

Spending Cap Commission  
Wednesday, May 25, 2016  
Minutes

**Attendees:**

Members:

Commission Co-Chairperson William Cibes, Commission Co-Chairperson Patricia Widlitz, Suzanne Bates, Representative Jeffrey Berger, Senator Steve Cassano, Representative Christopher Davis, Tom Fiore, Senator Joan Hartley, Roberto Hunter, Senator Michael McLachlan, Lori Pelletier, Richard Porth, Ellen Shemitz, Bart Shuldman, Representative Richard Smith, Representative Jonathan Steinberg, Ron Van Winkle, Representative Melissa Ziobron

Staff:

Susan Keane, Committee Administrator, Appropriations  
Amanda Zabel, Committee Clerk, Appropriations

**Call to Order by Chairperson Widlitz**

Chairperson Widlitz called the meeting to order at 10:06 A.M.

**Approval of the Minutes**

Chairperson Widlitz called for a motion to approve the minutes of the May 9, 2016 meeting. Roberto Hunter asked that approval of the minutes be deferred until the next meeting, as the version he received was truncated and he was unable to review the minutes in their entirety. Hearing no objection, approval of the minutes was deferred until the June 6 meeting.

**Answers to Questions Posed to and Raised by the Panel on the Calculation of the Spending Cap**

Tom Fiore presented responses to questions posed during the May 9 commission meeting (the document has been posted on the Commission's website), including three exhibits: 1) Exhibit A, which illustrated the long-term history of uncapped expenditures (fiscal years 1992 through 2016); Exhibit B, which showed capital gains realizations and adjusted gross income (AGI) reported by Connecticut residents for income years 1994 through 2014; Exhibit C, which laid out the components of the Bureau of Economic Analysis (BEA) definition of person income.

Mr. Fiore explained the various components of the Exhibit A spreadsheet.

Referencing line 13 (Estimated Federal Share of Medicaid) and line 14 (Total Appropriations Less Est. Federal Share), Chairperson Cibes observed that it appeared that in line 14 Mr. Fiore had backed out the federal share of Medicaid, starting in FY 1992 even though at the time it was appropriated. Further, he stated that when fiscal years 14, 15 and 16 are examined, it appears that one is looking at an "apples to apples" comparison with earlier years.

Mr. Fiore concurred with Chairperson Cibes' observations.

With regard to exempting the statutory grants to distressed municipalities from the spending cap, Mr. Fiore reminded members of Spencer Cain's remarks at the May 9 meeting regarding the impact of certain exemptions on the capped growth rate. He directed members' attention to the compound growth rate for the "distressed municipalities" grants, which is 3.3%, less than the capped growth rate. Mr. Fiore stated that had there been a more liberal interpretation of expenditures, it might have been wise to include the grants as capped items, as these grants would have been permitted to grow at a 4.3% growth rate on \$1.6 billion in expenditures, instead of the actual 3.3%.

Chairperson Cibes remarked that the Mr. Fiore's presentation illustrates that the spending cap has been pretty effective. He noted that news stories and opinion pieces in recent weeks have claimed that state spending has grown at a profligate rate or that spending has gone wild. He expressed his personal opinion that spending has not gone wild and has stayed within the statutory cap. He asked Mr. Fiore if that was a fair observation.

Mr. Fiore replied that it was a fair observation. He stated that in addition to the spending cap, the state has experienced bouts of decreased revenue, which combined have kept the growth rate to approximately 4.3%.

Ellen Shemitz shared that her predecessor at CT Voices for Children, Shelley Geballe, wrote a primer on the spending cap, where she looked at the average annual growth in appropriated spending prior to instituting the spending cap. Mr. Geballe found that, in the four years prior to the adoption of the spending cap (between 1987 and 1991), the growth rate was 10.8% per year. Further, Ms. Geballe found that between 1979 and 1993, state spending grew at an average rate of 9.6%. Ms. Shemitz stated that Ms. Geballe's figures seem to indicate that the spending cap cut the growth rate by over half. She asked Mr. Fiore if that was consistent with his understanding of the impact of the cap.

Mr. Fiore responded that he would have to verify those numbers. OPM has an exhibit that shows that the rate of growth was much higher before the spending cap came online.

Mr. Shuldman asked how much the state would have saved if a growth rate of 2.39% (using the lesser of CPI and personal income measure) had been applied versus the 4.33% growth rate as currently calculated. In addition, he asked about the treatment of pension and debt obligations and the impact of having those items outside the cap.

Mr. Fiore responded that the budget would be about \$13 billion if the rate of inflation had been used versus \$19 billion. With regard to pension and debt obligations, Mr. Fiore shared that the adopted FY 16 budget was only approximately \$25 million under the cap, so the budget would have been over the cap had the exemption not been enacted.

Suzanne Bates remarked that it appears that capped expenditures are growing at a slower rate than uncapped expenditures. Given how much is being moved to the uncapped category and the rate of growth of uncapped expenditures, she asked Mr. Fiore if he would still say that the budget is growing at a slower rate.

Mr. Fiore replied that the recently passed budget has a growth rate of approximately six-tenths of 1%, all funds, over the prior year. He hasn't looked at the rates of growth for uncapped expenditures versus capped expenditures. However, the overall rate of growth is very low.

Ms. Bates remarked that overall, the growth of uncapped expenditures has been significant. She sought clarification on how the pension unfunded liabilities are reflected in Mr. Fiore's spreadsheet.

Mr. Fiore responded that the spreadsheet shows the SERS/TERS unfunded liabilities as uncapped in FY 16, resulting in the 6.12% compound annual growth rate (CAGR) in column 26. The calculation was then adjusted to remove the \$1.8 billion (as it was considered uncapped for only one year of the 25 years reflected), which resulted in an adjusted CAGR of 4.49% as shown in column 27. Further, he stated that pension expenditures have been growing at a greater rate than the budget. Should pension expenditures remain uncapped, he believes that growth will keep an upward pressure on the uncapped growth rate.

Ms. Bates then asked for clarification on how Medicaid is reflected in the spreadsheet.

Mr. Fiore responded that the growth in the state share of Medicaid is captured in line 6, column 27. OPM backed out \$640 million (the federal share of Medicaid) from the FY 1992 base (see line 13, column 1), which resulted in the 4.38% CAGR reflected in column 27 (the cumulative annual growth rate in "total appropriations less est. federal share" (line 14), as shown in line 14, column 26, which is also shown on line 6, column 27).

Rep. Smith remarked that excluding items from the cap seems to defeat the purpose of the cap. He asked Mr. Fiore to share his thoughts on the issue.

Mr. Fiore replied that in the end, everything needs to be funded from the resources of the General Fund. Regardless of whether items are under the cap or outside the cap, items need to be paid for by the receipts the state has.

Rep. Smith stated that in his mind, if the cap is not acknowledged, then the issue is being avoided.

Mr. Fiore responded that to some extent, Rep. Smith's position was true. He pointed out that the state budget still has to be in balance based on all appropriated funds. Therefore, there are actually two limitations on spending – the expenditure cap and available resources.

Rep. Smith urged the commission be mindful during its deliberations that if the state is going to have a spending cap, it should have a real spending cap, not one that creates exceptions.

Bert Hunter asked Mr. Fiore if FY 16 was the first year the state addressed its unfunded liability issue, and if it wasn't, where are the unfunded liabilities addressed in the numbers presented.

Mr. Fiore responded that the state has been addressing its unfunded liabilities for years, however not to the level they should have been funded. Fiscal year 2016 was the first year that the

unfunded portion of the pension payments was exempted from the cap. He believes that the pension payments in FY 16 were \$2.4 billion and the \$1.8 billion is the underfunded portion. Mr. Fiore offered to provide data on the unfunded liability going back several years. Mr. Hunter replied that it would be helpful to see that data, and an analysis of what it would have looked like if the unfunded liabilities had been exempted over a series of years. He shared that he is gathering information to examine the issue of exceptions to the spending cap, particularly those items that are highly variable. He cited the fluctuations in debt service and the variations of the assumed rate of return on unfunded pension liabilities as variables that could have an unintended impact on the rest of the state budget. He thanked Mr. Fiore for his willingness to produce the requested data.

Chairperson Widlitz observed that, if all was in balance and liabilities has been paid as they were incurred, the commission would be having a very different discussion. The question of what should be exempted from the cap and what should be under the cap is the “push and pull” the commission is facing. She believes that moving all expenditures under the spending cap would result in a dysfunctional state government, with the state unable to provide necessary services. In her view, the dilemma faced by the commission is how to fashion a reasonable cap that doesn’t strangle the state. She remarked that it won’t be an easy task.

Rep. Steinberg concurred with Ms. Widlitz’s observations. He believes that the state’s failure to meet its obligations over the years is egregious and has created an anomalous circumstance that has taken the state beyond the typical balance of revenue and spending. He agreed with Ms. Widlitz’s view that putting everything under the cap would strangle the state’s ability to operate. However, he shared that he finds it difficult to accept the concept of a bifurcated cap definition to deal with the pension anomaly. Rep. Steinberg sees the struggle as being how to create a spending cap for the long term that also recognizes the anomalous circumstances; however, he’s not sure if the current structure would allow for what commission needs to do. He believes that it is part of the commission’s charge to help government “get to the other side” of its failure to pay its obligations.

Rep. Smith stated that he would agree with Ms. Widlitz and Rep. Steinberg’s observations regarding the great difficulty that would result in moving items back under the cap immediately. However, he believes that there has to be a way to phase in returning items back under the cap so that funds are accounted for. Even if the process takes several years, he believes it is one that should be undertaken.

Bart Shuldman asked Mr. Fiore if the numbers presented showed the pension payments made, not including the ARC.

Mr. Fiore replied that the exhibit, in line 4, column 25, shows the unfunded piece only. Further, he stated that the state has been making the total ARC payment for the state employees’ retirement fund since 2011 or 2012, and the teachers’ retirement fund ARC payment since 2008 or 2009.

Mr. Shuldman then asked Mr. Fiore to confirm that the state employees’ pension fund was 42% funded.

Mr. Fiore confirmed the percentage, and shared that the teachers' pension fund is funded in the 50's.

Mr. Shuldman asked, if the state is paying the ARC currently, what level of funding should be reflected for the pension plan.

Mr. Fiore replied that long term projections show the plan being funded at 100% by about 2032. He shared that a lot of the improvement takes place in the last five years. The Governor had commissioned a Boston College study, which called for a plan to flatten out the curve.

Mr. Shuldman asked if the state's debt had recently been downgraded.

Mr. Fiore replied that it had, by two rating agencies.

Mr. Shuldman asked Mr. Fiore to share his thoughts on putting all the pension-related expenses under the spending cap so that all state expenditures were accounted for in one place, thereby identifying the level of revenue needed.

Mr. Fiore responded that the answer depends on the commission's perspective regarding the treatment of pension items. The decision was made to take the unfunded pension liability outside the cap not only because it is a fast growing item, but there was a recognition that the state does want to fund its long term obligations and those obligations are like a debt component in the state budget.

Mr. Shuldman inquired as to how the items outside the cap are funded.

Mr. Fiore replied that they are funded through the resources of the General Fund. He reminded commission members that the restrictions on spending are twofold – the expenditure cap calculation and available revenue.

Mr. Shuldman questioned if the rating agencies were looking at the unfunded liability being outside the cap and growing, as well as the state's borrowing and the decline in revenue.

Mr. Fiore offered that the rating agencies look at a number of factors. One of the attributes the agencies ascribe to Connecticut is that the pensions systems have been funded, although not at a ratio the agencies would like to see. Further, he shared that the two agencies that gave the state downgrades did comment favorably on the FY 17 budget and the structural changes that were made. However, the agencies view the state's Rainy Day Fund as not being sufficiently funded.

Lastly, Mr. Shuldman asked if in the FY 17 budget, all the savings are known or is some to be determined.

Mr. Fiore replied that there is a targeted amount of savings that the Governor and OPM need to realize. OPM is working on the plan to achieve those savings. He can provide that figure to commission members.

Chairperson Cibes pointed out to members that whether or not the unfunded liability is reflected under the spending cap or outside the cap, it is and has been funded over the years in an appropriations line. He added that the unfunded liability had consistently been included under the spending cap until Fiscal Year 16.

Mr. Cibes then spoke to the issue of payments made to the state employees' pension fund. He observed that the state promised retirees a certain amount of money; however, a number of collective bargaining agreements over the years allowed for reduced payments to the fund. Further, the accrued liability for current employees is far less than that for employees who have served over 30 years and are in Tier I. He shared that in many years in the 1990's and 2000's the state failed to pay the required payment to the pension system, a practice frowned upon by rating agencies. He stated that the state owes this money, has failed to pay it, and must now find a way to do so, as the state owes it to retirees to make them whole.

Mr. Cibes sought clarification regarding the "annual required contribution" and "normal costs." He asked Mr. Fiore if the "annual required contribution" includes the payment that is required for past pension and normal cost, or does the annual required contribution only refer to the normal costs for each year for current employees.

Mr. Fiore replied that he was referring to normal cost and past service liability.

Mr. Cibes then asked Mr. Fiore if normal cost generates enough money so the state will not experience an unfunded liability for current employees.

Mr. Fiore responded that Mr. Cibes was correct - that is the actuarial theory and should work out to that end.

Mr. Cibes shared that he feels it seems fair to include the normal cost under the cap, as it changes with collective bargaining agreements and it is far less than the total annual required contribution, which includes the past service liability. Further, he remarked that he believes the past service liability is an evidence of indebtedness and the General Assembly was right to consider it as such. He observed that bond rating agencies and the Governmental Standards Accounting Board regard past service liability as debt, and that the teachers' retirement system, by taking a pension obligation bond, converted a portion of its past service liability to an explicit debt service obligation.

Ellen Shemitz sought clarification regarding removing the unfunded liability from the cap. She asked Mr. Fiore to confirm that when the \$1.8 billion was taken out from under the cap there was a substantial rebasing, so that rather than creating \$1.8 billion in growth room, the growth allowed was in the hundreds of millions.

Mr. Fiore replied that Ms. Shemitz was correct.

Rep. Ziobron thanked Mr. Fiore for the data he produced for the commission. She stated that the commission had not yet discussed a concern of hers – the amount of intercepts and bonding for

programs that were previously appropriated. She asked Mr. Fiore if he could provide data on what the total is for those items.

Mr. Fiore replied that he could produce that data, but it would take some time. He cited CT-N as an example of an item funded through a revenue intercept that could be funded through the General Fund, and Town Aid Road as a program that had previously been funded through the budget that was now funded through bonding.

Rep. Ziobron commented that these funding mechanisms are why she believes taxpayers feel their dollars are not being properly stewarded. She shared that the bond package to be considered by the House of Representatives contains items that were previously appropriated. Further, she expressed her frustration that the General Assembly does not have a “ways and means” committee to craft a budget. She thanked Mr. Fiore for his willingness to gather the data she requested and told him that five years of data would be sufficient.

Chairperson Cibes supported Rep. Ziobron’s request. He informed the members that the Department of Economic and Community Development (DECD) maintains a list of other off-budget items that are subsidies of various kinds, including tax credits. He shared that an organization in Washington, Good Jobs First, has developed a subsidy tracker that has drawn on the DECD data. The organization found that since 1992, a total of \$4,246,000,000 in subsidies have been given to Connecticut businesses, either through bonding or tax credits. He remarked that tax credits significantly diminish the availability of revenue to support the appropriations process. There have been 2,954 in various subsidies issued to companies in the state. The DECD data includes bonding, intercepts and tax credits.

Rep. Ziobron thanked Mr. Cibes for the information and asked that the link to DECD’s website be shared with members.

Ms. Bates commented that more money will be going into the other postemployment benefits (OPEB) fund next year. She asked Mr. Fiore if that funding will be under the cap.

Mr. Fiore replied that those funds will be capped, unless the General Assembly enacts legislation taking it outside the cap.

Ms. Bates stated it appeared that the unfunded liability of the teachers’ retirement system was still growing, perhaps because the discount rate is so high. She asked Mr. Fiore if this was correct.

Mr. Fiore responded that the discount rate has been lowered from 8.5% to 8% recently. That action will impact the FY 18 budget development, as the line item will have to be increased quite a bit.

Ms. Bates then asked if the unfunded liability has grown or come down since the pension obligation bond was issued.

Mr. Fiore replied that the funded ratio has come down, in large extent due to the stock market performance and the two major corrections experienced since 2001. The rate of return has dragged, according to Mr. Fiore. He shared that data show that the funded ratio was 70% in 2008. It dropped to a low of 55% in 2012, and was at 59% in 2014.

Mr. Fiore then presented Exhibit B, which was developed in response to a question posed at the May 9 meeting regarding a history of the capital gains realizations by Connecticut residents. He shared that capital gains are primarily paid by high net worth individuals, most of whom earn \$1 million or more. He drew members' attention to FY 2007, which was a peak year of \$21 billion in realized capital gains before the financial markets collapsed. He pointed out that the following year, capital gains fell to \$8.3 billion (a 60% drop) and \$5.1 billion in 2009. Mr. Fiore stated that this variability illustrates what the May 9 panelists discussed regarding the difficulty in forecasting capital gains. Forecasting is further complicated because the data are not complete, as it is not just a matter of how the markets are performing, but what people are doing with their money – whether or not they are holding on to their stocks. He cited another example of variability in 2000. Although the markets had started to pull back, capital gains went up due to large increases in the stock market over the preceding seven years. In 2000, people received large pools of previously unrealized capital gains.

In response to a question posed on May 9 regarding when OPM receives data, Mr. Fiore informed members that the data is generally two years behind. The 2014 data will be received in September 2016 from the Internal Revenue Services and the state Department of Revenue Services. He shared that OPM has preliminary data, but it is not very valuable as it is from people who file on April 15. Most high net worth people file their returns in October, and these are the very people on whom OPM needs the data.

Chairperson Widlitz referred to discussion at a previous meeting regarding enacted legislation that seeks to control the rollercoaster impact of capital gains. She asked Mr. Fiore to review that legislation with members again.

Mr. Fiore explained that the state will look at the estimates and finals component of the income tax, under which are most of the capital gains, and at the corporation tax, which is another volatile revenue source. To the extent that those two revenue sources exceed a certain level of a ten year average growth rate, monies will be set aside within a fiscal year and will then be deposited at the end of the fiscal year into the Rainy Day Fund. The legislation will go into effect in 2020.

Mr. Shuldman wondered if it would be better to put the monies toward the pension funds, rather than the Rainy Day Fund.

Mr. Fiore replied that OPM staff debate that issue on an on-going basis. He offered that there would be trade-offs to each approach. If the monies were put toward the pension funds, they would yield the assumed actuarial return rate of 8%. If the monies go to the Budget Reserve Fund, they would be used for the state's daily cash needs or would be invested in much shorter term investments, which have lower rates of return. However, he informed the members that



rating agencies have cited Connecticut's low level of funding in the Rainy Day Fund, and would prefer that the state have the flexibility to respond to needs during a recession.

Mr. Shuldman asked if the process had to be so concrete. He wondered if there could be flexibility to put monies into the pension system when times were particularly good, and to address the Rainy Day Fund after the pension systems were addressed.

Mr. Fiore replied that one of the benefits of the spending cap language is that it has allowed governors to issue a declaration regarding the use of surplus funds. While the pensions were not addressed, cash was used to pay for items that otherwise would have been bonded, like school construction.

Chairperson Cibes remarked that such flexibility could be accomplished through general legislation, with a majority vote process, rather than through a provision of the spending cap, which would require a three-fifths vote.

Ms. Shemitz asked hypothetically if there should be an exceptional year that yielded additional revenue, wouldn't the unfunded liability need to be outside the cap in order to make an additional appropriation toward the pension funds. Otherwise, should the unfunded liability be under the cap, the growth in a particular year might not allow for the additional appropriation.

Mr. Fiore responded that if there was the desire to exceed the cap to make such an additional payment, a majority vote would be required.

Ms. Shemitz remarked that if the commission were to define the spending cap in a restrictive manner, it would prevent the kind of proactive response to the markets in order to correct past mistakes, as had been discussed by members.

Mr. Fiore concurred with Ms. Shemitz's remarks.

Rep. Ziobron pursued the pension fund scenario that had been discussed by other members. She asked if there was an executive branch process that would allow for additional monies to be put toward pension liabilities, while retaining a restrictive spending cap definition.

Mr. Fiore replied that General Assembly would need to enact legislation. The executive branch could not take action on its own.

Ms. Bates remarked that having a Budget Reserve Fund provides protection from having to make deep cuts during a recession, while allowing the state to make pension payments at a steadier rate. She referenced the provision in last year's Budget Reserve Fund legislation that funnels money into the pension fund once a certain threshold has been reached, thereby providing a mechanism to address the pension fund over time. She commented that it will take a while for the state to have such a robust Budget Reserve Fund.

Chairperson Cibes pointed out the additional columns in Exhibit B, which deal with the federal AGI. That data speak to the question that had been posed at an earlier meeting regarding

whether AGI is a better measure than personal income. Mr. Cibes suggested that the commission will need to discuss that question in greater detail at a future meeting. In the meantime, he advised members that Exhibit B shows how AGI had changed and that AGI includes realized capital gains.

Mr. Fiore explained the other components of the chart. Federal AGI is transferred from a resident's federal 1040 return to the CT return, where some adjustments (both positive and negative) will be made. On the addition side, municipal bond interest income is the largest adjustment, as Connecticut does not exempt such income from other states. On the subtraction side, Mr. Fiore explained that the largest adjustment (about 60%) is on Social Security, as it is treated very favorably on the state level.

Referring to the CT AGI column, Mr. Fiore pointed out that AGI peaked in 2007 at \$158 billion, then dropped in 2008 to \$140 billion, a decline of \$18.2 billion, with capital gains accounting for \$12.7 billion of the \$18.2 billion. He pointed out that the following year, CT AGI dropped to \$129 billion; that was the year CT started losing jobs. By the bottom of the recession, the state lost approximately 119,000 jobs.

Mr. Fiore then reviewed Exhibit C, which addressed the question of what is included in the definition of personal income. He explained that the definitions presented in Exhibit C are from the Bureau of Economic Analysis. In 2014, CT personal income totaled \$233 billion versus \$161 billion in AGI. Mr. Fiore stated that there are factors that account for the wide spread, one being that the federal government makes an imputed calculation for the value of a person's home as if that person were renting it. He cited additional factors including the employer contributions for healthcare and pensions, which are included in the BEA definition of personal income.

Chairperson Widlitz commented that she had not been aware of the imputed calculation and found it quite interesting.

Mr. Fiore explained that the imputed calculation for the value of a home is a non-cash component that doesn't show up on a tax return. The BEA believes it should be included in personal income. He stated that doing so, however, is a drawback when looking at what is received in tax receipts by DRS.

Chairperson Cibes remarked that as the commission delves more deeply into personal income at future meetings, the commission must keep in mind that imputed net rental income is not part of the revenue base, nor are employer contributions for healthcare and personal income. He believes that those factors illustrate the downside to using personal income as a measure.

Hearing no further questions, Chairperson Widlitz thanked Mr. Fiore for his presentation.

Chairperson Widlitz called upon Michael Murphy and Chris Wetzel from OFA to present the Revised FY 17 Statutory Spending Cap Calculation, which had been requested at the May 9 meeting.

Chairperson Cibes observed that the final budget is well below the spending cap (\$613 million), as anticipated.

Chris Wetzel reviewed the revised calculations. He pointed out that the FY 16 calculation was changed based on deficiency appropriations and a revised debt service level.

Rep. Ziobron asked if the spending cap calculation for FY 16 would be impacted should there be the need to transfer dollars from the Rainy Day Fund to cover a deficit.

Mr. Wetzel replied that, as transfers from the Rainy Day Fund are exempt under the statutory cap definition, the FY 16 cap calculation would not be impacted.

Rep. Ziobron had asked at a previous meeting how the definition of distressed municipalities is developed and by whom at DECD. She repeated her request for that information

Mr. Wetzel confirmed that DECD manages that information, but he does not know who specifically at DECD is in charge of the process. He referenced the link to the DECD website cited in a previous OPM document.

Rep. Ziobron referenced the note on the spending cap calculation document regarding the adjustment in FY 17 to reflect new distressed municipalities. She asked Mr. Wetzel to identify the changes.

Mr. Wetzel replied that he did not have the details with him regarding which municipalities stayed on the list and which municipalities were added or dropped off. He did share that the note referred to OFA's practice to rebase the calculation based on the latest data should any changes be made to the list of distressed municipalities.

Rep. Ziobron asked the administrator to send the link to the DECD distressed municipalities website to commission members.

Ms. Bates asked had the unfunded pension liability been included under the cap in FY 16, would expenditures have been over the cap.

Mr. Wetzel replied that they would have.

Mr. Shuldman asked how revenue projections factor into the process.

Mr. Wetzel explained that revenue projections are part of the consensus revenue process conducted jointly by OFA and OPM. Regarding out year projections for the spending cap, Mr. Wetzel explained that OFA looks at the current services projections for future budgets, including statutorily required adjustments to current levels of funding and inflationary adjustments, on an account by account basis. That data is run through a formula to project spending cap levels for future budgets. He shared that in OFA's most recent projections, the FY 18 budget would be under the cap, while the FY 19 and 20 budgets would be slightly over the cap.

Mr. Shuldman remarked that FY 16 revenues were significantly below the projections. He asked how revenue and growth rates are calculated.

Michael Murphy explained that OFA is constantly reviewing the current year revenues and that projected revenues for the out years are also being reviewed. OFA looks at the current year revenues and adopts growth rates for each revenue stream. He shared that OFA has adopted an assumed growth rate overall of 2.8%, which is lower than anyone in OFA can remember. He concurred with Mr. Shuldman's assessment of the FY 16 projections. Mr. Murphy informed members that the largest component of the income tax shortfall was attributable to 50 taxpayers. He stated that in either 2013 or 2014 those taxpayers' payments comprised 8% of the total income tax revenue. Such reliance on those taxpayers creates an inherent volatility. He added that there was a significant shortfall in other taxpayers' estimates and finals, and that withholding growth was less than expected. Mr. Murphy referenced the November Fiscal Accountability report, in which the projected expenditure growth matched the projected revenue growth. He stated that revenue growth has been consistently less than projected, even before fiscal year 16. OFA is considering a new methodology for projections, which if adopted would be reflected in the November report.

Rep. Smith referenced an earlier discussion regarding the potential for a phase-in of returning items back under the cap. He asked Mr. Murphy if there was a process for a phase-in that would be workable.

Mr. Murphy responded that such a process would be a policy decision by the legislature. He stated that OFA would use any inputs directed by the General Assembly.

Chairperson Widlitz commented that, while it was tempting to ask for OFA's opinion given their expertise, it was the responsibility of the legislature to develop policy and for OFA to do its best to implement policy.

Hearing no further questions, Chairperson Widlitz introduced Daniel Kennedy, a former senior economist at the Department of Labor (retired) and an adjunct professor of economics at the University of Connecticut. Mr. Kennedy was invited to give a presentation on the measurement of the changes in price level, inflation and deflation (Mr. Kennedy's PowerPoint presentation, "Spending Cap Considerations Related to Consumer Price Indexes" is on the Commission's website).

Following Mr. Kennedy's presentation, Chairperson Cibes remarked that the commission wants to look at the "basket of goods and services" that government purchases. He remarked that both the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) tend to measure the "basket of goods" purchased by consumers. He asked Mr. Kennedy if there is a measure of inflation on the "basket of goods" purchased by government or alternatively, which measure – CPI or PCE – is closest.

Mr. Kennedy responded he is not aware of such a measure. He added that CPI, and perhaps PCE, try to measure some of the public goods that are consumed by consumers, but not by

government. He offered that, while he couldn't say for certain, perhaps PCE might be the better of the two measurements to use.

Mr. Shuldman concurred that the commission should look at the cost of government. He referenced *Digital Deflation*, by Graham Tanaka, in which Mr. Tanaka writes of his study of measuring the cost of buying a computer for the same price each year, while the cost of other related factors increase. He added that both CPI and PCE do not account for that. Mr. Shuldman asked Mr. Kennedy how to account for similar factors in determining the cost of government.

Mr. Kennedy responded that the specifics for looking at the cost of government would have to be determined.

Chairperson Widlitz asked if CPI would be a better indicator of the taxpayer's ability to pay than government inflation. Additionally, she asked Mr. Kennedy which of the measures currently in the statutory spending cap language – inflation rate or growth in personal income – would be the better measure of what is reasonable for the taxpayers.

Mr. Kennedy responded that two indices should be examined – one that measures the cost of government to purchase things, and one that measures what consumers can afford.

Rep. Ziobron asked if there is an index specifically for Connecticut. She cited the state's high cost of living. She wondered if there were state by state indices published.

Mr. Kennedy replied that the Bureau of Labor Statistics (BLS) publishes indices for thirty metropolitan areas. Information on the three largest metropolitan areas (New York, Los Angeles, and Chicago) is published monthly. These three areas are considered Consolidated Statistical Areas (CSA), which are areas comprised of two or more metropolitan areas that have grown together. Fairfield County is considered to be part of the New York CSA. Mr. Kennedy informed members that one or two towns in Northern Windham County are included in the Worcester MSA. Hartford does not have its own index and he is not aware of any plans to develop one.

Rep. Ziobron asked that the links provided by Mr. Kennedy in his presentation be sent to members.

Chairperson Cibes referred to Mr. Shuldman's remarks regarding *Digital Deflation* and the issue of productivity changes. He stated that many of the services government provides are not productive; rather they are face to face personal services that are not subject to the use of technology as would be reflected in Moore's Law, according to William Baumol. He believes the commission will need to make a distinction between goods and services that are productive and those that are not, and will need to seek out what will best suit the commission's deliberations.

Mr. Shuldman asked if the computer issues experienced by the Department of Motor Vehicles would be part of the discussion.

Chairperson Cibes replied that Mr. Shuldman made a legitimate point, as there are some functions of government that are subject to Moore's Law.

Sen. Cassano asked if any states have created their own index. He stated that, while the state does not purchase things like fruit and milk, it does buy construction and highway materials, it does pay salaries, and it provides services to its citizens. He believes that, in reality, the spending cap has nothing to do with the CPI. Further, he believes the spending cap should be based on the services provided to state residents. He asked Mr. Kennedy if he knew of states that had constructed a spending cap to reflect that point.

Mr. Kennedy responded that he did not know of any states that had done such. He added that Sen. Cassano's remarks got to Chairperson Cibes' comments regarding developing an index for public services consumption.

Mr. Fiore referenced a calculation that might be close to government expenditures – the GDP calculation, which includes the implicit price deflator. He stated that there is one for state and local government. He asked Mr. Kennedy to comment on using this as a measure.

Mr. Kennedy replied that the implicit price deflator is at a more general level and does not get into the detail discussed by commission members.

Mr. Fiore stated that the biggest component of government expenditures is personnel costs.

Mr. Kennedy stated that the idea behind the implicit price deflator for GDP is to try to measure the quantity of output, rather than the price indices, which get at trying to measure expenditures.

Mr. Fiore asked Mr. Kennedy if he thought it would not be a good indicator of the goods government buys.

Mr. Kennedy replied that he would not rule it out. He offered that his comments were to point out that it is important to recognize the difference in the two types of indices.

Mr. Hunter commented that, over the long term, it's about balancing income and expenditures. One view that can be taken, by those who think they are taxed too little, is to look at expenditure growth over time and match income to that amount. Another view, taken by those who believe they are taxed too much, would be to look at income growth over time and match expenditures to that amount. He expressed an interest in looking at how to come to terms with projections or growth in the base, based on income. He asked Mr. Kennedy if there were indices to track that.

Mr. Kennedy responded that one could look at the indices that measure real income. However, that gets back to either CPI or PCE when deflating nominal income to determine real income.

Mr. Hunter remarked that it tracks back to decades ago when there were wage rates that moved in sync with some inflationary index. He stated that there are now a number of phenomena in play, such as the shifts in job categories, from high wage jobs to low wage jobs, which have resulted in lower income growth. He further remarked that there are a number of challenges that

need to be faced, such as paying for the unfunded pension liabilities and an uncertain outlook in the stock markets, along with a citizenry that is still under stress from the recession.

Mr. Kennedy commented that when a recession is accompanied by a financial crisis the recession is deeper, it lasts longer, and it is followed by a weaker recovery. He stated that this situation is putting pressure on the state's revenue component. He further stated that government and non-profits face a paradoxical situation, for when demand for their services increase, their revenues decrease. He advised that this should be considered during deliberations.

Mr. Porth commented that he found the last exchange to be interesting. He observed that the commission has a defined charge to create or refine a formula to cap expenditures, yet the social contract, the role that government plays, has changed over time. The proportion of government spending has changed as people have said they want more out of government or less. He urged commission members to keep the larger context and the role of government in mind in their deliberations. He cautioned that if their deliberations are just a matter of creating a formula, policy decisions will be made that will prevent future elected leaders from making decisions on behalf of the people and what they want from government.

Chairperson Widlitz thanked Mr. Kennedy for his presentations and the subsequent discussion.

Chairperson Widlitz then shared the results of the Doodle poll. The majority of respondents indicated that the first and third Mondays at 1 pm were the preferred meeting times. She announced that the June meetings would be held on June 6 and June 20 at 1 pm. The June 20 meeting will include a presentation by Comptroller Kevin Lembo.

Mr. Hunter informed members that he would be out of state on June 20. He requested some telephonic or "Go to Meeting" type accommodation.

Chairperson Widlitz assured him that an accommodation would be made.

Seeing no further discussion, Chairperson Widlitz adjourned the meeting at 12:26 PM.

Respectfully submitted,

Susan Keane  
Appropriations Committee Administrator