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Fitch: PA Budget Proposal Would Close Gap; Prospects Uncertain.

Fitch Ratings-New York-08 February 2018: Governor Wolf's fiscal year 2019 executive budget for Pennsylvania – which utilizes a severance tax, solid revenue growth and targeted savings efforts to support a roughly 3% increase in the general fund budget – will likely face headwinds in the legislature, Fitch Ratings says. The governor has advanced a severance tax proposal since his election campaign four years ago but has not won sufficient legislative support to date. This budget plan comes at the start of an election year for the governor, all members of the commonwealth's house and half of the senate. Fitch's focus during the commonwealth's budget process will be on whether Pennsylvania is able to continue making progress in addressing its still sizable structural budget gap. Fitch's 'AA-' Issuer Default Rating and Negative Outlook reflect concerns that the commonwealth may be challenged in continuing its current path of slow progress in reducing the imbalance. A pattern of weakening fiscal practices, including growth in the structural deficit, could trigger a downgrade.

PROGRESS IN REDUCING STRUCTURAL GAP

Based on analysis from the commonwealth's Independent Fiscal Office (IFO), Fitch estimates the current year (fiscal 2018) budget includes approximately $600 million in non-recurring revenues on a $32 billion general fund spending plan (2%). This is lower than prior years, reflecting recurring revenue increases and savings measures. In January 2016, the IFO estimated a $2.5 billion general fund structural gap for fiscal 2019 – by this past November, the IFO reported that gap had narrowed to $1.1 billion, or 3% of projected spending.

UNCERTAIN BUDGET PLAN PROSPECTS

While the budget proposal from the Democratic governor does not appear to include material non-recurring revenues, Fitch anticipates the Republican-led legislature will develop its own set of budget measures, leading to a final budget that could vary considerably from the original. Three previous budgets under the current governor, and the last one under the prior governor, were enacted after the start of the fiscal year due to policy and fiscal disagreements. This November's election adds additional uncertainty to the budget process – the speaker of the house is vying for the Republican nomination to replace the current governor, which could make for a particularly complicated political dynamic during budget negotiations.

LIMITED REVENUE MEASURES

The key revenue measure is a natural gas severance tax estimated to generate $250 million annually. The governor's three prior executive budgets unsuccessfully proposed a different version of the proposed severance tax. Last summer, the senate did approve a severance tax as part of a revenue package. While the measure did not pass the house, last year's senate passage could lead to additional momentum behind the measure this year. Notably, in contrast to prior years, the governor did not include any personal income or sales and use tax changes in his proposal. Instead, the executive budget forecasts steady organic growth in both sources this year and next. The IFO's revenue forecasts also anticipate continued growth, though at a somewhat more modest pace. Through January, the Department of Revenue reports general fund collections for fiscal 2018 are tracking $90 million (1%) ahead of the official estimate. Of the key tax revenues, sales and use taxes are essentially in line with the estimate while personal income tax revenues were 2% above estimate. An outsized increase in collections for non-withholding personal income taxes in December could be a one-time behavioral shift in reaction to the recent federal tax changes.

EDUCATION AND PENSION SPENDING DRIVE INCREASES

On the spending side, proposed general fund spending of $32.9 billion is up 3%, or just under $1 billion, over the enacted fiscal 2018 budget. The executive budget includes a $100 million increase in basic education aid funding (approximately 2%) for K-12 public schools. If approved, approximately 7% ($400 million) of $6.1 billion in basic education aid would be distributed using a new funding formula adopted in 2016. The governor also proposes increased funding for the Pennsylvania State System of Higher Education (PASSHE, revenue bonds rated AA-/Negative) for the fourth consecutive year.

For pensions, the executive budget proposes full funding of actuarially determined contributions for both the state employees retirement system (SERS) and the public school employees retirement system (PSERS) for the first time since fiscal 2004. The SERS contribution of $685 million is funded directly by the commonwealth, while the more significant PSERS contribution of $2.5 billion flows through school districts via commonwealth appropriations.

As in prior years, savings measures are a key focus of this executive plan. "Complement" (the commonwealth's term for its total workforce), continues trending downward and the administration reports the proposed level would be the lowest in over four decades.

MEDICAID SPENDING DOMINATES

Medicaid remains a major driver of the budget, with the fiscal 2019 budget proposing $7 billion in general fund spending, or more than one-fifth of the total general fund budget. Commonwealth Medicaid spending would increase less than 2% from the enacted fiscal 2018 amount under the executive budget, well below the rate of national medical inflation. The budget includes continued shifting of Medicaid services to a managed care model, including for long-term care which is a likely driver of future Medicaid spending.

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