Connecticut's Budget Ordeal: Any Gain From All The Pain?

By Arthur W. Wright

"No pain, no gain," runs the fitness mantra.

Connecticut has endured plenty of pain since the sneak attack on State revenues three years ago (see the Winter and Fall 2002 issues). Taxes have risen. Programs have been cut. State workers have suffered layoffs or deferred raises. The State's debt has waxed while its bond rating has waned. And still we face a projected deficit of $41 million (Budget Director Marc Ryan) or $85 million (Comptroller Nancy Wyman) this fiscal year, and of some $200 million next year, according to the *Fiscal Survey of the States: December 2003*.

What about gain? In hindsight it is clear that Connecticut—like many other states—wasn't adequately prepared for the extreme volatility of State revenues growing out of the recession and stock-market meltdown of 2000-2001. Will we be better prepared for the next crunch? The current preoccupation over whether to impeach the Governor may not conduce to sober improvements in the State's fiscal fitness. But the task is too important to put off for very long.

Live by the Sword...

Connecticut, with its shiny new income tax adopted in 1991 to help solve the last budget crisis, rode the roller coaster of capital gains and losses spawned by the bull-then-bear stock markets of 1995-2002 and the recent recession. The ride up was so exhilarating that we forgot how terrifying the ride down could be. From FY 1997 through FY 2001, actual general fund revenues exceeded those budgeted by an average of $646 million per year in current prices. But FY 2002 saw a shortfall of $1.1 billion—a net year-over-year swing of some $1.8 billion—about 15% of general fund outlays. General fund revenues, which soared by 8.5% in FY 2000 and 7.1% in FY 2001, plummeted by 7.5% in FY 2002—a full 25% more than the average drop for states of 6%.

Fortunately, the wild ride of State revenues was not matched on the spending side of the budget. The constitutional spending cap approved by voters in 1992 provided an anchor slowing the growth of general fund expenditures. The December 2003 state fiscal survey cited earlier shows Connecticut among the tighter-fisted states in spending growth during the go-go years after 1995. Even when we did join the party, in FY 2000 and FY 2001, our growth rates of 6% + per year remained below the all-state average of some 8%.

Projections of FY 2005 state budget deficits by the Center on Budget and Policy Priorities in Washington, DC, show Connecticut in a cluster of 21 states (including the District of Columbia) with projected deficits of "only" 3% or less of general fund expenditures. If the pain of others helps console us in wrestling with our lingering 2% problem, the other 30 states are in more serious trouble, with some projected shortfalls (in Alaska and California) over 21%. So Connecticut, if not out of the woods of its latest fiscal crisis, seems at least able to see some clear sky at the edge of the trees.

How'd we get from deficits of a billion dollars or more a few short years ago to a "mere" several hundred million today? Surprise! Through spending cuts, increased taxes—and (of late) upticks in tax revenues due to the economic recovery. Oh, yes, and by borrowing—that is, increasing State debt. More debt by any other name, even "Economic Recovery Notes," boosts interest costs and threatens the State's bond rating: The three top rating agencies (Moody's, S&P, and Fitch) have all stuck red flags on the map next to "Connecticut."

"We have met the problem and it is us"

Pogo Possum's old dictum, in Walt Kelly's comic strip, was about pollution in the Okefenokee Swamp, but it applies with equal force to fixing budget policy in Connecticut. The political process, of course, is the ultimate source of all that happens in the public life of a state. In the current crisis, Connecticut politicians arrived at spending cuts and tax hikes; they also resisted relaxing the spending cap.

Heroism comes easiest, of course, under duress. The same politicians who bravely voted for higher taxes and lower spending in the face of a billion-dollar deficit may be the ones all too easily tempted in good times to tax and spend (if they're Democrats) or the opposite (if they're Republicans). And we the people elect them.

Which is probably why state constitutions and law codes all across America are loaded with devices meant to protect politicians and voters from their own worst instincts, as well as against economic shocks. It's typically harder to change a fire-wall law than to pass an overly generous budget (late at night) when the money's there. And it's even harder to change the constitution. Connecticut has in place three such devices, two of them constitutional, the third statutory. How well have they worked in the last few years, and can we make them better?

Three Ways to Save Us from Ourselves

1. Bans on state deficits are near-universal—only Vermont and Indiana rely totally on the political process to balance their budgets. But, as Bill Clinton might have put it, define "deficit". We may prohibit the *adoption* of budgets that explicitly incoporate deficit spending, but changes in revenues or spending occur continuously during the budget year. Indeed, a ban on projected deficits may simply encourage politicians to postpone hard budget decisions till after a "budget" is passed. In Connecticut, Governor Rowland cites mid-budget "customary deficiency spending" adjustments as justification for routinely requesting expenditures below the State's "cap" (see #2 below).

Why not simply ban state borrowing? Because then you'd need to figure out some way to finance capital projects like new schools. And then some way to tighten the definition of "capital". And then… At bottom, constitutional bans on deficits are mostly hortatory: Go forth and do good.

2. "Thank goodness for the spending cap," runs a header in the Governor's proposed budget for the current biennium. The state's constitutional spending cap, which limits the annual growth rate of spending to a 5-year moving average of state personal income growth, has held down spending growth, as noted earlier. Interestingly, the cap worked *because* of politics: The Governor was able, when leaders of both parties legally overrode the cap in the late 1990s, to exclude the extra outlays from the spending base. But the cap may prove awkward as the State works its way out of the current crisis.

The cap ties spending growth to lagged income growth. Thus, as economic growth and stock-market recovery undo the revenue crunch, our past success in slowing the growth of spending will, under the cap, hold future budgeted spending well below the so-called "current-services" level—just carrying out the laws now on the books. The solution—an agreement between the General Assembly and the Governor to exceed the cap and to put some or all of the excess into the base—may have to wait until the impeachment process now underway works itself out. State leaders would do well, when they do get around to it, to rethink certain structural problems with the cap, such as the disincentive to apply for Federal grants inherent in counting Federal aid dollars in the spending base.

3. All but three states had "rainy-day funds (RDFs) on the books as the *tsunami* of red ink began to swell in 2001. In 1985, only 23 states had RDFs—revenue cushions officially called "budget stabilization funds"—and 12 states had added them by 1990. Connecticut's not atypical version provides for (a) putting any State budget surpluses into the RDF, but only up to a maximum of 5% of current expenditures; and (b) mandatory use of the funds to cover any deficits (but only for spending already authorized). The State's RDF was full going into FY 2002, but the huge revenue swing swamped the paltry 5% available. Even some states with larger RDFs burned through them rapidly in FY 2002 and FY 2003.

Yet contrary to popular perceptions, state governments' reserves were larger in relative terms in the latest revenue crisis than in earlier ones. RDFs are in fact just one form of reserve funds. During the flush revenue years, states (Connecticut included) also retired debt and used surpluses to fund capital projects or one-time outlays. (In a sense, cutting taxes—which Connecticut and many other states did—is also a form of budget reserves, albeit one requiring political action to enact.) Gonzalez and Levinson, writing in *State Tax Notes*, August 11, 2003, found that total state budget savings reached "unprecedented levels in recent years."

An interesting question is whether the growth of RDFs noted above simply substituted for other forms of state reserves, or instead helped increase total savings, thus enabling states to better cope with the sharp decline in revenues. Gonzalez and Levinson found that the expansion of RDFs contributed significantly to the marked increase in state reserves; and further, that those savings were large relative to the normal swings in state budget cycles. Their results corroborate the view that the states as a group, Connecticut among them, were actually fiscally prudent, or at worst not all that imprudent, during the binge years preceding the latest crisis. (A contrary view by Thomas A. Garrett appeared in the November 2003 issue of *National Economic Trends*, published by the Federal Reserve Bank of St. Louis.)

Still, there may be room for improvement. Our fearless leaders could consider modifying the RDF along the following lines:

- ◆Redefine the RDF to incorporate all State budget reserves.
- ◆Mandate minimum contributions to the RDF as part of total *spending*, not whatever surpluses happen along.
- ◆Raise the cap to 15% of current expenditures.
- ◆Require excess RDFs to be used for retiring debt, funding capital and one-time projects, or cutting taxes.