

Spending Cap Commission Written Testimony

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Chairman Cibes, Chairwoman Widlitz, and members of the Spending Cap Commission, thank you for the opportunity to speak with you about the state spending cap. I'd like to thank Sens. Hartley and Kane for asking me to appear. I also want express my appreciation to all commission members for your investment of time and energy to serve on this commission.

Formulating definitions for key spending cap terms and holding the line on exemptions from the cap in the name of fiscal responsibility will have a significantly positive impact on businesses' willingness to invest here and on our state's socio-economic future.

I am a Middlebury resident who was born and raised and works in the great city of Waterbury in our great state of Connecticut. I'm chairman and chief executive of Webster Bank. Webster was founded by my father, Harold Webster Smith, in Waterbury in 1935, the depth of the Great Depression, to help his neighbors build and buy their own homes. Over the years we've grown to become one of the largest commercial banks headquartered in New England.

For all of our recent growth into markets beyond Connecticut's borders, Connecticut remains our most important market, accounting for nearly 70% of our 185 banking offices and over 70% of our 3,300 bankers. Webster serves one of every nine Connecticut households and about 30,000

Connecticut businesses. Yet as Connecticut's growth has lagged the nation and the region in recent years, most of our growth is coming from faster growing regions in the Northeast.

As a bank, Webster is part of our state's infrastructure, making loans to finance the plans and dreams of Connecticut consumers and businesses, working with municipalities to help them achieve their financial goals and working with state government to support economic development. To a significant degree, as Connecticut goes, so goes Webster, since our balance sheet is a reflection of the well-being of the customers and communities we serve. Our success depends on the state's ability to create a stable, competitive economic environment where people can start and expand businesses and families, with confidence in the future operating environment. We feel we have a duty to our customers and communities to speak out on important policy issues, like the spending cap, as we strive to be a catalyst for positive economic change. We are driven by policy, not partisanship. We listen closely to our customers, and we share with you the thoughts and concerns of many of them today.

I am deeply concerned for the state's fiscal condition, which I think we can agree is deteriorating. I strongly believe that fiscal pressures and related uncertainty regarding taxes and regulatory rules are largely responsible for the low and waning confidence expressed by businesses and consumers and is contributing to our alarmingly low standing in surveys measuring the business environment and economic prospects in states across the country. CBIA surveys consistently have cited high taxes and the state's perilous finances as primary reasons. You've seen the CNBC surveys and

others that consistently rank us in the bottom 10-15 % of states with regard to the overall business tax burden. The 2016 State Business Tax Climate Index prepared by The Tax Foundation ranked Connecticut 44th among the 50 states.

It's well known that Connecticut has yet to recoup all of the jobs lost in the Great Recession and that we lag well behind the nation in economic growth. In fact, private sector employment is about what it was in 1990. At the same time, many of the jobs that are being created are in lower-paying sectors of the economy, so personal income is growing slowly. At the core of our stubbornly slow recovery lies a profound lack of confidence among businesses, large and small, in the sustainability of state fiscal policies. Despite the two largest tax increases in state history in recent years, our state nonetheless remains mired in an endless cycle of budget crises with no end in sight. Recent estimates from the Office of Fiscal Analysis indicate deficits in excess of \$1 billion for fiscal years 2018 through 2020.

This crisis atmosphere has had a predictable impact on business confidence. From Webster's perspective, business confidence is the animal spirits that seem to have decamped from Connecticut, leaving us to lament our losses. We are seeing a diminished appetite for capital investment among our state's businesses compared to what we customarily have seen in the past. Many of our clients are being acquired rather than becoming active acquirers. As a barometer for the future, these signs do not portend a robust economy that provides good jobs for our children and grandchildren.

More and more people are losing confidence in our ability to achieve fiscal sustainability given the 'new economic reality', asserting that the challenges are insurmountable and apparently accepting our fate as a second tier state sinking deeper into that "economic cul-de-sac" that Michael Gallis, the expert on state competitiveness, warned us about in 1999. I'm confident that we can turn it around if we adopt a 'control our destiny' approach to solving our fiscal problems, and that begins with you. You have it within your power to change the course of events by defining the spending cap, and especially the exemptions, in a way that sustainably controls total state spending, lowers the state's cost of doing business and improves public sector productivity, and enables investment of the savings in programs and infrastructure improvements that will facilitate and encourage economic investment, thereby increasing business confidence and job creation. If we do not instill businesses with confidence in our state's leadership and finances, the attrition of businesses to other states will accelerate.

Businesses in this state are vitally interested in what this commission recommends. I would rate achievement of a functioning, effective spending cap as their number one priority. The commission's recommendations will be closely watched to determine the level of discipline it seeks to impose on future spending, and taxes. You can be sure that businesses will make investment and location choices accordingly.

The plain truth is that our state has promised more than it can afford, or has been willing to fund, over many years. Governors and Legislatures made

and underfunded forward commitments for decades and only recently have begun to defease them. Not funding those commitments is the primary reason we're in the difficult situation we're faced with now, since it led directly to more spending under the cap, which would not have been possible had that funding occurred more responsibly. Now two powerful forces are colliding, threatening to push spending even higher...the need to fund our promises previously made, and the willingness of the legislature to continually raise taxes to meet seemingly insatiable overall spending desires.

As the required funding trajectory for unfunded liabilities now rises, some favor exempting these expenses from the cap. This is 100% contrary to the intent of the constitutional amendment, and I believe it's the biggest issue facing the commission.

The spending cap was intended to enforce fiscal discipline by limiting spending, and 'limit' is the key word in the constitutional amendment. This would require government to decide what to fund...and, importantly, what not to fund...and to make decisions that enable efficient management of government within our appropriately constrained ability to increase revenue consistent with growth in personal income or inflation.

Pushing fast-growing expenses out from under the cap in order to nominally comply with the cap while still satisfying our spending habit defeats the cap's purpose and the voters' intent. It's like trying to eat our cake and have it, too. Most recently a simple majority of legislators moved \$1.9 billion in payments toward unfunded pension liabilities outside the cap,

freeing up approximately \$100 million in additional spending under the cap this year. Such maneuvers violate the will of voters and only serve to make our finances more precarious. Unchecked, these maneuvers will surely produce a catastrophic result and would be the ruin of Connecticut. Exemptions from the cap now comprise approximately 30% of state expenditures. Remember that in the end, it's total spending that matters most, since that is the basis for determining appropriations and taxes.

The constitutional amendment envisioned that only debt service was to be exempted, since placing debt service under the cap could unsettle the credit markets, raise the state's cost of borrowing and possibly lead the state to postpone needed infrastructure improvements. I believe that only debt service should be exempted in the future since the fewer the exemptions, the more likely we can achieve true fiscal discipline. A case in point is that over the last forty-five years, total appropriations have grown at well over twice the rate of personal income.

We need to resurrect our Inner Yankee and become the "Land of Steady Habits" once again on spending. Despite its currently flawed status, the spending cap has acted as a brake on spending, encouraged bipartisanship, and spurred innovation in program delivery and organization of state government. And if the cap had been faithfully observed since 1992, cumulative state spending would have been reduced by as much as \$5.5 billion.

The spending cap was adopted by more than 80% of voters as part of the grand bargain that led to the state income tax. I urge you to adopt

definitions that allow the cap to work as voters intended. With proper definitions, an effective spending cap will encourage working across the aisle in the General Assembly, force our leaders to prioritize spending, and lead to new ways to deliver state services more efficiently.

To those who say that the spending cap is blind to needs, I point to the cap's safety valve. By a gubernatorial declaration and a three-fifths legislative vote, the cap can be exceeded, providing sufficient flexibility to respond to unforeseen needs.

Another area that needs attention is the Budget Reserve Fund ('rainy day fund') which is designed to protect surpluses to plug revenue shortfalls in recessions. Much of the surpluses were appropriated by the Legislature for other purposes such that in the early 2000's, when our state ran more than \$5 billion in surpluses, only about \$1.5 billion of that went to fill emergency revenue gaps or to retire outstanding obligations.

Had the Legislature faithfully adhered to the spending cap, Connecticut's rainy day fund in 2008 would have been over \$2 billion greater. A larger balance in the rainy day fund could have significantly reduced the need for subsequent tax increases. And as any economist will tell you, a recession is not the time to raise taxes. I hope your recommendations will include some reference to the need for tighter oversight of the BRF.

As you craft definitions, I urge you to consider to these thoughts,

1. In my view the most important issue the commission faces is deciding what expenditures should be included under the cap. The spending cap should be comprehensive and include all state spending other than debt service as envisioned in the constitutional amendment. The selective removal from the cap of fast-growing budget items guts the value of the cap and defeats the will of voters by allowing otherwise unallowable spending increases which in turn raise taxes.
2. Specifically, contributions to meet unfunded pension liabilities (and other post-employment benefits) should be under the cap, since this is one of the state's largest and fastest-growing expenditures. Yes, this will lead to hard choices, as envisioned in the constitutional amendment... and hard choices are required for Connecticut to regain competitiveness.
3. The definitions for income growth and the inflation rate should look back over at least five years to smooth out volatility and ameliorate the impact of one-time events.
4. Capital gains should continue to be excluded from the calculation of personal income due to their inherent volatility. Capital gains are subject to numerous influences beyond the control of the state, including market movements up and down and federal tax increases, such as the 2013 increase that most likely inhibited investors from taking gains and in turn affected state tax collections.

5. In years of revenue windfalls, a meaningful portion of revenue in excess of the cap should go automatically to the BRF with the remainder going to pay down the state's unfunded pension and healthcare obligations, the highest in the nation on a per capita basis.
6. The spending cap must be enforceable and include a mechanism for judicial review in anticipation of potential legislative attempts to exploit any ambiguity in the definitions.
7. Consider these three principles of fiscal responsibility -- stability, predictability, and competitiveness -- in crafting your recommendations:

Stability. Volatility and changeability are anathema to business investment. Businesses seek assurance that state finances, together with the BRF, are on solid footing when deciding where to invest or expand their workforce. The cap should act to protect both taxpayers and recipients of needed services from the unforeseen.

Predictability. Businesses need to have confidence in the state's policy direction. In recent years, the state has made repeated changes to the tax code that penalize businesses or create uncertainty as to tax structure and rates. Recent actions to limit the research and development tax credit, adopt the unitary tax, and restrict the use of net operating loss carry-forwards are prime examples of the whipsawing policy that unnerves businesses and discourages investment. Likewise, state retirees need the confidence

to know that the state can meet its pension obligations while fiscal responsibility requires that we adopt a credible plan for funding them, which we don't have today.

Competitiveness. Competition breeds advantage, while a lack of competitiveness breeds decline, whether for states or nations. Competition lowers costs and enhances affordability by continually improving efficiency and creating the capacity to invest, which otherwise would be lacking. Every service that government delivers should be subject to rigorous competitive review to ensure delivery through the most efficient means, including knowledge of other states' best practices. Our tax structure and rates must be competitive if we are to grow.

When Connecticut voters spoke in 1991, their message was loud and clear. They demanded a mandatory brake on state spending, which would be especially important in times when incomes are growing slowly. We live in such a time.

I urge the commission to recommend adoption of spending cap definitions that will impose constructive discipline on state spending, force our elected leaders to make choices, encourage public sector productivity gains, and regain the public's confidence. If this commission adopts and the Legislature enacts definitions that meet the principles I've shared, Connecticut's businesses will regain the confidence to grow and invest and create jobs.