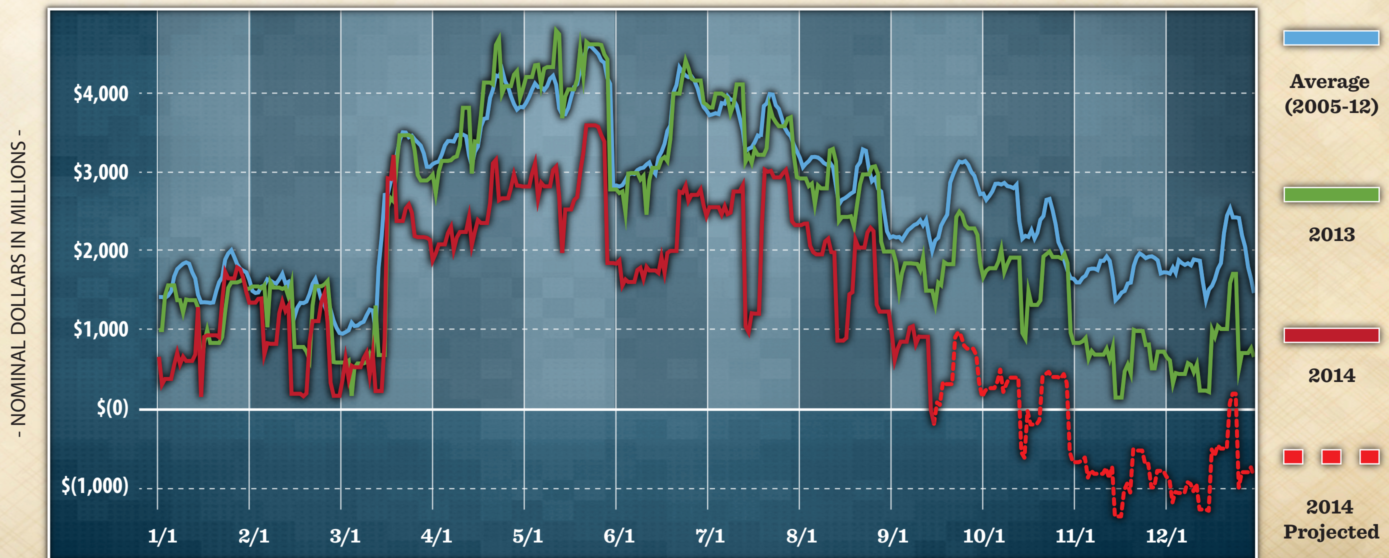
September 16, 2014

THE McCord Report

A look at Pennsylvania's economic vital signs.

General Fund Balance

The General Fund essentially serves as the state's primary checking account. Most revenues are deposited into the General Fund, and most operating expenses are paid from it. In recent years, cuts to certain categories of taxes have led to lower revenues and a persistent structural deficit. The resulting mismatch between incoming revenues and outgoing expenditures has resulted in lower General Fund balances this year than at the same time in previous years. This chart shows that, compared to the average of recent prior years, the General Fund's balance began to deteriorate sharply in 2013 and has been even lower in 2014 to this point. On September 15th, the General Fund balance became briefly negative, leading the Commonwealth to draw $700 million dollars under a line of credit Treasury established for it in anticipation of this need.



Source: Pennsylvania Treasury Department

A Message from Pennsylvania State Treasurer Rob McCord

Last year, the Independent Fiscal Office warned of structural deficits through fiscal year 2018-19 -- unless our state implements substantial fiscal policy reforms. This week, we received another large indication of that structural imbalance when the state's General Fund balance reached a 10-year low. Alarmingly, the General Fund balance dropped below zero in September, a 10-year historical low for this time of year, resulting in a $700 million draw on a Treasury-provided line of credit.

As a result of this low balance, Pennsylvania is now compelled to borrow unusually early in the fiscal year just to pay its bills. Rather than having the administration issue a tax anticipation note (a loan from financial markets), I approved a $1.5 billion line of credit from Treasury to the commonwealth after consulting with Auditor General Eugene DePasquale. While this line of credit is an innovative and low-cost means of addressing Pennsylvania's current cash-flow difficulties, it is not a long-term fix to the larger chronic budget problem that plagues our state and threatens our long-term economic health.

This edition of The McCord Report examines Pennsylvania's structural deficit -- from its origins to its current status and its consequences -- and compares Pennsylvania's fiscal health to that of neighboring states.

Sincerely,

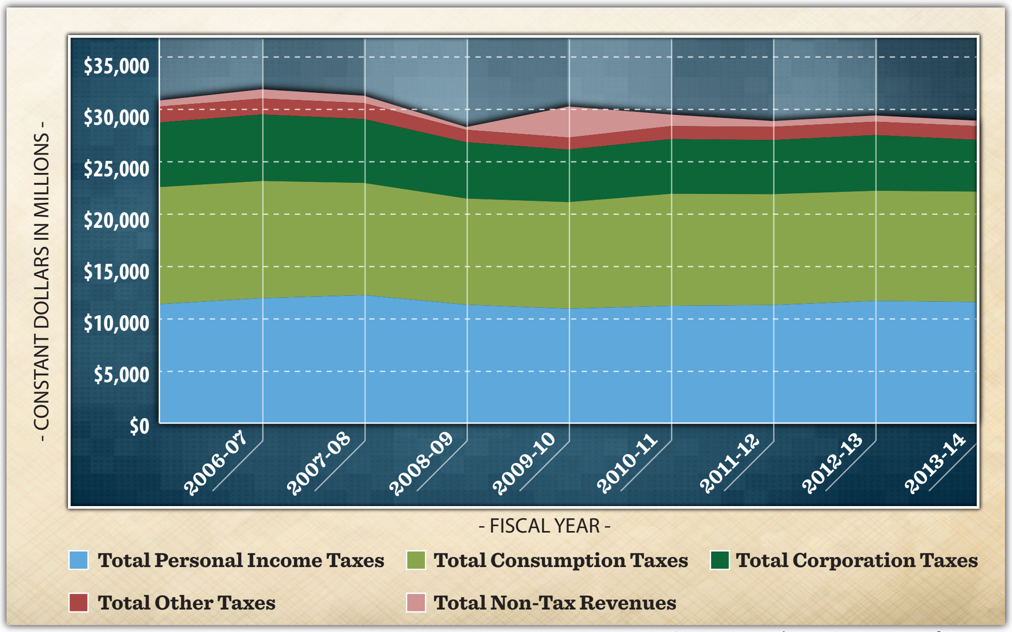
Rob McCord
State Treasurer

PENNSYLVANIA TREASURY
Earn. Learn. Invest.

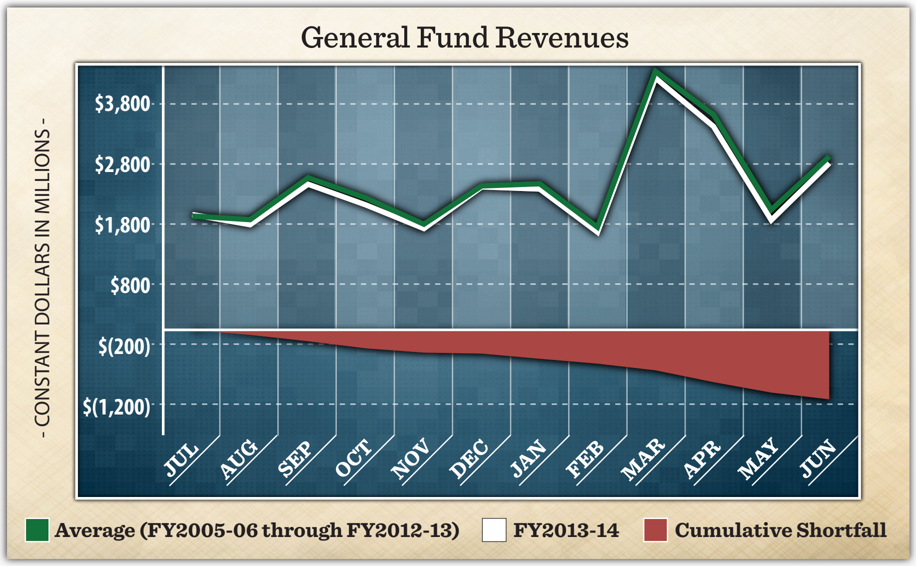
As always, we welcome your feedback, questions, and suggestions for future topics. Please do write to us at McCordReport@patreasury.gov.

Sources of General Fund Revenues

Over the last eight years, General Fund revenues have fallen by approximately 9.42% on an inflation-adjusted basis. While revenues have bounced back slightly from the low level reached during the Great Recession, they have still not fully recovered to pre-recession levels. During the same period, the composition of revenue sources also changed, as the General Fund has come to rely more on income taxes and less on corporate and business taxes. The chart at right illustrates the composition of General Fund revenues by major categories.



Source: Pennsylvania Department of Revenue



Source: Pennsylvania Department of Revenue

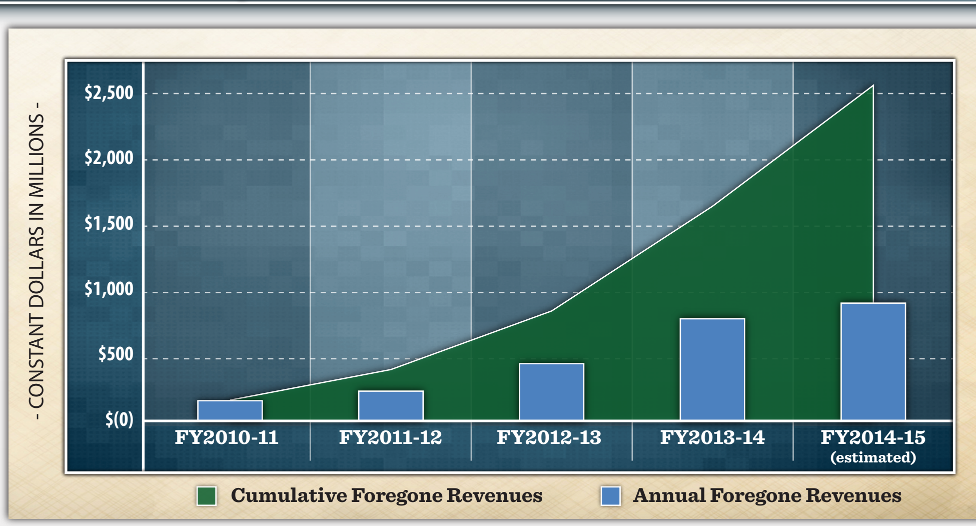
Share of Total General Fund Revenues

FISCAL YEAR	FY2005-06	FY2013-14	CHANGE
Non-Tax Revenues	1.9%	1.8%	-0.1%
Other Taxes	5.0%	4.6%	-0.4%
Corporation Taxes	20.0%	17.1%	-2.9%
Consumption Taxes	36.3%	36.6%	0.3%
Personal Income Taxes	36.8%	40.0%	3.2%

Adjusted for inflation, last fiscal year's General Fund revenues were sharply lower than prior fiscal years. Adjusted General Fund revenues were approximately $1.2 billion lower in FY 2013-14 compared to average inflation-adjusted revenues for the prior eight fiscal years.

Potential Revenues from 5% Severance Tax

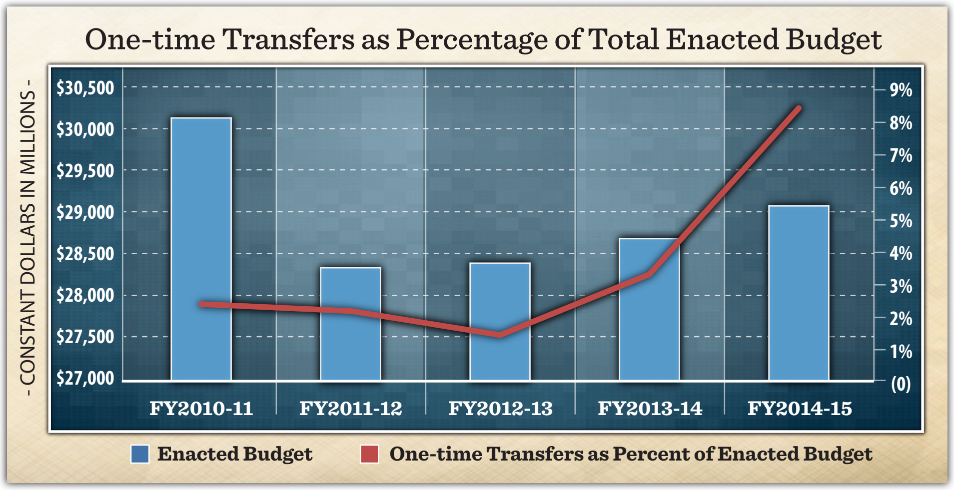
Pennsylvania remains one of the only states in the country that does not impose a severance tax on oil and natural gas extraction. Based on gas production figures reported to DEP for the last four fiscal years and average natural gas prices over that period, a 5% severance tax would have yielded $1.6 billion in revenue since fiscal year 2010-11. Additionally, using current NYMEX futures prices, another $900 million in revenue will be foregone in FY2014-15, making for a total of $2.5 billion in lost potential revenue.



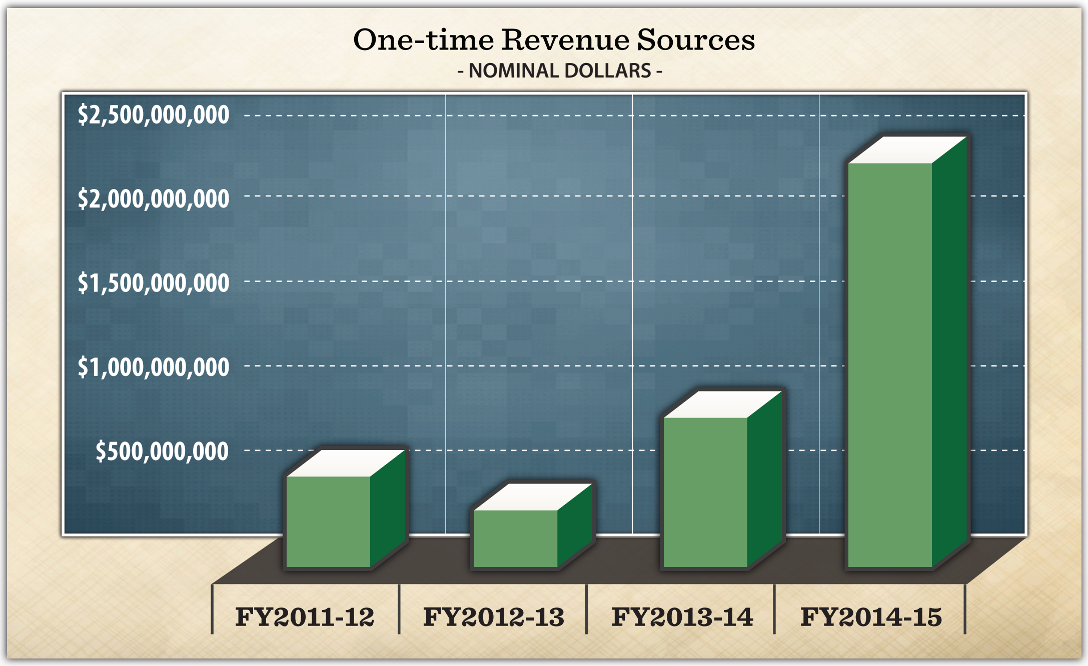
Sources: Pennsylvania Department of Environmental Protection, New York Mercantile Exchange, US Energy Information Administration

Tax Cuts and One-Time Budget Transfers

Though the total enacted budget fell sharply in fiscal year 2011-12 on an inflation-adjusted basis, lower revenues still created a structural deficit. This gap between revenues and expenditures was initially closed by utilizing federal dollars from the American Recovery and Reinvestment Act. Since 2012, however, the Commonwealth has increasingly relied on transfers from special funds to the General Fund. While these transfers from funds such as the Motor License Fund and the Oil Gas and Lease Fund may resolve short-term budget deficits, they deplete and jeopardize dedicated resources for other state projects.



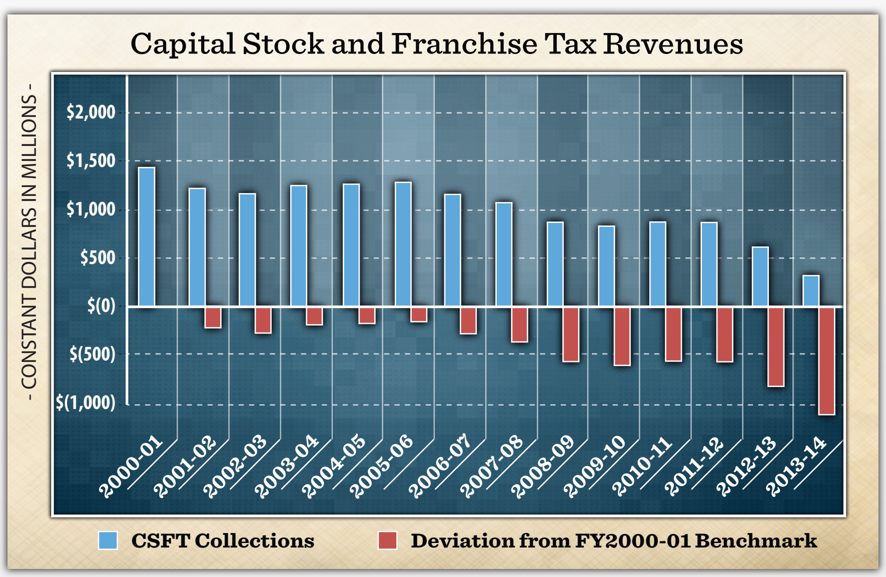
Source: Pennsylvania Office of the Budget



Source: Pennsylvania Treasury Department

This chart shows, in nominal dollars, the dramatically increasing reliance upon Special Funds transfers to prop up shortfalls in the General Fund in the last three fiscal years. Slightly less than $400 million in transfers in fiscal year 2012-13 more than doubled to over $900 million in 2013-14, and then more than doubled again to over $2.4 billion in the current fiscal year. These large gross amounts can conceal transfers that have real economic impacts on programs deprived of funds.

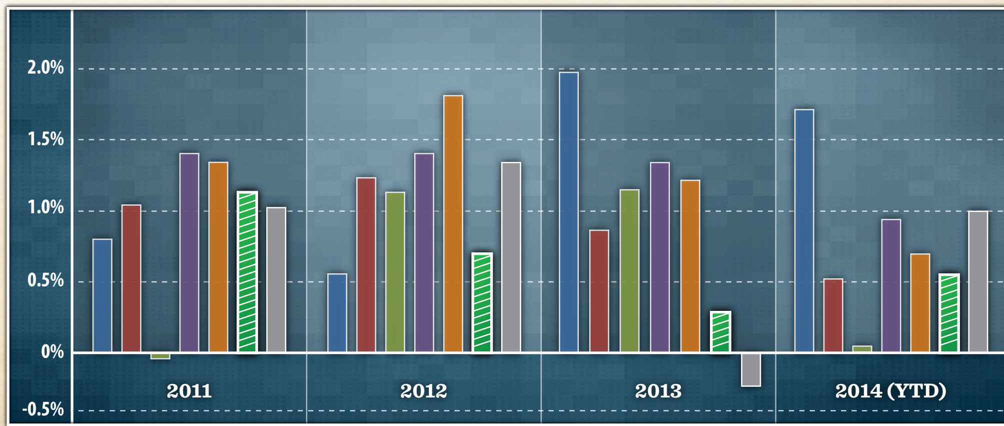
One of the major contributors to the reduction in General Fund revenues has been the phase out of the Capital Stock and Franchise Tax (CSFT) – a tax that has been imposed, in one form or another, on corporations in the Commonwealth since 1840 (though not on sole proprietorships or partnerships). Legislation passed by the General Assembly began a progressive elimination of the tax in 2001. Although the phase out schedule has been slowed several times in response to economic circumstances, this chart depicts the increasing erosion in Commonwealth revenues resulting from the 2000 decision. The tax is scheduled to be eliminated entirely by 2016. The cumulative revenue shortfall to this point, based upon the CSFT rate in 2000, is $4.8 billion.



Source: Pennsylvania Department of Revenue

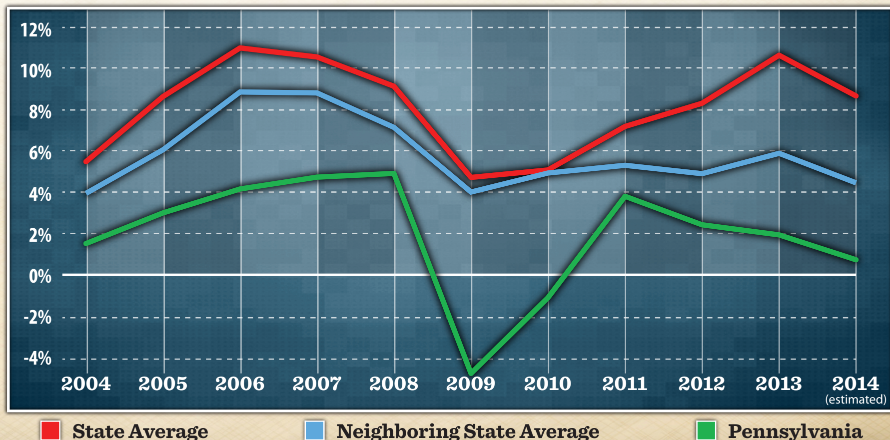
Change in Employment: 2010-2014

The chart to the right compares Pennsylvania to its neighboring states in terms of the change in average annual employment levels from the previous year.



Sources: Bureau of Labor and Statistics, Pennsylvania Treasury Department

State Comparisons: General and Rainy Day Fund Balances



Source: Pennsylvania Treasury Department

The dollars remaining in a state's General and Rainy Day Funds at the end of a fiscal year serve as one measure of a state's fiscal health -- and its ability to withstand economic downturns. Budget experts often describe fund balances as a percentage of expenditures in order to compare the fiscal condition of states relative to each other. The graph to the left demonstrates that Pennsylvania lags the national and neighboring-state averages in terms of balances held in General and Rainy Day funds as a percentage of expenditures.

State General Obligation Bond Ratings

Just as an individual's credit score suggests his or her credit worthiness, a state's bond (or credit) rating is a representation of its fiscal health. Generally, a state's credit rating affects the interest rate at which the state can borrow funds through bond issuances. The table to the right shows the credit ratings for Pennsylvania and its neighboring states in 2010 and 2014 as rated by each of the three leading credit agencies. Green text indicates an improved rating, while red text shows that the state's rating was downgraded. While Pennsylvania has maintained its AA rating from Standard & Poor's, the agency revised the state's outlook from "stable" to "negative" in 2012. Each of the other two agencies downgraded its rating for Pennsylvania between 2010 and 2014. Below the table is a scale to illustrate how individual ratings compare to one another in each system (although only those ratings assigned to high quality and speculative debt issuers are provided; lower ratings exist in each system).

2010				2014		
S&P	MOODY'S	FITCH		S&P	MOODY'S	FITCH
AAA	Aaa	AAA	DELAWARE	AAA	Aaa	AAA
AAA	Aaa	AAA	MARYLAND	AAA	Aaa	AAA
AA	Aa3	AA	NEW JERSEY	A+	A1	A+
AA	Aa3	AA	NEW YORK	AA+	Aa1	AA+
AA+	Aa2	AA+	OHIO	AA+	Aa1	AA+
AA	Aa2	AA+	PENNSYLVANIA	AA	Aa3	AA
AA	Aa3	AA	WEST VIRGINIA	AA	Aa1	AA+

RATING AGENCIES' SCALES

HIGHER QUALITY/LOWER RISK → LOWER QUALITY/HIGHER RISK

Note: Italics indicate the lowest rating considered investment grade.

S&P }	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	*BBB-*	BB+	BB	BB-	B+	B	B-
Moody's }	Aaa	Aa1	Aa2	Aa3	A1	A2	A3	Baa1	Baa2	*Baa3*	Ba1	Ba2	Ba3	B1	B2	B3
Fitch }	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	*BBB-*	BB+	BB	BB-	B+	B	B-

Sources: PA Treasury, U.S. Census Bureau, Bloomberg