State Budget Shortfall Takes Us Back to the Future

By William A. McEachern

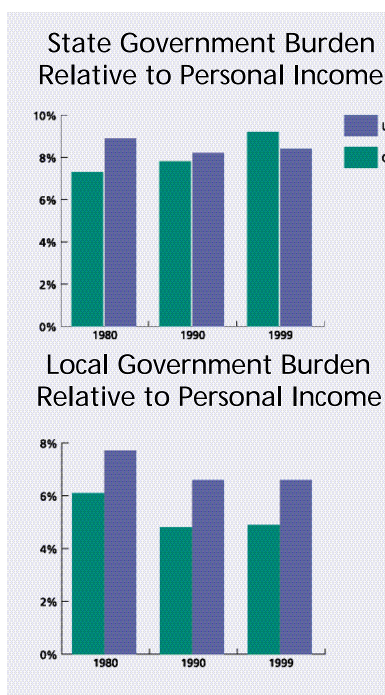
This April marks one decade since state taxpayers filed their first returns under the new income tax. That tax hit the state like an earthquake, and aftershocks continue even today. It created a fountainhead of revenue paid primarily by higher income households. But the state now faces its first budget shortfall of the income tax era. What have we learned from the experience?

Even if state lawmakers can make ends meet this year, which is far from certain, they still need to patch a projected $650 million breach in the $13.5 billion budget for next fiscal year. This is the third shortfall in the last two decades, each coinciding with an economic recession. New spending programs during the 1980s and tax cuts during the 1990s contributed to the shortfalls. Both decades ended badly, as the economy soured and revenues fell short. Let's see what happened.

The 1980s

Faced with a budget gap in the early 1980s amounting to about $200 million, or 6% of the budget, lawmakers raised some tax rates and expanded the sales tax base. These hikes combined with an improving economy to generate budget surpluses. Flush with revenue, legislators doubled state aid to local schools from $850 million in 1985 to $1,654 million in 1990, boosting teacher pay to the highest in the nation.

To put the 1980s in perspective, let's see what happened to the revenue burden for state government. A comprehensive measure of this burden is the general revenue that state government raises from its own sources (i.e., excluding aid from the federal government) measured as a percent of personal income of state residents. In Connecticut, this increased from 7.3% in 1980 to 7.8% in 1990. The average for all states fell from 8.9% to 8.2%. For Connecticut local governments, however, own-source general revenue (i.e., excluding state and federal aid) fell sharply from 6.1% of personal income in 1980 to 4.8% in 1990. In the nation, the local burden also fell—from 7.7% to 6.6%.



So by 1990, Connecticut's state revenue burden moved up toward the national average, but the local burden fell further below the national average. Connecticut's revenue burden increased at the state level in part to fund higher school aid to localities, thereby decreasing the burden at the local level.

The 1990s

The Great Recession of the early 1990s helped dig the budget hole that led to the income tax, but other factors compounded the problem. As mentioned already, the state sharply expanded aid to local schools, but it did so with essentially the same revenue base it had at the beginning of the 1980s. In 1990, Connecticut's rates on existing taxes were already among the highest in the country, so raising them further seemed counterproductive. For example, increasing the highest-in-the-nation sales tax above 8% would have encouraged more residents to shop elsewhere. What's more, that tax, once deductible on federal returns, lost its privileged status with passage of U.S. tax reforms in 1986.

Corporate tax rates were also the highest around, as were rates on interest, dividends and capital gains. Faced with a huge budget shortfall and with few alternatives, lawmakers turned to the income tax. They developed a tax reform package that included reductions in other taxes. The new tax not only closed the budget gap, it allowed the sales tax to drop from 8% to 6% and it covered the $625 million lost when the tax on interest, dividends and capital gains was repealed.

Rumor had it that the architects of the new tax fiddled with combinations of exemptions and credits until upper income households paid the lion's share. The idea was to give generous tax breaks to lower and middle income taxpayers, then strip those breaks as income increased. And that's pretty much how things worked out. The top 1% of tax filers based on adjusted gross income pay more of total state income taxes than the bottom 86% put together. The bottom third of filers pay little or nothing, and the median taxpayer averages less than $2 a day (see page 9 for a *Webster Survey* of residents' attitudes about the tax).

Income tax revenues gushed during the roaring 1990s, enough to lower the rate from 4.5% to 3% at the low end and to provide a property tax credit of up to $500 to all except high-income filers. The corporate tax rate was cut from highest in the nation to 23rd from the top. Inheritance and estate taxes were also peeled back.

Despite cuts in some other tax rates, the income tax harvested so much revenue that general revenue from state sources jumped from 7.8% of personal income in 1990 to 9.2% in 1999. The national average increased more modestly from 8.2% to 8.4%. Thus, the state revenue burden in Connecticut by 1999 exceeded the national average (see the upper chart). Connecticut's local revenue burden increased slightly from 4.8% in 1990 to 4.9% in 1999; the national average stayed at 6.6% (see the lower chart). Incidentally, the combined state and local revenue burden in Connecticut increased from 12.6% in 1990 to 14.1% in 1999; the national average increased from 14.8% to 15.0%. So, though Connecticut's combined burden rose during the decade, it remained below the national average.

Soaking the Rich?

Why haven't high-income filers complained more about paying most of the tab? First, 4.5% is still below the top rate imposed by 33 of the 43 states

with an income tax. The top rate is 6.8% in New York, 5.6% in Massachusetts, and about 10% in Rhode Island.

Second, since the state income tax is deductible on the federal return, this lowers the bite from 4.5% to more like 2.7% for those in the top federal bracket. The deductibility of state income taxes allows Connecticut residents to export hundreds of millions of dollars of the state income tax burden to the rest of the country.

Third, before our broad-based income tax was introduced, most high rollers were already paying the tax on interest, dividends, and capital gains at rates that reached 14%, the highest in the nation by far. Some got a tax cut when the broad-based income tax was adopted.

And fourth, many filers who worked in bordering states paid less when the income tax was introduced. Here's why. A Greenwich economist working in New York pays income taxes to New York on her earnings there, then gets a credit for that payment against her Connecticut return, thus erasing her Connecticut liability on that income. She still pays Connecticut taxes on other income—but at a 4.5% rate instead of 14%.

This last point works to Connecticut's advantage for those working in Connecticut but living elsewhere. Before Connecticut's income tax, this group paid income taxes to their state of residence (except for New Hampshire). They now pay taxes here and get credit on their home state return, with no change in their overall burden. Connecticut collects over $300 million a year from non-residents or part-year residents. Most of this money was simply paid to other states when Connecticut had no broad-based income tax.

In light of the above, the General Assembly may be tempted to close the projected budget gaps by simply raising the top rate on high-income filers. But that's dicey. When Connecticut adopted a broad-based income tax, it lost its unique status, especially with chief executives who get to choose where to locate corporate facilities. We minimized the damage by keeping the tax rate relatively low, but it wouldn't take much to lose that small advantage. For example, just a one-percentage point increase would virtually match the rate in Massachusetts.

And the new tax has broader implications for the economy. For example, it may have stalled our economic recovery during the 1990s and slowed our population growth to only 3.6%, fourth slowest nationally. Population in the seven states without an income tax grew an average of 22.9% between 1990 and 2000, double the 11.4% average for states with an income tax. We should be careful about inferring causality from this, since differences in demographics, living costs, climate, and the like also shape population patterns. Still, we should think twice before raising the top income tax rate.

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Same Old, Same Old… But With A Difference?

By Art Wright

The economy is once again in recession, and gold has again turned to dross in the State's budget. The surpluses that funded tax rebates just a short time ago have morphed into deficits that seem to swell with each passing week. Like clockwork, deficit politicking is in full swing. Republicans and Democrats disagree over how big the deficit will be, and also over how to cope with it—cut spending, raise taxes, issue new debt, or dip into State budget reserves?

The Capitol sausage machine is working as usual, but the problems seem less severe than the last time. Then, State politicos exhausted budget reserves in fiscal years 1988-1991 before biting the bullet and passing the current income tax, which took effect in September 1991. (See William A. McEachern's article on the facing page.) This time, the recession's effects seem to have been milder, and going into the downturn the State's Rainy Day Fund was full at its target 5% of spending. Recent State surpluses were used to fund capital projects and one-time outlays as well as to retire debt.

The Governor and the General Assembly deserve pretty good marks for their husbandry of Connecticut's fiscal resources over the past decade. Our elected officials have largely resisted the temptation to match strong revenue growth with new spending. How to use surpluses, the Rainy Day Fund, and new debt —to stabilize spending, fund capital projects, or start new programs—is still the stuff of political debate. But that is inevitable, and right.

Longer term, though, some see the pink if not rosy budget picture fading if certain structural problems in state finances prove tougher than now anticipated.

Dimensions of the Current Deficit

The general-fund budget for FY 2002 that the General Assembly passed in June 2001 was in balance at $11.9 billion in revenues and appropriations. (The *total* budget also includes more than a billion dollars in "special appropriations," 80% of it "Special Transportation Funds.") By the end of last year, a gap of more than $550 million had opened up in that budget. Several rounds of spending cuts and other maneuvers beginning in September brought the projected deficit down to $165 million as of this writing. For comparison, the Rainy Day Fund stood at about $600 million in July 2001, according to estimates in Governor Rowland's proposed FY 2002 budget, completed in February 2001.

Budget pains in the vicinity of 4-5 percent of originally targeted appropriations pale by comparison with the woes of some other states. A December 2001 report by the respected Fiscal Studies Program of the Rockefeller Institute of Government at SUNY-Albany put Connecticut near the bottom of the heap of troubles. Measuring projected FY 2002 budget shortfalls as a percentage of FY 2000 expenditures, the study found Alaska (with a double whammy from lower oil prices on top of the recession) at the top at 28.3%, trailed by Minnesota at 17.0%, and Arizona at 11.2%. In New England, Maine was in Connecticut's league, while Rhode Island, Vermont, and Massachusetts were in the next higher tier. (New Hampshire was not part of the analysis.)

Grounds for optimism? Smugness may be premature, given (a) the trend in the State's deficit since last summer; (b) the underestimate by the Rockefeller Institute of the size of Connecticut's FY 2002 shortfall ($96 million); and (c) warnings (*e.g.*, by Economy.com, the regional/national forecasters) that New England, late to the recession, may not have seen the worst of it yet (*Wall Street Journal*, "Regional Report," January 23, 2002, p. B12).

The usual suspects underlie Connecticut's current budget difficulties. The economic slowdown, prudently assumed in advance for the FY 2002 budget, turned into a slump. New appropriations, mostly recession-driven, now total $74.4 million. And tax revenue growth that was expected to tail off, instead went south: at mid-fiscal-year, the Office of Policy and Management (OPM) is projecting that personal income tax revenues will drop by more than $90 million (nearly 2%) from FY 2001, and sales tax collections by more than $35 million (1.1%). Big drops in projected corporation and inheritance-and-estate taxes (respectively, $119.3 and $92.8 million) were largely anticipated, reflecting