Communities at risk: Fiscal ties between the Commonwealth and its localities

JOHN P. HAMIIL

FACING RISING COSTS, LIMITED LOCAL AID, AND RESTRICTIONS ON RAISING REVENUES, MASSACHUSETTS CITIES AND TOWNS ARE EXPERIENCING A SERIOUS FISCAL SQUEEZE.

Virtually all Massachusetts cities and towns face financial problems. With many costs, especially for health care, rising faster than revenues from local taxes and fees, localities are left with virtually no ability to tap new revenue sources or to significantly increase existing taxes and fees. State aid for localities has dropped dramatically in recent years. And since the mid-1990s, a growing proportion of it has been reserved for education, with restrictions that do not allow local governments to redirect this local aid revenue to non-education uses.

Local source revenues in total, including property tax, local receipts and other revenue, have grown only 0.8 percent annually between fiscal 1981 and 2004. (See Figure 1.) As a percentage of municipal budgets, total local source revenues have decreased from 80.1 percent in fiscal 1981 to a low point of 69.0 percent in fiscal 1988, they then rose to 75.6 percent in fiscal 2004, which was their highest point in ten years.

For the fiscal 1981 to 2004 period, total local source revenues increased on average for all regions, income quintiles and population groups, except Boston. In general, communities with higher income and smaller population groups experienced greater annual average increases in total local source revenues than their poorer and larger counterparts.

This article is based on Local Communities At Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns, a comprehensive report by the Municipal Finance Task Force, a group of private sector, public sector and academic experts that was chaired by Sovereign Bank Chairman John P. Hamill. This article also draws upon material contained in Local Services, Local Aid, and Common Challenges, a Rappaport Institute for Greater Boston policy brief by Phineas Baxandall, Rappaport’s then-assistant director. The full report can be found at http://www.ksg.harvard.edu/rappaport/downloads/policybriefs/brief_finance.pdf.
Proposition 2½, which Massachusetts voters approved in 1980, set limits on the total amount by which localities can increase local property tax revenues to no more than 2.5 percent a year.

As a result of that law and an improved state economy, per capita, constant-dollar state aid for K-12 education, which had increased modestly in the mid-1980s and declined sharply during the recession, increased by 8.6 percent per year until 2004. In contrast, per capita, constant-dollar state aid for the two major local aid programs that can be used for non-educational purposes — Additional Assistance and Lottery Aid — declined during the same period. The state cut Additional Assistance sharply during the late 1980s recession and has reduced or level-funded it every year since. While per capita local aid from the lottery grew (after inflation) by 11.3 percent between 1981 and 1992, a maturing lottery market and legislative diversion of some proceeds into the Commonwealth’s general fund reduced growth in such aid to only 3.5 percent between 1993 and 2004.

The recession of the early part of this decade, along with cuts in the state income tax rate, caused state revenues to decline by 15 percent in 2002. As a result, per capita local aid (including aid for education), which had risen 5.3 percent per year in inflation-adjusted terms between 1992 and 2002, fell by 8.6 percent a year between 2002 and 2004.

20 percent of total state expenditures, fell to 13.4 percent of state spending in fiscal year 1993.

Patterns of local aid began to change dramatically after the Massachusetts Supreme Judicial Court ruled in 1993 that great disparities in funding between schools in poor and affluent communities meant that the state was not meeting its constitutional obligation to provide an adequate level of education for all students. The Education Reform Act of 1993, which was signed into law soon after that ruling, greatly increased state aid for education and revamped the formulas used to distribute it. Under the Act, the state calculates each locality’s “foundation budget,” which is how much each locality needs to spend to provide an adequate education for students in its schools. The state also calculates how much each locality can (and must) raise in local property taxes and makes up the difference between needed spending and available funds.

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The reductions in local aid came at a time of rapidly rising health insurance costs, which especially strained local governments because public services tend to be highly labor-intensive. Municipal spending for health insurance increased by 63 percent between 2001 and 2005, according to A Mounting Crisis for Local Budgets: The Crippling Effects of Soaring Municipal Health Costs, a survey of a sample of municipalities released by the Massachusetts Taxpayers Foundation (MTF) in July 2005. The increase in health insurance costs consumed approximately 80 percent of the 2.5 percent annual growth in taxes on existing properties allowed under Proposition 2½. Examining separate cost data from the Department of Revenue on all 351 cities and towns in the Commonwealth, the MTF report found an even more dire situation: increases in municipal health insurance costs, on average, exceeded this allowable revenue growth by an average of 8 percent a year during the same period.
In response to such pressures, many municipalities focused on new development, which was exempt from Proposition 2½’s limits. Most localities that were not already at one of the limits imposed by Proposition 2½ raised property taxes and many others asked voters to approve overrides to Proposition 2½ (though voters often turned down those requests).

As a result of these factors and skyrocketing residential property values, the average yearly residential tax bill for families increased 36 percent, or $910, before adjusting for inflation between fiscal years 2000 and 2005, according to the Massachusetts Department of Revenue. In 2004, property taxes provided 53 percent of localities’ total revenues, up from 46 percent in 1988, and user fees provided another 17.6 percent of revenue, up from 16.5 percent in 1988. By contrast, local aid provided only 24 percent of local revenues in 2004, down from 31 percent in 1988.

Health insurance costs and mandated local spending on education have forced localities to constrain spending on non-educational public services, such as police, fire, public works, parks, public health, community development and libraries. Between 1987 and 2004, real per capita expenditures by local governments for debt service increased by an average of 3.1 percent annually and per capita spending on other fixed costs — health insurance, pensions, unemployment, workers compensation and other employee benefits — grew by an annual average of 2.2 percent. Similarly, per capita school spending, the largest spending item for most municipalities, increased an average of 2.1 percent per capita annually after adjusting for inflation. (See Figure 3). By contrast, municipal expenditures for non-educational services declined 0.3 percent a year in real per capita terms. This drop, however, was far from uniform. Police and fire expenditures increased in real terms at rates that averaged 1.5 percent and 0.7 percent per capita between 1987 and 2004. Spending on public works, such as roads, waste collection, water distribution and snow removal, declined in constant-dollar, per capita terms by an average of 1.2 percent per year during this period. And per capita, constant-dollar spending on local health and welfare, which includes public health, clinics and veterans’ services, fell by an even sharper average of 2.7 percent a year.

Moody’s Economy.com, a Pennsylvania research firm, estimates that municipalities in Massachusetts reduced their workforces more steeply than any other state in the nation between 2001 and 2005.
spending statewide, reflecting the very heavy reliance of cities and towns on this revenue source. Although Proposition 2½ initially reduced the percentage of local budgets funded by the property tax, this situation is now reversing. By fiscal 2004, the percentage of local budgets supported by the property tax was at its highest level in more than 20 years. This increasing reliance on the property tax can be traced to the hole that was left in municipal budgets after the loss of equalizing Additional Assistance aid in the late 1980s and the diversion of lottery revenue to the general state budget in the 1990s and 2000s, often resulting in the need to pass overrides to meet cost increases.

As a result of Proposition 2½, the levy declined as a percentage of local budgets for almost two decades, before beginning its recent increase. Whereas the property tax represented 59.1 percent of municipal budgets in fiscal 1981, this figure dropped to a low of 46.1 percent in fiscal 1988 and increased to 52.9 percent in fiscal 2004. Between fiscal 1981 and 2004, the total levy increased by $5.67 billion from $3.35 billion to $9.02 billion, with an average annual per capita rate of increase of 0.6 percent after adjusting for inflation.

Many municipalities have attempted to override the limits of Proposition 2½. Nearly 3,600 separate overrides — roughly 160 per year and an average of $235,000 per override — have gone to local voters since fiscal 1983, with 39 percent of them approved. More overrides have been adopted than rejected in only eight of the past 22 years. In fiscal 1991, the year of highest activity, only 168 of 594 — or 28 percent — of override attempts were successful. From fiscal 1983 through 2004, overrides that were approved added $348.1 million to levy limits; those that failed kept $494.1 million out of the levy limit.

The Berkshire region has had the fewest override attempts but has had the most success in passing them, with 54.8 percent gaining approval. The Cape and Islands have attempted the most overrides (817), with a 48.7 percent success rate. The least successful region has been the Southeast, which passed just 110 of 392, or 28.1 percent, of its override attempts.

**Local aid fluctuates**

The second major revenue component of municipal budgets is local aid, which is state revenues distributed to local governments through a wide array of programs. The importance of local aid cannot be understated in a climate of otherwise restricted local revenue growth. Since Proposition 2½, municipalities have become more dependent on state aid. As noted above, during the early 1980s, many municipalities were forced to make substantial cuts to municipal budgets to comply with the newly approved limits on local property taxes. In order to manage these decreases and fill the gap between the cost of

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**Before Proposition 2½, the local property tax was unrestricted and was both the principal source of revenue for most municipalities and the major source of budget flexibility availability to fund additional spending.**

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![Figure 4. Proposition 2½ Overide Attempts, Passage and Value of Passed Initiatives Fiscal Years 1983 – 2004 aggregate current dollars](image)

<table>
<thead>
<tr>
<th>REGION</th>
<th>Attempts</th>
<th>Passed</th>
<th>Total Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Berkshire</td>
<td>199</td>
<td>54.8%</td>
<td>$7,055,323</td>
</tr>
<tr>
<td>Boston Metro</td>
<td>428</td>
<td>51.2%</td>
<td>$159,929,807</td>
</tr>
<tr>
<td>Cape and Islands</td>
<td>817</td>
<td>48.7%</td>
<td>$51,714,370</td>
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<tr>
<td>Central</td>
<td>545</td>
<td>25.9%</td>
<td>$22,571,625</td>
</tr>
<tr>
<td>Northeast</td>
<td>415</td>
<td>35.9%</td>
<td>$37,876,248</td>
</tr>
<tr>
<td>Pioneer Valley</td>
<td>787</td>
<td>35.7%</td>
<td>$38,406,671</td>
</tr>
<tr>
<td>Southeast</td>
<td>392</td>
<td>28.1%</td>
<td>$28,545,167</td>
</tr>
<tr>
<td>Massachusetts</td>
<td>3,583</td>
<td>39.27%</td>
<td>$348,099,211</td>
</tr>
</tbody>
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**INCOME PERCENTILE**

- Lowest 5th: 487, 27.3%, $32,241,655
- Second 5th: 703, 27.3%, $21,432,650
- Third 5th: 766, 37.9%, $34,414,526
- Fourth 5th: 947, 42.7%, $97,827,739
- Highest 5th: 680, 57.1%, $162,182,641
- Massachusetts: 3,583, 39.3%, $348,099,211

**POPULATION**

- 50 - 1,999: 609, 49.4%, $12,647,751
- 2,000 - 4,999: 860, 45.8%, $36,240,538
- 5,000 - 9,999: 1,171, 36.1%, $54,202,011
- 10,000 - 19,999: 582, 30.2%, $93,315,949
- 20,000 - 49,999: 313, 30.7%, $90,644,842
- 50,000 +: 48, 35.4%, $61,048,120
- Massachusetts: 3,583, 39.3%, $348,099,211

Source: Massachusetts Department of Revenue, Division of Local Services
services and local revenues, a state and local agreement was established that led to increasing state aid allocations for cities and towns.

From fiscal 1981 to 2004, the Commonwealth’s expenditures on local aid (net of municipal charges) increased $2.88 billion, while total state spending (excluding local aid) increased $13.95 billion. The net local aid increase translates into an inflation-adjusted, per capita increase of 3.0 percent per year, outpacing the state expenditures increase of 2.0 percent per year. State expenditures on net local aid as a percentage of total state spending (including local aid) have ranged from a high of 20 percent in fiscal 1988 to a low of 13.4 percent fiscal 1993. In fiscal 2004, the Commonwealth allocated 16.4 percent of its budget to net local aid.

Overall, local aid has fluctuated substantially from year to year, barely exceeding the rate of inflation in certain periods. In fiscal 2004, inflation-adjusted net local aid dollars were less than in fiscal 1989. As Figure 5 indicates, the annual growth in the Commonwealth’s net local aid expenditures generally follows the growth in its overall expenditures, except during economic contractions. In such downturns, direct local aid declines at a substantially higher rate than overall state expenditures. This phenomenon is closely related to the structure of the state budget. For the Commonwealth (as well as for municipalities), increases in mandatory costs force reductions in discretionary programs. Local aid is one of the largest “discretionary” programs.

At the outset of Proposition 2½ in fiscal 1981, net local aid receipts accounted for about 15.3 percent of total municipal revenues. This percentage peaked in fiscal 1988 at 28.4 percent and fell to 22.0 percent in fiscal 2004. Net local aid receipts increased from $868.3 million in 1981 to $3.75 billion in 2004. After adjusting for inflation, this increase translates into annual average growth per capita of 3.0 percent.

Growth in net local aid was greatest in the period immediately following Proposition 2½, at 10.4 percent annually, and lowest during the steep economic decline in the early 1990s, falling 13.3 percent annually. After the recession, growth in net local aid was lower during the period of economic expansion in the mid- late 1990s than it had been in the 1980s. The ensuing difficult years of the early 2000s were less severe than the recession of the early 1990s. While growth was fairly uneven across the different regions and in municipalities of all kinds, the highest income municipalities saw the largest increase in net local aid in the 1990s.
mainly because other items, such as state reimbursements for school construction, are included in the definition of total net local aid.

Recessionary periods tend to have lasting impacts on municipalities, especially in regard to local aid. From fiscal 1981 to 2004, there have been two periods of substantial reductions in net local aid to municipalities: 1989–1992 and 2002–2004. Both periods coincide with economic recessions and ensuing state fiscal difficulties.

**Expenditures**

Total municipal spending in Massachusetts from fiscal 1987 to fiscal 2004 has grown in constant dollars by 1.3 percent annually per capita, with wide variation in growth among major spending categories. Only a few expenditure categories, namely debt service, fixed costs (including employee health insurance, pensions and other benefits) and education, grew faster than this average increase in total municipal expenditures, which has the effect of forc-
ing reductions in other expenditure areas under a balanced budget framework. Figure 7 illustrates the growth, stability or decline in major expenditure areas as a percent of total municipal expenditures in 1987 and 2004. Combined, the spending areas of education, fixed costs and debt service have consumed approximately 80 percent of annual budget growth since 1987, with education alone taking up 52 percent of all new budget growth.

Figure 7. Major Expenditure Areas as a Percent of Total Municipal Expenditures FY1987 vs. FY2004

Source: Massachusetts Department of Revenue, Division of Local Services

LOCAL LABOR COSTS: DEFYING THE STEREOTYPE

Some contend that Massachusetts localities create their own budget woes by hiring excessive personnel or paying workers too much. The Massachusetts Taxpayers Foundation, however, reached a different conclusion in a recent report: “Although some observers occasionally suggest that some municipal employment contracts have been overly generous in recent years, it seems that most have been conservative enough to produce annual average growth per employee of only 0.7 percent, in inflation-adjusted terms, between 1994 and 2003, compared to 1.8 percent for private sector and 1 percent for state employees over the same period.”

Several other studies also suggest that in general, local government in Massachusetts is neither overstaffed nor overpaid, at least when compared to other governments around the country. Nick Turner and E. Matthew Quigley, two researchers at the Federal Reserve Bank of Boston, for example, found that in 2003, local governments in Massachusetts employed only 356 people per 100,000 residents, less than the national average of 398 employees per 10,000 residents. Combined, state and local government in Massachusetts employ 498 people for every 10,000 residents, well below the national average of 542 employees and less than any other state in New England.

Turner and Quigley also found that while salaries for state and local government workers in Massachusetts were 12 percent higher than the national average ($46,535 compared to $41,508), these generally higher wages reflect the higher living costs and private-sector salaries in New England and also mask considerable differences across public sector occupations. Correctional officers in Massachusetts, for instance, earn 30 percent more than the national average, but local public welfare employees earn 11 percent less. Turner and Quigley also found that for every $1,000 in personal income earned by Massachusetts residents, $4.96 went to state and local payroll, compared to an average of $6.08 nationally. By this measure, the only category of public employees for which payroll exceeded the national average were not municipal, but non-educational state employees, a category that also garnered the highest average salaries.

— Phineas Baxandall

Cities and towns in Massachusetts face problems similar to municipalities in other states but are more vulnerable to fluctuations in local aid because of their limited revenue-raising options and strict responsibility for schools. Examining 53 American cities in 2003–2004 (including Boston, Fall River and Worcester), Bruce Wallin, a professor of political science at Northeastern University, found that chief financial officers in those cities tend to report greater financial strain when, as in Massachusetts, they lack powers to levy local income or sales taxes.1

Similarly, municipalities in Massachusetts wield less flexibility when courts declare existing financing arrangements unconstitutional and mandate reductions in school finance disparities. According to Katherine Baicker and Nora Gordon, professors of economics at Dartmouth College and the University of California, San Diego, across the nation, “Each dollar of increased educational funding a locality received from the state resulted in an average decline in funds from the state for other purposes of about 20 cents.”2 They also found that localities tend to respond to increased education aid by reducing their own-source spending on both education and other programs. While the local aid story in Massachusetts is consistent with nationwide patterns described by Baicker and Gordon, state laws since 1994 have made it virtually impossible for Massachusetts localities to reduce their contribution to school spending.

– Phineas Baxandall
