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Bulletin

August 22, 2002

MTF

2003 Budget: Major Accomplishments in Closing Gap, But 2004 Promises Further Painful Choices

With a final vote just after midnight on July 31, state lawmakers brought at least temporary closure to the most challenging budget process in a decade. For nearly a full year, the state's fiscal leaders had struggled to fill a huge gap in 2002 finances and craft a balanced 2003 budget. Although their efforts fell short for 2002, the combination of spending cuts and tax increases adopted for 2003 represent real progress in erasing the disparity between state revenues and spending. Despite these gains, however, the Commonwealth still faces a serious structural deficit in 2004.

Table 1
State Response to Fiscal Crisis
($, Millions)

	Fiscal 02	Fiscal 03
Revenues	$20,712	$21,062
Spending before cuts	23,017	24,049
Problem	-2,305	-2,987
Solutions:		
Reserves & one-time revenues	1,741	844
Tax increases	--	1,140
Spending cuts	210	724
Tobacco dollars*	60	150
Pension funding cuts	134	129
Reversions & other	160	--

* Amounts in excess of 50 percent of annual settlement payment.

The crisis in the state's finances was precipitated by the almost 15 percent plunge in fiscal 2002 tax receipts, a stunning reversal of the double-digit annual revenue growth of the previous six years. The drastic drop in tax revenues opened a $2.3 billion hole in the budget that threatened to grow to almost $3 billion in 2003.

While almost all states are grappling with large revenue declines, Massachusetts' shortfall has been among the most severe, with a 26 percent drop in the fourth quarter of fiscal 2002 that was the worst in the nation.[1] Measured as a percent of state spending, the 2002 budget shortfall even exceeded the fiscal 1990 deficit in the depths of the state's last fiscal crisis.

[1] "Large Decline in April-June 2002 Quarter Caps Terrible Fiscal Year for States," *State Fiscal News*, Vol. 2, No. 10.

The collapse in capital gains receipts -- combined with Question 4 and other tax cuts -- are largely responsible for the state's current budgetary problems. Unlike the deep recession of a decade ago, the recent economic downturn has resulted in only a moderate loss of jobs. At the same time, in marked contrast to the years leading up to the last fiscal crisis, spending growth during the recent boom years was mostly held in check. From 1995 through 2001, annual spending grew 5.8 percent on average, roughly half the rate of increase in the second half of the 1980s.

Against this backdrop the state's leaders deserve recognition for their efforts to resolve the crisis. Given the size of the problem -- and the certainty that the lost capital gains will not be replaced for many years -- additional taxes and reduced spending represent the only realistic ways to address such an enormous structural mismatch between revenues and expenditures (see Table 1). Although the efforts to address this mismatch largely fell short for 2002, the combination of new revenues and spending cuts that were adopted for 2003 constitutes a major accomplishment.

Significantly, those who have argued against tax increases have failed to present any credible alternative plan to permanently fill a $3 billion budget deficit. They have also failed to acknowledge that Question 4's rigid three-year timetable for implementing the cut in the income tax to 5 percent has made the crisis much more difficult to manage.

Other states have resorted to desperate measures to deal with their budget problems, including relying on the short-sighted and irresponsible financial gimmick of "tobacco securitization," the borrowing against 30 or even 40 years of annual tobacco settlement payments to address a single year's shortfall. Far from serving as examples of creative solutions to the state's fiscal emergency, such measures would only delay the inevitable day of reckoning. In that context, the Legislature deserves significant credit for its willingness to make tough decisions to bring the state's revenues and expenditures into closer alignment. Likewise, the Governor's vetoes of over $350 million of appropriations made a major contribution to reducing the budget's spending base and its reliance on reserves.

Despite these positive efforts, however, the state's response to the current fiscal crisis falls short in two important respects. While the impending financial problems were recognized as early as last fall, very little action was taken in fiscal 2002 to shore up revenues or cut spending. As a result, the state has drawn much too heavily on its reserves, reducing a $2.3 billion "rainy day" balance to approximately $300 million in less than two years.

Apart from the additional taxes and spending cuts, the state is relying on almost $850 million of reserves and one-time revenues to "balance" the 2003 budget, a dependence that spells trouble for 2004. Even with an economic recovery, the expected growth in tax revenues next year will almost certainly be inadequate to both finance the expenditures being supported with reserves in 2003 and pay for inevitable increases in the costs of health care and other major programs. As a result, the state is likely to face a further structural deficit of $1 billion or more in 2004.

The state has also missed a major opportunity presented by the fiscal crisis to attack a long list of "sacred cows" and eliminate spending abuses and inefficiencies.[2] While no one with any clear understanding of the state budget argues that rooting out wasteful spending would solve the Commonwealth's fiscal problems, the state had both the occasion -- and the responsibility -- to take on longstanding abuses. To name just one egregious example, it is difficult to justify spending more on the scandal-ridden police incentive pay program (the "Quinn bill") when 50,000 long-term unemployed individuals are being dropped from the Medicaid rolls.

Total Spending

After taking into account vetoes and overrides, spending in the recently enacted budget for fiscal 2003 totals $23.1 billion, up $1.1 billion or 5 percent from 2001, the year before the fiscal crisis began. This two-year growth figure includes a $700 million increase in 2002 and an almost $400 million increase in 2003.

Behind the overall growth lies a combination of large increases in some programs -- health care in particular -- and reductions in other areas that only partially offset those increases. Over the last two years, expenditures in roughly a dozen major programs -- including Medicaid, employee health benefits, K-12 education, school building aid, and caseload-driven human services -- have risen $2.1 billion, or 15.6 percent, from 2001 to 2003 (see Table 2). While much of this growth occurred in 2002, almost $900 million of the increase will take place in 2003.

Offsetting these increases are approximately $725 million in administrative and program reductions below the 2001 spending level, including major cuts in other aid to schools, public health, higher education, housing, economic development, parks and recreation, tax administration and the courts.

The spending change from 2001 to 2003 also reflects almost $320 million of budget-balancing gimmicks, including an unwise reduction in annual pension appropriations that only shifts costs onto future taxpayers and the transfer of some administrative expenses to the capital budget.

While other dubious financial ploys -- such as deficit borrowing against future tobacco settlement payments -- were wisely rejected, serious spending reforms of the kind previously identified by the Foundation were either not considered or rejected out of hand. As a result, a number of cost-saving changes, including revamping the inequities in the Chapter 70 education formula, greater employee health cost-sharing, "Quinn bill" reforms, consolidation of court management, and privatization initiatives, remain unaddressed.

The Medicaid eligibility changes in the budget, expected to save $40 million in 2003 and more than $200 million when fully annualized, recognize that expansions in this huge program since 1997 have added tremendously to its costs. However, the ill-conceived attempt to generate savings by reducing prescription reimbursement rates below costs -- which would jeopardize the

[2] See the Foundation's May 29, 2002 Bulletin, *The Commonwealth's Fiscal Crisis: Important Opportunities for Spending Reform.*

Table 2
Spending Changes in State Fiscal Crisis

($, Millions)	Actual 2001	Estimated 2002	Budget 2003	Change from 2001	Pct. Chg. from 2001
Program Increases					
Medicaid	$4,783.1	$5,411.8	$5,984.2	$1,201.1	25.1
Chapter 70 K-12 school aid	2,989.5	3,213.2	3,259.0	269.5	9.0
Employee health benefits	659.6	734.8	812.9	153.3	23.2
Cash assistance	621.2	719.8	727.5	106.3	17.1
Social services	579.3	629.0	671.3	92.0	15.9
Debt service	1,431.8	1,398.1	1,506.4	74.7	5.2
Mental retardation	916.1	964.4	987.3	71.2	7.8
School building aid	316.5	361.5	381.9	65.4	20.7
Senior pharmacy	48.8	80.1	97.6	48.8	100.0
Police	205.3	246.2	231.8	26.4	12.9
Corrections	799.3	828.0	815.9	16.5	2.1
Day care	368.7	389.1	378.0	9.4	2.5
Subtotal	13,719.3	14,976.0	15,853.7	2,134.4	15.6
Cost Shifting/Underfunding					
Pension costs	1,035.7	797.6	814.0	-221.6	-21.4
Snow and ice control	72.5	24.2	15.0	-57.5	-79.3
Highway admin.	82.9	77.0	48.5	-34.4	-41.5
Capital asset management	5.8	1.0	0.0	-5.8	-100.0
Subtotal	1,196.9	899.7	877.6	-319.3	-26.7
Program Decreases					
K-12 school aid other than Ch. 70	416.0	379.7	299.7	-116.3	-28.0
Public health	534.5	495.1	429.7	-104.8	-19.6
University of Massachusetts	515.7	492.8	453.7	-62.0	-12.0
Chapter 81 gas tax aid	43.5	10.9	0.0	-43.5	-100.0
Housing assistance	158.4	143.2	122.3	-36.1	-22.8
Conservation and recreation	137.2	120.3	105.4	-31.8	-23.2
Additional assistance	477.6	477.6	446.6	-31.0	-6.5
Board of Higher Education	140.8	142.7	110.2	-30.6	-21.7
Judiciary	588.7	583.7	563.0	-25.7	-4.4
Community colleges	250.4	233.7	227.0	-23.5	-9.4
Capital needs investment trust	45.0	22.0	23.0	-22.0	-48.9
Econ. devel. and tourism	43.3	34.7	25.1	-18.2	-42.0
Environmental protection	107.9	101.7	91.3	-16.6	-15.4
Welfare administration	133.8	129.5	121.4	-12.4	-9.3
Tax administration	124.5	116.3	118.1	-6.5	-5.2
State colleges	202.2	188.4	200.2	-2.0	-1.0
Other net reductions	3,170.6	3,155.0	3,030.1	-140.5	-4.4
Subtotal	7,090.1	6,827.3	6,366.9	-723.3	-10.2
Totals	$22,006.3	$22,703.0	$23,098.2	$1,091.9	5.0

Note: Excludes RMV fees dedicated to Central Artery and contingency payments for revenue and debt collection.

ability of both large and small pharmacies to continue to fill prescriptions for the roughly one million Medicaid recipients in the state -- only underscores the overall need for a more thoughtful approach to spending reform.

Revenues

The 2003 budget relies on a tax estimate of $15.253 billion, a $974 million or 6.8 percent increase over 2002 (see Table 3) that reflects a revised consensus agreement by the state's fiscal leadership as well as the package of tax increases adopted by the Legislature.

This estimate presumes baseline tax growth (before law changes) of 2.4 percent, or about $350 million. With a sluggish economy, the forecast underlying the estimate assumes essentially no growth in baseline tax receipts in the first three months of fiscal 2003 and a gradual acceleration in the rate of increase through the end of the fiscal year.

The recently enacted tax package will add an estimated $925 million[3] to fiscal 2003 revenues, through the combination of lower personal exemptions, elimination of the charitable deduction, and increases in capital gains and tobacco taxes. At the same time, however, previously enacted tax cuts, primarily the cut in the income tax rate from 5.6 to 5.3 percent in January 2002, will reduce fiscal 2003 revenues by almost $300 million.

Table 3
Fiscal 2003 Tax Revenues
($, Millions)

Fiscal 2002 estimated taxes	$14,280
Baseline growth of 2.4 percent	348
Tax increases	925
Phase-in of prior tax cuts	-300
Fiscal 2003 total taxes	15,253
Change from 2002	973
Percent change	6.8

The tax package will also generate another $120 million of one-time revenues -- not counted in the figures above -- largely because of the January 1, 2002 effective date of the reduction in personal exemptions. Although the budget presented to the Governor did not rely on these non-recurring receipts to finance 2003 spending, the administration believes that the revenues will be needed because lawmakers overestimated the amount of non-tax revenues that will be collected this year. Both the Governor and the Legislature are also counting on the collection of about $42 million of tax arrearages in 2003 through a one-time amnesty program authorized in the new budget.

Reserves

At the beginning of fiscal 2002, Massachusetts seemed ideally positioned to weather any likely downturn in the state's economy and revenues, with fiscal stabilization or "rainy day" reserves totaling $2.3 billion, about ten percent of annual spending. However, as the year progressed -- and revenues continued to plummet -- the state consumed an increasingly large share of these funds, ultimately almost $1.5 billion of the

[3] The generally reported estimate of the value of the tax package, $1.14 billion, includes the impact of not implementing the previously scheduled cut in the income tax rate to 5.0 percent on January 1, 2003. While this provision negates $215 million of planned tax cuts, it does not generate additional 2003 revenues.

Table 4
Fiscal 2002 and 2003 Reliance on Reserves and Other One-Time Resources
($, Millions)

	Balance: Beginning of Fiscal 2002	Fiscal 2002 Uses	Fiscal 2003 Uses	Balance: End of Fiscal 2003
Stabilization fund	$2,293	$1,452	$550	$291
Other balances	446	289	132	25
One-time revenues				
Retroactive tax increase	--	--	120	--
Tax amnesty revenues	--	--	42	--
Grand total	2,739	1,741	844	316

Note: The stabilization fund balances shown here exclude an estimated $50 million of interest earned over the two fiscal years; the "other balances" total does not include the balance in the trust fund for future health care needs, approximately $515 million at the end of fiscal 2002, which reflects prior deposits of tobacco dollars into the fund.

original $2.3 billion total (see Table 4). To make ends meet in 2003, the state has already committed to using another $550 million of the stabilization reserves, leaving less than $300 million in the fund, a meager cushion in the event of further revenue shortfalls or unexpected deficiencies in major accounts such as Medicaid.

This focus on the rainy day fund actually understates the state's reliance on reserves and other one-time resources. In 2002, the state also tapped $289 million of balances that were originally set aside for other purposes, including $138 million of capital reserves. The 2003 budget uses $132 million of balances in other funds and also relies on $42 million of one-time revenues from the tax amnesty program. If the administration's lower estimate of non-tax revenues is correct, the $120 million of one-time revenues due to retroactive provisions of the tax package will also be needed in 2003.

Fortunately, the state has so far been able to resist the temptation to tap the trust fund established to meet future health care needs, which totaled $515 million at the end of 2002. However, fiscal 2003 marks the first year in which the state will use 100 percent of the annual payment by tobacco companies, about $300 million, to meet the current costs of health care, leaving none to set aside for future needs.

Despite the marathon efforts of state leaders to erase the shortfalls in the 2002 and 2003 budgets, the structural mismatch between revenue and expenditures has not been fully closed. More tough decisions lie ahead.