CONNECTICUT VOICES FOR CHILDREN

Connecticut's Radical New Budget Rules: Locking in Decreased Investment in our State for the Next Decade

Policy Report
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I. Introduction

Faced with increasingly difficult decisions in crafting the FY 18-19 biennial budget, Connecticut's General Assembly found itself at an impasse. In order to break the log jam, the legislature included drastic measures in the final budget deal. It is increasingly clear that the long-term effects of these measures will be deleterious to the well-being of Connecticut's children and families and to our state's economic prosperity.
Five fiscal restrictions, some new and some revised, were included in the budget:

- A spending cap;
- A volatility cap;
- An appropriations cap;
- A bond cap; and
- The "Bond Lock," which requires a covenant in Connecticut bonds issued during a two-year period promising not to change these fiscal restrictions for at least five years from the date of the bond issuance.

We will discuss each of these restrictions in more depth below.

While these fiscal rules were intended to stabilize our state budget and address the uncertainty caused by annual deficits, legislative stalemates, and lack of long-term budget planning, the result will be damaging to our state's economic growth and competitiveness. Our economic well-being will be undermined by the required deep reductions to our capital investments, and long-term cuts to higher education, social services, transportation, and workforce development.

Connecticut Voices for Children advocates for policies that prioritize economic growth and equitable opportunity for all children and families. Public policies that prioritize children and families require a fair and adequate tax system and investments in public programs and services essential to providing the opportunity for every child in our state to thrive. Connecticut´s prosperity depends upon smart public investments in high-quality public schools in all cities and towns, economic development that creates good jobs, reliable roads and bridges, and twenty-first century infrastructure.

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The Bond Lock, and the fiscal rules it freezes in place, is in practice an austerity lock, ensuring that Connecticut remains in a permanent state of fiscal deprivation, starving our schools, health systems and infrastructure of crucial investments. Our state budget determines how well we care for infants and toddlers, educate our children from birth through college and career, care for the sick or disabled, and more. Our commitments to these shared values are measured by the allocation and level of spending devoted to supporting the programs and systems that provide these essential supports.
To ensure that all Connecticut families and their children have an equitable opportunity to reach their potential and participate fully in a growing and thriving economy, the following actions are necessary:

(1) Repeal the Bond Lock;
(2) Utilize one of the legal strategies described below to free the state from the Bond Lock in bonds that have already been sold; and
(3) Amend the volatility cap to reflect the best practices volatility policy enacted in 2015.

Taken together, and absent the steps outlined above, these caps will result in the following:

- A forced ratcheting down of spending after an economic downturn or recession, exactly when we should be investing to grow our economy.
- A volatility cap that captures normal revenue, rather than one-time revenue, and requires us to deposit revenue into our Budget Reserve Fund *even in years with projected deficits*, causing deep and unnecessary cuts to essential programs like education and municipal aid.
- Long-term, annual reductions to "discretionary spending" (e.g., grants to municipalities for education, higher education, and human services) due to the spending cap's impact when fixed costs (i.e., contractually obligated spending) as a share of allowable spending within the budget is growing.
- These fiscal restrictions at the state level will push costs for education and essential services to cities and towns. These increased costs will require municipalities to boost the regressive property tax that costs low- and middle-income families a larger share of their incomes than the top earners.

II. Background

Connecticut's tight budget

Connecticut's economy is smaller than it was before the 2008 recession, with state real economic output shrinking since 2008.[1] It is also more unequal. From 2009 to 2015, income inequality grew: the income of the top 1 percent in Connecticut went up by an average of 22.9 percent, while incomes for everybody else dropped by an average of 1.8 percent.[2] Connecticut is the third most unequal state in the country.[3]

Connecticut's government is significantly smaller than just 10 years ago. Between 2008 and 2017, the state lost over 23,000 public sector jobs, a 9 percent decrease. Within government jobs, Connecticut lost 13 percent of state government jobs, 8 percent of local government jobs, and 7 percent of federal jobs. Since 2011, state spending grew at an annual rate of under 2 percent.[4]

When considering taxes as a percent of income, Connecticut is not a high tax state. Connecticut ranks seventh from the bottom in state and local taxes as share of state income and ranks second to last in total "own source revenue" (state and local revenues from Connecticut residents) as share of state income.[5] The erroneous perception that Connecticut is a high tax state makes it difficult for government to sufficiently increase revenue and, even if revenue were increased, the spending cap means that the increased revenue cannot be spent.

As a result, our budget is tight, and children and families in the state have already experienced painful cuts to essential programs, from birth through higher education. We continue to underfund Care 4 Kids, our flexible child care subsidy program. Parents earning low incomes may be unable to access affordable child care. We have seen repeated cuts to higher education, including, most recently, a $4.5 million cut to the University of Connecticut's operating budget.[6]

Low revenues make adequate funding difficult, and the budget is trim – there is little room for cuts without hurting people and cities in unacceptable ways. The recently enacted fiscal restrictions lock in this level of spending, despite how costs, revenues, or preferences may change in the future.

As we are beginning to see growth in Connecticut's economy and tax receipts, the novel and untested budget rules will prevent us from making the necessary investments to maintain and expand our state's high quality of life.

III. Connecticut's fiscal restrictions

The following is a description of the fiscal restrictions (caps) adopted in 2017 and 2018 and their impact on our state budget, absent reform.

The Spending Cap

The spending cap limits certain appropriated spending to the level of spending in the previous year plus a percent increase based on either average income growth in the last five years or the consumer price index (CPI) over the last year, whichever is greater. Connecticut adopted a spending cap in 1991 as part of a compromise when the income tax was enacted. Due to over three-fifths of the legislature voting in favor of the FY 2017-2018 budget implementer, in which new definitional language was included, the spending cap is now constitutional, meaning it requires a three-fifths vote by the legislature to overturn.[7]

What is capped

The spending cap limits all "General Budget Expenditures." These include all appropriated funds, except:

- Bond payments
- Transfers to the Budget Reserve Fund
- Federal funds
- Expenditures due to federal mandates or court orders and to federal programs where state receives matching funds in the first fiscal year of the program.
- Payments to fund the State Employee Retirement System (SERS) (through 2022), and
- Payments to fund the Teacher's Retirement System (TRS) (through 2026)

Grants to "distressed municipalities" now under spending cap

Previously, grants to distressed municipalities[8] were excluded from the cap, but now they are included under the cap. Grants that were excluded from the cap when they went to distressed municipalities included: Education Equalization Grants, School Based Health Clinics, Teen Pregnancy Prevention, Bilingual Education, and others. (See the Appendix for a full list.) As of 2018, these grants fall under the cap for all municipalities, which will make it harder to direct spending to where it is most needed and will put even more of a burden on distressed municipalities to fund their own services.

The spending cap calculation and the ratcheting down of spending after recessions

Because the base for calculating next year's spending cap is this year's *appropriated* (budgeted) spending, rather than this year's *allowed* spending, one low-revenue year that leads to lower appropriations will ratchet down spending in future years.

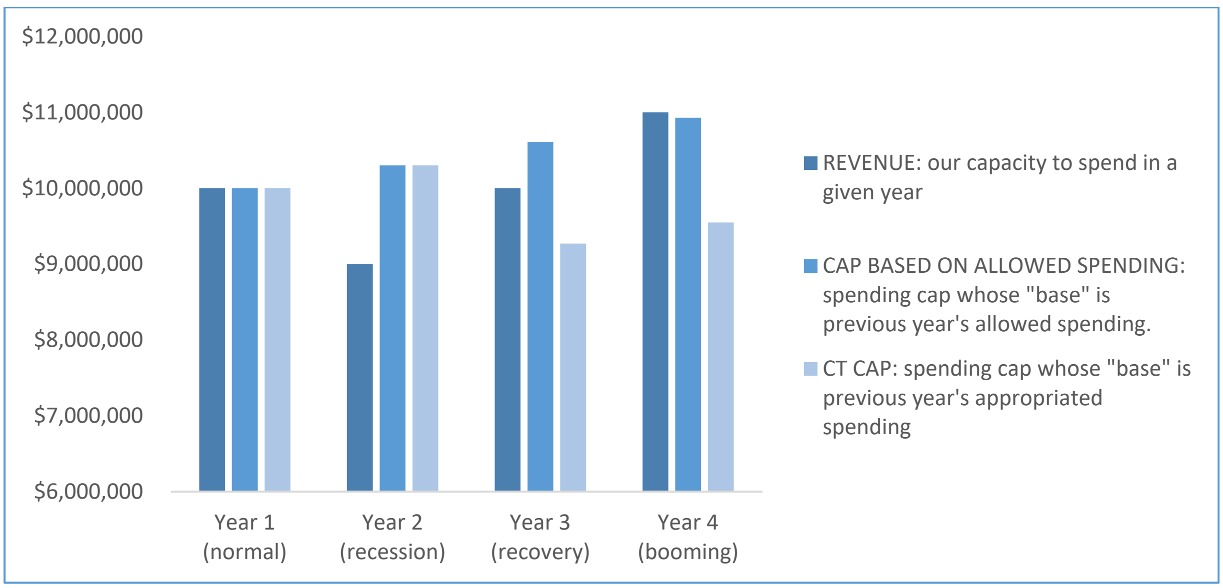
Hypothetical Example: How spending cap ratchets down spending after a recession

Consider the following hypothetical example of four years under the spending cap. In year one, the economy is normal. In year two – a recession year -- there is a 10 percent decline in revenue, comparable to the great recession. In year three, revenue recovers to where it was in year one. In year four, the economy is booming, and we see a revenue increase.[9]

See the below figure. The first bars in each year are our revenue received in a given year. The second bars represent a hypothetical spending cap based on *allowed* spending. This cap grows at a certain percent, year to year, along with income growth.

Now consider the third bars, which represent the current spending cap based on *appropriated* spending. This cap adjusts based on spending in the previous year and limits spending after a recession, even after state revenues have recovered (year three), permanently adjusting the base going forward. In other words, it treats the state budget like Connecticut is still in a recession, even when revenues have recovered, forcing unnecessary cuts and slowing economic growth.

Figure 1: Connecticut's spending cap (CT CAP) ratchets down spending after recession (hypothetical)



Note: Assumes spending cap is allowed to grow at a rate of 3% per year.

The ratcheting down that Connecticut's new spending cap causes is badly timed and long-lasting. The forced ratcheting down of spending occurs after a recession, the worst time to cut public investment. During recessions, people from all walks of life struggle, and more people become eligible for state programs. Spending to create jobs and fund state programs allows people to continue to spend and participate in the economy, which helps contribute to the economic recovery. Cuts in these programs mean less spending and less money injected into the economy, which hampers our economic growth. Even when the recession has ended and there is plenty of money to reinvest, the tight calculation regarding how much appropriations can grow means that public investment will be diminished for years into the future, unnecessarily hampering our economic growth and making the lives of people earning low incomes harder.

This constitutional spending cap interacts with the volatility cap and the appropriations cap to ratchet down spending even further.

State Spending Caps

More than half of the states have tax or spending limits, but there is little evidence that these limits are productive. The limits likely do not improve state economies, especially in high-income states like Connecticut.[10]

However, there is clear evidence that these limits have negative side effects.[11] They squeeze the budget when investment is needed most. They make government less transparent and therefore less accountable, as lawmakers find ways, outside of normal appropriations, of exceeding the caps, such as through non-appropriated accounts, borrowing, and shifting costs to local governments. The lack of transparency and oversight decreases efficiency, because regular and public cost-benefit analyses are not performed as they are during the budgeting process. Overall, tax and spending limits limit the ability of lawmakers to prioritize spending based on need and make government less efficient and less accountable to constituents.

The Volatility Cap

The volatility cap requires that all revenues from the Estimates and Finals portion of the personal income tax above a certain threshold be deposited in our Budget Reserve Fund (BRF) and excluded from budget making. Estimates and Finals taxes are one of several volatile sources of revenue because they are based, in part, on investments and capital gains, which vary widely from year to year. The volatility cap is indexed to average income growth over the past five years.

Best practices volatility caps are good policy, and Connecticut adopted a well-designed plan to capture and save volatile revenues in 2015 (PA 15-244) that was set to go into effect in 2021. Best practices volatility caps encourage responsible budgeting based on reliable revenues rather than one-time influxes, and they encourage saving revenues that can be used later to dig the state out of recessions. But, unlike best practices volatility policies, our current cap forces us to deposit revenues into the BRF even when we are facing deficits (which is akin to depositing money into your savings account when you cannot afford rent or to pay your medical bills).

Connecticut's current volatility cap, adopted without public notice, public hearing, or public knowledge, was inserted in the 2017 and 2018 budget implementer bills. It requires revenue transfers to the BRF *even when there are projected deficits*, as projected in 2020 and in 2021. In these years, the Office of Fiscal Analysis projects deposits of more than $550 million into the BRF, *despite projection of almost $4 billion of deficits*. These are years where we likely will not have enough revenue to pay for current services, and we are restraining ourselves further by forcing deposits into the BRF.[12] Eliminating budgetary access to these revenues will have real consequences for people's lives and force unnecessary cuts to programs upon which children, families, and communities rely.

Table 1: Volatility transfers even in deficit years projected

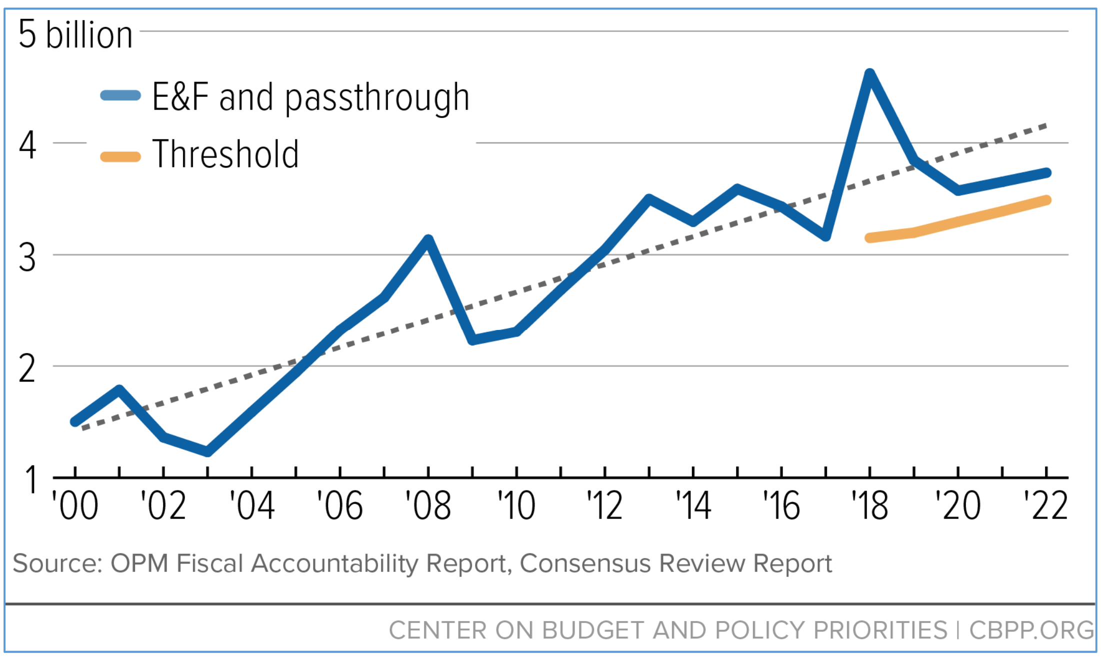
	2019	2020	2021
Projected Volatility Transfer to Budget Reserve Fund	- $648,000,000	- $280,200,000	- $269,100,000
Projected General Fund Surplus/Deficit	+$330,200,000	- $1,535,400,000	- $2,208,100,000

Sources: November Consensus Revenue Projections, Gov. Malloy's Transition Budget

The volatility policy that this cap replaced was developed in conjunction with academics and policy experts, and explained in detail in a report that can be found here: https://www.osc.ct.gov/brf/. Here are some reasons why our original volatility policy was better than the cap Connecticut has now:

- The original volatility policy did not require deposits to the BRF in years with projected deficits, avoiding a situation where the state of Connecticut diverts money that is needed to pay its bills and causes unnecessary and harmful cuts.
- The original volatility policy indexed the volatility threshold to economic growth over the past ten years rather than over the past 5 years. This is preferable, because ten years more fully encompasses a full economic cycle, with a recession and a recovery, whereas five years may make the threshold too low after a recession or two high after a boom period.
- The original volatility policy indexed the threshold to revenue growth rather than income growth. Although revenue and income are related, they are not perfectly related. A report from the Office of the Comptroller cites the example of Massachusetts, where income grew faster than revenue and the state ended up diverting too much revenue into the Rainy Day Fund.
- The current volatility threshold is too low, capping normal revenue growth rather than volatile revenue.

Figure 2: Current threshold diverts normal revenue not just above average revenue



Notes: The dotted line indicates the linear trend of estimates and finals and pass through income since 2000. Revenue above this line is above average. The current threshold captures revenue below this line.

After pausing or repealing the Bond Lock, we encourage the legislature to return to the original, research-based volatility policy so that we can save in a way that is responsible and not impossibly burdensome to children and families who rely on programs that would be cut under the current policy.

The Appropriations Cap

The appropriations cap requires that the legislature only appropriate a certain proportion of revenue to allow for unanticipated needs. In FY 2020, legislators can only appropriate 99.5 percent of revenue, and this amount declines gradually to 98% starting in FY 2026 (PA 17-2, Sec. 705).

Interaction of Spending, Volatility, and Appropriations Caps

Combining the current spending cap with the volatility cap and the appropriations cap ratchets down spending after a recession even more. The volatility cap and appropriations cap lower the amount of revenue available for appropriation. First, the volatility cap diverts revenue into the BRF. Then, the appropriations cap only allows us to appropriate a percent of the remaining revenue. It is uncertain whether the revenue cap will be used when rebasing the spending cap the following year. However, looking at the Governor's Proposed Budget for FY 20 and FY 21 it appears that our spending cap will be calculated in the following way:

$$\textit{Spending Limit in Year 2} = \textit{Year 1 Base} \times (1 + \textit{Allowed Growth Rate})$$

$$\textit{Year 1 Base} = \textit{Appropriations Cap Percent} \times [\textit{Revenue in Year 1} - \textit{Volatility Transfer in Year } 1]$$

Notes:

- *Year 1 Base* is spending that falls under the spending cap in Year 1.
- *Allowed Growth Rate* is average income growth rate or the growth of the Consumer Price Index, whichever is greater.
- *Appropriations Cap Percent* is the percent of revenue available for budgeting, gradually declining to 98 percent in 2026.
- *Volatility Transfer in Year 1*: is the required transfer of revenue from Estimates and Finals to the Budget Reserve Fund.

In other words, the volatility cap and the appropriations cap interact with the spending cap to further ratchet down spending after a recession. If a recession causes low revenue one year, this could affect spending in future years because of the spending cap. The volatility cap and the appropriations cap lower the amount of revenue available for spending in a given year and thus lower the next year's spending limit further.

The fiscal restrictions are supposed to encourage saving revenue from spikes or one-time revenue sources, but, as designed, they prevent spending normal growth of revenue and limit economic growth.

The Bond Cap

The bond cap is a constraint on the state's annual borrowing. Under the bond cap, the Treasurer may not issue general obligation or credit revenue bonds in excess of $1.9 billion per fiscal year, which grows as indexed to the CPI.[13] It comes amidst concerns that Connecticut has been borrowing unsustainably, especially in light of the state's unfunded pension liability.[14]

Despite its goal of responsible bonding, the hard bond cap risks crowding out resources for municipal school construction, other capital projects, and economic development.[15] Any bonding under the cap reduces, dollar for dollar, the state's capacity to bond for other purposes. We return to this crowd-out problem with the case study in Part IV, next.

IV. Locking in Restrictive Caps

The Bond Lock

The Bond Lock is a contractual obligation to not redefine or alter the four caps above—spending, volatility, appropriations, and bond. By statute, the Treasurer is required to write a promise into the covenants of all bonds issued "on or after May 15, 2018, and prior to July 1, 2020." Specifically, the Treasurer must pledge that "no public or special act of the General Assembly taking effect on or after May 15, 2018, and prior to July 1, 2023" can amend the four caps or alter the state's obligation to comply.[16] Until 2023—or at least until all bonds containing the covenant are repaid fully—<u>the four caps must remain in effect, exactly as they existed on May 15, 2018</u>.

If Connecticut prematurely amends any of the caps, it will violate the bond covenant, meaning bondholders could sue the state for technical default. <u>In essence, the state has handcuffed itself to the caps and given the key to Wall Street</u>.

There are just two ways to suspend the Bond Lock and allow lawmakers to change the caps.[17]

- First, the legislature may alter the underlying caps "if and when adequate provision shall be made … for the protection of the [bond] holders…"
- Alternatively, the Governor may declare "an emergency or the existence of extraordinary circumstances," followed by a three-fifths vote of the legislature to alter the caps. This lasts only for the current fiscal year.

We will discuss these exit options in Part VI below. In short, <u>any current flaws in the four caps are effectively locked in</u>, unless the state can clear very high hurdles. This quickly proved problematic when the legislature moved to amend the bond cap.

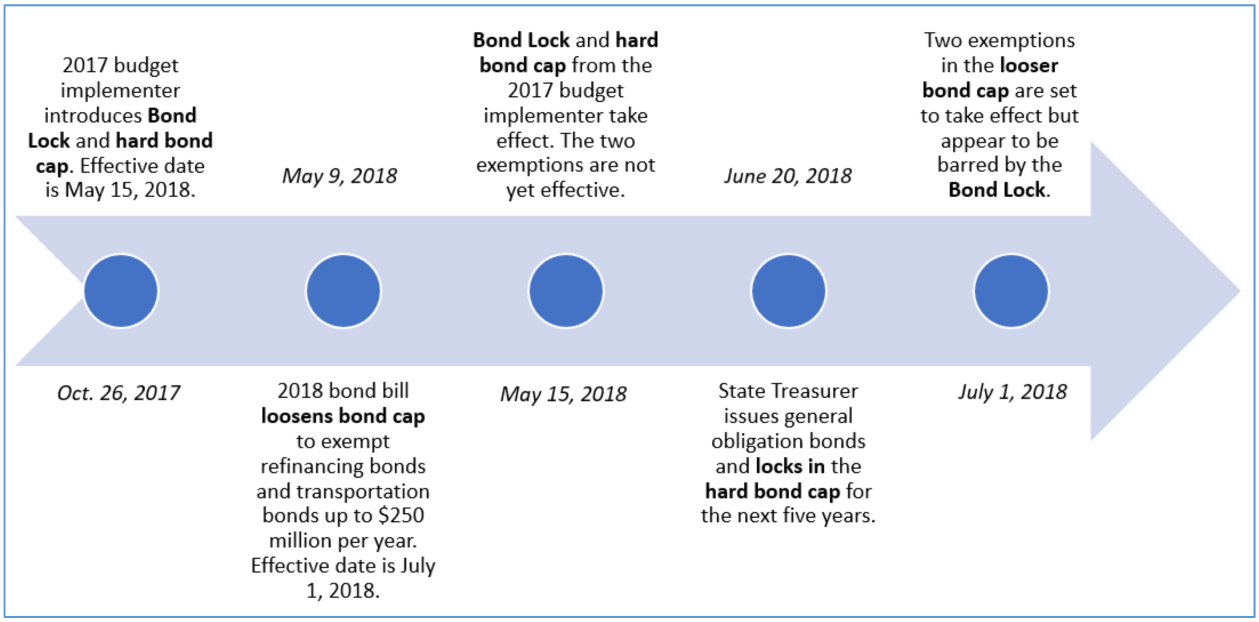
The Bond Cap "Drafting Error": A Case Study

In its original formulation, the bond cap even applied to commonsense borrowing categories, such as refinancing and transportation bonds. Refinancing saves the state money by obtaining a more favorable interest rate on outstanding debt, and transportation bonding can remedy the urgent need for infrastructure investment. When the legislature realized this crowd-out problem, it moved to amend the bond cap during the closing days of the 2018 short session. Refinancing bonds would be carved out entirely.[18] For calendar years 2018 and 2019, the state would also be authorized to bond up to $250 million a year for transportation projects, exempted from the $1.9 billion limit.[19] But now, there was a problem: the Bond Lock had seemingly tied the state to its original, stricter bond cap.

The Bond Lock imperiled those changes because they were set to take effect *after* the Treasurer had pledged no amendments to any caps. Thus, it appeared that refinancing and transportation bonds would be stuck under the cap, contrary to legislative intent, where they would crowd out borrowing for schools and economic development.

The Bond Lock began on May 15, 2018, after which the caps are to remain unchanged. In June 2018, the Treasurer issued bonds containing that covenant,[20] as required by statute. The legislature passed its bond cap amendment on May 9, 2018; however, the *effective date* was set to July 1, 2018[21]—which the Bond Lock says is impermissible. The Treasurer realized this problem in September 2018 and alerted the Governor that the exclusions "may not apply as intended for another five years."[22] If the state departed from the original bond cap, to utilize the two exemptions, it would risk technical default on the June bonds.

Figure 3: Timeline of the bond cap "drafting error"



Thus, if the state wanted to exercise those two bond cap exemptions, it needed to find a way around the bond covenants, lest it risk a potential lawsuit from the bondholders. The Treasurer outlined three such options in her letter, discussed in turn below.[23]

(1) **Judicial remedies**. Connecticut's former Attorney General, George Jepsen, recently issued an opinion wherein he attempted to harmonize the Bond Lock language with the bond cap amendment. By his reading, the legislature intended to lock in all the changes they had *passed*, then pledge no further changes after May 15.[24] The bond cap amendment had certainly passed by May 15—even though it was not "effective" until July 1. While not the most intuitive reading, Jepsen follows established rules of statutory construction to avoid an incoherent result (*i.e.* the legislature passing a bill with borrowing allowances in 2018-2019 that could not permissibly take effect until 2023). This does not immunize Connecticut from a bondholder lawsuit, but it does present one plausible defense.

(1a) As a corollary, we have investigated a **Scrivener's Error** theory. A Scrivener's Error means an objective, actual error in the legislation, as in a clerical mistake or a "typo." The July 1 effective date for the bond cap exemptions appeared in an amendment; prior to that, the bill read "*effective from passage*."[25] If the legislature changed the date by mistake, not through actual policy reasoning, then a court has leeway to correct it. While Scrivener's Error is recognized in many other states, though, no appellate court in Connecticut has yet tested it.[26] This defense would be breaking new legal ground; but it is perhaps more faithful to the actual sequence of events.

(2) **Fiscal emergency**. Each year until the Bond Lock expires, the Governor could declare a fiscal emergency and secure a three-fifths vote of the legislature to utilize the two borrowing exemptions. This follows the second statutory exit from the Bond Lock. Because it only lasts one fiscal year, however, it would need to be repeated annually until 2023. The road is extremely difficult. Each supermajority vote emboldens a minority of the legislature to exact costly compromises.

(3) **Refund and reissue**. Connecticut could clear all bonds issued since June, which contain the defective covenant, and then amend the Bond Lock statute. The Bond Lock could be revised to sweep in the bond cap amendments; it could also be repealed or temporarily paused. With no

covenants outstanding, the state would not risk a bondholder lawsuit. However, this option entails steep banking fees, and it grows costlier with each successive bond issuance.

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In summary, all options are expensive and risky. They signal poor financial health, which is precisely opposite the legislature's intent when enacting the Bond Lock. For now, the state has proceeded in line with the Attorney General's opinion (option 1). It is utilizing the refinancing and transportation exemptions, on a theory that they were included in the bond cap that "locked in" on May 15. If bondholders challenge that stance, the issue could quickly return.

A Risky Restraint

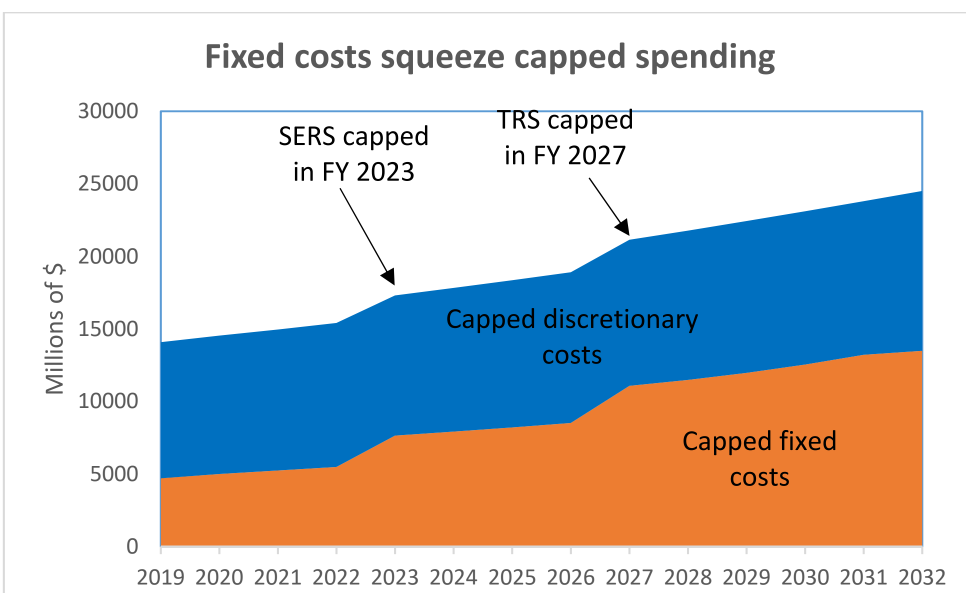
The bond cap amendments expose an inherent flaw in the Bond Lock. Just two months in, the legislature realized a flaw with one of their caps. The amendment passed unanimously,[27] and yet there are still serious doubts about whether it can take effect. It prompted an alarmed letter from the Treasurer, an opinion from the Attorney General, and (possibly) future litigation against the state. As detailed in the next section, it's quite likely that Connecticut will need to amend the caps again before 2023. With those future amendments, however, no reading of the statutory language can bring them into effect. The four caps are now plainly locked, in current form, and the Bond Lock will render amendments costly or even impossible.

V. The caps and the future

Absent reform, growing fixed costs will squeeze discretionary spending

Growing fixed costs will continue to squeeze spending, and, without reform, fixed costs under the cap (contractual spending, including state and teacher pension payments) will take up an increasing proportion of capped spending, leaving less room for discretionary spending (including education, municipal aid, and human services). (See Appendix for a full list of fixed costs and discretionary spending.) Currently, fixed costs constitute 33 percent of all capped spending. If nothing changes, due to growing pension payments going under the cap as well as increasing costs of services, by 2032, fixed costs could be over half of capped spending.

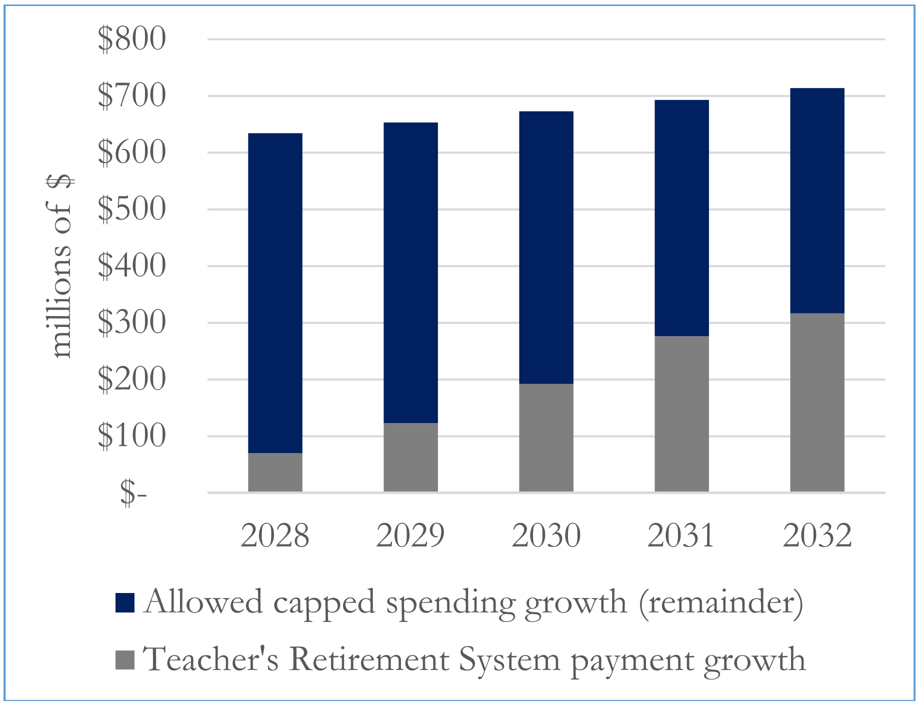
Figure 4: Growing fixed costs under spending cap will squeeze discretionary spending (estimate)



Starting in 2028, much of this growth in fixed costs will come from growth in required payments to the Teacher's Retirement System. By 2032, growth in these payments is projected to take up over 40 percent of allowed growth under the spending cap. Importantly, teachers should not be blamed for these problems. The important role of teachers in our society cannot be overstated, and teachers deserve to be able to retire with dignity. Rather, this reality was caused by lawmakers' failure to fully fund the pension system for decades.

It is important to note Governor Lamont has proposed reforms that would reduce yearly TRS payments substantially.[28]

Figure 5: Increasing required TRS payments will eat up more and more of allowed growth in capped spending



Note: Bars represent how much spending is projected to be allowed to grow (in millions of $) starting in 2028. The grey represents how much TRS payments will grow during this time, and the blue represents the remainder of allowed capped spending growth.

The below table puts this "squeeze" into concrete terms. The table lists selected budgetary line items and their 2019 appropriations, the percent of discretionary capped spending that that line item takes up in 2019 and, assuming that the percent of capped spending of each line item is the same in 2032, what the 2032 cut would be in 2019 dollars. For example, in 2019, about $2 billion was appropriated for Education Equalization Grants, or 22% of all discretionary capped spending. If Education Equalization Grants make up 22% of discretionary capped spending in 2032, then, because fixed costs will take up an increasing amount of capped spending, leaving less room for functional spending, this would require a cut of approximately $340 million in 2032. Importantly, this is without reform.

Table 2: In the absence of reform, spending cap will result in cuts

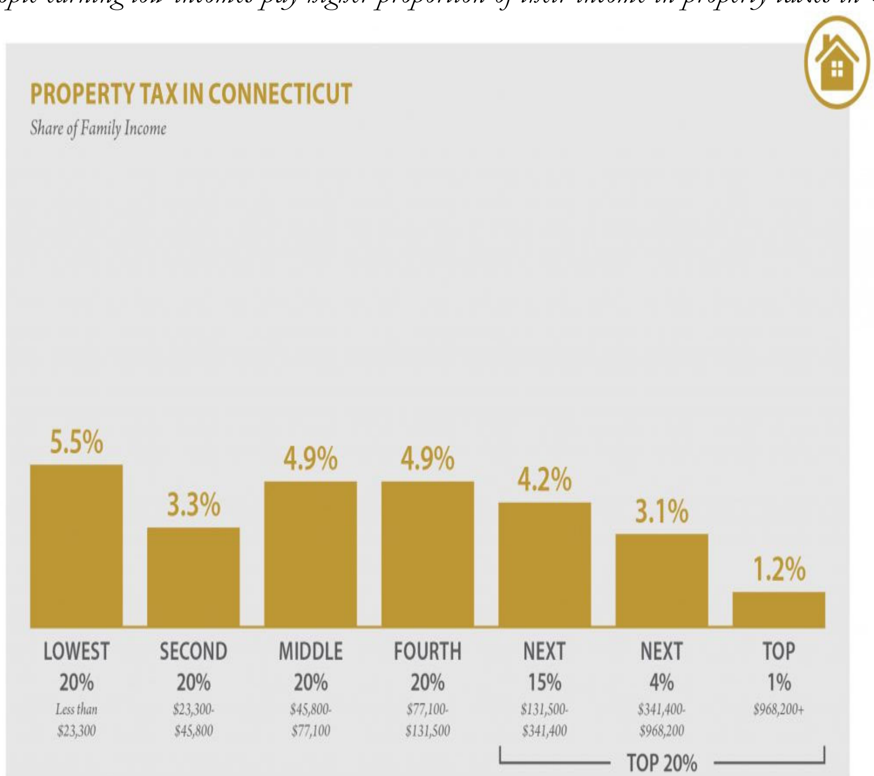
	2019 Approp.	% of functional spending under spending cap (2019)	Implied 2032 cut (in 2019 $)
Education Equalization Grants	$2 billion	22%	$340 million
Grants to Distressed Municipalities (newly under cap)	$1.5 billion	16%	$250 million
Dept. of Ed. (aside from Ed. Equal Grants)	$945 million	10%	$160 million
Higher Education	$635 million	7%	$105 million

Note: Assumes each line item in capped functional spending will be the same proportion of capped discretionary spending in 2032 as it is in 2019 and an inflation rate of 2.5% per year. See Appendix for calculations.

A squeeze on discretionary spending inequitably pushes costs onto towns

In 2019, the state spent nearly $4.5 billion on municipal aid, or about 30 percent of capped discretionary spending.[29] If aid to municipalities is cut due to budgetary squeeze-out, municipalities will have to raise more of their own revenue. This means they will need to raise property taxes, which burdens people earning low incomes the most. The lowest 20 percent of income earners in Connecticut pay 5.5 percent of their income in property taxes, whereas the highest 1 percent pay only 1.2 percent of their income in property taxes. Towns with lower property values also need to enact higher property tax rates to fund services (along with often needing more services). These disparities between towns, which reflect economic and racial disparities in the state, will only increase if fiscal restrictions force the state to push more costs onto towns.

Figure 6: People earning low incomes pay higher proportion of their income in property taxes in Connecticut



Source: ITEP (2018). Connecticut: Who Pays? 6th Ed., available at https://itep.org/connecticut/.

Caps make budget process less transparent, less accountable to voters

Another side effect of fiscal restrictions is that they incentivize lawmakers to get around the caps by finding other ways to spend, outside of the budget process. Since the spending cap was passed in 1991, tax expenditures (tax breaks with the goal of advancing certain policy goals) to businesses and state borrowing have increased exponentially.[30] Tax expenditures are not included in the official budget, but, because they forgo revenue, they are spending nonetheless.

Connecticut has a tight budget and needs to make every dollar count. This means honestly and transparently assessing the costs and benefits of all spending, including tax expenditures and other non-budgetary spending. Fiscal restrictions encourage the opposite behavior, because they incentivize non-budgetary spending that is hard to detect, harder to evaluate, and hardest to eliminate.

VI. Ways around the caps

The analysis above carries a common theme: when the state budget can't adapt to changing circumstances, problems arise. Indeed, the legislature already observed this with the bond cap amendments. There's good reason to anticipate that Connecticut will need to change some or all of its fiscal caps before the Bond Lock releases in 2023.

As long as the Bond Lock stays in effect, each cap can only be exceeded for one year at a time. To exceed the spending cap or bond cap, the governor must declare an emergency or extraordinary circumstances and at least three-fifths of both houses must vote to do so. This also works to exceed the appropriations cap, or the appropriations cap can be exceeded for the purposes of an adjusted appropriation and revenue plan by simple majority vote. The volatility cap can be exceeded with three-fifths vote of both houses – the governor does not need to declare extraordinary circumstances.

Table 3: Statutory ways to exceed the caps (for one year only, as long as Bond Lock is in effect)

	Governor declares emergency or extraordinary circumstances *AND* at least three-fifths of the both houses vote to do so	**At least three-fifths of both houses vote to do so** (due to changes in state or federal tax law or policy or significant adjustments to economic growth or tax collections)	**Majority vote of both houses vote to do so** (for purposes of an adjusted appropriation and revenue plan)
Spending Cap	X		
Volatility Cap		X	
Appropriations Cap	X		X
Bond Cap	X		

Removing the Bond Lock

Politically, the emergency declaration route is impracticably demanding. When the fiscal caps need amending, Connecticut should have an avenue that doesn't undermine confidence in the state's fiscal health and embolden a legislative minority to gridlock the process. The sounder policy, then, is to release the Bond Lock and restore decision making power to the legislature.

To that end, we present three proposals.

(1) **Adequate protection.** "Adequate protection" for bondholders is one of the statutory exit options from the Bond Lock. The state would be allowed to change the caps by simple majority vote if the bondholders are simultaneously protected—meaning their bond repayments are somehow secured.

The problem is that the Contracts Clause of the U.S. Constitution prevents any state from passing laws that impair its contractual obligations.[31] The covenant, after all, is a contract between the state and the bondholder. To survive Contracts Clause scrutiny, Connecticut would need to show the impairment is (a) not substantial, and (b) reasonable and necessary to serve an important public interest.[32]

Legislators might accomplish this via a public process, where the state solicits comments from the bondholders and carefully considers how proposed cap changes would affect the state's ability to repay outstanding bonds. If the cap changes were accompanied with a dedicated funding source for those bonds (*e.g.* lottery proceeds), then the bondholders would not be harmed. The risk, though, is that bondholders might exact costly concessions through those negotiations.

(2) **Repeal and refund.** The Bond Lock statute can be amended by simple majority vote. If the legislature voted to suspend or repeal it, the covenant language would not appear in any *future* bond issuances. Then, the Treasurer could refund all *current* bonds containing the problematic covenant. This clears the bad bonds and thus releases the Bond Lock entirely; but the associated banking fees grow costlier as more bonds are issued.

(3) **Constitutional challenge.** There's a sound legal argument that the Bond Lock was unconstitutional from its inception. Among others, Alex Knopp—a lawyer and former state legislator—has advanced this claim.[33] His main assertion is that the General Assembly cannot delegate away the core lawmaking powers granted to it by the state constitution. By one view of the Bond Lock, that's exactly what happened: the legislature handed away budgetary control to the state's bondholders. If the Bond Lock is, indeed, unconstitutional, then the covenant is unenforceable. This would require an opinion by sitting Attorney General William Tong—and quite possibly a court ruling.

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The handcuffs are tightening: the longer legislators wait to fix the Bond Lock, the more bond covenants are issued. The state should act quickly to ensure that it does not lose control over critical fiscal policymaking. At a minimum, the legislature should statutorily suspend the Bond Lock, so that future bond issuances do not contain the dangerous covenant. Then the legislature can investigate the most efficient solution for bonds already outstanding.

VII. Conclusion

Although the legislature may wish to change one or more of the budget rules adopted in 2017 and 2018, the existing covenant in bonds issued by the state in June of 2018 forbids any changes for at least five years. Whether it is ever smart budget policy to contractually relinquish legislative budget making powers to bond holders is unknown, since Connecticut is the first and only state to ever do so. But, the impact that the specific budget rules, now frozen in those promises to Wall Street, are having on Connecticut's ability to fashion a responsible budget is undeniable and crushing to our state's future.

To summarize:

- The caps are **flawed**: they ratchet down spending after a recession – exactly when it is needed most. And the volatility cap forces us to deposit money into the BRF, even if we have a deficit.
- The caps **remove discretion** from lawmakers and from constituents.
- The caps make the budget less transparent and further removed from democratic accountability.
- The caps will force additional cuts to in our investments in children and families and push those costs – inequitably – onto the towns.

No doubt, we need responsible budgeting. But excessive hand-tying is not the answer. Releasing the Bond Lock and fixing the four caps should be a top legislative priority.

Appendix

Projecting Capped Fixed Costs and Discretionary Spending though 2032

Projecting capped fixed costs through 2032 required two steps:

(1) We used capped spending amounts from FY2018- FY2020 from OPM's Transition Budget and assumed that capped fixed costs would grow the same average amount through 2032 (about 3%). Source: OPM's Transition Budget: https://www.ct.gov/opm/lib/opm/budget/transitionbudget/FY20-FY21_Transition_Budget_11-15-18.pdf.

(2) To #1, we added payments to fund State Employee Retirement Service (SERS) and Teacher's Retirement Service (TRS) when these payments go under the cap (FY 2023 for SERS and FY 2027 for TRS). Sources: State of Connecticut Teachers' Retirement System Viability Commission Report of the Commission, March 19, 2018: https://www.ct.gov/trb/lib/trb/formsandpubs/CT_TRS_Viability_Commission_Report_03192019.pdf and "Connecticut State Employees Retirement System Report of the Actuary on the Valuation Prepared as of June 30, 2016": https://www.osc.ct.gov/rbsd/reports/6-05-17CTSERS6-30-2016ValuationReport-Revised-FINAL.PDF.

Projecting spending limit through 2032.

- To project total allowable spending under the spending cap, we used allowable spending from OPM's transition budget and projected it to grow at its average rate from 2018-2020 of about 3%. We added actuarial projections of TRS and SERS pension payments when they go under the cap, assuming the cap will be re-based to account for their inclusion. Source: OPM's Transition Budget.

Projecting total remaining capped discretionary spending:

- We subtracted projected capped fixed costs from the projected spending limit to get an estimate for available remaining capped spending, meaning capped discretionary spending.

Grants that used to be excluded from the spending cap when directed to distressed municipalities but are now under the cap

DPH

- 17009 Local and District Departments of Health
- 17013 Venereal Disease Control
- 17019 School Based Health Clinics

DSS

- 17022 Child Day Care
- 17025 Human Resource Development
- 17029 Human Resource Development- Hispanic Prgm
- 17032 Teen Pregnancy Prevention

DOE

- 17014 School Building Grants and Int. Subsidy
- 17017 Vocational Agriculture
- 17027 Transportation of School Children

- 17030 Adult Education
- 17034 Health and Welfare Services- Private School
- 17041 Education Equalization Grants
- 17042 Bilingual Education
- 17043 Priority School Districts
- 17044 Young Parents Program
- 17045 Interdistrict Cooperation
- 17046 School Breakfast Program
- 17047 Excess Cost Program
- 17049 Non-Public School Transportation
- 17052 Youth Service Bureaus
- 16119 Charter Schools Lib
- 17003 Grants to Public Libraries
- 17010 Connecticutcard Payments

OSC

- 17004 State Property PILOT
- 17005 Mashantucket Pequot- Grants to Towns
- 17006 Colleges and Hospitals (Private Property) PILOT

DOT

- 17036 Town Aid Road

Calculations for Table 2: In the absence of reform, spending cap will result in the cuts (in millions of $)

Line Item	(1) 2019 appropriation	(2) % of total capped appropriations (2019) ^	(3) projected appropriation (2032)+	(4) projected appropriation (2032) in 2019 dollars ++	(1) – (4) Effective cut
Education Equalization Grants	$2,016.70	22%	$2,370.18	$1,677.38	$339.32
Department of Education (aside from Ed. Equal Grants)	$944.96	10%	$1,110.59	$785.96	$159.00
Higher Education	$636.90	7%	$748.53	$529.74	$107.16
Statutory Grants to Distressed municipalities (2017)	$1,496.80	16%	$1,759.15	$1,244.95	$251.85

^ Total capped appropriations in 2019 are $9375.
+ Projected total capped appropriations in 2032 (using methodology described above) is $11,018.22.
++ We assuming $1 in 2019 will be worth $0.71 in 2032, based on this calculator: https://smartasset.com/investing/inflation-calculator#YfZ1SuxCMw.

[1] Real Total Gross Domestic Product for Connecticut. FRED Economic Data. https://fred.stlouisfed.org/graph/?g=mPtA.

[2] Jamie Mills and Rachel Silbermann. (2018). "The State of Working Connecticut: Wages Stagnant for Working Families." CT Voices Report. http://www.ctvoices.org/publications/state-working-connecticut-wages-stagnant-working-families.

[3] Jamie Mills and Rachel Silbermann. (2018). "The State of Working Connecticut: Wages Stagnant for Working Families." CT Voices Report. http://www.ctvoices.org/publications/state-working-connecticut-wages-stagnant-working-families.

[4] Growth rates through 2017 from OPM presentation to Commission on Fiscal Stability and Economic Growth (217 Dec 15). Available at https://www.cga.ct.gov/fin/tfs/20171205_Commission%20on%20Fiscal%20Stability%20and%20Economic%20Growth/20171215/Ben%20Barnes%20Presentation.pdf. Growth rates in 2018 and 2019 from OFA Budget Books that can be found here: https://www.cga.ct.gov/ofa/add-bb.asp.

[5] Minnesota Department of Revenue. State and Local Tax Rankings by Tax Type. (2015). Tables. https://www.revenue.state.mn.us/research_stats/Pages/Rankings_by_Tax_Type.aspx.

[6] Connecticut Office of Policy and Management. (2018 Nov). "Fiscal Accountability Report, Fiscal Years 2019-2022." https://www.ct.gov/opm/lib/opm/budget/fiscalaccountability/fiscal_accountability_november2018.pdf.

[7] In other words, even if the Bond Lock did not exist, the spending cap would require a three-fifths vote by the legislature to change. For details on the history of the spending cap, see Ellen Shemitz and Ray Noonan. 2017. "Implementing an Effective Spending Cap." Available at http://www.ctvoices.org/SpendingCap.

[8] For more information on how distressed municipalities are determined, see DECD's distressed municipalities page: https://portal.ct.gov/DECD/Content/About_DECD/Research-and-Publications/02_Review_Publications/Distressed-Municipalities.

[9] We also make the following simplifying assumptions. Appropriations equal revenue exactly. This is not always true, but allowing revenue and spending to deviate would not change the main points. Consensus revenue, what budgets are actually based on, are the same as actual revenue. These are encompassed in the blue bars, which we can think about as our capacity to spend in a given year.

[10] Thad Kouser, Matthew D. McCubbins, and Ellen Moule. (2008) "For Whom the TEL Tolls, Can State Tax and Expenditure Limits Effectively Reduce Spending?" 2008 State Politics and Policy Quarterly 8: 331-361. https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=5981&context=faculty_scholarship;
Paul Eliason and Byron Lutz. (2018) "Can Fiscal Rules Constrain the Size of Government? An Analysis of the 'Crown Jewel' of Tax and Expenditure Limits." Journal of Public Economics. https://www.sciencedirect.com/science/article/abs/pii/S0047272718301336;
Steven Deller, Judith I. Stallman and Lindsay Amiel. (2012). "The Impact of State and Local Tax and expenditure Limitations on State Economic Growth." Growth and Change, Vol 43 No 1.
Lindsay Amiel, Steven Deller, and Judith I. Stallman. (2013). Economic Growth and Tax and Expenditure Limitations. The Review of Regional Studies, Southern Regional Science Association.
Suho Bae, Seong-gin Moon, and Changhoon Jung. (2012). Economic Effects of State-Level Tax and Expenditure Limitations. Public Administration Review.

[11] Steven Deller, Judith I. Stallman and Lindsay Amiel (2012). The Impact of State and Local Tax and expenditure Limitations on State Economic Growth. Growth and Change. Vol 43 No 1.;
Lindsay Amiel, Steven Deller, and Judith I. Stallman. (2013). Economic Growth and Tax and Expenditure Limitations. The Review of Regional Studies, Southern Regional Science Association.;
Suho Bae, Seong-gin Moon, and Changhoon Jung. (2012). Economic Effects of State-Level Tax and Expenditure Limitations. Public Administration Review.

[12] Office of Fiscal Analysis, Connecticut General Assembly. Connecticut State Budget, FY 19 Revisions. https://www.cga.ct.gov/ofa/add-bb.asp.

[13] Public Act No. 17-2, §712 (amending §3-21(f)(1)(A) of the Connecticut general statutes). This cap is on bond issuance; section 712 also contains separate, slightly higher limits on the amount of debt that the legislature can authorize to the State Bond Commission (SBC). Not all bonding authorized by the legislature will pass the SBC.

[14] See, e.g., Keith M. Phaneuf. (2019). Lamont Wants to Slam Brakes on State Borrowing. CT Mirror. Available at https://ctmirror.org/2019/02/12/lamont-slams-brakes-on-state-borrowing (describing Governor Lamont's pledge of a "debt diet").
[15] *Id.*
[16] Public Act No. 18-81, §21 (adding §3-20(aa) to the Connecticut General Statutes).
[17] *Id.*
[18] Public Act No. 18-178, §16 (amending §3-21(f)(1)(B) of the Connecticut General Statutes).
[19] *Id.*
[20] Letter from Denise L. Nappier, State Treasurer, to Dannel P. Malloy, Governor (Sept. 18, 2018), available at http://www.yankeeinstitute.org/wp-content/uploads/2018/10/DLN-Letter-to-Governor-RE-Bond-Cap-Glitch-9-18-18.pdf.
[21] Public Act No. 18-178, §16.
[22] Letter from Denise L. Nappier, *supra* note 20.
[23] *Id.*
[24] Letter from George Jepsen, Attorney General, to Denise L. Nappier, State Treasurer (Nov. 21, 2018), available at https://portal.ct.gov/-/media/AG/Opinions/2018/2018-04_Bond_Covenant.pdf.
[25] Compare section 3 of the bill as voted out of committee (available at https://www.cga.ct.gov/2018/FC/pdf/2018HB-05590-R000643-FC.PDF) to section 16 of the amendment (https://www.cga.ct.gov/2018/amd/H/pdf/2018HB-05590-R00HA-AMD.pdf). Other provisions in the amendment are set to take effect July 1—coinciding with the new fiscal year—which suggests that this change was an oversight. For the full bill history, see https://www.cga.ct.gov/asp/cgabillstatus/cgabillstatus.asp?selBillType=Bill&which_year=2018&bill_num=5590.
[26] Scrivener's Error is utilized in one lower court decision, *Monge v. Acabbo*, 63 Conn. L. Rptr. 340 (Super. Ct. 2016). Judge Ecker allowed plaintiff to recover court entry fees as a "taxable cost," despite their omission from an itemized list, because he found that court fees had been inadvertently dropped from the statute in an 1893 amendment.
[27] The House vote was 150-0, https://www.cga.ct.gov/2018/VOTE/h/pdf/2018HV-00303-R00HB05590-HV.pdf, and the Senate vote was 36-0, https://www.cga.ct.gov/2018/VOTE/s/pdf/2018SV-00334-R00HB05590-SV.pdf.
[28] Governor Lamont's Biennial Budget for FY20-21, available at https://portal.ct.gov/Office-of-the-Governor/2019-Legislative-Proposals.
[29] Office of Fiscal Analysis, Connecticut General Assembly. Connecticut State Budget, FY 19 Revisions. https://www.cga.ct.gov/ofa/add-bb.asp.
[30] For an in depth analysis of the side effects of Connecticut's spending cap, see Shelley Gabelle's 2007 report "Coping with the Cap: A Primer on Connecticut's State Spending Cap and Its Impacts" here: http://www.ctvoices.org/publications/coping-cap-primer-connecticuts-state-spending-cap-and-its-impacts.
[31] U.S. CONST. art. I, §10, cl. 1 ("No State shall pass any Law impairing the Obligation of Contracts").
[32] This test appears in the leading Supreme Court case, *United States Trust Co. v. New Jersey*, 431 U.S. 1 (1977).
[33] Alex Knopp, Opinion, *Six Reasons to Repeal the 'Doomsday Bond Covenant,'* CT News Junkie (Feb. 2, 2018), https://www.ctnewsjunkie.com/archives/entry/20180202_op-ed_six_reasons_to_repeal_the_doomsday_bond_covenant/.