State Budget '07: Soaring Appetites, Critical Choices

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With the Commonwealth well on its way to a third consecutive year of financial recovery, the landscape for fiscal decision-making has shifted dramatically. In striking contrast to the grim alternatives imposed by the recent fiscal crisis, the state’s leaders now face the challenge of choosing among a long and enticing list of competing priorities that – in combination – far exceed the state’s ongoing fiscal capacity.

The state’s leaders now face the critical challenge of choosing among a long list of competing priorities that – in combination – far exceed the state’s ongoing fiscal capacity.

This more positive fiscal environment has been characterized by sustained revenue growth, modest operating surpluses, and positive, though still weak, employment gains. Tax collections have consistently exceeded expectations for more than two years. The flow of red ink that followed the collapse of revenues in 2002 has been stanched. And after largely depleting reserves in 2002 and 2003, the state is now rebuilding its rainy day fund.

While these improvements are unequivocally good news, their apparent strength has been exaggerated by the effects of one-time receipts, such as almost $500 million of extraordinary federal fiscal relief during the crisis, and non-recurring savings, including the hundreds of millions of dollars of underfunding of the pension system in 2004.

Another source of fiscal misperception has been the adminstration’s focus on large “revenue surpluses” – that is, receipts in excess of the often overly conservative forecasts on which recent budgets have been based. However, the bulk of those added revenues have been needed to pay for annual spending that was originally financed by drawing heavily from the state’s reserves. Indeed, although the Governor has repeatedly highlighted the fact that 2006 tax revenues are expected to exceed the original forecast by almost $1 billion, his own 2007 budget projects a structural surplus of only $300 million for 2006.

Both of these pictures of fiscal improvement – the genuine and the ersatz – have fanned the appetite for a wide array of costly initiatives, including restoration of spending that was cut by billions of dollars during the fiscal crisis, large new spending commitments, and a major reduction in the income tax. Whatever the individual merits of these proposals, the state budget cannot possibly accommodate their many billions of dollars of combined costs.

It is clear that the state now has the financial capacity to act on some – but nowhere close to all – of the initiatives before the Legislature. While the unusually strong revenue performance of recent months is unsustainable, annual growth at close to the historical average of 5 to 6 percent appears achievable for several years to come. Although unavoidable spending increases in areas such as Medicaid, Chapter 70 school aid, debt service, and pensions will continue to consume a large share of the state's yearly revenue growth, the tempo of those increases is on a more manageable track.

However, this new-found flexibility has already been partially consumed by two freshly made commitments. The recent agreement on a sweeping package of health reforms will require at least $200 million of new annual spending, with the possibility that additional dollars will be required to implement the reforms successfully. And the Governor, House and Senate have all announced their support for lifting immediately the cap on local lottery aid which had been scheduled to phase out over four years.

Furthermore, despite the partial restorations of the last two years, projected spending for fiscal 2006, after adjusting for inflation, remains approximately $2.5 billion below 2002 in some of the most critical areas, including local aid, higher education, human services, public health, economic development, criminal justice, and the environment.

Neither the Governor's nor the House Ways and Means Committee's proposed budgets for 2007 will make an appreciable dent in this $2.5 billion gap. The recommended increases in overall spending – 5 percent by the Governor and the only slightly higher 5.4 percent by the House Ways and Means Committee – barely keep up with inflation, much less restore substantial amounts of the prior cuts. Without a major redirection of resources from other competing priorities, it is unlikely that the Senate will be any more successful in closing the gap.

Taking on commitments that exceed our ongoing fiscal capacity would be a major step backward from the prudent decision-making that saw the state through the recent fiscal crisis.

As the state's leaders consider other initiatives in the months ahead, it will be critical to hold in check the appetite for a profusion of expensive new initiatives. Taking on commitments that exceed our ongoing fiscal capacity not only would be a step backward from the prudent decision-making that saw the state through the recent crisis, it would undercut our ability to weather future financial downturns. Avoiding this outcome will require a tight focus on a few major financial priorities. In the Foundation's view, the following four priorities deserve to move to the top of the list:

- Implementation of the just-agreed-upon health reforms, with special attention to potential increases in the reforms' costs. While the initial financial assumptions behind the reforms are based upon the best available information and appear to be sound, several factors could result in increased costs.

  Under the provisions of the reform law the scope of the coverage to be offered is still to be determined, and the ability of insurers to develop affordable products is not yet known. In addition, the number of individuals to be covered may be greater than assumed. Finally, the costs of the Medicaid eligibility and benefit expansions authorized in the reform law are driven by external cost pressures. Any of these factors could result in larger funding needs.

- Move gradually to the Foundation's goal of dedicating 40 percent of annual income, corporate, and sales tax revenues to local aid for the state's financially pressed cities and towns, but at a pace that is less rapid than the local aid increases that the Governor has proposed for fiscal 2007.

  The additional dollars should be coupled with a focus on several key issues: reform of the often-criticized formulas used to distribute school and other state aid; new approaches to cost accountability that will provide assurances that aid dollars are being well spent; and changes in state law already proposed by the Governor that will help local officials rein in the rampant growth in municipal health care costs.

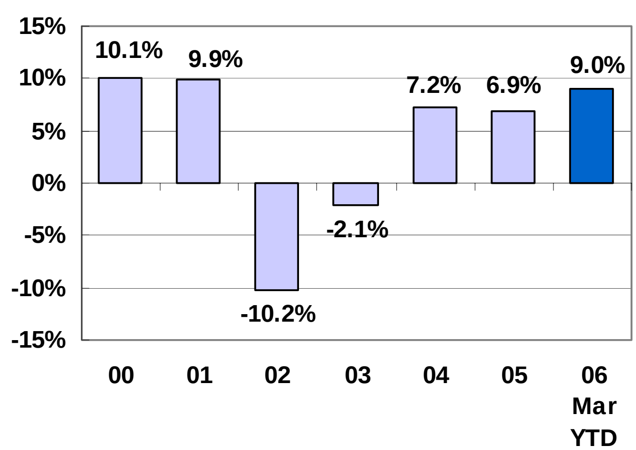
- Make a strategic investment in the state's economic future by gradually restoring funding to the University of Massachusetts and the other public colleges along the lines recommended by the Joint Committee on Higher Education and approved by the Senate. Lawmakers should also adopt the financial and managerial reforms previously proposed by the Foundation in order to provide UMass with the tools it needs to compete as a first class research university and at the same time give greater fiscal flexibility to the state and community colleges.

- Provide some greater capacity to address our many pressing infrastructure needs by increasing by $250 million the state's $1.25 billion annual cap on bond-funded capital spending, which has remained essentially unchanged since 2002. This increase would help address the urgent need to repair and expand the physical systems and facilities – in transportation, higher education, and other areas – on which our future economic growth depends. It is an increase that almost certainly would be accepted by the rating agencies and add little to yearly debt service costs.

In regard to the Governor's plan to reduce the income tax rate to 5 percent over two years, the Foundation's concern has been – and remains – the state's ability to manage the almost $700 million annual financial impact of this cut. It is abundantly clear that the budget cannot accommodate the income tax rate cut on the two-year schedule proposed by the Governor while simultaneously addressing even a handful of the many competing and costly priorities now being considered.

The 2002 legislation freezing the income tax rate at 5.3 percent also included a trigger mechanism to reduce the rate to 5

Figure 1
Baseline Tax Revenue Growth
Fiscal 2000 - 2006 Year-To-Date



percent in annual increments tied to the performance of the state economy and revenues. Although this trigger provides a critical protection for state programs in the event of an economic downturn, under the timetable provided by the law the rate reductions cannot begin until 2009 and the cut to 5 percent will take six years at a minimum.

Given the renewed strength of the state's finances, it may well be possible to provide more tax relief sooner than permitted by the 2002 law, but at a more moderate scale and pace than the Governor's overly aggressive proposal. If such an acceleration were undertaken, it would be essential to maintain the fiscal protections provided by the trigger mechanism now on the books. This course would recognize the voters' desire to cut the income tax rate to 5 percent – as expressed in their approval of the November 2000 ballot initiative – while preserving the ability to sustain state services. In order to be manageable, this alternative would have to take its place among the few carefully selected, high priority initiatives that the Commonwealth can affordably pursue. It is noteworthy that a variety of recently adopted tax cuts, including new incentives for movie production in the state, home heating and energy cost relief, and property tax reductions for seniors, have used up more than $100 million of fiscal flexibility that could have been applied to speeding up the income tax rate cut.

The Improving Revenue Outlook

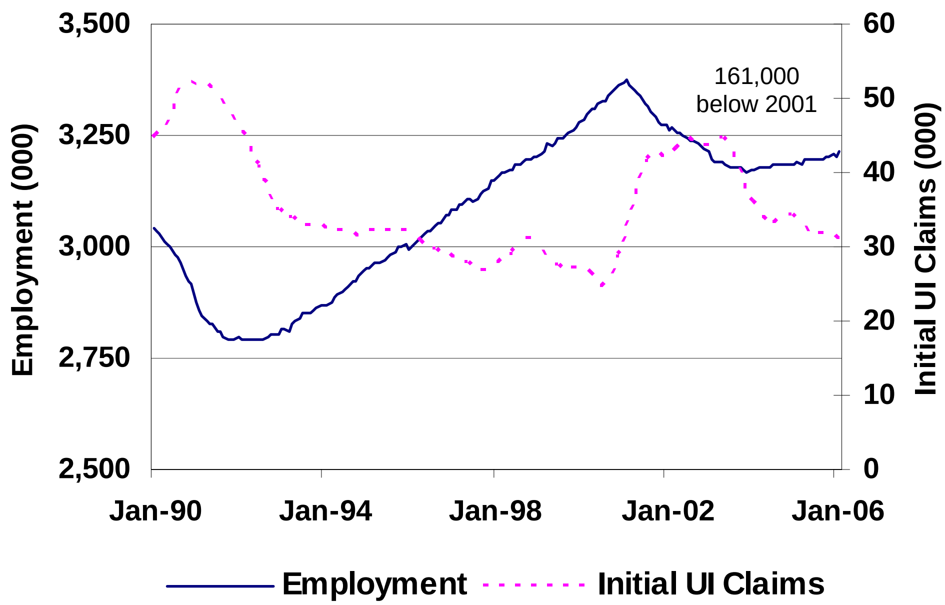
The state's recent revenue performance has been robust, especially in comparison to the 15 percent nose-dive of receipts in fiscal 2002. Baseline tax revenues before law changes grew by about seven percent in both 2004 and 2005 (see Figure 1). Through March, the first nine months of 2006, baseline revenues have surged nine percent over 2005.

While the 2006 performance is great news, its economic underpinnings give reasons

Figure 2

Massachusetts Employment Picture

(Thousands)



Since emerging from the recessionary trough at the beginning of 2004, job growth has inched upward at an annualized rate of 0.5 percent, and total employment remains 161,000 below the pre-recession peak.

for caution. Two-thirds of the year-to-date gains are concentrated in some of the state's most volatile revenue sources. Baseline tax receipts from capital gains, bonuses and other non-withholding income are up 19 percent. These sources were the first to collapse during the recession. Corporate and other business revenues make up almost half of this year's growth, leaping by 34 percent after being essentially flat in 2005. Business taxes comprised only 10 percent of the state's total tax collections in 2005.

Withholding revenues – which are driven by the combination of wage and employment gains – have risen a healthy 6.3 percent (baseline) through March. Nevertheless, employment growth remains a serious source of concern. Since emerging from the recessionary trough at the beginning of 2004, the monthly rate of job growth has inched upward at an annualized rate of 0.5 percent, on average, and total employment remains 161,000 below the pre-recession peak (see Figure 2). While there is some reason to believe the survey-based official employment figures may be modestly understating the rate of job growth (in particular, the monthly number of initial claims for unemployment insurance is consistent with a higher, although still moderate, pace of growth), any future statistical revision to the employment figures cannot be expected to significantly close the jobs gap.

Even with these cautions, tax revenues for both 2006 and 2007 could exceed the forecast by several hundred million dollars. The consensus forecast that is guiding 2007 budget deliberations assumes tax revenues of $19 billion – $800 million, or 4.4 percent, above the administration's forecast for 2006. At the present rate of collections, 2006 revenues could outpace current estimates by $200 to $400 million.

Barring a sharp correction in the financial markets or a collapse in corporate profits, that excess will carry forward into the revenue base for 2007. A continuation of the recent rapid pace of growth in the coming fiscal year, which we believe unlikely, would add even further to 2007 receipts.

Competing Priorities

While the revenue outlook is clearly positive, the current robust pace of growth, much less the more modest performance that is sustainable over the longer term, cannot possibly support the long list of competing priorities that are now before the state's leaders:

- Largely unavoidable, and in some cases contractually obligatory, increases in annual spending in areas such as Medicaid and debt service.
- The costs of previous commitments, such as eliminating the unfunded pension liability and earmarking sales tax revenues for the MBTA and school building assistance.
- The need to restore some portion of the large spending cuts imposed during the fiscal crisis.

A Long List of Competing Priorities

Existing Obligations and Commitments

- Medicaid and other health care
- Chapter 70 school aid
- Unfunded pension liability
- Debt service on capital spending
- Expanded school building assistance
- Lifting lottery cap
- Sustaining other state services
- Annual contributions to rainy day fund
- Unfunded employee health obligation

Restoration of spending cuts

- Aid to cities and towns
- Higher education
- Human services
- Public health
- Environment
- Economic development

Expansions

- Health care reform
- Early childhood education
- Infrastructure investment

Tax cuts

- Cut income tax rate to 5%
- Return personal exemption to pre-crisis levels
- Other recently adopted tax reductions

- A broad range of proposals for new spending in areas such as health care and early childhood education.
- The call for a major cut in the income tax.

Unavoidable and contractually mandated spending increases Even before considering any new initiatives, the state must address a catalog of unavoidable costs in the largest areas of the budget.

While the severe cost pressures of a few years ago have abated somewhat in several of these areas, the required spending increases will still consume a substantial share of annual revenue growth. For example, the Commonwealth is obliged by the federal government to increase spending to maintain services for the current Medicaid population; the Constitution requires that the state meet the rising costs of ensuring that every child in Massachusetts receives an adequate education; and the buyers of state bonds have a contractual right to principal and interest payments on those bonds. Based on reasonable assumptions about future growth, existing health care, education aid, and debt service obligations could require $400 to $500 million of additional spending each year.

Prior commitments Over a span of time that reaches back two decades, the state has made a series of major financial commitments, usually as part of important reform initiatives.

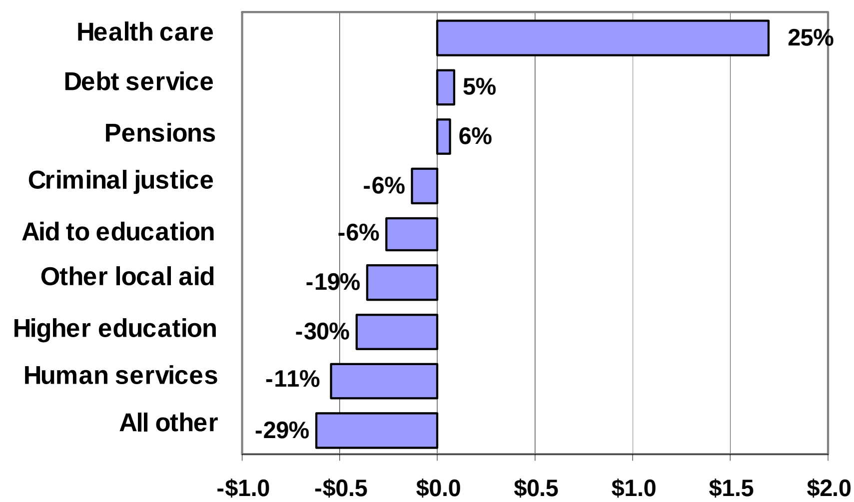
One of the oldest, and largest, of these ongoing commitments is to eliminate the unfunded liability for the pensions of retired state employees and teachers, an effort that began in 1987 and is costing the state $1.3 billion in 2006. At some point, new financial reporting rules will require the Commonwealth to embark on a similar endeavor to erase the unfunded liability for the state's share of health costs of its retired workers, which could rival the costs of the unfunded pension liability.

Other commitments will continue to claim a portion of annual revenues. In 2001, the state adopted reforms that put the MBTA on an independent financial footing, dedicating one cent of annual sales tax revenues, or about $700 million, to the T, thereby averting even greater increases in state costs that would have taken place without the reforms. More recently, lawmakers undertook to dedicate one cent of the sales tax to local school construction projects, a substantial increase in resources for this program that is being phased in over several years.

During the 1990s, the state made a major investment in its future fiscal health by setting aside large amounts in its stabilization fund. Without that reservoir, the impact of the recent crisis would have been much more severe. With the fiscal emergency now behind us, further withdrawals from the rainy day fund are unwarranted, particularly given the recent strong revenue growth. The state now needs to recommit itself to its statutory pledge to build up the fund through annual contributions based on a percentage of tax revenues.

Commitments have been made on the revenue side as well. The 2002 tax law has triggered the first two installments of a series of annual tax cuts, with an incremental revenue impact of $60 million each year, intended to reverse the reductions in the personal exemption imposed during the fiscal crisis. In recent months, the state has cut taxes by another $100 million, in part through generous new credits intended to stimulate movie production in Massachusetts.

Figure 3
Fiscal 2007 Spending Proposed by Governor
Inflation-Adjusted Difference from 2001
$ Billions



Restoration of prior spending cuts Over the course of the fiscal crisis, Beacon Hill leaders slashed spending by billions of dollars in order to balance the state's books. Despite the improving financial conditions in 2005 and 2006, only a small share of those cuts has been restored. After adjusting for inflation, the 2006 budget is $2.5 billion below 2001 in several of the most important areas of government. Although the Governor has recommended an overall 2007 spending increase of about 5 percent and the House Ways and Means Committee a slightly higher 5.4 percent, the gap in these areas will remain wide.

Among the programs most severely affected are higher education, 30 percent below 2001 after adjusting for inflation, and human services, 11 percent below 2001 (see Figure 3). Expenditures for local aid – for both education and municipal services – and for a broad range of other programs are still well below their earlier levels.

With the fiscal emergency behind us and revenue growth strong, further withdrawals from the rainy day fund are unwarranted.

Expansions Lawmakers have just approved a long-awaited package of health care reforms that will add to the Commonwealth's annual spending obligations. While the legislation solidly establishes the institutional framework for expanding health care to most of the state's uninsured, the ultimate costs will not be known until the reforms unfold.

Other potential expansions would also add substantially to state costs. The Joint Committee on Education has advanced (and the Senate has already approved) a thoughtful reform package that would increase funding for higher education campuses by an inflation-adjusted $400 million spread out over the next seven years.

Several proposals that were put on the back burner with the onset of the fiscal crisis will undoubtedly reemerge as the recovery continues. The largest of these initiatives is an ambitious plan to dramatically expand early childhood education in the state, which could cost as much as $1 billion over ten years.

Tax cuts As part of his 2007 budget, the Governor has proposed to reduce the income tax rate to 5 percent over two years. Although this change – considered in isolation – would have a relatively manageable $130 million impact in 2007, the annualized value of the cut would be $650 to $700 million, almost all of which would be felt in 2008.

In the 2002 tax law, the personal exemption was reduced by 25 percent (from $4,400 to $3,300 for a single filer), coupled with a trigger mechanism intended to restore the exemption at a pace tied to the performance of revenues. As a result of this mechanism, increases in the personal exemption have been triggered in each of the last two years, with a total revenue impact of $120 million. If revenues remain strong, similar increases will be triggered in 2007 and 2008, returning the exemption to its 2002 levels, with an additional annual impact of $120 million.

The 2002 legislation also obliges the state to begin reducing the income tax rate to 5 percent after the personal exemption is restored. Depending on revenue performance, the rate will be cut 0.5 percent a year with an annual revenue impact of approximately $110 million. Under the law, the earliest the rate cuts can commence is 2009, with the reduction to 5 percent taking at least six years.

As a result of the legislative response to the *Peterson* case, over the next four years the Commonwealth will refund approximately $250 million of previously collected capital gains taxes. The taxes had been paid as a result of a mid-year increase in the capital gains tax rate in 2002 that the Supreme Judicial Court ruled was unconstitutional.

In addition, over the last six months the state has authorized more than $100 million of tax cuts, including generous credits to stimulate motion picture production in Massachusetts, home heating and energy tax relief, and senior property tax relief.