Where does the Connecticut budget crisis come from?

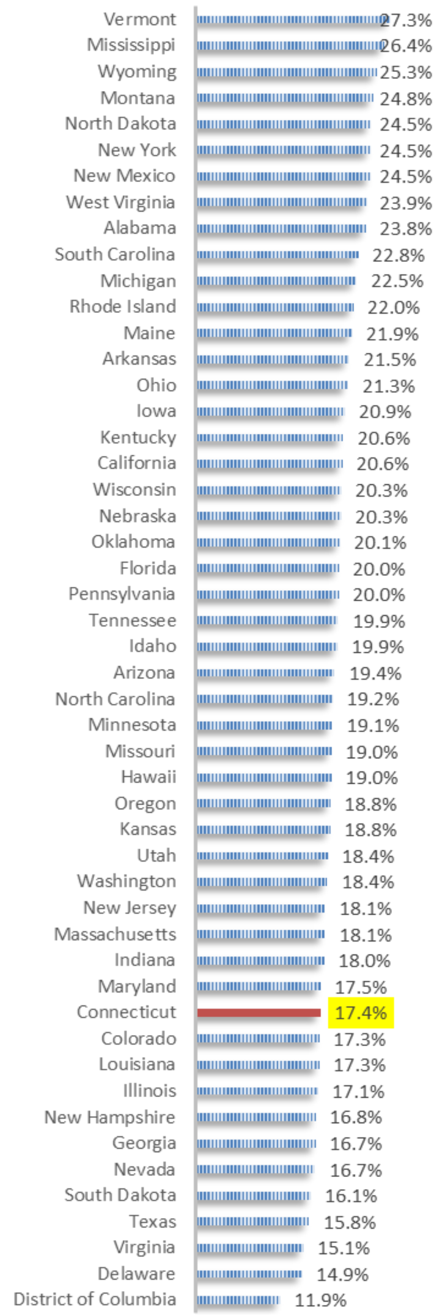
Connecticut has been in a fiscal crisis pretty much non-stop for the past eight years. It is likely that the state would have started looking at red ink before that, but the real estate and financial bubble of the 2000s masked the underlying reality. For close to a decade, and probably for longer, our state has been constantly on the edge of a fiscal chasm, with the General Assembly muddling through with a mix of tax increases and spending cuts.

The thing is, this is not really normal. Connecticut is one of the wealthiest states in the wealthiest country in the world. Even if the state´s economy hasn´t fully recovered, unemployment is relatively low, growth is weak but not anemic and labor productivity is still high. We have an economy in a mild slowdown enough to produce a shortfall that could be sorted out with some tweaks. Instead, we have a Groundhog Day of budget deficits.

For starters, it is not true that we have a state government we cannot afford. It is hard to stress enough the fact enough that Connecticut is *really* wealthy and we are not doing anything that other states aren't able to pay for, but it goes beyond that. Measured both in terms of state and local taxes as percentage of personal income and as size of state and local government as percentage of the state economy, we rank in the bottom half in terms of how much we tax and spend[1].

Of course, it is not that we have not raised taxes. The state, in fact, went through two rounds of pretty hefty tax increases, one just after Governor Malloy got elected, a second round last year. The Governor and legislature have been looking for money all over the place, and they have bitten the bullet (twice!) with unpopular tax increases. And yet, the budget hole does not get any smaller. Why?

The answer is a tad complicated, and requires having a closer look at how we tax and spend in the state. The main issue, however, is less that we spend too much or tax too little, but that we do both in really outdated, inefficient ways. We have a state budget based on 20th century assumptions, not 21st century realities. Let´s start with taxes.



Local and state revenues as percentage of Gross State Product (GSP). Bureau of Economic Analysis 2012 data.

An outdated tax structure

A. Taxing objects in the age of ideas

If we want to see how the Connecticut tax structure is designed for a 1960s style economy, look no further than the sales tax. About a quarter of the total tax revenue of the state comes from the sales and use tax, collecting a bit north of $4 billion a year. It is a fairly regressive tax, with families at the bottom of the income distribution paying much higher effective rates than anyone else.

This is due to the very nature of taxes on consumption (the poor dedicate a higher percentage of their income to it), but also because we happen to exclude a lot of things from it: primarily, many services. Connecticut´s tax code has a monumental amount of carve outs, exemptions, loopholes and special provisions that leave a huge and increasing percentage of our economy untaxed. This means that a diaper, sofa or cell phone has to pay sales tax, while things like repairing a boat, hiring an interior decorator or going to the gym are untaxed. In a sense, the state is raising money from tangible products in an economy that is more and more focused on services and ideas.

If we eliminated all the sales tax exemptions but the one for food purchases, Connecticut would be able to collect close to $2.5 billion in extra revenue a year at current rates – or it could cut the current rate by two points, giving a significant tax cut to low income families while still raising close to half a billion in additional revenue. To put it in one sentence, broadening and simplifying the sales tax makes sense.

The sales tax, however, is hardly unique. If we look at the state and local tax system as a whole, the property tax is by far the biggest source of funding for Connecticut´s public sector, with 45% of all tax revenue. Four or five decades ago, when Connecticut had a much more egalitarian income distribution and wealth was much less geographically segregated, it made sense: the core cities concentrated business, trade and industry and could raise revenue effectively. Today, cities have lost much of their former tax base, suffered years of underinvestment and concentrate most of the need, so they end up having higher mill rates. As a result, nearly 60% of Connecticut towns cannot cover the cost of their services on their own.

Things have changed in the past few years. Today, many business favor dense, vibrant urban areas instead of suburban campuses. GE left the state not looking for a low-tax haven, but for vibrant, urban Boston. Knowledge workers value active, diverse, lively, dense communities, and clustering creates strong network effects that promote innovation. In Connecticut, however, we are taxing those urban areas heavily, while leaving the most expensive suburban communities in the country paying much lower mill rates. Again, we have an outdated tax system, raising money in a way that doesn´t make much sense.

B. Giving tax breaks to fading industries

The rest of the state´s tax system is similarly geared to either raise money from a 1960s-style economy or promote growth like we used to have in last century. Connecticut´s business tax code heavily favors manufacturing over any other kind of industry: while the total effective tax rate for a factory (adding up business, property, sales and unemployment taxes) is 9.8%, a research facility or corporate headquarters ends up paying 22%.

This might have made sense decades ago, when manufacturing was both labor intensive and did not face international competition. Today 80% of the U.S. labor force is in the service sector, while manufacturing barely employs 8% of workers. Connecticut, even with all this help, barely looks any different, with less than 10% of the labor force in factories.

Our business tax code is needlessly complicated for no good reason, producing different tax impacts by sector. The legislature should consider creating a simpler business tax with lower rates and fewer credits and exemptions.

Connecticut has the largest income gap of the nation. The state tax system takes this into account thanks to a progressive income tax that raises roughly 60% of

C. Taxing (some) income instead of wealth

its revenue. The income tax does its job in making those that have the most pay more, but not terribly so: the effective tax rate for households in the top income decile (4.52% in 2011) is only three and a half points higher than those at the bottom (1.11%). Trouble is, wealthy, affluent households tend to receive a very high percentage of their income from investments, and Connecticut is not taxing capital gains that much.

In addition, in a state with very high levels of concentrated wealth, our property taxes remain firmly local. As a result, the more expensive the average median price of a house is in a town, the lower the mill rates are. As most of household wealth in the state is tied to housing, we are again raising revenue the wrong way from the wrong places.

Fixing these imbalances and modernizing Connecticut´s tax system to make it more efficient, fair and predictable won´t be easy. Even a non-binding, non-partisan tax panel this year had trouble producing a revenue-neutral set of proposals, and sidestepped proposing significant changes to the property tax. We are at a point, however, where Connecticut can no longer afford standing still. Our state and local tax system is regressive, inefficient and often just raises insufficient funding from the wrong things and places. It is time for state and local leaders to step up and start thinking big, not just look at piecemeal reforms. The current tax system will never be able to raise enough revenue to fund our current needs on the long run, or to foster sustainable economic growth.

20th Century Spending in a New Economy

Revenue is only half of the equation when talking about the budget – spending also plays an equal part. As with revenue, Connecticut has some spending practices that are both inefficient and outdated, creating a state and local government structure that is often not up to current challenges. In many areas, we just spend money in a lousy way.

A. An Outdated State Structure

Connecticut has a lot of departments and agencies. By our count, the state has 24 departments, 14 offices, 12 commissions, and 10 quasi-public agencies. The numbers, by themselves, are not all that meaningful, but how they share infrastructure and data is.

For instance, consider how Connecticut provides services to a family in need. These programs might be housed in several different agencies, like the Department of Social Services, Children and Families, Rehabilitation Services, Corrections, Public Health, Labor, Developmental Services, Access Health CT or the Office of Early Childhood. Not many families need to access *all* services at the same time, but many will require the support of more than one agency. A recently laid off worker would likely need health insurance (either through the Department of Social Services or Access Health CT) and unemployment benefits (Department of Labor). If he has a disability, the Department of Rehabilitation Services would be providing support; if he has children, he should seek support from the Office of Early Childhood.

Trouble is, none of these state agencies share any kind of infrastructure or data in any meaningful way. Each department has its own information technology and databases, and have set up their systems separately. This means that state agencies spend considerable time and resources either reinventing the wheel or building specific tools for themselves, even when another agency already has one in place. As each department has to work with its own separate, dwindling pot of money, crucial IT upgrades are postponed until systems are well beyond obsolete. The Department of Social Services, for instance, is in the (long) process to replace its 1989-vintage EMS mainframe, which was slowly falling apart. The roll out of ConneCT/ImpaCT, the new system, has been extraordinarily difficult in no small part because barely anyone still uses Cobol in their applications like

EMS does.

In addition to barely functional, outdated technology, state departments often serve the same clients but rarely, if ever, share data or coordinate services in any meaningful way – sometimes they are even barred by contract from doing so. This means that the state spends a considerable amount of resources doing intakes, over and over again, and providing services in a fragmented, uncomfortable and ineffective manner. This issue, by the way, is not limited to social services; economic development agencies are often hampered along similar lines.

Reorganizing bureaucracies is not exactly flashy, glamorous or popular, but it can improve services, and it can save money. It is not easy, either, but it needs to be done.

B. Local government and economies of scale

It is easy to fixate on state services and their problems, but it is important to keep in mind that Connecticut relies in local governments for about half of its public spending. Education, public safety and housing are largely in municipal hands, and but cities and towns are often ill-equipped to do the job well.

The issue, in this case, is economies of scale, or lack thereof. When providing services, the cost per client often goes down the more clients you are serving. Connecticut has 169 towns, and this fragmentation means that a lot of municipalities are paying more for less because of their small size. To make things worse, the larger cities (which are not that large to begin with) concentrate most of the poor and low-income families in the state. The result is small towns with high overhead costs, and cities with a bigger need for services but lacking the tax base to deliver them.

The answer to this issue is obviously some form of regionalization, but the steps Connecticut has taken in this direction are quite uneven. For instance, the boundaries of many regional organizations do not match; workforce development boards serve different groups of towns than the regional councils of governments, which in turn differ from the health districts, which happen to be different from the 911 call centers, and so on. These call centers are probably one of the clearest examples on what we are doing wrong: Connecticut has 107 public safety answering points, all fully staffed. Suffice it to say, economies of scale can be found there, as well as in many other places.

Again, it is often easier to spend money than to sit down and work to change institutions, especially when those changes might get people upset. We are at a point, however, when the legislature and municipal leaders should really look at these issues, and go beyond tinkering around the edges. This might mean seriously looking into shared insurance pools for municipal workers, integrating transportation departments and road repairs, and regional purchasing plans. If we want to *really* solve the issues at hand, regional education districts that cover *both* cities and suburbs, and larger, regional, police and fire departments should also be on the table.

C. Hidden subsidies: tax exemptions

We mentioned how the sales tax is riddled with carve outs and exemptions, meaning that a large (and growing) portion of our economy is left untaxed. The sales tax is our biggest money sink, but as CT Voices points out in a report it just released, it is far from being the only tax riddled with holes. Connecticut foregoes $7.2 billion in taxes every year this way.

In a sense, this is also state spending, though hidden in the tax code. Instead of giving a certain company or business a direct subsidy through an appropriation, the state increasingly relies on all kinds of exemptions, credits and targeted cuts to do the same. Some of these expenditures make sense (not charging sales tax on food, for instance), but many are just pointless giveaways. It is better to have a lower overall tax rate without exemptions than a higher rate on a tax riddled with loopholes; unfortunately, we have preferred complexity to fairness for many years, spending billions of dollars in the process.

D. Public education and human services

Social services and public education comprise a large part of the state budget. Connecticut, as a state, provides more social services than the national average. We have a generous (and very effective!) Earned Income Tax Credit, we expanded Medicaid, spend a good amount of money per student in K-12 and higher education, and have an extensive, if underfunded, pre-K and early care system. Because of all that, we also have lower levels of adult and child poverty than most states, which saves money in the long run.

One smart idea the Connecticut General Assembly has adopted is the use of "results based accountability" (RBA) to examine the effectiveness of safety net and other programs. Social service and other state spending should be driven by improving outcomes: are people better off? Connecticut should deepen its commitment to program evaluation, using data to assess which programs are really effective, and which are not.

We should bear in mind, however, that although our safety net services and costs are above average, they are not an outlier among blue states. Minnesota, Massachusetts, Washington, Maryland, California and Oregon offer comparable services. The thing is, those states aren't on a never-ending fiscal crisis treadmill as Connecticut is, so the source of our problems is not really spending on social programs. Again, we are a *really* wealthy place with modest spending and taxation levels; the problem is less on the size of the state budget, but on how we raise and spend it.

E. Not paying the bills on time: pensions

In the late nineties, Connecticut politicians came up with a very clever way to balance the state budget: they stopped putting away money in the public employees´ pension fund while giving early retirement incentives to a whole bunch of state workers. This made paying for state services much easier, but also opened an ever-deepening hole in the pension fund that eventually had to be paid.

The good news is that Governor Malloy and the Legislature are now paying into the fund, and the state is working hard to catch up with the overdue payments. The bad news is that it is eating up the budget.

How much? The figures come from this study from the Comptroller's office: in 2016, Connecticut's contribution to its pension fund was about $1.5 billion. This will climb to about $1.8 billion in 2017, $2 billion in 2019 and will keep climbing non-stop all the way to 2032, when it will get close to $4 billion. Adjusting for inflation, the numbers are a bit less daunting (up to $2.5 billion), but the problem remains – in a roughly $20 billion budget, rising pension costs are a challenge.

This is not sustainable, but it doesn´t mean that it cannot be fixed. Kevin Lembo, the Comptroller, presented a proposal on how to do it (PPT), giving a good overview of the challenges the state faces. His plan tweaks the amortization method and extends its schedule (translation: changes how inflation is calculated and adds more years to pay for the liabilities) to change the payment structure. The result would be a payment of $1.5B in 2016, $2B in 2017, $2.15B in 2018 and then remain pretty much flat in nominal terms until 2032 (that is, dropping, inflation-adjusted), when they would drop to $1.5 billion. This still would require more money up front (to be raised either from new revenue, cuts, changes on how benefits are calculated, or a mix of all three), but at least would make the state´s obligations more manageable.

The main point, however, is that this problem is not new, but the result of past budget sins. Two-thirds of state pension fund payments go to cover past unfunded obligations. For close to two decades, Connecticut just did not budget to cover its retirement bill. We are paying the price now.

E. Workforce Challenges

This does not mean, however, that the state spends the money wisely in regards to staffing – we both spend too much and too little.

For starters, Connecticut has a relatively small state and local labor force, well below the national average if we look at workers per capita. In addition, employment levels have been largely stable since the late nineties. We are a small, densely populated state, meaning that it is fairly easy to offer services. In addition, population growth has been largely flat. Many state agencies, however, remain understaffed with long waiting times, and poor service. Areas like tax enforcement do not have enough personnel, despite the fact that adding more workers would actually save money by collecting additional tax revenue.

Employee compensation, however, is also a factor. We want public employees to be well compensated; having a strong, motivated and well qualified labor force is what enables Connecticut to offer the strong public services that are one of the main competitive advantages of the state. We must keep in mind, however, that labor costs do not happen in a vacuum, but are part of a broader budget. Public employee salaries are, on average, comparable to private sector positions. As is common in the public sector, wages are higher than the private sector for entry-level positions, and lower for more experienced workers. The main difference, however, comes from benefits, and more specifically pensions (largely due to the state's past mismanagement) and health care.

For many years, the main driver for cost increases was retiree and employee health care, following a trend of increasing health care costs in the private sector. Health care costs climbed from 2.9% of the general fund in 1990 to 6.2% in 2011. Following the 2011 contract agreement, which included some important changes, health inflation has stabilized, although health care costs still takes a considerable percentage of the state budget (5.8% last year). Connecticut should consider adopting further cost control measures, ranging from payment advisory boards, narrower provider networks or more cost sharing. Health care reforms are not easy, and would need to be negotiated with state employee unions, but this is an area where costs potentially could be reduced but costs can be controlled.

Conclusion: Time for Real Change

Connecticut could be more effective both raising revenue and using its resources, although doing so would require bold institutional reforms that truly change how the state operates. This rethinking also has to include finding a way to pay for past budgetary sins, one way or another, especially regarding state pensions.

Above all, the state´s economic and financial doldrums leave little room to leave any reform stones unturned; we all need to share this burden. Everyone -government, unions, businesses, nonprofits, municipalities- needs to be at the table, and everyone should be willing to contribute to move the state forward, one way or another.

Connecticut has been the land of steady habits for too long. It is time for real change.

You can download this report with its linked references at
http://cahs.org/publications/kids-count-publications/