

# Policy Brief

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## The fiscal capacity of New England

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The economic downturn of 2001 presented policymakers with broad fiscal challenges. Amid declining revenues across myriad tax bases, states faced rising demand for public services, higher Medicaid costs, and heightened security concerns. Across the nation, state and local officials struggled to balance budgets—in New England, deficits for fiscal year 2002 (FY 2002) ranged from 2.7 percent of total expenditures in Rhode Island to 10.1 percent in Massachusetts.<sup>1</sup>

Short-term revenue shocks and spending pressures require state and local governments to make difficult decisions about taxation and spending policies. The severity of the tradeoffs inherent in such fiscal dilemmas depends upon a state's underlying *revenue capacity* and *expenditure need*.

Revenue capacity measures the resources available to a state and its local governments to finance public services. Expenditure need assesses the extent to which state and local governments face conditions that raise or lower the cost of and need for public services. *Fiscal capacity* measures each state's revenue capacity relative to its expenditure need, gauging a state's ability to pay for a given level of public services.

Overall, the New England states are on sound long-term fiscal footing relative to other states across the nation; they tend to have higher levels of revenue capacity and lower levels of expenditure need than the national average, resulting in comfortable levels of fiscal capacity. This conclusion holds despite the short-term budgetary stresses that many New England states are currently experiencing.

The relative fiscal capacity

of states is the subject of a recent working paper published jointly by the New England Public Policy Center at the Federal Reserve Bank of Boston and the Urban-Brookings Tax Policy Center. Using the methodology of the Representative Revenue System (RRS) and the Representative Expenditure System (RES) for FY 2002, the paper establishes a measure of revenue capacity and expenditure need for each of the 50 states and their local governments. Because different states assign taxing authority and expenditure responsibilities to differing levels of government, it is necessary to aggregate revenue and expenditure data across all subnational governments—state and local—within each state.

### Revenue capacity and expenditure need

A state with high revenue capacity is rich in the economic stocks and flows that state and local governments traditionally tax. For example, states with a large tourist industry generally enjoy high retail sales per capita and, therefore, a high sales tax capacity, while states rich in extractable minerals have a high severance tax capacity.

Similarly, a state may possess characteristics that, through no fault of its own, compel it to provide a wide array of public services or spend a large amount to provide a given per capita service level. Such a state would have a high expenditure need. For instance,

Fiscal capacity gauges a state's ability to pay for needed public services

## The Representative Revenue System (RRS) and Representative Expenditure System (RES)

The RRS and RES methodologies are complex and data intensive. Readers interested in reviewing the complete methodology, with a step-by-step walkthrough, and the strengths, limitations, and caveats to this research are advised to read NEPPC Working Paper 06-2.

The RRS estimates the revenues that a state and its local governments would raise if they adopted representative revenue policies reflecting the average tax rates and fees of the nation as a whole. For each potential revenue source, national and state-level bases—devoid of exemptions, deductions, and tax credits—are estimated, and a nationally representative (effective) tax rate is obtained by comparing actual revenues to the size of the base. Applying this nationally representative rate to each state's revenue bases and totaling across all potential revenue sources yields each state's revenue capacity. This is then adjusted to a per capita basis and indexed to 100, which represents the national average.

Similarly, the RES estimates the amount that each state would spend if it provided public services at a level equivalent to the national average. National expenditure levels are estimated across ten broad spending categories, such as higher education and public welfare. Workload factors—underlying economic and demographic conditions that generate need for public outlays, such as the percentage of people in poverty in each state—are identified for each spending category, and each state's share of the national workload factor is applied to national expenditure levels. The resulting estimate for each state is then calculated on a per capita basis and further adjusted to reflect the cost differentials that exist across the states. Totaling these estimates across all expenditure categories for each state obtains a state's expenditure need, which is then indexed to 100, representing the national average.

states with a large number of children per capita must spend more on education, while those with high levels of poverty must spend more on a wide variety of human services.

Information concerning the calculation of revenue capacity and expenditure need may be found in the accompanying sidebar.

States with high revenue capacities or low expenditure needs tend to have high fiscal capacity, while states with low revenue capacities or high expenditure needs tend to have low fiscal capacity. While low fiscal capacity does not necessarily imply that a state has an unbalanced budget, it generally indicates fiscal vulnerability—high levels of tax effort, low public service levels, or less ability to cope with shocks to its economy.

Revenue capacity, expenditure need, and fiscal capacity estimates for the New England states and the nation are presented in Table 1.

The national average is indexed to 100. The New England states have historically enjoyed high levels of revenue capacity and low levels of expenditure need, and FY 2002 was not an exception.

Connecticut, Massachusetts, and New Hampshire rank among the top five states in terms of underlying ability to raise revenues. New Hampshire and Vermont place in the bottom five states nationwide in terms of expenditure need. Combining the measures, Connecticut, Massachusetts, and New Hampshire have the three highest measures of fiscal capacity in the nation, and Vermont and Rhode Island rank highly as well (14 and 15, respectively).

The outlier within the region is Maine, which has a fiscal capacity equal to the national average. Had Maine adopted nationally representative revenue and expenditure policies in FY 2002, it would have raised 7 percent less revenue per capita than the national average, but, at the same time, would have spent 7 percent less per capita than the national average.

States tend to spend more than the revenue they raise, typically bridging the difference with aid from the federal government and new debt issue. Interestingly, had states adopted nationally representative tax and expenditure policies in FY 2002, three New England states—Connecticut, Massachusetts, and New Hampshire—would have been completely able to pay for all of their expenditures from their own revenue sources.

Even during the economic downturn early in the decade, the overall fiscal capacity of the New England states relative to the rest of the country was quite comfortable. On the revenue side, the region benefits from a wealthy and well-educated population, with ample amounts of income, property, and economic activity to tax. From an expenditure perspective, New Englanders face less of a need for public service provision than the rest of the nation.

### A measure of burden: Revenue and expenditure effort

Policymakers often face inquiries about the level of burden imposed on a state's residents by state revenue and expenditure levels. Numerous rankings of "tax burden" abound. Attempting to limit tax burdens, many states have adopted a variety of fiscal limits, including tax expenditure limitations (TEs) and taxpayer bills of rights (TABORs).<sup>2</sup>

Table 1: New England's fiscal capacity

|               | Per capita revenue capacity | Revenue capacity index | Revenue capacity rank | Per capita expenditure need | Expenditure need index | Expenditure need rank | Fiscal capacity index | Fiscal capacity rank |
|---------------|-----------------------------|------------------------|-----------------------|-----------------------------|------------------------|-----------------------|-----------------------|----------------------|
| United States | \$4,659                     | 100                    |                       | \$6,007                     | 100                    |                       | 100                   |                      |
| Connecticut   | 6,272                       | 135                    | 1                     | 5,772                       | 96                     | 30                    | 141                   | 1                    |
| Maine         | 4,342                       | 93                     | 29                    | 5,593                       | 93                     | 38                    | 100                   | 26                   |
| Massachusetts | 5,994                       | 129                    | 2                     | 5,709                       | 95                     | 34                    | 136                   | 2                    |
| New Hampshire | 5,482                       | 118                    | 5                     | 5,282                       | 88                     | 49                    | 134                   | 3                    |
| Rhode Island  | 4,701                       | 101                    | 19                    | 5,603                       | 93                     | 38                    | 109                   | 15                   |
| Vermont       | 4,662                       | 100                    | 20                    | 5,493                       | 91                     | 46                    | 110                   | 14                   |

Source: NEPPC Working Paper 06-2, 2006.

Note: Measures of capacity are indexed to 100, representing the national average.

By comparing estimates of revenue capacity and expenditure need to actual revenue and expenditure levels, the RRS and RES offer a sophisticated measure of burden, or fiscal effort, which may be disaggregated among many revenue and expenditure categories. States that raise more revenue than their revenue capacity have a high *revenue effort*. Similarly, states that spend more than their expenditure need have a high *expenditure effort*.

Estimates of revenue effort and expenditure effort are benchmarked to national averages, which are not necessarily optimal levels. To characterize above-average estimates as

“excessive” or below-average estimates as “deficient” is misleading. A state’s level of revenue or expenditure effort can only be measured relative to other states or the national average.

Table 2 shows levels of revenue and expenditure effort for the New England states. In general, New England states maintain lower levels of revenue effort and higher levels of expenditure effort than the rest of the nation.

On the revenue side, the New England states generally raise relatively more money from taxes than from other sources of revenue. “Taxachusetts” is an inappropriate nickname for the Bay State, as it actually raises

Table 2: Measures of fiscal effort in New England, FY2002

|                                    | CT         | ME         | MA         | NH        | RI         | VT         |
|------------------------------------|------------|------------|------------|-----------|------------|------------|
| Retail sales                       | 98         | 78         | 66         | 0         | 94         | 41         |
| Personal income                    | 102        | 136        | 126        | 7         | 113        | 99         |
| Corporate income                   | 28         | 87         | 100        | 319       | 32         | 80         |
| Property                           | 135        | 170        | 102        | 142       | 150        | 139        |
| Estate and gift                    | 97         | 79         | 75         | 178       | 82         | 70         |
| <b>Total tax effort</b>            | <b>107</b> | <b>118</b> | <b>94</b>  | <b>76</b> | <b>115</b> | <b>99</b>  |
| Lotteries                          | 57         | 88         | 101        | 176       | 92         | 84         |
| User charges                       | 40         | 81         | 56         | 68        | 57         | 82         |
| <b>Total revenue effort</b>        | <b>87</b>  | <b>112</b> | <b>86</b>  | <b>76</b> | <b>98</b>  | <b>97</b>  |
| Elementary and secondary education | 117        | 118        | 122        | 108       | 122        | 134        |
| Higher education                   | 86         | 98         | 70         | 89        | 80         | 141        |
| Public welfare                     | 139        | 130        | 108        | 138       | 171        | 150        |
| Environment and housing            | 94         | 96         | 102        | 71        | 92         | 97         |
| <b>Total expenditure effort</b>    | <b>121</b> | <b>110</b> | <b>116</b> | <b>94</b> | <b>113</b> | <b>112</b> |

Source: NEPPC Working Paper 06-2, 2006.

Note: Measures of effort are indexed to 100, representing the national average.

14 percent *less* revenue than it would if it adopted nationally representative revenue policies. New Hampshire—while exhibiting extremely low revenue effort on its retail sales and personal income tax bases—demonstrates high levels of tax effort on corporate income, property, and estates and gifts. Maine remains the sole New England state to exert more revenue effort than the national average, raising 12 percent more than its revenue capacity.

Levels of expenditure effort in New England tend to run higher than the national average, as demonstrated by large public commitments to elementary and secondary education and public welfare spending. But many New England states exhibit relatively low levels of expenditure in certain other categories, such as public higher education, environment, and housing.

New Englanders may demand high levels of government services, but their underlying need for public service provision remains quite low, and they tend to be able to better afford the costs of these services relative to the rest of the nation. As a result, the region's state and local governments face relatively less pressure to raise taxes or increase spending in order to achieve a basic level of public services, and constituent preferences may play a larger role in the fiscal decisions that New England policymakers make.

### Endnotes

<sup>1</sup> Quigley, E. Matthew and Amanda Lyon. "Dealing with Deficits: How New England States are Managing the Fiscal Crisis." *New England Fiscal Facts*. Fall 2002. <http://www.bos.frb.org/economic/neff/neff29/index.htm>

<sup>2</sup> For further discussion of tax burden, please see: Nagowski, Matthew. "Measures of State and Local Tax Burden." July 2006. <http://www.bos.frb.org/economic/neppc/memos/2006/nagowski071306.pdf>. For further discussion of TELs and TABORs, please see: Brome, Heather and Darcy Rollins Saas. "Reading the Fine Print: How Details Matter in Tax and Expenditure Limitations." October 2006. <http://www.bos.frb.org/economic/neppc/researchreports/2006/rr0603.htm>

This policy brief is based on *Measuring Fiscal Disparities Across the U.S. States: A Representative Revenue System/Representative Expenditure System Approach, Fiscal Year 2002*, a New England Public Policy Center working paper. The full paper is available at <http://www.bos.frb.org/economic/neppc/wp/2006/neppcwp0602.htm>. To receive a copy of future policy briefs, please contact us at [neppc@bos.frb.org](mailto:neppc@bos.frb.org) or 617-973-4257.

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