Massive Budget Deficit Bears Down on State
By Steve Higgins

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Connecticut is facing unprecedented budget deficits – estimated at a whopping $6 billion over the next two years – that will force major changes in the way the state conducts business. Legislators must ensure that Connecticut emerges from the turmoil in a position of strength, not in a posture of defeat.

The severe economic crisis roiling the nation is hitting Connecticut hard as state income tax revenue, sales tax receipts and casino profits plummet. While the state enjoys a well-diversified economy, 40 percent of state income tax revenue is paid by Fairfield County residents, many of whom work on Wall Street. That makes state coffers particularly vulnerable to downturns in the financial services industry, which is being decimated by the current crisis. As many as 100,000 Wall Street workers are expected to lose their jobs in the next two years.

In Connecticut, economists estimate 40,000 to 80,000 people will lose their jobs during the current recession, which will dampen revenue from income taxes, corporate taxes, sales taxes and motor fuel taxes.

Gov. M. Jodi Rell has called it the greatest financial crisis since the Great Depression and is calling for drastic spending cuts and structural changes in state government. She has said she opposes tax increases. Democratic lawmakers have pledged to work with Rell and other Republican lawmakers.

John Rathgeber, CBIA president and CEO, advises legislators to follow Rell's lead and keep the focus on spending cuts, resisting the temptation to try to tax their way out of the crisis.

"The state should position its response so that we can come out of this recession strongly and quickly," Rathgeber says. "During past recessions Connecticut lagged other states in terms of recovery, mostly due to tax increases. We need to remain competitive."

Rathgeber notes that when the severe recession of 1989-92 hit nationwide, Connecticut lost 160,000 jobs and took years to get them back. "In the late 1980s we had the highest corporate tax rate in the country and a high sales tax rate," he points out.

Raising taxes will drive businesses out of the state, stunting job growth and making it harder to emerge from the recession, Rathgeber says.

On the bright side, Connecticut has a diversified economy and has set aside $1.4 billion in its "Rainy Day Fund." However, Rathgeber opposes releasing those funds unless that becomes unavoidable.

"The state must look hard at all expenses, recognizing that the need for public services will rise as cities continue to struggle due to the wave of home foreclosures," he says. "The cities must change the way they do business as well. During a time of crisis you can make reforms, such as regionalization of services."

Todd P. Martin, a Fairfield-based economic consultant, agreed. "The state needs to get a handle on spending," he says. "Obviously they haven't kept honest in terms of the spending caps – when you look at real, inflation-adjusted spending at the state level it has quadrupled since the mid-1980s."

Like many households, the state needs to go on a strict budget after "going along for the ride" as the housing bubble fueled a credit boom and residents, businesses and governments alike ran up debt and skimped on savings, he says.

"Raising taxes is the worst way to go, and this is the worst time to do it," since tax increases prolong economic downturns, Martin said. "If you want less of something, tax it."

Martin also called on Connecticut's cities and towns to embrace regionalization and begin sharing the cost of services and other municipal expenses.

Estimated debt levels keep rising

In mid-November Rell released deficit projections of $2.6 billion in fiscal 2010, which starts July 1, 2009, and another $3.3 billion in fiscal 2011. Those numbers, which assume current state spending levels, are far higher than previous estimates.

"The forecast for our economy is indeed bleak," Rell said at a press conference, adding that the latest projections are "absolutely astounding."

Rell already had called for a special session Nov. 24 to deal with a $300 million deficit in fiscal 2009. Previously she had ordered $184 million in spending cuts toward balancing the state's $18.4 billion budget. She is expected to release a new budget plan in February.

"It's a scary time," Rell said at a press conference. "And it's a truly difficult time for our state and our nation."

Rell said the state needs to return to its "core functions" and that "everything is on the table."

CBIA economist Pete Gioia says Rell's proactive stance is necessary given the rapidly deteriorating situation.

"The numbers are bad and they are going to get worse," Gioia says. "The full effect will hit after April 15, because 70,000 taxpayers pay half the state's income tax, and many are in financial services or their wealth is tied to financial services. The damage is enormous and widespread in that industry."

Three million workers pay the other half of state income tax revenue, and many stand to lose their jobs as well.

"Consumer spending will drop because people are going to feel poorer, and poor sales during the holiday season will affect state sales tax revenue," Gioia says.

Donald L. Klepper-Smith, chief economist for DataCore Partners in New Haven, characterizes the current recession as a "perfect storm" because all three of the primary generators of consumer wealth are in crisis: housing, stocks and jobs.

"I think we're probably in the fifth inning of a nine-inning game. The next two to three quarters are going to constitute tough sledding for many businesses and consumers," says Klepper-Smith, who is chairman of the Governor's Council of Economic Advisors, which Rell formed a year ago. "Heading into the holiday shopping season, consumers are feeling gun-shy about spending dollars knowing they might need them in 2009 for the essentials. The outlook is more uncertain than at any time I can remember."

Klepper-Smith said the "wealth effect" holds that for every dollar a consumer loses in the value of their home they curtail their own spending by 6 to 7 cents, and that for every dollar a consumer loses in the value of their stock market investments they curtail spending by 4 to 5 cents. Add to that job losses and the fear of losing a job, and the downside pressure on the economy becomes enormous, he says.

Edward J. Deak, chairman of the economics department at Fairfield University, says the financial industry will be restructured and the federal government will play a direct role in helping states cope with the crisis.

Deak predicts that the federal government will first extend and broaden programs such as food stamps and unemployment compensation in order to help individuals, and will then provide $70 billion to $90 billion in direct aid to the states.

"The federal government has to do something," Deak says. "You don't want to print money, borrow money or further obligate the taxpayer, but it would be far worse to have a real depression."

What other states are doing

Connecticut is not alone in facing this economic crisis – 31 states are facing budget shortfalls, according to a mid-November report by the Center on Budget and Policy Priorities, a Washington, D.C.-based research institute. Among those were some of the 29 states that already had closed budget shortfalls in their 2009 budgets.

States cannot run deficits like the federal government, so they must cut spending or raise taxes in order to make up for budget shortfalls. However, both spending cuts and tax increases tend to make an economic downturn even worse. Further, states find themselves cutting services at the worst possible time, when economic woes increase the need for health care and other services among residents.

The center reports that 29 states and the District of Columbia closed budget shortfalls of $48 billion when putting together their fiscal 2009 budgets, which began July 1 in most states. The deficits made up an average 9 percent of the states' operating budgets.

Since then, 31 states and Washington, D.C., have identified further shortfalls producing mid-year deficits of more than $24 billion. The center estimates that 2010 state budget deficits will total $100 billion.

So far, 25 states have cut services and several have raised taxes, the center reports. At least 20 states have cut their state workforce, and other cuts have been made to health insurance programs; elderly and disabled services such as home care, rehabilitative and medical care; public education and early education programs; and public colleges and universities.

Several states have increased taxes, closed tax loopholes, restricted tax credits, raised tuitions or implemented other revenue-raising measures, the center reports, citing Maryland, Michigan and New York, which each have raised revenues by more than $1 billion for fiscal 2009.

Several states also have used budget reserves to make up shortfalls, the center reports. Some states, including California and Massachusetts, have reported problems obtaining short-term loans in the face of the nation's credit crisis.

Prescription for recovery

The state will work through these economic troubles as it has in the past, but it's important for the governor and legislators to focus on making Connecticut stronger as it moves beyond the current crisis.

“Connecticut’s leaders need to make economic competitiveness their top priority,” Rathgeber says.

Any actions taken by state lawmakers should foster economic growth, because Connecticut’s residents and communities need the benefits that come from a vibrant economy – good jobs and wages and a better quality of life. A thriving economy also generates the tax revenue that enables state and local governments to provide services.

In order to ensure that Connecticut returns to a healthy economic state after this crisis passes, lawmakers need to cut the cost of doing business here and lower taxes; enhance the educational system to increase the number of skilled workers available; and revamp the transportation system so that prospective new companies will know they can be connected to the global economy.

To those ends, the CBIA urges state officials to:

- Encourage economic growth at every opportunity.
- Strive to make Connecticut attractive to potential new employers.
- Resist raising taxes, fees and other costs associated with conducting business.
- Avoid imposing new regulations on businesses.
- Make structural changes at the state level.
- Adopt best practices in state government.
- Set benchmarks and run state government more efficiently.
- Encourage cities and towns to enter into regional cost-sharing agreements.
- Avoid raiding the “Rainy Day Fund” if possible.
- Reject partisan bickering and work together.

Connecticut is entering into an extremely challenging period during which its leaders and residents alike will be strongly tested. The way to meet the challenge successfully is to measure every idea and proposal against a single goal: To maintain a healthy business climate over the long term that will provide Connecticut residents with high-quality jobs, greater financial security and an ever-improving quality of life.