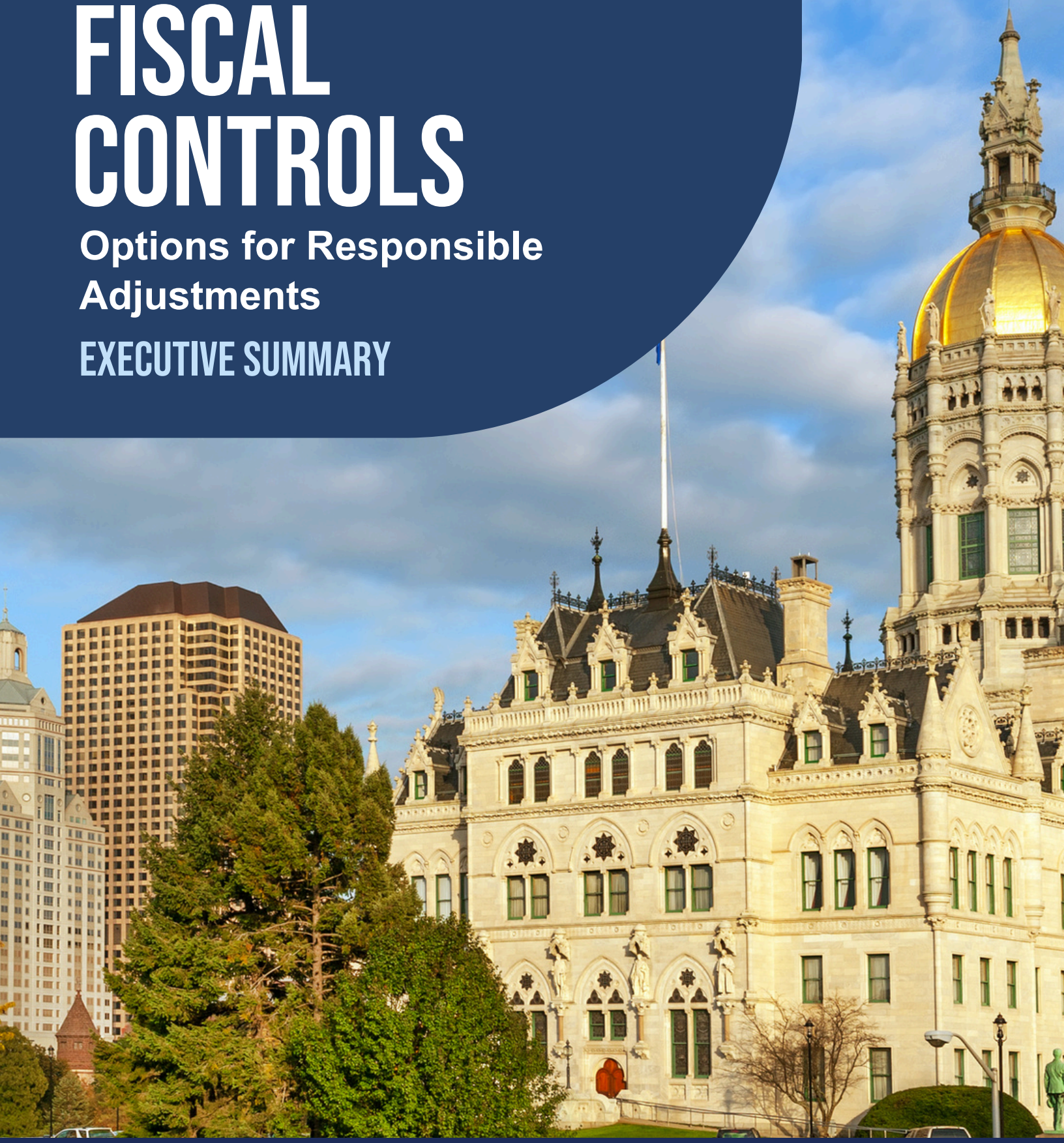
CONNECTICUT'S FISCAL CONTROLS

Options for Responsible Adjustments

EXECUTIVE SUMMARY

CONNECTICUT VOICES FOR CHILDREN

DECEMBER 2024



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Executive Summary

Starting in fiscal year (FY) 2018, Connecticut initiated a sweeping program of fiscal controls to stabilize the state's budget and long-term finances. These controls have contributed to $5.8 billion in total budgeted surpluses for the General Fund through FY 2024, which has grown to $12.5 billion in actual total surpluses—more than doubling the impact of the already substantial budgeted surpluses. While these surpluses demonstrate a strong shift to fiscal responsibility, they also highlight the challenge of balancing fiscal responsibility with current public needs.

Of the $12.5 billion in total surpluses to date, $3.9 billion (31 percent) has been allocated to the expanded Budget Reserve Fund, which is essential for stabilizing the budget, especially during economic downturns. However, $8.6 billion (69 percent) has been directed toward additional payments for unfunded retirement liabilities dating back to the 1930s. Based on the structuring of the retirement liabilities, these additional payments reduce future annual obligations into the 2040s, which, along with the regular payments, place a combined burden of billions of dollars a year on current taxpayers for commitments that span more than a century. At the same time, total appropriations for the regular budget have decreased by hundreds of millions of dollars in inflation-adjusted terms, reducing the resources available for current public services and investments. Together, these trends make clear that the fiscal controls have prioritized long-term liabilities at the expense of immediate public needs and critical public investments, all in the name of fiscal responsibility.

The same trends persist in the current FY 2025 budget. The General Fund's surplus was initially budgeted at $957 million but—at the time of this writing—it has increased to a projected $1.6 billion. Similar to previous years, the vast majority of the projected surplus is earmarked for additional payments toward unfunded retirement liabilities, meaning current taxpayers will once again bear an excessive burden of obligations incurred by past generations by making additional payments that largely benefit future taxpayers. Adding to the intergenerational inequity, policymakers are working to reduce General Fund spending by hundreds of millions of dollars to comply with the spending cap, further constraining the resources available for current public services and investments.

This report does not advocate for dismantling Connecticut's fiscal controls, nor does it support rigid adherence to the fiscal controls as currently designed as the sole path to fiscal responsibility. Instead, the report makes the case for a more balanced approach—one that maintains fiscal discipline while introducing the flexibility necessary to fund current needs and make public investments essential to growing the state's economy. In addition to better addressing current needs, this more balanced, pro-economic growth approach would allow Connecticut to reduce its long-term liabilities relative to the size of its economy, improving the state's fiscal standing without making substantial additional payments to the retirement systems. In contrast, the current approach of prioritizing additional payments to the retirement systems at the expense of all other priorities risks slowing the state's economic growth, partially offsetting the benefits of directly reducing the long-term liabilities. This is a major concern for Connecticut, as the state has experienced historically slow economic growth since the implementation of the spending cap.

To be clear, the more balanced, pro-economic growth approach outlined in this report retains all the major revenue and spending controls while advocating for responsible adjustments to their design to address key flaws identified in practice. In support of this approach, the report proceeds in three sections. The first section, divided into two parts, reviews Connecticut's revenue controls and makes the case for responsible adjustments. The first part focuses on the volatility cap, revenue cap, and Budget Reserve Fund, reviewing their statutory design and actual impact. The key findings include:

- The purpose of Connecticut's major revenue controls—the volatility cap and revenue cap—is to stabilize the budget and long-term finances by directing surplus revenue, particularly from volatile sources, into the Budget Reserve Fund and toward paying down unfunded retirement liabilities.

- From FY 2018 to FY 2024, the approved budget surplus for the General Fund totaled $5.8 billion, while the actual budget surplus totaled $12.5 billion, making the revenue controls more than twice as restrictive in practice as originally budgeted, primarily due to the volatility cap, and nearly 70 percent of the surplus has been used to pay down unfunded retirement liabilities.

- Two of Connecticut's taxes—the personal income tax estimated and final payments and the pass-through entity tax—remain highly volatile and substantial in size, making a well-designed volatility cap essential for stabilizing the state's budget.

- The current volatility cap has an initial threshold that was set too low and is indexed to a variable that has no meaningful correlation to the volatile taxes, resulting in excess restricted revenue of up to $755 million per year on average and $5.3 billion in total from FY 2018 to FY 2024.

- Despite the increased challenges presented by the two volatile taxes, generating revenue from them is crucial because they both operate as progressive components of Connecticut's regressive tax system.

The second part compares Connecticut's revenue levels to those of all 50 states and New England states, offering additional context for the proposed adjustments. The key finding is:

- Connecticut's state and local revenue level as a percentage of state personal income is below the average for all 50 states and New England states, demonstrating that the state has capacity to responsibly increase its revenue.

The second section, divided into two parts, reviews Connecticut's spending controls and makes the case for responsible adjustments. The first part focuses on the spending cap, debt limit, and bonding caps, reviewing their constitutional and statutory design and actual impact. The key findings are:

- The purpose of Connecticut's major spending controls—the spending cap, debt limit, and bonding caps—is to stabilize the budget and long-term finances by limiting the growth in spending.

- In FY 2025, Connecticut's appropriations totaled $25.99 billion but could have totaled $32.7 billion—an increase of $6.7 billion—if the state's personal income had grown at the same rate as the U.S. over the past three decades rather than at a historically slow rate that has made the spending cap excessively restrictive.

- In FY 2025, Connecticut's appropriations totaled $25.99 billion but could have totaled $26.46 billion—an increase of $466 million—if the state's spending cap had continued adjusting since FY 2018 based on the original inflation index rather than a narrower index that excludes food and energy, which has made the spending cap excessively restrictive.

- From FY 2018 to FY 2025, Connecticut's total appropriations in inflation-adjusted dollars decreased by over $250 million due to historically slow personal income growth and the use of a narrow inflation index, both of which have made the spending cap excessively restrictive and caused real spending reductions in several areas, including regulation and protection, human services, elementary and secondary education, and higher education.

- From FY 2018 to FY 2024, Connecticut's actuarially determined employer contributions for the two largest retirement systems averaged $3.4 billion per year, largely due to unfunded liabilities dating back to the 1930s. The state also used surplus funds to make additional payments averaging $1.2 billion per year, reducing future obligations into the 2040s but placing a total annual burden of $4.6 billion on current taxpayers for commitments spanning more than a century—all while total appropriations decreased in inflation-adjusted dollars.

- From FY 2018 to FY 2024, Connecticut's retirement system debt decreased by $2.9 billion due largely to regular and additional payments, but the state lost out on the equivalent of a $2.3 billion debt reduction due to slow economic growth, partially offsetting the benefits of the debt payments.

The second part compares Connecticut's spending levels to those of all 50 states and New England states, offering additional context for the proposed adjustments. The key finding is:

- Connecticut's state and local spending level as a percentage of state personal income is below the average for all 50 states and New England states, demonstrating that the state has capacity to responsibly increase its spending.

The third section, divided into two parts, provides options for a more balanced, pro-economic growth approach that retains all the major revenue and spending controls but makes responsible adjustments to their design to address key flaws identified in practice. The first part reviews the procedural options to end or work around the bond lock securing the revenue and spending controls. The key finding is:

- Connecticut's major revenue and spending controls are secured by the 2023 bond lock set to remain in effect until 2033, but policymakers can adopt a resolution to end it in 2028 or provide adequate protection for bondholders to work around it before 2028.

The second part provides policy and procedural options to adjust the revenue and spending controls. The key finding and recommended policy options include:

- Policymakers can develop a more balanced, pro-economic growth approach that retains all of Connecticut's major revenue and spending controls but incorporates responsible adjustments to their design to address key flaws identified in practice.

The Volatility Cap

- Adjust the volatility cap using an inflation-adjusted moving average of the covered volatile revenue.

The Revenue Cap

- Adjust the revenue cap for the General Fund based on the balance of the Budget Reserve Fund.
- Adjust the revenue cap for the Special Transportation Fund based on the balance of the STF.

The Budget Reserve Fund

- Adjust the restrictions on surplus funds to allow for uses beyond debt reduction.
- Adjust the restrictions on surplus funds to limit the amount used for debt reduction.

The Spending Cap

- Adjust the spending cap's definition of increase in personal income to account for the state's historically slow growth and below-average spending levels.
- Adjust the spending cap's definition of increase in inflation to more accurately reflect changes in the cost of living.
- Adjust the spending cap's definition of general budget expenditures to use allowable appropriations.
- Adjust prior calculations of the spending cap based on upward data revisions in personal income growth.
- Adjust the spending cap's base to exclude regular retirement system payments.

The Debt Limit and Bonding Caps

- Adjust the bonding process to require economic impact estimates for proposed expenditures.
- Adjust the bonding process to require economic impact estimates for actual expenditures.