Budget Points

Stimulus Transition Fund Reduces Future Deficits, Preserves Education & Health Care

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The Looming Loss of Federal Recovery Act Funds

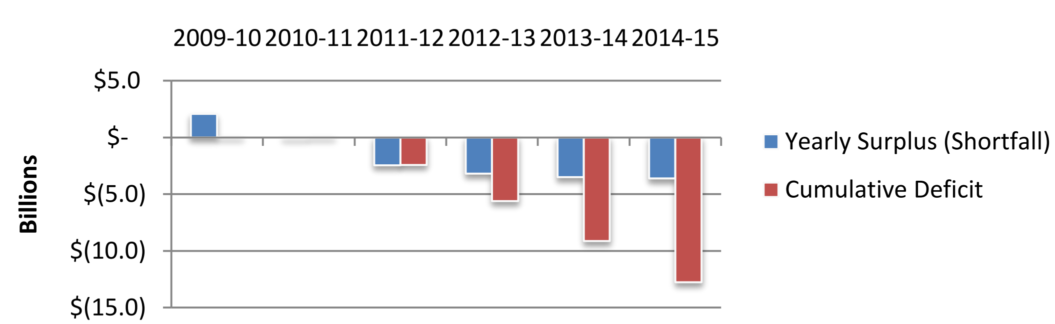
Beginning in 2008, the national recession left states with declining tax revenues and significantly fewer resources to fund education, health care, public safety and services for people affected by the economic downturn. By 2009, 48 states, including Pennsylvania, had significant shortfalls, with the Commonwealth's revenue falling $3.3 billion below budgeted estimates by June 2009.

In February 2009, Congress passed the American Recovery and Reinvestment Act (ARRA). The bill included two programs designed to help states avoid deep service cuts. The State Fiscal Stabilization Fund provides Pennsylvania with $1.9 billion over two fiscal years for basic education, higher education and public safety. ARRA also includes a temporary increase in the Federal Medicaid Matching Percentage (FMAP), providing Pennsylvania with approximately $4 billion over nine quarters beginning in October 2008. For Pennsylvania and other states, ARRA has provided a budgetary lifeline.

Governor Rendell's proposed 2010-11 budget counts on $2.7 billion in ARRA funding to preserve health care, education, and corrections. This includes $921 million in State Fiscal Stabilization Funds and $1.8 billion in increased FMAP funds. (The Governor's budget assumes that federal FMAP funds will be extended for two more quarters, through June 2011. This extension is currently under consideration in Congress.)

Federal ARRA funds will be exhausted by June 2011, opening a $2.7 billion funding gap in the budget. While tax revenues are projected to grow with the expanding economy, the growth is expected to be far short of the receding ARRA dollars. Without additional revenue in place in July 2011, Pennsylvania will be forced to make deep cuts to education, health care, public safety, and the environment.

Figure 1. Deficits Build Without New Revenue



The General Assembly balanced the 2009-10 budget with one-time revenues and transfers from all of the state reserves, including the Rainy Day Fund. Without additional funds, a gap will open up in 2011-12 and quickly mushroom if nothing is done. The Rendell Administration estimates the General Fund could be $12.8 billion out of balance by 2014-15 (Figure 1). This equates to 37% of state General Fund estimated spending that year.

Stimulus Transition Fund Will Help Maintain Services

In February, Governor Rendell proposed the creation of a Stimulus Transition Reserve Fund to replace lost ARRA funding and prevent a large budget shortfall. The Reserve Fund would be financed through a series of new revenue measures. In addition to raising revenue, the proposed changes would:

- Modernize our tax system.
- Increase tax fairness.
- Provide critically needed funding in the coming fiscal years.

The tax changes include:

- Modernizing the sales tax by eliminating exemptions to better reflect today's economy and reducing the overall tax rate.
- Eliminating the antiquated sales tax vendor discount for firms filing timely returns.
- Closing corporate tax loopholes by enacting Combined Reporting.
- Enacting an excise tax on smokeless tobacco and cigars.
- Levying a severance tax on the extraction of natural gas from the Marcellus Shale that underlies much of the Commonwealth.

By the end of 2010-11, the balance of the Reserve Fund is projected to reach $874 million. By 2014-15, these tax changes are expected to generate more than $1.8 billion per year.

How Do the Sales Tax Changes Modernize the System?

The proposed changes to Pennsylvania's sales tax system not only bring it into the 21st Century but also reduce the tax rate across the board, saving Pennsylvania families money on a host of everyday consumer goods currently subject to the tax.

The sales tax in Pennsylvania is largely collected from the purchase of goods, with only a few, select services being taxed. This does not reflect our changing, and increasingly digital, economy. Nationally, the purchase of goods (excluding groceries) has declined from 39% of household consumption in 1970 to 32% in 2007. Over this same time period, the typical household's consumption of services has increased from 31% to 45%. Add to this a whole host of non-staple goods that have been excluded from sales taxation, and the result is clear – an uneven, unpredictable, and unproductive sales tax system.

The Governor is proposing to eliminate 74 current sales tax exemptions, ranging from candy and gum to accounting services, and reduce the tax rate on all taxable goods and services from 6% to 4%.

The Governor's sales tax modernization proposal is projected to generate $532 million in 2010-11.

What is the Sales Tax Vendor Discount and Why Should it Be Repealed?

The sales tax discount gives businesses 1% of the total sales tax collected for complying with the law. Before the age of computers, the discount had more merit, as it cost businesses time and money to gather the information and file the returns. With the widespread computerization of sales and accounting systems, the costs of collecting and remitting sales tax to the Commonwealth have plummeted. Big box retailers are the largest beneficiary of the sales tax discount, which equates to millions of dollars in lost revenue. No other tax filers in Pennsylvania are allowed to keep a portion of the tax for filing on time, and with the sales tax vendor discount, it is the tax collectors – not the customers who pay the tax – who are getting the break.

Eliminating the sales tax discount would increase sales tax collections by $74 million in 2010-11.

Why Should Pennsylvania Close Corporate Tax Loopholes?

Pennsylvania's corporate net income tax system allows multi-state businesses to easily and legally shift Pennsylvania profits to low- or no-tax states, such as Delaware and Nevada, in an effort to avoid paying taxes. Companies often do this by "buying" and "selling" goods and services to related companies at artificial prices that reduce profits in higher taxing states and increase profits in low- or no-tax states. These accounting tricks can become quite complex to help businesses stay one step ahead of taxing authorities.

Pennsylvania, like the majority of other states with corporate income taxes, can adopt Combined Reporting to slam the door on the vast majority of corporate tax avoidance schemes. Combined Reporting would require groups of related corporations to file taxes like they currently operate – as a single taxpayer. Combined Reporting has been around for more than 60 years and is used in many of our neighboring states. The Governor's proposal also permits companies to more freely use operating losses and cuts the corporate income tax rate by 10% – providing a tax reduction to corporations operating solely in Pennsylvania.

Closing corporate loopholes by adopting Combined Reporting would generate $67 million in 2010-11.

Why is an Excise Tax on Cigars and Smokeless Tobacco Necessary?

Pennsylvania is the only state in the U.S. that does not have an excise tax on smokeless tobacco and one of only two, along with Florida, without an excise tax on cigars. States, including Pennsylvania, levy tobacco taxes to discourage use of the products and to help raise money to offset the health costs exacerbated by tobacco products. The Commonwealth is providing an unintended incentive for Pennsylvanians to use cigars and smokeless tobacco by not taxing them like cigarettes. Putting an excise tax on smokeless tobacco and cigars would help make them less affordable to young people and will likely reduce consumption of the goods, improving the health of Pennsylvanians and saving lives.

Adding an excise tax to other tobacco products would generate an additional $42 million in revenue for the Commonwealth in 2010-11.

Why is a Tax on Natural Gas Extraction Good for Pennsylvania?

Pennsylvania is in the midst of a natural gas drilling boom. While the frenzy to tap a non-renewable resource will likely create jobs and generate wealth for landowners, it will also impose environmental and social costs on all Pennsylvanians. Virtually every significant energy-producing state has enacted severance taxes to help repay state and local governments, and their citizens, for costs generated by energy extraction.

Pennsylvania has a long and mixed history with resource extraction – from timber, to oil, to coal – and taxpayers have had to foot the bill for replanting forests, plugging abandoned wells, and treating acid mine drainage. Enacting a severance tax now, at the beginning of the boom, will ensure that all companies that benefit from the natural gas extraction pay their fair share for the environmental damage and social costs that will be incurred.

The Rendell Administration estimates that enactment of a severance tax on natural gas extraction at the same rates as in neighboring West Virginia would generate $161 million in 2010-11.

The Pennsylvania Budget and Policy Center is a non-partisan policy research project that provides independent, credible analysis on state tax, budget and related policy matters, with attention to the impact of policies on working families.