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News Release

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MTF Analysis: State Faces Escalating Multi-Billion Dollar Budget Deficits; Major Spending Reductions Required

Massachusetts will face escalating multi-billion dollar budget deficits over the next several years unless state leaders make major spending reductions in the fiscal 2002 budget, according to a new analysis released today by the Massachusetts Taxpayers Foundation.

The Foundation stressed the urgency of the Legislature and administration agreeing on a total of $850 million in budget cuts, plus the use of $550 million in reserves, to help close a $1.4 billion gap between state revenues and the 2002 budgets passed earlier this year by both the House and Senate.

"The state is facing a multi-year problem which will require a multi-year strategy," said MTF President Michael J. Widmer. "Without quick and decisive action to dramatically reduce spending, state leaders will confront more difficult and onerous cuts later, as well as jeopardize the state's hard-earned fiscal stability."

The Foundation's analysis shows that even assuming a gradual economic recovery beginning in 2002, the state will face budget deficits totaling $6.3 billion for fiscal 2002 through 2005 unless spending cuts and other steps are taken to close the gap. Even with $850 million in spending reductions in fiscal 2002 and the use of reserves, the state would have budget deficits totaling almost $800 million in fiscal years 2003 and 2004. Under an extended recession, this $800 million gap would increase to a staggering $2.5 billion.

While large spending reductions are the critical first step, the analysis suggests that the state may need to take other measures to address the long-term problem, including sharp limits on further spending growth, using a larger share of the annual tobacco payments, increasing the cigarette tax to meet existing health care needs, and delaying or slowing the pace of the income tax cut.

Given the expected financial problems over several years, it will be critical to limit annual withdrawals from reserves to $550 million in 2002 and $500 million in subsequent years, according to the analysis. The state's reserves total approximately $2.3 billion -- including $1.7 billion in the stabilization fund and almost $600 million currently in a temporary escrow fund.

"Failure to act promptly in response to a rapidly deteriorating fiscal situation was one of the great failings of the state's leadership in the last fiscal crisis," the report concluded.

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MTF Multi-Year Budget Analysis

The Fiscal Problem

Over the last several months, the state's financial outlook for fiscal 2002 and beyond has taken a sharp turn for the worse. In the first four months of the fiscal year, baseline tax revenues (adjusted for one-time factors) were down 3.0 percent, in striking contrast to the 4.5 percent increase assumed for the year in the House and Senate versions of the 2002 budget. On top of this rapid decline, 2002 revenues will be reduced by approximately $725 million as the result of previously approved tax cuts, including about $425 million for the Question 4 income tax reduction.[1] Even before the recent poor revenue performance, the legislative budgets were already out of balance by almost $300 million due to underfunding of Medicaid and several other accounts.[2] Although there is great uncertainty about the course of the economy in the coming months, a continuation of the current revenue trends would produce a 2002 budget gap (deficit) of at least $1.4 billion (see Table 1).

Table 1
Estimated FY 2002 State Budget Deficit
($, Millions)

Baseline tax receipts: 3.0 percent decline for first four months, extrapolated to entire year	$1,100
Underfunding of Medicaid and other accounts (net of federal reimbursements)	300
Total	$1,400

While in recent weeks attention has focused on the rapidly deteriorating financial picture in 2002, a new MTF financial analysis underscores that the Commonwealth can expect significant financial shortfalls for several years. Given the likely size of this larger problem, it is virtually certain that the state's leaders will have to take additional steps -- beyond the spending cuts and use of reserves that are now being considered for 2002 -- in order to produce balanced budgets in the years ahead.

Based on a series of assumptions about future expenditures and revenues, the analysis projects the annual surplus or deficit in the state budget over the four-year period from fiscal 2002 through fiscal 2005.

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1 Approximately one-half of the $425 million Question 4 impact reflects the income tax rate reduction to 5.6 percent on January 1, 2001; the other half reflects the impact of the further reduction to 5.3 percent on January 1, 2002.

2 This imbalance reflects underfunding of $400 million for Medicaid (offset by $200 million of federal reimbursement revenue) and at least $100 million for other accounts.

Spending Assumptions

On the spending side, our analysis incorporates several measures intended to help address the state's fiscal gap, including spending cuts in 2002 of at least $850 million from the amounts proposed in the legislative budgets (which are adjusted upward to account for underfunding of Medicaid and other largely nondiscretionary accounts). Even with the $850 million of reductions, fiscal 2002 spending would still grow by over $500 million from the prior year. In view of the potential longer-term shortfalls, the analysis also assumes that spending growth will be held to a tight 3.0 percent per year beyond 2002. In addition, the analysis builds in the judicious use of the state's sizable reserves -- which now total $2.3 billion -- including approximately $550 million in 2002 and up to $500 million annually in succeeding years. This pace of withdrawal would avoid using up all of the rainy day reserves over the next four years. In the Foundation's view, conserving at least a small portion of the reserves for future contingencies is critical given the major uncertainties about the economy and the even larger questions about additional terrorist activities. (Both the proposed spending cuts and the use of reserves are discussed more fully below.)

Revenue Assumptions

On the revenue side, we examined the impact of three different scenarios for future growth in state tax receipts:

Gradual Recovery	A 3.0 percent decline in baseline tax revenues in 2002 -- consistent with performance in the first four months of the fiscal year -- followed by a modest 3.0 percent growth in 2003, with 4.5 percent annual growth thereafter. Baseline tax revenues grew 9.9 percent in fiscal 2001.
Extended Recession	Baseline tax revenues decline 3.0 percent in fiscal 2002 with the further shock of an additional 25 percent decrease in tax receipts from capital gains, resulting in an overall decline in baseline receipts of 4.4 percent. Revenue growth would improve marginally to an anemic 1.5 percent in fiscal 2003, with gradual increases to 3.5 percent in 2004 and 4.5 percent in 2005.
Rapid Rebound	A strong recovery beginning as early as January 2002 that limits the decline in baseline tax revenues in fiscal 2002 to 1.0 percent and produces baseline revenue growth of 5.0 percent in 2003, 5.5 percent in 2004 and 6.0 percent in 2005, a scenario that virtually no one considers likely in the aftermath of September 11.

All three revenue growth scenarios also assume that the previously enacted tax cuts that are still phasing in will be implemented on schedule. These cuts will reduce annual revenues by an estimated $725 million in 2002, $550 million in 2003, and $300 million in 2004.

The results of the Foundation's analysis are presented in two tables below. Table 2 summarizes the projected budgetary balance under all three of the revenue growth scenarios -- gradual recovery, extended recession and rapid rebound -- after the solutions[3] assumed in the analysis have been implemented. Table 2 looks in more detail at the gradual recovery revenue growth scenario, showing the projected annual state budget surplus or deficit for fiscal 2002 through 2005. This table shows both the overall size of the problem before the proposed solutions, as well as the resulting balance after cutting spending in 2002 and using reserves.

Table 2
Projected Surplus/(Deficit) After Solutions
for Three Revenue Growth Scenarios
($, Millions)

	Surplus/(Deficit) After Solutions				
Revenue Scenarios	FY02	FY03	FY04	FY05	Total
Gradual Recovery	0	(448)	(316)	0	(764)
Extended Recession	(196)	(862)	(887)	(520)	(2,465)
Rapid Rebound	0	0	0	621	621

Table 3
MTF Multi-Year Financial Analysis of
Gradual Recovery Revenue Scenario
($, Millions)

	FY02	FY03	FY04	FY05	Total
Projected Surplus/(Deficit) Before Solutions	(1,398)	(1,824)	(1,718)	(1,352)	(6,292)
Proposed Solutions					
Fiscal 2002 Spending Cuts (Annual Impact)	850	876	902	929	3,557
Use of Reserves	550	500	500	423	1,973
Surplus/(Deficit) After Solutions	2	(448)	(316)	0	(762)

[3] The $850 million of spending cuts in 2002 and the use of reserves in 2002 and beyond.

The results of this analysis are striking. As Table 2 shows, the multi-year picture reveals an even larger financial problem than looking at 2002 alone, requiring deeper spending cuts and a more cautious use of reserve funds, particularly in view of the economic and other uncertainties the state and country now confront.

Under the gradual recovery scenario, over the next four years the Commonwealth would face deficits totaling $760 million, as shown in Table 2. These deficits would be produced even after taking the extraordinary steps of cutting the state's spending base by $850 million in 2002, making measured withdrawals from reserves of roughly $500 million per year, and holding annual spending growth to an extremely low 3.0 percent, a rate that has been achieved in only two of the last 20 years. Even in fiscal 2005, the state would still have to rely on over $400 million of reserve funds in order to achieve a balanced budget (see Table 3).

The state's fiscal problems would be even more dire under the extended recession scenario -- summarized in Table 2 -- which assumes a deepening recession in 2002 and anemic revenue growth in 2003. Having exhausted almost all of its reserves, the state would still confront cumulative deficits totaling a staggering $2.5 billion. Even under the extremely optimistic rapid rebound scenario, achieving the budgetary balance for fiscal 2002-2004 shown in Table 2 would require withdrawals from reserves totaling over $600 million.

Addressing the Problem

Given these negative prospects, it is clear that the Commonwealth will need to take major steps to address both the immediate and longer term fiscal problems. For fiscal 2002, the necessary actions include large cuts in 2002 spending and the restrained use of a portion of the state's reserves. The Foundation has identified several options for addressing the budget gaps that lie beyond 2002, including further spending reductions, using a higher share of the annual tobacco settlement payments, increasing the cigarette tax to meet existing health care needs, and delaying or slowing the pace of the Question 4 income tax reductions. Depending on the severity and length of the state's economic and revenue problems, some -- and possibly all -- of these measures, as well as others, may need to be implemented.

Fiscal 2002 Actions

Spending Reductions

Cutting proposed 2002 spending by $850 million is a critical -- although by no means easy -- first step in addressing the current financial challenge (not including the additional cuts that will be necessary to offset the added public safety costs arising from the September 11 attacks). A reduction of $850 million would decrease the rate of spending growth in 2002 (including appropriations for underfunded non-discretionary accounts) from 6.2 percent to 2.3 percent -- a more appropriate rate given the dramatic slowdown in the state's revenues -- while lowering the base of spending for future years. With less than two-thirds of the current fiscal year remaining, budget leaders need to move quickly to identify reductions, since every day that goes by makes real reductions in spending increasingly difficult to achieve. Failure to act promptly in response to a deteriorating fiscal situation was one of the great failings of the state's leadership in the last fiscal crisis.

Policy makers should consider areas of the budget that previously have been considered untouchable. Increasing cost-sharing of state employee health benefits to more closely match private sector norms, rejected by the Legislature in more prosperous times, should now be a top priority. Reducing the state share of health insurance premiums from 85 percent to 75 percent would save $60 to $70 million per year. Reform of the state law requiring costly police details at construction sites affords another important opportunity for significant savings. Eliminating this burden would allow the Commonwealth to refocus its public safety resources on providing security to the state's residents and businesses and stop a needless drain of taxpayer and private sector dollars.

Use of the State's Rainy Day Reserves

Given the expected financial problems over several years, it will be essential to protect most of the state's $2.3 billion of rainy day reserves, including $1.7 billion in the stabilization fund and almost $600 million currently in a temporary escrow fund. In fiscal 2002, almost one-quarter of this total will be needed to fill the estimated $550 million budget gap that will remain after cutting spending by $850 million. With the potential for even larger shortfalls in fiscal 2003 and beyond, MTF considers it absolutely critical to limit annual withdrawals from reserves to $550 million in 2002 and $500 million in subsequent years. As noted earlier, this pace of withdrawal would preserve a small portion of reserves for future contingencies.

This limitation would be consistent with the Foundation's earlier proposal to establish clear guidelines for using the state's stabilization reserves and to restrict annual withdrawals to no more than one-third of the rainy day balances.[4] Unlike the majority of states, Massachusetts law allows the rainy day fund to be tapped under essentially any circumstance, for practically any purpose, and without any restriction on the amount that may be withdrawn each year.

Further Steps to Address the Problems Beyond 2002

Additional Spending Reductions

MTF's analysis makes clear that the state will need to restrain sharply the rate of spending growth for the next several years. This will necessitate cuts in some programs in future years as well as in 2002.

[4] See MTF's April 12, 2001 *News Release* "MTF Proposal: Tighter Standards for Tapping Rainy Day Fund."

For example, with increases in annual health care costs averaging 10 percent or more for the foreseeable future, the 3.0 percent annual limit on spending growth assumed in our financial analysis would essentially require level funding across all other state programs. Since the costs of some of these programs will surely continue to grow -- most notably, the annual increases needed under education reform to maintain local school spending at adequate levels -- such a limit would require further cuts in other areas of the state budget.

Tobacco Settlement Payments

Using a larger share of the $300 million annual tobacco payments *for a limited period* may be necessary to support existing health care obligations and reduce the financial burden the state is placing on financially ailing health care providers. The Senate version of the 2002 budget spends 60 percent of the annual revenue while the House uses about 30 percent.

Although MTF has strongly supported the prior legislative agreement to set aside 70 percent of tobacco settlement payments to meet future health care needs, a combination of factors may force the state to revise this policy temporarily. Health care expansions enacted in the late 1990s have greatly increased the Medicaid rolls to the point where the Commonwealth now insures almost one million residents. At the same time, the faltering economy is causing enrollments to grow -- surging almost five percent or 43,000 in six months -- while funding for the prior health care expansions has already proven to be insufficient. As a result, Medicaid is underfunded by at least $400 million in both the House and Senate budgets. However, most of the tobacco revenues currently available for the budget are required to be dedicated to the new senior pharmacy entitlement, with growth in the program expected to consume all of the available receipts in a short time.

Medicaid reimbursements to providers are woefully inadequate -- falling several hundred million dollars short of meeting providers' costs -- exacerbating the financial problems of a number of hospitals, nursing homes and other care givers. A state-sponsored study of hospital reimbursement rates showed that the Commonwealth covers only 71 percent of the cost of hospital-based care. The state should begin to bring payments to providers in line with costs, a process that will undoubtedly take several years. Although changes to the health care delivery system should also be pursued, the current health care crisis requires immediate action and an increase in the Medicaid reimbursement rates is long overdue.

While these circumstances would justify a redirection of annual tobacco settlement payments for a brief period, the $415 million that has already been set aside in the trust fund should continue to be saved for future health care needs. Using this one-time source of funds to address chronic underfunding of health care would accomplish little in the long run and would erase the modest progress the Commonwealth has made toward creating a stable endowment for the future.

Cigarette Tax Increase

Another option would be to increase the tax on tobacco products by 50 cents per pack, which could generate $150 million annually. However, like the tobacco settlement payments, any revenue raised through an increase in the cigarette tax should be used to meet current health care needs and not for further expansion of the state's already considerable health care obligations.[5] The 1996-97 expansions of Medicaid and the launching of other health care programs -- including the first-in-the-nation senior pharmacy program launched in April -- combined with the double-digit rise in health care costs will severely strain the state's resources for the foreseeable future. While health care advocates have been pushing for a tobacco tax increase to fund additional Medicaid expansions, the current economic reality makes any expansion proposal impractical.

Defer or Slow Income Tax Cuts

Given the enormous budget deficits that are looming over the next several years, it is clear that the state must cut spending in 2002 and rein in future spending growth. Depending on the severity of the recession, the state will also have to tap most, if not all, of its rainy day reserves over the next four years. However, these solutions could prove to be inadequate, and the Commonwealth may have to reconsider the pace of implementation of the Question 4 income tax cut approved by the voters last year. The rate reductions still to be phased in could be deferred for a limited period or reduced more slowly than currently scheduled.

With voters approving the tax cut by a large margin, postponing the reductions would be politically difficult. However, the Commonwealth's economic and fiscal condition is vastly different than it was in November 2000. Signs of the coming slowdown were only beginning to appear a year ago, and no one anticipated how quickly the state's budget picture would deteriorate in the wake of September 11. Continuing to phase in the scheduled tax cuts during a recession will make the task of balancing the budget over the next three years far more difficult.

Deferring or slowing down the pace of the tax cuts would have only a small impact on fiscal 2002, with a much larger impact on fiscal 2003 and 2004. A two-year postponement of the scheduled rate cuts -- which reduce the current 5.6 percent rate to 5.3 percent on January 1, 2002 and 5.0 percent on January 1, 2003 -- would increase estimated annual tax receipts by about $250 million in fiscal 2002 (reflecting an impact for half the fiscal year), $730 million in 2003 and 2004, and $240 million in 2005. Implementing the tax cuts at a slower pace -- with cuts to 5.45 percent in 2002, 5.30 percent on 2003, 5.15 percent on 2004 and 5.0 percent on 2005 -- would have annual impacts in these years approximately half as large as the impacts of a two-year postponement.

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[5] See MTF's June 27, 2001 *News Release* "Tobacco Tax Increase: Meeting Current Obligations First."