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AN OUNCE OF PREVENTION IS WORTH A POUND OF CURE

Executive Summary

As Massachusetts begins to emerge from the budget crisis that began in FY 2002, several competing proposals have been offered that would shape the Commonwealth's fiscal policy for years to come. This paper examines one such proposal – a Constitutional amendment that would mandate annual deposits into the Commonwealth Stabilization Fund and impose restrictions on future withdrawals from the Fund. The paper also discusses other budgetary rules that the Commonwealth could adopt to help prevent future deficits from emerging.

In brief, the proposed Constitutional amendment seeks to build on both one of the major successes of the 1990s – the accumulation of sizable budgetary reserves – and one of the principal lessons of recent years – the value of such reserves during periods of fiscal stress. However, the amendment does not respond to other, no less important lessons, both in its basic premise and in the methods it employs.

Since the advent of the fiscal crisis, Massachusetts has reduced spending on public services by roughly $3 billion and continues to face a structural budget deficit – not because the Commonwealth failed to maintain an adequate Stabilization Fund, but because the Commonwealth, by statute and by ballot initiative, reduced annual tax revenue by more than $3 billion over the course of the 1990s. The proposed amendment would neither remedy such permanently depressed revenue levels, nor would it prevent similar crises from emerging in the future.

In addition, three provisions of the proposed amendment could hinder the Commonwealth's ability to respond to future fiscal challenges. Those provisions would:

- subject withdrawals from the Stabilization Fund to a two-thirds vote in both chambers of the Legislature;
- limit total annual withdrawals from the Fund to 50 percent of its balance; and,
- potentially mandate deposits into the Fund during periods of fiscal stress.

The underlying aims of the proposed amendment – to promote long-term fiscal discipline and to ensure that essential public services can be protected during inevitable economic downturns – are laudable. In the end, though, an ounce of prevention – avoiding the kinds of policies that created Massachusetts' structural budget deficit – would be worth as much as, if not more than, the pound of cure it seeks to provide.

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Introduction

As Massachusetts begins to emerge from the budget crisis that began in FY 2002, several prominent and competing proposals have been offered that would shape the Commonwealth's fiscal policy for years to come. Some proposals – most notably, the recently suggested reduction of the personal income tax rate to 5.0 percent – would simply repeat the mistakes that precipitated the current crisis; others reflect an attempt to learn from the successes and failures of the recent past.

This paper focuses on one proposal from that latter category – a constitutional amendment that would mandate annual deposits into the Commonwealth Stabilization Fund and impose restrictions on future withdrawals from the Fund. More specifically, the proposed amendment consists of three main elements: a requirement for annual deposits into the Stabilization Fund equal to one percent of total tax revenue in the preceding fiscal year; the approval of two-thirds of each chamber of the Legislature to withdraw money from the Fund; and a limit on total withdrawals from the Fund in any given year equal to 50 percent of the Fund's balance. The amendment would also enshrine in the Constitution the same limit on the total balance that may be held in the Fund that now exists in statute – 15 percent of total annual revenue.

Unfortunately, while the amendment seeks to build on one of the principal lessons of the 1990s – namely, the importance of sizable budgetary reserves – in order to ensure long-term fiscal discipline and to leave Massachusetts in a position to weather future budget crises, it does not respond to other, no less valuable lessons, both in its basic premise and in the specific methods it employs. Consequently, the amendment would not address the root cause of the Commonwealth's ongoing fiscal crisis and, thus, would not prevent similar crises from emerging in the future. This paper provides a brief overview of the Commonwealth Stabilization Fund, examines both the premise and the specific provisions of the proposed amendment, and discusses other strategies that could make fiscal crises less likely.

The Commonwealth Stabilization Fund – Overview

Created in 1986, the Commonwealth Stabilization Fund – or the "rainy day" fund, as it is often called – is intended to hold surplus funds, accumulated during periods of economic growth, in reserve for less propitious circumstances. More specifically, Massachusetts General Law stipulates that the Stabilization Fund may be used to compensate for inadequate state revenue, to replace lost federal funds, or to cope with "any event which threatens the health, safety, or welfare of the people or the fiscal stability of the commonwealth or any of its political subdivisions."[1] Under current law, an amount equal

[1] MGL, Chapter 29, Section 2H

to one-half of one percent of total tax revenue in the preceding fiscal year is deposited into the fund on an annual basis, as is any consolidated net surplus that may remain at the end of a given fiscal year. (Direct appropriations also may be made into the Fund – and have been in years past.) However, the total balance in the Fund may not exceed 15 percent of budgeted revenues.[2]

Figure 1.

Stabilization Fund Balances and General Fund Transfers
all figures in thousands of current dollars

FY	Stabilization Fund Balance (at start of fiscal year)	Interest Earnings	Required Transfers to Stabilization Fund	Direct Appropriations to Stabilization Fund	Transfers *Out* to General Fund	Transfers *Out* to Other Funds	Total Transfers to Stabilization Fund (percent of total taxes)	Stabilization Fund Balance (percent of prior year total taxes)
1992	59,199	1,161	170,020	-	-	-	1.8%	0.6%
1993	230,380	2,260	76,872	-	-	-	0.8%	2.4%
1994	309,512	7,972	65,423	-	-	-	0.6%	3.1%
1995	382,907	14,568	27,930	-	-	-	0.3%	3.6%
1996	425,405	22,215	177,405	-	-	81,722	1.5%	3.8%
1997	543,303	21,744	134,253	100,000	-	-	1.0%	4.5%
1998	799,300	42,931	167,357	150,000	-	-	1.2%	6.2%
1999	1,159,588	63,313	165,622	-	-	-	1.2%	8.3%
2000	1,388,523	104,988	114,871	-	-	-	0.7%	9.7%
2001	1,608,382	80,845	51,693	-	-	25,930	0.3%	10.2%
2002	1,714,990	196,781	-	-	1,030,000	-	-	10.2%
2003	881,771	6,456	75,673	356,950	550,000	129,525	0.5%	6.1%
2004	641,325	2,656	-	-	99,815	33,633	-	4.3%

Figure 1 above summarizes the deposits that have been made into – and, recently, the withdrawals that have been made from – the Commonwealth Stabilization Fund. Of note, total transfers to the Fund (both direct appropriations and deposits required under law) averaged $115 million per year from FY 1992 to FY 2001 – or about 0.9 percent of total tax revenue each year. The balance of the Fund averaged 5.25 percent of total annual tax receipts during that span.[3]

[2] This limit has grown over time. When the Fund was established in 1986, the limit was 5 percent of "total state tax revenues received in that fiscal year." In 1997, it was increased to 7.5 percent of budgeted revenues for the preceding fiscal year. In 2001, it was raised again – to 10 percent – and, in 2003, it was raised once more – to its present level of 15 percent. In fact, as approved by the House of Representatives, Section 13 of the FY 2005 budget would increase the cap once again – to 17 percent. In addition, the mandate for deposits of 0.5 percent of total tax revenue is relatively new as well; it was imposed as part of the FY 2004 budget.

[3]For FY 2000 and FY 2002, "Interest Earnings" include transfers from the Transitional Escrow Fund of $25 million and $157.2 million respectively. For FY 1996 and FY 2001, the amounts recorded under "Transfers Out to Other Funds" are transfers to the Tax Reduction Fund. For FY 2003, the roughly $357 million listed under "Direct Appropriations" consists of $170 million in revenue collected due to the clarification of the tax treatment of payments from Real Estate Investment Trusts, $76.5 million from insurance company demutualization, and $170.3 million from the consolidation of a variety of other budgetary funds; the $129.5 million recorded under "Transfers to Other Funds" that year is actually a transfer to the General Fund, but is listed separately since that sum is attributable to the consolidation of other budgetary funds. Finally, the $33.6 million "Transfer to Other Funds" in FY 2004 is a transfer to the Economic Stimulus Trust Fund created by the November 2003 economic stimulus package.

In some respects, Massachusetts' practices are consistent with that of other states, as well as with the recommendations of public finance experts. For instance, 45 states and the District of Columbia now have in place legal mandates to make deposits into their respective "rainy-day" funds under various sets of circumstances. Similarly, in 2002, the Government Finance Officers Association called on states to maintain reserves of no less than 5 to 15 percent of total tax revenue, while an earlier report by the non-partisan Center on Budget and Policy Priorities in Washington, DC found that states would need reserves of roughly 18 percent of total tax revenue to weather a three-year recession. In other respects, though, Massachusetts is in the minority – and would become even more so if the proposed Constitutional amendment were adopted. A mere four states besides Massachusetts – Hawaii, Maryland, Oregon, and Rhode Island – require rainy-day fund deposits of a specific size, while only nine states have given their rainy-day fund mandates constitutional force. In addition, just ten states have super-majority barriers to the use of rainy day funds; thirteen have limits on withdrawals from their respective funds. Finally, six states have both constitutionally-mandated rainy day funds and super-majority barriers to their use.[4]

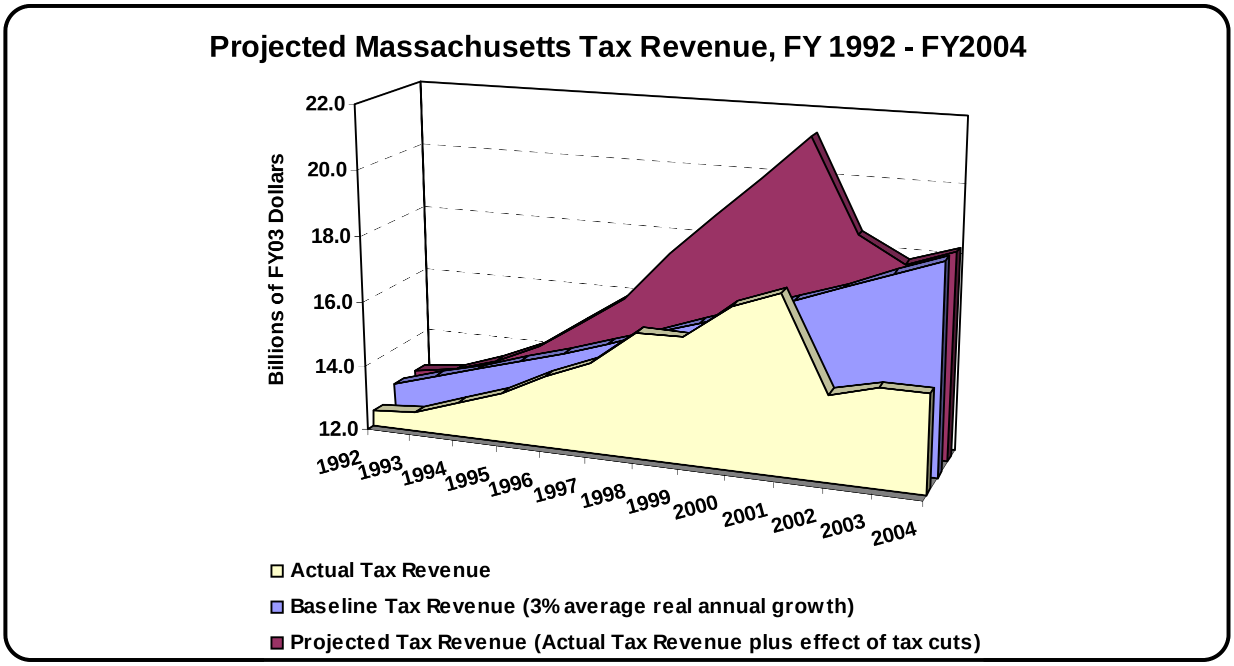
Tax Cuts – Not an Inadequate Stabilization Fund – Are the Source of the Fiscal Crisis

The budget deficits with which Massachusetts has had to grapple over the past several years – and which it will continue to confront for the foreseeable future – are largely structural in nature, not cyclical. That is, they reflect a fundamental mismatch between the revenue the Commonwealth collects on an annual basis and the public services it provides, rather than a temporary downturn in revenue due to Massachusetts' poor economic performance. While the accumulation of significant budgetary reserves – the likely result of the proposed amendment – would help address any cyclical deficits that might arise, they would not be able to resolve any structural deficits – the present one included.

[4] Zahradnik, Bob and Ribeiro, Rose, *Heavy Weather: Are State Rainy Day Funds Working?*, Center on Budget and Policy Priorities, Washington, DC (May 13, 2003); *Rainy Day Funds: State Budget Stabilization Funds*, National Conference of State Legislatures, available at http://www.ncsl.org/programs/fiscal/rdfaxa.htm. Of the six states that have both constitutionally-mandated rainy day funds and super-majority barriers to their use, four – Alaska, Delaware, Louisiana, and Maryland – always face super-majority barriers, while two – Oklahoma and Texas – face them only under certain circumstances.

Stated slightly differently, Massachusetts has not experienced budget deficits in excess of one billion dollars for four consecutive years because the Commonwealth did not have an adequate Stabilization Fund; to the contrary, as Figure 1 indicates, at the onset of the fiscal crisis in FY 2002, the balance of the Stabilization Fund was over $1.7 billion. In fact, between the Stabilization Fund and other reserves, Massachusetts had one of the largest budgetary cushions in the nation at that time.[5]

Figure 2.



Rather, deficits emerged because the Commonwealth, over the course of the 1990s, permanently reduced annual tax revenue by over $3 billion. As Figure 2 above shows, during the latter half of the 1990s, the Commonwealth experienced a temporary revenue "bubble," taking in significantly more revenue than historical trends would have projected. Over roughly the past twenty years, personal income in Massachusetts has grown at a real average annual rate of approximately three percent; one might reasonably expect tax revenue to grow in line with it. In fact, as Figure 2 shows, from FY 1992 to FY 1996, projected tax revenue – that is, actual tax revenue plus the revenue lost due to tax cuts – did keep pace with that trend. However, from FY 1997 to FY 2001, projected tax revenue levels dramatically exceeded that baseline. Projected tax revenue levels plummeted in an equally dramatic fashion in FY 2002 and have not rebounded since.

[5] Zahradnik and Ribeiro, p. 16. Specifically, budgetary reserves in Massachusetts in FY 2001 amounted to 10.4 percent of expenditures; only Alaska, South Dakota, and Wyoming had larger reserves when measured in this fashion.

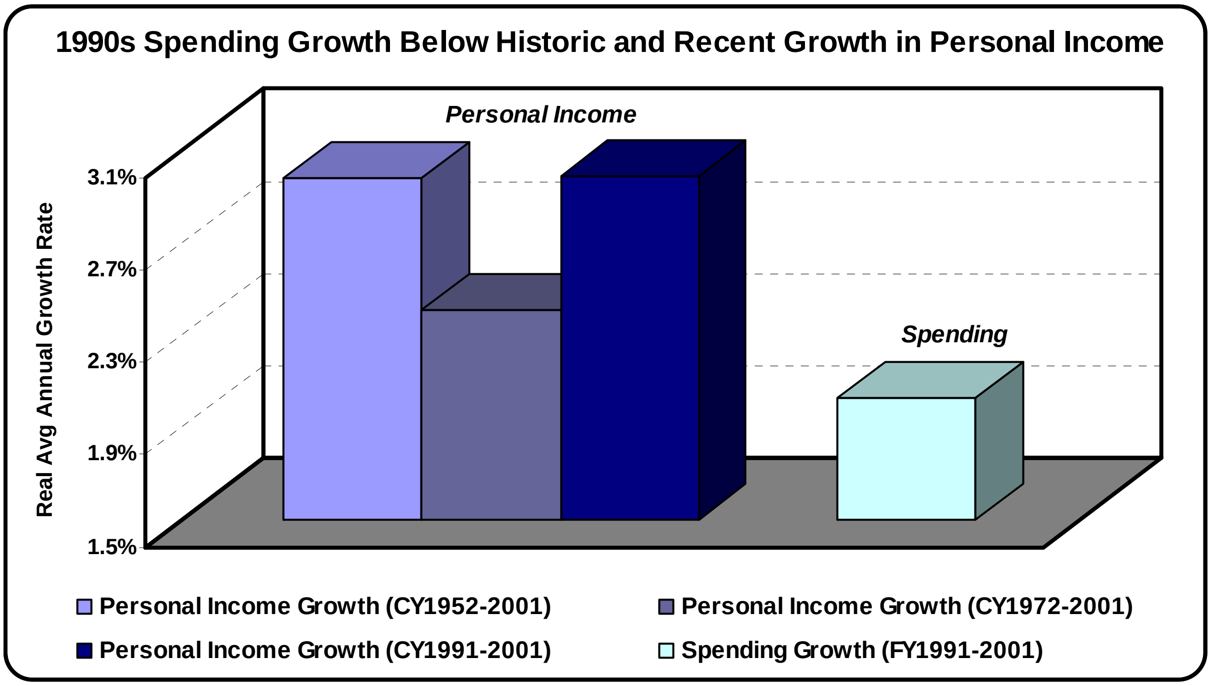
In response to this *temporary* phenomenon, the Commonwealth acted, both through statute and voter initiative, to reduce revenue on *permanent* basis. Between 1991 and 2001, over forty tax cuts were put in place in Massachusetts. All told – and after taking into account the 2002 tax package as well as the closing of some corporate tax loopholes in 2003 – such cuts have reduced the amount of revenue the Commonwealth collects each year by approximately $3.3 billion. Consequently, actual tax collections are now significantly below the baseline level described above.

Of note, a significant fraction of the total tax cut adopted during the 1990s is attributable to reductions in the personal income tax rate. In 1999, Governor Paul Cellucci approved legislation that would have reduced the personal income tax rate from 5.95 percent – its level since 1992 – to 5.75 percent by 2002. However, that legislation was superseded just two years later by the 2000 ballot initiative known as Question 4, the result of which has been to lower the rate still further, to its present level of 5.3 percent. It is estimated that a return to a personal income tax rate of 5.95 percent would generate slightly more than $1 billion for the Commonwealth.

The proposed Constitutional amendment would neither remedy such permanently depressed revenue levels, nor create the most effective mechanism for stopping policymakers from acting in the same fashion should a similar situation arise in the future. To be sure, by mandating deposits into the Stabilization Fund, the amendment could make future “bubbles” appear smaller and thus could reduce the likelihood that temporary run-ups in revenue will be used as the basis for permanent policy decisions. Ultimately, though, budgetary reserves – such as those held in the Commonwealth Stabilization Fund – can only be used to alleviate a crisis; they can not prevent one. Only spending within one’s means – or, as Massachusetts failed to do during the 1990s, ensuring that one has the means to meet vital public needs – can accomplish that.

Of course, it would be exceptionally difficult to claim that Massachusetts did not spend within its means during the 1990s. Data from the Office of the State Comptroller indicate that, after adjusting for inflation, budgeted expenditures grew from $18.0 billion in FY 1991 to $22.4 billion in FY 2003, a real rate of growth of 1.8 percent per year. In contrast, budgeted expenditures rose by more than twice that rate between FY 1983 and FY 1991 – 4.7 percent per year in real terms. Perhaps even more importantly, unlike during the 1980s, the growth in personal income in Massachusetts during the 1990s outpaced spending growth, meaning that, by FY03, state spending consumed a smaller share of all dollars earned in the Commonwealth than it had in FY91. Specifically, real personal income climbed 2.3 percent per year over the FY91-FY03 period, while, again, spending rose by just 1.8 percent; as result, spending as a share of personal income fell from 9.4 percent in FY91 to 8.9 percent in FY03. Finally, as Figure 4 below suggests, spending growth during the 1990s was relatively slow when compared to even longer periods of personal income growth. During the 50-year stretch between 1952 and 2001, personal income in Massachusetts grew at a real average annual rate of 2.98 percent, while during the 30-year period of 1972-2001, it grew by 2.41 percent. Yet, between FY 1991 and 2001, budgeted expenditures in Massachusetts climbed just 2.03 percent annually.

Figure 3.



Specific Provisions of the Amendment Could Prove Problematic

Leaving aside the preceding conceptual discussion, three provisions of the proposed amendment could hinder the Commonwealth's ability to respond to fiscal challenges in the future. Those provisions would:

1. Subject withdrawals from the Stabilization Fund to a two-thirds vote

As written, the amendment would require that any effort to use monies held in the Stabilization Fund would have to be approved by a two-thirds vote "in each branch of the general court." Consequently, just 14 Senators – or 7 percent of the entire General Court – could block the use of rainy day funds in the midst of a fiscal crisis. In turn, the Legislature would be forced to consider either more wrenching changes – such as deeper cuts in essential public services – or less responsible ones – such as securitizing the annual tobacco settlement payments the Commonwealth now receives, an option many states have pursued in recent years.

2. Establish a limit on withdrawals from the Fund in any given year

The proposed amendment stipulates that no more than 50 percent of the Stabilization Fund may be expended in any given year. This too could create a dynamic in which less desirable approaches to closing a particular budget gap would need to be used. For instance, one could envision a scenario in which the Legislature, as part of a comprehensive plan to address a budget deficit, would need to appropriate more than 50 percent of the balance of the Stabilization Fund as a "bridge" to a more lasting solution, such as a phased-in increase in taxes or programmatic reforms that might incur additional costs upfront but that would ultimately yield significant savings. If the Legislature were barred from using more than half of the Stabilization Fund, then, again, some form of borrowing, such as the securitization of tobacco settlement funds, or other gimmicks might become part of the picture. The amendment itself recognizes the need to view the use of reserves as part of a larger solution to budget deficits, as it requires any bill that uses monies from the Stabilization Fund to "…contain a plan for decreasing the necessity for the use of said fund…"

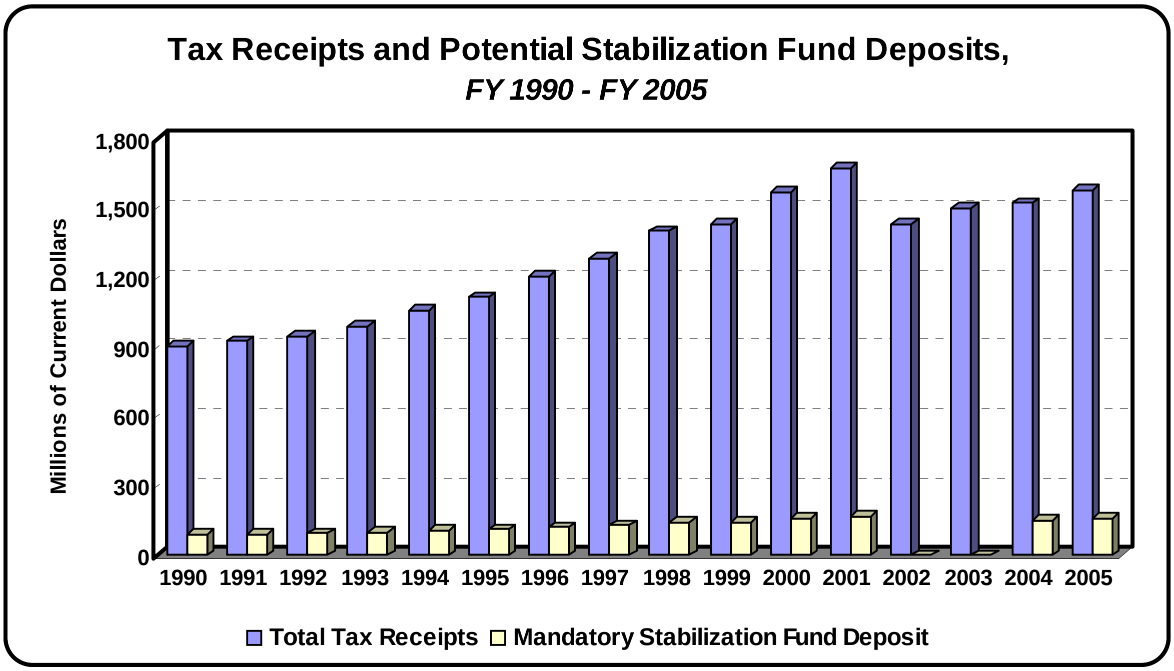
Limiting annual withdrawals to 50 percent of the balance of the Stabilization Fund would have created considerable difficulty in recent years. As Figure 1 indicates, in FY 2002, policymakers used $1.03 billion from the Stabilization Fund to address that year's budget deficit, an amount that exceeded 50 percent of the Fund's balance at the start of the fiscal year. Similarly, the FY 2005 budget approved by the House of Representatives on April 30 relies on a $340 million transfer from the Stabilization Fund to the General Fund to support current spending. Yet, according to the Office of the Comptroller, the Fund held just $510 million as of the end of February. This is not to suggest that policymakers should necessarily resort to other means to balance the budget. The monies reserved in the Stabilization Fund are there to be used in the event of a crisis and that is certainly what Massachusetts has been experiencing for the past several years. Rather, this information is included to illustrate the very real constraints that the proposed amendment would impose.

3. Potentially mandate deposits into the Fund during periods of fiscal stress

In its current form, the proposed amendment would require the Commonwealth to set aside each year, in the Stabilization Fund, a sum equal to one percent of the preceding year's total tax receipts. That requirement would be lifted only in a year in which tax receipts have declined (or failed to grow) from the preceding year or in the first year immediately following a year in which receipts have declined (or failed to grow).

However, as recent experience shows, declining tax receipts are not necessarily a prerequisite for a fiscal crisis. As seen in Figure 4, during the fiscal crisis of the early 1990s, tax receipts continued to climb year after year, yet few would argue that it would have been in the Commonwealth's best interest simply to set aside nearly $100 million per year during that stretch.[6]

Figure 4.



What's more, while tax receipts did decline during the current fiscal crisis, the Commonwealth's fiscal woes have continued beyond the second year of relief allowed for by the proposed amendment. More specifically, had the amendment been in force at the start of the current crisis, deposits would have been suspended in FY 2002 – when total tax receipts plummeted by 14 percent. So too would they have been suspended in FY 2003 – the first year after that 14 percent drop. Deposits would have then resumed for FY 2004 and FY 2005. Yet, by any reasonable definition of the term, these have been – or will be – "rainy days" for Massachusetts: budget deficits in excess of one billion dollars have persisted, spending was reduced by roughly $1.5 billion below the level needed to maintain current services in FY 2004, and the Commonwealth now confronts the prospect of several hundred million dollars in additional cuts in FY 2005.

[6] Although not shown in Figure 3, total tax receipts rose between FY 1988 and FY 1989 and again between FY 1989 and FY 1990; therefore, under the provisions of the proposed amendment, deposits would have been made in FY 1990 and FY 1991.

Other Rules Could Help to Prevent Structural Deficits

Until 2003, the federal budget process was governed, in part, by what were known as "PAYGO" rules. These rules required any legislation that would have cut taxes or increased entitlement spending (that is, spending on programs such as Medicare) to offset such changes with a corresponding tax increase or spending reduction elsewhere in the budget. If a measure failed to do so, its consideration was subjected to certain procedural restrictions in the U.S. Senate. The adoption of these rules in Massachusetts could help to prevent permanent, large-scale tax cuts from jeopardizing the Commonwealth's long-term fiscal health.

Alternatively, Massachusetts could defend against future structural deficits by adopting budget process rules that would:

- Require that, in any given year, any tax revenue that exceeds a specified baseline (for instance, a projection of three percent real annual growth from a pre-determined base year) be deposited in a newly-created Fiscal Responsibility Fund (FRF);

- Prohibit appropriations from the FRF except for non-recurring uses such as building roads, bridges, schools, or community health centers, retiring debt, providing one-time tax cuts similar to those that occurred in 1996, 1997, and 1998, or making deposits into the Commonwealth Stabilization Fund;

- Ensure that the full fiscal impact of any tax cut or spending increase is not shifted off into future years, by requiring that the difference between the current cost of any such tax cut or spending increase and its full annualized cost be deposited in the FRF. For instance, imagine a tax cut that, either because it was phased-in or because it was implemented mid-year, reduced revenue by $200 million in its first year, but that ultimately reduced revenue by $400 million annually. Under this hypothetical set of rules, in the year of enactment, the Commonwealth would have to set aside the difference between the initial cost of the tax cut and its fully-implemented cost – in this case, $200 million.

Variations on these rules are of course possible, but the basic goals should remain the same: the promotion of long-term thinking about fiscal policy, the preservation of the Commonwealth's flexibility in addressing changing economic and fiscal circumstances, the recognition that tax cuts should be treated in the same manner as spending increases, and the accumulation of budgetary reserves during times of prosperity.

Conclusion

Ultimately, it will be political will that protects the fiscal health of the Commonwealth. In some respects, policymakers demonstrated that will during the 1990s, building up one of the largest stores of reserves in the nation, even in the absence of a Constitutional mandate to accumulate reserves or to limit their use. Rules such as those contained in the proposed amendment may help to create an environment in which that will can develop, but they are no substitute for it. In fact, in the event that the amendment were adopted, a significant amount of political will would still be necessary to maintain fiscal discipline, for the amendment would still permit the Legislature to resort to gimmicks such as reducing contributions to the state pension system, extending the period over which the Commonwealth issues debt, shifting operating costs onto the capital budget, or securitizing tobacco settlement monies. To its credit, the Legislature has, for the most part, avoided these maneuvers in recent years.

The underlying aims of the proposed amendment – to promote long-term fiscal discipline and to ensure that essential public services can be protected during inevitable economic downturns – are laudable. Specific provisions of the amendment, however, may keep those aims from being realized, as they would severely limit the Legislature's flexibility in dealing with a fiscal crisis, possibly leading the Commonwealth down a less fiscally responsible road or producing changes that are more wrenching than necessary. In the end, an ounce of prevention – avoiding the kinds of policies that created Massachusetts' structural budget deficit – would be worth as much as, if not more than, the pound of cure the amendment seeks to provide.