

# Fiscal Facts

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## Can Guaranteed Tax Base Formulas Achieve Either Wealth Neutrality or Spending Equality? *Part 2*

By Daniel G. Swaine, with Lynn E. Browne

Three highly publicized events are forcing Vermont state policymakers to reconsider the wisdom of the revenue-sharing mechanism that governs the local option portion of the state's recently enacted school finance reform, Act 60:

- Residents of the property-rich "gold" town of Stowe sued the state, in *Anderson et al. v. State of Vermont (1998)*, claiming that Act 60 violated their constitutional right to the "substantially equal" educational opportunity that was stipulated by the state Supreme Court in *Brigham et al. v. State of Vermont (1997)*. Specifically, the plaintiffs argued that the disincentives contained in the revenue-sharing mechanism associated with the local option taxes allowed under Act 60 would make educational spending in property-rich "gold" towns significantly less than spending in the property-poor towns, violating the wealth-neutrality principle that was also stipulated in the *Brigham* decision. The court ruled against the plaintiffs.

- Three property-rich towns, Dover, Searsburg, and Whittingham, have withheld from the state their payments of the statewide property tax enacted by Act 60, as well as the revenue-sharing portion of their local option taxes.

- Some property-rich communities have threatened to circumvent the revenue-sharing feature of the local option taxes allowed under Act 60 by forgoing such taxes altogether and encouraging their residents to make voluntary contribu-

tions to an educational foundation, which would then funnel the money back to the schools in these communities.

In this issue of *Fiscal Facts*, we ask whether the complaints of the property-rich towns are simply the normal grumbling that could be expected as a result of the redistributive feature of the reform, or whether they indicate fundamental problems with the redistributive approach that was chosen in Vermont – a guaranteed tax base (GTB) system.<sup>1</sup> We discuss three major points:

- the definition and measurement of spending disparity and wealth neutrality,
- why a GTB system may not achieve wealth neutrality, and
- why wealth neutrality may not eliminate spending disparities.

### Four Part Series

This article is Part 2 of a four-part series on school finance reform. 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 3 will discuss the use of foundation formula grants to achieve equalization. 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  
Timeables**

*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

## The Design of Act 60

As discussed in the previous issue of *Fiscal Facts* (Fall/Winter 1998), the *Brigham* decision forced policymakers in Vermont to enact legislation to meet two court mandates: wealth neutrality and substantial equality in per-pupil spending. Courts have noted that differences in per-pupil spending across districts are often correlated with differences in per-pupil property wealth. The absence of a correlation between property wealth and spending is termed wealth neutrality. Court decisions that overturn school financing systems commonly stipulate that subsequent reforms can pass constitutional muster only by eliminating this correlation. Additionally, in cases such as *Brigham* that are brought on equal protection grounds, once the court has determined that the existing system is not wealth neutral, the decision usually stipulates that any reform must also achieve "substantial equality" in per-pupil spending.<sup>2</sup>

In designing Act 60, Vermont policymakers attempted to satisfy both mandates. To achieve both substantial equality in spending and wealth neutrality, the first tier of Act 60 provides for an identical per-pupil grant of about \$5,200 to all school districts. This grant is completely state-funded and provides about 80 percent of statewide school spending.<sup>3</sup> A second tier of Act 60, designed to provide about 20 percent of statewide school spending, allows local districts the option of adding on a local tax in order to give districts some choice over school spending levels. To try to maintain wealth neutrality, the local option property tax is operated as a guaranteed tax base (or GTB) system.

A GTB system guarantees that each community has an identical property tax base upon which to levy its local option taxes. Property-rich communities remit the funds they collect in excess of what would be raised by a typical community, via the state, to property-poor communities. The same school finance experts who created the wealth-neutrality principle as a basis for school finance court cases also proposed the GTB system as the primary means by which to achieve wealth neutrality. They assumed that achieving wealth neutrality would leave only small, random differences in districts' per-pupil spending.

## Spending Disparities

Spending disparities exist as long as spending levels are not equal across districts. If the spending levels for each district are arranged in ascending order (from smallest to largest), various measures can be used to summarize the disparity in spending. One common measure is the range – the largest value less the smallest. The range ratio is the largest value divided by the smallest value. Because both measures can be dramatically affected by extreme values, a restricted range may be preferable. A common choice is the value of the 95th percentile district less the value of the 5th percentile district. The comparable restricted range ratio is the value of the 95th percentile district divided by the value of the 5th percentile district.

For the state of Vermont in FY96, the restricted range ratio was 2.17 (the 95th percentile district spent more than twice the level of the 5th percentile district), and the restricted range was \$3,636. The

1 The first article to discuss price incentives in GTB systems and the unanticipated problems that result was by Martin Feldstein. See his "Wealth Neutrality and Local Choice in Public Education," *The American Economic Review*, March 1975, pp. 75-89.

2 The term "substantially equal" spending was borrowed from the well-known *Serrano v. Priest* case in California. The California state Supreme Court stated that per-pupil spending could not vary by more than \$100 across districts in 1976. In 1998 dollars, this amount would be equal to approximately \$250 per pupil.

3 The original flat grant figure that was typically quoted in the press is \$5,000. This figure has been increased to \$5,200, but it is for net current expenditures, which includes all expenditures for education except transportation expenditures for students and school construction. Regular program expenditures, the concept that we use throughout this article, subtracts expenditures for special education from net current expenditures. We eliminate special education expenditures from consideration because of the controversial problems that special education causes.

4 The restricted range ratio is calculated from actual data on regular program expenditures and takes into account the fact that the foundation grant system was both partially equalizing and partially wealth neutralizing.

5 Each of the ten districts contains exactly 10 percent of statewide enrollment (i.e., a decile of students). The property wealth level for each of the ten districts is statistically representative (i.e., a weighted average) of the property wealth levels of the districts that make up the decile.

6 Please note that this assumption allows for negative state aid, or revenue recapture. If we were to plot the sloped line of Chart 1 along with the flat line of Chart 2 in a combined chart, then for each district, the vertical distance between the sloped and flat lines would illustrate the amount of state aid that each district either receives or pays back to the state for redistribution.

plaintiffs in the *Brigham* case were able to argue successfully that these disparities in per-pupil spending were primarily due to disparities in wealth; in other words, the system was not wealth neutral.<sup>4</sup>

### Wealth Neutrality: An Illustration

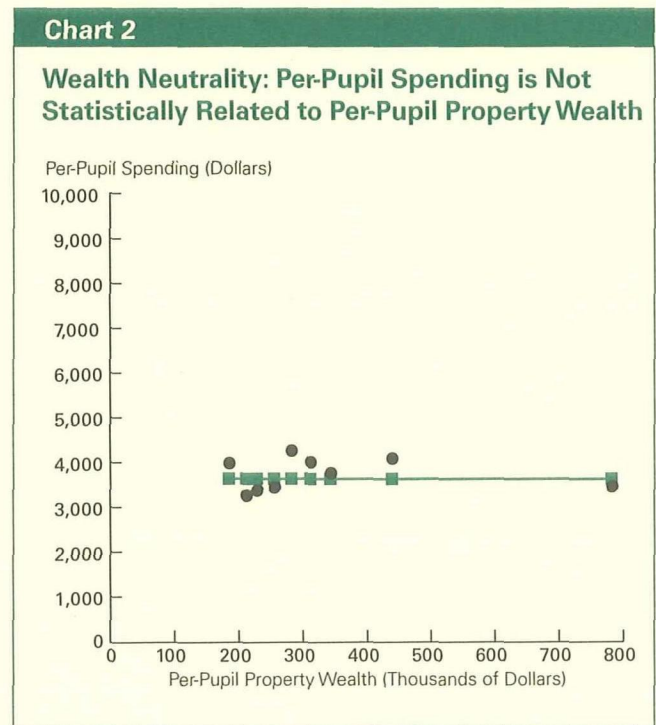
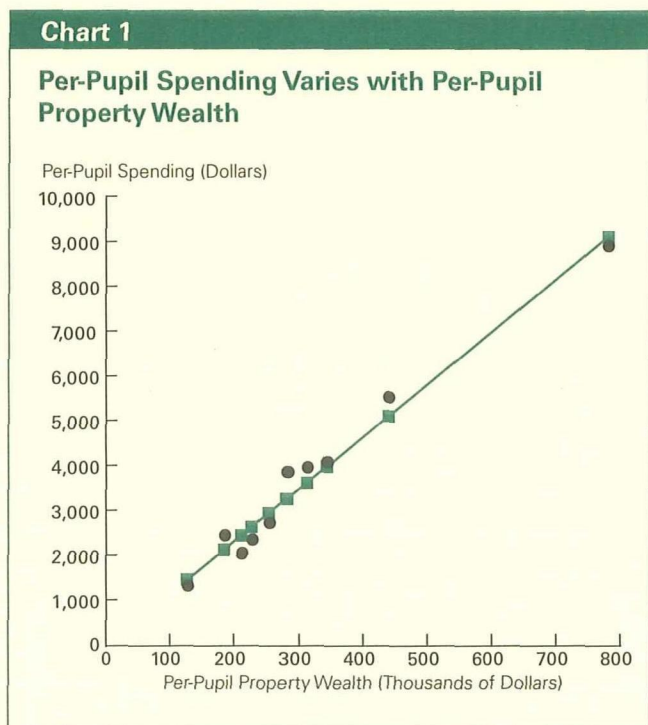
To illustrate the principle of wealth neutrality, we have created ten representative Vermont school districts with significantly different levels of per-pupil property wealth.<sup>5</sup> We make two simplifying assumptions. First, we assume that the ten districts do not receive state aid for education. Second, we assume that all ten districts levy the same property tax rate (equal to the statewide average). These two assumptions assure that differences in per-pupil property wealth across districts are the only reason for per-pupil spending differences across districts – a system that is not wealth neutral by construction. Chart 1 illustrates such a system. The squares along the straight line show the per-pupil revenues that would be raised (and spent) for these ten Vermont districts. Since the line has a positive slope, the school financing system can be said to exhibit a positive relationship between spending levels and property wealth.

What would spending look like if the state were to distribute equalizing aid to the districts in order to render the system wealth neutral? Again, we make two simplifying assumptions. First, we assume that the state employs a GTB system of aid that guarantees each community the same tax

base. Second, we assume that each town continues to tax at the statewide average. Since property-rich towns raise more money for the same (statewide average) tax rate than property-poor towns, this means taking the additional property revenues raised by the rich towns and giving them to the poorer communities.<sup>6</sup> The outcome is the flat line in Chart 2. There is no relationship between wealth and spending levels; and because of our assumption about equal tax rates, achievement of wealth neutrality also achieves perfectly equal spending levels.

Now assume that factors other than wealth also affect spending decisions and that these factors, collectively at least, are not related to wealth. Thus, in the absence of state aid, per-pupil spending would equal per-pupil property wealth multiplied by a tax rate that deviates randomly (with respect to wealth) from the statewide average. Local spending would continue to exhibit a positive relationship to property wealth; but as shown by the circles in Chart 1, the relationship would be fuzzy, with spending levels randomly distributed around the straight line.

Now assume the state redistributes property tax revenues as before, employing a GTB system, so that each community has, in effect, the same tax base. Also assume that each community continues to levy the same tax rate as before. The result is shown by the circles in Chart 2. Spending exhibits no *statistical* relationship (i.e., no correlation) with wealth. However, since tax rates vary randomly around the state average,



district expenditure levels are also randomly distributed around the flat (zero slope) line. Thus, spending levels in this wealth-neutral system are no longer equal. The disparities displayed in Chart 2 are relatively small; but if other factors were important enough, a wealth-neutral redistribution system could still leave a sizable degree of spending disparity.

### Measuring Wealth Neutrality

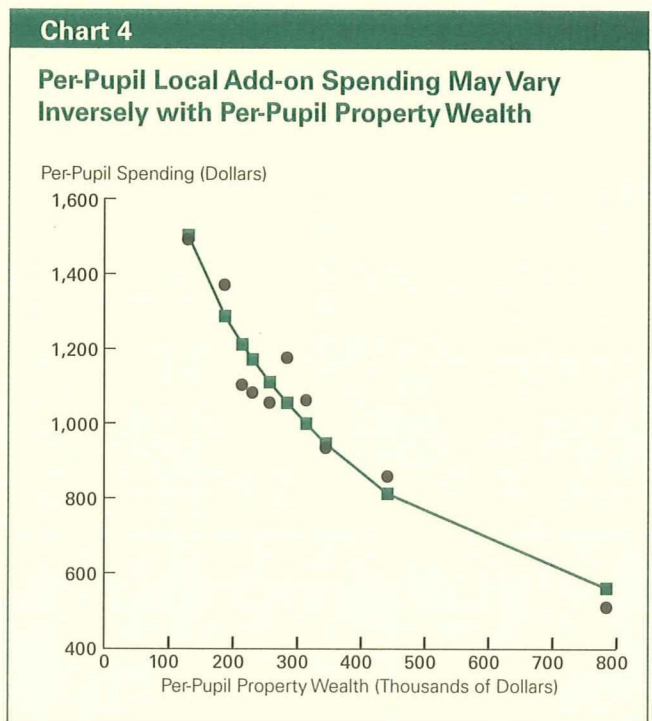
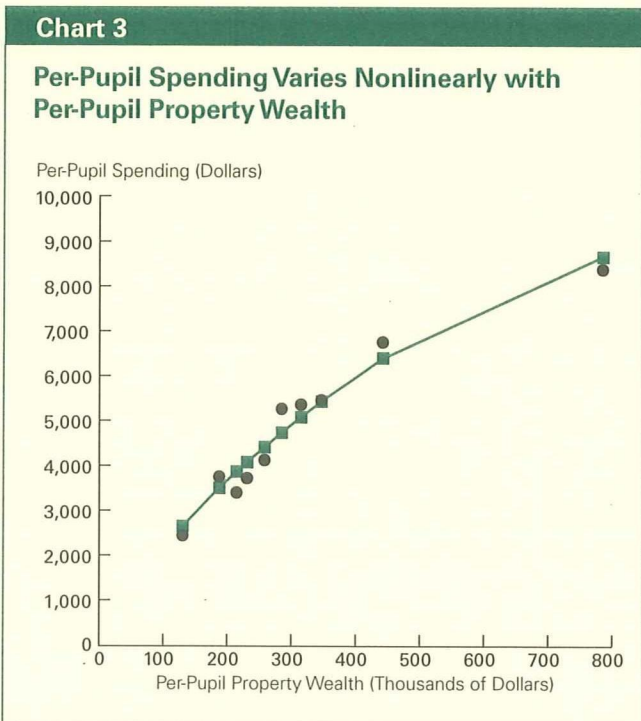
Because other factors besides wealth affect local spending decisions and cause tax rates to vary among districts, the relationship between spending and property wealth is likely to be much less clear than Chart 1 suggests. Statistical techniques may be necessary in order to determine whether spending does, indeed, increase with wealth. A further complication is that some of the other factors affecting spending/tax rates may themselves be correlated with wealth. For example, per-capita income may affect residents' willingness to tax themselves to support school spending. In metropolitan areas, income and wealth are often correlated, with higher-income suburbs having relatively high property wealth. In contrast, in rural or vacation areas, property wealth may be considerable because of vacation properties and agriculture and timber resources, but the incomes of the local residents, who vote on school spending, may be quite low. In the former case, the relationship between income and spending will reinforce the wealth-spending link, while in the latter it will offset the tie to wealth.

In addition, to the degree that voters in different communities have a common sense of what constitutes an adequate or desirable level of expenditure per pupil, there will be some breakdown in the tie between wealth and income. Property-poor communities may impose higher tax rates to compensate for their low tax bases, while property-rich communities may levy very low tax rates because even these low rates yield sufficient revenues to provide high-quality education.

In Vermont in FY96, property tax rates actually varied inversely and *nonlinearly* with property wealth. In other words, property tax rates declined with wealth, and the effect was more pronounced at high levels of wealth. The level of school spending depended on the tax rate levied, the level of state aid that a district received, and the level of wealth. If we control for the level of state aid that a district received, then the resulting property-wealth / school-spending relationship would take a form something like that shown in Chart 3. Spending still increases with wealth, so the system is not wealth neutral. However, according to our estimates, a 10 percent increase in property wealth would increase spending by about 2-1/2 percent — not 10 percent.<sup>7</sup>

### GTB Formulas and Local District Behavior

As discussed above, a pure GTB school aid formula guarantees all districts access to the same property tax base, effectively redistributing property wealth – and tax revenues –



from property-rich to property-poor communities. If all communities maintain their former tax rates and if these tax rates are uncorrelated with wealth, the link between spending and wealth will be eliminated. However, if tax rates are themselves correlated with wealth, then spending will still be a function of wealth. It will be a positive function if communities with more wealth have higher tax rates, and it will be a negative function if property-rich communities have lower tax rates – as was the case in Vermont. Thus, the switch to a GTB could result in property-rich communities spending less than property-poor communities.

Not only could the switch to a GTB system have such a result, but it also actually provides an incentive in this direction. The switch to a GTB formula effectively changes the price paid by the local district for education. A pure GTB formula operates as a matching grant/tax, with the state paying a percentage of each dollar that property-poor districts spend for education and demanding a portion of the funds raised by property-rich districts. Because of the state match, an additional dollar of educational spending costs less than one dollar to districts receiving state aid, while districts subject to a tax pay more per dollar of spending.

The matching rates and their effects on the local price of education can be illustrated with a simple example, using three hypothetical districts: a poor district with a wealth level of \$100,000, a rich district with a wealth level of \$1,000,000, and a “median” district with a wealth level of \$250,000. If the state sets the GTB at \$250,000, the matching rates would be 60 percent for the poor district  $((250 - 100)/250)$ , 0 percent for the median district  $((250 - 250)/250)$ , and -300 percent for the rich district  $((250 - 1,000)/250)$ .<sup>8</sup> Thus, the price of an additional dollar of education would be 40 cents for the poor district, \$1 for the median district, and \$4 for the rich district.<sup>9</sup>

How does a change in the price of education alter the behavior of a local school district? Just as a decrease in price tends to cause consumers to demand more of a good, a decrease in the price of public goods like education also increases the quantity demanded. Conversely, as we increase the price of education (by reducing the matching rate or by imposing a tax through revenue-recapture provisions), a district's demand for education declines.

Thus, a pure GTB system, which guarantees all communities access to the same property tax wealth, affects local school spending behavior in two ways: through a wealth effect and through a price effect. The wealth effect is intended and works to neutralize the influence of wealth on spending. The price effect is unintended and, by making education more costly in

property-rich communities, tends to discourage spending in property-rich communities. Because the wealth effect and the price effect operate simultaneously, the shift to a pure GTB system may reverse the normal positive slope that characterizes the property-wealth / school-spending relationship, producing an inverse relationship, as in Chart 4.

In Vermont, Act 60 provides all districts with a flat grant of \$5,200 per pupil for net current expenditures. This grant achieves both wealth neutrality and spending equalization. However, Act 60 also allows a local option add-on, which is subject to a GTB formula for equalization. Under this formula, the price of education spending funded by the local option taxes is substantially higher for the property-rich towns and very much higher for the “gold” towns. For districts in the top decile of property wealth, the price of a dollar of education is roughly three times the price for the median district.

Various studies of how education spending responds to price suggest that a 1 percent reduction/increase in price will lead to a 0.5 percent increase/reduction in spending. Such estimates are valid only for relatively small changes in price, and thus cannot be readily applied to the Vermont situation. However, it seems clear that the large price increases faced by Vermont's property-rich communities are likely to be a powerful disincentive to spending, and it is not surprising that some communities have reacted as described at the beginning of this article.

## Implications and Conclusions

This analysis suggests two important policy implications:

- First, many court challenges to local school financing are based on the equal protection clause of the state constitution. In these cases, once the court has determined that a system is not wealth neutral, the court usually orders that the reformed system must achieve substantial equality in per-pupil school spending as well as wealth neutrality. However, steps taken to achieve wealth neutrality do not necessarily achieve spending equality. Because many other factors affect

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<sup>7</sup> Using actual Vermont data, we statistically estimated the nonlinear relationship between property tax rates and property wealth, while controlling for the state aid received by each district. Combining this estimated relationship with a second nonlinear relationship that we estimated between state aid and property wealth, we compute the wealth elasticity for the median wealth district to be 0.265. This implies that a 10 percent increase in wealth would increase per-pupil spending by 2.65 percent.

<sup>8</sup> The state matching rate for a GTB formula is given by  $(GTB - W)/GTB$ , where GTB is the guaranteed wealth level, and W is the district's wealth level.

<sup>9</sup> The local price of education is equal to  $(1 - m)$ , where m is the state matching rate. For the poor district, m is 0.6. For the median district, m is 0. For the wealthy district, m is -3.0.

## Across *the* Region

**R**eflecting a healthy economy little affected by overseas economic turmoil, revenue growth across the region remained robust as of the end of February 1999. Responding to the strong revenue flows as well as to bulging cash reserves accumulated from past budget surpluses, most New England states accelerated their spending.

The major issue registering on all state radar screens was the continuing problem of school finance. Massachusetts and Vermont are implementing the school finance reform acts passed recently in these two states. Connecticut is dealing with a new lawsuit, *Johnson v. Rowland*, filed in the state courts in 1998. It asks the court to enforce the historic 1977 decision in *Horton v. Meskill*, as well as the 1985 decision in the follow-up suit, *Horton v. Meskill III*. In Maine, discontent among property-poor, rural school districts has caused the state to consider modifying its local aid formula. In Massachusetts and Rhode Island, suburban school districts are criticizing their states' policy of distributing the lion's share of local aid to financially strapped and relatively property-poor communities. Finally, media attention has been focused on New Hampshire, where the governor and the legislature have struggled to find a new way to fund public education in light of the state Supreme Court's 1997 decision in the case of *Claremont v. Governor et al.* In late April, it appeared that a solution, involving a variety of new and increased taxes, had been cobbled together.

### Enacted State Appropriations for FY99 and Proposed Appropriations for FY2000<sup>a</sup> Excluding Federal Dollars

	FY99	FY00	Percent Change
	Millions of Dollars		
Connecticut	8,912.7	9,379.2	5.2
Maine	2,226.1	2,423.8	8.9
Massachusetts	16,111.0	16,902.5	4.9
New Hampshire <sup>b</sup>	1,222.1	1,342.9	9.9
New Hampshire <sup>c</sup>	1,222.1	2,066.9	69.1
Rhode Island <sup>d</sup>	2,782.4	2,922.0	5.0
Vermont <sup>e</sup>	1,422.2	1,448.0	1.8

<sup>a</sup> Unless otherwise noted, includes general fund and transportation fund appropriations only.

<sup>b</sup> Excludes expenditure of federal grants and reimbursements.

<sup>c</sup> Includes budgeted income from sweepstakes earmarked for foundation aid and special education.

<sup>d</sup> Includes new state educational funding measure due to *Claremont et al. v. Governor et al.*

<sup>e</sup> Includes general revenue and other unrestricted funds.

<sup>e</sup> Includes Act 60 spending.

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

# Six-State Review



## Connecticut

Through the end of February, Connecticut collected \$4.6 billion in tax revenues, up 3.3 percent from the same period last year. This was slightly ahead of the administration's forecast of 2 percent growth. Both personal income tax and sales tax collections led the way, growing at rates of 6.6 percent and 6.0 percent, respectively. Business and fuel tax collections fell by 7.2 percent, slowing overall revenue growth. The decline in these revenue sources is attributable to overseas economic problems and the continued phase-in of previously enacted tax cuts. State officials had anticipated an even steeper falloff. Although revenue growth is slower than the pace set last year, if current trends continue, Connecticut should realize a revenue surplus of about \$112 million.

In early February, Governor John Rowland submitted his FY99 supplemental budget adjustments along with his budget proposal for FY2000. For FY99 he would add \$59.1 million (a scant 0.7 percent) to the budget enacted last June. For FY2000 the governor proposed to spend \$9.4 billion out of own-source revenues, an increase of \$407.4 million (4.5 percent) over projected FY99 expenditures. Almost half (about \$171 million) of this spending increase is targeted toward new education initiatives. The governor proposed to spend \$54 million to improve early childhood education, \$86 million to reduce racial isolation in urban school districts, and \$31 million for increased local aid.

With close to \$200 million in enacted tax cuts scheduled to take effect in FY2000, the governor proposed only two relatively small additional tax cuts. First, he would reduce the tax on hospitals by \$15 million. Second, he would bring the state's personal income tax laws into conformity with the federal Internal Revenue Code by allowing state income taxpayers to take tax credits for education. The resulting revenue loss is estimated at \$16 million.

In other fiscal developments, the recently filed school finance suit, *Johnson v. Rowland*, 1998, has prompted a special task force to recommend that the state increase its share of local education expenditures from 42 percent to 50 percent. In early March, Superior Court Judge Julia Aurigemma ruled against the plaintiffs in *Sheff v. O'Neill*

II. The plaintiffs had argued that the state was acting too slowly in carrying out the state Supreme Court's order in *Sheff I* to desegregate the schools. Judge Aurigemma ruled that the state was acting expeditiously and that the plaintiffs had failed to wait a reasonable time before returning to court.

## Maine

Tax collections for Maine in the first eight months of the FY99 budget cycle totaled \$1.4 billion, up 5.4 percent over the same period last year. On a same-tax comparison basis, total tax revenue growth would have been 7.1 percent for the period. However, on October 1, a reduction in the sales tax rate from 6 percent to 5.5 percent took effect, costing the state an estimated \$23.7 million in revenue through February. Policymakers are considering another 0.5 percentage point cut in the sales tax as part of the FY2000 budget. The bright spot for the state's revenue picture was income tax collections, which grew 11.2 percent during this eight-month period.

In early February, Governor Angus King submitted his FY99 supplemental budget adjustment and a spending proposal for FY2000. For FY99, the governor proposed a supplemental spending adjustment of \$97.9 million, up 4.4 percent from the enacted FY99 budget of \$2.2 billion. For FY2000, the governor proposed to spend \$2.424 billion, an increase of 4.3 percent (\$99.8 million) above the adjusted FY99 expenditure level. In total, the proposed FY2000 budget would be 8.9 percent above the enacted FY99 spending level. This sizable increase in spending for FY99 through FY2000 would be partially financed with the large budget surpluses that have accumulated from past years. Two major spending initiatives were included in the FY2000 budget proposal: an increase of \$27.9 million (4.3 percent) in funding for new local education aid, and an increase of \$18.2 million (12.8 percent) in research and development funds for the University of Maine system.

One fiscal issue that has received a lot of attention is the governor's proposal to increase both the gas tax and a special fuels tax by 5 cents per gallon, primarily to close an estimated \$38.3 million shortfall in the highway fund.

# Maine's Revenue Growth

Readers of *Fiscal Facts* may have wondered why the official revenue growth numbers that are published in Maine's monthly Undedicated Revenue Report do not match the numbers reported in newspaper accounts and other published sources, including *Fiscal Facts*. The official state revenue reports provide a snapshot of the revenue flows *after* the diversion of certain revenues to special reserve accounts. *Fiscal Facts* and most other sources report revenue flows *before* these diversions take place (i.e., they report the actual revenues collected by the state).

Two specific revenue diversions were initiated in FY98, while a third revenue diversion was added in FY99. The first diverts 5.1 percent of sales, income, and corporate tax collections to a municipal revenue-sharing account. The second diverts "excess" tobacco tax revenues to a tax relief fund. Excess revenues are defined as those revenues from the tobacco tax that were collected in excess of the old tax rate in effect prior to a doubling of the tobacco tax rate in November 1997. This diversion of tobacco tax revenues was made during the period from November 1997 to January 1999. The tobacco tax and sales, income, and corporate tax revenue diversions affect both FY98 and FY99 revenues.

The third diversion affects FY99 revenues only for the period from July through October 1998. This final diversion is for the "excess" revenues collected from the sales tax, that is, the difference between the revenues that were collected at the 6 percent rate existing between July and October and the revenues that would have been collected between July and October had the new 5.5 percent rate been in existence. In order to adjust the officially reported revenues to arrive at the actual revenues that were collected by the state before these diversions, the amount of these diversions must be computed and added back to the officially reported figures. These additions are listed in the table below.

## Undedicated Revenues vs. Tax Collections State of Maine FY98 & FY99

*Millions of Dollars*

	Undedicated Revenues	Revenue Sharing	Tobacco Tax Excess	Sales Tax Excess	Total Adjustments	Actual Collections
<b>FY98</b>						
Sales	546.4	29.4			29.4	575.8
Income	531.8	28.6			28.6	560.4
Corporate	58.4	3.1			3.1	61.6
Other	160.0		12.4		12.4	173.4
Total	1,297.6	61.1	12.4		73.5	1,371.1
<b>FY99</b>						
Sales	513.8	27.6		25.5	53.1	566.9
Income	591.1	31.8			31.8	622.9
Corporate	51.8	2.8			2.8	54.6
Other	174.1		26.4		26.4	200.5
Total	1,330.8	62.2	26.4	25.5	114.0	1,444.9



The gas and fuels tax increase is estimated to provide about \$27.9 million of the spending gap. The remaining \$10.4 million would be financed with budget surpluses that have accumulated from past years. A second fiscal issue that has received attention recently is a push by many of the state's relatively property-poor, rural school districts for a change in the formula for distributing state education aid. The rural districts want an increase in the amount of overall aid that is distributed as well as a change in how the aid is distributed. The legislature is considering proposals to increase the share of state aid from 44 percent to 55 percent of education expenditures.

## Massachusetts

Through the first eight months of FY99, tax revenues showed no sign of an anticipated slowdown in economic growth. During this period, the Commonwealth collected \$9.0 billion, up 7.7 percent from the same period one year earlier. Collections continued running significantly ahead of the flat growth projected by both Governor Paul Cellucci's administration and the Massachusetts Taxpayers Foundation. Both income and sales tax collections posted strong growth, up 6.7 and 11.2 percent, respectively, from the same period one year ago. If revenue growth were to continue at the current pace, the Commonwealth would end the year with another \$1 billion revenue surplus. However, because many previously enacted tax reductions are scheduled to take effect during the second half of the fiscal year, the administration expects slower revenue growth, with a surplus of about \$300 million.

In January, Governor Cellucci submitted his annual budget proposal. For FY99, the governor proposed a supplemental spending increase of \$508.3 million, up 3.2 percent from the budget enacted last June. If this increase is approved, overall expenditures will increase 7 percent during FY99. For FY2000, the governor proposed a \$16.9 billion own-source spending budget, up \$283.2 million, or 1.7 percent, over adjusted FY99 expenditures.

Consistent with recent spending patterns, most of the proposed FY2000 budget increase is allocated to education, health care, and child care. State aid to education would increase by \$260 million to fund the last year of education reform. About two-thirds of the state's \$300 million share of the settlement with tobacco companies would be allocated to health care initiatives. The major portion of this increase would fund an expansion of the state's Medicaid program. Finally, the governor's budget proposes an increase of \$102 million in child care and

early education expenditures.

The governor's budget proposal also includes two tax cuts. First, the governor re-submitted his FY99 call for a reduction in the income tax rate from 5.95 percent to 5 percent. When fully phased in four years from now, this proposal would cost the Commonwealth about \$1.4 billion per year in lost revenues. Second, the governor proposed to reduce unemployment insurance tax rates for employers by up to \$200 million. The governor would also like to change the method of calculating the unemployment insurance tax rates on employer payrolls.

In June 1998, Congress passed a reauthorization of the highway bill, providing federal funding for various transportation projects across the nation. As expected, Massachusetts was the only state to receive less federal funding than it had previously enjoyed. From 1991 through 1998, Massachusetts received an average of \$830 million annually, which helped to fund the Central Artery/Tunnel (CA/T) project. In the new bill, the Commonwealth will receive federal funding of about \$528 million annually. The state will fund the \$300 million annual gap with grant anticipation notes — short-term bonds that anticipate excess federal funds after most of the CA/T construction has been completed. This reduced level of federal funding has put a financial squeeze on many other capital spending projects. In order to restart these projects, the governor proposed to use the entire FY99 budget surplus for the one-time funding of certain high-priority projects.

## New Hampshire

Tax collections totaled \$669.9 million for the first nine months of FY99, representing a 6.6 percent increase over the same period last year. This was significantly above the 3.5 percent increase that forecasters had predicted. The state's two largest taxes, the business profits tax and the business enterprise tax, exhibited healthy revenue growth, with combined revenues increasing to \$175.3 million, up 5.2 percent from FY98. Meals and room tax revenues increased to \$105.8 million, up 7.1 percent from a year earlier. If revenue growth continues at this pace for the last three months of the fiscal year, the state will realize a revenue surplus of \$38.1 million.

In early February, Governor Jeanne Shaheen submitted a supplemental spending adjustment for FY99 along with her budget proposal for FY2000. Supplemental appropriations for FY99 would increase spending by \$27.7 million (up 2.2 percent). For FY2000, the governor pro-

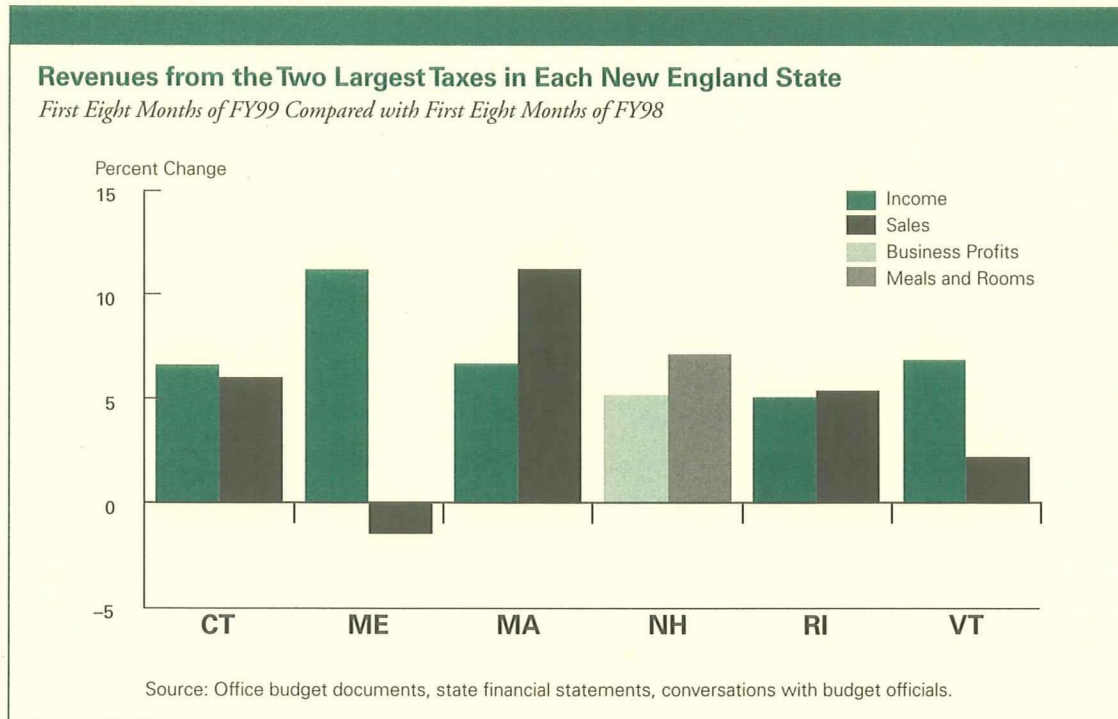
posed own-source spending of \$2.067 billion, up \$817 million (or 65.4 percent) over adjusted FY99 spending levels. These proposed spending levels and growth rate figures include the recently enacted \$825 million school-financing solution to the state Supreme Court's decision in *Claremont v. Governor et al.*

The legislature's attempt to craft a solution dominated this legislative session. The solution that was finally enacted into law on May 1 involves a mix of taxes – it establishes a uniform statewide property tax of \$6.60 per \$1000;

\$42 million and \$90 million. At a funding level of \$825 million, the state will finance approximately 62 percent of current educational expenditures.

In addition to the new school-funding package, the FY2000-2001 budget proposal highlights include:

- an increase of \$40 million (8.2 percent) in aid to cities and towns,
- an increase of \$7.5 million (5.0 percent) for the University of New Hampshire system, and
- an increase of \$16.5 million in capital spending



it increases the business profits tax from 7 to 8 percent; it increases the business enterprise tax from 0.25 to 0.5 percent; it increases the property sales tax from \$5 to \$7.50 per \$1000; it establishes a new 8 percent tax on car rentals – and it earmarks most of the money (\$40 million) from the state's expected \$43 million annual funding from the national tobacco settlement.

This mix of revenues is projected to raise between \$630 and \$680 million per year. Adding in the current state aid figure of \$101 million brings total state financing to somewhere between \$730 and \$780 million. These revenues will be distributed as a block grant to local school districts and provide an average of \$4,220 per-pupil. However, since the total cost of the state funding mechanism is pegged at \$825 million, the state must find additional revenues to cover an estimated revenue shortfall of somewhere between

aid to cities and towns to repair bridges that are considered to be in critical condition.

## Rhode Island

Through the end of February, Rhode Island collected tax revenues of \$943.2 million, a 5.4 percent increase from the same period one year earlier. However, this strong growth was skewed by an unexpected \$20 million windfall in inheritance and gift taxes. Excluding this windfall, total tax revenue growth would have been 3.1 percent, slightly below the 3.4 percent revised revenue growth projected in November. Income tax revenues were up a better-than-expected 5.1 percent.

In early February, Governor Lincoln Almond proposed a \$25.1 million supplemental spending adjustment to the FY99 budget enacted last June. If the adjustment is

enacted, FY99 own-source expenditures will be 10.7 percent above the \$2.54 billion FY98 budget. Also in February, the governor proposed \$2.9 billion in own-source expenditures for FY2000, an increase of 4.1 percent (\$114.7 million) over projected FY99 expenditures. Both the FY99 budget and the proposed FY2000 budget are balanced by the spending down of accumulated reserves.

Most of the proposed budget increase in FY2000 is allocated to increases in local aid. The phase-out of the motor vehicle excise tax at the local level will cost the state an additional \$22.9 million in FY2000. Local aid for education is slated to increase by \$31.5 million, while other local aid would increase by \$32.2 million. In addition, expenditures for the public higher education system would increase by \$8.5 million.

Discontent with the local aid formula adopted by the state in 1995 is intensifying among some of the suburban school districts. Since 1995, state aid to education has increased by an average of 5.9 percent per year. However, the lion's share of that increase has gone to financially strapped and property-poor communities, such as Providence. After nearly four years of relatively small increases in state aid to education, the suburban districts want increases in both the amount and the share of funds that are distributed to their communities.

## Vermont

by Pei Zhu

For the first eight months of FY99, after a necessary adjustment for Act 60 revenue transfers, Vermont's tax receipts reached \$535.2 million, an increase of 7.7 percent (\$38.3 million) over the same period one year earlier. This result was slightly below expectations. However, the collections from two major consumption taxes—the sales tax and the meals and rooms tax—were about 10 percent below target performance for February, accounting for half of the overall revenue gap between February tax collections and target tax collections. Diminished tourism, attributable to a weak ski season and weakness in the Canadian dollar, is probably responsible for this poor result.

In January, Governor Howard Dean revised his FY99 spending projections and submitted his budget proposal for FY2000. He suggested a 0.2 percent supplemental spending increase in FY99 appropriations. For FY2000, the governor proposed own-source spending of \$1.45 billion, an increase of 1.6 percent from the expected FY99 level.<sup>1</sup> Based on these spending recommendations, the

administration projects a \$23 million operating surplus for FY2000.

With the general, transportation, and education fund account balances full of accumulated reserves, the ratings given by Wall Street for Vermont's bonds are on the rise.<sup>2</sup> And with substantial new revenues from three sources expected for next year,<sup>3</sup> the governor has proposed two separate income tax cuts. The first is an across-the-board 8 percent cut in the income tax rate. The second is elimination of the income tax for filers with incomes less than \$15,000. He has also recommended that the projected FY99 budget surplus be used to reduce the state's debt burden, increase funding for higher education, and support other one-time spending projects.

Act 60 – Vermont's education finance reform law – continued to generate new developments. In order to avoid sharing their revenues, many property-wealthy towns have established private funds that will collect donations to be made to schools, rather than taxes, from their citizens. This development has the potential to undermine the revenue-sharing portion of the education finance reform. Meanwhile, residents of Manchester have agreed on adding a penny to the state's 5 percent sales tax in order to reduce property taxes and ease Manchester's transition to Act 60. This is the first town in Vermont to enact a local sales tax. Finally, three property-rich towns—Dover, Searsburg, and Whittingham—have decided to withhold payment of their statewide property tax collections, which were due on December 1, 1998, as a protest against Act 60. The state has resorted to legal action to force the payment of these collections, and the cases are still pending in the courts. Seeking to resolve these problems, Governor Dean has appointed a special panel to discuss possible changes to Act 60. **FF**

1 The numbers are calculated by excluding one-time expenditures (\$67.8 million for FY99 and \$17.1 million for FY2000) from the total budget and including special categorical state aid (\$84.1 million for FY99 and \$78.9 million for FY2000).

2 Standard & Poor's raised Vermont's bond rating from AA minus to a solid AA in October 1998.

3 First, the passage of TEA-21 (Transportation Efficiency Act for the 21st Century) will provide Vermont with an additional \$177 million for transportation projects between FY99 and FY 2003. Second, the recent tobacco settlement will bring Vermont about \$26.4 million in new revenues in FY2000. Third, the Department of Education and the Agency of Human Services have worked to allow Medicaid funds to support certain special education expenditures, a step that will bring the state approximately \$12.9 million in FY2000.

local school spending decisions, the degree of spending equality actually achieved in a wealth-neutral system depends on the relative variation of these remaining factors.

• Second, in order to design a wealth-neutral system that maintains local control, the local behavioral responses to the matching GTB grants must be understood by state policymakers. GTB systems create price incentives that may cause spending patterns to deviate significantly from what might be considered substantial equality.

In Vermont, Act 60 includes local option add-on spending, which is subject to a GTB formula intended to achieve

both wealth neutrality and spending equalization. However, because of the price incentives that are implicit in a GTB formula, local taxing and spending choices may be different from those expected by state policymakers. Preliminary calculations by *Fiscal Facts* suggest that the second tier of Act 60 may actually reverse the wealth / spending relationship. However, Vermont policymakers appear to have intuitively understood the distinction between wealth neutrality and spending equality in designing Act 60. To satisfy the court ruling of substantial equality in spending, Vermont imposed a mostly state-funded system, with only about 20 percent of funding coming from the local option taxes subject to a GTB formula. **FF**

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## New England Fiscal Facts

Federal Reserve Bank of Boston  
P.O. Box 2076  
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