ANNUAL REPORT 2012

A Citizen's Guide To the State of The States

PENNSYLVANIA

THE STATE OF THE STATES

EXECUTIVE SUMMARY

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PRODUCED BY

John F. Kennedy School of Government
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AEF AMERICAN EDUCATION FOUNDATION

Fels Institute of Government
UNIVERSITY of PENNSYLVANIA

Dear Citizens of the State of Pennsylvania,

2012

We are pleased to present to you the Annual Report of Pennsylvania 2012, a joint venture of the University of Pennsylvania's Fels Institute of Government, Harvard University's Institute of Politics at the Kennedy School, and the American Education Foundation for the fiscal year ending June 30, 2011, the last year for which data is available. The data in this report were drawn from Pennsylvannia's Comprehensive Annual Financial Reports ("CAFRs") from 2002 to 2011, FY 2012 and FY 2013 state budgets, the 2010 United States Census, and other official data sets and reports that we have found to be reliable sources on state finance.

This report was designed to synthesize the complicated financial information available from many sources into one easy-to-read document that can provide context and create a comprehensive analysis of trends in state government finance. We believe that citizens deserve to know "the state of the state" and we hope that our report will help inform you about the basics of state finance and the challenges that lie ahead. We did our best to ensure that this report reflects a nonpartisan analysis of the state's fiscal health. With all the politics and noise surrounding budgeting and state financial planning, we believe that this neutral perspective is vital when assessing budgets.

We begin the report by looking at basic demographic and financial information about the state to provide a snapshot of Pennsylvania's financial position. The report then moves on to discuss key budget topics that we believe are crucial to understanding financial trends: health care, education, and pensions.

We hope that this document is both an informative and useful guide for understanding the many challenges that Pennsylvania faces. To find out more about the States Project and how you can get involved, please visit our website at http://www.thestatesproject.org.

Sincerely,

Meredith Bagby
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{ executive summary }

OVERVIEW

Across the country, states are grappling with difficult fiscal issues. The financial crisis of 2008 and subsequent years of stagnant economic growth have brought state finances to a near critical condition. As tax revenue fell, the country saw mass layoffs of state workers, from teachers to police officers to judiciary employees. Nevertheless, the demand for public services continued to increase. A stagnant economy sent more Americans toward public programs like unemployment insurance and Medicaid. Health care costs swelled and our educational capacity was stretched. Infrastructure, including government buildings, schools, roads, and bridges, continued to suffer with little funding left for repair. In 2009, the federal government stepped in with much needed stimulus for the states, but those funds will expire in FY 2012, leaving states with even bigger deficits to fill, despite an improving economy.

"The state of Pennsylvania suffers from many of the same issues that plague other states: underfunded pensions, high health care costs, stretched educational resources, and stagnating revenues."

The state of Pennsylvania suffers from many of the same issues that plague other states: underfunded pensions, high health care costs, stretched educational resources, and stagnating revenues. Though Pennsylvania's unemployment rate is below the national average, the manufacturing sector is in a state of extended decline, and rural areas of the state are losing population as young people seek out opportunities elsewhere. The state is also one of the oldest in the nation, and all signs indicate that the commonwealth is only getting older — posing further problems for an economy that is sputtering and a system of public benefits, including Medicaid, pensions, and other post-employment benefits for public employees, that is stretched to the limit. Though policymakers have sought to address some of these issues by trimming budget deficits and reforming the state's public employee pension system, the fact that Pennsylvania's debt bonds have already been downgraded by all the major credit agencies indicates that the state's reforms are not nearly enough to put the state on solid financial ground.

REVENUES AND EXPENDITURES

The state collected $72.7 billion in revenues in FY 2011 primarily through operating grants, taxes, and charges for sales and services. Operating grants and contributions from the federal government made up 43% of the state's revenues in FY 2011, more than any other revenue source. The state spent a total of $72.4 billion in FY 2011.[1] After five straight years of spending increases,

1 Pennsylvania CAFR 2011.

expenditures as a whole decreased by $2.5 billion, or 3.3%, between FY 2010 and FY 2011, largely due to a decrease in unemployment compensation expenses.

In FY 2011, Pennsylvania reported a surplus, which is a significant improvement from the previous year's $1.5 billion deficit. This net surplus was due to a drop in expenses — most notably unemployment insurance — as well as modest increases in revenues from taxes, including a 3.8% gain in income taxes and a notable 7.8% gain in corporate income taxes. While numbers are still being finalized, FY 2012 looks to have been a more difficult year for the state than FY 2011. Pennsylvania is set to end FY 2012 with a $162.8 million deficit due to tax revenue coming in 0.6% lower than expected, [2] largely because corporate tax revenue fell short.[3]

"Because of the state's high debt as well as its high level of unfunded liabilities in its pension and health care systems, Moody's downgraded Pennsylvania's credit rating from Aa1 to Aa2. Standard & Poor's and Fitch followed suit."

NET WORTH, ASSETS AND LIABILITIES

According to the State Comptroller, in FY 2011 Pennsylvania had a positive net worth of $22.7 billion. The state's net worth is calculated by taking the difference between the state's total assets ($54 billion) and total liabilities ($31.3 billion). Using a broader a measure of liabilities as calculated by the U.S. Census Bureau, the state debt for Pennsylvania was close to $45 billion, or $3,533 per capita. Because of the state's high debt as well as its high level of unfunded liabilities in its pension and health care systems, Moody's downgraded Pennsylvania's credit rating from Aa1 to Aa2. Standard & Poor's and Fitch followed suit. Though the state has taken some steps to improve its creditworthiness, Pennsylvania has a long way to go to reach sound fiscal footing.

DEMOGRAPHICS

Pennsylvania's total population is 12.7 million, making Pennsylvania the sixth most populous state in the nation.[4] However, like many states in the eastern United States, Pennsylvania has experienced slow population growth in recent years. Between 2000 and 2010, the total population of the United States grew by 9.7%. Pennsylvania's population, on the other hand, grew only 3.4%.[5] This slow growth is due in part to an exodus of young people from the rural counties, a trend that has also led Pennsylvania to rank as the second-oldest state in the nation. The median household

2 Thomson Reuters. "Pennsylvania deficit was $162.8 mln in fiscal 2012." [http://www.reuters.com/article/2012/07/03/pennsylvania-deficit-idUSL2E8I3F4W20120703]. July 3, 2012.

3 Pennsylvania Budget and Policy Center. "Revenue Tracker: Tax Revenues Up Over Last Year, But Corporate Collections Disappoint." Jan 12, 2012. [http://pennbpc.org/revenue-tracker-12-2011].

4 "United States Census Bureau. "2010 Census Interactive Population Search." [http://2010.census.gov/2010census/popmap/ipmtext.php?fl=34].

5 "Population Distribution and Change: 2000 to 2010." United States Census Bureau. Page 2. [http://www.census.gov/prod/cen2010/briefs/c2010br-01.pdf].

income is $50,398, slightly below the national average of $51,914. As of July 2012, the state had an unemployment rate of 7.9%, below the national average of 8.3% in the same month.[6]

HEALTH CARE

As in many states, health care is Pennsylvania's biggest expense. In FY 2011, total spending on Health and Human Services was $30.4 billion, or nearly 42% of total spending.[7] Health and Human Services receives twice as much as education, the second largest state expenditure. While health care costs in Pennsylvania have grown more slowly than in other states, the state has higher health spending per capita ($7,730 vs. $6,815) than the rest of the nation.[8]

"The Great Recession and the retirement of Baby Boomers have driven up the costs associated with funding public health programs such as Medicaid, but the federal government has borne most of the cost increases."

The Great Recession and the retirement of Baby Boomers have driven up the costs associated with funding public health programs such as Medicaid, but the federal government has borne most of the cost increases. In 2008, the state covered 46% of Medicaid spending, or $7.4 billion. By 2009, however, the state was covering only 36% of Medicaid spending, or $6.2 billion. Still, Medicaid currently comprises nearly one-quarter of the state budget. By some accounts, if current policies remain, Medicaid could account for over 90% of the state budget by 2075.[9]

EDUCATION

In FY 2011, Pennsylvania spent $14.9 billion on public education (20.5% of the state budget), making public education the second largest area of state spending. In recent years, public education spending has grown relatively slowly, from $14 billion in FY 2009 to $14.9 in FY 2011. Education spending as a percentage of the state budget has remained relatively constant, at around 20%.[10] At $15,612 per pupil, Pennsylvania spends well above the national average of $12,306.[11] School districts in Pennsylvania rely more heavily on local property taxes for funding than state or federal funding.[12] Pennsylvania ranks 42nd among the 50 states in the percentage of public school costs that are funded by the state versus localities.

6 Bureau of Labor Statistics. [www.bls.gov].
7 PA CAFR 2011, page 48.
8 "Pennsylvania." Kaiser Family Foundation. [http://www.statehealthfacts.org/profileglance.jsp?rgn=40] and "Pennsylvania: Medicare Spending." Kaiser Family Foundation. [http://www.statehealthfacts.org/profileind.jsp?cat=6&sub=72&rgn=40].
9 Policy Points. "Pennsylvania Welfare Spending & Medicaid." [www.commonwealthfoundation.org. Commonwealth Foundation]. [http://www.commonwealthfoundation.org/research/detail/pennsylvania-welfare-spending-medicaid]. May 20, 2011.
10 Pennsylvania CAFR 2009, 42; and Pennsylvania CAFR 2010, 46.
11 "Public Education Finances: 2010." The United States Census Bureau. [http://www2.census.gov/govs/school/10f33pub.pdf]. Page 11.
12 Ibid.

"Pennsylvania ranks 42nd among the 50 states in the percentage of public school costs that are funded by the state."

Higher education in Pennsylvania is housed within the Office of the Secretary of Education. There are fourteen universities in the Pennsylvania State System, along with four state-related universities and sixteen community colleges. The budgets of higher education institutions have been cut in recent years and, as a result, students have seen their tuition skyrocket to make up for the loss of funds. According to the Project on Student Debt, 70% of Pennsylvania's higher education students graduate with debt, the sixth-highest percentage in the country.

PENSIONS

In Pennsylvania, there are three separate pension systems for retired public employees. The largest pension fund — the Public School Employees' Retirement System (PSERS) — serves over 600,000 members (all current or retired public school workers or their beneficiaries). The fund's funded ratio — the ratio of the net assets to its net liabilities — has suffered in the years since 2008 and is now considered "underfunded" with a fund ratio below 75%.[13] The second largest public employee pension system in Pennsylvania is the State Employees' Retirement System (SERS), which serves over 200,000 retirees, workers, and beneficiaries.[14] At the end of 2011, the fund reported serious underfunding with a funded ratio of just 65.3%.[15]

"By early 2012, however, state leaders acknowledged that the 2010 pension reforms were not enough to solve the state's pension crisis."

Major pension reform, passed in November 2010, included reducing retirement benefits for new employees, mandating an "actuarial fresh start," and capping future employer contribution increases. In the long term, legislators hope that these changes will help bring the state's unfunded pension liabilities under control.[16] As a result of the reform, the state's portion of the pension obligation will increase dramatically. The FY 2012 budget calls for $1.1 billion in pension payments, but by FY 2016 this figure will increase to more than $4 billion annually.[17] By early 2012, however, state leaders acknowledged that the 2010 pension reforms were not enough to solve the state's pension crisis.

13 Pennsylvania PSERS CAFR 2011, 28.
14 Pennsylvania State Employees' Retirement System (SERS) CAFR 2011, iii.
15 Pennsylvania SERS CAFR, iii.
16 Pennsylvania SERS CAFR 2011, iii-iv.
17 Olson, Laura. "Gov. Corbett adds pension reform to budget agenda." Pittsburgh Post-Gazette. [http://www.post-gazette.com/stories/local/state/gov-corbett-adds-pension-reform-to-budget-agenda-636794/].

THE FUTURE

The state's FY 2013 budget provides an indication of the course Pennsylvania will chart. Governor Corbett signed the $27.7 billion budget into law on June 30, 2012. The governor said his budget prioritizes economic growth, education, and human services, while containing spending. Spending will increase by only 1.7% over the FY 2011 budget. The budget also includes no new taxes or tax increases. Critics argue that the budget contains too little spending for public education (still down from FY 2011 levels) and health and human services. Given that the Federal Reserve predicts two more years of slow national economic growth and that federal stimulus has ended, it is unlikely that Pennsylvania will restore these cuts anytime soon. ★

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INSTITUTE OF POLITICS AT HARVARD UNIVERSITY
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