TO: All Democratic Members

FROM: Rep. Bradford, Chair

SUBJECT: Cost-to-Carry Budget

DATE: January 31, 2019

Gov. Tom Wolf will present his 2019/20 budget proposal to the General Assembly on Tuesday, February 5th. Your eventual decision about the annual budget represents one of your most critical votes of the year and garners much debate, as it should.

I'm writing to impress upon you the fiscal realities that lawmakers will continue to struggle with as we work toward consensus on this upcoming commonwealth budget. Work remains to fully address a large reoccurring structural deficit, this year estimated at $1.8 billion, based on a recent review by our appropriations committee staff.

A structural deficit is a fundamental imbalance between current year income and current year expenses. We can debate the size of this deficit, but those who follow the detail can all agree that the imbalance is big and continues to demand our focus.

Despite what some might say, replacing one-time budget balancing measures, rather than runaway spending, is the main reason our budget gap is yawning so big. We must eliminate our dependence on these temporary gap closers.

Under Gov. Wolf's leadership, we have made laudable progress, but the crisis has yet to be resolved. We have replaced some budget balancing gimmicks with lasting solutions. We have reigned in spending, made programs run more efficiently, and shored up our revenue base by increasing the cigarette tax and expanding gaming in PA. Despite this progress, more must be done.

For nearly a decade, Republican majorities in the General Assembly – especially House Republican leaders - have made clear their preference for short-term budget solutions, postponing the day of reckoning, still claiming allegiance to conservative values.

Let me be clear, there is nothing conservative about one-time budget balancing gimmicks. House Republicans, unfortunately, despite very public and bipartisan support, refuse to implement even the most reasonable of revenue solutions, like the severance tax on natural gas. Conversely, their appetite for spending cuts diminishes when the real-life effects on education and human services are made clear.

Such choices have forced the commonwealth to compromise on short-term gap closers to get through the year, like $1.5 billion from monetizing payments from the Tobacco Settlement Fund. This borrowing generated one-time revenue so we could pay for day-to-day operating expenses (not capital improvements), but we will have to repay this gimmick for more than a generation. This is neither wise, sustainable, nor prudent.

It can be argued that tough economies dictated decisions made in prior budgets. But our economy has turned the corner. The Great Recession is gone, Pennsylvanians are, largely, working, and businesses are growing.

There may be a few more gimmicks left and difficult decisions may be postponed again this year, but I urge our caucus to continue a meaningful conversation about how to effectuate substantive steps toward a permanent and fiscally responsible solution. We must devise a plan to end our dependence on short-term gap closers.

When Gov. Wolf presents his budget, he will offer ways to address this large gap. As we look toward final passage, our staff will analyze proposals from all viewpoints within the context of achieving long-term structural balance, even if we must phase it in.

As an introduction to this analysis, our appropriations staff has completed a "cost-to-carry" budget for the General Fund so we can all better understand what is financially required simply to keep the lights on before we consider any discretionary increases, like increased investments in education.

In this document, you will find more detail on the cost drivers and issues behind the cost-to-carry budget that our staff has assembled. As you will see, the projected budget increases before discretionary growth are concentrated in a few areas beginning with human services, followed by education related programs, criminal justice, debt service, and state police.

Contents

Department of Human Services ... 4

Medicaid expenditures represent all of the 2018/19 spending increase ... 4

Replacing disappearing revenue drives up 2019/20 state spending ... 4

A Little More on the Transfer from JUA ... 5

Pre-K-12 Education ... 5

PHEAA ... 6

Repaying Old Pension Debt ... 6

Criminal Justice ... 6

Debt payments ... 7

State Police ... 7

Additional Resources:

- A spreadsheet (printout) with a little more detail on our expenditure assumptions
- A table outlining further detail on issues
- A table of one-time budget balancing measures assumed in the 2018/19 enacted budget

Our cost-to-carry General Fund budget for 2019/20 totals $35.3 billion in state funds (non-federal), an increase of $2.2 billion over our revised 2018/19 budget that assumes a $450 million upward adjustment, all contained within the Medicaid program. After taking into account estimated revenue growth for the budget year, and repayment of a $165 million loan from the Workmen's Compensation Security Fund we are left with a $1.8 billion budget gap. That WCSF loan repayment has already been postponed before and we suspect that may happen again. Some would argue that should not be counted toward a technically defined "structural deficit."

A structural deficit is a fundamental imbalance between current year income and current year expenses.

We can debate the size of the structural deficit, but those who follow the detail can all agree that the imbalance is big and continues to demand our focus. In Pennsylvania's case, replacing one-time budget balancing measures, rather than runaway spending, is the main reason our budget gap is so large.

The General Fund represents only a portion of the commonwealth's combined operating budget, however we focus on it because this is the fund where legislators have the most direct influence on spending. It's also where the most PA-specific taxpayer dollars are concentrated.

Department of Human Services

The Department of Human Services accounts for $12.1 billion, or 37 percent, of state spending in the enacted 2018/19 General Fund budget.

The DHS budget is large and complex, supporting a comprehensive array of programs and services benefitting one-of-every-four Pennsylvanians. In many cases, the programs are prescribed by state and/or federal law, regulation, legal agreements or negotiated contracts that must be altered in order to achieve significant funding changes, and are not discretionary.

We estimate DHS requires an additional $1.6 billion in General Fund revenue to cover 2018/19 supplemental appropriations ($449 million) and 2019/20 cost-to-carry increases ($1.16 billion). Some important takeaways:

- The department's Medicaid programs account for all of the estimated 2018/19 supplemental and more than 88 percent of its 2019/20 cost-to-carry increase. These programs benefit 2.9 million Pennsylvanians, especially our elderly parents and grandparents and those with disabilities; and
- County child welfare services – which are largely mandated by state and federal law – make up nearly 5 percent of the 2019/20 increase. These services promote the safety and well-being of roughly 220,000 children who have been (or are at risk of being) abused or neglected.

Medicaid expenditures represent all of the 2018/19 spending increase

We estimate the department will require $449 million in additional 2018/19 state appropriations for its Medicaid programs (Medical Assistance, long-term living and intellectual disabilities). Most of the increase is needed to address adjustments to several one-time revenues assumed in the enacted budget (for example, we use General Fund revenue to backfill the $200 million hole that was created when the courts blocked the JUA transfer [see discussion on the Pennsylvania Professional Liability Joint Underwriting Association below]). Additionally, based on trends through the first five months of 2018/19, we project state Medicaid expenditures will be $155.5 million higher than originally budgeted due largely to an increase in the cost of long-term living programs that serve the elderly and adults with physical disabilities.

Replacing disappearing revenue drives up 2019/20 state spending

DHS's cost-to carry budget increases $1.16 billion over our revised 2018/19 budget estimate and two factors represent nearly $900 million of the increase. By far, the single largest cost driver is the $785 million needed to replace one-time revenue that will no longer be available in 2019/20. We will also lose federal funds due to a reduction in the federal Medicaid matching rates (or FMAPs) for Medicaid expansion and the CHIP program, increasing state spending by over $100 million.

Additionally, program expenditures will increase roughly $400 million because of changing utilization and costs of services. These funds are needed to cover spending associated with Medicaid caseload growth, managed care rate increases, the full-year cost of the 2018/19 initiative that expanded intellectual disabilities services, county child welfare services, and reinstatement of the General Assistance cash grant program, to name just a few.

Offsetting these increases are one-time savings, worth an estimated $200 million due to federal suspension of the Affordable Care Act insurer fee and changing how Pennsylvania pays managed care providers. This payment modification was assumed in the current budget, but circumstances lead us to believe it will occur in 2019/20 instead. The change continues decades-long budget practices where the commonwealth finds ways to delay paying its bills until the next fiscal year. This is just another example of why Pennsylvania continues to struggle with chronic structural deficits.

A Little More on the Transfer from JUA

The Pennsylvania Professional Liability Joint Underwriting Association (JUA) has repeatedly taken legal action to block the commonwealth's attempts to transfer $200 million from its reserve accounts to the state's General Fund. Initially proposed as a loan in the 2016/17 budget, the subsequent two budgets have assumed a transfer of these funds to offset Medical Assistance costs in the Department of Human Services.

The most recent court decision by the U.S. District Court for the Middle District of Pennsylvania blocked the transfer of these funds finding that the updated language included in the 2018/19 budget violated the takings clause of the U.S. Constitution.

Pre-K-12 Education

Together, basic education, special education, and early childhood education account for $7.75 billion (or 23.7 percent) of the enacted 2018/19 state General Fund budget. The cost-to-carry increase for 2019/20 totals $423 million.

The following increases are driving 2019/20 costs within the Department of Education's budget:

- $25 million for school employees' social security to account for the growth in school personnel payroll,
- $30 million for the early intervention program serving 3- to 5-year olds,
- $214 million for PlanCon. Over the past four years, the General Assembly used $1.2 billion in school construction bond revenue to pay existing school construction reimbursement (PlanCon) obligations. To phase out of this "multiple-time gimmick," the state General Fund appropriation for PlanCon must increase by $214 million, and
- $147.5 million for the state employer contribution payment to the Pennsylvania School Employees' Retirement System, most of which goes to pay off old debt as explained in more detail below.

The budget for 2019/20 maintains the $838 million increase for basic, special and early childhood education during Gov. Wolf's first term, but again, no discretionary increases are assumed under a cost-to-carry budget scenario. These additional funds from prior years made real progress preventing property tax increases, keeping down classroom sizes, reducing inequities, and increasing the number of state-funded pre-k seats.

Additionally, long-term legal concerns about whether the General Assembly is meeting its constitutional responsibility to fund the commonwealth's public K-12 school system are left unaddressed in this exercise. PA's 37 percent state share of education funding, which ranks 46th among states, is a major contributing factor to vast inequities in our school system and is evidence that more needs to be done. Decisions awaited in the courts may have an even larger impact on future education budgets.

PHEAA

Over the past several budgets, the Pennsylvania Higher Education Assistance Agency (PHEAA) has been required to supplement the General Fund appropriation with its business earnings to support the PHEAA state grant program and other similarly supported smaller programs. Due to changing business dynamics, the PHEAA board indicates it will not be able to continue this practice in 2019/20. General Fund appropriations increase by nearly $106 million to maintain these programs and the current level of support to students across the commonwealth.

Repaying old Pension Debt

A major component of the cost-to-carry budget is employer contribution payments to the Public School Employee Retirement System (PSERS) and State Employee Retirement System (SERS). The magnitude of required appropriations largely stems from the fact that past General Assemblies borrowed from the pension funds to balance state budgets for many years.

The cost-to-carry budget for 2019/20 anticipates the full payment – the annual required contribution (ARC) – to both state pension systems, which represents the fourth time in 17 years for PSERS and the third time in as many years for SERS. While the contribution amounts increase in our analysis, the magnitude of the annual increases are beginning to rapidly diminish as more of the contributions pay down the debt

For PSERS, the 2019/20 state General Fund budget assumes an increase of $147.5 million, or 6 percent, from 2018/19, compared with the highest year-over-year increase of 49 percent in 2015/16.

For SERS, the 2019/20 cost-to-carry budget assumes about an $8 million, or 1 percent, increase in state General Funds for offices under the governor's jurisdiction. SERS' annually required employer contribution is allocated across a multitude of appropriations that include personnel expenditures.

Each system's respective increase reflects the multi-year and predictable adjustments in employer funding to pay down the state's unfunded pension liability debt pursuant to the funding schedule under the Act 120 reforms of 2010 and continued with Act 5 of 2017.

Criminal Justice

The Department of Criminal Justice (Corrections and the Board of Probation and Parole) makes up 7.7 percent of the enacted 2018/19 state General Fund budget, with state appropriations totaling $2.54 billion. The cost-to-carry increase for 2019/20 totals $107.6 million.

If business-as-usual continues and no prisons close, most of the increase ($100.8 million) in 2019/20 would be for state prisons and inmate healthcare:

- $77.8 million increase, largely driven by personnel costs, is for operating 25 state prisons.
- $23 million is for inmate healthcare costs. Rising healthcare costs are exacerbated by a $14.1 million bump in spending to meet needed treatment levels mandated by a 2018 settlement for inmates with hepatitis-C.

Debt payments

Payments for general obligation debt for capital and voter approved projects represents 3.4% percent of the state 2018/19 General Fund budget, with state appropriations totaling $1.1 billion. For 2019/20, we estimate payments for outstanding debt will increase by $106 million year-over-year due to projected additional debt issuances. While this represents a relatively smaller portion of the budget, debt repayment is given priority under the constitution.

State Police

Appropriations to state police total $305.6 million (or 1 percent) of the current state General Fund budget, and are expected to increase by $51.3 million (or 16.8%) in 2019/20, the second year of unusually large increases. State police is jointly funded by the General and Motor License funds. The sharp uptick in cost-to-carry spending in the General Fund is needed to absorb increasing costs due to a statutory cap that is reducing support from the Motor License Fund by $32 million per year.

Condensed summary of preliminary General Fund cost-to-carry expenditure and supplemental appropriation estimates Based on November 2018 Data

Amounts in Thousands	2018/19 Enacted	Supplemental Appropriation Estimate	2018/19 Revised	2019/20 Fall CTC Estimate	Change
Governor's Office, Lt. Governor and Executive Offices	**188,446**		**188,446**	**195,248**	**6,802**
Row Officers - Attorney General, Auditor General, Treasurer	**1,312,341**		**1,312,341**	**1,419,478**	**107,137**
General Obligation Debt Service	1,118,000		1,118,000	1,223,884	105,884
Other Row Office Appropriations	194,341		194,341	195,594	1,253
Criminal Justice	**2,540,692**		**2,540,692**	**2,648,288**	**107,596**
State Correctional Institutions	2,006,115		2,006,115	2,083,911	77,796
Inmate Medical Care	270,117		270,117	293,124	23,007
Other Criminal Justice Appropriations	264,460		264,460	271,253	6,793
Education	**12,668,783**		**12,668,783**	**13,089,420**	**420,637**
Authority Rentals and Sinking Fund Requirements	10,500		10,500	224,571	214,071
School Employees' Social Security	541,205		541,205	566,238	25,033
School Employees' Retirement	2,487,500		2,487,500	2,635,000	147,500
Other Department of Education Appropriations	9,629,578		9,629,578	9,663,611	34,033
State-Related Univ., State System of Higher Ed., Thaddeus Stevens College	**1,064,249**		**1,064,249**	**1,064,249**	**0**
PA Higher Education Assistance Agency	**322,661**		**322,661**	**428,553**	**105,892**
Grants to Students	273,391		273,391	368,233	94,842
PHEAA-funded off-line programs	0		0	11,050	11,050
Other PHEAA Programs	49,270		49,270	49,270	0
Human Services	**12,137,374**	**448,876**	**12,586,250**	**13,749,811**	**1,163,561**
Medical Assistance appropriations	4,151,706	280,211	4,431,917	4,709,220	277,303
Long Term Living appropriations	2,656,468	156,180	2,812,648	3,462,382	649,734
Intellectual Disabilities appropriations	2,008,731	12,485	2,021,216	2,123,951	102,735
County Child Welfare	1,225,354	0	1,225,354	1,281,237	55,883
Other DHS appropriations	2,095,115	0	2,095,115	2,173,021	77,906
All Other Executive Agencies	**1,725,881**		**1,725,881**	**1,816,592**	**90,711**
Judiciary	**355,503**		**355,503**	**355,503**	**0**
Legislature and Government Support Agencies	**399,061**		**399,061**	**399,061**	**0**
General Fund Appropriation Subtotal	**32,714,991**	**448,876**	**33,163,867**	**35,166,203**	**2,002,336**
Plus - Workers' Compensation Security Fund Loan Repayment				**165,000**	**165,000**
Expenditure Total - Financial Statement	**32,714,991**	**448,876**	**33,163,867**	**35,331,203**	**2,167,336**

Prepared using November 2018 data. Estimates will change based on updated information and policy changes.

Appendix - Long Term Issues

Issue	Description
Adequate & Equitable Education Funding	Citing inequities and inadequate funding, a 2014 lawsuit is challenging whether Pennsylvania is meeting its constitutional charge to "provide a thorough and efficient system of public education to serve the needs of the commonwealth." The Commonwealth Court trial date is tentatively scheduled for summer 2020. The case for equity is well-documented. For example, a 2012 analysis by the Washington Post identified PA as having the widest per-pupil spending gap between wealthy and poor school districts in the U.S. In 2018/19, the school districts receiving less than their fair share of basic education funding were shortchanged by $1.2 billion. Adequacy comes with a larger price tag. When examining total education funding (including local sources) a 2006 "costing-out" study commissioned by the General Assembly concluded that an additional $4.38 billion, or 25.4 percent, was needed in order to meet state academic standards. It remains to be seen what the courts will mandate or what the will of the General Assembly will be to address the issues of equity and adequacy.
HUMAN SERVICES:	
General Assistance Cash Grants	General Assistance (GA) provides state-funded cash benefits to certain low-income adults who do not qualify for federal TANF benefits. Act 80 of 2012 eliminated the GA cash benefit; however, the PA Supreme Court paved the way for its reinstatement last July when it ruled Act 80 was unconstitutional on procedural grounds. DHS began making GA cash payments in November and (as of Jan. 2) has issued approximately $2 million in benefits to approximately 4,500 people. The full year cost of the GA cash benefit, which is about $200 per month per person, is estimated to be $30 million in 2019/20. Future costs will depend upon the number of adults receiving monthly payments.
	• NOTE: Rep. Dunbar (R) has introduced legislation (House Bill 33) that would eliminate the General Assistance cash benefit. The original legislation (Act 80-2012) passed the House of Representatives on a party-line vote, 102-91, with five Republicans voting with Democrats against the bill.

Appendix - Long Term Issues

Issue	Description
Medicaid Expansion FMAP	Funding for Medicaid is shared between the state and federal government, with the federal share of Medicaid spending determined by the federal matching rate (or FMAP). As stipulated in the Affordable Care Act (ACA), the FMAP for Medicaid expansion will decrease from 92 percent for calendar year 2019 to 90 percent for calendar year 2020 and each year thereafter. The reduction of the ACA FMAP, effective Jan. 1, 2020, is estimated to increase state spending by $51 million in 2019/20 and $105 million in 2020/21 (the first full fiscal year with the 90 percent federal matching rate).
Children's Health Insurance Program (CHIP) FMAP	The ACA increased the CHIP federal matching rate (or FMAP) by 23 percentage points; however, federal law reduces the enhancement to 11.5 percentage points effective Oct. 1, 2019 and ends it on Sept. 30, 2020. Pennsylvania currently receives an FMAP that covers 89.58 percent of CHIP expenditures. The phase-out of the ACA enhanced match, beginning October 2019, is estimated to increase state spending by $45 million in 2019/20 and $66 million in 2020/21.
Medicaid Assessments	Medicaid programs are partially funded with revenue generated from assessments levied on various providers. The assessment revenue reduces the need to use state General Funds to pay for Medicaid expenditures. Three assessments are set to expire after June 30, 2019: the nursing facility assessment, the Philadelphia hospital assessment, and the ICF/ID assessment (levied on state and private intermediate care facilities for individuals with intellectual disabilities). These three assessments currently offset a quarter billion of state Medicaid expenditures. The cost-to-carry 2019/20 budget assumes the General Assembly reauthorizes the assessments and that the savings to the General Fund continue.

Appendix - Long Term Issues

Issue	Description
Nursing Facility Budget Adjustment Factor (BAF)	Beginning in 2005/06, the department uses a “budget adjustment factor” or BAF to limit Medicaid payment rates for nursing facility services to the amount permitted by the funds appropriated in the General Appropriations Act. Prior to the BAF, nursing facility rates were determined under the case mix methodology established in state regulation. In 2018/19, the BAF is saving the state an estimated $380 million - this is the difference between what nursing facilities would have been paid under the case mix rate methodology compared to the limited rates under BAF. The authority for DHS to utilize the BAF is provided in statute; however, it is set to expire after June 30, 2019. The 2019/20 cost-to-carry estimates assume the General Assembly reauthorizes the BAF. Without renewal, nursing facilities would have to be paid the full un-capped rates calculated under the case mix rate methodology, which would drive up state spending by several hundred million dollars.
ACA Insurer Fee	The Afforable Care Act (ACA) includes an annual fee that is levied on certain insurers, including Medicaid managed care organizations (MCOs), to help pay for the health care coverage provided through the ACA. State Medicaid programs are responsible for reimbursing their Medicaid plans for the fees they pay; consequently, the enacted 2018/19 budget includes $83 million in state funds as reimbursement for the 2018 fees paid by Pennsylvania’s Medicaid MCOs. Because Congress suspended the ACA insurer fee for 2019, state spending is reduced by $83 million in 2019/20. However, if Congress does not act to suspend the fee for 2020, it will return in 2020/21 at an estimated state cost of $95 million.

Appendix - Long Term Issues

Issue	Description
Child Care Funding	The 2019/20 cost-to-carry budget maintains state General Fund spending for child care at the 2018/19 level by using federal funding from the TANF and Child Care Development Fund (CCDF) block grants to cover projected growth in program expenditures. However, the federal block grant funds used to pay for the increased expenditures are not sustainable and eventually will have to be replaced in future budgets.
	• The federal Balanced Budget Act of 2019 increased CCDF block grant funds by roughly $123 million over a two-year period. Our analysis uses $20.5 million in 2018/19, $32.6 million in 2019/20 and $66.1 million in 2020/21 to cover increasing child care expenditures. This leaves $14.3 million available to spend in the 2021/22 budget. Unless Congress act to continue the CCDF increase, there will be at least a $50 million hole in child care funding that must backfilled.
State police funding gap	In 2016, the General Assembly began a long-term shift in State Police funding to reduce its reliance on the Motor License Fund. The Fiscal Code caps and reduces Motor License Fund appropriations to the state police annually until they reach $500 million in 2027/28. These caps, combined with normal cost growth that the Motor License Fund historically helped absorb, mean the State Police's funding gap will grow each year and put budgetary pressure on the General Fund. While the General Fund absorbed $54 million of the gap in the 2018/19 budget, cost trends indicate that the funding gap could grow to $717 million by 2027/28, absent any new funding or cost-containment measures.
Collective Bargaining Agreements	The commonwealth is currently negotiating several of its collective bargaining agreements that expire at the end of the 2018/19 fiscal year. Most executive agencies will be affected by these agreements.

General Fund Budget Balancing Measures to Monitor

($ Amounts in Millions)

EXPENDITURES	2018/19	2019/20
General Fund Expenditures Shifted Offline or to Special Funds	**$54.9**	**$54.9**
Increase in MA expenditures funded through Lottery Fund (compared to revised 17/18)	$54.9	$54.9
Other Questionable/Unsustainable Budget Savings	**$1,073.7**	**$120.0**
MA expenditures funded with one-time revenue received March 2017 from Managed Care Organization Gross Receipts Tax	$351.7	$0.0
MA savings from changes to the payment schedule for MCOs	$0.0	$120.0
MA savings from one-time revenues pursuant to Tobacco Master Settlment Agreement litigation	$341.6	$0.0
Department of Human Services expenses funded with one-time surplus from assessment on Philadelphia hospitals	$54.0	$0.0
Authority Rentals & Sinking Fund Requirements (PlanCon) reduced reliance on bond proceeds	$214.0	$0.0
Use of PHEAA resources to reduce General Fund expenditures on higher education - this multi-year support will need to be suspended in 2019/20	$112.4	$0.0
Subtotal Expenditures	**$1,128.6**	**$174.9**
REVENUES		
Transfers to General Fund	**$74.6**	**$0.0**
Miscellaneous revenues and loan repayments to the General Fund	$33.4	$0.0
Use of premium proceeds from capitalized debt service	$41.2	$0.0
Other Questionable/Unsustainable General Fund Revenue Raisers	**$203.5**	**$16.3**
Gaming expansion (Act 42 of 2017) - Interactive gaming (iGaming) license fees	$106.0	$0.0
Gaming Expansion - Interactiving gaming (iGaming) license fees at airports	$0.0	$3.8
Gaming Expansion - Sports wagering license fees at $10 million per license	$70.0	$0.0
Gaming Expansion - Category 4 (satellite casinos) table games	$0.0	$12.5
Gaming Expansion - Category 3 additional slot machines and table games	$3.5	$0.0
Change of ownership fees for casinos	$8.9	$0.0
Repayment of gaming loans to the General Fund	$15.1	$0.0
Subtotal Revenues	**$278.10**	**$16.30**
TOTAL	**$1,406.70**	**$191.20**