BUDGET BRIEFING

Report on Key Issues from the House Appropriations Committee

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Addressing the Gap: A General Fund Update

On June 30, 2010, the General Assembly adopted a balanced budget. However, in the months following, a variety of events led to a gap between General Fund revenues and expenditures. In August 2010, Governor Rendell proposed to resolve this gap through a combination of spending freezes (budgetary reserves) and funds from a proposed Marcellus Shale severance tax which has not been enacted. While revenue collections have been encouraging, the Commonwealth still faces significant challenges to close the budget gap in the current and upcoming fiscal years. The disappearance of Federal Stimulus Funds, loss of one-time revenue, and increasing mandatory costs (such as pensions) will continue to grow the gap in the upcoming budget year.

The General Fund is the major operating fund of the Commonwealth, representing the largest portion of state and federal spending. It also is the fund over which policymakers have the most influence on expenditures. Note that other funds, such as the Motor License Fund and the Tobacco Settlement Fund, currently have fiscal issues as well. However, this briefing will focus on the General Fund.

2010/11 Financial Statement Update

On June 30, 2010, the General Assembly adopted a balanced budget. However, in the months following, a variety of events led to a gap between General Fund revenues and expenditures.

The most significant event occurred in August 2010 when Congress passed legislation that only partially extended the increase in federal medical assistance percentages (FMAP) for states, resulting in much lower federal Medicaid funds for Pennsylvania than was anticipated in the enacted 2010/11 budget. Specifically, the enacted budget assumed Congress would fully extend, through June 2011, provisions in the American Recovery and Reinvestment Act of 2009 (ARRA) that significantly increased the FMAP and were due to expire after December 2010. Instead, Congress passed legislation that phased down the ARRA FMAP provisions over the six-month extension period, resulting in an FMAP increase that is much lower than that under ARRA. The impact of this partial FMAP extension is to increase the need for state dollars during the second half of the 2010/11 fiscal year to pay for Medical Assistance and Pennsylvania's other Medicaid-related programs, resulting in an estimated $282 million spending gap in the current budget.

Legislation passed by Congress in August 2010 resulted in lower federal Medicaid funds for Pennsylvania than was anticipated in the enacted 2010/11 budget.

At the end of August 2010, Governor Rendell proposed to resolve this gap through a combination of spending freezes (budgetary reserves) worth $212 million and funds from a proposed Marcellus Shale severance tax estimated at $70 million. At the time of this briefing, a severance tax has not been enacted and funds placed in budgetary reserves have not been lapsed (returned) back to the General Fund. Typically, lapses do not occur until the next budget agreement is reached.

For several months of the current fiscal year, General Fund revenues have come in above estimate. As of December 31, 2010, revenues were more than $191 million above estimate for the fiscal year. If this trend continues, additional revenues could help offset the current year budget gap.

Through December 31, 2010, revenues were more than $191 million, or 1.7 percent, above estimate for fiscal year 2010/11.

Stronger than expected revenue growth is an encouraging sign of an improving economy. Medium term projections of gross domestic product growth are modest, but positive, with around 3 percent growth per year expected over the next few years. **But even as the economy moves into recovery and returns to growth, it will be impossible to rely solely on revenue growth to cover upcoming budget shortfalls.**

Below is an analysis of major tax collection patterns followed by a discussion of the gap that must be addressed to balance the upcoming 2011/12 budget.

2010/11 Revenue Collections

With six months of the 2010/11 fiscal year now complete, the General Fund has collected over $11.45 billion, exceeding the official revenue estimate by $191.2 million or 1.7 percent. Tax revenues account for $11.13 billion of the total, with non-tax revenues contributing $319.4 million. Compared with tax collections during the same period last year, 2010/11 tax receipts are up $648.2 million, or 6.2 percent. By comparison, at the same point of the budget cycle last year, 2009/10 tax receipts had fallen 6.9 percent from their 2008/09 levels.

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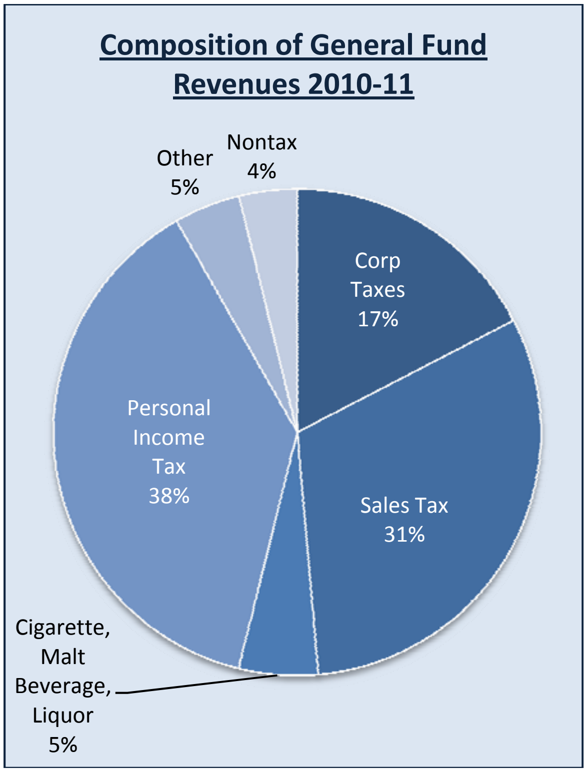
While the national recession reached its technical end in June 2009, recovery has been slow. However, recent signs are encouraging. Gross domestic product growth in the third quarter of 2010 was revised upward by a tenth of a percentage point to 2.6 percent, and fourth quarter growth is anticipated to accelerate to near 3.5 percent. During calendar year 2011, the economic forecasting company IHS Global Insight expects growth to be 3 to 3.5 percent.

The national unemployment rate stands at 9.4 percent, based upon December figures. In comparison, Pennsylvania's December unemployment rate was 8.5 percent. During this most recent recession, Pennsylvania's unemployment rate consistently has remained below the national rate.

Based on December figures, Pennsylvania's unemployment rate stands at 8.5 percent, compared to the 9.4 percent national rate. The Commonwealth's unemployment rate consistently has remained below the national rate.

Consumer spending nationally, adjusted for inflation, grew 2.4 percent in the third quarter at an annualized rate, marking the strongest quarterly rate since 2006. While final figures are still pending, IHS Global Insight expects national consumer spending to grow by 4.3 percent in the fourth quarter. If this forecast is accurate, real consumer expenditures will have recovered to their pre-recession peak in the fourth quarter of 2007. In addition, experts believe holiday retail sales increased around 5 percent compared to last year.

Detail on Tax Receipts



Sales and Use Tax

The **Sales and Use Tax** is an important revenue source comprising over 30 percent of General Fund revenue. Through December, Pennsylvania's sales and use tax collections suggest that that consumers are starting to spend more, with revenues $102.8 million, or 2.5 percent ahead of estimate for the current year and $198.2 million, or **5 percent, more than the same period last year. Last year at this point, sales tax revenues had declined 5.9 percent from their 2008/09 levels.**

Both motor vehicle and non-motor vehicle collections have been outperforming expectations. Motor vehicle sales tax collections are $41.8 million (8.7 percent) ahead of estimate through the first six months of this fiscal year and are **$32.1 million (6.5 percent) higher than the same period last year.** During the first six months of the prior fiscal year, **motor vehicle sales tax collections** had increased slightly compared to 2008/09, edging up by 0.4 percent.

Sales and Use Tax collections comprise 31 percent of General Fund revenue. Through December, collections were $102.8 million, or 2.5 percent ahead of estimate for 2010/11.

Non-motor vehicle sales tax collections are $61 million (1.7 percent) ahead of estimate for the year, and **$166.1 million (4.8 percent) higher than last year at this time.** This stands in stark contrast to the trend facing the Commonwealth last year, when non-motor sales collections had fallen 6.8 percent from their 2008/09 levels. Note that most sales tax collections are remitted to the Department of Revenue in the month following the sale, so a large portion of the holiday shopping season's revenue will arrive in January.

Personal Income Tax

Another major component of General Fund revenues is the **personal income tax**, comprising 38 percent of the total. As of December 31st, personal income tax (PIT) collections for the year are $16.6 million or 0.4 percent higher than expected. Compared to same period during the previous year, **total PIT collections are up by $152.9 million (3.6 percent).** The trend last year was sharply negative, with 2009/10 collections down 6.4 percent from their 2008/09 levels.

Personal Income Tax collections comprise 38 percent of General Fund revenue. Through December, collections were $16.6 million or 0.4 percent ahead of estimate for 2010/11.

While this year's overall PIT revenues are slightly ahead of estimate, the component parts vary in their results. While withholding collections from wages and salaries have performed better than anticipated, non-withholding payments on non-wage income like investment earnings and proprietors' income have not met estimate. **Withholding collections** are $71.8 million or 1.9 percent ahead of estimate; however, most of this surplus arrived in December and cannot yet be considered a solid trend. Year over year, **withholding payments for the PIT have increased $200.3 million or 5.4 percent.** Last year, withholdings had dropped 4 percent compared to their 2008/09 levels over the same period.

Thus far in 2010/11, PIT withholding collections from wages and salaries have performed better than anticipated; however, non-withholding payments on non-wage income like investment earnings and proprietors' income have not met estimate.

Non-withholding payments consist of both quarterly estimated payments (due in April, June, September and January) and annual final payments. Non-withholding revenues are $55.2 million or 9.4 percent lower than expected for the current year and $47.4 million or **8.2 percent below last year's levels.** 2009/10 trends showed a decrease of 19.2 percent from the 2008/09 levels. The current shortfall in non-withholding payments primarily is caused by lower than expected final payments in October. October was also the month by when taxpayers who requested a six month extension in April 2010 must file with the Department of Revenue. The vast majority of annual final payments for the current fiscal year will arrive in April 2011, and the next quarterly estimated payment will arrive in January.

Corporation Taxes

Corporation taxes are $91.4 million, or 7.9 percent, ahead of estimate so far this year. Compared with last year, **corporation tax collections have grown by $146.4 million, or 13.3 percent.** Last year's first six months experienced an overall decline of 19.3 percent from the 2008/09 corporation tax collections in the same time frame.

Through December, the **corporate net income tax (CNI) collections** are $32.6 million or 4 percent higher than anticipated. In comparison, these revenues are $112.9 million (15.3 percent) more than was collected over the same period last year. Similar CNI collections in 2009/10 were 21.5 percent lower than they were in 2008/09. Similar to non-withholding payments for the personal income tax, corporations make four quarterly estimated payments each year followed by a final payment about three months after the close of their year. A large portion of corporations operate on a traditional calendar year basis and so cash flow experts closely watch quarterly estimated payments in March, June, September and December. Final payments are due in April. CNI quarterly estimated payments remitted for tax year 2010 in September and December comprise the bulk of collections thus far this fiscal year. The fact that these payments were better than expected is encouraging for the first quarter 2011 estimated payment due in March, as well as the final payment for 2010 that calendar filers will remit in April 2011.

Corporation Tax collections comprise 17 percent of General Fund revenue. Through December, collections were $91.4 million or 7.9 percent ahead of estimate for 2010/11.

The **Capital Stock and Franchise Tax (CSFT)** also requires quarterly estimated payments in the same manner as the CNI, and both September and December collections have been ahead of estimate. CSFT collections for the year are $32.1 million higher than expected or 10.3 percent. This represents a $67.4 million increase (24.3 percent) over last year. The CSFT rate is currently at 2.89 mills, and will remain at that level through 2011. Under current law, the rate then will phase out at 1 mill per year until the tax is eliminated.

The third major corporation tax, the **Gross Receipts Tax (GRT)**, is levied on electric, water, telecommunications and transportation companies and is due in its entirety by March 15. It is not possible to gauge, based on revenue receipts, how the GRT will perform, as there is no monthly deposit history to compare to estimate. The official estimate for 2010/11 assumes GRT collections of $1.33 billion for the year, 3.4 percent higher than the prior year.

Note while overall **tax** receipts have been encouraging, the total General Fund revenues compared to last year are lower, because of a large number of transfers recognized as **non-tax** revenue. **Detailed charts on General Fund revenues through the first six months of the fiscal year are attached to this briefing.**

Challenges in 2011/12

Closing the General Fund budget gap for the current year is of great concern; however, this amount is minor compared to that projected for the 2011/12 budget.

PA Use of Federal Stimulus Funds (in thousands)		
2008/09	2009/10	2010/11
$ 1,239,475	$ 2,698,066	$ 2,756,113

The largest contributing factor to the budget gap in the upcoming year is the loss of additional federal stimulus funds that states have used to close budget gaps over three fiscal years. While stimulus funds were not enough to allow for normal growth in expenditures, Pennsylvania was able to mitigate some of the effects of reduced revenues on programs. The loss of these federal funds in the upcoming year, even if revenue growth turns positive again, will leave Pennsylvania with a very large gap.

In addition to the gap created by the loss of federal stimulus funds, the current year budget utilized more than $748 million in one-time revenue sources, which are no longer available to balance the 2011/12 budget. These one-time revenues consisted of approximately $486 million in transfers from various special funds, and $262.3 million from changes in the sales tax filing schedule and a reduction in tax credits.

In addition to the nearly $2.8 billion gap created by the loss of Federal stimulus funds, the current year budget utilized more than $748 million in one-time revenue sources, which are no longer available to balance the 2011/12 budget.

Over the past several years, the Commonwealth has cut expenditures significantly, so any future spending reductions will be very painful. **Several cost increases are unavoidable in the 2011/12 budget due to mandatory requirements.** For example, Medical Assistance and other safety net programs continue to expand due to caseload growth and inflationary trends. In addition, while recently enacted pension reform legislation will save the Commonwealth nearly $115 million in 2011/12 and $1.78 billion in 2012/13, pension liabilities still are anticipated to grow by nearly $346 million in the upcoming fiscal year (and by nearly $400 million in 2012/13).

Aside from further cuts and the elimination of programs, there are not many options available to close the budget gap without additional revenues. One possible revenue source may include additional Fiscal Stabilization funds ($387 million) that Congress enacted in August 2010 for education. However, details regarding distribution still are in flux, and therefore these funds are not guaranteed to help address the gap. **Again, note that while revenue collections appear to be strengthening, the total growth in revenues in 2011/12 is not expected to be drastic enough to close the General Fund budget gap.**

House Appropriations Committee (D)

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Attachment A

2010/11 General Fund Revenues: Estimated versus Actual Collections
Through December 2010
(in millions)

	Official Estimate	Actual Collections	$ Change	% Change
General Fund Total	$11,263	$11,454	$191	1.7%
I. Tax Revenue	$10,950	$11,135	$185	1.7%
A. Corporation Taxes	$1,155	$1,246	$91	7.9%
B. Consumption Taxes	$4,776	$4,886	$110	2.3%
1. Sales	$4,060	$4,162	$103	2.5%
a. Non-Motor Vehicle	$3,577	$3,638	$61	1.7%
b. Motor Vehicle	$483	$524	$42	8.7%
2. Cigarette	$557	$559	$1	0.3%
3. Malt Beverage	$14	$14	$0	1.5%
4. Liquor	$146	$151	$5	3.6%
C. Other Taxes - Total	$5,020	$5,003	($17)	-0.3%
1. Personal Income	$4,428	$4,444	$17	0.4%
a. Withholding	$3,840	$3,912	$72	1.9%
b. Non-Withholding	$587	$532	($55)	-9.4%
2. Realty Transfer	$182	$149	($33)	-18.1%
3. Inheritance	$376	$381	$5	1.3%
4. Minor & Repealed	$1	$2	$1	66.7%
5. Table Games	$34	$27	($6)	-19.0%
II. Non-tax Revenue	$312	$319	$7	2.2%

Attachment B

General Fund Revenues: 2010/11 Comparison with Prior Year Through December 2010 (in millions)				
	2009/10	2010/11	$ Change	% Change
General Fund Total	$ 12,406.2	$ 11,454.4	$ (951.8)	-7.7%
I. Tax Revenue	$ 10,486.7	$ 11,134.9	$ 648.2	6.2%
A. Corporation Taxes	$ 1,099.5	$ 1,245.9	$ 146.4	13.3%
B. Consumption Taxes	$ 4,557.5	$ 4,886.1	$ 328.6	7.2%
1. Sales	$ 3,964.2	$ 4,162.4	$ 198.2	5.0%
a. Non-Motor Vehicle	$ 3,471.9	$ 3,638.0	$ 166.1	4.8%
b. Motor Vehicle	$ 492.3	$ 524.4	$ 32.1	6.5%
2. Cigarette	$ 439.8	$ 558.8	$ 119.0	27.1%
3. Malt Beverage	$ 13.9	$ 13.8	$ (0.1)	-0.7%
4. Liquor	$ 139.4	$ 151.0	$ 11.6	8.3%
C. Other Taxes - Total	$ 4,829.7	$ 5,002.9	$ 173.2	3.6%
1. Personal Income	$ 4,291.2	$ 4,444.1	$ 152.9	3.6%
a. Withholding	$ 3,711.9	$ 3,912.2	$ 200.3	5.4%
b. Non-Withholding	$ 579.2	$ 531.8	$ (47.4)	-8.2%
2. Realty Transfer	$ 161.7	$ 149.2	$ (12.5)	-7.7%
3. Inheritance	$ 375.3	$ 380.8	$ 5.5	1.5%
4. Minor & Repealed	$ 1.4	$ 1.5	$ 0.1	4.6%
5. Table Games	$ -	$ 27.2	$ 27.2	-
II. Non-tax Revenue*	$ 1,919.4	$ 319.4	$ (1,600.0)	-83.4%

*Note while overall tax receipts have been encouraging, the total General Fund revenues compared to last year are lower, because of large one-time transfers recognized as non-tax revenue.