New England
Fiscal Facts

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

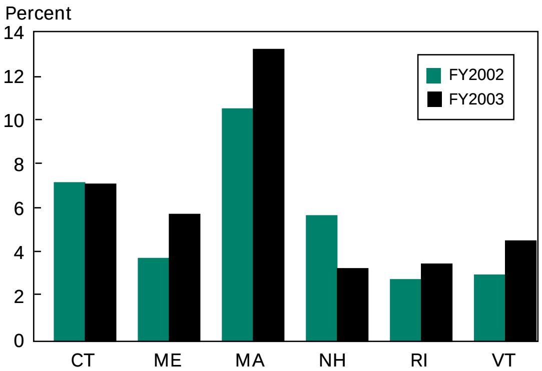
By E. Matthew Quigley, with Amanda Lydon

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.

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.

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.

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.

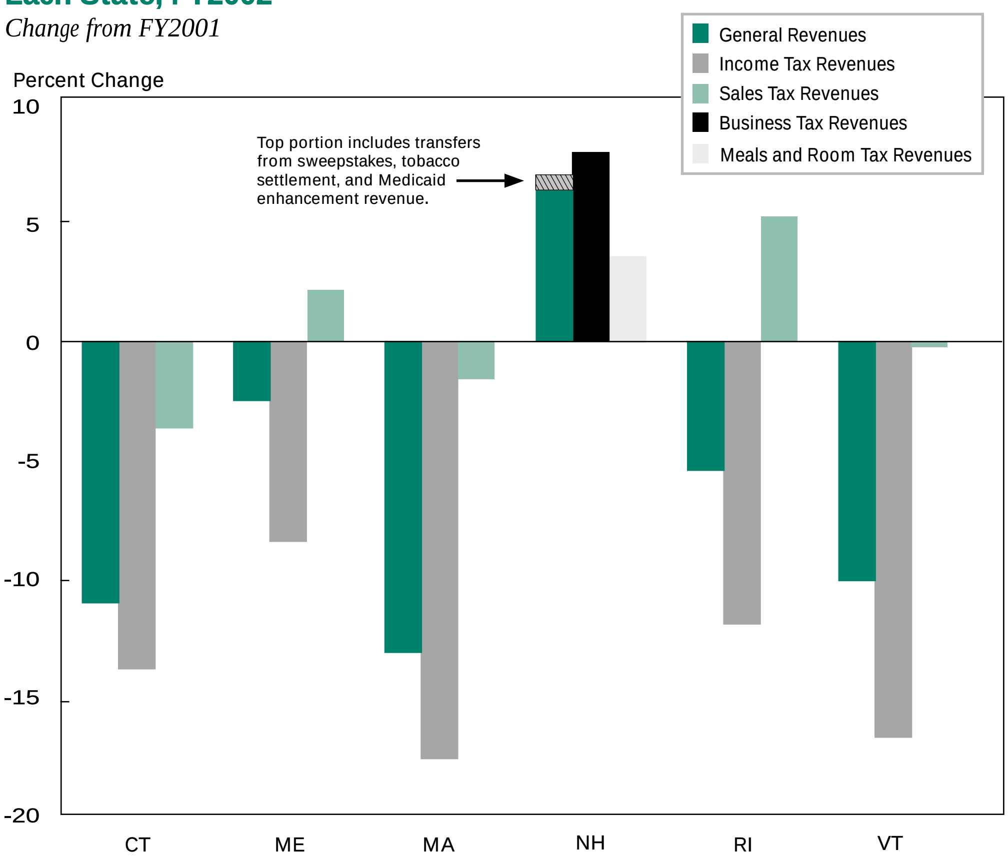
Spending

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).

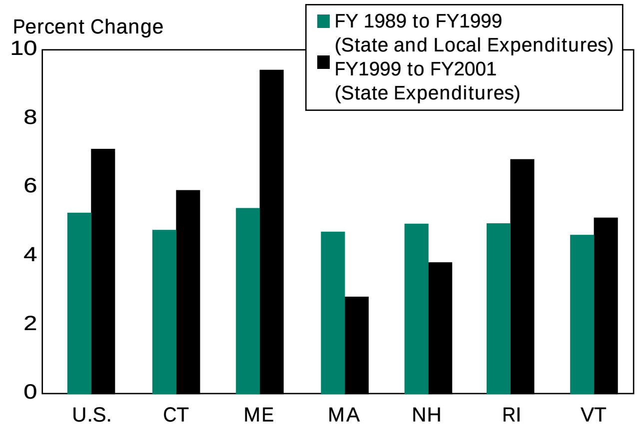
While it is possible that rapid growth in Maine's state outlays offset sluggish growth in local spending, indirect evidence from the state's Department of Revenue Services suggests otherwise. Growth in local revenue is a good proxy for growth in local spending. Maine's two primary sources of local revenue, 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

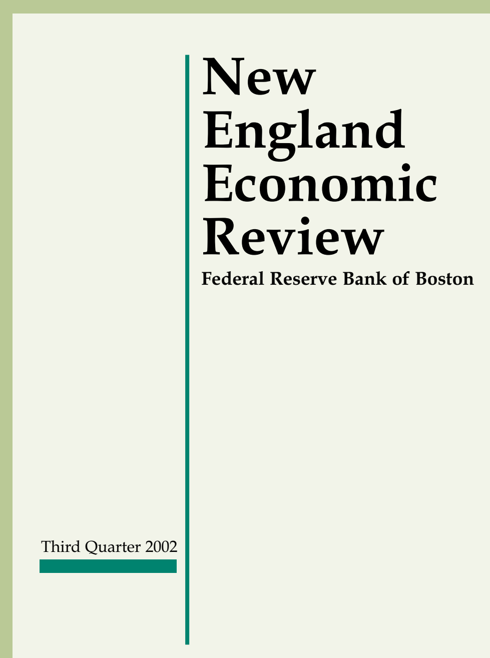
While the economic recovery remains stalled in New England, budget crises are likely to continue. Revenues in five of the six New England states (excluding New Hampshire) were down in FY2002 and may continue to fall below year-ago levels in FY2003. Spending pressures from the rising costs of health care (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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