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Bulletin

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2004 Budget: Major Strides, But More Pain Ahead

Barring further overrides of gubernatorial vetoes in the fall, state leaders have completed their actions on the 2004 budget, with a \$23.1 billion "no new taxes" spending plan that relies heavily on fee increases and spending cuts in almost every area of government. Although the budget makes great strides in closing a potential gap of \$2.5 billion, it fails to eliminate fully the state's structural deficit. The task of balancing the 2005 budget will be exacerbated by 2004's reliance on approximately \$400 million of one-time resources. The need to replace those non-recurring revenues, combined with expectations of only modest revenue growth and continued escalation of health care costs, will produce a shortfall of more than \$1 billion in 2005.

While the 2004 budget includes many of the organizational changes proposed by Governor Romney, lawmakers turned their backs on more substantive reforms that would have had a positive long-term impact on state operations. In several

significant instances, the conference committee that reconciled the differences between the House and Senate budgets opted for the weaker version of the generally modest reform measures adopted by each branch. As a result, the final budget makes only token changes to the Pacheco law's unreasonable restrictions on competitive contracting and does little to improve the management of the courts. Reflecting a lack of action by both branches, the budget is silent on civil service and other important workforce reforms. Even worse, in one area where meaningful reforms were adopted -- placing dollar caps on the costly "Quinn bill" educational pay incentives for local police -- the Governor sent the provision back with an amendment, most likely killing the opportunity for reform.

It will be critical to watch revenue collections closely in the next few months, since the just-adopted budget provides no room for fiscal error. Although it is too early in the year to conclude

Table 1
Total State Spending
(\$, Millions)

	2003	Fiscal 2004 Budget			Final
	Estimated*	Conference	Vetoes	Overrides	
Regular appropriations	\$22,385.2	\$22,335.1	-201.0	158.3	\$22,292.3
"Off-budget" spending	389.8	805.7	-26.6	26.6	805.7
Total	\$22,775.0	\$23,140.8	-227.6	184.9	\$23,098.0

* These totals do not include any appropriations authorized in the final deficiency budget for 2003, which has not yet been acted on by lawmakers.

Note: For purpose of comparison, 2004 spending totals include \$687 million of pension appropriations moved off budget in 2004. An additional \$145 million of pension appropriation requirements met by the transfer of the convention center to the pension fund are excluded. See Table 2 for an explanation of 2004 "off-budget" spending. Under financial reforms adopted in the fiscal 2000 budget, one cent of the state's sales tax (other than the tax on meals) is devoted to support of the MBTA. Since these annual revenues -- an estimated \$684 million in 2003 and 2004 -- are dedicated to an independent agency, not a state-operated program, and are otherwise unavailable for appropriation or transfer in the state budget, their use is not included in the expenditure totals reported here.

whether or not the state's finances are in balance, the risk is clearly on the downside. While July tax receipts were on target with the administration's benchmark, withholding collections remain weak and sales tax receipts are flat. Once again, the state's fiscal fortunes depend on a mid-year improvement in economic performance that could fail to materialize.

The disagreement between the administration and lawmakers about the estimate of nontax revenues supporting the 2004 budget is also a source of concern, though the gubernatorial spending vetoes not overridden by the Legislature partially offset the nontax shortfall identified by the Governor.

The budget has risks on the expenditure side as well. The administration faces a major challenge in realizing the hundreds of millions of dollars of planned Medicaid savings in 2004, which come on top of the substantial reductions in 2003. The transfer of the Hynes Convention Center and the Boston Common Parking Garage to the state pension fund -- a one-time measure that reduces required pension funding in 2004 -- is almost certain to be worth less than the \$145 million assumed in the budget, and legislative leaders have pledged to make up any shortfall with a state appropriation. The budget also underfunds several programs -- including snow and ice removal and legal representation of indigent defendants -- by tens of millions of dollars, deficiencies that will almost certainly have to be offset with not-yet-identified savings in other accounts.

Spending

The final budget authorizes \$23.1 billion in 2004 spending, after accounting for \$227.6 million of gubernatorial vetoes and \$184.9 million of veto overrides by lawmakers (see Table 1). Included in this total are \$22.3 billion of regular budgetary appropriations and \$805.7 million of other "off-budget" spending, almost all of which is authorized in outside sections of the budget (see Table 2).

While total spending is up slightly from 2003 (an estimated \$323 million or 1.4 percent), that increase masks substantial cuts in most areas of state spending that are offset by higher health care expenditures. The 2004 reductions in local aid, higher education, and other areas total \$692 million, which come on top of the deep cuts in 2002 and 2003. At the same time, however, health care

Table 2
Fiscal 2004 Spending Authorizations
(\$, Millions)

Regular appropriations	
Line item appropriations	\$21,605
Pension appropriations moved off-budget in 2004	687
Total regular appropriations	22,292
Off-budget spending	
Outside section authorizations	
Medicaid and other health care	696
Retained tuition	31
Other off-budget spending*	79
Total	\$23,098

* Including \$47 million of RMV fees dedicated to Central Artery costs and approximately \$30 million of contingency payments for revenue and debt collection activities that are counted in the state comptroller's annual tally of total budgetary spending.

spending -- primarily for the massive Medicaid program -- will increase by \$1 billion in 2004, despite the many cost-cutting measures implemented over the last 18 months. (MTF's estimate of the increase in health care spending has been adjusted upward in part to reflect the state's decision to delay until 2004 a Medicaid rate increase of \$129 million for nursing homes that had been originally authorized for 2003.)

Examining the changes in state spending since 2001 -- before the fiscal crisis began -- the contrast between health care and other state programs is even more striking. Since 2001, annual health care expenditures have risen \$2.1 billion, or 38.6 percent, compared to a decrease of \$1.2 billion, or 7.0 percent, in all other programs. Because of its rapid rate of growth, health care's share of total state spending has jumped from 25 percent in 2001 to a staggering 33 percent in 2004 (see Table 3).

This analysis of aggregate spending levels actually understates the impact of cuts on individual programs. Based on the Foundation's updated analysis of program-by-program changes in expenditures from 2001 through 2004, the state has cut programmatic spending by \$2.9 billion during the fiscal crisis (see Table 4). This total includes \$2.1 billion in reductions in absolute spending levels in specific programs and another \$720 million in avoidance of further increases in state health care costs. (The Foundation's estimate of

health care cost avoidance reflects a combination of Medicaid program cuts, a failure to adjust reimbursement rates to reflect fully the growth in health care providers' costs, and the shifting of a greater share of the costs of health benefits to state employees.) The magnitude of these cuts raises serious questions about whether Massachusetts will be able to maintain its long-term economic competitiveness in such key areas as health care, K-12 education, higher education, and workforce training.

Revenues

Given the enormous fiscal shortfall, it was inevitable that the 2004 budget would entail some combination of new revenues, spending cuts, and further use of reserves. Although the Commonwealth avoided increases in broad-based taxes for 2004, it has raised other taxes by almost \$200 million, including a roughly 20 percent increase in the annual taxes paid by corporations. Massachusetts also raised fees dramatically, more than any other state in the nation according to a recent study. The estimated \$500 million of fee increases that support the 2004 budget -- including hikes in Registry of Deeds fees far in excess of any reasonable measure of the cost of services -- will surely hit taxpayers' pocketbooks as hard as any tax increase and, many would argue, less fairly as well.

It is striking that the amount generated from the fee increases is more than half the \$800 million in tax hikes approved for 2003. Also, because of the deep cuts in local aid, property taxpayers in dozens of cities and towns are facing large rate hikes that fall disproportionately on lower income residents.

Outlook

Unfortunately, the revenue increases and spending cuts adopted in 2004 do not solve the state's fiscal problems. That is partly due to the sheer magnitude of the revenue losses sustained in 2002 (which reflected the combined impact of the collapse of capital gains, previously authorized tax cuts, and the economic recession). Indeed, a large share of the 2004 revenue and spending solutions -- more than \$600 million -- are devoted to reducing the state's reliance on one-time revenues, which have for two years served as a stopgap response to the earlier plunge in revenues.

However, even with a rebound in the economy and revenues, Massachusetts will face serious financial problems, largely because of a resurgence of growth in health care costs that coincided almost exactly with the onset of the state's revenue problems. With an underlying annual rate of growth of 12 to 15 percent that remains almost untouched by the recent savings measures, health care costs will consume

Table 3
Overall Spending Changes
Fiscal 2001-2004
(\$, Millions)

	Cumulative Increase/(Decrease)		Percent of Total Budget	
	Amount	Percent	2001	2004
Health care	\$2,132	38.6	25.0	33.2
Education/other local aid	-270	-5.1	24.1	21.9
Human services	7	0.2	18.5	17.8
Pensions and debt service	-201	-7.5	12.2	10.8
Public safety	24	1.4	7.7	7.5
Higher education	-293	-26.5	5.0	3.5
All other	<u>-432</u>	<u>-26.1</u>	<u>7.5</u>	<u>5.3</u>
Total	\$967	4.4	100.0	100.0

Note: "Health care" includes MassHealth (Medicaid), employee health benefits, and the senior pharmacy program. "Education/other local aid" excludes MTF's estimate of amount of pension appropriations attributable to retired local teachers (which has been cut from roughly \$760 million in fiscal 2001 to approximately \$500 million in 2004).

most -- if not all -- of the modest annual revenue growth that is anticipated over the next several years, even with the federal government sharing 50 percent of the cost of Medicaid, the state's largest health care program.

The outlook for fiscal 2005 and beyond is further darkened by the need to address other major obligations. Pension funding alone must rise by \$500 million or more a year to keep the state on track to eliminate its huge unfunded liability. The costs of school building assistance and debt service for the state's capital construction program will add to the fiscal pressures. These factors, in combination with inflation, lead to the Foundation's preliminary projection of a \$1 to \$2 billion shortfall in 2005.

As this discussion makes clear, a rebound in the economy -- which remains in doubt -- will not eliminate the difficulties that the state confronts in financing its health care and other obligations in 2005 and beyond. The Commonwealth's rainy day reserves, which totaled \$2.2 billion at the beginning of 2002, are now largely depleted. Although substantial balances remain available from tobacco settlement payments that were set aside in previous years and from the recently approved federal fiscal relief package, relying too heavily on those one-

time resources would only delay the day of reckoning in addressing the underlying structural problem in the state's finances.

In many ways, state leaders will face a much starker set of choices in 2005, having already cut basic programs by almost \$3 billion and largely exhausted the opportunities for fee and other nontax revenue increases. It is clearly time for a thoughtful and honest debate about what levels of annual spending -- and spending growth -- are in the best long-term interest of the citizens of the Commonwealth, and what levels of revenue are needed to support that spending.

That effort must include more substantive consideration of -- and collective action on -- the important structural reforms that were left unaddressed in the 2004 budget. Although such reforms will contribute only modestly to addressing next year's fiscal problem, the case for making long overdue changes in the Pacheco law, civil service, the Quinn bill and other areas that will yield significant benefits to taxpayers over time is now more compelling than ever.

Table 4
Major Spending Increases and Decreases
Fiscal 2001 to 2004
(\$, Millions)

Spending Category	Programs with Increased Spending		Programs with Decreased Spending		Net Change	
	Amount of Increase	Pct. Chg. from 2001	Amount of Decrease	Pct. Chg. from 2001	Amount	Pct. Chg. from 2001
Health care	\$2,134	38.7	-\$2	-12.4	2,132	38.6
Education & local aid	317	9.4	-587	-29.9	-270	-5.1
Human services	362	16.7	-355	-18.3	7	0.2
Debt service/pensions	208	13.7	-409	-34.6	-201	-7.5
Public safety	55	5.5	-31	-4.4	24	1.4
Higher education	0	0.0	-293	-26.5	-293	-26.5
Other*	29	16.6	-461	-31.2	-432	-26.1
Total	\$3,105	22.6	-\$2,139	-25.5	\$967	4.4
Health Care Cost Avoidance						
Medicaid savings inits.			-462			
Rate shortfalls			-220			
Employee health costs			-39			
Grand Total			-\$2,860			

* Areas of major reductions in the "Other" category include environmental management, economic development, highways, business and consumer regulation, snow and ice removal, and a variety of administrative accounts.