Observations on Governor Lamont's Budget Proposal

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Commission on Economic Stability and Economic Growth

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Outline

- What are the major problems the Governor faced?
  - Deficits (General Fund)
  - Debt and unfunded liabilities
  - Lack of funding for infrastructure
  - Lack of economic growth

- What solutions did he propose and how do they match up with the Commission proposals?

Deficits

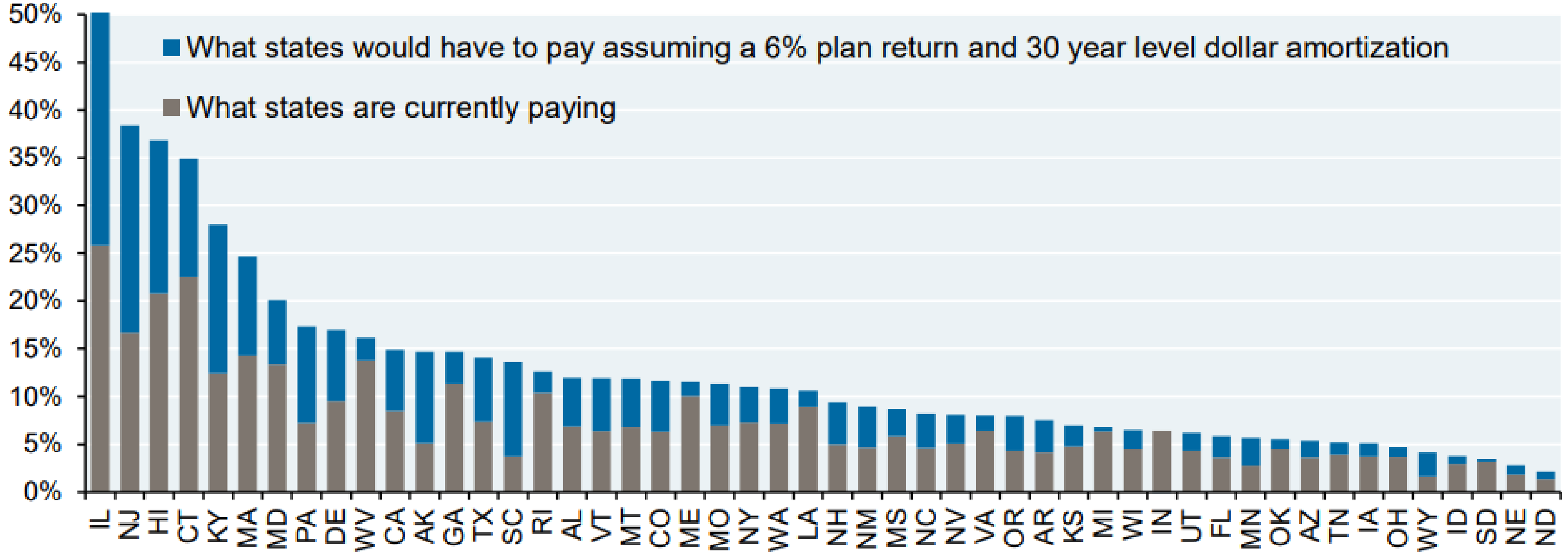
- $3.7 billion over FY 2020-21, and growing by $500 million/year
- Deficit growth driven by high fixed costs—51% and growing over the biennium
- Four key elements of fixed costs
  - Interest on debt
  - State employee pensions and health care
  - Teachers' pensions
  - Entitlements—Medicaid and social services entitlements

Connecticut's Ratio of Fixed Costs (Excluding Entitlements) to State Revenues is the 4th Highest—A Recipe for Fiscal Instability

JP Morgan Chase's "IPOD Ratio" evaluates states' capacities to pay down fixed costs over 30 years assuming a 6% return on assets

The cost of unfunded pensions and retiree healthcare as a % of state revenues

% of state revenues required to pay the sum of interest on net direct debt, the state's share of unfunded pension and retiree healthcare liabilities, and defined contribution plan payments

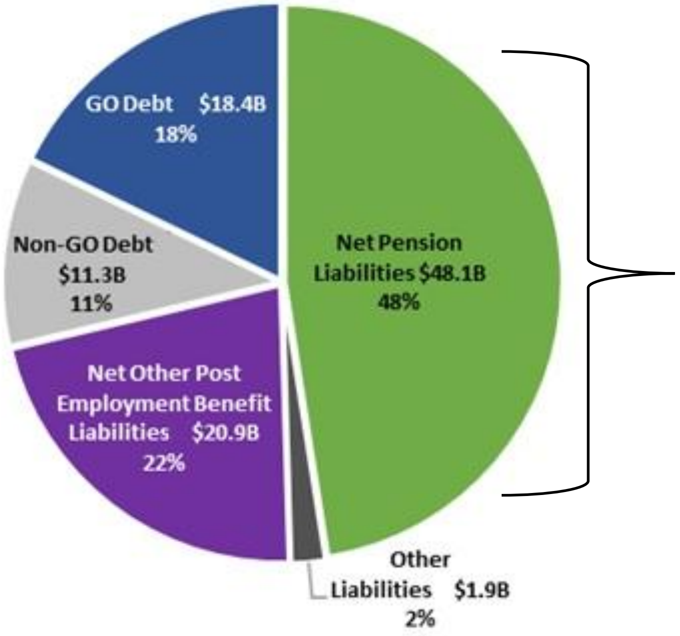


Source: J.P. Morgan Asset Management, State Annual Financial Reports, Moody's. FY 2017.

In addition, the State is Carrying Over $100 Billion of Debt and Unfunded Liabilities

Total Connecticut Liabilities Assuming 6% Pension Discount Rate

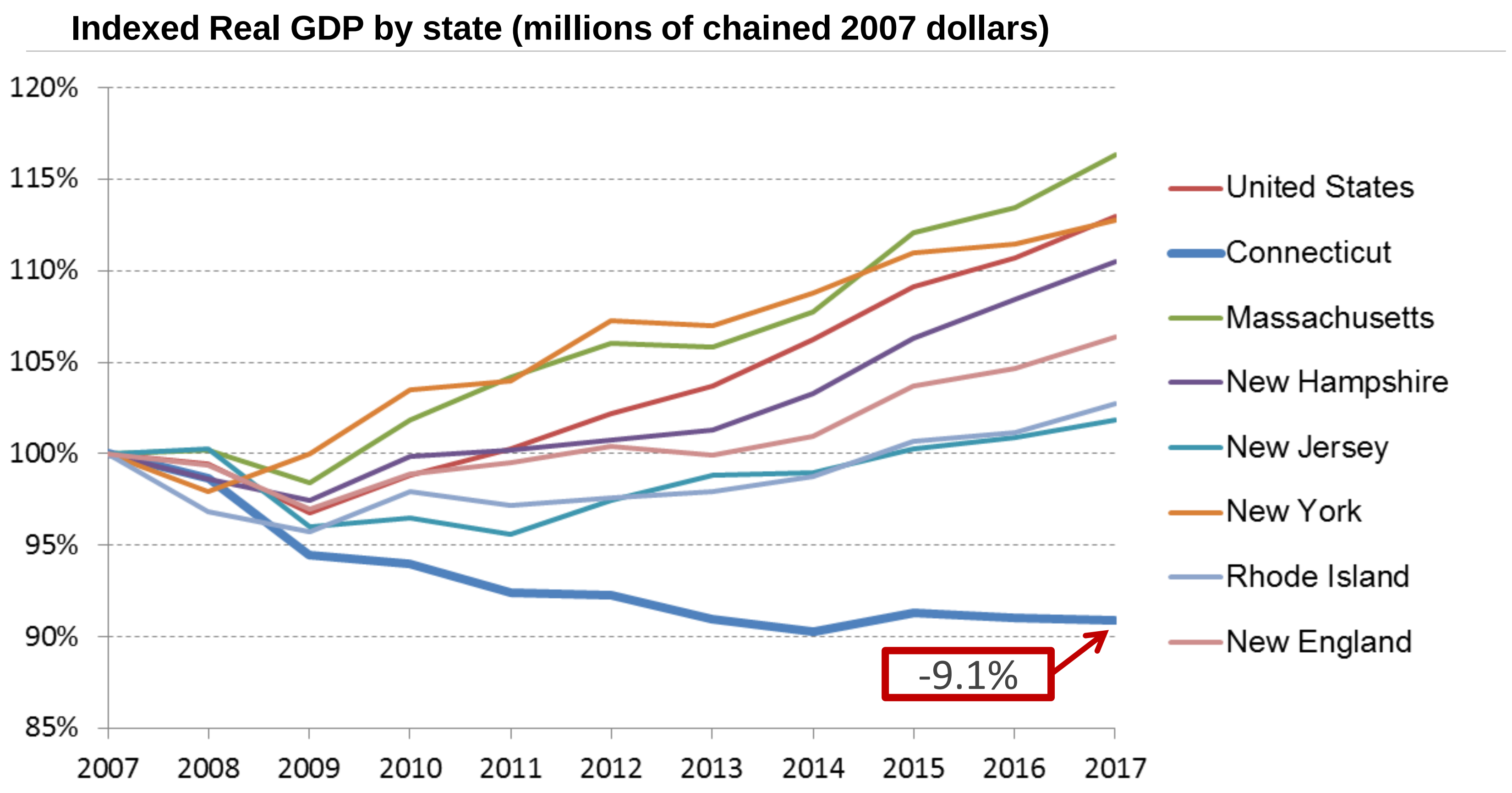
Total Connecticut Liabilities as of June 30, 2017



Total Connecticut Net Pension Liabilities as of June 30, 2016

Plan	Adjusted Discount Rate: Net Pension Liability	Adjusted Discount Rate: Discount Rate	Current Plan Discount Rate: Net Pension Liability	Current Plan Discount Rate: Discount Rate
State Employees	$26.6B	6.0%	$23.0B	6.9%
Teachers	$21.1B	6.0%	$14.2B	8.0%
Judicial	$0.3B	5.9%	$0.2B	6.9%
Total Pension	**$48.1B**		**$37.5B**	

Lack of Economic Growth



Promising signs of recovery through three quarters of 2018, with GSP up at almost the national rate of growth

Commission Recipe to Restore Growth

- Fiscal stability
- Pro-growth tax reform
- Infrastructure investment
- Investment in STEM scholarships to meet skills gap

So, what did the Governor propose?

Governor’s Budget Proposal (in millions)

	FY 2020	FY 2021
Revenues		
Maintain current policies	1,022	1,096
New policies	254	652
Total	1,276	1,748
Expenditures		
Maintain current policies	94	42
New policies	(364)	(523)
Total	(270)	(481)

Observations

- Deficit reduction is light on expense cuts vs. tax increases
- Most deficit reduction over 2 years comes from rescission of previous revenue reductions

What were the major policy choices Lamont made compared to COFEG?

(The "comments" are mine only)

1. Non-fixed expense reduction

Lamont: “efficiency and operational savings” of $37M and $46M in FY 2020-21, more than offset by discretionary program increases elsewhere. No reduction in headcount (+/- 45,200 employees)

COFSEG: Hire a consultant to help take out $1 billion of deficit through operational efficiency, improved tax collection, privatization, sale of Dempsey hospital, etc.

Comment: Lamont failure to cut expenses forces unfortunate policy choices—net tax increases, lack of pro-growth tax reductions, reduced STP funding

2. Fixed Cost Reduction

A. Debt

Lamont: debt diet to reduce interest cost by $14M in FY 2020, $64M in FY 2020

COFEG: no proposal

Comment: Lamont proposal is excellent, we should have thought of it!

B. Teachers Retirement System

Lamont: stretch out amortization with creative use of capital reserve to start refi early; transfer portion of normal cost to municipalities; no increase in teacher contributions; no pay down of UAL

COFSEG: re-amortize beginning 2025; increase contributions, transfer Lottery proceeds to pension fund to pay down UAL

Comment: Lamont proposal is solid except for failure to increase teacher contributions--which could have lowered or eliminated cost shift to towns.

2. Fixed Cost Reduction (continued)

C. State Employees' Pension

Lamont: limited re-opener of SEBAC to include risk sharing in retiree COLA

COFSEG: broadly re-open SEBAC to change planned wage increases, increase pension contributions, move up COLA reduction date, take overtime out of pensions

Comment: While acknowledging the difficulty of re-opening SEBAC, Lamont proposal only scratches the surface. We need a carrots and sticks plan to right-size benefits.

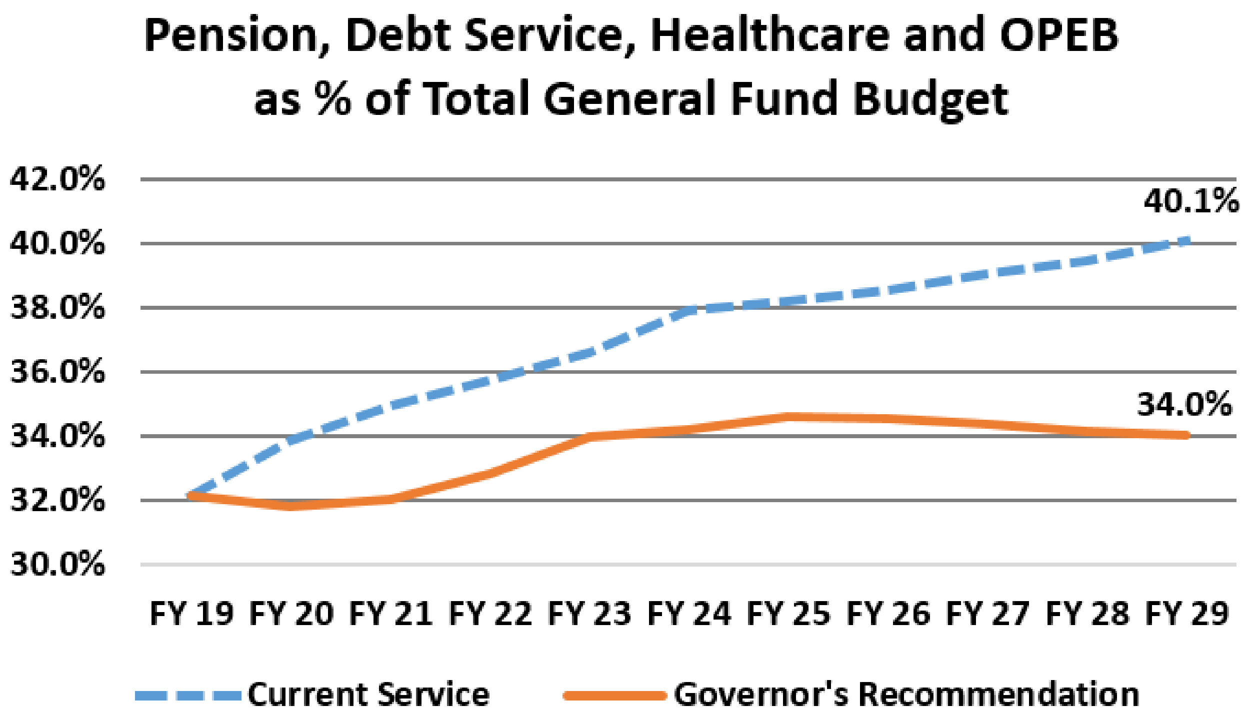
D. OPEB/Healthcare

Lamont: achieve savings of $185M over biennium through reductions of payments to providers and use of preferred networks

COFSEG: re-open SEBAC to move toward defined contribution health care

Comment: Lamont lowers state costs but cost-shifts to private sector; ignores overly rich benefits). Need to re-open SEBAC to limit state's risk.

Lamont Budget Does Reduce Fixed Cost Burden



Although improved, fixed cost ratio still unacceptably high and understated because does not use 6% discount rate

3. Tax Reform

Lamont:

- uses tax reform mainly to raise revenue ($328M in FT 2020 and $706K in FY 2021) through broadening of sales tax base (COFSEG concept) and various new “sin taxes”
- Extends limited tax relief to specific groups—income tax credits for property taxes for middle income, eliminates Business Enterprise Tax for small business, eliminates gift tax
- Avoids raising taxes on upper income, but does not repeal estate tax
- Virtually no pro-growth initiatives

COFEG:

- Revenue neutral, pro-growth policies; aimed at improving business tax ratings
- Reduction of business taxes, highest PIT bracket (unrealistic) and repealed estate tax
- Funded by sales tax base broadening

Comment: Lamont makes mistake in not cutting key business taxes--<$100M)

4. Infrastructure

Lamont:
- Changed position to embrace tolling of Interstates
- Would halt further diversion of car sales tax to STF
- P3s

COFSEG:
- Statewide tolling
- P3s

Comment: Good decision on tolls, but unfortunate decision to cut transfer of car sales tax to STF (driven by lack of cuts elsewhere)

5. Other

- Minimum wage: both embrace $15/hour in steps over time
- Municipal wage: both embrace incentivizing regionalization, and better targeting of current grants
- Skills Gap: Lamont did not accept COFSEG proposal to add 5,000 STEM scholarships per year through bonding
- Economic development: Lamont has embraced and helped lead an aggressive marketing campaign to recruit new businesses (co-chaired by Jim Smith)

Summary

- The Governor has offered a comprehensive plan that deals with the major issues, and has adopted a collaborative strategy with the legislature.
- His proposal's most constructive elements are a conservative approach to the Rainy Day Fund, his unwillingness to raise income or sales tax rates, his understanding of the need to broaden ("modernize") the sales tax base, his debt diet, and his embrace of statewide tolls.
- His proposal's biggest shortcomings are a failure to cut non-fixed costs, to cut certain business and estate taxes, to reduce unfunded liabilities, and to be more aggressive with labor on state employee and teacher pensions and OPEB.

ALL IN ALL, OUR NEW GOVERNOR GETS GOOD MARKS FOR OFFERING A BALANCED PLAN TO START THE DIALOGUE WIT THE LEGISLATURE