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TESTIMONY

FISCAL HEALTH TAX CLIMATE AND BEST PRACTICES FOR BUDGETING

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Pennsylvania Senate Finance Committee and Senate State Government Committee

August 20, 2015

Thank you Chairman Folmer and Chairman Eichelberger for inviting me to testify today on the subject of Pennsylvania's budget and fiscal outlook. The Commonwealth of Pennsylvania has weathered several years of budgetary stress and continues to face near-term difficulty balancing the yearly budget.

Pressures in the form of lower-than-projected revenues, increasing programmatic costs, and demographic changes have been building for many years. Pennsylvania's financials are weak on a short-term and on a long-term basis, partially owing to policy and fiscal choices over the years, and partially because of the wider economy. Three credit ratings agencies—Moody's Investors Service, Fitch Ratings, and Standard & Poor's—downgraded the commonwealth's bond rating in 2014 in response to these trends.

In my recent research, "Ranking the States by Fiscal Condition," Pennsylvania is ranked 41st out of the 50 states. In my testimony I will highlight several areas of fiscal weakness:

1. Poor and deteriorating cash liquidity. Pennsylvania is ranked 45th in the nation for cash solvency.

2. Ongoing difficulty matching revenues and expenses during the fiscal year. Pennsylvania is ranked 39th for budget solvency.

3. Long-run obligations are significant. Pennsylvania is ranked 36th for long-run solvency.

4. Unfunded pension and other postemployment benefits (OPEB) liabilities are a fiscal risk. Pennsylvania is ranked 26th for trust fund solvency.

I will also offer some suggestions for improving the fiscal position of the commonwealth.

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BACKGROUND

Recently I authored a study that ranks the 50 states according to their fiscal condition. The motivation for this study was to devise a tool for policymakers and the public to assess their state's fiscal condition, relative to the other states, based on the audited reports of the state government.

Fiscal condition is made up of five "dimensions" of solvency: cash, budget, long-run, service-level, and trust fund. Each of these dimensions consists of two to three indicators that measure the extent to which a state has sufficient resources to meet short-term and long-term commitments. The data to assess solvency is taken from each state's Comprehensive Annual Financial Report (CAFR) for fiscal year (FY) 2013, the most recent year available when the analysis was performed. This study measures the financial position of the total primary government and includes both governmental activities and business-type activities.

Based on FY 2013 and compared to the other 49 states, Pennsylvania's overall fiscal ranking is 41 with a score of −1.14, which means Pennsylvania's fiscal performance is 1.14 standard deviations below the average performance of the states. This score only provides a measure of relative position. For a better understanding of Pennsylvania's fiscal condition, it is necessary to look at the individual indicators that make up each dimension of solvency.

In the following sections I go through the individual metrics for each dimension of fiscal solvency. In addition to providing the metrics from the FY 2013 study, I updated Pennsylvania's metrics using recently released FY 2014 data to see how things have changed.

1. CASH SOLVENCY

For FY 2013 Pennsylvania ranks 45th for cash solvency. Cash solvency measures the degree to which the state has enough cash on hand to cover short-term bills, which include accounts payable, vouchers, warrants, and short-term debt. The three metrics that make up cash solvency include the cash ratio, quick ratio, and current ratio. The cash ratio only includes the most liquid forms of cash. The quick and current ratios include less liquid forms of cash. A ratio of 2 or greater for any of these metrics is generally considered healthy.

As table 1 shows, Pennsylvania fell short of this standard in FY 2013. A cash ratio of 0.83 indicates that the most liquid forms of cash (cash, cash equivalents, and investments) cover 83 percent of short-term bills. When including receivables, Pennsylvania's liquidity increases, producing a quick ratio of 1.19. The current ratio includes all forms of cash, or current assets. According to this metric, Pennsylvania has 1.48 times the amount of current assets relative to short-term liabilities.

For FY 2014, Pennsylvania's cash position worsened. Each liquidity ratio declined. These metrics signal the immediate risk that in the event of a downturn, the commonwealth will find it difficult to cover short-term bills.

The Management Discussion and Analysis (MD&A) in the CAFR provides context for the individual liquidity metrics. In FY 2013 total cash and investments increased by $1.5 billion.[1] In spite of gains in the most liquid forms of cash for a total of $9.8 billion, short-term liabilities were larger at $11.8 billion resulting in a cash ratio of 0.89. Including receivables boosted the quick ratio to 1.19.

One notable change occurred in FY 2013 that resulted in a current ratio of 1.48. Owing to an increase in federal grants for managed care organizations, governmental activities posted an overall increase of $393 million in FY 2013 for a total of $3 billion in federal grants.[2]

1. This change was largely driven by including the financials for the Commonwealth Financing Authority and the Philadelphia Regional Port under business-type activities. The purpose of the Commonwealth Financing Authority "is to engage in financial assistance in the form of loans, loan guarantees, grants and private equity participating loans to promote the health, safety, employment, business opportunities, economic activity and general welfare of the people of the Commonwealth." See Commonwealth of Pennsylvania, Office of the Budget, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2013*, 22, 34.
2. Ibid., 22.

In FY 2014, all three cash solvency metrics show Pennsylvania's liquidity worsened. The cash ratio fell to 0.75, reflecting a decline in cash and investments. While there were increases in other less liquid assets, short-term liabilities also increased. The MD&A cites increases in mandated spending, in particular for the Department of Health, the Department of Human Services, and medical assistance programs, without a corresponding increase in related net revenues.[3] Another source of increasing liabilities is an increase in corporate tax refunds due to a new computing system, and increased participation and payouts for tuition benefits.[4]

All three liquidity metrics are subpar. The most robust liquidity metric—the current ratio—owes its performance to the presence of federal funds for health care. The liquidity metrics for Pennsylvania in FY 2013 and FY 2014 point to short-term risk for the commonwealth's fiscal position. In the event of a recession, Pennsylvania is in a poor position to meet short-term commitments.

2. BUDGET SOLVENCY

Pennsylvania ranks 39th in budget solvency. This dimension measures whether a state can cover fiscal year spending out of current revenues. It consists of two metrics: the operating ratio, which measures the ratio of total revenues to total expenses; and the surplus or deficit per capita. As table 2 shows, in FY 2013, Pennsylvania's operating ratio of 1.01 indicates that revenues exceeded expenses by 1 percent. This is lower than the national average of 1.07. The commonwealth reported a small surplus of $69 per capita. In FY 2014 Pennsylvania's budget position worsened. An operating ratio of 0.99 reflects an increase in expenses for governmental activities from $58.7 billion to $60.9 billion and a marginal and insufficient increase in revenues from $59.3 billion to $59.5 billion. This negative position is also reflected in a deficit per capita of $55.

Total tax revenues in FY 2013 amounted to $70.1 billion.[5] Total revenues in the General Fund increased in FY 2013, a reflection of improvement in the economy and increased collections in personal and corporate income taxes. While revenues increased, expenditures also grew, largely owing to public education and protection of persons and property.[6] In FY 2014 there was a slight increase in some tax revenues, but also a decline in some federal operating grants (Education and Emergency Services) and the discontinuation of federal American Recovery and Reinvestment Act grants for Military and Veterans Affairs projects.[7]

The budget solvency indicators for FY 2013 and FY 2014 show Pennsylvania is operating on a very tight margin and is struggling to match revenues and expenses. Gains in revenues are outpaced by increases in ongoing spending, in particular for medical assistance programs and public education.[8]

3. LONG-RUN SOLVENCY

Pennsylvania ranks 36th in long-run solvency in FY 2013. Long-run solvency measures whether the state has a hedge against large long-term liabilities. It consists of three metrics: the net asset ratio, which is the ratio of restricted and unrestricted assets relative to total assets; the long-term liability ratio, or the ratio of long-term liabilities to total assets; and the long-term liability per capita. A negative net asset ratio of −0.09 can be interpreted to mean that Pennsylvania may be using deficit or pay-as-you-go finance to cover spending. A long-term liability of 0.41 indicates that long-term liabilities are 41 percent of total assets. This is displayed in table 3.

3. Commonwealth of Pennsylvania, Office of the Budget, *Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2014*, 22.
4. Ibid., 23.
5. Total revenues consists of $31.7 billion in taxes and investment income, $24 billion in operating grants and contributions (e.g., revenue from federal government grants), and $13.5 billion in charges for sales and services such as fees, licenses, permits, and registrations.
6. The largest areas of spending in FY 2013 are health and human services ($30 billion) and public education ($13 billion).
7. CAFR 2014, 25.
8. Ibid.

According to the MD&A, in FY 2013 unrestricted net assets reported a deficit of $8 billion. This deficit reflects increases in expenses for highway and bridges, but is largely due to increases in OPEB liabilities and an increase in the employer share of retirement expenses.[9]

Total liabilities amounted to $35 billion ($1,888 per capita) or 41 percent of total assets in FY 2013. The largest components of long-term liabilities are general obligation bonds payable ($11.2 billion), revenue bonds payable ($4.4 billion), and OPEB ($2.1 billion).[10] In FY 2014 long-term liabilities increased by $367 million, driven by growth in OPEB.[11]

These indicators show that increases in employer costs for pensions and OPEB are contributing to weak long-run indicators.

4. SERVICE-LEVEL SOLVENCY

Pennsylvania ranks 17th for service-level solvency. The most subjective measure of fiscal condition, service-level solvency measures the ratio of total taxes, total revenues, and total expenses to state personal income.[12] According to these metrics, Pennsylvania performs better than average for the states. This is shown in table 4. Total taxes are 5 percent of state personal income in FY 2013. Revenues and expenses each account for 12 percent of total state personal income. These metrics attempt to capture "fiscal slack." These metrics help to determine if there is growth in spending and tax collection relative to the income of residents over time. A very high or increasing level of taxes, revenues, or expenses relative to state personal income is an indicator of stress and the potential for harm to the economy, or an inability to raise revenues to match expenses. These measures cannot help to evaluate the performance of the revenue system. Such an evaluation requires an analysis of Pennsylvania's tax system according to the principles of good tax design: simplicity, transparency, neutrality, stability, broad bases, and low rates.

Total taxes increased in FY 2013 to $31.7 billion or 5 percent of total state personal income.[13] Revenue from other sources include $13.6 billion in charges for sales and services and $24 billion in federal grants, bringing Pennsylvania's total revenues to $70 billion or 12 percent of state personal income.[14] Expenses were slightly less than revenues in FY 2013 at $69 billion or roughly 12 percent of state personal income. In FY 2014, revenues declined slightly for corporate, personal income, and cigarette taxes, with a slight increase in sales, inheritance, realty transfer, and gaming taxes. Intergovernmental grants fell owing to the discontinuation of a high-risk health insurance program and a decline in emergency management grants, Medicare Part D, and early retiree reinsurance rebates. Fees, licenses, and other income also fell.[15] Total expenses increased in FY 2014 in all categories: public education, payments to individuals, personnel, and growth in expansion of managed care organizations. The FY 2014 CAFR notes that increases in pension expenses contributed to the growth of expenditures for public education and protection of persons and property.[16] Two years of service-level solvency metrics show the possibility of a widening gap between revenues and expenses.

9. CAFR 2013, 23.
10. Ibid., 43.
11. CAFR 2014, 23.
12. State personal income measures the economic well-being of state residents and represents the disposable income available for consumption or saving. Disposable income is personal income less personal current taxes. State personal income includes "the sum of wage and salary disbursements, supplements to wages and salaries, proprietors' income with inventory and capital consumption adjustments, rental income of persons with capital consumption adjustments, personal dividend income, personal interest income, and personal current transfer receipts, less contributions for government social insurance." See Department of Commerce, Bureau of Economic Analysis, "Regional Economic Accounts: State Personal Income," http://www.bea.gov/regional/pdf/overview/regional_spi.pdf.
13. The largest sources of tax revenues are personal income ($10.7 billion), sales and use ($9.1 billion), and corporate taxes ($4.7 billion).
14. CAFR 2014, 26.
15. Ibid., 29.
16. Ibid.

5. TRUST FUND SOLVENCY

Pennsylvania ranks 26th for trust fund solvency. Trust fund solvency measures the size of the state's debts including unfunded pension liabilities, OPEB, and total primary government debt. This study calculates unfunded pension liabilities on a guaranteed-to-be-paid basis. In FY 2013 total unfunded pension liabilities amounted to $153 billion on a market valuation basis, thus accounting for 26 percent of state personal income. OPEB totaled $16.27 billion or 3 percent of personal income. Total primary government debt amounted to $17.2 billion or 3 percent of state personal income. These measurements can be seen in tables 5 and 6.

The size of Pennsylvania's unfunded pension obligation and the pressure it places on the state's fiscal health is borne out by these metrics. OPEB, while a relatively small portion of state personal income, is financed on a pay-as-you-go basis, and as the other metrics indicate, is a big driver of the pressure in the near and longer term.

According to the FY 2014, CAFR general obligation debt has grown at an average annual rate of 5.8 percent.[17] The Commonwealth has $11.4 billion in outstanding general obligation bonds issued mainly for capital activities, infrastructure, and water supply and wastewater treatment. Revenue bonds add $4.5 billion to the total primary government debt. These consist of bonds issued by enterprise authorities including the Unemployment Compensation Fund, the Commonwealth Financing Authority, and the Philadelphia Regional Port Authority.[18]

RECOMMENDATIONS FOR IMPROVING PENNSYLVANIA'S FISCAL CONDITION

The 14 metrics that constitute fiscal solvency help to form a general picture of a state's fiscal health. These indicators are broad and basic, and intuitive to interpret. But no single metric, or group of metrics, can definitively assess a state's true fiscal picture. Metrics can flag patterns and point to potential risks but they cannot fully reveal the causes of fiscal stress. A deeper analysis is always required. These metrics, I contend, are much like a patient's vitals: weight, blood pressure, and body temperature. Just like vitals, financial metrics provide a benchmark, but should not be used to make a full diagnosis.

In the case of Pennsylvania, the metrics point to two warning signs: a weakening cash position and the pressure of growing long-term liabilities on current spending. Increasing costs in health care spending and education, some of which are driven by pension costs, are likely to continue over the medium term.

These metrics suggest increased prudence in the management of revenues and in the use of debt. I offer three general recommendations for how Pennsylvania might improve its fiscal outlook over the short term, medium term and long term.

First, improve the state's cash solvency. By three measures of liquidity—the cash ratio, the quick ratio, and the current ratio—Pennsylvania's cash position is weak and worsening. With metrics well below a healthy benchmark of 2 times cash reserves to cover short-term liabilities, these metrics indicate that Pennsylvania is in a poor position to weather a downturn. The state should consider increasing its budgetary reserves via the Budget Stabilization Reserve Fund, the state's rainy day fund. Unfortunately, the fund has been severely weakened over the years by a failure to make deposits, as figure 1 shows.

Currently the rainy day fund has $231,000 remaining. The rule that governs the fund requires that the legislature deposit 25 percent of any fiscal year end surplus in the General Fund. This is reduced to 10 percent where the fund reaches 6 percent of General Fund revenues. Given the ongoing stress in Pennsylvania's budget, this may be a difficult requirement to meet in the near term, but this should be a priority for the state. The deposit and withdrawal rules for Pennsylvania's rainy day fund are relatively strict, though they could be strengthened. Currently, the legislature makes a deposit in the event of a surplus. A stricter rule would require a contribution to the rainy

17. Ibid., 37.
18. Ibid., 103.

day fund if there were positive revenue growth. The most conservative and disciplined rules for rainy day deposits follow a mathematical formula, thus removing legislative discretion from the decision to make a deposit. The current withdrawal rule is relatively strong and allows the legislature to draw down funds with approval via a supermajority vote. This rule could be made stricter by imposing a mathematical formula for withdrawals to limit the possibility of the fund being used for nonemergencies. Pennsylvania could also increase the threshold for contributions for a larger fund balance. The balance should match the likely revenue needs of the state during an average downturn. Forthcoming research from the Mercatus Center at George Mason University estimates balance parameters for each state's rainy day fund to guard against recessions of various sizes.

Second, on a budget basis, Pennsylvania continues to experience difficulty in balancing revenues with expenses—as seen in figure 2. While revenues have improved since the recession, the growth in expenses has outstripped this increase. Largely driven by cost increases in health care programs, public education pensions, and public safety, these pressures speak to both demographic trends and structural drivers in existing programs. Reforms of these spending drivers, coupled with an analysis of the efficiency of the revenue system, may help the state to better match revenues with commitments.

Third, on a long-term basis, there are three areas to highlight in Pennsylvania's fiscal picture. Unfunded pension obligations are large and constitute an ongoing fiscal risk. OPEB is unfunded and growing annually. While overall debt loads are similar to those of other states, the issuance of general obligation debt has increased by 5.8 percent annually since 2008. As fiscal stress grows it is important that debt finance not be used as a "measure of last resort" to solve near-term and medium-term fiscal problems. Pension and public employee benefit reform is necessary. Prudence in the use of debt suggests that bonds should not be issued to cover ongoing spending obligations.

CONCLUDING STATEMENT

Pennsylvania's fiscal condition exhibits a number of red flags: no cash buffer against a recession, increasing costs in health care expenses, pension obligations and other employee benefits, and an increase in the use of debt over the past several years. These red flags speak to the need for better principles of fiscal governance. These include stricter and more conservative rules to bolster the rainy day fund, spending reform, and vigilance in the use of debt. Lawmakers must resist the temptation to mask structural spending drivers with short-term debt or accounting maneuvers.

Thank you for the opportunity to testify today and I am happy to answer any questions.

Table 1. Cash Solvency Metrics

	Cash ratio *(cash + cash equivalents + investments)/current liabilities*	**Quick ratio** *(cash + cash equivalents +investments + receivables)/current liabilities*	**Current ratio** *current assets/current liabilities*
Pennsylvania FY 2013	0.83	1.19	1.48
Pennsylvania FY 2014	0.75	0.92	1.38
National average FY 2013	2.23	3.02	3.37

Source: Unless otherwise stated, source for tables is author's analysis of and calculations based on Commonwealth of Pennsylvania Comprehensive Annual Financial Reports for FY 2013 and FY 2014.

Table 2. Budget Solvency Metrics

	Operating ratio *total revenues/total expenses*	**Surplus per capita** *change in net assets/population*
Pennsylvania FY 2013	1.01	$69
Pennsylvania FY 2014	0.99	−$55
National average FY 2013	1.07	$473

Table 3. Long-Run Solvency Metrics

	Net asset ratio *restricted and unrestricted assets/total assets*	**Long-term liability ratio** *long-term liabilities/total assets*	**Long-term liability per capita** *long-term liabilities/population*
Pennsylvania FY 2013	−0.09	0.41	$1,888
Pennsylvania FY 2014	−0.11	0.42	$1,959
National average FY 2013	0.03	0.40	$2,768

Table 4. Service-Level Solvency Indicators

	Tax to personal income ratio	**Revenues to personal income ratio**	**Expenses to personal income ratio**
Pennsylvania FY 2013	0.05	0.12	0.12
Pennsylvania FY 2014	0.05	0.11	0.12
National average FY 2013	0.06	0.14	0.13

Table 5. Trust Fund Solvency Metrics

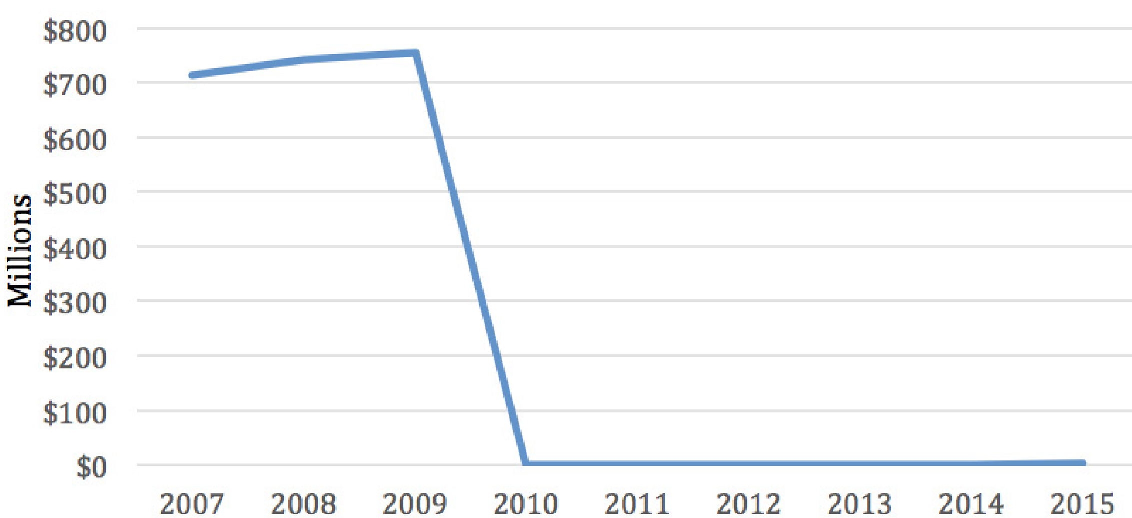
	Pension to personal income ratio	OPEB to personal income ratio	Debt to personal income ratio
Pennsylvania FY 2013	0.26	0.03	0.03
Pennsylvania FY 2014	n/a	0.03	0.03
National average FY 2013	0.29	0.04	0.04

Table 6. Unfunded Pensions, OPEB, and Total Debt Outstanding

	Total unfunded pension obligation (risk-free rate)	OPEB obligation	Total primary government debt outstanding
Pennsylvania FY 2013	$153 billion	$16.2 billion	$17.2 billion
Pennsylvania FY 2014	n/a	$17.3 billion	$17.6 billion
National average FY 2013	$78.7 billion	$10.8 billion	$12.6 billion

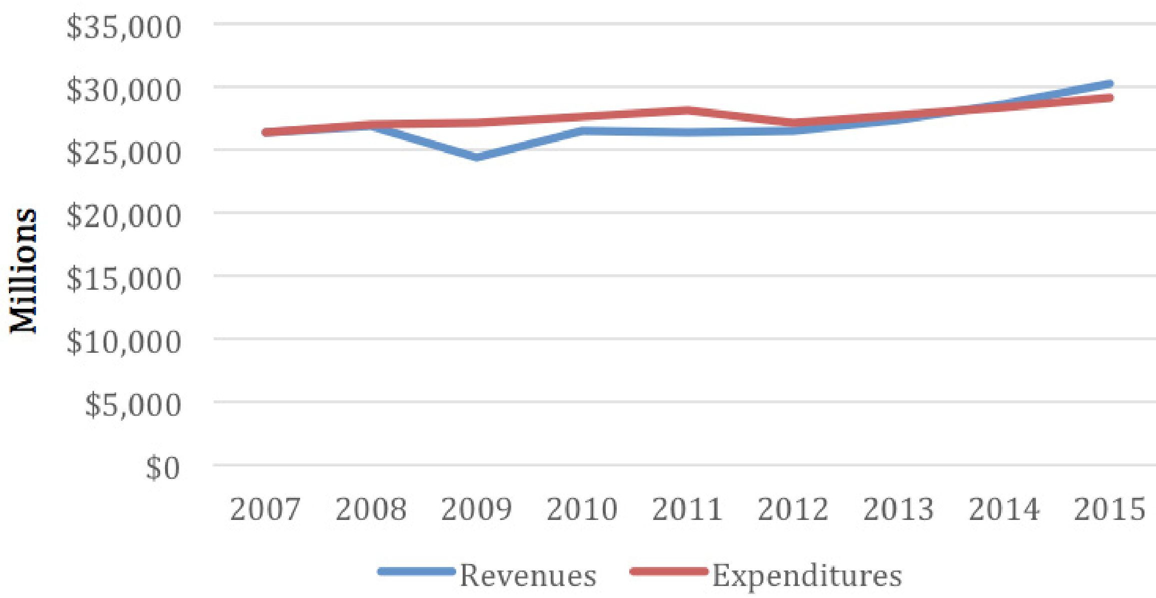
Source: Author's calculations, Commonwealth of Pennsylvania Comprehensive Annual Financial Reports for FY 2013 and FY 2014; Comprehensive Annual Financial Reports for SERS, PSERS and MRS for FY 2013.

Figure 1. Rainy Day Fund Balance



Source: National Association of State Budget Officers (NASBO), "Fiscal Survey of the States," Fall 2014. 2015 data is estimated.

Figure 2. General Fund Trends



Source: NASBO, "Fiscal Survey of the States," Fall 2014. 2015 data is estimated.