

# New England Fiscal Facts

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## Preparing for the Storm: Rainy Day Funds in New England

By E. Matthew Quigley

**R**ainy day funds have played an important role in alleviating the current state fiscal crisis. This article examines the benefits of these funds, the various ways in which they can be structured, and the differences in the structure and use of these funds in New England.

The cause of the states' current fiscal crisis is vigorously debated. Some believe that states "spent themselves into this mess" by chasing rising revenues with unabashed vigor. The solution to the ensuing difficulties, they say, is obvious: reduce spending. Others argue that states enacted excessive — in light of their long-term spending needs and commitments — permanent tax cuts during the boom years. The solution for these observers is equally clear: reverse the tax cuts.

To some extent, both sides are correct. In retrospect, some states did finance expenditure expansions on the back of extraordinary (and temporary) surges in revenue. Still others enacted generous tax cuts without curbing spending. Common to both arguments is the assertion that conscious decisions on the part of lawmakers, either to spend more or to tax less, created the budgetary gaps of today. But discretionary choices were only part of the problem.

Cyclical forces affect state governments just as they do households and businesses. During a recession, tax revenues generally fall, and expenditures, particularly on transfer programs, increase. Even if there is no change in fiscal policy, these two pressures shift budgets toward

deficit. Conversely, during economic expansions, tax revenues increase and transfer payments decline, shifting budgets toward surplus.

The federal government can ride out these waves of recession and growth, running surplus, then deficit, and so on. State governments cannot. With the exception of Vermont, all 50 states have some form of balanced budget requirement — when expenditures outpace revenues, steps must be taken to bring them back into balance.<sup>1</sup> Pro-cyclical state fiscal policy is often the result: officials raise taxes and cut spending during recessions and lower taxes and increase spending during expansions. Even if policymakers wanted to run counter-cyclical fiscal policies, given their balanced budget requirements, most would be unable to do so.

### Rainy Day Funds

Rainy day funds are one way states can limit the need for pro-cyclical fiscal policy. States can build rainy day funds in prosperous times to be able to call upon them during leaner years. These set-asides of tax and other revenues benefit the states themselves and, to lesser extent, the overall economy. There are four benefits to consider:

First, drawing on reserve funds may aid an economic

1 With the exception of Vermont, all six New England governors must submit a budget in which expenditures are balanced with revenues. If the budget falls out of balance during the year, states may borrow or take additional supplemental action to achieve balance, but, unlike the federal government, they cannot plan on borrowing to cover operating expenses as part of the initial budget submission.

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## State Budget Timetables

### Annual Budgets

Massachusetts  
Rhode Island  
Vermont  
FY03: July 1, 2002  
to June 30, 2003  
FY04: July 1, 2003  
to June 30, 2004

### Biennial Budgets

Connecticut  
Maine  
New Hampshire  
FY02-03: July 1, 2001  
to June 30, 2003  
FY04-05: July 1, 2003  
to June 30, 2005

recovery by lessening the need to raise taxes or cut spending, both of which exert a drag on the economy. It is estimated that the collective actions of the states to erase their current deficits may shave 20 basis points (two-tenths of one percentage point) from GDP growth this year and as many as 40 basis points (four-tenths of one percentage point) next year.<sup>2</sup>

Second, a more stable fiscal policy — possible when surplus funds are used instead of tax increases and/or expenditure cuts — promotes private investment. Volatile tax rates and erratic spending contribute to economic uncertainty, which inhibits investors, while a stable fiscal policy is conducive to private investment. Private purchases of plant and equipment are an important component of the economy and a critical source of improvement in labor productivity.

Third, evidence exists that reserves help reduce the excess burden of taxes — the language economists use to describe the cost to society created by tax-induced distortions of private economic decisions. One team of researchers found that “states that have rainy day funds are more likely to cope with fiscal stress through spending reductions than through tax increases.”<sup>3</sup> To the extent this is true, rainy day funds indirectly promote economic efficiency.

Finally, the presence of reserves potentially improves a state’s fiscal standing with bond rating agencies, resulting in lower interest payments by the state and a lower cost of capital projects. The existence of the reserves implies a better preparedness for financial emergencies. A recent statement on budget reserves by Standard & Poor’s makes this point: “These reserves are accumulated in order to be spent during times of budgetary imbalance and extraordinary economic events. The last month has highlighted the importance and critical nature of these reserves from a credit standpoint. Given this period of economic uncertainty, a balanced approach of adjusting spending and drawing on reserves will reduce year-out structural imbalance.”<sup>4</sup>

*In a field one summer’s day a Grasshopper was hopping about, chirping and singing to its heart’s content. An Ant passed by, bearing along with great toil an ear of corn he was taking to the nest. “Why not come and chat with me,” said the Grasshopper, “instead of toiling and moiling in that way?”*

*“I am helping to lay up food for the winter,” said the Ant, “and recommend you to do the same.”*

*“Why bother about winter?” said the Grasshopper. “We have got plenty of food at present.”*

*...When the winter came, the Grasshopper had no food and found itself dying of hunger... Then the Grasshopper knew: It is best to prepare for the days of necessity. — Aesop*

## Structuring Rainy Day Funds

In making the decision to save, policymakers incur opportunity costs (i.e., the funds are not available to increase spending and/or lower taxes). These costs, measured by the depth of reserves, are the first consideration in structuring stabilization accounts. Are the reserves meant to cover short-term adjustments or long-term revenue shortfalls — the rainy day or the rainy season? If policymakers view reserves as a way to “buy time” — a means of continuing services in the face

2 Mark M. Zandi, “Reasons for Optimism,” *Regional Finance Review*, April 2003.

3 Russell S. Sobel and Randall G. Holcombe, “The Impact of Rainy Day Funds in Easing State Fiscal Crises During the 1990–1991 Recession,” *Public Budgeting and Finance*, Fall 1996.

4 Robin Prunty, Alexander M. Fraser, and Steven J. Murphy, *Commentary: The State of the States*, Standard and Poor’s, October 18, 2001.

of a temporary dip in revenues — a relatively small reserve may suffice. However, if lawmakers wish to design reserves sufficient to weather a significant downturn, the reserve fund must be significantly larger.

Several researchers have found that the five percent rule of thumb advocated by Wall Street — reserves should equal roughly 5 percent of expenditures — has been woefully inadequate in smoothing the impacts of the revenue cycle.<sup>5</sup> Even the deeper reserves accumulated by several states during the 1990s have proved insufficient in the face of the massive revenue falloffs of the new millennium.<sup>6</sup>

If policymakers take a long-term perspective and wish to build up reserves deep enough to maintain spending throughout a period of contraction, how severe a contraction should they plan for? One as severe as the average contraction in recent decades? The sharpest contraction in recent decades? Another Great Depression? And what percentage of revenues should policymakers try to cover? What percentage of revenues is vulnerable to cyclical downturns?<sup>7</sup>

Besides size, other fund features must also be determined. Should reserves remain in the general fund as unallocated surplus dollars, or be sequestered into a reserve or stabilization account? Should the size of the fund be capped? What should be the procedures for withdrawing from and depositing into the fund? What should be the procedures for replenishment?<sup>8</sup> This list is not meant to be exhaustive but merely to raise some of the issues involved.

### Rainy Day Funds in New England

As shown in Table 1, the six New England states have structured their rainy day funds in different ways. All six have formal budget reserves and are among the 40 states nationally that cap the overall size of their reserve fund. Connecticut, Massachusetts, and New Hampshire are among the nine states nationwide that cap their fund balance at 10 percent of expenditures; Maine is among the eight states with a cap of 5 to 10 percent of expenditures; and Rhode Island and Vermont are two of 19 states with a cap of less than 5 percent of expenditures. Procedures

**Table 1**

#### Structural Characteristics of New England's Rainy Day Funds

State	Name of Fund	Cap	Source of Deposits	Supermajority Requirement	Limit on Use	Replenishment
Connecticut	Budget Reserve Fund	10 percent	Year-end Surplus	None	None	None
Maine	Rainy Day Fund	6 percent	Year-end Surplus	2/3 vote of legislature for bonds/construction	None	None
Massachusetts	Commonwealth Stabilization Fund	10 percent	Year-end Surplus	None	None	None
New Hampshire	Revenue Stabilization Account	10 percent	Year-end surplus	2/3 of legislature for all but revenue shortfalls	None	None
Rhode Island	Budget Reserve & Cash Stabilization Account	3 percent	2 percent of revenues annually	None	None	Must be repaid within 2 years
Vermont	Budget Stabilization Reserve	5 percent	None	None	None	None

Source: Bob Zahradnik and Rose Ribeiro, "Heavy Weather: Are State Rainy Day Funds Working?" *Center on Budget and Policy Priorities*, May 13, 2003, Appendix Table D.

5 See, for example, Philip G. Joyce, "What's So Magical about Five Percent? A Nationwide Look at Factors that Influence the Optimal Size of State Rainy Day Funds," *Public Budgeting & Finance*, Summer 2001.

6 Bob Zahradnik and Rose Ribeiro, "Heavy Weather: Are State Rainy Day Funds Working?" *Center on Budget and Policy Priorities*, May 13, 2003.

7 Two papers presented at a recent Urban Institute-Brookings Institution conference on the current state fiscal crisis offer innovative techniques for estimating revenue volatility and optimal reserve size that improve on the existing ex-post method utilized in previous research. See Ray D.

Nelson and Gary Cornia, "Rainy Day Funds and Value at Risk," and Christian Gonzalez and Arik Levinson, "State Rainy Day Funds and the Budget Crisis of 2002-?" both presented at *State Fiscal Crises: Causes, Consequences, and Solutions*, April 3, 2003, The Urban Institute, Washington, D.C.

8 The Center on Budget and Policy Priorities, the National Association of State Budget Officers, and the National Conference of State Legislators have published several reports on the structural features of reserves.

for deposits, withdrawals, and replenishment also vary.

As shown in Table 2, New England's states have drawn heavily upon their rainy day funds during the current downturn in revenues:

- Connecticut used its entire \$595 million balance to offset the deficit that emerged in FY2001.
- Maine exhausted its \$144 million balance by the end of FY2002.
- Massachusetts' balance has dwindled from a high of \$2.3 billion to \$348 million.
- New Hampshire's fund balance has hovered at around half of its statutory cap.
- Rhode Island, drawing upon the proceeds of tobacco securitization, has maintained a reserve balance equal to roughly 3 percent of expenditures throughout the current downturn.
- Vermont's fund currently stands at just under 2 percent of expenditures.

Without these funds, the budget cuts and tax increases enacted last year and during the current year would have been significantly larger. (For details of current budget balancing actions, see the individual state write-ups in this issue.)

## Conclusions

Rainy day funds, if structured properly, offer significant protection from the fiscal impacts of recession. Despite their potential benefits, however, they raise several potential problems:

First, some would argue that the funds create what economists call a moral hazard problem, the tendency of a party with insurance against an unfavorable event to engage in behavior that makes it more likely that the event will occur. In other words, policymakers may be less

likely to worry about careful planning of expenditures if they feel that reserves will cover any revenue shortfalls that arise. Although researchers have examined the impact of reserves on state savings decisions, they have not examined this potential problem explicitly.

Second, the opportunity cost of a large reserve account may be substantial. Generally speaking, surpluses are viewed positively by the public. As these surpluses grow larger and larger, however, "disutility" begins to appear. On one side of the political spectrum, many believe that surplus funds should be returned to taxpayers — in the form of tax cuts or tax rebates — and not "hoarded" by government. For these people, a substantial reserve account is anathema. At the other end of the political spectrum are people who believe that many pressing social needs are currently under-funded. For these people, a substantial reserve account represents a significant lost opportunity to increase spending. In short, the potential political difficulties associated with large rainy day funds are not minor.

Finally, not all state fiscal woes are cyclical in nature. The increased budgetary demands placed on states by Medicaid and other health care programs are substantial. To some extent, the extraordinary revenue run-ups of the late 1990s masked this problem, but they did not alleviate it. A host of other spending demands arising from an aging infrastructure, rising education costs, and crowded prison systems are additionally straining state coffers. These are structural problems requiring solutions beyond smoothing the cyclical volatility of revenues.

Despite these cautions, the business cycle will roll on, and states with a means of bracing themselves against its waves of boom and bust will find themselves in more comfortable circumstances than those without. **FF**

**Table 2**

### New England's Rainy Day Fund Balances, FY2001–FY2004

State	FY2001 (Actual)		FY2002 (Preliminary Actual)		FY2003 (Appropriated)		FY2004 (Proposed)	
	Balance (\$ millions)	Percent of Expenditures	Balance (\$ millions)	Percent of Expenditures	Balance (\$ millions)	Percent of Expenditures	Balance (\$ millions)	Percent of Expenditures
Connecticut	595	5	0	0	0	0	0	0
Maine	144	5.4	34	1.3	0	0	0	0
Massachusetts	2,294	10.4	877	3.8	347	1.5	348	1.5
New Hampshire	55	5.2	55	4.7	55	4.6	55	3.9
Rhode Island	80	3.2	82	3.1	82	3.1	85	3
Vermont	43	4.9	14	1.6	18	2	26	1.7

Source: FY2001–FY2003: National Association of State Budget Officers, *Fiscal Survey of the States*, November 2002. FY2004: state budget documents.

## A Tale of Two States

### Massachusetts

The recession of the late 1980s and early 1990s hit the Commonwealth of Massachusetts hard. In response, policymakers raised taxes and enacted significant spending cuts. Despite these efforts, the state was forced to borrow to meet current funding obligations. In an effort to head off similarly painful actions in the future, officials began building up a budget stabilization account.

In explaining his support for the account, Speaker of the House Thomas Finneran said, “The boom and bust, the feast and famine, is not a good thing. . . so you set aside during the good years for when it’s not going to be so good.”

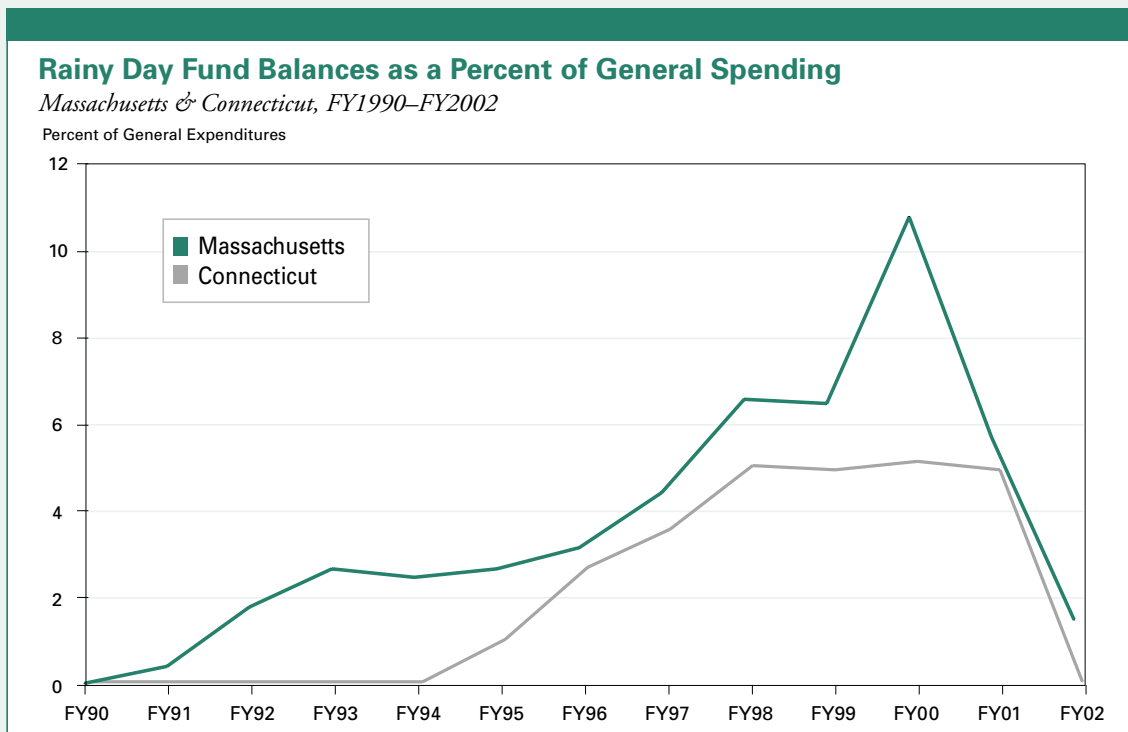
As steady revenue growth fueled burgeoning reserve balances, the legislature voted, in a series of increments, to boost the cap on the account from 3 percent of expenditures to 10 percent. With this constraint loosened, the Commonwealth’s rainy day fund swelled, reaching \$2.3 billion by FY2000. When revenues collapsed shortly thereafter, the legislature began drawing down the account. Roughly \$2 billion in savings was used, with about \$350 million left as of FY2003. Massachusetts is one of only a few states with reserves left on hand.

### Connecticut

Connecticut followed a different path. During the recession of the late 1980s and early 1990s, officials quickly drained Connecticut’s rainy day fund to cover deep deficits. By 1991, with no reserves left, the state was forced to borrow \$1 billion to balance its budget.

Burdened with a high debt load and faced with modest economic recovery through the early 1990s, Connecticut did not begin making annual deposits into its reserve account until 1995. By 2001, these annual deposits totaled roughly \$600 million, or about 5 percent of general fund spending. When a new recession hit, revenues declined precipitously, and Connecticut fell back into a deficit situation. Policymakers applied the entire rainy day fund balance toward deficit mitigation and began issuing “economic recovery notes.”

In commentary accompanying his proposed biennial budget, Governor John Rowland wrote, “In retrospect,...the state should have placed additional dollars in a Budget Reserve Fund as opposed to concentrating its one-time surplus on debt avoidance and debt retirement.” Determined to end the cycle, the governor recently signed into law a deficit mitigation plan, increasing the state’s reserve cap to 10 percent of expenditures.



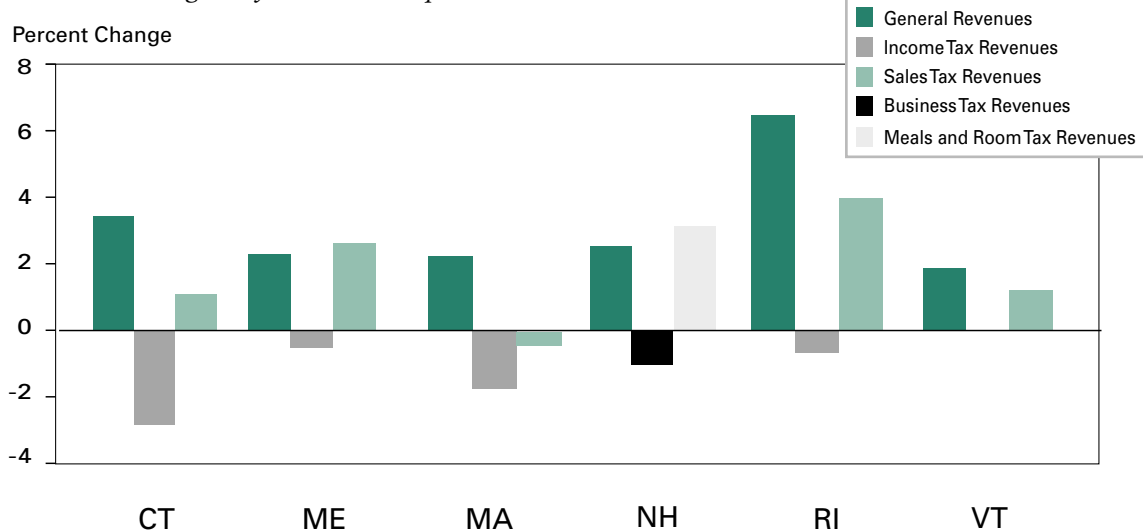
## Across the Region

As FY2003 drew to a close, revenue collections in New England's six states remained weak. Another year of flat or falling income tax collections had hit the region hard. Through May, income tax receipts were down 3 percent from FY2002 levels in Connecticut, down 2 percent in Massachusetts, down 0.7 percent in Rhode Island, and down 0.5 percent in Maine. Receipts were flat in Vermont. In New Hampshire, revenues from the business tax, the state's largest revenue source, were off by 1 percent. In Massachusetts, declining sales tax receipts exacerbated the falloff in income tax receipts. While sales tax receipts were up modestly in Connecticut, the state was still under considerable fiscal pressure.

All told, general revenue collections for FY2003 were up from FY2002, but not significantly. Policymakers were eagerly awaiting June's figures for an idea of how their budgets would fare in the coming fiscal year.

### Total Revenues and Revenues from the Two Largest Taxes in Each State

*Collections through May, FY2003 Compared with FY2002*



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

## Six-State Review

### Connecticut

Between FY1995 and FY2001, Connecticut's general fund recorded surpluses totaling \$3.1 billion. Saddled with a heavy debt load, partially a legacy of the previous recession, policymakers elected to use the surplus funds to retire debt and increase general fund spending rather

than build substantial budgetary reserves. When state revenues collapsed in FY2002, a deficit of \$817 million surfaced in the general fund (a deficit of roughly 7 percent of general expenditures). To cover the gap, Connecticut drew down its entire \$600 million reserve and issued approximately \$220 million in economic recovery notes.

Connecticut's fiscal situation continued to deteriorate in FY2003. Revenue increases, both one-time enhancements and longer-term measures, were enacted at midyear; without these, FY2003 general revenue collections would have remained flat relative to FY2002. Most of the revenue slowdown is attributable to the personal income tax. The state revised its projections for personal income tax receipts downward by \$421 million. Projections for income tax withholding were revised to a decrease of 1 percent from a gain of 6 percent. The new numbers show capital gains receipts, originally forecast to rise by 5 percent, declining by 10 percent. Receipts from the sales and use tax, the state's second largest source of general revenue, originally projected to increase by 4.3 percent, were revised to show growth of only 1 percent.

In February, as this dismal picture emerged together with the likelihood of cost overruns in Medicaid and other social service programs, Connecticut's comptroller projected a deficit of \$602 million for FY2003. To try to close this gap, the legislature passed a deficit mitigation package containing nearly \$400 million in additional one-time and recurring revenue enhancements, \$70 million in inter-fund transfers, and \$138 million in spending reductions. Despite these actions, the state still faced a potential unresolved deficit for FY2003 of \$66 million to \$101 million.<sup>1</sup>

FY2004 and FY2005 continue to look grim. According to Governor Rowland's proposed FY2004–FY2005 biennial budget, “current service gaps” are expected to swell to \$2 billion in FY2004 (15 percent of general expenditures) and to \$2.5 billion in FY2005 (17 percent of such expenditures). In the face of such enormous potential deficits, the governor has proposed spending cuts totaling \$1.3 billion in FY2004 and \$1.7 billion in FY2005. He would eliminate the remaining gap with broad-based tax increases, including the following:

- an across-the-board increase in all income tax rates of 0.5 percentage points, expected to raise an additional \$500 million in revenue;
- a reduction in the state's property tax credit of \$100, raising an additional \$70 million;
- a 10 percent corporate surcharge for FY2003 and FY2004;
- broadening of the sales tax base; and

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<sup>1</sup> The lower estimate reflects the budget estimate of the Office of Policy and Management, while the higher figure represents the June estimate of the state comptroller.

- an increase in the sales tax rate on computer and data processing services from 1 percent to 3 percent.<sup>2</sup>

## Maine

by Robert Roose

Like its regional peers, Maine has felt the burden of slow revenue growth and rising spending needs. Continued weakness in personal income tax receipts and capital gains tax collections held general revenue growth to a lackluster 2.2 percent increase for FY2003.

In an effort to head off a potential deficit in FY2004, Governor Baldacci proposed in February a budget that includes no general tax increases, but relies on a number of revenue enhancements, including increased fees; an insurance premium tax expansion; delayed tax reductions; and increased tax collection activity. He also proposed several one-time revenue actions, including the sale of the state's wholesale liquor operation; an extended contribution schedule to the Maine State Retirement System (an extension from 17 years to 25 years); transfers from the highway fund to the general fund; and numerous expansions of reliance on federal Medicaid funds.

The budget adopted by the legislature largely followed the governor's proposal, with some modifications. In one change, some state jobs were preserved through revenues generated from increased fees for parks, meat inspection, commercial fishing, recreational hunting, and fishing, among other items. General purpose aid to education was increased modestly over the governor's recommended levels — to \$732 million in FY 2004 and \$725 million in 2005, up from \$714 million in FY2003.

The state's swift action was favorably received by the credit rating agencies, which announced in June that they would maintain the state's high ratings (AA+ rating from Standard & Poor's and Fitch; Aa2 rating from Moody's Investor Services).

## Massachusetts

Although the Commonwealth closed FY2003 with an unexpected budget surplus of \$133 million (roughly 0.6 percent of expenditures), officials continue to anticipate anemic revenue growth of \$30 million in FY2004 (an increase of less than 0.5 percent over FY2003 levels).

In the face of this grim fiscal future, the legislature-conference committee passed a \$23.1 billion budget for

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<sup>2</sup> Beginning on July 1, 1997, the sales tax was phased down by 1 percentage point per year (from 6 percent). It was dropped to 1 percent as of July 1, 2001. The governor is proposing a permanent rate of 3 percent.

## An Update:

### The Recent Economic Performance of the New England States

The July 2003 issue of *New England Economic Indicators* features an overview of the economic performance of the New England states in 2002 and early 2003. The article reviews economic activity in the region as a whole as well as the performance of individual states in the context of the national situation and the prior year. Key industrial sectors are highlighted in addition to economy-wide performance as reflected in such indicators as employment, unemployment, personal income, and prices. Although the primary focus is on the year 2002, for which complete data are available, indicators for early 2003 (through May in many cases) offer a preliminary perspective on the outlook for the current year.

The complete text of this overview article, including all charts and references, is available on the Boston Fed's web site.

<http://www.bos.frb.org/economic/nee/nee.htm>

At this site, you'll also find the most recent issue of *Indicators*, articles that have appeared in earlier issues, and the entire *Indicators* database of current and historical data for more than 130 series in easy-to-access format.

FY2004 that relies heavily on broad-based fee increases and approximately \$175 million in "corporate [tax] loophole closing" to bolster receipts. Spending is slated to increase by \$292 million, or 1.3 percent, over FY2003 levels. This increase is driven almost exclusively by health care related spending and debt service. Medicaid expenditures alone are expected to be higher by \$600 million, a 10.5 percent increase. Debt service is expected to increase by \$120 million, or 8.1 percent.

Beyond health care related spending and debt servicing, all other state spending is budgeted to decrease by \$462 million (roughly 3 percent) from FY2003 levels. Among the largest cuts are \$252 million in local educational aid (down 6 percent from FY2003), \$153 million in higher education spending (down 15 percent), and \$57 million in general aid to local governments (down 4 percent).

As part of the budget, the legislature also adopted a number of structural reforms proposed by Governor Romney. The most significant of these include the following:

- streamlining the Commonwealth's human services bureaucracy;
- combining the state's Economic Development,

Consumer Affairs and Business Regulations, and Labor and Workforce Development departments into one office; and

- merging the Metropolitan District Commission and the Department of Environmental Management.

Soon after the conference committee completed its work, the governor vetoed appropriations worth approximately \$200 million. "Because I believe that available revenues will not be enough to support the level of expenditures that [legislators] have recommended," the governor wrote in his veto message, "I am vetoing \$201 million to ensure that the Fiscal Year 2004 budget is balanced and that we maintain a more sustainable level of government spending." Local aid experienced the greatest cuts under the governor's veto — a total of \$57 million, including \$23 million in unrestricted general aid, \$10 million in kindergarten grants, \$6.5 million in special education reimbursements, and \$5 million in sewer rate relief funds. The governor also vetoed increased spending across a wide variety of programs, including funds to provide legal aid to the poor (\$9.6 million) and travel and tourism expenditures (\$3.7 million).

As of this writing, House and Senate overrides have restored roughly \$42 million of the vetoed expenditures.



Legislative leaders have until the end of the current legislative session to resolve the remaining differences, and Speaker of the House Thomas Finneran has indicated that consideration of contested budget items may continue into the fall.

## New Hampshire

In February, Governor Benson submitted an all-funds budget of \$8.7 billion for FY2004–FY2005. The budget would close the \$223 million gap projected to arise in the FY2004–FY2005 biennium (approximately 2 percent of expenditures).

The governor's proposal calls for a "taxpayer bill of rights" that would require a two-thirds majority vote of the legislature to raise taxes and would limit the rate of future budget increases to inflation.<sup>3</sup> It also includes several expenditure changes, most notably affecting education. It recommends an overhaul of the state's adequacy formula under the governor's "No Community Left Behind" program. This program would redesign the state's efforts to meet its constitutional obligation to fund an adequate education. Among the changes proposed are the following:

- redefine what constitutes an "adequate" education to ease the fiscal requirements imposed on the state;
- eliminate the need for some towns to share their property tax revenues with other towns;

<sup>3</sup> State of New Hampshire, *Governor's Executive Budget Summary* (Revised), February 13, 2003, p. 2.

- make state aid to education more fiscally equalizing, that is, concentrate it more on poorer school districts;
- increase the level of state aid to education by \$87 million; and
- nearly halve the state's property tax rate over the next five years.

The budget proposes \$20 million in funding for the No Community Left Behind program and \$4 million for a matching grant program for municipalities seeking to create charter schools. Proposed cutbacks include a 5 percent cut in Medicaid reimbursement to providers and a slight reduction in higher education funding. The budget also recommends a prison consolidation and across-the-board reductions in personnel through layoffs and attrition.

The legislature restored roughly \$212 million of the governor's proposed cuts (the conference committee's recommended general fund spending is roughly \$66 million higher than the governor's proposal). In late June, the governor vetoed the budget passed by the legislature. As of this writing, the governor and legislative leaders are engaged in negotiations.

## Rhode Island

Rhode Island experienced fiscal challenges similar to the other New England states in FY2002. But Rhode Island's approach to dealing with them was different: The Ocean State joined a number of other states (not in New England) in securitizing its tobacco settlement revenues.<sup>4</sup>

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Securitization allowed Rhode Island to accomplish three things:

- to balance its books in FY2002;
- to buy back existing general obligation debt, thereby freeing up funds otherwise budgeted for debt service payments; and
- to carry reserved proceeds forward into the current and next fiscal years.

Largely, although not solely, as a result of securitization, Rhode Island's fiscal situation is now stable. Policymakers anticipate a balanced budget in FY2003 and FY2004.

In this climate, Governor Carcieri has proposed a revised budget for FY2003 containing roughly \$38 million, or 1.4 percent, in additional spending above the previously authorized level. He has also proposed a budget for FY2004 that would increase state spending by \$124 million, or 2.3 percent, over the level proposed for FY2003.

The FY2004 budget assumes modest general revenue growth of 3.0 percent. Personal income tax collections, which account for roughly 31 percent of total receipts, are expected to increase by 5.6 percent over revised FY2003 estimates. Sales tax collections, which account for 29 percent of general revenues, are expected to total \$814 million in FY2004, an increase of 4.6 percent. The introduction of newly approved video lottery machines is expected to bring in an additional \$48 million in general revenues.

Dragging down the rate of revenue growth are (1) business tax collections (7.4 percent of revenues), which are expected to decline by 1.7 percent from FY2003 levels, and (2) a host of "other sources," which are expected to bring in significantly less revenue. Foremost in this latter category is the absence of one-time revenue enhancements, such as the state's tobacco securitization, used to balance the budget in FY2003.

On the spending side of the equation, the governor's revised budget for FY2003 increases expenditures for corrections by \$6.8 million, for school construction, by \$4.8 million, and for debt service, by \$8.6 million. His proposed budget for FY2004 envisions expenditures of all types totaling \$5.6 billion. Roughly 49 percent of this \$5.6 billion reflects general fund spending, which is expected to increase by \$67.6 million, or 2.5 percent, over budgeted FY2003 levels. The \$67.6 million increase is distributed as follows:

- \$23.6 million for debt servicing;
- \$16.5 million to the Department of Human Services to cover caseload growth;
- \$11.3 million for School Housing and Local Education Aid;
- \$9.6 million for costs associated with growth in the state's inmate population; and
- \$5.0 million to expand higher education scholarship programs. School aid is level-funded at \$622.6 million.

In an effort to control costs, the governor's budget increases Rhode Island state employees' share of pension costs from 8.75 percent to 10.75 percent of salary and correspondingly decreases the state's share of contributions from 9.6 percent to 7.6 percent. Teachers' pension contributions are raised from 9.5 percent of salary to 11.5 percent. Combined, these two actions are expected to save the state \$18.1 million per year. Further savings are sought through a reduction in the state's full time equivalent worker authorization from a cap of 15,383 employees for FY2003 to 15,251 for FY2004. This reduction is expected to save the state \$7 million.

The state's budget reserves are expected to remain fully funded at their legally mandated level of 3 percent of expenditures, and the state expects to close FY2004 with a balance of \$85 million.

## Vermont

Within the New England region, comparatively speaking, Vermont's fiscal situation and outlook are strong. After utilizing reserve accounts and enacting roughly \$22 million in budget rescissions, the state expects to close FY2003 with a \$4.6 million surplus, less than 1 percent of expenditures. Total expenditures for the year are expected to come in at \$1.5 billion, down 1 percent from budgeted levels, and the state's budget stabilization reserve account is expected to end the year with a balance of \$26 million. With the exception of the state's human services caseload reserve, all other reserve accounts are expected to have zero balances by the end of FY2003.

After experiencing a 7 percent decline in revenues in FY2002, the Green Mountain State anticipates overall revenue growth of 2.3 percent for FY2003 and 3.2 percent in FY2004. Revenues from the personal income tax, the state's largest source of general revenues, fell 11 percent in FY2002, will likely be flat in FY2003, but are expected to grow by 4.4 percent in FY2004. Revenues from the sales and use tax, the second largest revenue source, are expected to close FY2003 up 2.3 percent over FY2002 levels and to rise 3.6 percent in FY2004. Corporate income tax revenues, down 37 percent in

4 Securitization is the sale of the right to future settlement payments — in this case, from tobacco companies — in exchange for an upfront lump-sum payment. For discussion of this transaction in the case of Rhode Island, see the Winter 2002/2003 issue of *New England Fiscal Facts* (No. 30).

FY2002, are expected to fall again in FY2003 and then to rebound in FY2004, although the FY2004 level is still expected to be some 30 percent less than in FY2001.

While far from rosy, Vermont's financial position is relatively strong, as Governor Douglas recognizes: "We as Vermonters are fortunate that, while these revenue sources are insufficient to fund all our desired programs," the governor wrote in his revenue outlook, "we are in substantially better position to weather these challenges than our counterparts in other states."

Reflecting these sentiments, the governor submitted a budget to the general assembly limiting growth in general fund spending to 1 percent, growth in the transportation and education funds to 1.1 percent, and special funds growth (including Medicaid) to 4.6 percent. To keep these growth rates low, the governor asked all agencies to seek cost reductions totaling 5 percent to 10 percent of prior year appropriations.

The budget proposal would, however, expand fund-

ing in certain areas. To spur economic development, the governor proposed a jobs and economic security package worth \$107 million, including \$60 million in low-interest loans to entrepreneurs and \$25 million in bridge financing for small businesses. He also proposed providing \$15 million to the Vermont Agricultural Credit Corporation for low-interest financing to farmers, and he recommended the creation of a new Department of Information and Innovation to upgrade the state's provision of web-based services.

In increased funding for education, the University of Vermont, Vermont state colleges, and the Vermont Student Assistance Corporation would receive a 2 percent increase, and \$239 million would be transferred from the state's general fund to the education fund to support elementary and secondary education.

Collectively, the governor believes that these actions will stave off a potential \$30 million deficit for FY2004 (3 percent of general expenditures). **FF**

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