

Budget CONNECTION\$

A Connecticut Voices for Children
Research Brief

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BEFORE YOU CUT, THINK ABOUT THE ALTERNATIVES

Shelley Geballe, JD, MPH & Douglas Hall, PhD
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On October 1, Governor Rowland informed state agencies and departments of proposed budget cuts of \$87.8 million, of which \$57.3 million were to be spending holdbacks from programs funded using SFY 01 surplus.¹ Many of the programs and services cut enjoyed bi-partisan support in the 2001 Session – support for children’s and adult mental health, transportation, education and job training. Governor Rowland commented, “All indications show that Connecticut is entering a period of declining tax revenue. State government should strive to spend *no more than it takes in.*”

This short report highlights six alternatives that are illustrative of a range of options to making cuts in programs and services that the General Assembly – and the Governor in his budget address – considered essential to the state. Three options – increasing federal funding, reviewing tax expenditures and targeted tax increases – shift the focus of this debate to what the state is taking in and how *that* can be expanded, in lieu of making cuts. The fourth urges use of bonding, when appropriate. The fifth – spending funds smarter – focuses on how certain cuts now would cost money long term. The sixth highlights the Budget Reserve (or “Rainy Day” fund) as a means to buy some precious time to assess and implement options. This report *does not* address alternative expenditure reductions that might be considered (e.g. for new prison construction).

1. **Collect All That Is Due Connecticut From Uncle Sam**

¹ Since this announcement was made, the projected General Fund deficit for SFY 02 has increased to \$301.7 million, according to an October 2001 letter from the OPM Secretary to the State Comptroller. The State Comptroller estimates the General Fund deficit at \$283.5 million, as of October 30, 2001. [Comptroller Letter to Governor, 10/30/01]. NOTE, however, both OPM and the Comptroller agree that there is a projected Transportation Fund *surplus* in SFY 02 of nearly \$175 million.

In the Comptroller’s October 17, 2001 letter to the Governor, Sen. Sullivan, and Speaker Lyons, she indicated “possible options that will require early legislative intervention” including “reconsideration of phased in tax reductions (most of which utilize a Jan. 1, 2002 phase-in date); and the transfer of debt avoidance surplus appropriations to bonding.” These initiatives, the Comptroller indicates, “could be supplemented with targeted agency reductions” which she suggests “should be accomplished in conjunction with the Office of Fiscal Analysis and the full input of commissioners and agency heads.” Letter from Nancy Wyman to the Governor re: Budget Deficit –October 17, 2001. www.osc.state.ct.us/public/letters/budgetdeficit.htm

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Connecticut is second to last in the nation in the amount of federal funding coming into the state per dollar of federal taxes paid.² In 1998, Connecticut received just \$0.69 back from the federal government for every \$1.00 in federal taxes that were paid. Only New Jersey fared worse (receiving \$0.68 per dollar of taxes paid).³

For much of the past decade, the rationale for not seeking unclaimed federal reimbursements and new federal grant funds was the spending cap. Now that the spending cap is not the issue, but insufficient revenues are, state agencies should be directed to seek all available federal reimbursements, *before* they are told to cut programs.

EX: The DSS report, *Delivering and Financing Children's Behavioral Health Services in Connecticut* (February 2000), reports that CT can increase federal Medicaid reimbursements for children's behavioral health services by *at least* \$14 million. For example, DSS' Medicaid State plan currently covers Private Non-Medical Institutions, but federal Medicaid reimbursement is not claimed for DCF's placements of children in residential facilities. The KidCare implementation plan estimates that – conservatively - \$20.8 million in federal revenue could be claimed for these placements, *without any additional expenditure of state funds*. This amount would be offset by a loss of about \$11.8 million in Title IV-E revenue (which could not be claimed for facility costs when claimed under Medicaid), resulting in a *net* gain of \$9 million in federal funds. Other opportunities to claim significant federal reimbursement for currently state-funded services exist in children's mental health, and in adult mental health as well.

2. Review the Money We Chose *Not* to Collect, When Times Were Good

Tax expenditures (tax credits, exemptions, exclusions and deductions) reduce the revenue available to the state, while conferring special benefit on certain taxpayers. The extent to which current tax expenditures reduce revenue available for budgetary expenditures is shown in Figure 1. The \$3.8 billion projected to be lost in SFY 02 represents 29% of the revenue projected to be collected in SFY 02, according to the Office of Fiscal Analysis' report, *Highlights of the 2001-2003 Biennial Budget*.

Importantly, Figure 1 documents *only* tax credits, exclusions, exemptions, and deductions; additional tax reductions achieved through other means – notably through base and rate changes and the total elimination of a tax – are not reflected here. If included, the revenues currently being foregone by the state would be far in excess of \$3.8 billion. Using this broader measure of tax cuts (e.g., rate reductions, tax phase-outs, as well as tax expenditures), a January 4, 2001 report by OFA found that the tax cuts *affecting businesses alone* that have been enacted since the 1991 legislative session will result in a projected \$1.3 billion in lost revenues in SFY 02.

2 Federal spending is defined to include grants to state and local governments, payments to individuals (such as Social Security and the EITC), wages and salaries of federal employees, and purchases of goods and services. Congressional Quarterly, State Fact Finder 2000, Table E-12.

3 28 states get more than \$1.00 back from the federal government for every \$1.00 in federal taxes. Highest is New Mexico, receiving nearly two dollars back for every dollar paid.

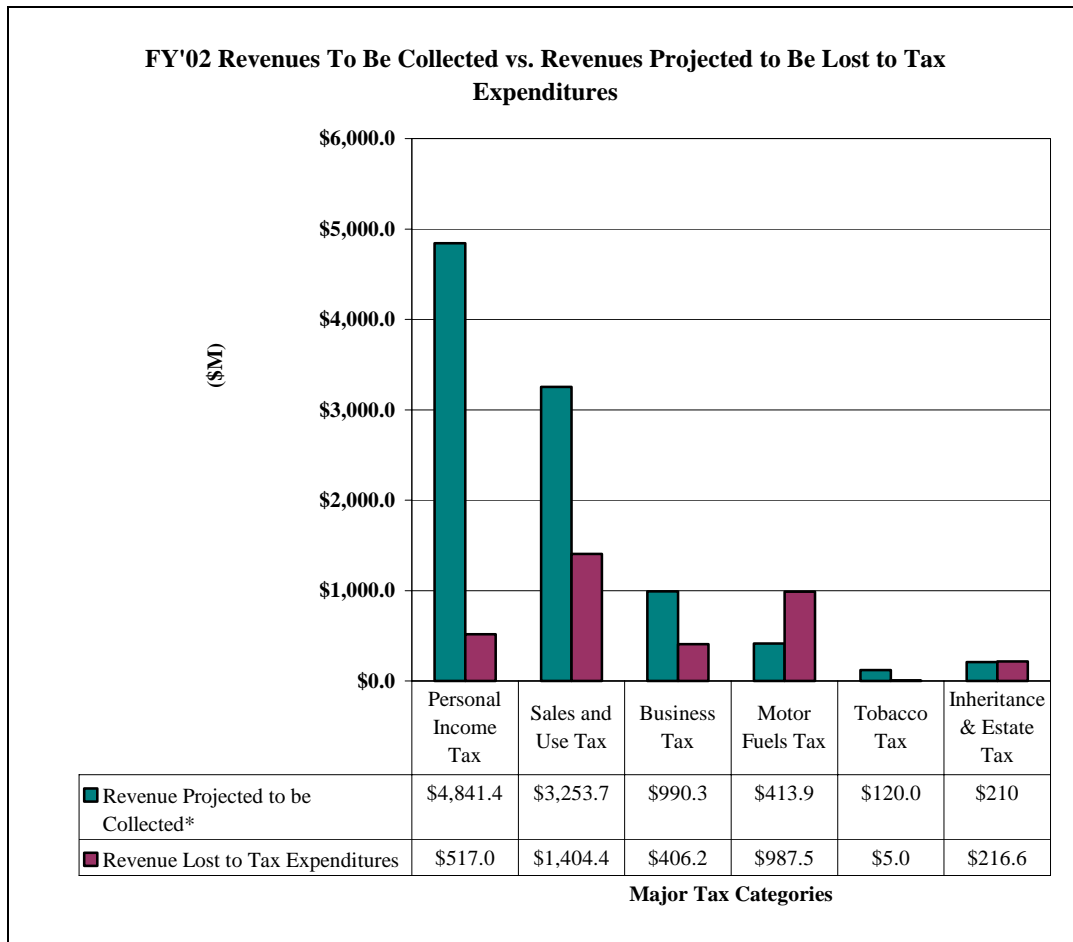


Figure 1 Sources: Office of Fiscal Analysis, *Highlights of the 2001-2003 Biennial Budget*, and Office of Fiscal Analysis, *Connecticut Tax Expenditure Report, 2001* * NOTE: Revenue projections reflect gross revenue, totaling \$13.8 billion, including \$783.3 million in revenue adjustments due to be netted out. This amount to be netted out is comprised mainly of Refunds of Taxes.

With revenues falling and a budget deficit growing, each of these special tax benefits should be carefully reviewed. The General Assembly should assess whether the needs of the taxpayers who are receiving such preferential tax treatment *continue to* outweigh the needs of those state residents who are benefiting from the programs or services that *could* continue to be funded if these revenues were not foregone. Tax expenditures that fail this basic test could be repealed, and/or a planned expansion of a tax phase-out be postponed.⁴

EX: The continued phase-out of the inheritance tax will result in a projected revenue loss of \$29.7 million in FY 02 and \$40.7 million in FY 03, yet benefit only the more

⁴ In an October 16, 2001 report, *Tax Changes Affecting General Fund Revenue Collections*, OFA estimates that already-enacted tax cuts that will reduce revenue collections over the period FY 02 through FY 06 will result in a revenue loss of more than \$290 million in FY 02 (using FY 01 as the base year) and nearly \$320 million in FY 03.

distant relatives and friends of the state's wealthiest taxpayers.⁵ This projected loss of \$29.7 million in revenue in FY 02 is *more than three times greater* than Connecticut's current investment in CT Community KidCare, the state's initiative to enhance home and community-based services for children with mental illness to keep them out of far more expensive, and often clinically-inappropriate, hospitals and residential care.

EX: The Office of Fiscal Analysis has identified dozens of tax expenditures that it classifies as "expedient." Tax expenditures of this type, according to OFA, "violate one or more of the principles of a high-quality revenue system without any counterbalancing or compensating precept." Repeal of these tax expenditures would generate substantial additional revenue, and also enhance the quality of the state's revenue system.⁶

EX: OFA also has identified dozens of tax expenditures as intending "to encourage the performance of certain desirable activities such as economic growth and development..." The rationale for such tax expenditures, according to OFA, is "incentive." In more difficult economic times, it is fair to assess whether the activities receiving such incentives remain desirable when compared to the essential services that could remain funded if this special tax benefit were ended. For example, advertising agency services (including the production of direct mail advertising) are exempt from the sales/use tax, resulting in \$20 million/year in lost revenue. The sales/use tax exemption for computer and data processing services results in \$100 million/year in lost revenue.

EX: For some forgone taxes, the original rationale for enactment is no longer evident. For example, in 1974 CT exempted from the sales/use tax items sold from one-cent vending machines, based on the rationale that the amount of revenue that could be collected was too small to justify the administrative cost. In the late 1990s, however, vending machine owners argued that equity required that this exemption be extended to all food sold through coin-operated vending machines. CT now loses \$1.2 million in sales tax revenues from vending machine sales – more than the funding cut in the current budget for mental health services in our school-based health centers.

5 As of January 1, 2001, transfers of property to a surviving spouse or member of the immediate family already were totally exempt from the inheritance tax, as were transfers of less than \$600,000 to other relatives (e.g. siblings, nieces, nephews) and transfers of less than \$200,000 to anyone else. The phase-out scheduled for FY 02 increases the exemption for transfers to siblings, nieces and nephews from \$600,000 to \$1.5 million per inheritor, and the exemption for transfers to anyone else from \$200,000 to \$400,000 per inheritor.

6 Examples include: sales/use tax exemptions for "lease and rental of motion picture film for display by theatre owner" (lost revenue in FY 02 \$2 million), car washes (\$1 million loss), renovation and repair of residential real property (\$10 million loss), tax preparation services (\$4 million loss); health club and massage therapist services (>\$500,000); the exemption of Subchapter S corporations from corporate business tax (\$26 million loss); insurance premiums tax credits for personal property tax paid on data processing equipment (benefiting 10 taxpayers at a cost of \$20 million/year).

3. Enact Targeted Revenue Increases

Joseph Stiglitz (a 2001 Nobel Laureate in Economics) and Peter Orszag (the Joseph Pechman Senior Fellow in Tax and Fiscal Policy at the Brookings Institution) recently assessed the options available to states that are faced with balanced budget rules, declining revenues and increasing expenditures.⁷ They wrote that -- in the absence of new federal revenue sharing to help states balance their budgets:

The conclusion is that, if anything, tax increases on higher income families are the least damaging mechanism for closing state fiscal deficits in the short run.

They explain, “a reduction in government spending on goods and services is likely to be more harmful to the economy in the short run than an increase in taxes or a reduction in transfer program spending” and “reductions in transfer payments to lower-income families would generally be *more* harmful to the economy than increases in taxes on higher-income families, since lower-income families are more likely to spend any additional income than higher-income families.”⁸

That is, when faced with the need to balance a state budget, raising revenue through taxes on higher income families is preferable to cutting transfer payments to lower-income families (such as cash assistance benefits), and both options are preferable to cutting state spending for programs and services.

Because Connecticut is blessed with the highest per capita income in the nation, a *time-limited* state income tax rate increase on the state’s wealthiest taxpayers could generate significant additional dollars to bridge the deficit gap and allow for continued funding of essential services until the economy improves.

EX: In 1999 there were 2,634 Connecticut resident taxpayers who reported an Adjusted Gross Income of \$2 million *or more*. (Another 2,300 were non-residents in Connecticut part-time, who paid *some* income tax in Connecticut.). These wealthy resident taxpayers (just 0.2% of all filers) reported a total Adjusted Gross Income of \$18.5 *billion*, enjoyed an average Adjusted Gross Income of \$7.031 million *each*, and paid, on average, \$227,260 in state income tax (about 3.2% of their average Adjusted Gross Income).

If one increased the top bracket rate on these taxpayers from 4.5% to 5.5% one could have generated *an estimated \$175 million* in additional revenues in SFY 1999,⁹ while still

⁷ Peter Orszag and Joseph Stiglitz, *Spending Cuts Vs. Tax Increases at the State Level: Is One More Counter-Productive Than the Other During a Recession?* (October 31, 2001). <http://www.cbpp.org/10-30-01sfp.htm>

⁸ Stiglitz and Orszag also note “Some state policy-makers apparently believe that from a macroeconomic perspective, reducing spending is preferable to raising taxes. For example, members of the Connecticut Economic Conference Board apparently have argued that, ‘The worst action the state could take would be to raise taxes during a recession; the best course would be to cut spending.’” Contesting this point, they write, “Despite these claims, economic analysis suggests that tax increases would *not* be more harmful to the economy than spending reductions. Indeed, in the short run (which is the period of concern during a downturn), the adverse impact of a tax increase on the economy may, if anything, be *smaller* than the adverse impact of a spending reduction, because some of the tax increase would result in reduced saving rather than reduced consumption.”

⁹ This number may over-estimate revenue since it does not include credits that these taxpayers may have taken against this tax, but would also under-estimate revenue since it does not include revenue that would be realized from non-resident, part-year

keeping Connecticut's top income tax bracket *less than* that of neighboring states (e.g. NY's top bracket is 6.85%, NJ's is 6.37%, RI is 10.098%, and MA's *highest (and only)* bracket is 5.85%). Moreover, the impact of this increase on these wealthy taxpayers would have been relatively modest – they would pay about 4% of their AGI in state income tax, rather than 3.2%, further increasing the progressivity of the state income tax.¹⁰

Other tax increases could not only increase state revenues, but also serve other important public purposes.

EX: Connecticut could increase its cigarette tax. In 1990, when Connecticut was last faced with a significant revenue shortfall, the cigarette tax was increased from \$0.26/pack to \$0.40/pack. The tax has been \$0.50/pack since 1995. It is estimated that increasing the tax to \$1.00/pack could generate \$55 million in this fiscal year, and also serve an important public health purpose.

Research has unequivocally shown that increasing the tax on cigarettes reduces smoking, and – in particular – reduces smoking by youth because of this age group's sensitivity to the price of tobacco products. The 1999 Youth Risk Behavior Survey by the United States Centers for Disease Control and Prevention (CDC) found that 31% of Connecticut high school students smoked cigarettes in the past month and 15% smoked cigarettes on 20 or more days during the past month. Further, a reduction in smoking will cause a reduction in smoking-related diseases, including cancer, heart disease and asthma. CDC estimates that, in 1993, Connecticut's medical costs related to smoking were about \$963,000,000.

In the prosperous 1990s, Connecticut cut its revenue by *billions* of dollars by enacting tax exemptions, exclusions, deductions and rate reductions. Now, when the economy slows, carefully targeted revenue increases should be considered. Like a family faced with a budget crisis, adding revenue (by adding more hours at work, or a second job) would *always* be considered as a way to make ends meet, and might well be found preferable to cutting household expenses, particularly those that are essential. Similarly, in her October 30, 2001 letter to Governor Rowland, the Comptroller advises “caution in implementing deep allotment reductions that will diminish the effectiveness of investments we are making in our state's future, and will intensify the economic problems we are experiencing now.”

taxpayers who paid some income tax in Connecticut. The estimate is also based on averages – of AGI and of average state tax liability.

¹⁰ One could impose a lesser rate increase on a wider group of taxpayers, and achieve the same effect. For example, increasing the top tax bracket from 4.5% to 5% could have generated as much as \$225 million in 1999 if imposed on CT resident taxpayers with AGI of \$150,000 or more, and more than \$140 million if imposed on CT resident taxpayers with AGI of \$500,000 or more. One could also impose the higher rate *only on* the AGI that exceeds some given amount. For example, one could impose the 5% tax only on the AGI that exceeds \$300,000.

4. Consider Bonding

Connecticut routinely uses bonds to finance the construction of school and other public buildings, for state parks and open space, and for a variety of other capital and economic development projects. In recent years, when Connecticut has enjoyed multi-million dollar surpluses, it has chosen to pay cash, rather than to borrow, for such projects. Now that revenues have fallen (and particularly since interest rates are low), it is reasonable –instead – to return to the routine use of bond funds to pay for capital projects, thereby freeing FY 01 surplus funds for other uses.

EX: The General Assembly approved the use of SFY 01 surplus funds for school construction (\$75 million in FY 02 and another \$50 million in FY03), school wiring (\$10 million), purchase of open space (\$30 million), and a variety of other capital projects such as residential underground storage cleanup, the private provider infrastructure program, and capital equipment.¹¹ Using bond funds instead for this purpose would make more than \$190 million in FY 01 surplus funds available for other purposes.

5. Spend It Smarter

Some of the cuts proposed are “penny wise and pound foolish,” in that they slow efforts to develop service delivery systems that are more cost-effective in the long term. The predictable consequence of such cuts will be that we will pay anyhow, but at a *higher* rate and with greater harm to the people served.

EX: Included among the Governor’s cuts are nearly \$18 million in cuts to community-based mental health services for adults and children. These services are not only essential to the functioning of the individuals served – enabling them to hold jobs, attend school, contribute to their families – and *especially* critical after the events of September 11, they are also cost-effective as they avert far more costly institutional care – within in-patient psychiatric, general hospital, and emergency room settings, in residential care, in corrections.

For example, between FY 94 and FY 02, DCF’s budget for residential board and care increased from \$47 million to more than \$134 million. Also, in FY 01, CT spent more than \$100,000/year on each of the more than 450 children sent out-of-state for residential care, and – in that same year -- paid as much as \$27 million in re-insurance to cover the costs of Medicaid children who are “stuck” in in-patient settings -- children who no longer needed in-patient care, but who could not be released because of a lack of adequate behavioral health services in the community. That is, we currently are paying millions of dollars for the *wrong kind of care* for children. All of these expenses are a

¹¹ Because the SFY01 surplus was less than had been projected when the budget bill was adopted, a 5.9% cut in each program/service funded with surplus funds was imposed as an across-the-board cut (as required by the budget bill). Thus, the surplus funds that would become available if school construction was now to be bonded would be \$125 million less 5.9%, or \$117.6 million.

predictable consequence of token increases in an already under-funded home and community-based children's behavioral health service system.

The funding cuts the Governor is proposing for home and community-based services for children and youth with behavioral health problems will not “save” money – rather, they will ensure that DCF will continue to run significant deficiencies in its board and care-residential account, send children out-of-state for care, and have children lingering in hospitals. Moreover, children will be harmed, unnecessarily, by being taken from their homes and communities for care and lingering in clinically-inappropriate settings.

6. Declare That It Really *IS* Raining – and Look to the Budget Reserve (Rainy Day) Fund

Since November 2000, the state's unemployment rate has more than doubled. Even before the unprecedented events of September 11, and the additional strain it has put on the economy, Connecticut's economy was slowing. That the state is now projecting as much as a \$300 million deficit after enjoying surpluses nearly double this for the past several years shows how quickly Connecticut's economic “weather” has changed.

The Budget Reserve Fund was established by the General Assembly in 1978 “to finance a state operating deficit at the end of a fiscal year.” [OFA, *Connecticut's Budget*]. It is currently funded at 5% of net SFY 02 appropriations as reflected in the budget act bill (\$594.7 million as of 6/01).

Relying on revenue in this Fund, established precisely for this purpose but available only at the end of the fiscal year (unless change by the General Assembly), will provide the additional time that state agencies need to recover additional federal revenue and shift to more cost-effective ways of providing services and also will provide the General Assembly time to carefully review the billions of dollars of revenue reductions enacted in the flush years of the 1990s to assess which of them no longer serve *as important* a public purpose as some of the programs and services that might otherwise be cut.

An October 18, 2001 advisory¹² by Standard and Poor's on the impact of the national recession on state credit quality notes, “use of reserves is not a credit weakness in and of itself. These reserves were accumulated in order to be spent during times of budgetary imbalance and extraordinary economic events. The last month has highlighted the importance and critical nature of these reserves from a credit standpoint.”

¹² R. Prunty, A. Fraser, S. Murphy, *The State of the States* (reprinted from RatingsDirect)(October 18, 2001).