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Response to questions
Submitted by Suzanne Bates, Policy Director

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Thank for the chance to respond to questions posed during the public hearing.

As a frame for all of the answers to these questions, I first want to lay out a few assumptions that we are guided by. First, we assume that **the reason we have a spending cap is because taxpayers want limits on how much they are taxed.** This is as true for middle- and lower-income residents as it is for the wealthy.

When we talk about how much the "state" spends, and how much it will spend in the future, what we are really talking about is how much money the state collects through taxes on state residents. So the spending cap should act as a cap on tax increases as much as it is a cap on spending.

In addition, the spending cap – if applied correctly – can add a layer of **transparency** to state spending. Spending that is kept under the cap receives another layer of scrutiny, which should lead to greater confidence that it is spent on our top priorities.

By increasing confidence in spending choices, the spending cap – if applied correctly – should also limit the **risks** that lawmakers take when making policy and spending decisions. Knowing that spending increases can only grow at a rate that keeps pace with income growth or inflation, new programs and additional spending should receive greater scrutiny and be weighed against the risk to taxpayers.

1. Question: Should we include capital gains as a part of personal income growth definition?

Answer: No. This is a highly volatile source of income, and including it in the personal income calculation will lead to wild fluctuations in the amount of money available under the spending cap, making it more difficult to build and maintain a sustainable budget.[1]

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[1] See, for example, "Why Taxing the Wealthy Can Be Trouble for States," Stateline, Pew Charitable Trusts. http://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2016/03/08/why-taxing-the-wealthy-can-be-trouble-for-states

This year, Connecticut's 50 top taxpayers reported $3 billion less in earnings than a year ago, resulting in a loss of $217 million in tax revenue.[2] This is likely because some of the wealthiest taxpayers left Connecticut last year and were replaced by individuals with lower earnings, but also because realized capital gains were lower than usual because of stock market fluctuations.

The Bureau of Economic Analysis provides an explanation as to why the agency does not include capital gains in the definition of personal income:

> Why do the NIPAs exclude capital gains from income and saving?
> Capital gains differ from ordinary income in three important respects. They are less available to fund expenditures, because to spend a capital gain, the asset that has appreciated must first be sold. (A capital gain can sometimes be used indirectly to fund spending if the asset is pledged as collateral for a loan that is based on the value of the collateral.)
> Second, ordinary income is generally stable enough to view as a sustainable source of funds to meet expenses, but capital gains are volatile and not always positive. For example, in 2002, capital losses on stocks and mutual funds caused a decline in personal net worth that exceeded 20 percent of disposable personal income. A measure of saving that is stable and dependable is more meaningful for most purposes than one that is subject to wide, unpredictable fluctuations.
> Finally, adequate funding for investment is critical for a nation's future economic prospects, and the NIPA definition of saving is the appropriate one for measuring funds made available to finance new investment. Capital gains represent changes in the price of already-existing assets, but only an expansion of the real stock of assets via investment represents an increase in the wealth of a society. Unlike saving out of ordinary income, capital gains are not a source of funding for needed investment. A nation that does not save, as this concept is defined in the NIPAs, must either do without the investment needed to maintain or improve its standard of living, or it must depend on saving by other nations for the financing of its investment needs.[3]

The Budget Reserve Fund plan creates a better use for capital gains by funneling a portion of the tax payments from these gains into the reserve fund if they are over a certain threshold. This should be allowable under the spending cap, and is a better way to handle capital gains instead of using them to create space for additional spending increases.[4]

2. Question: Should we include the full cost of pensions under the spending cap?

Answer: Yes. Last year a simple majority of lawmakers voted to exclude accrued pension liabilities from the spending cap calculation. This is problematic for several reasons, the largest being the incentive this creates to underfund state pensions in the future. If

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[2] See http://ctmirror.org/2016/05/04/cts-top-taxpayers-took-a-big-earnings-hit-last-year/

[3] - See more at: http://www.bea.gov/faq/index.cfm?faq_id=67#sthash.e3CsV32s.dpuf

[4] For more information about the Budget Reserve Fund see http://www.osc.ct.gov/brf/

unfunded pension liabilities are allowed to again grow unchecked, Connecticut could find itself in the same disastrous situation we now find ourselves in.

In the past, union negotiators and former Connecticut governors agreed not to make full payments to the state employee and teachers retirement funds. This accounts for a portion of the state's unfunded pension liabilities. The rest of the liability comes from decisions that were made about the discount rates (currently 8 percent for SERS and 8.5 percent for TRS) and other actuarial assumptions used to calculate the annual contribution rate.

If state lawmakers want to continue to fund defined benefit pensions for state employees, they should make a concerted effort to make these benefits less risky for taxpayers. The enormous cost of our current pension liabilities, which will likely stay with us for decades, is something we need to make all efforts to avoid in the future. Moving pension liabilities out from under the spending cap will make them less transparent, which must be avoided, and will remove some accountability for their growth.

Question: Should we include debt service under the spending cap?

Answer: Yes. We already have a statutory cap on the amount we can borrow in a given year, but we do not cap debt service. This is one reason that debt service is one of the fastest growing parts of our budget. Connecticut has the most state bonded debt per capita in the nation. From 2008 to 2015, Connecticut's bonded debt increased by 39 percent.[5] If we continue to cap other spending but let debt grow unimpeded, it will push more current services spending into debt, creating even more problems for future taxpayers. By including only debt service under the cap, but not the debt itself, this gives the state room to borrow more when rates are low and another reason to borrow less when rates are high.

Question: Should we lower the discount rate on SERS and TRS to 5 percent?

Answer: Yes. This represents a safe discount rate in the current market environment. The current discount rates of 8 percent for SERS and 8.5 percent for TRS have led to higher liabilities even as the state increases its payments into these systems. If, as a public policy decision, Connecticut continues to offer and fund defined benefit plans for state employees, these plans must be fully funded up front so as to lesson the risk for future taxpayers.

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[5] See "Maxed Out: Connecticut's Debt Problem" http://www.yankeeinstitute.org/wp-content/uploads/2016/04/Maxed-Out-Policy-Brief.pdf