



COMMISSION ON FISCAL STABILITY
AND ECONOMIC GROWTH
REPORT 2.0

November 2018

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COMMISSION ON FISCAL STABILITY AND ECONOMIC GROWTH REPORT 2.0

EXECUTIVE SUMMARY

The statutorily established Connecticut Commission on Fiscal Stability and Economic Growth delivered its report to the Governor and General Assembly in March of 2018, as required, and was officially disbanded. But we did not quit. While the reaction to the report was generally good, its major provisions could not have been expected to be enacted in the short 2018 session, and they were not. So we kept going as an entirely private group, meeting with legislators, citizen groups, and candidates for office—explaining the problems the state confronts and discussing solutions. It has been a productive eight months “seeding the ground”.¹

Now, the timing is right. We have a new Governor-elect and General Assembly-elect, and a full legislative session coming in 2019. In this interim period we have refined and focused our recommendations, and now present our “Report 2.0”. We believe it is the correct starting point for comprehensive and bipartisan reform. While our problems are severe, we are convinced they are fixable. Now we need the public and private sector leadership to get the job done. We offer a clear roadmap for corrective action to achieve fiscal stability and economic growth in Connecticut. These two are interlinked, with fiscal stability being the “chicken”, and economic growth the “egg”—you can’t get to the second without being on a path to achieve the first. Our roadmap is built around six priorities.

1. We must cut expenses and deficits on a sustainable basis. The state realistically faces \$ 1 to \$1.5 billion deficits per year for the next two years (taking into account recent added tax revenues and the likely rescission of certain future spending increases), with fixed costs growing at between \$500 and \$600 million per year thereafter. The legislature has a legal requirement to present a balanced biennial budget and we are confident they will do that. The challenge is whether they will do it on the basis of sound policy and with an eye to restraining future deficit growth. We offer the following guidelines:

- Cut the base deficit by at least \$1 billion/year through operating efficiencies and revenue optimization (not new taxes), and use outside help to do it;
- Do not use funds from the Rainy Day Fund that are not recurring, because that would not be sustainable
- Reduce the rate of growth of fixed expenses and the size of our debt and unfunded liabilities (\$101 billion!), especially in state employee and teacher compensation and benefits.

¹ In referring to the Commission’s activities since March 1, 2018, neither this report nor any of its authors is implying any statutory or official imprimatur or standing. Report 2.0 is entirely the work of a group of private citizens, exercising their civic responsibility.

2. Right-size state employee and teacher compensation and benefits, and reduce unfunded liabilities. We propose four key strategies here:

- Pass the proposal we recommended in March to reform the Teachers' Pension System (TRS), including higher member contributions, sharing the risk of investment returns between the state and the beneficiaries, and paying down \$7 billion of the unfunded liabilities through a dedication of the Lottery net revenues. The legislature can do most or all of this without waiting for collective bargaining approval;
- Change the model for retiree health benefits (called "OPEB") from an open-ended defined benefit to a defined contribution model for active and, if possible, retired state employees;
- Re-open the 2017 SEBAC collective bargaining agreement with state employee unions to achieve a two-year freeze on compensation and benefit increases, with the exception of a FY 2020 increase of 2 percent in annual compensation to be offset by a 2 percent annual increase in pension contributions, and make key structural changes to restrain future pension growth.
- Reduce unfunded retiree benefit liabilities over time by about one-third across TRS, OPEB, and state employee pensions, with positive annual budget impacts as a result.

3. Enact pro-growth, revenue neutral tax reform. In order to achieve fiscal stability, restore business growth and reverse outmigration, we must fix our tax system. Currently, our taxes are uncompetitive with comparable states and are driving businesses and residents away. We advocate a specific plan of business, individual income, gift and estate tax cuts to be paid for by a modest broadening of the sales tax base. Highlights include:

- Cutting the Corporate Income Tax to rate to 7 percent, removing the capital stock tax method of assessing the Corporate Income Tax, improving access to Net Operating Losses, and limiting the Business Personal Property Tax at the local level;
- Cutting the top rate on the Personal Income Tax to 6.7 percent and removing the recapture provisions for upper income taxpayers, removing the punitive Tax Add-Back for middle and upper income taxpayers, and increasing the Earned Income Tax credit for lower income earners;
- Doubling the credit (to a \$400 maximum) against the income tax for property and car taxes paid by lower and middle-income taxpayers;
- Repealing the Gift, Estate, and Business Entity taxes;
- Broadening the sales tax base by reaching into internet sales, services provided to non-business users, and a few currently exempt consumer products, and adding a new restaurant meals tax at a low 2 percent rate.

Altogether business and personal taxes would drop by approximately \$700 million in FY 2020,² balanced by base broadening steps in the sales tax. These changes would improve our Tax Foundation competitive rankings from 47 in the country to 37.

² More precise estimates are pending from the Office of Fiscal Analysis

4. Financing and prioritizing our transportation needs. Drawing on its first report, the Commission continues to believe that we need to focus more heavily on projects that have direct economic development and growth payoff—principally highway and rail projects in heavily congested corridors. We now propose an added approach to getting there—the use of public-private-partnerships (“P3s”) where large private contractors can take over design, engineering and construction on an expedited basis as compared to using state procurement and personnel.

For that to work, we need to enact P3 enabling legislation and project specific funding streams against which revenue bonds can be issued. Federal highway administration rules permit the assessment of user fees (point-specific tolls) for projects to de-congest Interstate highways, including rail projects in the same corridors. Other states have done this successfully—we need to do so.

5. Bridging the skills gap. Along with state fiscal stability and improved transportation connectivity, businesses need an adequate supply of skilled employees, and Connecticut—along with other states—is suffering from a shortage of STEM graduates. We propose a new program of four-year STEM scholarships at public and private state colleges and universities at the level of \$20 million/year (\$80 million when fully ramped). The program would include students seeking to teach in the STEM disciplines and would encompass elements of the arts that are relevant to business and urban revitalization (some have called this “STEAM”). Added funding should also be made available for high priority vocational training programs. The funds would come through bonding, since these are true infrastructure investments that pay for themselves over time.

6. Rebalancing municipal revenues and spending. The issues surrounding property taxes, municipal expense management, and regionalization cannot be ignored. We propose specific initiatives to:

- Rationalize state municipal aid programs;
- Expand local revenue sources;
- Better manage local worker compensation and benefits; and
- Enhance regionalization of services.

If the Commission were running for office, this would be our platform. But we are not, and it probably would be too controversial to get us elected. But it is a valid and comprehensive template for those who have now been elected, and we hope to work with the new Governor and General Assembly as they pick up their new and weighty mandate to produce change.

INTRODUCTION

In late 2017 the Commission on Fiscal Stability and Economic Growth was charged by the Governor and the General Assembly to make comprehensive recommendations by March 1, 2018, and we did so.³ It was perhaps not surprising that the General Assembly was unable to enact the expansive legislation we called for in the remainder of the short legislative session and in an election year. Nevertheless, the Commission succeeded in raising awareness of the state's serious problems and in planting the seeds for reform, and certain of our recommendations were referred for further study in the bipartisan budget.⁴

Since March 1, Commission members and especially the co-chairs have continued their work, even though our status as a public body has sunset. So, as a group of private citizens we have met with members of the General Assembly, presented at formal hearings, and traveled to community groups throughout the state to describe the report's findings and proposals. The record shows over a hundred meetings and presentations.

In the eight months since the report was completed, the state's problems have not abated. Action is needed now more than ever. With a new Governor and General Assembly, we have a refreshed opportunity. Our Commission has also learned a lot more in the intervening months about the problems and solutions, and we have refined our proposals accordingly. Whereas our original report presented over thirty proposals, this "Report 2.0" focuses on six top priorities for action and presents more detailed plans with regard to each.

It is our hope that by presenting Report 2.0 immediately after the election we can provide the new Governor and General Assembly with a comprehensive set of actions which they can adopt and build upon when the legislature meets in January.

UPDATE ON THE BURNING PLATFORM

The nature and depth of Connecticut's fiscal and economic problems were extensively explored in our initial report—we called it the "Burning Platform". Major points to remember are:

- With fixed costs (principally interest on debt, Medicaid, and public employee retirement benefits) growing as a percent of the General Fund by almost 6 percent per year, to a staggering 53 percent by FY 2020, our budget deficits are growing by \$500 to \$600 million per year. This is simply unsustainable.

³ Connecticut Commission of Fiscal Stability and Economic Growth, Final Report, March 2018 (hereinafter "Report 1.0"). This report can be found at www.CTRising.org, and the Commission can be contacted through the link on this website.

⁴ PA 18-81, SB 543 at sections 56-58.

- Further, our economy has actually been shrinking—real Gross State Product has shrunk by 9.1 percent in the last 10 years—in contrast to the states around us (which have grown by more than 10 percent) and the US as a whole. Connecticut has left \$50 billion in relative GSP “on the table” during this time
- Personal income growth has consistently lagged in our state, and in 2017 was seventh worst in the nation
- We have had persistent budget deficits—in every year but one from 2007 through 2016
- We have total debt and unfunded liabilities of approximately \$100 billion, when measured with a 6 percent investment return rate on assets. With approximately one million homeowners in the state, that is equivalent to an approximate \$100,000 mortgage on every home in the state. This overhang of debt and unfunded liabilities must be reduced as part of any serious plan to restore fiscal stability and economic growth
- At 13 percent, we have the highest ratio of debt service to underlying revenues in the country, and state and local debt taken together as a percent of personal income is the fourth highest
- Our state pensions are the fourth most underfunded in the country
- We have critical infrastructure needs in our cities, with roads and rail, and in the supply of skilled labor in the STEM fields most sought by employers
- Not surprisingly, in the face of this massive negative fiscal overhang Connecticut has lost its competitive edge and ranks in the bottom 10 in most surveys of businesses attractiveness.

The Commission was supported in its work by several consultants, including Millstein & Company (“Millstein”, now Guggenheim Securities), a New York and Washington-based economic analysis and consulting firm. Their compendium of charts on Connecticut is very helpful and can be found at www.CTRising.org.⁵

Notwithstanding this bleak litany, there is some positive economic news in 2018. Job numbers and state GDP are growing modestly, and as a result state tax revenues are up over initial projections by several hundred million dollars. In addition, the state has very important assets—its strategic location, highly educated workforce, wonderful topography, deep cultural and educational infrastructure, highly rated Bradley airport (third best in the nation according to user surveys), moderate housing prices compared to the megacities, high quality of life, and many other desirable attributes. Now we need to build on these assets.

⁵ “State of Connecticut Discussion Materials”, Millstein & Co, February 2018. Archived at www.CTRising.org.

GOALS AND CRITERIA

Our goals for Connecticut have not changed since Report 1.0:

- Achieve fiscal stability in terms of sustainably balanced budgets and manageable levels of debt and unfunded liabilities
- Target economic growth of 3+%
- Raise the state's competitiveness rankings to above median in 3-5 years
- Maintain critical services while protecting vulnerable populations
- Achieve a sustainable high quality of life for all Connecticut residents.

In Report 2.0 we focus squarely on a subset of proposals aimed at our statutory assignment--fiscal stability and economic growth. Without fiscal stability we cannot have economic growth, and without growth we will not generate the state revenues to provide critical government services.

The criteria we applied in selecting new programs or modifying current arrangements were focused importantly on competitiveness. Are our tax, infrastructure, and business incentives at least as attractive as comparable states, and where can we create competitive advantage? Given our fiscal constraints, are our levels of government employee compensation and our service programs appropriate in comparison to the states we compete with? Do the changes we propose set us on a path of fiscal stability and confidence in the eyes of investors and employers?



RECOMMENDATIONS

RECOMMENDATIONS

In Report 2.0 we refine and prioritize our recommendations into six initiatives. All are matters on which we would urge action in the upcoming 2019 legislative session. The six initiatives that are the most critical for the next legislature and Governor are the following:

1. Reduce expenses and eliminate deficits on a sustained basis
2. Through a combination of executive and legislative action, bring state employee and teacher compensation and benefit programs into alignment with our fiscal capacity and with comparable states, and get on a path to reduce unfunded employee benefit liabilities to acceptable levels
3. Enact a pro-growth and revenue neutral tax reform plan
4. Break the logjam on long term transportation funding and start action on key economic development-related projects
5. Make a major new investment in STEM education to close our state's skills gap, and
6. Take initial steps on diversifying municipal revenues and controlling local spending.

Here are our revised recommendations.

1. Cut expenses and deficits on a sustained basis.

The legislature took important steps in 2017 to create a system of fiscal caps (spending cap, bonding cap, and volatility cap) that will have a major impact on stabilizing state finances and reassuring investors and employers. However, large structural budget deficits still remain. In fact, PEW Charitable Trusts (“PEW”) reports that Connecticut is tied with Hawaii in having the fourth biggest gap between revenue and expenses from 2003-2017.⁶ According to the most recent projections from the legislature’s Office of Fiscal Analysis (OFA) and the Office of Management and Budget (OPM), the next budget biennium faces deficits of \$1.7 billion in FY 2020 (starting on July 1, 2019), and \$2.3 billion in FY 2021. Recent information reveals higher tax revenues by several hundred million dollars, some of which would reduce the deficit and some of which would flow to the Budget Reserve Fund (the “Rainy Day Fund”).

In addition to improving tax revenues, there are opportunities to reduce these deficits by up to \$1 billion per year by reversing certain budget decisions scheduled to occur in FY 2020. Taking those factors into account, the next biennial deficit might be in the range of \$1 to 1.5 billion/year.

⁶ <https://www.pewtrusts.org/research-and-analysis/data-visualizations/2014/fiscal-50#ind9>

By law, the legislature must enact a balanced FY 2020-2021 budget, and to assure fiscal sustainability it must moderate future deficit growth of \$500 to \$600 million per year. How does it do both of these things? We believe these targets are achievable through a mix of revenue optimization initiatives (not tax increases) and expense reductions that do not threaten the safety net. Any release of funds from the Budget Reserve Fund should not be a substitute for budget discipline and needs to be strictly limited to those amounts which are judged to be recurring, or else we will not achieve sustainably balanced budgets.

Quite simply, the Governor and legislature need to achieve a reduction in General Fund expenses and deficits by at least \$1 billion per year within the next two years on a sustainable basis and not through budget gimmicks. The Commission recommended that the state hire an expert consultant to find \$1 billion in revenue optimization and expense reductions, and included in its Appendix 3 a lengthy catalogue of options (e.g., automation and process improvements, streamlining procurement, privatization, consolidating agencies, and sharing services). The legislature agreed and instructed OPM to issue a request for proposal (RFP) at the \$500 million target level. The state should proceed expeditiously to implement this directive. The RFP responses are in and the new Governor should move ahead and expand the target for reductions to at least \$1 billion.

Building on the Commission's first report, and in addition to the consultant-driven search for operational efficiencies referenced above, we propose a specific range of initiatives to help eliminate the budget deficits:

- Increase sales tax compliance to a goal of 63% by FY 2021 (each 1% increase over the current 58% level is worth \$70 million)
- Increase fees and charges (for example, for licenses, use of state property, use of airports and highway rights of way, etc.), now at 13% of annual state revenues, to be closer to the national average of 17%. According to one paper prepared for the 2015 State Tax Panel, if Connecticut increased its charge revenue as a share of "own state revenue" sufficiently to cover the same percentage of expenditures as three other states that are close to the national average on charges, our state's revenues would increase by between \$349 million and \$867 million.⁷
- Consistent with state law passed in 2017, sell, lease, or enter into a joint venture for John Dempsey Hospital, while maintaining relationships with it and with other area hospitals to support the needs of the UCONN Medical School. Not only could this produce a cash payment, it would eliminate the hospital's drag on the state's operating budget of close to \$100 million per year. (Note that, in order to make a sale possible, the state would probably have to retain some or all of

⁷ "Diversifying Municipal Revenue in Connecticut", David L. Sjoquist, Georgia State University, November, 2015, at page 8.

the employees' unfunded pension liabilities to date.) Other real estate optimization, including sale-leasebacks, has generated upwards of \$500 million per year in peer states

- Aggressively pursue savings in state employee and teacher pension and retiree healthcare benefits that would have positive impacts on current spending (see Recommendation 2, below).

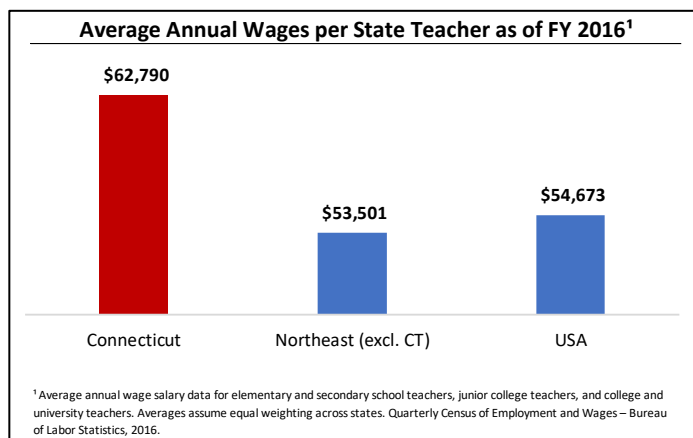
Reducing General Fund deficits on a sustainable basis by \$1 to \$1.5 billion per year will go a long way to restore business, taxpayer and rating agency confidence in our state.

2. Right-size state employee and teacher compensation and benefits, and get on a path to reduce unfunded benefit liabilities

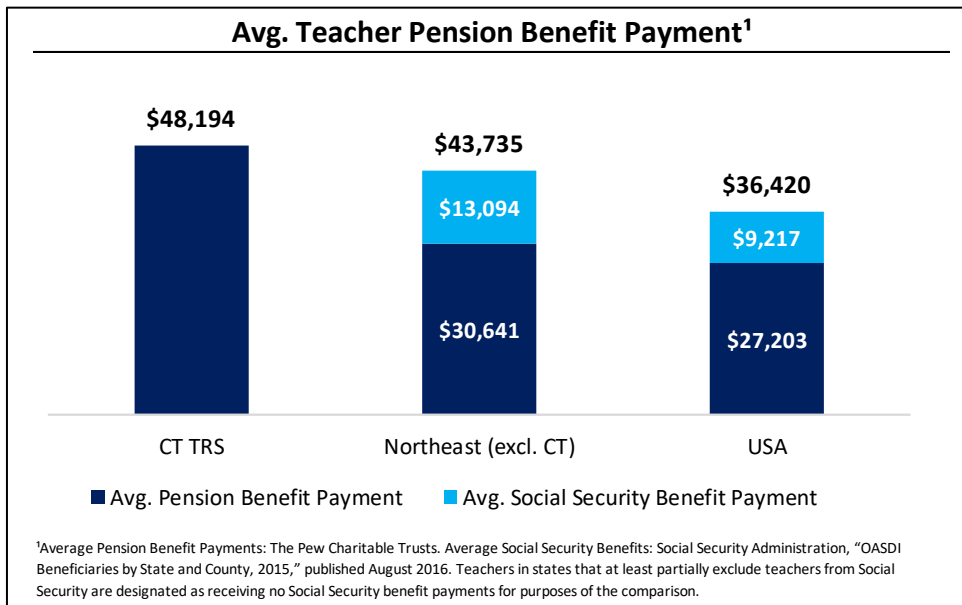
There is ample evidence that Connecticut's state employees and teachers are better compensated than comparable public employees in the Northeast and U.S. Data from 2016 compiled by Millstein show our state's average annual state employee wages as second highest in the country (behind only New Jersey) and well ahead of private employees. Similarly, our state's teachers are paid average annual wages that are 17 percent and 15 percent higher than those of teachers in the Northeast and nationwide. While teacher salaries are paid by localities, not the state, these salaries drive teacher pension costs which are borne by the state.

| 2016 Average Annual Wages by State (Public vs. Private) ⁽¹⁾ | | | |
|--|---------------|-----------------------|------------------|
| # | State | Public State Employee | Private Employee |
| 1 | New Jersey | \$70,632 | \$62,421 |
| 2 | Connecticut | 69,963 | 66,584 |
| 3 | Massachusetts | 67,224 | 68,083 |
| 4 | Rhode Island | 65,931 | 49,562 |
| 5 | New York | 62,569 | 69,101 |
| 6 | Pennsylvania | 58,556 | 52,106 |
| 7 | Vermont | 55,664 | 44,137 |
| 8 | Delaware | 54,543 | 53,642 |
| 9 | New Hampshire | 51,828 | 54,215 |
| 10 | Maine | 44,163 | 42,118 |
| Average Northeast⁽¹⁾ | | \$60,105 | \$56,197 |
| Average US⁽¹⁾ | | \$54,522 | \$49,085 |

(1) Per Quarterly Census of Employment and Wages - Bureau of Labor Statistics
(2) Assuming equal weighting across all 50 states



At the same time, our state employees and teachers enjoy superior pension benefits. In the case of state employees, average pension benefits are almost \$38,000, well ahead of the average in the Northeast and the US as a whole. (More recent 2017 data from PEW puts the average state employee pension now over \$42,000.) Likewise, teacher pension payments are also comparatively high.



Further, to get a complete picture of the value of state employee post-retirement benefits we need to add to pensions the so-called "OPEB" benefits (principally medical, dental, and prescription drug coverage), net of any retiree cost sharing. For a retiree and spouse between the ages of 60 and 65, before Medicare kicks in, that is a very substantial annual value indeed—between \$29,000 and \$33,000 per couple. Post-65, the state-provided OPEB value per couple declines to approximately \$5,000 to \$6,000 as Medicare comes into play.⁸ So, depending on a retiree's age, the Connecticut state employee post-retirement benefits are worth in total between \$43,000 and \$71,000 per year, far eclipsing private sector benefits where no OPEB is normally available.

These comparatively generous state employee and teacher compensation and post-retirement benefits are part of our legacy as a state—in fact they have given us generations of high quality civil servants. However, are certain elements substantially more generous than comparable states and is their projected future growth more than we can reasonably afford?

Starting with pensions, our state has two major public employee pension programs—the State Employees' Retirement System or "SERS", and the Teachers' Retirement System or "TRS". Under the Malloy Administration, the state has finally begun to pay in full the Annual Required Contribution (the so-called "ARC"), which includes both the employer's "normal cost" needed to fully fund benefits for active employees plus the "unfunded actuarial liability" (UAL) which is the cost of amortizing any shortfalls in previous funding of normal costs.

⁸ "State of Connecticut Other Post-Employment Benefits Program", Accounting Valuation Report, Segal Consulting, January 2018, at page 26.

The current ARC for the state's approximately 50,000 active and 50,000 retired and deferred vested SERS members, and its approximately 51,000 active and 38,000 retired and deferred vested TRS members, is a considerable portion of the General Fund--\$1.2 billion for SERS for FY 2019 (another \$400 million is charged to the Special Transportation Fund), and \$1.3 billion for TRS, or together about 13 percent of General Fund expenditures projected for FY 2019. However, the true economic costs are far higher since these ARC requirements are derived using somewhat unrealistic assumptions on investment returns for SERS and TRS—6.9 percent and 8 percent respectively. Using a more realistic 6 percent assumption, state pension costs would be a substantially higher percent of the General Fund.

These numbers are more than our budget can bear. Instructive in this regard is a very recent study by J.P. Morgan entitled "The ARC and the Covenants 4.0"⁹. It uses an "IPOD ratio", defined as the combination of Interest on Net Debt (without amortization), Pension, OPEB, and Defined Contribution payments as a percent of state revenues. The authors posit that states that have IPOD ratios of 15 percent or less are "manageable". Using a 6 percent investment return assumption on pension fund assets for all states, Connecticut has an IPOD ratio of 35 percent (the 4th highest) and is one of only six above 20 percent (IL, NJ, HI, CT, KY, and MA).

The dangers inherent in our high and growing SERS annual costs are spelled out in PEW's September 2018 "State Stress Test Analysis", which shows what would happen to state finances in the event of a market correction lowering returns to 5 percent annually.¹⁰ (Parenthetically, this is not far from current reality—the Connecticut SERS pension return over the last 10 years has averaged 5.14 percent, compared to Massachusetts at 5.7 percent, New Jersey at 5.9 percent, and New York at 5.7 percent. We are in 35th place among the states on investment performance.¹¹)

PEW stated:

"If Connecticut were to follow its current state funding policy under the fixed 5 percent return scenario, the required contribution rate is projected to reach over 80 percent of payroll during the 20-year forecast period. . . . This spike would push pension contributions from 14 percent to over 20 percent of annual revenue, consuming more than \$1 billion of additional available revenue on an annual basis. . . . Indeed, our analysis found required contributions closely mirror or exceed the state's tolerance for payment . . . through much of the forecast period under this scenario. . . . The clear finding for Connecticut is that market downturns could increase that cost beyond the state's capacity to pay under the current funding policy (emphasis added)."

⁹ "The ARC and the Covenants 4.0", Michael Cembalest, J.P. Morgan, October 9, 2018

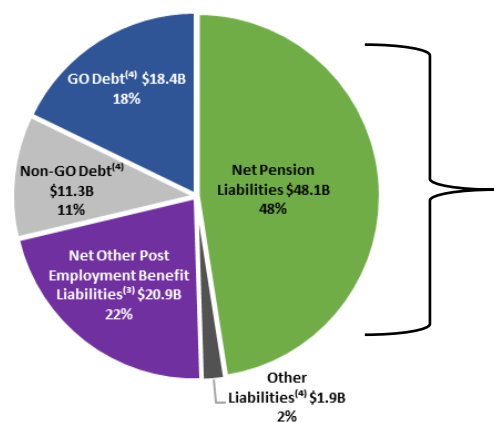
¹⁰ "Assessing the Risk of Fiscal Distress for Public Pensions: State Stress Test Analysis", Greg Mennis et. al., PEW Charitable Trusts, May 2018.

¹¹ "State Public Pension Funds' Investment Practices and Performance: 2016 Data Update", PEW Charitable Trusts, September 2018.

Beyond the annual budgetary impact of SERS, TRS, and OPEB, the unfunded liabilities of these programs together with state debt total a crushing \$101 billion (at a 6 percent return):

Total Connecticut Liabilities Assuming 6% Pension Discount Rate

Total Connecticut Liabilities as of June 30, 2017⁽²⁾



Total Connecticut Net Pension Liabilities as of June 30, 2016⁽¹⁾

| Plan | Adjusted Discount Rate | | Current Plan Discount Rate | |
|------------------------------------|------------------------|---------------|----------------------------|---------------|
| | Net Pension Liability | Discount Rate | Net Pension Liability | Discount Rate |
| State Employees ⁽⁵⁾ | \$26.6B | 6.0% | \$23.0B | 6.9% |
| Teachers ⁽⁶⁾ | \$21.1B | 6.0% | \$14.2B | 8.0% |
| Judicial ⁽⁷⁾ | \$0.3B | 5.9% | \$0.2B | 6.9% |
| Total Pension⁽⁸⁾ | \$48.1B | | \$37.5B | |

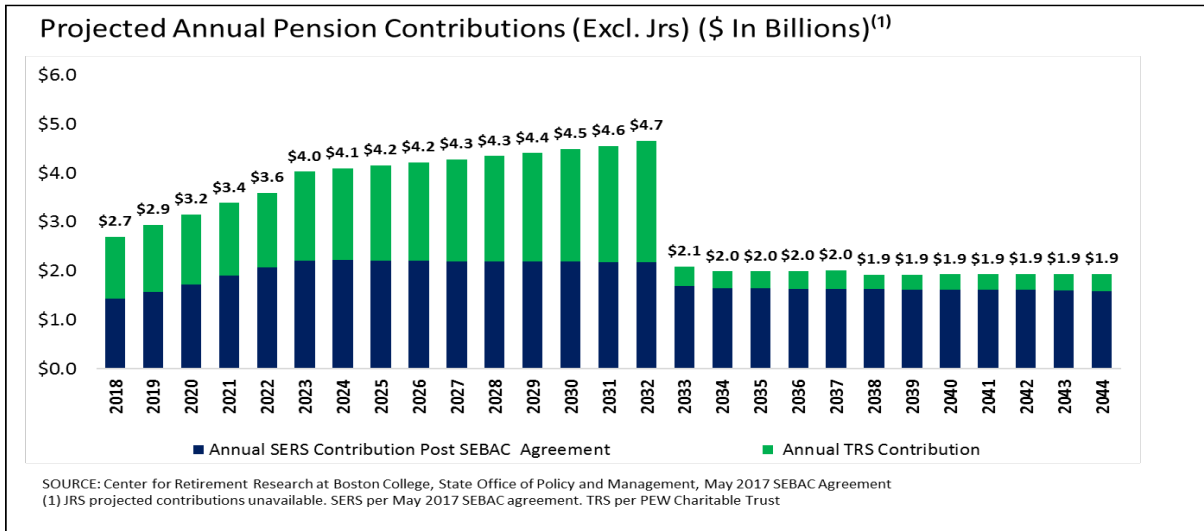
(1) Sensitivities at a 6% discount rate available only for the State Employees' Retirement System ("SERS") and Teachers' Retirement System ("TRS"), CT's two largest pension funds. Analysis assumes a 5.9% adjusted rate for the Judicial Retirement System ("JRS"), as that is the only sensitivity available for that system that is closest to 6%.
 (2) All liabilities are as of June 30, 2017 except the Net Pension Liability ("NPL"), which is shown as of June 30, 2016, as that is the only date at which 6% pension sensitivities are available for SERS and TRS.
 (3) Net Other Post Employment Benefit ("OPEB") Liability ("NOL") as of June 30, 2017 per the 2017 Connecticut CAFR. Consists of the NOL for the Retired Teacher Healthcare Plan ("RTHP"), amounting to \$3.5 billion, and the State Employee OPEB Plan ("SEOPEBP"), amounting to \$17.4 billion.
 (4) As of June 30, 2017, per the 2017 Connecticut Comprehensive Annual Financial Report ("CAFR").
 (5) Adjusted NPL per Pew Charitable Trusts. Pew uses the market value of assets ("MVA") and sensitizes the actuarial accrued liability ("AAL") using a formula based on the sensitivity and convexity of the AAL. Note that the NPL is the difference between the AAL and MVA. Current plan NPL as of June 30, 2016 per 2017 Connecticut CAFR. Current plan NPL as of June 30, 2017 is \$21.1 billion per SERS 2017 Actuarial Report – GASB 67 Supplement.
 (6) Adjusted NPL per Pew Charitable Trusts. Current plan NPL per 2017 Connecticut CAFR. Current plan NPL as of June 30, 2017 is \$13.5 billion per TRS 2017 Actuarial Report – GASB 67 Supplement.
 (7) Adjusted NPL per JRS 2016 Actuarial Report – GASB 67 Supplement. Current plan NPL as of June 30, 2016 per 2017 Connecticut CAFR. Current plan NPL as of June 30, 2017 is \$0.2 billion per JRS 2017 Actuarial Report – GASB 67 Supplement.
 (8) Total CT liabilities is approximately \$87.3 billion as of June 30, 2017, using current plan discount rates and unadjusted NPL figures as of June 30, 2017.

Not only is our unfunded state employee pension liability large in absolute terms, at \$26.6 billion, it is large in relative terms. PEW reports that Connecticut has the fourth most underfunded state employee pensions.¹²

Our pension and OPEB expenditures and liabilities are consistently growing faster than state revenues. We cannot achieve fiscal stability and economic growth unless we are demonstrably on a path to deal with both the excessive annual growth in the cost of our state employee and teacher benefits and our excessive debt and unfunded liabilities, without resorting to new taxes. People set goals for themselves—the new Governor and General Assembly must also set goals. We suggest targets of achieving over time: (1) an IPOD ratio below 20 percent; and (2) a reduction in our \$69 billion in unfunded pension and OPEB liabilities by at least one-third. How can we accomplish this without impinging on the quality of our public employee workforces and without triggering lengthy, expensive and alienating litigation? To start us on the path of achieving these goals, the Commission proposes three initiatives, listed here in priority order.

¹² "The State Funding Gap: 2015", Pew Charitable Trusts, April 30, 2017

A. Pass the Commission’s proposals to reconfigure the Teachers’ Retirement System (see Appendix 2 of Commission’s Report 1.0). This is perhaps the most urgent priority, given the serious impact the TRS as it currently stands will have on future deficits.



Fortunately, this is probably also the easiest priority to accomplish. Since collective bargaining is not a factor with TRS, the legislature can make these changes unilaterally and should urgently do so in 2019.

The Commission’s March proposal regarding TRS included: dedicating the net revenues of the State Lottery for 30 years to the teacher pension fund; re-amortizing the remaining liabilities starting in 2025 to reach full funding by 2045; raising teacher contributions from 7 percent currently to 9.85 percent (the average of similar states where teachers do not participate in Social Security, according to PEW); and introducing a risk-sharing feature that makes benefits dependent in part on investment returns. The contribution of the Lottery revenues to the TRS fund is estimated to be the equivalent of a lump sum contribution of approximately \$7 billion, enough to raise the funded ratio of the plan to the national average or above. We believe these changes should be made to apply to all active (not retired) teachers, vested and unvested, although more legal work is needed on possible constraints with regard to vested members of TRS.

The forthcoming work of the Pension Sustainability Commission will be a welcome addition to this discussion.

B. Change the state’s OPEB plans to defined contribution. Given the size of the state’s unfunded OPEB liability and the potential for rapid escalation in current pay as you go costs, dealing with OPEB should be the second highest priority.

By way of background, post-retirement health care benefits are unusual and have virtually disappeared in the private sector. American workers typically rely on Medicare for post-retirement health care, and buy private Medicare Supplement insurance or pay out of pocket with their own funds to fill in the gaps and coinsurance costs. Only certain public employees have an expectation that taxpayers will pick up some of these costs, and as these expenses have grown, governments are pushing back.

OPEB represents a huge financial overhang for Connecticut--\$709 million for health care only in FY 2019 in General Fund expense for about 50,000 retirees, rising to over \$1 billion by FY 2020, plus \$20.9 billion in unfunded liability with virtually none of that liability prefunded. Our OPEB liability exposure is three times the 75th percentile of the national average, according to J.P. Morgan analyses. PEW further reports that the state's ratio of OPEB liability to personal income is 9 percent, which is the 5th highest in the country. Not only is the liability very large, it is unpredictable since there is no long-term certainty how much of post-retiree health care Medicare itself will cover.

According to PEW, Connecticut is one of 27 states that contribute to retiree health care costs based on a "percentage of premium", where the state pays 60% to 100% of the premium based on a sliding scale that accounts for retirement age and years of service. In fact, in Connecticut beneficiaries pay very little for this lifetime benefit (which also covers spouses)—3 percent of compensation for 10 years, then zero thereafter. In effect, the state has elected to assume a defined benefit obligation to pay most of the premium of a Medicare wrap-around plan whose long term cost—unlike a pension—is unknowable.

It is imperative that the state get off this defined benefit risk and move over time to a defined contribution model for OPEB, freezing the initial state contribution at the current per beneficiary levels for all active employees. Twenty-three states provide such a "fixed dollar" contribution (or less), that limits the impact on state budgets of health care cost growth or Medicare reductions, though none of these states is in New England. (Nine of these states only provide access to private coverage, and two states do nothing on OPEB.)

Lastly, the state can and should immediately stop picking up one-third of teacher OPEB, at an annual cost of \$40 million, since the state has no control over health benefit plans at the local level.

C. Re-open SEBAC 2017. While the SEBAC agreement for the most part does not expire until 2027 (wage provisions and certain job protection language expire on July 1, 2021), the new Governor must work with the SEBAC bargaining coalition to re-open the agreement right away on a voluntary basis in order to reduce costs and liabilities. This is an urgent priority, and it applies to provisions covering both retirees and active employees.

While some observers believe that the pension and OPEB benefits of already vested retirees are not subject to change, there is a growing body of evidence that court opinions on this subject are being modified in the face of state

budget and economic exigencies. The previously cited “ARC and the Covenants 4.0” cites examples of recent state actions that have modified pension COLAs and OPEB benefits for retirees.¹³ In fact, in Connecticut both SEBAC 2011 and 2017 made adjustments in retiree health care cost sharing, so there is precedent for re-opening retiree OPEB benefits.

Since retirees account for slightly over 70 percent of the annual state employee ARC pension cost and most of OPEB, this is a subject for urgent examination by the Governor-elect and the legislature. Our recommendation with respect to retirees would be to (1) move up the effective date of the new and more constrained COLA formula and the scheduled increase in retiree health care cost sharing from July 1, 2022 to January 1, 2019 (in order to avoid a “rush to the exit” before July 2022), and (2) implement a phased reduction of health care benefits to achieve either a defined contribution outcome or at least a cost-sharing arrangement that more fairly reflects private sector benefit plans for unionized retirees.

As a matter of equity, it is only fair that retirees share some of the impact of benefit concessions with active workers. Otherwise, it seems inevitable that active workers and other important program areas like education and health and human services (which together consume 55 percent of the General Fund) will have to bear the burden of accommodating the looming incremental SERS and OPEB costs. (The SERS increases alone grow to \$700 million annually between now and FY 2023.) This would be a heavy burden for this generation to bear for underfunding by past administrations and legislatures.

For the approximately 50,000 active employees, in addition to the proposed changes in OPEB we advocate a two-year freeze on compensation and benefits increases, with the exception of a 2 percent FY 2020 increase in annual compensation to be offset by a 2 percent increase in ongoing annual pension contributions. Our state employees already have compensation and benefits packages that exceed those in the Northeast and the country as a whole. Our budgetary constraints are such that we cannot tolerate the planned 3.5 percent annual increases (plus step increases and longevity payments) that were negotiated for FY 2020 and FY 2021 as part of SEBAC 2017, as well as the comparatively low level of employee pension contributions.

Under our proposal, the SERS employee pension contribution level would increase to 6 percent (the national median) from 4 percent for Non-Hazardous Tiers I, II-A and III. As a matter of fairness, Tier II should likewise be increased to the 6 percent contribution level from the current 2 percent (which is the lowest contribution rate in the country). We further propose that any new overtime payments not be includable for pension purposes. Lastly, we propose to increase from 1 percent to 2 percent the state matching payment under the new Tier IV hybrid defined contribution plan, which we believe is not competitive in the employment market.

¹³ Ibid, at page 4.

Collectively, these changes will more fairly allocate burdens between taxpayers and employers, and between active and retired workers. It will lower ARC costs and budget deficits, produce better funded pension plans, and reduce the disparity between public retirement plans and what is available to private sector workers. While this will be a difficult negotiation, it is a fair deal.

These proposals for concessions from active and retired employees should be coupled with improvements such as the pay-down of unfunded liabilities so that pensions are better funded (see below), and possibly the introduction of new elements like pension buy-outs and VEBA-like trust arrangements. The Governor-elect and the new legislature should unite in attempting to achieve this grand bargain.

Even if the state is successful in achieving a slow-down in the increase of employee compensation and benefits costs, it still needs to deal with its crushing burden of \$69 billion in pension and OPEB unfunded liabilities. We propose a three-part attack on that liability overhang: (1) a \$7 billion reduction for TRS, as already discussed; plus (2) an \$8.7 billion reduction for SERS (one-third of that UAL); plus (3) up to a 43 percent reduction in the \$20.9 billion OPEB liability (up to \$9 billion), based on removal of the active employees from those now covered by the defined benefit model.¹⁴

In the case of the SERS pay-down, these funds could come from a variety of sources—for example, state real estate sales, lease-backs, or transfers to trust arrangements, or dedication of new revenue streams such as fees on sports betting or sales taxes on marijuana (if legalized). Since the \$700 million bulge in the SERS ARC only occurs between now and 2032 (14 years) and begins to diminish after that, the commitment of secured revenues could even be limited to that time period. An actuarial firm would need to be retained to determine the reduction in the SERS ARC that would result of from the dedication of property or revenues worth \$8.7 billion to the pension fund.

This plan would reduce unfunded liabilities by about one third, and would accomplish a very material improvement in plan funding ratios and state balance sheet stability.

It is the Commission's view that achieving fiscal stability for Connecticut simply cannot happen without a re-opener and modification of pension and OPEB obligations for active and retired employees under SEBAC 2017. This is not a speculative conclusion from the Commission—it is clear from any analysis of the J.P. Morgan and PEW studies cited above.

¹⁴ The projected reduction in the unfunded OPEB liability is not age-adjusted in this analysis and is likely to be lower. The state's actuaries should be requested to do that analysis as soon as possible.

It is greatly preferable that this re-opener be done on a voluntary basis, led by the new Governor. Accordingly, contrary to the Commission's recommendation in its original report, we would leave the current collective bargaining structure in place for now to allow for the voluntary path to be explored.

Any new collective bargaining agreement must be subjected to an independent review of its actuarial and budget impacts and be certified as consistent with good financial practice by the Controller before going to the legislature for approval.

3. Pro-Growth Tax Reform

One of the principle parts of the Commission's initial recommendations was a revenue neutral, pro-growth tax reform plan. That is still our intention. As the state achieves a positive fiscal climate, it must also have a competitive tax climate to stimulate growth and residential retention and in-migration.

According to the Tax Foundation, which is arguably the leading analyst of state tax systems, Connecticut now stands in a discouraging 47th place in the "2019 State Business Tax Climate" rankings.¹⁵ The Commission's revised tax reform recommendations 2.0 draw heavily on our first report, the 2015 State Tax Panel materials, and the active involvement of Tax Foundation senior staff and on their July 2018 report entitled "Enhancing Tax Competitiveness in Connecticut"¹⁶.

In its March recommendations, the Commission recommended a wide-ranging realignment of state taxes, reducing the Personal Income Tax (PIT) and paying for that principally through base expansions in the sales tax. That policy, of shifting from a heavy and increasing reliance on personal income taxes towards more consumption (sales) taxes, is widely supported by economists and remains at the heart of our new proposals. Moving toward a heavier reliance on the sales tax does not, however, require higher rates. It can be achieved instead by broadening the tax base. Data provided by the Tax Foundation finds that in 2017 Connecticut was 4th from the bottom in terms of the breadth of its sales tax base. Further, our sales tax revenue has declined from 2.42 percent of total personal consumption expenditures to 2.30 percent from 2012 through 2017.¹⁷ Our state's narrow sales tax scope results in part from the shift in recent decades to a service-oriented economy, coupled with an outdated tax policy that taxes all goods unless specifically exempted by the legislature, while taxing services only where specifically identified. This has left fast growing sectors outside the scope of the tax.

¹⁵ "2019 State Business Tax Climate", Tax Foundation, July 2018.

¹⁶ "Enhancing Tax Competitiveness in Connecticut", Jared Walczak, The Tax Foundation, July 31, 2018.

¹⁷ Fred V. Carstensen, Director, Connecticut Center for Economic Analysis, University of Connecticut School of Business.

We therefore propose several specific recommendations which form a more modest and targeted pro-growth and revenue neutral reform package that would help businesses and individuals. The summary below includes in bold type the preliminary revenue estimates supplied by the OFA and others for these proposals. The package should be taken as a whole, and not cherry picked.

A. Improve the business tax climate

- Eliminate the capital stock base method of determining Corporate Income Tax (CIT) liability **(-\$53M)**
- Liberalize the rules on allowing company use of Net Operating Losses, conforming as many states have done to the new federal standard for federal taxes which provides for an unlimited carryforward capped at 80 percent of a taxpayer's liability **(revenue loss estimate not yet available from OFA)**
- Return the cap on the percent of R&D, R&E, and site reinvestment tax credits which can be taken against annual profits to the pre-existing 50.01 percent level, repealing the annual increases that would take this limit to 70 percent by January 1, 2019 for certain "excess credits" **(revenue gain estimate not yet available from OFA)**
- Eliminate the business personal property tax for most current taxpayers by creating an exemption of \$25,000 in assessed value. This would have no revenue impact at the state level, but would reduce total local property tax collections by a few hundredths of 1 percent
- Allow the 10 percent surtax on the CIT for companies earning over \$100 million to expire as scheduled in FY 2019, and lower the top CIT rate to 7 percent, putting our state near the middle of business tax rates in New England **(-\$36M)**
- Eliminate the Business Entity Tax of \$250 every two years, which is charged regardless of profitability or company size **(-\$46M every other year beginning in FY 2021).**

B. Lower Personal Income and Wealth Taxes

- Eliminate the recapture provision that now kicks in at \$200,000 in Adjusted Gross Income (AGI) for a single filer, and \$400,000 for a joint filer. This punitive provision gradually eliminates the benefit of lower brackets by adding a recapture penalty at the rate of \$90 per person for every \$5,000 of income above the thresholds, up to a maximum of \$3,200 per person. This provision creates marginal disincentives and is particularly severe for owners of pass-through entities who see their business taxes increase when they cross the AGI thresholds. Only three other states (AK, NE and NY) have any type of recapture provision.

- Lower the top rate from 6.99 percent to 6.7 percent, the level it was at before 2015 and at the median of comparable neighboring states (Massachusetts at 5.1 percent top rate, New Jersey at 10.75 percent, New York at 8.82 percent, and Rhode Island at 5.99 percent).

The combined revenue estimate for eliminating recapture and lowering the top rate is approximately -\$350 million.

- For lower and middle-income taxpayers, significantly expand the income tax credit for property taxes paid on a primary residence and up to two motor vehicles. This credit is available on a gradually declining basis for income up to \$145,000 for a single filer and \$190,000 for joint filers, with the credit currently capped at \$200. Last year, the legislature temporarily limited this benefit to people 65 years of age or older. The Commission proposes to remove the age limitation and to double the maximum credit to \$400. This will provide meaningful tax relief for middle income home and car owners **(-\$118 million)**
- Eliminate the illogical and punitive add-back of taxes that applies to lower middle income taxpayers. Known as the “Tax Rate Phase-Out Add-Back”, this arcane provision increases taxes as much as \$200 for all filers starting at \$56,000 in income for single and \$100,500 for joint filers **(-\$125M, Commission estimate)**
- Raise the Earned Income Tax Credit, which helps low income families, back to 30 percent of the federal amount claimed **(-\$28M)**. Note that with a graduated standard deduction of \$15,000 (the highest in the country) and other credits, Connecticut ensures that low income families pay very little if any state income tax
- Repeal the new law that would exempt private pensions from the PIT for people with AGI under \$75,000 or \$100,000 for single or joint filers. By far the majority of other states don’t do this, and we can’t afford it **(+\$25 million in FY 2020 per Malloy Budget Update, May 21, 2018)**
- Repeal the Gift and Estate Taxes effective FY 2021—they are uncompetitive since no other state has a Gift Tax and only 13 others have estate taxes **(Commission/Tax Foundation estimate of -\$80M in FY 2021, no OFA estimate yet)**

C. Sales Tax Base Broadening. The above changes would produce a revenue loss of approximately \$740 million in FY 2020. We requested from the Tax Foundation their suggestions for a list of sales tax exemption eliminations by broad category that would raise the funding needed to pay for the above revenue reductions. Here it is, with their estimates of tax revenue raised:

| Estimates of Tax Revenue Raised | |
|--|----------------|
| 1. Remote sales tax collections (GAO midpoint estimate) | \$161 M |
| 2. Partial rate (2%) on groceries (food stamps, WIC, etc., still exempt) | 148 |
| 3. Dentistry | 96 |
| 4. Legal services, tax prep and accounting, consumer only | 47 |
| 5. Nonprescription drugs | 31 |
| 6. Renovations and repairs of residential property | 31 |
| 7. Veterinary | 30 |
| 8. Parking | 22 |
| 9. Dry cleaning | 16 |
| 10. Newspapers and magazines | 13 |
| 11. Amusements and recreation | 12 |
| Total | \$607 M |

Of course, this list is meant to be illustrative; other combinations of changes could produce the same result. Most of these proposed changes have to do with expanding the sales tax to the personal services and internet sales economies.

The various revenue gain and loss estimates above total to \$685 million in FY 2020, with certain as yet unknown positive and negative impacts that may total to a further net negative impact of perhaps \$50 million. With a positive proposed impact of \$607 million from sales tax base broadening, that leaves a gap of approximately \$128 million in FY 2020. We propose to close this remaining gap in funding by imposing a 2 percent restaurant meals tax (worth approximately \$140 million) on top of the current sales tax. All of our neighboring states except New York have a supplemental meals tax at either the state or local level, and in the case of New York their combined state and local sales tax of 8.49 percent would still exceed the combined rate for restaurant meals in Connecticut.

The Commission's proposed revenue reductions and increases are summarized in this table, showing a small surplus in FY 2020. The repeal of the Gift, Estate and Business Entity Taxes effective in FY 2021 could create a net deficit on the order to \$100M in that year, but estimates are too uncertain at this time to propose corrective changes.

| Revenue Impacts of Proposed Tax Changes (\$ in millions) | |
|--|--------------|
| FY 2020 | |
| Business Taxes | \$ (115) |
| Personal Income & Gift Taxes | |
| 6.7% Top Rate And Recapture | \$ (350) |
| Eliminate 3% Bracket Addback | \$ (125) |
| Additional \$200 Property Tax Credit | \$ (118) |
| EITC | \$ (28) |
| Sales Tax Base Broadening | \$ 621 |
| Meals Tax | \$ 140 |
| Total | \$ 25 |

These changes would make our tax structure competitive as compared to other states in New England, New York and New Jersey. The Tax Foundation has informed the Commission that, if enacted, these changes would move Connecticut up from 47th place in terms of overall tax climate, to 37th, a very significant improvement in our competitiveness. Further, on the component parts of the ranking, we would move from 29th to 8th on the corporate tax, 43rd to 40th on individual income tax, 30th to 24th on the sales tax, and 50th to 39th on the property tax.

4. Financing our transportation needs

The Commission in its first report proposed an extensive strategy for financing the state's transportation needs, and prioritized certain projects for attention. The priority list of projects remains the same in this Report 2.0, but we propose an adjusted approach on transportation finance.

Current levels of funding for the Special Transportation Fund (STP) are likely to be inadequate to support the major project needs we have, including safety-driven repairs of the Hartford Viaduct and the Waterbury Mixmaster, widening of I-84 and I-95 to add decongestion or "managed lanes", and commuter rail improvements along the New Haven line including replacement of three moveable bridges and access to Penn Station. Full replacement of the Viaduct and the MixMaster could push total costs to \$50-60 billion over 20 to 30 years.

There are a variety of financing devices open to the state and none of them should be off the table. A mix of them is likely the most appropriate solution:

- Both the Transportation Finance Panel and the Commission recommended modest increases in the gas tax to be spread over several years (although Connecticut already has the 7th highest total state taxes and fees on gasoline, and gas tax revenues will decline with the ramp-up of electric vehicles)
- Imposition of congestion management tolls on certain highways (federal rules permit tolling of Interstates as long as that is part of a plan to manage demand and reduce congestion)
- The use of General Obligation bonds to supplement transportation bonds backed by Special Transportation Fund revenues. In fact, in the last bipartisan budget bill, the legislature authorized \$700 million in GO bonds for transportation projects, with a projected increase to \$800+ million in future years. Given the priority we ascribe to transportation funding, the Commission welcomes some use of GO bonds, but cautions that transportation not crowd out other needed investments.

To this mix of financing options, the Commission proposes to add one additional strategy--use of project-specific funding and bonding for major highway and rail initiatives, employing public-private partnerships (so-called "P3s") to finance and execute the projects. This concept requires explanation. We are proposing toll-like user fees collected only from those who use the affected portion of the highway in question. This would not be a statewide system of tolls, which has so inflamed the public debate, but a project financing revenue bond vehicle. Under federal law, we can collect targeted tolls on bridges and viaducts and for variable pricing or decongestion highway projects and for rail improvements in those same corridors.

If and only if we can develop dedicated funding streams like this, can we look to the private sector for P3 project involvement. We would issue revenue bonds against these income streams, and would use private companies to execute the projects, under CONNDOT oversight. This has been very successfully demonstrated in states like Virginia and Florida. Some states have gone so far as to have the private contractors own and operate the projects, leasing them back to the states for "availability payments".

It is important to stress that P3s are much more than a financing device—they use private companies to design, engineer and execute massive projects, greatly accelerating timetables compared to using overworked CONNDOT staffs. To implement this strategy, it is likely that our state will need to pass P3 enabling legislation, and should do so in the 2019 session.

Some have suggested that we can look forward to major increases in federal infrastructure funding to support our needs. The Commission's inquiries about that have met with skepticism that such federal funding will be available, so it seems that our planning needs to be based on a projection of flat federal funding at best.

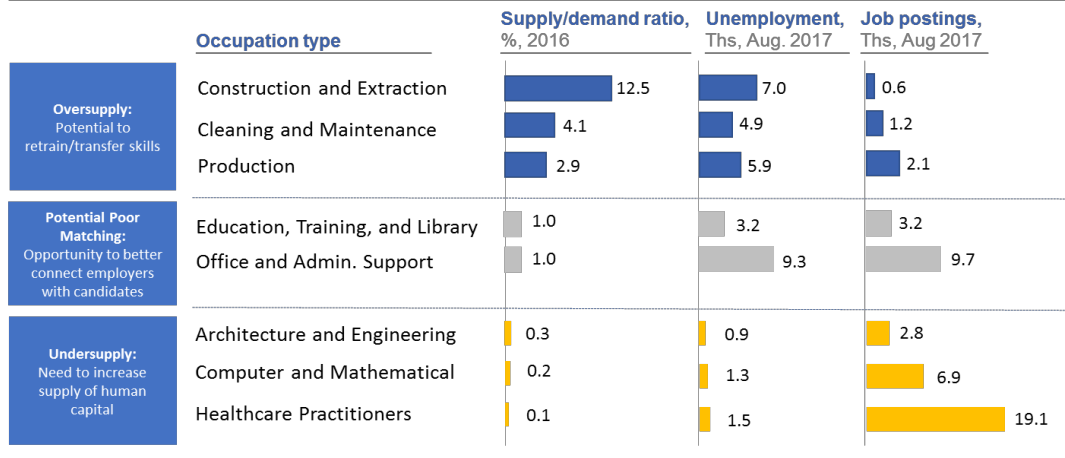
The list of project priorities we identified in our initial report remains current today. Special priority should be given to:

- Adding extra traffic lanes on I-95 and I-84 in limited key segments to “decongest” at those points
- Speeding rail transit to Manhattan from the shoreline and Hartford by increasing frequency and reducing the number of stops
- Reconfiguring the I-95/I-395 Interchange
- Investing in critical projects to ensure all highways are in a state of good repair, including the Hartford Viaduct and the Waterbury MixMaster
- Investing 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
- For Tweed Airport, repealing as soon as possible the legislation limiting runway length
- For Bradley Airport, funding a \$10 million airline revenue guarantee fund to enable the CAA to negotiate for non-stop service to high priority business destinations (e.g., the West Coast and London)
- Evaluating the consolidation of the 26 transit districts and other steps to improve bus service
- 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.

5. Bridging the Skills Gap

In addition to achieving fiscal stability, creating a pro-growth tax system, and investing in key transportation projects, there is one more urgent building block for economic growth—bridging the skills gap, especially for STEM educated graduates. Connecticut is one of only two states where jobs placed in STEM fields have declined. As pointed out in Report 1.0, we have a mismatch of labor supply and demand:

Connecticut Has A Mismatch Of Labor Supply And Demand



Source: EMSI and BLS data

In this Report 2.0, the Commission proposes a new initiative aimed directly at this skills gap problem: the state should offer a \$5,000 per year scholarship for up to 4,000 students per year to any Connecticut resident to attend a four-year public or private college or university in Connecticut in a STEM or health professions discipline, or to obtain an education degree and teaching certificate in the STEM fields to teach at the high school level. We would further broaden STEM to “STEAM” by adding certain disciplines in the arts given the contribution that graduates in those fields can make to both business and quality of life in our cities especially.

The program would be administered by the Department of Education, using the infrastructure already in place for the Willis or Governor’s Scholarships. Since a large majority of all Connecticut students who graduate from an in-state four-year college or university remain to work in Connecticut, we would not require proof of employment in the state after graduation. Since the state no longer provides scholarship support to students enrolled in the state’s numerous private colleges and universities—which in fact produce the majority of STEM graduates—this new program should have a very large impact in terms of expanding STEM capacity and enrollment.

The estimated cost of the program would be \$20 million for the first year, rising to \$80 million and 16,000 students enrolled in four years. Importantly, given existing deficits in the General Fund, we would fund this program through General Obligation bonds since it will pay for itself in terms of expanded Connecticut payroll. Since bond funds are constrained, the Commission recommends reducing state support for local school construction (we already have a reported 30,000 unfilled seats in our schools), especially in wealthy districts.

The Commission considered a further initiative to increase our STEM workforce by having the state, perhaps in a matching program with employers, forgive some portion of college debt for in- or out-of-state STEM graduates who

work in the state for up to five years. (See, for example, the recently adopted program in Maine.) This concept deserves further analysis and research, in part to determine if there are ways to avoid or mitigate the tax impact of loan forgiveness on the individuals involved.

Further, the Commission recognizes the importance of vocational training and apprenticeship programs for many of our key employers, and would support added funding for those programs in coordination with the promising work being done by the industry workforce advisory boards.

6. Rebalancing municipal revenues and spending

We cannot ignore the array of issues associated with the revenue and expense problems of our municipalities: their almost sole dependence on their real and personal property taxes; the special disadvantages of the cities in terms of tax exempt property and high mill rates; the relatively small (aside from education) and confusing mix of state aid to municipalities; and the inherent inefficiency of 169 municipal service infrastructures. The Tax Foundation in its 2019 ranking puts Connecticut 50th among the states for its property tax burden (which in their analysis includes the estate and gift tax).

The Commission has benefitted from much good input about this subject since publishing its first report, and we would now winnow our recommendations to focus on four key areas:

- Rationalizing the state's municipal aid programs
- Expanding local revenue sources
- Better managing municipal employee and teacher compensation and benefits, and
- Reducing operating costs through regionalization of services.

A. Municipal aid from the state. Putting aside education funding and the legislatively allocated grants from the Mashantucket Pequot and Mohegan Fund, the category of “grant payments to local governments” from the state has been growing modestly: from \$241 million in FY 2016 to \$314 million in FY 2019. There are six major sub-categories of grants to local governments that make up 95 percent of the \$314 million: \$56 million for PILOT grants for state owned property, \$106 million for PILOT for colleges and hospitals, and \$133 million split among four other categories. For the most part, this assistance is designed to make up for the loss of property taxes at the local level due to state policy decisions—property tax exemptions for state owned property, colleges and hospitals, and the state cap on the local car tax. There is no unifying theory of trying to allocate this state aid on the basis of relative local wealth.

As politically difficult as it may be, the Commission recommends that the state move away from allocating this \$300 million on the basis of a “make up the loss” theory, to a system based on relative municipal wealth as measured by Net Grand List Per Capita. (We chose this measure because, unlike mill rates, it cannot easily be manipulated in order to qualify for more aid.) The Office of Management and Budget maintains a ranking of municipalities by “Equalized Net Grand List Per Capita” which shows that, for FY 2016, the numbers vary from \$802,000 in Greenwich to \$50,000 in New Britain. The median is \$135,000 and the bottom 15 include all the state’s major cities. A transition to a formula based on this measure would need to be done on a phased basis, perhaps over five years.

It makes little sense to provide rich municipalities with big PILOT payments just because they have a lot of tax exempt property. Those municipalities get significant benefits from hosting those state-owned properties, colleges and hospitals, and they should charge the colleges and hospitals service fees to offset their direct costs. (PILOT payments for state owned property set at the level of appropriate service fees would remain.) PILOT payments and other forms of non-education municipal aid should be used as an intentional counterweight to disparities in local wealth and tax base.

In addition to conventional municipal aid, the state should fund through bonding \$50 million per year for expanded Capitol Region Development Authority (CRDA) programs in up to three additional cities and their contiguous towns (see Commission’s first report at p. 56), with consideration given to encouraging revenue sharing arrangements on new development across a city and its surrounding towns. School construction funding should be reduced to provide room for this bond allocation

B. Expanding local revenue sources. We do not support providing local option income or sales taxes as is done in many other states, because we feel that could lead to relatively poorer cities and towns further jeopardizing their business growth prospects in favor of their richer neighbors. However, we do support state action as needed to enable towns to expand their access to user charges and fees—which are underutilized in Connecticut—and to permit towns to use referenda to gain voter approval of bond funding for specific capital projects, as is done in other states. Further, we strongly support the charging of service fees in lieu of taxes (“SILOTS”) to non-profit organizations above some size threshold.

C. Better managing municipal level expenses, including compensation and benefits. While many of our municipalities need more help from the state, they should not get it without a demonstration of major effort to rationalize local employee and teacher compensation and benefits. The state should make available the powers of the Municipal Accountability Review Board (MARB) process at Tier 3 or 4 to any municipality in, say, the lowest 20

percent of the Net Grand List Per Capita rankings, with a view to reducing their expenditures. For municipalities in the bottom 10 percent, submitting to the MARB process should be mandatory.

The Commission's proposal, made earlier in this report, to extract OPEB from the purview of collective bargaining at both the state and local levels, would also help municipalities manage their expenses. Other proposals which the Commission made in its first report—e.g., moving to the selection of single neutral arbitrators and “binding interest arbitration” in employment disputes, protecting a budget reserve of 15% from arbitration awards, and permitting use of non-union labor on rehabilitation projects costing less than \$1 million—remain important.

D. Promoting regionalization of services. The Commission remains convinced that moving toward rationalization of local service delivery along regional lines is a necessity. Our earlier proposal regarding access to coalition bargaining for regional projects remains in place. The Regional Performance Incentive Grants should be fully funded to Councils of Government (COGS) to support regional service delivery and economic development programs. The DECD Commissioner should be given powers to decertify a municipality from certain categories of state aid if it elected without good cause not to participate in a regional services delivery program that projected a positive ROI.

Other Matters. While not rising to the level of priority of our top six categories, there are two other recommendations from our original report which we urge the legislature to consider in 2019, including raising the minimum wage in steps over time to \$15/hour, and reforming the General Assembly's own budgeting process.

All of our recommendations should be viewed holistically, with a view to producing a balanced set of reforms. A piecemeal approach will not work to achieve sustainable fiscal stability and economic growth.

A nighttime photograph of a city skyline with several illuminated skyscrapers. In the foreground, a highway interchange is visible with light trails from traffic. A concrete retaining wall separates the highway from the city buildings. Streetlights and building lights create a warm, glowing atmosphere.

CONCLUSION & ACKNOWLEDGMENTS

CONCLUSION

The Commission well understands, based on its own experience in the last session of the legislature, that it takes more than good policy proposals to effect major change. It takes courageous political leadership, preferably on a bipartisan basis, and good timing.

While we are sure that our policy proposals can be improved by full debate, they are currently the only comprehensive plan that has been offered and they are a good starting point for discussion. Based on the language of the just completed campaign, our newly elected leaders all say they want to make fundamental changes. Whether they have the will and ability to negotiate in good faith to achieve fiscal stability and economic growth for our state will depend in large part on what we—the citizens—demand of them.

Ultimately, the fate of the Commission's recommendations will depend on whether opinion leaders throughout the state get engaged to make sure positive change happens. The 2019 legislative session is an historic make-or-break political and policy opportunity for Connecticut. Now, the timing is good. The fate of the state is literally in the hands of all of us to help our Governor and legislature make the hard decisions that are needed.

To our fellow Connecticut citizens we say—now it's your turn, please get to work!

ACKNOWLEDGEMENTS

The Commission had access to numerous subject matter experts throughout the course of our work since March, when our first report was completed. Many were from various executive branch departments and agencies and from the General Assembly's membership and staff—all people who had heavy workloads and did not have to help a volunteer group like ours. We are very grateful.

Others were from the private sector, and all helped us on a pro bono basis. While there were many individuals who gave us advice and research content, a few deserve individual mention for the efforts they made:

- **Emil Frankel**, former Secretary of CONNDOT, Assistant Secretary for Transportation Policy for the U.S. Department of Transportation, and member of the 2016 Transportation Finance Panel
- **Walter Harrison**, former President of the University of Hartford
- **Jim Millstein** and **Elizabeth Abrams** of Guggenheim Securities
- **PEW Charitable Trusts**
- **The Tax Foundation**, and particularly its Senior Policy Analyst **Jared Walczak**

Thank you to all of you, named and unnamed, and may our work together be greeted with approval by policymakers in 2018 and beyond.