

Fiscal Facts

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Are Excise Tax Revenues a Quick Fix?

by Jeannette Hargroves

At the moment, most New England states are in good financial shape. Down the road, however, states may have to consider tax increases to offset impending cuts in federal aid. It's likely they will take an early look at excise taxes. Broad-based taxes, like the personal income tax, the property tax, and the retail sales tax, are hard to raise because they are so visible. People are reminded of them every time they open a paycheck, buy a big-ticket item, or receive a property tax bill. In contrast, excise taxes — levies on unit sales of gasoline, tobacco products, alcoholic beverages, and the like — are less visible and easier to sell. But how lucrative and stable are excises as sources of revenue?

Excises have considerable appeal. Motor fuel tax revenues are generally earmarked for the construction, maintenance, and operation of highways, thus benefiting the drivers who pay the tax. Taxes on "sin" — cigarette smoking and drinking — are acceptable, because they discourage consumption as well as raise revenue.

Countering the appeal of excises are two major disadvantages:

- Excise taxes are generally *in rem*, not *ad valorem*, meaning the excise is based on per unit sales (a gallon of gas or beer, a pack of cigarettes) as opposed to a rate on the dollar value of a commodity sold. As a result, inflation-adjusted revenues tend to erode over time

unless the tax rate is increased periodically.

- Interstate competition limits the extent to which lawmakers can increase the taxes on commodities without encouraging residents to purchase the products in neighboring states at lower prices.

Excise Revenue Trends: 1985 to 1995

The share of total state tax collections from excise taxes has declined in most New England states over the last ten years. This shrinkage is attributable to excise taxes' lack of sensitivity to inflation, changes in patterns of consumption, and, in the case of the tax on motor fuels, sluggish economic growth.

Gasoline Taxes

Motor fuel taxes have generally been the most lucrative of the excises because motor fuel is a large tax base and tax rate increases have been frequent. However, motor fuel taxes are often negatively influenced by business cycles, seasonal demand, hikes in petroleum prices, and improvements in automobile fuel efficiency.

From 1985 to 1995, the New England states have seen real motor fuel tax revenues (adjusted for inflation) grow more rapidly than state tax revenue as a whole. Several factors are responsible. From 1985 to 1988, gas consumption grew even faster than the region's

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**State
Budget
Timetable**

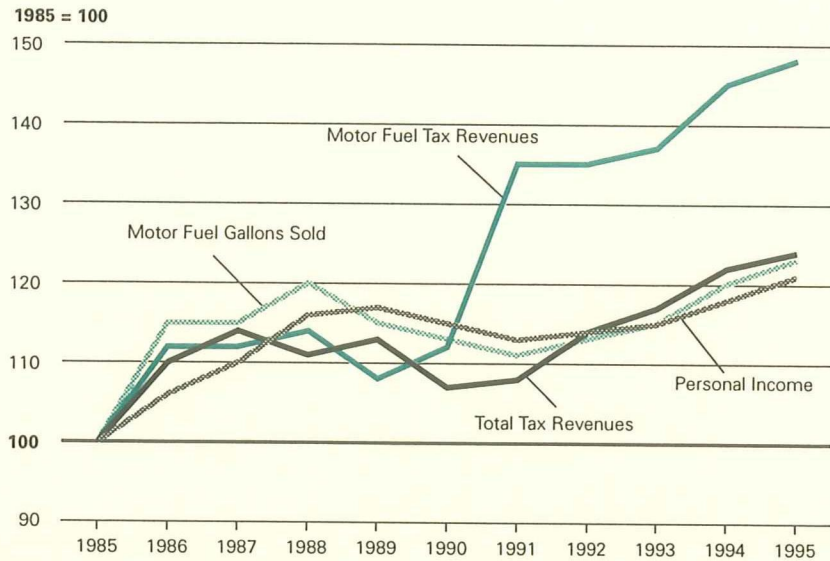
Annual Budgets
Massachusetts
Rhode Island
Vermont
FY96: July 1, 1995
to June 30, 1996
FY97: July 1, 1996
to June 30, 1997

Biennial Budgets
Connecticut
Maine
New Hampshire
FY96-97: July 1, 1995
to June 30, 1997

Chart 1

Motor Fuel Tax Take Spurts Ahead of Revenue Base

*Tax Revenues, Motor Fuel Gallons Sold, and Personal Income
Six New England States (1995 Dollars)*



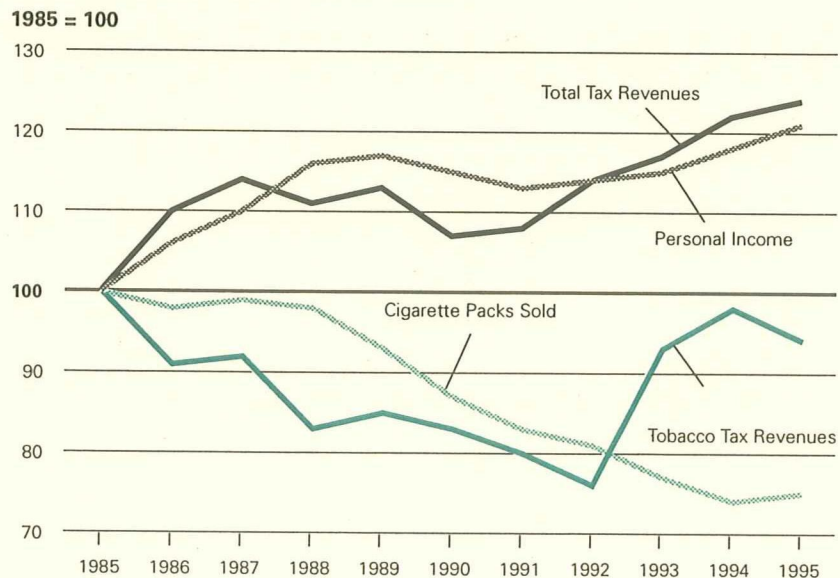
Note: In Charts 1 to 3, revenue and personal income figures have been adjusted for inflation using the CPI-U for Boston and the New England Economic Project Implicit Price Deflator for Consumption Expenditures, respectively. Source: U.S. Advisory Commission on Intergovernmental Relations; U.S. Bureau of the Census; U.S. Dept. of Commerce, Bureau of Economic Analysis; official state budget documents.

rapidly expanding personal income (Chart 1). In 1989, the slowing economy and cyclically sensitive gas consumption caused real fuel revenues to fall. The surge in fuel revenues in 1990 and 1991 is attributable to significant rate increases in gasoline taxes in every New England state but Vermont. Massachusetts, for example, raised its tax on gasoline from 11 to 17 cents per gallon in August 1990, followed by another 4 cent increase in 1991.

Chart 2

Tax Hikes Prop Up Tobacco Tax Revenues in 1993 and 1994

*Tax Revenues, Cigarette Packs Sold, and Personal Income
Six New England States (1995 Dollars)*



Note: See Chart 1 note. Source: Tobacco Institute; U.S. Bureau of the Census; U.S. Dept. of Commerce, Bureau of Economic Analysis.

Since 1993, gas consumption has expanded modestly as the region's economy has recovered. Real revenues have also been boosted by lower rates of inflation and the phasing in of a 6 cent tax increase in Connecticut. In addition, automobile fuel efficiency (miles per gallon) has remained stable in recent years, after many years of increasing efficiency.

Cigarette Taxes

A dwindling number of smokers has made cigarette taxes far less lucrative than motor fuel taxes. Hefty tax rate hikes in recent years have offered the only offset to an otherwise shrinking revenue stream.

1985 marked the start of a heightened anti-smoking campaign, driven by concern over the effect of smoke on non-smokers. In New England, as elsewhere, smoking became less socially acceptable. From 1985 to 1992, cigarette consumption and cigarette tax revenues declined, even as real personal income rose by well over 10 percent (Chart 2). Buoyed by the anti-smoking mood, lawmakers in every state except New Hampshire raised their tax rates on cigarettes between 1992 and 1995, thus reducing the erosion of tobacco revenues. Despite rate increases and a very recent leveling-off in the decline of cigarette sales, real tobacco tax revenues in 1995 were below their 1985 levels.

Alcoholic Beverages Taxes

The revenue potential is similarly bleak for alcoholic beverage taxes. Inflation-adjusted tax revenues from alcoholic beverage sales have deteriorated steadily since 1986, because of inflation, declines in liquor, beer, and wine consumption, and the absence of frequent tax increases (Chart 3). From 1986 to 1988, real revenues declined because of a shift in drinking patterns from hard liquor to beer, which is less heavily taxed. Since 1988, the decline in revenues has accelerated, as the consumption of beer, like hard liquor, has waned.

Despite the revenue decline, lawmakers have re-

sisted tax hikes for the most part. During the last ten years, only three New England states have passed significant alcoholic beverage tax increases, and all were enacted between 1989 and 1991. Since 1991, there have been no further increases.

Prospects for the Future

Excise taxes are not likely to offer long-term relief from revenue difficulties. Cigarette and alcoholic beverage tax collections are least likely to be an expanding source of revenue because of the decline in consumption and the constraints of interstate competition. The effects of interstate competition can be significant. In 1993, for example, Massachusetts raised its tobacco tax from 26 cents to 51 cents per pack. Neighboring New Hampshire, with no sales tax and a 25 cent tax on cigarette packs, saw its per capita sales of cigarette packs increase by over 3 percent in 1993 and 1994, at a time when most states experienced a decline in cigarette sales.

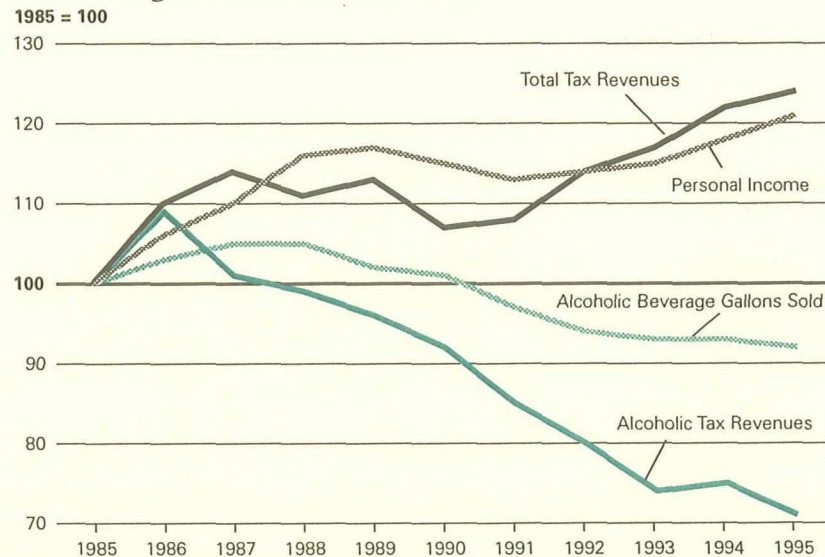
Competition from border states, however, has not deterred lawmakers from proposing cigarette tax increases as a quick fix. In May, for example, New Hampshire's House budget writers proposed increasing the cigarette excise tax by 11 cents per pack (raising \$18.6 million) in order to erase a potential budget im-

continued on last page

Chart 3

Less Drinking Causes Plunge in Alcoholic Beverage Tax Revenues

Tax Revenues, Alcoholic Beverage Gallons Sold, and Personal Income Six New England States (1995 Dollars)



Note: Figures for alcoholic beverage sales are for distilled spirits and beers. See Chart 1 note.
Source: Beer Institute; Distilled Spirits Council of The United States; U.S. Bureau of the Census; U.S. Dept. of Commerce, Bureau of Economic Analysis.

Across the Region

Skyrocketing income tax revenues in the fourth quarter of FY96 gave most New England states sufficient revenue to end the fiscal year with healthier-than-expected surpluses. Thanks to a booming stock market, five states reported double-digit year-over-year gains in income tax collections. By exception, New Hampshire enjoyed higher business profits tax revenues than expected, but ended the first year of its biennial budget with a slight shortfall.

The propitious revenue picture did not sway most lawmakers from passing prudent FY97 budgets, favoring tax reform over new spending initiatives. Connecticut continued to phase in the income tax cut passed two years ago. Rhode

Island turned down Governor Lincoln Almond's proposal to double the hospital tax. Massachusetts extended its 3 percent investment tax credit for another five years, approved a tax cut for the mutual fund industry in return for the promise of jobs, and authorized a one-time reduction in 1996 personal income taxes, as a result of a hardy year-end surplus.

On the human services front, Rhode Island passed a major welfare reform bill, and Massachusetts hiked the state's cigarette tax in order to expand publicly financed health insurance for children and low-income elderly. New Hampshire promised to partially fund statewide kindergartens.

Estimated Total State Spending for FY96 and Appropriations for FY97,^a Excluding Federal Dollars

	FY 96	FY 97	Percent Change
	Millions of Dollars		
Connecticut	8,223.5	8,340.3	1.4
Maine	1,904.7	2,024.7	6.3
Massachusetts	13,965.8	14,718.6	5.4
New Hampshire ^b	1,152.3	1,183.5	2.7
Rhode Island ^c	2,313.2	2,380.2	2.9
Vermont	859.8	877.9	2.1

^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 state budget officials.

Six State Review

Connecticut

Connecticut ended FY96 with a generous surplus of \$224 million, 2.5 percent of general fund outlays, thanks largely to hefty stock market returns. FY96 collections from income and inheritance taxes grew 11 percent and 23 percent, respectively, over year-earlier levels. Sales tax receipts grew a more modest 4 percent (see the chart).

Spending for FY97, the second year of the biennial budget, will increase less than 2 percent over FY96 outlays. The \$10 billion budget includes a personal income tax cut of \$160 million, effective July 1, 1996. The legislature debated revoking the tax cut, originally promised in FY95, because the state had not approved plans to compensate for anticipated lost revenue. Governor Rowland had proposed a plan to sell 6 percent of the lottery to private investors to compensate for the income tax cuts. Lawmakers rejected this privatization plan, but approved the creation of Connecticut Lottery Corporation, a quasi-public corporation with an

independent board of directors. The legislature expects the new lottery corporation to raise an additional \$30 million a year through new promotions, advertising, and lottery games. Elected officials intend to finance the remainder of the tax cuts by drawing on funds of \$110 million that are budgeted for FY97 but not yet designated, as well as tapping the FY96 surplus.

Lauren Fine

Maine

Maine ended FY96 in the black, with a surplus of over \$28 million, 2 percent of general fund spending. Year-end revenues were up 6 percent over the prior year and 2 percent above projections. Collections from personal and corporate income taxes were particularly strong, with year-over-year growth of 11 percent and 19 percent, respectively. The latter exceeded projections by 17 percent.

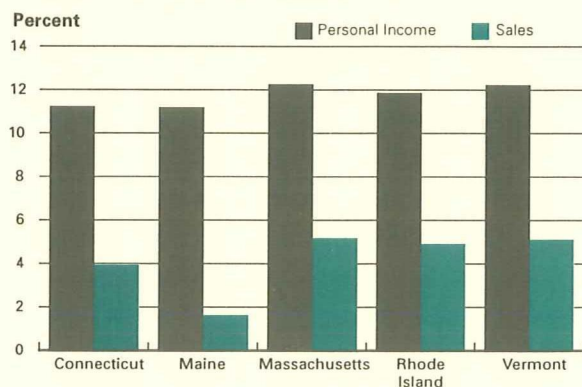
In late March, lawmakers passed a supplemental budget that increased outlays for the FY96-97 biennial budget by \$6.7 million. (See Fiscal Facts, Spring 1996.) Spending for FY96-97 is 7 percent over the previous biennial budget (FY94-95), a projected annual rate of growth of 3.5 percent. The sharp spending increase in FY97 over FY96 (see the table) is a result of the state's carrying forward from FY96 into FY97 \$44.3 million in non-encumbered funds and \$18.6 million in encumbered funds in the mental health and human services areas.

In January, Governor Angus King proposed an education reform bill that would lay the groundwork for developing learning goals in eight subjects and state and local assessments to measure student performance. The governor asked for \$2 million a year to help train teachers to implement the new system. Lawmakers supported the governor's plan, but in a last-minute stalemate before the 1996 session adjournment, the Appropriations Committee blocked the \$2 million funding, thus postponing the start of the teachers' training program.

Wei Sun

Income Tax Revenues Show Double-Digit Gains

Growth in Personal Income and Sales Tax Revenues FY96 Compared with FY95



Note: New Hampshire has no sales or personal income tax.
Source: Official budget documents, state financial statements, and conversations with state budget officials.

Massachusetts

Massachusetts finished FY96 with extra cash, thanks to strong personal income tax collections, up 12 percent over last year. Total tax revenues were \$366 million above projections. Accordingly, in late July, legislators deposited \$117.6 million into the Commonwealth's Stabilization Fund, bringing the fund to its \$543 million cap, 5 percent of total tax revenues. Because amounts in excess of that figure are to be applied to the reduction of personal income taxes, this year legislators plan to return to taxpayers \$150 million through a one-time tax cut. Income tax filers will see an increase in their personal exemption for 1996 income taxes, which on average will save individual taxpayers \$40, heads of households \$60, and married couples \$80.

Massachusetts lawmakers approved a FY97 spending plan of \$14.7 billion (\$17.7 billion including federal dollars), an increase of 5.4 percent over estimated FY96 expenditures (see the table). Spending is increased for cities and towns (\$91.5 million), debt service (\$76 million), higher education (\$66 million), and Medicaid (\$39 million). An increase of \$273 million in state aid for local education provides financing for the fourth year of educational reform. The legislators provided a college tuition tax credit, which is expected to cost the state \$10 million. In addition, they extended the state's 3 percent business investment tax credit for five years. The new spending plan does not include a permanent income tax cut, as Governor Weld had originally proposed.

In the last week of July, lawmakers approved an estimated \$50 million tax cut for the mutual fund industry, in exchange for the promise of 11,000 jobs over the next five years. They also passed legislation that broadens publicly financed health care coverage for 165,000 uninsured children and provides prescription drug assistance to 65,000 low-income elderly. Funding for this initiative relies on federal aid increases and an increase of 25 cents per pack in the cigarette excise tax. The legislation became effective August 1.

Jeannette Hargroves

New Hampshire

Strong revenues from New Hampshire's business profits tax enabled the Granite State to finish FY96 with a smaller revenue shortfall than the \$15 million originally anticipated. Receipts from the busi-

ness profits tax were 16 percent above year-earlier levels and 8 percent higher than estimated. FY96 total tax receipts, however, still lagged 1 percent below projections, principally because of sluggish rooms and meals tax collections, which grew 5 percent over year-earlier levels but were 5 percent below projections.

In May, the legislature passed a mid-term budget adjustment bill to cover any FY96 shortfall and a projected gap of \$45 million to \$65 million in FY97. To erase the imbalance, the state plans to

- collect \$20 million in overdue third party health care payments;
- borrow \$20 million from the state's \$100 million Health Care Transition Fund, if Medicaid revenue estimates are not reached;
- reduce this year's spending by \$8 million;
- impose a freeze on hiring, purchases, and out-of-state travel for government employees; and
- collect business enterprise taxes through a new estimated payment system.

If the budget remains unbalanced at the end of the biennium, the state intends to tap into its rainy day fund to erase any remaining shortfall.

The mid-term budget adjustment bill also includes an additional \$5 million in outlays to fund a statewide kindergarten initiative. Currently, the state does not require districts to offer public kindergartens, and those districts that do, have limited capacity. The new legislation aims to expand districts' capacities by appropriating \$500 per student to districts with existing programs or development plans under way.

Lauren Fine

Rhode Island

Strong fourth quarter revenues helped Rhode Island, like the other New England states, end FY96 on more solid footing than had previously been anticipated. Year-end total revenues were up 7 percent over FY95 levels, in large part because of personal income tax collections, which came in 12 percent over year-earlier levels and 8 percent above projections.

Officials have become more optimistic about FY97 revenues. In late spring, the state's Revenue Estimating Conference raised revenue estimates for FY97 by \$35.2 million. The brighter revenue picture, however, did little to temper the differences between the General Assembly and the governor. These differences delayed agreement on a state spending plan until late July. Key points

of debate were the governor's proposals to increase the hospital tax and to offer an early retirement package to state workers. The governor wanted to double the hospital tax, currently set at 2.2 percent of gross patient revenues, and offer an early retirement plan aimed to eliminate nearly 1,000 jobs.

In late July, the legislature passed a general fund budget for FY97 of \$1.73 billion, 1.4 percent over FY96 appropriations and almost 2 percent more than what the governor had proposed. The new budget calls for no increase in the hospital tax and proposes trimming state employment levels through attrition, rather than an early retirement package. The new budget level-funds most major programs. School districts will get a marginal increase of \$10 million, 2 percent of outlays, to offset cost-of-living increases. As expected, the governor vetoed the budget bill, but the Assembly overrode the veto.

In separate legislation, lawmakers and the governor forged a compromise welfare reform proposal, which imposes stricter employment and training rules on recipients but offers increased health and child care services. Key provisions are

- health insurance for poor children up to age 18;
- child-care services for all employed recipients;
- a requirement that recipients spend 20 hours per week working, looking for work, or training for jobs during the first two years of assistance;
- a requirement that recipients have 20 hours per week of paid employment or community service work after two consecutive years of assistance; and
- a reduction in a parent's portion of the benefit if a recipient fails to comply with work requirements.

The welfare reform bill is not expected to alter spending over the next three years.

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Vermont

Vermont ended FY96 with a general fund surplus of \$12.6 million, thanks to robust income tax revenues in the fourth quarter of FY96 and additional belt-tightening. Year-end collections from income tax revenues were 12 percent above year-earlier levels and 6 percent above projections. The surplus and a transfer of \$6.5 million from the transportation fund enabled the state to erase a \$14.5 million deficit carried over from FY95 and deposit \$4.8 million in its budget stabilization fund.

Vermont's FY97 budget of \$878 million calls for a 2 percent increase in spending, similar to what the governor had requested. Medicaid received a 4 percent increase, although the governor had asked for more, in order to fund low-income health care.

For the third year in a row, lawmakers could not agree on major property tax reform. The Senate rejected the House's plan to create a statewide property tax to help alleviate disparities in public school spending among rich and poor towns. Elected officials took two steps to provide tax relief:

- They expanded the property tax relief fund by almost one-third (\$7.4 million), to assist households with limited income and high property taxes.
- They reduced the tax rate on farm and forest lands assessed at agricultural values, but cut in half funds to reimburse towns for the revenues lost because of the difference between the agricultural value and full market value of the lands.

Lawmakers did appropriate limited funds to towns that would be forced to increase tax rates dramatically in FY97, in order to cover the lost revenue from farm and forestlands. Town officials, however, called for a special session to repeal the new law or at least delay by one year the effective date of the new legislation. The governor established a panel to determine the long-term effects of the changes.

Jeannette Hargroves

The Boston Fed Now Has a Home on the World Wide Web

The Federal Reserve Bank of Boston has established a site on the World Wide Web (WWW). The new "home page" is a gateway to information on the services and activities of the Boston Fed and the entire Federal Reserve System.

Guests to the site can read and download a variety of Bank publications, gain access to a wealth of statistical information, and learn more about the Federal Reserve System and its operations in Boston.

The following Research Department publications are featured on the new WWW site:

- New England Economic Review
- Regional Review
- New England Banking Trends
- Fiscal Facts
- New England Economic Indicators
- Conference Proceedings; Research Reports and Special Reports; Working Papers
- "Beige Book" (district-by-district summary of current economic conditions, produced every six weeks)

World Wide Web address: <http://www.bos.frb.org>

balance. This summer, Massachusetts' legislature approved a 25 cents per pack increase in the cigarette tax, as well as higher taxes on other tobacco products, to help fund a health care plan for uninsured children and elders. By contrast, legislators have been reluctant in the past to raise the tax rates on alcoholic beverages.

Among the three major excise taxes, legislators' best bet for steady, and possibly expanding, revenue growth is the motor fuel excise, because of this tax's large base and the ease of enacting small rate increases. Small tax increases seem not to elicit taxpayer protest similar to that generated by income and property tax hikes. Since 1991, for example, two-thirds of the country's states have raised their gas taxes without major resistance by taxpayers, largely because the revenues are earmarked for roads and bridges.

Most important, legislators feel comfortable justifying fuel taxes. In May, New Hampshire's Governor Stephen Merrill proposed eliminating the state's gasoline excise tax — 18 cents per gallon — from Memorial Day through the end of July, arguing that it would attract out-of-state tourists as well as benefit state residents through lower prices at the pump. The Senate killed the proposal in an almost unanimous vote, determined to preserve millions of dollars needed for highway and bridge improvement projects this year. The senators reasoned that well-paved roads were more important for tourists than lower gas prices.

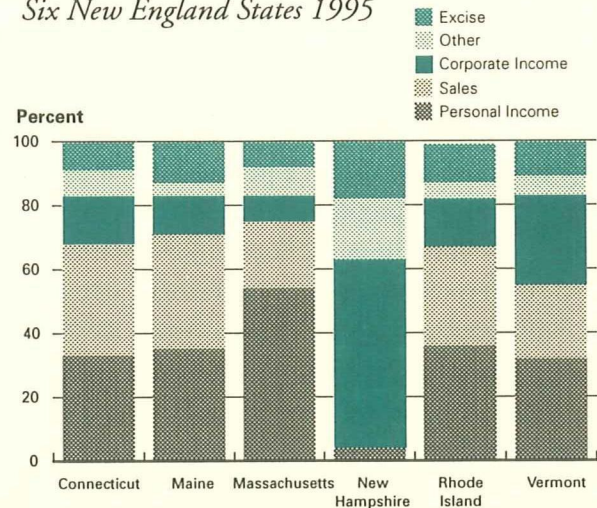
Note: The author wishes to thank Bethany Pugh for her valuable research assistance.

Chart 4

Excise Taxes Account for 8 to 18 Percent of States' Total Tax Revenues

Tax Revenues by Category

Six New England States 1995



In New England, excise taxes as a percent of states' total tax revenues range from 8 percent in Massachusetts to 18 percent in New Hampshire. The Granite State relies more heavily on excises and a room and meals tax than the region's other states, because it has neither a general sales tax nor a broad-based personal income tax.

Source: U.S. Bureau of the Census.

New England Fiscal Facts

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