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Testimony of

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to

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Spending Cap Commission
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My name is Elizabeth McNichol. I'm a senior fellow with the State Fiscal Project of the Center on Budget and Policy Priorities in Washington DC. The Center, located in Washington, DC, is a leader in analyzing a broad range of budget and policy issues that affect low- and moderate-income families and individuals in the United States. The Center's State Fiscal Project prepares analyses and provides technical assistance on state tax and budget issues. We have extensive experience analyzing state tax systems in terms of their impact on fiscal stability and their impact on low- and moderate-income residents.

For a number of years I have been studying Connecticut's spending cap. I appreciate the opportunity to share some of my observations and I'm sorry I cannot be with you in person.

Since 1992, Connecticut's budget has been subject to a spending cap. By now the state has had considerable experience with the cap, and some clear patterns have emerged that raise questions about the design of the spending cap. The spending cap has limited the ability of the state to make the public investment needed to promote broad prosperity in in the aftermath of recessions, made public understanding and oversight of the budget more difficult, and reduced the state's ability to set priorities.

Some steps that the state could take to mitigate the undesirable consequences of the spending cap include:

- Use allowable spending rather than actual spending as the base for spending cap calculations.
- Exclude the first year of new and significantly expanded federal spending from the spending cap and then add this to the base.
- Change the definition of personal income to include capital gains income.

- Adjust the number of years used to determine average personal income growth.
- Define general expenditures to include some or all of spending from budget surpluses in the base for spending cap calculations.
- In addition, Connecticut should continue to exclude payments made to reduce the unfunded pension liability under the debt exclusion.

Background

The years following the 2007 – 2009 recession highlight some of the problems with the cap's design. Public investments in education, health care, and transportation are critical to Connecticut's economic recovery. With the state's economy growing, the years following the recession should have provided an opportunity for these investments to be made. The design of Connecticut's cap, however, means that it did not reflect the change in the state's fortunes.

This lack of connection between a state's economic fortunes and the workings of a spending or tax limitation is not unique to Connecticut. Tax or spending limits that operate by applying an allowable growth rate to spending in the prior year — as Connecticut's does — end up "ratcheting down" during economic downturns. This happens because the rate of allowable budget growth is applied to a level of spending that was reduced because of lower revenues. This means that even when the immediate fiscal crisis caused by an economic downturn passes the state can't fully restore services to pre-recession levels. This prevents important needs from being met and crucial public investment from taking place. The design of Connecticut's spending cap compounds this problem by tying allowable growth in the current budget to economic conditions from a number of years ago.

The public has recognized this problem in many states. For example, after the 2001-03 recession, voters in Colorado acted to suspend their state's TABOR limit for five years to address this problem. In addition, attempts to institute new tax or spending limits failed in recent years in New Hampshire, Florida, Washington, and Maine in part because of concerns about the inflexibility of the limits.

The design of Connecticut's spending cap makes the ratcheting down problem particularly acute as you can see by examining the details of the cap. A spending cap has two key elements – the growth rate allowed – and the base to which the growth rate is applied.

The base of Connecticut's spending cap is the prior year's appropriated funds minus these exemptions — payments for debt service and unfunded pension liabilities, grants to distressed municipalities, and new federal mandates and court orders. This base is multiplied by the allowable spending growth rate in order to determine the year's allowable spending increase. In Connecticut, the allowable spending growth rate is defined as the average annual growth in personal income for the preceding five years. Connecticut is one of only two states that uses an average computed over this long a period. Calculations based on one or two years are typical.

One reason the allowable growth has been so low in recent years is the formula used to calculate the rate. Tying the growth in the cap to growth in personal income is meant to ensure that state government can grow at the same rate as the economy, without consuming a larger share of the economy over time. Under the current method of calculating allowable growth, however, the years used to determine allowable growth have little to do with the *actual* growth in the economy during the budget year under consideration. Sometimes the allowable growth is considerably lower than actual growth, sometimes considerably higher. The lag in the years used to calculate the growth factor virtually guarantee that allowable growth will be less than actual growth in the years just after an economic downturn — a time when states generally attempt to restore spending cut during economic downturns. So the state's ability to make public investments that help communities thrive will always lag.

In addition, using personal income as the base for calculating allowable growth excludes a major source of income in Connecticut – realized capital gains.

As a result, Connecticut's spending cap is often overridden. There are a number of ways the cap can be overridden — both official and unofficial ones. The spending cap statute includes provisions for spending more than the cap allows when the governor declares an emergency or the existence of extraordinary circumstances and at least three-fifths of each house of the legislature concur.

In addition, to stay within the technical boundaries of the cap and still meet demands for state services the state has employed some budgetary "gimmicks." These strategies reduce budget accountability by removing significant parts of the state budget from the legislative and public oversight of the appropriations process —worsening rather than improving the state's fiscal integrity. In some cases the state has borrowed to fund ongoing programs outside of the appropriations process, since only appropriated funds are subject to the cap and debt service payments are exempt from the cap. In addition, when the budget is close to or at the cap, the state has relied on so-called "revenue intercepts" which direct revenue sources to particular purposes, avoiding the need for annual appropriations. The state has also increasingly used tax credits and exemptions to accomplish policy goals rather than spending programs. These are also ways of overriding the cap — without an official declaration.

The fiscal year 2015 budget provided a clear example of problems with the design of Connecticut's spending cap. For fiscal year 2015, the years that were used to determine the allowable growth rate were 2009 through 2013. The beginning of this period includes years when the state's economy – and therefore personal income -- was hit hard by the Great Recession. As a result, allowable growth for fiscal year 2015 was only 1.7 percent. This would have greatly hampered the state's ability to address its needs. In the end, changes in how Medicaid funds are appropriated allowed for additional growth under the cap.

In the past, there have been similar situations when the retrospective nature of the personal income calculation has resulted in low allowable growth at times when the state economy and state revenues are growing at an average or above average rate. In many of these situations, the state has spent more than the cap would have allowed. For example, between 1992 and 2007 Connecticut's personal income growth was above average in seven years. In all but one of those years, the spending cap was overridden after a declaration by the governor.

Once the state has decided to exceed the cap, a decision must be made about whether to include the spending that is above the cap in the base for the following year's cap calculation. When the additional spending is for programs that will continue beyond one budget year, adjusting the base reflects the reality that these programs must be maintained at this higher level of spending to maintain needed services in subsequent years.

Often, the state did not acknowledge the ongoing nature of many of these obligations by adjusting the base of the cap to include this spending. When the base of the cap is not adjusted, the state is faced with either reducing funding for these initiatives after one year or cutting back on other programs in order to keep the budget under the spending cap in the following year.

Regular reliance on override mechanisms rather than the normal budget process reduces the amount of oversight by the legislature and the public. Rather than increasing accountability, this reduces public oversight of budget decisions.

The definitions of personal income growth and general expenditures that this commission is tasked to recommend could be designed to address some of the problems with that Connecticut's experience with the spending cap has revealed. Some alternatives are discussed below.

Use allowable spending rather than actual spending as the base for the cap calculation

One way to address the ratcheting-down problem that occurs during fiscal downturns is to maintain the base of the spending cap at the level that would have been allowed each year. This would leave room under the cap for restoring spending to pre-recession levels once the state's economy recovers.

Exclude the first year of new federal spending from the cap

The spending cap was never intended to restrict additional revenue coming in from the federal government. Yet when the state is close to the spending cap limit, the cap discourages the state from accepting new federal revenue. In this situation, the state is forced to cut other programs in order to make room under the cap for the federally-funded program.

The state exempts spending required by federal mandates and court orders from the cap for one year. Exempting all new federally-funded spending from the cap for one year would enable Connecticut to capture new federal revenues and reduce the amount of state revenue it needs. (To get the most benefit from this change, the state would need to include federal revenues that enable the expansion of existing programs in its definition of "new" federal funds.)

Use Adjusted Gross Income rather than personal income

Connecticut uses the Bureau of Economic Analysis (BEA) data on personal income to determine allowable growth. BEA personal income does not include the value of realized capital gains. Capital gains, however, are a relevant measure of the aggregate ability of state residents to pay taxes and are included in the state's income tax base. Including this income would better reflect the state's economic growth. Using Adjusted Gross Income as the measure of income growth rather than personal income would be one way to account for capital gains growth.

Use current personal income rather than the lagged 5 year average

Using the projected growth in personal income for the coming budget year, rather than the lagged average, as is done now, would result in a much better match between allowable growth and growth in the state's economy and ability to pay.

One potential problem with using an estimate rather than actual personal income to calculate allowable growth is that the projection could change after the budget is adopted. However, there are ways to address this issue. If economic growth is significantly slower than projected, the state could revisit the budget, as it currently does because slower economic growth generally means slower revenue growth and some adjustments may be required. If, however, economic growth is higher than projected, two responses are possible: either end the budget year with a surplus, or adopt the higher figure as the new spending cap and create more flexibility in deciding the disposition of additional revenues.

Include some or all of spending from budget surpluses in the base

In some years the governor and the General Assembly determine that the state must spend more than the cap allows in order to fund needed services. When this happens a decision must be made about whether to adjust base spending under the cap to reflect this additional spending going forward.

When the additional spending is for programs that will continue beyond one budget year, adjusting the base reflects the reality that these programs must be maintained at this higher level of spending to maintain needed services in subsequent years.

When the state does not adjust the cap to acknowledge the ongoing nature of these obligations, the state is faced with either reducing funding for these initiatives after one year or cutting back on other programs in order to keep the budget under the spending cap in the following year.

In conclusion, experience shows that the spending cap has weakened rather than improved Connecticut's fiscal accountability and ability to plan. Changing the cap to more accurately reflect the reality of the state's economy and spending needs would result in greater ability to meet the state's needs and a more transparent and accountable budget process.