

Local Communities At Risk

Revisiting the Fiscal Partnership Between
the Commonwealth and Cities and Towns

September 2005
Municipal Finance Task Force

The Municipal Finance Task Force

The Municipal Finance Task Force was created by the Metro Mayors Coalition to review trends in municipal finance and local aid, to understand the impact of such trends on municipal budgets and services, to enable municipalities to develop strategies and policies to better navigate these trends, and to provide recommendations to municipal leaders, the Legislature and the Executive Branch.

The Metro Mayors Coalition

The Metro Mayors Coalition is an organization of the ten chief executive officers for urban core communities in metropolitan Boston, who are committed to working together across geographic and political lines to solve the region's problems. Current members of the Coalition are Mayor Thomas Menino of Boston, City Manager Robert Healy of Cambridge, City Manager Jay Ash of Chelsea, Mayor David Ragucci of Everett, Mayor Richard Howard of Malden, Mayor Robert Dolan of Melrose, Mayor Michael McGlynn of Medford, Mayor Thomas Ambrosino of Revere, Mayor William Phelan of Quincy, and Mayor Joseph Curtatone of Somerville. The Metro Mayors Coalition is facilitated by the staff members of the Metropolitan Area Planning Council (MAPC).

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Note: Task Force member Kathleen Kelley, President of the Massachusetts Federation of Teachers, endorses this report, but wishes to reserve her rights in relation to the discussion of potential municipal health insurance reforms.

Message from the Chairman

Fifteen years ago I chaired a Commission which studied the partnership between state and local government in Massachusetts and the need for a better way to fund the governmental responsibilities undertaken by each. The complexities of the system then had created significant difficulties in making that partnership effective.

Over the last several months, I once again have chaired a Commission to study the same fundamental issue. The complexities of our system now have become even greater due to a number of factors spelled out in our Report: an increasing share of state and local revenue going to the very worthwhile cause of education, a decreasing share of state and local revenue going to all other local services, a growing reliance on property taxes by cities and towns – notwithstanding Proposition 2½ – and an increasingly frustrated citizenry who are unable to find coherency in a situation where property values have gone up but fundamental governmental services at the local level are threatened or have deteriorated.

There are some fundamental principles that form the basis for the recommendations in the Report: Revenue sharing from the state to local governments must be even-handed, favoring neither state nor local interests or programs; that sharing of revenue should be based upon a substantially enhanced needs-based approach; non-educational governmental services at a local level must be adequately funded or we will have a growing crisis about the fundamental ability of governments to deliver basic services; local government officials should be given the tools to raise local municipal receipts and control costs, in some cases by reducing the constraints of state law.

We have a system that has been cobbled together over many years in an attempt to solve multiple problems. The Commission members, drawn from many different disciplines, have spent many hours poring over the technicalities of our system in order to explain it and suggest improvements. This effort has brought home to me, once again, how difficult a job our state and local officials have in attempting to address a diverse society's issues while dealing with laws and regulations that have been enacted at different times over many decades.

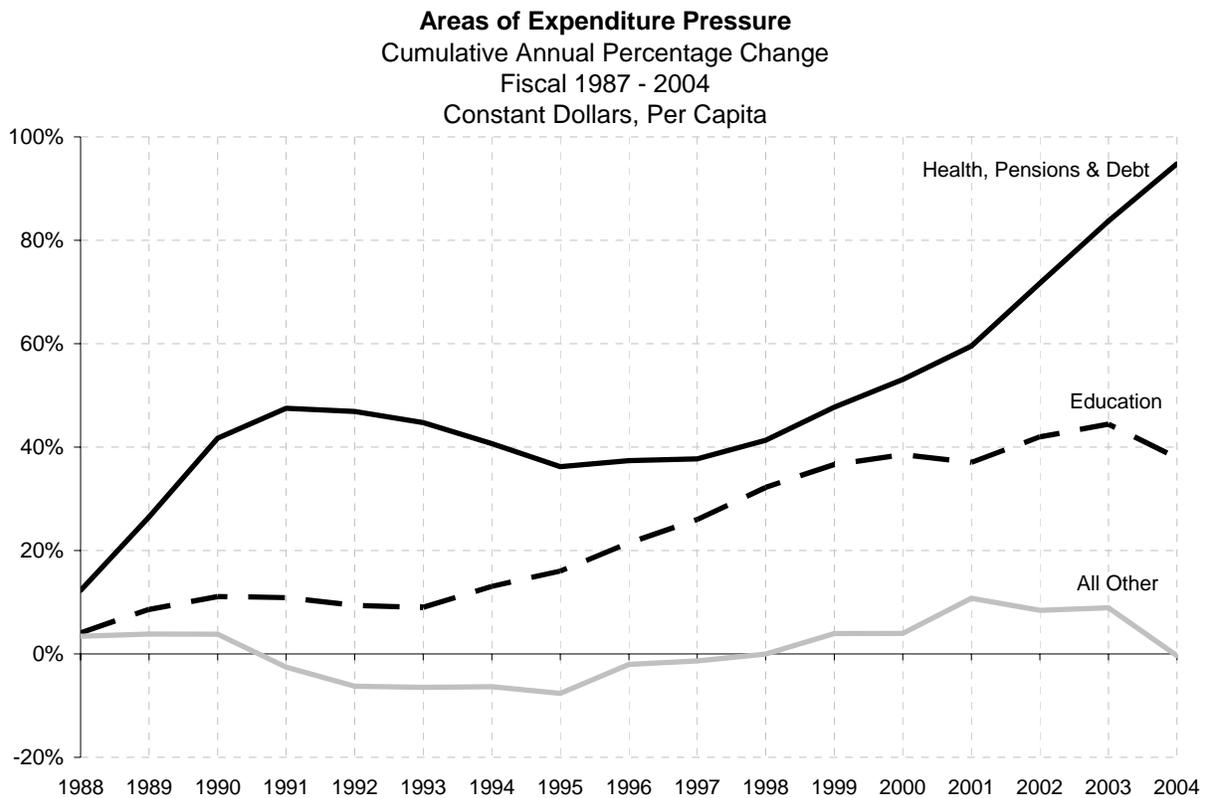
I want to thank all the Commission members and those mentioned in the following pages who served as ex-officio members and technical advisors. They are an outstanding group of dedicated and hardworking individuals. I hope the Report will contribute to a thoughtful dialogue among officials and citizens attempting to find the right balance for this great Commonwealth.



John P. Hamill
September 6, 2005

Executive Summary

Massachusetts cities and towns are facing a long-term financial crunch caused by increasingly restricted and unpredictable local aid levels, constraints on ways to raise local revenue, and specific costs that are growing at rates far higher than the growth in municipal revenues. Although there were significant increases in public education funding during the 1990s, general local aid has been stagnant for more than a decade and non-school expenditures have been flat. These long-term structural issues are already squeezing the finances of municipalities – both large urban communities and small rural towns – and Massachusetts has begun to see a decline in municipal services across the Commonwealth. This situation has created a serious strain on municipal budgets that, without changes to state and local policies, will evolve to crisis proportions.



Massachusetts cities and towns are partners with the Commonwealth in delivering public services, such as local and state police protection, educational services from preschool through graduate school, and a transportation system that runs from neighborhood cul-de-sacs to Interstate highways.

Municipalities and the state must work together to solve the short-term fiscal challenges as well as the long-term structural issues that are threatening the viability of local government.

Maintaining a Critical Partnership

For much of the decade, the Administration and Legislature have had to work in an enormously difficult fiscal environment. In 2002, revenues plunged a staggering 15% due to the combined impact of a collapsing stock market, an economic recession, and a major income tax break that took effect just as the recession began; the resulting financial crisis was made significantly worse by a surge in the largely unavoidable costs of Medicaid, employee pensions, and other major programs.

To deal with the crisis, state policymakers were forced to make difficult and unpopular decisions, including cutting programs across the board and increasing taxes by approximately \$1 billion. For municipalities, it meant cuts to local aid accounts and a “cap” on lottery revenue payouts to cities and towns. It is critical to understand the fiscal context in which those decisions had to be made, and to applaud the positive actions taken in what the Massachusetts Taxpayers Foundation described as the worst state fiscal crisis in a half century.

- Legislative leaders and Administration officials had the foresight to build an enormous “rainy day fund” through the good times of the 1990s, which had reached \$2.3 billion by 2001. Without that rainy day fund, the impact of the fiscal crisis on all state programs, including local aid to municipalities, would have been much worse.
- In 2004, legislators, Administration officials and the Massachusetts State Treasurer created a system to provide a long-term partnership between the state and municipalities to jointly fund the building of public schools in Massachusetts, including a dedicated revenue stream to ensure stability of finances. In addition, after years of wrangling, all the key stakeholders came together in that same year to pass a construction reform package intended to make it easier to build schools and other public buildings.
- Special education (SPED) costs, which can sometimes reach more than a \$100,000 per child, have provided enormous fiscal challenges to municipalities trying to educate children with special needs. State policymakers have created a special SPED “circuit breaker” to share costs with municipalities once a certain threshold of costs is reached with individual students, a change that was enacted in 2000 and implemented in 2004. This has been extremely helpful to municipal budgets.

Clearly, even in the most challenging fiscal times, the Legislature and Administration have tried to maintain a partnership with city and town governments.

Fifteen years ago, a Governor’s Task Force on Local Finance, informally known as the “Hamill Commission,” was asked to review issues related to municipal finance and make recommendations to the Legislature and the Governor. The Hamill Commission brought together many of the state’s leading citizens and municipal finance experts and provided an in-depth analysis of municipal

finances in the 1980s. The Hamill Commission made comprehensive recommendations, many of which became law and helped Massachusetts municipalities navigate through the recent recessions.

This Municipal Finance Task Force report expands on the work of the Hamill Commission to update the story of municipal finances in Massachusetts through the present. The purpose of the Task Force was to review the trends of municipal finances since 1981 in order to highlight important lessons and facts, and to make recommendations about how local governments can continue to provide the kind of public services – quality schools, adequate police and fire protection, accessible libraries, key public health services – that are required in any well-functioning society.

The Task Force held the following principles as core to their review:

- Adequate municipal services – good schools, safe streets, quality human services, roads in good condition – are important to our common quality of life.
- Local government services require sufficient and predictable sources of revenue.
- Revenues through local aid should be provided fairly and the distribution of those resources should be readily understandable.

Plunging state tax receipts during the latest recession forced significant cutbacks in local aid accounts and resulted in a diversion of Lottery proceeds intended for municipalities, undermining the already fragile financial situation of many, if not most, municipalities. The impact of the recession would have been much worse without the foresight of legislative leaders in building a rainy day fund, which helped enormously in managing the fiscal fallout.

However, the problems with municipal finance are not short-term issues. The recent recession reflected long-term municipal finance problems including: dependence on local aid that is both unpredictable and increasingly dedicated to school accounts; the lack of adequate financing structures to give municipalities fiscal flexibility; and insufficient authority to control some municipal costs.

One striking feature of the last several years is the severity of public sector layoffs at the municipal level. The Massachusetts Taxpayers Foundation reported in 2004 that Massachusetts municipal workforces lost 14,200 jobs, or 5.2% of all municipal employees, between February 2002 and August 2004. According to Economy.com, a Pennsylvania research firm, municipalities in Massachusetts cut their workforces more steeply than in any other state in the nation between 2001 and 2005. That reduction in staff often has translated directly into service cuts, such as shortened library hours, fewer health and human services offered to residents, closed fire houses, or fewer police patrols in neighborhoods.

The Situation in Cities and Towns

Across the Commonwealth, all types of municipalities are facing difficult, long-term fiscal issues. Urban centers, affluent suburbs and rural communities are struggling with tough budget choices and grappling with the beginnings of a municipal finance crisis.

Somerville

As a culturally, economically and socially diverse urban community of about 76,000 people, Somerville's municipal leaders had to take aggressive measures to balance their budget in the midst of steeply declining state aid. Between FY02-FY05, the city endured state aid cuts of more than \$11 million, including a \$4.1 million reduction in Additional Assistance.

The following steps are examples of how the City of Somerville has been working to raise revenues, cut costs and seek efficiencies:

- Laid off a total of 65 municipal employees and eliminated 85 vacant positions. The reductions included: Police (16); Fire (13); and DPW (34).
- Tapped all available excess capacity and raised the property tax levy to the maximum allowable under Proposition 2½.
- Raised virtually all fees, fines and permit rates, and aggressively pursued outstanding taxes from prior years.

Lincoln

An affluent community with a rural and historical ambiance, the Town of Lincoln is facing significant fiscal pressures from cuts to state aid and rising fixed costs. Voters in Lincoln have considered six override elections in the past six years just to maintain basic services.

Growing fixed costs – largely due to personnel expenses such as health insurance premiums, contractually required salary increases, and pension obligations – have forced Lincoln officials to reduce budgets, draw down reserves, and pursue all allowable fee and property tax increases. Six override votes since FY02, and two different votes in FY02 alone, have raised \$1.93 million for the community to use mainly for general operating costs.

Hampden

A rural town of under 5,000 residents in Western Massachusetts, Hampden recently took severe actions to cut town costs. After a failed override vote, the town closed the town library, shut down the senior center and recreation department, laid off two highway department employees, increased transfer station fees, and reduced hours in a number of town departments. Town officials even decided to turn off all 150 of its streetlights.

These steps were taken after voters rejected an override measure to increase property taxes.

Categories of Local Aid

Across the Commonwealth, all types of municipalities are facing difficult, long-term fiscal issues. Urban centers, affluent suburbs and rural communities are struggling with tough budget choices and grappling with the beginnings of a municipal finance crisis.

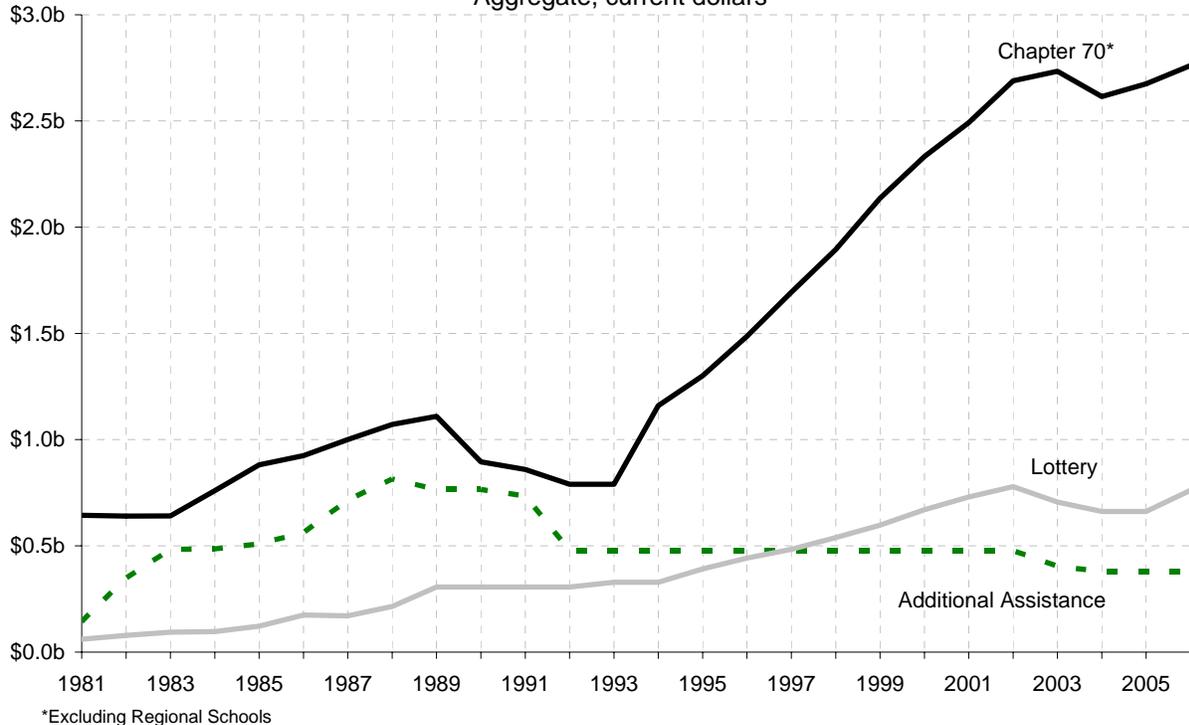
The Commonwealth's partnership with local government is characterized by three main categories of direct local aid, known as "Section Three accounts" because of their placement in the budget:

- **Chapter 70 Aid** provides direct and dedicated funding for public schools in Massachusetts. After the Massachusetts Supreme Judicial Court ruled that the Commonwealth was responsible for providing adequate education to all school-age residents, the state dramatically increased funding for schools, particularly for property-poor communities, through the 1990s.
- **Lottery Aid** is generated by revenues from the Massachusetts State Lottery and is allocated to cities and towns for general support of municipal government. There has been steady growth in Lottery revenues, but the Legislature has twice "capped" payments to cities and towns to divert revenues to state budget line items.
- **Additional Assistance** began as an attempt to recognize disparities in municipal costs and resources, and provides support for general government services. Originally all municipalities received Additional Assistance, but this category of local aid has been cut significantly since 1988, and now only 159 of the state's 351 communities receive this type of general government aid.

There are other ways that state government provides resources to local government, such as school building assistance, Chapter 90 assistance for local roads, and grants for programs such as kindergarten expansion. However, the overwhelming amount of local aid passes through these three budget accounts and most of the discussion in this report focuses on those accounts.

The Municipal Finance Task Force is primarily concerned with *net* local aid, which refers to the state's financial assistance to municipalities after taking into account the state's deductions from cities and towns for services such as charter schools, regional transportation and county governments. The concept of net local aid best reflects the actual dollars being sent to municipal governments.

Components of "Section Three" Local Aid
 Fiscal 1981 - 2006
 Aggregate, current dollars



Report Highlights

- Despite stereotypes to the contrary, municipal budgets have seen only modest real increases over the past 24 years. Since 1981, per capita annual growth for municipal budgets has averaged only 1.1% after adjusting for inflation.
- After Proposition 2½ capped growth in local property tax revenues, local aid became increasingly important to municipalities. However, the percentage of state expenditures for local aid has never returned to its fiscal 1988 peak of 20% of total state expenditures. After dropping to 13.4% in 1993, direct local aid accounted for 16.4% of total state expenditures in 2004.
- The advent of Education Reform has meant that almost all real increases in local aid since 1993 have gone to Chapter 70, the state’s education local aid account. Massachusetts has a constitutional duty to provide adequate education opportunities to all children, and under the 1993 *McDuffy v. Robertson* decision, Massachusetts was required to boost state support to public

education to equalize resources among property-poor and property-rich school districts. Over the past 12 years, the Commonwealth has more than doubled its financial support for public schools, with much of this additional aid going to poorer school districts. This increased funding has been a boon for many communities, but Chapter 70 aid also requires all municipalities to increase their budget commitments to schools by a fixed percentage each year.

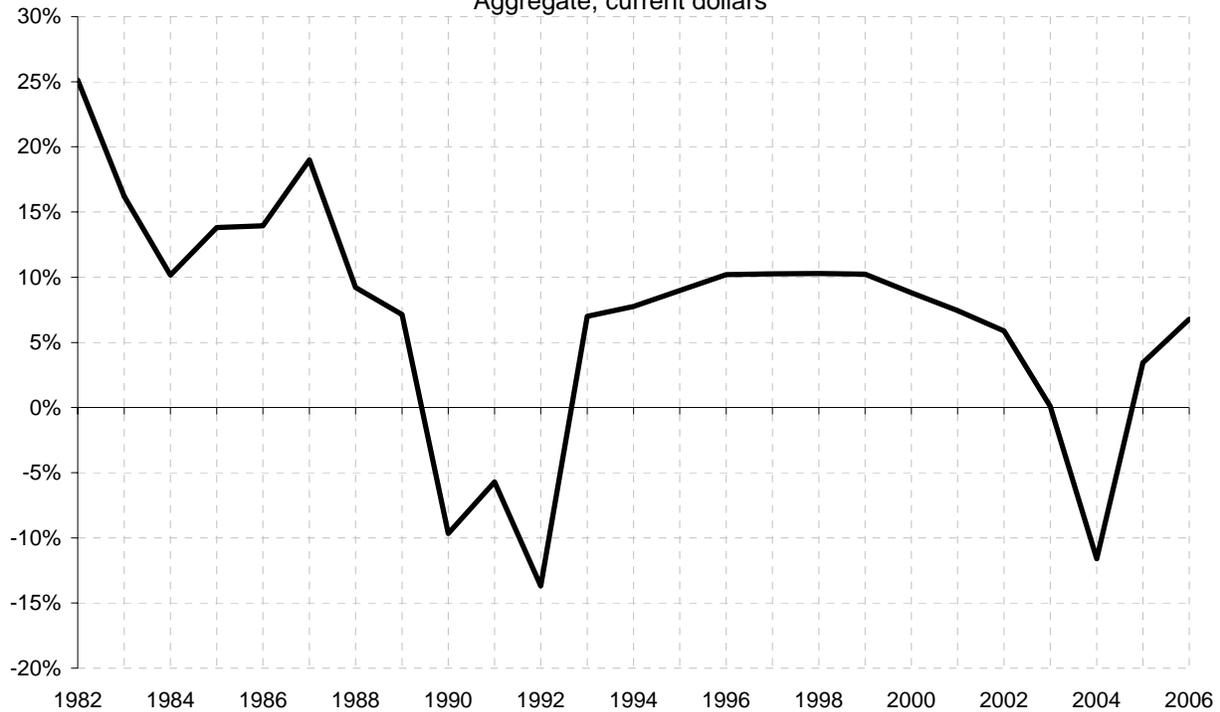
- Although the major increases in school aid to many school systems have been welcome and helped to improve public school education, particularly in poorer school districts, the emphasis on school aid and school spending has meant that other parts of the municipal budget – including such core municipal services as libraries, public health, public works, community development and planning, and police and fire protection – have faced ongoing challenges. Since 1987, annual municipal expenditures for core municipal services (excluding school spending, health care insurance, and some “fixed costs” like pension obligations) have been stagnant in real terms, with -0.3% average growth in per capita expenditures.

Potholes in Public Works Spending

The decline in public works spending is one indicator of the tough budget choices that municipal governments have been making. Cities and towns have gone from spending 15% of their municipal budgets in 1987 on public works, such as street maintenance and trash pickup, to 9% in 2004. As an example, in Northampton, Mayor Clare Higgins was forced not to fill 10 public works employee positions, or 19% of her public works staff. Likewise, in Somerville, Mayor Joseph Curtatone now has 34 fewer public works employees as a result of the recent recession.

- The concept behind the Additional Assistance local aid account – providing aid in proportion to costs and inverse to resources – is a sound one. However, over the past sixteen years this account has either been level funded or cut. Communities’ specific dollar amounts were frozen, reduced proportionately or eliminated altogether. Since 1988, 192 municipalities have stopped receiving general government support through Additional Assistance. Moreover, even those communities that still receive Additional Assistance have seen that category of local aid fall by \$436 million since 1988.
- Overall, local aid has proven extraordinarily unreliable during periods of economic recession. The two recessions in the late 1980s and the early 2000s reveal a clear pattern of significant reductions to local aid accounts when the Commonwealth’s budget is strained, disrupting municipal finances. As the largest “discretionary program” in the state budget, aid to municipalities has been extremely vulnerable to fluctuations in the state’s revenues.

Annual Percent Change in Net Local Aid
 Fiscal 1981 - 2006
 Aggregate, current dollars



- Massachusetts communities are seriously limited in the ways they can raise their own revenues, resulting in a return to reliance on the property tax. In 1990, property taxes represented 48% of total municipal revenues. By 2004, property taxes represented 53% of total municipal revenues, meaning that local homeowners and business owners have shouldered an increasing burden. This trend contrasts starkly with the long-term nationwide trend away from reliance on the property tax and toward state aid, local option taxes and user fees to fund local services.

- Homeowners also bear an increasing tax burden because home values have continued to rise while commercial property values have stagnated or declined since 2000. Under the rules of Proposition 2½, municipalities do not receive less property tax revenue when one class of property declines and the other increases: instead, the tax burden shifts to the growing class of property. Consequently, residential taxpayers have seen tax increases of hundreds or thousands of dollars, despite temporary legislation to smooth the tax shift in communities with different tax rates for commercial and residential properties. The Massachusetts Department of Revenue reports that residential property taxes now represent 72% of all property taxes paid, up from 68% in 2000. Excluding communities with residential tax exemptions, the Department of Revenue reports that the average family tax bill on residential properties has increased \$910 from

FY2000 to FY2005. In communities that classify properties, commercial property taxpayers pay significantly higher rates than residential taxpayers.

- Municipalities are experiencing tremendous pressure from health insurance costs, which are growing many times faster than general inflation. Municipalities have faced double-digit increases in health insurance costs since the late 1990s, and that one line item has grown by more than 60% since 2001. Indeed, many communities now spend more than 10% of their total budget on health insurance. These trends in health insurance costs are not sustainable and have put enormous pressure on municipal budgets.

The State Revenue Context

Revenues from state taxes and fees directly and dramatically affect the ability of the Commonwealth to assist municipal governments through local aid, and many of the state revenue questions currently being debated are relevant to municipal government finances. This report does not go into detail on these state-level debates, but they cannot be ignored because of their potential impact.

During the boom times of the 1990s, the Legislature cut state taxes more than 40 different times. The unprecedented growth in the economy allowed the state to expand local aid, build up state programs, and still cut taxes to individuals and businesses. Taxes were lowered on individual income, capital gains, and corporations, and special tax deductions were given to senior citizens and newly-graduated students with college debts. Many of these tax policies achieved important policy objectives.

Massachusetts has shed its earlier "Taxachusetts" label. According to an analysis of U.S. Census data by the Massachusetts Taxpayers Foundation, the Commonwealth ranked 47th nationwide in 2002 for state and local taxes and fees as a percentage of personal income. At the same time, the Foundation reported that Massachusetts property taxes were 9.1 percent above the national average, and that the state ranked 17th in terms of property tax burden.

The Legislature is currently and continually debating income tax rates. A proposal to reduce the income tax has been contentious for many years. In 2000, citizens voted to lower the income tax rate to 5%; however, the state's financial situation has changed considerably since the vote occurred prior to the most recent recession. The fact remains that cutting the state income tax rate to 5% would diminish annual state revenues by approximately \$575 million at a time when municipalities need growth in local aid accounts simply to return to the level of support they received in FY2002.

For local officials in many struggling communities, increases in the state's two broad-based taxes – the income and sales taxes – are appealing because of their potential for generating significant additional revenues that could help ease the pressure on municipal finances. For example, a one-half percent increase to the income tax rate would bring in approximately \$950 million and a one cent increase in the sales tax rate would raise about \$800 million in revenue. Historically, however, the Commonwealth has financed expanded spending from growth in the existing tax base, and turned to tax increases only in times of fiscal crisis.

Recommendations

In order for municipalities to survive and thrive over the next two decades, the Commonwealth should pursue local aid and policy strategies that can fulfill three goals:

- **Ensure that state assistance to local governments is sufficient and predictable,**
- **Provide cities and towns with flexibility to control local revenues, particularly those revenues that do not depend on the property tax, and**
- **Give communities the tools to control costs as much as possible and require sound financial management at the local level.**

1. Ensure State Assistance is Sufficient and Predictable

The Commonwealth of Massachusetts should formalize its partnership with cities and towns by adopting a revenue sharing policy that allocates a fixed percentage of state tax receipts for the primary local aid accounts that support municipal government, with this percentage based on the prior year's actual state revenue. Even though such a policy cannot prevent fluctuations caused by economic factors and changes in state revenues, it can protect local aid accounts so that they will not bear a disproportionate share of cutbacks, and it will provide certainty to local budget writers.

In the years following the adoption of Proposition 2½, the state followed an informal revenue-sharing policy that made it possible for cities and towns to meet the requirements of that measure to reduce or stabilize property taxes, while continuing to support schools, public safety and provide other services. The policy resulted in the allocation of an increasing share of state revenues to local support. Two recessions and increased state expenditures on health care and

other services have upset that informal arrangement, and the Commonwealth's percentage commitment to local aid has been reduced over the last fifteen years.

As Massachusetts policymakers make annual decisions on local aid, they should recognize the state's critical responsibility to support local government generally, in addition to their support for public education. The viability of municipal government is at stake. Additional Assistance and Lottery proceeds now account for only about 20% of total local aid. More importantly, correcting for inflation, the state's support for the non-school side of municipal government has suffered decreases since the early 1990s.

Massachusetts should support general municipal government by returning to a formula-based approach of distributing local aid that captures and responds to the disparities in the cost of providing services compared to available municipal resources. To succeed, this reform effort should hold current Additional Assistance communities harmless, but use additional funding as a base to broaden non-school aid. Such a reform will take time, research and resources to implement.

The previous Hamill Commission made a strong statement that local aid should be done using a "needs based" formula: "This formula has general acceptance among local governments. This acceptance reflects its utility. It should continue to be the vehicle for allocating the annual increase in all revenue sharing support, with the exception of regional school aid." The present Task Force concurs that one of the rationales of state assistance must be to even out disparities in resources available to municipalities, and that this distribution should be done in a transparent manner.

The Legislature may want to consider whether certain categories of municipal expenses that are prone to uncontrollable increases should be treated as special cases and whether it makes sense to create a "circuit breaker" mechanism to help municipalities deal with these costs.

Municipalities face certain especially volatile and difficult to control costs, such as snow and ice removal. One way to provide relief would be to provide direct, partial state reimbursement for such cost spikes, modeled on the existing special education (SPED) "circuit breaker," which provides a state contribution once SPED costs reach a threshold amount for an individual student. This "circuit breaker" model developed by the Legislature has proven to be an exceptionally welcome solution for municipalities to help them handle SPED costs.

The Commonwealth should fulfill its commitment to use Lottery proceeds to benefit local government by lifting the current cap, which diverts Lottery income from cities and towns. The Municipal Finance Task Force endorses an accelerated schedule to uncap distributions, and urges the Legislature to honor its commitment to use Lottery proceeds to benefit local communities exclusively. Massachusetts adopted the State Lottery in 1971 for the explicit purpose of generating local aid to cities and towns: MGL Chapter 35 §10 has as its goal: “provide local property tax relief and continue services at the local level.” By statute, Lottery revenues are intended to be used only for payment of prizes, administrative expenses, and local aid to municipalities.

The Municipal Finance Task Force believes it is time to review and revise funding for public education through Chapter 70 local aid. The Task Force urges a re-examination of the municipal revenue growth factor and the minimum local contribution, and is open to considering the idea of adding an income element to Chapter 70. However, any reforms must be fully understood to avoid creating new inequities in such a complex funding system. There is now active discussion in the Legislature and Administration about potential changes to the Chapter 70 formula, which represents two thirds of all direct local aid funding. Chapter 70 has not been significantly modified since the reform law was adopted in 1993. Specific attention should be given to regional school districts, which present unique issues.

2. Provide Communities with Additional Ability to Control Non-Property Tax Local Revenues

Municipalities should be granted additional flexibility in developing local option revenue sources. Special excise taxes, such as local option meals taxes, parking excise taxes or rental car surcharges, would give municipalities help with their financial bottom lines and diversify municipal revenue streams.

Because these special excise taxes will have varying relevance to different communities and large disparities in tax rates across communities may distort economic location decisions, this strategy of broadening local revenue options should be part of a comprehensive strategy to stabilize municipal finances.

The Municipal Finance Task Force believes it is time to consider changes to update the motor vehicle excise tax. In particular, the valuation schedule should be brought into line with actual vehicle values, and Massachusetts must aggressively tackle widespread fraud in vehicle registrations that cost municipalities revenue.

The Commonwealth should consider changes to the motor vehicle excise tax (MVE) to better reflect the value of the automobile, as well as to aggressively tackle the issue of tax evasion caused by misrepresentation on car and truck registrations. The MVE is an underappreciated component of municipal finance, which generated more than \$600 million for municipal budgets in FY2004. A more realistic depreciation schedule would require only a slight modification to current law while generating significant new revenues for municipalities.

Widespread fraud in automobile registrations costs municipalities significant revenue every year. The Commonwealth could correct issues with fraud by making registration and MVE tax collection dependent on the primary residence of the owner, rather than where the car is reported to be garaged.

There are several tax issues currently being debated at the State House that have a direct impact on municipal revenues. Although these are certainly contentious matters and arguments can be made on either side, the questions of telecommunications taxation and hotel/motel taxes deserve serious review.

One particularly controversial issue involves the way Massachusetts taxes or does not tax property owned by telecommunications companies. One side, led by Boston Mayor Thomas Menino and other municipal leaders, argues that a 1913 statute and recent court cases unfairly exempt telecommunications companies from personal property taxes that they feel should be paid to cities and towns at a time when residential property taxes are already going up. Estimates of the potential loss in tax revenue to municipalities vary widely; however, the Massachusetts Municipal Association estimates it to be as much as \$140 million.

The other side, led by telecommunications companies and organizations like the Massachusetts Taxpayers Foundation, argues that current tax laws provide an important incentive for telephone companies to invest in Massachusetts and that a tax increase would raise consumer phone and cable rates and send a poor signal to employers as the economy is just emerging from a recession.

Whatever the merits of these arguments, it is an important public debate that deserves careful consideration because of its serious impact on private investment and municipal budgets across the state.

Also, Governor Mitt Romney last year put forward a proposal to close a tax loophole caused by confusion over what the rate of hotel/motel taxes should be for reservations made through the Internet: Should the tax be calculated on the amount the person actually paid for the room or on

the discounted rate given to the Internet company that resold the room? For municipalities, this issue is important because the hotel/motel tax is one of the few local option taxes available to cities and towns. According to estimates from the Massachusetts Department of Revenue, this loophole will cost cities and towns between \$5 million and \$7.3 million in FY2006, and slightly more in FY2007. The Legislature is again considering the reform, which directly affects local budgets.

3. Give Municipalities the Tools to Control Costs

Massachusetts policymakers must make the municipal health care crisis a top priority because current cost trends are unsustainable for municipal budgets and these health insurance increases are crowding out other public benefits. This is a very contentious issue, but Massachusetts must find a way to mitigate spiraling municipal health care costs while also protecting employees and retirees.

Fortunately, the Governor and leaders from the House of Representatives and State Senate are focused on major statewide reforms to the health care system because of its continuing high cost impact on employees and employers. While recognizing that the health care crisis is a systemic problem not easily resolved, dealing with municipal health insurance must be high on state policymakers' agenda.

A recent Massachusetts Taxpayers Foundation report underlined the crisis in municipal health insurance costs. Their survey of 32 cities and towns, undertaken in cooperation with the Massachusetts Municipal Association, found that employee health care appropriations had risen 63% since 2001, at the same time that total municipal budgets had only grown 14%. Eighty percent of all Proposition 2½ allowed growth on property tax revenue from existing properties went to one line item – health insurance for employees – and one-fifth of communities responded that health insurance costs ate up *all* the revenue growth allowed by Proposition 2½.

There are competing ideas for how to deal with the municipal health care crisis. Municipal leaders propose the following strategies to help them better manage health care costs:

- Massachusetts cities and towns could be required to enroll retirees in Medicare within the next three years since they already pay to belong to the Medicare system and enrollment can save municipalities millions of dollars in premiums. State employees are already automatically enrolled in Medicare once they turn 65. The City of Springfield will save \$3 to \$5 million in 2006 because it recently adopted the local option to enroll retirees in Medicare.

Chapter 32B § 18 mandates that the benefits in the Medicare plan offered to the employees must be comparable to those in their municipal plan.

- Municipalities could be given additional flexibility under Chapter 32B to bargain individually with unions on contribution rates for indemnity plans, rather than requiring unanimous consent by potentially dozens of unions. These ideas are already part of the public debate through both the Governor's and the Senate President's health care proposals.
- The Administration and the Massachusetts Taxpayers Foundation have proposed creating individual municipal Group Insurance Commissions to govern local health insurance plans, a proposal that will be debated in the Legislature.
- The Commonwealth could make it easier for municipalities to jointly purchase health insurance plans, particularly for urban communities that do not have the same history as smaller towns of collaborating on the procurement of health insurance.

Public employee unions argue that some of these strategies represent cost-shifting to employees rather than real solutions to the health care crisis and that any proposal to change collective bargaining is an assault on employee rights. Moreover, some union supporters argue that municipal employee benefits were negotiated by public employee unions, that those employees may have given up other benefits or pay during the negotiation process, and that any changes in health insurance should be negotiated directly between union and municipal leaders.

This is an important and controversial debate, and these diverse perspectives should be heard to find solutions that alleviate this budget-busting line item while protecting employees and retirees.

The Commonwealth should do everything possible to encourage regional service delivery and cost sharing in order to promote efficient government. One simple way to boost regional service delivery is to make inter-local agreements easier to negotiate and sign. The Massachusetts Municipal Association has sponsored legislation that would allow boards of selectmen to authorize these agreements, rather than requiring a vote of town meeting. Beyond that, the Legislature and Administration should look for opportunities to create incentives for municipalities to work together. For example, state grant programs could favor applications submitted jointly and that demonstrate a willingness to share costs and resources. There are a number of areas where joint provision of services may make sense, particularly for smaller communities. Examples of potential areas for collaboration include joint delivery of veterans' services, building inspections and public health departments.

The Legislature, Governor and municipal representatives should look for ways to clarify the roles of municipal and state governments, and develop a plan to let the state take responsibility for what are properly state functions. In particular, there are unresolved questions about improving the way that regional transit authorities, including the MBTA, are funded so that they can be stand-alone organizations with dedicated funding, rather than being subsidized through complex assessment systems on local governments. In addition, county government is still being supported by municipal assessments in some parts of the Commonwealth. It would make more sense – if the Legislature chooses to continue with any form of county government – to organize them without requiring a financial drain on cities on towns.

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Introduction

In 1990, with the state on the verge of a sharp economic downturn that would have effects on municipal finances, the Governor's Task Force on Local Finance, informally known as the Hamill Commission, highlighted the need to provide stability in local finances through adjustments to Proposition 2 ½ and dedicated state aid to cities and towns.

Fifteen years following the recommendations of that Task Force, Massachusetts is beginning to emerge from one of its worst fiscal periods in decades, and policymakers have gathered once again to highlight the fiscal pressures facing municipalities, and the need for change.

Since 2002, balanced budget requirements in combination with sharp reductions in the major local aid accounts, the rise in uncontrollable costs, and limited ways to raise revenue have forced municipalities to reduce services, raise existing and initiate new fees or request property tax overrides to maintain programs.

The sustainability of these actions over the long-term is in question, as specific examples in three Massachusetts municipalities will show. Clearly, however, increases in locally generated revenue streams and decreases in services cannot continue in perpetuity. Structural change to municipal finance must be made in order to maintain balance.

The challenges facing local governments are real. Our cities and towns provide a comprehensive set of services, which build community and invest in our future. If municipalities are not able to access the resources necessary to meet the needs that changing communities demand, the entire Commonwealth suffers.

This report represents a collaborative effort to identify the key challenges facing local governments, and to offer recommendations that will build a stronger and more responsive municipal finance system.

It does not concentrate on one aspect of the municipal finance system; rather it takes a comprehensive view of the changes, trends, and pressures that have evolved over the past few decades.

Organization of Report

Section I. Municipal Budgets Fiscal 1981 - 2004: Trends and Analysis: This section evaluates trends in municipal budgets from 1981 to 2004. It analyzes municipal budget growth statewide, and the effects of cyclical economic changes on local budgets.

Section II. Municipal Revenue Fiscal 1981 - 2004: Trends and Analysis: This section takes a comprehensive look at municipal revenue sources, evaluating trends in both local-source revenue, such as the property tax, and the Commonwealth's major local aid programs. It evaluates trends over the past 25 years by taking an in-depth look at the declining levels of general-purpose aid and the increasing dependence on the property tax and local receipts to fund local services. This section also looks at municipal assessments.

Section III. Municipal Expenditures Fiscal 1987 - 2004: Trends and Analysis: In an attempt to identify trends in municipal budgets between fiscal 1987 and 2004, this section evaluates major expenditure categories such as education and fixed costs.

Notes on Data:

To identify trends, this report groups municipalities by region, per capita income quintile, and population. For more description of the methods used please refer to the Methodology section at the end of the document.

All of the data used in this report are provided on a per capita basis and in 2004 constant dollar terms, unless otherwise noted as "aggregate" or "current dollar".

Section I. Cycles in Municipal Budgets, Fiscal 1981 - 2004

Our discussion of municipal finance begins with an overview of trends in local budgets since 1981. The local budget and the local budgeting process enable municipalities to set priorities and allocate resources to fund their desired level of local services. As this report shows, using the budget as a means to meet local needs and fund services has been impacted by property tax restrictions, earmarked state aid, and rising non-discretionary costs, such as health insurance. The consequence of these and other factors, in particular the loss of a working Additional Assistance formula (a needs-based formula used to distribute aid aimed at equalizing cost disparities among municipalities), has created significant fiscal disparities among municipalities over the past several decades that without structural changes – will persist.

This section looks at the behavior of municipal budgets during economic cycles, and evaluates the implications of being heavily reliant on two primary revenue sources, the property tax and state aid, to fund services.

It should be noted that Massachusetts law requires that cities and towns have balanced budgets. While actual spending and revenue collections over the course of the year differ somewhat from budgeted amounts, any deficits must be covered in the very next year. For practical purposes, total municipal spending equals total revenues; in this report the total budget is the total local resources available for municipal purposes.

Budget Highlights

- On average, municipal budgets have increased 1.1% per capita annually since 1981. This rate of municipal budget growth is lower than the per capita percent increase in state expenditures over the same period, which averaged 2.0% a year.
- Municipal budgets have experienced five distinct economic periods between 1981 and 2004, defined largely by adjustments following the adoption of Proposition 2½, shifts in the economy, and changes in state aid.
- Growth in municipal budgets has been uneven among region, income and population categories. These differences have been for the most part driven by changes in state aid, property tax overrides and growth in municipal receipts.

- According to three separate sources, municipal employment in Massachusetts declined by 14,200 between February 2002 and August 2004¹, declined more steeply than another state in the nation between 2001 and 2005², and grew at a similar rate to that of the nation for the decade preceding these declines³.

Municipal Budget Growth

Between fiscal 1981 and 2004, statewide total municipal budgets increased in current dollars from \$5.7 billion to \$17.0 billion. Even with the negative impact of Proposition 2½ on revenues that is evident in the earliest years, real annual growth has averaged 1.1%, as shown on Table 1.1.

Over the same period, the budget of the Commonwealth excluding local aid increased from \$5.2 billion to \$19.2 billion, with average real annual growth of 2.0%.

Looking at the state's different regions, the growth in municipal budgets was inconsistent. The Cape and Islands and Pioneer Valley regions experienced the greatest real percentage growth over the entire period, at 1.6% annually. Only Boston increased at less than the municipal average.

By city and town income groupings, the average annual budget increases of all groups ranged between 1.0% and 1.5%. The highest income group had the highest annual average budget increases largely due to their high override success rate and their relatively high rate of growth in local receipts (The contributing factors are examined later in this report.).

By population group, municipal budget growth averaged between 1.0% and 1.9% annually. As a general rule, the rate of budgetary growth was closely linked to size: the larger the municipality, the slower the growth.

Municipal Budget Cycles

From fiscal 1981 to 2004, local budgets experienced five distinct periods of growth or reductions:

1. Fiscal 1981 - 1984

Total spending adjusted for inflation fell over \$600 million during this period or an average of -2.2% annually, reflecting the effects of Proposition 2½ on the property tax and motor vehicle excise tax. Every region, income or population group experienced budget reductions during this period.

¹ Massachusetts Taxpayers Foundation (MTF), Municipal Financial Data: 34th Edition, October 2004.

² Boston Globe, Economy.com quote

³ Federal Reserve Bank of Boston, Economic Indicators Database, Local Government Employment, not seasonally adjusted, Bureau of Labor Statistics.

Table 1.1
Average Annual Change State & Municipal Budgets,
Selected Year Groupings
 Constant dollar, per capita

| | 1981-1984 | 1984-1989 | 1989-1992 | 1992-2002 | 2002-2004 | 1981-2004 |
|--------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Massachusetts* | -0.3% | 6.3% | 2.3% | 0.9% | -1.3% | 2.0% |
| Municipal Total | -2.2% | 4.1% | -1.6% | 2.1% | -0.4% | 1.1% |
| Region | | | | | | |
| Berkshire | -3.6% | 5.3% | -0.6% | 2.4% | -1.2% | 1.4% |
| Pioneer Valley | -1.3% | 4.5% | -0.2% | 2.5% | -1.4% | 1.6% |
| Central | -3.6% | 4.5% | -3.3% | 3.1% | 0.6% | 1.2% |
| Boston Metro | -2.5% | 4.1% | -1.3% | 2.1% | 0.4% | 1.1% |
| Boston | -1.8% | 2.7% | -0.5% | -0.2% | -0.7% | 0.0% |
| Northeast | -0.7% | 4.4% | -3.1% | 2.5% | -1.3% | 1.2% |
| Southeast | -2.3% | 4.7% | -2.4% | 2.9% | -0.8% | 1.4% |
| Cape and Islands | -2.5% | 5.9% | 2.0% | 1.1% | 0.1% | 1.6% |
| Per Capita Income | | | | | | |
| Lowest 5th | -2.3% | 5.2% | -2.9% | 3.1% | -1.9% | 1.4% |
| Second 5th | -2.2% | 4.5% | -2.3% | 2.3% | -1.1% | 1.0% |
| Boston | -1.8% | 2.7% | -0.5% | -0.2% | -0.7% | 0.0% |
| Third 5th | -3.6% | 4.8% | -1.9% | 2.2% | -0.7% | 1.0% |
| Fourth 5th | -1.2% | 4.2% | -0.6% | 1.6% | 0.6% | 1.2% |
| Highest 5th | -1.9% | 3.2% | -0.5% | 2.6% | 1.8% | 1.5% |
| Population | | | | | | |
| 50-1,999 | -4.1% | 3.4% | 3.0% | 2.2% | -0.5% | 1.3% |
| 2,000-4,999 | -2.9% | 4.7% | 0.1% | 2.5% | 2.6% | 1.9% |
| 5,000-9,999 | -3.1% | 4.2% | 0.4% | 2.7% | 1.4% | 1.7% |
| 10,000-19,999 | -2.3% | 4.4% | -1.0% | 2.6% | 0.7% | 1.5% |
| 20,000-49,999 | -2.0% | 4.0% | -2.0% | 2.5% | -0.5% | 1.2% |
| 50,000+ | -2.1% | 5.1% | -2.6% | 2.2% | -1.3% | 1.0% |
| Boston | -1.8% | 2.7% | -0.5% | -0.2% | -0.7% | 0.0% |

*Based Massachusetts Taxpayers Foundation calculation of total budgeted state expenditures net of local aid expenditures

part of the 1993 Education Reform Act. A stable national economy aided this long period of growth, as local budgets in all regions, income and population groups expanded.

5. Fiscal 2002 - 2004 Most recently, real local spending declined by \$19.2 million, or -0.4% annually on average, due almost solely to local aid reductions. Like the previous economic downturn of fiscal 1990 - 1993, regions, income and population groups in this recessionary period experienced uneven budget growth.

2. Fiscal 1984 - 1989 In this period, real local spending grew by \$1.25 billion or an average of 4.1% annually, largely due to increased aid from the Commonwealth. Every region, income and population group experienced budget growth, in contrast to the previous period.

3. Fiscal 1989 - 1992 In this recessionary period, real local spending declined by a total of \$192 million or -1.6% annually, due mostly to local aid reductions and the impact of a downturn in the real estate market on local property taxes. The unevenness of budget growth during this period, especially among different income groups, is discussed in detail at the end of this section.

4. Fiscal 1992 - 2002 Real local spending during this period grew \$1.89 billion or 2.1% a year on average, again largely due to increased local aid, though this time the additional aid dollars were restricted to education as

Fiscal 1990 to 1993: An Example of the Implications of Revenue Source Dependence

Fiscal years 1990 - 1993 were marked by several challenges to municipal finance:

- Weaknesses in all of the major local revenue streams;
- Strains in the property tax due to a fragile real estate market;
- Severe cuts in state aid assistance, including the abandonment of Additional Assistance, an aid program aimed at equalizing cost disparities among municipalities.

Each factor contributed to the uneven distribution of municipal budget reductions, especially among income groups.

While all city and town income groups experienced budget reductions, the declines for municipalities with the highest incomes were smaller, even though they experienced the largest percentage cuts in per capita aid. At the same time reductions for municipalities in the lower income groupings were greater even though the municipalities in those groups experienced the least severe aid cuts.

This was also the case during the most recent economic downturn. As Table 1.1 shows, the budgets of municipalities in the two highest income groups actually expanded during this period, while the budgets of the lowest income group fell by 1.9% a year.

Part of the reason for these trends may be the revenue characteristics of these municipalities. Those with lower incomes and higher populations are more dependent on state aid and less able or willing to increase local revenues. As a result, they are more directly affected by the volatility of state aid. In contrast, higher income municipalities, which receive less aid and are willing and able to increase local revenues, can mitigate the (smaller) effects on their budgets of reductions in local aid.

Municipalities that experience lower budget growth during economic downturns must reduce service levels more drastically than their counterparts that have less volatile revenue streams and a greater willingness to request additional taxes from their residents. These trends are especially noteworthy because, as will be discussed in more detail in Section III of the report, it typically costs more to provide services in larger and lower income municipalities due to their economic and environmental traits, making the process of adjusting to – and recovering from – financial adversity more difficult.

These disparities in the ability of higher and lower income municipalities to generate the additional revenues needed to replace state aid cuts and sustain local services has several implications for local aid policy. In particular, local aid formulas need to take into account the differing characteristics of

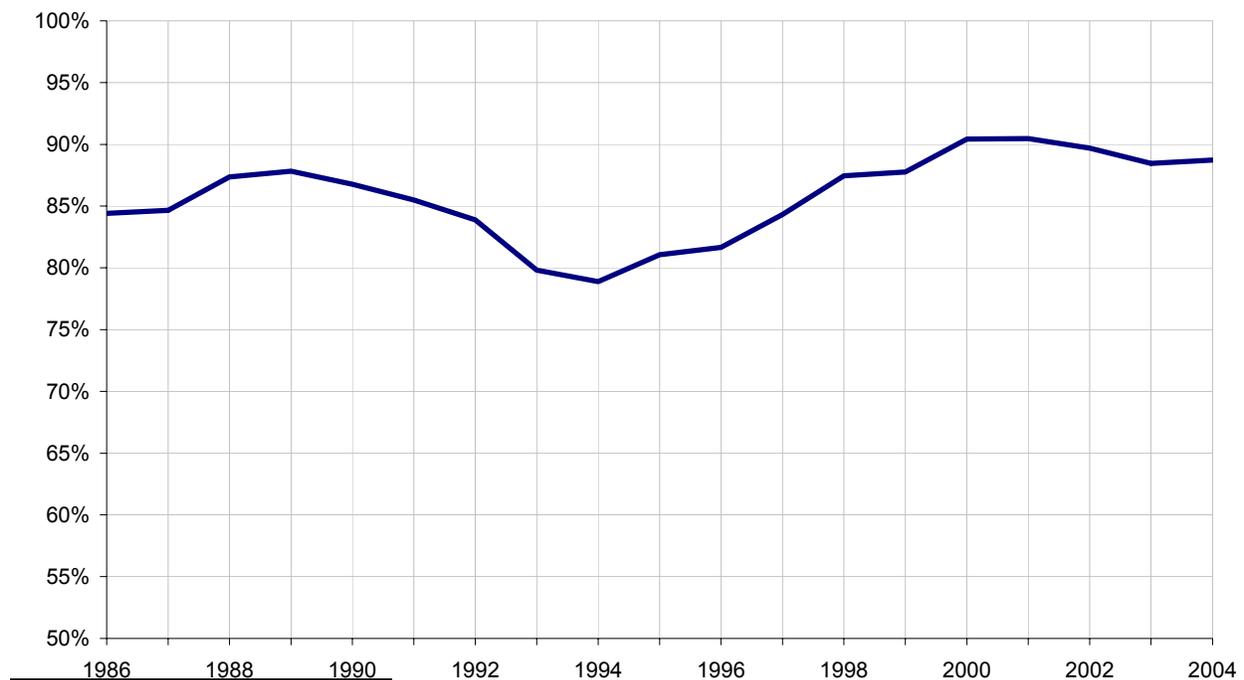
municipalities revenue bases. More generally, the effects of these differences could be reduced by diversifying local revenue bases.

At the same time, the difference between higher and lower income municipalities should not be overstated. Higher income municipalities face many of the same fiscal pressures as lower income municipalities, and their continued need to increase local revenues to meet service demands is a signal of the structural deficiencies caused by local revenue limitations. Additionally, the need for continued local revenue increases through the property tax belies the purpose and intent of Proposition 2½, to limit property tax growth.

Adjusting to Change: Municipal Fiscal Management

Given the swings in municipal budgets since 1981, it would be helpful to utilize an objective measure of local fiscal management over the period. However, obtaining a reliable and comprehensive measure is difficult. For the purposes of this report, bond ratings are used as an independent measure of municipal stability, as rating agencies take into consideration factors such as the economic environment, financial performance and flexibility, municipal debt burden, and management when assessing risk.⁴

Chart 1.1
Massachusetts Municipal Bond Ratings - Moody's
Percent of those with ratings that scored "A" or better



⁴ Standard & Poor's. *Public Finance Criteria*. McGraw-Hill. 2005

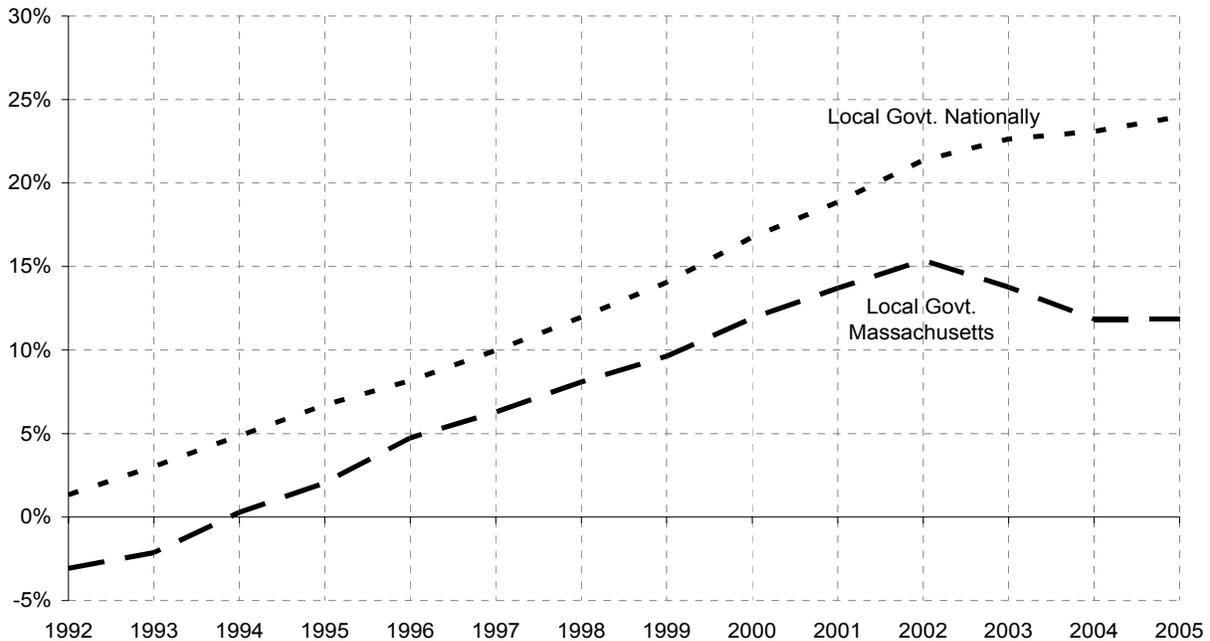
As reflected in the ratings of Moody’s Investors Services, most of the state’s municipalities have been able to manage their local finances with relative stability. As Chart 1.1 shows, of the 225⁵ Massachusetts cities and towns that on average were rated by Moody’s each year between 1986 and 2004, 80% to 90% were consistently rated “A” or higher.

Many dimensions of finance, especially revenues, are considered when a municipality is reviewed for a rating. For example, revenue diversification and the local control of revenue like local option taxes or dedicated revenue streams for debt play a role in the rating process, as do the stability or volatility of major revenue sources. It is worth noting that the percentage of municipalities with “A” or higher ratings has dipped for the most part during those periods when local aid to municipalities has fluctuated considerably, as is indicated in Chart 1.1 on the previous page.

Adjusting to Fiscal Change: Municipal Employment

Changes in employment numbers are another indication of how municipalities adjust to economic downturns. The Massachusetts Taxpayers Foundation reported in 2004 that Massachusetts’ municipalities cut 14,200 jobs, or 5.2% of all municipal employees, between February 2002 and August 2004. According to Economy.com, a Pennsylvania research firm, municipalities in Massachusetts cut their workforces more steeply than in any other state in the nation between 2001

Chart 1.2
Local Government Employment
 Cumulative Percent Increase
 Fiscal 1991 to 2005



⁵ In fiscal 1986, 186 municipalities were rated by Moody’s, 84.4% rated “A” or higher. In fiscal 2004, 257 municipalities

and 2005.

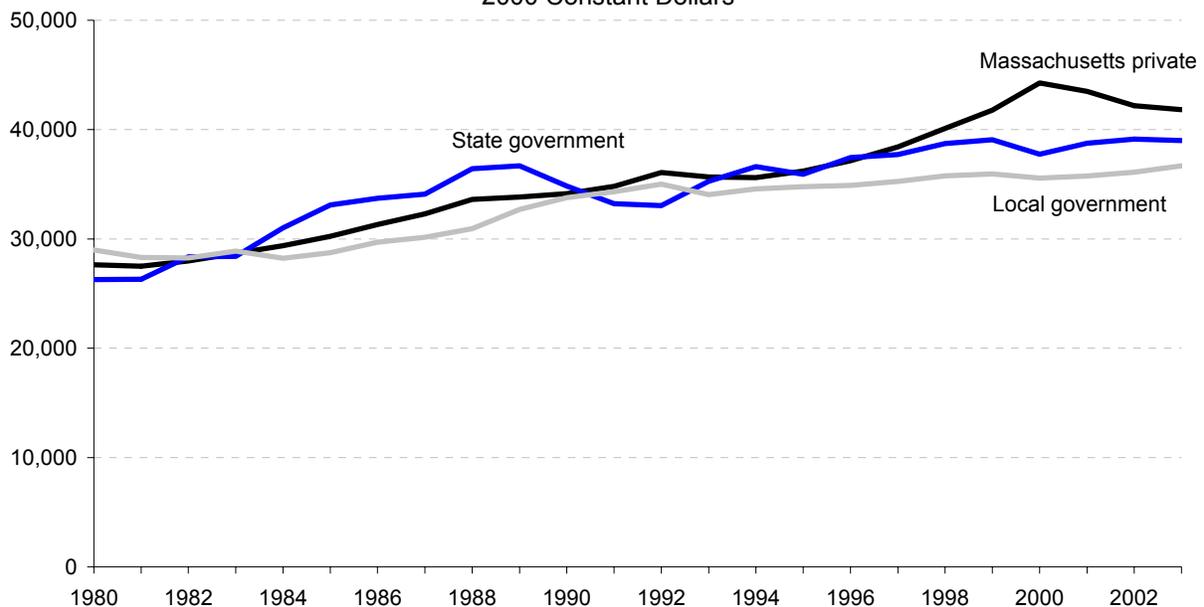
Recent data from the Bureau of Labor Statistics (detailed in Chart 1.2), dramatically illustrate the same point: After tracking the nation throughout the 1990s, local government employment growth in Massachusetts – as measured by its cumulative annual percent increase – declined sharply in the early 2000s as local government employment growth nationally only slowed.

Adjusting to Fiscal Change: Municipal Wages

According to data from the Bureau of Economic analysis, wages & salaries of state and local government employees have fallen considerably behind those of private sector employees in Massachusetts over the last decade (Chart 1.3).

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%, in inflation-adjusted terms between 1994 and 2003, compared to 1.8% for private sector and 1.0% for state employees over the same period.

Chart 1.3
Real Wage & Salary Disbursements
Massachusetts Private Industry versus State And Local Government
per wage & salary employee
2000 Constant Dollars



Source: Bureau of Economic Analysis (BEA)

were rated by Moody's and 88.7% were rated "A" or higher.

Section II. Municipal Revenues: Trends and Analysis, Fiscal 1981 - 2004

The mix of local revenues has serious implications for municipal management, specifically around issues of stability, predictability, flexibility and fairness.

As the previous section on municipal budgets highlighted, municipalities that are highly dependent on state aid have been forced to make deeper adjustments to their budgets to reach balance, while those able to expand their property taxes during difficult fiscal times have not been forced to impose such severe reductions.

This section discusses the two major municipal revenue sources: local source revenue, including the property tax and local receipts, and local aid to cities and towns. The first part offers a brief description of the major local source revenues available to municipalities and looks at trends over the period among regions, income and population groups. The second part examines local aid,

Chart 2.1
Fiscal 1988 Municipal Revenue Sources
Peak Local Aid Year
Constant Dollars, Per Capita

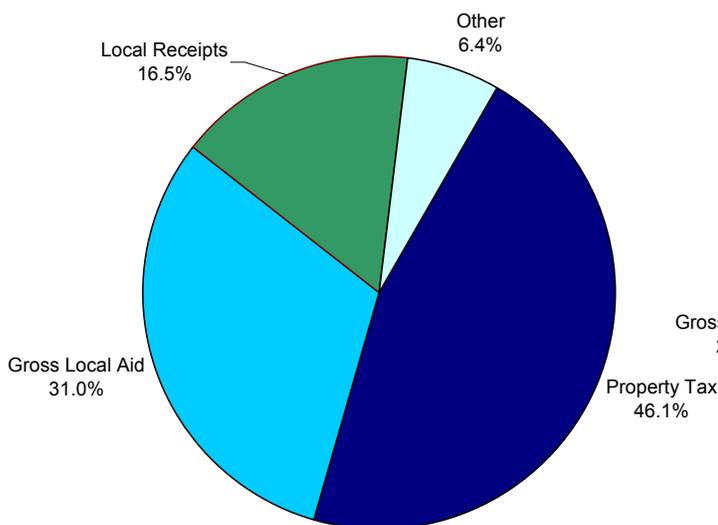
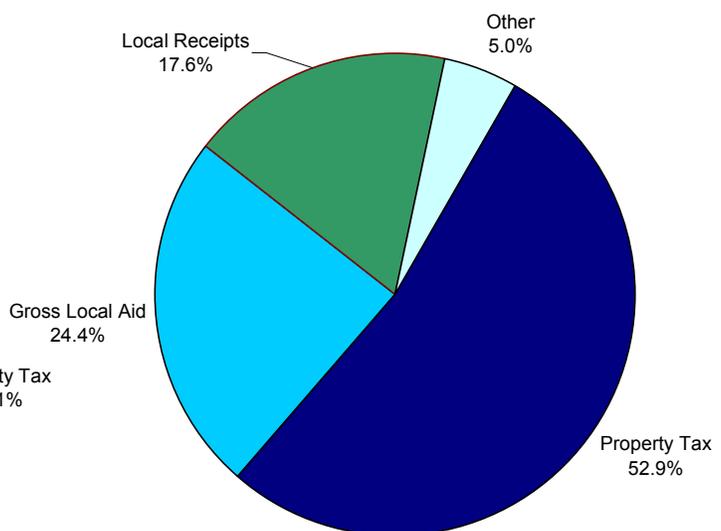


Chart 2.2
Fiscal 2004 Municipal Revenue Sources
Most Recent Year
Constant Dollars, Per Capita



which is made up of state revenue distributed to local governments through a wide array of programs.

Probably the most significant aspect of the financial picture for cities and towns during the past two decades has been the shift among revenue sources. Sharp aid reductions during recessionary periods, stagnant general-purpose aid, restrictions on the use of school aid and the need to become increasingly reliant on the property tax and local receipts to fund local services have all contributed to this shift. Charts 2.1 and 2.2 ⁶ illustrate the change in the municipal revenue mix since the fiscal 1988 peak of local aid funding.

Local Source Revenue Highlights:

- In the most recent period, the overall trend has been increasing reliance on local source revenues – the property tax and local receipts – to fund municipal services.
- The property tax decreased from 59.1% of municipal budgets in 1981, before Proposition 2½, to a low of 46.1% in 1988. Signaling a greater dependence on the property tax, that share has increased since that time, reaching 52.9% of total budget revenue in 2004.
- Local source revenue in total has grown an average of only 0.8% annually since fiscal 1981. (As mentioned previously, the growth rates in this and other sections of the report reflect the inflation-adjusted change in per capita amounts, unless otherwise noted.)
- Local receipts (fees, charges and other local revenue) have on average grown 2.3% annually in real terms since fiscal 1981. As a percentage of local budgets, local receipts increased from 13.9% in fiscal 1981 to 17.9% in fiscal 2004.
- Since fiscal 1992, new growth has increased the Proposition 2½ levy limit statewide an average of 2.4% a year. In some regions, the growth in local receipts as a result of new residential and business construction has outpaced the annual increase in taxes on existing property that is allowed under Proposition 2½.
- Compared to the nation, municipalities in Massachusetts are far more reliant on the property tax, and less reliant on other local taxes to fund municipal services. While approximately 41 states have some type of limitation on property taxes, Massachusetts is one of only a few states, including Arizona, Colorado, Missouri, Montana, New Mexico, Oregon and Washington, that

⁶ The charts display “Gross Local Aid” which Cherry Sheet local aid (net of Boston Teacher Pension reimbursement) before assessments are charged. The rest of this document refers to “Net Local Aid” – defined as “gross local aid” minus assessments. Net Local Aid as a percent of budget was 28.4% at its fiscal 1988 peak and 22.0% in fiscal 2004. In fiscal 1981, the first year of data, net local aid was 15.3% of budget.

added strict limitations to the property tax following the 1978 passage of Proposition 13 in California.

- Except for Montana and Oregon, the states listed above that have strict property tax limitations also allow local option sales taxes for their municipalities.⁷

Local Aid Highlights:

- Net local aid per capita accounted for 15.3% of total municipal revenues in 1981, peaked at 28.4% in 1988, and then fell to 22.0% in 2004.
- Since fiscal 1981, “Section Three” local aid – Chapter 70, Lottery and Additional Assistance, – in total, have increased by an average of 3.0% a year, but growth in the components of this aid have varied drastically.

| Local Aid Type | Annual Growth in Aid: 1981-1993 | Annual Growth in Aid: 1993-2004 |
|------------------------|---------------------------------|---------------------------------|
| School Aid/Chapter 70 | -2.1% | 8.6% |
| Lottery | 11.3% | 3.5% |
| Additional Assistance* | 27.4% | -7.4% |

* Annual growth figures for Additional Assistance are for the years of fiscal 1981 - 88 and 1988 - 2004. Fiscal 1988 was the last year this account received any funding increase.

- Chapter 70 funding has been dedicated solely to education since fiscal 1993. Since that time, Chapter 70 aid saw the largest increase of all Section Three accounts, increasing 8.6% annually.
- Since fiscal 1988 Additional Assistance has either been level-funded or reduced, leaving no formula in place to equalize aid for the uncontrollable costs borne by certain types of municipalities. Additional Assistance was the fastest growing component of local aid prior to fiscal 1988 at an annual average of 27.4%, but has since averaged annual decreases of 7.4%.
- The growth in Lottery aid has slowed considerably since the 1980s. In inflation adjusted terms, Lottery aid increased at an average annual rate of 11.3% between fiscal 1981 and 1993, and 3.5% between fiscal 1993 and 2004. Lottery aid has been under state-imposed caps that have reduced aid to municipalities for much of the 1990s and 2000s.

⁷ Shuford, Gordon, and Richard Young.2000. A Report on Local Government Funding: An Overview of National Issues and Trends. Columbia: University of South Carolina.

- Growth in the Commonwealth's net local aid expenditures generally follows growth in the Commonwealth's overall expenditures – except during economic contractions where growth in net local aid declines at a substantially higher rate than overall expenditure declines.

Local Source Revenue

Table 2.0
Average Annual Change in Total Local Source Revenues, Selected Year Groupings

| Constant dollar, per capita | 1981-1984 | 1984-2004 | 1981-2004 |
|-----------------------------|-----------|-----------|-----------|
| Municipal Total | -4.9% | 2.0% | 0.8% |

Region

| | | | |
|------------------|-------|------|-------|
| Berkshire | -7.6% | 2.6% | 1.1% |
| Pioneer Valley | -4.7% | 2.0% | 0.9% |
| Central | -7.3% | 2.5% | 0.9% |
| Boston Metro | -4.9% | 2.3% | 1.0% |
| Boston | -5.9% | 1.0% | -0.2% |
| Northeast | -2.3% | 1.6% | 0.8% |
| Southeast | -5.3% | 2.3% | 1.1% |
| Cape and Islands | -2.7% | 2.5% | 1.7% |

Income

| | | | |
|-------------|-------|------|-------|
| Lowest 5th | -7.0% | 1.6% | 0.2% |
| Second 5th | -5.2% | 2.0% | 0.8% |
| Boston | -5.9% | 1.0% | -0.2% |
| Third 5th | -5.9% | 2.4% | 1.0% |
| Fourth 5th | -2.7% | 2.2% | 1.2% |
| Highest 5th | -3.1% | 2.5% | 1.6% |

Population

| | | | |
|---------------|-------|------|-------|
| 50-1,999 | -5.2% | 2.9% | 1.6% |
| 2,000-4,999 | -4.0% | 3.1% | 2.1% |
| 5,000-9,999 | -4.9% | 3.0% | 1.8% |
| 10,000-19,999 | -4.0% | 2.7% | 1.6% |
| 20,000-49,999 | -4.0% | 2.0% | 1.0% |
| 50,000+ | -5.9% | 1.6% | 0.3% |
| Boston | -5.9% | 1.0% | -0.2% |

assessment process. These characteristics can create complex political, social and economic consequences for municipalities.

Local source revenues in total, including the property tax, local receipts and other revenue has grown only 0.8% annually between fiscal 1981 and 2004 (Table 2.0). As a percentage of municipal budgets, total local source revenues decreased from 80.1% in fiscal 1981 to their lowest point of 69.0% in fiscal 1988 and have since risen to 75.6% in fiscal 2004 – their highest point in ten years.

For the period fiscal 1981 - 2004 as a whole, total local source revenues increased on average for all regions, income quintiles and population groups except Boston⁸. In general, higher income and smaller population groups have better annual average increases in total local source revenues than their poorer and larger counterparts.

The Property Tax and Its Characteristics

The property tax – the total amount a municipality raises by placing a levy on real and personal property – is arguably the most important source of revenue available to municipalities. Compared to other revenue sources, the tax has a number of advantages, including its relative stability, predictability, and difficulty of evasion. At the same time however, the tax tends to be regressive, is highly visible, and is perceived by some to be the result of a subjective

⁸ Since Boston is displayed separately it should be noted that the city did see a reduction in local source revenues as a result of the sale of Boston City Hospital in fiscal 1996. The figures in table 2.0 do not adjust for this change or other similar “unique” circumstances of other municipalities over the 25 year period.

Prior to the passage of 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. In fiscal 1981, the year before the implementation of Proposition 2 ½, the property tax supported 59.1% of local budgetary spending statewide, reflecting the very heavy reliance of cities and towns on this revenue source.

Although Proposition 2½ had the initial effect of reducing the percentage of local budgets funded by the property tax, this situation is now been reversing. By fiscal 2004, the percentage of local budgets supported by the property tax was at its highest level in over 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 state budget in the 1990s and 2000s, resulting in the subsequent need in many cases to pass overrides to meet cost increases.

The following case study on Hampden, Massachusetts provides an example not only of the fiscal pressures resulting from rising expenditure demands and the actions that have had to be taken to live within revenue limitations, but also of the impact on local services of the defeat of a property tax override.

Hampden, Massachusetts

Basic Facts

Region: Pioneer Valley

Population: 5,309, 2004 Census estimate

Per Capita Income: \$26,690, 2000 Census

Type of Government: Board of Selectman-Town Meeting

Municipalities in western Massachusetts have not been spared the challenges facing municipalities elsewhere in the state. The small municipality of Hampden, located on the Connecticut border 10 miles southeast of Springfield, has seen its local services drastically decline over the past few years due to the rising costs of regional schools, healthcare, and county retirement assessments.

In response to cost increases, this year the municipality requested a \$584,000 Proposition 2½ override. The override was defeated and the municipality was forced to eliminate all but essential services and significantly reducing many programs including:

- Closing the town library
- Closing the town Senior Center
- Laying off 40% of the town's full-time highway employees (2 of 5)
- Eliminating funding for Parks and Recreation staff. (Some fee-for-service programs remain in operation.)
- Turning off all town streetlights

In response to their rising non-discretionary costs and prior to requesting a voter override, Hampden made significant changes to municipal operations to balance its budget:

- All non-bargained town employees have taken 2 years of wage freezes.
- Aggressively negotiated a 1-year wage freeze with 2 out of 3 of its bargaining units with the third bargaining unit going over a year without a new contract.
- Reduced hours for the Board of Health, Board of Selectmen, Town Clerk, Assessor and other offices through shorter workweeks.
- Increased transfer station fees to include operational as well as disposal costs.
- Liquidated stabilization fund to cover operating expenses.

Proposition 2½: The Basics

Proposition 2½ is the title given to the initiative petition passed in 1980 that set limits on the amount of property tax a municipality can raise each year.

The provision does not limit individual tax bills to a 2.5% increase each year. It sets a limit on the entire property tax levy for the municipality. The property tax levy is limited in two ways:

The Levy Ceiling: *Total property taxes* cannot exceed 2.5% percent of the total full and fair cash value of all real and personal property in the municipality. For example, if the total assessed value of property in a municipality were \$100 million, the maximum property tax levy that municipality could raise would be \$2.5 million.

The Levy Limit: *From year to year*, the levy limit on property taxes, with certain exceptions for new growth and voter overrides, cannot increase more than 2.5%. Communities who tax themselves at less than their levy limit may increase their taxes up to the limit at any time. Using the most basic example, if the property tax levy of a municipality that is taxing at its limit is \$10 million, it can only raise an additional \$250,000 in property taxes for the next fiscal year. The levy limit may not exceed the levy ceiling.

Please refer to the glossary for detailed definitions of terms related to Proposition 2½ including new growth, debt exclusions, excess capacity, override capacity and overrides.

Trends in Property Tax Levies

Proposition 2½ fundamentally changed the municipal finance equation by placing limits on the property tax. Initial reductions in the property taxes of some municipalities in order to get levies below the new “ceiling” caused considerable problems. More adjustments were necessary on an annual basis for municipalities to live within the restrictive parameters of the allowed 2.5% increase in property taxes, plus new growth.

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% of municipal budgets in fiscal 1981, this figure dropped to a low 46.1% by fiscal 1988 and has since increased to 52.9% 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 a per capita rate of annual increase that averaged 0.6% after adjusting for inflation.

As Table 2.1 shows, fiscal 1981 - 1984 was a time of adjustment to the new constraints of Proposition 2½. Some regions, income and population groups fared better than others in this

Table 2.1
Average Annual Change in Tax Levy - Selected Year Groupings
 Constant dollar, per capita

| <i>Region</i> | 1981-1984 | 1984-2004 | 1981-2004 |
|---------------|-----------|-----------|-----------|
| Statewide | -6.8% | 2.1% | 0.6% |

| | | | |
|------------------|--------|------|------|
| Berkshire | -8.8% | 2.5% | 0.8% |
| Pioneer Valley | -6.2% | 2.1% | 0.8% |
| Central | -7.1% | 2.2% | 0.7% |
| Boston Metro | -5.6% | 2.0% | 0.7% |
| Boston | -12.9% | 3.0% | 0.1% |
| Northeast | -4.0% | 1.8% | 0.9% |
| Southeast | -6.9% | 1.8% | 0.5% |
| Cape and Islands | -3.4% | 2.1% | 1.2% |

| <i>Income</i> | | | |
|---------------|--------|------|-------|
| Lowest 5th | -9.0% | 1.3% | -0.4% |
| Second 5th | -6.6% | 1.7% | 0.4% |
| Boston | -12.9% | 3.0% | 0.1% |
| Third 5th | -6.1% | 2.1% | 0.8% |
| Fourth 5th | -4.4% | 2.1% | 1.1% |
| Highest 5th | -3.1% | 2.3% | 1.4% |

| <i>Population</i> | | | |
|-------------------|--------|------|------|
| 50-1,999 | -5.5% | 2.9% | 1.6% |
| 2,000-4,999 | -3.8% | 3.1% | 2.0% |
| 5,000-9,999 | -5.1% | 2.8% | 1.6% |
| 10,000-19,999 | -4.7% | 2.4% | 1.3% |
| 20,000-49,999 | -4.9% | 1.8% | 0.7% |
| 50,000+ | -7.6% | 1.5% | 0.0% |
| Boston | -12.9% | 3.0% | 0.1% |

adjustment. For example the Cape and Islands region posted a comparatively small annual average decrease in levy during this period of -3.4%, while Boston experienced a decrease of -12.9%.

Higher income cities and towns fared better in this adjustment, with municipalities in the highest two income groups experiencing annual average per capita decreases in their levies of -4.4% and -3.1%, while all other groups experienced declines ranging from -6.1% to -9.0%.

The largest and smallest population groups were the most affected by the implementation of Proposition 2½, with the 50-1,999 group seeing annual average declines in their levies of -5.5% and the 50,000+ group of cities and towns declining by -7.6% on average.

In the remaining years of the period, fiscal 1984 - 2004, the change in property tax levy varied less by category and was positive.

By region, Boston experienced the largest annual average increase at 3.0% – largely due to additions to the levy from new construction – with all other regions seeing growth between 1.8% and 2.5%.

By income, the highest fifth of municipalities increased the most by an annual average of 2.3%, while the lowest fifth increased the least by 1.3% annually on average.

By population, smaller municipalities recovered more rapidly than larger ones with the 2,000-4,999 group increasing 3.1%, and the 50,000+ group increasing the slowest at 1.5%.

Trends in New Growth

Beginning in fiscal 1992, the “New Growth” allowance under Proposition 2½ was expanded. Municipalities today have the ability to add to their property tax bases the value of new development and other growth that is not the result of revaluation. This includes new subdivisions and condo

conversions along with properties that have increased in value due to development or additions. Between fiscal 1992 and 2004, \$112.45 billion in value was added to tax bases through new growth,

Table 2.2
Average Annual Percentage
Addition to Levy from New
Growth
 Aggregate, current dollar

| <i>Region</i> | 1992-2004 |
|-------------------|-----------|
| Statewide | 2.38% |
| Berkshire | 1.90% |
| Pioneer Valley | 2.30% |
| Central | 2.87% |
| Boston Metro | 2.28% |
| Boston | 2.85% |
| Northeast | 2.41% |
| Southeast | 2.47% |
| Cape and Islands | 2.11% |
| <i>Income</i> | |
| Lowest 5th | 2.17% |
| Second 5th | 2.43% |
| Boston | 2.85% |
| Third 5th | 2.52% |
| Fourth 5th | 2.54% |
| Highest 5th | 2.27% |
| <i>Population</i> | |
| 50-1,999 | 2.15% |
| 2,000-4,999 | 2.45% |
| 5,000-9,999 | 2.79% |
| 10,000-19,999 | 2.59% |
| 20,000-49,999 | 2.06% |
| 50,000+ | 1.91% |
| Boston | 2.85% |

for an increase of \$1.91 billion in local levy limits. Overall, new growth increased the levy limit statewide by an average of 2.38% each year during this period, almost as much as the Proposition 2½ base increase of 2.5%.

As Table 2.2 shows, some regions fared well with regard to new growth. Both Boston and the Central region experienced annual average increases from new growth of 2.85% and 2.87% respectively, each in excess of both the statewide average and the Proposition 2½ base increase.

By income, the 4th quintile (2.54%) was highest followed by the 3rd quintile (2.52%), both averaging more than the 2.5% allowable increase under Proposition 2½. No group added less than 2.0% annually through new growth.

By population group, medium-sized municipalities surpassed the statewide average, while the largest (except Boston) and smallest municipalities did not.

Excess Capacity

Excess capacity is the “space” between the actual tax levy and the tax levy limit. It is the result of a municipality’s willingness or ability to increase taxes by less than the basic 2.5% allowed by Proposition 2½ plus new growth. It is expressed as a dollar amount and as a percentage of the levy limit. Excess capacity can accumulate annually as municipalities defer taking the full

allowable increase, and communities retain the option of using their excess capacity in portions or all at once.

During tough budget periods, excess capacity generally diminishes in the aggregate as municipalities take full advantage of their accumulated excess capacity as well as new allowable increases in the annual levy to fill budget gaps caused by reductions in other revenue streams. For example, during the fiscal 1991 - 1993 period that included a national recession and state aid reductions, statewide average excess capacity dropped to \$26.1 million or just 0.73% of the levy limit from a high in fiscal 1987 of \$102.0 million or 4.36% of the limit.

As Table 2.3 indicates, statewide excess capacity over the fiscal 1985 - 2004 period has averaged

Table 2.3
Average Annual Excess & Override
Capacity as a Percentage of the Levy
Limit

Fiscal 1985 - 2004

Aggregate, current dollar

| <i>Region</i> | <i>Excess</i> | <i>Override</i> |
|------------------|---------------|-----------------|
| Statewide | 2.7% | 43.6% |
| Berkshire | 6.1% | 49.4% |
| Pioneer Valley | 3.6% | 37.5% |
| Central | 3.2% | 44.2% |
| Boston Metro | 1.4% | 39.8% |
| Boston | 0.0% | 20.2% |
| Northeast | 1.8% | 43.2% |
| Southeast | 1.3% | 41.9% |
| Cape and Islands | 2.8% | 68.9% |

Income

| | | |
|-------------|------|-------|
| Lowest 5th | 4.1% | 35.9% |
| Second 5th | 3.2% | 44.5% |
| Boston | 0.0% | 20.2% |
| Third 5th | 2.5% | 45.0% |
| Fourth 5th | 2.1% | 46.4% |
| Highest 5th | 1.8% | 46.4% |

Population

| | | |
|---------------|------|-------|
| 50-1,999 | 5.8% | 47.3% |
| 2,000-4,999 | 3.4% | 48.4% |
| 5,000-9,999 | 2.1% | 46.3% |
| 10,000-19,999 | 1.7% | 43.0% |
| 20,000-49,999 | 1.6% | 39.7% |
| 50,000+ | 2.1% | 30.7% |
| Boston | 0.0% | 20.2% |

2.72% or \$106.7 million of the levy limit, decreasing during recessions and increasing during expansions. By region, Berkshire has maintained the highest average annual excess capacity over the period at 6.1% of the levy limit. Boston has maintained the lowest at 0.0% of the levy limit. In other words, Boston has levied to its levy limit with no excess capacity while the Berkshire region taken as a whole has considerable space under the limit.

By income, the lowest quintile had the largest average annual excess capacity at 4.1% following inversely with income are the 2nd (3.2%), 3rd (2.5%), 4th (2.1%), and 5th (1.8%) quintiles. Boston has the lowest average annual excess capacity at the above-mentioned 0.0%.

By population, excess capacity tended to fall as municipal population increased, with the 50-1,999 grouping having the highest annual average excess capacity of 5.8% and the 20,000-49,999 grouping having the lowest at 1.6%.

Excess Capacity: A Measure of Fiscal Flexibility

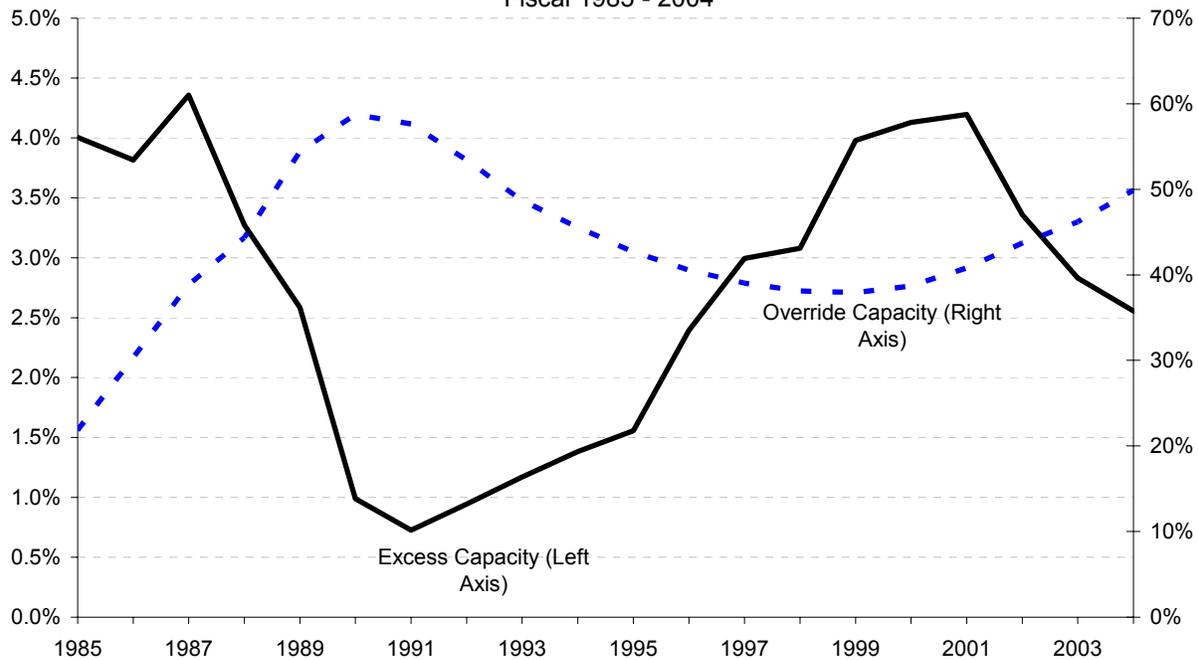
Excess capacity can be an important source of revenue during economic downturns, as municipalities utilize unused property taxing capacity to make up for state aid cuts.

A closer look at excess capacity shows that most municipalities currently have very little room to increase property taxes without requesting voter approved overrides, another indication of decreasing budgetary discretion.

For example, in fiscal year 2004 approximately 32% of municipalities had excess capacity of .05% (one-twentieth of 1%) or less as a percent of the levy limit, and 65% of municipalities had excess capacity of 1% or less.

On the other hand, 26% of municipalities could increase their levies by a full 2.5% percent or more

Chart 2.3
Excess Capacity & Override Capacity
 As a Percentage of the Maximum Levy Limit
 Aggregate, current dollar
 Fiscal 1985 - 2004



without requesting an override. However, these municipalities may have accumulated excess capacity due to their inability or unwillingness to increase taxes on a less wealthy population. As noted above (and shown in Table 2.3,) the lowest income municipalities generally had considerably more excess capacity during the period than the highest income municipalities.

Override Capacity

Override capacity is the difference between the levy (including the value of debt and capital exclusions) and the levy ceiling, or 2.5% of the total value of all property. This amount is available to fund voter overrides of the levy limit by town residents and it becomes a permanent part of the levy limit when an override is passed. Override capacity expands or contracts on its own in direct proportion to overall assessed property values. In other words, if assessed values decline, the ceiling lowers to closer to the levy limit, reducing override capacity. The opposite occurs when values rise.

Since the late 1980s, override capacity has far exceeded the levy limit in the vast majority of municipalities, as shown in Chart 2.3. However, a small number of municipalities – such as

Springfield – saw their override capacity dwindle sharply or even vanish as a result of steep declines in local property values during economic downturns. The financial consequences for some of these municipalities were harsh, since they were unable to take advantage of the additional annual revenues from the allowable increase of 2.5% or overrides of the levy limit without exceeding the local levy ceiling, the absolute limit on annual property taxes imposed by Proposition 2½.

Springfield: Hitting the Levy Ceiling

Dwindling override capacity has not been a major issue for most municipalities, as property values have continued to increase in municipalities throughout the state. The City of Springfield has been an exception. The combination of a \$10.8 million operating override in FY91 and declining assessed property values for much of the 1990s reduced override capacity to zero between 1996 and 2000, heightening fiscal challenges by preventing the municipality from accessing additional revenue from property taxes.

Springfield's experience highlights the fiscal pressures that can result from interplay of Proposition 2½ and the economic realities of local real estate markets. If the assessed value of property stagnates or declines precipitously, as in Springfield, local budgets, and local services, suffer seriously when coupled with the inability to approve overrides or expand the tax base through new construction.

Proposition 2½ Overrides

Many municipalities in the state have made numerous attempts to override the levy limits of Proposition 2½.

Nearly 3,600 separate overrides, roughly 160 per year and an average of \$235,000 per override, have been voted on since fiscal 1983. Voters passed 39% of those attempted. In only 8 of 22 years were more overrides adopted than rejected.

In fiscal 1991, the year of highest activity, out of the 594 overrides attempted, 426 failed – a success rate of 28%. From fiscal 1983 through 2004, overrides that were approved added \$348.1 million to levy limits, while those that failed kept \$494.1 out of the levy limit.

By region, the Berkshire region, with the fewest override attempts, had the most success in passing overrides with 54.8% receiving approval. Meanwhile, the Cape and Islands have attempted the most (817) and were successful 48.7% of the time. The least successful region has been the Southeast, attempting 392 overrides and passing 110, a success rate of 28.1%.

Table 2.4
Proposition 2 1/2 Override Attempts, Passage & Value of Passed Initiatives
 Fiscal 1983 to 2004
 Aggregate, current dollars

| <i>Region</i> | Attempts | Passed | Total Value |
|---------------|----------|--------|----------------|
| Statewide | 3,583 | 39.3% | \$ 348,099,211 |

| | | | |
|------------------|-----|-------|--------------|
| Berkshire | 199 | 54.8% | \$ 7,055,323 |
| Pioneer Valley | 787 | 35.7% | 39,406,671 |
| Central | 545 | 25.9% | 22,571,625 |
| Greater Boston | 428 | 51.2% | 159,929,807 |
| Boston | 0 | 0.0% | 0 |
| Northeast | 415 | 35.9% | 37,876,248 |
| Southeast | 392 | 28.1% | 29,545,167 |
| Cape and Islands | 817 | 48.7% | 51,714,370 |

Income

| | | | |
|-------------|-----|-------|---------------|
| Lowest 5th | 487 | 27.3% | \$ 32,241,655 |
| Second 5th | 703 | 27.3% | 21,432,650 |
| Boston | 0 | 0.0% | 0 |
| Third 5th | 766 | 37.9% | 34,414,526 |
| Fourth 5th | 947 | 42.7% | 97,827,739 |
| Highest 5th | 680 | 57.1% | 162,182,641 |

Population

| | | | |
|---------------|------|-------|---------------|
| 50-1,999 | 609 | 49.4% | \$ 12,647,751 |
| 2,000-4,999 | 860 | 45.8% | 36,240,538 |
| 5,000-9,999 | 1171 | 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 |
| Boston | 0 | 0.0% | 0 |

Looking at income, the highest income group, with the fourth most attempts (680), has been the most successful with a 57.1% approval rate. The lowest income group attempted the least number of overrides (487) and passed the least number as well (133), with a success rate of 27.3%.

By population, the smallest municipalities exhibited the highest success rate, with the rate of approval generally declining with the size of municipality. This trend may be due to the stronger connection citizens in smaller municipalities have with their local governments, and their ability to access local policymakers.

Debt Exclusions Trends

Debt exclusions – temporary property tax increases for the purpose of raising funds for debt service costs – have been a powerful tool for the improvement of municipal infrastructure. Through this mechanism debt service is added to the levy limit or levy ceiling for the life of the debt only.

Like overrides, debt exclusions must be approved by the voters. However, unlike overrides they do not become a permanent part of the base upon which the levy limit is calculated in future years.

As Chart 2.4 shows, the highest percent of exclusions have gone toward school-related projects. Part of this high percentage for schools is most likely explained by the state’s School Building Assistance program, which reimburses cities and towns for a substantial share of the annual cost of repaying local borrowing for school construction projects and the simple fact that schools are a large proportion of municipal spending.

Chart 2.4
Debt Exclusion Vote Attempts
Percent of Total by Use
Fiscal 1999

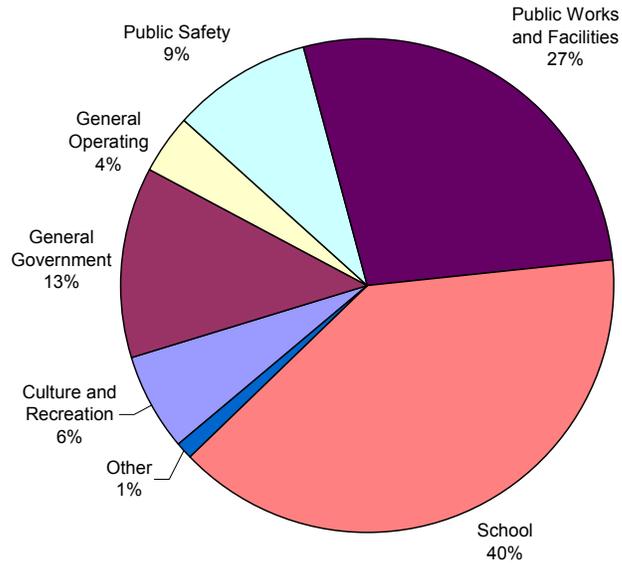


Table 2.5
Average Annual Percentage Growth in
Residential & Commercial Property
Value*

Fiscal 1983-2004
 Aggregate, current dollar

| <i>Region</i> | Residential | Commercial |
|---------------|-------------|------------|
| Statewide | 10.9% | 8.0% |

| | | |
|------------------|-------|-------|
| Berkshire | 8.5% | 6.5% |
| Pioneer Valley | 8.3% | 6.3% |
| Central | 11.9% | 10.0% |
| Boston Metro | 10.9% | 9.7% |
| Boston | 11.0% | 6.7% |
| Northeast | 10.5% | 6.9% |
| Southeast | 12.1% | 8.9% |
| Cape and Islands | 12.9% | 9.9% |

Income

| | | |
|-------------|-------|------|
| Lowest 5th | 12.9% | 9.3% |
| Second 5th | 11.0% | 7.4% |
| Boston | 11.0% | 6.7% |
| Third 5th | 11.2% | 8.7% |
| Fourth 5th | 11.4% | 9.9% |
| Highest 5th | 10.3% | 7.7% |

Population

| | | |
|---------------|-------|-------|
| 50-1,999 | 11.0% | 7.0% |
| 2,000-4,999 | 12.4% | 7.6% |
| 5,000-9,999 | 10.9% | 8.6% |
| 10,000-19,999 | 10.8% | 8.0% |
| 20,000-49,999 | 10.2% | 7.7% |
| 50,000+ | 13.2% | 12.0% |
| Boston | 11.0% | 6.7% |

residential real estate market.

Split Tax Rates

Municipalities vary in the ways they tax different classes of property. While most municipalities have a uniform property tax rate, with both residential and commercial properties taxed equally, approximately one-third of municipalities have adopted a split rate system. This “classification” system allows for higher taxation of commercial property than residential property. Under this system, municipalities may tax commercial property at a rate that is 175% of the rate without classification while taxing residential properties at a rate that is at least 50% of the rate without classification.

Trends in Property Classifications/Taxes

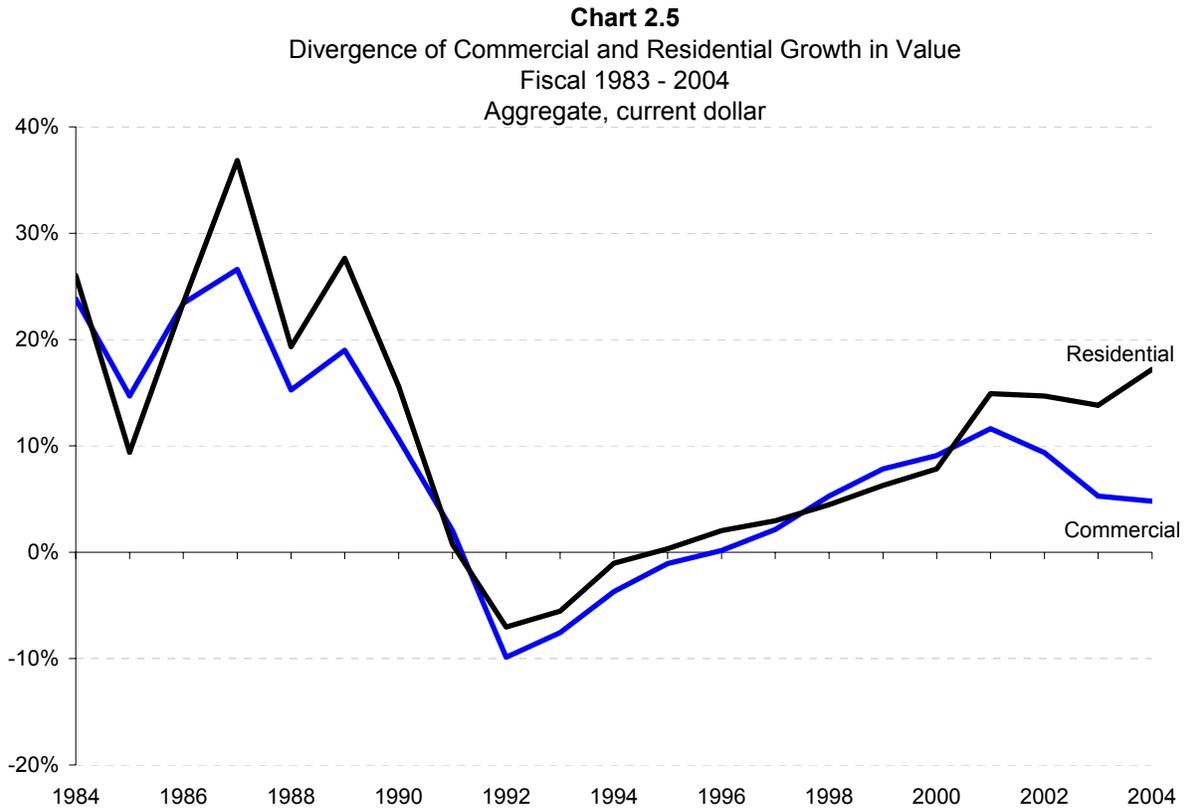
Commercial/Residential

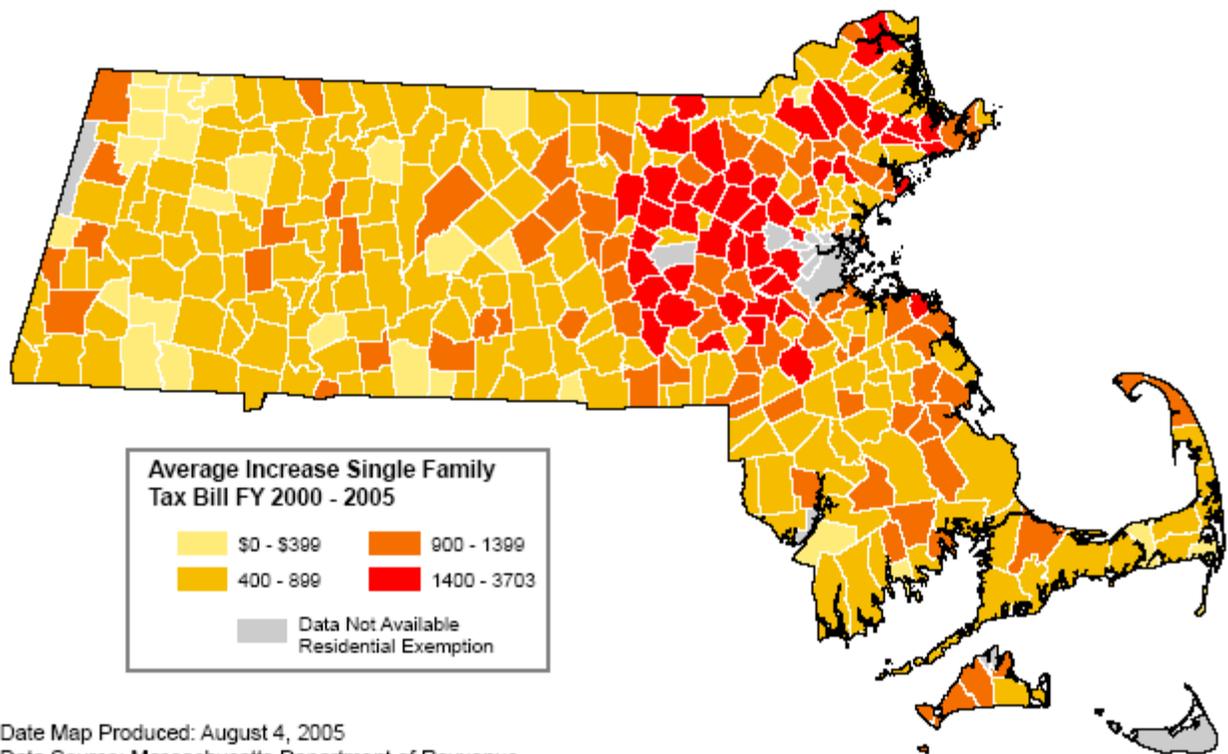
Growth in the total value of residential property has exceeded growth of commercial property over the 1983 - 2004 period in every region, income quintile and population group. As a general rule, the growth in commercial property tracks the growth in residential property. However, there have been periods where a substantial gap in the rate of growth has developed between the two classes of property, such as the late 1980s.

The largest gap of this type occurred recently – and remains largely unclosed at this time. In 2004, the gap in the rate of growth between the two sectors was 12.4%. The next highest growth gap of 10.2% occurred in 1987.

Under the constraints of Proposition 2½, a gap of this sort produces unusually large increases in the annual tax burden for the higher growth class. While the present situation has been unpleasant for residential taxpayers, the annual rates of growth of both residential and commercial properties are still substantially less than that of the late 1980s period when a speculative bubble had formed in the

Recent law has provided communities with the option to temporarily further increase the tax burden of commercial properties in order to lessen the burden of residential taxpayers during the gap in growth between the classes mentioned above. This temporary legislation increased the allowable commercial percentage of tax to 200% for fiscal year 2004, but imposes an annual step down to 170% by fiscal 2009.





Growth in Property Tax Bills

Since fiscal 2000 the average single-family tax bill of municipalities without a residential exemption⁹ has grown by 36% or \$910 before adjusting for inflation, from an average of \$2,679 in 2000 to \$3,589 in 2005. This above-normal rate of growth is most likely due to the combination of increased overrides to fund local services, and a shift of tax burden from commercial to residential property taxpayers because of the combination of decreasing commercial values and rapidly rising residential values in most areas across the state (see map).

Tax Exempt Property

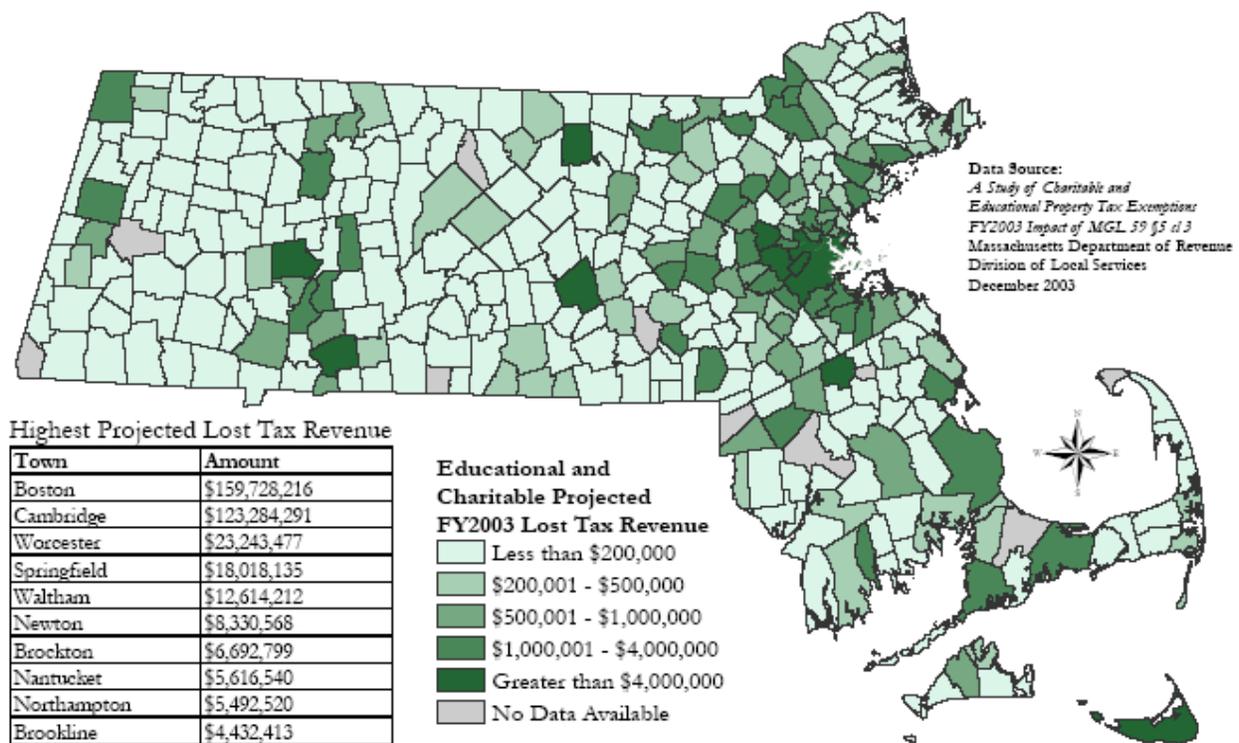
The Commonwealth grants property tax exemptions to a variety of property owners including charities, government bodies, and religious organizations. In some municipalities and regions these exemptions represent a substantial amount of unrealized property tax revenues. Fiscal year 2003 data from the Department of Revenue and a report by the Massachusetts Institute for a New Commonwealth (MassINC)¹⁰ were used to analyze the impact of property tax exemptions on

⁹ Excludes eleven communities (Boston, Brookline, Cambridge, Chelsea, Marlborough, Nantucket, Somerset, Somerville, Tisbury, Waltham and Watertown) with residential exemptions.

¹⁰ Werkema, Rachel, Dana Ansel, Greg Leiserson. 2005. *The Massachusetts Non-Profit Sector, An Economic Profile*. MassINC. Boston.

municipalities throughout Massachusetts (see map). It should be noted that the Department of Revenue data include only charitable and education tax exemptions, and not those exemptions granted to governmental organizations, which own substantial parcels of land in some areas.

The Massachusetts nonprofit sector has become an increasingly important part of the economy over the past 10 years. In 2004 approximately 24,500 nonprofits were based in the state, with human service, public benefit, education, and health care and humanities organizations comprising over 85% of the nonprofit sector. The Department of Revenue estimates that \$505.8 million in local tax revenue is being foregone by granting tax-exempt status, as of December 2003, to these non-profit institutions.



By region the total value of charitable and educational tax exempt property is highest in Boston with approximately 32% of the total property value being exempt. The Pioneer Valley and Berkshire regions experience the second highest percent of exempt property as a percentage of total property values at 14.5%, followed by the Metro Boston region at 10% and the Cape and Islands region at 9.5%.

In 2003, the total value of tax exempt property tended to be greater in less wealthy municipalities. Municipalities in the lowest income quintile exhibited the highest share of tax exempt property at

16.5%, while municipalities in the fourth and fifth income quintiles, had the lowest percentage at 8.9% and 9.9% respectively.

Local Receipts

Local receipts are the second major source of own source revenue available to municipalities. These are locally-generated funds from a number of sources including the motor vehicle excise tax, local option taxes, fines, licenses and permits, charges for services such as water, sewer and refuse collection, departmental revenues, and investment income.

Table 2.6
Average Annual Change in
Local Receipts - Selected Year
Groupings

| Constant dollar, per capita | | | |
|-----------------------------|---------------|---------------|---------------|
| <i>Region</i> | 1981- 1984 | 1984- 2004 | 1981- 2004 |
| Municipal Total | -1.8% | 2.9% | 2.3% |

| | | | |
|------------------|--------|-------|------|
| Berkshire | -6.4% | 4.7% | 3.2% |
| Pioneer Valley | -2.5% | 3.9% | 3.1% |
| Central | -11.1% | 3.7% | 1.8% |
| Boston Metro | -6.7% | 4.4% | 2.9% |
| Boston | 11.8% | -1.4% | 0.3% |
| Northeast | -0.5% | 1.8% | 1.5% |
| Southeast | -3.2% | 5.2% | 4.1% |
| Cape and Islands | 1.4% | 5.0% | 4.5% |

Income

| | | | |
|-------------|-------|-------|------|
| Lowest 5th | -7.5% | 4.1% | 2.6% |
| Second 5th | -2.6% | 3.4% | 2.6% |
| Boston | 11.8% | -1.4% | 0.3% |
| Third 5th | -8.1% | 4.1% | 2.5% |
| Fourth 5th | -1.6% | 3.1% | 2.5% |
| Highest 5th | -4.0% | 4.8% | 3.7% |

Population

| | | | |
|---------------|-------|-------|------|
| 50-1,999 | -1.4% | 3.2% | 2.6% |
| 2,000-4,999 | -3.0% | 4.5% | 3.6% |
| 5,000-9,999 | -2.7% | 4.7% | 3.8% |
| 10,000-19,999 | -3.7% | 5.0% | 3.9% |
| 20,000-49,999 | -4.0% | 4.0% | 3.0% |
| 50,000+ | -6.6% | 3.3% | 2.0% |
| Boston | 11.8% | -1.4% | 0.3% |

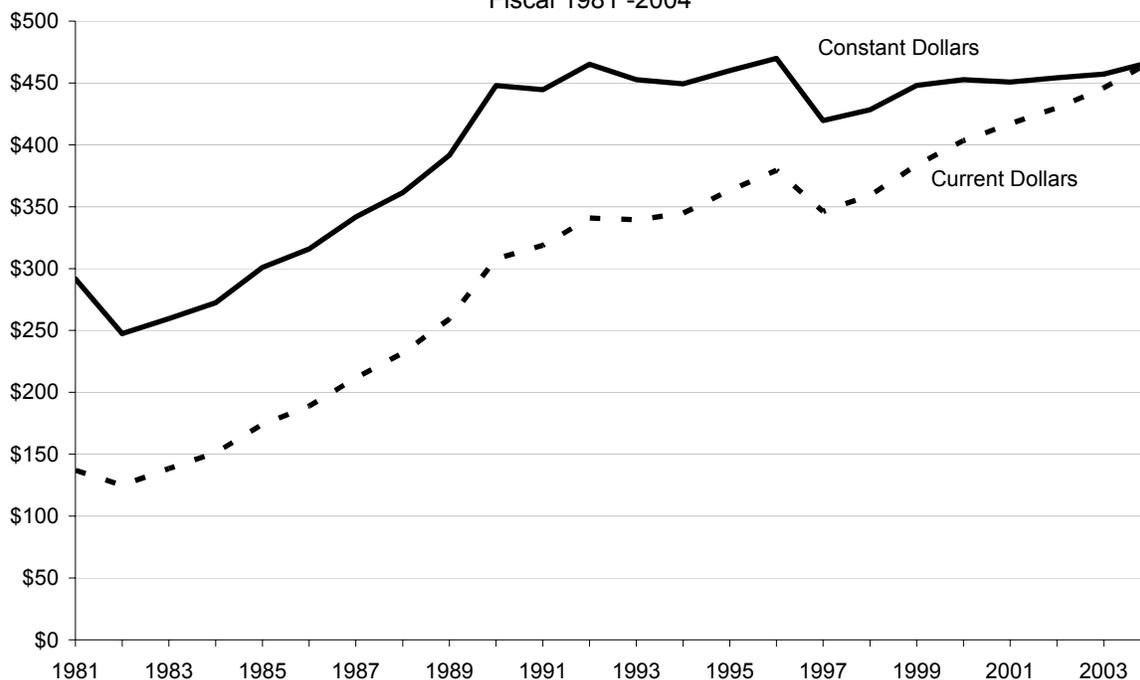
Starting in fiscal 1986, local receipts benefited from the addition of local option taxes on hotel rooms and jet fuel. Prior to 1986, annual local receipts per capita adjusted for inflation fell, due mostly to the reduction of the motor vehicle excise tax rate under Proposition 2 ½. Since then, the growth in local receipts has outpaced inflation across all regions, income and population groups.

Between fiscal 1981 and 2004, total local receipts rose from \$785.5 million to \$3 billion, an increase of \$2.22 billion (in current dollars). As a percent of local revenues, local receipts increased from 13.9% to 17.9%.

By region, the Cape and Islands saw the largest average growth in local receipts at 4.5% annually since 1981, with Boston seeing the slowest growth at 0.3% since 1981.

By income and population all groupings had positive growth in local receipts since 1981. The highest income communities had the highest annual average growth rate at 3.7%. In terms of population, the two groups of municipalities with populations ranging between 5,000 and 19,999 residents experienced the largest rates of growth at 3.8% and 3.9% respectively.

Chart 2.6
Per Capita Local Receipts
 2004 constant dollar
 Fiscal 1981 -2004



Motor vehicle excise

The motor vehicle excise tax (MVE) is a local tax in lieu of a personal property tax. The MVE was included under the limits imposed by Proposition 2 ½ which reduced the rate from \$66 per \$1,000 of value to \$25 per \$1,000 (essentially 2.5%) of the value of the automobile, truck, motorcycle or trailer. The total value of the vehicle is depreciated on a five-year sliding scale.

In fiscal 2004, the MVE generated over \$600 million for municipal budgets, with an average increase of 2.3% statewide since 1981. The excise can fluctuate substantially from year to year depending on the sale of new and used cars, the rate of inflation in prices, and the timing of manufacturer incentives and billing by municipalities.

The MVE tax suffers from a link with automobile insurance that affects which municipality collects the tax. Insurance rates for automobiles, trucks and trailers are determined by where the vehicle is “garaged”; similarly, the MVE tax must be paid to the municipality where a vehicle is “garaged”, not where the owner of the vehicle resides. A 1997 Inspector General’s report¹¹ noted evidence of substantial registration anomalies, including manipulation of the “garaging” provision, which serve to avoid higher insurance rates. As a by-product, these actions likely distort motor vehicle excise tax

¹¹ A Study of Improper Motor Vehicle Registrations, Massachusetts Office of the Inspector General, March 1997

collections between municipalities as well. In general, urban areas with higher insurance rates suffer MVE revenue losses while rural areas benefit from gains. Reworking the MVE to completely separate the excise location from the insurance location would serve to increase the fairness of this tax among municipalities.

Additional Sources of Revenue

Other Available Funds

An additional component of own-source revenue is, for lack of a more specific term, referred to as “other available funds”, which includes such items as free cash and stabilization fund money that municipalities may use in support of their annual budgets. These other available funds increased in current dollar terms from \$405.8 million in fiscal 1981 to \$853.9 million in fiscal 2004. As a percent of budgets, this component decreased from 7.2% to 5.0% of total revenues. However, in inflation-adjusted dollars, other available funds actually decreased during this period from \$864.7 million in fiscal 1981 to \$853.9 million in fiscal 2004. The annual average real change per capita was approximately -0.3%.

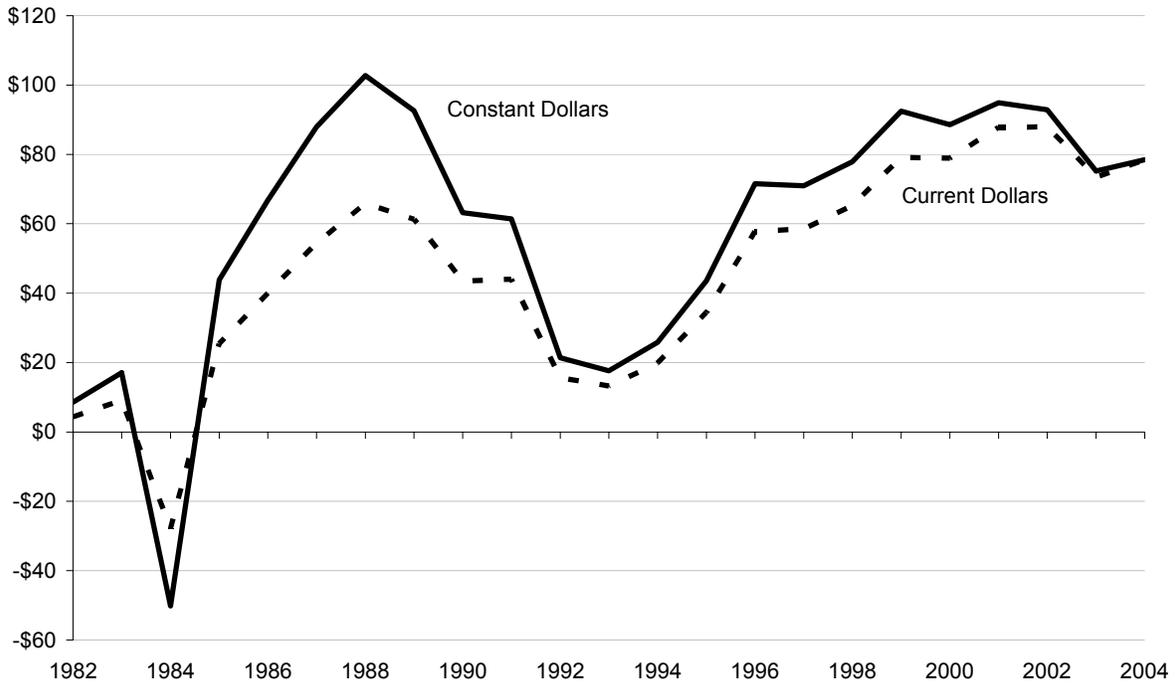
Free cash

A municipality’s free cash is the amount of funds that are unrestricted and available for appropriation (that is, available to be spent). Free cash is the result of revenue collections in excess of forecasted estimates, and previous year property tax collections and spending that was less than appropriations.

Free cash may be used to fund appropriations at annual and special town meetings. For most municipalities it is an annual source of revenue in budgets approved at town meeting. For others it provides flexibility as a major source of funding for supplemental appropriations after the establishment of the annual budget via the tax rate approval process.

Municipalities have their free cash certified after July 1 each year upon submission of a balance sheet ending June 30. Some municipalities may choose not to certify free cash annually. In addition, not all free cash is used in budgeting. In practice, municipalities appropriate a significant portion of their free cash annually. Free cash is also held for emergencies. As Chart 2.7 shows, free cash can decline sharply during certain periods. For example, in inflation-adjusted dollars, while averaging over \$46.85 per capita up to fiscal 1992, that figure dropped to \$17.63 in fiscal 1993. This period coincides with a national recession and precipitous declines in local aid from the Commonwealth.

Chart 2.7
Per Capita Total Net Free Cash
 2004 constant dollar
 Fiscal 1982 - 2004



Measured in inflation-adjusted dollars, certified net free cash (as free cash can be negative) peaked in fiscal 1988 at \$102.74 and is now at \$78.50 per capita in fiscal 2004, just above the annual average from fiscal 1994 to 2004 of \$73.86.

Stabilization fund

Prior to fiscal 2004, the stabilization fund was a source of funding for local capital items, or for any purpose for which a municipality is authorized to borrow. After fiscal 2004, stabilization funds could be used for any lawful purpose. A municipality can appropriate up to 10 percent of its tax levy each year for deposit in its stabilization fund, as long as the balance in the fund does not exceed 10 percent of the municipality's equalized property valuation.

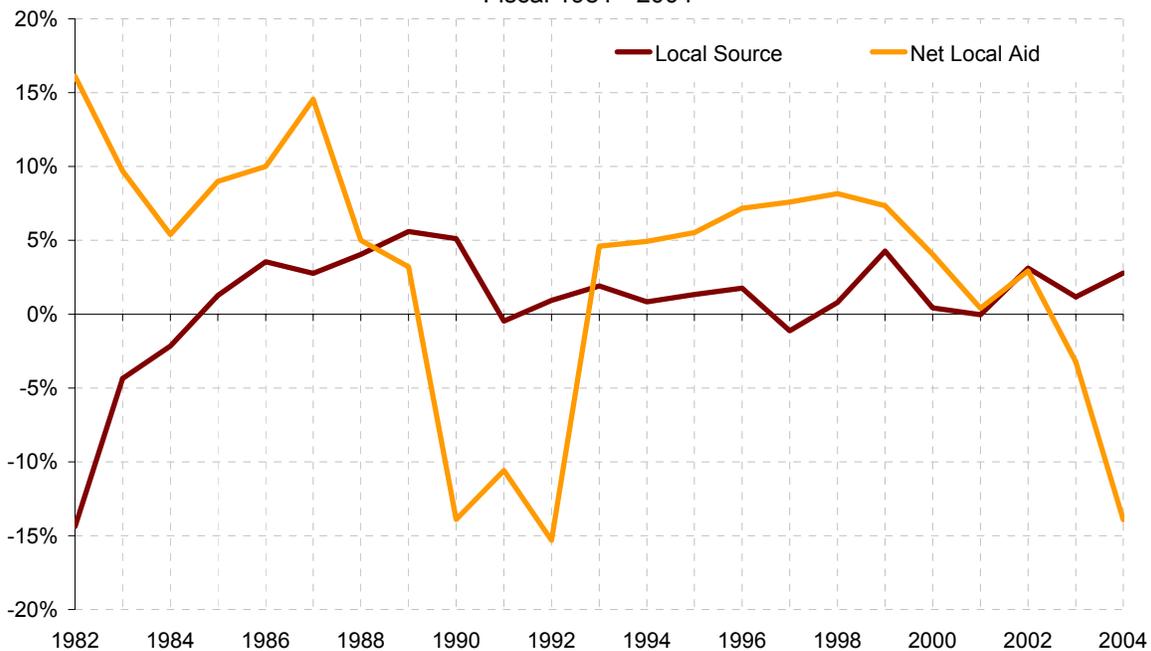


Local Aid:

The second major revenue component of municipal budgets is local aid, that is, state revenues distributed to local governments through a wide array of programs. The importance of local aid as a revenue source cannot be understated in a climate of otherwise restricted local revenue growth.

Following the adoption of Proposition 2½, the state-local relationship played an increasingly important role. As the local-source discussion noted, 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 services and local revenues, a state and local agreement was established that led to increasing amounts of state aid allocations for cities and towns.

Chart 2.8
Locally Generated Revenue vs. Net Local Aid
Annual Percent Change
Constant dollar, per capita
Fiscal 1981 - 2004



As the following analysis shows, that state-local fiscal relationship has since proven to be inconsistent, unpredictable, and restricted, a conclusion that is dramatically illustrated by Chart 2.8. Today, the only general-purpose aid available to many municipalities comes in the form of Lottery distributions, as the other major general purpose aid program, Additional Assistance, has been

phased out for many municipalities. Moreover, Additional Assistance has not seen funding increases since fiscal 1988, leaving many policymakers to question what role it should play in the future. This section looks at Additional Assistance in considerable detail, as well as the other two major local aid programs for cities and towns, Chapter 70 school aid and Lottery aid.

The following case study on Somerville, Massachusetts highlights the importance of local aid to cities and towns and the disruption that sharp and unpredictable cuts have on municipal services, particularly for those municipalities that rely on substantial state assistance to fund local programs and where Proposition 2½ overrides are not feasible.

What is Local Aid?

State aid to local government comes in a variety of forms, both direct and indirect, and there has never been agreement about what constitutes the appropriate reference point. However, in the context of local budgets, the most appropriate local aid figure to use is that reported annually on the “Cherry Sheet,” so-called for the color of the paper on which aid figures were originally printed. The state Department of Revenue annually distributes aid through the Cherry Sheet to municipalities. Cherry Sheet aid represents the vast majority of aid to cities and towns and must be reported as their local aid figure in the municipal budget process.¹²

The Cherry Sheet is comprised of dollar figures that a municipality receives either as a “distribution” or a “reimbursement.” Distributions are state funds given to each city and town according to various formulas and funding mechanisms. The largest distributions by far are Chapter 70 school aid, Additional Assistance and Lottery, which are referred to as “Section Three” aid in the budgets of both the Executive and Legislative branches. These three accounts should be primary focus of all discussions about local aid, as the remaining reimbursement programs are options that a municipality may adopt or that are given to some municipalities only for the purpose of providing for certain activities or services that the state supports.

Further, Cherry Sheet aid should be reduced by the dollar value of municipal charges. Municipal charges, usually referred to as “state assessments” are charges billed to cities and towns for services that the state or its authorities provide and deem municipalities should share in the cost. These charges are deducted from the state’s quarterly local aid payments and therefore reduce the amount of state aid available to municipalities. It should be noted that starting in fiscal 2004, state rules changed the accounting of Charter School Tuition making it a municipal charge.¹³ Depending on how each municipality accounted for Charter Schools prior to this change, an increase or decrease in

¹² The City of Boston receives a reimbursement on its Cherry Sheet for the annual cost of paying the pensions of teachers, a cost that the commonwealth has directly assumed for all other cities and towns whose Cherry Sheets therefore do not show a reimbursement.

¹³ Treatment of Charter School tuition charges varied across municipalities prior to 2004. In some cases it was treated as negative revenue, in others as a school department expense.

the apparent amount of local aid revenue could occur. This is another reason to view local aid as net of municipal charges.¹⁴

Somerville, Massachusetts

Basic Facts

Region: Boston Metro

Population: 76,296, 2004 Census estimate

Per Capita Income: \$23,628, 2000 Census

Type of Government: Mayor-City Council

Meeting the needs of a culturally, economically, and socially diverse municipality has been increasingly difficult for the City of Somerville. The city endured state aid cuts of over \$11 million (17.8%) in FY02-FY05, including a \$4.1 million reduction in Additional Assistance, reducing state aid from 42.5% to 36.3% of total City revenue. Combined with spiraling fixed costs, including paying between 90%-99% of the costs of some employee health care plans, these pressures have significantly hindered the City's ability to provide services to its residents.

In order to confront these costs and maintain a balanced budget, municipal leaders have taken a number of steps to raise revenue, reduce expenses and seek efficiencies.

- Used all available excess capacity – raising the property tax levy to the maximum allowable under Proposition 2 ½.
- Laid off a 65 municipal and school employees, and eliminated 85 vacant positions. Reductions in key departments including Police (16), Fire (13), and DPW (34).
- Adopted two early retirement incentive programs, including the state-legislated Early Retirement Incentive program, resulting in 126 employees opting to retire early.
- Deferred contract negotiations with the City's largest union, the Somerville Municipal Employees Union (SMEA). Additionally, no cost-of-living raises were granted for either SMEA or non-union employees in FY03 and FY04.
- Raised virtually all fees, fines, and permit rates, and aggressively pursued outstanding taxes.
- With the exception of state-reimbursed school construction and certain infrastructure projects, the City's capital improvement plan went unfunded in FY03-FY05 operating budgets.
- Eliminated the Human Services Department and merged the Youth Program with the Recreation Department.
- Used reserves and relied on non-recurring revenue sources, including the sale of two City buildings.
- Established a water and sewer enterprise fund in FY03 in order to shift the water/sewer system costs from the property tax to ratepayers.

¹⁴ Net local aid receipts are defined as Cherry Sheet aid net of Boston teacher's pensions and net of municipal charges.

Table 2.7
Annual Change in Total Massachusetts Expenditures* vs.
Expenditures on Net Local Aid
 Constant dollars, per capita

| Context | Fiscal Year | Total Expend. | Net Local Aid |
|-------------------------------------|-------------|---------------|---------------|
| Implementation of Proposition 2 1/2 | 1982 | -3.1% | 16.1% |
| | 1983 | -1.6% | 9.7% |
| | 1984 | 3.8% | 5.4% |
| Needs-Based Aid Formula in Use | 1985 | 7.2% | 9.0% |
| | 1986 | 10.5% | 10.0% |
| | 1987 | 6.3% | 14.5% |
| | 1988 | 1.9% | 5.0% |
| | 1989 | 5.6% | 3.2% |
| Recession/State Fiscal Crisis | 1990 | 3.4% | -13.9% |
| | 1991 | -0.9% | -10.6% |
| | 1992 | -3.4% | -15.3% |
| Education Reform | 1993 | 10.1% | 4.6% |
| | 1994 | 2.6% | 4.9% |
| | 1995 | 0.7% | 5.5% |
| | 1996 | 0.0% | 7.2% |
| | 1997 | 3.0% | 7.6% |
| | 1998 | 3.0% | 8.2% |
| | 1999 | 3.1% | 7.3% |
| | 2000 | 2.8% | 4.1% |
| | 2001 | -2.8% | 0.4% |
| | 2002 | -4.1% | 2.9% |
| Recession/State Fiscal Crisis | 2003 | -4.1% | -3.2% |
| | 2004 | 1.4% | -13.9% |

*Based on Massachusetts Taxpayers Foundation calculation of total budgeted state expenditures net of local aid expenditures

Trends in Direct Local Aid Expenditures from State Government

Before looking at the trends in local aid by region, income and population group, it will be helpful to get an overall picture of local aid looking at the Commonwealth as a whole.

From fiscal 1981 to 2004, the Commonwealth’s expenditures on net local aid 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% per year and the state expenditures increase, 2.0% per year.

State expenditures on net local aid, expressed as a percentage of total state spending (including local aid), have ranged from a high of 20.0% in fiscal 1988 to low of 13.4% fiscal 1993. In fiscal 2004, the Commonwealth

allocated 16.4% of its budget to net local aid.

Overall, the Commonwealth’s local aid expenditures have fluctuated substantially from year to year and have barely exceeded the rate of inflation in certain periods. In fiscal 2004, inflation-adjusted net local aid dollars were less than in fiscal 1989.

As Table 2.7 indicates, the annual growth in the Commonwealth’s net local aid expenditures generally follows the growth in the Commonwealth’s 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’s budget. For the Commonwealth (as well as for municipalities), increases in mandatory costs force reductions in discretionary programs – with local aid one of the largest such programs in the state budget.

Trends in Net Local Aid Received by Local Governments

In fiscal 1981, at the outset of Proposition 2½, net local aid receipts accounted for about 15.3% of total municipal revenues. This percentage peaked in fiscal 1988 at 28.4% and has since fallen to 22.0% in fiscal 2004.

Table 2.8
Average Annual Change in Net Local Aid, Selected Year Groupings

Constant dollar, per capita

| | 1981-1984 | 1984-1989 | 1989-1992 | 1992-2002 | 2002-2004 | 1981-2004 |
|------------------------|-----------|-----------|-----------|-----------|-----------|-----------|
| Municipal Total | 10.4% | 8.4% | -13.3% | 5.3% | -8.6% | 3.0% |
| <i>Region</i> | | | | | | |
| Berkshire | 12.7% | 9.8% | -12.1% | 4.5% | -7.9% | 3.5% |
| Pioneer Valley | 7.5% | 9.7% | -10.7% | 6.0% | -7.0% | 3.7% |
| Central | 6.5% | 7.3% | -12.6% | 5.8% | -6.4% | 2.8% |
| Boston Metro | 16.9% | 9.7% | -15.5% | 5.5% | -10.2% | 3.8% |
| Boston | 15.5% | 6.4% | -12.4% | 1.5% | -14.0% | 1.2% |
| Northeast | 6.3% | 8.3% | -13.3% | 7.1% | -8.6% | 3.2% |
| Southeast | 6.6% | 8.1% | -12.2% | 5.6% | -6.1% | 3.0% |
| Cape and Islands | 4.4% | 9.5% | -22.9% | 9.3% | -14.6% | 2.4% |
| <i>Income</i> | | | | | | |
| Lowest 5th | 7.8% | 9.3% | -10.9% | 6.7% | -6.2% | 4.0% |
| Second 5th | 9.1% | 8.9% | -13.5% | 5.0% | -8.1% | 2.8% |
| Boston | 15.5% | 6.4% | -12.4% | 1.5% | -14.0% | 1.2% |
| Third 5th | 11.4% | 8.5% | -15.1% | 4.9% | -11.0% | 2.6% |
| Fourth 5th | 10.5% | 8.0% | -15.3% | 4.6% | -9.1% | 2.3% |
| Highest 5th | 14.5% | 8.4% | -20.0% | 7.9% | -11.0% | 3.6% |
| <i>Population</i> | | | | | | |
| 50-1,999 | 5.3% | 6.0% | -8.0% | 4.4% | -12.7% | 1.7% |
| 2,000-4,999 | 6.6% | 9.1% | -15.9% | 4.5% | -12.4% | 1.7% |
| 5,000-9,999 | 7.6% | 8.9% | -14.9% | 5.2% | -7.5% | 2.6% |
| 10,000-19,999 | 6.0% | 6.8% | -13.7% | 5.3% | -8.2% | 2.1% |
| 20,000-49,999 | 11.7% | 8.9% | -14.5% | 6.3% | -8.4% | 3.6% |
| 50,000+ | 10.1% | 9.7% | -12.2% | 6.1% | -7.2% | 3.9% |
| Boston | 15.5% | 6.4% | -12.4% | 1.5% | -14.0% | 1.2% |

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%.

The following analysis of net local aid is broken down into five short time spans in Table 2.8. The three growth periods between 1981 - 1984, 1984 - 1989 and 1992 - 2002, as well as the two periods of economic downturns between 1989 - 1992 and 2002 - 2004 are examined.

As the data indicates, growth in net local aid was greatest in the period following Proposition 2½, at 10.4% annually, and lowest during the steep economic decline in the early 1990s, falling - 13.3% annually.

During the early 1980s, the rate of growth in net local aid receipts showed a clear pattern with annual increases of over 8.0% for municipalities across all income groups.

In contrast, during the deep aid cuts of the early 1990s, declines in net local aid tended to affect municipalities with lower incomes less severely than those with higher incomes, with reductions of -

10.9% and -20.0%, respectively. While the percentage cuts at the lower income levels were smaller the impact was most likely no less harsh since a greater percent of revenues in those municipalities consists of state aid.

After the recession, growth in net local aid was lower during the period of economic expansion in the mid and late 1990s than it had been in the 1980s. The ensuing reductions in the early 2000s were less severe than the earlier 1990s downturn. While growth was fairly uneven among region and population groups, 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 contained in net local aid in addition to the three major sources local aid.

Table 2.9
Cumulative Change in Net Local Aid, Selected Year Groupings
 Constant dollar, per capita

| | 1989- 1992 | 2002- 2004 |
|-------------------|---------------|---------------|
| Municipal Total | -34.8% | -16.7% |
| <i>Region</i> | | |
| Berkshire | -32.2% | -15.4% |
| Pioneer Valley | -28.8% | -13.7% |
| Central | -33.2% | -12.6% |
| Boston Metro | -39.8% | -19.8% |
| Boston | -33.2% | -26.8% |
| Northeast | -34.9% | -16.7% |
| Southeast | -32.4% | -11.9% |
| Cape and Islands | -54.3% | -27.8% |
| <i>Income</i> | | |
| Lowest 5th | -29.3% | -12.2% |
| Second 5th | -35.3% | -15.8% |
| Boston | -33.2% | -26.8% |
| Third 5th | -39.0% | -21.3% |
| Fourth 5th | -39.4% | -17.9% |
| Highest 5th | -49.2% | -21.3% |
| <i>Population</i> | | |
| 50-1,999 | -27.5% | -24.0% |
| 2,000-4,999 | -41.8% | -23.7% |
| 5,000-9,999 | -38.6% | -14.6% |
| 10,000-19,999 | -35.9% | -16.0% |
| 20,000-49,999 | -37.5% | -16.4% |
| 50,000+ | -32.3% | -14.2% |
| Boston | -33.2% | -26.8% |

The ensuing reductions in the early 2000s were less severe than in the 1990s downturn. However, these higher income municipalities, much as in the recession of the early 1990s, saw the largest decline in local aid receipts during the early 2000s.

Reductions in Net Local Aid

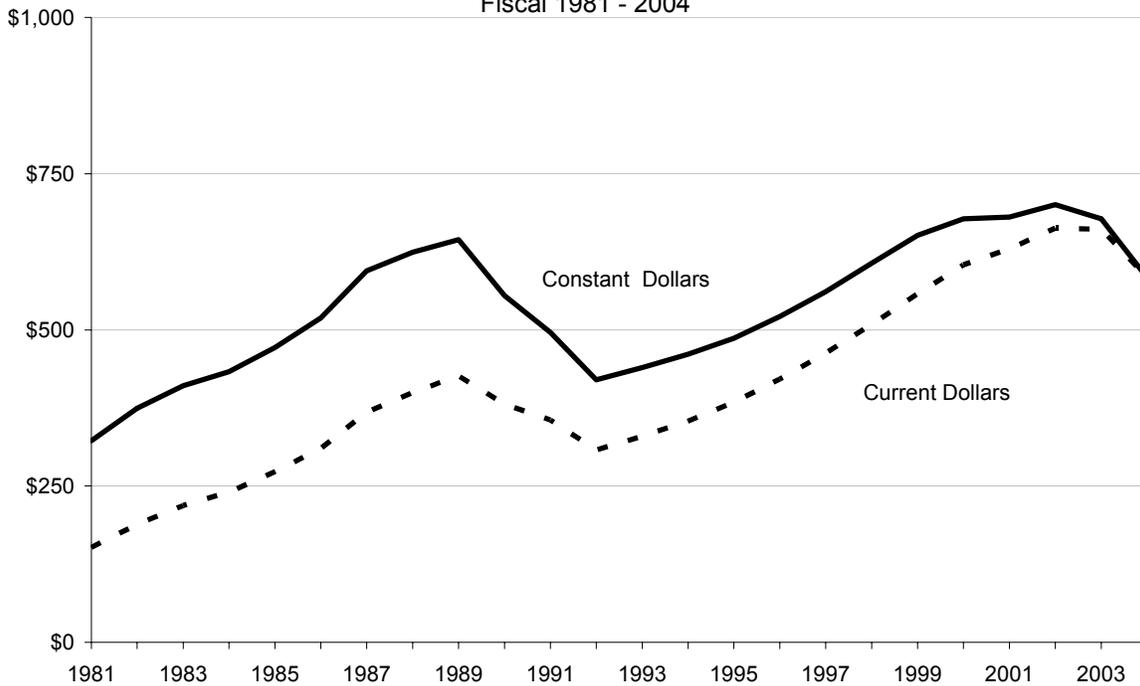
Recessionary periods tend to have lasting impacts for municipalities, especially in regard to local aid.

Over the period of 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 national recessions and ensuing state fiscal difficulties.

As Table 2.9 shows, there were isolated differences from the overall average reduction in net local aid during fiscal 1989 - 1992. In fiscal 2002 - 2004 there were bigger differences between groups. Here we discuss cumulative reductions, differing from the data in the preceding net local aid discussion, which looked at average annual changes.

The data indicate that reductions in net local aid were far deeper in the three years from 1989 - 1992 at -34.8%, than the two years of the most recent fiscal downturn at

Chart 2.9
Per Capita Net Local Aid
 2004 constant dollar
 Fiscal 1981 - 2004



-16.7%. While there is no clear pattern by region, it is evident that the Cape and Islands saw the largest decline in both periods at -54.3%, and -27.8%, respectively. In the recent period, Boston also endured a much larger than average cumulative reduction.

By income, the aid reductions during both periods affected the highest income groups the most; they lost -49.2% in the earlier period and -21.3% in the later period. While also experiencing deep cuts, the lowest income municipalities saw the smallest reductions at -29.3% and -12.2% in the two periods.

Smaller municipalities saw the largest decline in net local aid during the most recent economic downturn; this is in contrast to the recession of the early 1990s, when these municipalities saw the lowest reduction. Overall, in the most recent period examined, the larger municipalities saw the least decline in net state aid (except Boston), a pattern that may be due to the mechanism used for education funding, the largest major state aid program.

“Section Three” Local Aid

The major sources of state assistance to municipalities are commonly referred to as Section Three local aid, which consist of Chapter 70 school aid, Additional Assistance, and State Lottery distributions.

Table 2.10
Annual Average Change in
Section Three Local Aid, Selected
Year Groupings

| Constant dollar, per capita | 1981- | 1993- | 1981- |
|-----------------------------|-------|-------|-------|
| | 1993 | 2004 | 2004 |
| Municipal Total | 1.5% | 4.6% | 3.0% |

| <i>Region</i> | | | |
|------------------|-------|-------|------|
| Berkshire | 3.9% | 4.0% | 4.0% |
| Pioneer Valley | 1.6% | 7.1% | 4.2% |
| Central | 0.4% | 6.0% | 3.1% |
| Boston Metro | 1.7% | 3.2% | 2.4% |
| Boston | 3.1% | 0.8% | 2.0% |
| Northeast | 0.5% | 6.6% | 3.4% |
| Southeast | 1.6% | 5.7% | 3.6% |
| Cape and Islands | -3.5% | 15.8% | 5.7% |

| <i>Income</i> | | | |
|---------------|-------|------|------|
| Lowest 5th | 1.9% | 7.0% | 4.4% |
| Second 5th | 1.5% | 4.1% | 2.8% |
| Boston | 3.1% | 0.8% | 2.0% |
| Third 5th | 1.5% | 3.3% | 2.4% |
| Fourth 5th | 0.6% | 3.4% | 2.0% |
| Highest 5th | -0.9% | 4.7% | 1.8% |

| <i>Population</i> | | | |
|-------------------|-------|------|------|
| 50-1,999 | 2.2% | 7.3% | 4.6% |
| 2,000-4,999 | -0.5% | 4.7% | 2.0% |
| 5,000-9,999 | 0.3% | 4.8% | 2.4% |
| 10,000-19,999 | 0.0% | 4.8% | 2.3% |
| 20,000-49,999 | 1.4% | 5.3% | 3.3% |
| 50,000+ | 2.0% | 5.7% | 3.8% |
| Boston | 3.1% | 0.8% | 2.0% |

Not only have these major sources of aid experienced wide growth swings over the past several years, but they have also changed in value relative to each other. As Chart 2.10 shows more specifically, the relationship between Chapter 70 and Additional Assistance experienced drastic transformation following the implementation of the Education Reform Act in 1994. Note that these data on Section Three aid (and Chapter 70 in the following section) do not include Chapter 70 aid that goes to regional school districts. Only Chapter 70 aid sent directly to cities or towns is included.

Prior to 1994, the split between the two accounts was 60%/40% in favor of Chapter 70 while following 1994 the split shifted dramatically in favor of Chapter 70 to 80%/20%, signaling a significant rise in dedicated school funding, and the loss of Additional Assistance to some municipalities altogether.

The following overview of Section Three aid is separated into two time periods, to show the changes in these accounts before and after the passage of education reform.

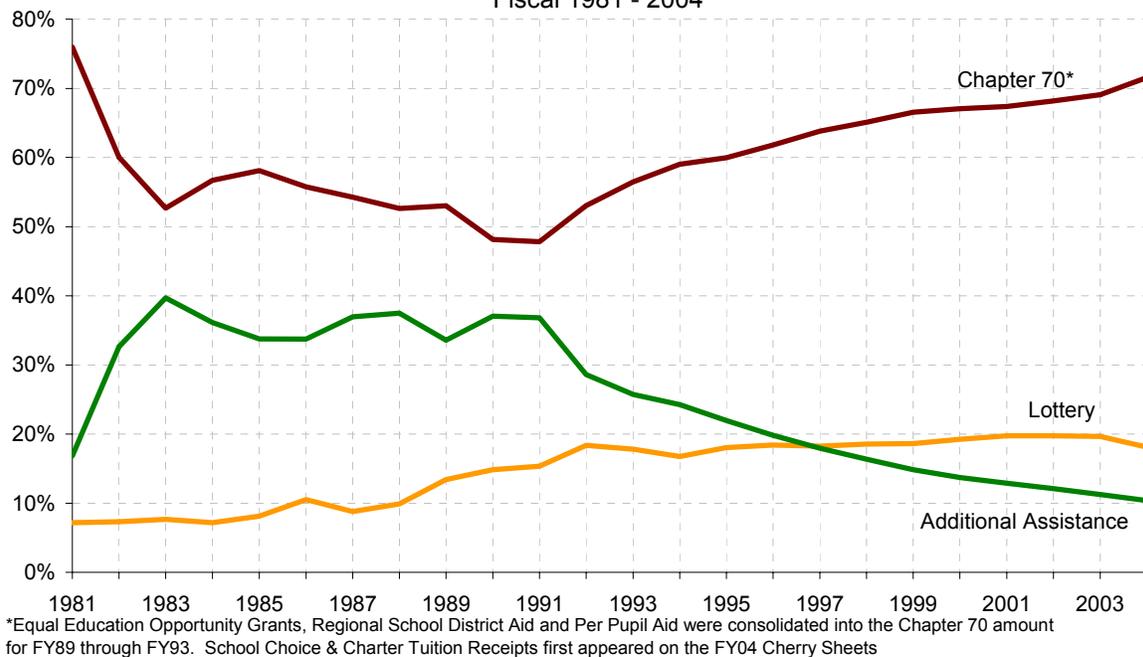
The statewide total change in Section Three aid shows significant differences during the two periods, with

annual growth more than three times as rapid in the time span following education reform. This reflects the strong increases in Chapter 70 during the mid and late 1990s, following a period of relative flat growth during much of the 1980s, and a deep economic downturn in the early 1990s.

By region, changes in Section Three aid were fairly sporadic. However, the Cape and Islands experienced the largest annual change in Section Three aid during 1993 - 2004 period at 15.8%

annually. This is in contrast to the previous period in which the Cape and Islands saw a –3.5% decline, mostly due to sharp cumulative aid reductions of 57% in the early 1990s. From 1993 to 2004, the period in which education reform was implemented, the lowest income municipalities saw the highest rate of growth in Section Three aid at 7.0% annually. Changes in Chapter 70 as a result of Education Reform channeled more dollars to poorer districts less able to raise revenue locally. Growth among most other income groups was lower, with higher income municipalities experiencing the second highest growth rate at 4.7% annually.

Chart 2.10
Major Sources of Local Aid
 Percentage of Total Net Local Aid
 Constant dollar, aggregate
 Fiscal 1981 - 2004



Growth among population groups was fairly uneven during both periods, with small and medium sized municipalities (population 2,000-20,000) seeing the smallest increases in both periods.

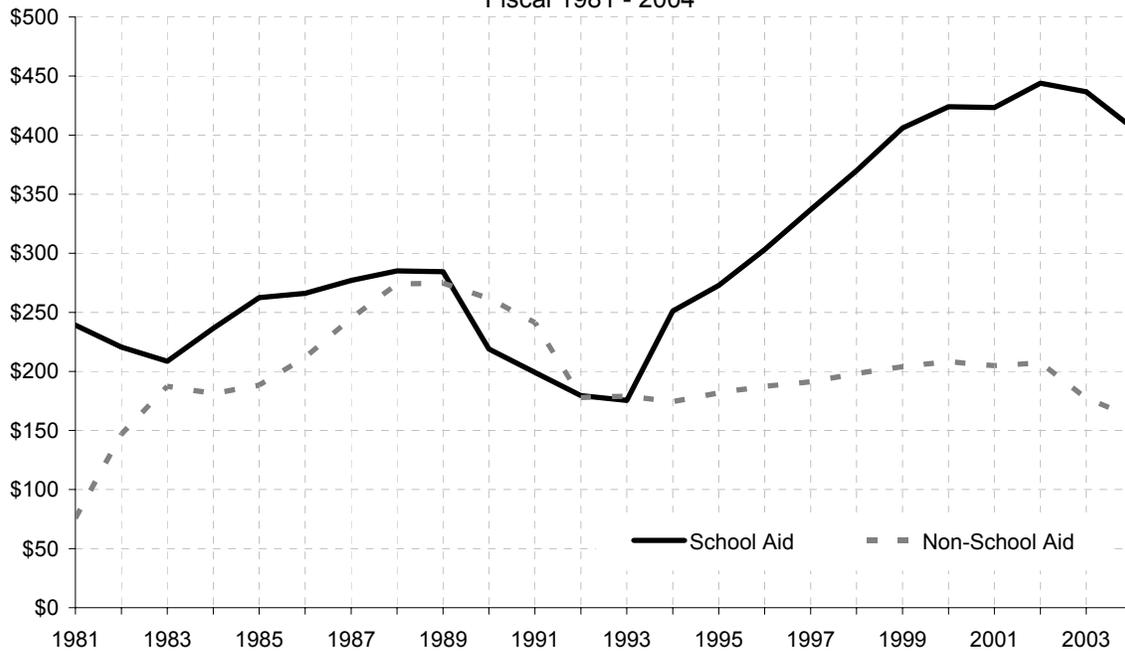
A Vital Distinction - School versus Non-School Local Aid

In the 1980s Chapter 70 was considered “unrestricted aid”, meaning it could be used for schools or any other purpose. It was not until the Education Reform Act of 1993 that the distinction between school and non-school aid took on importance as Chapter 70 funds became earmarked solely for school spending.

It is likely that this change would not have emerged as an issue if municipalities had the option of adjusting their local education spending as the state took on a larger share of school funding. However, the Education Reform Act required a minimum local contribution to education that began as roughly equal to the amount most municipalities were already spending on schools. Earmarked education aid in combination with the required minimum local contribution from local revenue sources meant that communities had little discretion in school spending and could no longer divide their total revenue “pie” as local residents or officials might choose.

As Charts 2.10 and 2.11 indicate, the vast majority of direct aid increases since the early 1990s have

Chart 2.11
Per Capita School versus Non-School Local Aid
 Chapter 70 (non-regional) versus Lottery and Additional Assistance
 2004 constant dollar
 Fiscal 1981 - 2004



gone to Chapter 70 aid, with sharp declines in another Section Three account, Additional Assistance. This trend – toward dedicated school aid and away from general-purpose aid – has been a major contributor in limiting the discretion of local policymakers to properly fund general government services.

Additional Assistance

Additional Assistance, once an important and comprehensive component of local aid, has lost both its meaning and purpose over the past several decades. Originally designed as an equalizing formula used to offset fiscal disparities across municipalities, the program was later reduced to the lowest funded and least understood of the three main local aid accounts.

The most recent fiscal crisis has once again drawn increased attention to this source of local aid, and it has renewed calls to revisit the goals of the program and the formula previously used to allocate Additional Assistance dollars.

Above all, the history of Additional Assistance highlights the need to reconstruct a state-local partnership, with well-defined policy goals, that identifies and addresses the needs of diverse municipalities.

The following discussion looks back at the emergence of Additional Assistance in the early 1980s, its loss of funding in the late 1980s, and the years of inattention that have followed.

Looking Back at Additional Assistance - Purpose and Goals

Municipalities are unique. They are defined by their demographic, environmental and economic characteristics. While some municipalities are almost exclusively residential, others are regional job centers. Some are densely populated; others take pride in their vast amounts of open space. Some have high poverty levels; others have barely any poverty at all.

These characteristics affect the cost of providing municipal services: For example, municipalities with such features as dense housing, many commuters, poverty, and many challenged students will have to spend more per person than other municipalities to provide any specific level of services.¹⁵

In the early 1980s, the Additional Assistance program was implemented to recognize such differences between municipalities and the need to address the unavoidable additional costs municipalities face due to those differences.

¹⁵ Bradbury, Katherine, Helen Ladd, Mark Perrault, Andrew Reschovsky, John Yinger, "State Aid to Offset Fiscal Disparities Across Municipalities," *National Tax Journal* (37:2) June 1984

Using the variables listed in Table 2.11, the Commonwealth established an equalization formula to assist municipalities that were subject to fiscal difficulties due to high local costs relative to their local resources.

Table 2.11

| Original Formula Components of the Needs Based Formula | |
|---|---------------------------------------|
| Cost Factors: | Local Revenue Raising Factors: |
| Special Needs Students | Property Tax Capacity |
| Population Density | Motor Vehicle Excise |
| Manufacturing Employment | Cherry Sheet Aid |
| Service & Trade Employment | Local Reserve |
| Pre-1940 Housing | Hotel/Motel Taxing Capacity |
| Road Miles | |
| Poverty | |
| Extent of Local Services | |

Part of the reasoning behind such a formula was that if a municipality could not generate adequate local revenues to meet increasing costs, a situation would develop in which the taxpayers of that municipality would bear an inequitable burden for those uncontrollable expenses, and the municipality would face extremely tight budgets on a regular basis.

This is especially true in an environment of restrictive revenue raising capacity. Adjusting for disparities across municipalities – by compensating for the gap between local revenue raising capacity and the actual uncontrollable cost of producing local services – was essentially the purpose of Additional Assistance following the property tax restrictions of Proposition 2½.

Additional Assistance - Funding History

From the 1980s and until the implementation of education reform in 1993, al Section Three accounts –Lottery aid, Additional Assistance and Chapter 70 aid –were sources of general-purpose funding to municipalities.

In the early years, a community’s allocation of Additional Assistance and Chapter 70 aid were explicitly tied together in a “needs-based” formula. The process of determining the level of funding for each type of aid is useful to describe, as it explains the significant decline in the number of municipalities receiving Additional Assistance over the past sixteen years.

In the mid- to late 1980s, Chapter 70 and Additional Assistance aid were calculated in the following steps:

- The Commonwealth would appropriate a statewide dollar amount to non-Lottery Section Three local aid.
- The total was allocated through the needs-based formula generating the amount of new aid for each municipality based on the gap between service costs (including those related to public schools) and the municipality's ability to raise revenue.
- The pre-education reform Chapter 70 formula was then run to determine how much of this new aid was allocated (labeled) as Chapter 70 aid
 - The remainder (if any) was distributed (labeled) as Additional Assistance; that is, the remaining funds were allocated among municipalities in proportion to the cost revenue gap *net* of Chapter 70 aid.

Table 2.12
Annual Average Change in
Additional Assistance, Selected
Year Groupings

Constant dollar, per capita
 1981- 1988- 1981-
 1988 2004 2004

| | | | |
|-----------------|-------|-------|------|
| Municipal Total | 27.4% | -7.4% | 3.2% |
|-----------------|-------|-------|------|

Region

| | | | |
|------------------|-------|--------|-------|
| Berkshire | 19.8% | -10.3% | -1.2% |
| Pioneer Valley | 18.1% | -11.5% | -2.5% |
| Central | 18.2% | -9.8% | -1.3% |
| Boston Metro | 32.3% | -6.8% | 5.1% |
| Boston | 37.4% | -5.5% | 7.5% |
| Northeast | 24.9% | -8.1% | 2.0% |
| Southeast | 18.8% | -10.2% | -1.4% |
| Cape and Islands | 37.4% | -12.8% | 2.4% |

Income

| | | | |
|-------------|-------|-------|------|
| Lowest 5th | 20.5% | -8.9% | 0.0% |
| Second 5th | 23.7% | -8.0% | 1.6% |
| Boston | 37.4% | -5.5% | 7.5% |
| Third 5th | 29.2% | -7.4% | 3.7% |
| Fourth 5th | 30.1% | -7.3% | 4.1% |
| Highest 5th | 29.4% | -8.4% | 3.1% |

Population

| | | | |
|---------------|-------|--------|-------|
| 50-1,999 | 21.3% | -12.1% | -2.0% |
| 2,000-4,999 | 17.5% | -10.6% | -2.0% |
| 5,000-9,999 | 15.5% | -11.4% | -3.2% |
| 10,000-19,999 | 19.7% | -9.5% | -0.6% |
| 20,000-49,999 | 27.9% | -7.9% | 3.0% |
| 50,000+ | 25.8% | -7.6% | 2.6% |
| Boston | 37.4% | -5.5% | 7.5% |

In this framework, there were always some municipalities for which Chapter 70 aid filled the entire gap measured by the needs-based formula: This could occur whether or not these municipalities had other non-school equity issues that needed to be addressed because the two formulas and the dollar amounts budgeted for them were independently determined.

Any time Chapter 70 aid grew faster than Additional Assistance, the number of municipalities for which Chapter 70 funds filled the entire Additional Assistance gap grew. For this reason, in combination with funding cutbacks, fewer than half of the Commonwealth's 351 cities and towns have received Additional Assistance aid during the 1990s and to the present.

At its peak funding level in fiscal 1988, Additional Assistance was distributed to all Massachusetts cities and towns. Aid cuts made in the subsequent years – without the use of the formula – have weakened the relationship between the way dollars are distributed and the original purpose of the aid. For example, 46 of the

highest per capita income cities and towns in Massachusetts including Carlisle, Wellesley, Wayland, Lincoln and Belmont, still receive some Additional Assistance.

As Table 2.13 shows, all growth in Additional Assistance occurred between fiscal 1981 and 1988

Table 2.13
Count of Additional Assistance
Receiving Communities - Peak
Funding Year and Current

| | 1988 | 2004 |
|------------------------|------------|------------|
| Municipal Total | 351 | 159 |
| <i>Region</i> | | |
| Berkshire | 32 | 14 |
| Pioneer Valley | 69 | 16 |
| Central | 62 | 18 |
| Boston Metro | 74 | 61 |
| Boston | 1 | 1 |
| Northeast | 42 | 29 |
| Southeast | 48 | 14 |
| Cape and Islands | 23 | 6 |
| <i>Income</i> | | |
| Lowest 5th | 70 | 36 |
| Second 5th | 70 | 21 |
| Boston | 1 | 1 |
| Third 5th | 70 | 19 |
| Fourth 5th | 70 | 36 |
| Highest 5th | 70 | 46 |
| <i>Population</i> | | |
| 50-1,999 | 61 | 17 |
| 2,000-4,999 | 45 | 13 |
| 5,000-9,999 | 68 | 21 |
| 10,000-19,999 | 83 | 36 |
| 20,000-49,999 | 71 | 51 |
| 50,000+ | 22 | 20 |
| Boston | 1 | 1 |

when growth averaged 27.4% annually. After fiscal 1988, growth averaged -7.4% annually, with no growth occurring from fiscal 1988 forward.

Additional Assistance as a Component of Section Three Aid

Additional Assistance has now fallen behind Lottery as a percent of all local aid. The troubling issue with this shift between Additional Assistance and Lottery aid is the distribution method. While just under half of all cities and towns receive Additional Assistance, all municipalities, based on property values and population, receive Lottery aid.

On the surface this may seem to be a more equitable way of distributing aid, but in reality population and property wealth, the basis of lottery distributions, are just two of a number of factors determining need for aid. A variety of per capita costs determinants and their value relative to a municipality's ability to pay (including but not limited to property values) were the basis of the Additional Assistance formula. Many of those cost related variables are no longer represented in any state aid formula used today.

Furthermore, as noted earlier, Chapter 70 aid is now restricted to education, while Additional Assistance is available for general government expenditures. With new

pressures on municipal budgets such as increasing health care costs, the need for unrestricted aid is as great as ever.

Table 2.14
Annual Average Change in
Lottery Aid, Selected Year
Groupings

| Constant dollar, per capita | 1981- 1993 | 1993- 2004 | 1981- 2004 |
|-----------------------------|---------------|---------------|---------------|
| Municipal Total | 11.3% | 3.5% | 7.6% |

Region

| | | | |
|------------------|-------|------|------|
| Berkshire | 15.7% | 3.0% | 9.7% |
| Pioneer Valley | 13.4% | 3.7% | 8.8% |
| Central | 12.2% | 3.6% | 8.1% |
| Boston Metro | 11.2% | 3.4% | 7.5% |
| Boston | 5.0% | 3.5% | 4.3% |
| Northeast | 11.5% | 4.3% | 8.1% |
| Southeast | 13.8% | 2.8% | 8.5% |
| Cape and Islands | 14.1% | 4.7% | 9.6% |

Income

| | | | |
|-------------|-------|------|------|
| Lowest 5th | 12.6% | 3.8% | 8.4% |
| Second 5th | 13.2% | 3.2% | 8.4% |
| Boston | 5.0% | 3.5% | 4.3% |
| Third 5th | 12.7% | 3.3% | 8.2% |
| Fourth 5th | 11.4% | 3.2% | 7.5% |
| Highest 5th | 11.7% | 3.3% | 7.7% |

Population

| | | | |
|---------------|-------|------|------|
| 50-1,999 | 15.1% | 3.9% | 9.7% |
| 2,000-4,999 | 13.4% | 3.3% | 8.6% |
| 5,000-9,999 | 14.3% | 3.1% | 8.9% |
| 10,000-19,999 | 13.1% | 3.0% | 8.3% |
| 20,000-49,999 | 12.9% | 3.5% | 8.4% |
| 50,000+ | 11.6% | 3.8% | 7.9% |
| Boston | 5.0% | 3.5% | 4.3% |

Lottery Aid

The Massachusetts State Lottery was established in 1971 as a means of providing financial support to local municipalities. While some Lottery revenue supports the Arts Lottery Fund, Department of Public Health and the Massachusetts Cultural Council, most Lottery proceeds provide formula-based, general-purpose aid to all municipalities.

The lottery formula distributes aid based on equalized property values and population. Localities with lower property values receive proportionally more per capita aid than municipalities with higher property values.

Dollars distributed through the lottery formula, as noted earlier, now exceed Additional Assistance, due in part to growth in the lottery and in part to the reductions in Additional Assistance.

As Table 2.14 indicates, growth in Lottery aid was much higher from 1981 to 1993, than after 1993, due mainly to sharp increases in Lottery ticket sales in the earlier period. During the latter period growth in Lottery distributions was much slower, averaging 3.5% annually. This slowdown was due in part to a cap placed on lottery aid that directed some lottery revenue into the Commonwealth's general fund. This diversion of lottery revenue began in 1989 and

continued until the cap was gradually lifted in 2000. A new cap was placed on lottery aid in 2003 to mitigate the effects on the state budget of the recession. The 2003 cap diverted over \$97 million into the state's general fund in that year alone.

Lottery distributions to cities and towns have been fairly even among regions, income groups and population groups. The patterns do exhibit some progressivity however, as the lowest income municipalities saw among the largest increases over both periods, with growth generally slower for higher income municipalities. This pattern reflects the distribution formula, which allocates aid inverse to property values.

Table 2.15
Annual Average Change in Chapter
70, Selected Year Groupings
 Constant dollar, per capita

| | 1981- 1993 | 1993- 2004 | 1981- 2004 |
|-----------------|---------------|---------------|---------------|
| Municipal Total | -2.1% | 8.6% | 3.0% |

Region

| | | | |
|------------------|-------|-------|-------|
| Berkshire | 3.9% | 5.0% | 4.4% |
| Pioneer Valley | 1.2% | 8.7% | 4.8% |
| Central | -0.7% | 7.8% | 3.4% |
| Boston Metro | -4.4% | 8.7% | 1.9% |
| Boston | -8.4% | 12.0% | 1.4% |
| Northeast | -2.2% | 10.2% | 3.7% |
| Southeast | 0.9% | 7.2% | 3.9% |
| Cape and Islands | -8.8% | 36.9% | 13.0% |

Income

| | | | |
|-------------|-------|-------|------|
| Lowest 5th | 0.9% | 9.1% | 4.9% |
| Second 5th | -0.6% | 6.3% | 2.7% |
| Boston | -8.4% | 12.0% | 1.4% |
| Third 5th | -2.2% | 6.5% | 2.0% |
| Fourth 5th | -5.2% | 8.8% | 1.5% |
| Highest 5th | -6.8% | 11.0% | 1.7% |

Population

| | | | |
|---------------|-------|-------|------|
| 50-1,999 | -0.1% | 12.6% | 6.0% |
| 2,000-4,999 | -3.6% | 8.1% | 2.0% |
| 5,000-9,999 | -1.3% | 6.4% | 2.4% |
| 10,000-19,999 | -1.8% | 6.6% | 2.2% |
| 20,000-49,999 | -1.8% | 9.0% | 3.4% |
| 50,000+ | -0.4% | 8.8% | 4.0% |
| Boston | -8.4% | 12.0% | 1.4% |

Chapter 70 School Aid

As the largest part of the local aid mix, Chapter 70 has always been an important source of revenue for local governments. Between fiscal 1981 and 2004, Chapter 70 increased by 3.0% annually on average.

As noted previously, Chapter 70 aid is now dedicated to schools. As the importance of this local aid source has grown, so have the challenges of managing local services in an environment of limited property taxes and earmarked state aid to education.

Given the implications of the changes in Chapter 70 for local fiscal flexibility, it is appropriate to take a closer look at how school funding at both the local level and the state level has evolved over the past several decades.

Chapter 70 and Education Reform

Equity in school financing has been a major public policy issue since 1978, when a court case was initiated to address disparities between school districts. That case, which went on to become known as *McDuffy v. Robertson*, resulted in a 1993 Massachusetts Supreme Judicial Court decision which ruled that the Commonwealth was not

meeting its constitutional requirement to provide an adequate level of education for all students.

Within days of the Court's ruling, the Commonwealth took on the bold task of creating a more equitable and well funded public school system. The Education Reform Act of 1993 set out to make significant changes to the public education system over a 7-year period by creating funding goals and implementing accountability measures for students, teachers, and school districts.

The overhaul of Chapter 70 aid to education was an integral component of achieving the school financing equity goals put forward in the 1993 Education Reform Act. The law established a concept called the **foundation budget**, which specified the dollar amount needed to provide an adequate level of education in each school district. The law also defined how much a municipality would be required to contribute toward its foundation budget, known as the **local contribution**. This local

contribution depended on local ability to pay (the property tax base per student) as well as what the city or town had been spending from locally raised revenue. In concept, Chapter 70 was aimed at filling the gap between a municipality's foundation budget and its local contribution.

The determination of how much each municipality will pay toward public education, the local contribution, has been one of the main factors preventing municipalities from spending fewer dollars on schools (substituting state dollars for local dollars), as state aid for schools increased following the implementation of the Education Reform Act. The local contribution, determined in 1994, increases each year by a municipality's **municipal revenue growth factor**, which is the percent increase in total general purpose revenue available to a city or town. This general purpose revenue includes such items as the property tax, including new growth, certain state aid accounts, and fees, fines, and local receipts.

Chapter 70 Growth Across Municipalities¹⁶

The Education Reform Act was a watershed moment for this local aid account. In the period prior to Education Reform, 1981 – 1993, Chapter 70 aid actually experienced a decline of -2.1% (Table 2.15). After the law was enacted, the rate of growth increased to 8.6% annually between 1993 and 2004. This reflected the Commonwealth's financial commitment to ensuring that all municipalities reached their foundation budgets.

During the more recent period, 1993 - 2004, Chapter 70 growth was fairly steady across regions with the exception of the Cape and Islands, which saw a 36.9% increase over the period. This growth rate may be due to the significant changes in the Chapter 70 aid formula as a result of the 1993 education reforms, as the region experienced growth of over 300% in fiscal 1994 alone.

Among income groups, the highest quintile experienced the greatest annual growth in Chapter 70 aid at 11.0% between 1994 - 2004, while the lowest income group saw the second highest increase at 9.1% annually. Again, the aid growth among the highest income municipalities may be attributable to the aid changes following Education Reform.

Since 1994, the smallest municipalities with populations between 50-1,999 residents saw the highest annual average growth in Chapter 70 aid at 12.6%. The remaining population groups saw aid increases ranging from 6.4% to 9.0% annually.

¹⁶ Chapter 70 numbers do not include regional schools because a consistent methodology for attributing regional Chapter 70 to individual municipalities could not be determined after consultation with the Department of Education and the Department of Revenue. As a result, annual average changes in Chapter 70 for municipalities in the western part of the state, where regional schools are more prevalent, are likely understate the annual growth rates represented in the groups where they fall in table 2.5

State Assessments or “Municipal Charges”

State assessments or “municipal charges” are subtracted directly from quarterly local aid distributions by the Office of the State Treasurer. On the Cherry Sheet, these charges are organized in five separate categories: County Assessment/Tax, State Assessments and Charges, Transportation Authorities, Annual Charges Against Receipts, and Tuition Assessments. By far the largest assessments are for transit and Charter School related charges.

Charter School Assessments

In fiscal 2004, Charter School Sending Tuition totaled \$132 million. The Charter School assessment is charged only to school districts with children enrolled in charter schools, which are publicly funded schools that operate independently of the local school committee. In fiscal 2004, 164 municipalities paid charter school tuition. Larger municipalities have the highest Charter School Tuition assessments, as municipalities with 20,000 or more residents paid 91% of the total 2004 assessment, and the largest municipalities of 50,000 or more paid 76.7% of the total.

Transit Assessments

There are two main charges for transit assessments: charges paid to the Massachusetts Bay Transportation Authority (MBTA) and those paid to Regional/Boston Metro Transit (regional transit authorities).

In fiscal 2004, MBTA assessments totaled \$139.4 million and represented one-third of the total \$404.6 million in assessments. The MBTA assessment is not charged to all municipalities, but rather only to those with MBTA rail or bus service available. In all, 152 municipalities paid an MBTA Assessment in fiscal 2004.

In the aggregate, the 12 cities and towns of Boston, Cambridge, Newton, Brookline, Somerville, Medford, Malden, Revere, Arlington, Quincy, Everett, and Watertown paid 75% of the total fiscal 2004 MBTA assessment or a total of \$104.4 million or \$82.93 per capita, while the remaining 130 municipalities in Massachusetts that receive MBTA service paid \$35.0 million or \$14.25 per capita.

By region, the fiscal 2004 MBTA assessment cost the most in Boston at \$111.06 per capita or a total of \$64.6 million (46.3% of the total assessment). Boston is followed by the Boston Metro region with a per capita cost of \$23.54 or a total of \$66.1 million in fiscal 2004. The Northeast, Southeast and Central regions all have fiscal 2004 MBTA assessment costs of less than \$7.50 per capita and \$8.7 million in total, while the Berkshire, Pioneer Valley and Cape and Islands have no assessment for MBTA service.

By income, the highest quintile paid the highest fiscal 2004 per capita MBTA assessment amount of \$15.34 and the lowest quintile paid the lowest at \$2.81. Except for Boston, the assessment is highly

progressive – as the per capita assessment increases slowly between the first two income quintiles (by 5.8%) and then very quickly between the second and third (by 43.5%) quintiles, the third and fourth (by 53.8%) and the fourth and fifth (133.3%)

By population group, larger municipalities pay higher per capita MBTA assessments increase as well. The 50,000+ population group paid MBTA assessments at a rate of \$23.00 per capita in fiscal 2004, while the 50-1,999 population group (which included no municipalities within the MBTA service area) paid nothing and the 2,000 to 4,999 population groups paid \$1.86 per capita.

Regional Transit assessments totaled \$19.3 million in fiscal 2004 and were paid by 221 municipalities, ranging in cost from nine dollars to \$1.9 million. The Cape and Islands region pays by far the highest per capita regional transit assessment at \$312.20 in 2004 followed by the Pioneer Valley region at \$259.26 and then the Central Region at \$145.29 annually. The remaining regions (except for Boston which is covered almost entirely by the MBTA) ranged between \$70 and \$90 in annual per capita assessment cost.

County Tax Assessments

County governments were eliminated in Massachusetts through Chapter 34B of the Massachusetts General Laws. Even so, there are remnants of several county expenses that are still billed to municipalities. These expenses include portions of the cost of jail, registry of deeds and court facilities, as well as payments on any remaining liabilities of the eliminated county. The latter are the subject of agreements between the state and municipalities and are not contained in Chapter 34B. It is expected that all the remnants of county government across the state will be fully eliminated by the end of the decade.

In fiscal 2004, municipalities paid \$17 million in county tax. In all, 180 municipalities paid a county tax assessment in fiscal 2004 in amounts ranging from \$57 to \$985,000 per municipality. Of the 14 counties in Massachusetts, 10 still had an assessment charged to municipalities in fiscal 2004. Barnstable, Bristol and Norfolk counties each had assessment charges over \$4.0 million annually and Plymouth and Worcester greater than \$1.0 million.

The Special Case of Suffolk County

In fiscal 2004, the City of Boston paid an annual “maintenance of effort” charge of 5% of the annual budget of the Suffolk County Sheriff totaling approximately \$4.5 million. The three other municipalities of Suffolk County – Chelsea, Revere and Winthrop – are not required to pay any of this cost. While this item is not considered an assessment, it is a remnant of Suffolk County which, unlike other counties and their functions has not been scheduled for elimination in Chapter 34B, even though the Suffolk County Registry of Deeds and other county functions have been moved to state control.

Section III. Municipal Expenditures¹⁷: Trends and Analysis, Fiscal 1987 - 2004

Municipal budgets and the fiscal pressures facing local policymakers must be analyzed in the context of local expenditures, particularly under a system of revenue constraints. This section utilizes Department of Revenue data to analyze municipal expenditure trends and highlight major trends since 1987.

Total municipal spending in Massachusetts has grown in constant dollars by 1.3% annually per capita, with wide variation in growth among major spending categories. To analyze these growth trends more closely expenditures have been broken down into three sections: Areas of Expenditure Growth, Areas of Expenditure Stability and Areas of Expenditure Decline.

Given the similar basket of public services most municipalities provide and the widespread nature of some specific cost pressures, municipalities across the Commonwealth face similar issues. Therefore, data among region, income and population groups did not show substantial differences and instead statewide changes suffice to identify spending trends.

Chart 3.1
Fiscal 1987 Local Government Expenditures by Category
Constant Dollars, Per Capita

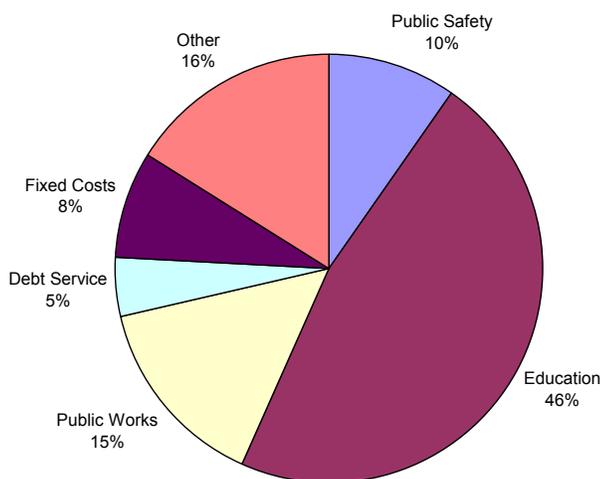
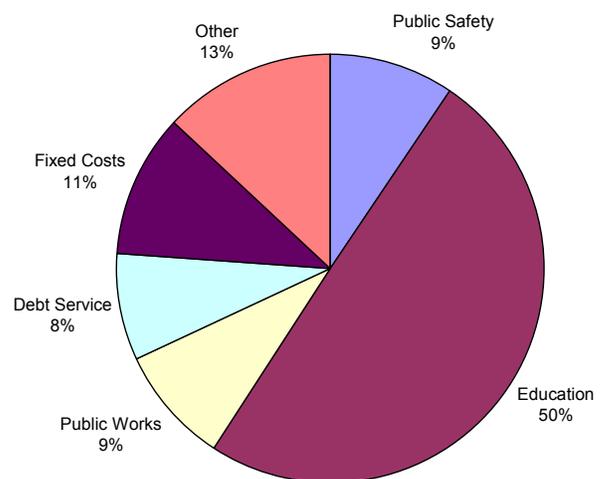


Chart 3.2
Fiscal 2004 Local Government Expenditures by Category
Constant Dollars, Per Capita



¹⁷ Massachusetts Department of Revenue Division of Local Services definition of Expenditures: General Fund Expenditure data are gathered and obtained through the Schedule A that is submitted to the Division of Local Services by Local Government Officials. Expenditures are from the general fund and do not reflect spending from special revenue, enterprise, capital projects, or trust funds. This may result in wide variations among communities in the "Public Works" category, because many communities account for spending on sewer, water, utilities, and other public works functions in enterprise or special revenue funds. Capital outlay and construction expenditures are also excluded in order to encourage fair comparisons.

As the following discussion shows, only a few expenditure categories, namely debt service, fixed costs (including employee health insurance, pensions, and other benefits)¹⁸, and education, have exhibited rates of growth in excess of the average increase in total municipal expenditures of 1.3%. This growth has the effect of forcing reductions in other expenditure areas under a balanced budget framework. Charts 3.1 and 3.2 illustrate the growth, stability or decline in major expenditure areas as a percent of total municipal expenditures in 1987 and 2004.

The following case study of the town of Lincoln, Massachusetts provides an example of the effects that cost increases on nondiscretionary items, such as employee benefits, have had on the ability of local policymakers to manage growing budget pressures within the constraints of Proposition 2½.

¹⁸ “Fixed Costs” are generally not in the control of local budget writers in any given year. They are subject, in most cases, to collective bargaining agreements or funding schedules that cannot be adjusted without negotiation with unions or approval of state regulators.

Lincoln, Massachusetts

“Over the last several years the palatable opportunities for productivity and efficiency gains have been exhausted. In the future service levels will inevitably decline without operating overrides.”

-Town of Lincoln, 2005-2006 Finance Committee Report

Basic Facts

Region: Boston Metro

Population: 8,066, 2004 Census estimate

Per Capita Income: \$49,095, 2000 Census

Type of Government: Selectmen - Town Administrator-Town Meeting

Thirteen miles northwest of Boston, the municipality of Lincoln, Massachusetts, has found its fiscal challenges, largely the result of state aid cuts and rising fixed costs, so constraining that local policymakers have requested Proposition 2 ½ overrides five out of the last six years to maintain basic services.

With a \$23.5 million dollar budget, 80% of which goes toward personnel related costs, Lincoln has found much of its revenue growth consumed by contractual salary increases and by health insurance costs in particular. It is estimated that in FY06, non-discretionary spending on such items as health insurance, retirement, and debt will consume 72% of the allowable increase in property taxes, with health insurance costs alone estimated to grow 13%, the fourth year of double digit percent increases.

To mitigate the effects of these pressures Lincoln has been forced to become increasingly reliant on own-source revenue to fund local services. State aid has declined from 14% of total revenue in FY01 to 8.1% in FY06. After having reduced budgets, drawn down reserves, maximized the allowable fee and property tax increases, the municipality has been forced to resort to Proposition 2½ overrides each of the last five years to maintain the same level of services.

Areas of Expenditure Growth

Areas of expenditure growth are defined as those major spending categories that have increased above the average rate of total government expenditure, 1.3%, since 1987.

The three areas of expenditure growth consist of:

Debt Service: This category, which includes the retirement of debt principal and the interest on debt, has increased the fastest of all expenditure areas at 3.1% annually.

Fixed Costs: Consisting of items such as health insurance, pensions, unemployment, workers compensations and other employee benefits, fixed costs have grown in constant dollars by 2.2% annually on average in per capita terms since 1987, with a sharp increase in recent years.

Education: As the largest area of spending in most municipalities, education has grown by an annual average rate of 2.1% annually.

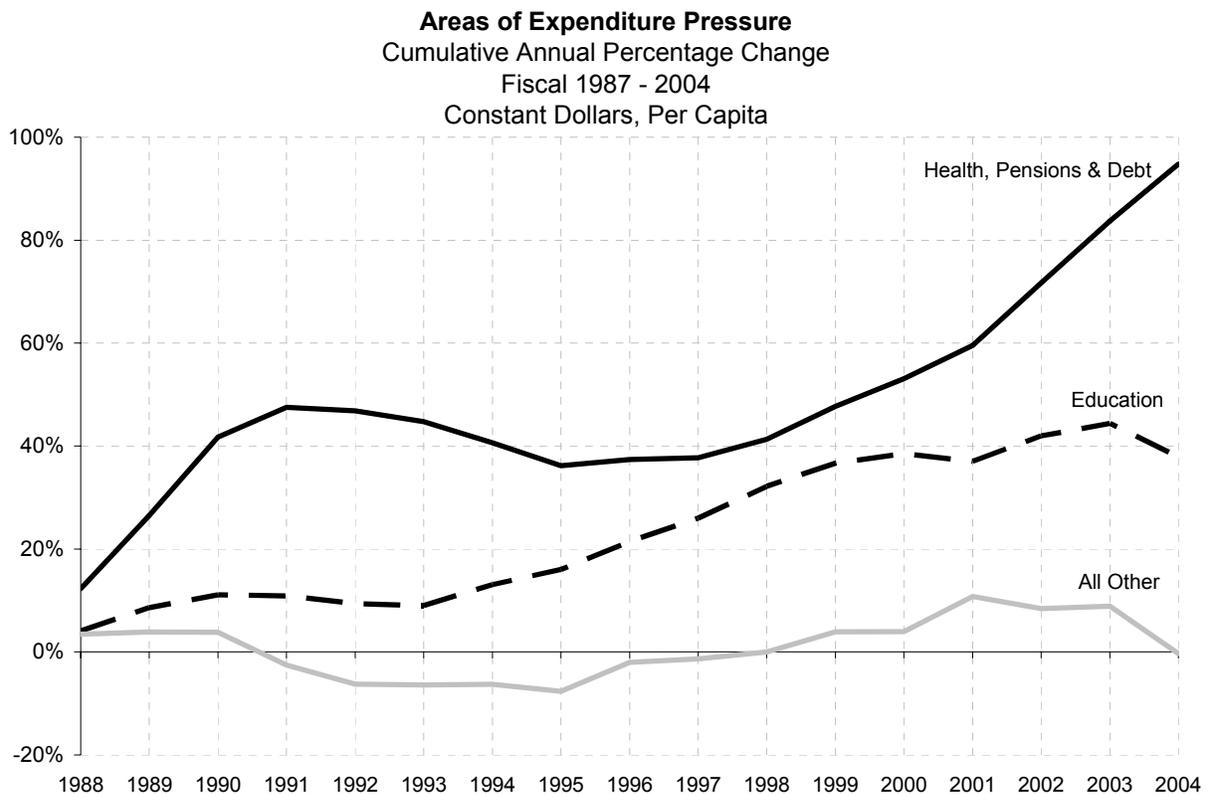


Table 3.0
Drivers of General Fund Expenditure Growth
 Fiscal 1987-2004
 aggregate, current dollar

| | | |
|-----------------------------------|---|---|
| Average Annual Percent Growth | 4.8% | |
| General Fund Expenditure Category | Average Annual Percent of Total Budget Growth | Addition to Annual Average Percent Growth |
| General | 6.0% | 0.3% |
| Police | 7.1% | 0.3% |
| Fire | 4.5% | 0.2% |
| Other Public Safety | 0.4% | 0.0% |
| Education | 51.8% | 2.5% |
| Public Works | 4.1% | 0.2% |
| Health & Welfare | -2.9% | -0.1% |
| Culture & Recreation | 2.0% | 0.1% |
| Debt Service | 9.5% | 0.5% |
| Fixed Costs | 17.5% | 0.8% |
| Intergovernmental | 4.8% | 0.2% |
| Other | -4.7% | -0.2% |
| Total | 100.0% | 4.8% |

Municipal Budget Drivers:

As Chart 3.3 shows and the previous expenditure pies (Charts 3.2 and 3.3) comparing the composition of municipal expenditures in 1987 and 2004 indicate, spending on debt service, fixed costs, and education has seen noticeable growth as percent of total government expenditures since 1987.

Table 3.0 provides further illustration of the impact of these three expenditure areas as they relate to budget growth. The following figures are compared using current dollars.

Combined, the spending areas of education, fixed costs and debt service have consumed approximately 80% of annual budget growth since 1987, with education alone taking up 52% of new budget growth.

The nine remaining expenditure categories received only 20% of annual budget growth. The largest three areas, police, fire and general government accounted for 7.1%, 4.5% and 6.0% of growth annually. The remaining six groups in total (Other Public Safety, Public Works, Health & Welfare, Culture & Recreation, Intergovernmental, and Other) accounted for only 2.4% of annual growth.

Table 3.1
Average Annual Change in Total
Municipal Expenditures vs. Total
Expenditures less Education, Fixed
Costs & Debt Service (all other)
 Constant dollar, per capita

| | Total | All Other |
|------------------------|-------|-----------|
| Municipal Total | 1.3% | -0.3% |

| <i>Region</i> | | |
|------------------|-------|-------|
| Berkshire | 1.2% | -0.4% |
| Pioneer Valley | 1.9% | -0.4% |
| Central | 2.0% | 0.2% |
| Boston Metro | 1.0% | -0.5% |
| Boston | -0.2% | -0.8% |
| Northeast | 1.6% | -0.2% |
| Southeast | 1.8% | 0.4% |
| Cape and Islands | 3.3% | 2.4% |

| <i>Income</i> | | |
|---------------|-------|-------|
| Lowest 5th | 1.7% | -0.5% |
| Second 5th | 1.5% | 0.4% |
| Boston | -0.2% | -0.8% |
| Third 5th | 1.6% | 0.8% |
| Fourth 5th | 1.2% | -0.6% |
| Highest 5th | 1.6% | -0.1% |

| <i>Population</i> | | |
|-------------------|-------|-------|
| 50-1,999 | 1.7% | 0.4% |
| 2,000-4,999 | 2.5% | 1.4% |
| 5,000-9,999 | 2.3% | 0.7% |
| 10,000-19,999 | 2.0% | 0.5% |
| 20,000-49,999 | 1.4% | -0.1% |
| 50,000+ | 1.2% | -0.7% |
| Boston | -0.2% | -0.8% |

rate at -0.7% annually since 1987.

Municipal Expenditures outside of Debt, Fixed Costs and Education:

Table 3.1, looks beyond budget growth and evaluates how increases in debt, fixed costs, and education have impacted the annual change in municipal expenditures¹⁹. As the table indicates, after adjusting for these costs, municipalities have been forced to make tradeoffs between spending categories, as spending outside of these expenditure growth areas has had negative growth of -0.3% annually, in per capita inflation-adjusted terms since 1987.

By region, just the Central, Southeast, and Cape and Islands saw positive expenditure growth, with the Cape and Islands the only region experiencing growth above 1%.

In terms of income groupings, only the second and third income groups saw positive growth outside of debt, fixed costs, and education spending, with both the highest and lowest income groupings experiencing negative expenditure growth outside of those areas.

By population groupings, only large municipalities, those with over 20,000 residents, had negative expenditure growth, with those communities having populations above 50,000 having the slowest growth

¹⁹ Since Boston is displayed separately, it should be noted that the city did see a reduction in local expenditures as a result of the sale of Boston City Hospital in fiscal 1996. The figures in table 3.1 do not adjust for this change or other similar “unique” circumstances of other municipalities over the 25 year period.

The Challenge of Managing Health Care Costs

Health insurance costs for municipal employees, a major component of the fixed cost category, have been growing substantially over the past few years adding enormous pressure to municipal budgets. Growth in this area is particularly noteworthy because the cost of health care remains out of the control of local officials.

A recent survey-based report released by the Massachusetts Taxpayers Foundation and done in conjunction with the Massachusetts Municipal Association provides evidence of the rapid and steep increase in the cost to municipalities of providing health insurance to their employees.

Thirty-two municipalities, comprising a cross-section of municipalities by size and wealth were surveyed and the report findings suggest that this mounting cost pressure is increasing in municipal budgets at twice the rate as that of the Commonwealth. The report also suggests that the annual increases in health insurance have absorbed 80% of allowable annual increases in the local property tax. In 20% of the communities surveyed health insurance cost increases have outstripped the allowable annual 2.5% increase in the tax levy. This increase is occurring in a time when state aid to municipalities has been reduced and property taxes are increasing though overrides.

Areas of Expenditure Stability

Areas of expenditure stability are defined as those expenditure categories that have had positive budget growth at or below 1.3% annually on average since 1987.

The areas of expenditure stability include:

Police: Statewide, police expenditures have increased on average by 1.5% annually in inflation-adjusted terms, and have remained a consistent 6% of per capita total expenditures over the period.

General Government: This category includes the administrative functions of local government – treasurer/collector, auditing, legal counsel, assessing and others. General government has grown by 0.9% annually on average and in 2004 made up 6% of total expenditures.

Fire: Across all municipalities fire expenditure have grown 0.7% above inflation over the period, and has also remained a consistent percent of total government expenditures at approximately 4% since 1987.

Areas of Expenditure Decline

Areas of expenditure decline are defined as those categories of spending which have declined in real terms since 1987. These expenditure areas include:

Health and Welfare: This category includes health, clinical and veteran services provided by municipalities. Spending in this area has declined in inflation adjusted terms by -2.7% annually over the period, the lowest rate of growth of all expenditure areas.

Public Works: Including items such as highway departments, waste collection, water distribution, and snow and ice removal, the public works category has shown a negative annual average growth rate of -1.2% since 1987. As Charts 3.1 and 3.2 show, public works spending has also declined as a percentage of total expenditures from 15% in 1987 to 9% in 2004.

Crowding Out: Losing Local Budgetary Discretion

Recent expenditure history has been characterized by an increasing loss of budgetary discretion. Pressures resulting from the rising costs of employee benefits, the demands of meeting state and federal education mandates, combined with limited local revenue raising capacity and stagnant general-purpose aid, have left local officials with limited resources to meet current needs, expand existing services or adequately plan for the future.

The net result of these combined pressures has been more local fees and property taxes and less direct local services. As the expenditure growth data and the various case studies in the report indicate, municipalities have made layoffs, implemented hiring freezes, reduced hours of operation, cut discretionary programs and, in some cases, eliminated programs and services altogether to maintain budget balance.

Without change, many cities and towns will be forced to continue to implement service reductions and/or seek voter approved overrides to fund local services. Modifying this trend will require a new state-local partnership that recognizes cost differences and revenue constraints to establish a more responsive local finance system.

Methodology

Methodology Detail:

In the preceding analysis, per capita information is provided for the Commonwealth's 351 cities and towns²⁰, by geographic regions developed by the Donahue Institute at the University of Massachusetts at Amherst for its "Benchmarks" publication (see graphic below). Additionally, per capita income quintiles²¹ are provided and in some cases population classes²². Please note that

figures for the City of Boston are provided separately due to the vastly different nature of the City from the rest of the Commonwealth's municipalities.

Historical Population Changes

U.S. Census Years

| | 1970- 1980 | 1980- 1990 | 1990- 2000 | Average |
|-----------|---------------|---------------|---------------|---------|
| Statewide | 0.8% | 4.9% | 5.5% | 3.7% |

Region

| | | | | |
|------------------|--------|-------|-------|-------|
| Berkshire | -2.9% | -4.0% | -3.2% | -3.3% |
| Pioneer Valley | 0.6% | 4.2% | 1.0% | 1.9% |
| Central | 1.1% | 10.0% | 5.7% | 5.6% |
| Boston Metro | -3.3% | 0.9% | 5.1% | 0.9% |
| Boston | -12.2% | 2.0% | 2.6% | -2.5% |
| Northeast | 3.0% | 7.8% | 8.0% | 6.3% |
| Southeast | 13.4% | 7.0% | 7.0% | 9.1% |
| Cape and Islands | 52.0% | 26.1% | 20.8% | 33.0% |

Income

| | | | | |
|-------------|--------|------|------|-------|
| Lowest 5th | -3.9% | 4.3% | 1.4% | 0.6% |
| Second 5th | 7.1% | 7.3% | 8.1% | 7.5% |
| Boston | -12.2% | 2.0% | 2.6% | -2.5% |
| Third 5th | 9.4% | 7.5% | 7.0% | 7.9% |
| Fourth 5th | 5.5% | 5.7% | 9.5% | 6.9% |
| Highest 5th | 0.7% | 2.2% | 6.4% | 3.1% |

Population

| | | | | |
|---------------|--------|-------|------|-------|
| 50-1,999 | 20.8% | 14.9% | 7.2% | 14.3% |
| 2,000-4,999 | 13.0% | 12.9% | 8.9% | 11.6% |
| 5,000-9,999 | 11.3% | 9.7% | 8.6% | 9.9% |
| 10,000-19,999 | 8.6% | 7.6% | 9.3% | 8.5% |
| 20,000-49,999 | 3.4% | 4.3% | 6.3% | 4.7% |
| 50,000+ | -4.4% | 2.9% | 2.2% | 0.2% |
| Boston | -12.2% | 2.0% | 2.6% | -2.5% |

Boston presented significant differences when variables were laid against each other, rather than being different in the category itself, except in the case of population. For example, Boston's per capita income falls comfortably within the second quintile of all cities and towns and as a region it is not as big or as populous as the other regions. But, substantial differences in the make-up of its property tax base, its composition of local aid, size of school district and overall budget make it likely to skew whatever group to which it might be reasonably added.

The source of all data is the Massachusetts Department of Revenue, Division of Local Services' Municipal Data Bank.

²⁰ Population estimates by municipality were not available for the 1981-1985, 1987, 1989 periods. These years are estimates by the author based on trending between the available data points.

²¹ Per capita income is 1999 income and population from the 2000 census.

²² Population classes were developed based on 2003 population estimates.

Region (count of cities or towns)

| |
|-----------------------|
| Berkshire (32) |
| Pioneer Valley (69) |
| Central (62) |
| Boston Metro (74) |
| Boston (1) |
| Northeast (42) |
| Southeast (48) |
| Cape and Islands (23) |

Per Capita Income

| | |
|-------------|-----------------------|
| Lowest 5th | (\$12,400 - \$21,010) |
| Second 5th | (\$21,017 - \$23,701) |
| Boston | (\$23,353) |
| Third 5th | (\$23,711 - \$26,364) |
| Fourth 5th | (\$26,400 - \$32,116) |
| Highest 5th | (\$32,117 - \$79,640) |

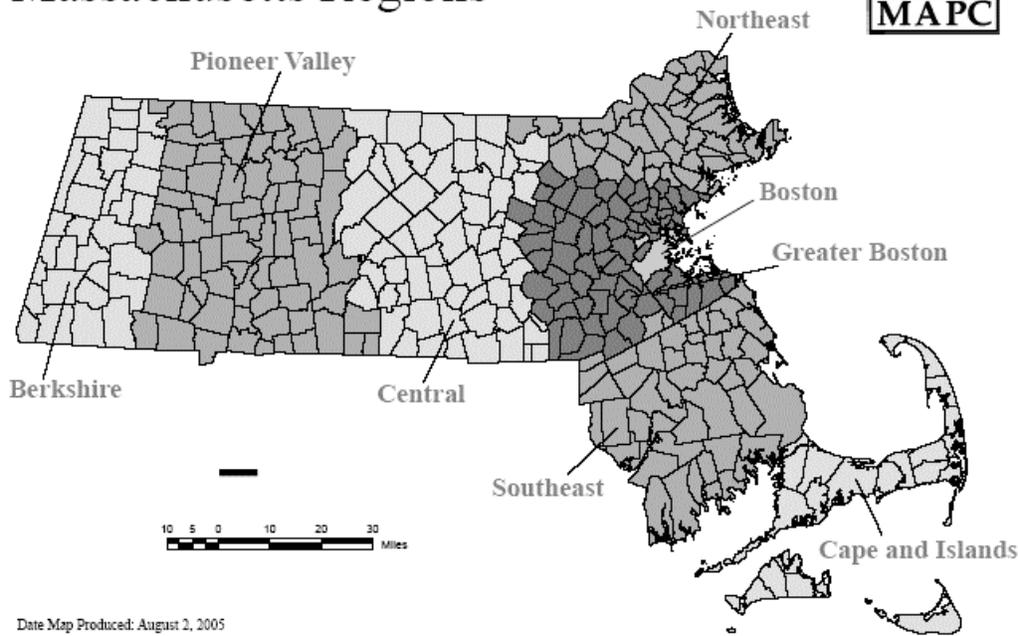
Population (count of cities or towns)

| |
|--------------------|
| 50-1,999 (61) |
| 2,000-4,999 (45) |
| 5,000-9,999 (68) |
| 10,000-19,999 (83) |
| 20,000-49,999 (71) |
| 50,000+ (22) |
| Boston (1) |

In calculating constant dollars, the deflator used is the U.S. Department of Commerce, Bureau of Economic Analysis price index for state and local government purchases of goods and services, adjusted to a fiscal year basis. Annual averages are geometric, meaning that they are the average of each year's percentage change. A geometric average takes into account the effect of compounding and is a better measure of long-term growth where a data series has large swings in annual value.

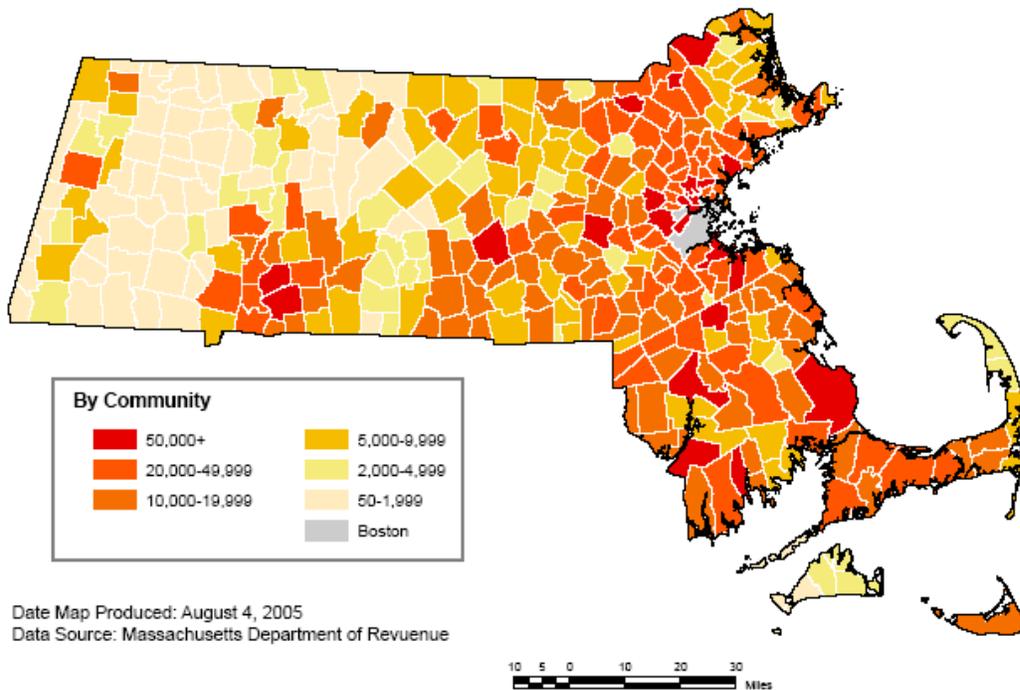
Population changes can affect both revenue and expenditures of a municipality in fairly rapid sequence. Prior to fiscal 1992, a municipality had very little ability to adjust to a large influx of population. During this period, under Proposition 2 1/2, the addition of new growth to the tax rolls was limited, thus forcing overrides of the levy limit in municipalities with substantial population change. To account for this, per capita variables by grouping are used wherever appropriate and possible.

Municipal Finance Task Force Massachusetts Regions



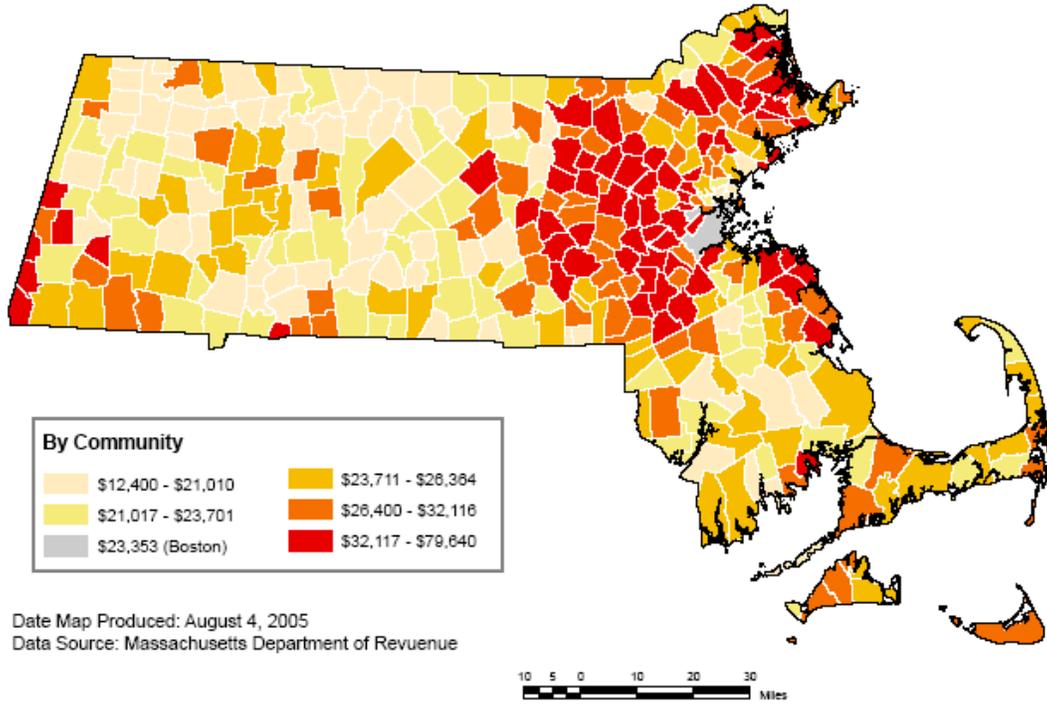
Date Map Produced: August 2, 2005

Municipalities by Population Groups



Date Map Produced: August 4, 2005
Data Source: Massachusetts Department of Revenue

Municipalities by Income Groups



Glossary:

Additional Assistance – This state aid program provides unrestricted, general fund revenue to a certain number of municipalities through the Cherry Sheet. Additional Assistance evolved from the old resolution aid formula of the 1980s, but following state budget cuts, it was level funded beginning in FY92 and then subsequently reduced.

Appropriation – An authorization granted by a town meeting, city council or other legislative body to expend money and incur obligations for specific public purposes. An appropriation is usually limited in amount and as to the time period within which it may be expended. (See Encumbrance, Line-Item Transfer, Free Cash)

Available Funds – Balances in the various fund types that represent non-recurring revenue sources. As a matter of sound practice, they are frequently appropriated to meet unforeseen expenses, for capital expenditures or other onetime costs. Examples of available funds include free cash, stabilization fund, overlay surplus, water surplus, and enterprise retained earnings.

Budget – A plan for allocating resources to support particular services, purposes and functions over a specified period of time. (See Level Funded Budget, Performance Budget, Program Budget, Zero Based Budget).

Chapter 70 School Aid – Chapter 70 refers to the school funding formula created under the Education Reform Act of 1993 by which state aid is distributed through the Cherry Sheet to help establish educational equity among municipal and regional school districts.

Cherry Sheets – Named for the cherry colored paper on which they were originally printed, the Cherry Sheet is the official notification to cities, towns and regional school districts of the next fiscal year's state aid and assessments. The aid is in the form of distributions which provide funds based on formulas and reimbursements which provide funds for costs incurred during a prior period for certain programs or services. (See Cherry Sheet Assessments, Estimated Receipts).

Cherry Sheet Assessments – Estimates of annual charges to cover the cost of certain state and county programs. Prior to FY04, if the yearend actual assessments or charges differed from the estimates, adjustments were made on the subsequent year's cherry sheet. However, adjustments are no longer be made.

Collective Bargaining – The process of negotiating workers' wages, hours, benefits, working conditions, etc., between an employer and some or all of its employees, who are represented by a recognized labor union.

Debt Exclusion – An action taken by a municipality through a referendum vote to raise the funds necessary to pay debt service costs for a particular project from the property tax levy, but outside the limits under Proposition 2½. By approving a debt exclusion, a municipality calculates its annual levy limit under Proposition 2½, then adds the excluded debt service cost. The amount is added to the levy limit for the life of the debt only and may increase the levy above the levy ceiling.

Education Reform Act of 1993 – State law authorized the seven-year, Ch. 70 funding program for education and that established spending targets for school districts as a means to remedy educational inequities. Scheduled end by FY00, the program has been extended, pending agreement on further reforms.

Enterprise Funds – An enterprise fund, authorized by MGL Ch. 44 §53F½, is a separate accounting and financial reporting mechanism for municipal services for which a fee is charged in exchange for goods or services. It allows a municipality to demonstrate to the public the portion of total costs of a service that is recovered through user charges and the portion that is subsidized by the tax levy, if any. With an enterprise fund, all costs of service delivery—direct, indirect, and capital costs—are identified. This allows the municipality to recover total

Equalized Valuations (EQVs) – The determination of an estimate of the FFCV of all property in the Commonwealth as of a certain taxable date. EQVs have historically been used as a variable in distributing some state aid accounts and for determining county assessments and other costs. The Commissioner of Revenue, in accordance with MGL Ch. 58 §10C, is charged with the responsibility of biannually determining an equalized valuation for each city and town in the Commonwealth.

Excess Levy Capacity – The difference between the levy limit and the amount of real and personal property taxes actually levied in a given year. Annually, the board of selectmen or city council must be informed of excess levy capacity and their acknowledgment must be submitted to DOR when setting the tax rate.

Exemption – A discharge, established by statute, from the obligation to pay all or a portion of a property tax. The exemption is available to particular categories of property or persons upon the timely submission and approval of an application to the assessors. Properties exempt from taxation include hospitals, schools, houses of worship, and cultural institutions. Persons who may qualify for exemptions include veterans, blind individuals, surviving spouses, and persons over 70 years of age.

Expenditure – An outlay of money made municipalities to provide the programs and services within their approved budget.

Fiscal Year – Since 1974, the Commonwealth and municipalities have operated on a budget cycle that begins July 1 and ends June 30. The designation of the fiscal year is that of the calendar year in which the fiscal year ends. For example, the 2000 fiscal year is July 1, 1999 to June 30, 2000. Since 1976, the federal government fiscal year has begun October 1 and ended September 30.

Fixed Costs – Costs that are legally or contractually mandated such as retirement, FICA/Social Security, insurance, debt service costs or interest on loans.

Foundation Budget – The spending target imposed by the Education Reform Act of 1993 for each school district as the level necessary to provide an adequate education for all students.

Free Cash – (Also Budgetary Fund Balance)

Remaining, unrestricted funds from operations of the previous fiscal year including unexpended free cash from the previous year, actual receipts in excess of revenue estimates shown on the tax recapitulation sheet, and unspent amounts in budget line-items. Unpaid property taxes and certain deficits reduce the amount that can be certified as free cash. The calculation of free cash is based on the balance sheet as of June 30, which is submitted by the municipality's auditor, accountant, or comptroller. **Important:** free cash is not available for appropriation until certified by the Director of Accounts. (See Available Funds).

Full and Fair Cash Value (FFCV) – Fair cash value has been defined by the Massachusetts Supreme Judicial Court as "fair market value, which is the price an owner willing but not under compulsion to sell ought to receive from one willing but not under compulsion to buy. It means the highest price that a normal purchaser not under peculiar compulsion will pay at the time, and cannot exceed the sum that the owner after reasonable effort could obtain for his property. A valuation limited to what the property is worth to the purchaser is not market value. The fair

cash value is the value the property would have on January first of any taxable year in the hands of any owner, including the present owner" (Boston Gas Co. v. Assessors of Boston, 334 Mass. 549, 566 (1956)).

General Fund – The fund used to account for most financial resources and activities governed by the normal town meeting/city council appropriation process.

Hotel/Motel Excise – A local option since 1985 that allows a municipality to assess a tax on short term room occupancy. The municipality may levy up to 4 percent of the charge for stays of less than 90 days at hotels, motels and lodging houses. The convention center legislation imposed an additional 2.75 percent charge in Boston, Cambridge, Springfield and Worcester.

Levy – The amount a municipality raises through the property tax. The levy can be any amount up to the levy limit which is re-established every year in accordance with Proposition 2½ provisions.

Levy Ceiling – A levy ceiling is one of two types of levy (tax) restrictions imposed by MGL Ch. 59 §21C (Proposition 2½). It states that, in any year, the real and personal property taxes imposed may not exceed 2½ percent of the total full and fair cash value of all taxable property. Property taxes levied may exceed this limit only if the municipality passes a capital exclusion, a debt exclusion, or a special exclusion. (See Levy Limit).

Levy Limit – A levy limit is one of two types levy (tax) restrictions imposed by MGL Ch. 59 §21C (Proposition 2½). It states that the real and personal property taxes imposed by a city or town may only grow each year by 2½ percent of the prior year's levy limit, plus new growth and any overrides or exclusions. The levy limit can exceed the levy ceiling only if the municipality passes a capital expenditure exclusion, debt exclusion, or special exclusion. (See Levy Ceiling).

Local Aid – Revenue allocated by the Commonwealth to cities, towns, and regional school districts. Estimates of local aid are transmitted to cities, towns, and districts annually by the "Cherry Sheets." Most Cherry Sheet aid programs are considered general fund revenues and may be spent for any purpose, subject to appropriation.

Local Receipts – Locally generated revenues, other than real and personal property taxes. Examples include motor vehicle excise, investment income, hotel/motel tax, fees, rentals, and charges. Annual estimates of local receipts are shown on the tax rate recapitulation sheet.

Motor Vehicle Excise (MVE) – A locally imposed annual tax assessed to owners of motor vehicles registered to an address within the municipality. The excise tax rate is set by statute at \$25.00 per \$1000 of vehicle value. Owner registration and billing information is maintained by the State Registry of Motor Vehicles and is made available to a city or town, or to the Deputy Collector who represents it.

New Growth – The additional tax revenue generated by new construction, renovations and other increases in the property tax base during a calendar year. It does not include value increases caused by normal market forces or by revaluations. New growth is calculated by multiplying the assessed value associated with new construction, renovations and other increases by the prior year tax rate. The additional tax revenue is then incorporated into the calculation of the next year's levy limit. For example, new growth for FY03 is based on new construction, etc. that occurred between January and December, 2001. In the fall of 2002, when new growth is being estimated to set the FY03

Operating Budget – A plan of proposed expenditures for personnel, supplies, and other expenses for the coming fiscal year.

Overlay – (Overlay Reserve or Allowance for Abatements and Exemptions) An account established annually to fund anticipated property tax abatements, exemptions and uncollected taxes in that year. The overlay reserve is not established by the normal appropriation process, but rather is raised on the tax rate recapitulation sheet.

Override – A vote by a municipality at an election to permanently increase the levy limit. An override vote may increase the levy limit no higher than the levy ceiling. The override question on the election ballot must state a purpose for the override and the dollar amount. See underide.

Override Capacity – The difference between a municipality's levy ceiling and its levy limit. It is the maximum amount by which a municipality may override its levy limit.

Payments in Lieu of Taxes – An agreement between a municipality and an entity not subject to taxation, such as charitable or educational organizations, in which the payer agrees to make a voluntary payment to the municipality. By law, a city or town must make such a payment to any other municipality in which it owns land used for public purposes.

Personal Property – Movable items not permanently affixed to, or part of the real estate. It is assessed separately from real estate to certain businesses, public utilities, and owners of homes that are not their primary residences.

Proprietary Funds – Funds that account for government's business-type activities (e.g., activities that receive a significant portion of their funding through user charges). The fund types included in proprietary funds are the enterprise fund and the internal service fund. The internal service fund accounts for certain central services (e.g., data processing, printing, postage, motor pool) and then allocates the cost among departments or funds within the governmental unit.

Reserve Fund – An amount set aside annually within the budget of a city (not to exceed 3 percent of the tax levy for the preceding year) or town (not to exceed 5 percent of the tax levy for the preceding year) to provide a funding source for extraordinary or unforeseen expenditures. In a town, the finance committee can authorize transfers from this fund for "extraordinary or unforeseen" expenditures. Other uses of the fund require budgetary transfers by town meeting. In a city, transfers from this fund may be voted by the city council upon recommendation of the mayor.

Schedule A – A statement of revenues, expenditures and other financing sources, uses, changes in fund balance and certain balance sheet account information prepared annually by the accountant or auditor at the end of the fiscal year. This report is based on the fund account numbers and classifications contained in the UMAS manual.

Stabilization Fund – A fund designed to accumulate amounts for capital and other future spending purposes, although it may be appropriated for any lawful purpose. (MGL Ch. 40 §5B). Municipalities may appropriate into this fund in any year an amount not to exceed ten percent of the prior year's tax levy or a larger amount with the approval of the Emergency Finance Board. The aggregate of the stabilization fund shall not exceed ten percent of the municipality's equalized value, and any interest shall be added to and become a part of the fund. A two-thirds vote of town meeting or city council is required to appropriate money from the stabilization fund.

Tax Rate – The amount of property tax stated in terms of a unit of the municipal tax base; for example, \$14.80 per \$1,000 of assessed valuation of taxable real and personal property.

User Charges/Fees – A municipal funding source where payment is collected from the user of a service to help defray the cost of providing the service. Note that any increases in the fees must satisfy the three tests set forth in the so called Emerson case. See Emerson College v. Boston, 391 Mass. 415 (1984); also DOR IGR 88-207
