



## It's Time to Put Connecticut's Fiscal House in Order

March 2007

**State Fiscal Year 06 ended with a \$940.5 million operating surplus. The State Comptroller projects a \$560 million General Fund operating surplus for the current fiscal year. So everything is A-OK, right? Well, not really.** Our current budget surpluses hide a far grimmer picture of the state's fiscal situation. Key expenses are growing, including obligations to pension funds and other post-retirement benefits, debt service, health care expenses and state employee costs. Revenues are higher than projected for reasons largely out of the control of policy-makers, including a bullish stock market that is producing higher-than-anticipated personal income and corporate income tax revenues. What's more, these additional revenues are resulting in a surplus in part because Connecticut also has so dramatically reduced spending in some key budget areas (despite growing needs) and has used a variety of budget gimmicks to achieve a "balanced" budget (e.g., shifting costs to towns and to the next generation, using past years' surplus funds to pay some of this year's bills, and failing to use Generally Accepted Accounting Principles (GAAP)).

**In fact, Connecticut has a structural deficit.** When the FY 07-09 Biennial Budget was being prepared, the Office of Policy and Management projected that the cost of maintaining current services exceeded anticipated General Fund revenues by nearly \$550 million in FY 08 and \$717 million in FY 09. Contributing to this structural deficit are the \$2 billion in tax cuts enacted in the late 1990s, tax cuts adopted in the 2006 Session (that reduce projected revenue growth between FY 07 and FY 08 from 3.8% to 2%) and a tax code that is increasingly outdated given the changes in our state economy. For example, we now fail to collect about \$520 million annually in sales and use tax on Internet and mail-order sales. Also contributing to the structural deficit is the use of more than \$430 million of FY 05 and FY 06 surplus funds to fund on-going expenses in the FY

07 budget. Deficits also are projected in FY 09 and FY 10.

While the current budget surplus *does* enable one time funding of some important state needs, it cannot restore fiscal integrity to the budget nor provide the increased funding necessary to meet the challenges of Connecticut's future. Connecticut's fiscal house requires more structural repairs.

### **Connecticut's fiscal house must be repaired.**

Connecticut is on a collision course between unwise budget choices made over the past decade and state demographics. There is a small window of opportunity to get Connecticut's fiscal house in order before the retirement of the Baby Boomer generation results in reduced tax revenues and increased health care costs. To do so, we must address these budget challenges:

**1. Connecticut's current budget is under-funded in multiple ways.** Connecticut's budget does not fully reimburse cities and towns for the revenues they lose through state-enacted property tax exemptions (e.g., on state-owned property, colleges and hospitals, manufacturing equipment and machinery). Connecticut's share of K-12 education funding has declined from 46% in 1990 to 38%. When the state cuts funds to towns, increases in local property taxes result. Connecticut ranks 7th highest among states in property taxes as a share of personal income.

The funding that was cut from some agency budgets in the last recession still has not been fully restored. The FY 07 General Fund budgets of the Department of Higher Education, Office of Policy and Management, Office of Workforce Competitiveness, Department of Economic and Community Development, Department of Environmental Protection, the State Library and the Office of Protection & Advocacy remain *less than* their actual

FY 02 spending, *not adjusted for inflation*. The FY 07 General Fund budgets of the UConn Health Center, the State Universities and Regional-Community Technical Colleges, the Department of Labor and the Department of Public Health are less than FY 02 spending, adjusted for inflation. While the State Department of Education's FY 07 budget keeps pace with inflation, it does not also keep up with the growth in the student population since FY 02.

In general, Connecticut's public investment has not kept pace with its economy. As a percentage of the Gross Domestic Product, Connecticut's state and local spending has steadily declined over the past decade - from 9.8% of GDP in 1994 to about 8.75% in 2003 (4th lowest among all states). If Connecticut's state and local spending *now* were the same share of its GDP as in 1994, our public investment would be about \$1.76 billion more than it is now - funds that could help address our pressing needs for increased public investment in health care, education, affordable housing, and transportation.

**2. Connecticut's budget is *unnecessarily* under-resourced.** A recent Federal Reserve Bank of Boston/Brookings Institution study ranked Connecticut highest among all states in its "fiscal capacity" - a measure that compares states' revenue capacity to their expenditure needs. Although Connecticut's per capita public investment is relatively high, Connecticut lags behind other states in state and local investment as a share of its personal income. According to the most recent comparative Census data (2004), Connecticut ranked:

- 50th (lowest) in transportation spending.
- 49th (2nd lowest) in total direct general expenditures, capital spending, spending on higher education, and spending on housing and the environment.
- 47th (4th lowest) in spending on public safety.
- 44th (7th lowest) in social service spending.
- 39th (12th lowest) in primary and secondary education funding.

**3. Connecticut has been shifting fiscal obligations onto the next generation.** Together, Connecticut's long-term obligations now total *more than \$50 billion*:

- \$14.8 billion in bonded indebtedness;
- \$7.9 billion in unfunded state employee pensions and \$5.2 billion in unfunded teachers' pensions;

- \$21.1 billion in unfunded state employee post-retirement health and life insurance benefits and an as-yet-undetermined unfunded liability for teachers' post-retirement health and life insurance benefits; and
- \$1.1 billion Generally-Accepted Accounting Principles (GAAP) deficit.

Connecticut ranks 4<sup>th</sup> highest among states in general long-term debt as a share of personal income (8.4% in 2004 compared to the 50-state median of 2.4%) and 3<sup>rd</sup> highest in per capita state debt. As our bonded debt has increased, so has debt service. In FY 90, 5.4% of Connecticut's *total* general state expenditures were for debt service. In the FY 07 budget, 11.4% of General Fund and Special Transportation Fund spending will be on debt service. Increases in debt service payments crowd out other public investment; if debt service *now* were the same share of state spending as in FY 90, \$964 million more would be available for other purposes.

**Our failure to put Connecticut's fiscal house in order and invest in programs with proven results will result in a Connecticut we won't like and can't afford.** The state's structural and investment deficits will persist until the state has a revenue system that reliably meets its investment needs and grows with the economy. The alternative is short-term "savings" with serious long-term costs. We can put Connecticut's fiscal house in order by:

- Increasing the level of public investment by eliminating tax cuts that we cannot afford, modernizing our tax code, enacting a more progressive income tax, preserving the combined estate/gift tax, and reforming business taxes.
- Meeting our current state obligations rather than transferring them on to the next generation or to our cities and towns;
- Fully funding the Budget Reserve Fund to avoid precipitous funding cuts and tax hikes during economic downturns.