State Budget Blues: Whence, and Whither, our Structural Deficit?

BY ARTHUR W. WRIGHT

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Forces lurking beneath the surface of the frenetic scrambles of recent years to balance Connecticut's State budgets have morphed into a nagging structural budget deficit. As I recounted in the Spring 2005 issue, it ran about 3% of General Fund revenues in Fiscal Year 2004, and may be growing—contrary to the impression one might gain from this year's burgeoning surplus now figured at $700 million. Connecticut is not alone: Many other states have awakened from the budget nightmare that began in FY 2002 to the reality of structural deficits that just won't go away.

State fiscal woes have to trace either to income, or to outgo, or to a combination of the two. The conventional, from-the-hip story of excessive spending growth is tempting but, in Connecticut as in many other states, too simple—indeed, even wrong. A structural deficit can come into being and persist even if a "land of steady habits" limits the growth of spending amid gushing State revenues, as Connecticut did during the 1990s. So what are the prospects for solving this pesky problem?

A working definition of a "structural deficit" is when "normal" or "permanent" revenues persistently fall short of "permanent" spending. Under a balanced-budget constraint, a persistent structural deficit requires repeated resort to one-off sources of revenue or deferrals of spending. Governor Rell has vowed to end this making-it-up-as-you-go-along fiscal policy. Her first biennial budget, for FY 2006-FY 2007, makes good progress, but her work is not yet done.

Interestingly, the structural deficit has persisted largely due to lagging revenue growth. Spending has contributed some, of course; in particular, sustained growth in a few programs, like Medicaid, has impeded progress in overcoming the structural deficit.

BIRTH OF A STRUCTURAL DEFICIT
($ MILLIONS)

FISCAL YEAR	INCOME TAX	AVERAGE % YEARLY GROWTH	% CHANGE OVER YEAR BEFORE	SALES TAX	AVERAGE % YEARLY GROWTH	% CHANGE OVER YEAR BEFORE
		FROM 1993:			FROM 1993:	
2000	$4,238.2	8.5%	11%	$3,096.8	6.1%	6%
2001	$4,744.2	8.9%	12%	$3,125.1	6.0%	1%
2002	**$4,265.9**		**-10%**	**$2,997.8**		**-4%**
2003	**$4,263.1**	FROM 2001:	**0%**	**$3,025.7**	FROM 2001:	**1%**
2004	$4,943.4	1.4%	16%	$3,134.0	10.0%	4%
2005	$5,370.0	3.1%	9%	$3,278.8	1.2%	5%
2006	$5,769.0	4.0%	7%	$3,455.1	2.0%	5%
2007	$6,034.0	4.1%	5%	$3,593.2	2.4%	4%

Sources: Connecticut Comptroller's reports; Governor's Budget Summaries; 2005: estimated; 2006 and 2007, projected.

INCOME

The gaping hole in the FY 2002 budget opened up when a stock market meltdown drove a 10% drop in personal income tax receipts, and the national recession—early to start and late to end in Connecticut—knocked 4% off sales tax receipts (see the table at left). Those two major taxes made up some 87% of General Fund revenues in FY 2000.

Having knocked us into the pit, personal income tax revenues have been slow to lend a hand in pulling us out. Relative to the last flush year, FY 2001, income tax receipts for FY 2005 will have grown only by an average of 3.1% per year. That contrasts with the 6-9% yearly gains (relative to FY 1993) realized during FY 1996-2001. The recent uptick in revenues as the current budget year nears its end is grounds for some optimism, but talk of a "soft patch" in the national economy must be unwelcome around the Capitol in Hartford. Putting the structural deficit behind us will take several more years of strong income tax gains.

A similar story can be told about sales tax revenues, which had sustained average annual gains in excess of 6% per year (relative to FY 1993) through FY 2001. Since then, compared with 2001, sales tax receipts have turned in lackluster average yearly increases of less than 2.5% (though that figure is rising as year-over-year gains are holding in the 4-5% range).

A different take on the kick in the teeth from the bursting of the stock-market bubble and the national recession is to simulate what would have happened to income and sales tax revenues, had the average growth rates of the 1990s persisted. Between 1993

CONNECTICUT'S SPENDING CAP: HATS OFF? OR DOFF IT?

BY STANLEY MCMILLEN

The political deal that gave the Nutmeg State a personal income tax in 1991 included a spending cap to keep the new tax from becoming a license to spend taxpayers' dollars.

Should Connecticut taxpayers feel better knowing this? "Not necessarily," is the conclusion to be drawn from work recently undertaken by the Connecticut Center for Economic Analysis (CCEA).

For openers, the General Assembly has never actually implemented the Constitutional cap passed in 1992 by enacting detailed definitions and standards. Furthermore, governors have routinely of late found "extraordinary circumstances" to warrant exceeding the statutory cap, with legislative concurrence.

Two sets of questions arise: (1) Does the cap in fact constrain State expenditures? (2) If not, is something wrong with it, and can or should it be fixed?

(1) Does the Spending Cap Cap Spending?

It's hard to tell. Connecticut, like most other states, has in place a variety of informal and formal measures to control spending, including a Constitutional balanced-budget requirement—though it is possible to meet that requirement by State borrowing.

Then, too, as former President Clinton might say, "It depends on what your definition of 'spending' is." Connecticut's statutory spending cap expressly excludes some 20% of expenditures, including interest on bonded debt, some aid to distressed cities and towns, and first-year outlays on Federal mandates. And the General Assembly may at any time change the definition of "spending" covered under the cap.

If anything, the empirical evidence suggests that tax and spending controls are more important for local than state governments. CCEA's econometric study for all 50 states finds the spending-cap variable to be statistically significant for local spending and for state-&-local spending combined—but not for state spending alone!

(2) Does Connecticut's Spending Cap Need Fixing?

If the cap is ineffective, it could be because State officials just want to spend money without limit. Alternatively, something could be wrong with the inner workings of the measure. Shelley Geballe of Connecticut Voices for Children, in a 2000 primer on the spending cap, argued that including most Federal funds provided to the State under the cap may act as a disincentive to seek new Federal grants, costing the State money.

Geballe also cites incentives in the cap to increase bonding (because interest payments are excluded); to resort to "tax expenditures" to avoid direct expenditures; and to fail to make needed public investments during prosperous times, when revenues are growing strongly.

Potentially worse: Connecticut re-bases its cap every year, and ties it to one of *two* broad measures—personal income or the CPI—that may not align well with the duties of State government. Because the cap formula uses a 5-year moving average, a sustained period of slow spending growth can keep spending below what is warranted or needed to catch up, once budgetary pressures ease. Indeed, both Governor Rell's and the General Assembly's budgets exceeded the cap for FY 2006.

What's more, if the State wanted or needed to spend to redistribute incomes, basing a cap on overall personal income growth could get in the way. And tying the cap to increases in the national CPI holds Connecticut to a national average, and one that measures the cost of a basket of goods and services consumed by people, not by a state government.

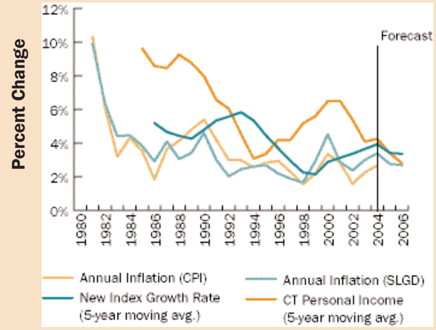
In fact, the CPI has never actually set Connecticut's spending cap because personal income growth has thus far always been greater (see graph). But a period of slower income growth could put the CPI-based cap in charge of State expenditure growth. To ward off such problems, CCEA's recent work suggests basing the price-index version on a weighted average of price indicators tied to the major components of State spending. The national-income-and-product accounts include a "state-and-local-government" price index that could be applied to much of State spending. The medical price component from the CPI could be applied to Medicaid spending, which is growing faster than other State spending. Implementing this revision would be no more difficult than finally passing a law implementing the Constitutional spending cap.

WHAT IS TO BE DONE (IF ANYTHING)?

If Connecticut's spending cap is not effective, we needn't doff it.

Any well-managed state probably should have a Constitutional balanced-budget constraint on spending, coupled with limits on spending growth that would compel elected leaders to cut taxes or retire debt during flush years. Apart from possibly tightening up our State's ability to borrow to balance budgets (perhaps by adding a super-majority-vote requirement), a modest proposal would be to finally pass the enabling law to put the 1992 Constitutional spending cap into effect.

ALTERNATIVE INDICES FOR PEGGING SPENDING CAP GROWTH



and 2001, personal income tax proceeds grew by 8.9% per year. The comparable figure for the sales tax was 6.0%. Had those growth rates persisted from 2001 through the current fiscal year, 2005, total income and sales tax revenues would have been nearly $1.9 billion larger than the Governor projects in her February 2005 budget calculations. Her projections for FY 2006 and 2007 would have grown by $2.1 and $2.6 billion, respectively. Sayonara, structural budget deficits.

Alas, in 2002 it was sayonara instead to the rosy market and macroeconomic conditions of the late 1990s. The unexpected good news about State revenues this spring—personal income tax, sales tax, and corporation tax proceeds up by a net of nearly $500 million over the "budget plan" figures, according to the legislature's Office of Fiscal Analysis (OFA)—will need to be repeated for at least another year or two to wipe out our structural deficit.

OUTGO

Spending, by contrast, has played a relatively modest role in this story. The State of Connecticut did not abandon its steady spending habits (extolled in these pages in the Winter 2002 issue), once the bottom fell out of revenues in FY 2002. State General Fund expenditures are a lot like an ultra-large crude oil tanker: it takes a while to slow or turn them significantly. By FY 2003 and 2004 their growth had been slowed to about 2% per year from the 4-6% range of the 1990s.

TWO DRIVERS OF STATE SPENDING
($ MILLIONS)

FISCAL YEAR	STATE AID TO LOCAL GOVTS.	% CHANGE OVER YEAR BEFORE	MEDICAID OUTLAYS	% CHANGE OVER YEAR BEFORE
1998	$1,864.8	3%	$2,040.1	5%
1999	$1,965.0	5%	$1,997.90	-2%
2000	$2,073.6	6%	$2,216.9	11%
2001	$2,128.3	3%	$2,372.9	7%
2002	$2,237.2	5%	$2,547.1	7%
2003	$2,170.8	-3%	$2,703.2	6%
2004	$2,192.5	1%	$2,785.1	3%
2005	$2,203.3	0.5%	$2,926.1	5%
2006	$2,269.3	3%	$3,165.7	8%

Sources: Budget Document of OFA and Governor, 2005: proposed (*Hartford Courant*, May 6, 2005), 2006: projected.

Much of the inertia in State expenditures derives from the momentum of several large components. For instance, the OFA's "Budget Book" for FY 2001-FY 2003 noted that Medicaid and education grants to towns account for nearly 29% of the total State budget. As the nearby table shows, State aid to towns—the subject of Heffley and Lenon's piece on page 7—acts like a shock absorber for State spending, rising when times are good and falling or at least slowing when budgets get tight. Medicaid, by contrast, tends to rise inexorably, driven by Federal matching rules and broad political support (from providers as well as clients). In the 1990s and on into the new century, Connecticut's Medicaid outlays have marched along by about 5.5% a year on average, through thick and thin. That's not "out of control" relative to total General Fund spending growth, despite the inflated rhetoric one often hears about medical-care costs these days. But it is still sustained upward pressure on State spending, which (when budgets are tight) just intensifies the pressure for cuts elsewhere in the budget.

Connecticut did manage to hold down the growth of Medicaid spending to just over 3% per year in FY 2004 and 5% in FY 2005. But outlays are set to rise by some 8% in FY 2006, which will show a hefty overall budget deficit if this year's burgeoning surplus is not transferred to next year.

Prospectively, states face uncertainties about Medicaid spending growth when the Bush Medicare prescription drug benefit kicks in next year. Washington is making noises about making states give back part of their matching funds to compensate for Medicare's picking up the drug costs of "dual eligibles"—Medicaid clients who also qualify for Medicare.

Stay tuned as the saga worthy of soap opera known as the Connecticut State budget process unfolds over the next several years.