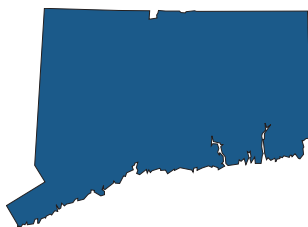


Across the Region

Six-State Review

by Nick Turner

Revenue collections were strong across New England during the first two-thirds of FY05 (July 2004 through February 2005) compared with the same period one year earlier. All states experienced positive growth in total revenue, with increases ranging from 1.3 percent in New Hampshire to 9.1 percent in Connecticut.¹ Year-over-year revenue growth from the largest tax — the personal income tax in all states except New Hampshire where the business tax produces the most revenue—was also positive in all states. Revenue growth from these taxes ranged from a low of 5.1 percent in Maine to a high of 17.0 percent in New Hampshire. The performance of the second largest tax — the sales and use tax in all states except in New Hampshire, where the second-ranking tax is the meals and rooms tax — was mixed. Collections from these second-ranked taxes were up during the first eight months of FY05 in all New England states except Maine and Vermont, where collections dropped by 1.9 percent and 17.0 percent, respectively.²



Connecticut

Collections in general-fund revenues were strong in Connecticut during the first eight months of FY05, increasing 9.1 percent from the same period in FY04. This was the largest percentage increase in general-fund revenues in New England during this period and was driven by increases in nearly every major tax category. Collections from the personal income tax, the state's largest tax, grew by 10.1 percent, while collections from the sales and use tax, the state's second largest tax, were up 3.7 percent. Corporate-tax revenues surged by 63 percent, although some of this growth reflects earlier tax filing by corporations. Declines in revenue were observed in only two major tax categories. The cigarette tax was off by 4.5 percent, and total public service corporation taxes were down by 2.2 percent.

In February, Governor M. Jodi Rell presented her first state budget, a two-year \$31.1 billion plan that includes both new taxes and spending cuts in order to close a projected budget gap of \$1.3 billion in FY06. The proposed budget would limit spending increases to 3.9 percent in each of the next two fiscal years. For FY06, a few major increases are proposed. Special education funding to cities and towns would be increased by \$26 million, or 38 percent, while major grants to cities and towns for education would increase by \$31 million, or 2 percent.

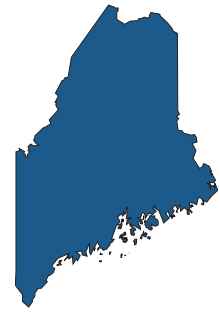
The proposed budget offers a total of \$298 million in new taxes, with \$140 million coming in FY06 and \$158 million in FY07. Much of this new revenue is created by higher "sin" taxes. Cigarette taxes would increase by \$0.74 per pack, to a new rate of \$2.25 per pack, an increase estimated to produce \$192 million in added revenue over the biennium. Several other tobacco products would see a tax increase from the current 20 percent of their wholesale value to 90 percent, bringing in \$32 million over the biennium. Alcohol taxes would increase by 15 percent, creating an additional \$15 million in both FY06 and FY07.

In contrast, the Governor proposed a slow phase-out of the corporate surcharge tax over the next three fiscal years. Although eliminating the surcharge will eventually reduce revenue significantly, it is still expected to generate \$67 million in FY06. The Governor's budget would enhance revenues from the corporate sector by reducing the net operating loss carryforward provision from 20 years to only 5 years. This change is expected to save the state \$7 million in FY06 and \$18 million in FY07. The Governor's budget also includes a new tax on nursing home services that is expected to generate \$139 million in FY06 and to allow Connecticut to receive additional federal monies, as much as \$118 million, for Medicaid.³

One portion of the Governor's budget that is receiving scrutiny is her proposal to spend \$1.3 billion on the state's transportation infrastructure. The plan calls for new transit buses, additional rail cars for Metro-North's New Haven line, and improvements to Interstate 95. To fund the plan, gasoline taxes would increase by 6 cents over the next eight years and then later decrease by 1 cent in 2016. Each 1 cent change in the gasoline tax is estimated to raise or lower tax revenues by approximately \$16 million per fiscal year. In addition, passengers on Metro-North's New Haven line would pay a surcharge of \$1 per ticket beginning in 2008 in order to fund renovations on that line.

Maine

Total revenue growth was strong in Maine in the first two-thirds of FY05, increasing 7.4 percent from the same period one year earlier. This was the second largest percentage increase in New England over the period. The performance of the state's two largest taxes—the personal income tax and the sales and use tax—was mixed. While personal income tax collections increased 5.1 percent, sales and use tax collections contracted, dropping 1.9 percent in the face of both lower auto sales and lower sales of general merchandise. Bolstering total revenue growth were the estate tax and the corporate income tax. Buoyed by a strong real estate market, estate tax collections grew 34.8 percent. Corporate income tax collections also grew rapidly, increasing 35.4 percent.



Long awaited promises of property tax reform have finally come to fruition in Maine. In the shadow of last fall's failed ballot initiative for a property tax cap, and facing the prospect of another citizen referendum on the issue led by the Maine State Chamber of Commerce, Governor John Balducci and state lawmakers came to a consensus on a property tax reform package, LD1. Property tax relief is delivered through two programs, which are estimated to reduce the average property tax bill for Mainers by 13 percent. The first, the Maine Residents Property Tax Program, expands Maine's circuit breaker program. It doubles the maximum allowable property tax rebate from \$1,000 to \$2,000 for Mainers who pay more than 4 percent of their "adjusted" income in property taxes. The second program, the Homestead Program, increases from \$7,000 to \$13,000 the amount of home value that municipalities can deduct from principal residence properties when calculating property tax liabilities.

LD1 also clarifies the state's share of education funding and limits growth in state agency appropriations and in spending increases requested by the Governor. It obligates the state to pay 50 percent of education expenses by FY07 and 55 percent by FY09. The spending constraints imposed by LD1 are summarized in the table below. LD1 sets as a goal that by 2015 Maine's total state and local tax burden should be in the middle one-third of all states; an independent commission, appointed to measure progress toward this goal, is to make its first report by January 15, 2006.⁴

The Governor and lawmakers also came to a consensus on the state budget. With spending increases of only 3.5 percent, the new budget represents the lowest average general fund increase in 30 years. The budget contains a number of tax cuts, including \$225 million in immediate property tax relief, \$153 million in business-machinery tax cuts, and \$51 million in personal income tax cuts. Education spending is forecast to

Summary of Maine State Spending Limits in LD1

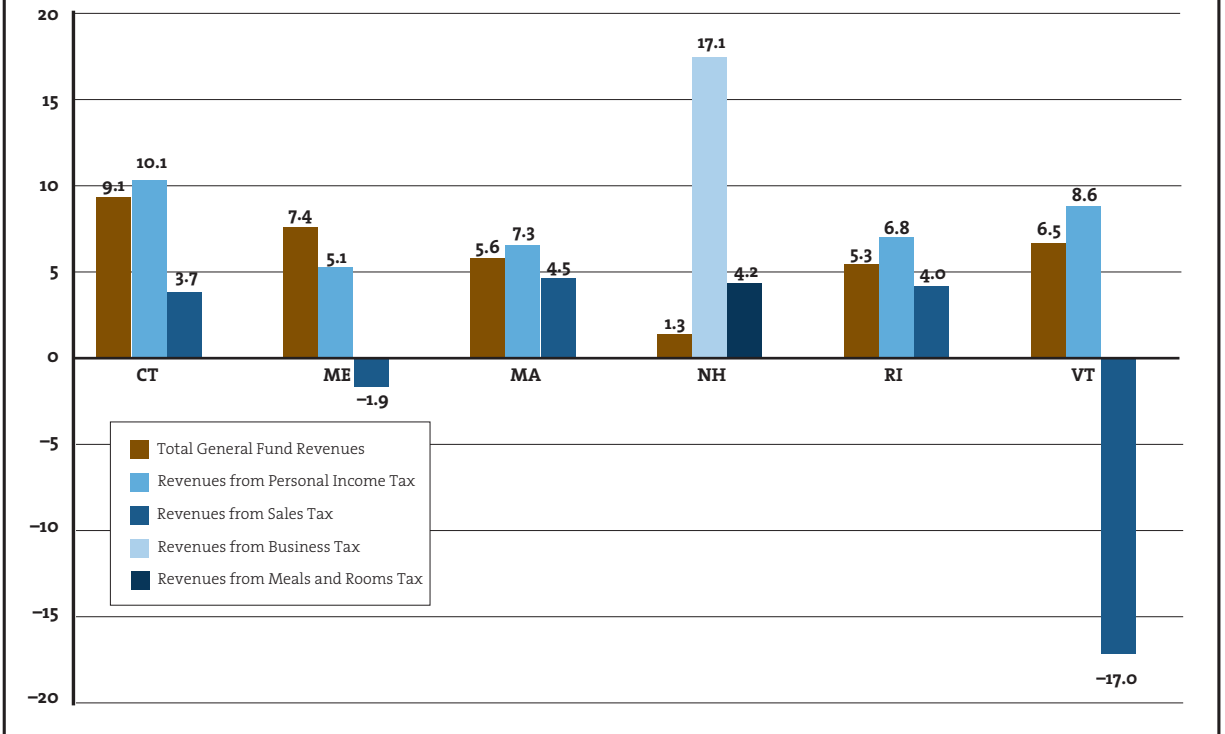
Agency Budgets:	<i>General Fund (GF) appropriation requested by state agencies is limited to the lesser of</i> (1) the previous year's appropriations multiplied by one plus the average real rate* of personal income growth in the previous 10 years; or (2) 2.75 percent
Governor's Request:	<i>When Maine's tax burden (determined by an appointed Commission) is in the highest one-third of states,</i> the budget submission may not exceed the GF appropriation from the previous year multiplied by one plus the lesser of (1) the average real rate* of personal income growth in the previous 10 years or (2) 2.75 percent plus the 10-year average rate of population growth. <i>When Maine's tax burden (determined by an appointed Commission) is in the middle one-third of states,</i> the budget submission may not exceed the GF appropriation from the previous year multiplied by one plus the average real rate* of personal income growth in the previous 10 years plus the 10-year average population growth plus the forecast inflation.**
Exceptions to the Limits:	<ol style="list-style-type: none">1. Catastrophic events such as natural disaster, terrorism, war2. Unfunded or underfunded state or federal mandates3. Citizens' initiatives or referenda4. Court orders5. Loss of federal funding
Override Procedure:	State spending limits may be exceeded by a majority vote of both houses in the legislature in separate measures.

*The real rate of growth in personal income is defined as the growth in the previous 10 calendar years and is calculated as the percent change in personal income as estimated by the U.S. Bureau of Economic Analysis minus the percent change in the Consumer Price Index as reported by the U.S. Bureau of Labor Statistics.

**Forecast inflation is the forecasted change in the Consumer Price Index underlying the revenue estimates developed by the appointed committee.

Growth in State Revenues

First Eight Months of FY2005 Compared with First Eight Months of FY2004



increase 8.3 percent in FY06 and 5.5 percent in FY07.

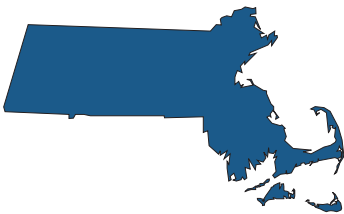
Several issues remain to be solved. For instance, no agreement has been reached on the Governor's lottery capitalization plan,⁵ which involves capitalizing up to \$40 million of lottery revenues for the next ten years in order to generate \$250 million for use in the upcoming biennial budget. Governor Balducci has also outlined a proposal for nearly \$200 million in new state borrowing, including \$50 million for land acquisition and conservation, \$28 million for highways and bridges, and \$22 million for a statewide biomedical research and development fund.

Massachusetts

Revenue growth got off to a strong start in the Bay State during the first eight months of FY05. Total general revenues increased 5.6 percent from the same period in FY04. Personal income tax collections were up by 7.3 percent, while sales and use taxes rose 4.5 percent, corporation excise taxes increased 8.9 percent, and other excise taxes were up by 7.7 percent. The overall strong revenue picture caused Revenue Commissioner Alan LeBovidge to declare: "With year-to-date collections well above benchmark, this bodes well for the end of fiscal year results."⁶

Governor Mitt Romney was also bullish on state revenue collections. In late March, the Governor raised his original revenue forecast for FY06 by \$164 million and cited the improved revenue outlook as further justification for the spending plans and tax cuts incorporated in his FY06 budget. This budget calls for \$23.2 billion in expenditures, an increase of 2 percent over the requested FY05 level. Spending growth would be concentrated in Chapter 70 education aid (up 2.5 percent), K-12 education aid (up 2.6 percent), and local non-education aid to cities and towns (up 4.3 percent). In contrast, the Governor proposed reductions for income-support programs (down 3.4 percent), Medicaid and other health programs (dropping 4.8 percent), and funding for the Department of Community Housing (down 7.7 percent).

Lawmakers on Beacon Hill were able to avoid potentially large expenditure increases in both state education aid and the Medicaid program. The recent decision by the State Supreme Judicial Court on the Hancock education finance case allowed the state to avoid mandated increases in education aid. The Court ruled against the plaintiff school districts and found that state spending on education was adequate. Massachusetts also avoided a threatened \$583 million cut in federal funding for Medicaid, the program that provides health care for the poor and uninsured. However, the state may not have completely dodged the Medicaid issue. The Governor proposes using the FY05 Medicaid surplus to pay Medicaid bills in FY06. Normally these expenses are paid by funds generated in the same fiscal year. As a result, FY06 Medicaid expenditures are artificially low, slated to increase only 5.6 percent from FY05. This cost will likely rise significantly in FY07. Nevertheless, the Governor has used the low Medicaid expenditures in FY06 as a cornerstone of his universal health care plan,



which aims to provide insurance for the state's 460,000 uninsured residents.

A series of tax changes are included in the proposed budget. The Governor redoubled his efforts to reduce the personal income tax rate from 5.3 percent to 5.0 percent. This tax cut is estimated to have a price tag of \$737 million by FY07. The Governor also renewed his efforts to close "loopholes" in corporate income tax laws and regulations; closing the loopholes would raise an additional \$170 million in revenues. In response to businesses' concerns that his proposals would harm the Commonwealth's economy, the Governor offered a second, scaled-down proposal. This latest plan would give the revenue commissioner less authority than the original plan to challenge the validity of transactions claimed in corporate tax returns.

New Hampshire

In the first eight months of FY05, New Hampshire's total general and education fund revenues showed slight growth, up 1.3 percent from the same period in FY04. This anemic performance reflects in part unusually high revenues in FY04 as a result of (1) one-time revenue gains from the estate and legacy tax and (2) the receipt of federal funds in FY04 that did not continue into FY05.

Revenues from the estate and legacy tax were lower by \$21.4 million, or nearly 72 percent. The majority of the revenue loss, \$17 million, was the result of an unusually large number of returns in February 2004. In addition, New Hampshire has phased out some legacy provisions, and the estate and legacy tax is tied to a narrowing federal definition. The shrinkage in federal aid occurred as federal grants received as part of the President's Job Reconciliation Act in both FY03 and FY04 did not continue into FY05.

The state's two taxes generating the most revenue — the business tax and the meals and rooms tax — both exhibited strong year-over-year revenue growth for the first eight months of FY05 compared with the same period in FY04. Collections from the meals and rooms tax increased 4.2 percent, while business tax collections were up a sizable 17.1 percent.

Governor John Lynch presented his \$8.7 billion biennial budget to the legislature in mid February. The proposal includes general-fund spending increases of \$21 million, or 1.5 percent, for FY06 and \$54 million, or 3.9 percent, for FY07. The ability of the state to increase spending while confronting a \$370 million projected shortfall rests on Governor Lynch's belief that strong business growth will increase total tax collections. The Governor projects that the state will receive an additional \$105 million from business taxes, an extra \$44 million from the tax on property sales, and an extra \$87 million from a 28-cents-per-pack cigarette-tax increase in the coming biennium. Some members of the legislature are less sanguine about future revenue growth and are calling for \$300 million less in spending than the Governor's recommendation.

The Governor proposed a comprehensive overhaul of New Hampshire's five-year-old approach to education funding. The statewide property tax, set at \$3.33 per \$1,000 valuation, would be removed, thereby eliminating the situation that has so-called "donor towns" paying more in property taxes than they receive in state aid. The state would make up for this lost revenue with the 28-cents-per-pack increase in the tax on cigarettes and would distribute state school aid in a manner deemed more fiscally equalizing. Under this new approach, state education expenditures would be allocated based on need using an "education equity index" that takes into account not only per-pupil property values and median income, but also factors such as test scores and English proficiency. With the index, less affluent communities and urban communities would receive larger grants than currently, while many wealthier towns would receive no aid at all. The plan would be implemented over six years to give towns time to adjust.

Rhode Island

Total general revenues collected in the Ocean State during the first eight months of FY05 were up 5.3 percent compared with the same period one year earlier. Correcting for anomalies, actual growth was perhaps greater. The state received several one-time payments in FY04 that inflated revenues in that year. These include payments made by Blue Cross/Blue Shield of Rhode Island for a contractually obligated settlement and a payment from the Procaccianti Group to retire outstanding debt owed to the Rhode Island Depositors Economic Protection Corporation. In addition, complications associated with the new sales and use tax affect year-over-year comparisons. Adjusting for these and other small differences increases total revenue growth to roughly 7.6 percent for the first two-thirds of FY05 compared with the same period in FY04.

Collections from the personal income tax, the state's largest revenue generator, were up 6.8 percent, while receipts from the state's next largest revenue generator, the sales and use tax, increased 4.0 percent. This 4.0 percent is artificially high, however. Because of the administrative complexity of implementing a new meals and beverage tax, sales and use tax collections for July 2003 through February 2004 were underestimated by more than \$7 million. After adjustment for this discrepancy, sales and use tax collections for July 2004 through February 2005 were up only 2.6 percent on a year-over-year basis. Growth in general business tax collections, up over 65 percent, was also inflated, although for different reasons. FY04 collections were artificially low



because refunds recorded in FY04 should have been allocated to FY03; at the same time, collections for FY05 were artificially high because a tax credit recapture allocated to FY05 should have been assigned to FY04. Taking into account these adjustments, growth in receipts of business taxes was 20.3 percent.

At the end of January, Governor Donald Carcieri proposed a \$6.3 billion budget for FY06. The budget includes a spending increase of 2.9 percent over the revised FY05 budget. General revenue expenditures are budgeted to increase by \$106 million, or 3.6 percent, over FY05. This \$106 million includes nearly \$50 million, or 3.0 percent more than current funding, to the Department of Human Services to help offset Medicaid increases and just over \$42 million, 4.3 percent more, to the Department of Elementary and Secondary Education for education aid, teacher retirement, and school construction aid.

The budget proposal anticipates revenue increases in FY06. The largest source of general revenues, the personal income tax, is projected to generate \$999.3 million in FY06. This is above predictions made in November 2004. Sales tax collections are forecast to expand more slowly, eclipsing FY05 levels by \$1.9 million, or 0.2 percent. In contrast, a steep decline, \$11.4 million, or 8.3 percent, is anticipated in cigarette tax collections. This drop is attributed to previous tax increases, which caused cigarette purchases in Rhode Island to decline.

Vermont

Total general revenues collected in Vermont through the first two-thirds of FY05 were 6.5 percent higher than in the first two-thirds of FY04. Collections from the state's biggest revenue generator, the personal income tax, increased 8.6 percent. Although sales tax collections declined 17.0 percent, this precipitous drop reflected legislative changes.⁷ Taking these changes into account, total sales tax receipts grew by 3.8 percent. This growth puts sales and use tax receipts slightly above targeted levels.

Governor Jim Douglas forwarded his budget recommendations in January. Total expenditures across all funds would increase only 2.5 percent in FY06. General fund expenditures would increase 1.4 percent, and education fund expenditures, 5.8 percent, while transportation outlays would decline 0.5 percent. The official government revenue forecast enacted on January 14 anticipates an increase of \$46.8 million, or 4.8 percent, in general fund revenues, an increase of \$3.9 million, or 2.6 percent, in education fund revenues,⁸ and a decline of \$1.0 million, or 0.5 percent, in revenues to the transportation fund.

Vermont's budget continues to struggle under the growing weight of the state's Medicaid deficit. This deficit is anticipated to be more than \$61 million, or 9.1 percent of total Medicaid costs, at the end of FY06; almost \$285 million, or more than 36 percent of Medicaid costs, at the end of FY07; and nearly \$600 million, or 65 percent of Medicaid costs, by the end of FY2010.⁹ The deficit is driven by several factors. First, Vermont has a generous Medicaid program, which has increased enrollments. Second, the state has more intensive Medicaid utilization per participant compared with other states. Third, inflation and the growing cost of medical services have increased program outlays. Fourth, the federal government's share of support for the program has declined as a result of growth in Vermont's per capita personal income relative to the national average.

In order to meet the Medicaid budget challenge, Governor Douglas has lobbied the federal Centers for Medicare and Medicaid Services for block grant funding. This funding formula, also known as a "global commitment," would force the federal government to provide the state with a set amount of Medicaid funds annually, as opposed to the current funding method whereby federal government matches state outlays at a percentage determined by Vermont's relative per capita income. Another option, advocated by Southern Vermonters for Fair Economy and Environmental Protection, would be to increase the personal income tax rate and the corporate income tax rate to address the state's Medicaid dilemma.

Despite the looming Medicaid budget issue, some key areas would still receive spending increases in the Governor's budget. Education funds would grow, with the University of Vermont, the Vermont State College system, and the Vermont Student Assistance Corporation each receiving 3 percent increases. One of the largest budget items in the FY06 budget is a \$10 million increase in the transfer from the general fund to the education fund for K-12 education costs. The budget also offers an extension of the property tax relief offered under Act 68. Beyond the 5 cent reduction per \$100 valuation for property taxes given in FY05, the new budget includes an additional 3 cent reduction for FY06.

¹The slight growth for New Hampshire is attributable in part to one-time revenue gains in FY04 and the receipt of additional federal funds in that year. See the New Hampshire section for details.

²Vermont's decline is more apparent than real, resulting from recent legislative action. See the Vermont section for a fuller discussion.

³For more detail on Medicaid financing arrangements, see Hargroves and Tannenwald, "New England Has Relied Heavily on Vulnerable Medicaid Financing Arrangements," Federal Reserve Bank of Boston, *Fiscal Facts*, Winter 1996.

⁴For a more detailed discussion of LD1 provisions, see: <http://www.maine.gov/governor/baldacci/issues/taxes/Summary%20of%20LD%201.doc>

continued on page 12



⁵Capitalization occurs when the government or a business converts a future revenue stream into capital that can currently be used. Revenue bonding is a common form of capitalization.

⁶<http://www.dor.state.ma.us/pressreleases/2005/march05revenues.htm>

⁷Due to Act 68. For a fuller description, see Turner, "Across the Region: Six State Review," Federal Reserve Bank of Boston, *Fiscal Facts*, Winter 2004/2005.

⁸This represents only non-property-tax revenues, which in FY05 made up 13 percent of the total education fund. Property taxes accounted for 64 percent; the transfer from the general fund, 22 percent; and other sources, 1 percent.

⁹Medicaid projections from "Saving Medicaid: The Douglas Administration's Plan for Saving the Vermont Medicaid System," prepared by the Office of the Secretary of Administration and the Office of the Secretary of Human Services. <http://www.ovha.state.vt.us/docs/savingmedicaid.pdf>.

State and Local Employees, continued from page 6.

ability of private sector providers of services may also help to explain the region's small per capita state and local work force and low ratio of public payroll to personal income. It is likely that the New England states allocate relatively smaller shares of their state and local public outlays to institutions of higher education and health in part because the region has relatively more extensive networks of private colleges, universities, and hospitals.⁵

¹ Most notably, 3,000 Connecticut state employees received layoff notices in December 2002.

²In 1992, New England state governments employed 32,764 full-time equivalents (FTEs) in the hospital sector. By 2001, this number had decreased to 22,285. This represents a decrease of 32 percent largely attributable to the closure of many state-run mental hospitals in the 1990s. Over the same period, local governments increased the number of FTEs employed in the Education sector by 29 percent. This change coincides with an increase in the school age population (5- to 17-year-olds) from 16 percent of the total population in 1992 to 18 percent in 2001.

³Full-time equivalent employment is a computed statistic that represents the number of full-time employees that could have been employed if the reported number of hours worked by part-time employees had been worked by full-time employees. This statistic is calculated by dividing the "part-time hours paid" by the standard number of hours for full-time employees in the particular government and then adding the resulting quotient to the number of full-time employees.

⁴Average annual salary is estimated by multiplying average monthly salary in March 2003 by 12.

⁵For a more detailed discussion of the region's mix of public services, see Tannenwald 1990.

References

U.S. Census Bureau. State and Local Government Employment and Payroll Data. <http://www.census.gov/govs/www/apestl.html>

Clayton-Matthews, Alan, Yolanda K. Kodrzycki, and Daniel Swaine. 1994. "Indexes of Economic Indicators: What Can They Tell Us about the New England Economy?" *New England Economic Review*, November/December 1994, pp. 17-41.

Tannenwald, Robert. 1990. "Taking Charge: Should New England Increase Its Reliance on User Charges?" *New England Economic Review*, January 1990, pp. 56-74.

NOTE: This is the last issue of *Fiscal Facts*. The New England Public Policy Center, at the Federal Reserve Bank of Boston, will resume reporting on fiscal developments and conditions in New England after a comprehensive redesign of existing publications. Thank you for your helpful comments and insights over the years.

Robert Tannenwald
Editor

Editors

Robert Tannenwald
E. Matthew Quigley
Nick Turner

Designer

Heidi Furse

State Budget Timetables

Annual Budgets

Massachusetts
Rhode Island
Vermont
FY05: July 1, 2004
to June 30, 2005
FY06: July 1, 2005
to June 30, 2006

Biennial Budgets

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

The views expressed in this publication do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System.



New England Fiscal Facts

Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston MA 02100

Change Service Requested

PRSRT STD
U.S. Postage
Paid
Danvers, MA
Permit No. 355