Will Connecticut Recover?

The Connecticut Economic Outlook: May 2013

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Executive Summary

Connecticut's economy is recovering slowly, very slowly, well behind national recovery. Connecticut is one of the few states whose economy, whether measured in output or household income, is not close to its 2007 peak. Job recovery has been equally slow, with barely a quarter of the jobs lost (since 2007) restored, with many of those who have returned to work going to lower quality jobs than the one they lost. Solid if modest national and regional performance over the last three quarters has laid the foundation for robust growth in Connecticut, but the state faces such large deficits that contraction in the public sector may thwart recovery.

Sluggish growth resulted in the unavoidable outcome of lower-than-forecast tax revenues, which has put increasing pressure on the state's budget, presenting the Governor and Legislature with a host of challenges. Expenditures for the current fiscal year have already been cut significantly, by executive action and Legislative initiative, and the projected operating budget deficit is currently well in excess of a billion dollars over each of the next two fiscal years. The scale of reductions in the operating budget will weaken the economy proportionately--a painful choice made more difficult by an badly-designed spending cap that denies Connecticut substantial federal monies that would help mitigate the fiscal crisis.

This *Outlook* assesses the potential impact of fiscal options for the State as it addresses massive deficits. If the state were to address deficits of $1.4 billion in FY2014 and $1.5 billion in FY2015 solely with budget cuts, the CCEA projection is that Connecticut could expect to lose as many as 32,500 full time equivalent (FTEs) jobs. Such cuts would eliminate virtually all job creation during the next two-years, and in the long run may mean the economy does not see full recovery for decades.

There are alternatives to straight budget cuts. One option is maintaining projected expenditures while raising funds through various alternative taxes, licenses, or grants. Alternatively, even as the state cuts its current services budget, it could push forward with strategic capital projects, funded through bonding. This *Outlook* evaluates the degree to which tax changes and public sector investments of the same scale as budget cuts could offset the expected economic damage from the impending reductions. Different policies will impact both the rate of growth and the distribution of job impacts between the private and public sectors and the generation of income, measured as Connecticut Real Gross Domestic Product (CTRGDP). Such policies can partially mitigate the overall impact on the state's economy, avoiding recession, potentially hastening its recovery, and strengthening Connecticut's competitive position. Ironically, Hurricane Sandy may improve conditions as the region rebuilds.

In the final analysis, this *Outlook* argues that addressing the current fiscal crisis only through cuts is the worst approach; it might condemn the state's economy to decades of weak performance, actually worsening long-term problems. Implementing a very modest state-wide equity tax (possibly including a rebate for legal residents), the modeling argues, offers the best solution to improving revenues. Perhaps most important, reforming the spending cap could fundamentally change the ability of and the incentives for both the State and many of its municipalities to capture very substantial--perhaps hundreds of millions--federal dollars.

Connecticut has a very significant capacity to shape its own future, to restore its economic health, and to build its long-term competitiveness, but to achieve those ends requires the political will to undertake a serious reframing of the state's revenue structure, to undertake sustained policy analysis (e.g., dynamic tax incident analysis), and to build the institutional capacity to support both such analysis and a concerted effort to capture federal funds.

Introduction

Based on a retrospective view, U.S. and Connecticut economic recoveries are showing signs of taking root. One of the driving forces is the Federal Reserve policy of sustained low prime bank rates, a policy many other central banks are now adopting, reflecting growing recognition by central bankers that they need to stay focused on broader targets than inflation. Moreover, addressing the massive accumulation of long-term government debt demands attention for driving stronger growth; only strong growth will lower the debt to RGDP ratio.[1]

However, current national policies significantly complicate anticipating the pattern of recovery in the American economy. Sequestration, restoring the full Social Security tax, limiting unemployment benefits, and other policies are clearly beginning to weigh on the national economy, as is the expanding recession in Europe and the dramatic slowing of the Chinese economic machine. At the state level, the typical constitutional requirement for balanced operating budgets and critical need to redress shortfalls in government pension funds and funding for other post-employment benefits is limiting the capacity of strategic public sector initiatives to accelerate growth. Indeed, these limitations can potentially re-enforce each other and could thus derail not just the American economy, but the global one as well.

Retrospective Modeling

CCEA's forecasting depends on two models that look at key retrospective macro variables--employment, national RGDP and CTRGDP-- and then adds a different additional variable to project Connecticut's eight-quarter outlook, commencing in 2013Q2. The first model relies on those macro variables and CT housing permits; the second replaces the permits with the prime bank rate. Implicitly the first model assumes that the national rates of change in residential building permits will be similar to those in Connecticut. In general, earlier projections done for the *Outlook* argue such an assumption is not justified. The prime bank rate is the same for both nationally and in the state, so the expectation is that incorporating it should provide better results, but the proof is in the pudding. While this approach is intuitively appealing, CCEA has not used it long enough to validate its sustained superiority.

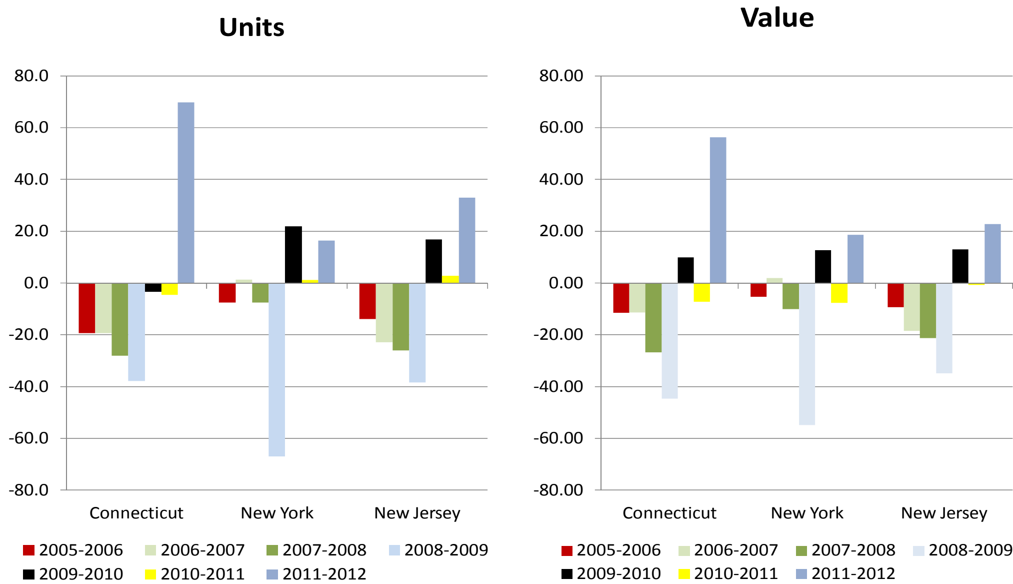
Housing Permits: Units and Values

Housing permits offer an upbeat sign in emerging from the recession's gloom-and-doom, much re-enforced by the recent Case-Schiller report on record growth in home prices. Growth in the number of residential housing permits for the first four quarters of 2012 was 69.7% above those in 2011. Yet that result overstates the improvement; assessing changes in the value of permits reveals that average values had generally fallen with a shift in emphasis from single housing units to multiple units, particularly buildings with more than five units. By the end of 2012, the value of Connecticut housing permits rose 57.2% relative to the previous year. The gain in units represents a reversal of declining permits over the previous six years, with parallel filings

[1] Ironically, austerity (or sequestration) can actually make the situation worse, not better. Insofar as growth falls faster than deficit reduction, the result is an *increase* in the debt/RGDP ratio. It is the ratio of income to debt that is crucial, not the total of outstanding debt.

visible in the value of Connecticut permits in all but 2011. While Connecticut permit growth over the last year far outpaced those of New York and New Jersey, it did so in part because, unlike declining permits in Connecticut, New York had positive growth in two of the previous three years while New Jersey had experienced growth during each of the previous three years. When compounded losses from the previous three years are taken into account, Chart 1 suggests there is still a long way to go before declaring full recovery in the housing market. The 5,200 permits issued in 2012 remains well below previous peaks of 26,800 issued in 1986, 12,300 in 1998, and 11,885 permits in 2005, the most recent peak.

Chart 1: Connecticut Housing Permits 2005/06-2011/12 (Percent Change)



Source: US Census Bureau, Housing Permits

The Forecast

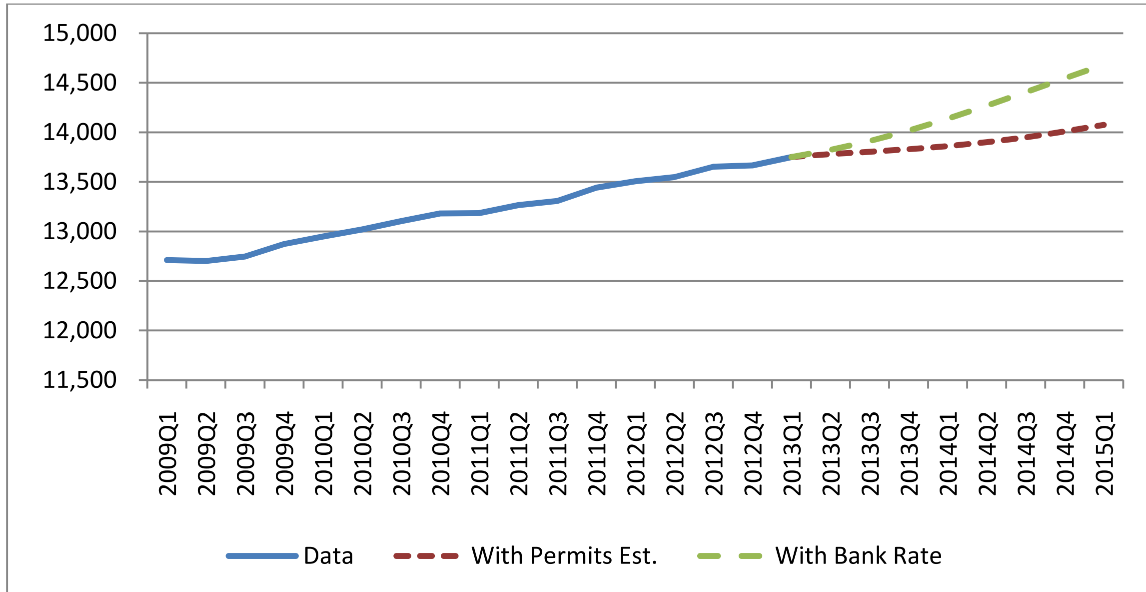
The following charts present the results from both CCEA models. Except for employment in the two models being very similar over the next few quarters of the outlook, the results from the model including the bank rate yields more optimistic results. Even with a creeping rise in the prime bank rate by 110 basis points over the two years.

National RGDP

Sequestration, tax increases, and other federal actions that are slowing the national economy will also impact Connecticut (e.g. the twenty furlough days imposed on the civilian workforce at the Groton sub base). Those impacts need to be netted out of the following results from the two CCESA models, based on either projected expansions of housing permits or a continuing low prime bank rate. Given such uncertainties, the model based on housing permits modestly curtails national annual average RGDP growth from an already

conservative 1.4% annual rate[2] in the previous *Outlook* to 1.1% annual average rate 2013Q1 to 2015Q1. The model based on the now low prime bank rate, even assuming that is creeps up 110 basis points over the period (which now looks unlikely) yields a higher annual average growth rate of 3.4%. See Chart 2 below.

Chart 2: National RGDP 2009Q1-2015Q1 (Billions Fixed 2005 $)



The recently revised national outlook from the University of Michigan's RSQE, completed prior to Congress driving over the fiscal cliff, set its expectations for national growth at 2.8% to the end of 2014. It attributed its increasing optimism to:

- Consumption resilience, including the monthly demand for vehicles that has been 900,000 units higher in each of the last four months than in October;
- National employment growth in excess of two million in 2012 inclusive of over 190,000 FTEs monthly since August 2012;
- Residential construction contributing 0.3 percentage points to national growth in 2012 so that currently national single-family home inventories have fallen to less than four months and housing prices are growing at 7.3% annually, according to the S&P/Case-Schiller index.[3]

Connecticut CTRGDP

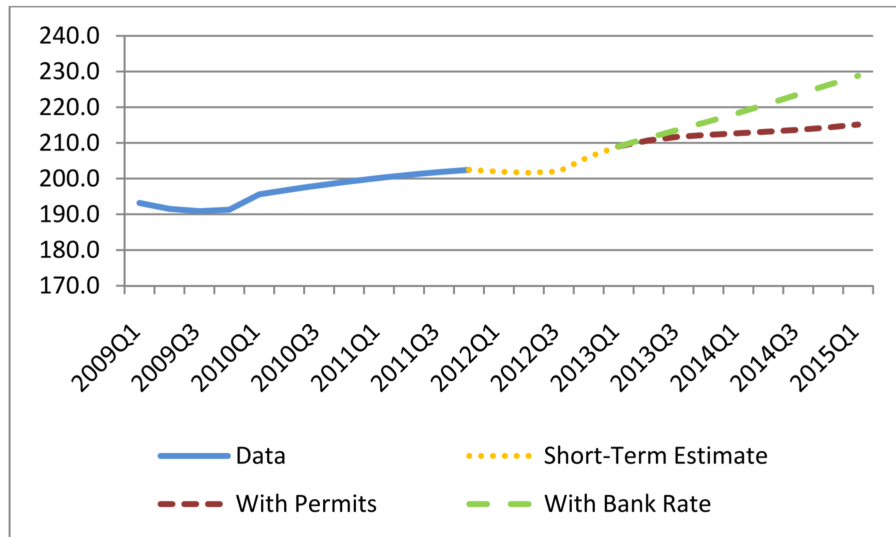
Connecticut's modeled CTRGDP growth appears in Chart 3. Utilizing an ongoing low prime bank rate for forecasting clearly delivers stronger national and state growth—and would drive Connecticut output above its previous peak in 2007. The dotted line from the end of 2011 to 2013Q1 shows that CCEA has estimated

[2] Recent University of Michigan's Regional Seminar on Quantitative Economics (RSQE) forecasts national growth of 2.14% RGDP this year followed by 2.02% next year and 2.62% in 2014, sufficient to grow national employment and induce, marginally, a lower national unemployment rate but insufficient to initiate inflationary threats.

[3] George A. Fulton and Hymans, S.H. *The U.S. Outlook for 2013-14 Executive Summary*, RSQE, March 2013, p.1.

the CTRGDP for that period based largely on the growth in real personal incomes over that period. Those and earlier data on CTRGDP are subject to change when the Bureau of Economic Analysis revamps its data over the next quarter. In the interim these estimates are the best available.

Chart 3: Connecticut RGDP Projections 2013Q1-2015Q1 (Billions of 2005 Fixed Dollars)

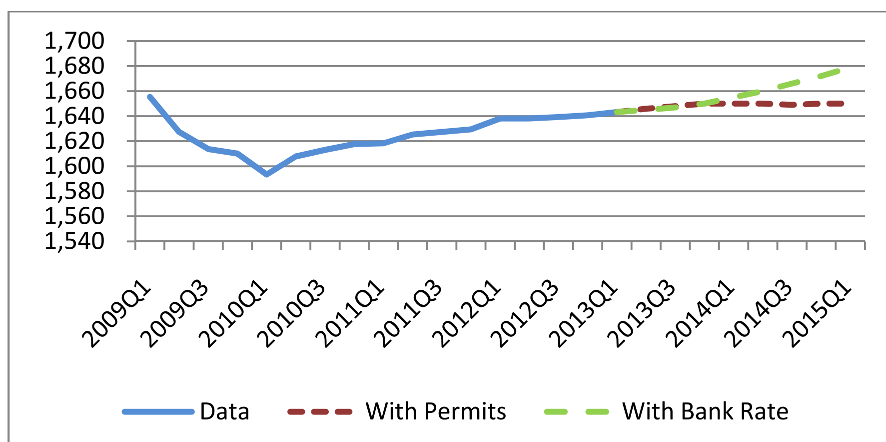


Connecticut Employment

Employment patterns differ in the same manner as noted in Chart 4, where the first model yields growth of 5,000 FTEs this year but then flattens out and remains below that in 2009. If this is the pattern, it would mean Connecticut would see essentially *no improvement in employment*.

The employment growth captured in the model inclusive of the prime bank rate may appear optimistic in the last couple of quarters because it sees government employment growing about 7,000 FTEs after a year of painful trimming by 3,000. Conceivably, employment growth would be cut by a seventh from making those government cuts permanent. Adjusting government employment inclusive of that at casinos and other venture Native Americans operate, to when it reaches bottom at 232,000 in 2014Q1 would cut employment growth by about a seventh, thereby moving the second estimate much closer to RSQE's rates.

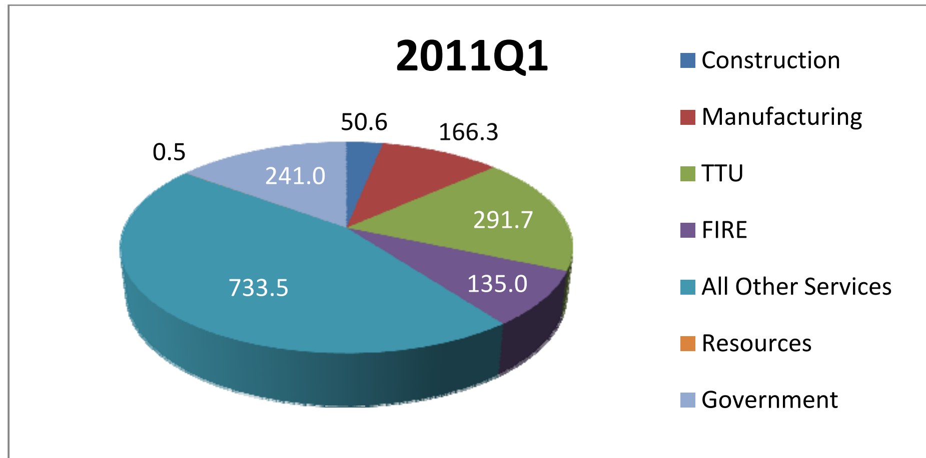
Chart 4: Connecticut Full-time Employment Equivalents 2013Q1-2015Q1 (1,000s of FTEs)

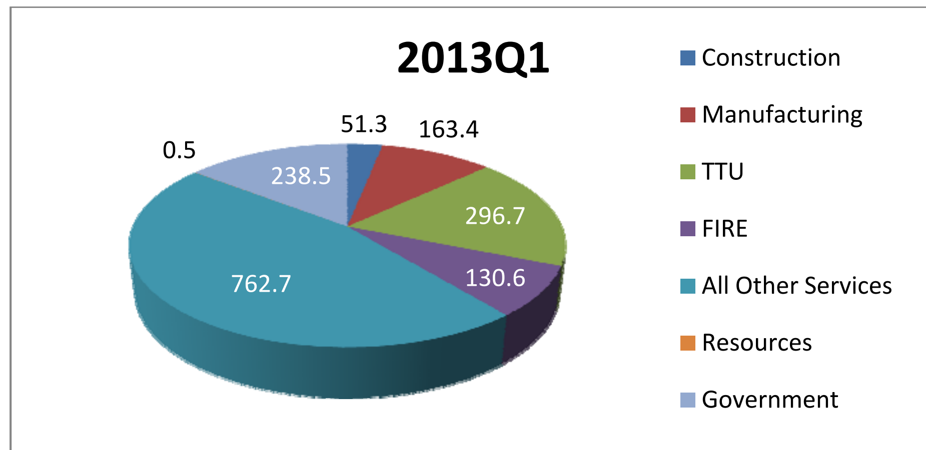


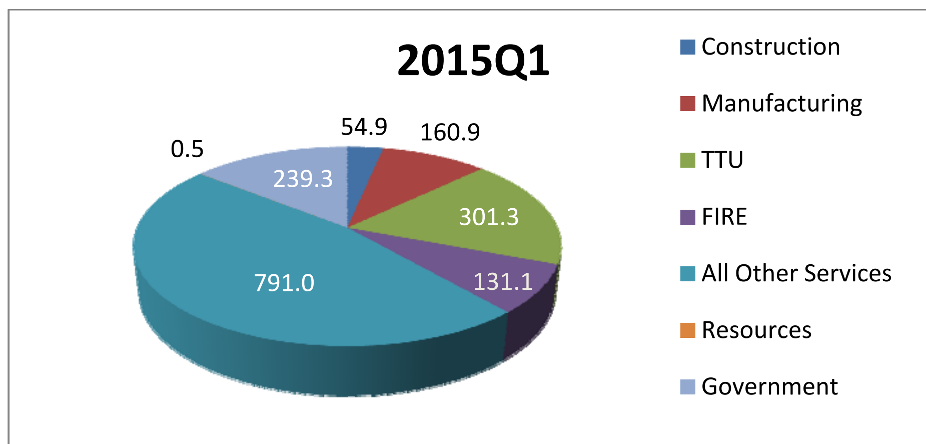
Sector Employment Shifts

Looking two years back and two years forward yields sector shifts in employment that have been occurring and are likely to continue. The following industries continue to grow – construction, transport trade and utilities, and other services. The other services group is the destination of most additional jobs, reaching 656.5 thousand FTEs over the four years. Resources are stagnant. Manufacturing continues to decline slowly. Both government and FIRE oscillate. As noted earlier, government is not likely to expand as much as the modeling anticipates in 2014—it is more likely to contract.

Chart 5: CT FTEs 2011Q1, 2013Q1 and 2015Q (1,000s)







Other Positive Signs

Positive synergistic indicators of consumer sentiment and the stock market counteract other downward pressures. The University of Michigan Consumer Sentiment Index increased from 59.6 in 2011Q3[4] to about 76.2 in 2013Q2[5]. At the time of writing[6] the Dow Jones Industrial Index is up 24.8% from the end of March 2011[7]. With Connecticut's concentration in financial activities, gains in the Dow complement both incomes and expenditures in the state.

Recovery from Sandy

Sandy wrought devastation on vulnerable coastal communities, but is there a silver lining? Reconstruction needs to be undertaken with forethought and planning not just to recover the past but also to better protect the future. The impact on CTRGDP of recovery efforts from Sandy in 2013 is expected to reach $2.9 billion, with continuing construction of $1.4 billion a year later. These impacts are sufficient to nudge CTRGDP growth rates above the federal level in 2013, but Connecticut growth remains below national expected rates the following year.[8]

It is clear that the adjustments post-Sandy may be larger than suggested if the Federal government spends more, the State utilizes emergency funds that would otherwise have remained in reserves, and if residents spend more, supported by insurance companies, which, in-turn, are bolstered by increases in more broadly distributed new premiums. Downward adjustments could result from the opposite of the above factors, with homeowners more than offsetting repair expenditures with severe cutbacks in other purchases and governments squabbling instead of getting on with planned recoveries.

State Fiscal Issues

Slower than expected recent growth in CTRGDP is forcing the Governor and Legislature to trim the state budget, in addition to the cuts that the Governor has already announced for the current fiscal year the Legislature. The Legislature is now considering more cuts to address massive deficits projected for the operating budget in the next biennium. The following section explores the economic impacts of options to redress that situation and bring operating budgets into balance:

- Decreased state operating expenditures without increased capital expenditures; or
- Institute tax measures to raise sufficient funds to cover the expected deficit and support at $300 in transfers to offset the most severe outcomes of the tax increases.

[4] RSQE the Economic Outlook for 2012, p. 104.
[5] http://research.stlouisfed.org/fred2/graph/?s[1][id]=UMCSENT (March 08, 2013)
[6] March 8, 2013 2 10:42 am EST.
[7] Dow Jones, Industrial Average Index ($US: INDU), May 30, 2:27 pm.
[8] Post-Sandy activities sponsored by the Federal government should directly and indirectly add about 29.2 thousand FTEs in 2013 and 14.9 thousand the following year, thereby, substantially improving Connecticut employment prospects. See Pervious *Outlook* for fuller details.

Approach

The starting point for this analysis is the initial threat of the state operating deficits in the biennial budget. In modeling impacts, CCEA assumes that the measures adopted will be permanent to avoid government falling back into deficit.

Approaches to rebalancing the operating budget range from cuts to government spending (and therefore services and jobs) to raising additional funds. Incremental funds may come from a series of sources:

- Raising various taxes with varying incidences for each type of tax;
- Expending tax bases such as inclusion under the general sales tax of presently excluded goods and services;
- Increased user fees; and
- Broader use by the state and municipalities of federal transfers, feasible only if the State reforms its spending cap that, inexplicably, includes federal monies.

While not recommending any one or all of these approaches, the following results demonstrate possible adverse impacts of adhering to balanced operating budgets as well as some alternative for mitigating the damage to the economy. Using the same REMI model on which the State relies to evaluate economic development initiatives, CCEA simulated three scenarios – budget cuts, personal income tax hikes, and an equity tax.

If budget cuts were to be pursued as the single method of rebalancing, the economic gains to which the previous discussion pointed would be eliminated with the loss about 32,400 jobs by 2016,[9] losses heavily concentrated among public sector employees at 19,700 FTEs. The overall long-term impacts of rectifying the expected deficit with only cutbacks include severe and prolonged employment losses as well as declines in aggregate and disposable CTRGDP. 2013 losses in disposable CTRGDP (2012 fixed dollars) are forecast at $2.1 billion in 2016, easing to $2.8 billion by 2040 (in 2012 constant dollars). CTRGDP declines by $3.2 billion in 2013 but mildly recovers in the mid 2020s before dropping-off back to $-3.1 billion in 2040. This is a worst case scenario—but his analysis projects that addressing the budget crisis only through cuts in the public sector results in *Connecticut's economy essentially never recovering*.

In capturing the full magnitude of such declines, even the best of economic models are myopic because they quantify economic negative outcomes without taking likely ancillary damage into account. Cutbacks of the magnitude currently being considered by the Governor and Legislature are apt to constrain state transfers to municipalities, resulting in damages to vehicles from unattended potholes, less policing with all that implies – higher crime rates and increased insurance rates – and other, similar undesirable consequences. Cutbacks will also lower incentives for transitions to energy saving technologies, fewer innovations due to the lack of research funds, and deterioration of an education system struggling to address vast disparities in outcomes and to keep pace with (or catch up with) international achievements. Many of these outcomes would be over and above those measured in the model.

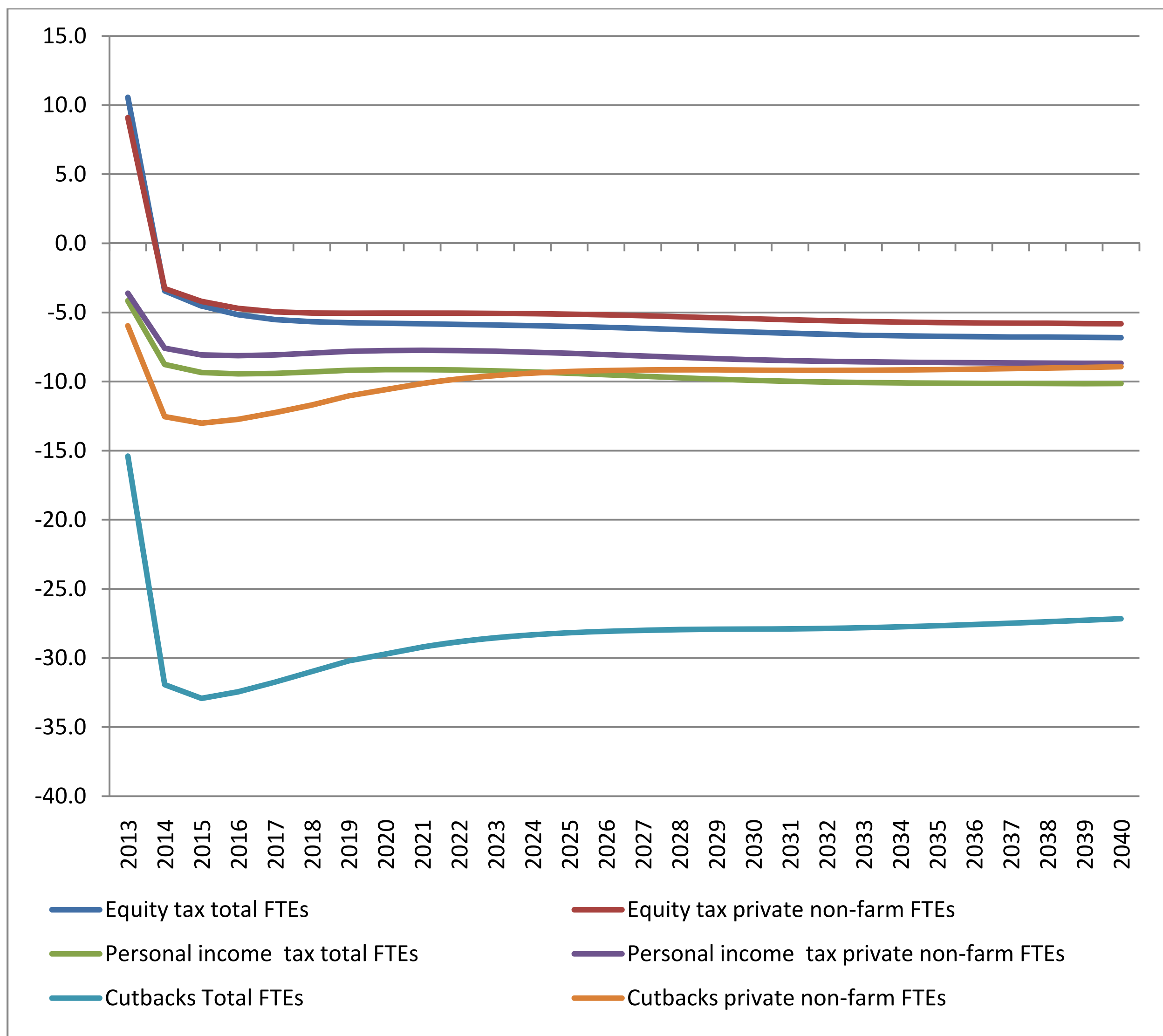
[9] The REMI model yields the number of jobs that would be cutback so that CCEA has converted those job losses to FTEs using current ratios of FTEs to jobs by industry.

Raising Revenue

There are options to cutting spending, one of which is raising taxes. This section demonstrates the extent to which expanding the personal income taxes sufficient to balance the budget and generate an additional $300 million in transfers mitigate the negative impacts of adopting just budget cuts. The second alternative is to raise the same level of funds through an equity property tax so that the state's many non-resident property owners begin to make a more equitable contribution to the public services that support the quality of life they share. The share of out-of-state owners is set at fifty percent. While this is likely high, there may also be other avenues whereby Connecticut residents can transfer funds into the state, e.g. grants for Sandy repairs.

The worst outcomes for employment flow from relying totally on government cuts, as Chart 6 shows. While they do not entirely obliterate the expected gains over the next two-years, they severely constrain them. The alternative approaches have much smaller employment impacts, though the income tax scenario still costs 10,000 jobs out over the entire forecast period.

Chart 6: Employment impacts of Alternative Scenarios for Rebalancing Connecticut's Operating Budget.



Alternative approaches to raising additional government revenues through sales taxes requiring more public servants (if the needlessly complex current structure remains in place, necessitating more oversight) could

result in a different balance that would reduce pressures on public employment but increase them on private sector employment. Impacts on disposable CTRGDP are also severe. Structuring the alternative case to include the equity tax increase on residential properties mitigates the worst of the immediate impacts on disposable CTRGDP, but this mitigation wanes over time as if are able to pass the costs of that tax through to renters.

Table 1 offers a comparative assessment of the impacts of three different approaches to revenue enhancement.

Table 1 Income Impacts of Rebalancing Connecticut's Operating Budget (Fixed 2012 $) 2013 & 2018

	2013			2018		
	Cutbacks	**Equity Tax**	**Personal Income Taxes**	**Cutbacks**	**Equity Tax**	**Personal Income Taxes**
Personal Income	-1.16	4.17	-0.29	-3.53	0.65	-1.04
Disposable Personal Income	-0.92	2.60	-0.95	-2.79	-1.13	-2.53
Real Gross Domestic Product	-1.50	1.01	-0.43	-3.09	-0.65	-0.93
Real Disposable Personal Income	-0.87	2.47	-0.92	-2.20	-1.01	-2.16

With the marginal exception of personal income taxes in 2013, all options are superior to just spending cuts: *they do less damage*. The equity tax (a statewide property tax which captures revenue from non-resident owners who, while enjoying Connecticut's quality of life, contribute little towards maintenance of the public services from which they benefit) is superior everywhere to increasing the personal income tax.

This analysis did not look at an important and potentially critical source of funding: federal transfers. Connecticut currently includes most federal transfers under its peculiar spending cap—preferring apparently to spend state taxpayer dollars to accepting federal funds. The result is that Connecticut is last nationally in federal funds returned to the state relative to taxes paid and systematically fails to claim federal monies to which it is entitle or for which it might compete. Simply improving from a return of 69 cents on the dollar to 75 cents would dramatically close the budget gap. Removing federal transfers from the spending cap would reverse the current perverse incentives under which the State operates—and might lead to the creation of the institutional mechanisms that capture significantly more federal funds for both the State and individual municipalities.[10]

Finally, a recent analysis CCEA and CAI completed revealed that Connecticut is far more reliant on core taxes (incomes, sales, and corporate) than most other states for its revenues; clearly Connecticut needs to undertake systematic analysis and reform of its revenue system. That is an unavoidable step both to stabilizing state finances and to restoring Connecticut's economic competitiveness and vitality.

[10] Because of the perverse incentives of the current spending cap, the State has no incentive to development a comprehensive, sophisticated database that would vastly facilitate capturing federal funds. And without that database, municipalities are severely handicapped in their efforts to capture such funds. Revising the spending cap would reverse the incentives, opening the door to the state making the needed strategic investments. A relatively modest investment could reaped tens, even hundreds, of millions in additional federal funds.

Final Thought

Addressing the current fiscal crisis only through cuts is the worst approach; it might condemn the state's economy to decades of weak performance, actually worsening long-term problems. Implementing a very modest state-wide equity tax (possibly including a rebate for legal residents), the modeling argues, offers the best solution to improving revenues. Perhaps most important, reforming the spending cap could fundamentally change the ability of both the State and many of its municipalities to capture very substantial federal monies.

Connecticut has a very significant capacity to shape its own future, to restore its economic health, and to build its long-term competitiveness, but to achieve those ends requires the political will to undertake a serious reframing of the state's revenue structure, to undertake sustained policy analysis (e.g., dynamic tax incident analysis), and to build the institutional capacity to support both such analysis and a concerted effort to capture federal funds.