



Bulletin

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MTF Commonwealth Faces Large and Growing Structural Deficits

Despite improving revenues and declarations of budget surpluses, the state is still confronting a large and growing structural deficit. An updated analysis by the Foundation, detailed in the attached table, estimates that the structural gap has grown from \$170 million in fiscal 2004 to a projected \$750 million in 2005 and \$910 million in 2006.

Even though tax revenues in fiscal 2004 exceeded expectations by over \$700 million, ongoing revenues are not sufficient to meet ongoing expenditures, and surging spending in key programs is still outpacing revenue growth. With its budget nominally balanced only with a heavy reliance on one-time resources, the Commonwealth can afford neither significant spending increases nor major tax cuts.

Extra Tax Revenues Insufficient to Offset One-Time Funding Sources Used in 2004

Tax revenues in the fiscal year that ended in June were \$724 million more than forecast, a figure that has been widely mischaracterized as a budget surplus. In fact, the unexpected tax revenues were insufficient to make up for the nearly \$900 million in one-time revenues, balances and savings used to support the 2004 budget.

After accounting for these non-recurring resources, the state ended the year with an estimated structural deficit of about \$170 million that carried over into fiscal 2005.¹

Capital gains, stock options and bonuses attributable to the stock market's recovery in 2003 – the same revenue sources that disappeared so quickly when the dot-com

bubble burst in 2001 – were a major source of the unanticipated tax revenues in fiscal 2004. The Foundation's analysis makes the conservative assumption that \$300 million of non-recurring revenues was

generated from these sources in 2004. Baseline income tax revenues in the last six months of fiscal 2004 grew 15.4 percent over the latter half of fiscal 2003, while personal income, which does not include capital gains and stock options, grew by only 4.5 percent, a differential that suggests that the one-time component of 2004 tax receipts could be as high as \$500 million. The flat stock market of recent months cannot be expected to generate these revenues again in fiscal 2005.

In addition to the stock market-driven income tax revenues, the \$900 million of one-time

Structural Deficit

The gap between spending in ongoing programs and revenues from recurring sources.

¹ The analysis of fiscal 2004 is based on preliminary figures and MTF estimates; final totals will be available when the Comptroller issues his official financial report at the end of October.

budgetary resources also includes federal fiscal relief, deferral of pension contributions, and withdrawals from the rainy day fund and other fund balances. While the Commonwealth did not exhaust these funding sources in 2004, in the long run they will not be available to cover ongoing expenditures.

Growing Dependence on One-Time Resources in 2005

The same factors – a heavy reliance on one-time funding sources that is only partially offset by growth in tax revenues – underlie an even larger structural deficit of approximately \$750 million in fiscal 2005. The 2005 budget is “balanced” with over \$990 million of non-recurring resources, even more than used in 2004. The total includes almost \$620 million withdrawn or appropriated from the stabilization fund and \$270 million in one-time federal aid.

Tax revenue growth in fiscal 2005 is expected to be healthy but not nearly enough to compensate for the use of one-time funding sources in the budget. The 2005 tax forecast is generally regarded as too low, largely because of the better-than-expected 2004 performance. The Foundation’s analysis assumes that tax revenues will again exceed budget estimates, but by only \$415 million (after accounting for an automatic tax cut – worth \$30 million in fiscal 2005 – triggered by the revenue growth).

This \$415 million of additional tax revenue is insufficient to offset the combination of the \$170 million gap carried forward from 2004 and the \$990 million in new non-recurring resources used in 2005. The result is an estimated structural deficit of approximately \$750 million that will carry over into fiscal 2006.

Deficit Widens as Spending Outpaces Revenue Growth in 2006

The Commonwealth’s structural budget gap is likely to grow wider in 2006. Even assuming healthy revenue growth, additional tax revenues will not be sufficient to both eliminate the structural imbalance going into the year and compensate for unavoidable spending growth in key programs, leaving an estimated structural deficit of approximately \$910 million.

The Foundation’s analysis assumes that tax revenues will grow by five percent or \$724 million in 2006, after accounting for the \$60 million full-year impact of another automatic tax cut. If there were no spending increases in the 2006 budget, the additional revenue would be nearly enough to make up for the \$750 million structural deficit carried forward from 2005. However, even if lawmakers hold the line on discretionary spending, inescapable increases in Medicaid, debt service, education aid and other programs will drive total spending up by nearly \$900 million, perpetuating the structural deficit.

The actual deficit to be resolved in 2006 is likely to be even larger than MTF’s estimate of \$910 million. Limiting spending growth in discretionary accounts will be extraordinarily difficult in the face of intense pressure to restore funding to programs that have been cut by \$3 billion over the last three years. Any restorations – or even allowances for inflationary cost increases – would only add to the budget shortfall. At the same time, the Governor’s call to cut the income tax rate from 5.3 to 5.0 percent would reduce revenues – and increase the structural deficit – by about \$250 million in fiscal 2006 and roughly \$500 million in 2007.

MTF Structural Deficit Analysis
\$ millions

Fiscal 2004

Tax revenues in excess of forecast	\$724
Less one-time resources:	
Non-recurring tax revenue	300
FMAP (federal fiscal relief)	188
Pension "savings"	145
Withdrawals from stabilization	103
Teachers endowment and other balances	160
Subtotal	896
Structural deficit	(172)

Fiscal 2005

Deficit carried forward from 2004	(172)
Potential tax revenues in excess of forecast	445
"Automatic" tax cut	<u>(30)</u>
Subtotal	415
Less one-time resources:	
Withdrawals from stabilization fund	340
Supplemental spending appropriated from stabilization fund	277
FMAP (federal fiscal relief)	270
MassHealth Essential balance forward	75
Other	<u>29</u>
Subtotal	991
Structural deficit	(748)

Fiscal 2006

Deficit carried forward from 2005	(748)
Tax revenue growth at 5 percent	784
"Automatic" tax cut	(60)
Net tax revenue growth	724
Spending growth	
Medicaid and other health care at 10% (net of federal reimbursements)	465
Pensions	58
Debt service and contract assistance	139
Chapter 70 school aid	95
School building assistance	93
Sales tax dedicated to MBTA	34
Subtotal	884
Structural deficit	(\$908)