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Fiscal commission has the wrong prescription for Connecticut

Report By Josh Bivens, Monique Morrissey, and Mark Stelzner March 22, 2018
Summary: The recommendations of Connecticut's Commission on Fiscal Stability and Economic Growth would greatly increase income inequality while slowing economic growth. Connecticut is spending too little, not too much, on public services and investments as it tries to repay debts incurred decades ago. The smart way out of this predicament is to raise taxes in a progressive fashion.

Sections

Economic context

The Connecticut economy and the state's fiscal position have faced headwinds in recent years. These include an economy that relies on precision manufacturing, finance, and insurance and thus is vulnerable to the loss of middle-class jobs from foreign competition, computers, and outsourcing. The state has also seen slow population growth, with actual declines since 2014.

Some of Connecticut's problems could have been avoided, notably delays in paying for the pensions of teachers and other public-sector workers. These legacy costs date back decades. In the case of state employees, for example, the unfunded liability can be traced to the pensions of workers employed before July 1, 1984—very few of whom are still working. Similar shortsightedness has also led to underinvestment in infrastructure and higher education (Phaneuf 2017a).

The slow recovery from the Great Recession and a shrinking population make repaying debts and investing in the future more challenging. However, these challenges should not be exaggerated to justify drastic and counterproductive measures, such as those proposed by the state's Commission on Fiscal Stability and Economic Growth (2018). Connecticut also has many advantages, including a highly skilled, educated, and productive workforce and, in most of the state, median incomes that are high even relative to the high cost of living (authors' analysis of EPI 2018 and Bullard 2017). The state's high income inequality creates demand for safety net programs, but also means more income is subject to the higher marginal tax rates in the state's tax code.

Though the economic recovery has been more sluggish in Connecticut than in the rest of the country, per capita income grew faster before, and did not fall as sharply during, the Great Recession. Therefore, living standards in the state have grown about as much in the new millennium as in the rest of the country, and from a higher starting point (authors' analysis of BEA 2018a).

Budget shortfall

The state has a $2 billion budget deficit, which is projected to grow as legacy pension costs come due. As laid out in a recent EPI report, Connecticut should close its fiscal gap by raising revenues in a progressive fashion (Bivens 2017). State and local government spending in Connecticut was 8.4 percent of the state's gross domestic product in 2015, lower than average for the United States (9.0 percent) (authors' analysis of BEA 2018b). While the state faces budget shortfalls, the economic impact of further spending cuts would be more damaging to economic growth than tax increases, especially progressive ones (tax hikes on higher-income households or corporations).

It is possible to boost aggregate demand and create jobs even while closing a deficit by raising revenues in ways that do less damage and by directing spending in ways that do more good. Connecticut should focus on policies that foster job creation, invest in human and physical capital, and boost the incomes and benefits of low- and middle-class families—who have a higher propensity to consume in the state and might otherwise rely on means-tested government benefits.

Moody's economist Mark Zandi has estimated that a dollar of spending by state governments has roughly four times the fiscal stimulus as a dollar of income tax cuts (in the case of Zandi's analysis, making the Bush tax cuts permanent) (Zandi 2010). Conversely, closing a budget shortfall by reducing spending does roughly four times as much damage to the economy as closing it by increasing revenues—and the difference is greater with well-targeted revenue increases or poorly targeted spending cuts.

Recommendations of the Commission on Fiscal Stability and Economic Growth

The report of the Commission on Fiscal Stability and Economic Growth (2018) gets this exactly wrong. Instead of closing the budget shortfall with the least damage to the economy by heeding macroeconomic multipliers, the commission would magnify the damage by closing the deficit on the spending side while shifting the tax burden to enrich the wealthy at the expense of low- and moderate-income families. While wealthy households save more of their money and spend more of it out of state, spending by low- and middle-income families fuels the state's economy. Lower-income families already pay a much higher share of their incomes in state taxes—around 24 percent for households with adjusted gross incomes under $48,000—than millionaires, whose income share going to state taxes ranges from around 6 to 8 percent, according to a 2014 government report (Connecticut Department of Revenue Services 2014).

The commission's regressive tax plan

Instead of addressing this gross inequity, the commission proposes a revenue-neutral tax overhaul that reduces progressive income taxes while increasing regressive sales and payroll taxes. It scraps progressive estate and gift taxes altogether. A new payroll tax proposed is effectively a tax on employment borne in large part by workers, though the commission characterizes the tax as a "corporation tax" to give the impression of shared sacrifice. Smaller employers would be fully or partially exempt from this tax, which is presumably intended to spur entrepreneurship but is as likely to increase outsourcing to subcontractors whose only competitive advantages is lower pay. A proposal to raise tolls and gasoline taxes, though earmarked toward needed transportation infrastructure, is also regressive.

The commission bemoans the volatility of tax revenues, but this volatility is only a problem when state policymakers fail to smooth spending over the business cycle. Pro-cyclical taxation (as opposed to pro-cyclical spending) actually *dampens* business cycles in a potentially useful way. The key is ensuring that taxes in flush years are used to pay down the pension debt or increase savings in the rainy day fund rather than increase spending or cut taxes. However, the "bond lock" provision included in the state's 2018–2019 budget is poorly designed and draconian, and hence fails as a smart mechanism for this tax smoothing (Noonan, Marks, and Shemitz 2018). (The commission praised the bond-lock provision, but conceded that it was enacted without hearings and should be deferred a year pending further study.)

The commission provides little justification for its proposals beyond self-serving claims that the tax overhaul would make the state more competitive. It makes much of the fact that high-income taxpayers are moving to states like Florida, which has no state income tax (as well as poor schools and public services). But of course, much outmigration to states like Florida is driven by weather and retirement decisions, not tax rates.

The commission's report implies, but fails to demonstrate, that lowering taxes on the wealthy would stem outmigration enough to recoup revenues lost from lower rates. This is highly doubtful, because all wealthy residents—not just those who might be dissuaded from leaving—would see tax cuts. Research has shown that income taxes have little effect on migration, certainly not enough to suggest that lowering rates would result in higher revenues (for an overview, see Bivens 2017 and Young et al. 2016). While the commission's report shows that migrants to Connecticut from New York, Massachusetts, New Jersey, and California have somewhat higher incomes than migrants leaving Connecticut for these states, all these states except Massachusetts also have a higher cost of living (BEA 2018c). Connecticut is similar to other northeastern states in having net outmigration to warmer, cheaper parts of the country, especially by retirees. What differentiates Connecticut from other states in the region is not outmigration but a low birthrate. Whether or not this should be considered a problem, it is not one the commission tackles by addressing childcare costs or other means.

The commission's harmful budget cuts

The commission recommends $1 billion in unspecified cuts to the annual budget in addition to further cuts to employee benefits. State and local government employment in Connecticut has already shrunk by 15,000 jobs (6.3 percent of the total) since 2008. While public-sector employment fell nationwide in the wake of the Great Recession and has not fully recovered, Connecticut, which had lower-than-average government employment even before the recession, is unusual in that it continues to shed government jobs (authors' analysis of BEA 2018d; Phaneuf 2017b).

The state should *not* further shrink public-sector employment, which would only serve as a drag on the state's feeble recovery and further degrade public services. Once the economy picks up steam, the state can look for ways to deploy these resources more effectively through local government consolidation and by better taking advantage of economies of scale and the state's bargaining power to restrain health cost inflation.

The commission's attacks on workers

The commission scapegoats public-sector workers and their unions, who have already borne the brunt of a shortfall they had no role in creating. Collective bargaining is not to blame for pension underfunding. As the AFL-CIO has pointed out, the state began prefunding pension benefits only after state workers won the right to bargain over these benefits (Pelletier 2018). In just the latest round of bargaining, state employees agreed to over $24 billion in pay and benefit cuts to help pay back a shortfall created decades ago when benefits were legislated, not collectively bargained (Phaneuf 2017c). These cuts included further reductions to pension and health benefits, including the creation of yet another lower pension tier for newly hired workers.

Nevertheless, the commission recommends revoking unions' ability to bargain over benefits—core components of public-sector compensation that encourage employee retention. But today's teachers and state employees are already paying a steep price for the state's failure to pay for their predecessors' benefits. Workers' pension contributions have doubled while retiree health benefits have been slashed (Phaneuf 2017d). Since public-sector workers are already paid less than their private-sector counterparts, benefit cuts would have to be more than offset by higher salaries to avoid losing skilled workers (Morrissey 2016).

Unions reduce inequality and grow the middle class. While claiming concern over income disparities, the commission wants to weaken laws designed to ensure that government-funded construction projects do not undercut union pay standards. The commission also meddles in arbitration rules to promote untested methods that give neither side in an employer-employee dispute an incentive to bargain in good faith or share information and that bestow too much power on individual arbitrators.

Protecting workers' rights also strengthens the economy. Recent research has found that unions have a positive net fiscal impact on governments by turning bad jobs into middle-class ones with benefits, thereby reducing reliance on public services (Sojourner and Pacas 2018). Even unions that raise public-sector workers' pay reduce costs to taxpayers. This counterintuitive finding stems from the fact that public-sector unions have the largest effect on the pay and benefits of lower-paid workers who might otherwise qualify for Medicaid and other means-tested programs. An EPI report (Morrissey 2016) found that in Connecticut, as in the rest of the country, public-sector unions raise pay among less-educated workers more than among highly educated workers. Even with a union pay advantage, college-educated public-sector workers remain underpaid compared with their private-sector counterparts.

Conclusion

The recommendations of the Commission on Fiscal Stability and Economic Growth are unlikely to be adopted in their entirety as the co-chairs have urged. However, the report may be used as a basis for further discussion and policy advocacy, even though it is rife with misinformation and sloppy research. This includes a claim that Connecticut's regressive sales taxes are low by national standards, which the report's own figures belie. Another misleading claim is that pension benefits are overgenerous, based on comparisons that do not take into account salaries, years of service, or the benefit cuts Connecticut workers have already experienced. In fact, benefits are modest, especially for teachers who are not eligible for Social Security yet have a benefit multiplier equal to just 2 percent of final average salary per year of service. This is in line with what many workers receive *on top of* Social Security (authors' analysis of NEA 2016 and CRR 2016).

The report exaggerates the pension shortfall by reducing projected returns on pension fund assets even though these are in line with realized returns. The commission bases its claim on 10-year returns in a period that included the 2008 financial crisis, while inflation-adjusted returns have exceeded current assumptions over both shorter and longer time periods (authors' analysis of Connecticut Office of the Treasurer 2017; Cavanaugh Macdonald 2017a, 2017b, 2017c; and BLS 2017). Far from being aggressive, the 6.9 percent investment return assumption used by the State Employees Retirement System is already one of the most conservative in the country (NASRA 2017).

Connecticut should not make fiscal decisions that ignore national developments. The Tax Cuts and Jobs Act passed by Congress at the end of last year gave large and permanent tax cuts to Connecticut corporations and their owners. Given this windfall, they should be able to afford modest increases in state taxes, rather than reaping additional tax cuts. Further, recent federal proposals for both infrastructure and Medicaid would offload federal responsibilities for financing them onto states. These proposals have not been passed into law yet, but they seem to presage states needing more, not less, revenue in the near future.

Connecticut is spending too little, not too much, on public services and investments as it tries to repay debts incurred decades ago. The smart way out of this predicament is to raise taxes in a progressive fashion. This not only spares its most vulnerable citizens, but also does the least harm to the economy and reduces inequality. In a nod to addressing "the issue of income disparity," the commission expresses support for an increase in the minimum wage—as do we. But this nod appears more like a feint in light of everything else in the report that would greatly *increase* income inequality while slowing economic growth.

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