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Bulletin

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MTF

2003 Budget: Major Spending Cuts Still Required

With the Governor's announcement last week of a major downgrade in the administration's estimate of tax revenues for 2003, the deliberations on the state budget for the new fiscal year have entered a critical, and potentially perilous, phase. Under the revised estimate, both the House and Senate versions of next year's budget are out of balance by at least $650 million despite the difficult and, in the end, largely constructive efforts of both branches to address a fiscal 2003 gap that totaled $2.7 billion before the latest negative revenue news.

To address the enormous structural deficit in the state's budget, the House approved a balanced package of solutions that included $1.1 billion of additional tax revenues, a judicious $500 million limit on the use of rainy day reserves in 2003, and some spending cuts. While taking a similar approach to the House on taxes, the Senate financed its higher 2003 spending total in part by drawing more heavily on reserves, including an additional $125 million of tobacco dollars and $80 million of one-time tax receipts.

Despite reductions in a variety of programs -- including unwise cuts in pension funding that only shift costs onto future taxpayers -- both budgets increase spending by a surprising margin given the severity of the state's fiscal problems. After taking into account the savings measures adopted in 2002, total spending in the House budget is up roughly $700 million, and the Senate budget grows even more, by almost $1 billion.

Table 1
Untapped Savings Opportunities in the 2003 Budget

Education funding reform
Police incentive pay (Quinn bill)
Court management and personnel
Sentencing guidelines reform
Workers' compensation - public safety personnel
Construction reform
Employee health cost-sharing
Contracting for state services (privatization)
Emergency salary savings
Elimination of retirement abuses (addressed in the Senate budget)

Given the magnitude of these increases in combination with the expected shortfall in revenues, major additional spending cuts will be needed to bring any compromise version of the two legislative budgets into balance. As the Foundation noted in a recent *Bulletin,*[1] lawmakers can

[1] MTF Bulletin: *The Commonwealth's Fiscal Crisis: Opportunity for Important Spending Reforms.* May 29, 2002.

meet a part of this challenge by curbing longstanding spending abuses and eliminating other inefficiencies that have not been addressed in either the House or Senate budgets (see Table 1). By tackling reforms that would normally be left untouched because of their political difficulties, the state's leaders can avoid some program cuts while at the same time increasing citizens' confidence that their tax dollars are being well spent.

Closing the new gap in 2003 finances will require a major effort that goes beyond the normal procedures for reconciling the two branches' proposed budgets. The consensus revenue estimate on which those budgets are built is now clearly unrealistic, and reaching a new agreement on revenues is an absolutely essential first step in addressing the latest shortfall.

At the same time, lawmakers must recognize that the spending levels in each branch's budget are no longer affordable. With more than $1 billion of additional tax revenues already included in the legislative budgets and as much as $1.8 billion of the state's reserves needed just to fill the fiscal 2002 deficit, further cuts in 2003 are both necessary and unavoidable. The alternative -- failing to make the requisite cuts and sending an unbalanced budget to the Governor -- would tarnish what lawmakers have accomplished to date and erode the public's trust in the state's financial leadership.
The temptation will be great to turn to gimmicks and other short-sighted fiscal fixes to "balance" 2003, but these must be avoided at all costs. Using more of the state's reserves than the $500 million that has already been committed for 2003 would only set the stage for more painful choices in 2004, as would relying on uncertain revenue initiatives such as the Governor's lottery payout proposal or casino gambling. Even worse would be deficit borrowing in the form of so-called "securitization" of tobacco settlement proceeds.

Table 2
Proposed 2003 Spending
($, Millions)

	House	Senate
Regular appropriations	$23,006	$23,227
Other proposed spending:		
Off-budget Medicaid	342	359
Capital needs investment trust	45	23
Uncompensated care - tobacco	0	45
Total*	$23,393	$23,654

* Excluding approximately $90 million of other off-budget authorizations, including $60 million of RMV fees dedicated to capital.

Total Spending

Proposed spending in the Senate budget totals $23.65 billion, an amount that includes $359 million of off-budget Medicaid expenditures as well as $68 million of other authorizations (see Table 2). The Senate total is $950 million or 4.2 percent above estimated fiscal 2002 spending of $22.7 billion (adjusted for administrative and other savings measures to address this year's budget gap).[2] Proposed spending in the House budget totals $23.39 billion, including

[2] These savings include so-called "9C" reductions and a $134 million decrease in 2002 pension funding but exclude assumed reversions (unspent agency appropriations at the end of the year).

$342 million of off-budget Medicaid expenditures and $45 million of other authorizations. The House spending total is $690 million or three percent above estimated 2002 spending.

Table 3
Proposed 2003 Spending Growth
($, Millions)

	House	Senate
Health care	$676	$844
Debt service	121	115
Human services	68	90
Education	-5	92
Cash assistance	21	44
Pensions	16	16
Subtotal	897	1,201
Rest of government	-206	-250
Total	$691	$951

In both of the legislative budgets, the increase in health care expenditures is staggering. Spending for Medicaid, employee health benefits, uncompensated care, and prescription drug and other benefits for the elderly is up $844 million, or 13.5 percent, in the Senate budget compared to $676 million, or 10.8 percent, in the House. These stunning rates of growth account for most of the increased spending in both budgets (as shown in Table 3).

Debt service costs in the two plans are up roughly $120 million, or more than eight percent, explained in part by a debt refinancing in 2002 which generated $40 million of one-time savings. Both the House and Senate provide for a roughly 2.5 percent overall increase in human services spending.

Despite these broad similarities, there are a number of smaller differences that could pose significant obstacles to the deliberations of the conference committee named to reconcile the two legislative budgets. In a change that the House is likely to resist, the Senate proposes to increase to 87 percent the share of annual tobacco settlement dollars to be spent on current health care programs, compared to the 50 percent set into statute by the 2002 budget.[3] In sharp contrast to the Senate, the House funds education aid to poorer districts at a level that fails to meet the requirements of the state's education reform law. While the Senate proposes important management reforms for the judiciary, it also cuts court budgets by $46 million -- versus close to level funding by the House -- a reduction that will cripple judicial operations.

Both the House and Senate budgets reflect the agreement by legislative leaders in April to adopt annual pension funding cuts totaling approximately $130 million that had been proposed by the Governor. To achieve these cuts, the state will extend the period for repaying its large unfunded pension liability, shifting even greater costs onto future taxpayers, a change strongly opposed by the Foundation. Since the cuts affect 2002 as well as future years, 2003 pension funding is essentially flat in both budgets.

Revenues

Taxes Both the House and Senate budgets rely on a 2003 tax estimate of $14.716 billion, reflecting the consensus

[3] In April, the Governor and legislative leaders also agreed to use an additional $60 million of tobacco dollars to help balance the 2002 budget.

agreement reached in April by the state's fiscal leadership, plus approximately \$1.1-\$1.2 billion of additional revenues from tax law changes.

However, with April and May revenue collections falling well short of projections, the tax figures used in the legislative budgets are now at least \$650 million too high. The administration recently reduced its forecast of 2003 receipts before tax law changes to \$14.175 billion, \$540 million below the consensus amount. Given this reduction -- which is almost entirely due to further shortfalls in capital gains -- the Foundation estimates that the value of the proposed tax increases must by reduced by at least \$100 million as well. Before factoring in this change, the Senate tax proposal was worth an estimated \$1.2 billion, about \$50 million more than the House proposal.

The tax plans of the two branches are largely identical, including freezing the income tax rate at the current 5.3 percent -- with further reductions tied to growth in the economy -- and reducing the personal exemption to \$3,300 -- with restoration to the prior \$4,400 level also tied to economic growth.

Unfortunately, both the House and Senate are proposing to reverse two important tax reforms of the 1990s -- the establishment of significant incentives for long-term capital gains and a new deduction for charitable contributions that was strongly supported by human service, arts, and other nonprofit organizations that depend on private giving to accomplish their missions. It is worth noting that adopting the Foundation's proposal to return the income tax rate to 5.6 percent, with further cuts tied to growth in the state's economy, would have generated as much additional revenue as the proposed changes in capital gains and the charitable deduction combined.

While superficially attractive, the Legislature's plan to tax capital income at the same rate as ordinary income would effectively double the tax rate on economically important long-term investments and send precisely the wrong message to those who might be considering investing in Massachusetts' economic future. Even worse is the proposal to apply this tax increase retroactively to January 1, punishing individuals who sold assets under the good faith presumption of a reasonable degree of constancy in the tax laws. This is a serious inequity that should be addressed before sending any final tax package to the Governor.

It would also be wise to consider preserving an incentive in the capital gains tax rate for longer term investments. Setting the tax rate on gains from assets held six years or more at one-half the tax rate on ordinary income would provide an important signal to investors, while effectively reinstating the 50 percent deduction on these gains that was in place prior to 1994. While it is true that such a change would generate fewer additional dollars than the original proposal, the lost revenues could be partially offset by adopting the Senate's recommendation to maintain the current 12 percent rate on gains from assets held less than one year.

The legislative tax packages are also marred by a proposal to "postpone" for at least a decade the new deduction for charitable contributions that went into effect last year, a timetable that strains belief. A far more credible approach, which the Foundation strongly supports, would provide for reinstatement of the voter-approved deduction in 2004 or 2005.

The Senate tax package also includes a fiscally significant, although little-noticed, provision that would prevent the eventual elimination of the Massachusetts estate tax as a result of cuts in the federal estate tax. The Commonwealth's estate tax is currently tied to the maximum credit for state estate taxes allowed under federal law. Under federal changes enacted earlier this year, this credit will phase out by 2005. The Senate proposal preserves the tax by tying the amount of state tax to the federal credit that was in effect prior to the change in the federal law. In fiscal 2002, estate taxes are expected to total $170 million.

The Senate budget also contains an important provision to bring the state's tax laws regarding retirement and college savings plans into conformity with recent changes in federal law. Without this action, taxpayers will face two different sets of tax rules for contributions to their retirement savings, and employers and individuals will be burdened with dual record-keeping requirements, unlike the vast majority of states which have conformed to the new federal changes.

Fees In a notable departure from recent practice, both the House and Senate are proposing significant new fees -- or substantial increases in existing fees -- to support their 2003 budgets. The budgets of the two branches establish new nursing home "bed" fees which are expected to generate $145 million of additional revenues to support Medicaid costs, as well as new pharmacy dispensing charges worth $36 million. While both budgets increase court fees (the Senate to a lesser extent than the House), only the House proposes to hike drivers' license and vehicle registration fees, raising an estimated $29 million of additional revenues.

Use of Reserves

With the state almost certain to run through $1.8 billion of reserves in just one year,[4] both legislative budgets limit withdrawals from the rainy day fund to $500 million in fiscal 2003. However, with revenues falling even further since the budgets were developed, the state now risks completely draining its remaining reserves to balance the 2003 budget.

At the beginning of 2002, the state's reserves totaled $3.0 billion (see Figure 1). The withdrawals needed to balance 2002 and the use of reserves proposed in the two budgets will reduce this total to $800 million,[5] even before dealing with the new $650 million gap in 2003 revenues or the possibility of further shortfalls in the coming months. The danger is that the state will deplete all its reserves in 2003 and carry forward to 2004 a huge structural deficit that will come on top of large and difficult-to-control growth in health care costs.

Lawmakers are to be commended for wisely rejecting proposals to “securitize” -- that is, borrow against -- future annual tobacco settlement payments, which supporters have equated with the use of reserves. On the contrary, tobacco

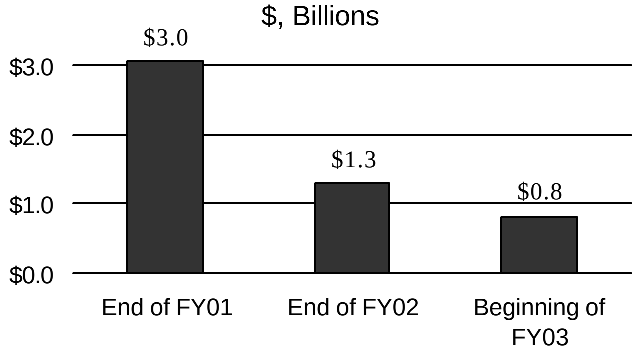
[4] Including additional withdrawals proposed by the Governor in May.
[5] The 2003 withdrawals include $500 million from the rainy day fund and $55 million from the welfare caseload fund, offset by approximately $85 million of expected deposits to the tobacco settlement fund.

securitization is simply another name for borrowing to pay for operating expenses, akin to the debt financing of the late 1980s that burdened state budgets for much of the last decade. Unfortunately, the ongoing financial problems of the Commonwealth -- combined with the fact that several other states have resorted to such fiscal gimmickry -- may increase the apparent appeal of this bad idea.

Figure 1

Available Reserves

$, Billions



While the House budget largely avoids using one-time revenues to support ongoing spending in fiscal 2003, the Senate budget takes a less responsible approach. Under both the House and Senate plans, the proposed tax increases are scheduled to take effect retroactively on January 1, 2002, resulting in more than $200 million of one-time revenues in fiscal 2003. In contrast to the House, the Senate budget imprudently depends on these nonrecurring revenues -- one-third of the total up to $80 million -- to support ongoing spending. The Senate also drains an additional $125 million of tobacco settlement dollars from the trust fund for future health care needs. The Senate's proposed reliance on one-time revenues only undercuts the efforts to put the state's finances on a sound structural footing and should be rejected by the conference committee.

Medicaid

Devouring almost every available dollar of new revenue, the Medicaid program will once again require double-digit increases in spending, with the House budget climbing $583 million or 10.8 percent and the Senate budget rising $677 million or 12.5 percent over 2002.

The state is confronting the stark reality that its financial resources have not kept pace with the dramatic expansion of the Medicaid population -- from 690,000 residents insured under MassHealth five years ago to approximately one million today. On top of this large jump in enrollment, the state has established one of the most generous Medicaid programs in the nation -- at an annual cost of $6 billion -- while attempting to cope with the same intense pressures that are driving up health care costs across the U.S.

State leaders must either develop a financial strategy to support a program of this magnitude and generosity or begin the difficult task of scaling back eligibility and reducing the program’s comprehensive package of benefits.

The Senate budget contains no changes in either eligibility or benefits but rather dips further into the tobacco settlement fund to help pay for these rapidly escalating health care costs. The House, on the other hand, eliminates coverage for 30,000 long-term unemployed adults and ends the methadone treatment program for heroin addicts.

While much attention has been paid to "savings" that reportedly can be achieved through initiatives such as bulk purchasing of drugs, additional rebates from drug manufacturers, and reduced payments to pharmacists for filling Medicaid prescriptions, the revenues from these and other measures -- even if they are achieved -- pale in comparison to the $600 million annual increase in health care spending necessary to pay for the current program. Nibbling around the edges and slowing cost growth by $10 million or $20 million is clearly insufficient.

Both budgets include new fees to generate additional revenues to cover the 2003 surge in the costs of health care. A daily assessment on nursing home patients will raise $145 million, which will be matched with federal funds and used to increase Medicaid payments to nursing facilities. Non-Medicaid nursing home patients -- that is, elderly individuals who pay for nursing home care out of their own pocket or through long-term care insurance -- will be forced to pay $3,300 annually as a result of this new charge.

In addition, both budgets include a new fee on prescription drugs that will be assessed on each prescription sold in Massachusetts, excluding those paid for by Medicare or Medicaid. The $36 million generated by this charge, when combined with federal matching funds, will be used to help pay for prescription drugs provided to Medicaid recipients.

Human Services

The Senate should be commended for adopting two amendments that draw on the recommendations of the Foundation's joint study with United Way, *"Off Welfare, On to Independence."* The proposed changes to the Commonwealth's welfare program would allow education and training to count toward the work requirement and provide recipients with extended benefits in order to complete a recognized education or training program.

Separately, the Joint Committee on Human Services recently approved a more comprehensive welfare reform bill that encompasses these two provisions. The state's current work requirement -- the most restrictive in the nation -- effectively denies the type of education and training opportunities that will help recipients develop the skills necessary to achieve long-term economic independence.

The House and Senate differ in their approaches to the state's largest cash assistance program, Transitional Aid to Families with Dependent Children (TAFDC). After several years of large declines, the TAFDC caseload has grown by nearly 5,000 since last July to the current level of 46,835; the House assumes further growth of 12 percent in fiscal 2003, while the Senate projects a nine percent increase. Given the slower growth of recent months, the Senate's estimate appears sound. On a policy level, the Senate did not adopt the House proposal to cut supplemental TAFDC benefits to approximately 1,700 legal immigrants for a savings of $11 million.

In addition, the Senate added to the bottom line in two areas cut by the House: Nearly $25 million was restored for food stamp benefits to legal immigrants and for rent arrearages to prevent low-income families from becoming homeless. The Senate also added $3.5 million to the Department of

Mental Retardation's Boulet settlement to ensure that the Commonwealth complies with the agreement to eliminate the long waiting list for services by 2007.

Education

The Senate deserves credit for funding Chapter 70 school aid for 2003 at the levels needed to maintain adequate spending in poorer school districts, as required by the state's education reform law. Under the formula used by the Senate -- which is based in part on reforms recommended by the Governor -- all districts would receive sufficient aid to maintain spending at the reform law's "foundation" standard, local contributions to schools would be adjusted to reflect the growth in municipal revenues, and the funding inequities under the current formula would be partially addressed. In sharp contrast, the House freezes each district's aid -- and each community's local contribution -- at their 2002 levels, an approach that abandons the core principles of the school finance reforms adopted in 1993 and leaves the state vulnerable to costly litigation.

While the Senate's school aid proposals are preferable to the House's on policy grounds, their additional cost of $65 million will be difficult to accommodate in the present fiscal environment. However, as the Foundation noted in a recent *Bulletin* (see footnote 1), the current distribution of education aid dollars -- which even the Senate proposal largely maintains -- is rife with costly disparities. Implementing fundamental reforms could save the state $100 to $200 million in 2003. Such reforms would ensure that the neediest districts have the resources to maintain school spending at adequate levels while at the same time providing an equitable distribution of aid to other districts.

Unlike the Senate, the House budget provides approximately $60 million of additional funding to implement the special education "circuit breaker" authorized in the 2001 budget. Under the legislation, communities would receive state reimbursement for extraordinary local costs of educating students with special needs. It will be difficult for the conference committee to accommodate this expansion in 2003, and it is likely that the scheduled July 1, 2002 startup of the program will be delayed.[6]

The two branches are far apart in funding several programs intended to improve student performance. The Senate budget maintains local grants for MCAS remediation at their 2002 level of $50 million, while the House cuts the program by $30 million. In addition, the House budget eliminates the $18 million program of grants to reduce class sizes, which the Senate budget preserves.

Courts

The House and Senate took markedly different approaches to the thorny issues of funding and management of the state's court system in 2003 after making substantial budget cuts -- $40 million -- to the judiciary in 2002. The House restored all but $4 million of the $44 million in additional cuts proposed by its Ways and Means Committee, resulting in

[6] Both the House and Senate also change the structure of the reimbursement schedule in the circuit breaker law from separate reimbursements for in-district placements and out-of-district placements to a single reimbursement of 75 percent of any costs in excess of four times the statewide average per-student foundation budget amount.

a reduction of only 0.7 percent from 2002 spending levels. While a damaging amendment that would have eliminated judges' authority to hire any court personnel was withdrawn, the House did nothing to reform the detailed line items that enable legislatively-mandated patronage hires for positions not even requested by court administrators and undermine the judiciary's ability to achieve administrative efficiencies.

The Senate took the positive step of consolidating the number of line items from 164 to 34, centralizing court administration and enabling the judiciary to reallocate personnel and resources to the courts with the heaviest workload. However, the centralization comes at a high and unacceptable price: an additional $45.5 million in funding cuts. The conference committee should embrace the consolidation of line items proposed by the Senate while restoring funding to a more reasonable level.

RTAs/MBTA

The House deserves credit for reversing a Ways and Means proposal that would have undermined the MBTA "forward funding" reforms, one of the Legislature's most important accomplishments of the past decade. The plan to fund the regional transit authorities with sales tax revenue already dedicated to the MBTA would likely have resulted in a downgrade of the T's credit rating and the elimination of the surpluses required to pay for the T's enormous backlog of capital needs. The Senate left the T's dedicated revenues intact, but underfunded by $7.1 million the state's support for the RTAs, which are still retrospectively reimbursed for their spending in the preceding fiscal year. Without sufficient revenue to cover costs already incurred, the RTAs would have little choice but to invoke the statutory provision that requires the Treasurer to make the payments regardless of the appropriation.

Capital Finances

The House and Senate each took a variety of steps -- both positive and negative -- in their budget proposals that will affect the Commonwealth's ability to finance its extensive capital needs.

Registry Fee Increases Among the fees increased by the House are those for vehicle registration and drivers' license renewals, which together are expected to generate an additional $29 million. These fees were instituted to support the costs of building and maintaining transportation infrastructure, and, if they are to be increased, the revenue should be used to help meet the Commonwealth's enormous backlog of transportation capital projects. With no contingency for covering potential future cost increases on the $14.6 billion Central Artery, no plan for funding the operations and maintenance of the new highway after the project is complete, and much of the state's future transportation funds already committed to paying for the Artery, now is not the time to divert additional Registry fees to help balance the operating budget.

Central Artery Finances Both chambers took the positive step of establishing a Central Artery finance commission. The advisory panel will be charged with examining a wide range of Artery finance options and recommending more equitable alternatives to the current system of imposing tolls on east-west turnpike and tunnel drivers but not on north-south drivers who will benefit more directly from completion of the Artery. For a number of years, the Foundation has advocated for the development of a statewide transportation finance plan that is fair to taxpayers, drivers and transit riders, and that meets the challenges of financing the Artery and other important transportation priorities. The creation of the finance commission takes a major step toward achieving this objective.

Capitalization A portion of the cuts contained in the House and Senate budgets will be achieved by shifting operating costs to the capital budget and financing them with long-term bonds, a dubious budget balancing strategy that the Legislature appears to be taking too far. Most of the roughly $6 million cost of the Division of Capital Asset Management and Maintenance was capitalized in fiscal 2002, and both chambers propose to fund 100 percent of the agency with bonds in 2003. Similarly, much of the cut in the Highway Department's administrative account -- $16 million in the House and $26 million in the Senate -- will actually be absorbed by highway project funds.

Using capital dollars to pay for costs, including personnel, that legitimately result from capital projects is entirely appropriate. However, bonding for true operating costs that are only tangentially related to capital investments is a form of deficit borrowing that shifts the costs of current services to future taxpayers.

Capital Needs Investment Trust Fund Adding to the demands on the state's capital budget is the Senate's proposed $22 million cut to the Capital Needs Investment Trust Fund, which would eliminate funding for maintenance and repairs to capital assets owned by the Commonwealth. The fund, proposed by the Senate two years ago, represents the most significant effort to address the enormous backlog of deferred maintenance needs at state facilities.

School Building Bond Pool On the other hand, the Senate wisely opted to study the merits of a bond pool for school building assistance before implementing the program recommended by its Ways and Means Committee. The savings expected from pooling are debatable at best, and under the Senate Ways and Means proposal it would have been difficult for cities and towns to opt out of the proposed pool even if they could borrow at less cost than the state.