Across *the* Region

New England states are facing their worst fiscal crises in at least a decade. General revenues, especially those from the personal income tax, fell sharply in every New England state except New Hampshire in FY2002. All six states closed the fiscal year with deficits. Although preliminary reports suggest that FY2003 revenue collections in some states may be up from last year, deficits are still expected throughout the region. In response, all six states are cutting expenditures, drawing down reserve accounts, and/or raising taxes and fees.

Six-State Review

by E. Matthew Quigley, with Lin Gong and Amanda Lydon

Connecticut

According to the State Comptroller, Connecticut ended FY2002 with a budget deficit of $817 million, or 6.8 percent of general fund spending. The deficit is attributable in large part to revenue collections' being significantly below target. At $7.6 billion, revenue collections were 11 percent below their year-ago level. Notably, collections from the personal income tax and the general sales tax, the state's two largest tax sources, were down 13.7 percent and 3.5 percent, respectively. Falling income tax collections alone punched a $561 million hole in the budget.

The legislature voted to use the balance of $595 million in the state's rainy day fund to cover a portion of the deficit, leaving a gap of $222 million. This remaining deficit will be financed through the issuance of notes during the current fiscal year.

At the end of June, the legislature enacted a revised FY2003 budget that relies on a combination of one-time revenue enhancements, spending cuts, and tax increases to close a projected gap of approximately $850 million. Approximately $400 million of this gap was filled with one-time revenue enhancements, including:

• the sale of approximately $125 million in stock held in the Anthem Demutualization Fund;[1] and

• the recapture of approximately $100 million from three state agencies: Connecticut Housing Finance Authority ($85 million), Connecticut Innovations Inc. ($7.5 million), and Connecticut Development Authority ($7.5 million).

The remainder of the shortfall was met through approximately $300 million in spending cuts and $130 million in tax increases.[2] Despite these actions, the governor's office predicts that Connecticut will end the current fiscal year with a deficit of approximately $280 million. The comptroller's office, using lower estimates of income tax and corporation tax receipts for the current year, places this deficit figure at $361 million.

Maine

Maine closed FY2002 with a $93 million deficit in its general fund budget; an additional $150 million deficit is predicted for FY2003. The state will likely end its biennial budget cycle in June 2003 with a $243 million hole in its $5.3 billion general fund budget. This gap represents roughly 5.5 percent of the state's general fund expenditures for the FY2002/2003 budget cycle. In reaction to the budget shortfall, Governor King imposed a tight hiring freeze on state employees, restricted travel, blocked discretionary purchases, and ordered state agencies to cut expenditures by 2 percent across the board. The remaining hole is to be filled by transferring $10 million from the state's rainy day fund for FY2002 and an additional $86 million for FY2003. These transfers, in tandem with other transfers from the rainy day fund to other funding areas, will completely drain the rainy day fund by the end of FY2003.[3]

With a special legislative session to address the state's fiscal crisis in the offing, Governor King has proposed several ideas to close the budget gap. Highlights of his

1 The Anthem Demutualization Fund was created upon the conversion of Anthem-Blue Cross from a mutual to a stock company.

2 *State Tax Notes*, July 15, 2002.

3 State of Maine, Bureau of the Budget.

plan include the following:

• imposing a package of unilateral spending caps designed to save approximately $60 million;

• delaying property tax reimbursements to save $48 million;

• imposing a new tax on hospitals, nursing homes, and group homes to raise $18 million;

• cutting $10 million from state aid to local school districts and reducing the size of the state's laptops-for-students fund by $10 million;

• transferring $6.5 million from the state's tobacco settlement fund; and

• mandating that state employees take three days of leave without pay to save $4 million.

Although the governor has implemented some of these proposals already, saving approximately $60 million, others will require legislative approval.[4]

Massachusetts

While most states throughout the nation are confronting large revenue declines, Massachusetts has been hit especially hard.[5] The state collected $20.7 billion in revenues in FY2002, down by $1.2 billion from FY2001. While revenues fell, spending continued to climb, reaching $23 billion for the entire fiscal year and creating a $2.3 billion hole in the state's budget.

Massachusetts has relied on a combination of actions to plug the hole:

• The state's rainy day fund was tapped for approximately $1.5 billion, while tobacco-fund settlement dollars were drawn down by $60 million.

• One-time revenue enhancements raised roughly $200 million.

• Retroactive spending cuts, including a reduction of $134 million in pension funding, saved an additional $344 million.

• Other miscellaneous adjustments raised or saved an additional $160 million.

Similar actions are expected to be taken to fill the nearly $3 billion revenue shortfall expected for FY2003. The Commonwealth will tap reserves in the amount of $844 million, reduce pension contributions by an additional $150 million, reduce spending on other items by $724 million, and drain another $150 million from the tobacco settlement fund. By the end of FY2003, it is estimated that balances in the rainy day fund and tobacco settlement fund will have fallen to approximately $350 million and $500 million, respectively.

Massachusetts also plans to raise an additional $925 million in FY2003 revenues through a combination of lower personal exemptions, elimination of the charitable deduction, and increases in the capital gains and tobacco taxes. The state also hopes to collect an additional $42 million of tax arrearages through a one-time amnesty program authorized in the FY2003 budget.

Massachusetts has been, and will continue to be, particularly hard hit by increased health care costs and other human services spending. Between FY2001 and FY2003, expenditures for Medicaid, employee health benefits, K-12 education, and caseload-driven human services will likely have risen by 15.6 percent ($2.1 billion).[6] Although the state has attempted to offset this additional spending through reductions of approximately $725 million in program and administrative spending, significant spending pressures will likely continue to drain resources well into the next few budget cycles.

New Hampshire

New Hampshire's revenue collections for FY2002 increased over FY2001 levels, but at a lower rate than expected. In anticipation of a deficit, Governor Shaheen ordered $6.5 million in budget cuts for FY2002 along with a statewide hiring freeze and a ban on out-of-state travel—measures resulting in $3.4 million in cost savings. Despite these actions, the state ended FY2002 with a $62.6 million deficit (2.7 percent of budgeted expenditures for the 2002/2003 biennial budget cycle). In response, Shaheen ordered a $25 million draw on the state's rainy day fund and an additional $15.2 million in spending cuts for FY2003. These actions leave the state carrying over a shortfall of roughly $10 million into the second year of the biennium; the Governor's legal counsel has indicated that an additional dip into reserves is the most likely solution.

Over the past few years, New Hampshire has experienced a series of tax developments worthy of notice. First, the state increased its business enterprise tax by 300 percent between 1998 and 2002. The tax is currently imposed at the rate of 0.75 percent on the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by business enterprises, after special adjustments and apportionment. In tandem with the business profits tax, it brought in about $440 million in FY2002 and is expected to bring in approximately $430 million in FY2003. Also worth noting is the growing

4 "King Offers New Ideas for Closing Budget Gap," *Portland Press Herald*, August 30, 2002.

5 "Large Declines in April-June 2002 Quarter Caps Terrible Fiscal Year for States," *State Fiscal News*, Vol. 2, No. 10.

6 "2003 Budget: Major Accomplishments in Closing Gap, But 2004 Promises Further Painful Choices," *MTF Bulletin*, August 22, 2002.

importance of the real estate transfer tax in the state's revenue mix. During the first two months of FY2003, this tax brought in more revenues ($22 million) than one of the state's two perennially largest tax categories, business taxes ($18.7 million).[7] While revenues from the real estate transfer tax increased 19.6 percent over FY2002, business-tax revenues were down by 5.6 percent.

Rhode Island

Like the other New England states, Rhode Island experienced shrinking revenues in FY2002. In May,[8] the state reduced estimated revenue collections for FY2002 and FY2003 by $92.9 million and $74.6 million, respectively. As is the case for its peers, Rhode Island's declining revenues are chiefly attributable to a decline in income tax revenues, offset only slightly by increased sales tax revenues.

Unlike the rest of New England, Rhode Island is relying on an unusual approach to balance its FY2002 and FY2003 budgets: securitization of the state's tobacco settlement proceeds.[9] The state has sold the right to the next 40 years' worth of payments to the newly formed Tobacco Settlement Financing Corporation. This corporation, in turn, has sold $685.4 million in tobacco bonds on the open market.[10] After establishing a debt-service account and paying for other issuance-related expenses, the sale has netted $544.2 million in funds available for expenditure. The state used $295.3 million of these funds to refinance existing debt, freeing up $51.6 million in debt service payments for FY2003; $135.0 million to balance the FY2002 budget; and $77.3 million to balance the FY2003 budget.

7 New Hampshire's two largest tax revenue sources have historically been business taxes and the room and meals tax.

8 This represents the most recent data available to the public.

9 In 1998, Rhode Island – along with 46 other states – signed a master settlement agreement with domestic tobacco manufacturers resulting in payments to the states in perpetuity.

10 "FY2003 State Budget – Part III: Deferring Tough Budget Choices," *Comments on Your Government*, RIPEC, July 29, 2002, p. 4.

In addition to this unique approach, the state has relied on more conventional techniques to raise revenues and balance the budget, including:

- a 32 cents per pack hike in the cigarette tax from $1.00 per pack to $1.32, raising $25.3 million in additional revenue;
- a 2 cents increase in the gasoline tax rate to 30 cents per gallon, a measure projected to raise $9.4 million; and
- additional spending cuts identified by the governor, totaling $25.7 million.

Vermont

Vermont's general revenues declined by 10 percent from FY2001 to FY2002. This decline, led mainly by a 16.6 percent drop in income tax receipts, caused a budget gap for FY2002 of $25 million, or 3 percent of general fund spending. To balance the FY2002 budget, the governor and legislators drained $25 million from the state's rainy day fund.

In June, lawmakers approved a general fund budget of $3.3 billion for FY2003, but eroding revenues quickly threw this out of balance. In response, on August 23, a special legislative committee approved a package designed to correct the shortfall. The $39 million package eliminates 84 state jobs, cuts chiropractic and denture coverage for Medicaid patients, and drains $9 million from tobacco settlement accounts to fund other health care programs. Lawmakers also increased the cigarette excise tax by 49 cents per pack, raising $19.7 million. Finally, under current law, Governor Dean is allowed to cut 1 percent from general fund spending, but he is seeking to reduce spending by an additional 2 percent over the course of FY2003. **FF**