State Budget '05-'06: The Clash Between Expectations and Reality

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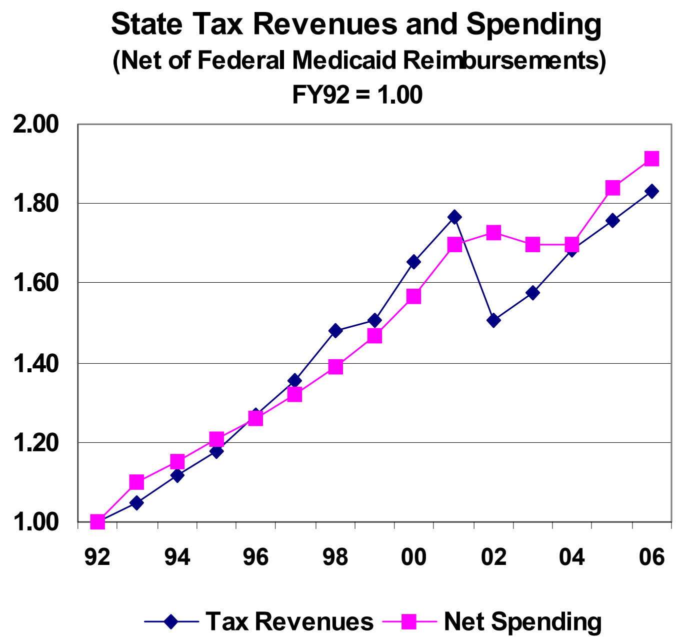
OVERVIEW

Introduction

Having successfully addressed one kind of fiscal crisis created by the collapse of tax revenues in 2002, the Commonwealth now confronts a different kind of long-term fiscal problem. This new financial challenge is rooted in a fundamental imbalance between the rate of growth in state revenues and the rate of growth in spending that the state is obliged—or has already committed—to maintain in critical areas such as health care, capital investments, and education. Because of this imbalance, the structural gap in the state's finances that was closed in 2004 has already reopened, and threatens to widen even further over the next several years (see Figure 1). Governor Romney's proposed 2006 budget—with its less than one percent spending growth and reliance on hundreds of millions of dollars of questionable business tax increases and Medicaid cost shifting to achieve balance—provides immediate evidence of the difficult choices that lie ahead.

It is now clear that fiscal 2004 marked the end of the fiscal crisis that was triggered by a staggering 15 percent plunge in tax revenues in 2002. Attributable in part to a nationwide recession and plummeting stock market and in part to the ill-timed phasing in of major tax cuts, the crash in revenues produced a seismic break in the state's finances that could only be bridged with drastic fiscal action. To bring revenue and spending back into alignment, the state's leaders raised taxes and fees, slashed spending, and depleted reserves over the course of three difficult fiscal years. In fiscal 2004, those efforts paid off, as a slowly improving economy and a surge in tax receipts combined to produce a tiny structural surplus in the state budget.[1]

Figure 1



The fiscal forces now gripping the state are very different in character than those that drove the crisis just ended—less obviously dramatic but longer term in their effects. In some ways, the new financial problems will be much tougher to resolve.

To put it simply, state spending growth in core programs will consume all of the revenue growth generated by the state's economy and tax base over the long term, leaving next to nothing for restoring budget cuts or funding new initiatives. In particular, the most difficult-to-control

[1] The officially reported "surplus" of more than $1 billion was almost entirely due to one-time federal revenues and underfunding of the state pension system.

growth comes in some of the largest areas of state spending:

- In Medicaid, where the combination of federal mandates, escalating costs and widespread support for expanded health care coverage leave few realistic options for controlling the rate of growth;
- In debt service on state borrowing for capital investments, which in the short term is contractually unavoidable and in the long term will have to rise even more rapidly if the state is to address its huge backlog of critical capital projects;
- In aid to education—a financial responsibility anchored in the state Constitution—where there is extensive support for greater state funding, as well as the expensive new school building assistance program and a commitment by legislative leaders to expand early childhood education, at an added annual cost of up to $1 billion when fully implemented;
- In pension funding, where the Commonwealth's credit rating depends on staying on course to eliminate the huge unfunded liability in the state's pension system by 2023, requiring annual spending increases greater than inflation for the next two decades;
- And in a number of other smaller programs, where spending is contractually obligated or mandated by the courts.

Taken together, these spending imperatives will require almost a billion dollars of additional expenditures each year—before considering inflation, restoration of spending cuts, or new initiatives.

Offsetting the upward pressure on spending is the potential for growth in the Commonwealth's tax base. Over the long term, the state's tax revenues can grow only as fast as the Massachusetts economy. Looking at the last two and one-half decades, revenues have grown barely more than five percent a year on average (at present inflation rates), or roughly $800 million of annual revenue growth in terms of the current state budget.

Largely because of this mismatch between the rates of growth in revenue and spending, the 2005 budget is almost $500 million out of balance, a hole that is being filled by further withdrawals from the state's reserves. The Foundation projects that the Commonwealth faces a structural shortfall of more than $700 million in fiscal 2006 due to the same "growth gap," even with a continuing economic recovery and forecasted tax growth that is only slightly below the long-term trend. And while revenue collections in both years could exceed our forecast by a modest amount, the lion's share of the additional revenue growth clearly should be used to rebuild the state's reserves in anticipation of the next downturn in the economy.

Looking ahead several years, the Commonwealth's financial difficulties are likely to be even more challenging because of a daunting array of other looming obligations. These include the estimated $1 billion eventual cost of the recent commitment to expand early childhood education, previous commitments to roll back over time the $750 million of crisis-driven income tax increases imposed in 2002, the need to reimburse hospitals and other Medicaid providers for the full cost of their services, and the unknown financial impact of the wide-ranging proposals to expand health care coverage for Massachusetts citizens.

This extraordinarily difficult outlook has sobering implications for state budgeting for the foreseeable future:

- While the Commonwealth was briefly out of the fiscal woods at the end of 2004, it is now heading back into them. The decisions required to achieve budgetary balance are likely to be especially wrenching after all the hard choices of the last four years.

- The actions that worked in solving the recent crisis—tax and fee increases and spending cuts—will yield only temporary relief from the widening gap, since they have little effect on the differing rates of growth that are driving that gap.

- Until rapidly rising costs—especially Medicaid and other health care costs—are brought under control, it will be enormously difficult to alleviate the new squeeze on the state's finances. Although Medicaid has emerged from the recent revenue crisis essentially intact, that achievement came at a huge price: cuts across the rest of state government that were significantly deeper than otherwise would have been required, and shifting of costs to the providers of Medicaid services, who were already being reimbursed inadequately before the crisis began. Neither of these approaches is viable over the long term.

This new challenge will require extremely tight budgets for some time to come, a reality that is reflected in House 1, Governor Romney's proposed budget for fiscal 2006.[2] Despite a reasonable revenue forecast that assumes continued economic recovery, the budget is a "bare-bones" document. Excluding the major areas of largely non-discretionary spending—education aid, health care, debt service, and pensions—the proposed expenditures for 2006 are slightly less than estimated 2005 spending, and a substantial 3.0 percent less after accounting for inflation.

Even with the minimal spending growth, the Governor's budget would fall short of balance were it not for its reliance on an extraordinary accounting change: shifting payment of approximately $450 million of 2006 Medicaid costs into 2007 and then permanently funding those costs one year in arrears.[3] This change produces one-time budgetary "savings" of about $225 million in 2006, after accounting for federal reimbursements of 50 percent of state Medicaid costs.

Because this "savings" is insufficient to offset the combined financial impact of the administration's recommended 2006 spending growth and its plan to cut the income tax rate to 5.0 percent, Governor Romney has also proposed substantial increases in business taxes under the banner of "loophole closing," the third round of such increases in as many years. The latest proposed increases—which go far beyond mere loophole closing—continue a major reversal of the progress that Massachusetts made during the 1990s in improving its tax climate.

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[2] The name "House 1" refers to the bill number traditionally assigned to the Governor's budget when it is filed with the House Clerk.

[3] Under the change, bills that otherwise would be paid from 2006 Medicaid appropriations would instead be paid from 2007 appropriations.

A Successful Response to Revenue Shock: Fiscal 2002-2004

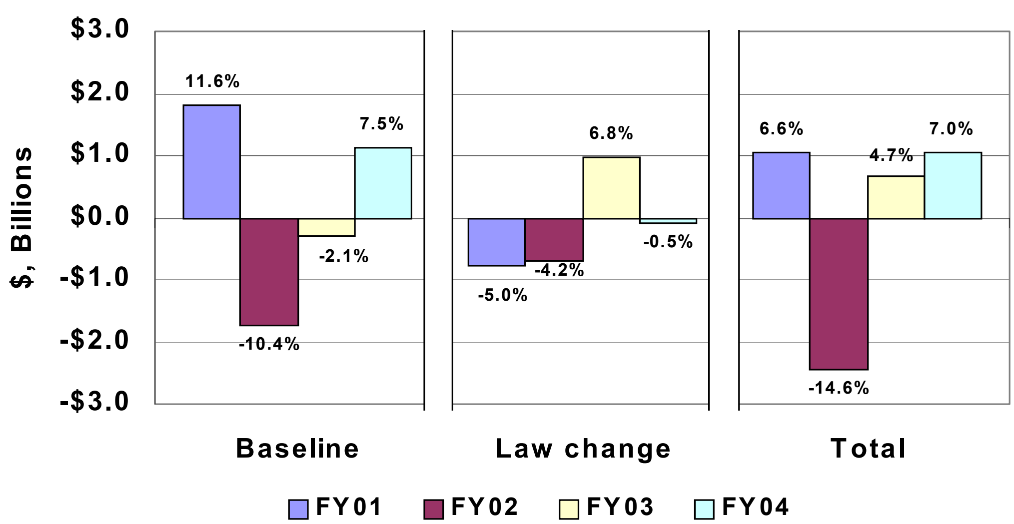
Following almost three years of tax and fee increases and spending cuts, the Commonwealth ended fiscal 2004 on a positive note. After two consecutive years of decline, baseline tax revenues (before law changes) increased by more than seven percent (see Figure 2). Even after accounting for one-time resources that inflated the apparent "surplus" to more than $1 billion, ongoing 2004 revenues still exceeded spending by a small amount. And after huge withdrawals from reserves to make ends meet in fiscal 2002 and 2003, the state deposited almost $500 million in the stabilization fund in 2004, nearly doubling the balance in that critical financial buffer.

All these fiscal pluses are clearly good news. Moreover, they mark a major turning point in the struggle to overcome the fiscal upheaval brought on by a $2.4 billion, or 14.6 percent, plunge in state tax revenues in 2002 that was produced in significant part by the disappearance of capital gains receipts following the collapse of the stock market. In the ensuing three-year effort to cope with that enormous revenue shock, the state's fiscal decision-makers:

- Cut more than $800 million of spending from the fiscal 2002 budgets originally adopted by the House and Senate;
- Reduced expenditures in specific programs by almost $3 billion between 2001 and 2004, with double-digit decreases in almost every area of government (see Figure 3);
- Despite skyrocketing health care costs, kept a tight rein on spending, actually reducing 2003 expenditures below 2002 levels and holding average growth in annual spending to just 1.1 percent between 2002 and 2004;

Figure 2

Annual Change in Tax Revenues
Fiscal 2001-2004
(Amount and Percent)



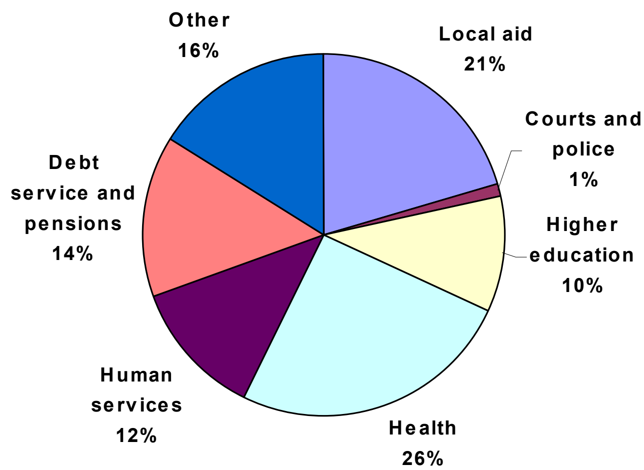
- Reversed approximately $700 million of previously authorized tax cuts and enacted tax increases that generated an additional $275 million, including a significant hike in the taxes paid by corporations;

- Put on hold another $400 million of voter-approved income tax rate reductions that had been scheduled to go into effect in 2003;

- Increased state fees and charges by almost $400 million, or one-third, from 2001 to 2004 (see Table 1);

Figure 3

Fiscal 2001-2004 Spending Reductions



Total reductions: $2.9 billion

Table 1
Increase in Fee Revenues
Fiscal 2001-2004
($, millions)

Category	2001 Amount	2004 Amount	Increase from 2001
Registry of Deeds	$16	$186	$170
Vehicle license/ registration fees	247	319	72
Petroleum product deliveries	16	77	61
Court fees/ fines	55	72	28
Public health licensing/registr.	7	28	21
Environment/parks	51	67	16
Professional licensure	10	19	9
Public safety insp. and licensing	8	17	9
Bank exam. fees	11	13	2
Alcohol filing/licensing	<0.1	2	2
All other	324	333	9
Total	$806	$1,205	$399

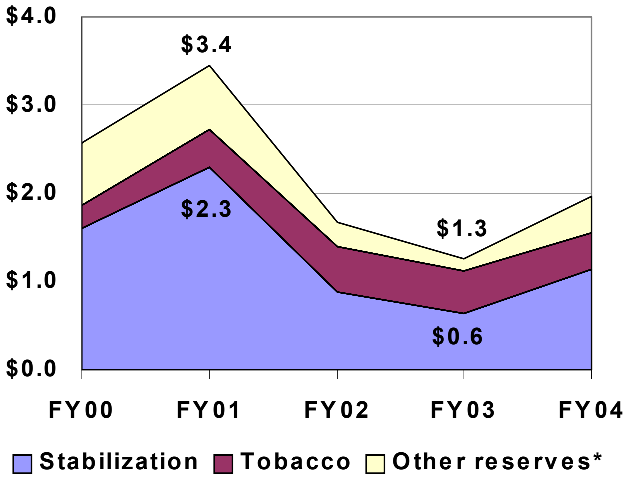
- Used $1.7 billion of the "rainy day" reserves built up during the 1990s and drew down more than $600 million of other balances (as shown in Figure 4).

Against this backdrop of highly unpopular, but fiscally necessary, actions in response to a real crisis, the positive financial results for 2004 could easily be taken as a huge, or even definitive, turnaround in the state's fiscal fortunes. However, after taking into account non-recurring revenues and savings, the underlying structural surplus in 2004—how much continuing revenues exceeded expenditures for ongoing programs—was only a little over $200 million (see Table 2).

While achieving even this modest surplus was a considerable achievement given the financial

Figure 4

Available State Reserves ($, billions)



* Other reserves include balances in the budgetary funds (excluding appropriation amounts carried forward to the following fiscal year) and non-budgetary reserves used to help fund the budget.

difficulties of the previous two years, it is a far cry from the $1.1 billion excess of revenues over spending that was officially reported.[4] Three factors explain why the underlying 2004 structural balance was so much smaller than the nominal surplus figure.

First, while much attention was paid to the more than $700 million of tax revenues in excess of forecast that was collected in the second half of the fiscal year, another key driver of the fiscal 2004 ending balance—the almost $460 million of one-time federal revenues in 2004—has been largely ignored. These dollars were the final payment on $550 million of fiscal relief for Massachusetts, part of the $20 billion package for states authorized by Congress in 2003. This one-time payment—half of which came in the form of an increase in the normally 50 percent rate of federal reimbursement for state Medicaid spending—accounted for 40 percent of the total 2004 surplus (see Table 2).

The second, again mostly unrecognized, underpinning of the surplus was underfunding of the state's pension system. This underfunding came about in two ways: through the adoption in 2002 of a three-year annual pension funding schedule that ignored the precipitous drop in the value of pension assets as a result of the plunge in stock market values; and through the ill-advised, and ultimately unsuccessful, initiative to transfer the

Table 2

Fiscal 2004 Structural Surplus ($, millions)

Official excess of revenues over spending reported by the State Comptroller	$1,140
Plus excess revenues set aside:	
School building construction	150
Springfield fiscal recovery	52
Fiscal 2004 total excess revenues	$1,342
One-time resources:	
Federal fiscal relief	$457
Pension underfunding	532
Reserves and non-tax revenues	123
Total one-time	$1,112
Fiscal 2004 structural surplus after subtracting one-timers	$230

[4] By the Foundation's tally, the actual 2004 excess was $1.3 billion, an amount that includes the officially reported $1.1 billion adjusted upward for the $150 million of school building assistance and $52 million for Springfield that, while classified as 2004 spending, were actually transferred at the end of the fiscal year to newly created "off-budget" funds for future use.

Hynes Convention Center and Boston Common Parking Garage to the state's pension fund in lieu of $145 million of otherwise required appropriations to the fund. In a highly responsible decision, the Governor and Legislature agreed to address in 2005 both the larger funding deficiency and the hole created by the failure of the Hynes/Parking Garage initiative. As a result, the state contribution to the pension fund had to be increased by $532 million in fiscal 2005, effectively consuming another major portion of the apparent 2004 surplus.

Finally, 2004 finances also relied on several smaller non-recurring resources, including $68 million previously set aside to provide incentives for improved teacher quality, and approximately $60 million of one-time revenues from the sale of abandoned property.

What emerges in the end is a picture of minimal structural surplus—a $230 million, or 1.1 percent, margin on state spending that totaled almost $23 billion in 2004.

Table 3
One-Time Resources Supporting Initial 2005 Budget
($, millions)

Appropriations carried forward from 2004*	$358
Stabilization withdrawal	340
Federal fiscal relief	270
Total	$968

* Excluding an estimated $96 million authorized for non-recurring expenditures

The New Fiscal Challenge: A Widening Gap in Fiscal 2005 and Beyond

Unfortunately, the Commonwealth now faces a new set of fiscal forces that has already reopened the structural gap in the state budget. While the budgetary shortfall that was successfully closed in 2004 had its origin in the dramatic plunge in tax revenues in 2002, this new gap in the state's finances is the result of a deeper-rooted imbalance between the rates of growth in tax revenues and spending. Put simply, the additional expenditures needed each year to sustain existing programs exceed likely tax revenue growth, even assuming a continued recovery in the state economy.

The strains on the state's finances are already being felt in fiscal 2005 and are likely to intensify in 2006. At the time of its adoption,[5] the 2005 budget relied on almost $1 billion of one-time resources (see Table 3). While this figure overstates the magnitude of the structural deficit because it is based on a consensus revenue estimate that has proven to be overly conservative, authorized spending for fiscal 2005 exceeds expected revenues by approximately $475 million, according to the Foundation's latest analysis (see Table 4).[6] This projection is based upon the Foundation's December forecast of 2005

[5] Including 2005 spending authorized in the final supplemental appropriation for 2004.

[6] Based on appropriations authorized to date (including Medicaid and other off-budget spending). The amount shown does not include any additional supplemental appropriations that may be authorized before the end of the fiscal year or so-called reversions (unspent agency appropriations which the administration estimates will total $215 million net of federal reimbursements).

Table 4
The 2005 Structural Deficit
($, millions)

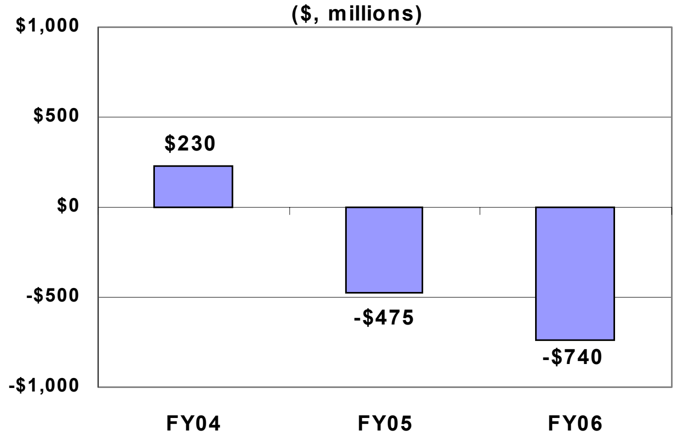
Revenues for budget excluding one-timers	$23,874
Authorized spending	25,047
Revenues minus spending	-1,172
MTF Dec. 2004 tax forecast	697
Remaining difference	-$475

revenues, which assumes 4.5 percent tax growth and is almost $700 million higher than the forecast used to develop the budget.

The discrepancy between rates of revenue and spending growth is even more apparent in fiscal 2006. Based on MTF's projections, the gap between revenues and spending will grow to $740 million in 2006 (see Figure 5). This estimate assumes 2006 tax revenue growth of $700 million, or 4.2 percent, including the impact of an additional $60 million "automatic" cut in the income tax, reasonable assumptions about the growth

Figure 5

Actual/Projected Structural Surplus/(Deficit)
($, millions)



of non-tax revenues, and the increases that will be needed to meet the state's legal obligations and other largely uncontrollable increases in costs, including:

- MTF's estimate of an eight percent increase in Medicaid and other health care costs (net of 50 percent federal reimbursements);
- Estimates of the amounts required by state law or contractual obligations for debt service payments, Chapter 70 local aid, school building construction, pensions and the MBTA;
- A small allowance for inflation as well as other cost increases that are likely to be unavoidable due to consent decrees and other factors.

At the same time, the analysis does not include restoration of previous spending cuts, additional expenditures for the new commitment to early childhood education, or the costs of expanded health coverage. Nor does it provide for the potential impact of other looming concerns, such as the loss of a portion of disputed federal "disproportionate share" revenues in the Medicaid program.

While the Foundation has made no explicit projections beyond fiscal 2006, we believe that the Commonwealth faces a growing structural gap for the foreseeable future. This is particularly evident after examining more closely the longer-term trends in tax collections and the specific forces driving the state's major spending programs.

Table 5
Proposed Fiscal 2006 Spending
($, millions)

		Change from FY05		Change from FY01 Nominal		Change from FY01 Inflation-Adjusted	
	FY06	**Amount**	**Percent**	**Amount**	**Percent**	**Amount**	**Percent**
Health care	$7,818	-$107	-1.3	$2,261	40.7	$1,386	24.9
Human services	4,584	83	1.8	322	7.5	-349	-8.2
Education aid	3,730	92	2.5	276	8.0	-268	-7.8
Criminal justice	1,858	24	1.3	149	8.7	-120	-7.0
Debt service	1,793	115	6.9	362	25.2	136	9.5
Other local aid	1,356	6	0.4	-185	-12.0	-427	-27.7
Pensions	1,275	58	4.7	258	25.4	98	9.6
Higher education	922	8	0.8	-187	-16.8	-361	-32.6
All other	1,476	-128	-8.0	-282	-16.0	-558	-31.8
Total	$24,811	$150	0.6	$2,974	13.6	-$234	-1.1

Note: For purposes of comparison, fiscal 2006 health care spending excludes $231.8 million of recommended Medicaid appropriations for Medicare buy-in costs that in prior years were deducted from federal reimbursements; education aid in all years has been adjusted to exclude school building assistance costs to be funded from dedicated sales tax receipts beginning in fiscal 2005.

The fiscal 2006 state budget proposed by Governor Romney vividly illustrates the continuing squeeze on the Commonwealth's finances. With its minimal spending growth and heavy reliance on business tax increases and a Medicaid accounting change to achieve fiscal balance, the Governor's proposal clearly reflects the difficult fiscal realities facing the Commonwealth.[7] While the Governor is proposing spending growth of less than one percent in an apples-to-apples comparison to estimated 2005 expenditures, the increases are for the most part directed toward legal obligations such as Chapter 70 school aid and debt service (see Table 5). Excluding these and other largely non-discretionary costs such as health care and pensions, the proposed expenditures for 2006 are actually less than estimated 2005 spending. Despite a reasonable revenue forecast (essentially identical to the Foundation's) that assumes a continuing economic recovery, the budget does little or nothing to restore the deep spending cuts of the last four years.

Unfortunately, the Governor's 2006 budget—if enacted—would substantially worsen the structural gap that the Commonwealth will face in fiscal 2007 and beyond:

- Through an accounting maneuver, the administration is proposing to shift payment of approximately $450 million of 2006 Medicaid costs into 2007 and then permanently fund those costs one year in arrears. While that change would produce one-time "savings" in 2006, in 2007 the state would again face the full brunt of Medicaid cost increases that have

[7] See the Foundation's February 2005 bulletin, *Governor's 2006 Budget: Continued Lean Times; Medicaid Accounting Change Key to Balance.*

abated only slightly from the double-digit rates of recent years.

- Those cost pressures would be intensified further by a separate proposal to defer roughly $45 million of Medicaid rate increases for nursing homes into 2007 (approximately doubling the amount needed for such increases in that fiscal year) and by an almost $100 million reduction in state contributions to the uncompensated care pool that would further exacerbate the gap between uncompensated care costs borne by hospitals and the payments they receive.

- At the same time, the budget makes no provision for the future costs of the Governor's proposals to extend health care coverage to the uninsured, to reform school finances, and to promote job creation.

- And while the budget accommodates the impact on 2006 revenues of the proposed cut in the income tax rate from 5.3 to 5.0 percent—$225 million according to administration estimates—it does not address the larger impact on 2007 revenues. Based on the Foundation's projections, the full-year reduction of tax revenues would be $575 million in 2007, or an additional $350 million on top of the $225 million in 2006.[8]

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[8] Although the tax cut would be in effect for six months of fiscal 2006 (from January 1 through June 30), the administration's $225 million estimate of the cut's 2006 revenue impact reflects less than six months of collections at the proposed new rate. Factors that could explain this uneven impact include delays by some taxpayers in adjusting their withholding and estimated payments to reflect the lower rate, as well as expected growth in the tax base in fiscal 2007.

STATE REVENUES: PROSPECTS AND CONSTRAINTS

Although the Massachusetts economy is no longer in free-fall, its rate of recovery has been tepid. While in 2004 the U.S. economy grew at the fastest rate since 1999 (4.4 percent inflation-adjusted), Massachusetts has been recovering at a slower pace. After losing almost 200,000 jobs since 2001, only in the most recent quarter has the state begun to see a turnaround in employment. The rate of improvement is expected to be slow, however: The Foundation is predicting less than one percent job growth in both fiscal 2005 and 2006—a minuscule 20,000 additional jobs a year. Other forecasters are slightly more optimistic, but there is agreement that it will take years to return to the pre-recession employment peak of 2001.

Tax Revenues

While the outlook for the Massachusetts economy is mildly positive, the incremental improvements to date are already translating into higher tax revenues for the Commonwealth. Revenue performance was unexpectedly strong in 2004, with underlying tax growth of almost seven percent.

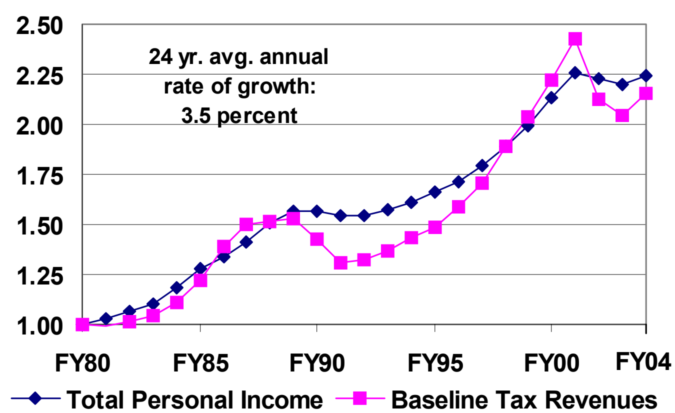
Through February, tax collections in fiscal 2005 were up a solid 5.8 percent—5.4 percent baseline[9]—from the previous year, roughly $150 million above the year-to-date benchmark. However, that overall performance was heavily dependent on higher-than-expected estimated income tax payments (up 23 percent) and payments with returns (19 percent). In contrast, sales tax receipts were up a more modest 4.5 percent, and income withholding—the tax source most closely tied to the economy—lagged even further, with year-to-date growth of only 3.7 percent. This mixed pattern of growth raises a potentially serious fiscal concern. While the additional revenues from estimated payments are good news, they are almost certainly driven by one of the most volatile segments of the income tax base: capital gains and bonuses, particularly in the financial industry. As the state painfully learned in fiscal 2002, revenues from these sources can vanish almost overnight.

Over the long term, baseline tax revenues have grown at almost exactly the same rate as the Massachusetts economy (see Figure 6). From fiscal 1980 through fiscal 2004, total personal incomes in the state grew at an average pace of 3.46 percent a year (after adjusting for inflation), while baseline revenues rose 3.45 percent a year

Figure 6

Massachusetts Total Personal Income and Baseline Tax Revenues

(Inflation-Adjusted, 1980=1.00)

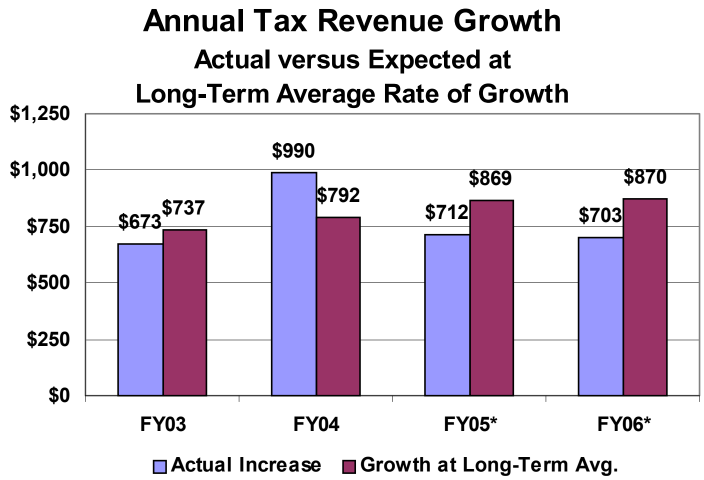


[9] That is, excluding the impact of tax law changes..

on average. At current rates of inflation, this translates into average annual growth of 5.5 percent.

This 5.5 percent figure is important for two reasons: It provides a rough benchmark for how much growth in annual tax revenues it is reasonable to expect; and it places an approximate upper limit on the amount of additional annual resources that, over time, will be available to fund state programs and services or to provide relief to taxpayers.

Figure 7



* MTF Dec. 2004 forecast

From this perspective, it is noteworthy that the state's current revenue performance is close to this long-term average (see Figure 7). In fiscal 2005 and 2006, the projected increase in revenues is roughly $150 million less than the 5.5 percent average.

The $150 million of additional annual revenues would offset only about one-third of the estimated $445 million structural deficit in 2005 and just one-fifth of the projected $730 million gap in 2006. That is to say, even with revenue growth that matched the long-term average, the Commonwealth would still face a large and growing budgetary shortfall in the next two fiscal years.

One other factor to consider is the state's tax cap, which limits the amount of annual revenue growth that is available for the budget to inflation plus two percent. The measure of inflation used in this calculation—based on increases in the costs of goods and services purchased by state and local governments[10]—has in recent years exceeded inflation in the economy as a whole, which has averaged about two percent. As a result, permissible tax revenues in 2005 and 2006 are slightly higher than the revenues that would be expected if receipts rose at the long-term average rate, according to the Foundation's estimates (see Table 6).

Under current law, revenue in excess of the cap must be deposited in the stabilization fund (tax collections through December reportedly exceeded the cap by almost $100 million). Realistically, however, neither the tax cap nor other legal stipulations which require that budget surpluses at the end of the year be set aside in the stabilization fund provide any guarantee that the fund will be built up in good fiscal times. All these provisions are set in statute and, like any law, are subject to change by lawmakers who may be inordinately swayed by the mounting fiscal pressures on the state budget.

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[10] As determined periodically by the federal Bureau of Economic Analysis.

Table 6
State Tax Revenue Growth, Fiscal 2005-2006
($, millions)

	FY05	FY06
MTF tax forecast	$16,665	$17,368
Additional receipts at long-term rate of growth	157	167
Additional taxes allowable under state tax cap	76	117
Total Allowable Tax Revenues	$16,898	$17,652

That is why the Foundation supports the constitutional amendment advanced by former Speaker Finneran that would require that one percent of tax revenues be deposited in the stabilization fund each year and would tighten the process for making withdrawals from the fund. Endorsed by the Legislature last year, the amendment must be approved a second time in order to be placed before the voters in 2006.

Federal and Other Nontax Receipts

The preceding discussion of revenues has focused on taxes because the roughly $9 billion of non-tax receipts collected annually by the state contribute little—positively or negatively—to the longer-term structural problems in the state budget.

Federal revenues account for more than half of non-tax receipts, about $5.1 billion in fiscal 2004. While revenues from the federal government have grown relatively rapidly in recent years (13 percent in 2004), that growth is largely attributable to increased state Medicaid spending that is matched dollar-for-dollar by Washington (the 2004 total was also swelled by non-recurring federal dollars for fiscal relief).

Lottery revenues have some potential for growth—particularly with the reinstatement of an advertising budget for the Lottery Commission—but the rapid increases that typified earlier years can no longer be reasonably expected. Despite the likelihood of some expansion in lottery sales over the next several years, lottery revenues available for state programs will soon begin to decline. While the state diverted roughly $150 million of lottery receipts to help balance the budget in 2004, those revenues have traditionally been distributed to cities and towns through an equalizing formula. The state has committed to returning the diverted funds—plus any growth—over five years beginning in fiscal 2007. The Governor has proposed to accelerate the start of that schedule to fiscal 2006.

The Commonwealth's other non-tax collections—ranging from driver's license renewal fees to interest earnings on the state's checking accounts—are stable in comparison to other revenue sources. As noted earlier, the 50 percent growth in fee revenues from 2001 to 2004 is almost entirely the result of rate hikes.

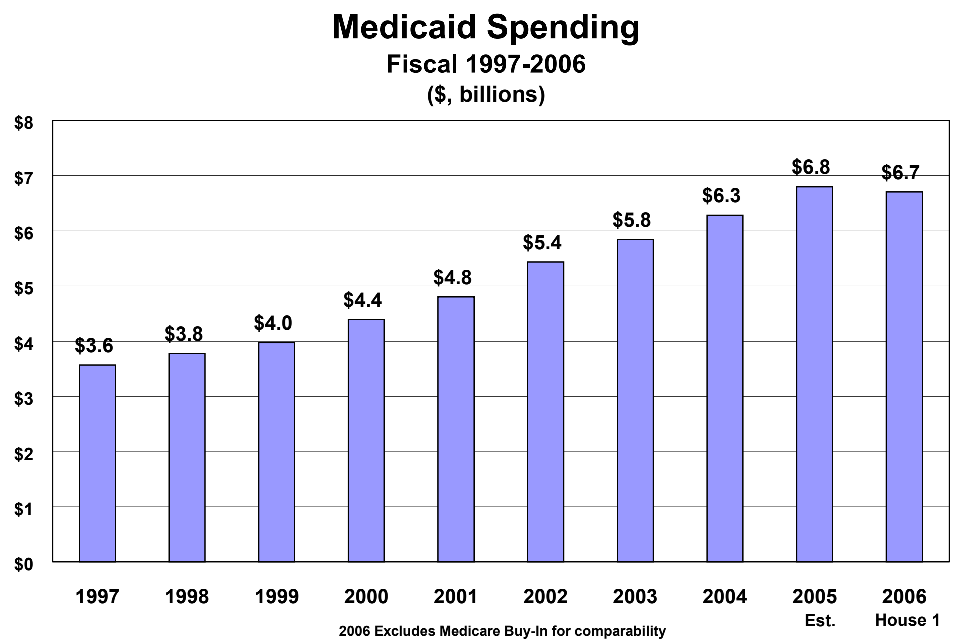
MAJOR SOURCES OF STATE SPENDING GROWTH

Escalating Costs of Health Care for the Poor, Elderly and Disabled

Financing health care creates a profound quandary for state leaders—finding ways to control the escalating costs of serving nearly one million poor, elderly and disabled residents while extending coverage to hundreds of thousands of additional uninsured residents. The objectives are to some degree inherently contradictory. Efforts to control Medicaid spending by reducing eligibility have contributed to the growing number of uninsured and the demand for so-called free care by health care providers. This, in turn, puts pressure on the state to increase its contributions to the uncompensated care pool, offsetting the Medicaid savings. At the same time, expanding health care coverage will require spending more money, running counter to attempts to limit the impact of health care spending on the rest of the budget.

While concerted efforts to rein in spending have slowed the rate of growth, Medicaid remains among the fastest growing of the Commonwealth's major programs and one of the leading causes of the state's long-term fiscal problems. After being held largely in check in the mid-1990s, Medicaid spending has skyrocketed over the last six years and placed enormous pressure on the rest of the budget (see Figure 8). With an average annual growth rate of 9.4 percent—over four times as fast as other programs—Medicaid's share of total state spending has expanded from 20.3 percent in fiscal 1999 to 27.6 percent in 2005.[11] Spending on all health care

Figure 8



[11] The Medicaid spending totals reported here include several off-budget program components, including enhanced nursing home rates and the new MassHealth Essential program for the long-term unemployed, as well as administrative costs for the Division of Medical Assistance and the Division of Health Care Finance and Policy. As part of the reorganization of the Executive Office of Health and Human Services in 2004, the budget and management of Medicaid for seniors was transferred to the Executive Office of Elder Affairs, but the spending—$1.7 billion in 2005—is still included in the Medicaid totals in this report.

House 1 for FY06 includes $237.9 million of Medicare buy-in costs—the cost of Medicare premiums for eligible Medicaid recipients—which programs, including uncompensated care, senior pharmacy assistance and employee health benefits, now accounts for nearly one-third of the total.

Since the start of the fiscal crisis, Medicaid spending has continued to increase rapidly while growth in other state programs has been curtailed by budget cuts. Spending on Medicaid jumped 41.5 percent between fiscal 2001 and 2005—an annual average of 9.1 percent—while spending on all other programs increased only 4.9 percent, or 1.2 percent per year, well under the rate of inflation.

Nonetheless, the administration and Legislature have made substantial progress in their efforts to control Medicaid spending. The pace of increases has slowed significantly over the last two years, while still exceeding the rate of state revenue growth by a substantial margin.

The 2005 Medicaid budget totals $7.0 billion, an increase of $705 million, or 11.2 percent, over 2004 spending. However, spending during the year has been running below forecasts—as it did in fiscal 2004—primarily due to slower-than-expected enrollment growth. The administration projects savings of $200 million by the end of the year, reducing the growth rate to 8.2 percent. In addition, almost $350 million in unspent funds will be carried forward to be spent after June 30 on fiscal 2005 bills—and counted as part of 2005 spending.

The rate of growth is projected by the administration to continue to slow to 5.6 percent in fiscal 2006, which would result in total spending of approximately $7.4 billion.[12] However, the Governor's budget depends on a change in Medicaid accounting that produces a one-time reduction in appropriations of approximately $450 million. In effect, those costs are moved to fiscal 2007. As a result, the proposed 2006 Medicaid budget of $6.9 billion is nearly $70 million, or one percent, below projected 2005 spending (see the accompanying box for an explanation of the accounting shift).

While Medicaid spending per member has been growing more slowly than employer-paid insurance premiums, the projected underlying cost growth of 5.6 percent in 2006 is an aggressive and potentially over-optimistic assumption in an environment where the cost of private health coverage is still increasing at double-digit rates. Achieving the 5.6 percent growth rate is dependent on successfully implementing a set of initiatives, including deferred nursing home rate reviews, drug list reforms and rule changes regarding asset transfers and disability eligibility, that are together expected to save $93 million. Without the savings, the growth in spending would be about 6.9 percent.

Moreover, the proposed budget makes no provision for the Governor's proposal to extend health care coverage to the uninsured, in part by expanding Medicaid enrollment, and takes no steps to address the problem of below-cost provider reimbursement rates. At the same time, a number of unresolved issues concerning federal funding add an extra layer of

were previously deducted from federal reimbursements. Except where noted, these costs are excluded from this analysis to allow comparisons across years.

[12] Including the Medicare buy-in costs noted above.

Medicaid Accounting Shift

Almost all state programs—with the conspicuous exception of Medicaid—pay for the goods and services they purchase in a fiscal year from the revenues collected in that fiscal year. Since the bills for some of those purchases (especially those late in the fiscal year) come in after the official June 30 ending date of the year, departments are required to settle late-arriving bills after June 30, during a so-called "accounts payable" period that begins July 1 and ends September 15. Only after the close of this period can the state comptroller prepare his official tally of spending and revenue for the fiscal year.

For fiscal 2005, the administration projects that the Medicaid program will pay approximately $350 million during the accounts payable period. For fiscal 2006, however, the administration has proposed an appropriation that will only pay for bills received by June 30, and assumes payments for fiscal 2006 bills received after that date will be paid from 2007 appropriations. As a result, the 2006 appropriation will, in effect, cover less than a full year—about 11 ¼ months—of Medicaid costs. This change allows the administration to make a one-time reduction in 2006 appropriations of $450 million, or $225 in state funds after accounting for federal reimbursements. While this shift would affect the fiscal year in which payment of the bills is recorded, it is not expected to change the actual timing of payments to Medicaid providers.

The administration characterizes this accounting shift as a correction that will bring the Medicaid budget back to a July 1-June 30 "cash basis," the pattern for most of the 1990s when bills arriving after June 30 were charged to the next fiscal year. However, over the last three years, appropriations have, in increasing amounts, exceeded what was needed to pay the bills received through June 30—a result of over-budgeting according to the administration—and have been used to pay bills received during the accounts payable period.

This increase in payments during the accounts payable period can be viewed as progress in paying Medicaid bills in the same fiscal year in which the services are delivered—the norm in other state programs—and the accounting shift as a reversal of that progress. Regardless of the relative merits of the two approaches, the bottom-line impact of the change is a one-time "savings" that the administration relies upon to help balance its budget. Resisting the temptation to follow the administration's lead would require the Legislature to identify $225 million of other spending cuts or new revenues, adding considerably to the challenge of producing a structurally balanced budget.

uncertainty to the state's health care finances.

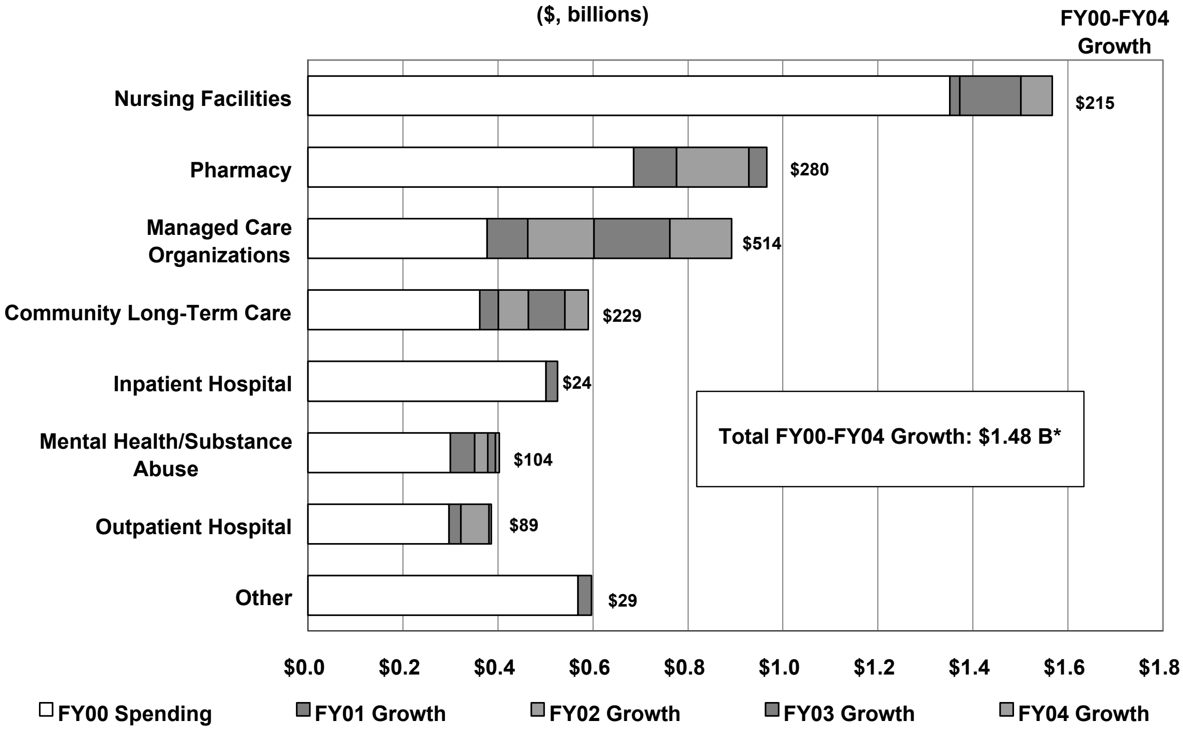
Massachusetts is not alone in its struggle with Medicaid costs. Virtually every state—and private insurer—is facing surging health care spending as a result of more intensive utilization of technology and pharmaceuticals and rising prices for medical services. Although the state's Medicaid eligibility and benefit criteria are somewhat more generous than in most other states, the reductions that have already been made required painful choices, and covering future spending increases by making additional cuts to Medicaid will be extraordinarily difficult.

Figure 9

Medicaid Spending Growth By Type of Care

Fiscal 2000-2004

($, billions)



Resolving the dilemma of Medicaid—simultaneously controlling spending growth, expanding health care coverage and producing a structurally balanced budget—is the greatest fiscal challenge facing state policymakers today.

Medicaid Cost Drivers While Medicaid spending growth in the late 1990s was driven largely by rising enrollment that resulted from expanded eligibility enacted in 1997 and 1998—Medicaid now provides health coverage for a staggering one-sixth of the state's population—enrollment has declined since 2002, and recent spending increases are the result of increased use of costly technologies and pharmaceutical drugs, greater utilization of services overall, and medical inflation. Total Medicaid spending per enrollee, a rough measure of unit costs, has risen from about $5,570 in fiscal 2002 to over $7,200 in fiscal 2005, a 30 percent increase in just three years.[13]

An analysis of Medicaid spending growth by type of service between 2000 and 2004 is presented in Figure 9.[14] Nursing homes—the largest category of service providers—and community long-term care together account for over a third of Medicaid spending and 30 percent of the $1.5 billion total increase, despite an accelerating drop in the number of nursing home beds in the state. With an aging population and increasing longevity, spending on residential care will continue

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[13] This measure includes administrative and other programmatic costs and therefore does not represent the costs of direct services provided to enrollees.

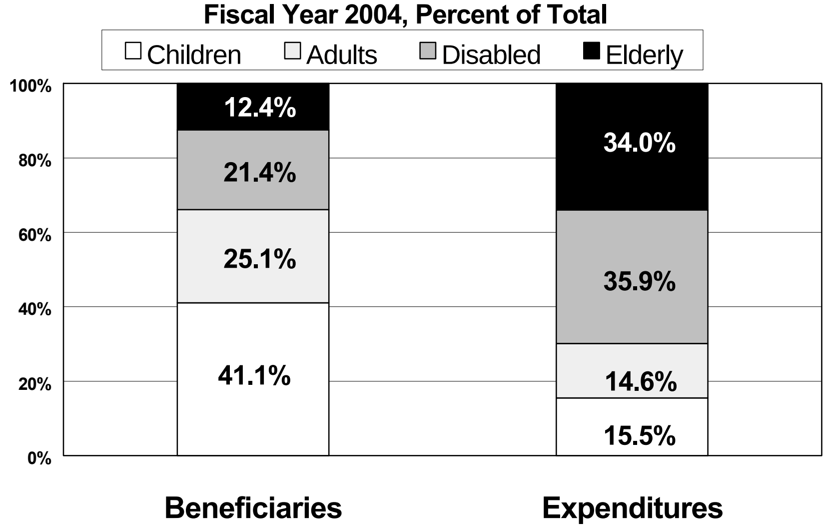
[14] Spending from off-budget accounts is excluded from these figures.

to increase and account for a growing share of Medicaid outlays.

Figure 10

Medicaid Beneficiaries and Expenditures

Fiscal Year 2004, Percent of Total



Source: Executive Office of Human Services

While spending for most types of health care services has been escalating rapidly, prescription drug expenditures stand out, largely reflecting the rise in drug utilization that is taking place across the country. Spending for prescription drugs is second only to nursing homes as the largest category of Medicaid spending. Between 2000 and 2003, pharmacy expenditures swelled by almost $300 million, or 43 percent, to nearly $1.0 billion. However, spending on pharmaceuticals declined slightly in 2004, due at least in part to the pharmacy management program described below. These figures do not include pharmaceuticals provided by managed care organizations which contract with the state.

Spending on pharmaceuticals, nursing homes, hospitals and other providers would be increasing even more rapidly if not for the shift of Medicaid recipients to managed care plans. Increased reliance on HMOs to coordinate services to members has been a central part of the state's strategy for controlling Medicaid spending since the mid-1990s. In November 2004, 278,000 members—nearly 29 percent of the total—were served by HMOs, up 19,000 or 7.4 percent over the previous year. As a result of this shift, Medicaid spending on managed care has increased by 136 percent since 2000 and now accounts for 15 percent of the total. However, the increase in spending on managed care is offset by reduced growth rates for direct spending on other categories of services.

Medicaid spending is especially affected by the enrollment of high-cost populations, particularly the elderly and the disabled. Elderly beneficiaries were 12 percent of the enrollment in 2004 but accounted for approximately 34 percent of spending. The disabled accounted for 21 percent of enrollment and 36 percent of spending (see Figure 10).

Part of the growth in Medicaid spending over the last few years is attributable to the rising number of disabled beneficiaries. Enrollment of disabled adults and children rose by 14,600, or 7.8 percent, between 2000 and 2003, faster than any other group. However, over the last year disabled enrollment has risen more slowly than other groups, contributing to the slowdown in spending growth.

Though overall enrollment has not been the major factor underlying Medicaid spending growth in recent years, it could again become an important issue if proposals to expand coverage, discussed further below, are implemented.

Medicaid enrollment reached a peak of 996,000 in August 2002 and then dropped steeply to 913,000 a year later. The decline was due to a combination of the elimination of "MassHealth Basic" coverage for 50,000 long-term unemployed state residents in 2003, and what critics contend were deliberate efforts to manage costs by making it more difficult for individuals to enroll in the program.

Enrollment has been climbing slowly since August 2003. The December 2004 count of 973,000 is up nearly 45,000, or 4.9 percent, from a year earlier, but is still more than 22,000 below the August 2002 peak.

Nearly all of the recent growth is in the "MassHealth Essential" program that was created in fiscal 2004 to replace MassHealth Basic in providing pared-down coverage for the long-term unemployed who are not eligible for standard Medicaid benefits. Enrollment in the $160 million Essential program reached its cap of 36,000—compared to 50,000 covered by MassHealth Basic—late in 2004, and additional applicants were put on a waiting list. Early in 2005 the state received approval from federal authorities of a waiver that allows the state to increase enrollment to 44,000, though spending must be kept within the $160 million budget.

Despite the Governor's call to enroll all of the estimated 106,000 uninsured residents who are currently eligible for Medicaid but not enrolled, his budget contains no proposals to expand eligibility for Medicaid, and anticipates enrollment growth of only 13,000, or 1.3 percent, in fiscal 2006, including the higher cap on MassHealth Essential. The rise follows an expected increase of 29,000 in 2005.

The projected growth is aided by a newly developed "virtual gateway," a web-based, single application for a variety of health and human services programs, together with a new requirement that hospitals providing free care under the uncompensated care pool seek to enroll patients in Medicaid. House 1 would also provide grants to community organizations to conduct outreach and enroll eligible members.

At the same time, the budget would discontinue funding for 3,000 elderly and disabled legal immigrants whose eligibility was temporarily restored over the Governor's veto in fiscal 2005. Restoring eligibility for this group and another 7,000 legal immigrants who were made ineligible by budget cuts in fiscal 2004 would cost about $15 million.

Medicaid Savings Measures Medicaid's spending growth is occurring despite a series of cost-cutting measures adopted in the 2003 and 2004 budgets, including cuts in eligibility and services as well as payments to health care providers.

In addition to the reduced eligibility for the long-term unemployed discussed above, coverage for special-status immigrants, emergency detoxification for uninsured recipients, and enrollment freezes for the Family Assistance and Commonhealth programs were adopted in 2003, reducing annual spending by about $40 million.

A strict prior approval process for expensive prescription drugs, including popular new medications for arthritis, ulcers, allergies and mental illnesses, was instituted in 2003. The pharmacy management program is designed to encourage the utilization of the most cost-effective alternative in each class of drugs, as well as less costly generic versions. A prior authorization requirement for all prescriptions for members receiving seven or more prescriptions per month was added in 2004. This initiative is estimated to have saved $98 million—and contributed to an overall decline in pharmaceutical spending—in fiscal 2004, and another $47 million in 2005._House 1 assumes another $31 million in savings from refinements to the program.

The Commonwealth also revised its rules for counting income and assets of Medicaid recipients and their spouses, reducing annual spending on nursing home care by an estimated $23 million. A new process for reviewing the disability status of Medicaid recipients has saved another $7 million annually.

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

Reductions of three to five percent in rates paid to hospitals, nursing homes and other providers were imposed in 2004. Together with other reductions implemented in 2003, provider rate cuts were projected to save $144 million annually. However, legislative language in the 2005 budget required the administration to revert to the rates in place before the 2004 reductions.

Despite the reversal of the 2004 cuts, Massachusetts continues to pay Medicaid providers much less than the full cost of services. Hospitals, for example, argue they are reimbursed at some 70 percent of their costs. Underpaying only adds to the financial strains on the state's health care system and creates incentives for providers to shift costs to other payers, adding to the rising costs of private insurance premiums. The need to develop and implement a multi-year plan to bring provider reimbursements in line with costs remains one of the Commonwealth's most significant unfunded obligations.

The Governor's proposed 2006 budget offers no solutions to the problem of below-cost Medicaid reimbursement rates, while two "cost-saving" provisions would exacerbate the impact on provider finances. A proposed nursing home rate freeze would defer an estimated $43.5 million in rate increases to fiscal 2007—on top of the accounting shift discussed above—and a $92 million reduction in state contributions to the uncompensated care pool, discussed further below, would increase the projected gap between uncompensated care costs borne by hospitals and payments they receive from the pool.

House 1 also proposes to save Medicaid dollars by increasing funding for utilization review and audits, and stepping up efforts to root out fraud and abuse.

Finding additional savings in fiscal 2006 without further eliminating eligibility for existing populations or reducing mandated services will be enormously difficult, especially with the focus of policymakers turning to expanding coverage of the uninsured.

Uncompensated Care Pool The state substantially increased its contributions to the uncompensated care pool—the mechanism for paying "free" care provided to the uninsured—in fiscal 2005 in an attempt to relieve serious financial shortfalls for hospitals and other providers. Financed primarily through surcharges on hospital 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. State contributions have increased from $85 million in 2004 to $198 million in 2005, bringing the total pool budget to $839 million this year.[15]

As noted above, House 1 proposes to reduce state spending on the pool by $92 million (net of MassHealth Essential spending). As a result, hospitals project that their uncompensated care costs will exceed their reimbursements from the pool by $333 million, doubling the projected gap in 2005. Cuts in Medicaid eligibility, together with benefit cutbacks by private employers faced with soaring insurance premiums, have added to the demand for uncompensated care. Without corrective action, the financial burden of pool funding gaps will fall on the state's already stressed hospitals. The administration's plan to enroll Medicaid eligible patients who now receive free care through the pool is designed to reduce the demand for uncompensated care. However, House 1's proposed Medicaid funding anticipates only a tiny increase in Medicaid enrollment that would be insufficient to offset the cut in state funding for the pool.

After a slow start, the administration has begun to implement positive and much needed reforms of the pool's mission, scope and administration that are intended to bring greater accountability and hold down costs. The reforms, enacted in the 2004 budget, were drawn from the recommendations of subcommittees of a special commission convened in 2002 to examine the pool's finances and management. These include an independent audit to examine the costs of services being billed to the pool; redefining the scope of hospital services which would be covered to include only emergency, urgent and critical access services; requiring verification of income as well as eligibility for Medicaid or other coverage before providing free care; and implementing utilization review for the pool.

Threats to Federal Funding Financing for Medicaid and other health care spending is made more difficult by a series of unresolved questions concerning federal funding. On top of the inexorable rise in costs, the Commonwealth faces a variety of threats to the federal reimbursements that pay for roughly half of the state's Medicaid and uncompensated care pool spending. While the size and final impact of each of these remains unknown, any significant cutback in federal funding would exacerbate the challenges state leaders face in sustaining current services and expanding health care coverage.

One issue stems from the creation of prescription drug benefits for Medicare beneficiaries under the federal Medicare Modernization Act of 2003. Medicaid is responsible for providing drug benefits to the 190,000 so-called "dual-eligibles"—low income seniors and disabled residents who are eligible for both Medicaid and Medicare—until January 1, 2006, when the new Medicare benefit is fully implemented and assumes responsibility for paying for drugs for this group. Rather

[15] The state contribution figures are net of transfers from the pool back to the Commonwealth for the MassHealth Essential program.

than receiving windfall savings on their Medicaid spending, states will be required to make so-called "clawback" payments to the federal government based on their prior spending on pharmaceuticals for dual-eligibles.

The financial impact of the new Medicare drug benefit will not be known until the formula for the clawback payments is made final. The payments, estimated in House 1 at $120 million, as well as reduced rebates from drug manufacturers, will offset savings to the state from lower spending on pharmaceuticals for dual-eligibles. The budget assumes a bottom line cost of $77 million. At the same time, the budget projects savings of $18 million from proposed changes to asset transfer rules and disabled eligibility, but approval of the required federal waivers is uncertain.

Also in a state of uncertainty is the extension of the waiver that allowed federally funded health care safety net payments to hospitals and other providers—so-called intergovernmental transfers and disproportionate share hospital payments—leaving $600 million in federal funding for providers at risk. The state secured a commitment to extend the waiver through fiscal 2008, but new mechanisms to support the safety net payments will have to be developed. The payments are in addition to federal reimbursements for the Commonwealth's on-budget Medicaid spending, that is, they are on top of the roughly $3.5 billion in Medicaid reimbursements that are built into the state budget. Nevertheless, the payments are a key part of the state's strategy for financing its health care safety net, and their loss would have a major impact on the state's ability to provide care for its low income, elderly and disabled residents.

Compounding the threat to safety net payments is the Bush administration's proposed budget, which reportedly would reduce the Commonwealth's Medicaid reimbursements by $1.2 billion over the next decade. The greatest potential threat to future federal Medicaid payments are proposals under consideration in Washington to convert Medicaid from an entitlement—where the federal government and states are obligated to share the costs of services to all eligible beneficiaries—to a block grant, under which states would receive fixed federal payments to cover part of their Medicaid spending. Depending on how block grants were structured, states would be responsible for most or all cost increases due to inflation, increased utilization or rising enrollments, liabilities they now share with the federal government. A 2003 Bush administration proposal that offered states larger block grants in the initial years of the new system in exchange for more limited payments in future years was not adopted but could be reintroduced as the administration struggles to reduce federal budget deficits.

Universal Health Care Expanding health care coverage is clearly at the top of the agenda for state policymakers, with a proposed ballot initiative and proposals by the Governor and health care advocates to extend coverage to an estimated 460,000 to 650,000 uninsured state residents.

Expanding access to health insurance will require additional spending, and proposals that simply reallocate current spending will help address the problem only on the margins. A study commissioned by the Blue Cross Blue Shield Foundation as part of the Roadmap to Coverage project estimated that it would cost between $374 million and $539 million annually to cover the uninsured, depending on which estimate of the number of uninsured is used.[16] This cost is in addition to what the Commonwealth already spends on health care for the uninsured through the uncompensated care pool and other programs, and would come on top of the increases in spending that will be required just to maintain current levels of Medicaid and other health care services.

The proposals that have been made to extend coverage vary widely in their specificity and their approaches to paying for the costs of expanded coverage. In 2004 a proposed constitutional amendment that would require the Legislature to ensure that every state resident has comprehensive, affordable, equitably financed health insurance received the first of two required legislative endorsements before going to the voters for final approval. The proposal includes no cost estimates or plan for funding expanded coverage—those are left to the Legislature. The measure was amended to require voter approval of any legislative plan for universal health care, providing an important safeguard against adopting an unaffordable and economically ruinous system.

Last November the Governor outlined a proposal to expand coverage by offering basic no-frills insurance plans and replacing the uncompensated care pool system with a new "Safety Net Care" managed care network for the estimated 150,000 residents who cannot afford insurance but are not eligible for Medicaid. The proposal would also extend Medicaid coverage to the estimated 106,000 residents who are eligible but not enrolled. Other than a projected 13,000 increase in Medicaid enrollment, the proposal was not included in House 1, and the administration has suggested that the plan could be implemented without spending additional funds. However, even if the cost of covering the Medicaid-eligible individuals was no more than the cost of the reduced-benefit MassHealth Essential program for the long-term unemployed, adding 106,000 to the Medicaid rolls would cost over $450 million annually ($225 million net of federal reimbursements). The state's share of the cost could be partially offset by reduced contributions to the uncompensated care pool, but these funds are also expected to fund Safety Net Care.

A proposal developed by the advocacy group Health Care for All and introduced in the Senate would go further in expanding Medicaid by extending coverage to individuals with incomes up to 200 percent of the poverty level (currently Medicaid generally covers up to 133 percent) and providing sliding scale subsidies for people with incomes up to 400 percent of poverty to buy into Medicaid. The plan would also include higher Medicaid reimbursement rates for providers based on provider costs, reinsurance of catastrophic health care costs in order to lower private insurance premiums, and an expanded Insurance Partnership program with additional subsidies for small businesses to offer insurance to their employees. An estimate of the total cost of the program is not yet available, though the proponents have suggested some possible funding sources, including an assessment on employers who do not offer insurance and a 50-cent tobacco tax increase.

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[16] *Caring for the Uninsured in Massachusetts: What Does It Cost, Who Pays and What Would Full Coverage Add to Medical Spending?*, The Urban Institute, November 2004.

State Employee Health Benefits Many of the same pressures that are driving Medicaid spending also affect the cost of health insurance for state employees. In an effort to control state expenditures, the Commonwealth has shifted a variety of costs to employees, moved from fully insured plans to self-insured plans, and restructured reimbursements to health care providers.

The 2004 budget increased the share of health insurance premiums paid by state employees from 15 percent to 25 percent for new hires, and to 20 percent for current employees who make $35,000 or more, saving roughly $25 million. All other active employees and recent retirees continue to pay 15 percent. The 20 percent rate is scheduled to expire and revert to 15 percent at the end of this fiscal year.

The Commonwealth will also save an estimated $35 million in 2005 from a combination of measures adopted in prior years—higher employee premiums, increases in co-payments for prescription drugs, office visits and other services, larger deductibles for hospital stays, and elimination of the Commonwealth's 85 percent subsidy of premium costs for Medicare Part B coverage for retirees. Another $40 million in estimated savings results from moving to a market-based reimbursement system in which hospital payments are linked to prices paid by HMOs.

As a result of these measures, health benefits for state workers are budgeted to rise by only 5.0 percent to $850 million in fiscal 2005. However, the savings from moving employees to self-insured plans has been less than anticipated, and a supplemental appropriation may be required to cover higher spending.

The Governor's budget for fiscal 2006 includes a positive proposal to have all active employees and able-bodied retirees under the age of 65 pay 25 percent of the cost of their health benefits, saving an estimated $60 million. Even with these savings, benefit costs are projected to reach $920 million, an 8.3 percent increase, due to rising insurance premiums and self-insurance payments.

Clearly, the Legislature will need to address the issue of employee benefit costs in its 2006 budget. Failure to take action on employee contribution rates would add approximately $88 million in spending—the loss of the $60 million savings in the Governor's budget and another $28 million due to the sunset of the current 20 percent rate for higher paid employees.

Need for Critical Capital Investments

Over ten percent of the budget, $2.8 billion in the Governor's 2006 House 1 proposal, 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 of operating dollars to off-budget funds for spending on capital projects (see Table 7).[17]

Table 7

10% of Operating Budget Pays For Capital

Fiscal 2006 House 1

($, millions)

On-Budget	
Debt Service on Commonwealth Bonds	$1,800.5
Water Pollution Abatement Trust	72.5
Route 3 North Lease Payments	26.8
Mass. Turnpike Authority Subsidy	25.0
Capital Projects Reserve	24.0
Nanotechnology Manufacturing Center	21.0
Convention Center Authority Debt Asst.	14.7
Mass. Development Finance Debt Asst.	13.3
Foxborough Industrial Dev. Fin. Auth. Debt Asst.	5.3
Subtotal	$2,003.1
Off-Budget	
Dedicated Sales Tax: School Building Assistance	$488.7
Dedicated Sales Tax: MBTA Debt Service	approx. 300
Registry Fees: Transportation Infrastucture Fund	52.2
Total	**$2,844.1**

Spending on debt service and contract assistance has been rising as the state grapples with an enormous backlog of capital needs. In House 1, total outlays for capital are budgeted to jump by about $250 million, or 9.6 percent, in 2006. While discretionary proposals by the Governor for a nanotechnology manufacturing center, two new courthouses and repairs to parks and recreation facilities account for $45 million of the additional costs, the bulk of the growth is the result of largely unavoidable—at least in the short term—increases in debt service and sales tax revenues dedicated to school building assistance.

Despite the increased spending on debt service and contract assistance, the cost of the Commonwealth's capital investment priorities far exceeds its financial capacity, and the need to repair, replace, enhance and expand the state's aging infrastructure represents a huge long-term challenge.

With the state's ability to issue bonds—the primary means of financing capital projects—limited by its heavy debt burden, a host of projects compete for a share of the bond cap, including roads and bridges, transit lines, seaports, drinking water and wastewater systems, parks and recreational facilities, open space, higher education campuses, courthouses, prisons, public housing, and information systems.

At the same time, other capital funding sources dedicated to transportation

[17] 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.

needs—the largest category of capital spending—are also stretched thin. Over the next decade, $1.5 billion of federal highway aid will be diverted from road and bridge projects to repay Central Artery debts. Uncertainties regarding toll revenues threaten to undermine the finances of the Artery and the Turnpike Authority, and the MBTA is under fiscal stress and cannot afford any of the long list of expansion projects it is expected to build.

The administration's recently released long-range transportation plan highlights the state's challenges. On the positive side, it recognizes that the Commonwealth must assume responsibility for financing most transit expansions and focuses on the state's growing backlog of deficient bridges. However, the plan includes no significant new funding sources other than optimistic assumptions of future federal aid, thus ensuring that the state will fall further behind in meeting its capital needs.

Increasing Costs Debt service on Commonwealth bonds constitutes the largest item in this category and is the source of most of the growth. Even though the administration limits the amount of bonds issued each year to control growth in debt service costs, spending is budgeted to jump by $123 million, or 7.3 percent, in fiscal 2006, following an 11 percent increase in 2005. Several factors are contributing to the rapid growth:

- The administration increased its bond cap from $1.0 billion to $1.2 in 2002 and to $1.25 billion in 2004 to help address the long list of capital projects awaiting funding, resulting in approximately $75 million in additional debt service costs in 2006.

- Starting in 2000, $1.5 billion in bonds were issued—outside of the bond cap—to cover Central Artery overruns. Payments on these bonds, budgeted at $65 million in 2006, are supported by revenues from the reinstatement of Registry of Motor Vehicle fees.[18]

- Approximately $500 million in bonds—also outside of the cap—will be issued in fiscal 2005 to capitalize the new School Building Authority (discussed further below), boosting annual debt service costs by roughly $40 million; another $500 million will be issued in 2006.

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

In addition to the debt service costs of the school building bonds, under the reform legislation adopted in 2004, an increasing portion of sales tax revenues will be dedicated to school building assistance until it reaches one cent of the state's five-cent sales tax in 2011. Sales tax transfers are scheduled to increase from $396 million in 2005 to $489 million in 2006, eventually reaching approximately $800 million in 2011.

This large commitment of taxpayer dollars addresses one of the Commonwealth's biggest fiscal challenges: helping cities and towns pay for hundreds of current and future school building projects while

[18] Revenue from the restored Registry fees that is not needed for debt service on the Artery bonds is transferred to an off-budget fund for spending on transportation capital projects; these transfers are also included in Table 7.

limiting the state's obligations over the long term. The funding levels under the new plan are sufficient to finance $5 billion in remaining payments for projects already receiving reimbursements, to make payments on all projects on the program's waiting list within 3½ years, and to begin payments for future projects in fiscal 2008. At the same time, the Commonwealth's share of future costs will be capped by the dedicated revenue source, a critical improvement over the old financial structure.

Table 8

Capital Demands Far Exceed Cap

($, millions)

Category	Previously Authorized / Unissued Bonds 2003/4	Prior Years	Total	FY05 Capital Allotment
Transportation	$2,759	$2,762	$5,521	$573
Environment	0	822	822	132
Housing	470	624	1,094	123
Courts	0	453	453	106
Higher Education	0	232	232	72
Information Technology	0	185	185	82
Public Safety	0	141	141	61
Other	0	1,145	1,145	131
Total	$3,229	$6,364	$9,593	$1,280

Does not include $1 billion authorized for School Building Assistance

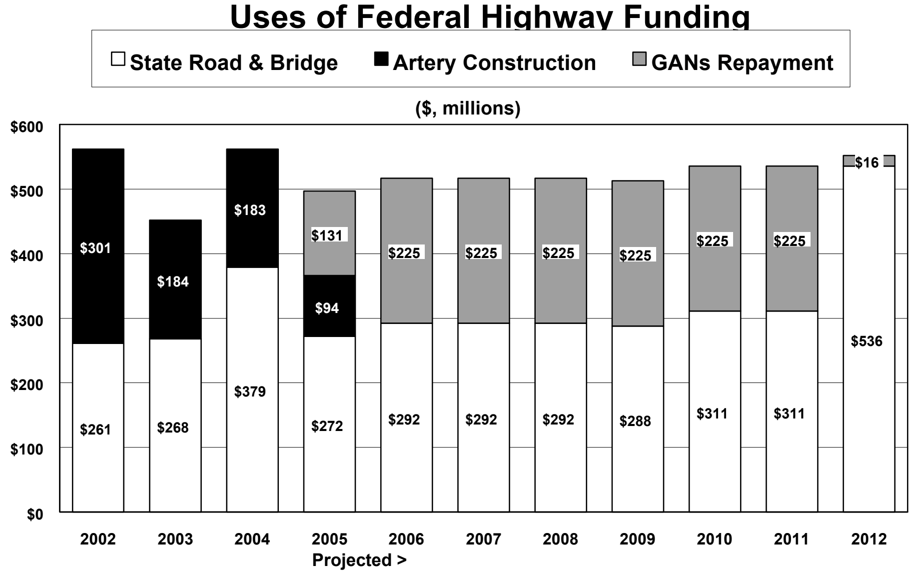
Bond Cap Double-digit growth made debt service one of the budget busters contributing to the fiscal crisis of the late '80s and early '90s and led the Weld administration to impose an $825 million annual limit on bond issues in order to control growth in debt service costs. The bond cap has been increased several times, most recently in fiscal 2004, and now stands at $1.25 billion.

The cap has been successful in slowing the growth in debt service, which increased at a moderate average annual rate of 3.6 percent from 1993 to 2006, but has also led to a long backlog of unfunded projects. The cost of projects authorized for bond funding is now nearly eight times the annual spending under the bond cap, and many additional projects have not yet been authorized. Over $3.2 billion was authorized in the 2003-2004 legislative session alone, primarily for transportation (see Table 8). The administration's proposed long-range transportation plan commits billions of future bond dollars to transit expansions—projects that have traditionally been financed outside the cap in the MBTA's capital budget—a necessary step if the projects are to be built, but one that will only add to the squeeze without a substantial increase in the cap or the identification of other sources of revenue.

With nearly the highest debt levels in the country, the Commonwealth cannot afford to borrow its way out of the backlog. Ideally, the cap should increase to reflect growth in the state's economy and ability to invest in infrastructure. However, with rising debt service costs already a contributing factor in the state's structural deficit, a substantial increase in the cap without new revenues to fund the added debt service would necessitate deeper cuts elsewhere in the state budget.

Figure 11

Uses of Federal Highway Funding



Source: Central Artery/Tunnel Project Finance Plans

Federal Transportation Aid Congress continues to consider reauthorization of federal funding for highways and transit. While the amount Massachusetts will receive under the new legislation remains uncertain, there are indications that the state should see an increase in federal aid. The Commonwealth currently receives between $500 and $600 million in federal funds annually for highway projects and roughly another $200 million for MBTA transit improvements.

The level of future federal highway aid is especially critical because the state will need to divert $1.5 billion of that aid to repay so-called Grant Anticipation Notes issued in the late 1990s to help cover Central Artery costs. Even though spending on Artery construction is winding down, the note payments will limit the state's ability to finance other transportation needs until at least 2012 (see Figure 11).

The administration's new transportation plan tries to leverage an additional $1.6 billion in federal New Starts funding to cover 60 percent of the costs of four major transit expansion projects—the Silver Line Phase III, New Bedford-Fall River commuter rail, Blue Line extension to Lynn and Urban Ring Phases I and II. New Starts funds are competitive, discretionary grants that are awarded for selected projects on top of the state's formula-based funds. Winning federal funds for all four projects would be an extraordinary achievement. Currently, only the Silver Line project is near the stage of receiving approval for New Starts funds.

Toll Issues The long-term finances of the Central Artery project and the Turnpike Authority are also threatened by unresolved issues regarding tolls. Toll revenues, a critical element of Artery finance plans, are expected to cover about $1.3 billion or nine percent of construction expenditures, and all of the ongoing operating and maintenance costs totaling at least $40 million per year.

Discounts created to offset the impact on tollpayers of the 2002 toll increase are costing the Turnpike Authority $14 million per year in lost revenue, with no ongoing funding sources to take their place. The Turnpike is currently covering the discounts with one-time revenues from land sales, an unsustainable position. Moreover, in order for the Authority to meet its debt service and maintenance obligations, the Artery finance plan requires additional toll increases in 2008—$0.25 at Rt. 128 and Cambridge/Allston and $0.50 for the harbor tunnels—and every six years thereafter. Given the resistance to the 2002 increases, implementing future increases is likely to be problematic.

The state's ability to cover Central Artery costs with toll revenues would be further undermined under the Governor's proposal to merge the Turnpike Authority and the Highway Department. The Governor has proposed to use the projected savings to cover the discounts over the long term, and to use Turnpike debt reserves to provide additional toll relief, potentially including deferring the 2008 toll increase. If this proposal were implemented, the state would be cutting a major source of transportation funds at the very time it needs more revenues to finance investments in transportation that are critical to the state's economic future. While the use of tolls to finance transportation improvements is expanding across the country and the world, Massachusetts would be marching in the opposite direction by reducing user fees.[19]

MBTA Capital Funding Pressures Even after a decade of rapid expansion in the 1990s, the Commonwealth is still under tremendous pressure to expand the transit system, including more than $2 billion in projects legally required as environmental mitigation for the Central Artery. The agreement signed by the Executive Office of Transportation and Construction and the Executive Office of Environmental Affairs commits the state—not the MBTA—to construct the Greenbush commuter rail line, restore Green Line service on the Arborway, complete the central segment of the Silver Line between Boylston Station and South Station in Boston, extend the Green Line north to Medford, and connect the Red and Blue lines in Boston. Major enhancements to the Blue and Orange lines bring the total costs to over $3 billion (see Table 9).[20] Other proposed expansion projects that are not legally required but have persistent and vocal support, such as the New Bedford-Fall River commuter rail line, the Blue Line extension on the North Shore, and the Urban Ring, would cost at least $5 billion more.

At the same time, the Authority's focus on expansion in the 1990s left the T with a $2.7 billion backlog of deferred maintenance and modernization of its

Table 9
MBTA Artery Commitments
($, millions)

Expansions	
Greenbush Commuter Rail	$479
Silver Line Phase III	859
Arborway Restoration	95
Green Line Extension to Medford	461
Blue Line/Red Line Connector	237
Subtotal	2,131
Enhancements	
Blue Line stations/6-car trains	579
Orange Line signals & vehicles	367
Total	$3,077

[19] MTF's May 2004 report on transportation restructuring, *The Road to Reform: Restructuring the Commonwealth's Transportation Agencies*, included an analysis of an earlier administration merger proposal.

[20] The total cost includes approximately $500 million that has already been spent and another $750 million that is funded in the T's capital plan.

present system. The T would need to spend about $450 million per year on repair and replacement projects—about $100 million more than it currently spends—just to stay even, and $570 million per year—about $75 million more than the T's total capital spending, including expansion—to eliminate the backlog over 20 years.

The T's ability to finance its capital program under the forward funding fiscal reforms that took effect in 2001 is limited by the finite state subsidies it now receives and by the need to control spending on debt service, which already consumes 30 percent of the T's budget. MTF's analysis of the T's capital finances concluded that the T cannot afford the mitigation requirements or any other expansion projects within its new fiscal constraints without sacrificing needed maintenance and modernization of its current system or undermining its long-term fiscal viability.[21]

The administration's new long-range transportation plan, which includes each of the projects referred to above,[22] represents a major step forward by recognizing the value of expanding the transit system and proposing that the Commonwealth take the lead in financing the most important new lines, while the MBTA focuses its more limited capital resources on sustaining the existing system (though the plan does saddle the T with one more costly expansion project—the Silver Line Phase III—in addition to the Greenbush line currently under construction).

Inclusion in the long-range plan does not constitute a firm funding commitment, and of the major expansion projects outlined above, only Greenbush is funded in the T's five-year capital plan. The funding levels contemplated in the long-range plan—$31 billion over 20 years—are comparable to what the Commonwealth and the T now spend on transportation improvements, and the plan proposes no new funding sources other than the uncertain-at-best federal New Starts funds discussed above and a modest $279 million from tax increment financing and other local sources.

Without additional revenue sources, the state cannot afford to issue bonds for T expansion projects without sacrificing other important capital investments. As a result, the competition for capital dollars will only intensify, with the new emphases on transit and bridges claiming funds that might otherwise have been spent on highway maintenance or other non-transportation capital needs.

Gaining support in the Legislature for bond funding for some of administration's priorities may be difficult. A massive transportation bond bill enacted in 2004 includes authorizations for $850 in bonds for MBTA projects—an acknowledgement of the need for the state to take responsibility for transit expansion—but none of the authorizations is for Artery mitigation projects.

Finding ways to finance the capital costs of expansion projects is only part of the problem. Each new line will add substantially to the T's operating costs—no transit line covers its operating costs from fares—exacerbating the pressure on the Authority's operating budget, which is already experiencing shortfalls due to

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[21] *MBTA Capital Spending, Derailed by Expansion?*, February 2002.

[22] The administration has initiated a process to reconsider the Arborway, Green Line and Red Line/Blue Line projects, but interested parties have threatened to file suit to enforce the agreement.

sluggish sales tax growth, a dip in ridership and rising fuel costs.

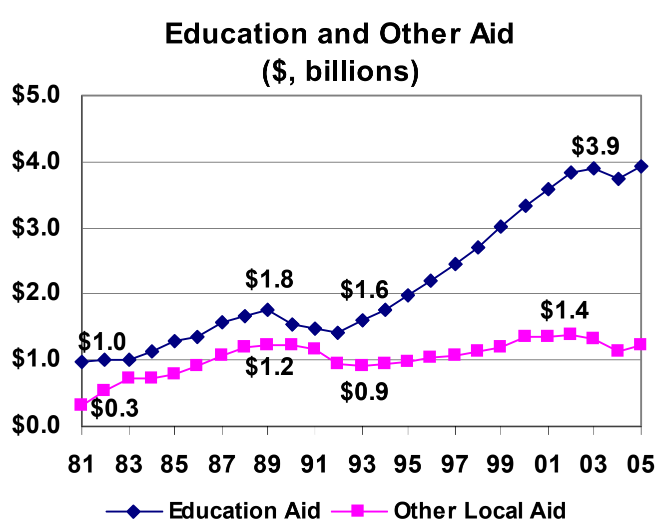
The transportation plan and its funding sources will be considered by the Transportation Finance Commission created by the 2004 restructuring legislation. The commission has been given the daunting task of assessing the level of resources needed to finance the highest priority projects and developing recommendations for new revenues, financing mechanisms and cost-saving measures necessary to implement the plan.

State's Obligation to Provide An Adequate Education to Massachusetts Children

For more than a decade, state aid to local schools—especially schools with above average educational needs and below average resources—has been one of Massachusetts' preeminent fiscal priorities. From 1992 to 2001, the state increased its funding for local education by almost $2.2 billion, or 11 percent a year on average, triple the rate of growth for non-education aid and more than double the rate of growth for the budget as a whole. Even with the onset of the fiscal crisis, education aid continued to rise for another two fiscal years, reaching a peak of $3.9 billion in 2003 (see Figure 12).

This huge increase in support for local education reflects a funding commitment undertaken as part of the education reform law adopted in 1993. Under the law, the state has an ongoing responsibility to

Figure 12



Note: Includes aid to municipalities and regional school districts distributed via the annual "cherry sheet," reimbursements for certain special education costs, and grants for early childhood ensure adequate spending in every school district, with increased aid for communities lacking the resources to support the necessary level of school spending on their own.

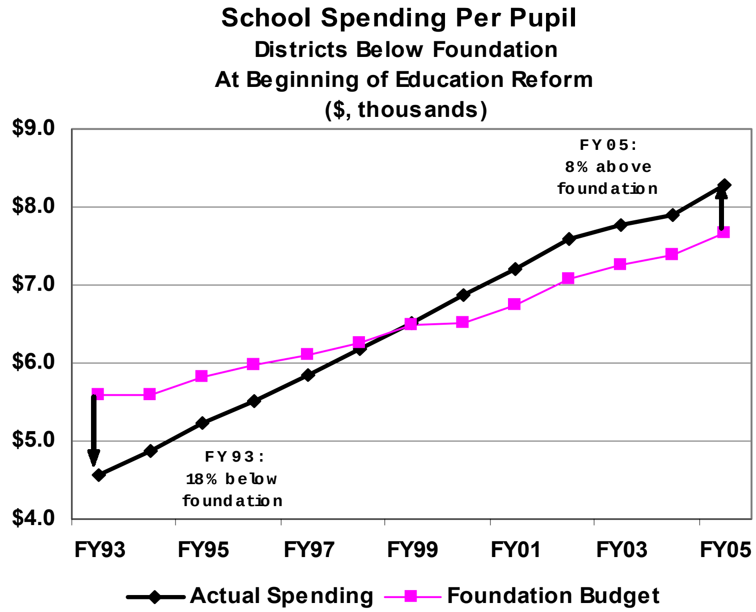
The adoption of the reform law was in part a response to the Supreme Judicial Court's *McDuffy* decision, which explicated the Commonwealth's obligations under the state Constitution to make available an appropriate public education to every child. The law defined the level of resources for each school district (the so-called foundation budget) that was thought to be sufficient to provide a constitutionally adequate education. It committed the state to major increases in funding that were intended to bring spending in each district up to the foundation level by fiscal 2000. It also established standards for student academic achievement that would be backed by "high-stakes" testing, and instituted managerial reforms intended to give local educators greater administrative flexibility in their efforts to improve student performance.

By many measures, the state's progress on both the financial and academic goals of the reform law has been outstanding:

- The Commonwealth met its fiscal commitment to bring all districts up to the foundation standard of spending by fiscal 2000—via a distribution formula that targeted aid dollars to the districts that needed them most—and since then has continued to meet that standard.

- While education aid was cut in fiscal 2004, the commitment to an adequate level of local school spending was preserved (although significant cuts in non-school aid undercut many communities' ability to meet that goal without major sacrifices in other areas of local budgets).

Figure 13



- Per pupil spending in the neediest districts—which had on average been 18 percent below the foundation amount in fiscal 1993—had risen to seven percent above foundation by 2001, a margin that was maintained through 2004, despite the cuts in state aid, and increased to an estimated eight percent in 2005 (see Figure 13).

- The state has developed detailed frameworks specifying the information and skills that students need to know in English and math, two of the seven areas of academic competency identified in the original *Duffy* case, and it is testing students in every district on their mastery of those two areas, with a minimum level of performance required for graduation from high school.

Even with this progress, the state still faces many managerial and financial challenges in its efforts to improve student performance, a point that was underscored by the Supreme Judicial Court when it set aside the *Hancock* school funding suit.

Even with the dismissal of the *Hancock* suit, the fiscal burden of continued progress will be substantial. Maintaining school spending at the foundation level required by the 1993 education reform law will necessitate annual increases in state appropriations of roughly $100 million per year at current rates of enrollment growth and inflation. A review of the "foundation budget" benchmark for adequate school spending—which has not been formally reviewed in almost four years—could well add substantially to those costs.

Following through on the other goals set out in the 1993 reform law will require some additional dollars as well. The state still needs to develop and expand curriculum frameworks in more subject areas, and to put in place the tests needed to measure performance against those frameworks.

At the same time, given the state's limited resources, most (if not all) of any additional state spending above the minimum required by the foundation budget will need to be targeted for results by coupling the funding with initiatives designed to improve school (not just student) performance.

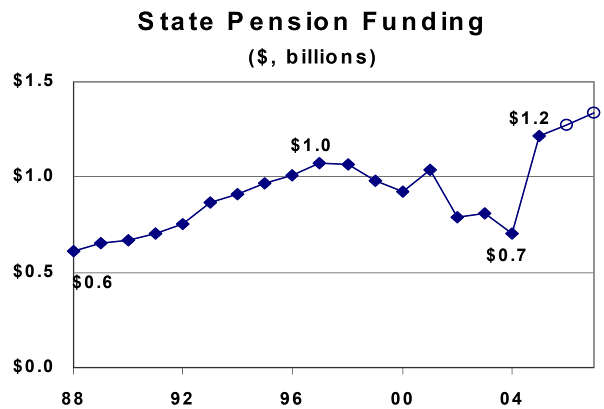
While the state's efforts to raise the level of school spending in the poorest districts has been successful, in many instances the higher levels of expenditure have not translated into significantly improved student achievement. This result is explained in part by some districts' inability to implement the basics of standards-based education reform—aligning their curriculums with state standards and using student achievement data to improve teacher performance—and in part by the state's lack of the administrative capacity needed to intervene effectively in under-performing schools.

Finally, fulfilling the commitment to expand early childhood education—already in state law—will place yet another major demand on the state's limited resources. With an estimated cost of up to $1 billion over the next decade, this long-term strategy for improving student achievement will have to vie with the shorter-term imperative to bring faltering schools up to an acceptable level of performance.

Long-Term Costs of Eliminating the State's Large Unfunded Pension Liability

After an unprecedented $532 million, or 77 percent, increase in fiscal 2005, annual funding for the state employee pension system is scheduled to rise between four and five percent over the next several years, a more moderate pace that is still double the rate of inflation (see Figure 14).

Figure 14



The future growth in annual pension costs—as well as this year's unprecedented hike—is required under financial reforms adopted in 1988 to eliminate the state's huge unfunded pension liability by 2028, a deadline that was subsequently advanced to 2023. The goal of the reform law is a "fully funded" state pension system, with enough assets on hand to cover the current costs of benefits already earned by retired employees, and annual contributions sufficient to cover the future costs of pension benefits earned each year by state employees.

The drastic increase in state pension costs in 2005 was the result of a combination of funding decisions and events over recent years:

- A precipitous loss in pension assets—almost $5 billion, or 20 percent, between 2000 and 2003—due to collapsing stock market values, which wiped out a significant portion of the previous funding gains;
- Significant benefit enhancements for state employees (as well as for local teachers, who participate in the state-funded system) that added more than $2 billion to the unfunded pension liability;
- Budgetary decisions that cut annual pension funding by almost one-third between 2001 and 2004, even as pension assets were declining and benefits expanding;
- An ill-advised, and ultimately unsuccessful, attempt in 2004 to transfer ownership of the Hynes Convention Center and the Boston Common Parking Garage to the pension fund in lieu of $145 million of state contributions that would otherwise have been required.

According to state law, the annual pension appropriation is determined through a funding schedule adopted by the Legislature and updated every three years. While the current schedule sets the appropriation for fiscal 2005-2007, any major expansion of retirement benefits would add to the unfunded liability and require a further substantial increase in annual pension funding. At the same time, the fiscal difficulties of the last five years have proven the folly of reducing pension funding on the basis of short-term performance in the stock market, and it would be a mistake to cut the state's appropriation based on the recent strong gains in the value of pension assets.

RESHAPING OF STATE PRIORITIES AS A RESULT OF THE FISCAL CRISIS

One of the most striking consequences of the 2002-2004 fiscal crisis has been the reshaping of the state's spending priorities, with rapid cost growth in some areas—especially health care—and deep cuts in others—including higher education and local aid. Medicaid, in particular, has become the tail that wags the dog: the program that drives the budget, rather than a program where spending levels are largely determined by policymakers' priorities.

While total spending grew by $2.82 billion, or 12.9 percent, between 2001 and 2005, that growth was driven by large increases in a handful of programs (see Table 10). Medicaid and other health care spending alone grew by over 40 percent between 2001 and 2005, rising from 25.6 percent of total spending to 32.3 percent in just four years. At the same time, most of the other areas of state government experienced major reductions or apparent level funding that masked sharp cuts in many smaller programs.

In fact, in an account-by-account analysis of the 2004 budget,[23] MTF identified spending cuts of nearly $2.9 billion since 2001—over $2.1 billion in direct spending reductions and another $720 million of averted increases in health care spending. While the pace of cuts slowed and funding was increased for selected programs in 2005, appropriations in most areas remain well below 2001 levels.

Higher education has been the hardest hit of the major spending categories. Despite a $54 million or 6.3 percent increase over 2004, the 2005 budget remains 17.5 percent below 2001 spending. While Chapter 70 education aid to cities and towns is higher in 2005 than in 2001, other forms of local aid have been cut by almost $290 million or 13 percent between 2001 and 2005, resulting in a miniscule increase of 0.2 percent in all forms of local aid.

- Education aid other than Chapter 70, a category which includes grants for class size reduction and early childhood education, has fallen by a total of $106 million or 13 percent since 2001;
- The distribution of lottery revenues to cities and towns has been cut by $121 million or 16 percent;
- Additional assistance has been scaled back by $98 million or 21 percent; and
- Chapter 81 gas tax distributions to cities and towns were cut in 2002 and eliminated in 2003, reducing local aid by another $43 million.

State assistance in fiscal 2005 remains well below its level prior to the fiscal crisis in roughly four out of every five communities in the Commonwealth. Taken in aggregate, these 273 municipalities in 2005 will receive $312 million, or almost nine percent, less in aid than at their prior peak. In 40 communities, 2005 aid levels will fall short by 20 percent or more.

These cuts have had a broad impact on cities and towns. The number of municipal employees, almost two-thirds of whom are teachers and front-line public safety personnel, declined by 14,200, or 5.2 percent, from the peak in February

[23] *2004 Budget: Major Strides, But More Pain Ahead*, August 11, 2003.

Table 10
Overall Spending Changes
Fiscal 2001-2005
($, millions)

	Cumulative Increase/(Decrease)		Percent of Total Budget	
	Amount	Percent	2001	2005
Health Care	$2,379	42.6%	25.6%	32.3%
Pensions and debt service	442	16.3%	12.4%	12.8%
Human services	183	4.1%	20.5%	18.9%
Public safety	136	7.9%	7.9%	7.6%
Education/other local aid	10	0.2%	22.4%	19.8%
Higher education	(194)	-17.5%	5.1%	3.7%
All other	(131)	-9.8%	6.1%	4.9%
Total	$2,824	12.9%	100.0%	100.0%

2002 to August 2004. Furthermore, local property tax burdens have been increasing at an accelerated pace in response to the cuts in state aid. Between 2001 and 2004, per capita taxes on the existing property tax base have risen roughly twice as rapidly as in most of the 1990s, adding more than $300 million to the local property tax burden. Other measures of fiscal health, including "free cash" levels and reliance on stabilization reserves, have also deteriorated.[24]

The state's environmental agencies have also absorbed a disproportionate share of budget cuts, with combined spending down $58 million or 24 percent since 2001.

[24] For more on the impact of local aid cuts, see the Foundation's *Municipal Financial Data* report released in October 2004.

After factoring out one-time supplemental appropriations for deferred maintenance and repairs at state parks, beaches and other facilities, expenditures for ongoing programs of the new Department of Conservation and Recreation are $38 million, or 34 percent, below spending in 2001 by its predecessor agencies, the Department of Environmental Management and the Metropolitan District Commission; only a small portion of the cuts could reasonably be attributed to administrative savings resulting from the merger.

Spending on the Department of Fisheries, Wildlife, and Environmental Law Enforcement is $9 million or 34 percent below 2001 levels even after a 29 percent budget increase in 2005. The Department of Environmental Protection has been reduced by a total of $15 million or 23 percent.

Like the overall budget, substantial spending increases in some human services departments, particularly Mental Retardation and Social Services, are offset by deep cuts in others, especially the Department of Public Health and housing assistance programs (see Table 11). The cuts in Public Health, where 2005 appropriations are more than 20 percent below 2001 spending despite a modest budget hike over 2004, are among the deepest of any department:

- Smoking prevention and cessation efforts have been reduced by $29 million or 62 percent;
- HIV/AIDS prevention and treatment has been cut by $15 million or 30 percent;
- Breast cancer detection and research dropped by $7 million or 68 percent, despite increases in funding in 2004 and 2005; and
- Family health services were pared by $6 million or 45 percent.

Table 11
Human Services Spending Changes
Fiscal 2001-2005
($, millions)

	Cumulative Increase/(Decrease)	
	Amount	Percent
Mental retardation	$170	18.5%
Social Services	138	24.1%
Transitional Assistance	64	10.0%
Youth Services	15	12.5%
Mental Health	(4)	-0.6%
Housing Assistance	(50)	-31.8%
Child Care	(56)	-11.0%
Public Health	(111)	-21.7%
Other	16	3.6%
Total	183	4.1%

Housing and homelessness programs in the operating budget have also been hit hard, with reductions of $50 million or 32 percent since 2001. While spending on housing production and preservation programs in the capital budget has increased over the same period, direct housing assistance to low-income residents and support for public housing authorities have been cut:[25]

- Rental vouchers and other rental assistance programs have been scaled back by a total of $10 million or 30 percent;
- Assistance for homeless individuals by the Departments of Transitional Assistance and Housing and Community Development has been cut by $7 million or 18 percent; and
- Support for public housing authorities is $1 million or 3 percent below 2001 levels despite a 31 percent increase in funding in 2005.

In addition to the pressure on lawmakers to restore these cuts, funding will also be needed over the long term to reform the rates paid to private human service providers. As documented in the Foundation's 2003 report, *Reforming the Commonwealth's $2 Billion Purchase of*

[25] Spending on bond-funded housing programs has increased from $79 million in 2001 to a projected $123 million in 2005.

Human Services: Meeting the Promise for Clients and Taxpayers, reimbursements to the private agencies that deliver the bulk of the state's human services are often far below the costs of providing quality services. Most human service providers have few options for shifting costs to other payers, so the results are a reduced ability to attract and retain a qualified workforce and downward pressure on the quality of services. The Governor's 2006 budget commendably includes $5 million to initiate rate reform, but much larger sums will be needed to align rates with costs.

The Governor's budget recommendations for fiscal 2006 demonstrate how difficult it will be to restore any substantial amount of these myriad cuts for the foreseeable future, or to significantly reshape the spending priorities emerging from the fiscal crisis. As a recent Foundation *Bulletin*[26] chronicled, the Governor has proposed an essentially level-funded budget for the coming fiscal year, with a bare 0.6 percent increase from 2005 (see Table 5 on p. 9). Only by means of an extraordinary accounting change was the administration able to avoid a further major increase in Medicaid in 2006, and most of the other growth was in debt service, education aid, pensions and other largely non-discretionary programs.

It is striking that after adjusting for inflation, the Governor's recommended 2006 expenditures are below 2001—by margins ranging from substantial to huge—in all but three areas—Medicaid and other health programs, debt service, and pensions.

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[26] *Governor's 2006 Budget: Continued Lean Times, Medicaid Accounting Change Key to Balance*, February 17, 2005.