Yankee Institute Policy Brief

Crowding Out What Matters: The 2016-2017 State Budget

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Introduction

The two-year budget just proposed by Gov. Dannel Malloy contains the clearest warning signs yet that Connecticut must reform its public sector pay and benefits, as the growth in employee compensation continues to outpace the growth of state revenue.

In order to pay for these increased costs the state has had to both reduce spending in other areas and to increase taxes, primarily on businesses.

Connecticut is already overtaxed, and a recent Department of Revenue Services study shows the burden these high taxes impose on every segment of the population. Increased taxes will only further inhibit economic growth in Connecticut.

In addition, the state projects that in the next ten years Connecticut's working population will shrink, even as the population of people over the age of 65 is expected to increase by 55 percent. At the same time, the school-age population (future employment pool) is expected to decrease by 10 percent.[1]

Red flags are waving. State lawmakers should take into account the expected growth in state employee compensation as well as the projections about the state's population growth as they deliberate what to do with the governor's budget.

Crowding Out Vital Functions

The state's proposed budget calls for more state spending over the next two years, yet this same budget has been called "devastating" by progressive lawmakers.[2] That's because even with spending increases of 3.3 percent in 2016, and 3.1 percent in 2017, this year's budget still calls for deep cuts to social services and higher education.

So why is it that cuts are necessary, even as state spending continues to increase?

The answer: Runaway growth in just a few areas of the budget are "crowding out"[3] the other functions of state government – including social services, education, and transportation.[4]

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[1] Connecticut Office of Policy and Management. "2016-2017 Biennium Economic Report of the Governor." Feb. 18,

[2] Stuart, Christine. Lawmakers Have Harsh Words For Malloy's Proposals To Reduce Safety Net Funding. CTNewsJunkie.com. Feb. 20, 2015. http://www.ctnewsjunkie.com/archives/entry/lawmakers_have_harsh_words_for_malloys_proposals_to_reduce_safety_net_fundi/

[3] The term "crowding out" is used by progressives like California's David Crane and scholars such as Daniel DiSalvo at the Manhattan Institute. See for example, "Government Crowded Out: How Employee Compensation Costs Are Reshaping State and Local Government," at http://www.manhattan-institute.org/html/cr_77.htm#.VOtP2bPF90w.

[4] Crowding out can also refer to how the growth of the public sector can hurt the private sector, which is also occurring in Connecticut.

In Connecticut, this runaway growth is occurring primarily in two areas: (1) State employee compensation, especially benefits; and (2) the repayment of debt.

The cost of employee pay, benefits and debt service will increase $565 million from 2015 to 2016 – exceeding the $521 million proposed increase in overall spending. That means, even with increased spending, other areas of the budget will have to be cut.

In particular, the cost of state employee benefits is growing at a rate of 10 percent a year, which is far faster than the growth in tax receipts. If this segment of the budget is allowed to continue to out-pace the growth of revenues, the state will be forced into even greater reductions in other spending, or into further tax increases.

> **Recommendation:** State lawmakers must address the growth in state employee compensation this year, rather than continuing to push the issue into the future. Employee and retiree cost-sharing for health benefits should increase, and cost of living increases should be phased out for pensions over the median state income.[5]

The Growing Size of Government

Although Gov. Malloy deserves credit for slowing the rate of growth in state government, he cannot claim credit for “cuts” as taxpayers generally understand them. The budget reduces the planned rate of growth in government spending – often called the “current services budget” – but those cuts aren’t deep enough to constitute actual cuts in state spending from the previous year.

Based on the growth estimates provided by the administration[6], if the proposed budget is adopted Connecticut government spending will have increased 135 percent between 1996 and 2017. Spending per person is up 118 percent.

During the Malloy administration alone, per-person spending is up 14 percent.

Because it was impossible to sustain this growth through existing revenue streams, state lawmakers increased taxes. To keep future spending growth in check, the state should budget for future cost-cutting.

When announcing the budget, Office of Policy and Management Secretary Ben Barnes made a revealing point. He said that the severance cost of laying off state employees is often a quarter- to a half-year of salary, limiting the immediate savings from that approach.[7]

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[5] All recommendations are listed in Appendix A.

[6] The administration adjusted these budget numbers to exclude the federal portion of Medicaid costs. This adjustment undercounts the impact of Medicaid cost growth relative to the rest of the budget.

[7] OPM secretary media budget briefing, Feb. 18 2015.

The lack of flexibility in managing the state government workforce contributes to its costs, especially because state employees often collect benefits worth between a third and half of their salary.

> **Recommendation:** Budget $3.5 million, about .1 percent of payroll, to fund severance costs for employees who work in low-need areas; are unproductive; or fail to meet basic employment standards (i.e., commit crimes or otherwise violate the public's trust).

Over time a rebalancing of the state workforce could pay for needs like more engineers and project managers in the Department of Transportation to complete essential projects.

> **Recommendation:** Make additional cuts totaling $58 million. (See Appendix A for details.)

Our Spiraling Debt

For the past two years, Connecticut has put off paying back a portion of its debt. This year the cost of that decision is realized. Debt service payments have increased by 7.7 percent (or $148 million) this year, even as the state plans to increase its bonded debt.

Connecticut has significantly more debt per capita at the state level than other states. In the governor's economic report, Connecticut's debt is pegged at $32 billion, or $8,898 per person. This is more than double the fifty state average, which is $3,661 per person.[8]

The cost of this debt is considerable. In 2016, the state expects to spend $2.4 billion on interest and principal, with another $2.6 billion in 2017. That represents 12 percent of total state spending in 2016, and 13 percent in 2017. As the state ramps up its transportation spending and borrowing, this number is likely to increase even further.

> **Recommendation:** Delay all bonding by six months to reduce debt service, saving about $15 million in the first year and $90 million in the second. Use bond premiums to reduce net borrowing (rather than paying debt service) at a cost of $150 million in the first year and $135 in the second year.

In addition, there are significant liabilities in the state's two pension funds, and in its retiree healthcare fund. According to the state budget, the balance in the teacher's retirement fund is expected to be below its current balance by 2017, which means the state will have additional pension liabilities. However, this projection is based on a conservative estimate of returns on investments. The state employee retirement fund assumes much higher returns, which allows a much more optimistic projection that the fund will end 2017 in a better position than it is in now.

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[8] Connecticut Office of Policy and Management. "2016-2017 Biennium Economic Report of the Governor." Feb. 18, 2015. Hartford, Connecticut. These numbers are from FY 2012, which are the most recent available.

Recommendation: Over time, all pension funds should move to an expected 4 percent rate of return, which is considered a safe rate and is used by private pension funds.

Recommendation: Bill agencies for 5 percent of fringe benefits, excluding agencies that already pay full cost. Offer agencies to a $1 increase in their budgets for every $2 of fringe benefits saved.

The Tax Burden

The growth of government increases the tax burden on the people of Connecticut. A select few have the luxury of leaving Connecticut to avoid this growing burden, but that only leaves more for the rest of us to pay.[9]

The proposed budget makes a positive move by eliminating the business entity tax, which is biased against small and new businesses. But the budget makes Connecticut less attractive for large employers, by increasing the effective corporate tax rate on many successful businesses.

Recommendation: Cancel $377 million in "economic development" borrowing and put the debt-service savings toward canceling these tax increases, about $15 million in FY2017 and $30 million in following years. Cut an additional $13 million from the DECD budget. Eliminate the corporate tax surcharge as a first step toward real economic development, more jobs and better pay.

The budget also makes a complicated series of adjustments to the sales tax. Rather than cutting the sales tax and increasing other taxes, leave taxes in place at current rates until the Tax Review Committee reports on comprehensive tax reform.

Recommendation: Remove the sales tax cuts (and compensating tax increases) from the proposed budget.

Educating Our Children

Even as the number of school children in Connecticut shrinks, costs continue to increase. Lawmakers must find ways to reduce state mandates on cities and towns so that they can adjust their education budgets to meet the needs of their local populations.

One way to reduce education costs is for education dollars to "follow the child." Currently, school districts that lose students to magnet, charter, private, or other public schools nevertheless continue to receive money for those students. This creates bad incentives for school districts, since those districts are rewarded when students leave failing schools for better

[9] See High Taxes Hurt, Yankee Institute Policy Brief, Feb. 11, 2015.

alternatives. Over time, this double-funding should be reduced, so that eventually school districts are no longer funded for students who attend school elsewhere.

> **Recommendation:** Reduce “phantom student” grants by 10 percent to save $18 million per year.

Improving Our Healthcare

One positive change in the budget involves shifting some residents from Medicaid to the state’s insurance exchange. Medicaid has notorious problems with access to care, which are only likely to become worse with additional provider cuts. The state should move toward a smaller Medicaid program that can more effectively meet the needs of residents who receive coverage.

> **Recommendation:** Move additional Medicaid recipients onto the insurance exchange. Split the savings between Medicaid providers and taxpayers. In other words, eliminate provider cuts in favor of narrowing the scope of Medicaid to those most in need.

This budget doubles down on a gimmicky, ethically dubious tax – which taxes hospitals and redistributes money between them solely for the purpose of increasing their costs, in order to extract more money from the federal government. In other words, the tax inflates healthcare costs to increase reimbursements, a practice the state would likely discourage – and even prosecute – among its own providers.

> **Recommendation:** Keep the hospital tax at current levels to make it easier to eliminate in the future.

Rather than increasing access to health care, the state Office of Health Care Access actually limits it – as seen most recently when its interference caused the cancellation of a large planned investment in Connecticut hospitals.

> **Recommendation:** Eliminate the Office of Health Care Access for savings of about $2 million.

Empowering Our Poor

Connecticut often takes an indirect approach to helping the poor. A more effective and empowering approach puts more money in people’s pockets through the existing Earned Income Tax Credit program, which makes employment more attractive to the working poor.

> **Recommendation:** End the connection between the state and federal EITC. Instead the state should pay workers 6.35 percent on the first $15,000 in income ($30,000 for married couples) through their paychecks. Cut non-Medicaid human services spending by $100 million to pay for the expansion.

Helping Those Who Need It

The Department of Developmental Services is perhaps the agency that suffers the most from the inflexibility and high cost of the state workforce. State-run facilities for people with the greatest need cost 2 to 2.5 times the cost of similar care from private providers. There is a long waiting list for state services. Over time we should shift most DDS clients to private providers. Doing so will enable the state to serve more people for less money.

Improving Our Transportation

The governor has proposed an ambitious transportation program. There is good reason for this - the state's aging and crumbling infrastructure is in urgent need of repair. But the governor does not say how he will pay for this plan, and under current revenue projections the special transportation fund will be depleted by 2018.

> **Recommendation:** The state should use tolls and congestion pricing to pay for its infrastructure needs. At the same time it should also reduce the gas tax so that Connecticut's fuel pump prices are more competitive regionally. For each dollar raised through tolls or congestion pricing, the state should cut other taxes by a dollar. This more fairly distributes the cost of infrastructure upgrades, by charging those who use the infrastructure most.

In addition, one of the largest projects planned for the next five years is the expansion of the New Haven to Springfield rail line. According to Department of Transportation projections, this line is expected to carry 3,500 passengers a day, while the cost to preserve and expand the line is projected to be $1.58 billion. That's more than $450,000 per passenger.

Meanwhile, projected spending over the next five years for the New York-New Haven corridor is projected to be $890 million. This region sees by far the most congestion, while around 150,000 rail passengers are frustrated daily by delays and other maintenance issues. The state should reprioritize its spending so that the greatest needs are addressed first.

> **Recommendation:** Cancel plans to redevelop the New Haven to Springfield rail line and instead concentrate spending first on the state's most pressing needs. In particular, more spending should be focused on the roads and rail needs in Fairfield County, where there is insufficient transportation infrastructure for the current population.

Restructuring the Department of Corrections

The governor expects to see savings in corrections based on changes in his proposed "second chance" initiative, which would divert non-violent offenders into community or other rehabilitation programs. The state would increase the number of parole officers and also the number of members on the parole board. As the number of inmates in jail continues to drop, the state should decrease the number of prison guards.

> **Recommendation:** State lawmakers should continue to find safe, sensible ways to divert non-violent offenders from the prison system, and should also reduce the number of prison guards.

Looking Ahead

There are several good things in the governor's proposed budget – such as the elimination of the business entity tax. The tax raises very little revenue, and is a nuisance tax for Connecticut's businesses. Likewise, although the proposal to reduce incarcerations for non-violent offenders is in a preliminary stage, is has merit, as does moving some residents off Medicaid and onto the state's healthcare exchange.

But the state still relies far too heavily on gimmicks to keep state spending afloat, including using bond premiums as operating revenue, and pushing more spending off the books to keep the budget under the spending cap.

There are many common sense ways that state lawmakers could significantly reduce the state budget. Lawmakers should begin by acknowledging the negative impact on the state's finances of the growing cost of state employee salaries and benefits. Without sensible and meaningful reform, these costs will increasingly crowd out vital government services, even as taxpayers are forced to pay more and more to subsidize a government that offers them less and less.

Appendix A: Recommendations

- **Recommendation:** State lawmakers must address the growth in state employee compensation this year, rather than continuing to push the issue into the future. Employee and retiree cost-sharing for health benefits should increase, and cost of living increases should be phased out for pensions over the median state income.

- **Recommendation:** Budget $3.5 million, about .1 percent of payroll, to fund severance costs for employees who work in low-need areas; are unproductive; or fail to meet basic employment standards (i.e., commit crimes or otherwise violate the public's trust).

- **Recommendation**: Make additional cuts totaling $58 million distributed across the Legislative ($5 million) and Judicial Branches ($15 million), plus general government ($5 million), regulation and protection ($5 million), DEEP ($1 million), Department of Housing ($3 million), technical high schools ($2 million), Office of Early Childhood ($3 million), UConn ($2 million), UConn Health Center ($1 million), community colleges ($8 million), state universities ($4 million) and Department of Correction ($2 million).

- **Recommendation**: Delay all bonding by six months to reduce debt service, saving about $15 million in the first year and $90 million in the second. Use bond premiums to reduce net borrowing (rather than paying debt service) at a cost of $150 million in the first year and $135 in the second year.

- **Recommendation**: Over time, all pension funds should move to an expected 4 percent rate of return, which is considered a safe rate and is used by private pension funds.

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