MASSACHUSETTS BUDGET AND POLICY CENTER

January 17, 2006

BUDGET MONITOR

A Preview of the FY 2007 Budget

OVERVIEW

As new revenue numbers are announced each month, the public hears constantly evolving and conflicting claims about whether Massachusetts has a budget surplus, and, if there is a surplus, how big it is.

This *Budget Monitor* dissects the budget and revenue numbers now available, describing the state's current fiscal condition and examining the difference between expected revenues and expenses that will set the parameters of the Fiscal Year 2007 budget.

As this *Monitor* notes, current projections suggest that tax revenue for this fiscal year will exceed the levels on which the original budget was based by just about one billion dollars. This does not, however, mean that the state has a surplus of that amount.

First, the original FY 2006 budget relied on $600 million from the Stabilization Fund, meaning that the first $600 million of additional tax revenue would have to be deposited into the Stabilization Fund just to restore structural balance.

Second, the state has adopted changes in tax policy that will reduce tax revenue by nearly $200 million in FY06; these changes are designed to help moderate-income families with heating costs, to subsidize the motion picture industry, to refund certain capital gains tax liabilities from tax year 2002, and to expand the senior citizen property tax circuit breaker.

Third, the state has enacted supplemental budgets restoring accounts that were under-funded in the original budget and also funding new initiatives, including efforts to reduce gang violence and to provide additional heating assistance to low-income families and individuals. Supplemental appropriations enacted so far cost $155 million.

Inside:

15 COURT SQUARE, SUITE 700, BOSTON, MA 02108

TEL: 617.426.1228 • FAX: 617.695.1295 • www.massbudget.org

While these three items account for virtually the entire billion dollars by which revenues are likely to exceed projections, there are several other important pieces of legislation currently being negotiated by conference committee that carry significant costs.

The most significant of such bills are the pending FY 2006 supplemental appropriations and economic stimulus bills approved by the two branches and their respective health care reform bills. These bills could add several hundred million dollars in additional costs. Those costs could be met either by the use of reserve funds or by revenue that could be available if – as is possible – final revenue receipts end up even higher than the most recent estimates.

Building on this analysis of the FY 2006 budget, this *Monitor* also projects baseline revenue and expenditures for FY 2007. If tax collections for FY 2007 simply reach the level announced last week as part of the consensus revenue process – $18.975 billion – and costs outside of MassHealth and a select few other areas grow at the rate of inflation, the state could open the FY07 budget cycle with a modest structural surplus of $120 million.

If tax collections for FY 2007 ultimately prove higher than those now envisioned, this positive gap could be larger. For example, the FY07 surplus could exceed $210 million if tax collections attain the upper bound of the FY07 estimate put forward by the Department of Revenue in December; it could climb to roughly $390 million if tax collections sustain their recent rates of growth and continue to grow in a robust fashion throughout FY07. Of course, if revenue growth slows or if unexpected cost pressures arise, it could get smaller. For example, the gap will shrink if, as expected, additional General Fund revenue is needed to finance health reform efforts. Any "unfunded" FY 2007 costs for the health care initiative would have to be counted against this potential surplus.

It is important to remember, however, that any surplus the Commonwealth may realize in the coming months was created by four years of deep budget cuts. From 2002 to 2004 Massachusetts led the nation in cutting real per pupil state support for K-12 education. In addition, between 2001 and 2006 other local aid was cut by over $280 million, after adjusting for inflation. Public health has been cut by 26 percent, environmental affairs by 25 percent, and higher education by more than 21 percent.

As our economic recovery continues, there will be choices to be made: should the state seek to expand access to health care, to restore funding for K-12 and higher education, and rebuild our state's capacity to promote public health and protect the environment? Or should we begin another round of tax cuts that would weaken the state's capacity to meet these other challenges and, the next time our economy cools, likely force another round of severe budget cuts? This *Budget Monitor* doesn't answer these questions, but it does provide the background needed to understand more clearly the choices we face.

THE FY 2006 BUDGET

To assess the fiscal situation for FY 2007, it is useful first to examine the state of the current budget. Although the General Appropriations Act (GAA) is often referred to as *the* budget for a fiscal year, supplemental budgets and other initiatives may alter the final bottom-line. Fiscal year 2006 was no exception as, to date, three supplemental budgets have been enacted.

The Legislature is expected to pass additional supplemental budgets, including one to support operations and another designed to stimulate economic growth in the Commonwealth. Moreover, other policy initiatives like health care reform will likely add to the base for the FY 2006 budget.

FY 2006 General Appropriations Act

The final FY 2006 General Appropriations Act is very similar to the one passed by the Legislature on June 23, 2005, since the Legislature restored $108.9 million of the $109.7 million that the Governor vetoed from the budget. (For MBPC's analysis of the FY 2006 Conference budget, click **here** or visit **www.massbudget.org**.) The Legislature let stand the Governor's veto of $75,000 in retained revenue from sex offender registry fees and a $50,000 earmark for an anti-terrorism commission. The Legislature also chose not to override several instances where the Governor struck line-item language; the stricken language enforced state agencies' reporting requirements. Because of an accounting adjustment, the total amount available for the Uncompensated Care Pool dropped from $206.0 million in the Conference budget to $181.9 million in the GAA. (The Legislature restored the funding in a supplemental budget appropriation.) The bottom-line for the FY06 GAA – line item appropriations plus off-budget expenditures – totals $25.9 billion.

Figure 1.

Spending by Program Area

(in Millions of $)

Program	FY05	FY06 GAA	FY06 Current
Local Aid (Lottery, Addtl Asst, and PILOT)	1,131.6	1,159.7	1,159.7
K-12 Education	4,064.5	4,264.5	4,264.5
Higher Education	989.8	951.2	965.3
Early Education and Care	449.8	481.1	481.1
Medicaid and Other Health Care Programs	7,022.8	7,306.2	7,330.3
Other Health and Human Services	4,134.4	4,323.8	4,325.2
Environmental Affairs	258.7	203.3	203.3
Transportation	219.1	150.2	150.2
Housing & Community Development	95.8	91.9	111.9
Economic Development	130.3	141.4	144.5
Public Safety	1,292.8	1,305.4	1,342.6
Judiciary & Courts	744.0	767.5	767.5
Debt Service	1,753.8	1,793.2	1,793.2
Pensions	1,217.4	1,275.2	1,275.2
Group Insurance	852.3	1,023.2	1,023.2
Other Administrative	739.1	690.9	746.7
TOTAL	**25,096.1**	**25,928.6**	**26,084.4**

*For greater details on these categories, budgeted amounts, and explanatory notes refer to the MBPC's *Budget Monitor* on the **FY 2006 Conference Budget**.

Enacted Supplemental Budgets

Since the FY 2006 budget was enacted, three supplemental budgets have been passed. Chapter 106 of the Acts of 2005 provides funding for fiscal years 2005 and 2006. Although the bulk of spending in this bill supports FY05 operations, $58.0 million is devoted to the FY06 operating budget, including the restoration of $24.1million for the Uncompensated Care Pool to make up for the unexpected reduction in the General Appropriation Act. In a separate supplemental bill, the Commonwealth appropriated an additional $20.0 million to supplement the federal Low-Income Home Energy Assistance Program to help low-income families with the high cost of heating bills this winter. The most recent supplemental budget, totaling $53.7 million, provides funding for various purposes, including $11.0 million for anti-gang programs. Combined, these supplemental budgets make the current FY06 budget $155.7 million higher than the FY06 GAA. Figure 1 above outlines FY06 budgeted spending by program area.

Pending Supplementals and Initiatives

Additional supplemental budgets and policy proposals will likely affect FY 2006 spending levels. Among these initiatives are supplemental funding to support existing operations and to maintain or improve the state's infrastructure, an economic stimulus package, and legislation to reform and to expand the state's health care system.

FY 2006 Operations and One-time Spending Proposals

On January 10, 2006, the Governor filed a supplemental budget totaling $59.6 million to eliminate FY06 deficiencies and to finance new collective bargaining agreement obligations. Among its provisions are $23.0 million for snow and ice removal, $5.9 million to support state and county sheriff operations, and $10.4 million to fund higher education collective bargaining agreements.

In addition to this proposal, there are two versions of a supplemental budget that would substantially increase FY 2006 spending. A conference committee has been appointed to resolve major differences between the two proposals. The House bill (House 4443) appropriates $302.8 million, while the Senate's version (Senate 2291) totals $260.5 million. Both proposals devote a substantial portion of overall appropriations to one-time expenses.

There are several similarities between the two proposals. Both branches provide an additional $25.0 million for the MassHealth Essential plan. This increased amount would alleviate a funding shortfall associated with increased program costs. The House version also directs the administration to seek approval for the enrollment of an additional 10,000 enrollees (for a total of 54,000). The current waiting list for this health insurance program for the long-term unemployed hovers at approximately 10,000 people.

The House and Senate bills both provide a $55.0 million appropriation to support road construction and repairs. This one-time capital expense would be funded through FY 2007. Both bills would also increase the budget account which pays private attorneys assigned to criminal and civil cases by $20.0 million.

Despite the common items between the House and Senate proposals, there are significant differences. For example, the House recommends $100.0 million to fund higher education capital projects – $50.0 million for state and community colleges and $50.0 million for the UMass system. The Senate does not include funding for this purpose. On the other hand, the Senate proposes $20.0 million for substance abuse services, while the House does not include an appropriation for these services. The Senate bill also includes language that would direct funding towards a continuum of services for the prevention and treatment of substance abuse.

The Senate bill includes provisions that would provide for coverage for prescription drugs for elders previously eligible for the state-funded Prescription Advantage program who would now be eligible for the new Medicare Part D prescription benefit. The intent of these provisions would be to provide a “wrap-around” benefit for elders who would receive a lesser amount of coverage under the new program. However, on December 30, the Lieutenant Governor signed legislation that would provide a significant pharmacy benefit for elders arranging their transition to Medicare prescription coverage. This new legislation will ensure that during the first six months of 2006, the state will cover the cost of 30 days’ worth of any prescription not currently covered by Medicare Part D for a person receiving Medicare and Medicaid or a Prescription Advantage member who shows up at a pharmacy and finds that their Medicare Part D plan will not pay for one or more of their medications. The bill also states that the Commonwealth will cover the difference between Medicaid prescription co-pays and Medicare co-pays for persons dually eligible for Medicaid and Medicare. Even with this legislation, low-income elders have been unable to receive coverage for needed medications. On January 6, the Commonwealth, through MassHealth, took “emergency action” to ensure that no person dually eligible for Medicaid and Medicare be unable to receive needed prescription medication.

Although both bills offer additional funding for economic development grants to nonprofit organizations and for the maintenance of parks and beaches, the proposed amounts differ between the two branches. The House bill appropriates $15.7 million for economic development grants, while the Senate bill includes $14.6 million. On the other hand, the Senate offers a higher amount than the House for parks and beaches – $8.2 million versus $3.8 million. These and other differences between the two proposals will be decided in the conference committee.

Economic Stimulus Package

Also still pending in conference committee are competing versions of legislation to stimulate the Commonwealth’s economy adopted by the House of Representatives in October 2005 and by the Senate in November. The House’s version of the legislation expends approximately $320 million in FY06, while spending under the Senate’s version amounts to about $485 million in the current fiscal year. In both cases, the vast majority of expenditures are intended to be for one-time purposes only, though both versions of the legislation include supplemental appropriations that could be viewed as ongoing commitments. (About $25 million worth of appropriations in the House’s version and about $40 million in the Senate’s fall into this latter category). In addition, both versions of the legislation would create a new tax credit for medical device manufacturers and would expand several existing tax expenditures. Those tax provisions are discussed at greater length below, but it is important to note here that they would further diminish the surplus the Commonwealth could be expected to realize in FY06. On the other hand, both versions of the stimulus package rely on $200 million in bonding authority to support the expenditures they would make, thus obviating the need to draw on either a FY06 surplus or accumulated reserves for that sum. All told, then, the House's version of the legislation would likely add approximately $135 million to FY06 costs, while the Senate's approach increases them by closer to $290 million.

Among the particular spending provisions common to both versions of the legislation are enhancements to a variety of workforce development programs, including $2 million in additional funds for one-stop career centers, $3 million in supplemental appropriations for adult basic education programs, and $3 million more for school to career connecting activities.
In addition, both versions of the legislation make transfers of $13 million and $30 million respectively from the General Fund to the Massachusetts Cultural Facilities and the Brownfields Redevelopment Funds, as well as establish a Workforce Competitiveness Trust Fund to distribute grants of up to $500,000 to leverage federal, private, and philanthropic resources supporting programs to improve worker skills and to boost the competitiveness of Massachusetts firms. Finally, both versions of the legislation provide funding for the Massachusetts Opportunity Relocation and Expansion (MORE) Jobs Capital Program, "related to site remediation, preparation, and ancillary infrastructure projects," though at significantly different levels. The House provides $200 million, while the Senate recommends $77 million (with more than $67 million of such funds earmarked for dedicated purposes).

Some of the key differences between the two bills lie in several specific projects which the Senate seeks to finance but for which the House does not provide separate funding. That is, the Senate appropriates $19.5 million for transportation improvements in Allston and Fall River, $36 million for transportation improvements in the Longwood, Kenmore Square, and Fenway portions of Boston, $30 million for the parking garage at the University of Massachusetts Boston, $21 million for nanomanufacturing facilities at the University of Massachusetts Lowell, and $26 million for a one-time grant to the City of Worcester for financing of its CitySquare project. The House's version of the legislation does not explicitly support these projects, though it is conceivable that the $200 million in funding for the MORE Jobs Program could be used to achieve similar purposes.

Health Care Expansion

The Legislature has repeatedly stated that in Fiscal Year 2006 it will pass legislation to increase access to health care for the close to 500,000 persons without health insurance in Massachusetts. Although Massachusetts ranks among the states with the best rates of health care coverage, the rate of uninsurance has been growing.

The imperative to expand health care coverage has a deadline. The federal government, which shares in the funding of the Medicaid program, has stated that the Commonwealth must come up with a plan to provide coverage for the state's uninsured, or risk hundreds of millions of dollars in federal funds that Massachusetts has relied on to pay for health care costs. Our signed agreement with the federal government requires that the plan (the "MassHealth Waiver") be in place by July 1, 2006.

Moreover, the federal government requires that there be particular fiscal constraints ("budget neutrality") in order for this plan to be eligible for matching federal dollars. A Conference Committee is currently reviewing a proposal recommended by the Senate and a proposal recommended by the House.

The budgetary impact of health care reform is hard to quantify for Fiscal Year 2006 or for Fiscal Year 2007. There are wide programmatic variations among the proposals under discussion, and there are widely varying estimates as to the net cost to the Commonwealth as the proposals currently stand. The budgetary impact of any proposal is also highly dependent upon when that proposal comes into effect.

There are four main sets of issues described in these two bills: eligibility and service expansions for the MassHealth program, coverage for low-income persons without health insurance who currently may receive care paid for by the Uncompensated Care Pool, changes to rates paid to health care providers, and restructuring the private health insurance market. In addition, the bills differ in their assumptions about how the Commonwealth should fund these program expansions and changes.

Both the House and the Senate bills provide for significant expansions in eligibility and service in the MassHealth program, however the estimates of FY07 costs vary, partly because of different assumptions about how quickly the expansions could be implemented. Many of the proposed expansions in the MassHealth program would be eligible for federal reimbursement, and therefore the net cost to the state treasury would only be 50 percent of the cost of those proposed expansions. Both bills would:

- Enroll in MassHealth all currently eligible but unenrolled persons (estimated FY07 cost: $35 million within the operating budget)
- Expand Medicaid eligibility for children from 200 percent to 300 percent of the federal poverty level (estimated FY07 cost: approximately $21 to $42 million)
- Expand Medicaid eligibility for parents from 133 percent to 200 percent of the federal poverty level (estimated FY07 cost: approximately $25 million to $50 million)
- Increase enrollment in the MassHealth Essential, CommonHealth and HIV Positive programs by raising the enrollment caps (estimated FY07 cost: approximately $41 to $83 million)
- The addition of a pilot MassHealth smoking cessation benefit (estimated FY07 cost: $7 million, paid out of dedicated funds from tobacco taxes)

There are other significant provisions, however, where the Senate and House proposals diverge.

- The House proposal expands MassHealth eligibility to all 64,000 childless adults up to 100 percent of the federal poverty level. (Adults are currently eligible only if they are parents, are disabled, are HIV positive, working for small employers participating in the Insurance Partnership, or are long-term unemployed.) The estimated FY07 cost of this initiative is $131 million which the House would pay for from the Safety Net Care fund within the MassHealth Waiver. The Senate bill does not provide coverage for these childless adults.

- The House bill extends MassHealth Essential coverage for only elderly/disabled “special status” immigrants, and the Senate bill expands coverage to an additional 7,000 legal immigrant adults – primarily parents of children under age 19 – for an estimated cost of $10 million.

- The Senate bill identifies more than a dozen public health program expansions that would be funded at approximately $26 million in FY06. These costs would presumably carry into FY07, but the FY07 funding levels are not specified.

- Both proposals recommend restoring certain MassHealth benefits that had been cut during the state’s fiscal crisis: the House and Senate both propose restoring adult dental benefits (estimated FY07 cost $35 million); but only the Senate proposal restores adult eyeglasses and chiropractic services (estimated FY07 cost approximately $7.1 million).

The MassHealth program costs may increase depending upon whether significant numbers of people currently insured by their employers switch from private insurance to MassHealth coverage. If health care reform legislation encourages employers to provide adequate health insurance coverage for their employees, that would have the effect of limiting the costs of the MassHealth program expansions.

The two proposals differ on proposed adjustments to health care provider rates, but both proposals seek to remedy historically low rates paid to providers by the Medicaid program.

- The House bill allocates an additional $90 million each year on Medicaid rates for providers, compared to $106 million in the Senate. The House bill ties rates to a new payment for performance system, and the Senate bill ties rates to the Medicare reimbursement system.

There are both similarities and differences between the two bills in their proposals for providing coverage to the uninsured within the private insurance market.

- The House proposal mandates that uninsured individuals purchase health insurance or risk a fine, if affordable coverage is available for the individual, and reforms the small group health insurance market. The House plan also repeals the Insurance Partnership program, but provides sliding scale insurance purchasing subsidies for families up to 300 percent of the federal poverty level.

- The Senate proposal expands the Insurance Partnership, and allows for lower-benefit private health insurance products in order to make the purchase of health care more affordable.

- Both proposals create a mechanism to facilitate portability of coverage for part-time workers, and new insurance mechanisms to cover young adults (19-25 years old.)

- The Senate proposal retains the current Uncompensated Care Pool, and would encourage workers to accept employer-provided health insurance by assessing a fee on some individuals who decline available health insurance from an employer and then receive care paid for by the Uncompensated Care Pool. The proposal would also assess a fee on employers who do not offer their employees coverage if that employee receives care paid for by the Uncompensated Care Pool.

- The Senate bill creates a "Reinsurance Trust Fund" to reimburse catastrophic costs incurred by insurers of very small groups.

Between expanding access and providing adequate funding to pay for existing services, the House and Senate bills both reallocate existing resources to fund a portion of their reforms, and include approximately $200-$300 million in new FY07 costs for the Commonwealth. The two bills differ; however, in the revenue sources they identify to fund these costs.

The House allocates approximately $216 million from Tobacco Master Settlement revenue to pay for their health reform initiatives. The Commonwealth has used Tobacco Settlement revenue each of the past four years, however, to support other spending.

The fiscal projections in this Budget Monitor assume that the Tobacco Settlement revenues will continue to be used elsewhere in the budget. Using these revenues to support new health reform initiatives would reduce the potential FY07 budget surplus by the amount of Settlement money used to fund this legislation.

The House bill also creates a new assessment that would be paid by employers that choose not to provide insurance for their own employees. Because of two amendments adopted during the floor debate on the House bill that reduce the revenue the assessment will raise, it is unclear whether this assessment will be able to generate enough revenue over time to fund the costs of the program expansions.

The employer assessment could, however, ultimately reduce the public cost of health care coverage. The current system assesses employers who provide insurance for their employees in order to help pay for the health care costs of the uninsured. The House proposal would shift the burden of covering the uninsured onto those employers who do not provide coverage, thereby discouraging employers from dropping health insurance. If this proposal is successful in encouraging private coverage, this proposal could in turn be successful in controlling the costs of the public program expansions.

Figure 2.

HEALTH CARE REFORM
FY07 Cost Assumptions as of 1/17/06

	H. 4479	S. 2282
Sources of Funding		
Federal Revenue		
Safety Net Care	672	591
Medicaid Program Expansions Match	125	63
Hospital Assessment	160	160
Insurance Surcharge Assessment		160
Employer Contribution*	77	
"Free Rider" Assessment Contribution		80
Tobacco Master Settlement	216	
Tobacco Trust Fund (including interest)	27	7
Stabilization Fund		163
Total Sources	**1,277**	**1,224**
Uses of Funding		
Medicaid/MassHealth Expansions	330	136
Coverage of Otherwise Uninsured		
Safety Net Care/Supplemental Rates	750	770
Mental Health Facilities	6	
Reimbursement Increases	90	212
Insurance Subsidies/Private Market Reforms		
Tax Breaks for Health Savings Accounts		4
Insurance Partnership/Commonwealth Care	94	20
Reinsurance		50
Public Health Expansions		
Screening and Prevention		26
MassHealth Smoking Cessation Pilot	7	7
Total Uses	**1,277**	**1,224**

**First-year revenue; bill assumes significant increase in following years.*

The Senate also identifies two primary funding sources: the state's Stabilization ("rainy day") fund and a new "free rider" surcharge to be paid by employers who do not provide insurance and whose employees make use of free care provided by hospitals.

The Senate bill projects spending $163 million from the Stabilization fund in FY06 and FY07. Stabilization funds are a limited one-time revenue source, however, and the costs of health reform are ongoing. For the purposes of calculating structural balance in FY07, we count the use of this revenue source as a reduction in the budget surplus.

The Senate bill also anticipates that the free rider surcharge would generate $80 million a year. In FY07, the Senate allocates $50 million of these funds to pay for the reinsurance program, and allocates the remainder to help fund the costs of the program expansions.

There is no way of knowing at this point exactly how much money the "free rider" surcharge could generate. To the extent that this new mechanism fails to generate that level of revenue, or the costs of the bill exceed the revenue sources identified, the Commonwealth would need additional dollars from the General Fund or another source.

While many issues remain unresolved, and the Conference Committee may be able to identify new revenue sources to offset the costs of health care reform, there is a significant likelihood that the legislation produced by this Conference Committee will carry a FY07 cost of $200 million or more.

Taxes and Other Revenue

Since the FY 2006 budget was enacted at the end of June, tax collections have exceeded expectations, improving the prospects for a surplus in the current fiscal year. On the other hand, recent changes in tax policy – ranging from the decision to provide rebates for certain capital gains taxes paid in 2002 to new tax breaks for companies producing motion pictures in Massachusetts – will combine to reduce tax revenue by nearly $200 million in FY06, thus dimming those prospects.

Recent Changes in Tax Policy

Since last summer, the Commonwealth has enacted four pieces of legislation entailing significant changes in tax policy. A description of each measure and the Department of Revenue's estimate of its effect on tax revenue for FY 2006 are as follows:

(a) House 2511: Expanding eligibility for the senior property tax "circuit breaker" (FY06: -$6.2 million) Under prior law, homeowners who (i) were aged 65 and older, (ii) had incomes below $40,000 (for individuals) or $60,000 (for married couples), and (iii) had a home valued at less than $400,000 were eligible to receive a personal income tax credit of no more than $840 for the amount by which their property taxes exceeded 10 percent of their incomes. House 2511 expands the eligibility for this tax credit – also known as the senior property tax "circuit breaker" – by raising the threshold for home values to $600,000 and by indexing that threshold to the annual rise in property values across the Commonwealth. The effect of this change will grow slightly to $7.3 million in FY07.

(b) House 4473: Promoting energy efficiency and mitigating home heating costs for low- and moderate-income residents (FY06: -$93.9 million) House 4473 creates a personal income tax deduction of up to $800 for the cost of oil, natural gas, or propane used for home heating purposes; eligibility for the deduction is limited to individuals with incomes of less than $50,000 and couples with incomes of less than $75,000. The deduction is only available in tax years 2005 and 2006. House 4473 also establishes a tax credit for homeowners and other residential property owners equal to 30 percent of the cost of any energy efficient heating purchase (such as home insulation or fuel-efficient furnaces or boilers) made between November 1, 2005 and March 31, 2006. The value of the credit is capped at $600 for an individual residence or $1000 for a multi-unit building. The Department of Revenue projects that these changes will reduce tax revenue by $27.6 million in FY07 as well, but that they will not have any impact beyond then, given their limited duration.

(c) **House 4252: Reducing the taxes paid by companies producing motion pictures in Massachusetts (FY06: -$27.4 million)** House 4252 reduces the taxes paid by motion picture production companies in three ways. First, it creates a tax credit, for motion picture production companies with Massachusetts production expenses of $250,000 or more, equal to 20 percent of the payroll paid to Massachusetts residents. Second, it establishes an additional tax credit, equal to 25 percent of a motion picture production company's Massachusetts production expenses (excluding payroll), provided that the company either (a) had Massachusetts production expenses equal to or greater than 50 percent of its total production expenses or (b) spent 50 percent or more of its "principal photography days" in the Commonwealth. Third, it provides an exemption from the sales tax for any purchases of tangible property made by a qualifying motion picture production company. The Department's estimate for FY 2006 reflects the fact that these incentives will not be in effect for the entire fiscal year. Their annual cost is expected to be $46.1 million.

(d) **House 4169: Closing a number of tax loopholes, conforming to federal tax law, and providing rebates for certain capital gains taxes paid in 2002 (FY06: -$71.6 million)** House 4169 is perhaps best considered as three separate elements. The first element closes a number of different tax loopholes – for instance, it applies the sales tax to sales of computer software delivered electronically and ensures that out-of-state owners of Massachusetts real estate pay personal income taxes when such property is sold. It will have a positive and permanent impact on tax collections, generating $36 million in FY 2006 and at least $85 million each year thereafter.

The second element increases the extent to which the Massachusetts tax code is linked to the federal tax code. As a result, Massachusetts residents will now be able to claim, on their Massachusetts tax returns, several deductions that were previously only available at the federal level, such as those for contributions to Health Savings Accounts and for college tuition expenses. They will also be able to exclude certain kinds of income, such as employer-provided education or transportation assistance, from taxation.

When the original version of House 4169 was introduced in January 2005 (as House 21), the Department of Revenue estimated that this greater degree of conformity would not materially affect tax collections; the Department recently revised its estimates to show a $32 million loss in FY06 and a $17 million loss each year thereafter.

The third element provides tax rebates for certain capital gains taxes paid in 2002 and has a negative but temporary impact on tax collections. More specifically, in 2002, the Commonwealth changed the rate at which capital gains are taxed from as low as 0 percent (on assets held six years or longer) to 5.3 percent (as long as the asset is held for more than one year).

This third element of House 4169 moves the effective date for that change from January 1, 2002 to January 1, 2003. As a result, anyone who realized a capital gain in 2002 and who paid taxes on that gain at the higher 5.3 percent rate is now entitled to a rebate equal to the difference between the 5.3 percent rate and whatever rate they would have paid under prior law.

Under the provisions of House 4169, those rebates will be paid out over the next four years and are expected to result in a total revenue loss of $257 million, with a FY06 loss of $75.5 million.

As Figure 3 below indicates, taken together, this set of four measures will reduce the amount of tax revenue the Commonwealth will collect in the current fiscal year and in each of the next three years thereafter. [1] In FY 2006, they are expected to reduce tax collections by $199 million; they will reduce tax revenue by $45 million to $75 million per year between FY 2007 and FY 2009.

However, as the energy-related tax breaks and the capital gains tax rebates are temporary in nature (with their effects on the budget complete by FY 2008 and FY 2010 respectively), this set of measures will begin to increase the amount of revenue collected by FY 2010, generating an additional $15 million annually.

This positive effect could be greater in the future, as the tax breaks for motion picture companies are set to expire in FY 2014. It is worth noting, though, that, when the Commonwealth increased the value of its investment tax credit from 1 percent to 3 percent in 1993, it was originally scheduled to fall back to 1 percent in 1996. Subsequent legislation extended that date multiple times until, in 2003, the credit was permanently set at 3 percent.

[1] Figure 3 simply assumes each change's FY07 impact continues indefinitely and does not account for any underlying economic or social trends that could alter the impact of any such change.

Figure 3.

RECENT CHANGES IN MASSACHUESTTS TAX LAW

Chapter No. (Acts of 2005)	Bill No.	Description	FY06	FY07	FY08	FY09	FY10	TOTAL FY06-10
			Impact on Tax Revenue (in $M)					
163	House 4169	Loophole closings	35.9	85.0	85.0	85.0	85.0	375.9
		Updated estimates of federal conformity	-32.0	-17.0	-17.0	-17.0	-17.0	-100.0
		2002 capital gains refunds	-75.5	-61.0	-61.0	-61.0	0.0	-257.0
158	House 4252	Motion picture tax incentives	-27.4	-46.1	-46.1	-46.1	-46.1	-211.8
140	House 4473	Energy efficiency and home heating cost relief	-93.9	-27.6	0.0	0.0	0.0	-121.5
136	House 2511	Expansion of senior property tax circuit breaker	-6.2	-7.3	-7.3	-7.3	-7.3	-35.2
TOTAL			**-199.1**	**-74.0**	**-46.4**	**-46.4**	**14.7**	**-349.6**

A fifth piece of legislation currently under consideration could help to suppress tax collections still further over the next few years. Tax reductions contained in the competing versions of the Legislature's economic stimulus initiative would cut taxes by another $5 million to $15 million in FY06 and by $20 million to $65 million annually. Both versions of the legislation include provisions to create a tax credit for the federal user fees paid by medical device manufacturers and to increase the value of the historic rehabilitation tax credit (although the House would raise the cost of the latter credit from $15 million to $50 million, while the Senate would only go as high as $30 million). In addition, the House's version of the measure would expand eligibility for the investment tax credit to research and development corporations. All told, then, the House's version would likely reduce tax revenue by about $15 million in FY06 and by $65 million per year once fully implemented. The Senate's version excludes the provisions related to the investment tax credit, but adds language establishing a two-day sales tax holiday in Taunton and in communities in western Massachusetts affected by flooding this past fall. It also grants a $2,000 tax credit to affected businesses in those same communities. As the revenue impact of the provisions the Senate excludes are relatively sizable, while the flood relief initiatives are expected to have only a negligible impact on revenue, the Senate's version of the economic stimulus bill would probably reduce tax collections by only $5 million to $10 million in FY06 and by slightly more than $20 million per year thereafter.

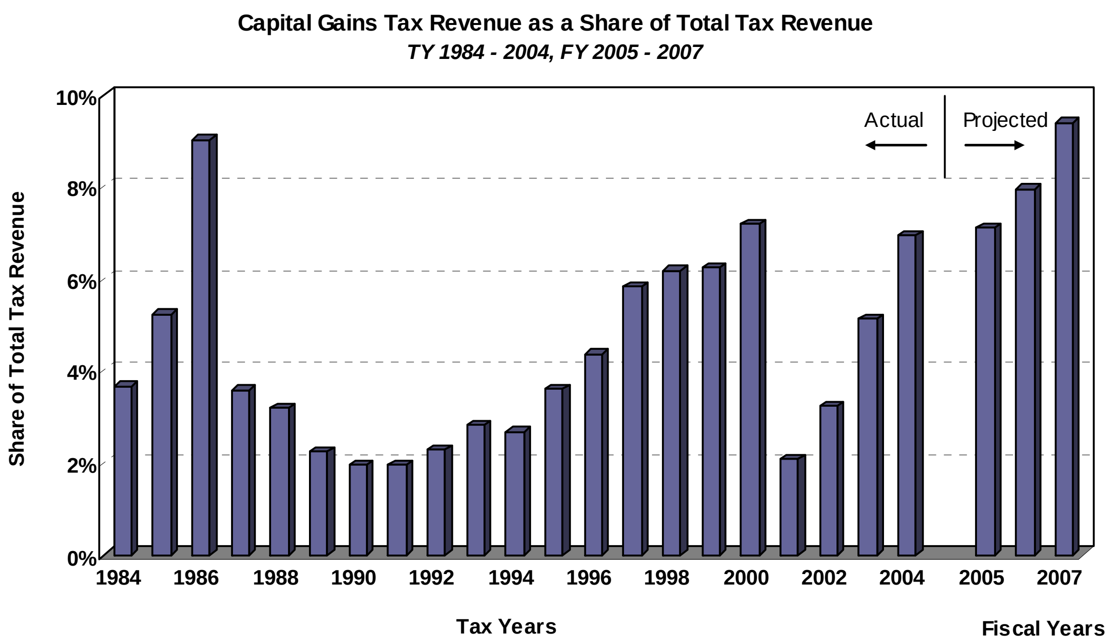
FY 2006 Tax Collections

Despite the above changes in tax policy, the Department of Revenue (DOR) still anticipates relatively significant growth in tax collections in FY 2006. In testimony during the FY 2007 Consensus Revenue Hearing on December 12, 2005, Commissioner Alan LeBovidge announced that DOR expects FY 2006 tax collections to total between $17.95 billion and $18.08 billion, even after accounting for the $199 million tax cut discussed above. Recent remarks by Governor Romney suggest that FY06 collections could reach as much as $18.27 billion.

FY06 collections within the range expected by DOR (and corrected for the loss of revenue due to changes in tax policy) would represent growth of 6.2 to 7.0 percent over final FY05 collections of $17.09 billion and would mark the third consecutive year of relatively robust tax revenue growth. However, there are some warning signs that the current growth rate may not be sustainable. For instance, as Figure 4 below suggests, capital gains tax collections – generally regarded as a somewhat volatile source of revenue – may comprise a larger share of total tax collections in FY06 than even at the height of the late 1990s economic boom. In tax year 2000, capital gains taxes amounted to $1.16 billion or 7.2 percent of the $16.2 billion the Commonwealth collected that year; for FY06, capital gains taxes are projected to constitute 7.9 percent of total tax collections. Accordingly, in its briefing materials for the Consensus Revenue Hearing, DOR warns that "it would be prudent to reduce [the Department's] FY06 forecasts by $75 million to account for uncertainty in forecasting capital gains taxes."

If one were to add back the revenue lost due to tax cuts enacted in 2005, FY06 tax collections within the range described by DOR in December would be close to a billion dollars more than the amount of collections on which the FY06 budget was based. When the FY06 budget was enacted in June, it assumed that FY06 tax collections would reach $17.28 billion ($17.1 billion in baseline collections, plus $105 million from closing tax loopholes and $78 million from enhanced audits at the Department of Revenue). Were it not for the recent tax cuts, DOR's December testimony implies that the Commonwealth would ultimately take in as much as $18.28 billion in tax revenue in FY06. Nevertheless, the difference between these two sums does *not* represent an outright budget surplus. As will be discussed below, numerous claims against this apparent surplus already exist – not the least of which are the above changes in tax policy – with more claims likely to be made before the close of the fiscal year.

Figure 4.



FY 2006 Balance and Implications for Reserves

While it now appears that, based on the Department of Revenue's December estimates, the Commonwealth will collect several hundred million dollars more in taxes than was anticipated when the FY 2006 budget was finalized in June, a significant budget surplus may not materialize this year, due to the structural gap the original budget papered over, additional spending enacted since the start of the fiscal year, and recently adopted changes in tax policy. That is, correcting for changes in tax law adopted since the budget was finalized, Massachusetts stands to collect about $1 billion more in taxes than was used to support the FY06 General Appropriations Act. Yet, the effect of laws already on the books will erase almost all of that apparent surplus:

- The Legislature counted on a $600 million withdrawal from the Commonwealth Stabilization Fund to support FY06 spending; thus, any apparent FY06 surplus must first be reduced by $600 million to compensate for that withdrawal.

- Supplemental appropriations, including those to provide additional aid under the Low-Income Heating and Energy Assistance Program (LIHEAP), to combat violent crime, and to compensate state employees for back pay that they were owed but had not yet received, have increased FY06 spending by $155 million since the General Appropriations Act became law.

- Recent changes in tax policy, including an expansion in eligibility for the senior property tax "circuit breaker," efforts to promote energy efficiency and to mitigate home heating costs for low- and moderate-income residents, reductions in the taxes paid by companies producing motion pictures in Massachusetts, and rebates of certain capital gains taxes paid in 2002, will combine to produce a net tax cut of $199 million in FY06.

However, if FY06 tax collections continue to grow at their current pace, the Commonwealth could end the current year with a surplus of over $200 million. That is, through December, year to date tax collections were 8.1 percent higher than at the same point in FY05, a difference larger than predicted by the Department of Revenue in its December estimates. In addition, Governor Romney on Friday, January 13, indicated that he expected FY06 tax collections to reach $18.27 billion; if this turns out to be the case, then the FY06 surplus could surpass the $200 million mark.

Importantly, though, the combined fiscal impact of two major pieces of legislation still awaiting action in their respective conference committees could exhaust any remaining FY06 surplus entirely and could also lead to significant withdrawals from the Commonwealth's budgetary reserves in the current year. According to the Office of the Comptroller, the Commonwealth ended FY 2005 with a balance of $1.73 billion in its Stabilization Fund, the largest year-end balance since FY 2001. Higher than expected tax collections in FY05 also enabled the Commonwealth to set aside another $304 million in what is known as the Transitional Escrow Fund. However, taken together, the pending economic stimulus package and the FY06 supplemental appropriations bill currently in conference committee could add another $380 million to $585 million to FY06 spending. More specifically:

- As noted above, the competing versions of the economic stimulus initiative would increase net spending in FY06 by anywhere from $120 million (under the House's proposal) to $285 million (if the Senate's approach were followed).[2] In addition, each version includes a variety of tax cuts that would drain a total of roughly $5 million to $15 million out of the Commonwealth's incoming revenue stream.

- Another major supplemental to FY06 operations would add between $260 million and $303 million to the budget. Although both proposals by the House and Senate provide one-time funding to support investments to the state's infrastructure, each proposal contains sizeable amounts for ongoing commitments.

OUTLOOK FOR FY 2007

Looking ahead to the coming fiscal year, if tax collections for FY 2007 simply reach the level announced last week as part of the consensus revenue process – $18.975 billion – Massachusetts will likely begin the FY07 budget process with a modest surplus of $120 million and, thus, should not have to rely on infusions of funds from temporary sources of revenue. Tax collections above this amount could push the anticipated FY07 surplus to as much as $390 million.

The prospect of a budget surplus necessarily raises questions about how it will be used and casts the choices facing policymakers in new light: should the Commonwealth seek to expand access to health care, restore funding for K-12 and higher education, and seek to rebuild our state's capacity to promote public health and protect the environment? Should it instead begin another round of tax cuts that would weaken the state's capacity to meet these other challenges and, the next time our economy cools, likely force another round of severe budget cuts?

The following sections explain how the MBPC's FY07 projections are derived.

Projected FY 2007 Appropriations

MBPC projects that appropriations will reach $27.3 billion in FY 2007. This figure is determined by taking projected FY 2006 appropriations, adjusting for any one-time spending, and then making assumptions about the rate at which spending must grow in order to maintain the same level of public services in FY07 as in FY06.

As of January 1, 2006, enacted FY06 appropriations totaled $26.1 billion; MBPC assumes that pending legislation will bring this amount to $26.6 billion.[3] However, $416 million of this amount represents temporary initiatives or costs that will not recur in FY 2007 and have thus been excluded from MPBC's projections of maintenance-level spending.

In general, maintenance-level spending is determined by the rate of growth in the cost of providing a particular service from one year to the next. This rate of growth necessarily varies from service to service, as the number of people participating in a

[2] These amounts are net of the $200 million in bonding authority included in both versions of the measure, though the $200 million could be used for different purposes under each bill.

[3] This section of the *Budget Monitor* assumes that total spending for the pending economic stimulus package (less any bonding authority) will be roughly $200 million in FY06. It further assumes that total spending in the yet to be approved FY06 supplemental appropriations bill will be $280 million. As noted previously, it does not include the effect of pending health care reform legislation.

program or receiving a benefit rises or falls or as the costs associated with employee compensation, utilities, supplies, or materials increase or decline. For the most part, though, to arrive at maintenance estimates for FY07, MBPC simply adjusts appropriations for FY06 to account for inflation. Based on Congressional Budget Office estimates for the Consumer Price Index for all Urban Consumers (CPI-U) for calendar years 2006 and 2007, MBPC assumes that inflation will be 2.35 percent in FY07.

MBPC does make exceptions to this general rule. Maintenance-level spending in some areas, such as the Commonwealth's pension funding obligation, may be determined by statutory or contractual schedules; alternatively, the cost of providing services in some areas, as is the case with MassHealth, tend to grow more rapidly than the basic rate of inflation. The specific assumptions employed by the MBPC in these areas are as follows:

- Pensions: The FY 2005 budget stipulates the level of appropriations to the Commonwealth's Pension Liability Fund for FY 2007 – $1.335 billion or roughly 4.7 percent above the level mandated for FY 2006.

- MassHealth and related programs: Most analysts agree that health care costs have been rising – and will continue to rise – much more quickly than the general rate of inflation. Consequently, the MBPC assumes that spending for MassHealth and related programs will rise by 7 percent in FY 2007, the growth rate assumed in the Commonwealth's MassHealth waiver with the federal government. Thus, under the MBPC's projections, appropriations for MassHealth and related programs will climb from $7.36 billion in FY06 to $7.87 billion in FY07.

- Group Insurance Commission: The same trends that affect MassHealth extend to the costs incurred by the Group Insurance Commission (GIC) to provide health care coverage to state employees, retirees, and their families. Consequently, the MBPC assumes that appropriations to the GIC will climb 6.7 percent in FY 2007, the annual rate at which the Office of the Actuary at the Centers for Medicare and Medicaid Services anticipates private spending on health care will climb between 2006 and 2014.[4] This means that, under the MBPC's projections, GIC appropriations will go from $1.02 billion in FY06 to $1.09 billion in FY07.

- School Building Assistance: Legislation approved in 2004 altered the manner in which the building of schools in Massachusetts is financed. In particular, that legislation stipulates that, by FY 2011, one-fifth of all sales tax revenue will be dedicated to school building assistance to cities and towns. In the interim, that legislation specifies the minimum amounts of sales tax revenue that are to be devoted to such purposes in each of the next several fiscal years. On January 13, the Secretary of Administration and Finance and the Chairpersons of the House and Senate Ways and Means Committee announced that, for FY 2007, the amount of sales tax revenue that the Commonwealth will dedicate to school

[4] Heffler, Stephen, Sheila Smith, Sean Keehan, Christine Borger, M. Kent Clemens, and Christopher Truffer, *U.S. Health Spending Projections for 2004-2014*, Health Affairs, February 23, 2005, available at: **http://content.healthaffairs.org/cgi/reprint/hlthaff.w5.74v1**

building assistance is $572.52 million, some 17 percent above the FY06 amount of $488.7 million. The MBPC, in turn, uses this amount in its projections of appropriations. (In the annual budget process, these transfers are treated as an automatic reduction in tax revenue. To remain consistent with its analyses of prior year appropriations, MBPC treats such transfers as spending. The effect on the Commonwealth's bottom line is the same under either approach.)

- Lottery: Based on projections from the Massachusetts Municipal Association, baseline growth in lottery revenues, combined with the gradual "uncapping" of the distribution of lottery aid should bring this form of local aid to $804 million in FY07, an increase of slightly more than 6 percent from FY06 levels.

Projected FY 2007 Revenue

Tax Revenue

On January 13, the Secretary of Administration and Finance and the Chairpersons of the House and Senate Ways and Means Committees announced the official FY 2007 tax revenue estimate of $18.975 billion. MBPC uses this sum as the basis for its FY 2007 projection of tax revenue available for appropriation.

More specifically, the MBPC adjusts this "Consensus Revenue" estimate for transfers of sales tax revenue to the MBTA, for mandatory deposits into the Commonwealth Stabilization Fund (equal to 0.5 percent of the prior year's total tax revenue), and for the mandatory tax revenue carry-forward (also equal to 0.5 percent of the prior year's total tax revenue). It also reduces the Consensus Revenue estimate by $19 million to account for an assumption that all of the changes in tax law contained in the House's version of the economic stimulus package will be enacted. These adjustments yield a tax revenue projection for FY 2007 of $18.13 billion.

Of note, the agreed-upon Consensus Revenue estimate is actually somewhat lower than the range of FY07 tax collections projected by the Department of Revenue just one month ago. On December 12, 2005, in his annual testimony at the Consensus Revenue Hearing, Commissioner of Revenue Alan LeBovidge indicated that the Department of Revenue's projection for FY 2007 tax revenue was $19.028 billion to $19.070 billion – or about $50 million to $95 million more than the amount ultimately chosen. As will be discussed below, if tax collections end up falling within the range predicted by the Department of Revenue, then the Commonwealth's FY07 budget picture could be appreciably brighter.

Other Sources of Revenue

In the November 14, 2005 version of the Commonwealth's *Information Statement Supplement* (which is intended to accompany the bond prospectuses issued by the Commonwealth), the Executive Office of Administration and Finance (A&F) projected that the Commonwealth will receive $3.52 billion in revenue from departmental fees, budgetary transfers, and other sources in FY 2006. As with its general approach to spending projections, MBPC adjusts this figure for inflation to arrive at an estimate for these sources of revenue for FY 2007. Consequently, the MBPC assumes that these sources will total $3.60 billion in the coming fiscal year. In addition, A&F expects that the Commonwealth will receive $5.36 billion in federal reimbursements for expenditures on programs such as MassHealth or Temporary

Assistance to Families with Dependent Children. The MBPC assumes that a portion of these reimbursements will grow in line with MassHealth spending and that the remainder will simply keep pace with inflation. Thus, MBPC projects that federal reimbursements will equal $5.67 billion in FY07.

Projected FY 2007 Surplus

If the MBPC's projections for FY 2007 appropriations and revenue are realized, then the Commonwealth will experience a budget surplus on the order of $120 million in the coming fiscal year. Such a surplus would be fairly modest, representing under 1 percent of total anticipated spending, and could rise or fall depending on underlying revenue growth or unanticipated cost pressures. For instance, if FY07 tax collections hit the upper bound of the range first estimated by the Department of Revenue in December – $19.070 billion – rather than the Consensus Revenue estimate of $18.975 billion, then the surplus could rise to over $210 million. The surplus could reach $390 million if final FY06 collections total $18.27 billion – the amount suggested by the Governor in recent remarks – and if they then grow by 5.35 percent in FY07 – the midpoint of the range of growth rates implied in the Department of Revenue's testimony before the Consensus Revenue hearing in December.

In the end, while relatively small, a projected budget surplus of $120 million would enable policymakers both to craft a FY07 budget without the use of reserve funds and to begin to meet a variety of outstanding public priorities. Policymakers could use that $120 million to help to finance health care reform efforts or to restore a portion of the billions of dollars in spending cuts enacted during the depths of Massachusetts' fiscal crisis. Undoing those cuts in a more comprehensive fashion, though, would require either faster tax revenue growth than envisioned in the Consensus Revenue estimate or the repeal of some of the tax cuts the Commonwealth put in place during the 1990s.