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Bulletin

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Governor's 2005 Budget: Fourth Year of Spending Cuts; Health Care Vulnerable

Reflecting the reality of the state's ongoing fiscal crisis, Governor Romney's 2005 budget proposes the fourth straight year of spending cuts. While education is the budget's primary area of emphasis, the modest increases in local school aid and higher education funding recommended for 2005 do not come close to offsetting the reductions of the previous three years.

For much of state government, the administration is recommending either outright cuts or essentially level funding that shifts the burden of accommodating the inevitable increases in annual costs to program managers. In the case of local aid, the proposed flat funding will necessitate reductions in municipal budgets already hard pressed by the rapid escalation in health care and other costs.

Health care clearly fares the worst in the Governor's budget, along with key portions of human services. Although the administration acknowledges the financial fragility of the state's health care system, the proposed cuts in 2005 Medicaid reimbursement rates—which come on top of previous reductions—and lower funding for uncompensated care would only further destabilize the precarious finances of health care providers. Public health programs, which have already sustained a more than 30 percent cut since the beginning of the fiscal crisis, are reduced by more than eight percent in the Governor's budget.

On the positive side, the financial underpinnings of the 2005 budget are considerably strengthened by the consensus reached by the Governor and Legislature on the forecast of next year's tax receipts. The agreed-upon revenue figure, which assumes 3.75 percent growth in 2005, is clearly conservative, and may prove to be overly so given the relatively strong collections in recent months. MTF's forecast for 2005 taxes is almost $300 million higher than the consensus estimate. Although the Governor's budget proposes no increases in broad-based income or sales taxes, it raises taxes on businesses by $70 million on top of the almost $200 million of new business taxes adopted in 2003.

The state leadership's early accord on 2005 pension funding—a $530 million increase in annual funding—is another positive development. The agreement removes an otherwise difficult-to-resolve issue from the pressured atmosphere of budgetary debate while responsibly meeting an important state financial obligation.

In contrast to last year's sweeping recommendations, the Governor takes a more focused approach to governmental reform in the 2005 budget, including sensible proposals to curb long-standing pension abuses, implement cost-saving construction reforms, and ease the Pacheco law in order to encourage competition in providing state services.

After an unsuccessful attempt in the 2004 budget, the Governor is again proposing to merge the operations of the independent Turnpike Authority with the state Highway Department, citing savings of up to $20 million a year from eliminating duplicative or unnecessary costs and the freeing up of $190 million of Turnpike reserves. However, it is not yet clear how the proposed merger will fit into—and strengthen—the more comprehensive organizational structure that is needed to manage the state's transportation resources as a whole.

The Governor is also recommending a restructuring of the Commonwealth's financial obligations for the construction of local school projects. By bonding the state's share over 40 years—double the current 20 years—the administration proposes to fund all currently approved school building projects over the next five years and generate $150 million of short-term savings in 2005. While undoubtedly attractive to local officials coping with a moratorium on new state reimbursements that was put into effect in 2003, the proposal raises two important concerns. The longer repayment period would raise the program's costs to taxpayers as much as 50 percent over the life of the bonds. Although the Governor's proposals for much-needed reform in the state's capital construction process would reduce this impact somewhat, the underlying reasons for the current program's spiraling costs—overly generous local reimbursement rates and high demand for school construction—remain to be resolved.

While the Turnpike and school building initiatives deserve careful debate on their policy merits, one aspect of the plans is clearly problematic. As set forth by the Governor, the proposals would further the state's dependence on non-recurring revenues to support ongoing costs by diverting $190 million of Turnpike reserves and $150 million of temporary savings from school building assistance to help balance the 2005 budget. In total, the administration proposes to use $500 million of one-time resources in 2005, an amount that would have to be replaced in 2006.

Table 1
House 1 Spending
($, Millions)

Line item appropriations	$22,979
Pension funding transfer	1,217
Off-budget health care:	
Medicaid nursing home rates	289
MassHealth Essential	160
Uncompensated care	35
Total	484
Other off-budget	110
Total	24,790
Turnpike spending offset by revenues	275
Total minus Turnpike	$24,515

Spending

The Governor's budget (commonly called House 1) provides for $24.79 billion of spending in fiscal 2005, an amount that includes $275 million for operations of the Turnpike Authority that would be offset by authority revenues, principally tolls, under the proposed merger with the state Highway Department. After adjusting for the impact of this initiative, the proposed spending is $1.1 billion, or 4.7 percent, above 2004 authorizations to date.[1] The

[1] For purposes of comparison, 2004 authorizations have been increased to reflect a change in accounting for $160 million of expenditures from Medicaid recoveries that has been proposed by the administration.

recommended spending total includes $22.98 billion of line item requests, $1.22 billion of pension costs funded by a transfer from tax revenues, and almost $600 million of other off-budget spending, primarily for health care (see Table 1).

Table 2
Major Areas of 2005 Spending Growth
($, Millions)

	Amount	Percent Change	Percent Share of Growth
Major programs:			
Pensions	530	77.1	48
Medicaid	427	6.3	38
Debt service	176	11.0	16
Subtotal	1,132	12.6	102
Rest of government	-24	-0.2	-2
Total	$1,108	4.7	100

* Excluding Turnpike initiative.

Behind the more than $1 billion rise in overall spending are major increases in three large accounts that in combination exceed the growth in the 2005 budget as a whole:

- Almost half of the 2005 increase—$530 million—is due to the funding requirements of the state pension system, following a steep decline in the value of assets, early retirement and other benefit expansions, and shortsighted cuts in annual appropriations since 2001.
- Another 40 percent of the growth supports Medicaid and related health care programs. Despite provider rate cuts and other budget reductions totaling almost $300 million proposed by the Governor, Medicaid expenditures are still slated to increase by $427 million, or 6.3 percent, in 2005 (the federal government reimburses the state for 50 percent of these Medicaid costs).[2]
- Debt service on borrowing for the state's financially strained capital program accounts for another $176 million, or 16 percent, of the total increase.[3]

Together, the largely unavoidable growth in these three areas totals $1.13 billion.

For the rest of state government, total 2005 spending would fall slightly—by $24 million or 0.2 percent—from 2004, a change that reflects the impact of $313 million of proposed increases that are offset by $337 million of proposed decreases (see Table 3).

Excluding the growth in the three major programs, education is the primary beneficiary of the proposed additional spending in 2005, including a $66 million, or 2.1 percent, increase in Chapter 70 school aid and a $27 million, or 3.4 percent, increase for higher education campuses.

Unfortunately, the recommended increases in local school support do not come close to offsetting the cuts of the last three years. The Governor's recommendations for school aid other than Chapter 70 are $234

[2] The $300 million in reductions includes a $65 million cut in state funding for the uncompensated care pool which is not reflected in the Medicaid spending figures.

[3] In addition, $250 million in new debt service would replace school building assistance payments, and $113 in new payments on Turnpike Authority bonds under the proposed merger would be added to the budget, offset by toll revenues.

Table 3
Spending Increases and Decreases in Governor's Budget*
($, Millions)

	Change from 2004		Change from 2001	
	Amount	Pct.	Amount	Pct.
Major programs				
Pensions	530	77.1	200	19.7
Medicaid	427	6.3	2,370	49.5
Debt service**	176	11.0	341	23.8
Total – major programs	**1,132**	**12.6**	**2,911**	**40.2**
Rest of government				
Increases				
Chapter 70 school aid	66	2.1	188	6.3
Mental retardation	30	3.0	128	14.0
Employee health	28	3.4	196	30.5
Higher education campuses	27	3.4	-194	-19.4
Other local school support	26	10.5	-234	-46.1
Social services	20	2.9	128	22.3
Environment and parks	17	9.4	-50	-20.2
Police	15	6.6	35	17.0
Indigent counsel	11	12.7	1	1.0
Elderly	9	4.9	20	11.2
Cash assistance excl. SSI	5	1.3	50	13.6
Youth services	5	3.7	12	10.5
Scholarships	4	5.1	-22	-19.5
SSI	4	2.1	-31	-13.1
All other increases***	47	6.8	-57	-7.2
Total Increases	*313*	*3.2*	*172*	*1.9*
Lottery/addl. asst-no change	*0*	*0.0*	*-229*	*-17.9*
Decreases				
School building assistance	-150	-37.5	-66	-20.7
Uncompensated care	-65	-54.2	35	100.0
Public health	-31	-8.3	-176	-34.3
Corrections	-15	-1.8	19	2.4
Business and labor	-12	-9.9	-44	-29.4
Child care	-8	-1.2	-27	-6.9
Judiciary	-6	-1.2	-4	-0.8
Regional transit	-5	-10.1	7	16.0
Mental health	-5	-0.9	-15	-2.4
All other decreases	-41	-1.8	-167	-12.8
Total decreases	*-337*	*-7.5*	*-437*	*-9.5*
Total – rest of government	**-24**	**-0.2**	**-494**	**-3.3**
Grand Total	**$1,108**	**4.7**	**2,417**	**10.9**

* Excluding Turnpike initiative.

** Excluding Turnpike and school building assistance initiatives.

*** After taking into account the supplemental appropriations needed—but not yet authorized—for snow and ice in 2004, most of this apparent increase of $47 million largely disappears.

million, or almost 50 percent, below 2001 spending. Municipalities—which finance 60 percent of local school budgets—have also sustained cuts in lottery aid and additional assistance totaling $229 million, or 18 percent, since 2001, and the administration proposes to level fund these accounts in 2005.

Similarly, the increases in higher education spending take only a small step toward reversing the previous huge cuts. The Governor's 2005 recommendation for campus budgets is still $194 million, or 19 percent, below 2001; the recommendation for scholarship support is $22 million, or 20 percent, below 2001.

While the proposed increases clearly add to the state's permanent spending base, large portions of the recommended cuts either are temporary or will be difficult to sustain. Of the $337 million in total reductions, $150 million comes from the decrease in school building assistance appropriations; $65 million is due to a cut in state support for the financially troubled uncompensated care system; and an additional $35 million is squeezed from the already decimated public health budget. The proposed 2005 appropriation for public health is $176 million, or 34 percent, below 2001. Apart from these explicit reductions, inflationary cost increases of more than $100 million are not funded. At the same time, another $153 million of proposed savings in Medicaid (not included in the $337 million total) are problematic as well.

Medicaid

The Governor's budget proposes to slow the rampant growth in Medicaid spending that has been a leading cause of the state's fiscal crisis, but at the cost of adding to the intense pressures that are already straining the state's health care network. At $7.15 billion, the Governor's proposed Medicaid budget represents an increase of $427 million, or 6.3 percent, over fiscal 2004 authorizations.[4] The slower growth—authorized spending increased by 13 percent in fiscal 2004 and by an annual average of 9.2 percent since 1997—is the result of $153 million in savings measures, as well as the elimination of $70 million in off-budget spending items that were authorized in the 2004 budget.[5]

The administration projects Medicaid spending would have increased by about 10 percent without the reductions. Enrollment is expected to grow in 2005, reversing the trend of the past year in which membership declined by about 34,000 to a total of 928,000. The reduction was primarily due to the elimination of eligibility for the long-term unemployed in April 2003. Although the MassHealth Essential program was created in the 2004 budget to restore limited services to this group, enrollment in MassHealth Essential—16,000 in December 2003—has only partially offset the earlier reduction. Enrollment of members other than the long-term unemployed has been declining slightly, in all likelihood because of the new and increased premiums, co-payments and eligibility restrictions that have been imposed in a variety of Medicaid programs.

The Governor's budget proposes to reduce reimbursements to health care providers that are already unsustainably low. The state has long paid less than the full cost of services for Medicaid recipients, with hospitals, for example, currently reimbursed less than 70 percent of their expenses. The Commonwealth needs to

[4] The total includes $449 million in off-budget spending for MassHealth Essential and enhanced nursing home rates, as well as funding for the Division of Health Care Finance and Policy.
[5] The 2004 off-budget authorizations include $28 million from the balance of the Uncompensated Care Trust Fund and a series of one-time grants to hospitals and community health centers.

develop and implement a multi-year plan to bring reimbursements in line with costs, but House 1 continues to move the state in the opposite direction.

About half of the proposed savings measures take the form of additional rate reductions, including $35 million from acute care hospitals and $31 million from nursing facilities. Other provisions would disallow Medicaid recipients from relying on hospital outpatient departments as their primary care physicians, saving $16 million, and discontinue $11 million in special payments to hospitals that serve a disproportionate share of uninsured patients. The savings projections assume that several of the measures will not be implemented until October, so their annual impact on already shaky provider finances would be even greater. The budget also continues reductions made in previous years, such as limiting payments for inpatient hospital stays to 20 days.

At the same time, funding for the uncompensated care pool, the state's mechanism for funding health care for the uninsured, will be cut by $65 million while the assessments that hospitals and insurers pay into the pool will rise by $7.5 million each under the Governor's budget. With tighter restrictions on Medicaid eligibility driving more state residents into the "free care" system, hospitals project that uncompensated care costs will exceed reimbursements from the pool by over $300 million. The budget contains no new proposals for long-term reforms to the financing or management of free care, and much needed reforms of the pool's scope and administration that were included in the 2004 budget have not yet been implemented, and are overdue.

The same national forces that are driving up spending on Medicaid and uncompensated care are also adding to the cost of health insurance for state employees and retirees. The Group Insurance Commission (GIC) expects premiums to rise about 10 percent in 2005, but its proposed budget is only $26 million, or 3.1 percent, higher than 2004 appropriations. Part of the difference is explained by $25 million in anticipated savings in 2004 due to aggressive management of pharmacy and other costs, which results in a lower base for 2005.

The Governor's budget also proposes to require employees to pay, on average, 25 percent of their insurance costs, reducing GIC spending by another $30 million. Counting on these savings is problematic. This positive proposal has been offered repeatedly by governors over the last several years, but has always been rejected by the Legislature. Under a compromise adopted in the 2004 budget, employees currently pay between 15 and 25 percent depending on their salary and when they were hired.

Reforms

Turnpike Authority/Highway Department Merger. Reviving a plan that was rejected by the Legislature last year, the Governor's budget proposes to merge the operations of the now independent Turnpike Authority with the state Highway Department. The Commonwealth would cover the costs of operating the Turnpike and the Central Artery ($162 million in 2005) and making payments on the Authority's debt ($138 million) by transferring tolls and other Turnpike revenues to the state. The administration believes that the merger will save $20 million annually in operating and overhead costs.

Providing Commonwealth backing for the Turnpike's bonds would eliminate the need for debt reserves, allowing an additional one-time transfer of $190 million, which the administration proposes to use to help balance the state's budget. The transfer raises both financial and policy questions. The original source of the $190 million is

Turnpike borrowing that will be repaid with tolls. If the Commonwealth is going to rely on borrowed funds to cover a portion of its budget deficit, there may be more cost-effective means than the Turnpike's relatively high interest debt. In addition, the Foundation has long argued that one-time revenue sources are best spent on one-time projects. Addressing a portion of the state's enormous backlog of transportation capital needs would be a more appropriate use of funds that—in the end—come from the tolls paid by users of the highway system.

In making its case for the merger, the administration has focused on the potential savings. While the Commonwealth's fiscal crisis demands that duplicative or unnecessary spending be eliminated wherever possible, the reorganization of the state's transportation agencies should also be driven by the answers to broader questions: How should the Commonwealth organize itself to develop and operate a high quality and coordinated transportation system that supports economic growth in Massachusetts? What structure would most effectively safeguard the taxpayers' massive investments in the Central Artery, public transit and other elements of the transportation system? Among other issues, the Commonwealth will need to consider the organizational capacities required for managing the Artery, which is enormously more complex than other state highways. A special commission that was created in the 2004 budget in response to the Governor's first Turnpike proposal is examining the organization of the state's transportation agencies.

The Foundation plans to produce a more detailed analysis of the merger proposal and the related questions it raises over the next several weeks.

School Building Assistance. With his proposal to refinance the state's obligations to cities and towns for the costs of school construction projects, the Governor is attempting to rein in a program that has spiraled out of control. The state is already spending $400 million annually to reimburse local governments for an average of 70 percent of their payments on bonds issued to finance school building costs. However, the state's funding has not kept pace with demand, and 420 projects with a total state cost of over $4 billion are now awaiting funds. Initiating payments for all of the projects on the waiting list would require nearly doubling annual spending to $760 million, but no funding is available for any new projects in fiscal 2004. To keep the list from growing even longer, a moratorium on approving new projects until 2007 has been imposed.

The Governor's proposal has two financial components: a $4 billion bond issue to finance the remaining payments for the 700 projects already receiving reimbursements, and another $4 billion in bonds to be issued between 2005 and 2009 to pay up front the state share of the construction costs of all projects that are currently on the waiting list. Both bond issues would have a maximum term of 40 years, twice the life of the bonds now issued by cities and towns. Debt service on the bonds in 2005 would be $250 million, producing $150 million in short-term savings in fiscal 2005.

No change would be made in reimbursement rates for projects already on the waiting list. However, the legislation creates a reform commission to redesign the program for future projects.

While the Governor's plan provides assurance to cities and towns that the Commonwealth will meet its obligations to pay its share of school building costs, and preserves the reimbursement rates that were promised when voters approved local bond issues, the proposal does raise a number of concerns:

- Aside from the creation of the commission, the plan offers no long-term reforms of the SBA program, such as project approval criteria or reimbursement rates, that would help contain the explosive growth in spending once the moratorium on new projects is lifted.

- There is no provision for financing projects that are not already on the waiting list and no plans to approve additional projects before 2010.

- The short-term savings in fiscal 2005 are achieved by stretching out the financing from 20 years to an unusually long 40, adding roughly 50 percent to debt service costs and potentially exceeding the useful life of the schools.

- Like the Turnpike reserves, using the savings to help balance the budget will only prolong the state's structural deficit.

Construction Reform. Included in the Governor's school building assistance legislation are several positive proposals to modernize the antiquated laws that add costs, create delays and reduce quality in public construction projects. Allowing alternative procurement methods that are widely used in other states and in the private sector, such as design-build and construction-manager-at-risk, as well as the ability to factor quality into the contractor selection process, would shorten project schedules, reduce cost overruns and increase the quality of the capital asset. The proposal would also require professional project managers for municipal projects to improve oversight by cities and towns.

Barriers to Competition. The Governor has revived another important initiative with his amendments to the "Pacheco law," which creates a series of obstacles to using competition to reduce the cost and improve the quality of government services. The proposal specifies that the costs of the proposed contract be compared to actual state costs rather than the hypothetical costs of state employees working in the "most cost-efficient manner," and makes other changes to the law's most egregious provisions in order to provide a more level playing field for competitive proposals. Modest reforms and exemptions to the Pacheco law offered by the House Ways and Means Committee last year did not survive the legislative process.

Pension Abuses. House 1 also puts forward several proposals to curb abuses of the state employee pension system and require timely funding of new pension obligations. The amendments would reduce the incentives for gaming the system by establishing a pension cap based on earnings over the employee's entire career, excluding auto and housing allowances from earnings, and closing loopholes such as special pensions for certain terminated employees. While some of the proposals may go farther than necessary and produce some unintended consequences, on the whole they would help restore public faith in the pension system, which has been tarnished by a series of well-publicized abuses. On the fiscal front, new pension liabilities, such as those created by early retirement programs, would have to be funded within three years based on actuarially projected costs.

While the construction, Pacheco law and pension reforms will not produce any immediate savings, addressing the state's long-term fiscal problems and meeting its obligations to taxpayers requires that the Commonwealth take reasonable steps like these to make state services as cost-effective as possible.