

Spending Cap Commission

Established pursuant to Section 24 of PA 15-1 (December Special Session)

January 20, 2017

To:

Committee on Appropriations and the Budgets of State Agencies
Committee on Finance, Revenue and Bonding
Committee on Government Administration and Elections

Cc: Clerk of the Senate
Clerk of the House of Representatives
Office of Legislative Research
State Librarian

We are sending you, as attachments, a complete set of reports and separate statements produced by members of the Spending Cap Commission.

This set includes:

- Letter of the Co-Chairpersons transmitting their Report.
- Report of the Chairpersons
- Senate Republican Report on the Spending Cap Commission
(Separate Statement by Sen. Frantz, Sen. Kane, and Sen. McLachlan)
- A Statement from Like-Minded Members of the Spending Cap Commission
(Separate Statement by Rep. Ziobron, Rep. Davis, Rep. Smith, Mr. Shuldman, and Ms. Bates)
- Separate Statement of Mr. Cibes

Please note that there is no official report of the Spending Cap Commission, because it was unable to agree on a set of recommendations for defining "increase in personal income," "increase in inflation," and "general budget expenditures." Instead, the chairpersons are submitting their report, and various members, as agreed, are submitting "separate statements."

We wish to thank the members of the Commission for their dedication to the work of the Commission.

We hope that their work will be helpful to the General Assembly as it seeks to adopt a statutory spending cap which implements the constitutional spending cap embodied in Article III, Section 18 b. of the Connecticut Constitution.

Respectfully submitted,



Patricia Widlitz
Co-Chairperson



William J. Cibes, Jr.
Co-Chairperson

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We regret to inform you that the Spending Cap Commission was unable to agree on a unified set of recommended definitions for "increase in personal income," "increase in inflation," and "general budget expenditures," as it was charged to do in Section 24 of PA 15-1 (December Special Session).

However, the Commission did undertake extensive deliberations which canvassed a wide range of alternative components of these definitions. It took seriously the charge it had been given: it met 20 times over a period of 10 months, and conducted public hearings in each of the five congressional districts. It requested and received detailed analyses of topics from many experts, and diligently reviewed a multitude of alternative definitions.

The Commission, in preliminary votes, did tentatively approve definitions of "increase in inflation" and "increase in personal income," as well as a number of components that it thought should be included in a definition of "general budget expenditures." Although it was unable to agree on an overall report that combined these tentative recommendations into a final product, we believe that these individual elements merit the consideration of the General Assembly as it seeks to fulfill its constitutional responsibility to implement the provisions of Amendment 28 of the Connecticut Constitution.

Accordingly, although there are no official recommendations, the co-chairpersons are submitting the attached report, in order to document the work of the Commission.



Patricia Widlitz
Co-Chairperson



William J. Cibes, Jr.
Co-Chairperson

Report of the Chairpersons

Spending Cap Commission

Established pursuant to Section 24 of PA 15-1 (December Special Session)

Patricia Widlitz
Co-Chairperson

William J. Cibes, Jr.
Co-Chairperson

Submitted January, 2017

To

Committee on Appropriations and the Budgets of State Agencies

Committee on Finance, Revenue and Bonding

Committee on Government Administration and Elections

Report of the Chairpersons Spending Cap Commission

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Report of the Chairpersons Spending Cap Commission

Executive Summary, Part 1.

Provisional Recommendations

Members of the Commission agreed early in their deliberations that they would consider a wide range of options for the three definitions which they had been charged with recommending, and that they would vote preliminarily and tentatively on the options which appeared to have support. But they also agreed that these votes would be provisional in nature, subject to revision in a final vote on the Commission's complete set of recommendations.

In the end, despite extraordinary efforts to find a broad consensus, the Commission was unable to agree on an overall report that combined these tentative recommendations into a final product.

However, we believe that the General Assembly would benefit from the exhaustive analysis of the various options considered by the Commission, as it proceeds to grapple with adopting a statute to implement, by 3/5 vote, the constitutional spending cap.

The following table reports the individual components of recommendations which received majority support, on a preliminary basis, of the Commission. The Full Report provides detailed background and commentary, keyed to this table, on these tentative recommendations.

A.		"Increase in personal income" means the compound annual growth rate of personal income in the state over the preceding five calendar years, calculated using data reported by the United States Bureau of Economic Analysis. (as revised by LCO)
B.		"Increase in inflation" means the increase in the consumer price index for all urban consumers, all items less food and energy, during the preceding calendar year, calculated on a December over December basis, using data reported by the United States Bureau of Labor Statistics. (as revised by LCO)
C.		"General budget expenditures" means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided
	C.1.	(1) general budget expenditures shall not include
	C.1a.	<ul style="list-style-type: none">expenditures for payment of bonds, notes or other evidences of indebtedness,

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	C.1b.	<ul style="list-style-type: none"> • expenditures pursuant to Section 4-30a,
	C.1c.	<ul style="list-style-type: none"> • the expenditure of any federal funds granted to the state or its agencies,
	C.1d.	<ul style="list-style-type: none"> • expenditures for statutory grants to distressed municipalities,
	C.1e.	<ul style="list-style-type: none"> • expenditures by the state or any of its agencies of gifts, grants, contributions, trust income or other aid from private sources or foundations which have been given for restricted purposes specified by the donors of such funds,
	C.1f.	<ul style="list-style-type: none"> • expenditures supported by revenues which have been statutorily set aside for specific purposes in a dedicated fund or separate, nonlapsing account created by the General Assembly,
	C.1g.	<ul style="list-style-type: none"> • for each fiscal year through the year ending June 30, 2022,¹ annual expenditures for the payment of the portion of the actuarially determined employer contribution representing the unfunded liability, for that fiscal year, of the teachers' retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission,
	C. 2.	and (2)
	C.2a.	(a) expenditures for the implementation of court orders (including agreements or stipulations approved by the General Assembly pursuant to Sections 3-125a and 4-160 of the General Statutes) shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized or increased, but shall be considered general budget expenditures for the purposes of determining general budget expenditures for the ensuing fiscal year,
	C.2b.	(b) state expenditures required to be eligible for receiving federal funds which are mandated or which the General Assembly has voted to accept, including any increase in such expenditures required as a result of changes in the required state contribution to meet federal entitlement and eligibility criteria in order to receive federal reimbursement, shall not be considered general budget expenditures for the first fiscal year in which such expenditures are required or increased, but shall be considered as general budget expenditures for

¹ If there is a negotiated change in the projected ramp-up period, this date – and the July 1 date below – may need to be changed.

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		such year for the purpose of determining general budget expenditures for the ensuing fiscal year, and
	C.2c.	(c) expenditures on or after July 1, 2022, for the payment of the portion of the actuarially determined employer contribution of the teachers' retirement system or any retirement system or alternative program administered by the State Employees Retirement Commission representing an increase in the unfunded liability attributable to changes in actuarial assumptions or cost methods for such system or program shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year.

Executive Summary, Part 2.

Suggested Additions and Modifications

As part of the deliberative process, there were also suggestions for modifications of the provisions detailed above for components of the definition of “general budget expenditures.” The Chairpersons agreed that these modifying suggestions would be incorporated into the report.

These include:

Proposed modification of Component C.1d: “distressed municipalities”

During the deliberation of the Commission concerning Component C.1d., several members suggested that there should be an explicit limitation on the number of distressed municipalities, and that the General Assembly should specifically define the criteria which determined “distressed.” Hence this proposed modification:

“General budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- expenditures for statutory grants to the 25 most distressed municipalities as defined by criteria adopted by the General Assembly,**

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Proposed addition to Component C.1g: “exemption of unfunded pension liability”

As part of the discussion surrounding Component C.1g., some members pointed out that it was important to provide for a transition from the period when these expenditures would not be included in the cap to the first year of the period when they would be fully under the cap. The chairpersons agreed to include such a recommended provision in their report. Accordingly, it was suggested that the following additional language be appended to the end of the language of Component C.1g which had been tentatively approved:

“provided that the portion of the full unfunded liability for these systems for FY 2022 shall be considered as general budget expenditures for FY 2022 for the purpose of determining general budget expenditures for FY 2023.”

so that, in full, Component C.1g. would read:

“general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- for each fiscal year through the year ending June 30, 2022,² annual expenditures for the payment of the portion of the actuarially required employer contribution representing the unfunded liability, for that fiscal year, of the teachers’ retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission, provided that the portion of the full unfunded liability for these systems for FY 2022 shall be considered as general budget expenditures for FY 2022 for the purpose of determining general budget expenditures for FY 2023.**

Proposed modification of Components C.1g. and C.2c: “phase-in the full unfunded pension liability”

In an effort to develop an overall consensus, the Chairpersons also recommended a modification of Components C.1g. and C.2c. -- which would provide for an incremental phase-in of the exemption of the unfunded pension liability, so that the full portion of the actuarially determined employer contribution of the unfunded portion of the pension liability would gradually be brought under the cap – as follows:

² If there is a negotiated change in the projected ramp-up period, this date – and the July 1 date below – may need to be changed.

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“General budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **for each fiscal year beginning July 1, 2017, through the fiscal year ending June 30, 2022, annual expenditures for the payment of the portion of the actuarially determined employer contribution representing, respectively, 100%, 80%, 60%, 40%, and 20% of the increase in the unfunded liability, for that fiscal year, of the teachers’ retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission *provided that the portion of the full unfunded liability for these systems for FY 2017 shall be considered as general budget expenditures for FY 2017 for the purpose of determining general budget expenditures for FY 2018,*³**

and (2)

(c) expenditures on or after July 1, 2019, for the payment of the portion of the actuarially determined employer contribution of the teachers’ retirement system or any retirement system or alternative program administered by the State Employees Retirement Commission representing an increase in the unfunded liability attributable to changes in actuarial assumptions or cost methods for such system or program shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year.

Additional recommendation concerning Component C.1c: “federal funds”

Finally, the Chairpersons recognized that, with respect to Component C.1c. (receipt of federal funds), removing all federal funds from the scrutiny of the appropriations process⁴ may well make the use of these funds less transparent to both legislators and citizens, who should be able to track these funds and their uses, so that input and oversight can be provided. Accordingly, although it is outside the charge of this Commission, the Chairpersons recommend, as suggested by the Fiscal Policy Center at Connecticut Voices for Children, that **all federal funds “that can be forecast should be enumerated clearly in the budget document and receive a public hearing alongside appropriated funds.”** A single, separate “Federal Fund” which would include all federal funds received by the state would make it easier to identify them as federal funds, indicate how they related to the operation of state agencies,

³ The italicized language was added subsequent to the presentation of this recommendation to the Commission

⁴ If this component is incorporated into the definition of general budget expenditures, federal funds would be in non-appropriated accounts.

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and focus attention on the overall impact of federal funds (and their potential increase or decrease) on the state budget.⁵

Full Report

Introduction

In the narrative that follows, we transmit those individual elements each of which was tentatively approved by members of the Commission during its deliberations, together with background explanation, analysis and commentary prepared by the Co-chairpersons of the Commission. In addition, we raise additional recommendations – together with language and explanations -- for your consideration, some of which involve a modification proposed by the Co-chairpersons in an effort to secure a broader consensus on the issue of unfunded pension liabilities.

Several members of the Commission took exception to the process whereby the Commission considered, step-by-step, potential individual elements that would ultimately be combined in a comprehensive set of recommended definitions that would receive a final overall vote. They expressed their preference that the Commission not take a “piecemeal” approach to arrive at an overall set of recommendations. They would rather have had the Commission start with a comprehensive set of definitions, and negotiate individual elements “in” or “out.” Because such a process would have been an extremely complex undertaking, it was decided to take a series of provisional votes on proposed individual components, with the understanding that a comprehensive cumulative version of these components would be subject to a final vote of the Commission.

We wish to re-emphasize that our reports on these votes on various components of the three definitions before us do not in any way imply that these are final decisions by the Commission. During our proceedings, we continually stressed that votes that were taken were preliminary and tentative in nature, subject to revision in a final vote on our overall recommendations.

As we have observed above, that final vote failed.

Nevertheless, we believe that information from the Commission’s deliberations might be of value to the General Assembly as it grapples with adopting a statute to implement the constitutional spending cap.

⁵ Wade Gibson, “Removing the Quirks in Connecticut’s Treatment of Federal Funds,” Fiscal Policy Center at Connecticut Voices for Children, October 2013, <http://www.ctvoices.org/sites/default/files/bud13federalfunds.pdf>

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General Perspectives: Background

As we approached the charge that the Commission had been given, we adopted the following two general perspectives:

First, we believed that the Commission had broad discretion in proposing the elements of the three definitions we were charged with recommending. The proponents of the constitutional cap in the General Assembly in 1991 were very clear about two things:

- When the General Assembly was charged with defining three terms, there were no parameters placed on its discretion,⁶ and
- Future General Assemblies might well alter the definitions to adapt to new circumstances.

With respect to the first point, Rep. McNally and Rep. Maddox – both proponents of the constitutional cap – agreed that when a statutory cap was enacted, the legislature “could make it as broad or narrow as we would like.”⁷ Rep. McNally later reiterated that “general budget expenditures are left for future definition. That could include whatever . . . three-fifths of both Chambers of the General Assembly define it as.”⁸

Second, in the Senate debate on the constitutional cap, leading proponents of the resolution clarified that not only were there exclusions from the spending cap other than the payment of bonds, notes and other evidences of indebtedness – such as those contained in the language of the statutory cap concurrently under consideration – but that future legislatures might well add other provisions: Sen. Herbst gave a terse, definitive answer of “yes” when asked by Sen. Fleming:

“So, . . . you would anticipate that at some point in time the legislature would have to in the definition, when they come up with their definitions of general budget expenditures provide for some types of exclusions from the cap other than the expenditures for the payment of bonds?”⁹

These remarks by the proponents of the constitutional cap provided context for our deliberations. The Commission agreed, midway through our discussions, on a menu of options to be considered that was very wide-ranging; the possible options were certainly not limited to the exclusion of bonds by the constitutional language, or even limited to the exclusions delineated in the statutory language of Section 2-33a.

⁶ Except, of course, “general budget expenditures shall not include expenditures for the payment of bonds, notes, or other evidences of indebtedness.”

⁷ Debate on HJR 205, A Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, House of Representatives, July 1, 1991, transcript, pages 800-801.

⁸ House debate, *op. cit.*, page 804.

⁹ Debate on HJR 205, A Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, Senate, August 21, 1991, transcript, page 206. See also comments by Senator Spellman, transcript, pages 197-198.

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General Perspectives: Emerging Framework

As we proceeded, it seemed to us, as chairpersons, that the following elements of a conceptual framework emerged from our discussions and preliminary, tentative votes:

- The Commission should seek to provide recommendations for definition of the three spending cap items in question which would in good faith implement the constitutional spending cap by enhancing fiscal responsibility in the state, holding the growth in spending under the cap to the increase in personal income of the state's residents, but providing for some reasonable exceptions to the cap.

This, after all, was what the 1991 General Assembly – which sent the constitutional amendment to the voters – did in concurrently adopting Section 2-33a, the original statutory spending cap. See above text at notes 6-9.

- Based on the discussions and outcomes of provisional votes, many – although not all – members of the Commission seemed to believe that:
 - The spending cap does not stand alone, but works in conjunction with both the balanced budget requirement and the budget reserve fund to control the growth of the state budget and to help the state maintain a balanced budget through economic downturns;
 - It became apparent during our discussions that in many circumstances, the balanced budget portion of Amendment 28 [Section a of Amendment 28] has been and frequently will be the operative effective cap on expenditures. Even if the spending cap permitted spending up to a certain level, lack of sufficient revenue to pay for that level of spending would mean that the projected expenditures must be reduced. This proved to be the case, for example, in FY 2017.
 - This might well mean that the legislature must develop additional tools to make sure that even uncapped expenditures are within available revenue, such as, for example,
 - ❖ developing legislative procedures to carefully scrutinize tax expenditures to make sure that revenue is not unduly reduced by their implementation
 - ❖ developing legislative procedures to limit bond authorizations in order to make sure that debt service does not require so much revenue that both capped and uncapped spending programs are shortchanged.
 - The spending cap is not intended to limit the ability of the state to accept federal, philanthropic or other funds available to improve economic competitiveness and equitable opportunities in the state.
 - Although the spending cap should require the state to establish priorities for its expenditures, the spending cap is not intended to erect such a barrier so high

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that it would prevent the state from meeting the legitimate needs of its residents.¹⁰

- The spending cap is not intended to prevent the state from making strategic investments in economic growth strategies to improve the state's economic competitiveness, including investment in infrastructure, workforce development and adequate education (the last of which is a non-delegable constitutional responsibility of the state¹¹).
 - The spending cap should not impose greater limits on certain economic growth strategies, such as the investment in quality education for all students, over other strategies (such as tax expenditures which are wholly outside of the limits of the spending cap).
 - The spending cap is not intended to result in the unreasonable devolution of costs to the local level, especially to those municipalities which have insufficient resources to meet their objectively-measured needs.
 - The spending cap is not intended to prevent the state from meeting the long-term obligations of the state in a stable and predictable manner, such as to avoid the need for massive tax increases in future years if obligations are unduly deferred.¹²
 - Given the fiscal exigencies facing the state, an excessively stringent cap may be unrealistic: as the Fiscal Accountability Report for FY 2017 to FY 2020 presented by OPM has recently demonstrated, it is likely that the spending cap would permit an increase in capped expenditures of about \$300 million in FY 2018,¹³ but fixed costs alone (for both capped and uncapped expenditures) might require an increase of greater than \$1 billion.¹⁴ The increase in the expenditures required for payment of the portion of the actuarially determined employer contribution representing the unfunded pension liability of the Teachers Retirement System alone would almost exhaust the projected cap.
- In short, the definitions required by the constitutional amendment should be tailored for the times, as the 1991 General Assembly recognized in the debate on the constitutional amendment.

General Perspectives: The Existing Statutory Spending Cap has been Effective.

We first observe that the statutory spending cap enacted in 1991 – Section 2-33a of the General Statutes – has been remarkably effective in limiting the growth of state

¹⁰ The constitutional spending cap itself permitted the existence of an emergency or extraordinary circumstances, upon declaration by the Governor and approval of the General Assembly, to justify exceeding the cap.

¹¹ As was asserted by Judge Moukawsher in his Superior Court decision in *CCJEF v. Reil*, September 7, 2016.

¹² See the discussion of unfunded pension liabilities, in later sections of this report.

¹³ OPM Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, page 16, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

¹⁴ OPM, Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, page 5, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

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expenditures. Despite assertions to the contrary¹⁵, total expenditures in all appropriated funds – even though some of those expenditures have been in uncapped categories –

¹⁵ A widely-repeated assertion is that, over the period from FY 1992 through FY 2015, lawmakers failed to adhere to the cap, and that the state could have saved a cumulative “\$5.2 billion had lawmakers kept spending under the cap.” See Yankee Institute Policy Brief, “Sustainable Spending: Respect the Cap,” (January 2015), at page 4. Available on the Commission’s website at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/Yankee%20Institute%20Policy%20Brief%20Sustainable%20Spending.pdf This Policy Brief was also apparently the basis of testimony to the Commission on September 7, 2016, that “if the cap had been faithfully observed since 1992, cumulative state spending would have been reduced by as much as \$5.5 billion.” “Jim Smith Testimony,” page 6, at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20160907/Jim%20Smith%20Testimony.pdf Efforts to verify the numbers presented in the Policy Brief, however, have proved fruitless. Indeed, the numbers appear to be flatly contradicted by the annual calculations of the Office of Fiscal Analysis, which determines if appropriations comply with the provisions of the statutory spending cap. As reported in the annual OFA Budget Books, available at <https://www.cga.ct.gov/ofa/add-bb.asp>, total original appropriations each year for the period examined by the Policy Brief have been under the cap by the amounts shown in the following table, with the exception of those years in which Governors Rowland and Rell made proclamations of extraordinary circumstances, proclamations approved by the requisite 3/5 vote of the General Assembly, pursuant to the explicit terms of the constitutional spending cap, resulting in revised appropriations. Part of the reason for the divergence between the Policy Brief numbers and the OFA data appears to be that the Policy Brief failed to observe that the constitutional language permits exceeding the cap in the event of extraordinary circumstances.

Year	\$ amount <u>under</u> the cap (millions) (original approp.)	\$ amount <u>under</u> the cap (millions) (revised)	
FY 93	N.A.	N.A.	
FY 94	50.3	50.3	As revised
FY95	26.4	53.4	
FY 96	84.8	84.8	
FY 97	212.0	212.0	
FY 98 *	0.4	194 over	“extraordinary circumstances”
FY 99 *	82.3	525.7 over	“extraordinary circumstances”
FY 00 *	68.6	498.3 over	“extraordinary circumstances”
FY 01 *	49.4	608.1 over	“extraordinary circumstances”
FY 02	78.17	78.17	
FY 03	62.97	376.1	As revised
FY 04	356	122.9	
FY 05 *	129.1	370.8 over	“extraordinary circumstances”
FY 06 *	24.4	394.5 over	“extraordinary circumstances”
FY 07 *	4.0	497 over	“extraordinary circumstances”
FY 08 *	690.4 over	690.4 over	“extraordinary circumstances”
FY 09	79.6	4.9	As revised
FY 10	840.9	840.9	
FY 11	338.1	338.1	As revised
FY 12	1.0	1.0	
FY 13	142.2	142.2	

(footnote continued: see references to *)

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have, since the statutory cap was enacted, grown less than permitted by the greater of the increase in personal income or the increase in inflation.

Information was presented to the Commission that the compound annual growth rate of the appropriate metric (either personal income or inflation) as defined in Section 2-33a over the 25 year period from FY 1992 through FY 2017 was 4.29%.

But the compound annual growth rate of appropriated funds over this period of time, including both capped and uncapped expenditures (but excluding federal Medicaid funds¹⁶) was only **4.19%**.¹⁷

This rate of increase is in remarkable contrast to the compound annual growth rate of appropriations – **10.96%** – during the period from FY 1980 to FY 1991, before the enactment of the statutory cap and the adoption of the constitutional amendment.¹⁸

What factors explain this success?

Potential reasons include:

- The General Assembly and the Governor consistently followed Attorney General Blumenthal's formal opinion in 1993 that Section 2-33a, even though not adopted by the requisite 3/5 vote specified in the constitutional amendment, should be treated as the operative requirement until it was amended by 3/5 vote.
- Some capped expenditures have grown more slowly than the rate permitted by the cap – thus leaving room under the cap for increases in other spending.
- On the other hand, the stringency of the cap has led policymakers in some years to defer some required expenses to future years – for example: not funding the full actuarially determined employer contribution, or redefining the value of assets

* Fiscal Year in which the Governor proclaimed the existence of extraordinary circumstances, approved by 3/5 vote of the General Assembly. Note that in most years, if not all, the existence of surplus revenue was cited as the reason for permitting the cap to be exceeded.

¹⁶ For FY 2014, the General Assembly determined to follow the lead of all other states and exclude federal Medicaid grants from state appropriations. To avoid biasing the calculation of growth in appropriated funds by excluding those funds now, while including them before the changeover, the Commission requested OPM to recalculate appropriations growth over the 1991 to 2017 period by excluding the Medicaid funds for all years. In the vernacular, this meant comparing apples to apples. This recalculation is the basis for the compound annual growth rate reported in the text.

¹⁷ Data concerning the compound annual growth rate of the spending cap and total appropriations are from OPM's spreadsheet, which may be accessed at the Commission's website at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20160815/History%20of%20Spending%20Cap%20from%20OPM%20-%20Updated%20for%20FY%2017.pdf

¹⁸ Data from the FY 1991-92 and FY 2004-05 Budget Books (pages ix and 47, respectively), available on the OFA website at <https://www.cga.ct.gov/ofa/add-bb.asp>

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(as in SEBAC IV and V), thus decreasing the required amount of the actuarially determined employer contribution, so as to “kick the can down the road.”

- Some expenditures previously funded through appropriations have been moved to non-appropriated accounts or bonded.
- And although on at least 7 occasions, affecting 8 fiscal years, Governors Rowland and Rell, with the required legislative supermajority, made a declaration of extraordinary circumstances which bypassed the spending cap, the resulting amount of expenditures, over time, did not contribute to exceeding the CAGR of personal income (and one year of inflation).

Because of the relative success of Section 2-33a in controlling spending, it did not seem unreasonable to parallel the language of this statute in attempting to make recommendations for a new statutory spending cap.

The Heart of the Report:

tentative recommended language, and commentary, for the three definitions for which the Commission was charged with making recommendations.

A. Increase in Personal Income

The Commission first turned to consideration of a definition for “increase in personal income.” After exploring various aspects of this issue, the Commission voted preliminarily and tentatively, but unanimously, (17 yea, 0 nay) to support the following recommendation:

“Increase in personal income” means the compound annual growth rate of personal income in the state over the preceding five calendar years, calculated using data reported by the United States Bureau of Economic Analysis. (as revised by LCO)

Commentary:

I. Calculating “increase in personal income.”

The language regarding “increase in personal income” in the statutory spending cap adopted in 1991 (Section 2-33a) is susceptible to misinterpretation. It may seem appropriate to some to calculate the average of the annual increases in personal income over a period of years by taking the sum of annual percentage point changes over that period, and dividing that sum by the number of years to determine an average percentage point change. This process yields the arithmetic mean.

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That method, however, is not used by economic and financial analysts. They divide the final amount resulting from changes over “x” period of years by the amount at the beginning of the period, and then take the “x”th root of the quotient. This calculation produces a growth rate [a *compound annual growth rate (CAGR)*] which, if compounded over time and applied to a starting figure will produce the ending figure. The process is analogous to the calculation of a compound interest rate. This calculation produces the geometric mean.

Utilizing the compound annual growth rate is viewed as preferable in economic and financial analysis because averaging percentage changes in a time series may produce a result, at the end of a specific time period, which is different from the actual final number. Applying the CAGR over five years to the personal income figure in the base year five times will yield the personal income in the fifth year. Averaging the five annual percentage changes from one year to the next and applying that average five times will not yield the same result. It may be close, but it would not be exact.

It should be observed, as did the ancient Greeks, that the geometric mean is always smaller than the arithmetic mean. So using the geometric mean to calculate the growth of personal income will yield a slightly smaller number than using the arithmetic mean.

To resolve any ambiguity concerning the statutory spending cap language, when the spending cap was first implemented, the compound annual growth rate of personal income in the state over the preceding five years was used by OPM to operationalize “the average of the annual increase in personal income in the state for each of the preceding five years.” OFA used this same methodology for calculating growth when the first budget under the cap was adopted. The common practice has now been in place for twenty-five years.

Because of the accepted method of analysis, and the fact that using the CAGR has been embedded in past practice, the Commission preliminarily and tentatively recommended that the General Assembly take this opportunity to clarify the language in the spending cap statute to avoid any ambiguity, and state explicitly that the compound annual growth rate should be the measure of increase in personal income.

II. Should realized capital gains be included in the measure of personal income?

Based on recommendations from several members, the Commission considered whether to adjust BEA personal income by adding realized capital gains. However, it was pointed out¹⁹ that, if such an adjustment were to be made, adjustments should also

¹⁹ The presentation by Professor Dan Kennedy on July 18th listed items which were included in BEA personal income, and AGI (see p. 36 of presentation). In addition, on July 7th, the Commission was presented copies of a letter from analysts at the New England Public Policy Center at the Federal Reserve Bank of Boston to staff at the Massachusetts Budget and Policy Center, July 30, 2008, a letter which canvassed potential modifications to BEA personal income, modifications which could be used to better define personal income as a benchmark for purposes of assessing the growth in costs of

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be made to more closely approximate the revenue base that could be taxed by either or both of the following factors:

- A. Adjusting for place of residence – adding the income of non-residents who worked in Connecticut and whose wages would accordingly be subject to taxation here, but subtracting the income of residents who worked out-of-state and whose wages would accordingly be subject to taxation there.
- B. Subtracting from personal income the imputed rents of homeowners, which are not part of the revenue base subject to income taxation, as it is a non-cash computation by the federal government.

The Commission requested staff at OPM to do back-testing of data pertaining to these various modifications since the inception of the cap. The information was presented to the Commission at its meeting on August 1.²⁰

For compound annual growth rates over successive lookback periods of ten years, the computations demonstrated that if BEA personal income had been modified by including realized capital gains, modifying for residence and subtracting imputed rent, the compound annual growth rate of this adjusted personal income measure over ten year periods would have been almost exactly identical to the growth rate for BEA personal income, unadjusted, for those periods (5.18% per annum vs. 5.18% per annum since the inception of the cap).

For compound annual growth rates over successive lookback periods of five years, the computations demonstrated that if BEA personal income had been similarly adjusted by including realized capital gains, modifying for residence and subtracting imputed rent, the compound annual growth rate of this adjusted personal income measure over five year periods would have been about 20 basis points (0.2 percentage points) lower than the growth rate for BEA personal income, unadjusted, for those periods (4.36% per annum (adjusted) vs. 4.56% per annum (unadjusted) since the inception of the cap).

The computations also show that the volatility of both measures is less when ten-year lookback periods are used, as opposed to five-year lookback periods.

However, for the immediate future, because past ten year periods will include the years of the Great Recession, it appears that using five-year periods will be more reflective of the current income base.

Other considerations:

Availability and timeliness: BEA personal income data for the state is available quarter by quarter, with about a quarter's lag so the data is nearly contemporaneous. (By January, BEA personal income is available through the end of September of the

Massachusetts' Medicaid program. (Copies of this letter were made available to members of the Commission, but it is no longer accessible on the NEPPC website.)

²⁰ See spreadsheet from OPM, presented to the Commission August 1, 2016.

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previous calendar year.) Data about realized capital gains, however, is available only after a two-year lag. The Commission concluded that a measure which included realized capital gains data would accordingly be reflective, not of the current economic situation, but of the economic situation two years earlier.

Transparency:

Because of the number of adjustments that would be made to personal income to arrive at the adjusted measure of personal income, the latter measure would be less simple for replication by the ordinary citizen, and thus less transparent than using the unadjusted personal income measure.

Volatility:

For both five year and ten year lookback periods, the inclusion of realized capital gains made the adjusted measure of personal income more volatile than the unadjusted measure.

The unadjusted measure of personal income for ten year lookback periods is less volatile than the same measure for five year periods.

In the end, the provisional vote of the Commission was to use unadjusted BEA personal income data, over a five-year period, as the basis for determining the increase in personal income.

III. Should AGI be used as the measure of personal income?

Another option that was considered as a measure of personal income was to use Adjusted Gross Income (AGI) of Connecticut taxpayers, as reported by the United States Internal Revenue Service, because AGI includes realized capital gains.

However, AGI does not adjust for place of residence. (Accordingly, income subject to taxation may be misattributed to the wrong state. The place of residence for in-state taxpayers who work out-of-state is Connecticut, so their total income would be counted under Connecticut's totals, even though their out-of-state earned income is not subject to Connecticut's personal income tax.) Also, IRS reports of Connecticut AGI on its website has often differed from information transmitted by IRS to Connecticut's Department of Revenue Services. Moreover, AGI does not include the income of non-filers. In addition, there is a delay of two years in reporting AGI.

Finally, volatility of AGI over both 5 and 10 year lookback periods is substantially greater than the volatility of both the adjusted and unadjusted BEA personal income measures.

For these reasons, the Commission decided not to use AGI as a replacement for the definition of personal income.

IV. Clarifying the reference years to be included in the calculation of personal income.

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The Commission also considered whether the reference “years” should be calendar years or fiscal years.

The existing statutory spending cap does not specify whether the reference year should be the preceding calendar year or the preceding fiscal year. In the first fiscal year under the cap, OPM used fiscal years and OFA used calendar years. In the years since, until the legislature specified otherwise, both OPM and OFA used fiscal years as the reference. Per legislative directive, calendar years are now used. Calendar years were used as the basis for data on personal income that were provided to the Commission during its deliberations.

Data about BEA personal income is available each quarter, after a lag time of about a quarter. (Data for the quarter April through June is available by the first of October.) Accordingly, as the Governor’s budget is being prepared during December of each year, personal income data for the previous fiscal year ending June 30 is available, but the most recent data available is for the third quarter of the calendar year. However, by the time that the General Assembly adopts a budget for the fiscal year beginning July 1, data for the previous complete calendar year is available.

Using calendar years as the reference years would require OPM to use a projection for the final quarter of a calendar year, but this reference would provide the most recent data at the time of the adoption of the budget.

Using fiscal years as the reference years would enable both OPM and OFA to use the same data, but the data would be almost a year old when the budget is adopted.

The Commission, having weighed both options, preliminarily and tentatively determined that calendar years should be the reference years – and the definition should explicitly state that.

B. Increase in Inflation

The attention of the Commission then turned to consideration of a recommended definition for “increase in inflation.” It voted preliminarily and tentatively (16 yea, 2 nay) to support the following:

“Increase in inflation” means the increase in the consumer price index for all urban consumers, all items less food and energy, during the preceding calendar year, calculated on a December over December basis, using data reported by the United States Bureau of Labor Statistics. (as revised by LCO)

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The increase in the consumer price index for all urban consumers, all items less food and energy – generally known as the “Core CPI-U” – was tentatively supported by majority vote of the Commission members as the appropriate metric to be used for inflation because it was more readily recognized by the public than other potential measures. In addition, excluding food and energy from the CPI-U results in a lower inflation number than would be the case if those items were included.

After full consideration, the members of the Commission also tentatively determined that the appropriate lookback period for the Core CPI-U should be the calendar year preceding the adoption of a fiscal year’s budget. Although the calendar year would not be concluded by the time OPM began to draft a fiscal year budget for consideration, projections by consultants for the end of the calendar year would be available, and final figures would be in place by mid-January for OPM’s use in proposing, and for the General Assembly’s use in adopting, a budget for the next fiscal year.

The Commission rejected a proposal to focus on the increase in the consumer price index just for those urban consumers living in Connecticut. Because the Bureau of Labor Statistics does not produce such a measure specifically for the state, the proposal that was advanced recommended using the average of the CPI-U for the New York metropolitan area, which includes New York, northern New Jersey, Long Island, and a few towns in southwestern Connecticut, and the CPI-U for the Boston metropolitan area, which includes Boston, Brockton, Nashua, New Hampshire and a few towns in northeastern Connecticut. Because the two CPI-Us are calculated for different months of the year, it was recommended that the calculation be based on the final month of the year available for each measure. After deliberation, however, the majority of the Commission voted tentatively to support the definition above, on the grounds that the definition above was more recognizable and understandable by the public

The Commission also rejected a proposed definition of “increase in inflation” which would have used as an inflationary measure the increase in the cost of the basket of goods and services used by government, as opposed to the increase in the cost of the basket of goods and services used by the individual consumer. Although the debate in the Senate on the proposed constitutional amendment drew the clear distinction between the two different “baskets,”²¹ and experts presented similar testimony to the Commission this year,²² the majority of the Commission preferred to recommend the more recognizable and understandable measure of inflation.

²¹ See the remarks of Senator Jepsen in the debate on HJ 205, RESOLUTION PROPOSING A CONSTITUTIONAL AMENDMENT IMPOSING A LIMIT ON STATE EXPENDITURES, August 21, 1991, transcript, pp. 193-194. “the CPI has very little to do with the real growth in cost in running a state government. That is because the state government does not buy a bundle of groceries, a tank full of gasoline and the other consumer products and services that are the normal indicia of the Consumer Price Index.” Instead, the government buys medical services, and provides for incarcerating an increasing number of prisoners, etc.

²² See, especially, Stan McMillen, et al., “Connecticut’s Spending Cap: Its History and An Alternative Spending Growth Rule,” Connecticut Center for Economic Analysis, University of Connecticut, September

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C. General Budget Expenditures

The Commission finally took up consideration of several potential components of a definition of “general budget expenditures” –involving both what should be included under the cap, and what should not be included under the cap. These discussions were quite spirited, involving as they did the significance of the underlying issues. The discussions revealed a diversity of opinion – along a broad continuum – within the Commission, a continuum which was reflected in the various votes taken.

The Commission provisionally voted individually on each of the components detailed below. They are first aggregated here for the purpose of showing what a comprehensive definition of “general budget expenditures” would be – and then discussed individually in detail.

As noted above, provisional – preliminary and tentative – votes were taken on each individual component, with the understanding that a comprehensive cumulative version of these components would be subject to a final vote of the Commission. When that final vote was taken on a proposed effort to achieve consensus, however, it failed to achieve a majority vote.

“General budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided

(1) general budget expenditures shall not include

- **expenditures for payment of bonds, notes or other evidences of indebtedness,**
- **expenditures pursuant to Section 4-30a,**
- **the expenditure of any federal funds granted to the state or its agencies,**
- **expenditures for statutory grants to distressed municipalities,**
- **expenditures by the state or any of its agencies of gifts, grants, contributions, trust income or other aid from private sources or foundations which have been given for restricted purposes specified by the donors of such funds,**
- **expenditures supported by revenues which have been statutorily set aside for specific purposes in a dedicated fund or separate, nonlapsing account created by the General Assembly,**

2005. “...the costs state governments face are materially and significantly different from the costs (prices) consumers face. This situation is primarily due to differences in the composition of the ‘baskets’ of goods and services state governments and consumers purchase.” (p. i)

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- for each fiscal year through the year ending June 30, 2022,²³ annual expenditures for the payment of the portion of the actuarially determined employer contribution representing the unfunded liability, for that fiscal year, of the teachers' retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission,

and (2)

(a) expenditures for the implementation of court orders (including agreements or stipulations approved by the General Assembly pursuant to Sections 3-125a and 4-160 of the General Statutes) shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized or increased, but shall be considered general budget expenditures for the purposes of determining general budget expenditures for the ensuing fiscal year,

(b) state expenditures required to be eligible for receiving federal funds which are mandated or which the General Assembly has voted to accept, including any increase in such expenditures required as a result of changes in the required state contribution to meet federal entitlement and eligibility criteria in order to receive federal reimbursement, shall not be considered general budget expenditures for the first fiscal year in which such expenditures are required or increased, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year, and

(c) expenditures on or after July 1, 2022, for the payment of the portion of the actuarially determined employer contribution of the teachers' retirement system or any retirement system or alternative program administered by the State Employees Retirement Commission representing an increase in the unfunded liability attributable to changes in actuarial assumptions or cost methods for such system or program shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year.

C. All expenditures from appropriated funds are under the cap, unless otherwise excluded.

²³ If there is a negotiated change in the projected ramp-up period, this date – and the July 1 date below – may need to be changed.

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Each motion for an individual component of “general budget expenditures” included the provision that it applied to appropriated funds, as in Section 2-33a.²⁴ Specifically,

“General budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly,

This definition clearly provides that – unless there are explicit exclusions as specified in the exceptions listed – **all** expenditures from appropriated funds authorized by the General Assembly are limited by the spending cap.

For example, the “normal cost” portion of the actuarially determined employer contribution required to be paid each year for the pension systems of the teachers’ retirement system or those administered by the State Employees Retirement Commission is under the cap. Also, the portion of the actuarially determined employer contribution representing the unfunded liability of the those pension systems, which has been excluded from the spending cap by Section 35 of PA 15-244 through the end of FY 2017, will be included in the spending cap automatically as of July 1, 2017, unless otherwise specified.

C.1. Introductory language to each of the individual components which are recommended NOT to be included in general budget expenditures.

Each of the motions concerning individual components recommended not to be under the cap included the preface:

(1) general budget expenditures shall not include

To take each of these elements in turn:

C.1a. Expenditures for payment of bonds, notes or other evidences of indebtedness

The Commission voted preliminarily and tentatively (20 yea, 2 nay) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **expenditures for payment of bonds, notes or other evidences of indebtedness,**

²⁴ Restricting “general budget expenditures” to “appropriated funds” is not unusual. In addition to Section 2-33a, at least 71 of the 74 bills proposed or raised since 1993 for the purpose of defining the terms of the spending cap use identical language. See Rute Pinho, “Spending Cap Definitions,” OLR Research Report 2016-R-0137 (August 11, 2016) (page 4), available on the Commission’s website under date of August 15, 2016, and on the OLR website.

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I.

The existing statutory spending cap excludes from general budget expenditures “expenditures for payment of the principal and interest on bonds, notes or other evidences of indebtedness.” (*emphasis added*) This language is different from the constitutional language, which states that general budget expenditures “shall not include expenditures for payment of bonds, notes or other evidences of indebtedness.”

There has been some controversy as to whether the addition of “the principal and interest on” was intended to confine the exclusion from general budget expenditures of payments on “bonds, notes or other evidences of indebtedness” to those obligations issued by the Treasurer on which debt service (principal and interest) is paid.²⁵ This controversy arose because Section 35 of PA 15-244 stated that, for fiscal years 2014 through 2017, “evidences of indebtedness” included expenditures for paying for the portion of the actuarially required contribution representing the unfunded liability of various pension systems for which the state is responsible.²⁶

In reaction to this legislative action, some members of the Commission proposed specific language to restrict the meaning of “other evidences of indebtedness” to those evidences “as issued by the state treasurer,” and/or to define “other evidences” as “a security as defined by federal law.” The Commission did not accept such language.

Although some members cited statements in the debate in the House of Representatives on the constitutional spending cap, review of that debate did little to clarify the intent of the proponents of the constitutional cap on this matter. When asked what “or other evidences of indebtedness” meant, Rep. McNally, the proponent of the resolution, replied, “That was language provided to us from the Treasurer’s Department in discussions over the need to provide an exemption for debt obligations. . . . That

²⁵ For example, Anthony Randazzo, in his testimony to the Commission on September 7, 2016, distinguished “traditional government debt” from other kinds of indebtedness: “traditional government debt—such as general obligation bonds or revenue bonds—involves *bonded debt with fixed interest rates and fixed repayment schedules*. This is debt that is underwritten by financial institutions and sold to investors. These tax---exempt municipal bonds, revenue bonds, or forms of taxable government debt are securities that can be purchased by private sector investors and an array of different types of institutional investors (including public pension funds themselves).” Testimony of Anthony Randazzo, Managing Director, Pension Integrity Project, Reason Foundation, September 7, 2016, page 6. https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20160907/Anthony%20Randazzo%20Testimony.pdf

²⁶ Section 35(b): “For the purpose of determining the increase in general budget expenditures that may be authorized for the fiscal years ending June 30, 2015, through June 30, 2017, evidences of indebtedness for the fiscal years ending June 30, 2014, through June 30, 2017, shall include the portion of the annual required contribution representing the unfunded liability of (1) any retirement system or alternative retirement program administered by the State Employees Retirement Commission, or (2) the teachers’ retirement system.” Please note that the term “annual required contribution” has been replaced by the term “actuarially required employer contribution” in pension analyses in recent years, pursuant to new GASB statements.

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language was found to be acceptable by all parties involved and thought that would be required to protect our bond rating. That's the best answer I can give you."²⁷

There is, unfortunately, no record of the reasoning undergirding the language supplied by the Treasurer's office with respect to what it meant by "debt obligations" or what was needed to "protect our bond rating." However, subsequent events relevant to these questions have lent credence to the arguments of those who opposed the restrictive language.

First, various GASB statements since the mid-1990s have required pension liability to be included – either as supplementary information or directly on the balance sheet – on governments' financial statements as obligations to be paid, certainly providing a strong implication that these liabilities are evidences of indebtedness.²⁸

Secondly, bond rating agencies in recent years have consistently taken pension liabilities into account in providing bond ratings. Moody's "US States Rating Methodology" lays out two equally balanced categories under the general heading of "debt": the first is "bonded debt" and the second is "adjusted net pension liabilities."²⁹ Moody's also issued a report which describes their approach to adjusting pension liabilities for the purpose of their credit analysis. That report specifies:

Moody's focus is the evaluation of credit risk of rated debt obligations. Because pensions represent material financial commitments that affect a government's financial risk profile, we have always incorporated pensions into our credit analysis where we have been aware of significant pension liabilities.³⁰ (*emphasis added*)

Consideration of pension liabilities contributes to Moody's state bond ratings: "we have taken rating actions with respect to Connecticut, Illinois, Pennsylvania, New Jersey, Hawaii, Puerto Rico and Kentucky partly or primarily due to pension funding pressures. In the future, growth of Moody's adjusted net pension liabilities or adherence to unsustainable pension practices could put additional downward pressure on individual state ratings."³¹ (*emphasis added*)

The New England Public Policy Center at the Federal Reserve Bank of Boston also confirms that unfunded pension liability is a kind of debt:

²⁷ Rep. McNally, debate on HJR 205, A Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, July 1, 1991, transcript, pp. 802-803.

²⁸ See, for example, GASB No. 25 and GASB No. 27.

²⁹ Moody's Investors Service, "US States Rating Methodology," April 17, 2013.

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM129816 See Figure 1, page 4, in which the two categories are given equal weight. Further discussion on pages 13 and 14 emphasizes that "In assessing state long-term liabilities we treat pension liabilities as a form of debt."

³⁰ Moody's Investors Service, "Adjustments to US State and Local Government Reported Pension Data," April 17, 2013, page 2.

https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM151398

³¹ Ibid., page 6.

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Pensions represent long-term obligations of state governments and, like bonded debt, enjoy strong legal protections. Rating agencies also consider these liabilities when assessing the financial health of states and assigning credit ratings, as retirement obligations also place a competing claim on state resources.³²

In short, nothing in the debate on the spending cap, constitutional version, when considered in the overall context of ensuring that the state pay its “debt obligations” in order to protect its bond rating, suggests that unfunded pension liability is not an evidence of indebtedness. Certainly, it is evident that unfunded pension liabilities can affect the state’s bond rating.

However, because it was apparent from the highly-contested nature of the lengthy discussions of the Commission on this point that the Commission was severely divided, the members of the Commission voted overwhelmingly³³ to revert to the constitutional language regarding this exception – thus avoiding a definitive resolution as to whether only debt service on securities sold to investors should be included in the category of “other evidences of indebtedness.”

Instead, the Commission decided to continue the debate on unfunded pension liability as a separately identified element of a recommended definition of general budget expenditures. See below, concerning Component C.1g.

II.

In other discussions related to this component of a potential definition of general budget expenditures, the Commission considered at length whether bond premiums should be included under the cap – or more precisely, should the expenditure of bond premiums to pay for current interest on outstanding bonds be included under the cap.

As the Assistant Treasurer for Debt Management has written,³⁴ “Bond premiums . . . are up-front payments by investors to the State in exchange for a higher coupon interest rate on a given bond. When interest rates are low, many large investors want tax-exempt bonds with higher coupons to defend against rising interest rates. . . . [The up-front bond premiums that the State receives are equivalent to the higher future interest payments over the life of the bonds, discounted to today’s dollars. . . . [B]uyers of our bonds pay the State up front . . . and we, in turn, repay that amount to bond buyers over the life of the bonds.” That is the way things are supposed to work.

But these premiums constitute current revenue to the state. So the temptation is to not set these funds aside to pay later, but to use the revenue when it is received. One possibility is for this revenue to be “used to fund capital projects already authorized for

³² “Assessing the Affordability of State Debt, NEPPC Research Report 13-2 (December 2013), page 9. [<https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2013/assessing-the-affordability-of-state-debt.aspx>]:

³³ See meeting notes of October 24, 2016.

³⁴ Sarah Sanders, Assistant Treasurer for Debt Management, to Senator Michael McLachlan, June 21, 2016. This letter was made available to the Commission.

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bonding, thereby reducing the total amount of debt issued and consequently, total future debt service,” as the State Treasurer has urged, but her recommendation has not been adopted. Instead, the state’s current practice is to use bond premiums to pay current interest on outstanding bonds – thus reducing the appropriations required in the current year to pay current interest, and therefore making it possible to divert other revenue to pay for other expenses of the state.

The Commission engaged in a lengthy discussion about whether the expenditure of bond premiums in this set of circumstances made such expenditure susceptible to inclusion under the spending cap. During this full deliberation, OFA confirmed that Section 3-20(f) of the General Statutes governed the use of bond premiums, and that as a matter of practice, bond premiums for General Obligation bonds are used to pay interest costs. The Commission arrived at a consensus that because these funds were expended for payment of bonds or notes, such expenditures were outside the constitutional spending cap. Moreover, even if they were regarded as revenue, that would mean that they would be a budget balancing tool, rather than a spending cap issue. Under neither scenario would bond premiums be regarded as a cappable expenditure. Accordingly, the Commission did not follow this line of inquiry further.³⁵

C.1b. Expenditures pursuant to Section 4-30a.

The Commission voted provisionally (17 yea, 0 nay, 5 abstentions) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **expenditures pursuant to Section 4-30a,**

This component of a definition of general budget expenditures was taken directly from the language of Section 2-33a of the General Statutes, as passed in 1991. The Commission saw no need to alter this language.

Section 4-30a(a) specifies how amounts resulting from budgetary surpluses may be spent:

- (1) moneys may be transferred to the Budget Reserve Fund, up to a stipulated limit,
- (2) moneys in excess of the amounts going into the Budget Reserve Fund will be deemed to be appropriated to the State Employees Retirement Fund, up to a stipulated limit, to be allocated to pay toward unfunded past liability, and
- (3) moneys in excess of these earlier amounts shall be deemed to be appropriated to be used by the Treasurer to reduce the outstanding indebtedness of the state by any of several methods.

³⁵ See meeting notes of September 26, 2016.

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Section 4-30a(b) further provides that moneys in the Budget Reserve Fund shall be deemed to be appropriated to fund a deficit from the preceding fiscal year.

In short, neither moneys going into the Budget Reserve Fund, or spent for specified reasons, nor moneys expended from the Budget Reserve Fund to fund a deficit, should be considered as general budget expenditures.

C.1c. Expenditure of federal funds.

The Commission voted provisionally (12 yea, 10 nay)³⁶ to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **the expenditure of any federal funds granted to the state or its agencies,**

For years, if not decades, funds received from the federal government have been treated by Connecticut in inconsistent and disparate ways: some federal funds were received and spent for specified purposes without being appropriated, and some federal funds were treated as reimbursements for a portion of total state appropriated expenditures for programs funded in part by state funds and in part by federal funds.

Most Medicaid programs fell into the second category: the full cost of a Medicaid service was budgeted as a state expenditure, even though some or all of it was covered with federal money. This was commonly called a “gross appropriation” approach. The dollars from Washington showed up as revenue.

Most states, however, followed a “net appropriation” approach. The appropriations budget showed only the expenditure of state funds for a program: the federal reimbursement was subtracted from the total program cost, and was not reported as revenue offsetting the total program cost.³⁷

In 2013, faced with a major influx of federal funds associated with the implementation of the Affordable Care Act, under which states could receive 100% reimbursement (for a few years) for an expanded Medicaid program³⁸ which the state agreed to put into place, legislators were faced with the options of continuing the practice of ‘gross

³⁶ This vote was for a motion which **combined** this language (C.1c) with the language of C.2b.

³⁷ We are indebted to Keith Phaneuf and Arielle Levin Becker for their concise explanation of the two approaches. See “Democrats may sidestep spending cap,” CTMirror, May 22, 2013, <http://ctmirror.org/2013/05/22/democrats-may-sidestep-spending-cap/>

³⁸ This expanded program was not mandated. The state had the option to decline the dollars. And under the 1991 statutory spending cap, “expenditures for program or service components which are optional under federal law or regulation shall be considered general budget expenditures.”

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appropriation” of this class of Medicaid funding, or switching to a “net appropriation” approach, which by removing a substantial sum of federal dollars from appropriated expenditures to non-appropriated funding would remove those federal funds from the spending cap. The General Assembly chose the latter.

This action was certainly not without precedent. A number of programs funded with federal dollars were in 2013, and remain, “off-budget,” non-appropriated. They range from block grants to Pell grants to research grants. Many, but not all, are enumerated in a report from Connecticut Voices for Children in 2013. The partial listing of these off-budget federal funds totaled \$540 million for FY 2012.³⁹

On the other hand, many other federal funds were “gross appropriated” and thus remained under the spending cap. The Voices report projected that \$1.5 billion in federal funds in FY 2016 would still be in this category. There appears to be no good reason for doing so. As the Voices report notes, “Not only is the inclusion of federal funds under the spending cap counterintuitive, but also it is unusual: only two of the 24 other states with expenditure limits include federal funds under their limits.”⁴⁰

There is this to be said in favor of leaving the \$1.5 billion under the cap. If some of those dollars are for federally mandated programs, they were exempt from the existing 1991 cap in the first fiscal year in which they were authorized, but then were considered to be under the cap for the purpose of determining general budget expenditures for the ensuing fiscal year. If they did not increase from year to year, or increased only minimally, their slow growth would mean that there would be more room under the cap for other programs.

However, if any federal funds remain subject to appropriations, there is certainly the possibility – and the possibility has in fact occurred – that the spending cap may cause the state to turn down these dollars.

And while the dollars are not “free,” they come from revenue raised by taxpayers all across the country, only some of whom are from Connecticut. And, in general, Connecticut receives back from the folks in Washington only some of the dollars it sends there.⁴¹ So why should Connecticut turn down any federal grants to the state

³⁹ Wade Gibson, “Removing the Quirks in Connecticut’s Treatment of Federal Funds,” Fiscal Policy Center at Connecticut Voices for Children, October 2013, <http://www.ctvoices.org/sites/default/files/bud13federalfunds.pdf>

⁴⁰ Ibid., page 1. The legislature’s Office of Legislative Research is the source of the assertion that only two of the other 24 states with spending caps include federal funds under the caps. See Daniel Liston, “OLR Backgrounder: State Spending Caps Analysis,” Office of Legislative Research, May 30, 2013. <https://www.cga.ct.gov/2013/rpt/2013-R-0244.htm>

⁴¹ The National Priorities Project, State Smart, estimates that Connecticut residents and businesses paid \$53 billion in taxes to the federal government in 2014. It also estimates that “Connecticut receives about \$45 billion dollars from our federal budget over the course of a year, between federal grants and contracts to business and governments, federal assistance going right to its residents, and federal employees working there.” So for every dollar Connecticut residents and businesses pay in federal taxes, they receive about 85 cents back. <https://www.nationalpriorities.org/smart/connecticut/>

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government that the federal government is willing to send our way to support programs the state finds desirable?

It certainly appears that federal grants to Connecticut state government make up a far smaller share of total state revenue than the national average, and a smaller share than surrounding states. The National Priorities Project reported that in FY 2013, “Connecticut got \$6.1 billion dollars from the federal government, which is 23.4% of its total revenue.” The national average was 30%.⁴² The Pew Charitable Trusts recently updated the data to FY 2014, and found that federal funds constituted 24.6% of state revenue in that year – third lowest in the country – as opposed to the national average for states of 30.8%.⁴³ Assuming that 24.6% was \$6.1 billion (as Pew estimated for FY 2013), simply moving to the national average share of 30.8% would have meant a roughly estimated additional \$1.5 billion⁴⁴ in federal funds. If Connecticut would be able to receive, on a consistent basis, its fair share of federal funds which Connecticut taxpayers have paid federal taxes to support, those additional funds could mean the creation of thousands of additional jobs, raised household incomes and, as a consequence of additional jobs and income, improved state revenues. Receiving those federal funds could also potentially mean that critical public service programs and strategic investments in education and infrastructure could be funded without additional Connecticut state taxes.

These potential outcomes are just, at this time, potential opportunities. It may be that the low poverty rate in Connecticut will mean that the federally determined low reimbursement rate for traditional Medicaid will continue to be the lowest in the country. Given the prospective shift in policy in the new national administration, it may be that federal funding for all programs in all states will be reduced. But without thorough investigation of the possibilities, we will never know if the state would qualify for additional funding for existing and other programs.

Accordingly, there was widespread support among members of the Commission for this component of a definition for general budget expenditures.⁴⁵ It concluded, provisionally, that the state should not turn down dollars paid by Connecticut taxpayers to the federal

⁴² Ibid.

⁴³ Anne Staufer and Justin Theal, “Federal Funds Supply 30.8 Cents of Each State Revenue Dollar,” Pew Charitable Trusts, July 28, 2016. <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/07/28/federal-funds-supply-308-cents-of-each-state-revenue-dollar> A complete data table for all fifty states going back to FY 2000 is linked at this site.

In addition, the Pew Charitable Trusts has provided a visualization tool which enables comparison of one state to the national average, and to other states. See <http://www.pewtrusts.org/en/multimedia/data-visualizations/2014/fiscal-50#ind0> Data in the table and on the visualization tool show that the corresponding shares were 27.8% in Massachusetts, 32.8% in New York, 34.7% in Rhode Island, 28.1% in New Hampshire, 33.6% in Vermont, and 36.6% in Maine.

⁴⁴ To be clear, this ballpark \$1.5 billion is different from the \$1.5 billion in federal funds already received, and still gross appropriated.

⁴⁵ Although there was less support for the language of C.2b, which was **combined** with the language of C.1c when the preliminary vote was taken.

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government which the feds have determined to allocate back to the state, nor should it establish disincentives or erect obstacles to receiving such funds. Care should be taken in crafting a definition of general budget expenditures so as not to disadvantage the state when considering accepting federal support when deemed advisable by the legislature and the Governor.

C.1c. Additional Recommendation concerning federal funds

However, removing all federal funds from the scrutiny of the appropriations process⁴⁶ may well make the use of these funds less transparent to both legislators and citizens, who should be able to track these funds and their uses, so that input and oversight can be provided. Accordingly, although it is outside the charge of this Commission, we recommend, as suggested by the Fiscal Policy Center at Connecticut Voices for Children, that **all federal funds “that can be forecast should be enumerated clearly in the budget document and receive a public hearing alongside appropriated funds.”** A single, separate “Federal Fund” which would include all federal funds received by the state would make it easier to identify them as federal funds, indicate how they related to the operation of state agencies, and focus attention on the overall impact of federal funds (and their potential increase or decrease) on the state budget.⁴⁷

C.1d. Expenditures for grants to distressed municipalities.

The Commission voted preliminarily and tentatively (13 yea, 9 nay) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **expenditures for statutory grants to distressed municipalities,**

The Commission considered three alternative provisions for excluding grants to municipalities from the spending cap. A majority of the Commission tentatively voted to support the above provision.

⁴⁶ If this component is incorporated into the definition of general budget expenditures, federal funds would be in non-appropriated accounts.

⁴⁷ Wade Gibson, “Removing the Quirks in Connecticut’s Treatment of Federal Funds,” Fiscal Policy Center at Connecticut Voices for Children, October 2013, <http://www.ctvoices.org/sites/default/files/bud13federalfunds.pdf>

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It was evident from discussion that one alternative – to exclude statutory grants to all municipalities – would not win support from a majority of the Commission. Although there was considerable support for allocating funds to all municipalities to assist them in meeting the needs of their residents, especially to promote the state’s economic competitiveness by providing improved educational opportunities to their students, there was also pushback from other members of the Commission who believed that such a broad provision would encourage the diversion of funds to municipalities which did not exhibit great need.

Similarly, a second alternative – to restrict the exclusion only to grants to distressed municipalities, and to limit the eligible grants only to those in place on June 30, 1991 (substantially the same language as in Section 2-33a) – appeared to many to be a quarter-century out-of-date. Some 1991 grants are no longer in use. Moreover, some new grants have been developed since that time – and in some cases, the formulas for distribution of those grants had been distorted in order to make it appear that they were just extensions of 1991 grants, so that the distributions to distressed municipalities under those grants would qualify for exclusion from the spending cap.⁴⁸

Finally, it appeared likely that there will be some new statutory grants to municipalities in the future -- some of which, of course, will go to distressed municipalities. Accordingly, some members of the Commission did not want to limit the exclusion of statutory grants to distressed municipalities to those in place on a date certain, and certainly not 1991. Instead, the Commission voted provisionally to support the third alternative under consideration: excluding from the spending cap expenditures for any grants to distressed municipalities. The following considerations appeared to support this recommendation:

a. The outcome of the *CCJEF v. Rell* court case is likely to produce a new formula for educational assistance to towns/school districts. And this new formula is not likely to be the result of a court order.⁴⁹ At least, Judge Moukawsher's Superior Court decision of September 7, 2016, recognized that the development of a new formula for educational aid was not within the purview of the judicial branch. "Beyond a bare minimum, the judiciary is constitutionally unfit to set the total amount of money the state

⁴⁸ A primary example of initiating a new grant in such a way as to make some grants eligible for grants to distressed municipalities is the Mashantucket Pequot and Mohegan Fund (Section 3-55i and 3-55j). When initiated in 1993, the method of distribution invoked a number of grants that had been in place in 1991. See Section 3-55j. In recent years, a series of specific block grants to towns has replaced the original distribution plan. See, for example, Section 23 of PA 16-2 (May Special Session).

Also, the many revisions of the Educational Cost Sharing Formula might be said to be distortions of the original formula. Since at least 2013, the ECS formula originally set out in Section 10-262h of the General Statutes has not been followed. Instead, a series of specific block grants to towns has been included in the appropriated budgets. See, for example, Section 20 of PA 16-2 (May Special Session). A history of the changes to Section 10-262h is appended to the section in the Connecticut General Statutes. For a general background, see Connecticut School Finance Project, "School Finance 101," updated January 2, 2017, page 59 et seq. <http://ctschoolfinance.org/assets/uploads/files/School-Finance-101-Current.pdf>

⁴⁹ Hence, it would not fall under the "court order" exclusion of provisionally recommended Component C.2b.

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has to spend on schools." (p. 17) "A formula can be designed that distributes money in proportion to need regardless of the overall amount the General Assembly decides to spend." (p. 43) The spending plan must be "rational, substantial and verifiable." (p. 43) But the judiciary will not draft it: it will only "review the formula to be sure that it rationally, substantially, and verifiably connects education spending with educational need." (p. 44)

b. there is likely, at some time in the future, to be a new formula for distributing non-educational funding to towns. The New England Public Policy Center (NEPPC) at the Federal Reserve Bank of Boston in 2015 provided an analysis, in conjunction with the Legislative Program Review and Investigations Committee, which found that there are large non-school fiscal disparities across cities and towns in Connecticut, "directly tied to the uneven distribution of the property tax base."⁵⁰ The report observed that the gaps between municipal costs (measured by factors outside the control of local officials) and municipal capacity were in part addressed by current grants to municipalities, but concluded "Our analysis of gaps compared with current non-school grants reveals that these programs have a limited effect in reducing non-school fiscal disparities in Connecticut. . . . these grants are relatively small and their allocation does not fully consider the factors that affect municipal gaps."⁵¹ To more fully address the disparities will likely require a new grant with a new formula.

c. A new distribution formula for grants to municipalities has been recommended by the State Tax Study Panel. The Panel, which reported in December 2015, decided early on that it would not look at state and local expenditure policy: "(A)ddressing the magnitude and design of state grants to local governments in Connecticut is beyond the Panel's scope of work." However, it then went on to say in its Final Report, (essentially reinforcing the NEPPC analysis)

in view of evidence presented to the Panel that there are significant differences in property tax capacity of municipalities (fiscal disparities) across municipalities, the Panel concludes that state grant policies should be re-examined in an effort to further relieve pressure on the property tax and to equalize fiscal disparities.

1. Property taxes are regressive.
2. The property tax fails to meet requirements of horizontal and vertical equity.
3. The property tax system is detrimental to Connecticut's economic competitiveness.
4. State grant policies should be re-examined in an effort to further relieve pressure on the property tax to address fiscal disparities across municipalities.

⁵⁰ Zhao and Weiner, "Measuring Municipal Fiscal Disparities in Connecticut," NEPPC Report 15-1 (2015), p. 2. (The full text document, with appendices (with detailed data), is available at <https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2015/measuring-municipal-fiscal-disparities-in-connecticut.aspx>)

⁵¹ Ibid.

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5. The State needs to look at the distribution formula which addresses closing the "need-capacity gap."⁵² (*emphasis added*)

To sum up, for a variety of reasons, there are likely to be new distribution formulas developed to meet current needs, so exempting from the spending cap those statutory grants to distressed municipalities in existence in 1991 is no longer sufficient. The majority of the Commission provisionally voted to support the provision reported here.

C.1d. Recommended modification to “distressed municipalities” component

Many members of the Commission expressed their view that this provision was too open-ended: there is no explicit limitation on the number of distressed municipalities, and there is no explicit reference to a statutory definition of distressed municipalities. It appears that – by tacit acceptance – the number of distressed municipalities has been limited to 25. And the criteria used to define what makes municipalities distressed have been developed by the Department of Economic and Community Development pursuant to Section 32-9p of the General Statutes – but without being explicitly authorized for this purpose by the General Assembly.

Accordingly, there seemed to be a general sentiment, despite strong opposition from some members to an arbitrary cap on the number of municipalities to be considered “distressed,” that we report to you that this provision be modified to read:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **expenditures for statutory grants to the 25 most distressed municipalities as defined by criteria adopted by the General Assembly,**

This language would provide a specific limit to the number of municipalities classified as distressed, and require the General Assembly to identify the explicit criteria to be used to determine which municipalities would be categorized as distressed.

⁵² See the Final Report of the State Tax Panel (page 10) , available through a link at https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929_State%20Tax%20Panel . This recommendation was adopted by the State Tax Panel without dissent.

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C.1.e. Expenditures from private sources.

The Commission voted provisionally (18 yea, 5 nay) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **expenditures by the state or any of its agencies of gifts, grants, contributions, trust income or other aid from private sources or foundations which have been given for restricted purposes specified by the donors of such funds,**

This exemption would include grants or gifts made by private individuals, or groups, or foundations for restricted purposes – analogous to restricted funds granted to 501(c)(3) organizations – such as creating a pilot program for early childhood education, etc.

Ordinarily, one might expect that such funds would be automatically treated as “pass-through” items, and never be subject to the appropriation process. But apparently, in some instances in the past, major grants – such as one to form a public-private partnership which resulted in the creation of the Office of Early Childhood – have been deemed to be appropriated.

Because of the possibility of this happening, some members of the Commission were concerned that private sources might fear that if their gifts or grants for restricted purposes came under the spending cap, these funds might squeeze out other state programs that were capped. This scenario might discourage potential grantors from contributing.

Please note that any taxpayer dollars supporting or matching these private grants would be under the cap.

A strong majority of the members of the Commission provisionally supported this component.

C.1f. Expenditures from dedicated or separate, non-lapsing funds

The Commission voted provisionally (12 yea, 11 nay) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

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- **expenditures supported by revenues which have been statutorily set aside for specific purposes in a dedicated fund or separate, non-lapsing account created by the General Assembly,**

This exemption would include such separate, non-lapsing accounts as the community investment account (Section 4-66aa), the state parks maintenance, repair and improvement account (Section 23-15b), and other similar separate, non-lapsing accounts. It would also include revolving funds dedicated to specific purposes.

Some members of the Commission also speculated that, without such an exemption, funds dedicated to a proposed “Transportation Lockbox” could be capped. Others feared that expenditures from tuition and fees paid by students in the state’s public higher education system might, if subject to appropriation, be capped.

This language would admittedly not prevent such dedicated funds or funds in nonlapsing accounts from being “swept” or “raided” to be included as revenue to support other programs. But the intention of this provision is to make a clear statement that when funds – like fees to use the state park facilities – have been clearly designated for a specific purpose, they should be used for that purpose. By dedicating these revenues, or placing them in separate non-lapsing accounts, the General Assembly deliberately excluded expenditures of those funds from the cap. If all such revenue in such accounts were swept up as revenue to the General Fund or other appropriated funds, then the programs which that money originally supported would have to compete with other appropriated programs for funding under the cap – thus frustrating the goal of the Assembly to make sure the revenue was spent for the purposes originally stated.

This language is accordingly intended to strengthen the resistance to the proclivity of the legislature in recent years to take moneys from uncapped funds, leaving nothing left to support the programs funded by that off-budget revenue.

A narrow majority of the members of the Commission provisionally supported this language.

C.1g. Expenditures for payment of unfunded pension liabilities.

The Commission voted provisionally (12 yea, 9 nay)⁵³ to support the following component:

⁵³ This vote was for a motion that **combined** this language (C.1g) with the language of C.2c (exclusive of the italicized language (see note 55)).

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As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **for each fiscal year through the year ending June 30, 2022,⁵⁴ annual expenditures for the payment of the portion of the actuarially determined employer contribution representing the unfunded liability, for that fiscal year, of the teachers’ retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission, *provided that the portion of the full unfunded liability for these systems for FY 2022 shall be considered as general budget expenditures for FY 2022 for the purpose of determining general budget expenditures for FY 2023.*⁵⁵**

The most contentious issue that emerged for the Commission involved the question of whether the portion of the actuarially determined employer contribution attributable to the unfunded liability of the various retirement programs for which the state is responsible should be under the spending cap, or excluded from it. (Appropriately phrased: should “general budget expenditures” include, or not include, the portion of the actuarially determined employer contribution attributable to the unfunded liability?)

As noted above, the Commission first considered – at length – whether this question could be answered by classifying the unfunded liability as an “evidence of indebtedness.”

Ultimately, however, rather than attempt to reach a definitive recommendation as to whether “other evidences of indebtedness” encompassed the unfunded liability of the state’s pension systems, and thus constitutionally excluded this liability from “general budget expenditures,” the Commission agreed to consider this issue as a separately-stated component of the definition of “general budget expenditures.”

Just to be clear: the total actuarially determined employer contribution for each year is the sum of two separate parts:

- the normal cost, or annual benefit cost, which represents the portion of the cost of projected benefits allocated to the current plan year, based on the benefits earned by current employees in the current year⁵⁶

⁵⁴ If there is a negotiated change in the projected ramp-up period, this date – and the July 1 date below – may need to be changed.

⁵⁵ The italicized language was added subsequent to the provisional vote of the Commission, in response to concerns that this rebasing needed to be specifically included.

⁵⁶ As the Center for Retirement Research at Boston College has put it: “putting aside enough money in a trust each year while an employee is working in order to fund the payment of the employee’s retirement benefits.” Jean-Pierre Aubry and Alicia H. Munnell, “Final Report on Connecticut’s State Employees Retirement System and Teachers’ Retirement System,” Center for Retirement Research at Boston

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- the amount needed in that fiscal year to amortize the existing unfunded liability over a period of years

There was, first, unanimous agreement by the members of the Commission that the normal cost of the various pension programs should remain under the cap. Although the normal cost includes the cost of projected benefits earned by current employees based on past collective bargaining agreements and legislative decisions, part of the normal cost is subject to control by current policymakers. Leaving the normal cost under the cap would require policymakers to determine, as part of the appropriations process, what priority to give to retirement benefits that future employees would earn. [Should future employees be in a defined benefit plan, or a defined contribution plan? How should benefits in a defined benefit plan be calculated: e.g., What should be the retirement age? What should be included in the final average salary used as a base for determining the benefit payout in a defined benefit plan? How much should an employee be expected to contribute under either plan type? Etc.]

On the other hand, the unfunded liability of the retirement systems is attributable not to current decisions, but to past decisions which “kicked the can down the road.” The Center for Retirement Research at Boston College⁵⁷ has pointed to a combination of four factors which are behind the current underfunding of the State Employees Retirement System (which also apply to the Teachers’ Retirement System):

- 1) legacy costs due to benefits promised before SERS was pre-funded;⁵⁸
- 2) a history of inadequate contributions once the State decided to pre-fund;⁵⁹
- 3) low investment returns relative to expectations since 2000;⁶⁰ and
- 4) poor actuarial experience, relative to expectations.⁶¹

The combination of these factors has resulted in a situation in which more than 80% of the actuarially determined employer contributions each year for the state’s retirement systems is to pay for unfunded liability caused by decisions made in the past. Indeed,

College, November 2015, page 6. http://crr.bc.edu/wp-content/uploads/2015/11/Final-Report-on-CT-SERS-and-TRS_November-2015.pdf

⁵⁷ Jean-Pierre Aubry and Alicia H. Munnell, “Final Report on Connecticut’s State Employees Retirement System and Teachers’ Retirement System,” Center for Retirement Research at Boston College, November 2015, page 7. See also page 31. http://crr.bc.edu/wp-content/uploads/2015/11/Final-Report-on-CT-SERS-and-TRS_November-2015.pdf

⁵⁸ From 1939 to 1971, SERS was funded on a pay-as-you-go basis. Essentially no dollars were set aside for future benefits. Aubry and Munnell, op.cit., pages 6-7. For TRS, see pages 32-33.

⁵⁹ See a full explanation of deliberately making inadequate contributions: Aubry and Munnell, op. cit, pages 9-10 (SERS) and 32-33 (TRS) ,

⁶⁰ Primarily, using an expected rate of return which is higher than can be expected in today’s economic climate. See Aubry and Munnell, op. cit., pages 12-15 and 34-37.

⁶¹ Including the impact of ad hoc Early Retirement Incentive Programs, which affected assumed retirement patterns. See Aubry and Munnell, op cit. page 11.

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“most of [this unfunded] liability is related to already-retired employees.”⁶² Therefore, current and future decisions would be ineffectual in limiting those costs.

The combined effect of these factors was to create a situation in which paying for these unfunded liabilities, using the funding plans currently in place, would result in an unsustainable cost to the state budget in future years, as presentations by Secretary Barnes of OPM, and Joshua Wojcik of the Office of the State Comptroller made clear.⁶³ The situation had certainly come to the attention of Connecticut’s business community – which feared that the unpredictability of the state’s response to the need to fund these liabilities might result in unpredictable, volatile tax burdens which it would be impossible to plan for.

In order to achieve stability,⁶⁴ a number of actions would have to occur: (1) recognize that the current assumed rate of return is too high, so it should be reduced in order to begin to make appropriate employer contributions which provide for investment of dollars before an apocalyptic event occurs (which would require huge increases), and (2) move to “level dollar” amortization, to avoid kicking the can down the road (backloading) with “level % of payroll” amortization. Because an inevitable consequence of these two actions is to push up the total cost, the only way to avoid unacceptable levels is to (3) extend the amortization period.

Accordingly, the question before the Commission became “what definition of general budget expenditures would make it possible to pay for these costs in a sustainable way, without exhausting all the room under the cap, to the extent that other government functions would be crowded out?”⁶⁵

⁶² OPM Fiscal Accountability Report, Fiscal Years 2017 – 2020, page 30.

http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

Detailed backup data is included in the Center for Retirement Research Study, op. cit., p. 28.

⁶³ OPM, Presentation on Connecticut Pension Fund Issues, October 5, 2016, available at

https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20161005/Ben%20Barnes%20-%20Pension%20Fund%20Issues%20Presentation.pdf and Office of the State Comptroller, “Pension

Funding Reform,” October 5, 2016, available at

https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20161005/Josh%20Wojcik%20-%20Pension%20Reform%20Presentation%20-%20Spending%20Cap.pdf

For additional background information, see OPM’s Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, pages 32-33, available at

http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

⁶⁴ Achieving stability was an outcome that was the goal of the Boston College report, OPM, the Comptroller, the business community (as reflected in the testimony of several business representatives), as well as, we believe, the members of the Commission.

⁶⁵ **This is probably the appropriate place to highlight the need to recognize long-term fiscal realities. On the final day of the Commission’s deliberations, OFA presented estimates that the adoption of the proposed comprehensive recommendation of “general budget expenditures” would result, in FY 2018, in the movement of \$635 million in expenditures from being included under the cap to being excluded from the cap. Of that amount, about \$360 million was estimated to result from excluding additional grants to municipalities from coming under the cap. (This, however, could be remedied by rebasing.) The remainder of the total amount was from two sources: about \$50 million was attributable to the increased expenditures for Medicaid required**

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All members of the Commission, we believe, held the view that – as was said by a national expert whose work was submitted by a member of the Commission – that

Public sector workers form a critical part of American civil society. They rescue and protect us when we're in danger; they make our lives safer, cleaner and more efficient; they educate our children; they enforce the rule of law and provide remedies when laws are broken; they ensure access to clean air, water and food; and they heal us when we're sick. The legal, medical, environmental and educational problems sometimes found in other countries are a reminder of what life might be like without them. They earned the benefits they accrued and which were granted by state legislatures, and have the right to expect them to be paid.⁶⁶ ⁶⁷ (*emphasis added*)

The Yankee Institute, in a paper reviewed by the Commission, noted that “For years, the pensions were underfunded. . . . It is imperative that . . . decision makers fully fund Connecticut’s yearly pension obligations moving forward.” The report concluded, “It is

under the terms of the Affordable Care Act, and more than \$226 million was attributed to the projected increase in the portion of the actuarially determined employer contribution representing the unfunded pension liability for SERS and TRS. [In actuality, the \$226 million figure should probably be about \$360 million, based on OFA’s Fiscal Accountability Presentation on November 30, 2016. See OFA, Fiscal Accountability Presentation, November 30, 2016, pages 15 (re SERS) and 17 (re TRS). https://www.cga.ct.gov/ofa/Documents/year/FF/2017FF-20161130_Fiscal%20Accountability%20Presentation%20FY%2017%20-%20FY%2020.pdf] The expenditures for unfunded pension liabilities alone would exhaust the projected spending cap for FY 2018. To leave that spending under the cap would make it very difficult, if not impossible, to meet the widespread demand from both sides of the political aisle to restore funding in FY 2018 for such programs as the maintenance of state parks, services to persons with developmental needs, and educational cost sharing – not to mention Medicaid services – programs that were reduced in FY 2017. Moreover, those projected expenditures NOW are critical in order to achieve long-term stability for future funding of past unfunded pension liability through levelling off future payments. So demanding that such expenditures remain under the cap, as some members of the Commission did on the last day of deliberations, essentially elevates temporary, short-term benefits over long-term advantages.

⁶⁶ Michael Cembalest, “The ARC and the Covenants, 2.0: an update on the long-term credit risk of US states,” May 19, 2016, page 1, *Eye on the Market*, J.P. Morgan, <https://www.jpmorgan.com/jpmpdf/1320702681156.pdf> Available on the Commission’s website: https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/05-19-2016%20-%20The%20ARC%20and%20the%20Covenants%202.0-2.pdf

⁶⁷ During the Commission’s deliberations, some members contended that pension benefits were a part of employee compensation, and accordingly unfunded liabilities associated with these benefits were not a debt obligation that should be exempt from the spending cap. It was pointed out, however, that if these benefits were part of a compensation package, they were contractually bound to be paid, and if they were not paid, they are now owed, and thus become a debt obligation. [On the other hand, future pension benefits based on **current** compensation are included in the **normal cost**, which the Commission recommends to be **under** the spending cap. (see pp. 22, 37, and 42) As long as the normal cost is paid, this part of compensation does not become a debt obligation.]

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imperative that the state continues to pay for these obligations so the pension debt does not grow.”⁶⁸

Despite their agreement that the liabilities must be funded, members disagreed on whether the expenditures to pay for those liabilities should be under the cap, or exempt from the cap.

However, although several members of the Commission contended that expenditures for the payment of these unfunded liabilities should be under the spending cap, they also argued that the expected rate of return – 8.0% for both SERS and (as of 2016) TRS – was unrealistically high in the current economic climate, and should be reduced. Such a reduction, of course, would increase the size of the unfunded liability, making the path to fully funding these liabilities even more difficult.

Under the amortization schedules currently in place for both SERS and TRS, the portion of the actuarially determined employer contribution for unfunded pension liabilities for each would about double from the FY 2017 level to FY 2032. And assuming a reduced rate of return in both might well cause the out-year requirements for annual funding to almost quadruple.⁶⁹

In the face of these daunting estimates, the Secretary of OPM and the State Comptroller made the Commission aware that efforts were underway to find a solution which could moderate, and perhaps eliminate, the projected balloon payments, even while moving to a more realistic rate of return assumption.

For SERS, the potential alternative solution would

- reduce the long-term rate of return assumption from 8% to 7%
- change the amortization method from level percent of payroll to level dollar
- change the actuarial cost method from projected unit credit to entry age normal
- introduce a “layered amortization” period, adhering to the existing period of Tier I retirees, but extending the amortization period for additional years for others.⁷⁰

⁶⁸ Yankee Institute for Public Policy, “Connecticut’s Pension Debt and the Spending Cap,” May 21, 2015, pages 3 and 7. Available on the Commission’s website:
https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/Pension%20Debt%20and%20the%20Spending%20Cap.pdf

⁶⁹ See Aubry and Munnell, op.cit., pages 19, 27.

⁷⁰ For additional details, see the presentations by OPM and the Office of the State Comptroller, October 5, 2016. OPM, Presentation on Connecticut Pension Fund Issues, October 5, 2016, available at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20161005/Ben%20Barnes%20-%20Pension%20Fund%20Issues%20Presentation.pdf and Office of the State Comptroller, “Pension Funding Reform,” October 5, 2016, available at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20161005/Josh%20Wojcik%20-%20Pension%20Reform%20Presentation%20-%20Spending%20Cap.pdf

For additional background information, see OPM’s Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, pages 32-33, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

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For TRS, although many of the parameters in the calculation of the payment of unfunded liabilities have been restricted by the terms of the bond covenant which was part of the issuance of the Pension Obligation Bonds issued in 2009, the recent valuation of the TRS included

- a reduction of the long-term rate of return assumption from 8.5% to 8.0%.⁷¹

Additional changes for TRS being investigated include

- a potential reduction in the long-term rate of return assumption to 7%.
- changing the amortization method from level percent of payroll to level dollar
- extending the amortization period under some circumstances.⁷²

If these potential changes are achieved for SERS, the consequence would be an increase in the required payments for the portion of the actuarially determined employer contribution representing the unfunded liabilities of SERS over the next 3 to 5 years, above and beyond what has been projected under the current amortization schedule. But then, the annual required payment would level off, with very little increase over the remaining (and extended) amortization period.

For TRS, the reduction of the long-term rate of return assumption to 8.0% in the latest actuarial valuation will require a major increase in the actuarially determined employer contribution for FY 2018, of about \$280 million.⁷³ Additional changes in the future might also require major increases in the actuarially determined employer contribution – but like the changes in SERS, could produce a leveling off of required payments over the years.

Because this “leveling off” would bring stability and predictability to out-year budgets, it appeared to a majority of the Commission that it was desirable to tailor an exemption from the spending cap so that the application of the spending cap in the near term would not be an obstacle to making these changes. As Secretary Barnes told the Commission, “Inclusion or exclusion of pension contributions under the cap does not

These efforts were based on the report of the Center for Retirement Research at Boston College, Aubry and Munnell, op.cit.

⁷¹ See the most recent Actuarial Valuation of the Connecticut State Teachers' Retirement System, as of June 30, 2016, presented to the Teachers' Retirement Board on October 27, 2016, page 13, available at http://www.ct.gov/trb/lib/trb/formsandpubs/actuarial_valuation_rep_2016.pdf

⁷² See Aubry and Munnell, op.cit., pages 41-54.

⁷³ See the projection in OPM's Fiscal Accountability Report for Fiscal Years 2017-2020, November 15, 2016, at page 34.

http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

Note that this increase alone, if were under the spending cap, would nearly exhaust the expected \$300 million permitted increase in spending under the cap. (See page 16 of OPM's Fiscal Accountability Report.)

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impact the requirement that the state pay its ADEC, however, inclusion under the cap may limit the State's ability to implement a more rapid pay-off of these liabilities."⁷⁴

The intent is to exempt the unfunded liability portion of the actuarially determined employer contribution (ADEC) from the spending cap during a ramp up period, but to bring it under the spending cap once that payment has leveled off. Maybe this can occur sooner than FY 2022 (in which case the date should be changed).

The specific language provisionally approved by the Commission provided that the portion of the actuarially determined employer contribution representing the unfunded liability of the pension systems would not be included in general budget expenditures through the fiscal year ending June 30, 2022, to permit a ramp-up of payments over a reasonable period to the level which would be maintained through the end of the amortization period.

To sum up, under the tentatively approved language, for both SERS and TRS (and any other retirement plan administered by the State Employees Retirement Commission)

1. Expenditures for payment of the normal cost each year will be under the spending cap.
2. Expenditures for the unfunded accrued past liability each year will be exempt from the spending cap through FY 2022.
3. After FY 2022, expenditures for unfunded past liability will be under the spending cap.⁷⁵ Hence, the exemption will be sunset.

C.1g. Recommended modification to tentative recommendation concerning unfunded pension liabilities

As part of the discussion surrounding the provisional recommendation, some members pointed out that it was important to provide for a transition from the period when these expenditures would not be included in the cap to the first year of the period when they would be fully under the cap. The chairpersons agreed to include such a recommended provision in their report. Accordingly, the following additional language has been appended to the end of the language which was tentatively approved:

⁷⁴ OPM, Presentation on Connecticut Pension Fund Issues, October 5, 2016, page 11, available at https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20161005/Ben%20Barnes%20-%20Pension%20Fund%20Issues%20Presentation.pdf

⁷⁵ The intention was that there would be a rebasing when this occurred. See next recommended modification.

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provided that the portion of the full unfunded liability for these systems for FY 2022 shall be considered as general budget expenditures for FY 2022 for the purpose of determining general budget expenditures for FY 2023,

Subsequent to the vote by the Commission, the administration announced that it had reached an agreement with SEBAC to substantially implement the provisions of the alternative that had been proposed by the administration.⁷⁶ Most notably, the agreement recommends that the Retirement Commission adopt an assumption of a 6.9% rate of return, much more in line with conservative assumptions in other states.⁷⁷

Although this agreement still needs to be approved by the General Assembly, it has met with favorable reviews. A bond-rating agency, Moody's Investor Services, quickly termed the agreement a "credit positive" for the state.⁷⁸ And the state's business community, which had been very concerned that the prospective spike in future pension payments might lead to unpredictable tax increases, appeared to be pleased with the action: a leader of the community is reported to have said that it brings the type of stability that business leaders are looking for. "It will be better to manage"⁷⁹ because it avoids "the deadly spike in ARCs by terming out the obligation and resetting the actuarial investment return to something more reasonable that can be levelled out and funded over time."⁸⁰

C.1g. Suggested modification of the provisional recommendation concerning unfunded pension liabilities, in an attempt to reach consensus.

At the meeting at which the above language received tentative approval, a number of members of the Commission expressed a desire that the Commission attempt to reach a consensus conclusion that could possibly achieve a 3/5 vote of approval in the General Assembly. These members were particularly concerned that the above pension language, which provided for a total exemption of the payments for unfunded liability from the spending cap until the end of FY 2022, could not receive sufficient votes. Instead, they thought a phase-in of the unfunded liability under the cap [alternatively phrased, a phase-out of the exemption from the cap] over a short time period would be more acceptable.

⁷⁶ Press release, December 9, 2016. <http://portal.ct.gov/en/Office-of-the-Governor/Press-Room/Press-Releases/2016/12-2016/Gov-Malloy-and-State-Employee-Unions-Reach-Agreement-on-Pensions>

⁷⁷ The California Public Employees Retirement System has adopted a 7% rate of return assumption, effective in 2020. See Heather Gillers, "Calpers Wants to Speed Up Cuts in Investment Goals," *The Wall Street Journal*, December 15, 2016, page B3, and Rory Carroll, "CalPERS votes to lower expected investment return rate to 7 percent by 2020," Reuters, December 21, 2016, <http://www.reuters.com/article/us-california-calpers-idUSKBN14A2EE>

⁷⁸ <http://ctmirror.org/2016/12/15/wall-street-agency-gives-ct-pension-deal-a-credit-positive/>

⁷⁹ Russell Blair, "Malloy Touts Long-Term View," *Hartford Courant*, December 13, 2016, page B3, quoting Jim Smith of Webster Bank.

⁸⁰ See the CT-N on-demand video, MetroHartford Alliance Rising Star Breakfast with Governor Malloy, December 12, 2016, minutes 21-22, <http://ct-n.com/ctnplayer.asp?odID=13525>

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The Chairpersons accordingly agreed to consult with members of the Commission to see if a consensus recommendation could be crafted. Over several days, they focused on a revision of this component of the definition of general budget expenditures, and produced the following suggested alternative:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided (1) general budget expenditures shall not include

- **for each fiscal year beginning July 1, 2017, through the fiscal year ending June 30, 2022, annual expenditures for the payment of the portion of the actuarially determined employer contribution representing, respectively, 100%, 80%, 60%, 40%, and 20% of the increase in the unfunded liability, for that fiscal year, of the teachers’ retirement system or any retirement system or alternative retirement program administered by the State Employees Retirement Commission, provided that the portion of the full unfunded liability for these systems for FY 2017 shall be considered as general budget expenditures for FY 2017 for the purpose of determining general budget expenditures for FY 2018,**

Briefly, the potential revised pension liability language provided that the portion of the ADEC representing unfunded pension liability be brought fully under the cap in FY 2018, and that the annual increase in such liability in the future be brought under the cap in increments over a period of five years. (The increase from FY 2017 to FY 2018 would be 100% exempt from the cap, from FY 2018 to FY 2019 80% exempt from the cap, etc. This phase-in schedule would apply to both SERS and TRS. The 100% exemption of the increase in FY 2018 would also apply to the major increase of about \$280 million for TRS.)

We did not know if this proposal would meet with the approval of those who voted for the relevant original language. It does bring under the spending cap, in the next five years, a total of about \$145 million, as opposed to the originally voted language of \$0. But it did, we thought, address the wishes of those who desired a phase-in.

This language assumes that the language of Section 35(b) of PA 15-244 was applicable only to the fiscal years ending June 30, 2014 through June 30, 2017, and that accordingly, the portion of the actuarially determined employer contribution representing the unfunded liability of both SERS and TRS comes back under the cap as of July 1, 2017 (since it is no longer exempt) – and the amount for FY 2017 would be the base for FY 2018.

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The above language proposes that the increase for FY2018 in that portion of the actuarially determined employer contribution representing unfunded liability would be 100% exempt from the cap, as a phase-in period begins.

Based on tentative projections we received from the Office of the State Comptroller, for FY 2018, for the current amortization plan of SERS, there would be an increase to \$1,363,814,000, from what is \$1,281,918,000 in FY 2017, or \$81,896,000.⁸¹ Under this proposal, that increase would be 100% exempt from the cap. And if the consensus alternative plan is adopted,⁸² the increase to the anticipated actuarial valuation of \$1,363,094,000 – less than under the current plan – would also be exempt from the cap. For FY 2019, the portion of the actuarially determined employer contribution representing the unfunded liability is estimated to be – for the consensus option – \$1,566,933,000 or an increase of \$203,839,000 of which 80% would be outside the cap, and 20% (about \$40,768,000) would be under the cap. The calculation would be similar for the remaining years of the “phase-in.” so that gradually 40%, 60%, and 80% would be under the cap. And in FY 2023, the entire annual increase (100%) – if any, and it does not appear that there will be one – would be under the cap. And in all years after that, the portion of the actuarially determined employer contribution representing the unfunded portion of the liability would be under the cap.

For TRS, the latest valuation for the current plan shows that the increase from FY 2017 to FY 2018 would be somewhere around \$280 million or so. That increase would be 100% exempt from the cap. But after that, the increase each year would be phased in at 80%, 60%, 40% and 20%, with the full amount of the portion of the actuarially determined employer contribution representing unfunded liability coming under the cap in FY 2023.

And the normal cost would always be under the cap.

As Chairpersons, we believed that incorporating this alternative language into a final recommendation of the Commission would attract additional votes, so as to forge a consensus on the overall recommendation.

This effort proved to be insufficient, however. When this revised language was included in the final overall proposal presented to the Commission, the final proposal failed to achieve a majority vote. (11 yea, 12 nay)

⁸¹ A roughly equivalent estimate is provided in the Fiscal Accountability Report of OPM for FY 2017 through 2020, November 15, 2016, page 5, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

⁸² Please note that when a new SERS valuation is approved, incorporating the provisions of the SEBAC negotiation concluded in December 2016, the numbers projected to be associated with the “consensus alternative plan” may be different than those presented here.

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C.2a. Treatment of expenditures for court orders.

The Commission voted provisionally (16 yea, 6 nay) to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided . . . (2) (a) expenditures for the implementation of court orders (including agreements or stipulations approved by the General Assembly pursuant to Sections 3-125a and 4-160 of the General Statutes) shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized or increased, but shall be considered general budget expenditures for the purposes of determining general budget expenditures for the ensuing fiscal year,

This basic language for this component of the definition of general budget expenditures comes directly from Section 2-33a.

In the Senate debate on the adoption of the constitutional spending cap, Sen. Spellman, a leading proponent of that cap, referred approvingly to this provision in the soon-to-be-approved statutory cap which provided for the treatment of expenditures for the implementation of court orders.⁸³ There appeared to be no opposition to its inclusion.

During the course of the Commission’s deliberations, however, it became aware that, in addition to court orders, consent agreements and stipulations arising from legal proceedings may also require expenditures to implement.⁸⁴ If those agreements and

⁸³ Sen. Spellman, debate on HJR 205, Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, August 21, 1991, transcript, page 198.

⁸⁴ The Fiscal Accountability Report issued by OPM on November 15, 2016, reports that on September 29, 2016, an agreement to modify the Exit Plan from the *Juan F.* consent decree was approved by the U.S. District Court. This agreement, according to the Fiscal Accountability Report (page 48), has several fiscal implications, requiring among others, maintenance of the 2017 DCF appropriation, limiting the average caseload of social workers, and a \$6 million service expansion in certain areas. The report continues:

It is anticipated that the Attorney General will submit the agreement to the General Assembly for approval at the start of the next legislative session. The agreement will be deemed approved within 30 days of submittal if not acted upon within that time. If approved, *the agreement will be entered as an order of the court.* (page 48) [emphasis added]

This “anticipation” appears to be based on reading in conjunction, Sections 3-125a and 4-160 of the General Statutes. Section 3-125a provides

(a) . . . the Attorney General *shall not enter into any agreement or stipulation in connection with a lawsuit to which the state is a party that contains any provision which requires an expenditure from the General Fund budget in an amount in excess of two million five hundred thousand*

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stipulations have been approved by the General Assembly pursuant to the existing statutes named, the Commission concluded that the required expenditures should be treated in the same manner as expenditures pursuant to court orders.

In general, because court orders or approved stipulated agreements might occur at any time during a fiscal year, including expenditures pursuant to those actions in the fiscal year in which they occur might cause a violation of the spending cap, and/or a violation of the balanced budget requirement. Moreover, eliminating the first-year exemption might lead to a situation in which the legislature determined not to implement a court order because requisite expenditures would violate the cap – thus producing an unwelcome confrontation between the legislature and the judiciary.

C.2b. Treatment of state expenditures related to the implementation of programs funded by federal moneys.

The Commission voted provisionally (12 yea, 10 nay)⁸⁵ to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided . . . (2) (b) state expenditures required to be eligible for receiving federal funds which are mandated or which the General Assembly has voted to accept, including any increase in such expenditures required as a result of changes in the required state contribution to meet federal entitlement and eligibility criteria in order to receive federal reimbursement, shall not be considered general budget expenditures for the first fiscal year in which such

dollars over the term of the agreement or stipulation, unless the General Assembly, by resolution, accepts the terms of such provision. The General Assembly may reject such provision by a three-fifths vote of each house. Such provision shall be deemed approved if the General Assembly fails to vote to approve or reject such provision within thirty days of the date of submittal pursuant to subsection (b) of this section.

(b) Each such agreement or stipulation shall be submitted to the General Assembly by the Attorney General and shall be referred to the committees of cognizance which shall report thereon by resolution. [emphasis added]

Further, Section 4-160 provides, in relevant part, that “The Attorney General, with the consent of the court, may compromise or settle any such action [to which the Claims Commissioner has consented]. *The terms of every such compromise or settlement shall be expressed as a judgment of the court.*” (subsection (h)) And further, that “all actions . . . brought against the state *under any other provision of law* and in which the interests of the state are represented by the Attorney General,” (subsection (k)) shall be reported to the Committee on Judiciary. [emphasis added]

The proposed definition of general budget expenditures concerning court orders was accordingly modified to reflect this understanding of the statutory provisions.

⁸⁵ This vote was for a motion which **combined** the language of C.1c with this language (C.2b).

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expenditures are required or increased, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year, and

Provisional language in Component 2.1c., above, exempts from the spending cap any federal funds granted to the state or its agencies.

This proposed language, which also received preliminary approval, refers to state implementation funds related to federal programs.

- If state expenditures are required in order for the state to be eligible for mandated federal programs, then those expenditures would be exempt in the first year in which the expenditures were required or increased, but not thereafter (although the state expenditure would be included in the base going forward). This language, for mandated programs, parallels the language in the existing Section 2-33a.
- For programs which the state has the option to accept or not – such as the 100% Medicaid program under the ACA (decreasing to 90%), or the Medicaid funds provided to match a portion of the hospital tax – if the General Assembly votes to accept the federal funds, then any state expenditures required initially or increased would be exempt in the first year, but not thereafter (although the state expenditure would be included in the base going forward).
- If the General Assembly votes not to accept such optional program, then of course the federal funds would not be received, so no state expenditures related to the program would be required.

C.2c. Treatment of expenditures for increased unfunded pension liabilities if actuarial assumptions are changed.

The Commission voted provisionally (12 yea, 9 nay)⁸⁶ to support the following component:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided . . . (2) (c) expenditures on or after July 1, 2022, for the payment of the portion of the actuarially determined employer contribution of the teachers’ retirement system or any retirement system or alternative program administered by the State Employees Retirement Commission representing an increase in the unfunded liability attributable to changes in actuarial assumptions or cost methods for such system or program shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered as general budget expenditures for such year

⁸⁶ This vote was for a motion which combined the language of C.1g with this language for C.2c.

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for the purpose of determining general budget expenditures for the ensuing fiscal year.”

The language in this component is intended to recognize the fiscal reality that would accompany a change in actuarial assumptions that would increase the unfunded liability of the various pension programs. Most, if not all, of the members of the Commission have recognized that at least one such assumption – the long-term rate of return – has been unrealistically high and should be reduced. The recent collective bargaining agreement provides for the rate of return to be reduced to 6.9%. But what if that rate also proves to be too high, as several members of the Commission have adamantly argued? A decreased assumption would result in a spike upward in the unfunded liability, again producing an instability and unpredictability in how this increase would be paid off. This language provides that the first year of the increase resulting from such an action would not be included in general budget expenditures, but that the increase would be used as a base for the next fiscal year.

Accordingly, this language provides that, for fiscal years beginning on or after July 1, 2022, any **increase** in the portion of the actuarially determined employer contribution representing the unfunded liability of SERS or TRS attributable to changes in the actuarial assumptions⁸⁷ or cost methods⁸⁸ (and only because of those changes) would be outside the cap in the first fiscal year, but under the cap subsequently.

⁸⁷ What are such *actuarial assumptions*? They include:

- withdrawal or termination assumption - how long will participants continue to work for the sponsor
- retirement assumptions - when participants will retire;
- mortality assumptions - how long participants will live;
- disability assumptions - at what rate and at what ages will participants become disabled
- payroll growth assumptions - how much participants will be paid in the future;
- Inflation rate - the future inflation rate; and
- investment return assumptions - future investment returns on pension assets
- Cost of living assumptions

If any of these assumptions change in the future, they are likely to require an increase in valuation of the unfunded liability, rather than a decrease. Certainly, attempts to move to *more conservative actuarial assumptions* would cause an increase in valuation of the unfunded liability. Most notably, the long term investment return assumption (the discount rate) is likely to decrease, thus requiring an increase in the valuation of the unfunded liability.

⁸⁸ Actuarial *cost methods* are the methods used by actuaries to calculate the amount that must be contributed to a pension plan to cover its expenses. Common actuarial cost methods include Entry Age Normal (EAN) and Projected Unit Credit (PUC). Definitions of each from the Society of Actuaries is below:

- Entry age normal - "is a method of splitting the present value of benefits (PVB) into the actuarial accrued liability (AAL) and the present value of future normal costs (PVFNC). The AAL is based on projected pay and current service. The method defines the normal cost as a level percent of pay from

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Exempting these adjustments removes an impediment to the adoption of more conservative assumptions and cost methods in the future for SERS (and TRS). Moving to more conservative assumptions is a short-term cost for the state, but provides for more stability and predictability. The spending cap should not be a reason for maintaining unrealistic assumptions.

Some members of the Commission expressed concern that this language might permit a repeat of the change in the actuarial valuation of the unfunded liability which accompanied bad practices included in SEBAC IV and V. But the changes in SEBAC IV and V had the effect of decreasing the unfunded liability in the valuation by increasing the value of assets. The value of assets was increased by resetting the actuarial value of assets to the market value of assets which at that time were running significantly ahead of the book value of assets. The language proposed here would exempt from the cap in the first year any increase in the unfunded portion of the liability because of actuarial assumptions or cost methods and therefore would not apply to future actions that seek to reduce annual actuarially determined employer contributions by reducing the unfunded liability, artificially or otherwise, as was done in SEBAC IV and V.

C.2c. Suggested Modification of treatment of expenditures for increased unfunded pension liabilities if actuarial assumptions are changed, in an effort to achieve consensus.

As noted above, the efforts of the chairpersons to seek a consensus definition of general budget expenditures resulted in an alternative version of when and how the portion of the unfunded pension liability of the actuarially determined employer contribution would be exempted from the spending cap calculation. If the alternative version noted above were to be adopted, a concomitant change would be required in the language in this section, as follows:

As used in this section, . . . “general budget expenditures” means expenditures from appropriated funds authorized by public or special act of the General Assembly, provided . . . (2) (c) expenditures on or after July 1, 2019, for the payment of the portion of the actuarially determined

entry age until retirement. EAN generally puts more of the liability into the AAL and less into PVFNC than other methods."

- Projected Unit Credit - "is a method of splitting the PVB into the AAL and the PVFNC is based on projected pay and current service. The normal cost for each member increases as the member approaches retirement age. PUC generally puts less of the liability into the AAL and more into the PVFNC than EAN."

The consensus plan proposed by the administration, and substantially included in the SEBAC collective bargaining agreement, switches from PUC to EAN, thus increasing the unfunded liability.

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employer contribution of the teachers' retirement system or any retirement system or alternative program administered by the State Employees Retirement Commission representing an increase in the unfunded liability attributable to changes in actuarial assumptions or cost methods for such system or program shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered as general budget expenditures for such year for the purpose of determining general budget expenditures for the ensuing fiscal year.

The only change in the originally voted language moves the effective date of this language to FY 2020 (the fiscal year beginning July 1, 2019), in case the Teachers' Retirement Board decides to lower the long-term investment income rate for TRS from the current 8% level – or makes other changes effective then or thereafter which increases the unfunded liability.

Conclusion

The Commission, in preliminary votes, provisionally approved definitions of “increase in inflation” and “increase in personal income,” as well as a number of components that it thought should be included in a definition of “general budget expenditures.” Those provisional definitions are detailed above.

We had also attempted to see if other proposals could garner more support for a consensus. However, we found that some proposals would pick up some votes from some members, but lose votes from other members.

In short, the provisional votes on individual components of the proposed definition of general budget expenditures, even with some modifications, did not strike the right balance to bring all sides of the Commission together.

Although the Commission was unable to agree on an overall report that combined these tentative recommendations into a final product, we believe that these individual elements merit the consideration of the General Assembly as it seeks to fulfill its constitutional responsibility to implement the provisions of Amendment 28 of the Connecticut Constitution.

Report of the Chairpersons Spending Cap Commission

Appendix

I. Statutory Charge to the Spending Cap Commission

Sec. 24 of PA 15-1 (December Special Session) (Effective from passage) (a) There is established a spending cap commission to create proposed definitions of "increase in personal income", "increase in inflation" and "general budget expenditures" for purposes of the general budget expenditures requirement pursuant to section 18 of article third of the Constitution of the state.

II. Members of the Commission

Member	Position/Appointing Authority
William Cibes	Commission Co-Chairperson Appointed by the Senate President Pro Tempore
Patricia Widlitz	Commission Co-Chairperson Appointed by the House Majority Leader
Sen. Beth Bye	Appropriations Committee Co-Chair
Rep. Toni Walker	Appropriations Committee Co-Chair
Sen. Rob Kane	Appropriations Committee Ranking Member
Rep. Melissa Ziobron	Appropriations Committee Ranking Member
Sen. John Fonfara	Finance, Revenue & Bonding Committee Co-Chair
Rep. Jeffrey Berger	Finance, Revenue & Bonding Committee Co-Chair
Sen. Scott Frantz	Finance, Revenue & Bonding Committee Ranking Member
Rep. Christopher Davis	Finance, Revenue & Bonding Committee Ranking Member
Sen. Steve Cassano	Government Administration & Elections Committee Co-Chair
Rep. Jonathan Steinberg	Government Administration & Elections Committee Appointed by Rep. Ed Jutila
Sen. Michael McLachlan	Government Administration & Elections Committee Ranking Member
Rep. Richard Smith	Government Administration & Elections Committee Ranking Member
Tom Fiore	Designee of OPM Secretary Ben Barnes
Roberto Hunter	Appointed by the Governor
Richard Porth	Appointed by the Governor
Ron Van Winkle	Appointed by the Governor
Lori Pelletier	Appointed by the Senate President Pro Tempore
Sen. Joan Hartley	Appointed by the Senate Majority Leader
Suzanne Bates	Appointed by the Senate Minority Leader
Robert Frankel	Appointed by the Speaker of the House
Ellen Shemitz	Appointed by the Speaker of the House
Bart Shuldman	Appointed by the House Minority Leader

The Chairpersons wish to express their appreciation to the members of the Commission for their dedicated commitment to the work of the Commission.

A special thanks to Susan Keane, the administrator of the Committee on Appropriations and the designated administrator of the Commission, and her staff.

Senate Republican Report on the Spending Cap Commission
December 2016

TO: Appropriations Committee
Finance, Revenue and Bonding Committee
Government, Administration and Elections Committee

Dear Fellow Legislators,

As you may recall, our caucus leader Senator Len Fasano asked the Attorney General for a formal opinion regarding the enforceability of the spending cap in November 2015. Our caucus asked for this opinion after years of witnessing the majority party violate the spirit and integrity of the constitutional cap that was approved overwhelmingly by taxpayers in 1992. It appeared that there was no end in sight to the tactics lawmakers used to get out from underneath the spending cap without the declaration of an emergency by the governor and without the super-majority votes by the legislature.

Attorney General Jepsen's opinion confirmed what we had all witnessed – that without definitions the cap could easily be circumvented. The opinion stated that definitions must be enacted by the necessary three-fifths vote of the members of each house of the General Assembly in order for the constitutional spending cap to have a legal effect. This opinion enabled our caucus to bring to the forefront the fact that the General Assembly has still not fulfilled their promise to restrain spending after the enactment of the personal income tax. The spending cap was initially marketed by the legislature and the governor in 1991 as a check on government spending and a way to ensure that taxpayers were not unduly burdened with the taxation of their income. We believe, and fellow Republican Senators believe, that taxpayers have done their part by paying \$135.6 billion in personal income taxes. It is 24 years past due for the General Assembly to fulfill their end of the bargain.

During the December 2015 deficit mitigation discussions Republican leadership pushed for the enactment of definitions for the spending cap. Republican leadership also pressed for appointments to be made to said commission after Democrat leadership missed multiple deadlines for making appointments and setting up initial meetings this year. Enacting an enforceable spending cap remains one of our top priorities for the 2017 legislative session.

We acknowledge the herculean task of getting the necessary three-fifths vote for the passage of said definitions. That is why our approach on the spending cap commission was one of pragmatism. We understand that different individuals on the commission would have liked certain items excluded from the calculation of the spending cap and that everyone on the commission had their own individual goals and interests. That is why Senator Kane participated on our behalf in good faith discussions with the co-chairs of the commission in an attempt to identify cohesive and widely supported definitions to be voted out of the commission.

However, in the end these discussions fell short and we ultimately could not support the final package as put forth by the co-chairs for a number of reasons. First, the final package would have resulted in at least \$635.9 million in new spending not being included under the spending

Senate Republican Report on the Spending Cap Commission
December 2016

cap in just Fiscal Year 2018 alone. Second, the co-chairs were unwilling to tighten the language that they proposed to prevent any additional gimmicks from being employed in the future that could undermine the integrity and strength of the spending cap.

As previously stated, taxpayers have suffered paying \$135.6 billion in income taxes while their government has not fulfilled their part of the pledge. The vitality of our economy and the livelihood of our citizens rely on a government whose expenses do not grow without restraint. Pragmatism and compromise are critical to get the super-majority vote, especially amid a new tied Senate Chamber. We remain hopeful that definitions can be enacted in the upcoming legislative session. Taxpayers deserve no less.

Respectfully Submitted by:

Senator Scott L. Frantz

Senator Robert J. Kane

Senator Michael McLachlan

January 11, 2017

As like-minded members of the Spending Cap Commission, we are submitting the following report as an official document for your consideration.

First, we would like to recognize and thank the co-chairs of the commission for their work. The amount of information gathered and the number of people and organizations involved were significant – more than any other commission or task force of this sort in recent history. We would also like to thank fellow commission members who worked diligently to understand the subject matter and contribute to the process; it made for a vigorous and spirited debate.

We are submitting this report because we want to be certain that the viewpoint and rationale of our contingent of the commission are clearly presented and will be made available to all of the legislative committees that will determine the fate of the commission's work.

More than 24 years have passed since the spending cap was enshrined in the state constitution by 81% of voters. From the start of the commission's work, our goal was to honor those voters, as well as a majority of voters who still want a strong spending cap today – a spending cap that will provide the much needed foundation to resolve the fiscal crisis facing Connecticut today.

At the heart of our approach was a desire to honor earlier legislators' work in 1991 on definitions for the spending cap, as well as honoring the needs of current and future taxpayers.

Thank you for your consideration, and we look forward to working with members of the General Assembly, as this very important issue continues in the next step of the legislative process.

Respectfully,

Melissa Ziobron, State Representative

Christopher Davis, State Representative

Richard Smith, State Representative

Bart Shulldman, Appointee of House Republican Leader Themis Klarides

Suzanne Bates, Appointee of Senate Republican Leader Len Fasano

A Statement from Like-Minded Members Of the Spending Cap Commission

Brief History of the Spending Cap

When a narrow majority of members of the Connecticut General Assembly voted to adopt a broad state income tax in 1991, many were concerned that the new tax created a potential revenue source that would continue to enable massive growth in state spending – which would fall on state taxpayers to fund. In order to appease moderates and to win their votes, income tax proponents agreed to a compromise – a constitutional spending cap. At the same time, members also voted to approve a statutory spending cap, which was seen as a placeholder until the constitutional cap was fully implemented.

In 1992, 81% of voters approved the constitutional cap, enshrining the language in the state constitution. However, in order for constitutional cap to be fully enacted, legislators were tasked with defining three key terms: “Inflation,” “Personal Income,” and “General Budget Expenditures.”

While definitions were proposed in the intervening years, no final action was taken, so those terms remained undefined as it related to the constitutional spending cap. In 2015, Attorney General George Jepsen released an opinion that because the terms in the cap were never defined by a 3/5 majority of state lawmakers, the constitutional cap was not in force.

In 2016, the creation of a Spending Cap Commission – tasked with coming up with suggested definitions for the terms – was included in the deficit mitigation package.

Legislation Creating the Spending Cap Commission, Section 24 of Public Act 15-1

Sec. 24. (*Effective from passage*) (a) There is established a spending cap commission to create proposed definitions of "increase in personal income", "increase in inflation" and "general budget expenditures" for purposes of the general budget expenditures requirement pursuant to section 18 of article third of the Constitution of the state.

(b) The commission shall consist of the following members:

- (1) Two appointed by the speaker of the House of Representatives;
 - (2) Two appointed by the president pro tempore of the Senate;
 - (3) One appointed by the majority leader of the House of Representatives;
 - (4) One appointed by the majority leader of the Senate;
 - (5) One appointed by the minority leader of the House of Representatives;
 - (6) One appointed by the minority leader of the Senate;
 - (7) Three persons appointed by the Governor;
 - (8) The chairpersons and ranking members of the joint standing committees of the General Assembly having cognizance of matters relating to appropriations and the budgets of state agencies, finance, revenue and bonding, and government administration and elections, or each chairperson's or ranking member's designee; and
 - (9) The Secretary of the Office of Policy and Management, or the secretary's designee.
- (c) Any member of the commission appointed under subdivision (1), (2), (3), (4), (5), (6) or (8) of subsection (b) of this section may be a member of the General Assembly.
- (d) All appointments to the commission shall be made not later than thirty days after the effective date of this section. Any vacancy shall be filled by the appointing authority.
- (e) The speaker of the House of Representatives and the president pro tempore of the Senate shall select the chairpersons of the commission from among the members of the commission. Such chairpersons shall schedule the first meeting of the commission, which shall be held not later than sixty days after the effective date of this section.
- (f) The administrative staff of the joint standing committee of the General Assembly having cognizance of matters relating to appropriations and the budgets of state agencies shall serve as administrative staff of the commission.
- (g) The commission shall hold a public hearing relating to the proposed definitions in each congressional district in the state.

(h) Not later than December 1, 2016, the commission shall submit its proposed definitions to the joint standing committees of the General Assembly having cognizance of matters relating to appropriations and the budgets of state agencies, finance, revenue and bonding, and government administration and elections, in accordance with the provisions of section 11-4a of the general statutes. The commission shall terminate on the date that the commission submits its proposed definitions or December 1, 2016, whichever is later.

Spending Cap Commission Charge and Activity

On March 30th, the Spending Cap Commission convened its first meeting. Since its inception, the commission has been extremely active, including:

- Approximately 20 meetings;
- Accepted testimony from dozens of people of diverse backgrounds, including legislators, business owners, think tanks, and more;
- Received presentations from subject matter experts, business leaders, agency personnel, non-partisan staff, and others;
- Conducted a public hearing in every state congressional district;
- Received, reviewed, and debated hundreds of pages of related documentation.

After months of testimony, presentations, and debate the Commission began to take action on the three measurers dictated in their mandate. Various measures of “Inflation” and “Personal Income” were discussed and debated and the commission came to agreement with regard to these two definitions. On the basis of historical analysis and comparisons of different measures, the differences of the definitions discussed were relatively small, which resulted in minimal contention among commission members. The following are the two definitions adopted by commission members:

“Increase in personal income” means the compound annual growth rate of personal income in the state over the preceding five calendar years, according to United States Bureau of Economic Analysis data.

“Increase in inflation” means the increase in the consumer price index for urban consumers, all items less food and energy, during the preceding calendar year, calculated on a December over December basis, according to United States Bureau of Labor Statistics data.

Coming to agreement on the third component of the spending cap – a definition of “General Budget Expenditures” – proved to be much more difficult. Members of the commission were divided among those who believed in a more inclusive definition of a spending cap – one that would include almost all state spending – and those who wanted to exclude many items from the definition, and therefore exclude them from the spending cap.

Our Proposed Definition of General Budget Expenditures

We, the signees of this document, proposed the following definition of “General Budget Expenditures”:

(1) general budget expenditures for any fiscal year shall not exceed those authorized during the previous fiscal year by a percentage which shall be determined by the greater of the percentage increase in personal income or the percentage increase in inflation, and (2) general budget expenditures shall not include (i) expenditures for payment of the principal of and interest on bonds, notes or other evidences of indebtedness as issued by the state treasurer, (ii) expenditures pursuant to section 4-30a, (iii) expenditures of any federal funds granted to the state or its agencies, and (iv) expenditures for the implementation of federal mandates or court orders shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered general budget expenditures for such year for the purposes of determining general budget expenditures for the ensuing fiscal year. As used in this section, “federal mandates” means those programs or services in which the state must participate, and in which the state must meet federal entitlement and eligibility criteria in order to receive federal reimbursement, provided expenditures for program or service components which are optional under federal law or regulation shall be considered general budget expenditures.

Our reasoning follows:

The conclusion we reached from our independent research, from listening and debating the hundreds of documents brought forward by commission members, outside experts, and concerned citizens, is that the spending cap is meant to protect taxpayers from state government spending that grows faster than taxes collected to pay for the expenditures. Over and over, we heard from citizens, organizations and businesses who asked for a definition of expenditures that was inclusive of all state spending.

A spending cap is a critical control for lawmakers to set priorities when budgeting taxpayer dollars. And, to paraphrase one resident's comments during a public hearing, by including all state spending under the cap, every resident starts out equal in the budget process. Every time a category of spending is moved out from under the cap, it privileges some residents over others.

In addition to developing those priorities, lawmakers will continue to have the ability to override the spending cap by a 3/5 vote. This emergency valve is an important provision that must be maintained to protect Connecticut should a difficult budget situation arise.

An explanation for the components of the *"general budget expenditure"* definition follows:

(i) expenditures for payment of the principal of and interest on bonds, notes or other evidences of indebtedness as issued by the state treasurer

This is language included in the state constitution. Removing this would require a constitutional amendment.

(ii) expenditures pursuant to section 4-30a

This is money reserved for the state's "Budget Reserve Fund." Money deposited to this fund comes from highly volatile sources of state revenue. This use of this fund is meant to smooth out state revenues during periods of growth or recession – and to protect taxpayers from tax increases during recessionary periods.

(iii) expenditures of any federal funds granted to the state or its agencies

The constitutional spending cap was meant to cap state spending in order to protect taxpayers from regular tax increases that would occur if spending grew faster than state revenues. While there are arguments to be made about how the federal government spends its money, we believe that is outside the primary purpose for the state's spending cap.

(iv) expenditures for the implementation of federal mandates or court orders shall not be considered general budget expenditures for the first fiscal year in which such expenditures are authorized, but shall be considered general budget expenditures for such year for the purposes of determining general budget expenditures for the ensuing fiscal year. As used in this section, "federal mandates" means those programs or services in which the state must participate, and in which the state must meet federal entitlement and eligibility criteria in order to receive federal reimbursement, provided expenditures for program or service components which are optional under federal law or regulation shall be considered general budget expenditures.

This is to protect key state services in years when an outside body, like the federal government, imposes a new and unplanned spending requirement for a mandated program. After the first year, that program or expenditure is no longer unplanned and should be counted towards the spending cap.

Other Proposed Exclusions From General Budget Expenditures

We will briefly explain below why we believe the exclusion of other spending categories from the definition of "General Budget Expenditures" is unwise.

(i) Payments toward unfunded pension liabilities

Spending on employee benefits and teachers' retirement comprises a significant and growing portion of the state's budget. As we heard in testimony from Webster Bank President, James C. Smith, regarding moving pension liabilities out from under the cap: "Such maneuvers violate the will of voters and only serve to make our finances more precarious."

Pension reform is critical to Connecticut's future fiscal health. Removing pension liabilities out from under the cap reduces the pressure to pursue reform.

(ii) Expenditures for statutory grants to distressed municipalities

A definition that will essentially become constitutional language should be built to last. The definition of “distressed municipalities” is outdated, and it would be difficult to define the term in a way that satisfies the needs of current and future residents. This is not to say that helping distressed municipalities is unimportant, but rather that this vital spending should be included in the list of all priorities and potential investments lawmakers must grapple with year after year.

(iii) Expenditures by the state or any of its agencies of gifts, grants, contributions, trust income or other aid from private sources or foundations which have been given for restricted purposes specified by the donors of such funds.

This type of spending is already excluded from the spending cap since it comes from dedicated funds.

Conclusion

While the Spending Cap Commission did not achieve consensus on the definition of “general budget expenditures”, the Commission still did a significant amount of important work. During the 2017 legislative session, lawmakers face a difficult task already, given the large budget deficit projected, and they should use the work by the commission as the foundation for discussions and deliberations.

It is our hope that lawmakers do take up this important task in 2017 so that once and for all we can implement the constitutional spending cap – and finally keep the promise that was made to taxpayers over two decades ago.

Separate Statement of William Cibes

To:

Committee on Appropriations and the Budgets of State Agencies
Committee on Finance, Revenue and Bonding
Committee on Government Administration and Elections.

In addition to the proposed tentative provisions considered by the Spending Cap Commission which received preliminary and tentative majority votes during the deliberations of the Commission, several additional provisions merit the consideration of the General Assembly as it considers a statute to implement the constitutional spending cap.

These additional matters fall into three categories:

Part I. Two proposals, concerning the terms which the Commission was charged to define, that were rejected by the Commission

- A. Adopt a better definition of “increase in inflation”
- B. Include tax expenditures as “general budget expenditures”

Part II. Proposals to modify language of the statutory cap (existing Section 2-33a) which concerns matters other than the three definitions before the Commission

- A. Prevent a “ratcheting down” of the cap when insufficient revenues hold expenditures below the cap
- B. Prevent a “ratcheting down” of the cap in years after surplus revenues are used to support expenditures

Part III. Proposals to initiate new legislative procedures which would provide greater transparency and more effective legislative oversight of state fiscal matters.

- A. Create and annually use a “tax expenditure” budget, to provide a comprehensive, consistent process to initiate and review tax expenditures
- B. Improve the review of, and tighter controls on, bonding, so as to limit uncapped expenditures for payment of bonds and notes, thus avoiding extra interest costs and reducing revenue diverted to pay for debt service.

I encourage the General Assembly to consider these options carefully.

Part I.

I recommend that the General Assembly consider two provisions concerning the terms the Commission was asked to define which were considered by the Commission, but which did not receive approval:

- A. A definition of “increase in inflation” which is more consistent with the understanding of those in the General Assembly who voted for the language of the constitutional spending cap which was ultimately approved by the voters at the 1992 election. This definition focuses on the increase in price of the basket of goods and services purchased by government.
- B. A provision which would modify the definition of “general budget expenditures” to include what are commonly called “tax expenditures,” especially those tax incentives and credits applicable to business entities.

A. Increase in Inflation

The definition of “increase in inflation” which received a tentative vote of approval by the Commission was based on the consumer price index for all urban consumers, including all items less food and energy, an index known as Core CPI-U. I voted against using this index, because it does not adequately reflect the true cost of inflation which affects government services. Instead, I supported the following alternative definition of “increase in inflation,” which in my view uses a better measure of what government purchases.

“Increase in inflation” means the increase in the national price index for state and local government consumption expenditures and gross investment during the most recently completed calendar year, according to United States Bureau of Economic Analysis data.

Let me explain my reasoning.

Neither the consumer price index for all urban consumers – the CPI-U – nor the consumer price index for all urban consumers excluding food and energy – the Core CPI-U – is adequate to measure the true cost of inflation in government’s service provision.

1.

Although the original 1991 statutory spending cap used the consumer price index for urban consumers (CPI-U) to measure “increase in inflation,” the CPI-U is not a good measure of the cost to government to purchase the goods and services it provides.

During the debate on adoption of the constitutional spending cap in 1991, it was observed that the basket of goods and services purchased by consumers is quite different from the basket of goods and services purchased by government.¹

Information presented to the Commission provided detail to support that distinction.²

Specifically, the categories of expenditures included in the price index for consumers³ are listed below.

Major Group of Consumer Expenditures	Weight (2015)
Food and beverages	14.97
Housing	42.24
Apparel	3.10
Transportation	15.26
Medical Care	8.38
Recreation	5.73
Education and Communication	7.15
Other Goods and Services	3.18

The basket of goods and services purchased by government is significantly different. Governments purchase little housing, little food, little apparel, little recreation. On the other hand, governments purchase educational, judicial, public safety and human services, as well as support services for children and families, for those with developmental needs, and those with mental health needs, by paying employees to provide them, and sometimes by paying private vendors to deliver them. These

¹ During the debate on the constitutional amendment, Sen. Jepsen clearly delineated why using the Consumer Price Index as the measure of inflation would be “strait jacketing state government growth.” “the CPI has very little to do with the real growth in cost in running a state government. That is because the state government does not buy a bundle of groceries, a tank full of gasoline and the other consumer products and services that are the normal indicia of the Consumer Price Index. The government buys medical services, primarily and also coaxed [?] with the growth and real problems, Medicaid with 15 to 16% annual growth, medical expenses coupled with the demographic growth of 3% roughly for our senior citizens, means that to provide a particular service, that service, it’s not a 5, 6 or 7% growth rate, but in the last five years it has been 14, 15, 16, 17%. . . . Prisons and our state felon population, the number of convicted felons in our State has more than tripled in just 12 years. Yet if we were strait jacketed by the CPI index . . . we would be artificially strait jacketing growth in that area as well.” Sen. Jepsen, debate on HJ 205, Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, August 21, 1991, transcript, pp. 193-194.

² See, especially, Stan McMillen, et al., “Connecticut’s Spending Cap: Its History and An Alternative Spending Growth Rule,” Connecticut Center for Economic Analysis, University of Connecticut, September 2005. “...the costs state governments face are materially and significantly different from the costs (prices) consumers face. This situation is primarily due to differences in the composition of the ‘baskets’ of goods and services state governments and consumers purchase.” (p. i)

³ See Appendix 5, “The Consumer Price Index,” in *Handbook of Methods*, published by the U.S. Bureau of Labor Statistics, U.S. Department of Labor, as referenced in the presentation by Dr. Dan Kennedy, May 25, 2016, who included a convenient summary, with 2015 weights.

services, which constitute a major share of what government does, are usually face-to-face personal services, not amenable to major productivity increases (and concomitant cost savings) that might be possible in conjunction with the goods and services purchased by an individual consumer.⁴ Accordingly, the cost of providing government services is likely to increase by a greater amount than the cost of what consumers buy. There is a need for a metric which focuses on these kinds of services, as opposed to the goods and services purchased by consumers.

There is such a metric. The U.S. Bureau of Economic Analysis has constructed a price index for government consumption expenditures and gross investment, whether at the national level or the state and local level. The BEA says that government consumption expenditures and gross investment

can be viewed as expenditures incurred by general government for goods and services – primarily services that are produced by labor and capital within the general government sector – that are provided without charge to the public, whether to individual members of society (such as education at public schools) or to society as a whole (such as national defense or law enforcement).⁵

The cost of the goods and services those governments provide (such as public safety, corrections, judicial, health services, human services, social services, education, etc. at the state and local level) consists mainly of compensation of government employees

⁴ This was the insight of the economist William Baumol, who has for more than fifty years hypothesized that there is a “cost-disease of the personal services” – greater increases in prices in low productivity growth industries than in high-productivity industries. First suggested in the 1960s in a paper which used the example of the inability to achieve greater productivity in personal services in the performing arts [When Mozart wrote a quintet in the 1780s, it took five people to perform it. It still does.], it has been subsequently elaborated in the many editions of his introductory economics textbook [e.g. Baumol and Blinder, *Economics: Principles and Policy*, e.g. 11th edition, 2009, in chapters 15 (pp. 324-328) and 24 (pp. 530-31)], and most recently in *The Cost Disease: Why Computers Get Cheaper and Health Care Doesn't* (Yale University Press, 2012).

Without further exploration, it is not possible at this time to assess whether the price index discussed here adequately accounts for such cost increases. But see William Nordahl, “Baumol's Disease: A Macroeconomic Perspective,” Working Paper 12218, for the National Bureau of Economic Research, May 2006, which concludes, inter alia, that “The hypothesis of a cost-price disease due to slow productivity growth is strongly supported by the historical data. Industries with a relatively lower productivity growth show a percentage-point for percentage-point higher growth in relative prices.” (pp. 18-19). (This paper is available on the Commission's website, under date of July 7, 2016.) Government is among those “industries” with relatively lower productivity growth.

But there is little dispute that in most years since 1991, the BEA national price index for state and local government consumption expenditures and gross investment has been greater than either the CPI-U or the Core CPI-U. See the data compiled by OPM and submitted to the Commission on August 15, 2016, “Inflation Exhibit from OPM.PDF,” available on the Commission's website under the meeting date of August 15, 2016.

⁵ “Government Transactions: Methodology Papers, U.S. National Income and Product Accounts” (September 2005), U.S. Bureau of Economic Analysis, U.S. Department of Commerce, linked at http://www.bea.gov/methodologies/index.htm#national_meth (listed as “MP-5 Government Transaction”)

and the cost of purchasing intermediate goods (durable and non-durable) and services.⁶ Overall, nationally, about 34% of consumption expenditures is comprised of the purchase of intermediate goods and services, and 66% involves the compensation of government employees, with both categories offset by sales to other sectors. Of gross investment, about half is investment in structures, and the rest is investment in equipment and intellectual property products.⁷ It would be expected that the mix of purchases is likely to be different at the state and local levels, but there is apparently no state-specific, or even level-of-government specific, data to provide a basis for determining the distribution of costs at those levels.⁸

The price index of government consumption expenditures and gross investment can be broken down into “Federal” and “State and Local” government expenditures for these costs.⁹ However, relatively contemporaneous data for the latter measure is only available as an aggregate figure for all states and local governments. The aggregate data is available on a quarterly basis with only about a 3-month lag. State-specific data is not available for 6 months to 12 months after the end of a calendar year.

Please note that data for the “price index for state and local government consumption expenditures and gross investment” is nearly identical to the “implicit price deflator for state and local government consumption expenditures and gross investment.”¹⁰ If one compares data in NIPA Table 1.1.4 “Price Indexes for Gross Domestic Product,” with data in NIPA Table 1.1.9, “Implicit Price Deflators for Gross Domestic Product,” one finds that disparity between the data in one table for “Government Consumption Expenditures and Gross Investment” diverges from data in the other table by 0.002 of an index point or less across the last ten quarters.¹¹

⁶ See Chapter 9, “Government Consumption Expenditures and Gross Investment,” (November 2014) in *NIPA Handbook: Concepts and Methods of the U.S. National Income and Product Accounts*, published by the U.S. Bureau of Economic Analysis, U.S. Department of Commerce, esp. page 9-5 through 9-7. (linked at http://www.bea.gov/methodologies/index.htm#national_meth)

⁷ See Table 9.1, at page 9-5 in the chapter cited in footnote 6.

⁸ An explanation of the use of the BEA State and Local Government Price Index in Vermont, in 2009, provided to the Commission by Dr. Stan McMillen on July 7, 2016, observes that the index “is an aggregation of all state and local expenditures . . . and does not account for regional price differences. Although it would be possible to develop an independent Vermont-specific measure of education inflation, the cost of developing and maintaining such an index would be extremely expensive.” (“State and Local Government Price Index: Questions and Answers,” p. 2. (linked on the Commission’s website under date of July 7, 2016)

⁹ See, e.g., NIPA Table 1.1.4 in the interactive data section of the BEA website: <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=4>

¹⁰ In his presentation to the Commission on July 18, 2016, Dr. Dan Kennedy stated, “The change in the GDP Implicit Price Deflator is roughly equal to the change in the GDP Price Index.” See “State GDP Deflator and State PI,” p. 11, linked on the Commission’s website under date of July 18, 2016.

¹¹ See in the interactive data section of the BEA website: <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=4> and <http://www.bea.gov/iTable/iTable.cfm?ReqID=9&step=1#reqid=9&step=3&isuri=1&903=13>

Ideally, one might prefer to use price index¹² data for government consumption expenditures and gross investment that is specific to the state of Connecticut. Indeed, such data is available by performing calculations from Connecticut data on GDP in current dollars and Connecticut data on real GDP in chained dollars on the BEA interactive data website. However, there are two issues with this approach. First – and foremost – the use of state-specific data runs the risk of ratcheting up the index over a period of time. Because so much of the index is based on compensation of employees, basing a measure of inflation on past compensation increases in one jurisdiction might make it possible to dramatically increase the index over a period of time. For this reason, it makes sense to use an index based on the change in government consumption expenditures and gross investment in all states. This national data is included in the index recommended here.

Secondly, as noted above, state-specific data are only available after a significant time lag. If it makes sense to provide an exception to basing the spending cap on the increase in personal income because of recent increases in inflation, then surely one should use the most current data available to measure inflation.

Why should the costs associated with local government be included in the measure of “increase in inflation” as part of a state spending cap? Apart from the fact that BEA only reports data on a combined “state and local government” basis, a large part of Connecticut’s state budget – which pays for the basket of goods and services government purchases – pays for spending for local public schools, and for road repair, economic investment, and property tax relief.¹³

All in all, the increase in the national price index for state and local government consumption expenditures and gross investment is a better measure of “increase in inflation” than any metric based on consumer purchases.

2.

If CPI-U is a mis-measure of inflation in the cost of the services government provides, the Core CPI-U can be even less accurate. And accordingly it leads to another reason for using the less restrictive “national price index for state and local government expenditures and gross investment” as the measure of inflation, as opposed to the Core CPI-U.

Using **Core** CPI-U as the gauge of inflation – thus excluding the cost of food and energy from the normal CPI-U measure – often results in a lower inflation number than would

¹² Assuming congruence with the implicit price deflator measure.

¹³ As Stan McMillen and his colleagues observe, “. . . the relevant standard for a spending cap is arguably state and local expenditure, not state expenditure alone—especially as the state has ramped up its transfers to local government. Local expenditures are typically nearly a quarter of total public sector expenditures; a spending cap that ignores the interdependence between state and local expenditure may result in significant increases in the inequality of local tax burdens, inequalities that may then generate negative feedbacks on a variety of areas, including economic competitiveness.” McMillen, “Connecticut’s Spending Cap . . .”, p. 10.

be the case if those items were included. And using Core CPI-U as the gauge of inflation of the basket of goods and services purchased by government has in 15 of the 25 years since 1991 resulted in a lower number than the price index recommended here.¹⁴ That runs precisely contrary to the expectations of the framers of the constitutional spending cap.

When it adopted the constitutional spending cap, later ratified by the people in 1992, the General Assembly specifically rejected the proposal that the cap on state expenditure should be the lesser of the increase in inflation or the increase in personal income. Those who prevailed argued that, in most years, the increase in personal income would be greater than the increase in inflation. But in extraordinary circumstances, when inflation was rampant, running ahead of limited growth in personal income, using the increase in inflation as the appropriate limit would better enable the state “to pay for the real growth in services demanded of government”¹⁵ to meet constituents’ needs.

In short, an appropriate definition of “increase in inflation” would provide an exception on the upside to a constrained growth in personal income. Majorities in both the House and Senate, in short, wanted to make sure that there would be room under the cap to address the real inflationary costs of the times. Even though they deferred to the General Assembly to define the precise measure of inflation, there are good reasons to think they would not want that measure to be unduly restrictive.

B. Including Tax Expenditures as “General Budget Expenditures”

Just as the fiscal condition of the state is affected when appropriations exceed a specified limit, so is it affected if revenue which it would otherwise receive pursuant to the state’s tax laws is forgone by giving tax breaks to individuals and business entities. Appropriations for the payment of goods and services which the state purchases confer tangible benefits on the recipients of those payments. Tax expenditures – including tax exemptions, tax deductions, and tax incentives and credits – are similarly employed by governments to “reduce the taxes an individual or entity otherwise would owe, with the intent of encouraging those individuals or entities to engage in certain behaviors.”¹⁶

¹⁴ Compare the data for the CPI-U (column D) with the data for Core CPI-U (column E) with the data for “National State and Local Gov. IPD” (column L) in Exhibit C of the report provided by OPM to the Commission on August 15, 2016. “Inflation Exhibit from OPM.PDF” available on the Commission’s website under date of August 15, 2016.

¹⁵ As Sen. Jepsen characterized it. Sen. Jepsen led the opposition, ultimately successful, against the effort to modify the language of the constitutional amendment as originally proposed to provide that the spending cap should be the LESSER of the increase in inflation or the increase in personal income. See Senate debate on HJ 205, Resolution Proposing a Constitutional Amendment Imposing a Limit on State Expenditures, August 21, 1991, transcript, page 195.

¹⁶ GASB, “Statement No. 77 of the Governmental Accounting Standards Board: Tax Abatement Disclosures,” August 2015, p. 3, linked at http://www.gasb.org/cs/ContentServer?c=Document_C&pagename=GASB%2FDocument_C%2FGASBDocumentPage&cid=1176166283745

Although all tax expenditures are of interest, I think it makes sense to focus on tax abatements and credits for economic development purposes, as does the Governmental Accounting Standards Board, because they involve such a large share of tax expenditures.

Because the revenue loss from such abatements and credits reduces the funds available to pay for appropriations which are limited by the spending cap – and hence adversely affects the “balanced budget” provision of the constitutional amendment – and because I believe they deserve the same – or analogous – careful scrutiny required of capped appropriations, I supported the following provision considered by the Commission:

“General budget expenditures” means (A) expenditures from appropriated funds authorized by public or special act of the General Assembly, and (B) the value of tax incentives for business entities authorized by public or special act of the General Assembly, and credits authorized by public or special act of the General Assembly against taxes imposed on business entities by provisions of Chapters 207, 208, 209, 210, 211, 211a, 212, 212a, 212b and 213a of the General Statutes, . . .
(new language is underlined)

1.

As the report of the chairpersons observed, there was support among the members of the Commission to the effect that:

- The spending cap should not impose greater limits on certain economic growth strategies, such as the investment in quality education for all students, over other strategies (such as tax expenditures . . .).

Despite support for this proposition, the proposal as stated above (in **bold**) did not receive approval by the Commission (the motion to approve failed (6 yea, 17 nay)).¹⁷

If appropriated expenditures that provide assistance to individuals and local governments – for education, for assistance to those with disabilities, for assistance to children, and for medical assistance – are limited by a spending cap, it is difficult for me to understand why tax incentives and credits that provide assistance to business entities are not similarly constrained.

¹⁷ Many members of the Commission apparently voted to reject this proposal because they thought that such a provision was outside the purview of the Commission since it “was a revenue item,” not a matter of expenditure. To be consistent, those who adhere to such a view should also reject proposals which would classify revenue intercepts as budget expenditures, since intercepted revenue is also a “revenue item.” Like tax expenditures (see below), they should be examined closely before they are put in place, and regularly reviewed thereafter, but if tax expenditures are to be outside the spending cap, so should revenue intercepts.

2.

Moreover, given that the effective cap on appropriated expenditures has been in recent years (and may be in the foreseeable future) the lack of available revenue, the diversion of revenue for tax abatements and credits inevitably affects the capacity of the state to meet other needs. If not reviewed regularly, there can be a permanent reduction in the state's revenue stream.

The Fiscal Accountability Report issued by the Office of Policy and Management on November 15, 2016, estimates that \$285,500,000 in business tax credits will be claimed in FY 2018, increasing to \$308,400,000 in FY 2020.¹⁸ The estimate of the Office of Fiscal Analysis in its Fiscal Accountability Report of the same date is roughly of the same magnitude.¹⁹

The consequence of granting these tax credits is to reduce available revenue by \$285 to \$308 million. If they were not granted, the projected deficit for FY 2018 would range from \$1.0 billion to \$1.2 billion, rather than \$1.3 billion to \$1.5 billion.

(The U.S. Government Accountability Office, in a July 2016 report on Tax Expenditures, observed that tax expenditures – “special credits, deductions, and other tax provisions that reduce taxpayers’ tax liabilities” – represent a substantial commitment on the part of government. At the federal level, as much revenue was forgone in FY 2015 as was committed in discretionary spending.²⁰)

3.

Tax expenditures are often aimed at policy goals similar to those of spending programs. However, their contribution toward achieving those goals is much less visible, and indeed, is frequently not identified in any specific manner. And usually only proposed tax expenditures and those that expire are subject to legislative review.²¹ In short, they

¹⁸ Connecticut Office of Policy and Management, “Fiscal Accountability Report, Fiscal Years 2017 – 2020,” November 15, 2016, p. 8. This report may be found at

http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

¹⁹ Office of Fiscal Analysis, “Fiscal Accountability Report, FY 17 – FY 20,” November 15, 2016, p. 30. This report may be found at https://www.cga.ct.gov/ofa/Documents/year/FF/2017FF-20161115_Fiscal%20Accountability%20Report%20FY%2017%20-%20FY%2020.pdf

https://www.cga.ct.gov/ofa/Documents/year/FF/2017FF-20161115_Fiscal%20Accountability%20Report%20FY%2017%20-%20FY%2020.pdf

²⁰ U.S. Government Accountability Office, “Tax Expenditures: Opportunities Exist to Use Budgeting and Agency Performance Processes to Increase Oversight,” (GAO-16-622) July 7, 2016, p.2 (of PDF).

<http://www.gao.gov/products/GAO-16-622>

²¹ U.S. Government Accountability Office, “Tax Expenditures: Opportunities Exist to Use Budgeting and Agency Performance Processes to Increase Oversight,” (GAO-16-622) July 7, 2016, p.2 (of PDF).

<http://www.gao.gov/products/GAO-16-622> The comments above largely reiterate the language of the GAO's earlier 2013 report: “Similar to spending programs, tax expenditures represent a substantial federal commitment to a wide range of mission areas. If the Department of the Treasury (Treasury) estimates are summed, an estimated \$1 trillion in revenue was forgone from the 173 tax expenditures reported for fiscal year 2011. Tax expenditures are often aimed at policy goals similar to those of federal spending programs. Existing tax expenditures, for example, are intended to encourage economic development in disadvantaged areas, finance postsecondary education, and stimulate research and development. For some tax expenditures, forgone revenue can be of the same magnitude or larger than

are both stealthy (tax expenditure policy is often set behind closed doors toward the end of a legislative session without public input and close examination) and semi-permanent (tax expenditures are self-perpetuating until someone serendipitously notices that a credit is still on the books). Counting tax expenditures as general budget expenditures should make sure that there is sufficient legislative oversight.

4.

For all these reasons, I recommend the adoption of language which classifies these tax expenditures as part of “general budget expenditures.”

However, if the General Assembly decides to follow the lead of the Spending Cap Commission, and determines that these tax expenditures are “revenue items” and not “expenditure items,” there is still an opportunity for legislators to establish procedures to review them closely. See Part III, Section A, below.

Part II.

Although outside the strict purview of the Commission, because these Part II issues do not involve the three definitions for which the Commission was charged with making recommendations, I recommend that other changes to the statutory spending cap language in Section 2-33a or its replacement should be made. Both of these recommendations suggest a remedy to a “ratcheting down” effect, an effect that currently inhibits the ability of the state (a) to restore investment in programs and services that had been curtailed only because of a shortage of revenue, or (b) to continue investment in programs and services that it deemed as of sufficiently high priority to fund with surplus dollars.

A. Prevent a “ratcheting down” of the cap when insufficient revenues hold spending below the cap: use allowable expenditures as the base for future calculations of the spending cap

“Ratcheting down” can occur when actual expenditures under the cap do not exhaust allowable expenditures under the cap.

This issue was identified as a potential problem by the National Conference of State Legislatures in a policy report in 2012: a spending limit can “cause a ‘ratchet-down-

related federal spending for some mission areas. The revenue the federal government forgoes from a tax expenditure reduces revenue available to fund other federal activities, requires higher tax rates to raise any given amount of revenue, increases the budget deficit, or reduces any budget surplus.”

effect' where the limit causes the spending base to decrease so that maximum allowable growth will not bring it up to the original level."²²

In the years of the Great Recession, the ability of the state to fund critical investments in education, health care and transportation was constrained by limited or no growth in the state's revenue stream. Unfortunately, the resulting reduced level of state expenditures also has an impact in future years.

Accordingly, a revision to the spending cap language is required to establish the base for calculation of the permitted increase as either the amount actually appropriated during the preceding year, or the amount that would have been allowed under the spending cap during the preceding year. If the latter alternative is not permitted, reduced spending in recession years ends up curbing growth in state spending once the economy recovers, even though state revenues are on the rise and funding could be restored to programs that were cut. "This prevents important needs from being met and crucial public investment from taking place."²³ Using allowable spending as the base prevents the budget from ratcheting down with each recession (because of a slow rate of growth applied to a depressed budget base). "This would leave room under the cap for restoring spending to pre-recession levels once the state's economy recovers."²⁴

This problem has not been, and will not be, confined to the years of the Great Recession and the subsequent economic recovery. It will also be manifest in FY 2018, when the base used to calculate the spending cap will be low because appropriated spending in FY 2017 was \$635 million less than allowed because revenue was not sufficient, even after tax increases in immediately prior years, to pay for current services. The consequent reduction in services occasioned a major pushback both from those who opposed the reduction in appropriations and those who supported it – with both sides vowing to restore funds in FY 2018.²⁵ But if the spending cap is not revised

²² National Conference of State Legislatures, "State Tax and Expenditure Limits – 2012," page 8, available on the Commission's website, under meeting date of March 30, 2016.

²³ Elizabeth C. McNichol, Senior Fellow, State Fiscal Project, Center on Budget and Policy Priorities, "CBPP CT Spending Cap Testimony May 9, 2016", page 3, available on the Commission's website (under "information"):

https://www.cga.ct.gov/app/taskforce.asp?TF=20160330_Spending%20Cap%20Commission

²⁴ MicNichol testimony, page 6.

²⁵ See, for example, "Eastern Connecticut legislators and their challengers ... all agreed that funding for human services nonprofits must be preserved. . . incumbents and challengers from both sides of the aisle generally agreed that they'd support The Arc and similar groups when budget negotiations threaten them" as reported in "Our View: Candidates unequivocally defend human services groups," *The Norwich Bulletin*, October 13, 2016 <http://www.norwichbulletin.com/opinion/20161013/our-view-candidates-unequivocally-defend-human-services-groups>, "Looney Adds Voice to Fare Hike Opposition," *New Haven Independent*, October 4, 2016, http://www.newhavenindependent.org/index.php/archives/entry/looney_fare-hike_opposition/, "Riders Gird for Fare Hike: Harp Opposed," *New Haven Independent*, August 18, 2016, http://www.newhavenindependent.org/index.php/archives/entry/bus_fare_hike/, and "A Confident Future: The Senate Republican Legislative Agenda, 2017 Legislative Session," linked at <http://ctsenaterepublicans.com/2016/09/senate-republicans-unveil-legislative-agenda-a-confident-future-2/#.WHk8dmq7qM8> which variously proposes to "reinstate recent reductions to Care4Kids" (page 6),

to permit FY 2018 spending cap calculations to be based on allowable expenditures in FY 2017, rather than actual, service restoration is not likely to be possible.²⁶

To reiterate, to avoid “ratcheting down” the spending cap in those years when actual expenditures under the cap do not exhaust allowable expenditures under the cap, language should be incorporated into the statutory cap which clarifies that allowable expenditures in one fiscal year may serve as the base for calculating the spending cap for the ensuing fiscal year.

B. Prevent a “ratcheting down” of the cap in years after surplus revenues are used to fund expenditures: use expenditures permitted as the result of a declaration of “extraordinary circumstances” as the base for future calculations of the spending cap

A second type of “ratcheting down” occurs when surplus dollars are used to fund appropriations in excess of the amount permitted by the spending cap, but the base for calculating the spending cap for the next fiscal year is not adjusted upward to incorporate those additional expenditures.

If the Governor and the General Assembly take action to exceed the spending cap, the amount permitted should automatically be included in the base for the calculation of the cap in the next fiscal year. If new programs are initiated, or existing programs expanded, because additional revenue is available to make it possible to provide additional services which the legislature deems to be of high priority, it makes no sense to cut them out in the following year through the arbitrary application of a spending cap pegged to the level of expenditure before the programs were added.

Certainly, unavailability of surplus dollars in future years may compel hard choices to be made, and re-prioritizations to occur. But unless the new services are clearly “one-time” in nature, there is little reason to start or expand services only to trim them back after a single year only because the spending cap was not rebased. Such action strongly

“increase[e] mental health and substance abuse treatment to former offenders” (page 6), “restore funding to appropriate levels for local education” (page 8), “provide additional funding for the programs that provide direct support to our seniors. . . . reinstate funding for the mobile bus program” (page 8), “creat[e] . . . a new appropriation to solely fund cases defined by the Department of Developmental Services (DDS) as emergent” (page 9).

²⁶ As the Fiscal Accountability Report for FY 2017 to FY 2020 presented by OPM has recently demonstrated, it is likely that the spending cap would permit an increase in capped expenditures of about \$300 million in FY 2018, but fixed costs alone (for both capped and uncapped expenditures) might require an increase of greater than \$1 billion. OPM Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, pages 16 and 5, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

implies a lack of foresight. Better to make the hard decision in the first place not to add these costs.

The constitutional spending cap – standing alone – does not specify that ratcheting down must occur. Language of the constitutional cap provides only that the Governor may declare the existence of an emergency or extraordinary circumstances to permit the spending cap to be exceeded, provided the legislature approves by a 3/5 vote.

It is the language of the existing statute (Section 2-33a) which adds potentially constraining language, stating that the Governor “may provide that such proposed additional expenditures shall not be considered general budget expenditures for the current fiscal year for the purposes of determining general budget expenditures for the ensuing fiscal year.” (*emphasis added*)

In short, the language of the statute assumes that if surplus funds permit expenditures in excess of the spending cap, by virtue of gubernatorial and legislative action, the extra expenditures will be automatically included in the budget base for the calculation of the cap in the subsequent fiscal year, unless the Governor and General Assembly specify otherwise.²⁷

Unfortunately, this reading of the statute is not always followed. Since 1992, Governors Rowland and Rell declared the existence of extraordinary circumstances seven times, for eight years, in order to spend more than allowed by the cap.²⁸ Seven of these were years when state revenues exceeded original estimates. Except in two years,²⁹ however, this spending was not added to the base used to determine the next year’s allowable spending – resulting in an artificially low base for future calculations.

To prevent “ratcheting down” when surplus funds are utilized to increase expenditures beyond the level permitted by the spending cap, there are three options:

1. In a new statutory spending cap, foreclose the option that currently exists for the Governor to exclude additional spending from the base, by omitting the language included in the existing Section 2-33a, which states that the Governor, in a declaration of emergency or exceptional circumstances, “may provide that such proposed additional expenditures shall not be considered general budget expenditures for the current fiscal year for the purposes of determining general budget expenditures for the ensuing fiscal year.”

²⁷ Much of this language and analysis is taken from Shelley Geballe, “Coping with the Cap: A Primer on Connecticut’s State Spending Cap and its Impacts,” Voices for Children (April 2007), p. 8. Linked at <http://www.ctvoices.org/publications/coping-cap-primer-connecticuts-state-spending-cap-and-its-impacts>

²⁸ See Report of the Chairpersons, Spending Cap Commission, page 12, note 15.

²⁹ Declarations pertaining to FY 2007 and FY 2009.

2. Clarify, and make standard practice, that this language, if retained, unmistakably assumes that the extra expenditures are automatically included in the base unless the Governor³⁰ specifies otherwise.
3. In a new statutory spending cap, insert language which explicitly states that such proposed additional expenditures “shall be considered general budget expenditures for the current fiscal year for the purposes of determining general budget expenditures for the ensuing fiscal year”

One of these options, or a variation thereof, would avoid a scenario in which the spending cap base for a new fiscal year “is less than actual spending on programs and services,” making it “all the more difficult in the out-years for funding to keep pace with current service needs.”³¹

Part III.

A. Adopt legislative procedures to strengthen legislative oversight over tax expenditures.

If the definition of “general budget expenditures” does not include tax expenditures, as proposed in Part I, Section B above, the General Assembly should develop processes for reviewing tax expenditures in ways analogous to those used to adopt budget appropriations. Specifically, it should provide for adoption of a comprehensive Tax Expenditure budget which requires legislative approval before a tax credit or tax expenditure is initiated. The review process could be reinforced by sunseting each and every tax expenditure, and requiring such reviews to justify re-authorization.³² And if there is no express expiration date on a tax credit or expenditure, there should be a process for legislative review and approval every five years.

What the GAO has said about the need to review federal tax expenditures appears to be equally applicable to Connecticut tax expenditures.³³ They suggest that – if the General Assembly does not adopt the language I supported as part of the definition of “general budget expenditures” – the state’s fiscal condition would nevertheless benefit from a regular, comprehensive review of these provisions.

³⁰ There is an additional ambiguity in the existing language of Section 2-33a, which appears to some to permit the General Assembly, acting on its own, to provide that additional expenditures using surplus funds not be included in the base for calculating the cap for the subsequent fiscal year. This language follows the option discussed in the text, which continues: “and any act of the General Assembly authorizing such expenditures may contain such provision.” A well-placed comma before the quoted phrase might resolve the ambiguity. (See Lynne Truss, *Eats, Shoots & Leaves*.)

³¹ Geballe, “Coping with the Cap. . . .”, page 15.

³² Institute on Taxation and Economic Policy, “Five Steps Toward a Better Tax Expenditure Debate,” October, 2012, http://www.itep.org/pdf/fivesteps_1012.pdf

³³ U.S. Government Accountability Office, “Tax Expenditures: Background and Evaluation Criteria and Questions,” (GAO-13-167SP) November 29, 2012, p. 2. <http://www.gao.gov/products/GAO-13-167SP>

The following questions are among those suggested by GAO that could be answered if tax expenditures were subject to the same kind of review as appropriated programs:

- What is the tax expenditure's intended purpose?
- Have performance measures been established to monitor success in achieving the tax expenditure's intended purpose? (similar to RBA)
- Does the tax expenditure succeed in achieving its intended purpose?
- Does the tax expenditure generate net benefits for society?
- Is it fair or equitable?
- Is it simple, transparent and administrable?
- Is it coordinated with other state government activities?
- Does it duplicate or overlap another governmental effort?
- Would an alternative to the tax expenditure more effectively achieve its intended purpose?
- Are there options for limiting the tax expenditure's revenue loss?³⁴

Under current law and procedure, not only is there not a comprehensive analysis of the merit of a tax expenditure performed before it is enacted, the tax expenditure only rarely is fully reviewed after enactment.

As the Legislative Program Review and Investigations Committee stated in 2003, in its comprehensive review of the state's budget process,

Unlike a direct appropriation, a tax expenditure does not need to be reenacted each budget period. It continues indefinitely until amended, repealed, or a sunset date is placed upon it. Therefore, a tax expenditure is typically not revisited or reviewed after passage.

The Committee observed that although state law (Section 12-7b(e) requires the preparation of a tax expenditure report every two years, which has historically included a description of each tax expenditure, the year it was enacted, its purpose, an estimate of revenue loss, and the number of taxpayers that benefit,

The report does not evaluate the expenditures, make conclusions or recommendations regarding whether a provision should be continued, repealed, expanded, or restricted.

And although the Committee notes that the report "is made available to all legislators, and "state law requires the finance committee to meet and analyze the report," it damningly noted that, at the time, "It does not appear that this has ever occurred." Hence its recommendation, which still remains appropriate:

³⁴ U.S. Government Accountability Office, "Tax Expenditures: Background and Evaluation Criteria and Questions," (GAO-13-167SP) November 29, 2012, p. 2. <http://www.gao.gov/products/GAO-13-167SP>

The program review committee believes Connecticut's tax expenditures should be analyzed periodically to ensure they still make fiscal sense with the changing economy or policy priorities, or continue to be in the state's best interests. The analysis would promote greater transparency and accountability in the enactment and continuation of tax expenditures as well as the development and adoption of the state budget.³⁵

In the thirteen years since the LPRI report was published, required committee meetings may well have occurred. But there is need for improvement.

Both prior and subsequent reviews can be facilitated in the future because of the newly implemented disclosure requirements of GASB, embodied in GASB 77, which took effect for fiscal years beginning after December 15, 2015. Although Statement 77 does not require a projection of how much revenue will be lost in future years, and does not require the identification of recipients, it does require an estimate of the revenue lost for each program in the reporting year, and disclosure of the provisions, if any, for recapturing abated taxes.³⁶ The General Assembly should take full advantage of the information provided pursuant to GASB 77, and build on it, by

- Requiring an entity or agency independent of the agency that administers tax expenditures to conduct an independent evaluation of tax expenditures
- Requiring the independent entity to recommend continuation, modification or repeal of each tax expenditure
- Requiring public hearings on the results of such tax expenditure reports
- Requiring the Finance Committee and the General Assembly to vote on the recommendations of the tax expenditure reports.³⁷

³⁵ Legislative Program Review and Investigations Committee, "Connecticut Budget Process," (December 2003), pages 64-65. This report is now available in the LPRI archives, available through a link at <https://www.cga.ct.gov/pri/2003.asp>

³⁶ See Good Jobs First, "GASB Launches a New Era of Subsidy Transparency," <http://www.goodjobsfirst.org/blog/gasb-launches-new-era-subsidy-transparency> And here's the good news, Good Jobs First has high praise for Connecticut's subsidy tracker: <https://clawback.org/2014/04/01/connecticuts-open-data-website-leads-nation-in-adopting-economic-development-transparency-best-practices/>

³⁷ These recommendations follow those presented in Nick Defiesta, "Reviewing Tax Expenditures: Improving Transparency and Accountability in Over \$7 Billion of Off-the-Books Public Spending," Connecticut Voices for Children, April 2016, pages 3-4.

Sections 2 and 3 of sHB 5636, passed by the General Assembly as PA 16-183, but vetoed by the Governor on July 9, 2016, lodged these responsibilities in the Legislative Program Review and Investigations Committee (subsequently eliminated as a committee of the General Assembly):

- (A) A description of the tax credit or abatement program, its beneficiaries and its intended statutory and programmatic goals;
- (B) An analysis of the fiscal impact of the tax credit or abatement program and whether the cost thereof is likely to increase or decrease in future years;
- (C) An analysis of the economic impact of the tax credit or abatement program and whether the statutory and programmatic goals are being met, with obstacles to such goals identified, if possible;

B. Continue strict adherence to the statutory bond cap – and perhaps adopt even more stringent legislative procedures, such as a “bond budget” – to control bonding.

In addition to the statutory cap on “general budget expenditures,” the state has had in place since 1959 a statutory cap on bonding (Section 3-21), which since 1991 has limited bond authorizations payable from General Fund tax receipts to 1.6 times General Fund tax receipts. The Governor and the General Assembly have consistently complied with the terms of this statute over the years.³⁸

Nevertheless, despite the existence and relative success of the statutory bond cap, I believe that bonding needs to be reviewed using a more stringent review procedure than is currently used to keep bonding below the statutory bond cap.

However, it would be inappropriate to conduct this bonding review procedure as part of the appropriations process for general budget expenditures, controlled by the spending cap. The constitutional spending cap provides specifically that all payment of bonds, notes and other evidences of indebtedness is excluded from the limitations of the spending cap. As a consequence, it would be difficult for the General Assembly to make the case that bonding for some purposes is under the spending cap which limits general budget expenditures, and bonding for other purposes is not.

In my view, bonding should be reserved for capital projects which have a useful life as long as the bonds issued to support those projects; those who benefit from the project in

(D) An analysis of whether the tax credit or abatement program is being administered efficiently and effectively and the ease or difficulty for taxpayers to comply with the requirements of such tax credit or abatement program;

(E) A recommendation as to whether the tax credit or abatement program should be continued, modified or repealed, and the basis for such recommendation;

(F) Any recommendations for improving the administrative efficiency or effectiveness of a tax credit or abatement program; and

(2) The methodology and assumptions used in carrying out the evaluations required pursuant to subdivisions (1) of this subsection.

The bill also required the Finance Committee to hold hearings on these reports.

For further analysis and recommendations of “best practices” concerning review of tax expenditures, see NCSL, “Tax Expenditure Budgets and Reports, Best Practices,” August 18, 2014, at http://www.ncsl.org/documents/task_forces/Tax_Expenditure_Report.pdf and Pew Charitable Trusts, “Tax Incentive Programs: Evaluate Today, Improve Tomorrow,” January, 2015, linked at <http://www.pewtrusts.org/en/projects/economic-development-tax-incentives>

³⁸ See the summary of the history of the statutory debt limitation for the period from 1982 through 2015 in the *Connecticut Capital Budget Report*, pages 27 and 77, issued by OFA in February 2014, available at a link on the OFA website, <https://www.cga.ct.gov/ofa/bondgrant.asp> Most recently, in 2016, PA 16-4 (May Special Session) reduced previously existing bond authorizations by slightly over \$1 billion. Despite this action, OPM’s projection is that over the next several years, assuming annual new authorizations of General Obligation bonds of \$1.625 billion, Section 3-21 will require further cancellations of several hundred million dollars annually in order to comply with the debt limitation. See OPM Fiscal Accountability Report, Fiscal Years 2017-2020, November 15, 2016, pages 14-15, available at http://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2016.pdf

the future would incur an appropriate share of the cost. Unfortunately, utilizing what I believe to be a bad practice, legislators in past sessions have authorized bonds for some grants that appear to support current operating expenses.³⁹

That means, in part, that the state must not only pay for the original operating expense, it must pay interest on the moneys borrowed to pay the original expense.

And although both principal and interest are exempt from the spending cap, payments of these costs use up revenue which might otherwise go to pay for appropriated expenditures under the cap.

I accordingly suggest that the General Assembly adopt procedures that provide for the creation of a “bond budget,” which explicitly provides for a review of the reasons for initiating a bond project and a systematic periodic review of projects for which bonds have been authorized but not allocated. This would be analogous to the review of all federal funds recommended in the report of the chairpersons, and to the review of tax expenditures recommended in Part III, Paragraph A above. This procedure would help to distinguish the use of bonding for capital purposes from the use of bonding for operating expenses – and perhaps highlight that operating expenses should be funded by appropriations.

(Please note, however, that if the state uses bonding only for capital projects, the spending cap must have room to accommodate current operating expenses that have – inappropriately – been recently funded by bonds.)

³⁹ For example, the Manufacturing Assistance Act (Chapter 588L), the Small Business Express Act (Sections 32-7g and 32-7h), the Subsidized Training and Employment Program (Section 31-3pp), all of which might better be funded by grants from the General Fund operating budget. Contrast these programs with funding of capital projects by School Construction Grants (Chapter 173) (as distinguished from its predecessor, under which bonds were issued to reimburse towns for interest costs), LoCIP (Sections 7-535 through 7-538), Town Aid Roads (TAR) (Sections 13a-175a through 13a-175k) (except for “plowing of snow, and sanding of icy pavements”, which are obviously operating expenses), and most of the purposes of Urban Action (Section 4-66c) and STEAP (Section 4-66g) grants.