Massachusetts Taxpayers Foundation

333 WASHINGTON STREET
BOSTON, MA 02108-5170
617-720-1000
FAX 617-720-0799

Bulletin

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Missed Opportunity in 2002 Creates Larger Fiscal Problem in 2003

As the House prepares to unveil its budget plan for 2003, the state faces a large multiyear structural deficit that has not been addressed -- despite the efforts of the Governor, Senate President and Speaker of the House to reach agreement on a solution to the budget shortfall in 2002.

The leadership's $700 million plan for fiscal 2002 is the final step in closing a more than $1.6 billion gap[1] between operating revenues and budgeted spending. As part of their agreement, the officials have also adopted a conservative revenue estimate for fiscal 2003, a critical step in putting the state's finances back on track.

However, while the spirit of cooperation among the state's top leaders is a favorable development, it comes much too late to produce structural solutions to the huge mismatch between revenues and spending in 2002. The announced measures for dealing with this year's red ink include only modest cuts in spending -- other than a problematic plan to push pension costs into future years -- and instead draw too heavily on the state's reserves. As a result, the Commonwealth still faces an enormous challenge in bridging an even larger $2 billion deficit in the budget for fiscal 2003, which begins in two months.

Table 1
The Fiscal 2002 Problem
$, millions

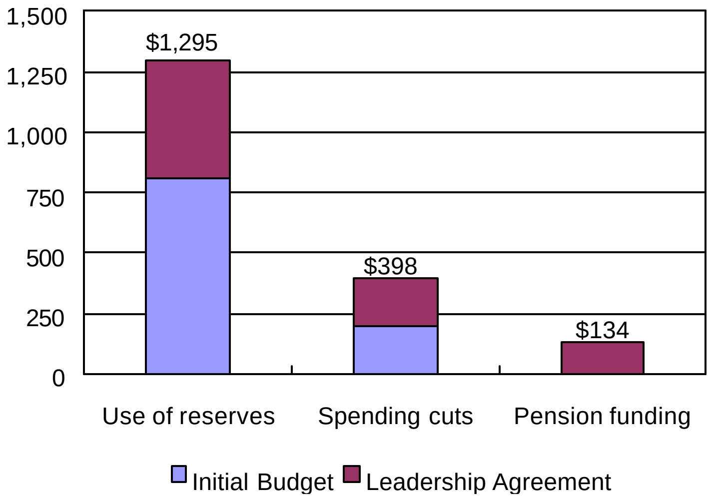
	2001	2002	Change
Revenue	$22,867	$21,158	($1,709)
Spending	22,106	22,785	679
Surplus/(Deficit)	760	(1,627)	

The fiscal 2002 problem is largely the result of a sharp drop in revenues that began last fall. With the steep declines in the stock market, tax receipts from capital gains, bonuses and stock options have plummeted, removing at least $500 million from the revenue base. Employment losses from the mild economic recession -- and the impacts of September 11th -- have added even further to the state's revenue troubles. The phasing in of Question 4 and other previously authorized tax cuts have

[1] This amount excludes an additional $200 million shortfall which was offset by cuts in the House and Senate versions of the budget that brought 2002 appropriations below the 2001 levels of spending in human services, higher education, revenue administration and the courts.

Figure 1

Actions to Resolve Fiscal 2002 Shortfall
($, millions)



reduced 2002 revenues by another $700 million. While total revenues are falling by $1.7 billion, the budget adopted in November provides for spending increases of $680 million after accounting for additional unavoidable appropriations for Medicaid and other programs (see Table 1).

Unfortunately, the solutions that have been adopted or proposed by the state's leaders for 2002, while likely to ensure that the state's bills get paid, do little to address the multiyear structural imbalance between revenues and spending. To close the 2002 gap the proposed solutions rely much more -- by a margin of more than three to one -- on the use of one-time reserves than on reductions in the spending base (see Figure 1). In total, almost $1.3 billion will be drawn from reserves in 2002, including $800 million authorized at the time the budget was adopted and almost $500 million more proposed in the leadership agreement (detailed in Table 2). Another $134 million will be generated by reducing the 2002 contribution to the state's massive unfunded pension liability.

In contrast, spending cuts comprise only $400 million of the package of fiscal solutions. Faced with declining revenues in the early part of fiscal 2002, lawmakers reduced this year's budget by $200 million below 2001 in higher education, human services, revenue administration, the courts, and other areas. However, despite the ensuing months of further drops in revenues -- and broad recognition that more cuts in the state's spending base will be necessary to reduce the expected deficits in future years -- the Commonwealth's leaders have only been able to agree on $200 million of additional cuts in a budget totaling approximately $23 billion. The cuts include $132 million in reductions announced by the Governor in early February, of which at least $32 million reflects savings from one-time

Table 2
Use of Reserves in Fiscal 2002
($, millions)

Rainy day fund	$979
Capital reserves	138
Tobacco dollars	60
Welfare caseload reserves	50
Medical security trust	41
Tax reduction fund	27
Total	$1,295

expenditures, $40 million of non-recurring savings from debt refinancing, and $24 million of yet-to-be-identified additional reductions.

The fiscal challenges confronting the state's leaders remain immense. With the mild economic recovery, the pace of growth in baseline tax receipts is expected to be modest in 2003. That growth will be more than offset by the impact of Question 4, which reduced the 5.6 percent income tax rate to 5.3 percent in January 2002, with a further decline to 5.0 percent in January 2003. Reflecting those realities, the leadership's consensus tax forecast for the coming year -- $14.72 billion -- is actually lower than expected 2002 revenues. At the same time, the state faces continuing cost pressures, particularly in health care, that will unavoidably drive up 2003 spending.

In addition, initiatives that held out some hope of partially relieving the stress on 2003 finances are falling short of expectations. While the early retirement program for state employees was projected to save $125 million in 2003, that target is not likely to be met because participation has been lower than expected. Although the proposal to increase the state's return on the lottery by reducing prize payouts continues to deserve consideration, it now appears to be administratively impractical to realize even a fraction of the administration's $275 million estimate of revenues from this proposal in 2003.

Against this backdrop, the failure to agree on significant spending cuts in fiscal 2002 will make it much more difficult to achieve a balanced budget in 2003. As a result of the overreliance on reserves in 2002, the state is consuming almost half of the balance in the stabilization fund in a single year, as well as drawing heavily on other reserves originally dedicated to other purposes. Despite the recent steps toward fiscal cooperation among the state's leaders, the danger of using up the remaining reserves in 2003 is now greater than ever. Such a course of action would leave a huge structural deficit in place that could only be addressed by major tax increases and harsh budget cuts in 2004.

The reluctance to tackle the underlying structural deficit in fiscal 2002 only increases the need for a more balanced approach in 2003. The Foundation continues to recommend a three-pronged strategy for addressing the state's multiyear fiscal problems, including cutting spending by an additional $700 million in 2003, restoring the income tax rate to 5.6 percent and tying future rate reductions to the pace of growth in the state economy -- a change that would generate $700 million of additional revenue in 2003, and using no more than $500 million of reserves annually.