



Governors' Budgets Reflect Strong Revenue Growth

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With state tax collections surging, budget proposals submitted by governors are revealing their priorities for dealing with these surpluses. In January, the Rockefeller Institute released a summary of New York Governor Pataki's (R) budget proposal, which based on strong tax collections, advanced a multi-year tax cut agenda and proposed rolling the current year surplus into fiscal years 2007-08 and 2008-09. This brief describes the budgets advanced by governors Napolitano (D-Arizona), Schwarzenegger (R-California), Rell (R-Connecticut), Ehrlich (R-Maryland), and Romney (R-Massachusetts). All five of these states are holding gubernatorial elections this fall, with four incumbents seeking the post again; Governor Romney is not running for re-election.

Based on these five proposals, some of the earlier submittals among the states, the governors are emphasizing tax cuts, education funding, and replenishing budget reserves. Figure 1 shows the relative growth in the states' General Funds, and in contrast to recent years, few proposed budgets are relying heavily on sweeping Medicaid cuts to finance other priorities or close budget gaps.

Arizona

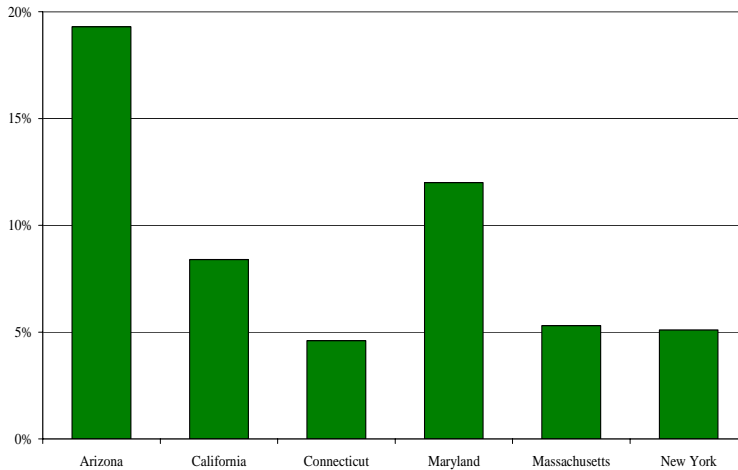
Governor Napolitano released her budget recommendations for fiscal year 2006-07 on January 17. Arizona has a biennial budget and the current two-year period covers FYs 2005-06 and 2006-07. Revenue growth in the current year has been strong, allowing the governor to add approximately a net \$1 billion in spending for the 2006-07 fiscal year of the biennial period.

Overall Structure: Arizona's General Fund is the most widely used measure of the state budget. The FY 2005-06 spending plan contained actual expenditures of almost \$8.3 billion plus the carry-forward of over \$1.0 billion in fund balance. Total spending in FY

2006-07 is projected at \$9.9 billion, an increase of about 20 percent — at least \$400 million of this projected spending is for repayments of prior year withdrawals from state funds to close budget gaps, and other nonrecurring purposes.

Tax Reductions: The proposed adjustments to the budget include four tax reductions. These proposals would: provide an income tax credit to encourage small businesses to provide health insurance for their employees; create a three-day holiday from state sales

Figure 1: Percentage Increase in State General Fund Budgets
Fiscal Year 2005-06 to Fiscal Year 2006-07



tax for school supplies, clothing, and the first \$1,000 of the purchase cost of computer equipment; reduce the vehicle license tax for fuel efficient vehicles; and expand the state’s Research and Development (R&D) tax credit for investments in new products, systems, and technologies. These actions are projected to reduce state revenue by an aggregate \$100 million in FY 2006-07.

Education: Funding for K-12 education would increase 17.2 percent in FY 2006-07. Specific initiatives include: expanding voluntary full-day kindergarten to all school districts (estimated at \$105 million); complying with a court-ordered expansion of programs for English language instruction (\$45 million); \$456 million to raise teachers’ salaries; and \$45 million to raise teacher salaries to offset increases in retirement contribution rates.

In higher education, the budget provides full funding for state college and university growth formulas and community college funding, and funds an incentive to the colleges to graduate their students on time.

Medicaid: The governor’s budget includes \$1.3 billion in General Fund support for the Arizona Health Care Cost Containment System (AHCCCS). This reflects an increase of nearly 22 percent over FY 2005-06. More than half of this is attributable to a projected 1.2 percent growth in enrollments and a 5.8 percent capitation rate increase. The budget proposal also returns premiums for the state’s Child Health Insurance Program (CHIP) to October 2003 levels, supports CHIP outreach efforts, and restores the Health Insurance Flexibility and Accountability (HIFA) Parents program, which provides AHCCCS services to the parents of CHIP-eligible children.

California

Governor Schwarzenegger released his fiscal year 2006-07 budget January 10. Buoyed by strong revenue growth, the plan includes a spending increase of 8.4 percent in the General Fund, with significant growth in support for education.

Overall Structure: California is enjoying the same surge in revenue collections we are seeing in many states. General Fund Revenue projections for the two fiscal years (2005-06 and 2006-07) now exceed estimates prepared last summer by \$5.5 billion. Increases in capital gains taxes and revenue from stock options are credited for this unanticipated increase. Fiscal year 2006-07 revenue is projected at 4.4 percent above FY 2005-06 levels, but spending is projected to grow 8.4 percent. This expenditure growth is driven largely by an 11.4 percent increase in Proposition 98 funding for education. The \$6.4 billion gap between ongoing spending and revenue in FY 2006-07 would be covered by the \$7 billion fund balance projected at the close of the current fiscal year in June.

When California's special funds and bond funds are included, spending would total \$125.6 billion. This is 1.5 percent less than the current year, primarily because spending from bond proceeds drops by \$9 billion in the budget year. Including spending from federal funds, the budget totals \$182.9 billion.

Education: Much of California's budget is built around voter propositions, and none was more sweeping than Proposition 98. This ballot initiative set minimum funding guarantees for education, including school districts, community colleges, and other agencies that provide K-12 educational services. State funding for covered programs is based on the prior year's funding level adjusted for the cost of living, enrollment increases, personal income, General Fund tax receipts, and local tax support (which is constrained).

Total school funding from all sources in FY 2006-07 is projected at \$66.2 billion in the budget, an increase of \$4.1 billion or 6.6 percent. Local property tax funding is projected at just over \$12.2 billion, virtually the same as in FY 2005-06. After all other sources of funds such as federal aid are considered, the required level of support from the California General Fund is budgeted at \$40 billion. This is \$3.9 billion or 10.9 percent more than the current year. This aggregate increase includes adjustments for cost of living factors (\$2.3 billion), attendance growth, funding to reduce class sizes, and special education programs.

Medicaid: The governor's FY 2006-07 executive budget includes \$13.7 billion in General Fund support for Medi-Cal, California's Medicaid program, reflecting approximately a 4 percent increase from FY 2005-06. Major program changes proposed by the budget include outreach activities to enroll more eligible individuals, streamlining the program's redetermination form to decrease turnover, and freezing the state's contribution to county overhead costs and salaries.

Infrastructure: The governor proposed a Strategic Growth Plan of investments in infrastructure. The plan would cover 20 years and the governor submitted proposed elements for the first 10 years. In that period, investments would total \$222 billion, with the largest components being transportation and air quality improvements (\$107 billion), K-12 education (\$48.2 billion), and flood control and water quality projects (\$35 billion). Financing would come from various sources including General Obligation (GO) bonds (\$68 billion), and public-private partnership arrangements such as in transportation networks.

Connecticut

Governor Rell released her proposed mid-term adjustments to Connecticut's biennial budget on February 8. Surging tax collections enable the state to project a sizeable surplus in fiscal year 2005-06 and significant revenue growth in FY 2006-07 compared to original estimates. The governor proposes to devote those additional FY 2006-07 revenues to tax reductions.

General Structure: Connecticut has a biennial budget structure, with mid-point adjustments. The General Fund accounts for over 90 percent of the All Funds budget.

Tax collections are exceeding expectations in the state — driving an estimated surplus of over \$510 million for the current year (first year of the biennium). Governor Rell proposes to use a portion of this surplus to pre-fund out-year debt service costs attributable to deficit notes issued during FYs 2001-02 and 2002-03 and to pay certain FY 2006-07 expenses. But nearly two-thirds of the surplus would be deposited to the state's budget reserve fund, moving the funding level closer to the target of 10 percent of the General Fund.

For FY 2006-07, the state also projects a sizeable surplus due to strong revenue growth. Revenue projections for next year are up \$410 million over earlier estimates. Spending increases are needed for energy costs, collective bargaining and fringe benefits, which are largely funded through spending reductions in other categories, especially lowered estimates of spending needs in social services. Spending for new initiatives, such as pre-school education, criminal justice, and mental health and mental retardation services would be offset with reductions elsewhere. Overall, year-to-year spending growth would total 4.6 percent in the General Fund and 4.1 percent in All Funds.

Tax Reductions: The governor proposes to apply most of the unanticipated revenue for FY 2006-07 to tax reductions. These initiatives include: elimination of the property tax on automobiles, repeal of the corporate tax surcharge, phase-out of the estate tax and reduction of 25 percent in the gross receipts tax on electricity and gas. To help finance the cost of these reductions, the governor proposes to repeal the income tax credit for property taxes. The net impact of these proposals is \$295 million in FY 2006-07.

Maryland

Governor Ehrlich submitted his fiscal year 2006-07 budget recommendations on January 18. Maryland is experiencing strong revenue growth, with collections of individual income and sales taxes up more than six percent from last year.

Overall Structure: Total all funds expenditures for FY 2006-07 are projected at \$29.6 billion, up 12 percent from FY 2005-06 levels. However, this amount includes a deposit of over \$1.4 billion to the state's reserve fund. The state expects to close the current year with a balance of \$1.2 billion, up slightly from the beginning fund balance amount. Somewhat less than half of that amount would be used to support spending in the proposed budget while \$670 million is deposited to a reserve for the FY 2007-08 budget.

Tax Reductions: The budget includes several targeted proposals to reduce taxes. The most significant, at least in terms of the fiscal impact in FY 2006-07, is to increase the exemption level for the state estate tax to match that at the federal level; that provision together with adding a tax deferral for marital trusts would reduce state tax collections by an estimated \$14 million in FY 2006-07. In addition, the budget would make military retirement income exempt from the income tax (\$10.3 million); provide a tax deduction for families who care for a disabled relative in their homes; and cut the statewide real property tax by 15 percent (this statewide tax accounts for about five percent of the total property tax in Maryland).

Education: State General Fund support for K-12 education would increase by \$467 million or approximately 11.5 percent. This growth is termed the largest in history.

Higher education funding from the General Fund, for public and private colleges, community colleges, and financial aid, would be increased by \$172 million. The largest component of this is support for the University System of Maryland, which is in line for an increase of \$117 million, or 14.5 percent.

Medical Care Programs: The governor's budget recommends \$2.2 billion in General Fund support for Maryland's medical care programs including Medicaid and the Maryland Children's Health Program (MCHP). This reflects an increase of nearly ten percent when compared to FY 2005-06, and supports a 3.6 percent increase in Medicaid enrollments and an 8.1 percent increase in MCHP enrollments.

Massachusetts

Governor Romney released his annual budget proposal January 25, and like governors in many other states, reported a surplus in the current year. The governor is proposing a \$25.2 billion budget, which reflects a 5.3 percent increase from the current year's budget.

Overall Structure: State revenue is out-performing expectations in Massachusetts as well. The state projects that tax revenue in the current fiscal year will exceed enacted budget estimates by \$650 million, contributing to a projected \$544 million surplus.

All Funds spending in fiscal year 2006-07 is recommended at almost \$25.2 billion, an increase of 5.3 percent from the levels budgeted for FY 2005-06. In Massachusetts, the great preponderance of state spending is in the General Fund — which is projected to total \$24.2 billion, up \$1.6 billion — or 7.1 percent from the current year total (although this is inflated by the transfer of approximately \$500 million in spending from a separate fund into the General Fund).

Tax Reductions: The governor has called for reducing the top rate in the state's personal income tax. His plan would cut the top rate from the current 5.3 percent to 5.15 percent on January 1, 2007, and again to 5 percent on January 1, 2008. Compared to baseline estimates, the reduction would decrease state revenue by \$132 million in FY 2006-07 and \$488 million in FY 2007-08.

Education: Funding under the state's Chapter 70 education aid program would rise by \$164 million, almost five percent. Nearly half of this increase is dedicated to fund inflation and enrollment growth. The governor also is recommending revisions to the aid distribution formulas to increase the degree to which aid allocations reflect community enrollment and wealth. Other major education initiatives include \$25 million targeted to improve under-performing school districts, \$25 million for teacher performance pay, and \$15 million to fund extended learning times.

Local Aid: The governor has also proposed increases in Local Aid distributions to cities and towns by \$198 million dollars or 17.1 percent by directing all state lottery surpluses to be distributed as was done prior to the fiscal problems of FY 2003-04. This uncapping of the lottery surplus, as well as other increases in Local Aid, brings Local Aid distributions to cities and towns to their highest levels in history. The budget also includes additional funding for payments in lieu of taxes on state-owned property and funding for community policing.

Other Features: The governor recommends addressing the problems created by the new Medicare drug benefit program by ensuring that state residents who previously received prescription drug coverage under the state's program will receive at least the same benefit under the new Medicare coverage. The governor is also highlighting changes to the state's welfare program that would institute the federal work requirements in an effort to increase the current 15 percent work participation rate for recipients.