implement two safeguards to end Pennsylvania's broken budget process. The first is performance-based budgeting, which would require an independent analysis of state programs to determine their effectiveness. If a program is deemed ineffective, based on certain objective criteria, it could be scheduled for elimination unless lawmakers vote to protect the program or reform it to address deficiencies. Performance-based budgeting would take at least a portion of state spending off autopilot and require periodic examination of programs. It would also increase accountability, requiring lawmakers to go on record as defending or reforming a given program.

State expenditure limits are the second safeguard. Under this proposal, state spending would not be permitted to grow faster than the combined rate of inflation and population growth—known as the Taxpayer Protection Act index. This proposal would require lawmakers to prioritize spending and ensure any surplus revenue is deposited in a rainy-day fund or used to reduce taxes. Had state spending limits been in place since 2003, taxpayers would have saved a cumulative \$29.4 billion or \$2,300 per person. Pennsylvania would also have ended the 2016–2017 fiscal year with an approximate \$2 billion surplus.

Elected officials on both sides of the political aisle mistakenly believe Pennsylvania has a revenue problem. This assumption has led to calls for higher taxes and borrowing to pay overdue bills. A closer look at the evidence reveals a different story. The state has failed to control spending for the last four and a half decades. Policymakers in Harrisburg must acknowledge this truth. Only then can the state begin to repair its finances and implement pro-growth policies that will make Pennsylvania the economic hub of the Northeast.

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## The Continuing Pennsylvania Crisis in Perspective

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### The Rise of the Right in Pennsylvania Politics

#### Fads

There are fads in politics, like every other human endeavor. One such fad has, in the last 10 years, wreaked havoc with the finances of states in every part of the country—the claim that the path to prosperity can be found in relentless cutting of spending and taxes, especially taxes on business.

#### The Far Right Comes to Pennsylvania

During the late 1990s this ideology took hold here mainly but not entirely among Republicans. Even some Democrats embraced the notion that reducing taxes, especially on corporations, might spur economic growth. As Governor Ed Rendell was raising the personal income tax to fund increased education spending, he was cutting corporate taxes. Republicans embraced the theory with a vengeance, promising everyone tax cuts, although most tax relief went to corporations.

Republicans could cut taxes at the federal level without concern for running up deficits. But in the states, tax cuts had to be balanced by spending cuts. So Republicans needed a rationale for those cuts and came up with one—arguing, falsely, that public services were growing fast and were too expensive because public sector unions were receiving salaries and pensions far above those in the private sector.

### The Corbett and Wolf Years

#### The Right Takes Advantage of the Recession

As late as the last years of the twentieth century, the Republican Party in the General Assembly was fairly moderate, and leadership tended to come from centrists. But ideological shifts in the Republican electorate and district lines that empower the far right have gradually led both the House and, to a lesser extent, the Senate to move to the right.

When the Great Recession took hold and state tax revenues fell dramatically, right-wing Republicans found their opportunity. In the last two years of his administration, federal stimulus funds enabled Rendell to balance budgets without deep reductions in spending. But as those funds ran out, Pennsylvania, like other states, was faced with the choice of raising new revenues or making deep cuts in state spending. The right found an accomplice in Governor Tom Corbett, who embraced the far-right prescription of budget cutting.

The result was deep reductions in every area. There was a \$1 billion cut to state funding of K–12 education. And since Pennsylvania had abandoned a funding formula for distributing money, those cuts were felt far more deeply in poor districts, especially urban but also some rural ones. The result was layoffs of over 20,000 teachers, guidance counselors, and librarians. Pennsylvania schools, already undersupported by the state, came to be the most unequally funded schools in the country, with schools in the most prosperous 25% of districts spending 33% more than schools in the least prosperous 25% of districts.

Reductions of over 30% to higher education had similar effects. Tuition went up in the Pennsylvania State System of Higher Education (PASSHE) by 20%. The Corbett administration cuts on top of a decade of neglect led Pennsylvania to fall to fourth from the bottom of all states in funding per college student. In 2013 only 56.1% of Pennsylvania adults 25 and over had more than a high school degree, ranking us 41st of 50 states.

Governor Corbett and the right-wing General Assembly also drastically reduced general assistance to the poor and increased waiting lists for child-care, mental health, and disability services.

At a time when the growth of natural gas fracking demanded more from the Department of Environmental Protection, it suffered similar reductions and today remains funded at roughly two-thirds the level it was before the Great Recession.

Spending on Pennsylvania's crumbling infrastructure also fell until, in the last year of the Corbett administration, a coalition of business-minded Republicans and Democrats pushed through an increase in gas taxes to restore our roads, bridges, and transit systems. The state still remains near the top of the list of those with serious infrastructure problems.

Overall General Fund spending in the 15 years before Governor Corbett averaged 4.7% of the state GDP. It fell by 7.25% to 4.33% during his years as governor. Unfortunately for state finances, tax revenues fell by 8.25%, creating persistent deficits. The phase-out of the Capital Stock and Franchise Tax continued, and Governor Corbett took advantage of a change in federal law to reduce the corporate income tax in Pennsylvania by about \$300 million.

Perhaps more important, Corbett and the extremist Republicans refused to institute a severance tax on natural gas drilling. Although the state has huge natural gas reserves that are relatively cheap to exploit, we remain the only state without a severance tax, costing Pennsylvania billions in revenue during the Corbett years and about \$300 million a year since gas prices dropped.

## The Wolf Years

Governor Corbett's policies were repudiated at the polls in 2014 when he became the first Pennsylvania governor ever to be defeated for reelection. But even though Governor Wolf promised to reverse the direction of the state, the General Assembly continued to tilt even further to the right as a result of the impact of partisan redistricting and national political trends in 2014 and 2016.

The Republican General Assembly has forced additional spending cuts, as General Fund spending as a share of GDP continued to decline under Governor Wolf to 4.25%. Even including special funds, spending as a share of GDP has fallen from 7.36% to 6.91% over 15 years. (It is misleading to include federal spending in Pennsylvania for such things as Medicaid and education in the total of state spending.)

Similarly, taxes continue to decline in Pennsylvania as the state has fallen to 23rd among all states in taxes per capita. (Again, it is misleading to count taxes paid by relatively well-off Pennsylvanians to the federal government as part of state taxes.)

The Wolf administration's effort to find over \$1.5 billion in efficiencies has enabled it to direct more money to K–12 education, while also meeting mandatory cost increases in corrections, Medicaid, and pension costs. The Corbett cuts to education have been fully restored for the most prosperous school districts and partially restored for the least prosperous ones. While this is an important achievement, Pennsylvania still needs to spend billions more to equitably and adequately fund every school.

The Wolf administration has also directed small increases to human services, especially for opioid addiction, child care, and services for the intellectually disabled, and for the PASSHE colleges and universities.

## Recurring Deficits

Despite these increases, budgets under Governor Wolf have remained austere, in no small part because the state has started each year with a deficit between \$1 and \$1.5 billion just to provide the same level of services as in the previous year.

The deficits have long- and short-term causes. The long-term cause is the decline in tax revenues, especially from corporate taxes, which have fallen from 30% of all revenues in 1972 to 20% in 2006, to only 15% this year. If corporate taxes still made up 20% of all revenues, the state would bring in an additional \$2.3 billion per year, enough to close the yearly budget deficit while also increasing public investment.

The short-term cause of recurring deficits is that, except for increases in tobacco taxes in 2016–2017, the General Assembly has refused to raise recurring revenues, preferring to balance the budget with one-year funds, such as the sales of licenses to sell liquor or promote gambling, and budget gimmicks such as borrowing from (or raiding) special funds that serve important state purposes, overestimating revenues, and shifting spending from one fiscal year to the next.

Republicans in the General Assembly insist on balancing budgets with smoke and mirrors rather than real revenues for two ideologically based reasons. On the one hand, they oppose new taxes. On the other, continuing budget deficits serve as a political cudgel to force deeper cuts in spending. It can be an effective tactic, especially when paired with the false claim that spending increases, rather than tax reductions, are the main source of budget deficits.

## **The Failure of the Right and Another Path**

### Economic Distress in Pennsylvania and Beyond

The United States conducted a natural experiment in political economy in the years after the Great Recession as some states responded to declining revenues with deep cuts in public spending and taxes while others raised taxes, especially on the rich, and increased spending especially for pre-K, K–12 and higher education.

Today, the states that raised taxes and spending, such as California and Minnesota, are growing relatively fast, have balanced state budgets, and have rising wages. The states that cut spending and taxes, such as Kansas and Louisiana, have found themselves in a deepening morass as spending reductions have slowed their economies and wage growth and, together with tax cuts, further reduced revenues creating deep budget deficits.

Pennsylvania did not go as far as Kansas and Louisiana in cutting spending and taxes, but the cuts of the Corbett years reduced economic growth and worsened deficits. And, together with our failure to raise the minimum wage, the decline in public investment in the state explains why wage growth

remains below all of our neighboring states, especially for those in the bottom 20% of wage earners.

## A Way Forward

The recent action by a bipartisan group of Pennsylvania senators, to raise recurring revenues and institute a small severance tax to balance the budget for the current year, suggests that here, as in Kansas, the right-wing tax- and budget-cutting fever may be breaking. So perhaps the time has come to put forward another direction for the state. A growing body of evidence clearly shows that, far from harming the economy, public investment, especially in infrastructure and education at all levels, including training for those who do not go to college, is critical to economic growth and especially growth that benefits low- as well as high-income Pennsylvanians.

The question, however, is how to pay for investment in a way that is fair and politically palatable at a time when slow income growth for all but the top 1% makes tax increases unpopular. That's a particularly difficult problem because we have a Constitutional uniformity clause that prohibits graduated tax rates. As a result, we have one of the most inequitable tax systems in the country. Families in the bottom quintile pay 12% of their income in state and local taxes, families in the middle quintile pay 10%, and those in the top 1% pay only 4.3%.

To address that problem, we have supported closing corporate tax loopholes and a severance tax that in the next few years would bring in \$1 billion a year. We have also called for a Fair Share Tax that would increase the tax rate on income from wealth (capital gains, business profits, dividends, royalties, and estates) while reducing the rate on wages and interest. Increasing the tax on income from wealth from the current 3.07% to 6.5% combined with reducing the rate on wages and interest to 2.8% would raise \$2 billion, while cutting taxes for 60% of Pennsylvanians and leaving taxes unchanged for another 25%. Over 50% of the new revenue would come from the top 1%, and 82% would come from the top 5% of households. And yet taxes on the top 1% would remain below those of all neighboring states and half the rate of New York and New Jersey.

## Conclusion

Right now, Pennsylvania's government is torn between a Republican General Assembly that is still in the grip of radical right-wing ideas that mainly benefit the very rich and corporations and a Democratic governor who recognizes

that broadly shared prosperity requires selective increases in public investment paid for by new, and equitable, taxation. It is up to the people of Pennsylvania to choose between these two paths forward.

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