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In this edition of State Tax Merry-Go-Round, Hamilton discusses Pennsylvania's budget woes.

"Harrisburg, we have a problem." That, in essence, was Pennsylvania State Treasurer Joe Torsella's message to lawmakers July 25. Torsella said time was running out for General Assembly budget negotiators to agree on a revenue package to pay for the budget the legislature passed at the end of June.

"Dominos will begin to fall starting in August and September, and our message to everyone is . . . from a very narrow cash-flow perspective, the state will not have enough money to pay its bills coming sometime soon," Torsella said during an interview with the *Pittsburgh Tribune-Review*.[1]

Torsella's problem stems from business left undone in June: Though lawmakers passed the budget on June 30, the final day of the state fiscal year, they didn't pass what's known as the fiscal code. The General Assembly must pass the fiscal code — enabling legislation that directs how the administration should spend budget dollars — after it passes the budget. Lawmakers must also pass a series of other bills, including a tax code, school code, and human services code, as "trailers" to the budget. This two-step process is the result of a 2005 state supreme court ruling that limits what can be put in the budget bill.[2]

This year the requirement became a double-edged sword that's skewered the state's already shaky budget process. Pennsylvania has consistently run deficits since the recession, the result primarily of sluggish tax growth, rising healthcare costs, and the need to catch up on public pension obligations. During that time, the governor and General Assembly have been unable to agree on a comprehensive fix, instead doing just enough to get by from year to year — and from crisis to crisis.

True to form, the Republican-dominated General Assembly and Gov. Tom Wolfe (D) spent most of the last year squabbling over what to do with the 2018 budget. State revenues for fiscal 2017 came in far below estimate. Also, the legislature never passed a gambling expansion bill as it was supposed to, resulting in a total deficit of about $1.5 billion. The new fiscal year could add another $700 million to the deficit — bringing the total to $2.2 billion — without additional revenue, spending cuts, or both.

As time ran out in the fiscal year, lawmakers were finally able to agree on a budget bill, and it

[1]Kevin Zwick, "Pennsylvania Treasurer: Budget Negotiators Need to Reach a Consensus — And Soon," *Pittsburgh Tribune-Review*, July 26, 2017.

[2]*Hospital & Healthsystem Association of PA v. Department of Public Welfare*, 888 A2d. 601 (Pa. 2005).

was sent to the governor. On July 10 Wolf said he would allow the $32 billion budget to become law without his signature, but he was awaiting the necessary fiscal and administrative bills to implement the spending plan. "In the coming days, it is my hope that the General Assembly will come together to pass a responsible solution to balance our books," he said.

So far, no solution — sensible or otherwise. Philly.com's John Baer recently described what's transpired since June 30: "As a reminder, the legislature half-passed a budget June 30 (you can drop the 'p' for greater accuracy) and Gov. Wolf, for reasons only he and tarot cards know, let it become law with no way to pay for it. Since then, the Republican House blames the Republican Senate. The Republican Senate blames the Republican House. And two announced Republican candidates seeking to oppose Wolf next year ask, 'Where's Wolf?'"[3]

Third Time's Not the Charm

This marks the third budget in as many years that Wolf has refused to sign. Lawmakers passed the 2015-2016 budget after a nine-month stalemate between the legislature and the governor. In the end, Wolf refused to sign it. During the protracted budget battle, Wolf pressed for tax increases to boost education spending and close a structural deficit. The tax plan included billions of dollars in tax shifting to reduce property taxes and increase state spending on schools. Wolf proposed taxing production from the Marcellus shale formation and various other revenue-raising measures. Republican lawmakers painted the governor's plan as a massive tax increase, and at one point, the House rejected a version of the plan on a 193-0 vote.

The budget the legislature finally passed didn't include any tax changes, and when Wolf refused to sign it, he made it clear he didn't believe it was properly funded. However, he said he was allowing it to lapse into law without his signature so that schools could stay open. Looking ahead, he said, "We need to move on. We need to confront the real challenge we have in the [2016-2017] budget."

On July 10, less than four months later, he refused to sign the 2016-2017 budget after he failed to reach agreement with lawmakers on how to overcome the deficit, which had swelled to $2 billion. Two weeks later, the governor did sign a $1.2 billion tax and revenue bill that was far from what he wanted in the way of policy but was necessary to balance the budget. Most of the new revenue in the bill came from higher taxes on cigarettes, tobacco products, and e-cigarettes, as well as a scattering of other taxes.

'It's a Mess'

Now, the state finds itself facing yet another variation on the familiar theme of fiscal dysfunction, with the governor and legislature engaged in a sort of multi-corner tug of war over how to pay for the budget. To try to get a fix on what's happening in this long-running melodrama, I contacted my friend and expert Bob Strauss, a professor of economics and public policy at Carnegie Mellon University in Pittsburgh and a longtime observer of state fiscal issues.

I first asked Strauss about his thoughts on a process that's so broken that the governor has refused to sign three straight budgets. "It's a mess," he said, pointing to Torsella's worries about running out of cash in August. "People are staring at one another trying to come up with a new solution. The problem is that you can't suspend the rules of mathematics all of the time."

Strauss said the legislature has been proceeding in closed meetings involving only Republicans from the two houses, with the goal of finding a plan that both houses and, presumably, the governor can support. It then will be up to Wolf to deliver Democratic lawmakers. "We're about where we were in 2015 and 2016," Strauss said, "but it's not as angry and public this time." He said it's anyone's guess how the process plays out, but whatever the legislative leadership agrees to do could flounder even before reaching Wolf because of Tea Party legislators.

"There are plenty of dynamics for things not getting resolved," Strauss said. "All sides believe they can rely on short-term borrowing to help fill the deficit, but it's not clear to me that the capital

[3] John Baer, "Harrisburg's Race to Irrelevancy," Philly.com, July 26, 2017.

markets will support it." He said the problem with the legislature's enthusiasm for borrowing is that the result may be another downgrade of the state's credit. In early July, S&P Global Ratings put the state's AA- rating on "negative watch" after it failed to enact the fiscal code before the fiscal year began July 1. Moreover, any borrowing requires the approval of the governor, the auditor general, and the treasurer — all Democrats. "The governor will vote to borrow. The treasurer has made noises about limits on borrowing, and no one knows where the auditor general stands," he said.

If the General Assembly and the governor are feeling the pressure, their actions so far don't reflect it. Strauss said the three sides — House, Senate, and governor — all want something different from the revenue package. Wolf wants higher taxes to justify additional borrowing to help pay last year's deficit without further damaging the state's credit rating. The Senate has been willing to go along with a smaller level of additional "recurring revenues," including new taxes. The House, however, wants nothing to do with tax increases and appears ready to exhaust every trick in the book to avoid them.

Plan du Jour

This dynamic created a pattern of dueling revenue plans that played out during July. On July 9 Wolf rejected a proposal, which had the agreement of the leaders of both the House and Senate Republicans, because it didn't include enough recurring tax revenue. The $2.2 billion package raised about $800 million in revenue and borrowed the other $1.4 billion from the state's Tobacco Settlement Fund.

On July 18 House Speaker Mike Turzai (R) decided on a more hard-line approach and put together a "no new taxes" plan that relied heavily on a mix of borrowing, raids on other state funds, and a further liberalization of the state's alcohol sales laws — although the details weren't spelled out in public comments about the plan. "We think that we can close this with non-tax revenues," Turzai said.[4] The speaker made it clear that where the House was concerned, tax increases are a non-starter.

[4] Charles Thompson, "Pa. State Budget Update: House Republicans Offer New No-Taxes Plan to Raise Revenue," PennLive, July 18, 2017.

Strauss said Turzai appears likely to run for governor next year and is sticking close to what the Republican base wants to hear. But the message isn't working with House Republicans. In mid-July, the speaker summoned House members back to Harrisburg to vote on his fiscal package but kept the plan's details close to his vest. House Republicans were shown the proposal and debated it during what was reported to be a rough, four-hour caucus. In the end, they couldn't agree on a plan to bring to the floor. Instead, Turzai sent members home a day early and announced that the House would wait to see what proposals came from the governor or the Senate.

The Senate answered on July 27 with a plan that includes a mix of new and increased taxes, fund transfers, and an anticipated expansion of gambling in the state. These measures are anticipated to raise about $970 million — to which the Senate added an authorization to borrow nearly $1.3 billion in future tobacco settlement payments.

The tax package, estimated to bring in about $530 million a year, includes a severance tax on natural gas drilling that could produce about $100 million per year and faces strong industry opposition. Gas drillers would continue to pay an existing impact fee that is split by the state government and communities in the Marcellus. The package also includes new or higher taxes from a gross receipts tax on natural gas, electric, and telecommunications bills, which could eventually bring in about $400 million a year. Though the state ended the gross receipts tax on natural gas bills in 2000 as part of a broader restructuring of natural gas utility regulation, the Senate plan would restore the tax on natural gas bills while raising taxes on telecommunications and electricity. The tax on natural gas would be 5.7 percent. The tax on electric bills would rise to 6.5 percent, while the tax on phone bills would increase to 6 percent.

Also included in the plan is a requirement for online marketplaces like Amazon.com Inc. and eBay Inc. to collect sales tax from third-party sellers using their sites and $200 million from an expansion of casino-style gambling that hasn't been approved and is still the subject of a disagreement with the House.

The plan drew bipartisan Senate support and the endorsement of Wolf. Its future in the House is less certain. In addition to drawing the line on any new taxes, the House earlier rejected the plan to borrow from tobacco settlement funds, which was part of Turzai's proposal.

Ahead of the Senate vote, Majority Leader Jake Corman, a Centre Republican, urged passage, saying lawmakers had held the line on new taxes as long as they could, but the state simply needs more revenue to avoid a freeze on some government spending. "We came here to make tough choices," he reminded senators.

Some Senate members objected to the bill either because it increased taxes or because it didn't increase taxes enough. Corman said enough was enough, urging senators to focus on what was in the bill instead of what wasn't. "What we need to do on July 27 at 11 a.m. is balance the budget," he said, which reminded me of producer Lorne Michaels's quip about *Saturday Night Live*: "The show doesn't go on because it's ready; it goes on because it's 11:30."

As expected, the House hasn't rushed to rubber-stamp the plan. House members will have "questions and concerns" about the Senate plan, House GOP spokesman Stephen Miskin said after the Senate passed the bill. He said the Senate plan was not shared with or agreed to by House leaders before passage, "so a review of what's actually in these bills is necessary." He said there's no timetable for the House to take up the legislation.

Getting a deal that looks like the Senate plan could be a steep climb in the House, which has its own internal fractures. Last year, PennLive's Charles Thompson described the House GOP caucus this way: "Gone are the days when House GOP leaders could negotiate and deliver a deal a majority of their caucus didn't like, like the Rendell budget that raised the state income tax in 2003, or the legalization of slot machine gambling in 2004. In its place is the so-called Hastert rule, named for the former U.S. Speaker of the House, that says you only move forward with those bills or policy initiatives supported by the majority of the majority."[5] He said the caucus divides into three parts: antitax conservative hardliners; moderate, more labor-sensitive Republicans, generally from Philadelphia or its four suburban counties; and a group of more traditional right-of-center representatives who move toward the two opposite poles depending on the issue.

Also delaying the process is the House's timetable. Unless its plans change, the House may not come back to Harrisburg until after Labor Day. Turzai set no new session days before departing for a Republican political event, but he did take time to blame the Senate and Wolf for the impasse and voice his opposition to any tax increases.

For the moment, the government continues to operate normally. The parks and state offices are open, and no funding has been frozen, as was the case for school and social services funding during the long budget fight in 2015-2016. But that doesn't mean Torsella's problems are solved.

One issue is the difference in timing between when revenue is received and dollars are spent. In most states, revenues and expenditures don't match during the fiscal year because the bulk of income tax receipts come in April, while school and other spending starts at the beginning of the fiscal year. This mismatch can become impossible to manage on a day-to-day cash basis when revenues are short of budgeted spending, which is Torsella's concern.

"Treasury will continue to pay all lawful and correct expenditures pursuant to the current fiscal year enacted budget," Torsella's spokeswoman said.[6] If budgeted funds run out, she said, the department would work with the governor to cover priority needs.

"How all this affects the hopes of making a budget deal is anyone's guess," Strauss said.

'The Status Quo Seems to Be the Preferred Outcome'

I asked Strauss why Pennsylvania is struggling so much. "The economy is a big problem," he said. "Philly has made a comeback, but many areas of the state are losing population." Many of those areas haven't fully

[5] Thompson, "The Elephant in the Room: Pa's House Republicans Are Making Their Mark(s) on State's Divided Government," PennLive, Jan. 7, 2016.

[6] Steve Esack, "Pennsylvania Budget Fight Heating Up Politics Only," *The Morning Call*, July 25, 2017.

recovered from the recession, and the financial troubles of cities like Harrisburg have been well documented. Strauss said the state could be approaching a time when dozens of boroughs could go out of business because they're losing their tax base as businesses close and people leave. The state, he said, will continue to face fiscal problems unless it changes its fiscal approach.

"A lot of people want to be governor," Strauss said. "It seems to me it would be a bad job because as things now stand, you'll always be facing a budget crisis." He said Pennsylvania really needs real tax reform to fix the structural deficit and better stabilize revenues. "Many people make the same point," he said, "but the response is always to wait until after the next election."

I asked him what he would recommend as a way out of the current cycle of dysfunction. "As I wrote in *State Tax Notes* a couple of years ago, given our rapidly aging population, broadening the personal income tax base to include retirement income could close the structural deficit overnight," Strauss said. "The tax expenditure for excluding private and public retirement income from the personal income tax base for 2017 was at least $3 billion or about the entire size of the structural deficit."

Another possible area of reform is the sales tax. "The last time I looked closely, Pennsylvania had one of the narrowest sales tax bases among the major industrial states," Strauss said. "My favorite sales and use tax base broadening idea would be to include all clothing into the sales tax base. The income elasticity of demand for clothing is pretty close to 1.0, which means that including it wouldn't necessarily be regressive. So, it would be possible to expand the base, drop the rate below the current 6 percent, and still bring in more revenue that, by itself, could cover a good portion of the structural deficit. Adding clothing in, and reducing the rate a bit, and taxing half of retirement income would more than close the deficit."

Strauss said reforms are needed on the spending side of the budget as well. "The costs of public education in Pennsylvania could be materially lowered by allowing school districts to furlough teachers due to economic circumstances," he said. "There is a massive demographic shift in the school-age population, and school districts need more flexibility in rearranging their budgets. However, Pennsylvania's public education is unionized, and the right to strike remains on the books. Student-teacher ratios have dramatically fallen in Pennsylvania over the past decade because of a lack of flexibility."

Strauss also thinks retired teachers should be allowed to return to the classroom on a part-time basis with a temporary reduction in retirement benefits. "This would take some pressure off of our very underfunded teacher's retirement plan and forestall yet more local property tax increases. While this change in the teacher's retirement system would require getting IRS approval, it wouldn't endanger its tax-exempt status as some have argued. . . . I explored that issue with the general counsel's office at the IRS, and it can be done."

"None of this seems to be really heavy lifting in other states; however, there is something that happens when folks get to Harrisburg," Strauss said. "The status quo seems to be the preferred outcome. However, maybe the state's declining population will serve as a signal to the elected class that the electorate has lost patience with them."

'Are We Illinois?'

Pennsylvania isn't the only state facing budget problems this year. For a variety of reasons, a surprisingly large number of states struggled to produce balanced budgets in the recently ended fiscal 2017.

At the start, fiscal 2017 looked like a promising year for states, but during the course of the year, many saw worsening fiscal conditions. By spring, the National Association of State Budget Officers reported that at least 29 states had lowered their fiscal 2017 revenue estimates during the year and that 23 states had made midyear budget cuts, a "historically high number outside of a recessionary period."[7]

[7] Lisa McKinney, "Slow Growth in State Spending and Revenue Continues, NASBO Data Shows," Council of State Governments, May 2, 2017; and National Association of State Budget Officers, "Summary: Spring 2017 Survey of the States," June 15, 2017.

Many states also struggled to deal with their problems. According to the National Conference of State Legislatures, 10 states failed to pass budgets by the start of fiscal 2018, and three of those states — Connecticut, Rhode Island, and Wisconsin — still hadn't done so by the end of July.[8] Eighteen states required an extended session or a special session to finish their budgets, even if they made the fiscal year-end deadline. And there's no clear evidence the situation will improve significantly in the short run. The National Association of State Budget Officers reported that in fiscal 2018, state spending is expected to increase by just 1 percent, the smallest aggregate growth rate since the recession.

In a recent article about the NCSL report, Kim Rueben and Richard Auxier link the midyear budget problems and blown budget deadlines to several factors, including underperforming tax collections, rising costs (particularly for pensions and healthcare), and federal funding uncertainties.[9] On the tax side, many states face a combination of problems, including lagging economies that hurt income and sales taxes; sales tax losses due to consumer shifts to untaxed services and online shopping; low energy prices, which have hurt energy-producing states; and income tax problems connected to taxpayer delays in capital gain realizations in anticipation of federal tax cuts.

Pennsylvania shares several of these problems. In May the state reported that its year-to-date tax revenue was running 4.5 percent below estimates and the gambling expansion law approved last year hadn't emerged from the legislature, creating a $1.2 billion deficit with just two months left in the fiscal year. Taxes on corporate income, personal income, and sales were off nearly $1.1 billion at the end of April, the state data showed.

There's one problem that Rueben and Auxier mention only in passing that deserves greater attention — political polarization that makes compromise on key fiscal issues increasingly difficult. "What we're seeing at the states is a mirror of what we're seeing at the national level," Boris Shor, a political scientist at the University of Houston, told *The Christian Science Monitor* recently. "A lot of the policy battles that we've seen at Congress are getting shifted over to the states."[10]

One place where the battles are most fierce is in the area of tax and spending policy. New Jersey, Maine, and Illinois all faced budget stalemates this year caused directly by conflicts between Republican governors butting heads with legislatures dominated by Democrats. In Pennsylvania, the same is true except the roles are reversed.

Political polarization certainly plays a prominent role in Pennsylvania, where the ideological divide not only separates the governor from the legislature but also splits the House. The good news is that up till now, most states have eventually managed to reach compromises and get a budget in place, even if there are delays. The bad news is that passing a budget is not the same as solving larger fiscal problems. Political intransigence makes effective decisions difficult. Effective decision-making requires compromise and having everyone at the table. These days, that's often lacking in state debates over a range of issues, including fiscal policy. The problem isn't unique to Pennsylvania.

But maybe I'm being too pessimistic. As a final question, I asked Strauss for his overall assessment of Pennsylvania's fiscal condition once it gets beyond the current impasse. "Are we Illinois?" he said. "I don't think so, but we're close. We did have a pension fix, but overall, we just keep kicking the can down the road." ■

[8] National Conference of State Legislatures, "FY 2018 Budget Status," July 18, 2017.

[9] Kim Rueben and Richard Auxier, "Don't Laugh at Illinois, Your State Could Be Next," TaxVox, July 10, 2017.

[10] Laurent Belsie, "Why States Pass Budgets Despite Rising Political Divide," *The Christian Science Monitor*, July 5, 2017.