BUDGET CONNECTION$

A Connecticut Voices for Children
Research Brief

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The Governor's Proposed Revisions to FY04-05 Budget
Part I: Overview & Proposed Revenue Changes

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I. Overview

The Governor's recommended FY 05 budget for *all* funds is $14.235 billion, or $179 million more than the net FY 05 budget adopted last year.

The Governor's proposed net FY 05 *General Fund* budget is $13.154 billion ($13.263 billion less $109 million in lapses and other savings)[1], or $187 million more than the net FY 05 General Fund budget adopted last year (and $592 million more than the FY 04 appropriation). However, the proposed Governor's proposed revised FY 05 budget is $1.354 billion (9.3%) less than the net FY 05 General Fund Current Services budget of $14.618 billion. By comparison, the FY 04 General Fund budget is *nearly 9% less* than necessary to maintain state services at current levels.

The Governor's proposed FY 05 budget is under the spending cap by $58.6 million. By comparison, the FY 04 budget is under the state spending cap by $346 million. Based on current General Fund revenue estimates, the Governor's revised FY 05 budget would result in a General Fund surplus of $0.5 million. Inflation-adjusted growth, compared to FY 04 estimated spending, is just over 3%, compared to less than 1% real growth in the preceding year.

The biennial budget's continued use of one-time revenues (including temporary corporate surtaxes, the proposed securitization of tobacco revenue funds and various fund transfers) results in a significant structural deficit in FY 06 unless action is taken to add permanent revenues, make further cuts to spending, or *continue* to rely on one-time revenue sources. The Governor reports that the revised FY 05 budget would include $513.2 million in one-time revenues (compared to $574.6 million in one-time revenues in the FY 04 budget).[2] While one-time revenues represent a relatively small percentage of overall revenues (4.6% in FY 04 and 3.9% in the proposed revision to FY 05), the failure to restore an adequate permanent revenue stream means budget crises will continue to exist after this year. *OFA has projected a $606 million General Fund deficit in FY 06, even if the economy improves*.[3]

The Governor's revised FY 05 budget increases state aid to towns by about $6.5 million over the original FY 05 budget and about $26 million over estimated appropriations for this year. However, proposed statutory aid to towns in FY 05 ($2.196 billion) is *less than* provided in FY 02 ($2.237 biillion), even without adjusting for inflation.

This short report first summarizes the Governor's proposed revisions to the FY 05 budget, then reviews proposed changes in revenues, putting these changes in context of recent deficit-mitigation. Part II of this report summarizes proposed changes in spending in FY 05.

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[1] The FY 05 General Fund budget as adopted last year included an estimated $282 million in lapses and other savings. The Governor's proposed revision includes $109 million in lapses and savings: the same amounts in savings for legislative unallocated lapses ($2 million), other unallocated lapses ($75 million) and general personal service and other expense reductions ($25 million), but *no* savings from the Early Retirement Plan (the original FY 05 budget included $140.4 million in savings), from reductions in workers' compensation (the original FY 05 budget included $5 million in savings), and "extraordinary rescissions" (the original FY 05 budget included $55 million in savings). Savings from fleet reduction are decreased from $5 million to 2.5 million.

[2] *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 27.

[3] OFA, *Connecticut State Budget 2003-05* (December, 2003), p.17.

II. The Governor's Proposed Revised FY 05 Budget: A Summary

A. The Net Budget. The following table compares the Governor's proposed revised net FY 05 budget (and the net budgets of its key funds) with the net budgets for FY 02, FY 03 (as revised for the second year of the biennium), and FY 04, the FY 05 Current Services budget, and the Governor's proposed FY 05 revisions.[4]

Changes in *Net* Appropriations (in millions)[5]					
	Net FY 02 (as originally budgeted)	**Net FY 03 (as revised by PA 02-1 (MSS))**	**Net FY 04 Budget**	**FY 05 Current Services**	**Gov's Revised Net FY 05**
General Fund	$11,893.951	$12,091.804	$12,451.955[6]	$14,617.854	$13,153.658
Transportation Fund	$840.747	$903.162	$897.565	$971.548	$915.090
Mash. Pequot & Mohegan Fund	$135.000	$134.220	$85.000	$135.000	$85.000
All Other Funds	$86.305	$88.582	$85.997	$95.183	$81.518
GRAND TOTAL	**$12,956.003**	**$13,217.768**	**$13,520.517**	**$15,835.985**	**$14,235.266**

As shown in this table, the Governor's proposed revised net FY 05 budget is $1.6 billion *less than* the original FY 05 Current Services budget. By comparison, net FY 04 General Fund appropriations were *less than* the FY 04 Current Services Budget by $1.18 billion. The proposed revised FY 05 budgets for the Transportation Fund, the Pequot Fund, and the total of all other Funds are also less than FY 05 Current Services.

[4] OFA defines the Current Services budget to be the amount required to provide -- in the succeeding fiscal year -- the same services as in the current fiscal year plus any scheduled or required changes. Estimated expenditures are updated for inflation, annualization of partial year costs, projected increases or decreases in caseload, completion of projects, collective bargaining increases, costs mandated by statute or court order, and the scheduled opening of new buildings, for example. "FY 05 Current Services" thus represents OFA's estimate of the funding required to provide in FY 05 the same level of services as were provided in FY 04.

[5] This chart presents net *appropriations* for the years shown. The amount of funds actually spent in the corresponding fiscal year will differ. This is particularly true since November 2001 when mid-year reductions have resulted in cuts to various budget accounts. These reductions have occurred not only through normally-occurring lapses, but also through "forced" lapses and rescissions imposed by the Governor and by action of the General Assembly. In addition, deficiency appropriations result in funding at year-end that exceeds the originally-budgeted amounts in certain accounts. Actual General Fund spending in FY 02, for example, was $11.66 billion, not the $11.89 billion budgeted. Actual General Fund spending in FY 03 was $12.12 billion, or $28.2 million higher than the $12.092 billion originally appropriated.

[6] The FY 03-05 budget bill included a total of $12.445 million in net FY 04 General Fund appropriations. Subsequently, however, in a budget implementer bill (PA03-6, JSS, §208), $7.1 million was appropriated to DPH for immunization services. This increase was supported by revenues from a new "health and welfare" fee to be assessed by the Insurance Commissioner on companies doing life and health insurance, with funds deposited in the General Fund (PA 03-3, JSS, §6). The sum shown in the table includes this $7.1 million increase in FY 04 net General Fund appropriations. The Governor's proposed revised FY 05 budget would reduce this assessment by $1 million, to $6.1 million/year.

B. Proposed Revisions to the FY 05 General Fund Budget. The following table summarizes the Governor's proposed changes to the FY 05 budget:

	(In Millions)
Original FY 05 General Fund Appropriation	**$12,966.9**
Increased General Fund Appropriation	
-Net Technical Adjustments[7]	$94.1
-Reductions[8]	($63.5)
-Expansions	$74.1
-CATCH-F Appropriation[9]	$27.1
-Extraordinary Rescission Addback	$55.0
Total Increase	**$186.8**
Original Revenue Forecast	**$12,967.1**
-Revisions to Revenue Forecast	($28.7)
-Tax Increases	$100.8
-Other Revenue Enhancements/Federal Fund Changes	$115.0
New Revenue Forecast	**$13,154.2**
New Proposed General Fund Appropriation	**$13,153.7**
Revised Balance 6/30/05	**$0.5**
Source: *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 23	

C. Budget Growth. The Governor estimates that his revised FY 05 budget for all appropriated funds is 4.4% greater than the FY 04 budget, not adjusted for inflation. (Inflation-adjusted growth is about 3.0%). This compares to a 2.68% growth in appropriations between FY 03 and FY 04 (and inflation-adjusted growth of just 0.8%.)[10]

D. Spending Cap. The Governor's proposed revised FY 05 budget is under the spending cap by $58.6 million. By comparison, the FY 04 budget is $356 million under the state spending cap and the FY 03 budget was $376 million under the cap. Because agency deficiencies in the past five years have averaged more than $88 million (though just $66 million in FY 04), total state spending is likely to be right at, or exceed, the cap.

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7 This includes adjustments for changes in caseloads, inflation rates, lost savings due to delays in savings initiatives, roll-out of deficiencies, and inclusion of certain collective bargaining funds.

8 The reductions and additions are discussed in Part II of this budget analysis.

9 The new Commission on Arts, Tourism, Culture, History, and Film (CATCH-F) was funded in the biennial budget through a $20 million revenue intercept. The Governor proposes, instead, to eliminate the revenue intercept, put the funds in the General Fund, and fund CATCH-F with a deficiency appropriation this year. He also proposes to increase funding by $7.1 million. He explains that the elimination of the revenue intercept "does not impact the amount of money going to tourism. But it does bring more accountability to the use of the funds and forces the agency and its programs to compete with other agencies for limited resources." *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 31.

10 By comparison, between FY 02 and FY 03, state spending grew just 1.7%, which was *less than* the rate of inflation over this period (which was 2.1%). M. Ryan, *The State Budget and the Economy* (October 15, 2003 PowerPoint presentation). If one adjusts spending growth from FY 04 to proposed FY 05 for the change in funding for the new Commission on the Arts, Tourism and for one-time expenditures, all funds growth is 4.6% (3.2% adjusted for inflation) and General Fund growth is 4.8% (3.4% adjusted for inflation). *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 27.

E. Aid to Towns. While total statutory aid to towns is increased very slightly in the Governor's proposed revisions to the FY 05 budget (by $6.5 million), proposed town aid in FY 05 is $40 million *less than* FY 02 aid and the gap is even larger if one takes inflation into account. While the Governor proposes to level-fund the majority of school grants[11] and non-education grants,[12] he proposes to eliminate: a) the housing Payment-in-Lieu-of-Taxes (PILOT) grants funded by DECD to help compensate some towns for the loss of taxes on non-profit developments and housing authorities ("saving" $4.8 million for the state); and b) the drug enforcement grants (which had been funded at $15 million in FY 02 but just $0.85 million this year). The Governor also proposes to maintain the last years' change in state reimbursement for veteran's property tax reductions – continuing to require towns to providing tax relief to the 185,000 veterans who have higher incomes, but failing to compensate towns for the lost property tax revenues (a "savings" of $5.9 million to the state, but a comparable loss to the towns). The state would continue to provide state reimbursements for the 22,000 lower-income veterans' property tax breaks.

To help relieve financial pressure on towns, the Governor proposes to identify state resources to "remove the $55 million extraordinary rescission in the original adopted budget" which would likely have resulted in midyear cuts to towns. As noted below, the Governor also proposes to allow the eighteen distressed municipalities the option of increasing their local real estate conveyance tax by 0.25% over the base rate, but would not maintain the temporarily higher current base rate of 0.25%, allowing it to return to 0.11%. The Governor proposes to increase the Priority School District grants by $18.7 million compared to FY 04 and the current FY 05 budget. Of this, $2.7 million is for new programs in schools designated as "In Need of Improvement" under the federal "No Child Left Behind" law.

III. The Governor's Revised FY 05 Budget: Revenues

A. A Bit of Context. The Governor reports that between the time he first took office and 2002, $2.064 *billion* in permanent tax cuts were enacted that have been fully implemented. These include: $711.5 million in personal income tax reductions; $496.6 million in corporation business tax reductions; $193.3 million in sales tax reductions; $190.4 million cut from the hospital tax; $190.2 million cut from gas and petroleum taxes; $158.1 million cut from the inheritance tax; $68 million cut from taxes paid on machinery and equipment, and $57.8 million in other tax cuts.[13]

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[11] Level-funded are grants for: vocational agriculture, public and non-public transportation of school children, adult education, health services for pupils in private schools, ECS grants, young parents program, school breakfast program, special education excess cost-student based, school to work opportunities, youth service bureaus, and early reading success programs. *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 151.

[12] Level-funded are grants to distressed municipalities, elderly circuit breaker property tax relief, PILOT for state owned property and for colleges and hospitals, town aid road, and PILOT of new machinery and equipment, as well as grants to public libraries and Connecticard payments. *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 151.

[13] Governor's *2003-2005 Biennial Budget Introduction Supplement* (p. 34). OPM Secretary Marc Ryan reports that tax cuts fully implemented over this period have resulted in a total $2.08 billion cut in taxes. Secretary Ryan reports a total of $72.3 million in "other taxes" cut, compared to the Governor's $57.8 million total cut in this category. M. Ryan, *The State Budget and the Economy* (October 15, 2003 PowerPoint presentation), p. 43. Note, moreover, that there were significant tax cuts in the 1990s even *before* Governor Rowland was elected.

Since then, budget bills enacted to address the FY 02, 03 and 04 budget deficits have included a total of more than $900 million in net permanent tax increases.[14] In short, the *total* of all recent permanent tax increases – including those enacted in the 2003 regular and June special session -- is still *less than half* of the $2 billion in taxes cut in the prosperous late 1990s when a temporary surge in capital gains taxes generated state budget surpluses.[15]

B. FY 05 Proposed General Fund Revenue Changes, In Short. The Governor proposes to increase net taxes in FY 05 by $100.8 million, principally through "sin" taxes. In addition, delays in tax reductions, a proposal to escheat bottle deposits, and all other net revenue changes account for an additional $115 million. Offsetting these increases is a reduction of $28.7 million in the original FY 05 revenue estimates. Contributing to this reduction is a $97 million downward revision in projected corporate tax revenue projections, a $5 million reduction in Indian gaming payments, and a $3 million increase (to $17 million) in the cost of the refundable research and development tax credit "exchange" program (that allows corporations with little or no tax liability to "sell" back to the state at 65% of value "unused" tax credits). Offsetting increases in estimated revenues include an increase in estimated personal income tax and sales tax revenues.

C. A Closer Look at the FY 04-05 Biennial Budget's Revenue Changes. The Governor's proposed revenue changes in the FY 05 budget are as follows.

GOVERNOR'S PROPOSED GENERAL FUND REVENUE CHANGES	**FY 04** (in millions)	**FY 05** (in millions)
TAXES		
Personal Income Tax		
Change treatment of non-resident partners/members of pass-through entities (e.g. LLCs, LLPs, S corporations) to capture income taxes currently going uncollected	$0	$8.0
Sales & Use Tax		
-Delay repeal of tax on sales of newspapers & magazines until 7/1/05 (exemption had been repealed in PA 03-2, but biennial budget had restored exemption effective 7/1/04).	$0.0	$15.0
-Increased sales & use tax resulting from cigarette tax increase	$1.8	$5.3
-Increased sales & use tax resulting from alcohol tax increase	$0.1	$0.3
-Adopt model legislation to recover lost revenues from internet and catalog sales through Streamlined Sales Tax Project		

14 During this period of time, there also have been some tax reductions, notwithstanding the existence of deficits. PA 02-1 (MSS), for example, exempted business analysis, management, consulting, and public relations services furnished "in connection with an aircraft" retroactive to 1/1/94 ($0.8 million revenue loss in FY 03 and $0.2 million each year thereafter), while PA 02-4 (MSS) extended and expanded various tax breaks for clean fuels (a $1.3 million revenue loss in each of FY 03 and FY 04).

15 The spending cap's measure of personal income growth does *not include* capital gains income. Thus, when capital gains income surged in the late 1990s, budget surpluses resulted. In 1994, Connecticut residents reported $2.547 billion in capital gains income. By 2000 this had increased to $15.435 billion. In 2001, however, the capital gains income reported by Connecticut residents fell to $7,391 billion. Although this 52% drop in a single year was very significant, capital gains realizations reported by Connecticut taxpayers in 2001 still exceeded those reported in 1997 (adjusted for inflation) and each of the three years before that. M. Ryan, *The State Budget and the Economy* (October 15, 2003 PowerPoint presentation), p. 34; *Governor's Midterm Budget Revisions: FY 2004-05* (February 2004), p. 3.

GOVERNOR'S PROPOSED GENERAL FUND REVENUE CHANGES	FY 04 (in millions)	FY 05 (in millions)
Corporation Business Tax		
-Allow, *on a permanent basis*, corporations that pay the $250 Alternative Minimum Tax or the capital base tax to qualify for the Research and Development Tax Credit exchange program (which allows the corporation to "sell back" to the state at 65% of value all tax credits that cannot be taken because the corporation does not have sufficient corporation tax liability to offset with tax credits).	A temporary extension to capital base companies was passed last year in PA 03-1, JSS, §§ 89, with an estimated annual revenue loss of $12.5 million/year in FY 04 and FY 05. This would make that revenue loss permanent.	
Succession & Estate Tax		
-No changes proposed		
Gift Tax		
-No changes proposed		
Insurance Companies Tax		
-Disallow Insurance Reinvestment Tax Credits for investments made after December 31, 2004	Unknown	Unknown
Public Service Companies Tax		
-No changes proposed		
Oil Companies Tax		
-No changes proposed[16]		
Cigarette/Tobacco Tax		
-Increase cigarette tax from $1.51/pack to $2.05/pack (eff. 4/1/04)	$32.8	$93.7
-Increase tax on cigars, pipe and chewing tobacco from 20% to 30% of wholesale price and tax on snuff from $0.40 to $0.60/ounce (eff. 4/1/04)	$0.5	$2.4
-Floor tax on inventory	$8.6	$0.0
Alcohol Beverage Tax		
-Increase alcohol tax by 10% (from $0.11 to $0.12/6 pack of beer; from $0.60 to $0.66/gallon of wine; from $4.50 to $4.95/gallon of distilled spirits)(effective 4/1/04)	$2.0	$4.4
-Floor tax on inventory subject to increased alcohol tax	$0.6	$0.0
Misc. Taxes		
-Eliminate revenue intercept of $20 million in taxes from hotel occupancy tax. Revenues to return to General Fund, w/ Commission	$20.0[17]	$20.0

[16] The revised budget proposes to eliminate the 1-cent/gallon "tax break" for ethanol-based fuels if the amount of ethanol in the fuel equals or exceeds 10%. This change is said to be necessary because the prohibition of MTBE in gasoline (effective January 1, 2004) is resulting in gasoline in the state being formulated insetead with ethanol. In November 2003, sales of gasohol were 40% of all fuel sales, compared to just 4.5% in November 2002. Elimination of this "archaic" tax break would ensure that all gasoline remains taxed at the same rate, and could save as much as $15 million/year in revenues. The Governor explains, "It was not the law's intent to have the 1-cent decrease kick in just because of the ban on MTBE in gasoline. In truth, the discount law is an anachronism; it was put in place nationally by an aggressive lobby promising that ethanol would mean a much cleaner environment." *Governor's Midterm Budget Revisions: FY 2004-05* (February 2004), p. 34.

GOVERNOR'S PROPOSED GENERAL FUND REVENUE CHANGES	**FY 04** (in millions)	**FY 05** (in millions)
on Arts, Tourism, Culture, History, and Film (CATCH-F) now to rely on yearly appropriation rather than intercept "to bring more accountability to the use of the funds" and force the agency and its programs "to compete with other agencies for limited resources"		
-Amend Urban Reinvestment Tax credit program to reduce the required capital investment to qualify for the credit from $20 million to $5 million		
-Implement DRS Integrated Tax Administration System (expected to increase collection of various state taxes)		$49.0
FEES		
-Reduce by $1 million (from $7.1 million to $6.1 million) the total annual "health & welfare" fee imposed in the biennial budget on each domestic insurer or HMO that does any life or health insurance in CT to pay for DPH's child and adult immunization program, TB and communicable disease treatment & data collection re immunization status of Medicaid children [PA 03-3, JSS, §6]	**($1.0)**	**($1.0)**
ESCHEATS		
-Escheat unclaimed deposits on unreturned beverage containers (eff. on passage, with first quarterly payment for quarter ending 6/30/04)	$4.5	$20.0
TRANSFERS *TO* THE GENERAL FUND FROM OTHER FUNDS		
-Transfer "excess" revenue in Pretrial Alcohol and Drug account to General Fund	$1.5	
-Transfer "excess" revenue from State Marshalls account to the General Fund	$0.3	
-Transfer $2 million of boat registration revenue to General Fund (as registration is converted to a biennial system)	$2.0	
-"Permanently" move $13 million of petroleum gross earnings taxes currently scheduled to go to the Special Transportation Fund back to the General Fund	$13.0	$13.0
TOBACCO SETTLEMENT FUNDS		
-Transfer "remaining interest balance" of the Tobacco Trust Fund (after funding DPH asthma program)	$0.1	
-Transfer to the General Fund the remaining $2 million of tobacco settlement revenue that is to go to the Biomedical Research Trust Fund (the other $2 million was transferred in the biennial budget)	$2.0	
GOVERNOR'S PROPOSED SPECIAL TRANSPORTATION FUND REVENUE CHANGES		
-Increase rail fares by 5.5% effective July 1, 2004 and bus fares by $0.15 on July 1, 2004 (rather than January 1, 2005, as originally scheduled)		$8.0
-Increase sixteen DMV fees		$7.6

[17] The Office of Fiscal Analysis records earmarked funds as a General Fund revenue loss. Therefore, this elimination of earmarking is a revenue gain to the General Fund.

GOVERNOR'S PROPOSED GENERAL FUND REVENUE CHANGES	FY 04 (in millions)	FY 05 (in millions)
GOVERNOR'S PROPOSED MUNICIPAL REVENUE CHANGES	**FY 04 (in millions)**	**FY 05 (in millions)**
-Return local real estate conveyance tax to 0.11% (from temporarily-increased 0.25% rate, effective through 6/30/04), but allow distressed municipalities to increase their rate by 0.25% above the 0.11% base rate (i.e. to 0.36%) by vote of local legislative body		Depends on which cities exercise the option[18]

Special Transportation Fund. As noted above, the Governor proposes to increase sixteen motor vehicle fees for a total annual revenue gain of $7.6 million. Fees increasing to $20 include fees on title record copies, vehicle transfers, record transfers, assigning a security interest in a vehicle, auction permits, flashing light permits, temporary registration fees, etc. The bad check fee is to increase from $15 to $35, the commercial driving instructor fee from $10.75 to $50, the vehicle suspension restoration fee from $100 to $200, and the driving school branch fee from $88 to $350. In addition, the Governor proposes to increase rail fares on Metro-North to and from Connecticut stations by 5.5% effective July 1, 2004, and to accelerate the start of the $0.15 bus fare increase to July 1, 2004, rather than January 1, 2005. These two fare changes are expected to save the Special Transportation Fund about $8 million in FY 05 and $5.5 million annually thereafter. Between the fee increases and fare increases, there are on-going revenues and savings that total about $13 million/year in the STF. This offsets the fiscal impact on the STF of the Governor's proposal to "permanently" move $13 million of petroleum gross earnings tax currently scheduled to go to STF back to the General Fund on an on-going basis.

D. The Governor's Proposed FY 04-05 Tax Changes – Some Analysis

a. There is excessive reliance on "sin" taxes. Taxes on cigarettes and alcohol often serve two purposes – to raise revenue and to reduce consumption. Since an increase in taxes on a good tends to reduce public consumption of the good, such taxes are not a stable source of revenues. Most studies find, for example, that a 25% increase in the price of cigarettes reduces the consumption of cigarettes by slightly more than 11%. Since state services tend to increase in cost each year because of inflation and publication growth, a sin tax is ill-suited to cover such costs since the gap between declining sin tax revenue and rising government expenditures will grow over time. In addition, even if a sin tax is unsuccessful at decreasing consumption, it cannot keep pace with the rising cost of state services. These taxes are imposed at a specific rate that is based on the quantity of the product purchased, not its price. The same tax is imposed on a $5 bottle of cheap wine as on a bottle of very expensive wine. Thus, unlike a general sales tax increases with the cost of the product, sin taxes only increase if consumption increases.

18 OFA had estimated a $10 million revenue gain in 2003 if all 18 distressed municipalities had increased their local real estate conveyance tax to 0.50% as temporarily allowed. In fact, 12 of the 18 municipalities chose to so increase the tax.

In addition, sin taxes – like other sales-type taxes – are regressive; lower-income people spend a greater proportion of their income than high income people, so are disproportionately subject to sales and sales-like taxes. In addition, cigarette taxes, in particular, are regressive since lower-income people are more likely to smoke than higher-income people.

Unless "sin" taxes are used for primarily one-time or short-term costs, they should be coupled with more stable and progressive revenue sources so that revenues can grow with state costs. Also, "sin" tax increases should be coupled with low-income tax relief (such as through a refundable state earned income tax credit) that is enacted to offset their regressivity. The Governor's budget proposes to do none of this.

b. Recent increases in taxes remain less than half the cuts in taxes enacted since Governor Rowland was elected. As shown in the table below, net tax increases enacted since the November 2001 Special Session are less than half the total tax cuts made between the time Governor Rowland was first elected and deficits began.[19]

	Tax Cuts in Rowland Tenure, Pre-November 2001 Special Session[20]	Total Net On-Going Tax & Fee Increases[21] (FY 04 revenue)	*Net* Change in Taxes & Fees (net increases since 11/02 less cuts prior to 11/02)
Income Tax	-711.5	537.4	-174.1
Sales Tax	-193.3	-49.5	-242.8
Corporation Tax	-496.6	114.0	-382.6
Hospital Tax	-190.4	0	-190.4
Cigarette Tax	0	193.2	193.2
Inheritance Tax	-158.1	28.1	-130.0
Gasoline/Diesel/Petroleum Tax	-190.2	14.5	-175.7
Local Business Property Tax	-66.1	0	-66.1
Other Taxes & Fees	-57.8	48.7	-9.1
TOTAL	**-2,064.0**	**886.4**	**-1,177.6**

c. Although net taxes are less, *who* is paying them is not the same. To gain revenues, Connecticut did not simply roll-back each of the various taxes that were cut in the late 1990s. Rather, there is significant variation among the taxes that were *increased* since General Fund deficits emerged in FY 02 and the taxes that were *cut* when there were General Fund surpluses in the late 1990s. The following chart shows graphically how the *net* tax *increases* enacted through, and

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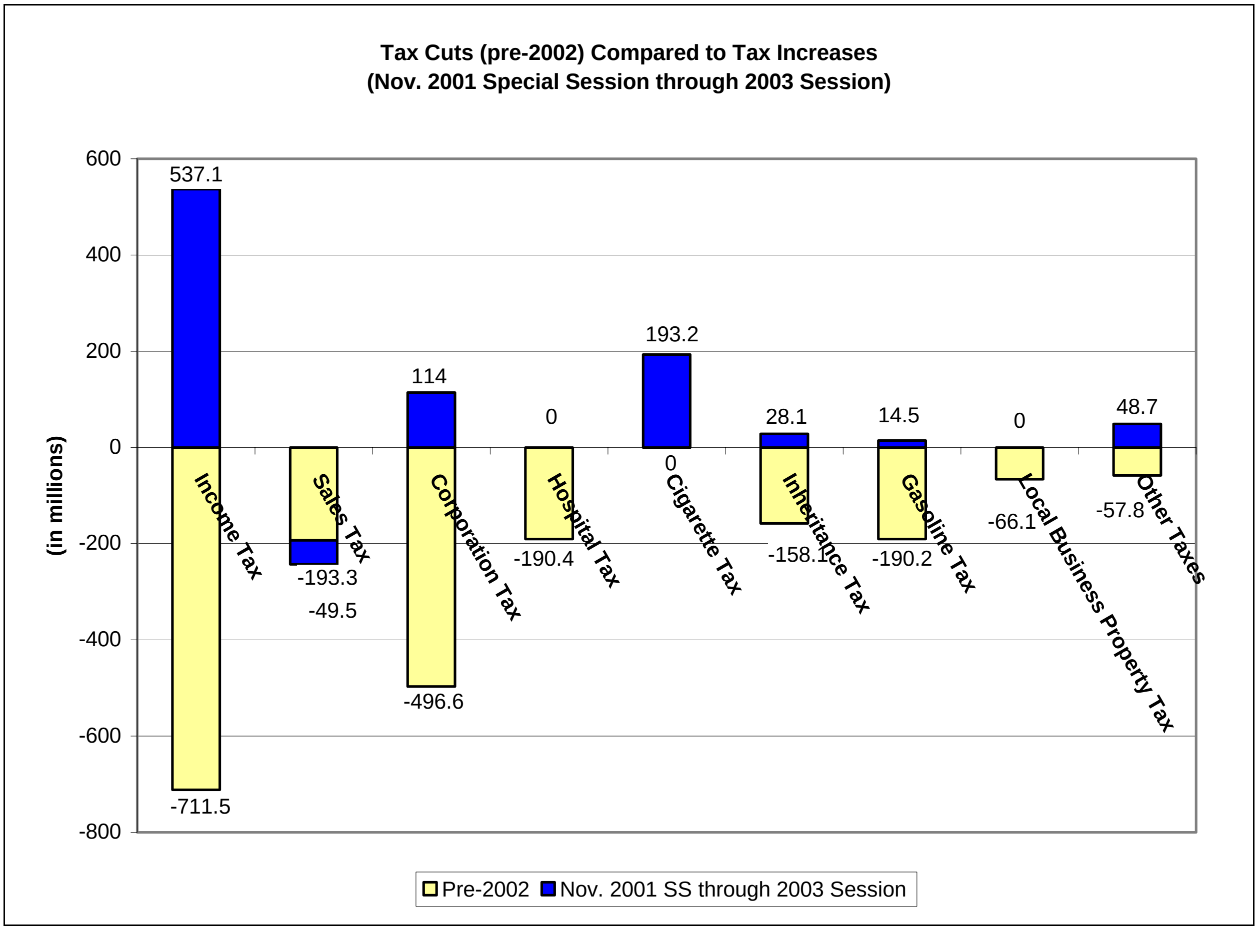
19 Note, these numbers differ somewhat from the numbers reported in the *Governor's Midterm Budget Adjustments: FY 2004-2005*. It appears that the table on p. 35 reports tax *increases* over the period 2002-03 but not necessarily all tax cuts enacted over the same period (i.e., the *net* tax change in the period). Over this period, for example, Connecticut eliminated the 5.75% sales tax on patient care services. The revenue loss of more than $116 million in FY 05 alone appears not to be captured on the table.

20 *Governor Rowland's Budget Proposal FY 2003-2005 Biennium* (March 4, 2003 Powerpoint), p. 46.

21 The table does not include revenues from temporary surtaxes since fail to address the structural deficit in a permanent way. The table *does* include revenues resulting from delays in implementation of tax cuts. Because OFA reduces General Fund revenues whenever funds are earmarked, this table assumes the same. NOTE: taxes and fees shown in this table include not only General Fund fees and taxes, but also Special Transportation Fund fees and taxes.

including, the FY 03-05 budget compare to the tax *cuts* from the time Governor Rowland took office and the time that deficits emerged, by type of tax.[22]

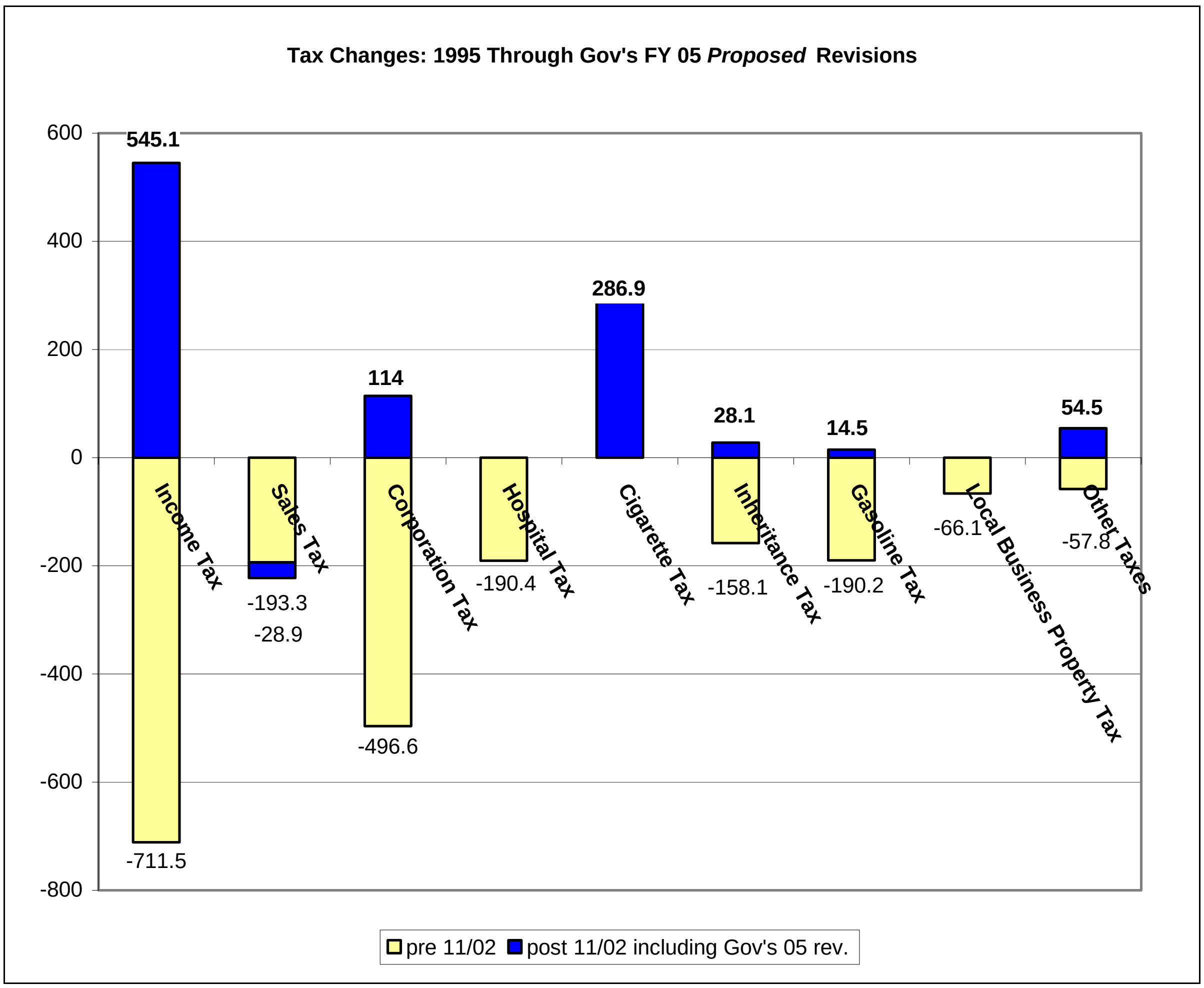


As shown on the chart above, in the late 1990s the personal income tax was reduced by a total of $711.5 million (largely because of the property tax credit). To date, deficit-mitigation efforts have *increased* the personal income tax by $537.4 million, primarily from the rate increase from 4.5% to 5% (resulting in $403.9 million in additional FY 04 revenue) and the reduction in the maximum property tax credit and elimination of the residual $100 credit for high-income taxpayers (resulting in a $112 million in additional FY 04 revenue). *That is, a little more than ¾ of the personal income tax cuts made in the late 1990s have been rolled-back since deficits began.*

[22] The chart includes only those net tax increases (and reductions) that are *not temporary*. Excluded as tax cuts, for example, were Connecticut's two tax rebates in the late 1990s (a total of $219.2 million for an income tax rebate in FY 99 and a sales tax rebate in FY 00). Similarly excluded as tax increases are the 20% surcharge on the corporation tax for income year 2003 (in PA 03-2) and the 25% surtax for income year 2004 (in the FY 03-05 budget bill) that together add a projected $82.4 million to FY 04 revenues (since they do not result in permanent changes in the corporation business tax). *Included*, however, are revenues from *delays* in the implementation of tax cuts already enacted (such as the delay in the phase-out of Connecticut's inheritance tax).

By comparison, the corporation business tax was cut by nearly $497 million between the time the Governor was first elected and the November 2001 Special Session. Since then, structural changes to the corporation business tax have resulted in $114 million in net new FY 04 revenues. *That is, just 23% of the corporate tax cuts made in the late 1990s have been rolled back permanently.* Sales taxes were cut by $193 million pre-2002, and have been cut another $49 million (net) since. Since corporations pay a significant share of sales taxes, these reductions also benefit businesses.

d. Governor Rowland's proposed changes would further add to the tax burden borne by individuals, but would spare corporations. As noted above, the vast majority of on-going tax increases proposed by Governor Rowland to increase FY 05 revenues are from increases in the cigarette tax. This tax falls disproportionately on lower-income individuals (who smoke at a greater rate, and who spend a greater proportion of their income on taxable goods). The following chart shows the total changes in tax since 1995 *if Governor Rowland's* proposed changes were adopted without change:



e. The trend away from the use of one-time revenues to address state deficits continues. The following table illustrates how the mix of new revenues since FY 02 deficit-mitigation began has changed – from nearly exclusive reliance on one-time revenues and fund transfers to more emphasis on restoring permanent revenues.

Proportion of New Revenues from Various Sources: FY 02-FY 04				
	FY 02	**FY 03**	**FY 04**	**FY 05 (proposed)**
On-going Tax/Fee Increases	7%	31%	62%	83%[23]
Delay in Implementation of Already-Enacted Tax Cuts	0%	4%	1%	9%
One-Time Revenues & Fund Transfers	93%	65%	37%	8%[24]

e. Reliance on one-time revenues remains excessive. As the Governor concedes in his revised FY 05 budget, while "one-time revenues remain a concern….given the magnitude of spending cuts and tax increases, eliminating the one-time revenues in the FY 2004-05 adopted budget was impractical." As a proportion of total General Fund revenues, one-time revenues are a relatively small, and declining, share (4.6% in FY 04 and 3.9% in FY 05). Yet they create a sizeable structural deficit. In FY 04, one-time revenues total $575 million. In FY 05, they total $513 million.[25]

Certain of these one-time revenues are also more costly than first appear. For example, included in the FY 05 one-time revenues is $300 million from tobacco securitization. Securitization is a particularly inefficient way to generate one-time revenues, since states receive only about 30%-40% of the value of the revenue stream securitized (here, tobacco settlement funds) and in some cases have been required to dedicate other revenue as backing for the sale of bonds should the payments from the tobacco settlement be reduced or eliminated.

While the Governor proposes to "replace the current reliance upon $300 million of tobacco securitized revenue with any additional growth in our current revenue sources" resulting from the positive effects of an economy recovery, a better solution would be to continue to restore more of the tax revenues cut in the late 1990s. As noted above, Connecticut families and corporations are still paying much less in state tax now than in the mid-1990s. While some of this reduction has been offset by increases in local property tax (as the state transfers obligations and less funding to towns), the reductions have been enhanced – particularly for our highest income taxpayers – by recent cuts in federal taxes. Reducing reliance on one-time revenues by restoring permanent ones is sound fiscal practice. The additional revenues from an improving economy could then be directed to restoring resources in our Budget Reserve Fund, increasing our contributions to under-funded state pension funds, and paying down some of our indebtedness, which has markedly increased in the last decade.

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23 This includes $20 million from proposed escheat of bottle deposits.

24 Governor's proposed FY 05 budget revision includes a *greater* sum in one-time revenues and fund transfers in FY 04 than in FY 05. FY 05 includes the permanent transfer of $13 million of petroleum gross earnings taxes currently scheduled to go to the Special Transportation Fund back to the General Fund. FY 04 includes *this* transfer ($13 million), but also the transfer to the General Fund of "excess" revenue in the Pretrial Alcohol and Drug Account ($1.5 million), the State Marshall's account ($0.3 million), boat registration fees ($2.0 million), and remaining tobacco settlement funds ($2.1 million).

25 For a listing of the various one-time revenues in the FY 04 and FY 05 budgets, see *Governor's Midterm Budget Adjustments: FY 2004-2005* (Feb. 4, 2004), p. 27.

IV. The Re-Emerging Impact of the State Spending Cap on Essential State Investments

As noted above, the Governor's revised FY 05 budget is just $58.9 million below the state spending cap.

The fact that the budget has grown so close to the cap results in part from a declining allowable rate of growth (because of the recently weak economy)[26] and also from a smaller budget base than would be the case if the last several years' budgets had been closer to the spending cap. In FY 03, the state budget could increase by $633 million and still remain under the spending cap. In FY 04, growth could be just $552 million, and in FY 05 just $478 million.

Importantly, the budget growth allowed by the spending cap is now *far less than* the budget growth needed to maintain current services. Last year, OPM Secretary Marc Ryan reported that the growth rate then allowed by the spending cap (just over 6%) was less than half the growth rate of the FY 04 current services budget (12.3%). As a result, the FY 04 Current Services budget was $763 million *more than* the FY 04 appropriation allowed by the state spending cap. In FY 05, this gap is even greater. *The gap between the original FY 05 Current Services budget and the FY 05 appropriation allowed by the spending cap is more than $1 billion ($1.055 billion).*[27]

In short, *even when the economy recovers and tax revenues again begin to increase* it will be difficult to restore funding for many of the essential state programs and services that were cut so drastically over the last three years. Despite ample revenues and significant wealth in the state, some of the most fundamental needs of our most vulnerable state residents will remain unmet, and the investments needed to maintain our economic competitiveness – in education, health and infrastructure – will remain less than needed.

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[26] Allowable "capped" growth is calculated by multiplying total "capped" expenditures by the 5-year average growth in personal income. The allowable growth rate using this 5-year average is falling – from 6.2% in FY 03 to 5.3% in FY 04 to 4.5% in FY 05. Because Connecticut relies on a 5-year average, the low growth in personal income in 2002 and 2003 (when the economy was floundering and unemployment relatively high) will continue to depress the average growth rate for some time to come. The result is that "allowable" budget growth is also falling.

[27] M. Ryan, *The State Budget and the Economy* (October 15, 2003 PowerPoint presentation).