# *State Budget '04: The Long Road Back*

**JANUARY 2004**

The Massachusetts Taxpayers Foundation is a nationally recognized, nonprofit research organization working to promote the most effective use of tax dollars, improve the operations of state and local governments, and foster positive economic policies.  Our credibility is based on independent, objective, and accurate analysis of state and local spending, taxes and the economy. The quality and impact of the Foundation's work is reflected in eight prestigious national awards recently earned for research on business costs, capital spending, state finances, MBTA restructuring, state government reform, and health care.

Founded in 1932, MTF ranks among the largest and most effective organizations of its kind in the country.  Our reports and recommendations have resulted in new policies, new laws and other changes that have saved taxpayers hundreds of millions of dollars.  We are supported by our employer members, representing virtually all sectors of the Massachusetts economy across the state.

**Massachusetts Taxpayers Foundation**
**333 Washington Street, Suite 853**
**Boston, MA  02108-5170**

**617-720-1000     Fax:  720-0799**
**E-mail:  mtfinfo@masstaxpayers.org**
**Website:  www.masstaxpayers.org**

This report was produced by MTF staff members Carol L. Cardozo, E. Cameron Huff, and Glen R. Tepke.

# State Budget '04:
# The Long Road Back

## Table of Contents

## Overview

While the improving revenue picture of recent months is a welcome change from the sharp declines of the last two years, the Commonwealth has not yet resolved the huge mismatch between spending and revenues that has plagued the state's finances since the onset of the fiscal crisis in the fall of 2001. Despite a series of emergency actions over the last three years—including major tax and fee increases, the draining of reserves, and almost $3 billion of spending cuts—the state still faces a structural deficit of more than $1 billion in fiscal 2005. Given the magnitude of the shortfall, further spending cuts will inevitably be needed to close the gap and put the state's budget on a sound footing.

In two major reports on the state's budget over the last three years, the Foundation described a "perfect storm" of forces that has produced a financial emergency rivaling the fiscal crisis of the early 1990s:

- A sharp decline in tax revenues that was precipitated by the bursting of the stock market and the dot.com bubble and made worse by the extended recession;
- The voter-approved cut in the income tax rate that locked the state into a $1 billion tax reduction just as capital gains receipts collapsed; and
- Rapid growth in the costs of largely unavoidable state obligations, including health care, pensions, and debt service.

All of these forces continue to buffet the state's finances. Even with a recent upward revision in the forecast for 2004, tax collections for the year will still be $1.5 billion below 2001, before the fiscal crisis began. Despite a doubling of the tax rate on capital gains, revenues from that source are only about a third of the pre-crisis total.

At the same time, spending on health care and other major obligations continues to drive relentlessly upward. Medicaid and other health care expenditures have increased more than $2 billion, or about 40 percent, since 2001, with double-digit increases expected in 2005. Because of the combined impact of market losses, benefit expansions, and imprudent funding cuts, the appropriation required for state employee pensions will increase by more than $500 million, a staggering 77 percent jump, in fiscal 2005. Debt service on the state's capital projects is up almost $400 million, or 25 percent, from 2001 to 2005, with annual increases of $100 million or more ahead for the foreseeable future. Adding even further to the fiscal problem, the state is still relying heavily on one-time resources to pay for ongoing costs, with almost $900 million of 2004 receipts that will not recur in 2005.

Realistically, the Commonwealth should expect only modest revenue growth for the next several years, with annual increases that are likely to fall short of the escalating costs needed to support the Commonwealth's current obligations. That means that any hope of significant restoration of the deep spending cuts of the last three years—much less actual expansion—is premature, at best. While the sweeping cuts that were required in 2003 and 2004 are probably not needed to balance the 2005 budget, some significant reductions are inevitable. Additional spending in one program will have to be offset by reductions in others. It is worth remembering also that even level funding will necessitate some cuts in services or operations because of the impact of inflation. In local aid, for example, holding spending constant would mean that municipalities must cut services in the face of rising health care and other costs.

While there are a long list of reforms the Commonwealth should undertake—such as improving management of the courts, eliminating pension abuses, and easing the anti-competitive "Pacheco" law—those measures will produce only modest savings over time, and almost none in the short term.

Despite the improving revenue picture, the task of producing a balanced budget for 2005 will in some ways be harder than it was in 2004, because of the pain that has already been inflicted through spending cuts, tax increases on businesses and individuals, and fee hikes. Although it may be possible to forestall some spending cuts by relying on reserves or by pushing obligations onto future taxpayers, those measures would only delay the day of fiscal reckoning.

## Fiscal 2004

While the Commonwealth's fiscal problems are far from over, the 2004 financial picture is much improved over a year ago. With moderate gains in the state economy—propelled in part by a much stronger pace of recovery for the nation—2004 revenues are on track to exceed the budget's conservative estimate by several hundred million dollars.

Expenditures in the most difficult to control areas of the budget are by and large being held to authorized levels. In the huge Medicaid program, lower than projected caseloads are easing some of the pressure to meet the aggressive and painful savings targets for 2004. While some supplemental appropriations will inevitably be required, for example to address underfunding of snow and ice removal, routine "reversions" (unplanned end-of-year surpluses in agency accounts) are likely to be sufficient to offset the additional spending.

However, even with this positive financial picture, the state's leaders still face an enormous challenge for 2005, due to the difficult combination of double-digit increases in health care costs, a large jump in required pension funding, and an expected rate of revenue growth that is less than half that of the boom years. Given this reality, the state cannot afford any easing of spending discipline in the months ahead. Adding to the state's spending base in 2004 would only deepen the cuts required in 2005.

### 2004 Revenues

Taxes

Fiscal 2004 tax revenues are projected to total $15.23 billion, almost $270 million, or 1.8 percent, above 2003 receipts (see Table 1), according to a consensus agreement recently reached among the administration, House and Senate. This revised estimate is $422 million higher than the tax forecast on which the 2004 budget was based.

**Table 1**
**State Tax Revenues:**
**Fiscal 2004 Forecasts**
($, Millions)

| | Amount | Change from 2003 | Pct. Chg. |
|---|---|---|---|
| 2003 actual | $14,964 | – | – |
| 2004 budget | 14,808 | -156 | -1.0 |
| Consensus | 15,230 | 266 | 1.8 |
| DOR "low" | 15,238 | 274 | 1.8 |
| MTF forecast | 15,417 | 453 | 3.0 |

That $14.81 billion budgetary forecast assumed underlying growth in the state's tax base of just 0.7 percent, or about $100 million. After adjusting this underlying rate for the loss of tax amnesty and other one-time revenues in 2003, actual tax collections for 2004 were expected to fall almost $156 million, or 1.0 percent, versus the $266 million increase now projected.

The consensus forecast is $8 million below the low end of a range of 2004 projections prepared by the Department of Revenue in December and $187 million below the Foundation's forecast. The department and MTF presented their tax forecasts at the state's annual revenue hearing convened by the chairs of the House and Senate

Committees on Ways and Means and the Secretary of Administration and Finance.

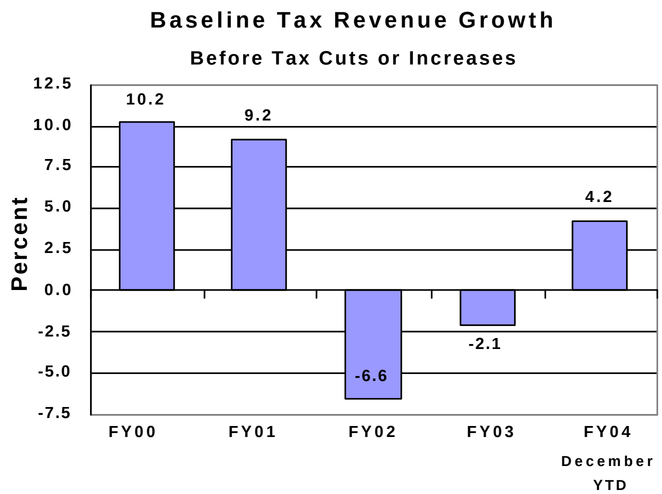
While cautioning that the Massachusetts economy is not out of the woods yet, economists at the revenue hearing pointed to the numerous signs of a strong, albeit "jobless," national economic recovery as well as underlying tax growth of 4.2 percent through December (see Figure 1), compared to the 0.1 percent baseline growth that was expected for the same period under the forecast in the budget. In the first six months of fiscal 2004, tax collections were $356 million above projections, and about $250 million more than the growth that the budget counts on for the entire fiscal year.

Almost half of the year-to-date growth is due to a surge in baseline corporate taxes, which are up roughly $150 million. Most of the remaining increase is attributable to the income tax, which benefited from higher than expected estimated payments and lower than expected refunds.

While the consensus forecast projects about 3.4 percent underlying tax growth in 2004, the actual increase over 2003 is substantially less than that baseline figure because of the impact of one-time revenues and prior tax law changes. In total, an estimated $433 million of fiscal 2003 tax revenues will not recur in 2004, including:

- $150 million collected under the tax amnesty program;
- Almost $130 million of payments for prior tax obligations related to real estate investment trusts (REITs); and
- More than $100 million collected in 2003 as a result of the retroactive decrease in personal exemptions in 2002.

**Figure 1**




In addition, an accounting change—the movement of Boston Convention Center financing off budget—will lower 2004 taxes supporting the budget by roughly $50 million.

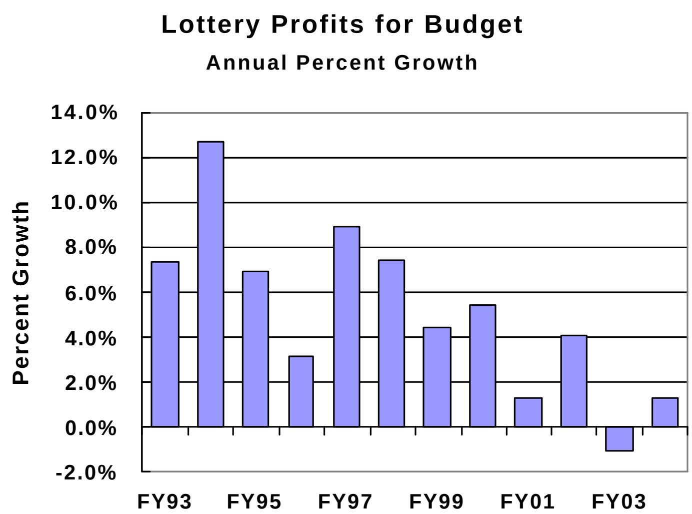
The loss of one-time receipts will be partially offset by the continuing effect of previously adopted tax increases. The business tax “loophole closing” legislation adopted in 2003 will generate almost $150 million of new revenues in 2004, including $65 million for business purpose transactions and more than $30 million for qualified "Q" subsidiaries. In addition, other tax law changes are expected to produce net new revenues of more than $100 million, primarily from the capital gains tax increase.

Other Revenues

*Federal Reimbursements* Under a fiscal relief package to the states enacted by Congress in May 2003, the Commonwealth's federal revenues will be boosted by $550 million over two fiscal years. A modest portion of that total, roughly $55 million, was received in fiscal 2003, leaving approximately $495 million that will be collected in 2004.

About half of the 2004 payment will take the form of a temporary increase in the rate at which most of the Commonwealth's Medicaid spending is reimbursed. The rate increment—from 50 percent to 52.95 percent—is expected to generate approximately $275 million for the state in fiscal 2004. The balance of the one-time federal relief payment, more than $200 million, comes to the state with no federal strings attached.

**Figure 2**




Under the 2004 budget, $55 million of the new federal monies will help support the uncompensated care pool. Legislation passed after the fiscal year began directs the remaining monies, more than $440 million, be credited to a newly created reserve fund. While these dollars have not yet been appropriated for expenditure, any unused revenues in the fund at the end of the fiscal year will count toward balancing the 2004 budget. Under the administration's assumptions prior to the consensus tax agreement, all of these one-time receipts would have been needed in 2004, primarily to offset significant erosion in the nontax revenues assumed in the original budget.

*Fees and Charges* State agencies are projected to collect $1.92 billion in fees and other departmental revenues in fiscal 2004, over $300 million more than 2003. Departmental revenues include vehicle license and permit fees, court fees and fines, and charges for a wide range of other state services.

The 21 percent rise in departmental revenues over the last three years is almost entirely due to increases in fees in order to help balance the state budget. Approximately $145 million of the growth in fee revenue stems from last year's more than doubling of fees charged by the state's 14 registries of deeds, with as much as $60 million also expected from the quintupling of the per gallon charge imposed on the delivery of petroleum products. Fees for court filings, professional registrations, alcohol permits, firearm licenses, public golf course use, and a host of other services were also increased. In addition, the state also dramatically raised charges at the University of Massachusetts and other public colleges—by 30 percent or more in just the last year. The revenues from these charges are retained by the campuses and not included in the totals reported here.

*Lottery* The state lottery is expected to generate between $965 and $975 million of net profits in fiscal 2004. These revenues represent the amount remaining after prizes and ticket agents have been paid, which is transferred to the Treasurer's Office for distribution as state aid to cities and towns, reimbursement of the costs of lottery administration, and other budgetary purposes.

While the projected increase in net revenues for 2004, less than two percent, is modest by

**Table 2**
**2004 Spending Authorizations**
($, Millions)

| | |
|---|---|
| Appropriations continued from 2003 | $55 |
| Line item appropriations | 21,604 |
| Transfers/off-budget spending | |
| Medicaid and related health care | 696 |
| State employee pension funding | 687 |
| RMV fees for Central Artery | 47 |
| Revenue/debt contingency payments | 32 |
| Tuition retention | 31 |
| Subtotal | 1,493 |
| Supplementals to date | 140 |
| Total | $23,292 |

Note: Total spending shown here does not reflect $45 million of supplemental spending for snow and ice control or $150 million of reversions assumed in the Foundation's analysis of 2004 balance.

historical standards, it reflects the beginnings of a concerted effort by the Lottery Commission to reinvigorate the flagging growth in lottery receipts. In recent years, a combination of factors has driven a trend of slowing growth that culminated in the first-ever decline in net profits in fiscal 2003 (see Figure 2). The contributing factors include the economic recession, competition from casinos and other state lotteries, and the almost complete elimination of spending for lottery advertising in the 1990s. The commission expects the $5 million authorized for advertising in the 2004 budget to generate an additional $25 million in net profits. To further bolster revenues, lottery officials have restructured the on-line Keno game and are exploring other changes.

**2004 Spending**

Authorized spending totals $23.29 billion in 2004, $670 million or 3.0 percent higher than 2003. This total includes $21.60 billion of regular line item appropriations in the budget (after vetoes and overrides), $140 million of supplemental appropriations to date, $55 million carried forward from 2003, and $1.49 billion of transfers and other authority for "off-budget" spending (see Table 2).[1] These off-budget authorizations primarily reflect expenditures in two areas that were previously part of the regular budget: almost $700 million of Medicaid and related health care expenditures, including $160 million for MassHealth Essential, the successor to the program for the long-term unemployed that was eliminated in 2003; and $687 million for pension funding that will now be met through a transfer from revenues.

**Table 3**
**Major Decreases in State Spending**
**Fiscal 2001 to 2004**
($, Millions)

| Spending Category | Amount of Decrease | Percent Change |
|---|---|---|
| Education & local aid | $569 | 27.6 |
| Pensions | 330 | 32.4 |
| Human services | 326 | 14.2 |
| Higher education | 293 | 26.5 |
| All other | 475 | 20.1 |
| Total Decreases | $1,992 | 22.5 |

[1] The $23.29 billion total does not include another $100.9 million that the recently enacted stimulus package (Chapter 141, Acts 2003) transferred from the state's reserves to fund future economic development activities.

While total authorizations are up only modestly from 2003, that increase reflects the combined impact of 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 $652 million, a figure that comes on top of the severe cuts in 2002 and 2003 and would be even higher were it not for supplemental appropriations that have restored some prior reductions. Offsetting the 2004 reductions are almost $1 billion of increased expenditures for Medicaid and other health care services, despite the cuts in these programs.

The tradeoff between health care and other state programs is put into even sharper relief when the entire period of the state's fiscal crisis is examined. Since fiscal 2001 (before the fiscal crisis began), annual health care expenditures have increased $2.1 billion, or 39 percent, while spending for all other state programs has fallen by $1.1 billion, or almost seven percent.[2] Because of its rapid rate of growth, health care's share of total state spending has jumped from almost 25 percent in 2001 to just under 33 percent in 2004, a comparison that includes Medicaid, uncompensated care, employee health, and senior pharmacy costs.

Looking behind these aggregate figures, the impact of the crisis-driven cuts on individual programs is more striking still. Absolute levels of programmatic spending have been cut by $2.0 billion, or 22.5 percent, from 2001 to 2004, a decrease that does not include almost $700 million of savings initiatives, cuts, and other cost revisions in the Medicaid program (see Table 3). The hardest-hit areas include education aid ($569 million or 27.6 percent), pensions ($330 million or 32.4 percent), human services ($326 million or 14.2 percent), and higher education ($293 million or 26.5 percent).

**Table 4**
**2004 Balance**
($, Millions)

| | |
|---|---|
| Revenues with consensus tax forecast | $23,650 |
| Estimated spending | 23,187 |
| Balance: | |
| Using consensus forecast | 463 |
| Using MTF tax forecast | 650 |
| One-time resources | |
| Federal fiscal relief | -458 |
| Hynes/Convention Center transfer | -145 |
| Transfer from stabilization | -103 |
| Teacher's quality trust balance | -62 |
| All other | -98 |
| Total one-time resources | -866 |
| Structural deficit: | |
| Using consensus forecast | -403 |
| Using MTF tax forecast | -216 |

Note: Both revenue and spending amounts include $55 million of prior appropriations continued from 2003, $687 million of tax revenues to be transferred to pension funds, and approximately $820 million of other "off-budget" financial activity; the spending total assumes $45 million of deficiency spending for snow and ice control and $150 million of reversions (unplanned surpluses in agency appropriation accounts at end of year).

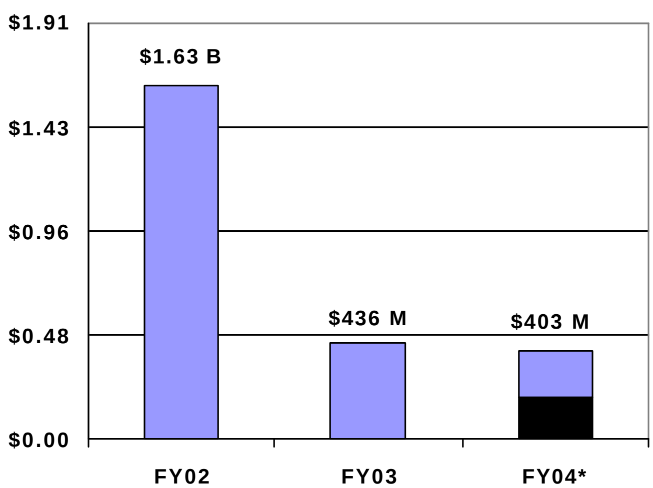
[2] Based on an update of the comparison of 2001 spending and the 2004 General Appropriation Act in MTF's August 11 Bulletin, *2004 Budget: Major Strides, But More Pain Ahead.*

These reductions are offset by the $2.1 billion increase in health care spending noted above, as well as $865 million of net increases in other programs, including education aid, human services programs operating under consent decrees, and debt service.

**2004 Balance**

Given the improving revenue outlook—and reserves that have been bolstered by last year's business tax increases and federal fiscal relief—the Commonwealth clearly has sufficient resources to finance the authorized levels of spending for 2004. Using the consensus tax forecast and taking into account known supplemental needs and likely reversions, 2004 revenues would exceed estimated spending by more than $460 million; using MTF's more optimistic forecast, revenues would exceed spending by $650 million (see Table 4).
However, this "surplus" depends on the use of almost $900 million of one-time resources, including more than $450 million of non-recurring federal dollars (which does not include $33 million authorized to be transferred to the newly created economic stimulus trust fund), $145 million from the transfer of the Hynes Auditorium and Convention Center, and $100 million transferred from the stabilization fund.

**Figure 3**
**State Operating Deficits**
($, Billions)




* Deficit assuming MTF tax forecast is shown in black.

Adjusting for these factors reveals an underlying structural deficit of more than $400 million. Using the higher MTF forecast still leaves an imbalance of more than $200 million that will carry forward into 2005 (see Figure 3).

Unfortunately, in spite of the series of painful actions that have reduced the operating shortfall from its $1.6 billion peak in fiscal 2002, the state has not closed the structural budget gap.

## BUDGET SUMMARY

**Fiscal 2000-2004**

| ($ Millions) | Actual 2000 | Actual 2001 | Actual 2002 | Actual 2003 | 2004 Authorized[3] | $ Change 2003 to 2004 | 2004 Percent Total |
|---|---|---|---|---|---|---|---|
| **Investment in Children** | **$5,527.6** | **$6,014.3** | **$6,270.7** | **$6,139.3** | **$5,819.6** | **($319.6)** | **25.0%** |
| Education Local Aid | 3,534.4 | 3,830.1 | 4,096.6 | 4,022.0 | 3,794.7 | (227.3) | 16.3% |
| Higher Education | 1,006.3 | 1,109.1 | 1,037.1 | 982.3 | 852.6 | (129.7) | 3.7% |
| Services to Children | 537.6 | 573.6 | 631.8 | 646.0 | 681.9 | 35.9 | 2.9% |
| Youth Services | 111.9 | 118.3 | 122.5 | 122.8 | 126.0 | 3.2 | 0.5% |
| Child Care Services | 337.5 | 383.2 | 382.7 | 366.1 | 364.4 | (1.6) | 1.6% |
| **Criminal Justice and Law Enforcement** | **$1,586.4** | **$1,708.7** | **$1,752.8** | **$1,714.0** | **$1,744.5** | **$30.5** | **7.5%** |
| Corrections | 745.5 | 799.4 | 824.6 | 808.8 | 833.6 | 24.8 | 3.6% |
| Judiciary | 545.8 | 588.7 | 580.0 | 566.5 | 574.9 | 8.4 | 2.5% |
| Police | 195.0 | 205.4 | 231.0 | 230.7 | 225.3 | (5.4) | 1.0% |
| DAs | 72.1 | 81.4 | 81.4 | 75.8 | 77.1 | 1.3 | 0.3% |
| Attorney General | 28.0 | 33.8 | 35.7 | 32.2 | 33.5 | 1.3 | 0.1% |
| **Local Government** | **$1,553.7** | **$1,541.0** | **$1,523.1** | **$1,295.7** | **$1,241.8** | **($53.9)** | **5.3%** |
| **Assistance to the Poor** | **$5,374.6** | **$5,817.0** | **$6,494.9** | **$6,926.9** | **$7,711.2** | **$784.3** | **33.1%** |
| Medicaid | 4,390.4 | 4,783.4 | 5,415.6 | 5,847.9 | 6,638.9 | 791.0 | 28.5% |
| Cash Assistance | 637.5 | 646.1 | 682.6 | 688.8 | 690.0 | 1.2 | 3.0% |
| Housing Assistance | 156.9 | 158.4 | 142.6 | 109.9 | 94.7 | (15.1) | 0.4% |
| Elderly | 189.8 | 229.1 | 254.1 | 280.3 | 287.6 | 7.3 | 1.2% |
| **Assistance to the Sick and Disabled** | **$1,946.8** | **$2,053.8** | **$2,076.3** | **$2,007.0** | **$1,975.1** | **($31.9)** | **8.5%** |
| Mental Retardation | 868.3 | 916.1 | 966.1 | 986.4 | 1,014.3 | 27.9 | 4.4% |
| Mental Health | 571.7 | 602.3 | 607.6 | 597.3 | 592.8 | (4.5) | 2.5% |
| Public Health | 506.8 | 535.3 | 502.6 | 423.3 | 368.0 | (55.3) | 1.6% |
| **Transportation** | **$764.6** | **$260.4** | **$215.2** | **$222.1** | **$186.4** | **($35.7)** | **0.8%** |
| Regional Transit | 591.5 | 41.2 | 49.3 | 42.4 | 53.2 | 10.7 | 0.2% |
| Highways | 116.2 | 155.4 | 98.8 | 115.4 | 66.8 | (48.6) | 0.3% |
| Registry | 56.9 | 63.8 | 67.1 | 64.3 | 66.4 | 2.1 | 0.3% |
| **Economic Development** | **$356.8** | **$403.5** | **$373.7** | **$315.5** | **$300.4** | **($15.1)** | **1.3%** |
| Business and Labor | 137.8 | 158.4 | 142.3 | 127.3 | 121.6 | (5.7) | 0.5% |
| Environment | 219.0 | 245.1 | 231.5 | 188.2 | 178.8 | (9.4) | 0.8% |
| **Central Costs** | **$2,835.4** | **$3,127.0** | **$2,903.6** | **$3,017.4** | **$3,132.6** | **$115.2** | **13.4%** |
| Employee Benefits[1] | 1,588.6 | 1,695.3 | 1,527.4 | 1,567.0 | 1,536.0 | (31.0) | 6.6% |
| Debt Service | 1,246.8 | 1,431.8 | 1,376.2 | 1,450.4 | 1,596.6 | 146.2 | 6.9% |
| **Other** | **$1,073.3** | **$1,178.9** | **$1,144.9** | **$984.1** | **$1,180.2** | **$196.1** | **5.1%** |
| General Government | 677.0 | 698.5 | 695.5 | 618.1 | 650.6 | 32.5 | 2.8% |
| Residual | 396.3 | 480.4 | 449.3 | 365.9 | 529.5 | 163.6 | 2.3% |
| **Total Budget** | **$21,019.2** | **$22,104.6** | **$22,755.2** | **$22,622.0** | **$23,291.8** | **$669.8** | **100.0%** |
| Adjusted for MBTA[2] | | **$22,759.2** | **$23,439.5** | **$23,306.3** | **$23,976.1** | | |

1. Does not include workers' compensation and unemployment insurance that are budgeted in agency accounts.
2. In 2001, expenditures (and supporting sales tax revenues) for operating and debt service assistance to the MBTA were moved off-budget.
3. Including appropriations continued from 2003, supplemental appropriations through December 31, 2003, legislative overrides of gubernatorial vetoes for the same period, and "off-budget" spending authorizations and transfers, primarily for Medicaid and pension costs; prior years adjusted to reflect shift of Boston Convention Center financing off-budget in 2004.

## Fiscal 2005

Despite the improving revenue outlook and almost $3 billion of spending cuts over the last three years, the structural imbalance in the state's budget will require further tough choices in the coming year.

Fiscal 2005 will mark the fourth straight year that the Commonwealth's revenue base is insufficient to support the ongoing costs of state programs and services, leaving a gap of $1 billion or more that will have to be addressed. Even though revenues are expected to grow by at least 3.8 percent, rapid spending increases in several key programs—most notably health care, pensions, and debt service—will more than consume the additional revenues. On top of that, in 2005 the state will need to replace almost $900 million of one-time 2004 resources.

The recently revised tax cap will further restrict the state's fiscal choices in 2005—and beyond. Under amendments adopted in the 2003 budget, tax revenue growth for the budget cannot exceed inflation plus two percent, with any excess receipts dedicated first to replenishing reserves.

### 2005 Revenues

Following the December hearing on tax projections for the coming year, the state's fiscal leaders have agreed on a consensus revenue estimate for fiscal 2005 of $15.8 billion, $572 million or 3.75 percent above the consensus forecast for 2004 (see Table 5).

Like the Foundation's 2005 forecast, the consensus estimate assumes that Massachusetts will experience a slower—and milder—economic recovery than the nation as a whole in both job and income growth. Given the current strong performance of the national economy, as well as the 4.2 percent growth in baseline state taxes in the first half of fiscal 2004, the consensus revenue forecast is clearly conservative, perhaps overly so. However, some caution continues to be warranted, in part because of the softness in income tax withholding and sales tax collections.

The 2005 revenue outlook is a positive change from the dismal revenue performance of recent years, though still far from the double-digit growth of the late 1990s (see Figure 4). Baseline taxes (before tax increases or cuts) fell 6.6 percent in fiscal 2002 and a further 2.1 percent in 2003.

The consensus forecast is only about $100 million below the state's tax cap. The cap limits annual increases in tax collections that may be used for the budget to the rate of inflation in state and local government spending plus two percent. The Foundation estimates that the allowable growth under the cap in 2005 will be 4.46 percent over actual 2004 tax collections. Based on the consensus forecast of 2004 receipts, the allowed percentage growth translates into a cap of $15.91 billion on taxes that may be spent in 2005 (with a slightly higher $16.1 billion cap based on MTF's 2004 forecast). Any collections in excess of the tax cap

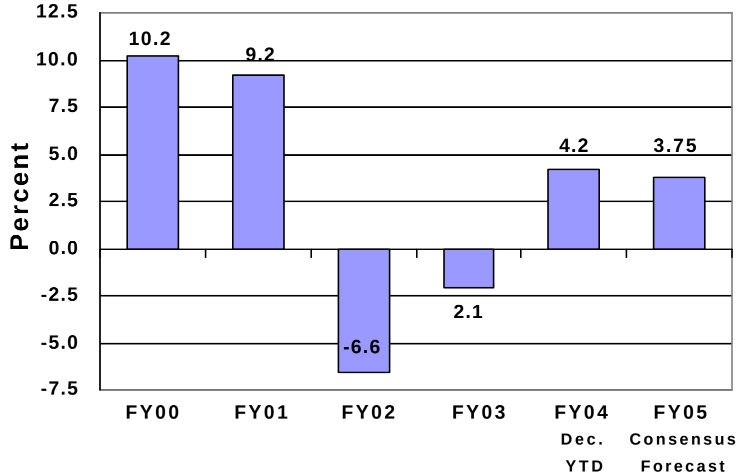
**Table 5**
**2004-2005 Tax Revenues**
($, Millions)

| | 2004 | 2005 | Chg. | Pct. Chg. |
|---|---|---|---|---|
| Budget/October 15 | $14,808 | $15,422 | $614 | 4.1 |
| Consensus forecast | 15,230 | 15,802 | 572 | 3.8 |
| DOR "Low" | 15,238 | 15,847 | 609 | 4.0 |
| MTF | 15,417 | 16,091 | 674 | 4.4 |

would not be available for spending but would instead replenish the rainy day fund.

Nontax revenues will also rise in 2005, although much of that growth will be driven by increases in Medicaid spending, most of which is reimbursed 50 percent by the federal government. Our analysis of fiscal 2005 finances assumes 12 percent growth in Medicaid expenditures, which would produce almost $400 million of federal reimbursements. The combination of an improving economy and efforts to expand sales is likely to generate some additional lottery revenues for the budget as well. For purposes of this analysis, the Foundation is assuming a three percent—or $29 million—increase in net lottery profits in 2005, with some potential for modest additional growth.

**Figure 4**
**Baseline Tax Revenue Growth**
**Before Tax Cuts or Increases**




## 2005 Spending

Based on the Foundation's analysis, the spending required in 2005 to sustain the state's programs and services at 2004 levels would total $25.1 billion, an increase of $1.9 billion or 8.4 percent. This total is built on the base of estimated 2004 expenditures. Further legislative overrides of the Governor's budgetary vetoes and supplemental appropriations that are not offset by savings would result in an even higher estimate of 2005 spending. The analysis does not include any restorations of prior spending cuts.

These projections are based on estimates and reasonable assumptions about the likely growth in a set of key spending accounts (summarized in Table 6), including:

- A $795 million, or 12 percent, increase in Medicaid expenditures, reflecting the continuing impact of price inflation, greater utilization, and expensive new treatments that have driven up health care costs in recent years. This figure includes increases in "off-budget" Medicaid expenditures such as MassHealth Essential, which has replaced the health benefit program for the long-term unemployed that was eliminated in fiscal 2003, as well spending for uncompensated care that is financed by off-budget transfers in 2004.

- A $230 million, or 14.4 percent, rise in debt service costs. The rapid growth is primarily explained by three factors: the loss of one-time savings from refinancing of old Commonwealth bonds that lowered costs in 2003 and 2004; additional debt service due to the issuance of most of the bonds needed to cover Central Artery overruns; and the delayed impact of increasing the state's bond cap from $1.0 billion to $1.2 billion in 2002.

**Table 6**
**Assumed 2005 Spending for**
**MTF Analysis**
($, Millions)

| | Amount | Increase |
|---|---|---|
| Medicaid | $7,420 | $795 |
| Ch. 70 education aid | 3,158 | 50 |
| Debt service | 1,827 | 230 |
| Pensions | 1,217 | 530 |
| Employee health benefits | 890 | 81 |
| Lottery | 661 | 0 |
| All other | 9,951 | 252 |
| **Total** | **$25,124** | **$1,937** |

- An $81 million, or 10 percent, increase in the state costs of employee health benefits, a program that faces similar cost pressures as Medicaid.

- No increase in the amount of lottery revenues distributed to cities and towns. We assume that the amount appropriated for lottery aid will remain the same as in 2004, with the additional 2005 proceeds, estimated at $29 million, being used to help balance the budget.

- A $50 million, or 1.6 percent, increase in formula aid to local schools, the amount of additional aid that is likely to be needed to maintain school spending in poorer districts at the "foundation" levels required by the Chapter 70 education reform law.

- A $530 million, or 77 percent, increase in annual pension appropriations required under the recently approved revision of the state's pension funding schedule. The increase is necessary because the state's unfunded pension liability has ballooned over the past three years, due to the combined impact of large losses in the value of pension assets, the added costs of early retirement and other new benefits, and prior cuts in the annual pension appropriation.

- In all other areas of state spending, a $252 million, or about 2.5 percent, increase for inflation.

**2005 Use of Reserves**

The Foundation's analysis does not assume any use of reserves in 2005. The state was forced to make a huge $1.4 billion draw on the stabilization or "rainy day" fund in fiscal 2002 and depleted the fund by another $240 million in 2003. As a result, the fund's balance was reduced from $2.3 billion at the end of 2001 to $505 million today.[3] In addition, smaller balances in a variety of other reserves were consumed completely over the past two years.

The state also has two other significant reserves: the off-budget tobacco settlement trust created to help fund future health care needs, with a current balance of $410 million after deducting $33 million recently authorized to be transferred to support economic development; and the recently established reserve fund for fiscal relief dollars from the federal government. Of the $550 million total relief from Washington, the state has already spent approximately $200 million, including $33 million recently dedicated to economic development. Under current law, any remaining balance in the

[3] This estimated balance reflects the $103 million withdrawal to fund supplemental 2004 spending. It also takes into account the $33 million withdrawal authorized by recently enacted economic development legislation; similar withdrawals were also authorized from the tobacco and federal fiscal relief reserve funds discussed below.

fund at the end of fiscal 2004 will carry forward into 2005.

**2005 Balance**

The Foundation's analysis projects a 2005 deficit of $1.1 billion, based on the MTF tax forecast and likely growth in the largest and most difficult to control areas of state spending (see Table 7). Using the lower consensus tax forecast for 2005, next year's deficit would be $1.4 billion. To the extent that required 2005 spending in other programs is higher than the assumed rate of inflation, possibly due to court decrees or contractual agreements, these deficit estimates would be higher.

However, even if revenues meet the MTF forecast and the expected deficit is "only" $1.1 billion, the state still faces an enormous challenge in crafting a balanced spending plan for 2005. In the struggle to deal with the prolonged fiscal crisis, the state's leaders have already cut spending by almost $3 billion, increased taxes on businesses and individuals, dramatically hiked the fees paid—directly or indirectly—by every Massachusetts resident, and drained reserves. And while much more can be done to meaningfully reform state operations, such initiatives will only produce savings over the longer term, and even then not on a scale that would sustain the annual spending growth of eight percent projected for 2005.

It is almost certain that the ultimate solution to the 2005 shortfall will require some use of the state's remaining reserves. It must be recognized, however, that such stopgap solutions will prolong the impact of the structural deficit. One-time resources used in 2005 will have to be replaced in 2006, either by committing tax revenue growth that could have been used in other ways or by making further reductions in spending. In any event, it will be difficult to restore any substantial amounts of the recent deep cuts given the size of the 2005 projected deficit and the limited support for new revenues. Unfortunately, the prospects for future restoration of those cuts are little better beyond 2005: For the foreseeable future, the continued double-digit increases in health care costs will consume most of the revenue growth allowed under the state's stringent new tax cap.

**Table 7**
**Fiscal 2005 Balance**
($, Millions)

| | |
|---|---|
| Revenue | |
| Consensus tax forecast | 15,801 |
| Less: Sales tax dedicated to MBTA | -684 |
| Nontax revenue | 8,649 |
| Total | 23,766 |
| Spending | 25,124 |
| **Revenue minus spending** | **-1,358** |
| Added taxes using MTF forecast | 290 |
| **Adjusted revenue minus spending** | **-1,068** |

## Major Spending Categories

### Medicaid

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| Medicaid | | | |
| Administration | $115 | $110 | $116 |
| Benefits | 5,301 | 5,738 | 6,509 |
| **Total** | **$5,416** | **$5,848** | **$6,625** |

Despite concerted efforts to rein in Medicaid spending, this huge state program continues to experience double-digit growth, which is one of the leading causes of the state's fiscal crisis.

Like virtually every other state, the Massachusetts Medicaid program must contend with the relentless increases in health care costs that are sweeping the nation.

Although the Commonwealth's Medicaid eligibility and benefit criteria are somewhat more generous than in most other states, the reductions that have already been made required painful choices, and additional cuts to Medicaid will be extraordinarily difficult. Because Medicaid serves many of the state's residents most in need of expensive health care, paring back the scope of the program adds to costs for "free care" and exacerbates the financial strains on the state's health care system.

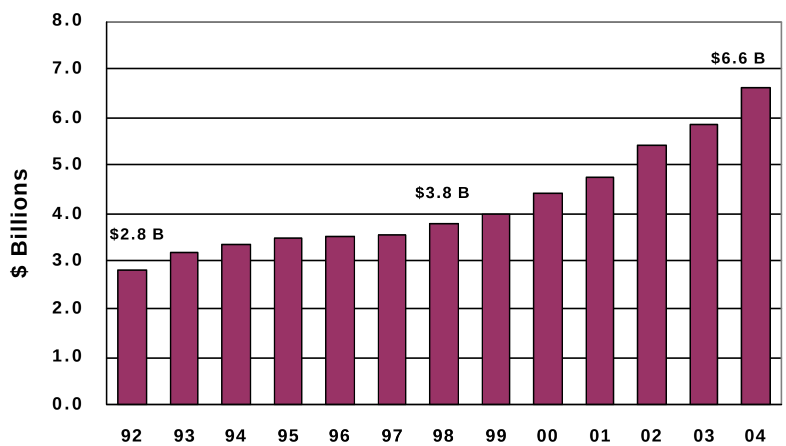
After being held largely in check through the mid-1990s, Medicaid spending has skyrocketed over the last seven years (see Figure 5). With an average annual growth rate of 9.2 percent—more than twice as fast as the state budget as a whole—Medicaid's share of total state spending has expanded from 20.8 percent in 1997 to 28.4 percent in 2004. Spending on Medicaid has jumped 38.5 percent over the last three years while spending on all other programs has fallen 3.8 percent.

Despite a series of cost savings measures adopted in 2003 and 2004, spending growth accelerated in this year's budget. The Commonwealth will spend an estimated $6.6 billion on Medicaid in fiscal 2004, up $777 million, or 13.3 percent, from 2003. The growth rate is the second highest of the last decade.[4]

**Figure 5**

**Medicaid Expenditures**

Fiscal 1992-2004

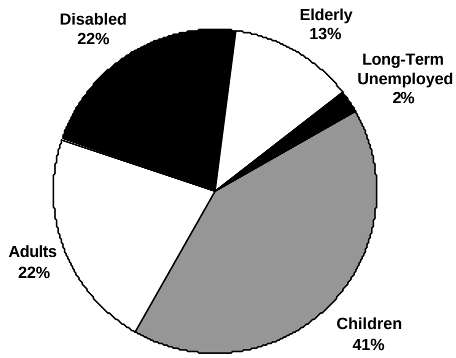



[4] The 2004 spending total includes several off-budget program components, including enhanced nursing home rates, pharmacy dispensing fees, the new MassHealth Essential program for the long-term unemployed, and state funds transferred to the Uncompensated Care Pool. As part of the reorganization of the Executive Office of Health and Human Services, the budget and management of Medicaid for seniors was transferred to the Executive Office of Elder Affairs, but the spending—$1.5 billion in 2004—is still included in the Medicaid totals in this report.

**Figure 6**

**FY 2004 Medicaid Enrollment**

**Average Total Through November 2003: 920,000**




There are few signs that the rate of growth in Medicaid spending will slow substantially from a pace that will continue to drive state budget deficits in 2005 and beyond. With costs projected to increase by roughly 12 percent, total Medicaid spending would increase by approximately $800 million next year. Even with half of Medicaid outlays covered by federal reimbursements, net state costs would still jump by $400 million.

**Cost Drivers**

Despite the growth in Medicaid spending, total enrollment has begun to decline. The November 2003 enrollment of 927,000 low-income, elderly and disabled Massachusetts residents represents a drop of nearly 39,000, or 4.0 percent, from a year earlier and is more than 68,000 below the peak in August 2002. Most of the recent decline in enrollment is attributable to the elimination of coverage for the long-term unemployed in April 2003 (discussed further below under savings measures). Even with the reduced enrollment, Medicaid provides health coverage for a staggering one-sixth of the state's population as a result of eligibility expansions authorized in 1997 and 1998.

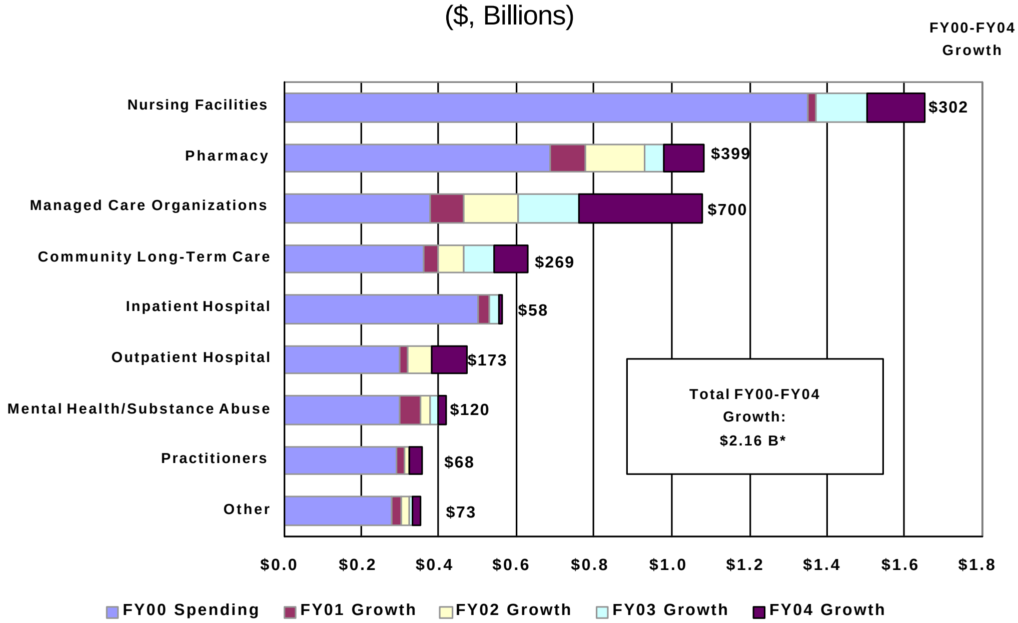
Part of the growth in Medicaid spending is attributable to rising caseloads of high-cost populations, particularly the disabled. Enrollment of disabled adults and children has risen by nearly 12,000, or 6.3 percent, since 2000—faster than any other group—and continued to increase over the last year while enrollment of other groups fell. While disabled members are still a relatively small share of the total, about 22 percent in 2004 (see Figure 6), they account for about 36 percent of spending, according to the Foundation's analysis.

While spending for most types of health care services has been escalating rapidly, prescription drug expenditures stand out, largely reflecting the rise in drug utilization that is taking place across the country (see Figure 7). Spending for prescription drugs is second only to nursing homes and other institutional care, primarily for the elderly, as the largest category of Medicaid spending. Since 2000, pharmacy expenditures have swelled by more than $400 million, or 58 percent, and now total $1.1 billion. These figures do not include pharmaceuticals provided by managed care organizations that contract with the state.

Spending on managed care has been the fastest growing component of Medicaid as the Commonwealth has shifted more members to HMO coverage. In November 2003, 258,000 members were served by HMOs, up 22,000 or 9.4 percent over the previous year, even though total enrollment declined in the same period. Community long-term care and outpatient hospitals have also contributed significantly to the surge in spending.

**Figure 7**

**Medicaid Spending Growth By Type of Care**
**Fiscal 2000-2004**
($, Billions)




## Savings Measures

Medicaid's double-digit spending growth is occurring despite a series of cost-cutting measures adopted in the 2003 and 2004 budgets. In addition to new fees on nursing home care and prescriptions, the state has implemented a host of cuts in eligibility and services as well as payments to health care providers. In total, these measures are expected to reduce 2004 spending by about $400 million.

Eligibility for "MassHealth Basic" coverage for approximately 50,000 long-term unemployed individuals was eliminated in 2003, with projected savings of $180 million in 2004. However, eligibility for pared-down services for this group was restored with a new $160 million off-budget "MassHealth Essential" program in the 2004 budget. Enrollment in the new program—only about 14,000 as of November 2003—has been running well below the projected 36,000, so additional savings are likely this year. Other eligibility cuts adopted in 2003, including coverage for special status immigrants, emergency detoxification for uninsured recipients, and enrollment freezes for the Family Assistance and Common-health programs, are expected to reduce spending by about $40 million in 2004.

A strict prior approval process for expensive prescription drugs, including popular new medications for arthritis, ulcers, allergies and mental illnesses, was instituted in 2003. The pharmacy management program is designed to encourage the use of the most cost-effective alternative in each class of drugs, as well as less costly generic versions. A prior authorization requirement for all prescriptions for members receiving seven or more prescriptions per month was added in 2004. While savings in 2004 attributable to the drug list are currently estimated to be only half of the $165 million originally projected, Medicaid spending on pharmaceuticals overall has been below budgeted levels. The total pharmaceutical budget for 2004, including drugs provided by managed care organizations, is approximately $1.2 billion.

Optional dental, eyeglass and hearing aid benefits for adults were eliminated in 2003, producing $9 million in savings in 2004. Premiums and co-payments for non-emergency services and pharmaceuticals were increased in both 2003 and 2004, yielding about $2 million in 2004.

The Commonwealth is also reducing rates paid to hospitals, nursing homes and other providers by up to five percent, with most providers receiving a three percent reduction. Savings in 2004, including the impact of reductions imposed in 2003, are projected to total $144 million.

For years, the state has paid Medicaid providers much less than the full cost of services, and the recent actions only compound the problem. Hospitals, for example, are reimbursed less than 70 percent of their costs, creating a shortfall of more than $200 million. Underpaying for services is neither fair nor sustainable, and only adds to the financial strains on the state's health care system. The Commonwealth needs to develop and implement a multi-year plan to bring provider reimbursements in line with costs.

Other measures adopted in 2004, including tightened clinical disability criteria, verification of a lack of employer-sponsored insurance, and adjustments to asset tests and nursing home clinical standards, have encountered legal or administrative obstacles to implementation and are now expected to produce little, if any, savings. However, the reduction in Medicaid enrollments beyond the long-term unemployed is reducing spending across the board by as much as $50 million. For the first time in several years, Medicaid expenditures in 2004 are expected to remain within budgeted amounts despite the lack of savings from some of the initiatives.

Finding additional savings in fiscal 2005 without further eliminating eligibility for existing populations or reducing mandated services will be enormously difficult. Massachusetts operates its Medicaid program under federal guidelines that define the core requirements for eligibility and benefits and how much of the program's costs are paid by the federal government. As in other states, the Massachusetts program substantially exceeds the federally mandated minimums, but making further reductions in optional populations and services will require even more painful choices than those made over the last two years.

**Uncompensated Care Pool**

The state's uncompensated care pool—the mechanism for paying "free" care provided to the uninsured—faces a serious and growing financial shortfall, estimated at $300 million before a temporary financing plan was cobbled together for 2004. Financed primarily through surcharges on hospitals and insurers, the pool has evolved from a payer of last resort to a program that too often functions as a de facto health insurance program for those who have no insurance.

The 2004 budget temporarily covers the pool's deficits by relying on $55 million in one-time federal funds and other non-recurring state resources, as well as an additional $57 million from insurers. The legislation also provided one-time rate increases for hospitals and called for the administration to propose a new long-term financing plan by October 2003. However, the administration has not yet made its recommendations.

At the same time, the budget includes positive and much needed reforms of the pool's mission, scope and administration that are intended to bring greater accountability and lessen the need for additional funds. The reforms were drawn from the recommendations of subcommittees of a special commission convened in 2002 to examine the pool's finances and management. These include an independent audit to examine the costs of services being billed to the pool; redefining the scope of hospital services which would be covered to include only emergency, urgent and critical access services; requiring verification of income as well as eligibility for Medicaid or other coverage before providing free care; and implementing utilization review for the pool.

Unfortunately, to date little action has been taken to implement the reforms. Failure to improve management of the pool only adds to the funding shortfalls and impedes the development of a new financing mechanism for uncompensated care.

**Employee Health Insurance**

Many of the same pressures that are driving Medicaid spending also affect the cost of providing health insurance to state employees. In fiscal 2004, health benefits for state workers will cost approximately $831 million, a $72 million or 9.5 percent increase over spending in 2003 (not included in the Medicaid spending summary at the beginning of this section).

In an effort to control state expenditures, the Commonwealth has shifted a variety of costs to employees. The budget increases the share of health insurance premiums paid by state employees from 15 percent to 25 percent for new hires, and to 20 percent for current employees who make $35,000 or more, though the latter provision expires after two years. With hiring severely limited for at least the next two years by budget cuts and layoffs, these measures will produce far smaller savings than moving to 25 percent for all employees as originally recommended by the Governor and the Foundation.

The Commonwealth has saved an estimated $100 million between fiscal 2001 and 2004 through a combination of higher employee premiums, increases in co-payments for prescription drugs, office visits and other services, higher deductibles for hospital stays, and the elimination of the Commonwealth's 85 percent subsidy of premium costs for Medicare Part B coverage for retirees.

## Local Aid

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| School Aid | | | |
| Chapter 70 | $3,218 | $3,259 | $3,108 |
| Other school aid | 878 | 762 | 687 |
| Subtotal | 4,097 | 4,022 | 3,795 |
| Revenue Sharing | | | |
| Lottery | 778 | 705 | 661 |
| Additional assistance | 478 | 405 | 380 |
| Subtotal | 1,256 | 1,110 | 1,041 |
| Other direct aid | 267 | 185 | 201 |
| Total | 5,620 | 5,318 | 5,037 |
| Indirect aid - teachers pensions | 521 | 568 | 420 |
| **Total** | **$6,141** | **$5,885** | **$5,456** |

Appropriations for state aid total $5.46 billion in fiscal 2004, including more than $5 billion of direct aid to cities, towns, and school districts and an estimated $420 million of indirect aid in the form of state support for the costs of teachers' pensions. Aid to localities accounts for almost 22 percent of state spending—still the second largest area—although the share has slipped several percentage points in the last several years. Roughly three-quarters of 2004 assistance supports local schools, with 57 percent going directly to districts under Chapter 70, the state's education reform law. Another 19 percent goes out as discretionary grants, with the lion's share from net lottery profits allocated to cities and towns through an equalizing formula that takes into account both population and local property wealth.

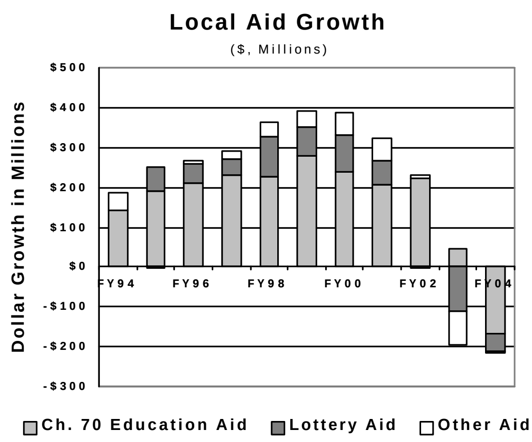
Assistance to cities and towns has declined at an accelerating pace since the beginning of the state's fiscal crisis. While only a few aid accounts were reduced in fiscal 2002, large cuts produced a major drop in overall aid levels in both 2003 and 2004 (see Figure 8).

In a recent review of municipal finances,[5] the Foundation concluded that no single measure fully communicates the scope of the recent cuts because of the complexity of the state's local aid system. However, even by the simplest of measures—a comparison of total assistance in 2002 and the current fiscal year of 2004—state aid has been cut by $617 million or 10 percent, including $335 million in direct aid and $282 million in reduced pension appropriations.

This result actually understates the impact of the cuts in many communities. Since some communities received aid increases, the comparison of statewide totals does not fully reflect the reductions that were experienced by the majority of localities. In addition, some cities and towns were at their peak levels of aid in 2001 or 2003—not 2002—and the change in the aid levels between 2002 and 2004 does not capture the full impact of the cuts on those communities.

As a result of the recent aid reductions, property tax burdens across the state—including those communities with concentrations of poor and moderate-income residents who can ill afford larger local tax bills—have risen significantly in the last two

**Figure 8**




**("Cherry sheet" aid to cities, towns, and regional school districts)**

[5] *Municipal Financial Data, 33rd Edition*, October 2003.

years. According to MTF's recent analysis, the per capita burden of property taxes increased 3.0 percent a year on average in 2002 and 2003. This increase, which excludes growth in local tax bases because of new construction, is well above the rate of inflation. It is also roughly twice as rapid as the 1.7-percent average increase of the previous eight years.

**State Aid to Schools**

State assistance to local education totals $3.8 billion in 2004, $302 million, or 7.2 percent, less than 2002 and $35 million, or almost one percent, below 2001. More than 80 percent—$3.1 billion—will be distributed as direct formula aid to schools under Chapter 70. Another $687 million finances categorical grants and other programs, including $401 million for local school construction and $111 million for kindergarten and early childhood education. Another $122 million of school-related spending—to reimburse districts for a portion of the non-educational costs of students with special needs—is not included in the education spending total discussed here. Nor is the $420 million that the state spends for the employer's share of the costs of retirement benefits for local teachers.

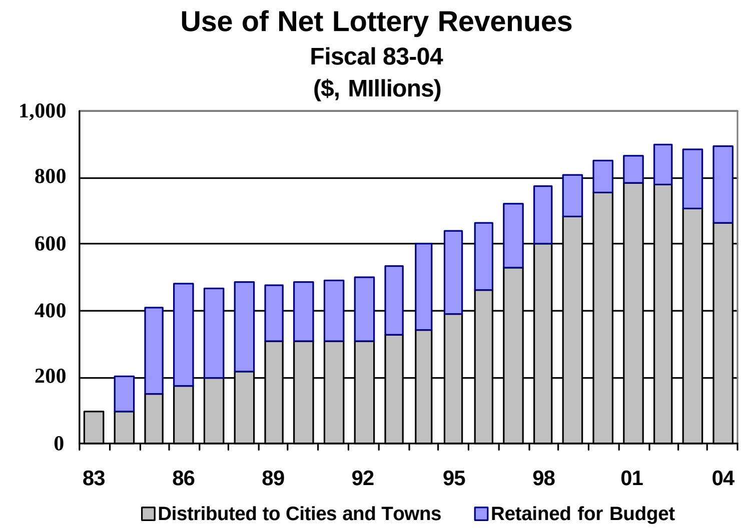
Under the Chapter 70 education reform law adopted in 1993, the state has an ongoing obligation to ensure adequate spending in every district, with increased aid for communities lacking the resources to support the necessary level of school spending on their own. To fulfill this financial responsibility, the state increased school aid from $1.29 billion in 1993 to $2.8 billion in 2000, an almost 120 percent increase that brought spending in every district up to the reform law's "foundation" standard of spending. Since 2000, the state has provided sufficient additional aid to prevent spending in any district from falling below the foundation level.

Reversing the trend of ever-increasing Chapter 70 assistance, the 2004 budget cuts formula aid to schools by $151 million, or 4.6 percent, to a total of $3.11 billion. The aid amount for each district was determined in a two-step process: Each district's 2003 aid amount was first cut by 20 percent; if that cut resulted in overall school spending below the foundation level, aid was added back to bring spending up to the required level. At the same time, each community's required contribution to its schools was adjusted to reflect the 2004 cuts in non-school aid.

While this methodology preserved the commitment to the foundation standard, it also produced highly uneven results. Eighty-three districts experienced aid increases totaling $34 million, or 3.5 percent on average, with almost one-third of that total going to three large urban districts. These gains were more than offset by cuts in 281 municipal and regional districts that totaled $185 million, or 8.2 percent, including reductions of 15 percent or more in 197 of those districts.

It must also be recognized that the effort to maintain school spending at the foundation level has been undercut by the $130 million of net reductions in other aid, including a $67 million decline in school transportation assistance. Looking just at aid distributed via the Department of Revenue's "cherry sheet" for the 83 municipal and regional districts with increases in Chapter 70 in 2004, fully half of the gains were offset by net reductions in other aid accounts. And districts with Chapter 70 losses sustained an additional $50 million of other aid reductions.

**Figure 9**




The blunt ax of a 20 percent proportional cut that was applied in 2004—even with its protection of the law's minimum school spending requirements—did little to address serious inequities in the current school funding formula. This is especially true for the communities hardest hit by this year's school aid reductions, better-off localities that did not initially have a school funding "gap" when the reform law was adopted.

In recognition of the growing concerns about the aid formula, the 2004 budget established a legislative working group to study the problem and recommend improvements. While the group was able to agree on the general principle that communities of similar fiscal strength should receive similar aid and face similar spending requirements, they were unable to achieve a consensus on the specifics of a fairer approach.

In an effort to move toward a future agreement on formula reforms, the working group has invited educational funding experts and others to weigh in on a set of specific questions that arose during the group's discussions. Although this input will undoubtedly shed further light on the complexities of school finance, it is unlikely to produce an easy solution to a fundamental, essentially political, problem the state now faces: Because of the lack of budgetary resources, implementing a "fairer" school aid formula will mean aid cuts for a significant number of communities, including many who have already experienced large reductions in 2004.

While the legislative group did not reach agreement on reforms in the school aid formula, over the last several years the state's school finance experts have developed a consensus on many elements of an improved approach. As reflected in several proposals advanced since 2000, a more equitable methodology would have two major features. It would preserve the core formula for providing aid to poorer school districts, which has in general worked well. And it would establish a new mechanism for determining assistance to better-off districts, by tying annual aid amounts to local educational costs (the foundation budget) and to local property wealth per student adjusted for income differences among communities.

One area where the funding authorities, school district officials, and others have not reached consensus is the adequacy of the foundation standard itself. On the plus side, by annually adjusting the standard for inflation, Massachusetts has avoided one of the main sources of inadequacy in other states. However, many school officials and advocacy groups argue that the assumptions used in calculating the foundation amount—such factors as student-teacher ratios and additional costs of students from low-income families—are too low.

The question of adequacy may in the end be resolved by the courts. Plaintiffs in a long-standing suit on school funding have asked the courts to appoint a special commission to determine how much money districts need to adequately educate students attending public schools. A decision on the suit is expected later this year.

**Revenue Sharing and Other Aid**

Other non-school assistance to cities and towns totals $1.24 billion in 2004, almost $300 million or 20 percent below 2001. Two unrestricted revenue sharing programs—lottery aid and so-called additional assistance—account for all but 15 percent of non-school aid.

The lottery distribution to cities and towns is the Commonwealth's largest pure revenue sharing program, with a $661 million authorization in 2004. The amount of annual lottery aid is determined by appropriation and cannot exceed lottery profits, that is, ticket sales net of prizes and other expenses. Any increase in the annual appropriation for lottery aid is distributed to cities and towns through an equalizing formula that allocates more aid to places with lower property value per resident and less aid to wealthier places.

After two years of cuts in the amount distributed to cities and towns, the $661 million appropriation for 2004 is almost $150 million less than expected lottery profits net of expenses,[6] with the "excess" revenues helping balance the state budget (see Figure 9). In the previous fiscal crisis at the beginning of the 1990s, annual lottery aid was capped—but not actually cut—to capture the revenues from growth in sales. That earlier cap was not fully lifted until fiscal 2000.

So-called "additional assistance," the other major source of state aid, totals $380 million in 2004, $98 million, or 21 percent, below 2002. Prior to the recent reductions, additional assistance had been level funded for more than a decade. Originally distributed under an equalizing formula and sharply cut in the previous fiscal crisis, additional assistance is directed primarily to the state's urban centers, with more than 40 percent of the total appropriation going to Boston. More than half of the state's cities and towns, 192 out of a total of 351, receive no additional assistance.

**Other Aid**

Since 2001, other state assistance to municipalities has been cut by 29 percent to a total of $201 million in 2004. Lying behind this decline, however, are significant increases in two programs: $18.0 million, or 64 percent, in the "Quinn bill" program of salary supplements for local police officers who obtain college degrees; and $18.2 million, or 38 percent, in local water construction aid. The remaining programs sustained cuts totaling $117 million, or 57 percent, including the elimination of the $44 million Chapter 81 program for local road and bridge repairs and the $54 million program of rate relief for MWRA consumers.

[6] These expenses include $72.6 million for lottery administration and $78.6 million retained annually to fund other local aid programs.

**Human Services**

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| Social Services | $632 | $646 | $682 |
| Youth Services | 123 | 123 | 126 |
| Child Care | 383 | 366 | 364 |
| Cash Assistance | 683 | 689 | 690 |
| Housing Assistance | 143 | 110 | 95 |
| Mental Retardation | 966 | 986 | 1,014 |
| Mental Health | 608 | 597 | 593 |
| Public Health | 503 | 423 | 368 |
| **Total** | **$4,039** | **$3,941** | **$3,933** |

Human services programs have been the focus of many of the budget cuts made over the last three years, with some departments among the hardest hit in state government. At the same time, rising caseloads and efforts to reduce waiting lists in other areas have caused overall human services spending to remain fairly constant.

Major reforms of human services were initiated in 2003. The reorganization of the Executive Office of Health and Human Services is the largest and most significant of several restructurings contained in the 2004 budget. The reorganization, in turn, sets the stage for an overhaul of the troubled system by which the state purchases human services from private providers, an initiative that was recently launched by the administration.

In fiscal 2004, appropriations for the major human services functions total $3.93 billion, slightly below spending in 2003 and virtually equal to 2001, the last year before budget cuts triggered by the state's fiscal crisis.[7] Spending reductions in the 2004 budget would have been more significant if the Legislature had not overridden $30 million of the $50 million in human services spending vetoed by the Governor, and then added another $23.

The minor reduction in overall spending compared to 2003 masks major cutbacks in some areas offset by significant growth in others. These changes continue the pattern since 2001, with significant increases for social services and mental retardation offsetting substantial reductions for housing and public health (see Table 8).

**Table 8**
**Human Services Spending Changes**
**2001 to 2004**
($, Millions)

| | Change | Pct. Chg. |
|---|---|---|
| Social Services | $108.9 | 19.0 |
| Mental Retardation | 98.2 | 10.7 |
| Cash Assistance | 44.0 | 6.8 |
| Youth Services | 7.7 | 6.5 |
| Mental Health | -9.5 | -1.6 |
| Day Care | -18.8 | -4.9 |
| Public Health | -146.4 | -27.4 |
| Housing | -63.7 | -40.2 |
| Total | $20.4 | 0.5 |

By far the largest cuts over the last three years have been to public health programs, where spending has fallen by $146 million or 27 percent[8]:

- Smoking prevention and cessation efforts have been reduced by $31 million or 68 percent;
- HIV/AIDS prevention and treatment was cut by $18 million or 35 percent;

[7] This total includes the major departments under the umbrella of the Executive Office of Health and Human Services (excluding Medicaid, Elder Affairs and smaller departments such as the Massachusetts Rehabilitation Commission) and housing assistance programs operated by the Department of Housing and Community Development.

[8] This figure is adjusted for the transfer of the Children's Medical Security and Healthy Start programs to the Medicaid unit of EOHHS in 2004. Spending on these two programs in 2003 totaled $20.9 million.

- Substance abuse programs were reduced by $10 million or 23 percent;
- Family health services were pared by $8 million or 66 percent, primarily in 2004;
- Breast cancer detection and research was cut by $7 million or 68 percent despite a small increase in funding in 2004.

Housing and homelessness programs in the operating budget have also been hit hard, with reductions of $64 million or 40 percent since 2001. While the cuts are partially offset by increased spending on other housing programs in the capital budget, reducing the total commitment remains a questionable strategy when the lack of affordable housing is one of the state's greatest challenges[9]:

- Assistance for rental housing production was eliminated, a cut of $24 million;
- Rental vouchers were scaled back by $12 million or 35 percent;
- Support for public housing authorities was cut by $9 million or 26 percent (though this trend was reversed in 2004);
- Assistance for homeless individuals through the Department of Transitional Assistance was cut by $5 million or 15 percent.

While many programs have been cut, spending on certain caseload-driven services and benefits has increased substantially. The Department of Social Services' budget for child protection and welfare increased $109 million or 19 percent over the three years in response to rising group care caseloads, a more severe mix of cases, higher special education costs, and implementation of collectively bargained social worker caseload limits. Spending on the developmentally disabled rose by $98 million or 11 percent as a result of efforts to reduce the Department of Mental Retardation's long waiting list for services, including implementation of the Boulet and Roland lawsuit settlements.

The economic downturn also pushed up caseloads in programs that provide direct cash assistance to poor, elderly and disabled residents, with total spending increasing by $44 million or seven percent between 2001 and 2004. However, spending growth leveled off in 2004, with budget reductions in Transitional Aid to Families With Dependent Children (welfare) and emergency aid for low-income elderly and disabled residents offsetting increased spending on emergency assistance for homeless families.

Welfare spending was cut by about $5 million, or 1.5 percent, in 2004, while caseloads rose 2.5 percent to about 49,500 between December 2002 and November of 2003. If this trend continues, the current appropriation will prove to be inadequate.

Elderly and disabled emergency aid caseloads have also been increasing, with a 5.3 percent jump over the last year. In response to the rising numbers of beneficiaries and a $3.7 million or 5.5 percent reduction in funding, the Governor cut benefits by 11.5 percent in September, but was stopped by a court injunction.[10] Supplemental food stamps for non-citizens, which accounted for $7 million in spending in 2001, were cut to zero in 2004, following the elimination of cash assistance for legal immigrants in 2003.

[9] Spending on bond-funded housing programs has increased from $79 million in 2001 to a projected $119 million in 2004.

[10] The Legislature later restored $2.4 million of the budget cut in a supplemental appropriation.

**Human Services Reform**

Budget cuts will only exacerbate the problems clients face in negotiating an increasingly dysfunctional system for providing services. MTF's major report released in September 2003, *Reforming the Commonwealth's $2 Billion Purchase of Human Services: Meeting the Promise for Clients and Taxpayers*, concluded that the Commonwealth's vast system for purchasing human services from private providers is desperately in need of an overhaul.

The problems engulfing the system range from a lack of integrated care for clients to difficulties in attracting and retaining a qualified workforce for providers to a lack of basic information about how the system is performing. The systems for purchasing and managing human services are not designed to ensure high quality care and positive outcomes for clients. Rather than spurring superior performance, the structures, policies and procedures of POS create powerful incentives that undermine efforts to provide quality services.

The current system of procurement and monitoring focuses on conforming with process requirements and financial accountability rather than producing results for clients. Few contracts are performance-based, with little attention to measuring quality and outcomes. Inconsistent approaches among human services departments add costs and complexity to procurement and monitoring, diverting time and energy from service delivery. Participants at every level of the system lack the information they need to help make services more responsive to the needs of clients and taxpayers.

With a growing disconnect between rates paid to providers and the cost of providing services, the quality and effectiveness of the human services workforce—and the services they provide—is being eroded. At the same time, the Commonwealth has attempted to expand services without addressing the problems in the existing system.

While the system's flaws affect all of its stakeholders—no one involved thinks the system works well—in the end the burden falls on the clients, who too often do not receive the quality services they need, and the taxpayers, who are not getting a fair return on their $2 billion investment in purchase of services.

MTF's recommendations for addressing these issues fall into four broad categories:

- *Focus on clients* by designating a single case manager to oversee the services provided to each client; developing information technology systems to share information among departments and coordinate services to clients; and producing assessments of provider performance for use by clients, families, caseworkers and providers.
- *Focus on performance* by developing quality standards and outcome measures for all human services contracts; establishing reasonable and adequate rates based on the costs of meeting standards; employing performance contracts that pay providers when clients attain specified outcomes; and providing incentives for superior performance.
- *Eliminate unnecessary requirements* by developing and enforcing more consistent procurement policies, procedures and reporting across purchasing agencies; ending licensing and certification regulations that no longer serve to ensure safe and effective services; consolidating licensing and certification reviews; and changing the

Uniform Financial Report to include only data the state actually needs.

- *Set priorities* using needs assessments, program evaluation and cost data.

The Governor and the Legislature clearly recognize the need for changes and deserve credit for initiating the first phase of a reform agenda. The fiscal 2004 state budget enacts a major restructuring of human services agencies intended to strengthen coordination among departments, improve access to care and reduce administrative costs.

The reorganization groups 17 departments and offices that provide human services into five clusters:

- The Office of **Health Services** includes the Division of Medical Assistance (including Medicaid except for seniors), Department of Public Health, and Department of Mental Health;
- The Office of **Disabilities and Community Services** includes the Department of Mental Retardation, Massachusetts Rehabilitation Commission, Massachusetts Commission for the Deaf and Hard of Hearing, Massachusetts Commission for the Blind, and the two Soldiers' Homes;
- The Office of **Children, Youth, and Family Services** includes the Department of Transitional Assistance, Department of Social Services, Department of Youth Services, and the Office of Child Care Services;
- The Executive Office of **Elder Affairs** was moved under EOHHS umbrella but retains its cabinet-level status, and now includes Medicaid for seniors, including nursing homes and community-based services; and
- The Office of **Veterans' Services** was also moved to EOHHS.

Each of the new offices is headed by an Assistant Secretary who is also an agency commissioner. The Secretary of Health and Human services for the first time has been given budget and regulatory authority over the departments in the secretariat, and administrative functions such as human resources and finance are being centralized under the Secretary.

The grouping of departments into clusters should help break down their isolation—the "silo" effect—and foster greater communication and collaboration. By developing more integrated approaches to serving broad groups of clients—the mentally ill, the disabled, and children and their families—services delivered by multiple agencies can be better coordinated and the "maze" of departments and programs can be made more accessible.

However, to bring about real improvements in service delivery, the organizational restructuring of state agencies needs to be complemented by fundamental reforms of the business relationship between the Commonwealth and the private providers that deliver the bulk of human services in Massachusetts. In October the administration launched the second phase of the reform effort, an initiative to revamp several elements of the purchasing process along the lines recommended by the Foundation. The purchasing strategies initiative includes several task forces working to develop more uniform purchasing policies and procedures across human services agencies, to overhaul licensing regulations and procedures, to streamline the Uniform Financial Report, and to integrate data management systems across departments.

The initiative will also lay the groundwork necessary for two fundamental reforms at the heart of the Foundation's report: basing contracts on provider performance in terms of quality of services and client outcomes, and setting rates based on the costs of providing quality services. Shifting the focus of the purchasing system to performance and providing adequate reimbursements to providers will be difficult and costly but nonetheless essential to addressing the core problems in human services.

Achieving these goals will take time. With providers and state agencies mired in a tangle of bureaucratic impediments to delivering high quality services, it will take a thoughtful, sustained and inclusive reform effort to strengthen the performance of the system in this era of sharply limited resources. The ultimate goal of these reforms is to achieve better outcomes and quality of life for the clients and, at the same time, a healthier return on the taxpayers' massive investment in human services.

## Capital Investments and Debt Service

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| Debt Service | | | |
| Gen. Capital Bonds | $1,266 | $1,322 | $1,433 |
| Artery Bonds/GANs | 99 | 116 | 136 |
| Other Debt Service | 11 | 13 | 27 |
| Subtotal | 1,376 | 1,450 | 1,597 |
| Contract Assistance | | | |
| School Building Assistance | 365 | 383 | 401 |
| Sewer Rate Relief | 59 | 0 | 5 |
| Water Pollution Abatement | 56 | 58 | 66 |
| Route 3 North | 0 | 0 | 27 |
| Other Contract Assistance | 47 | 41 | 51 |
| Subtotal | 527 | 482 | 550 |
| Transfers for Capital | | | |
| Capital Needs Investment Trust | 22 | 16 | 0 |
| Other Transfers | 104 | 72 | 47 |
| Subtotal | 126 | 88 | 47 |
| **Total** | **$2,029** | **$2,021** | **$2,194** |

Nearly ten percent of the budget, $2.2 billion in 2004, supports capital investments ranging from highways and housing to schools and sewers. This spending takes the form of debt service on Commonwealth bonds issued to finance capital projects, contract assistance to other governmental entities to help pay debt service on their capital bonds, and transfers to off-budget funds for spending on capital projects.[11]

Spending on debt service and contract assistance has been rising as the state grapples with an enormous backlog of capital needs. Total outlays for capital borrowing are budgeted to jump by $173 million, or 8.6 percent, in fiscal 2004, and the Foundation estimates that the total will increase by about another $240 million, or 11 percent, in 2005. Most of the growth in both years is for debt service on Commonwealth bonds, but contract assistance payments for Route 3 North, school buildings and the Central Artery are also increasing.

Despite the increased outlays, Massachusetts has far more demands for capital spending than it can afford. Developing a comprehensive approach to setting priorities among competing needs and a strategy for financing the most critical projects is discussed further below.

### Debt Service

The largest item in this category and the source of most of the growth in 2004 and 2005 is debt service on the Commonwealth's own capital bonds. Even though the administration limits the amount of bonds issued each year to control growth in debt service costs, spending is budgeted to increase by $146 million, or 10 percent, in fiscal 2004 and is projected to jump by about another $230 million, or more than 14 percent, in 2005. A number of factors are contributing to the rapid growth:

- One-time savings generated by refinancing older Commonwealth bonds were used to reduce debt costs in 2003 and 2004, and payments for these bonds are now returning to their earlier levels.

- Starting in 2000, $1.5 billion in bonds were authorized to cover Central Artery overruns. Payments on these bonds, which total $61 million in 2004 now that the bonds are largely issued, are supported by revenues from the

[11] Each of the items in this total other than debt service is included in other spending categories in the budget summary of this report. School building assistance is included in Education, sewer rate relief and water pollution abatement are included in Local Aid, and other contract assistance payments and transfers are included in Residual.

Not included in these figures is the sales tax revenue dedicated to the MBTA, a substantial part of which is used to pay debt service on the T's capital bonds. The T's debt service costs in 2004 are $349 million.

reinstatement of Registry of Motor Vehicle fees.[12]

- In addition, the bond cap was increased from $1.0 billion to $1.2 in 2002 to help address the long list of capital projects awaiting funding, resulting in approximately $16 million in additional debt service costs in 2004.

After vetoing an ill-advised legislative plan to reduce the bond cap to $1.1 billion (only $800 million in the original House proposal), the administration increased the cap to $1.278 billion for 2004 and $1.25 billion for 2005 and beyond. However, bond issues that had previously been considered outside of the cap, such as the Central Artery overrun bonds, will now come within the cap. Squeezing these bonds under the cap will leave slightly less funding for other projects despite the apparent increase in the total. Given the state's fiscal challenges, the new bond cap represents a reasonable balance between the need to control growth in debt service costs while moving ahead with important capital investments.

Even at $1.25 billion, the backlog of unfunded capital projects will continue to grow. Over $8 billion in authorized capital projects are currently in the queue awaiting funding, with nearly $2.8 billion of the total approved in just the last two years. The administration has announced plans to introduce a major new transportation bond bill, and many more investment needs remain to be authorized.

The recently enacted authorizations include $70 million for affordable housing projects approved in the 2004 budget. The bond funding is in lieu of operating dollars funneled through the Capital Needs Investment Trust Fund, a five-year plan to spend $45 million annually on housing, education technology and building repairs that was eliminated in 2004.

Annual $27 million payments on Route 3 North begin in fiscal 2004, further contributing to the growth in spending on capital. The payments take the form of contract assistance to a quasi-public corporation created to finance the project, and proponents have suggested using the Route 3 North model to build other high-cost projects outside of the cap. However, the administration has announced that all future Commonwealth capital projects will be financed within the cap.

The administration is correct when it argues that these alternative financial arrangements offer little advantage if the Commonwealth is still paying for the entire project from existing resources and that traditional general obligation financing typically has lower interest costs. However, the state should remain open to and actively pursue alternative mechanisms that generate new revenues to help fund construction, such as tolls or lease payments from private development associated with a project. It is also important to evaluate the advantages of innovative procurement methods—design-build-operate-transfer in the case of Route 3 North—apart from the financing mechanism, and continue to employ alternatives to traditional design-bid-build procurement when they offer lower costs, higher quality or shorter project schedules.

---

[12] Revenue from the restored Registry fees that is not needed for debt service on the Artery bonds is transferred to an off-budget fund for spending on transportation capital projects; these dollars are included in the Transfers line in the summary table above.

**Contract Assistance**

Contract assistance to a variety of quasi-independent authorities and local governments to help pay their debt service costs is increasing by $68 million, or 14 percent, to $550 million in the 2004 budget. The increase is primarily due to the initiation of payments on Route 3 North, but subsidies for school construction, water and sewer projects, and the Central Artery are also rising.

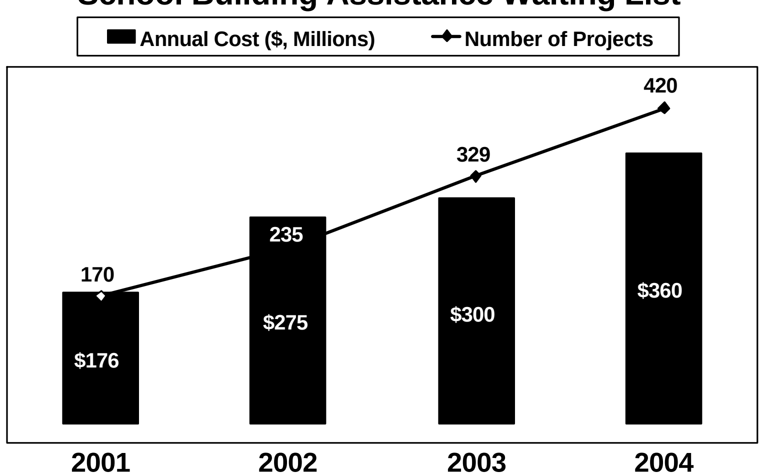
School building assistance (SBA) is by far the largest contract assistance item, and until funding for new projects was scaled back starting in fiscal 2002, SBA was one of the state's fastest growing programs.[13] Despite a moratorium on approvals of new projects until 2007, spending in 2004 will increase $18 million, or 4.7 percent, to $401 million. Spending would remain level in 2005 because for the first time the budget language includes no authorization to initiate payments for projects that have been approved and are awaiting funding.

The budget also reduced the line item for projects that are already receiving SBA payments by one percent (about $4 million) below the amount required to fund the state's commitments. The shortfall is being passed on to cities and towns, which will have to absorb the difference even though their bonds were sold with the promise of specific state payments. A legislative proposal to restore the cut using state bond funds from the capital budget was vetoed by the Governor. While debt payments should not be made with borrowed money, the Commonwealth does have an obligation to meet its prior commitments.

The moratorium and the spending cut were imposed in response to the enormous costs of school building assistance, which have grown far beyond the Commonwealth's fiscal capacity. The state is committed to spending nearly $5.5 billion over the next 20 years on projects for which payments have already begun. On top of that, 420 projects with a total cost of $7 billion have been approved and are on a waiting list for funding. Initiating payments on all 420 projects would add $360 million, or 90 percent, to annual SBA spending (see Figure 10).

**Figure 10**

**School Building Assistance Waiting List**




The slowdown in funding for new projects has increased the time local governments wait for reimbursements. Approved projects sit on the waiting list until funding is authorized, with the amount budgeted for new projects determining the pace at which projects are funded and taken from the list.

[13] School building assistance payments cover an average of 70 percent of the debt service on school construction bonds issued by cities and towns, with payments beginning in the year after the funding is authorized by the Board of Education, and continuing for the life of the bonds, typically 20 years. Language in the budget sets the amount of funding for new projects the Board can authorize, which, in turn, drives the budget increase required in the following year.

Even if the moratorium were lifted and $20 million added to the budget every year for new projects—the pace set in 2002 and 2003—it would be 18 years before reimbursements have begun on all 420, and in the meantime, many more projects would have been added to the list.

The moratorium on new project approvals is a stopgap solution intended to buy time while the Legislature and the administration consider proposals to revise the SBA program and reduce state costs.

The administration has unveiled a proposal to finance the state share of school construction costs with Commonwealth-issued bonds. The state bonds would have 40-year terms rather than the 20 years of most local bond issues. This would reduce the cost of annual payments (while increasing interest costs over the long term), allowing more projects to be funded each year. Providing the state share up front would give cities and towns greater certainty that the state will meet its commitments.

An alternative would be to reduce the Commonwealth's relatively generous reimbursement rates, which range from 50 to 90 percent of a community's debt service costs. However, many of the projects awaiting funding were sold to local voters with the promise that the state would cover a specific percentage of the costs, and it would be difficult for some cities and towns to absorb a larger share at a time when other forms of local aid have been reduced.

In any case, steps need to be taken to lower the costs of school projects. Reforms to the SBA program adopted in the 2001 budget to create new incentives to repair and rehabilitate old schools rather than build costly new buildings could be strengthened.

Construction reform, discussed below, can also help to lower costs. Like other public construction jobs, school building projects are burdened with design-bid-build and filed sub-bid procurement requirements that contribute to cost overruns, construction delays, and low quality work. Alternative financing mechanisms can also bring down costs. Private developers may be able to lease school buildings to cities and towns at lower costs because of tax advantages and added revenues from other building uses. With the current SBA program clearly unaffordable for the Commonwealth, both the state and local governments will need to be open to new and different ways of building schools.

**Capital Strategy**

Despite some positive steps by the administration, the state still lacks a realistic strategy for financing its most critical capital needs. Developing such a strategy will require new approaches to setting priorities, greater flexibility in procurement to reduce project costs, and new revenue sources.

*Priority Setting* The Commonwealth will never be able to afford every worthy capital project. Selecting the top priorities will require honest assessments of the relative merits of competing proposals. The administration's new criteria for evaluating transportation proposals and its review of pending transportation projects are important first steps. The state's transportation decision-making process should allow transit projects to compete with highways for funding, with the projects that deliver the greatest benefits earning state support.

Priority setting also requires new ways of thinking about how state policies and practice affect its infrastructure needs. The administration has rightfully asked whether the state can afford to operate and maintain its 19th century system of 116 courthouses that was developed when state residents were far less mobile. Putting renovation funds into creating a network of regional courthouses could reduce both capital and operating costs while maintaining reasonable access to the courts.

Similarly, the Commonwealth simply cannot afford to continue its expensive, debt-financed boom in prison construction. Changes in criminal justice policies such as eliminating lengthy mandatory minimum sentences and extending eligibility for parole and treatment to non-violent, first-time inmates could offer both capital and operating savings over time.

*Construction Reform* Reforming the Commonwealth's archaic public construction laws to allow more flexibility should also be a top priority for the administration and the Legislature. The state can no longer afford the inefficiency, waste, and shoddy construction that too often result from rigid design-bid-build procurement requirements, costly project labor agreements, and a variety of other restrictions, particularly when the state is facing a growing capital funding gap.

*New Financing* Financing strategies that draw on new revenue sources will also have to be part of the solution to the capital funding shortfall, since the state will never be able to afford to finance all of its capital needs with traditional general obligation borrowing alone.

Transportation projects offer the greatest potential for generating new revenues to support capital investments through user fees such as tolls. The pressing need for revenues for transportation makes it absolutely critical that the Commonwealth not give up sources it already has, and proposals to eliminate tolls should be rejected.

The state will also need to take a more entrepreneurial approach and develop alternative financing tools, on a project-by-project basis, to meet more of its transportation needs. Alternative financing mechanisms work by tapping into the added value created in areas served by new roads and transit lines, as well as through revenues generated directly by the project, and could include:

- Funding for new interchanges and transit stations by private developers whose projects will be served;
- Tax increment financing or benefit assessments for projects that add substantially to property values;
- Transit-oriented development of state- and MBTA-owned real estate; and
- Project financing for developments such as parking garages that generate revenue sufficient to cover the costs of construction.

**Pensions**

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| **Pensions** | **$1,017** | **$772** | **$687** |

As a result of losses on pension assets and questionable budgetary decisions over the past several years, the state employee pension system faces its greatest financial challenge since funding reforms were enacted in 1988.

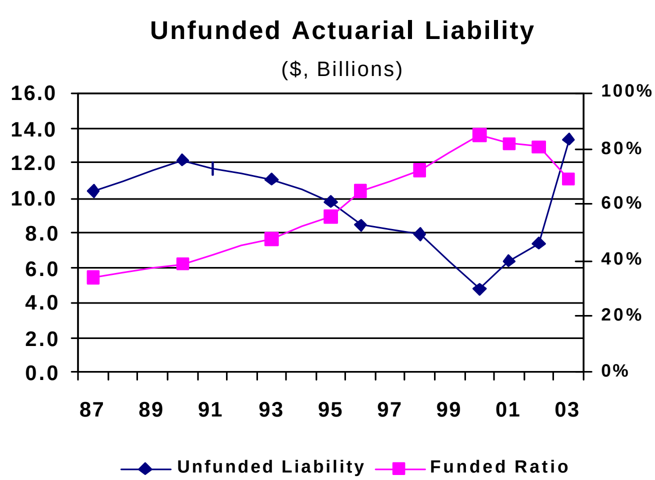
The reform law was intended to put the pension system on a firm financial footing by requiring the state to set aside enough funds to cover the future costs of retirement benefits earned each year by current state employees and to appropriate additional amounts that would by 2028 eliminate the unfunded portion of retirement benefits earned prior to enactment of the reforms. Under the law, the annual pension appropriation is determined by an actuarially sound funding schedule that must be updated at least every three years.

Through most of the 1990s, the Commonwealth made rapid progress toward meeting its pension funding goals. The unfunded portion of the state's liability declined from a high of $12.2 billion in 1990 to just $4.8 billion in 2000 (see Figure 11). At the same time, the share of the total liability for which funds had been set aside rose from 39 percent to 85 percent. Given the pace of improvement, the reform law was amended in 1997 to advance by 10 years—to 2018—the deadline for fully eliminating the unfunded liability.

However, three developments over the last four years have dramatically darkened the pension funding outlook. The first and most significant was a precipitous loss in pension assets. Against the backdrop of a 40 percent decline in the stock market as a whole, [14] the market value of the state's pension assets plummeted $4.9 billion, or 19 percent, from January 2000 to January 2003. Even with a "smoothing" methodology initiated in 1998 to spread the effect of market changes over five years, the impact of the losses in asset values—versus assumed annual gains of 8.25 percent—on the size of the unfunded liability has been severe.

The Commonwealth has added even further to the unfunded liability through three major benefit enhancements for state employees and local teachers, who participate in the state-funded pension system. In fiscal 2000, the state significantly expanded retirement benefits for teachers, a change that added $1.5 billion to the overall pension liability and roughly $150 million to annual pension funding requirements. In 2002 and 2003, the state adopted two early retirement incentive programs for state employees to help reduce payroll costs. According to estimates prepared by state pension officials,

**Figure 11**



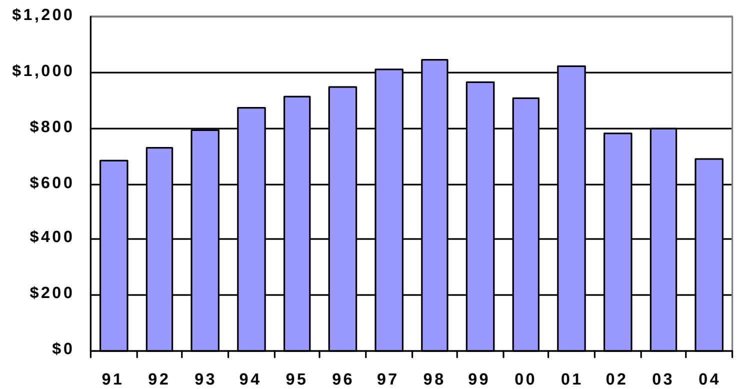

[14] As measured by the change in the S&P index from July 2000 through February 2003.

the first of these programs—with 4,600 employees opting for early retirement—added $338 million to the total pension liability; the second program is expected to increase the liability by another $250 million.

**Figure 12**

**Annual Pension Funding**

($, Millions)




Finally, even as pension assets were declining and benefits expanding, the state has sharply reduced its annual pension funding. From fiscal 2001 to fiscal 2004, budgetary resources dedicated to the pension system have dropped from a high of $1.02 billion a year to just $687 million, a 33 percent decline to the same funding level as in 1991 (see Figure 12). Although the 2004 budget attempts to increase the state's pension contribution by another $145 million by transferring ownership of the Hynes Auditorium and the Boston Convention Center to the pension fund, the actual value of those assets remains in serious dispute.

Because of all these factors, the state faces the need to increase its annual pension funding by over one half billion dollars in 2005. The Governor and Legislature have agreed on a 2005 pension contribution of $1.22 billion, an increase of $530 million, that strikes a reasonable balance between the need for a higher annual payment and the continuing fiscal crisis.

The three-year funding schedule upon which that figure is based:

- Retains the current 2023 target for eliminating the unfunded liability (the previous 2018 deadline was extended by five years in 2002);
- Recognizes the estimated value of pension assets and liabilities through December 2003 (a positive change from the prior procedure of using year-old data to update the funding schedule);
- Takes into account the increased liabilities due to the expanded benefits for teachers and the two state early retirement programs;
- Modestly adds to the "backloading" in the annual payment schedule, by raising from 4.15 percent to 4.5 percent the allowed increase in the portion of the annual pension contribution that goes to reducing the unfunded liability.

The 2005 pension funding agreement was adopted within the framework of a positive legislative initiative in the 2004 budget. Under the new mechanism, each year's pension contribution will be met through a transfer from revenues that is based on the most recent approved funding schedule and determined as part of the required consensus agreement on annual revenues.

In contrast to the experience of recent years, the budget proposals of the Governor, House and Senate will all use the same pension payment assumptions. This will remove the annual pension funding decision from the regular budget process, reducing the temptation to sacrifice long-term pension funding goals to short-term budget priorities.

The Legislature should also consider several other measures to provide greater stability in pension funding. As the many difficulties associated with the transfer of the Convention Center make clear, meeting the state's funding obligations through such transfers is a dubious means for eliminating the unfunded liability. Lawmakers should amend the pension funding law to prohibit this practice in the future.

They should also codify in statute the use of more timely data in revising the annual funding schedule. In particular, this would help ensure that any adjustments in the schedule adequately reflect the impact of volatile capital markets on the value of pension assets.

Although the previous, woefully inadequate funding schedule was approved in April 2002, it was based on valuation data from January 2001. In the intervening 15 months, the value of the state's pension assets had fallen by four percent, and the stock market as a whole by 21 percent—clear signs of even rougher waters ahead that were ignored in establishing the state's required pension appropriations for 2002 through 2004. Because of the recent rebound in the stock market, using more current data on the value of pension assets has averted the need to increase the required 2005 pension appropriation by even more than the agreed-upon $530 million. For the next triennial revision of the payment schedule in 2007, it will be critical that the state continue to use the timeliest data available in order to avoid repeating past mistakes.

In retrospect, the earlier decisions to reduce annual pension appropriations were enormously shortsighted, especially given the uncertainties about future economic performance over the decades that will be required to eliminate the unfunded liability. Had the state chosen to maintain the annual pension contribution at its 2001 level, only a minimal increase, if any, would have been required for 2005. The financing changes adopted in the 2004 budget provide some protection from future funding reductions by requiring that the last approved funding schedule be used in determining the annual pension transfer if no revised schedule has been agreed upon. Even greater funding stability could be achieved by prohibiting any reduction in annual funding until the state comes within some set amount—perhaps five years or five percent—of its goal of completely erasing the unfunded liability.

## Higher Education

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| Campuses | | | |
| UMass | $474.3 | $453.8 | $388.0 |
| State Colleges | 208.8 | 196.8 | 172.9 |
| Community Colleges | 240.0 | 225.7 | 197.0 |
| Total | 923.1 | 876.3 | 757.9 |
| Other | 114.0 | 106.0 | 94.7 |
| **Total** | **$1,037.1** | **$982.3** | **$852.6** |

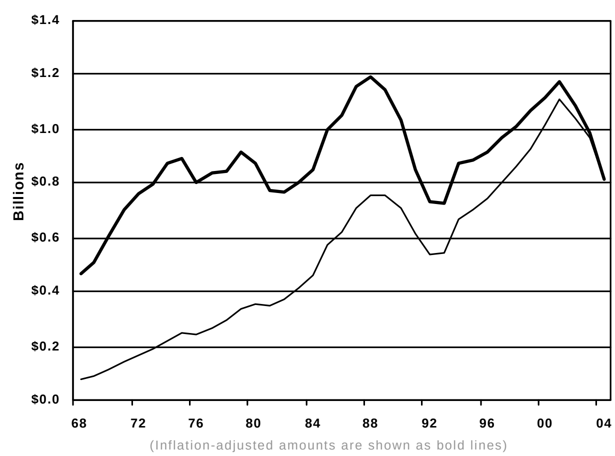
Since the beginning of the fiscal crisis, public higher education in Massachusetts has suffered a series of deep, disruptive cuts in state spending. The fiscal 2004 appropriation total of $852.6 million includes $815.7 million authorized in the 2004 budget—a staggering $293 million, or 27 percent, below 2001 spending—as well as $36 million of what are considered to be one-time supplemental appropriations approved in December.[15]

Although the importance of public higher education to Massachusetts' economic future is widely recognized, support for the state's 29 university and college campuses has been disturbingly erratic for the last two decades (see Figure 13). The recent reductions repeat a pattern that was established in the state's last fiscal crisis, when appropriations for higher education were slashed 29 percent from 1988 to 1992. As in this earlier round of reductions, the recent spending cuts have wiped out most of the increases of the previous decade, reducing state support to approximately the level of 30 years ago, after adjusting for inflation. The budget reductions have disrupted academic programs, necessitated significant hikes in tuitions and fees, and put plans for operational and capital improvements on hold.

In another indication of the inconsistent budgetary priority given to higher education, the state's spending as a percent of the total budget has dropped from 6.5 percent in 1988—the previous peak in higher education funding—to roughly 3.5 percent in 2004. Further reflecting this trend, the state's share of funding for the University of Massachusetts, which once accounted for most of the university's expenditures, is only 23 percent today.

**Figure 13**

**State Spending for Higher Education**
Inflation-Adjusted and Nominal




Given the severity of the recent cuts, it is not surprising that Massachusetts had the highest percentage decrease in appropriations for public higher education from 2003 to 2004, according to a recent survey by researchers at Illinois State University, and ranks second in the percentage reduction from 2001 to 2004 based on an MTF calculation. The sharp drop ensures that the Commonwealth will at best maintain its close-to-dead-last ranking (47th in 2003) in expenditures per capita for

[15] Most of the $36 million funds collective bargaining costs for the University of Massachusetts; the $8.2 million in collective bargaining appropriations for state and community colleges has been allocated in the totals above based on their respective shares of 2003 payroll costs.

public higher education. Also, spending per student by the Commonwealth—a fairer measure of the state's financial effort because it excludes the unusually high proportion of our students that attend private colleges—will likely tumble from its better-than-average rank of 15th in 2001, the most recent year for which comparable enrollment data is available.[16]

As we noted in a recent *Bulletin*,[17] the state's funding of higher education raises serious doubts about the ability of even the most talented and dedicated leaders to build a first class system that will meet the needs of the almost one-half of college-bound Massachusetts high school graduates that attend our public institutions of higher education. Only with such a system will we be able to maintain the highly skilled workforce that is critical to Massachusetts' economic future.

While there undoubtedly are efficiencies that can be achieved in campus operations over time, it is clear that further cuts in the higher education budget in 2005 would only compound the harm already done, which may well take a full decade to repair. Lawmakers could help alleviate the damage by paring back a host of state restrictions on the campuses' financial operations that lead to duplication of effort and costly delays. These procedural hurdles range from the Pacheco law's unreasonable limits on competitive procurement, to inefficient centralized purchasing requirements, to state-imposed obstacles to capital projects that are wholly funded with non-state resources.

Looking over a longer time horizon, it is critical that the administration and Legislature bring greater stability to the state's financial support of public higher education. A variety of options should be considered, including the "fair share" approach—considered in the 1990s but not permanently adopted—that combines formula-based funding for campuses with greater accountability for results.

[16] The ranking for the highest percentage reduction in appropriations from 2003 to 2004 is drawn from an annual survey conducted by the Center for the Study of Education Policy at Illinois State University; the other rankings cited in this section are based on MTF calculations that use 2001-04 state appropriation data for 46 states (collected by the State Higher Education Executive Officers Association), National Center on Education Statistics enrollment data, and Census Bureau population estimates.

[17] *State Spending More on Prisons than Higher Education*, November 24, 2003.

**Corrections**

| (millions) | 2002 | 2003 | 2004 |
|---|---|---|---|
| State (DOC) | $423.2 | $416.8 | $439.1 |
| County | 386.7 | 378.1 | 381.4 |
| Parole | 14.8 | 13.9 | 13.1 |
| **Total** | **$824.6** | **$808.8** | **$833.6** |

Authorized spending on corrections, including state and county prisons and the Parole Board, totals $833.6 million in 2004, almost $25 million more than 2003 expenditures and $34 million above 2001. Since 2001, corrections officials have been successful—if only temporarily—in reining in the rapid growth in annual spending that goes back more than a decade. Nevertheless, corrections is one of the only areas of state government that has not experienced actual spending cuts during the fiscal crisis.

It is increasingly clear that the state can no longer afford the rapid expansion in prison populations—and prison facilities—that has driven costs ever upward. Between 1988 when the Commonwealth took over the county jail system and 2001, spending on corrections grew more rapidly than the budget as a whole, averaging 8.4 percent a year (see Figure 14). During that same period, the total capacity of the system more than doubled, with a more than 150 percent increase in the number of costly secure beds.

While the rate of growth in corrections spending averaged only 1.3 percent a year from 2001 to 2004, the financial respite has been achieved in part at the expense of a roughly 10 percent overall increase in overcrowding that has affected all parts of the system. The resulting fiscal relief will be short-lived if the state's leaders fail to address one of the underlying causes of the explosion of prison costs—a "get tough on crime" correctional philosophy that has packed the Commonwealth's penal system to the bursting point and driven an expensive, debt-financed boom in prison construction.

Even with the expansions, the state's prisons and jails were still operating at 137 percent of capacity in the first quarter of fiscal 2004, only moderately less than the peak of 157 percent in 1986. Moreover, after making steady progress for several years, overcrowding was up sharply in fiscal 2003 and is continuing to rise, albeit at a slower rate, in the first quarter of 2004 (see Figure 15). A 12 percent jump to 22,526 in the average daily population, combined with an almost nine percent reduction in capacity, explain the increase in overcrowding since 2002.

The administration has recently raised appropriate concerns about the economic and social costs of the state's correctional approach, emphasizing the need to place inmates in more appropriate levels of incarceration and better prepare prisoners

**Figure 14**

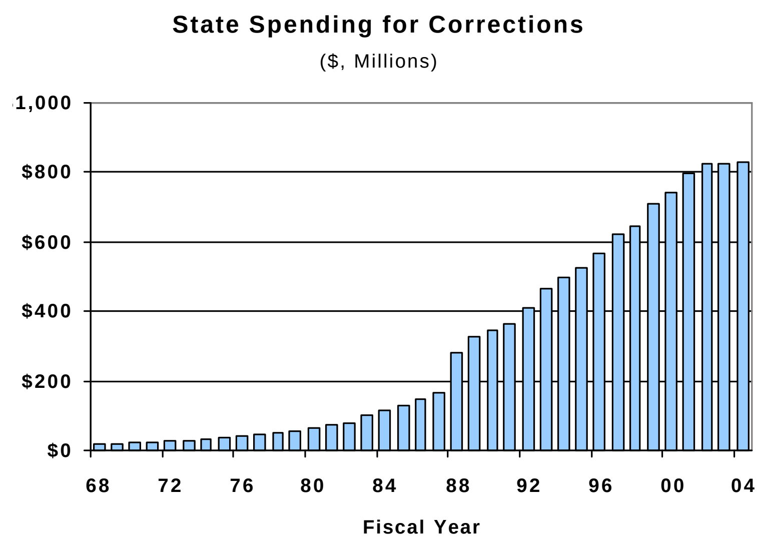
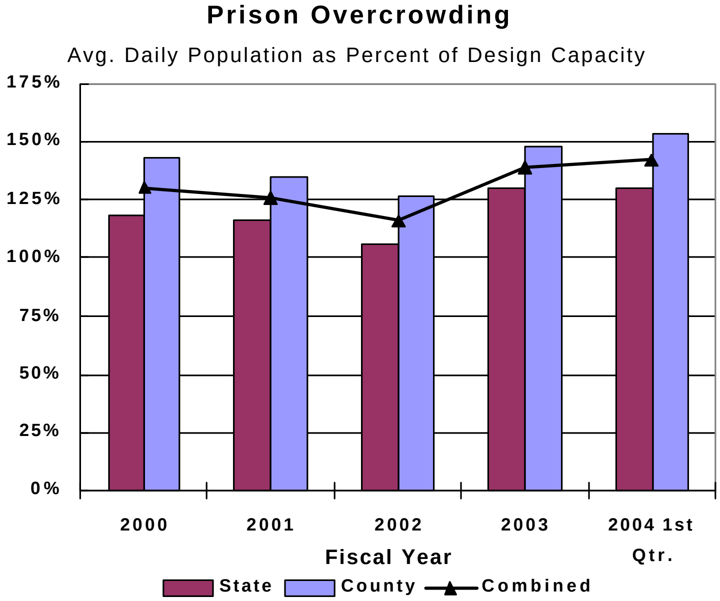


**Figure 15**




for their return into society. This shift in philosophy reflects a growing national trend that has already led many other states to enact laws eliminating lengthy mandatory minimum sentences for nonviolent offenders.

The Commonwealth could take a positive step by adopting the sentencing guidelines recommended by the Massachusetts Sentencing Commission. Also, the "blue ribbon" commission that is investigating systemic problems at the Department of Correction presents an important opportunity to address prisoner over-classification and the role of community corrections, both of which have a large impact on prison costs as well as safety. Although initiatives in areas such as these are unlikely to produce immediate savings, they will reduce the cost pressures on the system over the longer term.