



## Fiscal Challenges to Address in the Revised FY 09 Budget<sup>1</sup> Shelley Geballe, JD, MPH

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State Fiscal Year (SFY) 06 ended with a \$940.5 million operating surplus and SFY 07 with a \$1,060 million surplus. However, in early February OFA projected that FY 08 will end with a \$160.4 million surplus and FY 09 with a \$37.6 million surplus. What's happening? Our declining budget surplus is just one indicator of the deterioration in the state's fiscal situation. Key expenses are growing, including debt service, health care expenses, and unfunded obligations to pension funds and other post-retirement benefits. The State Comptroller reports, "State and national economic indicators point to a slowing economy at risk for further contraction in the second half of fiscal 2008." What's more, the current FY 08 "surplus" results in part from the use of a variety of budget gimmicks to achieve a "balanced" FY 08 budget (e.g., using past years' surplus funds to pay some of this year's bills, not meeting all current obligations, and shifting costs to towns and to the next generation).

Connecticut is on a collision course between state demographics and some unwise budget choices made over the past decade. There is a small, and narrowing, 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 and other costs. To do so, Connecticut's revised FY 09 budget must address these state budget challenges:

**1. Connecticut has a structural deficit that *must* be addressed.** A structural deficit exists when spending growth is projected to exceed growth in revenues. Based on current services projections, OPM estimated that Connecticut's operating budget would be in deficit in FY 10 (by \$551.2 million), FY 11 (by \$796 million) and FY 12 (by \$630.6 million), even before the Governor's proposed revenue reductions. Contributing to the structural deficit is:

- a) The use of \$372 million of FY 07 surplus funds to provide revenues and fund on-going expenses in the FY 09 budget (including \$210 million used to fund the Teacher's Retirement Fund that will need to be restored to FY 10 appropriations and \$80 million transferred to FY 09 as revenues);
- b) Tax cuts adopted in the 2006 Session (that reduced projected revenue growth between FY 07 and FY 08 from 3.8% to 2%);
- c) A tax code that has grown outdated given changes in our state economy (e.g., increased Internet sales, a shift from a goods-producing to a service-based economy);
- d) Newly-enacted tax credits (including the three "movie" tax credits for which OFA projects a \$116 million FY 09 revenue loss, and the historic rehabilitation tax credit with a projected \$16.7 million FY 09 revenue loss);
- e) Increased debt service costs related to the issuance of \$2 billion in pension obligation bonds to fund a portion of the unfunded liability in the Teachers' Retirement Fund;
- f) Significant increases in energy costs (100% increase since FY 00) and health care costs (71% increase in Medicaid and 127% increase in state employee pension and health benefits since FY 03)
- g) Expiring federal grants;
- h) Important new investments (e.g., in early care and education, K-12 education).

**2. Compared to other states, Connecticut is relatively under-funded. Increasing state revenues in a manner that enhances equity among families and businesses is important.** Connecticut ranks 45<sup>th</sup> (6<sup>th</sup> lowest) among states in total own-source (state and local) revenue as a share of total personal income. In 2005 (the most recent comparative data from the US Census Bureau), Connecticut's own source revenue was equal to

14.3% of total personal income, compared to the 50-state average of 15.8%.

**If Connecticut's own-source revenue as a share of personal income simply were increased to the 50-state average, there would be \$2.44 billion more for public investment in health care, education, affordable housing, transportation and economic development to address our pressing needs.**

In general, Connecticut's public investment has not kept pace with its economy.

- Connecticut's own-source revenue as a percentage of total personal income has declined since 1990. Over the decade from 1990 to 1999 our own-source revenue averaged 14.1% of total personal income (compared to the 50-state average of 15.4%). By comparison, over the period FY 2000 to 2005, Connecticut's own-source revenue averaged 13.8% of total personal income (compared to a 50-state average of 15.5%).
- Connecticut's state and local spending also has declined over the past decade as percentage of the state's Gross Domestic Product (GDP) - from 9.8% of GDP in 1994 to about 8.75% in 2003 (4th lowest among all states).

Indeed, some agency budgets remain below actual spending in FY 02, prior to the deep budget cuts made in the last recession. For example, the FY 08 General Fund budgets of the Office of Policy and Management and the State Library remain *less than* their actual FY 02 spending, *not even adjusted for inflation*. Further, notwithstanding last year's infusion of additional aid to education, the State Department of Education's FY 08 budget remains *less* than what it spent in FY 01, adjusted for inflation (\$2,552.9 million in FY 08, compared to \$2,575.0 million in FY 01 in inflation-adjusted dollars).

**3. Connecticut's budget is *unnecessarily* under-resourced.** In 2006, Connecticut ranked highest among states in per capita income (as it has for many years) at \$49,852 and ranked 2<sup>nd</sup> highest in per capita real state GDP at \$50,332. Connecticut also ranked 3<sup>rd</sup> highest in median household income in 2005 (at \$60,941). Indeed, a 2006 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.

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Although Connecticut's per capita public investment is relatively high, Connecticut lags behind other states in state and local spending as a share of its total personal income. On this measure, according to the most recent comparative US Census Bureau data (2004), Connecticut ranked:

- 50th (lowest) in transportation spending.
- 49th (2nd lowest) in: a) total direct general expenditures; b) capital spending; c) spending on higher education; and d) 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.

**4. Connecticut's budget has grown out of balance in multiple ways.** The ratio of state spending on "education" (which includes the budgets of the State Department of Education, Department of Higher Education, state funding for all Connecticut's public colleges and universities, and the Teachers' Retirement Fund) to state spending on "corrections" (which includes the budgets of the Department of Corrections and Department of Children and Families) has fallen dramatically in the past two decades. In 1988, Connecticut spent \$6.60 on education for every dollar it spent on corrections. In 2008, Connecticut is spending just \$2.40 on education for every dollar spent on corrections.

Debt service payments also have swelled as a share of total appropriated spending in the last two decades (see below).

Connecticut is making many more of its economic development investments through preferential tax credits, exemptions, deductions, rate reductions and changes in the apportionment formulae in the state tax code. The estimated revenue loss in FY 09 from corporate business tax credits alone (\$305.6 million) is nearly **six times larger** than the total FY 08 operating budget of the Department of Economic and Community Development (including bond and carry-forward funds). The increasing use of tax expenditures to promote economic development reduces both the transparency and accountability of these important investments because tax expenditures are not reviewed annually (like appropriated spending) and there is no disclosure of the companies that are

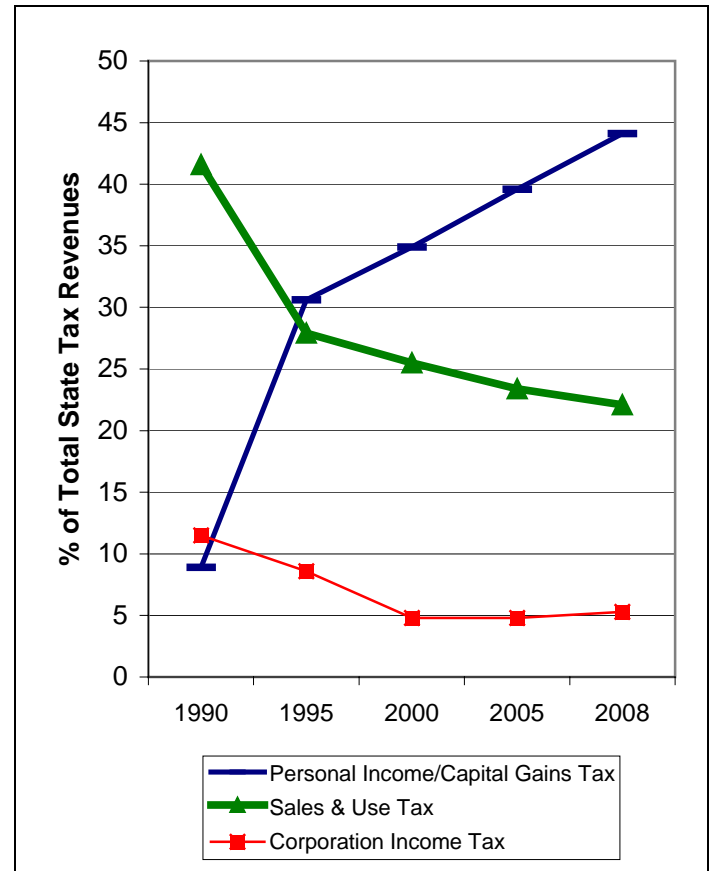
benefiting from the tax breaks nor analysis of the state's return on its investment.

**5. Connecticut's state and local revenues also should be better balanced.** While Connecticut is 45<sup>th</sup> highest (i.e., 6<sup>th</sup> lowest) among states in own-source revenue as a share of total personal income (at 14.3%), it is 10<sup>th</sup> highest in tax revenues (11.6% of total personal income). Although in the bottom half of all states on general sales taxes (39<sup>th</sup> highest), selective sales taxes (29<sup>th</sup> highest) and corporate income taxes (27<sup>th</sup> highest), Connecticut ranks 8<sup>th</sup> highest in property taxes as a share of total personal income, and 12<sup>th</sup> highest in personal income taxes. Connecticut also ranks 48<sup>th</sup> (third lowest) in federal revenues as a share of total personal income (2.7%) and 50<sup>th</sup> (lowest among all states) in fees, charges and miscellaneous revenues.

*Property tax.* Connecticut relies more on the local property tax than many other states for multiple reasons, including: a) Connecticut's budget fails to 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); b) the state's share of K-12 education funding has declined from a high point of 46% in 1990; and c) Connecticut cities and towns are not authorized to levy income, sales and other taxes (as is true in many other states). As a result, when the state cuts funds to towns, increases in local property taxes result.

*Business taxes.* State and local business taxes are **not** high in Connecticut relative to other states. A 2005 study<sup>2</sup> released by the Council on State Taxation (COST), a non-profit trade association consisting of approximately 575 multi-state corporations, examined the total impact of *all* state and local taxes on businesses across the 50 states. Included in its analysis were property, sales, excise and gross receipts, payroll, income (including the personal income taxes paid by owners of pass-through businesses), workers comp, and all other taxes imposed on business. It found that total state and local business taxes were about one-third of Connecticut's total taxes in FY 2004, the third *smallest* share among all states. Only in Maryland and Oregon were total state and local taxes paid by businesses a smaller share of total tax revenues. Further, the *increase* in total state and local business taxes in Connecticut over the period FY 2000 through FY 2004 was 4<sup>th</sup> lowest among all states.

Less than 30% of the total growth in state and local tax revenues over that period was in taxes paid by businesses; the balance was borne by families. Corporate income taxes as a share of Connecticut's total tax revenues have declined markedly since 1990. The graph below shows changes in the share of total state tax revenues contributed by Connecticut's three primary taxes:



**6. Connecticut's shifting of fiscal obligations onto the next generation is accelerating and should be addressed.** Together, Connecticut's long-term obligations now total \$54.2 billion, *up 10.6%* from last year's reported amount of \$49.0 billion. These long-term financial obligations include:

- \$14.4 billion in bonded indebtedness;
- \$7.9 billion in unfunded state employee pensions and \$6.9 billion in unfunded teachers' pensions;
- \$21.7 billion in unfunded state employee post-retirement health and life insurance benefits and \$2.2 billion in unfunded teachers' post-retirement life and health insurance benefits; and
- \$1.1 billion Generally-Accepted Accounting Principles (GAAP) deficit.

These long-term obligations are close to *40 times greater* than the state's Budget Reserve Fund (currently \$1.38 billion) and rank us as one of nation's most indebted states. Specifically, Connecticut ranks 6<sup>th</sup> highest among states in state debt as a share of personal income (13.9% in 2005, compared to the 50-state average of 7.8%) and 3<sup>rd</sup> highest in state debt per capita (\$6,584 per Connecticut resident, compared to the 50-state average of \$2,693 per person).

Further, Connecticut's unfunded *pension* liabilities are 4<sup>th</sup> greatest among all states. Current pension fund assets cover just 58.3% of the state's liability, compared to the 50-state median of 81.6%. Further, it becomes *more difficult* with each passing year to try to make up for past inadequate payments because the *annual* required contributions continue to increase. For example, the required contribution to the teachers' retirement system in FY 00 was \$204 million, in FY 08 it is \$519 million and by FY 10 it is projected to be \$699 million.

As Connecticut's bonded debt has increased, so has its debt service. In FY 88, debt service was 5.3% of total state spending. In FY 08, an estimated 10.4% of General Fund and Special Transportation Fund spending (\$1.84 billion) will be for debt service. Increases in debt service payments crowd out other public investment. Indeed, if debt service now were the same share of total state spending as in FY 88, there would be an additional \$897 million in the FY 08 budget that could be used for other purposes.

High debt levels also impair Connecticut's bond rating and low bond ratings result in higher costs to borrow funds. Among the 39 states whose General Obligation bonds are rated by the major bond rating entities, only two states are ranked lower than Connecticut by Moody's, while Standard and Poor's ranks just six states lower, and Fitch ranks just eight states lower.

**7. The Budget Reserve ("Rainy Day") Fund is not adequate for Connecticut to weather a deep recession and should be increased.** The Budget Reserve Fund is Connecticut's "savings" account, to be tapped when state revenues decline precipitously (as in FY 02) to avoid steep cuts in state investment, particularly in programs and services that are especially crucial when the economy is weak (e.g., assistance for families who are out of work). In the last recession, the Budget Reserve Fund – though

fully funded at the then-statutory level of 5% - was inadequate to cover even a single year of deficit. Even after deep spending cuts were made, Connecticut had to borrow funds to make ends meet. Since then, state law has been amended to increase the maximum amount allowable in the Fund -- from 5% to 10% of net General Fund appropriations for the current fiscal year (i.e., \$1,631.5 million in FY 08). The Budget Reserve Fund balance now is \$1,381.8 million, or 8.4% of FY 08 net General Fund appropriations (and 84.7% of full Fund capacity).

A recent study of state Budget Reserve Funds<sup>3</sup> found, however, that the 50-state average in 2006 for state Budget Reserve Funds was 11% of appropriations (i.e., more than Connecticut's statutory limit), and recommends that states maintain a reserve of at least 15% of a year's spending.

**Connecticut is running out of time to put its fiscal house in order.** The state's structural and investment deficits will persist until the state has an equitable revenue system that reliably meets its investment needs, grows with the economy, and addresses the challenges discussed in this issue brief. The alternative is short-term "savings" with serious long-term costs.

To put Connecticut's fiscal house in better order before the Baby Boomers begin to retire, the revised FY 09 budget should raise additional revenues *while the Boomers are still in the labor market* - in a manner that improves the equity of our state and local tax codes – to: a) fulfill current state obligations rather than transferring them to the next generation or to our cities and towns; b) reduce state debt and pay down pension and other unfunded obligations; c) fully fund the Budget Reserve Fund, and d) increase the level of state investment to assure equal opportunity for children and families, an adequate infrastructure, and a healthy economy.

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<sup>1</sup> This report relies primarily on data in reports by the Office of Fiscal Analysis, the Office of Policy and Management, and the Legislative Program Review and Investigations Committee, as well as CT Voices' analysis of Connecticut's budgets over time.

<sup>2</sup> Council on State Taxation, *Total State and Local Business Taxes, Nationally 1980-2004 and by State 2000-2004* (April 12, 2005).

<sup>3</sup> McNichol & Filipowich, *Rainy Day Funds: Opportunities for Reform* (Center on Budget and Policy Priorities, 2007), available at [www.cbpp.org](http://www.cbpp.org).