New England Fiscal Facts

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Dealing with Deficits: How New England States are Managing the Fiscal Crisis

By E. Matthew Quigley, with Amanda Lydon

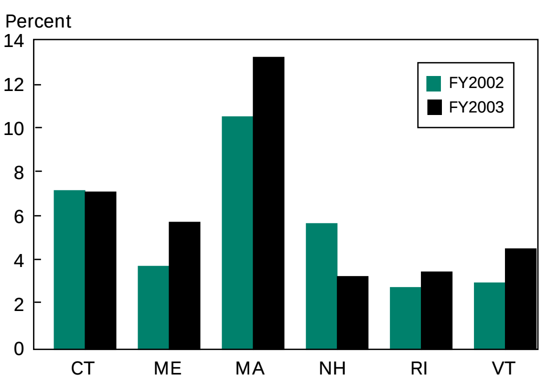
Throughout the nation, states are facing their worst fiscal crisis in at least a decade. Following the economic boom of the late 1990s, the current recessionary period has caused revenues to decline and demand for government services to rise. Meanwhile, the rising cost of health care – particularly Medicaid and prescription drug costs – has led to unanticipated expenditures. Now, government executives and lawmakers, faced with persistent budget deficits, are struggling with difficult decisions: "What cuts should we make?" "Could we, should we, raise taxes?" "How deeply do we dip into quickly diminishing reserves?" In many states, the budget process is now a protracted battle. Relations are strained between legislatures and governors; citizens and businesses are confused and worried.

New England is no exception. All six of the region's states experienced deficits for FY2002 and anticipate problems in FY2003.[1] As seen in Figure 1, the region closed FY2002 with deficits ranging from a high in Massachusetts of 10.1 percent of expenditures to a low in Rhode Island of 2.7 percent. For the current fiscal year, Maine, Massachusetts, Rhode Island, and Vermont all expect larger deficits than in FY2002. Connecticut expects a slight decline in its deficit-to-expenditures ratio, while New Hampshire expects its deficit-to-expenditures ratio to be 2.3 percentage points lower than in FY2002 (Figure 1). Although the underlying causes of these deficits vary from state to state, certain common trends are worth noting.

Figure 1

Deficits as a Percent of Expenditures

FY 2002 and FY2003, Expected



Note: "Deficit" is defined as (revenues + carried-over surpluses) – spending. See footnote 1.
Source: NASBO, *Fiscal Survey of the States*, May 2002, and newspapers.

Revenues

With the exception of New Hampshire, New England states experienced a dramatic decline in revenues from FY2001 to FY2002. As seen in Figure 2, general revenue declined by over 10 percent in Connecticut, Massachusetts, and Vermont, while Maine and Rhode Island experienced smaller drops of 2.5 percent and 5.4

1 For the remainder of this article, unless otherwise noted, "deficit" = (revenues + carried-over surpluses) – spending. It does not include loan receipts or withdrawals from reserve accounts or tobacco settlement accounts.

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State Budget Timetables

Annual Budgets
Massachusetts
Rhode Island
Vermont
FY02: July 1, 2001 to June 30, 2002
FY03: July 1, 2002 to June 30, 2003

Biennial Budgets
Connecticut
Maine
New Hampshire
FY02-03: July 1, 2001 to June 30, 2003

percent, respectively. Falling income tax receipts, resulting from drops in the stock market and higher unemployment, largely account for this deterioration in general fund revenues. In a survey conducted this spring, budget officials from all five of the New England states that impose an income tax (New Hampshire does not) expected FY2002 personal income tax receipts to be well below original estimates.[2]

In Massachusetts alone, dips in receipts from taxes on capital gains, bonuses, and stock options removed at least $500 million from the state's revenue base.[3] New Hampshire, without an income tax, avoided these falls in general revenues, instead seeing growth in receipts from both its business tax and its meals and room tax. Still, this revenue growth was below expectations and insufficient to maintain a balanced budget. Drops in sales tax revenues in Connecticut, Massachusetts, and Vermont further contributed to the overall revenue loss, while slight gains in sales tax revenues in Maine and Rhode Island partially offset lost income tax revenue in these two states.

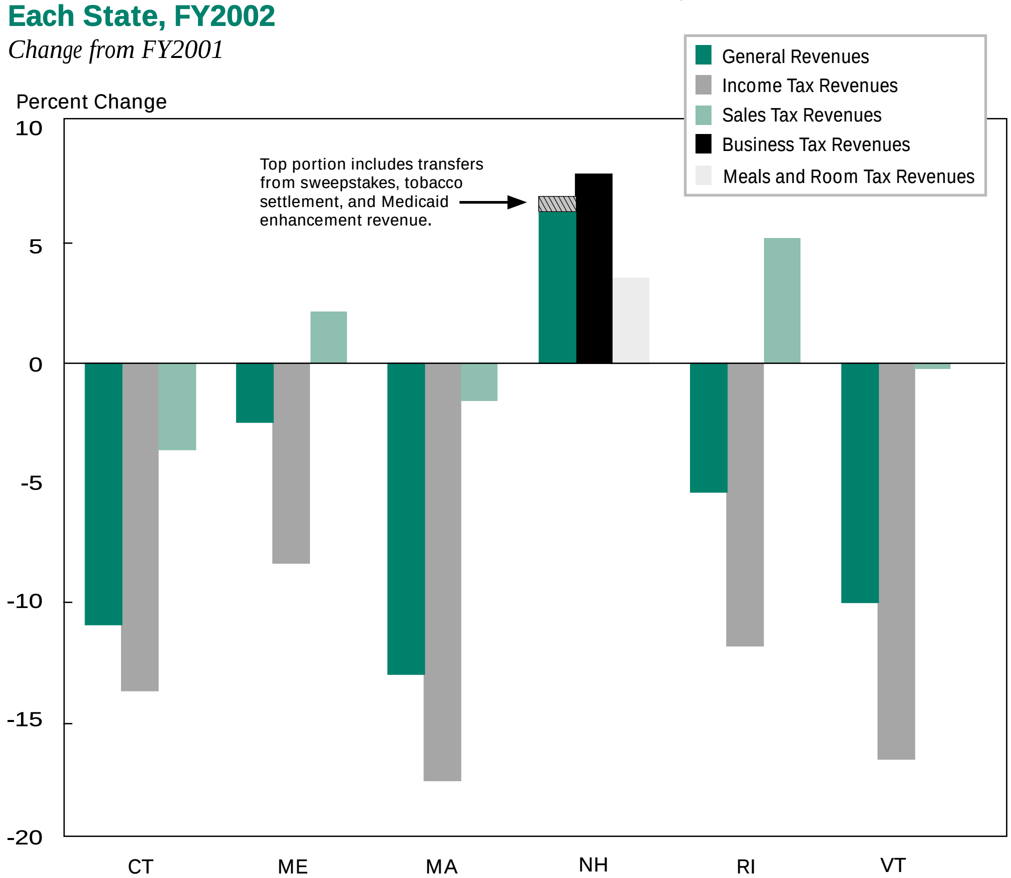
Spending

The states have been hard hit by rising demand for their services. Higher Medicaid costs (which account for 20 percent of all state spending nationwide),[4] increased prescription drug costs (contributing to both rising Medicaid costs and higher employee health costs), higher public assistance caseloads due to the economic downturn, and rising security costs following September 11 are all exerting spending pressures on the states. Medicaid growth rates in particular are staggering. According to the National Association of State Budget Officers (NASBO), in FY2002

Figure 2

Total Revenues and Revenues from the Two Largest Taxes for Each State, FY2002

Change from FY2001



Note: For Connecticut, Maine, Massachusetts, New Hampshire, and Vermont, collections are through June 2002; for Rhode Island, collections are through May 2002. Rhode Island's general revenue is adjusted to account for differences in the timing of the receipt of the hospital license fee and the disproportionate share payment between FY2001 and FY2002.
Source: Official budget documents, state financial statements, conversations with state budget officials.

Medicaid costs (excluding the federal share) rose throughout the region at rates ranging from 5.3 percent in Connecticut to 15.0 percent in Massachusetts.[5] Additionally, a less quantifiable factor, citizen expectations of service provision, elevated during the recent boom years, remain high, making cuts unpopular.

Some might protest, "States went crazy in their spending throughout the 1990s. Cut the fat out of the budget, and leave my paycheck alone!" The reality, particularly here in New England, is more complex.

From 1989 through 1999, all six states in the region increased spending at a similar pace with none diverging significantly from the national average. The story that emerges after 1999, however, is a different one entirely (Figure 3).

Unfortunately, we have no Census data – the only official statistics comparable across states – for both state and local spending after FY1999. Since that year, however, state spending behavior has changed dramatically. During the height of the recent economic boom—FY1999 to FY2001—Maine's per capita state spending grew at an annual rate of 9.4 percent. By comparison, Massachusetts held per capita state spending down to an annual growth rate of merely 2.8 percent. While the rate of growth in Maine's per capita state spending exceeded the national average of 7.1 percent, Massachusetts' grew much more slowly than the either the nation's or the region's (Figure 3).

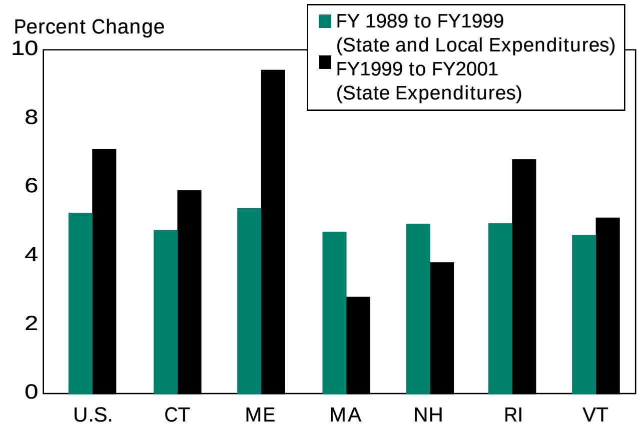
While it is possible that rapid growth in Maine's state outlays offset sluggish growth in local spending, indirect evidence from the state's Department of Revenue Services suggests otherwise. Growth in local revenue is a good proxy for growth in local spending. Maine's two primary sources of local revenue, the property tax and state aid, produced revenue at a combined per capita annual rate of 5.3 percent between FY1999 and FY2001. The sum of per capita property tax revenues, local aid, and state spending (net of local aid) grew at an annual rate of 7.6 percent over the two-year period.

Similarly, fast growth in local spending could have offset Massachusetts' relatively slow growth in state spending.

Figure 3

Annual Percent Change in Per Capita State and Local Government Expenditures

FY1989 to FY1999 and FY1999 to FY2001



Source: Census of Governments, National Association of Budget Officers; *State Expenditures Report* and *Fiscal Survey of the States*, and state budget documents.

Evidence from the Commonwealth's Department of Revenue, which collects local spending data, provides some support for this hypothesis. Unlike Maine, the Commonwealth has data on local spending through FY2001. From FY1999 through FY2001, per capita local spending in Massachusetts increased at an annual rate of 5.8 percent. Per capital state plus local spending (with local aid netted out) also grew at an annual rate of 5.9 percent.

Thus, when both state and local levels of government are taken into account, the difference between the two states in the recent rate of growth in governmental spending narrows considerably. Nevertheless, perhaps because of soaring state spending on functions other than local aid, Maine has decided to rely heavily on budget cuts to deal with its current fiscal woes. By contrast, Massachusetts, having reduced local aid and having increased other state outlays much more slowly than Maine, has opted to rely more heavily on tax increases.

Budgetary Solutions

State spending increases in Maine and Massachusetts are the extremes in New England, but these two states, like the others, can be expected to try a variety of solutions to close their budget gaps. Across-the-board spending cuts, focused cutbacks such as closing parks, focused tax hikes, closing tax loopholes, and accessing rainy day funds are some of the options under consideration or already implemented.

The governors of Maine and New Hampshire have imposed hiring freezes, restricted travel, and cut agency budgets by 2 percent and 3 percent, respectively. Hikes in

2 National Governors' Association and National Association of State Budget Officers, *Fiscal Survey of the States*, May 2002. Subsequently released revenue statistics validated these forecasts, although Rhode Island has yet to release its complete FY2002 revenue totals.

3 *MTF Bulletin*, Massachusetts Taxpayers Foundation, April 24, 2002, and Alan Clayton Matthews, University of Massachusetts at Boston.

4 "NASBO Analysis: Medicaid to Stress State Budgets Severely into Fiscal 2003," National Association of State Budget Officers, March 15, 2002.

5 The Medicaid program is jointly funded by state and federal governments. For New England, the federal government pays 50 percent of the costs of Connecticut, Massachusetts, and New Hampshire, 52.5 percent of Rhode Island's costs, 63 percent of Vermont's costs, and 66.6 percent of Maine's. The growth rates reported in this article represent the state portion of costs only.

the cigarette tax have been common: Connecticut, from $.60 to $1.11 per pack; Vermont, from $.40 to $1.11 per pack; Massachusetts, by $.75 to $1.51 per pack; and Rhode Island, by $.31 to $1.31 per pack.[6] Massachusetts reduced its 2002 budget by 1.7 percent from 2001, New Hampshire reduced its by 3 percent, and Vermont cut its by slightly less than 1 percent. Massachusetts, Connecticut, Maine, and Vermont are all drawing on rainy day funds to plug holes in their 2002 budgets, and Rhode Island is securitizing tobacco settlement funds (see state write-up on Rhode Island for details).

For 2003, all six New England states are relying on a combination of spending cuts, tax increases, and reserves to balance their budgets. These are reviewed in the "Six State Review" section of this issue of *Fiscal Facts*.

6 Maine raised its cigarette tax sharply in 2001 and chose not to exercise a further increase in 2002.

Conclusion

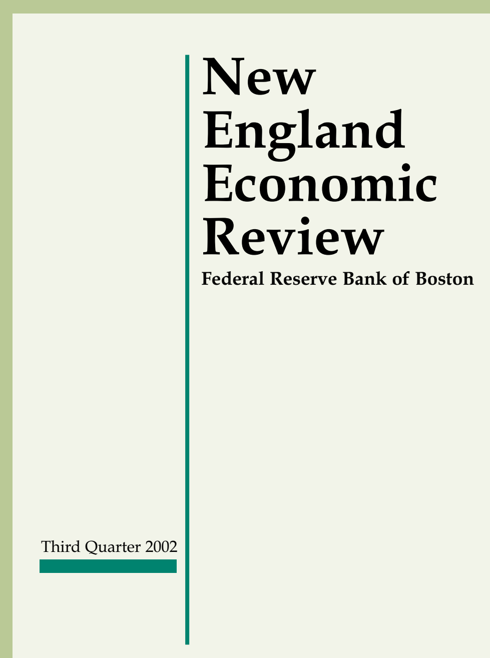
While the economic recovery remains stalled in New England, budget crises are likely to continue. Revenues in five of the six New England states (excluding New Hampshire) were down in FY2002 and may continue to fall below year-ago levels in FY2003. Spending pressures from the rising costs of health care (Medicaid and prescription drugs in particular), welfare, and security costs are rising. Reserve and tobacco-settlement accounts are dwindling, spending cuts are unavoidable, and broad-based tax increases may be needed. There is no magic formula that fits all states; each is responding to its own array of fiscal problems and economic conditions. **FF**

Interstate Fiscal Disparity in 1997

by Robert Tannenwald

New England Economic Review, Third Quarter 2002

The third quarter 2002 issue of the *New England Economic Review* features "Interstate Fiscal Disparity in 1997" by Robert Tannenwald, Assistant Vice President and Economist at the Boston Fed. The article updates state-by-state estimates of fiscal capacity, fiscal need, and fiscal comfort to fiscal year 1997. New England, according to Tannenwald's analysis, is still the most fiscally comfortable region in the nation. The article discusses the principal issues analysts confront when evaluating fiscal comfort and details changes in Tannenwald's methodology from previous studies.



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Across *the* Region

New England states are facing their worst fiscal crises in at least a decade. General revenues, especially those from the personal income tax, fell sharply in every New England state except New Hampshire in FY2002. All six states closed the fiscal year with deficits. Although preliminary reports suggest that FY2003 revenue collections in some states may be up from last year, deficits are still expected throughout the region. In response, all six states are cutting expenditures, drawing down reserve accounts, and/or raising taxes and fees.

Six-State Review

by E. Matthew Quigley, with Lin Gong and Amanda Lydon

Connecticut

According to the State Comptroller, Connecticut ended FY2002 with a budget deficit of $817 million, or 6.8 percent of general fund spending. The deficit is attributable in large part to revenue collections' being significantly below target. At $7.6 billion, revenue collections were 11 percent below their year-ago level. Notably, collections from the personal income tax and the general sales tax, the state's two largest tax sources, were down 13.7 percent and 3.5 percent, respectively. Falling income tax collections alone punched a $561 million hole in the budget.

The legislature voted to use the balance of $595 million in the state's rainy day fund to cover a portion of the deficit, leaving a gap of $222 million. This remaining deficit will be financed through the issuance of notes during the current fiscal year.

At the end of June, the legislature enacted a revised FY2003 budget that relies on a combination of one-time revenue enhancements, spending cuts, and tax increases to close a projected gap of approximately $850 million. Approximately $400 million of this gap was filled with one-time revenue enhancements, including:

• the sale of approximately $125 million in stock held in the Anthem Demutualization Fund;[1] and

• the recapture of approximately $100 million from three state agencies: Connecticut Housing Finance Authority ($85 million), Connecticut Innovations Inc. ($7.5 million), and Connecticut Development Authority ($7.5 million).

1 The Anthem Demutualization Fund was created upon the conversion of Anthem-Blue Cross from a mutual to a stock company.

The remainder of the shortfall was met through approximately $300 million in spending cuts and $130 million in tax increases.[2] Despite these actions, the governor's office predicts that Connecticut will end the current fiscal year with a deficit of approximately $280 million. The comptroller's office, using lower estimates of income tax and corporation tax receipts for the current year, places this deficit figure at $361 million.

Maine

Maine closed FY2002 with a $93 million deficit in its general fund budget; an additional $150 million deficit is predicted for FY2003. The state will likely end its biennial budget cycle in June 2003 with a $243 million hole in its $5.3 billion general fund budget. This gap represents roughly 5.5 percent of the state's general fund expenditures for the FY2002/2003 budget cycle. In reaction to the budget shortfall, Governor King imposed a tight hiring freeze on state employees, restricted travel, blocked discretionary purchases, and ordered state agencies to cut expenditures by 2 percent across the board. The remaining hole is to be filled by transferring $10 million from the state's rainy day fund for FY2002 and an additional $86 million for FY2003. These transfers, in tandem with other transfers from the rainy day fund to other funding areas, will completely drain the rainy day fund by the end of FY2003.[3]

With a special legislative session to address the state's fiscal crisis in the offing, Governor King has proposed several ideas to close the budget gap. Highlights of his

2 *State Tax Notes*, July 15, 2002.
3 State of Maine, Bureau of the Budget.

plan include the following:

• imposing a package of unilateral spending caps designed to save approximately $60 million;

• delaying property tax reimbursements to save $48 million;

• imposing a new tax on hospitals, nursing homes, and group homes to raise $18 million;

• cutting $10 million from state aid to local school districts and reducing the size of the state's laptops-for-students fund by $10 million;

• transferring $6.5 million from the state's tobacco settlement fund; and

• mandating that state employees take three days of leave without pay to save $4 million.

Although the governor has implemented some of these proposals already, saving approximately $60 million, others will require legislative approval.[4]

Massachusetts

While most states throughout the nation are confronting large revenue declines, Massachusetts has been hit especially hard.[5] The state collected $20.7 billion in revenues in FY2002, down by $1.2 billion from FY2001. While revenues fell, spending continued to climb, reaching $23 billion for the entire fiscal year and creating a $2.3 billion hole in the state's budget.

Massachusetts has relied on a combination of actions to plug the hole:

• The state's rainy day fund was tapped for approximately $1.5 billion, while tobacco-fund settlement dollars were drawn down by $60 million.

• One-time revenue enhancements raised roughly $200 million.

• Retroactive spending cuts, including a reduction of $134 million in pension funding, saved an additional $344 million.

• Other miscellaneous adjustments raised or saved an additional $160 million.

Similar actions are expected to be taken to fill the nearly $3 billion revenue shortfall expected for FY2003. The Commonwealth will tap reserves in the amount of $844 million, reduce pension contributions by an additional $150 million, reduce spending on other items by $724 million, and drain another $150 million from the tobacco settlement fund. By the end of FY2003, it is estimated that balances in the rainy day fund and tobacco settlement fund will have fallen to approximately $350 million and $500 million, respectively.

Massachusetts also plans to raise an additional $925 million in FY2003 revenues through a combination of lower personal exemptions, elimination of the charitable deduction, and increases in the capital gains and tobacco taxes. The state also hopes to collect an additional $42 million of tax arrearages through a one-time amnesty program authorized in the FY2003 budget.

Massachusetts has been, and will continue to be, particularly hard hit by increased health care costs and other human services spending. Between FY2001 and FY2003, expenditures for Medicaid, employee health benefits, K-12 education, and caseload-driven human services will likely have risen by 15.6 percent ($2.1 billion).[6] Although the state has attempted to offset this additional spending through reductions of approximately $725 million in program and administrative spending, significant spending pressures will likely continue to drain resources well into the next few budget cycles.

New Hampshire

New Hampshire's revenue collections for FY2002 increased over FY2001 levels, but at a lower rate than expected. In anticipation of a deficit, Governor Shaheen ordered $6.5 million in budget cuts for FY2002 along with a statewide hiring freeze and a ban on out-of-state travel—measures resulting in $3.4 million in cost savings. Despite these actions, the state ended FY2002 with a $62.6 million deficit (2.7 percent of budgeted expenditures for the 2002/2003 biennial budget cycle). In response, Shaheen ordered a $25 million draw on the state's rainy day fund and an additional $15.2 million in spending cuts for FY2003. These actions leave the state carrying over a shortfall of roughly $10 million into the second year of the biennium; the Governor's legal counsel has indicated that an additional dip into reserves is the most likely solution.

Over the past few years, New Hampshire has experienced a series of tax developments worthy of notice. First, the state increased its business enterprise tax by 300 percent between 1998 and 2002. The tax is currently imposed at the rate of 0.75 percent on the sum of all compensation paid or accrued, interest paid or accrued, and dividends paid by business enterprises, after special adjustments and apportionment. In tandem with the business profits tax, it brought in about $440 million in FY2002 and is expected to bring in approximately $430 million in FY2003. Also worth noting is the growing

4 "King Offers New Ideas for Closing Budget Gap," *Portland Press Herald*, August 30, 2002.

5 "Large Declines in April-June 2002 Quarter Caps Terrible Fiscal Year for States," *State Fiscal News*, Vol. 2, No. 10.

6 "2003 Budget: Major Accomplishments in Closing Gap, But 2004 Promises Further Painful Choices," *MTF Bulletin*, August 22, 2002.

importance of the real estate transfer tax in the state's revenue mix. During the first two months of FY2003, this tax brought in more revenues ($22 million) than one of the state's two perennially largest tax categories, business taxes ($18.7 million).[7] While revenues from the real estate transfer tax increased 19.6 percent over FY2002, business-tax revenues were down by 5.6 percent.

Rhode Island

Like the other New England states, Rhode Island experienced shrinking revenues in FY2002. In May,[8] the state reduced estimated revenue collections for FY2002 and FY2003 by $92.9 million and $74.6 million, respectively. As is the case for its peers, Rhode Island's declining revenues are chiefly attributable to a decline in income tax revenues, offset only slightly by increased sales tax revenues.

Unlike the rest of New England, Rhode Island is relying on an unusual approach to balance its FY2002 and FY2003 budgets: securitization of the state's tobacco settlement proceeds.[9] The state has sold the right to the next 40 years' worth of payments to the newly formed Tobacco Settlement Financing Corporation. This corporation, in turn, has sold $685.4 million in tobacco bonds on the open market.[10] After establishing a debt-service account and paying for other issuance-related expenses, the sale has netted $544.2 million in funds available for expenditure. The state used $295.3 million of these funds to refinance existing debt, freeing up $51.6 million in debt service payments for FY2003; $135.0 million to balance the FY2002 budget; and $77.3 million to balance the FY2003 budget.

In addition to this unique approach, the state has relied on more conventional techniques to raise revenues and balance the budget, including:

• a 32 cents per pack hike in the cigarette tax from $1.00 per pack to $1.32, raising $25.3 million in additional revenue;

• a 2 cents increase in the gasoline tax rate to 30 cents per gallon, a measure projected to raise $9.4 million; and

• additional spending cuts identified by the governor, totaling $25.7 million.

Vermont

Vermont's general revenues declined by 10 percent from FY2001 to FY2002. This decline, led mainly by a 16.6 percent drop in income tax receipts, caused a budget gap for FY2002 of $25 million, or 3 percent of general fund spending. To balance the FY2002 budget, the governor and legislators drained $25 million from the state's rainy day fund.

In June, lawmakers approved a general fund budget of $3.3 billion for FY2003, but eroding revenues quickly threw this out of balance. In response, on August 23, a special legislative committee approved a package designed to correct the shortfall. The $39 million package eliminates 84 state jobs, cuts chiropractic and denture coverage for Medicaid patients, and drains $9 million from tobacco settlement accounts to fund other health care programs. Lawmakers also increased the cigarette excise tax by 49 cents per pack, raising $19.7 million. Finally, under current law, Governor Dean is allowed to cut 1 percent from general fund spending, but he is seeking to reduce spending by an additional 2 percent over the course of FY2003. **FF**

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7 New Hampshire's two largest tax revenue sources have historically been business taxes and the room and meals tax.

8 This represents the most recent data available to the public.

9 In 1998, Rhode Island – along with 46 other states – signed a master settlement agreement with domestic tobacco manufacturers resulting in payments to the states in perpetuity.

10 "FY2003 State Budget – Part III: Deferring Tough Budget Choices," *Comments on Your Government*, RIPEC, July 29, 2002, p. 4.

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