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Getting Connecticut's Fiscal Ship In Order

Part I: Seven Reasons Why Connecticut's Budget Still Has Problems, <u>Despite</u> Its Surplus

Part II: How to Address Connecticut's Ongoing Budget Problems

While pride in Connecticut's past is justified, action on behalf of its future is imperative.
Connecticut Economic Resource Center
Benchmarking Connecticut's Economy (September 2005)

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Introduction

> *Whenever there is a surplus, there is debate about whether state government is overtaxing Connecticut taxpayers.*[1]
>
> *A budget "surplus" can be a misleading indicator of whether or not a state's fiscal situation is strong. Mid-year surpluses occur when revenues come in stronger than the state estimated when the budget was enacted. A state that at budget time cut important services in order to bring its expenditures into balance with what later turned out to be an overly-conservative revenue estimate would still show a mid-year surplus.*[2]*…But a surplus does not mean that states have more money than they need to reverse recent service cuts, make progress toward restoring programs to pre-recession levels, or even fund the ongoing costs of state programs as they stand in fiscal year 2006.*[3]

In early January 2006, the State Comptroller and the Office of Policy and Management projected a $327.8 million General Fund surplus in the state fiscal year ending June 30, 2006. On January 20, Governor Rell announced that the projected surplus had increased to $511.8 million.[4] By February 1, the State Comptroller was projecting a surplus of $538.8 million[5] and the Office of Fiscal Analysis projecting a $661.5 million surplus.[6]

With the November 2006 elections approaching and the Governor and all 187 legislators up for re-election, it is no surprise that there are multiple proposals for spending these surplus funds. To date, they have included: a) eliminating the corporate tax surcharge;[7] b) eliminating the personal property tax on all manufacturing equipment;[8] c) creating a new tax credit to attract

1 P. Hughes, "End predicted to state's run of budget surpluses," *Waterbury Republican-American* (January 27, 2006, p. 5A).

2 This is the case in Connecticut this year. For example, the FY 06 budget assumed 5.2% growth in personal income tax revenues, but current estimates are for 12% growth. Similarly, the FY 06 budget assumed a 5% *decline* in corporate income tax revenues, but there has been 12% growth. In total, the projected $606.3 million *net* increase in FY 06 General Fund revenue collections results from increases above what was originally budgeted of a total of $709.0 million in ten of the revenue sources, offset by declines of a total of $102.7 million in four revenue sources (most significantly the sales and use tax, where growth of 5.1% was projected but growth is only 3.1%). Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006), p. 10.

3 E. McNichol & I. Lav, *State Revenues and Services Remain Below Pre-Recession Levels* (Center on Budget and Policy Priorities, December 6, 2005), pp. 1, 3, available at www.cbpp.org/12-6-05sfp2.pdf.

4 Associated Press, "Rell: State surplus up sharply" (January 21, 2006).

5 Office of the State Comptroller, *Wyman Projects $536.8 Million Surplus for 2006* (February 1, 2006).

6 Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006).

7 G. Hladky, "Politicians vie to lay claim to $500M surplus," *New Haven Register* (January 9, 2006)(noting that House Speaker Amann, House Minority Leader Ward, and Gov. Rell all had suggested ending or reducing this surcharge, which is expected to generate $65-70 million in revenues in FY 06); D. Gurliacci, "Debate on taxes heats up in state legislature," *Fairfield County Business Journal* (February 1, 2006)(quoting Rep. Sharkey as saying there is a widespread consensus in the legislature that the surcharge should be repealed); D. Troise, "CBIA calls for corporate tax cuts," *New Haven Register* (February 4, 2006).

8 D. Troise, "CBIA calls for corporate tax cuts," *New Haven Register* (February 4, 2006)(reporting on CBIA proposal to repeal the corporate tax surcharge and eliminate property tax on manufacturing equipment); D. Gurliacci, "Debate on taxes heats up in state legislature," *Fairfield County Business Journal* (February 1, 2006)(quoting Rep. Sharkey as saying there may be a proposal to eliminate this tax and provide the towns with about $100 million to make up for lost property tax revenues); "[Sen.] Williams Unveils Top Legislative Priority: Jobs and the Economy:

motion picture producers to Connecticut;[9] d) eliminating and/or reducing state excise and petroleum gross earnings taxes on biodiesel fuel;[10] e) eliminating or revising the estate tax;[11] f) eliminating the real estate conveyance tax;[12] g) enacting a refundable earned income tax credit for the state's working poor;[13] h) increasing education cost-sharing grants;[14] i) using $246 million of the surplus to shore up the pension fund for public school teachers;[15] j) using $235 million of the surplus for scholarships and housing aid for career scientists;[16] and k) adding to the state's Budget Reserve ("Rainy Day") Fund.[17]

Before one assumes that the FY 06 projected surplus means that it is possible (or wise) to enact new tax credits or exemptions (as is now being proposed by some), it's prudent to ask just what kind of a surplus Connecticut has:

- Is it a *structural* surplus? That is, are revenues projected to continue to exceed spending in the years after this one?
- Or, is it a *temporary* surplus? That is, although revenues exceed spending in the current year, this is not projected to be the case in the future.

Senate Bill #1: An Act Concerning Connecticut Jobs for the 21st Century," available at http://www.senatedems.ct.gov/pr/williams-060110.html (proposing elimination of property tax on manufacturing equipment); M. O'Leary, "DeStefano trumpets plan for state jobs," *New Haven Register* (February 4, 2006)(also calling for elimination of the property tax on manufacturing equipment, *but* having the state cover the towns' loss of property tax revenues by adding $140 million to the payment in lieu of taxes, or PILOT, sent to cities and towns).

9 R. Green, "Studio tax breaks pitched: Support grows for movie biz incentives," *Hartford Courant* (January 24, 2006, p. B1)(discussing movie producers' proposal for a 25% transferable tax credit for productions with expenses of $250,000/year or more).

10 "[Sen.} Meyer, Representatives Heinrich and Widlitz Propose Biodiesel Tax and Investment Plan for Connecticut", available at http://www.senatedems.ct.gov/pr/meyer-060113.html (proposing elimination and/or reduction of state excise and petroleum gross earnings taxes on biodiesel fuel).

11 D. Gurliacci, "Estate taxes may be driving retirees out of state," *Fairfield County Business Journal* (February 1, 2006)(quoting Rep. Hetherington as saying that repeal of the estate tax may be possible this year, "given the state surplus).

12 L. Cafero, "The numbers don't lie," *Fairfield County Business Journal* (February 1, 2006).

13 G. Hladky, "Politicians vie to lay claim to $500M surplus," *New Haven Register* (January 9, 2006)(reporting that Senate Majority Leader Looney proposes using some of the surplus to pay for this credit, which would take the form of a direct cash payment to poor working families to compensate them for other taxes they pay, such as sales and property taxes).

14 C. Keating, "Towns come to Capitol seeking more state aid," *New Haven Register* (February 2, 2006)(reporting that the 0.4% increase in Education Cost Sharing grants in FY 07 is the "smallest increase in education funding in 10 year" and that mayors and first selectmen were calling on Governor Rell to boost state aid).

15 C. Keating, "Surplus sought for pensions," *Hartford Courant* (January 7, 2006)(reporting that the Teachers' Retirement Fund currently holds $11.3 billion, but should contain $16.5 billion based on actuarial projections, reporting that $246 million is the amount the actuaries say would be needed – in addition to the $562 million/year already budgeted - to fully fund the *annual* contribution required over the next two years, and reporting Speaker Amaan as saying that this payment would save taxpayers $737 million over the next 25 years because interest and dividends on the funds would compound on annual basis); C. McCluskey & K. Phaneuf, "Surplus may feed teacher pensions," *Journal Inquirer* (January 7, 2006)(quoting Rep. Merrill, co-chair of the Appropriations Committee, as saying, "We think this is the most important place we could put that surplus money at this time.")

16 M. O'Leary, "DeStefano trumpets plan for state jobs," *New Haven Register* (February 4, 2006)(outlining proposal to use $145 million of the FY 06 surplus for scholarships for students in bioscience, computer science, engineering and physical science, $35 million for nursing scholarships, and $50 million for a housing trust fund, similar to the Yale Homebuyer's program, to provide down-payments for home purchases by persons in science-related industries).

17 G. Hladky, "Politicians vie to lay claim to $500M surplus," *New Haven Register* (January 9, 2006)(reporting on Gov. Rell and Sen. Looney's support for using surplus funds to fill up the Rainy Day fund as a hedge against a future budget crisis).

Data from the Office of Fiscal Analysis and the Office of Policy and Management agree. Connecticut has a *temporary* surplus, but also a *structural deficit.* That is, starting in FY 08, Connecticut's revenues are projected to be less than the spending that will be necessary simply to maintain current state services.[18]

The difference between a temporary surplus and a structural surplus (or deficit) can be illustrated by thinking about the Jones family's budget. Both parents work, earning a combined income of $80,000/year which just covers their current living expenses. They support two children, one of whom is about to enter college. They have a mortgage on their home, and -- because Mr. Jones was laid off for a year in the most recent recession -- some significant credit card debt, a large, unpaid medical bill, and some repairs needed to the roof of their home that they deferred until their financial situation improved. They have $1,000 in a savings account and have not been able to put much money away for retirement. In the current situation, the Jones family faces a structural deficit. While their income currently covers their expenses, the cost of a child attending college next year is likely to exceed any increase in parental earnings. In addition, the family still has much financial ground to make up from when Mr. Jones was laid off if it is to begin to feel more economically secure. So if Mr. Jones today buys a winning lottery ticket worth $50,000, is that reason for him to decide to cut back his hours at work (the family equivalent of cutting taxes)? Or are there more prudent ways to respond to this temporary good fortune, such as paying down some of the family's debt, fixing the roof, and putting aside funds for college?

However, our analysis of Connecticut's fiscal situation must not stop here. It is essential that we ask the far more fundamental question: Is Connecticut making the level of public investment that is essential to keep our state economically competitive and preserve our high quality of life? That is, is Connecticut's projected ***operating*** deficit just one piece of a far larger ***public investment*** "deficit" in this state?

As this report will illustrate, the answer to *this* question is "YES." Connecticut's excessive frugality in public investment, its use of budget gimmicks to balance its budget, its propensity to pass off current fiscal obligations onto future generations, and its very limited internal capacity to evaluate *which* public investments provide best return and to make and execute a comprehensive long-range plan for the state that assures its continued competitiveness and high quality of life pose long term challenges to the state that are far more troubling than its near-term projected operating deficit. Moreover, with Connecticut's Baby Boomer generation now at the peak of their earnings -- but poised to begin retiring -- Connecticut has a quite limited time to get its fiscal ship in order before these budget challenges grow even more daunting and Connecticut begins a possibly irreversible slip in its national standing on multiple measures of health, safety, education, economic competitiveness, and quality of life.

[18] *State Policy Reports* recently developed a Continuum of Fiscal Stress, based on state responses to the National Association of State Budget Officers (NASBO)'s annual *Fiscal Survey of States.* Connecticut was placed in the "could be better, could be worse" category, along with ten other states. By comparison, thirty states were ranked in the "trending up" category and seven in the "all systems go" category – both reflecting less fiscal stress than in Connecticut. Measures used to rank states, however, related only to specific *current* fiscal conditions (did the state have to cut its 2005 enacted budget, did tax collections meet or exceed expectations, did the year-end balance exceed 5% of general fund expenditures, are total balances as a percent of spending expected to increase between FY 05 and FY06). The measures do *not* take into account other, longer-range fiscal problems. State Policy Reports, *The Continuum of State Fiscal Stress* (Federal Funds Information for States, December 2005).

This report highlights some of the reasons why Connecticut's fiscal situation remains troubling, notwithstanding its current "surplus."

Part I: Seven Reasons Why Connecticut's Budget Still Has Problems, Despite Its Surplus

1. Connecticut's current budget is "balanced" with significant amounts of one-time revenues. According to the Office of Policy and Management, the FY 06 and FY 07 budgets were balanced with $765.0 million in one-time sources: $619.8 million in FY 05 surplus funds to be used in FY 06 and FY 07 and $145.2 million in other one-time revenues.[19] OPM states, "The reliance on these revenue sources creates a hole in the fiscal year 2008 budget when spending cuts and tax increases will be required to balance the budget."[20] The use of FY 05 surplus to fund on-going programs and services *alone* creates a $165.5 million hole in the FY 08 budget.[21]

2. Connecticut's "surplus" is temporary; OPM and OFA project deficits beginning in FY 08. Both OFA and OPM report that Connecticut has a structural deficit. That is, our state revenue system is not expected to produce revenues that grow at the same pace as projected state spending (even *without* any new public investment).[22]

Although OPM projects a surplus in FY 07, as well as in FY 06, it projects a deficit of $209 million-$619 million in FY 08[23] increasing to a deficit of $706 million -$862 million in FY 10. OFA concurs that there will be General Fund deficits beginning in FY 08, though it projects slightly smaller deficits than OPM: a deficit of $224.4 million in FY 08 increasing to $412.5 million in FY 10.[24]

A state revenue system that is no longer in sync with the current economy,[25] and very rapid growth in certain areas of the budget (particularly those related to health care and energy costs)[26]

[19] For example, $65 million of Connecticut's FY 07 revenues come from the following three sources: a) a transfer of funds from FY 06 to FY 07 before the close of FY 06 ($41 million); b) a transfer from the Energy Conservation Fund to the General Fund ($12 million); and c) elimination of a otherwise required transfer to the Tobacco Health Trust Fund from the General Fund ($12 million). OFA, *Connecticut State Budget 2005-2007* (August 2005), p. 36.

[20] Office of Policy and Management, *Ability to Pay* (PowerPoint presentation, August 25, 2005), p. 15.

[21] Office of Fiscal Analysis, *Where does the money come from? Where does the money go?* (PowerPoint presentation, February 7, 2006).

[22] Details about *why* this is the case will be the subject of a subsequent paper. See, generally, Center on Budget and Policy Priorities, *Faulty Foundations: State Structural Problems and How to Fix Them* (Washington DC: August 2005).

[23] The $619 million deficit represents the difference between projected revenues and total projected expenditures. The $209 million deficit in FY 08 represents the difference between projected revenues and the amount of spending that would be allowed under the state spending cap.

[24] OFA attributes the FY 08 deficit in part to the use of $53 million in one-time revenues in the prior year's budget, and also to the fact that current services spending is increasing at 5.9% while revenues are projected to increase at just 3.7%. Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006).

[25] As one example, OPM has estimated that Connecticut may lose as much as $440 million in sales tax revenues in FY 06 because purchases were made through catalogs or over the Internet. Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p. 26.

[26] OPM estimates, for example, that FY 05-07 health insurance costs for active state employees will be 26.1% more than in FY 03-05, and health insurance costs for state retirees about 20.7% more. Total state energy costs

contribute to much of this projected gap between revenues and expenses. An analysis of state expenditure data from FY 00 through FY 05 by the Office of Fiscal Analysis found that while General Fund revenues increased a total of about 13.5% (2.7% per year on average) and General Fund expenditures increased a total of about 19% (3.8% per year on average), Medicaid grew by almost 30% over this period, debt service by 40%, and the Retired State Employee Health Services account by a cumulative total of nearly 88%.[27]

3. Connecticut's current budget is under-funded in some obvious, and less obvious, ways. That is, Connecticut's "surplus" results in part from spending less than was necessary to maintain current state services over the past several years. It also results from failing to make the new investments we must make to keep Connecticut competitive and maintain our high quality of life. For example:

- *Under-funded areas in state budget.* According to OPM, there are many "under-funded" areas in the current FY 06 budget that may need to be addressed in the FY 07 mid-term adjustments, including no managed care organization rate increases, no private provider rate increases, escalating energy costs, no nursing home rate increases, and unsettled collective bargaining agreements.[28]

- *Under-funded municipal grants.* The FY 06 budget fails to provide full funding for the major grants to municipalities at required statutory levels. In addition, current statutory formulas fail to require *full* reimbursement to municipalities for all the revenues they lose through state-mandated property tax exemptions.[29]

- *Past spending cuts not fully addressed.* Although there are some important funding increases in the FY 06 budget, Connecticut still has not restored funding for many significant programs and services that suffered deep cuts during the most recent recession.

  For example, as shown in the following table, the FY 06 General Fund appropriation for many state agencies is *less than* these agencies ***actually spent*** in FY 02, *not* even adjusting for inflation. Among the programs and services that were cut, and for which funding has remains below FY 02 levels, is scholarship aid for Connecticut college students (DHE), positive youth development programs (OPM, e.g., Boys and Girls Clubs, Neighborhood Youth Centers, the Leadership, Education, Athletics in Partnership program), job training programs (DOL, OWC), and children's health initiatives, tobacco education programs, and grants to local public health departments (DPH).

(electricity, natural gas, motor vehicle fuel, fuel oil) in the General Fund and Special Transportation Fund are projected to increase from $79.9 million in FY 05 to $103.4 million in FY 06. Office of Policy and Management, *Connecticut's Economic and Budget Outlook* (PowerPoint presentation for CT Voices for Children's 5th Annual State Budget Forum, , January 12, 2006), pp. 23, 26.

27 Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p. 19.

28 Office of Policy and Management, *Ability to Pay* (PowerPoint Presentation, August 25, 2005), p. 17.

29 In FY 06, the state under-funded the major statutory grant programs by about $177 million. In addition, if the PILOT on state-owned property provided 100% reimbursement for property taxes lost on tax exempt state property (rather than the current 45%), towns would receive an additional $118 million. Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), pp. 4-5. The PILOT for new manufacturing machinery and equipment is set at 80% of the property taxes lost due to the exemption.

Decline in Funding from FY 02 (actual) to FY 06 Appropriated Selected State Agencies Ranked by Percentage Reduction [in millions]				
State Agency	FY 02 (Actual)	FY 06	Decline	Decline [%]
Office of Policy & Management	$226.08	$125.330	-$100.750	-44.6%
State Library	$17.44	$10.87	-$6.57	-37.7%
Department of Economic & Community Development	$23.63	$16.99	-$6.64	-28.1%
Department. of Higher Education	$62.70	$45.44	-$17.26	-27.5%
Department of Environmental Protection	$42.58	$33.15	-$9.43	-22.1%
Office of Workforce Competitiveness	$6.77	$5.61	-$1.16	-17.1%
Department of Labor	$59.42	$52.66	-$6.76	-11.4%
Department of Public Health	$77.75	$72.00	-$5.75	-7.4%

A Closer Look At Education. The State Department of Education's (SDE) FY 06 General Fund budget ($2.181 billion) is just $11 million more than the amount SDE ***actually spent*** in FY 01 ($2.170 billion). That is, over a five-year period, SDE's budget increased a total of just 0.5%, not adjusting for inflation. **However, adjusted for inflation, state funding for primary and secondary education has *fallen by more than 10%,* despite a 3.3% increase in the number of children enrolled in public schools in the state over this period.** In fact, taking inflation into account, Connecticut's average *state* investment *per student* has declined by nearly 12% ($500) over this five-year period – from $4,257 per student in FY 01 (in 2005 dollars) to $3,756 per student in FY 06.[30]

Because close to 91% of the FY 06 SDE budget is for grant payments to towns, this erosion of state support for public education shifts funding responsibility to towns (and the property tax) and represents a significant withdrawal of state commitment to maintaining the highly trained workforce Connecticut needs to remain competitive. Significantly, Connecticut ranks among the lowest of all states (47th) in the share of funding for elementary and secondary public school education that comes from the state.[31]

30 This amount was derived by dividing SDE's General Fund budget for a given year by the total number of students enrolled in that year. The FY 01 budget was adjusted to 2005 dollars, so the decline as of FY 06 will in fact exceed what is reported in the text.

31 The national average for state funding of elementary and secondary education is 49%; Connecticut contributes 36% (a figure that *includes* state support of school construction, debt service, and payments to the retirement system on behalf of local schools). To achieve the oft-cited goal of 50% state funding of public education, Connecticut would have to invest an additional $563 million, a 25% increase in the current SDE

- *Funding below Current Services.* Connecticut's total FY 06 budget ($15.283 billion) is significantly *less* than the amount the Governor reported in her February 9, 2005 Budget was necessary to maintain Current Services[32] at FY 05 levels ($19.059 billion).[33] Similarly, the FY 05 budget ($14,322 billion) was well below the amount the Governor reported to be necessary to maintain Current Services in that year ($20.001 billion).[34] Note that the Current Services budgets are calculated based on the prior year's budget. That is, no adjustment is made to show what "current services" would be *today* had there been *no* deep cuts in various agency budgets in FY 02-FY 04.

- *Overly frugal public investment.* Connecticut's public investment, as a share of its personal income, is extremely modest compared to other states and the District of Columbia. According to United States Census Bureau data, in 2002 Connecticut ranked: *lowest* among states in state and local spending on transportation as a share of personal income; second lowest in total state and local spending on education and spending on housing and the environment; third lowest in spending on state and local government employees' wages and salaries; fourth lowest in *total* direct spending by state and local government; and ninth lowest in total state and local spending on social services (including health care).[35] In fact, in 2002, *The Connecticut Economy* ranked Connecticut the second most frugal state in the nation (second to New Hampshire only).[36]

- *State public investment is lagging growth in the state's economy.* Connecticut's state spending has declined from about 9.8% of the Gross State Product (GSP) in 1994 to about 8.75% in 2003. That is, our state public investment is not keeping pace with our state economy, although adequate public investment is essential to continued economic growth.

  Multiple studies and reports have documented the need for increased public investment in various programs and services integral to Connecticut's economic competitiveness and high quality of life, including enhancing our transportation system, narrowing our educational achievement gap, increasing the supply of affordable housing, and providing health care to uninsured residents.[37] Connecticut risks losing ground to other states that

budget. Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), pp. 5, 11. Connecticut's state rank in its investment in elementary and secondary education as a share of its personal income is also very low; Connecticut is *second lowest* among states in the share of its personal income spent on elementary and secondary education according to the most recent Census data. J. McLynch, *Measuring Up: Taxes and Spending in Massachusetts, FY 2002* (Massachusetts Budget and Policy Center, 2005).

32 Current Services is defined as the "amount required in order to provide in the succeeding fiscal year the same services as in the current fiscal year plus any scheduled changes or required changes. Estimate Expenditures are updated, for example, 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." *Governor's Budget: FY 2006-FY 2007,* p. 57.

33 *Governor's Budget Summary: FY 2006-2007 Biennium,* p. A-26.

34 *Governor's Budget Summary: FY 2003-FY 2005 Biennium,* p. A-27.

35 J. McLynch, *Measuring Up: Taxes and Spending in Massachusetts, FY 2002* (Massachusetts Budget and Policy Center, 2005), available at: www.massbudget.org/measuringupfy02.pdf. NOTE: Because some states (like Connecticut) lack county government, cross-state comparisons in state spending and revenues are most accurately made by comparing total state *and local* spending and revenues; in this way, the *level* of government at which a service is funded or a tax imposed does not skew the comparison.

36 D. Heffley, "My Big Fat State Government?" *The Connecticut Economy* (Fall 2002), pp. 4-5.

37 *Report of the Interagency Council on Supportive Housing and Homelessness (2005);* Office of Policy and Management, *Child Poverty Council Initial Plan (2005)* and *Child Poverty Council Progress Report (2006);* Connecticut Economic

are making significant new public investments, particularly in their education systems (from pre-school through college) and their infrastructure.

- *The state is not prepared for the next economic downturn.* The Budget Reserve ("Rainy Day") Fund currently holds about $605.6 million, or about 4.3% of net General Fund appropriations for the current fiscal year. This is $807.6 million short of the 10% statutory level established recently[38] by the General Assembly and also less than the 5% Budget Reserve Fund that proved to be inadequate to get the state through its most recent economic downturn.[39] Moreover, even if *all* projected FY 06 and FY 07 surplus funds were added to the Fund, the balance would increase to just 6.2% ($1.12 billion). OFA projects that even in the *absence* of an economic downturn, this whole sum would be depleted by FY 10 just to meet the state's general operating costs, given the projected *structural* deficits in FY 08 and FY 09.[40]

4. Connecticut's budget *is unnecessarily* under-resourced. *If a surplus exists while significant state needs remain unmet, the surplus results from inadequate spending, not from excessive taxation.* Compared to its economic capacity, Connecticut is a quite parsimonious state. Indeed, total government spending in Connecticut as a percentage of gross state product (now at 8.7%) is 4th lowest among all states, second lowest among Northeastern states, and substantially below the United States average (11.9%).[41] Further, as compared to its economic capacity, Connecticut is not a high tax state. Taxes *are,* however, not borne equitably; our tax code remains regressive.[42] Census Bureau data show that as of 2002 Connecticut was third lowest among states in total state and local revenues as a share of total personal income, tied for 29th lowest in total state and local *tax* revenues as a share of personal income, but 7th *highest* in property taxes as a share of personal income.[43]

5. Connecticut has been shifting *current* fiscal obligations onto the next generation. A surplus that results from deferring payment on our *current* obligations is no surplus. Rather, it results from shifting costs that are *our* responsibility to the next generation. That has been the case in Connecticut.

Resource Center, Inc., *Benchmarking Connecticut's Economy: Technology, Finance, Entrepreneurial & Business Vitality, Human Capital, Global Links* (2005); Transportation Strategy Board, *Transportation: A Strategic Investment (2003);* The State Prevention Council, *Statewide Comprehensive Prevention Plan for Connecticut (2003); Report of the Governor's Blue Ribbon Commission on Mental Health* (2000).

38 PA 02-118 increased the Budget Reserve Fund maximum from 5% to 7.5% of net General Fund appropriations; PA 03-2 thereafter increased the maximum to 10%.

39 Going into the most recent recession, the Budget Reserve Fund had $594.7 million. The fund was totally depleted in FY 02 to partially cover a $817.1 million deficit. Connecticut was forced to borrow to cover the remaining deficit, issuing $222.4 million in Economic Recovery Notes in FY 03. Connecticut also was forced to borrow to cover the FY 03 deficit, issuing an additional $96.6 million in Economic Recovery Notes. These FY 02 and FY 03 deficits remained even *after* deep spending cuts and some tax increases. Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006), p. 8.

40 Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p. 18.

41 Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p.42.

42 Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006).

43 J. McLynch, *Measuring Up: Taxes and Spending in Massachusetts, FY 2002* (Massachusetts Budget and Policy Center, 2005).

❖ *Connecticut has high un-funded pension liabilities.* One of the ways Connecticut has balanced its budget in past years has been to pay less than is actuarially needed into the state employees' and the teachers' retirement funds.[44] At this point, the state employees' retirement fund is short $6.9 billion and the teachers' retirement fund is short $5.2 billion.[45]

Connecticut's pension funds are quite under-funded compared to other states. In 2004, Connecticut's state employees' defined benefit retirement plan was funded at about 54% and its teachers' plan funded at about 65%.[46] These funding levels are well below the 50-state average for the 127 pension funds listed by the National Association of State Retirement Administrators and the National Council on State Teacher Retirement in their annual Public Fund Survey; on average, these funds are about 88% funded.[47]

❖ *Connecticut has a significant unfunded liability in non-pension retirement benefits for state employees and teachers, including health care benefits.* The Governmental Accounting Standards Board (GASB) requires large employers, like the State of Connecticut, to quantify (beginning in FY 08) the amount of non-pension retirement benefits offered to employees. The preliminary estimates of this unfunded liability in Connecticut are that it exceeds the state's $12.1 billion in unfunded pension liabilities.

Thus, Connecticut's total unfunded pension and non-pension liability is likely to exceed $24 billion, an amount that is more than 1.5 times Connecticut's *total* current state budget for FY 06.

❖ *Connecticut's bonded indebtedness also has increased markedly.* Connecticut has significantly increased its bonded indebtedness in the last 15 years.[48] In FY 90, just 5.4% of Connecticut's total state budget was used to pay debt service. In the current FY 06 budget, 11.1% of all spending will be for debt service – a more than doubling of the share of the state budget being used to pay off debt. This growth in debt service crowds out discretionary spending. In addition, although Connecticut's net tax-supported debt as a percentage of its personal income has *declined* somewhat in the last decade, it remains high relative to other states: 8.4% in Connecticut in 2004, compared to the 50-state mean of 3.1% and 50-state median of 2.4%.[49]

[44] The pension pool for the approximately 26,000 retired teachers and 50,000 active teachers is 65.3% funded, leaving an unfunded liability of about $5.2 million. For twelve of the last thirteen years, Connecticut's contributions to the fund have been *less* than the amount the actuaries have determined is required; unlike state employees, teachers (who have this statewide pension plan) lack a contractual contribution requirement. C. Keating, "Surplus sought for pensions," *Hartford Courant* (January 7, 2006).

[45] Office of Policy and Management, *Ability to Pay* (PowerPoint presentation, August 25, 2005), pp. 55,58.

[46] Office of Policy and Management, *Connecticut's Economic and Budget Outlook* (January 12, 2006 PowerPoint presentation), pp. 21, 24.

[47] See, The Government Performance Project, *Grading the States '05: Connecticut* (Governing Magazine, 2005), available at www.governing.com. The Public Fund survey for 2004 can be found at: http://www.publicfundsurvey.org/Summary%20of%20Findings%20FY04.pdf.

[48] One of the reasons that Connecticut's debt is high relative to other states is that Connecticut lacks country government. As a result, the state assumes some of the debt that would in some other states be issued by counties, such as for school construction and renovation.

[49] See, The Government Performance Project, *Grading the States '05: Connecticut* (Governing Magazine, 2005), available at www.governing.com.

While some of this increase in debt is attributable to school construction expenses incurred in the 1990s and other projects that provide long-term benefit to state residents, Connecticut also has used debt to fund recurring program activities, particularly in the areas of conservation, development, and education.[50] Using bond funds for current expenses means Connecticut pays *extra* for these costs. Further, high debt levels impair the state's bond rating, driving up the cost of borrowing funds. Moody's downgraded the state's General Obligation Bond grade to Aa3 in July 2003. Only three states have a lower grade.[51]

6. **Connecticut's current budget assumes a specific amount of federal funding; this assumption may no longer be realistic.** The FY 06 budget assumes that Connecticut will receive $2.601 billion in federal revenues (16.1% of the total) to support programs and services. The FY 07 budget assumes receipt of $2.676 billion in federal revenues (15.9% of the total). This assumption may no longer be a reasonable one, given the very significant cuts in federal spending that Congress has just enacted.

Already, Connecticut is seeing some of the impacts of federal budget reductions. For example, when PA 05-2 (October Special Session) was enacted to provide additional funds for the Emergency Home Heating Assistance program, the total increase in funds appropriated for this purpose was $26.8 million: $3 million of state funds and the remaining $23.8 million anticipated to come to Connecticut from the federal government. OFA now estimates that Connecticut will receive just $10 million in federal funds for this purpose, so an additional $14 million of state funds will needed.[52] Similarly, $300,000 of the projected deficiency in the Department of Public Health's FY06 budget "is attributable to the unbudgeted pickup with state funding of the salaries of five staff formerly funded from federal Centers for Disease Control and Prevention (CDC) Bioterrorism Preparedness grant dollars." Likewise, a $1 million shortfall in the Department of Correction's FY 06 budget is "largely attributable to the reduction in available United States Department of Agriculture (USDA) supplemental food commodities.[53]

7. **Using Generally Accepted Accounting Principles (GAAP), Connecticut currently has a deficit, not a surplus.** Connecticut's budget is reported by OFA and OPM using a modified cash accounting system, rather than the Generally Accepted Accounting Principles (GAAP) that prevent artificially positive outlooks.[54] Although the

[50] Office of the State Comptroller, *Connecticut's Economic Health* (January 1997).

[51] Office of Policy and Management, *Ability to Pay* (PowerPoint presentation, August 25, 2005), p. 37.

[52] Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006), p.6.

[53] Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Budget Projections* (February 1, 2006), pp.13, 14.

[54] As the Comptroller explains, "The difference between budgetary [state modified cash accounting system] and GAAP basis projects is primarily due to the recognition under GAAP of the projected liabilities, revenues, and other items which will be outstanding at year end and which are not reflected in the modified cash basis currently used for budgetary reporting." Quoted in Legislative Program Review and Investigations Committee, *Connecticut Budget Process* (December 2003), pp. 20-21. Said more simply, the way Connecticut currently reports its budget, it recognizes its revenues promptly, but delays the recognition of its expenditures until they are paid. This results in a potentially misleading appearance of fiscal balance.

General Assembly passed a statute in 1993 requiring the state to use GAAP, implementation is postponed each legislative session. The State Comptroller, however, uses GAAP in preparing the Comprehensive Annual Financial Report. In early January 2006, she reported that there was an unaudited cumulative General Fund *deficit* of $900.6 million as of June 30, 2004 (an increase in deficit of $58.3 million from the year before) and that this deficit is expected to have increased again in FY 05.[55]

Part II: How to Address Connecticut's Ongoing Budget Problems

> *The State has a vision of remaining one of the country's most dynamic and attractive areas characterized by a robust economy; strong linkages to regional and global economies; a pristine set of shoreline and rural areas; stimulating urban centers; valued educational institutions; a hot bed for technology, bioscience, and other critical industry clusters; and employment opportunities to enable all of its residents to pursue their dreams.*
>
> Connecticut Transportation Strategy Board

> *While pride in Connecticut's past is justified, action on behalf of its future is imperative.*
>
> Connecticut Economic Resource Center
> *Benchmarking Connecticut's Economy* (September 2005

Given the significant budget challenges identified in Part I, and the relatively short time remaining to get Connecticut's fiscal ship in order before the state's Baby Boomers age-out of the workforce, *bold* and *strategic* budget action is required.

A. Connecticut should avoid all actions that would *exacerbate* its current budget problems. In the late 1990s, as Connecticut pulled out of the recession of the early 1990s and state budget surpluses began to mount with the booming stock market,[56] the state enacted permanent tax cuts that reduced state tax revenues by $2 billion annually. Then, when the most recent recession began in FY 02 and tax revenues dropped precipitously, we found ourselves in a fiscal crisis from which we are still struggling to recover (despite increasing net permanent taxes by slightly more than $1 billion). In short, Connecticut was taught the hard lesson that reducing Connecticut's tax base based on temporarily-inflated revenues is not wise.

The situation today is even more precarious. As noted earlier, both OLR and OFA predict a operating deficit in the FY 08 budget, *even without* any downturn in the economy, and our current Budget Reserve Fund is not adequate to see us through the next recession. For

[55] Office of the State Comptroller, *Monthly Letter to the Governor* (January 3, 2006), p. 2.

[56] Capital gains income soared in the late 1990s, from just over $2 billion in FY 04 to more than $14 billion by FY 00. It then fell off by 42% in FY 01 (to slightly more than $8 billion), then declined again in FY 02 (to about $5 billion). Double digit growth began again starting in FY 03. Office of Fiscal Analysis, *Where does the money come from? Where does the money go?* (PowerPoint presentation, February 7, 2006).

these reasons, ***any proposal to cut taxes (whether through the elimination or reduction of taxes, or through adoption of new tax credits) must be coupled with a proposal to raise taxes in some other way, so that the net result is – minimally -- revenue neutral.***

We also must curb our past enthusiasm for budget gimmicks that further deepen the state's "other" deficits, such as our unfunded pension and non-pension liabilities, our high bonded debt, and the shift of an increasing share of education costs to towns.

Finally, we must remember that *many* programs and services that are essential to the state's most vulnerable residents and to keeping Connecticut competitive still have not recovered from the funding cuts of the last five years. Others that were "flat-funded," such as the State Department of Education, have also lost significant economic ground after adjusting for inflation. All proposals to *cut* funding, and even to *increase* funding, must be reviewed in the context not only of the budget choices made *last* Session, but also the budget choices made since FY 02.

B. To avoid past mistakes, Connecticut should use surplus funds prudently and resist the temptation to reduce revenues based on a temporary operational surplus.

The basic principles we all use in managing our family budgets can inform how Connecticut should use its current "surplus." If a family finds itself with extra cash in its checking account, but has charged its grocery bills to a credit card, put aside its electric bills to pay some other time, and failed to buy clothes for its growing children, the family wouldn't think it had reason to cut back on the number of hours a parent is working. Rather, the parent would keep working, and use the funds to buy clothes for the kids, pay down debt, address unmet family needs, and sock some away for a rainy day.

So too with our state budget. With large unfunded liabilities, significant debt, and unmet needs, our current operating surplus provides a good chance to begin to put Connecticut's fiscal house in order. It is *not,* however, a reason to further reduce state revenues, which remain below what is necessary to meet the state's essential needs. Rather, it should be used only for such purposes as paying for one-time expenses (and particularly those that could result in longer-term savings, such as building capacity in Connecticut's home and community-based mental health service system to reduce use of more costly institutional and residential care), replenishing the budget reserve fund, shoring up pension plan reserves, and reducing state debt. To the extent surplus funds *are* used for on-going purposes, it is also essential that the funds be added to the budget base so that allowable growth under the spending cap rests on what was actually spent for state-funded programs and services.

C. Connecticut Must Get Serious About Putting the State's Fiscal Ship in Order.

Importantly, using this year's state surplus *prudently* is a *necessary, but not at all sufficient* step toward putting Connecticut's fiscal house in order.

As discussed above, while Connecticut's operating budget is projected to have a structural *deficit* by FY 08, Connecticut's "deficit" is not limited to this. Connecticut has large un-funded liabilities and there is widespread understanding that Connecticut needs significant *new* public investment (including in education, transportation, and affordable housing) to maintain its competitiveness and high quality of life. To address these multiple "deficits" in Connecticut's current budget and budget process, much more must be done, *and soon.*

Understanding how we got to this point can help illuminate how best to reverse course. Two factors appear particularly important.

- *Connecticut lacks a comprehensive strategic plan for its growth.* Connecticut's failure to address these state fiscal issues to date results, in part, from its failure to have a *comprehensive* and *well-integrated* strategic state plan that has a longer time horizon than the next election. To be sure, Connecticut has multiple plans that seek to address various issues for which long-range planning is essential, [57] but these are *not* integrated into a single state plan to assure that they work in concert. Such a plan would assure that state policy and budget decisions are consistent with a long-term vision for the state that takes into account the state's economic and community development (given the new challenges of a global economy) and addresses the state's projected educational, health, and human service needs (given, for example, the aging and increasing diversity of Connecticut's population).

  In the absence of such a comprehensive state plan, with defined and measurable outcomes, Connecticut has no well-defined idea where public investments are best made, and no metric by which to measure the effectiveness of its current public investments nor the likely economic return of proposed new investments. As a result, our public investment decisions too often are based more on inadequate (or inaccurate) information[58] and political influence. This results in some ineffective and even wasteful uses of scarce state funds, as well as an undermining in confidence in state government.

- *Frugal or Stingy? Connecticut is not investing enough to remain competitive.* Connecticut's failure to address these state fiscal issues results, in significant part, from its excessive Yankee thrift. While being prudent in state spending decisions is a virtue, stinginess is not. As noted earlier, Connecticut's state and local tax burden is relatively low compared to its wealth, and the burden is not shared equitably among high and lower income families, and small businesses and large corporations. Connecticut's state and local public investment, particularly in areas key to its continued prosperity, also seriously lags other states, as a share of personal income.

  Further, Connecticut's failure to invest *now,* when its Baby Boomer generation is still in the labor market and at the peak of its earnings, will prove to be particularly penny-wise

[57] To list just a few of these plans: Office of Policy and Management; *Conservation and Development Policies Plan for Connecticut 2005-2010; Report of the Interagency Council on Supportive Housing and Homelessness (2005);* Office of Policy and Management, *Child Poverty Council Initial Plan (2005)* and *Child Poverty Council Progress Report (2006);* Transportation Strategy Board, *Transportation: A Strategic Investment (2003); Report of the Blue Ribbon Commission on Property Tax Burdens and Smart Growth Incentives* (authorized by SA 02-13); The State Prevention Council, *Statewide Comprehensive Prevention Plan for Connecticut (2003); Report of the Governor's Blue Ribbon Commission on Mental Health* (2000). Reports done or commissioned by those outside of state government also provide guidance, such as: Connecticut Economic Resource Center, Inc., *Benchmarking Connecticut's Economy: Technology, Finance, Entrepreneurial & Business Vitality, Human Capital, Global Links* (2005); Connecticut Regional Institute for the 21st Century, *Connecticut Strategic Economic Framework (1999, the "Gallis" Report)* and *Economic Vitality and Land Use (2003);* CenterEdge, *Connecticut Metropatterns: A Regional Agency for Community and Prosperity in Connecticut.*

[58] The capacity of legislators to make sound decisions would be enhanced by increasing the number of policy and research staff available to them for independent evaluation of the information provided by the Governor and lobbyists.

and pound-foolish, as Connecticut will miss the this unique opportunity to maintain our strategic advantage over other states that includes – importantly – our well educated workforce.

In fact, data from multiple sources suggest that Connecticut *already* has begun to slip relative to other states. As the Connecticut Economic Resource Center warned in its recent report, *Benchmarking Connecticut's Economy* (September 2005):

> *The analysis conducted for this report reveals a state that is at a critical juncture. On the one hand, Connecticut is in an enviable position, possessing a wealth of attributes essential to innovation and global competitiveness, such as high productivity, an educated workforce, and more. On the other hand, the state's long-term economic viability is threatened by several factors. Many states are outpacing Connecticut. Urban-suburban disparities; lack of business and job growth; an aging, shrinking population and other forces are undermining our prospects for a prosperous future.*
>
> *Not all of the factors negatively affecting Connecticut's competitiveness are within the state's control. But many are. It is essential that public- and private-sector leaders take decisive action today so that the Connecticut of tomorrow may offer all its citizens opportunity, prosperity and a high quality of life.*

Similarly, noting that recent data from the United States Bureau of Economic Analysis found Connecticut again leading the nation in per capita income (at $47,978, some $4,000 more than Massachusetts, the next highest state), a recent *Hartford Courant* editorial[59] warned the state not to get "too comfortable." It pointed out that Connecticut's rate of growth in personal income is slowing, there are fewer "decent-paying" jobs in the state as traditional manufacturing "continues its downward spiral in the state," and that the people "poised to inherit" a larger share of the remaining knowledge-based jobs – "blacks and Hispanics" – also have the lowest levels of education.

To get Connecticut's *fiscal* house in order before the Baby Boomer generation ages out of Connecticut's workforce will require some bold changes. These changes include (but certainly are not limited to):

1. Markedly increasing state investment in state planning, management, and evaluation functions that are essential for sound fiscal decision-making. No corporation with more than $15 billion/year in annual revenues would function without a comprehensive strategic plan and good data to measure its progress against the plan's goals and objectives. Nor should Connecticut. Funds spent *now* to re-build the planning and evaluation capacity of state government will result in savings longer-term, as the state can better understand which state-funded programs and services work best, and which should be eliminated or changed because they are ineffective and/or not cost-effective. It also can promote the types of economic and community development that best build on Connecticut's strengths, in ways that are most cost-effective.

59 "Richest: But For How Long," *Hartford Courant* (January 17, 2006).

There is much room for improvement in this area.

Governing magazine last year commented, in its *Grading the States '05* report, that "Connecticut's management processes are just now emerging from a decade of neglect." In giving Connecticut a "C+" overall grade,[60] this report cited as the sole "major strength" of Connecticut's state government its capacity to "retain employees." By comparison, Connecticut's "major weaknesses" were cited as the state's failure to "do well in budgeting and planning for the long-term," as well as multiple deficits in its "contracting/purchasing" processes, in "managing employee performance," in "capital planning," in "strategic planning," in "budgeting for performance," and in "program evaluation."[61]

In marked contrast, *Governing* magazine ranked Virginia, characterized as a state that has "long been a model for good government management," as best among states. Some of the steps Virginia has taken in planning and management may be useful to import to Connecticut. They include: a) creation of The Council on Virginia's Future in 2003 to create a vision for Virginia's future and a state government system that aligns with and supports achievement of the vision;[62] b) the Virginia Results on-line performance management system that provides agency-level performance information in a searchable and easy-to-access on-line database, as well as statewide quality of life indicator data for multiple years;[63] c) six-year revenue and expenditure projections; d) eVA, an order-to-payment procurement system that allows state agencies to compare the prices and features of more than 5 million products on line[64] and a capacity to conduct procurement electronically and through the Internet that is among the most highly developed of any state; e) a requirement that specific program evaluations be conducted for all new initiatives; f) a performance-based compensation program for state employees; and g) two separate and relatively well-staffed independent audit agencies (the Joint Legislative Audit and Review Commission[65] and the Auditor of

60 In *Grading the States 2005,* 29 states were ranked better than Connecticut in government performance (including Maine, New York, New Jersey, Pennsylvania, and Vermont), 15 states were tied with Connecticut (with a "C+" grade, including Arkansas, Colorado, Massachusetts, Mississippi, Rhode Island, and Tennessee), and 5 states were ranked lower than Connecticut (Alabama, California, Hawaii, New Hampshire, and Wyoming).

61 The Government Performance Project, *Grading the States '05: Connecticut* (Governing Magazine, 2005), available at www.governing.com.

62 The Council is charged with responsibility to provide a long-term focus on high priority issues, create an environment for improved policy and decision-making, increase government accountability and transparency, improve government performance, and engage citizens in dialogue about Virginia's future. Annually, the Council submits two reports: 1) *The Virginia Scorecard* (focused on state government performance); and 2) *the Virginia Report* (an annual report of the Council's proceedings). Chaired by the Governor, it is a public-private partnership with representatives from the General Assembly, the Governor's Cabinet, the business community and citizens. For more information, www.future.virginia.gov/Index.htm. The Connecticut Progress Council, established in the early 1990s, was similar in mission to this effort, but has not been active for more than a decade.

63 See www.dpb.virginia.gov/VAResults/. Note: Some of the recent discussions in Connecticut about performance-based budgeting are beginning to move Connecticut more toward this type of budgetary and program oversight.

64 See www.eva.state.va.us/

65 The website of the JLARC is particularly impressive, with not only links to its multiple reports (e.g., *Virginia Compared to Other States, State Spending: December 2005 Update, Impact of Aging Population*), but also downloadable primary data (in excel format) used in the reports as well as historical data on state finances, caseloads, and basic state demographics). See http://jlarc.state.va.us/welcome.htm.

Public Accounts) that conduct performance audits of "remarkably high quality" according to *Governing* magazine.[66]

2. Reforming, modernizing, and increasing the administrative efficiency of Connecticut's state and local tax systems. It is essential that Connecticut modernize, and adjust, its state and local tax system to assure that *sufficient* revenues are generated in a way that is equitable and that furthers other longer-term state objectives. The Legislative Program Review and Investigation Committee's comprehensive review of Connecticut's tax system includes a number of recommendations that merit serious consideration, including: [67]

- Requiring an accurate assessment of the cost of state mandates on municipalities and consideration of fully funding the current Education Cost Sharing grant and increasing and fully funding the statutory reimbursement rate for PILOT;
- Increasing state reliance on the personal income tax, while making that tax more progressive through a state refundable earned income tax credit and the addition of new rates for higher-income filers;
- Broadening the base and reducing the rate of the state sales tax, while preserving exemptions that decrease regressivity (i.e., food, health care);
- Fully participating in the Streamlined Sales Tax Project increase sales tax capture of more e-commerce and mail transactions.
- Increasing the Budget Reserve Fund to 15% of net General Fund appropriations;
- Reducing or eliminating the property tax on manufacturing equipment;
- Reducing the corporate tax rate while eliminating corporate tax credits;

The goals of such reform are to make Connecticut's existing state and local tax systems better balanced, more equitable and neutral, more accountable, and also more reliable in generating the revenues necessary not only to address Connecticut's current service needs, but also address the state's *other* underlying public investment deficits and need to remain economically competitive. For this reason, therefore, it is extremely important that such reform efforts not be piecemeal, lest the end result be a system that produces even *less* revenues and in an even more inequitable and unaccountable manner.

It is also imperative that Connecticut expand the professional staff within OPM, OFA, and the Connecticut Department of Revenue Services (DRS) to enhance their capacity to

[66] The Joint Legislative Audit and Review Commission (similar to Connecticut's Program Review and Investigations Committee) was described by the National Conference of State Legislatures as one of the oldest and most successful legislative oversight groups in the nation. NCSL, "Over Here, Over There, Oversight," *State Legislatures* (May 1994). Note that Virginia's Joint Legislative Audit and Review Commission has 28 full-time professional staff, compared to Program Review's 11 professional staff.
[67] These are mentioned as examples, rather than an exhaustive list, of the Program Review suggestions that merit serious consideration by the General Assembly.

evaluate existing tax policy and proposals for reform, and thereby enhance the efficacy, accountability and transparency of the tax system.[68]

An important first step to expand capacity was taken this past year. The FY 06 budget authorized funding for OFA to establish and maintain a multi-tax estimating and forecasting system that would be able to provide revenue forecasting, revenue estimates of proposed changes to current law, distributional and incidence analysis and data analysis, periodic analysis of the current tax structure and of proposed changes to the major component taxes, including the property tax.[69] Expansion of internal capacity should not stop at this point.

It is also important to restore *all* staff positions cut in DRS during the most recent recession to increase its administrative efficiency and tax compliance work. Since FY 00, DRS' budget has been essentially flat-funded (which has meant declining dollars when adjusted for inflation). Even DRS' revenue-producing positions (e.g., tax examiners in the audit and collection units) were cut or not refilled as part of these budget cuts. The Program Review and Investigations Committee's report documents the impacts of these reductions, such as a marked increase in the average age of accounts receivable and a 27% decline in audits between FY 03 (92,234) and FY 05 (67,009). In addition, the report finds that DRS' "overall lack of management information" impedes its ability to identify where performance improvements are needed and identify opportunities for greater efficiency.

3. Definitional adjustments to our state spending cap are necessary to allow intended – and essential – state spending. Even if Connecticut were to generate the revenues necessary for essential public investment, the current definition of the state spending cap would prevent these investments from being made at the level needed. With fifteen years' experience with our state spending cap, we can now better understand why.

Two elements of the state spending cap operate *in concert* to rachet down public investment with each new economic cycle:

- ❖ The statutory spending cap uses a *lagged five-year average* of personal income growth and the measure of personal income used does not include capital gains income (though this is a significant source of income in Connecticut);

- ❖ Allowable growth under the cap is based on what was *actually spent*[70] in a prior year, *rather than what the spending cap would have allowed* to be spent, e.g., if there had been sufficient revenues.

68 The Program Review and Investigations Committee study, *Connecticut's Tax System,* notes that DRS' research office is staffed by three persons, who have legislative liaison duties in addition to their primary function of providing statistical information on state taxes to OPM and OFA for their revenue forecasting and tax change analysis duties. Similarly, OPM and OFA each have the equivalent of about four full-time analysts who have some responsibility for tax policy research. As a result, Connecticut's capacity for revenue analysis, policy research, and long-term financial planning is very compromised, although bond rating agencies report that the most highly rated states are very strong in these areas. Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p. 66.

69 Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p. 67.

70 Note, however, that appropriated surplus funds are not routinely added to the budget base even when used for on-going purposes.

The effect of the interaction of these two elements has now become evident. In times of recession, state spending has been less than the cap allows because there are insufficient revenues to spend up to the cap level. This reduces the budget base for spending cap calculations in subsequent years.[71] Then, when the economy improves and revenues increase, the cap's allowable growth rate actually declines for a time because the slow growth in personal income in the recession years is included in the five-year average. This five-year average, therefore, virtually assures that *allowable* growth will be less than *current* personal income growth whenever the state is recovering from a recession.

As illustrated in the table below, in FY 04 (for example) allowable budget growth under the cap using the *five-year average* of personal income growth was 5.27%,[72] while personal income growth in FY 04 alone was just 4.0%. By comparison, in FY 05 the five-year average of personal income growth declined to 4.46%[73] while the one-year growth in personal income increased to 6.6%. By FY 08, the five-year average in personal income growth is projected to be only 3.53%, although the rate of personal income growth in that single year is projected to be 4.3%.[74]

Difference in 5-year average and single year growth in personal income			
	FY 04	FY 05	FY 08 (proj.)
Growth allowed under cap (lagged 5-year average of personal income growth)	5.27%	4.46%	3.53%
Personal income growth	4.0%	6.6%	4.3%

Since the FY 06 budget is now just $21.4 million under the state spending cap, and the FY 07 budget about $28.5 million under the cap,[75] it will be impossible to maintain current services in the years ahead – despite adequate revenues – unless the Governor and General Assembly agree to exceed the cap, or modify it. Indeed, OFA projects that the FY 08 current services budget will exceed the spending cap by $297.6 million, even if the spending in FY 06 and FY 07 is at the maximum allowed under the cap.[76]

The chart on the next page graphically illustrates how the allowable growth in state spending under the spending cap bears little relationship to the growth in personal income in any given year:

71 For example, appropriations were $78.2 million under the spending cap in FY 02, $333 million under the cap in FY 03, and $122.9 million under the cap in FY 04, reducing the budget base going forward by those amounts in each year and therefore the amount of budget growth that is allowable under the spending cap, given any specific growth rate.

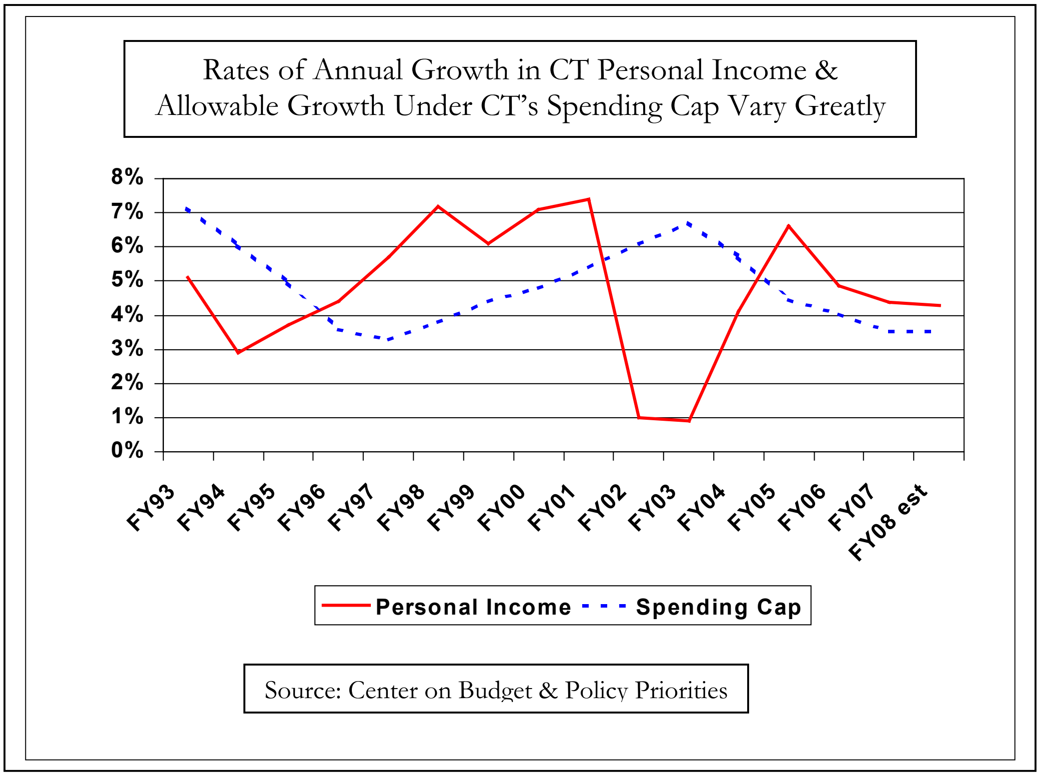
72 By comparison, in FY 04, revenues from the personal income tax increased by 22% over FY 03. OPM, *Ability to Pay: Correctional Supervisors (NP-8)* PowerPoint presentation (August 25, 2005), p. 8.

73 By comparison, in FY 05, revenues from the personal income tax are estimated to have increased by nearly 23% over FY 04. OPM, *Ability to Pay: Correctional Supervisors (NP-8)* (PowerPoint presentation, August 25, 2005), p. 8.

74 OPM, *Ability to Pay: Correctional Supervisors (NP-8)* (PowerPoint presentation, August 25, 2005)(projections for FY 08 are as of August 2, 2005, by Economy.com), p. 63.

75 Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Projections* (February 1, 2006), p.3.

76 Office of Fiscal Analysis, *FY 06-FY 10 General Fund and Transportation Fund Projections* (February 1, 2006), p.3.



The impact of the second troublesome element in the spending cap -- defining the budget base to be actual appropriations, rather than the level of spending allowed by the cap -- can be illustrated by the following simple example.

Assume that Connecticut adopts a $10 million budget in year 1 (which is precisely at the limit the spending cap allowed that year). It then finds, mid-year, that a new recession has resulted in a reduction of $1 million in revenues. The state responds by reducing the budget to $9 million. Assume then that for the next two years, the spending cap allows the budget to grow 3% each year. The following table illustrates how significant a difference it makes how one defines the budget base for purposes of spending cap calculations:

Allowable spending as a function of how the "budget base" is defined (assuming 3% growth/year)			
"Budget base" definition	**Year 1 cap**	**Year 2 cap**	**Year 3 cap**
Maximum the cap allows	$10,000,000	$10,300,000	$10,609,000
Amount actually appropriated	$9,000,000	$9,270,000	$9,548,100
Difference		$1,030,000	$1,060,900

If, for example, by year 2 the economy improved and the $1 million in revenues was restored, the $1 million in cuts could not be undone under the cap's current definition of budget base. The most that could be restored would be $270,000 of the $1 million cut. By year 3, just over half the cuts could be undone (not adjusting for inflation), and even then, the year 3 budget would be more than a million less below what the spending cap would have allowed in public investment had there been no sudden decrease in revenues and a corresponding cut in spending.

Thus, by defining the budget base to be what was actually spent in a given year, rather than what the cap would have allowed to be spent, our years of recession result in a significant reduction in allowable state spending in the subsequent years. In this example, a $1.06 million reduction. ***In sum, the state can never wholly undo its cuts in public investment, no matter how strong state revenues become.***

It is because of the very harmful impacts of this racheting down effect that Colorado, one of the first states to adopt a strong limit on growth in state revenues and spending, just voted to relax its "cap." This was in response to advocacy by many in the state – including business leaders – who recognized that the cap was resulting in a reduction of public investment that was significant enough to be harming the state's economic competitiveness.[77]

In short, if the goal of Connecticut's state spending cap is to keep the growth in state spending in step with growth in the state economy, it is defined in such a way that it is failing to achieve its goal. Rather than assuring that public investment keeps pace with the economy, it assures that public investment will continue to decline as a share of GSP and thereby jeopardize our continued competitiveness.

A solution?[78] Connecticut would better assure that its level of public investment remains adequate by:

[77] See, e.g., D. Bradley & K. Lyons, *A Formula for Decline: Lessons from Colorado for States Considering TABOR* (Center on Budget & Policy Priorities, 2005), p. 9.

[78] In the absence of changes in the cap, there is increasing pressure to adopt budget gimmicks that avoid it, but then also reduce on-going legislative oversight over spending. The increased use of revenue intercepts coupled with the creation of new funds whose expenditures are not subject to spending cap limits is illustrative. The Governor's proposed Casino Assistance Revenue Fund joins two similarly-constructed funds approved last year: a) PA 05-228 established the "Land Protection, Affordable Housing and Historic Preservation Account" within the General Fund, is funded by the diversion of recording fees for land records, with funds expended based on a statutory formula that gives equal amounts to tourism, housing, open space and farmland preservation ($30 million in FY 07); and b) PA 05-5 (October Special Session) created a Citizen's Election Fund as a non-lapsing account in the General Fund, funded with escheats (unclaimed property) that would otherwise have been credited to the General Fund, with funding distributed based on a specified mechanism ($17 million in FY 07). OFA states that because spending from these two accounts (as well as the Governor's proposed Casino Assistance Revenue Fund) is "not specifically appropriated" and "falls outside the customary purview of the legislature's appropriations review process," the spending is *not* to be counted against the spending cap. OFA rests this interpretation on the text of Conn. Gen. Stat. §2-32a, which defines general budget expenditures as "…expenditures from appropriated funds authorized by public or special act of the general assembly." While the revenue intercept/non-lapsing fund is a creative mechanism to avoid the constraints of our current spending cap, it is not a sound budget practice. As OFA notes, "[I]t is uncertain as to whether these off-budget funding mechanisms will be subject to the same level of examination afforded to items for which appropriations are distinctly made." Office of Legislative Research, *Supplemental Analysis of the Governor's 2005-2007 Midterm Budget Adjustments* (February 27, 2006), p. 20.

- Using a more comprehensive measure of personal income growth (such as Connecticut AGI) and a two-year average of personal income growth (rather than a lagged five-year average); and
- Defining the budget base as the allowable – rather than the actual – spending in a given year.

The table above also illustrates the importance of the Budget Reserve Fund. If the hypothesized $1 million cut in spending could have been averted by drawing on Budget Reserve Fund reserves, this ratcheting down effect would not have occurred.

For this reason (and recognizing that Connecticut's revenues will become increasingly volatile as reliance on the personal income tax increases), it is also prudent to increase the statutory limit of the budget reserve fund to 15%[79] and then be disciplined about using state surpluses to keep the fund as close to that target as possible. This larger fund would hopefully avert the need for sudden and deep cuts in spending with every economic downturn, and help keep Connecticut's public investment at levels consistent with its economic growth.

Conclusion

The clock is ticking for Connecticut. Past budget choices coupled with an overly rigid state spending cap, have resulted in multiple "deficits" for the state that are now threatening some of our most valued assets – our highly educated workforce, our high quality of life, and our continued competitiveness as a state.

Although aptly called the Land of Steady Habits, it is time for Connecticut to shed that image a little, and act a bit more boldly to address the multiple challenges identified in this report *now,* while the Baby Boomer generation is still in the workforce and at the peak of its earnings.

[79] Increasing the limit is also suggested in the report of the Legislative Program Review and Investigations Committee's, *Connecticut's Tax System.*