Financial Rescue Plan for the Commonwealth of Pennsylvania

The crisis background:

The Commonwealth of Pennsylvania has suffered from a series of setbacks financially since 1930s.

Major industry failures in the steel industry, the rail industry, and the coal industry have wreaked havoc on the finances of our Commonwealth and our citizens.

The measures of effectiveness which indicate that Pennsylvania is struggling include:

1. Significantly underfunded pension obligations to Commonwealth employees and municipal workers.
2. Substantial expected budget shortfalls in the 2017 fiscal year.
3. Loss of congressional representation from 34 representatives and House of Representatives at the federal level to 18 in 2016.
4. Massive infrastructure shortfalls in virtually every category of infrastructure to include highways, electric power grid, water and sewer systems, and bridges.
5. The decline in job creation for people under the age of 30
6. The net exodus of population since 2015

There are other measures of effectiveness which reflect the problems in our Commonwealth but the intent is to reinforce the inherent nature of the financial crisis in our state.

Our Commonwealth is essentially insolvent. In my 40 years of experience in helping keep companies out of bankruptcy, insolvency usually precedes bankruptcy by 10 to 15 years.

An insolvency is one in which the financial options to cure the problems are so severe as to create a situation in which the solution causes the next crisis and eventual failure. Pennsylvania has time, but precious little time, to reverse the trends seen above.

The plan of action we are proposing is intended to be a complete financial restructure of the Commonwealth. The plan includes many aspects of bills that have already been submitted to the legislature for approval. What we have attempted to do here today is to provide a sequence or battle plan so to speak to allow for the political will to adopt a credible solution.

The financial problems in Pennsylvania started well into the 1930s. It is my considered opinion that we have approximately 2 to 4 years before solutions are not possible without severe economic dislocations to various sectors of the Pennsylvania economy and government.

Critical success factors:

The following are considered to be critical success factors. A critical success factor is one in which the presence or absence of this risk factor may result in the success or failure of a plan. The Committee on Sponsoring Organizations (www.coso.org) provides exceptional guidance in understanding enterprise risk (see Appendix 6) as does a book by Francis X Ryan entitled "Revolutionizing Accounting for Decision Making – Combining the Disciplines of Lean with Activity Based Costing".

Certain critical risk factors include:

1. Interest rates and quantitative easing within the Federal Reserve - these abnormally low interest rates since 2008 have resulted in substantial underperformance in the states pension plans.
2. Four nation results of quantitative easing - the results of quantitative easing in the four industrialized nations of the Bank of Japan, the European Central Bank, the United States Federal Reserve, and the Bank of England reflect significant inability to resurrect and revive the economy since the housing bubble.
3. The economic impact of quantitative easing and Keynesian 2.0 have resulted in limited economic growth and will continue to do so until the effects of quantitative easing and Keynesian 2.0 have been alleviated.
4. Earnings rate on Pennsylvania pensions of 7.5% versus the commercial sector which uses an average of 5.5%. This is expected to result in an increase in the unfunded pension liability of an additional $40 billion.
5. The underfunded nature of the current pension plans at the state and municipal levels.
6. The aging Pennsylvania population which reduces income from the income tax rate and puts more citizens into tax-exempt income since retirement income is not taxed in the Commonwealth.

7. The Pennsylvania Corporate Income Tax at 9.99% is one of the highest in the nation and is negatively impacting job creation in the Commonwealth.
8. Municipal defaults in Detroit and Puerto Rico are not likely to cause municipal problems to rise to a level of a sense of urgency to solve.
9. A municipal bankruptcy in Chicago will however trigger a national effort to resolve all municipal and state wide financial problems in much the same way that Bethlehem Steel's triggered a resolution of the problems facing the steel industry.

Critical assumptions:

The following critical assumptions are being made relative to any fiscal rescue plan:

1. The Commonwealth will be able to maintain its bond rating and borrow at market rates for municipalities and states
2. The year before the gubernatorial elections is the most likely year for major reforms of pension and property tax issues
3. Interest rates are likely to increase by 100 basis points in 2017.
4. The momentum of HB 76/SB 76 is likely to continue forcing the legislature to act in favor of the legislation.
5. Pennsylvania revenue is unlikely to increase for the remainder of fiscal year 2017 and the beginning of fiscal year 2018 is likely to see slight increases and tax revenue from economic growth.

Goals of the economic rescue plan:

The goals of the economic rescue plan for the Commonwealth of Pennsylvania include:

1. Elimination of the property taxes for the funding of school taxes – HB76/SB76
2. Development of a balanced budget based upon realistic spending and revenue assumptions
3. Beginning to pay down the unfunded pension obligations of the Commonwealth
4. Converting all new employees to a defined contribution plan.
5. No new taxes

The Financial Rescue Plan:

The financial rescue plan is made up of the following key components:

1. A resolution seeking damages from the Federal Reserve from the negative impacts of quantitative easing on the earnings of state municipal pension plans. The estimated amount of damages is 200 to 400 basis points per year for 40% of the state's portfolio and municipal portfolio of pension assets. These damages would be for the years 2009 up to and including 2016 and are estimated to be between $12 billion in $18 billion plus damages for the losses associated with municipal plan assets. Should this effort be successful the funds would be paid into the pension plans to reduce the unfunded liability. Since the Federal Reserve has claimed sovereign immunity in prior court cases, the resolution will seek Congressional action to reimburse the states for losses sustained by the quantitative easing policies.
2. A resolution seeking payment from the federal government for the unfunded mandates associated with children with disabilities at a rate of 100% funding. It is expected that this would amount to 15% of the Department of Education's budget or approximately $1.5 billion annually to $2 billion annually. This reimbursement will allow for reduction in property taxes immediately in the amount of approximately 15% of the property taxes. This will provide temporary property tax relief while the remainder financial rescue plan is implemented. This resolution has been entered and is currently in front of the Education Committee
3. Passage of the SMART Act from Rep. Seth Grove or appropriate Performance Based Budgeting standards. This would include an additional provision that the results of the auditor general's audits must be responded to by the state agencies and cost savings implemented or face the risk of losing funding pending the implementation of the cost savings. It is expected that this program may result in annual savings of $3 billion per year. These savings would be used to pay down the unfunded pension liability.
4. Amend the Act of 1929 providing for mandated responses to the Auditor General's Audits within 120 days or risk losing funding. HB-453 is expected to be passed by the House on April 24 and the Senate version of the bill in in the Senate Finance Committee.
5. Passage of Medical and Medicaid Waste Fraud and Abuse statute - It is estimated that this bill will reduce costs by $1.5 Billion after implementation. The net proceeds would be used to pay down the existing pension liability
6. Passage of the Defined Contribution bill by Warren Kampf or a similar bill by John McGinnes to put new employees in a defined contribution plan immediately.

7. Passage of HB-76 – with the changes above; the net amount of school funding to be “replaced” will be under 50% most of which the State of PA currently provides each school.   Any shortfall would be made up with an expansion of taxation on certain limited sales taxes.

Implementation

In order to increase the likelihood that this plan will be adopted, it is recommended that a working group be established that would be made up of the following interested parties:

Operating under the auspices of either the majority leader or the speaker the house, the working group would have no specific responsibilities other than to work out the details of the seven step plan above.

The purpose of the committee will be to merely point out the implementation methodology for the above plan and to offer refinements to specific implementation ideas only.