



[A Very Deep Hole Indeed](#)

The Connecticut Economic Outlook: November, 2010

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Summary

Connecticut's economy is in a deep deep hole. Measuring unemployment on the basis of historical patterns of labor force participation, there are nearly 400,000 working age adults who would like to have jobs, but don't. That translates to a real unemployment rate approaching 20%. Though this CCEA Outlook anticipates growing state output and modest gains in jobs, this growth will offer little opportunity for employment to the many residents who would like a job.

Compounding the challenge for Connecticut is the fiscal reality that the state government faces massive deficits, officially aggregating \$9.5 billion over the next three fiscal years. If revenue growth fails to live up to expectations, the aggregate deficit could easily grow to \$12 billion, more than twenty per cent (20%) of the projected budgets. The next Governor and Legislature will unavoidably make significant cuts in spending and find ways to increase revenue. Yet preliminary analysis reveals that cutting the budget by \$2 billion dollars, absent offsetting policies and actions, would overwhelm private sector job growth, significantly raise the unemployment rate, reduce state revenues while raising public sector costs, and ultimately lead to losing population. A falling population would then further undermine an already weak housing sector. Thus cutting state spending by itself would unleash a negative feedback loop that would partially nullify the cut in expenditures, damage Connecticut's economic health, and make recovery even more elusive.

The goal then is to balance the necessary fiscal adjustments with policies and initiatives that will create sufficient vitality in the private sector to offset the contractionary impact of budget cuts. Initiatives include making smart efficiency-based (not across-the-board) cuts in state spending, restructuring the dysfunctional revenue base, and freeing-up capital. Two obvious strategies are to unleash a highly focused capital investment program based on the more than \$1 billion in accumulated R&D tax credits major Connecticut firms currently hold but cannot use and to use state bonding authority to make major investments that deliver the largest economic impact directly on the state's economy, both through job creation and improvements to its long-term competitive position.

This mixture of initiatives can not only redress the massive fiscal deficits the state now faces, but also could drive a vigorous recovery and sustained job creation. Done right, Connecticut could reclaim its historic position as a national economic leader, instead of a follower. The state faces a very deep hole indeed, but there is a way out!

Introduction

CCEA constructs its forecast on the basis of historical patterns since 1973; for this Outlook that means developing the base forecast with data and trends from pre-election Connecticut and the nation. The base forecast includes retrenchment of Connecticut state and local government employment by 10,300 positions over the next two-years. There is brighter light for the private sector with the growth of 38,500 new jobs in the private sector for a net gain of 28,500. This optimistic forecast flows largely from a bullish assumption about national growth.

In addition, this forecast evaluates separately the consequences of the state permanently cutting expenditures by \$2 billion (approximately half of the projected FY 2012 budget deficit). Since this reduction is targeted at deficit reduction, no offsetting tax reductions are considered. This reduction results in a 13% decrease in direct, indirect, and induced jobs in the state and local public sector. The resulting job losses overwhelm anticipated gains in the private sector, drive up costs of government, reduce revenue, and initiate a negative feedback loop. A subsequent section of the Outlook examines the broad economic implications of such large public sector cuts.

This Outlook begins with a look at labor force utilization in Connecticut to establish a broader context for evaluating the state's economic performance. It then turns to a discussion of the baseline forecast, based on pre-election patterns. Next this Outlook considers the economic consequences of cutting state's operating budget by \$2 billion. The final section points to initiatives and policies to ameliorate those impacts.

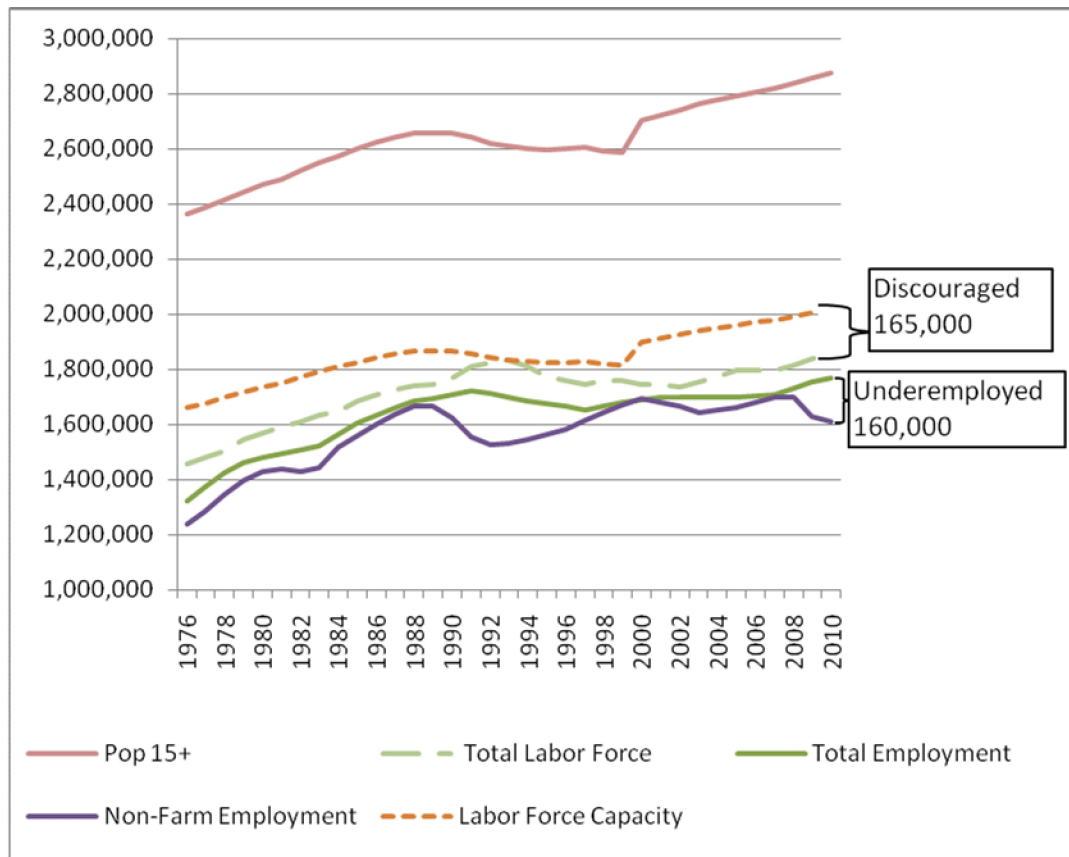
Labor Force Utilization

Despite official Connecticut unemployment hovering around 9% of people counted as participating in the labor force, the number of people who would like to work but are no longer looking and the number of people working part time who want to work more translates into a much higher level of real unemployment. Through analyzing Connecticut labor force utilization this analysis reveals how severely the official rate understates the real rate. From 1976 to the present, Chart 1 illustrates the historical pattern of the size of working age population (15+), maximum labor force availability (those of labor force age times the maximum annual participation rate over the period), actual participation levels, total employment, and total non-farm employment. The difference in the size of the labor force, measured by the official participation of 64.2% and the maximum labor force participation—illustrated by the perforated lines—is currently 165,000. If the same proportion of the population were willing to work now as in 1993, when the state reached its highest participation rate (70.3%), then there are 160,000 discouraged workers in Connecticut. While the population has aged since 1993, labor force participation rates among seniors have also risen.

In addition, there are two employment series with significant differences between them. Total employment includes non-institutionalized persons 15+ as well as those employed within seven days of

the survey. The non-farm employment series includes non-institutionalized persons 16+ employed on the day of the survey. The differences between the two employment series, shown by the lower two solid lines in Chart 1, now 160,000, arise primarily from differences from inclusion of farm employees in the overall total as well as differences in the timing of definitions used to estimate who is employed. As part time employment increases as a share of total employment, the spread between these two employment-series widens as illustrated in the Chart. This difference represents primarily underemployment of part-time workers

Chart 1: Connecticut Labor Force 1976-2010



Source: BLS various databases.

Because the official non-farm unemployment rate shows only the percentage of those without jobs who are actively seeking work as a percentage non-farm labor force participants, it captures only the difference between those two series, currently 87,000 or 8.8%. It vastly understates the underutilization of the labor force revealed by the difference between labor force capacity and non-farm employment plus an adjustment for inclusion of both farm employees and labor force participants who are 15 years old. Given the close proximity of the two employment series for much of the time, these adjustments are not large. Adjusting for the low participation rate of 15 year-olds in the labor force,

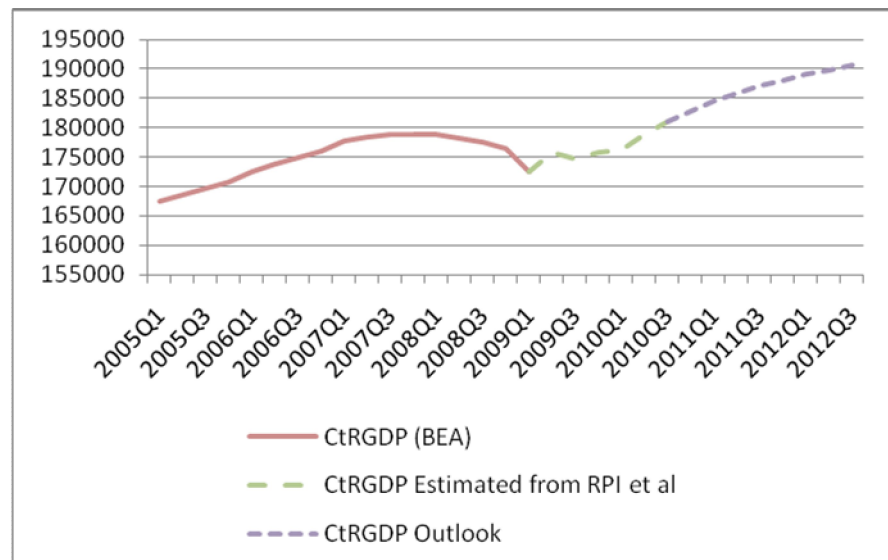
seniors' labor force participation rates rising since 1993 and estimated farm employment,¹ Connecticut's total labor force underutilization approaches 397,000 or 19.6%. On this calculation, one of every five Nutmeggers who would like to work is unemployed or underemployed.

Outlook: Based on Pre-Election Data

CCEA developed the base case on the basis of national RGDP growth rates of 2.8% in 2010 and 2011, followed by 1.9% in 2012. While the forecast is bullish for 2011, it is modest for 2012, with expected growth in CTRGDP 2.9% in 2010, 3.7% in 2011, and 1.9% in 2012, thus outpacing national performance in the first two years. By 2012, in this forecast, CTRGDP reaches \$189.9 billion (constant dollars).

CCEA builds the forecast in two stages. CTRGDP data up to the end of 2008 are based on actual observations. CCEA then derives data for 2009 and thus far in 2010 econometrically, based on personal income for each economic sector, using historical relationships. CCEA then uses Bayesian vector auto-regression techniques to forecast state output, as Chart 2 shows.

Chart 2: CTRGDP Outlook (Millions 2002 \$)



CTRGDP growth is sufficient to stimulate Connecticut employment growth at modest rates of 0.6% in 2010, 1.0% on 2011 and 0.6% in 2012. If such a recovery were achieved, it would increase non-farm employment by 38,500 over the eight quarters from 2010Q3. Based on recent trends increased employment would be concentrated in these sectors:

- +40,900 in trade, transportation, public utilities, and
- + 4,900 in construction, meeting mostly pent-up non-residential demand at 3,400.

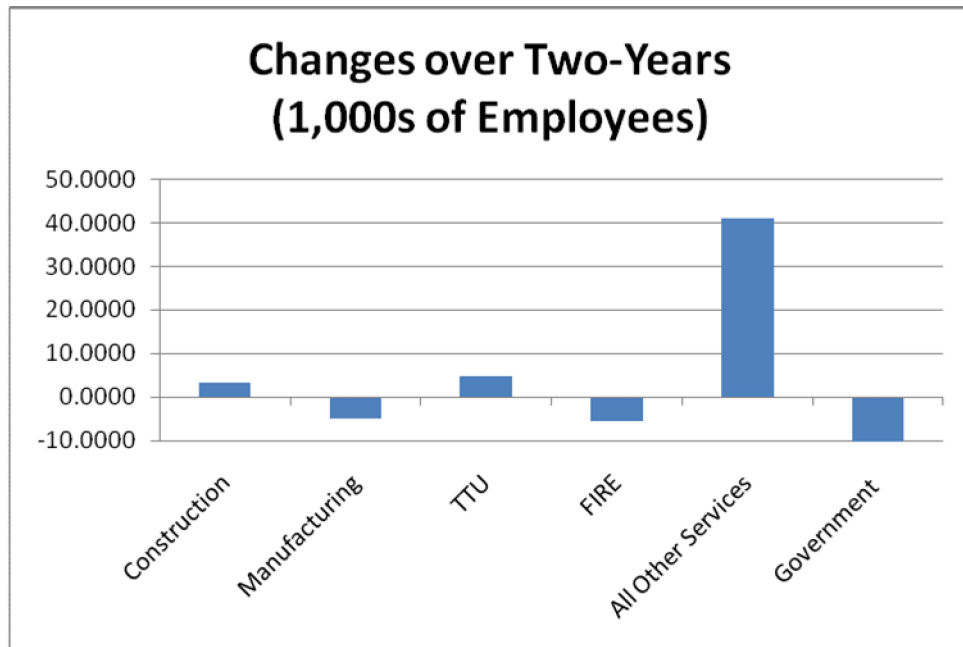
¹ Lopez, Rigoberto A. D. Joglekar, C Zhu, P. Gunther and F. Carstensen, Economic Impacts of Connecticut's Agricultural Industry, UConn, Sept. 2010. This publication sets Connecticut agricultural employment at 10.6 to 15.4 thousand.

Declining employment would occur as follows:

- -10,300 in government,
- -5,400 in finance, insurance and real estate (FIRE),; and
- -5,100 in manufacturing.

Chart 3 provides the breakdown by sectors.

Chart 3: Employment Growth by Sector



This view is almost certainly an optimistic forecast, based on a modestly healthy national recovery. The current consensus is that national growth will be somewhat lower. Despite the possible fiscal impact of reduced federal programs due to the election, there is still room for some optimism due to pent-up demand from deferred household formation, strengthening exports resulting from devaluation of the U.S. dollar, and increased consumer demand for durables that usually follow from these developments. Another potential positive is the Federal Reserve's post-election announced monetary expansion of \$600 million over eight months—a policy that appears to be working—which occurred subsequent to developing the base case forecast.

Less optimistically, recent election results signal a return to fiscal conservatism focused on retrenching government spending and shrinking direct government employment, each of which has indirect and induced impacts that will further curtail expenditures.

Reduced State Expenditures

Public policy initiatives also frame private sector dynamics. In the face of massive state deficits, this section considers a scenario in which Connecticut permanently cuts \$2 billion from its expenditures, without any other adjustments. Using a dynamic model of Connecticut's economy (REMI), such budget cuts would erode much of the expected income growth, resulting in significant negative impacts compared to the baseline forecast; Table 1 summarizes these impacts:.

- In 2011, the \$2 billion in cuts would subtract 1.85% from CTRGDP in 2011, a year in which Connecticut's economy is expected to grow at best 2.8%. Thus state reductions would cut growth in half.
- In 2012, the implications are more severe, with state cuts resulting in a loss of 1.7% of CTRGDP, essentially cancelling out most of the expected growth of 1.9%.

Table 1: Connecticut Income Impacts of a Two-Billion Dollar State Expenditure Cut (Billions 2000 \$)

Indicators	Billions of Fixed 2000 dollars	
	2011	2012
CTGDP	-3.456	-3.278
Real Personal Income	-3.038	-3.221
Real Personal Disposable Income	-2.472	-2.632

While the state might still see growth in output, employment would be hard hit. A reduction of \$2 billion in state expenditures would offset all of the employment gains this Outlook anticipates, with government job losses reaching 23,900, more than double estimated losses in the base forecast. In addition, due to the reduced indirect and induced demands from curtailed government expenditures and employment, private sector employment will shrink an estimated 15,000, eliminating 38% of the expected increase in private sector employment over the two-years.

Table 2: Employment Impacts relative to the initial Outlook of a \$2 Billion Cut in State Expenditures (1,000s)

Indicators	Numbers	
	2011	2012
Years		
CT Employment	-39.62	-37.29
State Gov Employment	-23.92	-22.51
Government Demand Employment	-1.98	-1.87
Private Sector Employment	-15.69	-14.69
Intermediate demand	-6.38	-5.86
Local consumption direct demand	-6.64	-6.23
Government demand employment	-1.98	-1.87
Investment activity demand employment	-0.99	-1.37
Exports to the rest of the nation	0.27	0.59
Exports to the rest of the world	0.02	0.05
Population 1,000s	-9.7	-16.3

Such a severe expenditure cut would also reduce State revenues, so that the full two billion dollars in expenditure cuts would not be fully realized in deficit reductions. The analysis anticipates State revenues declining as a result of the cuts by \$314 to \$318 million (1.2% above current expectations) in each of the projected years. In addition, expenditures on welfare and social services would rise 2.7% above current expectations. Thus less than three-quarters of the expenditure cuts would be realized in deficit reduction.

The employment impacts would likely lead to an exodus of the population of 9,700 in 2011 and 6,600 in 2012. This would further depress housing markets in most areas of the state. In the longer run, this analysis argues that such a severe cut would prolong or even jeopardize an already weak recovery.

Prospective Offsets

Prospective offsets include making smart efficiency-based (not across-the-board) cuts in state spending, restructuring the dysfunctional revenue base, and providing stimulus through state bonding of capital projects and/or restructuring rules governing use of outstanding R&D investment tax credits to encourage private sector investment and job creation in Connecticut. There are efficiency gains to be gained by office sharing, shifting to LED lights and greater accountability of staff time. In addition, revisions to the tax system could spread the burden of taxation more equitably, improve and stabilize revenues, and simultaneously make Connecticut more attractive to investors.

Capital expenditures by the state of a billion dollars could offset about half the erosion in jobs flowing from the \$2 billion cut in the current services budget and generate efficiencies in the delivery of services that lower their costs. In addition, the Spring CCEA Outlook revealed a billion dollars in currently unused R&D tax credits could be used to stimulate private sector investment and accelerate both construction and permanent hiring. This latter stimulus alone could increase employment by 27,000 by the end of 2012, enough to more than offset the negative impacts of cuts to government operating budgets. In the longer run, these initiatives could add as many as 50,000 jobs in Connecticut. And, critically, a properly structured release of these tax credits would deliver significant new revenue over and above the cost of the credits.

Conclusions

Absent severe government cutbacks, this CCEA Outlook anticipates a modest recovery in Connecticut economic output and employment. But such growth would have little impact on the massive level of unemployment and underemployment in Connecticut's working age population. Separate consideration of a dramatic cut in state spending, deployed to help balance the state operating budget, would reduce CTRGDP to less than half of its expected growth and expected employment growth in its entirety. Without further other policies adjustments and initiatives, the impact of a \$2 billion cut in expenditures on the State's deficit would deliver only about three quarters of the expenditure cuts as a result of rising welfare payments and reductions in the tax base associated with lower earnings; the analysis also argues that the negative feedback loop would trigger a population exodus that would perpetuate the downward spiral.



Those negative impacts could be largely or entirely offset through tax reform, selected efficiency-based expenditure cuts, use of bonding authority to initiative investments with a high local impact, and adoption of strong incentives for firms to utilize their currently moribund R&D tax credits to make focused capital investments. Collective these policies and initiatives would jump start a robust recovery and drive major job recovery in Connecticut.