


**AFTER THE REVOLT:
A FRAMEWORK FOR FISCAL RECOVERY**

**JOSEPH S. SLAVET
RAYMOND G. TORTO**

**John W. McCormack Institute of Public Affairs
University of Massachusetts at Boston
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FOREWORD

This paper is not designed to stake out an absolute and inviolable position on the future direction of Massachusetts. We do hope to generate further discussion about what we think is the most important aspect of state public policy -- what can help turn the Massachusetts economy around. Our basic premise is that a sound state fiscal policy is the sine qua non of the state's economic recovery.

The paper is a sequel to "After the Miracle: A History and Analysis of the Massachusetts Fiscal Crisis," which we issued in the Spring. Our intent in that earlier report was simply to present the background and indicate the consequences of the state's fiscal policies over the last few years.

"After the Revolt: A Framework for Fiscal Recovery" looks forward to the next few years and foresees escalating deficit spending if major policy changes are not undertaken. After reviewing the state's fiscal and economic conditions as of October 1, 1990, the report suggests a framework for fiscal recovery. Specific budgetary targets are offered. They will be tough medicine for the state to swallow, but we believe that difficult choices must be made, and that our options grow fewer the longer we wait.

We trust that this paper will be useful both to the incoming Administration and Legislature in designing a fiscal recovery program and to the citizens of the Commonwealth in judging the results.

We acknowledge our gratitude to Pat Mullen and Ruth Finn for bringing this effort to a successful conclusion.

Edmund Beard

Director

John W. McCormack Institute of Public Affairs

Dedicated to the memory of our colleague

KERMIT C. MORRISSEY

He really knew the numbers

EXECUTIVE SUMMARY

Despite the injection of new taxes in the amount of \$1.2 billion in fiscal 1991, and recently announced cuts in the budget of approximately \$464 million, the Commonwealth's fiscal condition -- irrespective of the outcome of CLT's petition -- is precarious. Although the political juices are flowing in Massachusetts, with an eye on November 6th, Massachusetts decision-makers have not faced up to the problems inherent in the long-term, structural spending patterns of the state's budget.

Our five-year budget projection indicates that if expenditure trends continue without dramatic restructuring -- particularly in the "non-discretionary" accounts -- the Commonwealth faces a steady rise in annual deficits that could exceed \$700 million in fiscal 1993 and may escalate beyond \$1.3 billion by 1995. Between now and 1995, total expenditures are estimated to increase by 32%, whereas revenues will grow by only 24%.

The most recent news from the Governor is that another round of employee layoffs must be initiated and that more services will be cut. Just a week ago the Governor announced that some MDC skating rinks will be closed along with one of the state's zoos; supportive services for certain people on welfare will be cut; and home care for the elderly, job training programs, prenatal and postnatal nutrition care and college scholarships would be substantially reduced. While these cuts are painful, it should be noted that this year's spending program is above last year's expenditure by approximately \$20 million.

What is driving this uncontrolled expenditure growth are the well-known, notorious "Budget Busters" -- Medicaid, MBTA (and regional transit) subsidies, Pensions, Group

Insurance and Debt Service. These items ate up 32.3% of the budget in 1990, and are projected to require 38% of the budget in 1991. By 1995 they are likely to claim 45.7%. For every dollar of new revenue the state receives between now and 1995, about 90 cents will be needed for these "Budget Busters."

Over the past three years, the Administration and Legislature have carried out a spending strategy that essentially balanced budgets by chipping away at the so-called discretionary items -- accounting for about half of the state's expenditure budget -- while treating the "budget busters," -- that consume two out of every five revenue dollars -- as legally-bound commitments requiring longer-term restructuring. To date, however, the enactment and implementation of fundamental changes in entitlements, contractual arrangements, subsidies and fixed charges have been limited to trimming their budget allocations around the edges -- to mandating gradual revisions through the use of outside budget sections -- while avoiding basic overhaul of their authorizing legislation.

This budget strategy has reduced state support for higher education from FY88 to FY91 by \$125 million, a cut of over 16%. Direct local aid is 12% below the level of two years ago. Home care for the elderly is down by 15% over 1989. There are substantially fewer subsidized day care slots than two years ago. Swimming pools were closed this past summer. Workforce reductions have particularly affected the Governor's office, the Legislature, several constitutional offices (Attorney-General, Auditor and Secretary of State), the Departments of Education, Communities and Development, Public Health and Public Works, and the state police.

Meanwhile, welfare recipients and state retirees have gone three years without cost-of-living adjustments. State employees have been working without collective bargaining agreements for 18 months, and state agency managers have not had salary increases since 1986.

Whether the CLT-High Tech petition is approved or not, the newly-elected Administration and Legislature will need the 6-month period from January-June 1991 to formulate and begin implementation of a detailed plan to restructure the state government, a plan that reflects the voters' concerns about the state's economy, taxes and out-of-control costs.

A fiscal recovery plan must contain the following ingredients if it is to demonstrate sensitivity to the public call for budget stability and relief from tax escalation, and if it is to avert the escalating deficits projected for the period, 1992-95.

1. Tax policy changes that are consistent with the competitive requirements of a state economy dominated by professional services, high technology, high-wage manufacturing and relatively high per capita personal income.
2. Future tax revenue estimates that reflect the recent gloomy predictions of the State Department of Revenue, and a general consensus of economists that the state's economy will begin to rebound slowly, at best, in late 1992.
3. Careful review of the state's "big-ticket" entitlement, contractual, subsidy and fixed charge expenditures, mainly "budget busters" that are driven by both statutory and budgetary policy constraints, and which hold the key to bringing the state's costs into line with available resources. These cannot be treated as "off the table," "non-discretionary" accounts.
4. New budgetary targets that cap annual percentage increases for the "budget busters" to add critical budgetary discipline to adopted and pending statutory and administrative reforms designed to curb the upward trend of "budget-buster" costs.

Our proposed fiscal recovery plan is tough medicine. It requires the following actions:

1. The Commonwealth, vulnerable to the potentially negative impact of recently-enacted sales and income tax increases on a stagnant economy, will initiate a 3-year gradual tax reduction plan totalling \$1 billion, effective on July 1, 1991 and ending on June 30, 1994, and containing the following steps:
 - a. Repealing the new sales tax on selective professional services to businesses and miscellaneous services.
 - b. Reducing prevailing income tax rates applicable to the 1993 and 1994 fiscal years and subsequent years by \$700 million in two steps, in order to restore the state's income tax rates to more competitive interstate levels.
2. Modifying annual property tax levy limits, and exempting debt service on newly-issued municipal debt from the limits (so that cities and towns would have access to an additional \$300 million a year in property taxes) and increasing the proportion of lottery receipts distributed to cities and towns by reducing the proportions for prizes and administration (bringing Massachusetts more into line with the experience of other large states).
3. Holding "budget buster" growth to percentage targets which reflect sharply reduced rates of increases in these accounts, while direct local aid is level funded and "all other" categories of state government are reduced by 2% for FY1992. As tax revenues are projected to improve by modest percentages during the next three years, budgets for direct local aid and "all other" categories should receive commensurate annual percentage increases.

The implications of such a drastic budget strategy for state services will be far-reaching. The alternative -- continued deficit spending -- will drag the state down to insolvency.

Whether or not the state's voters approve the CLT-High Tech initiative petition that would roll back up to \$2.3 billion in revenues and/or the petition of the Massachusetts Municipal Association that would require 40% of the state's largest taxes to be paid annually to cities and towns as local aid (thereby increasing local aid by \$1.2 billion in FY92), the next Administration and Legislature cannot avoid putting every expenditure "on the table" and raising tough questions about everything on which the state spends money, including:

Who should be eligible for Medicaid and for state support in nursing homes when the proportion of elderly in Massachusetts nursing homes is far above the national average and when Massachusetts spends much more than the national average for nursing home Medicaid patients?

How many of the Medicaid options should be provided when only a handful of states including Massachusetts provides a full menu of options?

When will mentally retarded patients be shifted from institutions to community-based facilities -- after more than 25 years of state policy emphasizing de-institutionalization?

Should MBTA fares, lowest of any urban transit system in the nation, be raised to cover at least one-third of MBTA expenses?

Should the state continue to operate zoos in view of its historically poor performance and limited resources?

Whether our current systems of two-year and four-year state colleges may require institutional consolidation in view of the state's declining college-age population?

Is a publicly subsidized maritime academy warranted when the state no longer has significant maritime economic interests?

Is a state subsidy for professional education of veterinarians in a private institution justifiable?

Should the missions of a sworn Capitol Police force, essentially providing building security services, be re-examined in the context of escalating demand for more crime-fighting police officers?

Are the number and distribution of 70 district courts outdated in light of significant changes in population densities, transportation access and caseloads?

Until now the tendency has been to reduce budgets by merely doing less or having fewer service recipients. A number of explanations have been offered as to why major reforms cannot be undertaken, i.e.: it will take more money to save money; the Legislature will not amend the authorizing statute; the affected client group is too large and too vocal. Such excuses wear thin as the state's economy flounders.

AFTER THE REVOLT: A FRAMEWORK FOR FISCAL RECOVERY

Will the Miracle Ever Revive?

Why prepare an epilogue to the Massachusetts drama, "After the Miracle," as we had promised in May? An epilogue is rendered after the conclusion of a play. The curtain for the final act of this political tragedy cannot come down until the state's newly-elected constitutional officers and members of the General Court have taken their oaths of office in January 1991.

In a real sense, the final curtain cannot come down because despite the Governor's recent optimistic proclamation that revival of the miracle had begun, the Commonwealth's short-term fiscal problem has not been resolved. In the absence of firm fiscal discipline, state spending for big-ticket items continues to spin out of control. State tax revenues defy more prudent forecasts as indicated in collections for July-September of the new fiscal year.

Moreover, long-term prospects for economic and fiscal recovery are clouded by the distinct possibility that the state's voters might approve initiative petitions on November 6, 1990, the fiscal impact of which will severely exacerbate the dimensions of the state's current problem. Meanwhile, the state primary election returns of September 18th provided clear-cut evidence that a majority of voters were unhappy with the incumbent political establishment and identified state taxes and the economy as their leading concerns.

Recap: FY 1987-90

Lagging Economy. The latest numbers dramatize the precipitous recent decline in the state's economy:

1. The unemployment rate in Massachusetts has climbed to 6.7% (August, 1990) compared with 3.7% only 16 months before.

2. Employment growth in Massachusetts during the 12-month period between July 1990 and the year before actually declined by 3%, reflecting a loss of over 90,000 jobs, compared with an employment growth rate of about 2% a year since the early 1980s.

3. Growth in the state's total personal income for the first quarter of 1990 was below personal income growth for the nation as a whole, a new and disturbing trend; for almost a decade, per capita personal income in Massachusetts was substantially above the national average.

4. Forecasts of growth rates for personal income, employment, unemployment, housing starts and net outmigration, compounded by higher levels of inflation and soaring oil prices as a result of the Mideast crisis and the steep plunge in consumer confidence as shown by weak retail sales, indicate that the Massachusetts economy is not likely to revive until late 1992 at the earliest.

Deteriorating State Finances: An Overview. The state's finances over the past four years (FY 87-90) have had all the earmarks of a floating "craps game." On the spending side, authorizations have been a crazy quilt of line items in the annual general appropriations act, off-budget spending of retained revenues, spending from continuing accounts, (authorizations carried over from the prior year), supplementary appropriations, deficiency appropriations and non-appropriated distributions, offset from time to time by allotment withholdings, appropriation vetoes, and appropriation reversions.

The revenue side of the state's fiscal planning process resembles a continuing "shell game," conducted quarterly or more frequently as actual tax revenue collections fall behind original estimates and constitutional requirements for budgetary balance dictate knee-jerk revisions of revenue estimates plus a resort to the use of fund balances, inter-fund transfers and accounting adjustments to bolster available receipts and balance the books. It should be noted, moreover, that the state's finance statutes do not require legislative adoption of the state's revenue estimates as part of the annual

fiscal plan as they do require definitive legislative appropriations to spend. Further confusing the tax revenue forecasting dilemma is the current mechanism for revenue estimation, which is legally under control of the Department of Administration and Finance, whose track record, based on technical advice and counsel from the State Department of Revenue and the Advisory Board on Revenue Resources and the State Economy, has been far off the mark since June 1987. (See Table 1.)

The Commonwealth has lost heavily in these floating craps and shell games over the past four years. Between the 1987 and 1990 fiscal years, on the budgetary basis of accounting as defined by current state finance law, the state's principal operating funds (general, local aid and highway) have been in the red by amounts ranging from \$300 million a year in 1987 (equivalent to 3% of total revenues) to over \$1.2 billion (10% of total revenues) in 1990. The annual budgetary deficit during this period skyrocketed by over 300%. Although revenues between the 1987 and 1990 fiscal years grew by \$1.3 billion or almost 12%, expenditures escalated by \$2.2 billion or over 19%. (See Table 2.)

To close the \$1.8 billion in gaps between operating revenues and expenditures over the last two years, to cover an accumulation of unpaid Medicaid bills of past years (totaling over \$600 million) and to finance a Supreme Judicial Court judgment against the state in tax cases (\$23 million), the Commonwealth has borrowed to date and will be borrowing during the current fiscal year a total of \$2.4 billion in notes and bonds. This debt, which will not pay for any useful state assets, will cost over \$600 million in interest expense, bond insurance premiums (to enhance sale of the state's bonds) and letters-of-credit fees (to secure the payment by credit-issuing banks of principal and interest due on notes and bonds in case of Commonwealth default). The \$600 million would have been more than enough to meet the state's 10% federal matching requirement for the \$5 billion Central Artery/Third Harbor Tunnel Project.

Not only has Massachusetts been forced to rely increasingly on above-average interest rates, bond insurance and letters of credit to market note and bond issues in an

TABLE 1
TAX REVENUE FORECASTS AND RESULTS
 FY 1987-1990

Fiscal Year	Date of Original Forecast	Original Estimate % Change Over Prior Year	Date of Revisions	Revised Estimate % Change over Prior Year	Actual % Change Over Prior Year
1987	June 1986	+ 7.6	August 1987	+ 6.2	+ 8.3
1988	June 1987	+ 7.4	August 1987	+ 6.8	+ 2.1
1989	June 1988	+10.9	December 1988	+ 7.2	+ 6.5
			May 1989	+ 6.0	
1990	July 1989	+ 7.0	August 1989	+ 5.1	- 3.6
			November 1989	+ 0.7	
			April 1990	- 1.9	

TABLE 2
FINANCIAL RESULTS, 1987 - 90 FY, STATE'S PRINCIPAL OPERATING FUNDS*
(in millions)

	FY 1987	FY 1988	FY 1989	FY 1990	% Change 1987 - 90
Actual Expenditures	\$ 11,249.2	\$ 12,032.5	\$ 12,812.1	\$ 13,451.0	+ 19.6
Actual Receipts	10,948.9	11,641.8	12,255.0	12,238.8	+ 11.8
Deficiency of Actual Receipts Over Actual Expenditures	(300.3)	(390.7)	(557.1)	(1,212.2)	+ 303.7

Note: Data presented on budgetary accounting basis.
*General Fund, Local Aid Fund, Highway Fund.

Source: Preliminary Official Statement (September 15, 1990), accompanying initial prospectus for Massachusetts dedicated income tax bonds, Fiscal Recovery Loan Act of 1990.

effort to offset the lowest-in-the-nation state credit rating, it has also been forced to pledge and dedicate proportions of tax receipts as further guarantees of debt repayment for deposit in euphemistically-labelled trust funds from which the debt service would be paid. The Commonwealth Liability Reduction Fund and the Medical Assistance Liability Fund were established in the 1990 fiscal year to receive deposits of the temporary income tax increase of 15% on certain salaries and wages. The Commonwealth Fiscal Recovery Fund was established in the 1991 fiscal year to receive deposits equivalent to 15% of all personal income tax collections.

FY 1990: The Gory Details. If the major fiscal decisions and modifications for the 1990 fiscal year were plotted on a graph, the line would look like a giant roller coaster. Spending authorizations and revenue adjustments bolted wildly between January 25, 1989 when the Governor submitted his original budget proposal of \$13.5 billion and August 1, 1990, when the Governor signed the largest deficit funding bailout bill in the history of the Commonwealth, "An Act Providing for Certain Fiscal Requirements of the Commonwealth" (c. 151 of the Acts of 1990).

In authorizing the so-called Commonwealth Fiscal Recovery Loan bond issues of \$1.4 billion for financing the FY 1990 bondable deficit of \$1.3 billion in the state's general and local aid funds and for financing another \$126 million in unpaid Medicaid bills of prior fiscal years, this statute finally made possible the closing of the Commonwealth's accounts for 1990, thereby ending the wild revenue and expenditure gyrations. (See Table 3 for a fiscal chronology of the 1990 fiscal year.)

State Fiscal Plan for 1991: Replay of 1990?

Tax Fix. Two weeks before he signed the unprecedented \$1.4 billion bond authorization bill, which finally resolved the 1990 fiscal problem, the Governor approved a record-breaking tax revenue increase measure, culminating nine months of rancorous

TABLE 3
A CHRONOLOGY OF FISCAL DECISIONS, FISCAL YEAR 1990

January 1989 -	Governor submits spending program of \$13.5 billion, based on projected tax revenue growth of \$650 million, or 7.4% over prior year and new taxes of \$600 million.
July 1989 -	State Department of Revenue recommends lowering of tax revenue estimates to growth of 5.1%.
July 1989 -	Legislature enacts a general appropriations bill of \$12.650 billion, rejecting proposed spending and tax increases and reflecting recent downturn in tax revenue collections. Governor reduces authorized spending by \$490 million to \$12.1 billion through appropriation vetoes, budgetary language vetoes, and expenditure allotment withholdings based on arguments that Legislature had under-funded several critical budget line-items while overestimating tax revenue collections.
August 1989 -	Executive Office of Administration and Finance (EOAF) reduces original revenue estimates by \$170 million.
October 1989 -	Governor submits revenue-enhancement and budgetary-saving legislative package totalling \$184 million and withholds additional expenditure allotments totalling \$153.8 million, while reiterating support for original tax increases of \$600 million.
December 1989 -	Legislature passes Budget Control and Reform Act, reducing estimated deficit by \$350 million and containing final appropriations for 1990 fiscal year.
January 1990 -	After selective item vetoes and disapproval of certain budgetary language, Governor signs final appropriation legislation, leaving the Commonwealth with an unresolved budgetary shortfall of over \$500 million and total appropriations estimated at \$12.5 billion.
July 1990 -	EOAF estimates total spending for 1990 fiscal year at \$13.3 billion and tax revenue at \$6.6 billion, 3.3% below prior year collections. Sales taxes down by 5.2%, corporate taxes down by 19.3%, income taxes up by 4.2%. Legislature enacts bond authorization of \$1,421,200,000 to fund 1990 bondable deficit of \$1.3 billion and to pay for \$126 million in unpaid past Medicaid bills. Bonds to be redeemed by December 31, 1997 and debt service to be secured by dedicated income tax revenues (15% of total).

legislative debate. This tax compromise was designed to provide funds over the next seven years to cover debt service requirements on the state's Fiscal Recovery Loans (funding the 1990 bondable deficit) and to provide sufficient additional tax revenues to balance the adopted FY 1991 spending program, then estimated at \$13.8 billion. Approved by only 4 votes in the House of Representatives and by 5 votes in the Senate, the tax legislation, according to EOAF estimates of August 15, 1990, will result in additional revenue from higher income, sales and gasoline taxes of \$1.162 billion (plus \$50 million in accelerated corporate tax payments) in the 1991 fiscal year and \$1.680 billion during the 1992 fiscal year. For FY 1991, however, 83% of the estimated additional tax yield will not be realized until the latter half of the fiscal year.

Below is a summary of the principal components of the new tax program:

-- Personal income tax rates are increased retroactively to January 1, 1990. On interest (excluding Massachusetts bank interest), dividends and capital gains,¹ the tax rate is increased from 10% to 12%; on all other types of income, the tax rate for 1990 is increased from 5.75% to 5.95%.²

-- For 1991, the income tax rate of 5.95 will increase to 6.25% and revert in 1992 and subsequent years to 5.95%.

-- Sales excise tax statutes are amended to apply the current 5% tax rate effective December 1, 1990, to legal, accounting, engineering and architectural services provided to most businesses in amounts larger than \$20,000 per year and to a number of general services, mainly applicable to businesses.

-- The motor fuel or gasoline tax is increased effective July 28, 1990 by six cents (from 11 to 17 cents) and by another four cents (to 21 cents) on January 1, 1991.

¹The current deduction of 50% of net capital gains is retained, resulting in an effective capital gains rate of 6%.

²The tax rate for unemployment compensation, alimony, Mass. bank interest, rental income from real estate, pension and annuity income and IRA/Keogh distributions is maintained at 5%.

A breakdown of estimated additional revenues by tax source (excluding \$5.0 million in accelerated corporate taxes) is shown below:

	<u>FY91</u>	<u>FY92</u>
	(in millions)	
Income Tax	\$742.0	\$1,037.0
Sales Tax	192.6	376.2
Motor Fuel Tax	177.0	263.0

The fiscal 1991 budget approved by the Legislature had been based on projected tax revenues of \$9.748 billion. Early in September the Secretary of Administration and Finance scaled down these tax revenue estimates to \$9.594 billion, a reduction of \$154 million in the face of the continuing slide in tax collections during July and August, 1990 totalling about \$30 million as compared with the benchmarks originally established by the State Department of Revenue. Late in September, reacting to projections of a worsening state economy, the State Department of Revenue further modified the revised estimate to a new total of \$9.227 billion.

There are a number of factors that render tenuous even the latest tax revenue projection of \$9.2 billion for the current fiscal year, not only because of the sliding economy, but because of the sales tax extension to services:

1. Adding the sales excise tax to broad categories of professional services is a brand new tax venture for Massachusetts. State Department of Revenue forecasters do not have actual collection experience to guide them in their analysis of projected yields.
2. The \$20,000 exemption opens the door to creative techniques that lawyers, accountants, engineers and architects and their clients may devise to evade the sales tax.

Moreover, the tax yield from professional services may be adversely affected by the administrative nuisance of the intricate exemptions -- the tax applies to businesses within the state but not to services for out-of-state clients, raising the issue of client confidentiality betrayal in the case of legal services; services for individuals are exempt; exemption of the first \$20,000 of bills could result in taxpayer confusion, i.e. a small business has legal bills totalling \$25,000 from two law firms, one for \$15,000 and the other for \$10,000: how will the \$5,000 in legal services subject to the tax be prorated between the two firms?

3. Despite the split-decision advisory opinion of the Supreme Judicial Court that extending the sales tax to services was constitutional, several legal challenges have been launched by professional associations of attorneys and accountants and by a statewide taxpayers group which argue that the state constitution limits the sales tax to "commodities" and which question the constitutionality of extending the corollary "use" tax to services. In addition, a major metropolitan newspaper is disputing a separate amendment of the sales tax statute that takes away from newspapers the exemption of the sales tax from the purchase of equipment used in newspaper publishing, arguing that the tax was unconstitutional and discriminatory, in violation of the freedom of the press under the state and U.S. constitutions.³

The Revenue Plan. According to revised estimates for the 1991 fiscal year made by the Secretary of Administration and Finance late in September 1990, total revenues of the state's principal operating funds, including estimated additional taxes from the recently-enacted tax bill, will total \$13.288 billion, as detailed in Table 4.

The initial projected tax revenues for FY1991, made in August but excluding estimated yields from the new tax increases and reflecting continued slowing of the economy, had been based on the following assumptions of the state's Advisory Board of

³Only 3 other states (Hawaii, South Dakota and New Mexico) apply their sales taxes to legal services.

TABLE 4
ESTIMATED STATE REVENUES, FY 1991
(in millions)

<u>Tax Revenues</u> ¹	<u>Estimates</u> *
Income Tax	\$5,183.7 ⁴
Sales Tax	1,982.6
Corporate Excise	602.0
Non-Business Corporate ²	407.7
Other Excises ³	1,051.5
Total Taxes	<u>\$ 9,227.5</u>
 <u>Non-Tax Revenues</u>	
Federal Reimbursements	\$ 2,014.4
Departmental and Other Revenues	1,275.2
Interfund Transfers & Other Sources	770.9
Total Non-Tax Revenues	<u>\$ 4,060.5</u>
Total Revenues	<u>\$ 13,288.0⁵</u>

Source: Executive Office of Administration and Finance.

* As of September 30, 1990.

¹ Tax revenues exclude \$56.6 million in other state taxes accounted for in other budgetary funds.

² Includes bank, insurance and public utility issues.

³ Includes motor fuels, cigarette, estate, alcoholic beverage, room occupancy, deeds and miscellaneous excises.

⁴ Excludes \$444.5 million estimated to result in FY90 from temporary increase in income tax dedicated to Commonwealth Liability Reduction Fund (covering FY89 deficit) and Medical Assistance Liability Fund (covering payment of prior year Medicaid bills), and \$293.9 million estimated to result in FY91 from income tax increase dedicated to Commonwealth Fiscal Recovery Loan Fund.

⁵ Excludes \$1.3098 billion for prior-year debt financing.

Revenue Resources and the State Economy: income tax revenues would increase by a modest 3%, sales tax revenues would grow only slightly by 0.7%, while business corporation tax revenues would fall by 9.3% and tax revenues from banks by 18.7%. The September downward revisions totalling \$464 million in tax revenues mean that the original assumptions have been abandoned.

The Spending Plans. The legislative disarray that characterized the debate in the General Court from May to mid-July 1990 over state tax policy spilled over into simultaneous and subsequent disagreements over spending totals, allocations, priorities and savings for the 1991 fiscal year.

Legislative activity on the Governor's budget for FY1991 did not intensify until May because, unlike past years, the Governor had refrained from recommending additional taxes and the emphasis was on crafting a tax revenue package that would not only meet the financing requirements for the prior year's deficit but would close the gap between eroding tax revenues and built-in spending increases for the 1991 and subsequent fiscal years.

The Governor's proposed budget for 1991, submitted to the General Court on January 24, 1990, totalled \$12.9 billion. It had been based on the assumption of no tax increases, although it did include a "current service" budget as an expression of his distaste for the no-tax budget that he called "a disgrace". Budgetary ping-pong between the executive and legislative branches began in May, 1990 when the House of Representatives passed and sent to the Senate a budget of about \$13.9 billion (including anticipated debt service in FY1991 for the forthcoming deficit bond authorization) and based on its previous passage of collateral increases in income and gasoline taxes.

In June, 1990, the Senate enacted a budget of \$13.7 billion but substituted a tax package that shifted the emphasis from higher income taxes to extending the state sales tax to services. After both branches of the Legislature had enacted a compromise tax bill providing for an estimated \$1.2 billion in increased income, sales, and gasoline taxes

for FY1991 and an additional \$1.8 billion for FY1992 early in July, a budget conference committee late in July recommended an alternative budget based on the enacted tax bill. Whereupon the House of Representatives, sensitive to charges that the budget was still several hundred million dollars out of balance, erupted in revolt over the budget conference committee's report, finally rejecting it.

Opposing further tax revenue adjustments offered by the House Committee on Ways and Means, the conference committee recommended across-the-board decreases of 4% in so-called discretionary budgetary accounts, thereby cutting appropriation requests by another \$265 million and enacting on July 28th a total budget of \$13.967 billion, which included \$167 million in additional anticipated spending provided for in the overall budgetary plan for FY1991.⁴ The Governor gave final approval on August 1 to the 1991 general appropriations act after vetoing 34 budgetary line items, disapproving the language in four items and returning four budget sections to the Legislature for amendment.

The ink on the Governor's signature was hardly dry, however, when disappointing tax revenues in July, down by 1.6% from the same month in 1989, and again in August, when tax collections were over \$27 million or 4.6% below the estimates for that month (not the projected increase of 4.8% over August 1989), prompted the Governor to order further budget reductions of \$154 million on September 4, thereby reducing the state's spending plan for FY91 to \$13.8 billion. On September 25th, the Governor ordered additional reductions in appropriations totalling \$310 million, acting upon the pessimistic outlook made by the State Department of Revenue as to economic trends and their impact on future tax revenues. The latest tax revenue estimates reflect a decrease of

⁴To meet operating expense requirements in July, the Legislature passed two interim appropriation acts and temporary notes were issued to provide the necessary cash. The 4% cut was applied to \$6.8 billion of proposed spending and excluded so-called legally-mandated expenditures and reimbursable expenditures.

about \$374 million or 4.4% from the baseline tax revenue total of \$8.5 billion collected in the past year.

Little seems to have changed. The state's budget and tax revenue pictures are still in disarray.

Another Operating Deficit? The state's 1991 spending plan as of October 1, 1990 totals \$13,451.0 million, while revenues are estimated at \$13,288.0 million, indicating a deficit of \$183.0 million after only three months into the 1991 fiscal year. Tax collections in July and August 1990 were \$30 million below the benchmarks of the State Department of Revenue.

In September tax collections fell short of revised benchmarks by another \$15 million as sales tax and corporate tax proceeds continued to lag badly behind revised projections. And if past experience is repeated, supplementary appropriations could add substantially to the state's current spending plan.

The state's short-term fiscal problem is due to the fact that the economy no longer generates tax revenue growth. The state's more serious longer-term fiscal dilemma is attributable to a state spending pattern that grows faster than its resources.

A Grim Outlook for the Future

Using the most recent (October 1, 1990) revenue and expenditure estimates for the 1991 fiscal year as our baseline for projecting state revenues and expenditures over a 5-year period (FY91-95), we have prepared Table 5 to show the dimensions of the state's structural gap between estimates of reasonable levels of revenue and tax growth and projected expenditures for the next four years.

The Senate Committee on Ways and Means, as part of its FY1991 budget recommendations released on June 1990, prepared a 5-year budget projection (FY91-95) based on assumptions that additional revenues would not be forthcoming and that spending reductions would not be made. According to the projections of the

TABLE 5
MASSACHUSETTS BUDGET PROJECTIONS
(in millions)
FISCAL YEAR

	Revised Preliminary 1990 ¹	1991	1992	1993	1994	1995
Revenues						
Tax Revenues	\$8,517.6	\$9,227.5	\$9,921.1	\$9,987.9	\$10,287.5	\$11,110.5
Federal Reimbursements	1,774.4	2,014.4	2,235.0	2,476.4	2,738.9	3,032.0
Departmental Revenue & Other	1,145.6	1,275.2	1,303.2	1,320.1	1,334.6	1,350.6
Interfund Transfers & Other	801.3	770.9	846.9	869.8	893.8	923.8
Total	\$12,238.9	\$13,288.0	\$14,177.2	\$14,654.2	\$15,254.8	\$16,416.9
Expenditures						
State Aid	\$2,939.1 ²	\$2,606.6	\$2,613.3	\$2,615.0	\$2,722.2	\$2,869.2
Medicaid	2,120.6 ³	2,671.3 ⁴	3,072.0	3,532.8	4,062.7	\$4,672.1
Public Assistance	1,000.9	1,030.3	1,100.9	1,166.6	1,227.3	1,288.0
Debt Service	769.6	860.8	940.0	1,019.0	1,048.5	1,074.7
Pensions	639.3	705.9	750.4	796.9	847.1	900.5
Group Insurance	433.4	479.8	551.8	634.6	729.8	839.3
META & Regional Transit	354.5	411.2	463.4	517.6	577.6	646.8
All Other	5,163.6	4,705.1	4,696.0	5,089.0	5,267.5	5,492.7
Total	\$18,451.0	\$18,471.0	\$14,398.6	\$16,371.5	\$18,502.7	\$17,764.3
Surplus or (Deficit)	(\$6,212.1)	(\$183.0)	(\$2,221.4)	(\$1,717.3)	(\$1,247.9)	(\$1,357.4)

Source: Preliminary Official Statement accompanying proposed state bond issue, September 15, 1990.

¹ Reflects revenue and budget revisions ordered by Governor during September 1990; data for FY90 and FY91 from revised Preliminary Official Statement (September 27, 1990), Tables on p.29 and p.45.

² Includes \$210 million in previously withheld c.70 aid.

³ Excludes \$486 million in retroactive rate adjustments and prior year date of service spending supported by off-budget financing and a dedicated revenue stream.

⁴ Includes \$126 million authorized by c.151, Acts of 1990, for retroactive Medicaid provider settlements.

Committee, total revenue would increase by an average of 5.5% each year and tax revenue by an average of 6.0% each year. Our own revenue projections are similar - 5.9% annually for total revenue and 5.1% each year for tax revenue, but we have based our estimates for the FY91 baseline year and for FY92 on the expected yields from the recently-enacted tax legislation.

As for expenditures, the Senate Committee estimated that they would grow by a total of 7.9% in FY91 and by an average of 6.4% each year from FY92 to FY95 if current levels of service were to be maintained. Our expenditure projections are based on more recent figures for the FY91 base year than were available to the Committee. These reflect budget reductions totalling over \$700 million for FY91 but maintain the assumption about current levels of service. According to our projections, total expenditures would grow by an average of 6.4% between the 1991 and 1995 fiscal years. For major expenditure categories, including the budget busters, we have adopted the Committee's year-to-year percentage estimates and applied them to our FY91 base period. These indicate that Medicaid and Group Insurance, for example, will increase by an annual average of 15%, MBTA subsidies by over 11%, pensions by 5.5%, public assistance and debt service by 5%, "all other" expenditures by over 3.4% and direct local aid by 2%.⁵

Thus the 5-year budget projections in Table 5 reveal that if expenditure trends continue without drastic change, particularly the steep upward trends in so-called non-discretionary accounts, mainly in the large budget busters, the Commonwealth faces a steady rise in annual deficits that could exceed \$700 million by 1993 and escalate beyond \$1.3 billion by 1995. Between the 1991 and 1995 fiscal years, total expenditures are estimated to increase by 32% whereas revenues will grow by only 24%, even with the comprehensive tax increase package that will provide over \$1.6 billion in additional estimated revenues in the 1992 fiscal year.

⁵See the Senate Committee on Ways and Means, "Fiscal Year 1991 Budget Recommendations, Budgeting for Economic Recovery", June, 1990, p. 1-9-11.

"Budget Buster" Termites: Still Gnawing Away

That the so-called budget-busters were growing at extraordinary annual rates is evident from the percentage changes for the FY87-91 period, as shown in Table 6.

Table 6
Estimated Expenditure Trend by Major Category

FY 1987-91

Expenditure Category	<u>%Overall Change</u>	<u>% Average Annual Change</u>
Direct Local Aid	+ 0.2%	+ .05%
Medicaid	+ 83.8%	+ 20.9%
Group Health Insurance	+ 100.3%	+ 25.1%
Public Assistance	+ 34.0%	+ 8.5%
Debt Service	+ 64.2%	+ 16.0%
Pensions	+ 13.4%	+ 3.4%
MBTA	+ 68.4%	+ 17.1%
All Others	<u>+ 1.9%</u>	<u>+ 0.5%</u>
Total	+ 19.7%	+ 4.9%

Moreover, as indicated in Table 7, the FY91 budget allocations for Medicaid, group insurance for state employees and retirees, debt service on short-term and long-term borrowing, employee pension costs for state employees, and state subsidies to the Massachusetts Bay Transportation and regional transit authorities will increase by over \$780 million or 19% over the prior year (FY90) as contrasted with spending for all other major budget categories (direct local aid, public assistance and "all other"), the total budgets of which will decline by over \$760 million or 8.4%.

If our expenditure projections hold up, Medicaid could approach \$4.7 billion by the 1995 fiscal year, an extraordinary increase of 220% over 1987 costs. Group health insurance is expected to exceed \$800 million by 1995, or 250% over the 1987 level. Debt service could climb above \$1 billion, more than double the cost in 1987. Subsidies for the MBTA and regional transit authorities would grow to \$647 million, or 165% above the 1987 expenditure. By 1995 pension expenditures will hit \$900 million, 72% above the cost in 1987. Between the 1987 and 1991 fiscal years, the rising cost of pensions had slowed down to an average increase of just over 3% a year by adoption of a fully-funded pension system the annual costs of which had been spread out over 40 years, with lower costs during the early years of the new system.

Although a myriad of outside budget sections in appropriation legislation of the last two years has been enacted to curb the upward spiral of the budget busters, because of laggard implementation of measures to control these costs, exacerbated by federal and state laws and standards that impede cost control efforts, and the reality that cost containment of the larger budget busters require longer periods to realize reductions, the budget busters are expected to continue their dramatic rise.

In fiscal 1991 the budget busters account for 38.1% of total spending compared with 32.3% in the prior year. By 1995, they are likely to claim 45.7% of the total. The budget busters are projected to increase by 58.6% by FY95 while all other accounts, including direct local aid and public assistance, will rise by only 15.7%. By 1995, Medicaid will absorb over 26% of the state's total spending compared with 20% in fiscal 1991. By contrast, cities and towns will see their direct local aid decline from 19% of total state spending this year to 16% in fiscal 1995. (See Table 7.)

Appropriation levels for the current (1991) fiscal year demonstrate that the Governor and Legislature have ignored the warnings of the Senate Committee on Ways and Means that budget buster authorizations must not only be drastically reduced to balance the budget even after taxes are raised, but their upward spending rates must be

TABLE 7
PROJECTED MASS. STATE SPENDING GROWTH. "BUDGET BUSTERS" vs. OTHER ACCOUNTS
(in millions)

<u>Budget Category</u>	Preliminary FY1990	FY1991	FY1995	% Change FY91 - 95	Average Annual % Change
<u>"Budget Busters"</u>					
Medicaid	\$2,120.6	\$2,671.3	\$4,672.1	+ 74.9	+ 15.0 %
Group Insurance	433.4	479.8	839.3	+ 74.9	+ 15.0
Debt Service	769.6	860.8	1,074.7	+ 24.8	+ 5.0
Pensions	669.3	705.9	900.5	+ 27.6	+ 5.5
MBTA & Regional Transit	354.5	411.2	646.8	+ 57.3	+ 11.4
Sub-Total	\$4,347.4	\$5,129.0	\$8,133.4	+ 59.6	+ 11.7 %
% of Total	32.3%	38.1%	45.7%		
<u>Other Accounts:</u>					
Direct Local Aid	\$2,939.1	\$2,606.6	\$2,869.2	+ 10.1	+ 2.0
Public Assistance	1,000.9	1,030.3	1,288.0	+ 25.0	+ 5.0
All Other	5,163.6	4,705.1	5,493.7	+ 16.8	+ 3.4
Sub-Total	\$9,103.6	\$8,342.0	\$9,650.9	+ 15.7	+ 3.1
% of Total	67.7%	61.9%	54.3%		
Total	\$13,451.0	\$13,471.0	\$17,784.3	+ 32.0	6.4%

Source: Adapted from Table 1, p. 1-9, "Budgeting for Economic Recovery", Fiscal Year 1991 Budget Recommendations, The Senate Committee on Ways and Means, June 1990.

controlled lest inappropriately large reductions become necessary in other budget accounts and there be no budgetary margin for dealing with future state needs.

A Proposed Fiscal Recovery Plan

What is crystal clear from the analysis in this report, which corroborates the conclusions of the Senate Committee on Ways and Means, is that the Commonwealth faces a steadily deteriorating fiscal condition over the next five years even if the voters reject the Committee for Limited Taxation (CLT)--High Tech Council initiative petition to roll back state taxes and fees to the June 30, 1988 levels. The evidence is mounting that the recently-created record-breaking tax package along with a second round of heavy borrowing to fund accumulated operating deficits will not achieve the state's goal of restoring badly-needed stability to state finances in the near term.

Whether the CLT-High Tech petition is approved or not, the newly-elected Administration and Legislature will need the 6-month period from January-June 1991 to formulate and initiate implementation of a detailed plan to re-structure the state government, a plan that reflects the voters' concerns about the state's economy, taxes and out-of-control costs, and that takes into consideration the tax revenue collections for the last quarter of calendar 1990 and tax revenue projections.

A fiscal recovery plan must contain the following ingredients if it is to demonstrate sensitivity to the public mood for budget stability and relief from tax escalation, and if it is to avert the escalating deficits projected for the 1992-95 fiscal years:

1. Tax policy changes that are consistent with the competitive requirements of a state economy dominated by professional services, high technology, high-wage manufacturing and relatively high per capita personal income.

2. Future tax revenue estimates that are predicated on the recent gloomy predictions of the State Department of Revenue and on a general consensus of economists that the state's economy will rebound slowly.

3. The state's big-ticket entitlement, contractual, subsidy and fixed charge expenditures, mainly budget busters that are driven by both statutory and budgetary policy constraints, hold the key to bringing the state's costs into line with available resources, and must be the major focus of future short-term and longer-term budget planning. These non-discretionary accounts can no longer be "off the table."

4. New budgetary targets that cap annual percentage increases for the budget busters are needed to reinforce budgetary discipline contained in adopted and pending statutory and administrative reforms designed to curb the upward trend of budget-buster costs.

Our proposed fiscal recovery plan, shown in Table 8, is tough medicine. It abides by the above criteria and reflects the following assumptions:

1. The Commonwealth, vulnerable to the potentially negative impact of recently-enacted sales and income tax increases on a stagnant economy, will initiate a 3-year gradual tax reduction plan totalling \$1 billion effective on July 1, 1991 and ending on June 30, 1995 which contains the following steps:

a. Repealing the new sales tax on selective professional services to businesses and on miscellaneous services, thereby reducing tax revenue estimates for FY92 and subsequent years by about \$350 million and eliminating a new tax that attacks the heart of the state's economy.

b. Reducing prevailing income tax rates applicable to the 1993 and 1994 fiscal years by \$700 million (by \$350 million each year) in order to restore the state's income tax rates on both earned and unearned income to more competitive interstate levels.

2. Modifying annual property tax levy limits and exempting debt service on newly-issued municipal debt from the limits so that cities and towns would have access to an additional \$300 million a year in property taxes and increasing the proportion of lottery receipts distributed to cities and towns by reducing the proportions for prizes and administration (bringing Massachusetts more into line with the experience of other large

TABLE 3
PROPOSED FISCAL RECOVERY PLAN FOR MASSACHUSETTS
(in millions)
FISCAL YEAR

<u>Revenues</u>	1991	1992	1993	1994	1995
Tax Revenues	\$9,227.5	\$9,442.1	\$9,537.9	\$9,987.5	\$10,387.0
Federal Reimbursements	2,014.4	2,235.0	2,476.4	2,738.9	3,032.0
Departmental Revenue & Other	1,275.2	1,303.2	1,320.1	1,334.5	1,350.3
Interfund Transfers & Other	770.9	846.9	869.3	893.3	923.3
Total	\$13,288.0	\$13,827.2	\$14,304.2	\$14,954.3	\$15,693.4
<u>Expenditures</u>					
Direct Local Aid	\$2,606.6	\$2,606.6	\$2,684.2	\$2,791.6	\$2,931.2
Medicaid	2,671.3	2,858.3	3,058.4	3,272.5	3,501.6
Public Assistance	1,030.3	1,061.2	1,093.0	1,147.6	1,205.0
Debt Service	860.8	940.0	1,019.0	1,048.5	1,074.7
Pensions	705.9	752.2	798.8	849.1	902.6
Group Insurance	479.8	513.4	544.2	576.8	611.1
MBTA & Regional Transit	411.2	431.7	453.3	476.0	499.8
All Other	4,705.1	4,611.0	4,653.3	4,792.7	4,940.7
Total	\$13,471.0	\$13,774.4	\$14,304.2	\$14,954.8	\$15,667.0
Surplus or (Deficit)	(\$183.0)	\$52.8	—	—	\$26.4

states).⁶ These changes would offset the declines in direct local aid in FY90 and FY91 and proposed level-funding of direct local aid in FY92.

3. Table 9 shows what we propose as percentage targets for each budget category in each of the years, FY92-95. We emphasize that the targets are relative to recent trends and can be modified to meet alternative value judgements as to allocation of resources.

4. The proposed budget for the 1992 fiscal year in our recovery plan is the most difficult to balance. It is based on the following assumptions: (a) that there will be no growth in the tax revenue baseline of \$8.5 billion for FY91, (b) that the estimated additional yield of \$564.6 million from the higher income and gasoline taxes mandated by the 1990 tax legislation will be collected plus an estimated 8% increase in nontax revenues, but (c) these revenue additions will be offset by our proposed repeal of the sales tax on services.

⁶In Massachusetts (for calendar 1989), 30.2% of the \$1.5 billion from lottery receipts represented net income (after deductions of prizes, commissions and administrative expenses), which is well below the percentage of lottery net income for the U.S. as a whole (38.9%) and for such large states as California (38.5%), N.Y. (43.1%), Florida (39.5%) and Pennsylvania (41.0%).

TABLE 9
PROPOSED ANNUAL PERCENTAGE CHANGES OVER PRIOR FISCAL YEAR

<u>Expenditure Category</u>	<u>Fiscal Year</u>			
	<u>92</u>	<u>93</u>	<u>94</u>	<u>95</u>
Direct Local Aid	--	+ 2%	+ 4%	+ 5%
Medicaid	+ 7%	+ 7%	+ 7%	+ 7%
Public Assistance	+ 3%	+ 3%	+ 5%	+ 5%
Debt Service	+ 9%	+ 8%	+ 3%	+ 3%
Pensions	+ 6.6%	+ 6%	+ 6%	+ 6%
Group Insurance	+ 7%	+ 6%	+ 6%	+ 6%
MBTA and Regional Transit	+ 5%	+ 5%	+ 5%	+ 6%
All Other	- 2%	+ 1%	+ 3%	+ 3%

In FY92 the five budget busters are held to sharply reduced rates of increase while direct local aid is level-funded and the "all other" category must be reduced by another 2% in order to balance the budget. It should be noted that legislative modification of the property tax limits as recommended would be equivalent to a 10% rise in direct local aid.

5. The proposed budget for FY93 anticipates a slight improvement in tax revenues of 2% along with a 6.4% increase in non-tax revenues and begins to rebuild gradually the appropriations for expenditure categories that had either been previously cut below the baseline year of 1991 or level-funded, as in the case of direct local aid.

6. In light of the projected increase of 3% in tax revenues and a 6.5% estimated increase in non-tax revenues, the proposed budget for FY94 begins to restore appropriations in the "all other" category.

7. The proposed budget for FY95 maintains the steady improvement in appropriation levels based on the expectation that a stronger economy will bolster tax revenues by an estimated 4%.

Budget Targets for Budget Busters: FY92-95

If the five budget busters are not restrained and kept in check, the proposed fiscal recovery plan will quickly fall apart. Prior efforts to contain their upward spiral by mandated statutory and administrative reductions in services, program design changes and special mechanisms to control costs have had limited results. For example, the Governor's original Medicaid budget for FY91 assumed over \$700 million in reductions through legislative amendments and waivers of federal regulations. The final Medicaid budget for the current fiscal year is \$2,671.3 million, 26% above the prior year's estimated expenditure.

Anticipating the political difficulties and counteracting cost-driving forces that propel the budget busters, we felt it necessary to push for the concept suggested by the Senate Committee on Ways and Means that would establish budgetary targets limiting the annual percentage increases in budgetary allocations to the budget busters:

- (1) bringing the annual rise in Medicaid budgets down to 7% over the FY92-95 period;
- (2) reducing the FY92 increase in the Group Insurance budget to 7% and for subsequent years of the recovery period to 6%;
- (3) including a 9% increase for FY92 and an 8% increase for FY93 in debt service, and a reduced increase of about 3% for both FY94 and FY95;
- (4) continuing the average yearly rise of just over 6% for pensions throughout the next four years; and
- (5) bringing down the increase in the state's subsidies for mass transit to 5% during the FY92-95 period.

If it becomes clear that caps on annual percentage increases reinforced by legal and administrative reforms fail to bring the budgets of Medicaid, Group Insurance and transit subsidies down to the desired targets, it may be necessary, as the Senate

Committee on Ways and Means concluded, to undertake complete re-drafts of the legislative authorizations underlying these programs. (It should be noted that the Governor vetoed an outside section of the FY91 appropriations act that would have moved in this direction. It would have terminated any Medicaid benefits not required under federal law if Medicaid program expenditures exceeded 18.25% of total state spending and would have required the MBTA to raise any expenditures in excess of 2.75% of total state spending from its own source revenues.)

A similar outside section strategy to place into a kind of "administrative receivership" a number of less costly budget accounts with excessive growth since FY88 spending levels and patterns of inefficient management plus increased demand similar to the budget busters was not vetoed by the Governor, however. The Legislature prescribed an oversight process for the following appropriations -- workmen's compensation, the Committee for Public Counsel Services, emergency assistance by the Department of Public Welfare, and the Turning 22 programs managed by Mental Health, Mental Retardation, the Executive Office of Human Services, the Mass. Rehabilitation Commission and the Mass. Commission for the Blind -- under which overall management, operations, case management, eligibility criteria, regulations, etc., would be given special scrutiny and evaluation.

Medicaid

If legislative reforms alone could curb Medicaid costs, the Budget Control and Reform Act of 1989 (BCRA) would have resolved this problem. This legislation included over 20 sections, the intent of which was to reduce the skyrocketing trend -- giving responsible Medicaid administrators additional contractual authority to control costs, giving them limited power to approve Medicaid rates, establishing needs-based criteria for new health providers, requiring certain relatives of Medicaid recipients to pay 2% of nursing home costs, revising rate formulas to emphasize cost-effectiveness and establishing managed-care programs.

The general appropriations act for FY91 contained another round of some 20 outside sections affecting Medicaid, with an emphasis on programmatic and administrative reforms and jump-starting the implementation of reforms delineated in the BCRA, e.g., imposing an independent audit of the Medicaid program (costs, receivables, payables, cost-effectiveness of cost-saving efforts); requiring the Medicaid program to adopt by January 1, 1991 an accrued liability accounting system; directing the Medicaid program to adopt a management information system that identifies cost and utilization patterns for each category of program beneficiary and by health care provider categories and setting criteria and reporting requirements; requiring the Medicaid program to enroll all beneficiaries in managed care programs by January 1, 1991, assuming that federal waivers are received; authorizing the Medicaid program to contract for specialized, high-cost, high technology services with acute care hospitals and to require exclusive use of such services by beneficiaries; prohibiting the Medicaid program from providing options not mandated by federal law.⁷

Other outside sections of this year's appropriation act mandated that the state's public health and mental health agencies implement inpatient screening for all Medicaid recipients under age 21 admitted to private psychiatric hospitals except for court-ordered admissions and require the Medicaid program to implement a comprehensive strategy to control private psychiatric hospital payments for persons under age 21. Concern over the rising costs of pharmaceutical products prompted inclusion of an outside section that authorized "sole and competitive bids" by the Medicaid program for drugs dispensed to Medicaid patients in nursing homes and other institutions and creation of a special commission to study the feasibility of a pharmaceutical manufacturers' rebate program, a highly controversial issue.

⁷Such as adult dental services, except for dentures and emergency diagnostic and restorative dental care, over-the-counter drugs prescribed for non-dependent children, cosmetic surgery except as medically necessary, services of chiropractors, podiatrists or social work interns except as medically necessary.

If the myriad of legislative and administrative reforms fail in reducing and maintaining annual Medicaid increases to 7% over the prior year as assumed in the fiscal recovery plan, it may be necessary as a last resort to negotiate an annual lump sum Medicaid authorization for internal allocation by major segments of the Medicaid-provider community which is limited to the 7% annual cap increase. Massachusetts is only one of a handful of states that offers all 32 Medicaid options to beneficiaries. It is one of a few states that does not include a recipient's primary residence in the calculation of assets for determining Medicaid eligibility.

Group Insurance Until now the principal reform to contain the escalating cost of Group Insurance for active state employees and retirees, which had been the fastest growing item in the state budget, has been the requirement of the BCRA that the state share of the employer-employee cost-sharing arrangement should be limited to 90% of premiums regardless of selected health plan. This basic change, supplemented by the downward trend in health plan insurance participation from work force reductions, seems to be having the desired effect. The FY91 appropriation for Group Insurance is 10.7% above the prior year's estimated expenditure compared to the annual average of over 27% for the prior four years.

Concerned that the changing Group Insurance participation pattern of more family members and more elderly members, who generally need more expensive care, exacerbated by Medical care inflation, expensive medical technology, a greater number of catastrophic health claims, and higher costs of outpatient care, would outstrip savings from implemented reform, the Legislature directed the Group Insurance Commission in an outside section of the 1991 appropriations act to study the benefits, premiums, co-payments and deductibles under current health insurance plans, making comparisons with plans used in the private and governmental sectors and evaluating the cost effectiveness of the current state indemnity plan and potential savings that might be generated by utilization of preferred payer organizations (PPO's) and increased managed care. (The study report must be filed by November 1, 1990.)

In addition the Legislature imposed a freeze on adding new mandated benefits to any available health insurance plans as an interim step to help curtail growth in Group Insurance without affecting the current benefits package.

Transit Subsidies

Despite the strategies contained in the BCRA to curb the large annual increases in state contractual assistance and debt service for the MBTA and other regional transit authorities, the FY91 appropriation is 16% above last year's expenditures and these subsidies have gone up by a yearly average of 17% since 1987. Aware of the fact that the state's subsidy of the MBTA accounts for over three-quarters of its operating budget, up from 55% in 1982, the Legislature had included provisions in the BCRA that the MBTA raise at least one-third of its operating revenues through fares and related sources, that capital spending be limited to \$300 million a year, that MBTA employees pay at least 10% of health insurance premiums, and that a study be undertaken of the MBTA's financing structure.

Although the BCRA required the MBTA to implement a revenue-recovery ratio of one-third from its own revenue sources, there has not been any fare adjustments to date although an outside section of this year's budget act made possible an increase in the senior citizen fare by eliminating language that the amount of such fare be specifically set in the statute.

The mandated report on MBTA finances, released late in May 1990, contained a limited number of revenue-enhancement and cost-saving recommendations. It proposed \$7 million in fare increases through either a small fare increase for all riders or increases in fares for the elderly, disabled and students. It also proposed legislative changes eliminating restrictions on MBTA purchases of electric power energy (estimated savings of \$2-3 million) and setting a \$100,000 limit on tort liability cases against the MBTA (estimated saving of \$5 million.) These recommendations were not implemented in outside sections of the appropriations act for FY91, however.

Other proposals in the MBTA financing report would restore the local operating subsidy share of cities and towns in the MBTA district to 50% from the current 30% by raising the MBTA assessments on 25 of the 78 cities and towns being served. This would merely shift some of the cost burden from the state to municipalities. As for substituting state forward funding for retroactive funding of the MBTA, the report concluded that this would cost the state \$600 million and should not be implemented during a period of fiscal crisis.

Unless the Legislature limits the MBTA to an annual increase in state subsidy capped at the index measuring the prices that state and local governments pay for goods and services (an inflation rate), which we have currently estimated at 5%, and demands on fare increases and related revenue changes that guarantee the one-third revenue-recovery ratio, the transit subsidy budget buster will continue unabated. Capping the MBTA costs through an inflation rate increase is consistent with our related proposal that the annual limit on the property tax levy be raised from the current 2.5% to such an inflation rate.

Debt Service

If the Commonwealth in FY92 and subsequent years borrows less for capital improvements than it pays off in debt by eliminating and/or deferring all low-priority outlays previously authorized and will continue this policy over the next three years, the state should realize a gradual decline in the annual cost of debt service. Moreover, by using receipts from expanded sales of surplus state properties to finance some needed capital outlays, the state can further reduce its borrowing requirements. In the next few years, however, the annual cost of debt service will continue to rise. In FY92, for example, the cost of principal and interest on the loan to cover the prior year deficit will account for over 20% of the state's total debt service requirements for that year.

Pensions

Legislation of 1987 established a new pension payment schedule as part of a fully-funded system thereby easing annual pension expense requirements during the early years. However, the shift deferred the cost impacts of the new system until the 21st century.

The Politically Easier Way Means Budget Distortions

Over the past three years, the Administration and Legislature have carried out a spending strategy that essentially balances budgets by chipping away at the so-called discretionary items, accounting for about half of the state's expenditure budget, while treating the budget busters, that consume two out of every five revenue dollars, as legally-bound commitments requiring longer-term restructuring. To date, efforts to enact and implement fundamental changes in entitlements, contractual arrangements, subsidies and fixed charges have been limited to trimming their budget allocations around the edges, and to mandating gradual revisions through the use of outside budget sections while avoiding basic overhaul of their authorizing legislation.

As tax revenue collections have fallen below projections and the Administration has been forced to scale back current year appropriations by over \$700 million within a brief 3-month period after their original enactment, the more recent budget reductions indicate that slowing down the upward rates of spending has given way to more drastic budget decisions with telling impact on the availability, volume and quality of services rendered. One must speculate whether this is political "blood letting" or informed, compassionate choices among the state's priorities.

This overall budget strategy, for example, has reduced state support for higher education from FY88 to FY91 by \$125 million, a cut of over 16%. Direct local aid is 12% below the level of two years ago. Home care for the elderly is down by 15% over 1989. There are substantially fewer subsidized day care slots than two years ago. Swimming

pools were closed this past summer. State scholarship assistance has been scaled down by about 20%. By the end of the 1990 calendar year, the state payroll will be leaner by about 7,500 employees or 9% over July 1988. Workforce reductions have particularly affected the Governor's office, the Legislature, several constitutional offices (Attorney-General, Auditor and Secretary of State), the Department of Education, Communities and Development, Public Health, Public Works and the state police.

Meanwhile, welfare recipients and state retirees have gone three years without cost-of-living adjustments. State employees have been working without collective bargaining agreements for 18 months and state agency managers have not had salary increases since 1986.

Administration and legislative initiatives to slow down the upward spiral of spending growth of both the budget busters and discretionary budget accounts have been impeded by the following examples of executive and/or legislative reluctance to act boldly and in concert:

1. The badly-needed consolidation of the state's health care programs, including Medicaid, into a new Secretariat, as recommended by an outside panel appointed by the Governor and implemented through an outside section of the 1991 appropriations act, was at least temporarily derailed by the Governor's decision to return this section for amendment by substituting a new Department of Health within the Executive Office of Human Services, thereby perpetuating an unwieldy bureaucratic behemoth responsible for over 40% of the state's operating budget.
2. Legislative resistance to the consolidation of the state's sworn police forces despite the Governor's recommendation to carry out this long overdue reform.
3. Legislative resistance to delegating powers over the number of district courts, the deployment of court resources and control over court system facilities, finances, personnel and operations so that the Chief Justice of the Supreme Judicial Court and

other legally-designated court administrators can re-structure the court system to meet changing needs, enhance cost/effectiveness, reduce cost disparities among individual courts and improve the administration of justice.

4. Not yet in place, because it lacks vigorous executive and legislative endorsement, is a performance measurement system applicable to human services that defines objectives in programmatic and measurable terms and is used to evaluate client services and areas of need.

Harder Choices: Up to the Next State Administration

Although the Governor has pledged that he will leave office with the Commonwealth in good fiscal shape, recent events and future projections indicate that the Commonwealth's fiscal problems will persist and are likely to dominate state concerns over the near term in the face of a weakening economy, despite record-high borrowing to cover budget deficits, despite huge tax increases and despite sporadic cost-cutting efforts.

Whether or not the state's voters approve the CLT-High Tech initiative petition that would roll back up to \$2.3 billion in revenues and/or the petition of the Massachusetts Municipal Association, that would require 40% of the state's largest taxes to be paid annually to cities and towns as local aid (thereby increasing local aid by \$1.2 billion in FY92), the next Administration and Legislature cannot avoid putting every expenditure "on the table" and raising tough questions about everything the state does and spends money for:

Who should be eligible for Medicaid and for state support in nursing homes when the proportion of elderly in Massachusetts nursing homes is far above the national average and when Massachusetts spends much more than the national average for nursing home Medicaid patients?

How many of the Medicaid options should be provided when only a handful of states including Massachusetts provides a full menu of options?

When will mentally retarded patients be shifted from institutions to community-based facilities after 25 years of state policy emphasizing de-institutionalization?

Whether MBTA fares, lowest of any urban transit system in the nation, should be raised to cover at least one-third of MBTA expenses?

Whether the state should continue to operate zoos in view of its poor performance and limited resources?

Whether our current networks of two-year and four-year state colleges require institutional consolidation in view of the state's declining college-age population and the need for less duplication and more cost-effectiveness.

Whether a publicly subsidized maritime academy is warranted when the state no longer has significant maritime economic interests?

Whether state subsidy for the professional education of veterinarians in a private institution is justifiable as public policy?

Whether the missions of a sworn Capitol Police force, essentially providing building security services, should be re-examined in the context of an escalating demand for more crime-fighting police officers?

Whether the number and distribution of 70 district courts is outdated in light of changes in population densities, transportation access and caseloads?

Until now the tendency has been to reduce budgets by merely doing what has been done for fewer service recipients or with smaller appropriations. A variety of explanations have been offered as to why major reforms cannot be undertaken, i.e. it will take more money to save money; the Legislature will not amend the authorizing statute; the affected client group is too large and too vocal. Such excuses wear thin as time grows short.

**AFTER THE REVOLT:
A FRAMEWORK FOR FISCAL RECOVERY**

**JOSEPH S. SLAVET
RAYMOND G. TORTO**

**John W. McCormack Institute of Public Affairs
University of Massachusetts at Boston
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FOREWORD

This paper is not designed to stake out an absolute and inviolable position on the future direction of Massachusetts. We do hope to generate further discussion about what we think is the most important aspect of state public policy -- what can help turn the Massachusetts economy around. Our basic premise is that a sound state fiscal policy is the sine qua non of the state's economic recovery.

The paper is a sequel to "After the Miracle: A History and Analysis of the Massachusetts Fiscal Crisis," which we issued in the Spring. Our intent in that earlier report was simply to present the background and indicate the consequences of the state's fiscal policies over the last few years.

"After the Revolt: A Framework for Fiscal Recovery" looks forward to the next few years and foresees escalating deficit spending if major policy changes are not undertaken. After reviewing the state's fiscal and economic conditions as of October 1, 1990, the report suggests a framework for fiscal recovery. Specific budgetary targets are offered. They will be tough medicine for the state to swallow, but we believe that difficult choices must be made, and that our options grow fewer the longer we wait.

We trust that this paper will be useful both to the incoming Administration and Legislature in designing a fiscal recovery program and to the citizens of the Commonwealth in judging the results.

We acknowledge our gratitude to Pat Mullen and Ruth Finn for bringing this effort to a successful conclusion.

Edmund Beard

Director

John W. McCormack Institute of Public Affairs

Dedicated to the memory of our colleague

KERMIT C. MORRISSEY

He really knew the numbers

EXECUTIVE SUMMARY

Despite the injection of new taxes in the amount of \$1.2 billion in fiscal 1991, and recently announced cuts in the budget of approximately \$464 million, the Commonwealth's fiscal condition -- irrespective of the outcome of CLT's petition -- is precarious. Although the political juices are flowing in Massachusetts, with an eye on November 6th, Massachusetts decision-makers have not faced up to the problems inherent in the long-term, structural spending patterns of the state's budget.

Our five-year budget projection indicates that if expenditure trends continue without dramatic restructuring -- particularly in the "non-discretionary" accounts -- the Commonwealth faces a steady rise in annual deficits that could exceed \$700 million in fiscal 1993 and may escalate beyond \$1.3 billion by 1995. Between now and 1995, total expenditures are estimated to increase by 32%, whereas revenues will grow by only 24%.

The most recent news from the Governor is that another round of employee layoffs must be initiated and that more services will be cut. Just a week ago the Governor announced that some MDC skating rinks will be closed along with one of the state's zoos; supportive services for certain people on welfare will be cut; and home care for the elderly, job training programs, prenatal and postnatal nutrition care and college scholarships would be substantially reduced. While these cuts are painful, it should be noted that this year's spending program is above last year's expenditure by approximately \$20 million.

What is driving this uncontrolled expenditure growth are the well-known, notorious "Budget Busters" -- Medicaid, MBTA (and regional transit) subsidies, Pensions, Group

Insurance and Debt Service. These items ate up 32.3% of the budget in 1990, and are projected to require 38% of the budget in 1991. By 1995 they are likely to claim 45.7%. For every dollar of new revenue the state receives between now and 1995, about 90 cents will be needed for these "Budget Busters."

Over the past three years, the Administration and Legislature have carried out a spending strategy that essentially balanced budgets by chipping away at the so-called discretionary items -- accounting for about half of the state's expenditure budget -- while treating the "budget busters," -- that consume two out of every five revenue dollars -- as legally-bound commitments requiring longer-term restructuring. To date, however, the enactment and implementation of fundamental changes in entitlements, contractual arrangements, subsidies and fixed charges have been limited to trimming their budget allocations around the edges -- to mandating gradual revisions through the use of outside budget sections -- while avoiding basic overhaul of their authorizing legislation.

This budget strategy has reduced state support for higher education from FY88 to FY91 by \$125 million, a cut of over 16%. Direct local aid is 12% below the level of two years ago. Home care for the elderly is down by 15% over 1989. There are substantially fewer subsidized day care slots than two years ago. Swimming pools were closed this past summer. Workforce reductions have particularly affected the Governor's office, the Legislature, several constitutional offices (Attorney-General, Auditor and Secretary of State), the Departments of Education, Communities and Development, Public Health and Public Works, and the state police.

Meanwhile, welfare recipients and state retirees have gone three years without cost-of-living adjustments. State employees have been working without collective bargaining agreements for 18 months, and state agency managers have not had salary increases since 1986.

Whether the CLT-High Tech petition is approved or not, the newly-elected Administration and Legislature will need the 6-month period from January-June 1991 to formulate and begin implementation of a detailed plan to restructure the state government, a plan that reflects the voters' concerns about the state's economy, taxes and out-of-control costs.

A fiscal recovery plan must contain the following ingredients if it is to demonstrate sensitivity to the public call for budget stability and relief from tax escalation, and if it is to avert the escalating deficits projected for the period, 1992-95.

1. Tax policy changes that are consistent with the competitive requirements of a state economy dominated by professional services, high technology, high-wage manufacturing and relatively high per capita personal income.
2. Future tax revenue estimates that reflect the recent gloomy predictions of the State Department of Revenue, and a general consensus of economists that the state's economy will begin to rebound slowly, at best, in late 1992.
3. Careful review of the state's "big-ticket" entitlement, contractual, subsidy and fixed charge expenditures, mainly "budget busters" that are driven by both statutory and budgetary policy constraints, and which hold the key to bringing the state's costs into line with available resources. These cannot be treated as "off the table," "non-discretionary" accounts.
4. New budgetary targets that cap annual percentage increases for the "budget busters" to add critical budgetary discipline to adopted and pending statutory and administrative reforms designed to curb the upward trend of "budget-buster" costs.

Our proposed fiscal recovery plan is tough medicine. It requires the following actions:

1. The Commonwealth, vulnerable to the potentially negative impact of recently-enacted sales and income tax increases on a stagnant economy, will initiate a 3-year gradual tax reduction plan totalling \$1 billion, effective on July 1, 1991 and ending on June 30, 1994, and containing the following steps:
 - a. Repealing the new sales tax on selective professional services to businesses and miscellaneous services.
 - b. Reducing prevailing income tax rates applicable to the 1993 and 1994 fiscal years and subsequent years by \$700 million in two steps, in order to restore the state's income tax rates to more competitive interstate levels.
2. Modifying annual property tax levy limits, and exempting debt service on newly-issued municipal debt from the limits (so that cities and towns would have access to an additional \$300 million a year in property taxes) and increasing the proportion of lottery receipts distributed to cities and towns by reducing the proportions for prizes and administration (bringing Massachusetts more into line with the experience of other large states)
3. Holding "budget buster" growth to percentage targets which reflect sharply reduced rates of increases in these accounts, while direct local aid is level funded and "all other" categories of state government are reduced by 2% for FY1992. As tax revenues are projected to improve by modest percentages during the next three years, budgets for direct local aid and "all other" categories should receive commensurate annual percentage increases.

The implications of such a drastic budget strategy for state services will be far-reaching. The alternative -- continued deficit spending -- will drag the state down to insolvency.

Whether or not the state's voters approve the CLT-I High Tech initiative petition that would roll back up to \$2.3 billion in revenues and/or the petition of the Massachusetts Municipal Association that would require 40% of the state's largest taxes to be paid annually to cities and towns as local aid (thereby increasing local aid by \$1.2 billion in FY92), the next Administration and Legislature cannot avoid putting every expenditure "on the table" and raising tough questions about everything on which the state spends money, including:

Who should be eligible for Medicaid and for state support in nursing homes when the proportion of elderly in Massachusetts nursing homes is far above the national average and when Massachusetts spends much more than the national average for nursing home Medicaid patients?

How many of the Medicaid options should be provided when only a handful of states including Massachusetts provides a full menu of options?

When will mentally retarded patients be shifted from institutions to community-based facilities -- after more than 25 years of state policy emphasizing de-institutionalization?

Should MBTA fares, lowest of any urban transit system in the nation, be raised to cover at least one-third of MBTA expenses?

Should the state continue to operate zoos in view of its historically poor performance and limited resources?

Whether our current systems of two-year and four-year state colleges may require institutional consolidation in view of the state's declining college-age population?

Is a publicly subsidized maritime academy warranted when the state no longer has significant maritime economic interests?

Is a state subsidy for professional education of veterinarians in a private institution justifiable?

Should the missions of a sworn Capitol Police force, essentially providing building security services, be re-examined in the context of escalating demand for more crime-fighting police officers?

Are the number and distribution of 70 district courts outdated in light of significant changes in population densities, transportation access and caseloads?

Until now the tendency has been to reduce budgets by merely doing less or having fewer service recipients. A number of explanations have been offered as to why major reforms cannot be undertaken, i.e.: it will take more money to save money; the Legislature will not amend the authorizing statute; the affected client group is too large and too vocal. Such excuses wear thin as the state's economy flounders.

AFTER THE REVOLT: A FRAMEWORK FOR FISCAL RECOVERY

Will the Miracle Ever Revive?

Why prepare an epilogue to the Massachusetts drama, "After the Miracle," as we had promised in May? An epilogue is rendered after the conclusion of a play. The curtain for the final act of this political tragedy cannot come down until the state's newly-elected constitutional officers and members of the General Court have taken their oaths of office in January 1991.

In a real sense, the final curtain cannot come down because despite the Governor's recent optimistic proclamation that revival of the miracle had begun, the Commonwealth's short-term fiscal problem has not been resolved. In the absence of firm fiscal discipline, state spending for big-ticket items continues to spin out of control. State tax revenues defy more prudent forecasts as indicated in collections for July-September of the new fiscal year.

Moreover, long-term prospects for economic and fiscal recovery are clouded by the distinct possibility that the state's voters might approve initiative petitions on November 6, 1990, the fiscal impact of which will severely exacerbate the dimensions of the state's current problem. Meanwhile, the state primary election returns of September 18th provided clear-cut evidence that a majority of voters were unhappy with the incumbent political establishment and identified state taxes and the economy as their leading concerns.

Recap: FY 1987-90

Lagging Economy. The latest numbers dramatize the precipitous recent decline in the state's economy:

1. The unemployment rate in Massachusetts has climbed to 6.7% (August, 1990) compared with 3.7% only 16 months before.

2. Employment growth in Massachusetts during the 12-month period between July 1990 and the year before actually declined by 3%, reflecting a loss of over 90,000 jobs, compared with an employment growth rate of about 2% a year since the early 1980s.

3. Growth in the state's total personal income for the first quarter of 1990 was below personal income growth for the nation as a whole, a new and disturbing trend; for almost a decade, per capita personal income in Massachusetts was substantially above the national average.

4. Forecasts of growth rates for personal income, employment, unemployment, housing starts and net outmigration, compounded by higher levels of inflation and soaring oil prices as a result of the Mideast crisis and the steep plunge in consumer confidence as shown by weak retail sales, indicate that the Massachusetts economy is not likely to revive until late 1992 at the earliest.

Deteriorating State Finances: An Overview. The state's finances over the past four years (FY 87-90) have had all the earmarks of a floating "craps game." On the spending side, authorizations have been a crazy quilt of line items in the annual general appropriations act, off-budget spending of retained revenues, spending from continuing accounts, (authorizations carried over from the prior year), supplementary appropriations, deficiency appropriations and non-appropriated distributions, offset from time to time by allotment withholdings, appropriation vetoes, and appropriation reversions.

The revenue side of the state's fiscal planning process resembles a continuing "shell game," conducted quarterly or more frequently as actual tax revenue collections fall behind original estimates and constitutional requirements for budgetary balance dictate knee-jerk revisions of revenue estimates plus a resort to the use of fund balances, inter-fund transfers and accounting adjustments to bolster available receipts and balance the books. It should be noted, moreover, that the state's finance statutes do not require legislative adoption of the state's revenue estimates as part of the annual

fiscal plan as they do require definitive legislative appropriations to spend. Further confusing the tax revenue forecasting dilemma is the current mechanism for revenue estimation, which is legally under control of the Department of Administration and Finance, whose track record, based on technical advice and counsel from the State Department of Revenue and the Advisory Board on Revenue Resources and the State Economy, has been far off the mark since June 1987. (See Table 1.)

The Commonwealth has lost heavily in these floating craps and shell games over the past four years. Between the 1987 and 1990 fiscal years, on the budgetary basis of accounting as defined by current state finance law, the state's principal operating funds (general, local aid and highway) have been in the red by amounts ranging from \$300 million a year in 1987 (equivalent to 3% of total revenues) to over \$1.2 billion (10% of total revenues) in 1990. The annual budgetary deficit during this period skyrocketed by over 300%. Although revenues between the 1987 and 1990 fiscal years grew by \$1.3 billion or almost 12%, expenditures escalated by \$2.2 billion or over 19%. (See Table 2.)

To close the \$1.8 billion in gaps between operating revenues and expenditures over the last two years, to cover an accumulation of unpaid Medicaid bills of past years (totaling over \$600 million) and to finance a Supreme Judicial Court judgment against the state in tax cases (\$23 million), the Commonwealth has borrowed to date and will be borrowing during the current fiscal year a total of \$2.4 billion in notes and bonds. This debt, which will not pay for any useful state assets, will cost over \$600 million in interest expense, bond insurance premiums (to enhance sale of the state's bonds) and letters-of-credit fees (to secure the payment by credit-issuing banks of principal and interest due on notes and bonds in case of Commonwealth default). The \$600 million would have been more than enough to meet the state's 10% federal matching requirement for the \$5 billion Central Artery/Third Harbor Tunnel Project.

Not only has Massachusetts been forced to rely increasingly on above-average interest rates, bond insurance and letters of credit to market note and bond issues in an

TABLE 1
TAX REVENUE FORECASTS AND RESULTS
 FY 1987-1990

Fiscal Year	Date of Original Forecast	Original Estimate % Change Over Prior Year	Date of Revisions	Revised Estimate % Change over Prior Year	Actual % Change Over Prior Year
1987	June 1986	+ 7.6	August 1987	+ 6.2	+ 8.3
1988	June 1987	+ 7.4	August 1987	+ 6.8	+ 2.1
1989	June 1988	+ 10.9	December 1988	+ 7.2	+ 6.5
1990	July 1989	+ 7.0	May 1989	+ 6.0	
			August 1989	+ 5.1	- 3.6
			November 1989	+ 0.7	
			April 1990	- 1.9	

TABLE 2
FINANCIAL RESULTS, 1987 - 90 FY, STATE'S PRINCIPAL OPERATING FUNDS*
(in millions)

	FY 1987	FY 1988	FY 1989	FY 1990	% Change 1987 - 90
Actual Expenditures	\$ 11,249.2	\$ 12,032.5	\$ 12,812.1	\$ 13,451.0	+ 19.6
Actual Receipts	10,948.9	11,641.8	12,255.0	12,238.8	+ 11.8
Deficiency of Actual Receipts Over Actual Expenditures	(300.3)	(390.7)	(557.1)	(1,212.2)	+ 303.7

Note: Data presented on budgetary accounting basis.
*General Fund, Local Aid Fund, Highway Fund.

Source: Preliminary Official Statement (September 15, 1990), accompanying initial prospectus for Massachusetts dedicated income tax bonds, Fiscal Recovery Loan Act of 1990.

effort to offset the lowest-in-the-nation state credit rating, it has also been forced to pledge and dedicate proportions of tax receipts as further guarantees of debt repayment for deposit in euphemistically-labelled trust funds from which the debt service would be paid. The Commonwealth Liability Reduction Fund and the Medical Assistance Liability Fund were established in the 1990 fiscal year to receive deposits of the temporary income tax increase of 15% on certain salaries and wages. The Commonwealth Fiscal Recovery Fund was established in the 1991 fiscal year to receive deposits equivalent to 15% of all personal income tax collections.

FY 1990: The Gory Details. If the major fiscal decisions and modifications for the 1990 fiscal year were plotted on a graph, the line would look like a giant roller coaster. Spending authorizations and revenue adjustments bolted wildly between January 25, 1989 when the Governor submitted his original budget proposal of \$13.5 billion and August 1, 1990, when the Governor signed the largest deficit funding bailout bill in the history of the Commonwealth, "An Act Providing for Certain Fiscal Requirements of the Commonwealth" (c.151 of the Acts of 1990).

In authorizing the so-called Commonwealth Fiscal Recovery Loan bond issues of \$1.4 billion for financing the FY 1990 bondable deficit of \$1.3 billion in the state's general and local aid funds and for financing another \$126 million in unpaid Medicaid bills of prior fiscal years, this statute finally made possible the closing of the Commonwealth's accounts for 1990, thereby ending the wild revenue and expenditure gyrations. (See Table 3 for a fiscal chronology of the 1990 fiscal year.)

State Fiscal Plan for 1991: Replay of 1990?

Tax Fix. Two weeks before he signed the unprecedented \$1.4 billion bond authorization bill, which finally resolved the 1990 fiscal problem, the Governor approved a record-breaking tax revenue increase measure, culminating nine months of rancorous

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TABLE 3
A CHRONOLOGY OF FISCAL DECISIONS, FISCAL YEAR 1990

- January 1989 - Governor submits spending program of \$13.5 billion, based on projected tax revenue growth of \$650 million, or 7.4% over prior year and new taxes of \$600 million.
- July 1989 - State Department of Revenue recommends lowering of tax revenue estimates to growth of 5.1%.
- July 1989 - Legislature enacts a general appropriations bill of \$12,650 million, rejecting proposed spending and tax increases and reflecting recent downturn in tax revenue collections.
- August 1989 - Governor reduces authorized spending by \$490 million to \$12.1 billion through appropriation vetoes, budgetary language vetoes, and expenditure allotment withholdings based on arguments that Legislature had under-funded several critical budget line-items while overestimating tax revenue collections.
- August 1989 - Executive Office of Administration and Finance (EOAF) reduces original revenue estimates by \$170 million.
- October 1989 - Governor submits revenue-enhancement and budgetary-saving legislative package totalling \$184 million and withholds additional expenditure allotments totalling \$153.9 million, while reiterating support for original tax increases of \$600 million.
- December 1989 - Legislature passes Budget Control and Reform Act, reducing estimated deficit by \$250 million and containing final appropriations for 1990 fiscal year.
- January 1990 - After selective item vetoes and disapproval of certain budgetary language, Governor signs final appropriation legislation, leaving the Commonwealth with an unresolved budgetary shortfall of over \$500 million and total appropriations estimated at \$12.5 billion.
- July 1990 - EOAF estimates total spending for 1990 fiscal year at \$13.3 billion and tax revenues at \$9.5 billion, 3.3% below prior year collections ... sales taxes down by 6.2%, corporate taxes down by 19.3%, income taxes up by 4.2%.
- Legislature enacts bond authorization of \$1,421,200,000 to fund 1990 bondable deficit of \$1.3 billion and to pay for \$123 million in unpaid past Medicaid bills, bonds to be redeemed by December 31, 1997 and debt service to be secured by dedicated income tax revenues (15% of total).

legislative debate. This tax compromise was designed to provide funds over the next seven years to cover debt service requirements on the state's Fiscal Recovery Loans (funding the 1990 bondable deficit) and to provide sufficient additional tax revenues to balance the adopted FY 1991 spending program, then estimated at \$13.8 billion. Approved by only 4 votes in the House of Representatives and by 5 votes in the Senate, the tax legislation, according to EOAF estimates of August 15, 1990, will result in additional revenue from higher income, sales and gasoline taxes of \$1.162 billion (plus \$50 million in accelerated corporate tax payments) in the 1991 fiscal year and \$1.680 billion during the 1992 fiscal year. For FY 1991, however, 83% of the estimated additional tax yield will not be realized until the latter half of the fiscal year.

Below is a summary of the principal components of the new tax program:

- Personal income tax rates are increased retroactively to January 1, 1990. On interest (excluding Massachusetts bank interest), dividends and capital gains,¹ the tax rate is increased from 10% to 12%; on all other types of income, the tax rate for 1990 is increased from 5.75% to 5.95%.²
- For 1991, the income tax rate of 5.95 will increase to 6.25% and revert in 1992 and subsequent years to 5.95%.
- Sales excise tax statutes are amended to apply the current 5% tax rate effective December 1, 1990, to legal, accounting, engineering and architectural services provided to most businesses in amounts larger than \$20,000 per year and to a number of general services, mainly applicable to businesses.
- The motor fuel or gasoline tax is increased effective July 28, 1990 by six cents (from 11 to 17 cents) and by another four cents (to 21 cents) on January 1, 1991.

¹The current deduction of 50% of net capital gains is retained, resulting in an effective capital gains rate of 6%.

²The tax rate for unemployment compensation, alimony, Mass. bank interest, rental income from real estate, pension and annuity income and IRA/Keogh distributions is maintained at 5%.

A breakdown of estimated additional revenues by tax source (excluding \$30 million in accelerated corporate taxes) is shown below:

	<u>FY91</u>	<u>FY92</u>
	(in millions)	
Income Tax	\$742.0	\$1,037.0
Sales Tax	192.6	376.2
Motor Fuel Tax	177.0	263.0

The fiscal 1991 budget approved by the Legislature had been based on projected tax revenues of \$9.748 billion. Early in September the Secretary of Administration and Finance scaled down these tax revenue estimates to \$9.594 billion, a reduction of \$154 million in the face of the continuing slide in tax collections during July and August, 1990 totalling about \$30 million as compared with the benchmarks originally established by the State Department of Revenue. Late in September, reacting to projections of a worsening state economy, the State Department of Revenue further modified the revised estimate to a new total of \$9.227 billion.

There are a number of factors that render tenuous even the latest tax revenue projection of \$9.2 billion for the current fiscal year, not only because of the sliding economy, but because of the sales tax extension to services:

1. Adding the sales excise tax to broad categories of professional services is a brand new tax venture for Massachusetts. State Department of Revenue forecasters do not have actual collection experience to guide them in their analysis of projected yields.
2. The \$20,000 exemption opens the door to creative techniques that lawyers, accountants, engineers and architects and their clients may devise to evade the sales tax.

Moreover, the tax yield from professional services may be adversely affected by the administrative nuisance of the intricate exemptions -- the tax applies to businesses within the state but not to services for out-of-state clients, raising the issue of client confidentiality betrayal in the case of legal services; services for individuals are exempt; exemption of the first \$20,000 of bills could result in taxpayer confusion, i.e. a small business has legal bills totalling \$25,000 from two law firms, one for \$15,000 and the other for \$10,000: how will the \$5,000 in legal services subject to the tax be prorated between the two firms?

3. Despite the split-decision advisory opinion of the Supreme Judicial Court that extending the sales tax to services was constitutional, several legal challenges have been launched by professional associations of attorneys and accountants and by a statewide taxpayers group which argue that the state constitution limits the sales tax to "commodities" and which question the constitutionality of extending the corollary "use" tax to services. In addition, a major metropolitan newspaper is disputing a separate amendment of the sales tax statute that takes away from newspapers the exemption of the sales tax from the purchase of equipment used in newspaper publishing, arguing that the tax was unconstitutional and discriminatory, in violation of the freedom of the press under the state and U.S. constitutions.³

The Revenue Plan. According to revised estimates for the 1991 fiscal year made by the Secretary of Administration and Finance late in September 1990, total revenues of the state's principal operating funds, including estimated additional taxes from the recently-enacted tax bill, will total \$13.288 billion, as detailed in Table 4.

The initial projected tax revenues for FY1991, made in August but excluding estimated yields from the new tax increases and reflecting continued slowing of the economy, had been based on the following assumptions of the state's Advisory Board of

³Only 3 other states (Hawaii, South Dakota and New Mexico) apply their sales taxes to legal services.

TABLE 4
ESTIMATED STATE REVENUES, FY 1991
(in millions)

<u>Tax Revenues</u> ¹	<u>Estimates</u> [*]
Income Tax	\$5,183.7 ⁴
Sales Tax	1,982.6
Corporate Excise	602.0
Non-Business Corporate ²	407.7
Other Excises ³	1,051.5
Total Taxes	<u>\$ 9,227.5</u>
 <u>Non-Tax Revenues</u>	
Federal Reimbursements	\$ 2,014.4
Departmental and Other Revenues	1,275.2
Interfund Transfers & Other Sources	770.9
Total Non-Tax Revenues	<u>\$ 4,060.5</u>
Total Revenues	<u>\$ 13,288.0⁵</u>

Source: Executive Office of Administration and Finance.

* As of September 30, 1990.

¹ Tax revenues exclude \$56.6 million in other state taxes accounted for in other budgetary funds.

² Includes bank, insurance and public utility issues.

³ Includes motor fuels, cigarette, estate, alcoholic beverage, room occupancy, deeds and miscellaneous excises.

⁴ Excludes \$444.5 million estimated to result in FY90 from temporary increase in income tax dedicated to Commonwealth Liability Reduction Fund (covering FY89 deficit) and Medical Assistance Liability Fund (covering payment of prior year Medicaid bills), and \$293.9 million estimated to result in FY91 from income tax increase dedicated to Commonwealth Fiscal Recovery Loan Fund.

⁵ Excludes \$1.3098 billion for prior-year debt financing.

Revenue Resources and the State Economy: income tax revenues would increase by a modest 3%, sales tax revenues would grow only slightly by 0.7%, while business corporation tax revenues would fall by 9.3% and tax revenues from banks by 18.7%. The September downward revisions totalling \$464 million in tax revenues mean that the original assumptions have been abandoned.

The Spending Plans. The legislative disarray that characterized the debate in the General Court from May to mid-July 1990 over state tax policy spilled over into simultaneous and subsequent disagreements over spending totals, allocations, priorities and savings for the 1991 fiscal year.

Legislative activity on the Governor's budget for FY1991 did not intensify until May because, unlike past years, the Governor had refrained from recommending additional taxes and the emphasis was on crafting a tax revenue package that would not only meet the financing requirements for the prior year's deficit but would close the gap between eroding tax revenues and built-in spending increases for the 1991 and subsequent fiscal years.

The Governor's proposed budget for 1991, submitted to the General Court on January 24, 1990, totalled \$12.9 billion. It had been based on the assumption of no tax increases, although it did include a "current service" budget as an expression of his distaste for the no-tax budget that he called "a disgrace". Budgetary ping-pong between the executive and legislative branches began in May, 1990 when the House of Representatives passed and sent to the Senate a budget of about \$13.9 billion (including anticipated debt service in FY1991 for the forthcoming deficit bond authorization) and based on its previous passage of collateral increases in income and gasoline taxes.

In June, 1990, the Senate enacted a budget of \$13.7 billion but substituted a tax package that shifted the emphasis from higher income taxes to extending the state sales tax to services. After both branches of the Legislature had enacted a compromise tax bill providing for an estimated \$1.2 billion in increased income, sales, and gasoline taxes

for FY1991 and an additional \$1.8 billion for FY1992 early in July, a budget conference committee late in July recommended an alternative budget based on the enacted tax bill. Whereupon the House of Representatives, sensitive to charges that the budget was still several hundred million dollars out of balance, erupted in revolt over the budget conference committee's report, finally rejecting it.

Opposing further tax revenue adjustments offered by the House Committee on Ways and Means, the conference committee recommended across-the-board decreases of 4% in so-called discretionary budgetary accounts, thereby cutting appropriation requests by another \$265 million and enacting on July 28th a total budget of \$13.967 billion, which included \$167 million in additional anticipated spending provided for in the overall budgetary plan for FY1991.⁴ The Governor gave final approval on August 1 to the 1991 general appropriations act after vetoing 34 budgetary line items, disapproving the language in four items and returning four budget sections to the Legislature for amendment.

The ink on the Governor's signature was hardly dry, however, when disappointing tax revenues in July, down by 1.6% from the same month in 1989, and again in August, when tax collections were over \$27 million or 4.6% below the estimates for that month (not the projected increase of 4.8% over August 1989), prompted the Governor to order further budget reductions of \$154 million on September 4, thereby reducing the state's spending plan for FY91 to \$13.8 billion. On September 25th, the Governor ordered additional reductions in appropriations totalling \$310 million, acting upon the pessimistic outlook made by the State Department of Revenue as to economic trends and their impact on future tax revenues. The latest tax revenue estimates reflect a decrease of

⁴To meet operating expense requirements in July, the Legislature passed two interim appropriation acts and temporary notes were issued to provide the necessary cash. The 4% cut was applied to \$6.8 billion of proposed spending and excluded so-called legally-mandated expenditures and reimbursable expenditures.

about \$374 million or 4.4% from the baseline tax revenue total of \$8.5 billion collected in the past year.

Little seems to have changed. The state's budget and tax revenue pictures are still in disarray.

Another Operating Deficit? The state's 1991 spending plan as of October 1, 1990 totals \$13,451.0 million, while revenues are estimated at \$13,288.0 million, indicating a deficit of \$183.0 million after only three months into the 1991 fiscal year. Tax collections in July and August 1990 were \$30 million below the benchmarks of the State Department of Revenue.

In September tax collections fell short of revised benchmarks by another \$15 million as sales tax and corporate tax proceeds continued to lag badly behind revised projections. And if past experience is repeated, supplementary appropriations could add substantially to the state's current spending plan.

The state's short-term fiscal problem is due to the fact that the economy no longer generates tax revenue growth. The state's more serious longer-term fiscal dilemma is attributable to a state spending pattern that grows faster than its resources.

A Grim Outlook for the Future

Using the most recent (October 1, 1990) revenue and expenditure estimates for the 1991 fiscal year as our baseline for projecting state revenues and expenditures over a 5-year period (FY91-95), we have prepared Table 5 to show the dimensions of the state's structural gap between estimates of reasonable levels of revenue and tax growth and projected expenditures for the next four years.

The Senate Committee on Ways and Means, as part of its FY1991 budget recommendations released on June 1990, prepared a 5-year budget projection (FY91-95) based on assumptions that additional revenues would not be forthcoming and that spending reductions would not be made. According to the projections of the

TABLE 5
MASSACHUSETTS BUDGET PROJECTIONS
(in millions)
FISCAL YEAR

	Revised Preliminary 1990 ¹	1991	1992	1993	1994	1995
Revenues						
Tax Revenues	\$8,517.6	\$9,227.5	\$9,792.1	\$9,987.9	\$10,287.5	\$11,110.5
Federal Reimbursements	1,774.4	2,014.4	2,235.0	2,476.4	2,738.9	3,032.0
Departmental Revenue & Other	1,145.6	1,275.2	1,303.2	1,320.1	1,334.6	1,350.6
Interfund Transfers & Other	801.3	770.9	846.9	869.8	893.8	923.8
Total	\$12,238.9	\$13,288.0	\$14,177.2	\$14,654.2	\$15,254.8	\$16,416.9
Expenditures						
Medicaid	\$2,939.1 ²	\$2,606.6	\$2,613.3	\$2,615.0	\$2,722.2	\$2,859.2
Medicaid	2,120.6 ³	2,671.3 ⁴	3,072.0	3,532.8	4,062.7	\$4,672.1
Public Assistance	1,000.9	1,030.3	1,100.9	1,166.6	1,227.3	1,288.0
Debt Service	769.6	860.8	940.0	1,019.0	1,048.5	1,074.7
Pensions	639.3	705.9	750.4	796.9	847.1	900.5
Group Insurance	433.4	479.8	551.8	634.6	729.8	839.3
META & Regional Transit	354.5	411.2	463.4	517.6	577.6	648.8
All Other	5,163.6	4,705.1	4,898.0	5,089.0	5,267.5	5,493.7
Total	\$13,451.0	\$13,471.0	\$14,398.8	\$15,671.5	\$16,502.7	\$17,784.3
Surplus or (Deficit)	(\$1,212.1)	(\$183.0)	(\$212.3)	(\$717.3)	(\$1,247.9)	(\$1,367.4)

Source: Preliminary Official Statement accompanying proposed state bond issue, September 15, 1990.

¹ Reflects revenue and budget revisions ordered by Governor during September 1990; data for FY90 and FY91 from revised Preliminary Official Statement (September 27, 1990), Tables on p.29 and p.45.

² Includes \$210 million in previously withheld c.70 aid.

³ Excludes \$488 million in retroactive rate adjustments and prior year date of service spending supported by off-budget financing and a dedicated revenue stream.

⁴ Includes \$126 million authorized by c.151, Acts of 1990, for retroactive Medicaid provider settlements.

Committee, total revenue would increase by an average of 5.5% each year and tax revenue by an average of 6.0% each year. Our own revenue projections are similar - 5.9% annually for total revenue and 5.1% each year for tax revenue, but we have based our estimates for the FY91 baseline year and for FY92 on the expected yields from the recently-enacted tax legislation.

As for expenditures, the Senate Committee estimated that they would grow by a total of 7.9% in FY91 and by an average of 6.4% each year from FY92 to FY95 if current levels of service were to be maintained. Our expenditure projections are based on more recent figures for the FY91 base year than were available to the Committee. These reflect budget reductions totalling over \$700 million for FY91 but maintain the assumption about current levels of service. According to our projections, total expenditures would grow by an average of 6.4% between the 1991 and 1995 fiscal years. For major expenditure categories, including the budget busters, we have adopted the Committee's year-to-year percentage estimates and applied them to our FY91 base period. These indicate that Medicaid and Group Insurance, for example, will increase by an annual average of 15%, MBTA subsidies by over 11%, pensions by 5.5%, public assistance and debt service by 5%, "all other" expenditures by over 3.4% and direct local aid by 2%.⁵

Thus the 5-year budget projections in Table 5 reveal that if expenditure trends continue without drastic change, particularly the steep upward trends in so-called non-discretionary accounts, mainly in the large budget busters, the Commonwealth faces a steady rise in annual deficits that could exceed \$700 million by 1993 and escalate beyond \$1.3 billion by 1995. Between the 1991 and 1995 fiscal years, total expenditures are estimated to increase by 32% whereas revenues will grow by only 24%, even with the comprehensive tax increase package that will provide over \$1.6 billion in additional estimated revenues in the 1992 fiscal year.

⁵See the Senate Committee on Ways and Means, "Fiscal Year 1991 Budget Recommendations, Budgeting for Economic Recovery", June, 1990, p. 1-9-1.

"Budget Buster" Termites: Still Gnawing Away

That the so-called budget-busters were growing at extraordinary annual rates is evident from the percentage changes for the FY87-91 period, as shown in Table 6.

Table 6
Estimated Expenditure Trend by Major Category

Expenditure Category	FY 1987-91	
	<u>%Overall Change</u>	<u>% Average Annual Change</u>
Direct Local Aid	+ 0.2%	+ .05%
Medicaid	+ 83.8%	+ 20.9%
Group Health Insurance	+ 100.3%	+ 25.1%
Public Assistance	+ 34.0%	+ 8.5%
Debt Service	+ 64.2%	+ 16.0%
Pensions	+ 13.4%	+ 3.4%
MBTA	+ 68.4%	+ 17.1%
All Others	+ <u>1.9%</u>	+ <u>0.5%</u>
Total	+ 19.7%	+ 4.9%

Moreover, as indicated in Table 7, the FY91 budget allocations for Medicaid, group insurance for state employees and retirees, debt service on short-term and long-term borrowing, employee pension costs for state employees, and state subsidies to the Massachusetts Bay Transportation and regional transit authorities will increase by over \$780 million or 19% over the prior year (FY90) as contrasted with spending for all other major budget categories (direct local aid, public assistance and "all other"), the total budgets of which will decline by over \$760 million or 8.4%.

If our expenditure projections hold up, Medicaid could approach \$4.7 billion by the 1995 fiscal year, an extraordinary increase of 220% over 1987 costs. Group health insurance is expected to exceed \$800 million by 1995, or 250% over the 1987 level. Debt service could climb above \$1 billion, more than double the cost in 1987. Subsidies for the MBTA and regional transit authorities would grow to \$647 million, or 165% above the 1987 expenditure. By 1995 pension expenditures will hit \$900 million, 72% above the cost in 1987. Between the 1987 and 1991 fiscal years, the rising cost of pensions had slowed down to an average increase of just over 3% a year by adoption of a fully-funded pension system the annual costs of which had been spread out over 40 years, with lower costs during the early years of the new system.

Although a myriad of outside budget sections in appropriation legislation of the last two years has been enacted to curb the upward spiral of the budget busters, because of laggard implementation of measures to control these costs, exacerbated by federal and state laws and standards that impede cost control efforts, and the reality that cost containment of the larger budget busters require longer periods to realize reductions, the budget busters are expected to continue their dramatic rise.

In fiscal 1991 the budget busters account for 38.1% of total spending compared with 32.3% in the prior year. By 1995, they are likely to claim 45.7% of the total. The budget busters are projected to increase by 58.6% by FY95 while all other accounts, including direct local aid and public assistance, will rise by only 15.7%. By 1995, Medicaid will absorb over 26% of the state's total spending compared with 20% in fiscal 1991. By contrast, cities and towns will see their direct local aid decline from 19% of total state spending this year to 16% in fiscal 1995. (See Table 7.)

Appropriation levels for the current (1991) fiscal year demonstrate that the Governor and Legislature have ignored the warnings of the Senate Committee on Ways and Means that budget buster authorizations must not only be drastically reduced to balance the budget even after taxes are raised, but their upward spending rates must be

TABLE 7
PROJECTED MASS. STATE SPENDING GROWTH. "BUDGET BUSTERS" vs. OTHER ACCOUNTS
(in millions)

<u>Budget Category</u>	Preliminary FY1990	FY1991	FY1995	% Change FY91 - 95	Average Annual % Change
<u>"Budget Busters"</u>					
Medicaid	\$2,120.6	\$2,671.3	\$4,672.1	+ 74.9	+ 15.0 %
Group Insurance	433.4	479.3	839.3	+ 74.9	+ 15.0
Debt Service	769.6	860.8	1,074.7	+ 24.8	+ 5.0
Pensions	669.3	705.9	900.5	+ 27.6	+ 5.5
MBTA & Regional Transit	354.5	411.2	646.8	+ 57.3	+ 11.4
Sub-Total	\$4,347.4	\$5,129.0	\$8,133.4	+ 58.6	+ 11.7 %
% of Total	32.3%	38.1%	45.7%		
<u>Other Accounts:</u>					
Direct Local Aid	\$2,939.1	\$2,606.6	\$2,869.2	+ 10.1	+ 2.0
Public Assistance	1,000.9	1,030.3	1,288.0	+ 25.0	+ 5.0
All Other	5,163.6	4,705.1	5,493.7	+ 16.8	+ 3.4
Sub-Total	\$9,103.6	\$8,342.0	\$9,650.9	+ 15.7	+ 3.1
% of Total	67.7%	61.9%	54.3%		
Total	\$13,451.0	\$13,471.0	\$17,784.3	+ 32.0	6.4%

Source: Adapted from Table 1, p. 1-9. "Budgeting for Economic Recovery", Fiscal Year 1991 Budget Recommendations, The Senate Committee on Ways and Means, June 1990.

controlled lest inappropriately large reductions become necessary in other budget accounts and there be no budgetary margin for dealing with future state needs.

A Proposed Fiscal Recovery Plan

What is crystal clear from the analysis in this report, which corroborates the conclusions of the Senate Committee on Ways and Means, is that the Commonwealth faces a steadily deteriorating fiscal condition over the next five years even if the voters reject the Committee for Limited Taxation (CLT)--High Tech Council initiative petition to roll back state taxes and fees to the June 30, 1988 levels. The evidence is mounting that the recently-created record-breaking tax package along with a second round of heavy borrowing to fund accumulated operating deficits will not achieve the state's goal of restoring badly-needed stability to state finances in the near term.

Whether the CLT-High Tech petition is approved or not, the newly-elected Administration and Legislature will need the 6-month period from January-June 1991 to formulate and initiate implementation of a detailed plan to re-structure the state government, a plan that reflects the voters' concerns about the state's economy, taxes and out-of-control costs, and that takes into consideration the tax revenue collections for the last quarter of calendar 1990 and tax revenue projections.

A fiscal recovery plan must contain the following ingredients if it is to demonstrate sensitivity to the public mood for budget stability and relief from tax escalation, and if it is to avert the escalating deficits projected for the 1992-95 fiscal years:

1. Tax policy changes that are consistent with the competitive requirements of a state economy dominated by professional services, high technology, high-wage manufacturing and relatively high per capita personal income.

2. Future tax revenue estimates that are predicated on the recent gloomy predictions of the State Department of Revenue and on a general consensus of economists that the state's economy will rebound slowly.

3. The state's big-ticket entitlement, contractual, subsidy and fixed charge expenditures, mainly budget busters that are driven by both statutory and budgetary policy constraints, hold the key to bringing the state's costs into line with available resources, and must be the major focus of future short-term and longer-term budget planning. These non-discretionary accounts can no longer be "off the table."

4. New budgetary targets that cap annual percentage increases for the budget busters are needed to reinforce budgetary discipline contained in adopted and pending statutory and administrative reforms designed to curb the upward trend of budget-buster costs.

Our proposed fiscal recovery plan, shown in Table 8, is tough medicine. It abides by the above criteria and reflects the following assumptions:

1. The Commonwealth, vulnerable to the potentially negative impact of recently-enacted sales and income tax increases on a stagnant economy, will initiate a 3-year gradual tax reduction plan totalling \$1 billion effective on July 1, 1991 and ending on June 30, 1995 which contains the following steps:

a. Repealing the new sales tax on selective professional services to businesses and on miscellaneous services, thereby reducing tax revenue estimates for FY92 and subsequent years by about \$350 million and eliminating a new tax that attacks the heart of the state's economy.

b. Reducing prevailing income tax rates applicable to the 1993 and 1994 fiscal years by \$700 million (by \$350 million each year) in order to restore the state's income tax rates on both earned and unearned income to more competitive interstate levels.

2. Modifying annual property tax levy limits and exempting debt service on newly-issued municipal debt from the limits so that cities and towns would have access to an additional \$300 million a year in property taxes and increasing the proportion of lottery receipts distributed to cities and towns by reducing the proportions for prizes and administration (bringing Massachusetts more into line with the experience of other large

TABLE 3
PROPOSED FISCAL RECOVERY PLAN FOR MASSACHUSETTS
(in millions)
FISCAL YEAR

<u>Revenues</u>	1991	1992	1993	1994	1995
Tax Revenues	\$9,227.5	\$9,442.1	\$9,637.9	\$9,987.5	\$10,387.0
Federal Reimbursements	2,014.4	2,235.0	2,476.4	2,738.9	3,032.0
Departmental Revenue & Other	1,275.2	1,303.2	1,320.1	1,334.6	1,350.6
Interfund Transfers & Other	770.9	846.9	869.3	893.3	923.8
Total	<u>\$13,288.0</u>	<u>\$13,827.2</u>	<u>\$14,304.2</u>	<u>\$14,954.3</u>	<u>\$15,693.4</u>
<u>Expenditures</u>					
Direct Local Aid	\$2,606.6	\$2,606.6	\$2,684.2	\$2,791.6	\$2,931.2
Medicaid	2,671.3	2,858.3	3,058.4	3,272.5	3,501.6
Public Assistance	1,030.3	1,061.2	1,093.0	1,147.6	1,205.0
Debt Service	860.8	940.0	1,019.0	1,048.5	1,074.7
Pensions	705.9	752.2	798.8	849.1	902.6
Group Insurance	479.8	513.4	544.2	576.8	611.1
MBTA & Regional Transit	411.2	431.7	453.3	476.0	499.8
All Other	4,705.1	4,611.0	4,653.3	4,792.7	4,940.7
Total	<u>\$13,471.0</u>	<u>\$13,774.4</u>	<u>\$14,304.2</u>	<u>\$14,954.8</u>	<u>\$15,667.0</u>
Surplus or (Deficit)	(\$183.0)	\$52.8	—	—	\$26.4

states).⁶ These changes would offset the declines in direct local aid in FY90 and FY91 and proposed level-funding of direct local aid in FY92.

3. Table 9 shows what we propose as percentage targets for each budget category in each of the years, FY92-95. We emphasize that the targets are relative to recent trends and can be modified to meet alternative value judgements as to allocation of resources.

4. The proposed budget for the 1992 fiscal year in our recovery plan is the most difficult to balance. It is based on the following assumptions: (a) that there will be no growth in the tax revenue baseline of \$8.5 billion for FY91, (b) that the estimated additional yield of \$564.6 million from the higher income and gasoline taxes mandated by the 1990 tax legislation will be collected plus an estimated 8% increase in nontax revenues, but (c) these revenue additions will be offset by our proposed repeal of the sales tax on services.

⁶In Massachusetts (for calendar 1989), 30.2% of the \$1.5 billion from lottery receipts represented net income (after deductions of prizes, commissions and administrative expenses), which is well below the percentage of lottery net income for the U.S. as a whole (38.9%) and for such large states as California (38.5%), N.Y. (43.1%), Florida (39.5%) and Pennsylvania (41.0%).

TABLE 9
PROPOSED ANNUAL PERCENTAGE CHANGES OVER PRIOR FISCAL YEAR

<u>Expenditure Category</u>	<u>Fiscal Year</u>			
	<u>92</u>	<u>93</u>	<u>94</u>	<u>95</u>
Direct Local Aid	--	+2%	+4%	+5%
Medicaid	+7%	+7%	+7%	+7%
Public Assistance	+3%	+3%	+5%	+5%
Debt Service	+9%	+8%	+3%	+3%
Pensions	+6.6%	+6%	+6%	+6%
Group Insurance	+7%	+6%	+6%	+6%
MBTA and Regional Transit	+5%	+5%	+5%	+6%
All Other	-2%	+1%	+3%	+3%

In FY92 the five budget busters are held to sharply reduced rates of increase while direct local aid is level-funded and the "all other" category must be reduced by another 2% in order to balance the budget. It should be noted that legislative modification of the property tax limits as recommended would be equivalent to a 10% rise in direct local aid.

5. The proposed budget for FY93 anticipates a slight improvement in tax revenues of 2% along with a 6.4% increase in non-tax revenues and begins to rebuild gradually the appropriations for expenditure categories that had either been previously cut below the baseline year of 1991 or level-funded, as in the case of direct local aid.

6. In light of the projected increase of 3% in tax revenues and a 6.5% estimated increase in non-tax revenues, the proposed budget for FY94 begins to restore appropriations in the "all other" category.

7. The proposed budget for FY95 maintains the steady improvement in appropriation levels based on the expectation that a stronger economy will bolster tax revenues by an estimated 4%.

Budget Targets for Budget Busters: FY92-95

If the five budget busters are not restrained and kept in check, the proposed fiscal recovery plan will quickly fall apart. Prior efforts to contain their upward spiral by mandated statutory and administrative reductions in services, program design changes and special mechanisms to control costs have had limited results. For example, the Governor's original Medicaid budget for FY91 assumed over \$700 million in reductions through legislative amendments and waivers of federal regulations. The final Medicaid budget for the current fiscal year is \$2,671.3 million, 26% above the prior year's estimated expenditure.

Anticipating the political difficulties and counteracting cost-driving forces that propel the budget busters, we felt it necessary to push for the concept suggested by the Senate Committee on Ways and Means that would establish budgetary targets limiting the annual percentage increases in budgetary allocations to the budget busters:

- (1) bringing the annual rise in Medicaid budgets down to 7% over the FY92-95 period;
- (2) reducing the FY92 increase in the Group Insurance budget to 7% and for subsequent years of the recovery period to 6%;
- (3) including a 9% increase for FY92 and an 8% increase for FY93 in debt service, and a reduced increase of about 3% for both FY94 and FY95;
- (4) continuing the average yearly rise of just over 6% for pensions throughout the next four years; and
- (5) bringing down the increase in the state's subsidies for mass transit to 5% during the FY92-95 period.

If it becomes clear that caps on annual percentage increases reinforced by legal and administrative reforms fail to bring the budgets of Medicaid, Group Insurance and transit subsidies down to the desired targets, it may be necessary, as the Senate

Committee on Ways and Means concluded, to undertake complete re-drafts of the legislative authorizations underlying these programs. (It should be noted that the Governor vetoed an outside section of the FY91 appropriations act that would have moved in this direction. It would have terminated any Medicaid benefits not required under federal law if Medicaid program expenditures exceeded 18.25% of total state spending and would have required the MBTA to raise any expenditures in excess of 2.75% of total state spending from its own source revenues.)

A similar outside section strategy to place into a kind of "administrative receivership" a number of less costly budget accounts with excessive growth since FY88 spending levels and patterns of inefficient management plus increased demand similar to the budget busters was not vetoed by the Governor, however. The Legislature prescribed an oversight process for the following appropriations -- workmen's compensation, the Committee for Public Counsel Services, emergency assistance by the Department of Public Welfare, and the Turning 22 programs managed by Mental Health, Mental Retardation, the Executive Office of Human Services, the Mass. Rehabilitation Commission and the Mass. Commission for the Blind -- under which overall management, operations, case management, eligibility criteria, regulations, etc., would be given special scrutiny and evaluation.

Medicaid

If legislative reforms alone could curb Medicaid costs, the Budget Control and Reform Act of 1989 (BCRA) would have resolved this problem. This legislation included over 20 sections, the intent of which was to reduce the skyrocketing trend -- giving responsible Medicaid administrators additional contractual authority to control costs, giving them limited power to approve Medicaid rates, establishing needs-based criteria for new health providers, requiring certain relatives of Medicaid recipients to pay 2% of nursing home costs, revising rate formulas to emphasize cost-effectiveness and establishing managed-care programs.

The general appropriations act for FY91 contained another round of some 20 outside sections affecting Medicaid, with an emphasis on programmatic and administrative reforms and jump-starting the implementation of reforms delineated in the BCRA, e.g., imposing an independent audit of the Medicaid program (costs, receivables, payables, cost-effectiveness of cost-saving efforts); requiring the Medicaid program to adopt by January 1, 1991 an accrued liability accounting system; directing the Medicaid program to adopt a management information system that identifies cost and utilization patterns for each category of program beneficiary and by health care provider categories and setting criteria and reporting requirements; requiring the Medicaid program to enroll all beneficiaries in managed care programs by January 1, 1991, assuming that federal waivers are received; authorizing the Medicaid program to contract for specialized, high-cost, high technology services with acute care hospitals and to require exclusive use of such services by beneficiaries; prohibiting the Medicaid program from providing options not mandated by federal law.⁷

Other outside sections of this year's appropriation act mandated that the state's public health and mental health agencies implement inpatient screening for all Medicaid recipients under age 21 admitted to private psychiatric hospitals except for court-ordered admissions and require the Medicaid program to implement a comprehensive strategy to control private psychiatric hospital payments for persons under age 21. Concern over the rising costs of pharmaceutical products prompted inclusion of an outside section that authorized "sole and competitive bids" by the Medicaid program for drugs dispensed to Medicaid patients in nursing homes and other institutions and creation of a special commission to study the feasibility of a pharmaceutical manufacturers' rebate program, a highly controversial issue.

⁷Such as adult dental services, except for dentures and emergency diagnostic and restorative dental care, over-the-counter drugs prescribed for non-dependent children, cosmetic surgery except as medically necessary, services of chiropractors, podiatrists or social work interns except as medically necessary.

If the myriad of legislative and administrative reforms fail in reducing and maintaining annual Medicaid increases to 7% over the prior year as assumed in the fiscal recovery plan, it may be necessary as a last resort to negotiate an annual lump sum Medicaid authorization for internal allocation by major segments of the Medicaid-provider community which is limited to the 7% annual cap increase. Massachusetts is only one of a handful of states that offers all 32 Medicaid options to beneficiaries. It is one of a few states that does not include a recipient's primary residence in the calculation of assets for determining Medicaid eligibility.

Group Insurance Until now the principal reform to contain the escalating cost of Group Insurance for active state employees and retirees, which had been the fastest growing item in the state budget, has been the requirement of the BCRA that the state share of the employer-employee cost-sharing arrangement should be limited to 90% of premiums regardless of selected health plan. This basic change, supplemented by the downward trend in health plan insurance participation from work force reductions, seems to be having the desired effect. The FY91 appropriation for Group Insurance is 10.7% above the prior year's estimated expenditure compared to the annual average of over 27% for the prior four years.

Concerned that the changing Group Insurance participation pattern of more family members and more elderly members, who generally need more expensive care, exacerbated by Medical care inflation, expensive medical technology, a greater number of catastrophic health claims, and higher costs of outpatient care, would outstrip savings from implemented reform, the Legislature directed the Group Insurance Commission in an outside section of the 1991 appropriations act to study the benefits, premiums, co-payments and deductibles under current health insurance plans, making comparisons with plans used in the private and governmental sectors and evaluating the cost effectiveness of the current state indemnity plan and potential savings that might be generated by utilization of preferred payer organizations (PPO's) and increased managed care. (The study report must be filed by November 1, 1990.)

In addition the Legislature imposed a freeze on adding new mandated benefits to any available health insurance plans as an interim step to help curtail growth in Group Insurance without affecting the current benefits package.

Transit Subsidies

Despite the strategies contained in the BCRA to curb the large annual increases in state contractual assistance and debt service for the MBTA and other regional transit authorities, the FY91 appropriation is 16% above last year's expenditures and these subsidies have gone up by a yearly average of 17% since 1987. Aware of the fact that the state's subsidy of the MBTA accounts for over three-quarters of its operating budget, up from 55% in 1982, the Legislature had included provisions in the BCRA that the MBTA raise at least one-third of its operating revenues through fares and related sources, that capital spending be limited to \$300 million a year, that MBTA employees pay at least 10% of health insurance premiums, and that a study be undertaken of the MBTA's financing structure.

Although the BCRA required the MBTA to implement a revenue-recovery ratio of one-third from its own revenue sources, there has not been any fare adjustments to date although an outside section of this year's budget act made possible an increase in the senior citizen fare by eliminating language that the amount of such fare be specifically set in the statute.

The mandated report on MBTA finances, released late in May 1990, contained a limited number of revenue-enhancement and cost-saving recommendations. It proposed \$7 million in fare increases through either a small fare increase for all riders or increases in fares for the elderly, disabled and students. It also proposed legislative changes eliminating restrictions on MBTA purchases of electric power energy (estimated savings of \$2-3 million) and setting a \$100,000 limit on tort liability cases against the MBTA (estimated saving of \$5 million.) These recommendations were not implemented in outside sections of the appropriations act for FY91, however.

Other proposals in the MBTA financing report would restore the local operating subsidy share of cities and towns in the MBTA district to 50% from the current 30% by raising the MBTA assessments on 25 of the 78 cities and towns being served. This would merely shift some of the cost burden from the state to municipalities. As for substituting state forward funding for retroactive funding of the MBTA, the report concluded that this would cost the state \$600 million and should not be implemented during a period of fiscal crisis.

Unless the Legislature limits the MBTA to an annual increase in state subsidy capped at the index measuring the prices that state and local governments pay for goods and services (an inflation rate), which we have currently estimated at 5%, and demands on fare increases and related revenue changes that guarantee the one-third revenue-recovery ratio, the transit subsidy budget buster will continue unabated. Capping the MBTA costs through an inflation rate increase is consistent with our related proposal that the annual limit on the property tax levy be raised from the current 2.5% to such an inflation rate.

Debt Service

If the Commonwealth in FY92 and subsequent years borrows less for capital improvements than it pays off in debt by eliminating and/or deferring all low-priority outlays previously authorized and will continue this policy over the next three years, the state should realize a gradual decline in the annual cost of debt service. Moreover, by using receipts from expanded sales of surplus state properties to finance some needed capital outlays, the state can further reduce its borrowing requirements. In the next few years, however, the annual cost of debt service will continue to rise. In FY92, for example, the cost of principal and interest on the loan to cover the prior year deficit will account for over 20% of the state's total debt service requirements for that year.

Pensions

Legislation of 1987 established a new pension payment schedule as part of a fully-funded system thereby easing annual pension expense requirements during the early years. However, the shift deferred the cost impacts of the new system until the 21st century.

The Politically Easier Way Means Budget Distortions

Over the past three years, the Administration and Legislature have carried out a spending strategy that essentially balances budgets by chipping away at the so-called discretionary items, accounting for about half of the state's expenditure budget, while treating the budget busters, that consume two out of every five revenue dollars, as legally-bound commitments requiring longer-term restructuring. To date, efforts to enact and implement fundamental changes in entitlements, contractual arrangements, subsidies and fixed charges have been limited to trimming their budget allocations around the edges, and to mandating gradual revisions through the use of outside budget sections while avoiding basic overhaul of their authorizing legislation.

As tax revenue collections have fallen below projections and the Administration has been forced to scale back current year appropriations by over \$700 million within a brief 3-month period after their original enactment, the more recent budget reductions indicate that slowing down the upward rates of spending has given way to more drastic budget decisions with telling impact on the availability, volume and quality of services rendered. One must speculate whether this is political "blood letting" or informed, compassionate choices among the state's priorities.

This overall budget strategy, for example, has reduced state support for higher education from FY88 to FY91 by \$125 million, a cut of over 16%. Direct local aid is 12% below the level of two years ago. Home care for the elderly is down by 15% over 1989. There are substantially fewer subsidized day care slots than two years ago. Swimming

pools were closed this past summer. State scholarship assistance has been scaled down by about 20%. By the end of the 1990 calendar year, the state payroll will be leaner by about 7,500 employees or 9% over July 1988. Workforce reductions have particularly affected the Governor's office, the Legislature, several constitutional offices (Attorney-General, Auditor and Secretary of State), the Department of Education, Communities and Development, Public Health, Public Works and the state police.

Meanwhile, welfare recipients and state retirees have gone three years without cost-of-living adjustments. State employees have been working without collective bargaining agreements for 18 months and state agency managers have not had salary increases since 1986.

Administration and legislative initiatives to slow down the upward spiral of spending growth of both the budget busters and discretionary budget accounts have been impeded by the following examples of executive and/or legislative reluctance to act boldly and in concert:

1. The badly-needed consolidation of the state's health care programs, including Medicaid, into a new Secretariat, as recommended by an outside panel appointed by the Governor and implemented through an outside section of the 1991 appropriations act, was at least temporarily derailed by the Governor's decision to return this section for amendment by substituting a new Department of Health within the Executive Office of Human Services, thereby perpetuating an unwieldy bureaucratic behemoth responsible for over 40% of the state's operating budget.
2. Legislative resistance to the consolidation of the state's sworn police forces despite the Governor's recommendation to carry out this long overdue reform.
3. Legislative resistance to delegating powers over the number of district courts, the deployment of court resources and control over court system facilities, finances, personnel and operations so that the Chief Justice of the Supreme Judicial Court and

other legally-designated court administrators can re-structure the court system to meet changing needs, enhance cost/effectiveness, reduce cost disparities among individual courts and improve the administration of justice.

4. Not yet in place, because it lacks vigorous executive and legislative endorsement, is a performance measurement system applicable to human services that defines objectives in programmatic and measurable terms and is used to evaluate client services and areas of need.

Harder Choices: Up to the Next State Administration

Although the Governor has pledged that he will leave office with the Commonwealth in good fiscal shape, recent events and future projections indicate that the Commonwealth's fiscal problems will persist and are likely to dominate state concerns over the near term in the face of a weakening economy, despite record-high borrowing to cover budget deficits, despite huge tax increases and despite sporadic cost-cutting efforts.

Whether or not the state's voters approve the CLT-High Tech initiative petition that would roll back up to \$2.3 billion in revenues and/or the petition of the Massachusetts Municipal Association, that would require 40% of the state's largest taxes to be paid annually to cities and towns as local aid (thereby increasing local aid by \$1.2 billion in FY92), the next Administration and Legislature cannot avoid putting every expenditure "on the table" and raising tough questions about everything the state does and spends money for:

Who should be eligible for Medicaid and for state support in nursing homes when the proportion of elderly in Massachusetts nursing homes is far above the national average and when Massachusetts spends much more than the national average for nursing home Medicaid patients?

How many of the Medicaid options should be provided when only a handful of states including Massachusetts provides a full menu of options?

When will mentally retarded patients be shifted from institutions to community-based facilities after 25 years of state policy emphasizing de-institutionalization?

Whether MBTA fares, lowest of any urban transit system in the nation, should be raised to cover at least one-third of MBTA expenses?

Whether the state should continue to operate zoos in view of its poor performance and limited resources?

Whether our current networks of two-year and four-year state colleges require institutional consolidation in view of the state's declining college-age population and the need for less duplication and more cost-effectiveness.

Whether a publicly subsidized maritime academy is warranted when the state no longer has significant maritime economic interests?

Whether state subsidy for the professional education of veterinarians in a private institution is justifiable as public policy?

Whether the missions of a sworn Capitol Police force, essentially providing building security services, should be re-examined in the context of an escalating demand for more crime-fighting police officers?

Whether the number and distribution of 70 district courts is outdated in light of changes in population densities, transportation access and caseloads?

Until now the tendency has been to reduce budgets by merely doing what has been done for fewer service recipients or with smaller appropriations. A variety of explanations have been offered as to why major reforms cannot be undertaken, i.e. it will take more money to save money; the Legislature will not amend the authorizing statute; the affected client group is too large and too vocal. Such excuses wear thin as time grows short.



CAMBRIDGE CITY COUNCIL

CITY HALL, CAMBRIDGE, MASSACHUSETTS 02139

(617) 498-9094

Ed Cyr
City Councillor

November 15, 1990

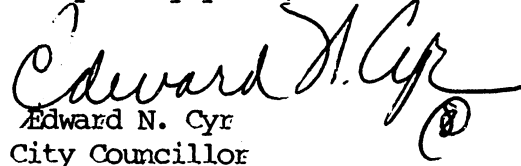
To The Honorable, the City Council:

Attached please find for your review and information a report entitled **AFTER THE REVOLT: A FRAMEWORK FOR FISCAL RECOVERY** by Joseph S. Slavet and Raymond G. Torto.

This report was issued by the John W. McCormack Institute of Public Affairs, University of Massachusetts at Boston, October, 1990.

I hope you find this information helpful.

Very truly yours,


Edward N. Cyr
City Councillor

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Enc.

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S-1157

COMMUNICATIONS & REPORTS FROM
CITY OFFICERS

Comm. from Councillor Edward N. Cyr
transmitting for review a report en-
titled "AFTER THE REVOLT: A FRAMEWORK
FOR FISCAL RECOVERY" by Joseph S. Slavet
and Raymond G. Torto.

In City Council,

November 19, 1990

Placed on file