

# Fiscal Facts

Spring 1994

Federal Reserve Bank of Boston

## Are New Englanders All That Reserved?

**R**eserves are a state's first line of defense in a fiscal crisis. In the late 1980s, they bought New England's state policymakers valuable time in which to devise strategies for stabilizing their budgets. While the region's state budgets are currently balanced, how well are its states reserved against possible future fiscal instability?

In addressing this issue, one should consider both the depth of each state's reserves and the state's commitment to tap them only in a fiscal emergency. This depth is measured as a percentage of general fund spending. A state's reserves are defined here as the sum of its unrestricted general fund surplus and the balance in its general stabilization fund. To evaluate a state's commitment to hold its reserves for

"a rainy day," the percentage of its reserves that is deposited in its general stabilization fund is considered. Most state stabilization funds, which have been established by practically every state in the nation, are reserved by law for use only in fiscal emergencies.<sup>1</sup> By contrast, unrestricted surpluses can be used under any fiscal conditions.

As a general rule of thumb, a fiscally prudent state

should maintain reserves equal to at least 5 percent of general fund spending.<sup>2</sup> At the beginning of the current fiscal year, New Hampshire was the only New England state that met this standard. At 3 percent, Massachusetts had the second-largest fiscal cushion. Connecticut, Maine, and Rhode Island had reserves of 2 percent or less (Table 1). The median

**Table 1**

RESERVES AS A PERCENTAGE OF SPENDING IN THE GENERAL FUND, FY93 AND FY94, NEW ENGLAND STATES

	FY 93 ACTUAL		FY 94 PROJECTED		RATING OF GENERAL OBLIGATION DEBT AS OF MARCH 1, 1994
	RESERVES AS PERCENTAGE OF SPENDING	PERCENTAGE OF RESERVES IN STABILIZATION FUND	RESERVES AS PERCENTAGE OF SPENDING	PERCENTAGE OF RESERVES IN STABILIZATION FUND	
CT	1.5	0	.8	0	Aa
ME	.6	38.5	.9	a	Aa1
MA	3.1	68.5	2.4	83.4	A
NH	6.8	38.9	4.7	60.9	Aa
RI	2.0	71.2	3.0	99+	A
VT	-7.2	—	.5	96.8	Aa

<sup>a</sup> At the end of each fiscal year, Maine's State Controller is required by law to "transfer from the unappropriated surplus of the general fund to the Maine rainy day fund an amount not to exceed one-half the excess of total general fund revenues received over accepted estimates in that fiscal year." The amount to be transferred to the rainy day fund at the end of FY94 has yet to be determined.  
Source: State budget documents, conversations with state budget officials, *Laws of Maine* 1993, c. 141, Title 5, p.1513, and *Moody's Municipal and Government Manual*.

percentage among the 50 states was 2.7 percent.<sup>3</sup>

Vermont entered FY94 with a general fund deficit equal to more than 7 percent of spending. The state had a cumulative deficit because its accounting rules permit it, not because its fiscal condition is dramatically worse than that of the region's other states. Vermont is one of the few states in the nation that allows itself to carry over a deficit from one budget period to the next. Vermont's fiscal condition, however, is not materially worse than that of other New England states. Note that the quality of Vermont's general obligation debt is rated better than that of Massachusetts and Rhode Island, and equal to that of Connecticut and New Hampshire. Within the region, only Maine's general obligation debt is rated higher.

The region's states also differ widely in the degree to which they maintain their reserves in a stabilization fund. Connecticut and Vermont had no money in their stabilization funds at the beginning of the current fiscal year. At the other extreme, Rhode Island held almost three-fourths of its reserves in its stabilization fund.<sup>4</sup> Connecticut's failure to make a deposit into its fund, despite enjoying a \$113 million surplus in FY93, has drawn criticism from some fiscal watchdog groups.

How large will the reserves of each New England state be at the end of the current fiscal year, and what percent-

age of them will be deposited in the state's general stabilization fund? According to official projections, both New Hampshire and Massachusetts will allow their ratio of reserves to general fund spending to decline somewhat, although they will increase the percentage of their reserves deposited in their stabilization fund. Rhode Island, a state that has had difficulty balancing its FY94 budget, nonetheless plans to raise its reserve-to-spending ratio and place virtually all of its reserves in its stabilization fund. Vermont expects to erase its cumulative deficit and make a small deposit into its stabilization fund. Connecticut and Maine will continue to have a relatively low ratio of reserves to spending. Moreover, Connecticut has no plans to deposit any of its reserves into its stabilization fund.

In the early stages of an economic recovery, states face a tough trade-off between satisfying neglected fiscal needs and saving for a rainy day. Over the course of the next several years, this trade-off will continue to be harsh for the New England states, given the severity of the region's recent recession, the weakness of its recovery to date, and the slow economic growth projected for the remainder of the century. However, the painful experiences of the last recession have made the region's states more aware of their fiscal fragility and of the consequences of failing to protect themselves against future fiscal shocks.

<sup>1</sup> In addition to earmarking the balances in their stabilization fund for fiscal emergencies, several states also require a "supermajority" to approve withdrawals from the fund. For example, in New Hampshire all withdrawals must be approved by both the governor and two-thirds of the legislature.

<sup>2</sup> See Barbara Yondorf, *A Legislator's Guide to Budget Oversight: After the Appropriations Act Has Passed, 1983* (Denver, CO: National Conference of State Legislatures), p. 54.

<sup>3</sup> Figures from New England states are from budget documents and con-

versations with budget officials. Figures for other states are from Corina L. Eckl et al., *State Budget Actions 1993, 1993* (Denver, CO: National Conference of State Legislatures), Table 2, pp. 8-9.

<sup>4</sup> Rhode Island is required by its constitution to deposit 2 percent of its general revenues each year into its stabilization fund until the fund's balances reach 3 percent of general revenues. The state expects the 3-percent target to be reached by the end of this fiscal year.

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## Around New England

All the New England states anticipate finishing fiscal year 1994 (FY94) in the black, although Rhode Island and Vermont have had to struggle to make ends meet. With short-term fiscal stability restored, the region is beginning to tackle long-term issues. Perhaps the most salient example during the past several months has been the funding of public education. Across New England, inequities exist among school districts, caused by heavy reliance on local property taxation for funding. In both New Hampshire and Rhode Island, the courts have recently ruled that these inequities deprive citizens in poor school districts of their state constitutional right to an adequate education. Vermont's House of Representatives has passed a bill abolishing the use of local property taxes to fund public schools. Massachusetts has begun to implement a long-term education reform program that, among other things, supplements the fiscal resources available to property-poor municipalities. As Massachusetts' program demonstrates, reducing reliance on local property taxes requires large increases in state school aid. Financing these increases poses a major long-term fiscal challenge.

### Connecticut

Connecticut's general fund revenues for the first seven months of FY94 were \$84 million, or 1 percent above original projections, according to the Comptroller, William Curry, Jr. In addition, the state carried over a \$113 million surplus from FY93. Connecticut is fortunate to have these two sources of extra funding, since the Controller estimates that general fund spending in FY94 will exceed appropriations by \$142 million. Cost overruns have been concentrated in Medicaid, welfare, corrections, and court-mandated children's services.

FY95 promises to be a replay of FY94. General fund spending is expected to exceed budgeted levels by \$131 million, but reserves and higher-than-anticipated revenues should be sufficient to cover the needed supplemental appropriations.

Whether Connecticut is adhering to the terms of its spending cap continues to be a contentious issue. (See *Fiscal Facts*, Winter 1994.) Especially controversial is the failure of the legislature to define clearly which expenditures are subject to the cap. The constitutional amendment implementing the cap constrains growth in "all general budget expenditures" and requires the legislature to "by law define" the term "general budget expenditures." The legislature has not yet explicitly done so, although certain categories of spending are exempt from the cap, for example, fiscal assistance to distressed municipalities and court-mandated outlays. A group of taxpayers has asked Hartford Superior Court to require the legislature either to stipulate clearly which expenditures are capped or to adhere to the terms of the FY92 budget. In another lawsuit, the Federation of Connecticut Taxpayer Associations argues that the state constitution does not permit exemptions from the cap.

### Maine

Maine has managed to stay in the black in FY94, despite the recent enactment of \$14 million in supplemental appropriations. The state has financed these extra outlays with a small surplus carried over from FY93 as well as FY94 general revenues slightly above projections. However, the state's low fiscal reserves, warnings of further cost overruns in FY95, and a potential legal challenge to the state's new nursing home tax have made the legislature wary about further spending initiatives and the income tax cut proposed by Governor John McKernan.

To date, FY94 supplemental appropriations have increased general fund spending by about 1 percent. Much of the extra money replenished an exhausted fund for property tax relief to elderly and low-income homeowners, financed overtime pay for prison guards and mental health workers, and covered cost overruns in foster care and Aid to Families with Dependent Children (AFDC). Agency heads have indicated, however, that they will need another \$23 million to maintain current service levels throughout the remainder of the FY94-95 biennium.

The state's controversial nursing home tax, enacted last July, is a 7 percent levy on the gross receipts of nursing homes. The tax, projected to add \$23 million to the state's coffers during the biennium, is controversial because most of its proceeds are used to reimburse nursing homes for their Medicaid expenses. In a preliminary ruling, the federal government has argued that the tax is, in effect, no tax at all, because the state's Medicaid reimbursements received by nursing homes are very similar to the taxes they pay, thereby holding each nursing home "harmless." Nevertheless, these state Medicaid expenditures generate federal matching grants. According to the federal ruling, the whole arrange-

ment indirectly, and illegally, channels federal grant money to Maine's general fund. (See *Fiscal Facts*, Spring 1992, for a more detailed explanation of how a previous arrangement worked in New Hampshire.)

Governor McKernan has proposed a phased-in 20 percent reduction in state graduated income tax rates. The governor would limit the aggregate tax liability for Maine's income tax payers in FY94 to \$582 million, the amount expected to be collected during the fiscal year according to the most recent official projection. Tax collections exceeding this amount would be returned to taxpayers through across-the-board income tax rate reductions for 1994. In FY95 the state anticipates \$606 million in tax collections, assuming current tax law. Collections in excess of that total would be returned to taxpayers through rate reductions for 1995. In subsequent years, income tax collections in excess of \$606 million would be returned to taxpayers through rate reductions until tax rates were 20 percent below their current levels. Several legislators have questioned the wisdom of committing the state to a long-term freeze on income tax revenues without regard to possible future spending needs.

## Massachusetts

Massachusetts is in better fiscal shape than other states in the region. State spending has remained within budgeted levels, and tax revenues are running approximately 1 percent above projections. In addition, the Commonwealth carried over an unrestricted balance of \$143 million from FY93, a cushion against any unforeseen shortfalls.

Governor Weld has proposed a FY95 budget that would increase state spending by 3 percent (Table 2). His budget would increase spending on educational reform and crime prevention at the expense of welfare. He has asked for a \$214 million increase (15 percent) in aid to local schools, the amount needed to fund fully the Commonwealth's Education Reform Act of 1993. His crime package would triple state aid for community policing and expand prison capacity by 4,000 cells.

In cutting back AFDC, the governor would eliminate cash grants for "able-bodied recipients," while increasing funds for child care, health insurance, and other benefits to allow

**Table 2**

TOTAL STATE APPROPRIATIONS FOR FY94<sup>a</sup> AND GOVERNORS' RECOMMENDED APPROPRIATIONS FOR FY95<sup>b</sup>

	BILLIONS OF DOLLARS		PERCENT CHANGE
	FY94	FY95	
CT	6.92	7.38	6.5
ME	1.80	1.83	1.9
MA <sup>c</sup>	12.83	13.25	3.3
NH	1.11	1.16	4.2
RI	1.71	1.75	2.0
VT	.78	.82	5.2

<sup>a</sup> Unless otherwise noted, includes general fund and transportation fund appropriations only. Excludes expenditures of federal grants and reimbursements. Supplemental appropriations currently being considered for FY94 but not enacted as of March 15, 1994 are not included.

<sup>b</sup> Figures for Maine and New Hampshire are monies appropriated for the second year of the FY94-95 biennium.

<sup>c</sup> Total spending and operations minus federal reimbursements.

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

single parents to work. Parents who are able to work but cannot find jobs would be provided a safety net and a program of temporary employment. The governor estimates that this new Employment Support Program would cut the welfare caseload by one-half, saving the state approximately \$40 million.

The governor's budget assumes an increase of \$50 million in net revenue

from the state lottery and \$132 million from new gambling initiatives. These initiatives, which include installing over 5,000 video poker machines at racetracks and legalizing riverboat casinos, have met with serious opposition from several legislators. Legislators have also questioned the governor's estimate of a \$50 million increase in lottery revenues. They fear that, since Massachusetts already has the highest per capita spending on lottery tickets in the nation, demand for these tickets may have peaked and may even weaken if new gambling alternatives are introduced. (See *Fiscal Facts*, Summer 1993.)

## New Hampshire

New Hampshire's revenues were on target for the first seven months of FY94. Thanks in large part to an increase in tourism, year-to-date collections from the meals and rooms tax are running 6 percent ahead of expectations, more than offsetting shortfalls in several other taxes. The rooms and meals tax accounts for roughly one-quarter of New Hampshire's general fund revenues.

New Hampshire's Supreme Court recently issued a ruling that could require the state to increase dramatically the amount of fiscal assistance it provides to its local school districts. New Hampshire's constitution explicitly requires the state to provide an adequate education to every educable child residing within its borders. State aid accounts for less than 10 percent of public school funding, the lowest percentage in the country. The state's school dis-

districts rely heavily on local property taxes.

In a case brought on behalf of five school districts, the Court ruled that, as a result of this heavy reliance on local property taxation, the state fails to provide property-poor districts with the means to educate their children adequately. The Court directed lower state courts to decide what changes are needed in the level of state aid to education, the formula by which that aid is distributed, and the tax mix used to fund that aid in order to ensure that all school districts can provide their children with an adequate education. Public officials are divided over whether the Supreme Court's ruling will require the state to adopt a broad-based personal income or retail sales tax.

## Rhode Island

Like Connecticut's, Rhode Island's spending has outpaced projections during the first seven months of FY94. Unlike its neighbor, however, Rhode Island has experienced a slight revenue shortfall and has practically no unrestricted balances carried over from FY93. As a result, in late January budget officials were projecting a FY94 general fund deficit of between \$36 million and \$38 million, or about 2.6 percent of projected general revenue. Cost overruns in Medicaid and general public assistance have contributed heavily to the problem. To make ends meet by June 30, the state is transferring balances from previously restricted funds and cutting spending on a wide array of programs. Nevertheless, the state plans to meet its constitutional requirement and deposit 2 percent of its general revenues into its budget stabilization fund (about \$28 million).

Given Rhode Island's persistent fiscal instability, Governor Bruce Sundlun has proposed an increase of only 2 percent in spending for FY95 out of general and transportation fund revenues. His FY95 budget provides for large increases in local aid (both general revenue and school aid), higher education, and public safety. Spending out of general revenues on several human service programs would be reduced, although increases in federal grant money would shore up many programs.

The governor's budget calls for an increase in the excise tax on cigarettes from 44 cents to 51 cents per pack, the tax rate currently imposed by Massachusetts. Also recommended is a new tax on hospitals (4.56 percent of gross receipts) to be used primarily to attract new federal Medicaid grant money to the state.

Like New Hampshire, Rhode Island has been told by its

courts that its system of financing public education is unconstitutional. According to a recent ruling by State Superior Court Judge Thomas H. Needham, the state's current system of financing public education violates the state constitution's "education" and "equal protection" clauses by depriving children in poor districts of an education comparable in quality to the education available in affluent districts.

Judge Needham has indicated that a pending educational reform package, referred to as the Guaranteed Student Entitlement bill, would pass constitutional muster. The bill would reduce reliance on the property tax for financing public education, increase the amount of state aid for schools by one-third, and alter the formula for distributing this aid among cities and towns. The new formula would take into account the relatively high costs of educating urban students attributable to their adverse social environment. In its current form, the bill would increase state spending by \$265 million over a five-year period.

## Vermont

Although Vermont has been carrying a cumulative deficit on its books for several years, the state will probably erase it by the end of this fiscal year. Curtailing growth in spending has played an important role in the state's progress to date. If current projections hold, general fund spending will decrease by about 1 percent and transportation fund spending will increase by less than 3 percent between FY92 and FY94.

Governor Howard Dean is maintaining a cautious stance. Vermont's revenues for the first seven months of FY94 were only 2 percent above year-ago levels. Administration Secretary William Sorrell has noted that, during this same time period, revenues from the state's sales and rooms and meals taxes were almost 5 percent below expectations. He has also expressed concern about the difficulty of predicting revenues from the personal income tax, given two changes in the tax's provisions that have recently taken effect. First, the increase in federal tax rates enacted last August automatically raised Vermont's income tax, since a Vermont household's state income tax liability is a percentage of its federal income tax liability. Second, the state reduced its personal income tax rates effective January 1, 1994, rescinding temporary tax increases enacted in 1990. Secretary Sorrell is also concerned that personal income tax refunds, to be mailed out this spring,

### State Budget Timetable

#### ANNUAL BUDGETS

FY94: July 1, 1993 to June 30, 1994

FY95: July 1, 1994 to June 30, 1995

Massachusetts, Rhode Island, Vermont

#### BIENNIAL BUDGETS

FY94-95: July 1, 1993 to June 30, 1995

Connecticut, Maine, New Hampshire

may exceed projections.

Governor Dean's proposed budget for FY95 calls for an increase in total spending of 5 percent. Most programs would be level-funded. Spending increases would be concentrated in the areas of debt service, corrections, mental health, social and rehabilitative services, and transportation. In addition, the governor is asking for \$20 million to help pay for a proposed health care reform package, to be financed by earmarked revenues from a new tax on hospitals and higher taxes on tobacco, beer, and gasoline.

Vermont's legislature recently acted on welfare and school finance reform. In January, the legislature enacted

a welfare reform bill, effective July 1, 1994, that will require many welfare recipients to obtain employment in order to maintain eligibility for benefits. In addition, the House of Representatives has passed a major school financial reform package that eliminates most local property taxes for school funding and replaces them with local income taxes (none currently exist), a new statewide tax on non-residential property, and increases in the sales tax and rooms and meals tax. The Senate is expected to modify this school finance reform proposal substantially.



Our new publication, *New England Banking Trends*, combines financial statistics with analyses of trends in the region's banking industry. Each issue provides a set of statistical tables, a concise summary of financial highlights, and an article on a pertinent technical issue. The summer issue considered home equity lending; the Fall issue reviews the progress of New England's banking recovery; the Winter issue examined restructured loans.

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