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Bulletin

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MTF 2007 State Budget: Fanning the Expansionary Flames

As a legislative conference committee works to reconcile the House and Senate versions of the 2007 budget before the new year kicks off on July 1, the Foundation is increasingly concerned about the easing of the budgetary discipline that saw the state successfully through the recent fiscal crisis. While the Commonwealth is in no immediate financial danger, it is clear that the mounting appetite for new initiatives is on a course that will rapidly overwhelm the state's ongoing fiscal capacity. Unfortunately, in all three branches recent actions have fanned the expansionary flames, a trend that is reflected:

- In claims of \$1 billion budget surpluses when the reality is much more modest.
- In the proposal to cut the income tax by almost \$700 million on a fixed two-year schedule, exactly the kind of approach that exacerbated the plunge in tax revenues in 2002 and worsened the fiscal crisis.
- In calls to spend huge portions of the state's surplus revenues rather than deposit them in the stabilization fund.
- In the large increase in education and lottery aid to municipalities, a positive step that nevertheless creates expectations for similar increases in 2008 and beyond that will be difficult to meet.

This collective mood of financial largesse ignores the inability to sustain the current pace of revenue growth, which is largely driven by capital gains and other volatile revenue sources, rather than by a recovery of the state's jobs base.

It also ignores the need to finance the ever-rising costs of the obligations and commitments that the state has already taken on. These range from longstanding financial priorities such as Medicaid, pensions, and debt service, to the recent pledges to dedicate one cent of the sales tax to school construction – which is still being phased in – and to expand health coverage, an effort that is widely supported but could be expensive over the long term.

Although the House and Senate budgets now being reconciled by the conference committee provide for a relatively manageable increase – 5.4 percent for the House and 5.9 percent for the Senate after adjusting for higher education spending that the Senate proposes to move off-budget – this total does not include the additional appropriations in the supplemental budget and economic stimulus package now awaiting the Governor's signature.

Nor does this total reflect the bottom-line impact of the tax cuts authorized in those bills, which will permanently reduce annual revenues by more than \$40 million. The reductions bring to \$160 million the total amount of tax cuts enacted over the last eight months, which come on top of the \$120 million of "automatic" increases in the personal exemption that are expected to be triggered for 2007 and 2008.

In combination, the supplemental and economic stimulus bills spend a staggering \$560 million of the state's reserves and surplus revenues – an amount equal to more than 25 percent of the balances available at the beginning of 2006 – and add another \$200 million to the state's debt via bond-funded capital spending.

The \$760 million total of the two bills supports a hodgepodge of programs that include ongoing operating costs, much-needed capital improvements at higher education campuses, and appropriately targeted one-time investments in industries that are important to the state's economic future. The \$760 million also funds transportation improvements in the Fenway and other areas, as well as a long list of local construction projects that range from flood control and seawall repairs to visitor centers and bicycle paths. Almost \$100 million will go to yet-to-be-identified projects intended to spur job creation by individual businesses or to provide other economic benefits.

Adding further to the concerns raised by these expansive proposals is the continuing reliance on reserves. The relatively affordable rate of spending growth in the legislative budgets is financed in part by withdrawals from reserves that come on top of those authorized in the supplemental and economic stimulus bills. The Senate budget depends on \$420 million of reserves to support its proposed 2007 spending. And although the House budget authorizes a smaller \$275 million, that figure understates the amount actually needed, since both budgets authorize essentially the same amount of spending and use the same revenue forecast. While such use of reserves was reasonable in the depths of the

budget crisis, it is unjustifiable in the third year of the state's fiscal recovery.

Moreover, this use of reserves reflects a breakdown in the consensus revenue process, which requires an early agreement by the Governor, House and Senate on the tax forecast to be used in building the next year's budget. By spending beyond the agreed-upon revenue forecast and using reserves to make up the difference, lawmakers are undercutting the principal purposes of the consensus process – to provide a level playing field for budget development, remove the otherwise contentious issue of revenues from the budget debate, and serve as an important check on the ever-present pressures to spend more than the state can afford.

What is really going on is that the legislative budgets are based on a bet that the recent strong growth in revenues will continue unabated in fiscal 2007, rendering unnecessary the reserve withdrawals authorized in the budget. A similar wager was made – and won – in fiscal 2006.

In addition to undermining the consensus revenue process, this reserve charade has the further harmful effect of creating the illusion that the state's fiscal affairs are better than they really are. As revenue collections outpace forecasts, the "excess" of revenues opens the door to incorrect claims of \$1 billion surpluses, ignoring the fact

The 2007 House and Senate Budgets: More Alike Than Different

- Recommended spending levels which differ by only \$135 million out of a budgetary spending total of approximately \$27.2 billion.
- Full funding of the state's pension, debt service, and other major obligations.
- Essentially identical appropriations for a broad sweep of state programs that include human services, corrections, parks, environmental protections, and elder services.
- Some restoration of prior cuts in local aid, with an overall increase over 2006 of about 8.0 percent that includes lifting the lottery cap and essentially identical growth in education aid.
- Substantive proposals in each of the budgets for major reform of the Chapter 70 school funding formula, with the same general approaches to resolving longstanding inequities in the formula and with differences that should be resolvable.
- First-year funding for the state's groundbreaking health care reform in the amount that all three branches have agreed will be needed.
- Rejection of the Governor's proposal to cut the income tax rate to 5 percent over two years.

that a significant portion of those revenues have already been spent for program costs that would otherwise require drawing on reserves.

There is no question that the Commonwealth has sufficient cash on hand to finance the spending bills now on the table. In addition to the reserves in the bank at the beginning of fiscal 2006, it is likely that the state will end 2006 with a surplus of \$300-\$500 million (substantial, but far less than the reputed \$1 billion surplus), before taking into account the spending in the supplemental and economic stimulus bills.

At the same time, it is clear that the state's revenue base cannot possibly accommodate the accelerating appetite for new big-ticket spending initiatives and for a major cut in the income tax. The sought-after expansions run the gamut from restorations of local aid and other spending cuts during the fiscal crisis (some of which the Foundation strongly supports), to major new commitments in areas such as foundation aid to schools and early childhood education. This wish list does not include a massive new funding need that will have to be dealt with in coming years: the state's unfunded obligation for the medical costs of its retirees.

While the Foundation believes that there will be sufficient revenue growth to pay for the 2007 budget without drawing on reserves, we are much less sanguine about 2008 and beyond. Much of the better-than-expected revenue growth of the last two years has been driven by capital gains and corporate profits, two of the most volatile revenue sources. The growth in withholding and sales tax receipts, which are much more closely tied to the state economy, has been modest by comparison. To illustrate the degree of revenue vulnerability, fiscal 2006 baseline receipts through May were up 9.1 percent over 2005, at least three percentage points above the rate of personal income growth and almost as much above the 6.5 percent historical rate of revenue growth. This differential is largely attributable to rapid growth in volatile revenues, and translates into \$500-\$600 million of revenues that could be at risk in future years.

Although the official statistics may slightly understate the employment picture, the state has regained only one-quarter of the jobs lost in the recession, and job growth is essentially flat, with an annualized rate of growth of less than two-

A Longstanding Problem: Inappropriate Use of Outside Sections

To its credit, the House budget seeks to limit the use of outside sections – budgetary riders that advance major unrelated legislation without the benefit of committee review or public hearing, a dubious practice long criticized by the Foundation. This effort reflects a conscious attempt by the House leadership to strengthen the committee process.

Senators have traditionally looked more favorably on outside sections, in part as a way to compensate for their numerical minority on the joint legislative committees. The Senate budget reflects that outlook in its inclusion of inappropriate outside sections that advance causes as diverse as promoting the use of hybrid and alternative fuel vehicles, raising the minimum wage, and providing greater protections against harassment and witness intimidation.

tenths of one percent since the beginning of 2006. While several of the investments in the just-approved economic stimulus package will strengthen developing industries that are important to the state's economic future, the likelihood that these investments will have an appreciable effect on the state's jobs and revenues within the next 12 months is small indeed.

Given all these uncertainties and risks, it is time to raise the yellow warning flag and check the breakneck rush to take on new initiatives. It is incumbent on the conference committee to exercise great caution in its deliberations on the legislative budgets: Now is certainly not the time to resolve the spending differences between the House and Senate by taking the larger number in each case. By the same token, the executive branch needs to give greater recognition to the risk of over-committing the state's resources to the detriment of future fiscal stability. The Governor has signaled his intention to use his veto pen to trim back any spending excesses in the economic stimulus and 2006 supplemental appropriation bills. He should be prepared to do the same when the 2007 budget reaches his desk.

BUDGET SUMMARY¹

(\$ Millions)	2001 Actual	2005 Actual	2006 ² Budget	2007 Proposed				
				Governor	House	Senate	Senate minus House Difference Pct. Diff.	
Investment in Children	\$5,758.8	\$5,814.0	\$6,052.1	\$6,400.2	\$6,383.3	\$6,455.5	\$72.2	1.1%
Education Local Aid	3,453.7	3,624.4	3,763.6	4,034.2	3,977.3	4,002.1	24.8	0.6%
Higher Education	1,109.1	911.0	918.4	962.4	985.2	1,015.0 ³	29.8	3.0%
Services to Children	573.6	700.6	747.8	764.4	772.1	773.1	1.0	0.1%
Youth Services	118.3	131.1	147.2	155.9	153.0	157.2	4.2	2.7%
Child Care Services	504.1	446.9	475.1	483.3	495.7	508.2	12.5	2.5%
Criminal Justice and Law Enforcement	\$1,708.6	\$1,805.7	\$1,877.6	\$1,980.1	\$2,047.3	\$2,035.0	-\$12.4	-0.6%
Corrections	799.3	845.7	862.9	909.9	926.4	926.2	-0.2	0.0%
Judiciary	588.7	616.8	645.2	694.7	739.6	728.2	-11.4	-1.5%
Police	205.3	229.1	247.2	252.1	254.1	251.4	-2.8	-1.1%
DAs	81.4	79.5	84.9	85.9	88.5	90.6	2.1	2.4%
Attorney General	33.8	34.7	37.5	37.6	38.6	38.6	0.0	-0.1%
Local Government	\$1,541.0	\$1,348.1	\$1,373.3	\$1,559.2	\$1,556.5	\$1,551.1	-\$5.4	-0.3%
Assistance to the Poor	\$5,893.6	\$7,939.1	\$8,656.2	\$8,836.0	\$8,885.5	\$8,991.9	\$106.4	1.2%
Medicaid/Other Health Care	4,860.0	6,837.9	7,502.6	7,730.8	7,753.6	7,848.5	94.9	1.2%
Cash Assistance	646.1	691.8	724.5	697.7	709.9	719.5	9.7	1.4%
Housing Assistance	158.4	111.1	122.2	129.0	138.6	139.1	0.5	0.4%
Elderly	229.1	298.4	306.9	278.5	283.5	284.8	1.3	0.5%
Assistance to the Sick and Disabled	\$2,032.2	\$2,058.5	\$2,176.1	\$2,256.8	\$2,275.0	\$2,277.7	\$2.7	0.1%
Mental Retardation	916.1	1,066.5	1,123.9	1,163.9	1,170.5	1,171.2	0.8	0.1%
Mental Health	602.3	594.9	626.1	642.1	643.0	645.5	2.4	0.4%
Public Health	513.7	397.2	426.1	450.8	461.5	461.0	-0.5	-0.1%
Transportation	\$260.4	\$265.4	\$212.8	\$211.6	\$248.9	\$218.1	-\$30.8	-12.4%
Regional Transit	41.2	48.8	50.2	51.4	51.9	51.4	-0.5	-1.0%
Highways	155.4	152.5	97.2	99.1	135.8	101.2	-34.6	-25.5%
Registry	63.8	64.1	65.4	61.0	61.2	65.5	4.3	7.1%
Economic Development	\$403.5	\$324.8	\$343.7	\$340.5	\$366.8	\$372.8	\$6.0	1.6%
Business and Labor	158.4	129.5	148.1	140.4	154.6	162.1	7.5	4.9%
Environment	245.1	195.2	195.6	200.1	212.2	210.7	-1.5	-0.7%
Central Costs	\$3,184.4	\$3,824.4	\$4,157.4	\$4,353.6	\$4,411.8	\$4,409.2	-\$2.6	-0.1%
Employee Benefits ⁴	1,677.2	2,081.8	2,317.4	2,394.4	2,421.6	2,422.1	0.5	0.0%
Debt Service	1,507.2	1,742.5	1,840.0	1,959.2	1,990.1	1,987.0	-3.1	-0.2%
Other	\$1,037.9	\$920.4	\$911.4	\$944.3	\$982.6	\$982.8	\$0.2	0.0%
Total	\$21,820.2	\$24,300.4	\$25,760.6	\$26,882.4	\$27,157.8	\$27,294.2	\$136.4	0.5%

1. Amounts are adjusted to include certain off-budget authorizations, primarily for health care and pensions, and to exclude MBTA, school building assistance, convention center, mosquito control and certain other expenditures moved off-budget during this period.
2. 2006 budget amounts reflect appropriations authorized in the 2006 initial budget; Medicare buy-in costs previously carried as an offset to revenues have since 2006 been appropriated as an on-budget expenditure (the 2006 amount was \$231.8 million).
3. For purposes of comparison, the 2007 higher education and total budget amounts for the Senate have been adjusted upward to include \$78.3 million of spending supported by tuition and fee revenues that the Senate proposes to move off-budget.
4. Does not include workers' compensation and unemployment insurance which are budgeted in agency accounts.