

Is New England's Fiscal Crisis Abating?

by E. Matthew Quigley

In summarizing a recent survey on state fiscal conditions, the National Association of State Budget Officers (NASBO) described the situation thus: "While the economy has begun to show some signs of improvement, states continue to grapple with short-term cyclical and long-term structural problems. Plagued by budgetary shortfalls for the past three years, states still face uncertainty in the current fiscal year and difficult budgetary choices in the years ahead, even amid strong growth recently in gross domestic product and declining job losses."¹

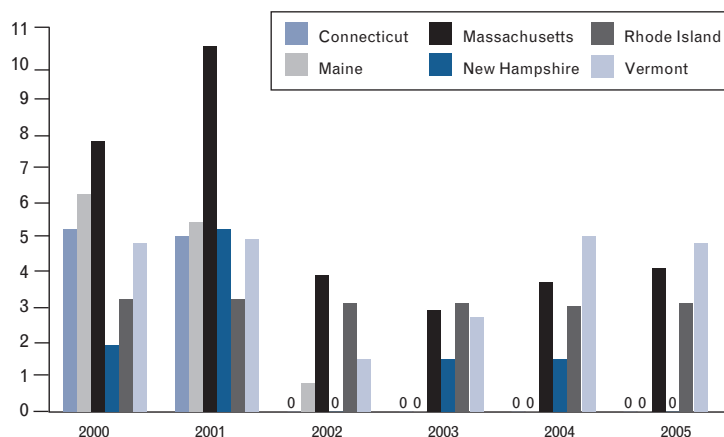
Just how great are these budgetary shortfalls and their ensuing uncertainty? The National Conference of State Legislators (NCSL), in a survey of state legislative fiscal directors, found that, as of February 2004, 18 states still expected to face budgetary shortfalls in fiscal year 2004 (including Connecticut and Rhode Island), and 31 states projected budget gaps in FY2005 (including these two states plus Maine and Massachusetts in New England).² These potential deficits, though smaller than in FY2002 and FY2003, still threaten to reach problematic levels. The largest threats loom at 12 percent of expenditures in Alaska in FY2004 and for FY2005, at a staggering 27 percent in Alaska and nearly 20 percent in California.

Here in New England, the potential for deficits in the current and next fiscal years, though not nil, is significantly reduced compared with recent years. Connecticut's unresolved FY2004 deficit remains roughly one-half of 1 percent of expenditures, and Rhode Island's is all but resolved. In FY2005, however, the New England states face potential budgetary shortfalls as high as 6.5 percent of expenditures in Massachusetts, 5.8 percent in Rhode Island, 5.2 percent in Maine, and less than 1 percent in Connecticut. New Hampshire and Vermont anticipate balanced budgets.

Complicating the budgetary situation for the coming fiscal year, reserve funds in New England have significantly diminished from their levels as recently as 2001 (see Chart 1). In response to falling revenues and rising costs, New England's states have drawn heavily on rainy day funds over the past few fiscal years. At their peaks, in FY2001, these funds ranged from a high of over 10 percent of expenditures in Massachusetts to a low of roughly 3 percent in Rhode Island. By FY2005, Connecticut, Maine, and New Hampshire will have completely drained their stabilization funds, and Massachusetts' rainy day fund will have dwindled to 4 percent of expenditures. Rhode Island and Vermont's funds remain close to their peak levels.

Fortunately, revenues are showing signs of significant improvement (see Chart 2). Through the third quarter of FY2004, tax revenues have rebounded in all six New England states. Vermont has led the pack with robust 8.8 percent growth in general revenues, while Massachusetts has experienced more moderate, though still healthy, growth of 4.3 percent. Connecticut, Maine, New Hampshire, and Rhode Island have all recorded year-over-year general rev-

Chart 1 - Stabilization Fund as a Percent of Expenditures



enue growth in excess of 6.0 percent. This continues a trend begun in the previous fiscal year, when revenues rebounded significantly after their precipitous declines of FY2002 (see Chart 2).

Concomitantly, states have begun to restore some of the spending cuts made during the depths of the fiscal crisis (see Chart 3). Still, from FY2003 to FY2004, the Center for Budget and Policy Priorities estimates that real per capita state spending has declined an average of 0.7 percent nationwide. With the exception of Rhode Island, the New England states are experiencing real per capita decreases in spending in excess of the national average. Rhode Island is expected to record a small (0.6 percent) increase in spending.³

How did we get here? Although there is no simple answer, speaking broadly, we can point to two culprits: cyclically based declines in revenue and discretionary choices in tax and spending policies (see Chart 3).

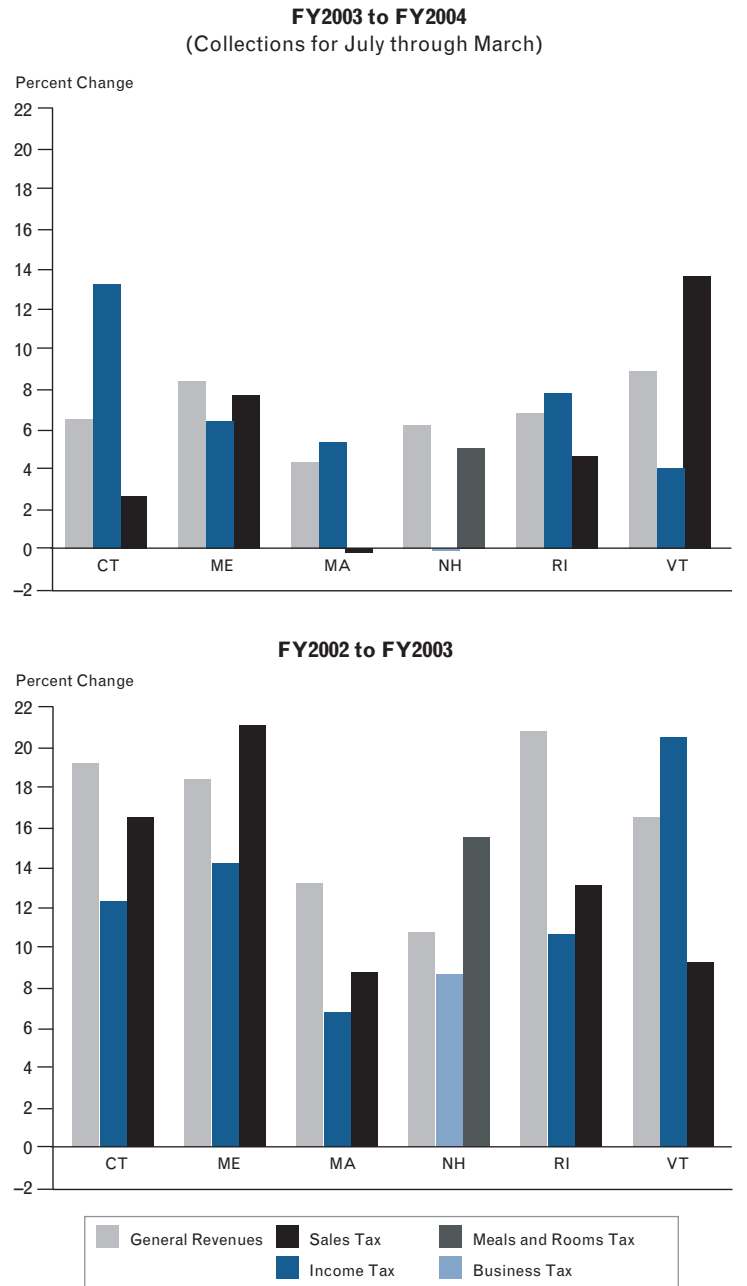
In FY2002, after several years of extraordinary growth, revenues plummeted in many states. General revenues declined a staggering 14 percent in Massachusetts, 9 percent in Vermont, and 8 percent in Connecticut. Drops in Rhode Island and Maine, though smaller (5 percent and 3 percent, respectively), also took a heavy toll on budgets. Only New Hampshire, whose tax structure is less sensitive to the business cycle, recorded an increase in general revenues. The states' revenue situations remained uncertain through FY2003 and, were it not for widespread tax and fee increases, tax amnesty programs, one-time assistance from the federal government, and other "revenue enhancements," most of the New England states would very likely have recorded a second straight year of declining revenues.

On the spending side of the equation, states expanded their spending obligations significantly through the late 1990s and into 2000 and 2001. These expansions came to a grinding halt in FY2002. Overall spending growth has remained muted through the current year and, for the most part, remains modest in plans for the coming fiscal year.

Despite the common problems of falling revenues and rising costs, the New England states have

Chart 2 - Growth in Tax Revenues

General Revenues and Revenues from the Two Largest Taxes in Each State



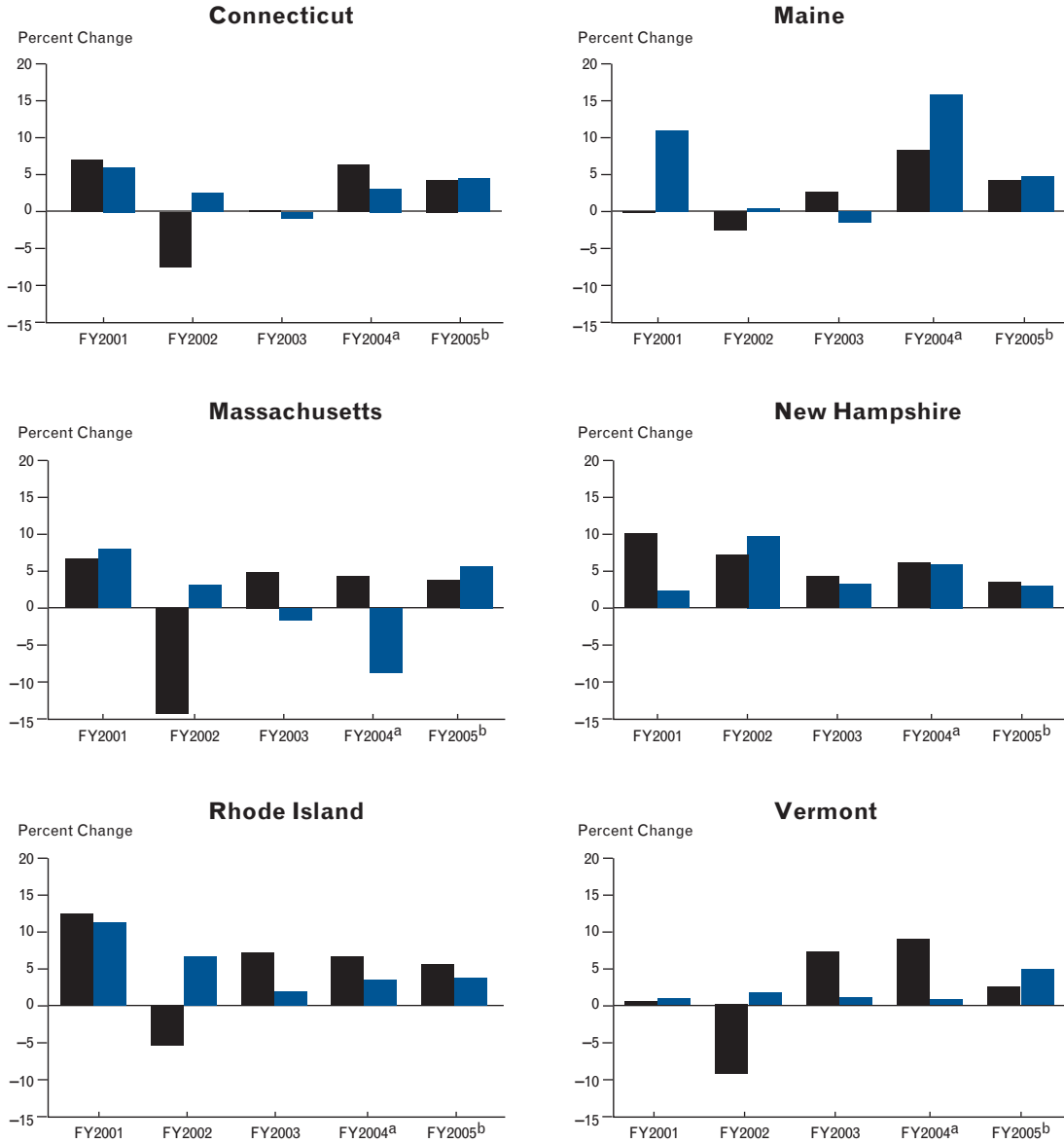
been disparately affected by this fiscal crisis. Some, through the use of stabilization funds and other fiscal management techniques, were well cushioned against the economic onslaught. Others were not. Some quickly reined in spending. Others did not. Some raised taxes and fees. Others did not. The following section provides a brief overview of the unique experiences of New England's states over the past few fiscal years and provides a glimpse of plans for the coming fiscal year.

Chart 3 - General Revenue Growth and General Spending Growth

Percent Change from Prior Fiscal Year

FY2001 to FY2005

■ General Revenue ■ General Spending



Source: State monthly revenue reports and governor's budgets.
^aThrough March 2004. ^bForecasted for Governor's Budget.

Connecticut

Connecticut has not fared well over the past few years. In FY2002, the Constitution State experienced a 7.5 percent decline in general revenues. With spending rising as well, the state quickly found itself facing a significant budget deficit. In response, the state borrowed \$220 million to

bridge the gap between revenues and spending and drew heavily on reserves. In FY2003, the state borrowed an additional \$125 million.

On the revenue side of the equation, Connecticut has increased taxes by over \$1 billion since FY2002. During the 2002 legislative session, legislators increased the cigarette tax; placed a surcharge on limited liability corporations, limited liability

partnerships, and S corporations; reduced corporate tax credits; and increased a number of miscellaneous taxes and fees for a total of \$185 million in additional revenues. During a 2003 special session to address the deficit for FY2003, the state increased the income tax rate from 4.5 percent to 5.0 percent, again raised cigarette taxes, reduced the clothing exemption from the sales tax base, and placed a tax on health and athletic clubs. All told, these actions raised an additional \$565 million in revenues. A second special session in 2003 raised an additional \$177 million in revenue through a combination of lowered tax credits—primarily through the phase-out of property tax credits—and tax increases. Finally, in 2004, the legislature raised an additional \$100 million through a third increase in the cigarette tax and an increase in the tax on alcoholic beverages.

On the spending side, the FY2004–FY2005 adjusted budget calls for total general fund spending of \$13.2 billion, a 4.7 percent increase over estimated FY2004 levels.

Maine

Building on rapid growth in tax collections in FY2003, Maine's revenue performance has continued to be strong in recent quarters. General revenues are up 8.3 percent, year-to-date, through the third quarter of FY2004. Underpinning this strong growth are significant increases in the state's two largest sources of tax revenue. Personal income tax receipts are up 6.3 percent, and sales tax collections are up 7.6 percent.

Despite this improvement, the state still faces continued challenges. Chief among these are continuing Medicaid program shortfalls, which, at their height, totaled \$135 million in FY2004 (5.2 percent of general expenditures).

Massachusetts

On May 3, 2004, Governor Mitt Romney announced that the Commonwealth had \$1 billion more in available resources for FY2004 and FY2005 than he believed when he submitted his budget to the legislature in January. Citing higher than expected tax collections and a \$250 million surplus in the Commonwealth's Medicaid budget,

he called on the legislature to lower the state's income tax rate from 5.3 percent to 5.0 percent and to increase expenditures on selected programs in the coming fiscal year.

The governor's budget, as submitted in January, proposed a fourth straight year of broad spending cuts and selected tax increases, primarily on businesses. Overall spending under the plan (\$24.8 billion) is 4.7 percent above FY2004 spending levels. Almost half of this total increase in proposed spending is intended to shore up the state's pension fund. Another roughly 40 percent of the growth is earmarked for Medicaid and related programs, which are expected to see increased spending of 6.3 percent in FY2005.⁴

Beyond these areas of expenditure, debt service (accounting for roughly 16 percent of planned spending increases) and education are the primary recipients of increases under the governor's plan. The Commonwealth's basic education support program—Chapter 70—is slated for a 2.1 percent increase in funding, and the state's higher education system would receive a 3.4 percent increase.

New Hampshire

Through March, New Hampshire's general revenues of \$1.6 billion were ahead of planned levels by \$16.9 million and up \$95.3 million over prior fiscal year levels. The bulk of this improvement is attributable not to tax revenues, but to significantly increased revenue from federal grants, Medicaid revenue enhancements, and tobacco settlement proceeds. As for the state's two largest sources of tax revenue, business tax collections remained flat, while the state's meals and rooms tax receipts were up year to date by 5 percent.

This improved revenue situation has helped New Hampshire resolve its potential budget deficit for FY2004. Despite the improvement, underlying structural imbalances, coupled with diminished reserve levels, still threaten the state's fiscal prospects moving forward. As a recent report by the New Hampshire Center for Public Policy Studies pointed out, "The last time the State of New Hampshire's General Fund and Education Trust Fund revenues exceeded expenses was FY1999."⁵

In FY2003, the gap between general revenues and general expenditures was \$203 million. To bridge this gulf, legislators used \$165 million in federal funds and tobacco settlement proceeds. The remaining \$38 million deficit was closed using the balance of the state's health care transition fund and through additional withdrawals from the rainy day fund. This heavy reliance on reserves was cited by Standard & Poor's and Fitch in December 2003 as one reason why these two rating agencies lowered the state's bond rating.

With this as a backdrop, Governor Benson proposed a revised FY2004-FY2005 biennial budget in February that holds general and education spending close to originally budgeted levels in FY2004 and increases expenditures by 3.0 percent in FY2005.

Rhode Island

Through the first nine months of FY2004, Rhode Island's general revenues were up 6.7 percent over FY2003 levels, year to date. Revenues from the state's two largest taxes—the personal income tax and the sales tax—increased 7.7 percent and 4.7 percent, respectively. Despite this recent growth, as of January, overall collections were slightly below forecasted levels. Coupled with increased spending pressures, these lower than expected revenues raised the specter of a small deficit in FY2004.

In response, Governor Carcieri proposed a revised FY2004 budget in January. Along with eliminating certain corporate tax credits and selectively increasing fees, the revised budget adjusts general spending levels upward by approximately \$11.8 million from enacted FY2004 levels.

In an effort to head off a potential \$192 million deficit in FY2005, Governor Carcieri proposed a \$5.9 billion all-funds budget that limits growth in state spending to 3.7 percent over originally allocated FY2004 levels and 1.0 percent over revised levels. General revenue expenditures (excluding federal funds, restricted receipts, and other special purpose funds) account for \$2.9 billion of these expenditures. This marks a 4.0 percent increase over FY2004 budget appropriations and a 3.7 percent increase over revised levels.

To keep state spending growth lean, the governor proposed a 1.2 percent reduction in direct school aid (a \$7.9 million decrease) and asked state employees to pay a portion of rising health insurance costs (potentially saving the state an additional \$10.6 million in the coming fiscal year). To bridge the remaining gap between current revenues and expenditures, the governor's budget calls for \$169 million in revenue enhancements, including \$57 million in tax and fee increases.

All told, state officials expect to achieve budgetary balance in FY2005 but remain concerned about FY2006 and beyond. The administration's five-year financial forecast estimates operating deficits beginning in FY2006, deepening to as much as 5.0 percent of expenditures by FY2009.

Vermont

Comparatively speaking, the Green Mountain State has weathered the current fiscal storm well. Despite challenges, Vermont has managed to maintain a balance between revenues and spending over the past few fiscal years. This seems unlikely to change in the near term. As of March (the end of the third quarter of FY2004), Vermont's general revenues were running ahead of expectations and outpacing collections over the same period last year. In total, general revenues were up 8.8 percent, year to date, over FY2003 levels. Underlying this strong growth, tax receipts increased 8.6 percent over FY2003 levels, while non-tax revenues (business licenses, fees, fines, forfeits, penalties, etc.) were up a robust 17.6 percent.

Despite additional spending pressures—primarily from cost pressures at the Vermont State Hospital, increased childcare caseloads, and higher costs in the Departments of Corrections and Health—state officials anticipate a small surplus at the end of the current fiscal year.

Moving forward into FY2005, Vermont appears to be on solid financial footing. The state senate gave final approval to the state's FY2005 budget on April 28, 2004. The \$952 million budget is close in size, though different in details, to the budget approved by the state's house of representatives and marks a 6 percent increase in general spending over FY2004 levels. Both the house and

the senate bills are approximately \$4 million higher than the budget submitted by Governor Douglas in January. As of this writing, the budget is winding its way through the conference process before heading to the governor for signature.

Endnotes:

¹ National Association of State Budget Officers, *Fiscal Survey of the States: December 2003*, p. ix.

² National Conference of State Legislators, *State Budget Update: February 2004*.

³ Elizabeth C. McNichol, "Fiscal Crisis is Shrinking State Budgets," Center for Budget and Policy Priorities, Revised, February 25, 2004.

⁴ Massachusetts Taxpayers Foundation Bulletin, "Governor's 2005 Budget: Fourth Year of Spending Cuts: Health Care Vulnerable," February 19, 2004.

⁵ Douglas E. Hall, "The NH Budget: Trends Through 2003," New Hampshire Center for Public Policy Studies, February 2004, p. 1.

New State Revenue Data Are More Timely

by Nick Turner

This issue marks the inauguration of a new dataset on state revenue in the *New England Economic Indicators* database. Some of the new data are featured in a new table on page 24. The new dataset, which stretches back ten fiscal years to FY1994, is compiled from monthly revenue reports obtained directly from state agencies. It replaces the previously reported quarterly revenue data provided by the U.S. Census. The table on page 24 features total general fund revenues for each state as well as collections from the two largest taxes for each state. The complete new dataset, which includes corporate tax receipts in addition to the concepts in the table, is available online at <http://www.bos.frb.org/economic/nee/needata.htm>.

Changing from Census data to data provided by individual states involves a number of tradeoffs, with both positive and negative aspects to making the change. On the plus side, monthly revenue numbers are available in a timelier manner. Monthly data will permit more current, as well as more frequent, comparisons of actual versus projected/benchmark revenues and help provide a more vivid picture of the current fiscal conditions of the states. The previously utilized Census data are released with a considerable lag, often as long as six months.

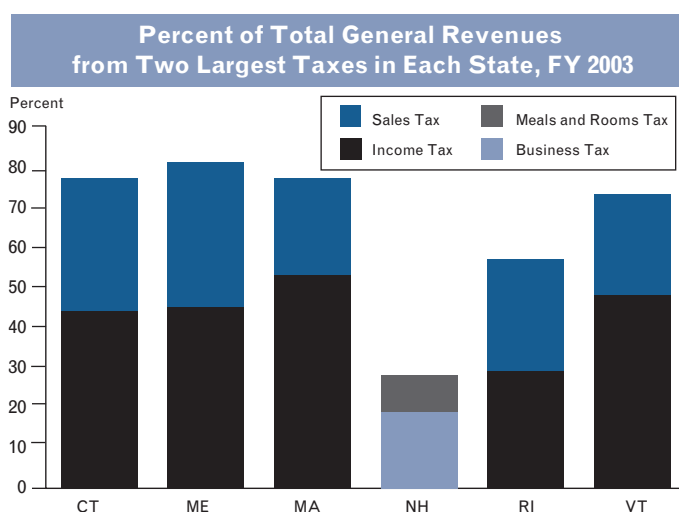
The new revenue categories—total general fund revenues, collections from the two largest taxes for each state, and corporate tax collections—are another potential benefit. The previous categories published in the *Indicators* database included two taxes—individual income tax and general sales tax—that are not especially relevant for the state of New Hampshire, which has neither a broad-based personal income tax nor a sales tax. For the state of New Hampshire, the new dataset includes collections from the business tax and the meals and rooms tax.

The accompanying figure shows the relative sizes of collections from the two largest taxes for

each of the New England states in FY2003. Combined, the two largest taxes produced revenue ranging from 28 percent of total general revenues for New Hampshire to 81 percent for Maine. The personal income tax produced the biggest share of revenue in all states except New Hampshire; the share ranged from a high of 53 percent for Massachusetts to a low of 29 percent for Rhode Island. Revenues from the sales tax ranged from 36 percent of total general revenues in Maine to 24 percent in Massachusetts.

Reporting total general fund revenues, rather than the Census “total taxes” category previously used, helps assess the total income, including fees and charges, available to the states’ general funds. Information on corporate taxes, notwithstanding the volatility of monthly data, provides insight into business activity within the states and offers added perspective on economic conditions. Annual numbers included in the database remove some of the volatility associated with monthly data and provide an important baseline for annual comparisons.

Despite the positive attributes noted above, there are some drawbacks to relying on revenue data provided directly by the states. First is the issue of comparability across states. The quarterly Census data are standardized to adjust for variations across states in their statutory definitions of



certain taxes. This standardization, while resulting in a significant time lag for data release, makes the data more appropriate for cross-state comparisons. In contrast, revenue information provided by the states reflects state-specific factors and is not always consistent from state to state. However, the New England states exhibit only moderate differences in tax definitions, so the absence of a universal standard for this six-state subset is not overly problematic.

A second potential drawback is the quality of the data. Monthly revenue reports are often subject to revision, making it possible that recently released data may not accurately capture the “final audited” revenue flows eventually released. The hope is that amendments to the monthly revenue reports are infrequent and relatively small in magnitude. By contrast, the lag in the release of the Census pro-

vides ample time to incorporate state revisions.

A third potential drawback is the fact that a total for the United States is lacking. Since monthly revenue collections are obtained from the individual state agencies, it is not possible to create a series for the entire United States in a timely manner. With its lag in release, the Census data are able to incorporate a U.S. total. While this is an unfortunate loss, it is not clear that comparisons between revenues of individual New England states and the United States as a whole are appropriate.

Ultimately, we judged the timeliness, increased frequency, and flexibility of state-provided monthly revenue data to be valuable improvements, offsetting these drawbacks.