Testimony of Michael Wood, Research Director, Pennsylvania Budget and Policy Center

Before the Pennsylvania Senate Appropriations Committee
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Chairman Armstrong, Chairman Lavalle, members of the Committee thank you for the opportunity to testify today. I am here on behalf of the Pennsylvania Budget and Policy Center. We are a relatively new policy research organization whose mission is to disseminate information and promote policies that support revenue adequacy, more progressive state and local taxes, and services that benefit low- and middle-income Pennsylvanians.

I want to commend you for providing this forum and your willingness to consider diverse points of view as you grapple with the challenge of balancing the Commonwealth's pressing needs, in health care, education, transportation and economic development with its ability support those needs, over the long term, in an equitable manner. I hope that these comments and those of my fellow presenters will clarify rather that cloud the choices before you.

Much of the early discussion of the Governors proposed budget for fiscal Year 2007-08 has centered on both the ambition of the agenda and the funding sources that are required to support new initiatives in health care, prekindergarten, education, energy and economic development. The budget sets forth a series of priorities that we believe are vital to Pennsylvanians quality of life and necessary if Pennsylvania is to successfully navigate the demands of increased national and international competition.

Let me start with some general observations about state spending levels and fiscal trends over the past few years. Some members of the General Assembly have expressed concerns over spending growth and wish to limit, whether by legislation or through the budget process, annual increases in state spending. Yet a historical look at the state budget and a comparative look across the states suggest that concerns over state spending may be exaggerated. Let us put your fears to rest. There is in fact room for the Commonwealth to support strategic investments and meet the challenges ahead.

Pennsylvania is not a high spending state. It is the sixth largest state in the nation, but consistently falls in the middle of the pack in terms of per capita spending, ranking between 22nd and 25th in per capita state spending over four administrations, according to data from the US Census.

You will hear, today perhaps and throughout the year that state spending is rising at unacceptable and unsupportable levels. We would argue instead that state spending has been remarkably steady over time when measured against overall growth in the economy, is lower than the national average, and has room to grow through policies that broaden the base rather than raise the rates.

To track spending over time and across jurisdictions, economists look at government spending a share of personal income. Using this yardstick, Pennsylvania's spending growth has remained essentially flat for more than 20 years. It consumes about the same share of economic growth today as it did when Ronald Reagan was President. In Pennsylvania state spending mirrors growth in the economy, but doesn't exceed it. In 2006-07, it is important to note, state General Fund spending as a share of the economy is less than the national average of 5.8%.

While Pennsylvania's spending trends have mirrored those of other states over the past few years its path has been more steady and less volatile. During the recession, revenues declined and General Fund spending declined in real dollars, even as Medicaid caseloads swelled. When the economy began to recover and revenues grew, Pennsylvania, like other states, was able to restore cuts made during the recession, and to begin to make up for lost purchasing power with healthy increases in education, human services and other programs. However, having chosen modest tax cuts and rebates in the 1990's the Commonwealth was able to avoid the severe budget cuts and more significant revenue enhancers required by other states to fill the budget hole. And in each of the past two years of rapidly increasing revenues, spend growth was lower than the national average.

A few short observations about the proposed spending plan.

A budget is about priorities and we concur with vision of the future that the Governor has laid out in this budget. I would urge you, in your budget deliberations to consider proposed taxes and fees in the context of the particular services and investments they are intended to support.

The state does have a structural budget deficit that the General Assembly will need to address. It is due in part to a significant loss of Federal funding, most notably the phase out of county IGT funds, and in some part to rising Medicaid enrollments, again a national phenomenon, though one that is greatly exacerbated by Pennsylvania's higher spending for seniors and for nursing home care. But it is also due to the phase out in the Capitol Stock and Franchise tax, which will remove approximately $1.2 billion in revenue annually by 2010 and cost almost $200 million in revenue this year. The General Assembly made no plan to replace this revenue and it is a significant drain on the budget.

Health care is a critical concern to Pennsylvanians, who are understandably worried that they may lose their insurance coverage, or that it will become unaffordable, or that they will pay ever higher premiums for less comprehensive insurance plans. Four states, Massachusetts, Maine, New York and Vermont have already forged a path toward broader and more affordable coverage, using the same public-private partnership model that Governor Rendell has proposed, and experimenting with methods to cover the uninsured and reduce system costs through participation mandates, for individuals and employers. The Prescription for Pennsylvania is part of the second wave of state plans, which place greater emphasis on cost containment and disease management and make greater use of so-called pay or play employer mandates.

There are three features to the plan we would like to highlight. First, the insurance reform components, including rate bands and higher stop loss ratios are critical to expanding access and reducing costs in the small group market. Second, the proposed increases in the cigarette tax and tax on other tobacco products are reasonable vehicles to raise revenue to expand health insurance coverage. Raising these taxes provides revenue but has a documented effect in reducing usage, especially among young people. Finally, the plan tackles the high system and social cost of the uninsured, and includes both incentives, through the CAP program and greater insurance rate regulation, and mandates to bring everyone into the market. The pay or play payroll tax should be viewed, not as a punitive measure, but as a method to reduce the economic incentive for employers to opt out of health care coverage for their workers.

Transportation. Transportation is key to the state's economic health regardless of its location or modality. Discussions that divide the state into rural or urban, road or mass transit are out of date, counterproductive and unacceptable in a modern economy. The state has to move goods and to move people. The reality is that counties served by mass transit contribute a great deal to the state's tax revenue and are vital to our economic future. New business in Allentown and Morrisville generate demand for goods that help support the state's burgeoning warehouse industry along I-81. Tax revenue from a suburban Philadelphia transit rider helps to keep down tuition at Penn State Mont Alto. We are all in this together.

The Governor has proposed some unorthodox funding sources to address the transportation crisis. We urge you to review turnpike lease with caution, as experience in other venues has been mixed. The Indiana and Chicago leases where for much smaller amounts, and Indiana's plan remains both controversial and unpopular. The promised billions don't come for free. Private operators are likely to raise tolls and when prices increase traffic may be diverted to secondary roads. Pennsylvania should explore options over which it has control before agreeing to a turnpike lease. Federal law gives states greater ability to toll existing highways which is perhaps better strategy in the long run. In 2005, the Pennsylvania Turnpike Commission received more than $570 million in toll revenue; it is likely that tolling other roads could raise comparable amounts.

The proposed Oil Company Gross Profits tax should not be dismissed out of hand as a funding source for transportation. Similar proposals have been recently considered in California, Wisconsin, and Maryland. Taxing companies on a combined reporting basis is a common state tax feature and the prohibition of passing this tax onto consumers has been found to be valid by the US Supreme Court. The enforcement of this aspect of the tax may prove difficult to administer, particularly with no additional funding being provided to the Attorney General's Office. Nonetheless, this tax provides a worthy alternative to directly laying it at the feet of consumers in the form of higher gas taxes.

We offer two suggestions: The current plan would provide significant increases state funds for both transit and roads and bridges, increases that may be hard to absorb in one year. The legislature may want to consider phasing in the increased spending over two or three years. Second, the legislature should consider using debt rather than operating funds for at least a portion of bridge and transit capitol improvements.

Finally, we are not opposed to increased spending to support these and other initiatives, but we are deeply troubled with the funding mechanism. A penny increase in the sales tax is among the most regressive ways to raise revenue and certainly the least acceptable option to fund property tax relief. Pennsylvania's tax structure is already highly regressive and frankly its property taxes for most, across the board are not that high.

What we do have is a narrow and incomplete tax base. Before increasing rates, the General Assembly must give serious consideration to broadening the tax base, for individuals and businesses. Tax base broadening raises revenue to be sure, but equally importantly, it makes the tax system more fair and eliminates competitive advantages that some industries and some individuals enjoy.

The House engaged in a healthy discussion last year about broadening the sales tax base. If Pennsylvania expanded the sales tax to all services currently exempt, revenue would essentially double. A more incremental approach could be considered. For example, if sales tax were added to gum, candy, and non-prescription drugs, the Commonwealth could raise about $120 million. Careful addition of some services would bring in additional revenue to support property tax relief and would allow for more robust revenue growth over time.

We believe the time has come to close corporate tax loopholes and enact mandatory unitary combined reporting. 19 states require combined reporting and the governors of four other states have included it in their budget proposals. The West Virginia legislature adopted combined reporting in its session that concluded this week. There is a renewed movement across the county to reign in some of the egregious tax avoidance strategies that have been developed and Pennsylvania should not be left standing on the sidelines.

Moreover, these tax loopholes smack of the kind of favoritism and undue political influence that state lawmakers would do well to avoid. Try explaining to a constituent the reason that sales tax should be charged on software purchased at Staples, but not online. That companies that can shelter income in offshore subsidiaries should be allowed to, when local mom and pop stores cannot.

The Governor's Business Tax Reform Commission recommended a revenue neutral approach to tax loopholes and mandatory combined reporting and we don't oppose this approach. A phase-in of business tax rate reduction might raise some revenue in the first year or two that could be used to fill the budget gap.

A final word about property tax relief. We would strongly urge you to move away from across the board tax relief and to enact, as most states do, income-based tax relief through the use of the circuit breaker program. This approach allows for higher rebates to those who really need the help. An analysis of a Pennsylvania circuit breaker program, prepared at our request by the Institute for Taxation and Economic Policy, which would replace the current program and offer rebates to individuals (homeowners and renters) earning up to $50,000 who spent more than 5% of their income in taxes, would provide rebates of between $775 and $855 per year for about $1.3 billion. It is something to consider and we would be happy to discuss it with you in more detail at a later date.

Thank you again for this opportunity.

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Founded in 2005, The Pennsylvania Budget and Policy Center (PBPC), is a nonpartisan, statewide policy research project that provides independent, credible analysis on state tax, budget, and related policy matters, with attention to the impact of current or proposed policies on working families. The Budget and Policy Center analyzes and disseminates information on short-term budget, policy and revenue proposals as well as long-term trends and challenges. The Pennsylvania Budget and Policy Center participates in a national network of similar organizations that exist in over half the states as part of the State Fiscal Analysis Initiative coordinated by the Washington, DC-based Center on Budget and Policy Priorities. PBPC is a project of the Keystone Research Center.

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