Massachusetts Taxpayers Foundation

333 WASHINGTON STREET
BOSTON, MA 02108-5170
617-720-1000
FAX 617-720-079

Bulletin

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Governor's 2007 Budget: Focus on Local Aid; Future Affordability A Concern

Governor Romney's proposed budget for fiscal 2007 takes several positive steps to address two major policy concerns that have emerged in the aftermath of the Commonwealth's fiscal crisis:

- The need to restore local aid for cities and towns that are struggling with rapidly rising health care costs and limited local revenue sources, and
- The broad consensus to expand health care coverage for the state's uninsured.

At the same time, however, the new expenditures proposed by the Governor would use up essentially all of the fiscal flexibility provided by the state's recent strong revenue growth. This would leave little room in 2008 and beyond to accommodate both the largely unavoidable increases in health care, debt service and other costs and the almost $700 million annualized revenue impact of the Governor's proposal to cut the income tax rate to 5.0 percent over two years, let alone fund health care or restore programs which have experienced severe cuts since 2001.

The Governor's budget gives high priority to the financial needs of the state's 351 cities and towns, with an almost 10 percent increase in total local aid, the largest annual rise since fiscal 2000. The budget proposes to lift in 2007 the cap on local lottery aid that is currently scheduled to phase out in 2009. The budget also proposes changes in the financing of Chapter 70 education aid, appropriately putting reform of the often-criticized school aid formula squarely at the center of the 2007 budget debate. The local aid increases would be a positive step towards restoring the deep cuts in state aid during the fiscal crisis, a key part of the Foundation's recent recommendation to dedicate to cities and towns an amount equal to 40 percent of annual receipts from the income, sales, and corporate taxes.

The budget also resubmits for legislative approval two proposals that are critical to the efforts of cities and towns to control skyrocketing health care costs. The first would give local officials the authority to set the share of health premium costs that are contributed by local employees, a decision that is now subject to collective bargaining. The second would allow municipalities to establish local "Group Insurance Commissions" to design and manage health plans for their employees.

Both of these proposals would give localities the same kind of flexibility in managing health care costs that the state already has. In a major report issued last summer, the Foundation concluded that between 2001 and 2005 the costs of health coverage for municipal employees rose more than four times as rapidly as local budgets—and almost twice as fast as the costs for state employees.

While the final shape of the state's plan to extend health coverage to the approximately one-half million uninsured in the Commonwealth is still being worked out in a legislative conference committee, the Governor's budget makes a significant initial financial contribution to that effort by setting aside $200 million for health care reform. Based on the Foundation's analysis, similar increases in annual funding will be needed in both 2008 and 2009 to finance comprehensive reform.

The more than $1 billion of proposed additional spending for local aid and other programs is affordable in 2007; however, the new expenditures consume essentially all of the fiscal flexibility created by the recent strong growth in tax revenues. And even though there are some questions whether several of the Medicaid and other savings measures put forth by the administration are achievable (or merely shift costs into the future), the more serious concern is the budget's potential impact on the state's finances beyond 2007.

The budget does accommodate the $130 million initial impact of the Governor's proposed income tax cut, but the approximately $550 million of additional revenue reductions in fiscal 2008 and 2009 would substantially limit the Commonwealth's future ability to restore previous spending cuts as well as pay for largely unavoidable increases in health care and several other areas of the budget. As a result, the large increases recommended by the Governor for 2007 are likely to be tough, if not impossible, to repeat in 2008 and beyond. The need to add substantial new dollars to fund health reform will only add to the difficulty.

Revenues

The consensus revenue forecast on which the Governor's budget is based—up almost $800 million or 4.4 percent from 2006—is a reasonable one, within 0.3 percent of the forecast that the Foundation presented two months ago at the state's annual revenue hearing. The continuing strength in tax collections—receipts in January were $80 million above the administration's revised benchmark—suggest that the risks in the 2007 forecast, at least for the near term, are minimal.

However, it would be a mistake to assume that the almost seven percent annual rate of tax revenue growth since 2004 will be sustainable over the next several years. It is generally recognized that much of the recent revenue growth is attributable to highly volatile capital gains and corporate receipts. Baseline growth[1] in income withholding and sales—the revenue sources most closely tied to the state's economy—lagged overall revenue growth by large margins in 2004 and 2005, a pattern that is continuing in 2006. The weak performance of these two sources is not surprising given the glacial pace of job growth in the state since coming out of the recession: The number of jobs remains 170,000 below the 2001 peak and has actually declined since the beginning of fiscal 2006.

Fiscal Balance

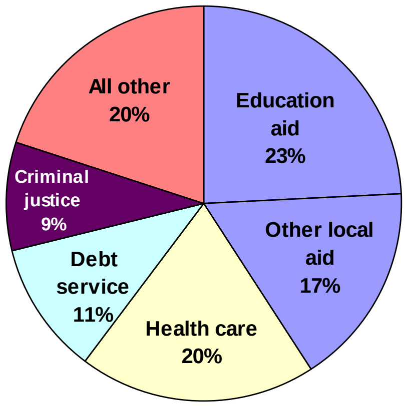
In announcing his budget, the Governor highlighted how the $1.3 billion increase in proposed expenditures over the 2006 budget matched the roughly $1.3 billion increase in 2007 tax revenues over the administration's initial estimate. This comparison conveys an imperfect picture of the Commonwealth's fiscal situation.

While it is true that spending under the proposed budget would rise by $1.3 billion over estimated 2006 expenditures (after accounting for tax-funded pension, MBTA, and school construction spending), the 2007 consensus revenue forecast assumed in the budget is actually only $800 million above the administration's current revenue projection for 2006.

The apparent gap of $500 million between these two figures is filled primarily by an estimated $300 million excess of revenues over spending at the end of 2006 that will carry over into 2007. Although this surplus in 2006 finances is partly due to the improving revenue picture, it also reflects the administration's expectation that roughly $200 million of 2006 appropriations (net of federal reimbursements) will remain unspent. The remainder of the $500 million gap between 2006 and 2007 is filled from a variety of sources, including increased federal reimbursements due to higher 2007 Medicaid spending as well as growth in other non-tax revenues.

[1] Actual receipts adjusted for tax law changes and the timing of collections.

Figure 1
Proposed 2007 Spending Growth Over 2006 Budget
(Percent of Total Increase)



Stabilization Fund

The projected increase in stabilization reserves announced by the Governor is a positive development for the state, although here too some additional explanation is necessary. The administration projects that the stabilization fund will rise to $2.6 billion at the end of 2006, up about $900 million from the current balance of $1.7 billion. Approximately one-third of this increase reflects the deposit of the expected 2006 surplus into the stabilization fund. However, the remaining $600 million is not from new surplus funds, but instead from other reserves that were carried forward from 2005.

The administration contends that no additional contributions to the stabilization fund will be needed in 2007. To be sure, the projected $2.6 billion balance is an impressive sum, about 10 percent of total revenues in 2007. However, this 10 percent margin is no more than the state had on hand at the beginning of the recent fiscal crisis, an amount that was not enough to avoid the deep cuts in local aid, higher education, and other programs needed to weather the crisis. Furthermore, the budget takes a step backwards by suspending the existing requirement that 0.5 percent of prior year tax revenue be transferred to the stabilization fund—estimated at just under $100 million for fiscal 2007.

Spending Growth

The budget proposes $26.9 billion in 2007 spending after accounting for off-budget expenditures, an increase of $1.1 billion or 4.3 percent above the 2006 budget. [2]

The lion's share of the proposed spending growth—40 percent—goes to cities and towns, including $164 million of Chapter 70 school aid, $159 million of lottery aid, and $134 million of other school and non-school assistance (see Figure 1).[3] The budget increases health care spending by $220 million,[4] or almost three percent, over the 2006 budget, a figure that incorporates the $200 million set aside for health care reform as well as $230 million of proposed savings initiatives that are explained below.

The budget also takes the positive step of raising to 25 percent the share of premium costs that is paid by state employees, most of whom now contribute 15 percent.[5] Recently hired employees (those hired after 2002) had paid 25 percent prior to January 1 of this year, when the share was reduced to 20 percent.

The third largest area of growth is debt service—that is, repayment of the state's borrowing for capital projects as well as certain contract assistance—a seven percent increase that incorporates about $40 million of savings from a change in the timing of planned debt issuances and from refunding of existing debt.

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[2] The off-budget spending is primarily for pensions and health care. The $1.1 billion change from 2006 differs from the previously cited $1.3 billion growth in spending largely because it excludes the 2007 increases in sales tax-financed support for the MBTA and school building construction that is not counted as budgetary spending by the state comptroller.

[3] In addition, the off-budget assistance for local school construction will increase by $85 million in 2007.

[4] This comparison of the 2006 and 2007 budgets excludes an additional $167 million of MassHealth spending over estimated 2006 expenditures.

[5] Retirees who are younger than 65 and not required to enroll in a Medicare Part B supplemental plan would also be obliged to contribute 25 percent as well. These retirees now contribute 10 percent or 15 percent depending on the date of their retirement.

After adjusting for inflation, total 2007 spending would be just $213 million, or 0.1 percent, below 2001. However, this slight difference masks a shortfall of $2.3 billion, or 13 percent, in a host of programs across state government that is offset by the huge growth in spending in just three areas—health care, debt service, and pensions (see Table 1). For the programs that remain below 2001, the shortfalls range from about five percent to almost 30 percent. In higher education, for example, inflation-adjusted 2007 spending would be almost $400 million, or 27 percent, below 2001, even though the budget provides for a $44 million, or almost five percent, increase over 2006.

Medicaid

The Governor's proposed budget for 2007 increases spending on MassHealth[6] by 6.1 percent to $7.7 billion, a $445 million increase that includes $200 million earmarked for health care reform (see Table 2). The remaining $245 million, only a 3.4 percent increase over estimated 2006 spending, will support cost and enrollment growth in existing MassHealth programs.

Cost Drivers Underlying program costs are projected to grow by $473 million, offset by proposed savings of $228 million from a combination of new initiatives and the deferral of some costs into future years. Of the $473 million, $300 million is attributable to medical inflation and utilization and $173 million to enrollment growth.

Medical inflation and utilization The budget assumes that the 2007 growth in costs due to medical inflation and utilization of services by the current MassHealth population will be just over four percent. This rate of increase is consistent with recent MassHealth trends and with Medicaid cost growth nationally. Although the average cost of MassHealth coverage per member continues to rise, each year's rate of increase since 2003—when cost growth per

Table 1
Proposed Fiscal 2007 Expenditures
Growth over 2006 Budget and Actual 2001 Spending
($, millions)

				Change from FY01			
		Change from FY06		Nominal		Inflation-Adjusted	
	FY07	Amount	Percent	Amount	Percent	Amount	Percent
Health care	$8,836	$220	2.6	$3,054	55.0	$1,765	25.8
Human services	4,550	90	2.0	456	11.1	-496	-9.8
Education aid	4,034	271	7.2	580	16.8	-222	-5.2
Criminal justice	1,980	103	5.5	272	15.9	-125	-5.9
Debt service	1,959	119	6.5	528	36.8	195	11.1
Other local aid	1,559	186	13.5	18	1.2	-340	-17.9
Pensions	1,335	61	4.7	318	31.3	82	6.6
Higher education	993	44	4.6	-115	-10.4	-373	-27.3
All other	1,680	29	1.7	-251	-13.0	-699	-29.4
Total	$26,928	$1,122	4.3	$4,859	23.3	-$213	-0.1

Note: Amounts have been adjusted to include certain-off-budget authorizations, primarily for pensions and health care. Fiscal 2001 amounts exclude school building costs that were moved off-budget beginning in fiscal 2005. The 2006 budget amounts on which the comparison with 2007 is based do not take into account supplemental spending or reversions (the amount of 2006 agency appropriations that will remain unspent at the end of the fiscal year). The administration estimates that 2006 reversions in MassHealth, the largest state program, will total approximately $270 million. In the comparison with 2001 spending, Medicaid buy-in costs which prior to 2006 were treated as an offset to revenues are excluded from 2007.

[6] The official name of the state's Medicaid program.

Table 2
MassHealth
Spending Changes over 2006
($, millions)

2006 estimated spending	$7,273	
Increase in underlying program costs	473	6.5%
Health care reform	200	2.7%
Cost savings	(228)	-3.1%
2007 proposed spending	7,718	6.1%

member reached a high of around 8 percent—has been smaller than that of the preceding year.

Paradoxically, the slowdown in annual cost growth is partly attributable to the effects of broadening coverage. Earlier MassHealth eligibility expansions were for populations, such as the disabled, which tended to require medically complex, and thus more costly, care. In contrast, the more recent expansions have brought in healthier populations that need less expensive basic medical support. Another key factor has been the state's successful strategies for containing MassHealth pharmacy costs. The "super-preferred" drug list, which targets high cost and high volume items, combined with the introduction of a third party pharmacy benefit manager, has resulted in an actual decline in costs since 2003.

Enrollment The second major driver of increased MassHealth costs is the addition of new members. Since 2004, MassHealth membership has grown as previously ineligible groups such as legal immigrants were added to the rolls and as the state pursued a policy of actively enrolling those eligible for Medicaid.

The administration forecasts that enrollment will increase by 26,500, or 2.6 percent, by the end of 2007. By comparison, enrollment growth in 2006 was 4.2 percent (the largest single year increase since 2002) as a result of new screening and outreach programs. As more of the eligible but unenrolled have been added to the rolls in recent years, there are fewer such individuals remaining to be enrolled.

The budget preserves the status quo for MassHealth eligibility. While it maintains enrollment caps on existing programs with waiting lists, it also sustains funding for coverage for legal aliens and the long-term unemployed; this is a break with previous budgets in which the Governor attempted to roll back such coverage.

Cost Savings The budget partially offsets the $473 million of underlying program growth with a series of savings and cost-shifting proposals that total $228 million, a target that is almost certainly overly optimistic (see Table 3).

Nursing home rates Over half of the budget's proposed MassHealth savings comes from the delay of a scheduled "re-basing" of nursing home rates into 2008, thereby achieving $130 million of one-time savings. Re-basing adjusts nursing home per diem rates to reflect cost increases that have not been taken into account in the annual rate increases for inflation. Re-basing last occurred in 2005 and is normally scheduled to occur every two years. Historically, re-basing has resulted in rate increases of about 6.5 percent.

Discontinuing special payments to providers In 2006 providers received $52 million in payments for facilities that incur losses as a result of treating a disproportionately high number of Medicaid patients.

While the proposed discontinuance of these payments represents real savings to the state, providers would argue that the payments offset real costs. The administration believes that other steps now being contemplated to bring reimbursement rates closer to actual costs will

Table 3
Proposed Cost Savings 2007
($, millions)

Nursing home rates	$130
Special payments to providers	52
Improved purchasing practices	15
Fraud and cost avoidance	31
Total cost savings	228

obviate the need for these special payments. However, while the Governor has suggested that some of the $200 million earmarked for health care reform be used to increase provider reimbursement rates, the budget takes no specific steps to accomplish this.

Improved purchasing practices Based on the experience of other states, the administration projects it can save $15 million by renegotiating a number of contracts up for renewal and by improving purchasing practices. These savings would come from selectively reviewing a small number of very high cost services and goods, many of which have already been successfully targeted by private providers in Massachusetts. Since the Commonwealth has already achieved significant reductions in its pharmacy costs through similar initiatives, the proposed savings from better purchasing strategies appear to be achievable.

Fraud reduction and cost avoidance Finally, the administration proposes to generate $31 million of savings by reducing fraud and more aggressively seeking third party payments from sources other than Medicaid. Although enforcing the legal obligation of a third party to cover costs of treatment is an approach that private insurers have successfully adopted, it has generally proven difficult to replicate this success in public programs. In addition, the Legislature has traditionally been reluctant to enforce some of the rules needed to access third party payments. Where such measures have been implemented in other states, the high costs of seeking payments have often resulted in lower than expected returns.

Despite these obstacles, changes at the federal level may require the state to adopt a stronger stance along the lines proposed by the Governor. For example, the federally determined 'look-back' period for large asset transfers is likely to be lengthened from three to five years, as proposed in the Governor's budget at an estimated saving of $9 million a year. The transfer of these assets often allows individuals to qualify for Medicaid coverage for long-term care expenses that they otherwise would have to pay.

Health Care Reform

The Governor proposes to set aside $200 million for health care reform, representing new funding for a goal—expanding health coverage for the state's approximately 500,000 uninsured—that has received broad support. A legislative conference committee is still working to reconcile the House and Senate's widely differing reform proposals. Meanwhile, the Commonwealth remains under a deadline to submit a proposal for federal approval in order to preserve $375 million in annual federal matching funds and to satisfy the terms of the state's Medicaid waiver.

In anticipation of health care reform, the Governor's budget makes no mention of financing for the Uncompensated Care Pool (UCP) which currently reimburses providers for a part of the costs incurred in treating the uninsured. However, the budget assumes that the state will continue to fund the UCP at approximately $200 million and that the provider assessment and insurer surcharge will be maintained in 2007. The federal government requires the state to replace the UCP with a new system effective July 1, 2006, to be known as the Safety Net Care Pool.