

# CONNECTICUT COMMISSION ON FISCAL STABILITY AND ECONOMIC GROWTH

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FINAL REPORT  
MARCH 2018

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## DRAFT

v3.1.2018

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# State of Connecticut

Robert Patricelli  
Co-Chair



James Smith  
Co-Chair

COMMISSION ON FISCAL STABILITY AND ECONOMIC GROWTH  
LEGISLATIVE OFFICE BUILDING, ROOM 3700  
Hartford, Connecticut 06106-1591

March 1, 2018

Governor Malloy, the Legislative Caucus Leaders, and the Chairs and Ranking Members of the Committees of Cognizance:

Pursuant to Section 250 of PA 17-2, it is our pleasure to submit to you the report of the Commission on Fiscal Stability and Economic Growth.

While we knew upon undertaking this work that the state faced considerable problems, we now understand that they are even deeper and more urgent than we knew. There is still a solid foundation and much that is attractive about Connecticut, but we have deeply embedded budget imbalances, unfunded liabilities that exceed \$100 billion if properly computed, flat economic growth in contrast to gains in states around us, and declining population in key demographic segments. The good news is that the situation is fixable if we take bold action. We are optimistic about the future, but only if our governmental leaders and the entire General Assembly share our assessment of the situation and are willing to take immediate action.

We are presenting you with a bold "Plan for Connecticut" that we believe is comprehensive and balanced. It will get us on the road to recovery, both in terms of budget stability and economic growth. Notwithstanding the abbreviated session this year, we believe that you have ample time to consider and enact the key elements of this plan. We must emphasize the conditional linkage among the Commission's recommendations. Speaking for all the members of the Commission, we are grateful for having had this opportunity to serve our cherished state, and we stand ready to testify and cooperate further in any way that would be useful.

Sincerely,

Handwritten signature of Robert E. Patricelli in black ink.

Robert E. Patricelli  
Co-Chair

Handwritten signature of James C. Smith in black ink.

James C. Smith  
Co-Chair

[Attachment]

# THE COMMISSION WILL DELIVER RECOMMENDATIONS BY MARCH 1<sup>ST</sup>

The Commission was formed by Connecticut budget PA 17-2 Section 250

*"Develop and recommend policies to achieve state government fiscal stability and promote economic growth and competitiveness....to (1) achieve consistently balanced and timely budgets that are supportive of the interests of families and businesses and the revitalization of major cities within the state, and (2) materially improve the attractiveness of the state for existing and future businesses and residents."*



**Bob Patricelli (Co-chair and Municipal Aid Leader)**  
Former Chairman and CEO, Women's Health USA, Value Health, Evolution Benefits



**Greg Butler**  
Executive VP and General Counsel, Eversource Energy



**Jim Smith (Co-chair and Fiscal Stability Leader)**  
Chairman and Former CEO, WebsterBank



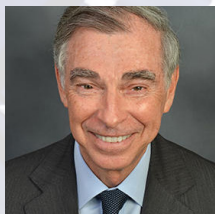
**Roxanne Coady**  
President and Owner, R.J. Julia Booksellers; Chair, Read to Grow, Inc.



**Pat Widlitz (Vice-chair)**  
Former Co-chair of CT Legislature House Financing, Revenue and Bonding Committee



**Eneas Freyre**  
Agent, New York Life Insurance Company



**Bruce Alexander (cities & Transportation Leader)**  
VP of New Haven and State Affairs, Yale University



**David Jimenez**  
Principal, Jackson Lewis P.C.; Member, CT Board of Regents for Higher Education



**Frank Alvarado**  
Veterans Affairs Officer, Small Business Administration, CT District



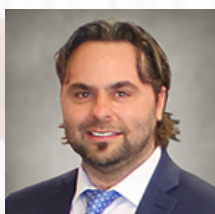
**Jim Loree (Competitiveness & Growth Leader)**  
President and CEO, Stanley Black & Decker



**Cindi Bigelow**  
President and CEO, Bigelow Tea



**Paul Mounds Jr.**  
VP for Communications and Policy, CT Health Foundation



**Michael Barbaro**  
President, CT Realtors



**Christopher Swift**  
Chairman and CEO, The Hartford

# CT HAS A LONG LEGACY OF INNOVATION AND GREAT HUMAN CAPITAL

Pratt and Whitney and Electric Boat made major contributions to the Allied war effort



1945



1939

While living in Connecticut, Igor Sikorsky designed and piloted the first helicopter in the United States

Connecticut businessman and chemist Charles Goodyear invented the process for vulcanizing rubber

1844

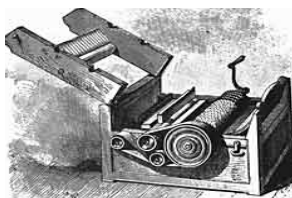


1832

Quaker teacher Prudence Crandall created 1st integrated schoolhouse

Connecticut resident Eli Whitney invented the cotton gin, leading the way into the industrial revolution

1794



1701



Yale University is the third oldest university in the United States

CT forefathers drafted "Fundamental Orders," becoming the first colony to adopt its own Constitution

1639



# EXECUTIVE SUMMARY

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# EXECUTIVE SUMMARY

PA 17-2 at Sec. 250 established a Commission on Fiscal Stability and Economic Growth to develop and recommend policies to achieve state government fiscal stability and promote economic growth and competitiveness within the state. The 14 private citizens appointed to the Commission present these recommendations based on a sober recognition that Connecticut is in quiet crisis by every measure: consistent budget imbalances, growing unfunded liabilities, falling bond ratings, stagnant economic growth, competitive disadvantages compared to neighboring states on most important indices, and increasing outmigration.

The legislature must act, and we believe it wants to do so. The legislature needs a plan, and we are presenting one that we believe can appeal to all segments and build a stronger and more prosperous future for Connecticut. Through our hearings and many conversations across the state, we believe there will be support for this plan. The time to act is now.

## KEY FINDINGS:

- While neighboring states and the United States as a whole have economies that are growing, our economy is shrinking—it is actually smaller than it was in 2004;
- We are losing ground on numerous key measures of competitiveness: tax climate, business climate, transportation quality, vitality of cities, and more;
- We are facing ongoing budget deficits of \$2 billion - \$3 billion in FY 2020 and beyond, growing by \$500 million per year.

State government's fiscal instability is itself a root cause of our poor economic growth because it leads to a lack of confidence by the business community and among state residents. Reigniting economic growth requires Connecticut to regain fiscal stability. The Commission's recommendations offer a roadmap for legislative action starting this session. This plan will not improve the situation overnight, but it does put Connecticut on a sustainable path.

## KEY RECOMMENDATIONS

In this report, the Commission will propose ten major recommendations:

1. Enact a revenue neutral rebalancing of state taxes (which becomes revenue positive when coupled with economic growth) that reduces income taxes in every bracket, selectively raises taxes on business, raises the sales tax rate by less than 1%, cuts exemptions and exclusions from all taxes by 14%, and eliminates the dwindling estate and gift taxes.
2. Raise the gas tax to fund transportation projects and produce a plan for eventual implementation of electronic tolls.
3. Create a Joint Budget Committee of the legislature with the power to set limits on revenues and expenses.
4. Have the legislature assume the responsibility to define state employee fringe benefits by removing them from collective bargaining for new contracts.
5. Amend binding arbitration laws to permit award of compromise outcomes.
6. Develop and implement a plan to cut \$1 billion out of annual operating expenses.
7. Reform the Teachers' Retirement System to lower costs and to make it sustainable by paying down unfunded liabilities.
8. Reinvest in transportation and cities, and build a major new STEM campus in one city in partnership with a major research university.
9. Undertake a series of growth initiatives, led by the executive branch, with the funding and support from the legislature to (1) develop and retain the workforce Connecticut needs, (2) support the growth of Connecticut's highest-potential economic sectors and (3) transform the business environment for entrepreneurship and innovation.
10. Diversify municipal revenue streams beyond the regressive property tax and stimulate regional service delivery.

The Commission also proposes linkage in the phasing of several of these proposals to ensure balance across all sectors for the above recommendations.

## SUMMARY OF TAXES, SPENDING AND INVESTMENTS

### TAX REFORM

Our tax reform proposal is based on re-balancing the income tax, sales tax, and business taxes—by approximately \$2.3 billion in total when fully implemented:

- **Personal Income Tax:** Dramatically reduce personal income tax rates, phased in over three years starting in FY 2020, by 18% in the top bracket (from 6.99% to 5.75%), by similar or greater amounts in lower brackets, and to zero for incomes below \$10,000. Reduced by \$2.1 billion when fully implemented in 2023.
- **Sales Tax:** Starting in FY 2020, increase the sales tax rate from 6.35% to 7.25% to help balance the loss of revenue from the income tax reduction (adding \$1.0 billion). Connecticut is currently quite low- 41st in the nation-in terms of sales tax burden as a percent of total personal income.
- **Corporation Tax:** Increase business taxes starting in FY 2020 by approximately \$475 million as a target. This would be accomplished by adding a tiered payroll tax of 0.8% on payrolls, but with a full credit (exemption) for the first nine employees, and a half credit for the next 10 through 99 employees.
- **Exemptions:** Starting in FY 2020, eliminate a significant proportion of the current “tax expenditures” (exemptions and deductions) that have proliferated over the years in connection with the sales tax, the income tax, the corporation tax, and a variety of special purpose taxes. We recommend removal of approximately 14% of the value of these exemptions in order to produce additional sales tax and other revenues on the order of \$750 million per year.
- **Estate and Gift Taxes:** These taxes should be repealed effective immediately.
- **Increase the Minimum Wage:** While not a tax proposal, Connecticut should increase its statutory minimum wage in annual steps from the current \$10.10 to \$15 per hour by 2022 to help address the issue of income disparity.
- **Provide Municipalities With Authority:** Allow municipalities to raise fees and an additional 0.5% sales tax to augment the existing property tax system. This new sales tax authority should be tied to policies promoting regional service delivery at the local level.

## SPENDING

- More effectively control state spending by establishing a Joint Budget Committee with responsibility for the establishment of revenue and spending policy. The current two-committee process lacks coherence and favors over-spending.
- Join the large majority of states that vest the power to determine pension and retiree health benefit formulas and funding policies for state employees with the legislature, rather than in collective bargaining.
- Immediately address the unsustainable burden of the Teachers' Retirement System (TRS) and the state Employee Retirement System (SERS) unfunded liabilities.
- Create a cost-management initiative within the executive branch that will produce savings of at least \$1 billion annually.

## INVESTMENTS IN TRANSPORTATION AND CITIES

Connecticut must invest in transportation and provide a stable funding source to pay for transportation investments that cannot be raided by the legislature for non-transportation expenditures. Priorities include: congestion-reducing highway improvements, higher speed rail service from Hartford, New Haven and Stamford to New York City, improved service at Bradley International Airport, repeal legislation limiting runway length at Tweed Airport and investment in Connecticut's deep-water ports.

With respect to central cities, the Commission recommends **the expansion of the Capital Region Economic Development Authority** model in two additional cities, and enhanced funding of the Payment in Lieu of Taxes (PILOT) program for state owned property in the state's largest cities.

## ECONOMIC GROWTH

Undertake a series of growth initiatives, led by the executive branch, with the funding and support from the legislature to (1) develop and retain the workforce Connecticut needs, (2) support the growth of Connecticut's highest-potential economic sectors and (3) transform the business environment for entrepreneurship and innovation. As part of this growth investment,

the Commission **recommends the creation of a new, nationally competitive Science, Technology, Engineering and Math (STEM) campus** in Hartford, New Haven or Stamford, following the Roosevelt Island model in New York City. The objective should be to recruit a major research university through a request for proposal (RFP) process to partner in the project.

## LINKAGE

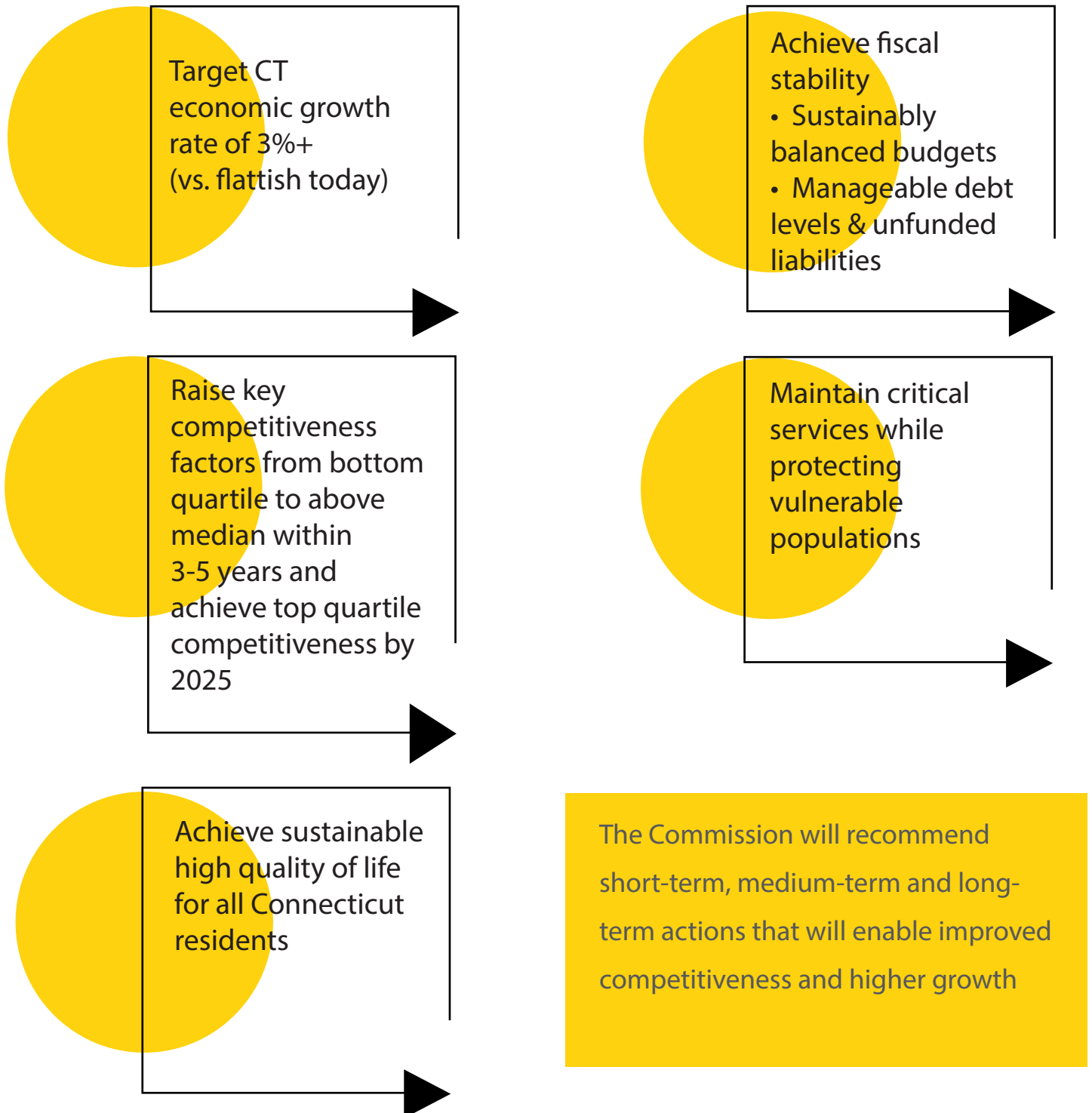
Implementation of several of these measures must be closely linked to the enactment or executive branch achievement of others. For example, while the tax changes would be enacted in 2018, their implementation at the July 2019 start of FY 2020 would be conditioned upon enactment in 2018 of the proposed changes in state employee collective bargaining and binding arbitration, and the submission by the executive branch of specific proposals to reduce core spending by \$1 billion before July 1, 2019.

## BUDGET IMPACT

The Commission's economic model suggests that the plan for Connecticut will produce balanced General Fund budgets through the next biennium (FY 2021). If the plan is successful in raising rates of economic growth and tax revenues by FY 2022 and beyond or if further cost saving measures are taken, those balanced budgets can be sustainable.

# A "STRAWMAN" VISION/GOALS OF CT

A long-term vision is required to propel our state back to greatness...



Vision and goals are not mere verbiage and platitudes. They translate into a social and political compact among interest groups. For example, business needs to be committed to a fair deal with labor, and labor needs to be committed to fiscal stability and economic growth. The towns and their elected representatives who control the legislature must be committed to building vital cities, which is a prerequisite to getting more companies to start, move and stay in Connecticut to generate the economic growth that will lead to increased state tax revenue to help all the towns. Connecticut and its representatives need to sign up to a common vision and goals, not a zero sum game of “we win, you lose”.

Beyond vision/goals, key principles have guided the formation of our recommendations.

We must:

- Be sensitive to, but not intimidated by, political repercussions—in fact, we may serve a useful purpose for political leaders by helping to “carry some of the water” for conventionally unpopular ideas;
- Be bold—the state is in dire straits, the time for half measures is behind us;
- Be fair—if there is sacrifice, it must be shared;
- Any increased spending must be balanced by spending cuts—at least until growth dividends kick in;
- Be focused—let’s get the big picture and the important things right and not get distracted by small issues, past arguments, and special interests;
- Produce some quick wins to achieve fiscal stability and re-inspire economic growth and wealth retention.

# CONNECTICUT'S COMPETITIVENESS

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# CONNECTICUT'S COMPETITIVENESS

The legislation establishing the Commission on Fiscal Stability and Economic Growth (the "Commission") was signed into law as Public Act 17-2 on October 31, 2017 as part of the bipartisan budget bill. The legislative charge to the Commission was ambitious, to:

*"Develop and recommend policies to achieve state government fiscal stability and promote economic growth and competitiveness....to (1) achieve consistently balanced and timely budgets that are supportive of the interests of families and businesses and the revitalization of major cities within the state, and (2) materially improve the attractiveness of the state for existing and future businesses and residents."*

In doing our work we have been laser focused on our twin and closely interrelated goals of fiscal stability and economic growth. We also decided to employ the concept of "competitiveness" as our primary criterion for measuring our current status and any proposals. A related test is the measure of a program's "affordability". If a current or proposed program is not affordable within current revenues, it could undermine the fiscal stability Connecticut needs as a pre-condition to creating sustainable economic growth.

Connecticut has reached a crossroads. Its strengths – a highly educated workforce, strong industry clusters, a legacy of innovation, and a high quality of life – once made it a competitive and economically growing powerhouse, attracting successful new residents and productive businesses from near and far.

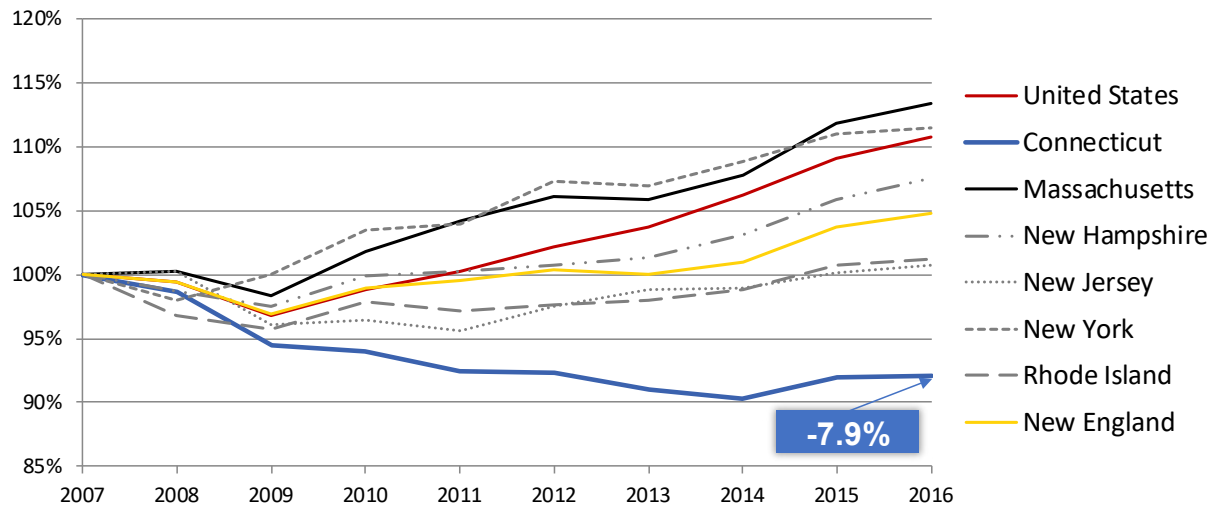
**Competitiveness measures the preconditions for economic growth** with sustainably high levels of per capita income (i.e. what it takes to attract and retain highly mobile businesses and families)...

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...and **creates the enabling environment** for workers to be productive and residents to enjoy a high quality of life

The hard fact is that Connecticut's economy, measured by Gross State Product (GSP), has actually declined since 2007 - in stark contrast to neighboring states and the US as a whole.

INDEXED REAL GDP BY STATE (MILLIONS OF CHAINED 2009 DOLLARS)



Source: Bureau of Economic Analysis, Gross State Product

The economic reality has changed: many of the state's talented people and growing businesses are decamping for other parts of the US. Connecticut's competitiveness rankings are declining and are generally bottom quartile when compared to peers as measured by the various reports published that evaluate livability and business climates across the nation.

To regain its stature and attract more talent and industry, Connecticut must improve in many areas at once, given their interconnectedness.

Among our findings are:

- **Fiscal Stability:** Connecticut's fiscal stability has deteriorated to crisis levels, eroding general public and business confidence. Fiscal stability is a condition precedent to competitiveness. State expenditures have been growing at a rate exceeding revenue growth since the Great Recession. At the same time, ballooning fixed costs related to rising debt and unfunded liability levels have crowded out infrastructure investments and discretionary spending line items for education, transportation, aid for the vulnerable, and other important government services and programs.

- **Tax Policy:** Connecticut's tax policy is not as competitive as it needs to be with its neighboring states, and is overly volatile with a high dependence on levels of personal income and capital gains.
- **Business Competitiveness**
  - **Talent and Human Capital:** Connecticut's workforce is shrinking as the population ages and outmigration rises. While many residents are highly skilled today, the state is not educating and retaining enough of its students for the 21st-century labor market. The state is already struggling to match existing talent with job openings. Educated and highly skilled residents are leaving faster than the state can replace them.
  - **Innovation and Entrepreneurship:** While the state leads the nation in many measures of technical innovation, it has not converted enough ideas into new businesses, leaving the state with an increasing reliance on older and larger companies.
  - **Ease and Cost of Doing Business:** Starting and running a business in the state presents many challenges, including regulations<sup>1</sup> and high costs in general, such as high cost for labor, electricity prices and other critical business expenses.
  - **Sectors and Clusters:** Among Connecticut's largest and most important sectors are healthcare, finance, and manufacturing.<sup>2</sup> Large companies in these sectors and small and mid-sized start-ups, suppliers and other companies in the ecosystem form mutually beneficial networks which must be enhanced.
- **Transportation and Infrastructure:** Connecticut lacks reliable funding sources to invest in needed infrastructure repairs and upgrades. Deferred upgrades to roads and bridges could result in future safety concerns, and funding for transportation initiatives that would enhance competitiveness is inadequate. Commute times for the state's workers are above average and growing.<sup>3</sup> Public transportation options for those outside of metro areas are limited.
- **Quality of Life:** While residents overall enjoy a high quality of life, there is a significant imbalance between those in the suburbs and those in the cities. In this regard, Connecticut's cities face significant issues, including a high level of inequality, unfunded pensions and deterioration in other fiscal conditions. As a result, Connecticut cities do not provide vibrant urban cores that are critical to the state's economic growth and well-being.

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<sup>1</sup> Connecticut is ranked 43rd nationwide by small businesses on friendliness of regulations according to the Thumbtack Small Business Survey

<sup>2</sup> Connecticut has a high location quotient in all three sectors, meaning the proportion of Connecticut's employment coming from all three is higher than the national average

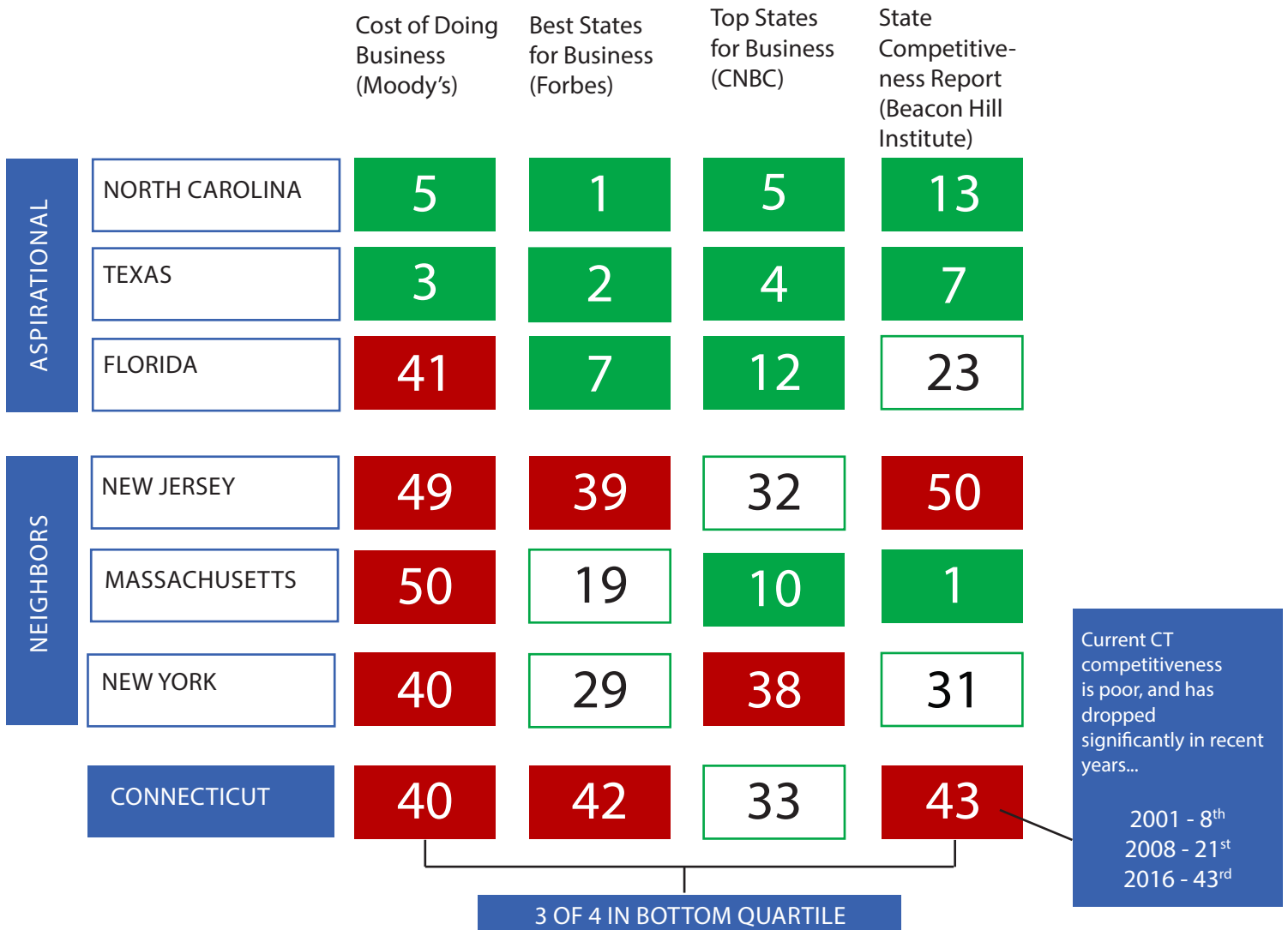
<sup>3</sup> Connecticut ranks 36th in the US on commute times according to the American Community survey

Competitiveness matters because in an increasingly transparent and mobile world it has become easier for people and firms to make highly informed decisions about where to live, work and hire. Countries, states and cities must do more than ever to compete for the talent, ideas, investment and other resources that are the foundations of economic growth and high standards of living.

A competitive state creates an environment that helps businesses and workers be productive and where residents enjoy a high quality of life. A competitive state has a compelling value proposition that attracts and retains highly mobile businesses and families. While certain features, such as good schools and roads, reliably attract companies and people, competitiveness is not an exact science. Families' and companies' decisions about relocating are highly complex and variable.

Many researchers study state competitiveness. Their findings, found in publications such as the Beacon Hill Annual State Competitiveness Report, the US News state rankings, and the Connecticut Economic Resource Center's Economic Review consider a range of elements to describe each state's overall competitive position. We present below a chart that summarizes Connecticut's standing in terms of attractiveness to business compared to nearby states and others against whom it competes. It is clear Connecticut needs to improve its standings.

## STATE OVERALL COMPETITIVENESS INDICES



1 = best state,  
50 worst



TOP 15



MID 20



BOTTOM 15

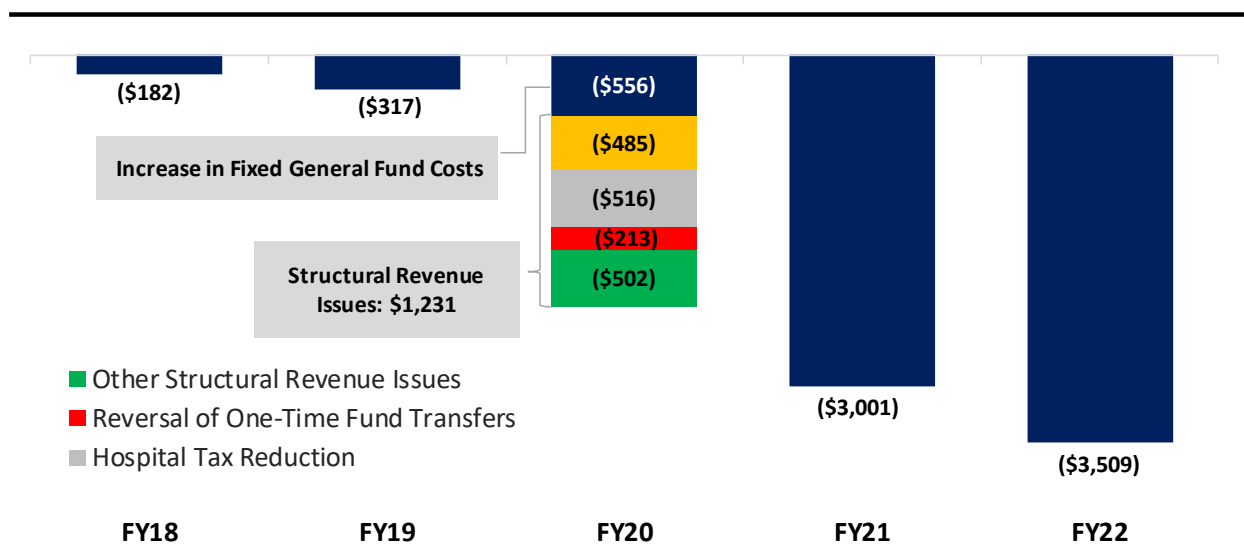
SOURCE: Moody's, Forbes, CNBC, Beacon Hill Institute

To further our understanding of Connecticut’s competitiveness, we can divide our analysis into four sections: fiscal stability, tax policy, business competitiveness, and quality of life.

## FISCAL STABILITY

Despite achieving a bipartisan budget in October, the state now forecasts multi-billion dollar budget deficits for the three years outside the FY 2018 – FY 2019 biennium. A large portion of the out-year deficits is due to potentially reversible budget decisions scheduled to occur in FY 2020, including a reduction in the hospital tax, the reversal of one-time fund transfers in the biennium, and the restoration of historical levels of municipal aid<sup>4</sup>.

CONNECTICUT STATE FORECASTED BUDGET BALANCES (\$ IN MILLIONS)<sup>5</sup>



Source: FY18-19 Biennial Budget, January 2018 Consensus Revenue Estimates, January 2018 OPM Budget Estimates, OFA Out Year Estimates

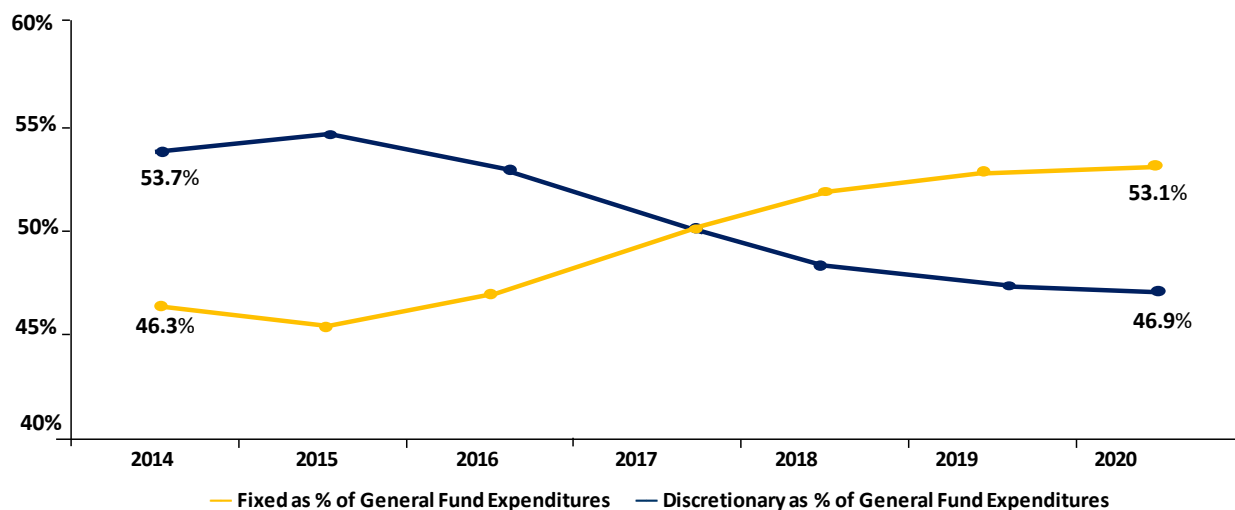
Even after removing all reversible items above, the budget deficit would still grow to over \$2 billion by FY 2022 as fixed expenditures (which include pension and retiree healthcare contributions, debt service, and entitlement programs such as Medicaid) are projected to grow at a compound annual growth rate (“CAGR”) of 5.9% from FY 2017 to FY 2020.<sup>6</sup>

<sup>4</sup> The governor’s Recommended Budget Adjustments for FY 2018, released February 7, 2018 addresses and would reverse all \$1.2 billion of the so-called “Structural Revenue Issues” in FY 2020.

<sup>5</sup> Includes General Fund and Other Appropriated Funds. FY18 and FY19 budget balances based on October’s Biennial Budget, adjusted to incorporate January 2018 consensus revenue estimates and January 2018 OPM budget estimates. FY20 – FY22 per the Office of Fiscal Analysis Out-Year Estimates

<sup>6</sup> OFA Fiscal Accountability Report FY17-20, does not account for enacted budget

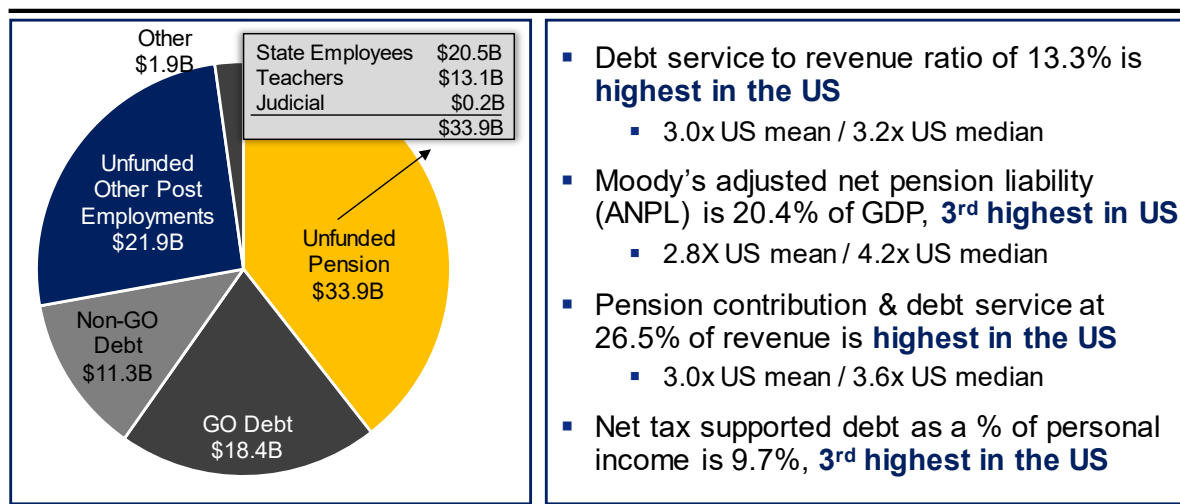
## GENERAL FUND FIXED VS. DISCRETIONARY COSTS (% OF GENERAL FUND EXPENDITURES)



SOURCE: 2014-2016 Annual Reports of the State Comptroller, OFA Fiscal Accountability Report FY17 – FY 20

At the same time, Connecticut's legacy liabilities are precariously high and trending higher. The state is estimated to have total liabilities of \$87 billion as of June 31, 2017. These liabilities, as well as the annual payments required to service them, are extremely high relative to other states.

## TOTAL LIABILITIES (\$ IN BILLIONS)<sup>7</sup>



SOURCE: 2017 CT CAFR, Moody's Investor Service

The state's \$87 billion of liabilities would increase to over \$100 billion if the state employee and teachers' pension systems reduced their weighted average investment return assumption from

<sup>7</sup> Pie chart: Debt includes component units. Unfunded pension and OPEB liabilities represent unfunded actuarial accrued liabilities ("UAAL") based on actuarial reports for the state's pension and OPEB systems. Bullet points: These ratios have been calculated based on Moody's definitions of debt, pension liabilities, debt service, contributions and own-source governmental revenues (revenues less federal funding), and in most cases will differ from a state's own published calculations or the calculations of other institutions

7.5% to 6%, more in line with recent historical returns and returns of other US public pensions<sup>8</sup>. Through 2015, the average 10-year return for the 41 largest state funds was 6.59%<sup>9</sup>. For Connecticut's State Employees' Retirement System and Teachers' Retirement System, the ten-year compound annualized returns over the same period were 6.18% and 6.30%, respectively – significantly below the current investment return assumptions of 6.9% for SERS and 8.0% for TRS. Rolling forward to 2017, the ten-year compound annual returns for SERS and TRS deteriorated even further to 5.50% and 5.59%, respectively<sup>10</sup>. An unreasonably high investment return assumption artificially reduces the unfunded liability and the calculation of the annual contribution required to amortize that liability, making the budget appear more flexible than it really is and allowing the government to spend money that should otherwise be dedicated to pension funding or other programs.

The legacy liabilities are high because of both inadequate funding over the years and the relatively generous benefits that Connecticut provides to its public workers compared to other states. The average pension benefit payment per beneficiary in Connecticut was 26% higher than the average Northeast state and 38% higher than the average state in the US.<sup>11</sup>

Pension liabilities, along with other legacy liabilities, are driving the high growth in fixed expenditures. Pension contributions for TRS and SERS are projected to increase from \$2.7 billion in FY 2017 to \$4.9 billion in FY 2032, representing a compounded annual growth rate of 5%.<sup>12</sup>

Connecticut could benefit from evaluating the in-kind contribution of assets to its pension systems to improve their funded ratios and lower the state's annual required contributions (ARC), thereby reducing fixed costs. This would free up funds for important investments that are being crowded out today. The state could consider in-kind contribution of land, buildings, airports, roads, healthcare facilities and other assets that the state does not need to own and which may have valuable development potential.

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<sup>8</sup> Pew Charitable Trusts

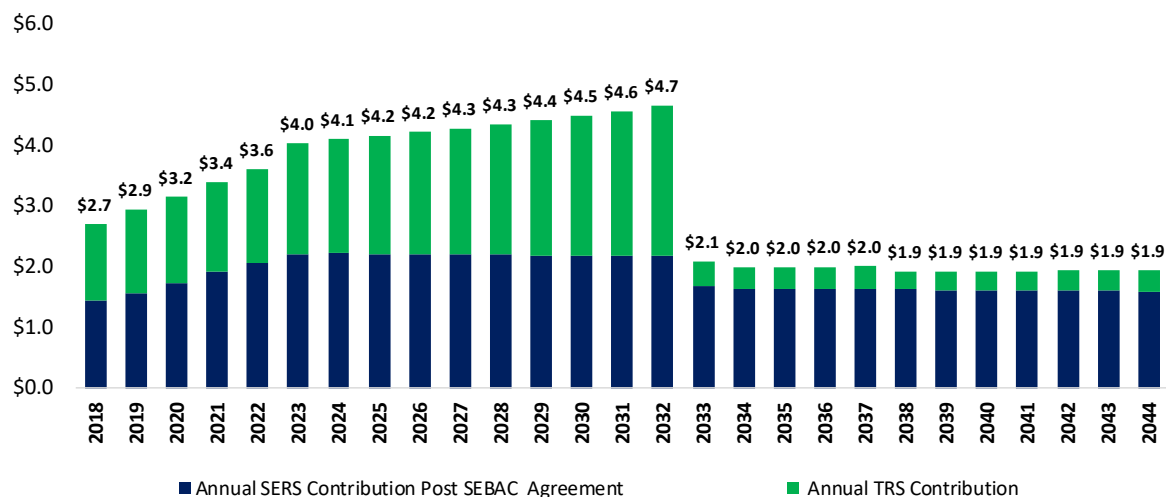
<sup>9</sup> Return reported net of fees. The Pew Charitable Trusts, "state Public Pension Funds Increase Use of Complex Investments", April 2017

<sup>10</sup> Reported net of all fees and expenses, for ten years ending December 31, 2017. CT Treasurer's Office Pension Fund Performance

<sup>11</sup> Figures calculated as benefits divided by total beneficiaries receiving periodic benefit payment. Annual survey of Public Pensions 2016 (US Census Bureau)

<sup>12</sup> TRS Contributions per the Pew Charitable Trust. JRS projected contributions unavailable

# PROJECTED ANNUAL PENSION CONTRIBUTIONS (EXCL. JRS) (\$ IN BILLIONS)<sup>13</sup>



SOURCE: The PEW Charitable Trust, State Office of Policy Management, May 2017 SEBAC Agreement

In addition to its significant pension liabilities, Connecticut has a total liability for other post-employment benefits (“OPEB”) of \$22 billion<sup>14</sup>, which is high on both a relative and absolute basis, and for which the state also does not currently have any material funding set aside.

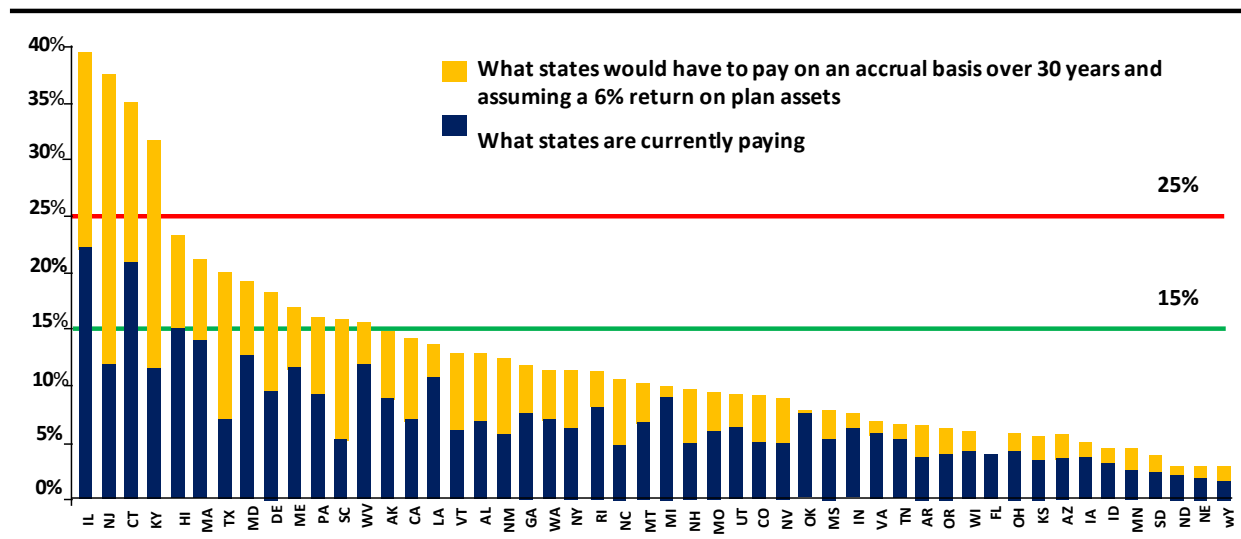
Connecticut’s significant OPEB liability is due, at least in part, to its benefits model. Connecticut is one of 27 states that contributes to retiree healthcare costs based on a “percentage of premium”, where the state pays 60% to 100% of health insurance premiums based on a sliding scale that accounts for retirement age and years of service. The average retiree receives a contribution from the state of approximately 90% of their health insurance premium, an amount that will decline by 5% for those retiring in 2022 or later, based on the 2017 SEBAC Agreement.

States that tie their OPEB contributions to premiums have relatively higher liabilities, as measured based on the ratio of OPEB liability to personal income. On this measure, Connecticut’s ratio is fifth highest in the country at 9%<sup>15</sup>. The 12 states that provide “fixed dollar” contributions have relatively lower liabilities. Connecticut’s OPEB liability was over \$200,000 per worker in FY 2015, nearly three times as high as the 75th percentile of all states, translating into a total liability of \$22 billion.<sup>16</sup>

<sup>13</sup> JRS projected contributions unavailable. SERS per May 2017 SEBAC agreement. TRS per PEW Charitable Trust  
<sup>14</sup> 2017 Comprehensive Annual Financial Report, does not reflect the implementation of Medicare Advantage program  
<sup>15</sup> PEW Charitable Trust  
<sup>16</sup> The ARC and the Covenant 2.0, J.P. Morgan Asset Management

In FY 2015, Connecticut spent approximately 21% of state revenues to fund debt, pension and OPEB liabilities. Connecticut would need to spend approximately 35% of state revenues to fund these liabilities on an accrual basis over 30 years, assuming an illustrative 6% return on plan assets. In order to do so, the state would need to either raise revenues by ~14%, cut direct spending by ~14%, or increase worker contributions by 699% to meet full accrual payments to retirees.<sup>17</sup>

PERCENT OF STATE REVENUE COLLECTIONS REQUIRED TO PAY THE SUM OF BONDS, THE STATE'S SHARE OF UNFUNDED PENSION AND RETIREE HEALTHCARE LIABILITIES, AND DEFINED CONTRIBUTION PLAN PAYMENTS<sup>18</sup>



SOURCE: The ARC and the Covenants 2.0, J.P. Morgan Asset Management, State/Pension Plan Comprehensive Annual Financial Reports, Census, Loop Capital Markets, FY 2015

As the state considers ways to address these fiscal challenges, it should be wary of attempts to do so by relying on revenue increases. Connecticut's overall tax burden is already one of the highest in the nation<sup>19</sup>, driven largely by high personal income and property tax rates.

<sup>17</sup> Full accrual payments represent amount needed to pay on sum of interest on bonds, the state's share of unfunded pension and retiree healthcare liabilities, and defined contribution plan payments over 30 years and assuming a 6% return on plan assets. Accrual basis expenditures include payments of benefits that have accrued even if cash payment for such benefits is not yet due. The ARC and the Covenants 2.0, J.P. Morgan Asset Management; state/Pension Plan Comprehensive Annual Financial Reports; Census; Loop Capital Markets. FY 2015

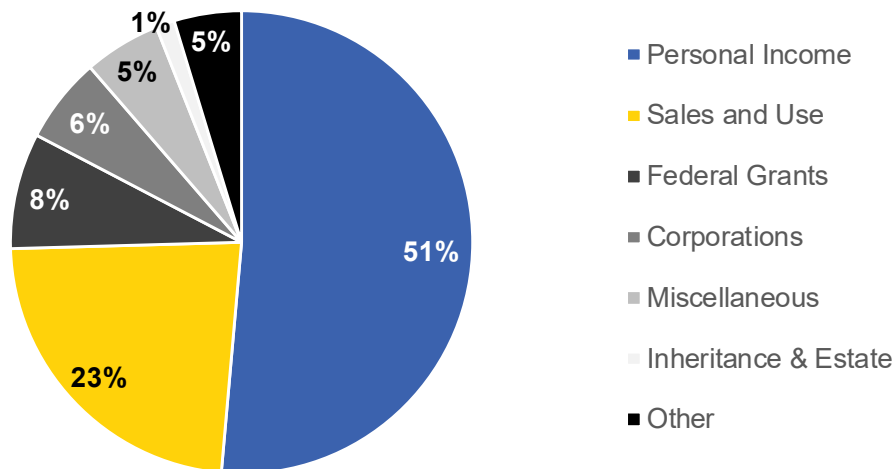
<sup>18</sup> (See FN 17)

<sup>19</sup> Connecticut's effective total state and local tax burden as a percentage of state personal income was 10.2% in FY 2015, which was the 6th highest ratio across the nation. State & Local Government Finance Data Query System, Urban Institute-Brookings Institution Tax Policy Center.

## TAX POLICY

In the last fiscal year (FY 2017), Connecticut's General Fund revenues were derived from four primary sources—the personal income tax (PIT), the sales and use tax, the corporation business tax, and the estate and gift tax—as well as a subset of smaller sources:

GENERAL FUND REVENUE (2017)



SOURCE: Office Of Policy Management

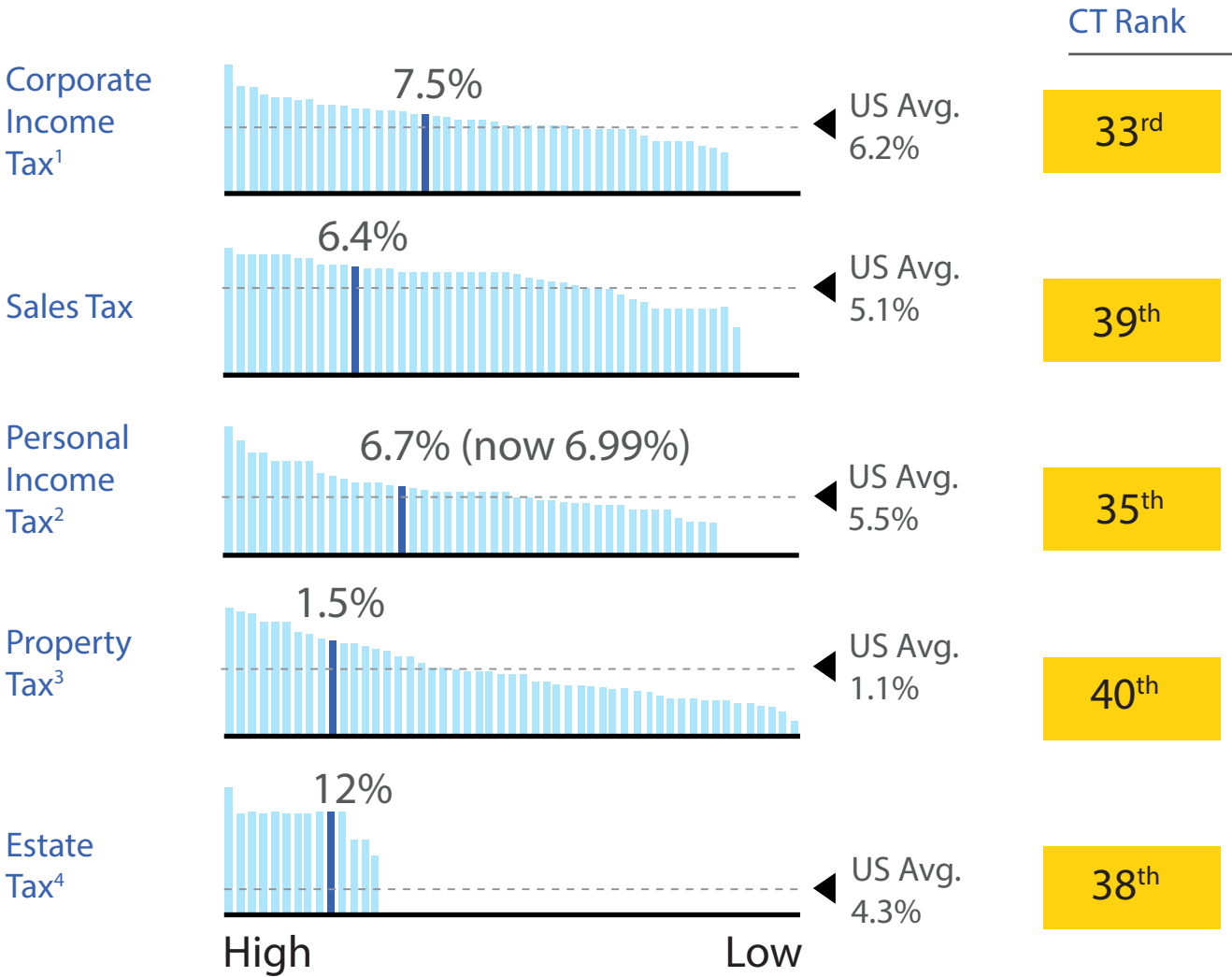
Based on external research and data, Connecticut has among the highest state tax rates in the country, with only Illinois, Nebraska, Wisconsin, New York, and Rhode Island having higher rates on a combined basis. Connecticut's tax rates are all higher than US averages. Connecticut residents pay almost 26.5% more than the US average<sup>20</sup>.

<sup>20</sup> 2017 Tax Burden by state, Wallethub

# CONNECTICUT'S TAXES ARE HIGHER THAN US AVERAGES



TAX RATES BY STATE, 2015, STATUTORY RATE, %  
Rate (%)

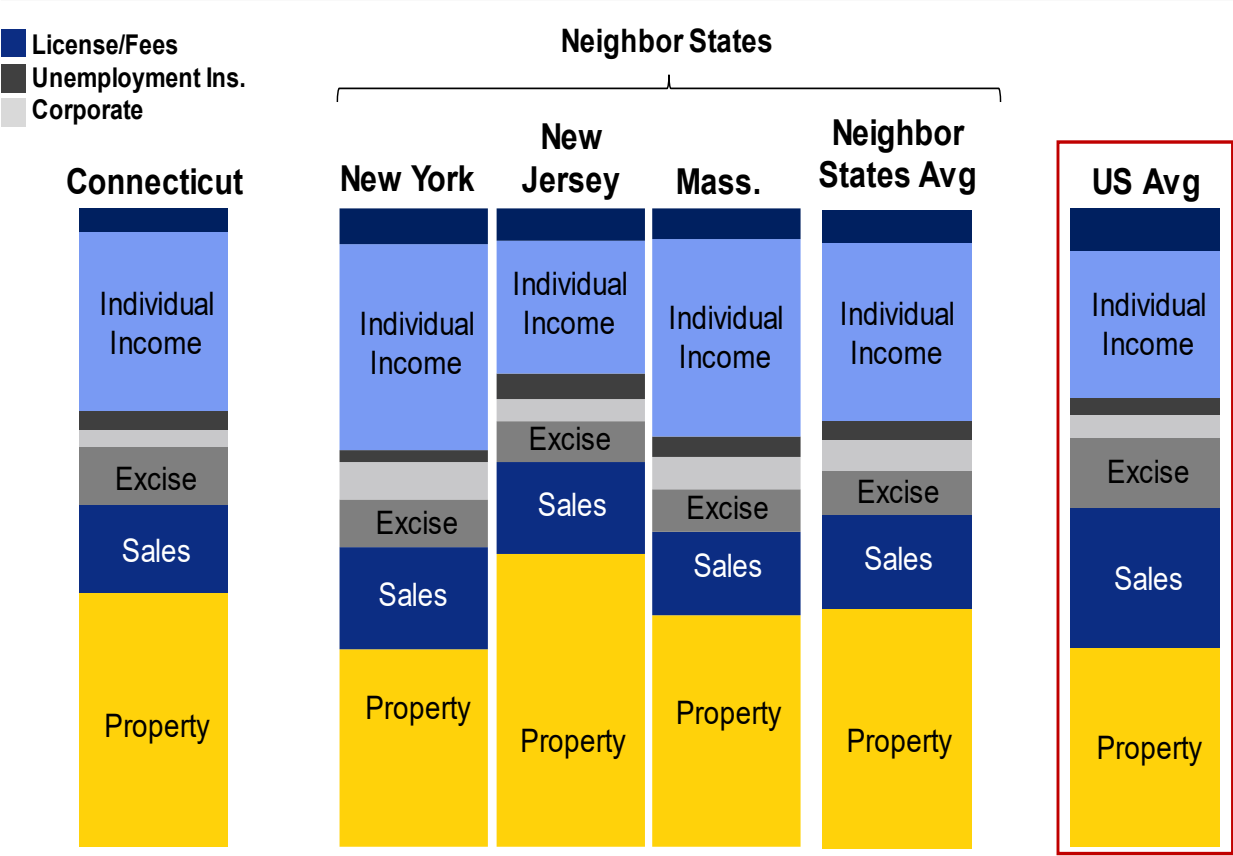


“The proposed tax increases are truly discouraging, and the company would seriously consider whether it makes sense to continue to remain in Connecticut.”  
– GE statement, Hartford Courant (2016)

1 Represents the highest marginal corporate tax rate  
2 Represents the highest marginal personal income tax rate  
3 Mean Property Taxes on Owner-Occupied Housing as Percentage of Mean Home Value as of Calendar Year 2011  
4 Tax Foundation data

In terms of the mix of taxes compared to certain neighboring states with which Connecticut competes (Massachusetts, New Jersey and New York), Connecticut relies relatively less on business taxes (corporate and unemployment insurance), and licenses and fees.

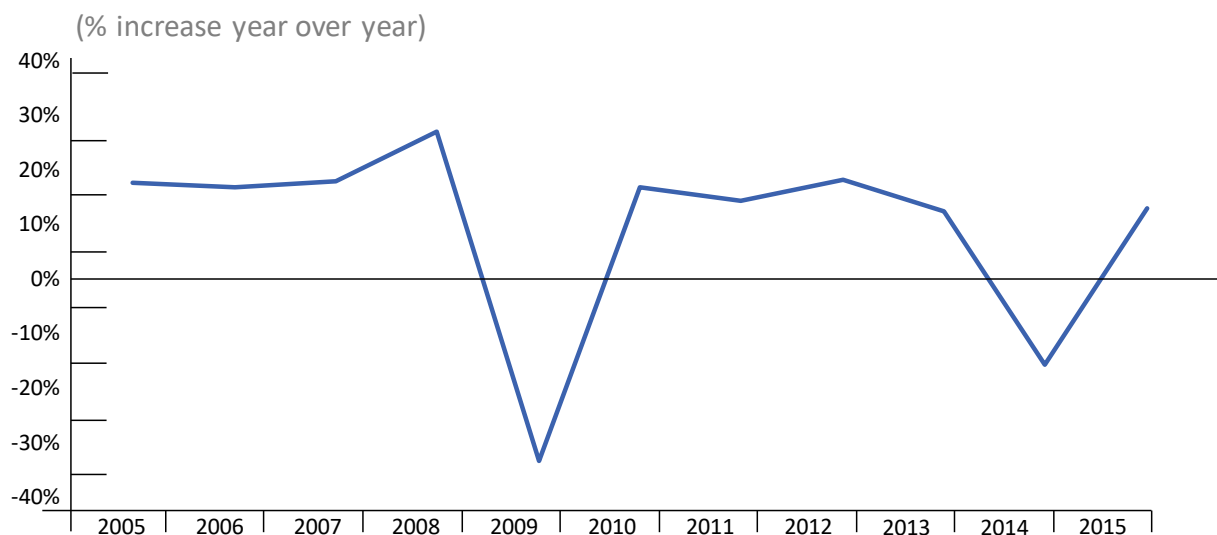
TOTAL STATE AND LOCAL TAXES VS. PEERS



SOURCE: Ernst & Young

Connecticut's income based revenue stream is highly volatile due to the demographic and economic makeup of the state.

#### CONNECTICUT'S INCOME BASED REVENUE STREAM IS HIGHLY VOLATILE



SOURCE: Forbes, Thumbtack.com, Kauffman

A significant portion of the income reported by high-income earners is from capital gains. Capital gains is reported through “estimated and final payments” of the income tax and is driving much of the volatility. According to a MassINC study in 2008, Connecticut was the second most at risk state in the country if capital gains income within the state declined.<sup>21</sup>

High concentrations of wealth and a substantial number of corporate headquarters also contributed to the large fluctuations. There is a significant geographic concentration in Connecticut's personal income tax revenue. In 2013, 36 of the 169 towns in Connecticut produced 64% of personal income tax revenue, 36% came from 10 towns (Greenwich, Stamford, New Canaan, Fairfield, Westport, Darien, West Hartford, Norwalk, Milford, Glastonbury), and in 2011, 357 families contributed 12% of the revenue.<sup>22</sup>

The state's business tax regimen is somewhat complicated. First, with regard to shareholder owned companies classified as “C-corporations”, which in 2014 comprised 41,194 firms or 19% of the state's businesses (usually the larger ones), the corporate income tax (“CIT”) applies. Its rates are set at the higher of (1) 7.5% of net income (or 8.25% of net income for companies

<sup>21</sup> [http://www.osc.ct.gov/brf/docs/BudgetReserveFund\\_policybrief.pdf](http://www.osc.ct.gov/brf/docs/BudgetReserveFund_policybrief.pdf)

<sup>22</sup> Department of Revenue Services (2011 & 2013)

above \$100 million in gross income) based on the percentage of their total national sales realized in Connecticut, or (2) a capital base method based on a 3.1 mill rate applied to net assets. Both methods are calculated for each entity and the one producing the higher tax is then applied, but subject to a \$2.5 million annual cap in the case of the net income method or a \$1 million annual cap under the capital base method. Connecticut also imposes a \$250 annual minimum tax, as well as a range of credits (the largest of which are for “fixed capital” and R&D). In 2014, the use of credits reduced overall CIT liability by 24%, with a subset of industries getting a significant portion of these benefits.<sup>23</sup> The CIT produced approximately \$1 billion in FY 2017.

The other group is the “pass-through” businesses (partnerships, S-corporations, LLCs, etc.) which are the large majority and faster growing segment of businesses, making them exempt from the CIT. Their net income is passed through to their individual owners where it is taxed at their PIT rate. Nationally, 95% of business entities are now pass-throughs, and 58% of state-level business income passes through them.<sup>24</sup>

The question of the relative equity of tax burdens between the “Cs” and the “pass-throughs” is much debated, but the PWC Report was able to conclude that on a national basis the effective tax rate (ETR) on C-corps was 6.1% of business income, while for pass-throughs it was 4.7%. There is no apparent reason why pass-through entities should have the same access to state services as the C-corps, but are responsible for a disproportionately smaller amount of the tax burden.

There is considerable significance in all of this for the Commission. We have the same question of relative equity between the two groups of business taxpayers at the state level, since Connecticut’s CIT only applies to C-corps. We also have received conflicting arguments regarding the ETR that Connecticut C-corporations pay and whether Connecticut companies enjoy a lower level of taxation compared to neighboring states. On the one hand, there is a 2017 report prepared by Ernst & Young (E&Y) that finds that Connecticut has the lowest total effective business tax rate (TEBTR) at 3.5%, compared to 4.5% across all states. As E&Y points out, there are many factors that influence TEBTR that make it debatable as a measure of tax burden. TEBTR is a ratio of tax rates against Gross State Product. Connecticut’s companies are highly productive (produce more GSP), but whether it follows that they should therefore be more highly

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<sup>23</sup> Connecticut DRS 2015-16 Annual Report

<sup>24</sup> Corporate and Pass-Through Business State Income Tax Burdens”, prepared by PWC for the State Tax Research Institute, Oct. 2017, hereinafter the “PWC Report”

taxed is not clear. (See “Total State and Local Business Taxes”, August 2017, E&Y)

Connecticut business taxes as a share of total state and local taxes in 2016 at 30% were well below those of both the neighboring states (Massachusetts 39%, New Jersey 42%, New York 41%) and the US average (45%)<sup>25</sup>. Below is a chart provided by CBIA that shows a comparison of per capita corporate income taxes across Connecticut and its neighboring states. It shows that Connecticut is from 4% to 20% below those other states on this measure.

Finally, the Commission wanted to understand Connecticut’s competitive positioning on the rates for each major tax compared to the neighboring states.

State	Gross CIT receipts (In \$ Millions)	Population	Per Capita (\$)	State	Income Tax (Top Bracket)	Combined State & Local Sales Tax <sup>1</sup>	Corporate Income
Connecticut	\$1,037.60	3,576,452	\$290.12	Connecticut	6.99%	6.35% <sup>4</sup>	7.50%
Massachusetts	\$2,471.00	6,859,819	\$360.21	Massachusetts	5.1% <sup>2</sup>	6.25%	8.00%
New York	\$6,000.00	19,849,399	\$302.28	New York	8.82%	8.49%	6.50%
New Jersey	\$2,495.00	6,860,000	\$363.70	New Jersey	8.97%	6.85%	9.00%

Source: CBIA, February, 2018

Source: Tax Foundation, 2017  
(1) State and Local Sales Tax Rates 2017 - Tax Foundation  
(2) Flat 5.1%  
(3) Also has an inheritance tax  
(4) 8.25% for companies >\$100M

The state’s uncompetitive and volatile tax structure coupled with its shrinking population is leading to stagnant economic growth. A new tax structure must be put in place. Tax policy drives economic behavior. A poll conducted by Sacred Heart’s Institute for Public Policy in 2017, shows that 49% of respondents making more than \$150,000 a year are considering moving out of the state within the next 5 years. That poll also indicated that 64% of respondents claimed that it was “very” to “somewhat” difficult to maintain their standard of living, 52% citing taxes as their primary concern.

Based on this analysis, the Commission concludes that we should recommend a revenue neutral restructuring of taxes in Connecticut along the following lines:

- Connecticut’s PIT rates, which are important both to individuals and pass-through businesses, need to be competitive, especially compared to Massachusetts (which is currently the lowest of the four states), but we should be more progressive than Massachusetts in Connecticut’s rate structure;

25 E&Y Total state and Local Business Taxes, 2016

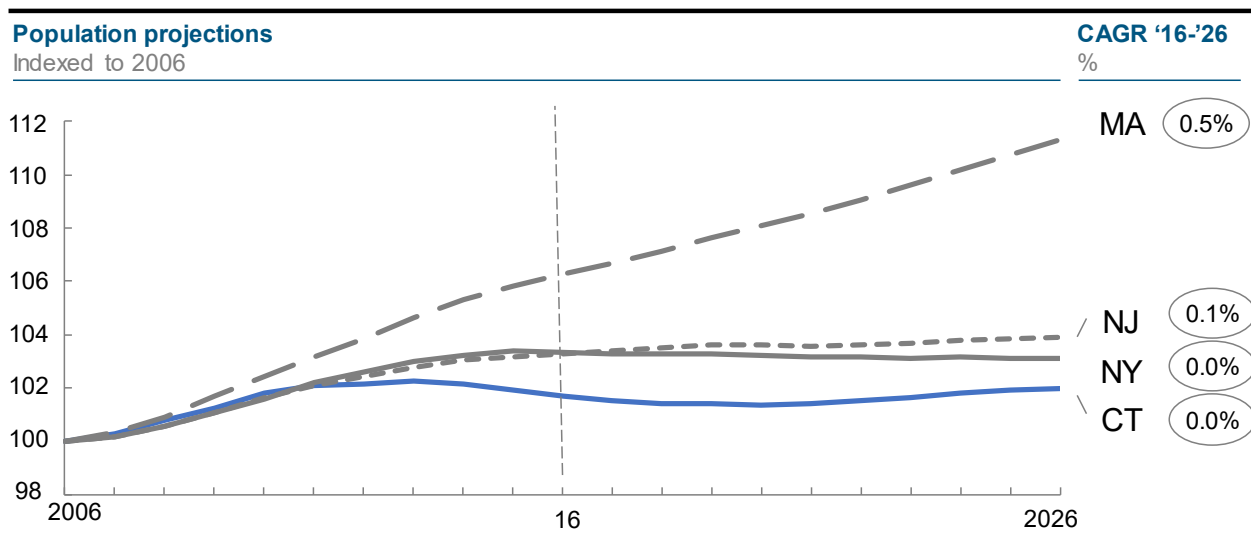
- Connecticut's sales tax rates can see a modest increase, but more importantly the sales tax base can be expanded materially both on grounds of tax equity and revenue needed;
- Connecticut's business taxes can increase moderately, and an entity-based approach for any increases that would be applicable to both C-corporations and pass-throughs should carefully be examined; and
- The gift and estate tax puts the state at a substantial competitive disadvantage in return for small dollars raised, and should be repealed. Wealthy people are some of the most mobile and this tax is a key factor in the state's outmigration problem.

## BUSINESS COMPETITIVENESS

**Talent and human capital** are crucial for any state's competitiveness. The larger and more skilled the workforce, the more tax revenues, innovation and other positive externalities a state can expect. A large skilled workforce is also one of the top reasons businesses choose a location for factories, labs and offices.

In 2016, Connecticut was home to 3.6 million people, a decline of about 1% over three years owing to outmigration and a low birth rate. Over a decade, Connecticut's growth has been effectively flat and is projected to remain flat in the coming decade.

### CONNECTICUT'S POPULATION GROWTH MAY REMAIN FLAT



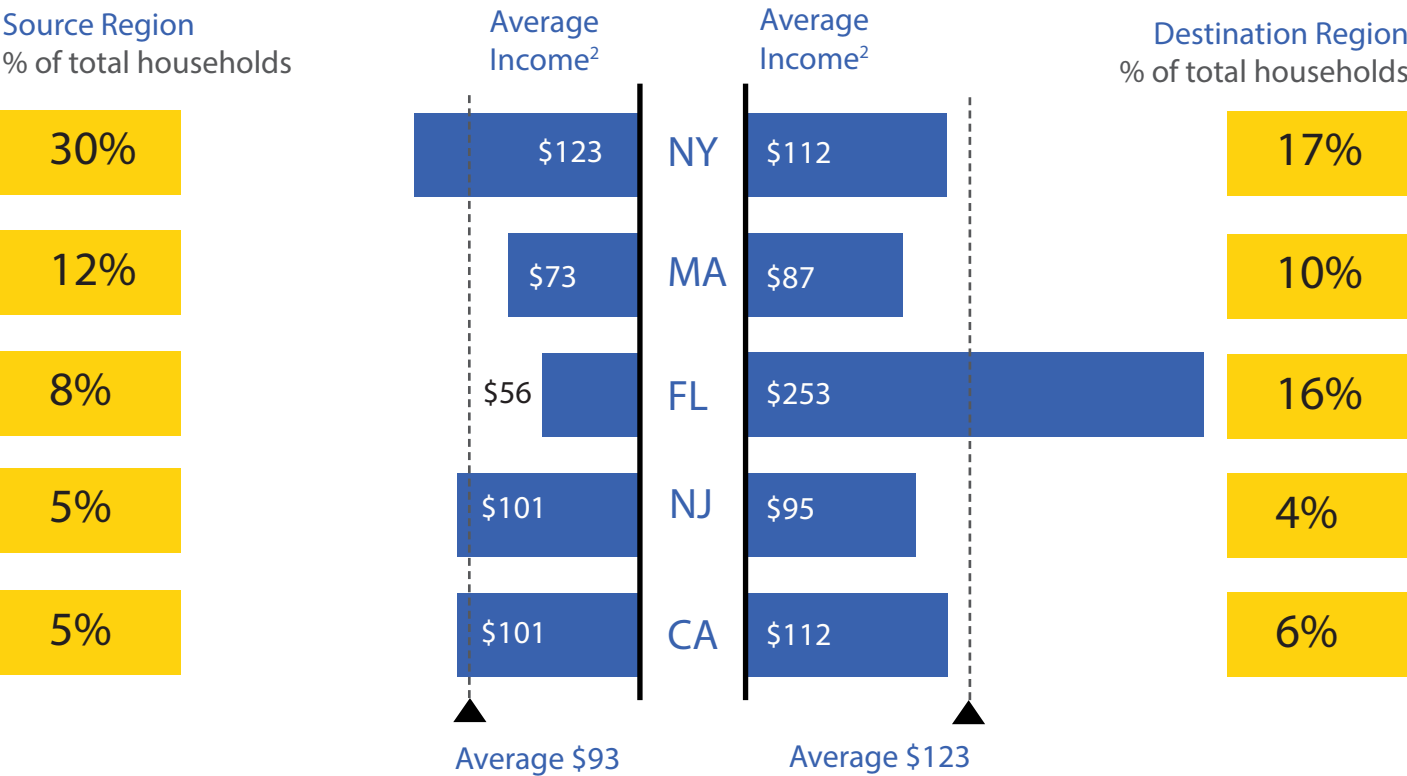
Source: US Census, American Community Survey, BLS

Contributing to Connecticut’s flat population growth has been a pattern of net outmigration, which correlates closely to income tax increases. At the same time, the state’s resident population has been aging.

Those migrating to Connecticut are earning less than those who are departing by \$30k per household. In 2009, a new income tax bracket was added for high-income earners and the corporate surcharge was added for large firms. In 2011, the top income tax rate, the number of personal income tax brackets, and the corporate surcharge all increased. In 2015, the income tax rate increased again, and by 2016 several high-profile corporations such as General Electric and Aetna announced decisions to move their headquarter locations out of the state. Along with corporations, Connecticut saw over 37,000 residents, with an average adjusted gross income (AGI) of \$123,377 (totaling over \$6 billion in total taxable income), migrate out of the state<sup>26</sup>.

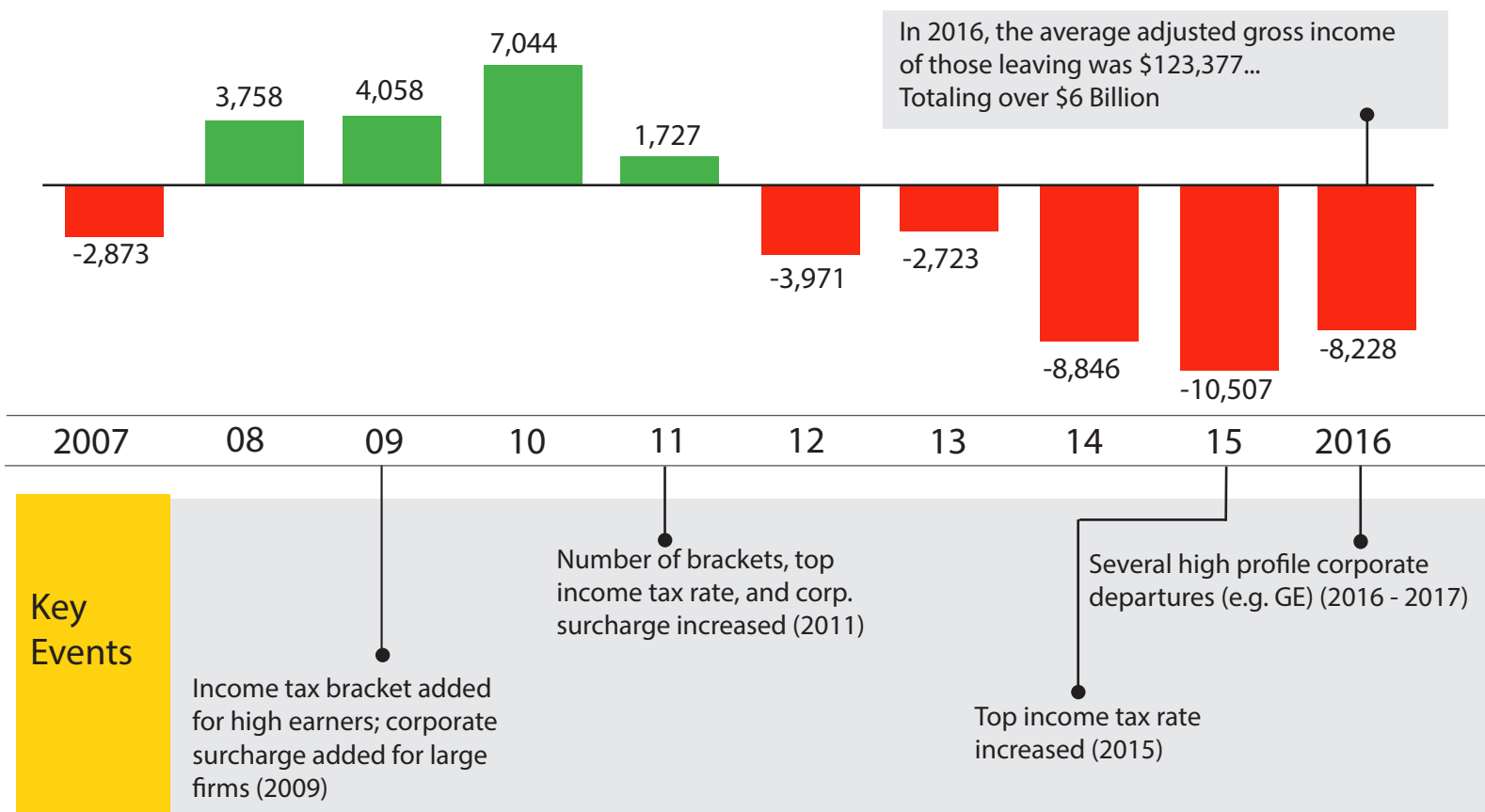
Households<sup>1</sup> moving to Connecticut earn \$93,000/year...

...while CT residents moving away earn more – averaging \$123,000/year



SOURCE: Internal Revenue Service (2015-2016)

## HISTORICAL NET MIGRATION IN CONNECTICUT, # OF PEOPLE



SOURCE: FY 2019 – FY 2020 Biennium Economic Report of the governor

## MIGRANTS TO CT EARN LESS THAN THOSE WHO LEAVE

In terms of talent, Connecticut struggles to retain both new graduates and more experienced professionals. In Connecticut, 32% of students who attend a university in state remain in the state past graduation, compared to 54% of graduates in New York and 46% of those in Massachusetts<sup>27</sup>.

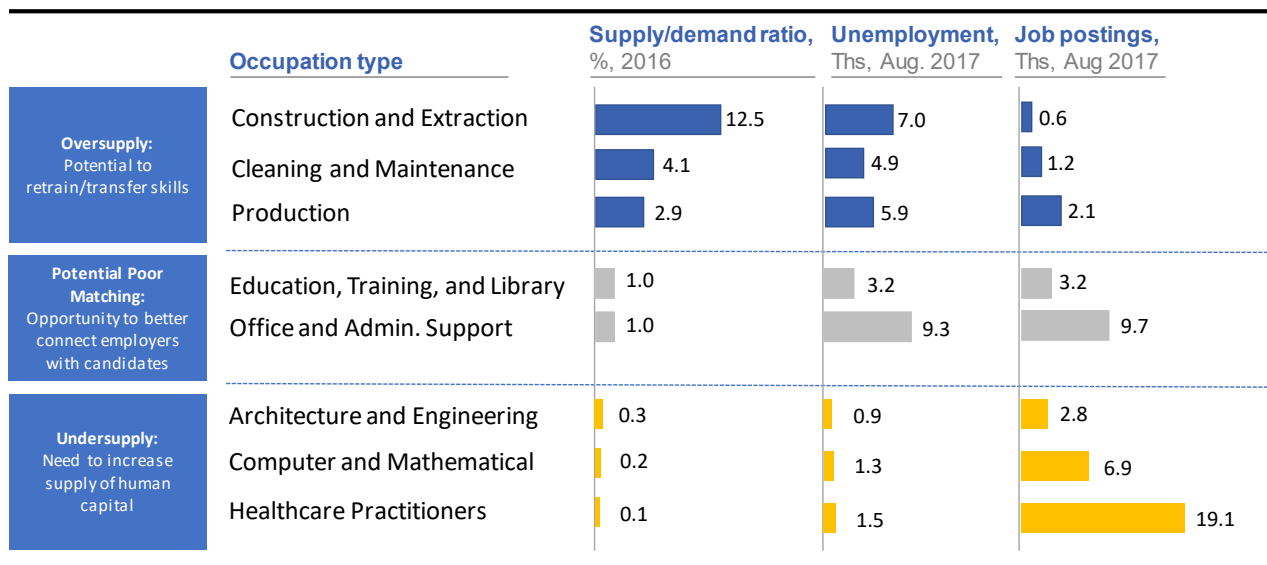
The state's residents today have high levels of educational attainment and strong labor productivity. In fact, Connecticut boasts one of the most educated workforces in the nation and its productivity rate is the 6th highest in the country. However, Connecticut's overall high educational attainment rate disguises a more nuanced picture of education. While the state ranks 4th in the quality of its primary and secondary education, its higher education system is

<sup>27</sup> Economic Modelling Specialists International (EMSI) 2017

ranked 27th overall by US News State Leading States Index<sup>28</sup>. Connecticut also ranks 28th among states in its overall graduates as a share of the population, and in science, technology, engineering and math (STEM) graduates as a percent of total graduates<sup>29</sup>.

The STEM graduate ranking indicates that the state is not educating a sufficient number of its students to meet the needs of the next generation of jobs, particularly since so much of the excess demand in Connecticut's labor market is in STEM fields. The state is one of two states where jobs placed in STEM fields have declined. Companies in the state are facing difficulties filling jobs in computer, mathematical and engineering-related roles, and healthcare, while cleaning, maintenance and production workers are having trouble finding jobs.

#### CONNECTICUT HAS A MISMATCH OF LABOR SUPPLY AND DEMAND



Source: EMSI and BLS data

Thus, Connecticut faces a range of human capital challenges: its workforce is aging and leaving, (shrinking the number of available workers), its people are highly educated today but its schools are receding in their ranking of portion of graduates and STEM graduates; and it is struggling to match its existing talent with job openings.

**Innovation and entrepreneurship** are also keys to competitiveness because they are an engine for economic vitality and future job growth, whether it's from fast growing startups of new products or supporting the supply chains of existing companies. A healthy pipeline of new ideas and new businesses keep states vibrant and growing.

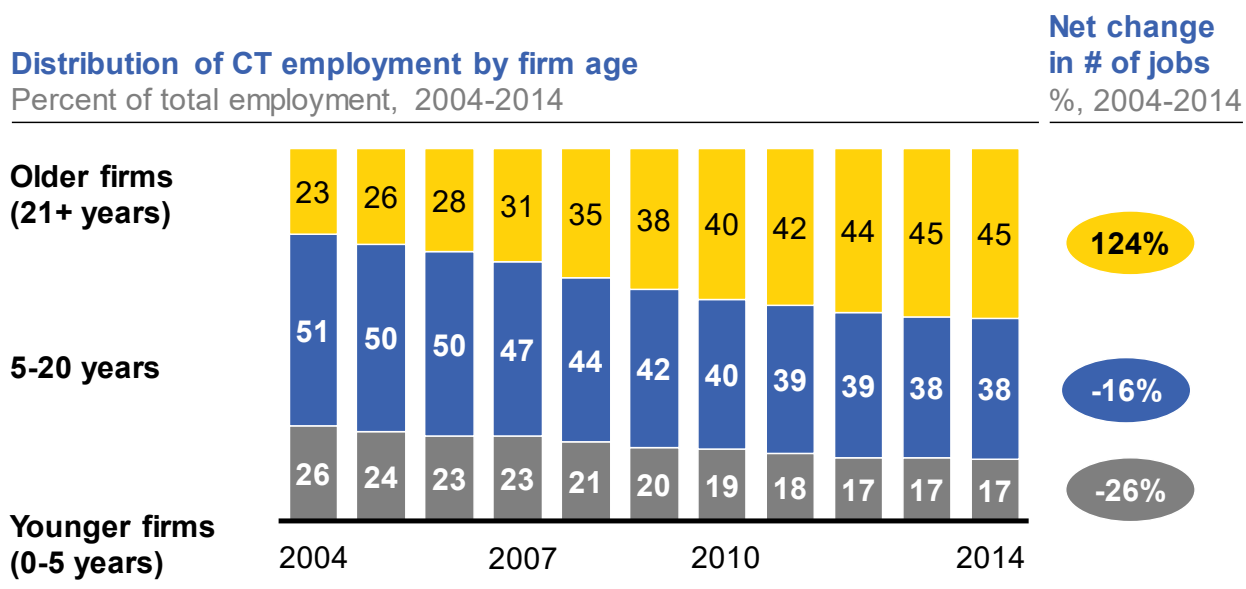
<sup>28</sup> US News Leading states Index 2017

<sup>29</sup> National Center for Education Statistics 2015

From Eli Whitney's cotton gin to Igor Sikorsky's first helicopter in the United States, Connecticut has a long history of innovations. Connecticut has continued this legacy as a modern-day leader in technical innovation. US News ranks the state as the 6th most innovative, and the National Science Foundation ranks it 6th in business R&D spend, 12th in academic R&D spend, and 8th in patents per capita – more than 600 per million people in 2015.

While Connecticut is clearly a national leader in academic and corporate innovation, the same cannot be said of its record on business entrepreneurship. Connecticut ranks 31st in percent of adults starting a business per month<sup>30</sup>, and 37th in new to 5-year-old firms as a share of the total<sup>31</sup>. The state's employment is increasingly concentrated in older firms. Employment by new and young companies declined by nearly a quarter from 2004-2014.

#### THE STATE'S NEWER FIRMS EMPLOY A DECLINING SHARE OF WORKERS



NOTE: Excludes employment data for companies where firm age data is unknown (~15-25% of total employment for each state)

SOURCE: U.S. Census: Business Dynamics Statistics

The lack of new businesses is accompanied by a mediocre investment environment for small firms. Venture capital funding and private equity investments per capita are near the US average: Connecticut ranks 24th and 26th respectively<sup>32</sup>.

<sup>30</sup> Kaufmann Entrepreneurship Index

<sup>31</sup> Longitudinal Business Database, US Census Bureau, 2014

<sup>32</sup> National Venture Capital Association/PricewaterhouseCoopers Report

**The ease and cost of doing business** is not a strong suit for Connecticut: CNBC ranks it 32nd among 50 states, and Forbes ranks it 42nd on its regulatory environment and 41st in overall ease of doing business. Small business owners surveyed by the Thumbtack Small Business Friendliness Survey point to a similar story, ranking the state at 40th in overall business friendliness and 33rd for ease of starting a business<sup>33</sup>.

On the same survey, small business owners ranked the state 43rd in the number and burden of regulations placed on them, 47th for rules related to employment, labor and hiring, 42nd for licensing, 47th in environmental regulations, and 42nd in zoning<sup>34</sup>.

On a separate survey of small businesses by CBIA, 68% of respondents said that additional business costs from government mandates, other than taxes, were among the top five concerns<sup>35</sup>.

## TRANSPORTATION & INFRASTRUCTURE

Transportation and Infrastructure are the backbone of the Connecticut economy; the ability to move quickly, efficiently, and safely is paramount for attracting, retaining and growing businesses and creating jobs, both of which support retention and expansion of the tax base. Despite its importance, the state has underinvested in transportation infrastructure for years. This has resulted in degraded infrastructure, causing congestion, potential future safety concerns and unreliable service. The resulting loss of productivity for business is a major impediment to economic growth.

Connecticut is strategically located between New York City and Boston. Access to both cities and many employment opportunities, combined with Connecticut's lower housing costs, should make the state an attractive place to live. However, Connecticut does not leverage this advantage because partial rail service is not rapid enough to commute to Manhattan from outside of Fairfield County and the highways are too congested for regular commutes to either New York or Boston. Similarly, because of slow rail service and anemic business growth, Connecticut is not generating opportunities for reverse commuting from New York City, especially among young college graduates. The ability of residents to reach New York and Boston quickly could be a driver of

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33 Thumbtack Small Business Survey asked several questions about business friendliness to >13,000 small business owners across the US, Connecticut small business owners contributed the input that was compared with other states to come up with final ranking

34 Thumbtack Small Business Survey asked several questions about business friendliness to >13,000 small business owners across the US, Connecticut small business owners contributed the input that was compared with other states to come up with final ranking

35 CBIA Small Business Survey, 2016

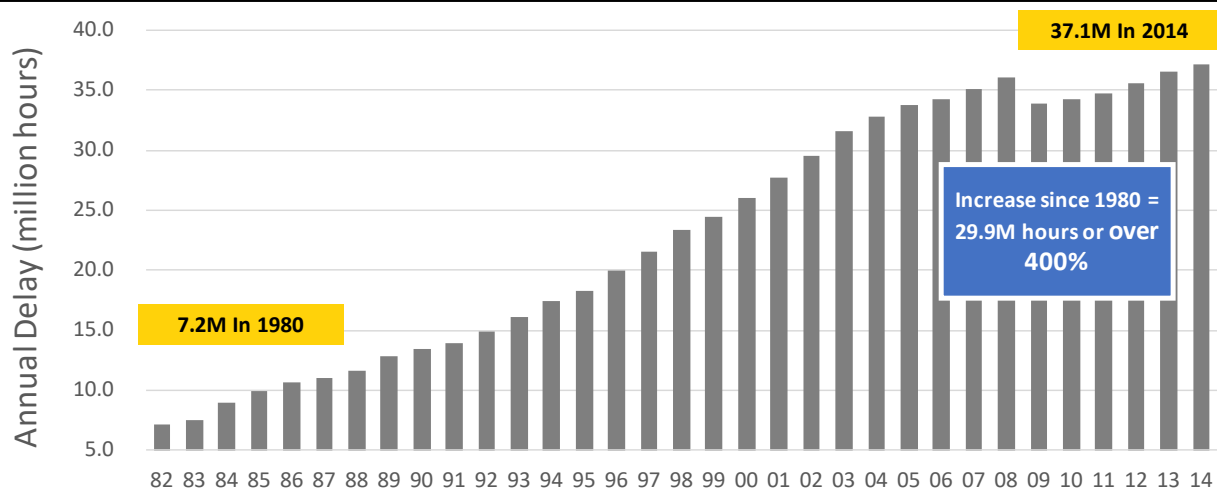
economic growth, enabling people to live in many parts of Connecticut and be able to reach these cities quickly.

In addition to land-based travel, air travel, which is overseen by the Connecticut Airport Authority (CAA), also requires significant investment. In Connecticut, air passengers must often travel first to hubs outside the state in order to connect to their final destination. As a result, Southern Connecticut is one of the most underserved air markets in the country, as most potential patrons of Tweed travel to airports in New York instead.

The key challenges facing Connecticut's transportation system include:

- Congested highway travel and unreliable traffic conditions cost businesses and citizens billions of dollars in lost productivity, wastes an immense amount of time and causes aggravation, and disincentivizes businesses from expanding or locating in the state. Productivity losses from congested highways are enormous. In 2014, commuters in the Bridgeport-Stamford Metro Area alone suffered 37.1 million hours of annual delay, up nearly 30 million hours since 1982.

MILLIONS OF HOURS OF DELAY ANNUALLY: BRIDGEPORT-STAMFORD METRO AREA



Source: Texas A&M Transportation Institute

- Of the 4,238 bridges in Connecticut, 332, or 7.8%, are classified as structurally deficient. This means one of the key elements is in poor or worse condition. There are 55 structurally deficient bridges in the state on the Interstate Highway System<sup>36</sup>.
- The commuter rail system to New York relies on five critical bridges that are each over 100 years old. In 2014, the 120-year old bridge over the Norwalk River failed to close and

<sup>36</sup> American Road & Transportation Builders Association. Data from the FHWA's 2017 National Bridge Inventory.

trains could not operate through this section for two weeks. The closure displaced tens of thousands of commuters every day, seriously impacted businesses, and cost Connecticut's economy an estimated \$50-\$100 million in Gross State Product. The estimated cost in today's dollars required over the next ten years to begin replacement of these five bridges is over \$2 billion.

- Connecticut's bus system is a primary means of getting to work by tens of thousands of Connecticut residents. However, its routes are outdated and service is provided by 26 different operators, leading to independent fare and service policies, factors which cause unnecessary connections and long commutes.
- Air travel is critical to connect local businesses to the global economy, but business travelers often utilize airports in New York or Boston rather than in Connecticut given lack of adequate service at Tweed (New Haven) and Bradley (Hartford) airports.
  - Specifically, there is a legislatively imposed restriction on the length of the runway at Tweed Airport, a potential key link for Southern Connecticut business travelers who instead support New York airports and add to I-95 traffic congestion. Commuter flights out of Tweed would be of significant benefit to biotech and other start-up companies in Southern Connecticut.
  - Bradley Airport lacks adequate non-stop service to the West Coast and to key international hubs. Bringing additional routes to Bradley would help generate economic activity and generate revenues that are currently going to airports outside of Connecticut.
- The state's aging transportation infrastructure needs major capital expenditures to maintain even current inadequate service levels. The Special Transportation Fund ("STF") oversees investment in buses, roads and rail, and relies primarily on appropriations from the General Fund each year for its operations. However, these appropriations have not provided a steady source of funding that can be relied upon for long-dated capital projects. The STF must have a steady and reliable revenue stream, which would enable it to engage in longer-term planning and related financing decisions.

## QUALITY OF LIFE

Quality of life is crucial for competitiveness because it helps attract and retain talented people; companies take quality of life into consideration when deciding where to locate.

Overall, Forbes ranks Connecticut 5th in the nation in quality for life. Most of its towns are safe, with good schools and access to quality healthcare, for example. US News ranks the state as 8th in crime and corrections, 4th in education and 12th in healthcare. On average, residents are also more affluent than the average American, with nearly 50% of households earning at least \$75,000 per year and 10% more than \$200,000.

Central to both quality of life and business competitiveness is a state's relative standing with regard to the appeal and vitality of its central cities. Connecticut's cities are not typically regarded as being at the leading edge. Yet, there are important strengths to build upon. Certain cities have become leaders in culture and arts organizations. Further, in the case of Hartford, Bill Cibes—a former Secretary of Management and Budget for the state, writes:

“The Hartford metro area not only ranks No. 4 in the nation in “digitalization,”<sup>37</sup> it also ranks No. 3 in the WORLD in terms of productivity per capita....In 2016, the Brookings Institution and JPMorgan Chase published a study of the 123 largest metropolitan economies in the world. Data from that study show that, with nominal GDP per capita of \$84,029, the Hartford metro area ranks No. 3 in the world, after only San Jose (at \$91,437) and Singapore (at \$84,309)<sup>38</sup>. And GDP per worker (\$158,428) ranks No. 4 in the world, after San Jose (\$171,288), Houston (\$166,808), and San Francisco (\$164,521) – ahead of New York (\$158,339), Los Angeles (\$158,165), and Boston (\$139,160)<sup>39</sup>. (Connecticut as a whole ranked #3 in the country (\$64,511), slightly behind Massachusetts (\$65,545) and New York (\$64,579), in GDP per capita in 2016.<sup>40</sup>) The Hartford metro is classified as one of the 19 “Knowledge Capitals,” which according to the authors of the study, “are the world's leading knowledge creation centers.”<sup>41</sup>

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37 Muro, Liu, Whiton and Kulkarni, “Digitalization and the American Workforce,” Brookings Institution, November 2017, page 30. <https://www.brookings.edu/research/digitalization-and-the-american-workforce/>

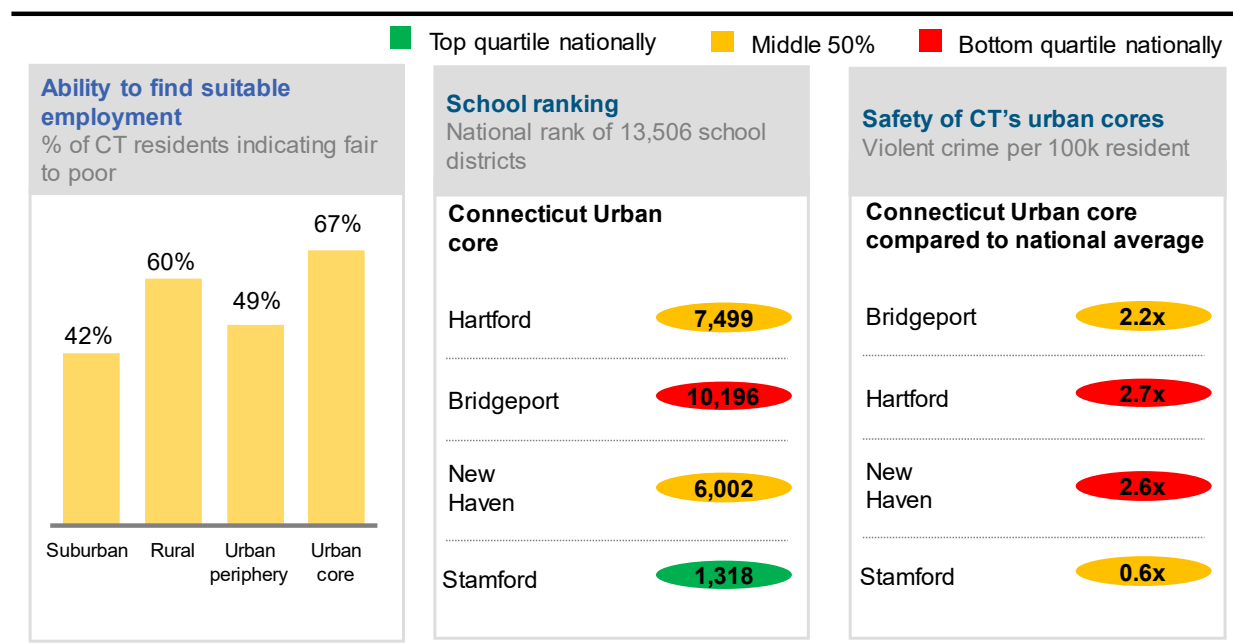
38 Jesus Leal Trujillo and Joseph Parilla, “Redefining Global cities: The Seven Types of Global Metro Economies,” Brookings and JP Morgan Chase, Global cities Initiative, September 29, 2016. The data for 2015 for all 123 metros are on pages 18, 21, 24, 27, 30, 33, and 36 of the PDF report, which may be downloaded via a link at <https://www.brookings.edu/research/redefining-global-cities/>

39 Jesus Leal Trujillo and Joseph Parilla, “Redefining Global cities: The Seven Type of Global Metro Economies,” Brookings and JP Morgan Chase, Global cities Initiative, September 29, 2016. The data for 2015 for all 123 metros may be accessed by hovering over charts for the seven types of metros at <https://www.brookings.edu/research/redefining-global-cities/>

40 <https://www.statista.com/statistics/248063/per-capita-us-real-gross-domestic-product-gdp-by-state/> 5 Trujillo and Parilla, pp. 2, 30.

41 Bill Cibes, from a Memorandum submitted to the Commission on February 22, 2018

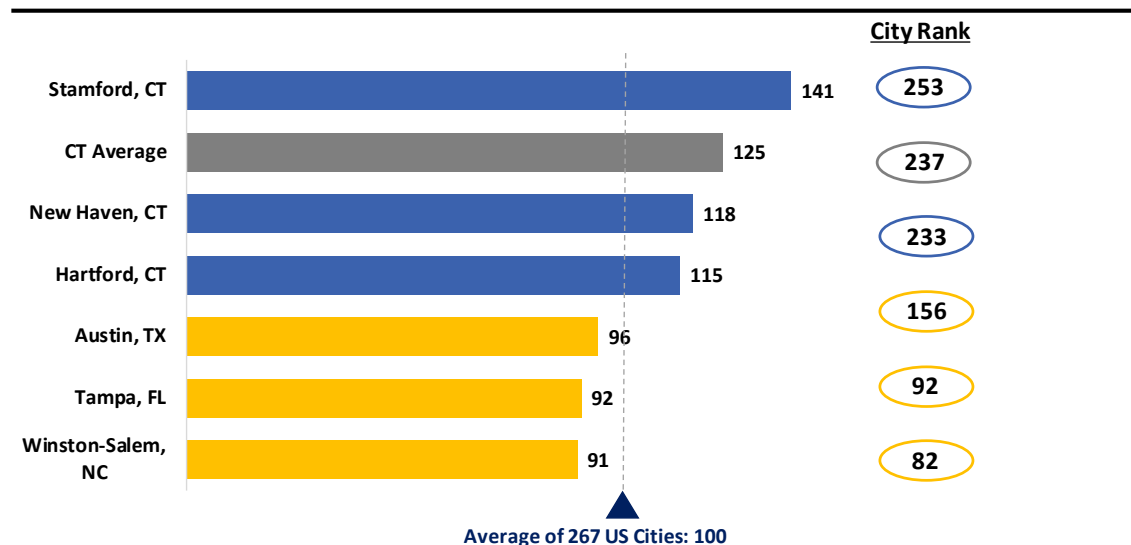
At the same time, Connecticut's cities provide a mediocre quality of life to the average resident. In AARP's Livability Index, which ranks cities based on housing, neighborhood attractiveness, transportation, environment, health, engagement and opportunity, Hartford has a livability score of 58, Stamford is 54, and New Haven just 51 out of 100. Vibrant urban cores are increasingly important for drawing new residents – especially millennials – but Connecticut's mediocre urban hubs fail to inspire them. Connecticut's cities also rank poorly on ability to find suitable employment, quality of its schools, safety, among other qualities.



Source: Education Week, CT Data Haven, FBI Crime Database, Zillow.com

In addition to scoring low on livability, living in Connecticut's cities costs more than living in an average US city and comparably sized metropolises.

#### THE COST OF LIVING IN CITIES IS HIGHER IN CONNECTICUT



SOURCE: National Association of Realtors (2015)

The promise of Connecticut's high quality of life once drew new highly educated residents from Boston and New York. They helped drive the state's growth and prosperity for generations. The quality of life in nearby cities has improved dramatically in recent years, while it has declined in Connecticut's cities, reversing the once steady stream of migration and exacerbating other challenges, such as a loss of income tax revenues.

## SUMMARY OF FINDINGS

Unfortunately, this extended discussion of findings presents a picture of steady fiscal and economic decline in Connecticut. Our challenge as a Commission is not just to understand the facts, but to communicate them in a compelling way so that our governmental leaders and the state's citizens at large have a shared starting point of concern as we approach the task of developing solutions.

# RECOMMENDATIONS

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# RECOMMENDATIONS

While the Commission's charge is to prepare legislative proposals, we need to direct certain recommendations to the governor for executive action and to the private sector across a broad range of engagements. While some of these recommendations may be more impactful than others, they are all important and should be acted upon as soon as possible, even though full implementation may take several years. Ideally, they should all be taken up by the legislature as a package, and some of them—those involving tax reform, spending management and transportation—must be dealt with in an integrated fashion. The Commission offers the following proposals for immediate action:

## PRO-GROWTH AND REVENUE NEUTRAL TAX REFORM

The Commission proposes a tax policy which would, if all provision were implemented simultaneously, be revenue neutral for the general fund, but revenue positive over time if joined with other initiatives. In developing this policy, we have tried to follow principles of fairness and neutrality among taxpayer groups, revenue adequacy, and attention to issues of economic equity. It seeks to drive economic growth which will ultimately produce the capacity to improve services and lower income disparities. It should send a very positive message to people at all income levels and help lift Connecticut's economy and our confidence in government back into positive territory.

This policy proposal has several elements:

**Personal income tax:** At the center of the Commission's recommendation is a dramatic reduction in the PIT rates, phased in over three years—by 18% in the top bracket (from 6.99% to 5.75%), by similar or greater amounts in lower brackets, and to zero for incomes below \$10,000:

## RECOMMENDED CHANGES IN PERSONAL INCOME TAX BRACKETS

Brackets	Today	2020	2021	2022+
<\$10K	3.00%	0.00%	0.00%	0.00%
\$10k-\$50k	5.00%	4.50%	4.00%	3.50%
\$50k-\$100k	5.50%	5.00%	4.50%	4.50%
\$100k-\$200k	5.50%	5.50%	5.00%	4.50%
\$200k-\$250k	6.50%	6.00%	6.00%	5.75%
\$250k-\$500k	6.90%	6.50%	6.00%	5.75%
\$500k+	6.99%	6.50%	6.00%	5.75%

The Commission's objective in the restructuring of the PIT is to create rates and tiers that compete more effectively with neighboring states, while at the same time retaining a graduated bracket structure - in contrast to Massachusetts' flat rate of 5.1%.

As described in CBIA and other surveys, the PIT is the most disliked tax by residents and business owners, and reducing it would deliver a powerful boost to the economy and confidence levels. A cut in the PIT also has the collateral effect of softening the impact of the new limit on the State and Local Tax (SALT) deduction recently enacted at the federal level.

**Corporation income tax:** We propose an increase of approximately \$475 million in total corporate taxes starting in FY 2020. These funds are needed to help offset the revenue losses from the reduction in the PIT (which itself is a reduction in taxes for pass-through companies). It is important that the business community shares some of the burden for what will be a major reduction in taxes for individuals and families, helping them to absorb increased sales and gas taxes.

We believe this can be accomplished without losing Connecticut's competitive positioning with neighboring states, and it should be done in a way that reaches equitably across both C-corporations and pass-throughs without an increase in the CIT rate. We propose to accomplish this through the levy of a 0.8% payroll tax across all companies, regardless of structure, but with a total credit (exemption) for up to the first nine employees and a reduction in rate to 0.4% for the next 10-99 employees. There is considerable interest in the Commission in exploring a business value or corporate activities tax and we believe that concept deserves further study. We believe that repeal of the Business Entity Tax, which produces only \$40 million every other year and is unrelated to entity profitability, should be part of any proposal. Insurance

companies, which are governed by a very different national regimen, would continue to be exempted while further analysis is done.

**Sales tax:** Effective in FY 2020, the sales tax rate would be increased from 6.35% to 7.25% to help balance the loss of revenue from the PIT reduction. While that rate would be tied with California as the highest in the country at the state level, the competitive comparison is better made by taking state and local sales taxes together. On that basis, Connecticut with a 7.25% state sales tax rate and no local sales taxes would rank 18th (from the highest) in the country. (If we include a local option 0.5% sales tax as discussed elsewhere in this report, Connecticut's ranking would move up to the 15th highest combined burden.) The chart below shows where Connecticut stands in comparison with neighboring states.

#### STATE AND LOCAL SALES TAX VARIANCE VS. COMMISSION PROPOSAL

	State Tax Rate	State Tax Rank	Avg. Local Tax Rate	Combined Rate	Combined Rank
Connecticut	6.35%	12	0.00%	6.35%	32
Commission Prop.	7.25%	1	0.00%	7.25%*	18*
New York	4.00%	40	4.49%	8.49%	9
Rhode Island	7.00%	2	0.00%	7.00%	21
New Jersey **	6.88%	6	-0.03%	6.85%	26
Massachusetts	6.25%	13	0.00%	6.25%	35

Note: Rankings expressed with 1 being the highest and 50 being the lowest

\*With 0.5% Additional Municipal Sales Tax Option, Ranking Would Drop to 15<sup>th</sup>

\*\*Salem County is not subject to the statewide sales tax rate and collects a local rate of 3.4375%. New Jersey's average local score is represented as a negative.

SOURCE: Tax Foundation, 2017

**Exemptions:** We propose eliminating a material proportion of the current “tax expenditures” (exemptions and deductions) that have proliferated over the years in connection with the sales tax in particular, but also the PIT, corporation tax, and a variety of special purpose taxes. The Office of Fiscal Analysis (OFA) estimates that these various tax expenditures, if repealed, would generate \$5.2 billion in additional revenues in FY 2019 (see materials under Appendix 2). There is a dizzying array of exemptions that has been the result of years of interest group lobbying. While many of these may have sound policy rationale (e.g., cost of collection, avoidance of cascading and redundancy, and conformity with federal or state law), others are not easily defended and reflect lobbying prowess more than public policy. We recommend that the legislature remove approximately 14% of the dollar value of these exemptions in order to

produce additional sales tax and other revenues on the order of \$750 million per year before rate adjustments. The governor should immediately direct the DRS to develop options to reach this goal. We further recommend that the legislature instruct the DRS to pursue all reasonable avenues to tax on-line sales, and start by reviewing the approach taken in Minnesota under its recently enacted Marketplace Sales Tax Law.

**Estate and gift taxes:** While the legislature recently voted to phase out the gift tax, Connecticut remains the only state to have a gift tax and one of only 14 states still to have an estate tax. These taxes are projected to produce only \$176 million in FY 2019, dropping to \$134 million in FY 2021. Because most states no longer have an estate or gift tax, Connecticut is at a significant competitive disadvantage that provides financial motivation for retirees and high net worth families to leave the state. Accordingly, these taxes should be repealed effective immediately.

**Increase the minimum wage:** While not a tax proposal, the Commission believes Connecticut should increase its statutory minimum wage and take that into account in terms of assessing the overall balance among income groups of our economic proposals. We would support increasing the minimum wage in annual steps from the current \$10.10 to \$15 per hour by 2022, starting with an immediate move to \$11. We are attracted by the approach recently taken in New York which provides for a slower implementation for smaller companies, and we would consider potential variations by age, full or part time status, region of the state, and other factors.

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Taken as a package, and they must be treated by the legislature as such, these changes would be highly beneficial to individuals and families, especially those in the lower income brackets. The increases in sales taxes are far more than outweighed by the decreases in income taxes. This is particularly important given the Commission's proposal elsewhere in this report to raise motor fuels taxes in order to refinance the Special Transportation Fund. Even with those increased gas taxes, the net effect for all individual taxpayers is significantly positive. If the Connecticut gas tax was raised by anywhere from 3 to 7 cents per gallon, that would add from approximately \$20 to \$46 per year in taxes per driver, far less than the tax savings headroom provided by the Commission's tax proposals.

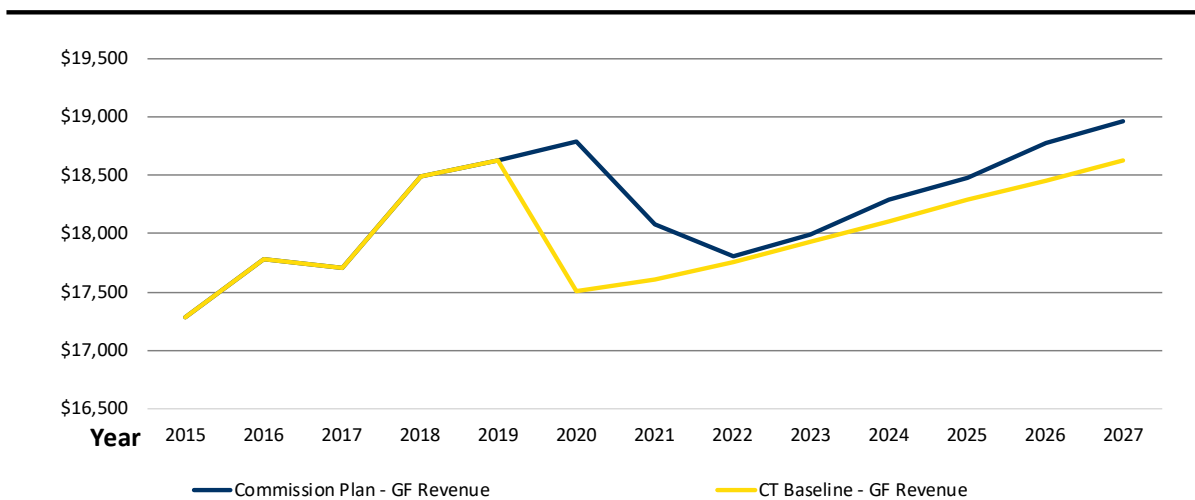
Annual Income (Single)	Estimated Income Tax Benefit	Estimated Sales Tax Impact	Estimated Net Impact
\$ 25,000	\$ 370.0	\$ (50.0)	\$ 320.00
\$ 40,000	\$ 530.0	\$ (80.0)	\$ 450.00
\$ 60,000	\$ 530.0	\$ (110.0)	\$ 420.00
\$ 80,000	\$ 620.0	\$ (140.0)	\$ 480.00
\$ 120,000	\$ 1,400.0	\$ (210.0)	\$ 1,190.00
\$ 250,000	\$ 1,280.0	\$ (410.0)	\$ 870.00

[1] All numbers assume average annual spending habits (30% of pay)

As noted above, the net impact of this rebalancing of taxes is designed to be revenue neutral, were they all to be enacted and go into effect at the same time. While we do seek their collective enactment in 2018 in order for them to go into effect in July of 2019, the PIT cuts are phased in over three years. This produces a bonus of additional revenues for calendar years 2020 and 2021 when implemented.

The tables below summarize these proposals and show the overall impact on state General Fund taxes and revenues.

#### Estimated General Fund Revenue - Commission Proposal vs. OPM Baseline



Source: Revenues – Comptroller’s Open Budget FY12 – FY17; OPM Consensus Revenue January 2018

Key Assumptions: All Rate Changes Take Effect IN 2020; Additional Economic Growth Of ~0.5% Assumed In Commission Plan Starting In 2020

In summary, we are proposing a package of tax changes which is pro-growth, saves people money even including likely gas tax increases, is revenue neutral were it all implemented immediately, drives revenue growth in the future, and provides a needed margin in the first two years which should allow for balanced budgets and contributions to the Rainy Day Fund. The legislature should enact this package as a whole in 2018.

## AGGRESSIVE AND SYSTEMATIC SPENDING MANAGEMENT

Connecticut has a spending problem. It must be attacked at the same time and in equal magnitude as tax reform, and achieving bipartisan and business support depends on that. We see six major spending management issues that need to be dealt with.

**1. The need for and refinement of expenditure management tools:** A central structural problem is that neither the legislature nor the executive branch has had an effective system in place to manage expenditures over time. In the case of the legislature, a promising and bipartisan start was made last year in the budget bill. Connecticut now has three “caps”: a spending cap put in place after over 25 years of trying, a so-called volatility cap, and a bonding cap. On top of that and with the strong support of the governor, Connecticut now has on the ballot a Constitutional “lock-box” to keep transportation revenues from being raided from the Special Transportation Fund. We note with pleasure the provision of the volatility cap which would direct surplus amounts above those needed for the Rainy Day Fund to the pay-down of unfunded liabilities. This is an example of the kind of social compact Connecticut needs: state employees will have every reason to join in the effort to grow the economy to be sure their pensions are funded.

We applaud these initiatives but note that in the case of the three caps, which were enacted without hearings, careful follow-up study is needed regarding their potential operation, interaction with each other, and unintended consequences for the budget.

Stepping back, these caps and lock-boxes are a fascinating example of government leaders trying to set boundaries on their own future actions and those of their successors, because they don’t trust the system to behave properly.

**2. The need for realignment in the legislature:** “Boundary limits” are not enough, inside the boundaries Connecticut needs a better legislative budget management system. The General Assembly’s budget system—according to those who are intimately familiar with it—has little coherence. Tax policy should determine revenue, and revenue should determine spending—but it doesn’t work that way. The Finance, Revenue and Bonding Committee attends to revenues and the Appropriations Committee attends to spending. They don’t meet together or work from a common script. In the end, the caucus leaders are typically left to forge a budget.

**3. Legislative control and collective bargaining:** The legislature has never had proper control over one of the biggest cost drivers—state employee wages and benefits, and teacher pensions. These have been left to collective bargaining between the SEBAC coalition bargaining group, in the case of state employees, and the governor’s office. The legislature only has the right to vote up or down on a negotiated contract. It has been effectively disenfranchised from managing one of the primary elements of the General Fund and the largest component of unfunded liabilities. The Commission was surprised to learn that only four states do it this way. By far the majority of states vest the power to determine pension and retiree health benefit formulas and funding policies in the legislature, rather than in collective bargaining. Getting these decisions more directly into the hands of the legislature where they can be broadly debated, can only drive positive results.

**4. The Teachers’ Retirement System (TRS):** Teachers’ pension benefits, and the state funding required to pay them, are putting an unsustainable burden on the state’s budget. With the assumption of full funding by 2032, the state will be required to contribute \$2.7 billion to the TRS in that year, implying an annual growth rate in the contribution of more than 6%.<sup>42</sup> This is not sustainable and must be addressed through a thoughtful restructuring of the funding policy, benefits and certain additional contributions by the state. Part of the solution must include a material reduction of the \$13 billion in unfunded TRS pension liability<sup>43</sup>, an amount which is artificially low because of the system’s use of an elevated 8% investment return assumption. Assuming a 6% return assumption, the unfunded liability would be \$21 billion. It would require a pay down of \$4.8 billion to get to the national teachers’ pension average of 55.5% funding ratio, assuming a common 6% discount rate. To reach an aspirational goal of 75%, a pay down of \$12 billion is required. The Commission’s more detailed proposal

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<sup>42</sup> The PEW Charitable Trust, assumed current 8% return assumptions

<sup>43</sup> 2017 TRS actuarial valuation report

in Appendix 3 contemplates a 30 year contribution of the lottery net revenue stream to the TRS pension fund, which would permit an approximate \$7 billion reduction in TRS unfunded liabilities using a hypothetical evaluation.

**5. Paying down SERS unfunded liabilities:** In addition to the TRS pension liability, the state has built up \$23 billion in SERS unfunded liabilities using a 6.9% investment return assumption.<sup>44</sup> On that basis, at a 29% funded ratio SERS is among the least well-funded plans in the country. If a more reasonable 6% return assumption were used, the unfunded liability number would grow to \$26.6 billion and its funded ratio would be 29%.<sup>45</sup> To get to the national state employees' pension funded ratio average of 64.9%, using a common 6% discount rate, a minimum goal which we should set to be competitive, would require a pay down of \$13.6 billion. To reach an aspirational goal of 75% funding ratio, a pay down of \$17.3 billion is required (pension experts would argue that a higher goal of 80% would be preferable). The source of this funding will ultimately have to come through higher minimum contributions and dedicated revenue streams, as in the case of the TRS proposal above, or from growth in the state's economy producing excess revenue above the volatility cap.

**6. Non-Fixed, discretionary cost management:** The state, under Governor Malloy's leadership, has made excellent strides towards controlling discretionary spending. In fact, non-fixed costs have declined from a peak of \$10.1 billion in FY09 to \$9.1 billion in FY17. However, based on the experiences of Massachusetts and Pennsylvania, a bold and comprehensive review led by a nationally prominent third party consultant such as Bain, Boston Consulting Group or McKinsey & Co. would likely result in expense optimization plans and actions to reduce the non-fixed costs by another \$1 billion without adversely impacting the social service outcomes of the state. This estimate has been reviewed by one of these firms and is considered achievable with a high level of confidence. It is understood that revenue related optimization may contribute a small share of this value creation and that fixed cost reduction opportunities would also be explored. This study should include a review of procurement practices and ways to expand the use of competitive bidding and performance analytics throughout state government.

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<sup>44</sup> Pew Charitable Trusts

<sup>45</sup> (See FN 44)

## PROPOSALS

Based on this analysis, we offer the following proposals regarding legislative process and capacity:

- The legislature should launch an immediate review of the three new caps enacted in 2017, including public hearings, with a view to improving and assuring their effectiveness. In particular, the May 15, 2018 effective date of the bond covenant provision of the volatility cap (the bond lock) should be changed until the end of the 2019 session. In the interim, consideration should be given to attempting to achieve the purposes of the bond covenant by means other than giving controlling influence to bond holders.
- The legislature should create a new leadership-driven Joint Budget Committee to establish aggregate state spending and revenue targets. (See testimony of Alex Knopp, former state legislator and Mayor of Norwalk, before the Commission on January 24, 2018.)
- The legislature should immediately enact statutory language vesting the authority to set state employee and retiree benefit formulas, funding and job protection policies in the hands of the legislature, to take effect upon the termination or renegotiation of any current SEBAC contract. This would be a necessary pre-condition for the Commission's proposed tax changes to take effect. In connection with these changes, the Comptroller should be charged with certifying that any financial or actuarial assumptions used by the legislature in exercising this authority are financially prudent and consistent with best practices.
- The legislature needs to adopt legislation as soon as possible to address the underfunding of the Teachers' Retirement System through a comprehensive reform of benefit and funding policies, the contribution of state assets to the system that would increase the funded ratio and lower the Annual Required Contribution (ARC), and the eventual restructuring of the amortization schedule. Re-amortization, which ultimately adds to taxpayer burdens, should not be undertaken without benefit reform. A more complete TRS reform proposal is presented in Appendix 3, including a plan for dedicating the lottery's net proceeds to the pension plan for a period of 30 years in order to reduce unfunded liabilities by an approximate and hypothetical value of \$7 billion thereby also reducing the ARC payment. Pending a complete review of municipal aid, discussed later in this report, the Commission does not recommend transferring a portion of TRS costs to municipalities.
- In view of the growing complexity of managing the state's finances and overseeing operations, the legislature should appoint a public-private commission to propose other

enhancements to legislative capacity and process. The Commission expresses its view that a poorly paid and part-time legislature may not be adequate to meet the state's needs, and believes that compensation and session length changes may be appropriate.

With regard to the executive branch, the Commission recommends:

- The governor should launch a process to select a consultant to conduct a 4-6 month review of discretionary costs with a goal of presenting its findings to the incoming governor and legislature after the November elections. Implementation would begin shortly thereafter and benefits would be realized over the four year period.
- The governor should promulgate a policy favoring privatization or outsourcing of state functions where that would enhance both service quality and cost effectiveness. Clear opportunities exist in the case of home and institution-based social services and in the case of John Dempsey Hospital, and the Commission would support energetic action by the executive branch to pursue them.
- The governor should appoint a public-private task force to examine issues presented by the current SEBAC agreement, including such matters as: the adequacy of Tier IV benefits in terms of attracting new workers; the likelihood of disruptive early retirements being prompted by recent contract changes; the potential to use structured financial transactions to pay down unfunded liabilities; the ability to implement privatization initiatives and how best to protect or buy out current employees in such circumstances; the need for a job freeze; options to remove quasi-public organizations like the Bradley Airport Authority and parts of the University of Connecticut from the SEBAC group in order to enhance their ability to compete for airline contracts and research grants, respectively; the relative equity of benefits among the tiers and between hazardous and non-hazardous categories of employees; the comparability of wages, benefits and funding policies to neighboring states and the private sector; and other related matters. Based on the results of this study, the governor should seek to re-open the current SEBAC contract on a voluntary basis. The Commission is taking no position on these issues, but rather is urging that they be studied by an impartial group outside of the confines of collective bargaining around any particular contract.

## TRANSPORTATION IMPROVEMENTS AND REVITALIZING CITIES

All of the Commission's research on the ingredients behind positive economic growth point to the importance of effective transportation systems and vital central cities. These are the key infrastructure "enablers" for businesses and residents and they are high on our list of priorities. Unfortunately, on both counts Connecticut comes up short in terms of competitiveness.

**Transportation** is obviously a key priority. Investments in transportation have a high return to the state in economic activity and job creation. The Commission spent considerable time reviewing the capital needs of the state's transportation infrastructure as cataloged by the State Department of Transportation. It is the Commission's conclusion that in order to maintain Connecticut's transportation infrastructure and to enhance economic growth, substantial additional capital expenditures are required as well as dedicated revenue streams.

### TRANSPORTATION PROPOSALS

The following recommendations are directed to the legislature, governor, and Office of Policy and Management for immediate action:

- Replenish the STF on an urgent basis by providing additional dedicated revenue streams. Further, the Commission supports passage of the Constitutional amendment creating a lock-box to protect any revenues that are provided to the STF. The Commission encourages the legislature not to redirect those revenues away from the STF before they are collected by the lock-box, honoring the spirit of the lock-box Constitutional amendment. The Commission supports the STF receiving the following dedicated revenue streams, in addition to those they receive today:
  - An increase of at least seven cents over four years in the motor fuels tax ("gas tax")
  - Retention of the half cent of sales tax currently contributed from the General Fund
  - Immediate receipt by the STF of the new car sales tax (not phased in over the five years through 2025 as current statute dictates)
  - Creation of tolls on major highways. The Commission regards tolls both as an inevitability (Connecticut is the only state on the Atlantic Coast without them) and as a means of developing a competitive revenue stream for investment purposes
- Transportation revenue streams that do not flow through the General Fund should be dedicated and committed directly to the Special Transportation Fund so it can become self-

sustaining without reliance on sporadic special funding.

- Prioritize capital projects that have the greatest likelihood of producing economic growth, and deprioritize others, while also maintaining a state of good repair on the system as a whole.

Special priority should be given to:

- Highways:
  - Adding extra traffic lanes on I-95 and I-84 in limited key segments to “decongest” at those points
  - Reconfiguring the I-95/I-395 Interchange
  - Improvements on the I-91 Corridor, including improvements to the Charter Oak Bbridge
  - Investing in critical projects to ensure all highways are in a state of good repair
- Rail:
  - Speeding rail transit to Manhattan from the shoreline and Hartford by (1) increasing frequency, (2) reducing the number of stops, and (3) using locomotives that do not require transfers in New Haven and CONNDOT should report annually to legislature on progress in that regard
  - Invest in direct rail service from Hartford and the shoreline to Manhattan’s West Side at Penn Station
  - Building the long-awaited parking garages in Stamford and New Haven
  - Investing in critical projects to ensure all rail segments are in a state of good repair
- Air:
  - For Tweed airport, repeal as soon as possible the legislation limiting runway length
  - For Bradley Airport, fund a \$10 million airline revenue guarantee fund to enable the CAA to negotiate for better service to high priority business destinations (e.g., West Coast and London)
- Bus Transit:
  - Evaluating the consolidation of the 26 transit districts and other steps to improve that service
- Ports:
  - Connecticut’s deep water ports in New London, New Haven and Bridgeport are an underutilized resource and should be the subject of a study by CONNDOT, DECD and the CT Port Authority to recommend a program of investments.
- The state should intervene as necessary to ensure CONNDOT is able to expedite projects that foster economic growth, including expediting local government approvals and permits.

- Bonding for CONNDOT should be done through Special Tax Obligations (STO's) only, and used for limited long-term capital projects. CONNDOT operating expenses should not be funded through bonds (as is sometimes current practice).
- Authorize new state funding sources and Public Private Partnership legislation that will enable Connecticut to utilize new federal or privately funded infrastructure programs, specifically to address limitations of the current 20-year Special Transportation Fund bond program.
- The budget should provide CONNDOT, the CAA, and the CT Port Authority with adequate human resources to plan and execute the capital projects the Commission recommends above.
- Current projections indicate that without a change in capital needs or without enhanced revenue streams, revenues in the out years (8 years+) will be insufficient to cover debt service for all the transportation projects currently contemplated. Therefore, CONNDOT's future capital projects in the pipeline need to be evaluated in detail at least biannually to determine the effect of possible technological changes (such as autonomous vehicles), to update the cost benefit analysis of such projects, and to determine methods of funding them.

The Commission believes the governor and the legislature in particular must approach the state's transportation needs with a longer-term perspective. This entails providing revenues to CONNDOT that will support a bonding program and pay-as-you-go investments in critical projects, with a multi-year view as to what revenues will be allocated to CONNDOT. Because of the nature of these longer-term investments, CONNDOT's ability to drive investment in Connecticut's critical infrastructure is constrained each time its budget is cut to enable the state to balance out its other expenditures.

**Cities** are a critical asset to all of our state's residents, whether they live there or not. Vital urban cores make for strong regions and support the entire metropolitan area and state with critical cultural, health care and higher education institutions. Given our focus on economic growth, vital cities are especially important because that's what job creators want in order to draw the talent they need.

In Connecticut, cities are challenged by several structural factors: they are relatively small and lack the ability to grow by annexation, there are no strong regional governments with which they can plan joint projects and share benefits and burdens and they are uniquely burdened by their concentrations of tax exempt property. Most importantly, they are saddled with high property

taxes that disadvantage them in the competition for businesses and residents. “While business owners and developers of housing for millennials must pay 74.29 mills on the assessed value of their property in Hartford, property tax rates in towns such as Simsbury, Bloomfield, Windsor, Wethersfield, Rocky Hill and Newington are less than 40 mills.”<sup>46</sup>

The issue of urban schools cannot be ignored when discussing cities. Without good schools, Connecticut cannot have stable and attractive city neighborhoods. The Commission appreciates the complexity of this subject and has no legislative proposals to advance at this juncture, but Appendix 5 suggests a range of administrative steps that should be considered.

## CITIES PROPOSALS

With respect to cities, we make the following recommendations to the legislature for immediate action:

- Expand to at least two other cities the model created by the Capital Region Development Authority (CRDA), a quasi-public agency that has been successful in Hartford. This entity would be leveraged by cities that wish to voluntarily utilize it to lead the development of high profile and high impact projects. It would be adjunct to municipal powers, applied as needed, and be released once the project reaches its completion milestones. There are several components to the CRDA model which could be considered for inclusion in a new entity: a board comprised of senior-level private sector leaders and municipal officials, a project team with a strong leader and small but capable staff, and a stable source of capital funding from the state to leverage private sector investment (but not grants). We recommend a reservation of \$50 million in bonding per year for each of up to three cities, once they are fully up and running. See Appendix 5 for more detail on this proposal.
- In the short-term, the Commission suggests to more fully fund the PILOT program with respect to state-owned property in central cities. In the longer-term, Connecticut needs a thorough review of the state’s municipal aid formulas with a view to mitigating the property tax “need-capacity gap” between its central cities and their suburbs.

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<sup>46</sup> Bill Cibes, *ibid*, p. 9. See also New England Public Policy Center at the Federal Reserve Bank of Boston: “measuring Municipal Financial Disparities in Connecticut”, Spring, 2015.

## TARGETED STRATEGIES TO DRIVE ECONOMIC GROWTH

Appendix 6 contains a comprehensive series of proposals which, when implemented in concert with the Commission's other recommendations, provides an integrated approach to catalyzing above average economic growth for the state. In the body of this report we single out some of the key recommendations and incorporate the comprehensive proposal included in the appendix by reference. For purposes of this summary, we condense our work under three headings: (1) supporting the growth of Connecticut's highest potential sectors, (2) developing and retaining the workforce Connecticut needs, and (3) transforming the business environment for entrepreneurship and innovation.

Under the heading of high potential sectors, we urge focused support in three areas: "InsurTech" (the intersection of insurance and financial technology), advanced manufacturing, and innovative healthcare delivery and biotech. The analysis of Connecticut's workforce issues identifies three imperatives: Connecticut needs to increase the quality and quantity of STEM talent, raise the national profile of its universities and intensify efforts to attract and retain talent. Finally, in order to stimulate entrepreneurship and innovation, our analyses examined improving the environment for small business, improving access to capital and other resources, and strengthening the support system of accelerators, incubators and labs.

## PROPOSALS

Appendix 6 contains numerous proposals directed to the private sector, public and private higher education institutions, and the ecosystem of support organizations. In this report, we single out the key recommendations directed to the legislature and executive branch.

- Inspired by the Roosevelt Island model in New York City, Connecticut should authorize the creation of a new, nationally competitive STEM campus in Hartford, New Haven or Stamford. The governor should launch an RFP process to recruit an in- or out-of-state university to lead this effort to enhance the advances already being made in STEM by Yale, UConn, and the state universities. The legislature should direct the executive branch to embark on this project and to hire a specialist consultant to assist.
- The importance of enhancing The University Of Connecticut's (UConn) status as a leading national research university cannot be overemphasized. While a lot of legislative attention

has been devoted to reducing UConn's budget and the number of highly paid professors, not enough effort has been spent on building its stature as a great public research institution and to measuring the ongoing success of the University's board and leadership. The legislature should consider appointment of a special Commission to determine what it would take to transform UConn into a top 10-15 US public university by 2025.

- Connecticut needs new state financial incentives to attract and retain STEM graduates and millennials in general. This could take the form of student loan payments or forgiveness, tax credits, or mortgage subsidies. The Rhode Island "Wavemaker" program offers one model.
- Connecticut needs to focus and fund DECD efforts to support incubators, accelerators, and analytics to assist the four key sectors, and to optimize the use of stranded tax credits as part of this effort.
- The governor or legislature should create a Red Tape Commission, similar to New Jersey. The target should be to rationalize existing regulations, as well as set guidelines for future regulations. To support this effort, a zero-based regulatory policy should be established — any new regulations must be offset by eliminating old ones.

## EXPANDED MUNICIPAL REVENUE SOURCES AND REGIONAL INITIATIVES

While our legislative charge focuses the Commission on fiscal stability and economic growth at the state level, we found that we could not ignore issues that lie at the junction of the state and its municipalities and among the municipalities. The towns are the legal creatures of the state and the state and the towns are mutually dependent.

We had many witnesses who spoke to these issues and we have organized their concerns into three main categories: (1) the virtually total dependence by the municipalities on the property tax and on uncontrollable levels of state aid; (2) the way in which the state imposes added financial burdens on the towns through labor-related requirements; and (3) the need for more state support for nascent regional and shared services initiatives.

On the first category, there is no disputing the point that the towns are unable to do much to diversify their sources of revenue—they have one direct taxing power, the regressive property tax. At 40% of total taxes, Connecticut does rely more heavily on the property tax than Massachusetts (36%), New York (31%), or the US as a whole (31%). The state's level

of municipal aid is relatively low, though not out of line with some neighboring states. Using 2015 numbers, Connecticut sends 24% of its own revenues (excluding federal transfers) to its local governments, compared to the 36% average for all states. The Commission further finds the state's current approach to municipal aid to be fragmented and unpredictable. In FY 2017 there was over \$600 million allocated, outside of education funding, in at least nine categories of seemingly discretionary grants (e.g., PILOT payments, road projects, "municipal aid projects", and the \$175 million Municipal Aid Revenue Account or MRSA).

Particular attention was devoted by local representatives in our hearings to three labor-related issues: the process in Connecticut for binding arbitration which requires arbitrators to select between the "last best offers" of the parties rather than something in between, the continued requirement to use union labor or "prevailing wage" on local projects (although this problem was partially alleviated in the 2017 budget legislation), and the difficulty in implementing multi-town projects when the bargaining units in each town must agree. Finally, we were pleased to hear strong support for Council of Governments (COGS) and regional initiatives, tempered by frustration that there was so little support from the state for these efforts.

By way of preface to our recommendations in this section we believe that Connecticut's landscape of 169 separate towns and no county government is not likely to change soon, and the Commission chose not to tilt at those windmills. However, important steps can be taken to support our municipalities and their efforts at regional collaboration.

## PROPOSALS

The Commission urges the legislature to take the following steps:

- Municipalities, acting separately or together through COGS, should be authorized to charge fees for:
  - Use of public rights of way, storm water fees, hotel, car rental, restaurant and other services;
  - "SILOTS"—service fees in lieu of taxes—to non-profit colleges and hospitals, while continuing to allow those institutions to retain their property tax exempt status.
- Municipalities, COGs or consortia of COGs should be authorized to impose supplemental time-limited sales or property taxes by special referenda to fund discrete capital projects.

Models exist in other states (e.g., Wyoming’s Special Purpose Excise Tax (SPET) or California’s voter-approved special purpose taxes).

- The state should change the binding arbitration requirements with regard to municipal employees and teachers to permit so-called “binding interest arbitration” instead of “last best offer”, thereby allowing arbitrators to make compromise awards. Consideration should also be given to requiring the consent of both parties to enter into binding arbitration and to setting time limits on the process. In assessing the financial capability of the municipality in an arbitration process, there should be an irrefutable presumption that a budget reserve of 15% or less is not available for payment of the cost of any item subject to arbitration under the Municipal Employees Relations Act and the Teacher Negotiation Act. Finally with regard to arbitration, the system should be changed to provide for the random selection of a single neutral arbitrator.
- Prevailing wage laws should be further amended to permit use of non-union labor on rehabilitation projects costing less than \$1 million, replicating the change made for new construction in 2017.
- Require municipal unions in towns proposing shared services arrangements to create a coalition collective bargaining agent that would apply to such arrangements.
- Give regionalization a major boost by empowering COGS to levy an additional sales tax of up to 0.5% (approximately \$400 million assuming base expansion) to be used solely for regional economic development and shared service arrangements.

We further ask that the governor:

- Convene a public-private task force to study and make recommendations to rationalize and make the state’s various municipal aid programs more predictable (see also the related proposal under cities, above);
- Apply under existing federal law to have the COGS receive federal designation as counties, in order potentially to qualify for additional federal funding.

## LINKED ENACTMENT

As we formulated our proposals, we encountered considerable skepticism that the General Assembly would be able to deal with and ultimately enact our proposals as a package. Yet, they were developed with a view to assuring shared benefits and burdens across sectors.

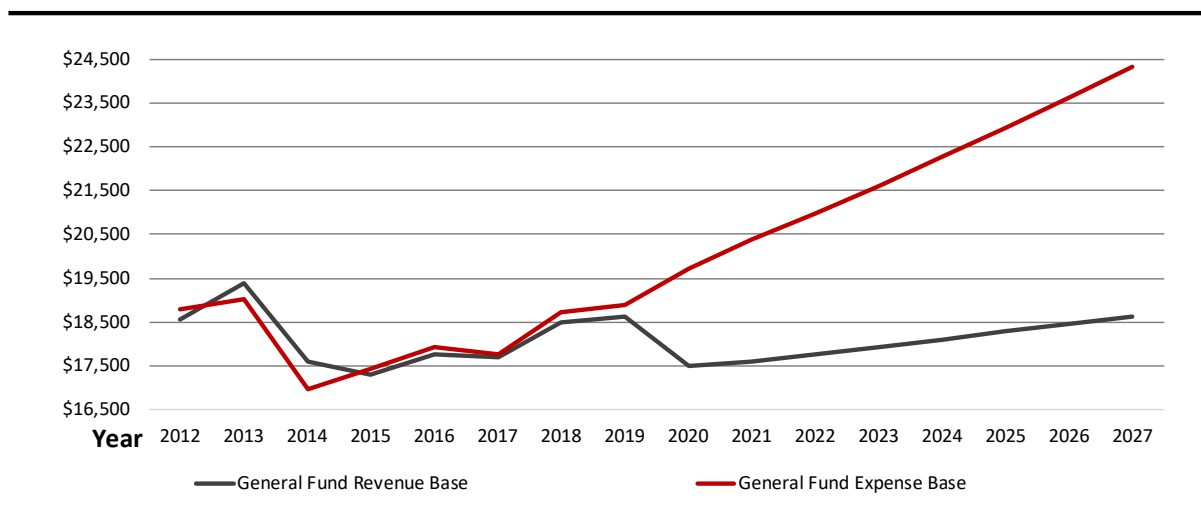
To deal with this important concern, we propose phased and conditional implementation. We would seek enactment of all the tax proposals in 2018, for implementation in July 2019 at the start of FY 2020. Implementation would be conditioned, however, on the General Assembly's enactment in 2018 of our recommendations regarding collective bargaining and binding arbitration and by the governor's implementation of the recommendation regarding a consultant-led cost management study and the resulting development by the governor of a proposal to extract \$1 billion in annual cost from state expenses.

This kind of cooperative and reciprocal action among parties at interest would be unusual, but consistent with the "grand bargain" we propose.

## A PATH TO FISCAL STABILITY IN THE NEXT BIENNIUM AND BEYOND

To assess the overall budgetary impact of its recommendations, the Commission used as a baseline the OPM/OFA General Fund consensus revenue projections for both the current and the next biennium. In the chart below you see the growing magnitude of the issues the state faces both in the near and long term.

### GENERAL FUND SURPLUS/DEFICIT PROJECTIONS - CURRENT POLICY



Source: Revenues – Comptroller's Open Budget FY12 – FY17; OPM Consensus Revenue January 2018 | Expenses – OFA Fiscal Accountability Report FY17 – FY20 & October Out Year Estimates

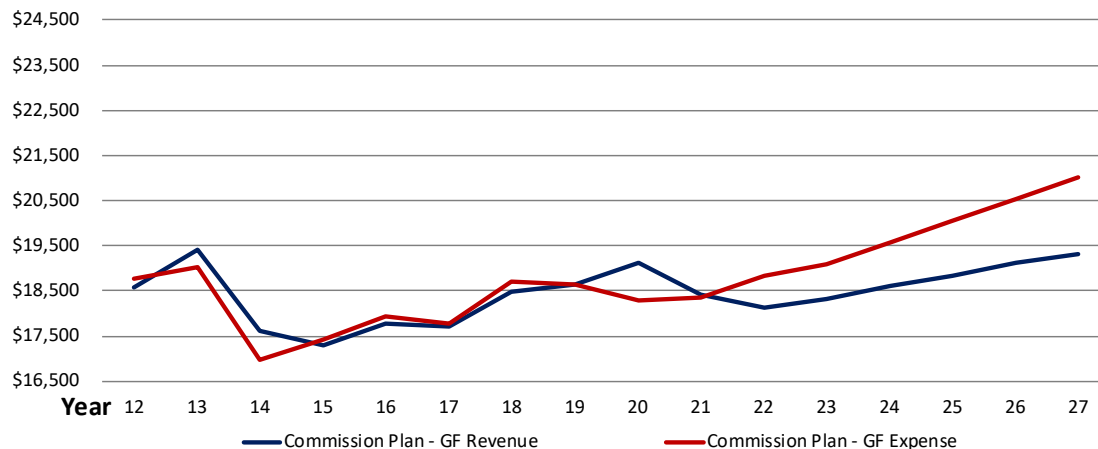
Key Assumptions: Fixed costs are growing at an average of ~5.5% each year; Total General Fund expenses growing at 3% in future years past 2022

These projections show growing annual deficits on the order from \$3 billion to \$6 billion in the FY 2022-FY 2027 period following the next biennium—clearly an unsupportable prospect.

The next chart depicts the surplus/deficit projections under the Commission’s plan, with three important assumptions: (1) the same reversal of the \$1.2 billion in so-called “structural revenue issues” (e.g., restoring the hospital tax and not funding the new MRSA program) that the governor recently recommended for the next biennium, (2) lowered TRS costs pursuant to our own proposal (see Appendix 3), and (3) the success of the \$1 billion cost reduction effort called for in our plan—an obviously essential part of the plan.

These projections assume an additional 0.5% of economic growth driven by the growth related initiatives and the pro-growth tax policy.

#### GENERAL FUND SURPLUS/DEFICIT PROJECTIONS - COMMISSION PLAN



SOURCE: Revenues – Comptroller’s Open Budget FY12 – FY17; OPM Consensus Revenue January 2018 | Expenses – OFA Fiscal Accountability Report FY17 – FY20 & October Out Year Estimates; CT Tax Expenditure Report February 2018  
Key Assumptions: All Tax changes are implemented in 2020 | Payroll Tax – OPM Population data; CT SBA Office of Advocacy

This projection suggests that the Commission’s plan can deliver balanced budgets through the next biennium, and also reduce the negative balance by over half in the out years.

Our plan for Connecticut “buys time” on fiscal stability. It should allow the state to enjoy balanced budgets through the next biennium, however the deficit from FY 2022-FY 2027 remains in the magnitude of \$1 billion - \$2 billion. As seen in the chart, the plan does provide ~\$800M surplus in 2020 due to the timing of tax plan phasing. The legislature could use these funds to: 1) assist with balancing the General Fund deficits in the near term, 2) solidify Rainy Day Fund, as the US economy is now eight years into one of its longest post-war expansion 3) fund various growth initiatives proposed in this report.

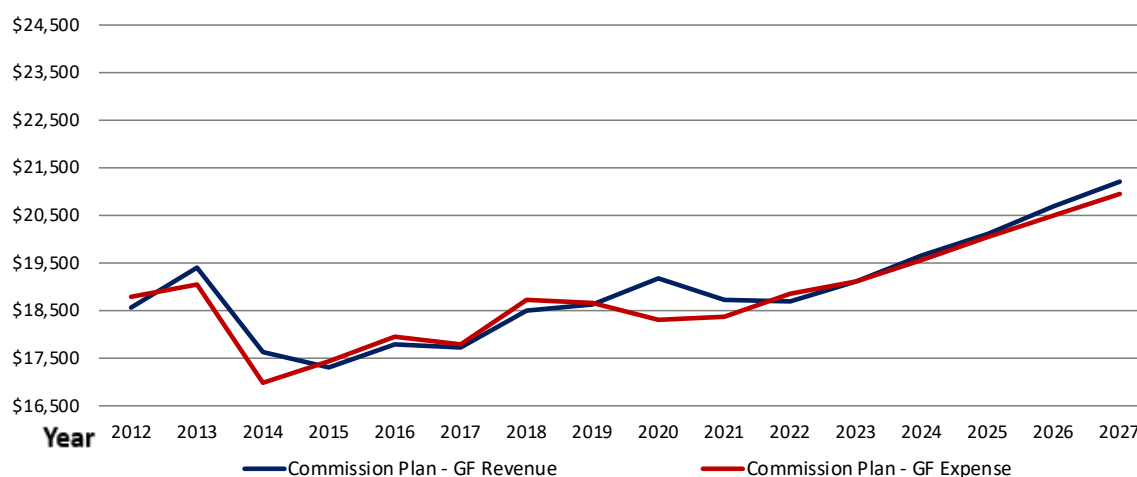
That said, it leaves more to be done to achieve sustainably balanced budgets beyond FY 2021.

At that point there should be several levers that policy makers can chose:

- Further expense reductions through modifications in Medicaid, re-opening of SEBAC, privatization, and additional structured asset transactions that can lower ARC payments and unfunded liabilities; and/or
- Selective revenue enhancements financed through growth or by tax base expansion.

If some of these changes are made and the state takes to heart the vision/goals presented by this Commission, there is a path forward. If you assume the 3%+ growth in the “straw-man” vision presented by this Commission (in this case using 3.5% GSP), the below charts shows that a path back to a balanced budget is possible with the potential for a surplus of ~\$250M by FY 2027.

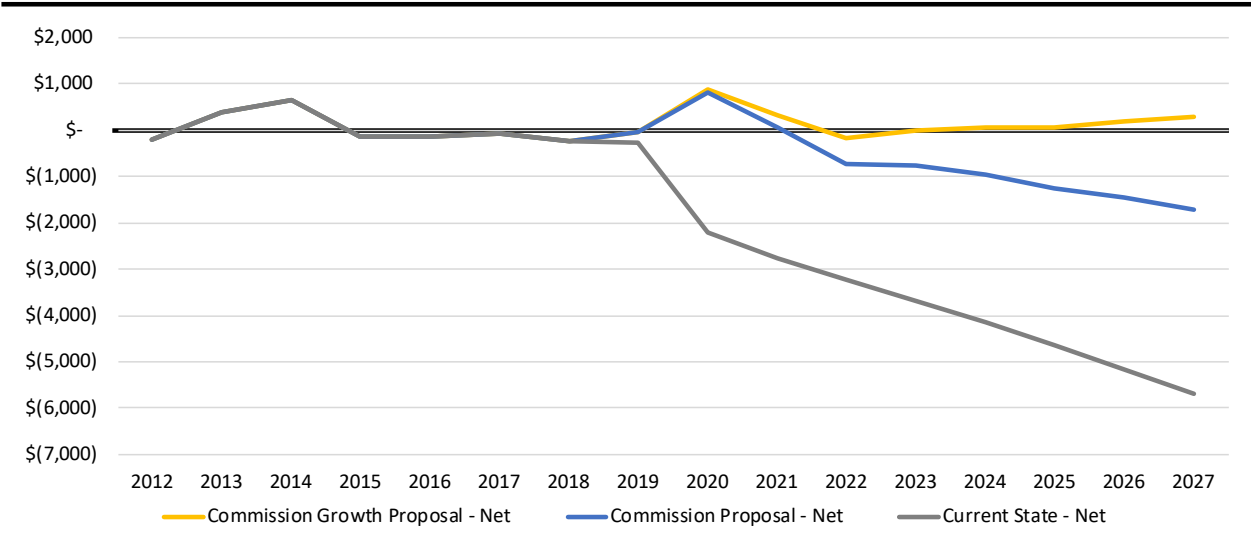
#### GENERAL FUND SURPLUS/DEFICIT PROJECTIONS - COMMISSION PLAN (GROWTH ASSUMPTION)



Source: Revenues – Comptroller’s Open Budget FY12 – FY17; OPM Consensus Revenue January 2018 | Expenses – OFA Fiscal Accountability Report FY17 – FY20 & October Out Year Estimates; CT Tax Expenditure Report February 2018

Key Assumptions: All Tax changes are implemented in 2020; | Payroll Tax – OPM Population data; CT SBA Office of Advocacy; Assume the pro-growth tax initiatives enable roughly 3% increased basis growth each year achieving our goal of a 3% – 3.5% Average GSP in 5-10 years

GENERAL FUND SURPLUS/DEFICIT PROJECTIONS - NET PLAN COMPARISON



Source: Revenues – Comptroller’s Open Budget FY12 – FY17; OPM Consensus Revenue January 2018 | Expenses – OFA Fiscal Accountability Report FY17 – FY20 & October Out Year Estimates; CT Tax Expenditure Report February 2018  
Key Assumptions: All Tax changes are implemented in 2020; | Payroll Tax – OPM Population data; CT SBA Office of Advocacy; Assume the pro-growth tax initiatives enable roughly 3% increased basis growth each year achieving our goal of a 3% – 3.5% Average GSP in 5-10 years

# SUMMARY AND CONCLUSIONS

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# SUMMARY AND CONCLUSIONS

In summary, Connecticut's platform is burning. By every measure—constant budget imbalances, growing unfunded liabilities, falling bond ratings, stagnant economic growth, competitive disadvantages compared to neighboring states on most important indices, increasing outmigration—the situation is at a crisis point.

The legislature must act, and we believe it wants to do so. It is often difficult to act boldly if you are not quite sure what to do. The legislature needs a plan, and we have presented one that we believe can appeal to all segments and get Connecticut back on the road to recovery. It is also difficult for a legislative body to act in the absence of support. Through our hearings and many conversations across the state, we believe there will be support for this plan. So the time to act is now, in this session of the General Assembly.

No doubt the breadth of our report might seem daunting—we offer over 30 discrete proposals and over one hundred pages of research and analysis. Let us simplify, while all of our recommendations have merit, we have outlined what appears to us to be the ten most important for immediate action.

- |   |  |
|---|--|
| 1) PRO-GROWTH TAX REFORM  | 7) REPLENISHING OF THE SPECIAL TRANSPORTATION FUND   |
| 2) INCREASE THE MINIMUM WAGE IN SEVERAL STEPS   | 8) EXTENSION OF THE CRDA MODEL TO TWO OTHER CITIES   |
| 3) CREATION OF A JOINT BUDGET COMMITTEE IN THE GENERAL ASSEMBLY   | 9) EXECUTIVE BRANCH LED GROWTH INITIATIVE INCLUDING CREATION OF A NEW NATIONALLY COMPETITIVE STEM CAMPUS IN ONE OF CONNECTICUT'S MAJOR CITIES  |
| 4) ASSUMPTION BY THE LEGISLATURE OF RESPONSIBILITY FOR SETTING THE KEY TERMS OF FUTURE EMPLOYEE CONTRACTS AND FRINGE BENEFITS, WITH SIGN-OFF BY THE COMPTROLLER | 10) DIVERSIFICATION OF MUNICIPAL REVENUE STREAMS AND GIVING COGS AN AVENUE TO RAISE MATERIAL FUNDING TO CARRY OUT REGIONAL SERVICE INITIATIVES |
| 5) REFORM OF THE TEACHERS' RETIREMENT SYSTEM  |  |
| 6) ORGANIZATION BY THE EXECUTIVE BRANCH OF AN EFFORT TO TAKE \$1 BILLION OUT OF SPENDING  |  |

The Commission itself, under its enabling legislation, goes out of business on March 1st. We hope that many of the Commission's members will become part of a reconstituted group of private citizens, affiliated with our non-profit support organization, Connecticut Rising. We want to be able to testify and advocate in support of our plan and we invite everyone in Connecticut to join the movement.

We are honored to have been chosen to do this important work.

Respectfully submitted,

BOB PATRICELLI

GREG BUTLER

JIM SMITH

ROXANNE COADY

PAT WIDLITZ

ENEAS FREYRE

BRUCE ALEXANDER

DAVID JIMENEZ

FRANK ALVARADO

JIM LOREE

MICHAEL BARBARO

PAUL MOUNDS JR.

CINDI BIGELOW

CHRISTOPHER SWIFT

# APPENDIX 1

## 1. Commission organization and work:

- The Commission was formally created by the General Assembly in section 250 of PA 17-2, signed on October 31, 2018. Most of its 14 members and the two co-chairs and vice chair were appointed by the governor during the week of December 11, and the last member was appointed in January. By statute, the Commission ceases to exist on March 1, 2018.
- In the two and a half months of its existence, the Commission has held seven public hearings, five in Hartford and two in New Haven; heard testimony from over 40 individuals and groups; and reviewed thousands of pages of submitted testimony and research.
- There have been numerous meetings with executive branch staff and with private individuals and groups, supplemented by access to dozens of research reports and the product of prior commissions.
- To organize its research, the Commission organized into “work streams”. These were not subcommittees with any delegated policy making authority, but research groups. The co-chairs sat in on all work streams. They included:
  - Fiscal stability and the Teachers’ Retirement System, led by Jim Smith and Pat Widlitz;
  - Competitiveness, Tax, and Economic Growth, led by Jim Loree;
  - Spending Management and Municipal Aid, led by Bob Patricelli;
  - Transportation and cities, led by Bruce Alexander;
  - Communications, led by Greg Butler.

We are tremendously grateful for the extra workload taken on by our work stream leaders.

- Immediately after the Commission legislation was passed, a non-profit organization- Connecticut Rising, Inc.-was formed to pursue research and public education in the general area of fiscal stability and economic growth, and to raise funds to hire consultants to support the work of the Commission. CT Rising is applying for IRS designation as a section 501c(3) entity. Its board of directors is comprised of Bob Patricelli as President, Jim Smith, and Alan Kreczko. To date, contributions of \$100,000 each have been received from the Robert and Margaret Patricelli Foundation, Webster Bank, and Yale University. More contributions are expected from entities associated with Commission members and others.

## 2. Grateful acknowledgments:

The Commission could not have done its work, especially on its accelerated timetable, without the dedicated work of numerous consultants and a large number of volunteers. We acknowledge their extra effort and thank them for their high quality work and patience.

- Our research and policy consultants have included:
  - McDowell Jewett
  - McKinsey & Company
  - Millstein & Company
  - The PEW Charitable Trust (volunteer)
  - Spencer Cain Associates
- Our individual volunteers are more than we can count, but include many employees of our members' own companies and organizations.

We simply could not have done this work as a diverse group of 14 volunteers without the dedicated effort of this corps of consultants and volunteers. We will be forever grateful.

A special word of thanks to the many senior officials of the executive branch who patiently met with us, answered our many question and advised on policy, especially Commissioners Catherine Smith of DECD, Kevin Sullivan of DRS, Jim Redeker of CONNDOT, Rod Bremby of DSS, Secretary Ben Barnes of OPM, Attorney General George Jepson, Controller Kevin Lembo, and Treasurer Denise Nappier, and their senior staffs.

To Tom Spinella, the Administrator of the Joint Committee on Finance, Revenue and Bonding, who flawlessly handled our administrative affairs as a public body, set up our government website and hearings, and handled our scheduling-you enabled our entire process, thank you!

The final word of thanks goes to our "appointing authorities": Governor Malloy and the six legislative caucus chairs, Senators Looney, Fasano and Duff, and Representatives Aresimowicz, Klarides, and Ritter. You trusted this process of private sector participation, and we hope that our report fulfills your expectations.

March 1, 2018

