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States May Face Higher Spending in Give-and-Take of Medicare/Medicaid Changes

by E. Matthew Quigley

Thursday, July 1, 2004, brought the beginning of fiscal year 2005 and, after several gloomy days, a markedly improved outlook for state finances. Despite this good news, New England's states still face significant fiscal pressures moving forward into the current and next fiscal years. Prominent among these challenges are two changes to the Medicaid and Medicare programs that could significantly increase state health care costs.

Fiscal Year 2005: Declining Federal Medicaid Assistance

In response to the recent fiscal crisis facing many states, Congress provided $20 billion in temporary fiscal relief in May 2003. Half of this money came in the form of a temporary increase in the Federal Medical Assistance Percentage (FMAP), the rate at which the federal government reimburses states for Medicaid expenditures. Specifically, the Jobs and Growth Tax Relief Reconciliation Act of 2003 temporarily increased each state's FMAP for the period April 1, 2003, through June 30, 2004. The FMAP of each New England state was increased by 2.95 percentage points.

As of June 30, the FMAP reverted to 50 percent for Connecticut, Massachusetts, and New Hampshire; 56 percent for Rhode Island; 61 percent for Vermont; and 66 percent for Maine. This return to the standard rates represents a significant funding reduction for the states at the start of fiscal year 2005.

Each state's FMAP is determined by the following statutory formula:

$$1-\left[\left(\frac{(\text{State Per Capita Income})^2}{(\text{National Per Capita Income})^2}\right)*0.45\right]$$

Under this formula, a state's federal matching rate is based on the ratio of its per capita income, squared, to the average per capita income of all states, squared. States with per capita incomes above the national average receive a lower federal matching percentage; states with per capita incomes below the national aver-

age receive a higher percentage. A state with average per capita income has an FMAP of 55 percent. The effect of the squaring is to increase the range of matching percentages. The operation of the formula is bounded by two statutory limits: a minimum of 50 percent and a maximum of 83 percent.[1]

The FMAP produced by this formula applies to a state's spending for almost all covered services on behalf of almost all Medicaid beneficiaries. Higher FMAPs have been established for a few services and populations. For example, in the case of family planning services and supplies, each state's costs are matched at 90 percent, regardless of its normal FMAP, to reflect a national priority on public health. Similarly, when a state buys any covered service — hospital care, physician services, prescription drugs, etc. — on behalf of a Native American or Alaskan Native beneficiary from a facility run by the Indian Health Service (IHS) or a tribal contractor to IHS, the federal matching rate is 100 percent. This ensures that state funds are not used to pay for services at federal facilities. Finally, to encourage states to take up the option of covering uninsured women who need treatment for breast or cervical cancer, the cost of treatment for these women is matched at the same higher FMAP that the state receives under the State Children's Health Insurance Program (SCHIP).

The FMAP formula does not apply to administrative costs. In this case, the matching rates vary by function, not by state. The basic matching rate for Medicaid administrative costs is 50 percent in all states. Higher rates apply to some administrative activities, such as the survey and certification of nursing facilities and fraud investigations and prosecutions.

Twelve states had FMAPs of 53 percent in FY2004 (including the temporary increase of 2.95 percentage points): California, Colorado, Connecticut, Delaware, Illinois, Maryland, Massachusetts, Minnesota, New Hampshire, New Jersey, New York, and Washington. Most of these states would have had FMAPs lower than 53 percent if it were not for the statutory floor constraining the operation of the formula. At the other end of the range, ten states had matching rates of 74 percent or more.[2]

The expiration of the 2.95-percentage-point increase, though seemingly small, is a major loss of funds to New England and will have a significant impact on budgets. As shown in Table 1, the decrease is nearly 10 percent in the case of Maine and exceeds 6 percent in all New England states. On average, the New England states spend roughly 18 percent of their budgets on Medicaid (Table 2), making Medicaid one of their largest single expenditures and a sizable area to be cut so significantly.

Table 1. Loss in Funds to the New England States Resulting from Decrease in Federal Medical Assistance Percentage, FY 2005

	Millions of Dollars	Percent Change FY 2004-FY2005	Percent of FY 2005 Budgeted Expenditures
Connecticut	165	–6.4	1.18
Maine	49	–9.7	1.62
Massachusetts	190	–6.4	0.83
New Hampshire	33	–6.4	0.74
Rhode Island	49	–7.3	0.83
Vermont	25	–8.7	1.62

Source: Author's calculations based on National Association of State Budget Officers data.

Table 2. Medicaid as a Percent of Total State Expenditures, New England States

	FY2001	FY2002	FY2003
Connecticut	20	21	22
Maine	12	12	14
Massachusetts	25	23	24
New Hampshire	19	19	20
Rhode Island	17	18	17
Vermont	11	12	12

Source: National Association of State Budget Officers, state budget documents.

Fiscal Year 2006: Medicare Part D

During FY2006, which begins on July 1, 2005, a second pending change to the system for financing public health care could also impose significant costs on the New England states. This second change is the voluntary prescription drug benefit — "Part D" of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003, signed into law on December 8, 2003. This new benefit is the largest expansion of the Medicare program since its inception in 1965.

Under the law's provisions, the federal government will provide prescription drug coverage to those individuals dually eligible for Medicaid and Medicare, a responsibility currently resting with the states.[3] But the federal government is not simply taking over this spending and letting the states off the hook. The legislation contains provisions for a phased-down contribution from the states — popularly referred to as a "clawback" provision — designed to reimburse the federal Treasury for much of the program's costs.

Beginning on January 1, 2006, each state participating in the Medicaid program will be required to make monthly payments (MSPs — monthly state payments) to the federal government based on the following statutory formula:

$$MSP = \left(\frac{1}{12}\right) * PerCapitaExpenditures * DualEligibles * PhaseDownPercentage$$

"Per Capita Expenditures" (PCE) are a state's total per capita Medicaid spending on prescription drugs for dual eligibles in calendar year 2003, inflated by the projected percentage rise in total prescription drug spending nationally since 2003. Such spending is currently projected to increase by 13 percent in 2004, 12 percent in 2005, and 12 percent in 2006.[4] The "Dual Eligibles" variable is defined as the number of full dual eligibles in a given month enrolled in a Part D plan or in a Medicare-approved alternative plan that offers full prescription drug coverage. The "Phase-Down Percentage" (PDP) begins at 90 percent in calendar year (CY) 2006 and drops by 1 and 2/3 percentage points each calendar year through CY2015. For CY2015 and beyond, the PDP will remain constant at 75 percent (Table 3).

Using a hypothetical example to illustrate, if, in January 2006, a state had 100,000 full dual eligibles enrolled in prescription drug plans, and if its per capita Medicaid spending for prescription drugs for these dual eligibles was $1,000, then the state's payment amount for the month would be $7.5 million (1/12 x $1,000 x 100,000 x .90). Placing this example in context, Massachusetts had 193,000 full dual eligibles in 2002, the latest year for which data are available (Table 4). Its per capita spending for prescription drugs for these individuals was $1,058. If we assume for the sake of example that these 2002 numbers apply to 2006, we can plug these data into the statutory formula and compute that Massachusetts' monthly payment would be $15.3 million (1/12 x $1,058 x 193,000 x .90).

Critics see a number of flaws in this formula for determining how much the

Table 3. Phase-Down Percentage

Calendar Year	Percentage
2006	90
2007	88 1/3
2008	86 2/3
2009	85
2010	83 1/3
2011	81 2/3
2012	80
2013	78 1/3
2014	76 2/3
2015	75

Source: Congressional Budget Office.

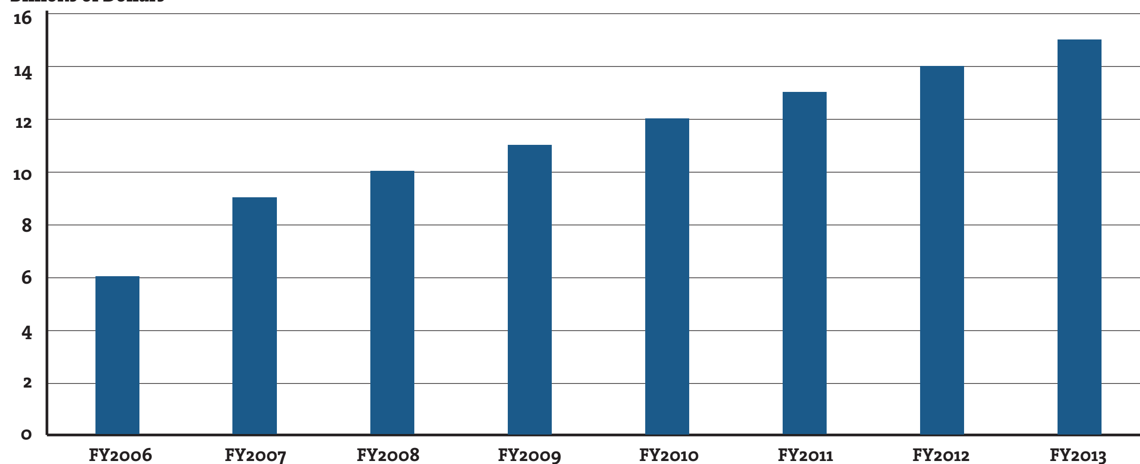
Table 4. Dual Eligibles and Full Dual Eligibles in New England, 2002

	Dual Eligibles	Duals as a Percent of All Medicaid Enrollees	Duals as a Percent of Aged and Disabled Enrollees	Full Dual Eligibles	Full Duals as a Percent of All Dual Eligibles
Connecticut	83,000	17	71	76,000	92
Maine	49,000	21	64	42,000	85
Massachusetts	216,000	17	61	193,000	89
New Hampshire	20,000	16	72	19,000	93
Rhode Island	33,000	16	59	27,000	82
Vermont	28,000	17	73	22,000	77

Source: Urban Institute estimates based on data from Medicaid Statisical Information System.

Figure 1: Projected Clawback Payments

FY2006-FY2013



states should reimburse the federal government. For example, the PCE measure is not necessarily an accurate proxy for how much a state will save when the federal government takes over responsibility for dual-eligibles prescription drug spending. States that happened to have high per capita prescription drug spending on dual eligibles in 2003 would have their clawback amounts calculated each year on this high spending base, putting them at a perpetual disadvantage. With the application of the trend factor (the national rate of increase in prescription drug spending), this disadvantage would increase relative to states having low 2003 per capita expenditures.

The trend factor itself is another weakness in the formula. If the rate of increase in a given state's prescription drug spending is less than the projected annual rate of increase in prescription drug spending *for all populations nationally,* the clawback formula would produce a required payment that is too high. Eventually, the required payment could exceed the state's actual savings. Under this scenario, states that effectively manage their future drug costs and keep spending growth down could end up paying a penalty for their effective management.

The Congressional Budget Office (CBO) estimates that between FY2006 and FY2013, states will pay in the aggregate approximately $88.5 billion toward Medicare Part D coverage, constituting the largest-ever single intergovernmental transfer of funds from the states to the federal government. Figure 1 shows the expected size of this transfer. To place this flow of funds in context, the second largest category of payments from the states to the federal government is premium payments for Medicare Part B and Part A.[5] In 2006, these premium payments are expected to total $3.5 billion; state clawback payments are expected to total $6 billion.

The clawback provision carries a multitude of additional implications for the states. Chief among these, as pointed out in a recent publication by the Kaiser Commission on Medicaid and the Uninsured, is that "the clawback links state fiscal liability for Medicare Part D financing directly to federal budget policy."[6] As of 2006, state clawback payments will be factored into the federal budget. As a result, if Medicare Part D expenditures are higher than projected, Congress may choose to increase state clawback payments as a means of addressing any shortfalls that may arise.

Another important concern is the extent to which the clawback provision limits states' ability to control costs. Under the law, the only meaningful way for states to avoid paying the clawback is to withdraw from the Medicaid program entirely — a highly unlikely scenario. Short of this action, states may take certain steps to reduce the number of dual eligibles covered within a given month, but this would be difficult to do and the impact would be minimal.

On a technical level, a number of logistical issues as yet unresolved remain as points of significant budgetary uncertainty to the states. Implementation of the clawback formula will, for example, require negotiations between state and federal officials over appropriate data sources to use, imputation of data in some instances, and a myriad of other administrative and reporting decisions. These decisions are being made concurrent with planning for the implementation of Part D in 2006. In the end, without a doubt, Part D of the new prescription drug bill offers considerable uncertainty for state budget officials.

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[1] Section 1905(b)(1) of the Social Security Act, 42 U.S.C. 1396d(b)(1).

[2] The program is designed to be a countercyclical program. During an economic downturn, as more people become unemployed and eligible for the program, it expands. The Urban Institute, for example, has estimated that an increase in the unemployment rate from 4.5 percent to 5.5 percent would result in an increase in Medicaid enrollment of 1.6 million people.

[3] For a detailed discussion of the prescription drug benefit and its implications for the New England states, see *New England Fiscal Facts*, No. 32.

[4] Heffler, S. *et al.*, "Health Spending Projections through 2013," Health Affairs, Web Exclusive, February 11, 2004, http://content.healthaffairs.org/cgi/content/full/hlthaff.wf.79vl/DC1

[5] Medicare Part B, funded by beneficiary premiums (co-payments by Medicare recipients) and federal general revenues, covers physician and outpatient hospital care as well as other medical screening and prevention services. Medicare Part A covers inpatient hospital care, home health care following a hospital stay, and hospice care. The federal government finances Part A with payroll taxes accumulated in a trust fund.

[6] Schneider, Andy, "The 'Clawback': State Financing of Medicare Drug Coverage," Kaiser Commission on Medicaid and the Uninsured, June 2004.

Across the Region

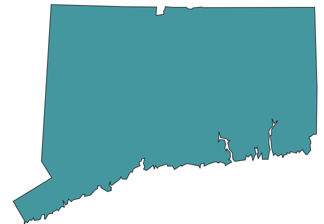
Six-State Review

by Nick Turner

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

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

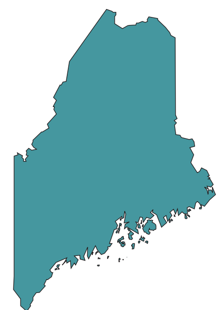
Connecticut



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

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

Maine

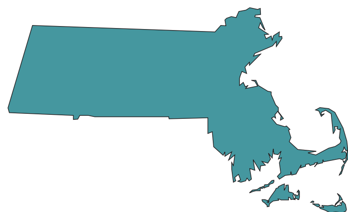


Maine had the largest percentage increase in revenues in New England in FY2004, up 12.1 percent over FY2003 levels. This strong growth was fueled by robust collections from the corporate income tax, which recorded revenue growth of 22.5 percent, and from Maine's two largest taxes, the personal income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

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

The big tax news in Maine concerned a ballot initiative to limit statewide property taxes to 1 percent of assessed value (although towns would be allowed to exceed this limit to pay for voter-approved debt financing). Mainers overwhelmingly defeated this measure on election day, although similar initiatives have been enacted elsewhere, including Proposition 13 in California and Proposition 2-1/2 in Massachusetts. A University of Maine study reported that the referendum proposal would have cost Maine municipalities as much as $688 million in FY2003. Property taxes are a primary source of revenue for localities in Maine; in FY2002, 97.4 percent of all

local tax revenues came from property taxes. Therefore, absent offsetting increases in state aid to local governments, the referendum would have had a dramatic impact on local public services. Some state lawmakers hinted that, if the initiative had passed, more state aid would have been forthcoming. However, raising sufficient funds at the state level to cover the gap would require substantial tax increases. The University of Maine study showed that collections from the personal income tax — the state's largest tax — would have to increase by 64 percent to cover the loss of property tax revenues. Likewise, collections from the sales tax — the state's second largest tax — would have to increase by 80 percent. The defeat of the resolution removes the prospect of these tax changes and helps the state's municipalities avoid a potential fiscal crisis.



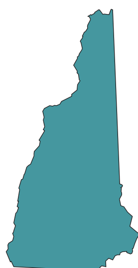
Massachusetts

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

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

For FY2005, the Commonwealth's budget calls for a fourth straight year of broad cuts in many spending categories as well as selected tax increases, primarily on businesses. Despite reductions in many programs, total appropriated spending, $24.8 billion, is 4.7 percent above actual FY2004 outlays. Almost half of this increase is intended to shore up the state's pension fund. Another roughly 40 percent of the growth is earmarked for Medicaid and related programs, which are expected to grow at a rate of 6.3 percent in FY2005.

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



New Hampshire

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

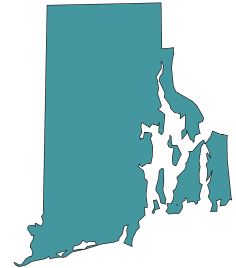
Strong revenue growth has continued in FY2005. Total revenues through the first three months of the new fiscal year were up 9.5 percent from a year ago. Business taxes rose 11.0 percent on strong growth from the business enterprise component (up 15.4 percent). Revenues from the state's second biggest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

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

As in Maine, the November elections had the potential to usher in fiscal policy changes for New Hampshire. On November 2, voters in the Granite State ousted the incumbent Governor Benson, electing John Lynch as the state's next governor. The two candidates differed on several tax policy issues. Governor-

elect Lynch proposed the elimination of the statewide property tax that results in some towns — "donor towns" — paying more in property taxes to the state than they receive in state education aid. A cigarette tax hike of 17 cents per pack would make up the loss of donor town property tax revenue. In contrast, Governor Benson favored removing the statewide property tax more slowly, ending it by 2010 and capping education aid at current levels. Governor Benson also backed a constitutional amendment, opposed by challenger Lynch, that would block courts from hearing cases on school funding issues.

Rhode Island



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

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

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

Vermont

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

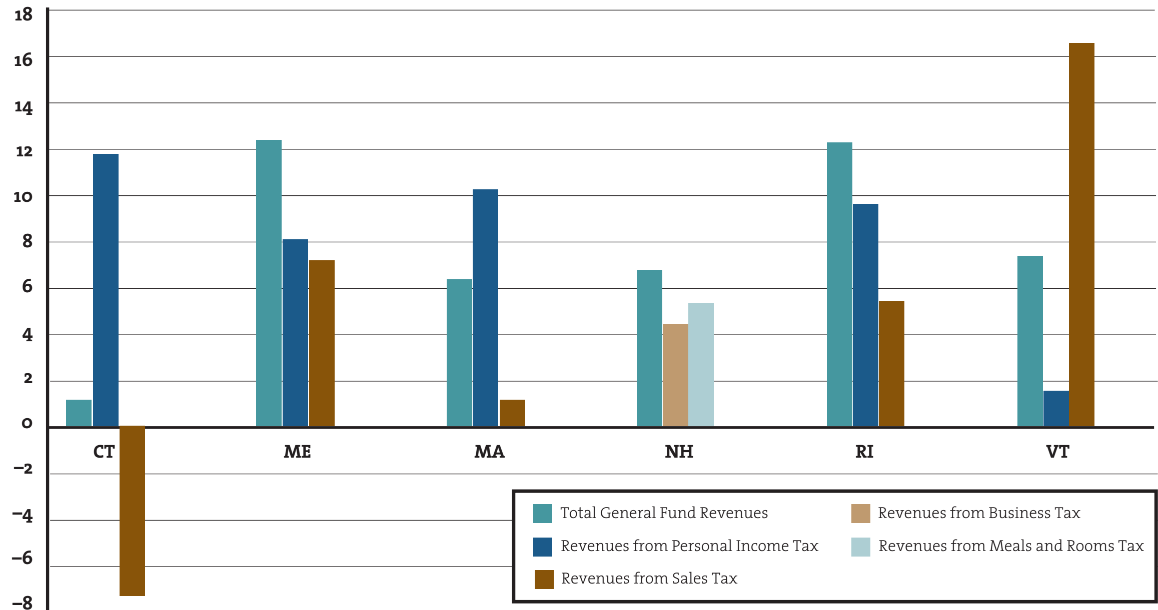
Moving forward into the first quarter of FY2005, Vermont's total general fund revenues were up 8.4 percent compared with the same period in FY2004. Corporate taxes registered a substantial revenue increase of 68.5 percent. Personal income tax collections were also up, increasing by 7.8 percent to exceed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

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

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

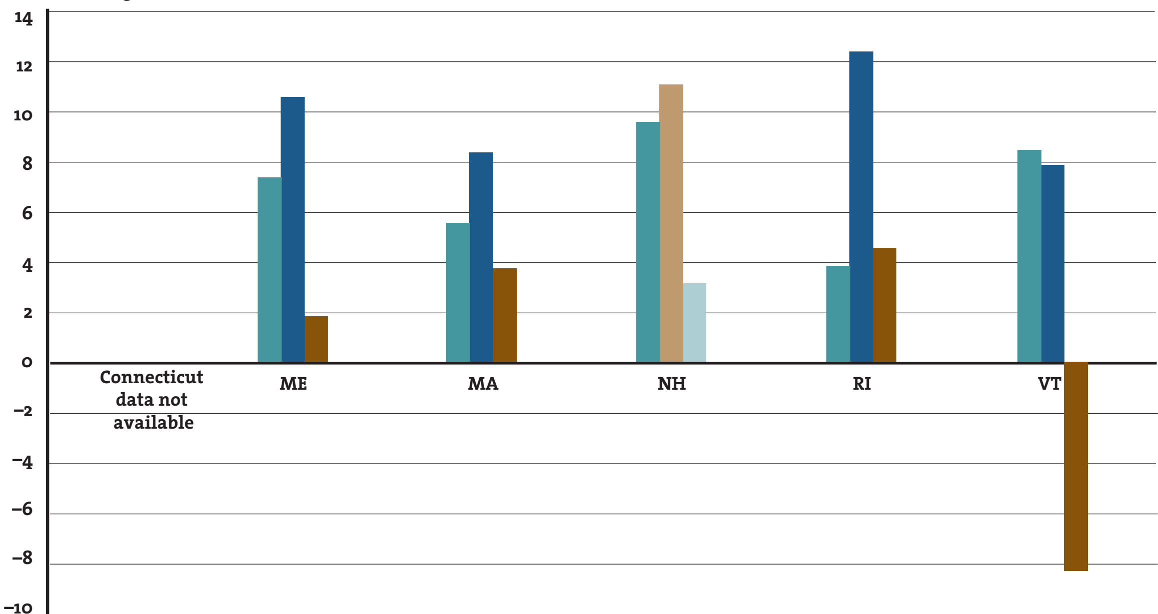
FY2004 Compared with FY2003

Percent Change



First Quarter of FY2005 Compared with First Quarter of FY2004

Percent Change



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

The November elections also had the potential to affect future tax collections in Vermont. In the guber-

natorial contest, challenger Peter Clavelle favored giving municipalities greater freedom to impose local taxes such as a meals and rooms tax and a sales tax. Governor Douglas opposed such changes. On November 2, Vermonters sent Governor Douglas back to Montpelier for another term, helping preserve the state's home rule status.[2]

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

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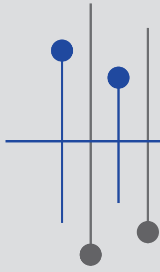
[1] Vermont's sales tax decline is more apparent than real. A legislative change altered the revenues flowing into both the education and the general funds, affecting the levels attributed to the sales tax in the state general fund. See the Vermont section below for a fuller explanation.

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

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



New England Public Policy Center

at the Federal Reserve Bank of Boston

a new research center

The **New England Public Policy Center**, a new venture of the Federal Reserve Bank of Boston, opened its doors in January 2005. The Center is dedicated to improving the quality of analysis on economic and policy issues that affect the region, such as:

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- economic development
- housing and land use
- health care
- regional economic conditions

our plans

In the next few months, you'll be hearing more about our upcoming outreach initiatives, including:

- issue briefs and background research for legislators and the media
- public policy research for analysts and academics
- conferences, policy forums, and other special events for legislators, analysts, the media, and the public

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State Budget Timetables

Annual Budgets
Massachusetts
Rhode Island
Vermont
FY04: July 1, 2003 to June 30, 2004
FY05: July 1, 2004 to June 30, 2005

Biennial Budgets
Connecticut
Maine
New Hampshire
FY04-05: July 1, 2003 to June 30, 2005
FY06-07: July 1, 2005 to June 30, 2007

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