Overview

- Concept and scope of report
- Summary of economic and demographic trends
- Impact on Connecticut’s revenues
- “What-if”-sensitivity of trends and impacts
Fiscal Architecture

• Revenue and expenditures are driven by many factors including economic and demographic characteristics
  – For example: Population size, age distribution, concentration of type of economic activity

• These factors change over time and may affect the natural growth of revenues and the basket of expenditure needs
  – Growth in service sector (loss of tax handles?), growth in very elderly (increased demand for transportation and housing?)

• Institutional context may affect ability to respond to these changes

• What makes *Fiscal Sense* as Connecticut looks ahead?
Concept

• Simple premise:

Revenue collection (receipts) = tax rate * tax base * administrative/compliance efficiency

• Similar case for expenditures (though not as much a focus in this report):

Expenditure need = client population * per unit cost of production
Drivers of Fiscal Architecture

- Factors affecting these relationships or any component affect revenues and expenditures in the short and long-term
- Factors studied include:

<table>
<thead>
<tr>
<th>Demographic</th>
<th>Economic</th>
<th>Institutional</th>
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</thead>
<tbody>
<tr>
<td>Age Distribution</td>
<td>Employment and output</td>
<td>Intergovernmental Landscape</td>
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<tr>
<td>Population growth</td>
<td>Personal income</td>
<td>State-Local Fiscal Structure</td>
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<tr>
<td>Race/ethnic diversity</td>
<td>Globalization</td>
<td>Debt</td>
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<tr>
<td>Health</td>
<td>Existing industries</td>
<td>Pensions</td>
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Highlights in Connecticut Trends

• Population:
  – Slower growth than U.S.
  – Growth in elderly; older than average state

• Income
  – High median income
  – Disparity in income

• Relatively homogeneous population

• Employment and output
  – Growth in service sector
  – Growth in education/health sectors
  – Change in capital/labor mix
  – Loss of finance/insurance dominance
Table 3. Projections of Connecticut’s Population by Age (percent of total)

Source: Office of Policy and Management, February 2015

<table>
<thead>
<tr>
<th>Age Group</th>
<th>2015</th>
<th>2020</th>
<th>2025</th>
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</thead>
<tbody>
<tr>
<td>0-19</td>
<td>891.8 (24.5)</td>
<td>852.5 (23.0)</td>
<td>822.9 (22.0)</td>
</tr>
<tr>
<td>20-44</td>
<td>1,107.6 (30.4)</td>
<td>1,129.4 (30.5)</td>
<td>1,143.9 (30.5)</td>
</tr>
<tr>
<td>45-64</td>
<td>1,062.9 (26.2)</td>
<td>1,049.7 (28.4)</td>
<td>996.5 (26.6)</td>
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<tr>
<td>65 and over</td>
<td>582.2 (16.0)</td>
<td>671.0 (18.1)</td>
<td>782.8 (20.9)</td>
</tr>
<tr>
<td>85 and over</td>
<td>94.6 (2.6)</td>
<td>94.9 (2.6)</td>
<td>96.4 (2.6)</td>
</tr>
<tr>
<td>Total</td>
<td>3,644.5</td>
<td>3,702.5</td>
<td>3,746.2</td>
</tr>
</tbody>
</table>
Table 6: Connecticut Concentration of Employment by Industry 2012 and 2022  
Source: Calculations based on Connecticut Department of Labor Industry Projections  
http://www1.ctdol.state.ct.us/lmi/ctindustry2012.asp

<table>
<thead>
<tr>
<th></th>
<th>2012</th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Construction</td>
<td>Manufacturing</td>
<td>Retail Trade</td>
<td>Finance/Insurance</td>
<td>Prof/Tech Services</td>
<td>Educational Services</td>
<td>Healthcare Services</td>
<td>Accommodation and Food Service</td>
</tr>
<tr>
<td>2012</td>
<td>2.91%</td>
<td>9.31%</td>
<td>10.26%</td>
<td>6.45%</td>
<td>5.04%</td>
<td>10.29%</td>
<td>15.56%</td>
<td>6.63%</td>
</tr>
<tr>
<td>2022</td>
<td>3.26%</td>
<td>8.57%</td>
<td>9.90%</td>
<td>6.08%</td>
<td>5.51%</td>
<td>10.33%</td>
<td>17.06%</td>
<td>6.61%</td>
</tr>
</tbody>
</table>
Trends, con’t.

• Globalization and technology
  – Continued competition for capital and labor
  – Growth in internet based activity for development, production, and dissemination

• Institutional issues
  – Heavy debt and pension overhang
  – Lack of local government fiscal space and autonomy
Where is Connecticut Headed and What-ifs

• Population growth and employment mix
  – Population growth expected to be relatively slow
  – Projected job growth is in lower paid sectors of health and education, reducing natural growth in income tax revenue

  – OPTIONS TO ADDRESS:
    • Natural growth in income and sales tax bases will reflect slow population growth
    • Pressures associated with increased income disparity
  – What if?
    • Population becomes more heterogeneous?
What to expect, cont.’

- **Service sector growth in employment and output**
  - Reduces tax handles, service-based industries are more difficult to identify and possibly to value
  - Employment in sector is less defined by location than by skill (outsourcing), reducing growth in income tax

- **OPTIONS TO ADDRESS:**
  - Adapting tax administration skills and procedures for new economy
  - How far can local governments tax?
- **What if?**
  - Investments in knowledge-industry pays off?
What to expect, con’t.

• Increase in share of elderly
  – Greater portion of their income is tax-exempt (Social security, pensions)
  – Greater share of consumption is tax-exempt (health care, food at home)
  – Demands for transportation, and health infrastructure
• OPTIONS TO ADDRESS:
  • Diversification of tax base
  • Continued pension liability with smaller work force
• What if?
  • Economic base expansions do not catch on?
What to expect, con’t.

• Globalization and Technology increase competition and decrease labor’s share of output
  – Capital’s share of output and tax base increases, but capital provides a difficult “tax handle”
  – Internet based activity will increase ability to evade/avoid taxes

– OPTIONS TO ADDRESS:
  • Reduced reliance on corporate income/profits base
  • Reassess areas to substitute fees and charges for income taxes
What to expect, con’t.

• Disparities among the population
  – Income is increasing disparate
  – Pressure on services (low income support)
  – Growth in diversity in needs

  – OPTIONS TO ADDRESS:
    • Balance between revenues and government services
    • Buoyancy of tax bases
Wrap-Up

- Institutions will play an important role in Connecticut’s plan of what makes fiscal sense:
  - Overall structure of state-local finance in Connecticut
  - How much room do local governments have?
  - Implications of debt and pension overhang
Overall Landscape

• See Table 11
<table>
<thead>
<tr>
<th>Trend</th>
<th>Revenue Implications</th>
<th>Impact of Institutions</th>
<th>What if?</th>
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</thead>
<tbody>
<tr>
<td><strong>Demographic</strong></td>
<td></td>
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<tr>
<td>Age composition</td>
<td>Decline in school-aged, increase in 20-44, and continued growth in retirement aged.</td>
<td>Income Tax ↑: Working age population will positively affect income tax. Property Tax ↓: fewer young children and transitions in retirement reduce demand for large houses; slow population growth and increased income disparities reduce demand for large properties. Sales Tax ↑: Sales tax revenue will see growth from consumption expenditures of the 20-44 age group but this is tempered by the decline in school aged children over the next 10 to 15 years. Income and Sales Tax ↓: Longer term the elderly dynamic will reduce buoyancy of both taxes.</td>
<td>Income tax growth is affected by the cross-border tax treatment (NY). The relatively large amount of pension liability and debt constraint options for Connecticut to deal with potential slowing of natural revenue growth. Previous growth in education expenditures will increasingly be in competition with support for elderly and public welfare.</td>
</tr>
<tr>
<td>Population size</td>
<td>Slow growth.</td>
<td>All Taxes ↑ →: Population growth will in general lead to increased revenue but the growth will be slower than for the average state; Connecticut has dealt with this slow growth for the last decade.</td>
<td>Not directly relevant. Population growth has been relatively slow; if efforts to attract knowledge industry development population growth could increase as well as the income base.</td>
</tr>
<tr>
<td>Health status</td>
<td>Relatively health; rates of obesity lower than U.S. average; high by international standards.</td>
<td>Little direct effect on tax revenues expected over the next 10 to 15 years. Increases in medical expenditures.</td>
<td>Pressure on health care costs expected to grow. Connecticut’s expansion into bio-tech and other knowledge industries could lead to gains in healthcare research and status in the state.</td>
</tr>
<tr>
<td>Economic</td>
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<td>Personal Income</td>
<td>Globalization and Technology</td>
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<tr>
<td>Increase in service sectors including health/education/accommodation Lower wage jobs Uncertainty around defense spending</td>
<td>Income Tax ↓: The mix of activity toward services and lower wage jobs will reduce the natural growth of the income tax Corporate Tax ↓: Service sector is less transparent and provides a weaker paper trail for tax administration Property Tax ↓: Service sector activities by nature use less property</td>
<td>Income Tax ↑: Increased share of income tax from higher income earners ↓↑: Potential for volatility associated with capital income for high income earners Income Tax ↓: Reduction in wage relative to transfer income will reduce the income tax base; Lower income individuals will have a larger portion of income tax exempt (standard deduction plus exemptions) reducing the elasticity of revenue Sales Tax ↓: Large concentration of low income jobs will increase relative consumption of food and housing (largely non-taxable)</td>
<td>Income Tax ↓: Shift from labor to capital inputs reduces the income tax handle Corporate Tax ↓: Competition in factor and output markets should increase the tax minimization strategies of companies</td>
</tr>
<tr>
<td>Ability for state to compete in knowledge industries a function of existing high tech manufacturing and higher education institutions</td>
<td>Increased burden on high income earners could have backlash in terms of payment of “fair share” for services provided</td>
<td>Internet sales legislation increasingly possible to stem the sales tax loss Local governments have less room to maneuver to deal with these pressures in Connecticut</td>
<td>If Connecticut is successful in the knowledge industry, the state could play a role in the production of the new technology and bolster its economic situation</td>
</tr>
<tr>
<td>Investments in knowledge industries including bio-tech and advanced manufacturing could mitigate the negative impacts on public finances associated with the status quo growth of lower paid service sector jobs.</td>
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