

New England

Fiscal Facts

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New England Lawmakers Reject Big Tax Cuts . . . At Least For This Fiscal Year

Concerned about revenue shortfalls, New England's legislatures resisted competitive pressures to include large tax cuts in their states' fiscal year 1996 (FY96) budgets. The two states that did reduce taxes sharply—Connecticut and Maine—deferred the effective date of large reductions until FY97 or later. Impending changes in federal-state fiscal relations, however, could make deep tax cuts difficult to implement.

FY96 Budgets

Following the lead of their newly elected governor, John Rowland, Connecticut lawmakers enacted major cuts in the personal income tax, to take effect at the start of FY97. The legislature lowered the tax rate on the first \$9,000 of a joint filer's taxable income from 4.5 percent to 3 percent (\$4,500 for single filers). Governor Rowland supported these changes, although he had wanted the 3 percent bracket to be wider and to be phased in starting in 1995. The legislature also passed a personal income tax credit for the first \$100 of real or personal property tax paid on a principal residence or automobile.

Connecticut lawmakers also supported Governor Rowland's request for a large, phased-in reduction in the corporate income tax rate, currently 11.25 percent. The tax rate will be reduced gradually to 7.5 percent by the year 2000. (Governor Rowland recommended

that the rate be cut to 8 percent, but over a shorter period of time.) The first rate reduction, to 10.75 percent, will take place on January 1, 1996, costing the state only \$10.3 million in FY96.

Maine lawmakers, despite strong opposition from Governor Angus King, voted to cap the state's personal income tax revenues starting in FY97. Income tax receipts would be limited to their forecasted FY97 level of \$676 million. Any collections above that cap, in FY97 and future years, would be refunded to taxpayers through reductions in tax rates on low- and middle-income brackets. The cap would be rescinded only after these rates were reduced to 80 percent of those in effect in FY97.

The legislature also repealed Maine's "sick tax" — a tax on hospitals, no longer reimbursable through federal Medicaid matching grants — by 1998. Other tax cut proposals offered by some of Maine's elected officials did not survive the protracted budget debate. Among them were a roll-back of the sales tax rate from 6 percent to 5 percent and elimination of snack foods from the sales tax base.

Elsewhere in the region, tax cut proposals fared poorly. The Vermont legislature delayed any consideration of tax cuts until next year. Governor Howard Dean had earlier proposed a 1 percentage point reduction in the state income tax rate and a \$100 tax credit for Vermont residents earning less than \$15,000.

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The views expressed in this publication do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System. This publication is available without charge. We welcome your ideas and comments; contact Jeannette Hargroves at 617/973-3096. Send requests to be placed on our mailing list to Federal Reserve Bank of Boston, T-8, Attn: *Fiscal Facts*, P.O. Box 2076, Boston, MA 02106-2076.

**State
Budget
Timetable**

Annual Budgets

Massachusetts
Rhode Island
Vermont
FY96: July 1, 1995
to June 30, 1996

Biennial Budgets

Connecticut
Maine
New Hampshire
FY96-97: July 1, 1995
to June 30, 1997

Table 1

Most States Ended the Fiscal Year with Little or No Cushion for FY96

New England States' Reserves at the Close of FY95

Millions of Dollars

	<i>Reserves</i>		Surplus (Deficit)	Total General Fund Spending	Surplus (Deficit) as % of Spending
	Stabilization/ Rainy Day Fund	Undesignated General Fund Balance			
Connecticut	74.5	0	74.5	8,398.7	.9
Maine	12.0	0	12.0	1,686.4	.7
Massachusetts	397.5	90.4	487.9	16,448.7	3.0
New Hampshire	20.0	0	20.0	857.7	2.3
Rhode Island	45.1	0	0	1,638.7	2.8
Vermont	0	0	(14.1)	689.6	(2.0)

Source: State budget documents, financial statements, conversations with budget officials.

Massachusetts lawmakers turned down Governor William Weld's tax relief proposals, which would have provided an assortment of credits and exemptions for both businesses and households. (See *Fiscal Facts*, Summer 1995.)

By contrast, Rhode Island's and New Hampshire's governors were in agreement with their legislatures. Elected officials from both branches of government set aside any hopes of sharp tax reductions, at least for this fiscal year. New Hampshire's tight fiscal circumstances are largely due to its history of heavy reliance on loopholes in Medicaid regulations to channel federal grants into the state's general fund. Recent federal action to tighten those loopholes has forced the Granite State to confront structural fiscal imbalances.

FY96 Revenues and Reserves

The enthusiasm of many legislators for tax reductions was dampened by fiscal difficulties emerging as FY95 drew to a close and by uncertainty over FY96 revenues. Vermont finished FY95 in the red, largely because of disappointing personal income tax revenues. (See Six-State Review.) Connecticut, Maine, New Hampshire, and Rhode Island ended the FY95 year in the black, but with scant undesignated balances to carry over into FY96 (Table 1). Massachusetts ended the year with a modest cushion to carry over into FY96, but only because welfare costs were lower than anticipated. Thus, most states were left with little or no hedge against downside risks to their revenue forecasts for FY96.

FY96 revenue estimates were revised downward in the first half of 1995, adding to legislators' fiscal worries. Four of the region's states lowered their projected estimates of FY96 revenue at least once during the first half of 1995 (Table 2).

Compounding legislators' reluctance to reduce taxes is the inherent difficulty of projecting the revenue consequences of changes in tax law. Two states, Vermont and Rhode Island, have recently experienced this difficulty firsthand. Both states lowered income tax rates in 1993 to offset increases in federal income tax rates. FY95 was the

first fiscal year in which these state tax cuts were effective in every quarter. Revenue forecasters for both states believe that they may have underestimated the revenue losses attributable to these tax cuts, and, therefore, were too optimistic about FY95 revenues.

Prospects for Future Tax Cuts

Even if the New England states enjoy robust economic growth over the next few years, proposed changes in federal aid to the states and in federal tax reform would hinder the ability of the region's legislatures to deliver large sustainable tax cuts to their constituents:

- The Republican Party's Contract with America proposes that block grants replace most open-ended matching grants, where the federal government matches what states spend on mandated entitlement programs, such as AFDC and Medicaid. Although such a switch might allow states more discretion and reduce administrative costs, proposed funding for the new grant system is significantly below that needed to maintain the current level of intergovernmental fiscal assistance. Moreover, under the new approach, federal aid would not automatically increase during a recession, as it does now. States would be expected to deal with cyclical increases in social welfare needs by themselves. Thus, states would need to spend more for welfare services under the block grant arrangement currently on the table.

- A proposal to substitute a sales tax for an income tax at the federal level would also put pressure on state budgets. To the degree that such a tax accomplished its objective of encouraging more saving and less consumption, it could erode the base of state sales taxes. In addition, since state revenue officials rely heavily on federal income tax data to enforce state income taxes, states would have to increase their spending for tax enforcement dramatically if the federal income tax were dismantled.

By contrast, proposals for radical reform of the federal income tax could increase pressures for state tax reduction. Most versions of a "flat rate" federal income

Table 2

Most States Lowered Revenue Estimates for FY96

General Fund Revenue Estimates

	Millions of Dollars		
	<i>Estimated as of</i>		
	January 1995	June 1995	% Change
Connecticut	7,062.8	7,012.5	-.7
Maine	1,731.0	1,731.0	0
Massachusetts	12,819.3	12,738.1	-.6
New Hampshire	828.3	831.1	.3
Rhode Island	1,493.8	1,444.7	-3.3
Vermont	693.0	691.5	-.2

Source: State budget documents, financial statements, conversations with budget officials.

tax would eliminate the deduction for state and local income and property taxes. As a result, the effective burden of these taxes would rise for those who itemize their deductions for federal tax purposes, strengthening their interest in seeing state tax reductions.

Perhaps the most important reason why states will find future tax cuts difficult to implement is that they are running out of spending programs that can be easily pared. Most programs, with the principal exceptions of corrections and Medicaid, have already been cut in inflation-adjusted terms over the past few years. Public education, a large portion of most state budgets, is likely to need new state funding, given projected enrollment growth and perennial dissatisfaction with local property taxes. **FF**

Across *the* Region

Uncertain about future revenues, New England's legislatures eschewed large tax cuts in their fiscal year 1996 (FY96) budgets. In addition, all states except Connecticut and Vermont either cut outlays relative to their FY95 level or authorized only small increases (Table 3). Soon after the fiscal year began, Vermont conceded that its budget was imbalanced, prompting Governor Howard Dean to propose almost \$23 million in additional cost cutting. Although Connecticut's rate of growth in spending in FY96 is the highest in the region, the state expects to slow its spending growth rate to 3.6 percent in the second year of its 1996-97 biennium.

Welfare and school funding continued to receive significant legislative attention. Three states — Connecticut, Maine, and Massachusetts — passed laws requiring mothers on welfare to work and limiting welfare eligibility to roughly two years. New Hampshire turned down a cost-of-living adjustment for welfare recipients.

Most new spending initiatives focused on public education. The largest spending increase for education was in Massachusetts, where lawmakers increased state aid for local education by 12 percent, honoring commitments made in FY93 for educational reform. **FF**

Table 3

Estimated Total State Spending for FY95 and Appropriations for FY96,^a Excluding Federal Dollars

	Millions of Dollars		
	FY 95	FY96	% Change
Connecticut	7,609	8,095	6.4
Maine	1,915	1,956	2.2
Massachusetts	13,414	13,831	3.1
New Hampshire ^b	1,178	1,152	-2.2
Rhode Island ^c	2,255	2,299	1.9
Vermont	838	883	5.3

^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 fund and other funds.

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

Six-State Review



Connecticut

In a dramatic turnaround, Connecticut ended FY95 with a surplus of \$75 million, 0.9 percent of general fund outlays. As recently as February, Connecticut had faced a projected deficit of \$174 million. The state's two largest revenue sources, the personal income tax and the sales tax, performed poorly throughout the fiscal year. Court-ordered restrictions on the state's hospital taxes further aggravated the state's revenue problems. (See *Fiscal Facts*, Summer 1995.)

To address the state's revenue shortfall, Governor John Rowland imposed a hiring freeze and requested that all state agencies reduce their budgeted expenditures by 5 percent for the final quarter. Further relief arrived when the U.S. Supreme Court, in a case concerning New York's plan for financing the health care costs of its uninsured, issued a ruling that in effect relaxed the restrictions that had been imposed on Connecticut's hospital taxes. In light of the decision, the legislature restored the state's hospital taxes, effective June 15. Since the revenues from the tax are used to reimburse hospitals for care provided to poor uninsured patients, they enabled the state to generate approximately \$60 million in additional federal Medicaid matching grants for FY95. This additional federal money, combined with the aforementioned austerity measures and stronger-than-projected corporate income tax receipts and lottery sales, tilted the state's fiscal picture from deficit into a small surplus.

The outlook for FY96 is optimistic. Cooperation and compromise between the governor and the legislature produced a balanced budget for the 1996-97 biennium, with the rate of growth in general fund spending falling from 5 percent in FY96 to 3.6 percent in FY97. The largest increases in the budget are for debt service payments, state employee wage hikes, Medicaid, and state employee pensions. State aid to cities and towns will increase roughly 3 percent, and

the state's major urban areas will see a substantial rise in school aid.

The legislature assembled a package of tax cuts that, while more modest than Governor Rowland's original proposals, remained generous enough for the governor's liking. (See article, page 1.) The legislature also passed a major welfare reform bill that would, among other things, limit AFDC benefits to 21 months and reduce cash payments to families receiving public assistance.

Maine

Maine ended FY95 in the black, after the legislature enacted a \$10 million supplemental appropriation in May, the second of the fiscal year.

With only 36 hours remaining in FY95, Governor Angus King signed a \$3.5 billion general fund spending package for the 1996-97 biennium. Action on the budget was delayed by a dispute between the governor and the legislature over the cap on personal income tax revenues. (See article, page 1.) Although opposed to the cap, the governor decided to sign the budget bill in order to avoid a government shutdown and to fight the cap later.

The budget bill also provides for the repeal of Maine's hospital tax, effective July 1, 1998. For the past four years, Maine's hospitals have been charged a tax equal to 6 percent of their gross receipts from patients. Each hospital, however, has been reimbursed for its tax payment with state Medicaid funds, thereby holding it harmless. Similar "tax and match" schemes have been used around the country to generate additional federal matching Medicaid funds that are then channeled, legally, into state general funds. (See *Fiscal Facts*, Summer 1995 and Spring 1992.) The loophole in federal Medicaid regulations permitting such schemes has largely been closed. Yet, Maine needs the revenue from the hospital tax. Although the tax will remain on the books for another three fiscal years, the state has promised to reimburse hospitals *as a whole* for approxi-

mately 60 percent of their estimated tax liability in FY96 and FY97 and 100 percent in FY98. The state, however, will provide reimbursements according to a formula that will not necessarily return to each hospital exactly what it paid, thereby conforming with federal regulations.

For the first time in four years, Maine will increase its assistance to local school districts, although the allotted increase of \$39 million will bring total school aid to only 2.5 percent above its FY95 level. The formula for distributing aid among districts will also change, from one based exclusively on average property values and student enrollment, to one also taking into account a district's per capita income and cost of living.

The FY96 budget includes a new "work-for-welfare" program designed to reduce caseloads and lower state spending. The legislation requires most welfare recipients to take part in training or educational programs during their first 27 months on welfare if they need it, and then to obtain part-time employment to remain eligible for future benefits.

Massachusetts

In mid-June, Massachusetts lawmakers approved an uncommonly spartan FY96 spending plan of \$16.8 billion, only 2 percent higher than FY95 estimated expenditures. (The average annual growth rate over the past three years has been about 4 percent.) The new budget, similar to that proposed by Governor William Weld, limits major spending increases to criminal justice, local school aid, and unrestricted local aid financed with earmarked lottery proceeds. The new monies for school districts include an increase in minimum aid from \$25 to \$75 per pupil, designed to raise outlays in low-spending schools and help better-financed schools maintain their budgets.

The legislature and the governor parted company over higher education. Lawmakers, heeding the concerns of the state's public colleges and universities, increased FY96 spending by \$22.5 million, 3 percent over FY95 outlays. The governor signed off on the budget, but vetoed, among other things, \$19.2 million of the higher education increase. In mid-July, both the House and the Senate overrode the governor's veto, thus restoring the \$19.2 million in question.

Lawmakers approved a \$49 million reduction in welfare, putting outlays for this purpose 4 percent be-

low last year's level. This reduction was one-third less than the governor had hoped for. Legislators increased funding for day care by one-half, recognizing that the policy of requiring mothers on welfare to work increases the need for day care.

Despite the legislature's attempts at frugality, the budget remains delicately balanced because of uncertain revenues. Total year-end tax receipts were 5 percent above their year-ago levels, below the 6.6 percent increase assumed when the FY95 budget was enacted last summer. The Commonwealth revised downward its estimate of FY95 tax receipts twice during the fiscal year and, in May, revised downward its FY96 estimate.

Adding to apprehensions over FY96 revenues is an anticipated drop in non-tax revenue, specifically fees and charges. The projected dip in these receipts, a cost to the state of \$41.9 million, is due primarily to the change in 1991 from a four- to five-year renewal period for drivers licenses.

One customary cushion against eroding revenues, surpluses carried over from the previous year, was smaller at the end of FY95 than FY94. After depositing \$15 million into its Stabilization Fund, the Commonwealth carried over into FY96 \$90 million in undesignated fund balances, one-quarter less than what it carried into FY95.

With their attention on revenues, lawmakers did not support Governor Weld's tax relief package recommended in his new budget. In mid-summer, however, they passed a sweeping bank tax reform bill designed primarily to narrow differences in state tax treatment among Massachusetts-based banks, nonbank financial institutions, and banks based out of state that compete in the Commonwealth's financial markets. The reforms achieved this purpose by:

- gradually reducing the tax rate on bank income from 12.5 percent to 10.5 percent, the estimated average effective rate borne by many nondepository financial institutions that compete with banks;
- broadening the definition of a bank for state income tax purposes to include many of these nondepository competitors; and
- stipulating that all banks should be taxed only on the income they earn within the Commonwealth, regardless of where they are based.

Because the provisions of the bank tax will be phased in over a five-year period, the bill will reduce tax revenues only by \$1.7 million in FY96.

New Hampshire

New Hampshire finished FY95 with extra cash, thanks to the strong performances of the rooms and meals tax and the business profit tax (BPT). Rooms and meals tax receipts, which account for approximately one-quarter of total general fund revenue, grew 7 percent over FY94 levels and finished 9 percent above projections. BPT receipts grew 21 percent over FY94 despite a reduction of one-half percentage point in the tax rate effective July 1, 1994. Lawmakers anticipate a 4 percent general fund surplus of \$32 million.

Just hours before the deadline, the legislature passed the FY96-97 budget, calling for \$1.7 million in general fund spending, 0.8 percent less than previous biennial outlays. Many feared the state would face difficulties balancing the budget in this biennium due to the loss of \$100 million per year in federal Medicaid funds. Lawmakers, nevertheless, balanced the budget without relying on reserves from the \$100 million Health Care Transition Fund or the rainy day fund.

With one exception, elected officials adhered to their promise not to raise taxes or create additional taxes. As of July 1995, non-profit health insurers, once protected by an exemption, will be responsible for the 2 percent tax on health care premiums that private companies now pay. Despite talk of lowering the rooms and meals, real estate transfers, and telephone taxes, legislators decided to continue them at current rates. In addition, several BPT credits for industry, as well as surcharges on rooms and meals, real estate transfers, and telephones, were renewed although scheduled to expire at the end of FY95.

Most programs, with the exception of the public schools and corrections, received level funding for FY96-97. The legislature accepted Governor Stephen Merrill's revisions of the school aid formula allocating \$2 million in new funds to local public education. This 2 percent increase in spending will be funded by Powerball, a multi-state lottery being introduced in New Hampshire in the fall of 1995. State lottery earnings are expected to reach \$5 million in FY96 and \$10 million in FY97.

The needed reductions in state spending will be achieved primarily through the postponement of raises for state workers, no cost-of-living increase for welfare recipients, and the layoff of approximately 140 state employees.

Rhode Island

As recently as June, Rhode Island's official revenue estimators were predicting a FY95 deficit of \$43.5 million, roughly 2.7 percent of general revenue fund spending. Their pessimism stemmed mostly from the state's disappointing income tax collections, whose year-to-date level at the end of May was down 0.6 percent from the year-ago level. According to one official, the state may have underestimated the effect of repealing its income tax surcharge on upper-income taxpayers starting in January 1994. Nevertheless, the state managed to balance the general revenue fund by transferring monies from other accounts and tightening its belt during the last weeks of the fiscal year.

Facing an uncertain revenue picture, Rhode Island decided to keep total spending for FY96 to its FY95 level. Planned general revenue fund spending, \$1.7 billion, is almost 4 percent higher. However, this increase reflects accounting changes that will integrate 239 special accounts, each financed by its own set of earmarked revenue sources ("restricted receipts"), into the general revenue fund.

Legislators were able to balance the FY96 budget by holding down spending and relying on a package of small revenue increases, which include:

- a 5 cent increase in the state's 56-cents-per-pack cigarette tax;
- an increase in the state's nursing home gross receipts tax, which was set to expire in September 1995, from 2.75 to 3.75 percent, effective October 1; and
- continuation and modification of the licensing fee paid by hospitals, which was scheduled to be rescinded in FY96.

The state also expects an additional \$8 million in revenue from lottery-run gambling enterprises.

Highlights of the budget include restoring \$25 million in local aid that the governor sought to eliminate in his original budget proposal and increasing school aid by \$20 million.

Also in the budget is a one-time increase in the bank excise tax and a phaseout of the deposit tax that banks pay. The excise tax is scheduled to increase from 8 to 9 percent, raising \$3.2 million in FY96. However, the tax banks pay on deposits is to be phased out over two years, beginning in January 1997.

Vermont

Deteriorating revenues caused Vermont to finish FY95 with a general fund deficit of \$14 million. Anticipating further revenue shortfalls, the state is bracing itself for sharp reductions in its FY96 budget. The chief culprit — personal income tax receipts — performed dismally in the fourth quarter and ended the fiscal year 9 percent below the projected target. Officials attributed this weakness to the lackluster Vermont economy and revenue forecasters' underestimation of the costs of the income tax cut enacted in 1994.

The modest growth of other tax receipts was not enough to keep the state out of the red. Total end-of-year general fund revenues were 4 percent below official projections. One bright note was the transportation fund's end-of-year surplus, a fraction of which was used to trim the deficit.

In mid-summer, Governor Howard Dean outlined a plan to erase the deficit and close a \$30 million gap in the general fund FY96 budget of \$729.7 million, passed in April. To dispose of the FY95 deficit, the governor would divert:

- \$7 million from state funds to teachers and state employee retirement plans;
- \$4 million from the Health Care Special Fund, earmarked for expanding health care coverage in FY98; and
- \$3.7 million from the transportation fund surplus.

To offset the revenue shortfall projected for FY96, Governor Dean has proposed \$22.7 million in spending reductions. The steepest cuts are aimed at programs for property tax relief: a 17 percent reduction in

funds for general property tax rebates and a \$1.6 million cut in a program targeted to farmers and owners of forest land. Other cuts include a reduction of \$2.8 million in pay raises for state employees and a \$2.2 million cut in human services spending.

The governor's reduction package would narrow the projected FY96 gap to \$6 million. To encourage additional reductions and close the gap completely, Governor Dean has sent legislators and employees a list of 59 cost-saving ideas.

Vermont's legislative session is not scheduled to begin until January of 1996. Governor Dean does not intend to call a special session in September to discuss budget cuts, anticipating that lawmakers will review and vote on the recommended cuts in January, when they return. In the short term, he has called for an immediate hiring freeze.

Some Vermont lawmakers have challenged the governor's authority to make extensive budget cuts without legislative approval. Legislators are particularly upset about the governor's deep cuts in property tax relief outlays, since this issue dominated this spring's budget discussions. The legislature's final compromise FY96 budget included the House's demand for action on property tax reform in the current session and the Senate's demand for \$1 million in additional funds for payment in lieu of local property taxes on state property. Half of that amount would be held back if the Senate should fail to pass some version of property tax reform by March 2, 1996. On the revenue side, lawmakers voted to extend the 5 percent sales tax for at least another year. **FF**

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