State Budget '02: Heading for a Crash

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MTF

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Overview

Despite the angst surrounding debate on the fiscal 2002 budget, the state's fiscal problems have just begun. Annual revenues are falling so far short of spending that the Commonwealth will confront billion dollar budget gaps in 2003 and at least the following two fiscal years -- even if the economy turns around in 2002.

A year ago, in MTF's annual report on state spending (entitled *The Perfect Storm*), the Foundation warned of the convergence of three major trends which were dramatically changing the state's fiscal landscape:

- an approaching economic recession with a sharp drop in the rate of growth of tax revenues;

- the phasing in of the Governor's $1.2 billion tax cut approved by the voters, as well as several hundred million dollars of previously enacted tax reductions;

- rapidly escalating and largely uncontrollable health care costs, which account for one-quarter of the state budget.

Unfortunately, the "perfect storm" metaphor has turned out to be on the mark. Driven by a dramatic decline in tax revenues, the state is heading for a crash similar to the fiscal crisis of the late 1980s.

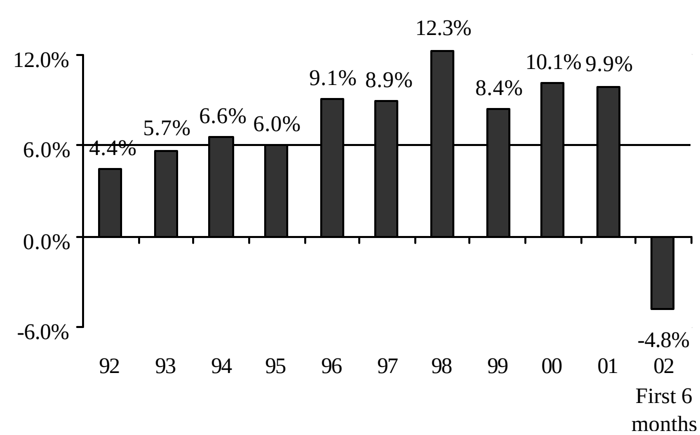
After growing an average of 10 percent a year for the past six years, baseline tax revenues (before adjusting for tax cuts) have actually dropped almost five percent through the first six months of fiscal 2002 (see Figure 1). This rate of decline rivals the freefall that created the last fiscal crisis, and like their counterparts a decade ago, state leaders have been unable to cope adequately with the dramatically changing fiscal circumstances.

Both the administration and Legislature have failed to propose sufficient spending reductions based on the new realities. To be sure, the Legislature cut several hundred million dollars from larger budgets passed earlier by the House and Senate. But the Foundation's analysis shows that spending will actually grow by 4.1 percent in fiscal 2002, and perhaps still be out of balance by up to $500 million by the end of the year. Budget makers avoided larger cuts by drawing too heavily on rainy day funds -- $800 million of the $2.3 billion -- and are likely to deplete the Commonwealth's reserves even further to cover expected year-end shortfalls.

Looking to fiscal 2003, the situation is even more ominous. In a highly contentious election

Figure 1

Tax Revenue Growth
(Before Cuts)



year, the state's leaders must struggle with a larger budget gap than in fiscal 2002. This analysis concludes that the 2003 budget shortfall will be between \$1.2 and \$1.6 billion, even after using another \$500 million in reserves and holding discretionary accounts to the same funding level as 2002.

The striking conclusion is that the state will confront a budget gap of this magnitude even if the economy recovers in 2002.

This is the case because the state will enter fiscal 2003 with a "structural deficit" of approximately \$1 billion, that is revenues are \$1 billion less than the rate of spending, which is driven by health care and other non-discretionary costs. In addition, the phasing in of the voter-approved income tax cut will reduce revenues by almost \$500 million in 2003.

Given the likelihood of a significant deficit this fiscal year and the size of the 2003 shortfall, there is serious risk that the Commonwealth will deplete all its reserves by the end of fiscal 2003. State leaders should do everything possible to avoid this outcome. Otherwise, the state will be in for a major crisis following the 2002 elections.

Fiscal 2002

While fiscal 2002 is now more than half over, the combination of plummeting tax revenues and ballooning health care costs is threatening to drive the already-out-of-balance budget further into the red. Of even more concern for the long term, the spending plan reflects an inability of the state's leadership to come to grips with the Commonwealth's dramatically worsened fiscal situation.

2002 Revenues

Even with a $1.1 billion downward revision in the 2002 tax estimate in November, collections continue to fall seriously short of expectations. Tax receipts through December -- the first six months of fiscal 2002 -- were $189 million below the Department of Revenue's revised benchmark, reflecting an underlying decline in baseline revenues (before tax cuts) of almost five percent. If current trends persist, revenues for the fiscal year will miss the official $14.93 billion estimate by roughly $275 million and quite possibly more (see Table 1).

Table 1
State Tax Revenues
($, Millions)

Actual for 2001	$16,075
Estimate for 2002 budget	14,930
Shortfall through December*	189
Shortfall extrapolated through June	277

* Relative to the midpoint of DOR's benchmark range.

In the last six months, the Commonwealth has experienced a dramatic decline in its revenue fortunes following six years of dramatic growth in its tax base. With the economy in full recession, weakness in income tax withholding and flat sales taxes have been compounded by a collapse in corporate tax receipts, which is showing the worst performance in decades.

On top of these recession-driven declines, previously enacted tax cuts are reducing 2002 revenues by almost $700 million. The Question 4 income tax cut alone will reduce taxes by approximately $425 million, with an additional impact of about $475 million in 2003.

As a result of these factors, the official $14.93 billion estimate of tax receipts for 2002 is a huge 7.1 percent below 2001 tax revenues. This decline could easily balloon to nine percent or more if the shortfalls in collections through December continue until the end of the fiscal year.

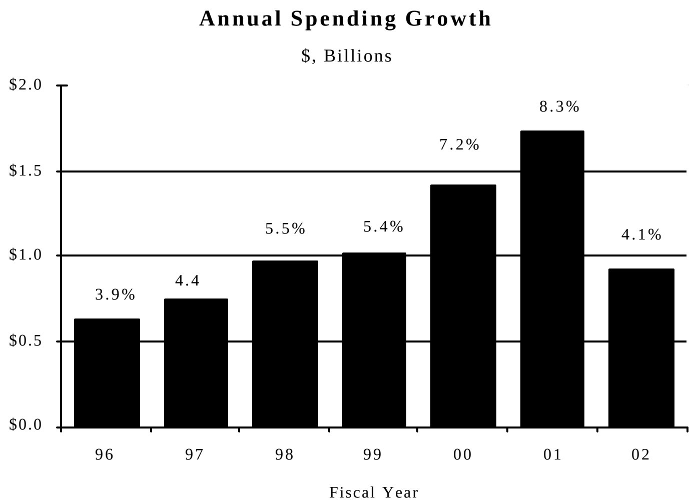
2002 Spending

Authorized spending for 2002 is expected to total $23.02 billion, an increase of $911 million or 4.1 percent from 2001. This sum includes $22.2 billion in the 2002 budget adopted in late November, $323 million in other spending authorizations,[1] and $495 million of expected further supplemental appropriations, including almost $300 million for Medicaid.

The 4.1 percent rate of spending growth in 2002 is about half of the increases of 8.3 percent in 2001 and 7.2 percent in 2000 (see Figure 2). With just two program areas -- Medicaid and local education aid -- accounting for over 90 percent of the new spending, most

[1] Including $60 million of motor vehicle fees dedicated to Central Artery costs, $45 million of income tax receipts to be transferred for capital and affordable housing investments, $14 million of SSI revenues retained for expenditure in the welfare program, and $204 million in supplemental appropriations to date.

Figure 2



areas of government faced a zero-sum game in which increases in one program were offset by decreases in another. As a result, for the first time since the early 1990s, several areas, including higher education, public health and environmental programs, experienced cuts from the prior year's spending level (see Budget Summary on page 6).

In spite of the extraordinary lateness of the budget and the need to trim spending levels from the amounts approved by the two legislative branches, significant additional appropriations remain to be authorized before the end of the fiscal year. The Governor has requested $297 million to pay unavoidable additional costs for Medicaid, a figure which could increase by $100 million given current growth trends in this program; lawmakers have authorized up to $80 million of further expenditures for social service and welfare programs; and as much as $125 million more of non-discretionary and other priority appropriations are likely to be approved in the coming months, including $30 million for snow and ice removal, $27 million for collective bargaining, and $24 million for state and local police costs in the aftermath of September 11.

In attempting to close the 2002 budget shortfall, the Legislature avoided the need to make more substantial spending cuts by relying heavily -- too heavily -- on reserves. Despite announcing a legislative agreement to draw only $700 million from the state's rainy day funds, the final budget passed just a few days later actually taps $806 million of reserves. The budget also reflects a reasonable agreement to spend 50 percent of the state's annual tobacco settlement payments in 2002 and the next two years, $60 million more than the earlier commitment to spend 30 percent and set aside 70 percent for future health care needs. Together, these actions allowed budget makers to cut only about $500 million from the House and Senate spending plans after accounting for funding

Table 2
2002 Balance Sheet
($, Millions)

Resources	
Revenues	22,086
Reserves	806
Total Resources	22,892
Spending	
Appropriations to date	22,522
Unavoidable deficiencies and other supplementals	495
Total Spending	23,017
Surplus/(Deficit)	(125)
Further Risks to Balance	
Potential tax shortfall	277
Further Medicaid deficiency*	50
Surplus/(deficit) with Risks	(452)

* Net of federal reimbursements

restored following adoption of the budget.

2002 Balance

As shown in Table 2, despite spending cuts and the planned use of over $800 million of the state's reserves, the 2002 budget is approximately $125 million out of balance, before taking into account the most recent revenue performance and the risk of even higher deficiency spending in Medicaid and other non-discretionary accounts.

Based upon the Foundation's analysis, these further risks could push the 2002 deficit to as much as $450 million. While this figure does not take into account reversions -- unspent agency appropriations at the end of the year which could reduce total spending by $200 million or more -- it also does not factor in other potential uncertainties in the coming months, such as the possibility of further reductions in capital gains receipts, which will not be known until the fourth quarter of the fiscal year, and as-yet-unidentified deficiencies in other accounts.

BUDGET SUMMARY

(millions)	1999 Actual	2000 Actual	2001 Actual	2002 Appro-priations To Date[1]	2002 Expected Additional Spending[2]	2002 Estimated Total Appro-priations	2002 Percent Change from 2001	2002 Avg. Annual Percent Change Since 1999
Investment in Children	**$5,010.0**	**$5,527.6**	**$6,005.5**	**$6,222.3**	**$94.8**	**$6,317.1**	**5.2%**	**8.0%**
Education Local Aid	3,186.8	3,534.4	3,830.1	4,091.7	0.5	4,092.2	6.8%	8.7%
Higher Education	935.4	1,006.3	1,109.1	1,040.7	33.4	1,074.1	-3.2%	4.7%
Services to Children	491.0	537.6	579.3	572.9	61.0	633.9	9.4%	8.9%
Youth Services	105.8	111.9	118.3	123.9	0.0	123.9	4.7%	5.4%
Child Care Services	291.0	337.5	368.7	393.1	0.0	393.1	6.6%	10.5%
Criminal Justice and Law Enforcement	**$1,527.1**	**$1,586.4**	**$1,708.6**	**$1,752.5**	**$31.7**	**$1,784.2**	**4.4%**	**5.3%**
Corrections	710.0	745.5	799.3	823.8	1.3	825.0	3.2%	5.1%
Judiciary	508.5	545.8	588.7	575.8	6.4	582.2	-1.1%	4.6%
Police	212.2	195.0	205.3	239.4	24.0	263.4	28.2%	7.5%
DAs	69.8	72.1	81.4	79.7	0.0	79.7	-2.2%	4.5%
Attorney General	26.6	28.0	33.8	33.9	0.0	33.9	0.4%	8.4%
Local Government	**$1,410.3**	**$1,553.7**	**$1,541.0**	**$1,526.7**	**$0.0**	**$1,526.7**	**-0.9%**	**2.7%**
Assistance to the Poor	**$5,006.0**	**$5,374.6**	**$5,811.3**	**$6,185.0**	**$324.6**	**$6,509.5**	**12.0%**	**9.1%**
Medicaid	3,975.2	4,390.4	4,764.2	5,078.4	297.4	5,375.8	12.8%	10.6%
Cash Assistance	702.4	637.5	640.1	685.4	27.2	712.6	11.3%	0.5%
Housing Assistance	158.0	156.9	158.4	144.4	0.0	144.4	-8.8%	-3.0%
Elderly	170.4	189.8	248.6	276.8	0.0	276.8	11.3%	17.5%
Assistance to the Sick	**$1,820.9**	**$1,946.8**	**$2,068.3**	**$2,088.3**	**$0.0**	**$2,088.3**	**1.0%**	**4.7%**
Mental Retardation	821.8	868.3	916.1	964.4	0.0	964.4	5.3%	5.5%
Mental Health	557.2	571.7	602.3	607.6	0.0	607.6	0.9%	2.9%
Public Health	441.9	506.8	549.9	516.3	0.0	516.3	-6.1%	5.3%
Transportation	**$712.4**	**$764.6**	**$260.8**	**$201.0**	**$29.7**	**$230.7**	**-11.5%**	**-31.3%**
Regional Transit Auth.[3]	537.7	591.5	41.2	42.2	0.0	42.2	2.5%	-57.2%
MDHighways	118.5	116.2	155.4	90.6	29.7	120.2	-22.6%	0.5%
Registry	56.3	56.9	64.2	68.2	0.0	68.2	6.2%	6.6%
Economy/Environment	**$360.3**	**$356.8**	**$403.5**	**$366.5**	**$3.2**	**$369.7**	**-8.4%**	**0.9%**
Business and Labor	146.1	137.8	158.4	145.5	2.5	148.0	-6.6%	0.4%
Environment	214.2	219.0	245.1	221.0	0.6	221.7	-9.5%	1.1%
Central Costs	**$2,783.1**	**$2,835.4**	**$3,127.0**	**$3,084.8**	**$6.8**	**$3,091.6**	**-1.1%**	**3.6%**
Employee Benefits[4]	1,567.8	1,588.6	1,695.3	1,656.9	3.4	1,660.3	-2.1%	1.9%
Debt Service	1,215.3	1,246.8	1,431.8	1,427.9	3.4	1,431.3	-0.0%	5.6%
Other	**$976.5**	**$1,073.3**	**$1,180.5**	**$1,095.3**	**$4.0**	**$1,099.3**	**-6.9%**	**4.0%**
General Government	632.2	677.0	688.4	664.4	1.3	665.7	-3.3%	1.7%
Residual	344.3	396.3	492.1	430.9	2.7	433.6	-11.9%	8.0%
Total Budget	**$19,606.8**	**$21,019.2**	**$22,106.5**	**$22,522.4**	**$494.8**	**$23,017.2**	**4.1%**	**5.5%**
Adjusted for MBTA[3]			**$22,761.1**			**$23,688.2**		**6.5%**

1. Appropriations to date include amounts authorized in chapters 177 (the general appropriation act for 2002), 183-199 and 203, Acts of 2001, adjusted to include transfers to the Capital Needs Investment Trust and Registry revenues dedicated to the Central Artery.
2. Additional expected appropriations includes amounts needed for unavoidable expenditures in Medicaid and other non-discretionary accounts, as well as other anticipated supplemental authorizations.
3. In 2001, expenditures (and supporting sales tax revenues) for contract assistance to the MBTA were moved off-budget.
4. Does not include workers' compensation and unemployment insurance which are budgeted in agency accounts.

Fiscal 2003

As challenging as fiscal 2002 finances are, the outlook for 2003 is even more bleak. Based on the Foundation's analysis, in 2003 the state will face an enormous budgetary gap of over $1.2 billion, even after tapping $500 million of the state's reserves and level funding discretionary accounts. This shortfall comes despite an expected turnaround in the economy and recent efforts to pare the state's spending base, including some $500 million of cuts in the 2002 budget and workforce reductions due to the recently adopted early retirement program for state employees.

If 2002 tax revenues fail to reach the official estimate -- as seems increasingly likely given the shortfalls in collections in November and December -- the 2003 deficit will get much worse, rising to almost $1.6 billion.

The 2003 budget gap is largely attributable to an underlying structural imbalance -- the shortfall between expected revenues and expenses. The Commonwealth will end 2002 with an operating deficit of more than $800 million that is being largely offset by the use of the state's reserves. Unavoidable spending growth in non-discretionary accounts will widen that gap in 2003. To complicate matters further, any revenue growth in 2003 will be offset by the continuing impact of Question 4 and other previously enacted tax cuts. Given the size of the structural imbalance, the state faces multi-billion dollar shortfalls through fiscal 2005.[2]

[2] As reported in the Foundation's November 8, 2001 *News Release*, "MTF Analysis: State Faces Escalating Multi-Billion Dollar Budget Deficits; Major Spending Reductions Required."

2003 Revenues

This updated analysis assumes that baseline tax revenue growth will improve substantially from a projected three percent decline in 2002 to a three percent increase in 2003, the result of gradual economic recovery beginning in the middle of calendar 2002. This six percentage point swing will generate approximately $450 million in additional baseline tax receipts (before cuts) in 2003 (see Table 3).

However, this growth would be more than offset by the almost $500 million estimated impact of Question 4 in 2003, which cut the income tax rate from 5.6 percent in 2001 to 5.3 percent in January 2002 and 5.0 percent in January 2003. In addition, other cuts to be phased in will reduce 2003 revenues by another $90 million, including the scheduled increases in the dependent under 12 deduction and the senior property tax credit for lower-income senior citizens, as well as state revenue losses due to the federal estate tax changes. Taking the cuts into account, 2003 taxes will be approximately $120 million lower than estimated 2002 tax receipts.

Table 3
Fiscal 2003 Revenues
($, Millions)

Tax estimate for 2002 budget	$14,930
Baseline growth at 3 percent	448
Tax cuts:	
Question 4	(476)
Other	(93)
Total estimated 2003 taxes	14,809
Change from 2002	(121)
Annualized impact of expected tax shortfall in 2002	(285)
Adjusted change from 2002	(406)

While this decline is substantial, 2003 revenues will be even lower if 2002 taxes do not meet the current estimate, as now seems likely. The shortfalls through December -- extrapolated to 2003 -- would result in a further reduction of $285 million, bringing the total tax revenue decline in 2003 to more than $400 million.

Table 4
Fiscal 2003 Spending
($, Millions)

	Change from FY02	Percent Change
Unavoidable obligations and other commitments		
Medicaid* and employee health	$623	10.2
School aid, incl. special education	154	4.7
Debt service and contract asst.	111	5.7
Human services	102	3.0
Collective bargaining	103	--
Cash assistance	50	7.0
Pensions	14	1.5
Subtotal for these accounts	1,156	7.1
Early retirement savings	(124)	--
Total for all state government	1,032	4.5

* 50% reimbursed by the federal government.

2003 Spending

On the expenditure side, this analysis identifies the amount of additional spending required to meet contractual and other largely unavoidable obligations, while maintaining funding at the 2002 level for all other state programs. Based on estimates and reasonable assumptions about the likely growth in a set of key accounts, the analysis finds that 2003 spending would need to grow by almost $1.1 billion, or 4.5 percent, even after taking into account an estimated $125 million of savings from this year's early retirement program (see Table 4).

The largest of the obligations driving 2003 spending growth is health care, which is climbing at double-digit rates. Medicaid and employee health benefits alone will require $623 million of additional funding in 2003 ($354 million net of federal reimbursements). The state's commitment to maintaining local school funding in poorer districts at adequate levels will cost another $84 million -- a figure that would allow little or no additional aid for many better-off districts -- and implementing special education funding reforms adopted in 2001 will require as much as $70 million. Other increases include debt service and contract assistance on capital borrowing ($111 million), collective bargaining ($103 million based on recent trends), cash assistance ($50 million), and pensions ($14 million). Rising caseloads and the costs of consent decrees and other legal obligations are likely to add at least $102 million to expenditures for human services other than Medicaid and cash assistance.

2003 Balance

Table 5
2003 Fiscal Analysis
($, Millions)

	Amount	Diff. from FY02
Resources		
Taxes	$14,808	(121)
Nontax revenues*	7,448	352
Use of reserves	500	(306)
Additional tobacco receipts	60	0
Total Resources	22,816	(75)
Spending		
Unavoidable obligations and other commitments	17,488	1,156
Early retirement savings	(124)	(124)
All other expenditures	6,686	0
Total spending	24,049	1,032
Surplus/(deficit)	(1,233)	
Impact of additional FY02 problems:		
Tax shortfall to date	(285)	
Higher net Medicaid deficiency	(50)	
Adjusted surplus/(deficit)	(1,568)	

* The increase in nontax revenues is due almost entirely to higher levels of federally reimbursable Medicaid expenditures and assumed increases in lottery receipts earmarked for distribution to cities and towns.

Looking in combination at the revenue and spending sides of 2003 (see Table 5), the analysis projects a deficit of $1.23 billion, despite the use of $500 million of the state's reserves and $60 million of additional tobacco receipts (as authorized in the 2002 budget).

Even worse, this gap is almost certain to grow due to the recent shortfalls in tax collections (which would reduce the base of revenues for 2003) and the prospect of greater Medicaid deficiencies in 2002. Taking these additional factors into account, next year's deficit could approach $1.6 billion.

The cuts needed to eliminate a projected gap of $1.23 billion would require that overall 2003 spending be $200 million, or almost one percent, less than 2002 levels; a $1.57 billion gap would necessitate a decline in total spending of over $500 million, or 2.3 percent (see Table 6). In the previous fiscal crisis, spending fell below the prior year's levels in only a single year (1992), and then by only 1.5 percent.

These percentages, however, significantly understate the impact of the cuts. Much of the state's spending is concentrated in entitlements such as Medicaid and legal obligations like debt service. Other spending, such as education aid to the neediest school districts and funding to eliminate the huge, unfunded pension liability on schedule, reflects longstanding policy priorities and financial commitments. As a result, the cuts would fall heavily on human services, higher education and general aid to cities and towns.

Use of Reserves

The Foundation's projections of the 2003 budget gap assume that the House and Senate will live up to their agreement to limit use of the Commonwealth's rainy day fund to $500 million per year in 2003 and 2004, which would leave about $500 million for potential deficits in 2005 or beyond. Given the enormity of the budget shortfall facing lawmakers, the temptation to rely more heavily on reserves will be difficult to resist, especially in an election year. As previously noted, the agreement to draw on only $700 million in 2002 held up for just a few days.

Draining the rainy fund would leave the state ill-prepared to weather the multi-year fiscal problem it faces, necessitating deep spending cuts in 2004. The run on the reserves will be compounded if the Commonwealth ends fiscal 2002 several hundred million dollars in the red, as the Foundation's analysis suggests. With no time to achieve savings late in the year, drawing down the reserves to make up the shortfall would be inevitable.

Table 6
State Spending Growth
Fiscal 2001-2003

	Percent Growth
Fiscal 2001	8.3
Fiscal 2002	4.1
Fiscal 2003	
Before cuts to offset deficit	4.5
After cuts:	
To offset $1.2B deficit	(0.9)
To offset $1.6B deficit	(2.3)

Major Spending Categories

Tackling the state's fiscal problems will be complicated by the need to address major policy issues involving the programs that account for most of the spending -- and nearly all of the growth -- in the state budget. None of these cost centers is easily controlled. Medicaid, employee health benefits, debt service, cash assistance and some human services are largely non-discretionary legal obligations of the Commonwealth, while K-12 education, the senior pharmacy program and pensions represent expensive, long-term commitments with broad support from the state's leadership.

The policy questions take different forms but all relate to the level of funding required in 2003 and beyond. Health care's largely uncontrollable cost growth is a key source of the budgetary shortfalls. Economy-driven caseloads in cash assistance and human service programs are pushing up spending. The need to address the state's excessive backlog of capital projects, including finishing the Central Artery, threatens to accelerate the growth in debt service and contract assistance. Together, these challenges make it far more difficult to sustain the Commonwealth's pledges to support education reform, provide prescription drug benefits and eliminate the state's unfunded pension liability in the upcoming round of budget cuts.

Health Care

Over one quarter of the state's budget, a staggering $6.2 billion, is dedicated to health care programs, including Medicaid, health insurance for state employees and the new senior pharmacy program. With expenses for these programs rising ten percent or more each of the past three years -- and double-digit growth expected in 2003 and 2004 -- gaining financial control over health care costs is crucial to the Commonwealth's fiscal stability.

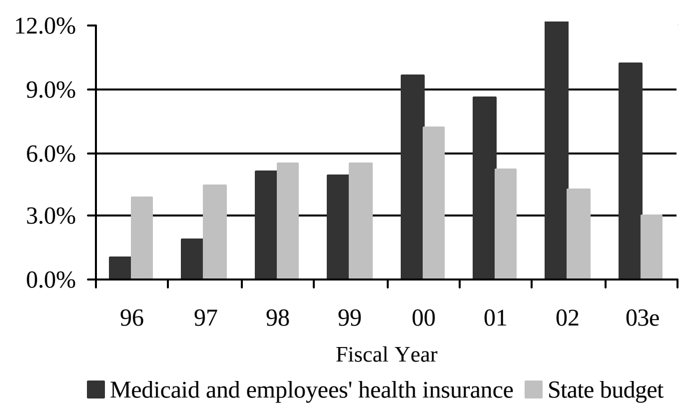
While health care has always been a major budget item, throughout the mid- and late-1990s Massachusetts' health care expenditures were increasing at a much slower rate than the overall growth in state spending. However, as Figure 3 reveals, since 2000 health care spending has climbed at a much faster pace than the total state budget. If current patterns hold, health care spending will grow from slightly less than 25 percent of the state budget in 2001 to 30 percent in 2004.

Medicaid

Medicaid, by far the largest of these programs, finances health care services for almost one million low-income and disabled Massachusetts residents, at a cost that will likely exceed $5.4 billion in 2002. A recent surge in enrollment along with greater use of health care services by recipients has caused expenditures to rise 22

Figure 3

Percentage Growth in Major Health Care Programs and Total State Budget



percent since 2000, with every indication that the program's costs will reach $6 billion in 2003. Even the ten percent growth rate projected for next year underestimates the program's actual costs, since it assumes that the state will continue its policy of granting only marginal increases in provider reimbursement rates, which are already well below the actual cost of delivering most services.

Coinciding with the slumping economy, Medicaid enrollment grew almost seven percent during calendar 2001, as more than 60,000 individuals were added to the rolls. This increase comes after a 15-month period -- October 1999 through December 2000 -- when enrollment grew by less than two percent, or fewer than 15,000 people (see Figure 4). A prolonged recession may cause thousands more to enroll in Medicaid, pushing costs even higher.

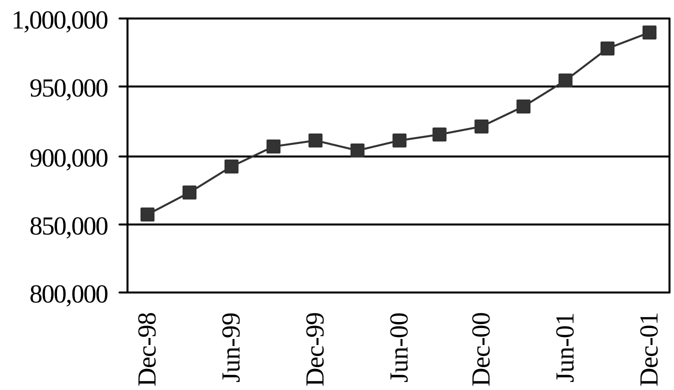
While the rise in enrollment has been a major cost driver, the average cost per Medicaid recipient has jumped from $4,700 in 2000 to more than $5,100 in 2002, as recipients increase their use of health care services. Elderly and disabled individuals are depending on community-based long-term care to a much greater extent, with expenses rising 35 percent in two years. Pharmaceutical expenditures have grown more than $200 million, or 31 percent, since 2000, due to a large jump in the number of prescriptions filled and the rising cost of newer drugs. In addition, hospital inpatient and outpatient use is on the rise, with the state's Division of Medical Assistance expecting these costs to increase 15 percent in 2002.

While expenditures are growing, Medicaid's reimbursement rates to health care providers remain woefully inadequate. Despite the fact that this well-documented problem has caused severe financial difficulties for providers across the state, the Commonwealth continues to grant only minimal rate increases.

Payments to nursing homes -- which increased less than three percent annually from 1998 through 2001 -- are slated to grow by less than two percent this year. Nursing home operators are seeking an additional $200 million from the state to fully cover their costs.

Figure 4

Change in Medicaid Enrollment



Reimbursement rates for hospitals are among the lowest in the nation, with last year's state-funded study showing that Massachusetts' Medicaid payments cover about 70 percent of hospitals' costs, approximately $200 million less than the cost of care. Yet rates are expected to rise only two percent this year.

Continuing this policy of below-cost payments will aggravate the fiscal problems of many health care providers. Although the state provided a total of $70 million in supplemental financial assistance to distressed providers in 2001 and 2002, a systematic change to the Medicaid payment system -- including higher reimbursement rates for providers and greater use of lower-cost community hospitals -- should be a priority for the Commonwealth.

State Employees' Health Insurance

Similar to Medicaid, the cost of state employees' health insurance has surged in recent years, increasing nine percent in 2001 and ten percent in 2002, with 2003 costs expected to jump at least 12 percent. Unless changes are made, the state will spend close to $800 million for employees' health insurance in 2003.

Given the increase in health care costs, the administration's annual proposal to reduce the state's share of employees' premiums from 85 percent to 75 percent deserves to be approved by the Legislature. While this initiative would save the state about $50 million if applied to active employees, other cost containment measures may also be necessary. The Group Insurance Commission, the agency responsible for administering health insurance for state employees, may need to establish higher deductibles and co-payments for all state workers and reduce the range of services covered. The Commission should also consider the costs and benefits of offering two-tiered plans that would allow employees to select a health plan with appreciably higher deductibles and co-payments, offset by lower premiums.

Senior Pharmacy Program

Complicating matters further, the latest addition to the state's health care programs, the comprehensive senior pharmacy program unveiled in April of 2001, will be even more difficult to fund as enrollment grows and prescription drug expenses climb 15 to 20 percent each year. The program's annual costs are likely to exceed $200 million in just a few years, compared to $100 million in 2002. Although envisioned as a short-term measure to assist seniors and the disabled pay for the rising cost of prescription drugs while the federal government crafted a Medicare prescription drug benefit, the return of federal deficits makes it unlikely that Congress will approve a drug benefit for Medicare beneficiaries any time soon.

Education Aid

Under the education reform law adopted in 1993 -- partly in response to a court suit challenging the Commonwealth's funding of local education -- the state has an ongoing obligation to ensure adequate spending in every district, with increased aid for communities lacking the resources to support this level of school spending on their own. Over the last nine years, aid to schools has been the state's foremost fiscal priority, with double-digit annual aid increases that brought all districts up to the reform law's "foundation" standard of adequate spending in fiscal 2000.

In fiscal 2003, the Department of Education estimates that $84 million will be needed to keep spending in all districts at the reform law's "foundation" standard and maintain per pupil expenditures in each school district at the fiscal 2002 level.

While this additional funding will sustain the state's core financial commitment under education reform, it is a far cry from this year's $224 million increase. It also provides little fiscal flexibility for potential revisions to the education funding formula, which is widely regarded as problematic because of its complexity, poor approach to dealing with rapid enrollment growth in better-off districts, and inequities inherited from the pre-reform distribution of aid. Unfortunately, these disparities have only been compounded in fiscal

2002, with a final distribution that reflected no coherent approach to determining each district's funding need, but instead based aid upon the highest amount calculated under three competing formulas.

In addition, as much as $70 million of new funding will be needed in 2003 to implement the state's new "circuit breaker" reimbursement program for extraordinary special education costs. Adopted in the 2001 budget, the program will roughly double the amount of state assistance for the local costs of educating special needs students. While the program is scheduled to go into effect in July 2003, its funding may not be included in the administration's fiscal 2003 budget proposal: Citing budget uncertainties, the commissioner of education has advised districts not to assume the higher level of reimbursement which the circuit breaker would provide in preparing their budgets for 2003, but instead to plan for a continuation of the existing "50/50" special education cost sharing program.

Cash Assistance

After years of significant decline, cash assistance costs are growing rapidly, driven by rising caseloads in a recessionary economy. An increase in the welfare population and the number of homeless families requiring emergency housing has produced a nine percent increase in cash assistance spending, from $651[3] million in 2001 to $712 million in 2002, following a five percent decrease in 2001. The expected need for supplemental funding could bring the 2002 growth to eleven percent. Cash assistance spending is likely to grow by close to this pace in 2003 as well.

Transitional Aid to Families with Dependent Children (TAFDC)

TAFDC, the largest cash assistance program, replaced the former federal welfare program -- Aid to Families with Dependent Children -- in 1996, and provides benefits primarily to single mothers with young children. The Massachusetts welfare caseload declined more than 60 percent from its peak in May 1993 (roughly 114,000) to its low of 42,013 in July 2001 (see Figure 5). However, as the economy dipped into a recession, the caseload began to rise in August, increasing by nearly 4,000 cases to 45,979 in December.

The $305 million budget for TAFDC benefits in 2002 is $17 million or six percent above 2001 appropriations, based on an expected average monthly caseload of 45,000. However, if the trend since July continues through the rest of the year, the average caseload will approach 46,500, requiring an additional $10 million and driving TAFDC costs up almost ten percent over 2001.

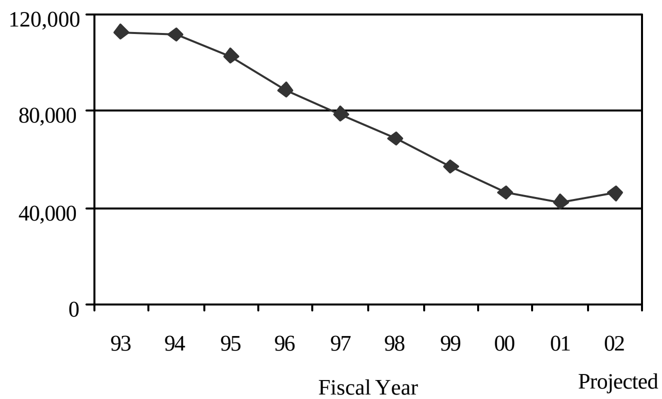
Complicating the picture is the return of former recipients to the welfare rolls. Massachusetts limits welfare recipients to two years of benefits within a five-year period. The first group of recipients reached their limit in December 1998 and can now return to the rolls if they meet other eligibility requirements. More than 15,000 recipients have lost benefits because they reached the time limit, and each month a new group of former recipients could begin collecting benefits again.

As the economy begins to recover, the growth in caseloads is likely to slow later this year. However, returning recipients make it highly

[3] Because of transfers of funds to other departments, DTA's 2001 spending figure of $640 million understates the total spending from cash assistance accounts, so 2001 budget figures are used as a fairer basis of comparison in this section.

Figure 5

TAFDC Caseloads FY96-02



unlikely that the caseload will decline. The Foundation conservatively projects TAFDC expenditures to increase by close to ten percent and approach the $350 million range in 2003.

Though much smaller than TAFDC, emergency assistance for family shelters is the other cash assistance program that is growing rapidly, partly because of more generous eligibility requirements. Expenditures jumped 63 percent in 2002, from $41 million to $68 million. Costs are likely to exceed $80 million in 2003.

Supplemental Security Income and other cash assistance programs are experiencing smaller growth.

Federal Funding

To complicate the fiscal picture, Massachusetts may face a cut in annual welfare assistance from the federal government with the expiration in 2002 of the five-year Transitional Aid to Needy Families (TANF) block grant. The state's annual TANF funding of $459 million is based on the 1992-1994 period when caseloads were more than double current levels. If reauthorization is based on spending for the now drastically lower caseload, Massachusetts could see a significant reduction in federal monies.

An increase in caseloads or reduction in federal funding could be partially offset by the state's caseload mitigation fund. Years of declining caseloads allowed the state to transfer $128 million of unused block grant and state monies to a reserve fund in 1997 to be used if caseloads increase significantly. In 2000, another $22 million was transferred to the fund, which with interest has brought the balance to $156 million, slightly less than a quarter of total annual spending on cash assistance and support services.

Human Services

While many human service programs have enjoyed significant funding growth during the recent period of fiscal plenty, legal requirements are mandating further increases in spending, particularly in the Departments of Mental Retardation (DMR), Mental Health (DMH) and Social Services (DSS). The *Boulet* lawsuit settlement required $15 million in 2002 and an additional $25 million in each of the next four years to eliminate DMR's long waiting list for services. The threat of a similar lawsuit is behind more modest funding increases for DMH.

DSS is required by statute to provide foster or group care to children at risk of abuse or neglect, and soaring caseloads are driving costs up by $55 million or nine percent in 2002, with continued growth expected in 2003. Collective bargaining agreements to limit caseloads of individual social workers add to the cost.

Looking ahead, the demand for subsidized child care will inevitably rise as welfare caseloads grow during the economic downturn. Regardless of the duration of the recession, budget makers will face continued pressure to more adequately fund salaries at private agencies that provide the bulk of human services and stave off a breakdown in the Commonwealth's ability to care for its most needy residents.

State Employee Pensions

One of the greatest challenges confronting state leaders is to maintain the Commonwealth's efforts to pay off its huge unfunded pension liability -- almost $6.4 billion according to the most recent official estimate -- by 2018. Given the tremendous budgetary pressures, the temptation will be enormous to find unwise "savings" in the scheduled annual pension payment in 2003 and future years.

Unfortunately, the administration has already advanced a plan to sharply reduce annual pension funding in 2002 and extend the planned repayment period by a full decade. This would reverse a major gain of the 1990s -- the decision in 1997 to take advantage of strong stock market performance to accelerate the repayment of the unfunded liability -- which helped the state win an upgrade in its credit rating. More importantly, it would irresponsibly burden future taxpayers in order to avoid the tough decisions required to implement Question 4's 15 percent income tax cut in the midst of a recession.

In rejecting the Governor's pension proposal, the Legislature committed to a funding level of just over $900 million in 2002, with modest increases in 2003 and 2004, after which the payment schedule would be revised to reflect changes in the value of pension assets and the costs of future benefits already earned by current employees and retirees. It is important to note that even this positive step falls short of what will be needed to eliminate the unfunded liability by 2018, as the law requires. Based on the most recent estimate of the liability, which takes into account stock market performance through January 1, 2001, an additional $100 to $200 million of annual pension funding is needed to erase the unfunded liability on schedule. Furthermore, the early retirement program is estimated to add $35 million a year to pension costs. Against this backdrop, proposals to reduce annual appropriations represent a serious retreat from the important pension funding gains of the last decade.

Capital Investments and Debt Service

Nearly ten percent of the budget goes to repaying the debt that finances the majority of the state's capital spending, both directly through debt service on the Commonwealth's bonds, and indirectly through contract assistance to authorities and local governments that undertake capital projects with their own bonds (see Table 6). The Foundation estimates costs will increase by nearly six percent to $2.1 billion in 2003.

In the 2002 budget, debt service on Commonwealth bonds and notes totaled $1.43 billion, rising by a modest $27 million or 1.9 percent.[4] Most of the increase is the result of payments on $1 billion in bonds issued to help cover $2.1 billion in cost overruns on the Central Artery project.

Debt service costs will climb more steeply in fiscal 2003 as the state continues to issue new bonds faster than old bonds are retired. The Foundation expects an increase of about $80 million or 5.7 percent, but interest rates and the timing of bond issues could significantly affect this projection. The jump is entirely the result of long-term general obligation bonds issued under the administration's bond cap; debt service on other debt is expected to remain constant.

In fiscal 2002, the administration, with the Foundation's support, raised the annual bond cap from $1.0 billion to $1.2 billion to help address a long backlog of capital needs awaiting funding. The increase in the cap will eventually add a modest $16 million to the state's annual debt service costs, but because of lags in bond sales and initial payments, most of the added cost will not be felt until 2004.

Much of the growth in the state's debt and debt service costs over the last few years is the result of the Registry fee-backed bonds and Grant Anticipation Notes issued outside of the bond cap to help finance the Central Artery. The specter of further cost overruns on the $14.5 billion project requiring additional Commonwealth contributions leaves the state vulnerable to sharper increases in debt service costs in the future.

Capital financing outside of the bond cap also takes the form of contract assistance to a variety of quasi-independent authorities and local governments to help pay their debt service costs. In total, these indirect debt service payments rose by $63 million or 14 percent in fiscal 2002, primarily as a result of greater support for school building assistance and water pollution projects (see Table 6). In addition to these appropriations, the Commonwealth supports MBTA debt by dedicating one-fifth of its sales tax revenue to the T. In 2002, over $300 million of the T subsidy will cover debt service costs.[5]

School building assistance (debt service subsidies for school construction bonds issued by cities and towns) has been one of the state's fastest growing programs, with a $45 million or

Table 6

Major Investments in Capital

($, Millions)

	FY 2001 Actual	FY 2002 Budget
Debt service on Commonwealth capital bonds	$1,404.3	$1,431.3
School Building Assistance	316.5	361.5
MWRA sewer rate relief	53.9	58.7
Water Pollution Abatement Trust	47.9	55.8
Convention Center Authority debt assistance	24.6	20.4
Mass. Development Finance debt assistance	13.3	13.3
Mass. Turnpike Authority operating subsidy	2.5	7.7
Other	6.4	11.1
Total	$1,869.4	$1,959.7

[4] Including a yet-to-be passed supplemental request from the Governor for $3.4 million for interest costs on Grant Anticipation Notes.

[5] The MBTA subsidy is treated as off-budget and therefore does not appear in the spending figures in this report.

14 percent increase in 2002. In response to the state's tightening finances, the Board of Education approved only $20 million in new projects in 2002, fewer than authorized in the budget and less than half of the $51 million approved in 2001. Nevertheless, total costs are still expected to rise by $25 million or seven percent in 2003, and the Commonwealth will be under enormous pressure to expand funding even more rapidly in the future to meet the tremendous demand for school construction and renovation.

In addition to debt service and contract assistance, the Commonwealth also meets some of its capital needs with pay-as-you-go spending in the operating budget. As the budget grows tighter, such spending is often the first to be cut. The Capital Needs Investment Trust Fund -- a five-year plan to spend $225 million on affordable housing, education technology and building repairs adopted in the 2001 budget -- survived intact in 2002 despite several proposals to reduce the state's commitment, but is likely to be targeted again in 2003. The year-end budget surpluses enjoyed by the state in recent years have also been major funding sources for capital projects such as the Central Artery, statewide road and bridge program, Chapter 90 local transportation aid, and local water projects. However, the end of such surpluses will only compound the capital funding shortfall and push the state to rely even more heavily on debt financing.