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The "Bond Lock" and Related Provisions from the FY 18-19 Budget

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EXECUTIVE SUMMARY

Connecticut's current fiscal challenges trace their origins to policy decisions made years ago. Failure to adequately fund state pensions has resulted in the accumulation of tens of billions of dollars in unfunded liabilities for the State Employees Retirement System (SERS), the Teachers' Retirement System (TRS), and state employees' other post-employment benefits (OPEB). Meanwhile, windfall capital gains and income tax revenues in the late 1990s and mid-2000s did not find their way into the Budget Reserve Fund (BRF), exacerbating the impacts of the 2002 downturn and the 2008 Great Recession and forcing public spending cuts at a time when the state needed economic stimulus. In negotiating last session's bipartisan budget, lawmakers were forced to deal head-on with the consequences of those short-sighted decisions. Ultimately, the FY 18-19 budget did more than just tackle the immediate question of funding the government for the next two years – it also included long-term reforms to how the state makes financial decisions. Those four provisions are summarized below.

The FY18-19 budget includes three limitations on future legislatures, "locked" into place through covenants in future bonds

1 **Spending Cap** (§ 709)
- Provides definitions required to interpret the 1991 constitutional spending cap, replacing a statutory cap already in effect
- Limits general budget expenditures to prior year levels, adjusted by the greater of the past five years' statewide personal income growth or the rate of inflation

2 **Volatility Cap** (§ 704)
- Diverts all "estimated and final" income tax payments above $3.15 B to the Budget Reserve Fund (or, once the Budget Reserve Fund hits certain levels, to pay off pension obligations or bonded debt)
- "Estimated and final" income tax payments come from taxpayers who make estimated income tax payments on a quarterly basis, rather than through annual withholding (generally those with substantial investment incomes)

3 **Bond Cap** (§ 710-12)
- Limits annual general obligation and credit revenue bonding to $1.9 B
- Adds to existing law, which already restricted general obligation bonds to 1.6 times the size of the General Fund

4 **The "Bond Lock"** (§ 706)
- Places covenants in all bonds issued between May 15, 2018 and June 30, 2020 that compel the state to comply with the spending, volatility, and bond caps until 2028
- Prevents the legislature from changing those three provisions until 2028

On the surface, these laws reflect reasonable policy goals:

- **The spending cap** is intended to ensure that public sector spending does not exceed the state's ability to pay. This cap was created through a 1991 constitutional amendment, but that amendment left it to the legislature to define, by three-fifths' vote, the terms "increase in personal income," "increase in inflation" and "general budget expenditures." The legislature only managed to define such terms by a simple majority, leaving the state with a statutory cap but not yet a constitutional one – although the statutory cap nonetheless significantly slowed state spending growth over the subsequent two decades. The bipartisan FY 18-19 budget redefines those terms and, because it was passed with a three-fifths' vote, gives those new definitions constitutional effect. Only by another three-fifths' vote can such definitions be modified.

- **The volatility cap** is intended to ensure that the state deposits windfalls from volatile sources into its Budget Reserve Fund, for use when revenues fall below expectations.

- **The bond cap** is intended to ensure that the state does not become saddled with debt that it cannot repay.

- **The bond lock** is intended to make it more difficult for future legislatures to bypass the above three provisions, forcing them to enact policies that are good for the state's long-term fiscal health.

Unfortunately, as written, these provisions will not achieve those objectives. Rather, they will likely worsen the state's long-term finances and increase economic uncertainty. Meanwhile, starting on May 15 of this year, § 706 will enshrine these three provisions in the state's bond covenants, effectively making it impossible to change the law until 2028.

Some likely unintended outcomes are as follows:

- The bond lock's removal of the ability to modify spending cap definitions (as the constitutional spending cap allows) means that the state will be unable to respond to changing conditions, such as the cancellation of a key federal program or a natural disaster that necessitates relief spending.

- The current ambiguous language of the spending cap, which phases SERS contributions into the definition of "general budget expenditures" in 2023 and TRS contributions in 2027, does not explicitly increase the spending cap's base of expenditures to reflect that phase-in. The "bond lock" will prevent the legislature from clarifying such language and may as a result arbitrarily force a reduction in non-fixed costs by 25% or more.

- The "volatility cap" will require the state to deposit all revenues above $3.15 B from the estimated and finals portion of the state income tax into the budget reserve fund. This $3.15

B trigger does not adjust to policy changes, economic growth, or the addition of other sources of budget reserve fund contributions. The "bond lock" will prohibit changes to this rule.

- The "bond cap" will limit the state's general obligation and credit revenue bond issuances to $1.9 B per year, regardless of prevailing interest rates, the state's bond ratings, municipalities' and the state's needs for capital expenditures, economic development plans, and other factors that go into bonding decisions. The "bond lock" will prohibit changes to this rule.

The spending, volatility, and bond caps all represent poorly-drafted policy, the result of a rushed negotiation process in the midst of a grinding budget debate. In the case of the volatility cap, this new law actually replaces a 2015 reform, proposed by the Comptroller's Office and passed by the legislature, which was scheduled to go into effect in 2019 and would have required automatic budget reserve fund deposits starting in FY 2022.

This fiscal year is the first time in the state's history that the legislature is bound simultaneously by all three restraints, and it is not yet clear how this combination of laws will constrain the legislature's capacity to make wise budget choices. Several technical changes are already necessary in order to promote the presumed policy goals of the law's authors and to avoid unintended negative effects. Once the law goes into effect, more defects will prove apparent.

The bond lock will effectively lock in these new laws as-is until 2028, preventing future policymakers from enacting any reforms other than one-time exceptions, which expire each year. Forced into bad fiscal policies by these bond covenants, the only alternative would be to refinance all general obligation and credit revenue bonds issued between 2018 and 2020, likely a costly and impractical proposition. Our primary policy recommendation is to repeal or at least delay the implementation of this bond lock. This recommendation is essential to allow lawmakers the time to agree upon thoughtful "fixes" to these laws.

Below is the full set of actions that lawmakers should take:

Provision	Policy Proposal	
"Bond Lock" (§ 706)	• Repeal the bond lock outright - Alternatively, delay its implementation until July 2019 to allow for careful study of its legality and policy impacts	***HIGHEST PRIORITY***
Spending Cap (§ 709)	• Exclude grants to municipalities • Exclude SERS, TRS, and OPEB expenditures from the definition of "general budget expenditures" - Alternatively, ensure that the cap's base (general budget expenditures) is adjusted upwards each year to incorporate annual required contributions (ARC), as per the most recent actuarial valuations; include OPEB payments in this adjustment - At a minimum, clarify that the caps will be re-based in 2023 and 2027 to reflect prior-year pension contributions • Set cap's base each year at the budget expenditures allowed under the cap, rather than the actual expenditures • Set allowable growth based on the larger of the ten-year rolling averages of income growth or inflation, rather than the five-year averages	
Volatility Cap (§ 704)	• Base deposit threshold on ten-year rolling average of estimates and finals (E&F) revenues, with allowable year-on-year growth set at the ten-year rolling average growth rate of E&F revenues. This recommendation is per the 2015 Comptroller's BRF reforms, which were repealed before going into effect • Apply the same rule to the corporate income tax (as per the 2015 reforms)	
Bond Cap (§ 710-12)	• Repeal immediately, pending reports from a new debt affordability commission • Establish said commission	

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