Fiscal Facts

Winter 1994

Federal Reserve Bank of Boston

Around New England

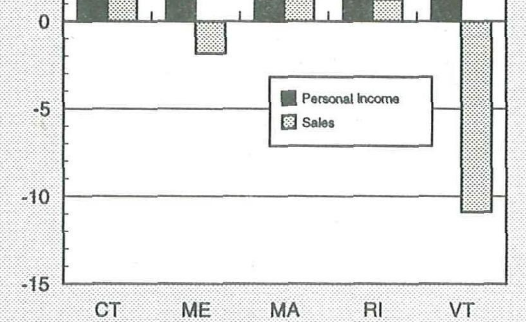
Revenue figures for the first four months of fiscal year 1994 (FY94) brought both good news and bad news to most New England states. The bad news is that, except in Massachusetts, revenues were the same or only slightly higher than their year-ago levels. The good news is that revenues met or exceeded expectations in Connecticut, Maine, Massachusetts, and New Hampshire, and were only slightly below expectations in Rhode Island and Vermont. During budget season last spring, legislators correctly anticipated that continued weakness in the regional economy would constrain revenue increases during the summer and early fall. Since economic recovery is under way or expected to begin soon in each New England state, policymakers are cautiously hopeful that growth in tax receipts will pick up and their revenue targets will be met by next June 30. Only Rhode Island has officially projected a revenue shortfall for the current fiscal year.

The strongest indication of economic improvement among the region's state revenue figures is the performance of personal income tax receipts, by far the most important tax revenue source for Massachusetts and Vermont (charts on insert). From July through October, collections from this source were between 4 percent and 9 percent higher than their year-ago levels (chart below). However, the performance of sales tax collections, by far the largest revenue source for Connecticut, underscores the recovery's tentative nature. During the July-October period, year-over-year growth in sales tax receipts was considerably slower than that of income tax receipts in every New England state except Massachusetts.

Sales tax collections in Maine and Vermont have been especially low, in part because of a reduced flow of Canadian shoppers across the border. The decline in Canadian patronage is attributable primarily to a weakening of the Canadian dollar. Vermont's collections were further reduced by a temporary percentage-point reduction in the sales tax rate, in effect during July and August of 1993.

Percent Change in Personal Income and Sales Tax Revenues

July – October FY93 to July – October FY94



Note: New Hampshire has neither a broad-based personal income tax nor a sales and use tax.
Source: Official budget documents, state financial statements, and conversations with state budget officials.

Connecticut

While revenues for the first four months of FY94 were higher than anticipated, so were the numbers of prisoners, public school students, Medicaid patients, and welfare clients. Two gubernatorial advisors have testified before the Legislature's Appropriations Committee that, in order to house prisoners adequately, honor all commitments under entitlement programs, and satisfy the requirements of school aid formulas, the state will have to spend $105 million more than the $8.6 billion budgeted for FY94. They warned of a comparable shortfall between spending demands and spending authorizations in FY95.

The state's formal spending cap could limit its ability to use higher-than-expected revenues to meet these unanticipated projected needs. Under the cap's provisions, state spending can grow no faster than the average rate of growth over the past five years in either statewide personal income or the national Consumer Price Index, whichever is higher. Some spending categories, such as fiscal assistance to distressed municipalities, are exempt from the cap. According to current estimates, the adopted FY94 budget is $50 million below the spending cap. Of the projected unanticipated spending required in FY94, an estimated $65 million will be subject to the cap. The state would therefore exceed the projected cap by $15 million if it attempted to satisfy all spending obligations, both anticipated and unanticipated.

Maine

Maine's revenues for the first four months of FY94, although only 3 percent above their year-ago level, were 3 percent above official projections. State policymakers are encouraged that receipts from all three major broad-based state taxes—personal income, corporate income, and sales—grew faster than anticipated.

One of the most divisive issues currently confronting the state is the distribution of state aid for schools. The Legislature's Education Committee has held hearings on this issue and an independent task force has been created to study it. The most controversial question is whether state aid for schools should continue to be distributed to municipalities in inverse proportion to their per capita property values. This distributional rule assumes that per capita property value is a good indicator of a community's capacity to finance its schools independently. Critics of the formula contend that other factors such as poverty rates, property taxes as a percentage of income, and educational costs should be taken into account. Meanwhile, officials from Maine's poorest communities, which are most dependent on state aid, continue to express concern over the sharp cuts in the level of aid in recent years.

Maine's retirement system for public employees has also received considerable public attention in recent months, as it has for the past several years. The system, whose costs consume approximately one-third of the state's budget, is more generous than most private and other public retirement programs. A committee recently created to study the system is exploring whether Maine should join the Social Security system, as most states have done, and replace its current pension system, which provides employees with a defined benefit at retirement, with a defined contribution plan. Under the latter, an employee's retirement benefit depends on investment results.

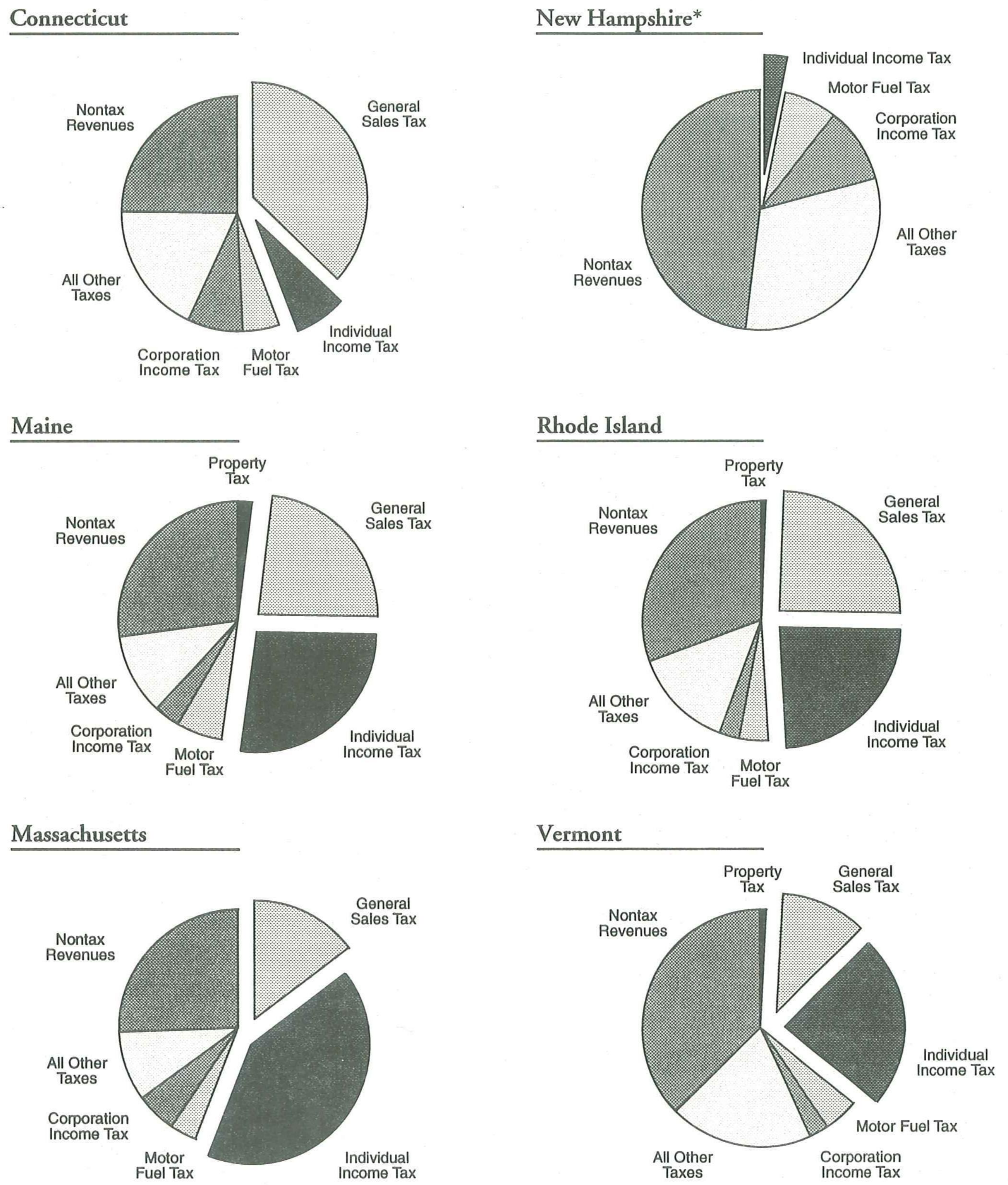
Massachusetts

Massachusetts' revenues for the first four months of 1994 were close to 9 percent above their year-ago level and 3 percent above the mid-point of the Commonwealth's official predicted range. Collections from the corporate excise tax and cigarette excise tax grew by 18 percent and 68 percent, respectively. The surprisingly rapid growth in receipts from the cigarette tax is attributable both to an increase in the cigarette tax rate by 25 cents per pack in January 1993 and a resurgence in the sale of tobacco products this spring. The growth in sales was stimulated by price reductions designed to 1) arrest the long-term downward trend in the demand for cigarettes, 2) compete with manufacturers of less expensive generic brands, and 3) offset recent increases in state cigarette tax rates around the country.

The Commonwealth's final figures for FY93 show a $67 million surplus, $20 million of which was deposited into its rainy day fund. The fund's balance now stands at a record high of $250 million. These indications of renewed fiscal stability have led Standard & Poor's and Fitch Investor Services to raise the state's bond rating to A+ status.

Governor Weld has proposed a tax cut of over $200 million to offset the effects of the recent federal tax increase on high-income households under the Omnibus Budget Reconciliation Act of 1993 (OBRA). The Massachusetts House of Representatives has voted down the two major pieces of the package: a reduction in the state income tax rate from 5.95 percent to 5.845 percent and a 4.3 cents-per-gallon cut in the state gasoline tax. The House did approve the Governor's proposal to raise the "no-tax status" threshold, the level of income below which taxpayers need not file a state return. Currently individuals earning $8,000 or less and couples

Distribution of State General Revenues from Own Sources, *FY91*



Source: U.S. Bureau of the Census, *State Government Finances: 1991.*

*Rooms and meals tax, cited in the text as New Hampshire's most important source of tax revenue in FY94, is included in the category, all other taxes. In 1991, the most important source of tax revenue was the corporation income tax.

making $12,000 or less are granted no-tax status. The new plan increases these thresholds to $9,000 and $13,500, respectively.

Governor Weld is expected to resubmit his tax package in the next legislative session. Rejecting the argument that the Commonwealth cannot afford it, he believes that his recommended tax cuts would amount to only 1 percent of state spending.

New Hampshire

New Hampshire's revenues for the first four months of FY94 came in 1 percent ahead of official projections, as higher-than-expected receipts from the rooms and meals tax and business profits tax more than offset a significant shortfall in collections from the recently enacted business enterprise tax.

Dramatic changes in the state's tax structure have complicated the task of estimating revenues for the current fiscal year. In addition to reforming its business taxes extensively (see Fiscal Facts, Summer 1993), the state has extended its rooms and meals tax to acute care hospitals and rehabilitation centers. As a result, revenues from this tax are projected to more than double in FY94. The tax is now the state's most important source of revenue.

The main incentive for extending the tax to these medical care providers was a revision of federal rules governing how states may reimburse health care providers for services rendered to Medicaid patients. Under prior rules, a state could 1) levy taxes on medical care providers, 2) channel some of the taxes' proceeds into its general fund, 3) earmark the remainder of the proceeds for increased outlays for Medicaid services, 4) obtain federal grants matching these outlays, and 5) use both the tax proceeds and federal grants to reimburse health care providers for exactly the amount of taxes that they paid. Such schemes in effect permitted New Hampshire, as well as other states, to augment their general revenues with taxes on providers of medical care without requiring these providers to incur any additional net tax liability. (See Fiscal Facts, Winter 1992.)

The federal government no longer permits a state to levy a tax targeted solely on providers of medical care and to disburse Medicaid grant money to these providers in proportion to their liability under the tax. In response to this rule change, New Hampshire has weakened the correspondence between taxes its providers pay and the Medicaid disbursements they receive. The state has reduced its tax on the gross receipts of acute care hospitals and rehabilitation centers from 8 percent to 6 percent, but it has made these institutions liable for the rooms and meals tax. Medicaid dollars financed with receipts from these taxes, as well as federal matching dollars, are returned to these medical care providers according to the following formula: 1) the providers receive disbursements equal to 8 percent of their gross receipts (even though they pay a tax of only 6 percent). 2) Any remaining dollars are disbursed according to the percentage of medical care provided to patients who cannot pay their bills because they lack medical insurance or are not fully covered by Medicaid or Medicare ("uncompensated care" patients). Under these arrangements, the distribution of tax collections is sufficiently different from the distribution of Medicaid disbursements to comply with federal regulations.

State Budget Timetable

ANNUAL BUDGETS

FY93: July 1, 1992 to June 30, 1993
FY94: July 1, 1993 to June 30, 1994
Massachusetts, Rhode Island, Vermont

BIENNIAL BUDGETS

FY94 - 95: July 1, 1993 to June 30, 1995
Connecticut, Maine, New Hampshire

Rhode Island

In July, the Legislature enacted an austere budget that requires the state to spend less in FY94 than in FY93, even before adjustment for inflation. Evidently, the budget is not austere enough. In November, the State Budget Officer, Michael O'Keefe, as well as key legislative fiscal advisors, acknowledged that, without spending cuts or tax increases, the state faces an estimated FY94 deficit of $50 million. He attributed the gap to higher-than-anticipated welfare caseloads and an estimated $22 million shortfall in revenues. In an attempt to close the gap, Governor Bruce Sundlun has ordered all state agencies to curb hiring and to reduce their FY94 spending plans by 3 percent.

While the Governor searches for new ways to reduce spending, he is encountering resistance to the implementation of reductions that have already been enacted. One especially unpopular cut was the elimination of 4,000 adults from general public assistance rolls, a policy projected to save the state $16 million. These individuals lost their eligibility for state medical and welfare benefits. The public outcry against this policy has been so strong that the Legislature has created two panels to reevaluate it. The Governor has restored medical insurance covering certain prescription drugs and outpatient treatments for these former welfare recipients.

Despite its fiscal problems, Rhode Island passed up an opportunity to reap a revenue windfall from the passage of the recent federal tax increase under OBRA. Because Rhode Islanders' state income tax liability is a fixed percentage of their federal income tax liability (often referred to as a "piggyback" arrangement), the state has usually enjoyed a boost in revenues whenever the federal government has increased its income tax. Shortly after OBRA was enacted, the state estimated that, in the absence of changes to its tax structure, it would receive a revenue windfall of about $17 million in FY94.

According to Rhode Island state law, however, special rules apply when the federal government revises its income tax while the Rhode Island Legislature is not in session. Under these conditions, the State Tax Administrator must adjust the state's income tax rates to eliminate the impact of the federal tax changes on the state tax liability of all affected Rhode Islanders. As a result, OBRA will generate no windfall revenues for Rhode Island.

Vermont

Vermont's general fund revenues for the first four months of FY94 were 1 percent above their year-ago level, slightly below what public officials had expected. The state's lack of revenue growth is attributable in part to a percentage-point reduction in the meals and rooms tax rate, effective July 1, 1993, and a temporary percentage-point reduction in the sales tax rate in effect between July 1 and August 31. However, in an official statement in early November, Administration Secretary William H. Sorrel noted several disturbing trends in FY94 revenues to date, such as disappointingly slow growth in corporate profits taxes and an uneven pattern of growth in the personal income tax. Secretary Sorrel cautioned that, while the property transfer tax has been running consistently ahead of expectations, it will continue to do so only if the number of real estate sales transacted within the state continues to grow rapidly.

In addition to these short-run concerns, Vermont still must contend with a cumulative deficit of $65 million, a legacy of previous years. The legislature has already implemented two of the four elements of Governor Dean's plan to reduce this outstanding deficit (see Fiscal Facts, Summer 1993): a 2 percent across-the-board reduction in spending, worth about $10 million (some educational programs are excepted) and restoration of the sales tax rate from 4 percent to 5 percent, at least until July 1995. The additional percentage point on the sales tax, effective September 1, is expected to generate $25 million in revenue. The legislature plans to cut spending by another $10 million when it meets in December.

In its attempts to enhance both short-run and long-run fiscal stability, Vermont is getting a little unanticipated help from federal tax reform. The state's personal income tax, like Rhode Island's, "piggybacks" on its federal counterpart. As a result, the recently enacted increase in federal taxes on high-income taxpayers will give Vermont an estimated $9 million revenue windfall in FY94. Unlike Rhode Island, Vermont has no plans to make its high-income taxpayers "whole" by enacting offsetting cuts in state taxes.

Revisions and Corrections · *Connecticut*
The following figures represent corrections and revisions to Connecticut data reported in the Fiscal Facts, Summer 1993 issue.

- An increase in the tax rate on cigarettes and a new environmental tax on tires together will generate additional revenues of about $9.3 million per year.
- The casino operated by the Mashantucket Pequot Native Americans at Ledyard will generate general fund revenues of $113 million in FY94, $88 million of which will go to cities and towns, and $135 million in FY95.
- Total state school aid for cities and towns will increase by 5.4 percent in FY94 and about 3 percent in FY95.

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