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In March...

Nonfarm Employment

Connecticut 1,688,100
 Change over month +0.07%
 Change over year +1.33%

United States 155,569,000
 Change over month +0.15%
 Change over year +2.74%

Unemployment Rate

Connecticut 4.0%
 United States 3.5%

Consumer Price Index

United States 301.836
 Change over year +5.0%

How Does Connecticut's Economic Growth Stack Up Against the Recent Budget Surpluses?

By Manisha Srivastava, Policy Coordinator & Economist, CT OPM

There is a common adage that a strong stock market does not necessarily indicate a strong underlying economy, that the stock market is not the economy. What about budget surpluses – do year upon year of budget surpluses indicate a strong underlying economy?

Connecticut (CT) has shifted from ongoing budget deficits during the 2010s following the Great Recession to budget surpluses, including billion plus dollar surpluses more recently. There are multiple factors responsible for these budget surpluses. As a result of the COVID-19 pandemic, the federal government stepped in with financial assistance including the Paycheck Protection Program and Enhanced Unemployment Insurance. In addition, the pandemic-mandated work from home policy (where possible) reduced state office expenses while waivers and other safety-oriented accommodations reduced the level of interactions with the public and hence expenses. And finally, certain tax revenue sources have continued to outperform and come in above projections. What do these strong revenues indicate regarding CT's

economic indicators similarly outperformed? Let's find out.

The primary revenue sources for the General Fund (GF) include Income Tax and Sales and Use Tax; in Fiscal Year (FY)¹ 2022, Income Tax made up 48.7% and Sales Tax made up 19.4% of General Fund revenues.² There are two components to Income Tax, Withholding and Estimates & Finals, representing 31.7% and 17.1%, respectively, of General Fund revenues in FY 2022. About 20 other taxes, revenues, fees, and federal grants comprise the remaining 31.9% of the General Fund, including sources such as Corporation Tax, slot revenues, Real Estate Conveyance Tax, and the Pass-through Entity Tax. The primary drivers of the budget surpluses include Income, Sales, and the Pass-through Entity Tax (see Table 1).

Another way to understand these recent budget surpluses is by looking at the economic growth rates of these tax sources. Economic growth rates are defined as baseline revenue growth prior to any policy changes. For example, if the Income Tax rate was increased, the increased tax revenue the following year would reflect natural growth in

Table 1. General Fund - Realized Over (Under) Budgeted
 In Millions \$

	FY 2022	FY 2021	FY 2020	FY 2019	FY 2018	TOTAL FY 2022 - FY 2018
Personal Income - Withholding	\$ 514.3	\$ 75.3	\$ (95.3)	\$ 518.1	\$ 173.3	\$1,185.7
Personal Income - Estimates and Finals	\$ 1,256.5	\$ 259.7	\$ (179.9)	\$ 14.5	\$ 1,414.3	\$2,765.1
Sales and Use	\$ 543.5	\$ 204.3	\$ (126.4)	\$ 184.5	\$ (18.3)	\$ 787.6
Pass-through Entity Tax	\$ 821.8	\$ 699.7	\$ 391.9	\$ 572.1	NA	\$2,485.5

Source: CT Office of State Comptroller: Annual Report - Budgetary Basis, OPM

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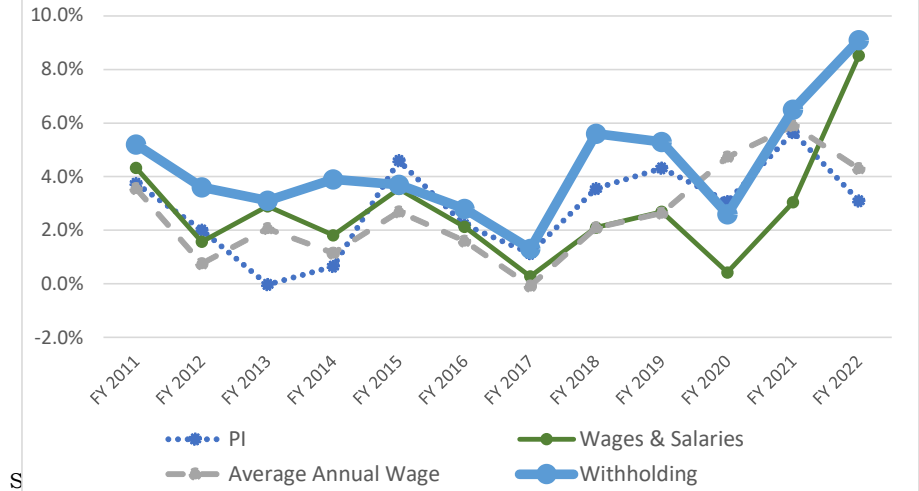
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Graph 1: Connecticut Withholding Indicators



the tax as well as increased collections attributable to the rate change. The Economics, Capital, and Revenue Forecasting budget section in the CT Office of Policy & Management (OPM) and the Office of Fiscal Analysis (OFA) estimate the impact of tax policy changes, and then reverse that from tax collections to estimate the underlying economic growth in the tax. OPM provides updated economic growth rates annually in the Fiscal Accountability Report.

Let's first consider the Withholding component of Income Tax. Withholding is the portion of wages and salaries that employers withhold on behalf of their employees and pay directly to federal and state governments. Taxpayers then true up any over or under-payment in Withholding when they file their annual taxes.

Graph 1 shows the economic growth rates of Withholding Tax from FY 2012 onwards, as well as the growth rates of some key related economic indicators including Personal Income (PI), Wages & Salaries (a component of PI), and the average annual wage.

Withholding generally tracks in the same direction as Wages & Salaries, with slightly stronger year-over-year growth, especially from FY 2018 onwards. In FY 2022, both Wages & Salaries and Withholding grew substantially at 8.5% and 9.1%, respectively. Despite these recent strong gains, how does CT's Wages & Salaries growth stack up against the nation? Graph 2 shows CT

generally trails the nation, though the gap reduced in FY 2021 and FY 2022 as compared to FY 2017 through FY 2020. Were CT to eventually fully match the national growth rates in Wages & Salaries, CT's Withholding revenues would be even stronger.

Personal Income (PI), a key economic indicator, measures income that people get from wages and salaries, transfer of payments including Social Security and other government benefits, dividends and interest, business ownership, and other sources. PI does not include capital gains income. In CT, Wages & Salaries generally makes up about 65% or more of our state's PI. Unsurprisingly, from Graph 1 we see that Withholding generally tracks in the direction of PI, except for FY 2015 and more notably in FY 2022. As a result of pandemic related payments to help prop up the economy, including extended Unemployment Insurance payments and the federal Child Tax Credit, transfer of payments grew from about 13% of PI to 15.5% in FY 2020 and 17.6% in FY 2021. By FY 2022 transfer of payments fell to 14.6% of PI as these extended payments came to a close, hence the divergence between Withholding and PI growth in FY 2022.

Graph 3 compares CT's PI growth rates to the nation overall. Post Great Recession, CT had strong PI growth in FY 2015, but otherwise generally was in the 2% range or less, behind the nation's

growth. CT's PI growth picked up from FY 2018 onwards, growing 3% or more and even reached 5.7% in FY 2021. Despite this stronger growth more recently, years of trailing the US and region in PI growth caused CT to lose the coveted #1 position in per capita personal income in FY 2022, a position CT has held for nearly three decades. However, in this same year (FY 2022), for the first time in more than a decade, Connecticut surpassed the nation in PI growth. Preliminary results for calendar year (CY) 2022 also show we surpassed the nation, growing by 2.6% as compared to the nation's growth of 2.4%. As a result of this recent strong performance, in CY 2022 CT regained the position of #1 in per

capita personal income (though early estimates are subject to change).

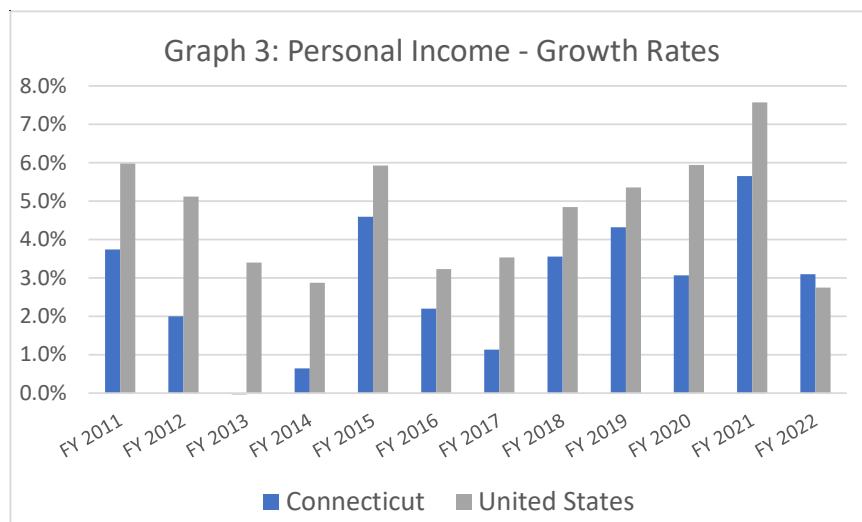
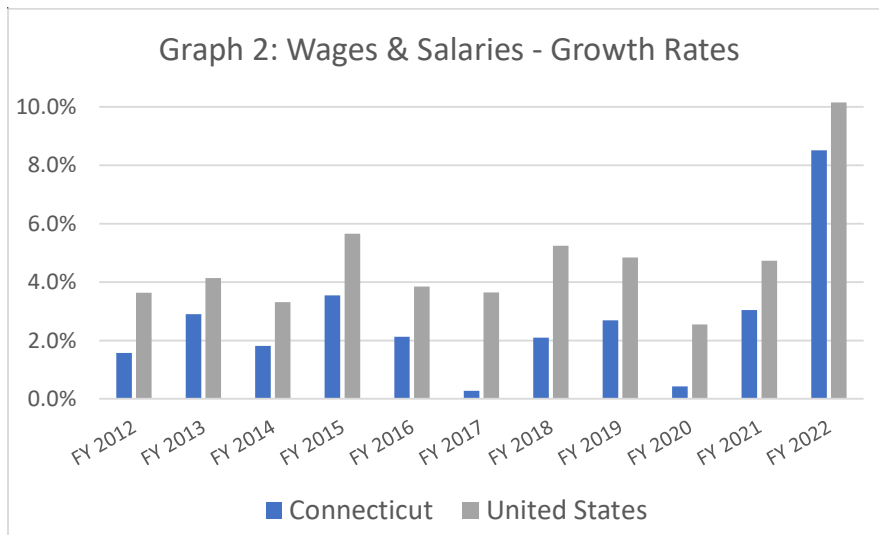
Referencing the state average annual wage in Graph 1 shows it is out of step with Withholding in FY 2020 and FY 2022. This is because during the COVID pandemic, a large number of lower wage front-line retail and service jobs were lost – thus the state's annual average wage increased while the Withholding growth rate was lower. As the economy is returning to (its new) normal, these lower wage jobs are coming back, resulting in a lower average annual wage as compared to Withholding growth.

The Estimates & Finals component of the Income Tax includes estimated payments on business income and capital gains. This tax source is highly correlated

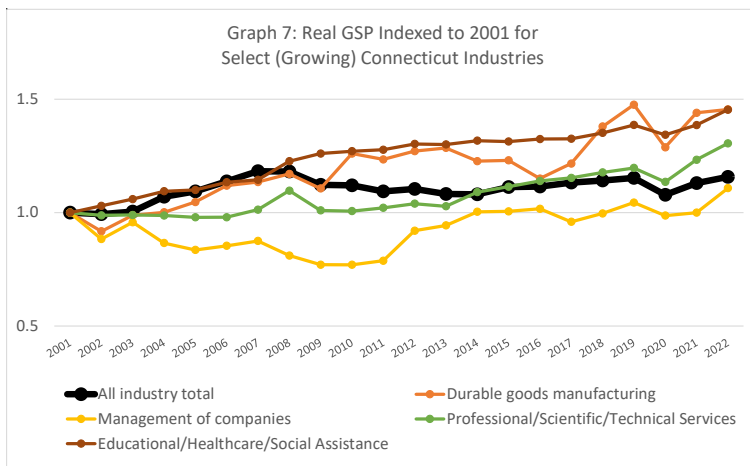
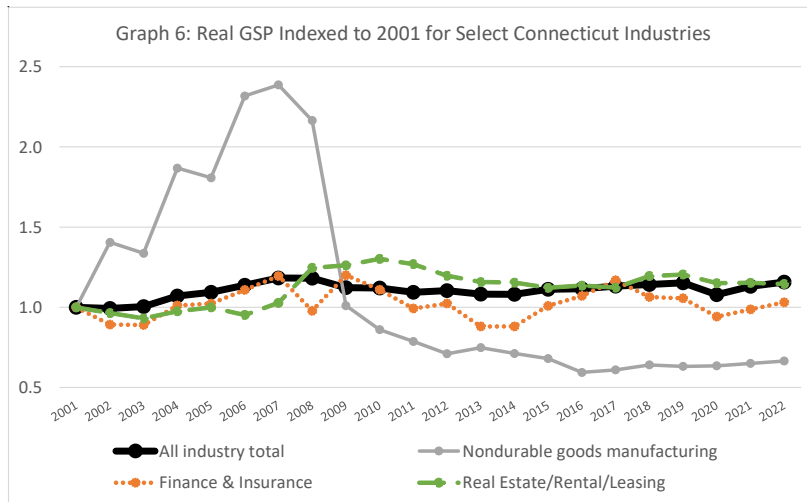
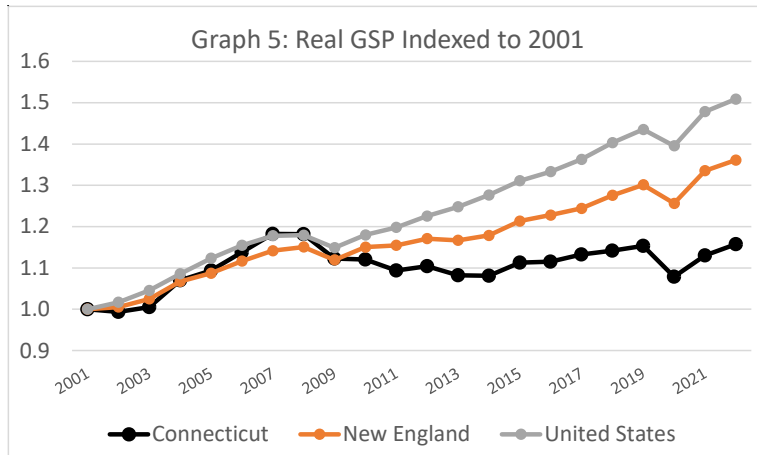
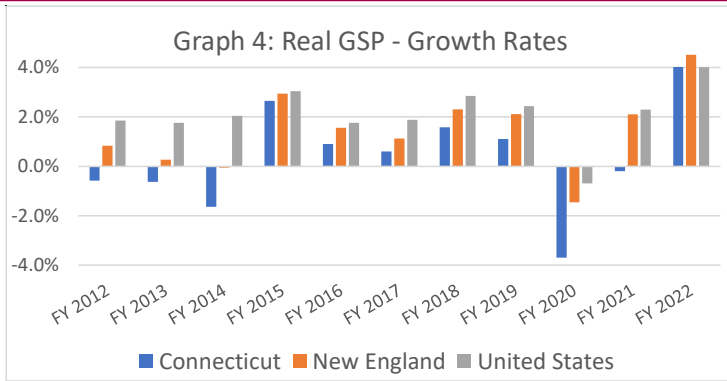
with capital gains and as a result largely dependent on how the stock market performs. This volatile revenue source often sees double-digit gains and declines year-to-year.³ As noted at the top of the article – the health of the economy cannot conclusively be determined from market performance. While Estimates & Finals have exceeded budget projections and contributed over \$1.25 billion in FY 2022, \$250 million in FY 2021, and \$1.4 billion in FY 2018 to budget surpluses, no conclusions on economic health can be drawn from this tax source. As of FY 2019, the Pass-through Entity Tax was carved out of the Estimates & Finals component of the Income Tax, and represents taxes paid by partnerships and S corporations. Since inception, this tax continues to come in stronger than projected, and generally is representative of the state's strong growth in business income.

Economic growth in Sales & Use Tax, the second largest revenue source for the General Fund, doubled in FY 2021 (8.4%) and tripled in FY 2022 (12.5%) as compared to even the top years between FY 2012 through FY 2019.⁴ There are multiple drivers of this strong growth in Sales Tax including inflation, which is increasing the costs of goods and services and as a result the tax collected on those goods and services. Other drivers include ability to spend from government stimulus checks coupled with increased spending on household goods during the pandemic and increased online sales.

Let's switch now to Gross Domestic Product, or Gross State Product at the state level, which is a measure of goods and services produced within a region. Gross State Product (GSP) is utilized as a broad measure of economic activity, and as such is broadly reflected in overall General Fund tax revenues. Graph 4 shows Real (inflation adjusted) GSP growth for CT, New England, and the nation. CT's Real GSP growth has been lagging the region and the nation since the Great Recession and continued to lag through FY 2021. In FY 2022



Source: Bureau of Economic Analysis, Author's calculations



CT's economic activity picked up, matching the nation at 4% growth, albeit still slightly behind our neighbors in the New England region.

Graph 5 shows Real GDP indexed to (calendar year) 2000. During the mid-2000's CT matched New England and nation in Real GDP growth but started to lag after the Great Recession of 2008-2010. What is driving CT's lower growth rates and divergence from regional and national trends throughout the 2010s?

Looking below the topline numbers of Real GDP by major industry sector sheds some light. Graph 6 shows CT's Real GDP for some of the industries that declined during the 2010s. Nondurable goods manufacturing, driven primarily by Chemical Manufacturing (which represents the pharmaceutical industry here in CT) exploded during the 2000's, clocking in 227% growth from 2001 to 2007. It then dramatically fell by 61% between 2008 to 2009 and continued declining through 2016. Chemical Manufacturing represented 9.5% of CT's GDP in 2007 at its peak; clearly the overall economic outcomes in the state as measured by Real GDP have dovetailed with the direction of the Chemical Manufacturing industry.

Other drivers for CT's lagging Real GDP include Finance & Insurance, which lost jobs through the 2010's and continues to through today. Accordingly, we see the decline in Real GDP from Finance & Insurance between 2009 to 2014 and again between 2017 to 2020. However, Finance & Insurance Real GDP has increased 9.5% between 2020 and 2022 – likely a sign of increasing productivity in the industry. Real Estate/Rental/Leasing also declined through the early part of the 2010s, though to a lesser extent.

Graph 7 shows industries that continued to perform relatively well through the 2010s, including Educational/Healthcare/Social Assistance and Professional/Scientific/Technical Services. Between 2020 to 2022, jobs in the Professional/Scientific/Technical Services industry grew by 6.8%.

Source: Bureau of Economic Analysis, Author's calculations

Real GSP from Management of Companies declined from 2003 to 2010, but then recovered and remained stable through the 2010s. Between 2021 to 2022, the high wage Management of Companies industry gained 1.2% in jobs and 10.8% in Real GSP. Durable goods manufacturing, primarily represented by Transportation Equipment Manufacturing (a measure of the defense industry in CT), experienced sharp growth in 2016 and more recently between 2020 to 2022.

Peeling back the layers and looking at the components of GSP show that though CT has been lagging the region and nation, there are areas of strengths. In a turn of good news, after almost a 'decade of lost growth', CT's GSP is growing stronger and exhibiting a turnaround in some of the state's

key industries. For the first time since 2015, the latest data shows CT's Real GSP growth matching the nation in FY 2022 and leading the nation in CY 2022.

While the stock market does not represent the economy, it could be argued that tax revenues are the pulse of the economy – specifically Withholding and Sales Tax directly show on a timely basis (within the month) how much residents are earning and spending. After years of budget deficits and cuts, the recent budget surpluses and stronger underlying growth indicators are promising. Connecticut never fully regained jobs lost from the Great Recession when the COVID recession hit; tax revenues throughout the 2010s reflected our lackluster growth. CT has now recovered 96.7% of jobs lost as a result of the COVID recession,

spread across high, medium, and low-wage industries. While there are many external factors also contributing to the budget surpluses in the state, the latest economic indicators also are showing resilience and strength compared to where they have been.

1 Fiscal Year runs from July 1 of the prior year to June 30 of this year; for example, Fiscal Year 2022 represents July 1, 2021 to June 30, 2022

2 Prior to transfers to/from the General Fund

3 See page 16, <https://portal.ct.gov/-/media/OPM/Budget/FiscalAccountability/OPM-2022-Fiscal-Accountability-Report.pdf>

4 See page 17, *ibid.*

GENERAL ECONOMIC INDICATORS

<i>(Seasonally adjusted)</i>	4Q 2022	4Q 2021	YoY CHG NO. %		3Q 2022	QoQ CHG NO. %	
General Drift Indicator (2007=100)*							
Leading	113.7	105.8	7.9	7.4	110.0	3.7	3.39
Coincident	95.6	95.1	0.5	0.6	95.6	0.0	0.01
Real Gross Domestic Product** (Millions of chained 2012 dollars)	3Q 2022	3Q 2021	YoY CHG NO. %		2Q 2022	QoQ CHG NO. %	
Connecticut	252,526	248,028	4,498	1.8	250,985	1,541	0.6
United States	20,054,663	19,672,594	382,069	1.9	19,895,271	159,392	0.8
New England	1,031,315	1,017,895	13,421	1.3	1,024,371	6,945	0.7
Per Capita Personal Income** (Current \$, SAAR)	4Q 2022	4Q 2021	YoY CHG NO. %		3Q 2022	QoQ CHG NO. %	
Connecticut	86,195	82,734	3,461	4.2	85,279	916	1.1
United States	66,944	63,626	3,318	5.2	65,851	1,093	1.7
New England	81,212	77,406	3,806	4.9	79,382	1,830	2.3
Philadelphia Fed's Coincident Index (2007=100)***	Mar 2023	Mar 2022	YoY CHG NO. %		Feb 2023	MoM CHG NO. %	
Connecticut	123.09	119.59	3.50	2.9	122.84	0.25	0.2
United States	137.45	132.36	5.09	3.8	137.03	0.42	0.3

Sources: *Dr. Steven P. Lanza, University of Connecticut, <https://steven-landa.uconn.edu/the-connecticut-green-sheet/>
U.S. Bureau of Economic Analysis *Federal Reserve Bank of Philadelphia

General Drift Indicators are composite measures of the four-quarter change in three coincident (Connecticut Manufacturing Production Index, nonfarm employment, and real personal income) and three leading (housing permits, manufacturing average weekly hours, and initial unemployment claims) economic variables, and are indexed so 2007 = 100.

The **Philadelphia Fed's Coincident Index** summarizes current economic condition by using four coincident variables: nonfarm payroll employment, average hours worked in manufacturing, the unemployment rate, and wage and salary disbursements deflated by the consumer price index (U.S. city average).