Testimony Supporting S.B. 21:
An Act Defining the Expenditure Cap
Wade Gibson, J.D.
Appropriations Committee
Thursday, March 8, 2012

Senator Harp, Representative Walker, and Members of the Appropriations Committee:

I am testifying today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to promote the well-being of Connecticut's children, youth, and families.

Senate Bill 21 is part of a much-needed effort to address Connecticut's precarious fiscal footing and avoid passing the debts of past and present generations onto our children and grandchildren. Ironically, such fiscal responsibility requires changing the rules of the state's spending cap, which were originally intended to encourage responsible budgeting.

The current rules of the spending cap encourage *irresponsible* budgeting. They render Connecticut's cap one of the Nation's most restrictive, placing great pressure on our ability to make public investments, yet they also exempt certain categories of spending that have come to act as escape valves: borrowing, non-appropriated funds, and tax expenditures. This spending escapes the rigorous oversight used for regularly appropriated funds, and in the case of borrowing, may harm the state's long-term fiscal health as well.

Rather than tamping down expenditures, the rules of the spending cap often encourage moving spending off budget, where it is less transparent, less accountable, and less sustainable. Even before the recession, these rules helped produce a marked shift towards non-appropriated funds:

- Debt service nearly doubled from FY 1988 to 2008, increasing from 5.3% to 10.4% of state spending
- Special, non-appropriated funds, often funded by revenue intercepts, nearly doubled from FY 1997 to 2007, to $1.9 billion
- Tax expenditures grew even more rapidly: in particular, corporate business tax credits increased 27-fold from FY 1987 to 2008, to $138 million

At the same time that the rules encouraged shifting billions into non-appropriated spending, they discouraged responsible actions such as committing funds to bring down the state's long-term pension and health liabilities, which would fall under the cap. While S.B. 21 fixes this latter flaw, it would leave the former, structural issues unaddressed.

The tendency to encourage less transparent, less accountable, less sustainable spending was evident even before the Great Recession—in March 2008 Connecticut Voices outlined the problem and explained how any recession would aggravate it further (see attached). What was true then is true now. As we take steps to tweak the rules of the spending cap today, let us not forget that other, broader issues remain.

CONNECTICUT VOICES FOR CHILDREN

The State Spending Cap Needs Some Repair

March 2008

Adopted in the early 1990s, Connecticut's state spending cap is among the most restrictive in the nation. Allowable growth in budget expenditures from one year to the next is dictated by a rigid formula: the greater of a lagged five-year average in personal income growth or the 12-month rate of inflation. The spending cap applies to all state appropriations except:

- Payments on the state debt;
- State grants to distressed municipalities that were in effect on July 1, 1991;
- First year expenditures on federal mandates or court orders.

The cap can be exceeded if the governor declares an emergency or the existence of extraordinary circumstances and 60% of the members of both the House and Senate vote to exceed the limit.

The spending cap's ill-considered definitions ensure that public investment will not grow with the economy as the cap intended, but will instead ratchet down with each recession. The spending cap was adopted to assure that growth in state spending does not exceed growth in the state economy. But the cap's definitions ensure that public investment will consistently *fall behind* growth in the economy, jeopardizing our future economic competitiveness.

Indeed, Connecticut's public spending as a share of its economy has *declined* –from about 9.8 percent of our Gross State Product in 1994 to 8.75 percent in 2003 (4th lowest among all states). If spending were now the same share of GSP as in 1994, state and local spending would be about $1.76 *billion* more.

The cap's problematic definitions include:

- The cap uses an untimely measure of personal income growth and its measure of personal income excludes capital gains income (though this is a significant source of income in Connecticut);
- The growth that is allowable under the cap is based on what *was appropriated* in a prior year, rather than what the spending cap *would have allowed* for spending, or even what was *actually* spent (including appropriated state surplus funds).

The effect of these restrictive definitions is evident. In recession, state spending is less than the cap allows; there are insufficient revenues to spend up to the cap. This reduces the budget base for spending cap calculations in subsequent years. Then, when the economy improves and revenues increase, the cap's allowable growth rate actually declines for a time; the slow growth in personal income in the recession years is included in the five-year average, perpetuating the recession's impact long after it has ended.

In FY 08, for example, the lagged five-year average included the recession years of 2002 and 2003, resulting in the lowest growth rate since the cap's adoption - 3.31 percent. In FY 09, by comparison, 2002 will no longer be in the five-year average and so the allowable growth rate increases to 4.10 percent – but just as the economy again is slowing. In short, the lagged five-year average virtually assures that allowable state budget growth will be less than current state personal income growth *whenever* the state is recovering from a recession; this ratchets down public investment with each new recession.

The state spending cap's ill-considered definitions ensure that public investment will not keep pace with our economy, jeopardizing our competitiveness in the long term.

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Further, 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, reduced revenues and spending in recession years also end up curbing growth in state spending once the economy recovers (though state revenues are on the rise and funding can be restored to programs that were cut). Why? The spending cap growth rate gets applied to a budget base diminished by the cuts made in the recession.

The cap makes it hard for state investment to ever "catch up" with meeting the state's needs after a recession. Indeed, even at *this* point, some state agency budgets remain below their actual spending just prior to the deep budget cuts made in the last recession. The FY 08 General Fund budgets of the Office of Policy and Management and the State Library are *less than* their actual FY 02 spending, *not even adjusted for inflation.* Further, notwithstanding last year's infusion of additional state funds for education, the State Department of Education's FY 08 budget is *less* than its FY 01 spending, adjusted for inflation ($2,552.9 million in FY 08, compared to $2,575.0 million in FY 01 in inflation-adjusted dollars).

The cap limits Connecticut from making desperately needed state investments. Increased public investment in certain strategic areas (e.g., reducing the state's educational attainment gap, creating affordable housing, providing health coverage to the uninsured, and improving our infrastructure) is necessary for Connecticut to continue to prosper in the national economy. The state spending cap limits investment in these essential programs even when revenues are ample.

The cap discourages Connecticut from claiming all federal funds to which it is entitled. Most of the federal funds that Connecticut receives count against the cap, since the state appropriates both the federal and state funds for various programs (e.g., Medicaid) and then counts federal reimbursements as "revenues" (like taxes). As a result, there is a disincentive to seek new federal funding; new federal funds could push the budget over the spending cap.

The cap encourages borrowing and budget gimmicks. With debt service payments excluded from spending cap limits, there is a temptation to use the state's "credit card" for ongoing expenses (e.g. salaries) and not only for long-term capital projects (e.g. school construction). The result? Debt service has nearly doubled in the past two decades — from 5.3% of state spending in FY 88 to 10.4% in FY 08.

The spending cap also encourages "outside-the-cap" spending through the use of "revenue intercepts" that direct specific revenues to special non-lapsing funds that provide funding for specific programs without any need for annual appropriations.

In addition, the cap's constraints encourage a shift in the state's economic development incentives from grants and loans to tax credits, exemptions, and deductions; tax revenues lost through tax expenditures do not count as "state spending." However, tax expenditures also reduce budget transparency and accountability. They are not reviewed annually (like appropriations). All the beneficiaries are not publicly disclosed. The economic returns to the state are not documented. Further, tax expenditures permanently deplete the state's revenues and, since many of the tax credits are uncapped, can reduce state revenues far more than first projected.

The spending cap should be repaired. The state's statutory state spending cap is one of the most restrictive in the nation and is written in such a way that it cannot achieve its original purpose – to keep public investment in step with the growth and the needs of our state's economy. The past decade's experience makes clear that some common sense repairs are in order. The General Assembly can amend the cap by a 3/5th vote in both chambers.

Connecticut could better assure that its level of public investment keeps pace with the needs of its families and its economy, and restore transparency and accountability to its budgeting practices by:

- Replacing the lagged, five-year average of personal income growth with a more current and a more comprehensive measure of personal income growth (that counts capital gains income);
- Defining the budget "base" to be the spending the cap *would* allow in a given year or, alternatively, the *true* total of all spending in that year, including surplus and carry-forward funds;
- Excluding *any* new federal funds from the cap in their first year (but adding them to the budget base) to eliminate the current disincentive to seeking new federal funds.