Economic Outlook

The economy emerged from the worst slowdown since the great depression in June of 2010 which made the recession 18 months in length. However, growth has not rebounded as sharply as many had hoped. Instead, growth has been sluggish as it often is, when a recovery begins.

It seems that economic growth started again in early 2010 only to slow down again over the summer. It appears that growth is here to stay now, but the question is how robust will that growth be? The Governor, in his mid-year budget briefing today, indicated that he believes that the economy will be experiencing decent growth over the next 18 months.

Real GDP growth in the second quarter was 2%. Not robust, but solid and higher than expected. Global Insight, the economic forecasting firm hired by the Commonwealth, was expecting real GDP growth of 1.7%. They were anticipating the growth of 2.7% for all of 2010. They now have increased their estimate slightly to 2.8% for this year. Global Insight is predicting slower growth of 2.4% for 2011. It is important to remember that the 2011 growth is unaided by fiscal stimulus programs. It is a rebound from businesses, not government. The growth in the first half of 2011 is estimated to be 2.1%.

It is always a concern that after a mild recovery the economy can slip back into a second recession because it is so weak after the first one. This is called the double dip recession and Global Insight had predicted a 25% chance of the double dip occurring. Their November estimate has reduced the possibility of a double dip to 20%. In their double dip recession scenario, real GDP grows 1.7% in the second quarter of 2010 and then plunges to .5% growth in the third quarter, before entering the second recession and contracting -0.8% in the fourth quarter and 1.5% in the first quarter of 2011. If their double dip recession scenario were to be accurate, the economy would currently be in a significant slowdown dropping from 1.7% growth to .5%. There are no indications that such a slowdown is occurring now.

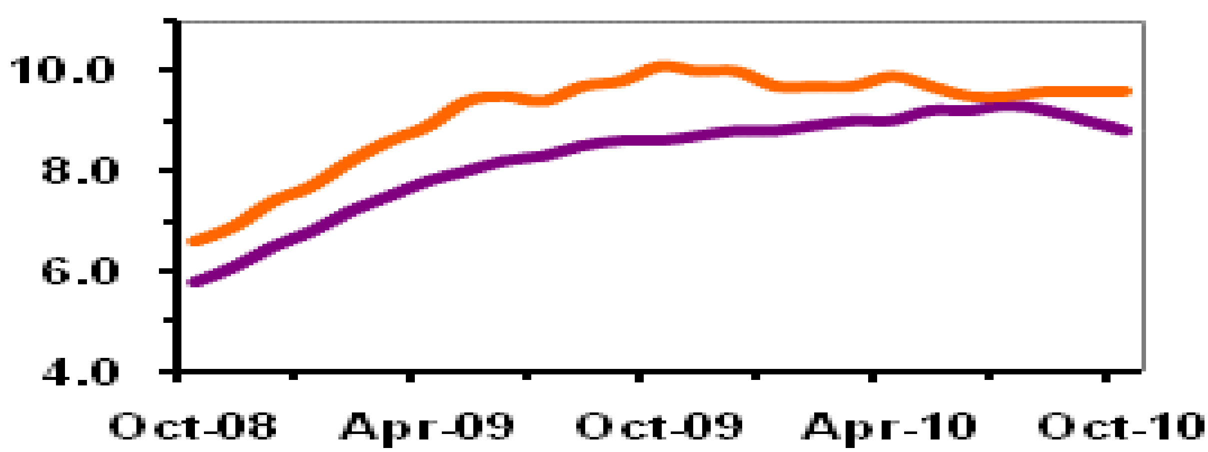
Many corporations have been profitable for over a year. In fact, businesses are holding record amounts of cash. They have not invested their riches in rehiring employees or investing in new plans or equipment. Instead, they have paid down debt or held onto their profits. They will continue to hold onto these funds until they are sure that the recovery is fully underway and the economic growth is not a temporary blip fueled by stimulus money. It is possible that when they feel confident, there could be a huge surge in spending that will accelerate the economy much more than Global Insight is projecting.

Unemployment Outlook

Pennsylvania's seasonally adjusted unemployment rate dropped to 8.8 percent in October, down two-tenths of a percentage point from September, marking the third consecutive month that the rate has fallen. The Commonwealth's rate was a full .8 percent below the national 9.6 percent unemployment rate for the month of October. The state's unemployment rate has now been below the national rate for 91 of the last 94 months. Pennsylvania's net job growth of 63,900 jobs this year, ranks us 17th among all states, and far ahead of neighboring Ohio, New York and New Jersey. In sharp contrast, our New Jersey neighbors continue to struggle with lost jobs and a declining economy. This good news for Pennsylvania is a refreshing change from the beginning of the decade when the Commonwealth ranked near the bottom in similar economic surveys. The turnaround has not been sudden, but has been consistent as the state benefits from key investments in new emerging industries, site and infrastructure investments, and efforts to build a better educated and trained workforce. The clear evidence of positive job growth coupled with declining unemployment is certainly encouraging news for Pennsylvania.

	PA Oct '10	US Oct '10
Civil Labor Force	6,366,496	153,904,000
Employment	5,618,100	139,061,000
Unemployment	560,118	14,843,000
Unemployment Rate	8.8%	9.6%

Unemployment Rates PA US



Tax Revenues

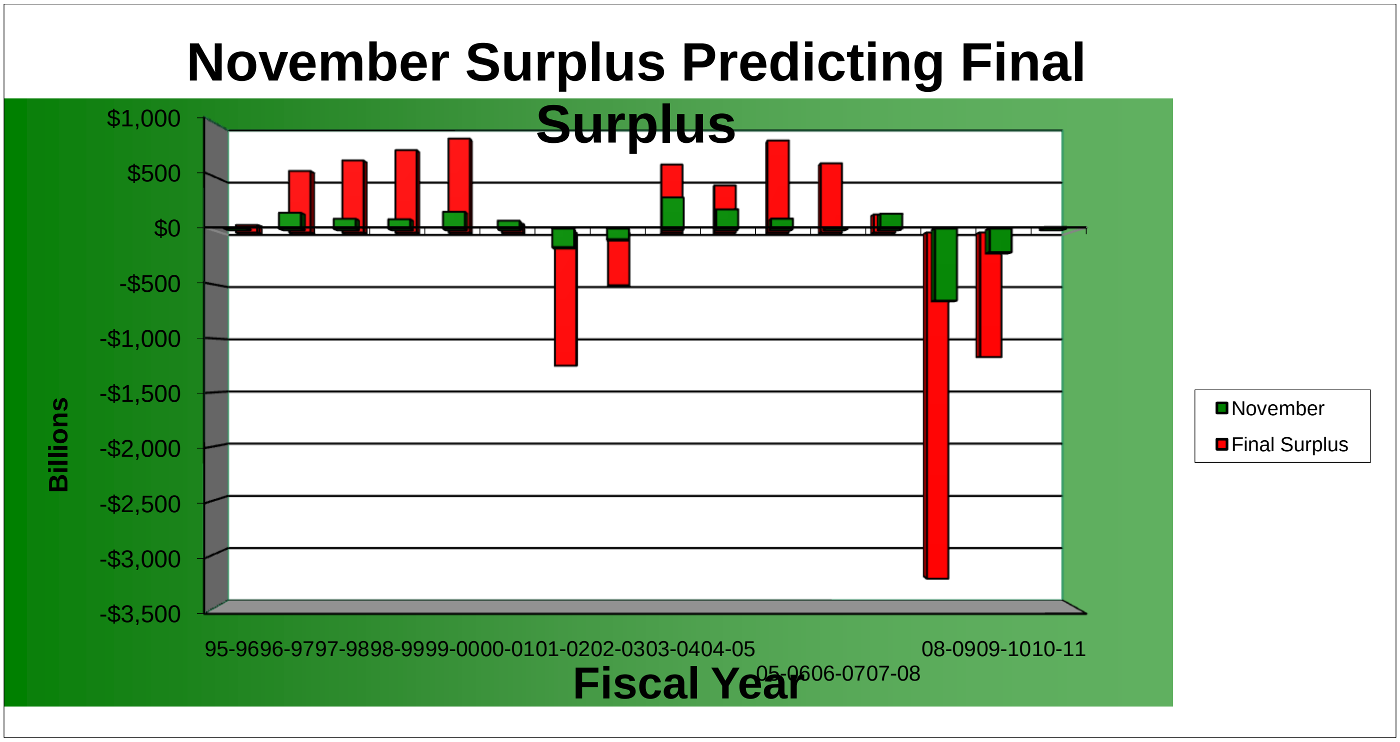
Commonwealth revenue collections are very dependent on the economic conditions of the nation and the state. For the year to date through November, collections are $14.3 million or .2% above the Governor's official estimates. The overage had been $71 million at the end of September, but revenues are still over estimates and the details of November collections still suggest that revenue collections are likely to be strong.

The three main tax sources: business taxes, sales tax and personal income tax (PIT), were mixed in November, as sales tax was over estimate and PIT and business taxes were below estimate. Sales tax collections have been over estimate each month of this fiscal year and are $71 million or 2.1% over the year to date estimates. Business tax collections are $55 million or 7.8% over the year to date official estimate, so the small shortfall in November has had no real impact.

It is only the last two months (October and November) that cause concern regarding PIT collections. Personal Income Tax collections ended $43 million or 5.9% short of estimate in October. The shortfall was all in non-withholding payments as PIT estimated and final payments were $15 million and $28 million below estimates, respectively. Withholding collections were short of estimate by only $209,000 which is really the same as being at estimate. November collections were better as they were only $22 million short of estimate. Non-withholding revenues were $9 million below estimate. For the year to date, withholding collections are $5.8 million or .2% under estimates. Non-withholding collections have trailed estimates each month and are now $72 million or 14% below estimates.

Tax collections through September were very positive. October collections took a step back, but it is important to note that other than non-withholding PIT collections, October collections were not bad. November's collections were slightly below estimate. The amount of tax revenue collected in November is less than any other month except for February. So it is wise not to draw too much inference from the tax collections in November. Collections are still on target to be over estimates at the end of the fiscal year in June.

There is a fairly good relationship between the overage/shortfall of collections at the end of November and the final end of June surplus/ deficit. The scale may not be exactly the same, but a surplus year to date through November has always guaranteed a surplus at the end of the fiscal year and unfortunately so has a deficit in November always resulted in a deficit in June. The chart on the next page shows this relationship and gives hope for June 2011.



Tax Issues

The tax mix of the Commonwealth is not ideal. As the Marcellus Shale natural gas play ramps up there is no extraction tax in place. Pennsylvania is one of only two states that have significant natural gas drilling that does not have an extraction tax. 28 states that have drilling activity do tax the extraction and the tax, while not recession proof, is recession resistant.

There are two concerns regarding the corporate net income tax (CNI). One concern is a legal mechanism in which corporations move income to states that don't have an income tax and thereby lower the tax liability in Pennsylvania. This is usually accomplished by setting up a nonfunctioning shell corporation in Delaware. This Delaware corporation will own the patent or the trademark of the corporation doing business in Pennsylvania. The Delaware corporation will charge the PA corporation an excessive fee for use of the patent or trademark and the business income of the PA corporation is significantly reduced. They owe less tax to Pennsylvania and the income earned in Delaware is not taxed since Delaware has no corporate income tax. Such a tax dodge is called the Delaware Loophole and the solution is requiring all corporations to show all their profits and expenses on a combined tax report.

The prominence of the Delaware Loophole is a substantial reason for the other issue with the CNI tax. Since so many corporations shelter so much income using the Delaware Loophole, the only way for the tax to raise sufficient money is to have a very high rate on those that do pay the tax. Pennsylvania's rate of 9.99% is the second highest in the country. Having the second highest nominal rate of tax is detrimental to the perception of the business tax climate, or how friendly is the system of taxation to the businesses that are operating here.

Pennsylvania does have a business tax that every corporation pays, but it is a tax on assets held within the Commonwealth and not net profits, which is a more fair way to tax businesses. However, the Capital Stock tax is being phased out due to its unfairness. This phase-out was originally schedule to be complete by 2008. The phase-out has been delayed each time there was a funding crisis for the budget. It is now scheduled to be completed by 2014 and the tax will not be collected anymore.

In October, the think tank Tax Foundation released its eighth annual State Business Tax Climate Index. Pennsylvania achieved the rank of 26th in their index, which suggests that the state is in the middle of all states for its business tax levy. The actual ranking is important but so is the change. In 2007 Pennsylvania ranked 30th in this same survey. This year's survey shows Pennsylvania ranked better than all its neighboring states except for Delaware. This ranking places the Commonwealth with the same business tax burden level as states in the southern region of the nation that are traditionally held out as very competitive states. These southern states and their ranking in this year's survey are South Carolina (24), Georgia (25), Alabama (28) Mississippi (21) North Carolina (41) Tennessee (27) Virginia (12) and Kentucky (19).

The Tax Foundation compiles their index by looking at 112 variables contained in 10 sub-indecies that are weighted based on the difference each state's score is from the mean. While the calculation seems fairly complex, the Tax Foundation offers a simple rule of thumb: "Good state tax systems levy low, flat rates on the broadest bases possible, and they treat all taxpayers the same." Under this criteria, Pennsylvania does a pretty good job in levying its taxes.

One area that Pennsylvania does really well in is its treatment of small businesses. Most small businesses pay the personal income tax on distributions to the owners. Pennsylvania levies a flat 3.07% tax on the distributions of net income. On the personal income tax component of the study, Pennsylvania ranks 14th in the nation. There are 11 states that have no personal income tax and only one other state (Indiana) has a lower rate.

Two areas that Pennsylvania does not do well in are the corporate tax index, because the high nominal rate of our tax (9.99%) earns us a 38th ranking and the property tax index which carries a 44th ranking. Pennsylvania has improved in this category in recent years. Its ranking in 2007 was nearly last at 47th. It is not a coincidence that this decrease occurred while the state was increasing its support for primary education, the largest single use of property tax in this state.

2010-11 Budget

The budget that was passed, on time, on June 30, 2010 spends $290 million less than the 2008-09 budget and is only $200 million or .7% more than the 2009-10 budget. As was discussed previously, revenues are on target through November with a slight $14 million surplus. An unexpected reduction in federal FMAP ARRA funds of $280 million prompted the Governor to place $200 million of spending into budgetary reserve. He is also anticipating the need for a $65 million supplemental to the Department of Welfare for additional needs during this tough economic period. These changes net out to a small $63 million or .22% expected deficit for the current budget.

Budget Problems for 2011-12

Balancing the budget since the recession of 2008 has not been easy. State tax receipts decreased in 2008-09 by 8.6% from the year before the recession. Tax receipts have not returned to the level they were in fiscal year 2007-08. To balance the budgets and protect important government services, a strategy of using one time sources of revenue and targeted spending cuts was utilized. One time revenues are just that, eventually those funds are used up and further hard choices have to be made. The Commonwealth is at that point now. The money from the federal government is expiring at the end of this year. This money has done exactly what it was designed to do; it allowed states to maintain a level of spending and investment that prevented the country's economy from coming to a complete stop and throwing more people out of work and shutting more businesses.

The federal funds were necessary at the time and have been a great help to the Commonwealth, but those funds will not be available this year. In this current budget, those funds were $2.7 billion. Other sources of one time revenues were about $1 billion. Some combination of new revenues, spending cuts and growth from existing taxes will be required to replace the $3.7 billion of one-time revenues that are in the current 2010-11 budget.

Below is a table that shows the one time revenue sources that are currently in this year's budget and will not be available to balance the 2011-12 budget when it is put in place in June of 2011. The total of $3.7 billion is a staggering amount.

One Time Revenues 2010-11 Budget
Dollars in Thousands
Small Fund Transfers

Rainy Day Fund	$745
Emergency Medical Services Fund	$5,000
Highway Beautiful Fund	$800
Key 93 Fund	$9,930
Local Gov't Capital Project Loan Fund	$1,000
Low Level Nuclear Waste Site Fund	$2,700
PERF	$5,400
Small Business First Fund	$4,000
State Stores Additional Transfer	$25,000
Total	$54,575

Additional Transfers

Transfer from Oil & Gas Lease Fund	$180,000
Tobacco Settlement Transfer	$250,000
Endowment Acct- PSERS Payment	$121,000
MCARE	$44,000
	$ 595,000

ARRA Money

Federal ARRA Funds	$ 1,789,766
State Fiscal Stabilization	$ 921,384

Expiring Tax Changes

Capital Stock Rate Reduction	$80,000
Tax Credits Reduction	$67,000
Sales Tax Payment Acceleration	$217,500
	$364,500

Total One Time Revenue	**$3,725,225**

Spending Increases

Not only was the budget balanced with one time revenue sources that will not be available this year, but it was also balanced by deferring some expenditures that will have to be done and are growing larger with our neglect. The major issues that will grow as part of next year's budget are:

1. The current state commitment to the pension funds is $584 million. Next year the commitment will nearly double to $1.14 billion. Even with the passage of HB 2497, which slowed the growth of the contribution to the pension funds, the state's commitment will increase significantly as the 2012-13 commitment is expected to be $1.6 billion, another $500 million higher. Had HB 2497 not been passed, the expected state commitment in 2012-13 would be $2.2 billion higher at $3.9 billion. None of the changes in the bill could affect the amount of the unfunded liability of the pension funds. The unfunded liability is the actuarial calculation of the pension benefits owed to current employees. It is payment owed for work already done and therefore cannot be altered.

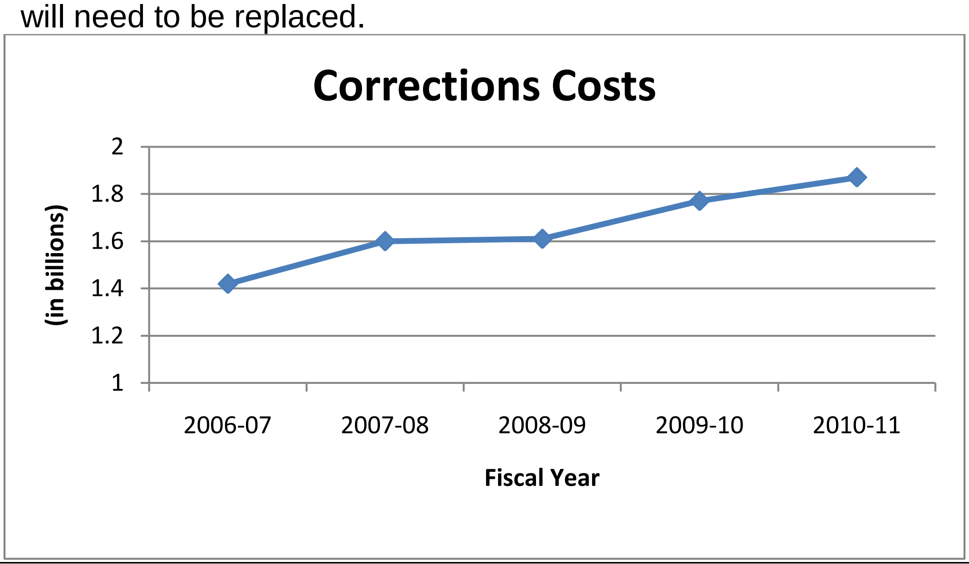
2. Another cost for services already rendered is debt service on existing debt. Debt service costs are expected to increase by $178 million for the 2011-12 fiscal year. This is a 17% increase from the current year.

3. The Commonwealth's adultBasic program was launched in 2002 to cover the basic healthcare needs of Pennsylvanians between the ages of 19 and 65 who have no health insurance and who meet certain eligibility requirements. Currently, there are 41,953 individuals enrolled in the state's adultBasic program. With the downturn in the economy and Commonwealth citizens losing their jobs and health care coverage, the waitlist for adultBasic services has grown to 478,785 as of the beginning of December.

   One of the major funding sources for the adultBasic program is the Community Health Reinvestment Agreement (CHR). The CHR agreement was entered into on February 2, 2005, by Pennsylvania's four Blue Cross and Blue Shield plans. This agreement was set to expire December 31st, 2010, which if not renewed, could have caused the existence of the adultBasic program to expire. The Blues plans have agreed to provide additional funding through the end of FY 10/11, which will allow for the adultBasic program to continue. However, the problem that remains is what happens to the adultBasic program July 1, 2011? The President's federal health care plan doesn't take effect until FY 2014. This will be one of many crucial issues facing Governor-elect Corbett and the legislature when negotiating the 11/12 state budget.

4. According to Act 44, the Pennsylvania Turnpike Commission was to collect tolls from I-80 and provide these funds for transportation projects across the state as well as use a portion to fix and maintain I-80. However, for this to occur the Act needed approval from the federal government to place tolls on Interstate I-80. The Federal Highway Administration denied Pennsylvania's authorization. Since Pennsylvania had already enacted a budget anticipating the approval of tolling I-80, this decision blew a $472 million hole in the budget. Act 44 still provides $200 million a year to the Motor License Fund and $250 million a year to the Public Transportation Trust Fund for transit projects in the state. If federal approval would have taken place, $950 million in funding would have continued to be provided for bridge, highway, and transit programs for the next twenty-five years. These funds desperately need to be secured if major bridge rehabilitation, highway construction, and essential transit services are to continue. According to this month's revenue account, the Motor License Fund has received $100 million from the Pennsylvania Turnpike Commission.

5. Pennsylvania's inmate population has been growing at a swift rate for the past several years which has led to corrections being a large cost driver for Pennsylvania's budget in the recent years. According to the U.S. Justice Department, Pennsylvania's prison population grew much faster than any other state's from 2007-2008. Nationwide, state and federal inmate population increased less than 1%, while Pennsylvania's was up 9.1%, well ahead of the 4.9% of second-place Arizona. Fiscal year 2010-11, however, seems to have bucked that trend. At the end of January 2010, there were 51,390 inmates in state prison. However, as of the end of November 2010, there were 51,193 inmates in state prison. This is contrary to the years of population growth in the inmate population and the projections for continued population growth. It is too soon to tell if this is a one year anomaly or if this trend will continue. The corrections budget for 2010-11 is $1.87 billion. Of that, $172 million is federal stimulus funds that will need to be replaced.



6. Pennsylvania continues to accrue billions of dollars of debt because of its insolvent unemployment compensation policy. Simply put, the unemployment compensation trust fund is not generating enough money to pay unemployment benefits. As a result, the state has had to borrow, and must subsequently repay, about $3.1 billion from the federal government to help pay unemployment benefits thus far. By the end of 2011, the state's outstanding loan balance to the federal government is expected to climb to $5 billion.

7. It is impossible to predict what level of education funding Governor-elect Corbett will be requesting when he presents his budget plan to the Legislature in March. Pennsylvania used a total of $748 million, in both the current and prior fiscal years (2009/10 and 2010/11), of federal ARRA money to supplement state funding for education. Specifically, $654.7 million in ARRA funding was used for the Basic Education Subsidy line, while the remaining $93.2 million supplemented state funds for community colleges, the State System of Higher Education, the four state-related universities and Thaddeus Stevens College of Technology. This federal money will no longer be available for the 2011/12 budget, and the new Administration will have to wrestle with how to fill this funding gap.

8. The payments to the Employees Benefit Trust Fund (PEBTF) were not made to the level that was needed to fully fund them in this budget year. This was an agreement reached between the Governor and the employee's unions. In fiscal year 2011-12, without further agreement, the full amount due will have to be put into the fund. Even if an agreement is possible, the full amount should be placed in the fund, as this type of deferral is what helped cause the huge problem in the pension funds as discussed above.

These challenges will greet the new Governor as he tries to craft his first budget in March.

Department of Corrections

There are four new prisons in various stages of the building process. SCI Benner Township is currently under construction. SCI Graterford, where two prisons are being built, is currently in the contract process. The new prison in Fayette County has been approved, but a request for proposal has yet to be issued. Building these prisons will allow Pennsylvania to bring back the 2,000 inmates that are currently being housed out of state in West Virginia and Michigan, but it will also add to the cost of the correction's budget.

Fiscal year 2010-11 saw the passage of Senate Bill 1161, which will begin to reign in a corrections budget that has grown exponentially over the last twenty-five years. The bill allows individuals that have mandatory programming to complete as part of their sentence to do so on probation if all other requirements of said sentence have been satisfied. More bills will be introduced with the goal of reducing the inmate population while being smart on crime.

Department of Community and Economic Development

Despite facing a large deficit going into budget negotiations, the General Assembly agreed that core support from the Department of Community and Economic Development (DCED) was necessary in order to move our economy forward. The overarching desire to create jobs and stimulate economic growth drove much-needed and wisely spent dollars into DCED.

While some areas had their budgets reduced, DCED's overall General Fund budget was increased by almost 25% over FY 2009-10. These funds will supplement existing programs and allow them to continue operating to support the communities of the Commonwealth. This includes $26.7 million for Infrastructure and Facilities Improvements Grants, $23.7 million for Community Conservation and Employment, $17.5 million in Opportunity Grants and another $17.5 million for Housing and Redevelopment Assistance.

The Commonwealth Financing Authority has been able to inject valuable dollars into many areas of the economy through loan and grant programs to help stimulate economic growth in Pennsylvania businesses and communities. Among these programs are:

- **Alternative Clean Energy Program** that has infused over $50 million into projects for the utilization, development and construction of alternative clean energy projects in Pennsylvania. $110 million still remains in this program.
- **Business In Our Sites** has successfully disbursed all $300 million to communities to help them attract businesses.
- **Building PA** has allocated $144 million of its $150 million to assist small to mid-sized Pennsylvania communities in acquiring capital for real estate development
- **First Industries Fund** has used loans, grants and guarantees to assist with agricultural and tourism initiatives, and continues to have $12.5 million available based on yearly loan repayments.
- The **High Performance Building Program** provides financial assistance through grants and loans to underwrite the cost premiums associated with the design and construction of high performance buildings in the Commonwealth, and they have a balance of $24.6 million in available funds.
- **PennWorks** has infused over $180 million into projects ensuring safe water and water infrastructure, with $13.5 million remaining.

- **Geothermal and Wind Projects** have an unused balance of $20 million after allocating $5 million in loans and grants to projects promoting this alternative and sustainable energy.
- **TIF Guarantee** has $51.6 million in available funds after allocating $40 million in guarantees that promote the general economic welfare of communities in Pennsylvania including assisting in the development, redevelopment and revitalization of Brownfield and Greenfield sites.
- **H2O PA** has provided about $556 million to municipalities and municipal authorities through Flood Control, High Hazard Dam, and Water and Sewer grants. While the High Hazard Dam grant funds have been exhausted, Flood Control and Water and Sewer have approximately $70 million and $172 million remaining, respectively.

Department of Education

Fiscal year 2010/11 marks the third year of Governor Rendell's proposed $2.6 billion, six-year goal to provide districts with adequate funding as defined in the "costing-out study." The 2010/11 budget continues towards that funding goal by allocating $5.73 billion of state and federal ARRA funding for the basic education subsidy payment to school districts, representing an increase of 3.6% or $200 million. The original enacted budget included an increase of $250 million, however due to the fact that certain federal funds coming to the state were below the expected amount, in August the Governor reduced the BEF increase to $200 million.

With the enactment of the 2010/11 BEF funding amount, the state is more than a third of the way towards the adequacy target goal of $8,355 per student (with supplements for low income, English language learners, school district size, and cost of living within the geographic region). And while the goal is not on track to be met in six years, Pennsylvania's investments in increasing student achievement are working:

- 82% of PA schools met the required academic goals for the federal No Child Left Behind (NCLB) law for 2010; up from 78% of schools last year.

- Three quarters of PA students are now on grade level based on 2009/10 PSSA scores in math and reading – the eighth consecutive year PA students posted gains in academic achievement.

- With the 2010 PSSA results, PA has the largest percentage of students scoring at the highest achievement level, and the smallest percentage of students at the lowest achievement level since PSSA testing began. In addition, the percent of students scoring "below basic" has decreased by half since 2002.

- In all grades and subjects, Black and Hispanic students have made double digit gains in achievement.

The ARRA FMAP Extension and Education Jobs Fund (federal) was signed into law in August, 2010. The law provides $10 billion for the Education Jobs Fund, a new program designed to save or create education-related jobs during the coming year. Pennsylvania is estimated to receive $387.8 million. Funding will be available for use by local education agencies (LEAs) during the 2010/11 school year. LEAs may use these funds to hire or rehire elementary and secondary education (K-12) school-level employees.

The General Assembly approved a long-term plan to spread the costs of paying for larger pension obligations during the next three decades. The plan will spread-out paying the unfunded liability of the system over the next 24 years. The PSERS Board has set 8.64% as a total salary cost for fiscal 2011-12 for each school district, up 3% from the current year's rate.

School districts and state government will split the costs of the employer contribution, which also covers health care costs, roughly 45% - 55%. Total employer contributions will top $1.1 billion in the next fiscal year. School boards usually pass along a hike in the contribution rate to property taxpayers when real estate taxes are set in June. And while these changes in the law lessen the increases in pension contributions that school districts would have faced in 2011/12, pensions will still require a significant infusion of funds in each of the next five years.

Pennsylvania Gaming Control Board

Slot Machine Gaming

The legalization of gaming in 2004 continues to provide economic and tax benefits to Pennsylvanians. As of December 2010, 10 of the 15 authorized gaming facilities have commenced operation. To date, the gaming industry has created over 13,000 jobs with family sustaining wages and benefits.

Since 2006, slot machine gaming has produced over $3.7 billion in tax revenue. As of November 30, 2010, the industry has generated over $2.3 billion for school district property tax relief. It is anticipated that in FY 11-12, the Commonwealth will again provide in excess of $750 million for both school district property relief and property tax relief available to senior citizens through the Senior Citizen Property Tax and Rent Rebate Program. In Philadelphia, revenues from gaming will continue to be used to reduce Philadelphia's onerous wage tax for both residents and non-residents.

Additionally, both the Commonwealth and local communities have reaped economic benefits because of the gaming industry. Counties and municipalities that host gaming venues have seen over $358 million in economic development money returned to their communities to fund worthwhile projects. Meanwhile, the Commonwealth has realized almost $340 million for large-scale economic development projects designed to promote tourism.

Finally, Pennsylvania's horse racing industry continues to rebound since the introduction of slot machine gaming. Since the inception of slots gaming, the Pennsylvania Race Horse Development Fund has provided over $740 million to the industry for, among other things, racing purses, breeder incentives, and health care and pension programs for the Commonwealth's horsemen. Countless horseracing related jobs have been generated and/or saved as a result.

Table Games

In January 2010, the General Assembly legalized table games. Pennsylvania generated $165 million in table games license fees, with additional fees expected from the venues not currently operational. In addition, since implementation in July 2010, table gaming has generated in excess of $20 million in tax revenue for the General Fund. Eventually, those tax revenues will return to the Property Tax Relief Fund to provide additional school district property tax relief.

Other Issues

Looking ahead, the gaming industry faces a number of issues. First, on December 16, 2010 the Pennsylvania Gaming Control Board ("PGCB") voted to revoke Foxwoods' gaming license in Philadelphia. This project has been beset by location, financing and other problems since the license was awarded in 2006. This decision will likely be appealed.

Second, the Pennsylvania Supreme Court is reviewing the PGCB's award of a Category 3 resort slot machine license to the Valley Forge Convention Center. Depending on the outcome, Valley Forge will either commence construction or PGCB will seek new applications for that license.

Third, the Pennsylvania Harness Racing Commission will accept a new application for a harness racing track, presumably in Lawrence County. American Harness Racing Tracks LLC recently purchased the rights to the last harness racing license from Centaur Gaming in federal bankruptcy court. Once that process is complete, American Harness Racing Tracks will apply to the PGCB for the last Category 1 racetrack gaming license.

Finally, in January 2011, the PGCB may award the second Category 3 resort license. Currently, four applicants exist – the Bushkill Group (Fernwood Resort) in Monroe County, Nemacolin Woodlands Resort in Fayette County, Mason Dixon Resorts in Adams County (Gettysburg, PA), and Penn Harris Gaming in Cumberland County (Mechanicsburg, PA). This will be the last Category 3 licensed issued by the PGCB until 2017, when the Gaming Act authorizes the issuance of another Category 3 resort license.

Department of Insurance

As the nation watched the outcome over the federal health care debate in Washington, D.C., so did the citizens and the Administration in Pennsylvania. The federal Affordable Care Act (ACA), the Patient Protection and Affordable Care Act, and the Health Care and Education Reconciliation Act of 2010 were signed into law March 23, 2010 by President Obama. The $960 billion federal health law aims to expand coverage to 32 million more Americans. It relies on a combination of Medicaid expansions, subsidies, tax credits and mandates. The law also allocates money to improve quality and halts certain widely criticized insurance practices. The biggest changes come in 2014 when Medicaid expands and states create exchanges or marketplaces for health insurance.

Next to Medicaid funding, healthcare funding has been a significant issue facing the Governor and the United States as a whole. Increases in healthcare costs are a growing national trend and the escalating healthcare costs will require Governor-elect Corbett to find new funding sources to maintain the status quo and to accommodate those who will need the services in the future. In recent years, health care costs have increased at an average annual rate of about 10 percent. This rate of growth creates significant budgetary challenges for the Commonwealth, both as an employer and as a provider of health care – including the 2.2 million people in the Medical Assistance program.

Department of Transportation

Federal Transportation Funding

Federal funding for Pennsylvania Transportation is funded through SAFTEA-LU which is authorization legislation to give states their federal funding allocation. This authorization language has expired and for the last four years Congress has been passing tentative extensions to this Act. Now, Congress is facing another extension, and is borrowing money from federal funds to place in the U.S. Highway Trust Fund. This temporary federal funding band aid limits the state's ability to plan long term transportation programs. Long term, multi-year reauthorizations of federal surface transportation programs will sustain transportation investment which is desperately needed. The 112th Congress has set its goal to develop a sustainable national strategy for surface transportation infrastructure.

Motor License Fund

In the 2010-11 budget the Governor is projecting revenue from the Motor License Fund of $2.619 billion. As of December 1, the <u>estimate</u> for year to date collections for 2010 was $964.290 million, and the <u>actual</u> revenues received are $1.007 billion. Therefore, the Motor License received $43.5 million more than was estimated at this point in time, or a difference of 4.5%.

The biggest increase in the Motor License Fund came from the sale of liquid fuels like gasoline and diesel fuel. This reflects the public having a bit more confidence in the economy. The Oil Company Franchise Tax also saw an increase of 6%. Also, there was a small increase in revenue received from the investments of the Motor License Fund made by the Department of Treasury.

Transit

Transit agencies across the Commonwealth are dealing with the loss of Act 44 money. Discretionary capital grants dropped from over $150 million to zero. This will result in increased maintenance costs to keep older equipment and facilities running. Starting in 2011, transit agencies will need to shift operating funds to maintain older assets causing less available funding to provide service.

In early December of this year Governor Rendell announced that the state will be helping the Port Authority of Allegheny County by making $45 million in federal transportation funds available to the Authority. The money was for federal economic development projects that have not moved forward. The Port Authority was facing a budget deficit of $47 million due in part to the failure to toll I-80. Earlier this year the Authority stated that in order to compensate for the deficit, service cuts of 35% and the elimination of dozens of bus routes would be necessary. The Southwestern Pennsylvania Commission approved the money transfer and it will now be up to the Port Authority to decide how exactly to spend the money. While service cuts may still be enacted, they will not be nearly as drastic.

U.C. Trust Fund Insolvency

Pennsylvania continues to accrue billions of dollars of debt because of its insolvent unemployment compensation policy. Simply put, the unemployment compensation trust fund is not generating enough money to pay unemployment benefits.

As a result, the state has had to borrow, and must subsequently repay, about $3.1 billion from the federal government to help pay unemployment benefits thus far. By the end of 2011, the state's outstanding loan balance to the federal government is expected to climb to $5 billion.

The primary revenue source for the trust fund comes from a tax imposed on employers. Employers are taxed on the first $8,000 that they pay a particular employee every year. The average tax is about 5%, but the $8,000 taxable wage base has not changed since 1984. There is also a small .08 percent tax imposed on employees. The tax on employees, which only goes into effect when a state's trust fund is insolvent, is about 80 cents per every $1,000 of wages.

However, the combined income from both of the taxes has not been enough to handle unemployment compensation claims in Pennsylvania. This year, the taxes are anticipated to generate about $2.5 billion in total for the fund, but the accrued benefits cost is expected to be $4.3 billion.

To pay off the loan, employers will be expected to pay increases in their federal unemployment compensation tax. Starting next year, the tax increase begins at 0.3% and will increase by 0.3% for every year the state has an outstanding loan with the feds. An additional state tax that cannot exceed 1% will also kick in to pay interest on the loan. That tax is expected to start at 0.4% in 2011. Employers will pay $32 for the state tax to pay interest on the federal loan per employee in 2011, and an additional $21 in federal tax per employee to pay off the loan. The increases that will go into effect in January will cost Pennsylvania businesses an additional $400 million annually for the next four years.

Over the next seven years, the taxes that go into effect to pay back the loan are expected to generate about $5.4 billion. However, at that point, the state will still be borrowing from the federal government and is projected to accrue a loan balance of more than $7 billion, highlighting the need for a legislative fix to pay back the loan, as well as the need for a solution for the insolvency of the fund.

Department of Public Welfare

According to the National Conference of State Legislatures, in the past five years, Medicaid enrollment grew when more people became eligible for the program because of the economic downturn and the reduction in employer sponsored insurance. At the same time, health care costs were rising--in fact Medicaid spending across the country grew faster than all other state programs.

Medicaid (MA) is the nation's largest publicly funded health financing program for low-income people. As a federal/state partnership, states have the option to participate or not. Even though the program has extensive federal requirements and restrictions, states administer the program with many options to tailor their programs to meet individual state's medical assistance needs. Medicaid plays a major role in our health care system, including paying for nearly half of nursing home care. Federal law sets the minimum requirements for eligibility but states have broad optional authority to extend Medicaid beyond these minimum standards. Because of this, Medicaid eligibility and coverage differ from state to state

When the economy is bad, the social service demands grow. More and more people will turn to their government for safety net coverage, especially the elderly and the disabled. In Pennsylvania, the elderly and the disabled account for approximately 70% of the Department’s Medicaid expenditures.

The Medicaid program already has federal and state governments carrying a huge economic burden. In Pennsylvania alone, the Department will provide health care and long term care services to more than 2.2 million Pennsylvanians during FY 10/11. Since November 2009, the average monthly MA enrollment has increased by approximately 120,000 individuals or 5.6%, which is 2.6% more than the Administration budgeted for during FY 10/11. The Administration is predicting this excessive growth in MA to continue until the economy becomes fiscally stable.

The state amount appropriated to the Department for FY 10/11 was approximately $8.3 billion. The Governor estimated the Department will need an additional $65 million to support the increased enrollment in the safety net programs. In addition to their state appropriation, the Department of Public Welfare's 10/11 budget was supported by $1.8 billion in additional federal support through an increase in the FMAP percentage. The American Recovery and Reinvestment Act of 2009 provided the temporary increase in the federal matching funds for Medicaid (FMAP) in order to help states maintain their programs in the face of recession driven revenue declines and caseload increases. Small changes in a state's FMAP can have a significant impact on state budgets.

The additional federal support was set to expire December 31, 2010 but due to the continued financial stress facing the U.S., Congress enacted H.R. 1586, which contained a six-month extension of the enhanced match for the Medicaid (FMAP) and Title IV-E programs. In particular, the law will provide states $16.1 billion through a phased-down enhanced match--providing 3.1 percent beginning the first calendar quarter of FY2011, then drop to 1.2 percent in the second calendar quarter.

When the general fund budget was enacted in July, it was built on the assumption the additional federal funding would be at 6.2%, not the step down version passed by Congress. This action by Congress reduced Pennsylvania's federal share by $280 million. The lower allocation required the Governor to find a solution. He proposed $212 million in additional budget cuts and $70 million in severance tax revenue from natural gas drilling in the Marcellus shale. To date, $200 million of the $212 million proposed spending cuts were frozen; however, the $70 million severance tax was not enacted. The Administration will use prior year appropriation balances to help address the shortfall.

Despite numerous cost containment initiatives, implementation of efficient pharmaceutical programs and fraud and abuse enforcement, the mandated costs for the Medical Assistance program will continue to present serious budget challenges in the future.