Response to Questions Regarding Testimony to the Spending Cap Commission (April 18, 2016)

Jesse Marks, Yale Law School Legislative Advocacy Clinic (on behalf of Connecticut Voices for Children) and Nick Defiesta, Associate Fiscal Policy Fellow

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Dear Co-Chair Cibes and Co-Chair Widlitz,

Thank you for the opportunity to testify at the Spending Cap Commission meeting on April 18. At that meeting, we received several questions to which we are now writing in response:

1. Mr. Shuldman asked whether we would consider the current spending cap "flexible" and whether such "flexibility" has caused Connecticut's current fiscal difficulties;
2. Ms. Bates asked whether we would include pensions and bonded debt under the spending cap;
3. Co-chair Cibes asked whether we would further distinguish between bonding for capital projects and bonding that would otherwise be categorized as "general budget expenditures"; and
4. Mr. Porth asked whether other states include capital gains in their calculations of personal income.

We have included responses to each question in the following paragraphs.

1.) **The current spending cap is both restrictive and ambiguous – the solution is more flexibility, clarity, and transparency**

As it stands, the spending cap accurately reflects neither our state's need for more public investments nor its ability to pay for them. In particular, the current interpretation underestimates personal income growth by not considering unearned income (and using an overly long look-back period), unnecessarily limits federal funds by counting some federal programs under the cap, and arbitrarily sets the budget "base" for a given year at the previous year's *actual* expenditures, rather than at levels *allowable* under the cap. All of these restrictions force lawmakers to do more with less, a problem that multiplies each year as authorized spending falls further and further behind the state's needs.

In addition to being restrictive, the current interpretation is also ambiguous. For example, the current does not specify 'increase in personal income,' 'increase in inflation,' and 'general budget,' as required by the amendment creating the constitutional spending cap.[1]

This restrictiveness and ambiguity has incentivized the legislature to use creative definitional interpretations and accounting techniques in order to pass budgets. In particular it has been common practice to use tax expenditures, state bonding, earmarked funds, lapses and carryforwards, and deferral of long-term pension obligations to fund government programs.[2]

Connecticut's spending cap needs to be redefined to accurately reflect the state's spending needs and its ability to mobilize resources. This will improve the state's long-term fiscal health without forcing lawmakers to use "creative" ways to make ends meet.[3]

2.) **Accrued pension debt and bonded debt should not fall under the spending cap**

Ms. Bates' question on pension liabilities and bonded debt need to be addressed separately.

i. Bonded Debt

With respect to bonded debt, neither debt incurred during a given year nor debt paid down should count against the cap.

As for debt incurred, we believe that bonding decisions are situationally dependent and therefore better left to the Finance Committee's discretion than to a blanket law. The optimal amount of bonding depends on what investments the state is considering in a given year. If chosen correctly, these investments should have a long-term impact on economic growth that more than offsets the cost of the debt incurred. The long-term time horizon of such investments makes a spending cap, designed to address operational spending in a given year, an inappropriate controlling mechanism.[4]

As for debt service, we believe that including it under the spending cap would unnecessarily constrain lawmakers' ability to fund the government while creating an incentive to continue to push the state's financial obligations further into the future. For lawmakers, spending today – particularly

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[1] This lack of definitions has also led the Attorney General to issue a formal legal opinion stating that the constitutional spending cap lacks legal effect until the General Assembly adopts such definitions by the required three-fifths vote of the members of each house. For the full legal opinion, see: http://www.ct.gov/ag/lib/ag/opinions/2015/2015-05_fasano_spending_caps.pdf

[2] For a thorough history of the spending cap and some of its structural ambiguities, please reference our report, *Coping With the Cap: A Primer on Connecticut's State Spending Cap and its Impacts*," available at: http://www.ctvoices.org/sites/default/files/bud07spendingcap.pdf. Although written in 2007, this report provides a detailed account of the failings of the spending cap – which are only more relevant today.

[3] In particular, we propose: (1) defining "general budget expenditures" as the amount *allowable* under the cap during the previous year, to ensure economic downturns do not irreparably harm public services; (2) excluding the first year of federal funds from the cap, and then including them in the budget base the following year; (3) expanding the definition of "personal income" to include all *unearned* income such as capital gains and dividends, to properly estimate year-to-year economic growth; and (4) establishing a more robust and regular evaluation process for tax expenditures so that annual off-the-books spending through our tax code – over $6.4 billion in the coming Fiscal Year – is appropriately assessed. For the full written testimony, see: http://www.ctvoices.org/sites/default/files/030516_approps_hb5086_spendcap.pdf

[4] Including new employee pension obligations under the spending cap does not appear to be up for debate, nor should it be – new employee obligations pale in comparison to the obligations already made for employees hired before 1984 ("tier 1") employees. The debate about the state's pension plan appears to be focused on paying off those obligations already made, with obligations to more recent hires a far smaller concern.

under tight spending cap – will almost always appear more attractive than paying down debt not due until after the next election cycle. We should not make that practice even more attractive.[5]

ii. Pension liabilities

Pension payments break down into two types, with different accounting treatments: current costs and accrued unfunded liability. Current costs refer to retirement benefits for current employees accrued during a given year. Payments are calculated for each employee based on factors such as expected years of service, expected future salary increases, and likely post-retirement longevity. These payments are part of annual employee compensation (both under current Connecticut accounting practices and Government Accounting Standards Board – GASB – standards) and would likely best fit under the spending cap.

Accrued unfunded liability, in contrast, is not a part of current year employee compensation. Rather, such liabilities require "catch-up" contributions to account for (a) mistaken forecasts of costs and interest rates and/or (b) failure to make full contributions in prior years. There is a growing consensus among actuarial services and ratings agencies to consider unfunded pension liabilities as state debt and payment of those unfunded liabilities as debt service.[6] Recently, GASB issued new rules that require that pension liabilities be included as a liability on balance sheets. As such, we believe both pension liabilities and payments against such liabilities should fall outside of the spending cap.[7]

3.) **Although we encourage lawmakers to avoid bonding for operational expenditures whenever possible, we do not recommend placing such bonding under the spending cap**

Finally, with regard to your question about distinguishing between bonding for capital projects and bonding for general budget expenditures under the spending cap, we believe that both should be excluded from the cap. Although we support the general principle that bonding should pay for long-

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5 As we've outlined in our recent report, *Arbitrary Austerity Harms Future Prosperity: Framing Connecticut's Long-Term Challenges and Opportunities*, Connecticut's bonded indebtedness and unfunded pension liabilities have increased dramatically over the past few decades. Counting payments against the spending cap will only make this problem worse. In that way, a spending cap designed to ensure that the state does not spend beyond its means could in fact create the conditions for a financial crisis later on. See our report, *Arbitrary Austerity Harms Future Prosperity: Framing Connecticut's Long-Term Challenges and Opportunities*: http://www.ctvoices.org/publications/arbitrary-austerity-harms-future-prosperity-framing-connecticut%E2%80%99s-long-term-challenges-

6 For instance, in April of 2013, Moody's Investor Service released its US States Rating Methodology in which it identified two components of debt: pension debt (that is actuarially accrued liabilities) and bonded debt. (See: Adjustments to US State and Local Government Reported Pension Data, April 17, 2013. Online at: http://www.moodys.com/viewresearchdoc.aspx?docid=PBM_PBM151398.) That same year, the New England Public Policy Center, a research unit of the Federal Reserve Bank of Boston, noted that some analysts choose to include unfunded pension liabilities when assessing state debt obligations because "pensions represent long-term obligations of state governments and, like bonded debt, enjoy strong legal protections." Research Report: Assessing the Affordability of State Debt, New England Public Policy Center Research Report 13-2, p 9 (December 2013). Online at: http://www.bostonfed.org/economic/neppc/researchreports/2013/neppcrr1302.pdf

7 The term "evidences of state indebtedness" needs to be read according to general principles of statutory interpretation. Sec. 1-1 of the Connecticut General Statues provides that: "In the construction of the statutes, words and phrases shall be construed according to the commonly approved usage of the language." So too the State Supreme Court has ruled repeatedly that statutory intent should be based on the plain words of the statute. See e.g., 168 C.112 (commonly approved meaning of "security" taken from dictionaries). Based on the plain words of the statute, and the commonly approved understanding of pension obligations, unfunded accrued liability falls within the term "evidence of indebtedness" and should be treated as debt without the need for any legislative change.

term capital investments rather than normal operating expenditures, we do not suggest complicating the spending cap with such a distinction. Doing so will inevitably lead to ambiguities in statutory interpretation, potentially with unintended results. Instead, we suggest leaving decisions on bonding to the Finance Committee. In turn, we encourage the Finance Committee to ensure that it maintains the long-term interest of Connecticut taxpayers in mind when making annual budgeting and bonding decisions.

4.) **Our research and consultation found that the vast majority of states include capital gains in their definition of personal income.**

According to the Tax Foundation[8], 41 states and the District of Columbia include a tax on capital gains, often as part of their personal income tax. Given that capital gains are an important part of state income across the nation (and, in particular, in Connecticut), their exclusion from the spending cap personal income calculation will result in a mismatch between true economic growth and state spending allowed under the cap. Recognizing that capital gains are an integral part of personal income — as policymakers in 41 states, including Connecticut, have done through their inclusion in the state tax structure — will ensure state spending capacity and statutory spending authority are better aligned.

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Thank you and the rest of the Spending Cap Commission for your consideration of the various options for refining the spending cap. Connecticut Voices for Children views such improvements to the current restrictive and ambiguous interpretation as one key ingredient in the long-term structural reforms required to help Connecticut out of this current era of disappointing economic and fiscal results and into an era of newfound prosperity. We look forward to continuing to work with you and the Spending Cap Commission in the coming weeks.

[8] Pomerleau, Kyle. The Tax Foundation. "The High Burden of State and Federal Capital Gains Tax Rates in the United States." March 24, 2015. Accessible at: http://taxfoundation.org/article/high-burden-state-and-federal-capital-gains-tax-rates-united-states