

# Bulletin

November 30, 2001

## *MTF* 2002 State Budget: Falling Short of the Mark

In an extraordinary atmosphere of budgetary posturing and dueling numbers, the Legislature has adopted a \$22.6 billion budget for fiscal 2002 that includes several positive elements but almost certainly fails to achieve balance despite substantial cuts from the budgets previously approved by the House and the Senate. On the plus side, the spending plan adopted by lawmakers maintains local education funding, preserves the commitment to pay off the state's huge unfunded pension liability on schedule, and leaves largely intact the previous decision to set aside a major share of the annual tobacco settlement payments for future health care needs.

On the other hand, in addition to its irresponsible delay, the Legislature's budget falls short in several respects:

- C It draws too heavily on the state's reserve funds, even tapping an extra \$100 million beyond that announced in the House-Senate conference budget agreement.
- C Like the Governor's original budget submission, it fails to adequately fund a wide variety of obligations, such as Medicaid and collective bargaining agreements, and the contingency funds included in the budget are insufficient to fully cover these costs.

- C It cuts some human service programs which the Commonwealth may be legally required to provide.

The Legislature's actions to close the 2002 budget gap are a far cry from what will be needed to address the state's multi-year financial problems.<sup>1</sup> With only \$600 million in spending cuts from the budgets originally approved by the House and the Senate, the final legislative budget draws on \$800 million of the state's reserves, \$250 million more than recommended by the Foundation. Further major cuts will inevitably be needed to achieve budgetary balance in 2003 and beyond. With most of the current reductions falling on human services, other areas of the budget will have to bear some of the burden when the additional cuts become necessary.

Despite these shortcomings, the legislative budget comes closer to achieving balance than the "fiscal recovery" budget recently filed by the Governor. The administration's plan, while wisely drawing less on reserves than the Legislature, has several major flaws. It proposes shifting more than \$100 million of 2002 pension costs onto future generations, uses up all

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<sup>1</sup> As detailed in the Foundation's November 8, 2001 *Release*, "MTF Analysis: State Faces Escalating Multi-Billion Dollar Budget Deficits; Major Spending Reductions Required."

tobacco payments over the next three years, and relies on an unprecedented accounting maneuver to finance a portion of spending in the annual appropriation act.

The Governor intends to veto some \$200 million from the budget approved by the House and Senate and submit supplemental appropriations to restore some of the cuts. The Legislature has agreed to reconvene on December 5 for a special one-day session to consider possible overrides of gubernatorial vetoes and to consider her supplemental requests.

### **State Fiscal Picture**

Determining the state's financial situation has been unusually difficult for the last several months. Since the beginning of the fiscal year, estimates of tax revenues have dropped rapidly while projections of funding needs in nondiscretionary accounts have ballooned. On top of all these factors, decision makers have had to keep track of five different proposals for 2002 spending, including the budgets previously approved by the House and the Senate, the administration's "provisional budget" that guided agency spending in the absence of the final budget, the "fiscal recovery" budget recently submitted by the Governor, and the compromise budget ultimately adopted by the Legislature. With no common baseline for comparison, it has been impossible for most observers to sort out the various proposals for solving the fiscal 2002 budget gap.

### *The Size of the Problem*

In January of 2001, the Foundation warned of a "perfect storm" that lay ahead for the state's finances, due to the confluence of major tax cuts, a dramatic slowing of the state economy and revenues, and a sharp surge in nondiscretionary costs, especially health care. Unfortunately, despite a fiscal 2001 surplus of

\$760 million,<sup>2</sup> this prediction has come true with breathtaking speed: In just a few short months, expected tax receipts have declined \$1.1 billion from the levels on which the legislative budgets were based, and rapid growth in health care and other legally mandated costs has created the need for more than \$300 million of funding (after federal reimbursements) above the amounts originally included in the House and the Senate versions of the budget.

### *How the 2002 Problem Has Been Addressed*

With weak revenue performance in the first four months of the fiscal year, there has been general agreement on Beacon Hill that the Commonwealth faced a budget gap of at least \$1.35 billion. Prior to final action on the budget, legislative leaders announced they would address the 2002 problem by cutting \$650 million from the House and Senate budgets and drawing on \$700 million of the state's \$2.3 billion of rainy day reserves.

According to MTF's analysis, the final legislative budget totals \$22.3 billion<sup>3</sup> -- an actual reduction of \$611 million from the higher Senate budget total -- and provides for reserve withdrawals totaling \$806 million,<sup>4</sup> including \$772 million from rainy day funds and \$34 million previously set aside for future tax reductions. Because of the

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<sup>2</sup> As reported in the Comptroller's statutory basis financial report for the fiscal year ended June 30, 2001. Of this total, \$579.2 million was set aside in a special rainy day reserve.

<sup>3</sup> Including \$22.257 billion of line item appropriations and \$59.4 million of retained revenue authorizations.

<sup>4</sup> The legislative budget also uses \$105 million of surplus funds in the Medical Security Trust Fund to help support the costs of uncompensated care and previously authorized Medicaid expansions. To varying degrees, both the Governor's original budget submission and the budgets previously approved by the House and the Senate tapped the fund for similar purposes.

five-month delay in approving the budget, lawmakers had an especially difficult time in achieving the proposed level of cuts -- with less time remaining in the fiscal year, any cuts will hit state programs and services harder.

Before the Legislature acted, the Governor announced her proposals to deal with the 2002 gap, which included cuts totaling \$850 million,<sup>5</sup> the use of \$300 million of reserves, and the use of the full amount of annual tobacco settlement payments in 2002, worth an additional \$200 million. Her subsequent "fiscal recovery" budget and accompanying supplemental legislation (filed two days before lawmakers adopted their spending plan) provided for \$700 million of cuts to specific line items,<sup>6</sup> including an unwise \$135 million reduction in pension funding, and used \$540 million of reserves,<sup>7</sup> as well as the \$200 million of additional tobacco monies.

### *Is the Budget Balanced?*

One of the most controversial questions in the aftermath of the Legislature's action on the budget has been that of balance, with claims and counter claims that have largely focused on selected pieces of the full financial picture. Here are the facts as the Foundation understands them.

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<sup>5</sup> In announcing her plan, the Governor called for \$600 million in additional cuts on top of \$250 million of previous cuts to the proposed spending levels in the budgets initially adopted by the House and Senate.

<sup>6</sup> The Governor's appropriation total of \$22.795 billion includes \$457 million for underfunded accounts and \$116 million for collective bargaining agreements. For purposes of identifying the amount of cuts relative to the initial legislative budgets, we have excluded these additions to the bottom line.

<sup>7</sup> Of the \$540 million total, \$50 million would fund the one-time costs of a proposed early retirement program and would not affect the annual operating budget.

The 2002 budget adopted by the Legislature authorizes \$22.3 billion of appropriations, an amount that does not include \$457 million of underfunding identified by the administration (which would be partially offset by additional federal reimbursements of \$149 million) or \$116 million for the costs of recently negotiated collective bargaining agreements (see table on page 4). Adding in these unavoidable costs results in total 2002 spending of \$22.9 billion under the lawmakers' plan.

The Governor has also proposed \$22.9 billion of appropriations, including \$10 million to be transferred to the capital needs investment trust fund, the underfunding and costs of collective bargaining agreements noted above, and \$100 million of supplemental appropriations for early retirement incentives and additional public safety costs.

The spending plan adopted by the Legislature provides for \$22.8 billion of revenues and other resources,<sup>8</sup> resulting in a budgetary deficit of \$144 million. After adjusting the Legislature's revenue estimate for differences in recommended reimbursable spending, there would be \$22.7 billion of resources<sup>9</sup> available to support the Governor's proposed budget, yielding a deficit of \$247 million.<sup>10</sup>

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<sup>8</sup> Adjusted to include the \$149 million of federal reimbursements from required supplemental Medicaid appropriations, as well as the use of \$806 million of reserves.

<sup>9</sup> Including the use of \$541 million of reserves and \$200 million of additional tobacco receipts.

<sup>10</sup> These calculations present an overall view of the two proposals and do not take into account the special rules defining statutory balance in the state's three main funds (the General, Highway and Local Aid Funds). According to the administration, the deficit under the statutory definition of balance would be \$170 million before taking into account reversions (unspent agency appropriations).

Furthermore, in order to produce a balanced budget, the administration relies on the assumption that agencies will not fully spend the amounts authorized in the budget. While it is typically true that for a variety of reasons some agency funds remain unspent at the end of the year (which are known as reversions), assuming such unspecified savings in the initial budget for the year is unprecedented.

In any case, if an estimate of reversions is to be used in determining balance, it should apply equally to the legislative budget. Based on prior experience, reversions could total between \$200 million and \$300 million in fiscal 2002, sufficient to erase the gaps in both the legislative and gubernatorial budget proposals. However, other budgetary risks are likely to re-open the financial gap in the coming months, necessitating even further cuts or greater reliance on reserves. Given such risks, the state's fiscal leaders should not count on reversions to produce a balanced budget.

*Risks to the Budget*

Additional Revenue Reductions While preliminary figures for November tax collections are generally consistent with the lower tax estimates now being used by both the administration and Legislature, the possibility of further erosion in tax receipts is very real, with the economy still in recession and great uncertainty about the future. There is the added danger of an unpleasant revenue "surprise" in the last quarter of the fiscal year, when final tax payments on 2001 capital gains become due. In the "extended recession" scenario of MTF's recent multi-year analysis of state finances, the Foundation estimated a risk of additional declines in capital gains receipts totaling almost \$200 million.

Further Deficiencies While the administration has already identified \$297 million of underfunding in the huge Medicaid program, current growth trends indicate an even greater

| <b>Fiscal 2002 Budgetary Balance</b><br><b>(\$, Millions)</b> |                       |  |
|---|-----------------------|--|
|   | Legislative<br>Budget | Governor<br>Fiscal<br>Recovery<br>Budget |
| <b>Resources</b>  |                       |  |
| Revenues*   | \$21,731              | \$21,918                                 |
| Addl. Federal Receipts  | 149                   | **                                       |
| Due to Supplemental<br>Medicaid Spending                      |                       |  |
| Reserves  | 806                   | 540                                      |
| Tobacco   | 60                    | 200                                      |
| <b>Total</b>  | <b>22,746</b>         | <b>22,658</b>                            |
| <b>Expenditures</b>   |                       |  |
| Appropriations  | 22,317                | 22,905                                   |
| Deficiencies  | 457                   | **                                       |
| Collective Bargaining   | 116                   | **                                       |
| <b>Total</b>  | <b>\$22,890</b>       | <b>\$22,905</b>                          |
| <b>Deficit</b>  | <b>(\$144)</b>        | <b>(\$247)</b>                           |
| * Based on estimates published in legislative budget.         |                       |  |
| ** Included in preceding total amounts.                       |                       |  |

shortfall is likely, requiring as much as \$100 million more in deficiency appropriations (which would be offset by \$50 million of additional federal reimbursements).

Despite the Governor's determination to contain cost growth in other programs, some additional funding needs are almost certainly unavoidable. For example, although the legislative budget includes \$26.5 million for increased public safety costs in the aftermath of September 11, the Governor has recently requested an additional \$24 million for this purpose, which she proposes to fund from the state's reserves.

Restoration of Cuts and Other Initiatives There will be considerable pressure in the coming months to reverse some of the most painful spending reductions in the Legislature's budget. The Governor has indicated that her veto

message will be accompanied by requests for supplemental funding to restore cuts that she considers inappropriate or would result in a loss of revenues. The restoration of cuts could be afforded if they are offset by an equal amount of vetoes, but it would be inappropriate to finance these programs by reducing pension funding as the Governor has previously proposed. With the state still facing a huge unfunded pension liability, it is unwise to shift \$135 million of current costs onto future generations, especially by renegeing on the much heralded previous commitment to reduce the repayment period for that liability from 30 years to 20 years, a change which helped win an upgrade in the Commonwealth's credit rating.

At the same time, some savings measures, such as the early retirement program proposed by the administration, would actually increase costs in the near term -- the Governor has already requested supplemental funding totaling \$50 million for the program, to be financed from reserves. Furthermore, early retirement programs are almost always a problematic way to achieve savings. With the most senior and valuable employees more likely to take advantage of early retirement -- sometimes in great numbers -- agency managers may end up contending with difficult-to-fill voids that affect the quality of service.

#### *Impact on the Multi-Year Financial Problem*

Although the budget outlook for fiscal 2002 is difficult at best -- despite the Legislature's actions to close this year's gap -- the prospects for fiscal 2003 and beyond are more worrisome still. In its recent analysis of the state's multi-year financial problem, the Foundation concluded that the Commonwealth would face budget gaps totaling \$450 million in 2003 and \$320 million in 2004, even after cutting spending by \$850 million in 2002, restraining future spending growth to three percent a year, and drawing up to \$500 million annually from the state's reserves over the next three years. These imbalances result

primarily from the continued slow growth in baseline revenues and the impact of Question 4 and other tax cuts that are still being phased in, which will reduce tax receipts by almost \$1.6 billion from fiscal 2002 through 2004.

However, the budget now on the Governor's desk cuts spending only \$600 million and instead relies more heavily on one-time reserves to address the 2002 problem, an approach that will result in even larger deficits of about \$700 million in 2003, \$575 million in 2004 and \$250 million in 2005. Given this multi-year outlook, it is clear that further spending cuts will soon be required. The Commonwealth has just begun what will be a long and contentious struggle to cope with its large fiscal problems.