

4-1-1993

Fiscal Smell Tests: A Mid-Term Reality Check of Massachusetts Finances

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The
John W. McCormack
Institute of
Public Affairs

***FISCAL SMELL TESTS: A MID-TERM
REALITY CHECK OF
MASSACHUSETTS FINANCES***

by
JOSEPH S. SLAVET, Senior Fellow
and
JOSEPH R. BARRESI, Visiting Fellow

University
of Massachusetts
at Boston

APRIL 1993

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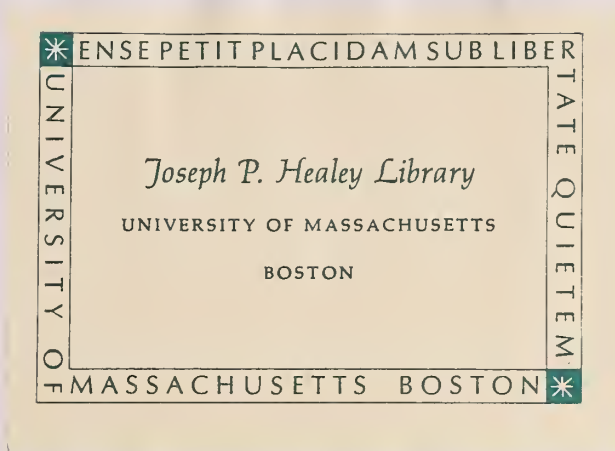
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FOREWORD

For the co-authors of *Fiscal Smell Tests*, this joint enterprise celebrates a new beginning for a professional partnership and close friendship spanning 40 years. Joe Slavet and Joe Barresi were policy wonks and agents of change long before these buzz words became popular in Little Rock and Washington.

The thickness and substance of newspaper clippings in the library files of Boston's daily newspapers carrying their names and institutional affiliations attest to the enormity of their influences over public policy in Boston and Massachusetts.

For the two Joes, now officially retired but active and vital McCormack Institute Fellows, their work on this major study may not match the celebrated return on stage of Peter, Paul and Mary, but their colleagues are betting that the Governor and Legislature will harken to their counsel and wisdom.

The authors wish to express their gratitude to Senior Fellow colleagues Richard Manley and Morton Myers for their critical examination of the text and tone of successive drafts. As for the manuscript itself, but for the perseverance and dedication of McCormack's clerical staff, particularly Kathleen Rowan, Megan Early, Barbara Karr and Ruth Finn, the final document might not have seen the light of day.

Raymond G. Torto
Interim Director
McCormack Institute of Public Affairs

EXECUTIVE SUMMARY

This 59-page report is a comprehensive and detailed analysis of the current condition of Massachusetts' finances. It measures the state's financial health over the FY91-93 period against a generally accepted list of performance indicators, benchmarks referred to as "fiscal smell tests," in order to render an independent judgment about the Commonwealth's fiscal plans, fiscal policies and fiscal results. It differs in perspective from the McCormack Institute's approach in its 1990-91 trilogy which looked at the state's fiscal problem through the lens of economic, budgetary and political analyses.

If we let the numbers in the report do the talking, the fiscal smell tests indicate that:

1. While the Commonwealth's deteriorating financial condition seemed to turn around in FY92, it was deteriorating seriously when measured by Generally Accepted Accounting Principles (GAAP) and is projected to be at least a billion dollars short on this accounting basis when the state closes its books on June 30, 1993.

2. In terms of public perception, when the state's finances collapsed in the late eighties, conditions in fact were worse than people thought; and as they have improved, they are hardly as favorable today as people think.

3. The Commonwealth's structural deficit, according to GAAP, is attributable to two major factors:

- a. Unlike the eighties, in which a robust economy was generating an unprecedented treasure of tax revenue collections, the state's-relatively weak economic recovery is generating only modest increases in tax collections, and the state's tax base is being eroded by a greater volume of tax refunds, abatements and uncollectible taxes driven by

the economic vicissitudes of taxpaying corporations and individuals.

b. When the Commonwealth's spending obligations are measured according to GAAP, they show that such big-ticket budget busters as Medicaid, MBTA/regional transit, pensions and debt service, and such unrecorded and/or under-stated obligations as employee vacations/sick leave and legal judgments, are chiefly responsible for the massive negative end-of-year budget balances, and for prolonging the structural deficit.

These components represent long-standing and complex accounting arrangements of such large scale that their conversion to GAAP can only be implemented gradually, particularly during a period of slow and long economic recovery, thereby providing minimum opportunity for resolving large-scale liabilities of the past in the near term.

4. Although down-sizing, restructuring and budget reforms ended a five-year string of consecutive operating deficits, averted financial collapse and temporarily resolved the Commonwealth's cash flow problems, the meager margin of budget balance in the Governor's message for FY94 and concerns that there are glaring examples of under-funding in this budget strongly suggests that Massachusetts has not yet achieved fiscal structural balance, and that much more needs to be done before the state can claim that it passes the smell tests in this report.

Below are the highlights in the Governor's budget recommendations for the next year which demonstrate the Commonwealth's continuing financial fragility:

1. Although budgeted expenditures for FY94 total \$15.2 billion, an ostensible \$180 million or 1.3 percent below total projected expenditures for FY93, the estimates not only

omit a continuation of \$185 million in additional school aid authorized for FY93, but also fail to include the estimated first-year cost of public school reforms. This would require another \$175 million in school aid to cities and towns for FY94.

2. If school reform is enacted by the Legislature, triggering the Commonwealth's financing commitment to implementation, at least \$360 million must be reduced from the Governor's original recommendations to maintain a balanced budget.

3. Setting aside the potential significant increase in additional school aid, the Governor's proposed budgeted revenues for FY94 of \$15.228 billion show a flimsy projected margin of only \$20.5 million (one-fifth of one percent) in excess of the proposed budgeted expenditures of \$15.208 billion.

4. Whether the Commonwealth will achieve a non-tax revenue target for FY94 totalling \$4.8 billion, slightly above the revised total estimate for FY93, is problematic in view of the large-scale shortfall experience in non-tax revenue collections for FY92. In addition to the uncertainty of reaching the FY93 target for non-tax revenues, the FY94 budget continues reliance on one-shot revenues such as the planned sale of the State Transportation Building and includes an undocumented estimate that new video poker and keno games would generate as much as \$50 million in the first year without adversely affecting receipts from other lottery games.

5. Despite the perilously slim margin of budget balance for FY94, it is difficult to comprehend the list of budgetary proposals that expands the use of tax expenditures and fee reductions, thereby further eroding the Commonwealth's constrained revenue base.

INTRODUCTION

In his latest budget message the Governor points to achievement of a "real, but fragile fiscal balance." On the credit side of the ledger, he cites four balanced budgets, reduced reliance on one-time revenues, no new taxes, five tax cuts, no deficit borrowing, and a triple upgrade in bond rating. On the debit side are continued spending pressures, slow tax revenue growth and burdensome levels of debt.

But is the fiscal condition of the Commonwealth stable, albeit fragile? Or would a careful reading of the numbers transmit another message?

The purpose of this report is to measure the Commonwealth's financial health against a generally accepted list of performance indicators in order to render an independent judgment about the state's fiscal progress and condition.

Among the major components of the report are:

1. Extensive analysis of operating budget results over the FY91-93 period, including a close-up inquiry into statutory accounting arrangements (rather than Generally Accepted Accounting Principles) that obfuscate some deep and persisting fiscal weaknesses.
2. Intensive probe of the Commonwealth's debt burden, with focus on how we reached a record-high debt level and how we plan to control and lighten the load.
3. Examination of the use of fiscal gimmickry as expedient mechanisms to claim budgetary balance and examination of budgetary decisions with positive short-term benefit but adverse longer-term consequences.
4. Revisiting of the state's budget busters, the principal source of its structural deficit, including an update on efforts to curb their escalating costs.
5. Review of how the Commonwealth has been allocating its resources between

spending for human resources and investment in human and physical development.

6. Evaluation of the state's revenue forecasting record, including both tax and non-tax sources, and analysis of the budgetary implications of optimistic and pessimistic estimating strategies.

7. Appraisal of the pros and cons of economic stimulus initiatives incorporated as part of budgetary policy.

8. Assessment of the impact of recent state tax policies on tax equity and tax reform.

In letting the numbers do the talking, our bottom line is that the negatives identified in the fiscal stability ledger of the Governor's budget message outweigh the positives. Thus, the report agrees with his admonition that "now is not the time to pop the cork."

THE SMELL TESTS

A relatively simple way to measure the financial condition of state government is to check its progress against a series of performance indicators. These indicators not only cover a wide range of basic questions about the state's fiscal plans, fiscal policies and fiscal results, but also are measures applicable to all forms of human organization, including the basic household.

- Is the state living within or beyond its means as measured by both statutory accounting standards and Generally Accepted Accounting Principles (GAAP)?
- Is the state's debt burden within or beyond the taxpaying ability of current taxpayers and the fiscal capacity of future generations?
- To what extent do the state's fiscal practices reflect sound or weak budgetary planning and budgetary discipline?
- To what extent do budgetary policies reveal deliberate choices to redress budgetary imbalances as among major spending categories, e.g., human services vs. public education, or to shift program emphasis toward the prevention of human problems and away from the maintenance and treatment of the human condition?
- What have been the budgetary consequences of over-optimistic or over-pessimistic tax revenue and non-tax revenue forecasts?
- Do tax policy initiatives and tax system changes reflect conscious efforts to achieve tax equity and tax reform objectives, to enhance greater revenue elasticity and to stimulate economic growth through tax incentives?

FISCAL PERFORMANCE, FY 1991-93

Operating Budget Results

Statutory Accounting Basis. According to final audited figures for the last completed fiscal year (FY92), the Commonwealth turned the corner by receiving in revenues more than it spent when measured on the so-called statutory basis of accounting. This was the first favorable budgetary performance enjoyed by the state since the 1986 fiscal year and appeared to bring an end to the fiscal structural imbalances of the past five years.¹

As shown in Table 1, the Commonwealth's net operating gain of \$312 million for FY92 on the statutory basis was in sharp contrast with the operating loss of \$21 million on this same basis incurred in the prior year. This improvement was clouded, however, by the fact that the state's General Fund showed a relatively large budgeted operating loss equivalent to about five percent of the revenues deposited in the General Fund. Operating gains in the Highway Fund, in the Local Aid Fund and in smaller budgeted funds offset the relatively large operating loss in this fund.

Moreover, the budgeted funds projection for the 1993 fiscal year signals that last year's encouraging turn-a-round in the state's current accounts may have been a single year's

¹Under the statutory basis of accounting, the Commonwealth's legal accounting arrangement, revenues are generally recognized when cash is received except for federal reimbursements, which are recognized when related expenditures are incurred. Expenditures are recorded when related cash disbursements occur, but through the use of encumbrance accounting, at year's end the payroll is accrued and payables are recorded to the extent of approved encumbrances. Under encumbrance accounting the full amount of purchase orders, contracts and other commitments of appropriated resources is deducted from the appropriation prior to actual expenditure. The underlying difficulty with the statutory basis of accounting is that legislatures are free to change the rules from year to year as suggested by the State Comptroller in his address to the New England Intergovernmental Audit Forum of October 22, 1992. Such changes have occurred in Massachusetts.

respite. Excluding the utilization of available reserves and fund balances from the prior year totalling \$549 million, the operating loss on the statutory basis for FY93 is estimated at \$319 million. This calculation is based on a projected total of \$15.4 billion in expenditures matched against estimated total revenues of \$15.1 billion.

Thus, once again, the Commonwealth is currently spending beyond what it expects to collect in current revenue and receipts. Unanticipated events, failure to realize cost avoidance and expense reduction targets, e.g., Medicaid, possible collection shortfalls in one-shot revenue estimates, relaxed discipline over spending, and exhaustion of available reserves could push the Commonwealth back into a pool of red ink.

TABLE 1
BUDGETED FUNDS - OPERATING RESULTS, STATUTORY BASIS
FY 1991-93

	Fiscal Year (amounts in millions)		
	Actual <u>1991</u>	Actual <u>1992</u>	Projected <u>1993</u>
Revenues and Other Sources	\$14,493.3	\$14,226.1	\$14,976.1
Expenditures and Uses	<u>14,514.5</u>	<u>13,913.8</u>	<u>15,380.6</u>
Operating Gain (Loss)	\$ (21.2)	\$ 312.3	\$ (319.4)

Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, p. 6 for FY91-92; FY93 figures are from p. A-13, Official Statement, General Obligation Refunding Bond Issues, 1993 Series A, dated February 15, 1993.

GAAP Accounting Basis. When the state's financial condition is measured according to generally-accepted accounting principles (GAAP), as defined by the Governmental Accounting Standards Board, the State Comptroller reports results, both actual and projected,

that reveal an even worse situation.² As shown in Table 2, the GAAP operating deficit for the 1991 fiscal year has been calculated at \$228 million, more than the relatively small loss on the statutory accounting basis. More serious, however, is the fact that the end-of-the-year fund balances according to GAAP escalated to a negative \$761 million in FY91 compared with a positive ending fund balance of \$237 million on the statutory accounting basis.

For fiscal 1992 the operating budget result on a GAAP basis turned positive for the first time since FY87, showing a surplus of \$380 million compared with \$312 million on the statutory accounting basis. But the end-of-year funds balance under GAAP in the same year showed a deficit of \$382 million, a condition that differs markedly from the ostensible end-of-year positive balances of \$549 million under statutory accounting. The wide difference of \$931 million in ending balances between the GAAP and statutory basis accounting calculations indicates the extraordinary extent to which the state's current budgetary accounting system tends to obscure fiscal reality in Massachusetts.

As for the current 1993 fiscal year, the State Comptroller's unofficial estimates indicate that, on a GAAP basis, projected total expenditures of \$15.5 billion will exceed projected total revenues of \$15 billion, thereby resulting in an estimated operating deficiency of \$500 million and a projected ending funds balance of almost \$1 billion. If these projections are realized, they would more than double the anticipated budget deficit and

²Under GAAP, modified accrual accounting is the basis for recognition of state revenues and expenditures. Moreover, financial reporting according to GAAP includes independent authorities and agencies, which are recorded primarily as non-budgeted enterprise funds. GAAP is designed to measure revenues and expenses on the basis of rational and systematic rules, that the financial data are comparable and consistent in the way they are measured from one fiscal year to another and that all the data that belong in a particular fiscal year are presented in that budget year. GAAP represents the best thinking of members of the accounting profession, principles agreed to and advocated by such respected groups as the American Institute of Certified Public Accountants, the Financial Accounting Standards Board, the Governmental Accounting Standards Board, the U.S. General Accounting Office, the American Accounting Association and the U.S. Securities and Exchange Commission.

ending fund balances on the statutory accounting basis.³ If the predictions hold, the end-of-year operating deficit for FY93 on a GAAP basis will approach the chronic annual operating GAAP deficiencies of FY88-90.

TABLE 2
BUDGETED FUNDS - OPERATING RESULTS, GAAP BASIS
FY 1991-93

	Fiscal Year (amounts in millions)		
	<u>Actual 1991</u>	<u>Actual 1992</u>	<u>Projected 1993</u>
Revenues and Other Sources	\$14,099.7	\$14,145.5	\$15,044.2
Expenditures and Uses	<u>14,328.1</u>	<u>13,765.9</u>	<u>15,544.0</u>
Operating Gain(Loss)	\$ (228.4)	\$ 379.6	\$ (499.8)

Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, p. 6 for FY91-92; FY93 figures are estimates cited by Comptroller in address of October 1992. (See note 3 below.)

End-of-year Operating Balances

Statutory Accounting Basis. The Commonwealth achieved positive end-of-year fund balances on a statutory accounting basis in both the 1991 and 1992 fiscal years. This means that revenues plus fund balances at the beginning of the year and subtracting expenditures during the year generated a surplus at the end of the year. Thus, the Commonwealth appeared to have reversed the negative fund balances of the prior two fiscal years (FY89 and FY90). The financial prognosis, at least for the near term, seemed more hopeful.

However, analysis of the available resources used to balance the spending plan for FY93, indicating a relatively modest year-end balance of \$230 million, calls to mind the

³Estimates in Seven-Year Trend Chart, Budget Funds Operations-GAAP Basis, used by State Comptroller in address of October 1992 to New England Intergovernmental Audit Forum.

unfortunate fiscal decisions and results of five years ago. (See Table 3.) In FY88 the grudging reluctance of the Administration to reduce spending to levels commensurate with sharply declining current revenues led to wholesale raiding of available reserves, including undesignated fund balances, continuing appropriation balances not yet spent, and the state's "rainy day" Stabilization Fund. The critical question is whether the combined funds balances projected for this year, equivalent to only 1.5 percent of available revenues, serves as a warning that the Commonwealth's finances could easily take an ominous U-turn.

TABLE 3
END-OF-YEAR FUND BALANCES - STATUTORY BASIS
FY1991-93

	<u>Fiscal Year</u>		
	(amounts in millions)		
	Actual <u>1991</u>	Actual <u>1992</u>	Projected <u>1993</u>
Beginning Fund Balances*	\$(1,104.4)	\$237.1	\$549.4
Prior Year Deficit Financing	1,362.7	-	-
End-of-Year Fund Balances	\$ 237.1	\$549.4	\$230.0

Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, p.6 for FY91-92; FY93 figures are projections from p. A-13, Official Statement, General Obligation Refunding Bond Issues, 1993 Series A, dated February 15, 1993.

*Includes reserves, designations for continuing appropriations or for such anticipated requirements as debt service or new bond issues, reserves in Stabilization Fund and undesignated surplus available for appropriation.

FY92 Results. The state's principal operating fund, its General Fund, fared very poorly in fiscal 1992, experiencing an operating budgeted deficiency of \$466 million despite the fact that actual expenditures, exclusive of Stabilization Fund transfers, were \$321 million below budgeted amounts. (See Table 4.) The disappointing end-of-year negative funds balance in the General Fund was due mainly to catastrophic shortfalls in actual receipts over budgeted revenue estimates, particularly in high-risk one-shot revenue components, and

despite tax revenue collections that were over \$700 million above tax revenue estimates. Departmental Revenues, which account for only about one-fourth of the \$4.2 billion in non-tax revenues, were mainly responsible for the non-tax revenue shortfall. They fell below projections by over \$563 million, 42 percent below the \$1.357 billion initially estimated for this category in the General Appropriations Act; and \$355 million or 31 percent below the revised estimate (1/22/92) of \$1.149 billion.

Among the significant disappointments in non-tax revenue collections was the failure to realize \$120 million projected through the planned debt swap between the Commonwealth and the Massachusetts Water Resources Authority (MWRA). In addition, contrary to the Administration's assumption that the sale of surplus state assets would generate \$231 million in state receipts, asset sales brought in less than \$16 million, creating another revenue shortfall of \$215 million. More judicious forecasting of non-tax revenues has emerged as a high priority budgetary issue as actual receipts of this major revenue source in FY92 plunged below budget estimates.

As shown in Table 3, the Commonwealth managed to close its FY92 accounts in its combined budgeted funds with favorable balances of \$549 million despite the extraordinary negative end-of-year balance of \$466 million in the General Fund. The overall surplus, as measured on the statutory accounting basis, may have been a Pyrrhic victory, however. The Commonwealth had to offset the General Fund deficit and several smaller fund deficits with other fund surpluses totalling over \$900 million. On a GAAP basis, as indicated in Table 5, the end-of-year fund balances for the combined budgeted funds in FY92 showed an unfavorable deficit of \$382 million.

TABLE 4
GENERAL FUND OPERATING RESULTS - STATUTORY BASIS
FY1992
(amounts in millions)

	1992 <u>Budget</u>	1992 <u>Actual</u>	Variance Favorable (Unfavorable)
REVENUE AND OTHER SOURCES			
Revenues:			
Taxes and assessments	\$ 4,891.3	\$ 5,810.8	\$ 919.5
Federal grants and reimbursements	2,299.4	2,382.7	83.3
Departmental	1,068.1	440.9	(627.2)
Miscellaneous	<u>0</u>	<u>289.8</u>	<u>289.8</u>
Sub-Total	8,258.8	8,924.2	665.4
Other financing sources:			
Fringe benefit cost recovery	0	80.1	80.1
Lottery reimbursement and distribution	68.8	66.6	(2.2)
Other operating transfers in	98.2	86.0	(12.2)
Sale of general fixed assets	<u>231.0</u>	<u>15.9</u>	<u>(215.1)</u>
Sub-Total	<u>398.0</u>	<u>248.6</u>	<u>(149.4)</u>
Total revenues and other sources	\$ 8,656.8	\$ 9,172.8	\$ 516.0
EXPENDITURES AND OTHER USES			
Expenditures:			
Agency operations	9,089.2	8,775.6	313.6
Pensions	269.1	265.5	3.6
Debt service	<u>486.9</u>	<u>482.6</u>	<u>4.3</u>
Sub-Total	9,845.2	9,523.7	321.5
Other financing uses:			
Fringe benefit cost assessment	0	11.0	(11.0)
Operating transfers out	1.9	1.9	0
Stabilization transfers	<u>0</u>	<u>102.0</u>	<u>(102.0)</u>
Sub-Total	<u>1.9</u>	<u>114.9</u>	<u>(113.0)</u>
Total expenditures and other uses	\$ 9,847.1	\$ 9,638.6	\$ 208.5
Excess (deficiency) of revenues and other sources over expenditures and other uses	\$(1,190.3)	\$ (465.8)	\$ 724.5

Source: Office of the Comptroller, Commonwealth of Massachusetts, Statutory Basis, Financial Report, Fiscal Year Ended June 30, 1992, P. 18-19.

FY93 Results. Projected end-of-year fund balances for the 1993 fiscal year reveal the extraordinary extent to which balancing the current year's budget required dipping into available reserves. In fact, were it not for large-scale drawing down of available reserves, this year's operating budget on a statutory basis (see Table 1) would have been out of balance by over \$300 million. For example, of the \$250 million in the state's Stabilization Fund as of July 1, 1992 (beginning of the 1993 fiscal year), an estimated \$32 million will be transferred to the General Fund during the course of the year. Since, the projected end-of-year budgeted fund balances on the statutory basis, estimated at a meager \$230 million, are only one and one-half of one percent of total estimated expenditures, the projected result does not conform with the recommended standard of many experts that end-of-the year balances, including rainy day funds, should be equal to at least 5 percent of state general fund expenditures. This standard is designed to protect budgets against unforeseen expenditures, emergencies and unanticipated revenue downturns.⁴

GAAP Accounting Basis. On a GAAP basis (see Table 5), end-of-year fund balances for fiscal 1993 (as of June 30, 1993) are tentatively projected at a negative \$998 million, more than double the end-of-year GAAP balances for the prior year, indicating that the Commonwealth's available reserves to offset unanticipated financial difficulties, may prove to be inadequate for avoiding future deficits.

⁴See Corina Eckl, "Strapped States Faces Hard Choices," State Legislatures (Nov. 1991), p. 20. Under Massachusetts state finance law, up to 5% of total state tax revenues can be accumulated in the Stabilization Fund and appropriation transfers from the Stabilization Fund are restricted as to purpose. This law also places a limit equal to 0.5 percent of total tax revenue on the amount of any aggregate surplus in the state's three principal budgeted operating funds that can be carried forward as a beginning balance for the next fiscal year. Any amount in excess of such limit is reserved in the Stabilization Fund from which funds can be appropriated for the following purposes: (1) to make up the difference between actual state revenues and allowable state revenues in which actual revenues fall below the allowable amount, (2) for any event, as determined by the Legislature, which threatens the health, safety or welfare of the people or the fiscal stability of the Commonwealth or any of its political subdivisions, and (3) to replace state and local losses of federal funds.

GAAP Measurement Reveals Persistent Fiscal Weakness

What is particularly portentous is the widening difference in the state's ending fund balances as between the statutory basis measurement and the GAAP measurement over the past three years. (See Exhibit 1.) Although the Commonwealth has been gradually altering its accounting practices so that they conform more closely with GAAP, and although the ending fund balances on the statutory basis during the last two completed fiscal years have been positive, major differences between the two measurement systems continue to be so persistent that they obscure the fragile state of the Commonwealth's fiscal condition. In fact, the Commonwealth is likely to end up with a negative funds balance under GAAP at the close of FY93 approaching a billion dollars.

TABLE 5
END OF YEAR FUND BALANCES -- GAAP BASIS
FY 1991-93
(amounts in millions)

	<u>Actual 1991</u>	<u>Actual 1992</u>	<u>Projected 1993</u>
Beginning Fund Balances*	\$(1,895.5)	\$(761.2)	\$(381.6)
Prior Year Deficit Financing	\$ 1,362.7	-	-
End-of-Year Fund Balances	\$ (761.2)	\$(381.6)	\$(997.6)

Source: Office of the Comptroller, Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, p.6 for FY91-92; FY93 figures are estimates cited by State Comptroller in address of October 1992. *Includes reserves, designations for continuing appropriations, or for such anticipated requirements as debt service of new bond issues, reserves in Stabilization Fund and undesignated surplus available for appropriation.

Sources of Unfavorable GAAP Effects

The State Comptroller's Letter of Transmittal accompanying the Commonwealth's most recent Comprehensive Annual Financial Report identifies the expense components that explain most of the past and projected unfavorable GAAP fund balance effects: (1) Medicaid, (2) Massachusetts Bay Transportation Authority (MBTA) liabilities, (3)

EXHIBIT 1

TRENDS IN FUND BALANCE

FY88-93



Source: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 1992, p.7. Trend lines for FY93 by McCormack Institute.

accumulated vacation and sick leave allowances, and (4) selective claims and risks.

Medicaid. On the statutory basis Medicaid expenses are treated as cash disbursements, and related federal reimbursement revenues under Medicaid are measured in proportion to such expenses.

Under GAAP accounting for Medicaid, however, the following expense items would be added to those compiled on the statutory basis--accrued expenses for Medicaid services provided in one year but not paid for until the next fiscal year, hospital and nursing home retroactive rate adjustments, plus other items of expense.

For example, payments made the following year for Medicaid services rendered in the current year have increased significantly from \$258 million in FY88 to \$809 million in FY92, and the latter component accounted for most of last year's accrued Medicaid expenses. These deferred payments are now made about three months after the close of the fiscal year in which they were accrued.

Medicaid Accrual for GAAP

	(in millions)				
	<u>FY88</u>	<u>FY89</u>	<u>FY90</u>	<u>FY91</u>	<u>FY92</u>
Accrued expenses	\$515.0	\$1017.0	\$825.0	\$932.0	\$967.0
Accrued revenues (50% federal reimbursement)	257.5	508.5	412.5	466.0	483.5
	_____	_____	_____	_____	_____
Net accrual-unfavorable effect to fund balance	\$257.5	\$508.5	\$412.5	\$466.0	\$483.5

Source: Idem, p. 8.

MBTA. On the statutory basis of accounting the Commonwealth's funding of the MBTA's operating deficit (its net cost of service) is done on a retroactive basis, 18 months in arrears. If the state's MBTA deficit commitments were measured on a current fiscal year

basis as required by GAAP, and those portions of the MBTA's operating deficit to be funded by assessments on cities and towns were counted as accrued revenues, the net accrual result would show steadily increasing unfavorable effects on GAAP fund balances.

As calculated for the past five years, the unfavorable MBTA effects on balances, as displayed in the following table, would range from over \$300 million in FY88 to \$475 million in FY92. These negative effects are due mainly to the fact that assessments for the MBTA deficit to cities and towns are capped by law to increases of 2 1/2 percent a year, leaving the Commonwealth with open-ended financial responsibility for MBTA operating deficits and debt service costs that have been growing at an average annual rate of 17 percent over the past four years.

MBTA Accrual for GAAP

	(in millions)				
	<u>FY88</u>	<u>FY89</u>	<u>FY90</u>	<u>FY91</u>	<u>FY92</u>
Accrued expenses (To be funded in future periods)	\$360.4	\$375.5	\$434.7	\$498.3	\$537.1
Accrued revenues (To be assessed to cities/towns)	57.8	59.2	60.8	62.3	62.3
Net accrual - unfavorable effect to fund balance	\$302.6	\$316.3	\$373.9	\$436.0	\$474.8

Source: Idem, p. 9.

Compensated Absences. The amounts of vacation and sick leave accumulated but not yet taken by state employees are not currently recorded as accrued expenses. Under GAAP expense accrual, however, the portion estimated to be taken within the next year would be

included in the GAAP calculation, as shown in the following table.

Compensated Absences Expense Accrual for GAAP

	(in millions)				
	<u>FY88</u>	<u>FY89</u>	<u>FY90</u>	<u>FY91</u>	<u>FY92</u>
Unfavorable effect to fund balance	\$131.2	\$135.2	\$139.2	\$144.3	\$197.3

Source: Ibid.

Claims and Risks. Accounting for claims and risks is another area of major difference between the two accounting systems. For example, judgments to be paid by the Commonwealth in such lawsuits as eminent domain takings are not measured under the statutory basis until actually paid; under GAAP, the Attorney General analyzes such lawsuits and provides estimates of potential judgments to be settled and paid within one year. Since insurance claims are not received or reported until after the accounting cutoff period, state employee health insurance and workers' compensation claims are not measured under the statutory basis until the next fiscal year. Under GAAP a special accrual is required as summarized below.

Claims/Risks Expense Accruals for GAAP

	(in millions)				
	<u>FY88</u>	<u>FY89</u>	<u>FY90</u>	<u>FY91</u>	<u>FY92</u>
Lawsuits	\$164.6	\$125.8	\$ 78.1	\$150.5	\$103.3
Health Insurance	33.6	34.1	32.9	46.9	41.7
Workers' compensation	--	--	--	50.4	49.5
Unfavorable effect to fund balance	<u>\$198.2</u>	<u>\$159.9</u>	<u>\$110.0</u>	<u>\$247.8</u>	<u>\$194.5</u>

Source: Idem, p. 10.

Finally, the State Comptroller also pointed out that tax revenues were measured differently under the statutory basis and GAAP basis: on the statutory basis, tax revenues are accounted for when cash deposits are received; under GAAP, additional compilations are made for taxes owed but to be collected and deposited at a later date and within one year. Moreover, a special accrual takes into account that portion of taxes owed and expected to be refunded or abated. The tax revenue accrual always affects the GAAP fund balance favorably, as shown below.

Tax Revenue Accrual for GAAP

	(in millions)				
	<u>FY88</u>	<u>FY89</u>	<u>FY90</u>	<u>FY91</u>	<u>FY92</u>
Taxes owed	\$862.4	\$788.3	\$1,022.4	\$1016.4	\$1,012.9
Less refunds/abatements	<u>(519.1)</u>	<u>(343.4)</u>	<u>(452.1)</u>	<u>(575.7)</u>	<u>(598.8)</u>
Favorable effect to fund balance	\$343.3	\$444.9	\$ 570.3	\$ 440.7	\$ 414.1

Source: Ibid.

Spectre of State's Structural Deficit

The following conclusions may be drawn from the wide differences between the Commonwealth's statutory basis of accounting and GAAP:

1. GAAP reveals that the state's financial condition has been and continues to be in deficit, and the surplus balance under the statutory accounting system understates by a net total of almost one billion dollars the true record by which current expenditures exceed current revenues.

2. The major components of the state's long-term structural deficit -- Medicaid, MBTA deficits, employee leaves and benefits, legal judgments, and other mandatory obligations -- represent long-standing and complex financial arrangements of such large scale that their conversion to GAAP can only be implemented gradually, particularly during a

period of economic recovery that is likely to be slow, long and relatively jobless, thereby providing minimum opportunity for resolving large-scale liabilities of the past.

Not included in this scenario are other structural impediments to real budget balancing -- (1) the state's relatively large debt burden (subsequently discussed in great detail), and (2) the minimum expenditure required by GAAP for amortization of the accrued actuarial liability for pension contributions. Since the Legislature has determined by law that amortization of the accrued liability should be significantly lower during the first 10 years of the 40-year schedule to cover the state's unfunded pension liability, for example, total pension contributions made by employees and the Commonwealth in the 1992 fiscal year were \$234.3 million below the minimum contribution required under GAAP.

Expenditure Escalation: A Reverse Trend

The sharp upturn of 10.5 percent in projected spending for the current 1993 fiscal year over the prior year, indicates significant change in state expenditure trends. (See Table 6.) It also represents major deviation from the Administration's original spending plan for the current fiscal year. According to House No. 1, the Governor's budget submission of January 22, 1992, budgetary spending for the 1993 fiscal year initially was estimated at a shade below \$14 billion, reflecting an ostensible continuation of expenditure stabilization. The abrupt rise in estimated FY93 appropriations to \$15.4 billion, almost \$1.5 billion over the original budget submission to the Legislature, shatters the illusion of spending stability. Although the Commonwealth will spend at an increased annual rate which is three times the inflationary trend, the anticipated increase in offsetting revenues will barely reach a total of \$15 billion, indicating an expected upturn in total budgeted revenues (excluding reserves) of

almost 6 percent. Tax revenues are expected to go up by 4.8 percent over those of the prior year.

Table 6 also identifies spending categories in which double-digit increases have occurred over the past two years and in which relatively large increases have taken place since FY90: direct local aid (up by about 8 percent since last year but down by 13 percent over the 4 years); regional transit (up by 17 percent since last year and by 52 percent since 1990); pensions (up by more than 16 percent since last year and by 30 percent over 4 years); and debt service (up by a whopping 33 percent over last year and by 55 percent since FY90).

Although the rate of expenditure increases for Medicaid and group health insurance did slow down this year, the three-year average increase for Medicaid during the 1990-93 fiscal period is still at the relatively high average yearly rise of 15.4 percent. The average annual rise in net costs of MBTA/regional transit continues to be high, at 17.5 percent. And debt service leads the pack with an average increase since FY90 that exceeds 18 percent a year.

Measures of Indebtedness

Of particular concern in this fiscal evaluation is the extent to which the Commonwealth has increased its debt in excess of generally acceptable standards of prudence. Although measurement of a state's potential to repay its debt is complex and somewhat subjective, according to measures generally used by bond credit rating agencies, underwriters and governments to assess debt burdens -- debt service trends, per capita debt load, ratio of debt to the full value of real estate, ratio of debt to personal income, percentage of annual

TABLE 6
EXPENDITURE TRENDS BY MAJOR BUDGET CATEGORY -
STATUTORY BASIS
FY 1990-93

<u>Budget Category</u>	(millions of dollars)					
	<u>Actual</u> <u>FY90</u>	<u>Actual</u> <u>FY91</u>	<u>Actual</u> <u>FY92</u>	<u>Projected</u> <u>FY93</u>	<u>% Change</u> <u>FY92-93</u>	<u>% Change</u> <u>FY90-93</u>
Direct Local Aid (1)	\$2,936.9	\$2,608.3	\$2,358.9	\$2,551.0	+ 8.1 %	- 13.1 %
Medicaid	2,120.6(2)	2,765.3(3)	2,817.7(4)	3100.0(5)	+10.0	+ 46.2
Group Health Ins.	433.4	446.0	466.1	509.1	+ 9.2	+ 17.5
Public Assistance	1,000.9	1,092.3	1065.0	1,089.1	+ 2.3	+ 8.8
Higher Education	701.9	608.6	534.0	547.0(7)	+ 2.4	- 28.3
Regional Transit	345.5	406.1	449.6	526.8	+17.2	+ 52.5
Pensions	671.9	703.9	751.5	873.8	+16.3	+ 30.0
Debt Service	770.9	942.3	898.3(6)	1,195.1	+33.0	+ 55.0
Other Programs	4,345.9	4,021.7	4069.9	4,584.2	+12.6	+ 5.5
Inter Fund Transfers (8) and Other Uses	137.8	340.1	502.8	404.5	-19.5	+193.5
Totals	\$13,474.7	\$13,934.6	\$13,913.8	\$15,380.6	+ 10.5 %	+ 14.1 %

Source: Fiscal 1990-92, Office of State Comptroller. Estimated fiscal 1993, p. A-28, Official Statement, General Obligation Refunding Bond Issues, 1993 Series A, dated February 15, 1993.

- (1) Cherry sheet aid, excluding certain pension funds.
- (2) Excludes \$488.0 million in retroactive rate adjustments and services, rendered in prior fiscal years which were funded in non-budgeted Medical Assistance Liability Fund.
- (3) Includes \$194.2 million for retroactive rate settlements, including \$126.0 million raised through Fiscal Recovery Bonds issued in 1991 to cover FY90 deficit.
- (4) Includes \$50.0 million in FY92 and \$50.0 million in FY93 for retroactive rate adjustments and settlements.
- (5) Includes \$3 billion in budgeted spending authority and \$100 million anticipated in supplemental appropriations.
- (6) Reflects reduction of debt services by \$261 million from issuance of refunding bonds during FY92.
- (7) Reflects transfer of \$75.0 in related tuition revenue and spending to an off-budget trust.
- (8) These are accounting transfers which reallocate resources among funds; including interfund transfers between Stabilization Fund and budgeted operating funds. Transfers to Stabilization Fund were \$59.2 million in FY91 and \$170.0 million in FY92. In FY93 it is estimated that \$32.4 million will be transferred from Stabilization Fund to General Fund.

budget allocated to payment of principal and interest on outstanding debt -- the current results for Massachusetts are unfavorable. It should be noted, however, that recent policy initiatives have been undertaken with the laudable objectives of gradually reducing the state's debt burden and its annual cost of debt service.

1. Debt Service Trend. The annual cost of debt service requirements for the state's budgeted funds operations over the past six years (FY 1987-93) has increased by 128 percent, an average jump of over 21 percent a year. For the 1993 fiscal year, repayment of principal and expense for interest has reached a record \$1.2 billion. This year's cost of debt service climbed by an extraordinary 33 percent over the past year. As a result, debt service now accounts for 7.8 percent of total budgeted expenses as compared with 4.7 percent in FY87 and 6.5 percent last year. (See Table 7 for summary of debt service trend.) Thus, although the current Administration has curbed the annual growth of capital expenditures from a peak of \$936 million in FY90 to about \$701 million in FY92 and to a proposed \$812 million to be spent from state funds for FY93, the annual cost of debt service is currently at an all time high.

2. Per Capita Debt. When the Commonwealth's indebtedness is measured in per capita terms, its overall debt liability is calculated at about \$2,000 for every resident man, woman and child. The state's outstanding bond and note liabilities, totaling \$12.4 billion as of January 1, 1993, includes its long-term general obligation debt, bonded debt issued to cover recent operating deficits, state-supported debt issued by certain public authorities such as the MBTA and Massachusetts Convention Center Authority, contingent state liabilities for debt incurred by other public authorities such as higher education authorities and outstanding

short-term obligations. (See Appendix Table). Since 1988, the Commonwealth's total debt liability has more than doubled, growing at a rate far in excess of the state's population.

TABLE 7
DEBT SERVICE, BUDGETED OPERATING FUNDS
FY1987, FY1990-93
(amounts in millions)

FY	Debt Service ⁵	Amount and Percent Change			
		Over FY87		Over Prior Year	
1987	\$524.1	\$ ---	---	---	---
1990	770.9	+246.8	+ 47.1%	+121.1	+18.6%
1991	942.3	+418.2	+ 79.8%	+171.4	+22.2%
1992	898.3	+374.2	+ 71.4%	- 44.0	- 5.7%
1993(Projected)	1,195.1	+671.1	+128.0%	+296.8	+33.0%

Source: p.A-13, Official Statement, General Obligation Refunding Bonds Issues, 1993 Series A, dated February 15, 1993.

3. Debt Ratios to Indices of Wealth. Bond rating agencies often measure state capacity for debt repayment by calculating the outstanding debt burden against the full value of real estate, a proxy for calculating the collateral that could be tapped in case of state default. If the full value of real estate in Massachusetts is estimated at \$427.6 billion for 1992,⁶ the ratio to its total indebtedness of \$12.4 billion as of January 1, 1993 is estimated at 2.90, far above the ratio of 1.78 for the 1989 fiscal year, peak year for this performance indicator during the booming eighties.

Bond rating agencies also compute the ratio of a state's debt to the personal income of its residents, another proxy to measure its capacity for carrying debt. On this basis, the most

⁵It should be noted that these debt service figures include only direct debt of the Commonwealth. They exclude debt service contract assistance to the MBTA (\$144.1 million in FY 92), to the Massachusetts Convention Center Authority (\$21.9 million in FY 92), and grants to cities and towns for school building assistance to cover part of the costs of debt service on local school bonds (\$145.2 million in FY 92).

⁶The estimated full value of real estate is based on the State Department of Revenue's valuation of \$427.6 billion for 1991 and 1992. (From p. A-41, Official Statement of 2/15/93 accompanying prospectus for general obligation refunding bonds issue of \$450,000,000-1993 Series A.)

recent Massachusetts ratio is 8.89, up significantly from 5.09 for FY89.⁷

Debt Limitation

Since the Massachusetts Constitution, unlike most state constitutions, does not incorporate any debt limitation devices, such as voter approval by referendum of borrowing proposals, recent governors and legislatures have launched administrative and statutory initiatives to slow down skyrocketing debt service requirements, to reduce total annual issues of general obligation bonds and to impose dollar limits on annual capital spending, which had climbed from about \$600 million in FY87 to \$971 million in FY89. For example, the Administration mandated in November 1988 that capital spending could not exceed \$925 million annually during each year of the 1989-91 fiscal period. Subsequently, the Legislature added several limitations in the Budget Control Act of 1989: (1) a ceiling of \$6.8 billion on the total amount of outstanding general obligations bonds, with an annual allowable increase of 5 percent; and (2) a requirement that annual debt service not exceed 10 percent of the state budget.

Further limits on state borrowing were imposed during the past two years and were ostensibly designed to tighten earlier ineffective reins. In December 1989, the 10 percent debt service limitation and the total outstanding debt limit of \$6.8 billion (with the limit for each subsequent year established at 105 percent of the prior year's limit) that had been adopted earlier was codified into the state's General Laws.

This legislation contains several inherent weaknesses, however. It may be amended, repealed or suspended in any annual General Appropriations Act. Moreover, by applying the limits only to "direct" bonds of the Commonwealth, by excluding debt service on the Fiscal

⁷Based on estimate total personal income of \$140 billion. (Idem.)

Recovery Bonds issued to cover billion dollar operating deficits of prior years from the computation determining the amount of bonds subject to the limit, and by excluding from the calculation of the prevailing limit the new Special Obligation Bonds (SOBs) and special refunding bonds for certain outstanding bond issues, the state's policymakers were granted considerable leeway to finance large-scale capital improvement projects. With these exclusions, for example, the FY93 limit on debt service is figured at 6.1 percent, far below the 10 percent debt service limit. It should be noted, also, that since the measurement of the statutory limit on outstanding direct bonds is determined under the statutory basis of accounting, not according to GAAP, the principal amount of outstanding bonds is calculated "net" of the discounts and costs of issuing bonds, thereby further liberalizing the borrowing margin. By any measure, Massachusetts debt limitation looks much like a "Swiss cheese."

New Debt Management Policies

The current Administration has launched a series of debt policy and debt management initiatives to promote the following objectives:

1. Slow down the Commonwealth's annual rate of capital spending.
2. Gain maximum leverage from the availability of federal funds for financing capital projects by giving priority in the state's borrowing program to matching federal fund requirements.
3. Fold the state's capital spending proposals into a long-term planning process that is targeted closely to economic development, job stimulation and high priority infrastructure improvements.
4. Coordinate more effectively the management of the state's debt with capital spending.
5. Finance certain highway and related improvement projects with the proceeds of

Special Obligation Bonds that are secured by dedicated revenues in the state's Highway Fund, thereby preserving the state's general obligation credit for capital needs other than transportation.

The specific mechanisms used by state officials to implement these objectives have included (1) debt refinancing, issuing refunding bonds at lower rates of interest and longer-term maturities than the bonds they replaced, and (2) debt restructuring, issuing Special Obligation Bonds for certain transportation projects that are secured by pledges of portions of revenues, particularly the motor fuels excise tax, to the Highway Fund. These new initiatives have both favorable and unfavorable consequences.

Debt Refinancing. For the 1992 fiscal year, the issues of advance refunding bonds gave the Commonwealth a one-year reduction of \$261 million in that year's cost of debt service. This brought debt service expense for FY92 down to \$898.3 million, \$44 million below the prior year's record-breaking outlay for principal and interest payments on the state's outstanding obligations.

The short-term benefit for current taxpayers, however, came at a high price for future taxpayers over the next 20 years. By advance refunding of certain general obligation bonds (including about \$57 million of the Fiscal Recovery Bonds used to pay off the FY90 operating deficit of \$1.362 billion) through the issuance of \$559.1 million in general obligation refunding bonds in FY92, the Commonwealth's regular debt service schedules were dislocated. In order to "make room" for the large issues of Fiscal Recovery Bonds within a normal amortization schedule (40 percent bond repayment within the first five years and the remaining 60 percent repayment in out-years), the regular debt was restructured, thereby excluding the Fiscal Recovery Bonds. As a result, in FY91, instead of 60 percent being repaid in the out-years, 65.5 percent of the bond maturities were extended into the out-years;

in FY92, 67.7 percent was pushed into the out-years.

More important perhaps, the accounting principle of promoting inter-fiscal period equity was further compromised. In using the proceeds from the massive refunding issues to purchase U.S. Government securities -- they were deposited in irrevocable trusts to cover all future debt service payments on the refunded bonds -- the latter have been "defeased",⁸ resulting in the removal of such liabilities from the Commonwealth's list of long-term obligations.

The long-term fiscal consequences of this refunding are not necessarily favorable for the state's credit rating. (1) Over the next 20 years, aggregate debt service was increased by about \$281 million; (2) interest costs will be running for a much longer period than the interest payments required under the original bond issues and ; (3) according to the Comprehensive Annual Financial Report for FY92 of the State Comptroller, the Commonwealth's economic loss resulting from refinancing, that is, the difference between the present values of debt service payments on the refunded and refunding bonds, is about \$12.3 million.

Large-scale refunding has had the following real impact: (1) the state's taxpayers will be paying \$376 million for interest costs on the Fiscal Recovery Bonds over a 7-year period (FY91-97); (2) debt service payments over the next 15 years (FY98-FY13) on the general obligation refunding bonds will total \$937 million (at a lower interest rate of 6.92% than was being paid under the original bond issue), thereby "sticking" our children and grandchildren for the sins of their parents.

⁸Voided or annulled.

The Commonwealth has resorted to debt refunding from time to time when interest rates declined and refunding at lower interest rates was appropriate. The refunding issue of \$426 million in FY93 was a classic case, providing an opportunity for net economic gains by refunding. What was unique and non-traditional about the FY92 refunding issues, however, was their enactment by the Legislature despite the concession in the text of the authorizing law that the refunding would result in net economic losses.⁹

In turning to this expedient device, a first in the state's fiscal history, the Commonwealth was compounding its extensive use of gimmickry (deficit borrowing, one-shot revenues, over-optimistic tax revenues, etc.) in efforts to extricate itself from a mounting fiscal crisis.

Debt Restructuring. When the Legislature adopted the so-called Special Obligations Act in 1991, authorizing the State Treasurer to issue revenue bonds that would be secured by a portion of taxes and fees credited to the Highway Fund up to a maximum of \$1.125 billion, it was creating a new general type of revenue bond financing for transportation projects, a financing device heretofore reserved in Massachusetts to public authorities supported in whole or in part by their own non-tax revenues. A major advantage of this initiative is that the Special Obligation Bonds, along with general obligation bonds for the same purposes, can be used to match federal funds allocated to Massachusetts for financing such high-cost transportation developments and improvements as the Central Artery depression and rapid transit projects.

⁹Authorized under Chapter 5, Acts of 1991. Note that Section 5 of this legislation, authorizing the state treasurer to borrow up to \$500 million in refunding bonds included the provision that such bond issues could be made "without a finding by the state treasurer that such refunding will result in present value savings to the Commonwealth..."

These revenue bonds are not general obligations of the Commonwealth. One of the benefits of such issues is that state officials will not be impeded by historic delays in issuing general obligation bonds to provide the proceeds needed to match federal grants. Debt limits and competing capital requests in bond issues have resulted in the past in tardy encumbrances and expenditures of available federal transportation funds.

Capital Spending Controls

The current Administration has also succeeded in reducing the elapsed time between the point when cash from the sale of related bonds becomes available and the time that such funds can be expended by more effective coordination of its 5-year capital plan with related debt management and cash management of bond proceeds.

In addition to establishing agency capital spending allocations and overall capital spending limits for each year through a new 5-year capital spending plan covering FY 93-97, the current Administration is seeking to impose further limits on the Commonwealth's debt burden by using executive power over the allotments of funds for capital appropriations to control the rate at which such appropriations are spent, thereby controlling the amount of bonds required to cover capital spending. The Commonwealth plans to spend on average about \$824 million a year between FY93 and FY97, an annual average that is about \$125 million a year above the FY92 capital spending estimate. These capital spending controls also have the objective of leveraging to the maximum, federal assistance available for capital purposes. According to the 5-year capital spending plan, the Commonwealth's planned outlay of \$4.12 billion for capital purposes is designed to generate \$4.8 billion in matching federal funds.

Finally, aware that prior internal controls on capital spending were ineffective, the Administration is planning and imposing new accounting procedures and fiscal mechanisms to ensure that agency capital spending does not exceed the amounts established in the capital spending plan. These include: (1) tracking actual agency spending against the plan on both a cash and encumbrance accounting basis in the State Comptroller's statewide computerized accounting system; (2) budgeting and monitoring actual federal matching reimbursements against anticipated federal receipts; (3) consolidating the number of capital project funds; (4) installing a new capital contracts approval process; and (5) curbing the traditional practice of using capital project funds for operating staff costs and related expenditures by requiring capital budgets to conform to a full-cost basis, thereby providing agency management with a useful tool to control capital spending.

It is not yet clear, however, that these administrative initiatives to put brakes on the Commonwealth's debt burden and to get "more bang for the capital spending buck" will prove to be more productive than prior debt management policies.

Budgetary Discipline

The extent to which responsible state officials have exercised budgetary discipline can be measured in a number of ways: by examining year-end actual versus estimated revenues and spending in budgeted operating funds, by analyzing the use of supplemental and deficiency appropriations, and by evaluating the reliance on financial gimmicks.

1. Actual vs. Estimated. The figures in Table 8, compiled on the statutory basis of accounting, show that state officials were exerting reasonable discipline in their budgetary planning and implementation over the last two fiscal years. Actual revenues for FY91 and

FY92 in the General Fund for example, exceeded estimated revenues by about three and five percent respectively, including Special Revenue Funds appropriated in the annual state budget, while total actual revenues exceeded estimates by about two percent and nine percent respectively for combined operating funds. Actual spending of budgeted funds in these two years, except for Special Revenue Funds in FY 92, ran below estimates in both years.

TABLE 8
ESTIMATED VS. ACTUAL REVENUES AND OTHER SOURCES
AND
EXPENDITURES AND OTHER USES
(amounts in millions)

	<u>General Fund</u>		<u>Spec. Rev. Funds</u>		<u>Total Combined Funds</u>	
	<u>Revenues</u>	<u>Spending</u>	<u>Revenues</u>	<u>Spending</u>	<u>Revenues</u>	<u>Spending</u>
<u>FY92</u>						
Budget	\$ 8,656.8	\$ 9,847.1	\$ 4,330.7	\$ 4,363.7	\$12,987.5	\$14,210.8
Actual	<u>9,172.8</u>	<u>9,638.6</u>	<u>5,053.4</u>	<u>4,275.1</u>	<u>14,226.1</u>	<u>13,913.8</u>
Difference	\$ + 516.0	\$ - 208.5	\$ + 722.7	\$ - 88.6	\$ + 1,238.6	\$ - 297.0
<u>FY91</u>						
Budget	\$10,882.5	\$10,609.8	\$ 4,662.5	\$4,147.8	\$15,544.9	\$14,757.7
Actual	<u>11,186.0</u>	<u>10,197.0</u>	<u>4,669.9</u>	<u>4,317.5</u>	<u>15,856.0</u>	<u>14,514.5</u>
Difference	\$ + 303.5	\$ - 412.8	\$ + 7.4	\$+ 69.7	\$+ 311.1	\$ - 243.1

Sources: Office of the Comptroller, Commonwealth of Massachusetts, Comprehensive Annual Financial Report, Fiscal Year ended June 30, 1992, pp. 34-35, and June 30, 1991, pp. 34-35.

When one peels off the top layer of these numbers, however, one begins to see the relative fragility of the state's financial condition, a situation obscured by its use of the statutory basis of accounting.

More detailed analysis reveals that current year revenues in FY91 and FY93 failed to cover spending fully. As a result there was heavy use of year-end balances, deficit borrowing, one-shot revenues and other gimmicks in those two years. Significant interfund transfers were necessary in FY91 and will have to be used again this year to balance the Commonwealth's books. For example, \$1.4 billion in operating deficit borrowing was

required in FY91 to offset a beginning-year funds deficit of \$1.1 billion. For FY93 state officials drew down \$319 million from beginning fund balances, including \$32 million from the Stabilization Fund, to offset the projected deficit. In FY92, although constrained spending below appropriations produced an increase over FY92 in the ending funds balance, for that year, there was considerable dependence on one-time revenue solutions.

On the other hand, had a comprehensive GAAP basis of accounting been in effect, the real financial picture would have showed year-end fund deficits rather than balances, thereby requiring more stringent budgetary disciplinary measures.

2. Supplementary/Deficiency Budgets. When good fiscal planning and effective control and execution of those plans prevail, there should be minimal need for frequent and relatively large supplemental/deficiency budgets.

A projected budget deficit for FY91 was obvious by mid-year. An interim period of executive-legislative harmony generated the self control needed to address the immediate problem, with the Governor using allotment reduction powers and uncovering the federal Medicaid reimbursement for uncompensated hospital care, and the Legislature agreeing to employee furlough legislation. Despite the budget-balancing collaboration between the two branches, there was a large volume of supplemental appropriations for FY91, including \$90 million authorized after June 30, 1991. The supplementals amounted to 4.1 percent of budgeted operating fund expenditures and 5.1 percent of General Fund expenditures.

The cooperative self-restraint between the two branches began to ebb the next fiscal year. The Governor's attempts to exert spending discipline through vetoes were largely unsuccessful. Although he reduced appropriations for General Relief (substituting a more

restrictive emergency assistance program) and group health insurance (for employees and retirees), the Legislature overrode the reduction of the group health appropriation and scaled down the appropriation for the emergency assistance program.

Moreover, the joint executive-legislative conservative revenue estimate, adopted as a fiscal disciplinary tactic, failed as revenue collections exceeded estimates, and stimulated a spurt of supplemental appropriations. Supplementals in FY92 almost doubled those of FY91, accumulating to a record \$1.02 billion, representing 7.3 percent of operating budgets. The Governor vetoed \$174 million of the supplementals. Although some of the vetoes were sustained, even if all the vetoes had been sustained, they would have reduced supplementals only to a level equal to 6.0 percent of budgeted operating funds, hardly an example of budgetary self control.

3. Gimmickry. The Commonwealth has made extensive use of fiscal gimmickry during the past three years, relying particularly on one-shot or non-recurring revenues and other expedient measures to balance its budgets. For example, the state used the gimmick of an employee furlough program to help address its projected deficit in FY91.

The Governor's proposed budget for FY92 included an original estimate of \$230 million in asset sales; only \$16 million was actually realized. Sales of assets for the operating budget are clear-cut, non-recurring devices. Even if fully collected, an equal amount of replacement receipts would have had to be found for next year.

The Governor's budget submission for FY93 included a total of \$411 million in one-shot revenue initiatives -- MWRA debt repayment, changes in the abandoned property law, sale of assets, and acceleration of certain motor vehicle licenses. In its final appropriations

act, the Legislature reduced the estimated yield of these estimates to \$219 million, including a decrease in the \$100 million estimate for asset sales to \$45 million. Realization of the latter amount is still very much in doubt. Also included in the final reckoning is an \$80 million one-time payment from the MWRA as forgiveness for its obligation to repay the Commonwealth for sewer and water debt liabilities of the state's Metropolitan District Commission.

Another gimmick -- somewhat benign, since the federal government continues to approve such payments as state matching -- is the federal Medicaid reimbursement for uncompensated hospital care. These reimbursements helped balance the FY91 budget by \$513 million in FY91 when its availability was uncovered. Similar reimbursement to the Commonwealth declined to \$164 million in FY92, and is estimated at \$213 million for FY93.

Early retirement incentives adopted as part of the current year's fiscal plan tilt into the expedient gimmick category of budget balancing. The FY93 budget submission of the Governor assumed a \$50 million saving from an early retirement plan. Net savings from the enacted version, however, are projected to be \$30 million for the combined years FY93 and FY94. While some initial budget savings may be realized, early retirement incentives have added to the Commonwealth's subsequent years' pension costs.

One of the more persistent gimmicks has been the extensive use of year-end fund balances and other reserves, especially the state's rainy day Stabilization Fund, for budget balancing. Reserves are supposed to protect budgets against unforeseen downturns in revenue collections, unexpected growth in entitlement programs, or unanticipated expenditure emergencies. Neither in FY92 nor in FY93 did the Commonwealth experience such revenue

and/or expense crises to warrant inordinate tapping of available reserves.

Ending fund balances for FY91 totalled \$237 million, or 1.7 percent of budgeted operating funds expenditures. Year-end FY92 balances added up to \$549 million or 3.9 percent of budgeted operating fund expenditures, while FY93 is projected to close with a \$238 million balance, only about 1.5 percent of budgeted operating expenditures. These balances, including unallocated balances in the Stabilization Fund, fall far short of the recommended standard of 5 percent reserves. Moreover, as indicated previously, if GAAP accounting were fully implemented, state officials would be faced with negative year-end funds balances in each year of the FY91-FY93 period. In fact, the Commonwealth's end-of-year fiscal position on a GAAP basis has been in deficit every year since FY87.

BUDGETARY POLICY INITIATIVES

Budget Busters

The so-called budget busters have been the major source of the state's long-standing structural fiscal problem. Unless their upward trend tendencies are restrained and kept in check, sustained fiscal stability and/or recovery cannot be achieved. Prior efforts to curb their upward spiral by mandated statutory and administrative reduction in services, program design changes and special mechanisms to control costs have produced limited results.

Imposing caps on annual percentage increases for certain runaway spending categories were suggested by the Senate Committee on Ways and Means a couple of years ago but not legislatively adopted. Such caps, reinforced by legal and administrative reforms, are still valid ways to address the budget busters. If the state fails to bring Medicaid, group

insurance, and transit subsidies down to desired targets, a more severe solution to re-draft the legislative authorizations underlying these programs may be necessary.

Spending for the five budget busters listed below has grown by almost 85 percent in the past five years. They currently represent over 41 percent of the Commonwealth's total program expenditures as compared with 28 percent in FY88.

TABLE 9
PERCENTAGE INCREASES IN SPENDING

	<u>FY91 over</u> <u>FY90</u>	<u>FY92 over</u> <u>FY91</u>	<u>FY93 over</u> <u>FY92</u>	<u>FY93 over</u> <u>FY88</u>
Medicaid	30.4%	1.9%	10.0%	88.8%
Debt Service	22.2	- 4.7	33.0	112.0
Pensions	4.2	6.8	16.3	45.6
MBTA & Regional Transit	14.5	10.7	17.2	92.2
Group Insurance	2.9	4.5	9.2	80.7

While there was a slowdown in the annual growth rate of spending for Medicaid, debt service, and MBTA/regional transit in FY92, their costs resumed their double-digit increases in FY93.

Medicaid budgetary spending in FY93 is the highest at \$3.0 billion -- a total which could rise at least to \$3.2 billion if anticipated reductions in cost from managed care are not realized -- followed by debt service at \$1.2 billion, pensions at \$874 million, MBTA and regional transit at \$527 million, and group insurance, just behind with \$509 million. Since FY88, the annual cost of debt service has climbed by an average of 22.4 percent; MBTA and regional transit, by an average of 18.4 percent; Medicaid, by an average of 17.8 percent; group insurance by an average of 16.1 percent; and pensions by an average of 9.1 percent.

1. Medicaid. Medicaid is the state's single largest spending program, reaching over \$3 billion in FY93. Underlying the relatively high Medicaid cost is the fact that

Massachusetts provides a progressive menu of Medicaid benefits to its residents, including most of the options available under Medicaid -- one of a handful of states to do so. Medicaid showed the highest average annual rate of growth until FY93 when debt service zoomed ahead. The current appropriation for Medicaid is 10 percent above FY92's spending total. It should be noted, however, that since two to three months of current bills for Medicaid services are not paid until the next year, the actual cost of Medicaid is understated by about \$500 million a year due to failure to use accrual accounting....

Forces driving the substantial increases in Medicaid include rising health care costs in general, and special factors driving up the aggregate cost of long-term care for the elderly and non-elderly disabled, especially intermediate care for the mentally retarded. Medicaid costs in the long-term care area were about \$1.39 billion in FY92, close to half the total expenses for Medicaid. Most of this was for nursing home care. The Commonwealth has a much larger portion of its elderly in nursing homes than the national average; 75 percent of the state's nursing home population is drawing Medicaid benefits. The State's Medicaid problem is compounded further by the fact that its nursing home costs are among the nation's highest, mainly because of comparatively high personnel costs, as documented by a large number of employees per nursing home resident.¹⁰

While Medicaid payments for needy aged have grown, their rate of increase has been overshadowed by the upward trend in expenditures for the disabled requiring long-term care. In fact, the numbers of eligible disabled are growing faster than the Medicaid population at

¹⁰Ed Moscovitch, Nursing Home Costs: A Comparative Analysis and Recommendations, pp. 3-4, Report prepared for the John W. McCormack Institute of Public Affairs, University of Massachusetts at Boston, June 3, 1992.

large, as has their share of total Medicaid payments. Much of the increase in the share of expenditures devoted to the disabled reflects the jump in payments to intermediate care facilities for the mentally retarded. The disabled caseload has expanded also because of the number of homeless and the AIDS epidemic. With continued growth in the state's elderly population and in its non-elderly disabled recipients, Medicaid costs are bound to escalate further.

To stem further annual cost increases, the Administration has begun implementation of a managed care program. Managed care requires prior approvals for certain procedures and for pre-admission nursing home screening coupled with case management of community-based alternatives to institutionalization plus voluntary enrollment in HMOs. The comprehensive managed care initiative and other discrete cost reduction initiatives have been assumed to avoid \$100 million of costs that would otherwise have been added to FY93 budget. Since the current fiscal year is the first full year of most of these initiatives, a \$100 million cost avoidance is in doubt and FY93 supplemental appropriations are estimated at \$100 million.

If the new National Administration accepts the option of the Congressional Budget Office to reduce the current 50 percent federal matching for Medicaid to Massachusetts and 12 other of the more affluent states to 45 percent, this would shift an estimated \$155 million in FY 94 from the federal share of Medicaid to the Commonwealth's share. Over a 5-year period (FY94-99), the added burden would accumulate to a total of \$775 million, based on current program levels, thereby nullifying state efforts to curb the state's liability for Medicaid spending.

2. Debt Service. This is the second state budget buster to surpass the billion dollar

cost barrier. After a small downward tick in FY92, debt service grew by 33 percent in FY93. The one-year decrease for FY92 resulted from the issuance of refunding bonds to capture the lower interest market, thus reducing that year's debt service but spreading repayment of the refunding bonds over a longer period. State debt, including debt service, has been discussed extensively in a prior section of this report.

3. Pensions. Pension costs, while nearing an annual \$900 million dollar level, have shown the smallest average annual increase over the last five years. However, FY93 costs are 16 percent above the prior's year total, the third highest annual increase of the five budget busters. Recent increases in pension costs are due mainly to the state's shift to a system of partially addressing its unfunded pension liabilities in addition to paying current benefits.

The FY93 increase also reflects the increase in the number of pensioners because of early retirement incentives and the cost of living increase for current retirees approved by the Legislature over the Governor's veto.

4. MBTA and Regional Transit Agencies. The state spends substantial amounts annually in support of the MBTA (T) and certain regional transit agencies as guarantees of their debt service, certain contract assistance, and payments covering their net cost of service. Almost 95 percent of the Commonwealth's transit costs are for the T.

FY93 appropriations for this budget buster total almost \$527 million, 89 percent higher than in FY88; the FY93 increase over FY92 is \$77 million, a jump of more than 17 percent. The state's contribution to the T has grown twice as fast as the T's own budget in the last 10 years because of major service expansion, the open-ended statutory arrangement of finances, declining federal assistance, and constrained local financial support.

The Commonwealth pays 90 percent of debt service for rapid and regional transit; there has been a sharp decline in federal grant operating assistance; Proposition 2 1/2 has limited the increase in the municipal share of the T's deficit each year; and slow adoption of modest fare increases has meant that revenues have not kept pace with the upward spending trend. Although the amount of increase for the T's contract assistance and assistance to the regional transit authorities is limited to five percent by fiscal 1994 budget estimates, further steps will be needed to remove this program from the class of budget busters.

5. Group Insurance. The cost of group insurance for the state's current workforce and retirees has gone up over 80 percent since FY88 to a level in FY93 of \$509 million, an average annual increase of 16 percent. There has been a slow-down in the annual rate of increase in the last two years, due mainly to rate negotiations with providers,

The Governor's attempts in FY92 and FY93 to increase the employees' share of premium from 10 percent failed. Instead, the Legislature authorized a study of the benefit plans offered by the Group Insurance Commission (GIC) and a comparison of GIC plans with similar ones in the public and private sectors. Findings showed that the Commonwealth's health care benefit costs are higher than those of most employers in both the public and private sectors because of higher than average use of health care services. The major conclusion of the study report was that improvement in the delivery and management of health care covered by group insurance could produce significant additional cost savings.

As a result, the GIC has widened plan choices, introducing a preferred provider plan which is generally priced in between prices for the HMOs and the state's indemnity plan. The GIC also is developing a separate mental health/drug abuse program. These

improvements plus the changes mentioned above reflect a projected \$24 million cost reduction in FY94 over the prior year. The Governor's proposed budget for FY94 of \$475 million for group insurance, a decrease of 6.7 percent, also assumes a \$47 million reduction from an increase to 20 percent from 10 percent in the employee premium share, an uncertain result if last year's legislative negative reaction is a predictor.

Spending Balance

Massachusetts spends heavily for human services programs, with Medicaid and public assistance alone consuming between 25 percent and 30 percent of the state's budgeted operating funds expenditures. Medicaid, with costs of over \$3 billion, represents the biggest part of these programs. Direct local aid, the next largest program category, constitutes about 19 percent of the state total, of which over half goes for public education.

Like all states, Massachusetts makes value choices in its public spending allocations. Have the Commonwealth's decision-makers elected to spend considerably more for human services than others?

A 1990 study found that expenditures for public services vary across states because of three major factors: (1) costs (public sector wages, cost of living, etc.), (2) circumstances (population, number of poor, per capita income, etc.), and (3) choices. By controlling for costs and circumstances, the study determined that differences in public spending allocations as between Massachusetts and other states could be explained by value choices.¹¹

While the overall level of state and local spending in Massachusetts differs from what would be expected given the socio-demographic characteristics and personal income of State residents by only a small amount, the pattern of value

¹¹Herman B. Leonard, The Choices Massachusetts Makes: A Comparative Analysis of State and Local Spending, p.1, Pioneer Institute, Boston, Massachusetts, November 1990.

choices exhibited by public spending in Massachusetts is markedly different."¹²

Leonard's conclusion is that spending on human services programs, even after allowing for higher input costs of providing these programs in Massachusetts, reflects considerably higher priority than other states give to spending in these same areas. At the same time, spending on several major "investment" areas -- public education, transportation infrastructure, etc. -- is materially lower, contends Leonard, than it would be if value choices in Massachusetts were more like those of other states.¹³ The conclusion is patent that the level of spending in Massachusetts for human services was attained by deliberate choice.

However, the Commonwealth has recently taken steps to shift the spending balance with measures designed to contain costs of human services programs and to increase funds for the "investment areas" such as public education.

FY92 saw fundamental change in the General Relief program, bringing its costs down by about \$55 million over FY91. Attempts are being made in FY93 to control the rate of Medicaid spending through managed care and other means.

Local elementary and secondary education is budgeted to receive \$175 million more school aid in FY94 if a reform education bill can be worked out. This would be in addition to the \$185 million in school aid added in FY93. Since neither item has been incorporated into the Governor's budget message, favorable action on school reform would mean either reductions in other parts of the state budget, presumably in human services, and/or a scaling-down of the additional outlays for school aid.

¹²Idem, p.4.

¹³Ibid.

After several years of reduced resources, state appropriations for public higher education is budgeted in FY94 to receive over \$90 million more, including the retention of revenue by the state and community college systems. However, since higher education agencies must cover the cost of the 13 percent two-year pay raise from their own resources, not by sharing in a statewide appropriation for salary increases, and since the lump sum appropriation for group insurance will be re-allocated to state agency budgets in FY94, the net benefit will be minimal.

Revenue Forecasting

Revenue forecasting, the wheel that tends to drive spending, can generate important budgetary consequences. Excessively optimistic revenue estimates may be used to justify higher budgetary spending levels. If the revenue predictions are not realized, higher taxes and/or expenditure control efforts become necessary to avoid a year-end budget deficit. For example, the current Administration had to resort to executive power available for withholding allotments in FY 91 (under Section 9C of Chapter 29 of the General Laws) when it became obvious that revenue estimates would not materialize. It took the unanticipated Medicaid reimbursement for uncompensated hospital care of over \$500 million to avoid the projected deficit in FY91.

From FY88 through FY91, as shown in Table 10, official tax revenue forecasts were overly optimistic. An unusually pessimistic tax revenue estimate, by contrast, was forecast for FY92, an estimate that was 7.8 percent below FY91 tax receipts and despite the analysis of independent sources that this was a low-ball forecast. Actual revenue collections were 5.6 above the under-estimate, a swing of over 200 percent. Much higher tax receipts in FY92, plus a further 2.1 percent increase originally estimated for FY93, stimulated a FY93 budget of about \$15.4 billion, an increase of \$1.4 billion over the previous year's budget. The hope

of the Administration that the low-ball estimates would effectively cork the spending bottle vanished.

TABLE 10
TAX REVENUES
ESTIMATED* VS. ACTUAL PERCENTAGE CHANGE

<u>FY</u>	<u>Estimated</u>	<u>Actual</u>	<u>Difference</u>
88	+ 7.4%	+ 2.1%	- 71.6%
89	+10.9	+ 6.5	- 40.4
90	+ 7.0	- 3.4	-148.6
91	+14.4	+ 5.6	- 61.1
92	- 7.8	+ 5.4	+244.4
93	+ 2.1		

Source: State Department of Revenue.

*By Executive Office of Administration and Finance.

The difference between estimated and actual tax revenues in each of the past five years, as shown in Table 10, has been significant. With tax revenues making up 69 percent of the Commonwealth's total revenues and other sources, the importance of careful tax revenue forecasting is obvious.

Total FY93 taxes to meet budgeted operating fund expenditures currently are estimated to grow 4.8 percent (revised estimates as of 2/28/93) above actual tax revenues during FY92, instead of 2.1 percent. For the first eight months of FY93, however, tax revenues rose by only 3.6 percent over tax revenues in the same period of the prior year, a pace that is even slower than that after six and seven months.

Sales taxes for the first six months of FY93 were 9 percent over a year ago, due in part to strong December collections, which were 15 percent above the same month in FY92. It is believed, however, that the December figure was skewed by large automobile dealer incentives and rebates. The eight-month sales tax collection record is less than 6 percent

higher than for the same FY92 period, a weaker rate of collection than mid-year, which lends credence to the automobile rebate theory and which contributes to the reduced rate of increase in overall collections.

The other ostensible growth improvement in tax revenues came in collections of so-called "estimated" income tax payments, which climbed by almost 10 percent in the first eight months of FY93 over the same period in FY92. While the Administration is encouraged by this "positive revenue trend," questions arise as to what extent taxpayer anticipation of higher federal marginal tax rates in calendar 1993 encouraged those making estimated state tax payments to push as much taxable income into 1992 as possible? In neighboring states such as New York, similar unexpected income tax collections have been attributed to such taxpayer behavior.

Since personal income taxes account for over 55 percent of total taxes (sales taxes 25 percent), it is disquieting that the eight-month record of income taxes collected through withholding shows a zero percent change over the same period in FY92. Corporation excise tax collections continued to deteriorate over the same period of FY92; the six-month drop was 1.4 percent; the seven month decrease was 2.2 percent, while the eight-month collection figure was 3.6 percent lower than FY92. Those trends reflect a continued contraction of the state's tax-producing labor force and wage base. While showing gradual improvement, the state economy continues to resemble a jobless recovery with limited potential for tax revenue growth.

The economy's negatives include a relatively high state unemployment rate and slow growth in personal income. The state unemployment rate continues to exceed the national rate; the 1992 average for the state was 8.5 percent vs. 7.4 percent for the nation; the January and February 1993 rates were 8.2 percent and 7.7 percent respectively compared to

7.1 percent and 7.0 percent for the nation. The Massachusetts civilian labor force dropped by 15,000 between December 1991 and December 1992, the only one of eleven industrial states to suffer such a reduction in that period; there has been a slight increase since December. Personal income growth for the period between the second quarter of 1991 through the second quarter of 1992 was 3.9 percent, ranking Massachusetts 43rd among the 50 states.

The economic and tax forecast of the Massachusetts Taxpayers Foundation (MTF) for the first quarter of 1993 predicts that the economy has bottomed out, but cautions that the recovery will be long and slow. Other economists confirm that the bottom has been reached, but that growth will be moderate through 1993. The MTF projections also highlight (1) slow growth of personal income in 1993, although the 1992 increase in personal income exceeded inflation for the first time since 1988; (2) an average annual unemployment rate for Massachusetts continuing to exceed the national rate; and (3) a continuation of population out-migration.¹⁴

Economists play an important role in forecasting state economic activity since their analysis is translated into state revenue forecasting through the application of modeling methodology. Yet, macroeconomic forecasting is more difficult at the state level than the national level because there are far less data available and fewer state macroeconomists who study and analyze regional or state economies in detail.¹⁵ Thus, state tax revenue forecasting is subject to far greater uncertainty. According to Professor Wolfe,

¹⁴Massachusetts Taxpayers Foundation, Inc., Economic Outlook Improved, January 25, 1993, pp. 2-4.

¹⁵Arthur G. Wolfe, The Economics and Economic Analysis of Boom and Bust, pp. 9-10, University of Vermont.

Economic forecasts are only as good as the data that underlie them and only as good as the theoretical understanding of what is causing the economy to behave the way it is. The quality of data that we have to work with is uneven; it is a well-known constraint with which all economic and revenue forecasters must deal.¹⁶

In the final analysis, state budgets are highly dependent on the performance of the national economy. A booming economy normally boosts state revenue; a sagging economy reverses the trend.

In his FY92 Annual Report, the Comptroller complimented state officials for the additional attention and disclosure given to revenue estimates in the budgetary formulation process beginning with the detailed disclosure of revenues in the FY92 General Appropriations Act and continuing with the FY93 Act.¹⁷ The legal formalization through legislative resolution of publicly announced revenue estimates has led to more reasonable Massachusetts tax revenue numbers about which the public can have greater assurance.

While the new process reflects a more disciplined approach to tax revenue forecasting, there is also the danger in the rush to spend the flush of unexpected revenues in excess of estimates through a flood of supplemental appropriations as in FY92, and to embark on much higher spending in the next budget, as happened in FY93.

Forecasting of non-tax revenues, however, has been more erratic, partly because of continuing revenue gimmickry, because of tendencies to keep revising the estimates, thereby diluting the discipline of a firm benchmark, and partly because of inherent methodological difficulties in estimating these revenues. Departmental Revenues, which account for between

¹⁶Idem, p.17.

¹⁷Office of the Comptroller, Commonwealth of Massachusetts Comprehensive Annual Report, Fiscal Year Ended June 30, 1992, p. 21.

25-30 percent of non-tax revenue, have been particularly vulnerable. For example, FY92 Departmental Revenue receipts were over 40 percent below the original estimate and about 30 percent below the revised estimate. Until more reliable methodologies are adopted, consideration should be given to a forecasting process for Departmental Revenues which would require estimates to be based on prior year actual collections.

Economic Stimulus Initiatives

The Governor's budget message for FY93 laid out a plan for economic recovery. A highlight of the economic strategy included a tripling of the investment tax credit (ITC) and making business loans available to counteract the shortage of capital that Massachusetts firms have been experiencing.

After modifications and delays, the Governor's bill passed the House but failed to be acted upon in the final days of the 1992 legislative session. Legislation was finally passed in March 1993 raising the ITC to 3 percent, but with a "sunset" provision of three years.

Also included in the law are a \$15 million loan-guarantee for small businesses, and \$3 million to help the state's exporting efforts; the law also allows distressed areas to be designated as economic opportunity zones where businesses would receive tax incentives to locate or expand.

The underlying theory of the increased ITC is that it will encourage capital investment which in turn will spur job creation and other economic activity.

The Administration estimates the following revenue effects from a 3 percent tax credit stimulus. The static estimate (before feedback impacts are taken into account) would reduce the corporate excise tax in the first year by \$21.5 million; by \$29 million in 1997. The net

revenue effect (after accounting for expected increased personal income, sales, and corporate taxes) is estimated as a reduction of \$7.6 million in total revenues during the first year; \$12.6 million in 1997.¹⁸

Manufacturing corporations, research and development corporations, and corporations primarily engaged in agriculture or commercial fishing would be eligible for the tax credits. Eligible property is defined as tangible personal property and industrial structures used and located in Massachusetts, excluding motor vehicles and trailers. The law continues to require that corporations report the number of new jobs created or existing jobs protected by the new investment receiving the tax credit.

Massachusetts has from time to time experimented with ITC's. It was introduced in 1970 at one percent, increased to 3 percent for the period between 1980 and 1986, and dropped back to one percent at the end of 1985. The State Department of Revenue found in 1984 that half the credits authorized during 1979-82 were used by high tech companies while the second largest group of entitlements were durable manufacturing industries.

The ITC's history has been marked by gnawing questions about its real effectiveness in encouraging capital expansion and creating jobs. With respect to its employment effects, the requirements that corporations report on jobs created or saved produce data that answers different questions than those asked. The firms may report on the number of employees that work in a plant or on a piece of equipment, but cannot answer what their employment levels would have been without the ITC, what was the increase in sales because of the ITC, and

¹⁸Price Waterhouse, Preliminary Tax Incidence and Economic Impact Analyses of Illustrative Tax Policy Options, June 12, 1992, p. 3.

what was the associated effect on employment and compensation.¹⁹

Evidence from experience in New York State casts strong doubt on the impact of the ITC in generating jobs. In New York, corporations receive a 6 percent investment credit at the time of capital purchase and are then eligible for 3 percent additional credits for each of the following three years if they increase employment by at least one percent a year. New York's State Tax Commission found that 83 percent of the corporations claiming the ITC did not increase New York employment by enough to claim the additional credits.²⁰

Short-Term v. Long-Term Fiscal Perspectives: A Budgetary Dilemma

A nationally recognized specialist in state and local finance concluded a year ago that (1) Massachusetts had "not faced up to structural imbalance in its budget," (2) despite boldness in spending reductions, the state was a "big temporizer, living on borrowed time" and (3) "its present policies are not sustainable in the long run."²¹ Among the factors behind these observations were budgetary decisions designed to achieve single-year or limited period fiscal benefits despite an awareness that these actions had adverse future implications.

Some of the short-term devices used to produce ostensible budgetary balance without cutting spending or increasing taxes have already been cited and evaluated in prior sections of this report -- (1) various examples of budget gimmickry and one-shot revenues, in the discussion of "budgetary discipline," (2) debt refinancing and debt restructuring, in the

¹⁹Commonwealth of Massachusetts, House No. 5263, April 2, 1987, The Eleventh Interim Report of the Special Commission Relative to the Corporations Excise Tax in the Development of a Tax Reform Program for the Commonwealth, p. 72.

²⁰Ibid.

²¹Steven Gold and Sarah Ritchie, "Fiscal Crisis in New England: How the States Responded, 1989 to 1992," p. 26, paper presented at conference held at Federal Reserve Bank of Boston, April 8, 1992.

discussion of "debt policies," and (3) inordinate depletion of available reserves, in the discussions of "operating budget results and end-of-year balances."

Although the state's budget-makers in both the executive and legislative branches stated their intentions to curb these expedient short-term budget-balancing practices, the FY92 operating budget results in the General Fund indicated the significant extent to which the failure of such fiscal devices to reach their targets was responsible for the large General Fund deficit. Although the final budgetary decisions for FY93 reflect a lesser dependence on such devices, it remains to be seen whether the extraordinary reliance on tapping available reserves to balance this year's state budget will offset an accumulation of uncertain spending and revenue assumptions.

On the other hand, the Administration has been pursuing with commendable effort and energy a variety of budgetary policies that emphasize the prevention of problems under a long-term view that such investments should not only prove more cost-effective in the short-run but result in out-year budget reductions, with more permanent benefits. Most of these desirable shifts in budget policy may be found in the human services and health areas.

Among the more notable initiatives are: (1) the implementation of managed care in Medicaid with the objective of reducing costly, ineffective emergency care, (2) expansion of pre-natal and post-natal services to low-income women and newborn children with the objective of reducing infant mortality rates, the number of low birth-weight babies and the high cost of neonatal health care, particularly among minority groups, (3) expansion of homeless prevention approaches, including those designed to keep families with children from being forced into emergency shelters and motels and to replace emergency shelters with community-

based housing for homeless persons with mental illness, (4) a far-reaching anti-smoking campaign, to be financed from the additional tax on cigarettes approved at the November 1992 referendum, with priority on educational programs for school-age children that may reduce the future rate of tobacco addiction among young adults and adults. Although there may be widespread support for creative prevention initiatives, they depend to a considerable extent on unpredictable behavioral response and change on the part of the target group. Moreover, the public tends to become impatient when unforeseen factors upset program assumptions about anticipated performance and results.

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

If the primary goals for improving a state's tax system, as Steven Gold has suggested, are (1) broadening its tax base, (2) enhancing the balance among its major tax sources, and (3) increasing the elasticity of its revenues whereby they are more responsive to economic growth, while maintaining or strengthening the system's tax equity, how has the Commonwealth performed when measured against these targets?²²

It should first be noted that the current Administration has made spending reduction the centerpiece of its overall strategy to restore the state's fiscal stability. Moreover, the Administration's support for selective tax cuts has been based on its belief that lower taxes are useful mainly for improving the state's economic competitiveness and as stimuli for promoting economic activity and job creation. There is little evidence that the Administration's tax policy initiatives, unlike those enacted in Connecticut in 1990 and 1991, have been fundamentally geared to broadening the state's tax base, securing better balance in

²²Idem, p 2.

its reliance on major tax sources or achieving greater equity in distribution of the tax burden among income groups.

Bipartisan efforts by the Governor and Legislature did succeed in sunsetting the temporary income tax rate increases on earned and unearned income that had been enacted to finance state operating deficits, bringing these rates down to 5.95 percent for the 1992 and subsequent tax years from their peak of 6.25 percent in the 1991 tax year.

But the Legislature's concern that letting income tax rates decline further to 5.75 percent would mean a \$140 million loss of potential revenue in the 1992 budget and ideological differences over both the revenue loss implications and income group benefits from the proposed capital gains reduction put an effective damper on the enactment of additional tax reduction proposals. Except for the investment tax credit and related economic incentive enactments, the Administration and Legislature have lost their earlier zeal for tax policy changes.

The Governor's energetic drive to repeal implementation of the 1990 legislation imposing the state's sales tax on certain professional services to businesses generated concentrated opposition from organized groups of lawyers, accountants, architects, engineers, etc. Moreover, their full-court press was bolstered by media opposition to a separate provision that would have applied the sales tax to newspaper production, thereby canceling tax exemptions.²³ Somewhat overlooked in the debate over the proposal was the fact that the current sales tax in Massachusetts is levied on a very narrow base, that exemptions for most retail services in this state are difficult to justify on equity grounds and that there is a serious

²³C.4, Massachusetts Acts and Resolves, 1991, approved on March 8, 1991.

imbalance among the major revenue resources of the Massachusetts tax system -- state income taxes account for 55 percent of total tax revenue as compared to 22 percent of the total from sales and use taxes. The political perception that a sales tax on professional services to business was inconsistent with the reality that Massachusetts is a relatively high-salary professional services state outweighed any argument that sales tax expansion would mean a more balanced state tax system and constitute badly-needed tax reform.

It should be noted that, although the short-lived sales tax on professional services was repealed and that extending the sales tax to newspaper and other media production was rendered unconstitutional by the State Supreme Judicial Court,²⁴ the 1990 legislation broadening the scope of the sales tax retained its extension to the sales and uses of electricity, gas and steam for non-residential use and to telecommunication services to both non-residential and most residential sales and uses. For fiscal 1991, the yield from these sales tax extensions was estimated at \$113 million; at \$180 million for fiscal 1992.

A review of tax policy legislation indicates that, during the 1990-1993 period, Massachusetts achieved only slight progress in making its tax system somewhat more balanced. With one of the most unbalanced state tax systems in the nation, because of the current configuration of relatively high income taxes and low sales taxes, the limited extension of the sales tax to certain utility and communication services represented some movement toward more favorable tax balance without adversely affecting the relatively progressive pattern of its tax system.

²⁴See *Globe Newspaper Co. vs. Commissioner of Revenue*, 410 Mass. 188. Court ruled that proposed sales tax amendments would subject newspaper publishers to tax treatment different from that provided other manufacturing processes and thereby violated a newspaper publisher's First Amendment rights under the U.S. Constitution.

Finally, the Commonwealth did take one small step toward tax reform. Initiated within the Legislature and supported by the Governor, this legislation gradually phases out the Massachusetts estate tax. In its place the new law substitutes a so-called "sponge tax," to be fully implemented by 1997, that coordinates the Massachusetts estate tax with the federal estate tax law. "Sponge" refers to the fact that the Massachusetts estate tax will now be based on the maximum amount of the credit for state estate taxes allowed under U.S. Internal Revenue Code provisions covering the federal estate tax.

Under the statutory phase-out arrangement, exemptions are increased annually from the current \$200,000 basic exemption level (increased from \$60,000 in 1985) by annual increments of \$100,000 during the 1993-96 period until it reaches the new maximum of \$600,000. Another reform in the state tax increases the current marital deduction, 50 percent of the adjusted gross estate, to a full 100 percent as of July 1, 1994. Estate tax revenue losses are estimated at \$2.2 million in FY93, \$24.8 million in FY94 and \$72.5 million in FY95 when the phase-in is completed. Since the total actual yield from Massachusetts estate and inheritance taxes in FY92 was \$260.2 million, while the static effects of the phase out are estimated to produce \$275 million in FY93 and \$265 million in FY94, the projected losses from a total state tax yield of \$10 billion are hardly onerous.

The tax reform elements incorporated in the comprehensive revision of the Massachusetts estate tax may be summarized as follows:

1. Federal-state tax coordination was achieved.
2. Revision of the asset liability threshold responded to the reality that the values of homes and other assets of middle-income

taxpayers appreciated significantly since their acquisition, thereby enhancing tax equity.

3. The anticipated short-term decline in estate tax revenue yields will be offset by higher collections of state income, sales and other taxes from retired wealthy residents who might ordinarily have migrated out of Massachusetts in order to escape estate taxes.²⁵

FY94 Proposed Budget: A Profile of Uncertainty

Below are highlights in the Governor's budget recommendations for the next year which demonstrate the Commonwealth's continuing financial fragility:

1. Although budgeted expenditures for FY94 total \$15.2 billion, an ostensible \$180 million or 1.3 percent below total projected expenditures for FY93, the estimates not only omit a continuation of \$185 million in additional school aid authorized for FY93, but also fail to include the estimated first-year cost of public school reforms. This would require another \$175 million in school aid to cities and towns for FY94.
2. If school reform is enacted by the Legislature, triggering the Commonwealth's financing commitment to implementation, at least \$360 million must be reduced from the Governor's original recommendations to maintain a balanced budget.
3. Setting aside the potential significant increase in additional school aid, the Governor's proposed budgeted revenues for FY94 of \$15.228 billion show a flimsy projected

²⁵See "The Impact of Estate Tax Reform on Massachusetts Tax Receipts," Analytical Resources, prepared by William H. Crouse and Thomas D. Leavitt (undated), A Study by the Boston Estate Planning Council in Association with The Massachusetts Society of CPAs and The Massachusetts Bar Association. The authors estimated that eliminating the estate tax would result in a net revenue gain of about \$82 million.

margin of only \$20.5 million (one-fifth of one percent) in excess of the proposed budgeted expenditures of \$15.208 billion.

4. Whether the Commonwealth will achieve a non-tax revenue target for FY94 totalling \$4.8 billion, slightly above the revised total estimate for FY93, is problematic in view of the large-scale shortfall experience in non-tax revenue collections for FY92. In addition to the uncertainty of reaching the FY93 target for non-tax revenues, the FY94 budget continues reliance on one-shot revenues such as the planned sale of the State Transportation Building and includes an undocumented estimate that new video poker and keno games would generate as much as \$50 million in the first year without adversely affecting receipts from other lottery games.

5. Despite the perilously slim margin of budget balance for FY94, it is difficult to comprehend the list of budgetary proposals that expands the use of tax expenditures and fee reductions, thereby eroding the Commonwealth's constrained revenue base:

- a. Tax credits for higher education tuition.
- b. Tax credits for health insurance of senior citizens.
- c. Roll-back of Registry of Motor Vehicles fees for operators of passenger vehicles.

MAJOR CONCLUSIONS

If we let the numbers do the talking, the foregoing fiscal smells tests indicate that:

1. Although the Commonwealth's financial condition deteriorated when measured according to the statutory accounting basis, it was deteriorating more seriously when measured by GAAP.

2. Although the state's financial condition seems to be on the mend, the situation is not as good as it should be.

3. In terms of public perception, when the state's finances collapsed, conditions in fact were worse than people thought; and as they have improved, they are hardly as favorable as people think.

4. The Commonwealth's structural deficit, at least a billion dollars according to GAAP, is attributable to two major factors:

a. Unlike the eighties, in which a robust economy was generating an unprecedented treasure of tax revenue collections, the state's relatively weak economic recovery is generating only modest increases in tax collections, and the state's tax base is being eroded by a greater volume of tax refunds, abatements and uncollectible taxes driven by the economic vicissitudes of taxpaying corporations and individuals.²⁶

b. When the Commonwealth's spending obligations are measured according to GAAP, they show that such big-ticket budget busters as Medicaid, MBTA/regional transit, pensions and debt service, and such unrecorded and/or under-stated obligations as employee vacations/sick leave and legal judgments, are chiefly responsible for the massive negative end-of-year budget balances, and for prolonging the structural deficit.

5. Although down-sizing, restructuring and budget reforms ended a five-year string of

²⁶Refunds of income taxes, corporate excise taxes and business excise taxes during the July 1992-February 1993 period, for example, have risen to 8.6 percent of taxes collected to date compared with 7.9 percent during the same period of last year. According to the state's balance sheets, uncollected state taxes net of the allowance for uncollectibles increased by 12.2 percent during the 1992 fiscal period over the prior fiscal year. And the balance sheets also indicate that the state's liability as of the end of FY92 for state tax refunds and abatements not yet paid increased by 13.9 percent over the refund/abatement payable total as of the end of FY91.

consecutive operating deficits, averted financial collapse and temporarily resolved the Commonwealth's cash flow problems, the meager margin of budget balance in the Governor's message for FY 94 and concerns that there are glaring examples of under-funding in this budget strongly suggests that Massachusetts has not yet achieved fiscal structural balance, and that much more needs to be done before the state can claim that it passes the smell tests in this report.

APPENDIX TABLE
Commonwealth Bond and Note Liabilities
January 1, 1993
(in thousands)

	<u>Long Term</u> (1)	<u>Short Term</u>
COMMONWEALTH DEBT		
General Obligation Debt	\$7,889,726 (2)	\$338,969 (3)
Dedicated Income Tax Debt	1,244,090	--
Special Obligation Debt	<u>103,770</u>	<u> </u>
Sub-total Commonwealth Debt	<u>9,237,586</u>	<u>338,969</u>
 COMMONWEALTH SUPPORTED DEBT		
MBTA	1,932,800 (4)	355,000
Massachusetts Convention Center Authority	163,669	--
Massachusetts Government Land Bank	5,725	--
Boston Metropolitan District	58,112	--
Steamship Authority	35,690	--
Regional transit authorities	<u>115</u>	<u>64,192</u>
	<u>2,196,111</u>	<u>419,192</u>
 COMMONWEALTH GUARANTEED DEPT		
Local housing authorities	--	--
Higher education building authorities	253,423	--
Town of Mashpee	<u>800</u> (5)	<u> </u>
Subtotal Guaranteed Debt	<u>254,223</u>	<u> </u>
 TOTAL COMMONWEALTH BOND AND NOTE LIABILITIES	 <u>\$11,687,920</u>	 <u>\$758,161</u>

Source: Preliminary Official Statement, General Obligation Refunding Bonds Issue, 1993 Series A, dated February 15, 1993.

- (1) Long term debt includes discount and costs of issuance. Does not include long term capital lease obligations. See "Indirect Obligations - Plymouth County Certificates of Participation" and "OTHER COMMONWEALTH LIABILITIES -- Long Term Capital Leases."
- (2) Includes interest on Commonwealth general obligation capital appreciation bonds to be accrued from January 1, 1993 through their maturity in the amount of \$437.3 million.
- (3) Represents \$240 million of Commonwealth General Obligation Notes issued for the purpose of financing the MBTA's 1991 calendar year net cost of service which matured on January 28, 1993 and \$98.969 million of the Commonwealth's "minibonds" (which are redeemable at the request of the holder on one business day's notice and are treated as short term liabilities). The Commonwealth intends to issue additional general obligation notes for the purpose of financing the MBTA's 1992 calendar year net cost of service by the end of fiscal 1993. See "General Obligation Debt; Commonwealth General Obligation Notes and Minibonds." As of February 16, 1993, the Commonwealth also had \$220 million of commercial paper outstanding. For a description of the Commonwealth's commercial paper program, see "General Obligation Debt; Commonwealth General Obligation Notes."
- (4) On January 19, 1993, the MBTA issued \$378,675,000 aggregate principal amount of bonds for the purpose of refunding \$323,070,000 of outstanding MBTA bonds.
- (5) On February 1, 1993, the Town of Mashpee made a \$200,000 principal payment with respect to these bonds.

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