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Navigating Tumultuous Waters

The Connecticut Economic Outlook: August 2011

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This CCEA Outlook explores state policies for sustaining recovery after better-than-expected state real gross product expansion in 2010 confronted choppy waters resulting from chaotic international markets and dwindling federal stimulus in 2011.

Executive Summary:

If the state and national economic performance of 2010 had been sustained, Connecticut would be looking for a strong recovery in both total output and especially employment by the end of 2013. The state would have enjoyed almost a ten percent growth in output and recovered another 55,000 jobs, performing better than the national economy. But this was not to be. The federal stimulus—offset virtually entirely by contractions in state and local expenditures—has largely expired, and anticipated federal spending reductions will work against national recovery. The financial chaos of this summer has again sucked confidence out of the equity markets, and the continuing crisis in sovereign debt in the European Union has scared investors into the safest available havens—gold and American Treasuries. Virtually all economic forecasts, both for the United States and for the global economy, have been trimmed back. Realistically, Connecticut will not see the improvements it might have seen.

In recognition of these hard realities, this *Outlook* develops a more realistic base-case for the state's economic performance over the next two years. CCEA then modifies that base-case to take account of both the recent labor agreement with state workers, freezing state salaries and significantly increasing employee contributions to the cost of fringe benefits, increased taxes, and the major capital projects to which the State has now committed itself. These developments have opposite effects: the labor agreement reduces economic growth; the capital projects accelerate it. The net result is a modest loss in output and employment compared to the base case, but significantly better than a pure budget cut, which would likely have put Connecticut back into recession.

Finally, the *Outlook* points to public policy initiatives that, if adopted, could help accelerate Connecticut's economic recovery, generate additional jobs, and strengthen its competitive position.

Introduction

Recently released data from the U.S. Bureau of Economic Analysis (BEA) shows 2010 seasonally adjusted Connecticut real gross domestic product (CTRGDP) grew more than anticipated, in excess of 3%, ahead of the national rate by 7 basis points. Had that national trend continued in 2011 and CTRGDP growth retained its acceleration over the rest of 2011 and 2012, the CCEA forecast would be relatively rosy, anticipating relatively robust growth from $224 billion in 2011Q1 to $241 billion in 2013Q4 while Connecticut employment would have accelerated, gaining 55,000 new jobs by the end of 2013, with 75% concentrated in services employment. Given the devalued dollar, both durable and non-durable manufacturing also would have continued the 2010 reversal of its prolonged downward trend. But it is now unlikely Connecticut will see such a nice improvement in its economic health: the financial tumult in American financial markets, the loss not simply of federal stimulus but a contraction of federal expenditures, the continuing crisis in sovereign debts in the European Union, and the apparent weakening of the American economy argue for a more sanguine projection for the state.

CCEA thus develops for this *Outlook* a more realistic forecast for Connecticut's economy, taking into account the state government's major initiatives to balance its budget, and outlines a few modest proposals to put the state on a strong fiscal and economic path.

More Modest Outlooks

Even set against the national debates over the federal deficit, the Connecticut economy has room to grow. In developing an alternative to this *Outlook*'s rosy projection based on the performance in 2010, CCEA developed alternative estimates to project CTRGDP over the first half of 2011, based primarily on documented growth in total real personal income. CCEA's alternative base approach combines projections for each sector CTRGDP into an aggregate CTRGDP projection. Over 2009-2010 this sectoral approach has yielded higher and more reliable forecasts than the total estimate. For the latest two quarters, the component projections yield lower results than the total one. Chart 1, the rosy outlook noted in the first paragraph, uses the more optimistic view of projected CTRGDP as its take-off point to generate its projection, in contrast to the base case relying on the sectoral aggregate to establish its more conservative projection.

Prior to adjusting for state policy initiatives, the base case results in more realistic growth rates[1] for national RGDP of 1.8% from 2010Q4 to 2011Q4, with Connecticut sustaining a growth rate of 3.3% for

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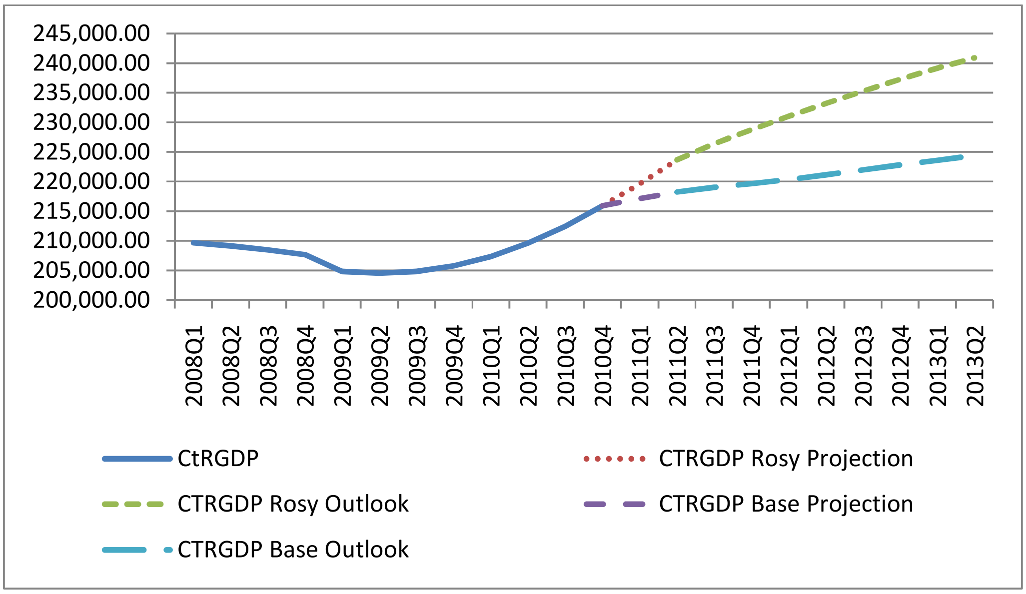
[1] There is a general consensus among forecasters and investors that the national economy faltered badly going into the 2011Q3 and that has led to a genera downward growth revision for 2011 – The Bureau of Economic Analysis (BEA) currently forecasts a 0.4% increase in GDP from 2010 to 2011 – and even some fear of a double-dip recession. On July 19, 2011 the Federal Reserve Board released its meeting minutes from May 9 through June 20. The release noted: "Federal Reserve Bank directors generally noted that recent economic data had been weaker than expected, and they expressed a heightened caution about the likely pace of improvement in the economy over coming quarters… Unemployment was elevated, and the housing sector remained depressed, despite some

the same period before falling to 1.7% for 2011Q4 through 2012Q4, even in the unlikely event of a national recovery in year over year fourth quarter growth to 2.7%. Modest though these results are, they have a stronger foundation, especially for 2011, than the rosy outlook outlined in the first paragraph. Subsequently, using dynamic modeling (REMI), CCEA has adjusted its base outlook to account for (1) curtailed benefits to government employees, (2) increased taxes, and (3) major capital projects approved in June.

Chart 1: Actual and Outlook Connecticut CTRGDP 2008Q1-2013Q2



The corresponding improvements in Connecticut labor markets are dampened considerably within the base outlook relative to the optimistic scenario, as Chart 2 shows. By 2013Q2 CCEA projects employment to rise to 1,642,000 or 20,000 above current levels, although 35,000 might have been achieved if conditions had not shifted so precipitously.

Given very modest national growth, CCEA estimates bank rate increases by 2013Q2 of about three quarters of a percent, more than ten percent lower than in the rosy scenario. The Federal Reserve announced intentions to maintain the present low bank rate could both improve development by keeping credit cheap and, through depreciation of the dollar, encourage exports, but at the cost of raising the cost of imports and perhaps re-igniting inflation.

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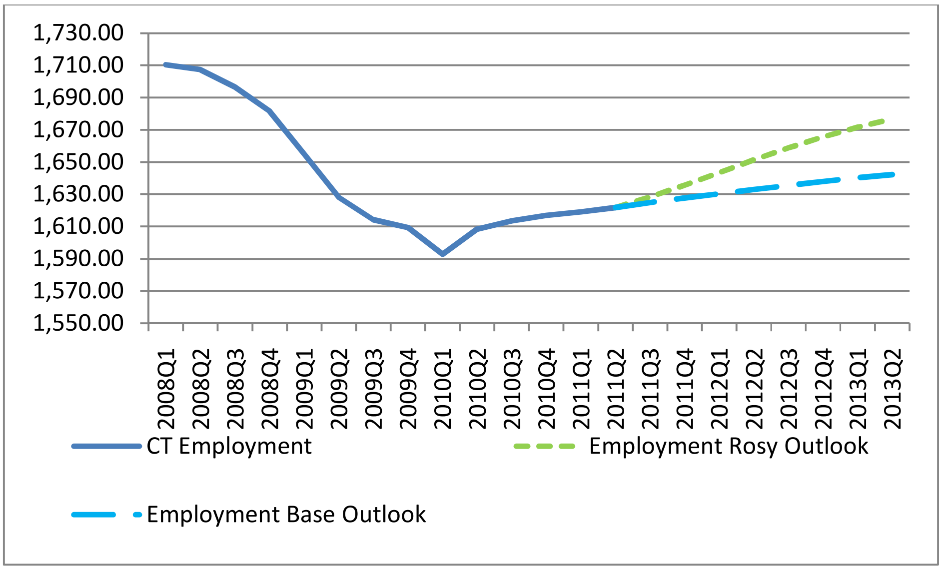
activity in multifamily construction." (http://www.federalreserve.gov/newsevents/press/monetary/20110719a.htm) BEA's July 29, 2011 "advance" estimate for 3Q2011 indicated a 1.3% 3Q to 2Q growth[does Y(3Q)-to-Y(2Q) matter as much as Q-to-previous-Q?] increase.(http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm). On July 15th, Goldman Sachs' Chief US Economist, Jan Hatzius, lowered his estimates for 2Q and 3Q GDP to 1.5% and 2.5%. Goldman Sachs does not see the national unemployment rate declining below the 8.75% rate in the near future.

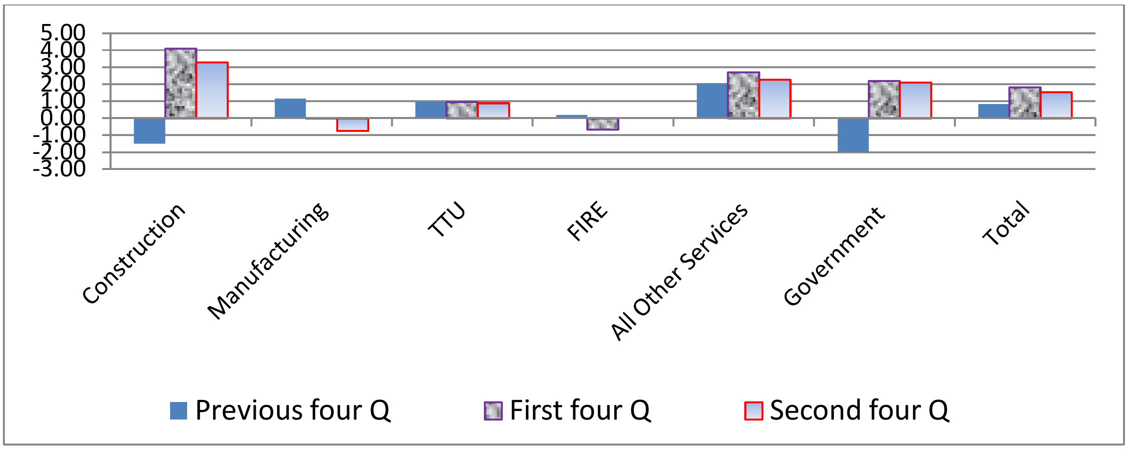
Chart 2: Actual and Outlook Connecticut Employment 2008Q1-2013Q2



Employment by Sector

The more modest forecast is consistent with the sector rates-of-growth Chart 3 illustrates, derived from employment estimates for each of the major sectors with government (inclusive of the casinos due to their ownership by Native Americans tribes) treated as the residual, after taking account of expected national growth. During the past four quarters cutbacks in construction and government employment have eroded overall state growth in employment, mostly flowing from job creation in trade transportation and utilities (TTU), manufacturing and other services — defined as services other than finance insurance and real estate (FIRE) and (TTU). With major projects proceeding, this *Outlook* expects recovery in construction and continued growth in TTU and other services. It is less bullish on continuing manufacturing growth due to some strengthening in the dollar, especially against the Euro and thus German competition. There is however room for some upside in that view.

Chart 3: Four Quarter Employment Growth Rates by Sector 2010Q2 to 2013Q2



Major Connecticut Public Policy Initiatives

Significant Connecticut government policies have reduced public service benefits while proposing public sector investments. For these reasons, CCEA has adopted a balanced view of public policy initiatives, taking the following into consideration:

- $1 billion cut in fringe benefits over two years;
- A $1.7 billion tax increase;
- Construction of the 80% federally funded $567,053,000[2] New Brittan-Hartford Busway during 2011-2013; and
- Initial construction resulting from the Biosciences Connecticut initiative.

In aggregate, the above indicate a modest downward adjustment in the forecast:

- Annual CTGDP is expected to be off by $1.5 billion in 2013 compared to the base-case forecast; and,
- Employment is projected to be off by 3,000 compared to the base-case forecast, at 1,627,000, but still solidly above 2010 annual employment of 1,608,000.

At least half of the weaker employment outcomes from the base-case forecast result come from about 10,000 fewer public sector jobs by 2013Q2. Though state policies have a modest dampening effect on the economy, they are benign compared to an across the alternative — a massive budget reduction — that, as modeled in a previous Outlook, would have probably put the state into recession.

Resetting the Connecticut Economy

There are a number of potential initiatives that would both help improve the economy in the short-run and help control public sector expenditure in the longer-term and reduce private sector costs – here are some examples.

Green Energy Projects

Conversion of street lighting, lights in large stores, meeting areas and freezers from metal halide lights to induction and other high efficiency lighting technologies could largely benefit the Connecticut economy. Electricity savings amount to 57% of what is currently consumed and with reengineering, electricity savings can amount to 60-70%. Parallel private sector applications could include use in walk-in freezers where savings are even higher because minimal heat from induction lights avoids cooling systems having to offset the unwanted heat from currently installed lamps. The initial installation and systems adjustments will stimulate short-term employment and the extended longevity of lamps (by 2 to 4 times over metal halide lights) significantly reduces replacement costs and associated labor expenses. Induction and other energy efficient lighting systems constitute a set of emerging

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[2] http://www.ctrapidtransit.com/News_Resources.htm Of these funds, $487,734,000 remains to be expended after April 4, 2011. http://www.ctrapidtransit.com/Web_Briefing_April-4-2011.pdf. Completion is expected by late 2013. http://www.ctrapidtransit.com/May_2009_Open_House_Summary.pdf.

technologies that will contribute to resetting the longer-term economy by providing private and public savings that release funds for other uses and investments, the essence of economic growth.

Electric Vehicle Promotion

Another emerging technology includes electric vehicles (EVs) that are becoming increasingly competitive against vehicles powered by internal combustion as international petroleum prices rise and new battery technologies facilitate more distance travel. In addition, some jurisdictions are subsidizing EVs as part of their broad policies to clean-up the environment and minimize health costs associated with releases of greenhouse gases and fine particulate matter. Combined with off-peak pricing of electricity' the shift to EVs over the next twenty years will have a positive impact in generating lower transportation costs with reduced adverse environmental and health outcomes, once again freeing consumers and businesses to expand other demands.

Movement to EVs can be stimulated through subsidized purchases, special parking considerations, (New Haven has extended free parking to EV and hybrid owners), sufficient rate spreads between off-peak and on-peak electricity rates to encourage off-peak consumption especially recharging of EV batteries, marketing of EVs capable of travelling over ranges of distances.[3] Combining recharging stations with smart meters, utilities can flatten their off-peak loads in order to minimize their expenses and maintain low recharging costs for their customers. Detroit Edison is offering $2,500 toward installation of a 240 volt recharging stations for the first 2,500 EV owners who sign-up.[4] So, done within the correct pricing structure, EV adoption could significantly reduce peak load demands, reducing Connecticut's heavy FERC congestion charges and reduce the need for significant capital expenditures for distribution system upgrades.

BioScience Connecticut Adoption

Biosciences, including genomics, continue to hold promises of improved medical treatments to improve both longevity and the quality of life, all of which directly contribute to labor forces quality and CTRGDP. The major state commitment to Biosciences Connecticut is intended to capture these benefits for the state's economy and its citizens.

State Policies and Tax Credits

Integral to the expansion of these and other innovations is the reduction in Connecticut's notorious bureaucratic hurdles. Doing so involves a fundamental change in the philosophy of executive agencies and local planning authorities to "How can we facilitate growth and choice?" While the bulk of the impacts of the two reset technologies are of longer term interest than the normal purview of this eight-

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[3] For example, Tesla has announced that it will begin marketing a mass assembled sedan in 2011-2012 with options on battery packs that will facilitate battery-powered travel ranging from 160 to 300 miles. GM's Volt travels 50 miles on battery-stored power and can extend distances by recharging or by using gasoline to generate electricity. In both cases the higher the voltage deployed to recharge, the shorter the time required. Both of these manufacturers offer 110 and 220-240 recharging while Tesla has a 440 volt recharging option. Nissan, with its Leaf, and Ford with several EVs including versions of its Focus are both expected to be competitive.

[4] [4] http://dteenergy.mediaroom.com/index.php?s=43&item=593.

quarter outlook, accelerating adoption of such reset technologies can focus Connecticut entrepreneurial ingenuity on propelling future growth.

Fundament to this cultural shift is facilitating use of the state's largest available asset: the massive accumulation of tax credits Connecticut businesses have earned in good faith. An earlier CCEA Study, *Driving Recovery* (March 2010) and *Outlook* [5] reviewed how they could be used without any short-term cost in revenue and thus with no impact on the state budget and then generate sufficient additional taxes in the medium term to offset the full cost of paying off tax credits. That *Study* modeled the use of a billion dollars in credits to fund major capital projects: used in this way, the credits would create 4 million square feet of new facilities, direct employment of nearly 17,000, and total employment impacts of 35,000. Thus unleashing the nearly $2.5 billion in currently unused credits to stimulate such forward-looking investments thus has the potential to restore fully all the jobs lost since 2008 and launch Connecticut on a new economic trajectory.

Conclusions

Even with the short-term pain associated with the initiatives to rebalance the state's budget, CCEA projects the Connecticut economy's real output and employment to continue to grow, though more modestly than would have occurred under the base-case scenario. In addition, this *Outlook* points to four mechanisms—investing in more efficient lighting, adoption of EVs, driving growth in biosciences, unleashing the accumulated tax credits—that would fundamentally reset the economy. Initiatives such as those described here need to be pursued in conjunction with policies for accelerating their adoption, including a new culture of actively supporting economic development. Nothing would underline that change in state attitude more definitively that permitting Connecticut businesses to use their very substantial earned tax credits to invest in their own, and the state's, future.

[5] Driving Recover: 2020 vision for Connecticut: http://ccea.uconn.edu/studies/Driving-Recovery-Report.pdf and CCEA Outlook May 2010: http://ccea.uconn.edu/forecasts/CTOutlook_2010May.pdf