I. A bit of background on the spending cap

Connecticut’s spending cap is a limit on state expenditures authorized by the General Assembly. A statutory spending cap (Conn. Gen. Stat. §2-33a) was passed by the General Assembly in August 1991 and, in November 1992, voters approved by 4 to 1 margin, a constitutional amendment to limit state spending. It was anticipated that the General Assembly would adopt new statutory language by the required 3/5th vote, but this has not been the case. Pursuant to an opinion of the Attorney General issued on April 14, 1993, the current statutory cap passed in 1991 remains in place until the General Assembly enacts the definitions required by the constitution by a 3/5th majority.

While at least half the states have some kind of tax and/or expenditure limit, Connecticut’s is considered among the nation’s most restrictive.

There are four major components to Connecticut’s spending cap:

1. **Permitted rate of growth.** The increase in budget expenditures from one year to the next cannot be greater than the five-year average in personal income growth or the 12-month rate of inflation, whichever is greater. (For the past few years in CT, the increase in personal income has been between 5 and 5.5% and the inflation rate has been between 1 and 1.6%).

2. **Applies to most expenditures.** The statutory spending cap applies to all “general budget expenditures” except: a) payments on the principal or the interest of bonds, notes and other forms of indebtedness; b) state grants to distressed municipalities (provided they were in effect on July 1, 1991); and c) first year expenditures on federal mandates or court orders (at which point these sums are added to the base, going forward). A three-fifths vote of each house of the General Assembly is necessary to amend this definition of “general budget expenditures,” provided that -- under the constitutional provision -- “general budget expenditures” may never include expenditures for the payment of bonds, notes or other evidences of indebtedness.

3. **Super majority needed to exceed.** The spending cap can be exceeded if the Governor declares an emergency or the existence of extraordinary circumstances,
provided that at least three-fifths of the members of both the houses vote to exceed the expenditure limit for this purpose. The declaration must specify the nature of such emergency or circumstances and may declare that the proposed additional expenditures are not added to the base budget for the current fiscal year for the purposes of determining general budget expenditures for the next fiscal year. For the past three years, the General Fund surplus has been spent after the Governor declared the “existence of extraordinary circumstances” (citing eight straight years of surplus, a projected surplus for the current year, a Budget Reserve Fund at the required 5% level, and that it is “prudent to expend certain state resources to avoid the issuance of long term debt as well as fund several projects that are primarily one-time in nature.”) These emergency declarations have allowed the cap to be exceeded over the last three years to spend about $1.5 billion in state surplus funds. [See accompanying paper on the state surplus.]

4. **Use of unappropriated surplus.** Any unappropriated surplus must be used to fund a budget reserve fund, to reduce bonded indebtedness, or for any other purpose authorized by at least three-fifths of both the House and the Senate. This year, for example, the General Assembly authorized that such “unappropriated” surplus is be used to wire schools (first $10 million) or for school construction (the balance).

II. The restrictiveness of Connecticut’s cap

Connecticut’s spending cap is more restrictive than the spending caps in other states in a number of respects:

A. **Most federal funds included in the cap**

Connecticut includes under its “cap” nearly all federal funds received by the state (such as federal reimbursements for Medicaid, Title IV-E foster/adoption, TANF). Federal funds that go directly to state agencies without any state appropriated dollars required are not included under the cap. Federal funds are approximately 17% of Connecticut’s General Fund revenue. By comparison, most other states’ caps exclude federal funds, because the limits are meant to apply to the appropriation of state tax revenue. Connecticut’s inclusion of federal reimbursements under the cap can act as a disincentive to seek new federal grant funds, a particular problem when the federal match rate is high.

For example, if the budget were within $11 million of the spending cap, and a new federal grant program was adopted with a 90% federal match rate, making the state eligible for $90 million in new federal funds for some purpose (say, for HUSKY outreach and enrollment activities) if the state put up $10 million, the state could not take advantage of this program, even though state spending would not exceed the cap, because the additional federal funds would put the state well over the cap.

If, however, the General Assembly voted either voted to exceed the spending cap by accepting these funds or interpreted the statute to exempt them (see below), the federal
reimbursement would be included in the base budget going forward, subject to the same maximum rate of annual increase.

NOTE: The General Assembly has interpreted the term “expenditure” with regard to a specific expenditure, on a single occasion, in such a way as has to exempt that expenditure from the cap. For example, this Session the Governor proposed, and the General Assembly accepted by passing the OPM implementer bill by more than a 3/5th margin, that the $27.1 million appropriation of Workforce Investment Act (WIA) federal grants be treated as a “federal mandate,” exempting these funds from the cap in FY 01 and placing them in the FY 01 base for spending cap calculations going forward. The WIA funds had replaced federal Job Training Partnership Act (JTPA) funds that were not subject to appropriation.

B. High proportion of state expenditures subject to the cap

The proportion of Connecticut’s state expenditures that are subject to the cap (80.4% in FY 93, 79.6% in FY 00) is very high by national standards. States with spending limits typically include between 30% and 80% of total state spending in their caps. Many apply their caps only to their state general funds, resulting in less spending being subject to the cap than in Connecticut, which includes under its cap all appropriated funds.

C. Conservative budget base calculation methodology

The manner in which Connecticut chooses to calculate its “base” in determining the allowable increase in the next year’s budget is conservative. In some states, the spending cap assumes the base budget for a given year to be the prior year’s budget plus the total amount that could have been spent under the cap, rather than the amount that actually was spent. Using this methodology, if the state stays under the cap in the first few years, a cushion is built and it is less likely that the state will “catch up” to the cap in later years.

Connecticut, however, uses the amount actually spent in the prior year as the cap, not what could have been spent under the cap. If, however, the alternative methodology had been used to calculate the base, the state’s base budget in FY 97, for example, would have been more than $240 million greater.

D. Income growth calculation

Connecticut uses a five-year average of personal income growth. This is long by national standards. Many states use a three-year average. This avoids having any one year weigh too heavily in the limit, but also protects against going “too far back” and having a previous business cycle influence current public spending requirements. Recently, Connecticut’s decision to use a five-year average has meant that current spending is constrained by the much lower rate of income growth in the years when Connecticut was just recovering from the recession. Were these “slower” years not included in the average, the current higher rates of income growth would allow greater state spending.
(The converse, however, is also true. If Connecticut were to enter a recession, and the state needed to spend more on such programs as cash assistance, the higher income levels of prior years would keep the five-year average higher, allowing greater spending.)

III. Some potentially unintended consequences of the cap

Beyond the obvious impact of limiting state spending in a time of unparalleled prosperity, the spending cap may have had some other impacts on the budget with potentially harmful long-term effects:

- **Increased state bonding.** Because debt service payments are explicitly excluded from the state spending cap it is not surprising that the state increasingly has turned to bonding as a funding mechanism for not only capital expenses, but also for on-going operating expenses. Total General Fund indebtedness has increased from $3.673 billion in FY 92 to $10.55 billion in FY 00 and $11.12 in FY 01. Connecticut now leads the nation in state tax supported debt per capita. Bonded debt per capita has more than doubled over the past decade, growing to $2,857 by the end of Fiscal Year 1999.

  Avoiding the spending cap in this manner has two harmful effects. First, it costs more in the long run to use borrowed money since one has to pay back interest as well as the principal. Second, with increasing indebtedness comes increased debt service payments which reduce the proportion of the budget that can be appropriated for other purposes. The multi-million dollar surpluses of the past years show that Connecticut has the means to pay for more of its expenditures directly, rather than by using bond funds. But such expenditures require that the cap be exceeded (as has been done the last three years).

- **Increased use of tax expenditures.** Because a tax credit, exclusion, exemption or deduction is not considered “spending” under the cap, there is increased reliance such tax expenditures. The Governor, for example, stated that his adjusted FY 01 spending plan was able to limit growth to 4.3% “largely by seeking to respond to many demands through innovative tax relief plans.”

**Example:** The 2000 General Assembly approved a $10.5 million credit against the insurance companies’ tax for the benefit of the managed care organizations providing HUSKY coverage. This credit, equal to $55 times the average monthly enrollment in the programs each year, is taken against the plans’ tax on their commercial policies (the plans are already exempt from tax on their HUSKY policies). This is functionally equivalent, therefore, to a $10.5 million/year grant to these plans, but is “spending” that is not subject to the spending cap.

The problem with this way of avoiding the cap is that it permanently reduces the state’s revenue stream (since tax expenditures are not reviewed annually, as are
regular expenditures). It also is a tool that preferentially helps those with economic means. Unless a tax credit is made refundable, it has no economic benefit to someone who has no tax liability. For example, the property tax credit against the state income tax, while providing economic benefit to thousands of state citizens that is \textit{not} subject to the spending cap, provides \textit{no} benefit to our lowest income families who do not pay state income tax. Also, there is unclear whether the \textit{refundable} portion of a tax is to be considered an expenditure subject to the spending cap. While the refundable portion of an earned income tax credit was to have been treated as an appropriation subject to the cap, the funds spent by the state when businesses sell back research and development credits are treated as “reductions in revenue” not subject to the cap.

- \textbf{Decisions to exceed the cap anyway, but not in a planful way.} As discussed more fully in the short report on use of state surplus funds, Connecticut has exceeded its spending cap in each of the last three years after a “declaration of extraordinary circumstances” and a 3/5\textsuperscript{th} vote of the General Assembly, allowing a total of more than $1.5 \textbf{billion} in state surplus to be spent. For example, the FY 99 budget was originally under the spending cap by $2.3 million. Approved spending of state surplus funds put the budget over the cap by $525.7 million. The FY 00 budget was to have been $68.6 million under the cap, but as a result of deficiency appropriations and surplus spending will be exceeded by more than $480 million.

Review of how these funds have been spent demonstrates no thoughtful plan for their use. In addition, though OFA has determined that some of the uses of this surplus funds are for on-going expenses, such funds have \textit{not} been added to the base budget for purposes of determining spending going forward, creating significant financial uncertainty for programs funded with surplus funds.

- \textbf{Failure to take full advantage of federal funding opportunities.} As described above, the spending cap acts as a \textit{dis}incentive to take advantage of \textit{new} federal funding opportunities, though such federal funds could offset state expenditures and reduce the amount of own-source revenue necessary to run our state programs.

- \textbf{Failure to make necessary public investments in this time of great economic prosperity.} Current economic literature is clear on the all-inclusive benefits of public investment:

  Government investment in education and training, infrastructure, and research and development has a proven track record. Well-directed spending in these areas can increase the economy’s productive capacities. Furthermore, many of these expenditures will have additional benefits not even picked up in standard economic accounts. For example, an individual’s gains from education extend beyond just getting a higher wage on the job. And the benefits from a well-planned infrastructure will include a cleaner environment and livable cities. [D. Baker, 1998, \textit{The Public Investment Deficit: Two Decades of Neglect Threatens 21\textsuperscript{st} Century Economy}. (Economic Policy Institute)]
Current economic and social literature is also convincing on the detrimental effects of *inadequate* public investment:

Inadequate investment has clear economic effects. Billions worth of time are lost in traffic jams. Businesses struggle to find skilled workers. Markets of the future are lost from lack of scientific research and development. Productivity suffers from a less healthy workplace. [R. Borosage, 1999, *America’s Growing Deficits: Public Investment and Public Leadership, The Investment Deficit* (Campaign for Americans Future)]

Connecticut’s recession of 1989-1992 – with its loss of thousands of manufacturing jobs -- was a painful part of its transformation to a “New Economy” -- a knowledge and idea-based economy where the keys to wealth and job creation are the extent to which ideas, innovation, and technology are embedded in all sectors of the economy. Connecticut entered the 21st century ranked 5th best in the nation on overall measures of the New Economy. (CT Voices, *CT’s Children, Families and the New Economy*).

However, while in the early 1990s spending cuts (and the adoption of the state income tax) were necessary to decrease the growing General Fund deficit at a time of recession, in the year 2000 *increased* public investments in certain strategic areas --- education, transportation, housing, research and development – will be necessary if Connecticut is to continue to be a leading player in the New Economy.

Spending cap limitations on such investments pose a direct threat to the state’s continued economic prosperity, and also will ensure that the New Economy’s benefits will extend only to *some*, and not to *all*, in the state.

**Questions**

1. Given the state constitutional basis for the spending cap, what *statutory* changes or *interpretations of the existing statute* are possible, in such definitions as “expenditure”, “aid to distressed municipalities” and the like, that would allow increased state spending that is well-targeted?

2. How do we address the financial collision course that is being created to avoid the strictures of the spending cap – where the state continues to increase its indebtedness and cut its revenues, while failing to make necessary public investments even with state surplus funds?

3. How do we increase public awareness about the spending cap and some of its possibly unintended adverse budgetary consequences? Would it matter if we did?