SPENDING CAP

REPORT HIGHLIGHTS

Since 1991, Connecticut's budget has been subject to one of the most restrictive spending limits in the country. This spending cap — part of an agreement to create a state income tax — is intended to ensure that the budget does not grow beyond the taxpayers' ability to pay for programs and services. However, Connecticut's spending cap goes far beyond this goal and has created unintended consequences. Because of the cap, the state faces a stark choice: either cut essential programs or change the way the cap works.

BACKGROUND

The cap limits the increase in general budget expenditures each year to the average growth in personal income during the past five years or the rate of inflation during the last 12 months, whichever is greater. It applies to all state spending except payments on state debt, state grants to distressed municipalities, and first-year expenditures on federal mandates or court orders. The cap can be exceeded if the Governor declares an emergency or the existence of extraordinary circumstances and at least three-fifths of the General Assembly agree.

The Connecticut Health Foundation (CHF), in collaboration with the Washington, D.C.-based Center on Budget and Policy Priorities, has updated its 2001 report to see if the cap is serving its intended purpose and if it has created any unintended consequences for the state's $15 billion dollar budget.

HAS THE CAP BEEN WORKING AS INTENDED?

The cap has helped reduce the overall rate of spending growth, from an average of 11.7 percent a year during Fiscal Years (FY) 1987-1991 to an average of 4.8 percent per year during FY 1995-2001. During FY 2002-2004, spending growth was even slower, averaging 2.1 percent per year, but that was the result of reduced revenues (due to the economic downturn) rather than the spending cap.

Now, however, the state is at a crossroads. While revenues have begun to rebound from the economic downturn, the cap may prevent the state from restoring cuts made during the downturn. Each year's cap is calculated based on the state's actual expenditures in the prior year, as opposed to the total amount allowed by law. Since actual expenditures in recent years have been below the allowable amounts, the base from which future caps are calculated has been lowered, or "ratcheted down."

The ratchet effect is compounded by other elements of the cap, such as the use of a lagged five-year average in calculating personal income growth and the omission of capital gains income — a significant source of wealth in the state — from the measurement of personal income. The cap limit is further depressed by the exclusion of some state spending from the base. *Based on current economic projections, the cap will restrict the budget to 3 percent growth in FY 2008 – some $1.1 billion less than the amount needed to maintain current service levels.*

The cap has created several unintended consequences. Since debt service payments do not count under the cap, state borrowing to finance ongoing expenditures has increased. Connecticut now has the third-highest rate of state tax-supported debt in the nation. Also, the cap has given the state an incentive to use the tax code rather than spending programs to deliver benefits, since tax expenditures do not count under the cap. In addition, the cap has created a disincentive for Connecticut to obtain new federal funds (since such funds count against the cap).

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OVERALL FINDINGS

Connecticut's spending cap is one of the most restrictive in the country. As we found in 2001, the cap will cause spending to decline relative to the economy in future years. This will put significant pressure on state expenditures in all areas, including those affecting vulnerable populations.

Since FY 2002, the economic downturn and lowered state revenues have limited state spending, not the cap. Although state spending each year has been below the level allowed by the cap, that situation is changing. According to projections from the General Assembly's Office of Fiscal Analysis (OFA), simply continuing current services would put the state $650 million over the cap in FY 2006. While the amount of revenue available still may restrict the state's ability to fully fund services, if revenue growth improves more rapidly than expected — as is very possible — or new state or federal revenues are identified, the cap will be a limiting factor in FY 2006 and beyond. For example, the Governor has proposed exceeding the cap in FY 2006 in order to obtain additional federal funding to meet the state's needs for long term care.

Our research shows that the cost of maintaining state programs will continue to exceed the cap for at least the next several years. Thus, the state faces a stark choice: either cut essential programs or change the parameters of the cap. In the short term, action could be taken to change the spending cap methodology to address the gradual "ratcheting down" of the base that occurs as a result of periodic economic downturns. Several long-term adjustments, listed below, could be made to ensure that the cap fulfills its intent without preventing the state from meeting the vital needs of all of its residents. The cap also could be eliminated altogether through the constitutional amendment process.

The following adjustments would create additional room under the cap:

- exempting Medicaid from the cap, assuming the program is not changed significantly;
- exempting all new federal funds (not just those that result from mandates) from the cap;
- increasing the factor used to calculate each year's cap by:
  - using a more current measure of personal income growth,
  - including capital gains in the measure of personal income,
  - adjusting the growth factor to account for growth in specific populations; and
- using the previous year's allowable spending instead of actual spending to calculate the following year's spending cap base.

The following adjustments, in contrast, would make the cap even more restrictive:

- exempting all federal funds from the cap (not just all new federal funds); and
- exempting Education Equalization (ECS) funds.

These two funding streams grow more slowly than the cap allows, which enable other programs under the cap to grow somewhat more quickly than the cap allows. Removing these slow-growing programs from the base, therefore, would tighten the spending cap. On the other hand, removing fast-growing programs from the cap, in contrast, creates additional room under the cap.

How Selected Changes Would Affect the Spending Cap (in millions)

Adjustments That Create Room Under the Cap	FY 2006	FY 2007	FY 2008
Exclude Medicaid	$111	$157	$279
Exclude Medicaid (assuming federal Medicare changes reduce state Medicaid costs)	$81	$62	$178
Increase allowable growth factor by 0.5 percent	$57	$120	$186
Use current personal income growth	$38	$149	$349
Use allowable spending as base	$127	$151	$201
Exclude Medicaid and use current personal income growth	$139	$268	$539
Adjustments That Reduce Room Under the Cap			
Exclude all federal grants	$-242	$-293	$-270
Exclude ECS	$5	$-48	$-94

Copies of the full report are available at www.cthealth.org or by calling 860.224.2200.

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