Massachusetts Taxpayers Foundation

State Budget ’03: The Perfect Storm…Unleashed

FEBRUARY 2003

MTF

State Budget ’03: The Perfect Storm…Unleashed

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Overview

Two years ago the Foundation warned in its annual report on state spending, entitled *The Perfect Storm*, that a series of forces were conspiring to change dramatically the state's fiscal fortunes. If some at the time suggested that those warnings were overstated, it is now clear that they were in fact understated. The Commonwealth is in the midst of its worst fiscal crisis in more than half a century. Despite tax increases and difficult spending cuts, the state remains in the grip of an enormous structural mismatch between revenues and expenditures that will require many more painful decisions in the months ahead, and many years to overcome fully. There is no quick fix for the state's fiscal woes: Bringing spending into line with revenues will require a multiyear strategy that recognizes the limited reserves now remaining and the long road ahead to economic recovery.

While last year's staggering $2.5 billion plunge in tax revenues helped precipitate the crisis, other factors have deepened and extended the state's fiscal problems.

- The ill-timed phasing in of Question 4, the voter-approved cut in the income tax rate, removed almost a billion dollars from the state's tax base just as the economy went into recession.
- Rapid growth in health care costs has dramatically pushed up expenditures for Medicaid -- despite cuts in benefits and eligibility -- with no signs of abating.
- The bursting of the stock market bubble has produced a collapse in capital gains receipts which have little prospect of recovering for years to come.
- A lingering recession continues to bleed jobs from the state's economy and revenues from the state's coffers.

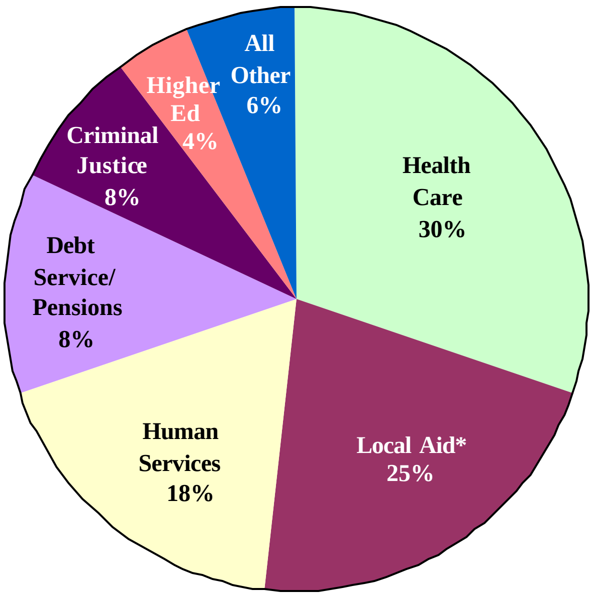
As a result, the Commonwealth now faces a gigantic gap between available revenues and the spending needed to sustain programs and services at their current levels, as well as a rate of annual spending increases that far outstrips likely revenue growth. This unhappy combination underlies the widening gap in the state's finances in 2003 -- which has required a series of mid-year gubernatorial spending reductions -- and the projections of a $2 to $3 billion budget deficit in 2004.

Strikingly, these shortfalls are occurring despite the roughly $1 billion of tax increases enacted last year, spending cuts approaching $2 billion over the last 18 months, and the expectation that the state economy will begin to recover in fiscal 2004.

Dealing with the structural deficit through further spending reductions will present enormous challenges to the state's decision makers. While there are certainly some areas of waste and inefficiency in state operations, the vast majority of spending is devoted to health care and other services to needy individuals, education and other aid to cities and towns, and other critical functions such as law enforcement, the courts, environmental and business regulation, and public higher education.

As illustrated in Figure 1, almost one-half of state spending in fiscal 2003 is directed to health care and human services, including the federally sponsored Medicaid program for elderly, disabled and low-income individuals. Aid to local schools and other assistance to cities and towns, including lottery revenue sharing, comprises 25

Figure 1
Fiscal 2003 Spending
Total: $22.9 Billion



* Including appropriations for local teachers' pensions.

percent of 2003 spending. The costs of capital borrowing, pensions, courts, prisons and public higher education account for another 20 percent of 2003 spending.

While estimated spending for 2003 -- including the impact of the latest "9C" administrative cuts by the Governor -- is up only 3.8 percent from 2001 actual expenditures, this aggregate result conceals huge increases in the costs of health care that offset major reductions in almost all other areas of state spending.

According to the Foundation's analysis, the state has already reduced spending in a broad array of specific programs by $1.6 billion below actual 2001 expenditures, a 20 percent reduction that does not include the additional cuts required to offset inflationary and other cost increases in these programs (see Table 1). Neither does it include, in the case of Medicaid, the $200 million additional impact in 2004 of eliminating 50,000 long-term unemployed individuals in the fourth quarter of fiscal 2003.

While spending in a few areas -- such as Medicaid, Chapter 70 school aid, and selected human service programs -- has increased substantially over the last two years, most other areas have sustained major cuts. Taking into account the most recent 9C reductions, local aid other than school assistance has been reduced by more than 15 percent. Public health, housing and other critical human services have been cut by more than 20 percent. Other major reductions include a $143 million or 13 percent cut in public higher education and a $222 million or 21 percent cut in annual pension appropriations at a time when the state's unfunded pension liability has ballooned because of losses in the value of pension assets.

The sheer scale of the reductions that have already taken place underscores how extraordinarily difficult it will be to close an even larger 2004 budget gap through spending cuts alone. While there are many opportunities for spending reforms, such as correcting inequities in the distribution of school aid, revamping human services, and eliminating unnecessary mandates and restrictions throughout state and local government, these initiatives are unlikely to generate more than a fraction of the savings needed to fill a $2 to $3 billion budget deficit. The Foundation strongly supports the Romney administration's commitment to improving the delivery of state services. As a practical matter, however, the dollar savings from such efforts are much more likely to be counted in the tens of millions than in the billions. Moreover, their benefits will be realized over years, not months, providing little relief from the immediate crisis.

Table 1
Major Spending Increases and Decreases
Fiscal 2001 to 2003
($, Millions)

Spending Category	Programs with Increased Spending		Programs with Decreased Spending		Net Change	
	Amount of Increase	Pct. Chg. from 2001	Amount of Decrease	Pct. Chg. from 2001	Amount	Pct. Chg. from 2001
Health care	$1,548	28.3	-$99	-100.0	$1,449	26.4
Education & local aid	384	11.4	-585	-22.0	-191	-3.2
Human services	371	14.8	-332	-20.5	39	1.0
Debt service/pensions*	63	4.2	-116	-27.8	-53	-2.8
Public safety	75	6.6	-26	-4.5	50	2.9
Higher education	0	0.0	-143	-12.9	-143	-12.9
Other	11	7.4	-323	-19.7	-313	-18.2
Total	**$2,451**	**17.4**	**-$1,613**	**-20.2**	**$837**	**3.8**

* Includes certain contract assistance counted as local aid elsewhere in the report.

Given available revenues, the Commonwealth cannot afford the level of spending needed to sustain the programs and services that have formed its core for the last decade or more. Clearly, wrenching choices lie ahead.

Fiscal 2003

With deteriorating tax collections over the last six months and major uncertainty about revenue prospects for the remainder of the year, the state's leaders have had to contend with an ever-rising tide of red ink in fiscal 2003. Unfortunately, the need to address this year's immediate shortfall -- and disagreements about who should bear the responsibility for finding solutions -- have distracted the state leadership from addressing the far larger financial problems that loom for fiscal 2004 and beyond.

2003 Revenues

Fiscal 2003 tax revenues are expected to total $14.65 billion, just $360 million, or 2.5 percent, above 2002 collections, according to the administration's newly revised forecast. This estimate is $770 million less than the tax forecast on which the 2003 budget was based and $497 million below the October 2002 downward revision of the forecast (see Table 2).

The $14.65 billion total for 2003 is essentially identical to the bottom end of the range of the Foundation's most recent revenue forecast, adjusted downward by $100 million for capital gains and certain other forecast risks identified by the Department of Revenue. While the top end of MTF's forecast range is $14.9 billion -- almost $250 million higher than the administration's estimate -- achieving that higher total will be difficult given the poor revenue performance in January, almost $160 million below DOR's benchmark for the month.

Table 2
2003 State Tax Revenues
($, Millions)

	Amount	Change from prior yr.
Actual for 2001	16,730	
Actual for 2002	14,289	-2,441
Estimate for 2003 budget	15,418	1,129
A&F October forecast	15,145	856
MTF forecast with risks*		
Bottom of range	14,658	369
Top of range	14,896	607
A&F February forecast	14,648	359

* Adjusted downward for capital gains and other risks to forecast totaling $100 M.

Table 3
2003 Tax Forecasts
Budgeted v. Revised Administration Forecast
($, Millions)

	Forecast for Budget	Revised Forecast
Base taxes for budget	14,537	13,963
Change from 2002	248	-326
Percent change	1.7%	-2.3%
Impact of prior tax cuts	-258	-258
Ongoing revenues from tax package*	925	725
One-time revenue from tax package	**	100
One-time tax amnesty	**	125
Total taxes	**15,419**	**14,648**
Change from 2002	1,130	359
Percent change	7.9%	2.5%

* Excluding $215 million due to maintaining the income tax rate at 5.3 percent, rather than reducing the rate to 5.0 percent on January 1, 2003 as previously authorized, a change which avoids a revenue loss but does not generate additional collections in 2003.

**Revenues from retroactive decrease in personal exemptions, originally estimated at $120 million, were not included in the forecast of revenues adopted in the initial 2003 budget. Tax amnesty revenues, estimated at $43 million, were counted as part of departmental revenues.

The meager increase in 2003 tax revenues is entirely due to the package of tax increases enacted last year. According to current estimates, the tax increases will generate approximately $825 million in 2003 (including one-time revenues from the retroactive reduction in personal exemptions), roughly $200 million less than originally projected (see Table 3).

However, these additional collections have been significantly eroded by the almost $260 million impact in 2003 of previously authorized tax cuts and a $325 million, or more than two percent, decline in the Commonwealth's underlying revenue base (see Table 2). The shrinkage of the base compounds an even larger drop in 2002 when baseline revenues plummeted 10 percent. The 2003 decrease is partially offset by higher than expected tax amnesty receipts, almost all of which represent one-time revenues.

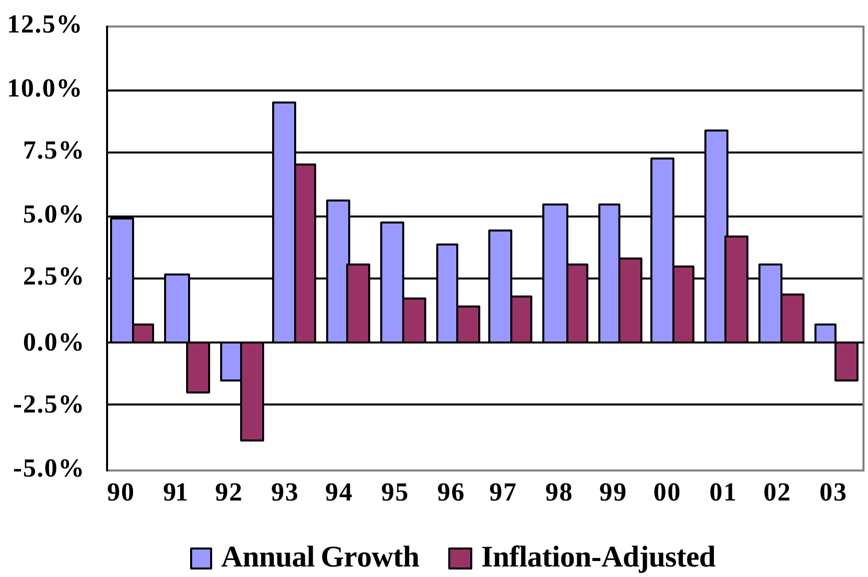
2003 Spending

Estimated spending for 2003 is projected to add up to $22.94 billion, a slim increase of $168 million from 2002. This total includes $22.69 billion of regular appropriations in the 2003 budget, $347 million of off-budget Medicaid authorizations, $271 million of anticipated deficiencies (including $190 million for Medicaid), $148 million of other budgetary authorizations, and $49 million appropriated in the final 2002 supplemental budget. These totals are offset by $212 million of 9C cuts by Governor Swift and $343 million of such cuts by Governor Romney.

Taking into account the latest round of 9C cuts, estimated spending for fiscal 2003 is essentially flat -- a minute 0.7 percent increase that could actually become a decline if further cuts are necessary. Even more striking, 2003 spending is almost two percent below 2002 after taking inflation into account, the first real reduction in annual spending since 1992, in the depths of the last fiscal crisis (see Figure 2).

Underlying this picture of an inflation-adjusted decline in overall spending are huge increases in a limited number of state programs, which have been offset by major reductions in a host of other programs. Almost all the spending growth since 2001 has been concentrated in just two priority areas -- Medicaid and Chapter 70 school aid -- as other programs and services have seen

Figure 2
Annual Spending Growth
Percent Change



"9C" Budget Cuts

Under section 9C of chapter 29 of the Massachusetts general laws, in the event of a shortfall in revenues the Governor has the power to reduce line item appropriations within agencies under his control. While rarely invoked, the "9C" budget cutting authority is a key tool to bring the state's finances into balance in the event of an unexpected large revenue decline. Because of the severity of the 2003 imbalance, the Legislature recently approved, on an emergency basis through the end of the fiscal year, the Governor's request to expand the scope of section 9C to allow reductions to local aid, higher education and other non-executive branch accounts.

increasingly large reductions. Over the past two years, school aid has risen $270 million, or nine percent, including a $41 million increase in 2003 (see Table 4). Despite a series of cost savings measures, Medicaid spending has grown by a phenomenal $1.3 billion since 2001, almost 13 percent a year on average (50 percent of which is reimbursed by the federal government).

Table 4
State Spending Growth
Fiscal 2001 - 2003
($, Millions)

	Actual 2001 Spending	Increase in 2002	Increase in 2003	Estimated 2003 Spending
Chapter 70 school aid	$2,990	$229	$41	$3,259
Medicaid	4,777	639	654	6,070
Human services*	3,993	106	-80	3,959
All other	10,407	-302	-448	9,657
Total	**$22,106**	**$671**	**$168**	**$22,945**

* Excluding services to elders, which are counted in "other."

Although spending for human services was largely spared from cuts in 2002, significant reductions in selected agencies have resulted in essentially level funding in 2003. At the same time, the rest of state government has experienced progressively more severe reductions, with a net decrease of $750 million, or more than seven percent, from 2001 to 2003.

2003 Balance

According to the Foundation's analysis, the 2003 budget is roughly in balance -- after taking into account the recently announced $344 million of administrative cuts and assuming legislative approval of a package of solutions equal in dollar value to those proposed by the administration. These solutions include the transfer to the General Fund of $50 million of 9C cuts by Governor Swift from accounts charged to the so-called "minor" funds, and proposed increases in fees at the Registries of Deeds (see Table 5).

Even so, substantial uncertainty still surrounds 2003 finances. The Governor has identified up to $165 million of risk to the revised revenue forecast, primarily due to the potential for an unknown number of taxpayers to offset current capital gains with prior losses. While the administration argues that it will make up any revenue shortfall by closing "corporate tax loopholes," these tax changes are not likely to produce significant additional collections in fiscal 2003. In particular, the administration has proposed legislation, retroactive to 1999, to disallow the use of real estate investment trusts (REITs) by banks. The misguided retroactive aspect of this change in tax law will

Table 5
2003 Balance
($, Millions)

	Amount
Resources	
Revenues	21,775
Reserves and one-time revenues	1,057
Total resources	22,831
Expenditures	
Appropriations net of 9C and other savings	22,524
Unavoidable deficiencies and other supplementals	296
Total spending	22,820
Surplus/(deficit)	11

almost certainly be challenged in court by the affected taxpayers.

The projection of 2003 balance also depends on significant as-yet-unidentified agency appropriations remaining unspent at the end of the fiscal year. While the estimated amount of such unplanned "savings" -- more than $100 million -- is reasonable based on prior experience, the final tally could be significantly lower given the tightness of the initial 2003 budget and the cuts that have already been made during the course of the fiscal year.

With these uncertainties, the state may have to draw even more heavily on its reserves to end the year in balance. The state is already relying on more than $1 billion of reserves and one-time revenues to pay 2003 bills.

BUDGET SUMMARY
Fiscal 1999-2003

(millions)	Actual 1999	Actual 2000	Actual 2001	Actual 2002	Preliminary Estimated 2003 (5)	January 9C Cuts	Total Estimated 2003
Investment in Children	**$5,010.0**	**$5,527.6**	**$6,014.3**	**$6,270.7**	**$6,198.0**	**($57.0)**	**$6,141.0**
Education Local Aid	3,186.8	3,534.4	3,830.1	4,096.6	4,046.4	(24.9)	4,021.5
Higher Education	935.4	1,006.3	1,109.1	1,037.1	985.1	(15.9)	969.1
Services to Children	491.0	537.6	573.6	631.8	665.7	(9.1)	656.6
Youth Services	105.8	111.9	118.3	122.5	124.8	0.0	124.8
Child Care Services (1)	291.0	337.5	383.2	382.7	376.0	(7.1)	368.9
Criminal Justice and Law Enforcement	**$1,527.1**	**$1,586.4**	**$1,708.6**	**$1,752.6**	**$1,763.2**	**($4.9)**	**$1,758.2**
Corrections	710.0	745.5	799.3	824.6	825.7	(1.6)	824.1
Judiciary	508.5	545.8	588.7	580.0	583.5	0.0	583.5
Police	212.2	195.0	205.3	230.8	242.7	(3.3)	239.4
DAs	69.8	72.1	81.4	81.4	78.5	0.0	78.5
Attorney General	26.6	28.0	33.8	35.7	32.7	0.0	32.7
Local Government	**$1,410.3**	**$1,553.7**	**$1,541.0**	**$1,523.1**	**$1,412.1**	**($114.7)**	**$1,297.4**
Assistance to the Poor	**$5,006.0**	**$5,374.6**	**$5,817.0**	**$6,494.9**	**$7,273.9**	**($107.9)**	**$7,166.0**
Medicaid	3,975.2	4,390.4	4,777.0	5,415.6	6,145.1	(75.2)	6,069.9
Cash Assistance	702.4	637.5	646.1	682.6	719.2	(12.4)	706.8
Housing Assistance	158.0	156.9	158.4	142.6	120.1	(10.3)	109.7
Elderly	170.4	189.8	235.6	254.1	289.5	(10.0)	279.5
Assistance to the Sick and Disabled	**$1,820.9**	**$1,946.8**	**$2,053.8**	**$2,076.3**	**$2,020.8**	**($28.6)**	**$1,992.2**
Mental Retardation	821.8	868.3	916.1	966.1	992.3	(4.6)	987.7
Mental Health	557.2	571.7	602.3	607.6	604.9	(2.3)	602.5
Public Health	441.9	506.8	535.3	502.6	423.6	(21.6)	401.9
Transportation	**$712.4**	**$764.6**	**$260.4**	**$215.2**	**$220.5**	**($0.7)**	**$219.8**
MBTA (2)	537.7	591.5	41.2	49.3	47.8	0.0	47.8
MDHighways	118.5	116.2	155.4	98.8	107.3	(0.7)	106.7
Registry	56.3	56.9	63.8	67.1	65.4	0.0	65.4
Economic Development	**$360.3**	**$356.8**	**$403.5**	**$373.7**	**$315.2**	**($22.0)**	**$293.2**
Business and Labor	146.1	137.8	158.4	142.3	121.4	(11.4)	110.0
Environment	214.2	219.0	245.1	231.5	193.8	(10.6)	183.2
Central Costs	**$2,783.1**	**$2,835.4**	**$3,127.0**	**$2,923.5**	**$3,075.7**	**$0.0**	**$3,075.7**
Employee Benefits (3)	1,567.8	1,588.6	1,695.3	1,527.4	1,599.2	0.0	1,599.2
Debt Service	1,215.3	1,246.8	1,431.8	1,396.2	1,476.4	0.0	1,476.4
Other	**$976.5**	**$1,073.3**	**$1,180.5**	**$1,147.2**	**$1,009.3**	**($8.0)**	**$1,001.3**
General Government	632.2	677.0	688.4	685.3	619.1	(5.9)	613.2
Residual	344.3	396.3	492.1	461.9	390.2	(2.2)	388.1
Total Budget	**$19,606.8**	**$21,019.2**	**$22,106.1**	**$22,777.3**	**$23,288.6**	**($343.8)**	**$22,944.8**
Adjusted for MBTA (4)			**$22,760.7**	**$23,441.6**	**$23,972.6**		**$23,628.8**

1. Prior to 1997 child care spending for welfare recipients is included in the figures for Cash Assistance.
2. In 2001, expenditures (and supporting sales tax revenues) for state assistance to the MBTA were moved off budget.
3. Does not include workers' compensation and unemployment insurance which are budgeted in agency accounts; includes appropriations for local teachers' pensions counted as local aid elsewhere in the report.
4. For purposes of comparability with prior years, includes MBTA support moved off budget in 2001.
5. Including 2003 general appropriation act, chapter 300 of 2002, Governor's Oct./Dec. administrative cuts, $190 million of estimated Medicaid deficiencies, and $81 million of other deficiency requests filed by the Governor in January 2003.

Fiscal 2004

It would be difficult to overstate the enormity of the financial and leadership challenge that the Governor and Legislature now confront. Based on the conservative consensus revenue forecast for 2004, the Commonwealth faces a budgetary deficit of $2.4 billion or more in the coming fiscal year that comes on top of almost $2 billion in cuts over the last 18 months. Even using the Foundation's more sanguine forecast of tax revenues (which presumes a modest economic recovery in 2004), the state still must contend with a roughly $2 billion gap in next year's budget, and larger shortfalls in future years.

At the broadest level, two important structural forces are driving the widening gap in the state's finances for 2004. The first is an imbalance between ongoing revenues and expenditures that will total more than $1 billion in 2003. The second is a mismatch between the rate of annual spending growth -- especially in health care -- and the rate of annual revenue growth that is creating an even larger gap in 2004. Without corrective action, these two forces will generate greater deficits beyond 2004.

2004 Revenues

Following the January hearing on tax prospects for the coming year, the state's fiscal leaders have agreed on a consensus revenue estimate for fiscal 2004 totaling $14.68 billion, just $30 million or 0.2 percent above the administration's newly revised forecast for 2003.

In contrast to the tax forecast initially assumed in the 2003 budget -- which has been revised downward by almost $800 million since the beginning of the fiscal year -- the consensus estimate for 2004 is deliberately conservative and appears to carry little downside risk. The estimate stands roughly $500 million below the lowest estimates of 2004 revenues presented by MTF and others at last month's revenue hearing (see Table 6).

After accounting for non-recurring revenues and the incremental impact of prior tax increases, the consensus forecast provides

Figure 3
Baseline Tax Revenue Growth
Before Cuts or Increases

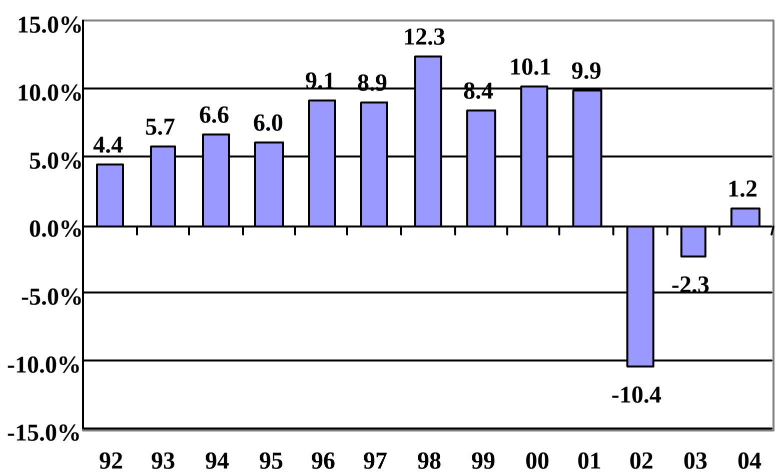


Table 6
2004 State Tax Revenues
($, Millions)

A&F 2003 forecast	14,648
Tax amnesty revenues not recurring in 2004	-125
Retroactive tax increases not recurring in 2004	-100
Incremental impact of prior tax increases	75
Baseline growth of 1.2 percent	180
Consensus forecast for 2004	14,678
Difference from A&F 2003 forecast	30
MTF 2004 bottom of forecast range with risks*	15,170
Difference from consensus forecast	-492

* Adjusted downward for capital gains risks totaling $100 M.

for baseline growth of only $180 million or 1.2 percent from 2003, an increase that is roughly half the expected rate of inflation for state and local purchases of goods and services in the coming year. Even if 2003 collections fall short of the administration's projection by as much as $200 to $300 million as some fear, the baseline tax growth needed to achieve the 2004 consensus forecast would be a still modest 3.3 percent, just 0.7 percent after adjusting for inflation.

Though the stringent new cap on state tax revenues enacted last year will probably not restrict the amount of revenue growth available for the 2004 budget, it will certainly have an impact in future years. The cap limits annual increases over the previous year's tax collections to the rate of inflation in state and local government spending plus two percent. The Foundation estimates that allowable 2004 revenue growth under the cap will be about 3.2 percent compared to the 0.2 percent rate of growth in the consensus revenue forecast.

2004 Spending

Based on the Foundation's analysis, the spending required in 2004 to sustain the state's programs and services at 2003 levels will total at least $24.8 billion, an increase of more than $1.6 billion or 7.0 percent. If the Governor's recent 9C cuts are carried forward into the new fiscal year -- permanently reducing the spending base -- maintenance funding for state government would still total about $24.3 billion, almost $1.2 billion more than is expected to be spent in 2003.

These projections are based on estimates and reasonable assumptions about the likely growth in a set of key spending accounts (summarized in Table 7), including:

- A $767 million increase in Medicaid expenditures, with a roughly $950 million, or 15 percent, growth in underlying costs that is partially offset by the additional $200 million of savings expected in 2004 as a result of the elimination of Medicaid eligibility for 50,000 long-term unemployed individuals on April 1, 2003. If the recent 9C Medicaid benefit and rate reductions -- also expected to take effect by April -- are made permanent, 2004 Medicaid costs will be reduced by a further $300 million. State Medicaid expenditures are reimbursed 50 percent by the federal government.

- A $160 million, or eight percent rise, in debt service and contract assistance costs. Included in this amount is an $84 million, or almost six percent, increase in principal and interest costs on the Commonwealth's capital borrowing, $30 million required because savings from a 2003 refunding of prior borrowing will not recur in 2004, $27 million for the annual costs of the Route 3 North project, and $19 million to fund the maintenance agreement for the Central Artery.

- A $114 million increase in the state costs of employee health benefits, a 15 percent rise that reflects the enormous cost pressures afflicting health care in Massachusetts and the nation at large. This amount assumes that the state reimbursement of retirees' Part B Medicare premiums, eliminated in 2003 as part of the 9C spending cuts last October, will not be restored in 2004. Since the Legislature has not yet acted on the administration's proposal to increase from 15 percent to 25 percent the share of premium costs paid by state employees -- a positive initiative that would bring the Commonwealth more in line with the private sector -- the analysis does not include any savings from this plan in 2004.

- A $36 million, or 4.5 percent, increase in lottery profits available for distribution to cities and towns. For the purpose of this analysis, we have assumed that the cuts to the base of lottery aid that were made in 2003 will remain in effect in 2004.

- A $49 million, or 1.5 percent, increase in formula aid to local schools, roughly the amount of additional aid that will be needed to maintain school spending in poorer districts at the "foundation" levels required by the Chapter 70 education reform law.

- $47 million for known cost increases in specific human services programs, including a $21 million, or 10 percent increase, for group care provided by the Department of Social Services, a $19 million, or six percent increase, for assumed growth in welfare caseloads, and $7 million for "Turning 22" costs at the Department of Mental Retardation.

- A $23 million, or 2.8 percent, increase in annual pension appropriations required under the state's currently approved pension funding schedule.

- In all other areas of state spending, a $230 million, or 2.5 percent, increase for inflation.

While the analysis takes into account the full impact in 2004 of the recent round of Medicaid cuts, it does not include any potential additional state obligations that may arise because of shortfalls in the financing for uncompensated care. Prior to the recent round of Medicaid cuts, the state's uncompensated care fund was expected to post annual deficits of $150 million in 2003 and $265 million in 2004. These deficits are almost certain to grow as individuals who lose health coverage as a result of Medicaid cuts turn to uncompensated care to meet their health care needs.

Table 7
Assumed 2004 Spending for MTF Analysis
($, Millions)

	Amount	Increase
Medicaid	6,837	767
Debt service	1,636	160
Employee health benefits	872	114
Selected human services	588	54
Ch. 70 education aid	3,308	49
Lottery	741	36
Pensions	836	23
All other	9,934	227
Total	**24,801**	**1,627**
2004 value of January 9C cuts*	-462	
Total with cuts	**24,339**	**1,165**

* Assuming full year impact of Medicaid cuts.

Use of Reserves

MTF's analysis of the structural deficit does not assume any use of reserves in 2004. Since the onset of the fiscal crisis, the state has drained almost all of the massive "rainy day" fund that was built up in the 1990s, reducing a balance totaling $2.3 billion at the end of 2001 to just over $300 million today, a small cushion that is at risk of being used up completely by the end of fiscal 2003. Moreover, a variety of smaller reserves originally intended for purposes other than budget stabilization have been drawn upon as stopgap solutions to the ongoing structural deficit.

The only significant reserve that remains untouched -- the off-budget tobacco settlement trust created to help fund future health care needs -- is actually losing value due to poor stock market performance. The current balance of $450 million is 12 percent below its value at the end of fiscal 2002.

2004 Balance

Taking into account both revenues and spending, the analysis projects a 2004 deficit of $2.36 billion, a figure that declines only marginally to $2.03 billion if the emergency 9C cuts undertaken to help balance the 2003 budget remain in place in 2004 (see Table 8).

These estimates of the 2004 structural imbalance are significantly below other recent projections -- including the administration's latest estimate of $3.2 billion -- for two major reasons:

- The Foundation's estimate takes into account the increase in federal reimbursements due to the assumed growth in Medicaid spending.

Table 8
Fiscal 2004 Balance
($, Millions)

Revenue	
Consensus tax forecast	14,678
Less: Sales tax dedicated to MBTA	-684
Nontax revenue	8,400
Total	22,394
Spending	24,752
Revenue minus spending	**-2,358**
Less: 2004 impact of January 9C cuts (net of federal reimbursements)	332
Difference	**-2,026**

- The Foundation's analysis uses different assumptions about how much spending would need to grow in fiscal 2004 in order to meet current obligations.

However the 2004 gap is measured, the end result is a huge deficit that cannot practically be addressed within the span of a single budget year. Without action on the structural problem that is driving the shortfall in 2004, the Commonwealth will surely face an even larger problem in 2005. The Foundation believes state leaders should join together to craft a consensus two-year plan to eliminate the structural deficit in the state's finances. Achieving this difficult goal will require the kind of bipartisan leadership and cooperation that was successful in addressing the state's last fiscal crisis.

Reforming Government

The need for extraordinary solutions to the fiscal crisis provides the best opportunity in over a decade to undertake important reforms of state government. At a time of significant cutbacks in programs and services, state leaders have a responsibility to curb spending abuses and inequities, improve management and establish stronger incentives for cost containment. Allowing inequities and inefficiencies that were tolerated in more prosperous times to continue under the state's dire circumstances would necessitate even deeper cuts, as well as foster the widespread public perception that state government wastes taxpayer dollars.

Policy makers are faced with a long list of candidates for reform. This report highlights a number of issues that should be at the top of the agenda: revamping the education local aid formula, redesigning the system for purchasing human services, restructuring the management of the courts, revising sentencing guidelines, ending pension abuses, encouraging competition to provide state services, and eliminating unnecessary mandates and restrictions that add to state costs. Although not nearly enough to solve a shortfall between annual revenues and expenditures that will likely exceed $2 billion in fiscal 2004, the opportunities for savings in the long term are significant. More importantly, such reforms would improve the quality and equity of services, make better use of taxpayers' dollars, and help restore public confidence in state government.

The administration has taken a positive first step toward reform by introducing legislation that would lift a variety of mandates and restrictions on cities and towns. Moving to streamline local government functions such as public construction and procurement should pave the way for even more significant reforms at the state level.

Education Local Aid

Reforming the Chapter 70 education aid formula to eliminate the inequitable distribution of school aid, while ensuring that the neediest districts have the resources to maintain school spending at adequate levels, is absolutely crucial at a time when the total amount of state support may need to be scaled back.

While the school aid formula has worked well in targeting dollars to needy districts, state assistance to better-off districts is inequitably distributed, in some cases actually rewarding inadequate local investment in schools. Not only has this approach preserved disparities that predate the 1993 reform law, it has actually made those disparities worse. The state has disproportionately subsidized communities whose support for schools falls short of the law's standard of local effort and has failed to adjust aid levels to appropriately reflect enrollment changes.

Both the Swift administration and the Taxpayers Foundation recommended needs-based reforms to the distribution formula that would tie the annual aid allocation -- and the required local contribution to schools -- to current measures of community wealth and income. Implementing such reforms could save the state $100-200 million in 2004, with a significant portion of those costs shifted to communities that would be required to contribute more to their schools under the reform's standard for local tax effort.

Human Services

As discussed in the Human Services section of this report, the Commonwealth's vast system for purchasing human services is desperately in need of an overhaul. State agencies and providers are trapped in a web of redundant and outdated organizational structures, bureaucratic paralysis, micromanagement, and misplaced priorities that make it nearly impossible for service providers to deliver quality services while remaining financially sound. Clients, who are the Commonwealth's most disadvantaged residents, face waiting lists, duplicative and uncoordinated care management, and services ill-matched to their needs as they attempt to navigate a byzantine system.

Former Secretary of Administration and Finance Charles Baker, Jr., recently authored an insightful examination of the system's structural and organizational problems. While making the case that there are many ways to approach restructuring, the report offered one proposal to reorganize the human services bureaucracy along functional lines. The current arrangement of organizing departments around populations of clients like the mentally retarded and mentally ill would be replaced by divisions focused on information technology, licensing, investigations, purchased services, administrative and financial operations, case management, and transitional assistance. Duplicative and overlapping regional and area offices would be consolidated, and disparate client databases would be integrated into a cohesive management tool.[1]

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. The goals of such reforms would be a new emphasis on performance -- in terms of quality of services and outcomes for clients -- over bureaucratic requirements, and a payment system that reflects the cost of achieving the performance standards for service providers.

To achieve these purposes, the Commonwealth should define standards for human services that measure the quality of care and outcomes for clients, and then establish reasonable and adequate rates for services based on those standards. The Executive Office of Health and Human Services should develop and enforce consistent policies, contracting and oversight procedures, and reporting requirements for each purchasing agency. Coordination of care should be strengthened by employing lead agencies and a single case manager for each client whenever feasible. The system should be held accountable by evaluating providers and state agencies based on agreed-upon performance standards. Accountability data should be used for licensing, contracting, financial incentives, budgeting and evaluation of the system as a whole.

As suggested, designing and implementing major reforms of human services would require an open, inclusive process that will take time. EOHHS should continue its efforts to improve data management and utilization as an interim step. Pilot programs should test more fundamental reforms such as standardized procedures across agencies and new organizational arrangements. Regardless of the chosen route, restructuring will be truly successful if its primary purpose is to improve the quality of services and strengthen the Commonwealth's safety net rather than merely to reduce the budget for human services.

Courts

The Legislature plays a stronger role in the management of the courts in Massachusetts than in any other state in the union. In 2001,

[1] *Rationalizing Health & Human Services*, Pioneer Institute for Public Policy Research, December 2002.

for example, lawmakers stripped judges of the power to hire probation officers and assistant clerks in their own courts. At the same time, resources are inequitably allocated among courts with insufficient regard to workloads, and the courts are struggling to absorb $22 million in spending reductions over the last two years.

Greater centralization of court administration would enable the judiciary to reallocate personnel and resources to the courts with the heaviest caseloads and reduce unnecessary staffing in less busy courts. At the same time, it must be acknowledged that the courts have not fully utilized the management powers they do have and efforts to rationalize budgeting have been paralyzed by turf battles.

A commission created by the Chief Justice of the Supreme Judicial Court represents the best opportunity to bring about important management reforms, but for restructuring to succeed it needs to be designed in partnership with the Legislature. While adequate funding for the courts is clearly required, the judiciary needs to embrace a more disciplined approach to budgeting as part of any plan to give it greater flexibility.

Sentencing Guidelines

With over $1.5 billion devoted to the criminal justice system and the state's prisons filled beyond capacity, the Legislature should seize the opportunity to adopt the sentencing guidelines established by the Massachusetts Sentencing Commission. The guidelines represent a major effort to rationalize the Commonwealth's arcane, and costly, sentencing system. A hodgepodge of statutes give judges discretion to impose wildly disparate sentences for similar crimes. Prisons are crowded with non-violent offenders while more serious crimes may result in little time served.

The Commission, chaired by Superior Court Chief Justice Robert Mulligan, worked for over two years to develop uniform sentencing policies and the integration of intermediate sanctions into judges' rulings. The recommendations proposed in 1996 set priorities for the type of crimes that warrant imprisonment and provide less-costly alternatives to incarceration for first time and non-violent offenders. The guidelines for minimum and maximum sentences for 1,800 crimes are based on the severity of the crime and the history of the convicted criminal. Judges who deviate from the guidelines would have to explain their reasons in writing.

Unfortunately, the sentencing guidelines approved by the House last year would be a step in the opposite direction, actually causing a significant increase in corrections spending by requiring longer prison sentences and limiting the use of alternatives to incarceration. The Sentencing Commission's guidelines would enable the Commonwealth to restrain the growth in corrections spending and gain greater control over the allocation of resources.

Pensions

The Commonwealth should form a commission to evaluate the state's pension laws and recommend reforms to curb the abuses that have led to a string of recent scandals. While the cost of these abuses is small relative to total pension obligations, the cost in terms of public ill will is substantial.

As one example, there is no justification for the statute that provides a generous early "pension" to state employees, regardless of age, who "involuntarily" leave their jobs after 20 years. These employees would otherwise be eligible for regular retirement benefits when they reach age 55. This provision has been widely abused, resulting in the award of sizeable pensions to employees younger than 55 who in fact voluntarily left their position, often for a lucrative job in the private sector.

Competition

The so-called "Pacheco law," passed in 1993 as an understandable reaction to the excesses of privatization efforts in the early 1990s, has raised almost insurmountable obstacles to competition in providing state services by tilting the rules in favor of public employees. The law should be amended to ensure a level playing field between public and private contractors and potentially save tens of millions of taxpayer dollars while preserving current safeguards against abuse.

Under the Pacheco law, the State Auditor is required to review any privatization plan and may halt the initiative if he finds that it fails to meet any of several tests which are stacked in favor of using public employees to deliver services. For example, a state agency must compare the cost of using a private sector vendor not with actual state costs but with the cost of existing state employees if they were working in a hypothetical "most cost-efficient manner."

Mandates

As the Commonwealth goes through the difficult process of cutting spending, it has both an opportunity and an obligation to lighten the load of burdensome mandates and bureaucratic restrictions the state imposes on its own departments, local governments and independent authorities. Inflicting costly requirements that serve only marginal public purposes is a luxury the state surely cannot afford while it is cutting back on local aid, higher education and other critical programs. Reducing spending without taking reasonable steps to help agencies do more with less would be fundamentally unfair. Lifting unnecessary mandates and introducing greater flexibility would not only help program managers cope with budget cuts in the short term, but would improve the performance of state government over the long run. For example:

- The state's archaic public construction laws drive up the already high costs of making capital investments in public infrastructure. Construction reform would reduce cost overruns and overly lengthy construction times, as well as improve project quality. Examples include allowing quality and schedule to be factored into contract procurement, authorizing state agencies and authorities to consider alternatives to the traditional design-bid-build contracting process, and increasing the dollar threshold for filed sub-bids. The administration's local government reform proposal would eliminate filed sub-bids for cities and towns and allow municipalities to employ design-build contracting in local construction projects.

- Regulations that treat the University of Massachusetts like other, less autonomous agencies restrict the university's ability to operate in a more business-like and entrepreneurial manner. Procurement reforms that enable university/industry partnerships and allow greater control over construction projects would enable the university to reduce administrative costs and take better advantage of opportunities to leverage its resources.

- Eliminating or reforming the salary supplements paid to local police under Massachusetts' unique "Quinn bill" would result in savings for both the state and local governments. Under this statute, the Commonwealth reimburses cities and towns for 50 percent of the cost of pay raises, ranging from 10 to 25 percent, for officers earning college and graduate degrees. Over the years, numerous media reports have exposed the many abuses under this program, including the wholesale awarding of questionable degrees for the sole purpose of qualifying police for additional pay.

In part because of the recent decision of the city of Boston to begin participating in the program, state costs have risen dramatically in the last few years, from just under $18 million in 1998 to an expected $41.5 million in 2003, with an equal amount spent by cities and towns. Limited reforms passed as part of the fiscal 2003 budget tightened the educational standards for earning pay raises under the program to eliminate obvious abuses. However, the growing costs of the program still need to be addressed. Converting the benefit to a fixed annual dollar amount -- or reducing the benefit percentage -- would preserve the program's intended incentive effect while constraining the growth in costs for both the state and local governments.

- With local aid reductions a necessary part of resolving the state's structural deficit, cities and towns should be relieved of some mandated costs and given greater flexibility to control their own spending. As with reorganizing and restructuring at the state level, suspending some mandates and restrictions will produce nowhere near enough savings to offset the cuts in local aid, especially in the short term. Nevertheless, state leaders need to make the most of the opportunity presented by the fiscal crisis to achieve long-overdue reforms, streamline local government operations and restore confidence that taxpayers' dollars are well spent. The administration has proposed several positive reforms along these lines, including amendments to public construction and purchasing requirements. In reviewing mandates imposed on cities and towns, policy makers should separate those that serve legitimate and critical public purposes, such as the local share of spending on education, from those that tie the hands of municipal officials with little, if any, public benefit, such as the inability of local governments to adjust employee health plan copayments and deductibles, and costly procedures required for procurement of goods, services and public construction contracts.

Major Spending Categories

Medicaid

(millions)	2001	2002	2003
Medicaid			
Administration	$105	$115	$117
Benefits	4,672	5,301	5,763
Anticipated deficiency			190
Total	**$4,776**	**$5,416**	**$6,070**

The Commonwealth will spend an estimated $6.1 billion on Medicaid in fiscal 2003, up $654 million or 12.1 percent from 2002. After being held largely in check through the mid-1990s, Medicaid spending has skyrocketed over the last six years (see Figure 4). This enormous rise in spending was initially sparked by eligibility expansions authorized in 1997 and 1998, the key drivers of a more than 50 percent increase in Medicaid enrollment over the last six years. Medicaid now provides health coverage for a staggering one-sixth of the state's population, more than one million low-income, elderly and disabled Massachusetts residents in all.

More recently, the program's spending base -- already enlarged by the eligibility expansions -- has swelled even further because of the huge cost pressures that are now burdening almost every element of the state's system of health care. Since fiscal 2000, when the eligibility changes were essentially fully in place, expenditures have jumped another 40 percent. For the entire period from 1997 to 2003, while Medicaid enrollment has increased by more than 50 percent, annual spending has risen by 70 percent.

Because of this rapid rate of growth (twice as fast as the state budget as a whole), Medicaid's share of total state spending has expanded from 20 percent in 1997 to almost 26 percent in 2003.

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 for eligibility and benefits.

Given Massachusetts' high personal income per capita, the state is eligible for only 50 percent reimbursement of most of its Medicaid costs, the low end of a range of federal matching rates that goes as high as 83 percent for states with the lowest personal income per capita.

Figure 4
Medicaid Expenditures
Fiscal 1992-2003
$, Billions

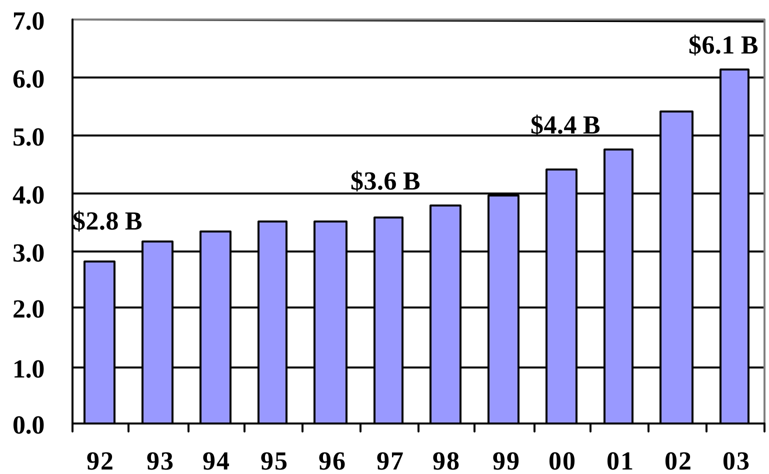
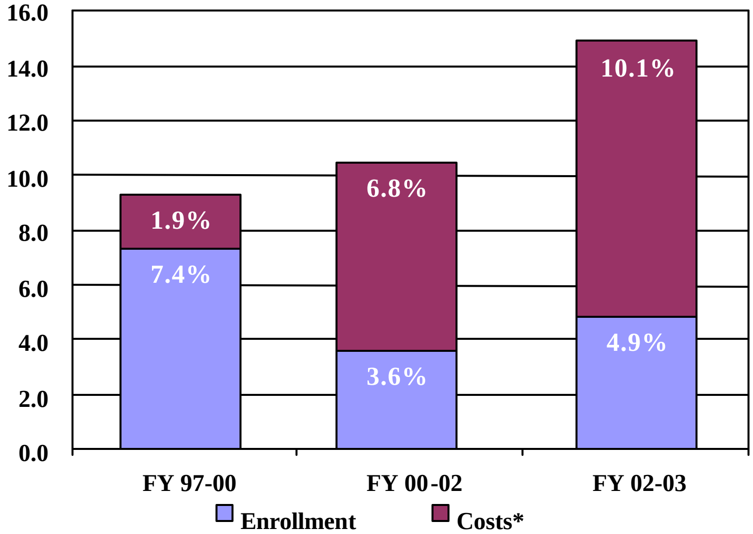


Figure 5
Sources of Medicaid Spending Growth
Date-of-Service Expenditures
Average Annual Percent Increase



* Excluding impact of 2nd nursing home rate increase and January 9C cuts.

Spending Growth

Medicaid's 12 percent spending growth in 2003,[2] with the likelihood of an underlying increase approaching 15 percent in 2004, is occurring despite a series of cost-cutting measures in the 2003 budget. In addition to new fees on nursing home care and prescription coverage that are intended to lessen the financial impact of the spending increases, the state has also:

- Eliminated eligibility for approximately 50,000 "long-term unemployed" individuals who meet income criteria, have been out of work for more than one year, and otherwise have no health coverage. With this reversal of one of the significant earlier expansions of eligibility, the state expects to save roughly $40 million in 2003 (the change is scheduled to take effect April 1, 2003) and an additional $200 million in 2004.
- Reduced reimbursements to pharmacies for the cost of prescriptions.
- Increased participant co-payments for non-emergency services.
- Instituted a strict prior approval process for expensive prescription drugs, including popular new medications for arthritis, ulcers and allergies.
- Eliminated dental, eyeglass and hearing aid benefits for adults.

Even with these major cuts, Medicaid expenditures are still soaring. While the substantial growth in Medicaid spending through fiscal 2000 was almost entirely attributable to expanded eligibility, the recent increases are largely due to higher costs and greater utilization of services, factors that are inherently difficult to control (see Figure 5).[3]

According to the Foundation's analysis, four-fifths -- or $657 million -- of the estimated $805 million increase in date-of-service spending for Medicaid services

[2] An increase that takes into account the $75 million of January 9C cuts and also includes the nursing home rate increases intended to defray the costs for Medicaid patients of new state user fees. While the Governor has filed legislation to eliminate these rate increases to help balance the 2003 budget, neither the House nor the Senate has taken action on the proposal.

[3] The expenditure figures underlying Figure 5 differ from the amounts in the state budget because they reflect the date of service, that is, when the Medicaid client actually received service, not the date of payment, when the provider's bill for that service was considered paid. The Foundation's analysis of the components on Medicaid growth is based on estimates of date-of-service expenditures developed by the Division of Medical Assistance, which have been adjusted to exclude the impact of new user fee spending in nursing facilities in 2003.

provided in 2003 reflects the continuing escalation in the underlying cost of care (excluding the impact of the January 9C reductions). As Table 9 illustrates, more than 40 percent of the total spending increase is attributable to disabled adults, a high cost population that has been growing almost six percent a year, on average, since 2000.

Although elderly recipients account for almost one-third of total Medicaid expenditures, their contribution to the recent spending growth has been significantly less than that of the other major client populations.

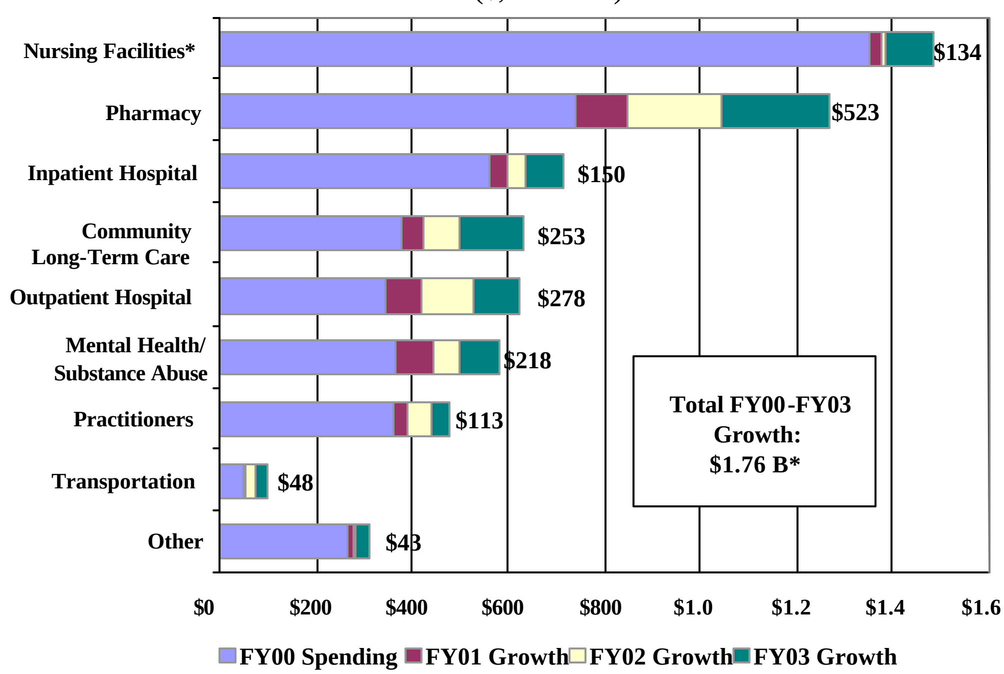
While spending for most types of health care services has been escalating rapidly, prescription drug expenditures stand out, largely reflecting the rise in drug utilization that is taking place across the

Table 9
Medicaid Spending Growth
Date-of-Service Expenditures By Type of Beneficiary
Fiscal 2002-2003
($, Millions)

	Enrollment-Driven Increase	Cost-Driven Increase	Total Increase	Percent Increase
Families				
Adults	76.0	30.5	106.5	17.8
Children	52.4	130.8	183.2	23.3
Disabled				
Adults	127.7	209.5	337.2	19.0
Children	7.4	27.6	35.0	19.9
Seniors*	41.1	123.6	164.7	9.1
Long-Term Unemployed	-42.7	20.7	-22.0	-9.0
Total	**261.8**	**657.1**	**804.5**	**14.9**

* Excluding impact of new user fee spending in nursing facilities; all amounts exclude impact of January 9C cuts.

Figure 6
Medicaid Spending Growth
By Date of Service and Type of Care
Fiscal 2000-2003
($, Millions)



* Excluding 2003 spending to offset costs for Medicaid patients of new state user fees; all amounts exclude impact of January 9C cuts.

country (see Figure 6). Since 2000, pharmacy expenditures have swelled by more than $500 million, or 70 percent, to an estimated total approaching $1.3 billion. Spending for prescription drugs is second to nursing homes and other institutional care, primarily for the elderly, as the largest category of Medicaid spending. Outpatient hospital and home health services have also contributed significantly to the surge in spending.

It is notable that the eligibility expansions adopted in 1997-1998 were the major factor in the growth in Medicaid spending through 2000, but since then have for the most part played a subsidiary role in the rapid growth in annual expenditures. According to the Division of Medical Assistance, the Medicaid expansion population will total 275,000 in fiscal 2003, a figure that takes into account the impact of dropping the long-term unemployed from the rolls on April 1, 2003. Based on the Foundation's analysis, the expansion population was responsible for two-thirds of the $1.0 billion increase in spending from 1997 to 2000,[4] with the remainder attributable to higher spending for the pre-expansion portion of the population (see Table 10). From 2000 to 2003, in contrast, the expansion groups were responsible for approximately $360 million of additional annual Medicaid expenditures, or one-fifth of the $1.7 billion increase during those years. Looking at 2003 alone, the expansion population is responsible for $115 million, or about 13 percent, of the estimated increase in spending for the year.

Although the financial picture painted here is truly daunting -- with rapid growth in high-cost populations, explosive cost pressures in pharmaceuticals and other major categories of care, and eligibility expansions undertaken in good fiscal times that are to a large degree unaffordable in the current environment of severe budgetary crisis -- it actually understates the challenge that the Commonwealth faces in containing Medicaid and other health care costs over the next several years.

Table 10
Medicaid Spending Growth
Base versus Expansion Population
Fiscal 1997-2003
($, Millions)

	Base	Expansion	Total
1997 Total	$3,386	$0	$3,386
Growth			
1998-2000	344	690	1,034
2001	307	114	421
2002	423	128	551
2003*	689	115	801
2003 Total	**$5,140**	**$1,047**	**$6,197**

* Excluding impact of new user fee spending in nursing facilities; all amounts exclude impact of January 9C cuts.

- *Reimbursement rates to health care providers remain woefully inadequate.*

  Despite the rapid growth in Medicaid spending, rates for hospitals, nursing homes and other providers still fail to fully cover the costs of care. Massachusetts' Medicaid payments reimburse only about 70 percent of hospitals' costs, a shortfall of approximately $200 million, largely because reimbursement rates are among the lowest in the nation.

- *The state's uncompensated care pool faces a serious and growing financial shortfall.*

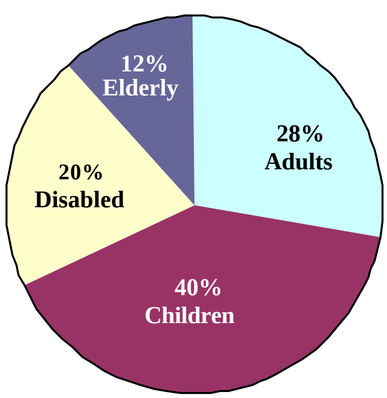
  According to the most recent estimates, the pool faces a $150 million deficit at the end of fiscal 2003 and almost double that amount in fiscal 2004. Financed primarily through surcharges on hospital

[4] The period in which the eligibility changes were implemented.

bills and insurance premiums, 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. Without corrective action, the financial burden of the growing deficits in the pool will fall on the state's already severely stressed hospitals.

A special commission was convened in 2002 to examine the pool's finances and management. Subcommittees of the commission recommended a number of significant steps to reform the pool, including tightening payment criteria to ensure that the pool focuses its resources on urgent, medically necessary care, disallowing payments where the individuals receiving care are eligible for Medicaid or other third-party coverage, and introducing a variety of other efficiency measures. However, the commission as a whole was unable to agree on a final set of reform proposals.

Figure 7
FY 2002 Medicaid Enrollment
(Total: 1.0 million)



Source: Division of Medical Assistance, fiscal 2002 estimated total client years.

- *The elimination of eligibility for the long-term unemployed in the 2003 budget will make only a small and temporary dent in the pace of annual spending growth.*

  Despite dropping 50,000 individuals from the Medicaid rolls, spending is expected to increase 12 percent or more in fiscal 2004 due to cost pressures from more rapidly expanding and higher-cost populations. At least some portion of those losing Medicaid eligibility will turn to the uncompensated care pool for health care, exacerbating its financial difficulties.

- *The Commonwealth also faces a similar surge in the costs of health insurance for state employees.*

  In fiscal 2003, health benefits for state workers will cost approximately $764 million, a $47 million or 6.6 percent increase that takes into account the $28.8 million of 9C cuts by Governor Swift earlier in the fiscal year. The 2003 budget had originally provided for a 10.5 percent increase in the costs of health coverage of state workers, compared to spending increases of 11.8 percent in 2002 and 9.0 percent in 2001, rates of growth that reflect the same kinds of cost pressures that are driving up Medicaid expenditures.

  To accommodate the 9C reductions, the Group Insurance Commission, the agency responsible for administering health insurance for state employees, eliminated the Commonwealth's 85 percent subsidy of premium costs for Medicare Part B coverage for retirees. At the beginning of the fiscal year, the Commission increased co-payments for prescription drugs, office visits and other services, and raised deductibles for hospital stays in order to hold spending to the original 2003 budget level.

- *Increased federal reimbursements are not likely to solve the Commonwealth's Medicaid problem.*

  While the state should certainly pursue every opportunity to maximize federal Medicaid revenues, greater financial assistance from Washington is uncertain at best given the current federal budget priorities.

Even with dramatic restructuring, spending for the state Medicaid program (and for state employee health insurance) is likely to continue to rise rapidly. Although the state's Medicaid eligibility and benefit criteria are somewhat more generous than in the majority of other states, paring back the scope of the program can provide only a temporary financial respite. Even with major reductions in benefits and eligibility, the Commonwealth will still have to contend with the extraordinary pressures -- due to the combination of higher costs and more intensive utilization of services -- that are buffeting both public and private payers of health coverage across the country. Despite the adoption of savings measures worth several hundred million dollars in 2003, Medicaid spending is up more than $650 million in 2003 and an increase of similar scale is expected in 2004.

Background -- Beneficiaries

In fiscal 2002, more than one million individuals were enrolled in Medicaid, almost 16 percent of the state's population, in the following four broad categories:

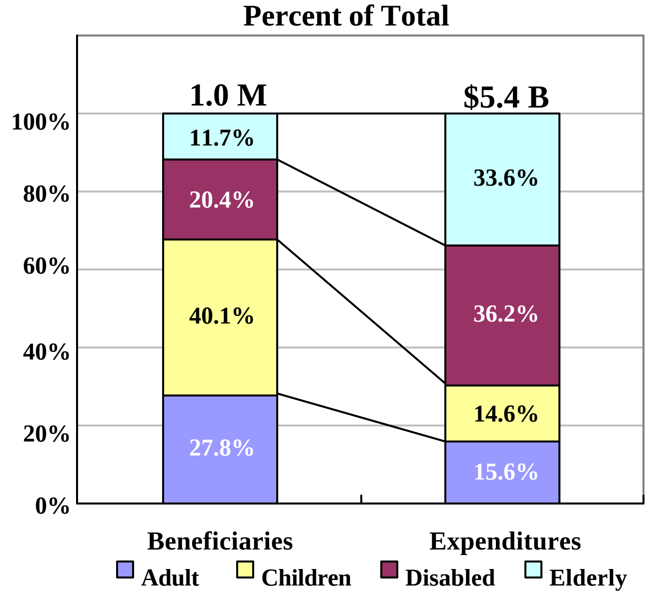
- A total of 404,000 non-disabled children, the largest single group (see Figure 7).
- 280,000 low-income adults without disability, primarily the parents of eligible children.
- More than 205,000 disabled individuals, including 19,500 children.
- And 118,000 elderly Massachusetts residents (aged 65 or over).

In general, childless adults under age 65, unless pregnant or disabled, do not qualify for the state's Medicaid program. Massachusetts does extend coverage to several limited groups of adults without children, including those who are HIV positive and, until this year, the long-term unemployed.

Background -- Expenditures

While elderly and disabled individuals comprise only about one-third of the state's

Figure 8
Medicaid Beneficiaries and Expenditures
Fiscal Year 2002
Percent of Total



Source: Massachusetts Division of Medical Assistance, fiscal 2002 estimated total client years and date-of-service expenditures.

Medicaid rolls, they consume 70 percent of annual expenditures (see Figure 8). In contrast, children represent the largest category of enrollment by far, but require only about 15 percent of Medicaid resources. Despite a share of enrollment approaching 30 percent, non-disabled adults under the age of 65 accounted for only about 15 percent of the program's costs in 2002.

Looking at the kinds of medical services provided, more than one fourth of Medicaid spending -- $1.4 billion, or 25.7 percent in 2002 -- pays for nursing home and other institutional care for the elderly and disabled (see Table 11). At the same time, pharmacy costs consume almost 20 percent of the Medicaid budget, with more than half of the pharmacy expenditures supporting the disabled population. Other major categories of Medicaid expenditures include inpatient hospital services ($635 million, or 11.8 percent in 2002), outpatient hospital services ($528 million, or 9.8 percent), home health and other community long term care dedicated largely to disabled recipients ($499 million, or 9.3 percent), mental health/substance abuse services ($499 million, or 9.3 percent), and physicians and other practitioners ($443 million, or 8.2 percent).

Table 11
FY02 Medicaid Expenditure By Type of Service
($, Millions)

	Amount	Percent
Nursing facilities	$1,385	25.7
Pharmacy costs	1,045	19.4
Hospital - inpatient	635	11.8
Hospital - outpatient	528	9.8
Home health	499	9.3
Mental health/ substance abuse	499	9.3
Practitioners	443	8.2
Transportation	75	1.4
All other	285	5.3
Total	**5,392**	**100.0**

Note: Payments to managed care organizations have been allocated by type of service.

Local Aid

(millions)	2001	2002	2003
School Aid			
Chapter 70	$2,990	$3,218	$3,259
Other school aid	841	879	763
Indirect aid - teachers pensions	745	520	563
Subtotal	4,575	4,617	4,584
Revenue Sharing			
Lottery	783	778	705
Additional assistance	478	478	405
Subtotal	1,260	1,256	1,110
Other direct aid	281	267	187
Total	**$6,116**	**$6,140**	**$5,882**

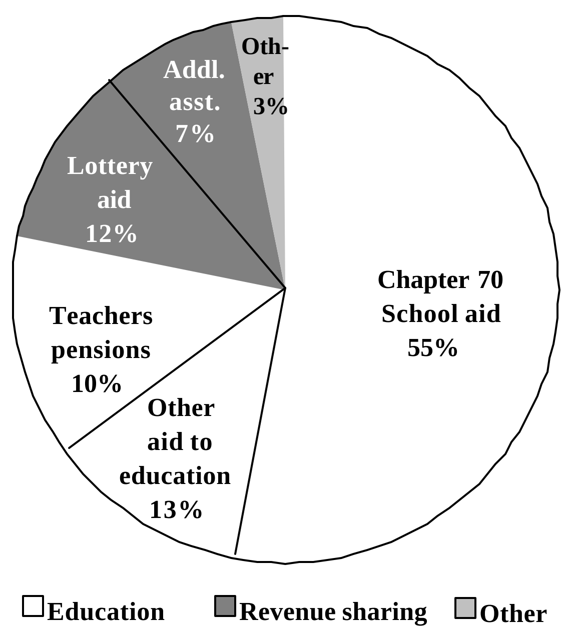
In fiscal 2003, appropriations for state aid to cities and towns total $5.9 billion, down $258 million or 4.2 percent from 2002. Aid to localities remains the second-largest area of state spending, accounting for 25 percent of the 2003 budget.

Overwhelmingly, the state's efforts to support municipal finances are directed to education, as shown in Figure 9. More than three-quarters of the 2003 local aid budget either directly or indirectly funds local schooling, with the lion's share going to school districts under Chapter 70, the state's education reform law. Another 19 percent flows through to cities and towns as "no-strings-attached" revenue sharing aid, largely in the form of net lottery profits that are distributed to cities and towns through an equalizing formula that takes into account both population and local property wealth. A small portion of the local aid budget supports a variety of other reimbursement and grant programs.

State Aid to Schools

In 2003, state assistance to local education totals $4.6 billion, with more than two-thirds, $3.26 billion, distributed as direct formula aid to schools under Chapter 70. Another $763 million finances categorical grants and other programs, including $382 million for local school construction, $109 million for kindergarten and early childhood education, $94 million for school transportation, and $50 million of targeted grants for improved student performance. Although not usually acknowledged as aid to schools, the state also assumes the employer's share of the costs of retirement benefits for local teachers, an annual obligation of $563 million in 2003 that is more than two-thirds of the state's total pension appropriation. The lion's share of the pension aid is devoted to reducing the unfunded liability for the teachers' pension systems, which was almost seven times as large as that of the state employees' pension system at the beginning of 2002.

Figure 9
Fiscal 2003 Local Aid
($5.9 Billion)



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 funding 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, aid to schools has increased by an additional 16 percent.

While the state has succeeded in fulfilling the key financial commitment of education reform -- to bring school spending in poorer districts up to an adequate level -- the current distribution of school aid is far from perfect. For better-off districts which did not initially have a school funding "gap," the school aid formula has exacerbated inequities that existed before 1993. Provisions of the law requiring communities that were not contributing sufficiently to their schools to increase their local effort over time were never implemented, creating even greater disparities. The heavy reliance on per pupil "minimum aid," a blunt instrument at best for dealing with the impacts of rapid enrollment growth and other cost increases, has created further inequities.

Since 2000, proposals have been advanced by the Swift administration, the House, the League of Women Voters, the Taxpayers Foundation, and others to deal with the inequities in the current distribution of Chapter 70 aid. Although differing in many details, the proposals share two major goals: to preserve the core formula for providing aid to poorer school districts, which has in general worked well; and to establish an equitable mechanism for determining aid to better-off districts by tying annual aid amounts to local educational costs (the foundation budget) and to local property wealth per student.

It can be argued that the state's approach to school aid has been "broken" since fiscal 2000 when all districts reached the foundation spending standard. In 2001, 89 percent of the $187 million increase in state aid was distributed as a flat $175 per student. In 2002, no single formula was used in allocating the $223 million of additional Chapter 70 aid, but instead each district received the highest of the amounts determined under three dissimilar formulas. In the crisis environment of the 2003 budget, poorer districts received the $40 million increase needed to keep them at a foundation level of spending while all other districts received the same amount of aid as in 2002.

An additional $40 to $50 million of school aid will be required in 2004 to maintain adequate school spending in poorer school districts. However, given the serious financial difficulties the state faces over the next several years, it makes little sense to maintain the present seriously flawed distribution of school aid for other districts. Adopting a "foundation share" approach in calculating annual Chapter 70 assistance to wealthier districts in 2004 would eliminate the many inequities in existing aid levels while reducing the state's overall aid obligation by $100 to $150 million. If local aid reductions are necessary to balance the 2004 budget, such reforms in the school finance formula would be far preferable to across-the-board cuts.

Apart from Chapter 70, two other school aid programs have experienced significant growth in the last two years: the grant program for districts with a high proportion of students performing poorly on MCAS, with a $50 million appropriation in 2002 (more than triple the funding in 2001) that was level funded in 2003; and school building assistance -- the program that reimburses districts for 50 to 90 percent of the costs of borrowing for local school projects -- which increased 15 percent in 2002 and an additional 5 percent in 2003.

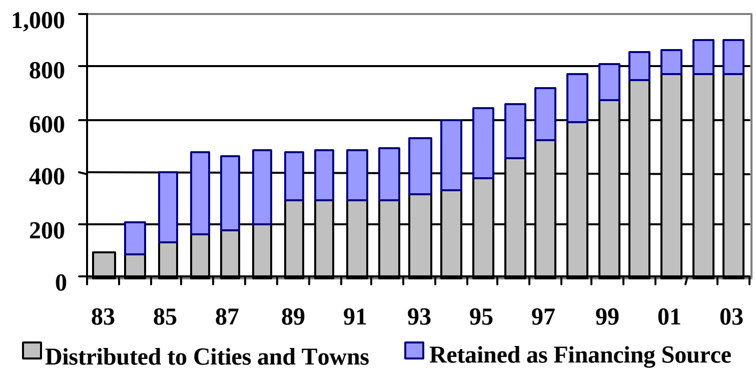
However, spending for a host of smaller school aid programs has been sharply cut since the fiscal crisis began, with reductions totaling $185 million, or almost 40 percent of 2001 spending in these programs. The affected program areas include early childhood education (down $29.4 million or 26 percent), school-based health (down $24.2 million or 100 percent), racial imbalance (down $13.2 million or 47 percent), reimbursements for state wards (down $17.0 million or 100 percent), charter school reimbursements (down $37.8 million or 100 percent), school transportation (down $11.0 million or 11 percent), after-school programs (down $10.4 million or 100 percent), early literacy (down $5.9 million or 48 percent), and various other accounts (down $35.6 million or 25 percent).

Revenue Sharing and Other Aid

Other assistance to cities and towns totals $1.3 billion in 2003, with about 85 percent distributed as unrestricted local aid. Since 2001, non-school aid has been reduced by $244 million, or almost sixteen percent.

The lottery distribution to cities and towns is the Commonwealth's largest pure revenue sharing program with a $778 million initial appropriation that has been subsequently cut to $705 million to help balance the 2003 budget. 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. Each year's 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. Since the introduction of Megabucks and other "lotto" style games in the early 1980s,

Figure 10
Use of Net Lottery Revenues
Fiscal 83-03
$, Millions



a portion of annual profits has been used to help finance other local aid programs (see Figure 10). In the state's previous fiscal crisis at the beginning of the last decade, annual lottery aid was capped at just over $300 million, with any "excess" revenues from growth in sales used primarily to help balance the state budget.

That earlier cap was not fully lifted until fiscal 2000 (a small portion of net lottery revenues continue to be retained for other programs such as the Arts Lottery Council, which supports local arts projects). However, with the advent of the current fiscal crisis, the lottery is once again being considered as a potential resource to help solve the state's budget woes. In October, Governor Swift indicated her intention not to request the appropriation of approximately $22 million of excess lottery revenues from 2002 for distribution to cities and towns in 2003, but instead to retain those revenues to help balance this year's budget shortfall. In January, Governor Romney cut the 2003 lottery appropriation by $73 million, or 9.4 percent. The Swift administration had proposed reducing the percentage of lottery revenues returned as prizes in order to generate up to $275 million of additional revenues for the 2003 budget. Although the Legislature rejected the proposal -- in large part because of questions about the impact of the lower prizes on overall lottery sales and about the administrative feasibility of realizing the additional revenues in 2003 -- it will undoubtedly be raised again in the context of the 2004 budget.

The other major source of state revenue sharing aid is so-called "additional assistance," which in 2003 was reduced by $73 million, or 15.2 percent, in two separate 9C cuts, to a total of $405 million.

Additional assistance was established in 1978 as a general revenue sharing program using the lottery formula to determine the amount of aid for each city and town. Following the passage of Proposition 2 1/2, it was substantially revised -- and its funding dramatically increased -- in order to direct more money to Boston and other urban centers, which were especially hard hit by the reductions in tax rates (and resulting revenue losses) imposed by the tax limitation measure. Over 40 percent of additional assistance goes to Boston, compared to eight percent of lottery revenues. After increasing from $60 million in 1980 to a peak of $815 million in 1989, the total annual appropriation for additional assistance had been reduced to $477 million by 1992 in response to the state's previous fiscal crisis. This funding level (and the amount of additional assistance dollars) going to each community was maintained until this year's cut.

Other Aid

Other assistance to cities and towns comprises only three percent of the state aid budget -- $187 million in 2003 -- but is nevertheless important to many individual communities. Some of the programs were created to address special problems or priorities, such as local infrastructure improvements or the burden on police, fire and other services from state-owned facilities that are not part of the local property tax base. Other programs support broader state priorities, such as operating assistance for public libraries.

Table 12
Other Local Aid
Fiscal 2001-2003
($, Millions)

	2001	2003	Pct. Chg.
MWRA rate relief	$53.9	$0.0	-100
Local water and sewer	47.9	58.5	22
Chapter 81 gas tax	43.5	0.0	-100
Libraries	29.0	24.6	-15
Quinn bill	28.1	41.5	47
Community policing	20.9	20.1	-4
Local tax abatements	19.4	18.3	-5
Payments in lieu of taxes for state-owned land	18.0	10.0	-44
Veterans tax exemptions	8.9	10.0	13
Revitalization grants	3.5	0.0	-100
Other	8.0	4.1	-48
Total	**$280.9**	**$187.2**	**-33**

Over the last two years, these programs have been reduced by 33 percent overall (see Table 12). Lying behind this decline, however, are increases totaling $24 million in two programs -- water and sewer construction aid and the "Quinn bill" program of salary supplements for local police officers who obtain college degrees -- that are more than offset by cuts to other programs totaling $118 million, a 57 percent reduction. The decline is largely due to the elimination of two programs: the $44 million Chapter 81 program for local road and bridge repairs; and the $54 million program of rate relief for consumers of MWRA water.

With the most recent round of administrative reductions, total local aid has fallen by $52 million, or one percent, over the last two years after adjusting for the $182 million decrease in the pension appropriation for teachers, which has only shifted the state's funding obligation to the future, not permanently reduced the spending base. Because of the nature of local aid, many of the other recent aid reductions, such as the cuts to additional assistance and Chapter 81, simply transfer greater financial responsibilities onto municipal budgets.

It is also clear that there are significant opportunities for spending reforms, particularly in Chapter 70 school aid and the Quinn bill, the increasingly expensive educational pay program for local police officers that has been marred by numerous abuses. On a broader level, there is an even greater opportunity to rethink the entire state-local fiscal relationship, and how the diverse elements of the Commonwealth's local aid efforts should fit together. Taking up this challenge is even more important in fiscal 2004, with major reductions in aid to cities and towns, including Chapter 70 school aid, almost inevitable.

Human Services

($ millions)	2001	2002	2003
Social Services	$574	$632	$657
Youth Services	118	123	125
Child Care	383	383	369
Cash Assistance	646	683	707
Housing Assistance	158	143	110
Mental Retardation	916	966	988
Mental Health	602	608	603
Public Health	535	503	402
Total	**$3,933**	**$4,039**	**$3,959**

Human services programs have been the focus of many of the budget cuts over the last two 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 a slight increase in overall human services spending.

Squeezing additional savings out of these departments without further reducing services will be extraordinarily difficult. About 90 percent of human services spending is on actual services and benefits, and the easy administrative cuts have already been made.

Budget cuts will only exacerbate the problems clients already face in negotiating an increasingly dysfunctional system for providing services. With providers and state agencies mired in a tangle of bureaucratic impediments to delivering high-quality services, it will take a thoughtful and sustained reform effort to strengthen the performance of the system in this era of sharply limited resources.

Table 13

Human Services Spending Changes 2001 to 2003

Category	Change	Pct. Chg.
Social Services	$83.0	14.5
Cash Assistance	60.8	9.4
Mental Retardation	71.6	7.8
Youth Services	6.5	5.5
Mental Health	0.3	0.0
Day Care	(14.3)	(3.7)
Public Health	(133.4)	(24.9)
Housing	(48.7)	(30.7)
Total	**$25.8**	**0.7**

In fiscal 2003, appropriations for the major human services functions total $4.0 billion, 2.0 percent below spending in 2002 and 0.7 percent higher than in 2001.[5] This tiny increase in overall spending since 2001 masks substantial cutbacks in some areas offset by significant growth in others (see Table 13).

By far the largest cuts have been to public health programs, where spending has fallen by $133 million or 25 percent over the last two years:

- Smoking prevention and cessation efforts have been slashed by $27 million or 57 percent;
- HIV/AIDS prevention and treatment was cut by $14 million or 28 percent;
- Substance abuse programs were reduced by $7 million or 15 percent;
- Breast cancer detection and research was cut by $7 million or 69 percent.

Housing and homelessness programs have also been hit hard, with reductions of $49 million or 31 percent since 2001, a questionable strategy at a time when the lack

[5] This total includes the major departments under the umbrella of the Executive Office of Health and Human Services (excluding the Division of Medical Assistance) and housing assistance programs operated by the Department of Housing and Community Development.

of affordable housing is one of the state's greatest challenges[6]:

- Assistance for rental housing production has declined by $15 million or 64 percent;

- Support for public housing authorities was cut by $11 million or 32 percent;

- Rental vouchers were scaled back by $8 million or 23 percent;

- Assistance for homeless individuals through the Department of Transitional Assistance was cut by $5 million or 15 percent.

Even departments where overall spending has increased have experienced significant cuts:

- Mental health administration was cut by $10 million or 21 percent;

- Cash assistance for legal immigrants was eliminated entirely, saving $8 million;

- Supplemental food stamps for non-citizens (included in the cash assistance category) were rolled back by $6 million or 85 percent.

While many programs were being cut, spending on certain caseload-driven services and benefits was increasing substantially. The Department of Social Services' budget for child protection and welfare increased $83 million or 15 percent over the two 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.

[6] The cuts to housing programs have been partially offset by increased spending on housing in the capital budget.

The economic downturn also pushed up caseloads in programs that provide direct cash assistance to poor, elderly and disabled residents. Total spending on Transitional Aid to Families With Dependent Children, Supplemental Security Income, and emergency assistance for homeless families and low-income elderly and disabled residents increased by $61 million or 9.4 percent between 2001 and 2003.

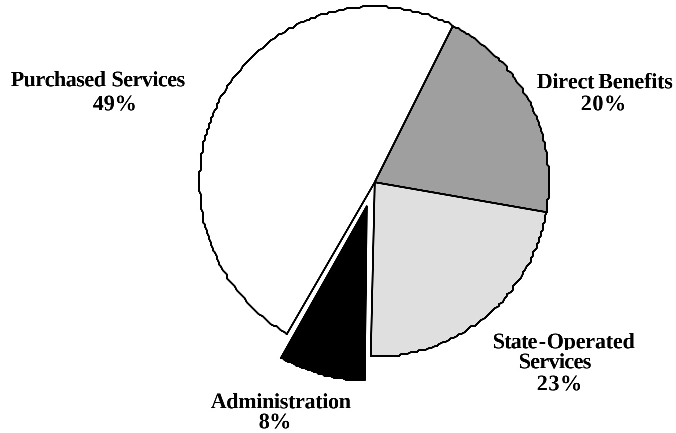
Spending on the developmentally disabled rose by $72 million or eight percent as a result of efforts to reduce the Department of Mental Retardation's long waiting list for services, including implementation of the *Boulet* and *Roland* lawsuit settlements. In each of these departments -- Social Services, Transitional Assistance and Mental Retardation -- spending growth has far outweighed budget reductions that have been made, including the 9C reductions imposed in fiscal 2003.

The vast majority of human services spending is for direct services and benefits, with a relatively small share for administrative costs. Of the $4.3 billion total spending for human services in 2002,[7] approximately $3.9 billion or 92 percent is for purchased services, direct benefits, and state-operated facilities and programs, and $341 million or eight percent is for purely administrative functions (see Figure 11).[8]

[7] The difference between this $4.3 billion figure and the $4.0 billion in the summary table is primarily administrative spending by the major departments that is categorized as "general government" in the Budget Summary of this report. The other difference is spending by smaller human services departments, such as the Massachusetts Rehabilitation Commission and the two soldiers' homes, that are counted as "residual" in the summary.

[8] Also included in this category is $97 million transferred to other government agencies that provide human services, such as public housing authorities and school districts.

Figure 11
Human Services Spending 2002
Total: $4.3 Billion



Nearly half of all spending in 2002 -- $2.1 billion -- was for services purchased from the private, community-based agencies that provide the bulk of human services in Massachusetts. These services assisted over 600,000 individuals and families, nearly one in ten people in the Commonwealth. This spending includes:

- $628 million for mental retardation residential, day respite and transportation programs;
- $446 million for social services group care, foster care and adoption services;
- $330 million for services to mentally ill adults, adolescents and children;
- $189 million for public health programs to combat alcoholism, AIDS, smoking, and health problems among low-income women and children;
- $177 million for day care;
- $96 million for family shelters, transitional housing and other homelessness programs;
- $78 million for residential and non-residential programs for youthful offenders;
- $65 million for low-income housing programs, including public housing authorities;
- $30 million for rehabilitation services for seriously injured residents;
- $23 million to school districts for smoking cessation programs; and
- $18 million for employment and training services for welfare recipients.

Another $866 million or 20.2 percent of human services spending was for direct benefits paid to or on behalf of eligible recipients, including:

- $305 million for Transitional Aid to Families with Dependent Children (welfare);
- $189 million for child care subsidies;
- $181 million for the state share of Supplemental Security Income for the elderly and disabled;
- $64 million in emergency aid to very low-income elderly and disabled;
- $46 million for housing rental vouchers and assistance;
- $27 million for acute and emergency mental health services for Medicaid beneficiaries; and
- $14 million for children's medical services.

Services provided directly by state agencies account for most of the remaining human services spending -- $970 million or 23 percent of the $4.3 billion total. Though the bulk of human services are purchased from outside vendors, nearly every agency provides a significant portion of its services with state personnel, including:

- $270 million for six developmental centers, housing over 1,200 residents, and other state-operated community residential facilities of the Department of Mental Retardation;
- $212 million for the Department of Public Health's four hospitals, the state health laboratory, and a variety of other public health programs;
- $200 million for the four inpatient facilities operated by the Department of Mental Health (including one slated to close) and a substantial portion of adult outpatient mental health services;
- $120 million for social workers and other Department of Social Services programs;
- $63 million for welfare caseworkers in the Department of Transitional Assistance;
- $39 million for state-operated pretrial detention, non-residential programs, and secure facilities operated by the Department of Youth Services;
- $38 million for operating the two soldiers' homes; and
- $11 million for rehabilitation programs.

The relatively small proportion of human services spending going to administration does not mean that the dollars could not be spent more effectively or that savings cannot be achieved. Several departments operate a bewildering array of area and regional offices that create overlapping, duplicative layers of management. And as noted above, several human service departments continue to serve clients in state-operated hospitals and other residential facilities even though many of these clients could be served more cost effectively by private providers in the community.

But the problems in the purchase of services system run much deeper. Excessive time and money is spent on contract administration by both purchasing agencies and providers. Numerous state agencies are involved in the oversight of each contract, with each agency employing inconsistent performance standards, contract requirements, policies and procedures. Procurement and contracting focus on processes rather than results. Monitoring and evaluation concentrate on satisfying bureaucratic requirements rather than ensuring quality services and positive outcomes. Excessive time and money are spent preparing financial reports and providing other data that is not used in managing the system.

These bureaucratic impediments compound the financial squeeze most providers face. Rates for many service contracts have been frozen for more than a decade while administrative requirements have increased, leaving many providers inadequately funded to attract and retain qualified staff. Special accounts to increase the salaries of the lowest-paid direct care workers have made only a small dent in a problem that is approaching crisis proportions.

These shortcomings produce a lower quality of services for clients. Consumers frequently face waiting lists, barriers to access and difficulty navigating the system. There is frequent duplication of care management functions between the state and providers. Individual clients with multiple needs often work with multiple case managers. Care management is program-focused rather than consumer-focused, often resulting in poor fits between needs and services provided.

With these problems engulfing the system, the time has come for a far-reaching and sustained effort to reform human services. The ultimate goals of these reforms should be improved services and better outcomes for the state's most disadvantaged residents, and a healthier return on the taxpayers' massive investment in human services. Achieving these goals will take a multi-pronged approach that addresses the weaknesses in the organization, integration, management, evaluation and funding of human services.

However, reforming human services should not be confused with resolving the state's fiscal crisis. It is unrealistic to assume that large savings could be achieved by reorganizing and restructuring. Even if 25 percent of administrative costs could be eliminated -- an ambitious target -- the savings would amount to only about $100 million, barely two percent of total human services spending.

The complexity of the service delivery system compounds the difficulty of achieving administrative savings through restructuring. The human services system is a vast enterprise, with approximately 1,100 private providers and scores of state-operated programs. Human services needs run the gamut from a lack of affordable child care to severe mental illness. Services as disparate as group homes for the developmentally disabled, welfare payments and AIDS prevention are offered to 1.3 million clients. Many clients with multifaceted problems receive services from more than one agency. Reorganizing and restructuring can streamline management and improve services but cannot eliminate the need for competent and capable administrative oversight of a complex array of programs and services.

Opportunities for savings are also limited by the fact that human services agencies have already been subjected to hundreds of millions of dollars in budget reductions over the last two years -- including cuts to administrative accounts -- both in the 2002 and 2003 budgets and in several rounds of 9C cuts. The early retirement program adopted as part of the 2002 budget led to substantial reductions in staffing at several human services agencies, with Transitional Assistance and Mental Health particularly hard hit.

A further problem is the time that would be required to restructure human services, making it unlikely that any meaningful savings can be achieved to help balance the fiscal 2004 budget. As discussed in the Reforming Government section of this report, developing a successful restructuring effort will be an elaborate undertaking with limited opportunities to realize savings in the short term. Moreover, restructuring is far more likely to succeed if its primary goal is improving the performance of the system rather than cutting the budget for human services.

Capital Investments and Debt Service

($ millions)	2001	2002	2003
Debt Service			
Gen. Capital Bonds	$1,288	$1,266	$1,308
Artery Bonds/GANs	104	99	128
Other Debt Service	40	31	41
Subtotal	1,432	1,396	1,476
Contract Assistance			
School Building Assistance	317	365	382
Sewer Rate Relief	54	59	0
Water Pollution Abatement	48	56	59
Other Contract Assistance	53	49	42
Subtotal	472	529	482
Transfers for Capital			
Capital Needs Investment Trust	45	22	23
Other Transfers	68	104	47
Subtotal	113	126	70
Total	**$2,016**	**$2,051**	**$2,029**

About nine percent of the budget, $2.0 billion in 2003, 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.[9] With few exceptions, these payments are contractual obligations that cannot be reduced in the short term without severe consequences for the state's credit rating or the fiscal stability of the agencies that receive state support.

Spending on debt service and contract assistance has been rising as the state grapples with an enormous backlog of capital needs, and the Foundation estimates that the total will increase by at least another $160 million or eight percent in fiscal 2004. The growth results from accelerated bond issuance and new payments for Route 3 North and the Central Artery. Potential increases in other items could drive the total even higher.

Developing a comprehensive approach to prioritizing competing needs and a strategy for financing the most critical projects should be high on the new administration's agenda. Despite the increased outlays, Massachusetts has far more demands for capital spending than it can afford. The state's heavy debt burden limits annual bond issues to a small fraction of the projects that have been approved for financing. Furthermore, up to half of the Commonwealth's annual federal highway aid, a major funding source for spending on transportation, has been committed to paying off Central Artery debts for the next decade, and Congress could cut the amount of aid Massachusetts receives when it debates highway funding reauthorization later this year.

Meanwhile, thorny issues of capital finance remain unresolved. For example, the Commonwealth has not yet determined how it will cover the operations and maintenance costs of the Artery after the project is complete, address the growing waiting list for school building assistance, or pay for the costly list of expansion projects at the MBTA.

Debt Service

The largest item in this budget category -- and the source of most of the growth in 2004 -- is debt service on the Commonwealth's long-term capital bonds. Under the

[9] 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 2003 are $358 million.

administration's $1.2 billion annual bond cap, new bonds are being issued faster than old bonds are being retired, causing debt service costs to increase by about $120 million to over $1.4 billion in 2004.[10] With the Foundation's support, the cap was increased from $1.0 billion in 2002 to help address the long list of capital projects awaiting funding.

Even at $1.2 billion per year, the state is making little headway. The Legislature and Governor approved $2.6 billion in new bond-funded projects in 2002 alone, bringing the total awaiting financing to over $9 billion, and many potential projects remain to be authorized. Another $138 million in projects was recently shifted from pay-as-you-go to bond funding, adding to the competition for funds under the cap. The money that had been set aside for the projects from prior budget surpluses was used instead to help balance the fiscal 2002 budget.

The increase in debt service costs in 2004 also results from $30 million in one-time savings from refinancing state debt that reduced spending in 2003.

In a clear sign of the Commonwealth's worsening fiscal straits, short-term borrowing to maintain positive cash flow is expected to increase by more than 75 percent to $2.3 billion in fiscal 2003. For the first time in eight years the state borrowed $1.3 billion in 2002 to finance local aid and other payments that had to be made before revenue collections were sufficient to cover the outlays. The $1 billion increase in 2003 is the result of weakened tax collections and tighter budgeting. Cash flow borrowing is repaid later in the year when tax collections peak, and as long as revenues are sufficient to cover expenditures by the end of the year the Commonwealth's fiscal balance is not affected. However, the state does incur substantial interest costs, which are budgeted at $21 million in 2003. Interest costs for short-term borrowing could increase in 2004 if the Commonwealth's cash position continues to deteriorate, but no increase was assumed in the Foundation's estimate of debt service costs.

Contract Assistance

Contract assistance to a variety of quasi-independent authorities and local governments to help pay their debt service costs will also increase to cover additional Commonwealth commitments. The Foundation estimates that despite cutbacks in school building assistance and sewer rate relief, new payments for the reconstruction of Route 3 North and the Central Artery will increase contract assistance by $46 million or 9.5 percent in 2004, bringing the total to over $525 million.

School building assistance (SBA) was one of the state's fastest growing programs until funding for new projects was scaled back starting in fiscal 2002. The fiscal 2003 budget allows the Board of Education to finance new projects that would add about $20 million to SBA costs in 2004, but the Board is waiting to see if the 2004 budget will support the new costs before awarding the funding. The Foundation's projection of contract assistance costs assumes that the new funding will not be granted, causing total SBA spending to hold steady at approximately $380 million in 2004.[11]

[10] Debt service on separate Registry fee-backed bonds issued to help finance the Central Artery will also rise in 2004, but the increase will be offset by a reduction in the amount of Registry fees used for pay-as-you go spending on the Artery (included in the Other Transfers line in the summary above).

[11] 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

The slowdown in funding for new projects has increased the amount of time local governments wait for reimbursements. Approved projects sit on a 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.

The Commissioner of Education recently announced a moratorium on the approval of new projects for the waiting list, citing the uncertainty of future funding for the program. The list currently includes 283 projects requiring annual payments totaling $213 million. Even if $20 million is added to the budget every year for new projects -- the pace set in 2002 and 2003 -- it would be more than ten years before reimbursements have begun on all 283, and in the meantime, many more projects will have been added to the list (assuming the current moratorium is eventually lifted). Increasing the school building assistance budget by even a modest $20 million a year may not be possible given the Commonwealth's long-term, structural budget deficit.

Funding part of the state's obligations within the $1.2 billion bond cap would take some of the pressure off the operating budget but would require sacrificing other capital priorities. Another option is to reduce the state'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 of the state covering a specific percentage of the costs, and it would be difficult for some cities and towns to absorb more of the costs at a time when other forms of local aid are likely to be reduced.

Payments of $27 million per year for the reconstruction of Route 3 North will also begin in 2004. This project was financed outside of the bond cap with the Commonwealth paying for construction and maintenance in the form of lease payments to the private development team.

Legislation enacted in 2002 commits the state to financing the MBTA's proposed New Bedford-Fall River commuter rail line through a similar arrangement. While payments on the $600 million plus rail line will not begin for several years, they represent only the tip of the iceberg of public transit expansion costs. The Foundation's analysis of the T's capital finances, *MBTA Capital Spending: Derailed by Expansion?*, concluded that the T could not afford any of the billions of dollars of expansion projects on its agenda without sacrificing the quality and reliability of existing services, jeopardizing ridership and overwhelming its fragile finances. With state subsidies now limited under forward funding and the cost of past expansions taking a heavy toll on the T's budget, the authority can barely afford to maintain and modernize the current system. Several of the pending expansion projects (not including New Bedford-Fall River) are legally required as environmental mitigation for the Central Artery, and if the Commonwealth is committed to these projects, it will need to find the resources to pay for them.

Another long-term fiscal obligation that the Commonwealth has not yet come to terms with is the cost of operating and maintaining the Central Artery after the project is complete. These costs are projected to total $41 million in 2005 when ownership of the project is turned over to the Turnpike Authority. The Authority will collect no

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authorized by the Board of Education, and continuing for the life of the bonds, typically 20 years. Language in the budget legislation limits amount of funding for new projects the Board can authorize, which, in turn, drives the budget increase required in the following year.

new tolls from most of the new road network, and the tolls it does collect are already committed to help pay off the $1.5 billion in bonds the authority issued to finance its contribution to Artery construction costs. The state is currently providing an annual subsidy to the authority, which will increase from $8 million in 2003 to $25 million when construction is complete and ownership is transferred to the Turnpike.[12] While the subsidy is nominally for operating and maintenance costs, the Turnpike Authority has pledged the state payments to repay $400 million of the $1.5 billion in bonds, and still has no revenue stream to pay for operations and maintenance.

The Turnpike Authority also has no funding lined up to offset the discounts it established when tolls were increased in July 2002. Revenue from the toll hike was the key to paying for the Turnpike's share of the Artery construction costs. A commission established by legislation in 2002 to evaluate a range of alternatives to the toll increase, including new tolls on other major highways, will need to consider ways to cover both Artery construction and operating costs.

Funding for another contract assistance payment, sewer rate relief, was cut from $59 million in 2002 to $39 million in 2003 and then to zero by the mid-year 9C budget reductions. The rate relief was provided to shield Massachusetts Water Resources Authority ratepayers from bearing the full costs of sewer projects stemming from the Boston Harbor cleanup.

Transfers for Capital Projects

In addition to debt service and contract assistance, the Commonwealth also meets some of its capital needs with pay-as-you-go spending in the operating budget. As the budget grows tighter, such spending is often the first to be cut. Funding for the Capital Needs Investment Trust -- a five-year plan to spend $45 million annually on affordable housing, education technology and building repairs adopted in the 2001 budget -- has been repeatedly cut back. The appropriation was reduced to $22 million in 2002 and $23 million in the 2003 budget. The Foundation's deficit projection assumes that funding is maintained at the $23 million level in 2004.

[12] The amount of the payment is based on the authority's costs for operating the Artery, and with major segments of the project opening to traffic in the next year, costs will likely reach $25 million in fiscal 2004. The Foundation's projection for contract assistance payments in 2004 assumes that the payment rises to $25 million, but the budget is likely to fund the payment at a lower level.

Higher Education

($ millions)	2001	2002	2003
Campuses			
UMass	$515.7	$474.3	$441.7
State Colleges	202.3	208.8	196.0
Community Colleges	250.4	240.0	224.9
Total	968.4	923.1	862.6
Other	140.8	114.0	106.6
Total	**$1,109.2**	**$1,037.1**	**$969.2**

The state's public higher education system has suffered heavy state budget cuts over the past two years. The fiscal 2003 appropriation of $969.2 million[13] is down $140 million or 12.6 percent from 2001 spending. This follows a period from 1992 to 2000 in which spending on higher education grew an average of 8.1 percent a year.

The University of Massachusetts system experienced a drop of $74 million or 14.3 percent between 2001 and 2003. The budget for the 15 community colleges is down $25.5 million or 10.2 percent, and for the nine state colleges, $6.3 million or 3.1 percent. The state college budget includes a 5 percent faculty pay raise.

The cuts have had a wide-ranging impact on the affordability and quality of public higher education, resulting in increased tuition and fees and decreased scholarship assistance for students and significant reductions in faculty and staff across the 29 campuses, as well as the failure to fund several collective bargaining agreements.

From 2001 to 2003, campuses raised tuition and fees approximately 28 percent on average, reversing the gains made in reducing student costs over the prior five years. Tuition and fees, which averaged $3,100 in 1996, were cut by 10.3 percent to an average of $2,782 in 2001. The 28 percent jump has raised the average to $3,554, a 14.6 percent increase over 1996, and equal to the 1996 level when adjusted for inflation.

Scholarship funding, which doubled during the 1990s to $113.6 million in 2001, was cut $17.6 million or 15.5 percent in fiscal 2002 followed by a small increase to $98.5 million in 2003. The 2002 funding reductions led to a 10 percent decline in scholarship recipients, from 61,906 to 55,772. Given their tight budgets, the campuses have limited ability to augment scholarship assistance from their own funds.

Table 14
Higher Education Spending Changes
2001 to 2003
($, Millions)

	Change	Pct. Chg.
Campuses		
UMass	-74.0	-14.3
State Colleges	-6.3	-3.1
Community Colleges	-25.5	-10.2
Total Campuses	-105.8	-10.9
Other	-34.2	-24.3
Total	**-140.0**	**-12.6**

The budget cuts have led to a major reduction in personnel, which in turn has undoubtedly had an impact on the quality of education as well as overall student services. Total public higher education personnel dropped by 1,522 positions or 9.8 percent in fiscal 2002. Because many of the reductions were accomplished through the early retirement program with a 20 percent cap on replacing retirees, there have been widely divergent effects across campuses and academic departments. Some departments -- mostly in the liberal arts and sciences -- have lost a significant share of their tenured faculty, which has resulted in larger class sizes, the elimination of certain electives, and the teaching of some courses by less experienced faculty.

[13] The 2003 numbers include Governor Romney's most recent 9C cuts of $15.9 million from higher education.

In addition, most University of Massachusetts employees, both faculty and non-faculty, have not had a salary increase since fiscal 2001. Governor Swift vetoed approximately $30 million of higher education appropriations from the 2003 budget, which essentially voided collective bargaining agreements that provided approximately 5 percent annual raises for UMass faculty and clerical and maintenance workers for fiscal 2002, 2003 and 2004. If the contracts were fully funded, the total cost for the UMass budget in fiscal 2004 would be $118.5 million, including $53.2 million in back pay for 2002 and 2003, $59.4 million to cover three years of cumulative pay increases on 2004 salaries, and $5.9 million for one-time professional costs. The Governor's veto also covered contracts for non-faculty employees at the state and community colleges.

Criminal Justice and Law Enforcement

(millions)	2001	2002	2003*
Corrections	$800.3	$825.6	$825.1
Judiciary	588.7	580.0	567.0
State Police	205.3	230.8	239.4
District Attorneys	81.4	81.4	78.5
Attorney General	33.8	35.7	32.7
Total	**$1,709.6**	**$1,753.5**	**$1,742.7**

* The 2003 numbers include Governor Romney's most recent 9C cuts of $3.3 million from the state police and $600,000 from corrections.

Criminal justice and law enforcement appropriations total $1.74 billion in fiscal 2003 and are $33 million or 1.9 percent higher than fiscal 2001. A large increase in the state police budget and a modest rise in corrections spending offset an almost four percent reduction in the judiciary budget.

Corrections

(millions)	2001	2002	2003
State (DOC)	$412.0	$424.1	$436.1
County	374.1	386.7	375.0
Parole	14.2	14.8	14.0
Total	**$800.3**	**$825.6**	**$825.1**

Spending on corrections, including state and county prisons and the Parole Board, was one of the fastest growing areas of the state budget throughout the 1990s. From 2001 to 2003, spending growth slowed to 3.1 percent or $24.8 million.

The Department of Corrections (DOC) accounted for virtually the entire increase, growing $24.1 million or 5.8 percent between 2001 and 2003. DOC spending rose an average of 6.5 percent a year between 1995 to 2001.

Generous collective bargaining raises have fueled much of the recent growth and led to cutbacks in other corrections programs. About 90 percent of DOC's 5,200 staff received approximately 5 percent annual pay raises in 2001, 2002 and 2003. These agreements pushed DOC's payroll costs up by $15.1 million or 5.4 percent since 2001 to a total of $294.8 million, despite a 3.3 percent decrease in the number of DOC employees. The cost of providing health care for inmates rose as well, by $10.5 million or 19.4 percent.

Because the DOC prison population declined by almost five percent over this period, the average cost per inmate jumped by $4,500 or 11.4 percent to almost $44,000.

To accommodate the cost increases, the Department closed five minimum security facilities with approximately 1,300 beds and eliminated some inmate education programs, a questionable strategy on both fiscal and correctional grounds.

The five facilities that were closed -- MCI Shirley minimum, MCI Lancaster, Park Drive Pre-Release, Longwood Treatment Center, and the Southeastern Correctional Center -- leave the Department with 12 minimum security facilities or units. However, some of the inmates from the closed facilities were placed in higher security and more expensive prisons. Costs per person are at least twice as high in maximum security operations.

Both minimum security and education programs are recognized as helpful in reducing inmate recidivism. DOC's limited education funding was further reduced by $900,000 or 17.3 percent from 2001 to 2003, resulting in the loss of 17 employees or almost a quarter of the education staff.

Table 15

Average Annual Inmate Population

	FY01	FY02	FY03*	Pct. Change
County	11,269	11,364	12,045	6.9%
State	10,457	10,264	9,950	-4.8%
Total	**21,726**	**21,628**	**21,995**	**1.2%**

* The fiscal 2003 numbers are based on data for six months.

Despite an almost seven percent increase in the county prison population between 2001 and 2003 (see Table 15), funding for county corrections was at the $375 million level in both years -- growing about $12 million in 2002 and declining by the same amount in 2003. Of that total, $166 million subsidizes the costs of the seven county prisons that continue to operate independently.

The Parole Board's 2003 appropriation of $14 million represents a 5.1 percent decline from 2002 and a slight drop from 2001, resulting in a reduction of 20 employees or 10 percent of total staff.

Judiciary

(millions)	2001	2002	2003
Judiciary	$588.7	$580.1	$567.0

Fiscal 2003 appropriations of $567 million for the judiciary are $21.7 million or 3.7 percent below 2001 spending, which has resulted in the reduction of approximately 800 employees or 10 percent of total personnel. The impact of these cuts has been widely felt, resulting in case delays and less security in the courtrooms.

The reduction of administrative and professional staff, including clerks, stenographers and translators, has created substantial delays in the processing of cases throughout the judicial system. Because criminal cases usually receive priority, civil actions, including tort, child support, custody dispute and small claims cases, have been particularly affected.

The courts have reduced security personnel by approximately 100 employees or 14 percent, resulting in some sessions being staffed below minimum standards. Twenty of the 116 courthouses have reported significant cutbacks in security, including five courthouses where security personnel have been eliminated and 15 where perimeter security staffing is below standards.

Funding for judges' salaries totals $42 million in 2003, an increase of $2.5 million or 6.2 percent over 2002. The increase anticipates bringing the total number of judges to the statutory limit of 378.

The fiscal 2003 budget wisely continues the state's investment in community corrections, a collaboration with public safety agencies to provide less expensive alternatives to incarceration. At an average annual cost of less than $4,100 per person -- compared to $44,000 for incarceration -- individuals undergo electronic monitoring or day reporting procedures while participating in programs such as GED training, substance abuse counseling, job training and community service. Funding for this initiative has remained constant at $15.6 million from 2001 to 2003.

State Police

(millions)	2001	2002	2003
State Police	$205.3	$230.8	$239.4

State police appropriations rose $34.1 million or 16.6 percent from 2001 to 2003, with most of the increase directed to enhanced security in the wake of September 11.

The 2003 budget included funding for a new state police class of 150 cadets, but Governor Romney has eliminated $2.9 million to pay for the class as part of his recent 9C cuts.

As discussed in the Local Aid and Reforming Government sections, funding to support the "Quinn bill" supplemental pay for state and municipal police is growing rapidly. Appropriations for 2003 total $41.5 million, a $13.3 million or 47.4 percent jump over 2001.