Administrative Circular

Commonwealth of Pennsylvania

Governor's Office

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The Program Policy Guidelines provide direction for the preparation of the 2014-15 Governor's Executive Budget agency budget requests. Executive Budget planning for 2014-15 is to be predicated on the fact that the Pennsylvania economy is growing very modestly and a number of factors are restraining its growth. The commonwealth budget, which is highly dependent on a growing economy, faces additional challenges, such as increased pension obligations, wage and benefit increases, debt service and medical and entitlement costs. These mandated cost drivers will consume virtually all revenue growth. Therefore, agencies should not assume funding increases for the 2014-15 fiscal year and should focus on efforts that contribute to achieving structural balance as well as on evaluating current programs and recommending changes that will improve program management and operations, reduce costs and optimize direct services.

BACKGROUND AND OVERVIEW

Fiscal discipline remains the key guiding principle in 2014-15 budget development. The commonwealth is operating in an environment which may be characterized as the "new normal" where mandated costs increase faster than new revenues. If we are to avoid a situation where we repeatedly constrain funding for all programs causing an inability for us to effectively deliver these programs, we must refocus efforts to achieve structural balance and direct the commonwealth's limited resources to areas where the investment will truly make a difference for Pennsylvanians.

In order to achieve these goals, as an agency develops program funding requests and its overall budget, it must ask: Is this program a core function of government and, if not, can it be eliminated? If it is a core function of government, is the product or service delivered as efficiently and effectively as possible and, if not, can it be retooled or replaced to better leverage and target limited resources? Agencies should comprehensively review each program and activity with these questions in mind.

To illustrate the depth of the financial issue the commonwealth faces, agencies should consider the following and begin to develop and implement strategies to live within the same amount of funding in 2014-15 as available in 2013-14:

- The commonwealth is spending more than $500 million more than it is taking in this year;

- The commonwealth's Rainy Day Fund balance is $61,000 when rating agencies suggest a minimum of about $1.5 billion and a process for replenishing it when it is drawn upon;

- For every dollar of salary costs, the commonwealth will spend an additional 72 cents for employee benefits for the average employee. The ratio of salary to benefits will be nearly $1 to $1 for jobs at the lower end of the commonwealth's pay scale; and

- Rating agencies have already begun to downgrade the commonwealth's bond rating, which increases borrowing costs and which has already had an impact on agencies' workers' compensation rates.

The 2014-15 Executive Budget that is presented to the General Assembly must be fiscally responsible and focused on supporting the core functions of state government and growing Pennsylvania's economy. It must send a message to the rest of the world that Pennsylvania is on solid financial footing and is positioned for economic growth and that the commonwealth maintains the resources to confront unforeseen challenges.

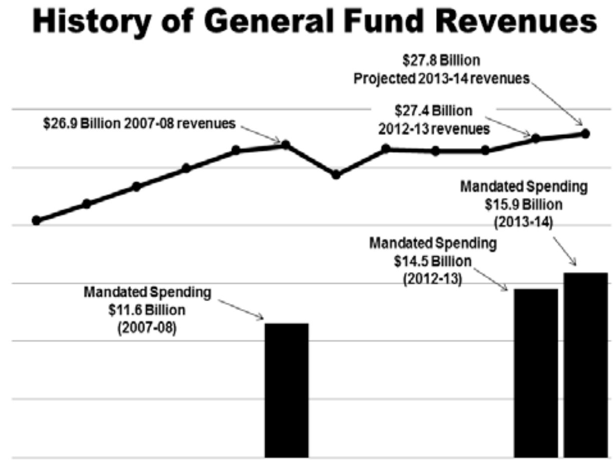
The previous three budgets have laid the foundation for Pennsylvania's resurgence with a focus on fiscal discipline, limited government and targeted investment. The budgets have reined in spending and streamlined government while protecting the most vulnerable of Pennsylvania's citizens, educating our children and adults, growing our economy and keeping our communities safe.

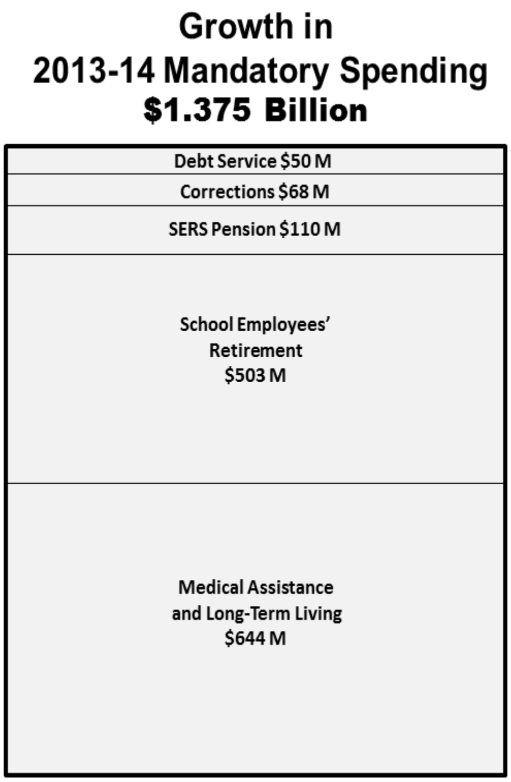
The 2014-15 Executive Budget will maintain the interests of the taxpayer, focusing spending on critical areas and in a cost effective manner. Programs and investment will focus on creating and supporting family sustaining jobs. Education investments will focus on student achievement and preparing our students to compete in an international economy.

While spending has been constrained, the commonwealth budget has not yet been brought into structural balance. The 2014-15 Executive Budget will focus on the unfinished business of putting our fiscal house in order so that we can meet our obligations and commitments to the people of Pennsylvania today and into the future.

The following graphics highlight the fiscal challenges before us and show the history of General Fund revenues compared to mandated spending and the cost drivers behind the mandated spending.

Illustrating the length and depth of the Great Recession, the 2012-13 fiscal year was the first fiscal year that General Fund revenues surpassed 2007-08 revenue levels and came in $500 million higher.





Over the same period of time, spending in mandated areas of the budget increased by $2.9 billion, crowding out spending in all other areas of the budget. The trend of mandated spending increasing faster than revenues continues in the 2013-14 fiscal year – with mandated spending increasing by $1.4 billion, and projected revenues increasing by $400 million.

The commonwealth is also faced with declining federal support for current programs receiving federal funds. While it is expected that federal sequestration will be replaced by more targeted cuts, as opposed to across-the-board cuts, agencies receiving federal funds should continue to monitor the potential for cuts and develop strategies to size federally supported programs accordingly. Federal funding cuts are inevitable and commonwealth agencies administering federal funds or reliant on federal funds should plan for funding reduction contingencies without any expectation that the loss of federal funds will be replaced by state funds.

2014-15 BUDGET DIRECTION

Preparing a balanced and structurally balanced 2014-15 Executive Budget will be difficult and challenging – more difficult and challenging than even the recent budgets. We are facing a $500 million structural deficit in the current year and our total mandated spending growth in 2014-15 is $500 million greater than our expected revenue growth. This puts the preliminary deficit for 2014-15 at about $1 billion. Our actions to address and resolve this deficit are limited. Past efforts to identify and use excess appropriation and fund balances as we developed and maintained balanced budgets through years of slow economic recovery were successful, but this success now limits these actions in current budget development. Our Rainy Day Fund balance is $61,000 at a time when the major rating agencies say we should have $1.5 billion in reserves. And, we are on a path of spending 72 cents in benefits for every $1 spent in salary for the average employee.

Given the immense challenges we face to develop a balanced 2014-15 Executive Budget, agencies must make difficult decisions about operations and program priorities as they develop their 2014-15 budget requests. Agencies will have to reconsider their organizational structure and propose changes to that structure to gain administrative efficiencies. In addition, agencies will have to reexamine their current responsibilities and functions and propose opportunities for consolidation of intra- and inter-agency administrative functions or wholesale elimination of low-priority functions.

It is incumbent upon us to continue to maintain fiscal discipline and make the tough choices which will allow future generations of Pennsylvanians to have a government that effectively delivers on its core responsibilities and does not bankrupt current or future generations.

Agencies should submit budget requests that adhere to the following guidelines:

- Request administrative appropriations at levels that do not exceed 2013-14 Enacted Budget amounts. When requesting administrative appropriations that do not exceed enacted levels, agencies must absorb all increases in salary and benefit costs within level funding.

- Agencies must eliminate positions that cannot be accommodated within the level-funding guidance. If necessary, agencies should actively begin to manage complement this fiscal year to mitigate the need for employee layoffs.

- Request no operating and fixed asset spending increases unless other efficiencies, consolidations or personnel cost reductions are sufficient to offset any increases in a realistic and sustainable manner.

- Request no program revisions requiring new or increased funding unless those program revisions can be offset by savings that are achievable in 2014-15 and sustainable in future years. Overall funding requested by the agency cannot exceed funding levels in the current year.

- Reexamine current responsibilities and functions and propose opportunities for consolidation of intra- and inter-agency administrative functions. Agencies should submit administrative consolidation proposals in their budget requests consistent with the guidance provided in the *Cost Cutting, Cost Avoidance and Consolidation of Administrative Functions* section of this document.

- Request no additional state funding to replace lost or reduced federal funding.

ACHIEVING STRUCTURAL BALANCE

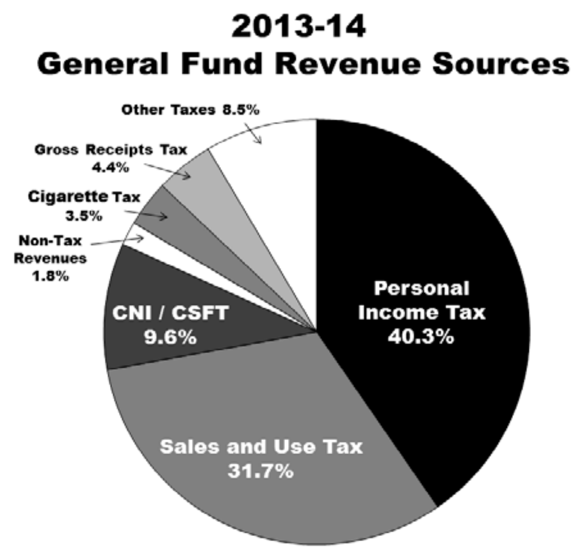
Over the past several years, state agencies have not been able to adequately plan and have been forced to make cuts and curtail service delivery to address revenue and budget pressures. Achieving structural balance is critical to establishing a steady state for government operations. Until we achieve a structural balance between available revenues and anticipated expenditures, agency operational decisions will be reactionary and the quality of government service, including perhaps in core functional areas, will inevitably suffer and decline.

Achieving structural balance will require a three-pronged approach: increasing revenue, implementing productivity and performance improvements, and reducing expenses and initiating cost avoidance approaches to delivering government services.

Increasing Revenue

Improving the bottom line by increasing overall revenue can take a number of forms: increasing tax revenue through job creation, updating fees and charges, identifying new revenue sources and innovative financing. Old strategies such as increasing tax rates and relying on the federal government for additional revenue will not work. Increasing tax rates when Pennsylvania already has one of the highest corporate tax rates in the world would have a negative impact on job creation and would actually result in less tax revenue. We cannot rely on the federal government for increased support, as we know federal funds in discretionary programs are likely to continue to shrink as the federal government continues its efforts to rein in the federal deficit.

The graphic illustrates the primary sources of revenue for the commonwealth. Personal income taxes and the sales and use tax account for more than 70% of total General Fund revenue. Finding ways to increase these revenue sources thus will have the greatest impact on total General Fund revenue. The most effective way to increase personal income tax revenue is to create jobs and the most effective way to increase sales tax revenue is to create jobs. More revenue provides the opportunity for increased spending on essential programs. Therefore, every agency must redouble efforts to focus its programs on job creation. Job creation leads to stronger communities and growing and robust state revenues to support the core functions of government, such as education, public safety and human services.



There are a number of state government activities or responsibilities for which the costs were intended to be covered by a fee paid by a particular applicant or beneficiary, or imposed for a particular benefit to cover the cost of a specific public good. Over time, many of those fees have become outdated or do not meet the cost to cover the activity. In many of those cases, the taxpayers are effectively subsidizing the cost of an activity that benefits a targeted beneficiary. In addition, the overall economic situation may be vastly different today than when legislation was first enacted or a program first created, justifying a new look at fees and charges. One such example is the proposed change to the Department of Environmental Protection’s unconventional natural gas well permit fee structure from a sliding fee to fixed fees based on well type. The new fee revenue will support the department’s regulatory costs related to compliance assistance, permitting, inspection and enforcement operations. There are other similar examples throughout the commonwealth where fees need to be adjusted so that taxpayers do not subsidize the costs that should be borne by regulated individuals or entities.

Agencies should review current fees and charges and evaluate if they are covering the appropriate costs, and if not, to make recommendations and submit a proposal to update the individual fee, fee methodology or fee structure. Agencies recommending fee increases must consider and include in their proposals the potential impact on taxpayers, both positive and negative, the return or increased benefits to the fee payer and be able to justify any fee increase due to already implemented process improvements or efficiencies.

While more difficult to identify or implement, agencies should also look to identify new and appropriate revenue sources or innovative financing opportunities to provide relief to the General Fund. As an example, the Department of Agriculture has successfully secured sponsorships to offset a portion of the costs of operating the Farm Show complex. In another example, the commonwealth is deriving more than $120 million in revenue through rents and royalties from responsible drilling for natural gas on commonwealth property. All agencies should pursue the revenue generating potential of their assets.

Productivity and Performance Improvement

A continuous focus on productivity and performance improvement through creativity and innovation is a hallmark of a world class organization and a necessity in today's competitive and fiscally challenging environment. Innovation not only provides dollar savings, but more importantly, offers better and faster service to people who need it most.

The commonwealth has a solid foundation in this area and we can build upon the early success of the Governor's Privatization and Innovation Council and the Governor's Innovation Office. The Governor's Privatization and Innovation Council was established in 2011 to help identify and evaluate opportunities to consider alternatives to the current delivery of government services. The Council worked with all state agencies to identify opportunities for process or performance improvements. The Governor's Innovation Office was created to help manage the portfolio of innovation projects and to assist agencies in conducting or carrying out these initiatives. Over the past fiscal year agencies have completed 115 innovation initiatives representing a savings of over $175 million.

Agencies should work with the Governor's Innovation Office to update their Innovation Action Plans to identify and implement new innovation initiatives and complete those initiatives currently underway. Agencies should include in their budget submissions innovation initiatives which will be implemented in the fiscal year, or from which the savings of the initiative will be realized within the fiscal year. Such initiatives may be critical in helping agencies manage through 2014-15 and future fiscal challenges. Agencies should clearly identify their sustainable productivity or performance improvement initiatives.

Cost Cutting, Cost Avoidance and Consolidation of Administrative Functions

Given the severe financial challenges the commonwealth faces, further cost-cutting is unavoidable. Consequently, agencies must again analyze each of their programs and cost centers and assess if these programs are indeed critical or core functions of government, and if not, can they be eliminated or retooled to better leverage and target limited resources.

Over the past few years we have made great strides in improving the overall tax and regulatory climate for economic competitiveness in Pennsylvania. Liability reform has been enacted. Unemployment insurance reform has been enacted saving Pennsylvania businesses $100 million. Business taxes have been reduced overall by more than $1.2 billion, through the continued phase down of the Capital Stock and Franchise Tax, exempting the inheritance tax on family farms and small business, adjusting the Corporate Net Income Tax sales factor, as well as through a number of changes being implemented in the 2013-14 fiscal year such as increasing the corporate net operating loss carry forward and providing certain small business exemptions.

By further rationalizing our patchwork of tax credits and incentives, we can further strengthen the climate for new business startups and expansions. Out of date or underutilized tax credit programs should be considered for elimination with the savings being redirected to additional tax climate improvement efforts.

Programs with less than acceptable performance results should be considered for elimination. Programs that do not directly contribute to job creation or other core functions of government or critical services should be considered for elimination. Programs where funding has been reduced to a level where they have minimal impact should be considered for elimination. Programs previously proposed for elimination in the governor's budget but restored in the enacted budget should not be included in agency budget requests.

There has been considerable progress toward meeting the goal of reducing the administrative expenses of state government by 10% over four years. To date, the administration has successfully reduced administrative spending by 7.7%. However, to continue to address fiscal challenges, agencies must continue to find additional administrative cost savings. As in previous years, agencies should not expect any increase in funding to cover mandated salary and benefit cost increases.

Every agency must continue to diligently work to control spending. Agencies cannot assume a cost-to-carry budget, but instead should prepare for no increase in funding and develop innovative approaches or process improvements to absorb program cost increases through efficiencies.

As an enterprise, the commonwealth should look for functional consolidations to achieve efficiencies and enhancements in customer service. Agencies should seek to reduce costs by consolidating various administrative support functions among agencies; functions such as human resources, information technology, procurement and budgeting. The Office of Administration and Office of the Budget will carefully review any request to fill positions in any of these areas and will request that agencies consider consolidations or mergers of these functions among agencies as an effective alternative.

- The Departments of Education and Public Welfare should finalize their plans and implement consolidation of their human resources functions in the current fiscal year.

- The State Civil Service Commission and the Milk Marketing Board should examine whether peer agencies can provide the same level of administrative support more efficiently than they can provide these services on their own. Specifically, the State Civil Service Commission should consider consolidating its print operations and other administrative functions. In addition, the commission should examine its regional office functions and consider alternative service delivery approaches.

- The Departments of Banking and Securities, Insurance and Revenue should explore whether consolidation of certain administrative functions will provide the same level of administrative support more efficiently than current separate operations.

- The Departments of Conservation and Natural Resources and Environmental Protection should explore whether consolidation of certain administrative functions will provide the same level of administrative support more efficiently than current separate operations.

- The Fish and Boat Commission and the Game Commission should be prepared to address the findings and recommendations of the Legislative Budget and Finance Committee's investigation of the financial feasibility, impact, costs and savings potential of eliminating duplicated duties and instances of services by combining fish and wildlife management activities into one commission. Other complementary agencies should consider such integration as well.

- The Department of Corrections, Board of Probation and Parole and Commission on Crime and Delinquency should revisit proposals to consolidate research functions not only to improve efficiency but more importantly to provide a better opportunity for increased public safety outcomes.

- The Departments of Agriculture, Conservation and Natural Resources and Environmental Protection should consider opportunities to consolidate conservation grant writing functions.

- All agencies should explore intra- and inter-agency field office co-location opportunities.

This direction is not limited to the specific examples above. All commonwealth agencies should be creative in their efforts, including efforts to partner with other agencies, to reconfigure administrative support functions to reduce costs and provide services in a more efficient and effective manner. On their own, these actions will not balance the commonwealth's budget. However, reexamining organizational structures, partnering with other commonwealth agencies and refocusing efforts to core government functions will yield savings that can be redirected to programs that create jobs and support valuable programs.

The overall commonwealth filled complement has declined by more than 3,100 employees since January 2011 and budget constraints are forcing all agencies to consider all costs, including real estate. Due to the decline in complement, agency space needs are not as great as they once were and agencies have an opportunity to rethink the space needs. Agencies currently occupying leased space should consider relocating to commonwealth owned or controlled space. There is approximately 80,000 square feet of vacant or underutilized commonwealth controlled space in the Harrisburg area; enough space to house 400 employees.

Other administrative cost savings examples for agencies to consider include virtual office and telecommuting options.

While most of our attention is directed toward General Fund programs, some special funds are also in poor financial conditions to support their programs. Agencies should also pay close attention to the solvency of special funds and identify approaches to shore up any potential fund weaknesses, especially if these weaknesses provide risk to the General Fund.

In searching for greater efficiencies, agencies should look to their employees to find better ways to do things and to identify and eliminate or modify wasteful practices or processes.

Summary

Pennsylvania, like most other states, is facing a protracted economic recovery that will take time and effort to work through. Times of great challenge are also times of great opportunity. The direction presented here is responsive to fiscal realities and addresses our 2014-15 Executive Budget challenges head on. In the coming fiscal year, agencies must establish clear priorities and objectives among programs and functions, including eliminating those that are no longer necessary or are not responsive to the needs of our people, and consolidating others that are duplicative or serve similar populations. The principles of fiscal discipline, limited government and free enterprise will continue to guide the administration's budget planning, allowing us to focus on the core functions and responsibilities of state government and to ensure future growth and prosperity for all.