This budget update was presented to the House Democratic Caucus on February 16, 2011.

Recessions

Lengths of Recessions	
1919 – 1945 Average	18 months
1945 – 2001 Average	10 months
Recessions beginning:	
December 1969	11 months
July 1981	16 months
July 1990	8 months
March 2001	8 months
December 2007	18 months

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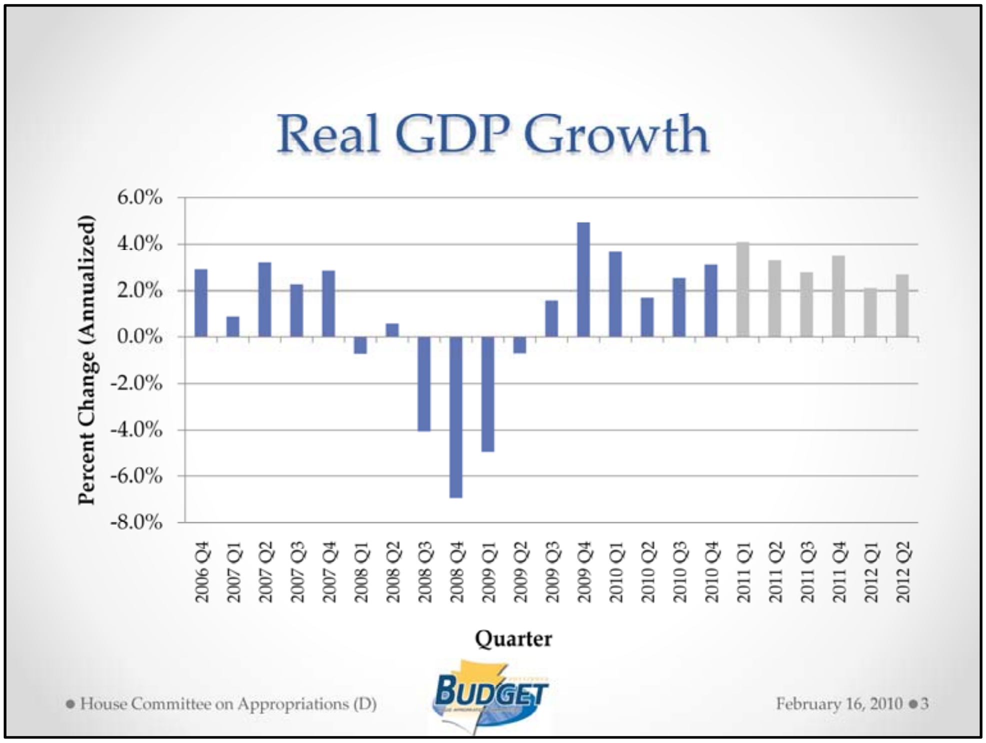
We are emerging from a recession, a period of significantly diminished economic activity. Sometimes it does not feel like we have emerged yet, but the National Bureau of Economic Research tells us we have. NBER is the entity that officially defines the beginning and end of a recession.

According to the NBER, the recession began in December of 2007 and lasted 18 months. In recent history, this recession is the longest except for the early 1900s when the average length of recessions was also 18 months.

The larger story about a recession also includes the length of recovery after a recession officially ends -- it takes time to recover lost jobs and return to the higher level of employment (Length of Recovery: When employment reaches its previous level as in number of jobs).

For Example – for recessions beginning:
Dec 1969, the recession lasted 11 months but recovery took 30 months.
July 1981, the recession lasted 16 months but recovery took 52 months.
July 1990, the recession lasted 8 months but recovery took 46 months.
March 2001, the recession lasted 8 months but recovery took 55 months.



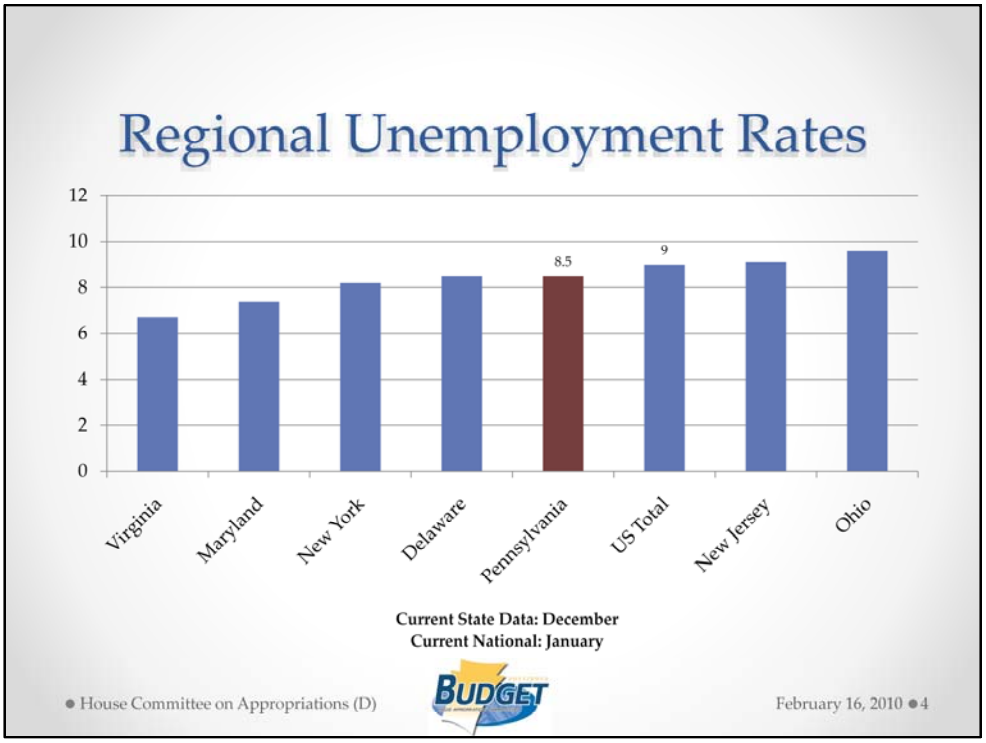
GDP, a measure of economic activity, helps us understand what to expect from income (taxes especially) to Pennsylvania programs. This GDP chart provides a picture of the change in economic growth.

The National Bureau of Economic Research uses GDP to help determine the length of recessions.

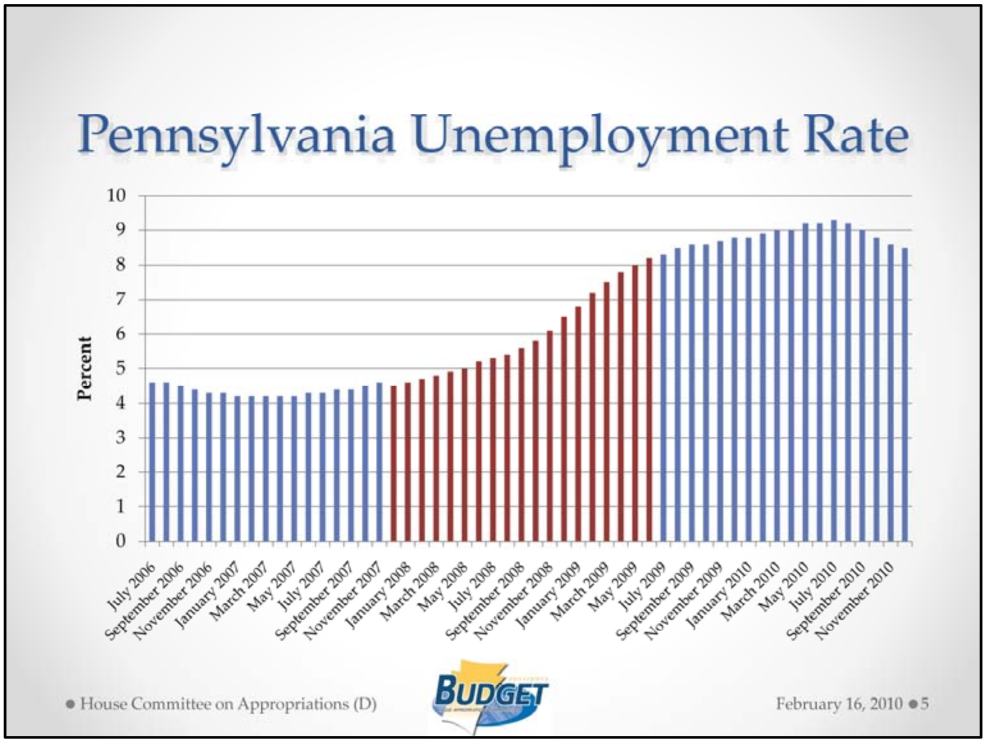
The chart here illustrates the dramatic **rate of decline** in GDP during 2008 and part of 2009. When we were entering the recession in 2008, most economists were predicting slow but positive growth. That meant that PA tax revenue projections were too optimistic. No major economist got it right as is often the case when trying to predict dramatic deviations in the rate of change for the economy (the beginning or end of a recession).

This year we expect positive GDP growth, but growth hovering around 3% is not dramatic and is an indicator for continued anemic growth in tax revenue.

***The gray bars are forecasted.



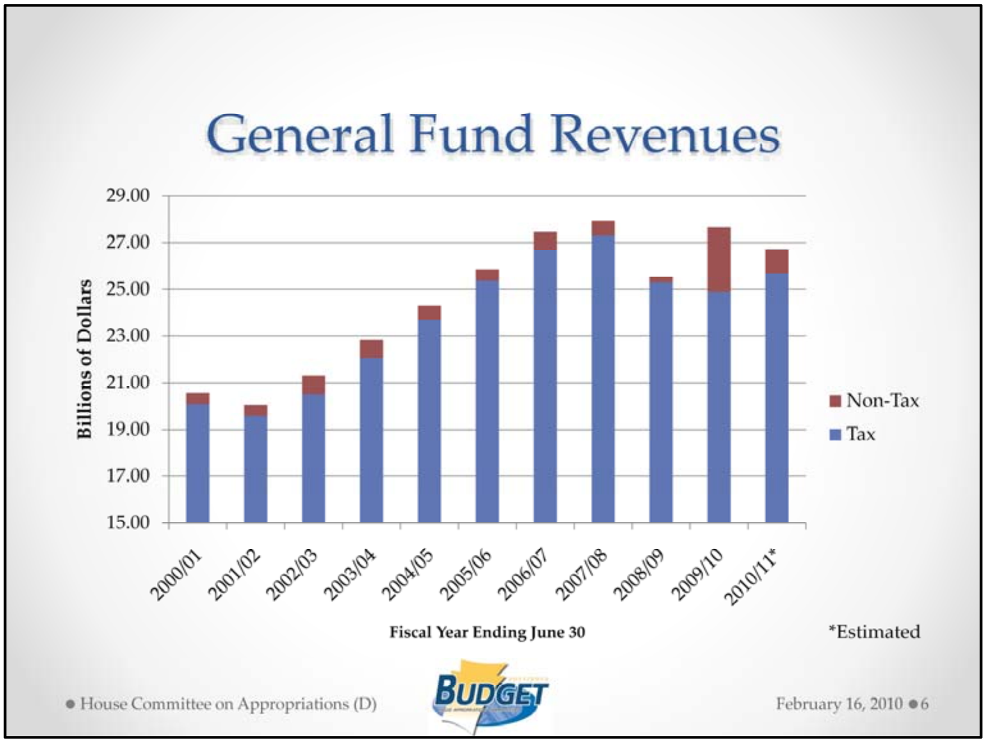
Other economic variables we watch are employment related indictors. We look at employment and ultimately personal income to tell us how personal income tax revenue will perform. In December, PA unemployment stood at 8.5 percent – not as bad as some nearby states or the nation (9.0% in January) but still nothing to brag about.



Again, the larger story about a recession also includes the length of recovery after a recession officially ends -- it takes time to recover lost jobs and return to the higher level of employment. Remember the length of recovery depends on when employment reaches its previous level as in number of jobs.

We are three years after the recession started and unemployment just now appears to be declining from peak levels.

Also an important note about employment and the effect on programs….The unemployment rate has remained above 8% since the recession officially ended in June 2009. During economic downturns, unemployment rises, incomes decline and individuals lose employer-sponsored health insurance. This results in increased Medical Assistance enrollment and spending. The December 2010 jobs report indicates Pennsylvania has 190,000 (or 3.3%) fewer non-farms jobs than prior to the recession's start in December 2007. During this same period, MA monthly enrollment has increased 271,383 (or 14.3%).



What does all this talk about economic variables mean to Pennsylvania? Revenue will continue to grow slowly. We will probably exceed our revenue estimate this fiscal year but we await the big tax months, March and April for our best prediction.

While revenue growth is recovering, the larger story is about how 10/11 General Funds are still below pre-recession levels.

Beginning in 2008/09, revenue has remained below the 2007/08 level. Also note that in 2008/09, revenue was actually lower than three years prior (2005/06).
Recurring tax revenues have been especially slow to rebound. This makes it especially difficult for the state budget to absorb the fiscal burden associated with disappearing federal funds in 2011/12 because most one-time strategies, especially fund transfers that are reflected in non-tax revenue, have already been exhausted.

Funding…Financial Statement

- The 2010/11 budget was balanced based on funding estimates that will change.
- Revenue through January has exceeded the official estimate by $264 million.

	General Fund Financial Statement	2008/09	2009/10	2010/11
	$'s in millions	**Actual $**	**Actual $**	**Available $**
1	**Adjusted Beginning Balance**	**585**	**(2,025)**	**(294)**
2				
3	**Revenue**			
4	Official Revenue Estimate	25,530	28,825	26,712
5	Adjustment to Official Estimate	(3,255)	(1,177)	?
6	**Official Estimate w/Adjustment**	**25,530**	**27,648**	**26,712**
7	Less: Refunds	(1,225)	(1,125)	(1,125)
8	**Revenue: Total**	**24,305**	**26,523**	**25,587**
9				
10	Plus: Prior Year Lapses	164	150	?
11	**Funds Available: Total (Lines 1, 8 & 10)**	**25,054**	**24,648**	**25,292**

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This represents the funding side of the financial statement. The 2010/11 fiscal year as shown reflects estimates that will change, the largest of which will be final revenue receipts (line 5) followed by prior year lapses (cuts in prior year spending authorization).

State Expenditures…Financial Statement

- The budget is based upon state expenditures that have changed significantly.

	General Fund Financial Statement *$'s in millions*	2008/09 Actual $	2009/10 Actual $	2010/11 Available $
1	Preferred Appropriations	26,339	24,430	24,581
2	Non-Preferred Appropriations	734	690	687
3	Executive Authorizations	11	17	21
4	**State Expenditures: Subtotal**	**27,084**	**25,138**	**25,289**
5	**Decline since 2008/09**		(1,946)	(1,796)

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This reflects the **state** expenditure portion of the financial statement. Again, 2010/11 reflects the budget package as enacted in the summer of 2010. These estimates will change, as the administration looks to find budget balancing cuts to state spending for this current year (2010/11).

Notice the significant decline in the state spending amount since 2008/09. This was driven by the decline in state available revenue as illustrated in an earlier chart.

Federal Offset…Financial Statement

- The 2010/11 budget was balanced based on estimates that have changed.
- Federal Stimulus Funds have minimized the need for state expenditure cuts.

		2008/09	2009/10	2010/11
	millions of $'s	**Actual $**	**Actual $**	**Available $**
1	ARRA FMAP (June 2010 Estimate)	1,177	1,777	1,833
2	ARRA State Fiscal Stabilization Fund (Education)	63	748	748
3	New Education Jobs Fund (Aug 2010)	0	0	0
4	ARRA State Fiscal Stabilization Fund (Flex)	0	173	173
5	**ARRA Offset: Subtotal**	**1,239**	**2,698**	**2,755**

This represents the portion of the General Fund financial statement where we show the amount of federal funds appropriated and agreed to be used as an offset to state expenditures. The federal offset funds shown here, as enacted, have minimized the need for state expenditure cuts. Again, the 2010/11 budget was balanced based on estimates that have changed. These numbers will change because of the ARRA FMAP extension and Jobs Fund Package passed by Congress in August 2010.

Post-Budget Changes (Aug 2010)

- A downward adjustment to the ARRA FMAP creates a 2010/11 gap.
- Use of Education Jobs Fund uncertain.
- It is too early to discuss adjustments to the Official Revenue Estimate.

$'s in millions	
Fed. ARRA FMAP Extension and Education Jobs Fund package (P.L. 111-226)	**$**
Reduction in FY 2010/11 estimate for enhanced ARRA FMAP	(282)
New Education Jobs Funds -- Use to offset General Fund Spend?	388
Revenue Surplus	?

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In August of 2010, the Rendell administration announced the need to reduce state spending by $282 million due to the changes under the Federal ARRA FMAP Extension and Education Jobs Fund package. The ability to appropriate the new Education Jobs Funds for Basic Education was unclear at that point.

2010/11 General Fund Gap Closers

- Rendell (8/10): closes $282m gap. Corbett (1/11): Offset w/Fed. Education Jobs Fund

	($'s in millions)	Rendell Aug-11 Proposed	Corbett Jan-11 Proposed	Change
1	**Revenue Surplus**	**?**	**?**	**?**
2	**Proposed Shale Tax to Minimize Cuts**	**70**	**0**	**(70)**
3	**Cuts**			
4	Basic Education	50	388	338
5	Other Education	19	19	
6	DCED	4	30	26
7	DEP	3	3	1
8	Other Cuts	136	114	(22) *
9	**Subtotal: Cuts**	**212**	**554**	**342**
10	**Total: Proposed Gap Closers**	**282**	**554**	**272**
11				
12	Fed Education Jobs Funds to offset State Basic Education Cut	?	(388)	(388)
13	**Net Impact on State Spending**	**282**	**166**	**(116)**

**A djustment assumes $190m of Rendell's $212m: informal from Budget Office*

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In January 2011, the Corbett administration released a letter indicating that it would cut the state appropriation for Basic Education further but use all of the new Federal Education Jobs Fund to offset the reduction. The administration also indicated that it would further reduce DCED and DEP. Based on an informal discussion with the budget office the administration would retain $190 million of the $212 million in cuts that the former Rendell administration proposed. Based on this latest **informal** understanding, this chart shows how the two administrations would compare. This is just a rough understanding.

Recap…Financial Statement

- The 2010/11 budget was balanced based on estimates that will change including: Revenue, Extension of ARRA FMAP Funds & Education Funds and Safety Net Enrollment.

	General Fund Financial Statement	2010/11	?	
	$'s in millions	Enacted $	Adjustment	
1	**Funds Available: Total**	25,292	264	*Actual Jan/11*
2				
3	**Less Expenditures: State + Federal Offset Enacted**	(28,043)		
4	**Federal Offset: Subtotal**	2,755	105	*Fed Act Aug/10*
5	**Supplemental Appropriations**	?	347	*Mid-Yr Briefing*
6	**State Expenditures Subtotal**	(25,289)		
7				
8	**Less Current Year Lapses ("Cuts")**	?	554	*Corbett--Jan/11*
9	**Preliminary Balance**	4		

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This page summarizes what we have covered so far. The funds available to spend number will likely be adjusted upward. Our analysts will be generating new forecasts soon and we await March and April for a more complete understanding.

Estimates for state expenditures and federal offsets will change.

The federal offset amount will be reduced by an estimated $282 million (ARRA FMAP) and will increase by $388 million (new Education Jobs Fund).

We will need to increase appropriations to pay for the state portion of medical assistance as a result of the reduction related to FMAP ($282 million). Also, higher than expected enrollment increases for safety net programs will drive the need for a supplemental appropriation ($65 million per Governor Rendell's mid-year budget briefing).
Potential supplemental appropriation(s) will address this $282 + $65 = $347 million.

To offset reductions and save money for the upcoming budget year, further cuts (current year lapses) are assumed.

Adjustments to Federal Funds

- After proposed adjustments, Federal funds will reach $2.8 billion in 2010/11.

	General Fund Financial Statement	2008/09	2009/10	2010/11	Inc/Dec	2010/11
	$'s in millions	Actual $	Actual $	Available $	?	? Adjusted
1	**Federal Offset**					
2	ARRA FMAP	1,177	1,777	1,833	-282	1,551
3	ARRA Fiscal Stabilization Fund (Education)	63	748	748		748
4	New Education Jobs Funds	0	0	0	388	388
5	ARRA Fiscal Stabilization Fund (Flex)	0	173	173	0	173
6	**Federal Offset: Subtotal**	**1,239**	**2,698**	**2,755**	106	**2,860**

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This chart shows how the federal offset expenditures will change based on our latest estimates and understanding of the ARRA FMAP extension and Jobs Fund Package passed by congress in August 2010.

That is $2.86 Billion (with a “B”) in federal offset funds that we will not have to support the General Fund in FY 11/12.

Adjustments to Use of Federal Funds

- Federal Funds Disappear – Basic Education

	2008/09	2009/10	2010/11
($'s in millions)	**Actual $**	**Actual $**	**Available $**
Federal Funds -- Basic Education			
Enacted 2010/11 Budget	0	655	655
Corbett additional proposed	NA	NA	388
Total	**0**	**655**	**1,043**

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Of that $2.86 billion, over $1 billion of federal funds for the Basic Education appropriation will go away in 2011/12.

That is $1.043 Billion (with a “B”).

2011/12 Budget Drivers

$'s in millions	$
Federal Stimulus Funds Disappear	2,860
One-Time State Revenue Sources Disappear	748
Increase in Pension Costs*	346
Offset to Pension Costs: Tobacco Settlement Funds	120
Medicare Part D Payment: Estimated Cost to Replace Federal Relief	250
Subtotal	**4,324**
Other Factors	
Increases in state costs due to inflation, caseload….	?
Example: Medical Assistance	
Pay back PA Employee Benefit Trust Fund	?
Adjustments to Revenue Estimate (hopefully good news)	?
*This is after pension reform saved nearly $115 million in 2011/12 and $1.78 billion in 2012/13.	

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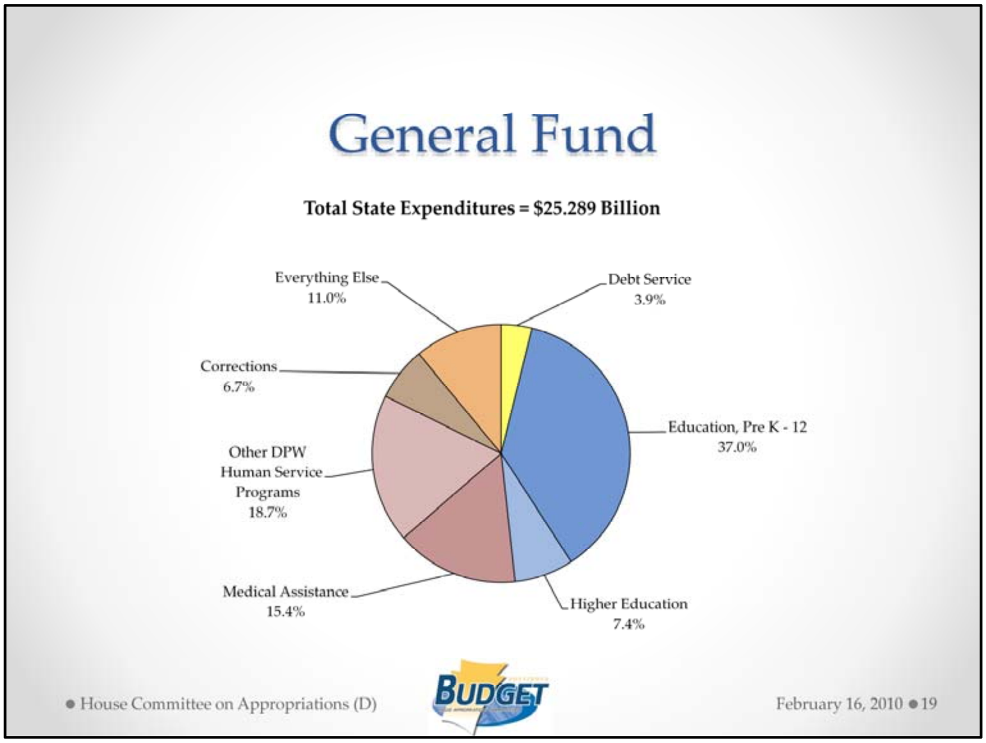
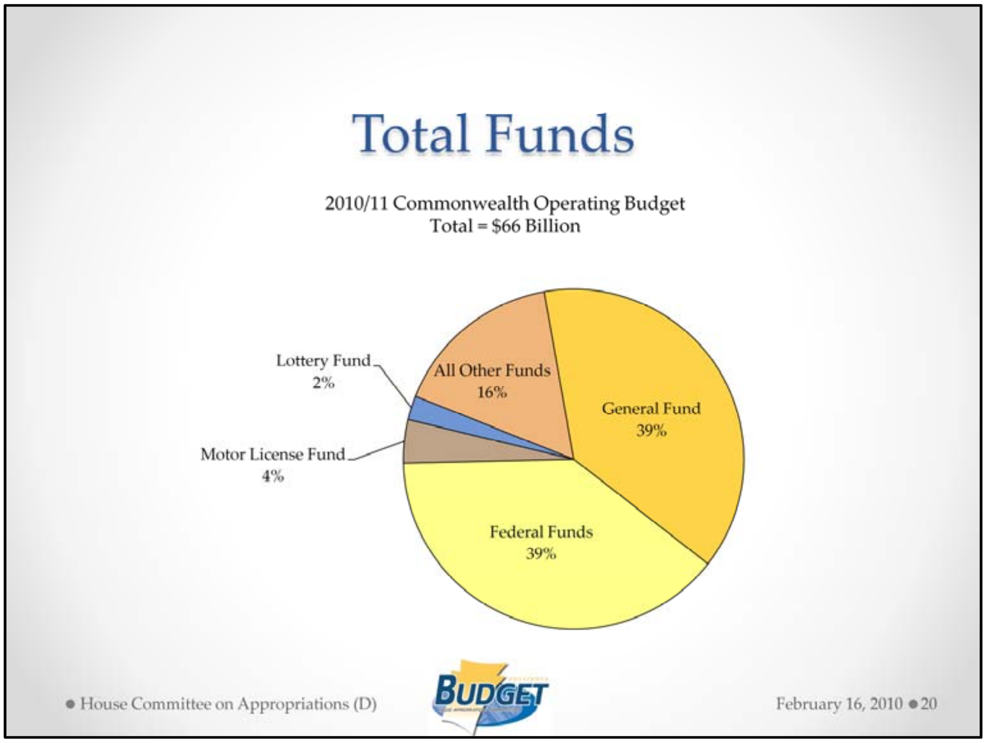
Stimulus funds were not enough to allow for normal growth in spending but those funds certainly closed a significant portion of the gap and kept programs from falling precipitously. In the upcoming Budget year, a total of $2.9 billion in federal offset funds will disappear and even if revenue growth is healthy, Pennsylvania is left with a large gap. Not only will stimulus funds disappear but one-time revenue infusions will be gone and the normal growth in programs will add to the problem. We face a $4 billion plus General Fund gap for the upcoming budget year before increased costs from normal inflationary and enrollment based increases in programs and offsetting adjustments from an expected revenue surplus.

That is $4 Billion (with a "B").



Incoming Governor Corbett has promised no tax or fee increases. While every million counts, he will need to find billions – even if he can cobble together the support to sell the liquor stores. The only two program areas where the state can find this kind of money are education and public welfare programs. Of those two programs, the flexibility to cut is significantly less in the Department of Public Welfare than in Education programs.

Medical Assistance represents a large portion of Department of Public Welfare programs. Medical Assistance is an entitlement and thus complex to adjust. Federal Health Care reform also eliminates state options. Not only is Medical Assistance complex to adjust, it is a major budget driver. Contrary to public opinion, Cash Assistance (or “welfare”) is NOT a major budget driver.



This presentation has focused primarily on the General Fund. The Commonwealth operating budget actually spends about $66 billion. About 40% is spent from the state portion of the General Fund. The focus has been on the state General Fund because this is the fund where policy makers have the most influence. However, fiscal issues affect other funds and will challenge policy makers.

Other Non-General Fund Issues

- MCARE/HCPRA- Court Challenge to return $800m.
- Transportation -- $3.5 b shortfall (2010)
  - State Highways/Bridges - $2.6b
  - Transit - $484m
  - County & Municipal Highways & Bridges -- $432m
- adultBasic - $54m to cover anticipated enrollment (10/11)
- Unemployment Compensation - Insolvency
- Marcellus Shale – Regulatory Issues/Tax or Fee
- Tobacco Endowment Account/Settlement Fund
- Cuts at State level shift burden to Local Governments
- Rebuild Rainy Day Fund

Corbett's Promised Solutions

- Reduce Cost of State Government by 10%
- Reduce Automotive Fleet by 20%
- Reduce Spending of State Legislature
- Reduce Legislative Reserves
- Health Insurance Contributions by Legislature
- Eliminate Permit Backlog at State Agencies
- Privatization of State Liquor Stores
- Reduce the Corporate Net Income Tax
- Phase out the Capital Stock and Franchise Tax
- Program Cuts
- Increased Efficiencies/Consolidation of Services
- Sunset and Audit of State Boards and Commissions
- Elimination of Discretionary Funds

Questions? Comments?

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