CONNECTICUT VOICES FOR CHILDREN

Independent research and advocacy to improve the lives of Connecticut's children

Testimony Regarding the Budget Reserve Fund in S.B. 294, H.B. 5958, and H.B. 5968
Testimony Opposing S.B. 128: An Act Concerning the Constitutional Spending Cap

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Appropriations Committee
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Senator Bye, Representative Walker, and distinguished members of the Committee:

Thank you for the opportunity to testify. We speak today on behalf of Connecticut Voices for Children, a research-based public education and advocacy organization that works statewide to advance opportunity for Connecticut's children and families.

Connecticut Voices for Children supports commonsense steps to restore a robust, reliable Budget Reserve Fund that will aid our state in absorbing the impact of economic downturns while maintaining crucial public investments:

1. **Increase the cap on the Budget Reserve Fund to 15 percent of the General Fund appropriations, as in S.B. 294; and**
2. **Regularize deposits into the Budget Reserve Fund to protect the state against revenue volatility while affording policymakers sufficient flexibility to address unforeseen fiscal challenges.**

1. INCREASE THE CAP ON THE BUDGET RESERVE FUND TO 15 PERCENT OF THE GENERAL FUND

The Budget Reserve Fund (commonly called the Rainy Day Fund) is one of the best tools available to policymakers to address budget volatility. By depositing money into the Fund during good fiscal years, the state can protect itself against budget shortfalls during recessions. Simply put, the Fund is a fiscal safety net for the state, ensuring that unavoidable downturns in the state's economy do not translate into unplanned, harmful budget cuts. =Experts at the Institute on Taxation and Economic Policy[1], the Center on Budget and Policy Priorities[2], and the PEW Charitable Trust Foundation[3] all endorse a robust Budget Reserve Fund as one of the best ways for states to manage revenue volatility.

The current cap of 10% is too low to protect against harmful cuts. Even if we had fully funded the Budget Reserve Fund up to its current cap of 10% of General Fund appropriations, we would not have had sufficient revenue to address the revenue shortfalls of past two recessions. According to the Office of the State Comptroller, state revenue fell by approximately 14 percent of net General Fund appropriations after the 2001 recession, and by approximately 15 percent after the 2009 recession. These experiences suggest that the current 10 percent cap is

[1] Institute on Taxation and Economic Policy. "In It for the Long Haul: Why Concerns Over Personal Income Tax 'Volatility' Are Overblown." March 2011. http://www.itep.org/pdf/volatility_0311.pdf

[2] *Ibid.* McNichol, Elizabeth. Center on Budget and Policy Priorities. "Strategies to Address the State Tax Volatility Problem." April 2013. http://www.cbpp.org/files/4-18-13sfp.pdf

[3] PEW Charitable Trusts. "Managing Uncertainty: How State Budgeting Can Smooth Revenue Volatility". Feb. 2014. http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2014/VolatilityManagingUncertaintypdf.pdf

insufficient to protect the state against unplanned and often harmful cuts caused by revenue shortfalls.

Increasing the Budget Reserve Fund cap from 10 to 15 percent of net General Fund appropriations as described in S.B. 294 would significantly improve the state's capacity to absorb the fiscal blows of future economic downturns, and would be a step toward more sustainable budgeting. Supported by both the Office of the State Comptroller and GASB (Governmental Accounting Standards Board) recommendations, such a change would better equip the state to manage inevitable revenue declines while minimizing reductions in critical public investments that support Connecticut's children and families.

2. Regularize Deposits into the Budget Reserve Fund while Allowing Policymakers Flexibility

Enacting an automatic mechanism by which the state deposits surplus revenue into the Budget Reserve Fund would ensure Connecticut saves sufficiently for economic downturns.
Although the cap on the Budget Reserve Fund is currently set at 10 percent, it has never been funded at that amount. While Connecticut saw considerable growth in the mid-1990s and 2000s, insufficient excess revenue was dedicated to the Fund during that time. According to the Comptroller's Office, Connecticut has had revenue windfalls[4] of over $5 billion since 1990 but deposited less than half that amount ($2.5 billion) into the Budget Reserve Fund. Requiring more regular deposits of excess revenue into the Rainy Day Fund would better prepare Connecticut for revenue shortfalls in the future.

Due to the uncertainty in revenue estimates, it is crucial that any deposit mechanism allow state policymakers the flexibility to address unforeseen fiscal challenges. As currently written, H.B. 5958 would regularize depositing certain excess revenues into the Budget Reserve Fund. While automatic deposits into the Fund are good policy in theory, the required revenue deposits in H.B. 5958 are overly restrictive, limiting policymakers' ability to address unforeseen fiscal challenges that may result from a revenue forecasting uncertainty.

A deposit mechanism that balances the need for regularized contributions to the Budget Reserve Fund deposits while still affording some amount of fiscal flexibility would address both concerns. Setting aside excess revenue for deposit with the January consensus revenue report and adjusting following the April report would provide legislators with an opportunity to choose deficit mitigation over a reserve fund deposit, striking a healthy balance between steady contributions and real time flexibility. With such a mechanism, excess revenues would automatically be deposited into the Budget Reserve Fund unless the state encounters fiscal difficulties, in which case the deposits could be used to support the agreed upon budget.

[4] Defined as "realized revenue minus budgeted revenue."

Connecticut Voices for Children opposes the spending cap proposal set forth in S.B. 128 as it would further restrict legislative appropriations authority.

As it currently stands, Connecticut has one of the most restrictive caps in the nation.[5] Connecticut's spending cap limits year over year growth in General Fund spending due to three primary provisions:

- It limits year over year spending to past year budgeted General Year spending multiplied by the greater of the 5-year average of state personal income growth or prior year inflation rate. In years following a recession, the lagged five-year average of personal income growth can result in undue limits on state spending: limits that make it difficult for the state to speed up economic recovery through strategic investments.
- It limits nearly all General Fund spending, including most federal funds that are appropriated by the state.
- It allows the state to exceed the cap only if two branches of government – the Governor *and* a three-fifths majority in both houses of the General Assembly – agree to take action.

If the State were to abide by the Spending Cap as currently applied, it would result in a drop in public investments as a share of our state's economy with each recession, threatening the well-being of children and families across the state. In fact, Connecticut Voices for Children found that, under the current spending cap, the state can never wholly undo cuts to public investments, no matter how strong state revenues grow following a recession. Likely for this reason, the Legislature and Governor declared an extraordinary circumstance and exceeded the spending cap in 1998, 1999, 2000, 2001, 2005, and 2006. The legislature has used loopholes to avoid the cap in other years, such as "stuffing" newer grants to distressed municipalities into older grants that existed prior to 1991 (and hence are exempt from the cap), relying more heavily on tax expenditures and revenue intercepts (which are not appropriated, and hence are not capped), and removing various federal funds from the appropriations process. Yet the broadly applied cap continues to be problematic to this day, making it difficult for legislators to reconcile funding programs at current services levels while also abiding by the past application of the spending cap.

The spending cap changes proposed in S.B. 128 would make the cap more restrictive by disallowing the use of funds spent in excess of the cap one fiscal year to be used in calculating the base of the cap in the next. Under current law, if the General Assembly and Governor agree to exceed the spending cap in a given year, it is at their discretion to determine whether funds spent in excess of the cap are counted as part of the "budget base" for the purposes of calculating the cap for the following year. The proposed bill would eliminate this discretion, and instead make it impossible to apply the funding in excess of the cap to the following year's calculations – in essence, forcing the state to ignore agreed upon increases in spending for subsequent year budgeting. Such a change would undercut the democratic process, add an additional obstacle to an already restrictive spending cap, and hurt policymakers' ability to make critical public investments in the future of our state.

Instead, fundamental spending cap reforms should be undertaken to ensure the cap functions as intended while allowing room for crucial programs and services that support Connecticut's children and families. Among the many structural reforms that should be undertaken are:

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[5] Geballe, Shelley. Connecticut Voices for Children. "Coping With the Cap: A Primer on Connecticut's Spending Cap and Its Impact." April 2007. http://www.ctvoices.org/sites/default/files/bud07spendingcap.pdf

1. Use the previous year's *allowable spending* – instead of *actual spending* – to calculate present year allowable spending, enabling the state to reinvest in the public good in the wake of recessions.
2. Limit the "lookback" period used to determine the average increase in personal income (which generally determines the allowable growth rate of the cap) from five years to one year, preventing limitations on spending in years following a recession.
3. Expand the definition of personal income, when calculating allowable growth in the cap, to include capital gains income. Capital gains are an essential part of Connecticut's State revenue, and their current exclusion may underestimate Connecticut's true year-to-year economic growth, thus underestimating allowable growth under the cap.
4. Clarify that accrued pension liability debt, like bond debt, is excluded from cap calculations, consistent with the debt definition used by the Governmental Accountant Standards Board (GASB).

Thank you for your time. We would be happy to answer any questions.

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