

ANNUAL REPORT 2012

A Citizen's Guide To the State of The States

MASSACHUSETTS



THE STATE OF THE STATES

EXECUTIVE SUMMARY

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PRODUCED BY





2012

Dear Citizens of the Commonwealth of Massachusetts,

We are pleased to present to you the Annual Report of Massachusetts 2012, a joint venture of Harvard University's Institute of Politics at the Kennedy School, the Fels Institute of Politics at the University of Pennsylvania, and the American Education Foundation, for the fiscal year ending June 30, 2011. This report presents information not only from the 2011 fiscal year (the latest year for which data is available), but also from fiscal year 2012, the FY 2013 Massachusetts budget, and previous years to provide context and enable a comprehensive analysis of state government financial trends. The data in this report were drawn from Massachusetts' Comprehensive Annual Financial Reports ("CAFRs"), produced by the state's comptroller, from years 2002 to 2011, the 2010 United States Census, and various other official data sources that we have found to be the most reliable sources on state finance.

This report was designed to synthesize the complicated financial information available into one easy-to-read document. We believe that you deserve to know "the state of the state" and we hope that our report will inform all citizens about the basics of state finance and the challenges that lie ahead. We did our best to ensure that this report reflects a nonpartisan analysis of the state's fiscal health. With all the politics and noise surrounding budgeting and state financial planning, we believe that this neutral perspective is vital when assessing budgets.

We begin the report by looking at basic demographic and financial information about the state to provide a snapshot of Massachusetts' financial position. The report then moves on to discuss four key budget topics that we believe are crucial to understanding financial trends: health care, education, infrastructure, and pensions.

We hope that this document is both an informative and useful guide for understanding the many challenges that Massachusetts faces. To find out more about the States Project and how you can get involved, please visit our website at <http://www.thestatesproject.org>.

Sincerely,

Meredith Bagby
PUBLISHER

Syon Bhanot
EDITOR-IN-CHIEF

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OVERVIEW

Across the country, states grapple with difficult fiscal issues. The financial crisis of 2008 and subsequent years of stagnant economic growth have brought state finances to a near critical condition. As tax revenue fell, the country saw mass layoffs of state workers, from teachers to police officers to judiciary employees. Nevertheless, the demand for public services continued to increase. A stagnant economy sent more Americans toward public programs like unemployment insurance and Medicaid. Health care costs swelled and educational capacity was stretched to its limits. Our infrastructure — government buildings, schools, roads, and bridges — continued to suffer with little funding available for necessary repairs. In 2009, the federal government stepped in with much needed stimulus for the states, but those funds will expire in 2012, leaving states with even bigger deficits to fill, despite an improving economy.

Massachusetts has weathered the economic recession better than most states. The state's highly educated workforce attracted thriving technology and biotech industries, which helped keep unemployment rates lower than elsewhere. Still, Massachusetts has not been immune to the crisis. Unemployment levels remain high by historical standards; Medicaid costs are ballooning; student debt is on the rise; and public education and infrastructure can barely keep pace with public use. Amid these budget strains, public debt has swelled, making Massachusetts one of the biggest debtor states in the country. Unfunded benefits in the state-employee pension and health care systems loom as potential threats to long-term fiscal health.

“The toughest work — reigning in health care and education costs, budgeting for unfunded liabilities, and managing Massachusetts’ debt — is very much still ahead.”

In response, policy makers are seeking cost control measures. In February 2011, Governor Deval Patrick proposed legislation designed to reign in health care costs by creating an integrated model of health care delivery, which rewards providers for the quality of their care, rather than the traditional fee-for-service model. Also in 2011, the state passed legislation that reduced pension costs by limiting excessive benefits and increasing the minimum retirement age for some workers. Recent efforts to tackle long-term fiscal planning have begun to lay a foundation for a more sustainable future. That said, the toughest work — reigning in health care and education costs, budgeting for unfunded liabilities, and managing Massachusetts’ debt — is very much still ahead. As Governor Deval Patrick and his Democrat-controlled legislature set the state’s fiscal year 2013 budget, they share common priorities: to control spending, promote education, and lower health care costs.¹

¹ Lee, Christine. “Senate releases 2013 state budget.” [http://www.wvlp.com/dpp/news/politics/state_politics/wwlp-senate-releases-2013-state-budget-cl]. May 16, 2012.

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REVENUES AND EXPENDITURES

In FY 2011 Massachusetts, brought in \$49.4 billion in revenues from three main sources: taxes, user fees from state-run programs, and grants from the federal government, and spent \$49.3 billion, creating a surplus of \$148 million.

The largest source of tax revenue in 2011 was from the state's flat income tax of 5.3%, which produced over 50% of total tax revenue.² Income tax collection rose nearly 60% from 2003 to 2008, but fell by 17% in 2009 due to the national economic downturn.³ In 2011, as unemployment fell below 8%, income taxes rose 16%. Still, tax collections have not returned to pre-recession levels. The Massachusetts sales tax (6.25%) is the second largest source of tax revenue, followed by the corporate tax (8%). User fees for the state programs provide nearly \$8 billion in state revenue and come largely from higher education fees. Grants from the federal government, often linked to specific programs, rose from 19.3% of state revenue in 2008 to 26.7% in FY 2011 due to increased funding for Medicaid, food stamps, and K-12 education.⁴

The state of Massachusetts spent a total of \$49.3 billion in FY 2011; including component units of the government like MassDOT, the total was \$55 billion.⁵ Since 2006, state expenses have grown 8.4% after adjusting for inflation, owing largely to increased expenditures on Medicaid and unemployment compensation, which saw greater public demand as a result of the recession.⁶ Like many states, the largest outlay by the Massachusetts state government, \$20.3 billion, went to health care — specifically to the MassHealth program, which funds health care for low-income individuals and has a total expenditure of \$12.1 billion.⁷ Medicaid spending alone has increased nearly 50% since 2006.⁸ Unemployment insurance spending has increased the most in percentage terms, as poor economic conditions have left more people to claim unemployment checks. Between 2007 and 2011, unemployment compensation costs increased 206.9%, from \$1.4 billion to \$4.4 billion.⁹

NET WORTH, ASSETS AND LIABILITIES

Massachusetts' net worth is calculated by taking the difference between its total reported assets of \$25 billion and \$43.9 billion in total reported liabilities.¹⁰ According to the Comptroller, Massachusetts has a negative net worth of \$18.9 billion.¹¹ That means that if Massachusetts sold

² Massachusetts CAFR 2011.

³ Massachusetts CAFRs 2003 - 2011.

⁴ Massachusetts CAFR 2011.

⁵ Ibid.

⁶ Ibid.

⁷ Total health care outlays were computed by adding Medicaid, Health and Human Services, and Group Health Insurance expenses together from the Massachusetts CAFR 2011.

⁸ Massachusetts Medicaid Policy Institute. "Massachusetts Medicaid in Perspective: An Analysis of Spending Growth and Economic Growth, 1996-2007." [<http://www.massbudget.org/reports/pdf/medicaid0925.pdf>]. September 2008.

⁹ Massachusetts CAFR 2011.

¹⁰ Assets can take the form of explicit value, like cash or investments, or of held value, like a bridge or a building. Liabilities are all debts for which the state is responsible, including bond issuances, the pensions and health care of state workers, tax refunds to citizens, and financing agreements such as leases for vehicles or land. All assets and liabilities are reported by the state Comptroller of the Commonwealth at the end of each fiscal year. These figures gathered by the Comptroller are as reported by each of the state agencies.

¹¹ Massachusetts CAFR 2011, Statement of Net Assets, P 40.

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off all its assets to pay all its debts, the state would still owe approximately \$19 billion. That amount of debt is nearly \$3,000 for every man, woman and child in the state of Massachusetts.¹²

As of the end of FY 2011, Massachusetts owed a total of \$24.2 billion in bonded debt secured by future revenues, state assets, and capital leases. This bonded debt represents 7% of the total annual personal income of the state. Using a broader measure of debt tallied by the Census Bureau, Massachusetts is actually the largest per capita debtor state, with liabilities of \$11,357 per citizen through FY 2009, or \$74.6 billion.¹³ This broader measure includes all debts owed by the state and its agencies, whether fully backed by the credit of the state or not.

Massachusetts will need to raise a significant amount of additional revenue and make reductions in services if the state is to remain solvent in the long run. Massachusetts and other states have taken action to reduce future liabilities, such as unfunded pension liabilities, but much more needs to be done. Massachusetts' population carries a relatively high debt load compared to other states and that load has only increased in recent years. Capital project expenditures provide some stimulus to the state economy, but there are limits to the efficacy of continually borrowing for capital projects and accumulating more debt in the process. Massachusetts retains high ratings on its debt and low borrowing costs, but the state is susceptible to market suspicion of state bonds given its position as one of the more heavily indebted states.

DEMOGRAPHICS

Massachusetts' demographics paint a picture of a state that is wealthy, well-educated, and recovering well from the recent recession compared to other states. Massachusetts' citizens have a median income 25% above the national average.¹⁴ They are better educated than the citizens of almost every other state, with a large proportion of residents, nearly 40%, holding at least a bachelor's degree. In comparison, the national average is 28%. The state poverty rate, incarceration rate, and unemployment rate are all below the national averages, and the unemployment rate, at 7% in the fall of 2012, has been steadily decreasing since 2009 and is well below the national average of 8.5%.¹⁵ The state population, however, is growing more slowly, at 3.1% from 2000 to 2010, than the national average of 9.7% for the same time period. And the state population is aging more rapidly, with the ratio of old to young exceeding the national average (0.79 in Massachusetts versus 0.69 nationally). Massachusetts' aging population could create fiscal issues in the coming years, as a growing retiree population drives up pension and health costs and a smaller number of current workers struggle to support them.

¹² Ibid.

¹³ U.S. Census Bureau. "State and Local Government Finances by Level of Government and by State." 2011.

¹⁴ Massachusetts CAFR 2011.

¹⁵ Massachusetts CAFRs.

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HEALTH CARE

At just over 40% of the state budget, health care spending constitutes the largest percentage of Massachusetts state expenditures. This figure is up from 23% in 2000, and Governor Patrick's administration estimates that at current rates, health care spending will consume 50% of the state budget by 2020.¹⁶ The main components of this spending category are Medicaid (administered as MassHealth and taking up 70% of the overall health care budget) and health insurance for state employees and retirees. Governor Patrick has made health care cost control a priority, proposing legislation in 2011 that would reform the payment metric for health services from fee-for-service to global payments, which incentivize more efficient care.

“Governor Patrick’s administration estimates that at current rates, health care spending will consume 50% of the state budget by 2020.”

EDUCATION

Massachusetts operates two systems of public education: kindergarten through twelfth grade (K-12), and a system of public universities and community colleges which provide higher education at a reduced cost to the state's citizens.

The state spends approximately 7% of its budget on K-12 education, with per-pupil spending well above the national average in K-12 education. Massachusetts ranks highly on nearly all measures of achievement nationally, including student scores, high-school graduation rates, and matriculation rates to higher education. That said, like many other states, Massachusetts suffers from an achievement gap between low-income and high-income communities. A growing (and controversial) charter school movement has developed in the state to help address these issues. As of 2011, charter schools educate 3% of the state's K-12 population.

In FY 2011, the deficit for higher education activities, i.e. the amount that total expenses exceeded total revenues from tuition and grants, was \$1.1 billion. Because the state is committed to higher education, Massachusetts funded this deficit through borrowing and the use of other revenues (like taxes) to fill in the gaps.¹⁷ Tuition costs continue to increase across the state, causing students to take on higher levels of student debt. Despite these economic woes, Massachusetts remains a national leader in education.

¹⁶ Patrick, Deval. “Addressing Health Care Costs.” [http://www.mass.gov/bb/h1/fy13h1/exec_13/hbudbrief4.htm]. 2012.

¹⁷ Massachusetts CAFR 2011, Statement of Activities, P 42.

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INFRASTRUCTURE

According to a 2009 survey by the American Society of Civil Engineers, 56% of Massachusetts state bridges were “structurally deficient or functionally obsolete,” compared to only 26% of bridges nationwide. Meanwhile, 41% of state roads were in “poor or mediocre condition,” compared to only 33% nationwide. As Massachusetts’ roads, bridges, and tunnels continue to deteriorate, the state must raise an additional \$15 to \$19 billion over the next two decades simply to maintain the existing transportation infrastructure.¹⁸ Governor Deval Patrick’s administration has taken steps to address Massachusetts’ deteriorating infrastructure system, including devoting stimulus funds to infrastructure projects and pushing forward the Accelerated Bridge Program which has improved these numbers. However, the need for significantly more investment in infrastructure remains.

“According to a 2009 survey by the American Society of Civil Engineers, 56% of Massachusetts state bridges were structurally deficient or functionally obsolete.”

PENSIONS

As with nearly every other state in the union, Massachusetts is struggling to control the costs of pension benefits for state employees. As of 2011, Massachusetts had approximately 90,000 pension-eligible working employees and 50,000 retirees currently receiving an annual pension benefit averaging \$26,363.¹⁹ The state of Massachusetts disburses a total of \$1.4 billion in these benefits annually.²⁰

According to the Public Employee Retirement Administration Commission, Massachusetts has \$64.2 billion in pension liabilities and \$45.6 billion in assets, which leaves an unfunded liability of almost \$19 billion.²¹ Pension funding levels have decreased over the last ten years as the state has passed off a greater share of the costs to employees. The state also uses a generous target rate of 8.25% to estimate the annual rate of return on invested pension funds. Setting such a high target means the state faces a high risk of falling short in the future. In the short term, the state plans to lower the expected return rate on invested pension funds, which will result in a much higher unfunded liabilities estimate than previously computed.

In 2011, Governor Patrick successfully proposed legislation to reform the state pension system. Like reforms made in other states, the Massachusetts law raises the minimum retirement age from

18 “Report Card for America’s Infrastructure.” [<http://www.infrastructurereportcard.org/state-page/Massachusetts>].

19 Public Employee Retirement Administration Commission Commonwealth of Massachusetts. “State Retirement System Actuarial Valuation Report.” [<http://www.mass.gov/perac/state/stateval11.pdf>]. January 2011.

20 Ibid.

21 Ibid.

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55 to 60 and lengthens the salary period used to calculate pension benefits from three to five years for new retirees. Though there was some opposition to this measure, it is likely the first of more reforms to come.

“According to the Public Employee Retirement Administration Commission, Massachusetts has \$64.2 billion in pension liabilities and \$45.6 billion in assets, which leaves an unfunded liability of almost \$19 billion.”

THE FUTURE

Massachusetts finds itself in a relatively strong fiscal position compared to other states, even after suffering the setbacks of the recent recession — but problems loom. The state’s population is wealthy and well-educated, but it is also aging rapidly. Revenues are on their way to recovering to pre-recession levels, but expenditures continue to increase on crucial and hard-to-cut areas like Medicaid. The state has made a commitment to repairing its crumbling infrastructure system, but much work remains to be done, and funding is short. Almost every Massachusetts resident has health insurance, but costs are skyrocketing and fundamental reforms are needed to ensure that the system survives. The state is a leader in education from K-12 to college, but troubling achievement gaps separate socio-economic communities within the state, and students are being forced to take on larger debts to fund their higher education goals. The state’s pension system, which provides for retired public workers, continues to be underfunded, despite recent reforms.

Massachusetts, more than almost any other state, has the resources to address these issues. Maintaining a responsible budget in the coming years, while ensuring that state services are not slashed severely, will require difficult political choices and a reassessment of the state’s priorities and its abilities to meet them. If Massachusetts cannot find this balance, it will be a troubling sign for the many other states in budgetary distress.

The state’s proposed budget for FY 2013 provides an indication of the course Massachusetts will chart. Governor Patrick, who released his annual budget proposals in January 2012, said that his administration has four key priorities: growing jobs, closing the achievement gap in public schools, lowering health care costs, and ending youth violence by supporting positive youth development. The administration’s budget, which maintains funding for education and health care, reflects these priorities. The State Senate and House of Representatives, which passed their own proposed budgets, cited similar priorities — job growth, public education, and reigning in health care costs. ★

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