New England
Fiscal
Facts

Federal Reserve Bank of Boston • Spring 2001 • No. 26

How Will New Hampshire Solve its School Funding Problem? Part 1 of 2

By Daniel G. Swaine

In December 1997, the New Hampshire Supreme Court decided that the local property tax used to fund the state's K-12 public education was unconstitutional. The court's reasoning revolved around two provisions in the New Hampshire state constitution. First, the court said that the education clause in the state constitution guarantees all state residents an "adequate" education, implying that the provision of an adequate education is a responsibility of state government. Second, the court said that the constitution requires that tax rates levied to fund any governmental program be "equal and proportionate" across all individual taxpayers within the appropriate taxing jurisdiction. Given the adequate education mandate, the appropriate taxing jurisdiction was deemed to be the entire state of New Hampshire. On this basis, with property tax rates in fact varying dramatically across New Hampshire's 259 communities, the court declared the local property tax to be unconstitutional (see *Fiscal Facts*, Fall/Winter 1998).

After a long and tortuous public debate lasting for almost two years, the New Hampshire legislature enacted HB999 in November 1999. HB999 provided for an interim statewide property tax designed to fund slightly more than half (about 53 percent) of the cost of adequate public education, which was estimated at $825 million. This interim property tax, which sunsets in 2003, gives New Hampshire policymakers time to develop a permanent funding solution. The statewide property tax rate was set at $6.60 per $1,000 of a property's value. On the surface, this measure would appear to meet the stipulation of "equal and proportionate," since a uniform tax rate is applied equally to all property owners across the state. However, on January 17, 2001, Rockingham Superior Court Judge Richard E. Galway ruled in *Sirrell, et al.* v. *State of New Hampshire, et al.* that the new statewide property tax was also unconstitutional. A divided state Supreme Court reversed this decision in early May.

The Galway decision and its reversal by the Supreme Court are crucial to the fiscal options available to New Hampshire policymakers in solving the school funding problem. In this issue of *Fiscal Facts*, we discuss the Galway decision and the Supreme Court reversal. First, we summarize briefly the Galway decision, which is rooted in a critique of property assessment techniques. Second, we review the mechanics of property valuation and assessment in general. Third, we discuss the specific property assessment techniques used in the state of New Hampshire. Finally, we analyze the different rationales behind the two separate court decisions.

Summary of the Galway Decision

Although the tax in question is a statewide property tax, property values have continued to be assessed at the municipal level in New Hampshire. But local assessment practices differ across communities. A property may be assessed a different value depending on its location within

New England
Fiscal
Facts

Editors
Robert Tannenwald
Daniel G. Swaine

Designers
Heidi Furse
Fabienne A. Madsen

State Budget Timetables

Annual Budgets
Massachusetts
Rhode Island
Vermont
FY02: July 1, 2001 to June 30, 2002

Biennial Budgets
Connecticut
Maine
New Hampshire
FY02-03: July 1, 2001 to June 30, 2003

the state. Data from the state Department of Revenue Administration (DRA), presented to the court in *Sirrell,* demonstrated this fact: When a property's assessed valuation was compared to its market valuation in ratio form, the value of this ratio varied across municipalities within the state as well as across individual property owners within any given municipality.

New Hampshire courts have historically maintained that any tax system must meet a constitutional test of "equal in valuation and uniform in rate" in order to comply with the "reasonable and proportionate" taxation clause of the state constitution. In view of the wide variation in assessed-to-market value ratios presented to the court, Judge Galway ruled that the statewide property tax system did not pass the constitutional test of "equal in valuation" across all individual taxpayers in the state.

A second provision of the New Hampshire constitution requires that a complete revaluation of all property within the state be conducted every five years. Because 30 percent of the municipalities in the state had not performed a complete property revaluation in more than seven years, Judge Galway ruled that this constitutional provision was also violated by the statewide property tax system.

Property Valuation and Assessment

The market value of a property is the standard by which property appraisal is judged. Assessors have at their disposal a variety of means to estimate a property's market value. The starting point for assessment is the tax roll, which contains a listing of properties, their location, and the physical characteristics of each property (e.g., the number of bedrooms, the number of bathrooms, the sizes of these rooms, etc.). Because property owners frequently reconfigure the physical characteristics of their building structures, the tax roll must be kept up-to-date by conducting periodic physical inspections of the premises.

For residential property, a second important piece of information is a large and representative sample of market prices from recent property sales. With this sample, plus the tax roll, statistical techniques can be used to estimate the value of each of the many different characteristics of a property.[1] Combining the estimated market values of property characteristics with information on the physical characteristics of all properties enables an assessor to estimate the market value for every property, regardless of whether a property has been sold recently.[2] (Because business and commercial properties rarely change hands in a market transaction, other techniques are used to compute an approximate market value for all business and commercial property.)

To keep assessed values relatively current, periodic revaluations of property must be conducted. A complete revaluation requires two updates:

(1) The tax roll must be updated through a physical inspection of the premises of each individual property in order to determine changes in the configuration of property characteristics; and

[1] The statistical procedure is called hedonic regression, which is a particular application of multiple regression. We use the sample of market prices of properties as the dependent variable, and each of the physical characteristics of the properties is an independent variable in the regression. Canned multiple regression procedures found in many off-the-shelf statistical packages will compute the coefficients for each of these independent variables. These coefficients provide the estimated (shadow) market prices for each property characteristic. With these shadow prices, we can employ a process similar to that used in footnote 2 to estimate a market value for each property that hasn't been sold recently.

[2] To illustrate the market value estimation process, let's assume we have three types of residential properties that have been sold recently. Property type A contains one bedroom and one bathroom and a variety of other characteristics that are identical in all other aspects to the remaining two property types. Property type B contains two bedrooms and one bathroom and is identical in all other aspects to the remaining two property types. Property type C contains one bedroom and two bathrooms and is identical in all other aspects to the remaining two property types.

Suppose we have a representative sample of properties that have been sold recently, and this sample contains a large number of properties that are identical to property types A, B, and C. Further, suppose the average sales price for property type A was $100,000, the average sales price for property type B was $115,000, and the average sales price for property type C was $120,000. We could infer that, on average, a bedroom is valued at $15,000, a bathroom is valued at $20,000, and the remaining characteristics of a residence are valued at $65,000 in total. Suppose that a fourth property type, property type D, has not been sold, but we are told that it contains three bedrooms and three bathrooms and has a variety of other characteristics that are identical in all other aspects to property types A, B, and C. Given the values of the characteristics that we estimated above, we would impute the market value of property type D at $170,000 (i.e., three bedrooms valued at $45,000; three bathrooms valued at $60,000; and the rest of the property valued at $65,000).

(2) A sufficiently large and representative sample of recent property sales must be collected in order to re-estimate the market values of each important property characteristic.

To compute new assessed values, the statistical technique referenced above is applied to these two collections of data.

Property Valuation in New Hampshire

Some municipalities in New Hampshire periodically perform physical inspections of properties to update their tax rolls for changes in the physical characteristics of properties. Some that do this actually perform only a partial revaluation – they do not physically inspect every property, but do inspect certain classes of property. Occasionally, municipalities may perform a complete revaluation. About 30 percent of municipalities in New Hampshire have not performed any revaluation (complete or partial) in more than seven years. Some municipalities rarely if ever perform a revaluation. Keene, for example, has not performed a complete revaluation in more than 30 years. Most New Hampshire communities revalue their property only infrequently because funding is not sufficient to inspect physically every property within the community.

Methods other than physical inspection are utilized to keep assessed values current with market values. In the most typical method, all property values are adjusted by a common multiple, which is based on a sample of recent property sales. This multiple adjusts for the degree to which properties may be under-assessed, or over-assessed, because of changes in market conditions and because of general price inflation. Changes in market conditions may cause properties to depreciate in value if demand conditions worsen, or appreciate if demand conditions improve. General price inflation causes property values to increase. If a sufficiently large and representative sample of property sales is collected, the price for each property in the sample can be compared to its assessed value in ratio form. The sample average ratio of sale price to assessed value can be calculated so that a common degree of appreciation or depreciation in the property values in the sample can be determined.

Using statistical inference, the sample average can be projected to the population of all properties in the community. In other words, all assessed property values in the community are leveraged up or down by this common multiple. If, for example, a sample of property sales suggests that, on average, market value exceeds assessed value by 10 percent, all assessed property values in that community would be increased by 10 percent. This method of adjusting property values by a common multiple is identical to the equalization process used by the Department of Revenue Administration.

Problems with the Common Multiple Method

The common multiple method of updating assessed valuations is intended to estimate the amount of appreciation or depreciation in property values caused by changes in real estate market conditions over time. But, over time, property owners can reconfigure the characteristics of their residences; this will also lead to changes in the market value of the property. Thus, the common multiple method does not circumvent the need to update, periodically, the tax roll for changes in the configuration of property characteristics. If physical inspections of property are infrequent, the common multiple will contain a mixture of effects that are impossible to disentangle – the common multiple will include changes in property valuation that are due to alterations in property characteristics as well as to variations in real estate market conditions.

To illustrate, consider the following example, which is summarized by the data in Table 1. Suppose we have three identical properties having both an assessed value and a market value of $100,000 – listed in column (1) of Table 1. Five years elapse, and market conditions are such that all three properties have appreciated in value by 10 percent to a market price of $110,000 – listed in column (2) of Table 1. But, of the three properties, two have had alterations in their property characteristics. The owner of property A eliminated a garage and a backyard deck, reducing the value of the property by 20 percent. The owner of property C added another floor to the residence, increasing the value of the property by 50 percent, while the owner of property B did not make any changes to his/her residence. These changes are listed in column (3) of Table 1. If all three properties were to be sold, the market price of property A would be $88,000, the market price of property B would be $110,000, and the market price of property C would be $165,000, as listed in column (5) of Table 1. Dividing column (5) of Table 1 by column (1) of Table 1 yields the ratios of market value to assessed value for the three properties. Property A has a ratio of market to assessed value of 0.88, property B has a ratio of market value to assessed value of 1.1, and property C has

Table 1

Common Ratio Calculation

Property	Assessed Value (1)	Market Value (with no structural changes) (2)	Percent Change in Value (due to structural changes) (3)	Structural Change Ratio (1+ (column (3)/100) (4)	Market Value (with structural changes) (column (4)xcolumn (2)) (5)	Ratio of Market Value to Assessed Value (column (5)/ column(1)) (6)
A	$100,000	$110,000	-20.0%	0.8	$88,000	0.88
B	$100,000	$110,000	0.0%	1.0	$110,000	1.10
C	$100,000	$110,000	50.0%	1.5	$165,000	1.65
Sum						3.63
Average						1.21

a ratio of market to assessed value of 1.65, as listed in column (6). The average ratio of market to assessed value – the common multiple – is 1.21.

For this community, the common multiple of 1.21 suggests that on average properties have appreciated in value by 21 percent, which is higher than the actual appreciation rate of 10 percent that is due solely to variation in market conditions. In addition, the properties in this sample have ratios of market to assessed values that vary considerably from this common multiple. If we were to apply the common multiple of 1.21 to the assessed value of each of the three properties, assessed valuation would increase to $121,000 for each property. The application of the common multiple method of updating property values for this community is summarized by the data in Table 2. For tax purposes, property A would be overvalued by 38 percent, property B would be overvalued by 10 percent, and property C would be undervalued by 27 percent, as listed in column (6) of Table 2. The errors due to this method of updating would result in the owners of properties A and B paying more than they should in property taxes, while the owner of property C would pay less than he/she should in property taxes. This raises serious concerns about the equal treatment of property taxpayers living in the same community.

On the other hand, if none of the properties had been modified, only market conditions would be changing. Each property would have a market price of $110,000 and a ratio of market to assessed value of 1.1. The average ratio of market to assessed value – the common multiple – would be 1.1. Each property would have the same ratio of market to assessed value, achieving the ideal of no dispersion. If we multiply assessed values by the common ratio of 1.1, each property owner would pay the correct share of property taxes. Therefore, if market conditions is the only factor that changes, there is no bias in using the common multiple method to update assessed property values.

The Equalization Process

As noted earlier, the equalization process used by DRA is a direct application of the common multiple method. It works as follows: A sample of recent property sales is collected for each community. The ratio of market value to assessed value is then computed for each property in each sample, along with a sample average ratio for each community. Updated assessment values are then computed for all properties in each community by multiplying each property value by that community's sample average ratio of market value to assessed value. To illustrate, let's assume that in comkunity A, a sample of property sales suggests that on average, market values are greater than assessed values by 10 percent. In community B, the sample suggests that, on average, market values

Table 2

Common Ratio Method of Updating Property Valuations

Property	Assessed Value (1)	Common Ratio (2)	Updated Assessed Value (column (2) x column (1) (3)	Market Value (4)	Ratio of Assessed to Market Value (column (3)/ column (4) (5)	Percentage Over or Under (-) Valued (column (5)-1)x 100) (6)
A	$100,000	1.21	$121,000	$88,000	1.38	38
B	$100,000	1.21	$121,000	$110,000	1.10	10
C	$100,000	1.21	$121,000	$165,000	0.73	-27

are below assessed values by 25 percent. To equalize assessed valuations across these two communities, all assessed values in community A would be multiplied by 1.1, while all assessed values in community B would be multiplied by 0.75.

The problem inherent in the common multiple method – that ratios of market value to assessed value contain a mixture of changes due to alterations in property characteristics as well as to changes in market conditions – also affects the equalization process. As a result, when complete property revaluations are conducted infrequently, as is the current practice in New Hampshire, measures of dispersion – the average percent variation of an individual property from the common multiple – can be quite large, indicating a high degree of variation in the ratios of market value to assessed value across individual taxpayers.[3] When this is the case, the common multiple method, if properly conducted, may equalize *average* property values across municipalities, but it cannot equalize property values across *individual* taxpayers.

The Statewide Property Tax in New Hampshire

Because New Hampshire's municipal governments do not all follow the same property assessment practices, locally assessed values are converted into a set of *baseline* property values that have been "equalized" across communities in the state, using the process described above. Once the equalization process has been completed, the uniform statewide tax rate is determined by dividing the revenues to be raised from the property tax by the statewide sum of "equalized" property values. For example, the statewide property tax was designed to raise $440 million. Equalized property values were estimated at $66.67 billion. Dividing $440 million by $66.67 billion yields a tax rate of 0.0066 per $1 of valuation. Multiplying 0.0066 by 1000 gives the uniform tax rate of $6.60 per $1000 of equalized valuation.

After setting the uniform statewide tax rate, New Hampshire's Department of Revenue Administration calculates individual taxpayers' bills by first converting the statewide tax rate into a set of locally equivalent tax rates, basing the conversion on each community's ratio of market value to assessed value. For example, a community has an average market to assessed value ratio of 1.2. If we multiply the uniform tax rate of $6.60 by 1.2, this yields the locally equivalent tax rate for this community of $7.92 per $1000 of locally assessed value. The locally equivalent tax rate is then multiplied by *local assessed value* of each taxpayer's property to calculate the individual taxpayer's bill.

Galway Decision and Supreme Court's Decision to Reverse

Two provisions of the New Hampshire constitution were at issue in the *Sirrell* case:

- Part II, Article 5, requires that taxes be "reasonable and proportionate" across all individual taxpayers in the taxing jurisdiction. The New Hampshire courts have traditionally interpreted the phrase "reasonable and proportionate" to mean "equal in valuation and uniform (i.e., equal) in tax rate" across all individual taxpayers within the taxing jurisdiction. For the property tax specifically, the phrase "equal in valuation" has been interpreted to mean that "every property is assessed at the same percent of true market value as every other property within the taxing jurisdiction." In other words, similarly situated taxpayers must be treated equally, an interpretation that derives from the equal protection clause of the New Hampshire constitution. In *Claremont II,* the New Hampshire Supreme Court established that the taxing jurisdiction for an education property tax is the entire state of New Hampshire.
- Part II, Article 6, states that "there shall be a revaluation of all the properties within the state once in every five years."

Judge Galway ruled that the statewide property tax was in violation of Part II, Article 5, for two reasons:

First, testimony showed that many of New Hampshire's 259 municipalities infrequently perform a complete property revaluation. As was explained above, when a complete property revaluation is conducted infrequently, the valuation ratio used to update assessed property values (i.e., the average ratio of market value to assessed value) will contain a mixture of effects attributable both to reconfigurations in property characteristics and to variations in market conditions. This mixture of effects can be detected with a statistical measure called the coefficient of dispersion, or COD (see footnote 3). A large value for the COD indicates a high degree of variation among individual ratios of market-to-assessed value across properties within the sample. Data presented to the lower court showed that 50 percent of the communi-

[3] For the data in Table 1, this coefficient of dispersion is 29 percent – an individual property in the sample has a market-to-assessed value ratio that varies from the common multiple of 1.21 by an average of 29 percent.

ties in New Hampshire exhibited a high degree of variation among individual ratios of market-to-assessed value across properties – the CODs for these communities demonstrated that an individual property had a ratio of market to assessed value that varied from that particular community's common multiple by an amount that, on average, was greater than 15 percent.

Second, testimony showed that DRA's procedures to equalize valuations across municipalities were not uniform across communities and, thus, failed to equalize, on average, valuations across municipalities. Therefore, Galway ruled that the statewide property tax was not "equal in value" either across communities or across individual taxpayers, violating Part II, Article 5, of the New Hampshire constitution.

The majority opinion of the state Supreme Court agreed with Judge Galway "that the administration of the statewide property tax raises serious concerns as to whether the tax is 'reasonable and proportional' as required by Part II, Article 5 of the New Hampshire constitution." Still, the majority disagreed with Galway that these flaws are unconstitutional.[4] The majority based its opinion on three reasons:

(1) Judge Galway said that the plaintiffs must demonstrate that inequality in valuation ratios exists. The dissenting opinion of the Supreme Court agreed with this standard.[5] But the majority changed the standard that plaintiffs must meet to the standard that valuation ratios must be "substantially unequal."[6]

(2) Based on New Hampshire case law, Judge Galway appeared to endorse a COD of 10 percent as showing inequality in valuation ratios. Based on expert testimony, the majority argued that the COD has to be greater than 20 percent to demonstrate "substantially unequal" valuation ratios. Although 50 percent of municipalities had CODs greater than 15 percent, only 30 percent of communities had CODs greater than 20 percent, and these communities accounted for an immaterial 7 percent of equalized property valuation.

(3) Judge Galway relied on New Hampshire case law interpreting "equal in valuation" as equity across individual taxpayers. The dissenting opinion agreed that individual taxpayer equity is the proper standard. But the majority argued that equity should be among taxpayers across different communities. The plaintiffs calculated a COD for each community, but a COD for the entire state was not computed. The majority said that because equalization corrects for inequality across communities, these CODs do not demonstrate "substantial inequality" across communities.

Evidence was also presented to the lower court demonstrating that the state was not in compliance with Part II, Article 6, of the New Hampshire constitution. As noted, testimony showed that many of New Hampshire's 259 municipalities infrequently perform a complete property revaluation. However, the state asked the court to determine whether or not the common multiple method of updating property assessments, which includes the equalization process, could act as a substitute for performing a complete revaluation every five years. Judge Galway said no. Because of the lack of uniformity in DRA's equalization procedures and because of the excessive variation in ratios of assessed value to market value exhibited by some 50 percent of New Hampshire's communities, Galway decided that neither the common multiple method nor the equalization process could substitute for a complete statewide revaluation of property values conducted every five years. Thus, Judge Galway ruled that the statewide property tax also violated Part II, Article 6, of the New Hampshire constitution.

The majority opinion of the state Supreme Court agreed that the state was in violation of Part II, Article 6, but it refused to rule that the statewide property tax was unconstitutional, because the plaintiffs did not demonstrate that this violation resulted in "substantially different" tax burdens across communities. However, the majority said that the state must set up proper enforcement procedures to ensure that property revaluations are conducted by municipalities every five years. The majority gave the state until 2003 to design and implement these enforcement procedures.

In the next issue of *Fiscal Facts*, we will examine the options available to New Hampshire to solve the school-funding problem. **FF**

---

4 Governor Shaheen appointed three new justices to the state Supreme Court during the last 18 months. These three justices composed the majority that reversed the Galway decision.

5 The dissenters were made up of Justices Brock and Broderick.

6 This higher standard for the burden of proof has never before been used in a New Hampshire court. The majority opinion based this higher standard on case law from other states.

Across *the* Region

Despite the nationwide economic slowdown, revenue growth has continued to outpace forecasts in four New England states: Connecticut, Massachusetts, Rhode Island, and Vermont. In New Hampshire, tax revenues have approximately met projections, while in Maine, revenue growth has fallen off noticeably, primarily because of a cut in the sales tax rate and a dramatic decline in tax collections from corporate profits. Despite concerns that economic growth is slowing, most states continue to spend at a vigorous rate. Only Maine, which faces a structural budget gap of $200 million, is moderating the rate of growth in spending. In New Hampshire, the legislature continues to struggle with developing a long-run plan to fund the public schools, more than three years after the State Supreme Court handed down its ruling in the *Claremont* case.

Enacted Appropriations for FY01 and Proposed Appropriations for FY02[a]

(Excluding Federal Dollars)

	FY01	FY02	Percent Change
	Millions of Dollars		
Connecticut	9,973.0	10,433.0	4.6
Maine	2,833.4	2,925.7	3.3
Massachusetts	17,788.9	18,677.0	5.0
New Hampshire	2,083.3	2,267.6	8.8
Rhode Island[b]	3,221.2	3,492.0	8.4
Vermont[c]	1,473.4	1,559.8	5.9

[a] Unless otherwise noted, includes general fund and transportation fund appropriations only.
[b] Excludes expenditure of federal grants and reimbursements.
[c] Includes general revenue and other unrestricted funds.
Includes Act 60 education fund spending.
Sources: Official budget documents, state financial statements, and conversations with state budget officials.

Six-State Review

Connecticut

Through the first nine months of FY2001, Connecticut collected $5.7 billion in revenues, up 5.8 percent from last year, and slightly ahead of the forecast in the budget. Income tax collections continued to grow much faster than predictions, up 14.6 percent from last year, while sales tax revenues, up 4.5 percent, grew more slowly than predicted. If revenue growth continues at this pace through the fourth quarter of the fiscal year, Connecticut will realize a small revenue surplus of $22.7 million.[1]

In February, Governor John Rowland submitted his FY2001 and FY2002 budget proposals to the legislature. For FY2001, the governor proposed a net supplemental appropriation of $133.9 million, most of which would be financed by a $127.8 million increase in federal funds. FY2001 own-source expenditures would increase by $6.1 million, up 0.1 percent from the FY2001 appropriation.[2] In addition, the governor proposed a second supplemental appropriation of $468 million for a variety of one-time spending projects; these projects would be financed from an expected FY2001 budget surplus of $500 mil-

[1] A revenue surplus is revenue in excess of official estimates. A revenue surplus provides the basis for operating budget surpluses, which also depend on supplemental spending changes.

[2] Own-source expenditures represent spending out of a state's own sources of revenue, and by definition exclude funds received from the federal government.

lion, but would exceed the spending cap for FY2001.[3] For FY2002, the governor proposed an own-source expenditure budget of $10.4 billion, an increase of $460 million, or 4.6 percent, over FY2001 appropriations.

During the FY2002-FY2003 biennium, $146 million in previously enacted tax cuts will take effect. In addition, the governor proposed $147 million in new tax cuts and two modest spending initiatives. Highlights of his FY2002 budget proposal include the following:

Tax Reductions ($147 million):

- Eliminate the sales tax on hospital services. This tax cut will cost an estimated $111.4 million in FY2002.
- Increase the sales tax exemption on clothing from $75 to $125, and increase the number of sales-tax-free weeks from one to two. This tax cut will cost an estimated $35.6 million in FY2002.

Spending Initiatives ($95 million):

- Spend an additional $55 million for mental health programs and for alternative incarceration programs.
- Spend an additional $40 million to start phasing out the cap on Educational Cost Sharing Grants.

Maine

by Amanda Lydon

Through the first eight months of FY2001, Maine collected $1.45 billion in tax revenue, down 1.1 percent from the same period last year. Corporate tax revenues showed the most significant decline, falling 43.3 percent from the prior year. Sales tax revenues were off by 3.3 percent; however, as of July 1, 2000, the sales tax rate was reduced by 0.5 percentage point, to 5 percent. Had this rate cut not occurred, sales tax revenue would have increased 6.4 percent from last year, and total tax collections would have increased 2.4 percent. Income tax revenues posted healthy growth of 6.9 percent, above revenue forecasts.

In early January, Governor Angus King proposed a $99 million supplemental spending adjustment to the FY2001 budget, an increase of 3.5 percent. In addition, he proposed an own-source expenditure budget for FY2002 of $2.9 billion, up 3.2 percent from FY2001. Governor King's recommended budget is expected to result in a $200 million deficit by the end of the FY2002-2003 biennium. He proposed the following deficit adjustment measures:

- Increase the tax on cigarettes by 26 cents, from 74 cents per pack to $1 per pack, a change expected to raise over $36 million in revenue and also to help deter the use of tobacco products. Last year, the cigarette tax was increased by 37 cents.
- Raise the meals and lodging tax from 7 percent to 7.5 percent, earmarking the additional revenue towards tourism promotion.
- Close the remaining 27 state liquor stores, resulting in $5 million in savings.

Highlights of the FY2002 budget include the following:

- Increase education spending on grades K-12 by 5 percent, adding an extra $130 million over the FY2002-FY2003 biennium.
- Increase spending on Medicaid by more than $126 million (half coming from the general fund and half coming from the tobacco settlement), in reaction to rising drug prices, increases in nursing home costs due to an aging population, and expansion of behavioral health services.

Massachusetts

Through the first nine months of FY2001, the Commonwealth collected $11.8 billion in tax revenues, up 7.7 percent from the same period last year. Both income and sales tax collections were ahead of predictions, growing at 10.5 percent and 6.8 percent, respectively. Although lower revenue growth is to be expected in light of the recent nationwide economic slowdown, no reduction is yet evident. During the third quarter (January through March), tax collections were up 8.8 percent from a year earlier. Should fourth-quarter revenues continue growing at this pace, Massachusetts would finish the year with a tax revenue surplus of $730 million. Even if revenue growth slows to zero during the fourth quarter, Massachusetts would still realize a $317 million tax revenue surplus. The year's surplus would be reduced by $51 million should the legislature decide to enact former Governor Paul Cellucci's supplemental spending proposal, which would raise spending by 0.2 percent.[4]

In January, Governor Cellucci proposed an own-source

[3] The spending cap requires a special vote of the legislature to be overridden. The legislature has voted to override the spending cap in each of the past three years.

[4] In April, Governor Cellucci resigned from his position as Governor after being confirmed by the U.S. Senate as the new ambassador to Canada. He was replaced by Lieutenant Governor Jane Swift, who now has the title of Acting Governor.

revenue budget of $18.7 billion for FY2002, up 5 percent over FY2001 appropriations. A combination of dramatic tax reductions ($1.5 billion) and a slowing economy will act to constrain revenue and expenditure growth through FY2004. Thus, the governor suggested only a few spending priorities, including a 10 percent increase in spending on health care and a 5.5 percent increase in spending on K-12 education. The remainder of the budget was held to a 2.4 percent rate of growth. FY2002 revenue and budget highlights include the following:

Budget:

- Increase spending on Medicaid programs by $577 million, up 6.3 percent.
- Increase direct local aid for education by $171 million.
- Make a one-year expenditure of $240 million to assist ailing local hospitals.

Revenues:

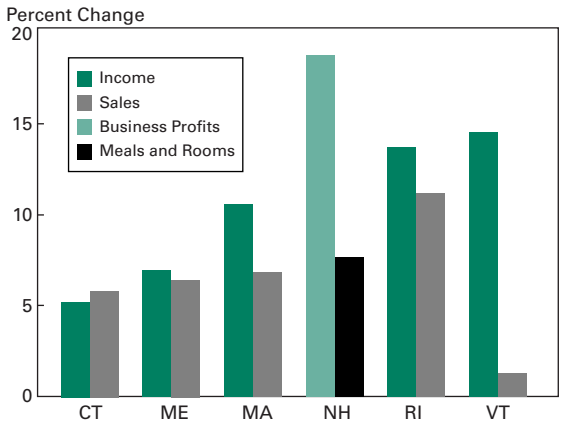
- Implement the first year of a three-year rollback of the income tax rate to 5 percent. The rollback was approved by voters in a November 2000 ballot referendum. When fully phased in, this initiative will cost the Commonwealth $1.2 billion in revenues. The FY2002 installment will reduce the tax rate from 5.85 percent to 5.6 percent, at a cost of $460 million.
- Implement a new charitable deduction that was approved by the voters in the same ballot referendum. This initiative will cost about $200 million.
- Change the allocation of revenues from the tobacco settlement (see *Fiscal Facts*, Spring 2000) from (1) 30 percent allocated to current spending and 70 percent invested in a trust fund to (2) 70 percent allocated to current spending and 30 percent invested in a trust fund. This proposal would add about $122.8 million in funds to FY2002 revenues.
- Transfer $240 million from the tobacco trust fund to finance the aid to local hospitals.

New Hampshire

Through the first nine months of FY2001, New Hampshire collected $851 million in tax revenues, up 3.3 percent from the same period last year and slightly ahead of predictions. Collections from the combined business profits and business enterprise taxes dramatically outpaced forecasts, growing at an 18.6 percent rate. Rooms and meals tax revenues grew slightly more slowly than forecasted, at a 7.6 percent pace. If total tax revenues continue to grow at this rate through the fourth quarter of the fiscal year, New Hampshire will realize a $40.1 million revenue surplus that can help offset an expected $100 million budget deficit attributable to under-financing of educational expenditures.

Revenues from the Two Largest Taxes in Each New England State

July through March, FY2001 Compared with FY2000



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

In mid February, Governor Jeanne Shaheen submitted a request for a supplemental appropriation for FY2001 along with her budget proposal for FY2002. For FY2001, she requested a supplemental appropriation of $17.6 million, 0.8 percent above the original FY2001 appropriation. For FY2002, she proposed $2.3 billion in own-source expenditures, up 8.8 percent from FY2001. Highlights of Governor Shaheen's budget proposal include the following:

- Increase non-education aid to local communities by $54 million (16 percent).
- Increase spending for the New Hampshire court system by $17 million (16.5 percent).
- Appropriate $10.2 million to fund a new state prison in Berlin.
- Increase spending for the University of New Hampshire by $7.7 million (5 percent).
- Increase spending for home nursing programs to benefit senior citizens by $6.8 million.

Along with the budget proposal, the governor submitted a long-run plan to finance fully K-12 public education. The governor's Excel tax plan would introduce a 2.5 percent sales tax from which most services, food, and

clothing would be exempt. The plan would also reduce the statewide property tax to $4.90 per $1,000 in valuation from the current rate of $6.60 per $1,000. In mid April, the New Hampshire House of Representatives voted down this proposal along with the Hager-Below-Fernold 3.3-percent income tax and the Petersen 1-percent gross-receipts tax. More recently, the House passed a plan to raise additional revenue from a variety of small taxes in order to help fill the $100 million budget deficit that was left when the *Claremont* reform bill was enacted in May 1999.

Rhode Island

Over the first nine months of FY2001, Rhode Island collected $1.8 billion in tax revenues, up 8.5 percent from the same period last year and in line with recently revised revenue forecasts. Revenues from personal income taxes and sales taxes grew strongly, up 13.6 percent and 11.1 percent, respectively. The nationwide economic slowdown has not yet affected overall tax revenue growth in Rhode Island. Should revenues continue growing at this pace through the fourth quarter of the fiscal year, Rhode Island would realize a revenue surplus of $134.8 million for FY2001.

In February, Governor Lincoln Almond submitted a supplemental FY2001 budget and a proposed FY2002 budget to the Rhode Island legislature. For FY2001, the governor proposed a supplemental spending appropriation of $106.9 million, equal to 3.3 percent of the FY2001 expenditure level enacted last June. For FY2002, the governor proposed own-source revenue expenditures of $3.5 billion, up 8.4 percent from the enacted FY2001 budget. Highlights of the governor's budget proposal include the following:

Tax Changes:

- Implement the fifth in a series of five planned income tax reductions of 0.5 percentage point. This particular reduction would lower the income tax rate from 25.5 percent to 25.0 percent of federal tax liability.
- Eliminate the income tax on capital gains. The tax would be phased out over a five-year period. In the first year, the reduction would cost an estimated $20 million. When fully phased in, the tax cut would cost an estimated $62 million.
- Earmark an additional one cent of the gasoline tax for the transportation fund, so that a total of 27.25 cents of the 28-cent gasoline tax would be earmarked.
- Freeze the phase-out of the property tax on motor vehicles.

Spending:

- Increase general revenue sharing to local communities by $21 million (14.5 percent).
- Increase education aid to local communities by $39.1 million (6.2 percent).

Vermont

by Amanda Lydon

Through the first nine months of FY2001, Vermont's total tax revenues grew a healthy 7.6 percent over year-ago levels — significantly ahead of the flat growth that was predicted for the period. Personal income tax revenues were up by a strong 14.4 percent — far ahead of the 1.1 percent growth that was forecasted. A one-percentage-point decrease in the personal income tax rate, effective January 1, 2000, had led forecasters to predict sluggish growth for income tax collections. When a base-to-base comparison is taken, income tax revenues increased by an impressive 19.2 percent. In contrast with this strength in personal income tax revenues, consumption tax revenues are a source of concern. Revenues from the sales and use tax were up by a modest 1.3 percent over the same period a year ago. Nevertheless, if total tax collections continue to grow at 7.6 percent through the fourth quarter of the fiscal year, Vermont will realize a $65.6 million revenue surplus.

In January, Governor Dean proposed a supplemental spending appropriation of $12.9 million, an increase of 0.9 percent in FY2001 appropriations. He proposed $1.6 billion in own-source revenue expenditures for FY2002, up $86.5 million, or 5.9 percent, over FY2001 appropriations. The governor attributed the need for such rapid spending growth to the spiraling cost of medical care. Otherwise, the budget contains no major changes in spending priorities.

Highlights of the FY2002 budget include the following:

- An increase of 67 cents per pack in the cigarette tax in order to help pay future health care costs and curb the use of tobacco. This tax hike would raise an additional $12.2 million of revenue.
- An allocation of $13.3 million from general fund reserves to spend on improving roads and constructing new roads and rail infrastructure.
- Spending $24 million from the projected $30 million FY2001 surplus to fund a number of one-time capital construction projects. This would be in addition to regular capital spending on roads and railroads. **FF**

Why are ticket prices **so** high?
Is anybody worth **that** much?
Why are owners and players **always** squabbling?

Peanuts & Crackerjacks

a **FREE web-based baseball game**,
answers these questions and more.

It's all on the web. Go to www.bos.frb.org. Click on Peanuts & Crackerjacks

New England Fiscal Facts

Federal Reserve Bank of Boston
P.O. Box 2076
Boston, MA 02106-2076

Change Service Requested

Bulk Rate
U.S. Postage
Paid
Danvers, MA
Permit No. 355