Across the Region

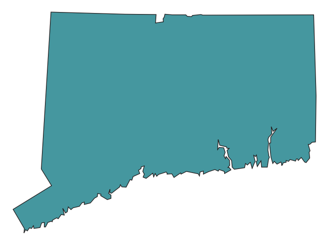
Six-State Review

by Nick Turner

State revenue growth in FY2004 was strong in every New England state except Connecticut. Apart from the Nutmeg State, rates of growth ranged from 6.2 percent in Massachusetts to 12.1 percent in Maine. Connecticut's revenues grew by only 1.1 percent, as its sales tax and business tax revenues both decreased. Collections from personal income taxes grew in all five states that impose them. (New Hampshire imposes neither a personal income tax nor a general sales tax.)

State revenues continued to grow rapidly during the first quarter of the current fiscal year compared with the first quarter of FY2004. New Hampshire's revenues grew the fastest (9.5 percent), followed by Vermont (8.4 percent), Maine (7.3 percent), Massachusetts (5.5 percent), and Rhode Island (3.8 percent). Connecticut data for the period were not released as of this writing. The personal income tax continued to be the strongest performer, posting revenue growth rates ranging from a high of 12.3 percent in Rhode Island to a low of 8.3 percent in Massachusetts. Growth in general sales tax revenues was considerably weaker. Rhode Island registered the largest percentage increase (4.5 percent), while Vermont suffered a decline (down 8.3 percent).[1]

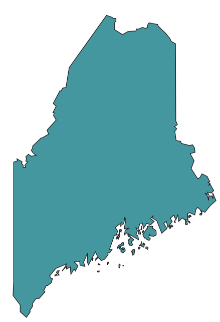
Connecticut



A contraction in revenues during the last half of FY2004 kept Connecticut's revenue growth to a slow 1.1 percent for the entire fiscal year. Robust growth in personal income tax revenues (11.5 percent) could not offset declines in collections from both the sales tax (down 7.2 percent) and the corporate income tax (down 5.5 percent). Because of discrepancies between revenue data provided by the Department of Revenue Services and by the Office of the State Comptroller, no FY2005 tax data had been publicly released at the time of this writing.

The FY2004-FY2005 adjusted budget calls for total general fund spending in FY2005 of $13.2 billion, a 4.3 percent increase over estimated FY2004 levels. The budget contains no new taxes while increasing educational assistance to cities and towns and restoring a $500 personal income tax credit for property taxes paid on primary residences and motor vehicles. Property tax revenues may decline in the future because the state deferred property revaluations for up to three years. Valuations for 2003 showed sizable increases in residential property values and relatively small increases in commercial property values. Without the deferral, the property tax burden would have shifted toward residential property owners and away from commercial property owners. In other changes, a sales tax exemption for hybrid cars was passed, and other exemptions on clean fuel alternatives were extended.

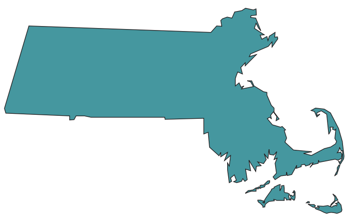
Maine



Maine had the largest percentage increase in revenues in New England in FY2004, up 12.1 percent over FY2003 levels. This strong growth was fueled by robust collections from the corporate income tax, which recorded revenue growth of 22.5 percent, and from Maine's two largest taxes, the personal income tax and the sales tax, which saw revenue growth of 7.9 percent and 7.0 percent, respectively, both exceeding budget forecasts.

Total revenues continued to grow rapidly during the first quarter of FY2005, recording year-over-year growth of 7.3 percent. Among components, personal income tax revenues were up 10.5 percent, while sales tax collections rose a lesser 1.8 percent. Because collections from these taxes exceeded expectations for FY2004, the State Revenue Forecasting Committee began reviewing FY2005 projections in November. There is speculation, however, that collections from these two taxes will wane in the coming winter months as Mainers face higher energy prices for heating. Declines will likely hit sales tax collections first. Corporate income tax collections were up more than 50 percent during the first quarter, reflecting both small refunds and large estimated first quarter payments. Bank tax revenues grew 17.9 percent. These first quarter results indicate that FY2005 may see a continuation of the strong revenue growth witnessed in FY2004.

The big tax news in Maine concerned a ballot initiative to limit statewide property taxes to 1 percent of assessed value (although towns would be allowed to exceed this limit to pay for voter-approved debt financing). Mainers overwhelmingly defeated this measure on election day, although similar initiatives have been enacted elsewhere, including Proposition 13 in California and Proposition 2-1/2 in Massachusetts. A University of Maine study reported that the referendum proposal would have cost Maine municipalities as much as $688 million in FY2003. Property taxes are a primary source of revenue for localities in Maine; in FY2002, 97.4 percent of all local tax revenues came from property taxes. Therefore, absent offsetting increases in state aid to local governments, the referendum would have had a dramatic impact on local public services. Some state lawmakers hinted that, if the initiative had passed, more state aid would have been forthcoming. However, raising sufficient funds at the state level to cover the gap would require substantial tax increases. The University of Maine study showed that collections from the personal income tax — the state's largest tax — would have to increase by 64 percent to cover the loss of property tax revenues. Likewise, collections from the sales tax — the state's second largest tax — would have to increase by 80 percent. The defeat of the resolution removes the prospect of these tax changes and helps the state's municipalities avoid a potential fiscal crisis.



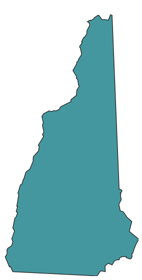
Massachusetts

Total revenues in the Bay State grew 6.2 percent in FY2004. Growth was driven by increases in income tax revenues, both corporate and personal, as well as in sales tax collections. Revenues from personal income taxes — the largest tax category — increased 10 percent. The second largest tax category — the sales tax — recorded only slight revenue growth, 1.1 percent. The public utilities excise tax also contributed to overall revenue growth. Following sluggish collections in FY2003, revenues from this tax were up 59.4 percent in FY2004.

The momentum has carried over into the new fiscal year. Total revenues for Massachusetts were up 5.5 percent during the first quarter of FY2005. Strong growth in revenues from the personal income tax (up 8.3 percent) and a more moderate increase in sales tax revenues (up 3.7 percent) were primarily responsible. First quarter revenues were also bolstered by strong collections from "other" excise taxes (including excise taxes on alcohol, cigarettes, and motor fuels in addition to several others), which increased 12.1 percent. On the negative side, revenues from the corporate excise tax were down by 2.3 percent.

For FY2005, the Commonwealth's budget calls for a fourth straight year of broad cuts in many spending categories as well as selected tax increases, primarily on businesses. Despite reductions in many programs, total appropriated spending, $24.8 billion, is 4.7 percent above actual FY2004 outlays. Almost half of this increase 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 grow at a rate of 6.3 percent in FY2005.

Even larger expenditure increases may be in store to fund Massachusetts public schools. The State Supreme Court heard arguments this fall in the *Hancock* v. *Driscol* case, in which 19 communities allege that the state is not meeting its constitutional obligation to provide an adequate education. The Court could mandate greater education spending. Increases in the "foundation level" (the minimum funding level deemed necessary to meet certain state education criteria set forth in the 1993 Education Reform Act) could lead to dramatic increases in state expenditures. For instance, a 30 percent increase in foundation level funding could cost as much as $2 billion. A ruling is expected shortly.



New Hampshire

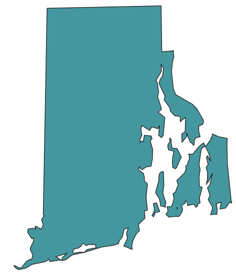
Total revenues grew 6.6 percent in New Hampshire in FY2004, surpassing planned revenues by 2.3 percent. Collections from the business tax were up 4.3 percent, while revenues from the meals and rooms tax grew 5.2 percent. Rising home prices and increased home sales combined with the removal of an exemption helped increase collections from the real estate transfer tax by 20 percent. Revenues from the tobacco tax and the liquor sales and distribution tax were up by 6.4 percent and 7.8 percent, respectively.

Strong revenue growth has continued in FY2005. Total revenues through the first three months of the new fiscal year were up 9.5 percent from a year ago. Business taxes rose 11.0 percent on strong growth from the business enterprise component (up 15.4 percent). Revenues from the state's second biggest revenue generator, the meals and rooms tax, were up a lesser 3.1 percent. The real estate transfer tax continued its strong performance, with collections up 29.6 percent. Rising interest rates helped interest and dividend tax collections increase by 27.8 percent. These higher revenues have led to speculation that New Hampshire will have a significant budget surplus in FY2005, after ending FY2004 with a small $16 million surplus.

Governor Benson proposed a revised FY2004-FY2005 biennial budget that holds general and education spending to nearly current levels for the remainder of FY2005. The enacted budget calls for a 4.6 percent reduction in education appropriations (all funds including federal aid) for FY2005, following a 5.6 percent increase in FY2004. In contrast, total general fund appropriations are expected to grow 2.6 percent in FY2005, after a 2.7 percent increase in FY2004. The 2.6 percent increase for FY2005 includes a 6.8 percent increase in general fund appropriations for education — not enough to counter an expected 11.2 percent reduction in federal aid for education in FY2005.

As in Maine, the November elections had the potential to usher in fiscal policy changes for New Hampshire. On November 2, voters in the Granite State ousted the incumbent Governor Benson, electing John Lynch as the state's next governor. The two candidates differed on several tax policy issues. Governorelect Lynch proposed the elimination of the statewide property tax that results in some towns — "donor towns" — paying more in property taxes to the state than they receive in state education aid. A cigarette tax hike of 17 cents per pack would make up the loss of donor town property tax revenue. In contrast, Governor Benson favored removing the statewide property tax more slowly, ending it by 2010 and capping education aid at current levels. Governor Benson also backed a constitutional amendment, opposed by challenger Lynch, that would block courts from hearing cases on school funding issues.

Rhode Island

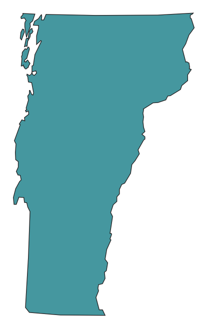


Total collections surged 12 percent in the Ocean State in FY2004, the second largest increase in the region. This growth was spearheaded by corporate income tax collections, which increased by 36.2 percent. Collections from personal income taxes grew by 9.4 percent, while sales tax collections were up by 5.3 percent. Collections from each of these taxes outpaced official revenue estimates issued in May 2004. Business tax revenues soared by 36.2 percent.

Rhode Island's revenue growth has cooled in the new fiscal year. Total general revenue collections for the first quarter were up only 3.8 percent from a year earlier, the lowest percentage increase in New England. Collections from the personal income tax remained robust, increasing 12.3 percent, but sales tax revenues were up only 4.5 percent. It should be noted that the sales tax numbers may overstate actual revenues because of complexities involved in administering the meals and beverage tax. Adjusting for this overstatement could reduce the increase to as little as 2.3 percent, leading, in turn, to a slight downward revision in total revenues. Business tax collections surged 42.1 percent. One business tax, the health care provider assessment, recorded revenue growth of 56.8 percent, largely because the legislature increased the statutory tax rate on gross patient revenue from 3.75 percent to 6.0 percent. Two taxes showed revenue declines: the real estate transfer tax (down 10.6 percent) and taxes on insurance companies (down 3.8 percent).

The final FY2005 budget increases education expenditures by only 2.9 percent over enacted FY2004 levels (0.4 percent over final actual FY2004 education spending). Total state spending is budgeted to grow moderately faster, recording a 3.8 percent increase over FY2004 enacted levels (1.4 percent greater than FY2004 final spending totals). The budget includes numerous revenue enhancements, including a reduction in incentives for enterprise zones, a restructuring of the income tax credit for lead-paint removal, and a cigarette tax hike of 75 cents per pack. A U.S. District Court decision expanded Rhode Island's cigarette tax to cover American Indian tribes operating on settlement lands. State officials expect to achieve budgetary balance in FY2005 but remain concerned about FY2006 and beyond. The administration's five-year financial forecast projects operating deficits beginning in FY2006, increasing to as much as 5 percent of expenditures by FY2009.

Vermont

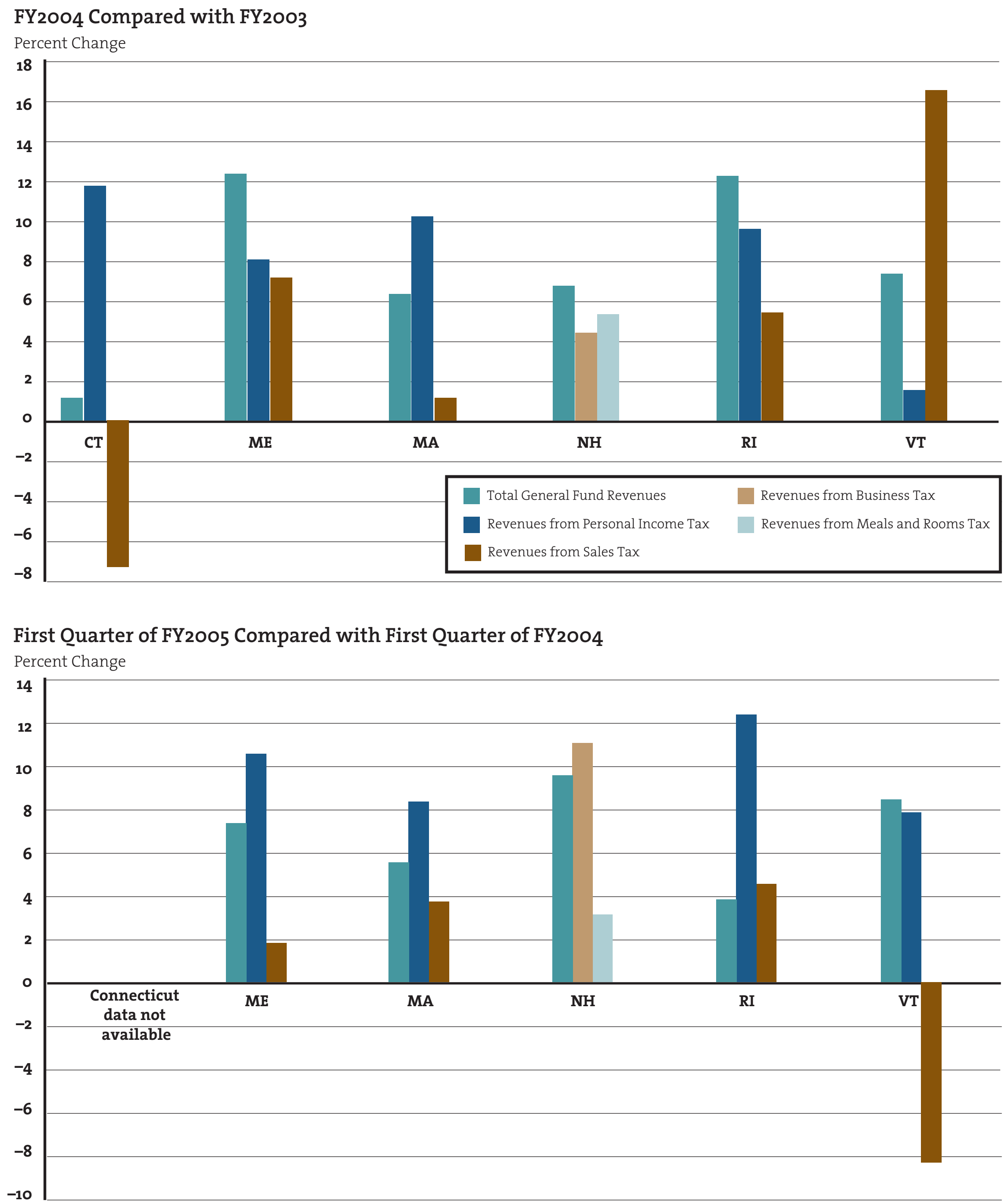


Vermont's total general revenues increased 7.2 percent in FY2004. Growth was driven by strong collections from the corporate income tax, where revenues increased by 24.1 percent. Vermont also had the region's largest percentage increase in sales tax revenues (up 16.2 percent). By contrast, revenues from the personal income tax grew only 1.5 percent, the slowest revenue growth from this source in the region.

Moving forward into the first quarter of FY2005, Vermont's total general fund revenues were up 8.4 percent compared with the same period in FY2004. Corporate taxes registered a substantial revenue increase of 68.5 percent. Personal income tax collections were also up, increasing by 7.8 percent to exceed the state's year-to-date target by $3.7 million. Sales tax revenues were down by 8.3 percent, although they were ahead of year-to-date targeted levels by $3.8 million. Meals and rooms tax revenues also exceeded year-to-date targeted levels (by $700,000) and were up 30 percent compared with the same period one year ago.

These growth rates in general fund revenues do not reveal the true growth in collections. They are affected by legislation that altered the destination fund for several sources of revenue. When the sales tax was increased from 5 to 6 cents per dollar in FY2004, two-thirds of the revenue for FY2005 (or 4 cents per dollar) was earmarked for the general fund, with one-third (or 2 cents per dollar) going to the state education fund. Previously, all sales tax revenues flowed into the general fund. This reduction in the general fund's share of sales tax revenues contributed to the 8.3 percent decline in sales tax collections flowing to the general fund. Total sales tax collections flowing to both the general fund and the education fund were actually up over 30 percent in the first quarter of FY2005. In return for re-directing some sales tax revenues to the education fund, several taxes and fees that were previously split between the education and general funds are now entirely dedicated to the general fund. These include the meals and rooms tax, the bank tax, the corporate tax, security registration fees, and several other smaller taxes and fees. Assigning all of these revenues to the general fund for the first time in the first quarter of FY2005 makes the strong growth in revenues from some of these taxes more apparent than real. For example, adjusting for this change, growth in revenues from the meals and rooms tax was only 7.1 percent.

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



Vermont's FY2005 state budget provides for a 4.4 percent increase in general fund spending over FY2004 levels. Spending from all funds is projected to increase by 9.8 percent, including an increase of 19.2 percent in general education and property tax support, 7.5 percent in human services spending, 6.8 percent in spending for protection, 3.7 percent in transportation spending, and 2.3 percent in spending for higher education. Spending cuts are greatest in employment and training (down 13.4 percent), general government (down 11.4 percent), and development and community affairs (down 9.7 percent).

The November elections also had the potential to affect future tax collections in Vermont. In the gubernatorial contest, challenger Peter Clavelle favored giving municipalities greater freedom to impose local taxes such as a meals and rooms tax and a sales tax. Governor Douglas opposed such changes. On November 2, Vermonters sent Governor Douglas back to Montpelier for another term, helping preserve the state's home rule status.[2]

Combined unitary reporting for corporations[3] is a major tax change that will take effect in FY2006. According to Vermont's Legislative Council, this change could result in an additional $5 million per year in tax collections. Another major change is the elimination of certain exemptions to the personal income tax, such as the exclusion of lottery winnings. However, a variety of tax reductions will also be implemented. Personal and business income tax rates will be lowered, and some business taxes, such as the franchise tax on transportation companies and the gross receipts tax alternative for telephone companies, will be eliminated or phased out over the course of several years.

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[1] Vermont's sales tax decline is more apparent than real. A legislative change altered the revenues flowing into both the education and the general funds, affecting the levels attributed to the sales tax in the state general fund. See the Vermont section below for a fuller explanation.

[2] Currently Vermont is a "home rule" state, meaning that municipalities have only the rights expressly given to them. As a result, any restructuring of the tax code to give localities greater freedom requires state legislative authorization.

[3] Unitary reporting requires a state to determine whether a corporate taxpayer is so closely linked with other establishments that it is in fact a component of a larger multiestablishment enterprise. If so, the taxpayer is deemed "unitary" with that enterprise and must report all of the enterprise's income, even if some of its branches, subsidiaries, or affiliates are located out of state. The state then taxes a fraction of the enterprise's total income, usually determined by the share of payroll, sales, and property located in the state. (Robert Tannenwald, "The Pros and Cons of Worldwide Unitary Taxation," *New England Economic Review*, July/August 1984, 17-28.)