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Slicing Pennsylvania’s Finances, Part 2: Revenue on Autopilot

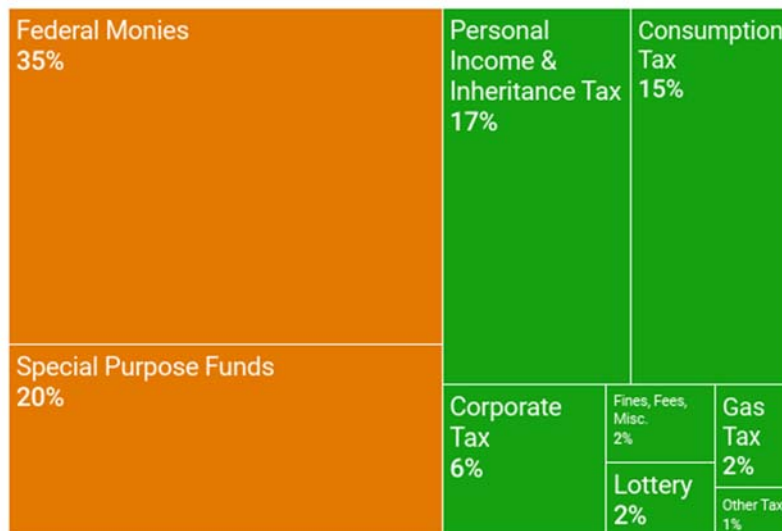
Andrew Abramczyk

The state constitution tasks the legislature with both raising and spending revenue. Over time, however, this simple plan has been disfigured. Today less than half of revenue is under direct legislative control. The legislature must consolidate and control revenue instead of letting it flow to programs automatically through a confusing maze of accounts.

The Pennsylvania government funds its operating budget through at least 26 major revenue sources that totaled \$86 billion last year. Under Article III of the constitution, all bills for raising revenue are supposed to originate in the House of Representatives, and payouts of public money are supposed to occur only after an appropriation.¹ Today, however, a majority of state revenue comes from the federal government and from special-purpose state funds, meaning it gets raised and spent according to formula and administrative rule rather than legislative action. Additionally, dependence on these alternative revenue sources is growing.

Power of the Purse

Legislature controls only 45% of operating revenue



Source: Commonwealth Foundation , Governor's Executive Budget 2019-2020

¹ Pennsylvania Constitution. Article III, Section 10: “Revenue Bills” and Article III Section 24: “Paying out Public Moneys.” <https://www.legis.state.pa.us/cfdocs/legis/LI/consCheck.cfm?txtType=HTM&ttl=0>

Thirty five percent of state operating revenue comes from the federal government. Most non-federal revenue comes from various taxes. The remaining one-fifth of operating revenue comes from what are marked in the annual *Governor's Executive Budget* as simply "Other Funds" but are more accurately called special purpose funds. These are monies taken in by a network of at least 150 special purpose state entities with their own revenue streams. The Public Transportation Trust Fund, for example, received \$450 million in statutory payments from the Pennsylvania Turnpike last year.

Excluding federal monies and monies drawn from the special revenue funds, the state's largest revenue item is the personal income tax (\$14 billion in projected collections this year according to the Governor's Executive Budget), followed by the sales and use tax (\$11 billion). Most other state revenue streams are \$1 billion or less in size. This includes payments from the state liquor monopoly, the Liquor Control Board. For all the talk of the liquor monopoly as an important earning asset of the state, and all the resistance to its privatization, it remits to the state only \$185 million of profit per year, which is two tenths of one percent of the operating budget. Liquor sales do generate significant tax revenue, but the same taxes would also be collected under a private liquor control regime.

Three Things Matter

Numerous other items raise little revenue and are unpopular besides



This graph shows the twenty largest revenue items excluding federal and special purpose fund revenue.

Source: Governor's Executive Budget 2019-2020, Commonwealth Foundation

Detail of key taxes and fees include the following:

- **Personal Income Tax:** 3.07% on household and proprietor earnings
- **Sales and Use Tax:** 6% charge on the retail sale, consumption, rental or use of tangible property and information. Food, most clothing and other items are excluded.
- **Corporate Net Income Tax:** 9.99% on profits of corporate business activity occurring in Pennsylvania, as determined by an apportionment formula.
- **Liquid Fuel Taxes:** \$0.576 per gallon on motor gasoline, with different rates for other types of transportation fuel
- **Gross Receipts Tax:** 4.5% on revenue earned from certain transportation, telecommunication and energy services. Some revenues are subject to 0.5% additional tax.
- **Cigarette Tax:** \$0.13 per cigarette
- **Inheritance Tax:** 4.5% on the transfer of a deceased person's property to lineal family, 12% on transfers to siblings, 15% on transfers to others. Transfers to surviving spouse are not taxed.

Tax collections generally flow to one of three state accounts:

- **The General Fund**, by far the largest account, receives all personal and corporate taxes as well as other revenues such as state liquor revenue and a variety of fees. It funds most legislatively appropriated expenses.
- **The Motor License Fund** receives gas tax and motor license revenue: most of these moneys can be appropriated only for transportation.
- **The Lottery Fund** receives lottery revenue: the majority of these funds are spent on services for the poor or infirm elderly.

From each of these funds (hereafter "core funds"), appropriations are made to various expense items. Monies from the core funds are largely unencumbered and free for legislative appropriation, but this has begun to change over the years, as small portions have been designated for automatic transfer to special purpose funds. Diversions of core revenue include:

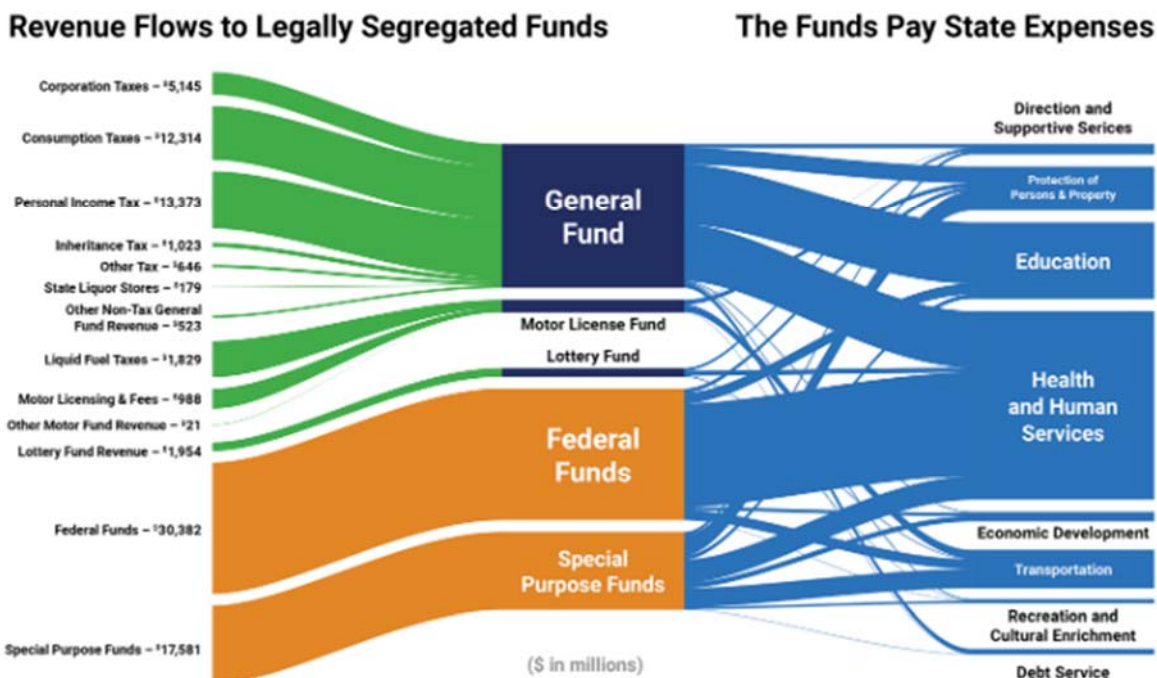
- 0.947% of sales and use tax receipts go to the Public Transportation Assistance Fund
- 4.4% of sales and use tax receipts are transferred annually to the Public Transportation Trust Fund.
- \$30.73 million annual transfer of cigarette tax collections to the Children's Health Insurance Fund and \$23.49 million annual transfer to the Agricultural Conservation Easement Purchase fund.
- Sales taxes will be transferred automatically if needed to pay the debts of the Commonwealth Financing Authority

Such monies are effectively removed from the regular appropriation process and redirected to pre-determined uses. The Governor's Executive Budget breaks down state programs² by funding source, which, with some compilation and reorganization, allows for an estimate of which revenue

² Unfortunately, the Budget Office's overly-broad "programs" do not line up with the more specific expense items analyzed in Part I. Health and Human Services, for example, could be helpfully split up into several more specific categories. "Economic Development" can mean nearly anything.

streams fund which purposes. Commonwealth Foundation estimates are shown in the flow chart below.

Revenue Sources and Uses



Source: Commonwealth Foundation, Governor's Executive Budget 2019-2020

A review of revenue sources and uses shows that legislatively appropriated funds (that is, funds that are not Federal Funds or Special Purpose Funds on the graph) are spent on a variety of sources. Education funding, for example, is effectively funded by a variety of different taxes which flow into the General Fund.

Health and Human Services is funded about 50/50 by federal and state revenue due to the structure of the Medicaid program, which was conceived at the federal level to be a system whereby state spending would be matched with federal dollars. Unfortunately, this is a recipe for cost laxity: it becomes very easy to spend when somebody else is paying a large portion of the bill. Indeed, Medicaid costs are among the largest and fastest growing parts of the budget.³ Such a funding structure has also led to questionable schemes designed to draw in more federal money such as the Quality Care Assessment, where the same hospitals paying the state assessment (tax) receive large amounts of federal funding.⁴

³ "Slicing Pennsylvania's Finances, Part I: Spending is Overgrown and Unsustainable." Commonwealth Foundation Policy Brief. August 21, 2019.

<https://www.commonwealthfoundation.org/policyblog/detail/slicing-pennsylvanias-finances-part-1>

⁴ "Hidden Human Services Spending." Commonwealth Foundation Policy Blog. June 27, 2018.

<https://www.commonwealthfoundation.org/policyblog/detail/hidden-human-services-spending>.

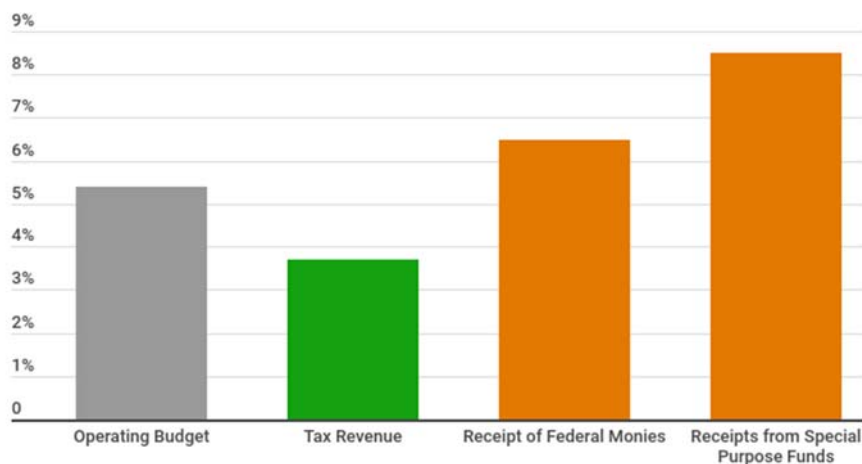
Readers interested in the pernicious influence of federal funding on state and local programs generally should read the Cato Institute report on the topic "Restoring Responsible Government by Cutting Federal

Certain policy priorities: Health and Human Services, Economic Development, Transportation (specifically, mass transit) and Recreation and Cultural Enrichment (largely environmental spending) are disproportionately funded by Federal money and special funds. Legislators have put these programs on “auto pilot” by design to defend against their dismantling by political opponents. It is far more difficult for a future legislature to dismantle spending that receives dedicated funds than to simply not appropriate the money. A future legislature must proactively enact new legislation to reverse the earlier automatic funding or shut down the special purpose entity. Otherwise money will continue to flow.

Dependence on federal and special funds has been growing, and consequently legislative control over spending has been shrinking. Tax revenue, the revenue stream that the legislators actually appropriate from year to year, has lagged total budget growth over the past five years. Federal money and special-purpose state money have made up the gap.

Growing Dependence

Tax revenue lagging budget growth, other monies filling the gap



Five year average rates of growth through 2020.
Source: Commonwealth Foundation, historical state budgets

For the purpose of expense control, transparency and responsive governance it is important that the state legislature re-assert fiscal primacy. Revenue streams properly belonging to the three core government funds (General, Motor License and Lottery) should not be sent by formula to special-purpose funds for non-discretionary use. Revenue currently collected outside of the core funds (For example: turnpike income, gaming revenue, and tobacco lawsuit monies to the extent permitted under the settlement), should be brought under legislative control. Changing direction starts with switching off the autopilot.

Aid to the States.” Policy Analysis No. 868, May 20, 2019. <https://www.cato.org/publications/policy-analysis/restoring-responsible-government-cutting-federal-aid-states>

Appendix: State Revenue Through Time

	actual 2012-2013	actual 2013-2014	actual 2014-2015	actual 2015-2016	actual 2016-2017	actual 2017-2018	estimated 2018-2019	estimated 2019-2020
Corporate Net Income Tax	\$2,423	\$2,502	\$2,811	\$2,842	\$2,751	\$2,879	\$3,343	\$3,423
Gross Receipts Tax	1,306	1,279	1,262	1,305	1,231	1,150	1,177	1,177
Public Utility Realty Tax	44	37	38	39	40	34	34	34
Insurance Premium Tax	447	432	454	465	433	451	400	400
Financial Institutions Tax	351	318	294	330	323	371	376	376
Corporation Taxes	\$4,572	\$4,568	\$4,860	\$4,981	\$4,778	\$4,885	\$5,330	\$5,411
Sales & Use Tax	8,894	9,130	9,493	9,795	10,004	10,381	11,103	11,447
Cigarette Tax	1,024	977	927	912	1,262	1,198	1,119	1,065
Other Tobacco Products Tax	0	0	0	0	84	119	128	134
Malt Beverage Tax	25	25	24	25	24	24	23	23
Liquor Tax	311	321	334	348	362	372	385	400
Consumption Taxes	\$10,254	\$10,453	\$10,779	\$11,080	\$11,736	\$12,094	\$12,758	\$13,069
Personal Income Tax	11,371	11,437	12,107	12,506	12,667	13,399	13,855	14,443
Inheritance Tax	845	877	1,002	962	978	1,019	1,060	1,106
Realty Transfer Tax	339	375	414	482	478	514	549	598
Gaming Taxes	89	90	96	100	121	123	150	174
Minor & Repealed Taxes	597	297	234	147	-2,961	-32	-29	-35
Other Tax	\$1,024	\$763	\$744	\$729	(\$2,362)	\$606	\$669	\$738
State Liquor Stores	80	80	0	0	216	185	185	185
Licenses & Fees	137	109	110	117	119	323	296	187
Miscellaneous	307	249	840	455	502	1,980	176	79
Fines, Penalties & Interest	55	71	70	72	79	75	70	74
Other Non-Tax	\$500	\$429	\$1,020	\$644	\$700	\$2,378	\$542	\$340
Refunds, Lapses and Adjustments	-1,048	672	-1,197	-1,383	-1,269	-1,035	-1,197	-1,143
All General Fund Revenue	\$27,599	\$29,280	\$29,315	\$29,518	\$27,445	\$33,532	\$33,203	\$34,149
Liquid Fuel Taxes	1,233	1,294	1,562	1,659	1,733	1,846	1,829	1,829
Motor Licenses & Fees	893	894	951	963	1,001	1,046	988	1,012
Other Motor Revenue	301	258	98	36	25	56	21	22
Motor License Rev (excl. restricted)	\$2,426	\$2,447	\$2,612	\$2,658	\$2,759	\$2,948	\$2,839	\$2,863
Net Lottery Game Collections	1,592	1,598	1,559	1,676	1,560	1,641	1,806	1,811
Transfer from Gaming Fund	167	167	163	167	148	146	142	146
Other Lottery Revenue	0	2	2	11	1	3	6	1
Lottery Fund Revenue	\$1,759	\$1,766	\$1,723	\$1,854	\$1,709	\$1,789	\$1,954	\$1,959
Federal Funds Revenue	22,175	22,178	24,811	26,566	27,796	28,968	30,382	29,586
Other State Funds	11,379	11,892	13,378	14,288	14,609	15,625	17,851	17,266
Total Revenue for Operating Program	\$65,338	\$67,562	\$71,839	\$74,884	\$74,318	\$82,862	\$86,228	\$85,822
<i>Taxes only</i>	<i>\$28,067</i>	<i>\$28,098</i>	<i>\$29,492</i>	<i>\$30,258</i>	<i>\$27,797</i>	<i>\$32,003</i>	<i>\$33,672</i>	<i>\$34,767</i>

Source: Governor's Executive Budget, multiple years. Dollar amounts in millions.