Massachusetts in the 1990s: The Role of State Government

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Why another study of Massachusetts state government? In the past year, two Commissions established by the Governor have submitted reports, nonprofit citizen groups have come forth with lists of suggested reforms, and the legislature has had its own proposals. There is no shortage of good and useful suggestions on how to improve the operation of the Commonwealth.

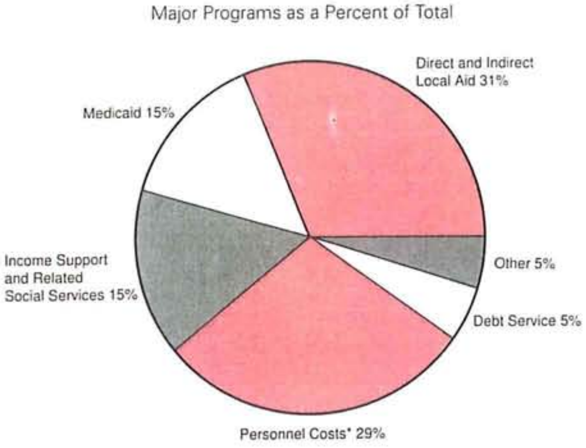
The goal of this study is quite different. Rather than offering solutions to the immediate budget problems, it examines the major expenditures of state government and the forces that caused them to grow so rapidly in Massachusetts during the 1980s. Many citizens have little idea how the state spends its money and have concluded that much of it is wasted. People know what they get from local government—their children are educated, their homes are protected by police and firemen, and their trash is collected. People also know that the federal government provides missiles for their defense and Social Security and Medicare benefits for their elderly relatives.

The difficulty in understanding state government programs rests in large part on the nature of services provided. State spending is concentrated in areas such as income support, social services, and Medicaid, where the typical taxpayer does not receive any direct benefits (Figures 1 and 2). The state also receives little recognition for the large sums of money it distributes to the cities and towns in the form of local aid; the local governments, who do the actual spending, get the credit for the services provided with the funds. Those few instances when the average citizen does have direct contact with an arm of state government, such as renewing a license at the Registry of Motor Vehicles, trying to do business with state regulators, or being stopped by the state police, are sometimes unpleasant. These experiences only reinforce the perception that state-provided services are of little value.

Because the benefits of state government expenditures are not visible to most citizens, the debate about restoring balance to the state

Figure 1

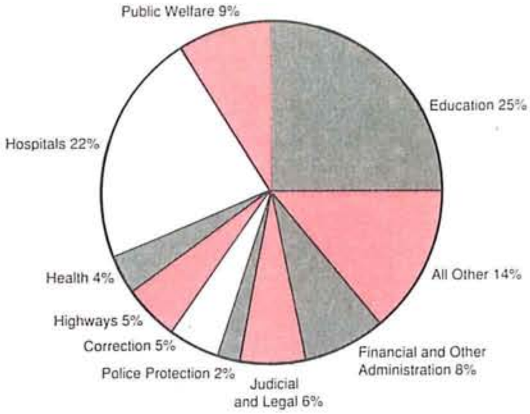
Massachusetts Expenditures, Fiscal Year 1989



*Includes wages and salaries, group insurance, consultants' fees and pension benefits.
Source: Commonwealth of Massachusetts, Budget Bureau; Massachusetts Taxpayers Foundation, *State Budget Trends: An Analysis of the Governor's Fiscal 1991 Budget Submission*; U.S. Bureau of the Census, *State Government Finances in 1989*.

Figure 2

Composition of Massachusetts State Employment, October 1989 Full-Time Equivalents



Source: U.S. Bureau of the Census, *Public Employment in 1989*.

budget has been carried out almost exclusively in terms of eliminating waste, fraud, and abuse. Some inefficiencies do exist in state government and they should definitely be eliminated. No one wants to spend more money than necessary for state services. The judicial system could easily be reformed; no need for every city to have its own court. The number of institutions of higher education could be consolidated and administrative staff eliminated. The delivery of social services is plagued with costly overlaps and should be revamped.

Such changes alone, however, are unlikely to restore balance to the state budget. The forces that exerted pressure for increased spending during the 1980s—decreased federal funding, rapidly rising health care costs, and Proposition 2½—will continue to exert pressure in the 1990s (Table 1). At the same time, state revenue growth has fallen far short of expectations for several years and will remain low for the foreseeable future. Massachusetts taxpayers will therefore have to choose between maintaining service levels and raising taxes, or keeping taxes where they are (or even reducing them) and cutting back on programs. The purpose of this study is to provide background on state expenditures in order to help policymakers and voters make these difficult decisions. In other words, the goal of the project is to expand the debate beyond the search for wasteful and inefficient practices, which definitely should be reformed, to the recognition of realistic hard choices that will face the Commonwealth even after waste has been eliminated.

The study consists of seven papers. Five focus on major categories of operating expenditures—Medicaid, income support and social services, local aid, personnel costs, and debt service. In addition, a chapter on revenues explains how the budget shortfall occurred and explores the outlook for the future. A final chapter on Massachusetts' capital spending includes a discussion of the "mega" projects. These topics are not parallel, but they allow the authors to address most of the important issues.

Each chapter explores the rationale for government intervention, considers the allocation of responsibility among different levels of government, documents the performance of Massachusetts, and compares Massachusetts with other New England states and states thought to face similar demands for public services. For consistency, this report uses the same "competitor" states as the Governor's Management Task Force (Crozier Commission); the "high technology states" include Arizona, California, Maryland, North Carolina, Texas and Washington, and the "industrial states" include Illinois, Michigan, New Jersey, New York, and Pennsylvania.

The conclusion that emerges from this survey of state government expenditures is that, for the most part, the Commonwealth has been spending revenues on activities that many, if not most, voters would consider worthwhile. The difficulty is that, while strong revenue growth during the prosperous 1980s permitted the state to spend liberally while taxing conservatively, the economy has slowed and these divergent policies toward spending and taxes can no longer persist.

The following is a brief summary of the major findings in each of the chapters. The analysis is based on two primary sources: data published by the U.S. Bureau of the Census and data issued by the Commonwealth of Massachusetts. The Census publication, *Government Finances*, reports annual revenues and expenditures by broad activity groups for all states, which greatly facilitates interstate comparisons. Massachusetts' own budget data are published in various reports, such as *The Governor's Budget Submission*, *Budget Recommendations of the Committee on Ways and Means*, and the Comptroller's *Annual Financial Report*. These data are more timely, but do not present a clear picture of government functions. Moreover, reconciling the data, both within the Massachusetts publications and between the state and federal sources, is a complicated task.

I. Medicaid

Medicaid is the state's largest single program and its preeminent "budget buster." Massachusetts is not alone, however; financing Medicaid has become a serious problem for all state governments. Medicaid is the jointly funded federal/state program enacted in 1965 to finance health care for specific categories of poor people. Each state administers its own program and has considerable discretion in determining its scope.

According to the program's original design, states *must* provide coverage for most poor children and their caretakers (primarily recipients of Aid to Families with Dependent Children, AFDC) and for poor aged, blind, and disabled individuals (generally recipients of Supplemental Security Income, SSI). In addition to these "categorically needy" groups, states

Table 1
Growth in Massachusetts Spending, Fiscal Years 1980–89 and 1989–91
Millions of 1989 Dollars

	Spending			Average Annual Percent Change	
Program	FY1980	FY1989	FY1991	1980–89	1989–91
Local Aid	2,370	3,928	3,377	5.8	−7.3
Direct	1,947	2,966	2,351	4.8	−11.0
Indirect	423	962	1,026	9.6	3.3
Medicaid	1,169	1,834	2,292	5.1	11.8
Personnel Costs	2,450	3,679	3,204	4.6	−6.7
Wages and Salaries	1,866	2,678	2,137	4.1	−10.7
Group Insurance	135	341	429	10.8	12.1
Pension Benefits	448	660	638	4.4	−1.7
Income Support and Social Services	1,671	1,953	1,937	1.7	−.4
Income Support	996	897	907	−1.2	.6
Social Services	675	1,056	1,031	5.1	−1.2
Debt Service	841	650	783	−2.8	9.8
Other	98	598	438	22.2	−14.4
Total	8,600	12,641	12,032	4.4	−2.4

Source: Commonwealth of Massachusetts, Budget Bureau; Commonwealth of Massachusetts, *Fiscal Year 1991 Budget*; Commonwealth of Massachusetts, Senate Committee on Ways and Means, *Fiscal Year 1991 Budget Recommendations* and *Fiscal Year 1985 Budget Recommendations*; Massachusetts Taxpayers Foundation, *State Budget Trends: An Analysis of the Governor's Fiscal 1991 Budget Submission* and *State Budget Trends 1974–83*.

also have the option to cover the "medically needy"; often these are elderly people who become impoverished while paying for uninsured medical and long-term care expenses. Although not its original focus, in 1989 long-term care accounted for 40 percent of national Medicaid payments—made on behalf of less than 7 percent of the recipients. While most long-term care recipients are elderly, the mentally retarded represent another important and very expensive group.

Contrary to widespread belief, the driving force behind the rapid growth in Medicaid expenditures has been soaring medical costs, not the growing long-term care needs of the elderly. Indeed, during the 1980s the aged actually declined as a share of all recipients, and payments to the elderly fell as a share of total Medicaid payments. By contrast, the cost of medical services has risen much faster than prices in general—in part because per patient use of medical services, such as diagnostic tests and procedures, has increased significantly.

Some observers believe that long-term care should be financed by a broad-based social insurance program in which all citizens participate rather than by a means-tested program designed for the welfare poor. While instituting such a program would relieve Medicaid of one-third to one-half of its current financial responsibilities, this (unlikely) change would still leave the states facing a smaller but significant budget buster with remaining costs continuing to rise faster than state revenues.

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Although state governments have been inventive in trying to devise ways to slow rising medical costs, they have limited ability to stem this tide since the states account for just 10 percent of personal health care spending. Moreover, if states try to set Medicaid reimbursement schedules below the going market rates, Medicaid recipients will have problems gaining access to care, as the whole history of the program demonstrates.

As the state with the third highest per capita personal income, Massachusetts has developed an unusually comprehensive Medicaid program. It covers a larger share of the state's impoverished population than does Medicaid nationally. In addition, Massachusetts provides most optional programs and services permitted by the federal government. In particular, like 28 other states, Massachusetts offers a medically needy program that includes nursing home care for the elderly—an expensive option but a service provided in one form or another by every state.

Accordingly, by all reasonable measures, Massachusetts' Medicaid expenditures are high. Even when adjusted for the demographic mix of recipients (necessary because poor children generally require less expensive medical care than the elderly and disabled), Massachusetts' Medicaid payments per "standardized" beneficiary were 23 percent above the national average. This remaining difference reflects Massachusetts' well-above-average personal health care costs.

How can policymakers reduce the cost of the Medicaid program to the state? At one extreme, eliminating all optional benefits would reduce state government spending on Medicaid by two-thirds. The bulk of these public sector savings would derive from terminating the medically needy program. The cost—financial, medical and emotional—of these public sector savings would fall largely on elderly and disabled individuals and their families. Moreover, some of those public sector savings would undoubtedly resurface, either within Medicaid or in other programs, such as General Relief, that are fully funded by the state; half of all Medicaid expenditures are reimbursed with federal matching funds.

If policymakers determine that such drastic cuts in the state's Medicaid program are unwise, they have limited room to maneuver. The remaining option involves reducing waste by promoting "best practice" delivery and reimbursement systems. The immediate savings resulting from such efforts would be modest, but they would cumulate. Without them, moreover, the federally required portion of the Medicaid program will continue to outpace state revenues. Because the Massachusetts Medicaid program is embedded in very costly state and national health care systems, achieving ongoing savings within Medicaid requires curbing national health care costs.

II. Income Support and Social Services

A broad array of programs intended to assist needy individuals and families falls under the category of income support and social services. Together these programs accounted for 15 percent of the FY1989 budget. Massachusetts' expenditures on such programs are high relative to those in other states, but do not appear excessive in relation to national standards of poverty. Thus, reducing benefit levels for cash assistance programs or tightening eligibility standards would result in less aid to the poor and would put pressure on other social services and private charities. On the other hand, increasing payments in recognition of the state's high cost of living would make Massachusetts appear even more out of line with other states and might add to the state's fiscal problems. Less controversial savings might be realized, however, from greater efforts to collect child support payments from non-custodial parents of welfare-dependent children and from more effective work preparation for custodial parents. In addition, the state should consider reorganizing its delivery system for social services to eliminate redundancies and establishing a systematic monitoring and evaluation process.

The Commonwealth shares the national ambivalence towards welfare, particularly for the non-elderly able-bodied.

While cash assistance payments are higher in Massachusetts than in most states, whether measured on a per capita basis, relative to income, or per recipient, they provide recipients with only a modest standard of living. Benefits under the largest cash assistance program, Aid to Families with Dependent Children (AFDC), are not sufficient to enable recipients to escape poverty. The aged and disabled receive just enough under the Supplemental Security Income (SSI) program to pass the federal poverty threshold; but since the cost of living is higher in Massachusetts than in most states, the federal poverty level understates need in Massachusetts. Moreover, while the fraction of poor people receiving cash assistance payments is also higher in Massachusetts than in most states, significant numbers of poor people receive no assistance at all. Thus, cutting payment levels or tightening eligibility to bring Massachusetts' programs more into line with those elsewhere, as has already happened with General Relief, would mean reducing an already low standard of living for recipients and denying assistance altogether to more poor people.

Although Massachusetts provides more assistance than other states, the Commonwealth shares the national ambivalence towards welfare, particularly for the non-elderly able-bodied. Reflecting this ambivalence, benefit levels are lower, relative to need, for AFDC than for SSI; and the real value of AFDC benefits has been allowed to fall over the past twenty years. Public concern about welfare dependence can also be seen in intensified efforts to collect child support payments from non-custodial parents and to shift custodial parents from welfare to work.

Massachusetts' record in collecting child support compares well with other states, but further efforts could yield significant savings. Massachusetts' Employment and Training Choices (ET) program has helped thousands of welfare recipients become self-sufficient since its inception in 1983. However, it does not appear to have reduced welfare caseloads appreciably, independent of general economic conditions. Some observers have suggested targeting more resources to those recipients with the greatest skill deficiencies to ultimately reduce welfare expenditures. Such a strategy, however, may not be very effective in the current sluggish economy. Alternatively, the state may want to consider lower-cost approaches to child care for the program's participants in order to increase ET's cost effectiveness. In any case, the state should ensure the collection of data needed for a thorough assessment of ET's performance, in order to choose among alternative recommendations.

Analysis of the large number of social services programs provided by the Commonwealth is handicapped by a lack of meaningful data. Massachusetts substantially expanded its expenditures on such programs in the 1980s in response to growing demands for social services and cutbacks in federal funding, but recent fiscal difficulties have caused expenditure reductions in many areas. No overall sense of mission seems to have shaped the expansion of these programs, nor does it guide present cuts. Instead, programs were developed haphazardly in response to specific problems. As a consequence, many programs are very small and administration is fragmented, with several departments providing similar services. This lack of coherent organization increases costs and reduces service quality and makes it very difficult to determine what the Commonwealth is getting for its money. The needs addressed by the social services programs—mental illness and mental retardation, homelessness, and family dissolution—are pressing. To ensure that scarce funds are spent effectively, redundancies must be eliminated, coordination improved, controls tightened, and priorities established.

III. Local Aid

Payments to cities, towns, and local school districts to support their activities represent one of the largest draws on the state budget. This so-called "direct" local aid amounted to more than 23 percent of state spending in FY1989. Another 8 percent of expenditures constituted "indirect" aid in the form of state spending for activities previously financed by local governments or serving largely local interests.

Why is the Commonwealth in the business of raising money and giving it to localities? The answer is threefold. First, most states provide substantial aid for schools in recognition of their responsibility (confirmed by a number of courts) to ensure an adequate education for all children regardless of the property tax wealth of their community. This concern about fiscal disparities and the unequal provision of services often spills over into other areas, such as fire and police protection. Second, at least in Massachusetts, opposition to heavy reliance on the property tax has spurred the demand for state-provided revenues. Third, Proposition 2½, which greatly constrained local property tax revenues, created pressure for additional state aid to cities and towns in the 1980s.

Throughout most of the 1980s, direct and indirect local aid grew rapidly as the state sought to reduce disparities and compensate localities for limitations imposed by Proposition 2½. After a decade of expansion in local aid, Massachusetts' reliance on the property tax is now much closer to the average for the nation and the disparity in property tax rates across Massachusetts communities has been reduced. Property-poor and low-income communities, however, continue to tax at higher rates than the more affluent, and property tax revenues per capita have grown more unequal between poor and rich communities during the 1980s. The reduced disparities in tax rates and the increased disparities in per capita revenues arise because affluent communities enjoyed greater growth in their per capita property tax bases than poorer ones.

Local aid has reduced disparities in service levels, but the equalizing effectiveness of the program has been blunted by a series of floors and ceilings in the aid calculation. These provisions reflect the divided purpose of local aid in the 1980s. Reducing fiscal disparities required targeting aid closely to the most needy communities; offsetting the effects of Proposition 2½ required increasing payments to all communities.

Given that property taxes in Massachusetts, on average, are no longer grossly out of line with other states, it would be appropriate for policymakers to rethink the objectives of local aid and, in particular, the priority placed on reducing property taxes as compared to reducing fiscal disparities and variations in education spending. The need for a careful assessment of the appropriate level of local aid, as well as the distribution pattern, is especially pressing in view of the voters' approval in November 1990 of Question 5, which calls for a substantial increase in local aid payments. In contrast, legislation passed in the summer of 1990 would reduce local aid, bringing the aid level for FY1992, after adjustment for inflation, close to that of the early 1980s.

Property-poor and low-income communities continue to tax at higher rates than the more affluent.

Both Question 5 and the earlier legislation adopted a revenue-sharing approach to local aid, whereby a set fraction of state revenue would be allocated to local aid. The intent of such an approach is to make local aid payments more predictable than they have been recently. Localities may find, however, that the growth in state taxes, and thus local aid, is not always sufficient to allow them to maintain local services without increasing property taxes at a rate faster than that permitted by Proposition 2½. Unless a community votes to override, the increase in property taxes is limited to 2.5 percent per year, plus an allowance for new growth. Thus, policymakers will have to consider whether overrides give communities sufficient flexibility to respond to local aid shortfalls. If not, the choice becomes one of either loosening Proposition 2½ or reducing local services.

The state also should take a close look at those programs it characterizes as indirect aid—support for the Massachusetts Bay Transportation Authority (MBTA), retirement benefits for local teachers, cost-of-living adjustments for other local government retirees' pensions, housing subsidies, and payments to county courts and corrections—to determine where they rank in terms of state and local priorities. Programs in which the state interest is paramount should be weighed against other state activities. Those where local interest is dominant should be compared to direct aid and other local programs. The state should consider exercising greater control in those areas where it has assumed a major financial responsibility, such as the MBTA.

IV. Personnel Costs

Personnel costs, which include both cash wages and benefits such as health insurance and pensions, accounted for 29 percent of state spending in FY1989. A substantial increase in the number of employees during the 1980s added to the state's budget problems; government employment expanded in line with the rapid growth of private sector employment throughout the economic boom. Even after the expansion, however, total state employment relative to population in Massachusetts is similar to that in the comparison states. The picture is somewhat different if employees in public education, who are relatively fewer here than elsewhere, are excluded; Massachusetts non-education state employees relative to population greatly exceed comparable state norms.

Another useful comparison is to consider combined state and local employment, since states vary significantly in their division of responsibility between the two levels of government. Census data for October 1989 indicate that Massachusetts' state and local governments employed 495 people for every 10,000 inhabitants, very similar to the average of 499 for the comparison states. (After the most recent round of cuts the Massachusetts figure would be a little lower.) As is the case for state employment alone, Massachusetts' "average" state and local employment is composed of an above-average share of non-education workers and a below-average share of education employees. This is not surprising; the Commonwealth has a smaller school-age population and relies more heavily on private schools than other states.

The wages paid to Massachusetts' public non-education employees in 1989 largely reflected the state's general wage gains during the economic boom of the 1980s. Average monthly pay (excluding benefits) for full-time state and local workers was 8 percent higher than the average of the comparison group; for full-time state employees the differential was 7 percent. In some specific functions, Massachusetts pay was considerably above average, probably the result of concentrations at upper ranks.

Total state employment relative to population in Massachusetts is similar to that in the comparison states.

Interstate data on public sector pay by occupation reveal wide ranges across states. However, for many specific jobs Massachusetts' wages were below those in the comparison group, sometimes by a substantial amount. Massachusetts pays significantly less than other states for skilled maintenance workers, judges, and certain medical support workers. Recent developments, including the expiration of many collective bargaining contracts and freezes in the managerial pay scale and higher education salaries, have undoubtedly caused Massachusetts government pay in all categories to deteriorate relative to other states.

While the cut in the number of employees and the stagnation of wages have reduced the state's total wage bill since FY1989, health insurance costs for state employees have continued to soar. To a large extent, this reflects the nationwide escalation in prices for medical services, but the costs of health insurance for Massachusetts state employees have risen even faster. As in other states, technological innovations and increasing utilization have been the driving forces behind cost increases, but certain practices in Massachusetts exacerbate these trends.

Annual deductibles and co-payments under the indemnity plan have not changed since 1965, and coverage is more comprehensive than in other places and also more comprehensive than that provided by private employers in the state. Though the state has made an effort in recent years to control costs by introducing more stringent utilization review and shifting employees to health maintenance organizations, other avenues could be pursued. These options include changing deductibles and co-payments, altering retiree benefits from a flat amount to one that varies with length of service, and investigating other cost control measures such as a preferred provider network.

In contrast to health insurance, the level of pensions—the other major employee benefit—does not appear out of line with that provided by comparable states. The comparison must be done carefully; most states use their pension plan only to supplement Social Security benefits, while the Massachusetts state pension must provide the entire retirement benefit since workers are not covered by the Social Security program. Recently, pressure has mounted for the state to reduce pension contributions, but the state should continue its effort to cover accruing pension costs and pay off the unfunded liability. This will ensure that the full compensation costs of today's government workers are borne by taxpayers who receive the services and that the burden of past obligations is spread evenly over time.

On the whole, the state's employment and compensation practices do not appear dramatically out of line with those of comparable states; desirable reforms for wages and salaries would involve rectifying inequities across groups of employees more than making overall adjustments. As a result, the state faces numerous managerial challenges, which will require improved information on employment levels and performance. The state might profitably undertake a study of relative pay and staffing across employees and functions, and develop a comprehensive mechanism for determining pay and benefits. Finally, as one of the few states whose workers are not covered by Social Security, Massachusetts needs to keep an eye on federal developments. The recent extension of Social Security coverage to state and local government workers not covered by a public employee retirement plan imposed fairly minor costs on the state. However, a decision by the federal government in the 1990s to extend Social Security to all state and local employees would add significant new payroll taxes to Massachusetts' personnel costs.

As one of the few states whose workers are not covered by Social Security, Massachusetts needs to keep an eye on federal developments.

V. Debt Service

Although Massachusetts has the lowest bond rating and its debt service charges have been called one of the "budget busters," a close look reveals that the burden of public debt in Massachusetts is similar to that in comparable states. This burden will remain affordable if the state and the localities balance their operating budgets and avoid postponing capital investment, which creates a hidden liability. The Commonwealth should also consider issuing indexed bonds to stabilize the real burden of debt service costs over time.

Over the last twenty years, while the per capita obligations of state and local governments and all of the Commonwealth's public authorities have risen almost sixfold in Massachusetts, the interest on this debt relative to personal income has doubled. This experience is similar to the comparison states. If anything, this comprehensive measure of debt may overstate the burden, since it includes the debt of all public authorities, much of which is not guaranteed by the state government.

Massachusetts and the other New England states have a significantly higher share of state debt than other industrial or high technology states, reflecting the larger role of state government here. Correspondingly, all the New England states rely less heavily on local debt, which is more prevalent in states where localities are larger and more autonomous than in New England. Massachusetts and the other New England states also rely more heavily on the debt of nonguaranteed public authorities than do other states. However, when all of these pieces are combined, the debt burden of state and local governments and public authorities in Massachusetts is very similar to that in other states.

Recent operating deficits have led to the severe downgrading of Massachusetts' bond rating and the deferral of both new capital investment and maintenance of existing public capital. While deferring public investment is a tempting deficit-cutting strategy, it is not a wise option. Postponing necessary investment does not eliminate state responsibility or reduce the state's burden. In fact, it probably increases the future burden for two reasons: forgone investment creates a hidden liability which does not appear on the state's balance sheet, and deteriorating infrastructure discourages economic development.

Massachusetts and the other New England states rely more heavily on the debt of nonguaranteed public authorities than do other states.

Because of the deficits, the state government has borrowed heavily to meet its budget. In FY1991, the state will issue Fiscal Recovery Bonds, amounting to almost one-quarter of its previous general obligations, in order to fund the cumulative liability of these recent deficits. The substantial, though manageable, burden of this debt will decline during the 1990s as these bonds are retired, provided the state balances its FY1991 and future budgets. Without balanced budgets, the burden of this debt will increase and soon become excessive.

Looking forward, outstanding obligations for the state government (other than the Fiscal Recovery debt) may grow between 8 and 10 percent annually in the 1990s, with debt service costs rising commensurately. This prospective burden will not exceed significantly that already borne by the comparable states. However, the debt burden could rise considerably if interest rates increase in the future. This potential burden can be mitigated by issuing indexed bonds, which have the added advantage of matching payments for public investments more closely to their benefits by maintaining a constant real debt service payment over the life of the bond.

VI. Revenues

Since FY1987, Massachusetts revenues have consistently fallen short of expectations. The repeated revenue shortfalls have been an important factor in causing the current fiscal crisis, since spending plans have been based on what proved to be overly optimistic revenue projections. Improvements can be made to the revenue data and forecasting models that will reduce the likelihood of such large errors in the future. Such improvements, however, are not a panacea; forecasts always involve a large element of judgment. More important, better forecasts will not solve the problem of revenue deficiencies arising from slow economic growth. Policymakers must react to disappointing revenues more rapidly if future crises are to be avoided.

The stability of a state's stream of taxes and other own-source revenues depends upon the stability of the economy, the sensitivity of revenues to fluctuations in economic conditions, and the timeliness of tax policy adjustments. The Massachusetts economy has been relatively volatile over the past twenty years, while revenues have been relatively stable. The main reason for this pattern has been the ability of policymakers to increase tax rates quickly in response to shrinking receipts.

In the past few years, optimistic forecasts contributed to the delay in reacting to declining revenues. The downturn of the Massachusetts economy, which has surpassed all expectations, was the primary cause of these forecast errors. In addition, special factors, including federal tax reform and court-ordered tax refunds, distorted the timing of revenues. Nevertheless, policymakers failed to heed several developments that had signaled revenue slumps in the past.

Massachusetts could moderate the inherent volatility of its revenues by increasing its reliance on user charges and on sales taxes, which tend to be more stable. However, efforts to enhance stability through, for example, taxing consumption of necessities currently excluded from the sales tax would increase significantly the proportion of taxes paid by lower-income groups.

Looking forward, Massachusetts' state revenues will probably grow at roughly the rate of personal income over the decade, given current laws. Because of Proposition 2½, however, the growth in state and local revenues combined will fall short of the growth in income and may just keep pace with inflation. Since state and local government expenditures are currently rising much faster than income, the growth in state and local revenues will not be sufficient to meet these demands; the debate over tax increases or cuts in services will recur again and again.

Loosening the constraints of Proposition 2½ would enable total state and local revenues to respond more readily to the demand for public services and would make the combined revenue stream less volatile. In recognition of concerns over excessive public spending, a coordinated system of tax limitations could be developed encompassing both state and local governments. The goal of such a coordinated system would be to exert fiscal discipline by keeping the combination of state and local revenues from growing faster than the state economy, while providing more flexibility than the current situation.

The Massachusetts economy has been relatively volatile over the past twenty years, while revenues have been relatively stable.

Since any limitation reduces the ability of policymakers to respond to a crisis, it would be prudent to combine such a limitation with the creation of stabilization funds at both the state and local levels. The system must also leave some room for public officials to use their discretion. If policymakers cannot make timely adjustments to stabilize revenues, revenues become dependent upon factors over which they have no control.

VII. Capital Expenditures

Massachusetts' capital expenditures in the 1980s were not high and capital spending was not an important contributor to the state's fiscal crisis. However, the state's failure to invest more in upgrading its infrastructure when revenues were ample means that the need is all the greater today when resources are limited. The state's current capital spending plans are ambitious and should yield long-term benefits in the form of higher economic growth, but, given the economic and fiscal situation, financing this program will be difficult. Priorities must be established, so that the most critical projects go forward.

Investment in the public infrastructure has been shown to result in greater private investment, higher output, and stronger employment growth. Despite these benefits, the federal government is reducing its support for public capital spending, while local governments all across the country are forgoing needed capital expenditures because of competing demands from their operating budgets and voters' resistance to higher taxes. Thus, the role of state governments in providing public capital is increasingly important.

In Massachusetts, the state has delegated responsibility for a large portion of capital spending to public authorities. The use of authorities has many advantages, but it greatly fragments decision-making. Each authority develops its own capital spending plan without regard to the programs and priorities of the other authorities or state government. While some of the authorities are self-supporting and can finance projects from their own revenue streams, authority fees impose a burden on taxpayers and, thus, can undermine support for state projects that depend upon tax revenues.

During the 1980s capital expenditures in Massachusetts were generally modest and Massachusetts saw the condition of its roads and bridges deteriorate from substantially better than average to average. For the 1990s, both the state itself and the independent authorities have very ambitious capital spending plans. The state will spend heavily on road and bridge repairs, wastewater treatment, solid and hazardous waste disposal, and public housing. The Central Artery Depression/Third Harbor Tunnel project is also a state initiative. While most of the funds for this project will come from the federal government, the state share is still significant. Moreover, annual costs for the federal portion must first be financed by the state and then be reimbursed. Some uncertainty continues to surround the extent of federal participation in this program.

The authorities also have major initiatives planned for the 1990s. The most ambitious are those of the Massachusetts Water Resources Authority (MWRA). Not only will the MWRA carry out the court-ordered cleanup of Boston Harbor, but it will also make substantial repairs and improvements to the water supply and sewer systems serving the Boston area. These projects will be financed through bonds, which will be paid off by user charges on

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residents and businesses. The cost to the typical homeowner will be substantial.

If Massachusetts is able to carry out its capital program, the result should be a substantial, well-maintained public infrastructure. However, given the demands of the state's operating budget and the prospect of slow revenue growth in the 1990s, fulfillment of these plans seems doubtful. Because of the federal court mandate, the cleanup of Boston harbor must take place; but funding for all the other projects that are planned may not be forthcoming. Priorities must be established. This will require a systematic assessment of the benefits and costs of all capital spending plans, including those of the authorities. Unless authority projects are weighed against the state's own capital plans, authority projects are likely to go forward while higher-priority state initiatives languish for lack of funds.

VIII. Summary

Through much of the 1980s, a vigorous economy enabled state government in Massachusetts to expand its activities rapidly. Not only did the state compensate for sharply declining federal support and significant limitations on the growth in local government revenues, but it was also able to respond to rising demands for public services with new state programs. The authors of this report found that, for the most part, the state spent revenues in an appropriate fashion on activities that most voters have generally supported.

Some of the areas most closely associated in the public's mind with waste and abuse turn out not to be major contributors to the current budget problem. Massachusetts' expenditures for income support are high relative to those in other states, but they have not been growing rapidly. Moreover, such expenditures do not appear inordinately high relative to the number of poor people and the federal definition of poverty. Employment in state government did grow rapidly in the 1980s, but recent budget difficulties have resulted in reductions. Comparisons with other states suggest that Massachusetts' employment and compensation practices are not markedly out of line with those elsewhere.

The preeminent budget buster is Medicaid. Rapidly escalating health care costs are driving up the costs of Medicaid and also health insurance for state employees. Massachusetts' problems are not unique, but they are bigger. The reasons are that health care costs, private as well as public, are higher here than elsewhere and that Massachusetts' Medicaid program is more comprehensive than most. Massachusetts has tried a number of innovations to slow the growth in Medicaid costs, but so far success has been limited. This is such an important expenditure area, however, that the state must continue to look for new approaches to controlling costs. Substantial one-time

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public savings could be realized by eliminating some of the major optional programs, but this would be very painful to affected individuals and their families, and some current Medicaid costs would crop up in other programs, such as General Relief, which are funded solely by state revenues.

Reorganizing the delivery of social services might achieve savings and also improve the quality of service. Improving financial management would reduce interest costs. Of course, no serious progress will be made on interest expenses unless the state balances its budget. Reforms in both areas, in particular introducing better monitoring and evaluation capabilities, would also help address public concerns about waste and abuse.

An important problem in the current crisis is that the state has not made a convincing case to the voters that it is spending its money effectively. Information is not forthcoming on exactly how many employees work for the state, which people receive social service benefits, or how much money the state is spending on capital projects. This lack of information is not part of a conspiracy to hide spending from the public. Even policymakers are confused and frustrated. Instead, it results from a long period of initiating and expanding programs without careful consideration of existing state efforts or the overall mission. It is also a result of the state's affluence through most of the 1980s; ample resources often encourage less-than-rigorous oversight.

The lack of information becomes an even more serious issue as the economy weakens. The same pressures that caused spending to increase in the 1980s will persist in the 1990s. The federal government continues to curtail funding. Local governments remain constrained by Proposition 2½. Health care costs keep rising, despite cost containment efforts. Capital spending initiatives, deferred during the boom, may well add to budget pressures in the 1990s. The outlook for revenue growth, however, is not encouraging, and projected revenues will be inadequate to fund all existing state activities. Choices will have to be made, between increasing taxes and reducing services, between state activities and local aid, between various state programs. Policymakers need to have a clear idea about what the state is doing and how well it is doing it.

The second major problem is that the state has ceded much control over its finances to other levels of government. It can do relatively little to influence federal policy, but the disproportionately large cuts in federal support suffered by Massachusetts in the 1980s suggest that the state has been less effective in securing federal grants than in the past. The state has also been rather passive in its relationship with local governments. It stepped in to fill the gap in local revenues created by Proposition 2½, but it has not exerted much control over the use of those funds. It has provided a general supplement to local resources rather than channelling money to those areas where the state's interest is compelling. Given that property tax burdens are no longer as onerous as they once were, a reassessment of the objectives of the state's local aid policy seems warranted. This assessment should consider the desirability of maintaining Proposition 2½ in its current form. Loosening Proposition 2½ would give communities more flexibility to respond to periods of slow aid growth and to any shifts in the pattern of local aid that might arise from such an assessment.

The activities of the public authorities raise questions about oversight and coordination. It may be worth considering some review mechanism for the public authorities to ensure that, at a minimum, they do not interfere with the state's own initiatives. Other industrial states, such as New Jersey, have adopted procedures that give the Governor veto power over authority projects.

Policymakers must establish clear priorities, based on comprehensive information, in order to make intelligent choices for the years ahead.

In conclusion, Massachusetts faces some very difficult choices, not just today, but for many years ahead. To make these choices requires much better information on the state's activities and a system for evaluating alternative programs. Even with process and program reforms, however, the state will not be able to fund all existing activities with current revenues. Either taxes must rise or programs must be cut. This situation makes it imperative to establish clear priorities, based on comprehensive information, in order to make intelligent choices.