

Testimony before the House Appropriations Committee
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Sharon Ward, Pennsylvania Budget and Policy Center

Chairman Evans, Chairman Civera, members of the committee, I am the Director of the Pennsylvania Budget and Policy Center, a non-partisan research and policy organization, which works for a fair tax system and to maintain services vital to the quality of life of all Pennsylvanians. Thank you for the opportunity to testify today on Senate Bill 850.

These are not easy times. The national recession is now the longest in the post-war era. Unemployment in Pennsylvania reached 7.8% in March, surpassing peak unemployment in the 2001 recession and matching the highest unemployment of the 1991 recession. April unemployment numbers, due for release this week will show unemployment continuing to rise. Those counties hardest hit by the recession are the rural manufacturing centers, where unemployment surpasses 10%.

The recession that is devastating Pennsylvania families is reflected in the dramatic decline in state tax revenue, which continues to fall behind projections. State revenue for April fell precipitously, almost \$1 billion below estimate. The current year deficit stands at \$2.5 billion and could surpass \$3 billion by the end of June. Demand for unemployment benefits, Medical Assistance, health insurance, and other safety net services grows, even as the funds available to pay for them diminish.

Conditions are the same across the nation. The Center on Budget and Policy Priorities reported this month that 47 states face budget shortfalls for Fiscal Years 2009 and 2010 totaling \$350 billion. Federal stimulus provides only \$140 billion to help close state deficits, far short of what is needed.

Governors and legislators are looking for budgetary savings, tapping rainy day funds, and increasing revenues to close budget gaps and avoid deep spending cuts. The dilemma is best expressed by the Speaker of the Oregon House of Representatives, who after a budget listening tour of his state concluded that citizens, "rural and urban, liberal and conservative, Republican, Democratic or independent did not want to turn their backs on school children and the most vulnerable."

SB 850 does precisely that. It is a budget that turns its back on school children and Pennsylvania's most vulnerable citizens.

SB 850 includes expenditures of \$27.3 billion for fiscal year 2010, \$1.7 billion less than the budget proposed by the Governor, a budget plan that already includes more than a billion dollars in spending cuts and eliminates more than 100 programs. The Senate plan would allocate only \$24.6 billion in state funds next year, reducing state support to levels not seen since 2005-06.

This plan should put to rest once and for all the myth that state spending can be cut without affecting state services or the people who depend on them. The plan includes cuts in every department from Community and Economic Development and Military and Veterans Affairs, to Agriculture and Aging.

Other speakers will go into more detail on those cuts, so let me just give some brief highlights.

First, SB 850 cuts programs that are jointly funded by state and local governments. For example, library subsidies are cut in half, county court reimbursements are reduced by 10%, and county needs-based budgets for services to abused and neglected children are cut by \$10 million. This continues the practice of shifting costs from the state to local governments and local taxpayers and will inevitably lead to higher property taxes.

The bill cuts the basic education subsidy back to 2005-06 levels and replaces \$711 million in state funds with temporary federal funds that will not be available in two years. Education funding is the state's largest and most important responsibility; this proposal is too much of a gamble. A more prudent approach would insure that state funding levels are adequate, stable and sustainable over time. The Senate plan also keeps education funding at current year levels, even with federal dollars, abandoning the commitment to education reform and school funding adequacy.

Second, SB 850 cuts programs that reach Pennsylvania's most vulnerable citizens. Head Start supplemental funds are cut in half, preventive health screenings for newborns are reduced, and on-site job training for individuals with significant disabilities are cut in half. State funding for legal services is eliminated, which will hurt Pennsylvanians, especially those who find themselves, for the first time, having to navigate the complexity of our safety net programs. Who will write the orders of protection for women fleeing abuse?

Finally, the budget cuts programs that save public dollars in the short run. Programs like Nurse Family Partnerships, Homeowners Emergency Mortgage Assistance (HEMAP) and supplemental payments to SSI recipients reduce reliance on public programs or divert citizens from more costly services.

The Senate budget plan is most notable for what it doesn't do. It rejects \$1 billion in fund transfers and revenue options proposed by the Governor. It leaves the state's \$740 million rainy day fund untouched, and leaves \$714 million in the Health Care Provider Retention Account. The Governor proposed using \$350 million from this surplus to help balance the budget. That plan leaves more than ample funds to keep the commitment to Pennsylvania's health care providers to pay down the unfunded MCARE liability.

SB 850 leaves Pennsylvania as the only state without an excise tax on smokeless tobacco and the only mineral-rich state without a severance tax, a tax which a spokesman for Chesapeake Energy acknowledged his company gladly pays in every state with the exception of New York and Pennsylvania.

The depth of the crisis demands that the Commonwealth spend carefully, and it is not inappropriate to root out inefficiencies and find budget savings where possible. But the Senate plan goes far beyond that.

The simple fact is that this crisis engulfing the states is a result of diminished revenue due to the global economic downturn. The highest-spending states and the lowest-spending states all have budget deficits. This is not a spending problem.

Pennsylvania continues to rank favorably nationally on spending, taxes, and debt levels. We ranked 32nd in state spending as a share of personal income in 2006 and 33rd in state taxes. Debt service payments are 3% of General Fund spending, well below the 10% levels considered acceptable by rating agencies and comparable to levels during the Ridge administration.

We propose a more balanced course of action on the state budget. The budget should first tap the Rainy Day Fund and Health Care Provider Retention Account. The planned phase out of the capital stock and franchise tax should be postponed as it was in 2002 and 2003. The Commonwealth should raise additional revenue. Across the country, 16 states have raised taxes and another 17 states are considering revenue proposals.

There has been concern that raising taxes during a recession can further weaken the economy. Prominent economists challenge that assertion. There is significant evidence that budget cuts are more harmful to state economies during a recession than properly structured tax increases.

Some suggest that Pennsylvania's 1991 tax increase caused permanent damage to the Commonwealth's economy. Pennsylvania was one of 44 states that raised taxes in 1991 and one of 26 states whose economy rebounded well enough to reduce tax rates throughout the decade.

States are using this crisis to reform their tax systems as well as raise revenue. Pennsylvania should consider doing the same. At a minimum, Pennsylvania should close the Delaware tax loophole by implementing combined reporting. The Delaware loophole, transfer pricing, and other tax loopholes allow multi-state companies to move income out of Pennsylvania and further shift the burden of taxation onto Pennsylvania companies. 23 of the 45 states with corporate taxes have enacted combined reporting, and four other states are considering it this year. We should make the system fairer by restoring the corporate minimum tax and adopting a pass-through entity tax to reduce the wide gulf between the corporate net income (CNI) tax rate and the personal income tax rate, paid by non-corporate entities. Yes, the Commonwealth should use some of the revenue from these changes to reduce the top CNI rate. Imagine if Pennsylvania could come through this recession with higher education, economic development and transportation intact, continue to meet its commitment to increase the state share of public school funding, and reduce its corporate rate when the economy turns around.

It is time that we pursue a constitutional change to create a graduated income tax. Pennsylvania has the second lowest top income tax rate of any of the 43 states with income taxes. Under the current system, a middle-class family pays less in taxes in New Jersey than in Pennsylvania.

In the meantime, to meet the fiscal needs created by the current crisis, we should consider raising the personal income tax rate. Expanding eligibility for the special tax forgiveness program could blunt the impact of a PIT rate increase on middle-class families. We could improve the fairness of the current tax system by increasing the tax rate on dividends, capital gains, royalties and other non-wage income. Since most of this income is earned by the top 5% of taxpayers, it would have little effect on most Pennsylvanians.

The Senate plan treats tax credit programs in the same manner as expenditures, and would reduce tax credits by \$250 million. Tax credits need careful scrutiny, better accountability, and should not be overlooked if cuts have to be made.

The actions outlined above, taken together, will help Pennsylvania weather the current storm, protect seniors and our most vulnerable citizens, preserve our commitment to better fund education, and emerge better prepared to help our citizens and businesses compete in the global economy.

Thank you for the opportunity to present our perspective on the budget and I would welcome your questions.