Federal Reserve Bank of Boston

Fiscal Facts

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Editor's Note:

This is the first issue of a quarterly newsletter designed to brief readers on fiscal developments in the New England states. The newsletter is based on newspaper reports, official state budget documents, and verbal reports from state budget officials throughout the region. From time to time, the newsletter will include a short analytical piece that investigates a fiscal issue especially relevant to New England.

Fiscal Facts *and Myths*

New England's state governments are beginning to face the fiscal facts. All are reducing growth in spending and/or raising taxes sharply in order to balance their FY92 budgets and to pay off debt generated by previous deficits. These stark realities have spawned at least two fiscal myths.

Myth #1. States can balance their budgets simply by eliminating waste. True, New England's state governments can, should, and have become more efficient. However, trimming fat alone will not achieve long-run fiscal stability. As a recent Federal Reserve Bank study of Massachusetts' fiscal problems points out, "the forces that exerted pressure for increased [state] spending during the 1980s—decreased federal funding, rapidly rising health care costs, and Proposition 2-1/2—will continue to exert pressure in the 1990s." Nor will greater efficiency reduce the instability of several of the region's state tax systems, a problem that has severely exacerbated the region's fiscal woes. Like it or not, New Englanders are being forced to make harsh trade-offs between higher taxes and lower service levels. The boom years of the middle 1980s only postponed the day of reckoning.

Myth #2. State tax increases in New England have made the region one of the most heavily taxed in the nation. Evidence concerning this contention is mixed. In FY90 (the latest year for which data are available), Connecticut, Massachusetts, New Hampshire, and Rhode Island had among the lowest ratios of state and local taxes and fees to personal income in the nation. Maine and Vermont ranked 24th and 19th, respectively, out of the 50 states (Table 1). On the other hand, Connecticut and Massachusetts both ranked in the top 10 in terms of state and local taxes and fees per capita (Table 2). Maine, Rhode Island, and Vermont were all near the median. Only New Hampshire ranked low according to the per capita measure.

It is easy to confuse fiscal fact and myth. One of the goals of this newsletter is to help New Englanders separate the two.

Table 1

State and Local Taxes and Fees, FY90

	As a percentage of statewide personal income	*Rank among the 50 states*
CT	13.9	47
ME	16.6	24
MA	14.3	42
NH	11.8	50
RI	15.3	37
VT	17.2	19
US Median	16.5	

Source: U. S. Bureau of the Census, preliminary data.

Overview

New England's states generally passed lean budgets for FY92. With the exception of Connecticut and New Hampshire, each appropriated an increase in general fund spending that is smaller than the projected national rate of inflation of 3.5 percent (Table 3). Items bearing a disproportionately large fraction of the cost-cutting were local aid, welfare, Medicaid, and compensation of state workers. With the exception of Massachusetts, each state is relying heavily on tax increases to keep its budget in balance (Chart 1).

Despite this belt-tightening, every state in the region except Massachusetts faces a deficit this fiscal year absent further spending budget cuts and/or tax increases. Revenues are falling short of projections. Several states are having difficulty limiting actual spending to appropriated levels. Tentative agreements between governors and public employee unions have not been ratified and recession-induced increases in entitlement programs are exceeding expectations. Newly enacted taxes in Connecticut and New Hampshire are under legal or political attack.

Table 2

State and Local Taxes and Fees, FY90

	Dollars per capita	Rank among the 50 states
CT	3,383	8
ME	2,678	29
MA	3,118	10
NH	2,386	38
RI	2,704	27
VT	2,844	19
US Median	2,711	

Source: U. S. Bureau of the Census, preliminary data.

Connecticut

Connecticut entered FY92 with a $970 million deficit, 14.5 percent of its FY91 spending. After several months of intense controversy, the state enacted a $7.6 billion budget that 1) increases general fund spending by 4.8 percent 2) increases taxes by $1 billion and 3) eliminates the deficit over a six year period.

The most controversial component of the new tax package is a flat-rate personal income tax, to be imposed at a rate of 1.5 percent in calendar year 1991 and 4.5 percent in subsequent years. It is expected to raise $1.4 billion in fiscal 1992. The tax package also lowers the state sales tax from 8 to 6 percent but broadens the tax's base to include selected personal services and clothing items costing at least $50. The 20 percent surcharge on the corporation income tax is to be phased out by 1993.

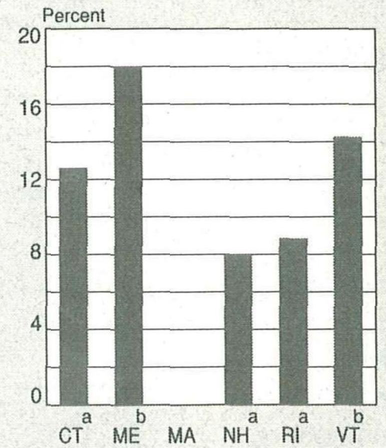
On the spending side, Connecticut's budget assumes total reductions in compensation to public employees of $354 million. Governor Lowell Weicker and representatives of the state's public employee unions are still negotiating the means by which these savings are to be realized. With negotiations stalled, the Governor has laid off more than 4,000 state workers to ensure that the savings targets are met.

Chart 1

FY92 Estimated Revenue Changes

Resulting from Recent Legislated Tax and Fee Increases, as a Percentage of FY92 General Fund Budgets

New England States



[a]Tax increases. [b]Tax and fee increases.

Source: Conversations with state budget officials and National Conference of State Legislatures.

Opposition to the new income tax has become so intense that the General Assembly convened a special session on November 18 to consider repealing the tax. Just before the session opened, the Governor forecast a general fund deficit of $175 million for the current fiscal year. The state legislature's Office of Fiscal Analysis forsees a deficit of $770 million in FY93.

Republican legislators have proposed replacing the state income tax with 1) $300 million in spending cuts, including reductions in welfare, job training, and housing assistance; 2) an increase in the sales tax from 6 percent to 8.25 percent, a quarter of a point higher than its previous level; and 3) restoration of the graduated tax on dividends, income, and capital gains. Other proposed alternatives to the current tax include a graduated income tax and a "piggyback" tax. Under the piggyback option, a household's state income tax liability would equal between 24 percent and 25 percent of its federal income tax liability.

Maine

As in Connecticut, Maine's debate on the current state budget began with projections of a large deficit—about 40 percent of the cost of maintaining state services at current levels. After a long, acrimonious debate, the state passed a budget in July that allows general fund spending to increase by only 1.3 percent (Table 3). The budget eliminated the projected deficit with program cuts worth approximately $450 million, tax and fee increases projected to raise approximately $300 million, deferral of pension payments, the refinancing of bonds, and a one-time increase in Medicaid reimbursements from the federal government.

Newly enacted taxes include an income surtax high-income households; a temporary 10 percent surtax on corporate income tax liabilities; an increase in the general sales tax from 5 percent to 6 percent; an increase in the meals tax from 6 percent to 7 percent; extension of the general sales tax to cable television, newspapers and magazines, and snack food; and acceleration of payments of premium taxes by insurance companies.

Despite these measures, state tax collections during the first four months of the fiscal year (July through October) were $20.6 million below projections. Public alarm over the rape of a baby in Portland has caused the legislature to appropriate additional funds for child protection and prison security. Economists have become more pessimistic about the near-term path of the state's economy. For all of these reasons, Governor John R. McKernan recently forecast a state deficit of $125 million for fiscal 1992, about 8 percent of 1992 appropriations.

In November, the governor proposed spending cuts to eliminate the current-year deficit and to achieve cost savings in FY93 and beyond. The short-term proposals include large cuts in general government administration, economic development programs, and general revenue sharing with cities and towns. Human service programs would be only marginally affected. The governor's long-term proposals include extensive privatization of state programs, intended to reduce the state work force by 20 percent. Hearings on the governor's proposals were being held as this newsletter went to press.

Massachusetts

Massachusetts enacted a balanced FY92 budget with appropriations 6 percent below FY91 spending levels. No other state in the region enacted a cut in spending. One of the budget's largest casualties was local aid, scheduled to decline by over 10 percent. General relief, mental health, and higher education were also cut by a disproportionately large fraction.

Although the budget provides for no increases in taxes, tax increases enacted in 1990 during the last year of the Dukakis administration, some of which did not take effect until after Governor Weld assumed office, have boosted revenues considerably. Had these tax increases not been enacted, state tax revenues in 1991 would have been 12 percent lower. The Weld administration's estimate of tax receipts for fiscal 1992, $8.3 billion, has been widely criticized as too pessimistic. If the estimate is realized, FY92 tax revenues will be 6.7 percent below their FY91 level. For the first four months of FY92, state tax collections were 9.4 percent above the year-to-date FY91 total.

The state's House of Representatives recently passed a hospital finance bill that increases the state's excise tax on cigarettes from 26 cents to 39 cents per pack. Whether the governor will veto the bill because of the tax is uncertain at this time.

New Hampshire

Several recent developments suggest that New Hampshire's FY92 budget is unbalanced. State revenue collections in the first four months (July through October) were $16 million below budget. Largely as a result, Governor Judd Gregg in November forecast a deficit of $80 million for FY92 (including a $24.5 million deficit carried

Table 3

General Fund Balance, FY91, and Planned Change in Spending, FY92

	General fund balance as a percentage of spending, FY91	*Planned percentage change in spending FY92* [a]
CT	- 14.5	+ 4.8
ME	+ 0.5	+ 1.3
MA	+ 1.6	- 5.8
NH	- 3.9	+ 21.9
RI	+ 0.0	+ 2.1
VT	- 9.1	+ 3.1

[a] Increase in FY92 appropriations over FY91 spending.
Sources: Newspaper reports, conversations with state budget officials, and National Conference of State Legislatures.

over from last year), about 15 percent of estimated spending. Estimates in November of the deficit for the 1992-1993 biennium ranged between $150 million and $200 million.

The state legislature's response to the projected shortfall was to enact a plan designed to elicit $117 million in additional federal Medicaid reimbursements in FY92. Under the plan, the state would increase its payments to hospitals with Medicaid patients. The federal government matches these payments dollar for dollar. The state, however, would tax the hospitals it subsidizes, recouping its subsidy. The net effect of this plan would be to extract federal Medicaid money for the state treasury, without an increase in care provided to Medicaid patients. This plan is intended to supplement a similar one enacted in June, which has turned out to be insufficient. The Bush administration wants to change the Medicaid program to prevent states from using it in this fashion.

Meanwhile, the state and its public employee unions have yet to agree on how to cut $24 million from state personnel costs, a reduction explicitly assumed in the 1992 budget. Also, lawsuits have been filed challenging the constitutionality of several state taxes, including the lucrative tax on dividends and interest and the new Seabrook property tax.

The governor and the House-Senate Fiscal Committee can cut spending to a limited degree without approval of the whole legislature. The governor and the Committee ordered a 3.5 percent across-the-board cut in state agency budgets this fall, a move estimated to save $11.5 million this fiscal year.

Rhode Island

Governor Bruce Sundlun is projecting a budget deficit of $51.4 million for FY92, about 4.4 percent of appropriations. The state's Revenue Estimating Conference has estimated the deficit at $63.1 million. The projected deficit reflects both revenue shortfalls and higher-than-expected welfare caseloads and prison population.

The state received an unanticipated $77.8 million Medicaid reimbursement from the federal government for having a disproportionately high share of low-income patients in public hospitals. These funds were used to repay the Rhode Island Public Buildings Authority for a loan that helped to balance the FY91 budget and to create a reserve against the looming FY92 deficit.

The adequacy of state aid to cities and towns has emerged as one of the state's most salient public finance issues. Growth in this aid is difficult to measure, because aid payments have been postponed from one year to the next several times in recent years. The state's FY92 appropriations for local aid are 6.8 percent lower than FY90 outlays.

Projected revenues for fiscal 1993 are $203 million below FY92's budgeted outlays of $1.48 billion. The state has promised to restore to its budget the savings it obtained this year through temporary cuts in state pay, reductions in pension fund contributions, and deferral of local school aid.

Vermont

Vermont's FY92 budget calls for a 3 percent increase in overall general fund spending. The budget includes a $100 million tax package that increases the state's "piggyback" personal income tax from a flat 28 percent of federal income tax liability to a tiered tax with piggyback rates ranging from 28 percent to 34 percent, depending on the taxpayer's income. The package also raises the sales tax rate from 4 percent to 5 percent and the rooms and meals tax from 7 percent to 8 percent. Local aid is level-funded. Payments to public pension funds totalling $15 million have been deferred until FY93. The budget includes a plan for eliminating the state's $58 million FY91 deficit over a period of three years. In late September, Governor Howard Dean asked state officials to plan for a 3 percent cut in spending in FY93, after he had received reports of a projected deficit for fiscal 1992. Projected shortfalls for 1992 range between $5 million and $15 million, or 0.8 percent and 2.3 percent of 1992 appropriations.

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