

ANNUAL REPORT 2012

A Citizen's Guide To the State of The States

MASSACHUSETTS



THE STATE OF THE STATES

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The State of the States
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2012

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TABLE OF CONTENTS

| | |
|--------------------------|-----------|
| Letter to Citizens | 1 |
| Executive Summary..... | 3 |
| Income Statement..... | 9 |
| Revenues | 11 |
| Expenditures | 19 |
| Balance Sheet..... | 25 |
| Demographics..... | 31 |
| Health Care..... | 39 |
| Education..... | 51 |
| Infrastructure..... | 61 |
| Pensions | 69 |



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

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/wvlp-senate-releases-2013-state-budget-cl]. May 16, 2012.

{ executive summary }

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.

{ executive summary }

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.

{ executive summary }

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.

{ executive summary }

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.

{ executive summary }

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. ★

{ income statement }

The income statement, or profit and loss statement, shows a snapshot of all revenues for a given year, set against all the expenditures. In FY 2011, Massachusetts' income statement showed a net gain, resulting from two factors. First, Massachusetts cut expenditures in response to increased concern over the fiscal sustainability of the state budget. Second, several areas of tax revenue began to recover from their recession-level lows. Historically, Massachusetts has had an annual deficit — expenditures have exceeded revenue. The accumulation of annual deficits over a period of years results in the state's debt.

| <i>FISCAL YEAR ENDING 6/30</i> | 2009 <small>(IN THOUSANDS)</small> | 2010 <small>(IN THOUSANDS)</small> | 2011 <small>(IN THOUSANDS)</small> |
|--|--|--|--|
| REVENUES | | | |
| Income Tax | \$10,451,006 | \$10,227,493 | \$11,862,298 |
| Sales Tax | \$3,850,485 | \$4,720,057 | \$4,924,958 |
| Corporate Tax | \$1,940,484 | \$1,857,090 | \$1,919,774 |
| Motor/fuel Tax | \$653,542 | \$658,197 | \$660,729 |
| Other Taxes | \$1,603,756 | \$1,571,390 | \$1,698,671 |
| Investment Earnings | \$102,183 | \$184,737 | \$194,137 |
| Tobacco Settlements | \$315,153 | \$263,678 | \$254,696 |
| Municipalities | \$49,780 | \$39,160 | \$55,231 |
| Net Lottery | \$950,274 | \$977,381 | \$968,731 |
| Other Net Revenue | \$1,162,129 | \$1,540,508 | \$1,182,473 |
| User Fees | \$6,571,351 | \$7,100,722 | \$7,819,405 |
| Total Revenues (excluding grants) | \$27,650,143 | \$29,140,413 | \$31,541,103 |
| Operating & Capital Grants & Contributions | \$15,369,011 | \$16,445,061 | \$17,886,60 |
| TOTAL REVENUE | \$43,019,154 | \$45,585,474 | \$49,427,706 |
| EXPENDITURES | | | |
| Health Spending | | | |
| Health & Human Services | \$7,452,418 | \$6,119,110 | \$7,124,865 |
| Medicaid | \$10,842,549 | 10,677,999 | \$12,124,261 |
| Group Health Insurance | \$977,565 | \$1,092,178 | \$1,113,544 |
| Total Health Spending | \$19,272,532 | \$17,889,287 | \$20,362,670 |
| Education Spending | | | |
| K-12 Education | \$3,210,200 | \$3,395,360 | \$3,649,543 |
| Higher Education | \$3,883,692 | \$4,118,703 | \$4,472,351 |
| Total Education Spending | \$7,093,892 | \$7,514,063 | \$8,121,894 |
| Direct Local Aid | \$5,210,451 | \$5,030,363 | \$4,845,738 |
| Unemployment Compensation | \$3,475,027 | \$5,435,611 | \$4,388,360 |
| General Government and Judiciary | \$3,768,733 | \$3,401,710 | \$3,298,773 |
| Public Safety | \$2,561,607 | \$2,409,557 | \$2,276,402 |
| Transportation | \$1,336,257 | \$2,088,354 | \$2,262,374 |
| Housing & Economic Development | \$1,042,084 | \$1,297,143 | \$1,362,822 |
| Interest on Debt | \$1,116,278 | \$1,090,471 | \$1,177,569 |
| Energy and Environmental Affairs | \$426,808 | \$326,128 | \$685,032 |
| Labor and Workforce Development | \$474,438 | \$483,091 | \$497,927 |
| TOTAL EXPENDITURES | \$45,778,107 | \$46,965,778 | \$49,279,561 |
| NET GAIN (DEFICIT) | (\$2,758,953) | (\$1,380,304) | \$148,145 |

OVERVIEW

Massachusetts collected nearly \$50 billion revenues, fees, fares, grants, and contributions in the 2011 fiscal year. The majority of revenues collected by the state can be categorized into three groups: taxes, user fees collected from state-run programs, and grants from the federal government.

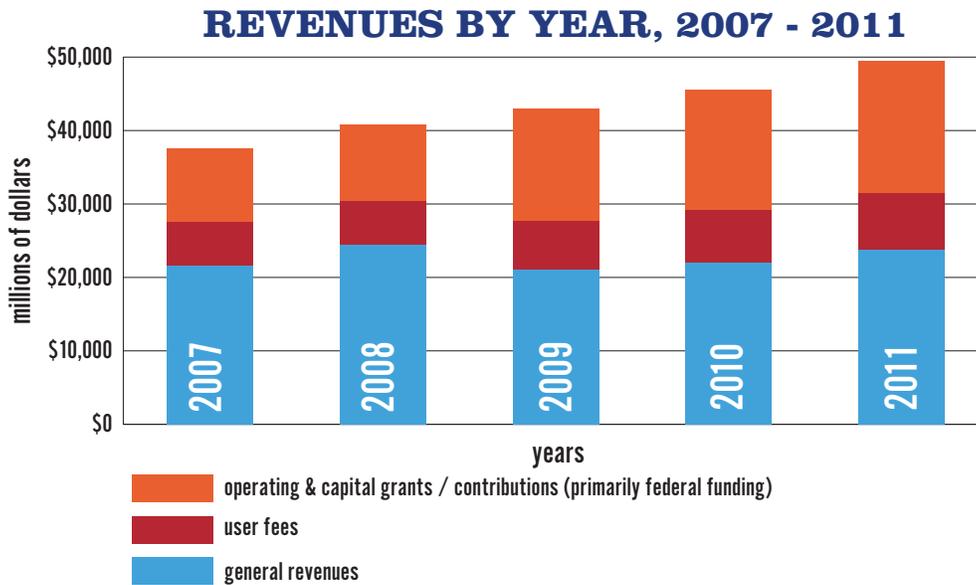


Figure 1 SOURCE: MASSACHUSETTS CAFRS 2007-2011

Figure 1 shows the revenue trends in Massachusetts over the last five years, which resemble those in other states. Specifically, 2009 marked a key moment in the way the state paid for services for its citizens. General Revenues dropped off dramatically in 2009, falling 14% in a year. This drop off was driven primarily by a decrease in state income tax revenues of over \$2 billion from 2008 to 2009, the result of the national economic crisis and its effects on the Massachusetts economy. To maintain adequate funding for state services, the federal government stepped in, with federal grants to the state rising by nearly \$5 billion from 2008 to 2009.

Figure 2 shows the breakdown state revenue in FY 2011. Figure 2 does not include federal grants as revenue, even though federal grants play a major role in helping fund many state programs in Massachusetts. Federal funds are not included because they are linked directly to specific state projects, and including them as a “revenue” source does not reflect the revenues the state is collecting from citizens for general use. Federal grants are discussed at the end of this section, because of the significant role they play in state finance.

**GOVERNMENT REVENUES BY CATEGORY
2011**

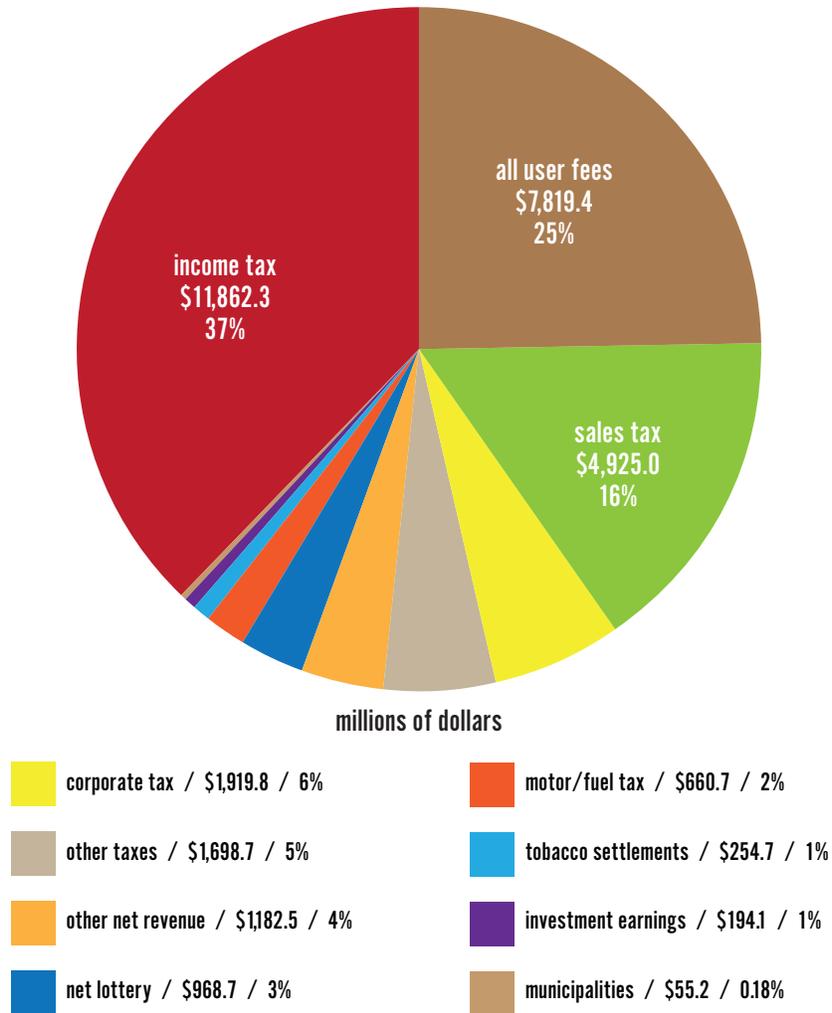


Figure 2 SOURCE: MASSACHUSETTS CAFR 2011

TAXES

There are three main sources of tax revenue in Massachusetts: income tax, sales tax, and corporate tax. The majority of taxes the state government collects come from income and sales, while local governments generally collect the largest portion of their revenue from property taxes.

Income Taxes

The largest source of tax revenue in Massachusetts is the income tax, which comprised 37% of general revenues and 56% of all tax revenues in Massachusetts in FY 2011. The Massachusetts income tax system, unlike in many other states, is a flat tax system. All citizens pay the same percentage — 5.3% of their pre-tax income to the state. Only six other states have this type of

{ revenues }

“flat” rate system — Colorado, Illinois, Indiana, Michigan, Pennsylvania, and Utah. Most other states have a “progressive” system, in which higher income earners pay a greater percentage of their income in state tax than lower income earners.

INCOME TAX REVENUES & UNEMPLOYMENT RATE

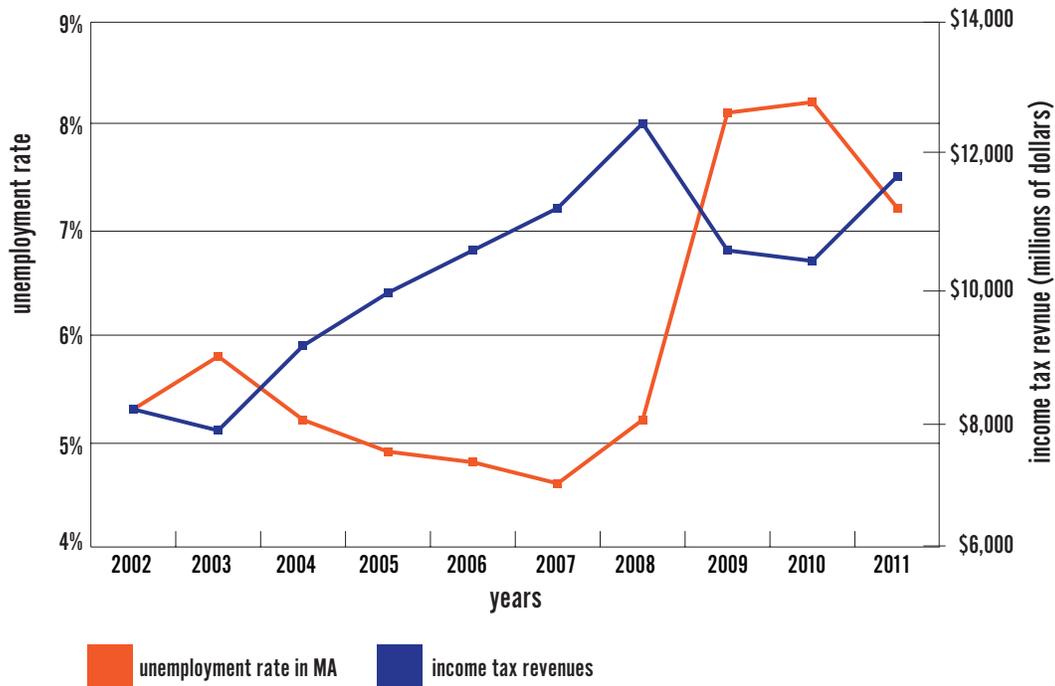


Figure 3 SOURCE: MASSACHUSETTS CAFRS 2002-2011

Concerned about income inequality, Governor Deval Patrick voiced support for moving towards a progressive system in Massachusetts in 2010.²² This remains a contentious issue in the state, with Democrats generally more supportive of the idea and Republicans against it.²³

Income tax collection rose steadily in Massachusetts from 2003 to 2008, increasing by 58.7% over that period. However, in 2009 income tax revenue fell by 17.4%.²⁴ The economic crisis that began in the fall of 2008 was certainly the main culprit. The crisis triggered higher unemployment and underemployment in the state, which meant less overall income for citizens and less income tax for the state. While 2009 and 2010 were hard years for the state economically, there were signs of recovery in 2011, with unemployment falling below 8% and income taxes rising 16% as a result.

22 Quinn, Garrett. “Patrick’s progressive income tax dream.” [http://boston.com/community/blogs/less_is_more/2010/10/patricks_progressive_income_ta.html]. October 6, 2010.

23 Cheny, Kyle; Kirk, Bill. “Poll shows strong support for graduated income tax.” [<http://www.patriotledger.com/news/x1696242155/Poll-shows-strong-support-for-graduated-income-tax>]. October 29, 2010.

24 Massachusetts CAFR 2009.

{ revenues }

Sales Taxes

Sales tax is the second largest source of tax revenue for Massachusetts, at 16% of general revenues and 23.4% of total tax revenue in FY 2011. Sales taxes are commonly the most “noticed” tax because citizens pay a sales tax with most consumer purchases. Massachusetts levies a state sales tax of 6.25%, slightly higher than that of other states. However, direct comparisons between states on sales taxes can be challenging. Many states allow local sales taxes on top of state sales taxes. Massachusetts does not.²⁵ In addition, the Massachusetts sales tax does not apply to some items, including food, periodicals, fuel for residential use, and some clothing.

Revenue from sales taxes has been relatively stable over the last ten years, with a notable spike in 2010. This increase in sales tax revenues was largely the result of an increase in the state sales tax rate from 5% (in 2008) to 6.25% (in late 2009).²⁶

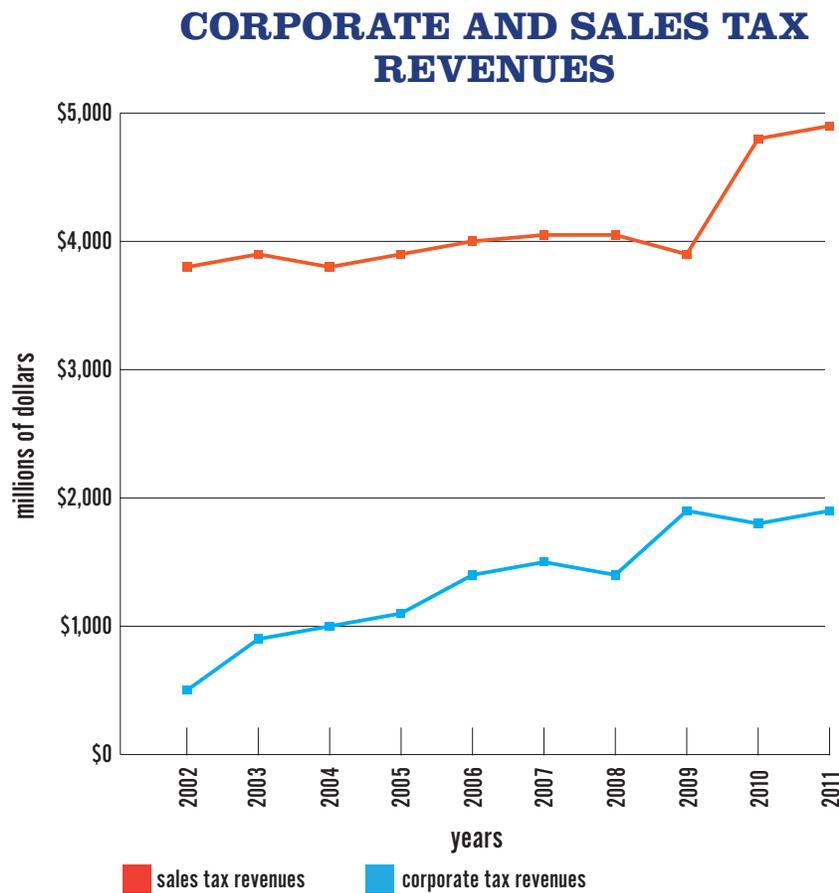


Figure 4 SOURCE: MASSACHUSETTS CAFRS 2002-2011

25 “State Sales Tax Rates.” [<http://www.salestaxinstitute.com/rates.html>]. June 1, 2012.

26 Levenson, Michael. “Mass. Senate approves sales-tax increase.” [http://www.boston.com/news/local/breaking_news/2009/05/mass_senate_app.html]. May 19, 2008.

{ revenues }

Corporate Taxes

Corporate taxes are levied on the profits of corporate entities, much like income taxes are on individuals. Revenues gained through corporate taxes have been volatile over the past decade, with corporate tax revenues rising from 2002–2009, then flattening out in 2010 and 2011. This flattening out in revenue is not only due to the recent economic downturn, but also because Massachusetts lowered the corporate tax rates from 9.5% in 2009 to 8.75% in 2010 to 8.25% in 2011 to 8.0% in 2012.²⁷

Governor Deval Patrick, who was a proponent of the corporate tax cut, says, “Our number one priority is job creation and continued economic growth. The reduction in the corporate tax rate puts real money into the hands of Massachusetts corporations, providing resources that can be used for job creation and business development in communities across the Commonwealth.”²⁸

Some in the business community, however, argue that the corporate tax cuts only softened the blow of other recent legislation, like the increase in the unemployment insurance tax that companies pay for each employee.²⁹ Furthermore, the Massachusetts Secretary of Housing and Economic Development, Gregory Bialecki, points out that while the most recent corporate tax cut (to 8.0%) will likely save state businesses around \$15 million in 2012, businesses will likely continue to face rising energy and health care costs in the near future.³⁰

Excise Taxes

Massachusetts collects revenue on the production of certain goods, or excise taxes. Because the tax is levied on the production (and therefore built into the price of the good itself), many citizens are not aware of excise taxes. Massachusetts levies excise taxes on many goods, including cigarettes, alcohol, and gasoline. Some excise taxes are sometimes referred to as “sin” taxes because they act to dissuade the consumption of the taxed items by raising their prices. The excise tax on cigarettes in Massachusetts, for example, is \$2.51 per pack of 20 cigarettes. This tax raises the price of cigarettes — and arguably keeps people from smoking as much as they would have without the tax.

Governor Patrick has recently advocated for raising the state cigarette tax to \$3.01 per pack, as part of a larger state plan to raise taxes on unhealthy products. The state is also planning to remove the state tax exemption for candy and soda. In a statement, the Executive Office for Administration and Finance argued in favor of these policy proposals, saying, “These revenue proposals will discourage public consumption of unhealthy products that increase public health costs and will fund public

27 “Corporate tax rate down to 8.25%; was 9.5% in calendar 2009.” [<http://revenue.blog.state.ma.us/blog/2011/01/corporate-tax-rate-down-to-825-percent-was-95-percent-in-calendar-2009.html>]. January 3, 2009.

28 Ibid.

29 Cheney, Kyle. “Corporate tax cut on schedule as businesses aim to prevent U.I. increase.” [http://www.wickedlocal.com/chelmsford/news/x1569728649/Corporate-tax-cut-on-schedule-as-businesses-aim-to-prevent-U-I-increase?zc_p=0#axzz1vkWdtgWm]. December 29, 2011.

30 Ibid.

{ revenues }

health investments that will help save money in the statewide health system and help all residents attain healthier lifestyles.”³¹

Not everyone agrees with these policies. Republican State Representative Bradley Jones argues, “Raising taxes is not the fiscally or economically responsible approach.”³² He argues that the tax increase on cigarettes may drive smokers to New Hampshire to buy cigarettes where taxes are lower (only \$1.68 per pack).³³ If that occurs, the state will not generate much more revenue from the tax increase, and smokers will not be deterred from behavior harmful to their health.

USER FEES

The State of Massachusetts, like all other states, collects significant fees from its citizens in direct exchange for the services it provides. In 2011, these collections totaled nearly \$8 billion, over half of which came from public higher education tuition and unemployment taxes collected.

This \$8 billion figure does not factor in lottery ticket revenues and money collected by the Massachusetts Department of Transportation (MassDOT), which represent roughly \$5 billion and \$1 billion in revenue, respectively. Lottery revenues are not included in the overall figure because lottery revenues are most accurately reflected by their net total, once lottery winnings are subtracted from the total lottery revenues. The net lottery contribution represents close to \$1 billion in revenue and is listed separately from user fees. Meanwhile, the MassDOT is considered a “component unit” of the government, and thus legally separate from the rest of the government financials. As such, this report assesses its financial situation separately, in the Infrastructure section of this report.

FEDERAL MONEY & ECONOMIC DOWNTURNS

During economic downturns, the federal government will often increase the amount of money it provides to states in order to make up for state deficits and shortfalls. The federal government can do this because it has the ability to both print more money and carry an annual budget deficit, whereas most states are required to balance their budgets every year. Giving more federal grants to states allows states to weather recessions with fewer layoffs of teachers and public safety workers, while still providing unemployment checks and basic services to state citizens.

31 Salsberg, Bob. “Mass. Gov. to seek hike in cigarette tax.” [<http://www.salemnews.com/region/x1456424376/Mass-Gov-to-seek-hike-in-cigarette-tax>]. January 21, 2012.

32 Ibid.

33 Sanborn, Aaron. “Tobacco tax cut remains party divide for Democrats, GOP.” [<http://www.seacoastonline.com/apps/pbcs.dll/article?AID=/20120311/NEWS/203110321/-1/NEWSMAP>]. March 11, 2012.

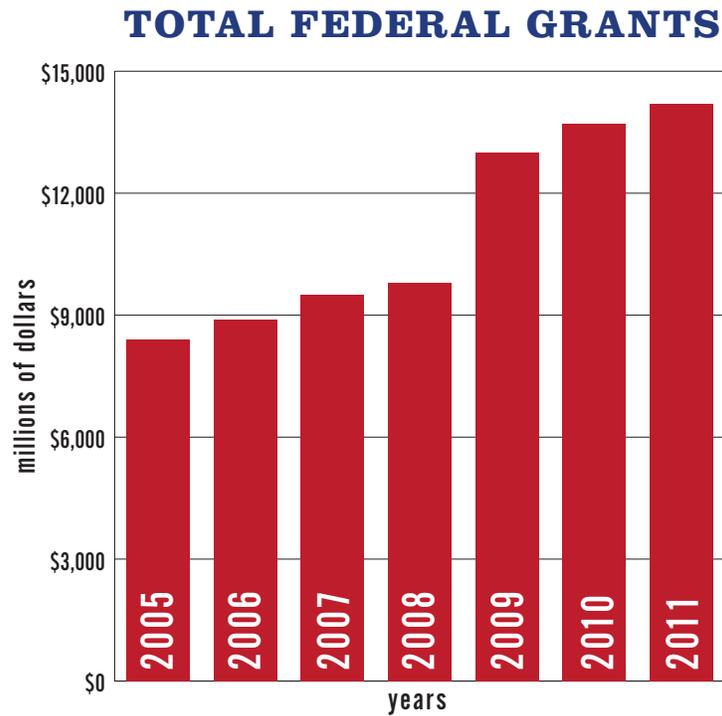


Figure 5 SOURCE: MASSACHUSETTS CAFRS 2005-2011

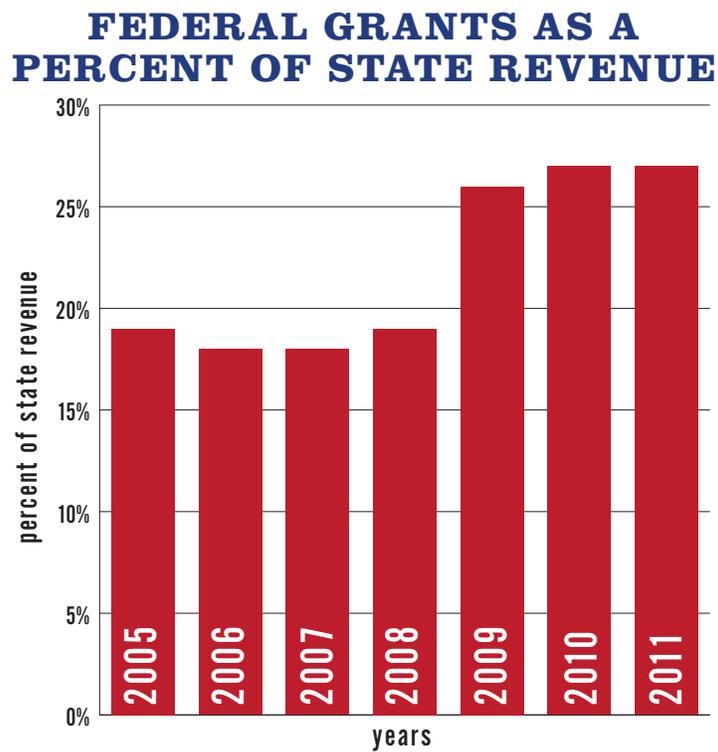


Figure 6 SOURCE: MASSACHUSETTS CAFRS 2005-2011

{ revenues }

OPERATING AND CAPITAL GRANTS

Another major source of revenue for Massachusetts is federal grant money, the primary contributor to a category of revenue called operating and capital grants/contributions. This federal money comes from federal tax dollars that are collected state-by-state from sources such as the federal income tax. According to figures from the National Association of State Budget Officers, states in the U.S. receive roughly 34.1% of their funds from the federal government.³⁴

In 2011, Massachusetts received \$14.4 billion in federal grants, or 26.7% of all its revenues, up from 19.3% in 2008. That amounts to around \$2,200 per citizen in Massachusetts. Still, Massachusetts is relatively less reliant on federal government funds than other states.

“In 2011, Massachusetts received \$14.4 billion in federal grants, or 26.7% of all its revenues, up from 19.3% in 2008.”

The majority of federal grants are spent on Medicaid, nutrition programs like food stamps and subsidized school lunch, and K-12 education. Many federal grant dollars are linked directly to specific programs and projects, which may carry certain requirements. Therefore, states are constrained in how they spend those grants. Requirements can come in the form of building code standards for affordable housing grants, coverage minimums for Medicaid assistance, or standardized testing requirements for K-12 education funding. State budgets that rely on federal grants for these programs face risks that federal funding for such programs will be reduced, leaving states to more fully fund these services. Because states do not always like the strings attached, some states choose to take federal dollars for some programs and not others. ★

³⁴ National Association of State Budget Officers. “2010 State Expenditure Report: Examining Fiscal 2009-2011 State Spending.” [<http://www.nasbo.org/sites/default/files/2010%20State%20Expenditure%20Report.pdf>]. 2011.

OVERVIEW

The state of Massachusetts spent \$49.3 billion in fiscal year 2011, \$2.3 billion more than the state spent in 2010.^{35, 36} This means state government expenditures increased by 4.9% in 2011, before adjusting for inflation. After adjusting for inflation, Massachusetts' government expanded by 1.8% in FY 2011. Since 2006, state expenses have grown by 8.4% after adjusting for inflation.³⁷

HISTORICAL EXPENDITURES 2006 - 2011

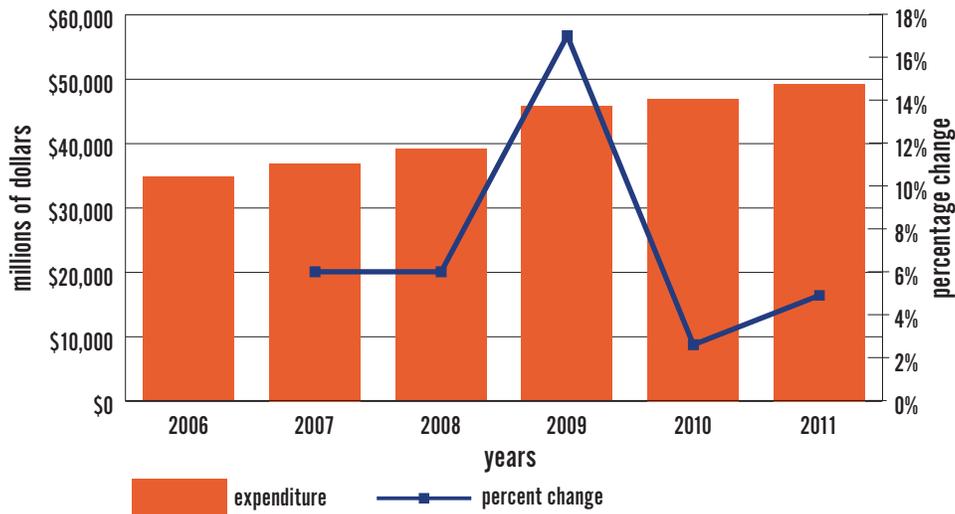


Figure 7 SOURCE: MASSACHUSETTS CAFRS 2006-2011

Massachusetts' largest expenditure category in 2011 was Health and Human Services, at \$20.3 billion, with Medicaid spending the largest component of that, at \$12.1 billion.³⁸ Transfers to cities and counties took up 10% of the budget, followed by funds for higher education and unemployment compensation, each taking 9% of the budget. Public school education takes another 7%, as does the justice system.

³⁵ Commonwealth of Massachusetts. Office of the Comptroller, Martin J. Benison. "Comprehensive Annual Financial Report: For Fiscal Year Ended June 30, 2011." [<http://www.mass.gov/osc/dosc/reports-audits/cafr/cafr-2011.pdf>]. ("CAFR").

³⁶ This figure excludes areas of government called "discrete component units," which are legally separate from but financially accountable to the state. The largest of these is the Massachusetts Department of Transportation (MassDOT). When the expenses of these component units is included, total spending by the state totals about \$55 billion in 2011. Component units will be excluded from the analysis in this section, but the financials of MassDOT will be explored in detail in the Infrastructure section. Lottery Expenditures were also not considered here because they are accounted for in Net Lottery Revenue in the Revenue section of the CAFR.

³⁷ Values in tables are not adjusted for inflation unless otherwise noted.

³⁸ Health and Human Services spending was computed by adding Medicaid, Health and Human Services, and Group Health Insurance expenses together from the 2011 Massachusetts CAFR.

EXPENDITURE BY CATEGORY, AS A PERCENT OF TOTAL EXPENDITURE, 2011

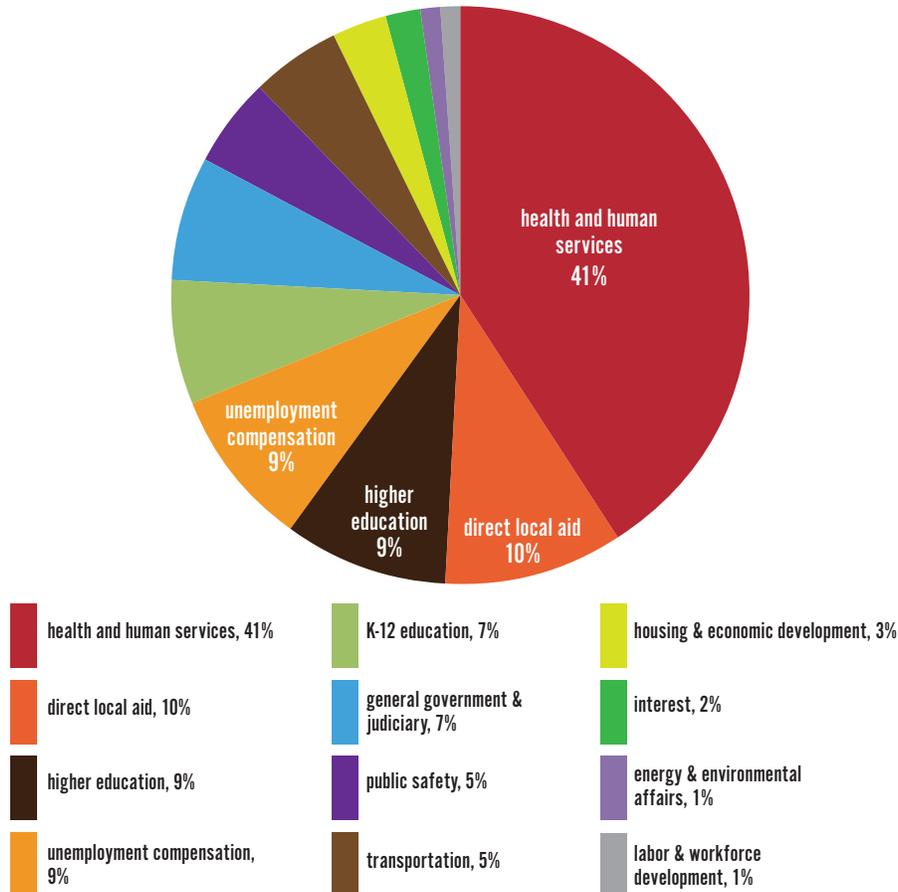


Figure 8 SOURCE: MASSACHUSETTS CAFR 2011

The major contributor toward the growth in government spending, in absolute terms, has been Health and Human Services, notably Medicaid, for which expenditures rose from \$9 billion to \$12.1 billion from 2007 to 2011. Massachusetts has been a national leader in health care, with its landmark 2006 health reform law outlining a system for universal health insurance coverage. The law has influenced expenses in the state, providing a series of subsidies for low-income individuals to allow them to afford health insurance. Overall, the growth in health care costs has been slightly lower in percentage terms than at the federal level. Federal health care expenditures increased by a lofty 40% from 2007 to 2010.³⁹

³⁹ See, e.g., Pear, Robert. "Recession Holds Down Health Spending." New York Times. [<http://www.nytimes.com/2012/01/10/health/policy/health-spending-held-down-by-recession.html>]. January 9, 2012.

{ expenditures }

| Table 1: Growth in Spending (2007-2011) | | |
|--|--|---|
| Spending Category | Increase/Decrease in Spending 2007 to 2011 (in Thousands) | Increase/Decrease in Spending 2007 to 2011 (in Percentage Terms) |
| Unemployment Compensation | \$2,958,230 | 206.9% |
| Housing and Economic Development | \$847,030 | 164.2% |
| K-12 Education | \$1,783,113 | 95.5% |
| Transportation | \$1,002,675 | 79.6% |
| Energy and Environmental Affairs | \$209,705 | 44.1% |
| Public Safety | \$582,110 | 34.4% |
| Higher Education | \$986,847 | 28.3% |
| Health and Human Services | \$3,957,321 | 24.1% |
| General Government and Judiciary | \$308,216 | 10.3% |
| Interest | \$98,018 | 9.1% |
| Direct Local Aid | -\$235,621 | -4.6% |
| Labor and Workforce Development | -\$135,890 | -21.4 |

SOURCE: MASSACHUSETTS CAFRS 2007-2011, STATEMENT OF ACTIVITIES

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. While this is a remarkable increase, much of it came between 2008 and early 2010. In fact, state expenditure on unemployment insurance actually fell by 19.3% from 2010 to 2011, as the state economy began to recover from the crisis and its effects.

Health and Human Services spending is unsurprisingly expected to be the largest component of state expenditures for the foreseeable future, and is expected to take up 41% of the overall budget in 2013.⁴⁰ Education (both K-12 and higher education), as well as unemployment insurance have been strong contributors to spending in the past six years. Meanwhile, direct local aid (or aid to cities and counties) has actually been decreasing.

Moving forward, the state hopes that continued economic improvement will see unemployment insurance expenditures decrease over time, with the state also planning continued to make cuts in some key areas of social spending, including family support services and disability programs.⁴¹ Other “cuts” are really just freezes in budgets, which are cuts in real terms, since inflation is expected to increase prices for goods and services.⁴² Some of the budget cuts will not be pleasant, but overall the state seems to have avoided the budgetary calamities facing other states like California. State Senator Michael R. Knapik says, “Make no mistake about it. Massachusetts has been positioned in such a way that it is in a stronger frame than other states.”⁴³

40 Ibid.

41 Bierman, Noah and Michael Levenson. “Mass. Senate Budget Would Increase Spending on Local Government and Education, but not Raise Taxes or Fees.” Boston Globe. [<http://www.boston.com/metrodesk/2012/05/16/mass-senate-budget-would-increase-spending-local-government-and-education-but-not-raise-taxes-fees/GMQPEYR6KVr3ablGmG6Z8M/story.html>]. May 17, 2012.

42 Ibid.

43 Ibid.

{ expenditures }

TABLE 2: OVERVIEW OF KEY PRIMARY SPENDING AREAS

| | |
|--|---|
| \$12.1 billion MEDICAID | Medicaid expenditures are 25% of the Massachusetts state budget and continue to be the largest single program expenditure in the budget. Medicaid spending was \$12.1 billion in 2011, an increase of 48.8% since 2006. Federal grants and contributions do provide Medicaid with a majority of their funding – 68% in 2011. Nevertheless, Medicaid is one of the largest causes of state budget increases throughout the country and Massachusetts proves no exception. |
| \$4.5 billion HIGHER EDUCATION | Massachusetts spent \$4.5 billion in 2011 to fund the University of Massachusetts, state universities, and community colleges. State support of higher education has been decreasing gradually as rising tuition fills in the gaps. In 2007, tuition and fees paid for 48% of those expenses; in 2011, that figure rose to 55%. This increase reflects the higher education system moving toward a business-type activity that requires less state support. |
| \$4.4 billion UNEMPLOYMENT INSURANCE | Unemployment insurance expenditures were \$4.4 billion in 2011, including paid benefits and administration. Unemployment compensation expenses were 19.8% lower in 2011 compared to 2010, likely reflecting a slightly improved economy. However, 2011 payments are still 1.8 times higher than they were pre-recession in 2007. Expenditures on unemployment insurance vary drastically with the unemployment rate and the average length of unemployment for those who lose their jobs. Unemployment insurance is intended to pay for itself, so that inflows to the insurance fund from employed workers match the payments that the fund makes to unemployed recipients. This is similar to how car insurance pools premiums from all drivers to compensate drivers who get into accidents. Since accidents (often like layoffs) are unpredictable and not always the fault of the insured, governments believe society is better off by everyone being insured. Because of the close dependence unemployment insurance has on the unemployment rate and length of unemployment, unemployment insurance tends to be a fairly unpredictable expense. |
| \$3.6 billion K-12 EDUCATION | Massachusetts spends 7% of its total budget on K-12 education. Massachusetts has resisted large cuts to its education expenses through the recession, and has funded its education spending with generous federal funding in the last few years. However, that may change in Massachusetts' 2013 budget. |
| \$3.3 billion GENERAL GOVT | General government expenditures include the administrative duties of the state, the judicial system, and revenue collection. These expenses totaled \$3.3 billion in 2011, 24% higher than 2007 spending. |
| \$2.3 billion TRANSPORTATION & PUBLIC WORKS | Transportation funding pays for the maintenance and construction of roads, bridges, tunnels, and waterways throughout the state. Infrastructure in Massachusetts is rapidly aging and the state has increased funds in an attempt to satisfy its transportation needs. Funding for transportation was \$2.3 billion in 2011, or 5% of the state's budget. However, the financials for this expenditure category are a bit distorted by the fact that the Massachusetts Department of Transportation (MassDOT) is actually a component unit of the state government – so this figure does not include expenditure by MassDOT, which exceeded \$4.2 billion in 2011. |
| \$2.3 billion PUBLIC SAFETY | Spending on public safety was \$2.3 billion in 2011, which was a 5.3% decrease from 2010. The reduction in public safety expenses was largely due to a cut in correctional, probation, and parole budgets. Public safety spending in Massachusetts goes toward police officer salaries and training, programs for prisoners re-entering society, for housing prisoners, and other anti-crime activities. |
| \$1.3 billion HOUSING & DEVELOPMENT | Costs for housing and economic development go toward the creation of homes and jobs in the state. The agency coordinates policies and programs in partnership with the private sector to accomplish this mission. The state received \$160 million in federal funds from the American Recovery and Reinvestment Act for this expense category. The state kept costs down by laying off employees; in 2010, full-time employees in HED went from over 2,300 to less than 900. |
| \$1.2 billion INTEREST ON DEBT | Massachusetts paid interest of \$1.2 billion on its bonds or debt in 2011, up 19.5% since 2006. Massachusetts' general obligation bonds, issued annually, have historically been rated well. It is not uncommon for the bonds to be rated in the high investment grade category of AA+ (for S&P and Fitch), which is just one tick below the top rating of AAA. Revenue bonds for specific projects are more unpredictable, because state entities have their own history of repayment, assets, and liabilities. |
| \$685 million ENERGY & ENVIRONMENT | In 2011, Massachusetts spent \$685 million on energy and environment expenditures for conservancy and land preservation agencies that regulate land use, energy development, and environmental protection. These expenditures are a small part of Massachusetts's budget, accounting for 1% of its expenditures and are largely supported through user fees of water use, parks, and through federal grants and contributions. |

SOURCE: MASSACHUSETTS CFRS 2006-2011

{ expenditures }

Overview of Key Discrete Component Spending Areas

The state of Massachusetts has several areas of spending that are not considered part of primary government spending in a legal sense, but are accountable to the state and its citizens. These “discrete components” areas of spending spent nearly \$6 billion in 2011.

TABLE 2A: COMPONENT AREAS

| | |
|---|--|
| \$4.2 billion MASSDOT | In 2009, the state passed sweeping transportation reform creating the Massachusetts Department of Transportation (MassDOT) as a discrete component unit of the government. This new department brought the many large transportation entities in the state (such as the Massachusetts Bay Transportation Authority, the Registry of Motor Vehicles, the Highway Department, and the Regional Transit Authorities), along with their assets, under the same umbrella. In 2011, MassDOT spent \$4.2 billion, an 8.8% increase in spending from 2010. |
| \$894 million COMMONWEALTH HEALTH INSURANCE CONNECTOR | The Commonwealth Health Insurance Connector offers subsidies for individuals without access to employer-sponsored health insurance and administers the Commonwealth Care health insurance product. |
| \$267 million MASS WATER POLLUTION ABATEMENT TRUST (MWPAT) | The MWPAT provides funding for water and sewer projects in the state, as part of the State Revolving Fund. |

SOURCE: MASSACHUSETTS CAFRS 2007-2011

BUDGETING AND DEALING WITH DEFICITS

Most states, including Massachusetts, require that the budget be “balanced,” meaning that lawmakers cannot plan to spend more money than they predict to take in through taxes and fees.⁴⁴ To pass a balanced budget, gaps between planned spending and revenue need to be closed.

Many times, states finance deficits by issuing debt in the form of state bonds and considering that money “revenue.” States also close the gap by using the governor’s “line-item” veto, whereby the governor can remove specific expenditures or even specific words from appropriations bills. Unfortunately, budget predictions are not always accurate. If the state government ends up spending more than the actual revenue, it must cut spending or borrow money mid-year in order to pay for the shortfall. Deficits can pile up and become costly, as bonds must be paid back in full, with interest.

⁴⁴ Massachusetts Constitution, Article 3, Section 2. See, e.g., National Conference of State Legislatures. “NCSL Fiscal Brief: State Balanced Budget Provisions.” [<http://www.ncsl.org/documents/fiscal/StateBalancedBudgetProvisions2010.pdf>]. October 2010. At 3.

{ expenditures }

Massachusetts has ranked either first or second in state debt per citizen in each of the past 11 years.⁴⁵ Most of this debt is for long-term capital improvements in the state, including transportation infrastructure repair, fixing and constructing buildings on public university campuses, and expanding courthouses.⁴⁶ The existence of this enormous debt puts much of the fiscal burden of state spending on future generations, who will continue to make interest payments on the debt as the capital assets created with that debt lose value over time. ★

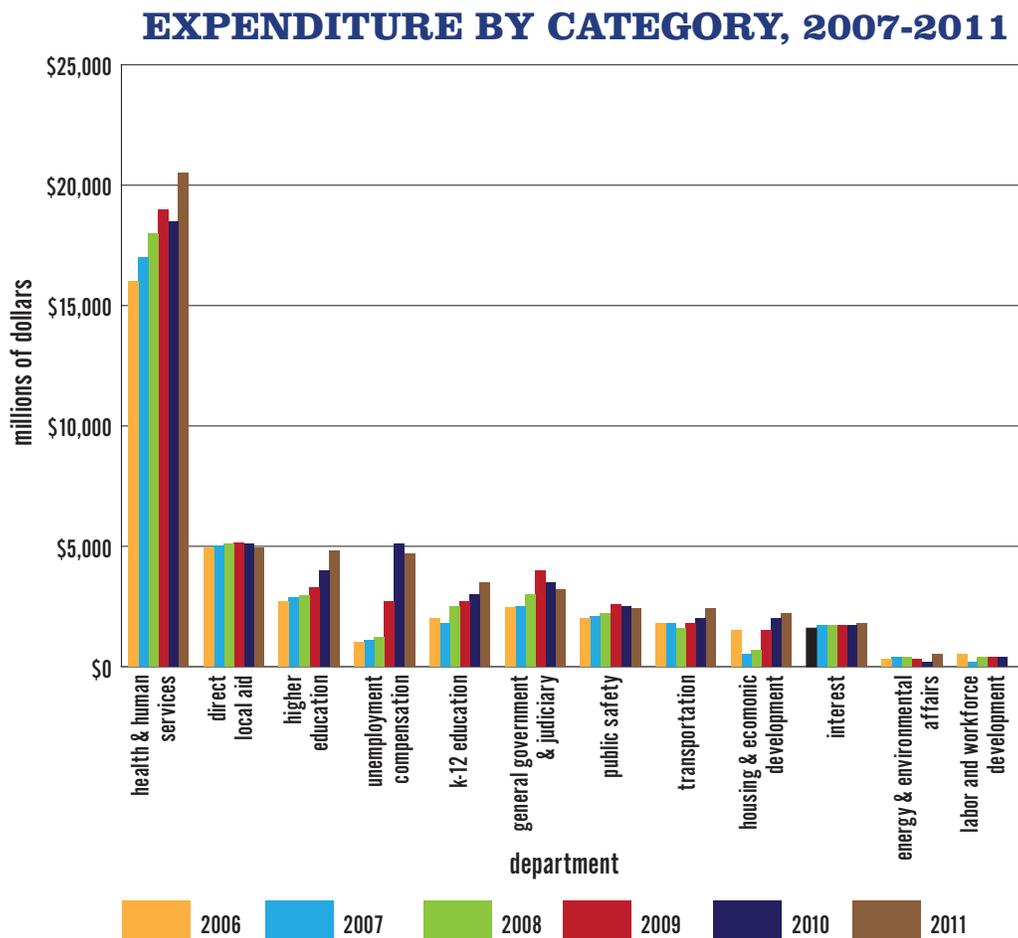


Figure 9 SOURCE: MASSACHUSETTS CAFRS 2007-2011

⁴⁵ FactCheck. "Spinning Romney's Debt." <http://factcheck.org/2012/06/spinning-romneys-debt/>. June 13, 2012.

⁴⁶ Ibid.

{ balance sheet }

FISCAL YEAR ENDING 6/30

| ASSETS (IN MILLIONS) | 2011 TOTAL GOVERNMENT | 2010 TOTAL GOVERNMENT | % CHANGE FROM 2010 TO 2011 |
|--|---------------------------------|---------------------------------|---|
| Current Assets: | | | |
| Temporary Investment | \$3,930,545 | \$2,630,038 | 49.4% |
| Receivables | \$5,374,544 | \$5,443,452 | -1.3% |
| Due From Other Governments | \$30,309 | \$52,084 | -41.8% |
| Other | \$74,758 | \$75,923 | -1.5% |
| Total Current Assets | \$10,391,805 | \$9,470,219 | 9.7% |
| Noncurrent Assets: | | | |
| Nondepreciable Capital Assets | \$2,331,910 | \$1,909,781 | 22.1% |
| Depreciable Capital Assets | \$5,956,877 | \$5,765,864 | 3.3% |
| Other | \$6,306,630 | \$5,900,639 | 6.9% |
| Total Noncurrent Assets | \$14,595,417 | \$13,576,284 | 7.5% |
| TOTAL ASSETS | \$24,987,222 | \$23,046,503 | 8.4% |
| LIABILITIES | | | |
| Current Liabilities: | | | |
| Accounts Payable & Accrued Liabilities | \$3,903,425 | \$3,926,224 | -0.6% |
| Due to Other Governments | \$1,350,603 | \$1,229,409 | 9.9% |
| Current Portion of Debt | \$1,867,679 | \$1,898,113 | -1.6% |
| Other | \$638,774 | \$667,745 | -4.3% |
| Total Current Liabilities | \$7,760,481 | \$7,721,491 | 0.5% |
| Noncurrent Liabilities: | | | |
| Payable to Other Governments | \$12,672 | \$404,383 | -96.9% |
| Pension & Post-Employment Benefits | \$4,119,830 | \$3,395,909 | 21.3% |
| Lease-Purchase & Other Financing Obligations | \$72,700 | \$93,947 | -22.6% |
| Bonds Payable | \$27,468,689 | \$25,687,164 | 6.9% |
| Other | \$4,412,203 | \$4,852,890 | -9.1% |
| Total Noncurrent Liabilities | \$36,086,094 | \$34,434,293 | 4.8% |
| TOTAL LIABILITIES | \$43,846,575 | \$42,155,784 | 5.3% |
| TOTAL NET ASSETS | -\$18,859,353 | -\$11,387,790 | 65.6% |

{ balance sheet }

NET WORTH

The Massachusetts balance sheet compares all the state's assets to its liabilities calculating a "net worth" for the state. Calculating the net worth for a public sector entity is not equivalent to calculating the net worth of a company. Still, the calculation is still an important determinant of liquidity and creditworthiness because it gives a snapshot of both the state's ability to generate revenue as well as its spending habits over time.

Massachusetts' net worth is calculated by taking the difference between the total assets of the state (measured at \$25 billion) and the total liabilities (\$43.9 billion). According to the Comptroller, Massachusetts has a negative net worth of \$18.9 billion.⁴⁷ That means that if Massachusetts sold off all its assets to pay all its debts, the state would still owe approximately \$19 billion, or nearly \$3,000 for every man, woman and child in the state.⁴⁸

“According to the Comptroller, Massachusetts has a negative net worth of \$18.9 billion — nearly \$3,000 for every man, woman and child in the state.”

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 as reported by each of the state agencies.

Massachusetts is not alone in having a negative net worth. In fact, in almost every state in the nation, as well as at the federal government level, liabilities exceed assets. The worry is that if debt accumulates over time through continued deficit spending, at some point investors will cease to lend to states or only lend at very high interest rates. Just as an investor would not want to lend money to a company that consistently loses money, so too would a potential bond investor not want to invest in a state that could potentially not have the ability repay the principal sum. If a state is unable to raise money from investors, the state must cut programs, raise taxes, and eventually, even face insolvency.

The good news for U.S. states is that the federal government has traditionally stood behind individual states' debt. When states sustained huge spending shortfalls in the years following the recession of 2008, the U.S. government stepped in with loans and stimulus in order to help the troubled states meet their basic obligations. While no implicit legislation requires the federal government to be a "lender of last resort" for states, the U.S. government has historically aided states in times of trouble. It is for this reason that most state debt are highly rated despite the fact

⁴⁷ Massachusetts CAFR Statement of Net Assets, 2011.

⁴⁸ Ibid.

{ balance sheet }

that collectively, after accounting for pension liabilities, a majority of the states have a negative net worth of several trillion dollars.

However, the rising debt in all U.S. states coupled with a fear of exploding pension and health care costs, have analysts worried that the federal government — struggling with its own massive debt — may not always be so generous. As a result, many are lobbying for a reform of state government spending which will lessen the debt of any given state and increase its net worth.

ASSETS

At the end of FY 2011, Massachusetts reported \$25 billion in assets, made up of \$10.4 billion dollars in current assets and \$14.6 in noncurrent assets.⁴⁹

Current assets are short-term assets which can be turned into hard dollars readily such as cash, receivables that the states expects to be redeemed within 12 months (e.g. taxes due), or investments (e.g. treasury bills or other stocks, bonds, or market positions). Massachusetts saw an increase in temporary investments on its balance sheet in 2011 that increased current assets by 9.7% from the previous year, due to improved investment performance overall. Non-depreciable capital assets also increased in 2011, mostly from construction projects in progress. Total assets increased by 8.4% from 2010.⁵⁰

Non-current assets are holdings that the state is unlikely to turn into a liquid asset within a short time frame. These assets include investments such as real estate, schools, roads, and long-term bonds (although those can often be securitized into liquid assets for a fee). The largest component of the non-current asset class is “Capital Assets.” These capital assets like schools, parks, and roads make up a big part of the state’s overall assets, and their valuations are highly debated. Some argue that these assets are undervalued, as they are valued at the cost of the asset, and not the market price. This means that capital assets do not capture the appreciation, for instance, in value of state land. However, others argue that capital assets like schools and roads could be worth significantly more in the public domain than the private domain, meaning these asset values would likely be overstated if measured in today’s dollars.

LIABILITIES

Massachusetts’ total liabilities were estimated at \$43.9 billion in 2011, which included \$7.8 billion of current liabilities and \$36.1 billion of noncurrent liabilities.⁵¹

Current liabilities are obligations that require payment within twelve months. Examples of current liabilities include salaries to government workers, payments to companies contracted by the government to provide services (such as private contractors who build and run prisons), entitlement

49 Ibid.

50 Ibid.

51 Ibid.

{ balance sheet }

and welfare payments to citizens (such as payments to Medicaid recipients or unemployment beneficiaries), or debts to other levels of government (negotiated payments for government goods and services).

Non-current liabilities are comprised of obligations that the state owes in the long term, i.e., outside a twelve-month horizon. Non-current liabilities include bond obligations, leasing agreements for financed projects, and employee pension and health care liability. These long-term liabilities generally represent the state's current spending and obligations that will be passed into the future as debt.

Overall liabilities increased in 2011 by 4%, largely due to bonds payable that were issued to pay for capital projects through Build America Bonds and bonds issued to the Massachusetts School Building Authority, and post-employment benefits to state retirees.⁵²

THE DEBT

Just like the federal government, the state funds its deficit spending by raising debt. States can raise debt in a variety of ways. They can issue general bonds in which investors bet on the full faith and credit of the state or they can issue special purpose bonds that are secured by the success of a specific project like road construction or the building of a school. Additionally, a state can sometimes borrow from federal grants that it expects to receive in the future, as Massachusetts did to fund the Big Dig project in 2007 (the mega road project which rerouted Interstate 93). In this instance, the state borrowed from future Department of Transportation grants.

“As of the end of FY 2011, Massachusetts owed a total of \$24.4 billion dollars in bonded debt secured by future revenues, state assets, and capital leases.”

As of the end of FY 2011, Massachusetts owed a total of \$24.4 billion dollars in bonded debt secured by future revenues, state assets, and capital leases. This bonded debt is the equivalent of \$3,720 for every person living in the state of Massachusetts, representing 7% of the total personal income of the state.⁵³

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 fiscal year 2009.⁵⁴ This broader measure includes all debts owed by the state and its agencies, whether fully backed by the credit of the state or not. Many of these debts include tuition repayment bonds and other bonds that the state is not technically liable for, but may assist state agencies in repaying to continue fulfilling

⁵² Ibid.

⁵³ Ibid.

⁵⁴ U.S. Census Bureau, “State and Local Government Finances by Level of Government and by State”. 2010.

{ balance sheet }

important policy objectives such as the availability of affordable higher education. Massachusetts has such high debt in part because of its local political structure, where localities tend to take on less debt than counties in other states. In other words, Massachusetts state debt is used to fund projects that might be funded by county debt elsewhere.

While it is true that a state can issue debt in order to finance its current spending, it is also true that a state cannot borrow without limits. Investors will only lend to a state — or any entity — if they believe that entity can and will pay them back. Once there are questions about the financial mismanagement or solvency, investors may become reticent to lend to that entity or only lend at higher rates of return, making the cost of capital high and even prohibitive. As a result, the capital that the state has access to can dwindle, no longer covering the shortfall between expenses and income.

UNFUNDED LIABILITIES

What may be more worrying than state debt is a state's unfunded liabilities, which are reported as noncurrent liabilities. According to the Massachusetts State Treasurer, the state's unfunded pension liability was \$19 billion at the end of FY 2011⁵⁵. In addition, estimates put total unfunded health care liabilities in Massachusetts at \$16.6 billion. When the costs of health benefits for city employees are included, the total increases to around \$40 billion.⁵⁶

“According to the Massachusetts State Treasurer, the state's unfunded pension liability was \$19 billion at the end of FY 2011.”

Many analysts argue that states are underreporting the level of liabilities that they will owe to citizens in the future. Much debate, for instance, has surrounded the issue of valuing the future liabilities for pensions. Pensions are paid to government workers upon their retirement, which is available to most state employees at age 55. A growing number of analysts are concerned, for instance, that the assumed rate of return used to value the pension assets themselves is overstated at 8.25% in Massachusetts,⁵⁷ considerably higher than the rate used in most other states (indeed, 40 states used assumed rates of 8% or lower).⁵⁸ If this assumed rate was adjusted downward in Massachusetts, as many have advocated, this would further decrease the state's net worth.

Foreseeing this problem, Massachusetts has taken some steps to address these concerns (see the Pension Section of this report), but much more is needed for reported pension assets and liabilities

⁵⁵ Massachusetts CAFR 2011.

⁵⁶ Darrell Preston. “States Facing Sleeping Cancer in 96% Unfunded Retiree Benefits.” [<http://www.bloomberg.com/news/2012-03-07/states-facing-sleeping-cancer-in-96-unfunded-retiree-benefits.html>]. Bloomberg. March 7, 2012.

⁵⁷ Syre, Steven. “Lower investment bar for Mass. pension fund.” [http://articles.boston.com/2012-03-16/business/31197337_1_pension-fund-massachusetts-pension-public-pension/2]. March 16, 2012.

⁵⁸ Cheney, Kyle. “Grossman: investment losses to send unfunded pension liability higher.” [<http://www.wickedlocal.com/concord/archive/x574393759/Grossman-investment-losses-to-send-unfunded-pension-liability-higher#axzz1xdnHwGKL>]. February 7, 2012.KL

{ balance sheet }

to accurately reflect the future costs of maintaining the pension system. Around the country, state legislatures are realizing the incredible urgency of pension reform and are taking steps to reduce costs by increasing retirement ages, reducing benefits, and increasing costs for public employees. States such as Utah have moved to defined contribution plans, where workers own responsibility for their own pensions, more like private sector 401(k) plans.⁵⁹ Rhode Island, which has severe pension funding shortfalls, had to make larger cuts into its cost of living adjustment for retiree pensions. Many think Rhode Island retirees' standard of living will likely decrease over the course of their retirement.⁶⁰

“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.”

PROGNOSIS

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 more needs to be done. Massachusetts' population carries a relatively high debt load compared to other states and debt has only increased in recent years. Capital project expenditures provide some stimulus to the state economy, but there are limits to continually borrowing for capital projects and accumulating more debt in the process. Massachusetts retains high ratings on its debt and low borrowing costs because of the states' robust income base. That said, the state is susceptible to any market suspicion of state bonds, given its position as one of the more heavily indebted states. ★

59 Liljenquist, Dan. "The 2010 Utah Response: Utah State Retirement Systems." [www.ncsl.org%2Fdocuments%2FLabor%2FLiljenquist_Pensions_LegSum2010.pdf]. July 27, 2010.

60 Gabriel Roeder Smith & Company. "Report with GRS." [<http://www.pensionreformri.com/resources/ReportwithGRSAppendix.pdf>]. November 14, 2011.

OVERVIEW

Massachusetts has over 6.5 million citizens according to the 2010 Census, representing just over 2% of the total U.S. population.⁶¹ It is also one of the more densely populated states, with much of the population located in the greater Boston area.⁶² Massachusetts is experiencing slower population growth than the rest of the United States. From 2000 to 2010, the Massachusetts population grew by just 3.1%, while the U.S. population grew by 9.7% over the same period.⁶³ While some have blamed cold climates or economic issues for anemic population growth in the state, Harvard economist Ed Glaeser has pointed out that the state’s relatively strong economy and high housing prices suggest another culprit – insufficient housing. Glaeser writes, “you don’t build, you don’t grow, and our state just doesn’t build.”⁶⁴ The numbers do not lie – despite being the 14th largest state in the U.S., Massachusetts was only 29th in building permits issued in 2011.⁶⁵ By comparison, the 15th largest state, Indiana, issued nearly twice the number of building permits as Massachusetts in 2011.⁶⁶

RACIAL BREAKDOWN & CHANGES FROM 2000 TO 2010

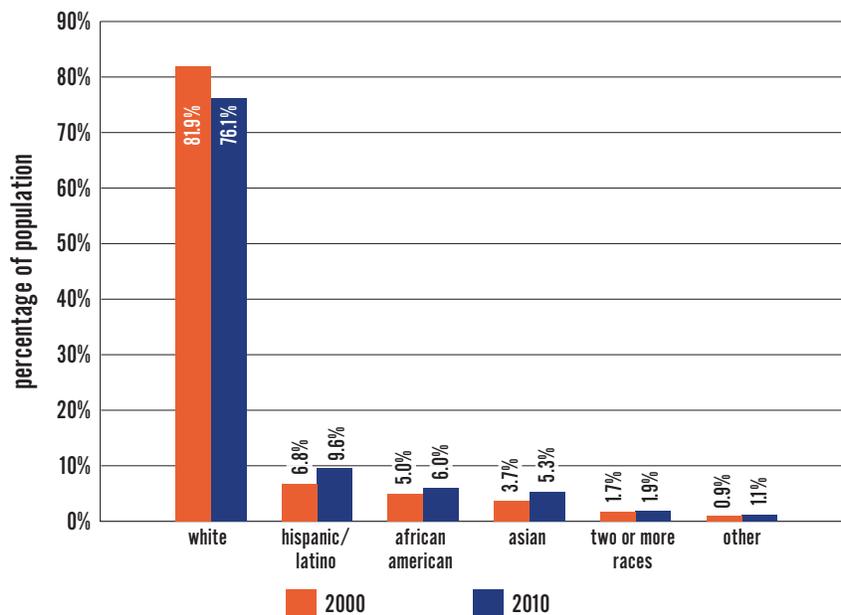


Figure 10

SOURCE: U.S. CENSUS BUREAU. “HISPANIC OR LATINO, AND NOT HISPANIC OR LATINO BY RACE.” 2010

61 U.S. Census Bureau. “State & County QuickFacts: Massachusetts.” [<http://quickfacts.census.gov/qfd/states/25000.html>].

62 See, e.g., U.S. Census Bureau. “Resident Population Data: Population Density.” [<http://2010.census.gov/2010census/data/apportionment-dens-text.php>].

63 U.S. Census Bureau. “The Counties and the Most Populous Cities and Towns in 2010 in Massachusetts: 2000 and 2010 (Table 1).” [http://2010.census.gov/news/xls/cb11cn104_ma_2010redistr.xls]; U.S. Census Bureau. “Population Distribution and Change: 2000 to 2010.” By Paul Mackun and Steven Wilson. C2010BR-01. [<http://www.census.gov/prod/cen2010/briefs/c2010br-01.pdf>]. March 2011. At 1-2.

64 Glaeser, Edward. “If We Build It, They Will Come: Why Aren’t More People Moving to Massachusetts?” Boston Globe. [http://www.boston.com/realstate/news/articles/2011/01/23/if_we_build_it_they_will_come/]. January 23, 2011.

65 National Association of Home Builders. “Building Permits by States and Metro Areas.” [http://www.nahb.org/fileUpload_details.aspx?contentID=55104]. April 2012.

66 Ibid.

{ demographics }

RACE, ETHNICITY, AND IMMIGRATION

Massachusetts' citizens identify predominantly as white; however, the white population has declined in both absolute and percentage terms in the last ten years. Meanwhile, black, Asian, and Hispanic populations in the state have increased dramatically since 2000. The growth in the Asian and Hispanic populations from 2000 to 2010 has been especially notable – a 46.8% increase for Asians and a 46.4% increase for Hispanics. In fact, Massachusetts would not have had a population increase at all from 2000 to 2010 if not for the Hispanic population surge.⁶⁷

The change in the state's racial makeup has significant political implications. The growing prominence of minorities in the population will bring issues that these groups care about into public focus. Angelo Falcon of the National Institute for Latino Policy argues that the ongoing national debates on immigration and education are of particular relevance for the Hispanic population in Massachusetts.⁶⁸ Massachusetts Governor Deval Patrick in particular has been notable for his strong rhetoric on immigration, recently arguing that “public discourse about immigration is as toxic today as McCarthyism or Jim Crow were in their time.”⁶⁹ This has led to accusations from Republican politicians, like the Massachusetts House Minority Leader Brad Jones, that Patrick is simply pandering to the growing Latino electorate in the state.⁷⁰

Immigrants (or foreign-born individuals) make up a large and growing segment of the Massachusetts population, with the state having the seventh largest immigrant population in the U.S.⁷¹ The most common countries of birth for Massachusetts' immigrants are China (7.3%), Brazil (7.2%), and Portugal (6%); however, collectively, more immigrants come to Massachusetts from Latin America than from any other part of the world, at 36.2% of all the state's immigrants.⁷²

| Year | Immigrant Population in MA | Immigrant Share of the Population in MA |
|-------------|-----------------------------------|--|
| 1990 | 573,733 | 9.5% |
| 2000 | 772,983 | 12.2% |
| 2010 | 983,564 | 15.0% |

SOURCE: MIGRATION POLICY INSTITUTE, “MASSACHUSETTS: SOCIAL & DEMOGRAPHIC CHARACTERISTICS.”

Immigrants tend to be younger and have a lower average income than the native-born population in the state. However, as a 2009 report by the Immigrant Learning Center shows, the differences

67 Schworm, Peter. “Growth Slows in Boston Metro Area: Minority Gains Stem Net Population Loss.” Boston Globe. [http://www.boston.com/news/local/massachusetts/articles/2011/03/28/census_figures_show_slow_population_growth_in_boston_metro_area/]. March 28, 2011.

68 Falcon, Angelo. “Latinos and the Political Earthquake in Massachusetts.” New American Media. [http://news.newamericamedia.org/news/view_article.html?article_id=23c6524d3136f3304d542e773eac9328]. January 20, 2010.

69 Powers, Martine. “Patrick Rips Ariz., Ala. Immigrant Legislation.” Boston Globe. [http://www.boston.com/news/local/massachusetts/articles/2012/05/02/governor_deval_patrick_criticizes_us_immigration_policy_and_controversial_laws_in_alabama_arizona/]. May 2, 2012.

70 Associated Press. “Patrick Slams Alabama, Arizona Over Immigration Policies.” CBS Boston. [<http://boston.cbslocal.com/2012/05/02/patrick-slams-alabama-arizona-over-immigration-policies/>]. May 2, 2012.

71 Migration Policy Institute. “Massachusetts: Social & Demographic Characteristics.” [<http://www.migrationinformation.org/datahub/state.cfm?ID=ma>]. 2010.

72 Ibid.

{ demographics }

between the native-born and immigrant populations are small.⁷³ In fact, some of the study’s findings suggest that immigrants may be better equipped to contribute to the state economy in the future than the native-born population.⁷⁴ For example, immigrants are more likely to hold a master’s degree or higher than natives (17.4% for immigrants, and 15.9% for natives).⁷⁵ This difference in education is even more pronounced among younger adults, aged 25-39 (22.1% for immigrants 25-39 years old, and 15.7% for natives 25-39 years old).⁷⁶

| MASSACHUSETTS: AGING...AND FAST | | |
|--|---|-------------|
| | Ratio of People 60+ Years Old to People Under 20 Years Old | |
| | 2000 | 2010 |
| United States | 0.57 | 0.69 |
| Massachusetts | 0.65 | 0.79 |

SOURCE: U.S. CENSUS BUREAU, “PROFILE OF GENERAL POPULATION AND HOUSING CHARACTERISTICS: 2010 DEMOGRAPHIC PROFILE DATA.”

AGE

The majority of Massachusetts’s citizens are adults over the age of 25, though Massachusetts has a relatively large segment of young people 20-24 years old. Analysts attribute this high proportion of young adults to Boston’s crowded urban university presence. Further, many students stay in Boston after graduation to work in the thriving high-tech job market.

MASSACHUSETTS AND U.S. POPULATION PERCENTAGES, BY AGE

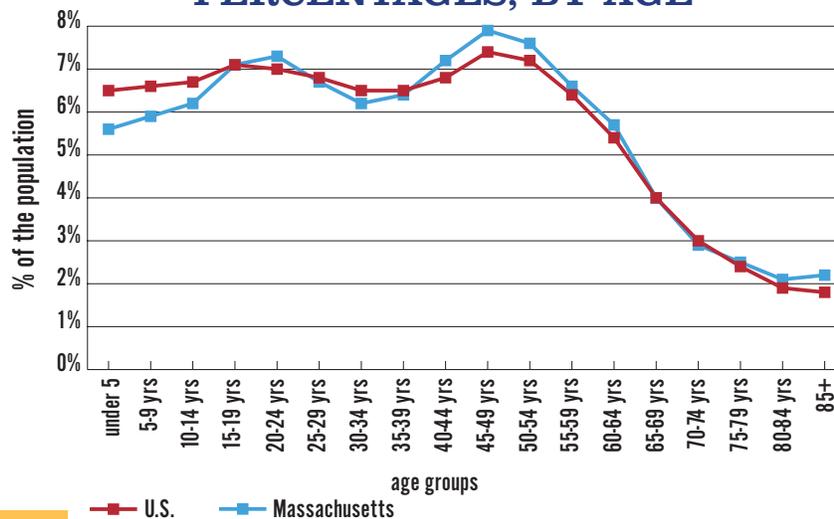


Figure 11 SOURCE: U.S. CENSUS, 2010

73 Clayton-Mathews, Alan and others. “Massachusetts Immigrants by the Numbers: Demographic Characteristics and Economic Footprint.” Immigrant Learning Center, Inc. [<http://sabes.org/resources/research/mass-immigrant-demographics-2009.pdf>]. June 2009. At 2

74 Ibid.

75 Ibid at 17-18.

76 Ibid at 17-18.

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Despite a strong young adult population, Massachusetts has a relatively small percentage of children (0-14 years old), and a slightly higher than average proportion of citizens over 40 (especially those over 85 years old). Taken together, this means that the ratio of old to young in Massachusetts is relatively high among states and certain to grow over time, as a large population of 40-60 years olds retires in the coming years. This demographic shift will strain the budget for state government programs which rely on young workers to pay for older retirees, such as state-run pensions, health insurance, and other services for the elderly.

INCOME

In 2010 the median household income in Massachusetts was \$62,072.⁷⁷ This means that half of Massachusetts' households earned more than \$62,072 in 2010, and half earned less.

INCOME DISTRIBUTION: MASSACHUSETTS COMPARED TO THE U.S.

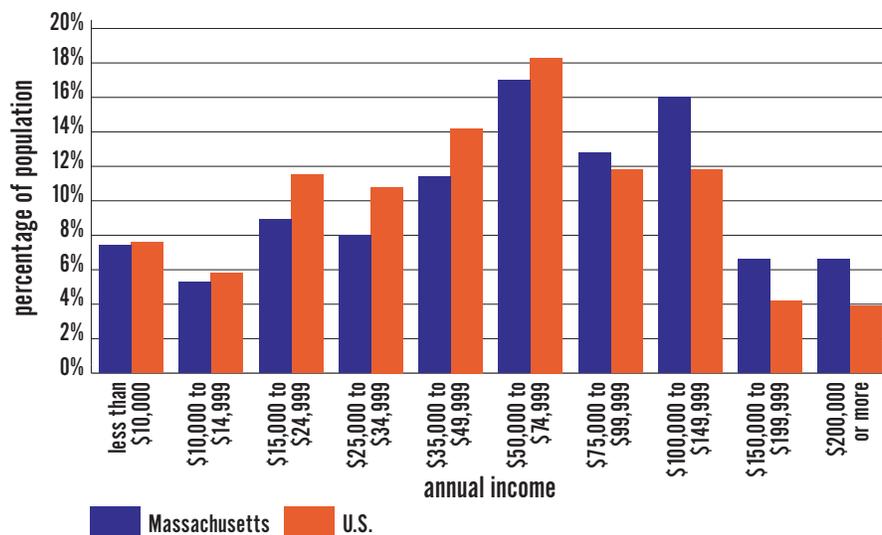


Figure 12

SOURCE: U.S. CENSUS BUREAU 2010, AMERICAN COMMUNITY SURVEY

Massachusetts boasts an exceptionally high median income – well above the national median of \$50,046.⁷⁸ Still, median income in Massachusetts fell by 4.9% from 2009 to 2010, an indication that the economy suffered from the economic downturn of 2008-2009.⁷⁹ Analysts attribute Massachusetts' relatively high incomes to the state's extremely well-educated workforce; over 43% of workers in the state have a Bachelor's degree or higher.⁸⁰ Massachusetts workers are the best-educated in the country, and the state therefore has a high concentration of high-wage jobs.⁸¹

77 Ibid.

78 Ibid.

79 Ibid.

80 Massachusetts Budget and Policy Center. "The State of Working Massachusetts 2011." By Sarah Nolan and Kurt Wise. [http://massbudget.org/report_window.php?loc=state_of_working_mass_2011.html]. January 1, 2012.

81 Ibid.

{ demographics }

Massachusetts similarly has a lower poverty rate than average, with 10.5% of citizens living below the poverty level as compared to 13.8% nationally.⁸² According to the U.S. Census Bureau, in 2010, a family of four was considered to be living in poverty if the household made less than \$22,314 per year.⁸³

Looking at the distribution of income across the population in a given state is another useful way of understanding the economic status of the state's citizens. In Massachusetts, there are a disproportionately large number of high-income households (those earning \$75,000 or more), and a disproportionately low number of low-income households (those earning under \$75,000), when compared to national averages.

EDUCATION

The citizens of Massachusetts are among the best-educated in the country, with the state outperforming national averages in every category of educational attainment. The state is also one of the more innovative states when it comes to education initiatives, with U.S. Secretary of Education Arne Duncan noting that "Massachusetts has long been a national leader in education."⁸⁴

| EDUCATIONAL ATTAINMENT (Age 25+) | U.S. | Mass. |
|---|--------------|--------------|
| Less than 9th Grade | 6.1% | 4.9% |
| High School Graduate or Higher | 85.6% | 89.1% |
| Bachelor's Degree or Higher | 28.2% | 39.0% |
| Graduate or Professional Degree | 10.4% | 16.7% |

SOURCE: U.S. CENSUS, "SELECTED SOCIAL CHARACTERISTICS IN THE UNITED STATES 2006-2010 AMERICAN COMMUNITY SURVEY 5-YEAR ESTIMATES."

UNEMPLOYMENT

Out of its 6.5 million citizens, Massachusetts has a civilian labor force of just under 3.5 million.⁸⁵ The state's unemployment rate of 6.1% in July 2012, was lower than the national average, which had dropped to 8.3%.⁸⁶ Thus, job prospects seem slightly better in Massachusetts when compared to the rest of the country. Most of the job market gains in 2012 have come from growth in private sector jobs, particularly in professional and business services. In fact, the number of public sector jobs in the state is declining.⁸⁷

Unemployment in Massachusetts has evolved differently than in the nation overall. While unemployment in the state was on the rise (just like the rest of the country) in 2008 and

82 "State & County QuickFacts: Massachusetts."

83 U.S. Census Bureau. "Poverty Thresholds for 2010 by Size of Family and Number of Related Children Under 18 Years." [www.census.gov/hhes/www/poverty/data/threshld/thresh10.xls].

84 DeForge, Jeanette. "Massachusetts Education Ideas Ranked Best, State Gets \$250 Million Race to the Top Money." The Republican. [http://www.masslive.com/news/index.ssf/2010/08/massachusetts_education_ideas_1.html]. August 25, 2010.

85 U.S. Bureau of Labor Statistics. "Economy at a Glance: Massachusetts." [<http://www.bls.gov/eag/eag.ma.htm>]. April 2012.

86 U.S. Bureau of Labor Statistics. "Economy at a Glance: United States." [<http://www.bls.gov/eag/eag.us.htm>]. May 2012.

87 Ibid.

{ demographics }

2009, Massachusetts has recovered relatively quickly from the economic crisis, with declining unemployment rates since 2009. It is challenging to know for sure why the state has recovered more quickly than others in terms of unemployment. Governor Patrick has cited the state's educated workforce and the government's investments in growing industries like biotech, life sciences, and green technology as the reasons.⁸⁸

“Massachusetts has recovered relatively quickly from the economic crisis, with declining unemployment rates since 2009.”

Many argue that the unemployment rate misrepresents the true state of the Massachusetts economy. The labor force is comprised of individuals over the age of 16 who are either in a job (“employed”) or not in a job but “actively looking” for work (“unemployed”). Thus, people who are not seeking employment are not counted. If a large fraction of people have fallen outside the labor force (for example, if they have given up looking for work), the unemployment rate will underestimate the economic struggles of a state. Furthermore, the unemployment rate does not factor in the possibility that people are taking part-time work because they cannot find full-time work. Such workers are called “underemployed.” These categorizations are extremely important in Massachusetts, where the number of “underemployed” workers increased by 18%, to 200,500, in the first eight months of 2011.⁸⁹

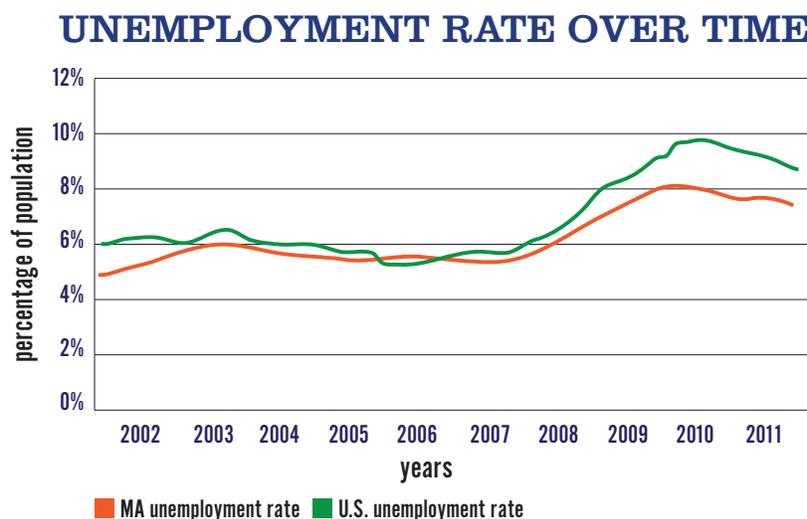


Figure 13

SOURCE: U.S. BUREAU OF LABOR STATISTICS. “LOCAL AREA UNEMPLOYMENT STATISTICS.”

⁸⁸ Governor Deval Patrick. “Governor’s Message.” [<http://www.mass.gov/recovery/see-the-impact/follow-recovery-updates/citizens-update/second-reporting-period-citizens-update/governors-message.html>]. December 2009.

⁸⁹ Woolhouse, Megan. “Part-time Workers on Rise in Mass.” Boston Globe. [http://articles.boston.com/2011-09-26/business/30205000_1_part-time-jobs-andrew-sum-underemployed-workers]. September 26, 2011.

{ demographics }

PRISONS

Compared to other states, Massachusetts has a relatively small number of incarcerated individuals. According to the 2010 Census, 0.38% of the Massachusetts population (24,638 individuals) resides in adult correctional facilities of any kind, compared to 0.73% at the national level (nearly 2.3 million individuals).⁹⁰ This is in part because Massachusetts has no federal detention centers, and houses less than 2,000 of the more than 250,000 individuals living in correctional residential facilities and federal prisons nationwide.⁹¹ Following this logic, if a Massachusetts resident is sent to a federal prison, it is unlikely to be in Massachusetts itself.⁹² The vast majority of the imprisoned population in the state resides either in state prisons or local jails, with each housing around 11,000 individuals.⁹³

MARRIAGE AND DIVORCE

Of the Massachusetts population over 15 years old, 46.5% are now married, which is slightly below the national figure of 48.8%.⁹⁴ Massachusetts also has a lower percentage of people who are divorced (9.6%) than the nation as a whole (10.9%).⁹⁵ This is true not only on average, but consistently across age and gender categories. For example, 8.1% of men 35-44 years old are divorced in Massachusetts compared to 11.7% nationally.⁹⁶

Non-traditional households are increasingly common in the United States, and Massachusetts is at the forefront of this demographic change. For example, a 2003 state court ruling legalized same-sex marriage in the state, and same-sex couples began marrying in Massachusetts in May 2004. Estimates suggest that since then, close to 20,000 same-sex couples have married in the state.⁹⁷ Recent estimates from the U.S. Census Bureau also confirm that Massachusetts has one of the highest proportions of same-sex couples in the country; however, experts note that exact figures on same-sex relationships are hard to pin down because of likely underreporting by same-sex couples.⁹⁸ ★

90 U.S. Census Bureau. "Group Quarters Population by Sex, Age, and Type of Group Quarters: 2010." [http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=DEC_10_SF1_QTP13&prodType=table].

91 U.S. Census Bureau: Census Summary File [<http://factfinder2.census.gov>].

92 Note that federal prisons and federal detention centers are different. There is a federal prison in Devens, MA, but no federal detention centers in the state.

93 2010 Census Summary File 1 at <http://factfinder2.census.gov>.

94 U.S. Census Bureau. "Marital Status: 2010 American Community Survey 1-Year Estimates: Massachusetts" [http://factfinder2.census.gov/faces/tableservices/jsf/pages/productview.xhtml?pid=ACS_10_1YR_S1201&prodType=table].

95 Ibid.

96 Ibid.

97 Associated Press. "Massachusetts Marks 8th Anniversary of Same-Sex Marriages." *Masslive.com*. [http://www.masslive.com/politics/index.ssf/2012/05/massachusetts_marks_eighth_ann.html]. May 17, 2012.

98 Schworm, Peter and Matt Carroll. "More Listed in State as Same-Sex Couples." *Boston Globe*. [http://www.boston.com/news/local/massachusetts/articles/2011/02/08/more_listed_in_state_as_same_sex_couples/]. February 8, 2011.

OVERVIEW

At just over \$20 billion, health care spending is the largest single expenditure in the Massachusetts state budget as well as one of the fastest growing. Estimates suggest that health care will constitute just over 40% of the state budget by 2013. The main components of this spending include Medicaid (the health insurance program for low-income families and individuals with disabilities), health insurance for state employees and retirees, and other subsidized insurance programs administered by the state.⁹⁹

Massachusetts has the lowest percentage of uninsured people in the country due to the state's landmark 2006 health reform law. According to the Massachusetts Health Reform Survey (MHRS),¹⁰⁰ the legislation has not driven health care costs higher in Massachusetts. However, the legislation has not lowered the high cost of health care in the state either. Overall, Massachusetts spends more than most states on health care per capita. In addition, there is concern about the rising costs of state and local employees' health care. Estimates from the Massachusetts Taxpayers Foundation suggest that unfunded liabilities for public employee health benefits stand at roughly \$20 billion across the state's 50 largest municipalities.¹⁰¹ Because health care accounts for such a large and growing percentage of the budget, cost containment is at the center of policymakers' agenda for the state.

RISING COSTS

As in other states, spending on health care in Massachusetts has outpaced growth in the general economy for over a decade. Health care has grown as a portion of total state spending from 23% in 2000 to an estimated 41% in 2013. State-subsidized health care spending grew at an average rate of 8% from 2008 to 2011.¹⁰² Governor Deval Patrick's Administration estimates that at current rates, health care spending will consume 50% of the state budget by 2020.¹⁰³ Per-capita spending for health care coverage in Massachusetts — when taking into account both those with public coverage and private coverage — exceeds the national average by almost \$2,500.¹⁰⁴ Furthermore, per-enrollee spending for Medicare (the health insurance program for retirees and the disabled) beneficiaries exceeds the national average (\$11,277 versus \$10,365),¹⁰⁵ as does per-capita Medicaid spending in the state (\$8,278 versus \$6,826).¹⁰⁶

99 Commonwealth of Massachusetts. Office of the Comptroller, Martin J. Benison. "Comprehensive Annual Financial Report: For the Fiscal Year Ended June 30, 2011." [<http://www.mass.gov/osc/docs/reports-audits/cafr/cafr-2011.pdf>]. At 42.

100 Dahlen, Heather, Long, Sharon K., Stockley, Karen. "Health Reform in Massachusetts: An Update as of Fall 2010." [<http://bluecrossmafoundation.org/Policy-and-Research/Reports-By-Topic/Massachusetts-Health-Reform/MHRS.aspx>]. Blue Cross Blue Shield of Massachusetts Foundation. January 25, 2012.

101 Ryan, Carolyn. "Retiree Health Care: The Brick That Broke Municipalities' Backs." [http://www.masstaxpayers.org/sites/masstaxpayers.org/files/The%20Brick%20That%20Broke%20Municipalities%27%20Backs_Feb%2025%202011.pdf]. Massachusetts Taxpayers Foundation. February 2011.

102 Governor's Budget FY 2013. FY 2013 Budget Recommendation: Issues in Brief. "Addressing Health Care Costs." [http://www.mass.gov/bb/h1/fy13h1/exec_13/hbudbrief4.htm]. Executive Office for Administration and Finance. 2012.

103 Ibid.

104 "Health Care Costs and Spending in Massachusetts: A Review of the Evidence." [<http://bluecrossmafoundation.org/~media/Files/Publications/Policy%20Publications/Cost%20Deck%20March%20report.pdf>]. Blue Cross Blue Shield of Massachusetts Foundation. March 2012.

105 State Health Facts. "Medicare Spending Per Enrollee by State of Residence, 2009." [<http://www.statehealthfacts.org/comparemtable.jsp?ind=624&cat=6&sub=72&rgnhl=23>]. The Henry J. Kaiser Family Foundation. 2011.

106 "The Book of the States 2012: Facts and Figures." [http://knowledgecenter.csg.org/drupal/system/files/east_medicaidspending_0.pdf]. Council of State Governments. January 2012.

TOTAL PUBLIC & PRIVATE HEALTH CARE SPENDING WILL DOUBLE FROM 2009 TO 2020



Figure 14

SOURCE: CENTER FOR MEDICARE AND MEDICAID SERVICES, HEALTH EXPENDITURES BY STATE OF RESIDENCE, CMS 2011; MASSACHUSETTS DIVISION OF HEALTH CARE FINANCE AND POLICY.

Several factors may explain the higher spending in Massachusetts. First, Massachusetts relies more heavily on teaching hospitals, which are typically more expensive to operate because of the more expensive experimental treatment they provide. In addition, teaching hospitals have the ability to provide more intensive care to sicker patients, driving up costs.¹⁰⁷ Second, Massachusetts has the highest concentration of specialists in the country, perhaps due to the significant presence of major academic medical centers. Research has shown that use of specialists rather than primary care doctors drives costs up.¹⁰⁸

Third, compared to other states Massachusetts has a relatively high concentration of elderly citizens, who typically need more expensive medical care. Massachusetts is the 12th oldest state in the country, with 13.5% of the population over the age of 65.¹⁰⁹ Finally, Massachusetts includes some concentrated provider markets, meaning that a few businesses provide the majority of health care services in certain parts of the state. When this is the case, providers may have more leverage in negotiating prices with insurers, leading to higher overall price levels.¹¹⁰

107 Rabinovitz, Jonathan. "Transformers: How Teaching Hospitals Could Lead Medicine's Metamorphosis." Stanford Medicine. [<http://stanmed.stanford.edu/2010summer/article1.html>]. Summer 2010.

108 "Health Care Costs and Spending in Massachusetts: A Review of the Evidence." [<http://bluecrossmafoundation.org/~media/Files/Publications/Policy%20Publications/Cost%20Deck%20March%20report.pdf>]. Blue Cross Blue Shield of Massachusetts Foundation. March 2012.

109 In the youngest state, Alaska, a mere 5.8% of the population is over age 65. Himes, Christine L., "Which U.S. States Are the 'Oldest?'" [<http://www.prb.org/articles/2003/whichstatesaretheoldest.aspx>]. Population Reference Bureau. April 2003.

110 "Health Care Costs and Spending in Massachusetts: A Review of the Evidence." [<http://bluecrossmafoundation.org/~media/Files/Publications/Policy%20Publications/Cost%20Deck%20March%20report.pdf>]. Blue Cross Blue Shield of Massachusetts Foundation. March 2012.

AVERAGE ANNUAL CASELOAD AND MEDICAID EXPENDITURES 2001-2010

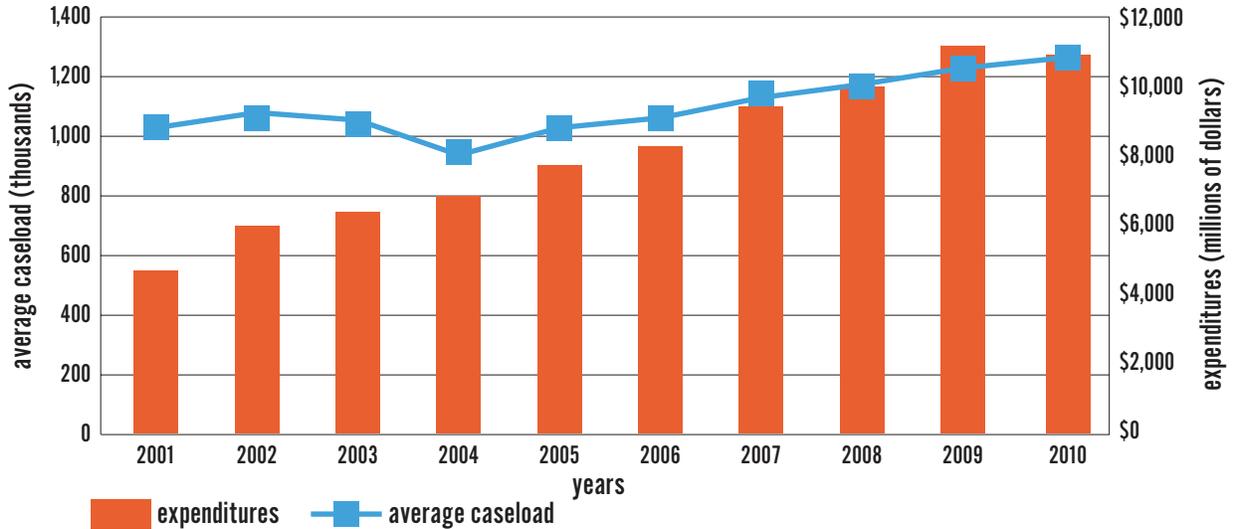


Figure 15 SOURCE: EXECUTIVE OFFICE OF HEALTH AND HUMAN SERVICES.

PUBLIC COVERAGE IN MASSACHUSETTS

State spending on health care falls primarily into three categories: MassHealth (the state’s Medicaid program), coverage for state employees and retirees, and Commonwealth Care, through which low-income residents who do not qualify for Medicaid can purchase subsidized private insurance.

The largest portion of state health spending goes toward MassHealth, which accounts for about 70% of total state health spending.¹¹¹ MassHealth covers about 16% of the state’s population, including children in low-income families, people with disabilities, and many residents in nursing facilities, along with other populations like pregnant women, the long-term unemployed, and some individuals living with HIV.¹¹²

Due to Massachusetts’ 2006 health reform law and previous expansions, MassHealth offers more generous coverage than most state Medicaid programs. For example, children are covered if they are in families with incomes up to 300% the Federal Poverty Level (FPL). Only 18 states provide coverage at this level.¹¹³ Massachusetts covers working parents up to 133% FPL via MassHealth. In other states, the level is significantly lower. For example, the Texas Medicaid program covers working parents up to 26% FPL.¹¹⁴ When the advocacy group Public Citizen ranked state Medicaid

111 “Commonwealth of Massachusetts: Long-Term Fiscal Policy Framework.” [<http://www.mass.gov/anf/docs/long-term-policy-document.doc>]. Massachusetts Executive Office for Administration and Finance. At 21.

112 Dahlen, Long and Stockley at 8.

113 Artiga, Samantha, Brooks, Tricia, Guyer, Jocelyn, Heberlein, Martha, Stephens, Jessica. “Performing Under Pressure: Annual Findings of a 50-State Survey of Eligibility, Enrollment, Renewal, and Cost-Sharing Policies in Medicaid and CHIP, 2011-2012.” [<http://ccf.georgetown.edu/index/medicaid-and-schip-programs>]. Georgetown University Center for Children and Families. January 18, 2012.

114 State Medicaid Fact Sheets. “Massachusetts and Texas.” [<http://www.statehealthfacts.org/mfs.jsp?rgn=23&rgn=45&x=13&y=5>]. The Henry J. Kaiser Family Foundation. May 2011.

{ health care }

programs by eligibility levels in 2007, Massachusetts ranked in the top ten.¹¹⁵ MassHealth also covers more people with disabilities than other state Medicaid programs because the state does not have an income limit for people with disabilities to qualify.¹¹⁶

DUAL ELIGIBLES

In 2011, Massachusetts received a \$1 million award from the U.S. Department of Health and Human Services to fund a pilot program focused on innovative methods for cost control for “dual eligibles,” or individuals with multiple conditions who are eligible for both Medicaid and Medicare. The program focuses on better care coordination, as dual eligibles often receive multiple treatments from multiple providers, increasing the likelihood of medical errors and duplicative care.¹¹⁴ The program targets citizens aged 21-64, as the dual eligibles in this age group generally have serious chronic health problems, like chronic obstructive pulmonary disease. According to state statistics, 64% of dual eligibles have also been diagnosed with a mental health or substance abuse condition.¹¹⁵

The pilot combines Medicare and Medicaid financing. Traditionally, the two funding streams have been separate, as Medicare is a federal program and Medicaid is administered by the states. Combining the funding streams can help reduce paperwork and ensure that clinical decisions are not based on the reimbursement levels offered by the respective programs, but instead on patients’ best interests. In addition, in order to lower costs, the state will contract with a variety of private providers to manage the care for dual eligible populations and evaluate these providers on the quality of the care they provide.¹¹⁶

MassHealth spending has increased significantly in recent years. Inflation-adjusted spending growth between 2005 and 2010 was 11%, increasing from \$6.3 billion in 2005 to \$7.0 billion in 2010. MassHealth as a proportion of total state spending increased from 27% in 2005 to 30% in 2010.¹²⁰ Much of this increase was due to increases in enrollment resulting from the economic downturn.¹²¹ Between 2008 and 2010, over 100,000 new enrollees entered MassHealth, which now covers over 1.2 million citizens.¹²²

All state Medicaid programs receive financing from the federal government; the federal match percentage for a given state is known as its Federal Medical Assistance Percentage (FMAP). The

115 Ramirez de Arrellano, Dr.PH. Annette B., Wolfe, Sidney M., M.D. “Unsettling Scores: A Ranking of State Medicaid Programs.” [<http://www.citizen.org/medicaid#eligibility>]. Public Citizen Health Research Group. April 2007.

116 “MassHealth: The Basics: Facts, Trends and National Context.” [<http://www.massmedicaid.org/~media/MMPI/Files/National%20comparisons%20chartpackv19.pdf>]. Massachusetts Medicaid Policy Institute. October 2011. At 8.

117 “Massachusetts Awarded \$1 Million in Federal Funding for Health Care Cost Containment and Quality Improvement Efforts.” [<http://www.mass.gov/eohhs/gov/departments/masshealth/funding-for-health-care-cost-containment.html>]. Massachusetts Executive Office of Health and Human Services. April 12, 2011.

118 Ibid.

119 “Integrating Medicare and Medicaid for Dual Eligible Individuals: Overview.” [<http://www.mass.gov/eohhs/provider/guidelines-resources/services-planning/national-health-care-reform-plan/federal-health-care-reform-initiatives/integrating-medicare-and-medicare/overview.html>]. Massachusetts Executive Office of Health and Human Services. 2012.

120 “MassHealth: The Basics: Facts, Trends and National Context.” [<http://www.massmedicaid.org/~media/MMPI/Files/National%20comparisons%20chartpackv19.pdf>]. Massachusetts Medicaid Policy Institute. October 2011. At 8.

121 Ibid at 3.

122 Ibid at 12.

{ health care }

federal match for MassHealth — the FMAP — is 50%. That means that the federal government covers half of the costs for insuring enrolled residents. Different states have different federal matching rates. Generally, poorer states receive more federal funds. Mississippi, as an example, receives a 75% grant. Because Massachusetts is a relatively high-income state, it receives the minimum federal match of 50%.

COMMONWEALTH CARE AND COMMONWEALTH CHOICE

Low-income Massachusetts residents not eligible for MassHealth can generally receive health coverage through Commonwealth Care. Commonwealth Care insures low-income adults up to 300% FPL. These adults receive their coverage through private insurance, but receive state subsidies to pay for the coverage. Members with the lowest incomes pay no premium; this group includes individuals with incomes up to \$11,172 and a family of four with up to \$23,052 in income.¹²³

Commonwealth Care has a total budget of \$822 million in 2012 and covers approximately 3% of the state population, or 175,000 residents.¹²⁴ As with the Medicaid program, Massachusetts receives a federal match of 50% for Commonwealth Care expenses.¹²⁵ This significant share is funded by the federal government as part of the Section 1115 waiver.¹²⁶

Commonwealth Choice is a companion program to Commonwealth Care that offers higher-income individuals who do not receive employer-sponsored coverage a range of insurance options, which they can purchase on the state's health insurance exchange (called the "Massachusetts Commonwealth Health Insurance Connector Authority"). Generally, individuals purchasing insurance via Commonwealth Choice have incomes too high to qualify for subsidies, but still struggle to pay the high price of private insurance. As of April 2009, the program had 16,945 enrollees and about 4,900 dependents and cost the state about \$30 million annually.¹²⁷ Enrollment increased throughout 2010 as the recession caused more individuals to seek out state-subsidized health care so that by 2010, there were nearly 50,000 enrollees.¹²⁸

123 See "Health Reform Facts and Figures." [<https://www.mahealthconnector.org/portal/site/connector/menuitem.d7b34e88a23468a2dbef6f47d7468a0c?fiSho wn=default>]. Massachusetts Commonwealth Health Insurance Connector Authority. Spring 2012. At 1.

124 Health Reform in Massachusetts at 8.

125 "Shared Responsibility: Government, Business, and Individuals: Who Pays What for Health Reform." [http://www.bcbsmafoundation.org/foundationroot/en_US/documents/090406SharedResponsibilityFINAL.pdf]. Blue Cross Blue Shield of Massachusetts Foundation. March 2009.

126 See, e.g., "Commonwealth Care Program Update." [<http://masslegalservices.org/system/files/Comm%20Care%20FY%2012.pdf>]. Health Connector. April 2011. At 5.

127 Cheney, Kyle. "Commonwealth Choice Plans Gain as Economy Lags." [<http://www.wickedlocal.com/maynard/newsnow/x1931071919/Commonwealth-Choice-plans-gain-as-economy-lags>]. State House News Service. April 13, 2009; "Commonwealth Health Insurance Connector Authority: FY09 Administrative Budget Update & FY10 Recommendation." [<https://www.mahealthconnector.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/About%2520Us/Publications%2520and%2520Reports/2009/2009-06-23/FY09%2520Administration%2520Budget%2520Update%2520and%2520FY10%2520Recommendation.pdf>]. June 23, 2009.

128 Doonan, Michael T.; Tull, Katharine R. "Health Care Reform in Massachusetts: Implementation of Coverage Expansions and a Health Insurance Mandate." *The Milbank Quarterly*; Published Online: March 24, 2010.

LEADING IN COVERING THE UNINSURED AND SETTING A PRECEDENT FOR NATIONAL HEALTH REFORM

Massachusetts has the highest rate of insurance coverage in the country; 98.1% of the population is insured.¹²⁹ The Massachusetts health reform law, passed in 2006 under then Governor Mitt Romney, has received broad praise for providing near-universal coverage to Massachusetts' citizens while not adding to the growth rate of health care costs.¹³⁰ In fact, since 2006, private insurance premiums in Massachusetts have grown more slowly than the national average.

The law provided for nearly universal coverage in the state through Medicaid expansions and new subsidies for the lower middle class families to buy insurance. According to the Massachusetts Taxpayers' Foundation, the state's share of spending to get to nearly universal coverage was about \$450 million in 2011 — less than 1.4% of the state's total budget.

The Massachusetts law includes several key provisions. Most individuals are required to have insurance or face a penalty.¹³¹ Employers with at least 11 full-time employees are required to provide health care coverage. The law also expanded Medicaid coverage to include children in families with incomes up to 300% the Federal Poverty Line (FPL). In addition, most adults with incomes up to 300% FPL became eligible for state-subsidized coverage. Single, childless adults, who have traditionally been excluded from Medicaid, are included in this group and can purchase state-subsidized coverage from private plans through a program called Commonwealth Care. In addition, the law created an insurance exchange called the Massachusetts Commonwealth Health Connector Authority, in which individuals who would otherwise purchase insurance through the private market can shop for, compare, and health insurance plans.

In making Massachusetts the national leader in health coverage, the 2006 Health Reform law also served as a blueprint for the Patient Protection and Affordable Care Act (ACA) — the national health reform law passed in 2010.

The key aspects of the Massachusetts law, which include individual and employer mandates, Medicaid expansions, public subsidies for the purchase of private insurance for those with low incomes who are not eligible for Medicaid, and the creation of insurance exchanges to facilitate the purchase of private coverage, formed the foundation of the ACA. The Massachusetts law blends ideas embraced by liberals and conservatives, and builds on the existing health care foundation rather than creating a new, government-run insurance system. As such, national reformers saw it as a pragmatic approach that had the potential to increase coverage while winning support from policymakers across the political spectrum.

The Massachusetts law continues to earn the support of a strong majority of state residents. According to the Blue Cross Blue Shield of Massachusetts Foundation, support for the legislation has remained stable since its passage. In the fall of 2006, 69% of non-elderly adults supported reform. In fall 2010, 66% of non-elderly adults supported the law.¹³² Further, 88% of physicians believe that the reform either improved or did not affect the quality of care provided in the state.¹³³

Since 2006, some other states have followed the Massachusetts example and passed more modest coverage expansions. For example, Colorado has expanded Medicaid coverage to childless adults up to 100% FPL, but with a benefit package more limited than Medicaid and Commonwealth Care.¹³⁴ Vermont has passed legislation even more aggressive than the Massachusetts model, establishing the first "single-payer" health care system in the country. The legislation, passed in 2011, establishes a health insurance system to be known as "Green Mountain Care." All residents will be eligible regardless of income. To contain health care costs, the law also includes a global budget for health spending.¹³⁵ ★

129 "Health Reform in Massachusetts: Assessing the Results." [<https://www.mahealthconnector.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Health%2520Care%2520Reform/Overview/HealthReformAssessingtheResults.pdf>]. Blue Cross Blue Shield of Massachusetts Foundation. April 2011.

130 "Health Care Costs and Spending in Massachusetts: A Review of the Evidence." [<http://bluecrossmafoundation.org/Policy-and-Research/Reports-By-Topic/Health-Care-Costs-and-Affordability/~media/Files/Publications/Policy%20Publications/Cost%20Deck%20March%20report.pdf>]. Blue Cross Blue Shield of Massachusetts Foundation. March 2012. At 12.

131 The poorest residents in the state — those with incomes below 150% FPL — are not subject to the mandate. Health Reform in Massachusetts: Assessing the Results at 4.

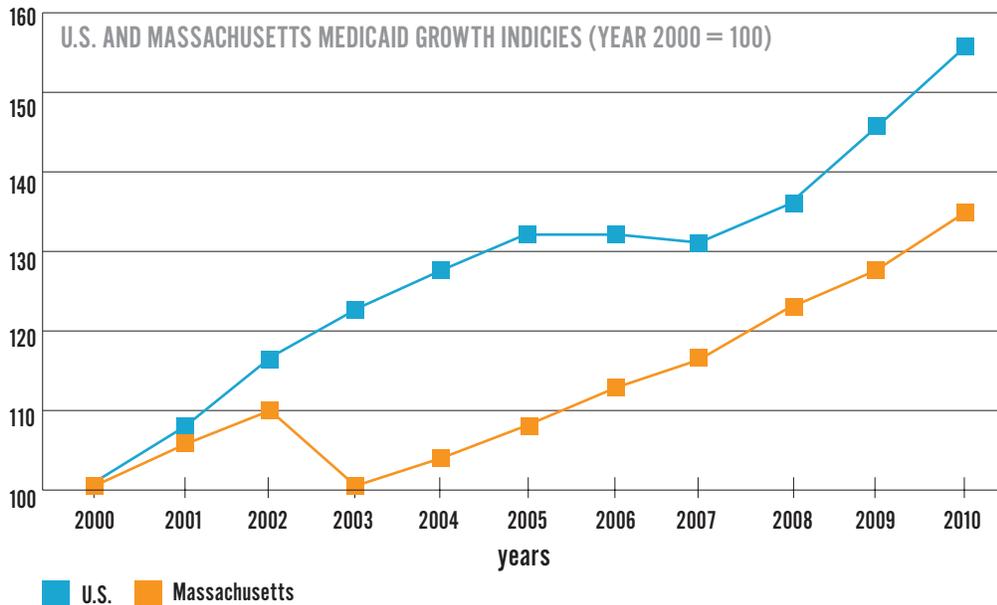
132 "Health Reform in Massachusetts: Assessing the Results." [http://bluecrossmafoundation.org/Health-Reform/~media/Files/Publications/Policy%20Publications/Monitoring_MA_Reform_May_2012_v2.pdf]. Blue Cross Blue Shield of Massachusetts Foundation. May 2012.

133 Ibid at 35.

134 "States Moving Toward Comprehensive Health Care Reform." [<http://www.kff.org/uninsured/upload/State-Health-Reform1.pdf>]. The Henry J. Kaiser Family Foundation. July 10, 2009.

135 Dube, Nicole. "Vermont's Single-Payer Health Insurance Legislation." [<http://www.cga.ct.gov/2011/rpt/2011-R-0288.htm>]. Connecticut General Assembly. August 15, 2011.

MEDICAID ENROLLMENT HAS GROWN IN THE PAST DECADE, BOTH NATIONALLY AND IN MASSACHUSETTS



Medicaid enrollment increased at a similar rate in Massachusetts and the U.S. between 2003 and 2010.

The accelerated growth in the U.S. since 2008 was due largely to the recession. Enrollment in Massachusetts did not grow as quickly during that period because employer sponsored insurance did not decline as much as it did in the nation as a whole.

Figure 16 SOURCE: MASSACHUSETTS CAFRS 2000-2010

MASSACHUSETTS HEALTH SAFETY NET

Massachusetts also has a Health Safety Net program that pays for the care of individuals with incomes below 400% FPL who do not qualify for MassHealth or Commonwealth Care, and do not have insurance or are underinsured. Some beneficiaries include undocumented immigrants who are not eligible for other state-subsidized care. Spending on the Health Safety Net was \$414 million in FY 2009.¹³⁶ Just under \$400 million was budgeted for 2012. The Health Safety Net creates an alternative for those without insurance from seeking expensive hospital emergency room care. The program completely or partially covers the cost of services, depending on the age and income of the beneficiary.¹³⁷ The program is funded with state dollars, as well as with assessments levied on providers and insurance plans.¹³⁸ In 2010, the program covered 1.1 million hospital visits.

¹³⁶ Health Reform Facts and Figures at 6.

¹³⁷ "Health Safety Net (Free Care): An Overview." [<http://www.massresources.org/hsn.html>]. Community Resources Information, Inc. 2012.

¹³⁸ Ku, Leighton, et al., "How is the Primary Care Safety Net Faring in Massachusetts? Community Health Centers in the Midst of Health Reform." [<http://www.kff.org/healthreform/upload/7878.pdf>]. Kaiser Family Foundation and George Washington University Department of Health Policy. March 2009.

HEALTH INSURANCE FOR STATE EMPLOYEES

Nearly 400,000 state employees, retirees, and their family members depend on the state's Group Insurance Commission (GIC) to administer their health insurance.¹³⁹ It is a quasi-public agency¹⁴⁰ with a 15-member board (three seats are currently vacant) that offers a variety of private plans from which employees can make selections.¹⁴¹

In 2012, the state appropriated approximately \$1.6 billion to GIC — an increase of 20% since 2010. The state has implemented several cost containment measures for the GIC. For example, in 2011 the state required most employees reenroll in a plan, with greater incentives to enroll in lower cost, limited network plans. These plans cost 20% less than the expanded network to alternatives. The state projected savings from this measure at \$20 million after 99% of employees re-enrolled and over 30% chose a limited network plan.¹⁴²

For FY 2011, the GIC reported total expenditures of \$1.5 billion and total revenue of \$750 million from member premiums, leaving a “Net Commonwealth Expense” — the amount the GIC could not fund itself and relied on the rest of the state government to cover — of over \$775 million for 2011 alone.¹⁴³ The GIC maintains three separate trust funds for state employees, elderly government retirees, and retired municipal teachers. For fiscal year 2011, the state employees' trust fund had a balance of just over \$4 million, \$50,000 in receipts, and \$806,000 in expenditures, leaving a year-end balance of \$3.3 million.¹⁴⁴ The much smaller elderly governmental retirees' trust fund had a regular balance of \$168,000 and expenditures of less than \$16,000, ending the year with a balance of \$150,000.

“Estimates put total unfunded health care liabilities at \$16.6 billion. When the costs of benefits for city employees are included, the total increases to around \$40 billion.”

139 Mitchell, Dolores L. “Who is GIC?” [<http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/oversight-agencies/gic/who-is-the-gic.html>]. Group Insurance Commission. 2012.

140 According to state's website, “[Q]uasi-public agencies are state agencies and boards created by statute, that are funded to some extent with state tax dollars, and that are not directly accountable to a single elected official. They tend to be headed by chief executive officers who report to boards of directors who in turn are appointed by multiple elected officials.” “Independent Authorities & Quasi-Public Agencies.” [<http://www.mass.gov/portal/government-taxes/branches-agencies/independent-quasis/>]. Commonwealth of Massachusetts. 2012.

141 Moran, John. “Massachusetts Act Opening State Health Plan to Municipalities.” [<http://www.cga.ct.gov/2008/rpt/2008-R-0039.htm>. AND <http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/oversight-agencies/gic/who-is-the-gic.html>]. OLR Research Report. January 11, 2008; “Who is the GIC?” [<http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/oversight-agencies/gic/who-is-the-gic.html>]. Massachusetts Executive Office for Administration and Finance.

142 “Annual Report 2011, Section 3.” [<http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/annual-reports/annual-report-fy-2011-section-3.html>]. Group Insurance Commission. 2011.

143 “Annual Report FY 2011: Statement of Expenditures and Revenues.” [<http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/annual-reports/annual-report-fy-2011-financial-and-trend.html>]. Massachusetts Executive Office for Administration and Finance. 2011.

144 “Annual Report FY 2011: Employees' Trust Fund Statements.” [<http://www.mass.gov/anf/employee-insurance-and-retirement-benefits/annual-reports/annual-report-fy-2011-financial-and-trend.html>]. Massachusetts Executive Office for Administration and Finance. 2011.

{ health care }

Overall, the GIC's claims liability fell from \$97.1 million in 2010 to \$80.3 million in 2011, as decreases in the liability estimate and payments into the system outpaced the increases in the liability estimate.¹⁴⁵

UNFUNDED RETIREE HEALTH CARE BENEFITS

While insurance for state employees constitutes a relatively small percentage of the overall health care budget today, as more employees retire the state will begin to face large shortfalls in the future. Estimates from the consulting firm AON put total unfunded health care liabilities in Massachusetts at \$16.6 billion.¹⁴⁶ When the costs of benefits for city employees are included, the total increases to around \$40 billion.¹⁴⁷

“Bloomberg News characterized the problem of unfunded health care benefits as the sleeping cancer of state and local finance, reporting that states overall have funded just 4% of a total liability which tops \$600 billion...”

In simplest terms, unfunded liabilities are “projected commitments that are not covered by projected revenues.”¹⁴⁸ Bloomberg News characterized the problem of unfunded health care benefits as the “sleeping cancer” of state and local finance, reporting that states overall have funded just 4% of a total liability which tops \$600 billion, according to Bloomberg Rankings data. New Jersey Governor Chris Christie has noted that “the whole country is dealing with” the ballooning projected costs of retiree health care.¹⁴⁹

In order to prepare for these coming expenses, Governor Patrick included a set-aside of 10% of the state's receipts from lawsuits against tobacco companies, or \$27 million, to be put towards this liability in the 2013 budget.¹⁵⁰ This percentage will grow each year by 10 percentage points (e.g., in FY 2014, 20% of tobacco settlement costs), until 100%, or an estimated \$276 million, is dedicated annually to help offset these health care costs.” In addition, the Governor also proposed transferring 5% of excess capital gains tax revenues into the state's retiree health liability trust fund.¹⁵¹

145 Martin J. Benison, CGFM. Massachusetts 2011 Comprehensive Annual Financial Report. [<http://www.mass.gov/osc/docs/reports-audits/cafr/cafr-2011.pdf>]. Comptroller of the Commonwealth. 2011.

146 “Commission Focuses on Healthcare Finances.” [<http://www.massretirees.com/article/issues/state-gic/commission-focuses-healthcare-finances>]. Mass Retirees. April 6, 2012.

147 Ibid.

148 Folbre, Nancy. “The Unfunded Liabilities You Love.” [<http://economix.blogs.nytimes.com/2012/06/04/the-unfunded-liabilities-you-love/>]. New York Times. June 4, 2012.

149 Darrell Preston. “States Facing Sleeping Cancer in 96% Unfunded Retiree Benefits.” [<http://www.bloomberg.com/news/2012-03-07/states-facing-sleeping-cancer-in-96-unfunded-retiree-benefits.html>]. Bloomberg. March 7, 2012.

150 Ibid.

151 Governor's Budget FY 2013. FY 2013 Budget Recommendation: Issues in Brief. “Improving Fiscal Management and Transparency.” [http://www.mass.gov/bb/h1/fy13h1/exec_13/hbudbrief19.htm]. Executive Office for Administration and Finance. 2012.

HEALTH CARE COST CONTROL: THE NEXT CHAPTER OF REFORM

In addition to measures addressing costs for MassHealth and state employee benefits, Governor Patrick has proposed legislation to address health costs in the state broadly. In 2011, Patrick proposed a landmark bill to reform the way health care is paid for in the state and strengthen regulations of rate increases by providers.

The legislation would facilitate a shift away from a “fee-for-service” model, where providers submit reimbursement requests to insurers for individual procedures, and toward global payments, in which providers are reimbursed for the overall cost of a particular patient or episode of treatment, such as for a heart attack or stroke. Global payments give providers incentives to carefully choose the treatments that are the most effective and least costly. Often, providers can keep some portion of the capitated amount not spent. The RAND Corporation, a leading health policy analysis research organization, cites such payment changes as the most promising way to control health care costs.¹⁵² Patrick’s proposal would move individuals receiving state-subsidized insurance and state employees into global payment arrangements.¹⁵³

Patrick’s proposal would also give the state’s Department of Insurance increased authority to reject unreasonable fee increases proposed by providers or insurers. This could prove a powerful tool in helping to reign in overall health care spending, much of which is driven by high prices in the state.

“Given that health care costs are a policy concern nationwide, political observers are closely monitoring progress in Massachusetts to assess the feasibility of the strategies it embraces.”

Patrick’s plan also emphasizes a more collaborative approach to managing patient health. His bill encourages the establishment of “Accountable Care Organizations” (ACOs), or groups of doctors and hospitals that have an agreement to take on responsibility for the care of a group of patients. Typically, ACOs are rewarded for improving patient care, sharing in any cost savings from better care management such as improved follow-up care after emergency room visits or hospitalizations. Patrick’s legislation sets up criteria for groups to be considered ACOs, bringing new providers into the market.¹⁵⁴

152 Eibner, Christine, Hussey, Peter S., Ridgely, M. Susan, McGlynn, Elizabeth A. “Controlling Health Care Spending in Massachusetts: A Policy Brief.” [http://www.rand.org/pubs/research_briefs/RB9464-1.html]. RAND Corporation. 2009.

153 Goodnough, Abby and Sack, Ken. “Massachusetts Tries to Rein in Its Health Care Costs.” [<http://www.nytimes.com/2011/10/18/us/massachusetts-tries-to-rein-in-its-health-care-cost.html?pagewanted=all>]. The New York Times. October 17, 2011.

154 “Key Elements of Governor Patrick’s Payment Reform Legislation.” [<http://www.massmed.org/AM/Template.cfm?Section=Home6&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=46644>]. Massachusetts Medical Society. February 19, 2011.

{ health care }

Given that health care costs are a policy concern nationwide, political observers are closely monitoring progress in Massachusetts to assess the feasibility of the strategies it embraces. The Massachusetts Senate has passed cost control legislation based on Patrick's proposal, as has the House. One point of contention between the two bills is the rate at which health care costs would be allowed to grow. The Senate bill allows for health care costs to grow at a faster rate than the House bill.¹⁵⁵

Observers expect the House and Senate to hammer out a compromise in 2012 and deliver a complete bill to Governor Patrick.¹⁵⁶ Other states are taking more modest steps of their own. For example, Oregon has passed legislation to move toward greater coordination of health care services through "coordinated care organizations" for residents who received subsidized coverage from the state (similar to ACOs in Massachusetts).¹⁵⁷

EFFECTS OF NATIONAL HEALTH REFORM IN MASSACHUSETTS

Because of the 2006 health care law in Massachusetts, national health reform ("the Patient Protection and Affordable Care Act of 2010" or "ACA") represents a much less drastic change in coverage for Massachusetts than in other states. The primary group of individuals who will benefit from expanded coverage will be individuals with incomes between 300% and 400% of FPL, who will be newly eligible for subsidies. The Blue Cross Blue Shield of Massachusetts Foundation estimates that this means that up to 50,000 additional residents will be eligible for subsidized coverage.¹⁵⁸

Many of the differences between the ACA and 2006 Massachusetts reforms lie in the mechanisms for coverage expansion and the details of the policy criteria for various populations to either become eligible for coverage or exempt from requirements. For example, in Massachusetts individuals with incomes less than 150% FPL are exempt from the individual mandate, along with those for whom premiums in their region exceed an affordability threshold for their income level. The ACA rules define the exemption from the mandate differently, with individuals who do not have to file taxes and individuals for whom the lowest cost plan exceeds 8% of annual income being exempt. While there will be significant overlap in these groups, some individuals will see their treatment change.¹⁵⁹

Perhaps the most significant change from a financing perspective is that the ACA will deliver more federal dollars to Massachusetts. Because federal funds will cover 100% of the insurance subsidies for those who are not Medicaid eligible (incomes between 133% and 400% FPL), and because there is an enhanced match from the federal government for those newly eligible for Medicaid, the

155 Johnson, Glen and Conaboy, Chelsea. "Patrick Pushes Health Care Cost Controls." [http://www.boston.com/news/local/massachusetts/articles/2012/05/16/patrick_says_health_industry_can_slow_cost_increases_without_hurting_quality/]. Boston Globe. May 16, 2012.

156 Bebinger, Martha. "Senate Passes Health Care Cost Control Bill with Few Major Changes." [<http://www.wbur.org/2012/05/18/mass-senate-health-bill>]. Boston National Public Radio. May 18, 2012.

157 Waldroupe, Amanda. [http://thelundreport.org/resource/the_applications_are_in_ccos_will_be_in_every_part_of_oregon]. The Lund Report. May 5, 2012.

158 Siefert, Robert and Cohen, Andrew P. "Re-Forming Reform: What the Patient Protection and Affordable Care Act Means for Massachusetts." [<http://bluecrossmafoundation.org/Policy-and-Research/Reports-By-Topic/National-Health-Reform/Reforming-Reform.aspx>]. June 2010. At 15.

159 Ibid at 10-13.

{ health care }

state should see significant increases in federal funding that will help offset any coverage increases. Whereas the state currently receives a 50% federal match for childless adults below 133% FPL, that rate will gradually increase starting in 2014, reaching 90% in 2020. That provision alone will bring nearly \$2 billion in federal dollars to the state between 2014 and 2019, and nearly \$350 million annually thereafter.¹⁶⁰ The federal contributions toward the coverage subsidies for those with higher incomes will save the state an estimated \$125 million per year.¹⁶¹ Increased federal dollars for other groups, such as children and legal immigrants, will also bring in additional federal dollars. ★

¹⁶⁰ Ibid at 5.

¹⁶¹ Ibid at 5.

OVERVIEW

Massachusetts, like all states, is responsible for two separate educational institutions. First, Massachusetts operates a public school system with a mandate to provide free education for all children from kindergarten through twelfth grade (K-12). State spending, along with contributions from cities and local governments account for over 90% of all funding for K-12 public education.¹⁶² Second, the state operates public universities and community colleges, which provide higher education at a reduced cost to the state's residents. Massachusetts, like other state governments, manages these two education systems separately.

In recent years, both of these educational institutions have suffered. Similar to other states, Massachusetts is struggling with a number of alarming trends in the U.S. educational systems, including rapidly rising college tuition, burdensome student debt, declining K-12 achievement compared to other nations (especially in math and science), entrenched underperformance at all levels in impoverished areas and, to make matters worse, a looming budget crisis.

“Governor Patrick’s 2013 budget has big cuts for education across the board, with some areas of spending seeing a funding decrease of more than 20%.”

K-12 EDUCATION

Overview and Financing

In 2011, Massachusetts spent \$3.6 billion on early elementary and secondary education, which represents 6.9% of the state's total primary government expenditure.¹⁶³ Both in absolute terms and as a percentage of the state budget, public education spending has been growing steadily since the early 2000s. The absolute increase in state spending on education over the past decade reflects a growing state budget over time, funded in part by greater deficit spending.

The larger percentage of the budget devoted to K-12 education, meanwhile, reflects disproportionately rapid cost increases in a number of areas. The number one cost driver in education is the rising cost of insurance and retirement programs for K-12 employees. Other cost drivers include special teaching services (largely special education) and overall school operations and maintenance.¹⁶⁴

Education spending has remained steady since 2008, in real dollars despite the budgetary effects of the financial crisis. That said, there are signs that Massachusetts is preparing to slash education

¹⁶² MassBudget. “Public School Funding in Massachusetts: Where We Are, What Has Changed, and How We Compare to Other States.” [http://www.massbudget.org/report_window.php?loc=Annual_Census_Education_paper_FY09_data_Sept_2011_release_v04.html]. September 1, 2011.

¹⁶³ Massachusetts CAFR 2011; Statement of Activities. Note: This excludes “lottery expenditure” from the CAFR, which consists of lottery winnings and is therefore not an expense of government in the traditional sense, and component units which are legally separate entities (like MassDOT).

¹⁶⁴ “Public PK-12 School Expenditures FY04 to FY10, All Funds: Massachusetts State Totals,” P 2.

{ education }

spending in the coming years. Indeed, while overall state education spending has been buoyed by mandatory Chapter 70 spending (allocated annually to school districts based on a set formula) other areas of education spending are under threat. An analysis by a nonprofit budget watch agency, MassBudget, showed that Governor Patrick's 2013 budget has big cuts for education across the board, with some areas of spending seeing a funding decrease of more than 20%. Early education and non-Chapter 70 aid to K-12 schools are likely to face especially severe cuts.¹⁶⁵

States and local governments are responsible for funding public education in Massachusetts, providing roughly 90% of the state's schools' budgets.¹⁶⁶ The federal government's contribution has varied between 4.5% and 6.5% from 1993 to 2008.¹⁶⁷ However, following the financial crisis of 2008, the federal contribution rose to 7.8% as Massachusetts cut its portion of state education spending (or directed it elsewhere) and instead used resources from the federal stimulus to fund education.¹⁶⁸

Overall, the state has been relatively well sheltered compared to other states from the drastic changes to education that followed the economic downturn. Massachusetts has avoided massive teacher layoffs and school shutdowns, largely due to a strong reliance on the local funding of schools (made possible by Massachusetts' position as one of the country's wealthiest states) and the use of a large portion of the state's federal stimulus funds to fill gaps.¹⁶⁹ According to J.C. Considine, a spokesman for the Massachusetts Department of Elementary and Secondary Education (DESE), the diversion of most of the recent federal funding to education was for "strategic investments" like teacher retention.¹⁷⁰ The state achieved this by using a larger portion of its State Fiscal Stabilization Fund (a one-time appropriation under the federal stimulus package) on education than did other states.¹⁷¹

However in 2012, most federal funding will dry up and the state will face a new series of challenges in funding K-12 public education.¹⁷² Since the traditional sources of revenue (the state's tax revenues as well as local property taxes) will take some time to recover from the recession, the need to address funding is urgent, especially since the newest budget proposals from the state's leadership indicate that massive cuts to K-12 education are on the way.

165 MassBudget. "Budget Monitor: The Governor's FY 2013 Budget." [http://www.massbudget.org/report_window.php?loc=budget_monitor_governor_fy13.php]. January 31, 2012.

166 United States Census Bureau. "Public Education Finances: 2009". [<http://www2.census.gov/govs/school/09f33pub.pdf>] P 5. May 2011.

167 MassBudget. "Public School Funding in Massachusetts: Where We Are, What Has Changed, and How We Compare to Other States." [http://www.massbudget.org/report_window.php?loc=Annual_Census_Education_paper_FY09_data_Sept_2011_release_v04.html]. September 1, 2011.

168 Ibid.

169 Ibid.

170 "Schools face cliff as education money dries up." [<http://m2.tbo.com/content/2011/apr/06/060607/schools-face-cliff-as-education-money-dries-up/>]. April 6, 2011

171 MassBudget. "Public School Funding in Massachusetts: Where We Are, What Has Changed, and How We Compare to Other States." [http://www.massbudget.org/report_window.php?loc=Annual_Census_Education_paper_FY09_data_Sept_2011_release_v04.html]. September 1, 2011.

172 Salsberg, Bob. "Tough choices for Massachusetts as stimulus funds run out." [<http://www.patriotledger.com/news/x118157913/Tough-choices-for-Massachusetts-as-stimulus-funds-run-out>]. Feb 9, 2011.

EDUCATION SPENDING AS A PERCENTAGE OF PRIMARY GOVERNMENT SPENDING

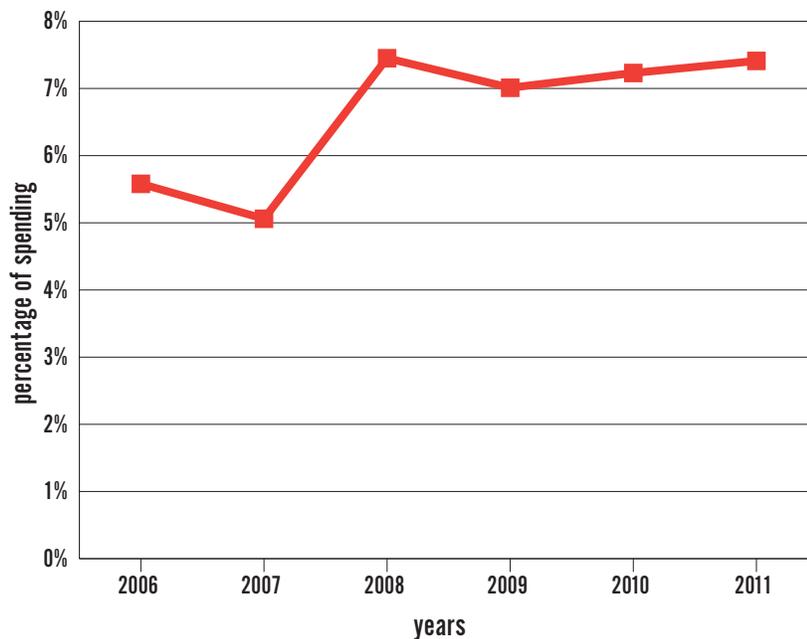


Figure 17 SOURCE: MASSACHUSETTS CAFRS 2006-2011

Measured as a percentage of the state budget, Massachusetts ranked 23rd in the nation in education spending in 2011.¹⁷³ Accounting for only the funds that go directly to the students (rather than construction and debt financing costs), the Commonwealth spends more per student, \$13,369 in 2011, than the national average of roughly \$10,000.¹⁷⁴ While the link between spending and achievement is controversial, Massachusetts consistently scores high on measures of national achievement and has a student/teacher ratio (13.5 students per teacher) below the national average (15.4 students per teacher).¹⁷⁵

Total K-12 school enrollment in Massachusetts stood at 953,369 students in 2011-2012.¹⁷⁶ Total enrollment has been steady in recent years, after a sharp decline in the late 1970s and early 1980s and steady growth through the 1990s. The slow, gradual growth in K-12 public school enrollment in Massachusetts in recent years is largely the result of the state's slow population growth due to lower birth rates and emigration from the state. Projected enrollment through 2019 predicts a steady decline in total public school enrollment, with decreases of nearly 1% of total enrollment annually.

173 U.S. Census Bureau. "State and Local Government Finances." [<http://www.census.gov/govs/estimate/>]. 2009.

174 New America Foundation. "Federal Education Budget Project: Massachusetts." [<http://febp.newamerica.net/k12/MA>]. 2009

175 Luckie, Mark. "Comparing student-to-teacher ratio nationwide". [<http://californiawatch.org/k-12/interactive-comparing-student-teacher-ratio-nation-wide>]. November 19, 2009.

176 Massachusetts DESE. "2011-2012 Enrollment By Grade Report." [http://profiles.doe.mass.edu/state_report/enrollmentbygrade.aspx?mode=school&orderBy=]. 2012.

K - 12 PUBLIC SCHOOL ENROLLMENT 1970 - 2012, AND PROJECTED TO 2019

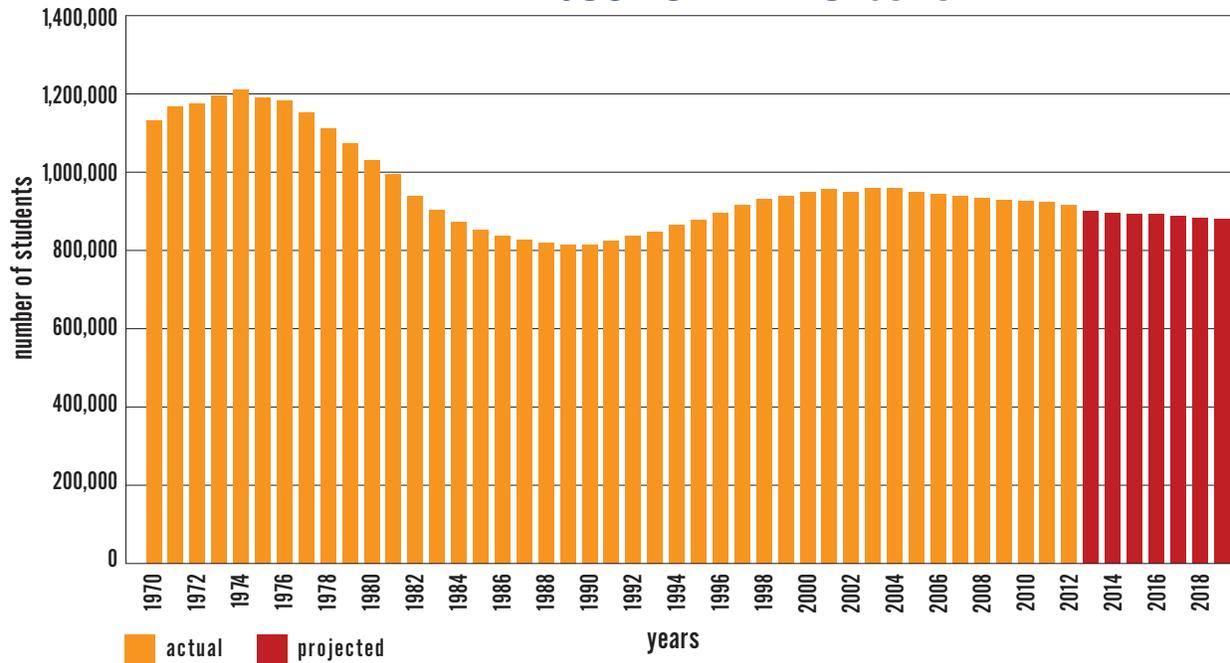


Figure 18 SOURCE: MASSACHUSETTS DEPARTMENT OF ELEMENTARY AND SECONDARY EDUCATION, “2011-2012 ENROLLMENT BY GRADE REPORT.”

Successes and Challenges in K-12 Education

Students of all age groups in Massachusetts rank highly on various measures of educational achievement. According to data from the 2011 National Assessment of Education Progress (NAEP), the largest continuing and nationally representative assessment given to 4th and 8th graders in every state, Massachusetts ranked first overall for the fourth straight year, with more than 10% of fourth graders ranked as “Advanced” in reading and math and 17% of eighth graders ranked as “Advanced” in math.¹⁷⁷

Despite this positive news, there exists a significant achievement gap within the state, especially when examining the outcomes of non-native English speakers and students from low-income communities to other students. Massachusetts State Representative Jason Lewis notes, “In 2008, 70% of English Language Learners and 40% of low-income students in the Class of 2010 failed to meet...graduation requirements. On the 2007 National Assessment of Educational Progress (NEAP), Massachusetts ranked near the bottom of all states with regard to the difference in reading and math scores between low and higher income students.”¹⁷⁸ According to a report from the Massachusetts Department of Elementary and Secondary Education, the 2011 NAEP scores

177 The Daily Beast. “States with the Smartest Kids.” [<http://www.thedailybeast.com/articles/2011/01/23/states-with-smartest-kids-from-massachusetts-to-mississippi.html>]. January 23, 2011.

178 Lewis, Jason. “Providing access to a quality education for all students.” [<http://www.repjasonlewis.com/news/op-eds/providing-access-to-a-quality-education-for-all-students>].

showed that eighth grade English language learners in Massachusetts “scored significantly lower than their counterparts in the nation” in reading.¹⁷⁹

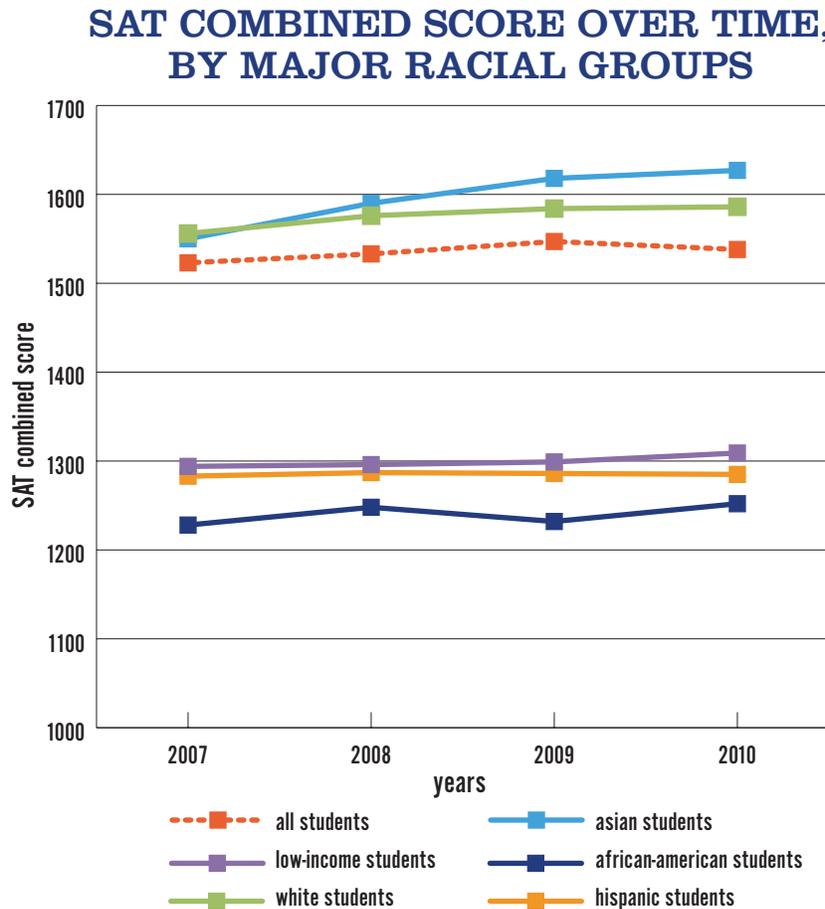


Figure 19

SOURCE: MASSACHUSETTS DEPARTMENT OF ELEMENTARY AND SECONDARY EDUCATION, “2009-2010 SAT PERFORMANCE REPORT (DISTRICT) ALL STUDENTS.”

These differences continue into high school, with large gaps in SAT scores for Massachusetts’s students across income and racial groups. Not only are the gaps clear in the most recent data, but trends over the past few years also show no signs of the gap in performance narrowing. Thus, despite the state’s strong overall performance, a large and persistent gap in achievement between socioeconomic communities and racial groups persists.

Charter Schools

Massachusetts has become the home to an especially vigorous charter school movement, with the state legislature enacting strong laws to encourage and protect budding charter schools. The state’s Education Reform Act of 1993, which authorized the creation of charter schools in the state, was

179 Massachusetts DESE. “2011 NAEP Reading and Mathematics: Summary of State Results.” [<http://www.doe.mass.edu/mcas/naep/results/11ReadingMath.pdf>]. November 2011.

one of the charter school movement's earliest victories. As of 2009–2010, the state had sixty-three charter schools educating 3% of the state's total school-age population.¹⁸⁰ The prominence of charter schools in the state is not surprising given that the charter school movement is a brainchild of Ray Budde, a professor at the University of Massachusetts–Amherst.

There is a vigorous debate surrounding charter schools and their educational and social benefits. Proponents argue that charter schools provide families with an alternative to a failing school system. In addition, the competition introduced into the educational system by charter schools can help improve results for students in every type of school. Finally, proponents cite the greater flexibility and accountability of charter schools: the vast majority of charter schools are not unionized, and thus principals have the flexibility to hire, fire, and reward teachers based on merit. Also, unlike a traditional public school, if a charter school does not perform, their charter is not renewed.

However, charter school critics maintain that charter schools are destroying rather than improving the public education system by diverting funding and talented students from traditional public schools. Funding is allocated to public schools based on the number of students they have, so every student who leaves a public school for a charter school takes with him tens of thousands of dollars in funding.

HIGHER EDUCATION

Massachusetts currently serves 260,000 students through its system of higher education, which is comprised of 15 community colleges, nine state universities, and five campuses of the University of Massachusetts. In the state budget, higher education is classified as a “business-type activity,” meaning that public colleges and universities are administered independently, receiving funding through student tuition, federal grants, and other federal and private sources. That said, these universities are still overseen by the state and receive a large part of their funding from the state.

Financing

In FY 2011, state expenditures on higher education totaled \$4.5 billion. These funds were used to support the University of Massachusetts, the state universities, Massachusetts' community colleges, the Department of Higher Education, and programs like the Massachusetts State Scholarship Program. Total state expenditures on higher education have grown slowly since 2008, at roughly the rate of inflation.¹⁸¹

During the fiscal year ending June 30, 2011, the deficit on higher education activities — the gap between total expenses and revenues from tuition and grants — was \$1.1 billion.¹⁸² This deficit is largely due to cuts in funding caused by the recession. To date, the state has serviced this deficit

¹⁸⁰ Center for Public Education. “Charter Schools by State 2010-11.” [<http://www.centerforpubliceducation.org/Main-Menu/Organizing-a-school/Charter-schools-Finding-out-the-facts-At-a-glance/Charter-School-Data-by-State-2010-2011.pdf>]. 2011.

¹⁸¹ Massachusetts CAFR 2008, P 40; Massachusetts CAFR 2009, P 42; Massachusetts CAFR 2010, P 44; Massachusetts CAFR 2011, P 50.

¹⁸² Massachusetts CAFR 2011, P 42.

{ education }

by borrowing money rather than cutting spending. To address these deficits, Massachusetts plans to cut funding for higher education by \$64 million, or 6.3% in FY 2012. Since FY 2009, after adjusting for inflation, the state will have cut funding by \$185 million, or 16.3%.¹⁸³

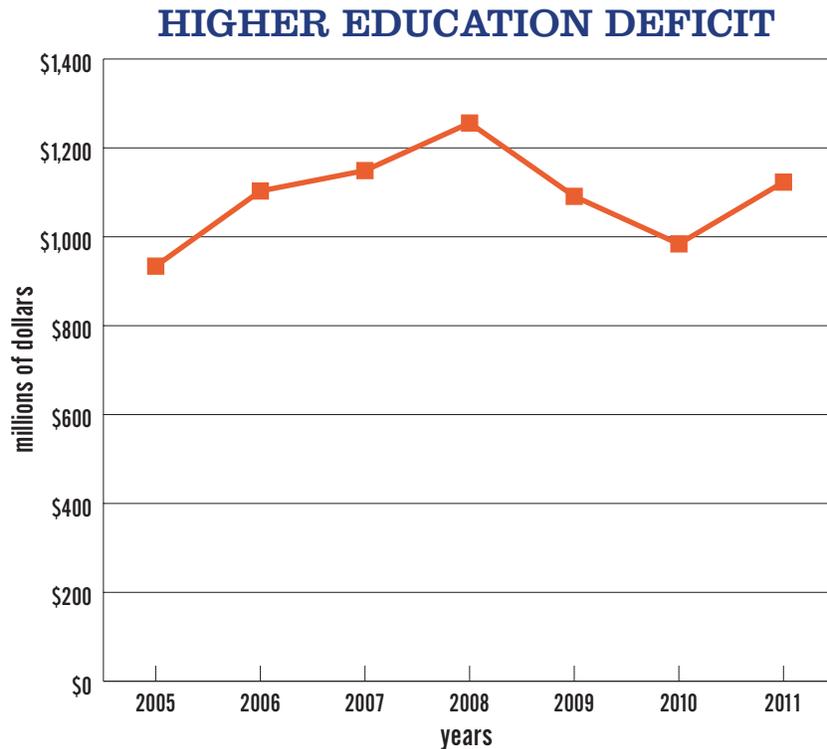


Figure 20

SOURCE: MASSACHUSETTS CAFR. COMPUTED AS THE AMOUNT BY WHICH EXPENSES EXCEED THE SUM OF USER FEES, OPERATING GRANTS, AND CONTRIBUTIONS

Nevertheless, Massachusetts, like most states, faces greater demand for universities than ever before. Increasingly, a college education is seen as a requirement for many jobs and therefore the demand for a college education continues to rise. The state's colleges and universities have continued to see record numbers of applications year after year as well as greater demand for financial aid.¹⁸⁴ With more students putting a strain on the system, deficits in higher education spending are expected to grow.

More worrying still, higher education is expected to suffer large cuts in funding, just like K-12 education. According to a budget analysis conducted by MassBudget, Governor Patrick's fiscal year 2013 budget does not adequately support the higher education in Massachusetts, especially when recent funding cuts are taken into account. Higher Education funding in fiscal year 2013 "would

¹⁸³ Williams, Erica; Leachman, Michael; Johnson, Nicholas. "State Budget Cuts in the New Fiscal Year Are Unnecessarily Harmful." [<http://www.cbpp.org/cms/index.cfm?fa=view&id=3550>]. July 28, 2011.

¹⁸⁴ Carmichael, Mary. "Colleges see record applicants." [http://articles.boston.com/2012-02-16/metro/31063784_1_early-decision-applicants-international-students-admissions]. February 16, 2012.

{ education }

represent an inflation-adjusted cut of 13 percent” from fiscal year 2009, and a 30% cut from fiscal year 2001.¹⁸⁵ Governor Patrick’s newest budget also proposes reforms to the state’s community college system in order to consolidate funding and leadership control. Governor Patrick wants community colleges to coordinate more closely with local employers and to focus more specifically on job training.

Tuition Rising, Student Debt Growing

Despite rising costs, higher education is one of Massachusetts’ crown jewels. The state’s leadership in private higher education is particularly notable, with world-renowned schools like Harvard and MIT, as well as many other highly-ranked universities and colleges. These schools are growing in popularity, with an increasing number of applications each year.¹⁸⁶ The state’s public institutions of higher education also perform well in the *U.S. News & World Report* rankings, but do lag behind those in other states (including California, Texas, and Virginia).¹⁸⁷

“Recent estimates from the Federal Reserve Bank of New York suggest that total student loan debt is nearly \$1 trillion nationwide.”

Nationwide, rising tuition and soaring student debt have made it harder for young Americans to pursue higher education. *The New York Times* attributed the rising cost of education to three main factors: the increasing popularity of for-profit colleges (colleges that generally charge higher prices and do not offer as much financial aid as private not-for-profit colleges), cuts in higher education spending at the state level since the 1990s, and decreasing state budgets due to the recession. These factors force colleges to raise tuition to cover their costs.¹⁸⁸ With tuition costs on the rise, especially since 2008, a generation of students has responded by taking out heavy loans to finance their education. Recent estimates from the Federal Reserve Bank of New York suggest that total student loan debt is roughly \$1 trillion nationwide.¹⁸⁹

Massachusetts has attempted to curb college costs by diverting additional funds to higher education. Still, the state has not defied the national trend of growing tuition. Between 2005 and 2010, the annual state university tuition increased from \$5,448 to \$7,436, community college tuition increased from \$3,477 to \$4,625, and tuition for the University of Massachusetts system increased from \$8,697 to \$10,804.¹⁹⁰ Even correcting for inflation between 2005 and 2010, these increases

185 MassBudget. “Budget Monitor: The Governor’s FY 2013 Budget.” [http://www.massbudget.org/report_window.php?loc=budget_monitor_governor_fy13.php]. January 31, 2012.

186 “In Like Me” blog. [<http://www.inlikeme.com/inlikeme-top-16/applications-soar-harvard-mit-duke-yale-brown-dartmouth-princeton-and-stanford-class>].

187 U.S. News. “Top Public Schools.” [<http://colleges.usnews.rankingsandreviews.com/best-colleges/rankings/national-universities/top-public>]. 2012.

188 Martin, Andrew; Lehren, Andrew. “A Generation Hobbled by the Soaring Cost of College.” [<http://www.nytimes.com/2012/05/13/business/student-loans-weighing-down-a-generation-with-heavy-debt.html?pagewanted=all>]. May 12, 2012.

189 Hamilton, Walter. “Student Loan Debt Continues to Rise.” [<http://www.latimes.com/business/money/la-fi-mo-student-debt-rise-20120531,0,543907.story>]. May 31, 2012.

190 Massachusetts CAFR 2011.

{ education }

represent tuition hikes of nearly 20%. Meanwhile, the tuition at private colleges and universities has skyrocketed. At Harvard University, for instance, tuition has climbed from \$28,752 in 2005 to \$36,305 in 2011. Students graduating from college in Massachusetts hold an average debt of \$25,541, just above the national average of \$25,250.¹⁹¹

“Student interest in science and math is on the wane at Massachusetts universities, as is funding for these subjects.”

Science and Math Lagging

Student interest in science and math is on the wane at Massachusetts universities, as is funding for these subjects. Legislators, worried about the long-term implications of these trends, founded the Science, Technology, Engineering, and Mathematics (STEM) initiative. Specifically, the Massachusetts Department of Higher Education maintains a STEM Pipeline Fund, designed to fund grants that increase the number of students participating in STEM fields, the number of STEM-qualified teachers, and education opportunities in STEM fields at the state’s public and private schools.

Many advocates of STEM see science careers as the key to future economic achievement and competition. Still, the program has faced its share of funding cuts. While the initiative hoped to provide \$20 million in grants from 2003 to 2008, only \$5.5 million were actually allocated due to overall budget strains.¹⁹² Keith Connors, the STEM Pipeline Fund Program Manager, says, “It’s been tough. There are a lot of programs out there and there’s an understanding of the need for resources to go in this direction, it’s just at a time when the state can’t afford to steer money into the trust.”¹⁹³

THE FUTURE OF EDUCATION

Massachusetts remains a leader in public education among states, both at the K-12 and university levels. The state’s K-12 students have outstanding levels of achievement on national standardized tests, high graduation rates, and notable matriculation rates to higher education. In the face of a general budget crisis, the state government prioritized education funding and used federal stimulus and bond issuance to prevent mass teacher layoffs in K-12 education and to slow college tuition increases. However, as recent budget proposals indicate, deep cuts are coming, both to K-12 and higher education. State financial support for every level of public education is waning, and how

¹⁹¹ Project on Student Debt. “State by State Data.” [http://projectonstudentdebt.org/state_by_state-data.php]. 2010.

¹⁹² Butler, Brandon. “Stunted Growth For State’s STEM Funding | \$20 million promise for money has never been realized.” [<http://www.wbjournal.com/article/20091221/PRINTEDITION/312219983>]. December 21, 2009.

¹⁹³ Ibid.

{ education }

schools respond and what cuts the state government chooses to make will have a profound effect on education in Massachusetts.

Other problems still persist. At the college level, tuition is rising alongside private student debt, with neither figure showing any signs of abating. In addition, the growing achievement gap between socioeconomic communities across the state is a worrying trend. Students from poor families and recent immigrants are much less likely to graduate high school and seek higher education, leaving a segment of the state population at a huge disadvantage.

Meanwhile, deep budget cuts are slated to take effect in fiscal year 2013. Many argue that the state is endangering one of its greatest resources and the key to its economic competitiveness and long-term growth. A strong system of public education from kindergarten to university has been a proud tradition of Massachusetts for many years. Faced with a growing budget deficit, however, the state needs to reconcile its revenue and expenditures, and leaders have put education on the chopping block. ★

OVERVIEW

Like other state governments, Massachusetts is responsible for funding and maintaining the physical and organizational structures needed to build and maintain roads, bridges, public transportation, cleaning and sanitary facilities, and government offices and buildings, such as courthouses or universities. This work is part of a larger state and national effort to build and maintain infrastructure that can sustain commerce, travel, and livable communities.

In 2011, Massachusetts spent roughly \$6.5 billion on transportation and public works, of which MassDOT (Massachusetts Department of Transportation) spent \$4.2 billion.¹⁹⁴ This figure has been rising in recent years because of efforts to improve infrastructure in the state, an endeavor motivated by alarming deficiencies in the state's roads, bridges and public transportation systems.

A SYSTEM IN NEED OF REPAIR

Nationwide, infrastructure is in a troublesome state of disrepair. A 2011 Urban Land Institute Report found that the United States needed to spend \$2 trillion to rebuild deteriorating infrastructure networks, and bemoaned the fact that America “continues to lag its global competition” on infrastructure quality.¹⁹⁵ The recession has only made matters worse for governments in recent years. Government officials have been forced to make significant cuts to budgets for infrastructure resulting in less safe and reliable roads, bridges, and public transportation.

“A 2011 Urban Land Institute Report found that the United States needed to spend \$2 trillion to rebuild deteriorating infrastructure networks.”

Massachusetts proves no exception to the country's trends in transportation infrastructure. A 2009 national survey by the American Society of Civil Engineers (ASCE) indicated that the state's infrastructure needs are acute when compared to that of other states. Roads, bridges, and public transportation systems are among the main concerns.¹⁹⁶ The ASCE survey concluded that 56% of state bridges were “structurally deficient or functionally obsolete,” compared to 26% of bridges nationwide.¹⁹⁷ It also found that 41% of state roads were in “poor or mediocre condition,” compared to 33% nationwide.¹⁹⁸

194 Commonwealth of Massachusetts. Office of the Comptroller, Martin J. Benison. “Comprehensive Annual Financial Report: For the Fiscal Year Ended June 30, 2011.” [<http://www.mass.gov/osc/docs/reports-audits/cafr/cafr-2011.pdf>]. At 42.

195 Urban Land Institute. “Infrastructure 2011: A Strategic Priority.” By Jonathan D. Miller. [http://www.uli.org/ResearchAndPublications/~/_/media/Documents/ResearchAndPublications/Reports/Infrastructure/Infrastructure2011.ashx]. 2011. At VI-VII.

196 American Society of Civil Engineers. “Report Card for America's Infrastructure: Massachusetts.” [<http://www.infrastructurereportcard.org/state-page/Massachusetts>]. 2009.

197 Ibid.

198 Ibid. See also American Society of Civil Engineers. “2009 Report Card for America's Infrastructure.” (Full Report). [http://www.infrastructurereportcard.org/sites/default/files/RC2009_full_report.pdf]. 2009. At 3-4.

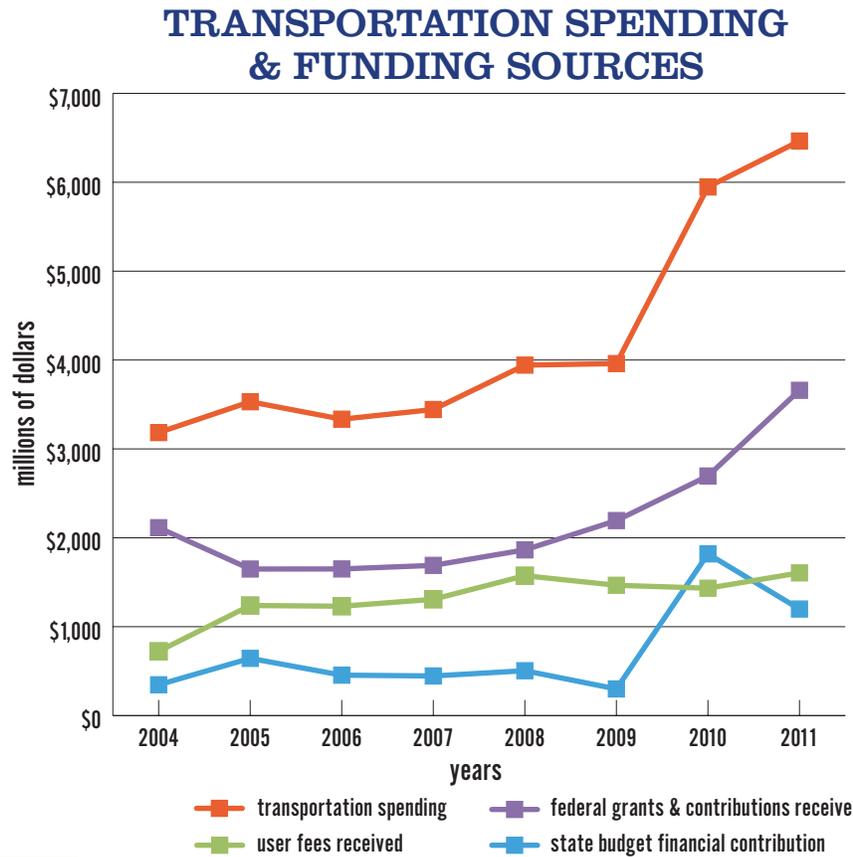


Figure 21

SOURCE: MASSACHUSETTS CAFRS 2004 - 2011, STATEMENTS OF ACTIVITIES

Governor Deval Patrick has taken these concerns seriously and implemented reforms to both improve the deficient transportation infrastructure in Massachusetts and address financing concerns.¹⁹⁹ For example, the Accelerated Bridge Program, created in 2008 by Patrick’s administration to address structural deficiencies, reduced the state’s borrowing costs by \$11 million for infrastructure spending and resulted in the completion of 63 projects by the end of 2011.²⁰⁰ In addition, the program contributed to an 18% decrease in the number of structurally deficient bridges in the state.²⁰¹

Further, the government created MassDOT in 2009, merging the state’s various infrastructure entities into one organization. The reform was intended to save money and improve both customer service and state infrastructure. While it is still too early to comprehensively assess the efficacy of this reform, the initial evidence is positive. MassDOT estimates suggest that the reforms saved

199 See e.g., Massachusetts Executive Office for Administration and Finance. “Massachusetts Awarded the Bond Buyer’s ‘Deal of the Year’ for Accelerated Bridge Program.” [www.mass.gov/anf/press-releases/ma-awarded-deal-of-the-year-for-bridge-program.html]. December 9, 2011. A new dashboard reporting the state’s performance on key transportation metrics, completed by the Pioneer Institute, a conservative think tank in the state, likewise shows significant improvement in the condition of bridges. See Pofatak, Steve. “The Scoreboard: Transportation Spending in Massachusetts.” Boston Daily. [http://blogs.bostonmagazine.com/boston_daily/2012/01/24/transportation-spending-massachusetts]. January 24, 2012.
 200 MassDot. “Accelerated Bridge Program: December 2010 Update.” [http://www.eot.state.ma.us/acceleratedbridges/downloads/ABP_update_1210.pdf].
 201 Ibid at 11.

{ infrastructure }

Massachusetts taxpayers around \$125 million in 2010 and \$150 million in 2011.²⁰² However, while these savings are notable, there is still a long way to go. Former MassDOT CEO Jeff Mullan notes, “Reform is not enough. We know it’s not enough.”²⁰³

FINANCING, INVESTMENT AND FEDERAL SUPPORT

The state spent roughly \$6.5 billion on transportation and public works in 2011. This represents a 103% increase since 2004, driven mostly by the recent efforts to overhaul many state-owned structures and services. The state finances infrastructure through taxes and selling state bonds. Some forms of infrastructure are also financed by grants and loans from the federal government or by road tolls. Much of the state’s spending on transportation does not appear on the regular income statement as it is considered in “component units.”

Massachusetts has increasingly relied on federal money to meet its growing infrastructure needs. In 2009, the federal government passed The American Recovery and Reinvestment Act, which provided over \$16 billion to Massachusetts over two years.²⁰⁴ Of that, \$1.1 billion was given to the state specifically to fund transportation-related projects, including \$374.7 million for the Massachusetts Bay Transit Authority (MBTA), which provides public transportation in the Greater Boston area; \$17.4 million for The Massachusetts Port Authority (Massport); and \$384.5 million for bridge construction.²⁰⁵

“The federal funding for infrastructure came from President Obama’s “shovel-ready” stimulus initiatives, intended to improve state infrastructure as well as provide jobs and needed stimulus for the state’s economy.”

The federal funding for infrastructure came from President Obama’s “shovel-ready” stimulus initiatives, intended to improve state infrastructure as well as provide jobs and needed stimulus for the state’s economy. The concern now is that federal funds will diminish in coming years, leaving the state unable to fund its considerable infrastructure priorities in the long-run.

Criticisms of the stimulus in Massachusetts have largely echoed those in the rest of the country. Many worry that the stimulus may worsen existing fiscal problems by digging the state further into debt (by funding projects in the short-run that require long-term funding and maintenance).

202 McMorro, Paul. “At the T, Reform Gives Way to Revenue.” *Commonwealth Magazine*. [<http://www.commonwealthmagazine.org/Voices/Back-Story/2011/Spring/At-the-T-reform-gives-way-to-revenue.aspx>]. April 29, 2011.

203 Ibid.

204 MBTA. “MBTA Fare and Service Changes: Join the Discussion.” [http://www.mbta.com/uploadedfiles/About_the_T/Fare_Proposals_2012/MC12149%20Fare%20Increase%20Booklet_v7.pdf]. January 2012. At 3.

205 MBTA. “MBTA Fare and Service Changes: Join the Discussion.” [http://www.mbta.com/uploadedfiles/About_the_T/Fare_Proposals_2012/MC12149%20Fare%20Increase%20Booklet_v7.pdf]. January 2012. At 3.

{ infrastructure }

Critics have also noted that because federal stimulus funds tended to go to “shovel-ready” projects, many long-term infrastructure needs still have not been addressed.

Polling shows that citizens have mixed views about the stimulus’ impact on infrastructure in the state. A 2012 MassINC poll of Massachusetts residents found that 48% did not believe the stimulus helped alleviate state infrastructure problems, while about 45% did.²⁰⁶

USER FEES

The state collects user fees for transportation services from citizens in the form of tolls and fares, which help offset state transportation expenses. User fees have remained relatively flat over time, failing to keep up with increasing costs; since 2000, the MBTA’s operating costs have risen by over 33%.²⁰⁷

In 2012, the MBTA and MassDOT sought to remedy the problem of stagnating user fees by increasing fares and changing services. On July 1, 2012, MBTA bus fares increased from \$1.25 to \$1.50, and subway fares rose from \$1.70 to \$2.00. The fare increase is expected to generate \$72.9 million in additional revenue in 2012 – not insignificant compared to the MBTA budget of \$1.6 billion.²⁰⁸

Additionally, the MBTA is rolling back student and senior discounts and eliminating or altering some bus, ferry, subway, and commuter rail routes. This is expected to save the state an additional \$15.4 million in 2012. Overall, the proposal aims to reduce MBTA’s operating deficit from \$185 million to \$159 million in the short term.²⁰⁹

BORROWING

To fund projects the state has relied heavily on borrowing to finance transportation needs. This borrowing burdens the state budget with annual debt service and repayment. The advocacy group Transportation for Massachusetts published a report in 2011 concluding that 45% of the operating revenues of MassDOT and MBTA would go toward debt repayment in 2012.²¹⁰ In other words, the Massachusetts state transportation entities will be using almost half of their revenue streams in the upcoming years to pay off the debt they incurred during years of heavy borrowing. This trend puts upward price pressure on tolls, bus fares, and other transportation fees.

If revenue continues to fall short of debt obligations, the state may find it harder to borrow for future projects, as potential investors become wary of the state’s ability to repay the debt. Perhaps

206 See Sullivan.

207 MBTA. “MBTA Fare and Service Changes: Join the Discussion.” [http://www.mbta.com/uploadedfiles/About_the_T/Fare_Proposals_2012/MC12149%20Fare%20Increase%20Booklet_v7.pdf]. January 2012. At 3.

208 MBTA. “The T Budget.” [<http://www.mbta.com/uploadedfiles/Documents/Financials/SORE%20History%20FY12%20budget.pdf>].

209 Commonwealth Conversations. “MBTA Final Fare, Service Recommendations.” [<http://transportation.blog.state.ma.us/blog/2012/03/mbta-updated-fare-service-recommendation.html>]. March 28, 2012.

210 Transportation for Massachusetts. “Maxed Out: Massachusetts Transportation at a Financing Crossroad.” [<http://www.t4ma.org/sites/default/files/uploads/documents/Maxed%20Out.pdf>]. October 2011. At 3.

more alarming is the notion that excessive infrastructure debt may crowd out other state spending. Legislative requirements prioritize debt repayment over other spending such as education or health care. Municipalities and states default on bonds only as a last resort.²¹¹

Recent estimates from MassDOT show the state needs \$6.17 billion to meet high priority transportation needs for the next five years, more than double the projected available amount.²¹² The needs of the MBTA alone stand at \$3 billion.²¹³ The amount of revenue available in the current fiscally constrained environment is significantly less than these estimates. Simply put, the state does not have the money it needs to make the improvements that many agencies deem necessary – even with the recent injection of federal money.

TROUBLES AT THE MBTA

Although the MBTA is the fifth-largest mass transit system in the U.S. in terms of ridership, insufficient funding is limiting the MBTA's ability to provide services to Massachusetts citizens. In 2009, Governor Deval Patrick commissioned an independent review of the MBTA, and the findings were alarming. The report highlighted large and growing deficits in the MBTA. In other words, user fees and subsidies have consistently fallen short of costs. This gap is growing wider over time largely due to increases in fuel and utility costs and growing payroll and benefit expenditures for MBTA workers.

The report also found that the MBTA infrastructure was disturbingly below par. Using a “State of Good Repair” criterion, which measures the degree to which an MBTA asset (like a bus or train) is overdue for replacement or renewal, the report found that a “large concentration” of MBTA assets were approaching or beyond their useful life. For example, of the 448 heavy rail cars used on the MBTA red, blue, and orange subway lines, nearly half (212) were found to be between 3 and 15 years beyond their useful life of 25 years.

ADDRESSING INEFFICIENCY AND THE PATH TOWARD REFORM

Given the stressors apparent in the various sources of infrastructure financing, it is imperative that the state uses existing funds wisely. Yet, the state has struggled with inefficiencies in infrastructure projects. Projects have gone over budget and lagged behind schedule. A 2011 report from the New England Center for Investigative Reporting spotlighted such problems with road and bridge projects.²¹⁴ One instance cited in the report described a project to relocate Route 44 in Plymouth that went more than \$20 million over budget.

However, some improvements have occurred in recent years. The Pioneer Institute, a state-focused conservative think tank, found that just over 20% of transportation projects were completed on

211 Ibid at 6.

212 Ibid at 5.

213 Moskowitz, Eric. “MBTA Board Approves Fare Hikes, Modest Service Cuts; Dozens Speak Against Plan at Packed Meeting in Boston.” Boston Globe. [<http://www.boston.com/Boston/metrodesk/2012/04/mbta-board-approves-fare-hikes-modest-service-cuts/0WlvZ8ZQUaHQpc4mADTLXM/index.html>]. April 4, 2012.

214 New England Center for Investigative Reporting. “Life in the Slow Lane: Bridge and Highway Repairs are Millions Over Budget while Running Years Behind Schedule.” [<http://necir-bu.org/investigations/life-in-the-slow-lane/>]. August 2011.

{ infrastructure }

budget or below budget in 2008, but that this figure jumped to over 70% in 2010.²¹⁵ The Institute pointed to similar improvements in the timeliness of project completion.

REFORM

Governor Patrick has made a point to prioritize infrastructure development and transportation reform. In March 2012, his administration submitted legislation that included \$200 million in funding for municipalities for infrastructure development. The legislation also included a provision for the establishment of an “infrastructure bank,” which recruits new private investment in addition to public funds to address the state’s infrastructure needs.²¹⁶ Senator John F. Kerry has proposed a similar idea for a national infrastructure bank. Patrick plans to propose a major long-term initiative to strengthen the state’s infrastructure in 2013.²¹⁷

Patrick also proposed legislation in 2006 to allow Massachusetts to leverage funds for infrastructure investment through another public-private initiative. The plan, known as the Infrastructure Investment Incentive Program (“I-Cubed”), includes \$250 million worth of infrastructure development funds to support a variety of economic development projects financed by the Commonwealth, municipalities, and private developers.²¹⁸ One of the innovative aspects of the I-Cubed scheme is that the money designated for infrastructure development is ultimately paid via tax revenues generated from the resulting increase in commercial property and real estate value that the new infrastructure supports.²¹⁹

One I-Cubed partnership led to a \$50 million investment to develop land and transportation accessibility in South Boston, contributing to the establishment of a large new business district. Higher real estate taxes, parking revenues, and improved commerce and sales to the community at large made this investment worthwhile. To ensure the investment and borrowings are covered for all projects under I-Cubed, the criteria for project approval are stringent. One such criterion requires that projected state revenues from a project be 1.5 times greater than the annual debt service.²²⁰ As further insurance, bonds are not only supported by generated revenues, but also secured by public and private escrows.

Regarding MBTA debt, Governor Patrick filed legislation in March 2012 to address the MBTA budgetary shortfall. This legislation included measures such as more severe penalties for fare evasion, a reform to the agency’s tort liability cap that would bring it in line with that of other state agencies (for example, a cap on payouts from the “Slip and Fall” law that allows an injured person

215 See Poftak.

216 Norton, Michael and Matt Murphy. “Gov. Patrick Proposes Infrastructure Bank in \$1.5B Bond Bill.” State House News Service. [<http://www.metrowestdailynews.com/news/x570354400/Gov-Patrick-proposes-infrastructure-bank-in-1-5B-bond-bill>]. March 7, 2012.

217 Ibid.

218 Massachusetts Executive Office for Administration and Finance. “Overview of I-Cubed.” [<http://www.mass.gov/anf/budget-taxes-and-procurement/cap-finance/i-cubed/overview-of-i-cubed.html>].

219 Office of Governor Deval Patrick. “State Issues \$10 Million in I-Cubed Notes for Assembly Square in Somerville, the First Use of This Innovative Economic Development Program.” [<http://www.mass.gov/governor/pressoffice/pressreleases/2010/10m-in-i-cubed-notes-for-assembly-square.html>]. May 4, 2010.

220 “Overview of I-Cubed.” [<http://www.mass.gov/>].

{ infrastructure }

to claim negligence in a property owner's maintenance), and the application of a multimillion dollar surplus in the state's Motor Vehicle Inspection Trust Fund to the MBTA.²²¹ The \$51 million surplus came from one-time revenue charges, accumulated payments, and interest due to the trust fund and will be applied to the MBTA budget shortfall.²²²

NEXT STEPS

Even with these significant reforms, Massachusetts will have to create new efficiencies, increase revenue, and make hard financial decisions regarding its infrastructure budget. With infrastructure still in poor condition, state budgets stretched, and federal funds drying up, the state needs more than incremental reform in the long-run. Because raising new debt to fund infrastructure needs crowds out other state spending and because all debt has its limits, the state will have to come up with additional solutions to deal with its past-due infrastructure needs. ★

221 Weir, Richard. "MA: T Seeks to Cap Injury Lawsuit Awards at \$100G." Mass Transit. [<http://www.masstransitmag.com/news/10689865/ma-t-seeks-to-cap-injury-lawsuit-awards-at-100g>]. April 9, 2012.

222 MassDot. "Patrick-Murray Administration Files Transportation Reform, Budget Legislation." [<http://www.massdot.state.ma.us/transit/main/tabid/1079/ctl/detail/mid/980/itemid/170/Patrick-Murray-Administration-Files-Transportation-Reform--Budget-Legislation.aspx>]. March 29, 2012.

OVERVIEW

As part of their compensation, state workers, ranging from clerks to police officers, receive pensions from the state. State pensions are managed by the Massachusetts State Employees' Retirement System. Massachusetts has approximately 90,000 pension-eligible working employees and 50,000 retirees currently receiving a pension.²²³ The average annual pension benefit paid to retirees is \$26,363. The state of Massachusetts pays out a total of \$1.4 billion in these benefits annually.²²⁴

Massachusetts runs a defined benefit pensions program. The money for these pensions comes from funds that the state government invests in the State Employees' Retirement System. The state provides not only pensions through this system, but also other post-employment benefits to retirees like health care, life insurance, and prescription drug benefits.

NET NORMAL COST DECLINES AS A PERCENTAGE OF TOTAL STATE BUDGET 2001 - 2010

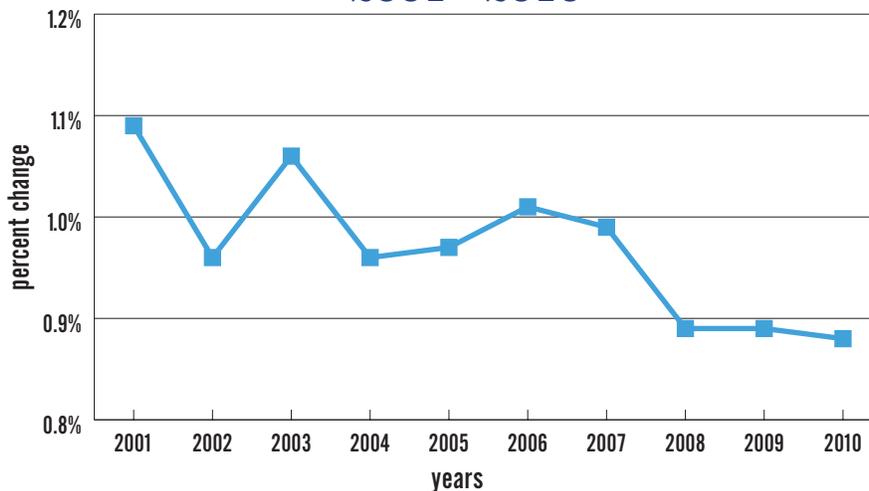


Figure 22

SOURCE: PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION, ANNUAL VALUATION REPORTS 2001-2010

Over the past ten years, the net normal cost (the total cost of pensions paid for by the state each year) of funding the pension fund has persistently been below one percent of the state budget, with a cost of \$287.5 million in 2010.²²⁵ This represents only 0.88% of the total state budget. Over time, the cost to the state has been declining.²²⁶ The relatively low cost of state pension contributions along with rising employee contribution rates obscure a growing unfunded pension liability problem in Massachusetts. This is the central fiscal issue in the state pension system.

223 "State Retirement System: Actuarial Valuation Report." Prepared by the Public Employee Retirement Administration Commission of the Commonwealth of Massachusetts. [<http://www.mass.gov/perac/state/stateval11.pdf>]. January 1, 2011.

224 Ibid.

225 "Demystifying the State Pension System." Massachusetts Budget and Policy Center. [http://www.massbudget.org/report_window.php?loc=Pension_3_11.html]. March 7, 2011.

226 Ibid.

{ pensions }

According to the Treasurer, Massachusetts has \$64.2 billion in pension liabilities and \$45.6 billion in assets, which leaves an unfunded liability of almost \$19 billion as of January 1, 2011.

“According to the Treasurer, Massachusetts has \$64.2 billion in pension liabilities and \$45.6 billion in assets, which leaves an unfunded liability of almost \$19 billion as of January 1, 2011.”

In the past, the state has avoided paying into the pension system by placing more of the funding burden on current employees themselves. As the Massachusetts Budget and Policy Center notes, “As the state’s share of the contribution toward employees’ pension decreased, the employees’ share increased in 2000, the state contributed 40 percent of the total normal cost; by 2010 the state’s contribution had decreased to 23 percent.”²²⁷ Due to past reforms, employees who entered the pension system after June 30, 1996, contribute a sizable portion of their salaries, between 9% and 12%, to their pensions, with little or no state contribution. However, workers who entered the system prior to that date contribute less towards their pensions, with some contributing as little as 5% of their salaries. A report by the Center notes that state workers who started after 1996 fund their pensions almost entirely through their contributions from salary. In short, workers who started earlier are a net cost to the state, but many currently employed state workers and teachers, who are paying into the system at a higher rate, are almost fully funding their own pensions.

UNFUNDED LIABILITIES AND RATES OF RETURN

Since pensions deal with expenses and contributions in the future as well as the past, the state needs to use a set of assumptions (called “actuarial assumptions”) to determine the financial condition of its pension system. These actuarial assumptions include estimates for key pension-relevant variables, such as state retirement ages, expected salary increases, life expectancy, and the state pension fund’s expected long-term rate of return.

A pension fund’s expected long-term rate of return, as an example, is key to its fiscal health and the cost of pensions to the state. If the pension fund selects a very low expected rate of return, the state will have little risk of falling short of its investment targets, but will have to contribute more money from the general fund to pensions. If the pension fund chooses a very high expected rate of return, the cost of pensions to the state will be kept low by the expectation that significant interest will be earned on contributions that are made; however, a high expected rate of return exposes the pension fund to a sizeable risk that it will fall short of investment return assumptions. In the event that earnings fall short of investment assumptions, the state must make up the shortfall from the budget.

²²⁷ Ibid.

{ pensions }

Massachusetts' pension fund uses an assumed long-term rate of return of 8.25%. This is a high assumed rate compared to other states. As such, some analysts argue that Massachusetts could be hiding a large long-term fiscal issue (by assuming money invested now will generate high returns later). State Treasurer Steve Grossman acknowledges the problem, saying "Moving to an 8% number within the year is my hope and expectation. Some people would say perhaps it should be lower, but you take these things in stages."²²⁸ The Public Employee Retirement Administration Commission (PERAC) in Massachusetts, which oversees and monitors the Massachusetts Public Pension Systems, has expressed support for transitioning to a 7.5% rate in the various funds it monitors, and also supports making this transition from the current assumed rates in a "measured way."²²⁹

STATE CONTRIBUTION TOWARD NORMAL COST DECLINES AS EMPLOYEE CONTRIBUTION RISES 2000 - 2010

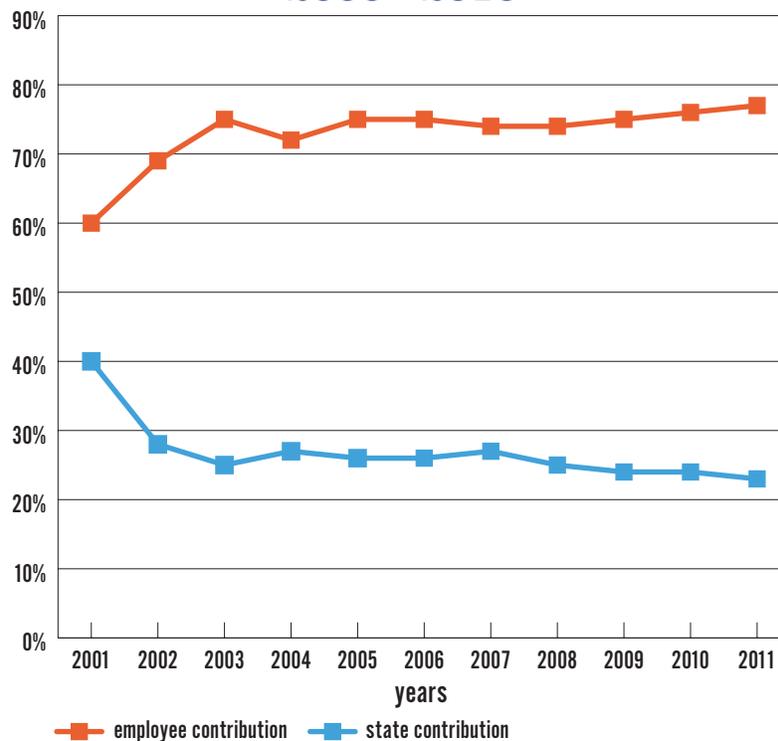


Figure 23

SOURCE: PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION, ANNUAL VALUATION REPORTS 2001-2010

There is substantial debate regarding what constitutes an appropriate long-term rate of return assumption for state pension funds. Supporters of return assumptions above 6% argue that public

228 Syre, Steven. "Lower Investment Bar for Mass. Pension Fund"

[http://articles.boston.com/2012-03-16/business/31197337_1_pension-fund-massachusetts-pension-public-pension] March 2012

229 Public Employee Retirement Administration Commission. Annual Report. 2009. Page 6.

{ pensions }

pension fund investment returns have been high historically, and that the state need not panic in response to a temporary economic dip. A 2009 report from the state Public Employee Retirement Administration Commission noted that in the 25 years leading up to 2009, investment returns in the state Pension Reserves Investment Trust averaged 9.7% per year, nearly 2% higher than the S&P 500.²³⁰

However, others argue that the recent economic crisis suggests that state pension funds need to use lower long-term return assumptions moving forward, in line with private sector pension funds. Massachusetts is one of only eleven states that uses an expected rate of return above 8.0%; California, for instance, uses a more modest expected return rate of 7.75% to calculate its annual pension contributions. And according to a report from BNY Mellon, an asset management firm, the United Kingdom's pension fund had a real rate of return of only 4.2% between 1963 and 2009.²³¹ In an alarming sign for states like Massachusetts that are in pension trouble, the city of Portsmouth in Rhode Island recently decreased its pension fund's expected rate of return from 8% to 6.75%. Other Rhode Island cities — if not the entire state government — are expected to follow suit.²³²

| EFFECT OF DISCOUNT RATE CHANGES ON STATE PENSION CONTRIBUTIONS | |
|---|--|
| DISCOUNT RATE | CONTRIBUTION AS A PERCENT OF STATE BUDGET |
| 5% | 7.6% |
| 8% | 4.6% |

SOURCE: CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

In the private sector, expected rates of return on pension funds are well below the average rate used by state pension funds, and many analysts argue that even funds that have fared well in the past are not guaranteed to achieve strong returns in the tumultuous years ahead for the country's budget.²³³ For instance, Warren Buffet, widely recognized as one of the nation's preeminent investors, only expects to achieve a 6.5% long-term rate of return with his pension fund. Warren Buffet's substantially lower return assumption suggests that it may not be possible to achieve the high rates of return that the pension funds project over the long term, which means that states will be left footing a huge bill when pensions are due and pension fund investment returns have come up short.

When the pension fund falls short of its expected rate of return in a given year, it must make up for the funds in increased contributions from the state. The shortfall, or unfunded liability, caused by losses to the pension fund or failure to meet the investment return assumption is amortized, or split

230 Ibid.

231 "Reference: Retirement fund discount rate." ClearOnMoney. [http://www.clearonmoney.com/dw/doku.php?id=public:retirement_fund_discount_rate].

232 Nesi, Ted. "Portsmouth slices pension fund's investment outlook to 6.75%." [<http://blogs.wpri.com/2012/06/12/portsmouth-slices-pension-funds-investment-outlook-to-6-75/>]. June 12, 2012.

233 "The Intelligent Investor: Are Pension Forecasts Way Too Sunny?" [<http://online.wsj.com/article/SB10001424052970203363504577185440666871560.html>]. January 28, 2012.

{ pensions }

up, over the next twenty years. The twenty-year amortization period combined with a high expected rate of return can obscure serious deficits in the pension fund by delaying a sizeable increase in how much of the budget goes to pensions. Instead, unfunded liability grows dramatically.

According to the Treasurer, Massachusetts has \$64.2 billion in pension liabilities and \$45.6 billion in assets, which leaves an unfunded liability of almost \$19 billion as of January 1, 2011.²³⁴ As a more recent estimate from Harvard University's Kennedy School indicates, unfunded pension liabilities are a growing problem: in April 2011, the Rappaport Institute for Greater Boston put the state's unfunded pension liability at \$23 billion.²³⁵ As pension funding provided by the state government has decreased over the last ten years while the expected rate of return on pension fund investments has remained high, the issue has become more and more serious. Essentially, the greater expected return, the less money that is set aside for the pension fund. With lower returns than expected, the pension fund has developed a sizable unfunded liability.

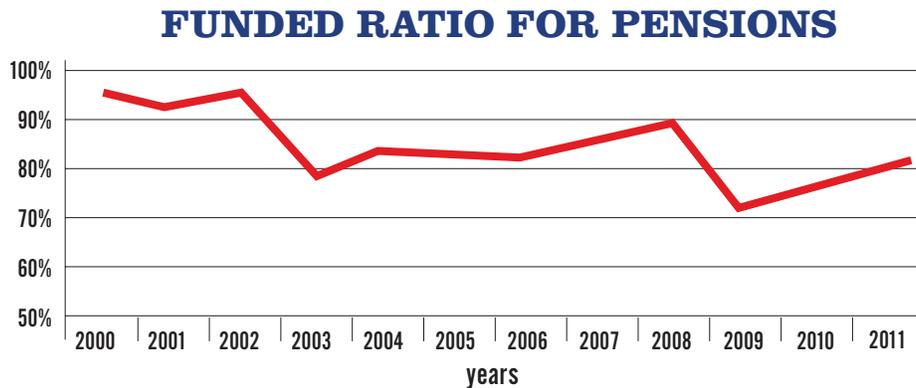


Figure 24

SOURCE: THE COMMONWEALTH ACTUARIAL VALUATION REPORT, JANUARY 1, 2011, PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION COMMONWEALTH OF MASSACHUSETTS, PAGE 5.

FUNDED RATIO

The “funded ratio” is another useful tool for assessing the health of a state’s pension system. This ratio is computed by dividing the actuarial value of assets in the state’s pension plan by the actuarial value of state liabilities in the state’s pension plan. The goal for any state is to have as close to a fully funded pension system, with a 100% funded ratio, as possible. However, most states do not have a fully funded pension system, with a recent Standard and Poor’s study estimating the mean funded ratio amongst U.S. states of around 75%.²³⁶

In Massachusetts, this funded ratio is relatively close to the national average. However, there are many reasons to be concerned about the fiscal health of the state’s pension system. First and

234 “Commonwealth: Actuarial Valuation Report.” Prepared by the Public Employee Retirement Administration Commission of the Commonwealth of Massachusetts. [http://www.mass.gov/perac/valuation/2011commonwealth.pdf]. Page 2. January 1, 2011.

235 Luberoff, David. “Cost of State and Local Pension Underestimated, Finance Expert Says.” Rappaport Institute for Greater Boston. [http://www.hks.harvard.edu/news-events/news/articles/rapp-pensions-joshue-rauh-apr11]. April 13, 2011.

236 Petek, Gabriel. “U.S. States Pension Funded Ratios Drift Downward” [http://www.nctr.org/Annual%20Convention/2011_Presentations/Sugden_USStatesPensionFundedRatiosDriftDownward.pdf] March 2011

{ pensions }

foremost, this ratio is computed using the states expected rate of return, which as mentioned is a relatively high 8.25%. When a more conservative rate of return is used, this funded ratio would fall, as the value of assets in the state's pension fund would have a lower estimated long-term value. Joshua Rauh, an Associate Professor of Finance at Northwestern's Kellogg School of Management, notes that if Massachusetts calculated its pension fund return ratio using the expected return on risk-free investments, such as a blended U.S. Treasury bill interest rate (currently about 3.5%), the unfunded pension liability of the state would more than double to \$55 billion. Even using a slightly lower rate of 7.5%, as some experts suggest, would instantly increase the state's liability by billions.²³⁷

Assuming the state's unfunded pension liability is \$23 billion (Harvard's estimate), that equals approximately 25% of the state's total debt. Covering the state's unfunded pension liability at its current level would require more than \$3,500 from every man, woman, and child in Massachusetts.²³⁸ Furthermore, the general trend in the state's pension funding is downward, with the recent economic crisis a major driver. If the economy improves over time, this funded ratio will increase, but if the economy worsens or remains flat, the state will struggle to keep funded ratios at reasonable levels – particularly if it lowers its expected rate of return as planned.

REFORMS

Because of a number of inefficiencies and the looming problem of unfunded liabilities, the state of Massachusetts recently took up a series of reforms to the pension system.

“In 2011, Governor Deval Patrick signed a pension reform law aimed at reducing pension costs through small adjustments and closing legal loopholes. The move by the governor is expected to save taxpayers over \$5 billion over a 30-year period.”

In 2011, Governor Deval Patrick signed a pension reform law aimed at reducing pension costs through small adjustments and closing legal loopholes. Some of the key measures in this reform include: 1) the elimination of double compensation for elected officials and early retirement subsidies (more commonly called “double dipping,” where an elected official receives a pension while at the same time receiving compensation for an elected position)²³⁹; 2) raising the minimum

237 Luberoff, David. “Cost of State and Local Pension Underestimated, Finance Expert Says.” Rappaport Institute for Greater Boston. [<http://www.hks.harvard.edu/news-events/news/articles/rapp-pensions-joshue-rauh-apr11>]. April 13, 2011.

238 “Massachusetts State Budget.” Sunshine Review. [http://sunshinereview.org/index.php/Massachusetts_state_budget].

239 Chabot, Hillary. “Gov to retire double dipping.” Boston Herald. [http://bostonherald.com/business/general/view/20110119gov_to_retire_double_dipping]. January 19, 2011.

{ pensions }

retirement age; 3) capping the maximum pension a retiree can earn; and 4) establishing new criteria to limit the payment of excessive benefits, like basing pension on average salary over a longer period of time and limiting “spiking” in pensionable earnings.²⁴⁰ The move by the governor is expected to save taxpayers over \$5 billion over a 30-year period. The administration argued that these reforms would “ensure the public employee pension system is fair, credible and fiscally sustainable for future state employees.”

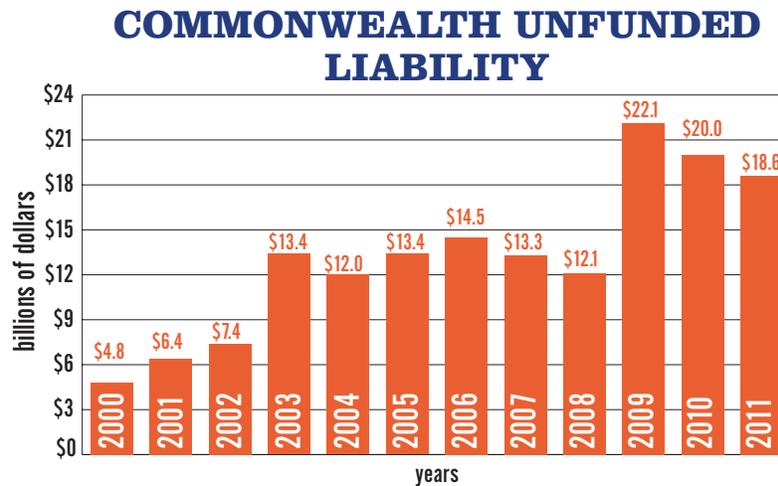


Figure 25

SOURCE: THE COMMONWEALTH ACTUARIAL VALUATION REPORT, JANUARY 1, 2011, PUBLIC EMPLOYEE RETIREMENT ADMINISTRATION COMMISSION COMMONWEALTH OF MASSACHUSETTS, PAGE 5.

Additionally, the legislation includes an increase in pension benefits through a Cost of Living Adjustment (COLA) from \$12,000 to \$13,000. This provision increases the base salary on which retirees receive a cost-of-living increase, thereby taking into account the changes in consumption costs that have occurred since the last round of pension reform and giving a more accurate reflection of the costs incurred during day-to-day purchases as a result of inflation.²⁴¹ While this COLA increase helps retirees receiving pensions, it increases unfunded liability because it increases the amount the pension fund owes all future and current retirees.

Not surprisingly, there was some resistance to the legislation. Unions were upset about what they perceived as a transfer of the burden of the unfunded liability onto employees. Some even argued that the reform would not be as financially successful as predicted. Ed Kelly, president of the Professional Firefighters of Massachusetts, opposed Patrick’s plans to increase the minimum retirement age for firefighters from 55 to 57, saying “If we ask firefighters to serve longer, disability pensions are going to go up.”²⁴² If this were true, the pension reform would not save as much

240 “Governor Patrick Signs Pension Reform Legislation.” [<http://www.mass.gov/governor/pressoffice/pressreleases/2011/111118-pension-reform-signed.html>]. November 18, 2011.

241 Ibid.

242 “Pension reforms spark union firestorm.” Gloucester Times. [<http://www.gloucestertimes.com/local/x1278096738/Pension-reforms-spark-union-firestorm>]. April 12, 2011.

{ pensions }

money as predicted, since the state also pays disability pensions. Proponents argued that while this analysis may hold for certain state jobs that entail a high degree of physical stress, increasing the retirement age for state workers overall will provide a net savings to the state.

Governor Patrick argued that the legislation was an important, if painful, first step in addressing the long-term liability of the pension system and ensuring that the system survives to meet its obligations to current and future retirees. Specifically, Patrick pointed to the unfunded liability problem, singling out a “series of loopholes and avoided decisions” which have burdened the state with a pension dilemma. He went on to say, “I support the defined benefit program, but without these reforms that program is not sustainable.”²⁴³

TYPES OF PENSION PLANS

There are two major types of pension benefits: defined benefit (which entitles retirees to a monthly payment of a certain value from their former employer) and defined contribution (which involves employees and employers making set payments into a retirement fund, which the employee receives access to upon retirement). With both defined benefit pension plans and retiree healthcare, the state government can decide to either “prefund” its obligations or “pay as it goes.” Prefunding involves the state putting money aside in advance to pay for retiree benefits, which is subsequently invested. When the employees retire and the benefits come due, the state can pay for the benefits with a combination of money from the general fund and investment returns. If a state chooses to “pay as it goes,” retirement benefits are paid out of the general fund, without investment returns to defray the cost.

While these pension reforms are a noteworthy first step, it is very likely that more painful work will need to be done to bring the Massachusetts pension system to long-term sustainability. Because the funding ratio of Massachusetts’s pension fund shows no signs of dramatically improving, eventually the unfunded liability will require further action, especially given the slow growth following the 2008 recession. Massachusetts’ relatively high expected rate of return will likely be a target for future attempts at pension reform, and rightly so. But amending this assumption will not actually solve the problem — it will simply reveal the true extent of the problems that lawmakers have been avoiding. Indeed, a lower return assumption would actually decrease the funded ratio and increase the total unfunded pension liability, necessitating further reform.²⁴⁴ Ultimately, the state needs a fundamental change in the pension system payouts or structure to achieve financial stability. ★

²⁴³ Ibid.

²⁴⁴ Luberoff, David. “Cost of State and Local Pension Underestimated, Finance Expert Says.” Rappaport Institute for Greater Boston. [<http://www.hks.harvard.edu/news-events/news/articles/rapp-pensions-joshue-rauh-apr11>]. April 13, 2011.

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