February 4, 2002

Governor's 2003 Budget: Failing to Close the Gap

While the Governor has publicly acknowledged that the Commonwealth faces multi-billion dollar fiscal shortfalls over the next several years, the administration's proposed budget does not come close to filling the gap in 2003, much less meaningfully address the state's longer term financial problems.

The shortcomings of the Governor's budget are particularly serious given the size of the 2003 gap -- between $1.7 and $2.1 billion according to MTF's estimates[1] -- and the news of a $185 million shortfall in tax collections in January. With the January revenue losses, the 2003 gap will almost certainly be at the top end of this range, and could rise higher, on top of what could be as much as a $500 million shortfall in fiscal 2002.

Although the administration's $23.6 billion spending plan for 2003 (commonly known as "House 1") includes several positive elements -- most notably, a reasonable estimate of Medicaid cost growth and funding increases for Chapter 70 school aid and special education -- those factors are more than offset by a long list of risky, dubious, or unwise assumptions which total well more than $1 billion (see Table 1):

- The budget forecasts $300 million more of baseline tax revenue growth (before tax cuts) than the Foundation believes is prudent, assuming a 5.1 percent rate of increase that is higher than the administration's forecasts of baseline growth in any of the previous six budgets.
- The Governor proposes to use $750 million of the state's reserves, $250 million more than agreed to by legislative leaders, to fund the 2003 budget, depleting rainy day funds that will be needed in 2004 and 2005. The state has already committed to using $806 million of reserves in 2002, a figure that will almost certainly increase given the continuing decline in tax receipts in recent months.
- Another $275 million of revenues depends on reducing the portion of lottery earnings devoted to prizes and diverting the proceeds -- which otherwise would be distributed to cities and towns -- to balance the budget. The receipts from this untested proposal could well fall short of projections, and, unwisely, the administration proposes to draw further on the state's reserves to make up any shortfall if sales do not meet the $275 million estimate.

Table 1
Problematic Elements of Governor's Proposed FY03 Budget
$ Millions

Risky tax growth assumption	$300
Reliance on untested new lottery receipts	275
Overuse of rainy day reserves	250
Revenue deficiency in children's & seniors' health care fund	200
Unwise pension "savings"	129
No provision for new collective bargaining costs	??
Uncertain early retirement savings	??
Other underfunding	75
Total	$1,229

1 As detailed in the Foundation's annual report on state spending, *State Budget '02: Heading for a Crash*, released last month.

- At the same time, revenues supporting the costs of earlier Medicaid expansions in the children's and seniors' health care fund are at least $200 million less than proposed expenditures -- a fact that is largely obscured in the 2003 balance sheet presented in the budget.
- Despite the Legislature's rejection of a similar plan in December, the Governor is again proposing to cut pension funding dramatically in 2003 -- by $129 million or 14 percent -- at a time when the state's pension obligations are growing rapidly as a result of market losses in the value of pension assets and the impact of expensive early retirement programs.
- The budget apparently makes no provision for the likely costs of newly negotiated collective bargaining agreements, which have averaged $115 million a year for the last several years. While the administration may be able to negotiate smaller increases given the state's economic and fiscal situation, some new costs will be unavoidable. With no contingency amounts set aside to meet these costs, funding will depend on the availability of reversions (unspent funds in other programs) which are likely to be scarce in view of the budget cuts.
- While the early retirement program for state employees has the potential to generate significant savings in 2003 -- if the administration adheres to the program's 20 percent limit on rehires -- the size of those savings depends on participation rates that are still unknown. As a result, the budget's $136 million estimate of savings from early retirement could be overstated by tens of millions of dollars.
- Finally, the 2003 budget underfunds known obligations by at least $75 million, including $40 million or more for employee health benefits (a figure which takes into account the benefit changes and increases in co-pays recently approved by the Group Insurance Commission), and $35 million of additional annual pension costs arising from the early retirement program for state employees.

There are some indications that the Governor's yet-to-be-released health care proposal may address the deficits in the children's and seniors' health care fund

Table 2
Major Spending Increases from 2002 Governor's Proposed FY03 Budget
$ Millions

Medicaid	$576
Chapter 70 school aid	100
Debt service/contract asst.	88
Cash assistance	55
Special education	48
Social services	46
Mental retardation	44
School building assistance	24
Subtotal	981
Net reductions in other accounts	(377)
Total increase over 2002	$603

Table 3
Major Spending Cuts from 2002 Governor's Proposed FY03 Budget
$ Millions

Early retirement	$136
Pension funding*	115
Capital needs	45
Smoking cessation	44
Water/sewer rate relief	20
Charter school reimbursements	16
Other net reductions	1
Total	$377

The current funding schedule requires a $14 million increase in 2003, or a total of $129 million more than proposed by the Governor.

and provide some funding to increase reimbursement rates for providers, which fall $400 million or more short of the cost of services. Unfortunately, that initiative is almost certain to rely on tobacco settlement reserves and other one-time funding sources to meet these ongoing obligations, an unsustainable approach that will only delay the inevitable need for significant modifications to the Medicaid program to rein in double-digit growth in costs.

In view of these major fiscal shortcomings, the administration's budget submission clearly fails the test of fiscal responsibility. Given such a shaky start to the 2003 budget process -- and the potential for further deterioration in the state's financial condition in the coming months -- lawmakers face an enormous challenge in crafting sound solutions to the state's multi-year fiscal problems.

Table 4
Significant Risks in the Governor's Fiscal 2003 Tax Forecast
$ Millions

- Despite the negative revenue performance in the last three months, the Governor's budget assumes 2003 baseline tax growth of 5.1 percent (before tax cuts), a large increase over the administration's 3.9 percent forecast in October.
- The 5.1 percent increase is higher than the tax growth projected by the administration for the last six budgets, even though the state is in the midst of a recession. The tax forecast appears to be predicated on a substantially stronger -- and earlier -- rebound in the state economy than now seems likely.
- The administration's forecast of 2002 revenues -- on which the 2003 forecast is built -- is at least $100 million higher than recent trends suggest.
- January collections for 2002 fell $185 million, or 10.5 percent, below expected revenues for the month, a decline that is not reflected in the budget's tax forecast.

Tax Revenues

The Governor's budget forecasts $14.93 billion of tax revenues in 2003, a figure that assumes 5.1 percent growth in baseline taxes (before adjusting for tax cuts). This growth is offset by the effects of Question 4 and other previously enacted cuts, resulting in an estimate of actual tax growth of 1.2 percent.

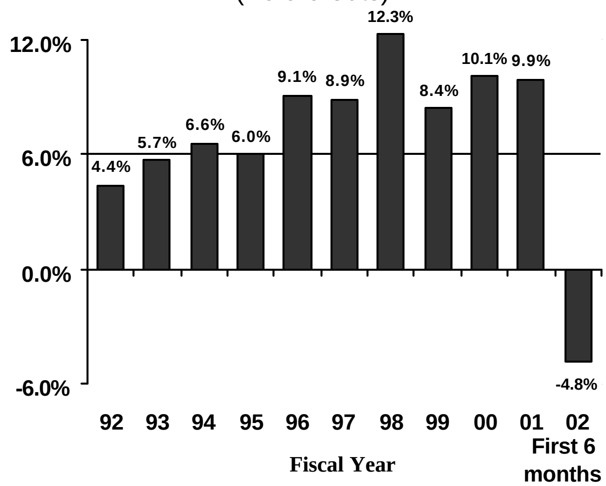
In the Foundation's view, this tax forecast is one of the riskiest aspects of the administration's budget plan (see Table 4). The 5.1 percent rate of baseline tax growth is a substantial increase from the administration's October estimate of 3.9 percent, despite the poor revenue performance of the past three months. It is two full percentage points -- or more than $300 million -- higher than MTF's estimate of three percent, a rate of increase that already factors in an economic recovery in mid-2002. As shown in Figure 1, a 5.1 percent increase would require an implausible 10 percentage point swing in revenue performance from the almost five percent decline in baseline taxes in the first six months of the current fiscal year. Tellingly, the 5.1 percent figure is higher than the administration's forecasts of baseline tax growth in any of the last six gubernatorial budgets.

Adding further to the risk, the budgetary tax forecast for 2003 is built on a projection of 2002 tax revenues that is almost $100 million higher than MTF's $14.65 billion estimate, a figure that takes into account the under-performance in tax receipts through December but does not reflect the $185 million shortfall in January (see Table 5).

Figure 1

Tax Revenue Growth

(Before Cuts)



Lottery Revenues

The administration's 2003 budget also relies on $275 million of uncertain revenues from a proposal to reduce the share of lottery receipts that are paid out as prizes. For the next three years, the additional annual revenues would be used to help balance the state budget while lottery aid to cities and towns would be capped at the fiscal 2002 level.

As the Governor's budget notes, Massachusetts currently pays out more in prizes than any other state, about 71 percent of revenues. According to the administration, reducing that percentage to 63 percent would bring Massachusetts into line with the average prize of the ten state lotteries with the highest payout rates.

Although changing the payout ratio may have merit (the Foundation has not yet analyzed the proposal in detail), using the expected additional revenues to help balance next year's budget introduces additional risk into 2003 finances. While the administration's revenue projection is based upon extensive analysis of the potential losses in lottery sales because of reduced prizes, the reality is that there is a large element of uncertainty in any such estimates. To offset the revenue risk, the administration unwisely proposes to cover any shortfall with withdrawals from the state's rapidly diminishing rainy day reserves.

Apart from these fiscal questions, the plan to divert all of the additional revenue to the general fund -- while level-funding lottery aid to cities and towns for the next three years -- faces an uphill battle with lawmakers, many of whom fought successfully in the mid-1990s to overturn a highly unpopular cap on lottery aid that was imposed during the state's last fiscal crisis.

Use of Reserves

Given the enormous, multi-year budget gaps that the state now confronts, the Foundation continues to urge that the Commonwealth's stabilization reserves be carefully rationed through fiscal 2005, with withdrawals limited to no more than $500 million per year. Without such discipline, the state could run through its $2.3 billion of reserves in as little as two years, ending fiscal 2003 with no remaining fiscal cushion and the prospect of huge budget gaps in fiscal

Table 5

Fiscal 2002 and 2003 Taxes
$, Millions

	MTF	House 1	Diff-erence
FY 2001 actual	$16,075	$16,075	--
FY 2002			
Estimate for budget	14,930	14,930	--
Adjustment for shortfall through December	(277)	(185)	92
Revised estimate	14,653	14,745	92
FY 2003			
Baseline growth			
Assumed percent	3%	5.1%	2.1%
Amount	440	752	312
Impact of tax cuts			
Question 4	(476)	(476)	--
Other cuts	(93)	(93)	--
Total	(569)	(569)	--
Estimate	$14,524	$14,928	$404

2004 and 2005.

While the legislative leadership has agreed to hold annual reserve withdrawals to $500 million in fiscal 2003 and 2004, the state has already approved plans to withdraw $806 million from reserves in fiscal 2002. State leaders will almost certainly have to tap the reserve funds for several hundred million dollars more in 2002 to offset the continuing revenue declines. With the fiscal year more than half over, it would be virtually impossible to make up such a shortfall through spending cuts.

Despite the consensus among legislative leaders, the Governor proposes to use $750 million of reserves in fiscal 2003, $250 million more than the Foundation believes is prudent. Furthermore, that figure is apt to grow -- rather than shrink -- as the House and then the Senate develop their versions of the 2003 budget.

The administration's recommendation for the use of reserves in fiscal 2003 stands in contrast to its criticism of the Legislature for overuse of stabilization funds in 2002. In vetoing $255 million of the legislatively approved $806 million withdrawal (a veto which was subsequently overridden by lawmakers), the Governor cited the need to protect the state from revenue shortfalls that would continue into the coming fiscal years.

Table 6
Governor's Fiscal 2003 Health Care Budget
$ Millions

+ Recommends $576 million of additional Medicaid appropriations, a 10.7 percent increase that appears reasonable given recent growth trends in the program.

  Underfunds employee health costs by at least $40 million, even with the savings from the increase in copayments and deductibles recently approved by the Group Insurance Commission.

? Leaves unaddressed the critically important budgetary issues of below-cost reimbursement rates for health care providers and funding for uncompensated care, which reportedly will be dealt with in a separate, yet-to-be-unveiled health care proposal.

Health Care

Medicaid For the first time in years, the Governor's budget appears to adequately fund the rapidly growing Medicaid program, at a cost of almost $6 billion in 2003, $576 million more than 2002 (see Table 6). Spending on Medicaid -- which covers one million residents -- is growing 10 percent or more annually and comprises a major share of the increased spending in the Governor’s 2003 budget proposal.

Even as Medicaid expenditures are spiraling out of control, these costs will grow even higher if the state is to address the long overdue, and well-documented, problem of below-cost reimbursement rates for health care providers. A separate health care proposal, which has not yet been unveiled by the administration, reportedly will call for increases in Medicaid payments for hospitals, nursing homes and other providers -- adding tens of millions of dollars to health care expenses -- as well as cover a major hole in the proposed 2003 budget, a $200 million shortfall in revenues supporting prior Medicaid expansions in the children's and seniors' fund (see Table 7).

While the Foundation strongly supports proper payments for providers, MTF is troubled by the reported use of tobacco settlement reserves or other one-time funds to pay for this initiative. Draining these accounts to pay for ongoing obligations is clearly unsustainable and will only delay the inevitable major effort needed to control the growth of Medicaid and other health care spending.

Table 7

Children's and Seniors' Health Fund:
A $200 Million Hole in the Proposed Budget
$ Millions

Under the administration's proposed 2003 budget, revenues will fall short of expenditures by at least $120 million in 2002 and $210 million in 2003 in the fund created in 1996 to support Medicaid expansions. In 2001, the deficit in the fund was $13 million.

The shortfall is largely due to the fact that a planned $170 million from the Uncompensated Care Pool to fund the expansions did not materialize. The pool pays hospitals and community health centers for services to uninsured and underinsured individuals and is funded through a combination of hospital assessments and state dollars.

As part of the original financing plan, the state assumed that increased Medicaid enrollment would reduce the amount of free care provided by hospitals, thereby allowing the state to transfer monies from the pool to the Medicaid program. Although the number of uninsured has declined, the amount of free care has not.

Employee Health Benefits The state's share of employees' health insurance costs will likely grow by at least $70 million, or 10 percent, next year, although the Governor's budget supports only a four percent increase in spending. As a result, lawmakers will need to add at least $40 million more to the House 1 budget or, as businesses across the nation are doing, require employees to pay a larger portion of their health insurance premiums.

Recognizing that health care spending is returning as a budget buster, the Group Insurance Commission -- the state agency responsible for administering health insurance for state employees -- has already approved an increase in the co-payments and deductibles paid by state workers. These changes -- which take effect in 2003 and may save the Commonwealth $30 million annually -- include doubling the co-payments for prescription drugs and for emergency room visits that do not result in a hospital admission, and instituting a new $200 deductible for hospital inpatient care.

However, given the likely continuation of double-digit increases in health care expenses, even with the changes in co-payments and deductibles cited above, the Commonwealth should consider reducing the state's share of employees' health insurance premiums. Although the Governor, unlike past years, did not propose that employees pay 25 percent of their premiums, compared to 15 percent currently, the Foundation believes a modest increase in the portion paid by workers is an equitable means of sharing the burgeoning cost of health insurance. Requiring active employees to pay 25 percent of their premiums -- comparable to the portion paid by many private sector employees -- would save the state about $50 million in 2003.

Pensions

Despite recent major increases in the state's pension obligations, the Governor continues to press for further reductions in annual pension funding, proposing a $797 million appropriation for fiscal 2003 that is $129 million, or 14 percent, less than the amount currently scheduled to be paid (see Figure 2).

While the state was able to make enormous progress in reducing its huge unfunded pension liability for much of the 1990s -- cutting the unfunded liability from 61 percent to 15 percent in a decade -- those gains have been significantly undercut in recent years. In 2001, the unfunded percentage rose for the first time since pension funding reforms were adopted in 1987, with further erosion in that performance likely over the next several years.

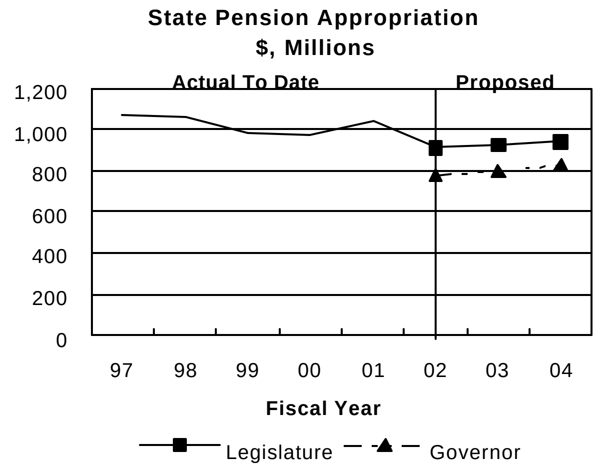
Figure 2

While Pension Obligations Grow,
Administration Proposes Funding Reductions

Growing Obligations

- $1.5 billion increase in unfunded pension liability in 2000, due to the combination of higher estimates of future benefit costs and the deteriorating stock market.
- $1.6 billion, or 5.2 percent, further decline in value of pension assets in 2001 due to even poorer market performance.
- $50 million of added annual costs for the teacher early retirement program adopted in 2000.
- $35 million of additional annual costs for the recently enacted state employee early retirement program, costs which go unfunded in the Governor's fiscal 2003 budget.

Declining Funding



This reversal of progress is largely attributable to the combination of three factors: an updated estimate of future liabilities based upon system experience; a sharp, market-driven downturn in the earnings and value of pension assets set aside to pay for future retirement benefits; and significant additions to the state's obligations as a result of early retirement incentive programs for teachers and state employees.

As a result, the unfunded pension liability surged $1.5 billion in 2000, a 32 percent increase in one year. In 2001, the overall value of pension assets plunged by $1.6 billion, or 5.2 percent, and investment returns fell short of the pension fund's 8.25 percent earnings target by a staggering $2.5 billion. At the same time, the early retirement program for teachers adopted in 2000 has added an estimated $50 million to annual pension funding needs, and early retirement incentives for state employees enacted in December will require an additional $35 million per year.

Even though unfunded obligations have increased dramatically, the state reduced its pension appropriation from $1.04 billion in fiscal 2001 to $912 million in 2002, a 12 percent drop. The Governor is proposing a similar reduction in 2003 -- despite the mushrooming liabilities -- and fails to fund the new $35 million annual obligation for the state employees early retirement program. The administration couples the funding decrease with a plan to extend to 2028 the deadline for completely eliminating the unfunded liability, a proposal that lawmakers wisely rejected in December. This shortsighted initiative would burden future taxpayers with the costs of repaying the state's pension debts for another full decade.

Cash Assistance

Increases in the welfare population and the number of families requiring emergency housing are driving up cash assistance costs. The House 1 recommendation of $768 million is eight percent above the 2002 appropriation. After reaching a low of 42,013 in July, the caseload for Temporary Aid to Families with Dependent Children (TAFDC) rose to 45,979 in December. Anticipated caseload growth of 10 percent in 2003 will add nearly $30 million to the 2002 appropriation of $305 million. Though spending for emergency housing and aid is much smaller than TAFDC, caseload growth approaching 10 percent will push expenditures to $150 million in 2003.

The administration plans to cover increased costs by tapping the state's caseload mitigation fund for $18 million in 2002 and $50 million in 2003, leaving a balance of $88 million. Years of declining caseloads allowed the state to transfer unused block grant and state monies to a reserve fund to be used if caseloads increased significantly. While drawing on the fund is appropriate, it is another example of the state's reliance on reserves to cover operating expenses and leaves the state vulnerable to rising caseloads in future years.

To complicate the fiscal situation, the Commonwealth may face a reduction in welfare assistance from the federal government with the expiration in 2002 of the Temporary 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 tied to the now drastically lower caseload, Massachusetts could see a significant reduction in federal support.