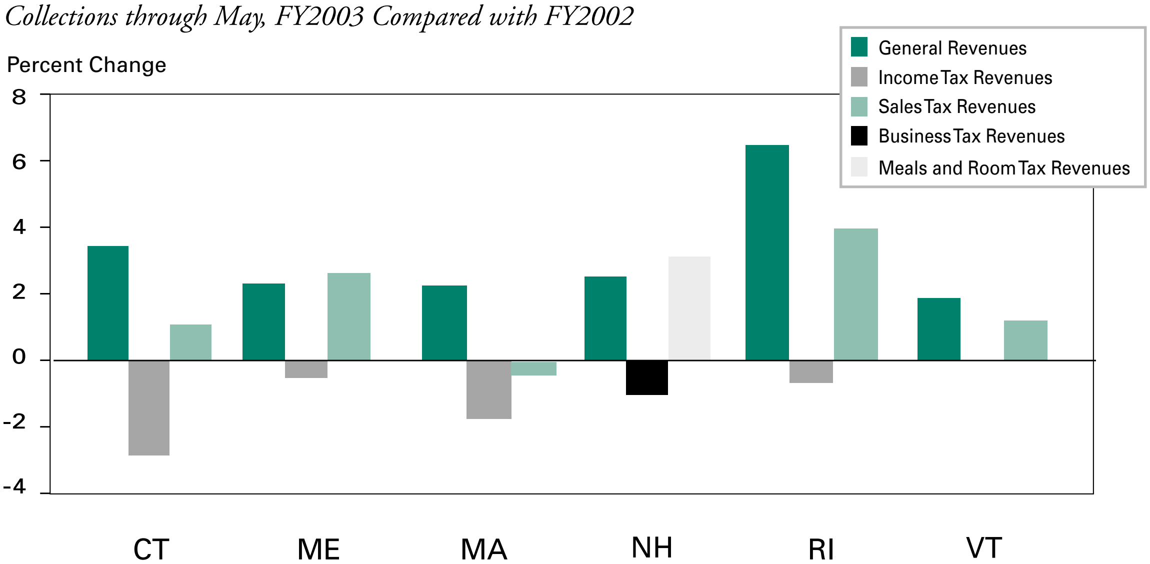
Across *the* Region

As FY2003 drew to a close, revenue collections in New England's six states remained weak. Another year of flat or falling income tax collections had hit the region hard. Through May, income tax receipts were down 3 percent from FY2002 levels in Connecticut, down 2 percent in Massachusetts, down 0.7 percent in Rhode Island, and down 0.5 percent in Maine. Receipts were flat in Vermont. In New Hampshire, revenues from the business tax, the state's largest revenue source, were off by 1 percent. In Massachusetts, declining sales tax receipts exacerbated the falloff in income tax receipts. While sales tax receipts were up modestly in Connecticut, the state was still under considerable fiscal pressure.

All told, general revenue collections for FY2003 were up from FY2002, but not significantly. Policymakers were eagerly awaiting June's figures for an idea of how their budgets would fare in the coming fiscal year.

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

Collections through May, FY2003 Compared with FY2002



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

Six-State Review

Connecticut

Between FY1995 and FY2001, Connecticut's general fund recorded surpluses totaling $3.1 billion. Saddled with a heavy debt load, partially a legacy of the previous recession, policymakers elected to use the surplus funds to retire debt and increase general fund spending rather than build substantial budgetary reserves. When state revenues collapsed in FY2002, a deficit of $817 million surfaced in the general fund (a deficit of roughly 7 percent of general expenditures). To cover the gap, Connecticut drew down its entire $600 million reserve and issued approximately $220 million in economic recovery notes.

Connecticut's fiscal situation continued to deteriorate in FY2003. Revenue increases, both one-time enhancements and longer-term measures, were enacted at midyear; without these, FY2003 general revenue collections would have remained flat relative to FY2002. Most of the revenue slowdown is attributable to the personal income tax. The state revised its projections for personal income tax receipts downward by $421 million. Projections for income tax withholding were revised to a decrease of 1 percent from a gain of 6 percent. The new numbers show capital gains receipts, originally forecast to rise by 5 percent, declining by 10 percent. Receipts from the sales and use tax, the state's second largest source of general revenue, originally projected to increase by 4.3 percent, were revised to show growth of only 1 percent.

In February, as this dismal picture emerged together with the likelihood of cost overruns in Medicaid and other social service programs, Connecticut's comptroller projected a deficit of $602 million for FY2003. To try to close this gap, the legislature passed a deficit mitigation package containing nearly $400 million in additional one-time and recurring revenue enhancements, $70 million in inter-fund transfers, and $138 million in spending reductions. Despite these actions, the state still faced a potential unresolved deficit for FY2003 of $66 million to $101 million.[1]

FY2004 and FY2005 continue to look grim. According to Governor Rowland's proposed FY2004–FY2005 biennial budget, "current service gaps" are expected to swell to $2 billion in FY2004 (15 percent of general expenditures) and to $2.5 billion in FY2005 (17 percent of such expenditures). In the face of such enormous potential deficits, the governor has proposed spending cuts totaling $1.3 billion in FY2004 and $1.7 billion in FY2005. He would eliminate the remaining gap with broad-based tax increases, including the following:

• an across-the-board increase in all income tax rates of 0.5 percentage points, expected to raise an additional $500 million in revenue;

• a reduction in the state's property tax credit of $100, raising an additional $70 million;

• a 10 percent corporate surcharge for FY2003 and FY2004;

• broadening of the sales tax base; and

• an increase in the sales tax rate on computer and data processing services from 1 percent to 3 percent.[2]

Maine

by Robert Roose

Like its regional peers, Maine has felt the burden of slow revenue growth and rising spending needs. Continued weakness in personal income tax receipts and capital gains tax collections held general revenue growth to a lackluster 2.2 percent increase for FY2003.

In an effort to head off a potential deficit in FY2004, Governor Baldacci proposed in February a budget that includes no general tax increases, but relies on a number of revenue enhancements, including increased fees; an insurance premium tax expansion; delayed tax reductions; and increased tax collection activity. He also proposed several one-time revenue actions, including the sale of the state's wholesale liquor operation; an extended contribution schedule to the Maine State Retirement System (an extension from 17 years to 25 years); transfers from the highway fund to the general fund; and numerous expansions of reliance on federal Medicaid funds.

The budget adopted by the legislature largely followed the governor's proposal, with some modifications. In one change, some state jobs were preserved through revenues generated from increased fees for parks, meat inspection, commercial fishing, recreational hunting, and fishing, among other items. General purpose aid to education was increased modestly over the governor's recommended levels — to $732 million in FY 2004 and $725 million in 2005, up from $714 million in FY2003.

The state's swift action was favorably received by the credit rating agencies, which announced in June that they would maintain the state's high ratings (AA+ rating from Standard & Poor's and Fitch; Aa2 rating from Moody's Investor Services).

Massachusetts

Although the Commonwealth closed FY2003 with an unexpected budget surplus of $133 million (roughly 0.6 percent of expenditures), officials continue to anticipate anemic revenue growth of $30 million in FY2004 (an increase of less than 0.5 percent over FY2003 levels).

In the face of this grim fiscal future, the legislature-conference committee passed a $23.1 billion budget for

1 The lower estimate reflects the budget estimate of the Office of Policy and Management, while the higher figure represents the June estimate of the state comptroller.

2 Beginning on July 1, 1997, the sales tax was phased down by 1 percentage point per year (from 6 percent). It was dropped to 1 percent as of July 1, 2001. The governor is proposing a permanent rate of 3 percent.

An Update:

The Recent Economic Performance of the New England States

The July 2003 issue of ***New England Economic Indicators*** features an overview of the economic performance of the New England states in 2002 and early 2003. The article reviews economic activity in the region as a whole as well as the performance of individual states in the context of the national situation and the prior year. Key industrial sectors are highlighted in addition to economy-wide performance as reflected in such indicators as employment, unemployment, personal income, and prices. Although the primary focus is on the year 2002, for which complete data are available, indicators for early 2003 (through May in many cases) offer a preliminary perspective on the outlook for the current year.

The complete text of this overview article, including all charts and references, is available on the Boston Fed's web site.

http://www.bos.frb.org/economic/neei/neei.htm

At this site, you'll also find the most recent issue of *Indicators*, articles that have appeared in earlier issues, and the entire *Indicators* database of current and historical data for more than 130 series in easy-to-access format.

FY2004 that relies heavily on broad-based fee increases and approximately $175 million in "corporate [tax] loophole closing" to bolster receipts. Spending is slated to increase by $292 million, or 1.3 percent, over FY2003 levels. This increase is driven almost exclusively by health care related spending and debt service. Medicaid expenditures alone are expected to be higher by $600 million, a 10.5 percent increase. Debt service is expected to increase by $120 million, or 8.1 percent.

Beyond health care related spending and debt servicing, all other state spending is budgeted to decrease by $462 million (roughly 3 percent) from FY2003 levels. Among the largest cuts are $252 million in local educational aid (down 6 percent from FY2003), $153 million in higher education spending (down 15 percent), and $57 million in general aid to local governments (down 4 percent).

As part of the budget, the legislature also adopted a number of structural reforms proposed by Governor Romney. The most significant of these include the following:

• streamlining the Commonwealth's human services bureaucracy;

• combining the state's Economic Development, Consumer Affairs and Business Regulations, and Labor and Workforce Development departments into one office; and

• merging the Metropolitan District Commission and the Department of Environmental Management.

Soon after the conference committee completed its work, the governor vetoed appropriations worth approximately $200 million. "Because I believe that available revenues will not be enough to support the level of expenditures that [legislators] have recommended," the governor wrote in his veto message, "I am vetoing $201 million to ensure that the Fiscal Year 2004 budget is balanced and that we maintain a more sustainable level of government spending." Local aid experienced the greatest cuts under the governor's veto — a total of $57 million, including $23 million in unrestricted general aid, $10 million in kindergarten grants, $6.5 million in special education reimbursements, and $5 million in sewer rate relief funds. The governor also vetoed increased spending across a wide variety of programs, including funds to provide legal aid to the poor ($9.6 million) and travel and tourism expenditures ($3.7 million).

As of this writing, House and Senate overrides have restored roughly $42 million of the vetoed expenditures.

Legislative leaders have until the end of the current legislative session to resolve the remaining differences, and Speaker of the House Thomas Finneran has indicated that consideration of contested budget items may continue into the fall.

New Hampshire

In February, Governor Benson submitted an all-funds budget of $8.7 billion for FY2004–FY2005. The budget would close the $223 million gap projected to arise in the FY2004–FY2005 biennium (approximately 2 percent of expenditures).

The governor's proposal calls for a "taxpayer bill of rights" that would require a two-thirds majority vote of the legislature to raise taxes and would limit the rate of future budget increases to inflation.[3] It also includes several expenditure changes, most notably affecting education. It recommends an overhaul of the state's adequacy formula under the governor's "No Community Left Behind" program. This program would redesign the state's efforts to meet its constitutional obligation to fund an adequate education. Among the changes proposed are the following:

• redefine what constitutes an "adequate" educationto ease the fiscal requirements imposed on the state;

• eliminate the need for some towns to share their property tax revenues with other towns;

• make state aid to education more fiscally equalizing, that is, concentrate it more on poorer school districts;

• increase the level of state aid to education by $87 million; and

• nearly halve the state's property tax rate over the next five years.

The budget proposes $20 million in funding for the No Community Left Behind program and $4 million for a matching grant program for municipalities seeking to create charter schools. Proposed cutbacks include a 5 percent cut in Medicaid reimbursement to providers and a slight reduction in higher education funding. The budget also recommends a prison consolidation and across-the-board reductions in personnel through layoffs and attrition.

The legislature restored roughly $212 million of the governor's proposed cuts (the conference committee's recommended general fund spending is roughly $66 million higher than the governor's proposal). In late June, the governor vetoed the budget passed by the legislature. As of this writing, the governor and legislative leaders are engaged in negotiations.

Rhode Island

Rhode Island experienced fiscal challenges similar to the other New England states in FY2002. But Rhode Island's approach to dealing with them was different: The Ocean State joined a number of other states (not in New England) in securitizing its tobacco settlement revenues.[4]

3 State of New Hampshire, *Governor's Executive Budget Summary* (Revised), February 13, 2003, p. 2.

Securitization allowed Rhode Island to accomplish three things:

• to balance its books in FY2002;

• to buy back existing general obligation debt, thereby freeing up funds otherwise budgeted for debt service payments; and

• to carry reserved proceeds forward into the current and next fiscal years.

Largely, although not solely, as a result of securitization, Rhode Island's fiscal situation is now stable. Policymakers anticipate a balanced budget in FY2003 and FY2004.

In this climate, Governor Carcieri has proposed a revised budget for FY2003 containing roughly $38 million, or 1.4 percent, in additional spending above the previously authorized level. He has also proposed a budget for FY2004 that would increase state spending by $124 million, or 2.3 percent, over the level proposed for FY2003.

The FY2004 budget assumes modest general revenue growth of 3.0 percent. Personal income tax collections, which account for roughly 31 percent of total receipts, are expected to increase by 5.6 percent over revised FY2003 estimates. Sales tax collections, which account for 29 percent of general revenues, are expected to total $814 million in FY2004, an increase of 4.6 percent. The introduction of newly approved video lottery machines is expected to bring in an additional $48 million in general revenues.

Dragging down the rate of revenue growth are (1) business tax collections (7.4 percent of revenues), which are expected to decline by 1.7 percent from FY2003 levels, and (2) a host of "other sources," which are expected to bring in significantly less revenue. Foremost in this latter category is the absence of one-time revenue enhance ments, such as the state's tobacco securitization, used to balance the budget in FY2003.

On the spending side of the equation, the governor's revised budget for FY2003 increases expenditures for corrections by $6.8 million, for school construction, by $4.8 million, and for debt service, by $8.6 million. His proposed budget for FY2004 envisions expenditures of all types totaling $5.6 billion. Roughly 49 percent of this $5.6 billion reflects general fund spending, which is expected to increase by $67.6 million, or 2.5 percent, over budgeted FY2003 levels. The $67.6 million increase is distributed as follows:

4 Securitization is the sale of the right to future settlement payments — in this case, from tobacco companies — in exchange for an upfront lump-sum payment. For discussion of this transaction in the case of Rhode Island, see the Winter 2002/2003 issue of *New England Fiscal Facts* (No. 30).

• $23.6 million for debt servicing;

• $16.5 million to the Department of Human Services to cover caseload growth;

• $11.3 million for School Housing and Local Education Aid;

• $9.6 million for costs associated with growth in the state's inmate population; and

• $5.0 million to expand higher education scholarship programs. School aid is level-funded at $622.6 million.

In an effort to control costs, the governor's budget increases Rhode Island state employees' share of pension costs from 8.75 percent to 10.75 percent of salary and correspondingly decreases the state's share of contributions from 9.6 percent to 7.6 percent. Teachers' pension contributions are raised from 9.5 percent of salary to 11.5 percent. Combined, these two actions are expected to save the state $18.1 million per year. Further savings are sought through a reduction in the state's full time equivalent worker authorization from a cap of 15,383 employees for FY2003 to 15,251 for FY2004. This reduction is expected to save the state $7 million.

The state's budget reserves are expected to remain fully funded at their legally mandated level of 3 percent of expenditures, and the state expects to close FY2004 with a balance of $85 million.

Vermont

Within the New England region, comparatively speaking, Vermont's fiscal situation and outlook are strong. After utilizing reserve accounts and enacting roughly $22 million in budget rescissions, the state expects to close FY2003 with a $4.6 million surplus, less than 1 percent of expenditures. Total expenditures for the year are expected to come in at $1.5 billion, down 1 percent from budgeted levels, and the state's budget stabilization reserve account is expected to end the year with a balance of $26 million. With the exception of the state's human services caseload reserve, all other reserve accounts are expected to have zero balances by the end of FY2003.

After experiencing a 7 percent decline in revenues in FY2002, the Green Mountain State anticipates overall revenue growth of 2.3 percent for FY2003 and 3.2 percent in FY2004. Revenues from the personal income tax, the state's largest source of general revenues, fell 11 percent in FY2002, will likely be flat in FY2003, but are expected to grow by 4.4 percent in FY2004. Revenues from the sales and use tax, the second largest revenue source, are expected to close FY2003 up 2.3 percent over FY2002 levels and to rise 3.6 percent in FY2004. Corporate income tax revenues, down 37 percent in

FY2002, are expected to fall again in FY2003 and then to rebound in FY2004, although the FY2004 level is still expected to be some 30 percent less than in FY2001.

While far from rosy, Vermont's financial position is relatively strong, as Governor Douglas recognizes: “We as Vermonters are fortunate that, while these revenue sources are insufficient to fund all our desired programs,” the governor wrote in his revenue outlook, “we are in substantially better position to weather these challenges than our counterparts in other states.”

Reflecting these sentiments, the governor submitted a budget to the general assembly limiting growth in general fund spending to 1 percent, growth in the transportation and education funds to 1.1 percent, and special funds growth (including Medicaid) to 4.6 percent. To keep these growth rates low, the governor asked all agencies to seek cost reductions totaling 5 percent to 10 percent of prior year appropriations.

The budget proposal would, however, expand funding in certain areas. To spur economic development, the governor proposed a jobs and economic security package worth $107 million, including $60 million in low-interest loans to entrepreneurs and $25 million in bridge financing for small businesses. He also proposed providing $15 million to the Vermont Agricultural Credit Corporation for low-interest financing to farmers, and he recommended the creation of a new Department of Information and Innovation to upgrade the state’s provision of web-based services.

In increased funding for education, the University of Vermont, Vermont state colleges, and the Vermont Student Assistance Corporation would receive a 2 percent increase, and $239 million would be transferred from the state’s general fund to the education fund to support elementary and secondary education.

Collectively, the governor believes that these actions will stave off a potential $30 million deficit for FY2004 (3 percent of general expenditures). **FF**