New England
# Fiscal Facts

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## Will the Current Boom Encourage States to Spend Too Much?

*By Daniel G. Swaine*

The robust economy appears to have erased from memory the relatively poor fiscal condition many states experienced during the early part of this decade. According to *The New York Times*, many governors are saying in their annual state-of-the-state addresses that times are "as good as it gets." The booming economy has caused revenues to grow faster than spending. Most states enjoyed record surpluses in FY97, and many are forecasting similar conditions for FY98. Bulging reserves have led some states to consider bold new spending programs combined with major tax relief. However, critics are warning that significant new spending and sizable tax cuts could lead to another fiscal crisis. One critic is so concerned about spending trends in his own state that he has proposed limiting expenditure growth to the rate of inflation. In this issue, *Fiscal Facts* examines the extent to which these concerns are warranted.

Booms and busts in a government's financial position are driven by two factors: fiscal management and the business cycle. We start our examination by comparing the two most recent business cycle expansions.[1]

### A Tale of Two Business Cycle Expansions

Table 1 compares expenditures, revenues, and personal income over the two most recent business cycle expansions. During the 1980s expansion, five of the New England states increased spending in excess of revenue growth. Only Maine refrained from this pattern, increasing spending less than revenue growth and in the process building up extensive cash reserves and a solid fiscal position. The pattern has been different in the 1992 to 1997 business cycle expansion. During this expansion, five of the six New England states are showing fiscal prudence, with spending growing more slowly than revenues. New Hampshire is the only state departing from this trend; although real spending has declined in New Hampshire, real revenues have declined faster, exhibiting the effects of legislated tax cuts.

A big difference between the most recent business cycle expansion and the 1980s expansion is the degree to which states have built up their reserves. During the 1980s, the two largest New England states (Connecticut and Massachusetts) spent in excess of revenues to the extent that by FY89 both states had saved little in cash reserves for a fiscal emergency. During the most recent expansion, these two states have built

[1] In order to make the spending and revenue comparisons reported in this article, it was necessary to pool data from numerous sources. For FY91 through FY99, we compiled state spending and revenues from past issues of *Fiscal Facts*, from available state budget documents and comprehensive annual financial reports, and from the National Association of State Budget Officers' (NASBO) *State Expenditure Report*. For FY84 through FY90, we used state revenue data compiled from *Government Finances*, published by the U.S. Bureau of the Census, and then subtracted state general fund surpluses from these Census revenue figures to obtain an estimate of expenditures. Surplus information for this time period was obtained from NASBO's *Fiscal Survey of the States*.

New England
**Fiscal Facts**

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**State Budget Timetables**

*Annual Budgets*
Massachusetts
Rhode Island
Vermont
FY98: July 1, 1997 to June 30, 1998
FY99: July 1, 1998 to June 30, 1999

*Biennial Budgets*
Connecticut
Maine
New Hampshire
FY98-99: July 1, 1997 to June 30, 1999

**Table 1**

**Inflation-Adjusted State Revenues, Spending, and Personal Income Showed Different Patterns of Growth in Two Most Recent Business Cycle Expansions**

*Average Annual Growth Rates*

| | 1984 to 1989 | | | 1992 to 1997 | | |
|---|---|---|---|---|---|---|
| | State Revenues | State Expenditures | Personal Income | State Revenues | State Expenditures | Personal Income |
| Connecticut | 4.7% | 6.8% | 5.6% | 4.6% | 4.3% | 2.1% |
| Maine | 9.2% | 8.8% | 6.3% | 1.4% | 0.4% | 1.3% |
| Massachusetts | 6.1% | 7.6% | 5.6% | 3.4% | 3.3% | 2.9% |
| New Hampshire | 2.9% | 4.1% | 7.4% | –1.4% | –0.4% | 3.3% |
| Rhode Island | 3.1% | 4.3% | 5.3% | –1.8% | –2.2% | 1.4% |
| Vermont | 6.1% | 7.2% | 6.0% | 0.7% | 0.1% | 2.6% |
| New England | 5.5% | 7.0% | 5.8% | 2.8% | 2.6% | 2.5% |
| United States | 3.8% | 5.0% | 3.8% | 3.5% | 3.3% | 2.8% |

up general fund reserves that are in excess of 6 percent of own-source revenues.[2] Another difference between the two expansions is the relatively lackluster performance of personal income growth during the most recent expansion. Region-specific growth in personal income has been only one-third to one-half as strong as during the 1980s expansion. Therefore, out of necessity, state governments have been forced to be more fiscally responsible.

A comparison of expenditure growth with personal income growth during these two time periods offers an idea of the expansion or contraction of government's role in the economy. From 1984 to 1989, four of the states (Connecticut, Maine, Massachusetts, and Vermont) expanded government's role, while the two remaining states (New Hampshire and Rhode Island) reduced it. During the 1992 to 1997 period, state government spending as a percent of personal income increased in Connecticut and Massachusetts. While this may suggest that these two states expanded the role of state government, it could also represent a return to normalcy from spending cutbacks during the 1989 to 1991 recession. In the 1992 to 1997 period, the other four New England states appear to have contracted the role of state government.

## The Big Chill: The Recession of 1989 to 1991

When a recession occurs, two things happen. First, revenues fall off concurrently with declining personal income, the main driver of state tax revenues. Second, there is a concommitant increase in the demand for state government services (unemployment compensation, welfare and Medicaid payments, and higher education). As a result, barring any change in policy, state governments usually experience operating budget deficits. However, most state governments are subject to budget balancing requirements, forcing them to raise taxes and cut expenditures in order to stay fiscally sound.

During the recession of 1989 to 1991, personal income declined sharply

**Table 2**

**Inflation-Adjusted State Revenues, Spending, and Personal Income Showed Big Declines in Recession of 1989 to1991**

*Average Annual Growth Rates*

| | 1989 to 1991 | | |
|---|---|---|---|
| | State Revenues | State Expenditures | Personal Income |
| Connecticut | –1.8% | 5.0% | –0.8% |
| Maine | –4.0% | –1.6% | –0.9% |
| Massachusetts | 0.6% | –3.3% | –2.2% |
| New Hampshire | –2.3% | –1.9% | –2.6% |
| Rhode Island | 0.0% | –1.1% | –2.0% |
| Vermont | 0.3% | 0.2% | –0.3% |
| New England | –0.6% | –0.6% | –1.6% |
| United States | 0.7% | 2.3% | 1.2% |

2 Own-source revenues exclude federal funds. Similarly, own-source spending does not include funds received by the state from the federal government.

in all six New England states, as can be seen in Table 2. Revenue growth was negative in three of the New England states (Connecticut, Maine, and New Hampshire) and was negligible in the other three. The three states with negligible revenue growth increased taxes in order to stem revenue losses.

**Table 3**

**Looking Ahead: State Revenues Versus State Spending Under Two Scenarios**

*Average Annual Growth Rates, FY98 to FY02*

| | A Continued Expansion | | | B Recession | | |
|---|---|---|---|---|---|---|
| | State Revenues | State Expenditures | Personal Income | State Revenues | State Expenditures | Personal Income |
| Connecticut | 6.4% | 4.3% | 2.8% | 3.4% | 4.3% | 1.5% |
| Maine | 4.1% | 3.1% | 2.9% | 2.2% | 3.1% | 1.6% |
| Massachusetts | 5.4% | 3.3% | 3.9% | 2.8% | 3.3% | 2.0% |
| New Hampshire | 1.6% | 1.2% | 3.7% | 0.9% | 1.2% | 2.0% |
| Rhode Island | 1.0% | 2.7% | 1.7% | 0.6% | 2.7% | 0.9% |
| Vermont | 1.5% | 0.1% | 1.5% | 0.9% | 0.1% | 0.9% |
| New England | 3.9% | 2.6% | 3.3% | 2.1% | 2.6% | 1.7% |

To satisfy budget balancing requirements, Maine, Massachusetts, New Hampshire, and Rhode Island cut expenditures during the recession. In Maine and New Hampshire, revenues declined still faster than the cutback in spending, eating into cash reserves. In Massachusetts and Rhode Island, large tax increases were enacted in order to curb the revenue decline.

Connecticut maintained expenditure growth in the face of declining revenues and in spite of a lack of available cash reserves. The run-up in debt that occurred as a result of this policy forced Connecticut to enact its first-ever income tax in FY92. The new tax altered the responsiveness of Connecticut's tax system to economic activity. Prior to FY92, Connecticut's revenues moved in tandem with personal income, but not quite as fast. With enactment of the personal income tax, revenues have increased faster than personal income.

Connecticut and Massachusetts, the two largest states in New England, account for three-fourths of the region's personal income and nearly four-fifths of the region's state government revenues and expenditures. Currently, these two states have revenue systems that are highly responsive to personal income. Unless they build sufficient reserves during profitable times, these states are highly vulnerable to fiscal problems during any economic downturn.

## Looking Ahead

As the preceding discussion indicates, the fiscal crisis in New England during the early 1990s derived from an extraordinarily harsh recession and a spending surge during the 1980s expansion that left reserve balances too low to provide much of a cushion when revenues subsequently turned down. In contrast, the fiscal restraint of New England's state governments during the current expansion has led to a healthy build-up in cash reserves, averaging 6.6 percent of current state government revenues. Will this be sufficient to cover shortfalls from a future recession?

Tables 3 and 4 attempt to answer this question.[3] Table 3, Panel A, compares planned state spending for FY98 to FY02 (projected average annual growth according to current plans) with projected average annual growth rates in personal income and state revenues, assuming the economic expansion continues. The personal income numbers are forecasts of the New England Economic Project (NEEP) for FY98 to FY99; it is assumed that these hold through FY02. The revenue growth numbers are derived from the personal income numbers. NEEP projects personal income growth that is "average" for an expansion period — ahead of the slower growth experienced in the 1992 to 1997 expansion (except in Vermont), but below the exceptionally strong growth seen in the 1984 to 1989 expansion. Under this scenario of continued economic expansion, all six New England states continue to maintain healthy fiscal positions. Only Rhode Island is proposing to increase spending faster than projected revenue growth.

Table 3, Panel B, forecasts what would happen if a regional recession occurred during the FY98 to FY02 time period. For this scenario, we project that personal income and revenue growth slow in a manner consistent with an

3 For the projections contained in Tables 3 and 4, we use personal income data for each New England state for FY49 to FY97 published by the Bureau of Economic Analysis, and reserve balances from various issues of the *Fiscal Survey of the States* published by the National Association of State Budget Officers (NASBO). In order to determine the number, duration, and depth of the recessions in New England, we eliminate the long-run trend in the personal income data series for the region. The "de-trended" data display four postwar recessions: two major recessions — FY74-FY76 and FY89-FY92; and two minor recessions — FY57-FY58 and FY81-FY82. Two other postwar recessions occurred nationwide, FY53-FY54 and FY70-FY71. The FY53-FY54 recession does not appear in the New England data. The FY70-FY71 recession appears in the actual data, while in the de-trended data, it is combined with the FY74-FY76 episode. The five New England recessions lasted an average of 1.6 years (peak to trough). The average annual rate of growth during these five recessionary periods was -0.5 percent.

## Table 4

### Looking Ahead: Prospective Budget Deficits Versus Current Reserves If a Recession Develops in FY99

*Millions of 1997 Dollars*

| | Connecticut | | Maine | | Massachusetts | | New Hampshire | | Rhode Island | | Vermont | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Revenues | Expenditures | Revenues | Expenditures | Revenues | Expenditures | Revenues | Expenditures | Revenues | Expenditures | Revenues | Expenditures |
| FY97 | 8,711.1 | 8,446.8 | 2,109.1 | 2,014.3 | 15,280.1 | 15,096.6 | 1,153.9 | 1,146.8 | 2,491.1 | 2,434.7 | 932.1 | 881.7 |
| FY98 | 9,265.9 | 8,807.2 | 2,195.5 | 2,076.4 | 16,107.5 | 15,599.5 | 1,172.9 | 1,160.6 | 2,517.1 | 2,499.7 | 946.5 | 882.4 |
| FY99 | 9,159.3 | 9,183.0 | 2,180.0 | 2,140.5 | 15,994.1 | 16,119.1 | 1,170.3 | 1,174.6 | 2,509.2 | 2,566.5 | 941.7 | 883.2 |
| FY00 | 9,224.5 | 9,574.8 | 2,189.5 | 2,206.5 | 16,063.7 | 16,656.1 | 1,171.9 | 1,188.7 | 2,514.1 | 2,635.0 | 944.6 | 883.9 |
| FY01 | 9,679.8 | 9,983.3 | 2,257.9 | 2,274.6 | 16,670.8 | 17,210.9 | 1,185.6 | 1,203.0 | 2,539.1 | 2,705.4 | 959.1 | 884.6 |
| FY02 | 10,296.4 | 10,409.3 | 2,350.4 | 2,344.7 | 17,573.5 | 17,784.3 | 1,205.1 | 1,217.4 | 2,565.5 | 2,777.7 | 973.9 | 885.4 |
| FY03 | 10,952.2 | 10,853.5 | 2,446.7 | 2,417.0 | 18,525.0 | 18,376.7 | 1,225.0 | 1,232.1 | 2,592.2 | 2,851.9 | 988.9 | 886.1 |
| Totals, FY98-FY02 | 47,625.8 | 47,957.7 | 11,173.3 | 11,042.7 | 82,409.6 | 83,369.9 | 5,905.8 | 5,944.3 | 12,644.9 | 13,184.3 | 4,765.8 | 4,419.5 |
| Cumulative Deficit FY98-FY02 | −331.8 | | 130.6 | | −960.3 | | −38.5 | | −539.4 | | 346.4 | |
| Current Reserves FY97 | 600.0 | | 63.0 | | 1,194.0 | | 19.0 | | 111.0 | | 35.0 | |
| Shortfall | 0.0 | | 0.0 | | 0.0 | | −19.5 | | −428.4 | | 0.0 | |

average recession occurring in FY99, while spending continues to grow in accordance with current plans. Under this recession scenario, real revenue growth for every New England state except Vermont would drop below real expenditure growth. With no change in inflation-adjusted spending, operating budget deficits would develop. Would the considerable cash reserves (including stabilization fund balances) built up by the states during the recent expansion be sufficient to cover these deficits?

Projected revenues, spending, and deficits, along with likely available cash reserves, are shown in Table 4. Since FY98 is more than half over, we project that current growth continues for one year (FY98). A moderate recession starts in FY99 and ends in the middle of FY00. Positive but sluggish economic growth occurs in FY01, with a return to trend growth in FY02. From this five-year prediction, we obtain the cumulative budget deficits that would exist at the end of FY02 in each of the New England states. Since the recession does not begin until FY99, the cumulative deficits take into account the large surpluses that are projected for FY98. We compare these deficits with each state's reserve balances at the end of FY97.

Multi-year deficits would accumulate in four of the six New England states: Connecticut ($332 million), Massachusetts ($960 million), New Hampshire ($39 million), and Rhode Island ($539 million). The size of these accumulated deficits is not large, averaging 6.6 percent of FY98 expenditures. In Connecticut and Massachusetts, FY97 reserve balances would be more than sufficient to finance the projected deficits. New Hampshire and Rhode Island would have unfinanced cumulative deficits of $20 million (1.7 percent of expenditures) and $428 million (17 percent of expenditures), respectively. Only Rhode Island — because of its historically sluggish revenue growth — appears to be vulnerable to fiscal problems in a moderate recession.

## Implications and Conclusions

Our analysis of state spending and revenue trends suggests that the New England states are not committing themselves to fiscally imprudent spending patterns. If the current expansion continues at its present rate of growth, both recent spending and proposed spending through FY99 represent rather modest increases that are within the states' fiscal means. Under this scenario of continued expansion, the New England states will continue to rack up hefty surpluses.

Inevitably, another recession will strike the region. Because the timing of the next recession is uncertain, it is prudent for state policymakers to continue to show fiscal restraint. Our recessionary projections show that if an "average" recession were to hit within another year, current reserve balances would be sufficient to finance current spending plans in most states. Only Rhode Island could be vulnerable to fiscal problems in a future recession. It should be emphasized that these conclusions are tentative and sensitive both to the duration of the recession (a longer duration means larger cumulative deficits) and to its depth (a more severe recession means larger cumulative deficits).

Connecticut and Massachusetts have legislated many large tax cuts whose full effects have yet to be felt. Furthermore, both states are considering enacting very large tax cut proposals during the current legislative session. Because of the uncertainties inherent in estimating the revenue losses from tax cuts, even more sizable deficits than we have projected could be possible in an average recession. Policymakers should keep these potential deficits in mind when weighing the merits of future tax cuts and spending increases. **FF**

# Across *the* Region

Revenue growth remains robust across the region, reflecting the strength of the regional economy. In almost every state, revenues are significantly exceeding projections, and every state expects to realize healthy budget surpluses. State legislators are currently debating how to dispose of the expected surpluses. Tax relief and one-time spending increases seem to be the preferred alternatives.

Connecticut and Massachusetts are both considering major tax cut proposals. Massachusetts is debating several tax reductions, including a $1.6 billion personal income tax cut proposed by Acting Governor Paul Cellucci. Connecticut, having already reduced personal income taxes by $250 million last June, is considering a further cut of $75 million in this tax.

Four states are making major changes in educational financing. Massachusetts is continuing to make substantial increases in its aid to local education in accordance with legislative commitments made in 1993. Vermont has recently revised its historic reform enacted last year. Connecticut is considering a five-year educational initiative recently proposed by Governor John Rowland. And New Hampshire is starting to outline a response to a state Supreme Court decision in December which said that its educational finance system violates the state's constitution. All in all, it is an exceptionally active legislative session.

**Total State Appropriations for FY98 and Proposed Appropriations for FY99[a]**

*Excluding Federal Dollars*

| | FY98 | FY99 | Percent Change |
|---|---|---|---|
| | Millions of Dollars | | |
| Connecticut | 8,521.8 | 8,819.1 | 3.5 |
| Maine | 2,055.4 | 2,226.1 | 8.3 |
| Massachusetts | 15,473.5 | 15,844.4 | 2.4 |
| New Hampshire[b] | 1,188.1 | 1,222.1 | 2.9 |
| Rhode Island[c] | 2,581.9 | 2,669.9 | 3.4 |
| Vermont[d] | 1,303.5 | 1,325.5 | 1.7 |

[a] Unless otherwise noted, includes general fund and transportation fund appropriations only.
[b] Includes budgeted income from sweepstakes earmarked for foundation aid and special education.
[c] Includes general revenue and other unrestricted funds.
[d] Includes Act 60 spending for FY99. FY98 expenditures are appropriately adjusted for comparison.

Source: Official budget documents, state financial statements, and conversations with state budget officials.

# Six-State Review

## Connecticut

Through February, FY98 tax collections totaled $4.7 billion, up 8.1 percent from the same period one year earlier. Connecticut's Office of Fiscal Analysis had projected revenue growth of 3.3 percent for the period. Personal income tax collections were up by 14.8 percent, far above projected growth of 6 percent, indicating strong labor market conditions. If collections continue to grow at this pace, the state should realize a revenue surplus of $338 million, or about 4.6 percent of projected revenues.[1]

Governor John Rowland has submitted a $184 million supplemental appropriation request for FY98 and a $394 million adjustment for the second year of the biennium budget enacted last June. The proposed budget adjustment sets FY99 own-source spending[2] at $8.8 billion, up $297 million (or 3.5 percent) over estimated FY98 expenditures. Most of the adjustments are for increases in social services, with increases in education spending making up most of the rest. The new educational funding is part of the state's response to the *Sheff* v. *O'Neil* case, in which the Connecticut Supreme Court ordered the state to reduce disparities between educational districts in both racial composition and property wealth starting in academic year 1998-99. As an initial response to the court order, in the biennium budget enacted last June, education expenditures were scheduled to increase by $52 million for FY99. In his budget adjustment, Governor Rowland proposed an additional supplement of $31.4 million as part of a new five-year educational plan, designed as a comprehensive remedy to the *Sheff* case.

The Governor's recently announced education plan calls for a $465 million increase in education funding spread over five years, and would provide an average annual funding increase of $93 million for the state's 20 "neediest" communities. The plan is the result of a study of spending disparities conducted by the Department of Education. The spending increases would be targeted to the sources of the spending disparities: class size ($50 million), instruction time ($45 million), and school condition ($265 million).

To reduce racial disparities as required by the *Sheff* ruling, new regional school districts would be formed, with a new formula to distribute local aid among them. The Governor's education proposal would create a commission to study the regionalization of school districts in calendar year 1998 and submit a report in early 1999. The plan would incorporate school choice (students would be allowed to choose which school in their regional district they would attend). The communities of Hartford, Bridgeport, and New Haven would each form regionalized school districts in FY99. The remainder of the state's communities would form such school districts in FY00. Although this plan appears to address the issues in the *Sheff* case, the plaintiffs are not pleased with the speed of implementation and plan to return to court to force a faster remedy.

In addition to the supplemental budget appropriations, the Governor has proposed an ambitious tax initiative for FY99, the centerpiece of which is a $200 million reduction in income taxes. The tax cut would comprise two parts: a permanent increase in the level of income that would be taxed at 3 percent (the lowest tax bracket), which would cost $75 million; and a one-time tax rebate of $125 million. The permanent tax reduction would be added to a similar broadening of the 3 percent tax bracket that was enacted last June. Combined, these two permanent income tax reductions would total $325 million. The one-time rebate of $125 million would be financed from

1 A revenue surplus is defined as the difference between projected year-end tax revenues based on current growth trends and projected year-end tax revenues from the official forecast. An operating budget surplus is the difference between year-end revenues and year-end expenditures. An operating budget surplus includes the revenue surplus, but is also more expansive than the revenue surplus concept.

2 Own-source spending does not include funds received by the state from the federal government. See *Fiscal Facts*, Spring 1997, for more information. Similarly, own-source revenues exclude federal funds.

an operating budget surplus that is projected to be about $175 million for FY98. The remaining $50 million of this surplus is scheduled for deposit in the state's "rainy day" fund.

## Maine

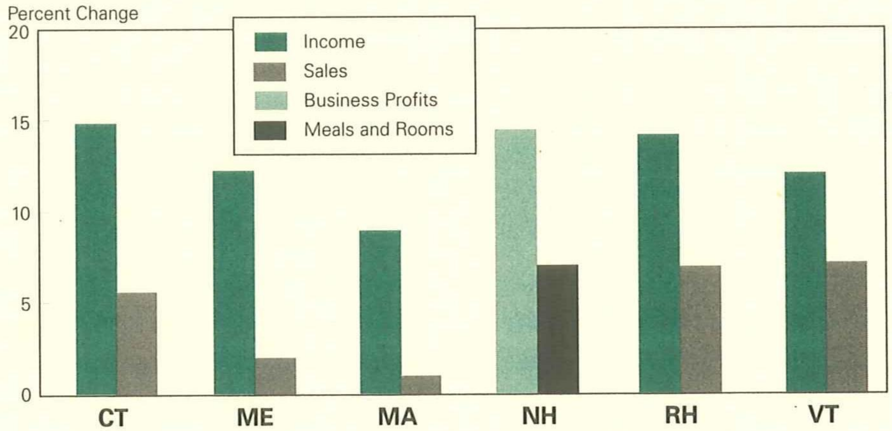
As of the end of February, total FY98 general fund receipts were up 7.1 percent from the same period one year earlier — 3.1 percentage points above expected growth. Reflecting a strong labor market, personal income tax receipts grew by 12.2 percent, exceeding expected growth of 7.7 percent. Corporate income tax receipts grew 7.6 percent, outstripping projected growth by 1.4 percentage points.

Maine expects an operating budget surplus to build to $215 million by the end of FY99. In February, Governor Angus King had proposed that $185 million of this expected surplus be earmarked for tax relief, with the remaining $30 million to be used for supplemental appropriations. However, at the end of March, the legislature enacted an adjustment for the biennium budget that appropriates the expected surplus quite differently. Less is given to tax relief, and more is provided for supplemental appropriations The adjustment specifies new spending of $97.1 million — $27.1 million for additional operating expenditures and $70 million for one-time capital expenditures. The capital spending includes $20 million for school repairs, $38 million for prison renovations, and $12 million for bridge and highway repairs. These supplemental expenditures might seem large, given that Maine's spending is projected to increase by 8 percent in FY99 (see table, page 5). However, most of the latter increase reflects a shift in certain hospital appropriations from "off-budget" to "on-budget" status. These appropriations had been funded by the hospital gross-receipts tax that was repealed last year and will now be funded with general revenues.

The budget adjustment also appropriates $76 million for property and income tax reductions. Property tax relief will take the form of a homestead exemption equal to the first $7,000 of the value of the taxpayer's primary residence. To reduce income taxes, the personal income tax exemption will be increased from $2,400 to $2,750. Approximately $30 million of the expected surplus is to be deposited in the state's "rainy day" fund.

**Revenues from the Two Largest Taxes in Each New England State**

*First Eight Months of FY98 Compared with First Eight Months of FY97*




Source: Official budget documents, state financial statements, conversations with state budget officials.

## Massachusetts

Revenues continue to flow into the Commonwealth's coffers at a healthy pace. For the first eight months of FY98, tax collections totaled $8.4 billion, up 5.9 percent from the same period one year earlier and significantly above projections. Both the Massachusetts Taxpayers Foundation (MTF) and the Cellucci administration had forecast revenue growth in the range of 2 to 4 percent.

Personav¯income tax collections grew at an annual rate of 8.9 percent, above projected growth of 6.5 percent. If revenue growth continues at this pace, Massachusetts should realize a revenue surplus of $465 million, or about 3.5 percent of projected FY98 revenues.

In January, Acting Governor Paul Cellucci submitted a budget adjustment recommending supplemental appropriations of $361 million for the FY98 budget (2.4 percent over initial appropriations). He also submitted a $15.8 billion own-source spending proposal for FY99, up 2.4 percent over the adjusted FY98 budget. The proposal projects a year-end operating deficit for FY99 of $99 million, due in part to recommended tax reductions. Accumulated fund balances should easily cover this shortfall.

The FY99 budget proposal contains one major spending initiative and some new tax cuts. The major spending initiative is an increase of $309.7 million (up 8 percent) in aid to cities and towns. The bulk of this increase is allocated to K-12 education ($269 million, or 10.4 percent) as required by the Educational Reform Act of 1993. The major tax cuts proposed by the Governor include a reduction in the personal income tax rate from 5.95 percent to 5 percent and a reduction in the unearned income tax rate from 12 percent to 5 percent. When fully phased in, these two tax cuts would cost the Commonwealth an estimated $1.6 billion per year in lost revenues (12 percent of projected FY98 tax revenues). The administration projects the FY99 revenue loss to be $235.8 million.

## New Hampshire

For the first eight months of FY98, tax revenues grew 7.9 percent over year-ago levels, exceeding projected growth of 3.6 percent. Sizable increases were reported in collections from the business profits tax, which were up 14.4 percent, and in rooms and meals tax collections, which increased 7.0 percent. For FY97, strong revenue growth combined with fiscal restraint yielded an operating surplus of $43 million, which reduced the accumulated deficit in the general fund balance from – $44 million to – $1 million.[3]

In the spring of 1997, New Hampshire lawmakers passed a biennium budget that sets own-source spending at $1.19 billion for FY98 and $1.22 billion for FY99. No supplemental appropriation requests have been made to date, and in January legislators vowed that there would be none.

In December, in *Claremont School District et al.* v. *Governor et al.*, the New Hampshire Supreme Court declared that the current method of financing K-12 education through the local property tax was unconstitutional. The Court said that relying on local property taxes creates gross inequities in terms of tax rates and per pupil spending between poorer and wealthier communities. The Court mandated the legislature to enact a new school finance plan by April 1, 1999. The ruling differs from educational reform in other states in that the legislature must also develop a satisfactory definition of educational adequacy.

Among the many proposals in front of the legislature is Governor Jean Shaheen's Advancing Better Classrooms, or ABC plan. Under this plan, the estimated cost per student would be $4,500, and the equalized property tax statewide would be $13.44 per $1,000 of assessed value. Currently, the average spending per pupil statewide is $5,390, with a school tax rate of $18.61. Yet spending per pupil in 1996 was as low as $3,949 in Allenstown and as high as $12,670 in Waterville Valley. School tax rates also vary widely across the state. Allenstown's 1996 school tax rate was $29.44 per $1,000 of assessed value, while Waterville Valley's was $3.92.

Under the ABC plan, communities that cannot raise the full amount per student at the equalized rate would be subsidized with additional state funds, supplied by a tax on legalized gambling or a hike in the cigarette tax. In June, the New Hampshire Supreme Court determined that the ABC plan does not remedy the problems raised in the *Claremont* decision in that it fails to equalize tax rates between wealthy and poor communities.

## Rhode Island

Tax revenues in Rhode Island continue to grow far above recently revised projections. Through February, FY98 tax collections totaled $943.2 million, up 10.4 percent from the same period one year earlier. Revenue forecasters had assumed that some recently legislated income and business tax cuts would reduce revenues and had

[3] The general fund balance is the accumulation of past operating surpluses and deficits. At the end of FY96, the general fund balance was $44 million in the red as a result of recent operating deficits. Strong revenue growth combined with fiscal restraint in FY97 yielded an operating surplus of $43 million, improving the general fund balance to –$1 million.

pegged projected growth at only 4.4 percent. However, revenues have surged across the board, with collections from income, sales, and corporate taxes registering growth rates of 14.1 percent, 7.7 percent, and 24.4 percent, respectively. Projected growth rates for these three taxes were 7.0 percent, 5.5 percent, and – 0.6 percent, respectively. If revenues continue to flow in at this pace, Rhode Island should realize a revenue surplus of $88.3 million, or about 5.7 percent of projected FY98 tax revenues.

In February, Governor Lincoln Almond submitted a budget adjustment that recommends supplemental appropriations of $45.3 million — 1.8 percent of the $2.5 billion FY98 budget enacted last June. He also submitted a $2.7 billion own-source spending proposal for FY99, a 3.4 percent increase over projected FY98 spending. The proposal would continue the policy set last year of transferring about 2 cents of the gas tax from the general fund to the transportation fund — a transfer amounting to $6.6 million, or about 7 percent of the transportation budget.

The budget proposal contains one major tax cut and one minor spending initiative. The spending initiative would increase state aid to local education by $15.6 million (a 3.6 percent increase). The major tax cut would provide tax relief to Rhode Island's property taxpayers. Property taxes would be lowered by $190 million over five years (an average of $38 million per year) through a credit to the property owner's tax bill. The value of this credit would be $135 per year per taxpayer in FY00 and would increase by $10 every year until reaching $175 per year in FY04. The credit would be rebated by the state to the municipality.

The Governor proposed to finance the $38 million annual cost of the property tax reduction with excess Depositors Economic Protection Corporation (DEPCO) sales tax revenues, a plan heavily criticized by the legislature. DEPCO was formed to pay off debts to depositors as a result of the state's 1991 credit-union collapse. DEPCO sales tax revenue for FY99 is estimated to be

## Overview of New England Economy in 1997

*New England Economic Indicators*, a statistics publication of the Federal Reserve Bank of Boston, features an article in the June 1998 issue on the 1997 economic performance of the six New England states. Authored by four Research Department staff members, the article reviews job growth, labor market conditions, and business-sector trends in each of the states. There is also information on growth in personal income, wages and salaries, and consumer prices.

Copies of the June issue of *New England Economic Indicators* may be obtained without charge upon request to the Research Library–D, Federal Reserve Bank of Boston, P. O. Box 2076, Boston, MA 02106-2076. The fax number is (617) 973-4221, and the e-mail address is boston.library@bos.frb.org.

The full text of the New England economic overview article is available on the World Wide Web at:

**http://www.bos.frb.org/economic/neei/perform.htm**

$48.9 million; the existing debt repayment schedule requires $18.6 million, leaving "excess" revenues of $30.3 million. The legislature wants to use this excess to repay debt — either by accelerating DEPCO debt repayment or retiring other state debt.

## Vermont

Tax revenue growth in Vermont continues to surpass projections. Through February, FY98 tax collections were up 8.2 percent over the same period one year earlier, above projected growth of 6 percent. If current growth continues, Vermont should end the year with a revenue surplus of $15.3 million, approximately 2 percent of projected revenues. Reflecting a combination of strong labor market conditions and fast growth in the stock market, personal income tax revenues were up 12 percent from one year ago, twice the projected growth of 5.9 percent.

In January, Governor Howard Dean released his proposed FY99 budget and revised his FY98 spending projections. He recommended that total FY98 appropriations be reduced by 0.3 percent and proposed FY99 own-source spending of $1.33 billion, up 1.7 percent from the adjusted FY98 figure.[4] With the exception of appropriations and revenues relating to the education finance reform legislation (Act 60), the FY99 budget proposal contains no new taxes and no deep cuts in any single function. A fraction of the projected budget surplus of $30 million for FY98 might be used for one-time expenditures. However, most of the surplus would be used to pay "unexpected costs" of Act 60. A tax cut is unlikely unless the projected surplus can be expected to continue for the foreseeable future. A box accompanying this text summarizes the provisions of Act 60 and revisions recently enacted into law. **FF**

### Act 60

**Major Provisions:**

- State increases its share of education spending from 32 percent to 79 percent.
- State education funding is to be paid for by:
  - Statewide property tax at a rate of 1.1 percent of all taxable property.
  - Increases in other taxes: rooms and meals taxes, gasoline tax, and corporate income tax.
- Local option taxes that are allowed are a property tax, sales tax, and room and meals tax.

**Major Revisions:**

- A yet to be determined public school choice program for students between grades nine and twelve will be "established" by the general assembly for the school year 2001-2002.
- Local governments will be allowed to grant property tax reductions to businesses for local development. However, if these property tax breaks are not approved by the state, the local government will have to subsidize the tax break so that the same total property tax revenue reverts back to the state.
  - Business tax incentives were enacted, for a total revenue cost of $2 million.
- Phase-in of revenue sharing was extended from three years to four years.

4 Previously, *Fiscal Facts* reported own-source spending in Vermont as the sum of the General Fund and the Transportation Fund. With the implementation of Act 60 education finance reform in FY99, Vermont has added a new fund, the Education Fund, to account for the state's educational funding. The measure of own-source spending used by *Fiscal Facts* now includes the General and Transportation Funds, plus the Education Fund. FY98 spending totals reported earlier have also been adjusted to incorporate this accounting change. FY98 education expenditure is the sum of total spending on education by the state and by local governments. These changes are summarized as follows:

**In Millions of Dollars**
**Budget Appropriations:**

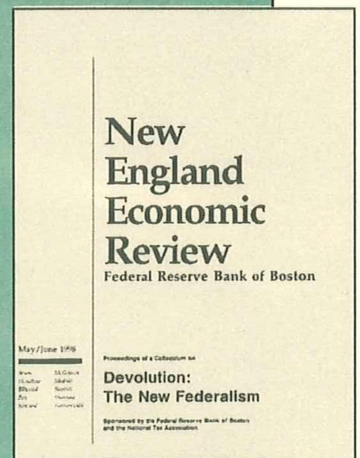
| | FY98 | FY99 |
|---|---|---|
| General Fund | 546.7 | 561.9 |
| State Education Expenditure | 208.9 | 575.3 |
| Transportation Fund | 161.4 | 163.6 |
| Special Act 60 Appropriations | 24.7 | 24.7 |
| Total Appropriations | 941.7 | 1,325.5 |
| Percent Growth | | 40.8% |

**Sources:**
(New Educational Financing by the State)

| Education Fund | FY99 |
|---|---|
| Act 60 Taxes | 63.5 |
| Statewide Property Taxes | 384.4 |
| State Aid to Education | 135.8 |

# Devolution: The New Federalism

*Devolution: The New Federalism*, the proceedings of a colloquium sponsored by the Federal Reserve Bank of Boston and the National Tax Association in October 1997, has been published in the May/June issue of the Bank's *New England Economic Review*. The colloquium brought together experts on intergovernmental relations; business executives; local, state, and federal policymakers; and leaders of national interest groups and private social service organizations whose constituents are significantly affected by devolution. In one session, participants focused on the devolution movement's fundamental tenets; its philosophical, political, social, and economic origins; and its progress to date in achieving its goals. In another session, they assessed devolution's probable impact on the behavior of states and municipalities, especially the capacity of lower levels of government to assume devolved responsibilities.




The proceedings include the two major papers presented at the conference and the prepared comments of the two groups of panelists, along with an overview of the entire colloquium. Authors of the papers are John Kincaid, Professor of Government and Public Service at Lafayette College, and Robert Tannenwald, Assistant Vice President and Economist at the Boston Fed. The panelists include David Beam of Illinois Institute of Technology, David T. Ellwood of Harvard University, William F. Fox, President of the National Tax Association and Professor at the University of Tennessee, William B. Modahl, Director of Tax Affairs at Digital Equipment Corporation, and Isabel V. Sawhill of the Urban Institute, among others.

Copies of the May/June issue of the *New England Economic Review* may be obtained without charge upon request to the Research Library–D, Federal Reserve Bank of Boston, P.O. Box 2076, Boston, MA 02106-2076. The fax number for the library is (617) 973-4221, and the e-mail address is boston.library@bos.frb.org.

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**http://www.bos.frb.org/economic/neer/neer98.htm#may/june1998**