Budget CONNECTion$

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AS GOOD AS IT GETS? A YEAR-END SUMMARY OF ECONOMIC AND STATE BUDGET CHANGES

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> *Republican or Democrat, we all agree one of the fundamental roles of government is to offer help to those whose struggles in life are greater than our own. Families in poverty. Children without parents. Adults without jobs. The sick, the addicted, the hungry.*
>
> *While most of the people of our state enjoy the riches of this strong economy, there are still many who have not had the same opportunity to share the prosperity. At a time of record employment, with the projected budget surplus nearing $500 million, there is an extra burden on government to provide help where it is needed most.*
>
> Governor John Rowland, 2001 State of the State Address

In 2000-2001, Connecticut continued to enjoy the benefits of a long economic expansion, marked by more than full recovery of the thousands of jobs lost in the recession of 1989-1992 and extremely low unemployment. Indeed, Connecticut's 1.7% unemployment rate in November 2000 was the lowest in the state since at least 1969. Nationally, this expansion was the longest ever, peacetime or not.

In many respects, Connecticut thrived in its transition over the 1990s to a "New Economy" that preferentially values a highly-skilled workforce. The state added thousands of high-tech jobs that pay very well, and diversified its economic base. The Milkin Institute ranked Connecticut fourth highest on its 2001 New Economy Index, and the Corporation for Enterprise Development put Connecticut on the "honor roll" of its annual *Development Report Card for the States 2001*, with "A" grades on all three indices (performance, business vitality, and development capacity) and rankings in the bottom 10 of all states on only 8 of 70 measures (long-term employment growth, short-term employment growth, manufacturing capital investment, new business job growth, loans to small business, energy costs, sprawl and conversion of cropland to other uses, air quality).

However, not all residents shared equally in the 1990's economic recovery. Connecticut's transition to a "New Economy" resulted in the creation not only of high-wage, high-tech jobs, but also of thousands of lower-wage service jobs. The inflation-adjusted wages of the state's lowest wage workers fell, and many lost health and pension benefits.

And while Connecticut enjoyed a General Fund surplus of more than $600 million in SFY 01, its sixth straight, the state spending cap constrained public investments necessary to ensure a shared

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prosperity in this New Economy. In particular, funds resulting from "savings" in cash assistance payments as welfare rolls plummeted were *not* re-invested in these lower-income families to help prepare them to weather the next economic storm.

Now, the nation's economy is formally in a recession. Connecticut lost more than 13,000 jobs between October 2000 and October 2001. State unemployment climbed to 3.2% in October 2001. A significant decline in projected revenues resulted in projections of a General Fund deficit of about $300 million, prompting the convening of a Special Session of the General Assembly in November, 2001. Hence, much of the data reported in this summary represent – in many respects – the state's "high water" mark for the forseeable future.

If the last several years were "as good as it gets" for the state's most economically vulnerable, then the many Connecticut residents left behind in the 1990s are at risk of losing even more economic ground as the economy cools. The divides in the state -- in income, assets, health and education -- can be expected to continue to grow, absent aggressive government response.

Connecticut has signficant assets, but is growing apart economically

A relatively well-educated work force. In a "New Economy" that emphasizes intellectual capital as its primary "raw material," Connecticut's relatively well-educated residents are a distinct asset. In 2000, only 37% of the population had a high school diploma *or less* education, while 35% had a college degree *or greater.* The proportion of Connecticut residents with an advanced degree (14% of men and 13% of women) was second highest among all states. Two in three (67%) Connecticut women now has at least *some* college training (compared with 58% of Connecticut men).

Relatively high income and wages. Since 1986, Connecticut has ranked first in the nation in per capita income. Connecticut's per capita income in 2000 was $40,640, about $10,960 (and 37%) more than the national average of $29,680. Connecticut also ranked first in the nation in 1999 in median household income for a family of four at $75,505 (in 1999 dollars), which was $15,520 (and 26%) over the national median income for a family of four of $59,980. CT Voices for Children, *State of Working Connecticut 2001*.

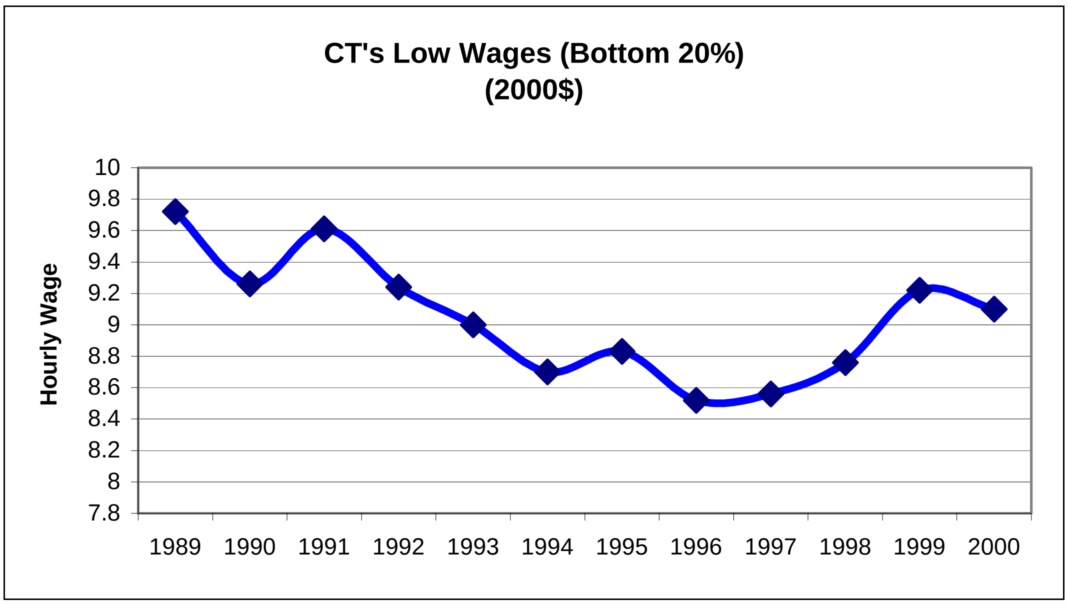
Connecticut's *growth* in personal income peaked in 1997, with a one-year gain of 6.4%. From 1997 through the first quarter of 2000, annual personal income growth remained above 5%. There was, however, a precipitous slowing in the growth of personal income in the second quarter of 2000 (just 0.5%). In 1999, Connecticut's personal income came from earnings (70.5%); dividends, interest, and rent (18.3%); and transfer payments (11.2%). Importantly, however, capital gains are *not* included in measures of personal income. *2001 Comptroller's Report on Connecticut's Economic Health*, p.17.

Connecticut was also tops in the nation in 2000 in hourly wages for low (20th percentile) and median (50th percentile) workers, and second highest in hourly wages for high (80th percentile) wage workers. CT Voices for Children, *State of Working Connecticut 2001*.

Unemployment and underemployment remain higher among the less well-educated. In the late 1990s, Connecticut's overall unemployment rate remained below 3%. However, for young men aged 18-35 without a high school diploma, the rate was 15% and for young men with *only* a high school diploma, the rate was 6%. Young men this age are also far more likely to be under-employed (i.e. are unemployed *or* are working part-time involuntarily, *or* have given up looking for work): 26% of young Connecticut men with less than a high school education were under-employed in the late 1990s boom years, as well as 12% of young men with *only* a high school education.

Though unemployment and underemployment rates among less well-educated young Connecticut *women* were also much higher than the state average in the late 1990s, they were less than the unemployment and underemployment rates of similarly-educated young Connecficut men. CT Voices for Children, *State of Working Connecticut 2001*.

Falling *real* wages among our lowest-wage workers. Although Connecticut's low-wage workers enjoy high wages relative to other states, they never recovered the economic ground lost over the early 1990s. This occurred despite some modest wage increases between 1996 and 1999 (when low unemployment and an increase in the state minimum wage helped increase wages at the bottom). The following chart illustrates this lost ground:



Greater poverty. Connecticut's statewide poverty rate increased from 2.9% in 1989 to 7.1% in 1999. This 4.2 percentage point increase was the greatest among the seventeen states that had *any* increase in poverty over the 1990s. Nationally, poverty declined over this period. Similarly, Connecticut's *child* poverty rate increased from about 11% in 1989 to 13% by 1998, resulting in approximately 110,000 Connecticut children living in poverty, 28,000 more than in 1989.

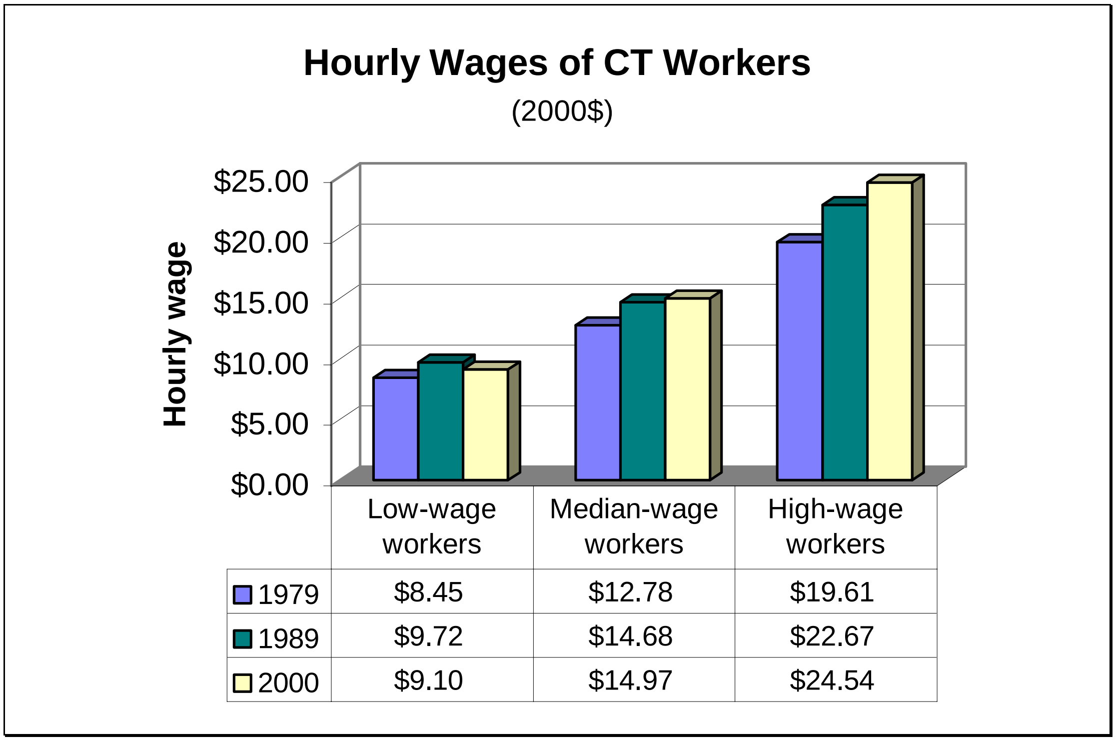
Greater work effort among Connecticut families. Connecticut families have been adding *many additional hours* of work to make ends meet. Over the last two decades, Connecticut married couples with children added nearly 12 weeks of full-time work to their work year (464 extra hours combined). By the late 1990s, these couples worked a total of 3,745 hours/year -- the equivalent of nearly two full-time, full-year jobs. Connecticut's single parent families also added about 300 hours to their work-year over this time period, averaging 1,940 hours of work/year by the late 1990s. This raises the important question of who is caring for the children in Connecticut's families, and what is the quality of their care.

Many working families still fall short of economic self-sufficiency. Despite Connecticut's relatively high hourly wages (compared to other states), and a significant increase in the number of hours worked per year, Connecticut's high cost of living (about 20% higher than the national average) leaves many families who are working full-time, full-year with incomes short of what it takes to make ends meet, as the following table illustrates:

2000 CT Hourly Wages		
Low wage workers (20th percentile)		$9.10/hr.
Median wage workers (50th percentile)		$14.97/hr.
High wage workers (80th percentile)		$24.54/hr.
CT Self-Sufficiency Standard for Family with One Infant and One School-Aged Child (2000$)		
	Two parent family: Average hourly wage needed for economic self-sufficiency for *each* working parent	**Single parent family:** Average hourly wage needed for self-sufficiency for a single working parent
Middletown	$9.72	$16.98
Northeast	$9.87	$17.29
Waterbury	$10.01	$17.57
New Haven	$10.06	$17.70
Stamford-Norwalk	$12.95	$23.55
Source: Pearce & Brooks, *The Self Sufficiency Standard for Connecticut* (1999). Note: Hourly wage data is for 2000, while the Self Sufficiency Standard report defines hourly wages necessary for self-sufficiency as of 1998. Accordingly, the "self-sufficiency" wages were adjusted for inflation using the CPI-U to allow a comparison in 2000 dollars.		

In addition, over the last two decades, there has been a decline in the proportion of Connecticut workers who are covered by employer-provided health insurance (from about 77% to 65% for workers who work more than half-time, half-year). The decline has been particularly great among the state's black and Hispanic workers. There also has been a significant decline in employer-provided pensions among Connecticut's black and Hispanic workers, although not for its white workers. CT Voices for Children, *The State of Working Connecticut 2001.*

A growing wage and income divide. Wages in Connecticut over the 1980s grew about 15% for low, median, and high wage workers alike. However, in the 1990s the economic expansion failed to "lift all ships" equally. Rather, between 1989 and 2000, the real (inflation-adjusted) wages of the state's low-wage workers fell by 6%, while the wages of median and high wage workers increased (by 2% and 8%, respectively):

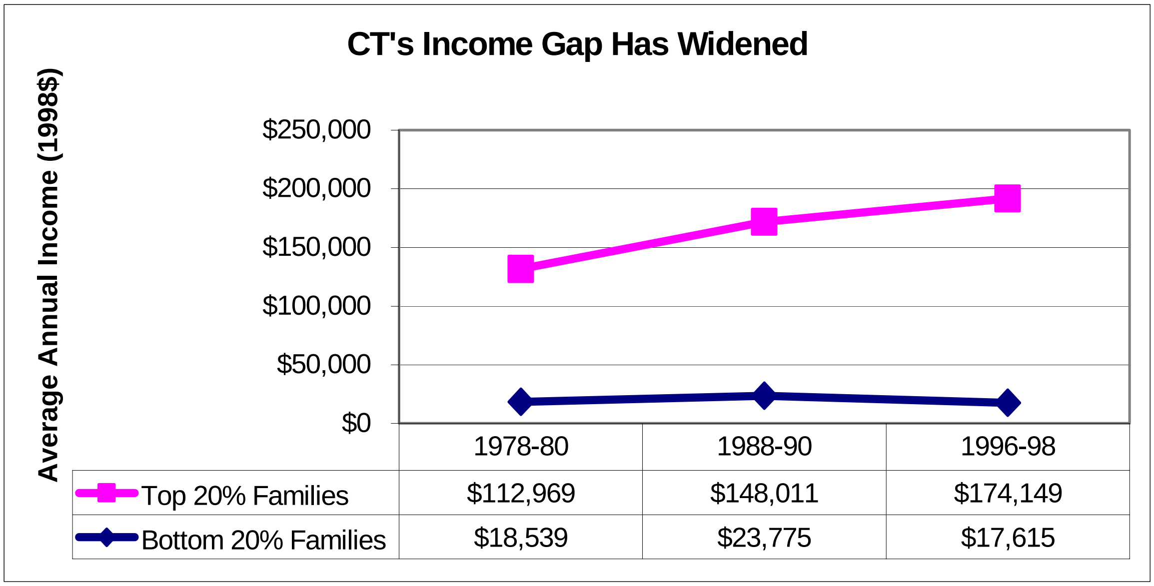


Also, from the late 1980s to the late 1990s, all but the top 40% of Connecticut *families* lost real income. In particular, over the 1990s Connecticut's bottom fifth "bottomed out." The $6,160/year decline in real income (-26%) was *greater than* the decline among the poorest families in any other state. The decline in hourly wages of low-wage workers (see above), together with an *increase* in jobs that pay poverty level wages (from 14% of all jobs in 1989 to 17% in 2000) contributed to this growing gap in income, as illustrated in the following table:

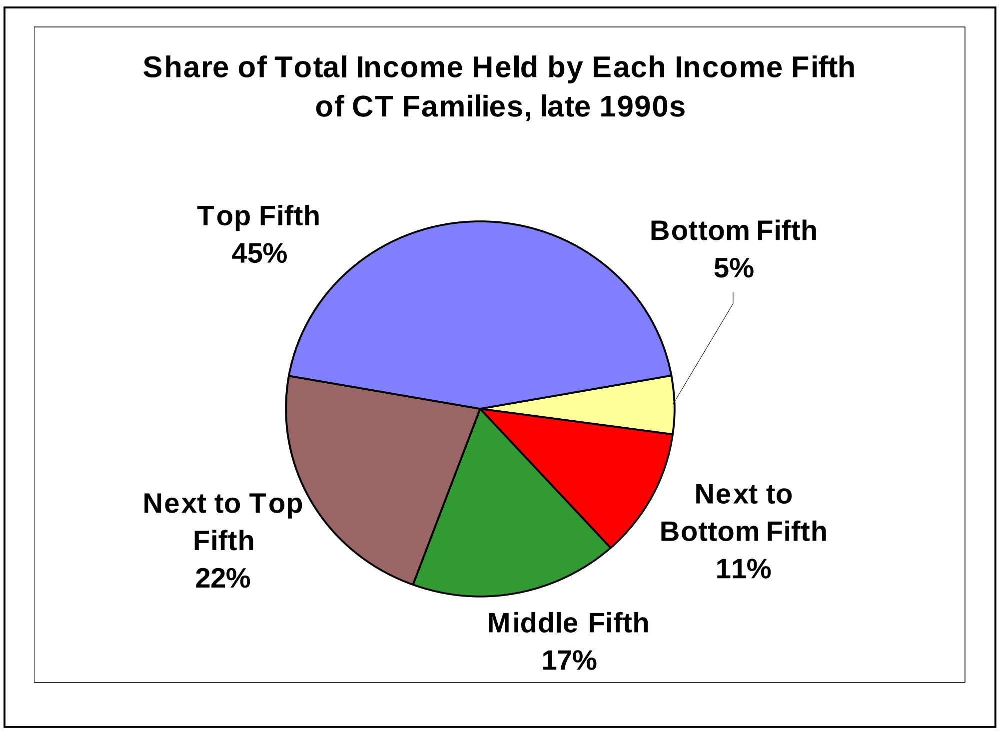
Average Annual Income for CT Families: Late 1980s to Late 1990s *(1997$)*			
	1988-90	**1996-98**	**Change (%)**
Bottom 20%	$23,775	$17,615	-$6,160(-26%)
Next-to-bottom 20%	$45,458	$37,953	-$7,505 (-17%)
Middle 20%	$64,453	$61,461	-$2,992 (-5%)
Next-to-top 20%	$86,486	$87,309	$823 (1%)
Top 20%	$148,011	$174,149	$26,140 (18%)

Source: Economic Policy Institute/Center on Budget and Policy Priorities, *Pulling Apart: A State-by-State Analysis of Income Trends* (2000). This report is based on before-tax income data for families (two or more related individuals living together) from the United States Census Bureau's March Current Population Survey public use files. All figures are expressed in 1997 dollars and were adjusted for inflation. The report compares "pooled" data from 1996-1998 to pooled data from the late 1980s. Pooling data increases sample size, and thereby the precision of the data.

Between the late 1980s and the late 1990s, only 14 states besides Connecticut had a significant *decline* in real income among the bottom fifth of families *and also* a significant increase in real income among its top fifth. As a result, the inequality in income between Connecticut's richest and poorest families expanded markedly over the 1990s, from a ratio of 6 to 1 through the 1970s and 1980s to a ratio of 10 to 1 by the end of the 1990s. Connecticut's *increase* in income inequality over the 1990s was greater than in all but three states (Rhode Island, Oregon, and Arizona) and was about three times the average national increase in income inequality over this period:



	1978-80	1988-90	1996-98
Top 20% Families	$112,969	$148,011	$174,149
Bottom 20% Families	$18,539	$23,775	$17,615



Importantly, Connecticut's increase in income inequality has health, as well as economic, consequences. An emerging and robust public health research literature establishes that income inequality is correlated with adverse health outcomes *across* the income spectrum. For example, middle-income groups in relatively unequal societies have worse health than comparable, or even poorer, groups in more equal societies. In the United States between 1980 and 1990, states with the highest income inequality showed slower rates of improvement in average life expectancy than did states with a more equitable income distribution. Daniels, Kennedy & Kawachi, 2000, *Is Inequality Bad for Our Health?*

Connecticut's economic capacity is sufficient to meet the needs of all of its citizens, and the strong economy provided us many chances to bridge Connecticut's divides

Connecticut taxes are not unduly burdensome. Connecticut relies more on its "own source" revenue than many other states, because it receives relatively little financial support from the federal government. In fact, Connecticut is the nation's "top donor" state. In FFY00, Connecticut received only $0.62 in federal spending[1] for every dollar paid in federal taxes, the lowest return among all states. In fact, Connecticut's "return" has fallen since 1990, when it received $0.78 back for every dollar in federal taxes paid.[2] NCSL, *State Budget & Tax News*, July 15, 2001. Connecticut also is 25th among states in federal spending *per capita,* receiving in FFY00 $5,731 in federal spending per resident per year. This is $132/person *less* than Connecticut received in FFY99 – a nearly 1% decline in just one year, largely related to a reduction in federal procurements. NCSL, *State Budget & Tax News,* June 1, 2001.

Despite Connecticut's reliance on "own source" revenue, it is not the nation's highest tax state.[3] Over the 1990s, however, an increasing proportion of the state tax burden has been shifted from corporations to individuals. Revenues from various business taxes (corporate, insurance, public service, and petroleum) have fallen from $1.3 billion in SFY97 (and 12.2% of all state revenues) to $0.99 billion in SFY 02 (and just 7.2% of all state revenues).

State taxes.[4] In 1999, Connecticut ranked 13th highest in the nation in total state tax collections as a percentage of personal income, with 7.66% of an individual's income, on average, going to pay Connecticut state taxes. *Economic Report of the Governor, FY 2001-2003 Biennium.*

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1 Defined as direct federal payments to individuals (such as Social Security payments and Medicare reimbursements); grants to state and local governments (including Medicaid reimbursements); federal procurement contracts; and federal spending on salaries and wages.

2 Contributing to this low return per federal tax dollar paid is Connecticut's highest-in-the-nation per capita income (which when subject to the progressive federal income tax results in substantial federal tax liability), a lower rate of federal reimbursement than is received by less wealthy states for programs like Medicaid, and a less than fully aggressive effort to capture federal funding by state agencies (in recent years in part due to spending cap concerns, see later discussion).

3 Although Connecticut had the highest *per capita* taxes in the nation in 1999 ($2,932), a *per capita* measure of tax burden ignores income differences across states that affect ability to pay. Because Connecticut also has the highest *per capita* income in the nation, it would not be surprising that its *per capita* taxes are also highest. A fairer measure of comparative tax burden is the proportion of an individual's personal income that is paid in taxes, rather than the total number of dollars paid. [NCSL, *State Budget and Tax News*, October 1, 2000] Importantly, however, if "personal income" does not include capital gains income (which is a significant factor in Connecticut) the percentages stated here *overstate* Connecticut's tax burden.

4 If one looks at the combined burden of state *and local* taxes, Connecticut ranks 8th in state and local tax collections as a percent of personal income as of FY97, with 12.56% of personal income being used to pay all state and local taxes. This is slightly more than the national average (11.14%), but less than New York (14.21%) and Maine (13.45%), and only slightly above Massachusetts (11.18%) and Rhode Island (11.75%). NCSL, *State Budget & Tax News,* March 15, 2001.

Income tax. Among the 43 states with a state income tax, Connecticut ranked 14th highest in state income tax collections as a percentage of personal income (with about 2.87% of personal income, on average, going to the state income tax in 1999). New York, Massachusetts, and Maine all collect a greater proportion of personal income through their income taxes. Connecticut's 4.5% "top" income tax rate is the 5th *lowest* top bracket rate among states with an income tax. By comparison, New York's top bracket rate in 1999 was 6.85%, New Jersey's 6.37%, Massachusetts' 5.95%, and Maine's 8.5%. (Vermont and Rhode Island set their rates as a percentage of federal tax liability, 25% and 26.5% respectively.) *Economic Report of the Governor, FY 2001-2003 Biennium*, pp. 114, 117.

Sales tax. Among the 45 states with a sales tax, Connecticut ranked 16th highest in 1999 in sales tax collections as a percentage of personal income (with about 2.56% of personal income, on average, going to state sales tax). Connecticut's sales tax rate (6%) exceeds the rates of New York (4%) and Massachusetts (5%). *Economic Report of the Governor, FY 2001-2003 Biennium*, p. 119.

After-tax income. Connecticut continues to lead the nation in per capita disposable (or after-tax) personal income, as it has since 1986. Connecticut's per capita *disposable* personal income in 1999 was $30,972, more than $1,400 *more than* the second ranked state – New Jersey. *Economic Report of the Governor, FY 2001-2003 Biennium*, p. 105.

Until SFY 02, Connecticut had enjoyed multi-year, multi-million dollar budget surpluses. The strong economy in the late 1990s resulted in substantial General Fund surpluses. [5]

Revenues were much greater than projected. Connecticut's strong economy resulted in much higher-than-anticipated tax revenues over the last five years – a total of nearly $2.8 billion more revenue than budgeted for SFY 96 through SFY 00, and an additional $704 million in excess revenues in SFY 01 alone.

Specifically, in SFY 01, revenue from the *income* tax was $507 million above projected collections. Much of this was due to more income than projected from non-wage sources (capital gains, dividends, interest, and stock options). In fact, the budget act had projected negative growth of 12.7% in tax receipts from this type of income, when actual receipts *grew* by 14.5%.[6]

Also contributing to this excess revenue were higher-than-expected revenues from the oil companies' tax (by $25.3 million) and from federal grants (by $115 million, largely due to an increase in Medicaid expenditures and "supplemental federal revenue against state reimbursable expenditures from previous fiscal years").

[5] NOTE, however, some of these "surpluses" would actually be deficits if Connecticut presented its financial data in accordance with Generally Accepted Accounting Principles (GAAP). In SFY 00, the state posted a net General Fund surplus of $300.4 million on a modified cash basis. However on a GAAP basis the state recorded a General Fund deficit of $77 million, according to the State Comptroller.

[6] Of the major General Fund revenue sources, the income tax has experienced the highest rate of increase, with a five-year average annual compounded growth of 10.4%. *2001 Comptroller's Report on Connecticut's Economic Health*, p.10.

Importantly, these excess revenues occurred *despite* nearly $2 billion in tax cuts enacted since SFY 94. Moreover, changes enacted during the 2001 session, as well as changes previously enacted, are projected to result in a net reduction of General Fund Revenue of $303.7 million in SFY 02 and $332.3 million in SFY 03.

Expenditures did not grow as rapidly as revenues. In SFY 01, actual expenditures were $97.8 million higher than originally anticipated. This sum included deficiencies in the budgets of DSS, DCF, SDE, and DMHAS. According to the State Comptroller, the deficiencies in SFY 01 were "primarily the result of medical inflation that is outpacing general price increases, double digit cost increases in prescription drugs, increased staffing based on resource assessments in the Department of Children and Families, and added coverage in psychiatric care and retention efforts for psychiatrists in the Department of Mental Health and Addiction Services." Comptroller's Monthly Letter to the Governor, November 2000.

General Fund surpluses were bountiful, but not necessarily wisely invested. In part because of the exceptionally strong revenue growth noted above and in part -- in recent years -- because spending has been limited by the state spending cap, Connecticut's General Fund surpluses in the late 1990s were significant. Review of the use of these surplus funds, however, suggests that they were allocated without a well-considered spending plan to assure that funds were used strategically to meet Connecticut's pressing needs for public investment. For example, the SFY 01 surplus appropriations (as reduced by 5.91% because the surplus was less than anticipated) were as follows:[7]

Use of SFY 2001 Surplus (in millions)	$
Debt avoidance: School Construction Grants	117.6
Transportation Strategy Board Initiatives	47.0
Energy Contingency Fund	32.9
Municipal Revenue Sharing	31.0
Open Space Land Acquisition (Kelda Properties)	28.2
Transfer of Worker Compensation Claims to Private Insurer	28.2
Hospital Financing Restructuring	27.4
Community Mental Health Strategic Investment Fund	23.5
Medicaid Excess Cost	23.5
Higher Education Matching Grant Fund	18.7
Private Provider Infrastructure/Debt Fund	16.9
Residential Underground Storage Tank Clean-up	15.5
Supportive Housing	14.1
Pre-fund Mashantucket Pequot and Mohegan Fund	15.0
Higher Education Constituent Units' Operating Reserves	12.4
School Wiring	9.4
Arts, Recreation, Culture Grants	10.0
All other items (including Reading Institutes; Teacher Training; Boundless Playgrounds; relocating Hartford City Offices ($6.1M); Lease Option for Adriaen's Landing ($7.5M); CTN ($1.6M); OPM "miscellaneous grants" ($6M); Jobs Funnel, Workforce Development Boards and School to Work funds ($7.6M); CT Tech Initiatives ($6.6M)	104.9

[7] As discussed later, some of these surplus appropriations were reduced to address the SFY02 deficit. In some cases, new bond funds were authorized to replace surplus funding that was cut.

Source: Connecticut State Budget 2001-2003, p. 24

The state spending cap restricted necessary public investments when the economy was strong and encouraged some unwise budgeting practices

What is the state spending cap? Connecticut's spending cap was adopted in the early 1990s as part of the compromise that led to the adoption of the state personal income tax. The growth in state spending in the years immediately preceding the cap's adoption was nearly 11%. This rate of growth, coupled with declining revenues as Connecticut entered a recession, resulted in the need to increase taxes and cut expenditures. The cap was intended as assurance that the state would not again allow spending to so greatly exceed growth in the state's economy.

Connecticut's constitutional limitation on spending, ratified by the Connecticut electorate by a 4 to 1 margin, is being implemented also under the terms of the 1991 spending cap statute (Conn. Gen. Stat. 2-33a). The cap restricts the growth in general budgeted expenditures to the five-year average growth rate of state personal income (now about 5.5%) or the inflation rate, whichever is greater. Further, the cap can only be exceeded if the Governor declares an emergency or the existence of "extraordinary circumstances" and three-fifths of both houses of the General Assembly concur.

The cap covers not only the General Fund, but also the Special Transportation Fund, the Mashantucket Pequot and Mohegan Fund and seven other separate Funds. Excluded from the cap are expenditures for payment of bonds and debt, certain grants to distressed municipalities, and expenditures for the implementation of federal mandates or court orders (but only for the first fiscal year in which such expenditures are authorized).

Connecticut's spending cap is considered one of the two or three most restrictive in the nation, since it covers a larger proportion of state spending than most other states (about 80% of CT general budgeted expenditures), uses a five-year average of personal income growth (which is more restrictive than shorter-year averages in times of economic growth), and requires action by two branches of government for an override.

Though growth in state spending is less now than it was just prior to the cap's adoption (a 4.8% average over the period 1995-2000, compared to nearly 12% between 1987-1991), the cap has been exceeded in the last several years and has encouraged some imprudent budgeting practices.

The cap has been repeatedly exceeded. In SFY98, the cap was exceeded for the first time to expend the state's surplus funds (in prior years, state appropriations remained well enough below the cap to allow surplus funds to be spent).

Consequently, as required by the cap, Governor Rowland issued a Declaration of "extraordinary circumstances" (citing the multiple years of budget surplus and the Budget Reserve Fund at 5% of General Fund appropriations, among other things) that stated that it "is prudent to expend certain state resources to avoid the issuance of debt as well as fund several projects which are primarily one-time in nature." The legislature approved the expenditure of surplus funds by the requisite 3/5th vote, though these expenditures placed state spending over the cap by $194 million in SFY 98.

By the same process, the spending cap was overridden again in SFY 99 by nearly $526 million, in SFY 00 by $496.3 million, and in SFY 01 by $576 million. [Connecticut State Budget 1999-2001; The Comptroller's Report, 2000; OFA, *Year-End Analysis of the FY 01 General Fund and Transportation Fund Budgets,* October 2001]

The cap has encouraged some unwise budget practices. With very strong revenues and pressing needs within the state, there has been consistent pressure to find ways to evade the cap. Now that the budget is in deficit, the short-sightedness of some of these tactics will become increasingly evident.

- ***Increased reliance on borrowing.***[8] One of the perhaps unintended consequences of the spending cap is that it has encouraged an increase in state indebtedness. Because debt service is *not* subject to the cap, expenditures paid for with bond funds avoid the constitutional spending limit.

  If all of these bond funds were spent on infrastructure or other assets benefiting future generations of taxpayers, then these additions to debt could be warranted. The State Comptroller estimates, however, that of the $1.126 billion in new debt issued by the state in SFY 2000, only $489 million (43%) was for such purposes, while the balance of $637 million (57%) was used to fund "ongoing state operating expenses." In SFY 00, Connecticut added an additional $397 million to its *net* outstanding bonded debt. The Comptroller warns, "To see growing debt burdens in these prosperous times is of great concern." *2001 Comptroller's Report on Connecticut's Economic Health,* p.12.

  This incentive to "charge" expenditures to the state's "credit card" to avoid the spending cap has resulted in a more than doubling of bonded debt per capita over the past decade, growing to $2,863 by the end of SFY 00.[9] Connecticut continues to lead the nation in state tax supported debt per capita.

  Importantly, as bonded debt has increased, so too has the proportion of the state budget needed for annual debt service (principal and interest) payments. Debt service expenditures increased from 6.9% of all General and Special Transportation Fund expenditures in SFY 90 to 11.6% in SFY 01, and then fell slightly to 11.0% in SFY 02.

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8 Importantly, the state's bonded debt is *not* the only long-term financial obligation the state has. In fact, it is only about half the total amount of the state's incurred long-term obligations that will need to be paid by future generations of taxpayers. In SFY 00, Connecticut's total long-term debt obligations totaled $18.002 billion, an increase of $798 million (or 4.6%) over the previous year's total of $17.204 billion. Of this, $9.752 billion was bonded debt (54%). The balance was unfunded pension liabilities ($7.623 billion), workmen's compensation claims ($284 million), compensated absence liabilities ($294 million) and capital leases ($49 million). *2001 Comptroller's Report on Connecticut's Economic Health,* p.13.

9 According to OPM, several other factors contribute to the state's high bonded debt:. They include lack of a county government, investments in the state's Higher Education infrastructure ($287 million in SFY 01), urban act revitalization initiatives ($130 million in SFY 01), conversion of the local school construction bonding program to reduce overall costs, and "extensive support of localities" compared with other states." OPM Gov's Council Presentation, October 2000

This increasing indebtedness presents two important challenges. First, as debt service increases, the proportion of the budget available for discretionary programs declines. Second, just like a family's credit card debt, debt service is a fixed cost that cannot be quickly adjusted if revenue falls and budget deficits are projected. As the Comptroller warns, "In difficult economic times a high debt load can cripple a state's ability to respond effectively to the fiscal challenges it faces." *2001 Comptroller's Report on Connecticut's Economic Health*, p.13.

Importantly, in the past several years, state surplus funds began to be used for "debt avoidance," most specifically for "grants-in-aid" for school construction. Whereas between 1996 and 1999 Connecticut used bond funds for school construction grants-in-aid ($132 million in SFY 96, $138 million in SFY 97, $187 million in FY 98, $324 million in SFY 99), beginning in SFY 00 surplus funds were also used. This has been a prudent use of state surplus funds. Specifically, $55 million of the $455 million in grants-in-aid for school construction in SFY 00 were surplus, rather than bond, funds. In SFY 01, $297 million of the $475 million were surplus funds. OPM Gov's Council Presentation, October 2000. More than $117 million in SFY 01 surplus funds were earmarked for school construction in SFY 02. However, this amount has been reduced by $17.6 million because of the projected SFY 02 deficit. Instead, already-authorized bond funds will again be used to cover these school construction costs.

- ***Use of state tax expenditures to provide financial assistance to businesses***. The spending cap also has encouraged the use of tax expenditures to provide financial benefits to specific businesses, since "tax expenditures" are not subject to the spending cap.

  Tax expenditures are preferential credits, exemptions, exclusions or reductions in a statewide tax that reduce the state's revenue and can only be amended or repealed by a change in state law. In one respect, Connecticut's tax expenditures represent the state's highest "spending" priorities – since the funds are never collected, they cannot be spent for something else.

  A recent example of the use of tax expenditures to avoid spending cap restrictions was passage in the 2000 session of a tax credit against the insurance companies tax for managed care organizations providing HUSKY A or HUSKY B coverage. These companies had already been given an exemption against the tax for the HUSKY policies themselves. This new credit (equal to $55 times the plan's average monthly enrollment in the programs per calendar year) was provided to the companies to offset the insurance companies tax due on their *commercial* policies. Though this credit provided $10.5 million of financial benefit to the plans in SFY 01, it was not considered an "expenditure" subject to the spending cap. This past session, this credit was *increased* from $55 to $73.50 times the average monthly enrollment per calendar year, imposing an additional revenue loss of $4 million – or a total benefit to the companies of more than $14 million/year and a revenue loss to the state of comparable size.

  The danger, of course, in avoiding the cap by providing financial benefits in this way is that state revenues are reduced permanently (unless the credit is repealed). This prevents these revenues for being used for other purposes. In SFY 02 alone, Connecticut will lose $175.0 million in General Fund revenue from tax cuts enacted in the 2001 session (compared to $125.8 million enacted in the 2000 session), and an additional $127.8 million in revenue losses from tax cuts that were previously enacted that are being phased in (compared to $123 million in the prior year).

That is, despite indications that the economy was slowing, the General Assembly *accelerated* its revenue reductions in the 2001 session. The majority of the tax relief provided in the 2000 and 2001 sessions benefited business, including $111.4 million from suspension of the sales tax on hospital patient care services; $17.1 million from the continued phase-out of the sales and use tax on computer and data processing services; $53.6 million in corporate tax relief (by switching to single factor apportionment for manufacturers and broadcasters, eff. FY 02); $75 million from elimination of the hospital gross receipts tax; and a total of more than $14 million for the credit for managed care organizations discussed above. While it is possible that some of these preferential tax breaks may have served an important public interest when first enacted, unlike regular appropriated expenditures these tax breaks are *not* reviewed annually to assure that they *continue* to serve an important public interest.

Now, ironically, it is these tax breaks, that have resulted in dramatic reductions in the state's revenues over the 1990s, that will act as the "cap" on state spending – as the state faces its first deficits in a decade.

- ***Untapped federal funds.*** Because Connecticut counts money spent on federally-reimbursed programs (and not just the state share) as expenditures subject to the cap, the cap limits Connecticut's ability to take full advantage of funding made available by the federal government.

  For example, the state budget includes as expenditures all the funds spent on the state's HUSKY program, including funds that are reimbursed by the federal government. If state expenditures are close to the spending cap, therefore, there is little incentive to seek additional federal dollars, since these new federal funds could push spending over the cap. This makes little sense, since the cap was intended to constrain *state* spending and, as noted earlier, Connecticut receives far less from the federal government in grants than it pays in federal taxes.

  Connecticut is, for example, now foregoing full utilization of the federal SCHIP funding (for health insurance for low-income children) even though the federal funds "cover" 65% of the program cost (and Connecticut pays only 35%). Connecticut has failed to take full advantage of these federal funds because *all* of the funds are subject to the cap and full utilization would place the state over the cap.[10]

Last year was as good as it gets, at least in the short term

[10] Connecticut's FFY 98 allocation of SCHIP funds was $8.05 million, however $5.76 million was left unexpended (72%). Although PL106-554 allowed states that did not expend all of their FFY 98 allotments to retain some of these funds, Connecticut ended up losing more than $2 million of these federal funds that are targeted for health services for our lower-income children and families. NCSL, *State Budget & Tax News,* April1, 2001.

The window of opportunity to narrow the income and opportunity gap in Connecticut quickly narrowed in 2001. Already slowing growth in the economy was accelerated by the events of September 11. Between October 2000 and October 2001, the number of unemployed in Connecticut jumped by 53%, or 19,000 individuals. The state has lost a net total of 13,100 jobs over the past year -- including 9,200 jobs in manufacturing jobs, 1,900 in construction/mining, and 3,800 in trade. As of October 2001, employment had declined for five consecutive months. Sales tax revenue dropped 6.8% in September alone. In the words of *The Connecticut Economy*, "For all the uncertainty triggered by the events of September 11, this much is clear: when it comes to the topic of recession, the question is no longer 'if,' but 'how deep and how long." *The Connecticut Economy* (Fall, 2001, p. 3).

Now, for the first time in nearly a decade, Connecticut projects a General Fund deficit in SFY 02 -- $301.8 million by OPM's estimates and $283.5 million by the State Comptroller's estimates. As explained by the State Comptroller in her October, 2001 monthly letter to the Governor:

> The large and sudden increase in the deficit is primarily attributable to steeper than expected declines in income tax withholding and sales tax receipts posted in September. The lower than expect actual receipts for September do not reflect the impact of the September 11th terrorist attack.

Adding to the decline in state revenues are tax cuts passed in prior legislative sessions that are being implemented in SFY 02. The two most significant changes enacted in the 2001 session were the suspension of the sales tax on hospital patient care services from July 1, 2001 to June 30, 2003 (revenue loss of $111.4 milion in SFY 02 and $114.8 million in SFY 03) and an increase in the amount of the credit for managed care organizations that provide health insurance under HUSKY against their insurance premiums tax (an *additional* revenue loss of $4 million in each of SFY 02 and 03). Revenues in SFY 02 also will be reduced by changes in the tax code passed in prior legislative sessions, including:

- Phase-out of sales/use tax on computer and data processing services (revenue loss of $17.1 million in SFY 02);
- Phase-out of sales/use tax on home paving, painting, wallpapering, roofing, siding (loss of $3.3 million);
- Various other sales/use tax exemptions (loss of $8.6 million)
- Single factor formula apportionment for manufacturers and broadcasters for corporate tax purposes (loss of $53.6 million)[11];
- Exemption of tax payments under minimum tax and capital base for S-corporations (loss of $3.5 million);
- Continued phase-out of inheritance tax (loss of $29.7 million). NOTE: In the November 2001 Special Session, this was delayed to help address the SFY 02 budget deficit, allowing Connecticut to recover some of this lost revenue beginning in SFY 03.

[11] This allows a multi-state corporation to apportion its income to Connecticut based *only* on its sales within Connecticut, and not also on the proportion of its property and staff that are within the state. For corporations with a significant Connecticut presence that sell most of their products out of Connecticut (e.g. ESPN, UTC), this change in the apportionment formula will reduce Connecticut corporate tax liability greatly, though these corporations rely on state and local government for a variety of services.

- Gift tax phaseout (loss of $2.8 million)
- Refundable research and development credits (loss of $14 million).

In addition to declining revenues, General Fund spending is expected to exceed budget expectations by nearly $60 million. With a slowing economy and the challenges of September 11, Connecticut faces additional demands on state resources. Agencies seeking deficiency appropriations in SFY 02 include not only those agencies that traditionally run deficiencies (e.g., DSS, DCF), but also the Departments of Public Safety, Public Health, Environmental Protection and the Military Department. The Comptroller estimates that $2-3 million of the deficiencies result from the terrorist attack and its aftermath. *State Comptroller Letter to the Governor*, October 30, 2001.

In addition, "safety net" expenditures can be expected to rise as unemployment increases. Connecticut had a 21% increase in its winter heating season Low Income Home Energy Assistance Program (LIHEAP) between 1999-2000 and 2000-2001 – increasing from 56,340 families to 68,000 families in just one year. NCSL, *State Budget & Tax News*, May 1, 2001. Connecticut's Medicaid enrollment increased from 392,000 in FFY1995 to 403,000 in FFY1998 – during some of the "boom" years. NCSL, *State Tax and Budget News*, April 15, 2001. Medicaid spending has increased from $1.756 *billion* in SFY 94 to $1.998 billion in SFY 99, $2.217 billion in SFY 00, $2.317 billion in SFY 01, and a projected $2.454 billion in SFY 02. Medicaid spending as a proportion of the total General Fund budget has increased from 19.4% in SFY 00 to a projected 20.5% in this current fiscal year. With many families now losing jobs and income, these expenditures are likely to continue to grow at this pace, at the least.

These trends are worrisome. Because Connecticut has relied more than nearly all other states on capital gains income tax revenue, the state is particularly vulnerable to stock market corrections or other declines in capital gains. NCSL, *State Budget and Tax News*, July 2000. As health care and debt service costs have climbed, funding available for other essential services has necessarily become more constricted.

In a sense, we must now pay the piper for some of our unwise budgetary decisions in the prosperous 1990s. By increasing our state indebtedness to avoid the spending cap, enacting billions of dollars of revenue reductions without sunset provisions to review their usefulness, failing to place our welfare "savings" into a cash assistance reserve fund, and failing to use all of our surplus funds to maximally enhance the state's physical infrastructure and intellectual capital, we enter the recession far less well prepared than a state of our means should be.

Connecticut's newest challenge – balancing the budget, but NOT on the backs of Connecticut's poor

Traditionally, federal policymakers fight recessions using both tax cuts and spending increases. However, such counter-cyclical fiscal policy – deficit spending during a recession to jumpstart economic activity – is largely beyond the reach of state governments due to their balance budget rules. States must increase taxes, cut spending, or both.

Joseph Stiglitz (a 2001 Nobel Laureate in Economics) and Peter Orszag (the Joseph Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution) recently wrote in *Spending Cuts vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?*[12]

> Some state policy-makers apparently believe that from a macroeconomic perspective, reducing spending is preferable to raising taxes. For example, members of the Connecticut Economic Conference Board apparently have argued that, 'The worst action the state could take would be to raise taxes during a recession; the best course would be to cut spending.' "

Stiglitz and Pechman contest this, writing:

> Despite these claims, economic analysis suggests that tax increases would *not* be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption. "

In the absence of new federal revenue sharing to help the states (the *best* alternative of all), Stiglitz and Orszag write:

> The conclusion is that, if anything, tax increases on higher income families are the least damaging mechanism for closing state fiscal deficits in the short run.

They explain, "a reduction in government spending on goods and services is likely to be more harmful to the economy in the short run than an increase in taxes or a reduction in transfer program spending" and "reductions in transfer payments to lower-income families would generally be *more* harmful to the economy than increases in taxes on higher-income families, since lower-income families are more likely to spend any additional income than higher-income families."

Similarly, in her October 30,2001 letter to Governor Rowland, the Comptroller advised "caution in implementing deep allotment reductions that will diminish the effectiveness of investments we are making in our state's future, and will intensify the economic problems we are experiencing now." And, in testimony before the Human Services Committee on November 7, 2001, in anticipation of the November Special Session to address the SFY 02 budget deficit, Professor Fred Carstensen, a professor of economics at the University of Connecticut and Director of the University's Center for Economic Analysis, testified strongly *against* any spending cuts, proposing – instead – a number of tax code changes that would both increase revenues and the progressivity of our state tax code.

As discussed in more detail in *Before You Cut, Think of the Alternatives*[13] the state's budget deficit can be addressed in a number of ways that do not involve cutting state spending on programs that help our most vulnerable citizens; cuts that would fuel the recession. These include: increasing our claims for federal funding; reviewing and eliminating tax expenditures that no longer serve essential public

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[12] Peter Orszag and Joseph Stiglitz, *Spending Cuts Vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?* (October 31, 2001). http://www.cbpp.org/10-30-01sfp.htm

[13] S. Geballe & D. Hall, *Before You Cut, Think of the Alternatives* (CT Voices for Children, November 7, 2001), on www.ctkidslink.org.

functions; well-targeted revenue increases (including by closing tax loopholes); using bond funds (again) to support school construction and open space purchases; investing in programs that save substantial sums long-term; and using the state's Budget Reserve (or "Rainy Day" fund) as a means to buy some precious time to allow the economy to recover and to assess options.

While deeper cuts could have been made – imposing greater cost on the economy and the state's most vulnerable residents -- the General Assembly in Special Session in November, 2001, adopted a number of more modest revisions to the SFY 02 budget. The General Assembly deferred action on projected agency deficiencies until the 2002 Session.[14] Specifically, the General Assembly cut $164.3 million in spending:

- $35.3 million in FY 02 General fund operating budget accounts
- $129 million in SFY 01 surplus funding for various state initiatives.

In addition, the Governor projects savings totaling $36.4 million from allotment reductions and from agencies achieving additional targetable savings ("lapses"). Thus, budget reductions total $200.7 million (offset by a $0.5 million federal revenue loss due to a $1 million reduction in the Medicaid account).[15] NOTE, however, that the impact of some of the surplus spending cuts was offset by a $67 million *increase* in bond authorizations. These new bond funds are now to be used to help cover some of the costs of projects that were to have been paid for with surplus.[16]

In addition, the General Assembly delayed the scheduled phase-out of the state's succession/inheritance tax by postponing the increase in exemption amounts for two classes of beneficiaries (who are more distant relatives or non-relatives).[17] This delay will result in a revenue gain in SFY 03 of $11 million, increasing to a revenue gain of more than $32 million in SFY 06.

Included among the programs and services on the cutting block were many that support the state's most vulnerable[18]; protected from the budget ax were many favored by the state's most politically-powerful.[19] In addition, only the inheritance tax phase-out was delayed; there was no serious consideration of delaying or repealing other preferential tax breaks that are contributing to the General Fund deficit.

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14 SA 01-1 (November 15, 2001 Special Session). See OFA, *Highlights of the November 13th and 15th Special Sessions* (December 5, 2001).

15 As originally adopted, the SFY 02 budget was under the spending cap by $78.2 million. Based on these reductions, the SFY 02 budget is under the cap by $101.4 million.

16 I.e..the private provider infrastructure program, school technology wiring, DOIT's education technology initiatives, the Kelda land purchase for open space, the residential underground storage tank program, the Transportation Strategy Board, and DPW minor capital improvements.

17 PA 01-1 (November 15, 2001 Special Session). In addition, in SA 01-1 (November 13, 2001 Special Session) the General Assembly voted to continue medical coverage/health insurance for dependents of state employees called to active duty, as well as to pay the state employee the difference between their state base rate of pay and their active service compensation. When this Special Act was passed, there were 50 Connecticut state employees on active duty; the estimated cost of this provision is about $120,000 per month for these 50.

18 E.g., Drugs Don't Work; Leadership, Education and Athletics in Partnership (a highly successful youth development program for inner-city youth); private provider infrastructure fund; school-to-work; AIDS services; community health services; supportive housing; community mental health services; HUSKY outreach; safety net services; services for persons with disabilities; school readiness; Head Start Services and Head Start enhancement

19 E.g. Lease option for Adriaen's Landing ($7.5 million) and funds to re-locate Hartford city offices ($6.1 million); OPM's "miscellaneous grants" budget line ($6 million).

While the State Comptroller reports that there are signs that the economy may be improving[20], she is still projecting that the state will end SFY 02 with a budget deficit of $95.7 million (even after taking into account changes made in the November 2001 special session). Office of the State Comptroller, Press Release, December 3, 2001.

Given this, one would hope that the 2002 General Assembly Session will carefully consider *all* alternatives for balancing the SFY 02 budget. These should include revenue enhancements (by closing tax loopholes and repealing tax expenditures that have outlived their usefulness) and not only spending reductions that fall disproportionately on those among us who have the least.

Otherwise, the divides in Connecticut will continue to grow, and – like fault lines – increasingly will threaten our state's economic and social security.

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