Pennsylvania Budget Outlook: Short-Term and Long-Term

PENNSYLVANIA
Budget and Policy Center

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By Marc Stier and Diana Polson February 14, 2023

Overview

The enactment of Pennsylvania's current year (2022-23) budget was greeted with bipartisan hosannas about the fiscal situation of the state. The projected budget surplus for the year was $5.27 billion, and additional contributions to the Rainy Day Fund brought it to $5 billion. After more than a decade of budgets balanced with one-year funds and fiscal legerdemain, it appeared the state's persistent budget difficulties were over.

Unfortunately, our analysis shows that this is a partial truth. We estimate that the state will have a combined $13.2 billion surplus at the end of the fiscal year on June 30. But the long-term prospects for the state budget remain problematic.

- After the current year, operating deficits are projected to return and grow from $1.5 billion in 2023-24 to over $3 billion in 2027-28. These projections from the IFO assume that expenditures increase with inflation while revenues increase with economic growth.
- These deficits are the result of the end of federal funding to deal with the COVID crisis, corporate net income tax cuts that will cost the state $1.3 billion in 2027-28, and the resumption of the pre-COVID imbalance between expenditures and revenues that was temporarily masked by federal funding and never resolved.
- While the accumulated surplus can cover projected deficits over the next three or four years, Pennsylvania will ultimately have a budget crunch in which yearly revenues do not cover the expenditures that the people of Pennsylvania demand.
- The budget projections do not include new funding to meet any of Pennsylvanians' needs. Most importantly, they do not meet the moral, and thanks to Judge Jubelirer's recent decision, now constitutional mandate to provide full and fair funding of K-12 education.
- The current $12 billion surplus was created by using ARP funds meant to provide relief to Pennsylvanians suffering from the COVID crisis—relief that was never fully provided.

In sum, the state will soon see a resumption of a structural budget deficit combined with the need for additional investments, especially, but not only, for meeting the constitutional requirement to fully and fairly fund K-12 education. To meet its responsibilities, the state will ultimately have to raise revenues. Given that our state and local tax system remains one of the most inequitable in the country, we believe that the budget crunch should be resolved by asking the wealthiest Pennsylvanians to pay their fair share of taxes. The huge budget surplus creates the potential for modest tax increases today to generate the funds we need to overcome the structural deficit and meet the needs of Pennsylvanians in the future.

The State's Budget Surplus

We expect Pennsylvania's General Fund to have a combined surplus of at least $13 billion by June 30th, the end of the current 2022-23 fiscal year. We project the General Fund to have an operating surplus of more than $8 billion and the Rainy Day Fund to have a balance of $5 billion. The components of this surplus can be seen in table 1.

The 2022-23 surplus projected at the beginning of this fiscal year, in July 2022, was $5.27 billion (row 1 in the table 1 below). But between July and December 2022, Pennsylvania brought in $503 million more than what was expected in revenue (row 2 in table 1). On top of that, the Independent Fiscal Office (IFO) projects that Pennsylvania will have an additional $1.03 billion in tax revenues above the June 2022 projection between January and June 2023 (row 3).

Table 1

Projected Accumulated State Surplus by the End of June 2023 in Billions	**Estimate**
1) Budget surplus projected in June 2022	$5.27
2) Additional revenues from July through December 2022 on top of original 2022-23 estimate	$0.50
3) Additional revenues expected over original projections for rest of FY 2022-23	$1.03
4) Remaining American Rescue Plan funds	$0.00
5) Reduction in expenditures due to FMAP* expected extension between January and March 2023	$0.62
6) Other savings related to the Department of Human Services	$0.69
TOTAL	**$8.11**
7) Rainy Day Fund	$5.01
TOTAL, including Rainy Day Fund	**$13.12**

*FMAP is Federal Medicaid Assistance Percentage--due to the pandemic the federal government has been providing an additional 6.2% to states on many eligble Medicaid costs. The extended FMAP was in the original budget for half of 2022/23 (and is reflected in the estimate in line item #1). FMAP has been be extended for the first quarter of 2023, adding additional funds (shown in line item #5 above).

Source: 1) From data provided by the PA Senate Democratic Appropriations Committee. 2) PA Department of Revenue estimated 2022-23 fiscal year revenues would be $43.579 billion. Actuals through December 2022 show revenue is greater than expected by $503 million. Calculated from PA Department of Revenue Monthly Revenue reports, https://www.revenue.pa.gov/News%20and%20Statistics/ReportsStats/MRR/Pages/default.aspx. 3) This is the difference between the original and mid-year update minus additional revenues from July through December 2022 (row 2). Data from IFO: http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/2023_Mid_Year_Update.pdf. 4) House Democratic Appropriations Committee report: https://www.houseappropriations.com/Topic/BudgetYears/720. Final ARP funds ($2.16 billion) are planning to be used in 2022/23. 5 and 6) From data provided by the PA Senate Democratic Appropriations Committee. Info on the FMAP extension: https://ccf.georgetown.edu/2022/12/20/congress-proposes-to-end-medicaid-continuous-enrollment-protection-in-early-2023/#:~:text=In%20the%20first%20quarter%20of%202023%2C%20states%20will,increase%20in%20the%20Federal%20Medical%20Assistance%20Percentage%20%28FMAP%29. 7) From data provided by the PA Senate Democratic Appropriations Committee.

Additional savings that lead to a higher surplus can be expected as well (rows 5 and 6). The federal government has been providing additional assistance to states for many eligible Medicaid costs in the form of the expanded Federal Medicaid Assistance Percentage (FMAP). The original 2022-23 budget projections in row 1 only include expanded FMAP through December 2022, but the federal government later extended expanded FMAP through March 2023, resulting in savings of $620 million for the state. The Department of Human Services is also expecting reduced spending of $690 million (row 6).

As row 4 shows, by the end of Fiscal year 2022-23 all American Rescue Plan funds will be allocated. Of the $7.3 billion in State Fiscal Recovery Funds allocated under the American Rescue Plan, $3.8 billion was transferred to the General Fund in fiscal year 2021-22, $1.3 billion was appropriated mostly for relief for various constituencies in the same fiscal year, and $2.2 billion was appropriated in the current fiscal year, in part for relief and in part to carry out the normal work of the state (table 2).

Table 2

American Rescue Plan State Fiscal Recovery Appropriations	
	Amounts in Millions
Total State Allocation	7291.3
Transfer to General Fund for Revenue Replacement in 2021-22	3841.0
Appopriated by the General Assembly in 2021-2022	1288.0
Appropriated by the General Assembly in 2022-2023	2162.3
Public Safety	260.0
Human Services	440.0
Envionment	640.0
Education	160.0
Housing	375.0
Other	262.3
Transfer to Uunemployment Compensation Trust Fun	42.3
Executive offices for pandemic response	40.0
DCED historically disadvantaged business assistenace	20.0
Cultural and museum presrevation grant program	15.0
Healtht-biotechnology research	5.0
Property Tax / Rent Rebate	140.0

All together, we estimate that the total projected state surplus will be approximately $8.11 billion by the end of the 2022-23 fiscal year. Adding to that the Rainy Day Funds balance of $5 billion, the total accumulate state surplus reaches $13 billion.

Fiscal Challenges

While the state's financial status is strong, looking at the IFO projections for the next five fiscal years shows this picture won't last.[1] Over the next five years, the IFO projects that Pennsylvania will run General Fund operating deficits that total nearly $13 billion.

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[1] PA Independent Fiscal Office, "Pennsylvania Budget and Economic Outlook: Fiscal Years 2022-2023 to 2027-2028," 41, http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/Five_Year_Outlook_2022.pdf.

Table 3

Projected ending balance for Pennsylvania's General Fund, FY 2023-24 to 2027-28 (in millions)	
Fiscal year	**Projected ending balance**
2023-24	-$1,532
2024-25	-$2,291
2025-26	-$3,015
2026-27	-$2,995
2027-28	-$3,121
Total	***-$12,954***

Source: See page 41 of the Independent Fiscal Office Economic and Budget Outlook for fiscal years 2022-23 to 2027-28. Online at: http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/Five_Year_Outlook_2022.pdf

Note that the IFO's budget projection includes assumptions about both expenditures and revenues. It projects that revenues will increase with economic growth and that expenditures will increase due to inflation in the provision of state services, including support for K-12 education and the costs of medical care; changes in the number and composition of people receiving state services, especially Medical Assistance and long-term care; payments for debt services and pensions; and contractually obligated salary increases for state employees. The IFO projection, in other words, assumes that the state will be given the same level of services that it does in the current year at the costs necessary to provide them.

Why does the General Fund budget projection show such a striking turnaround from the substantial current surpluses to future deficits? There are a few explanations.

First, the current year surplus is partially a product of a large influx of federal COVID relief funding. This includes the transfer of $3.8 billion of the federal American Rescue Plan State Recovery Funds into the General Fund last fiscal year (2021-2022), which led to a large surplus that carried over to this year. And at least part of the expenditures for the current year, which would be part of future projected expenditures, were covered by an additional $2.2 billion in State Recovery Funds. And the state also received an additional $2.4 billion per year in increased federal support Medical Assistance and Long-Term Care.

Second, the increase in recurring General Fund expenditures was held down by the flat funding of much of the budget outside of Human Services, pension costs, and debt service in fiscal year 2020-21. Flat funding a budget one year tends to have the effect of reducing future expenditures for another year or two as the base for calculating increases in spending is reduced.

And third, future revenues are reduced because of the corporate tax cut enacted in June. The corporate tax base was slightly expanded due to changes in how much of a business's income is apportioned to Pennsylvania and because of a clarification of economic nexus rules that determine whether a corporation must pay corporate taxes in our state. (These changes in the corporate tax base are welcome but fall far short of the expansion that would result from embracing combined reporting.) But as of January 1, 2023, the corporate tax rate was reduced from 9.99% to 8.99% and will be reduced by half a percentage point each year until it reaches 4.99% in 2031.

The IFO estimates that the combined effect of these corporate tax changes will cost the state $853 million by fiscal year 2025-26 and $1.3 billion by fiscal year 2027-28. These corporate tax cuts come on top of the more than $4 billion in corporate tax cuts that were put in place under Governors Rendell and Corbett. They are being put in place despite record-high corporate profits and substantial evidence that corporate tax cuts are a very costly and inefficient way of generating jobs for Pennsylvanians.

Table 4

Projected Corporate Net Income Tax Revenue FY 21-22 to FY 27-28 in millions of dollars							
Fiscal Year	21-22	22-23	23-24	24-25	25-26	26-27	27-28
Base Revenue	$5,323	$5,370	$5,283	$5,357	$5,480	$5,654	$5,852
Impact of base/ rate changes	$0	($200)	($281)	($608)	($853)	($1,113)	($1,373)
Total corporate tax revenue	$5,323	$5,170	$5,002	$4,749	$4,627	$4,541	$4,479
Gowth rate	20.30%	-2.90%	-3.20%	-5.00%	-2.60%	-1.80%	-1.40%
Source: Indepndent Fiscal Office, Pennsylvania Economic and Budget Outlook, Fiscal Years 2022-23 to 2027-28, p. 21. http://www.ifo.state.pa.us/download.cfm?file=Resources/Documents/Five_Year_Outlook_2022.pdf##							

The projected deficits can be covered by the surplus documented above provided we draw down the Rainy Day Fund. (While current statute requires a two-thirds vote of each house to spend Rainy Day Funds, this rule can be changed by legislation that only requires a majority vote of the House and Senate.) But covering operating deficits by spending down the surplus will not solve a multitude of problems faced by the state—nor will emptying our Rainy Day Fund when there is always a possibility of an economic downturn.

First, it is not a long-term solution. The government and people of Pennsylvania need to understand that we are again facing structural deficits in which the government does not raise sufficient revenues to cover the expenses of a government that does what the people of Pennsylvania want it to do. While it may be politically expedient to do so, it would be a dereliction of duty to return to the last decade of yearly budget deficits and the yearly use of budget gimmicks to cover them.

Second, in the last election, the people of Pennsylvania clearly said they want more, not less from the state government. Given the clearest possible choice between two visions of the future of our state, the voters chose Josh Shapiro. Governor Shapiro campaigned in favor of full and fair spending on K-12 education; for greater investments in career and technical training; for greater access to higher education (where we rank towards the bottom of all states); for additional funding for technical and other support programs that will businesses expand and create new, high-wage jobs for Pennsylvanians. He made clear his commitment to protecting the air and water of our state and limiting the dangers of climate change. He also pointed out, as we have for the last two years, that the state does not have enough to help people and small businesses recover from the pandemic, especially to help Pennsylvanians meet the need for housing that has become increasingly unaffordable.

Governor Shapiro's campaign promises reflects the reality of Pennsylvania's budget As we have documented for years, Pennsylvania ranks at the bottom of states when it comes to funding K-12 and Higher Education. It is far behind neighboring states in funding pre-K, in helping small and growing businesses. It has sharply cut funding for environmental protection. And it did far too little to help individuals and small businesses who suffered and continue to suffer due to the pandemic.

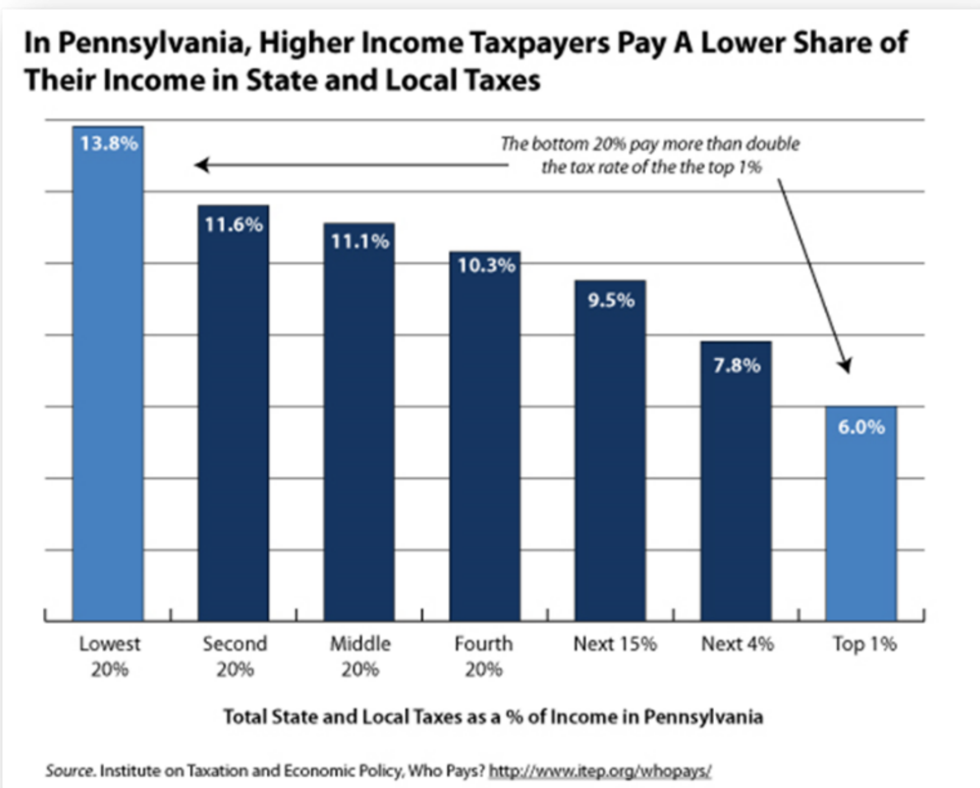
Third, in the last week, President Judge Renée Cohn Jubelirer ruled in favor of the plaintiffs in the education funding lawsuit. Her long, fact-filled opinion made clear what those of us who have studied the funding of K-12 education have long known: not just the moral but the constitutional rights of our children are violated every day by appalling inequities in how we fund our schools. And they have been violated for decades. Though the case is likely to be appealed, Judge Jubelirer's opinion vividly demonstrates not only why it will be upheld in the Supreme Court but why it would be wrong to delay efforts to begin meeting the requirements of justice and our constitution. We know that the state can't raise the additional $4 billion in funding we need to provide full and fair funding of our schools this year, but it can, and should, begin doing so now. And that will require both using the surplus available—not just to paper over the long-term failure of our state to raise sufficient funds to carry out its operations but to make a down-payment on education equity.

Solutions

A cold-eyed look at Pennsylvania's fiscal state shows us that to both deal with long-term structural deficits and to meet the needs of Pennsylvanians, the state will at some point have to raise revenues. To do that without hurting either the state economy or Pennsylvanians who are struggling economically, additional revenues should come from those most able to afford it, the wealthiest among us and the multi-state and multi-national corporations who, despite the recent reforms, continue to pay little or nothing in state corporate taxes.

Pennsylvania continues to have one of the most unfair tax systems in the country. As figure 1 below shows, low-income Pennsylvanians pay state and local taxes at more than double the tax rate as a share of their income (14%) than the richest 1% of income-earners in Pennsylvania (6%). This is not just terribly unfair—but it is the fundamental reason our taxes do not bring in sufficient revenues to pay for the services that the people of Pennsylvanian want and need.

Figure 1



Over the next several weeks, the Pennsylvania Budget and Policy Center will release a series of reports that outline a plan for Pennsylvania to raise significant resources moving forward. This includes: a Fair Share Tax, which taxes income from wealth at a higher rate, while reducing or keeping taxes the same for the vast majority of Pennsylvanians; legalization of adult-use cannabis; a severance tax on natural gas fracking that will ensure large oil and gas corporations pay their fair share for extracting our state's natural resources; a wealth tax to make sure the wealthy are paying their fair share; and corporate tax reform to close loopholes that large national and multi-national corporations use to get around paying state taxes.

Conclusion: Pennsylvania's Choice

The fiscal status of Pennsylvania is almost paradoxical. We have a huge surplus of more than $13 billion. Yet we are likely to have recurring budget deficits starting next year and critical needs for additional state spending, especially for full and fair funding of K-12 education. The huge surplus creates a temptation for politicians to avoid making hard decisions. But it also provides an opportunity to use the surplus and modest addition to revenues now to meet the needs of the state over the long term.

The test of statesmanship, which distinguishes political leaders who aim for greatness from those who just seek to hold office, is whether they are willing to lead the public in an effort to address our long-term needs. While the state's budget paradox may tempt our political leaders to avoid our long-term budget issues, it can also enable them to address those problems over a number of years without overly burdening Pennsylvania taxpayers.

That is the critical choice facing our political leaders, and ultimately, all Pennsylvanians.