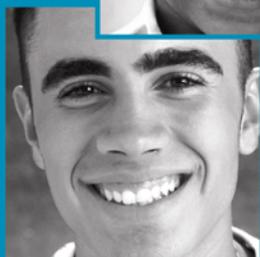


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## **Coping with the Cap: A Primer on Connecticut's State Spending Cap and Its Impacts**

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# Coping with the Cap: A Primer on Connecticut’s State Spending Cap & Its Impacts

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# Coping with the Cap:

## A Primer on Connecticut's State Spending Cap & Its Impacts

### Executive Summary

*What is the spending cap?* Connecticut's constitutional and statutory spending caps limit growth in state spending from one year to the next to the greater of: a) a lagged five-year average of growth in state personal income; or b) the percentage increase in inflation during the preceding twelve months. *Excluded* from spending cap limits are: a) funds earmarked for debt service; b) grants to distressed municipalities in effect on July 1, 1991; c) first year spending to implement federal court orders or federal mandates; and d) transfers of unappropriated surplus at the end of a fiscal year to the Budget Reserve Fund or State Employees Retirement Fund, or to reduce state indebtedness. The General Assembly can exceed the cap if the Governor declares an emergency or extraordinary circumstances *and* three-fifths of both houses of the General Assembly vote to do so.

*Connecticut's cap is considered one of the more restrictive caps in the nation.* About 80% of state spending is under the cap, as are federal funds that are appropriated (e.g., for Medicaid). The budget base is defined as "appropriated" spending, rather than spending allowed under the cap or even what was actually spent. The lagged five-year average of personal income growth is among the longest in the nation and assures that the budget growth allowed under the cap is unrelated to the state's economic cycle. Two branches of government must take action to exceed the cap.

*What are some of the impacts of the cap?* The cap's definition of personal income growth assures that allowable state spending as the economy recovers from a recession will always lag growth in the economy. The cap's budget base definition assures that spending cuts made in a recession will irrevocably reduce the budget base for subsequent years. Together, the definitions ensure that public investment will ratchet down as a share of the economy with each successive recession and, thereby, over time jeopardize our continued competitiveness and quality of life. In fact, since the statutory cap was adopted in 1991, the annual growth in state "appropriated" spending has been cut by half. Further, the gap between current services needs and state spending has grown since the last recession; multiple agencies now are funded at levels below FY 02 actual spending. Total government spending as a share of gross state product was 4<sup>th</sup> lowest in the nation in 2003; if at the national average (11.9% of GSP rather than Connecticut's 8.75%), state and local spending would have been about \$5.4 billion greater in 2003.

Although growth in "appropriated" spending has declined, there has been additional "spending" through budget techniques that circumvent the cap (e.g., through tax expenditures, bonding, and revenue intercepts). That is, an ironic consequence of the state's cap on the growth of "appropriated" spending is that less of the state's spending is being appropriated, reducing budget transparency and accountability. For example:

- The number of credits against the corporation tax has increased from eleven (when the cap was passed) to nearly thirty now and the amount claimed has increased nearly 100-fold (to \$133.9 million in 2000). Four in ten of the exemptions to our sales tax have been enacted since the cap was adopted. All told, nearly a quarter of state "spending" is through preferential tax credits,

exemptions, deductions and rate reductions, though such “spending” through the tax code is not subject to the same level and frequency of scrutiny as direct appropriations.

- Connecticut’s bonded debt has increased significantly since the spending cap was adopted. Connecticut is 4<sup>th</sup> highest in state debt as a share of personal income, and debt service as a share of state spending has increased from 4.9% in 1989 to 11.4% this year. If debt service were the same share of the state budget as in 1989, there would be an additional \$964 million available for other types of public investment.
- New non-appropriated budget accounts funded through “revenue intercepts” – such as the Citizen’s Election Fund and the Land Protection, Affordable Housing, and Historic Preservation Account – move state spending outside the cap. In the FY 07 state budget, more than \$1.9 billion is reported to be in special, non-appropriated funds, about \$900 million more than in FY 97. This type of “spending” is problematic because information about earmarked funds is not readily available, off-budget spending is not subject to annual review by the Appropriations Committee, and earmarking revenues for specific purposes reduces overall General Fund revenues.

In sum, how Connecticut’s statutory spending cap defines its terms assures that public investment will ratchet down with each successive recession, weakening our economy, as well as our high quality of life. Our policymakers seem to understand this danger. When Connecticut has surpluses, the cap is exceeded. Even when there are no surpluses, the cap is evaded. The “spending” that increasingly is being done outside the appropriations process – through the tax code, bonding, and other budget gimmicks – is reducing both the transparency and the accountability of our budget process.

The Constitutional spending cap explicitly envisioned the need to amend the spending cap definitions, stating, “the general assembly shall by law define ‘increase in personal income,’ ‘increase in inflation,’ and ‘general budget expenditures’ ....and may amend such definitions, from time to time.” A number of changes in the definitions of our spending cap would help assure that state spending is able to grow *with* Connecticut’s economy, reducing the temptation to evade its constraints. They include:

- Re-define “growth in personal income” to use a more current and comprehensive measure of personal income growth;
- Re-define “general budget expenditures” as the amount of spending allowed under the cap or, minimally, the total amount actually spent in a given year including surplus funds and transferred lapse funds used for on-going purposes;
- Exclude the first year of new federal funds from the cap, but then add them to the budget base.

This modest re-definition of spending cap terms would assure a closer fit between growth in state spending and growth in our economy; efforts to evade the cap to meet state needs will become unnecessary and the transparency and accountability of our state budget process will be restored.

# Coping with the Cap:

## A Primer on Connecticut's State Spending Cap & Its Impacts<sup>1</sup>

This report describes the key elements of Connecticut's statutory and constitutional spending caps. Then, with the wisdom that fifteen years' experience provides, the report critiques how the cap was defined in 1991, illustrating how these definitions prevent the cap from achieving its goal of keeping state spending aligned with growth in our economy. The report then highlights some of the ways the cap has been circumvented, undermining the transparency and accountability of our state budget process. It concludes by suggesting ways that key terms should be re-defined to create a cap that achieves its goals while also assuring budget transparency and accountability.

### I. What Is The State Spending Cap?

**A. In Brief.** Connecticut's constitutional and statutory spending caps limit growth in state spending from one year to the next. Specifically, general budget expenditures cannot grow more than the greater of: a) a lagged five-year average of growth in state personal income (as determined by the United States Bureau of Economic Analysis); or b) the percentage increase in inflation during the preceding twelve months (as determined by the United States Bureau of Labor Statistics). *Excluded* from spending cap limits are: a) funds earmarked for debt service; b) grants to distressed municipalities in effect on July 1, 1991; c) first year spending to implement federal court orders or federal mandates; and d) transfers of unappropriated surplus at the end of a fiscal year to the Budget Reserve Fund or State Employees Retirement Fund, or use of such surplus to reduce state indebtedness (as specified in Conn. Gen. Stat. §4-30a). The General Assembly can exceed the cap if the Governor declares an emergency or extraordinary circumstances *and* three-fifths of both houses of the General Assembly vote to do so. Connecticut's cap is considered one of the more restrictive caps in the nation.

**B. How did the spending cap come to be?** In PA 91-3 (section 30, June Special Session), the General Assembly enacted Connecticut's *statutory* spending cap, effective August 22, 1991. The cap was adopted as part of the agreement to enact a broad-based personal income tax to address a very significant state budget deficit. Some feared that the adoption of an income tax (which replaced a dividends, interest, and capital gains tax) would result in excessive growth in state spending. The cap was intended to "ensure annual growth in state spending does not surpass the growth of the state's economy."<sup>2</sup> This *statutory* cap can be amended by a 3/5<sup>th</sup> vote of each house of the General Assembly.

PA 91-3 (JSS), codified in Conn. Gen. Stat. §2-33a, prohibits the General Assembly from authorizing:

"an increase in general budget expenditures for any fiscal year above the amount of general budget expenditures authorized for the previous fiscal year by a percentage which exceeds the greater of the percentage increase in personal income or the percentage increase in inflation, unless the Governor declares an emergency or the existence of extraordinary circumstances

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<sup>1</sup> This report is an update of CT Voices' 2000 report, *Connecticut's Spending Cap*. It also draws from the 2001 and 2006 reports prepared for the CT Health Foundation, *Connecticut's Spending Cap: Questions and Answers*, which are available at [www.cthealth.org](http://www.cthealth.org).

<sup>2</sup> Legislative Program Review and Investigations Committee, *Connecticut Budget Process* (December 2003), p. 3.

and at least three-fifths of the members of each house of the general assembly vote to exceed such limit for the purposes of such emergency or extraordinary circumstances.”

Then, in November 1992, voters approved (by 4 to 1 margin) a constitutional amendment to limit state spending. The constitutional amendment states, in relevant part,

The general assembly shall not authorize an increase in general budget expenditures for any fiscal year above the amount of general budget expenditures authorized for the previous fiscal year by a percentage which exceeds the greater of the percentage increase in personal income or the percentage increase in inflation, unless the governor declares an emergency or the existence of extraordinary circumstances and at least three-fifths of the members of each house of the general assembly vote to exceed such limit for the purposes of such emergency or extraordinary circumstances.”

The constitutional amendment (Article XXVII) further states “The general assembly *shall by law* define ‘increase in personal income,’ ‘increase in inflation,’ and ‘general budget expenditures’ for the purposes of this section and may amend such definitions, from time to time, provided general budget expenditures shall not include expenditures for the payment of bonds, notes or other evidences of indebtedness. The enactment of such definitions shall require the vote of three-fifths of the members of each house of the general assembly.” (emphasis added)

Because the constitutional amendment explicitly directed the General Assembly to define the key terms in the constitutional spending cap, many thought the General Assembly would adopt new statutory language to implement the constitutional limit by the required 3/5<sup>th</sup> vote. This has *never* been done.<sup>3</sup> Nonetheless, based on an opinion of the Attorney General issued on April 14, 1993, the current statutory cap passed in 1991 remains operative until the General Assembly enacts the definitions required by the Constitution by a 3/5<sup>th</sup> majority.

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<sup>3</sup> Since the constitutional cap was adopted, there have been multiple efforts to define the terms in it, or otherwise alter the statutory definitions. These include, but are not limited to: in 1993, Raised Bill 1033 (repeal section 2-33a as a statutory spending cap and make it part of the constitutional cap); in 1994, Proposed Bill 5337 (re-enact section 2-33a to implement the constitutional amendment limiting expenditures), Proposed Bill 5338 (define “general budget expenditures” to exclude federal reimbursements), Proposed Bill 5339 (amend section 2-33a to treat federal reimbursements on a “net” not “gross” basis in state budgeting), Proposed Bill 5714 (exempt from “general budget expenditures” *all* current and increased statutory grants to municipalities, not just those to distressed municipalities or those in effect on July 1, 1991), Raised Bill 5763 (adopt section 2-33a’s definitions of “increase in personal income,” “increase in inflation,” and “general budget expenditures” as the constitutionally-required definitions), Proposed Bill 189 (define “general budget expenditures” to exclude all state aid to municipalities, including state funding of new or expanded state mandates on cities and towns, and state spending for property tax relief), Proposed Bill 190 (define “general budget expenditures” to exclude *all* state aid to municipalities and federal reimbursements for state spending); in 1995, Proposed Bill 5333 (exempt all grants to local and regional boards of education from the cap); Proposed Bill 6365 (implement constitutional spending cap immediately and define “general budget expenditures” to *include* appropriations for federal mandates and aid to distressed municipalities); in 1996, Proposed Bill 5099 (same as Proposed Bill 6365 in 1995); in 1997, Proposed Bill 5443 (limit exceptions from “general budget expenditures” to expenditures for payment of principal and interest on indebtedness), Proposed Bill 5995 (repeal 2-33a and amend general statutes to define “increase in personal income,” “increase in inflation,” and “general budget expenditures”); in 1998, Proposed Bill 5377 (limit exceptions from “general budget expenditures” to expenditures for payment of principal and interest on indebtedness); in 1999, Proposed Bill 6338 (implement and enforce constitutional spending cap immediately and limit exceptions from “general budget expenditures” to expenditures for payment of principal and interest on indebtedness); in 2000, Proposed Bill 334 (amend 2-33a to limit exceptions from “general budget expenditures” to expenditures for payment of principal and interest on indebtedness).

**C. How is the spending cap defined?** There are five key elements of Connecticut’s statutory and constitutional spending caps: 1) what spending is limited by the cap; 2) how the budget “base” is defined; 3) how much spending can grow from one year to the next; 4) how unappropriated surplus must be used; and 5) how the cap can be exceeded. A more detailed description of each element follows.

**1. What spending is limited by the state spending cap.** The statutory spending cap applies to all “general budget expenditures authorized for the previous fiscal year” with certain exceptions. The Constitutional spending cap exempts “expenditures for the payment of bonds, notes or other evidence of indebtedness.” The statutory cap has four exemptions:

- a) Expenditures for payment of the principal of and interest on bonds, notes or other evidence of indebtedness;
- b) Expenditures pursuant to Conn. Gen. Stat. §4-30a (i.e., transfers to the state Budget Reserve Fund and State Employees Retirement Fund and reducing state indebtedness);
- c) Current or increased expenditures for statutory grants to distressed municipalities (provided they were in effect on July 1, 1991); and
- d) Expenditures for the implementation of federal mandates<sup>4</sup> or court orders “for the first fiscal year in which such expenditures are authorized.” These expenditures, however, “shall be considered general budget expenditures for such fiscal year for the purposes of determining general budget expenditures for the ensuing fiscal year” (i.e., are to be added to the base).

A three-fifths vote of each house of the General Assembly is necessary to amend this definition of “general budget expenditures,” provided that – as required by the constitutional provision -- “general budget expenditures” may never include expenditures for the payment of bonds, notes or other evidences of indebtedness.

However, as pointed out by the Legislative Program Review and Investigations Committee report, *Connecticut Budget Process* (December 2003), “[w]hether certain proposed expenditures are subject to the spending cap depends on how funds are categorized during the budgeting process.” The Governor and the General Assembly have employed various techniques to exclude certain funds from mandated spending cap restrictions, such as earmarking funds from a particular source for a particular purposes and transfer of lapse funds to cover state agency deficiencies. These and other efforts to circumvent the cap are discussed later in this report.

**2. How the budget “base” is defined.** The budget base is “general budget expenditures authorized for the previous fiscal year,” i.e., expenditures from appropriated funds authorized by public or special act of the general assembly. There are some exceptions to this, however.

The statutory cap grants either the Governor (in the declaration of extraordinary or emergency circumstances) or the General Assembly the authority to *exclude* certain expenditures that are over the cap in one year from the budget base for that year. It states, “Any such declaration shall specify the nature of such emergency or extraordinary circumstances and *may* provide that such proposed additional expenditures *shall not* be considered general budget expenditures for the ensuing fiscal year

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<sup>4</sup> “Federal mandates” are defined as “those programs or services in which the state must participate, or in which the state participated on July 1, 1991, 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.” Conn. Gen. Stat. §2-33a.

and any act of the general assembly authorizing such expenditures may contain such provision.” Conn. Gen. Stat. §2-33a (emphasis added).

That is, the statutory cap *assumes* that funds expended in a given fiscal year, whether from appropriations during the normal budget cycle or from a subsequent appropriation of surplus funds that exceed the cap, will be *included* in the budget base for purposes of spending cap calculations, *unless the Governor or the General Assembly specifies otherwise*.

For example, in 2005, the Governor issued a declaration of extraordinary circumstances, citing the highest budget surplus on record (\$637.5 million), to exceed the cap for purposes of enacting a new nursing home provider tax that could draw down federal reimbursements to pay for a fee increase for nursing homes, and for other purposes. Although the FY 06 base was increased by the \$244 million in additional funds designated for the nursing homes, the Governor’s declaration stated that the \$20 million to be appropriated for stem cell research, and certain other appropriations that exceeded the cap, “shall not be considered general budget expenditures for the current fiscal year for purposes of determining general budget expenditures for the ensuing fiscal year.”

Conversely, the Governor’s declaration has sometimes explicitly *included* spending in the budget base. For example, the Governor’s April 30, 2006 Declaration, issued in conjunction with last year’s budget bill (PA 06-186), explicitly declared that a \$125.5 million appropriation from surplus funds for the Teachers’ Retirement Fund (that exceeded the spending cap) was to be included in the budget base for FY 07. Technically, it is not necessary under the statutory cap for the Governor to specify inclusion, as the statute *assumes* inclusion in the budget base as the default.

The legislature also may “adopt a statutory declaration that certain expenditures are to be deemed appropriated for purposes of the spending cap calculation.”<sup>5</sup> For example, as part of a reorganization of federal Job Training Partnership Act programs, the new federal Workforce Investment Act (WIA) required states to appropriate job training funds. Previously, job training funds were sent directly to the regional workforce development boards without approval of the General Assembly. The Governor proposed, and in PA 00-192 the General Assembly concurred, that the \$27.1 million in federal WIA funds should be treated as a “new federal mandate” (thereby exempting them from the FY 01 spending cap) but also were to be deemed to have been appropriated (even though they had not been previously), placing them into the FY 01 budget “base” for spending cap calculations in the subsequent year.<sup>6</sup>

**3. How much appropriated spending can grow from one year to the next.** The spending cap limits growth in appropriated spending from one fiscal year to the next to the *greater of* the percentage increase in personal income or the percentage increase in inflation. The statutory cap defines “percentage increase in personal income” to be the average of the annual increase in personal income in Connecticut for the five years prior to the last completed fiscal year, as determined by United States Bureau of Economic Analysis data. This definition results in a “lagged” five –year average. The percentage increase in “inflation” is defined as the increase in the consumer price index for urban consumers during the preceding twelve-month period, as determined by United States Bureau of Labor Statistics data.

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<sup>5</sup> Legislative Program Review and Investigations Committee, *Connecticut Budget Process*, p. 63.

<sup>6</sup> Program Review and Investigations Committee, *Connecticut Budget Process*, p. 63.

Since the cap was adopted, allowable growth as measured by the lagged five year average of personal income growth has ranged from a high of 8.06% in FY 92 to the all-time low in the upcoming FY 08 of 3.31%. Importantly, the United States Bureau of Economic Analysis data do *not* include capital gains realizations as part of personal income, though capital gains are an important component of Connecticut's total personal income and are subject to our state personal income tax.

**4. What must be done with any unappropriated surplus.** The *constitutional* spending cap states that any “unappropriated surplus” *shall* be used to “fund a budget reserve fund<sup>7</sup> or for the reduction of bonded indebtedness; *or for any other purpose* authorized by at least three-fifths of the members of each house of the General Assembly” (emphasis added). In 2000, for example, the General Assembly authorized that year’s “unappropriated” surplus be used to wire schools (first \$10 million) or for school construction (the balance of the surplus). The statutory spending cap is silent on the issue of what must be done with unappropriated surplus funds.

**5. How the cap may be exceeded.** The spending cap is not an absolute limit on the growth in state spending. Rather, the cap can be exceeded if the Governor declares an emergency or the existence of extraordinary circumstances *and* at least three-fifths of the members of *both* houses vote to exceed the expenditure limit for this purpose. The declaration must specify the nature of the 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.

In FY 98 to FY 01 – four years when the General Fund enjoyed significant surpluses and indebtedness from the last recession had been retired -- the spending cap was exceeded – by \$194.5 million in FY 98, \$525.7 million in FY 99, \$498.3 million in FY 00, and \$291 million in FY 01. To spend these surplus funds, the Governor declared the “existence of extraordinary circumstances” citing multiple 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.”. Surplus funds were spent for a variety of purposes, including tax rebates, various “one-time” expenditures, and even some on-going expenses. These emergency declarations allowed the cap to be exceeded by a total of *\$1.5 billion* over these four years.

In FY 02 to FY 04, Connecticut’s most recent recession resulted in a steep decline in state revenues. The state addressed the resulting budget deficits by draining the Budget Reserve Fund, cutting spending, increasing taxes, and issuing Economic Recovery Notes. Then, as the economy began to rebound, state budget surpluses re-emerged. In FY 05 and FY 06, once again, the Governor declared the “existence of extraordinary circumstances” and the General Assembly voted to exceed the cap – by \$232 million in FY 05 and \$553 million in FY 06. In her FY 08 Budget the Governor proposes, for the second time, prospectively to exceed the spending cap, this time to enable a significant infusion of new state funds into our educational system.

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<sup>7</sup> In 1978, the General Assembly established the Budget Reserve (“Rainy Day”) Fund. The Budget Reserve Fund, by law, can only be used to finance state operating deficits at the end of a fiscal year; it cannot be used to balance a proposed budget for the coming fiscal year. Originally, the Fund could have a balance up to 5% of net General Fund appropriations. PA 02-118 increased the maximum allowable in the Budget Reserve Fund from 5% to 7.5%, while PA 03-2 increased the maximum from 7.5% to 10%. When the FY 06 surplus is certified, it is expected that about \$446.2 million will be deposited into the Budget Reserve Fund, bringing the total to about \$1,112.3 million, or about 7.5% of General Fund appropriations. *FY 2007-FY 2009 Governor’s Budget Summary*, p.7.

**D. How Is The Cap Calculated?** The spending cap calculation is not complicated. These are three steps:

1. **Determine the “base.”** From the previous year’s appropriated funds are subtracted funds spent on purposes that are exempt from the spending cap (payment on debt, state grants to distressed municipalities, first year expenditures on federal mandates or court orders). This is the “base.”
2. **Determine the allowable growth rate.** The lagged 5-year average of personal income growth is compared to the annual rate of inflation. The larger is the allowable growth rate.
3. **Determine the allowable spending increase.** The “base” is multiplied by the allowable growth rate. This is the total number of dollars the budget can grow in the next fiscal year. This is added to the previous year’s total capped expenditures for the new total of capped appropriated funds. To this is added the estimated total of non-capped expenditures in the new fiscal year for a grand total of allowable expenditures.

The following is the statutory spending cap calculation for the Governor’s proposed FY 08 budget:

<b>Total All Appropriated Funds – FY 07 (revised to include deficiencies)</b>	\$16,198.5M <sup>8</sup>
Subtract Total “Non-Capped” Expenditures FY 07 (debt service \$1,813.2M; grants to distressed municipalities \$1,354.8M)	-\$ 3,168.0M
<b>Total “Capped” Expenditures FY 07</b>	\$13,030.6M
Multiply by 5-Year Average Growth in Personal Income (FY 01-FY 05)	3.31%
<b>Allowable “Capped” Growth in FY 08</b>	\$ 431.0M
<b>Total “Capped” Expenditures Allowed - FY 08</b>	\$13,461.7M
Add Total “Non-Capped” Expenditures – FY 08 (debt service \$1,855.3M; grants to distressed municipalities \$1,531.5M; federal mandates and court orders \$92.7M)	+\$ 3,479.4M
<b>Total All Expenditures Allowed – FY 08</b>	\$16,941.1M
<b>Governor’s Proposed FY 08 Appropriations</b>	\$17,461.9M
<b>Amount Total Appropriations are Over (Under) the Cap</b>	\$520.8M
<b>Governor’s Extraordinary Declaration (to exceed cap)</b>	(\$520.8M)
<b>New Total Appropriations Over/(Under) the Cap</b>	<b>0</b>
Source: FY 2008-FY 2009 Governor’s Budget Summary (February 7, 2007),p.A-4	

Note that in the above example, because the Governor’s proposed FY 08 appropriation exceeds the allowed FY 08 expenditures by \$520.8 million, she also has proposed issuing a declaration of extraordinary circumstances so that spending could exceed the cap by this amount.

**E. How Restrictive is 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 are included under the cap; b) a high proportion of state expenditures are subject to the cap; c) the method of

<sup>8</sup> Includes \$125.5 million of funds appropriated for the Teachers’ Retirement Fund from surplus funds that explicitly were added to the budget base by the Governor’s April 30, 2006 Declaration.

calculating the budget “base” is conservative; d) the definition of “personal income growth” is under-inclusive and not timely; e) exceeding the cap requires action by both the Governor and a 3/5 vote of the General Assembly.

**1. Most federal funds are counted under the cap.** Connecticut “gross budgets” much of its federal funding. For example, it appropriates both the state and the federal funds that are to be used for Medicaid, and then credits the federal Medicaid reimbursements as General Fund revenues. As a result of this budgeting choice, Connecticut includes under the spending a large share of the federal funds it receives (e.g., the federal reimbursements for Medicaid, Title IV-E foster/adoption, Temporary Assistance for Needy Families/TANF). By comparison, most other states’ caps *exclude* federal funds; the limits are meant to apply to the appropriation of *state* revenues. Connecticut’s inclusion of federal funds under the cap can act as a *disincentive* to seek *new* funds, a particular problem when the federal match rate is high.

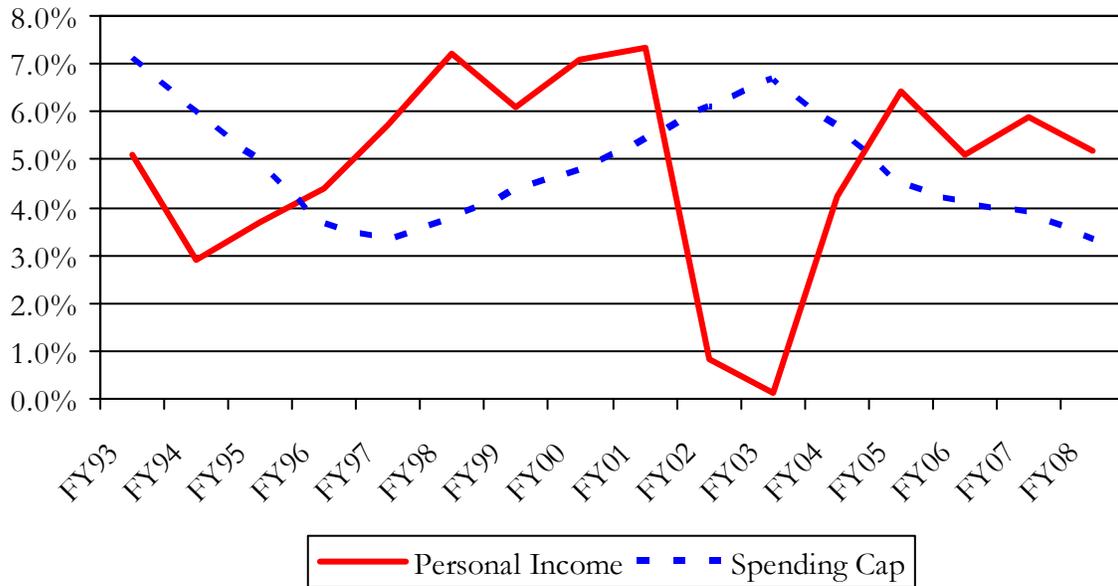
EX: If the state budget were within \$11 million of the spending cap, and a new federal grant program was adopted with a 90% federal match rate, making the state eligible for \$90 million in new federal funds for some purpose (say, for HUSKY outreach and enrollment activities) if the state put up \$10 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.

**2. Much of Connecticut’s state spending is under the cap.** The proportion of Connecticut’s state appropriated expenditures that are *subject* to the cap (80.4% in FY 93, 79.6% in FY 00; and 83.4% in FY 07) is 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.

**3. The definition of “general budget expenditures” in setting the budget “base” is overly conservative.** Connecticut is quite conservative in how it calculates its budget “base.” In some states, the budget base is the total amount that *could have* been spent under the cap, whether or not it was. Connecticut, however, uses the amount *appropriated* in the prior year as the budget base, not what *could have been spent* under the cap, or even what was *actually spent* (e.g., if all surplus funds that were expended were also included in the base). This, combined with the lagged five year growth rate, *assures* that the growth in state spending will lag the growth in the state economy. By comparison, using *allowable* spending as the base could help avoid the “ratcheting down” effect observed with Connecticut’s budget (discussed below).

**4. The definition of “increase in personal income” is under-inclusive and untimely.** The statutory spending cap, adopted in 1991 *before* the Constitutional cap approved by the voters, defines “increase in personal income” using a *lagged* five-year average of personal income growth. For example, it is the average growth in personal income over the period FY 02-FY 06 that is determining allowable growth in FY 08. Connecticut is one of only two states that uses an average computed over so long a period; most states use a shorter time period, from one to three years. While an average avoids having any one year weigh too heavily in the limit, an average as long as Connecticut’s *assures* that the impact of a recession on our state budget will far outlive the recession itself.

The following chart shows the striking lack of connection between growth allowed under the cap using the lagged five-year average of personal income growth and changes in the state's economy. When the economy is recovering from a recession and personal income is increasing, allowable growth under the cap is declining. When the economy is *in* a recession and personal income growth is very low, the cap allows growth in the state budget far in excess of what revenues would allow. In short, growth allowed by the cap is *unrelated* to the state's economic cycle, although a goal of the cap is to keep state spending in step with growth in the state's economy.



A second shortcoming in Connecticut's personal income measure is that *does not include* capital gains income.<sup>9</sup> In a state as wealthy as Connecticut, a measure of personal income growth that excludes capital gains income greatly *under-estimates* actual personal income growth and, therefore, the capacity of Connecticut to meet its essential state needs.<sup>10</sup> By comparison, Connecticut's personal income tax treats capital gains income as taxable personal income.

**5. Exceeding the cap requires action by both the Governor and General Assembly.**

To exceed Connecticut's cap requires both a declaration of emergency or extraordinary circumstances by the Governor *and* a vote by 3/5<sup>th</sup> of the members of both the House and Senate. Few states require action by two branches of government.

<sup>9</sup> The statutory spending cap, Conn. Gen. Stat. §2-33a, defines "increase in personal income" to be "the average of the annual increase in personal income for the state for each of the preceding five years, according to United States Bureau of Economic Analysis data." BEA data do not count capital gains income as "personal income."

<sup>10</sup> Between 1994 and 2000, capital gains realizations reported by Connecticut residents increased by more than 500% -- from \$2.547 billion in 1994 to \$15.435 billion in 2000. Though capital gains realizations fell sharply between 2000 and 2001, the capital gains realizations reported in 2001 (\$8.435 billion) still exceeded gains reported in any year from 1994 to 1997. OPM Secretary Marc Ryan, *The State Budget and the Economy* (PowerPoint Presentation, October 15, 2003), p. 34.

## II. What Has Been The Impact Of The Spending Cap On Appropriated Spending?

**A. Average annual growth in appropriated spending has been cut by half.** According to the Office of Policy and Management, since the spending cap was adopted in 1991 growth in state *appropriated* spending has been on a downward trend. In the four years prior to the adoption of the state spending cap -- between FY 87 and FY 91 -- state spending growth averaged 10.8% per year; over the slightly longer period between FY 79 and FY 93, state spending grew an average of 9.6% per year. Between FY 93 and FY 07, however, spending has grown by an average of 4.8% per year. That is, since the enactment of the cap, annual growth in *appropriated* spending has been cut by half.<sup>11</sup>

However, how much *actual* state spending has declined over this period is not as clear. For example, since 1993, personal income growth has exceeded the cap's allowable growth in seven years (1997-2001, 2005, 2006). In all of those years except 1997, through action by the Governor and the General Assembly, the spending cap was exceeded. All spending over the cap is not necessarily counted as growth in "appropriated" spending, nor is spending put on the state's credit card through bonding and "spending" for economic development through the tax code. In sum, while growth in *appropriated* spending may have declined by half, there also has been significant growth in spending that is not subject to the annual appropriations process, reducing budget transparency and accountability.

**B. State spending growth is ratcheting down with each recession.** Two elements of the spending cap, as currently defined, operate *in concert* to ratchet down public investment with each new economic cycle:

- The cap's *lagged five-year average* of personal income growth which also fails to include capital gains income;
- The cap's base for allowable growth, which is *appropriated spending* in a prior year, *rather than what the spending cap would have allowed* to be spent (e.g., if there had been sufficient revenues) or even *what was actually spent*.<sup>12</sup>

Our most recent recession has demonstrated the impact of these two elements together. In recession, state spending is less than the cap allows because there are insufficient revenues to spend up to the cap's limit. This reduces the budget base for spending cap calculations in subsequent years.<sup>13</sup> Then, when the economy improves and revenues increase, the cap's allowable growth rate

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<sup>11</sup> Office of Policy and Management, *Fiscal Accountability of State Government* (PowerPoint presentation, November 27, 2006), p. 21.

<sup>12</sup> Appropriated surplus funds are not routinely added to the budget base even when used for on-going purposes.

<sup>13</sup> For example, when the FY 02 budget was adopted it was \$78.2 million under the spending cap, the revised FY 03 budget was \$376.1 million under the cap (though the original FY 03 budget was under the cap by just \$63 million), and the FY 04 budget was \$356 million under the cap (though subsequent appropriations to address deficiencies and other expenses resulted in the FY 04 budget being \$122.9 million under the cap). Although the revised FY 05 budget was \$129.1 million under the cap when adopted, subsequent appropriations resulted in spending exceeding the cap by \$370.8 million in FY 05. However, the Governor's Declaration on June 6, 2005, specified that any general budget expenditures in excess of the allowed FY 05 budget would not be included in the base for purposes of determining allowable spending in FY 06. *Connecticut State Budget 2001-2003*, *Connecticut State Budget 2001-2003 Revisions*, p. 11; *Connecticut State Budget 2003-2005*, p. 12; *Connecticut State Budget 2003-2005 Revisions*, pp. 8-9; *Connecticut State Budget 2005-2007*, p. 8

actually declines for a time because the slow growth in personal income in the recession years is included in the five-year average. This five-year average, therefore, virtually assures that *allowable* growth will be less than *current* personal income growth whenever the state's economy is picking up after a recession.

**1. Impact of the lagged five-year growth rate.** As illustrated in the table below, in FY 04 (for example) allowable budget growth under the cap using the *five-year average* of personal income growth was 5.69%, while personal income growth in FY 04 alone was just 4.23%.<sup>14</sup> By comparison, in FY 05 the five-year average of personal income growth declined to 4.46% while the one-year growth in personal income increased to 6.41%.<sup>15</sup> By FY 08, the five-year average in personal income growth is 3.31%, *an all-time low*, although the rate of personal income growth is projected to be 5.20%. In short, over the period FY 04 to FY 08, as the economy was improving, growth in allowable state spending declined and after FY 04 was below current personal income growth.

Difference in 5-year average and single year growth in personal income						
	FY 04	FY 05	FY 06	FY 07	FY 08	FY 09
<b>Growth allowed under cap</b> (lagged 5-year average of personal income growth)	<b>5.69%</b>	<b>4.46%</b>	<b>4.06%</b>	<b>3.88%</b>	<b>3.31%</b>	<b>4.10%</b>
<b>Personal income growth</b>	<b>4.23%</b>	<b>6.41%</b>	<b>5.64%</b>	<b>5.70%</b>	<b>5.20%</b>	<b>4.7%</b>

The impact of multiple years of allowable growth that is below actual personal income growth is evident. As of February 2, 2007, OFA was estimating that the FY 08 current services budget would be \$542.5 over the spending cap, and the FY 09 current services budget \$612.6 million over the cap, even if spending in FY 07 was at the maximum allowed by the cap.<sup>16</sup> That is, it will be impossible to merely maintain current services in the years ahead – even if we have adequate revenues – unless the Governor and General Assembly agree to exceed the cap, or to modify it.

**2. Impact of the budget base definition.** The impact of the second troublesome element in the spending cap -- defining the budget base to be actual appropriations, rather than the level of spending allowed by the cap -- can be illustrated by the following simple example.

Assume that Connecticut adopts a \$10 million budget in year 1 that brings state spending up to the spending cap limit. In year 2, revenues drop by \$1 million, so appropriations are reduced to \$9 million. In year 3, the economy improves and the \$1 million in revenues are restored. Assume, also, for the simplicity's sake, a constant 3% growth rate.

The following table illustrates the difference in state spending depending on whether the budget base is *allowable* spending (scenario 1) or *appropriated* spending (scenario 2).

<sup>14</sup> By comparison, in FY 04, revenues from the personal income tax increased by 22% over FY 03. OPM, *Ability to Pay: Correctional Supervisors (NP-8)* PowerPoint presentation (August 25, 2005), p. 8. Since the personal income tax taxes capital gains income, it derives revenues from this component of personal income that is *not* included in the cap's definition of "personal income," contributing to state surpluses.

<sup>15</sup> By comparison, in FY 05, revenues from the personal income tax are estimated to have increased by nearly 23% over FY 04. OPM, *Ability to Pay: Correctional Supervisors (NP-8)* (PowerPoint presentation, August 25, 2005), p. 8.

<sup>16</sup> Office of Fiscal Analysis, *FY 07-FY 10 General Fund and Transportation Fund Projections* (February 2, 2007), p.6.

If the budget base for year 3 spending cap calculations is the *allowable* spending in year 2 under the cap (\$10.3 million), the full \$1 million of revenues can be used in year 3 to restore the \$1 million in cuts made in year 2. Indeed, if revenues were sufficient, up to \$10,609,000 could be appropriated in year 3 (the 3% increase over year 2).

However, if *appropriated* spending in year 2 is the base for year 3 spending cap calculations, growth in year 3 is limited to \$9 million (the amount appropriated in year 2) times 3%, or \$270,000. So, even though the \$1 million in revenues is available to fully restore the funding that was cut, only \$270,000 can be spent under the cap.

<b>Allowable spending as a function of how the “budget base” is defined (assuming 3% growth/year)</b>			
<b>“Budget base” definition</b>	<b>Year 1</b>	<b>Year 2</b>	<b>Year 3</b>
<i>Maximum</i> allowed by cap, if 3% growth rate is applied to cap’s “allowable” growth	\$10,000,000	\$10,300,000	\$10,609,000
1. Amount appropriated, when base is the amount allowable under the cap	\$10,000,000	\$9,000,000	\$10,000,000 to \$10,609,000
2.Amount appropriated, when base is the amount actually appropriated	\$10,000,000	\$9,000,000	\$9,270,000
<b>Difference</b>	0	0	\$730,000 to \$1,339,000

Thus, by defining the budget base to be what was appropriated in a given year, rather than what the cap would have allowed to be spent, our years of recession result in a significant reduction in allowable state spending in all subsequent years. In this example, a \$730,000 to \$1,339,000 reduction in year 3. In addition, when the base is tied to appropriated spending, the base becomes irrevocably indexed to the years when spending is reduced. In this simple example, for instance, the gap in allowable spending between the two scenarios will grow with each passing year after the year of economic downturn. Assuming 3% growth in year 4, the allowable growth under scenario 1 would be \$318,270, while the allowable growth for scenario 2 would be \$278,100.

***In sum, under the current spending cap, the state can never wholly undo its cuts in public investment, no matter how strong state revenues become after a recession.***

Connecticut compounds the cap’s definitional problems by not including in the budget base all *surplus* funds that are actually *appropriated* in any given year, even when they are to be used for on-going expenses. For example, close to \$640 million in FY 05 surplus funds were appropriated by the 2005 General Assembly; of this, about \$105 million was appropriated for on-going purposes.<sup>17</sup> When surplus funds that are appropriated for on-going purposes are not added automatically to the budget base, the spending cap base is less than actual spending on programs and services. This makes it all the more difficult in the out-years fo funding keep pace with current service needs. The following dialogue at a hearing before the Program Review and Investigations Committee highlights this point:

<sup>17</sup> Office of Fiscal Analysis, *Connecticut State Budget 2005-2007* (August 2005), p. 55.

Rep. Brendan Sharkey: *[D]uring the difficult times in the early [2000s], two or three years ago, we actually reduced spending in state government by approximately \$1.9 billion over two years. And the problem with that is that when you lower spending to that significant a degree, roughly almost 10% of our budget, basically, was cut,... that lower amount then becomes our baseline for establishing the cap for the next year. It's not like when we become, when we get those revenues back we can go back to where we used to be. We have to start back at the lower level, and we can only increase by a certain proportion.*

*That may be, that may not be news to you, but I think for a lot of members of the public, they don't realize that even if we could raise the money, we can't spend it. So what would be your solution to that?*

Mark Kosnoff: *Well, I think that [the] spending cap certainly needs to be reviewed. We're just kind of shackling ourselves by ....telling ourselves, on the one hand, we need to fund education more, and even the federal government is mandating us to do that, and yet we're shackling ourselves by saying, well, we can't spend it. So it's a no-win situation if we don't review the spending cap, at least in those terms.”* Program Review and Investigations Committee Hearing, Report on State Taxes, November 30, 2005

It is because of the very harmful impacts of this ratcheting down effect that Colorado, one of the first states to adopt a strong limit on growth in state revenues and spending, recently voted to relax its “cap.” This was in response to advocacy by many in the state – including business leaders – who recognized that the cap was resulting in a reduction of public investment that was significant enough to be harming the state’s economic competitiveness.<sup>18</sup>

### **3. Combined impact of the current growth rate and definition of the budget base.**

In short, the way Connecticut now defines growth in personal income assures that growth in state spending as the economy improves after a recession will *always* lag growth in the economy. The way Connecticut now defines its budget base assures that the spending cuts made in a recession will *irrevocably reduce* the budget base for succeeding years. Together, these definitions ensure that public investment will continue to decline as a share of the economy with each successive recession, and thereby – over time -- jeopardize our continued competitiveness. There are a number of measures that suggest that this is, in fact, occurring:

*a. The gap between current service needs and state spending has been growing since the recession.* In FY 02, General Fund appropriations were \$263 million less than the FY 02 current services budget required. In the following three years, the gap between current services needs and appropriated spending grew. In FY 03, spending was \$805 million less than the FY 03 current services budget. In FY 04, spending was \$964 million less, and in FY 05, spending was \$1.23 *billion* less than the FY 05 current services budget (as calculated before the recessionary cuts).

*b. Some state agency budgets are still below actual FY 02 spending.* The funding cut from some agency budgets in the last recession still has not been fully restored. The FY 07 General Fund budgets of the Department of Higher Education, Office of Policy and Management, Office of Workforce Competitiveness, Department of Economic and Community Development, Department of Environmental Protection, the State Library and the Office of Protection & Advocacy remain *less than* their actual FY 02 spending, *not adjusted for inflation*. The FY 07 General Fund budgets of the UConn Health Center, the State Universities and Regional-Community Technical Colleges, the

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<sup>18</sup> See, e.g., D. Bradley & K. Lyons, *A Formula for Decline: Lessons from Colorado for States Considering TABOR* (Center on Budget & Policy Priorities, 2005), p. 9.

Department of Labor and the Department of Public Health are less than FY 02 spending, adjusted for inflation. While the State Department of Education's FY 07 budget keeps kept pace with inflation, it does not also keep up with the growth in the student population since FY 02.

*c. State and local spending is a relatively small, and diminishing, share of our economy.* Comparisons of Connecticut's spending as a share of two standard measures of the state's economy<sup>19</sup> to spending in other states shows that our state and local public investment<sup>20</sup> already is quite low compared to our economic capacity.

*i. Total government spending as a share of Gross State Product (GSP).*<sup>21</sup> Total government spending as a percent of gross state product (GSP) is "relatively low in Connecticut."<sup>22</sup> In 2003, total government spending in Connecticut was about 8.75% of gross GSP; this was 4<sup>th</sup> lowest among all states, second lowest among Northeastern states, and substantially below the United States average (11.9%).<sup>23</sup> If Connecticut's total government spending as a share of its GSP were *at the national average* among states, our total state and local spending would have been about \$5.4 billion greater in 2003.

*ii. State and local expenditures as a share of personal income.* A recent Federal Reserve Bank of Boston/Brookings Institution study<sup>24</sup> ranked Connecticut highest among all states in its "fiscal capacity" – a measure comparing states' revenue capacity to their expenditure needs. Yet, Connecticut lags other states in its state and local spending as a share of its personal income. The following chart shows Connecticut's relative rank, based on United States Census Bureau data for

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<sup>19</sup> Gross domestic product by state (formerly gross state product) is a good measure of the economic vitality of a state. It is calculated as the sum of what consumers, business and government spend on final goods and services, plus investment and net foreign trade. However, states are not able always to capture the benefit of that vitality, as some of the benefits (income) generated can cross the border, to another state or out of the country. Personal income is the most widely used measure of a state's economic well-being; it measures the incomes of state residents, some of which can be generated in another jurisdiction. In 2005, Connecticut's gross domestic product was \$193.745 billion while its personal income was \$166.807 billion; personal income was about 86% of Connecticut's GDP (compared to a national ratio of 82%). Federal Funds Information for States, *State Policy Reports*, Vol.24 (20) (October 2006), pp. 7-10. Comparisons based on per capita expenditures, although common, fail to capture the significant differences in states' economic capacities (as are captured by comparisons based on share of personal income or share of GDP). Nonetheless, per capita comparisons are sometimes used to compare states at a given point in time, and also changes in state rankings over time. In 1998, Connecticut ranked 8<sup>th</sup> highest among states in revenues per capita (\$5,046) and 6<sup>th</sup> highest in expenditures per capita (\$4,434). By 2004, however, Connecticut's relative standing had fallen – to 22<sup>nd</sup> highest in revenues per capita (\$5,578) and 12<sup>th</sup> highest in expenditures per capita (\$5,580). United States Census Bureau, *State Government Financial Data*, available at: [www.census.gov/govs/www/state.html](http://www.census.gov/govs/www/state.html).

<sup>20</sup> Combined state and local data are used for cross-state comparisons since responsibilities for levying and collecting taxes and providing public services vary by jurisdiction across states.

<sup>21</sup> As noted above, gross domestic product by state is defined as the total value of goods and services produced by a state's economic resources. Like personal income, it includes all the income earned by a state's population, but also includes income generated within the state without regard to the location of the entity receiving the income. Compared to personal income, GSP better reflects the total amount of economic activity potentially subject to taxation by a state. It does not, however, include the income earned by its residents from out-of-state sources, which is a source of revenue that may be – but is not often – taxed by states. New England Public Policy Center at the Federal Reserve Bank of Boston Working Paper 06-2, *Measuring Fiscal Disparities Across U.S. States: A Representative Revenue System/Representative Expenditure System Approach*, Fiscal Year 2002 (2006), p. 19.

<sup>22</sup> Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p.193.

<sup>23</sup> Legislative Program Review & Investigations Committee, *Connecticut's Tax System* (January 19, 2006), p.193 (or 42?).

<sup>24</sup> New England Public Policy Center at the Federal Reserve Bank of Boston Working Paper 06-2, *Measuring Fiscal Disparities Across U.S. States: A Representative Revenue System/Representative Expenditure System Approach*, Fiscal Year 2002 (2006), p. 1.

FY 2004 (the most recent year available). A ranking of #1 indicates the state is the highest among states in the share of personal income for that measure, and a ranking of #50 the lowest.

CT's Rank on State & Local Expenditures in FY 2004 as a Share of Personal Income <sup>25</sup>			
Measure	CT Rank	% of Personal Income: CT	% of Personal Income: 50-State Average
Direct general expenditures <sup>26</sup>	49	16.3%	20.2%
State and local capital spending <sup>27</sup>	49	1.4%	2.5%
State and local spending on education <sup>28</sup>	47	5.7%	7.0%
-On primary and secondary education	39	4.29%	4.81%
-On higher education	49	1.20%	1.84%
State and local social services spending <sup>29</sup>	44	3.92%	5.33%
-On public welfare spending <sup>30</sup>	44	2.72%	3.56%
State and local transportation spending <sup>31</sup>	50	0.88%	1.51%
State and local public safety spending <sup>32</sup>	47	1.24%	1.77%
State and local spending on housing & the environment <sup>33</sup>	49	1.12%	1.48%

<sup>25</sup> "State personal income" is defined by the United States Department of Commerce's Bureau of Economic Analysis as "the income that is received by all persons [residing in a state] from all sources" and is the sum of wage and salary disbursements, supplements to wages and salaries, proprietors' income, rental income, personal dividend income, personal interest income, and person current transfer receipts, less contributions for government social insurance. It is measured before the deduction of personal income taxes and other personal taxes and is reported in current dollars. This chart is taken from an analysis of United States Census Bureau revenue and expenditure data for state and local governments for fiscal year 2004 by the Massachusetts Budget and Policy Center, *Measuring Up: Taxes and Spending in Massachusetts* (November 2006), available at: [www.massbudget.org](http://www.massbudget.org).

<sup>26</sup> "Direct general expenditure" is a broad measure of total state and local government spending that includes not only programmatic and operational spending, but also capital spending. It does not include utility, state liquor store, or insurance trust expenditures, but does include spending supported by federal grants and subsidies.

<sup>27</sup> The Census Bureau defines capital spending as expenditures for the "construction of buildings and other improvements" and for the "purchase of equipment, land, and existing structures." It does *not* include interest payments on any debt issued to finance capital outlays, nor does it include payments of principal to retire such debt. Connecticut's low ranking on this measure may reflect its high reliance on bonded debt relative to other states.

<sup>28</sup> The Census Bureau defines "education" spending to include capital investments (but not interest or principal payments on debt issued to finance capital outlays).

<sup>29</sup> The Census Bureau defines "social services" spending to include expenditures for public welfare programs, health programs, veterans' services, hospitals, and payments to augment Supplemental Security Income (SSI) benefits for the elderly and disabled.

<sup>30</sup> The Census Bureau defines "public welfare" spending to include direct cash assistance payments to low-income individuals and families, vendor payments (e.g., Medicaid payments to local health providers), and expenditures made to cover the costs of administering such programs.

<sup>31</sup> The Census Bureau defines "transportation" spending to include spending on highways (current and capital), on airports, and on sea and inland port facilities.

<sup>32</sup> The Census Bureau defines "public safety" spending to include spending on police and fire protection and on corrections.

<sup>33</sup> The Census Bureau includes in this category spending for the conservation and development of state and local natural resources, spending for parks and recreation, for housing and community development, and for sewers and solid waste management.

### III. Some Consequences Of Current Cap Definitions: Reduced Budget Transparency and Budget Choices with Harmful Long-Term Impacts

The very restrictive manner in which Connecticut's spending cap is defined has given rise to various forms of evasion. While these actions are often well-meaning efforts to keep public investment at levels that the Governor and members of this General Assembly understand are necessary to support our economy and our families, they result in diminished budget transparency and accountability, and can have harmful long-term effects.

This section discusses some of ways the cap has been circumvented. Not discussed are the multiple times that, by *the explicit* agreement of the Governor and General Assembly, the cap has been exceeded.<sup>34</sup>

**A. Increased use of tax expenditures.** Tax expenditures are defined as a departure from the normal tax structure that is designed to favor a particular industry, activity, or class of persons. This departure may be through a special tax exemption, deduction, credit, reduced rate or other mechanism that lowers the amount of tax revenue that would otherwise be collected. As OFA explains in its periodic *Tax Expenditure Report*:

A tax expenditure is similar to a direct expenditure in that it can be used to accomplish public policy goals. It may be enacted either to encourage a certain activity or to limit the tax burden on taxpayers in a certain situation. For example, government can attempt to encourage economic development directly by providing financial assistance to businesses through grants or indirectly through tax expenditures such as Corporation Tax credits or Sales Tax exemptions.<sup>35</sup>

Governor Rowland, 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."

**EX:** PA 00-170 enacted a \$10.5 million credit against the insurance premiums tax for the benefit of the managed care organizations providing HUSKY A and B coverage. This credit, equal to \$55 times the average monthly enrollment in each company's program each year, was to be taken against the plans' tax on their *commercial* policies (the plans already were exempt from tax on their HUSKY policies). PA 01-6 (June Special Session) subsequently increased the credit from \$55 to \$73.50 times the plans' average monthly enrollment. Though the credit was the functional equivalent of a \$14 million per year fee increase for these plans in FY 02 and \$15.6 million in FY 03, the "expenditure" was not subject to the spending cap. Indeed, when PA 02-3 eliminated the credit, it was replaced with supplemental

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<sup>34</sup> Since the spending cap was adopted in 1991, the state's growth in personal income has exceeded the lagged five-year personal income average (the spending cap allowable growth rate) in seven years. In six of these years, the Governor and General Assembly agreed to exceed the spending cap.

<sup>35</sup> Office of Fiscal Analysis, Connecticut General Assembly, *Connecticut Tax Expenditure Report, 1993-1995 Biennium* (February 1995), p. 2.

fee payments to the plans of \$14 million in FY 02 and \$18.3 million in FY 03 that *were* subject to the cap.<sup>36</sup>

Available data suggest that there has been some *increased use* of tax expenditures for economic development and other purposes since the spending cap was adopted. The following are a few examples:

**1. Increase in Corporate Tax Credits.** In 1983, there were eight credits against the corporation business tax. In 1991, when the spending cap was passed, there were eleven credits – just three more. Now, however, there are 29 tax credits against the corporation tax, including four that were adopted in the last two years.

Some of the newer credits are looking increasingly like direct expenditures, in that they can be redeemed for cash by corporations that have no tax liability to offset, or even sold for cash. For example, the research and development and research and experimentation tax credits, both created since the spending cap was adopted, are *refundable* credits. That is, if the corporation does not have any tax liability to offset with the tax credits, the company can sell the unused credits back to the state at 65% of their value. In short, Connecticut will pay corporations for unused research and experiment and unused research and development credits, just like awarding cash grants for these purposes. The “movie” tax credit enacted last year, like the historical preservation, urban sites reinvestment, and insurance reinvestment tax credits, are *transferable*. That is, the corporation that is eligible for the credit can sell the credit for cash to a corporation<sup>37</sup> that has tax liability to offset.

Further, last Session in PA 06-189, the General Assembly changed the law to allow limited liability corporations, limited liability partnerships, and other pass-through businesses that are *not* subject to the corporation business tax -- and so are not eligible for corporate tax credits -- to nonetheless claim the credits, *as if they were a corporation*, and pass them through to corporations that are members of the pass-through entity. There is one limitation on this quite significant expansion that allows a business that is not subject to our corporate income tax to claim corporate tax credits: the pass-through company must create at least 400 permanent, full-time jobs that are new to Connecticut, as certified by DECD.

This expansion in the number and types of credits has been accompanied, not surprisingly, by a marked increase in both the number of companies claiming the corporate tax credits, and the amount claimed in credits.

In 1983, 281 tax returns were filed claiming a total of \$1.44 million in credits. By comparison, in 2000, 16,374 returns were filed claiming a total of \$133.8 million in credits – a 57-fold increase in the number of tax returns claiming credits and a 92-fold increase in the amount claimed. In addition to this, OFA has projected that the annual revenue loss from the corporate tax credits that have been

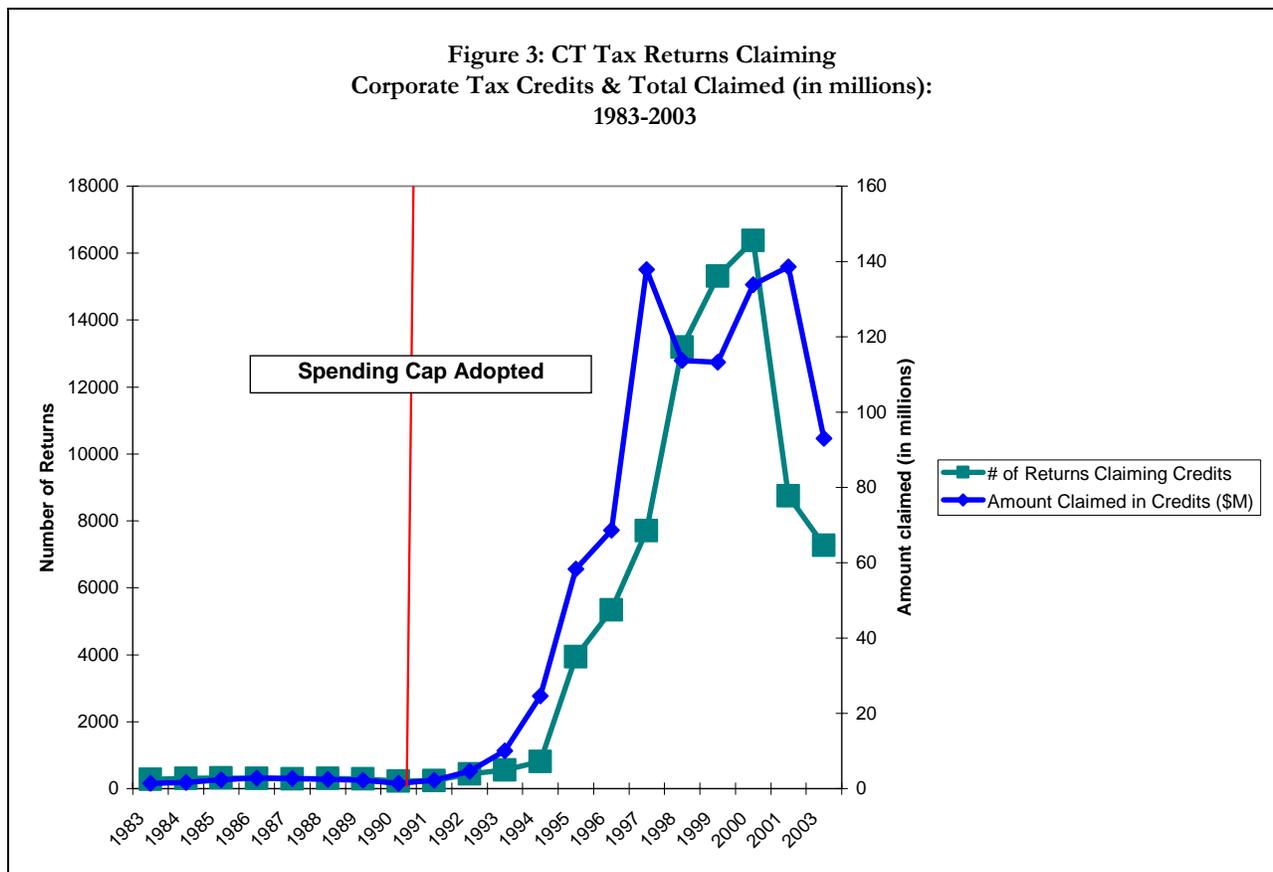
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<sup>36</sup> Office of Fiscal Analysis, Fiscal Note on P.A. 02-3 (SB 33, An Act Concerning Certain Taxes Related to Health Care and Reporting Requirements for Certain Managed Care Subcontractors).

<sup>37</sup> In this regard, the insurance reinvestment tax credit is unique, in that it also can apply to the personal income tax as well as business taxes. Conn. Gen. Stat. §38a-88a. This credit is limited, however, because the investments that generated the credits must be made through special insurance investment funds approved by the Department of Economic and Community Development and created before July 1, 2000. Also, total credits are capped at \$15 million for all investments in a single business and, for each fund, at the total amount originally invested in the fund. Investments made after December 31, 2015 are not eligible for a credit.

enacted, or expanded, in the last two years (e.g., the “movie,” “displaced worker,” “new jobs,” “housing,” “historic rehabilitation” tax credits) is close to \$27 million; this new revenue loss is in addition to the revenues now being lost through other credits. The increase in claimants and amounts claimed would be greater still had not subchapter S corporations become wholly exempt from the corporation business tax (a significant tax benefit in itself). PA 02-1 (MSS) also limited the total value of tax credits that could be claimed in any income year to 70% of a company’s pre-tax liability, starting January 1, 2002.

As shown in Figure 3 below, nearly all of the increase in claimed corporation business credits occurred after the spending cap was adopted.



**2. Increase in the number and total cost of sales tax exemptions.** Of the 116 current exemptions to the sales tax listed in Conn. Gen. Stat. §12-412, nearly 50 (42%) have been added in the fifteen years since the spending cap was adopted (by comparison, from the enactment of the sales tax to the early 1970s, no more than 23 exemptions to the tax existed). In addition, other exemptions to the sales tax have been adopted, including changes in what types of services are taxable.

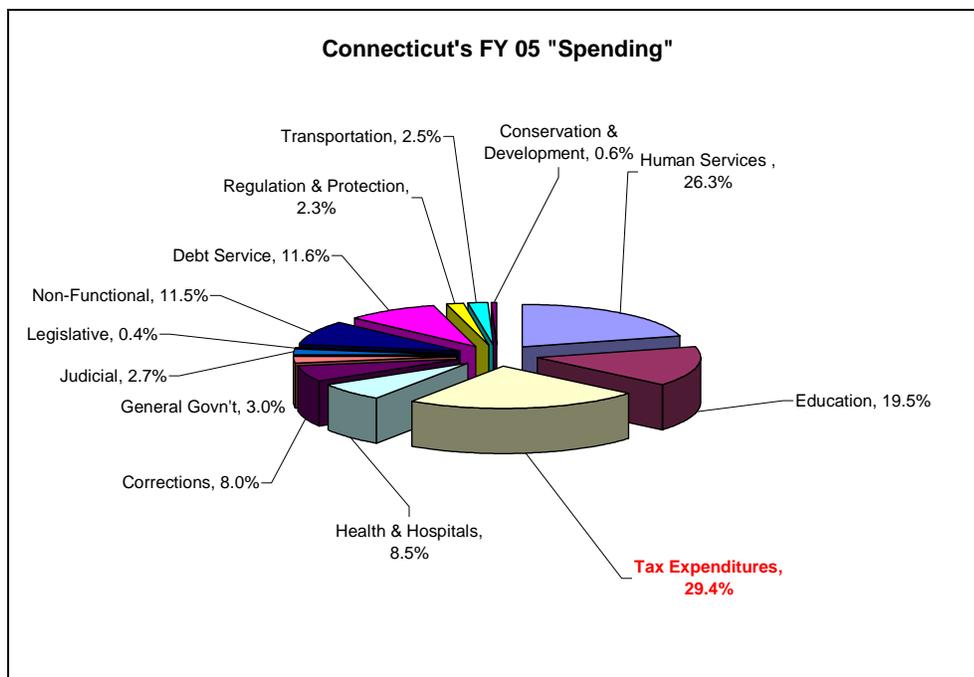
Among the exemptions enacted since the spending cap was adopted (with OFA’s estimated annual revenue losses in FY 05) are: a) computer and data processing services (\$58 million); b) advertising

services (\$20 million); c) sales of repair or maintenance services on boats/vessels (\$3 million); d) machinery, equipment and other materials used in the biotechnology industry (\$3.5 million).<sup>38</sup>

Although the Office of Fiscal Analysis estimated a FY 05 revenue loss of \$2,155.5 million from exemptions and rate reductions in Connecticut’s sales and use tax,<sup>39</sup> the Department of Revenue Services reported that \$11,291.9 million in revenues that were foregone in FY 05 –*five times more than DRS estimated* -- because of exemptions to the sales and use tax, or rate reductions for sales of certain goods and services.<sup>40</sup>

**3. Tax expenditures as a significant share of state “spending.”** The Office of Fiscal Analysis estimated that revenue losses from the various exemptions, deductions, credits, and rate reductions in Connecticut’s state tax code totaled about \$4.391 billion in FY 05, or close to one-third the FY 05 gross appropriated budget of \$14.442 billion.<sup>41</sup>

The following chart illustrates what the share of total state “spending” through tax expenditures would be if all state exemptions, deductions, rate reductions, and credits were repealed, the revenues thereby gained credited to the state budget, and direct appropriations were instead made to the current beneficiaries of our tax expenditures. Under this fictitious situation, “tax expenditures” would have been the single largest category of state “spending” in FY 05.



<sup>38</sup> Office of Fiscal Analysis, *Connecticut Tax Expenditure Report* (August 2004), pp. 5-7.

<sup>39</sup> Office of Fiscal Analysis, *Connecticut Tax Expenditure Report* (August 2004), p. 7.

<sup>40</sup> Connecticut Department of Revenue Services, *Annual Report Fiscal Years 2003-2004 and 2004-2005*, p. 56, available at: [www.ct.gov/drs/lib/drs/research/annualreport/drs\\_annual\\_report\\_fy04\\_and\\_fy05.pdf](http://www.ct.gov/drs/lib/drs/research/annualreport/drs_annual_report_fy04_and_fy05.pdf).

<sup>41</sup> By comparison, OFA estimated that tax expenditures resulted in a state revenue loss of about \$3.069 billion in FY 97. Thus, the revenue loss from tax expenditures increased by \$1.322 billion between FY 97 and FY 05 (or by about \$725 million adjusted for inflation). Office of Fiscal Analysis, *Connecticut Tax Expenditure Report* (February 1997 and August 2004). Tax expenditures as a “share” of total state spending remained relatively constant through this period, increasing at about the same rate as the appropriated budget.

**4. The challenges in using tax expenditures, rather than direct appropriations, to promote economic development and other activities.** One need not question the merits of each tax credit, exemption, deduction or other tax preference to question the wisdom of funding an increasing share of our economic development activities through the tax code and also to understand the impact this has on budget transparency and accountability. Unlike companies that benefit from direct grants or loans from the Department of Economic and Community Development, the identity of companies that benefit from these tax breaks is not a matter of public record. Further, although some of the tax credits are capped in the total amount that can be claimed in a year, others are not and therefore are a blank-check entitlement to state financial support in perpetuity. Using tax expenditures to promote economic development or other social or policy ends results in a permanent reduction in the state's revenue stream without periodic assessment of the state's return on its investment.

Tax expenditures differ markedly from direct expenditures in other ways that bear directly on budget transparency and accountability. As OFA explains:

A tax expenditure is different from a direct expenditure in that it does not need to be re-enacted. Unless a sunset date is placed on a tax expenditure provision, it may continue indefinitely, whereas direct expenditures must be appropriated for each budget period.

Not only does a tax expenditure not require re-enactment, its fiscal impact usually is not reviewed after it becomes law. When net revenues are forecast, most tax expenditures have already been excluded from the base. Typically, the fiscal impact of an existing provision is not estimated unless a proposal is made to change or repeal it.<sup>42</sup>

**B. Increased state bonding.** Because debt service payments are explicitly excluded from the state spending cap, it is not be surprising that Connecticut would turn increasingly to bonding to fund not only capital expenses but also on-going operating expenses. In fact, since the adoption of the spending cap, the use of the state's "credit card" for spending has increased and a non-trivial share of the spending has been for on-going expenses. In FY 01, for example, Connecticut issued \$1.3 billion in new debt of which \$511 million (39%) was to fund on-going state expenses. The percentage of debt used for operating costs was even higher in FY 00 (57%) and FY 99 (55%).<sup>43</sup>

Connecticut's bonded debt has increased significantly over the past fifteen years and is now very high relative to other states.<sup>44</sup> Connecticut ranks 4<sup>th</sup> highest in state debt as a share of personal income, and 3<sup>rd</sup> highest in per capita state debt.<sup>45</sup> The following chart shows how debt per capita (in nominal dollars) markedly has increased since about the time the spending cap was adopted:

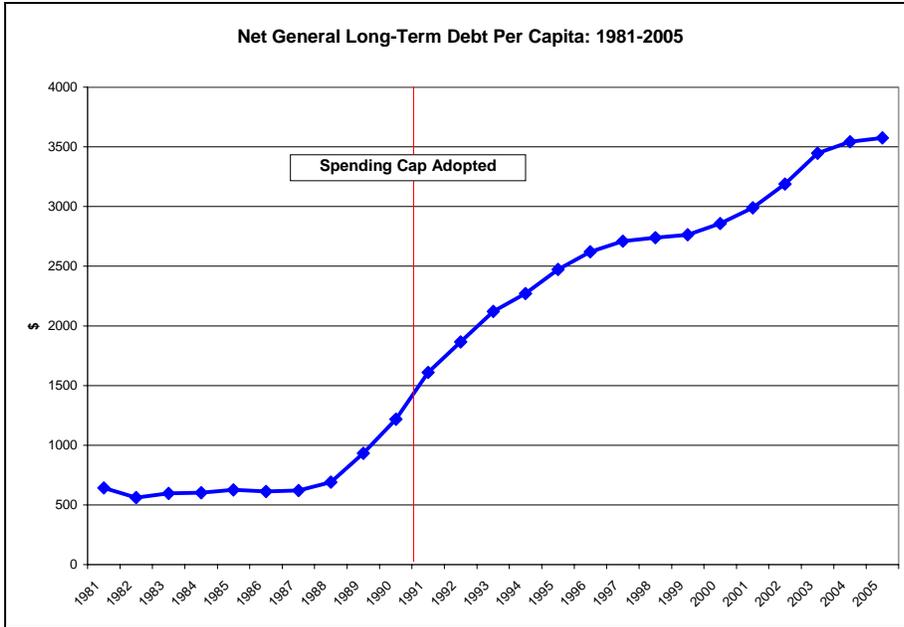
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<sup>42</sup> Office of Fiscal Analysis, Connecticut General Assembly, *Connecticut Tax Expenditure Report, 1993-1995 Biennium* (February 1995), p. 2.

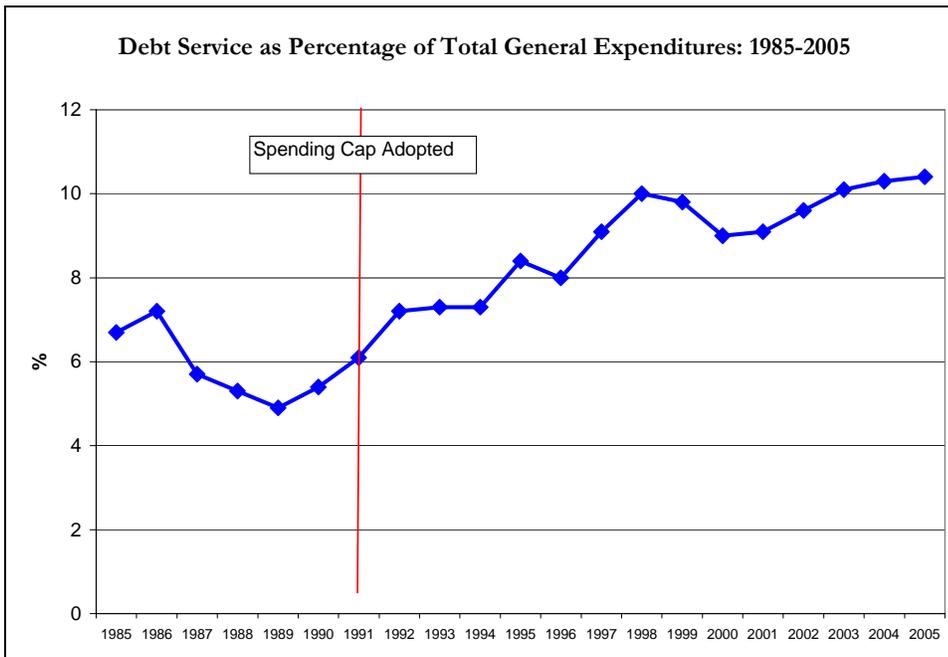
<sup>43</sup> Legislative Program Review and Investigations Committee, *Connecticut Budget Process*, p. 65.

<sup>44</sup> One of the reasons that Connecticut's debt is high relative to other states is that Connecticut lacks county government. As a result, the state assumes some of the debt that would in some other states be issued by counties, such as for school construction and renovation.

<sup>45</sup> CT Office of Policy and Management, *Report to the Appropriations Committee and the Finance, Revenue, and Bonding Committee, An Act Concerning Fiscal Accountability of State Government* (November 16, 2006), p. 37.



As bonded debt has increased, so has debt service. In FY 89, just 4.9% of Connecticut's *total* general state expenditures were used to pay debt service. This steadily increased to 8.4% in FY 95, 9.0% in FY 00, and 10.4% in FY 05.<sup>46</sup> In the current FY 07 budget, 11.4% of General and Special Transportation Fund expenditures will be for debt service. Debt service will continue to increase as a share of budget expenditures despite keeping General Obligation allocations and issuances fixed at the current level.<sup>47</sup> The increase in debt service as a share of state spending is illustrated in the following chart:



<sup>46</sup> State Comptroller, *Comprehensive Annual Financial Reports* for the FYs ending June 30, 1997 and June 30, 2005, p. 143.

<sup>47</sup> CT Office of Policy and Management, *Fiscal Accountability of State Government* (November 27, 2006 PowerPoint), p. 50.

**The problem with using bond funds, rather than appropriations, for operating expenses.** Connecticut's use of bond funds for operating expenses has a long-term cost. Using borrowed funds costs more in the long run; one must pay back interest as well as the principal. In addition, as debt service payments increase, they reduce the funding available to be appropriated for other purposes. This year, Connecticut will spend about \$1.8 billion of its \$16.07 billion budget on debt service; by 2010, if current trends continue, debt service should approach \$2.17 billion, or 12.1% of the total budget.<sup>48</sup> If debt service as a share of the current state budget were roughly comparable to FY 90, there would be an additional \$964 million available for other types of public investment.

**C. Increased Use of Other Budget Techniques to Circumvent the Cap.** As pointed out by the Program Review and Investigations Committee in its report, *Connecticut Budget Process*, “[w]hether certain proposed expenditures are subject to the spending cap depends on how funds are categorized during the budgeting process.” (p. 63) Two specific budget techniques have been used to avoid spending cap constraints by authorizing “spending” that is *not* categorized as “appropriated” and is therefore considered outside the cap.

**1. Earmarking funds.** Although the state budget has long had special funds that rely on designated funding streams for specific purposes (e.g., the Banking Fund), what is relatively new is the use of so-called “revenue intercepts” to fund new special, non-lapsing funds that support initiatives that would previously have been funded through the General Fund. This trend markedly reduces budget transparency and accountability.

The most recent example is the Governor's proposed Casino Assistance Revenue (CAR) Fund, which would “intercept” casino revenues before they are put in the General Fund and distribute them to towns to offset lost property tax revenues from her proposed repeal of the property tax on cars. It is modeled after two similarly-constructed funds that were approved in the 2005 Session:

a) The “Land Protection, Affordable Housing and Historic Preservation Account” was established by PA 05-228 as a special, non-lapsing account within the General Fund. It is funded by diverting \$26 of a new \$30 fee imposed when land records are recorded (the balance stays with the town). Funds are distributed every three months, based on a statutory formula, in equal amounts to the Commission on Culture and Tourism, the CT Housing Finance Authority, the Department of Environmental Protection and the Department of Agriculture. The Office of Fiscal Analysis projected that each agency would receive \$6 million in FY 07 for the purposes specified in the statutes, for a total of \$24 million distributed outside the appropriations process in FY 07 alone.

b) The Citizen's Election Fund (CEF) was established by PA 05-5 (October Special Session) as a separate non-lapsing account in the General Fund to be administered by the State Treasurer. The CEF is financed through: 1) an allocation of the cash receipts received from unclaimed property escheated to the state that would otherwise have been credited to the General Fund; 2) voluntary contributions from individuals, businesses, and PACs; 3) donations of surplus funds from dissolved candidate campaign or political committees and 4) investment earnings on CEF's resources. Funds are to be distributed to candidates who comply with certain program requirements, based on a specified mechanism specified in the enabling statute. The bill allocates \$17 million from the cash receipts received from unclaimed property escheated to the state in FY 06, \$16 million in FY 07, and beginning in FY 08, \$16 million plus an annual inflationary factor based on the change in the

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<sup>48</sup> K.Phaneuf, “Debt costs gobbling up budget,” *Journal Inquirer* (December 20, 2006).

consumer price index for all urban consumers. This allocation will result in an annual General Fund revenue loss; by restricting the use of revenue that is currently deposited into the General Fund, the revenues will no longer be available for General Fund purposes. In any year there is insufficient revenue generated from unclaimed property receipts to make the required transfer to the CEF, the bill requires revenue from the corporation business tax to make up any shortfall. Currently, unclaimed property receipts for FY 06 through FY 09 are projected at levels (\$50 to \$70 million/year) that would not require a diversion of corporation business tax revenue to the CEF; unclaimed property receipts not transferred to the CEF are credited to the General Fund.

The creation of the Citizen Election Fund and the Land Protection, Affordable Housing and Historic Preservation Account provoked heated debate in the General Assembly. Republicans argued that spending under both should be considered appropriations under the spending cap. Democrats countered that when funds are earmarked, they fall outside the normal appropriations process so are not subject to the cap. This position prevailed when taken to vote. Representative Ward's critique in the House debate on the CEF on November 30, 2005 was illustrative:

*This Bill says we'll intercept escheats money that's already spent in the budget, put it in a separate fund, not call it spending so it doesn't get counted under the cap. And if that's not enough, we'll intercept the corporate income tax. Well, folks, where do you think that tax goes now? To pay for things in the General Fund.*

*So we're pulling \$20 million offline, roughly, putting it in every year, and it'll probably grow and I think that's an underestimate, and saying it doesn't count under the spending cap. And I guess you plan to try to pass it with less than a three-fifths vote, so you're not even going to say you're going to change our statutory definition that's become our constitutional definition. We're just going to, once again, ignore the spending cap. But keep in mind, even ignoring the spending cap, you're not going to spend that \$20 million on something else. You still can't spend it twice. You can ignore it under the cap, but at some point in time you'll be raising other taxes to make up for it.*

The Office of Fiscal Analysis also takes the position that spending from these two accounts is not to be counted against the cap because it is "not specifically appropriated" and "falls outside the customary purview of the legislature's appropriations review process." OFA rests its interpretation on the text of Conn. Gen. Stat. §2-32a, which defines general budget expenditures as "...expenditures from appropriated funds authorized by public or special act of the general assembly." The Program Review and Investigations Committee, in its *State Budget Process* report, also agrees, noting that since "[e]armarking to fund specific programs eliminates the need to annually appropriate funds to them...earmarked funds are not subject to the spending cap."

*The problem?* Although the use of revenue intercepts to fund non-appropriated funds is a creative mechanism to avoid the constraints of our current spending cap, it is not a sound budget practice for a number of reasons:

*a. Information regarding earmarked funds is not readily accessible.* The Program Review and Investigations Committee reports, "OFA analysis estimates approximately \$141.5 million in General Fund taxes were earmarked in FY 04 for a variety of purposes," but notes that "[a]dditional analysis

would be necessary to accurately identify the amount of all earmarked revenue.”<sup>49</sup> Earmarking moves both the revenues, and how they are spent, outside typical legislative oversight.

*b. Off-budget spending is unlikely to get the same scrutiny as direct appropriations.* As OFA notes, “[I]t is uncertain as to whether these off-budget funding mechanisms will be subject to the same level of examination afforded to items for which appropriations are distinctly made.”<sup>50</sup>

*c. Earmarking revenues for specific purposes reduces the General Fund revenues available for all other purposes.* The Legislative Program Review and Investigations Committee notes that “Earmarking revenues...is not a practice generally endorsed by fiscal policy experts. It limits flexibility in the use of financial resources and puts decision-making outside the appropriations process.”<sup>51</sup>

**2. Lapses and carry-forwards.** The Legislative Program Review and Investigation Committee’s study *Connecticut Budget Process* notes (p. 63), “[t]he spending cap only limits how much the General Assembly and the governor can appropriate each year. There are several budgeting techniques that allow funds to be spent without ever being appropriated for purposes of the cap. The use of lapses and carry-forwards fall outside the spending cap after appropriations have been made.”

Lapses occur when a state agency does not actually spend all the funds appropriated to it. When lapses are transferred to cover deficiencies in other state agencies, the transfer is not considered an “appropriation.” Thus, “[t]his technique of using lapses to cover shortfalls results in spending that does not have to be appropriated and, therefore, is not counted toward the spending cap.” Between FY 01 and FY 04, a total of \$219 million in lapses were transferred to cover agency deficiencies. In FY 01, the \$47.4 million transferred was explicitly said not to be “appropriated.” However, if these additional funds are not added to the budget base in the year of the deficiency, the base is set at a level below what is necessary to maintain current services in subsequent years.

In addition, if an agency does not spend all of its appropriated funding in a fiscal year, the General Assembly may carry-forward the funds into the next budget year for use by that agency or any other agency, and for any other purpose, designated by the General Assembly. In this situation, “If funds are carried over from one year to the next, they only count against the spending cap limit in the year in which they were originally budgeted.”<sup>52</sup> Between FY 02 and FY 06, a close to \$1.4 billion was carried forward from one year for use in subsequent years. A total of \$662.63 million was approved to be carried forward from FY 06 into FY 07.<sup>53</sup> Because spending cap calculations are based on “net” appropriated spending (which *assumes* a certain amount of lapse) the carry-forward of lapse can result in expenditures in excess of what the cap would have allowed. Further, to the extent these one-time carry-forward funds are used for on-going purposes, a structural deficit is created in the following budget year.

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<sup>49</sup> Although the Legislative Program Review and Investigations Committee concluded in its *State Budget Process* report that there was “no evidence that earmarking is a significantly increasing practice” in response to the spending cap, the report preceded adoption of the Citizen Election Fund and the Land Protection, Affordable Housing and Historic Preservation Account in 2005.

<sup>50</sup> Office of Fiscal Analysis, Supplemental Analysis of the Governor’s 2005-2007 Midterm Budget Adjustments (February 27, 2006), p. 20.

<sup>51</sup> Legislative Program Review and Investigations Committee, *Connecticut’s Tax System* (January 2006), p. 160.

<sup>52</sup> Legislative Program Review and Investigations Committee. *Connecticut Budget Process* (December 2003), p. 64.

<sup>53</sup> Office of Fiscal Analysis, *Connecticut State Budget 2005-2007 Revisions* (July 2006), p. 19.

**D. Failing To Meet Current State Fiscal Obligations.** Although not a mechanism to circumvent the spending cap, budget decisions to defer current fiscal obligations to the next generation, or shift state fiscal obligations to cities and towns, also create “room” under the spending cap and the illusion of reduced state spending, but with adverse longer-term consequences.

For example, the state’s failure to contribute the actuarially-required amounts each year to the pension plans for state employees and teachers has resulted in an unfunded liability of \$7.9 billion for unfunded state employee pensions and \$5.2 billion for unfunded teacher pensions. There is also an estimated \$21.1 billion unfunded liability for state employee post-retirement health and life insurance benefits and an as-yet-undetermined unfunded liability for teachers’ post-retirement health and life insurance benefits. These liabilities will not evaporate; the cost to address them increases with each passing year.

Similarly, the state has reduced its share of K-12 education funding from about 46% in 1990 to 38%. Although *state* spending may decline, increases in local property taxes often result.

**E. Reluctance to Seek Additional Federal Funding.** Most of the federal funds in Connecticut’s budget are considered “appropriations” under our spending cap. Specifically, federal funds that require a matching state expenditure to be eligible for federal reimbursement (e.g., Medicaid, SCHIP, Title IV-E of the Social Security Act for foster care) are counted as “general budget expenditures.” Connecticut appropriates *both* state and federal funds, and then counts the federal reimbursements as General Fund revenues.. Thus, this federal funding is “counted” under the cap. Connecticut’s practice of “gross” budgeting can result in a reluctance to seek additional federal funds, and also in some gimmicks that reduce federal funds to gain room under the cap. For example, in 2001 (when state revenues were strong and the spending cap restricting spending) the General Assembly voted to lower the disproportionate share payments made to hospitals by \$100 million to make \$100 million “available” under the spending cap for other purposes. To make the hospitals financially whole, the General Assembly re-structured the disproportionate share program, substituting some tax relief for the direct payments. However, the impact of switching from a direct expenditure of \$100 million to a tax expenditure of equivalent value to gain some room under the state spending cap was a reduction in federal reimbursement of \$50 million (half the \$100 million that had been granted to the hospitals).<sup>54</sup>

#### **IV. Ways to Re-Define Key Spending Cap Terms So Connecticut’s Budget Can to Grow with its Economy, and so Budget Transparency and Accountability Can be Restored**

It is ironic that at the same time that the Appropriations Committee is expanding its innovative work in Results-Based Accountability in budgeting, the various budgetary techniques being used to circumvent our overly restrictive statutory spending cap are undermining its work. Each, in its own way, *reduces* the amount of state “spending” that is subject to annual review by the Committee.

For example, as noted earlier, total “spending” through the tax code – through preferential tax credits, exemptions, deductions, and rate reductions – was estimated by OFA to be close to \$4.4 billion in FY 05. That is, if all preferential tax breaks were repealed and cash grants instead made to all beneficiaries of these tax breaks, Connecticut’s budget in FY 05 would have been close to \$15

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<sup>54</sup> Legislative Program Review and Investigations Committee. *Connecticut Budget Process* (December 2003), p. 66.

billion and 24% of it would have been spent on these “tax expenditure” grants. However, state “spending” through the tax code is *not* reviewed annually, much less with the rigor of RBA budgeting.

Similarly, the use of bond funding for on-going purposes is outside the purview of the Appropriations Committee. Indeed, since the Governor sets the bond agenda, the General Assembly as a whole has a more limited role with regard to the ultimate use of bond funds than it does for other appropriated funds.

Revenue intercepts and special, non-appropriated funds are not well-labeled and described in state budget documents. Yet they, too, are an increasingly significant share of the state’s less visible spending. In the FY 07 state budget, more than \$1.9 *billion* is reported to be in special, non-appropriated funds; about \$900 million more than in FY 97. That is, for every \$100 appropriated in FY 07, there now are about \$12 in special funds that are non-appropriated. In at least one state agency (the Department of Environmental Protection) the funding in special, non-appropriated funds now *exceeds* total General Fund appropriations.

So an ironic consequence of the state’s cap on the growth in “appropriated” spending is that less and less of the state’s “spending” is being appropriated. This reduces both the transparency and accountability of the state budget process.

There *is* an option to the harmful course on which Connecticut now finds itself.

Our Constitutional spending cap anticipated the likelihood that the terms of the spending cap would need to be re-defined. It states, “The general assembly shall by law define ‘increase in personal income,’ ‘increase in inflation,’ and ‘general budget expenditures’ for the purposes of this section *and many amend such definitions, from time to time*, provided general budget expenditures shall not include expenditures for the payment of bonds, notes or other evidences of indebtedness. The enactment *or amendment* of such definitions shall require the vote of three-first of the members of each house of the general assembly.”<sup>55</sup> (emphasis added).

A number of changes in the definitions of the state spending cap would help assure that state spending is able to grow *with* Connecticut’s economy, reducing the temptation to evade its constraints.<sup>56</sup> They include:

**A. Re-define “growth in personal income” to use a more current and comprehensive measure of personal income growth.** For example, using the projected growth in personal income for the coming budget year, rather than the current five-year, lagged average would result in a closer match between allowable growth under the cap and growth in the state’s economy. This change alone would increase allowable spending under the cap by \$381 million in FY 08. One challenge in using an estimate rather than actual personal income to calculate allowable growth is that the projection could change after the budget is adopted. However, if growth is slower than expected, it is likely that state revenues also will decline, requiring an adjustment in the budget. If

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<sup>55</sup> Connecticut Constitution, Article XXVIII.

<sup>56</sup> The definitional alternatives and the revenue estimates included in this description of suggested changes are taken from a presentation by Elizabeth McNichol, Senior Fellow at the Center on Budget and Policy Priorities to the Appropriations Committee at its informational forum on the state spending cap, held March 26, 2007.

growth exceeds what was projected, the state can end the year with a surplus or adopt the higher growth figure as the allowable growth amount and create more flexibility in the disposition of the additional revenues.

**B. Re-define “general budget expenditures” as the amount of spending allowed under the cap or, minimally, the year’s *actual* spending (including surplus and transferred lapse funds used for on-going budget expenses).** At various times since the cap’s adoption, the Governor and General Assembly have agreed to exceed the cap to fund needed services. However, the additional funds, when used for on-going purposes, have not routinely been added to the budget base. When this occurs, the state is face with either reducing funding for these programs in subsequent years or cutting back on other programs to keep the budget within the cap.

An alternative, which is wholly consistent with the cap’s limit on growth in general budget “expenditures,” is to include *all* expenditures over the cap in the budget base when used for on-going purposes. Had Connecticut, for example, included a portion of the FY 05 surplus spending in the FY 06 budget base going forward, there would be an additional \$323 million of growth allowed under the cap in FY 08.

Defining the base to be growth *allowed* under the cap would provide even greater flexibility as it would address the ratcheting down problem that occurs in fiscal downturns.<sup>57</sup> Using “allowable” spending as the budget base would allow spending to be restored to pre-recessionary times when the economy recovers and revenues are restored. If, starting in FY 02, Connecticut’s spending cap “base” had been set to equal the prior year’s allowable spending, rather than its appropriated spending, there would be an additional \$389 million of growth allowed under the cap in FY 08.

**C. Exclude the first year of new federal funds from the cap, but then add to the budget base.** Since the spending cap was not intended to thwart the receipt of new federal funds, exempting all new federally-funded spending from the cap for one year (but then adding it to the budget base going forward) would enable Connecticut to claim additional federal funds and reduce reliance on state revenues. The impact of this change would depend entirely on the federal funds that are available to Connecticut that the state is not claiming currently.

These technical changes would keep Connecticut’s growth in state spending in step with growth in its economy and the needs of its residents – the cap’s goal. In addition, by creating a *sensible* gap that far more accurately reflects the reality of our economy, the temptation to circumvent the cap will diminish. This will result in a more transparent and accountable budget process, and budget choices that have fewer long-term adverse consequences

## V. Conclusion

The multiple, costly initiatives being discussed in the 2007 General Assembly – in education, health care, housing, transportation, economic development – suggest that Connecticut’s level of public investment is seriously lagging the state’s needs. As shown in this report, although Connecticut enjoys the #1 position among states in its “fiscal capacity,” its spending cap – as currently defined – assures that the state’s public investment *will not* keep pace with growth in its economy and that the

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<sup>57</sup> An adequate Budget Reserve Fund also can help reduce the ratcheting down effect, but reducing the depth of spending cuts needed in times of recession.

state's level of public investment is, already, is relatively low. Long-term, this is a dangerous situation.

The economic literature is replete with evidence documenting the importance 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.<sup>58</sup>

The detrimental effects of *inadequate* public investment also are known:

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.<sup>59</sup>

The way Connecticut's statutory spending cap defines its terms assures that public investment will ratchet down with each successive recession. The resultant decline in public investment will weaken our economy, as well as our high quality of life. Our policymakers seem to understand this danger. When Connecticut has surpluses, the cap is exceeded. Even when there are no surpluses, the cap is evaded. The "spending" that increasingly is being done outside the appropriations process – through the tax code, bonding, and other budget gimmicks – is reducing both the transparency and the accountability of our budget process.

A modest re-definition of spending cap terms, as suggested in this report, would help assure that our public investment can keep pace with our economy's and our families' needs. By assuring a closer fit between growth in state spending and growth in our economy, efforts to evade the cap to meet state needs will become unnecessary and the transparency and accountability of our state budget process will be restored.

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<sup>58</sup> D. Baker. *The Public Investment Deficit: Two Decades of Neglect Threatens 21<sup>st</sup> Century Economy* (Economic Policy Institute, 1998).

<sup>59</sup> R. Borosage. America's Growing Deficits: Public Investment and Public Leadership, *The Investment Deficit* (Campaign for Americans Future, 1999)