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Fiscal Issues in an Election Year: A Look at the Massachusetts Record

by

Joseph R. Barresi, Senior Fellow

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August 1994

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The McCormack Institute

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EXECUTIVE SUMMARY

Massachusetts is finally achieving short-term fiscal stability, but it has not yet reached its goal of structural fiscal balance as measured by Generally Accepted Accounting Principles (GAAP).

Continuing difficulties in achieving structural fiscal balance are demonstrated by the following results, among others:

a) End-of-year fund balances on a GAAP basis are still negative although the deficit margin has been shrinking.

b) When the books are finally closed, FY94 may at best show a marginal operating gain.

c) The state's principal budgetary fund, its General Fund, has been and is still in chronic deficit.

d) Operating budget margins have been perilously slim over the past three years because all of the improvement in tax collections have been used for additional spending.

e) Massachusetts has accumulated a steadily-growing, built-in budget crunch due to heavy, long-term fiscal commitments such as education reform which will consume about 75 percent of total tax revenue growth and dominate budgetary decision-making during every fiscal year until the year 2000.

The following are other major conclusions of the report:

a) The state's efforts to strengthen its financial planning and management capacity and to provide the public with a comprehensive, accurate and clear-cut picture of state finances are being stymied by unstemmed proliferation in the number of budgeted and non-budgeted funds, by the growing trend toward approving dedicated revenue streams for politically popular programs, by appropriation splitting among funds, and by end-of-year interfund transfers.

b) Sizeable annual surpluses in the Highway Fund, the Local Aid Fund and such politically-sensitive funds as the Health Protection (anti-smoking) Fund have become political "smoking guns."

c) The FY95 budget approved by the Legislature and Governor reflects a delicate balance of fiscal reality, driven by prudent assumptions on revenue growth and election-year initiatives, with the hot-button issue of welfare reform only temporarily resolved by the budget and to be further debated during the election campaign, and the graduated income tax amendment of the state Constitution and the collateral graduated tax bracket statute left to popular referendum for ultimate decision.

d) Concerted and continuing efforts to control the costs of the state's budget busters have paid off and, on balance, this cost-reduction campaign has proved successful. However, there is growing concern that corrections, water/sewer rate relief and welfare reform could easily shift from incipient to full-fledged budget buster status in view of their actual and/or potential escalating costs.

e) Since the low point of $2,330.7 million in FY92, the Commonwealth has increased its total distribution of direct local aid by $600 million, an improvement of 27 percent during the 3-year period, but in FY95 still $40 million below the FY89 total.

f) Local aid policy shifted dramatically effective in FY94 with enactment of the educational reform act from a general revenue sharing model to a targeted local aid model that requires two-thirds of direct local aid to be earmarked for educational purposes.

g) There has been a gradual increase in the total amount of lottery profits redistributed to cities and towns, from a cap of $306 million in FY89 to $391.6 million for FY95, and by the year 2000, municipalities will be entitled to all of the lottery profits as the law originally intended.

h) Cities and towns are still paying about $20 million a year as their share of all county expense, most of which is for county corrections, and the goal should be to fully integrate county corrections into the state's correctional system; this is an appropriate time to shift the correctional cost residual to the Commonwealth.

i) A long-term concern for cities and towns is whether they can comply with the foundation budget requirements of the educational reform act, which establishes a minimum level of spending for schools, without adversely affecting local resource needs for public safety, public works, and other non-school responsibilities.

j) Although public disclosure of agreed-upon budget revenue estimates through joint resolution of executive and legislative branch representatives has led to more careful and more conservative revenue forecasts, the Commonwealth failed to realize its <u>revised</u> tax revenue estimates in each of the past two years -- by $12 million for FY93 and by an estimated $90 million for FY94.

k) The Legislature made small scale changes in the Commonwealth's tax system, thereby adding slightly to the progressivity of a system already considered moderately progressive by the state's Department of Revenue.

l) Extension of the 3 percent investment tax credit to leased equipment as well as purchased equipment for certain businesses will do little to improve economic competitiveness since most industrial states have granted similar tax breaks.

m) According to a reputable economist who chaired the recent Special Commission on Business Tax Policy in 1993 and served as Executive Director of the 1986-87 Special Commission on Tax Reform, Massachusetts should feel fairly comfortable when business tax burdens are measured against the long-run rate of return on business investment.

n) The current income tax burden of high-income residents is the most single ignored aspect of relative tax competitiveness in Massachusetts.

Some of the report's major recommendations follow below:

a) Massachusetts should amend the state finance law to change the current budget process from the so-called statutory basis to one that is conducted in accordance with Generally Accepted Accounting Principles (GAAP), thereby identifying important financial trends in a more accurate and timely manner while creating confidence in the credit markets that the Commonwealth's accounts are structurally balanced.

b) There should be a phased-in program to eliminate the MBTA's GAAP liability by forward funding the T through a five-year loan. It is recommended that the loan be issued in 1997 when debt incurred for FY90 and prior year operating deficits will be paid off; the loan's interest cost should approximate that of current short-term loans being paid by the Commonwealth and MBTA to finance the T's operating deficit; in gradually eliminating this major unfavorable effect on fund balance, this step will ensure that state accounts are balanced on a GAAP basis.

c) The Commonwealth should create a more substantial hedge against future economic downturn by bringing its stabilization fund and unrestricted reserves to the nationally-recognized standard of 5 percent of total reserves.

d) A moratorium should be declared against creating new funds, followed by a reduction in the present number of such funds; moreover, the practices of authorizing dedicated revenue streams, appropriation-splitting, and end-of-year transfers should be discontinued.

e) The Commonwealth should act to ensure that the gradually-increasing cost of corrections, water and sewer rate relief, and welfare reform when it comes, do not become the new budget busters of the nineties.

f) The Commonwealth should establish a stabilization fund for local government similar to the state's own stabilization fund and annually transfer a specific percentage of surplus to it in order to protect cities and towns from reduced state aid and lowered real estate values due to economic downturns.

g) The Commonwealth should change the formula for distributing lottery proceeds from one based on population and equalized valuations to one that recognizes community expenditure needs and fiscal capacity to support such needs; the change to the formula now in use for resolution aid should be easier to implement over the next five years when communities will be receiving larger amounts of lottery proceeds.

h) The Commonwealth should move to improve its tax competitiveness by addressing the relatively high state income tax burden on professionals, managers, technical personnel, etc., which remains as the single most ignored aspect of this state's tax competitiveness.

INTRODUCTION

This in-depth analysis of Massachusetts finances, the McCormack Institute's fifth in a series, continues to measure the Commonwealth's fiscal health against a generally accepted list of performance indicators. As in prior reports, it evaluates the state's operating budget results and end-of-year fund balances on both a statutory and GAAP basis, it identifies the major sources of GAAP that impede achieving structural fiscal balance, and measures the extent to which state officials have exercised budgetary discipline. The analysis also updates progress in gaining control of perennial budget busters, and examines the short- and long-term implications of politically-sensitive budgetary initiatives -- state-local fiscal relations, educational reform, prevention-oriented programs and higher education tuition retention.

What makes this edition of Massachusetts finances different from prior reports, however, is its emphasis on the political context of fiscal policy. In a gubernatorial election year, the political content of the Governor's budget, with its focus on such hot-button issues as welfare reform and tax policy, and the expected alternative response of the opposition political party dominating the Legislature to these same issues mean that the McCormack Institute's independent analysis of the state's financial condition must devote appropriate attention to the short- and long-term fiscal implications of such policy issues. If the questions raised, conclusions arrived at, and recommendations proposed become useful grist for the impending public debate about the Commonwealth's fiscal condition, financial progress and unresolved policy issues, the time and effort that have gone into this project will have proved productive.

I. FISCAL PERFORMANCE, FY1992-94

The Good News: Short-Term Fiscal Stability

The numbers and trends clearly indicate that the Commonwealth is finally realizing short-term fiscal stability. Since the low point of the 1991 fiscal year, when the state had to use almost $1.4 billion in borrowed funds (equivalent to 10 percent of its operating revenues) to finance prior year deficits and its credit rating plummeted, the financial results have been encouraging, as documented below:

1. In each of the last two completed fiscal years (FY92 and FY93) for which final audited figures are available, as shown in Tables 1 and 2, the state's budgeted operating funds were balanced, whether measured according to the Commonwealth's finance laws (its statutory basis where current year expenditures are measured against current year revenues exclusive of beginning fund balances) and according to Generally Accepted Accounting Principles (GAAP).

2. In both FY92 and FY93, end-of-year fund balances, a critical measure of short-term fiscal health, exceeded $500 million on the statutory basis, a far more substantial safety net than in earlier years. Moreover, there has been a dramatic downward trend in the size of the state's end-of-year fund deficit on the GAAP basis, which has fallen from the record-high $1.9 billion in FY90 to a new low of $184 million at the close of FY93. This is the best performance since the beginning of GAAP reporting by the State Comptroller in FY86.

3. Unrestricted reserves in the Commonwealth's "rainy-day" stabilization fund and in undesignated balances available for future appropriation, its budgetary surplus cushion, have climbed to more acceptable levels, reaching 2.2 percent of operating revenues in FY92 and 3.0 percent in FY93.

Table 1
State Fiscal Summary, Statutory Basis
FY1991-95
(in millions of dollars)

Budgeted Operating Funds	FY91 Actual	FY92 Actual	FY93 Actual	FY94 Estimated	FY95 Estimated
Beginning fund balances	$(1,104.4)	$237.1	$549.4	$562.5	$382.0
Current year revenues and receipts	13,913.4	14,226.1	15,205.7	15,868.8	16,140.8
Tax revenues	8,994.9	9,483.6	9,929.9	10,694.0	11,226.0
Expenditures and uses	13,654.7	13,913.8	15,192.6	16,031.6	16,139.3
Operating gain (loss)*	(21.2)	312.3	13.1	(162.8)	1.5
Prior year deficit financing	1,362.7	-	-	-	-
Ending fund equity (deficit)	237.1	549.4	562.5	399.7	383.5
Stabilization fund balance	59.2	230.4	309.5	316.5	325.0
Ending unrestricted reserves**	117.3	313.2	452.1	395.9	379.6

Sources: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1993, p.7; FY94 figures from p.A-10, Official Statement, Commonwealth of Massachusetts, General Obligation Bonds, Consolidated Loan of 1994 Series A, dated June 1, 1994; FY95 figures from table p. 3-22, Fiscal Year 1995 Projected Financial Statement, House No. 1, Fiscal Year 1995 Budget Submission of Governor and Lieutenant Governor, January 21, 1994. FY94 and FY95 figures to be updated in September 1994.

*Defined as difference between current year's budgeted revenues and expenditures, current year's revenues including mass transit assessments on cities and towns and interfund transfers, but excluding beginning fund balances as revenues.

**Including balances in stabilization fund and in undesignated reserves available for appropriation.

4. Stimulated mainly by the national economic recovery, the Commonwealth's tax revenues, which fuel over two-thirds of the state budget, are showing steady improvement, having grown by $1.7 billion over the past three years to an estimated FY94 total of $10.6 billion -- up by 5.4 percent in FY92 over the prior year, up by another 4.7 percent in FY93, and by 6.8 percent, the total for the recently completed 1994 fiscal year.

5. With the executive and legislative branches having reached a political consensus that the utilization of one-time revenue sources is self-defeating fiscal policy, aware perhaps that such revenue-raising devices often fail to achieve their estimation targets, there has been a gradual reduction in the disposition to sell surplus state assets for budget-balancing and the Administration finally eliminated this expedient measure entirely in formulating its FY95 fiscal plan.

6. Equally encouraging is the fact that the Administration seems to be resisting the temptation to propose the kinds of short-term gimmickry that it used or planned to use in prior budgets, such as employee furloughs, borrowing from pension funds, making equity loans against prospective sales of assets, accelerating the dates for the collection of certain fees, etc., and the Legislature has been supportive of such budgetary discipline.

Structural Fiscal Balance: Still An Elusive Goal

Distinct progress in achieving short-term fiscal stability is clouded by the fact, however, that the Commonwealth's goal of structural fiscal balance has not yet been reached. It should also be noted that this objective is now within striking distance, and if Massachusetts budget policymakers give it high priority in allocating the state's resources over the next few years, this longer-range goal could also be realized. Not until Massachusetts has legally shifted to a GAAP-based budget, following the lead of such states as Iowa, Utah, Washington, and most recently Connecticut, will there be confidence in the credit markets that the Commonwealth's accounts are in structural balance. (Since FY86, the State Comptroller has presented the state's audited financial reports on a GAAP basis, but under the current statutory accounting system, the legal process for budget preparation and implementation does not require modified accrual accounting for the recognition of revenues and expenditures as the only acceptable standard for claiming interperiod financial comparison.)

That structural balance still eludes Massachusetts is confirmed by the following indicators:

1. End-of-year fund balances according to GAAP continue to be negative, although the deficit margin has been shrinking, as shown in Table 2.

Table 2
State Fiscal Summary, GAAP Basis
FY1992-93
(in millions of dollars)

Budgeted Operating Funds	FY91	FY92	FY93
Beginning fund balances	$(1,895.5)	$(761.2)	$(317.4)
Revenues and receipts	14,099.7	14,145.5	15,181.0
Tax revenues	9,131.1	9,471.0	10,015.8
Expenditures and uses	14,328.1	13,765.9	15,047.7
Operating gain (loss)	(228.4)	379.6	133.3
Prior year deficit financing	1,362.7	-	-
Ending fund equity (deficit)	(761.2)	(381.6)	(184.1)

Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 130, 1993, p.6.

2. As detailed in a subsequent section on funds analysis, the Commonwealth's principal fund, its General Fund, which accounts for over two-thirds of all budgeted operations, has been in chronic deficit -- in FY93, for example, its end-of-year operating deficit (excess of expenditures over current year revenues) totalled $340 million and its ending fund equity was a negative $702 million. The Administration has forecasted an end-of-year fund deficit of $890 million for FY94 and $795 million for FY95. This may be compared with FY92 results of a $466 million operating deficit and an ending fund deficit of $362 million.

3. The small operating gain of $13 million in the $15.2 billion budget of FY93, the recent estimate by the Secretary for Administration and Finance (A & F) that the final results for FY94 will show a small surplus of $28 million, although A & F's earlier prediction had been that the operating loss for FY94 could be $162.8 million (see Table 1), and the Administration's initial estimate that the $16.4 billion budget for FY95 would leave an operating surplus of only $1.5 million indicate that the Commonwealth's operating budget margins over the past three years have been perilously slim. Obviously the improvement in tax revenue collections, totalling $1.7 billion, has been allocated to the spending side of the budget.

4. Although estimated final results for FY94 project that there will be a minuscule operating gain when expenditures are measured against current year revenues (excluding the use of beginning fund balances), FY94 may at best show a marginal operation gain, due mainly to a $90 million tax revenue shortfall, including a $47 million tax refund judgment against the Commonwealth.

5. The FY94 end-of-year funds balance to be carried over into FY95 as an available revenue source will not benefit from any significant addition of undesignated surplus available for appropriation.

6. As the state's annual operating surplus in recent years has dwindled, thereby reducing how much is available each year for transfer to the Commonwealth's stabilization fund (only $76.7 million was transferred in FY93 vs. $170 million in FY92) the ending-year balance in the "rainy-day" fund has flattened out at just over the $300 million mark. This is equivalent to only 2 percent of the state's revenues, while the total amount of unrestricted reserves, which include undesignated balances plus the stabilization fund balance, has slipped back to a projected 2.4 percent for both FY94 and FY95, far below the recognized standard of 5 percent and below the 3.0 percent of total revenues achieved in FY93.

7. Although the outlook for the state's economy is far more promising than it was a year ago, key indicators projecting growth over the next five years (1994-98) in employment, personal income, housing permits, population and labor force portend a modest economic recovery in Massachusetts with an equally modest impact on the state's resource base: an average annual increase of 1.7 percent in non-farm employment, tempered by a 1.5 percent decline in manufacturing employment; an average annual increase of 1.8 percent in housing permits; an average annual increase of 0.5 percent in total population; an average annual increase of 0.8 percent in the size of the state's labor force; and the critical indicators for estimating state tax revenues, an average annual increase of 6.6 percent in personal income and 6.5 percent in disposable income.[1]

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[1] New England Economic Project - May 1994, 27 Emerson Road, Walpole, MA 02032.

8. The Commonwealth has accumulated a steadily-growing, built-in budget crunch. Heavy long-term fiscal commitments for education reform initiated by 1993 legislation, higher fixed charges for pensions, debt service, contract assistance, statutorily-required entitlements such as Medicaid and SSI, and full-year's budget requirements for new program initiatives represent budgetary obligations that will last throughout the rest of this century. The Administration estimates, for example, that these priority commitments will exceed $600 million for the 1996 fiscal year, thereby consuming about 75 percent of the total projected tax revenue growth in that same year. In fact, the trends in built-in commitments indicate that they will dominate fiscal decision-making and budgetary choices during every fiscal year until the year 2000.

GAAP Culprits

If achieving structural fiscal balance by reversing the current GAAP balance from negative to positive is within striking distance, it may be useful to identify and describe in some detail the budgetary components that account for negative GAAP results. As shown in Table 3, four of the five items are major liabilities that are not recognized under the Commonwealth's current budgetary system on the statutory basis, accrued liabilities that inflate the Commonwealth's unfavorable fund balance.[2]

For example, on the statutory basis of accounting,Medicaid expenses are treated as cash disbursements and related federal reimbursement revenues are measured in proportion to such expenses. Under GAAP accounting for Medicaid, however, the following expense items

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[2] For a detailed discussion of the GAAP issue, see letter of transmittal of State Comptroller accompanying Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 1993, especially pp. 8-12.

would be added to those compiled on the statutory basis -- accrued expenses for Medicaid attributable to one fiscal year but not paid until the next fiscal year (usually within three months later),accrued expenses for retroactive hospital and nursing home rate adjustments and other accrued expense items. These additional measurements under GAAP for Medicaid result in a large unfavorable effect on GAAP fund balance that has exceeded $450 million in each of the past two fiscal years (see Table 3.) Although state initiatives to curb long-standing growth in Medicaid spending have produced encouraging results, the state's net Medicaid liability continues to have a negative impact on its GAAP fund balance.

Equally significant in its negative effect on GAAP fund balance is the Commonwealth's funding of the operating deficit of the Massachusetts Bay Transportation Authority (MBTA), its net cost of service. This is due to the fact that the Legislature appropriates funds to cover the state's share of the MBTA's operating deficit on a retroactive basis, some 18 months in arrears. Although legislative and management restraints to reduce the upward trend in MBTA operating costs have been successful, the net MBTA liability under this arrangement adds over $470 million a year to the Commonwealth's GAAP fund deficit.

The amounts of vacation and sick leave accumulated but not yet taken by state employees also constitute a liability that is not measured under the statutory basis of accounting. Under GAAP expense accrual, that portion of compensated absences estimated to be taken within the next year would be included in the GAAP calculation, and as shown in Table 3, would have added a negative $197 million to the FY92 fund balance and $142 million to the FY93 fund balance.

Accounting for claims against the Commonwealth is another budgetary component that has an unfavorable effect on GAAP fund balance. For example, judgments in disputes over eminent domain takings and taxes are not measured under the statutory accounting basis until actually paid; under GAAP, the Attorney General analyzes pending lawsuits against the Commonwealth and provide estimates of potential judgments to be settled and paid within one year.[3] Moreover, since insurance claims, e.g., health insurance and workers compensation, are not received or reported until after the accounting period, such state employee claims are not currently measured until the next fiscal year. Under GAAP, this liability has an unfavorable effect on fund balance of about $200 million a year, as indicated in Table 3.

Finally, the State Comptroller points out that tax revenues are measured differently under the statutory basis and the GAAP basis: on the statutory basis, tax revenues are accounted for when cash deposits are received; under GAAP, additional compilations are made for taxes owed but to be collected and deposited at a later date, within one year. Moreover, a special accrual takes into account that portion of taxes owed and expected to be refunded or abated. The tax revenue accrual always affects the GAAP fund balance positively, and as the tax revenue base increases, the favorable affect on GAAP fund balance has grown commensurately, as may be noted in Table 3.

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[3] A recent example of the negative effect of state policy on accounting for judgments was a $47 million tax refund decision against the Commonwealth, a liability equivalent to almost one-half of the FY94 shortfall in net tax revenues.

Table 3
Effects on Fund Balance of Major Budgetary Components,
GAAP Basis, FY 1992-93
(in millions of dollars)

Budgetary Component	FY92	FY93
Medicaid accrual	$(483.5)	$(465.5)
MBTA accrual	(474.8)	(472.5)
Compensated absence expenses accrual	(197.3)	(141.7)
Claims and risks expenses accrual	(194.5)	(218.6)
Tax revenue accrual	414.1	460.4

Note: Unfavorable effects in parentheses.
Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1993, pp. 9-11.

Funds Analysis: Proliferation and Distortion

The Commonwealth's efforts to strengthen its financial planning and management capacity and to provide the public with a comprehensive, accurate and clear-cut picture of state finances are being stymied by proliferation in the number of active budgeted funds, which has now reached 34. This record-high total, for example, includes Highway, Local Aid and funds covering various environmental purposes. Moreover, there are 30 non-budgeted special revenue funds that are not subject to annual appropriation, such as the Government Land Bank Fund and the Federally-Assisted Housing Fund. As special interest groups have succeeded in persuading the Legislature to split off their favored programs from the General Fund budget, and have also convinced the Legislature in a growing number of cases that such operations should be financed from dedicated revenues, i.e. the new Health (estimated at $117 million in FY94 and financed from increased excise taxes on tobacco for the support of anti-smoking education and related prevention programs), and as the number of non-budgeted funds exempt from normal internal and external controls has grown, the normal budget process has been weakened and fragmented.

Moreover, splitting active budgeted funds from the General Fund has also encouraged the growing tendency to spread appropriations for specific purposes among several funds, a practice that complicates budget review at both the executive and legislative levels. The proliferation of funds not only curbs flexibility in making difficult budgetary choices, but generates unwarranted resort to transfers among funds for budget balancing purposes, a "net out" interfund practice that complicates legislative appropriation and oversight.

At the same time that selective programs and operations have been severed from the General Fund and revenues normally allocated to the General Fund have been diverted to Special Revenue Funds as dedicated revenues, the Legislature has by law allocated 40 percent of state tax revenues to the separate Local Aid Fund, while transportation-related taxes and non-tax revenues have been reserved for the Highway Fund, further eroding the General Fund's revenue stream. A convergence of these factors has resulted in chronic end-of-year deficits and negative balances in the General Fund, while the Highway Fund and Local Aid Fund have experienced sizable equity fund balances, as shown in Table 4. The Highway Fund, for example, ended FY92 and FY93 with an equity fund balance equivalent to over 20 percent of its fund revenues, while the Local Aid Fund ended FY92 with a similar positive balance exceeding 12 percent of fund revenues and FY93 with a balance equivalent to over 16 percent of fund revenues. By contrast, the ending deficit equity balance in the General Fund, over $700 million at the end of FY93 on a statutory basis, is projected to climb to $890 million at the end of FY94.

That the Highway Fund regularly shows spending far below available revenues and receipts is due to the one or both of the following explanations: (1) the fund's spending agencies lack the capacity and/or budgeted programs that carefully match planned expenditures with resource availability; (2) under-spending is a deliberate policy intent on leaving a surplus cushion large enough to offset almost half the anticipated deficit in the General Fund, although the law ostensibly prohibits revenues credited to the Highway Fund from being transferred to any other state fund for any purpose.[4]

As for the Local Aid Fund, several legislative provisions account for relatively large annual fund surpluses: (1) 40 percent of income, sales and business corporation taxes are allocated to this fund, and tax revenue growth, as in the last few years, has bolstered the Local Aid Fund surplus; (2) Local Aid Fund distributions to cities and towns are specifically capped in legislative appropriations, effectively ensuring that Local Aid Fund revenues will exceed distributions, thereby leaving a surplus that will on paper, at least, show that the Commonwealth's finances are not in deficit. The General Fund deficit is thus offset by the Highway Fund and Local Aid Fund surpluses, and by surpluses in other budgeted Special Revenue Funds.

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[4] See Ch. 110, Acts of 1993, that applies this legislative restriction to appropriations for FY94 and replicates a similar legislative prohibition in 1992 applicable to FY93 appropriations.

Table 4
Budgeted Operating Surplus (Deficit) and Ending Equity Balance
by Major Fund on Statutory Basis, FY1992-95
(in million of dollars)

	General Fund		Highway Fund		Local Aid Fund	
Fiscal Year	Operating Surplus (Deficit)	Ending Equity Balance	Operating Surplus (Deficit)	Ending Equity Balance	Operating Surplus (Deficit)	Ending Balance Equity
1992	$(465.8)	$ (361.7)	$213.4	$177.4	$340.7	$445.0
1993	(339.9)	(701.6)	4.0	181.3	177.5	622.5
1994*	(188.3)	(889.9)	89.0	387.1	(19.8)	516.8
1995*	94.6	(795.3)	51.9	439.0	(112.6)	404.2

*Projected.

Sources: Data for 1992 and 1993 from Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Report, Fiscal Year Ended June 30, 1992, p. 35 and p. 101, and Fiscal Year Ended June 30, 1993, p. 39 and p.113. Data for 1994 and 1995 from House No. 1, Fiscal Year 1995 Budget Submission, January 21, 1994, p. 3-23 and p. 3-22.

A separate Special Revenue Fund to finance a particular program does not necessarily mean that it is a self-supporting, financially healthy operation. The Environmental Permitting and Compliance Assurance Fund, for example, showed a fund deficit of $5.3 million as of June 30, 1993, while the Intercity Bus Capital Assistance Fund was $8.7 million in deficit and the Victim and Witness Assistance Fund was $2.3 million in deficit. As for non-budgeted Special Revenue Funds, as of June 30, 1993, the Government Land Bank showed a fund deficit of $20.3 million; the Federally-Assisted Housing Fund, a deficit of $9.1 million.

If the Legislature is to correct these negative fiscal results, it must either authorize transfers from the surplus balances of other funds or approve the consolidation of funds in order to eliminate deficits in the budgeted General Fund and selective Special Revenue Funds. Similarly, to resolve the deficits in non-budgeted Special Revenue Funds, the Legislature must authorize subsidies in the form of budgeted transfers or consolidation of non-budgeted funds into budgeted funds.

For the Legislature's Ways and Means Committees, often faced with Hobson's choices in allocating the Commonwealth's limited resources, these issues of (1) funds proliferation and complexity, (2) authorization of dedicated revenue streams for politically popular programs, (3) approval of appropriation splitting among funds, and (4) use of end-of-year interfund transfers are more than simple budgetary or accounting problems. The sizeable surpluses in the Highway Fund, the Local Aid Fund and such politically sensitive funds as the Health Protection Fund (with its claim over the increased tobacco tax receipts for anti-smoking education purposes) and the Clean Environment Fund (ever possessive of unclaimed bottle and can deposits for recycling purposes) have emerged as "smoking guns." The special interests that promoted special budgetary status for their own causes use their continuing political influence to lobby against fund revenue diversions, as in the recent debates over cigarette taxes and unclaimed bottle/can deposits, thereby preventing any legislative inclination to simplify the state's fund structure, to reduce the number of funds to a more manageable number, to prohibit "fund splitting" of appropriations and to reduce the number of non-budgeted funds. These are the changes needed to strengthen the budget process and to move the Commonwealth toward achieving a more comprehensive presentation of its finances.

Budgetary Discipline

The extent to which responsible state officials have exercised budgetary discipline can be measured in several ways: (1) by analyzing the magnitude and trends in the use of supplemental and deficiency appropriations; (2) by evaluating the reliance on financial gimmicks for budget balancing; and (3) by considering the degree to which the Administration and the Legislature resort to "outside sections" in general and supplementary appropriation bills for making or changing policy, e.g. directing the Board of Registration of Real Estate Brokers to reissue a broker's license to a named individual, establishing a new State Gambling Advisory Commission.[5]

Supplementary/Deficiency Budgets. When sound expenditure planning and effective control and execution of those plans prevail, there should be minimal need for frequent and relatively large supplemental/ deficiency appropriations.

To measure progress on efforts to restrain the use of supplementary budgets, a review of FY1991-93 activity should be instructive. A projected budget deficit for FY91 was obvious by mid-year. An interim period of executive-legislative harmony generated the self-control needed to address the immediate fiscal problem, with the Governor using allotment reduction powers and uncovering the federal Medicaid reimbursement for uncompensated hospital care, and the Legislature agreeing to employee furlough legislation. Despite the budget-balancing collaboration between the two branches, however, there was a large volume of supplemental appropriations for FY91, including $90 million authorized after June 30, 1991. The supplementals for FY91 amounted to 4.1 percent of budgeted operating fund

[5] Sections 293 and 39 of C.60 of the the Acts of 1994, the general appropriations act for FY1995.

expenditures and 5.1 percent of General Fund expenditures.

The cooperative self-restraint between the two branches that prevailed in FY91 began to ebb in FY92 as tax revenue collections improved and partisan disputes over budget choices intensified. The Governor's attempts to exert spending discipline through vetoes were largely unsuccessful. Although he reduced appropriations for General Relief (substituting a more restrictive emergency assistance program) and group health insurance (for employees and retirees), the Legislature overrode the reduction of the group health appropriation and increased more than the Governor recommended the appropriation for the emergency assistance program. Moreover, the joint executive-legislative overly conservative revenue estimate, adopted as a fiscal disciplinary tactic, failed to curb spending appetites when revenue collections in excess of estimates stimulated a spurt of supplemental appropriations. Supplementals in FY92 almost doubled those of FY91, accumulating to a record of $1.02 billion and representing 7.3 percent of FY92 operating budgets.

Although budgeted appropriations for FY93 were $1.3 billion above total appropriations in the prior fiscal year, an increase of 9.1 percent, the Administration proposed and the Legislature demonstrated a commitment to maintaining budgetary discipline by showing greater resistance to the use of supplementary and/or deficiency appropriations. As shown in Table 5, supplementary appropriations for FY93, whether authorized during this same fiscal year or enacted after the fiscal year had closed, declined to $489 million from the prior record total that had climbed above the billion dollar mark. As a result, supplementary appropriations accounted for only 3.1 percent of the total budget, a distinct improvement over the results of the past two years.

Gimmickry. As demonstrated in prior McCormack Institute reports on the state's finances, the Commonwealth made extensive use of fiscal gimmickry during the FY90-92 period, relying particularly on one-shot or non-recurring revenues such as sales of assets and other expedient measures to balance its budgets. The more recent temptation was the Governor's FY95 proposal to expand the state's use of gambling revenues as revenue replacements for state income tax reductions, a politically and fiscally speculative initiative.

The Governor's submitted budget for FY92, for example, included an original estimate of $230 million in asset sales; only $15.9 million was actually realized. The Governor's budget for FY93 proposed a total of $411 million in one-shot revenue initiatives covering MWRA debt repayment, changes in the abandoned property law, sale of assets, and acceleration of certain motor vehicle licenses. In its final appropriations act, the Legislature reduced the estimated yield of these estimates to $219 million, including a decrease to $45 million in the $100 million estimate for asset sales. Unfortunately, the Commonwealth's actual receipts from the sale of surplus assets totalled only $16.3 million, less than one-third the official budgetary estimate. Also included in the final reckoning was an $80 million one-time payment from the MWRA as settlement for its obligation to repay the Commonwealth for past sewer and water debt liabilities incurred by the state's Metropolitan District Commission, a transaction that was finally consummated.

Another gimmick, because of its temporary nature, although its use is somewhat benign since the federal government continues to approve such payments as state matching, is the federal Medicaid reimbursement for uncompensated hospital care. These reimbursements helped balance the FY91 budget by $513 million, when its availability was first uncovered. Similar reimbursement to the Commonwealth declined to $164 million in FY92 but rose to $273.4 million in FY93, and is expected to total $272.4 million in FY94. What remains uncertain, however, is whether this budget-balancing device will be incorporated in the final text of the national health care legislation.

Table 5
Summary of State Appropriations by Source of Legal Authorization, Fiscal Years 1992-93
(amounts in millions)

	FY92	FY93
General appropriation act*	$ 12,873,277	$ 14,564,173
Supplemental budget appropriations* enacted during fiscal year	800,832	412,636
Supplemental budget appropriations enacted subsequent to June 30	217,549	76,383
Appropriations continued from prior year	108,759	231,030
Interfund and interfund transfers directed by statute	210,392	223,330
Total appropriations	$ 14,210,809	$15,507,522

*Including direct appropriations, authorizations to retain and expend certain non-tax revenues, and interagency chargebacks.
Sources: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, Note 2, p.50 and Fiscal Year Ended June 30, 1993, Note 2, p.58.

"Outside Sections": A Budget Practice Abuse. When the Chairman of the House Ways and Means Committee warned his House colleagues in opening this year's budget debate that they should resist using "outside sections" of the budget in order to avoid normal procedures for enacting changes in the state's general laws, there was renewed hope that a two-decade lapse in budgetary discipline was to be corrected. A recent report of the McCormack Institute had claimed that "there are more changes in general law passed in the budget than there are law changes 'done the old-fashioned way,' . . . introduced by a member, heard in public hearings, voted by committee and brought to the 'floor' for debate and action."[6] The report found that the outside sections process put decision-making "essentially in the hands of the so-called Four Kingdoms -- the two presiding officers and their ways and means chairmen -- not the deliberative bodies themselves"[7] . . . it is our firm belief," the authors of the report concluded, "that the practice of adding changes in general law to general and supplemental appropriation bills is not only bad policy but also violates certain provisions of the Massachusetts Constitution."[8]

What had prompted the Chairman's plea for budgetary restraint in resorting to outside sections was the widespread growing abuse of this legislative practice. The total number of outside sections had climbed to an all-time high of 599 in 1992. The number of outside sections in 1993 was still an excessive total of 389. In keeping with the chairman's own commitment, the House Committee on Ways and Means reported out a new proposed low of 125 outside sections as part of its recommendations to the full House of Representatives. Unfortunately, the general appropriations bill enacted by the House showed a reversion to old

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[6] Richard A. Hogarty and Richard A. Manley, "Circumventing Democracy: Lawmaking by Outside Section," September 1993, McCormack Institute of Public Affairs, University of Massachusetts Boston, p. i, Executive Summary.

[7] Idem.

[8] Idem.

bad habits by more than doubling the total number of outside sections to 305. In its final general appropriations act, the Legislature raised the total slightly to 333, hardly an improvement in budgetary discipline, and a practice that can only be finally ended by a finding of the Massachusetts Supreme Judicial Court.

FY95 Budget: A Delicate Balance of Election Year Initiatives and Fiscal Reality

What could be predicted with reasonable certainty in Massachusetts, politically divided between the executive and legislative branches, was that the Governor's budget submission in House 1 would try to strike a careful election-year balance between bold initiatives, designed to remind voters in the fall of how he stands on the burning issues, and the fiscal caution driven by the realities of modest economic recovery. For its part, the opposition party dominating the legislative branch would counter with its pledge of political responsibility as an equal branch of government to propose an alternative list of initiatives, designed to discount the Governor's submission as politically and/or fiscally speculative, while agreeing in general with his assumptions on revenue growth and bottom-line limits on overall levels of appropriations. It should also be noted that both House 1 crafted by the Governor and the final budget authorizations of the House and Senate were in reasonable harmony with what might be deemed risk-free fiscal policies and priorities. Their disputes were over some budgetary details, particularly over spending allocations. A summary of agreements and disagreements is presented below.

1. In accordance with state law, the Secretary for Administration and Finance and the House and Senate Committees on Ways and Means developed a consensus tax revenue forecast for FY95, and this projection of $11.3 billion, reflecting an increase of 5.7 percent

over estimated collections for FY94, has been incorporated in the general appropriations act.

2. Executive and legislative budget makers have studiously avoided any temptation to incorporate gimmickry and one-shot revenue proposals into their proposed fiscal policies, indicating bipartisan support of sound budgetary principles.

3. Both branches have assigned the highest priority to continued full financing of major prior commitments such as school reform.

4. The budget proposals reflect a commitment to restoring and strengthening the state-local fiscal partnership, by allocating more funds to non-school purposes from lottery receipts in addition to full funding for school reform, and by providing larger budgets for anti-crime activities, including community police.

5. Finally, although they disagreed on budgetary totals, House 1 and the budget approved by the Legislature indicated approval of more state financial support for higher education.

The most spirited and partisan debates over fiscal policy revolved around the revenue side of the budget, tax issues stimulated by the knowledge that a constitutional amendment authorizing a graduated income tax and a collateral classified rate statute will be on the November 1994 ballot. The Governor also made welfare reform, galvanized by the President's promise "to end welfare as we know it," a high-priority issue in his proposed budget, an initiative countered by the Legislature with an alternative prescription.

II. FISCAL POLICY ISSUES

Control of Budget Busters: An Update

The so-called budget busters have been a major source of the state's structural fiscal problem for some time. Beginning with FY92, the Commonwealth began a concerted effort to bring them under control. On balance, that effort has been successful.

While this positive result may not be apparent when looking at the changes from FY91 through FY93, the picture for FY94 and FY95 reflects distinct improvement in the single-digit budgetary percentage increases; and for FY95 alone, the increases in these accounts, except for debt service, are below 5 percent. It should be emphasized, however, that the budget busters still make up over 40 percent of the overall budget. Therefore, even smaller increases in appropriations for Medicaid, Public Assistance, Debt Service, Pensions, Group Health Insurance, and MBTA/Regional Transit Authorities can have significant impact on state finances without further and steadfast restraint.

Table 6 shows the annual percentage variations since FY91 as well as the changes in FY95 over FY91. Moreover, peering over the horizon, like the rising sun, are two incipient busters -- corrections and water and sewer rate relief -- the expenditure trends of which could convert these categories from incipient to full-blown budget-buster status.

Medicaid

Contributing significantly to the state's improved fiscal status has been the noteworthy small increase in Medicaid costs in FY94 and the continued small growth projected for FY95. With an expense of over $3.3 billion proposed for FY95, however, Medicaid continues to be the biggest budget buster.

Table 6
Percentage Changes in Budget Buster Expenditures
FY91-95

	%Change FY92 over FY91	% Change FY93 over FY92	% Change FY94 over FY93	% Change FY95 over FY94	%Change FY95 over FY91
Medicaid	+1.9%	+12.4%	+1.9%	+1.8%	+18.9%
Public Assistance	-2.5	+3.7	+1.7	-2.4	+0.04
Debt Service	-4.7	+26.7	+7.7	+5.7	+37.5
Pensions	+6.8	+15.5	+9.5	+1.8	+37.5
Group Health	+4.5	+5.4	+2.9	+1.5	+15.0
MBTA & RTAs	+10.7	+11.0	+5.2	+1.7	+31.5

Sources: Official Statement, General Obligation Bonds, Consolidated Loan of 1994, Series A, dated January 1, 1994, p. A-28, and p.2, Massachusetts Taxpayers Foundation, Inc. release, dated July 7, 1994.

Much of Medicaid's success in cost containment can be attributed to the new managed care system in which health care to almost two-thirds of Medicaid recipients is currently controlled by a Health Maintenance Organization (HMO) or a primary care clinician. A recently-completed evaluation found that first-year enrollment by Medicaid recipients in managed care yielded estimated net savings of about $20 million. However, anticipated reductions in inpatient hospitalization utilization rates were not realized. In fact, such rates for first-year managed care enrollees were 10 percent higher than they would have been without managed care.[9]

The change from retrospective to prospective rates for paying hospitals and nursing homes has also had a positive impact on Medicaid costs by putting a lid on payments for prior years' Medicaid bills. It is the non-managed care population, however -- those in long-term care -- which continues to be the costliest part of the program, accounting for almost 50 percent of total outlays.

Although there is solace in having achieved greater control of Medicaid, the relative size of the Medicaid budget -- over 20 percent of the state's total appropriations -- means that even a modest annual budget increase of about 2 percent is equivalent to $65 million in additional appropriations. Moreover, the Governor's FY96 budget assumptions for FY96 anticipate a Medicaid increase of $150 million, or 4.6 percent over the prior year.

Public Assistance

Public assistance includes the programs of Supplemental Security Income (SSI), Emergency Aid to the Elderly, Disabled and Children (EAEDC) formerly General Relief, and Aid to Families with Dependent Children (AFDC). The latter is the largest single welfare category, accounting for over 60 percent of the costs of the three categories.

The public assistance budget for FY95 is $1,096 million, a decrease of 2.4 percent over FY94. Appropriations for public assistance have shown only modest annual increases over the last two years. The FY95 amount anticipates a continuing declining caseload, particularly in AFDC, as the state's economy improves and some form of welfare reform is

[9] A Report to the Massachusetts Division of Medical Assistance: Evaluation of the Primary Care Clinician Program, p. vii, McCormack Institute of Public Affairs, Boston, Massachusetts, June 9, 1994.

anticipated.

AFDC is a cash assistance or income maintenance program, mostly for women and children (about 110,000 cases) which will cost about three-quarters of a billion dollars in FY94, 50 percent of which is reimbursed by the federal government. Major changes are more likely in FY95 than in prior years because of increasing public intolerance of the program's perceived failure. It is on the reform agenda of the Governor, the Legislature, and the U.S. President and Congress.

AFDC was initiated nationally in the thirties as temporary relief for mothers with young children adversely affected by the Depression, and was modelled closely on a longstanding Massachusetts statute. The system gradually turned into a dead-end income maintenance program, a program in which many households can remain for long periods of time and a way of life from which there is little incentive to escape.

According to the Massachusetts Welfare Department, 26 percent of the current caseload has been on AFDC rolls for five years or more; another 13 percent has been receiving assistance for at least four years; more than half the present cases are at least three years old.[10] Those who stay on welfare the longest are younger mothers who have not married, have limited education and little or no work history.

At least 30 states have sought federal waivers to institute their own welfare reform experiments. The California waiver is one of the few that has shown some results based on a reasonable period of demonstration. Independent evaluation of its three-year experiment with a job training and placement program involving 33,000 welfare recipients showed that only 3

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[10] Massachusetts Taxpayers Foundation, "Budget '95: Welfare Reform," May 1994, p.2.

percent more from the experimental group receiving intensive training, education and job placement escaped welfare than from the control group whose enrollees received no special treatment.[11]

Moreover, according to evaluation findings of another welfare demonstration program entitled New Chance, an 18-month concentrated program combining education and social services to 1,408 teen-age mothers on welfare in 10 states, enrollees in the program were no more likely to leave the welfare rolls or secure a job than teen-agers in a control group who did not receive this concentrated menu of special services. The evaluation found that about 80 percent of the mothers in both the experimental and control groups were still collecting welfare after 18 months; only 26 percent had worked in the final three months of the program. Other findings of the evaluation are significant in view of growing acceptance of the reality that a new welfare reform strategy is fraught with difficulty:

1. Enrollee earnings were increasing with length of stay in the program, indicating that education and social services were a long-term investment.

2. Although 37 percent of enrollees gained high school equivalency through program participation compared with 21 percent in the control group, women on average in both groups were still reading below 8th-grade level.

3. Despite counseling and offers of contraceptive services, the program failed to prevent repeat pregnancies -- about 57 percent of the participating enrollees became pregnant during the 18-month demonstration period compared with 53 percent of the women in the

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[11] New York Times, June 15, 1994.

control group.[12]

Various reform suggestions run through all and/or some of the proposals put forward by Massachusetts elected officials and the U.S. President. These include imposing time limits for finding a job such as "two years and you're off"; providing subsidized jobs or community service jobs for those unsuccessful in their legitimate job searches; requiring teen-age recipients with children to finish school and live at home; denying additional benefits for having more children while on welfare; adding more day care slots and job training; initiating a "get tough" program for "dead-beat" dads; granting welfare recipients the right to retain some job income while still on AFDC.

The Governor's proposal was unique in that it limited welfare cash benefits to 60 days while a job search was made. Failure to get a job would have required able-bodied recipients to do 25 hours a week of community service or lose their day care and/or training benefits. The unique feature of the plan originally approved by the House was that it reduced AFDC checks by 5.5 percent and applied the savings to the added costs of day care and training.

The Governor's proposal unrealistically targeted a caseload reduction of almost 50 percent in the first year with estimated savings of $70 million, $30 million of which would be used to pay for day care expansion and the remainder to cover the wage costs of community service. Should most welfare mothers be required to do community service, costs for day care would have increased far beyond the Administration's estimate with no offsetting reduction in cash grants. The President's proposal, on the other hand, would require mothers to enroll in community service or subsidized jobs where they would earn minimum wages for

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[12] New York Times, June 22, 1994.

15 to 35 hours a week. Even with the additional cost of over $9 billion a year, it is expected that, by the year 2000, only about 8 percent of current AFDC enrollees, or a total of 400,000, would be in the national work program.

The final legislative alternative produced a modest beginning toward welfare reform. It denied additional benefits for welfare recipients who have additional children and required women younger than 21 to live with their families or in state-run homes in order to qualify for welfare. It included a work mandate cutting off benefits to nearly all able-bodied recipients after two years. It subsidized private jobs so that employers would have an incentive to hire people not possessing the necessary job skills. If recipients refused job training their benefits would be cut by $90 a month. Benefits for existing children would continue, however. The goal of the plan, subject to federal waiver approval, was to move people toward employment.

Since the Governor vetoed the legislation, however, and the Senate upheld the veto, a new legislative-executive compromise is likely to emerge. Real reform, however, must change the system from a check-writing model to an employment one. It should be noted, however, that reform can only succeed within the context of a thriving economy which opens up employment opportunities for persons with limited skills, education and job training, private sector jobs paying wages that exceed the dollar value of cash and service subsidies under the current welfare system, and expanded child care. This suggests an investment of far more public dollars for proposed welfare reform initiatives than is being currently spent for AFDC.

Debt Service

State obligations for principal and interest on debt has been one of the fastest growing budget busters, having increased by more than 37 percent over the FY91-95 period. The FY95 budget includes almost $1.3 billion for debt service, a 5.7 percent increase over FY94. Although the FY94 and FY95 jumps of 7.7 percent and 5.7 percent respectively are much less than the FY93 increase of 26.7 percent over the prior year, debt service has climbed to over 8 percent of the overall budget. Moreover, pro forma budget assumptions in House 1 anticipate an increase of $60 million or 4.6 percent more for debt service for FY96, indicating some easing over the last two years. Clouding the debt service picture is the fact that over 20 percent of debt service, about $275 million, is the bill for borrowing for FY90 and prior year operating deficits, an obligation which will continue until FY97 when the final bill is paid off.

Pensions

The Commonwealth's share of retirement contributions is the budget buster, along with debt service, which has grown the fastest since FY91, by 37.5 percent according to Table 6, although next year's increase is being held to 1.8 percent. The FY95 budget total of $978 million is approaching the billion dollar milestone, and, according to pro forma budget assumptions, will reach it by climbing 4.8 percent to $1,025 million in FY96.

Contributing to the recent rise in pension costs are the early retirements made available to state employees in FY91, the early retirement program for elementary and secondary school teachers mandated by education reform and payable by the Commonwealth, and most importantly, the initiative begun in FY88 to amortize the state's unfunded pension liabilities and the recent 5 percent cost of living adjustment for retirees. Moreover, the FY95 appropriations act budget provides another 3 percent increase in retirement allowances for persons retired prior to July 1, 1994.[13]

It should also be noted that some pension cost pressures on the state budget have been shifted to the period after FY97 because the Legislature has determined by statute that the funding schedule for the Commonwealth's unfunded liability should be minimized during the first 10 years of the 40-year amortization schedule and maximized during the ensuing 30 years. For example, the total premium contributions made by employees and the Commonwealth in FY93 were $234 million below the minimum required by generally accepted accounting principles.[14]

Group Health

The growth of the Commonwealth's obligations for health insurance premiums of active and retired state employees has been checked sharply since FY91, to an average rise of less than 4 percent a year. The approved budget of $513 million for FY95 is only about $8 million above that of FY94.

The Governor's recommendation to hike the employee premium share from 15 percent to 25 percent was rejected by the Legislature, but employees retiring after July 1, 1994 would pay the 15 percent share, unlike current retirees who pay only 10 percent.[15]

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[13] Section 208, C.60 of the Act of 1994.

[14] For a detailed explanation of the pension contributions required under GAAP and those made, see Note 11, Independent Auditor's Report as of June 30, 1993 to State Comptroller, Commonwealth of Massachusetts.

[15] Op. cit., C.60 of the Acts of 1994.

At the same time, the Administration deserves credit for instituting cost control measures beyond pressing for higher employee premium contributions, such as higher co-payments, fewer covered employees, more intensively managed care arrangements, new less costly offerings and tough rate-setting negotiations with group health providers.

MBTA and RTAs

State subsidies for public transit service, a steadily-growing budget buster since FY91, increased by over 31 percent during the past four years, just behind the escalation for debt service and pensions. However, the FY95 budget increase of 1.7 percent to $525 million represents the smallest annual jump since FY91.

Pro-forma budget assumptions anticipate an increase in FY96 to $592 million, or by 10.9 percent over the prior year. Most of this would be due to the state's statutory obligations for debt service assistance, which is expected to jump by 19 percent. On the other hand, control measures by T management are designed to limit operating budget subsidies to a 3 percent hike.

The Commonwealth currently pays 90 percent of the T's debt service, which has been growing in double digits annually. Moreover, the T plans to spend $300 million for capital projects in FY95, including expansion of commuter rail and new buses, outlays which will add to the state's share of debt service.

While the T has slowed the growth in its operating expenses, the fact that Proposition 2-1/2 limits increases in annual assessments on cities and towns to 2-1/2 percent as the local share of net transit expenses means that the state's share of T costs are really open-ended and that cities and towns are paying a smaller share of the total every year.

Despite its predominant role in funding the T, the state plays a very limited role in its budget process. By the time the Commonwealth is called upon to make appropriations for the T, the money has already been spent for anywhere from 6 to 18 months. A switch to forward funding would at least create some aspect of control, even a perception. The T then would have to justify past expenditures and proposed budget each year as do regular state agencies.

The most promising policies for controlling the deficit are unfortunately among the most politically unpalatable. Controlling labor costs, cutting less productive services such as feeder bus lines, raising fares even selectively, among others, impose highly visible costs on often well-organized and easily mobilized consumer groups.

Focusing the T's resources on the core of the system, where it stands the best chance of holding ridership and where it provides the most social benefits may make more sense than additional radial extensions with cost-benefit ratios requiring heavy public subsidies.[16]

Incipient Budget Busters

Corrections and water and sewer rate relief are two areas that could quickly become new budget busters unless checked and controlled early. As discussed earlier, welfare reform could exacerbate the budget-buster status of public assistance when a new employment strategy replaces the current system.

The State's cost of corrections for FY95, including county corrections, totals $529 million, up by 13.8 percent over FY93. Inmate populations in state and county prisons

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[16] Jose A. Gomes-Ibanez with Zhi Liu, Baker El-Hifnaivi, and Laura Belkind, Boston's Transit Future: The Dilemma of Maintaining Ridership While Controlling the MBTA Deficit, Taubman Center for State and Local Government, April 4, 1994, pp. 34-38.

increased 44 percent from FY88 to FY94; by contrast, corrections spending during the same period escalated by 77 percent. Capacity and expenditure pressures on the system continues unabated: the overcrowding rate in state facilities is estimated at 146 percent and at 122 percent in county institutions. Meanwhile, the Governor has announced plans to add 4,200 prison beds with a capital outlay estimate of $590 million.[17]

Although public support for prison expansion is manifest in the "three strikes and you're out" mandatory crusades and increased jailing of non-violent drug offenders, questions have been raised about the relative effectiveness of these remedies and about the tax funds required to implement them i.e. $30,000 annual cost per prison inmate. From 1986 to 1993, the number of drug offenders in state prisons grew by more than 140,000, bringing the number held for drug crimes to more than 183,000, of whom about 20 percent had no prior offenses and almost 60 percent had no prior incarceration for a crime of violence.[18] Moreover, alternatives to the extremely high capital and operating costs of additional prison cells, such as electronic monitoring, day reporting and boot camps for persons convicted of less serious crimes have not received equal consideration.

The outcry for water and sewer rate relief to resident households, especially from communities receiving water/sewer services from the Massachusetts Water Resources Authority (MWRA), led to a new $30 million rate relief program in the state's FY94 budget. The FY95 budget increased the amount to $40 million, but $10 million is for communities outside the MWRA district. FY96 pro forma budget assumptions anticipate another rise in

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[17] See Massachusetts Taxpayers Foundation, "State Budget '95: Choices to Make," p. 14.

[18] New York Times, July 9, 1994.

this new subsidy to $50 million.

Although the higher state subsidies prompted the MWRA to freeze its charges for FY95, this respite will be temporary since the harbor cleanup program is only halfway through, thereby delaying costs and resultant higher rates. Moreover, there are other water and sewer problems facing the MWRA, e.g. combined sanitary and storm sewers, leaking mains, etc., problems that will mean even higher water/sewer rates.

Once the Commonwealth's rate relief program becomes well established and encrusted in the state budget, as it now seems to be, and as MWRA rate changes continue to spiral, the outcry for further local rate relief will grow and the program could become permanent and difficult to constrain.

III. BUDGETARY INITIATIVES: SHORT- AND LONG-TERM IMPLICATIONS

State-Local Fiscal Relations

That the state's municipalities have been experiencing more fiscal stress than during the mid-eighties is certainly due to short-run budgetary pressures -- low levels of free cash and other unrestricted reserves, large amounts of short-term debt to pay current bills, cut-backs in capital spending as shares of total revenue, and low bond ratings. But the more serious aspect of municipal fiscal stress in Massachusetts may be traced to structural factors -- increasing constraints on the capacity of cities and towns to raise revenue (property tax limitation and reductions in state/federal financial assistance) and upward pressures on spending from factors largely beyond the control of local decision-makers (pension contributions, health insurance, other employee benefits, debt service, intergovernmental assessments, rising crime rates leading to higher costs for law enforcement, and increasing numbers of pupils, especially special education students.) Many cities and towns are facing both types of fiscal pressures. And those that have been able to manage their own budgets despite the pressures and constraints may be improving their short-term budgetary outlook without necessarily correcting their underlying structural condition.[19]

For many cities and towns, financial stress could remain a chronic situation even as an improving economy bolsters property tax collections, state aid, federal aid and miscellaneous local revenue sources. The conclusion of a respected student of the Massachusetts economy

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[19] For an in-depth analysis, see "Overview of Current Finances," Helen F. Ladd, paper prepared for Conference on Municipal Fiscal Stress in Massachusetts, October 15, 1993, Federal Reserve Bank of Boston, co-sponsored by John W. McCormack Institute of Public Affairs, Massachusetts Department of Revenue and Massachusetts Taxpayers Foundation, Inc.

is particularly instructive. He points out that the benefits of economic growth will not be shared widely throughout the Commonwealth since "the R & D processes that produce breakthroughs and create new opportunities are heavily concentrated geographically in eastern Massachusetts and centered in Cambridge." He also warns that "the strong growth possibilities that do exist are narrowly focused and technologically based, favoring only select areas within the state."

"As a result," he emphasizes, "the outlook for most municipalities is that fiscal stress will continue. The good news is that, in most locations, it is not becoming worse. Yet, even so, the road back to fiscal good health is likely to be long and difficult as fiscal stress will remain a common condition for the cities and towns for a considerable time to come.[20]

Financial pressures are also greater on those communities that rely more heavily on state aid. Thus the time may have come for the Commonwealth to devise ways for countering the adverse impact on local finances caused by fluctuations and uncertainties in state aid as well as by economic volatility.

A Turn in Local Aid Policy. Direct local aid, or state aid as it is commonly called, is what the Commonwealth returns to cities and towns via the "cherry sheets" in the form of tax revenue and lottery profit distributions or reimbursements. Until this year, state aid has historically been designed as general revenue sharing, to be equalizing in nature and targeted for local property tax relief.

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[20] See op. cit., "The Outlook for Municipal Fiscal Stress," Frederick S. Breimyer, paper prepared for conference on Municipal Fiscal Stress in Massachusetts.

The following data show the trends of direct local aid, how it was adversely affected by the state's own financial difficulties, and the more recent return to positive momentum.

(in millions)

FY89	FY91	FY92	FY93	Estimated FY94	Estimated FY95
$3001.8	$2563.8	$2330.7	$2503.9	$2716.6	$2956.6

Source: Op. cit., Massachusetts Taxpayers Foundation, "State Budget '95: Choices to Make," p.2. April 1994.

From a peak of over $3 billion in FY89, direct local aid dropped by $671 million or 22 percent to its nadir of $2330.7 million in FY92. As state tax revenues improved, cities and towns benefitted from higher appropriations of direct local aid. For FY95, distributions are back to $2960.6 million, a total that is still $41 million or 1.4 percent below that of FY89 amount.

Just as it had reversed direction in how much aid it sent back to cities and towns, by FY94 the Commonwealth made a U-turn in the basic goals of direct local aid, from local property tax relief under general revenue sharing to specific directions in how local aid was to be spent.

State aid has had a long history, but it was not until the sixties that the amount of aid became significant in municipal budgets. It was not until the eighties, however, with the advent of Proposition 2-½, when the state used additional local aid to mitigate the adverse impact of Prop. 2-½ on local revenues.

For the last four decades at least, whether in the form of tax revenue distribution or in the form of state assumption of local costs, i.e., welfare, state takeovers of county courts and corrections, metropolitan/state parks and recreation, etc., local aid was intended to relieve property taxes. Only minor attention was given to how that money was spent. By 1989, 80 cents of every local aid dollar was revenue sharing in nature; at the low point of local aid distributions in FY92, revenue sharing fell to 72 cents of the local aid dollar.[21]

Local aid policy shifted dramatically in FY94 with enactment of the education reform act. In lieu of a policy of revenue sharing, the state substituted detailed requirements for spending the additional aid under the educational reform act. As a result, about two thirds of direct local aid is now earmarked to attain school programmatic results or outcomes.

Not all local officials are pleased with the change. Where previously they could determine where and how to spend state aid, it must now be expended in large part for education; moreover, in many cases communities must also increase spending from their own resources to qualify for the additional education aid.

Another concern is whether the Commonwealth will stay the course in its monetary commitment for educational reform during periods of tighter tax revenue collections. Still fresh in the minds of local officials is the state budget policy of the early nineties. When economic conditions deteriorate and competing factors pressure state finances, will the state's long-term commitment to local aid be kept? That commitment for the next five years through the year 2000 amounts to over one billion dollars.

Will there be money available for other special local aid problems in the face of higher costs for school aid? Will other general purpose aid programs also be targeted or

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[21] Op. cit., Susanne E. Tompkins, "Local Aid - A New Policy Direction," p.8, paper prepared for the Conference on Municipal Fiscal Stress, October 15, 1994.

earmarked to achieve specific outcomes?

Local Share of Lottery. Another perennial issue in state-local fiscal relations deals with the distribution of lottery receipts. State lottery proceeds were intended originally for cities and towns after provision for administrative expenses and prizes. Lottery aid distributions were unrestricted revenue to be spent at the discretion of the communities themselves.

Although the Legislature did authorize small ad hoc diversions of lottery receipts to state purposes in an earlier period, the financial difficulties of the late eighties prompted it to cap the lottery distribution to cities and towns at $306 million a year beginning in FY89, with any excess to be diverted by the state to finance state-funded programs of local services. The result was a reduction in the amount of unrestricted direct local aid since the state in effect was using the money belonging to cities and towns rather than state money to pay for such local programs.

The original $306 million cap was retained until FY93 when $329 million, 79 percent of net lottery profits, was returned to local communities. An additional $20 million was returned to cities and towns in FY94, raising the local lottery distribution to $349 million. However, the local share of the net lottery profits declined to 71 percent of the total while the state diversion rose to $144 million from $87 million in the previous year.

Lottery aid to cities and towns in FY95 is projected at $391.6 million, an increase of $42.6 million, but the state diversion would climb to $161.2 million.[22] As a result the municipal proportion of aid from estimated net lottery profits would remain at about 71

[22] Section 3, C.60, Acts of 1994.

percent of the total.

The general appropriations act for FY95 also contains provisions for gradual correction of this state-local fiscal relations issue. Over the next five years, cities and towns would receive the annual growth in net lottery proceeds plus one-fifth of the FY95 diversion of $161.2 million.[23] Thus, by the year 2000, local communities would be receiving all of the net lottery proceeds, assuming no future legislative diversion.

A problem with the lottery beyond the diversionary dilemma is the formula used for distribution. The current allocation to individual cities and towns is based on their relative proportions of population and their state-determined equalized valuations in inverse proportions. In theory, richer communities, as measured by this index, would receive relatively less than poorer ones.

The formula is simplistically equalizing, however. It fails to recognize the connection between community expenditure needs and the fiscal capacity required to support such needs. These critical criteria were incorporated in the formula adopted by the Legislature in the mid-eighties for "new resolution aid" to govern the distribution of direct local aid in excess of the prior year's distribution.

That formula estimated the relative expenditures facing cities and towns by determining the statewide average cost per capita of providing basic local services and measuring how uncontrollable factors, i.e. population density, age of housing, etc. caused each municipality's cost of providing basic services to diverge from the statewide average.

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[23] Ibid.

The revenue side of the formula compared municipalities on the basis of their revenue-raising capacity by using revenue variables such as estimated property tax levy limit, local available reserves, state aid, local hotel/motel tax capacity and local motor vehicle excise tax collections.

This is a fairer and more rational equalizing formula which should be relatively easy to adopt when all net lottery profits will be returned to cities and towns over the next five years, and communities could be held harmless from any loss of such aid.

Finally, to resolve the long-festering complaint that cities and towns are paying for state-mandated county expenses from their limited resources, the Commonwealth should move to assume all county costs, a direction toward which it has been moving gradually since 1978 when district court costs became the state's fiscal responsibility as part of the restructuring of the judicial system.

Consolidation of all county corrections activities into a partially integrated state system in 1988 relieved local communities of much of this expense as well. Transfer of all the latter costs is incomplete, however, and some $12-15 million of this expense remains as the largest remaining county responsibility.

The FY95 budget for county corrections is $226.2 million, $38 million above the FY94 final figure. This increases the state's financial responsibility for county corrections costs, but still leaves an estimated $20 million of total county expenses to be borne by local property taxes.

Recent disclosure of the problems of some county sheriffs indicate that this is the time for complete state responsibility for county correctional institutional costs and operations is appropriate.

Educational Reform

In FY95, education reform enters the second year of a seven-year program to change and upgrade local education. The second year will see an increase of $184 million in school assistance with another $35 million allocated to other school reform initiatives. According to the Governor's FY96 budget assumptions, educational reforms will require another budgetary increase of $225 million; further annual increases through the year 2000 should be of similar magnitude.

The 1993 law establishes broad, rather than targeted goals for all schools. A new complex formula establishes a minimum level of spending--the foundation budget--for each local school district. This spending requirement, to be achieved over a period of years, defines the amounts local governments must contribute to their school budgets. The law also commits the state to annual increases in spending through the year 2000, money that must be spent on schools. The State Board of Education sets standards for curricula, graduation, and student performance, but the school program will be administered locally. Sanctions may be applied where students do not meet state standards and where communities fail to meet educational revenue and spending requirements.

As described above, the law has forced the state to shift its local aid policy to one where about two-thirds of the additional aid must be spent on schools to achieve programmatic results, a shift from the prior policy of general revenue sharing to achieve local property tax relief.[24]

Most importantly, education reform will exert major pressure on the state budget through the end of the decade. Continuing concerns revolve around the firmness of the state financial commitment and the ability of cities and towns to fulfill their statutory roles if revenue expectations are not realized and/or if economic conditions deteriorate.

Prevention Programs

The Administration has highlighted its investment in programs that help those in need and avert more costly problems later, claiming to have increased the investment by over $200 million since FY91. The FY95 budget maintains that trend. Among the priority areas of prevention are: AIDS, homelessness, pre-natal care, children's services, child support enforcement and support for the elderly.

An on-going comprehensive cost-benefit study by the Center of Risk Analysis of the Harvard School of Public Health has found, for example, that many of the preventive programs on the Massachusetts agenda are helping to avert premature deaths at the lowest possible costs. State interventions through childhood immunizations, prenatal care, drug and alcohol treatment have proved to be life-saving bargains according to calculations of the costs per life-year saved. Since they reduce the costs of caring for sick people, total costs are more than offset by health-care savings, thereby reducing the per-life-year costs to less than zero.[25]

While the purpose of these initiatives is to prevent more costly health and social

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[24] See op. cit., Tompkins, p 11.

[25] Wall Street Journal, July 6, 1994.

problems in the future, savings from them are necessarily long term and will remain difficult to calculate. Regardless, prevention programs will require additional funding annually.

Tuition Retention for Higher Education

The Commonwealth's public higher education system experienced among the deepest budget cuts of any state agency during the recent fiscal crisis. Retention of increased tuition by education institutions was initiated in FY91 as a way of mitigating the impact of the cuts and to give them more flexibility and efficiency in managing their funds.

The proposal to authorize higher education agencies to retain all their tuition, not merely the proceeds from tuition increases, was rejected by the Legislature in FY94. (One argument was that the growth of off-budget financing fragmented the budget process and reduced legislative oversight.) The state appropriation for higher education was raised by $35.5 million or 5.6 percent over FY93, although some of the benefit of this ostensible improvement was dampened by the collateral requirement that higher education agencies cover the cost of the 13 percent two-year pay raise and of group insurance from their own resources.

The Administration again trumpeted full-blown tuition retention as a policy for FY95 while proposing an appropriation increase of only $8.8 million or 1.3 percent. The Legislature approved an increase of $37 million for higher education, but rejected the policy of tuition retention.

The executive-legislative deadlock on tuition retention spotlights the need for answers to basic questions about financing the higher education system. What should the system look like in the nineties? How much should be spent on the system? And how much should be financed from tuition, fees and public appropriation?

Answers may emanate from a current study of the McCormack Institute on financing public higher education in Massachusetts as well as from the Higher Education Coordinating Council, whose Task Force on Fair Share Funding for Higher Education reported its findings in June 1994. The Council was charged by the Legislature in 1993 with coming up with a "funding formula for the allocation of state support for public institutions of higher education." The Task Force based its recommendations on principles such as access to educational opportunity, adequacy of total resources, stability in state appropriations, and predictability of student charges.

Among the Task Force recommendations:

1) The student share of education for those attending the University of Massachusetts and state colleges should equal 35 percent; 25 percent for those attending community colleges.

2) The Commonwealth should bear primary responsibility for funding public higher education.

3) There should be a five-year financing plan to be implemented with the FY96 budget and annual incremental increases until plan goals are realized.

4) Once maximum financial aid for neediest students squares with tuition and mandatory fees, financial assistance should be increased annually at the same rate as the increase in student charges.[26]

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[26] Stabilizing the Commonwealth's Investment: Toward a Five-Year Financing Plan for Higher Education; pp. 9-12, A Report of the Massachusetts Task Force on Fair Share Funding for Higher Education, June 15, 1994.

IV. REVENUE FORECASTING

Tax Revenues: A Progress Report

Budgets are built on revenue predictions, which can generate important fiscal consequences if not realized. The Commonwealth learned that lesson only too well recently.

From FY88 through FY91, the state based its spending plans on overly optimistic forecasting which resulted in well-chronicled fiscal agonies. By contrast, the Commonwealth in FY92 resorted to deliberate low-balling of revenues in order to try to cap the spending bottle despite higher tax revenue estimates from reliable independent sources.

The introduction of joint revenue estimates publicly disclosed in the annual appropriation act by designated representatives of the executive and legislative branches, a practice initiated in FY93 and continued since, has led to more careful and conservative estimating.

Taxes, which make up about 70 percent of total revenues, are easier to predict than non-tax revenues. The advent of sophisticated modeling techniques based on reliable, readily available data on national and state economic trends have reduced some of the uncertainties in tax revenue forecasting.

Original tax revenue estimates for FY93 of $9.685 billion were 2.1 percent above the final collection figures of FY92. The initial estimate was revised about mid-year to a 4.8 percent increase. Final tax revenue collections of $9.928 billion amounted to a 4.7 percent increase, within $12 million of the revised target.

Budgetary tax revenue estimates for FY94 were originally established at $10.560 billion, or 6.4 percent higher than FY93 actual revenues. This estimate was subsequently revised to $10.667 billion, which anticipated a projected growth of 7.7 percent over actual collections in FY93. According to final estimates of FY94 collections, indicating that the total will be $10.577 billion, $90 million below the revised target, revenue collections will reflect an increase of only 6.8 percent over the prior year. Tax estimates of $11.3 billion incorporated in the general appropriations act for FY95 will be 6.8 percent over actual collections, consistent with the FY94 increase above the prior year.

Non-Tax Revenues: Search For A Reliable Forecasting Methodology

Non-tax revenues are another story. They make up nearly 30 percent of budgetary revenue, but are more difficult to forecast. They consist of federal reimbursements (59 percent), departmental revenue (22 percent) and consolidated inter-fund transfers (18 percent).

Federal reimbursement estimates are based on state spending (mostly welfare). Estimates of departmental revenue depend on the best judgments of the various state agencies administering licenses, fees, etc., including lottery profits. The latter group includes the revenues of new gambling initiatives which, if Keno game revenue estimates and collection experience are indicative, are tenuous.

Since non-tax revenues are less predictable, they can be affected by tendencies to revise original estimates. Last year, the McCormack Institute recommended that estimates of departmental revenue not exceed prior year actual collections. That recommendation is repeated here with the added recommendation that agency heads certify their estimates to the House and Senate Ways and Means Committees. This could result in closer attention to the statistical bases for estimates and promote more realistic projections.

V. TAX POLICY ISSUES

Impact of State Tax Policies/Actions on Tax Reform and Tax Equity

The primary goals for improving a state's tax system are 1) broadening its tax base, 2) enhancing the balance among its major tax sources, 3) increasing the elasticity of its revenues so that they are more responsive to economic growth, and 4) maintaining or strengthening the system's tax equity. How has the Commonwealth performed recently when measured against these targets?[27]

Beginning in 1990, the state has attempted various tax reforms, some successful, some not. The Legislature broadened the sales tax in 1990 by imposing the tax on certain professional services provided to businesses, on newspaper production, on the sales and uses of electricity, on gas and steam for non-residential use and on telecommunication services to non-residential and most residential sales and uses. However, only the extension of the sales tax to certain utility and communication services survived the repeal of the legislation in 1991.[28]

In 1991, bipartisan efforts by the Governor and Legislature succeeded in "sunsetting" the temporary income tax rate increase on earned income enacted to finance prior state operating deficits, thereby bringing the basic rate on earned income down to 5.95 percent for the 1992 and subsequent tax years from its peak of 6.25 percent in the 1991 tax year.

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[27] Steven Gold and Sarah Ritchie, Fiscal Crisis in New England: How the States Responded, 1989 to 1992, p. 2, paper presented at conference held at Federal Reserve Bank of Boston, April 8, 1992.

[28] See Globe Newspaper Co. vs. Commissioner of Revenue, 410 Mass.188.

In 1992, the Governor proposed a further reduction in the earned income tax rate to 5.75 percent in addition to cuts in the capital gains rate. However, in its concern for a $140 million loss of potential revenue for the FY92 budget and because of its ideological differences about benefits for the "wealthy" from the capital gains reductions, the Legislature turned down the Governor's proposal. At the same time, it extended and increased the investment tax credit from one to three percent and added new research and development credits as moves to enhance the state's economic climate.

Changes in the Massachusetts estate tax, initiated by the Legislature and supported by the Governor, were enacted into law in 1993. The new law phases out the old statute and substitutes a new so-called "sponge tax," to be fully implemented by 1997. It would thereby coordinate the Massachusetts estate tax with the federal estate tax law. "Sponge" refers to the fact that the state tax will now be based on the maximum credit for state estate taxes allowed under the U.S. Internal Revenue Code.

In his FY95 budget submission, the Governor proposed a cut in the earned income tax rate from 5.95 percent to 5.85 percent, higher personal and dependent exemptions, as well as increased exemptions for the elderly and blind. The Governor also recommended expansion in no-tax status for low income households and an exemption from taxation of retired military pay. To be effective on January 1, 1995, the changes would have provided tax relief annually of $270 million, but he would have offset the tax loss with revenue from proposed new gambling initiatives.

The House countered with tax cuts that would have provided an estimated $200 million in tax relief. It rejected the basic earned income tax rate reduction, but included higher standard exemptions for most filers and special tax breaks for the elderly, blind, veterans, and households with substantial child-care expenses or water/sewer bills. The House made its changes provisional, however, subject to a December 1994 veto by either the House Ways and Means Committee, Senate Ways and Means Committee or Joint Taxation Committee.

The Senate, on the other hand, proposed small tax cuts for single-parent households and the working poor totalling about $24 million. There would be a new "head of household" tax status for single parents and an increase in the "no-tax status" threshold from the current $12,000 to $14,000 for a family of four. At the same time, the Senate extended the investment tax credit for businesses to leased as well as purchased equipment, which would cost the Commonwealth about $2.8 million in lost taxes.

Final legislative enactment resulted in a tax equity program with income tax relief of about $24 million aimed primarily toward poorer households and the extended investment tax credit. By its FY95 budget actions, the Legislature took the steam out of the Governor's hope to enjoy election-year credit for income tax relief.

Changes made in the state's tax system during the 1990-94 period represent some progress in improving tax equity, but only minimum movement in either broadening the tax base, enhancing balance among major tax sources, or increasing elasticity in revenues.

Tax Equity vs. Tax Competitiveness: Difficult Policy Choices

It's a given that the political/economic context drives initiatives for state tax reductions and business-related tax incentives. Improving economic conditions, higher rates of tax collections, growing sensitivity to the competition among states for more jobs and new industry and the coincidence of the election cycle with positive economic change provide a favorable climate for tax cut proposals. According to a veteran observer of tax trends, "the season for tax cutting is here," and nearly a score of states across the country are moving to do so.[29]

Whether tax reductions should enhance equity or strengthen a state's competitive position is the central issue of tax policy debate. For example, one important question that has long faced Massachusetts is whether the state's taxes are "deterring firms from locating and expanding within its territory." If they do, contends one economist, the state should move to eliminate or reduce tax deterrents to its interstate competitive position. If the conclusion, by contrast, is that state taxes do not place Massachusetts at a disadvantage, he argues, its policymakers should concern themselves with other important issues of concern to employers, such as energy prices, workers compensation, unemployment insurance taxes, and health care costs.[30] The importance of the competitiveness issue arose in 1993 when the Governor and Legislature concluded that the business tax climate would benefit from an increase from one to three percent in the investment tax credit. Most of the states competing economically with Massachusetts had also granted tax relief in 1993 in the form of new tax credits for investment, research and development.

In his FY95 budget message, the Governor labelled Massachusetts a high tax state. He claimed that efforts to relieve the tax burdens and to help stimulate economic activity must

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[29] Quotation of Steven Gold, New York Times, March 17, 1994.

[30] See Robert Tannenwald, "Massachusetts Tax Competitiveness," New England Economic Review, Federal Reserve Bank of Boston, Jan/Feb 1994, p. 31. Mr. Tannenwald served as Research Director of the Massachusetts Special Commission on Business Tax Policy.

include additional tax cuts, and argued that putting more money in the hands of people, mainly through income tax reductions, would fuel economic growth. However, a report prepared for the Special Commission on Business Tax Policy in 1993 found that Massachusetts compares favorably when business tax burdens are measured against the long-run rate of return on business investment. In a subsequent article, the Research Director of the Special Commission concluded that, on the whole, the Commonwealth's tax structure is neither an asset nor a liability in interstate economic competition, although the state's tax system may be a handicap in certain industries such as the Massachusetts bank tax.[31]

An exception to this conclusion, according to the author of this article, is the mildly anti-competitive feature created by the relatively high tax burden that Massachusetts places on upper-income households. The Commonwealth's tax burden on these households is average relative to its competitors as a group, but significantly higher than those imposed by such economic competitors as Arizona, Illinois, New Hampshire, Texas and Washington.[32] The Governor's tax proposals did not target the tax burden on upper-income households, the one area where Massachusetts does not compare well with competing states. Moreover, the graduated income tax proposal to be voted on in the fall would compound that burden on upper-income households by shifting taxes for 92 percent of taxpayers to the other 8 percent. Many business leaders also see a competitive downside from the proposed increase in taxes on substantially long-term capital gains incorporated in the collateral enabling bill and from an increase in taxes paid by small businesses formally known as subchapter S corporations.

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[31] Idem, p.32.

[32] Ibid.

The basic dilemma in constructing sound tax policy thus lies in striking a reasonable balance between the major goals of tax reform: equity and competitiveness. The problem for Massachusetts is compounded by heavy built-in budgetary commitments. Much of the new expected tax growth is pledged to complete education reform by the year 2000, to finance higher pension and debt service obligations, and to cover statutorily required entitlements for Medicaid and SSI, etc.

With all the hoopla over the importance of tax reduction to achieve more tax equity and/or to improve the state's economic competitiveness, final legislative action proved to be a dud. Income tax reductions were of small scale, and nothing was done to ameliorate the one anti-competitive characteristic of the state's income tax system. As for the liberalization of the investment tax credit, although its intent to provide a level playing field as between purchased and leased equipment is laudatory, independent analysis raises doubts about whether tripling of the tax credit last year and expanding it this year significantly increases benefits in absolute terms.[33]

The question today is whether more equity is needed and where it ought to be applied. ". . . Massachusetts should feel fairly comfortable about its tax competitiveness, concludes a respected economist who has directed several major research projects on the state's tax system.[34] Moreover, the current system, even with its two-tier flat rate system is moderately

[33] Simulations prepared for the 1993 Special Commission on Business Tax Policy showed that tripling the Massachusetts tax credit would raise the return on assets (ROA) for representative firms by less than 0.2 of a percentage point. The Commission also concluded that even a significant reduction in the state's corporate income tax rate from 9½ percent to 7½ percent would lower such ROA's by only an estimated 0.2 of a percentage point. See op cit. Tannenbaum, "Massachusetts Tax Competitiveness," p.44.

[34] See op. cit., Tannenbaum, "Massachusetts Tax Competitiveness," p. 46.

progressive; personal exemptions and low income exemptions and deductions make it even more progressive, according to the State Department of Revenue.[35]

The evidence for more equity, then, is not compelling. Rather, it shows that a more perfect balance can be struck between equity and competitiveness by targeting upper-income households with its ranks of skilled professionals and business managers to remove an anti-competitive feature of the Massachusetts tax system.

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[35] Massachusetts Statistics of Income, p. 22, Commonwealth of Massachusetts Department of Revenue, Bureau of Analysis, Estimation and Research, March 1994.

VI. MAJOR CONCLUSIONS

1. Massachusetts is finally achieving short-term fiscal stability as demonstrated by the following results:

a. Balanced budgets during each of the past two years when beginning fund balances are added to revenues and the total is measured against expenditures.

b. More substantial end-of-year fund balances, a critical indicator of short-term fiscal health.

c. More ample unrestricted reserves, the state's budgetary cushion.

d. Steady improvement in tax revenues, which fuel over two-thirds of state spending.

e. Gradual reduction and final elimination of one-time, non-recurring revenue devices.

f. Greater executive-legislative resistance to the use of short-term gimmickry for budget-balancing.

2. Massachusetts has not yet reached its goal of structural fiscal balance as measured by Generally Accepted Accounting Principles (GAAP) but this goal is within striking distance.

3. The following results demonstrate continuing difficulties in achieving structural fiscal balance:

a. End-of-year fund balances on a GAAP basis are still negative although the deficit margin has been shrinking.

b. When the state's books are finally closed, FY94 may at best show a marginal operating gain when expenditures are measured against current year revenues, resulting mainly from a $90 million tax collection shortfall.

c. The FY94 end-of-year funds balance to be carried over into FY95 will not benefit from any significant addition of undesignated surplus available for appropriation.

d. The state's principal budgetary fund, its General Fund, has been and is still in chronic deficit.

e. Operating budget margins generated by an excess of current year's revenues over expenditures have been perilously slim over the past three years because all of the improvement in tax revenue collections have been used for additional spending.

f. Preliminary budget figures for FY95 based on the general appropriations act approved by the Legislature and signed by the Governor, the anticipated FY94 deficiency appropriation, and the jointly approved revenue estimates indicate that current year's revenues totalling $16.297 billion may fall short by up to $100 million in covering planned expenditures.

g. The current balance in the state's "rainy-day" stabilization fund and in unrestricted reserves is far below the recognized standard of 5 percent and barely-balanced budgets have restricted the amount of recent new transfers to the "rainy-day" fund.

h. Key indicators measuring growth over the next five years project that the state's economic recovery will be modest, with a projected impact on the state's income tax base estimated at about 6.5 percent on average.

i. Massachusetts has accumulated a steadily-growing, built-in budget crunch due to heavy, long-term fiscal commitments for education reform, higher fixed charges for pensions, debt service, contract assistance, statutorily-required entitlements and full-year financing for new program initiatives, commitments which will consume about 75 percent of total tax revenue growth and dominate budgetary decision-making during every fiscal year until the year 2000.

4. The principal budgetary components that account for negative results according to GAAP are:

a. Medicaid, with a negative balance exceeding $450 million a year, attributable mainly to accrued obligations not paid until the next fiscal year, and

b. MBTA operating deficits, now over $470 million a year, financed on a retroactive basis some 18 months in arrears.

5. The state's efforts to strengthen its financial planning and management capacity and to provide the public with a comprehensive, accurate and clear-cut picture of state finances are being stymied by unstemmed proliferation in the number of budgeted funds, by the growing trend toward approving dedicated revenue streams for politically popular programs, appropriation splitting among funds, and end-of-year interfund transfers without legislative section.

6. Sizeable annual surpluses in the Highway Fund, the Local Aid Fund and such politically-sensitive funds as the Health Protection (anti-smoking) Fund have become political "smoking guns."

7. The executive-legislative restraint to rein in the use of supplementary/deficiency appropriations has succeeded in bringing them down from over $1 billion a year for FY92 to an estimated $250 million for the recently completed fiscal year, equivalent to about 1.6 percent of total appropriations.

8. Finally heeding the warnings of the chairs of its Committees on Ways and Means that using "outside sections" of appropriations acts to avoid normal procedures for enacting legislation had become a two-decade lapse in budgetary discipline, the Legislature in 1994 brought the number of outside sections down to almost half the record total of 1992.

9. The FY95 budget approved by the Legislature and Governor reflects a delicate balance of fiscal reality, driven by prudent assumptions on revenue growth and election-year initiatives, with the hot-button issue of welfare reform only temporarily resolved by the budget and to be further debated during the election campaign, and the graduated income tax amendment of the state Constitution and the collateral graduated tax bracket statute left to popular referendum for ultimate decision.

10. Concerted and continuing efforts to control the costs of the state's budget busters have paid off and, on balance, this cost-reduction campaign has proved successful.

11. However, there is growing concern that corrections, water/sewer rate relief and welfare reform could easily shift from incipient to full-fledged budget buster status, in view of their actual and/or potential escalating costs.

12. The report analyzes the short- and long-term implications of several budgetary policy issues -- state/local fiscal relations, educational reform, prevention program initiatives, and tuition retention for higher education -- and presents the following conclusions.

a. Since the low point of $2,330.7 million in FY92, the Commonwealth has increased its total distribution of direct local aid by $600 million, an improvement of 27 percent during the 3-year period, but still $40 million below the FY89 total.

b. Local aid policy shifted dramatically effective in FY94 with enactment of the educational reform act from a general revenue sharing model to a targeted local aid model that requires two-thirds of direct local aid to be earmarked for educational purposes, thereby severely limiting the proportion of local aid that may be spent entirely at the discretion of local elected officials and committing over $1 billion more in state tax revenues to K-12 education through the year 2000.

c. There has been a gradual increase in the total amount of lottery receipts redistributed to cities and towns, from a cap of $306 million in FY89 to $391.6 million for FY95, and, by the year 2000, municipalities will be entitled to all of the net lottery proceeds as the law originally intended.

d. Cities and towns are still paying about $20 million a year as their share of all county expense, most of which is for county corrections, and the goal should be to fully integrate county corrections into the state's correctional system; this is an appropriate time to shift the correctional cost residual to the Commonwealth.

e. A long-term concern for cities and towns is whether they can both comply with the foundation budget requirements of the educational reform act, which establishes a minimum level of spending for schools, without adversely affecting local resource needs for public safety, public works, and other non-school responsibilities.

f. The Administration has been gradually expanding its budgetary investment in so-called prevention program initiatives for AIDS, homelessness, prenatal care, children's services, child support enforcement, etc. based on the premise they will prevent more costly health and social problems in the future, and the Massachusetts prevention agenda includes many initiatives that risk analysis indicates will avert premature deaths at the lowest possible costs.

g. Although the Legislature increased state financial support for higher education by $37 million for FY95, 5.5 percent over the prior year, it should be noted that the higher education system must cover the cost of last year's 13 percent two-year pay raise and of group insurance from their own resources and that the Legislature turned down the proposal for retention of all its tuition.

h. As to continuing deadlock over how to allocate the cost of higher education between tuition charges/fees and state subsidies, a recent report of the Task Force on Fair Share Funding for Higher Education recommended that the student share should range from 25 percent to 35 percent of the total cost.

13. Although public disclosure of agreed-upon budget revenue estimates through joint resolution of executive and legislative branch representatives has led to more careful and more conservative revenue forecasts, the Commonwealth failed to realize its <u>revised</u> tax revenue estimates in each of the past two years -- by $12 million for FY93 and by an estimated $90 million for FY94.

14. The Legislature made small scale changes in the Commonwealth's tax system, thereby adding slightly to the progressivity in a system already considered moderately

progressive by the state's Department of Revenue.

15. Extension of the 3 percent investment tax credit to leased equipment as well as purchased equipment for certain businesses will do little to improve economic competitiveness since most industrial states have granted similar tax breaks.

16. According to a reputable economist who chaired the recent Special Commission on Business Tax Policy in 1993 and served as Executive Director of the 1986-87 Special Commission on Tax Reform, Massachusetts should feel fairly comfortable when business tax burdens are measured against the long-run rate of return on business investment.

a. Based on simulations prepared for the Special Commission, tripling the Massachusetts investment tax credit and even reducing the state's corporate tax rate from 9½ percent to 7½ percent would affect the return on assets for representative firms by only 0.2 of a percentage point.

17. The current income tax burden of high-income residents is the most single ignored aspect of relative tax competitiveness in Massachusetts.

VII. RECOMMENDATIONS

1. Massachusetts should amend the state finance law to change the current budget process from the so-called statutory basis to one that is conducted in accordance with generally accepted accounting principles (GAAP), thereby identifying important financial trends in a more accurate and timely manner while creating confidence in the credit markets that the Commonwealth's accounts are structurally balanced.

2. There should be a phased-in program to eliminate the MBTA's GAAP liability by forward funding the T through a five-year loan. It is recommended that the loan be issued in 1997 when debt incurred for FY90 and prior year operating deficits will be paid off; the loan's interest cost should approximate that of current short-term loans being paid by the Commonwealth and MBTA to finance the T's operating deficit; in gradually eliminating this major unfavorable effect on fund balance, this step will ensure that state accounts are balanced on a GAAP basis.

3. The Commonwealth should create a more substantial hedge against future economic downturn by bringing its stabilization fund and unrestricted reserves to the nationally-recognized standard of 5 percent of total reserves.

4. A moratorium should be declared against creating new funds, followed by a reduction in the present number of such funds; moreover, the practices of authorizing dedicated revenue streams, appropriation-splitting, and end-of-year transfers without legislative sanctions should be discontinued.

5. The widespread budgetary abuse of avoiding normal procedures for changing the state's general laws by using "outside sections" should be restrained.

6. The current practice of joint revenue estimates publicly disclosed in the annual appropriation act by designated representatives of the executive and legislative branches, which has led to more careful estimating should continue.

7. Agency heads should be required to certify non-tax revenues to the House and Senate Ways and Means Committees, thereby strengthening the estimation procedure for non-tax revenues.

8) The Commonwealth should act to ensure that the gradually-increasing costs of corrections, water and sewer rate relief, and welfare reform when it comes, do not become the new budget busters of the nineties.

9) The Commonwealth should establish a stabilization fund for local government similar to the state's own stabilization fund and annually transfer a specific percentage of surplus to it in order to protect cities and towns from reduced state aid and lowered real estate values due to economic downturns.

10) The Commonwealth should change the formula for distributing lottery proceeds from one based on population and equalized valuations to one that recognizes community expenditure needs and fiscal capacity to support such needs; the change to the formula now in use for resolution aid should be easier to implement over the next five years when communities will be receiving larger amounts of lottery proceeds.

11) The Commonwealth should move to assume all remaining county costs, particularly corrections costs, a direction toward which it has been moving gradually since 1978.

12) The Commonwealth should move to improve its tax competitiveness by addressing the relatively high state income tax burden on professionals, managers, technical personnel, etc. It remains as the single most ignored aspect of this state's tax competitiveness.

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