

Fiscal Facts

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Fuzzy Federal Funds Stymie Governors' Planning

by Jeannette Hargroves

Uncertainty over the future course of federal grant policy has complicated state fiscal planning for fiscal year 1997 (FY97). Over the long run, most proposed changes in intergovernmental assistance would slow growth in federal aid and give states more discretion in how they spend it. In the short run, however, the amount of federal aid that many states receive will vary dramatically depending on which federal policy is in effect.

The stakes are high because federal aid finances a

large proportion of state spending. New England's governors currently receive about \$8 billion in federal funds, which finances close to two-fifths of state spending in the region's four smallest states and slightly less than one-fifth in Connecticut and Massachusetts (Table 1). The ratio of federal to state spending has changed little since FY93, following a rapid rise in federal outlays between FY90 and FY93, mostly for Medicaid. (See *Fiscal Facts*, Winter 1996.)

Federal funds finance two kinds of programs:

Table 1

Federal Aid Finances Much of State Spending

Federal Funds to States

Millions of Dollars and Percent of Total State Spending

	FY90		FY93		FY96		FY97		FY96-97 Percent Change
	Dollars	Percent	Dollars	Percent	Dollars	Percent	Dollars	Percent	
New England	4538	17	7202	23	8416	23	8935	24	6.2
Connecticut	814	12	1367	17	1674	17	1733	17	3.5
Maine	641	27	1063	37	1329	40	1392	41	4.7
Massachusetts	1718	13	2575	18	2969	18	3347	19	12.7
New Hampshire	356	30	740	42	797	42	821	42	3.1
Rhode Island	667	31	921	38	1066	39	1037	38	-2.7
Vermont	343	33	537	41	581	40	605	41	4.2

Note: FY90 and FY93 data are actual spending. FY96 data are appropriations. FY97 data are governors' recommended appropriations.

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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. This publication is available without charge. We welcome your ideas and comments; contact Jeannette Hargroves at 617/973-3096. Send requests to be placed on our mailing list to Federal Reserve Bank of Boston, T-8, Attn: *Fiscal Facts*, P.O. Box 2076, Boston, MA 02106-2076.

**State
Budget
Timetable**

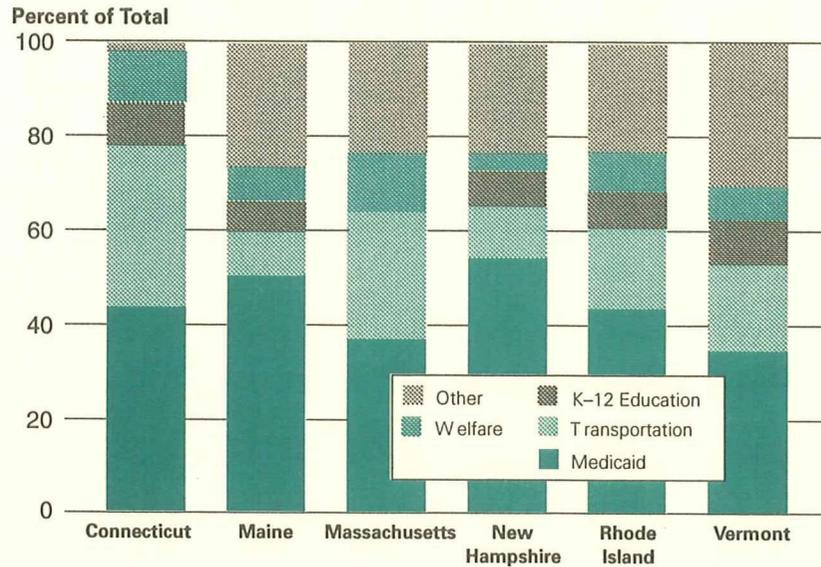
Annual Budgets
Massachusetts
Rhode Island
Vermont
FY96: July 1, 1995
to June 30, 1996
FY97: July 1, 1996
to June 30, 1997

Biennial Budgets
Connecticut
Maine
New Hampshire
FY96-97: July 1, 1995
to June 30, 1997

Chart 1

Medicaid Is By Far the Largest Federal Program

Federal Spending in New England, FY94



Source: National Association of State Budget Officers, 1996.

- Entitlement programs, generally serving low-income families, such as Medicaid, AFDC, JOBS, and school lunches. The federal government guarantees benefits to all eligible families and repays states a portion of their expenditures.
- Discretionary grants, earmarked for specific areas, such as highways and airports, education, food stamps, housing assistance, and disaster relief. Congress ordinarily approves the annual appropriations for discretionary grants before October 1, the beginning of the federal fiscal year.

Medicaid is, by far, the largest federal program (Chart 1). Federal transportation funds are also hefty, particularly in Connecticut and Massachusetts, while welfare payments are significantly smaller.

Governors' Proposed FY97 Budgets

In mid-winter, when the region's governors drafted their FY97 budgets, Congress and President Clinton were still deadlocked over Medicaid and welfare reform and the magnitude of federal reductions needed to balance the federal budget by 2002. Not knowing what would happen with federal funds, most governors calculated federal grants based on current law. In Massachusetts, Governor William Weld assumed that Medicaid and AFDC funds would be switched to block grants.

Governors in Connecticut, Maine, New Hampshire, and Vermont expect to see federal revenues grow modestly in FY97 (Table 1 and Chart 2). Rhode Island's Governor Lincoln Almond anticipates a 3 percent reduction in federal dollars, due to such factors as completion of a medical management system project and a change in estimated disbursements in education.

Governor Weld, basing his calculations on new block grant rules, assumes year-

over-year growth of 13 percent in Massachusetts' FY97 federal reimbursements, bringing in roughly \$378 million in new monies. The governor's projections assume that (1) under a block grant system, the federal government would reimburse the state for its Medicaid expenditure at a rate of 60 percent (rather than the current rate of 50 percent) until federal grants reach an established cap; and that (2) a block grant program for transitional aid to families (TAFDC) would contribute \$59 million above current reimbursements.

Prospects for Future Cuts

As of early May, Congress and President Clinton had resolved their differences over the 1996 Federal budget, but the stalemate continued over the spending cuts needed to achieve a balanced budget by 2002. So far, the deepest cutbacks in federal monies to state and local governments have been proposed in the House Republicans' Balanced Budget Act of 1995, known as the budget reconciliation bill, passed in late November. Under this legislation, New England would lose close to \$21.5 billion between FY96 and FY02. President Clinton has vetoed this bill, and more recent Medicaid and welfare proposals have modified some of

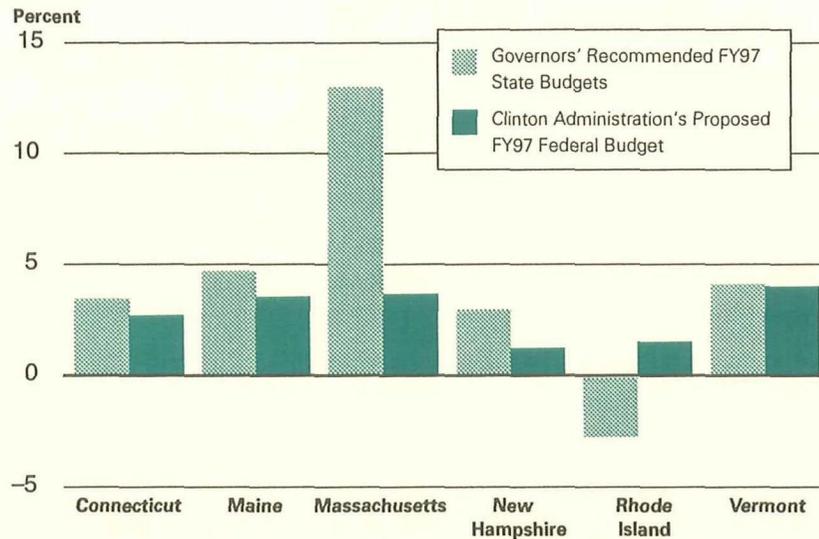
the cuts proposed in the reconciliation bill.

President Clinton's proposed FY97 budget, put forth in early February, calls for modest growth in federal grants to the states, a level of growth not dramatically different from the expectations of most New England governors (Chart 2). Governor Weld's expectations, based on a switch to block grant formulas, are above what the President has proposed, while Governor Almond is the most cautious of all. Given Congress' current agenda, all of these numbers could eventually prove far from the mark. **FF**

Chart 2

Most States Project Modest Growth in Federal Funding

Growth in Federal Funds to States FY96 to FY97



Note: U.S. government budget figures include estimated obligations only of \$3 billion or more in FY97.
Source: State Governors' Recommended FY97 Budgets; Budget Information for States, Budget of the United States Government, Fiscal Year 1997.

The Boston Fed Now Has a Home on the World Wide Web

The Federal Reserve Bank of Boston has established a site on the World Wide Web (WWW). The new "home page" is a gateway to information on the services and activities of the Boston Fed Publications and the entire Federal Reserve System.

Guests to the site will be able to find up-to-date information on what's new at the Boston Fed, read and download a variety

of Bank publications, gain access to a wealth of statistical information, and learn more about the Federal Reserve System and its operations in Boston.

The following Research Department publications are featured on the new WWW site:

- New England Economic Review
- Regional Review

- New England Banking Trends
- Fiscal Facts
- New England Economic Indicators
- Conference Proceedings; Research Reports and Special Reports; Working Papers
- "Beige Book" (summary of current economic conditions, produced every six weeks, for the U.S. as a whole and by Federal Reserve District)

World Wide Web address: <http://www.bos.frb.org>

Across *the* Region

Some New England states could use a boost in April's tax collections to help balance their current budgets. Rhode Island and Vermont face serious gaps in their FY96 budgets, due in large part to weak income and sales tax revenues in the first half of the fiscal year. Sluggish revenues also threaten to unbalance Maine's and New Hampshire's FY96-97 budgets. By contrast, tax receipts in Connecticut and Massachusetts have fared well. The Commonwealth, in particular, is likely to end the fiscal year with a healthy surplus.

Most governors' plans for FY97 call for more belt-tightening (Table 1). Only one governor, William Weld of Massachusetts, has proposed spending growth in excess of projected inflation. But he, along with the other governors, plans to

downsize and reorganize state government significantly in order to curb costs.

Tax reform remains high on everyone's agenda. Governor Weld has proposed an income tax cut. Governor John Rowland wants Connecticut to continue to phase in the income tax cut passed last year. Governor Lincoln Almond has proposed a package of tax changes, including new fees and a change in the personal income tax structure that would make Rhode Island's revenues less sensitive to federal income tax changes. **FF**

Table 2

Total State Appropriations for FY96 and Governors' Recommended Appropriations for FY97,^a Excluding Federal Dollars

	FY 96	FY 97	Percent Change
	Millions of Dollars		
Connecticut	8,121.7	8,270.6	1.8
Maine	1,990.0	2,012.0	1.1
Massachusetts	13,965.8	14,518.7	4.0
New Hampshire ^b	1,152.3	1,183.5	2.7
Rhode Island ^c	2,313.2	2,350.3	1.6
Vermont	860.7	873.8	1.5

a Unless otherwise noted, includes general fund and transportation fund appropriations only. Excludes expenditure of federal grants and reimbursements.

b Includes budgeted income from sweepstakes earmarked for foundation aid and special education.

c Includes general revenue and other funds.

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

Six-State Review

Connecticut

Because of higher than expected revenues, Connecticut will end the current fiscal year with little or no deficit. Revenues from the income and inheritance taxes have been especially strong. As of the end of February, cumulative receipts from these two taxes were up 9 percent and 23 percent, respectively, over their year-ago levels. Growth in income tax receipts was spurred by a sharp rise in capital gains, a result of the booming 1995 stock market. The deaths of four wealthy Connecticut residents were responsible for the sharp increase in estate tax receipts.

The outlook for FY97 is not as sanguine. Connecticut's comptroller estimates that the state faces a deficit of over \$400 million by the end of the FY96-97 biennium, more than 2 percent of appropriations. The projected deficit is this sizable in large part because the biennial budget includes Governor John Rowland's proposal to lower income tax rates and lighten the burden of local personal property taxes through an income tax credit, effective July 1. The governor has a two-part strategy to eliminate the gap. First, he would shrink FY97 appropriations by 1 percent, with the heaviest cuts targeted on welfare and the state payroll. (Nevertheless he would increase funding for foster care and nursing homes.) Second, he would issue up to \$160 million in short-term notes and use the proceeds to help finance operations in FY97. He would sell a 6 percent interest in the state lottery in order to pay off the notes.

Lauren Fine

Maine

In early February, Governor Angus King submitted a \$35.6 million budget-adjustment bill to close a potential gap in the state's \$4 billion FY96-97 biennium budget. The potential imbalance was due to an estimated \$19.4 million in additional costs, principally in human services, and to weak revenues in the first

half of FY96. The lower revenues resulted in a downward revision of \$16.2 million in FY96-97 revenue estimates.

After Governor King introduced his budget-adjustment bill, Maine's fiscal situation took a surprising turn. In late winter, officials discovered a surplus of over \$50 million in the Medicaid account (attributable primarily to reduced hospital and nursing-home admissions and cost savings through such innovations as managed care) and an additional \$14 million in federal child-welfare funds. The Medicaid surplus plus the new federal aid total over \$65 million, more than enough to relieve the state's short-run fiscal distress. However, legal constraints limit the extent to which these funds may be used to pay for other programs, and there was considerable disagreement among policymakers about how the additional money should be spent.

Governor King proposed using the new monies, among other things, to expand funding for elderly medical, mental health, and child abuse programs and to create a reserve of \$30 million to ease the shock of repealing the state's hospital tax, set for July 1, 1997. In late March, legislators passed a budget bill that reflects some of the governor's requests for additional human service outlays, but sets aside only \$17.5 million in reserves. In addition, the bill repeals the 7 percent tax on nursing home revenues, effective January 1, 1997. Governor King reluctantly signed the legislation, although he believes the state can ill afford another tax cut on the heels of tax reductions passed last year (an income tax cap and elimination of the hospital tax) and anticipated cuts in federal funds.

Governor King, like other New England governors, intends to cut costs through increased efficiency and downsizing in the next fiscal year. In March, the legislature approved \$21 million in savings, which, combined with \$23.6 million in cuts approved last November, totals almost \$45 million, the goal set by the governor for this two-year budget cycle.

Wei Sun

Massachusetts

As FY96 winds down, Governor William Weld faces fewer fiscal worries than other governors in the region. Massachusetts' revenues for the first eight months of FY96 were 7 percent above their year-ago level, and well above the upper bound of the state's predicted range. Receipts from income and sales taxes grew a robust 9 percent and 6 percent, respectively, over year-earlier levels. If this trend continues, the governor should have little difficulty balancing this year's budget, despite an estimated \$44 million reduction in corporate excise taxes due to the "single sales factor" tax cut signed into law in November. (See *Fiscal Facts*, Winter 1996.) By year's end, the Commonwealth's Stabilization Fund is expected to reach \$446 million (3 percent of FY96 appropriations).

Governor Weld has proposed a \$17.4 billion budget, 4 percent over FY96, that includes \$725 million in new spending and a personal income tax cut. The new monies are principally for education reform now in its third year, day care, and Medicaid. The personal income tax reduction, phased in over two calendar years, would lower revenues by \$133 million in FY97 and twice this amount the following year. The rate would be reduced from 5.95 percent to 5.7 percent on January 1, 1997, and lowered again to 5.45 percent on January 1, 1998.

To make up for the new spending and the revenue reductions, the governor is relying on \$378 million in new federal dollars (see feature article) and an estimated \$300 million in savings from a plan that would reorganize state government.

Jeannette Hargroves

New Hampshire

Late last spring, New Hampshire lawmakers passed a FY96-97 biennium budget of \$1.7 billion, 0.8 percent smaller than for the previous two-year budget. Despite reduced spending, the FY96-97 budget remains precariously balanced because of weak revenues in recent months. Eight months into FY96, New Hampshire's total revenues were 5 percent below year-ago levels and 4 percent below target. Lawmakers attribute over one-half of this shortfall to cuts in federal Medicaid funds, with the remainder due to deteriorating tax collections, particularly the meals and rooms

tax receipts, which were 5 percent below expectations at the end of February. By contrast, the business profits tax has performed well, 8 percent ahead of projections.

Lawmakers anticipate budget reductions in FY97 to offset this year's revenue shortfall. Governor Steve Merrill has promised, however, not to make additional cuts in the health and human services budget, which was already trimmed by \$32 million, as mandated in this biennium. Despite a potential deficit, the governor has decided to wait until early May before making a mid-term budget adjustment. In the meantime, he is supporting a bill before the legislature to fund state kindergartens starting in FY97. The plan would provide funding for over 1,100 children living in districts without established kindergartens. Profits from the multi-state Powerball lottery would provide partial funding for this \$3 million initiative. Officials hope this monetary incentive will motivate districts to create kindergarten programs next year.

Lauren Fine

Rhode Island

Sluggish revenues could leave Governor Lincoln Almond with a budget imbalance in this fiscal year. Eight months into FY96, total revenues were down 0.2 percent. Sales tax receipts were a scant 1 percent above year-earlier levels. By December, officials had lowered their revenue estimate by \$36.4 million. Lawmakers now have 2 percent fewer dollars than they assumed when they passed the FY96 budget last August. The revenue shortfall plus anticipated overspending of \$3.8 million mean the governor will need to find \$40 million in new revenues in order to balance the FY96 budget.

Dwindling revenues could cast a shadow over FY97 as well. Officials anticipate revenues will drop by 0.1 percent, because of tax and fee changes, particularly the partial phaseout of the bank deposit tax. Accordingly, Governor Lincoln Almond has proposed a bare-bones General Revenue budget of \$1.7 billion, 0.4 percent below current spending levels. He aims to eliminate over 1,000 jobs through an early retirement package and consolidation of many agencies, boards, and commissions.

The governor intends to increase revenues through tax law changes that would add an additional \$36.3 million. He plans to:

- extend the hospital tax and double its rate, from 2.2 percent of gross receipts to 4.4 percent; and
- change the personal income tax structure, so that taxpayers rates would range from 4 percent to 10.89 percent of their federal taxable income. The governor anticipates the new income tax structure would create a more reliable as well as a larger revenue source.

Governor Almond has also proposed a welfare reform package, which is now before the legislature but not included in the budget, since it is viewed as “budget neutral.”

After months of litigation, the Rhode Island Supreme Court ruled in mid-February that former Governor Bruce Sundlun lacked the constitutional authority to sign a compact with the Narragansett Indian Tribe in 1994 permitting them to build a casino on their Charlestown Reservation. Governor Almond has said he will not negotiate a casino compact with the Tribe. The matter appears to be far from settled. The Narragansett Tribe has threatened to take its case to the U.S. Interior Department, believing that the Secretary of the Interior has the authority to approve a casino on reservation land without the approval of a legislature or governor. A recent ruling by the U.S. Supreme Court, however, strengthens the hand of states in compact negotiations with Indian tribes.

Jeannette Hargroves

Vermont

As of late April, Governor Howard Dean and legislators were still hammering out an agreement on how to plug the hole in the FY96 budget, which amounts to over \$50 million. The hole is due, in large part, to the \$14.5 million deficit carried over from FY95 and weak tax and fee collections, particularly personal income tax receipts.

Eight months into FY96, tax revenues were 3 percent above year-earlier levels and 0.5 percent below target. Despite a recent uptick in consumption tax receipts — February’s collections from the sales tax and the rooms and meals tax were up 14 percent and 6 percent, respectively, over year-ago levels — collections were still less than what had been hoped for. March revenues are pivotal in determining the size of the budget gap.

To remedy this year’s budget shortfall, the governor is relying primarily on spending reductions. In July, he proposed lowering spending by \$21.7 million, and

in January he asked for another \$9 million in reductions, fund transfers, and savings. Combined, these cuts would limit spending to \$697.4 million, 4 percent less than that appropriated by lawmakers last spring.

If legislators approve the governor’s proposed cuts and if revenues meet the target in the last quarter, the state could end FY96 with a \$9.5 million operating surplus. The governor intends to use the surplus plus \$5 million from the transportation fund to erase the state’s \$14.5 million deficit.

Looking ahead, Governor Dean intends to exercise constraint in spending, having proposed a FY97 total budget of \$873.8 million, only 1.5 percent over his planned outlays for FY96. The governor wants to hold annual spending growth to 2.5 percent for the next several years by restructuring state services and promoting efficiency. Any revenue growth above 2.5 percent would fund a general fund “safety zone,” to put Vermont on more solid fiscal footing. Safety zone dollars would be used to replenish the rainy day fund, provide property tax relief, and support programs likely to be hit by federal cuts.

Jeannette Hargroves

Casino Development:

How would casinos affect New England’s economy?

In 1992, Connecticut became the first New England state to allow casino gambling within its borders. Since then, the region’s other states have seriously considered whether to follow Connecticut’s example. One of the most controversial, unresolved issues has been the economic effects of casino development. On June 1, 1995, the Federal Reserve Bank of Boston held a one-day symposium on casino development bringing together experts from academia, government, Native American nations, and the gaming industry. This special report summarizes the participants’ remarks.



Copies of *Casino Development: How would casinos affect New England’s economy?* may be obtained without charge by writing to Research Library - D, Federal Reserve Bank of Boston, P.O. Box 2076, Boston, MA 02106-2076. Or telephone (617) 973-3397.