

# Fiscal Facts

Spring 1993

Federal Reserve Bank of Boston

## State Spending for New England's Public Schools

During the past two years, fiscal troubles in New England have severely limited state governments' ability to increase funding for elementary and secondary schooling. Despite growing concerns about the quality of public education, two states, Connecticut and New Hampshire, cut inflation-adjusted K-12 spending in Fiscal Year 1992 (FY92) and FY93 (Chart 1). The other four cut spending in one of the two years. Looking ahead, the governor of Connecticut has proposed an increase for FY94; the rest have proposed cutting further.

These cuts have imposed significant stress on the region's local school districts, which rely on state aid to help finance their budgets. The impact of cuts in aid depends both on the extent of the cuts and on the share of local school budgets funded by the state.

It is unclear which school districts have been most affected by cuts in state aid. The state that cut its aid in FY93 by the greatest percentage,

Vermont, ranks fifth in New England in the degree to which it subsidizes its local school districts (Table 1). The state that cut its aid by the lowest percentage, Maine, ranks first. Despite their high degree of financial independence, New Hampshire's school districts have also been adversely affected by aid cuts.

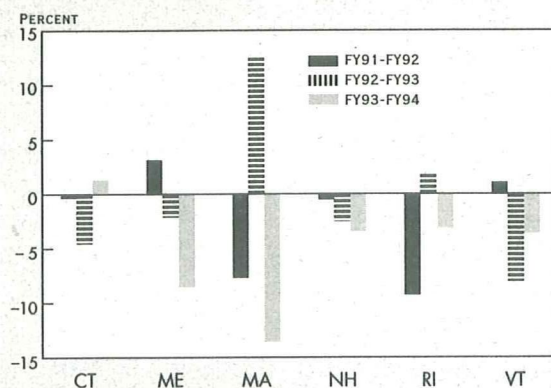
### State Aid to Schools in FY92 and FY93

Connecticut, Maine, New Hampshire, and Vermont budgeted fewer inflation-adjusted dollars for schools in FY93 than in FY92 (Chart 1 and Table 2). In FY92, all four states attempted to shore up their school spending by expanding it more than state spending as a whole or cutting it less (Chart 2). In FY93, however, they have reversed their priorities, shrinking inflation-adjusted K-12 appropriations while on average level-funding or slightly expanding other programs (Chart 3).

Massachusetts and Rhode Island increased their FY93 inflation-adjusted outlays for K-12 education by 12 percent and 2 percent, respectively. However, these increases do not fully offset reductions made in previous years. The Massachusetts increase follows three consecutive years of substantial cuts and its FY93 appropriation still leaves

Chart 1

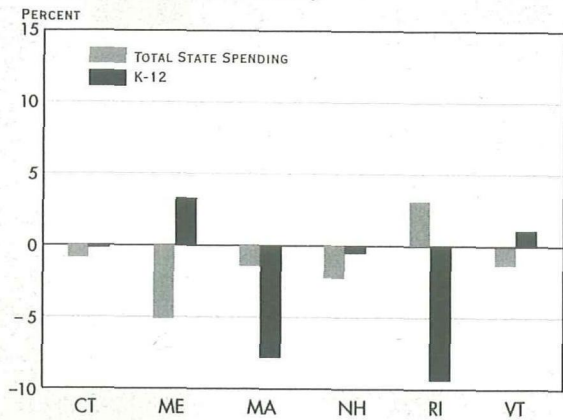
### State Spending for K-12 Education Rates of Change, FY91 to FY94 (1992 Dollars)



Note: Rates of change based on FY91 and FY92 spending, FY93 appropriations, and governors' FY94 recommended appropriations.  
Source: Official budget documents, state financial statements, and conversations with state budget and education officials.

Chart 2

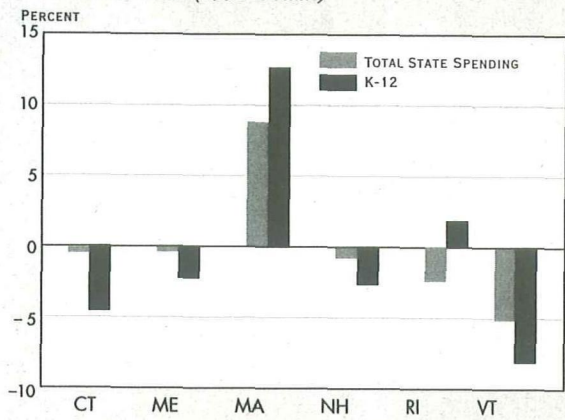
**Rate of Change in Total State Spending and State Spending for K-12 Education**  
 FY91 to FY92 (1992 Dollars)



Note: Rate of change based on FY91 and FY92 spending.  
 Source: See Chart 1.

Chart 3

**Rate of Change in Total State Spending and State Spending for K-12 Education**  
 FY92 to FY93 (1992 Dollars)



Note: Rate of change based on FY92 spending and FY93 appropriations.  
 Source: See Chart 1.

inflation-adjusted K-12 funding 20 percent below its previous peak, reached in FY89. Similarly, Rhode Island's small increase leaves inflation-adjusted K-12 spending 2 percent below its previous peak, attained in FY91. Furthermore, the percentage of Rhode Island's local school district costs borne by the state, 39 percent in FY93, falls far short of the 60 percent goal established by legislation in 1989. The legislation calls for attainment of the goal by 1996.

**Prospects for FY94 and FY95**

Only one of the region's governors, Connecticut's Lowell Weicker, has recommended increases in K-12 spending for FY94. Governor Weicker has called for an increase of 4.5 percent (approximately a 1 percent increase in real terms after adjusting for inflation). Governor Weld of Massachusetts supports an increase but it is not included in his proposed budget, which calls for a huge decrease in K-12 state spending of 14 percent (inflation-adjusted). Last year Governor Weld recommended that the Commonwealth increase its spending on K-12 education by \$800 million over the next seven years, contingent on the enactment of educational reform. To emphasize that contingency, he removed from his proposed FY94 budget \$186 million in increased

school aid enacted in FY93. The governor has also purposely not included an additional \$175 million in aid that he would like the legislature to enact as part of a comprehensive reform program.

Maine's governor John McKernan has proposed the region's largest percentage reduction in future K-12 spending, 6 percent over the FY94-95 biennium (close to a 9 percent cut in real terms). If enacted, his proposal would reduce inflation-adjusted K-12 state spending to below its FY91 level. The governor was persuaded to propose such a large cut by projections that Maine's total revenues for the FY94-95 biennium will fall \$1 billion short of the amount needed to maintain all state services at their current levels. Rhode Island's governor, Bruce Sundlun, is in a similar bind, proposing a 7 percent reduction in FY94 total spending and level funding for K-12 education.

Table 1

**State Aid for FY91 and Change in State Spending for K-12 Education**  
 FY92-FY93 (1992 Dollars)

	State Aid as	State Spending for
	Percent of K-12 Budgets <sup>a</sup>	K-12 Education, Percent Change <sup>b</sup>
	FY91	FY92-FY93
CT	40	-5
ME	50	-2
MA	32	12
NH	6	-3
RI	41	2
VT	31	-8

<sup>a</sup> Bradbury, Katharine, "Equity in School Finance: State Aid to Local Schools in New England," *New England Economic Review*, forthcoming.  
<sup>b</sup> Source: Official budget documents, state financial statements, and conversations with state budget and education officials.

**Movement toward Reform**

After several years of reductions in school aid, how can New England's school districts afford to educate the region's youth? This nagging question has forced state officials to confront the possibility that they must reform traditional systems of financing education. Connecticut's legislature intends to undertake a compre-

hensive reevaluation of school finance by the beginning of 1994. The governors of Maine and Rhode Island have initiated similar efforts. A common thread in these studies is the inequity resulting from heavy reliance on the property tax for school funding. Vermont's School Funding Commission has already recommended that the state consider giving municipalities the option to levy taxes on general sales and on rooms and meals, as well as limited personal income taxes.

Some of the governors and legislators may soon be forced by the judiciary to confront school finance issues. The Massachusetts Supreme Judicial Court is hearing a case this spring in which plaintiffs charge that municipalities' dependence on property taxes illegally discriminates against poor communities.

Table 2

State Funding for K-12 Education,<sup>a</sup>  
FY91 through FY94<sup>b</sup>

Millions of 1992 Dollars

	FY91	FY92	FY93	FY94
CT	1,339	1,339	1,277	1,294
ME	497	513	502	459
MA	1,549	1,429	1,607	1,389 <sup>c</sup>
NH <sup>d</sup>	86	85	83	80
RI <sup>e</sup>	370	335	341	330
VT	202	204	188	181

<sup>a</sup> Does not include teacher retirement funds.

<sup>b</sup> FY91 and FY92 spending; FY93 appropriations; FY94 governors' recommended appropriations.

<sup>c</sup> Does not include \$361 million contingent on enactment of an education reform bill.

<sup>d</sup> Includes New Hampshire sweepstakes revenues earmarked for K-12 education.

<sup>e</sup> Figures are for total school aid to school districts, adjusted for a FY91 \$61.8 million expenditure paid for in FY92 and FY93.

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

## Around New England

New England's governors balanced their state budgets in the first half of FY93. They remain cautious and vigilant, however, recognizing that the region's economic recovery is fragile and second-half budgetary adjustments may be necessary.

The governors' FY94 proposed budgets call for more belt-tightening (Table 3). Only two governors, Lowell Weicker of Connecticut and Stephen Merrill of New Hampshire, have proposed spending growth in excess of projected inflation.

With two exceptions, all have rejected tax increases in the aggregate and favor the repeal of temporary taxes on schedule. New Hampshire's Governor Merrill advocates delaying the proposed reductions on the state's real estate transfer and telecommunications taxes. Rhode Island's Governor Bruce Sundlun wants to raise the state's gasoline and cigarette taxes.

## Connecticut

Connecticut's FY93 revenues are nearly on target for the first half of FY93 and the budget is precariously balanced. Given the poor performance of Connecticut's economy, however, Governor Weicker has acknowledged that he has little room for error. Estimated income tax refunds owed taxpayers in the spring have already risen by over one-fifth since November. Spending projections show less chance of appropriated money going unspent this year. (In the past, the state has usually wound up with 1 percent of appropriations unspent.) To be safe, Governor Weicker has ordered spending reductions of \$25 million in the third and fourth quarters.

The state's fiscal stress may be eased somewhat by legislation passed in December allowing the Mashantucket Pequot Tribe to operate slot machines. In return, the state will receive \$30 million in FY93, \$100 million in FY94, and 25 percent of the gross revenues from the slot machines in succeeding fiscal years. The state's share will increase to 30 percent if the revenues it otherwise would receive fall below \$100 million a year.

The governor's FY94 general fund budget of \$7.6 billion represents a 5 percent increase over this year's. He calls for over \$500 million in spending cuts, including estimated sav-

ings of \$85 million by removing from the welfare rolls all General Assistance recipients who are deemed able to work. He recommends a five-cent fee on cans and bottles, replacing the present five-cent deposit. The fee would raise \$70 million for a new environmental fund to finance state parks and other environmental programs.

The Connecticut legislature has voted to raise the state's flat 4.5 percent income tax to 6.25 percent for couples who earn more than \$145,000 and single taxpayers earning more than \$75,400. The bill includes tax breaks for middle-income couples, particularly those with children. Governor Weicker has vetoed the bill because he is opposed to altering the two-year-old tax so soon after it was enacted and believes the change would make the state less competitive. His veto could jeopardize his budget proposals, since legislators have threatened to retaliate by refusing to support his other plans.

In November, Connecticut voters overwhelmingly approved an amendment to impose a cap on state spending. The amendment holds the maximum allowable rate of increase in general budget expenditures to either the rate of growth in Connecticut personal income averaged over the preceding five years or the national inflation rate for the preceding 12-month period, whichever is higher. The legislature can override the cap by a three-fifths vote of both the House and the Senate.

## Maine

Maine's revenues have been on target for the last seven months, off by less than 1 percent of what was projected. Nevertheless, Governor McKernan believes the state is living beyond its means, given its weak economy and persistently high unemployment levels. Consequently, the governor has proposed deep spending cuts for the next two-year budget cycle (FY94-95), which begins July 1.

According to state budget officials, revenue projections for the FY94-95 biennium will fall \$1 billion short of the \$4 billion needed to maintain state services at FY92-93 levels. As a result, Governor McKernan has proposed a \$3 billion general fund budget, which allows for no increase in state spending for FY94-95, not even an adjustment for inflation. He has asked the legislature to balance the FY94-95 budget without extending the temporary increases in income, sales, and gasoline taxes enacted two years ago.

Governor McKernan's general fund budget calls for a 6 percent reduction in state aid to public K-12 schools and a 5 percent cut for the University of Maine system and state technical colleges. On the human services side, he proposes to re-

### State Budget Timetable

#### ANNUAL BUDGETS

FY93: July 1, 1992 to June 30, 1993

FY94: July 1, 1993 to June 30, 1994

Massachusetts, Rhode Island, Vermont

#### BIENNIAL BUDGETS

FY94 - 95: July 1, 1993 to

June 30, 1995

Connecticut, Maine, New Hampshire

place the annual \$9 million General Assistance program with a \$3 million program that would provide only emergency shelter needs. In addition, new restrictions would be placed on Medicaid coverage for nursing home care and pregnant women and on Aid to Families with Dependent Children. The federal government would have to waive certain regulations and modify some laws before these restrictions could be imposed.

Governor McKernan also plans to lay off 570 state workers. He is asking state employees to work for present salary levels and to contribute more toward their pensions and family health insurance. However, he has no plans for unpaid furlough and shut-down days, which he used to help balance the FY92-93 budget.

## Massachusetts

This year, Massachusetts is in better financial shape than its neighbors. If budget trends continue as expected, at the end of June the state will have balanced its budget for three years in a row without increasing any of its broad-based taxes. The past three years of constrained state spending are paying off. Two Wall Street agencies, Standard & Poor's and Moody's, have upgraded the Commonwealth's credit rating to "A," which will lower its borrowing costs.

The Commonwealth's tax revenues for the first seven months of FY93, 4 percent above their year-ago level, met their target. Last minute end-of-year cuts in spending will probably not be needed. The gain in business excise tax revenues was especially large, reflecting the improved health of banks.

Governor William Weld has proposed a \$15.2 billion budget for FY94, a 1.5 percent increase over projected FY93 spending. Legislators are not likely to pass it, however, because the plan omits \$361 million in state aid for education promised in a hotly debated education reform bill.

The legislature has approved a compromise economic development bill that would increase the corporate tax credit from 1 percent to 3 percent for all investments, with a provision to end the tax credit increase after three years. Governor Weld has not signed the bill yet, and advocates a permanent increase in the credit.

The governor has promised tuition tax credits for college students and their parents, as well as for state residents returning to school to improve their skills. The tax credits, which would not be limited to tuition paid to Massachusetts schools, would cost the state \$20 million annually. In addition, the governor has proposed \$35 million to help the elderly pay for

health insurance.

To boost revenues, Governor Weld is proposing two new state-sponsored gambling games, which could bring in \$100 million a year. The governor also wants to use \$70 million of the revenues from a new cigarette tax to pay for 13 existing public health programs. This proposal is being criticized because voters enacted the new tax by referendum in the fall, believing that all of the revenues would be used for antismoking efforts. The governor's proposal would devote only 40 percent of revenues to smoking prevention programs. To appease critics, Governor Weld has asked the legislature to appropriate \$70 million for smoking prevention programs over an 18-month period, beginning retroactively on March 1, 1993.

## New Hampshire

Carrying over a surplus of \$18.6 million from the first year of FY92-93, New Hampshire is in relatively sound financial condition. For the first seven months of the second year, general fund revenues exceeded projections by 3 percent.

In the fall of 1993, the U.S. Supreme Court will rule on the constitutionality of New Hampshire's tax on out-of-state purchases of electricity generated by the Seabrook nuclear power plant. A special master appointed by the Court has already ruled that the tax violates federal laws governing interstate commerce and the distribution of electricity. Rescinding the tax could cost the state nearly \$30 million in refunds to electric utilities in Massachusetts, Connecticut, and Rhode Island. Presently, Governor Merrill is working toward an out-of-court settlement with plant owners in these three states.

The governor has recommended that state spending increase at a rate of about 4 percent per year over the course of the FY94-95 biennium. Most of the increase would cover rising costs of welfare, health care, corrections, and the judiciary. He has recommended that 205 positions be eliminated and 322 new positions be added, including 158 in the Department of Corrections. He wants to expand state-provided health care for pregnant women and infants, while aid to cities and towns would remain at \$51 million per year.

Table 3

### Total State Appropriations<sup>a</sup> for FY93 and Governors' Recommended Appropriations for FY94

Billions of Dollars

	FY93	FY94	PERCENT CHANGE
CT	6.58	6.94	5.4
ME	1.77	1.66	-6.3
MA	12.33	12.41	.6
NH	.92	.95	3.9
RI	1.54	1.44	-6.9
VT	.77	.79	2.8

<sup>a</sup> The figures in Table 3 reflect money that states have raised from their own sources (the General Fund and Transportation Fund). They do not include federal dollars or revenues raised for special funds, for example, workers' compensation or insurance funds.

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

Whether the Governor's FY94-95 budget is balanced depends importantly on two debatable assumptions: 1) that the state will be able to keep its revenues from the contested Seabrook tax, and 2) that it will collect at least \$200 million from a tax on acute-care hospitals. In previous years, the burden of the tax was mitigated by an arrangement by which the state plowed some of the tax's revenues into Medicaid. The resulting increase in state Medicaid spending triggered additional federal matching grants, which were then used to reimburse hos-

pitals for taxes paid. (See *Fiscal Facts*, Spring 1992.) Such a scheme will be more difficult to implement under new federal regulations.

Governor Merrill's budget includes a proposed tax reform designed to redistribute the burden of the state's business profits tax away from its largest and smallest businesses. The tax's statutory rate would be reduced from 8 percent to 7 percent. This would help the state's largest corporations, which pay most of the tax. At the same time, businesses with gross annual receipts of \$50,000 or less would not be required to file a tax return. The current threshold is \$12,000. The loss in revenue from these two tax reductions would be offset by the imposition of a new tax of 0.25 percent on wages, interest, and dividends paid. Businesses could take their liability under the new tax as a credit against their profits tax liability. The new tax is designed to ensure that businesses difficult to audit nevertheless pay some tax. Examples include small businesses, law firms, and doctors' offices, all of which can avoid the profits tax by increasing payouts to partners or owners.

Other tax revisions include reducing the real estate transfer tax from \$5.25 to \$5.00 per \$1,000 and lowering the telecommunications tax from 6 percent to 5 percent. These two proposals are actually tax increases because under current law the rates are scheduled to fall to \$3.50 per \$1,000 and 3 percent, respectively, on July 1.

## Rhode Island

The state's sluggish economy has caused spending on entitlement programs to exceed planned levels. State budget

officials have faith that they will end the fiscal year without a deficit, but recognize that they must make far-reaching structural changes in FY94's budget.

In November, voters adopted a referendum to replenish the state's "rainy day" fund. The referendum restrains annual state general revenue appropriations in any fiscal year to 98 percent of estimated general revenues and establishes a budget reserve account for the remaining 2 percent, to be used in emergency situations or in the event of an unanticipated deficit. Once this account reaches 3 percent of estimated revenues, the excess can be used to reduce state indebtedness, make debt service payments, or fund capital projects.

Governor Bruce Sundlun's proposed lean \$1.4 billion state budget is nearly 7 percent below expected state expenditures for the current fiscal year. The FY94 budget relies on more than \$14 million in new taxes and fees, although the governor calls for some tax breaks and suspensions. He also intends to reduce the state government's work force by 6 percent and cut human services programs severely.

Governor Sundlun's plan for new taxes includes a proposed one-cent increase in the state gasoline tax that will help finance free bus service for the elderly and a five-cent increase in the cigarette tax. The governor has also called for new and higher fees on a wide array of state services, including a new \$3 charge on Medicaid recipients who go to hospital emergency rooms for non-emergencies and an increase in the fee for a temporary license plate.

The governor plans to eliminate the 11 percent corporate income tax surcharge and double the investment tax credit for manufacturers. He also would suspend the temporary income tax surcharge now imposed on high-income taxpayers.

Governor Sundlun proposes a reduction of nearly 6 percent in spending for human services, the biggest portion of the state's budget. The major components of his plan include tightening eligibility rules for the state's General Assistance program and reducing the benefit limit from six to three months. In addition, AFDC recipients will receive no increase in their payments, for the third year in a row.

## Vermont

Vermont's general fund revenues are on target for the first seven months of FY93, but uncertainty about the strength of the state's economic recovery raises the specter of a revenue shortfall for FY93 as a whole.

Overall, revenues for the seven-month period were 7 percent above their year-ago level. Strong growth in personal and corporate income tax receipts more than offset slower-than-expected revenues from consumption taxes such as sales and use taxes, and taxes on rooms and meals. Offi-

cials attribute slow sales tax growth largely to sluggish tourist business and the weak Canadian dollar, which restrains shopping by nearby Canadians. Officials also fear that the demand for state income tax refunds will be strong during the remainder of the fiscal year, particularly for proprietors in Vermont's tourism and retail industries.

Despite the mixed signals from the Vermont economy, Governor Howard Dean still intends to eliminate most of the state's \$60 million cumulative deficit by the end of 1993. (Vermont is the only state in the nation that can carry over a deficit on its books from one year to the next.) After making cuts last July and this January in general fund appropriations, as well as in transportation fund appropriations, the governor hopes to wind up with a current-year surplus of \$58 million, all but eliminating the state's cumulative deficit.

Governor Dean's proposed FY94 budget calls for spending only 2 percent above FY93 general fund appropriations and ending on schedule three temporary tax increases enacted in 1991. If the governor's budget is adopted, total spending will be at virtually its FY91 level. His budget calls for level funding of state aid to local schools, cuts in welfare, and reductions in state-financed property tax relief for owners of undeveloped property.

To speed up Vermont's recovery, the governor has proposed an economic development package featuring investment tax credits, job tax credits, loan guarantees for small businesses, and modification of the state's corporate tax apportionment formula. Investment and job tax credits would be in effect for only two years. The proposed apportionment formula would give a weight of 1.5 to sales. Currently, Vermont weights property, sales, and payroll equally. The purpose of the proposed reform is to lighten the corporate income tax burden of Vermont-based firms, especially those that export their goods and services to other states.

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The views expressed in this publication do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System. For information call Lesley Eydenberg 617-973-3098. 