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Confronting the Cap: Modeling the Impact of Two Changes to Connecticut's Spending Cap

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As Connecticut lawmakers continue to formulate the FY 2014-2015 biennial budget, the state's statutory expenditure cap looms large. The flawed and highly restrictive rules under which the spending cap currently operates continue to create problems for responsible planning, the stability of the state budget, and maintaining investments that are crucial to families and the state's quality of life. Specifically, these rules:

- Prevent the cap from achieving its goal of aligning growth in state spending with growth in the state's economy by ratcheting down public investments with each successive recession.
- Create a barrier to restoring public investments that are reduced during economic downturns, even after state revenues rebound strongly after recovery, reducing the state's capacity to make the public investments needed to support our economy's growth, and meet residents' needs in subsequent downturns
- Create barriers to policies that would improve the fiscal health of the state such as a) maximizing federal funds to help pay for state services and b) paying down the state's unfunded pension liabilities.
- Result in volatility in allowable spending levels and non-transparent budget techniques used to circumvent the cap.

This report will briefly explain the history and structure of the cap under current law, and will then detail the policy and fiscal impact of two proposed common-sense changes to the definitions used to calculate capped expenditures – changes that, together, should help the state to link spending more closely with its capacity to fund services, and will help Connecticut maintain crucial investments during fluctuations in the business cycle.

The Nuts and Bolts of the Spending Cap

Connecticut's statutory spending cap, enacted through legislation in 1991, was adopted as part of an agreement to enact a broad-based personal income tax – a tax which was meant to modernize the state's revenue system and address a deficit of historic proportions. The goal of the cap was to align annual growth in state spending with growth in the state's economy.[1]

The following year, in November 1992, voters approved a constitutional amendment to limit state spending.[2] The constitutional amendment explicitly directed the General Assembly to define certain key terms in the constitutional spending cap (specifically, "increase in personal income," "increase in inflation," and "general budget expenditures"). Twenty years on, the General Assembly has not taken this action. Still, based on an April 1993

[1] The statutory spending cap is Section 2-33a of the Connecticut General Statutes (Conn. Gen. Stat. Sec. 2-33a).
[2] See Art. XXVIII, Amndnts., Conn. Const.

Attorney General opinion,[3] the statutory cap passed in 1991 remains in effect until the General Assembly enacts the definitions required by the Constitution by a three-fifths majority of both the Senate and House.[4]

Key Spending Cap Definitions

Spending Limited by the Cap: The spending cap requires that the General Assembly limit general budget expenditures for any given fiscal year by a specific percentage increase over the previous year. For the purposes of calculating the cap, "general budget expenditures" are those monies from appropriated funds authorized by public or special act of the General Assembly (these are considered "capped expenditures"). Excluded from the spending limitation are expenditures for the payment of principal and interest on "bonds, notes or other evidences of indebtedness," statutory grants to distressed municipalities in effect on July 1, 1991, and the first year of spending related to federal mandates or court orders (these are considered "non-capped expenditures").[5]

Allowable Growth in Capped Expenditures: Under current law, the percentage increase in allowable growth in capped expenditures is the greater of *either* the current rate of inflation (according to growth in the CPI during the previous year), *or* the five-year average of annual personal income growth for the state as recorded by the federal Bureau of Economic Analysis (BEA).

The spending cap may be exceeded if two conditions are met: The Governor must issue a declaration of emergency or extraordinary circumstances, *and* a three-fifths majority of both houses of the General Assembly must vote to exceed the cap.[6] This has occurred at least seven times since the creation of the cap, all in years of significant budget surpluses.[7]

Calculating the Cap

Under current law, the spending cap is calculated in three steps:

1. **Determine the base.** From the previous year's appropriated funds, subtract all expenditures that are not subject to the cap (i.e., debt service, grants to distressed municipalities, and first-year spending on federal mandates and court orders). What remains is the **base**.

2. **Determine the allowable growth rate.** As described above, the lagged five-year average of personal income growth is compared to the annual rate of inflation. The larger of these is the **allowable growth rate**.

3. **Determine the allowable spending increase.** The **base** is multiplied by the **allowable growth rate.** This is the total number of dollars that spending subject to the cap can grow in the next fiscal year. These "new dollars" are added to the previous year's total capped expenditures to determine the new total of capped expenditures. Finally, the estimated total of non-capped expenditures in new fiscal year is added to the new total of capped expenditures determine the **total allowable expenditures.**

[3] Conn. Att'y Gen. Op. No. 93-006 (April 14, 1993). See: http://www.ct.gov/ag/cwp/view.asp?A=1770&Q=281388
[4] For a detailed explanation of the legislative history surrounding the state's expenditure cap, see Geballe, Shelley: *Coping with the Cap: A Primer on Connecticut's State Spending Cap and Its Impacts.* April 2007. http://www.ctvoices.org/sites/default/files/bud07spendingcap.pdf
[5] Transfers of unappropriated surplus funds to the Budget Reserve Fund at the close of each fiscal year are also not considered expenditures for the purposes of determining the cap.
[6] Although the legislature has not formally adopted the various spending cap definitions included in the Constitutional amendment, the 1993 Attorney General opinion held that the requirement that cap definitions by approved by a three-fifths majority in both chambers applied to the statutory cap – as a result, each of the definitional changes proposed in this brief would be subject to this threshold.
[7] Id., at 4 above.

Here is how the cap was calculated for the FY 2014-2015 biennium:

	FY 13-14 Proposed	FY 14-15 Proposed
Previous Year Appropriated Funds Baseline	$ 20,735.0	$ 21,478.6
Less Non-Capped Expenditures	$ 4,993.2	$ 5,207.2
Total Capped Expenditures	$ 15,741.8	$ 16,271.4
Allowable Cap Growth Rate	1.79%	2.45%
Allowable Capped Growth	$ 281.8	$ 398.6
Allowable Capped Expenditures	$ 16,023.6	$ 16,670.0
Plus Non-Capped Expenditures	$ 5,456.3	$ 5,743.4
Total Expenditures Allowed	**$ 21,479.9**	**$ 22,413.4**
Proposed Appropriation	$ 21,478.6	$ 22,322.4
Over (Under) Cap	**$ (1.3)**	**$ (91.0)**

Table 1. Source: Office of Policy and Management, FY 2014-2015 Biennial Budget proposal.

The Governor's Proposed Changes to the Spending Cap

In his FY 2014-2015 biennial budget proposal, Governor Malloy suggested two key structural changes to the state spending cap. House Bill 6352, *An Act Concerning the Expenditure Cap,* would make the following changes:

- Spending related to federal programs that are 100 percent funded by the federal government would be exempted from the cap for the first full year in which such spending is authorized, and also would be rolled into the budget "base" for purposes of determining the cap for the following year. Under current law, the state would be penalized for seeking new federal dollars, as the cap would treat the expenditure of these dollars as state funds even though they essentially constitute federal spending through the state budget. The Governor's proposed reform would ensure that the cap achieves what it was established to do – limit *state* spending.

- The bill would clarify the definition of "evidence of indebtedness" to include the annual required contributions for the unfunded accrued liability in the teachers' retirement system (TRS) and the state employees' retirement system (SERS).[8] Governor Malloy has proposed increasing payments towards the state's unfunded pension liability to improve the state's long-term fiscal health. However, increasing these payments would exceed total allowable spending under current cap definitions.

Together, these changes would result in a reduction in "capped expenditures" of about $3.3 billion over the biennium – more than $3 billion of which is a result of the removal of the pension contributions described above.[9] These changes to the spending cap are central to the Governor's proposed budget, as his budget would otherwise exceed the cap by billions of dollars. Even *with* these changes, the proposed FY 2014 budget would clear the cap by only $1.3 million, and in the second year of the biennium by only $91 million (less than one-half of one percent of total spending in FY 2015).[10]

[8] "Unfunded accrued liability" refers to the dollar amount by which the pension funds' total projected liability (payments to future retirees) exceeds the value of assets accrued in these funds.
[9] CT Voices analysis of spending cap calculations presented in Governor's proposed FY 2014-2015 budget.
[10] The Appropriations Committee added substitute language to HB 6352 to include any programs that are *expanded* to 100 percent federal funding in the exemption for fully-funded federal programs. This effectively exempts spending on the current HUSKY D population (low-income adults below 56 percent of FPL, which is currently 50 percent state-funded) from the spending cap. This has the effect of exempting several hundred million in additional appropriations over the biennium.

Structural Changes for a More Workable Cap

The current definition of the state spending cap severely constrains the capacity of lawmakers to consider a broad range of policy options when creating the FY 2014-2015 biennial budget – especially those options that would allow the state to maintain current services expenditures with new tax revenues. At the same time, significant structural issues exist with the cap. Together with the Governor's proposed changes, the following changes to the definitions of the statutory spending cap would remedy flaws in the cap as currently defined – ultimately improving the capacity of the state to make and maintain crucial public investments during both good and bad economic times. In addition, these proposals would create additional flexibility within the parameters of the cap in the upcoming biennium. The changes, briefly, are the following:

1.) The "base" used to calculate allowable spending under the cap should be determined using the amount that would have been *allowed* during the previous year under the cap, even if not actually spent. The existing requirement that only *actual*, rather than allowable, spending must determine the following year's budget base leads to a "ratcheting-down" effect with each consecutive recessionary period, as slowing rates of growth (because of five-year averaging) are applied to budget bases depressed by recession. Cuts in public investments made during recessions, then, cannot easily be undone – even if state revenues rebound strongly in the post-recession period.

2.) The "lookback" period used to determine the average increase in personal income (which has determined the allowable growth rate in every year of the cap up to this year) should be expanded from five to ten years. This would have a smoothing effect on the growth rate, reducing some of the dramatic fluctuations in allowable growth in spending that we have experienced since the cap was adopted.

3.) The definition of "personal income," for the purpose of determining growth in the cap, should be expanded to include capital gains, which are currently excluded. Excluding this source of often fast-growing income may underestimate growth in Connecticut's economy from year to year, and as a result, the capacity of the state to support the vital functions of government.

There is a lack of current data to implement the third option – revising the definition of personal income. State adjusted gross income (AGI), published by the IRS, is the best measure of personal income that includes capital gains but it is often up to two years old. Thus, we will be excluding this option from this analysis until sufficiently recent data become available.

Nevertheless, implementing the first two proposed amendments to the definitions of the spending cap – in combination with the Governor's proposed changes – would create roughly $1.1 billion in new cap space over the course of the biennium. Table 2 lays out the individual impact of each proposed change in each year of the biennium.

	New Cap Space (millions of dollars)		
Policy Change	FY 2014	FY 2015	**Biennial Total**
Implement "allowable spending" baseline	$ 129.1	$ 133.6	**$ 262.7**
Implement ten-year lookback for personal income average calculation	$ 255.1	$ 177.4	**$ 432.5**
Both Changes Combined	**$ 441.5**	**$ 635.9**	**$ 1,077.4**

Table 2. Source: CT Voices analysis of OPM and OFA budget data and BEA personal income data.

Note that the combined impact of these changes is greater than the sum of each change considered individually. This is due to the fact that one change affects the baseline, and the other change affects the allowable growth rate.

When combined (applying a faster growth rate to a larger baseline), the reforms result in a bottom-line result that is larger than the impact of each individual change when simply added together.

Over the 20-year history of the spending cap, adjusting for these proposed definitional changes shows both a clear reduction in volatility due to economic changes, as well as an improved capacity to avoid the "ratcheting-down" effect that has occurred during recessionary periods due to constraints imposed by the current parameters of the spending cap.

The cumulative impact of implementing the "allowable spending baseline" in conjunction with the expanded, 10-year period used to calculate average growth in personal income would have rendered the cap substantially less volatile and restrictive over the two decades of its existence. As Figure 1 illustrates, the 10-year lookback over the course of the cap – given actual growth in personal income over this time period – would have significantly improved the ability of policymakers to maintain current services funding levels, as compared to using 5- and 2-year lookbacks (the former being a matter of current law, and the latter being a proposal often touted as a mechanism to more closely link the economy and state budget trends). The longer lookback period proposed here – in combination with the allowable spending baseline – would diminish the impact of "ratcheting down" in economic downturns by ensuring that the personal income component of the cap calculation is based on a more stable, less volatile reflection of trends that occur during recessions and recoveries.

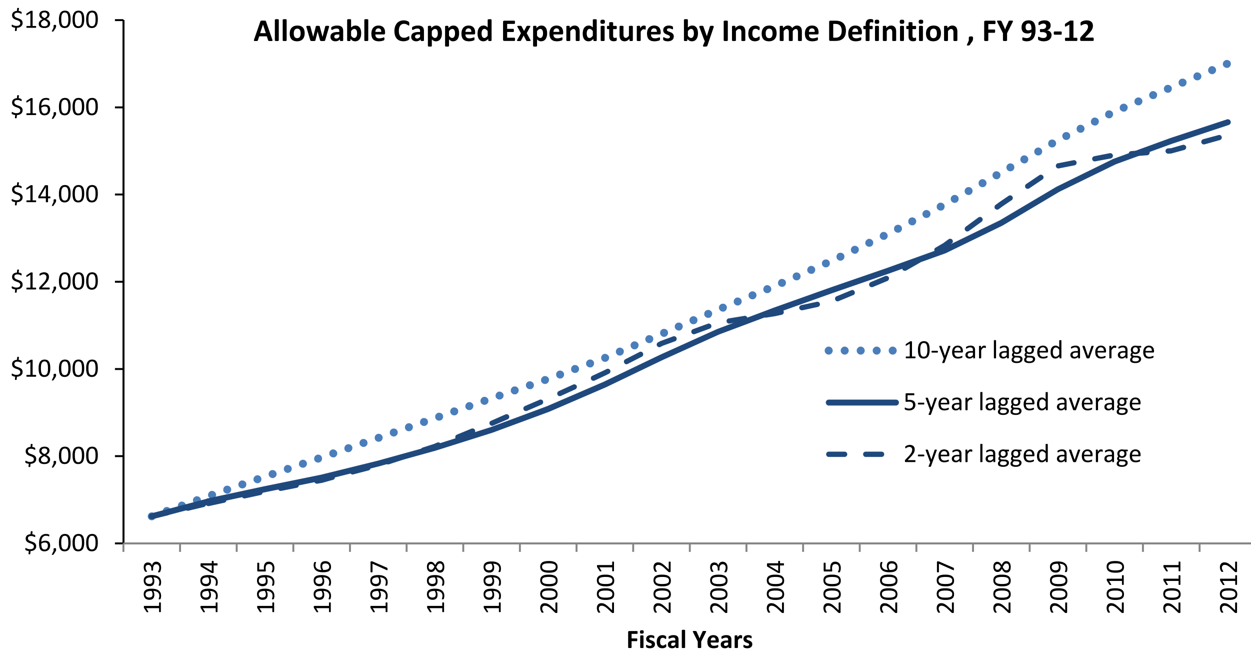

Figure 1. Source: CT Voices analysis of historical OFA biennial budget and BEA personal income data. Dollar amounts are in millions of nominal dollars (not adjusted for inflation). Calculations are based on FY 1993 cap level of $6,618.5 million. Calculations assume current-law CPI-U floor in years of negative personal income growth.

In addition, implementing the 10-year lookback period would result in less volatility in movement of the spending cap on a year-to-year basis. This would have a stabilizing impact on the state budget, and as a result, reduce the likelihood of either drastic cuts in bad years or unsustainable spikes in allowable spending in good years. Figure 2 makes clear the "smoothing" effect of the 10-year lookback relative to both the current-law 5-year average and (to a greater extent) a hypothetical 2-year average.

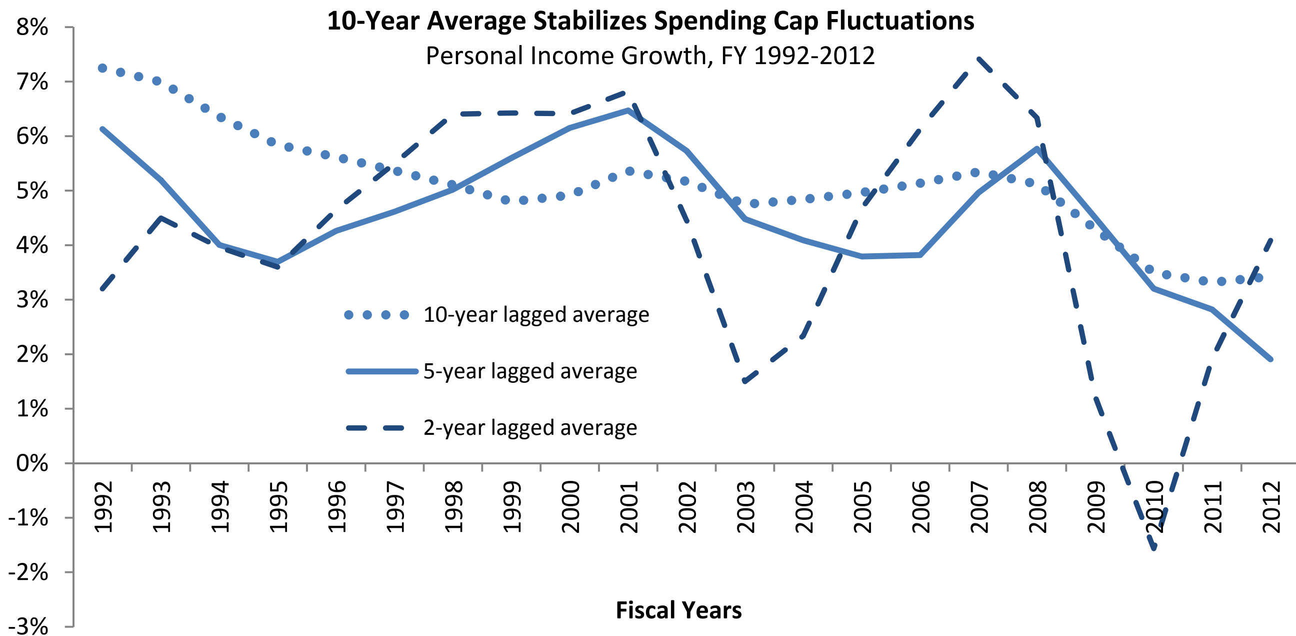

Figure 2. Source: CT Voices analysis of historical BEA personal income data. NB: It is important to remember that growth in the CPI-U is greater than the 2-year average in the following years: 2003, 2004, 2010, and 2011. In these years, this inflation metric would act as a "floor" if the 2-year lookback were implemented.

Conclusion: Building a Better Spending Cap

Connecticut has now lived for more than twenty years with statutory definitions of its constitutional spending cap that were enacted before the constitutional cap. With twenty years of experience, though multiple recessions and recoveries, Connecticut now has the benefit of better understanding the limitations of current cap definitions in achieving its goal of keeping public investment in line with growth in our state economy.

The changes in presented in this brief, in combination with those proposed by the Governor, would address some of these limitations. Exempting the first year of fully-funded federal programs from the cap, as the Governor proposes, is a common sense fix that ensures the cap does what it was originally meant to do – limit *state* spending, not federal spending (which will increase substantially as Connecticut receives hundreds of millions of dollars due to the Affordable Care Act's expansion of Medicaid for low-income adults, known as HUSKY D).[11] Further, exempting payments towards the state's unfunded pension liabilities from the cap enables policymakers to address these looming long-term fiscal challenges without crowding out other, more immediate public investments in Connecticut's children and working families.

In addition, the two further changes proposed in this analysis – changes that should occur in combination – would create additional flexibility in the upcoming biennium, while at the same time improving the capacity of the state budget to absorb the impact of downturns in the economy. As described above, the current "actual spending" baseline can permanently ratchet down spending, ensuring that the state cannot easily restore cuts in services that occurred during recessions – even once revenues recover. In addition, expanding the time period used to determine the average of personal income growth from five to ten years would help to smooth fluctuations in the business cycle. Taking a longer view of economic conditions in our state will help to reduce volatility in allowable spending, and as a result, help the state budget to respond to needs of state residents that will predictably grow during economic downturns.

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[11] For a further explanation of the state fiscal impact of the Medicaid expansion to low-income adults, see Santacroce, Matthew et al.: Expanding Health Coverage for Adults in HUSKY D: A Good Deal for Connecticut. April 2013. http://www.ctvoices.org/sites/default/files/h13huskydgooddeal.pdf

These re-definitions of terms governing the spending cap, in concert with the changes proposed by the Governor, would more closely link growth in state spending with growth in the economy – helping to assure that our public investments keep pace with the needs of Connecticut's families.