The Long-Term Mismatch Between Available Resources and Important State Priorities

A Five-Year Fiscal Analysis

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Introduction

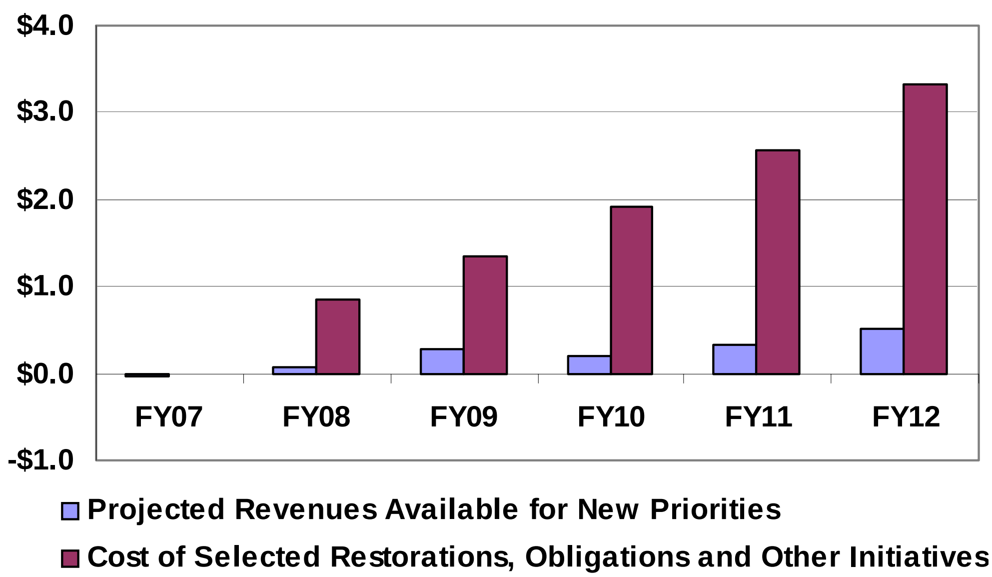
Despite the better-than-expected revenue performance in fiscal 2006, the state's leaders will soon have to grapple with a large and rapidly growing disparity between available resources and the costs of a broad array of important priorities. Dealing with this challenge is likely to dominate the financial decision making of the next Governor and Legislature for the foreseeable future.

The mismatch between expected revenues – and the costs of widely held goals such as greater local aid, additional spending for higher education, and increased capital investment – is staggering. Even with careful targeting on only those priorities of greatest importance for the long-term health of the Massachusetts economy, their costs are likely to exceed available resources by billions of dollars, according to a detailed analysis of the state's financial outlook over the next five years (see Figure 1). And contrary to the common belief that the Commonwealth can finance its unmet needs through economic growth, addressing any substantial portion of these spending ambitions would push the state budget deeply into deficit under any reasonable set of assumptions about future tax receipts and spending growth.

The situation is further complicated by proposals to cut the income tax rate from 5.3 to 5.0 percent, with an annual revenue impact of almost $700 million. The more accelerated the tax cut, the greater the impact on funding for various spending priorities, including providing relief to hard-pressed local property taxpayers via the

Figure 1

Long-Term Mismatch Between Available Revenues and Important State Priorities
($, billions)



Foundation's recommendation to dedicate 40 percent of tax revenues to cities and towns.[1]

Table 1

Selected Restorations, Obligations and Priorities Considered in the Analysis

Restorations Highlighted by MTF

"40%" local aid proposal
Additional funding for higher education
Raising the capital spending cap

Other Spending Priorities

Pay-as-you-go capital spending
Routine infrastructure maintenance and repair
Partial restoration of prior agency spending cuts

Looming Obligations

Unfunded liability for medical costs of state retirees

The Foundation's comprehensive new analysis examines the potential impact on the state budget through fiscal 2012 of a tightly focused list of initiatives that MTF believes are crucial to the state's long-term economic competitiveness.

The initiatives – a selected set of restorations, obligations and priorities – include rebuilding the financial capacity of cities and towns through the Foundation's proposal to dedicate 40 percent of tax revenues to local aid, restoring and increasing the state's investment in public higher education, maintaining and expanding the capital infrastructure, and preserving the Commonwealth's credit-worthiness by addressing the looming unfunded liability for the medical costs of state retirees (see Table 1).

In estimating the budgetary resources that are likely to be available to address these priorities, the Foundation prepared a baseline projection for fiscal 2008-2012 that uses reasonable assumptions about future revenue growth and the expectation of very tight annual budgeting. The analysis is predicated on annual tax growth of just over six percent, reflecting the long-term average rate of real growth of the Massachusetts economy and inflation of three percent a year. It assumes spending growth that is limited to largely unavoidable increases in areas such as Medicaid, pensions, and debt service, the costs of existing commitments such as school construction, and inflation in other state programs.[2]

Using these assumptions, the analysis projects a tiny budgetary surplus of only $62 million, or 0.2 percent of total revenues, in 2008; that figure would rise to about $500 million, or 1.4 percent of revenues, in 2012. However, achieving these surpluses would be possible only by adhering to strict maintenance budgeting, with no expansion in areas such as local aid, higher education, and human services beyond the rate of inflation, and no further restorations of the deep spending cuts during the fiscal crisis. Although those cuts undoubtedly eliminated some unnecessary spending, their magnitude – 2007 spending in these areas remains 15 percent below 2001 after adjusting for inflation – required significant reductions in services across state government.

Even under the favorable assumptions of the baseline projection – healthy revenue growth and sustained budgetary discipline –

[1] Under existing law, the 5.3 percent income tax rate will decline to 5.0 percent over an eight-year period if revenues remain strong.

[2] The analysis assumes an annual inflation rate of 3.0 percent for both revenues and spending.

the costs of the new priorities considered in the analysis would still far exceed available revenues. Taken in combination, the selected initiatives would require additional annual spending of $840 million in 2008 and rising to $3.3 billion in 2012, or more than six times the projected $500 million surplus in 2012.

While the new Governor and Legislature could well choose a different list of priorities than the ones considered here – including, for example, other large-scale initiatives such as greatly expanding early childhood education at a cost of up to $1 billion annually – they would still confront the same problem: a lack of sufficient resources to finance the additional spending.

And although the set of priorities to be considered could be trimmed, the major finding of the analysis – a huge disparity between the costs of new initiatives that could be undertaken and the state's ability to manage those costs – would remain essentially unchanged. Even if the priorities to be pursued, and their costs, were reduced by half, the state budget would still be unable to accommodate the required new spending.

The Foundation's analysis, if anything, overstates the state's capacity to take on new priorities. Far from a worst-case scenario, the baseline projection assumes that revenues will grow at the healthy rate of 6.2 percent a year over the next five years, without an evaporation of the capital gains and other volatile tax receipts that have supported the recent rapid growth in revenues, and without a recession. It also assumes that spending for current services and commitments will be held tightly in check, with the kind of fiscal discipline the state has rarely been able to sustain.

At the same time, the analysis makes no provision for cuts in the income tax beyond those that are already authorized in law, which include a restoration of personal exemptions to their 2002 levels and the gradual reduction of the income tax to 5.0 percent if revenue performance remains healthy. Nor does it add to the state's stabilization fund beyond the 0.5 percent of tax revenues that is required to be contributed annually under current law.

Although it is conceivable that the state's revenues could perform better for the next year or two than the roughly six percent rate of growth assumed in the analysis, the additional revenues would make only a small dent in the gap identified in the

Table 2
Fiscal 2006 and 2007 Finances
($, millions)

	FY06	FY07
Revenues		
Taxes (using consensus forecast for FY07)	$17,286	$17,604
Other revenues	9,052	9,555
Total	26,338	27,159
Estimated spending	25,951	27,722
Revenue minus estimated spending	387	-563
FY07 spending financed from prior year surplus revenues (not included in the 2007 spending total shown above)		805
End-of-year stabilization reserves, including impact of projected FY07 operating deficit	1,939	1,500

Note: The figures presented here are based upon administration estimates published in the August 17, 2006 Official Statement of the Commonwealth, adjusted to include certain off-budget spending, primarily for Medicaid costs, and the revenues supporting that spending. Tax revenues exclude sales taxes dedicated to the MBTA and School Building Authority, which total $1.2 billion in fiscal 2006 and $1.29 billion in fiscal 2007. FY07 spending does not include $200 million of bond-funded expenditures that were authorized at the end of fiscal 2006 for use in FY07 and future years. Fiscal 2006 stabilization reserves include $305 million of balances in the Transitional Escrow Fund which are reported separately in the Official Statement. The FY07 stabilization balance of $1.5 billion assumes a transfer from the stabilization fund to the General Fund to offset the projected $563 million operating deficit; this withdrawal would require legislative authorization.

analysis. However, that performance is unlikely, with employment that remains almost 150,000 below the pre-recession peak, a national economy that is starting to slow, and the heavy reliance on volatile capital gains and corporate receipts to achieve the well-above-average rate of revenue growth in 2006.

It is possible as well that a portion of the spending growth for some existing state programs that has been assumed in the analysis will not be necessary, but any such savings are almost certain to be offset by unforeseen requirements in other programs.

Dealing with this challenging fiscal outlook will be even more difficult given the buoyant atmosphere that marked the close of fiscal 2006. With baseline revenue growth topping nine percent[3] and an estimated surplus approaching $400 million, fiscal 2006 ended in a wave of last-minute authorizations that added almost $1 billion to the budget, almost all of which will carry forward for expenditure in 2007, including $200 million that will be financed through long-term borrowing (see Table 2).[4] These additional appropriations completely used up the 2006 surplus and required dipping into 2006 reserves as well. Despite public claims, there was no $1 billion surplus in 2006, and the much smaller actual surplus has already been spent.

Both those who are pressing for major expansions in spending and those who are advocating for a more rapid reduction in the income tax rate will have to come to grips with the far less positive fiscal reality that lies ahead.

That reality begins with a fiscal 2007 budget that is not even in structural balance. Using the consensus revenue forecast (which appears conservative given the 2006 performance), the 2007 budget is more than $500 million out of balance.[5] Attaining balance will require revenue growth slightly greater than the 6.2 percent assumed in our analysis, and almost two percentage points greater than the underlying rate of growth assumed in the consensus forecast on which the 2007 budget was built. While the 6.2 percent rate of growth may be achievable, it is by no means certain.

The detailed results of the Foundation's analysis are presented in the following sections of the report, including the assumptions on which it is built, the year-by-year projections of revenues and spending used in the baseline analysis, and the annual costs of the selected restorations, obligations and initiatives considered in the analysis.

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[3] The growth in baseline tax revenues (before law changes) was 9.1 percent in 2006, according to the Department of Revenue; actual collections rose by 8.2 percent.

[4] Approximately two-thirds of the additional authorizations are for one-time purposes.

[5] In the absence of stronger revenue growth, the 2007 authorized spending (excluding prior appropriations carried forward from 2006) that is in excess of the consensus revenue forecast will have to be financed from reserves.

Five-Year Analysis

The Foundation built its analysis on three elements that are critical to assessing the fiscal capacity of the Commonwealth over the next five years:

1. The revenues that will be available to meet future needs.

2. The costs of maintaining the state's current budgetary commitments and obligations.

3. The future financial impact of addressing new priorities and initiatives that already command widespread support.

Revenues

The Foundation's baseline analysis assumes that over the next five years state tax revenues will grow by 6.2 percent a year, before adjusting for already authorized tax cuts (see Table 3). While this rate of growth is substantially less than the 9.1 percent baseline increase in fiscal 2006, it reflects the historical performance of the state's economy, as measured by the average annual growth in total personal income.

In several respects, the 6.2 percent growth assumption is optimistic, at least over the five-year time horizon of the analysis. It does not take into account the potential evaporation of the recent surge in volatile revenue sources such as capital gains and corporate profits, or the possibility of an economic recession. As the Commissioner of Revenue noted in announcing final tax receipts for fiscal 2006, these two sources

Table 3
Five-Year Baseline Budget Analysis
(Before Selected Spending Restorations, Obligations and Priorities)
($, millions)

	FY07	FY08	FY09	FY10	FY11	FY12
Revenues						
Taxes						
Baseline taxes at 6.2% growth*	$19,633	$20,850	$22,143	$23,516	$24,974	$26,522
Increase personal exemption	-60	-120	-120	-120	-120	-120
Triggered income tax cut to 5%	0	0	-51	-191	-331	-494
Other authorized tax cuts	-46	-77	-57	-57	-57	-57
Total taxes	19,528	20,653	21,915	23,148	24,466	25,851
Non-tax revenues						
Lottery at 3% growth	920	948	976	1,005	1,035	1,067
All other excluding Medicaid (0%-1%)	4,194	4,214	4,234	4,254	4,275	4,295
Total revenues	$24,642	$25,815	$27,125	$28,407	$29,776	$31,213

* Tax revenues shown include income taxes dedicated to pension costs and sales taxes dedicated to the MBTA and School Building Authority.

Table 3 - Continued
Five-Year Baseline Budget Analysis
(Before Selected Spending Restorations, Obligations and Priorities)
($, millions)

	FY07	FY08	FY09	FY10	FY11	FY12
Spending						
Health care at 7% growth						
Medicaid net of federal reimbursements	$3,750	$4,013	$4,293	$4,594	$4,915	$5,260
Employee health costs	1,064	1,138	1,218	1,303	1,394	1,492
Senior pharmacy (not incl. in Medicaid)	64	68	73	78	83	89
Health reform (7% growth beyond FY10)	200	200	200	400	428	458
Uncompensated care	290	200	200	200	200	200
Total health care	5,367	5,618	5,984	6,575	7,021	7,498
Local aid						
Chapter 70 at 3% growth	3,506	3,611	3,719	3,831	3,945	4,064
Lottery at 3% growth	920	948	976	1,005	1,035	1,067
Additional assistance	380	380	380	380	380	380
Other local aid at 3% growth	789	812	837	862	888	914
Total local aid	5,594	5,750	5,911	6,077	6,248	6,424
Other major commitments						
Pensions	1,358	1,419	1,483	1,550	1,619	1,692
Debt service - $1.25 billion spending cap	1,987	2,066	2,149	2,235	2,325	2,417
MBTA sales tax at 6.2% growth	734	780	828	879	934	992
School Building Authority phase-in	557	770	866	971	1,086	1,153
Total other major commitments	4,636	5,036	5,326	5,635	5,963	6,254
All other programs at 3% growth	8,975	9,245	9,522	9,808	10,102	10,405
Required stabilization fund deposit	98	103	110	116	122	129
Total spending and stabilization deposit	24,670	25,752	26,853	28,211	29,457	30,711
Revenue minus spending and stabilization deposit	-$29	$62	$272	$197	$319	$502

Note: Totals may not add exactly due to rounding.

led the growth in revenues in 2006.[6]

Revenue collections from these sources are notoriously volatile, responding in the case of corporate profits to national trends that are closely tied to the business cycle, and in the case of capital gains and other investment-related income to the often sharp fluctuations in national and worldwide capital markets. In 2002, the headlong plunge in tax collections was attributable in large part to the collapse of the stock market. And while economists cannot predict with any certainty when the next downturn will come, the possibility of a recession, perhaps a severe one, is very real over the next five years.

Fiscal 2007 revenue performance further highlights the risks in the 6.2 percent growth assumption. Tax receipts in July and August fell short of the benchmark for the consensus forecast (which is approximately $600 million lower than the 2007 revenues assumed in the baseline analysis). Although

[6] The 6.2 percent rate of growth is also assumed for fiscal 2007, producing a revenue figure that is $598 million higher than the conservative consensus forecast upon which the 2007 budget was built.

collections in these two months account for a relatively small share of the annual total, the weak performance so far is an inauspicious start for a year in which the consensus forecast must be exceeded by more than one-half billion dollars in order to achieve structural balance in the budget.

Current Budgetary Commitments

In calculating the costs of the state's existing programs and commitments over the next five years, the Foundation assumed a "bare bones" approach to budgeting that provides only the minimum amounts needed to sustain current services and obligations and to honor commitments that have already been made. This approach makes no provision for the costs of restoring prior spending cuts in local aid, higher education, and other areas or taking on new initiatives and obligations. The analysis includes the following major assumptions about future spending requirements (see Table 3 on page 6):

- Growth in health care spending of 7.0 percent a year, including the costs of Medicaid (net of federal reimbursements), employee health benefits, and the senior pharmacy program.

- Carrying forward the $200 million funding of health care reform in 2007 to 2008 and 2009, with an additional $200 million in 2010.

- Growth in Chapter 70 aid of 3.0 percent a year – the rate of inflation assumed in the analysis – in order to meet the state's obligation to assure an adequate level of school spending in poorer school districts. This rate of increase assumes the foundation budget as currently defined, with no legislative adjustments or expansions.

- Annual lottery aid growth of 3.0 percent a year; and level-funding of additional assistance.

- Increases in annual pension contributions that are consistent with the most recently approved pension funding schedule, which provides for growth of about 4.5 percent a year.

- Projected increases of about 4.0 percent a year in the costs of debt service, assuming that annual bond-funded capital spending is held within the current $1.25 billion cap.

- Growth in sales-tax-funded contributions to the MBTA at the assumed rate of overall tax growth.

- Phasing in of sales-tax-funded contributions to the School Building Authority over seven years ending in fiscal 2011, as provided in the Authority's enabling legislation.

- Spending growth for all other state programs at the assumed inflation rate of 3.0 percent a year, resulting in level funding of these programs in inflation-adjusted dollars.

- Annual contributions to the stabilization fund at the statutorily required amount of 0.5 percent of total tax revenues.

As previously noted, the overall spending totals in the analysis make no accommodation for reversing prior spending cuts beyond the restorations already implemented in recent budgets, or for any initiatives beyond those already enacted. Under the analysis, total spending[7] would grow by an average of 4.5 percent a year over the next five years, well below the

[7] Excluding federally reimbursed Medicaid spending.

Table 4
Selected Restorations, Obligations and Priorities
(Increase over 2006 in millions of dollars)

	FY07	FY08	FY09	FY10	FY11	FY12
Priorities highlighted by the Foundation						
“40%” local aid proposal (10-yr. phase-in)	$0	$159	$369	$632	$956	$1,340
Additional higher education funding	0	59	120	184	251	325
Increase in capital spending cap to $1.5 billion	0	13	42	75	113	157
Other spending priorities						
Restoration of 50% of prior cuts over 5 years	0	131	270	417	573	738
Pay-as-you-go capital spending (5-yr. phase-in)	0	50	103	159	219	281
Routine capital maintenance and repair	0	50	52	53	55	56
Looming obligations						
Unfunded medical costs of state retirees	0	378	391	401	408	415
Total	$0	$841	$1,347	$1,921	$2,575	$3,313

roughly seven percent growth in the 2007 budget and also less than the approximately five percent rate of annual increase that the administration has set as an informal guideline for prudent budgeting.

Even with this tight budgeting, the state would have very little room for program restorations or new priorities. Based on the bottom-line results of the analysis, in 2012 the revenues available for new initiatives would total $500 million, a modest amount in the context of the overall budget and in relation to the potential new funding needs.

Selected Restorations, Obligations and Priorities

The third element of the analysis is the broad array of new priorities, commitments and obligations that are now being considered or that address long-recognized needs. We have not attempted to identify a comprehensive roster of potential future initiatives, but instead have concentrated the analysis on a short list of priorities that the Foundation considers crucial to the long-term health of the state economy and on obligations that are so pressing that they cannot be ignored.

The initiatives included in the analysis fall into three broad categories (see Table 4):

- Major priorities that the Foundation has highlighted over the last 12 months.
- Other expansions that would help strengthen the state’s competitiveness.
- Looming obligations that will be difficult, if not impossible, to avoid.

Table 5
Mismatch Between Projected Surplus Revenues and Selected Restorations, Obligations and Priorities
($, millions)

	FY07	FY08	FY09	FY10	FY11	FY12
Projected surplus revenues	-$29	$62	$272	$197	$319	$502
Selected restorations, obligations and priorities						
Priorities highlighted by the Foundation	0	232	531	891	1,320	1,822
Other spending priorities	0	231	425	629	846	1,076
Looming obligations	0	378	391	401	408	415
Total	0	841	1,347	1,921	2,575	3,313
Projected surplus revenues minus priorities and obligations	-$29	-$779	-$1,075	-$1,724	-$2,256	-$2,811

<u>Priorities Previously Highlighted by the Foundation</u> Three proposals supported by the Foundation have been considered in the analysis.

- *Dedicating 40 percent of income, sales, and corporate taxes to the state's major local aid accounts*. This MTF proposal would restore the deep cuts in aid during the state's fiscal crisis and expand future aid for our cash-strapped municipalities. Cities and towns face a long-term financial crunch due to dependence on uncertain state aid, rapidly rising costs, particularly for employee health care, and limited ability to raise revenues. The proposal would give local taxpayers much needed relief, while providing local officials with a degree of certainty about the ongoing share of state resources on which they can rely.

  The analysis assumes that the 40 percent goal would be phased in over ten years, with the first five years of the phase-in during 2008-2012.[8] At this pace of implementation, the plan would require an additional $160 million in 2008.[9] Due to the combined effect of the phase-in schedule and the assumed growth in annual tax revenues, this figure would rise to $1.3 billion in 2012.

- *Restoring the state's financial commitment to public higher education* along the lines proposed by the Joint Committee on Higher Education. In the Foundation's view, reversing the deep cuts in state support for higher education during the fiscal crisis is crucial to preparing our future workforce. Despite recent increases, 2007 funding for UMass and the state and community colleges remains almost one-third below 2001 levels after adjusting for inflation.

  The Committee's plan combines the additional funding with affordability safeguards for students and parents, a system to ensure that the new dollars are

[8] Under the Foundation's proposal, an amount equal to 40 percent of the actual income, corporate, and sales taxes in the calendar year preceding the beginning of the fiscal year would be made available to fund that year's Chapter 70 school aid, lottery, and additional assistance. The comparable figure for fiscal 2007 is 32 percent (2007 aid divided by calendar year 2005 tax collections).

[9] The additional dollars would come on top of the inflationary increases in the three main local aid accounts that have been assumed in the baseline projection (approximately $130 million in 2008).

distributed among campuses based on educational need, and governance reforms.

Based on MTF's estimates, this proposal would require approximately $60 million of additional appropriations in 2008, increasing gradually to about $325 million in 2012.

- *Raising the cap on bond-funded capital spending* from its current level of $1.25 billion to $1.5 billion in 2008, an amount that reflects the inflation in construction costs for state and local government since 2002, with additional annual adjustments in the cap in 2009 and beyond to keep up with inflation. The Foundation estimates that this action would require average increases in debt service of $30-$40 million a year over the next five years.

Other Spending Priorities The priorities emphasized by the Foundation represent only a small portion of the numerous initiatives and expansions which been identified since the state emerged from the recent fiscal crisis. We have not attempted to determine the potential fiscal impacts of a comprehensive list of these other spending priorities, but instead focused on a small number of potential program restorations and expansions, including additional capital investments.

- *Restoring a portion of the prior cuts in human service, environmental, and other programs.* The analysis assumes that half of these cuts would be restored over the next five years, requiring $130 million of additional spending in 2008 (beyond the three percent inflationary increase that is built into the analysis), rising to roughly $750 million in 2012.

- *Pay-as-you-go capital spending* Given the Commonwealth's enormous capital needs, it makes sense to use operating revenues as well as to raise the bond cap to help meet those needs. The analysis assumes that the additional pay-as-you-go capital expenditures would be phased in over five years beginning in fiscal 2008, reaching a total of $250 million a year (before adjusting for inflation) in 2012.

  Over the next ten years, the measure would support $2.4 billion of additional investments outside the capital spending cap. Although a substantial sum, this amount falls woefully short of the many billions of dollars more that are needed to proceed with capital projects that cannot be accommodated within the cap or that are not yet authorized.

- *Capital maintenance.* Providing $50 million a year for annual upkeep and repair would make at least a small dent in the large accumulation of deferred maintenance needs for state bridges, parks, campuses and other facilities.

Looming Obligations While the baseline analysis includes contractually or legally required costs, such as debt service payments to buyers of state bonds and refunds to taxpayers under the *Peterson* case, the state faces another major obligation that will soon have to be addressed:

- *The large unfunded liability for the future medical costs of state retirees*. These costs are now funded on a pay-as-you-go basis. In the recent actuarial valuation prepared for the state comptroller, the unfunded liability for these medical benefits was estimated at $7.6 billion (assuming that the state pays down the liability using the approach that was adopted for erasing the unfunded pension liability).

According to the valuation, if the state immediately adopted a funding schedule to eliminate the liability over 30 years, an additional $378 million would need to be appropriated in 2008. By 2012, the necessary funding would rise to $415 million, a figure that would continue to grow in subsequent years.

Although the Commonwealth may be able to put off addressing this obligation for a year or two, it will eventually have to be dealt with in order to protect the state's credit rating. However, the longer the delay, the larger the accumulated liability that will have to be funded.

Cities and towns will likewise face major unfunded liabilities for the medical costs of municipal retirees – the costs of which are not included in this analysis. In the absence of additional state assistance, such as that provided by MTF's "40 percent" aid proposal, these costs will inevitably have to be borne by local residents in the form of higher property taxes, reduced services, or both.

In combination, these three sets of initiatives – Foundation recommendations, other spending priorities, and the looming retiree medical obligation – would require an estimated $840 million of additional resources in 2008, increasing to $3.3 billion in 2012. These costs dwarf the surpluses projected in the baseline analysis, which range from $62 million in 2008 to $500 million in 2012.

This enormous mismatch does not take into account proposals to cut the income tax rate to 5.0 percent more rapidly than authorized in current law. While accelerating the tax cut would have only a modest impact in the final years of the analysis, over the short term it would even further limit the state's ability to take on new initiatives.

Far from exaggerating the disparity between resources and need, the Foundation's analysis, if anything, understates the financial challenges that lie ahead. On the revenue side, our assumption of 6.2 percent annual revenue growth does not account for an economic recession or for the loss of capital gains receipts that would result from a substantial downturn in the stock market. According to the analysis, the evaporation of the capital gains "bonus" that has pushed up receipts over the last two years would wipe out the projected surpluses under the "bare-bones" budgeting assumed in the analysis, throwing the state's finances into the red before addressing any of the priorities we have identified (see Table 6).[10] A recession would result in even larger deficits, requiring cuts in existing programs and precluding any consideration of restorations or expansions.

At the same time, a more optimistic revenue outlook would do little to change the overall picture. As Table 6 shows, even under the highly unrealistic assumption that baseline tax revenues continue to grow for another two years at the rapid 9.1 percent pace of 2006, the resulting strong surpluses – ranging from $1.2 billion in 2008 to $1.9 billion in 2012 – would still be insufficient to accommodate the initiatives we have considered.

Each of these alternative revenue scenarios assumes that the tight rein on spending growth built into the analysis can actually be achieved. The baseline projection – a rate of spending growth of 4.5 percent a year on

[10] The use of a more conservative revenue assumption along the lines considered prudent by the administration would result in greater deficits still. Assuming 5.0 percent, rather than 6.2 percent, annual growth in tax revenues over the next five years would produce deficits ranging from more than $300 million in fiscal 2008 to almost $600 million in 2012 – before accounting for the costs of initiatives.

Table 6
Analysis Using Alternative Revenue Assumptions
($, millions)

	FY07	FY08	FY09	FY10	FY11	FY12
Revenue growth at long-term average						
Assumed rate of tax revenue growth	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%
Revenue minus Table 3 spending	-29	62	272	197	319	502
Revenue minus Table 3 spending minus Table 4 restorations, obligations, and priorities	-29	-779	-1,075	-1,724	-2,256	-2,811
Strong revenue performance through FY08						
Assumed rate of tax revenue growth	9.1%	9.1%	6.2%	6.2%	6.2%	6.2%
Revenue minus Table 3 spending	505	1,168	1,443	1,431	1,621	1,877
Revenue minus Table 3 spending minus Table 4 restorations, obligations, and priorities	505	327	96	-490	-954	-1,436
Evaporation of capital gains “surprise”						
Assumed rate of tax revenue growth	3.1%	6.2%	6.2%	6.2%	6.2%	6.2%
Revenue minus Table 3 spending	-599	-484	-370	-481	-397	-254
Revenue minus Table 3 spending minus Table 4 restorations, obligations, and priorities	-599	-1,325	-1,717	-2,402	-2,972	-3,567

average – would require that much of state government be level-funded (after taking inflation into account) for the next five years, while making no provision for further restoration of previous spending cuts or for any significant expansions. This kind of spending discipline has rarely been sustained over any significant period of time – and then only in response to fiscal crisis, not in years of healthy revenue growth.

Although it is certainly possible to scale back the selected priorities and initiatives – by setting less ambitious goals or by implementing the initiatives at an even slower pace than we have assumed – the basic conclusions of the analysis again would remain essentially unchanged.

For example, if the pace of implementation of the Foundation’s 40 percent local aid plan were stretched out from the ten years assumed in the analysis to an untenably long twenty years, the costs of that initiative in 2012 would still consume essentially all of the projected available revenues for that year, before addressing any of the other priorities. Even if the scope of all of the priorities were reduced by half, the amounts needed to finance them would exceed available resources by more than $1 billion.

Conclusion

Considering the Foundation’s analysis as a whole, it is clear that the state’s fiscal leaders, both current and future, will face enormous challenges through the end of the decade. On the one hand, the analysis demonstrates that the Commonwealth will have sufficient resources to meet its current obligations and commitments – but *only* if it maintains the kind of fiscal discipline that enabled the state to weather successfully the recent fiscal crisis. It is equally clear that the state budget can accommodate only a small fraction of the long list of expensive initiatives that are now under consideration – which include further significant restorations of the severe spending cuts during the fiscal crisis – *and* that it will not be possible for the state to grow its way out of the mismatch between available resources and spending ambitions.

As the Foundation underscored in a recent *Bulletin*,[11] the 2007 budget process provides an example of the kind of decision making that must be avoided if the state is to maintain fiscal stability. In both its rate of spending growth and in its reliance on the stabilization reserve to support that growth, the 2007 budget reflects a worrisome lapse of fiscal discipline. It creates expectations for annual spending growth that cannot be sustained, and it risks the reserves that will be needed in the event of an economic downturn.

There is no question that the Commonwealth has sufficient cash on hand to pay for the spending that has been authorized in the budget, as well as in the economic stimulus and supplemental spending bills that were adopted at the end of fiscal 2006. Although the recent weak performance raises some concerns, we continue to believe that 2007 tax revenues will be sufficient to avoid a draw on the rainy day fund in order to support ongoing operating costs.

However, the Foundation's analysis paints a picture that is starkly at odds with the expansionary mood that has driven the budgetary choices for 2007. The financial proposals and decisions of the last six months have taken place in what can only be described as a misguidedly festive atmosphere. In light of the Foundation's new findings, the party will soon be over.

Methodology

The five-year financial analysis is intended to provide a framework for identifying longer-term trends in the state's finances, not to forecast specific financial results. For the purposes of presenting a fuller picture of the Commonwealth's tax-supported finances, the analysis includes spending for pensions, the MBTA, and school building construction, as well as the dedicated income and sales tax receipts which support that spending, and excludes the portion of Medicaid spending that is financed from federal reimbursements. Non-tax revenues other than Medicaid federal reimbursements are included in the analysis, with annual growth rates that average a modest three percent or less, reflecting historical performance that is much less robust than tax revenues.

Because of these and other accounting differences, the total revenue and expenditure amounts calculated in the analysis would differ from those reported in the Comptroller's official financial statements and those appearing in the General Appropriation Act ("the budget").

The analysis makes use of several simplifying assumptions in calculating the future impacts of initiatives, both currently authorized and proposed. These modeling simplifications in some instances may affect the timing of the initiatives' impacts in individual fiscal years, but should not materially change their cumulative effects.

Although the analysis of spending growth builds in annual inflationary increases in the costs of existing programs, it does not assume any "efficiency" gains that would reduce spending for those programs below inflation. Approximately two-thirds of the state budget is dedicated to fixed costs such as debt service and pensions, pass-through payments such as local aid to cities and towns and revenues set aside for the MBTA, and difficult-to-control Medicaid and other health care costs. A significant portion of the remaining one-third supports the direct delivery of human and other services.

[11] *State Budget 2007: Fanning the Expansionary Flames*, June 22, 2006.