the GOOD

the BAD

and

the UGLY

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House 1: Spending More Money We Don't Have

The governor's budget rolled in last week – an unwarranted spending binge marketed a week earlier as healthy "investment" and fresh "tax reform."

One has to hand it to the governor's belief in his own salesmanship that he started off his campaign by keeping new taxes on the front page of our major newspapers three days in a row. It certainly does seem like someone's food truck is headed for the 2016 Democratic cook-off. The plan's spicy highlight is the governor's suggestion to set aside all revenue from a lowered 4.5 percent sales tax to fund infrastructure. This welcome change is more than outweighed by heaping sides of tax hikes and meritless spending. The need to continue drawing down from the rainy-day fund, even in a year of (estimated) 3.9% tax revenue growth, is troubling. What's worse are the governor's long-term plan to increase state spending 6 percent a year through 2017 and to finance pet projects (good thing they are pet projects because they will have very few human riders) with another $1.9 billion of taxpayers' money annually.

In a responsible proposal, any additional revenue must be dedicated to needed maintenance and repair and bringing down the state's outstanding debt, not to digging budget holes for decades to come. Instead of addressing a multitude of pre-existing fiscal challenges, the governor's scheme would explode spending over the next 10 years, without even taking into account the long-term operating, maintenance and debt-service costs of the low-return infrastructure projects he has thrown into the mix.

After six economically challenging years, the governor seems to have lost his appetite for the hard work of fiscal responsibility. In many areas, next year's spending is held level or increased at a uniform rate. There is no deep-reaching effort to address the core causes of the state's structural deficit – healthcare and the cost of public employees' retirement benefits. There is no serious attempt to replenish the rainy-day fund. No squeezing efficiencies from departments and agencies. No paying down or refinancing the state's and the MBTA's debt. Yes, you are reading Pioneer's annual "The Good, the Bad and the Ugly" review of the governor's budget proposal.

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PIONEER INSTITUTE
PUBLIC POLICY RESEARCH

THE GOOD

Launching the Duals Pilot. – Starting in July 1, 2013, a pilot will commence to serve better those on both Medicare and Medicaid. These elderly and low-income patients currently receive some of the most disjointed and uncoordinated care because they straddle two different public programs. By combining the two funding streams together and hiring organizations dedicated to coordinating their interactions with the healthcare system, care is sure to improve and costs to be reduced from the $24,000 per enrollee average. This idea received the 2012 *Better Government Competition* award. However, early implementation should expand to include more innovative delivery systems beyond the five that have been selected so far.

Going after Waste and Fraud in Medicaid. – Some $1.5 million are slated for program integrity at MassHealth. However, as documented by the state auditor last year, the current initiative does not go far enough and there is much more work to be done. The auditor found (a) more than 6,000 members receiving benefits elsewhere and (b) 16,000 individuals using foreign passports or temporary visas to access benefits, which suggests they are not US residents, let alone residents of Massachusetts.

A More Rational Tax System. – In a move that will prove distasteful to many and will face a hard slog on Beacon Hill, the administration proposes the elimination of a long list of income tax exemptions, as well as some corporate and sales tax exemptions. If revenue-neutral (and not, cough, cough, a pretext to raise taxes), a number of these special exemptions should be eliminated. Whatever portion of the projected $1.33 billion is realized from their elimination should be offset by lowering the income tax to the promised level of 5 percent, lowering the sales tax, and/or raising the individual exemption. For the most part, a simpler tax code is a better tax code. Instead of keeping up the cottage industries that have cropped up around exploiting tax loopholes, the legislature should add more special exemptions to the list of those slated to go. For example, the bill puts a ceiling on the film credit expenditure at $40 million a year. Nice try, governor! Over a three-year period (to allow for planning), we should abolish the film tax credits completely. Though we at Pioneer hold David Bowie in esteem, must we really keep the special exemption for survival annuities of fallen astronauts on the books?

A simpler tax code is a better tax code. Whatever savings are realized from pruning back special exemptions to the income tax, should go to keeping the promise of lowering it back to 5 percent, raising the individual exemption level, and lowering the sales tax.

SOUND GOOD, BUT NEED MORE WORK

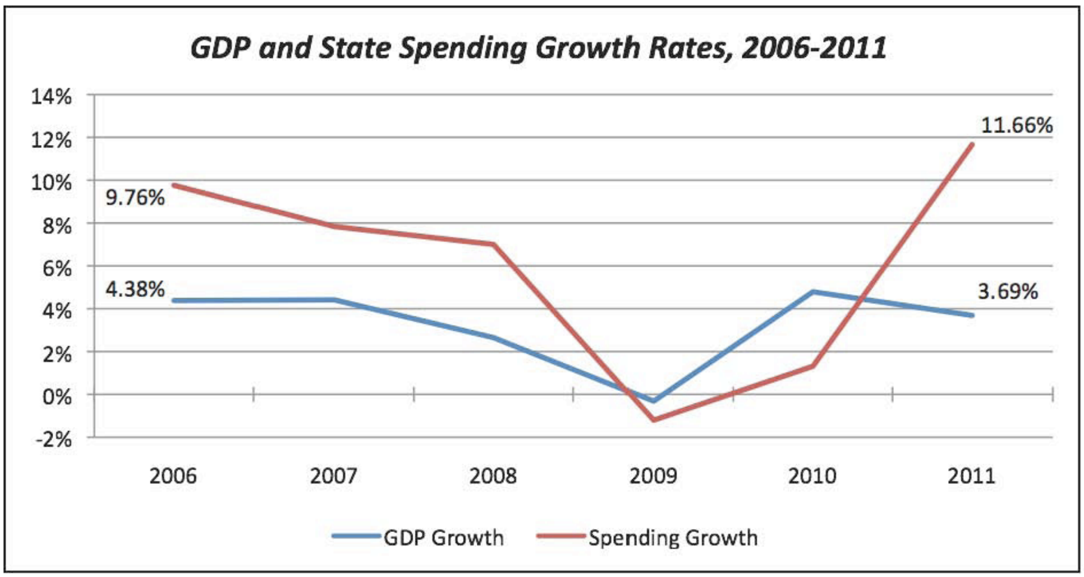
More Accountability for Localities. – The bill introduces a new formula for local aid that will supposedly allocate a quarter of the annual state funding to an incentive program beginning in 2015. This is to reward strong fiscal management, municipal healthcare cost containment and local government performance management. The rules on that program will be written by the A&F secretary. Until the administration does so, the jury will be out on whether accountability is finally coming for municipal subsides. There is real potential here as Pioneer has underscored in *Rehabbing Urban Redevelopment* (2006) and *Driving the New Urban Agenda* (2009).

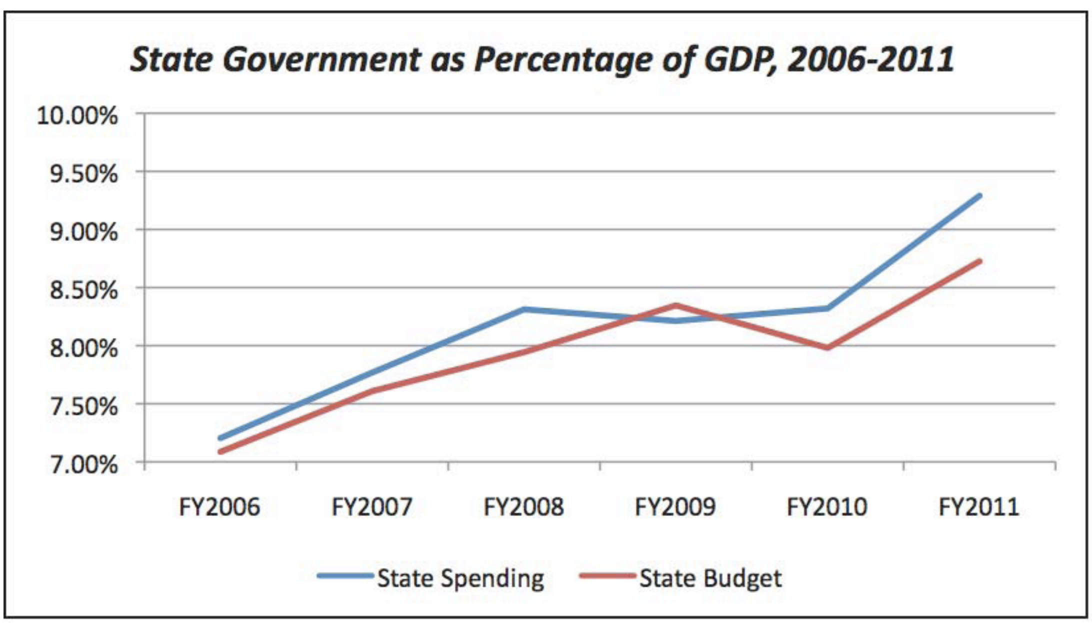
Retiree Health Reform. – Reconfiguring the generosity and structure of such benefits is necessary as the unfunded liability currently stands at $40 billion. The Governor made headlines outlining some broad ideas on this front, but no legislation has been filed yet. Based upon the minimal details that have been discussed so far, Pioneer believes that a more aggressive timeline for reform implementation and broader consumer engagement through plan design could yield even greater savings.

Rather Than Indexing the Gas Tax to Inflation, a One-Time Increase is Needed. – Given several reforms recently undertaken and the immediate need to support the next phase of infrastructure maintenance and repair, a gas tax increase of 6 cents is justified together with several other actions outlined in our Public Statement released before the governor's State of the Commonwealth. We do not support any funding for the interminable laundry list of (politically) "strategic" investments, revenue enhancements, things we *must* do together and money that's taken out of our pockets that the Governor shared on January 23. We recognize that only $500 million in savings from transportation reforms have actually been demonstrated (not the $6.5 billion promised!), but who's quibbling! We believe a gas tax still generated significant revenue, it serves as a strong incentive to purchase fuel efficient cars, and it approximates a user fee. All that said, clear conditions have to be put into place for any new gas tax revenue: (1) all the money has to go to maintenance and repair; (2) hard choices have to be made by the governor and the legislature to move the hundreds of people currently paid out of the bond capital accounts to the operating budget; and (3) MassDOT must fulfill the transparency directives in the 2009 Transportation Reform Act (it is the only way to build public trust for later needed funding for our infrastructure).

The Bad

Spend Like It's the End of the World. – The Mayan apocalypse is past us, so the governor wants to celebrate with a piñata of "investments" stuffed with $1.9 billion in new taxes. He wants to increase expenditures from $32.6 billion this year to $34.8 billion on projected revenue of $34.6

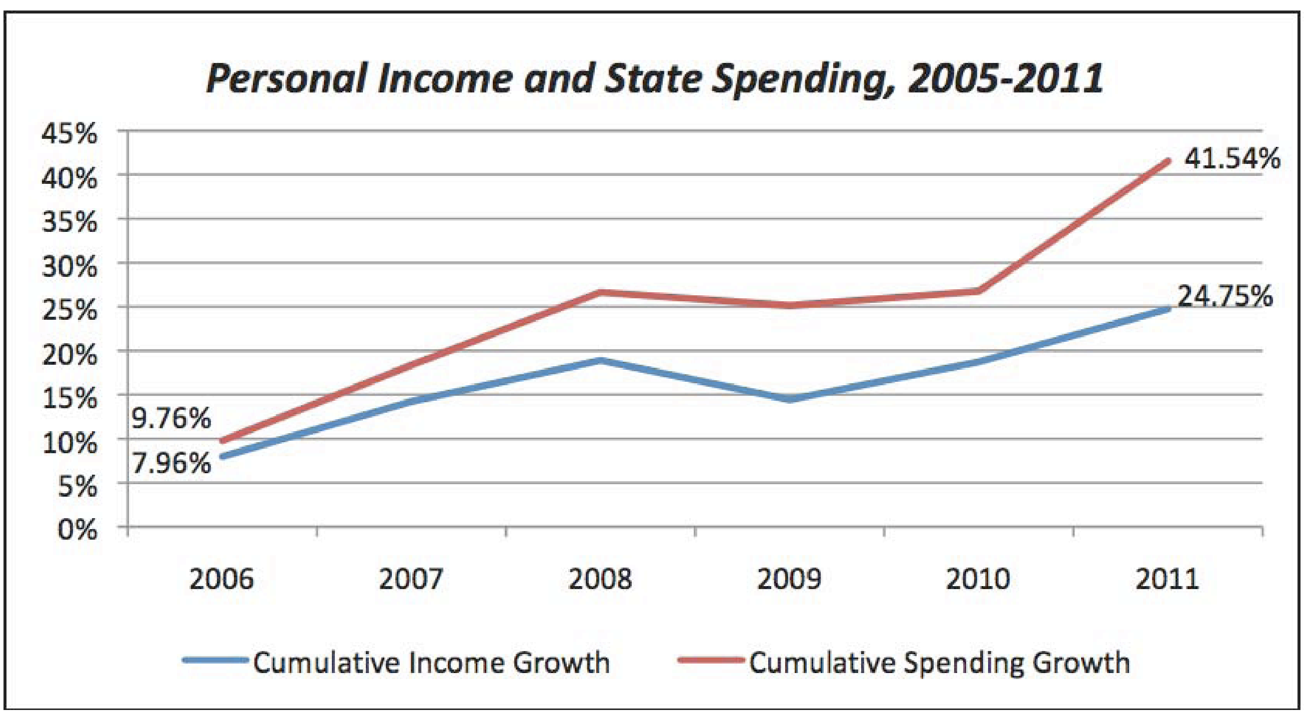




billion, compared with $31.9 billion budgeted in FY 2013. Without a proper strategy and assessment of alternatives, he promises to dedicate much of these funds to new transportation infrastructure in addition to the MBTA, MSTA and “other” priorities. Meanwhile, the T cannot even meet its current operating, maintenance and debt service needs, causing service to go from bad to worse. Adding insult to injury, the governor tops off the tax hikes by calling for recurrent fare increases.

Until Debt Do Us Tax. – The spending binge is to be funded – in part – with an increase of the state income tax rate from 5.25 to 6.25 percent, which alone must add $2.5 billion of revenue according to the administration. They project overall annual revenue increases of 6 percent (!) even as they expect the state’s economy to grow at 3-4 percent (!!) through FY 2017. These unreasonable assumptions mean more debt and taxes will be needed down the line to cover Mount Expenditure. But even in the unlikely event that the revenue projections turn out to be accurate, the ever-increasing share of the state government in commonwealth GDP will continue to… well, increase.

No Water Left in the Well. – Since 2005, the size of the state budget has grown from under $24 billion to under $33 billion, a 42 percent increase, even as there is so much more federal money flowing into state programs. During that same period, personal income in Massachusetts has grown under 25 percent.[1] Given the loss by members of the General Court of 1.8 percent of their salary, perhaps they will consider the negative impact of tax increases on economic activity – and income. This next graph understates the divergence in residents’ earning growth and state spending, as there have been a number of public accounts taken off-budget since 2005.



1. Note that fiscal years start in the middle of the previous calendar year.

More Education Money without an Evidence-Based Strategy. – The governor's "investment" agenda allocates $220 million more for Chapter 70. The bill also sets up a separate Education Innovation Trust Fund to be managed by the education secretary. Hmm. But what about some specifics?

- ***There is no solid reform proposal.*** – The $20 million for older industrialized cities might be great if we knew what it was for. If it is for "innovation" schools (which keep most work rules in place and have no empirical record of improving student achievement), that's a bad investment. Providing more money for assumed costs associated with out-of-district special education students might also be useful, but again it would require hard thinking about a program that is proving very difficult for local districts. We have no idea what reforms might or, more likely, might not be proposed here. Finally, if performance determines what will be funded, the Extended Learning Time program should not be receiving more money. Five years running, reports from Abt Associates in Cambridge have shown little to no overall benefit to student achievement coming from the program. Compare that to charter schools in the Bay State, 80 percent of which do better than their district peers.
- ***A stagnant student population and rising education expenses make this a difficult time to increase the budget.*** – Student population had been going down for years, and this year's enrollment increase is small. Even with recent declines, the Massachusetts state budget for education has grown by 20-plus percent since 2007 (already over a billion dollars), even as local taxes have gone up and the income of parents has grown at a much slower rate. Parents want more money left in their own pockets for books, computers, school trips, remediation and tutoring, and college tuition. They are also keenly aware that in Massachusetts the average teacher salary (not including the rich benefits) has climbed far faster than residents' average pay.

Pioneer has in the past supported new spending for education, when based on a clearly thought-out program such as the Commonwealth's landmark Education Reform Act of 1993, as well as additional borrowing by Governor Patrick to advance the Accelerated Bridge Program.

Education is a worthy investment, when the money is spent wisely. The governor's budget would have been on more solid footing if he had tied money to:

- fully funding and expanding METCO and interdistrict choice; currently only Boston and Springfield benefit from this program.
- further expansion of Commonwealth Public Charter Schools, the only consistent, proven way to close achievement gaps in Massachusetts. Expanding charters in our lowest performing cities is a no-brainer for the state budgeters given that the Commonwealth provides the majority share of funding for education in those districts.
- incentives for urban districts to grant autonomy to existing vocational-technical schools. Autonomous regional vocational technical schools have shown dramatic improvements in student achievement and this year boast dropout rates below 4 percent, notwithstanding their serving a far higher percentage of special needs students than the statewide average.
- implementation of the U.S. History MCAS test. Commissioner Chester has repeatedly cited the $2.4 million cost of administering the tests as the reason for the administration's 2009 postponement of the U.S. history MCAS, which was slated to be a graduation requirement for the class of 2012. A recent poll of state legislators shows that 68 percent of those surveyed said the test should be funded and implemented.

And Now for Something Completely Different. – The number of government employees is projected to remain virtually unchanged. We need to do better than that if we are to have a government that is affordable for Massachusetts residents. In 2010, there were 5,000 more FTEs in state government than in 2004. Since then, we have added employees, including those associated with new 2012 healthcare law and other initiatives. The administration should seek to use attrition over several years to bring the state's headcount to appropriate levels justified by actual needs.

Passing Up on Debt Refinancing. – Debt appropriations are on a steady path to infinity. Plus, the budget sets aside $125 million for advisory services on it. If the governor wants to demonstrate skilful fiscal management, he should wall off specific tax receipts for debt repayment and initiate a review of the state's debt structure. Record-low borrowing rates will not last forever. If there were a good time to refinance the debt, it would be now. One particularly attractive option is to issue long-term annuities instead of standard bonds. This would not only extend the duration of the debt, making it more vulnerable to inflation, but also provide for more fiscal discipline and stability, as the principal is paid out over the lifetime of the annuity rather than as a lump sum at maturity.

Creating State Dependency on the Federal Government. – Healthcare spending in Massachusetts is increasingly becoming dependent on federal dollars. This might be good news for state budget writers, but taxpayers have to raise questions about sustainability given the fiscal climate in Washington and worry about increasing tax liabilities as they pay both state and federal taxes. For example, the Medicaid program currently encourages low-income workers to take offers of employment-based insurance and provides an employer-side subsidy to incentivize that behavior to capture any employer contribution. Under the ACA, MassHealth is planning to discontinue that program. The result will be less private dollars spent on health insurance and more tax dollars subsidizing the Connector or more full enrollees in Medicaid.

Pit 224. – Thus begins spending to implement several unwise sections of Chapter 224, which suffers from a number of foundational flaws that could end up costing consumers more, not less. Pioneer has blogged in detail about the new laws. Here are a few examples for those with short-term memory loss:

- ***A 13% increase in the MassHealth budget.*** – Following ACA implementation, 1.6 million residents or 25% of the state's population will be on Medicaid. Currently, Medicaid is roughly 40% of the total state budget. The budget included additional spending for staff at MassHealth for enrollment to the tune of $2 million.
- ***$158 million in new hospital payments that are a mix of political handouts, bailouts, and quixotic attempts at system-wide reform.*** – For example, $58 million in additional base hospital rates for those that have "significant" use of alternative payment methodologies. The state will determine what significant means. Research by the Attorney General has documented that alternative payment methodologies rarely result in savings or better care.
- ***New ways to renege on the promise of the 2006 Health Care Law.*** – In this case, it's $105 million for "Delivery System Transformation Initiatives." This program offers incentive payments to safety net hospitals throughout the Commonwealth to move them away from fee-for-service payment contracts. This payment, along with another $105 million next year, can be added to a long list of hundreds of millions in fund transfers under different auspices to the safety net hospitals, even though the 2006 reform was based on the assumption that they would need less public money since more individuals would have insurance coverage.
- ***$1.61 million for Health Resource Planning.*** – The state will determine what is an "appropriate" level for health care services, providers, programs and facilities in the state and then tie it to an overly bureaucratic process to control the supply of medical services called Determination of Need, which will gobble up $502,000. It will require multiple state agencies to approve any proposed change in healthcare facilities or change in services. Research has shown that states that drop a similar process have lower costs per patient and equal if not better outcomes, including fewer deaths.[1]
- ***Unrealistic savings estimates at the Group Insurance Commission.*** – If the GIC is able to obtain the very ambitious future savings of

1. Ho and Ku-Goto, Medical Care Research and Review, 2012.

$1.29 billion over the next 4 years for local and state workers, it will likely come at the expense of cost-shifting onto commercial payers.

- ***$2.8 million more for the Center for Health Information and Analysis (CHIA) for new Chapter 224 responsibilities.*** **–** This is on top of a recently filed supplemental budget request $3 million for Chapter 224 implementation.

Is Platinum- or Gold-Plated Care Sustainable? – So this time it's only $118.5 million. Under the ACA, the state could have readjusted the generosity of its subsidized plans on the Connector to a more modest level, in line with national averages. Instead, the Governor is proposing to "wrap" the plans to maintain them as more expensive, so they can keep their platinum or gold rating.

The Ugly

Passing the Buck on MassHealth and the Health Safety Net. – The budget relies on some questionable $316 million in MassHealth cash-management savings, which started as a temporary practice a couple of years ago. Delaying the timing of payments is a bet that could backfire on the state if health claims are higher than expected in FY 2014. The administration is also making unreasonable assumptions about a decline in the demand on the Health Safety Net in FY 2014. The state has underfunded this program for years and hospitals have passed the cost on to commercial insurance plans, driving up other enrollees' premiums.

Double Dipping into the Punch Bowl. – The budget authorizes some $450 million in advance spending against future revenues to fund the governor's infrastructure agenda. Buried deep in the outside sections of the bill are a number of other brown gems that further highlight the administration's idea of prudent fiscal management. Section 26 authorizes $400 million in transfers from the stabilization fund for FY 2014 spending, while Section 20 reauthorizes the A&F secretary to sweep the budget leftovers from various government trusts and bodies. The state government has been dipping into the agency piggybank for each of the past three years and remains faithful to this new tradition. If various entities routinely return cash to the general fund, they should be audited and their tax disbursements reduced instead of seeking more revenue.

Tax Reform or Shooting in the Dark? – The governor's tax proposal has many merits, including a lower sales levy – at face value, a move which would provide much-needed tax relief to residents and lead to a less regressive tax system. But on further scrutiny, this looks ever less like courageous tax reform and ever more like a pretext to paper over long-term policy challenges with more money. One's excitement is quickly tempered by the following three points. First, the administration's own estimates show that the governor's "reform" in its totality will effectively increase the tax bills of at least 50% of households. Second, the sales-tax cut feels like another bit of math jujitsu. That is, put into a longer-term context (the five-percent rate from the olden days of 2008), the reduction amounts to only half a percentage point. And, third, just how odd (and confusing to both business and consumers) is it to raise the sales tax and then lower it in the matter of just a few years – only to seek more revenue by other means? The incessant fiddling with the tax code yet again serves to underscore the dearth of vision and of coherent strategy in the governor's office and on Beacon Hill.

Gutting Health Savings Accounts (HSA). - HSAs are a proven tool to save money in health care. Buried in an outside section of the budget, the Governor proposes to eliminate the deduction for Health Savings Accounts for the purposes of state taxes. Individuals would no longer be allowed to deduct contributions to an HSA. In 2012, the maximum deduction was $3,100 for an individual and $6,250 for a family. While Massachusetts has lagged all other New England states in adoption rates of HSAs, they are a powerful consumer tool to contain health care costs. A recent national estimate put the immediate savings of a switch to 50% HSAs at $57 Billion. This change would impact 10,000 filers to the tune of $15 million. Massachusetts should be encouraging greater adoption of HSAs, not pulling the rug out from under them.