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Point of Reckoning: Two Decades of State Budget Trends

BY CAMERON HUFF

THE MASSACHUSETTS STATE BUDGET has reached a point of reckoning. A stubborn structural imbalance threatens the state's ability to manage or grow current programs and services. Spending increases are outpacing revenue growth, with health care voraciously consuming a bigger slice of the fiscal pie.

This imbalance is exacerbated by volatility in revenue growth. Recent history reveals an over-reliance on the capital gains tax for more than half of the state's new tax receipts. Simply maintaining current programs now hinges on a revenue source that reacts in concert with Wall Street's boom and bust cycles.

Two trends add a sense of urgency to this situation: The nation is teetering on the brink of recession. As a result, Massachusetts is vulnerable to a dramatic drop in capital gains tax revenue—a drop that coincides with increased health care spending, stemming from rising costs, a likely expansion of the Medicaid rolls due to rising unemployment, and from the effects of the full implementation of the state's new universal health care law.

While Massachusetts is similar to other states in facing these pressures, the Bay State is also different because of its demographic trends. We continue to lose more people than we attract, with the exception of foreign immigrants. Unlike other states, Massachusetts is unable to rely on increased tax revenue from new workers and new businesses as a way to grow out of a recession. Furthermore, the state's existing population is older than the national average, which places greater strains on programs and services.

This brief outlines 20 years of Massachusetts budget history—at its core, a series of choices that reflect the state's collective values and priorities. There have been clear winners and losers over the last two decades. Most notably, health care has emerged as the state's top funding priority, with a long-term commitment to expand access to poor children and their families, the disabled, and the uninsured. A vigorous reform movement within K-12 education resulted in dramatic increases in spending since 1993. On the other hand, state support for public higher education and local aid was significantly cut back.

This history begs further discussion on the function and role of government. There are two obvious approaches to achieving structural balance: cut spending or raise taxes. Both have their perils. Which will work at this fiscal and economic moment? Is there a combination of the two? Do our volatile sources of revenue growth demand new strategies for injecting more stability into the system? Will the budget process now in place help or hinder in an effort to find long-term solutions to the imbalance? How can reform and increased transparency contribute to stability and potentially, to cost savings? Will we successfully navigate the politics of tough choices during tough fiscal times?

Cameron Huff can be reached at chuff@alum.mit.edu.

The policy brief's key findings, and the research behind it, are meant to jump start a statewide discussion that answers these questions. MassINC offers several recommendations to get the process moving. We look forward to hearing your voices and ideas.

I. What is the budget?

At the most basic level, the annual budget is a law. It gives state agencies and departments the legal authority to spend the money that the Commonwealth collects. In approving the budget, the citizens' elected representatives—the members of the House and Senate and the Governor—exercise their collective responsibility to determine how taxpayers' dollars will be used in the coming year—to decide where it puts its money. More broadly, the budget is the means by which the state puts its long-term spending priorities into effect.

It is the only formal financial planning process for the Commonwealth as a whole, and the only one in which the state's political leaders jointly participate.

The basic form of the budget—as proposed by the Governor and as ultimately adopted—is largely up to the Legislature. Over decades, much of the budget process has come to be set into state law, and the organization of the budget given a customary form:

✓ A statement of estimated revenues

KEY FINDINGS

- The Massachusetts budget faces a structural imbalance, with on-going spending exceeding revenues. This is an unsustainable situation that endangers the state's ability to meet basic commitments and key budgetary priorities, including the new universal health care law. At its core, there is a mismatch between expectations of reasonable revenue growth and the growth in spending required to maintain current programs and honor existing financial commitments. Based on historical performance, the growth in revenues in 2009 would be between $750 million and $1 billion, and the estimated growth in spending needed to sustain existing programs between $1.3 and $1.6 billion before any new programs or initiatives are included. This imbalance reflects long-term trends and is not particular to the current year. In order to balance the state's budget, state leaders have come to rely on nontraditional revenue sources and the rainy-day reserve fund.

- The state has become increasingly dependent on volatile funding sources for revenue growth—most notably, the capital gains tax. Between 2002 and 2006, capital gains tax revenues accounted for 54 percent of the state's growth in tax revenues. At the same time, this source of revenue has very large swings, tied to fluctuations in the stock market, including steep drops in revenue during bear markets. In 2002, capital gains tax revenues declined by almost $800 million in a single year. In 2006, capital revenue tax revenues were at a record high of $1.7 billion.

- In recent years the state has also become highly reliant on business taxes as a source of new revenue. Business tax receipts accounted for 41 percent of the state's new revenues between 2002 and 2006. Tax receipts from businesses are also volatile. Between 2000 and 2002, they dropped $700 million.

- On the spending side, health care has become the state's predominant spending priority, growing from 16 percent of the state's budget in 1987 to 30 percent in 2006. Medicaid accounts for nearly 90 percent of the state's health care spending. As an entitlement, the state is required to fund the state share in any given year or change the laws. The Massachusetts program offers more benefits than is federally mandated and also covers a broader population. Approximately half of the cost of Medicaid is paid by the federal government. Because many components of the program are not directly under the control of the state administrators (e.g. who and how many enroll and the health status of enrollees), spending can fluctuate unpredictably. Medicaid accounted for almost two-thirds of all spending growth since 1987. The state's new universal health care law adds further to the fiscal uncertainty.

- Over the last 20 years, there have been winners and losers as choices have been made about where to spend public dollars. At the same time that the state added almost $1.3 billion of new spending for education reform, non-school aid to cities and towns declined by almost $800 million. State support for public higher education fell by more than $300 million, with large swings in spending that led to major tuition increases. Public safety spending more than doubled from $600 million to $1.4 billion over the last two decades, while the overall human services budget remained essentially flat.

- Since 1987, the share of total state spending that occurs outside the annual budget has increased from 20 percent to almost 33 percent, creating confusion and a lack of transparency. In FY 2006, the state's budget was $25.6 billion, but total state spending was $37.5 billion. There is not consistency regarding what spending is on-budget and what is off-budget. In recent years, some spending for health care, employee pensions, public transit, and school construction has been removed from the state's annual budget.

✓ Numbered "line items" that specify the amounts that may be spent in individual programs

✓ Wording to earmark or constrain how some line item amounts are spent, and

✓ "Outside sections," separate provisions that may authorize additional spending, or alter the state's laws in ways that are totally unrelated to the budget.

After the budget is approved, it may be amended or added to over the course of the year, usually to provide money for programs that would otherwise run short of funds. At the end of the year, a final "wrap-up" spending bill is adopted, usually several months after the official close of the books on June 30th.

For much of the year, the budget is the major, and occasionally the sole, focus of the legislative process. Because the continued operation of state government depends on the spending authority it provides, the budget is the only legislation that must be acted on every year. Since it can include provisions on almost any subject—from tax laws and the organization of government to regulatory requirements and eligibility for state programs—it is considered by many lawmakers to be the surest, and speediest, way to get their legislative priorities implemented. Because lawmakers vote on the final budget as a whole, not piece by piece, legislation that might not win approval as a stand-alone bill—or even be recommended for adoption by the legislative committee responsible for reviewing the bill—is almost assured passage as an outside section.

RECOMMENDATIONS

MassINC offers the following recommendations as a way to jumpstart a statewide conversation on how to get the Commonwealth's finances back on track:

- Minimize the effects on the state's budget of capital gains tax revenues, which are, by their nature, highly volatile;
- Consider broadening the base of the tax revenue. While the broadening can be made revenue neutral by simultaneously reducing rates, such a change would inevitably shift a portion of the burden from some taxpayers to others. That said, tax increases in one area could be offset in another to ensure that no one group bears a disproportionate burden. This is a politically complicated option, and one that will take leadership, consensus building and compromise;
- Improve the transparency of Medicaid spending. While this federally-matching program has been leveraged strategically in certain instances, the state needs a better understanding of the cost drivers, given its size and impact on the state budget;
- Develop specific criteria for withdrawals from the reserve fund and limit the amount of withdrawals;
- Bring greater transparency to all government spending. Today's large amount of off-budget spending obscures the picture and prevents revenues and spending from being reviewed together; and
- Create a greater urgency around outcome measurement; eliminate duplication; and end programs that have outlived their purpose. While public policy experts agree that the structural imbalance cannot be solved through administrative reforms and greater efficiencies alone, it is imperative that the state foster a sense of responsibility and accountability through regular outcome measurement.

THE FORMAL PROCESS OF BUDGET MAKING

Under the Massachusetts Constitution, every tax dollar that government spends must be appropriated—must be authorized to be spent. Each January the Governor is required to submit to the Legislature his budget recommendations for the operation of state government in the coming fiscal year, which begins on July 1.* He must also provide evidence that revenues will be sufficient to pay for the spending that he recommends.

The Legislature may add to, reduce, place conditions on, or strike completely any of the Governor's spending proposals, and like the Governor, may include provisions that do not relate to budgetary expenditures at all. After lawmakers of both branches approve the budget—now in the form of a bill called the General Appropriation Act—it is sent to the Governor for his signature.

Although the Governor may decrease or eliminate specific appropriations in this bill, he cannot increase them. If the Governor does exercise this veto authority, his action can be overridden by a two-thirds votes in the House and Senate. Any additional spending that the Governor may propose during the course of the fiscal year must go through the appropriation process.

* In the Constitution, the term "budget" is reserved for this annual submission by the Governor.

FOUR EXAMPLES OF SPENDING AUTHORIZATIONS IN RECENT BUDGETS

0527-0100 For the operation of the ballot law commission $12,380

7061-0008 For school aid to cities, towns, regional school districts, counties maintaining agricultural schools, independent vocational schools and independent agricultural and technical schools to be distributed under chapters 70 and 76 of the General Laws and section 3 of this act; provided, that $200,000 of the funds allocated from this item to the city of Lawrence by said section 3 shall be transferred to the University of Massachusetts at Lowell for its college preparation program; provided further, that each school district shall report annually to the department of education on its professional development expenditures, in a manner and form prescribed by the commissioner and consistent with the accountability requirements of the federal No Child Left Behind Act; and provided further, that the department of education shall report annually to the house and senate committees on ways and means on school districts' professional development spending $3,288,931,062

SECTION 6. Item 4513-1010 of said section 2 of said chapter 149 is hereby amended by striking out the figure "$2,700,050" and inserting in place thereof the following figure:- $3,500,050.

SECTION 103. Notwithstanding any general or special law to the contrary, 10 days after the effective date of this act, the comptroller shall transfer $10,000,000 from the General Fund to the Massachusetts Life Sciences Investment Fund established pursuant to section 5 of chapter 23I of the General Laws.

Table 1

What Spending Is In the Budget, What Is Not Fiscal 2006 Actual Dollars (Millions)

IN THE BUDGET	
Spending from budgetary appropriations	$24,309
Pension contributions	1,275
Total spending in the budget	$25,584
NOT IN THE BUDGET	
Spending from special revenue funds,Lottery operations, including prize money	3,705
Federal grants other than Medicaid and capital	1,956
Health care	1,777
MBTA assistance	849
School building construction	475
Central artery/third harbor tunnel debt costs	212
Other	241
Subtotal	9,214
CAPITAL PROJECT SPENDING	2,390
OTHER	263
TOTAL NOT IN THE BUDGET	11,867
GRAND TOTAL*	**$37,452**

* Table excludes spending from the unemployment compensation and pension trust funds.
Note: Totals may not add due to rounding.

II. What is the budget not?

For all its importance, the annual budget is not the whole story of the Commonwealth's finances. A large share of the state's expenditures is decided and accounted for outside the budget process. In 2006, almost one-third of spending—roughly $12 billion of the $37.5 billion total—was not in the budget at all. In 1987, the share was 20 percent.

Most of this "missing" spending takes place in so-called special revenue funds—bookkeeping accounts, essentially—that are not included in the tally of budgetary expenditures.[1]

The costs of lottery operations and prizes, and payments for bond-funded state construction projects account for about half of the "off-budget" expenditures. The other non-budgetary spending encompasses a long and varied list of purposes: health care spending other than Medicaid, most of which supports uncompensated care, use of federal grants, the state's support for school construction and the MBTA, and many others.

The distinction between these "non-budgeted" funds and the spending that is counted in the budget is wholly a matter of state law. That law also requires that the comptroller, the state's chief accountant, report the Commonwealth's spending and other financial activity in two different ways each year, one reflecting the accounting framework stipulated in state law, the other conforming to generally accepted accounting principles or GAAP—the professional standards for financial reporting by businesses and state and local governments.

While segregation of different types of spending can be a useful accounting tool, the ways in which the Commonwealth makes use of its "non-budgeted"

TAKING INFLATION INTO ACCOUNT

A dollar is worth much less today than it was in 1987. In order to account for this erosion in purchasing power, the spending and revenue figures in the following sections of this report are stated in 2007 dollars, unless otherwise indicated. For example, $10.8 billion was actually spent in 1987; after adjusting for inflation that amount is equivalent to $20.8 billion in 2007 dollars.

This report uses the price index for state and local consumption expenditure and gross investment to adjust for inflation. Like the consumer price index, it is calculated by the U.S. Department of Commerce.

THE OTHER BUDGET: CAPITAL SPENDING

Capital spending supports the construction costs of state road and bridge projects, including the Central Artery/Third Harbor tunnel, and a broad array of other building and facilities projects.

Capital spending is largely financed by state borrowing — almost $1.8 billion in 2006 — as well as by federal dollars dedicated to highway construction. Debt service on this borrowing — annual principal and interest payments — is included in the regular budget. In 2006, debt service was almost $1.7 billion.

Budgeting for capital projects, which typically require several years to complete, is achieved through a series of capital budget bills. The borrowing to pay for the projects must be approved by two-thirds votes in both the House and the Senate.

Table 2

Total Budgetary Spending

Actual and Inflation Adjusted (millions)

	ACTUAL	2007 $
Fiscal 1987	$10,768	$20,846
Fiscal 2006	26,723*	28,046
INCREASE IN SPENDING 1987 TO 2006		
Dollars	15,955	7,200
Percentage	148%	35%
Annual average	4.9%	1.6%

* Includes $25.584 billion of on-budget spending and approximately $1.1 billion of off-budget spending for the MBTA, school construction, and Medicaid that was counted on-budget in 1987.

funds obscure the true scope of the state's finances. This opens the door to an incomplete or even false understanding of the fiscal health or shakiness of the Commonwealth—and to potentially bad decisions about whether taxes should be cut, spending reined in, or reserves tapped. The designation of some spending as on-budget, and other spending as not, makes it hard even to figure out what is being spent in individual programs, much less the budget as a whole.

III. The State's Spending Priorities

OVERALL SPENDING

In 1987, the Commonwealth spent a total of $20.8 billion—after adjusting for inflation—to provide health care, education and other aid to cities and towns, human services, and a host of other public programs and services.[2]

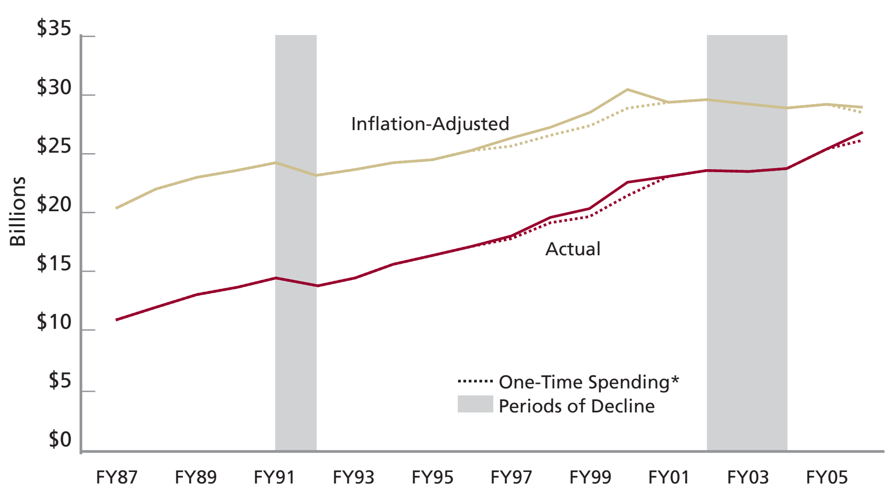
By 2006, the state budget had grown to $28 billion, up $7.2 billion, or roughly a third. Over the course of the two decades, expenditures increased by about one and a half percent a year, on average. Spending rose at a slightly slower pace than total personal incomes, but faster than the average paychecks of Massachusetts workers.[3]

While the annual averages may give the impression that the state's expenditures have grown steadily over the years, they have not.

Instead, spending has risen and fallen with the economy, with long periods of growth interrupted by two major economic downturns. Both times, the abrupt loss of state revenues brought on by these recessions helped push state government into fiscal crisis.

Figure 1

Massachusetts State Spending



*Non-recurring expenditures of surplus revenues totalling an estimated $319 million, $408 million, $638 million, and $732 million in fiscal 1997 through fiscal 2000, respectively, and $384 million in 2006.

In the first of these financial emergencies in the early 1990s, spending was wrenched downward by $1.5 billion, or more than 6 percent, in a single year (see Figure 1).

This was followed by ten years of growth as spending increased steadily at an inflation-adjusted average of three percent a year. Toward the end of the period, one-time expenditures of surplus revenues for capital projects and debt reduction added to the pace of spending growth.

Expenditures then fell again, dropping from almost $30 billion in 2002 to $28 billion in 2004. Although this $1.6 billion, or 5.5 percent, decrease was on the same scale as the 1992 decline, its impact on state programs was spread out over two years, in part because the rainy day fund was available to soften the blow during the downturn.

The 2002-2004 reduction was unlike that earlier decline in another respect: real spending did not immediately spring back, but instead continued to erode. While actual spending grew substantially in 2005-2006, it failed to keep up with rising inflation.

WHERE THE SPENDING WENT—THE BIG PICTURE

At the broadest level, the story of the Commonwealth's spending priorities is a simple one. Most of the state's resources go to a handful of major programs—health care, human services, local aid, and financial obligations—and have done so for decades.

In 1987, these four areas comprised roughly 75 percent of the state budget, about $15 billion of the $21 billion that was spent in that year. In 2006, their share of expenditures was practically

Figure 2

Total Budget by Major Area of Spending, Inflation-Adjusted 2007 Dollars

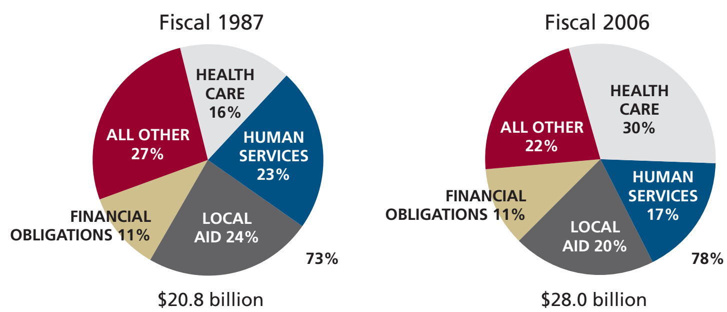


Table 3

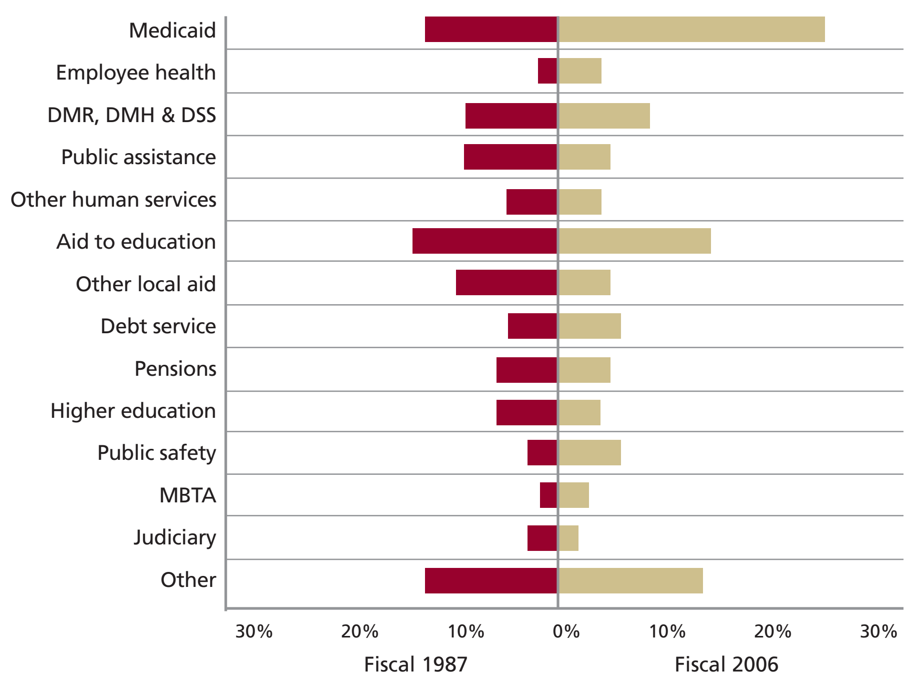
Broad Areas of State Spending, Inflation-Adjusted 2007 Dollars (millions)

	FISCAL 1987		FISCAL 2006		CHANGE FROM 1987-2006		
	AMOUNT	PERCENT OF TOTAL	AMOUNT	PERCENT OF TOTAL	AMOUNT	PERCENT CHANGE	AVG. ANNUAL CHANGE
Health care	$3,278	16%	$8,415	30%	$5,137	157%	5.1%
Human services	4,741	23%	4,881	17%	140	3%	0.2%
Local aid	5,054	24%	5,572	20%	518	10%	0.5%
Financial obligations	2,219	11%	3,086	11%	867	39%	1.8%
Subtotal	15,293	73%	21,995	78%	6,662	44%	1.9%
All other spending	5,553	27%	6,091	22%	538	10%	0.5%
Total	**20,846**	**100%**	**28,046**	**100%**	**7,200**	**35%**	**1.6%**

* Totals may not add due to rounding.

Figure 3

Spending by Major Program, Percent of Total Spending



identical—despite the budgetary roller coaster of the intervening years—accounting for almost $22 billion of the budget's $28 billion spending total.

What had changed—in fact, radically changed—was how that 75 percent was divided among the four areas:

✓ Health care's share of the budget almost doubled, from 16 percent in 1987 to 30 percent in 2006. This increase accounted for most of the growth in spending over that period. It also promoted health care—primarily for low income individuals, needy seniors, and the disabled—to the state's number one spending priority.

✓ The share devoted to the wide array of human services provided by the state fell from 23 percent to 17 percent over the twenty years, as flat human service spending lost ground to rapid spending growth in other areas.

✓ Local aid to cities and towns slipped in priority as well, dropping from 24 percent of spending in 1987 to 20 percent in 2006, even though local aid spending grew by 10 percent. This illustrates how a program's spending can grow while its share of the budget goes down.

✓ Only the state's long-term financial obligations to fund employee health benefits and to repay borrowing for capital projects held steady at 11 percent.

Of course, these large shifts say little about what should be spent in each of these areas—for example, whether the proportion of state spending devoted to health care was too low in 1987 or too high in 2006.

Nor do they necessarily mean that the amounts spent in other areas, say local aid, ought to have grown more rapidly.

What they do reveal is major transformations in the state's spending priorities over two decades. These long-term shifts—in how taxpayers' dollars are being used and what services are being delivered—become even more striking when spending within each of these areas is examined.

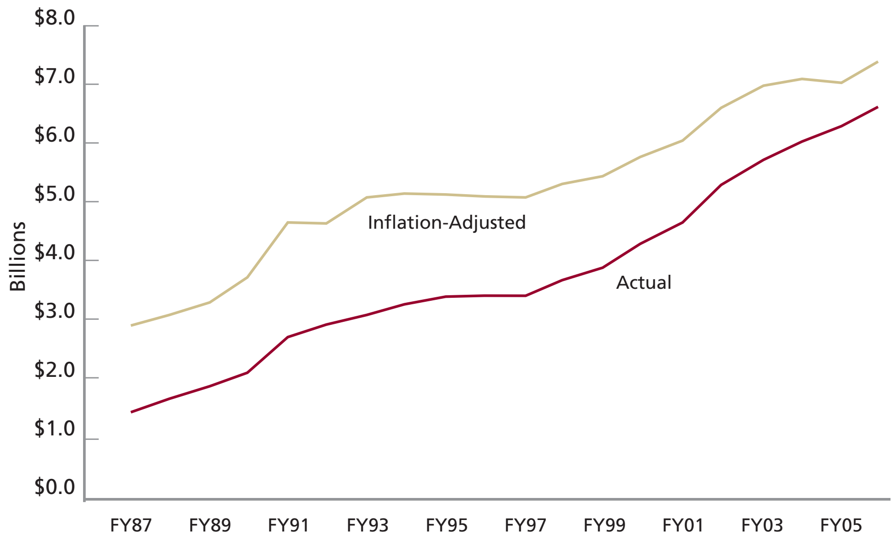
Table 4

State Spending by Major Program

	MILLIONS OF 2007 DOLLARS				
	FY1987	FY2006	CHANGE	PERCENT CHANGE	AVG. ANNUAL CHG.
HEALTH CARE					
Medicaid	2,814	7,403	4,589	163%	5.2%
Employee health	464	1,012	548	118%	4.2%
Total	**$3,278**	**$8,415**	**$5,137**	**157%**	**5.1%**
HUMAN SERVICES					
Public assistance	1,943	1,283	-660	-34%	-2.2%
Mental retardation	799	1,187	388	49%	2.1%
Mental health	714	661	-53	-7%	-0.4%
Social services	329	756	427	130%	4.5%
Public health	454	465	12	3%	0.1%
Youth services	94	147	54	57%	2.4%
All other	409	382	-28	-7%	-0.4%
Total	**$4,741**	**$4,881**	**$140**	**3%**	**0.2%**
LOCAL AID					
Aid to education	2,999	4,307	1,308	44%	1.9%
Other aid	2,055	1,265	-790	-38%	-2.5%
Total	**$5,054**	**$5,572**	**$518**	**10%**	**0.5%**
FINANCIAL OBLIGATIONS					
Debt service	1,015	1,748	734	72%	2.9%
Pension contributions	1,205	1,338	133	11%	0.6%
Total	**$2,219**	**$3,086**	**$867**	**39%**	**1.8%**
OTHER SPENDING					
Public safety	594	1,422	828	139%	4.7%
Higher education	1,350	1,037	-313	-23%	-1.4%
Judiciary	541	683	141	26%	1.2%
MBTA	457	748	292	64%	2.6%
Environment	285	205	-80	-28%	-1.7%
Housing	236	119	-117	-49%	-3.5%
Elder services	253	319	66	26%	1.2%
All other	1,836	1,558	-279	-15%	-0.9%
Total	**$5,553**	**$6,091**	**$538**	**10%**	**0.5%**
Statewide Spending	$20,846	$28,046	$7,200	35%	1.6%

Figure 4

Total Medicaid Spending



A CLOSER LOOK AT STATE SPENDING PRIORITIES

Health Care

In 2006, the state spent $8.4 billion for its two major health care programs, up more than $5 billion, or 150 percent, from 1987, after adjusting for inflation.[4]

Almost 90 percent of the $8.4 billion—and an equal share of the growth since 1987—went to Medicaid, a federal program that is administered by the Commonwealth, with costs that are shared equally between the state and Washington.[5]

The remaining 10 percent was spent on health benefits for 153,000 state employees and retirees and for their over 100,000 dependents.

Medicaid

Medicaid provides health care to more than one million low-income individuals—almost two-thirds of whom are poor children and their families—as well as the indigent elderly and disabled. While federal law and regulations provide the basic framework for the program, the state has considerable latitude in setting eligibility, benefits, and provider payments.

Medicaid spending totaled $7.4 billion in 2006, an increase over 1987 of more than $4.5 billion, or 163 percent. This percentage growth was almost five times that of the budget as a whole. Medicaid's share of the budget rose from 13 percent to 26 percent between 1987 and 2006. Increases in Medicaid were two-thirds of the overall growth in state spending.[6]

The course of Medicaid spending over the two decades can be divided into four broad eras that reflect both the economics of health care and important state policy decisions.

Rampant Growth: 1987-1993

In the late 1980s, the Medicaid program came to be known as a "budget buster"—one of five major accounts that threatened to wreck the state's finances if left unchecked.[7] Based on Medicaid's spending record from 1987 to 1993, it was a label more than well deserved. Half of the $4.6 million of the program's cost growth of the last two decades occurred during those years, a time of average spending increases of more than 10 percent a year, after adjusting for inflation.

The rapid growth was attributable to a variety of factors. Health care costs in general were going up, especially the costs of nursing homes and other long term care. New federal mandates were broadening Medicaid eligibility for pregnant women, infants, children, and others. And high unemployment in a weak economy made more people eligible for the means-tested program.

Managed Care and Other Cost Containment: 1994-1997

To stem the rapid growth in costs, the state introduced new controls on provider rates in 1991 and, on a larger scale, began to transform the program by introducing elements of managed care. That process began in earnest with approval from Washington to lift a federal regulation granting Medicaid recipients freedom of choice of provider.

By 1994, the rapid rate of spending growth of the previous seven years had begun to be reined in, and over the next three years, Medicaid spending actually declined.

The administrative changes were not the only reason for this dramatic turnaround: Medical cost inflation had slowed nationwide, and a long-lived expansion in the economy was pushing the state's unemployment rate steadily downward.

MEDICAID AND THE UNIVERSAL HEALTH CARE LAW

In 2006, Massachusetts broke new ground by mandating health care coverage for every state resident. Although the implementation of the many complex requirements of the new law is still in process, its major aspects can be boiled down to just a few elements:

- **A concentrated effort to enroll into Medicaid** those individuals who are eligible for the program but receiving their care free of charge from a small number of hospitals and other providers. The high costs of this care have been borne mostly by other hospitals, who recoup the costs through higher rates on all health care consumers. The state also bears a portion of those costs.
- **State-subsidized health insurance** for those who are ineligible for Medicaid but cannot afford private health coverage.
- **A requirement** that all but the smallest employers offer health coverage to their full-time employees and give both full- and part-time employees the opportunity to purchase insurance on a pre-tax basis.
- **New lower-cost health insurance products** for those who have some ability to pay but do not have access to employer-provided coverage.
- **Potential penalties** for those who can afford and have access to employer-provided or other coverage—either individually or through their spouse—but decline to be covered at all.

Expansion and Reform: 1998-2001

In 1997, Massachusetts gained federal approval to embark on one of the most ambitious plans in the nation to expand Medicaid coverage, especially for children. Over the next five years, the newly dubbed MassHealth program added more than 300,000 individuals to the Medicaid rolls, which went from less than 700,000 in 1997 to almost one million in 2002—about one out of every six Massachusetts residents.[8]

Most of the new enrollees were children, with fewer medical needs and lower costs of care, on average, than much of the traditional Medicaid population. Even so, inflation-adjusted spending grew by more than 30 percent in 1998-2002, with the additional recipients accounting for about one-third of the increase.

The Return of Health Care Cost Pressures: 2002-2006

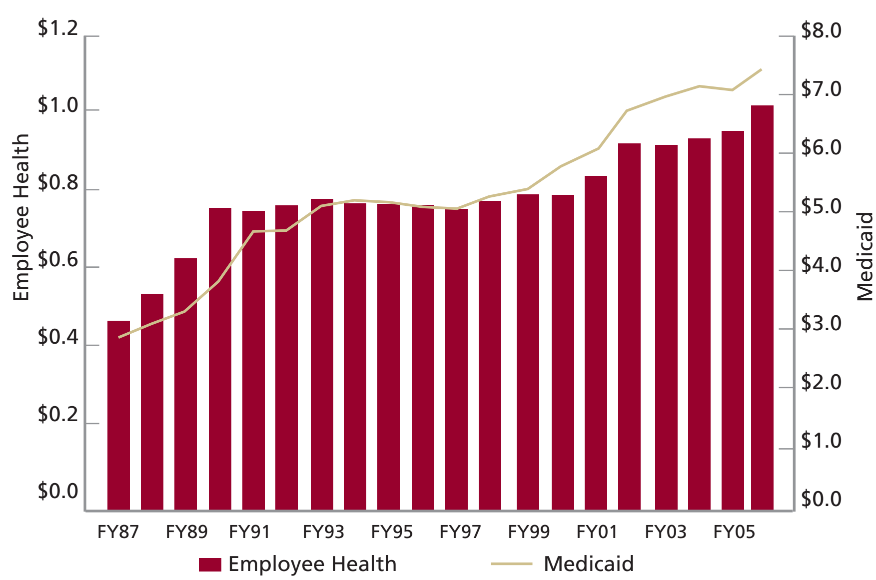
As the state drew nearer to fully achieving its eligibility expansion goals, health care payers across the country began to be squeezed from all sides by intense cost pressures. Rising medical inflation, higher expenses for both acute hospital and long-term care, and skyrocketing prescription drug prices were all contributing to double-digit increases in annual health insurance premiums.

Medicaid was subject to those pressures as well. Although the previously expanding membership had been stabilized at about one million, spending in 2007 dollars still grew almost three percent a year, on average. In actual dollars, that was equivalent to annual increases of almost eight percent, only moderately less than the ten percent average growth in premium costs of employer-sponsored health plans.

By 2006, Medicaid spending had climbed by more than $700 million, consuming one out of every four new tax dollars.[9] Interestingly, the Massachusetts' experience was not all that different from what was going on in other states. In 2004, for example, the rate of spending growth in Massachusetts ranked 27th among the 50 states, and between 1997 and 2004, spending grew at essentially the same rate as in

Figure 5

Employee Health Spending, Billions of Inflation-Adjusted Dollars



the nation as a whole.[10]

What emerges from this long view of the state's Medicaid expenditures is a strong sense of what has driven that spending:

✓ Rapid—and largely uncontrollable—growth in health care costs, both at the beginning of the 1990s and in more recent years, that was a nationwide phenomenon, not unique to Massachusetts.

✓ The state's long-term policy commitment to expand health care access to the poor and uninsured. This commitment was in evidence as early as 1987, in a plan for universal coverage that was enacted, but for a variety of reasons never implemented.

✓ Although federally mandated eligibility and benefit expansions were early contributors to rising spending, Washington appears to have been more a helpmate to the state's health reform efforts than an imposer of unwanted cost burdens.

While MassHealth expenditures per member are greater than most other states, so too are the overall costs of health care in the state. Compared with the eleven other "high income" states that participate in Medicaid, Massachusetts has a greater proportion of elderly and disabled recipients, populations with the highest costs of care. Though the state offers more of the so-called "optional" Medicaid benefits that are eligible for federal reimbursement, but not required to be provided, the list includes prescription drugs, physical therapy, and many other services that most would consider essential components of adequate health coverage.

The Commonwealth has now entered a new era with its first-in-the-nation plan to provide nearly universal health coverage to its citizens. While the health reform law realigns numerous components of the Commonwealth's health care structure—and creates new ones—Medicaid remains a critical component.

Under the reforms, Medicaid eligibility and enrollment for the poorest of the uninsured is to be expanded. Existing Medicaid dollars are used to finance state-subsidized private insurance for those above the poverty line. Medicaid reimbursement rates to hospitals, physicians and managed care organizations are increased. Some benefits that had been cut in the 2002-2003 fiscal crisis, including dental coverage for adults, are restored. The initiative's complex financing plan depended upon approval of key provisions by federal Medicaid officials.

In 2006, implementation of the universal health care reforms—which had been signed into law with only three months of the fiscal year remaining—had not yet begun, and thus its costs are not reflected here.[11] In 2007, those new costs totaled an estimated $275 million after taking federal reimbursements into account. Going forward, there is a tremendous amount of uncertainty in the costs because it is not known how many people will sign up for the state-subsidized plans.

Going forward, there is a tremendous amount of uncertainty in health care costs.

Employee Health Benefits

The costs of health benefits for state employees and retirees more than doubled between 1987 and 2006—from less than $500 million to just over $1 billion, about 3.5 percent of total spending. The program is administered by the Group Insurance Commission, or GIC, a quasi-independent state agency governed by an eleven member board appointed by the Governor.

While the GIC budget is only about one-seventh the size of Medicaid, it has been subject to many of the same cost pressures, and in broad outline its spending history resembles that of the larger program.

By the end of the 1980s, employee health spending was growing explosively, with average increases of almost 18 percent a year that placed it solidly in the ranks of the "budget busters."

However, that bounding pace was brought up short in 1991, some three years earlier than Medicaid costs were brought under control. The deceleration in spending reflected a combination of factors, including rate negotiations with providers, more intensive management of the Commonwealth's fee-for-service health benefit plan, and changes in benefits and co-payments. The slowing of spending growth was also attributable to substantial reductions in the state workforce, from more than 91,000 in 1988 to roughly 77,000 in 1992.

What followed was a decade of almost no growth in GIC costs—less than half a percent a year. That record is partly credited to the GIC's early embrace of managed care and its effective negotiations with insurers.

As health care costs in general surged at the beginning of the decade, state spending for employee health did as well, leaping up by almost 15 percent between 2000 and 2002. The rapid growth in state costs was eased temporarily via intensive management of costs and increasing the share of those costs which were borne by employees. Despite these measures, spending was up by another seven percent in 2006, a year in which the overall state budget was close to flat, after adjusting for inflation.[12]

Human Services

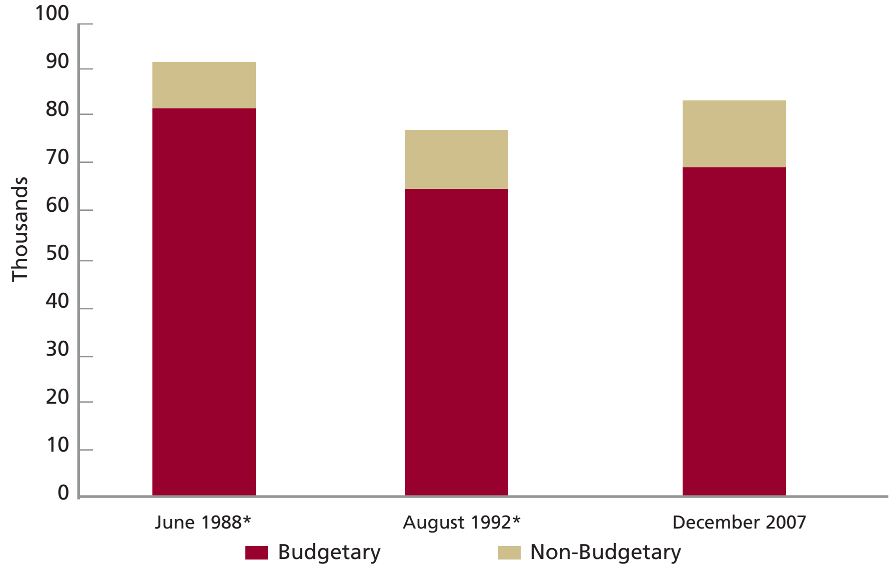
While the state's health care budget grew rapidly from 1987 to 2006, human services taken as a whole rose only slightly, about \$140 million or three percent, or about two-tenths of a percent a year, on average. Because of minimal growth, human services' share of the state budget fell from 23 percent to 17 percent.

However, this picture of almost flat inflation-adjusted spending is strongly influenced by declines in public assistance, primarily in federally-funded welfare grants.

In fact, when public assistance is excluded, spending in the remaining areas of human services actually grew by 29 percent, a rate of growth that was only modestly less than that of total spending.

Figure 6

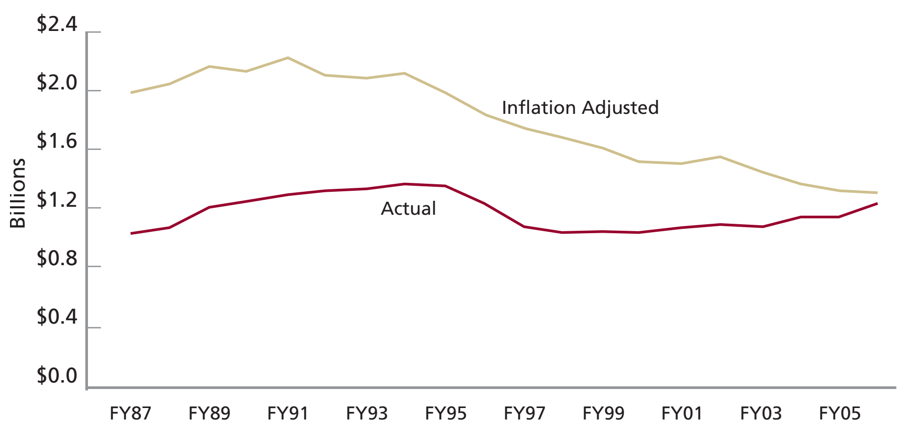
Total State Employees, Full-Time Equivalent Workforce



*Excluding certain higher education trust funds.

Figure 7

Total Public Assistance Spending



Public Assistance

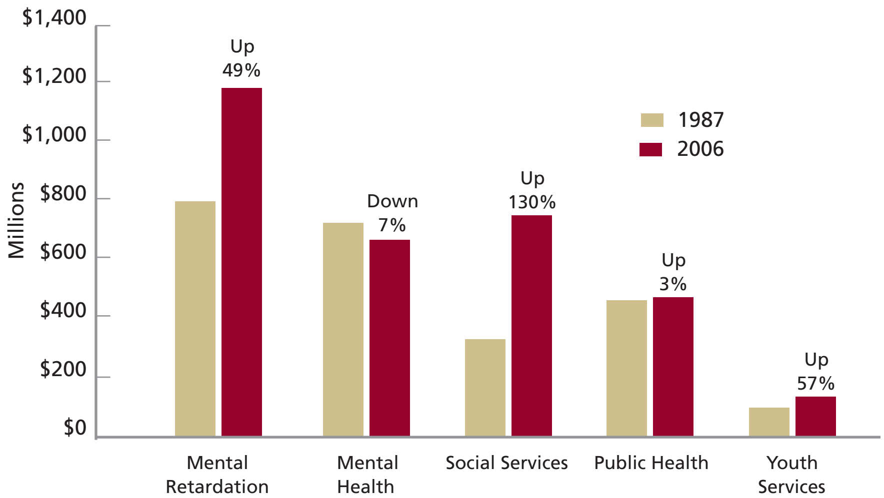
Income and other support for the state's poorest residents totaled \$1.9 billion in 1987, accounting for 40 percent of all human services spending. By 2006, this assistance had fallen to about \$1.3 billion, shrinking its share of human services to one-fourth.[13]

A substantial portion of this decline is attributable to a major shift in federal welfare policy in 1996.

In that year, AFDC income, employment, and child care assistance to poor families with children was converted from an entitlement fully funded by the federal government to a fixed-amount block grant.[14] The grant for Massachusetts was set at \$459 million, an amount that has remained fixed since 1996. Inflation has eroded

Figure 8

Major Human Service Departments, Inflation-Adjusted 2007 Dollars



the value of the grant tremendously since then.

Other Human Services

Spending growth in other human service programs offset the decline in public assistance.

One of the largest dollar increases was in the Department of Mental Retardation (DMR). Inflation-adjusted spending rose from approximately $800 million in 1987 to $1.2 billion in 2006, up almost $400 million, or 50 percent (including spending that is federally reimbursed by Medicaid). DMR provides services to mentally retarded adults and children, ranging from care and training in residential settings, to support for the families of its clients. It currently serves about 23,000 adults and more than 8,600 children.

Spending for social services went up even more. Department of Social Services spending grew more than $400 million, or 130 percent.[15] The department's mission is to protect children from abuse and neglect through family support, foster care, adoption and other services.

Inflation-adjusted spending for youth services was $147 million in 2006, adjusted for inflation, an increase of almost 60 percent since 1987. Juvenile offenders in Massachusetts are committed to the custody of the Department of Youth Services.

Public health spending, in contrast, was almost flat between 1987 and 2006, with an increase of $12 million or three percent.

State spending for mental health services declined. Expenditures of the Department of Mental Health dipped from about $715 million in 1987 to $660 million in 2006, down about $50 million or seven percent. The department is responsible for the treatment, rehabilitation, and support of adults and children with serious mental illness or emotional disturbance.

Local Aid

Between 1987 and 2006, state financial aid to Massachusetts cities and towns—school assistance, "no-strings-attached" lottery aid, and other forms of support—grew about $500 million, or 10 percent. Simultaneously, local aid's share of total state spending fell by four percentage points, to 20 percent.[16]

Behind this modest growth was a striking transformation in the Commonwealth's revenue sharing policies, a shift that gave overwhelming priority to local education.

The numbers tell the story: Over twenty years, state aid to schools climbed $1.3 billion, or 44 percent, to a total of $4.3 billion in 2006. Non-school aid, on the other hand, dropped by almost $800 million, or almost 40 percent, to $1.3 billion in 2006.

Aid to Education

How did it come to be that aid to education had such a prominent claim on the state's revenues for much of the last two decades?

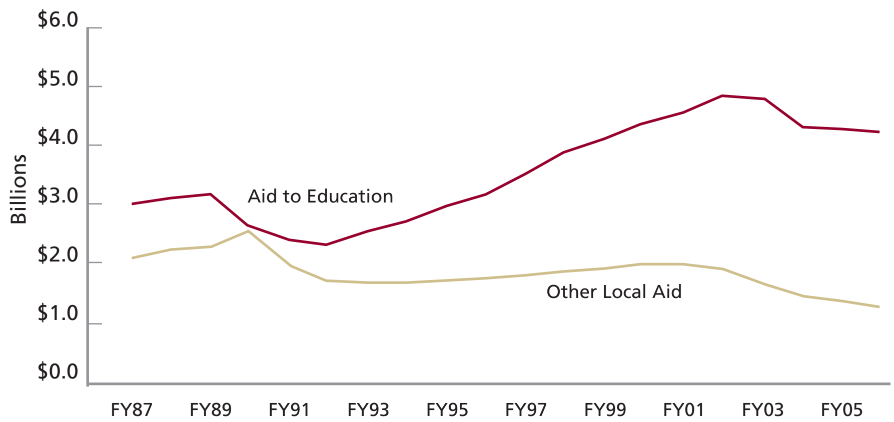
The short answer is that the state's leaders kept a promise made in the early 1990s—a very expensive promise.

In 1993, Massachusetts changed the way it financed local education in order to ensure that every school district—especially those in the poorest communities—had enough resources to provide an adequate education to their students. The revamping of the previously property-tax-based system came on the heels of a ruling by the Massachusetts Supreme Court that the Commonwealth was not fulfilling its constitutional duty to fund public education properly.

As one element of a larger reform package, the state pledged to provide $1.1 billion of additional education aid, plus inflation, by 2000. Most of the added money would go to districts that were spending far less than the state

Figure 9

State Education and Other Local Aid, Inflation-Adjusted 2007 Dollars



deemed was enough, using a new distribution formula adopted as part of the reforms.

That commitment was met in 2000, after increasing so-called Chapter 70 aid to schools by almost $2 billion, to more than double its pre-reform level in 1992. Chapter 70 aid grew by an average of almost nine percent a year and was responsible for all but a fraction of the total growth in education aid during this period.

Over the next two years, lawmakers continued to boost Chapter 70 and other school aid at a brisk pace, to a peak of $4.8 billion in 2002. Although education spending was temporarily shielded from the effects of the 2002 revenue downturn, that respite did not last. By 2004, spending had fallen by almost half a billion dollars, and in the ensuing years failed to keep up with inflation. In 2006, state school aid was $600 million below the 2002 peak. Even with these declines, 2006 spending was still more than $1 billion above 1987.

Seventy-five percent of the education aid that was added over the two decades was distributed directly to districts via the Chapter 70 formula. The remaining 25 percent reflected major increases in school construction and special education aid programs (which together rose by almost $500 million) that were partially offset by reductions in others.

State aid to schools climbed 44 percent

In 2005, the school building grant program—whose annual costs had risen sharply since the mid-nineties—was reshaped to stabilize its finances and address a large backlog of projects.

Roughly two-thirds of the almost $200 million increase in special education aid over the last two decades occurred between 2003 and 2005, with the creation of a new "circuit breaker" program designed to reimburse school districts for a portion of the extraordinary costs of educating students with the severest disabilities.

Other Local Aid

Non-school aid took a very different path. In 1987, the state's support for the general costs of local government was $2.1 billion after adjusting for inflation; by 2006 it had fallen to $1.3 billion. Many municipal officials would argue that a significant portion of the $1.3 billion actually went to education as well.

The dramatic decline was the combined result of two opposing trends: strong growth in the lottery that was more than offset by steep declines in other non-school aid.

In 1987, inflation-adjusted lottery aid totaled about $375 million; by 2006, that figure had grown to $800 million. Under the lottery distribution formula, the growth benefited each of Massachusetts' 351 cities and towns. Although intended as a source of local revenues, part of lottery receipts have also been used to balance the budget.

The state's other general revenue sharing program, so-called "additional assistance," took a sharp turn downward during the fiscal crisis of the early 1990s and has continued to decline ever since, going from a inflation-adjusted peak of $1.5 billion in 1988 to only slightly more than $400 million in 2006. Although originally distributed by formula, beginning in 1992 additional assistance grants to individual communities were frozen for 11 years. In 2003 and 2004, the aid program was cut again. Additional assistance goes to 159 of the state's 351 cities and towns, with Boston receiving about 40 percent of the total dollars.

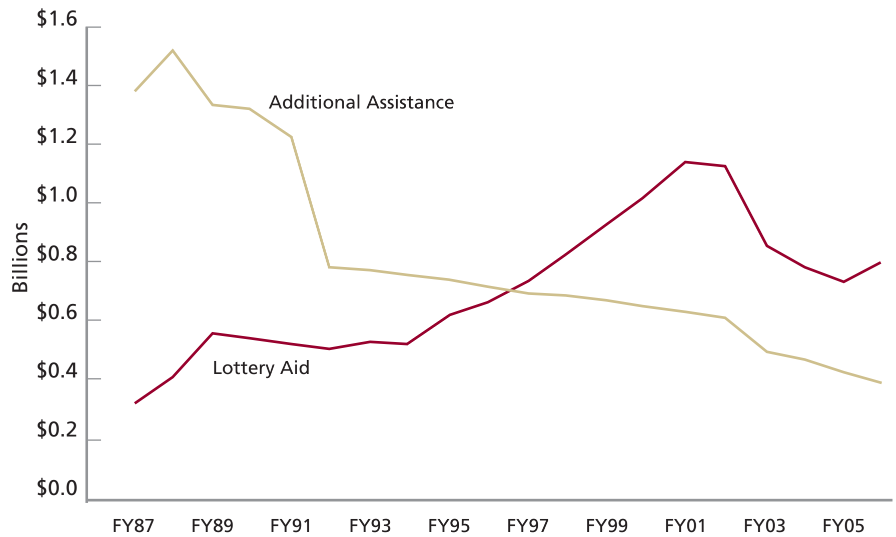
FINANCIAL OBLIGATIONS

In contrast to much of the state's expenditures, debt service and pension funding are contractual responsibilities—true financial obligations—rather than commitments to spend that may or may not be fulfilled.

Both were considered budget busters in 1987, when they consumed $2.2 billion, or about 11 percent of the budget. In 2006, their spending totaled $3.1 billion, almost $900 million more than in 1987. This 39 percent increase roughly equaled the growth in the budget, and their share of spending was essentially unchanged.

Figure 10

Lottery Aid and Additional Assistance, Inflation-Adjusted 2007 Dollars



Debt Service

Debt service repays the money that the state borrows to finance capital construction projects: road building, bridge repairs, administrative offices, park improvements, to name just a few.

In 2006, the state's debt service requirements totaled $1.7 billion, about $700 million, or 72 percent, above 1987. Almost all of this increase occurred before 1994.

Capital gains revenues have been a major source of the growth in tax revenues

In 1987, debt service totaled $1 billion, and was rising an alarming ten percent a year on average. By 1993, it had swelled to $1.8 billion, with much of the increase occurring in the depths of the state's fiscal crisis. That growth had been driven by major increases in debt-financed capital spending from as far back as 1981.

In 1991, the state put in place a planning process that capped the rate of growth in bond-funded capital spending. By 1993, that cap had succeeded in putting the brakes on debt service spending—and begun to achieve another goal that was important to Wall Street—holding down the growth in the state's debt burden.

Since then, the cap on annual capital borrowing has remained in place, and in 2006 totaled about $1.3 billion, $550 million less than 1993, after adjusting for inflation.[17] Because the cap's moderating effect held down the rate of borrowing, debt service—the annual repayment of prior borrowing—held steady at roughly $1.7 billion a year between 1993 and 2006.[18]

Many have argued that the fiscal success in holding down annual debt service costs has come at the expense of the state's capital assets—in a failure to adequately maintain, repair and expand the Commonwealth's roads and bridges, college campuses, parks, and other facilities. They also point to analyses that identify multi-billion dollar gaps between the state's capital needs and its financial capacity to meet those needs.

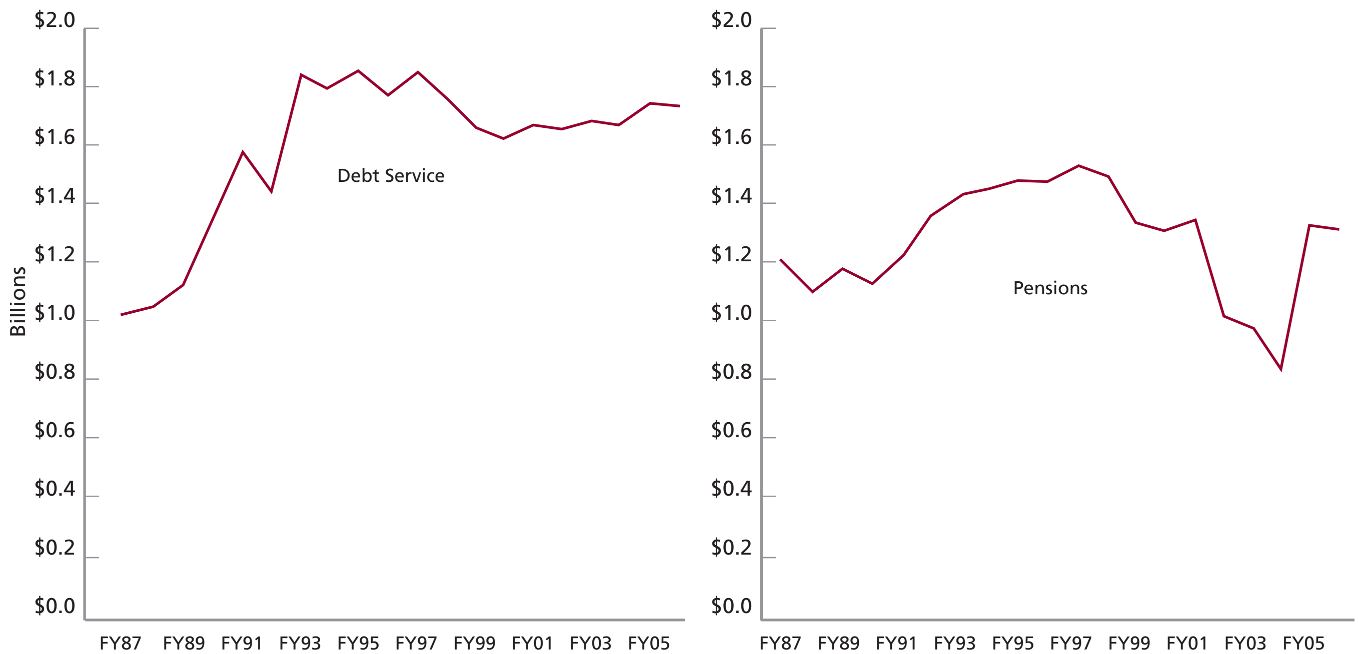
While the case for much greater capital investment is in many ways compelling, how that additional spending will be financed—whether by raising additional revenues, giving lesser importance to other programs, or some other means—is a question that remains unresolved.

Pensions

While paying retired state workers and teachers the pension benefits they were promised is a legal obligation, setting

Figure 11

Major Financial Obligations, Inflation-Adjusted 2007 Dollars



aside enough money to fund the future retirement costs of current employees and teachers is generally regarded as a positive financial practice. The state's annual pension appropriation is intended to both honor the legal obligation and achieve the financial goal of a "fully funded" pension system.

In late 1980s, the state's pension system was considered a ticking time bomb, in part because costs had been rising rapidly, but even more so because the expected cost of future benefits for which no money had been set aside was staggering: between $20 and $25 billion in 2007 dollars. Funding reforms adopted in 1988 set the state on a course to eliminate that massive unfunded liability over the next 40 years.

Pension spending since then reflects the impact of those reforms, with expenditures of $1.1 billion in 1988 that rose about three percent a year over the next nine years, to $1.5 billion in 1997.

In a sharp swerve from that course of increase, between 1998 and 2001 spending was reduced by almost $200 million as the booming stock market ballooned the value of pension reserves and shrunk the size of the unfunded liability that had to be paid off.

An even more abrupt $500 million drop over the next three years brought spending down to about $800 million in 2004. This major decline came after

OTHER FINANCIAL OBLIGATIONS

Debt service and pensions are the largest — but not the only — financial obligations that the Commonwealth faces, including several major ones that are paid outside the state budget:

- Debt service on the $1.5 billion of "grant anticipation notes" issued to help finance the Big Dig, at an annual cost of more than $200 million.
- Financial support for local school construction, a roughly $500 million annual liability that will eventually exceed $800 million.*
- The costs of state-backed capital borrowing by the MBTA, about $350 million a year.
- "Contract assistance" — agreements to repay bonds issued by state authorities — which totaled approximately $125 million in 2006.
- The as-yet-unbudgeted costs of eliminating the $7.5 billion unfunded liability for health care benefits that state employees are entitled to after they retire. Although originally estimated at roughly $350 million a year, these costs could rise to between $400 and $500 million because of delays in implementing a funding schedule and continued health care cost pressures.

* School construction costs are included in local aid in the analysis of 1987-2007 spending.

the collapse in the stock market had punched a large hole in the value of reserves—and demonstrated the vulnerability of the state's pension funding strategy to the pressures of the budget.

In order to avoid spending cuts in other programs during the fiscal crisis, the state's leaders "freed up" dollars that would otherwise have gone to pensions, by adopting a funding schedule that did not reflect the market losses and used less conservative actuarial assumptions, and in one year by substituting a dubiously-valued transfer of real estate for a portion of the annual cash contribution to reserves.

The state's leaders put pension spending back on track in 2005 and 2006, with spending of about $1.3 billion each year. In an attempt to shield pensions from future budgetary "raids," the line item appropriation for pensions is no longer included in the annual budget, although it remains subject to legislative changes, including the kind that led to the substantial decline in 2002-2004.

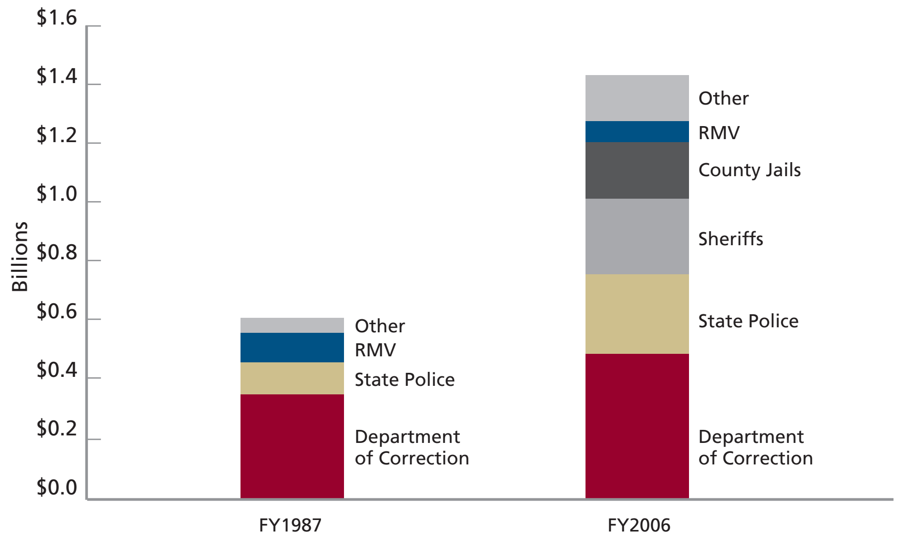
ALL OTHER STATE SPENDING

What remains after the four major areas of spending is a broad array of diverse programs and services. For many Massachusetts residents, these are the most visible part of state government—the Registry of Motor Vehicles, college campuses, the state police and courts, parks and recreational facilities, licensing boards for the professions and trades, the Department of Revenue, snow and ice removal, the MBTA and commuter rail, and many other programs.

In 1987, spending for these "other activities" totaled $5.6 billion after adjusting for inflation. By 2006, it had grown

Figure 12

Public Safety Spending, Inflation-Adjusted 2007 Dollars



to $6.1 billion, a ten percent increase that was roughly one-third as rapid of that of the budget as a whole. Along with the slower rate of growth came a decline in the share of the budget, from 27 percent in 1987 to 22 percent in 2006.

As in the four broad areas of spending, some programs fared much better—or worse—than others. Two striking examples are highlighted below.

Public Safety

Inflation-adjusted spending for state law enforcement grew by 140 percent over the last two decades, from just under $600 million in 1987 to $1.4 billion in 2006. This more than $800 million increase exceeded the overall increase in "other spending" by a large margin.

More than half of the additional spending—roughly $450 million—supported the operations of the county sheriffs' departments and jails. In 1987, these costs were paid by county governments. In the late 1990s, the state assumed financial responsibility for the sheriffs and jails, in the face of the chronic and increasingly severe fiscal difficulties of counties, as part of a larger initiative that eventually led to the dissolution of most county government in the state.

The budgets for other public safety programs were much up as well, including a $180 million, or 60 percent, increase in spending for state prisons. There were just over 9,000 individuals in state custody in 2006, roughly 50 percent more than in 1987. State police costs also rose dramatically, with a $130 million, or 90 percent increase, to a 2006 total of about $275 million.

The Registry of Motor Vehicles was one of the handful of public safety programs where spending declined, falling 14 percent to just over $70 million in 2006.

Higher Education

The story for public higher education—the University of Massachusetts and the state and community colleges—was

Table 5

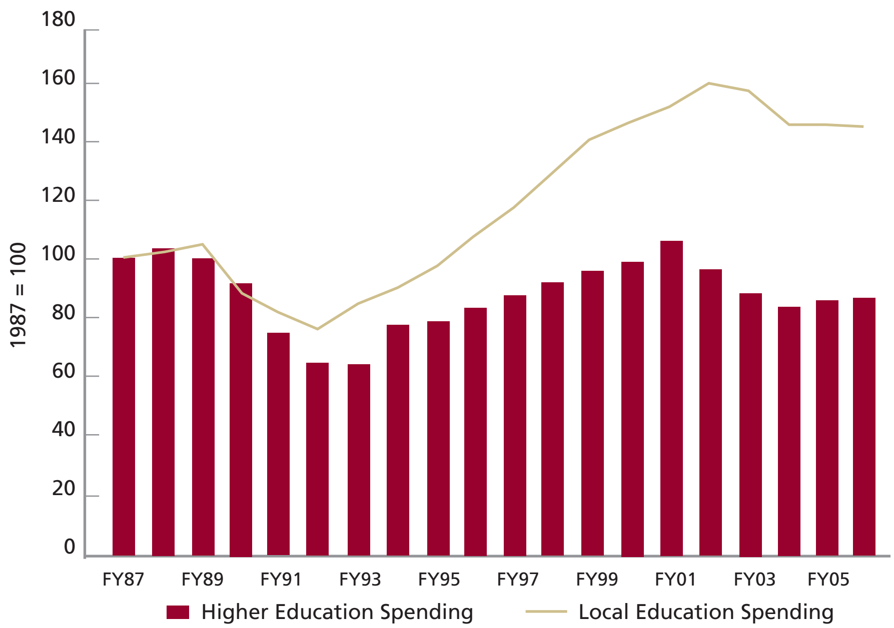
Higher Education Spending*, Millions of Inflation-Adjusted 2007 Dollars

		CHANGE FROM 1987	
	2006	AMOUNT	PERCENT
UMass	$480	-$136	-22%
State Colleges	232	-11	-5%
Community Colleges	214	-17	-7%
Scholarships	88	-51	-36%
Other	23	-99	-81%
Total	**1,037**	**-313**	**-23%**

* Excluding campus spending funded by student fees and charges, and other non-budgetary sources.

Figure 13

Higher Education and Aid to Local Schools, Inflation-Adjusted Spending 1987=100



quite different from that of public safety, with both an overall decline in state support, and large spending swings that weakened the ability of the campuses to pursue their educational mission.

Higher education spending fell over $300 million, or roughly 25 percent, between 1987 and 2006. This decline reduced its share of the budget from more than six percent in 1987 to less than four percent in 2006.

While spending at all campuses fell, UMass was most affected, with a $135 million reduction that, in percentage terms, was roughly four times as great as those at the state and community colleges. Expenditures for general scholarships decreased by about $50 million as well.

The contrast between the state's support for higher education and aid for local schools is striking. While both were significantly affected by the state's overall financial condition, it is clear that spending for higher education was cut more severely in the bad fiscal times, and did not grow as rapidly in the good times. In reality, students and their families were most affected by the budgetary roller coaster, especially those who had to pay the higher tuition and fees that were imposed when state support was cut.

IV. State Revenues

In 1987, budgetary revenues totaled a little over $20 billion after adjusting for inflation. By 2006, that figure had grown to almost $28 billion, up roughly $9 billion. This was a more than 40 percent increase that averaged just under two percent a year over the two decades.[19]

Most of these revenues came from taxes. In 1987, annual tax payments from individuals and businesses totaled almost $16 billion. That figure had grown to more than $19 billion by 2006, up 23 percent or slightly more than one percent a year on average.

At the same time, the share of state revenues coming from taxes fell from just under 80 percent in 1987 to 67 percent in 2006. Though taxes remained the largest source of revenue growth—accounting for $3.7 billion of the $8.7 billion of additional revenues—the rate of increase in non-tax revenues far outpaced them. Federal reimbursements more than doubled, transfers from off-budget revenue sources roughly tripled, and other non-tax collections, such as motor vehicle registration and license fees, increased by roughly 50 percent.

Receipts from the federal government—the major source of non-tax receipts—grew by almost $3 billion, or 119 percent, and their share of total revenues

Table 6

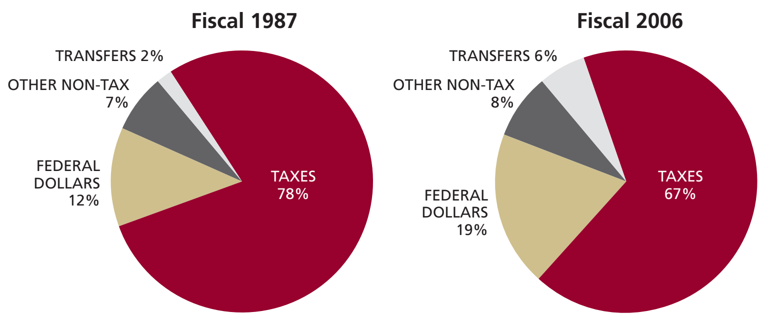
Major Sources of Budgetary Revenues, Inflation-Adjusted 2007 Dollars (millions)

	FISCAL 1987		FISCAL 2006		CHANGE FROM 1987-2006		
	AMOUNT	PERCENT OF TOTAL	AMOUNT	PERCENT OF TOTAL	AMOUNT	PERCENT CHANGE	AVG. ANNUAL CHANGE
Taxes	$15,747	78%	$19,403	67%	$3,656	23%	1.1%
Federal revenues	2,464	12%	5,402	19%	2,938	119%	4.2%
Fees and charges	1,428	7%	2,198	8%	770	54%	2.3%
Transfers	433	2%	1,800	6%	1,367	316%	7.8%
Total	**20,072**	**100%**	**28,803**	**100%**	**8,731**	**43%**	**1.9%**

* Fiscal 2006 includes $2.6 billion of off-budget tax collections that financed pensions, MBTA and school building spending which were appropriated in the budget in 1987.

Figure 14

Total Budgetary Revenues by Major Source, Inflation-Adjusted 2007 Dollars



Total FY87 Revenues: $20.1 billion

Total FY06 Revenues: $28.8 billion

rose from 12 percent to about 20 percent. The $3 billion increase was driven by the rapid growth in Medicaid spending, approximately half of which is reimbursed by Washington. In 2006, Medicaid revenues, including those from mental health and mental retardation spending that is eligible for reimbursements, accounted for roughly three-quarters of the state's federal receipts.

So-called "inter-fund transfers"—off-budget revenues that finance on-budget spending—rose tremendously as well, to a 2006 total of $1.8 billion that was $1.4 billion higher than 1987. The largest source of transfer revenues—lottery profits—more than doubled, to an inflation-adjusted total of roughly $1 billion in 2006.

Transfers in 2006 also included more than $200 million of tobacco settlement proceeds, a revenue source that did not exist in 1987. Other non-tax revenues from fees, fines, assessments, interest earnings and other sources also grew more rapidly than taxes.

A CLOSER LOOK AT TAX REVENUES

Taxes are the primary source of the state's receipts, despite growth in other revenue sources over the last twenty years. These taxes include the state's income tax, sales tax, corporate profits tax, and others. How much more taxes are collected each year depends on two critical factors:

- *Baseline revenue growth* due to expansion of the Massachusetts economy, and
- *Tax law changes* that affect what is taxed, and at what rates.

The interplay between these two elements determines each year's tax receipts. While the economic forces driving baseline growth usually dominate the annual revenue picture, major changes in tax law, such as cutting the income tax rate or closing "loopholes" in the corporate tax, can change that outlook by hundreds of millions of dollars.

In 2006, state tax revenues totaled $19.4 billion after adjusting for inflation, up $3.7 billion from 1987. This 23 percent rise was about half the rate of increase in total personal incomes of Massachusetts residents between 1987 and 2006.[20]

While the average annual gain in tax collections was about one percent a year over the twenty years, the path of growth was even rockier than that of spending.

Following a rapid run up in the early 1980s, which peaked with a 13 percent inflation-adjusted increase in 1986, tax receipts began to flag, and then dropped in 1990 by more than $1 billion, or almost seven percent. This downward pitch would have been even steeper had the Governor and Legislature not acted to raise taxes in the midst of the crisis. In 1989 and 1990, the tax rate on wage and salary income was raised from 5 percent to 5.95 percent and the rate on interest and dividends was changed from 10 percent to 12 percent.[21] The gas tax was raised from 11 cents per gallon to 21 cents, and a number of other,

Figure 15

Massachusetts Tax Revenues

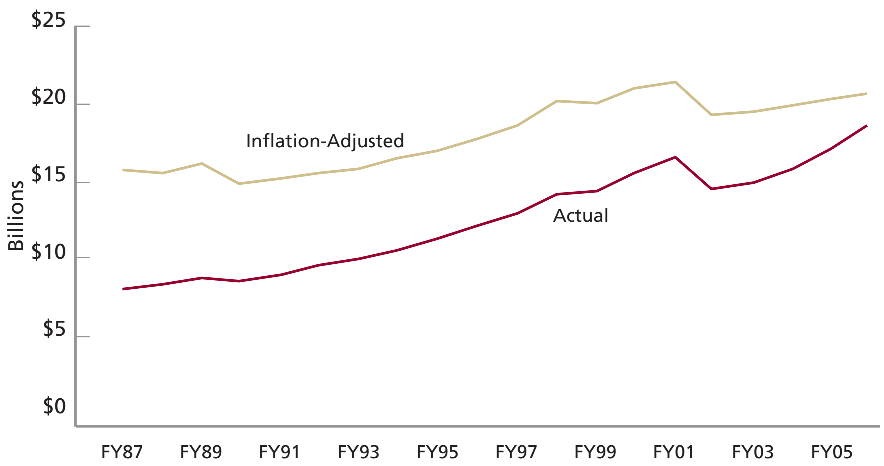
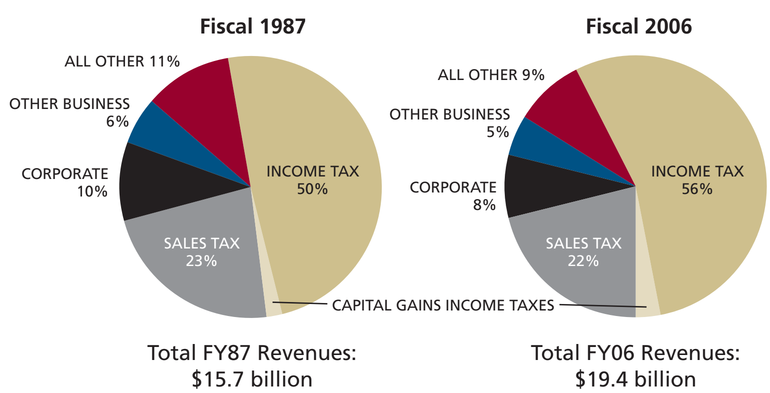


Figure 16

Major Sources of Tax Revenue



smaller increases were put into effect.

Tax revenues collapsed even more spectacularly in 2002, after eleven years of accelerating growth. Collections fell $3.5 billion in just 12 months. This 16 percent decrease—from almost $22 billion in 2001 to $18 billion in 2002—was more than twice the percentage decline in 1990.

The precipitous drop in 2002 was set in motion by a combination of factors—a national recession and the collapse of the stock market, both of which hit Massachusetts hard; the chilling effect of the September 11 terrorist attacks; and previously enacted cuts in the income tax that went into effect just as the economy was going downhill.

SOURCES OF TAX REVENUE

There are three major sources of tax revenues for the Commonwealth—the personal income tax (which includes capital gains taxes), the corporate and other business profits tax, and the sales tax—as well as smaller tax sources such as the motor fuels, rooms, alcohol, and cigarette taxes.

For the most part, both the kinds of taxes that the state collects, and the fundamental structure of those taxes, are largely unchanged since 1987.

The Income Tax

Proceeds from the state's primary source of tax revenues—the income tax—totaled $11 billion in 2006, up $3.3 billion from 1987, a 42 percent increase that averaged just under two percent a year. The $3.3 billion of additional income taxes accounted for almost 90 percent of total tax revenue growth between 1987 and 2006. Because of that predominance, the income tax's share of total receipts rose as well, from 50 percent to 56 percent.

Most of the income that the state taxes, roughly 75 percent, is from a single source—the wages and salaries of Massachusetts residents. Interest and dividends are another important source of income tax receipts. The earnings of the self-employed and individuals and partners who own businesses are taxed as well.

Capital Gains

The income tax is also imposed on capital gains—taxpayers' income from the sale of stocks, bonds, real estate and other assets they own. In 2006, capital gains taxes totaled $1.7 billion, or about 15 percent of income tax collections and almost 9 percent of total tax receipts. In 1987, capital gains taxes totaled $1.1 billion and comprised 7 percent of total receipts. From 1987 to 2006, capital gains revenues rose by approximately $500 million, a 44 percent increase that was almost twice as great as that of overall

Table 7

Total Tax Revenues by Major Tax Type, Inflation-Adjusted 2007 Dollars

	FY87	FY06	CHANGE	PERCENT CHANGE	AVG. ANNUAL
Income tax	7,735	11,002	3,267	42%	1.9%
Sales tax	3,612	4,203	591	16%	0.8%
Corporate tax	1,576	1,460	-116	-7%	-0.4%
Other business	972	908	-64	-7%	-0.4%
All other	1,794	1,830	37	2%	0.1%
Total	**15,688**	**19,403**	**3,714**	**24%**	**1.1%**

Source: Department of Revenue. Fiscal 1987 is approximately $60 million less than the Comptroller-recorded amount shown in Table 7.

tax collections.

While capital gains have added greatly to annual revenues, they have also been a major contributor to the state's fiscal crises because of their huge volatility. Because they depend for the most part on the stock market, capital gains are subject to larger and more difficult-to-predict swings than most of the other tax sources. Taxpayers get to choose when to sell their stocks and realize their gains.

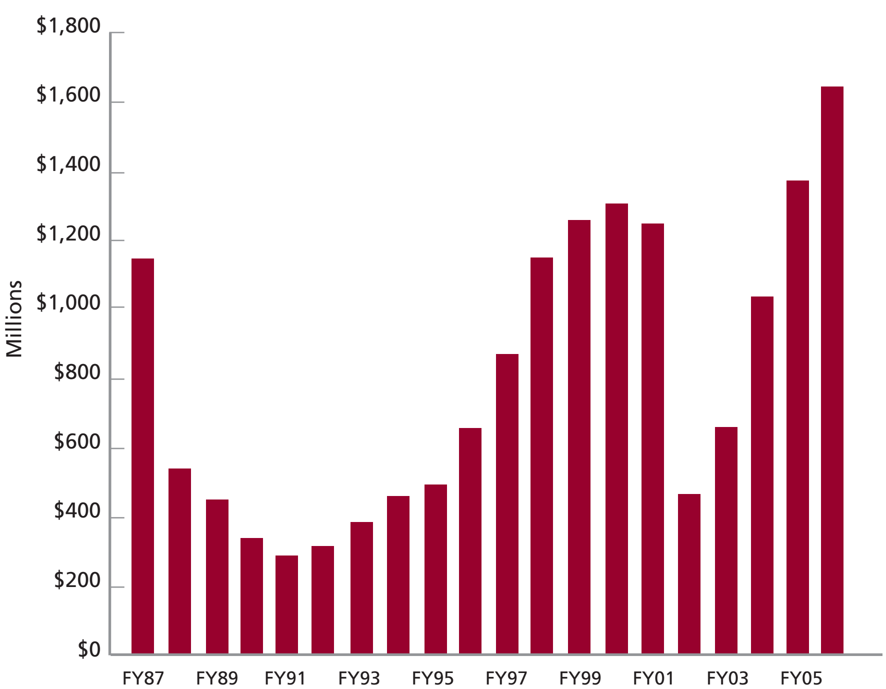
Between 1987 and 1991, capital gains revenues plummeted by almost $900 million, or about 75 percent. In the superheated stock market of the late 1990s, capital gain revenues topped $1 billion for four years in a row, only to collapse again in 2002, this time by almost $800 million, or roughly two-thirds. By 2006, capital gains had climbed to a new high of $1.7 billion.

As revenues from capital gains have grown, so too has the risk to the budget. Because almost all of the state's revenues are committed to maintaining on-going programs, a major drop in capital gains receipts could plunge the state's finances into crisis.

The risk has become even more acute in recent years, because capital gains have been one of the major sources of the growth in total tax revenues. Between 2002 and 2006, capital gains receipts grew $1.2 billion, an amount that is only slightly less than the overall amount of growth in tax revenues.[22]

Figure 17

Capital Gains: A Volatile Source of Tax Revenues, Inflation-Adjusted 2007 Dollars



Business Taxes

Tax payments by corporations and other businesses operating in the state are another important—and highly volatile—source of annual revenues. Business tax receipts totaled an inflation-adjusted $2.4 billion in 2006, approximately $200 million or seven percent less than in 1987, with an average annual decline of less than 0.5 percent. Overall, business taxes' share of total tax revenue fell from 16 percent to 12 percent.

During the intervening years, there were large swings in business tax revenues that were closely tied to the economy. After peaking at $2.7 billion in 1989, collections crashed to a low of $1.6 billion in 1991, a $1 billion, or 75 percent, drop that was a significant factor in the fiscal distress of the period.

Although companies bounced back from the recession, tax receipts did not regain their previous high, reaching $2.4 billion in 1998. Revenues then declined for the next three years, and took another sharp downturn in 2002, falling $900 million, or almost 40 percent, over the four years. Since then, business taxes have been a major contributor to the state's revenue growth, rising by just under $900 million from 2002 to 2006.

The Sales Tax

The other major source of tax revenues is the sales tax, with $4.2 billion of receipts in 2006, up approximately $600 million or 16 percent from 1987. The sales tax's share of total revenues was virtually identical in 1987 and 2006, about 22 percent. The state's five percent sales tax rate is likewise unchanged since 1987 and is well below the national average of 6.6 percent.[23] Due to the lower rate—and a narrower tax base—Massachusetts ranked 45th in sales tax receipts per capita in 2005.[24]

While the sales tax is much less volatile than the other major tax sources, it too is affected by the economy. Though the sales tax tends to respond less dramatically to economic events than the income tax, a relatively modest shift—such as the 4 percent drop in 2002—will have a significant effect on the budget. After adjusting for inflation, sales tax receipts continued to decline by roughly 3 percent a year since 2002 and fell by a total of almost $500 million by 2006.

Looking across all of the different tax types, two aspects of the more recent growth in revenues stand out. The first is how uneven the growth in 2002-2006 has been, and the second is the concentration of the growth in the most volatile sources of tax receipts: capital gains and business taxes.

Some of the growth in business taxes—roughly one-fourth—is attributable to state leaders' efforts to close "loopholes" in the state's tax code. In addition, the increase in cigarette taxes was due to a doubling of the tax rate in 2003. The declines in the sales tax and several smaller taxes in part reflect the erosive effects of inflation on flat or slowly growing revenue sources.

Figure 18

Tax Revenue Growth from 2002 to 2006, Inflation-Adjusted 2007 Dollars

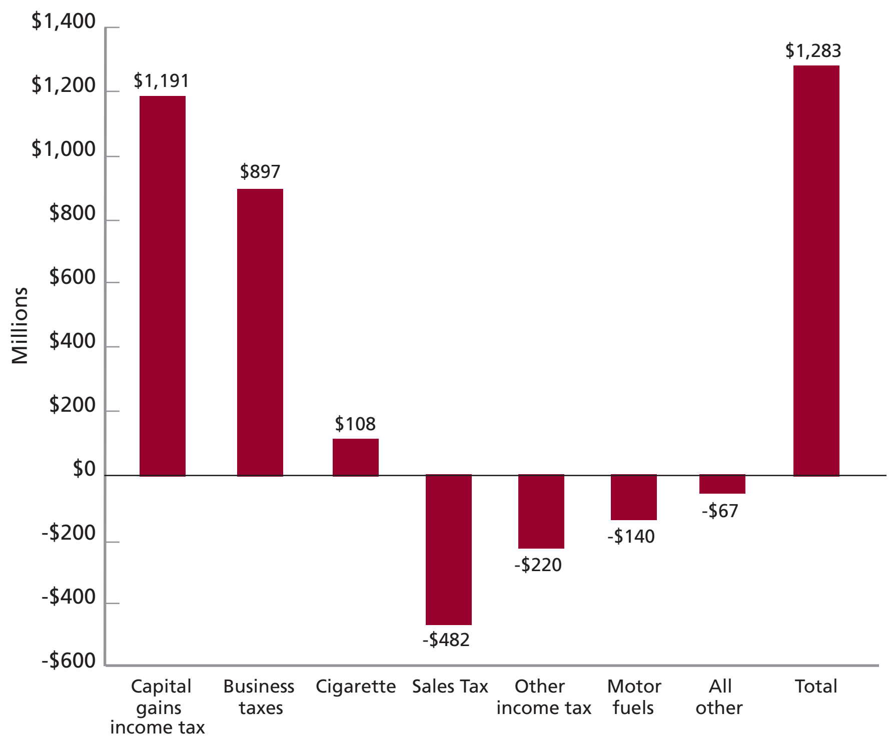
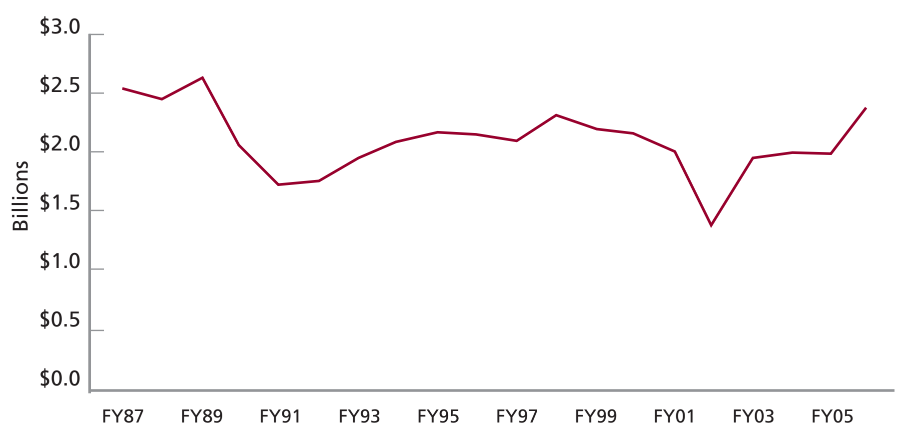


Figure 19

Business Tax Revenues, Inflation-Adjusted 2007 Dollars



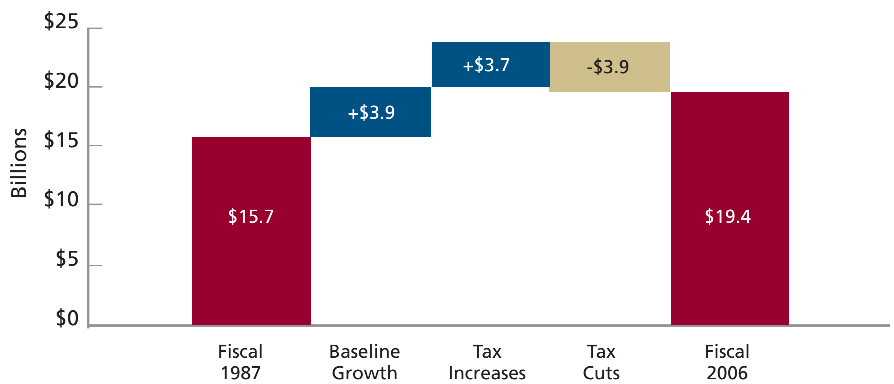
BASELINE TAX GROWTH AND THE IMPACT OF TAX LAW CHANGES

The amount of additional tax revenues the state collects each year is determined by the combined effect of two different factors.

The first is *baseline tax growth*—the

Figure 20

Total State Tax Revenues, Fiscal 1987 and 2006 with Impact of Baseline Growth and Tax Law Changes



amount of new revenues due to growth in the economy. As employment, wage rates, business profits, retail sales, and the stock market rise and fall, so too do payments into the state's coffers.

The second is *tax law changes* that may raise or lower tax rates, redefine what is deductible, or alter the state's tax base in other ways. These changes may affect most taxpayers or only a few, may be permanent or temporary, and may be felt immediately or phased in over several years. When and how these changes are made can greatly alter the amount of revenues that will be available for the budget.

Just how significantly these factors have affected state taxes is illustrated in a comparison of 1987 and 2006.[25] Inflation-adjusted tax receipts totaled $15.7 billion in 1987, rising to $19.4 billion in 2006, up $3.7 billion or about 25 percent.

However, this overall increase in tax collections reflected the combined impact of:

✓ $3.9 billion of baseline revenue growth due to economic expansion

✓ $3.7 billion of tax increases, three-quarters of which were enacted in 1989-1990 as the state struggled to cope with a 15 percent decline in baseline revenues

✓ $3.9 billion of tax cuts, with the bulk of those cuts adopted in 2000-2001, just before the collapse of tax receipts in 2002.

This means that Massachusetts taxpayers—both families and businesses—paid roughly $250 million less in 2006 than they would have if the tax

Table 8

Fiscal Year 2006 Impact of Massachusetts Tax Law Changes from 1987 to 2006, Inflation-Adjusted 2007 Dollars

	1987-1990	1991-2006	ENTIRE PERIOD
INCOME			
Rate increase on earned income from 5.0% to 5.3%	$1,892	-$1,376	516
Rate reduction on interest and dividends from 10% to 5.3%	167	-560	-393
Capital gains	277	-194	83
Personal exemption	-	-273	-273
Under age 12 deduction	-	-240	-240
Low income, senior and renter deductions	-	-147	-147
Other	-	-182	-182
Total	**2,337**	**-2,972**	**-636**
Sales	156	-17	139
Corporate and other business taxes	-	-188	-188
Cigarette	-	367	367
Motor	336	-	336
Estate	-	-281	-281
Other	-	19	19
Total	**2,828**	**-3,072**	**-$243**

Source: Author's estimates for 1987-1990 major tax law changes; Massachusetts Department of Revenue estimates for 1991-2006 changes.

laws of 1987 had still been in effect.

Beyond their effect on revenues, the changes in tax law over the last twenty years have changed who bears the burden of state taxes in several significant ways.

The tax rate on earned income went up slightly from 5.0 percent in 1987 to 5.3 percent in 2006, while that on interest and dividend income was roughly halved from 10 percent to 5.3 percent. Families with children under the age of 12, low income individuals, seniors and renters benefited substantially from higher exemptions and deductions. Despite the "loophole closing" and other increases of the last several years, the burden of taxes on business profits was modestly less under the tax laws of 2006 than under those of 1987. And both motorists and smokers have seen a doubling in the tax rates they must pay.

Figure 21

Total Massachusetts Tax Collections, State Taxes and Local Property Taxes FY87-FY06

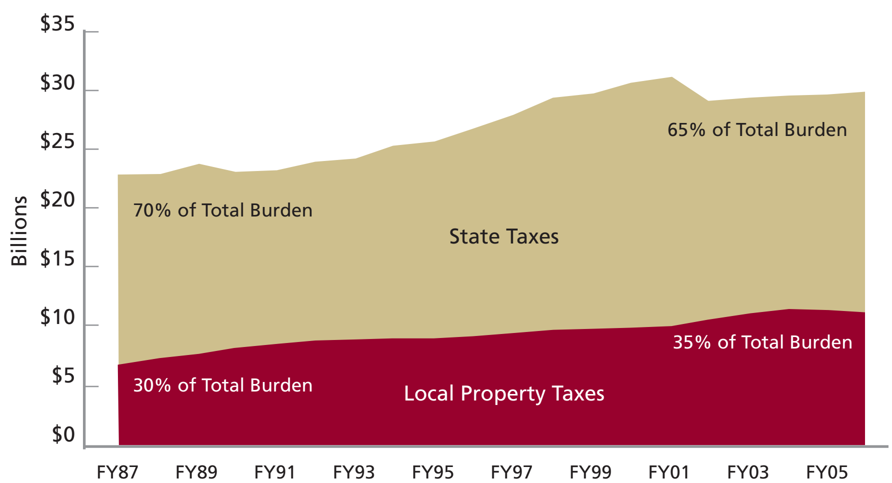


Table 9

State and Local Property Tax Burden, Inflation-Adjusted 2007 Dollars

TAX BURDEN	FISCAL 1987	FISCAL 2006	CHANGE	% CHANGE
PER $1,000 PERSONAL INCOME				
State	$72.90	$64.01	-$8.88	-12%
Local Property	31.81	34.57	2.76	9%
Total	**104.70**	**98.58**	**-6.12**	**-6%**
PER CAPITA				
State	2,643	3,014	371	14%
Local Property	1,153	1,628	474	41%
Total	**3,797**	**4,642**	**845**	**22%**

LOCAL PROPERTY TAXES

Massachusetts taxpayers face another major tax burden—the property tax.

In 2006, homeowners and businesses paid an inflation-adjusted total of $10.5 billion of local property taxes to the state's 351 cities towns—on top of the $19.4 billion they paid to the state. That $10.5 billion was $3.6 billion, or roughly 50 percent, more than they paid in 1987. State tax collections grew by less than 25 percent over the same period.

These differing rates of growth have led to a marked shift in the burden of state and local taxes in Massachusetts, whether measured relative to income or per capita. Moreover, the increase in property tax burden has fallen differentially because of overrides. Some cities and towns, usually the ones with more wealthy families, have chosen an increased burden, primarily to support the schools.

Looking first at tax receipts per $1,000 of total personal income, the burden of *state taxes* fell by almost nine dollars, or 12 percent, from $73 in 1987 to $64 in 2006.

In contrast, the burden of *local* property taxes per $1,000 of income rose from $32 in 1987 to $35 in 2006, a three dollar, or nine percent, gain.

Turning to tax receipts per capita, while the burden of both state and local taxes rose, the local burden per capita grew by $100 more than the state burden, with a 41 percent increase that was almost triple the state rate.

These burden statistics raise interesting questions that will require further research to understand fully. Even so, it is clear that the local property tax burden has been increasing at a more rapid rate than the state tax burden.

V. Fiscal Health

While the details of the state's financial condition are enormously complex, some of the most crucial aspects of the fiscal health of the Commonwealth can be found in the answers to two simple —and one complicated—questions:

✓ Do annual revenues exceed or fall short of annual spending—in other words, is the budget in balance?

✓ Does the state have sufficient reserves to weather economic downturns?

✓ Are the state's finances in structural balance—that is, are they capable of sustaining the state's key priorities and commitments and preserving budgetary balance over the longer term?

Do annual revenues exceed or fall short of annual spending?

The state's record in balancing the budget over the last 20 years has been mixed, at best.

The worst was at the beginning, when the state ran up five successive years of deficits that totaled a staggering $3.5 billion after adjusting for inflation.

That extended spell of red ink ended in 1992, and what followed was a decade of fiscal improvement that peaked with a $1.2 billion surplus in 2001.[26] Those good times came to a crashing halt in 2002 as declining economic conditions, a collapse in capital gains revenues, and major tax cuts helped create an almost $2 billion excess of spending over revenue.

Over the next three years, the state's fiscal picture turned sharply positive again, with inflation-adjusted surpluses of roughly $1.3 billion in 2004—exceeding the 2001 peak—$700 million in 2005, and $800 million in 2006. These substantial balances were due in large part to the rebound in capital gains and business tax receipts.

More recently, on-going spending exceeded revenues in 2007 by several hundred million dollars, and the budget for the current fiscal year is expected to end roughly in balance. This 2008 outlook assumes substantially slower baseline tax growth than the almost eight percent average of the last four years—about three percent taking into account the current rate of inflation—in part because of deteriorating capital gains.

Does the state have sufficient reserves to weather economic downturns?

The state's ability to maintain budget stability when the "rainy days" of economic recessions arrive depends critically on how much it has set aside for that eventuality.

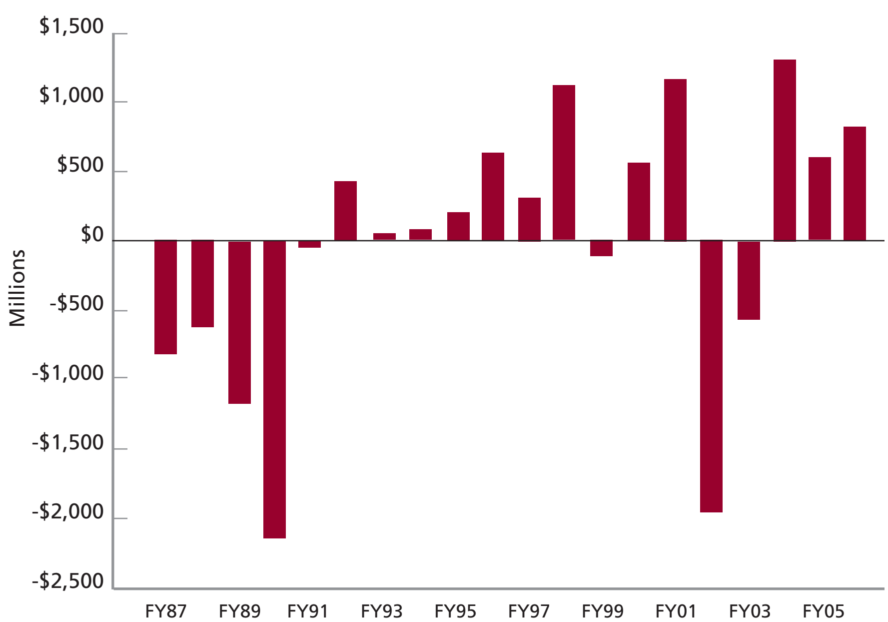
At the onset of the fiscal crisis of the early 1990s, the Commonwealth had practically no rainy day reserves. While a formal budget stabilization fund had been established, it was empty.[27] With no financial buffer, restoring balance in the budget required income tax increases of almost 20 percent and deep spending cuts.

Learning from that harsh lesson, the state's leaders took advantage of the strong economic and revenue performance of the 1990s to build up the stabilization fund to an inflation-adjusted total of $2.2 billion in 2001. Although the state still incurred an almost $2 billion deficit when revenues collapsed in 2002, the fiscal impact of that shortfall was blunted because there were reserves to fall back on.

While taxes still had to be raised and spending reduced, both the increases

Figure 22

Annual Operating Surplus/Deficit, FY87-FY06 Inflation-Adjusted 2007 Dollars



*Surplus/deficit amounts for 2000-2006 include all tobacco settlement revenues, including those portions which had been deposited in an off-budget reserve fund.

Figure 23

Stabilization Fund Balance, Inflation-Adjusted 2007 Dollars

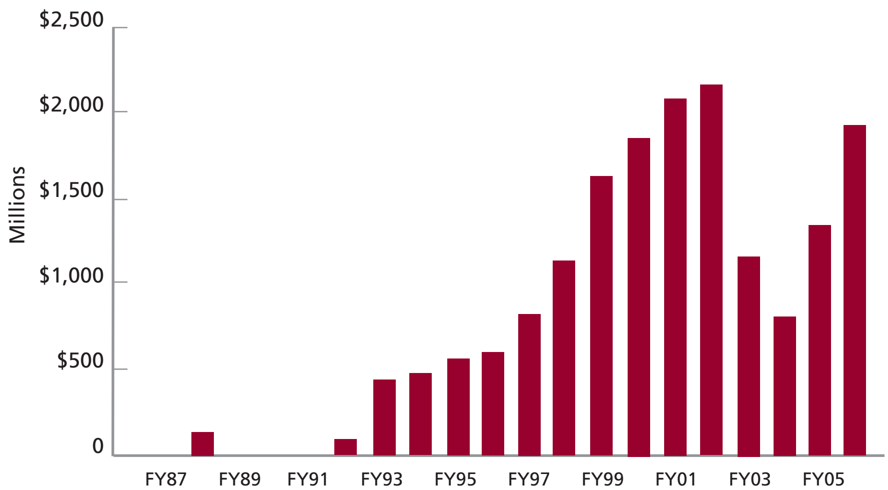
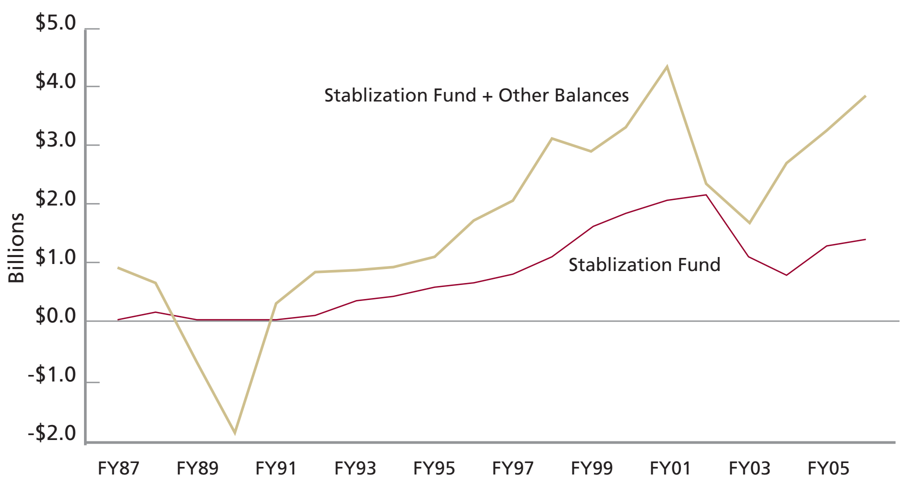


Figure 24

Total Fund Balances, Inflation-Adjusted 2007 Dollars



and the cuts were much less severe than would otherwise have been required.[28] Though withdrawals from the reserve were substantial, about $1.4 billion by the end of 2003, the state's leaders did not have to drain the fund dry.

The experience in this recent crisis raises the question of "How much is enough?" to set aside for future financial emergencies. While fiscal experts frequently recommend five percent of the budget as a prudent figure, the Commonwealth began 2002 with a rainy day reserve totaling more than six percent of the previous year's spending, and still had to take extraordinary actions to get the state's finances back on track.

As with other aspects of the budget, the stabilization fund does not tell the full story about the state's preparedness for fiscal crisis.

Accumulated surpluses that have not been deposited in the stabilization fund are available for use—and have been used—to help balance the budget in financial emergencies. In some cases, these funds have been set aside for a general purpose, but with no specific plans for their immediate use, such as the almost $500 million of tobacco settlement proceeds that were accumulated in 2000-2002 for unspecified future health care costs.[29]

This "all balances" view—which excludes capital and trust funds unavailable for budgetary use—provides an even more positive picture of the state's fiscal strength in recent years. At the end of 2006, the state had balances totaling $3.9 billion, including $1.8 billion in the official stabilization fund, and almost $1 billion of surplus revenues that had been earmarked for future use, such as economic development projects that were yet to be undertaken.

Are the state's finances in structural balance?

Since emerging from the fiscal troubles at the beginning of this decade, the Commonwealth has been faced with the paradoxical situation of apparent budgetary health—as measured by large surpluses and high levels of reserves—and repeated warnings by state officials that the budget is in deficit, or soon will be.

A significant structural imbalance in the Commonwealth's finances is what lies behind those warnings, which have not come to fruition so far largely because of unexpected—and unsustainable—increases in capital gains receipts.

This imbalance arises from the mismatch between the growth in tax rev-

Table 10

2009 Structural Imbalance, Millions of dollars

POTENTIAL REVENUE GROWTH	$750 to $1,000
LIKELY SPENDING GROWTH	
Net state Medicaid costs	300-400
Employee health benefits	100
Education aid	200
Debt service & pension	100
MBTA & school construction	100
Subtotal	$800-900
Rest of government	500-700
Total	**$1,300-1,600**
PROJECTED GAP	-$550 to -$850

enue that it is reasonable to expect over the long term, and the growth in spending required to meet the state's obligations, maintain current programs, and honor financial commitments that have already been made.

An analysis of the budget outlook for fiscal 2009—which will begin on July 1, 2008—will illustrate the nature of the problem.

Before filing his 2009 budget proposal, Governor Patrick identified a potential gap of more than $1 billion between projected revenues and the spending that would be needed to maintain services and follow through on prior financial commitments.

Without attempting to reproduce the Governor's projections in detail, it is not difficult to understand how he might have reached such a conclusion.

The starting point is revenues.

The Governor's estimate was based on the expectation that 2009 tax revenues would increase by about $750 million, or just under four percent (including inflation).[30] The long-term annual performance of state revenues is closer to five percent—a rate of growth that would generate about $1 billion in 2009.

Using either of these assumptions is reasonable. Both are substantially below the unsustainable eight percent growth in baseline revenues between 2004 and 2007. While the five percent rate is consistent with historical trends, the sluggish state and national economy and legitimate concerns about capital gains gives some credence to the lower four percent figure.

Stacked up against this $750 million to $1 billion of revenues is the expected growth in spending, both the generally unavoidable increases in the state's largest programs, and increases in smaller programs due to inflation and other cost pressures:

✓ $300-$400 million more for Medicaid, assuming 2009 growth between six and nine percent, an appropriate range given the general rise in health care costs. These amounts reflect the net cost to the state after subtracting federal reimbursements.

✓ Up to $100 million more for employee benefits, making similar assumptions about growth.

✓ About $200 million more for education aid, reflecting both inflation and a prior commitment to increase the share of costs borne by the Commonwealth.

✓ A bit less than $100 million for required pension contributions and the repayment of previous borrowing for capital projects.

✓ Approximately $100 million as well for the MBTA and the school building program. While these are "off-budget" expenditures, the money to pay for the increased spending will have to come from the $750 million to $1 billion of tax growth.

Massachusetts faces a structural imbalance, with spending increases outpacing revenue growth.

✓ Between $500 million and $700 million for all the rest of state government, which will go to keeping up with inflation, honoring collective bargain agreements, satisfying court mandates, and other spending needed to maintain current programs and services.[31]

All together, the expected spending growth comes to $1.3-1.6 billion. Subtracting this total from the $750 million to $1 billion of new tax revenues leaves a gap of $550-$850 million.[32]

There are several key points to be made about this analysis.

The first is its uncertainty. 2009 tax revenues could grow a bit more than the four to five percent built into the analysis, though almost certainly not at the rapid rates of previous years. Spending could grow less, but probably not by much if services are to be maintained. While the estimated gap is less than the Governor's, it is based upon a very general review of spending that could well have missed higher than average cost increases in some smaller programs.

The second point is what the analysis leaves out. It does not take into account two major revenue risks: the possibility of a recession, and a sudden decline in capital gains, either of which could wipe out a large portion of the assumed growth.

In a similar vein, it makes no room for unforeseen, and possibly quite large, cost increases related to the universal health care initiative. Nor does it incorporate a known new obligation—the $400-500 million a year that is likely to be needed to address the $7.5 billion unfunded liability for the future costs of health care benefits that state employees have already earned for their retirements.

And, it does not accommodate any major new financial commitments, such as expanding early education, providing tax relief to cities and towns, or using tax revenues, rather than borrowing, to make a dent in the long list of unmet capital needs.

The final—and most important—point to be made about the gap identified in the analysis is its structural nature. The revenue growth built into the projections reflects ongoing trends, not circumstances peculiar to 2009.

Likewise, the factors driving spending—including health care, debt service and other obligations, financial commitments to local education, and others—are almost certain to persist as well.

That means that a successful effort to close the gap in 2009 will be only a temporary victory if it does not also deal with the underlying structural imbalance. Unfortunately, the focus of the budget process on the short term —only on this year's budget, not on next year's or the one after that—will make it difficult to recognize and find solutions to this longer term problem.

VI. Concluding Thoughts

Massachusetts faces a structural imbalance, with spending increases outpacing revenue growth. This imbalance reflects long-term trends and is not particular to the current year. Yet, with the nation teetering on the edge of recession and health care costs rising at unsustainable rates, there is a new urgency to addressing this challenge. As a way to jumpstart a statewide conversation, we offer the following recommendations:

Minimize the effects on capital gains tax revenues on the budget

In recent years, Massachusetts has become heavily dependent on capital gains revenues for new revenue growth. From 2002 to 2006, the state collected $2,196 billion in new revenues. (This amount was offset by revenue losses in the sales tax and several other taxes.) More than half of the positive growth (54%) came from capital gains taxes, which by their nature are highly volatile.

Steps should be taken to better manage the known risk in the capital gains taxes. For instance, state leaders could take a historical average of capital gains receipts—perhaps over 7 years—and only use that amount in any given year, putting any excesses into reserve for use in years when revenues fall below that average. Such an effort would help avoid making ongoing spending commitments based on high levels of capital gains revenues that cannot possibly be sustained and would help create a cushion against the inevitable declines in those revenues.

Consider broadening the base of the tax structure.

Broadening the base of the state's tax structure would reduce our dependence on capital gains taxes. While broadening the base of a tax can be made revenue neutral by simultaneously reducing its rate, such a change would inevitably shift a portion of the burden from some taxpayers to others. Tax increases in one area could be offset by decreases in another to ensure no one group bears a disproportionate burden.

This is a politically complicated option, and one that will require leadership, consensus building and compromise. The primary goal is to reduce our dependence on capital gains taxes to fund on-going spending commitments.

Improve the transparency of Medicaid spending

Medicaid is both the largest program administered by state government and one of the least understood. Its spending totaled $7.4 billion in 2006—26 percent of the budget—and since 1987, the program has been responsible for almost two-thirds of all spending growth.

There are a number of reasons why the state's Medicaid spending has increased so much, including rising health care costs, a broader array of benefits than are federally mandated, a greater proportion of more-expensive-to-care-for elderly and disabled clients than other states, and a longstanding policy commitment to expand its rolls. Medicaid spending has also increased as a result of the state's efforts to strategically leverage federal dollars to fund programs.

At the same time, however, the program has become progressively more difficult to understand. While it, like the health care system as a whole, is inherently complex, its daunting jargon and baroque accounting raise high barriers to comprehension. The state budget process does little to shed light on how the program operates and what is driving up its costs.

The need for transparency—clearer, more timely information and analysis on how much is being spent, how that spending is financed, and who is being served—could not be more urgent. A recent report by the Center for Medicare and Medicaid Services' Office of the Actuary projects Medicaid spending to grow by 7.9 percent per year through 2017, a rate well above the overall growth expected in the economy.

Discussions in Washington suggest the federal government—which pays for about 50 percent of Medicaid's costs—could be on the verge of reducing its reimbursements to states. The Commonwealth's universal health care initiative has raised the stakes even further, with new, difficult-to-predict cost pressures and a major new layer of programmatic and financial complexity.

The state should foster a sense of responsibility and accountability through regular outcome measurement

Develop specific criteria for withdrawals from the reserve fund and limit the amount of withdrawals

There is currently almost unlimited flexibility in determining the use of the rainy day fund. There has not always been a clear or compelling rationale justifying the need for withdrawals nor the amount of those withdrawals.

The fiscal 2009 budget proposed by the Governor highlights the need for a fiscally responsible policy for stabilization fund use, and presents one approach to developing such a policy.

The reserve fund should be used judiciously to sustain state spending commitments during economic downturns. Its primary purpose is to preserve fiscal stability in response to revenue downturns, not to be routinely tapped to balance the budget or to fund new, ongoing spending commitments.

Bring greater transparency to all government spending

Between 1987 and 2006, the share of total state spending that occurred outside the annual budget increased from almost 20 percent to almost 33 percent. Today's large amount of off-budget spending prevents revenues and spending to be seen all together, creating obstacles to making a true set of choices around revenues and spending. The use of two different reporting standards for the state's financial activities is a further impediment to understanding the state's budget.

Create greater urgency around outcome measurement; eliminate duplication; and end programs that have outlived their purpose

While public policy experts agree that the structural imbalance cannot solely be solved through reforms and greater efficiencies alone, it is imperative that the state foster a sense of responsibility and accountability through regular outcome measurement. This will require tough political choices that are necessitated by the structural imbalance combined with a possible national recession. A Blue Ribbon Commission modelled on the base-closings commission might provide the best option to tackle these politically sensitive issues.

ENDNOTES

1. Special revenue funds account for the proceeds of specific revenue sources that are restricted to finance specific functions. The authority to spend the revenue that is credited to one of these funds is established at the time the fund is created, providing an "evergreen" appropriation that stands alone outside the budget.
2. For purposes of comparison, the 2006 spending shown here includes off-budget Medicaid, school construction, and MBTA assistance that until relatively recently were part of the budget. It does not include other off-budget spending for lottery operations, federal grants, universal health care, capital projects and certain other purposes.
3. Between 1987 and 2006, total personal incomes increased 1.8 percent a year, on average, compared to the 1.2 percent rate of growth in earnings. Wages and salaries are one component of personal income. The difference in growth rates is attributable to growth in non-wage components of income.
4. Not including the costs of Prescription Advantage, a drug insurance program for seniors, or off-budget, non-Medicaid health care spending, largely for "free care" provided by Massachusetts hospitals and primarily funded through assessments on those hospitals.
5. The percentage of Medicaid costs that are federally reimbursed varies from state to state. In 2006, the basic reimbursement rate for Massachusetts and 11 other states was the minimum of 50%.
6. Based on Medicaid spending as reported by the comptroller, with certain adjustments for off-budget spending and changes in accounting treatment. Medicaid totals used here do not include off-budget payments earmarked for hospitals that provide a disproportionate share of free care.
7. The other budget busters were employee health insurance, pensions, debt service and the MBTA.
8. The state's efforts to expand coverage included participation in SCHIP, a federally sponsored program of low cost health insurance for families and children.
9. While there had been an apparent pause in spending growth in 2005, the lull was due to an accounting change that reduced spending temporarily and in the process increased that year's budget surplus by approximately $150 million.
10. Based on total Medicaid and SCHIP expenditures for federal fiscal years 1997-2004, as reported by the Centers for Medicare & Medicaid Services.
11. Other than a small amount of startup funds approved in the final budget bill for the year.
12. GIC spending growth in 2006 was partly due to an increase in the percentage of premium costs that was paid by the state, reversing actions in previous years that had reduced the state's share.
13. The public assistance category, which includes child care spending and certain administrative costs, has been adjusted to ensure consistent comparisons across the years.
14. As part of the federal reforms, AFDC (Aid to Families with Dependent Children) was renamed Transitional Aid to Needy Families, or TANF.
15. The social services amounts exclude child care expenditures that the state comptroller reports in the public assistance category.
16. Other Department of Education spending in areas such as adult education, student assessment, and administration is not included in these totals.
17. The $1.3 billion does not include approximately $450 million of borrowing for local school construction that will be repaid with dedicated sales tax revenue; the $1.7 billion debt service total does not include approximately $350 million of MBTA debt service, also funded from dedicated sales taxes.
18. Current plans to increase the bond cap by $125 million a year through 2012 would, based on official estimates, have little impact on annual debt service requirements.
19. As with spending, the revenue totals shown here reflect the partial view of the state's finances that is built into the annual budget. For example, on-budget lottery profits are included, but off-budget proceeds of ticket sales that are distributed as prizes are not. Likewise, federal reimbursements for Medicaid are counted, but federal grants that finance off-budget health care spending are not.
20. Based on total personal income in the state adjusted upward to include taxable capital gains realizations.
21. The tax rate on wage and salary income was initially raised to 5.375% and 5.75% for 1989 and 1990, respectively, in order to pay for 1989 deficit and Medicaid related borrowing. The tax rate for 1990 was then raised to 5.95%, and temporarily increased to 6.25% for 1991. The rate reverted to 5.95% in 1992.
22. Inflation-adjusted capital gains tax receipts grew $1.2 billion from 2002 to 2006, while total tax receipts rose $1.3 billion. The difference of about $100 million was the product of two opposing forces: Growth in corporate and other business taxes of almost $900 million that was offset by decreases in other taxes, including a $500 million decline in sales tax revenues.
23. This average, based upon data from the Sales Tax Clearinghouse, takes into account both state sales taxes and local sales taxes that are permitted in the majority of states.
24. The ranking is from The Tax Foundation, using Census Bureau statistics.
25. The amounts shown are based upon an analysis of major tax law changes in 1987-1990 and on estimates prepared by the Department of Revenue of tax law changes in 1991-2006.
26. The small deficit in 1999 was the result of major tax cuts, not deterioration in the economy or a surge in spending.
27. Roughly $100 million was set aside at the end of fiscal 1988, a small sum that was used up in the following year.
28. The crisis was also eased by approximately $450 million of emergency aid from the federal government that was part of a broader package of relief for all 50 states.
29. Although the unspent tobacco money remained available at the end of 2006, the 2008 budget uses the funds to make an initial contribution towards eliminating the unfunded liability for the future costs of retiree health benefits.
30. The rough calculation that follows does not factor in changes in non-tax receipts (other than federal Medicaid reimbursements) which tend to grow at a low rate.
31. The lower end of this range reflects the rate of inflation in the economy as a whole, the upper end the rate for state and local governments.
32. The gap would be $300 million if revenues grew by the higher amount of $1 billion and spending by lower amount of $1.3 billion, an increasingly unlikely event given the recent trends in the economy and health care costs.