New England

Fiscal Facts

Federal Reserve Bank of Boston · Fall 1994

The Rising Cost of Operating State Prisons

State governments in most regions of the country have sharply increased corrections spending in recent years in order to cope with escalating prison populations (Chart 1). The growing number of inmates is attributable both to an increasing number of arrests, especially due to drugs, and judges' rising propensity to incarcerate convicted felons. Prison populations will likely expand rapidly for several more years, because state legislators, sensitive to the public's growing concern about violent crime, are lengthening prison sentences and reducing opportunities for parole. Corrections budgets (outlays for operating prisons) are apt to grow accordingly.

New England Trends

Since fiscal year 1990 (FY90), every state except Maine has increased inflation-adjusted ("real") outlays for corrections by over 20 percent (Chart 2). Connecticut's real spending for corrections has almost doubled, while New Hampshire's has increased by 50 percent. Yet, all five of these states have permitted little or no growth in real state spending as a whole. Maine has reduced real corrections spending and real total spending by 6 and 8 percent, respectively.

Within the region, the rate of growth in corrections spending has been strongly

Chart 1

New England Corrections Spending Outpaces Other Regions

Change in State Spending for Corrections, FY90 to FY93 (1993 Dollars)

Note: Corrections spending does not include capital spending for prison construction. In Charts 1 to 4, numbers for FY90 to FY94 are adjusted for inflation using the CPI-U for Boston; FY95 numbers are based on projections of the Boston CPI-U by the New England Economic Project.
Source: New England official budget documents, conversations with state budget and corrections officials; National Association of State Budget Officers, *1992 State Expenditure Report* and *1993 State Expenditure Report*.

New England Fiscal Facts

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The views expressed in this publication do not necessarily reflect official positions of the Federal Reserve Bank of Boston or the Federal Reserve System. This publication is available without charge. We welcome your ideas and comments; contact Jeannette Hargroves at 617/973-3096. Send requests to be placed on our mailing list to Federal Reserve Bank of Boston, T-8, Attn: *Fiscal Facts*, P.O. Box 2076, Boston, MA 02106-2076.

State Budget Timetable

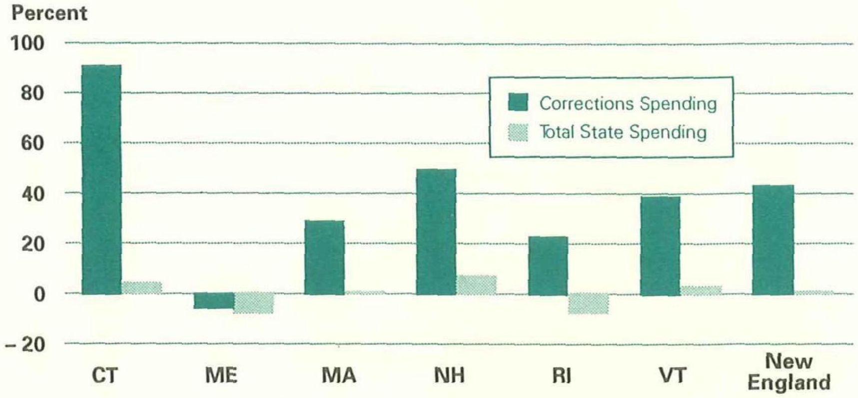
Annual Budgets
Massachusetts
Rhode Island
Vermont
FY94: July 1, 1993 to June 30, 1994
FY95: July 1, 1994 to June 30, 1995

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

Chart 2

Corrections Spending Growth Is Striking Relative to Total State Budgets

Change in State Spending for Corrections and Total Spending, FY90 to FY95 (1993 Dollars)



Note: Percent change based on FY90 spending and FY95 appropriations. Total state spending includes general and transportation funds, but does not include federal grants. Rhode Island figures are based on expenditures from general revenue. Spending for corrections does not include capital spending for prison construction.
Source: Official budget documents, conversations with state budget and corrections officials.

correlated with the rate of growth in the prison population (Chart 3).[1] Between 1988 and 1993, Connecticut and New Hampshire ranked first and fourth, respectively, among the 50 states in prison population growth. By contrast, the inmate population of Maine grew less than one-sixth as rapidly as Connecticut's and has been declining since FY92.

Although each New England state currently gives corrections a higher priority than it did five years ago, the region's corrections departments, like other fiscally strapped state agencies, have attempted to restrain spending growth. For example, Maine's Department of Corrections has cut staff, reduced or eliminated programs, postponed cost-of-living and merit increases, and shortened the workweek of some personnel. Massachusetts has increased its prison personnel by less than 2 percent. In addition, most states in the region, as well as in the rest of the nation, privatized some prison services, such as health care, food, and transportation. Connecticut is evaluating the operation of prisons run entirely by private contractors. A few such prisons already exist in the South.

Prospects for FY95 and Beyond

In FY95, three New England states will continue to expand significantly the share of their budgets allocated to corrections, while three will not (Chart 4). Connecticut, New Hampshire, and Vermont will expand real corrections outlays by 8 to 14 percent, while increasing total real spending by only 1 to 3 percent. Vermont's large planned increase in corrections spending partially reflects the opening of a new prison in April 1994, the state's first in the 1990s. Maine and Massachusetts, by contrast, have appropriated small real increases in corrections spending that are roughly proportionate to their planned increases in spending as a whole. Rhode Island plans an inflation-adjusted decrease in corrections spending while barely increasing real total spending.

Beyond the current fiscal year, most of the region's states are looking for innovative ways to cut costs and relieve prison crowding. One option is alternative sentencing programs for nonviolent first-time offenders, particularly juveniles, which include home confinement, intensive probation, community halfway houses, and boot camps. Although these alternatives could realize long-term savings, their start-up costs could be high. One Maine corrections official refers to these costs as a necessary "bridge loan," since a state cannot shut down one institution until other alternatives are fully operational. The prospect of incurring these start-up costs has caused several states, including Maine and Rhode Island, to postpone implementation of alternative sentencing programs.

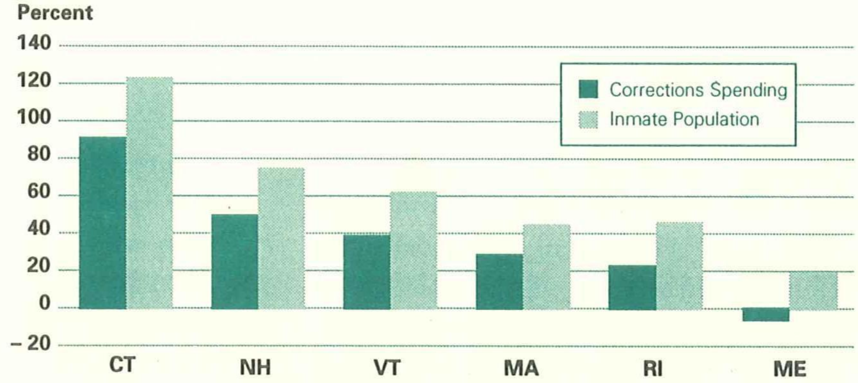
Although alternative sentencing might achieve long-run savings, they might be offset by the costs of President Clinton's "Three Strikes, You're Out" proposal. This proposal calls for persons convicted of three violent felonies to be given lifelong prison sentences with no possibility of parole. In FY94 "Three Strikes" bills were introduced in several New England legislatures, but none passed.

Since such legislation would add time to those sentenced in 1995 and beyond, it is not likely to affect state budgets in the short term. It could be costly over the long term, if only because of the need to provide health care to an aging prison population. Attaching a price tag is difficult, however. A number of the third-time felons incarcerated in a state have incurred their first or second convictions in another state. Moreover, the extent to which the policy would deter criminal behavior is uncertain. ▾

Chart 3

Rising Corrections Costs Closely Related to Growing Inmate Population

Change in State Spending for Corrections, FY90 to FY95 (1993 Dollars) and Inmate Population, 1988 to 1993

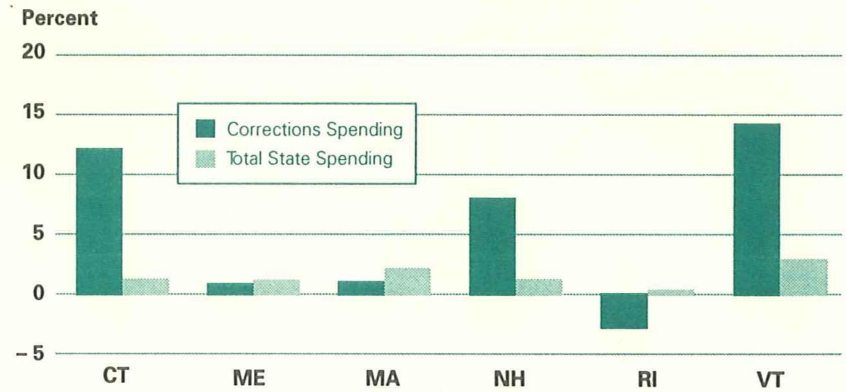


Note: Percent change in corrections spending based on FY90 spending and FY95 appropriations. Corrections spending does not include capital spending for prison construction. Inmates are defined as prisoners with sentences of more than one year.
Source: Official budget documents, conversations with state budget and corrections officials; U.S. Department of Justice; *Bureau of Justice Statistics Bulletin*, June 1994.

Chart 4

This Year's Corrections Spending Outpaces Total Spending in Three States

Change in State Spending for Corrections and Total Spending, FY94 to FY95 (1993 Dollars)



Note: Percent change based on FY94 estimated expenditure and FY95 appropriations.
Source: Official budget documents, conversations with state budget and corrections officials; Table 1.

[1] The most recent year for which complete state-by-state data on inmate populations is available is 1993. The correlation demonstrated in Chart 3 suggests that state corrections spending responds to growth in inmate population with a lag.

Across *the* Region

All the New England states ended fiscal year 1994 (FY94) in decent fiscal shape. Vermont erased a cumulative deficit that it had been carrying on its books since FY91. Mildly encouraged by the region's economic recovery, states anticipate enough revenue growth during FY95 to support spending increases ranging from 3 to 6 percent (Table 1). Aid to local schools will receive a disproportionately large share of the increases.

Welfare and school funding continued to be a top priority in recent months. Vermont passed welfare reform legislation; Maine created a small pilot four-year welfare and work program. Massachusetts and Rhode Island governors vetoed welfare bills with the intent of developing new reform plans more to their liking this fall. Four states debated new educational finance options; none, however, passed legislation.

Most of the region's states are taking steps to enhance their business climate. New Hampshire and Connecticut passed legislation to ease the cost of workers' compensation. Connecticut, Maine, and Rhode Island enacted new business tax credits. Vermont's Governor Howard Dean has proposed a reduction in the state's income tax rate, and New Hampshire's Governor Stephen Merrill hopes to lower the tax rate on business profits.

Table 1

Total State Spending for FY94 and Appropriations for FY95,[a] excluding Federal Dollars

Millions of Dollars

	FY94	FY95	% Change
CT	7,163	7,464	4.2
ME	1,803	1,878	4.2
MA	12,785	13,441	5.1
NH[b]	1,152	1,201	4.2
RI[c]	2,341	2,419	3.3
VT	787	834	5.9

[a] Unless otherwise noted, includes general fund and transportation fund appropriations only. Excludes expenditure of federal grants and reimbursements.
[b] Includes budgeted income from sweepstakes earmarked for foundation aid and special education.
[c] Includes general revenue and other funds.
Source: Official budget documents, state financial statements, and conversations with budget officials.

Six-State Review

Connecticut

Connecticut's fiscal position strengthened over the last half of FY94. At mid year, it appeared that the state would have to dip into its $113 million surplus from FY93 to balance its FY94 budget. (See *Fiscal Facts*, Winter 1994.) However, since January, receipts from all three major state taxes (personal income, sales, and corporate profits) have grown faster than expected. Receipts from the corporate profits tax have been especially high, exceeding official projections by almost 13 percent. As a result, the state carried over into FY95 a surplus of $136 million to help balance its FY95 budget of $9.1 billion.[1]

FY95 appropriations include $148 million in supplemental spending enacted in May. Over one-half of this additional funding is earmarked for Medicaid, while the bulk of the remainder is spread among the Department of Children and Families, general assistance, and the Department of Corrections. Governor Lowell Weicker's new program, "Youth Initiative," targeting urban youth, will receive $14 million, less than half the amount he had requested.

In June, Connecticut enacted a package of business tax incentives to be phased in over the next eight years. The incentive resulting in the greatest loss in revenue is a credit against the corporate and personal income tax for the purchase of computers and data processing equipment. The annual revenue forgone as a result of this package is projected to equal $259 million by the year 2000. This estimate does not take into account revenue gains that the tax incentives might generate by stimulating the state's economy.

Connecticut could lose $150 million in FY95 federal Medicaid grants, because hospitals in the state changed the way they cover the cost of caring for uninsured patients who have no other means of paying their bills ("uncompensated care"). Until recently, hospitals covered these costs by placing a surcharge on bills for services rendered. In effect, the hospitals took money from the insured to cover the costs of caring for the uninsured. An employee welfare fund providing health insurance successfully sued the state in federal court on the grounds that, by increasing employees' health insurance premiums, payment of the surcharge violated the Employment Retirement Income Security Act (ERISA). In response, the state replaced the surcharge with a tax on hospital bills. Proceeds from the tax are now used to reimburse hospitals for the costs of providing uncompensated care. Federal officials, however, may rule that this new arrangement violates federal regulations limiting the use of tax-and-reimbursement schemes to elicit federal matching Medicaid grants. Furthermore, in late July the Connecticut Hospital Association sued the state on the grounds that the new arrangement still violates ERISA.

[1] The FY95 state budget figure cited here includes federal grants and reimbursements. The FY95 state budget figure in Table 1 does not. See the notes on the table for further clarification.

Maine

Maine ended FY94 comfortably in the black, thanks largely to a surge in corporate income tax revenues produced by audits of two large companies. General revenues exceeded their budget target by almost 2 percent. Receipts from each of the state's two largest revenue sources—the sales tax and the personal income tax—were almost exactly as projected.

In March, after raising its revenue projections for FY95, the state appropriated an additional $15 million for that fiscal year. Almost half of this supplemental spending is earmarked for state aid to local schools. Even with this supplement, total FY95 school aid will exceed its estimated FY94 level by only 0.5 percent. Total FY95 appropriations currently exceed total FY94 spending by 4.2 percent.

Like other New England states, in recent months Maine has addressed the three long-run issues of welfare reform, school finance, and business climate. In April, the legislature enacted a pilot welfare reform program—"Project Opportunity." The four-year program will require 500 welfare recipients in test areas around Bangor and Portland to work or receive job-related training for at least 20 hours per week. Participating employers will be eligible for subsidies worth up to $3,780 per recipient over 18 months. The subsidies will eventually be replaced by training vouchers issued to participating welfare recipients.

With respect to school finance reform, the legislature continued to study alternatives to the state's traditional formula for distributing aid to school districts. For FY95 only, the legislature has decided to use a modified formula —the "60/40" plan. School districts slated for increases in aid under the traditional formula will receive only 60 percent of their increase, while those slated for decreases will incur only 40 percent of their decrease.

Maine has taken several steps to improve its business climate. It has relaxed conditions of eligibility for its investment tax credit and increased the maximum credit that businesses can claim. When these incentives are fully effective, the resulting revenue loss is projected at $4.5 million per year. The state has enacted an additional tax credit for investment by paper companies in pollution control equipment. It has also lifted its cap on credit card interest rates in hopes of luring financial firms to Maine.

This spring, the legislature rejected Governor McKernan's proposal to freeze state income tax collections at current levels and to use future surpluses to cut income tax rates. (See *Fiscal Facts*, Spring 1994.)

Massachusetts

Massachusetts ended FY94 in the black, even though its revenues fell about $90 million short of its latest official forecast. (The forecast level was raised over the course of the fiscal year.) Nearly half of the shortfall was the result of an unanticipated court-mandated refund to an individual tax filer. The rest was attributable to lower-than-anticipated sales tax receipts last winter (possibly depressed by bad weather) and disappointing income tax receipts this spring. Income tax revenues came up short because revenue officials overestimated tax payments accompanying 1993 tax returns. Tax witholdings, however, exceeded expectations.

In mid-July Governor William Weld signed into law a $16.3 billion spending plan for FY95, 4 percent higher than actual FY94 spending. Although lawmakers level-funded most programs, they increased state aid for local education by $219 million, thereby honoring commitments made last fiscal year.

The FY95 budget assumes no new taxes or revenues from new gambling initiatives. It increases the personal income tax exemption for single filers from $2,200 to $3,400 if they have dependents, a tax cut that will reduce FY95 revenues by an estimated $18 million in FY95.

Reform of Aid to Families with Dependent Children (AFDC) was the most controversial issue addressed in this year's budget debate. Governor Weld and the legislature disagreed on the extent to which AFDC benefits should be pared. The legislature enacted a budget in early July that included (1) a $90-a-month cut in benefits after two years for "able-bodied" welfare recipients whose children have reached school age; (2) benefit cuts if recipients refuse to sign up for training, education, or state-subsidized employment; (3) a cap on welfare benefits for recipients who have children while on welfare; and (4) a requirement that teenage welfare recipients live at home or in state-run homes. The governor, by contrast, has proposed more extensive benefit reductions. For example, he advocates termination of AFDC cash grants to able-bodied recipients after 60 days, at which time they would have to find work in order to retain health care and day care benefits.

Although the governor signed the FY95 budget, he vetoed the welfare reform proposal embedded in the budget and authorized enough AFDC funding for only eight months of FY95. In mid-summer, the Massachusetts House overrode Governor Weld's veto and restored AFDC funding for the whole fiscal year; however, the Senate failed to override his veto. The Governor hopes to create a reform bill more to his liking this fall.

New Hampshire

New Hampshire finished FY94 in the black, thanks in part to a mid-year windfall of $130 million in federal aid. Approximately $28 million of this windfall was given to the state's Welfare Department to cover $11 million in cost overruns in FY94 and to hedge against likely cost overruns in FY95. The remaining $102 million was earmarked for a Health Transition Fund, which will finance expansion of health insurance coverage for an estimated 50,000 low-income residents over the next six years.

New Hampshire generated this additional federal assistance by increasing the value it placed on the services rendered to Medicaid patients by its publicly funded mental health hospital (New Hampshire Hospital). Under a federally approved plan, the state increased the value it placed on these services by $260 million. The hospital's actual expenditures, however, did not increase. The increase in valuation of services rendered triggered a 50 percent federal matching grant of $130 million. Starting October 1, new federal regulations will prevent all states from attaching a value on Medicaid services higher than the actual cost of providing them.

Without additional reimbursements to the state mental health hospital, New Hampshire's total general fund revenues would have increased by nearly 8 percent from FY93 to FY94, almost exactly what budget forecasters had anticipated. Receipts from specific revenue sources, however, deviated significantly from their projected levels. Combined revenues from the business profits tax and the business enterprise tax, which together accounted for about one-eighth of all general revenues, were almost 7 percent below budget. By contrast, revenues from the meals and rooms tax, about 18 percent of general revenues, came in more than 5 percent higher than expected, thanks to a strong winter tourist season.

School finance reform is perhaps the most salient fiscal issue currently confronting New Hampshire. This winter, the New Hampshire Supreme Court ruled that the state's failure to give property-poor school districts the means to provide their students with an adequate education violates the state constitution. (See *Fiscal Facts*, Spring 1994.) This spring, the legislature enacted a bill that would address this inadequacy by almost doubling the level of school aid, thereby helping all school districts. Governor Stephen Merrill vetoed the bill, expressing concern that such a sharp increase in state outlays would require higher state taxes. In July, Governor Merrill proposed, in effect, that a larger share of school aid should go to poor school districts. The governor also suggested that $17.5 million be appropriated for assistance to kindergarten programs.

Over the past few months, Governor Merrill has taken several steps to enhance New Hampshire's business climate. He signed a bill that cuts workers' compensation costs by 19 percent in the short term and proposed a reduction in the business profits tax rate from 7.5 percent to 6.75 percent. The Governor would eliminate several business tax credits in order to compensate for the resulting loss in revenue, estimated at $4 million for FY95.

Rhode Island

As recently as January, Rhode Island officials were predicting that the state would end FY94 in the red. Yet, the state managed to post a $6 million surplus for the year, due largely to a second-half surge in revenues from video gaming, the bank tax, and the corporate profits tax. Revenue growth is expected to maintain its momentum into FY95.

Nevertheless, Rhode Island plans to keep a tight rein on spending this fiscal year. Its FY95 budget authorizes $2.4 billion, an increase of only 3 percent over FY94 outlays. The state has authorized only small spending increases in other recent years as well, although mid-year supplementary appropriations have been common.

The FY95 budget increases school aid by 12 percent over last year's level. Most of the new aid is targeted on low-income children, in response to a Superior Court ruling in February declaring Rhode Island's system of financing education unconstitutional because it discriminates against poor school districts. In part to help finance the increased school aid, the state is removing single adults from the general public assistance rolls, saving an estimated $2 million. However, $750,000 will be set aside to continue payments in cases of extreme hardship.

A plan to address the long-run requirements of the Superior Court ruling, the Guaranteed Student Entitlement bill, was tabled by the General Assembly this spring. The plan would have dramatically increased the importance of state aid in local school finance. (See *Fiscal Facts*, Spring 1994.) A legislative task force continues to study other proposals to reform school finance. The state Senate has appealed the Superior Court's ruling in order to buy time for the legislature to devise a new system that would satisfy the court. Meanwhile, voters will be presented this November with a nonbinding referendum on whether they want a reduction in the property taxes used to finance education.

Rhode Island has continued to enact business tax incentives. (See *Fiscal Facts*, Winter 1994.) One recently enacted incentive, targeted on financial firms and patterned on a Delaware law, exempts from taxation investment income earned through the management of investment portfolios in Rhode Island. A second reduces a company's corporate profits tax for creating new jobs in Rhode Island.

Rhode Island has also addressed the issue of welfare reform. In July, the legislature enacted a bill providing for subsidies to employers hiring welfare recipients and encouraging AFDC recipients to establish small businesses; however, the bill was vetoed by the Governor.

Vermont

Vermont finished FY94 in the black, ending four years of deficit financing. The state used a general fund operating surplus of $26 million and a transfer of $21 million from its transportation fund to erase the $46 million general fund deficit carried over from FY93 and to place $1 million in its stabilization reserve fund. At its peak in FY91, the cumulative deficit in the state's general fund was $65 million, over 10 percent of its general appropriations.

Tight spending controls helped Vermont balance its books; its revenues grew by less than 4 percent from FY93 to FY94. Much of this growth was attributable to a 36 percent increase in corporate income tax revenues and a one-time gain in estate tax revenues. Revenues from the personal income and sales taxes were practically flat. Receipts from the meals and rooms tax dropped by over 7 percent.

Vermont has responded to its disappointing overall revenue performance by postponing scheduled tax reductions and taking steps intended to improve the state's business climate, hoping thereby to enhance revenues in the long run. The rooms and meals tax rate remains at 7 percent, although a 1 percentage point reduction had been scheduled for July 1. Budget officials doubt that the legislature will reduce the sales tax rate from 5 percent to 4 percent in FY96 as planned.

In attempting to improve Vermont's business climate, the legislature passed a law designed to stabilize workers' compensation costs. The state has also taken steps to simplify and speed up the environmental permitting process (proposals for more extensive reform of the process were tabled). As a further means of attracting business to the state, Governor Howard Dean has proposed a reduction in the state's income tax rate from 25 to 24 percent of federal tax liability, effective January 1996. In addition, the governor would provide an additional $100 tax credit for those with incomes of less than $15,000. The tax cut is expected to cost the state roughly $15 million in FY96.

Vermont's FY95 budget calls for a 6 percent increase in spending. The budget provides modest increases to most programs but increases the property tax rebates for low-income homeowners by 41 percent. Lawmakers debated proposed reforms for school finance reform and comprehensive health care this spring but did not pass any legislation addressing these issues. Discussions will likely resume next year. ▼

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