The Fiscal Condition of the New England States

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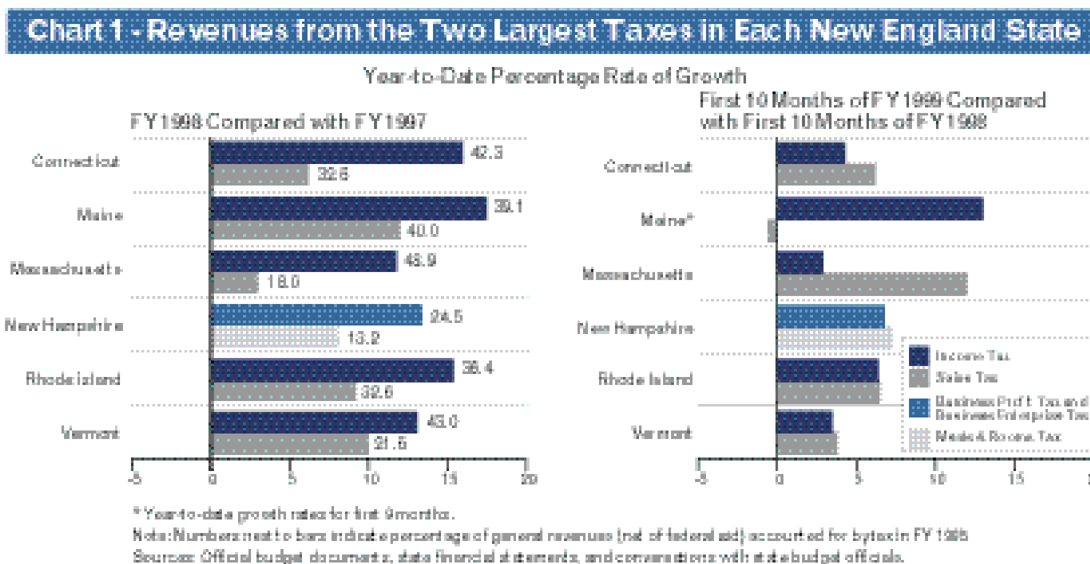
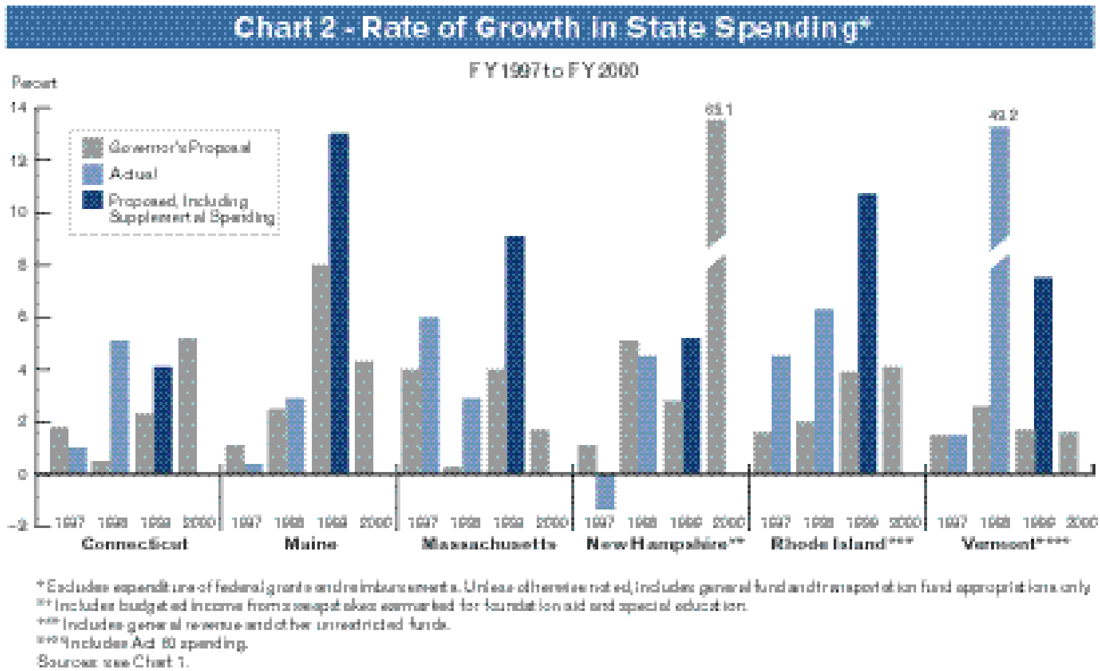
Everyone's talking about the arrival of the new millenium,now just around the corner. The new state fiscal millenium begins on July 1. To my knowledge, no state officials are planning fireworks or lavish three-day festivals, although the region's states have much to celebrate. During the past two years,they've been able to have their cake and eat it too — cutting taxes, increasing spending, and building deep reserves, all at the same time. Trade-offs will probably become more severe next fiscal year. While the states still want to spend more, give taxpayers a check, or both, they all foresee the need to dip into their free cash to do so. Yet, with the possible exception of New Hampshire, they should still have enough money on hand to deal with any difficulties they are likely to encounter.

Policymakers anticipate tighter constraints because they believe that a slowing economy and previously enacted income tax cuts will take their toll on revenues. The impact of these income tax cuts is already evident. Consider recent trends in the growth of each state's two largest sources of revenue (Chart 1). In every state except New Hampshire, these sources are the personal income tax and the general sales tax. The Granite State relies predominantly on business taxes and a rooms and meals tax.

In fiscal year 1998 (FY98), rates of income tax growth soared well into double-digit territory and outperformed the sales tax in all states. Income tax revenues ballooned even though several states cut their income tax.





*Excludes expenditure of federal grants and reimbursements. Unless otherwise noted, includes general fund and transportation fund appropriations only
**Includes budgeted income from sweepstakes earmarked for foundation aid and special education.
***Includes general revenue and other unrestricted funds.
****Includes Act 60 spending.
Sources: see Chart 1.

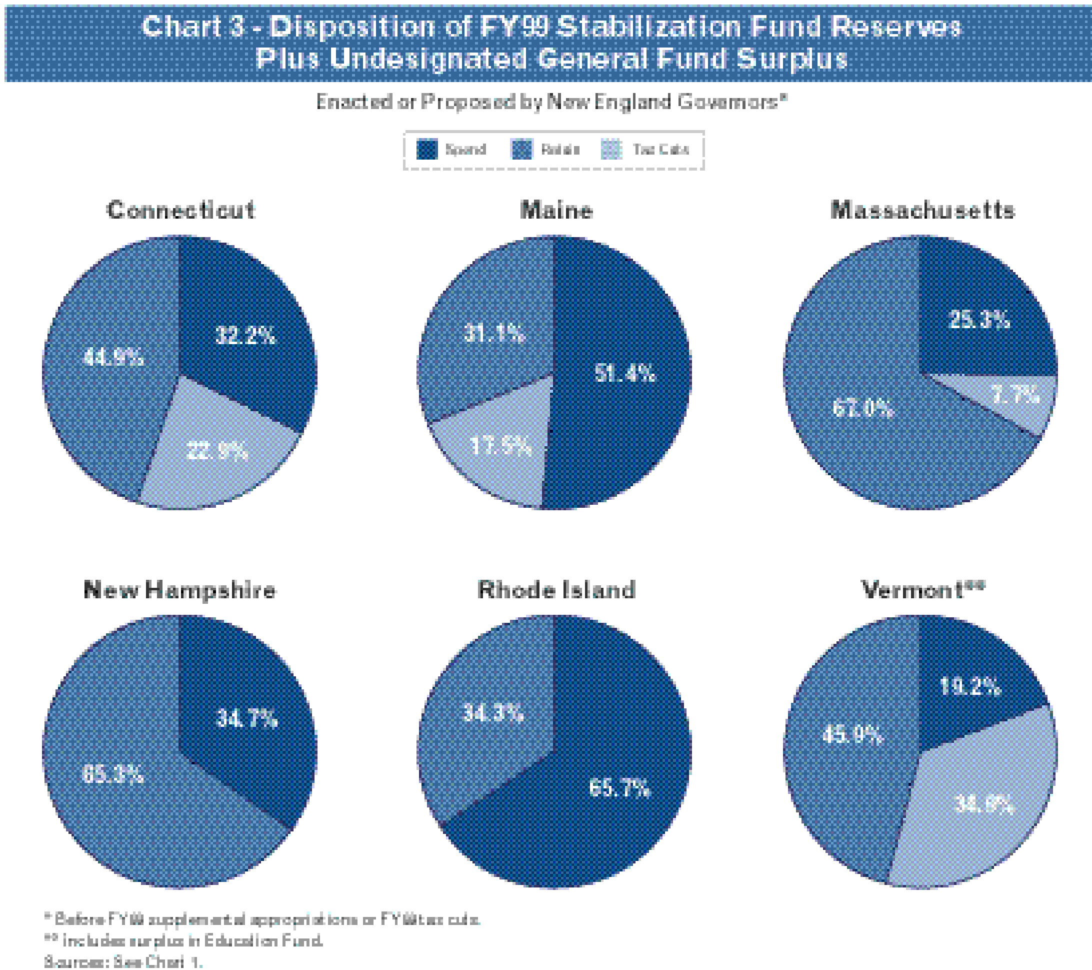
Taxes that lucrative beg to be cut again, and so they were in several states. Consequently, through the first ten months of FY99, the pace of income tax revenue growth slowed sharply across the region. Sales tax receipts expanded more rapidly than income tax receipts in every state except Maine, the only state to cut its sales tax rate this year. With the prospect of slowing economic growth and yet another round of tax cuts scheduled to take effect next year in some states, budget analysts are projecting state revenues to grow only between 2 and 4 percent next year.

Slowing revenue growth has not stopped the states from accelerating spending (Chart 2). Consider the rates of spending growth implied by FY99 mid-term supplemental spending bills. Note that every state is planning to accelerate spending well beyond the growth rate proposed by its governor over a year ago, with rates ranging from 4 percent in Connecticut to 13 percent in Maine.

In all six states, increases in outlays have been targeted to infrastructure and schools. States survived the fiscal crisis of the early 1990s and subsequently built up reserve funds in part by deferring capital spending. Potholes, buckling bridges, leaky waterworks, crumbling courthouses, and toxic spills have compelled governments to increase allocations to public construction.

As for education, the rise in the proportion of the population between the ages of 6 and 18, and the increased return to a college education, have heightened concern about the quality of primary and secondary instruction. The states have responded by allocating a larger fraction of their budgets to school aid. In Vermont and New Hampshire, this shift has been far more dramatic than in the other four states. The Supreme Court of each state has ruled that heavy reliance on the local property tax to finance education is unconstitutional. Each decision was based on the premise that, given wide interdistrict disparities in per capita property wealth, reliance on the property tax deprives some citizens of the right to an adequate education guaranteed by each state's constitution. In order to comply, Vermont in 1998 increased the state's share of the cost of public schooling from 32 percent to 79 percent. The requisite increase in funds has come from a new statewide property tax and increases in the state's rooms and meals tax, gasoline tax, corporate income tax, and sales tax. This is what caused Vermont's state spending to explode in FY98, with a 50 percent increase.

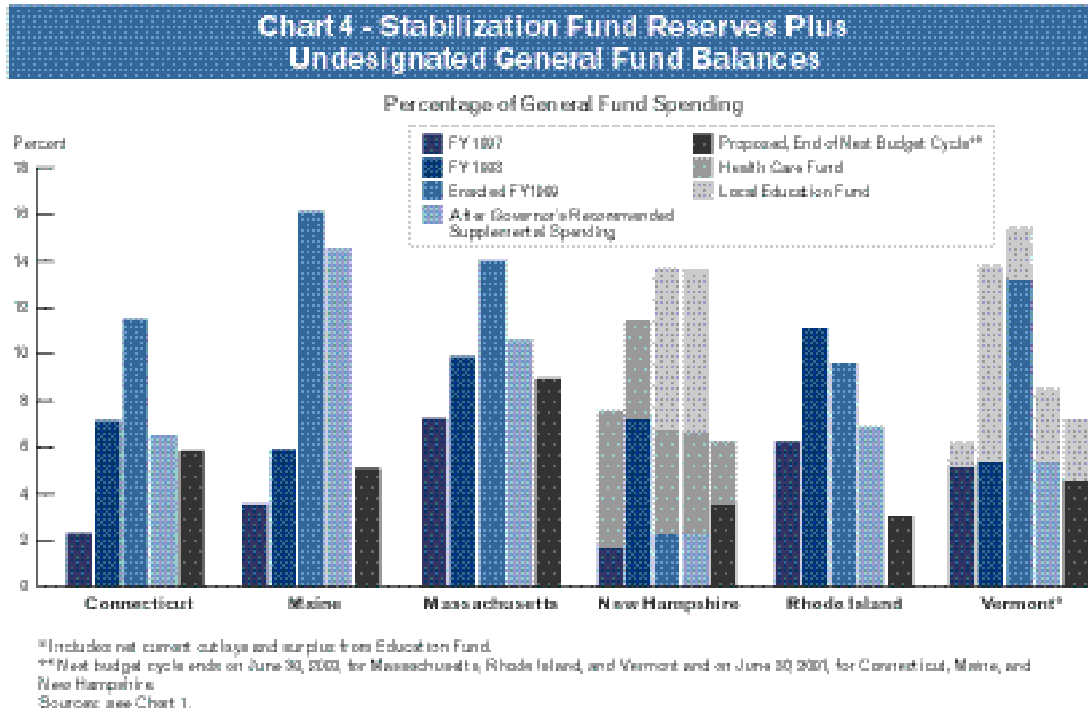
Whereas Vermont devised a plan fairly quickly, New Hampshire became mired in a long debate. The perception was widespread that, in order to satisfy its Supreme Court, the state would have to enact a



broad-based income tax, consumption tax, or both. No other taxes, it was argued, could raise enough revenue to fund the requisite degree of inter-district redistribution. Yet, New Hampshire has prided itself on being the only state except Alaska with neither an income nor a sales tax. Some argued that the absence of these taxes is one of New Hampshire's most attractive attributes. Eventually, the state decided on a plan that includes neither tax. Many features are similar to those adopted by Vermont – a statewide property tax, an increase in business taxes, and a hodgepodge of narrow-based new taxes and tax increases. Another integral component of New Hampshire's solution is the earmarking for school finance of most of the state's anticipated payment from the national tobacco settlement. These actions are responsible for the 65 percent increase in state spending recommended for next year.

There is, however, a problem remaining. The plan comes up between $40 million and $90 million short of the estimated $825 million needed to comply with the Court's decision. That's between 50 and 110 percent of all of New Hampshire's projected reserves, including its rainy day fund. Either the state will have to come up with more money in the future, or the estimate of needed funding will have to be revised downward.

With such fiscal pressures hanging over her head, New Hampshire Governor Jeanne Shaheen has not proposed any tax cuts for the current year or the next biennium. In most other states, tax cuts have been proposed or enacted. (See Chart 3 for estimates of the percentages of each state's projected reserves and surplus that would be allocated to tax cuts and spending increases under most recent plans. The charts for Massachusetts, New Hampshire, and Rhode Island — still in the midst of budget debates — are gubernatorial recommendations.) Percentages dedicated to tax



*Includes net current outlays and surplus from Education Fund.
**Next budget cycle ends on June 30, 2000, for Massachusetts, Rhode Island, and Vermont and on June 30, 2001, for Connecticut, Maine, and New Hampshire.
Sources: see Chart 1.

reduction range from 35 percent in Vermont to 0 percent in Rhode Island. In fact, Governor Almond of Rhode Island has recommended $40 million in tax increases.

These various fiscal changes will likely have a significant impact on the depth of each state's reserves (Chart 4). Note how sharply reserves have been built up and, conversely, how dramatically they're going to shrink. Still, every state except Rhode Island plans to keep its reserves-to-spending ratio at 5 percent or higher, probably enough to weather a moderate recession with only mild spending cuts.

Additional factors affect state reserves. First, the chart calculations do not take into account tax cuts already enacted and scheduled to take effect next year. For example, although Governor Almond has recommended about $40 million in tax increases for Rhode Island, previously enacted tax reductions worth $80 million are also scheduled to go into effect. Second, some proposed tax cuts for the next budget cycle would be phased in over several years. Their revenue consequences would grow sharply over time. An example is Governor Cellucci's recommendation to reduce Massachusetts' personal income tax rate from 5.95 percent to 5 percent. Finally, some tax cut proposals that have yet to be introduced officially have received serious attention. The foremost example is a proposal to reduce the income tax burden on the 1 percent of Rhode Island's taxpayers whose incomes exceed $200,000 a year. This proposal has the support of many of the states' most prominent business leaders. If the proposal is enacted, they promise to create 7,500 jobs.

All in all, the fiscal condition of the New England states remains strong. The region's policymakers deserve high marks for discipline. They know that their situation is likely to tighten next year and, by and large, are conscientiously trying to plan for it. And, if we gloomy economists are proved wrong yet again, revenues may again exceed expectations, giving the region another year of ample fiscal running room.