

The Fiscal Condition of the New England States: An Update

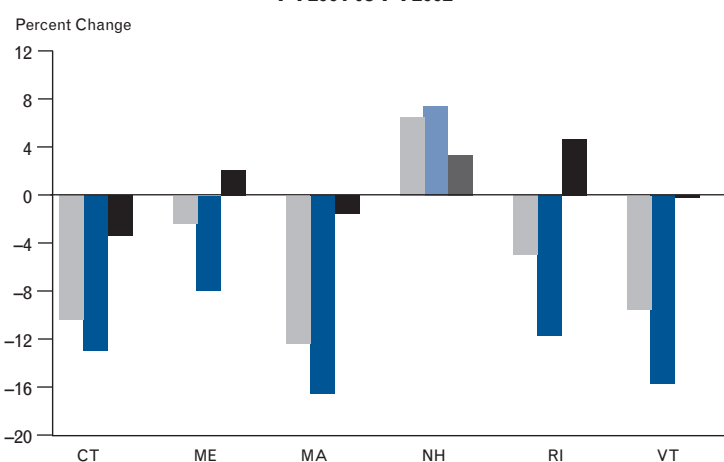
By E. Matthew Quigley

In 1999, *New England Economic Indicators* published an article detailing the fiscal condition of the New England states. At that time, all six states were experiencing double-digit revenue growth, spearheaded by soaring personal income tax receipts. Flush with cash, states were able to fund myriad programs, capitalize rainy day funds, and enact widespread tax cuts. The article concluded, quite correctly, that “all in all, the fiscal condition of the New England states remains strong.”¹ And remain strong it did through FY2000 and FY2001. In FY2002, the states’ fortunes changed.

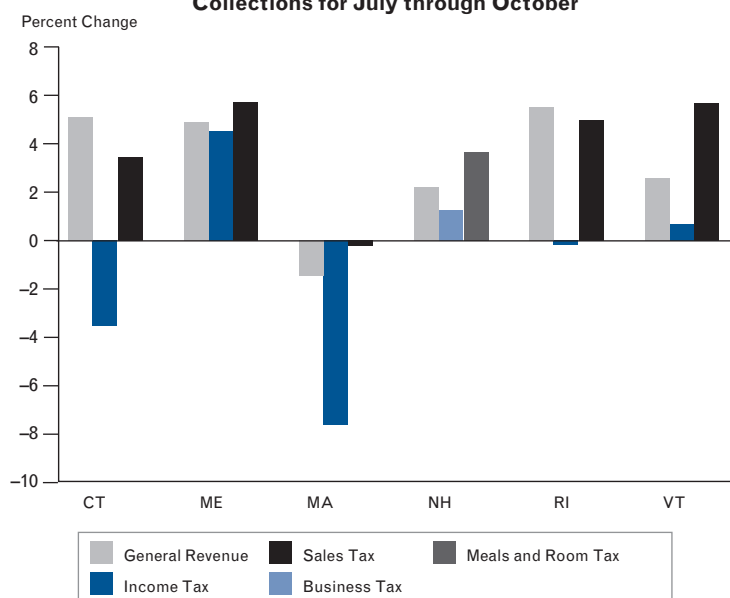
Rather than slide into trouble gradually, the states fell off a fiscal precipice. With the exception of New Hampshire, New England experienced an extraordinary decline in revenues from FY2001 to FY2002 (see Chart 1, top). After years of unusually rapid growth, general revenues declined by over 10 percent in Connecticut, Massachusetts, and Vermont, while Maine and Rhode Island experienced smaller drops of 2.5 percent and 5.4 percent, respectively. Falling personal income tax receipts, attributable to a shrinking stock market and rising unemployment, largely accounted for this deterioration. In Massachusetts alone, declines in receipts from taxes on capital gains, bonuses, and stock options totaled at least \$500 million. By contrast, New Hampshire, without an income tax, was insulated from such revenue losses; indeed, the state enjoyed growth in receipts from its two largest revenue sources, the business tax and the meals and rooms tax. Still, the Granite State’s revenue growth in FY2002 was below expectations and insufficient to maintain a balanced budget. Drops in sales tax revenues in Connecticut, Massachusetts, and Vermont exacerbated these states’ overall revenue loss, while slight

Chart 1 - Change in Tax Revenues from Prior Year

General Revenues and Revenues from the Two Largest Taxes in Each State
FY2001 to FY2002



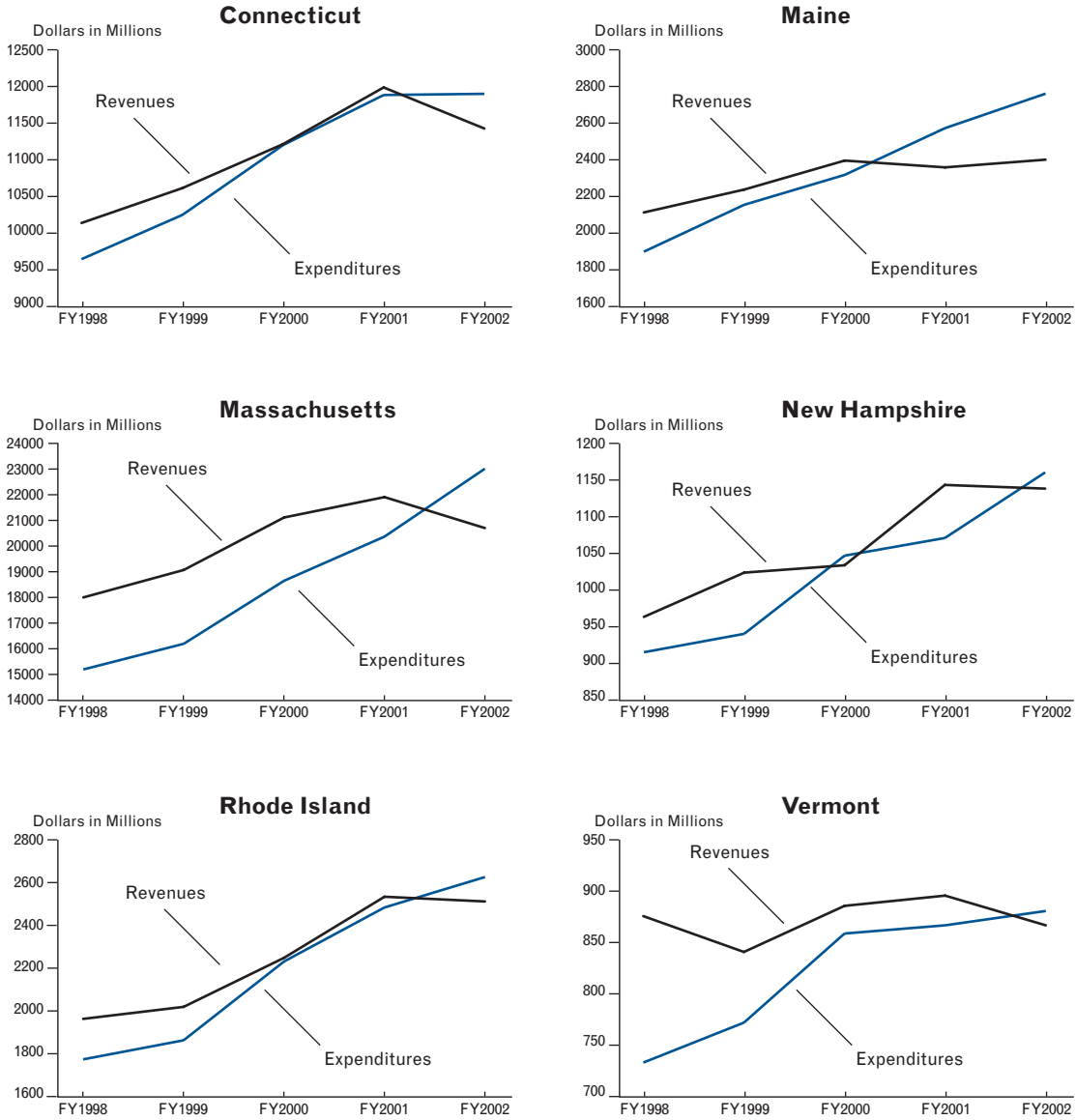
**FY2002 to FY2003
Collections for July through October**



¹ Tannenwald, Robert. “The Fiscal Condition of the New England States,” *New England Economic Indicators*, (June 1999), p. iv.

Chart 2 - Revenues and Spending in the Six New England States

FY1998 to FY2002



gains in sales tax revenues in Maine and Rhode Island partially offset lost income tax revenue.

Revenues recovered slightly in most New England states during the four months of FY2003, (see Chart 1, bottom) but, as of this writing, they are still below expectations. Four months into FY2003, general revenues were up in Connecticut, Maine, New Hampshire, Rhode Island, and Vermont over the same period last year, but were still falling in Massachusetts. For four of the gaining states — Connecticut, Maine, Rhode Island, and Vermont — the revenue gains were largely attributable to increased sales tax receipts, driven

mainly by strength in auto sales. In New Hampshire, revenue was fueled by a 4 percent increase in meals and rooms tax receipts. Personal income tax collections were up in Maine and Vermont, but still down dramatically in Massachusetts and Connecticut. Rhode Island’s personal income tax collections were virtually the same in the first few months of FY2003 as in FY2002.

Exacerbating the impact of falling revenues, state spending in New England grew an average of 9 percent per year between FY1998 and FY2002. Revenue growth rates through FY2001 were even higher, enabling the states to post surpluses despite the rapid

growth in outlays. Last year, however, the inertia of state spending combined with unexpected revenue declines to produce large deficits (see Chart 2). The problem worsened when states were hit by rising demand for their services as a result of the economic downturn. Higher Medicaid costs, increased prescription drug costs, higher public assistance caseloads, and rising security costs all exerted spending pressures on the New England states.

Squeezed by falling revenues and rising spending, the region’s state governments drew heavily on rainy day funds, which had been built up to significant levels during the boom years (see Chart 3). At their peaks, these accounts ranged from a high in Massachusetts of 11 percent of general spending to a low in Rhode Island of 3.5 percent.

Just how important have these reserve accounts been? Connecticut closed 73 percent of its \$817 million FY2002 deficit by using all of its reserves. Massachusetts faced a staggeringly high revenue shortfall of \$2.3 billion in FY2002. Using reserves alone, it closed 65 percent of this gap.

What is the likely future course of New England’s state budgets? According to survey data from the National Association of State Budget Officers, all six states expect to see revenue shortfalls again in FY2003 (see Chart 4). Although the shortfalls are expected to be smaller in relation to general fund expenditures in FY2003 than in FY2002, they may grow again in FY2004.

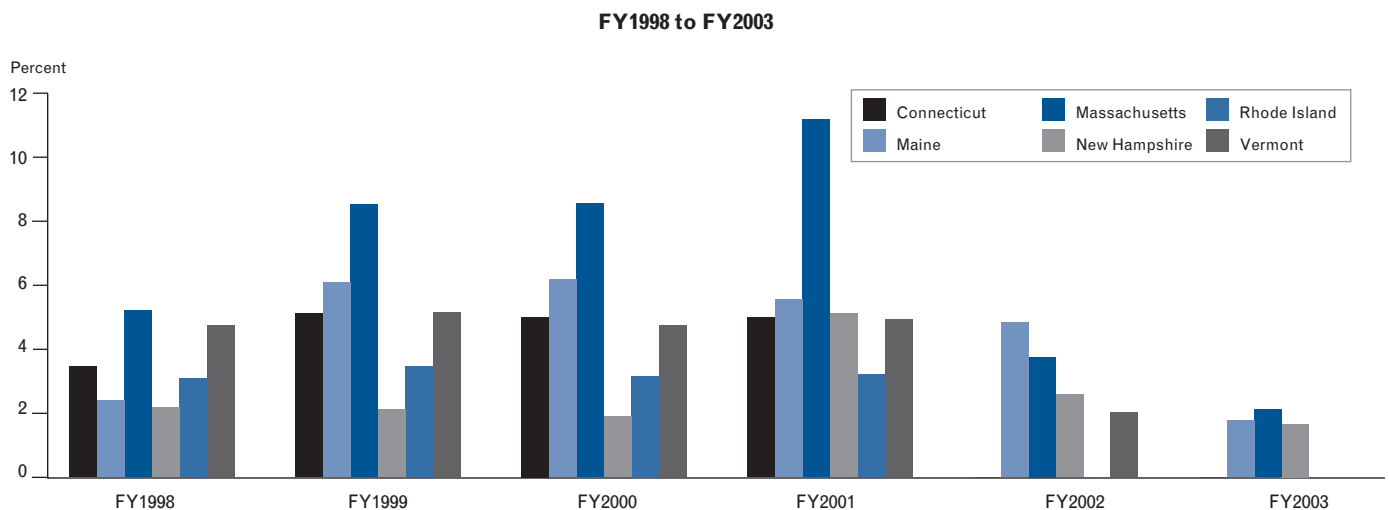
Connecticut ended FY2002 with a budget deficit of \$817 million, or 6.8 percent of general fund spend-

ing. Based on financial data collected through November 2002, Connecticut’s state comptroller projects that, without further spending cuts or changes in revenue trends, the state will end FY2003 with a deficit of \$414.9 million.² In FY2002, legislators voted to use the \$595 million in the state’s rainy day fund to cover a portion of the deficit. Lawmakers also authorized the issuance of roughly \$220 million in economic recovery notes during FY2003. A variety of actions, including spending cuts and excise tax increases, were taken to address the remaining shortfall. The FY2003 deficit, although likely smaller, may not be as easy to address, particularly without a rainy day fund.

Despite spending cuts, layoffs, and tax and fee increases, Maine closed the first year of its biennial budget cycle (FY2002-FY2003) with a general fund deficit of \$93 million. An additional deficit of \$150 million is predicted for the second year, FY2003. Thus, absent remedial measures, the state will likely end its biennial budget cycle in June 2003 with a \$243 million deficit, 4.5 percent of its \$5.3 billion general fund budget. Even if lawmakers decide to use the \$48 million remaining in Maine’s reserve accounts, the state will still likely confront a roughly \$200 million shortfall.

Massachusetts addressed a potential budget deficit of \$2.3 billion for FY2002 by transferring \$1.5 billion from reserve accounts, cutting spending, and raising roughly \$200 million in one-time revenues. The \$300 million remaining in the state’s rainy day fund was used to cover the rest of the deficit.² State of Connecticut, Office of the State Comptroller, “Wyman Projects Budget Deficit of \$414.9 million,” press release dated December 2, 2002.

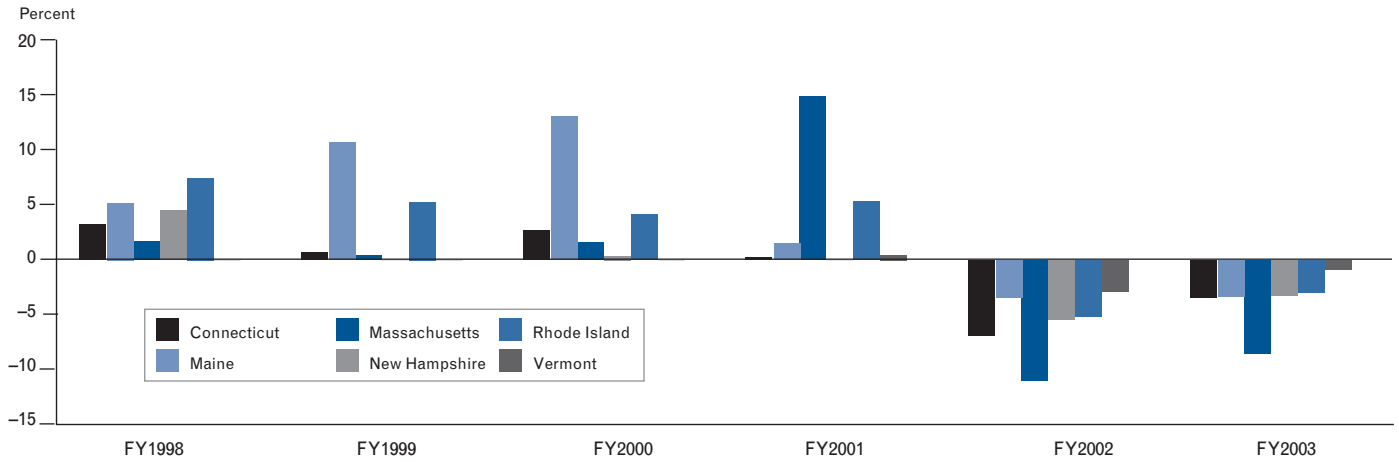
Chart 3 - Stabilization Fund Balances as a Percent of Expenditures



Source: National Association of State Budget Officers (NASBO). *State Expenditures Report, FY1998-FY2002*.

Chart 4 - State Surplus or Deficit as a Percent of General Fund Expenditures

FY1998 to FY2002 (actual), FY2003 (projected)



Source: For FY1998 to FY2002, National Association of State Budget Officers (NASBO), *Fiscal Survey of the States, FY1999-FY2002*. The FY2003 projections are based on NASBO estimates adjusted by the author for midyear spending cuts and revised revenue projections; see *New England Fiscal Facts, Winter 2002/2003*, No. 30, for methodology.

million remaining in the Commonwealth's budget stabilization fund and \$500 million in the tobacco settlement fund are expected to be applied towards balancing the budget in FY2003. Even after these actions, continuing revenue declines during the first few months of FY2003, coupled with increased spending pressures, are expected to produce a deficit for FY2003 that could exceed \$500 million. Governor Romney has warned that, in the absence of dramatic changes in revenue collections or spending cuts, the deficit could swell beyond \$3 billion in FY2004. The administration has further indicated that significant spending cuts will occur in the current and next fiscal years but that tax increases are undesirable.

Although New Hampshire was the only New England state to enjoy year-over-year revenue growth from FY2001 to FY2002, it still ended the first year of its FY2002-2003 biennial budget cycle with a deficit of \$62.6 million, 2.7 percent of the cycle's budgeted expenditures. Even after corrective action, the state carried over a \$10 million deficit into the current fiscal year. Officials have indicated that this gap will probably be closed through the use of reserves, but if expected revenues do not materialize in FY2003, further action may be necessary.

Despite the overall growth in Rhode Island's revenues during the early months of FY2003, the state still expects to face a budget deficit of \$50 million to \$70

million for the fiscal year as a whole. Officials have already set aside \$77.3 million in proceeds from the state's tobacco securitization (sale of bonds backed by tobacco settlement revenues) towards closing whatever gap may arise. An additional \$35.6 million from this bond sale has been placed in reserve to help address a projected FY2004 deficit of \$110 million. The state's house fiscal office expects its potential deficit for FY2004 to increase over FY2003 partly as a result of rising costs and partly as a result of diminished reserves.

Vermont is the one potentially positive budgetary situation in New England. Both the state's income and sales tax receipts surged unexpectedly during the first quarter of FY2003, creating a budget surplus. Four months into FY2003, revenues were ahead of expectations by \$10 million, or 16 percent.

Despite some positive signs for the first few months of FY2003, revenue trends and, therefore, budgetary situations for the New England states are expected to worsen over the current and next fiscal years. Spending growth in all six New England states was curtailed in FY2002, is being further restrained in FY2003, and will be cut even further in FY2004. Notwithstanding these cutbacks, some tax increases, and extensive use of reserve funds, all six New England states fear budget shortfalls in FY2003 and FY2004.