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Local Services, Local Aid, and Common Challenges

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

Combined these problems create "a system of municipal finance and local aid that… is broken and needs attention," asserts John Hamill, CEO of Sovereign Bank who chaired a task force on municipal finance that issued a report on local finance last September.[1] He adds, "Massachusetts residents across the state… have a common experience with local government over the past five years: Their family's property tax bill has increased significantly, they are now paying fees for many services that used to be covered by general revenues, and, still, core local government services are being cut."[2]

The task force, which was convened by the Metropolitan Mayors Coalition, a group of ten mayors from Boston and surrounding cities, has not been alone in raising the alarm. In October, the Massachusetts Municipal Association released a study that reached many of the same conclusions. That same month, The Boston Municipal Research Bureau issued a report warning that city revenues are unlikely to rise fast enough to cover the cost of recent contracts with the unions representing many city workers, which means the city will likely have to make painful cuts in key services. A few months earlier, the Massachusetts Taxpayers Foundation released a study showing the localities' health insurance costs have been rising faster than their revenues, which has forced them to cut back in other areas. Several recent national studies, finally, suggest that contrary to popular perceptions, localities in Massachusetts have fewer workers and spend less on personnel that localities in other states and also face particularly difficult constraints in dealing with their fiscal challenges.

When Four Forces Collide

Local governments in Massachusetts are inadvertently trapped by the convergence of four major forces:

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Proposition 2½, the state's landmark 1993 Education Reform Act, rising health insurance costs, and recent cuts in local aid.

Proposition 2½, which passed via a referendum in 1980, limits the total amount that localities can raise from taxes and also how fast those revenues can increase each year. The impact of the new law was initially buffered by new infusions of local aid, which on a constant-dollar, per capita basis, grew by 10.4 percent a year between 1981 and 1984 and by 8.4 percent a year from 1985 to 1989. During the sharp recession of the 1980s and early 1990s, however, real per capita local aid fell 13.3 percent a year from 1989 through 1992. As a result of these cuts, local aid which peaked in fiscal year 1988 at 20 percent of total state expenditures fell to 13.4 percent of state spending in fiscal year 1993.[3]

Local governments in Massachusetts are inadvertently trapped by the convergence of four major forces: Proposition 2½, the state's landmark 1993 Education Reform Act, rising health insurance costs, and recent cuts in local aid.

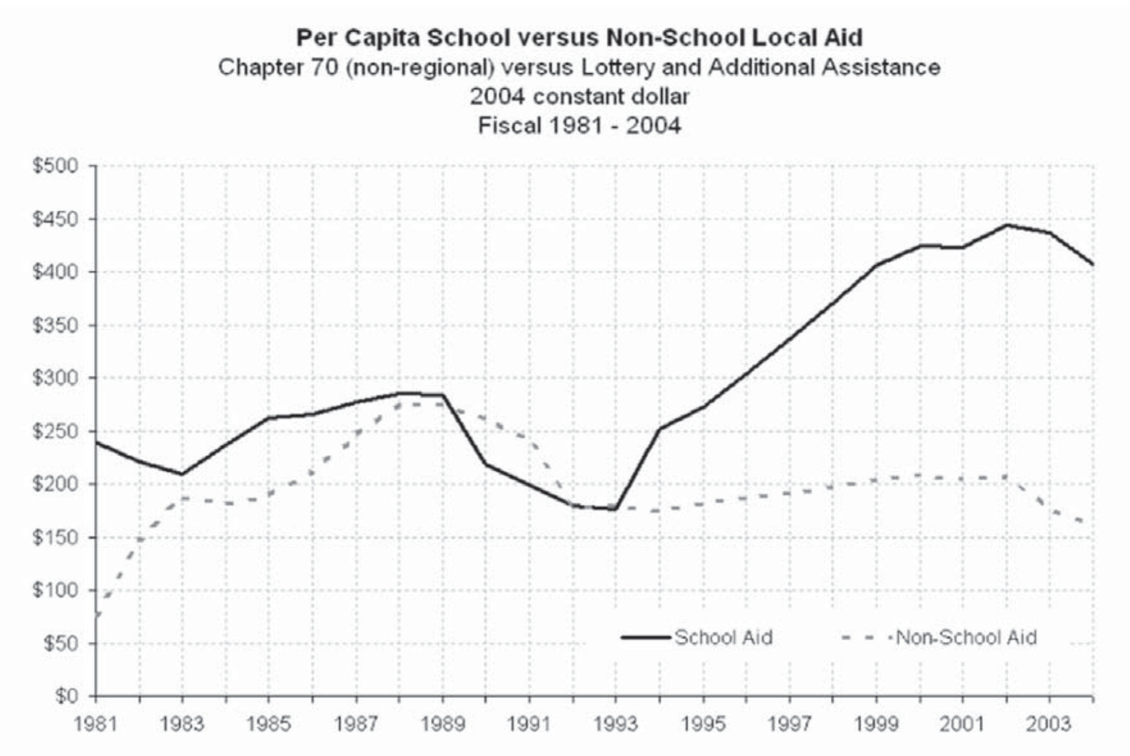
Patterns of local aid began to change dramatically in 1993 after the state's Supreme Judicial Court ruled that great disparities in funding between schools in poor communities and those in affluent ones meant that the state was not meeting its constitutional obligation to provide an adequate level of education for all students. The state's Education Reform Act of 1993, which was signed into law soon after the court's ruling, greatly increased state aid for education and revamped the formulas used to distribute that aid. Under the law, the state calculates each locality's "foundation budget"—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, where needed, the state makes up the difference between needed spending and available funds.

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 of time. The state cut the former program sharply in 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 has meant that such aid grew by only 3.5 percent between 1993 and 2004. (See Figure 1)

The recession of the early part of this decade along with cuts in the state income tax rate caused state revenues to plunge by 15 percent in 2002. As a result, per capita local aid including 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.

The reductions in local aid came at a time when health insurance costs were rising rapidly. These increases particularly strained local governments because public services tend to be highly labor-intensive. In addition, public employees generally receive more comprehensive health benefits than the private sector workers and, because most public-

Figure 1



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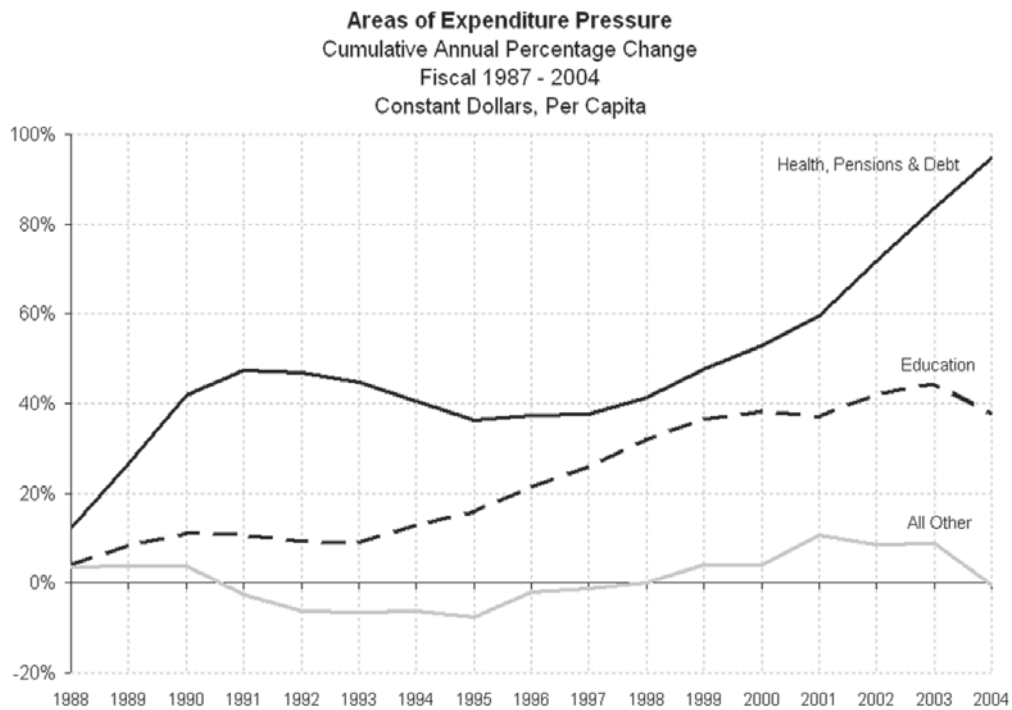
sector workers are unionized, many localities cannot unilaterally force workers to pay an increasing share of health insurance costs. As a result, municipal spending for health insurance increased 63 percent between 2001 and 2005, according to a recent survey of a sample of municipalities conducted by the Massachusetts Taxpayers Foundation (MTF). The increase in health insurance costs, moreover, consumed approximately 80 percent of the 2.5 percent annual growth in taxes on existing properties allowed by under Proposition 2½. Examining separate cost data from the Department of Revenue on all 351 cities and towns in the Commonwealth, the Massachusetts Taxpayers Foundation 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 requirement that local property tax revenues not grow faster than 2.5 percent a year. 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, between fiscal years 2000 and 2005 the average yearly residential tax bill for families increased 36 percent or $910 before adjusting for inflation, according to the state Department of Revenue.[4] Moreover, 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. In contrast, local aid provided only 24 percent of

Figure 2



Municipal Finance Task Force report, 2005, pg. vi.

local revenues in 2004, down from 31 percent in 1988.

Higher health insurance costs and required local spending on education have also forced localities to constrain spending on non-educational public services such as police, fire, public works, parks, public health, fire, 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 2)

In 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, which includes such items 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 even more sharply, dropping by an average of 2.7 percent a year.

The underlying constraints on local budgets were particularly severe when the state cut local aid during the recent recession. Cities and towns cut their workforces by 5.2 percent between February 2002 and August 2004, eliminating 14,200 jobs, according to a report by the Massachusetts Taxpayers Foundation. Likewise, Economy.com, a Pennsylvania research firm, estimates that municipalities in Massachusetts reduced their workforces more steeply than in any other state in the nation between 2001 and 2005.

Labor Costs

Some officials contend that Massachusetts's localities create their own budget woes by hiring excessive personnel or paying workers too much. The Boston Municipal Research Bureau, a privately funded watchdog group, for example, recently warned that city revenues are highly unlikely to increase fast enough to pay the cost of the city's recent contracts with firefighters, police officers, and others, particularly because those contracts did not give city officials significant new powers to better manage Boston's workforce.

Similarly, in 2004, Eric Kriss, who stepped down as Massachusetts Secretary for Administration and Finance the following September, observed that according to the federal Bureau of Labor Statistics "public employees earn 12 percent more than private-sector employees for comparable jobs in eastern Massachusetts." He attributed the disparity to the power of public-sector unions and warned, "The hidden tax of union monopoly is so heavy that many municipalities crack under the strain."[5]

The Massachusetts Taxpayers Foundation, however, reached a different conclusion in its recent report which contended, "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 1.0 percent for state employees over the same period."[6]

Several recent studies also suggest that local government in Massachusetts generally 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, recently 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, moreover, 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.

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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 groups. 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 per $1,000 nationally. By this measure, the only category of public employees for which payroll exceeded the national average were not municipal employees but non-educational state employees – a category that also garnered the highest average salaries of any subgroup at $50,328.

Structural Reform for Structural Problems

The Municipal Finance Task Force made several recommendations designed to ensure that localities have enough money to pay for basic local services and also have the power to control costs. The task force, for example, called on the state to adopt a formal revenue-sharing policy that allocates a fixed percentage of state receipts to local aid and it urged the state to allow local governments new revenue options such as taxes on restaurant meals, parking, and car rentals. Among other recommendations, it asked the state to give localities some of the same powers the state uses to control health insurance costs, such as more flexible rules for collective bargaining and Medicare enrollment.

Each of these proposals is likely to spark intense debates and taken individually each of these debates has the potential to obscure a growing consensus on the critical larger point: serious structural problems are making it increasingly difficult for localities in Massachusetts to provide basic public services

Endnotes

1. John Hamill, Chair of Municipal Finance Task Force, quoted in Metropolitan Area Planning Council press release, September 7, 2005. Available at http://www.mapc.org/Municipal_Finance_Task_Force/Press%20Release%209.7.05.pdf.

2. John Hamill, "How state policies put communities at risk," *MetroWest Daily News*, October 30, 2005, available at http://www.metrowestdailynews.com/columnists/view.bg?articleid=112977

3. Unless otherwise indicated, all figures are from the task force's report.

4. This figure excludes eleven communities with residential tax exemptions. In such communities, the distribution of tax increases are skewed toward residents with higher property values.

Less Flexibility than in Other States

Cities and towns in Massachusetts face similar problems as municipalities in other states, but often with less ability to adapt to change. Massachusetts' localities may be particularly 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 Worchester), 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.

Similarly, municipalities in Massachusetts wield less flexibility when courts declare existing financing arrangements unconstitutional and mandate reductions in school finance disparities. Katherine Baicker and Nora Gordon, professors of economics at Dartmouth College and the University of California, San Diego, find that "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."[7] 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 the patterns described by Baicker and Gordon, state laws since 1994 have made it virtually impossible for localities to reduce their own-source spending on schools.

5. Eric Kriss, "No more public-sector monopoly," *Commonwealth Magazine*, Summer 2004, available at http://www.massinc.org/fileadmin/CommonWealth/Summer_2004/cw_summer_2004.pdf

6. Massachusetts Taxpayers Foundation, 2005, p. 13.

7. Baicker and Gordon, 2004, p. 26. More precisely, for each dollar of increased state education aid, total state aid to localities rises by only 78 cents.

Further Reading

"The Effect of Mandated State Education Spending on Total Local Resources," by Katherine Baicker and Nora Gordon, *National Bureau of Economic Research Working Paper 10701*, August 2004, available at http://www.nber.org/papers/w10701

"Mounting Personnel Costs Threaten Boston's Competitive Edge," by the Boston Municipal Research Bureau, October 2005, available at http://www.bmrb.org/content/upload/Trends2005A.pdf

"Revenue Sharing and the Future of our Massachusetts Economy," by Barry Bluestone, Alan Clayton-Matthews, and David Soule, PowerPoint presented on October 18, 2005 at the Massachusetts Municipal Association Statewide Economic Forum and available at http://www.mma.org/news/news_files/local_finance_news/revenue_sharing_rpt.pdf . The full report will be released in January, 2006.

"Local Communities at Risk: Revisiting the Fiscal Partnership Between the Commonwealth and Cities and Towns," by the Municipal Finance Task Force, September 2005, available at http://www.mapc.org/

"A Mounting Crisis for Local Budgets: The Crippling Effects of Soaring Municipal Health Costs," by the Massachusetts Taxpayers Foundation, July 2005, available at http://www.mma.org/policies_positions/press_releases/MTFhealthfinal.pdf

"The Comparative Cost of Labor in Massachusetts and the Boston Metropolitan Area: Another Look at the Empirical Evidence," by Andrew Sum, Ishwar Khatiwada, Joseph McLaughlin, et. al., Center for Labor Market Studies, Northeastern University, prepared for The Commonwealth Corporation (May 2005).

"Do New England State and Local Governments Have Too Many Employees, and Are They Overpaid?" by Nick Turner and E. Matt Quigley, *Fiscal Facts*, New England Public Policy Institute at the Federal Reserve Bank of Boston, Summer 2005, available at http://www.bos.frb.org/economic/neff/neff34/neff34.pdf

"Budgeting for Basics: The Changing Landscape of City Finances," by Bruce A. Wallin, Brookings Institution Metropolitan Policy Program Discussion Paper, August 2005, available at http://www.brookings.edu/metro/pubs/20050823_budgetingbasics.htm

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PB-2005-1, January 2005
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by Phineas Baxandall (Rappaport Institute for Greater Boston) and Bruce Sacerdote (Dartmouth College)

PB-2005-2, February 2005
"Needed Corrections: Promising Strategies for Improving Massachusetts' Prisons and Jails,"
by Anne Morrison Piehl (Kennedy School of Government)

PB-2005-3, March 2005
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by Edward L. Glaeser (Harvard University)

PB-2005-5, September 2005
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by Anthony A. Braga (Kennedy School of Government) and Christopher Winship (Faculty of Arts and Sciences and Kennedy School of Government, Harvard University)

PB-2005-6, October 2005
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by Christopher Stone (Kennedy School of Government), Brian Buchner and Scott Dash (Police Assessment Resource Center)

PB-2005-7, November 2005
"Local Services, Local Aid and Common Challenges"
by Phineas Baxandall (Rappaport Institute for Greater Boston)

UPCOMING EVENTS IN THE BOSTON 101 SPEAKER SERIES

Funding Local Government: Revisiting the Fiscal Partnership
Wednesday, November 2, 5:00 p.m.
Bell Hall, 5th floor Belfer Building

John Hamill, Chairman and CEO, Sovereign Bank of New England and chair of the Municipal Finance Task Force
Representative Rachel Kaprielian, Massachusetts House of Representatives and Co-chair of the Joint Committee on Municipalities and Regional Government
Linda Bilmes, Lecturer in Public Policy, Kennedy School of Government; former Chief Financial Officer and Assistant Secretary for Management and Budget at the U.S, Department of Commerce

Sprawl in Overdrive: Hurdles to Smart Growth
Wednesday, November 9, Noon
Room 301, 3rd floor of the Taubman Building

Anthony Flint, Smart Growth Education Director at the Office for Commonwealth Development, former reporter for *The Boston Globe*
Alan Altshuler, Dean of Harvard's Graduate School of Design

Racial and Ethnic Disparities in Violence
Monday, November 21, 5:00 p.m.
Bell Hall, 5th floor Belfer Building

Robert J. Sampson, Harvard University
Larry Mayes, Chief of Human Services, City of Boston

The Effects of New Rail Transit: Lessons from Boston
Wednesday, December 7, 12:00 noon
Malkin Penthouse, 4th floor Littauer Building

Matthew Kahn, Tufts University
Nate Baum Snow, Brown University
James Kostaras, City of Somerville and Harvard's Graduate School of Design

More information on events can be found at the Rappaport Institute website at http://www.rappaportinstitute.org.