New England

Fiscal Facts

Federal Reserve Bank of Boston • Summer 1995

Lean State Funding Pinches Budgets of New England Public Colleges and Universities

Public spending for higher education was hard-hit during the recent New England economic downturn. States sharply cut funding for the region's 86 public colleges and universities, despite stable student enrollments (Chart 1). The steep reductions followed nearly a decade of strong growth throughout most of the region. The one exception, Rhode Island, posted a negligible increase in real (inflation-adjusted) appropriations between FY81 and FY88.

From the peak in FY88 to the trough in FY93, real funding for public colleges and universities dropped by over one-quarter, leaving FY93 outlays roughly level with those of ten years earlier. The cuts occurred across the region, with Massachusetts making the first cuts, followed by Rhode Island and New Hampshire. By FY93, all of the states had made double-digit reductions in real appropriations (Chart 2).

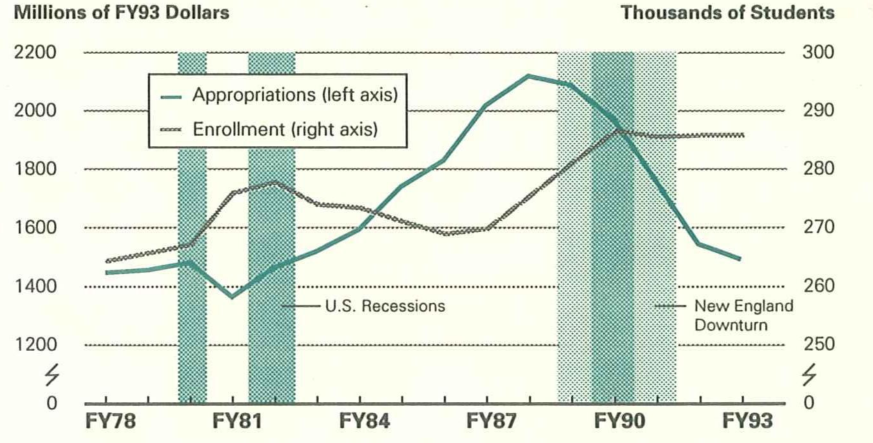
Since FY93, only Maine and Vermont, under severe fiscal stress, have continued to shrink real appropriations for public colleges. Other states have been able to finance increases ranging from 8 to 9 percent, not enough to replace the deep cuts of earlier years (Chart 2). Currently, the region's real appropriations for public higher education are still more than one-fifth below FY88 funding.

Public colleges have lost out to other state activi-

Chart 1

State Appropriations for Public Higher Education Drop in Late 80s and Early 90s While Enrollments Hold Steady

New England Public Colleges and Universities



Note: Enrollment data not available for FY79. In Charts 1 and 2, dollars are adjusted for inflation using Higher Education Price Index.
Source: Center for Higher Education, Illinois State University (appropriations); Research Associates of Washington, Washington, D.C. (enrollments).

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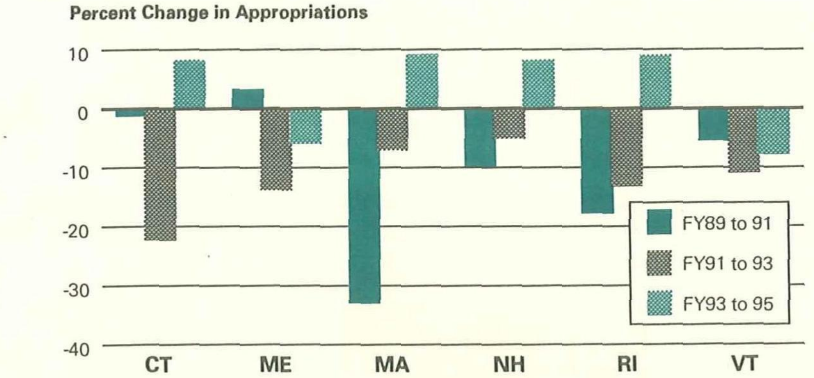
State Budget Timetable

Annual Budgets
Massachusetts
Rhode Island
Vermont
FY95: July 1, 1994 to June 30, 1995
FY96: July 1, 1995 to June 30, 1996

Biennial Budgets
Connecticut
Maine
New Hampshire
FY94-95: July 1, 1993 to June 30, 1995
FY96-97: July 1, 1995 to June 30, 1997

Chart 2

After Major Cutbacks, Most States Appropriate Somewhat More for Public Higher Education Starting in FY93



Note: State appropriations do not include tuition charges collected by institutions and remitted to the state as an offset to state appropriations.
Source: Center for Higher Education, Illinois State University; Massachusetts Taxpayers Foundation (Massachusetts numbers only).

ties. In FY95, funding for higher education is projected to account for 6 percent of the region's total general spending pie, down 1 percentage point from FY90. The largest shrinkages have occurred in Connecticut and Vermont, which posted declines of 2 and 3 percentage points, respectively.

Given the lack of state funds, tuition and fees have become an increasingly important revenue source. Accordingly, tuition rates have soared, rising by more than 30 percent since FY91 in each New England state, except New Hampshire and Vermont (Chart 3). New England's current tuition rates rank among the highest in the country.

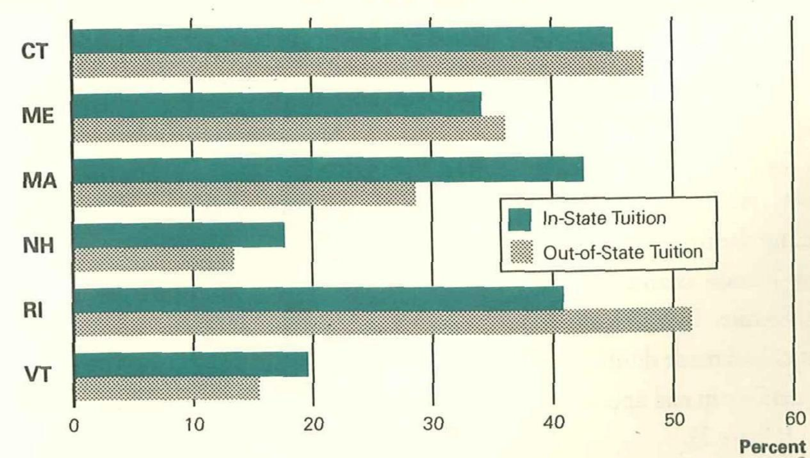
The financial burdens of college students and colleges are not likely to wane in the near future. Most of the region's governors have proposed level funding for higher education in FY96. Connecticut's Governor John Rowland would shrink public higher

Continued on last page

Chart 3

Tuition Marches Upward at New England Public Colleges and Universities

Increase in Undergraduate Tuition, FY91-FY95



Note: Tuition figures have been adjusted for inflation using the Consumer Price Index (CPI-U), Boston.
Source: *Connection, Facts: The Directory of New England Colleges, Universities and Institutes (1994 and 1995).*

Across *the* Region

All of the New England states were experiencing some fiscal discomfort as they entered the final quarter of FY95. Revenues were falling short of projections in Connecticut, Massachusetts, and Vermont, while spending was exceeding targeted levels in Maine and Rhode Island. New Hampshire, although enjoying higher revenues than expected last fall, still had to deal with a sharp reduction in federal Medicaid dollars. Nevertheless, most states should have sufficient revenue or free reserves to balance their books by June 30. Connecticut runs the biggest risk of a deficit because of successful legal challenges to its taxes on hospital care.

Anticipating sluggish economic growth, the region's governors have proposed lean budgets for FY96. In Connecticut, Maine, and Massachusetts, recommended growth in spending ranges from 2.5 percent to 3 percent, below the projected rate of inflation. Although Vermont's Governor Howard Dean has proposed an increase of almost 5 percent, much of it is earmarked for additional local aid to offset proposed property tax reductions. Rhode Island's Governor Lincoln Almond would like to keep state spending virtually flat. Faced with sharp reductions in federal Medicaid funding, Governor Steve Merrill recommends cutting New Hampshire's spending by almost 8 percent (Table 1).

In general, new state monies, if any, are targeted for primary and secondary education, while the steepest spending reductions are aimed at welfare programs.

Table 1

Total State Appropriations for FY95 and Governors' Recommended Appropriations for FY96,[a] Excluding Federal Dollars

Millions of Dollars

	FY 95	FY96	% Change
CT	7,658	7,872	2.8
ME	1,884	1,933	2.6
MA	13,414	13,746	2.5
NH[b]	1,222	1,128	-7.7
RI[c]	2,240	2,239	-0.1
VT	837	874	4.5

a Unless otherwise noted, includes general fund and transportation fund appropriations only. Excludes expenditure of federal grants and reimbursements.
b Includes budgeted income from sweepstakes earmarked for foundation aid and special education.
c Includes general revenue and other funds.
Source: Official budget documents, state financial statements, and conversations with state budget officials.

Six-State Review

Connecticut

In recent years, Connecticut's revenues and spend ing have both exceeded their budgeted levels. Not so in FY95: As of February, eight months into FY95, the state's revenues were running 4 percent below plan, according to Connecticut's comptroller, while spending was roughly on target. The comptroller is projecting a general fund deficit of almost $130 million, about 1.5 percent of projected net general appropriations.

Connecticut's revenue woes have two principal causes:

- First and foremost, the state's sluggish economy has retarded growth in revenue from the state's two most lucrative taxes, the personal income tax and the sales tax. As of March 1, collections from these taxes were running below plan by 2 percent and 2.5 percent, respectively. The only major tax performing above expectations was the corporate income tax, where revenues were exceeding projections by 2 percent.

- Second, court decisions have significantly narrowed the base for the state's hospital gross-receipts tax and sales tax on patients' bills. Proceeds from these taxes were formerly used to reimburse hospitals for indigent care. In general, the burden of these taxes was passed on to patients. Many health insurers objected to the taxes and their earmarked use, citing their legal obligation under the federal Employee Reinsurance and Income Security Act of 1974 (ERISA) to finance the health care only of the individuals that they insure. Agreeing with the insurers, the courts directed the state to apply the tax only to receipts and sales generated by services rendered to patients not insured by plans falling under ERISA's purview. To complicate matters, enforcement of the tax continues to be extremely difficult because hospitals are having difficulty distinguishing taxable from nontaxable receipts.

Revenues from the hospital receipts tax for FY95 are now projected at $76 million, only 37 percent of the level originally anticipated. This decline has had a double impact, indirectly reducing federal aid to the state. It has led to a proportional falloff in state reimbursements for uncompensated care, and consequently, a loss in matching federal Medicaid dollars for the state. In the past, the state has used matching Medicaid grants to finance general fund outlays.

In order to balance the state's books by June 30, Governor Rowland has proposed decoupling the taxes on hospital receipts and patient bills from uncompensated health care reimbursements, thereby hoping to avoid court- imposed restrictions on the range of taxable transactions. He would also use his limited authority to reduce spending without legislative approval.

With such difficulties clouding the fiscal horizon, Governor Rowland has proposed an increase in total state spending from FY95 to FY96 of only 2.8 percent. The growth of virtually every budgetary category would be subject to this tight constraint. Taking a chapter from the "Contract with America," Governor Rowland would also replace local aid programs with block grants to be awarded to existing regional agencies, which would be responsible for their disbursement. The governor has also recommended the consolidation of several state departments and agencies.

Tax reductions and tax reform, Governor Rowland's major campaign themes, are another key element of his proposed budget for the next biennium. He would replace the current flat-rate personal income tax with a two-tiered system. Starting this year, the tax rate on the first $6,000 of taxable income for single filers ($12,000 for joint filers) would fall from 4.5 percent to 3 percent. The lower rate would be extended to the first $10,000 of taxable income ($20,000 for joint filers) beginning January 1, 1996, and to the first $15,000 of taxable income ($30,000 for joint filers) as of January 1, 1997. The governor would also reduce the statutory corporate income tax rate from its current rate of 11.25 percent to 8 percent by 1999. Under current law, the rate is scheduled to fall to 10 percent by 1998.

To finance his proposed tax cuts, Governor Rowland has recommended selling state-owned land, imposing an annual licensing fee on school administrators and teachers, and postponing repayment of the final $240 million of notes issued to finance the 1991 deficit. His budget also assumes that the state will collect $300 million in both FY96 and FY97 from restructured, legal taxes on hospital gross receipts and patients' bills.

Maine

General fund revenues, sluggish in the first few months of FY95, have picked up since January 1. Nevertheless, unanticipated costs have prompted Governor Angus King to request a $6.5 million supplemental appropriation for the remainder of FY95.

One program not included in the governor's supplemental spending package is the Maine Health Program, which provides health insurance for 3,000 of Maine's working poor. The program was terminated on March 31. Because the fate of the health program had blocked several previous attempts to pass the supplemental budget, the governor was forced to strike a deal with the legislature, coupling elimination of the program with a legislative promise to provide $200,000 for previously covered Maine residents in need of medication. Taxes initially enacted to fund the program will remain on the books, freeing up $23 million over the next two years for other state programs.

Governor King's budget plan for the 1996-97 biennium would keep spending at roughly the expected rate of inflation. The plan calls for $3.5 billion in spending over the next two years — an increase of 3 percent in FY96 and almost 4 percent in FY97. Very little of the increase would be for new programs. The bulk of new monies would cover inflationary increases in the costs of current services and programs and the cost of servicing debts incurred during the previous administration. Local schools would receive a $40 million boost in aid over the next two years, a 2.5 percent increase over the current level of education funding. Although this is only half the amount requested by the state's commissioner of education, it would be the largest increase in school aid in four years.

The governor's budget assumes revenue growth of 4 percent annually over the next two years, with the largest growth in individual income taxes. Sales tax revenues are also expected to grow, but corporate income tax collections are projected to decline slightly. The budget does not rely on any new taxes or fees.

Governor King's proposed spending plan for the next biennium would close a projected $400 million gap between revenues and expenses. The legislature, however, has questioned the viability of several of his suggested cost-saving measures. For example, starting in FY96, Maine will no longer be able to collect a tax on hospitals' gross receipts, return the revenues from the tax back to hospitals for providing care to the indigent, and generate federal Medicaid matching grants in the process (new federal regulations disallow such an arrangement). Governor King's budget assumes that the state will collect $110 million in hospital taxes in the FY96-97 biennium, but will not appropriate the money back to the hospitals. In April, the governor proposed allocating $15-16 million to the hospitals to be funded by unspecified budget cuts. Under federal regulations, this allocation would generate $35 million in federal grants that would also go to the hospitals.

Massachusetts

Eight months into FY95, Massachusetts' tax revenues were 5 percent above their year-ago levels, below the 6.6 percent increase assumed in the FY95 budget enacted last summer. Income tax collections, which account for more than half of state tax revenue, were especially disappointing. Although in July, officials forecast an increase in income tax receipts of 9 percent, as of February, the year-over-year rate of growth was only 4.9 percent. By contrast, sales tax revenues, accounting for roughly one-quarter of all tax receipts, were running well above-target.

Governor William Weld has proposed a lean FY96 budget that would raise state spending by only 2.5 percent. The modest new monies would be allocated primarily to municipalities: $228 million to honor a long-term commitment to provide additional state aid for public schools, a $51 million increase in unrestricted local aid to be financed out of lottery proceeds, and an additional $10 million for water and sewer rate relief, mostly for metropolitan Boston residents forced to help pay for the Boston harbor clean-up. The welfare program, Aid to Families with Dependent Children

(AFDC), would receive the largest percentage cut. As in his FY95 budget, he has proposed reforms that focus on work requirements.

Despite the governor's conservative spending plans, his budget is precariously balanced, in large part because future revenues are uncertain. The disappointing performance of FY95 tax receipts, coupled with less robust state economic projections for the coming year, forced the governor and the state legislature this spring to lower their consensus forecast of FY96 tax revenues by $81 million. As a result, state taxes, fees, and charges are currently projected to grow in FY96 by only 2.5 percent. Given this revised forecast, the governor's FY96 budget would create an operational deficit that would have to be covered by surplus revenues carried over from FY95.

The numerous tax cuts proposed in the governor's budget have also contributed to uncertainty over future revenues, given the inherent imprecision in predicting the revenue consequences of changes in tax laws. The governor estimates that his proposed tax cut package would cost the state $35 million in FY96 and approximately $100 million in FY97. The package includes nine tax cuts, including: 1) a tax credit for employers to offset the costs of training workers who represent an increase in a business's work force; 2) an increase in the personal income tax exemption for dependents, the blind, and the elderly from $1,000 to $1,500; 3) a modification of the research and development tax credit that would permit defense contractors to claim credits for increasing non-defense R & D spending even though their defense-related R & D outlays were declining; and 4) elimination of the sales tax on bulk purchases of telecommunications services. Since unveiling his budget, the governor has also filed comprehensive bank tax reform legislation, whose revenue consequences have been especially controversial.

A third source of revenue uncertainty is tax reductions enacted in the recent past but phased in over a period of several years, including FY96. Of these tax cuts, the two most prominent ones are a sharp reduction in the estate tax, passed in 1992, and an equally significant reduction in the taxation of capital gains, enacted last December. According to the capital gains legislation, the tax rate on capital gains falls as the asset's holding period rises; no tax is paid on gains from the sale of assets held at least six years.

New Hampshire

For the first nine months of FY95, New Hampshire's general fund unrestricted revenues were almost 4 percent ahead of projections. Receipts from the state's two largest sources of revenue, the meals and rooms tax and the business profits tax, grew especially rapidly. This unanticipated spurt in revenues, combined with mid-year budget cuts in the neighborhood of $20 million, has erased a $45 million deficit that was projected last fall. At the end of the fiscal year, New Hampshire may even have a small surplus to add to its rainy-day fund.

While the state should have no trouble balancing its books for FY95, avoiding deficits during the FY96-FY97 biennium could be extremely difficult. Tightened federal regulations will curtail New Hampshire's revenues from Medicaid matching grants — the same problem facing Connecticut, Maine, and several other states throughout the nation. To keep the next biennial budget in balance, Governor Steve Merrill has recommended a level of spending 3 percent below that projected for the FY94-FY95 biennium. For FY96, he has proposed spending 8 percent below projected FY95 outlays. Over two-thirds of state agencies would have their budgets pared or level funded, and nearly 600 state jobs would be abolished. The budget of the Department of Health and Human Services would be cut by the largest percentage, close to 10 percent. The budget proposal does not recommend any new taxes, but does call for extending three surcharges — on rooms and meals, real estate transfers, and telephone taxes — originally scheduled to expire at the end of the current fiscal year.

The governor has also proposed replacing welfare with an employment program. Under the proposal, AFDC payments would be eliminated, and recipients would instead receive temporary unemployment insurance benefits for 26 weeks, after which they would be required to work. If a recipient finds a job that does not cover all living expenses, the state would extend health care benefits and child care assistance. While the governor expects the New Hampshire Employment Program to save $10-12 million in each of the next two years, many officials, including the Health and Human Services commissioner, believe the new program may increase costs.

Rhode Island

Even though revenues have been coming in ahead of projections, Rhode Island is facing a small ($7 million) shortfall in the current year due to overspending by state agencies. At the state revenue estimating conference held in January, revenue estimates were revised upward by $12.3 million, or nearly 1 percent, for the current fiscal year. Revenue estimates for FY96 were also increased, by $6.5 million; even with this increase, however, the budget gap for FY96 was projected to hit $62 million. (The projection is based on a level-funded budget that assumes state spending, except on education, will be the same as in FY94.)

In response, Governor Lincoln Almond has proposed an austere $1.6 billion budget for FY96, a 1 percent increase over FY95. Although most programs would be level-funded, there would be roughly a 6 percent increase in aid to local schools. The new school aid funds would be distributed according to the "poverty weight" formula devised last year to funnel extra money to the schools in proportion to the number of students in each district poor enough to qualify for free and reduced-price lunches. State agencies that would receive increases include the Department of Children, Youth, and Families, which would receive $3.5 million to hire 70 additional social workers, and the Department of Corrections, which is slated for a sizable increase to accommodate a rapidly growing prison population.

Welfare, on the other hand, is expected to take another hit in the coming year. The governor's budget would freeze AFDC for the sixth year in a row; it would also eliminate a $400,000 "bridge program" the legislature created last year to provide short-term aid to those losing their General Public Assistance but soon qualifying for federal Supplemental Security Income.

A key component of the governor's budget hinges on the termination of two municipal aid programs: a $12.8 million revenue-sharing program that guarantees Rhode Island communities a 1 percent share of the state's overall tax collections two years earlier; and a $12.6 million payment-in-lieu-of-taxes program that provides additional state aid to communities where tax-exempt hospitals, colleges, and prisons are located.

On the revenue side, the proposed budget assumes a modest 1.2 percent increase in general revenues, with 5 percent growth in personal income tax collections and 4 percent growth in sales and use tax receipts. The governor's only move on the tax front is a nickel increase in the state's 56-cent cigarette tax, that, if enacted, would be the fourth-highest in the nation. On the tax cutting front, he plans to allow a two-year-old 2.75 percent gross receipts tax on nursing homes to expire in September.

Limited progress has been made in recent months in the state's legal dispute with the Narragansett Tribe. A federal judge ruled that the Rhode Island Supreme Court, not a federal court, should decide whether former Governor Bruce Sundlun violated his constitutional authority when he signed a compact with the tribe last summer allowing them to build a casino on their Charlestown reservation. The attorney general sees this as a big win for Rhode Island because it means that for the first time the tribe's casino compact can be challenged under state law rather than federal law. In a related development, Governor Almond has asked the U.S. District Court for a judgement limiting the array of games offered by the Narragansett Tribe in their proposed reservation casino to those forms of gambling currently permitted under Rhode Island law. Although the compact negotiated by the former governor bars the tribe from just about every mode of gambling not currently allowed in the state, its language appears to allow coin slot machines. Without coin slots, the Charlestown facility is not likely to draw enough gamblers to be profitable.

Vermont

Uncertain about the short-run outlook for its general fund revenues, Vermont may have to reduce spending to avoid a deficit in FY95. February collections from the rooms and meals and sales taxes were especially low because January's warm weather discouraged skiers. Receipts from the personal income and corporate taxes have fallen short of plan for most of the fiscal year; strong April returns are needed to offset lagging collections. One encouraging sign was the modest improvement in February's income tax collections; however, officials remain concerned about the unpredictability of April tax returns. Transportation fund revenues present a brighter picture. Running nearly 6 percent above year-ago levels, these revenues will have little trouble meeting their target.

Governor Howard Dean has proposed a $724 million general fund budget for FY96, 5 percent higher than projected FY95 spending. Slightly more than half of the new monies ($20 million of $37 million) would be earmarked for state aid to municipalities designed to ease property tax burdens. The remainder would be used for welfare reform, higher education, corrections, and economic development. Without the proposed $20 million, state general fund outlays would increase only 3 percent in FY96.

The new school aid is a key component of the governor's plan for reducing Vermont's income and property tax burdens. According to the plan's principal elements, the personal income tax rate would be cut from 25 percent to 24 percent of federal income tax liability. Taxpayers earning less than $15,000 per year would be given a $100 tax credit. The rate of growth in a school district's spending would be capped (except in school districts where spending is low), thereby restraining growth in property taxes. In order to insure adequate levels of spending by each school district, school aid would be increased, and a larger share of it would go to poor districts. The increase in school aid and income tax cuts would be financed primarily by postponing indefinitely a scheduled reduction in the state's sales tax rate from 5 percent to 4 percent. In addition, a minimum property tax would be imposed on wealthy communities, forecast to generate approximately $10 million for the state in FY96. (See Fiscal Facts, Winter 1995.)

The legislature, however, tabled the governor's reform plan for this year's legislative session. As of mid-April, the only property tax relief agreed upon by a House-Senate Conference Committee addressing the FY96 budget was approximately $7 million in additional state funding to augment property tax abatements available under existing programs.

Lawmakers have been more successful in taking some first steps towards health care reform, passing legislation that would provide health coverage to 15,000 working poor Vermonters, currently uninsured. To cover the costs of the health care bill, the legislature plans to raise $11.8 million, by increasing the tax on cigarettes by 24 cents per pack and raising the tax on the price of tobacco products from 10 percent to 21 percent.▾

Public Higher Education

Continued from p. 2

education spending by 2 percent. Only Vermont's Governor Howard Dean has proposed a significant funding increase, a marked turnaround after six years of sharp reductions. According to the Governor's plan, outlays for the University of Vermont and Vermont state colleges would grow by 3 percent and 7 percent, respectively.

The governors' frugal budget proposals and legislators' preoccupations with tax cuts, property tax relief, and health and welfare costs help explain the financial pressures on state-supported colleges. Public college and university officials may be forced to reshape and restructure their institutions — shrinking faculty, cutting administrators, increasing faculty workloads, and initiating further tuition increases.▾

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