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Bulletin

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MTF

2005 State Budget: Structural Imbalance Persists Despite Improving Revenues; Important Reforms Adopted

The crisis in the state's finances has entered a new and challenging phase. While improved revenues have led some to conclude that the crisis is over, the reality is much less certain.

- The state is still spending more than it is taking in, with approximately $750 million of 2005 expenditures supported by reserves.
- The state's revenue base has not yet recovered from its double-digit decline in the depths of the crisis.
- The costs of health care and other major programs continue to grow more rapidly than revenues.
- The Commonwealth is facing a daunting array of looming obligations, including the underfunding of Medicaid provider costs, a new $1 billion initiative for early childhood education, and the potential impact of the Supreme Judicial Court's pending decision on the *Hancock* school finance suit (see Table 1).

It is also clear that the state's leaders need to consider restoring some of the $3 billion of spending cuts that have seriously affected a wide range of programs and services.

Although the surge in tax revenues in the final months of fiscal 2004—$724 million above projections for the year—was very good news, it has fostered a false impression of the state's ability to address its fiscal challenges: A significant portion of those additional receipts were due to capital gains in 2003 that are not likely to recur in the more subdued financial markets of 2004.

At the same time, the recent pace of growth in withholding and sales taxes, while healthier than the overly conservative rates assumed in the 2005 budget, is still insufficient to close the gap between ongoing revenues and spending.

That structural gap will almost certainly persist—and even widen—in fiscal 2006. While the budget can accommodate gradual reductions in taxes as revenues improve, as provided by current law, it remains premature to talk about a large tax cut.[1] In this environment, the state's leaders face a formidable challenge in bringing expectations into line with fiscal reality over the coming months.

To their considerable credit, policy makers have in recent weeks adopted among the most constructive series of reforms in years, all of them long-time priorities of the Foundation. Although reforms alone cannot resolve the Commonwealth's fiscal problems, initiatives to restructure the state's transportation agencies, the school building

[1] The first statutory condition for triggering a tax cut in 2005 has already been met: Inflation-adjusted baseline taxes grew more than 2.5 percent in fiscal 2004. If the growth over the next five months remains positive, a $60 million income tax cut in the form of increased personal exemptions will automatically take effect on January 1.

Table 1
Longer-Term Funding Obligations

Hancock school funding suit	$1.0 B. +
Early childhood education initiative	1.0 B.
Health care provider reimbursements (partially offset by federal reimbursements)	850 M.
Incremental tax cuts per 2002 law (over ten years)	750 M.
School building assistance (over six years)	450 M.
Capital gains suit (one-time)	250-300 M.
Lottery cap phase-out (over five years)	200 M. +
Debt service (annual average)	150 M.
Restoration of spending cuts—human services, local aid, higher education	?
Universal health care ballot question	?

assistance program, and the state's public construction laws are giant steps toward resolving thorny problems that had for many years defied solution (see the *Reforms* section starting on page 4).

The Current Situation

While the revenue picture for fiscal 2004 is essentially complete, spending for the year will take several weeks to determine, as the state comptroller documents the level of end-of-year "reversions" (unspent agency appropriations) and the Legislature concludes its actions on fiscal 2004 finances in a final appropriation bill that will have to be enacted in informal session. Only a small amount will need to be appropriated for true "deficiencies" (shortfalls in agency accounts). In the $500 million final supplemental request filed by the Governor in June 2004, such deficiencies totaled only $21 million (see Table 2).

Instead, the major focus of the final supplemental will be on how to use the unanticipated 2004 revenues. The Foundation believes that the first priority should be rebuilding the state's rainy day reserves, which have been badly depleted since the onset of the crisis. As we noted in a recent bulletin, the unexpected 2004 receipts also present an opportunity to address the severe shortfall in the Commonwealth's reimbursements to hospitals and other providers as the first step in a multi-year strategy to resolve this issue. [2]

While other one-time expenditures may also be appropriate, using the excess revenues to expand fiscal 2005 spending is a trap that should be avoided, since it would only add to the structural deficit. It is also important to recognize that the $724 million of extra revenues in 2004 does not represent a true structural surplus, because it ignores the roughly $400 million of one-time resources that supported spending in 2004. In addition, more than $200 million of the excess receipts has already been committed to school building assistance and the Springfield bailout.

[2] See MTF's June 7th Bulletin, *2005 Budget: Managing the Fiscal Recovery—Too Soon to Celebrate*.

Table 2
Governor's Final 2004
Appropriation Bill

Spending requests	
One-time capital	$254.3
Fiscal 2005 spending	
Local aid	100.0
Other	88.3
Total	188.3
Continued appropriations*	31.4
2004 deficiencies	20.8
Total requests	494.8
Deposit to reserves	130.0
Grand total	$624.8

* Requests to carry over to fiscal 2005 appropriations that would otherwise revert in 2004.

Sufficient resources will clearly be available to support 2005 authorized spending—even after accounting for legislative overrides of the Governor's spending vetoes. Before ending formal sessions for the year, the Legislature overrode $113 million of the $126 million vetoed by the Governor.[3]

However, the structural underpinnings of this year's budget are shaky at best. Strikingly, 2005 finances depend on roughly $750 million of reserves and other one-time resources—about $350 million more than 2004.

Although the heavy reliance on reserves is mitigated by the recent better than expected revenue performance, it is uncertain whether 2005 tax receipts will exceed the forecast by the same large margin as in 2004. As noted earlier, a portion of the additional 2004 collections were attributable to one-time capital gains that will not add to the 2005 tax base. On the other hand, the 3.75 percent baseline growth assumed in the forecast is low: The tax sources most closely tied to the economy have grown at a healthy pace in recent months, with withholding up 5.6 percent for the second half of fiscal 2004, sales taxes up 4.2 percent for the fourth quarter, and collections in July above forecast for both of those sources. If sustained, these higher rates of growth would replace some—but probably not all—of the nonrecurring capital gains revenues.

Given these developments, the best the state can hope to achieve is a rough structural balance between receipts and expenditures in fiscal 2005. That outcome is by no means certain, since it depends on continued growth in revenues—amid reports that the state economy may be slowing—and on holding spending to the levels authorized in the just-enacted budget.

Fiscal 2006 Outlook

Unlike the period following the last fiscal crisis in the early 1990s, the Commonwealth is now contending with less favorable circumstances for both spending and revenues. Medicaid and other health care costs are growing at double-digit rates, in sharp contrast to the tightly managed cost environment of a decade ago. While the state had to deal with only one major new financial commitment—funding of the 1993 education reform law—in the mid-1990s, the Commonwealth today faces a formidable list of longer-term funding obligations that potentially total billions of dollars (see Table 1). And by all accounts, there is no reason to expect a repeat of the extended, double-digit revenue growth of the last half of the 1990s.

[3] Including vetoes of off-budget spending authorizations.

Using reasonable assumptions about 2006 revenue, largely unavoidable increases in a handful of programs—including health care, debt service, Chapter 70 school aid, pensions and school building assistance —will alone exceed the growth in tax revenues by more than $100 million (see Table 3). However, in order to hold the 2006 structural deficit to even this level, much less close the gap, the Commonwealth would have to ignore inflationary cost increases in other areas of the budget and—more critically—close its eyes to the state's many longer-term obligations. Realistically, these cost pressures cannot be avoided, and managing them will necessitate further tough choices in programs that have already sustained billions of dollars of cuts over the last three years.

Table 3
Fiscal 2006 Outlook
($, millions)

Assumed tax revenue growth at 5 percent	$815
Less: "Automatic" tax cut	-60
Total tax revenue growth	755
Assumed spending growth	
Medicaid and other health care at 10 percent*	465
Debt service	139
Chapter 70 and other school aid	95
School building assistance	93
Pensions	58
Sales tax dedicated to MBTA	34
Total spending growth	884
Tax growth minus spending growth	-$129

* Net of federal reimbursements.

Reforms

In one of the most productive sessions in years, the Legislature enacted several important reform measures that address longstanding problems. In two instances, transportation restructuring and school building assistance, the Legislature's solutions substantially improve on ideas advanced by the administration. In other areas, reforms of public construction laws and state employee pensions, the Legislature did not go as far as the Governor proposed but still produced significant improvements.

Transportation Restructuring The legislation signed by the Governor strengthens the Commonwealth's ability to finance, build and maintain its transportation assets. While rejecting the administration's plan to merge the Turnpike Authority with the Highway Department, the reforms integrate the state's fractured array of transportation agencies but still retain the critically important operational and revenue-generating capacities provided by the independent authorities. The reforms closely follow the recommendations of the Foundation's recent report, *The Road to Reform: Restructuring the Commonwealth's Transportation Agencies.*

Under the restructuring, the Secretary of Transportation will become chair of the Turnpike Authority in 2007. At the same time, a new executive director position will be created to assume the administrative duties held by the current Authority chairman. The Secretary will also be added to the MassPort board, with the chair elected by the board, and will continue to chair the MBTA board. The Secretary is charged with using his expanded powers to identify and implement ways to achieve savings by sharing resources across departments and authorities.

A new Office of Transportation Planning under the Secretary will develop a longoverdue comprehensive transportation plan that includes the capital programs of the authorities. In addition, a Transportation Finance Commission of outside experts was created to recommend strategies for financing the state's most critical—but unfunded—transportation priorities.

School Building Assistance The overhaul of the school building assistance (SBA) program developed by the Legislature in conjunction with the Treasurer takes a responsible approach to solving one of the Commonwealth's biggest fiscal challenges: meeting the need to help cities and towns pay for hundreds of current and future school building projects while limiting the state's obligations over the long term.

Achieving these goals will require a large commitment of taxpayer dollars—one cent of the sales tax phased in over seven years (starting at $396 million in 2005), $1 billion in general obligation bonds, and $150 million from reserves. However, the Commonwealth's share of future costs will be capped by the dedicated revenue source. This is a critical improvement over the old financial structure, which had no limit other than the Legislature's willingness to appropriate funds. Spending on SBA grew rapidly during the 1990s until a moratorium on funding for new projects was imposed, adding to a long backlog of communities awaiting reimbursements. The funding levels under the new plan are sufficient to finance $5 billion in remaining payments for projects already receiving reimbursements, to make payments on all projects on the waiting list within 3½ years at previously promised reimbursement rates, and to begin payments for future projects in fiscal 2008.

The adopted plan has some significant advantages over the Governor's original proposal, which did not provide funding for future projects beyond the waiting list and relied on excessively long-term debt to shift the cost of current obligations further into the future.

The legislation also reduces the state's generous reimbursement rates by eight percent for projects not already on the waiting list, a necessary step to accommodate anticipated demand within available funding. Further revisions to the eligibility rules, cost standards and incentive structures that drive SBA spending will be developed by the new Treasurer-led independent authority that was created to manage the program. While the Foundation believes that SBA finances could have been revamped without creating another state agency, the new authority may prove to be better positioned to implement the necessary reforms.

The legislation fails to create a mechanism for giving priority to eligible projects that are denied funding in any given year solely because of limits on SBA funds. Without such a mechanism, local communities could remain in an uncertain—and unfunded—state indefinitely. The authority will need to address this issue as it works out the details of the new SBA program.

Public Construction The list of enacted reforms also includes another of the Foundation's long-time priorities, a major overhaul of the antiquated state laws governing public construction. The legislation, developed by a commission that included every interest group in the construction business, represents the most important reforms of public construction in more than two decades. The overhaul enables state agencies to increase accountability for quality by certifying subcontractors for the first time, and by prequalifying contractors and subcontractors before they bid on major projects. State and local agencies are authorized to employ alternative procurement methods—design-build and construction-manager-at-risk—that can save time and money, and are required to employ professional managers to help oversee complex projects.

However, the final compromise bill falls short of the Governor's proposal by imposing greater restrictions and bureaucratic obstacles to the use of these alternatives. The legislation also takes a step backward in one important area by removing the authority of the UMass Building Authority and, to a lesser extent, the State College Building Authority to use alternative procurement methods for construction projects built with non-governmental funds. The impact was partially mitigated by exempting UMass projects built with federal funds, but this provision applies only until 2006. As the Foundation underscored in its recent report, *The University of Massachusetts: Removing Barriers to Educational Excellence at the State's Public Research University*, achieving a first-rate public higher education system requires greater flexibility, not less.

Pensions The Legislature made less progress in curbing some of the opportunities for abuse that taint the state's pension system. A measure to eliminate a loophole that allowed certain retirees to collect a double benefit was the only one of several significant reforms offered by the Governor to survive the budget process. Other proposals fell by the wayside, such as a cap on pension benefits, clarification that allowances and other perks do not add to benefits, elimination of special pensions for certain terminated employees and elected officials, and an end to the practice of granting a full year of service to elected officials for as little as one day of work. While the amounts at stake are not large as a share of pension outlays, these reforms are important as matters of equity and public accountability.

Competitive Contracting The Governor wisely vetoed the budget section that would have expanded the state's anti-competition Pacheco Law to prohibit privatization contracts for services provided by labor based or employed outside the United States. This provision would only increase costs for taxpayers. The Legislature has not acted to override the veto.

Quinn Bill Modest steps were adopted to control escalating costs of the Quinn Bill, the state's unique educational incentive pay program for local police who earn college degrees after hiring, with the Commonwealth picking up half the costs. The budget imposed until 2015 a moratorium on payments to cities and towns that join the program after August 1, 2002, and codified new Board of Higher Education standards for the quality of degree programs.

The measures are the latest in a series of attempts to rein in Quinn Bill costs. Legislation passed in 2003 was returned by the Governor with an amendment, effectively killing the measure. The 2003 reforms would have reduced costs by changing incentive payments from percentage premiums to fixed bonuses.