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Bulletin

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Modest Structural Surplus in 2005; 2006 Finances Remain Tight

With the passage of a final spending bill for 2005, the Legislature has completed the actions needed to close the books on the state fiscal year that ended on June 30.[1] Much as in fiscal 2004, many have found the end-of-year finances for 2005 unusually difficult to sort out because of the interplay between much better than expected tax revenues and heavy reliance on reserves to finance some spending. While the official word on the 2005 surplus will not be reported by the state comptroller until the end of October, the essential elements of 2005 finances are now clear:

- Total receipts exceeded expenditures by roughly $300 million, the amount of the true "structural" surplus in 2005 programs and operations. This figure takes into account the almost $1.2 billion of tax revenues above the overly conservative initial forecast on which the 2005 budget was based (see Table 1).

- In addition, a Senate-proposed change in Medicaid accounting authorized in the final spending bill generated approximately $150 million of one-time "surplus" for 2005. Under this change, Medicaid accounting shifted to a "cash basis" as of June 30, leaving just over $300 million of unspent 2005 Medicaid appropriations (reduced 50 percent to reflect federal reimbursements) to revert at the end of 2005 rather than carry forward into 2006.

Table 1
Fiscal 2005 Closing Finances
($, millions)

Budgetary surplus	
"Structural" surplus	$300
Medicaid accounting change	150
Total	450
Reserves to stabilization fund	
2005 initial stabilization fund withdrawal	340
2004 "FMAP" revenues set aside for use in 2005	270
Other balances	81
Total	$691

Roughly $250 million of the $450 million total for these two items will be transferred

[1] Including the override of the Governor's veto of $42 million of the $129 million of spending that was authorized in the legislatively approved final supplemental bill. The $42 million funds prior-year collective bargaining costs at higher education campuses.

into a temporary holding fund created by the 2005 final spending bill.[2] The Legislature will have to take further action to use these funds.

- Finally, almost $700 million—attributable almost entirely to reserves set aside to finance 2005 spending that were not needed because of the stronger than expected 2005 tax receipts—will be transferred into the state's stabilization (rainy day) fund under the provisions of the final supplemental bill. Two one-time sources account for most of the amounts to be moved to this "rainy day" fund: $340 million originally authorized to be transferred out of the stabilization fund for use in 2005; and $270 million of so-called "FMAP" revenues from the federal government that were actually received in 2004.[3]

Looking more broadly at the 2005 financial results, lawmakers deserve considerable credit for their decision to return the unspent 2005 reserves to the stabilization fund. The approved transfer brings the state's rainy day reserves to a total of about $1.7 billion. (The approximately $600 million net increase in the stabilization fund reflects the impact of all authorized transfers into and out of the fund in 2005.)

While this total is impressive, it falls substantially short of the $2.3 billion of reserves that the state had on hand at the end of 2001. It stands even further below the stabilization target of at least ten percent of state spending, or about $2.7 billion based on the 2006 budget,[4] which the Foundation believes is the minimum fiscally prudent amount. At the onset of the recent fiscal crisis, the state had stabilization reserves equal to 10 percent of expenditures and still had to make a wide range of deep spending cuts and raise fees and taxes by almost $2 billion to achieve budgetary balance.

In thinking about the approximately $250 million of 2005 surplus that will remain available for expenditure in the temporary holding fund, an important point needs to be kept in mind. The 2006 budget is at best only barely in the black, and supplemental appropriations during the course of the year will inevitably boost the spending total higher, perhaps by sizable amounts if initiatives dealing with health care, energy assistance, and economic stimulus are adopted by the Legislature. Clearly, any decision to use the excess 2005 dollars should be undertaken with great care, preferably for one-time investments in areas that are critical to Massachusetts's long-term economic competitiveness.

Turning to fiscal 2006, the current outlook is positive, with several cautions. The state has restored only about 45,000 of the more than 200,000 jobs lost in the recession, and the pace of recovery remains slow. Looking beyond the state's borders, the impact of hurricanes Katrina and Rita on energy prices, the likelihood of more hikes in interest rates by the Federal Reserve, and the possible softening of consumer confidence all point to

[2] The official surplus amount could be somewhat higher or lower than the $450 million estimate, depending on the final tally of unspent agency funds and non-tax revenues. The approximately $200 million of remaining surplus after accounting for the transfer to the temporary holding fund has been appropriated for use in 2006.

[3] This $270 million of "Federal Medicaid Assistance Percentage" funds is the remaining, unspent portion of approximately $550 million of emergency fiscal relief to the state that was authorized by Congress in 2003.

[4] This 10 percent calculation includes "off-budget" spending for pensions, school building assistance, Medicaid and the MBTA, since all these programs rely on state tax revenues in full or in part.

substantial risks in the national economy as well.

Against this backdrop, the good news on September tax receipts must be greeted with some caution. Although the growth in baseline[5] taxes through September was an impressive 8.1 percent over fiscal 2005, most of that growth was concentrated in estimated income tax payments, which are largely driven by one-time non-wage income such as bonuses and capital gains, and corporate taxes, one of the most volatile revenue sources. Baseline withholding and sales taxes both posted healthy increases—5.1 percent and 5.2 percent, respectively—but much of that growth is eroded by inflation in the cost of goods and services purchased by state and local governments, which rose to 4.7 percent in the first quarter of fiscal 2006 (July-September, 2005).

At the same time, the positive tax performance must be viewed in the larger context of 2006 finances. Although taxes through September were $194 million above the quarterly benchmark based on the administration's $17.45 billion tax estimate for the year, the extra revenues still fall well short of the amount needed to close the almost $700 million operating deficit for fiscal 2006 recently identified by the administration.[6] Moreover, that deficit estimate does not take into account the costs of health care, K-12 education, energy assistance, and economic stimulus proposals that are not yet part of the 2006 budget.

In announcing the September revenue news, the Governor renewed his call for a reduction in the income tax from the current 5.3 percent to 5.0 percent, which would reduce tax revenues by approximately $225 million in fiscal 2006 and almost $600 million annually when fully implemented in 2007. This cut would come on top of the roughly $120 million of income tax cuts that are expected to take effect over those two years under current law.[7]

As the Foundation has previously documented, state spending for local aid, higher education, public health, and a host of other programs was cut by more than $2.1 billion during the fiscal crisis, only a modest portion of which has been restored.

The cuts in state aid have led directly to higher property taxes in communities across the state. Even with the restorations in the 2006 budget, funding for the three major state aid accounts remains $800 million, or 15 percent, below the pre-crisis peak after adjusting for inflation. If Beacon Hill leaders are truly serious about providing further tax relief, it makes far more sense to relieve the pressure on local property taxes by restoring aid levels than by making major new cuts in the income tax.

Fiscal 2006 Budget

The 2006 budget signed by the Governor on June 30 authorizes $25.81 billion of spending after vetoes and overrides, a modest $907 million, or 3.7 percent, increase over estimated 2005 spending. The Legislature overrode all but $800,000 of the Governor's $110 million in vetoes.

It is unfortunate that the budget depends on some $100 million of additional tax revenues from so-called "loophole closing," in reality

[5] Before the impact of tax law changes.

[6] Commonwealth Information Statement Supplement, September 30, 2005, page A-8. Even using the Foundation's more optimistic $17.8 billion tax estimate, the 2006 budget remains short of balance.

[7] These cuts will take the form of increases in the personal exemption that are tied to improvements in the state's revenue performance.

business tax increases that are neither fiscally necessary nor economically wise. Differing versions of the legislation imposing the hikes (the third round of such increases proposed by the Governor in as many years) have been approved by the House and Senate.

Unlike almost every budget of the last three decades, as a result of a positive House initiative the 2006 budget is largely devoid of so-called "outside sections," budgetary riders that address matters extraneous to the appropriation process. In the past, outside sections have been routinely used to make changes in state law that would not have prevailed if presented apart from the budget—including major policy initiatives that had not been considered by the appropriate legislative committees or aired at a public hearing.

As in much of the decade, spending growth in the 2006 budget is largely driven by the state's major obligations—with 50 percent going to health care and 11 percent to debt service—and by its major commitments, with more than 16 percent to local education aid. As a result of the improving financial conditions, the budget also provides significant increases for both higher education and human services, which sustained particularly deep cuts during the fiscal crisis.

Table 2
Fiscal 2006 Budget
Difference from Fiscal 2001 Spending
($, millions)

	Nominal		Inflation-Adjusted	
	Amount	Percent	Amount	Percent
Health care	$2,828	50.9	$1,895	29.2
Pensions	257	24.4	80	6.5
Debt service	348	24.3	107	6.4
Human services	395	9.4	-314	-6.4
Education and other local aid	142	2.8	-698	-12.0
Higher education	-159	-14.4	-346	-26.7
All other	-79	-2.3	-664	-16.3
Total	$3,731	17.1	$60	0.2

Note: Comparison excludes $231.8 of fiscal 2006 Medicare "buy-in" appropriations that in 2001 were deducted from federal reimbursement revenues. The 2006 budget amounts include some "off-budget spending," primarily for pensions and health care, but do not include appropriations carried forward from 2005 or additional 2006 spending approved after the budget was enacted; $316 million of 2001 spending for school building assistance has been excluded for purposes of comparison with 2006.

However, even with this year's increases, total appropriations for 2006 after accounting for inflation are essentially dead even with spending in 2001, before the fiscal crisis began (see Table 2). Behind that overall result is an even more striking dynamic: In inflation-adjusted dollars, 2006 appropriations for most of state government—local aid, human services, higher education, and a broad swath of other programs—are more than $2 billion below 2001 levels. That reduced level of spending is offset by increases in a handful of other areas, primarily health care.