Yankee Institute Policy Brief

Connecticut's Pension Debt and the Spending Cap

By Suzanne Bates
Policy Director, Yankee Institute

YANKEE INSTITUTE for Public Policy

Executive Summary

Connecticut's pension debt is still growing, even though $1 out of every $10 the state spends goes into the pension funds for teachers and state employees. The debt increased by 7 percent from 2012 to 2014, up to $26.3 billion, despite the state pouring more money into the pension funds. Payments into these funds will have to keep increasing over the next 20 years as the state tries to get a handle on its pension debt. Unless the state's economy starts to grow at a faster pace, this spending will either "crowd out" other state government spending, or lawmakers will want to keep raising taxes.

But there is something standing in the way of additional tax hikes – the state's constitutional spending cap.

The spending cap limits the growth in state spending to a percentage based on a five-year average of growth in personal income or last year's rate of inflation. What the spending cap is supposed to do is protect taxpayers from runaway government growth in the years when it would hurt them the most.

But lawmakers have voted numerous times to exceed the cap since it was enacted in 1992. In 2015, the statutory spending cap was redefined to so that pension debt payments were explicitly removed from the category of spending that is subject to the cap.

HIGH PAYMENTS, BUT PENSION DEBT KEEPS GROWING

The state will pay almost $2 billion – one-tenth of the total budget – into its three major pension funds in fiscal year 2015.[1] After years of not making the annual required contributions, the state is now trying to fund its annual pension obligations, to the credit of the current administration.

Despite this, moving the pension debt needle has proven difficult. According to the 2014 Comprehensive Annual Financial Report, issued by the state's comptroller, accrued liabilities in the three major funds totaled $26.3 billion, up from $24.5 billion in 2012, which means the pension funds are now only 41.5 percent funded.[2]

Connecticut's pension funds are extremely underfunded. On most lists, the state is in the top three of the most underfunded state pension systems in the nation.[3]

Now state lawmakers are trying to redefine the state's constitutional spending cap by moving payments to the pension system out from under the cap. The growing cost of Connecticut's pension debt is crowding out other state spending, so lawmakers want to make these payments less transparent by moving them out from under the cap. This would be a mistake.

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[1] The three major funds are the State Employee Retirement Fund, the Teachers Retirement Fund, and the Judicial Retirement Fund.

[2] Connecticut's Comprehensive Annual Financial Reports can be found on the state comptroller's website: http://www.osc.ct.gov/reports/index.html.

[3] See, for example, Cembalest, Michael. "The ARC and the Covenants: Assessing the Ability of States to Service Debt, Pension and Retiree Health Care Costs in a World of Finite Resources." Issued by J.P. Morgan, June 5, 2014.

As Sen. Beth Bye, chairwoman of the Appropriations Committee, said at the press conference where she announced the redefinition of the spending cap: “As (pension debt) grows, it crowds out other expenses. So that makes it tempting not to fund those long term obligations.”[4]

For years the pensions were underfunded. Multiple individuals and commissions bear some responsibility for the chronic underfunding. Union leaders, governors, legislators, and other state officials all have had a hand in deciding how much money to pay into the pension funds every year. [5] It is imperative that these decision makers fully fund Connecticut’s yearly pension obligations moving forward.

THE SPENDING CAP SHOULD BE LEFT TO DO ITS JOB

The growing pension debt is putting pressure on other areas of the state’s budget. The costs of paying for the pension debt is eating into the spending on other state programs and services. Many lawmakers would like to increase taxes and pay for both the pension debt and their favorite programs, but they complain they can’t because of the spending cap.[6]

They also say they aren’t able to spend as much as they want to because of the lingering effects of the 2008 recession, in which state residents saw a steep decrease in personal income. The spending cap calculation uses either a five-year look back in personal income growth or the average rate of inflation. But it isn’t just the 2008 recession that is affecting personal income growth. According to figures released by the U.S. Bureau of Economic Analysis, Connecticut’s income growth was only 0.84 percent from 2012 to 2013. The rate was only 3 percent from 2013 to 2014. Connecticut has lagged the national average in personal income growth every year since the recession.

The spending cap is supposed to limit expenditure growth when Connecticut taxpayers can least afford it – that is, when their own incomes are growing slowly. By constraining growth in state expenditures, the spending cap can protect taxpayers who are still struggling to get on their feet – a full six years after the official end of the recession in 2009.

The slow income growth of Connecticut’s residents is reflected in the slow rate of growth of state revenues. The taxes and fees collected by the state grew by 0.17 percent from 2013 to

[4] Press conference, April 27, 2015.

[5] Bates, Suzanne. “Yelmini Says Union Leaders Are As Guilty As Rowland for Pension Debt.” CTNewsJunkie.com, Dec. 5, 2014. http://www.ctnewsjunkie.com/archives/entry/op-ed_yelmini_says_union_leaders_are_as_guilty_as_rowland_for_pension_debt/

[6] Phaneuf, Keith. “CT spending cap threatens to squeeze education, other priorities in next budget.” CTMirror.com, Dec. 1, 2014. http://ctmirror.org/2014/12/01/spending-cap-threatens-to-squeeze-education-other-priorities-in-next-ct-budget/

2014, and by 2.97 percent from 2014 to 2015, according to consensus reports issued by the state's Office of Policy and Management, and the Office of Fiscal Analysis.[7]

Clearly the state's "permanent fiscal crisis" is about more than the recession. By increasing taxes and other regulatory requirements on citizens and businesses in the aftermath of the recession, lawmakers have put the state on an unsustainable path. By passing a huge tax increase just after the recession, lawmakers gave many people and businesses a reason to leave the state. This led to lower state revenues than were expected.

The spending cap could have stopped this slow-motion disaster if it had been adhered to since its inception in 1991. By once again "redefining the cap" – and doing it without the constitutionally required 3/5 vote – the members who approved this plan on the Appropriations Committee are only making our future fiscal situation worse.

GENEROUS STATE PENSIONS

One of the reasons state spending is growing so rapidly is because Connecticut state employees receive the most generous pensions in the nation. The average state employee pension was $39,172 in 2013, according to the Census Bureau, the highest in the nation.[8] But most costly to taxpayers were the 657 retired state employees who received pension payments over $100,000 in 2013. The top 10 pensioners that year cost the state $2.3 million– an average of $230,000 per retiree.[9]

This is a distortion of what pensions were meant to be – and particularly public pensions, which are paid for by taxpayers.

MORE TAXES TO PAY FOR PENSIONS

To pay for the increasing cost of public sector pay and benefits – which takes up a third of the state's budget – state lawmakers again raised taxes in 2015.

In a 2014 Yankee Institute study on public pensions, called *Born Broke,* we foresaw the need for either cutting services or increasing taxes to tame the pension debt:

[7] The consensus reports can be found at http://www.ct.gov/opm/cwp/view.asp?a=2965&Q=459726&PM=1&opmNavPage=%7C.
[8] U.S. Census Bureau. Annual Survey of Public Pensions, 2013. http://www2.census.gov/govs/retire/2013_summary_report.pdf
[9] For pension data see CTSunlight.org.

> With public pensions and retiree benefits eating up a greater portion of the state's budget, steep tax increases or deep cuts to government services are the only ways to achieve fiscal stability.[10]

Steep tax increases are clearly the way lawmakers want to get the state out of this fiscal mess, but this is the wrong move. It will lead to more people leaving the state – as many already have – and will make it even harder for Connecticut to stabilize its balance sheet.

By voting to move the pension debt out from under the constitutional spending cap, lawmakers on the Appropriations Committee have put Connecticut taxpayers at great risk. If this move is made permanent, the mounting cost of this debt would be allowed to grow without the protection of the constitutional spending cap.

The spending cap brings extra scrutiny to money the state government spends on its many functions. This includes state employee benefits. Connecticut lawmakers have approved giving state employees extremely generous pension, health, and other benefits. The cost of these benefits has risen substantially in recent years, making it more difficult for lawmakers to keep spending under the spending cap. By moving this portion of spending on state employee benefits out from under the cap, lawmakers will have fewer incentives to reform these benefits so that they are more sustainable, and more consistent with the benefits received by employees in the private sector.

MALLOY WANTED TO MOVE PENSION DEBT OUT IN 2013

In 2013, Gov. Malloy submitted a bill to the Connecticut General Assembly that would have fully implemented the constitutional spending cap and changed the language of the statutory spending cap.[11] The bill included language exempting pension debt from the spending cap calculation – two years before the Appropriations Committee used this approach – and also exempting any government program that is 100 percent funded by the federal government.[12] The bill was voted out of the state's Appropriations Committee, but was not debated by the House or Senate. Later that year, Malloy moved federal Medicaid spending out from under the cap, but left the pension debt alone.

This shows that at least initially Malloy recognized that any change to the definition of the spending cap required lawmakers to vote on a spending cap definition. But this year, the leaders of the state Appropriations Committee have continued the practice of redefining the

[10] Moody, J. Scott and Wendy P. Warcholik. "Born Broke: Our Pension Debt Problem." Yankee Institute for Public Policy, August 2014.
[11] For a more detailed explanation of Connecticut's Spending Cap, see recent Yankee Institute policy briefs *Sustainable Spending* and *Connecticut's Spending Cap: A Legal Overview*. These can be found at www.yankeeinstitute.org.
[12] The bill was introduced as HB 6352.

spending cap without the proper and transparent step of asking lawmakers to vote on a new – and binding – definition.

Significantly, the fiscal note on Malloy's 2013 spending cap bill said the change would end up moving a total of $440.9 million in pension debt payments out from under the cap. That is much less than the $1.828 billion in pension debt payments that the Appropriations Committee is moving out from under the cap this year. Lawmakers should ask for an explanation both of what was considered "debt" in 2013, and also why in this year's calculation, more of the payments to the pension funds are now considered debt payments.

REDEFINING A REDEFINITION

In the past when lawmakers "redefined" spending out from under the cap, the revised calculation was based on the amount the budget would have totaled without including that spending. To adhere to this precedent, the Appropriations Committee should have removed the pension debt from the total amount of the FY 2015 budget, and used that number to calculate the allowed spending growth for the 2016 budget. However, this year the Appropriations Committee decided not to remove pension debt from the previous year's budget, instead declaring its budget $1.5 billion under the spending cap.

The spending cap calculation for this year, according to the OPM, allows a 2.58 percent growth rate. The chart below shows that if lawmakers on the Appropriations Committee had followed precedent by removing pension debt from the FY 15 budget for the purposes of calculating allowable growth under the cap, their budget would have come in $279 million over the cap.

	FY 2015 Budget[13]	FY 2016 Budget	Percent Growth
Budget With Pension Debt	$17,480,500,000	$18,286,160,315	4.61%
Pension Debt Payments	$1,708,274,823[14]	$1,828,000,000	
Budget Without Pension Debt	$15,772,225,177	$16,458,160,315	4.35%
Amount allowed under spending cap	$15,772,225,177	$16,179,148,587	2.58%

This arbitrary redefinition doesn't make sense. Lawmakers should not redefine the constitutional spending cap to exclude pension payments. And if they do choose to redefine the

[13] These numbers are from the budget as amended by the Appropriations Committee.
[14] This number is based on rough estimates, since the Appropriations Committee did not explain which portion of the pension payments it defined as debt.

spending cap, they should remove the pension debt from the base year for the purpose of calculating the allowable increase in state spending.

SUGGESTIONS TO TAME THE PENSION DEBT

There is another way. Rather than facing years of mounting pension payments – which would result in increasingly dramatic tax increases or else the squeezing out of more state spending on social services, education, and other functions of government – state lawmakers could tame the pension debt by negotiating reforms with the public sector unions.

Other cities and states have negotiated changes to the cost of living adjustments granted to retirees, although many of these efforts are tied up in court. Currently, retired Connecticut state employees receive between 2 and 7.5 percent increases in their pension payments through cost of living adjustments (COLA). This amount should be capped at 2 percent, or the cost of living adjustment to social security. If this can't be done for current retirees, it should at least be put in place for all future retirees.

For the sake of the state's long-term fiscal health, Connecticut must switch from a defined benefit to a more sustainable 401(k)-style defined contribution pension system, consistent with what private sector employees receive.

As the state takes responsibility for the full cost of the pensions promised to state employees, lawmakers are starting to realize the enormous cost of these promises. It is imperative that the state continues to pay for these obligations so the pension debt does not grow. But there is also some hope that as the cost becomes clearer, reform will gain broader support.