

New England Fiscal Facts

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Are Foundation Grant Programs a Panacea or a Problem? Part 3

By Daniel G. Swaine

In 1977, the Connecticut State Supreme Court declared in *Horton v. Meskill I* that Connecticut's mostly locally funded school finance system was unconstitutional. While the court decision concluded that absolute spending equality was not required, it stated that any reform must eliminate the relationship between per-pupil expenditures and per-pupil wealth — the principle of wealth neutrality stressed in most such court decisions. In 1979, Connecticut implemented a guaranteed tax base (GTB) formula. The court affirmed that this was constitutional in 1985 in its follow-up decision in *Horton v. Meskill III*. In 1990, the legislature changed the state aid formula from a GTB formula to a foundation grant formula.

In 1998, four Connecticut school districts (Bridgeport, New Britain, Seymour, and East Hartford) filed a lawsuit (*Johnson v. Rowland*), arguing that the state had failed to fulfill the *Horton v. Meskill I* mandate. One of the reasons for this alleged failure, the plaintiffs said, was a decline in the share of educational costs borne by the state, a decline that began in 1990 with the switch to a foundation grant formula. The plaintiffs have asked the court to enforce the combined 1977 and 1985 *Horton v. Meskill* decisions. Because the court has not said that a foundation grant formula is constitutional, if a ruling in this case favors the plaintiffs, the state may be compelled to return to the GTB formula that the court affirmed was constitutional in 1985. In this issue

of *Fiscal Facts*, we discuss elements of the policy dilemma that faces state decision-makers as a result of the *Johnson v. Rowland* lawsuit.

Practical Consequences of Implementing a GTB Reform

In its 1978-79 session, the Connecticut legislature enacted a series of measures that implemented a GTB formula (see *Fiscal Facts*, Spring/Summer 1999, for information on GTB formulas). The guaranteed wealth level (or GTB) was set at the 98th percentile in per-pupil wealth. No district with wealth above the GTB would receive aid, but neither would such districts be subject to revenue recapture — payments made to the state that would be redistributed to prop-

Four Part Series

This article is Part 3 of a four-part series on school finance reform in New England. Part 1 (*Fiscal Facts*, Fall/Winter 1998) discussed the legal strategies that have been used to challenge school financing and the three main approaches schools have followed in narrowing spending disparities. Part 2 (Spring/Summer 1999) looked at the effectiveness of guaranteed tax base formulas in achieving wealth neutrality and/or spending equality. Part 4 will discuss educational performance reform in the context of school finance reform.

Editors

Robert Tannenwald
Daniel G. Swaine

Designers

Fabienne A. Madsen
Coleen Burgess

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**State
Budget
Timetables**

Annual Budgets

Massachusetts
Rhode Island
Vermont
FY99: July 1, 1998
to June 30, 1999
FY00: July 1, 1999
to June 30, 2000

Biennial Budgets

Connecticut
Maine
New Hampshire
FY98-99: July 1, 1997
to June 30, 1999
FY00-01: July 1, 1999
to June 30, 2001

erty-poor districts. This meant that 98 percent of all districts were eligible to receive state aid under the GTB program.

During a six-year phase-in period, the legislature enacted many modifications to the basic GTB funding formula. Three modifications directly affected the operation of the GTB system:

- A switch from reimbursing current, or one-year-old, expenditures to reimbursing three-year-old expenditures.
- The establishment of a minimum expenditure requirement (or MER), forcing each district to spend above a stipulated minimum in order to qualify for GTB aid.
- The establishment of a cap on the amount of aid that a district could receive.

The first modification — a switch from reimbursing one-year-old expenditures to reimbursing three-year-old expenditures — was designed to mitigate the effects of implicit price subsidies contained in a GTB formula. These subsidies alter district spending behavior and hinder the ability to achieve wealth neutrality through property tax-base equalization. The rate of the price subsidy varies inversely with a district's property wealth — property-poor districts have relatively large subsidies, while property-rich districts have relatively small or negligible subsidies. According to economic theory, the lower purchasing prices for education experienced by poor districts as a result of the subsidy will cause them to increase their educational spending relative to richer districts. These price-induced spending increases will be in addition to the greater spending allowed by equalizing property tax bases. Thus, the price subsidy may invert the normal positively sloped wealth/spending relationship, rather than achieve the zero slope necessary for wealth neutrality. Reimbursing three-year-old expenditures attempts to mitigate the inversion by breaking the link between the rate of price subsidy for a district and its current spending behavior.

The second modification — the establishment of a minimum spending requirement, or MER — was designed to force all districts to achieve some minimum, or foundation, level of spending. The MER for all districts was originally set at the median spending level. However, this was modified for districts with wealth levels below the median. They were required to tax themselves only at the median tax rate, with the result that a different minimum expenditure requirement was applied to each district with a wealth level below the median. In 1983, the MER was set at the 75th percentile of per-pupil spending in three-year-old data, but once again was applied only to districts that were above the median wealth level.¹

The final modification to the GTB formula — a cap on the amount of aid that a district could receive — was designed to limit the potential cost of the program to the state treasury. The cap was set so that no district could receive an amount in state aid that exceeded its minimum expenditure requirement.

The many different restrictions that were legislatively imposed on the GTB formula during the phase-in created a funding system that was cumbersome, difficult to understand, and hard to administer. Because of these problems, in 1990, Connecticut replaced the GTB program with a much simpler foundation grant formula, called the Educational Cost Sharing (or ECS) formula.

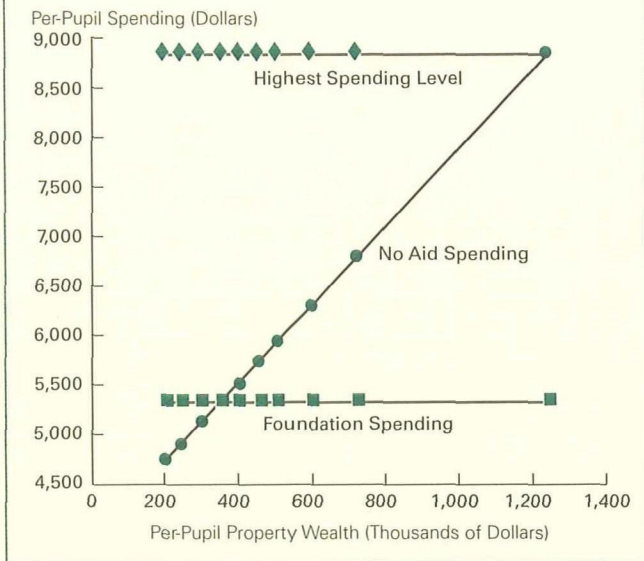
Mechanics of Foundation Grant Aid

Compared with the restricted GTB formula that was implemented in Connecticut, foundation grant formulas are easier to understand and administer. A foundation formula requires two pieces of information: the foundation expenditure level, which may be the same for all districts, and the required local contribution, which varies inversely with local property wealth. In a foundation system, state aid is equal to the foundation spending gap: the foundation spending level less the required local contribution. The required local contribution is equal to a state-determined target tax rate times the level of

¹ For 1988 to 1989, the last year of the GTB program, the MER for regular program expenditures was \$5,215 in 1997 dollars.

Chart 1

Foundation Grants and Wealth Neutrality



local property wealth. Typically, in systems without revenue recapture provisions, districts in which the foundation gap is greater than zero receive foundation grant aid, while districts with a foundation gap of zero or less receive no aid.

To illustrate how foundation aid is calculated using these two pieces of information, let's construct an example using three hypothetical districts. The first district, which we will call the foundation district, has per-pupil property wealth of \$423,933 and spends at a level of \$5,300. Let's assume that the state sets the foundation expenditure level at \$5,300. Let's also assume that the state sets the tax rate for the required local contribution at the rate that will achieve the foundation spending of \$5,300 for a district with a wealth level of \$423,933: a rate of 0.0125 for this example ($\$5,300 / \$423,933$). With the foundation spending level set at \$5,300, and the required local contribution equal to \$5,300, the foundation gap for the foundation district is zero, and it will not receive foundation grant state aid.

Now let's consider two additional districts. The second district has per-pupil property wealth of \$200,000. The third district has per-pupil property wealth of \$1,259,000. For the second district, the required local contribution is \$2,500 per pupil ($0.0125 \times \$200,000$), while for the third district, it is \$15,738 ($0.0125 \times \$1,259,000$). The second district would receive foundation grant state aid totaling \$2,800 per pupil ($\$5,300$ less $\$2,500$). The third district can easily achieve the foundation expenditure if it taxes at the required tax rate, so it would not be eligible to receive foundation grant state aid. But, in a foundation system with revenue recapture provisions, the third district would have to pay \$10,438 ($\$5,300$

less \$15,738) per pupil back to the state for redistribution to property-poor districts that spend below the foundation.

Foundation Grant Formulas and Wealth Neutrality

Can a foundation grant system achieve wealth neutrality? Chart 1 answers this question in the affirmative, under certain conditions. Chart 1 is based on 1997 data for 10 statistically representative Connecticut school districts that are "deciles."² The expenditure levels that are plotted on the positively sloped line in Chart 1 represent the estimates of what each district would spend on education in the absence of state foundation aid grants (that is, "no aid"). We call this line the "no aid" spending relationship.³ The flat line with squares for data points represents the 1997 foundation expenditure level for regular program expenditures of approximately \$5,300.⁴ As the chart shows, this foundation spending level is identical to the estimated "no aid" spending level of the fourth decile district — approximately the 40th percentile. The flat line with diamonds for data points represents the spending level of the top decile district — which is near the 100th percentile. The flat lines on the chart are impor-

2 The districts have been constructed so that each contains exactly 10 percent of statewide enrollment — a decile of students. The method of construction is as follows: First, the districts are arranged so that property wealth levels are in ascending order, from smallest to largest. Next, the districts are clustered into 10 groups each containing 10 percent of statewide enrollment. Finally, weighted averages of the property wealth and spending levels are calculated for each of the 10 groups, with the weights being the actual student enrollment levels of each district. With this method of construction, the 10 districts are statistically representative of the actual property wealth levels and spending levels of the districts that make up the deciles.

3 By "no aid," we mean an aid level of \$250 per pupil for each district. This is the minimum aid that has historically been granted in the state of Connecticut, a figure that preexisted the Horton case and the GTB formula. In order to project what district spending levels would be without state equalizing aid, we statistically estimate a multiple linear regression with actual spending rates (spending levels divided by property wealth) as the dependent variable, and with the natural logarithm of property wealth and the actual dollar level of state aid as the two independent variables. Estimated "no aid" spending rates are calculated using this equation by replacing actual state aid with a flat minimum aid grant of \$250 per pupil. The calculated spending rates are then multiplied by property wealth to obtain estimated "no aid" spending levels for all districts. The estimated spending levels are then grouped into deciles, following the procedure described in the previous footnote. Because these spending levels were estimated with a nonlinear relationship, in order to simplify the plot of this relationship, the grouped data are linearized with a simple regression using the estimated spending levels for each decile as the dependent variable and the property wealth levels for each decile as the independent variable. Because the predicted values from this regression are guaranteed to fall on a straight line, it is these values that are plotted on Chart 1.

4 School spending numbers that are typically reported are for net current expenditures, which include all education expenditures except school construction expenses, and expenses for transporting students. The foundation spending level for net current expenditures was about \$5,700 per pupil in 1997. On the other hand, regular program expenditures, the spending concept that we use throughout this article, subtracts expenditures for special education from net current expenditures.

tant, because if spending levels were the same for all districts, there would be no correlation between per-pupil property wealth and per-pupil spending levels, and the system would be wealth neutral.

In order for a foundation grant system to achieve wealth neutrality, the state aid formula must alter district behavior so that districts spend according to a flat spending line, rather than a positively sloped spending relationship. State policymakers might use two alternatives to achieve this goal. Chart 1 illustrates both approaches. The first alternative employs revenue recapture provisions. Consider the second and eighth decile districts on Chart 1:

- The second decile district has a wealth level of \$232,883 per pupil and spends \$4,858 with no aid. If we give this district an aid grant equal to the difference between the foundation spending level of \$5,300 and the “no aid” spending level of \$4,858, this district could achieve the foundation spending level provided that it does not change the level of tax effort that is implied by the “no aid” relationship.
- The eighth decile district has a wealth level of \$595,058 per pupil and spends \$6,242 with no aid. If we impose a tax on this district (negative state aid or revenue recapture) exactly equal to the difference between the “no aid” spending level of \$6,242 and the foundation spending level of \$5,300, this district would be forced to reduce its spending to the foundation spending level. We again assume that the district does not alter its tax effort.

Without revenue recapture, the only way for a foundation system to achieve wealth neutrality is for policymakers to raise the foundation to the spending level achieved by districts that are near the top of the wealth distribution. On Chart 1, the flat line with diamonds for data points represents this spending level. Consider the procedure that we described above for the second decile district, but using the higher foundation spending level. If we employ this procedure to distribute foundation grants to virtually all districts, then wealth neutrality could be achieved, provided that districts do not change the level of tax effort implied by the no aid spending relationship.

Using either alternative, it is theoretically possible for a foundation grant system to achieve wealth neutrality. However, in practice, achieving wealth neutrality is difficult. Recall that foundation grant aid is equal to the foundation gap: the difference between the foundation spending level and the spending level that state policymakers set as the required local contribution. Three conditions are necessary for a foun-

dation system to achieve wealth neutrality:

- First, “no aid” district spending levels and the required local contribution must be identical. Typically, they are not identical.
- Second, with the receipt of an aid grant, each district must continue to raise the amount of funds for education that it would have raised in the absence of the aid grant.
- Third, each district must spend the entire amount of its foundation aid grant on education. In practice, state aid grants enhance the revenue, or income, of the district, and this changes the district’s spending behavior in a way that may not be intended by policymakers. Some portion of the income enhancement — the aid grant — will be spent on education, but some portion will also “leak out” of education to be spent on other forms of municipal government spending or on property tax relief. This kind of behavior exemplifies what economists call the “income effect.”

What Has Connecticut’s Foundation Grant System Achieved?

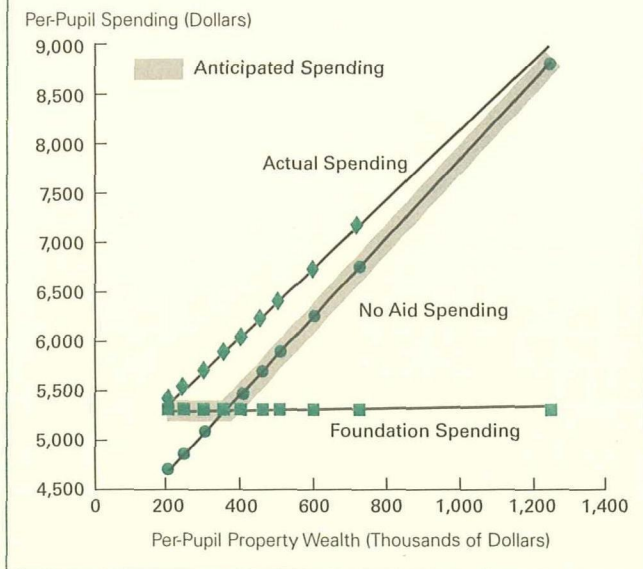
Has Connecticut’s foundation grant system achieved wealth neutrality? And if not, what has it achieved? Chart 2 answers these questions. The positively sloped line with circles for data points is the estimated “no aid” spending relationship that we used in Chart 1. Now, consider the positively sloped line with diamonds for data points. The expenditure levels that are plotted on this line represent estimates of actual expenditures on education in 1997.⁵ We call this line the “actual” spending relationship. The flat line with squares for data points is the foundation spending line that we used in Chart 1. Finally, the line segments highlighted in gray show the level of spending that we would expect from a foundation program without revenue recapture — the type of foundation program employed by Connecticut — assuming no change in tax effort. We call this “anticipated” spending.

A glance at the “actual” spending relationship reveals that Connecticut’s foundation grant program clearly has not achieved wealth neutrality. Because policymakers chose a fairly

⁵ Because factors other than wealth and state aid influence local district spending, actual spending levels would be scattered around the line plotted in Chart 2. In order to simplify the chart for expositional purposes, we linearize the actual spending levels with a simple regression that uses the actual spending levels for each decile as the dependent variable and the property wealth level for each decile as the independent variable. The projected spending levels from this regression are guaranteed to fall on a straight line, and it is these spending levels that are plotted for the “actuals” on Chart 2.

Chart 2

No Aid Spending Versus Actual Spending in 1997



low foundation spending level, the main reason that wealth neutrality has not been achieved is the absence of revenue recapture. As the highlighted line shows, anticipated spending itself is not wealth neutral. If Connecticut’s foundation system hasn’t achieved wealth neutrality, what has it achieved? Chart 2 also answers this question: Foundation grants have raised spending for the bottom districts to the foundation level, but wealthier districts are still spending more. In fact, in the absence of revenue recapture, this is as much as this particular foundation system can hope to achieve.

Why Does “Actual” Spending Exceed “Anticipated” in Almost All Districts?

- Districts are not spending as expected for two reasons:
- More districts than anticipated are receiving an enhanced aid grant because a “hold-harmless” provision was inserted into the foundation grant law.
 - The practical consequences of the “income effect” change local district spending behavior from what we anticipated.

Connecticut policymakers granted districts “hold harmless” aid when the switch to the foundation program occurred. What are the effects of “hold harmless” aid? The anticipated spending levels highlighted in Chart 2 suggest that foundation aid should be paid only to those districts with wealth levels below \$348,000 per pupil — approximately the 40th percentile in the wealth distribution. However, in the prior GTB system, the guaranteed wealth level was set at the 98th percentile, so that 98 percent of all districts were eligible to

receive aid. Providing “hold harmless” aid attempted to make each district at least as well off under the new policy as under the old. This meant that the target wealth level for the receipt of foundation aid grants had to be set very high, even though the foundation spending level was set fairly low.

In the 1996-97 school year, the target wealth level for receiving foundation aid was set at a value of \$657,200 per pupil — the 82nd percentile in the wealth distribution.⁶ Thus, approximately 82 percent of all districts received foundation grant aid. The remaining districts received the minimum aid level – traditionally \$250 per pupil, but in 1990 the level of minimum aid was also increased. As a result, “hold harmless” aid vastly expanded the number of districts eligible to receive enhanced aid grants. The practical effects of “hold harmless” aid can be seen in Chart 2 in the comparison between actual spending and “no aid” spending. Actual spending exceeds “no aid” spending for all districts because actual spending incorporates state aid grants for virtually all districts.

How does the “income effect” change local district behavior? To answer this question, let’s look at the behavior of the fifth decile district. In 1997, this district received foundation grant aid of about \$2,100 per pupil. How much of this grant was actually spent on education? As Chart 2 shows, actual school spending for the fifth decile district was about \$6,000 per pupil, while estimated “no aid” school spending was about \$5,500. Thus, out of the \$2,100 foundation aid grant, this district increased educational spending by \$500 per pupil, while directing \$1,600 per pupil to other municipal expenditures or tax relief. Policymakers typically impose spending restrictions on how foundation grant aid can be used, but Chart 2 shows that these spending restrictions were only modestly effective in stemming the leakage of funds away from education.

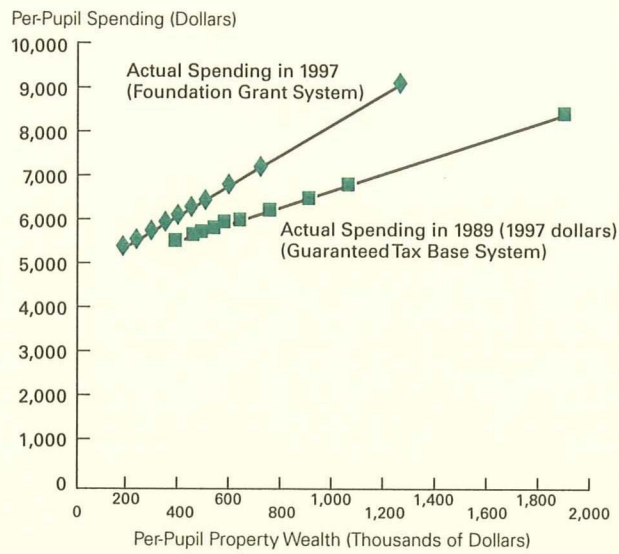
GTB System versus Foundation Grant System: A Brief Comparison

Chart 3 compares the wealth/spending relationship for the GTB system in 1989 (the last year of the program) to the wealth/spending relationship for the foundation grant system in 1997. The more steeply sloped line with diamonds for data points represents the wealth/spending relationship estimated for the foundation program in 1997. The less steeply sloped line represents the wealth/spending relationship for the GTB program in 1989, with both spending and

⁶ The value of \$657,200 is 1.55 times the median wealth level.

Chart 3

Comparing Spending Relationships in 1989 and in 1997



wealth levels expressed in inflation-adjusted 1997 dollars. As Chart 3 shows, wealth levels in 1989 were significantly higher than wealth levels in 1997, and the degree of disparity in wealth levels was greater in 1989.

Both of the wealth/spending relationships have positive slopes. Even though the GTB program did not achieve wealth neutrality, spending was somewhat less responsive to differences in wealth (that is, the GTB relationship was closer to being wealth neutral than the foundation relationship). The positive slope to the GTB relationship occurs either because imperfect methods were used to compensate for the GTB pricing subsidy, or because other factors not equalized by the GTB program are correlated with both wealth and spending. A caveat needs to be applied to these comparisons. Because of differences in the two wealth distributions, a more appropriate comparison could be made if the GTB program were applied to the 1997 wealth distribution. But this comparison can be accomplished only by resorting to simulation methods.⁷

7 The correct comparison requires simulating district behavioral responses to the two systems using the same wealth base. How each district responds to the rules of the system (behavior) determines the effectiveness of each respective system, given the underlying distribution of property wealth. Since the two periods have different wealth distributions, one could reasonably expect that district behavior would also be different, and an adequate comparison becomes difficult to make in the absence of a behavioral simulation.

Implications and Conclusions

In this and in our previous article, we showed that both a GTB system and a foundation grant system can achieve wealth neutrality in theory. However, it is difficult for either system to achieve wealth neutrality in practice. First, legislators find it difficult to impose the revenue recapture provisions that are necessary in order for either system to achieve wealth neutrality. Second, each redistribution system leads to behavioral responses that can defeat the goal of achieving wealth neutrality.

As discussed in the previous issue of *Fiscal Facts* (Spring/Summer 1999), a GTB system contains price subsidies that, if ignored, tip the slope of the wealth/spending relationship from positive to negative. To avoid this, the GTB formula must be modified to compensate for these price subsidies. In the GTB system implemented from 1979 to 1989, Connecticut countered the lack of revenue recapture by setting the GTB at a very high level (98th percentile). Connecticut also attempted to modify the GTB formula to compensate for the pricing subsidies, but despite this modification a positive relationship between wealth and spending remained.

Foundation grant systems rarely impose revenue recapture provisions, and Connecticut's Educational Cost Sharing program is no exception. However, without revenue recapture, a foundation system cannot achieve wealth neutrality, unless policymakers set the foundation at the spending level of the wealthiest districts, a step that would be costly to the state treasury. The result is a system left to achieve the less ambitious goal of establishing a floor beneath district spending levels. Foundation systems are usually successful in achieving this purpose, as has been the case in Connecticut. But, in foundation grant systems, a behavioral incentive known as the "income effect" implies that state aid funds will leak away from education towards other forms of spending. **FF**

Across *the* Region



Revenue growth across the region was less robust in FY99 than in FY97 or FY98. Slower growth resulted from the effects of previously enacted tax cuts that were phased in during FY99, combined with slower business tax collections due to overseas economic turmoil. Tax revenue surpluses ranged from a low of 1.7 percent of revenues in Massachusetts to a high of 7.6 percent of revenues in Connecticut. In FY2000, many New England states are spending down surpluses accumulated in past years, or are returning them to taxpayers. FY2000 budget growth will average between 6 percent and 8 percent for most states in the region — somewhat more rapid than FY99 tax revenue growth. Tax cuts dominated the legislative agenda in five of the six New England states. Only New Hampshire, preoccupied with educational finance problems created by the Claremont case, deviated from this trend.

Final State Appropriations for FY99 and Enacted Appropriations for FY2000^a

Excluding Federal Dollars

	FY99	FY00	Percent
	Millions of Dollars		Change
Connecticut	9,498.0	10,039.0	5.7
Maine	2,426.1	2,574.4	6.1
Massachusetts ^b	16,111.0	17,311.2	7.4
New Hampshire ^c	1,236.1	1,341.6	8.5
New Hampshire ^d	1,236.1	2,028.4	64.1
Rhode Island ^e	2,801.7	2,965.0	5.8
Vermont ^f	1,427.4	1,474.6	3.3

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

^b FY99 spending is the amount enacted by the legislature as of June 30, 1999.

^c FY00 spending is the amount passed by each house of the legislature during the spring of 1999.

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

^e Includes new state educational funding measure enacted in response to *Claremont et al v. Governor et al*.

^f Includes general revenue and other unrestricted funds.

^f Includes Act 60 spending.

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

Six-State Review



Connecticut

Connecticut ended FY99 with total tax collections of \$8.4 billion, up 2.4 percent over FY98. Sales and income tax collections led the way, growing 5.1 percent and 5.7 percent, respectively, significantly less than revenue estimators had projected. Most business income taxes declined substantially, slowing overall revenue growth. The weakness in business tax collections is attributable to a continued phase-in of previously enacted tax cuts, as well as lower business profits in the face of weak demand from overseas customers.

According to final figures, Connecticut realized an FY99 general fund tax revenue surplus of \$591.7 million. Also, the Comptroller's office released a report on August 31 stating that Connecticut recorded a combined general and transportation fund budget surplus of \$124.6 million in FY99. The \$124.6 million breaks down as follows: the \$591.7 million tax revenue surplus, less an initial built-in deficit of \$140.4 million budgeted for FY99, less \$326.7 million in net supplemental appropriations.

In mid-June, the legislature enacted and the governor signed a \$10 billion own-source revenue budget for FY2000, up 5.7 percent from the \$9.5 billion that the Comptroller's Office said was spent in FY99. However, because final FY99 spending was \$393 million (4.3 percent) greater than originally appropriated, the FY2000 budget is 10.3 percent above initial FY99 appropriations. Highlights of the FY2000 budget include:

- A \$50 per-person sales tax rebate totaling \$110 million. A second tax reduction of \$15 million eliminates sales taxes on home improvements.
- An income tax cut in the form of an increase of \$75 in the property tax credit for households with incomes of less than \$43,000 and property tax bills of at least \$500. This tax cut will cost an estimated \$44 million in FY2000.
- A reduction in the hospital gross earnings tax rate from 7.25 percent to 4.5 percent, reducing revenues by nearly \$50 million.
- \$55 million of the budget surplus to be spent on school construction.
- \$150 million from the tobacco settlement to be used

to freeze tuition and fees in the state public higher education system. The budget sets aside an additional \$23 million from the tobacco settlement to be deposited into a trust fund for health programs.

- Authorization of a \$300 million bond offering for the Adriaen's Landing development project located in Hartford, Connecticut.

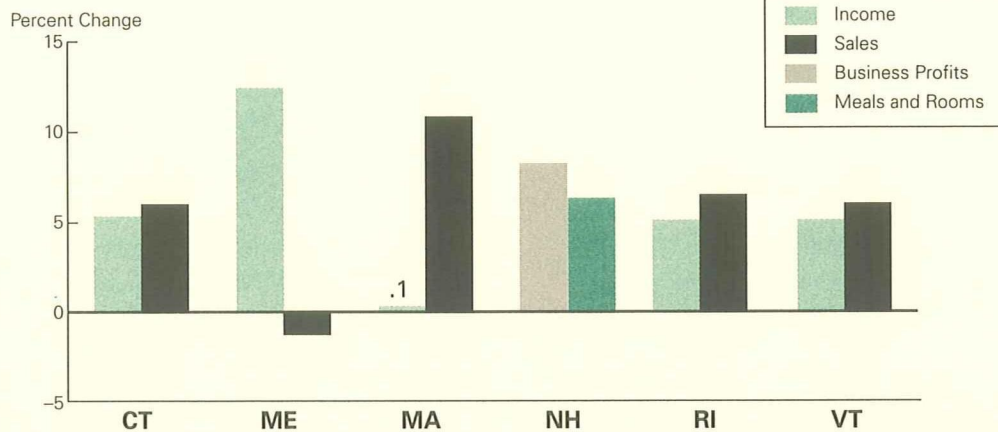
Maine

Maine collected an estimated \$2.3 billion in tax revenues during FY99, up 5.2 percent from FY98. Income tax collections led the way, with a growth rate of 12 percent, indicative of a very strong labor market. The reduction in the sales tax rate from 6 percent to 5 percent effective October 1 slowed sales tax collections from a 4.4 percent increase (a base-to-base comparison) to a 1.3 percent decline. This tax cut cost the state \$47 million, but its full impact was not felt because it took effect part way through the fiscal year. On a full-year basis, the cost would have been \$72.5 million in FY99. Corporate tax collections were also down by 1 percent for the year. Lowered profitability from overseas economic turmoil was the primary reason for the decline. Despite disappointing results in some tax components, overall revenue growth exceeded budgeted projections, resulting in an estimated \$77.6 million general fund revenue surplus for FY99.

The legislature enacted a \$29.8 million supplemental appropriation for FY99, bringing FY99 own-source spending to an estimated \$2.4 billion, up 10.3 percent over FY98 expenditures. In late June, the legislature finalized FY2000 spending plans by enacting a \$2.6 billion own-source revenue budget, up 6.1 percent from FY99. Despite the revenue loss from the sales tax cut, revenue estimators forecasted that final FY99 growth in tax revenues (using a base-to-base comparison) would once again exceed 8 percent, thereby triggering another 0.5 percentage point reduction in the sales tax rate. Legislators decided to forestall this trigger by enacting an additional 0.5 percentage point reduction in the sales tax effective January 1, and then repealing the automatic trigger. FY2000 budget highlights are as follows:

Revenues from the Two Largest Taxes in Each New England State

FY99 Compared with FY98



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

Spending:

- \$60 million in new spending for local schools: \$36 million in new general purpose aid and \$24 million for school construction.
- \$23 million for research and development grants awarded to the University of Maine.

Tax Cuts (\$204 million):

- \$120 million for the repeal of the hospital tax.
- \$40 million additional tax relief for homeowners.
- \$40 million tax reduction for new equipment purchases by businesses.
- An additional 0.5 percentage point cut in the sales tax rate, from 5.5 percent to 5 percent.

Revenue Increases (\$24 million):

- A 3 cents per gallon hike in the gasoline tax, raising \$21 million.
- A \$2 hike in auto registration fees, raising \$3 million.

Massachusetts

The Commonwealth collected a total of \$14.2 billion in taxes during FY99, up a very weak (but better than expected) 1.7 percent over FY98 collections. Given the large reduction in personal income taxes that was enacted with the FY99 budget, weak growth in tax collections was expected by the administration, which had projected flat revenue growth for the year. The slightly stronger than expected revenue growth resulted in a \$244.7 million revenue surplus for FY99. Sales tax collections paved the way to the revenue surplus, growing a bet-

ter-than-expected 10.4 percent during FY99.

Three months into FY2000, the Commonwealth has yet to enact a budget for the current fiscal year. This inaction is the result of a disagreement between Senate President Thomas Birmingham and House Speaker Thomas Finneran over spending priorities and the enactment of additional tax cuts. The House and Senate passed very different budget and tax reduction proposals, and the conference committee appointed by the two legislative leaders has been unable to resolve the differences between them. Because the amount of any new tax cuts will greatly influence the expected rate of growth in revenues during FY2000, and since the amount of any new spending depends upon this expected growth, the budget process has been held hostage to this disagreement. State government is operating, but under a series of interim monthly budgets that fund government services at FY99 spending levels.

New Hampshire

New Hampshire collected \$940.3 million in tax revenues during FY99, up 4.9 percent from FY98. Revenues from business taxes (business profits tax and business enterprise tax) and from the meals and rooms tax grew most rapidly, by 7.9 percent and 6.1 percent, respectively. Because receipts from these taxes are heavily influenced by the tourism industry, their relatively strong performance is evidence that the tourist business was quite healthy during the past fiscal year. As a result of this strong performance, New Hampshire realized a \$62.1 million tax revenue surplus for FY99.

In late June, the legislature enacted a \$2.03 billion own-source revenue budget for FY2000, up 64.1 percent from adjusted FY99 expenditures. These figures include the \$825 million school financing bill passed in response to the state Supreme Court's decision in the Claremont case (see *Fiscal Facts*, Spring/Summer 1999). On a basis comparable to earlier years, the own-source revenue budget for FY2000 is up 8.5 percent (or \$105.4 million) over adjusted FY99 expenditures. About half of the \$105.4 million spending increase is devoted to just three areas: a \$20 million increase in local aid, a \$26 million increase in the human services budget, and a \$5 million increase (up 7.0 percent) in the public higher education budget.

Despite having passed a school finance reform bill at the end of April, the Claremont case and school funding remain an issue for three reasons. First, the school funding appropriations bill that was enacted last spring left an estimated \$100 million deficit that has yet to be addressed by policymakers. Second and third, the state is facing two new school finance court challenges: a suit filed by the Claremont plaintiffs with the Supreme Court in late August, and a suit that is expected to be filed by property-rich districts during the fall.

Recall that the Claremont decision has two components: (1) that property tax rates for education should be equal across districts, and (2) that the state has a responsibility to fund an "adequate" education (see *Fiscal Facts*, Fall/Winter 1998). The court did not define the cost of an adequate education, and the new education financing law used an arbitrary method to set the level of educational funding at \$825 million. Herein lies the basis for the new case filed by the Claremont plaintiffs. The \$825 million figure is too low, the Claremont plaintiffs say, because it funds only 62 percent of the estimated \$1.33 billion spent by local districts during the past academic year. Critical of the arbitrary way in which the state arrived at the \$825 million, the Claremont plaintiffs have asked the court to appoint a court master to arrive objectively at an adequacy cost figure. In addition, their suit asks the court to remove six allegedly unconstitutional features of the new law. In October, the Supreme Court ruled that the provision in the new law phasing in a uniform property tax over five years was unconstitutional, throwing school financing in New Hampshire again into turmoil.

Rhode Island

Rhode Island collected \$1.7 billion in tax revenues in FY99, up 2.6 percent, slightly less than the 3.4 percent growth projected by the administration at mid-year. Consistent with

a strong labor market, personal income tax revenues grew 5.0 percent from FY98 levels despite a 0.5 percentage point reduction in the income tax rate. Sales tax collections also exhibited strong growth of 6.2 percent. Both taxes met mid-year projections. However, on a less sanguine note, business income tax collections declined 7.6 percent during FY99. Overseas economic turmoil combined with past business tax rate reductions was responsible for the weaker-than-expected results. Rhode Island realized a \$97.9 million general fund revenue surplus in FY99. Offsetting the revenue surplus was a \$28.2 million (1.4 percent) supplemental appropriation, which, when combined with a built-in budget deficit of \$93.7 million enacted in June 1998, left a \$24.0 million general fund operating budget deficit for FY99.

At the end of June 1999, the legislature enacted and the governor signed into law a \$3.0 billion own-source budget for FY2000, up \$163.3 million, or 5.8 percent, from the final FY99 spending figure. Most of this increase is devoted to two separate initiatives to increase state aid to municipalities. By far the lion's share reflects the continuation of a planned ten-year phase-in of a local property tax reduction enacted in June 1998 (see *Fiscal Facts*, Fall/Winter 1998). The revenue that is lost as the tax is phased out must be replaced with new state aid. The second initiative is an increase of \$38 million in aid for local education. Finally, the budget act affects future state revenues by continuing the third in a series of five planned 0.5 percentage point reductions in the personal income tax rate. This year, the tax rate falls from 26.5 percent to 26 percent of federal tax liability.

Vermont

by Pei Zhu

Vermont enjoyed tax revenue growth of 5.8 percent in FY99, slightly higher than projected growth of 5.2 percent. Meals and rooms tax collections were up 8.1 percent, followed by an 8.0 percent increase in corporate tax revenues. Sales and use tax and personal income tax collections also grew, by 5.6 percent and 5.0 percent, respectively. The state closed FY99 with an operating budget surplus of \$60 million. Most of this surplus is designated to finance a series of one-time capital projects, such as the purchase of the Champion lands, construction of a new prison, and related improvements in the town of Springfield. Any remaining surplus will be transferred to various reserve funds.

For FY00, an own-source revenue budget of \$1.47 billion was enacted into law in late June. It reflects a 3.3 percent increase over FY99 levels and is about 1.9 percent larger than that proposed by Governor Dean in January. The budget

contains no significant changes in spending priorities.

In June, the legislature passed Act 49, which makes several amendments to Act 60 (the educational finance reform law), as well as modifications in other state tax laws and in the collection of administrative fees. The major provisions of this act are the following:

1. The need for local-option education property taxes will be reduced in various ways: (a) An injection of \$36 million in state funds into the local option property tax revenue sharing pool will permit the guaranteed equalized yield to be at least \$42.09 per capita in FY00, an increase from the \$40.00 per capita that was originally expected.^{1,2} An estimated 213 towns receive aid from the revenue sharing pool, while 47 towns contribute to the revenue sharing pool. (b) Additional state funds will be used to reimburse school trans-

portation expenditures. (c) The current state-funded block grant will be indexed for inflation. (d) The \$75,000 income cap for homesteads valued at \$160,000 or less will be removed, a measure designed to increase benefits for the owners of business proprietorships.

2. Personal income tax rates will be reduced from 25 percent to 24 percent of the federal liability, starting January 1, 2000. The reduction is estimated to cost the state \$6.7 million in FY00.

3. Each article of clothing that costs \$110 or less will be excluded from sales taxation, beginning December 1, 1999. This will reduce tax revenues by an estimated \$6.1 million in FY00. The exemption will be expanded to footwear as of July 1, 2001. **FF**

1 Guaranteed yield means that a 1 percentage point increase in the local option tax rate is guaranteed to yield every district \$42.09 per capita in tax revenue.

2 \$11 million is funded by a transfer from the General Fund into the sharing pool. The remaining amount is from funds currently held in the Education Fund. The legislature appropriated \$36 million for the FY01 budget as well.

Fiscal Disparity Among the States

from the New England Economic Review

Fiscal Disparity Among the States Revisited

Robert Tannenwald

New England Economic Review

July/August 1999

The *New England Economic Review* presents economic and public policy research by the Bank's economists and others. Topics are regional, national, and international in scope.

The July/August 1999 issue features an article by Robert Tannenwald, Assistant Vice President/Economist at the Boston Fed, analyzing fiscal capacity versus fiscal need in the 50 states. The states differ sharply in the scope of public services their state and local governments must provide and in the costs of providing these services. The author updates state-by-state estimates of fiscal capacity, fiscal need, and fiscal comfort through fiscal year 1996. He finds New England to be by far the least fiscally stressed region in the nation.

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