

CAPITAL NEWS



PENNSYLVANIA ECONOMY LEAGUE – STATE OFFICE www.pelcapital.org 2/5/2002

Governor Proposes His “First and Last” Budget

Governor Schweiker unveiled his proposed budget for the fiscal year beginning July 1, 2002 on Tuesday, February 5. Because Governor Schweiker ascended to the governorship only last October and has decided not to run for a full term, he is in the unique position of formulating only one budget. Once that budget passes, he will administer only the first half of it; his successor takes office in January 2003.

The budget proposal is most unlike those of recent memory. Rather than higher than inflation increases in spending funded by a rising tide of revenues, recession forces and a decision not to raise taxes limit the spending proposals and actually result in significant cuts in many parts of the budget. The national economy is influencing the budgets of most other states in a similar manner although in many states the impact is much more severe. This proposed budget will be the center of attention for the Pennsylvania legislature and a large number of interest groups and individuals over the next five months

Overview

The proposed budget for the Commonwealth’s fiscal year 2002-03 would allocate over \$45 billion from all sources including state funds, federal funds and other revenues. This review and analysis concentrates on revenues and spending from the General Fund. The General Fund receives most of your taxes and pays for most of your state services.

This year’s General Fund discussion is dominated by a number of unusual budgeting events that have not been experienced in many years. These occur in both the current year and in the upcoming budget year and include:

- The budget predicts revenues to total \$677.7 million less than was estimated when the budget was passed last June. The biggest cause of the shortfall is the slowing economy. A 14% drop in profits of corporations resulted in a \$175 million shortfall in Corporate Net Income Tax revenues. Lower capital gains and smaller payrolls will cause a shortfall of \$265 million in the Personal Income Tax. The actual size of the total shortfall may vary up or down depending on a variety of factors, most of which are out of control of government.

- ❑ Spending will increase by \$78.7 million for this year to pay for costs not anticipated last June when the budget was passed. This spending is primarily driven by increasing medical payments for welfare recipients and instituting new security measures.
- ❑ A total of \$334 million in spending passed by the General Assembly for 2001-02 was withheld by the Governor to limit the impending deficit this year.
- ❑ An additional \$70 million in the current year and \$105 million in the upcoming budget year will be transferred from surpluses from operating the State Stores; this is over and above the \$50 million traditionally contributed to the budget each year by this Fund.
- ❑ The Pennsylvania Industrial Development Authority (PIDA), the state’s largest loan fund for business development, will be asked to borrow \$280 million and transfer that amount to the General Fund to lower debt service. PIDA will pay back their new debt over time using their cash flow which in the past has included state appropriations and loan repayments. The administration is linking the PIDA bond issue to the continuance of the phase-out of the Capital Stock and Franchise Tax.
- ❑ A total of \$181.8 million would be transferred from the Tobacco Settlement Fund this year and next to pay for “health related costs in the General Fund.”
- ❑ The Governor proposes to transfer \$550 million in the current year from the Rainy Day Fund to account for these negative events and to begin next year with a \$300 million surplus. Without the cash infusion, the General Fund would end this year \$250 million in the red.

An important element not considered in the budget is the impending outcome of the PPG court case involving the Capital Stock and Franchise Tax. A ruling nullifying the manufacturing exemption to the tax would have major implications for the budget and especially for those companies taking advantage of that \$350 million exemption. Budget Secretary Bittenbender stated that the administration would seek a revenue neutral solution with as few winners and losers as possible if the Supreme Court views the current exemption as unconstitutional.

The table below summarizes the General Fund Financial Statement for the coming fiscal year.

2002-2003 General Fund Financial Statement
(Dollars in Thousands)

Beginning Balance		\$	300,314
Total Net Revenues	\$		20,701,900
Less: Proposed Tax Changes	\$		<u>-103,400</u>
Available Revenues			<u>\$20,598,500</u>
Total Available for Spending			\$20,898,814
Less: Proposed Spending			<u>\$20,888,263</u>
Projected Ending Surplus		\$	10,551
Less: Transfer to Rainy Day Fund		\$	<u>1,055</u>
Projected Ending Balance		\$	9,496

The budget recommends a \$453 million increase in spending for next year. This is a 2.2% increase in appropriations over the present year, which brings General Fund spending to \$20.9 billion. (Note: the Governor's statement suggests that the increase is .6%. The Governor's calculation does not take into account the \$334 in withheld spending for 2001-02.)

The budget projects revenues to total \$20.9 billion, an increase of 3.5%. This total is net of a tax reduction of \$103.4 million. The budget bases the revenue projections on a middle of the road economic forecast that assumes a recovery from the recession in 2002 at a rate slower in Pennsylvania than for the nation as a whole.

Tax Cuts

In past years this section would outline a number of items. However, the budget proposes only two reductions, and one of those is not new but a modification of an already scheduled reduction:

- ❑ Increase the eligibility income limit for working families to qualify for full tax forgiveness from \$8,500 to \$9,000. Essentially, a family of four with two claimants and two dependents would owe no taxes on income up to \$31,000. This provision continues a trend started several years ago by Governor Ridge. This proposal would reduce revenues by \$12.4 million.
- ❑ Modify the already on-the-books phase-out schedule of the Capital Stock and Franchise Tax. Current law phases out the tax by 2009 by reducing the rate by one mill each year. This proposal would modify that schedule by reducing the rate by one-half mill in 2002 and 2003. The net effect is less tax relief in the next two years and delaying total phase-out until 2010.

Significant Program Spending Changes

As in past years, the budget proposal includes a number of expenditure changes that are meaningful to specific people or organizations. The small increase in overall proposed spending means that there are not many big winners in this budget. A look at the allocation of funding across agencies shows that those increasing their share of the pie are associated with three trends:

- ❑ Increasing expenditures for security as a result of 9/11 such as State Police, Corrections, and Military Affairs;
- ❑ Paying for the added costs of a recession, primarily through Public Welfare programs;
- ❑ Educating students in basic education and community colleges.

Increases in spending in several areas offset the reductions in others. These include significant savings in debt service, and decreases in economic development and environmental programs.

The following reviews the most significant changes proposed in the budget of interest to PEL members and staff.

Community and Economic Development

Total General Fund spending in the Department of Community and Economic Development would decline by \$144 million or 32%. The largest reductions include:

- ❑ Almost every grant and loan program would be cut. These include both economic and community development programs. For example, \$12 million less would be appropriated to the Opportunity Grant program and \$5.5 million less for the Infrastructure Development program.
- ❑ The so-called Community Revitalization program funded at \$85 million would be eliminated. Also known as legislative initiatives or WAMs, this program provides funding for a variety of local projects in legislative districts.
- ❑ The “Brain Gain” initiative would be reduced from \$10 million to \$2 million.

On the positive side, job training funds would receive increases. The Customized Job Training program would remain at \$37.5 million and would be supplemented by a new Workforce Leadership Grant program to be used to fund responsive programs essential for meeting the workforce needs of businesses, workforce investment boards, regions and the Commonwealth. These funds are in addition to the Critical Job Training Grants program developed in the current year.

Education

Education continues to consume the largest portion of the state budget. Highlights of the budget for basic education include:

- ❑ Increasing basic education funding, the largest subsidy for all school districts in the state, by \$40 million, or 1%;
- ❑ Providing new separate and additional funding of \$75 million for the Philadelphia School District;
- ❑ Increasing the state share of payment into the School Employees Retirement Fund by \$156 million or 285%. The increase is needed to make the Fund actuarially sound due to the reduction in the asset value of the Fund caused by the drop in the stock market, the increase in pension liability passed by the General Assembly last year, and a required increase in funding for medical payments for existing retirees. The added amount will be matched by local school districts.
- ❑ Boosting funding for Special Education by \$12.9 million or 1.5%;

The higher education budget takes on a different flavor. For the most part institutions of higher education will have to absorb decreases in state support. The State System of Higher Education would be cut by 3%. Three State Related schools (Penn State, Pittsburgh, Temple) would receive 5% less. The non-state related universities would be reduced by about 9%.

The exception in the budget is the Community Colleges. The budget proposes an \$8.3 million or a 4.4% increase to account for increasing enrollments.

Budget Analysis

This budget is unlike all others in recent history. Limited resources demand few new initiatives. The fact that this is the last budget of this administration also suggests that few bold new initiatives would be included anyway. It is also devoid of significant new tax reduction or tax increase proposals. Overall, on the surface it appears to be a real ho-hum budget proposal.

However, a number of subtle and sometimes significant implications can be found by looking deeper into the budget and into the future of its implementation. Some of the more notable include:

- ❑ The one-time infusions of revenue such as the PIDA bond issue, excess profits from the State Stores, and the Rainy Day Fund can have implications for the next Governor and his first budget. Spending these monies this year and next will build a spending base that will demand to be continued into the future without the advantage of this income.
- ❑ If the General Assembly adopts the Governor's proposed 1% increase in the biggest subsidy for local school districts, local school boards will face major decisions on taxes and spending next year. Many school districts are locked into increases in contracted personnel costs, by far the largest portion of a school budget, of more than 3%. Minimal increases in state subsidies will force increases in local tax rates, most often from the property tax.
- ❑ It is not clear that the General Assembly can pass a budget that essentially gives the School District of Philadelphia an increase that is twice the amount proposed for the rest of the state.
- ❑ Major reductions in community and economic development program funding will leave the well dry for the next governor who will inherit the second half of this budget. This will be particularly noticeable in some of the discretionary programs.
- ❑ The purpose of the Rainy Day Fund is to ease the strain on finances during economically difficult times. However, cutting the balance of the Fund in half can result in higher interest rates for future debt issued by the Commonwealth as the rating agencies view less of a cushion in state finances.

The State Office of PEL will continue to follow the debate as it unfolds and report on its final passage.