



Presentation to Commission on Fiscal Stability and Economic Growth January 24, 2018

Thank you for inviting us to participate today.

At Yankee Institute, we are committed to ensuring that every person in Connecticut is free to succeed. We are enthusiastic about the work of this commission and the opportunity it presents to help Connecticut thrive and prosper again.

Connecticut has so many advantages, including a prime location between two major cities; an educated population; several world-class universities; and, of course, it offers an excellent quality of life. Why, then, is Connecticut losing jobs and people?

Today, we will share with you what we believe are the biggest stumbling blocks to Connecticut's growth and success -- as well as solutions to address these challenges.

I. OUTMIGRATION AND TAX BURDEN

One reason Connecticut has struggled to grow is because people and businesses are leaving our state. Migration data compiled by the IRS shows revealing – and disturbing – patterns. Over the past several years, the state has experienced a large bump in outmigration of high-income earners. This was especially true in the years immediately following two large tax increases in 2011 and 2015.

From 2011 to 2012, the state had a net loss of \$2 billion in taxable income; from 2012 to 2013, the state lost \$1.8 billion; from 2013 to 2014, the state lost \$1.1 billion; from 2014 to 2015, the state lost \$1.3 billion; and from 2015 to 2016 the state lost \$3.1 billion in taxable income.¹ The chart below shows the net loss by category of income. The loss of high-income earners in the years immediately following the tax increases offers a cautionary tale for those who are pressing for another tax increase.

Net Outmigration By Income, 2011-2016²

	2011-12	2012-13	2013-14	2014-15	2015-16
\$1 to \$50,000	\$82,405	\$100,452	\$124,165	\$140,873	\$95,271
\$50,000 to \$200,000	\$312,866	\$412,276	\$451,975	\$320,142	\$503,261
\$200,000+	\$1,635,644	\$1,323,694	\$546,764	\$827,364	\$2,521,849

¹ IRS Migration Data, from migration by income. Totals are slightly different than reported state-to-state data because they are

² AGI is reported in thousands

Outmigration is part of a vicious economic cycle in Connecticut. It has led to a slowing state economy and lower-than-expected tax receipts; at the same time, slow job growth is both a cause and result of outmigration. Over the past 25 years, Connecticut has experienced the slowest job growth in the nation, and the state has yet to recover all the jobs lost in the last recession, which began more than a decade ago.

There's no dispute that people are leaving the state. What is disputed are the causes. Some -- who advocate for continued tax increases -- point to census data, which report primary reasons for migration, and note that few people openly report that taxes are their primary reason for migration. But the data tell a story: people are moving from high-tax to low-tax states. What's more, Connecticut experiences increased outmigration when it raises taxes. The data demonstrate a strong correlation between outmigration and higher taxes.

Our state's experience provides strong evidence that Connecticut should not continue to follow this destructive course -- tax hikes will only spur more outmigration, further slowing economic and job growth.

Connecticut was once the lower-tax alternative to its neighboring states, giving it a comparative advantage. That advantage has been eroded over time by policy decisions made at the state level. Today, Connecticut ranks second highest in the nation for its combined state and local tax burden, according to the Tax Foundation. While New York ranks first, other neighboring states fare better -- Massachusetts ranks 12th and Rhode Island ranks 9th.³

The Tax Foundation study also notes that Connecticut is one of only four states that has seen its taxpayer burden increase over the past 25 years (the others are Illinois, Ohio, and Arkansas). Connecticut collects 12.6 percent of state income in taxes; while it collected 11.1 percent in 1977. Most states are moving in the other direction, including Massachusetts, which has seen its percentage drop from 12.3 to 10.3 percent.

In addition, Connecticut is one of only 14 states that still levies an estate tax, and two of those 14 states -- New Jersey and Delaware -- are in the process of repealing their estate taxes.⁴ Several others have raised their exemption thresholds in recent years, including Connecticut. Connecticut remains the only state in the nation with a gift tax.

In 2007, the state Department of Revenue Services conducted a survey of accountants, lawyers, and estate planners to ask if the estate tax affected outmigration. Of the 166 respondents, 52.6 percent said their clients moved out of Connecticut primarily due to the estate tax, and 76.9 percent said their clients moved out of the state partially due to the estate tax.⁵

But the tax that most impacts low and middle-income families is the property tax. In most surveys that compare property tax burdens, Connecticut does poorly. This affects home sales and home values, which have stagnated in recent years. The median home value in our state is \$40,000 below what it was in January 2008.⁶

³ Tax Foundation, State-Local Tax Burden Rankings FY 2012

⁴ Yankee Institute, A Better Place to Die: Reforming Connecticut's Estate Tax, January 2016.

⁵ <http://www.ct.gov/drs/lib/drs/research/estatetaxstudy/estatetaxstudyfinalreport.pdf>

⁶ <https://www.zillow.com/ct/home-values/>

Solutions:

- Eliminate the gift and estate taxes;
- Enact a property tax cap, similar to the cap implemented in Massachusetts;
- Cut spending, rather than increasing taxes.

II. HIGH DEBT/LIABILITIES

Besides high taxes, Connecticut's continued economic instability and high fixed costs – including relatively high debt and liabilities – give rise to concerns that state lawmakers will continue to simultaneously increase taxes and cut services.

In the *Arc and the Covenants 2.0*, Michael Cembalest, chairman of Market and Investment Strategy at JP Morgan, examined the total cost of debt and liability payments as a percentage of state spending for all 50 states. He looked at how much states are currently spending on debt, pensions, and other post employment benefits (OPEB), and how much they would be spending if liabilities were amortized over 30 years and discounted at 6 percent.

He drew a red line to indicate which states were in trouble; the states whose payments rose above that red line were Illinois, New Jersey, Connecticut, and Kentucky. He estimated that for Connecticut to start paying down its debts and liabilities, the state would have to devote fully 35 percent of its spending -- up from the current level of 21 percent. The categories he includes are pensions, debt service, and retiree healthcare. Of the red line, Mr. Cembalest said: "When a state is at the red line...they've got some serious challenges since the math becomes very difficult."

The report goes on to explain that in order to achieve the requisite increase from 21 to 35 percent, the state would either have to increase revenue (taxes) by 14 percent, cut spending by 14 percent, or else increase employee contributions by 699 percent.

Other organizations have offered similar warnings. Truth in Accounting ranked Connecticut 48th out of 50 states based on the amount of debt per taxpayer -- the group estimates that Connecticut has \$63.6 billion in debt and liabilities, which amounts to an eye-popping \$49,500 per taxpayer.

Stanford University's Institute for Economic Policy Research ranks Connecticut 50th out of 50 states and the District of Columbia for the funded ratios of its pension systems, with a market-valued (discounted using the U.S. Treasury yield) pension debt per household ratio of \$112,911. Connecticut is ranked first for the amount it spends per year on pensions and pension liabilities, as a percentage of total state expenditures.⁷

Connecticut's pension and OPEB liabilities remain the state's albatross, even after recent attempts to reduce and re-amortize liabilities. Other states that face these exigent circumstances are considering extreme measures. California Gov. Jerry Brown has gone to court to try to change pension benefits for existing employees. Lower courts in California have held that pension payments can be reduced if the payments are still reasonable.⁸

⁷ <http://us.pensiontracker.org/RankingAllMatrix.php?name=Connecticut&id=CT&search=Search&selYear=2016>

⁸ Romy Varghese, California's Brown Raises Prospect of Pension Cuts in Downturn, Bloomberg, Jan. 10, 2018. <https://www.bloomberg.com/news/articles/2018-01-10/california-s-brown-raises-prospect-of-pension-cuts-in-downturn>

Solutions:

- Further limit debt accumulation by discontinuing borrowing for economic incentive programs;
- Review school construction formula;
- Reform pensions and retiree health care (more detail provided below).

III. MUNICIPAL HEALTH

Municipalities in Connecticut are also grappling with the weight of pension and OPEB costs. Four of Connecticut's struggling cities – Bridgeport, Hartford, New Haven, and Waterbury – owe a combined \$4.8 billion in retirement-benefit obligations, and the growth in cost of these benefits is outpacing revenue growth.⁹ To pay for these benefits, municipalities have had to cut services and workers, while also raising taxes.

Municipalities that opted into the state's Municipal Employee Retirement System have found that the cost of participating in the system have grown faster than tax receipts. Unfortunately, municipalities are not allowed to leave the system unless they offer employees the exact same benefits they receive under the system. One municipality had achieved, through collective bargaining, a concession from their local union to move to defined contribution retirement plans for new hires, but the state would not allow them to opt out of MERS.¹⁰ Many municipalities have reformed the way they compensate their employees, including moving to defined contribution retirement plans and high deductible health insurance plans. Those municipalities are reaping the benefits of these changes.

In research Yankee Institute will release in the coming months, the health of all of Connecticut's 169 municipalities was measured based on five metrics, including fund balances, long-term obligations, pension contributions, unemployment rates, and property values. Based on these factors, 61 municipalities fell below the level considered "healthy," and eight municipalities achieved a score that signified "severe fiscal distress." Those municipalities are: Hamden, Waterbury, Stratford, Hartford, Bridgeport, New Haven, West Haven, and Sprague.

Cities with high mill rates because of low real property values are also stifled by how those rates affect residents who own cars, and local businesses, which must pay business personal property taxes. Unlike real property, personal property does not change value depending on where it is located.

Many of Connecticut's cities are also affected by struggling schools and poor educational options. Research conducted by a finance professor at North Carolina State University showed that of 100 metropolitan areas, Bridgeport had the highest family flight in the nation. To make this determination, Prof. Bartley Danielson looked at census location data for families with children aged 0-4 and compared it to data for families with children aged 5-9. He found that Bridgeport saw the highest move-out rate for families with school-aged children in the nation. For Connecticut's cities to revitalize, they must offer parents more options for their children's education, and improve educational outcomes.¹¹

⁹ Stephen Eide, Connecticut's Broken Cities. Yankee Institute, January 2017.

¹⁰ <http://www.yankeeinstitute.org/2017/01/state-retirement-commission-blocks-towns-from-real-pension-reform/>

¹¹ Marc Fitch, Bridgeport ranks highest in the nation for "family flight" to avoid failing schools, Yankee Institute, Dec. 6, 2016. <http://www.yankeeinstitute.org/2016/12/bridgeport-ranks-highest-in-nation-for-family-flight-to-avoid-failing-schools/>

Of course, the need for greater educational achievement and innovation extends beyond Connecticut's cities. Workforce advancement cannot enjoy long-term success without a solid educational system that is responsive to the specific labor needs of the state.

Solutions:

- Review the benefits and cost of the Municipal Employees Retirement System, which is administered by the state but paid for by municipalities, and allow municipalities to leave the system;
- Eliminate personal property taxes, or introduce a single, low mill rate for personal property;
- Allow greater educational choice, especially in Connecticut's cities to spur revitalization;
- Foster greater cooperation between schools and the private sector to match students' education to job opportunities.
- Reform binding arbitration laws. (see labor section below)

IV. OVERREGULATION

Connecticut, as much as any state in the country, suffers from the suppressive impact of state-imposed mandates and regulations. Between June and December of 2017, Connecticut lost 15,300 jobs.¹² The regulatory burden in the state hinders growth, innovation, and business confidence. In its most recent survey of businesses, Blum Shapiro and CBIA observed that 68 percent of respondents indicated that regulations were hampering their growth and investment in the state.¹³

While businesses in the state have indicated their frustration with regulation generally, the quantity of regulations imposed is also sizeable. As part of an ongoing project to quantify the regulatory burden of each state, the Mercatus Center at George Mason University recently took a "snapshot" of Connecticut. In examining the online version of the *2017 Regulations of Connecticut State Agencies*, Mercatus scholars found that state agencies imposed 96,247 regulatory restrictions using 5.9 million words. This makes Connecticut's quantifiable burden slightly worse than Arizona and Utah.¹⁴

Solutions:

- Implement a one-in, one-out requirement for regulations;
- Continue to reform the state's occupational licensing laws.

V. THE PRIMARY CHALLENGE: GOVERNMENT UNIONS

Although there are many reasons for Connecticut's poor fiscal and economic situation, there is one area in particular where Connecticut is an outlier, compared not only to other states in our region but also to the nation as a whole – and that is in the special status the state grants its public sector unions, when it comes both to pay and a host of other privileges. That disparity is reflected in the fiscal and economic health of the state.

¹² <http://www1.ctdol.state.ct.us/lmi/laborsit.pdf>

¹³ 2017 Survey of Connecticut Businesses <https://www.cbia.com/wp-content/uploads/2017/09/2017SurveyofConnecticutBusinesses.pdf>

¹⁴ James Broughel and Daniel Francis, Mercatus Center at George Mason University https://www.mercatus.org/system/files/broughel_and_francis_-_policy_brief_-_regulatory_snapshot_ct_-_v1.pdf

Any successful effort to address Connecticut's challenges will first require the reform of state labor laws. States that have turned their economies around – including Indiana and Michigan, which are growing again after years of economic malaise – began by enacting changes to the way they interact with their public sector unions.

A. Public / Private Compensation Disparity

At the state level, Connecticut provides benefits to public employees that far outstrip those received in the private sector. In a 50-state study published by American Enterprise Institute, Connecticut was found to have the highest differential in the nation between public and private sector pay, with state government employees receiving a 42 percent premium.

One of the authors of that study, Andrew Biggs -- who is also a former deputy commissioner of the Social Security Administration -- conducted a closer analysis of that research for a Yankee Institute study. He found that while private sector workers collect salaries similar to those of state government workers, benefits are far more costly in the public sphere.

A point of interest: the category that most differentiates Connecticut from other states is the state's roughly equal salaries between the public and private sector. Connecticut has the highest state employee salaries in the nation, when compared to private sector salaries. In all other states, government salaries are lower than private sector salaries, but generous public sector benefits more than make up the difference. For example, the average public sector salary in Massachusetts was 11 percent below the average private sector salary, in New York the difference was 3 percent, and in California there was a 12 percent difference. Connecticut's public sector salary premium also affects pension benefits.

State Government vs. Private Sector Compensation¹⁵

	Private Sector Worker	State Government Worker
Salary	\$71,112	\$70,970
Paid Leave	\$8,747	\$7,161
Insurance	\$9,252	\$12,527
Retirement and Savings	\$4,026	\$27,667
Legally Required Benefits	\$7,346	\$7,206
Total Compensation	\$100,483	\$125,531

The largest differentials between public and private pay in Connecticut are found in the areas of pension, healthcare, and retiree healthcare benefits.

	Private Sector	Public Sector
Health Insurance	\$8,690	\$12,335
Retiree Health Insurance	\$329	\$11,017
Pension/Retirement	\$3,698	\$16,650
Total	\$12,717	\$40,002

¹⁵ Andrew Biggs, Unequal Pay, Yankee Institute, September 2015. This is using a 5 percent discount rate on defined benefit pensions. A bigger differential exists when pension costs are discounted using a 2.5 percent discount rate.

State workers receive pension benefits that are 4.5 times more expensive than workers in the private sector, and retiree healthcare benefits that are 33 times more expensive.

The high cost of public pensions discouraged former lawmakers from saving the full amount necessary to pay for those benefits in the future. Connecticut has the highest average state employee pensions and the highest average teacher pensions in the nation. Of the 52,233 state employee pensions paid out in 2016, 1,030 were over \$100,000.¹⁶ The top state employee pension that year was \$305,054, paid out to a retired UConn Business School professor, and 11 pensioners earned over \$215,000, which is the limit for public pensions designated by the IRS, putting Connecticut at odds with federal law.

Despite recent changes, Connecticut's pensions continue to be among the worst funded in the nation.

Connecticut's Pension Liabilities¹⁷

	2014	2015	2016	2017	% funded 2017	Discount Rate (%)
SERS	\$16	\$16.5	\$23	\$21.1	36.25	6.9
TRS	\$10.8	\$10.8	\$13.1	\$13.1	56	8
JRS	\$0.16	\$0.18	\$0.24	\$0.24	46.91	6.9
OPEB	\$19.5	\$19.5	\$18.9	\$18.9	1.2	5.7*
Total	\$46.71	\$47.19	\$55.53	\$53.64		

* OPEB discount rate is blended based on 8.25% expected rate of return on assets and 4.5% return for cash holdings.

B. A Web of Destructive Special Privileges

An impressive superstructure of state laws and regulations advantage government unions over ordinary citizens and taxpayers, leading to the imbalance between the public and private sectors. This is particularly true in three areas:

- The government unions' power to negotiate over pensions and other benefits;
- The unusually wide scope of binding arbitration, which can result in unelected arbitrators dictating labor contracts with wide-ranging financial consequences that carry the force of law; and
- Contract provisions that supersede state or local law.

As a result of these special privileges, Connecticut is out of balance. The recent negotiations between the state and multiple bargaining units over wage contracts, and between the state and the State Employees Bargaining Agent Coalition (SEBAC) over benefits for state employees, highlights how this imbalance plays out.

Benefits and wages are negotiated separately. Because the benefits contract was not up for negotiation until 2022, state negotiators had to seek permission to come to the bargaining table, putting the state at a disadvantage before negotiations had even begun. This contract was first negotiated in 1997, with an initial 20-year term (in itself unusual; similar contracts in other states generally run about three years). It

¹⁶ Data retrieved at CTSunlight.org

¹⁷ Based on latest actuarial valuations released by state.

has since been extended multiple times, most recently until 2027 -- resulting in a three-decade-long contract. Although some concessions were achieved, the negotiations will create serious challenges for lawmakers in 2019 -- when they will face a projected \$4.7 billion budget deficit, largely precipitated by growing pension costs and two years of 3.5 percent employee wage increases. In addition, a no-layoff provision will limit the efficiencies they can legislate.

Recent changes in the budget also empower arbitrators to make decisions that bind lawmakers at the state level, even as the contracts they negotiate can supersede state law. As a result, one unelected and unaccountable arbitrator can, in effect, create the law of Connecticut by fiat. This problem also exists at the municipal level. The wide scope of what can be decided during binding arbitration in the state can create distorted outcomes, as lawmakers worry about what an arbitrator may decide when it comes to salary and work conditions.

Connecticut has the second-most-unionized public workforce in the country, after only New York. This extends to many of the state's managerial class, including school principals, creating additional problems with managing state and municipal workforces. For example, in Hartford, 12 principals were removed from their schools for poor performance but had to be reassigned to other district jobs because of union protections.¹⁸

Even in a union-friendly region, Connecticut is an outlier in how much power it cedes to its government unions. In Connecticut, unions can bargain over wages, benefits, hours, and other working conditions. Other states, even in labor-friendly New England, do not extend the scope of collective bargaining nearly so far. In Massachusetts, for example, state and municipal workers can no longer negotiate over healthcare benefits. And none of Connecticut's neighboring states -- or New England states -- allows bargaining over pension benefits.

In addition, Connecticut's binding arbitration laws give more power to government unions than laws in other states. Other states have limited arbitrators' power over fiscal matters. Maine and Rhode Island do not allow arbitration over salary or benefits, for example. In Massachusetts, both parties must request arbitration to begin the process, ensuring that arbitration only ensues when a government entity agrees. In New York, final and binding arbitration exists only for public safety and some transit employees. There is no binding arbitration in New Hampshire. In Connecticut, however, either side may request binding arbitration, and an arbitrator's final decision can bind lawmakers at the state or municipal level, even when a contract overrides state law.¹⁹

Solutions:

- *Limit collective bargaining to wages only*, so that government employers can more easily fund worker compensation without deficits or rampant pension underfunding.
- *Prohibit unelected bureaucrats from writing law*. Because of the supersedence of labor contracts, arbitrators have the power to write legislation. These contracts - with the force of law - can be imposed by arbitrators even after the General Assembly twice rejects them. Agreements of such scope, expense, and consequence should not be implemented without the explicit approval of the people's elected representatives.

¹⁸ Jacqueline Rabe Thomas, "Massachusetts is like Connecticut, but does a better job educating the poor," CTMirror, <https://ctmirror.org/2017/12/11/massachusetts-is-like-us-but-does-a-better-job-educating-the-poor/>.

¹⁹ Information from upcoming Yankee Institute paper *Above the Law*.

- *End supersedence of labor contracts over state law:* If the legislature wants to change a law concerning government employees, it should do so by normal legislative means, wherein a bill passes both chambers and is signed into law by the governor. Enacting changes or privileges through collective bargaining agreements erodes the legitimate power of Connecticut legislators and undermines the people's right to self-government. Elected leaders across the state should have the final say on public policy, not arbitrators who are not accountable on election day for their decisions.
- *Implement meaningful and long-term public pension reform.* Pension reform should include either putting new hires on a defined contribution plan, or else creating an overall hybrid defined-benefit/defined-contribution system that places a greater emphasis on the defined-contribution portion. Employee contributions must rise, and the assumed rate of return on pension investments should be a realistic 5 percent. Pension calculations should exclude overtime pay and include a cap on how much compensation can be used to determine retirement payments. COLAs should be eliminated until the pension system is at least 80 percent funded. Also, teachers should pay into and receive Social Security.
- *Reform retiree healthcare.* As of 2027, retirees should receive a stipend to buy healthcare or supplemental health insurance, instead of remaining part of the state plan.
- *Enact Right-to-Work.* There are now 28 states that are right-to-work, meaning that they do not require workers to pay into a workplace union through agency fees as a precondition to starting or keeping a job. Indeed, from 2005 to 2015, right-to-work states have outperformed forced-union states in creating both more jobs and more personal disposable income. The cost-of-living-adjusted, per-capita income in right-to-work states is \$42,814, compared to \$40,377 in forced-union states.²⁰

These reforms would be an important step to resolving Connecticut's dysfunctional relationship with its government unions -- thereby addressing the fiscal and economic distress flowing from it.

Yankee Institute is grateful for the deliberation and hard work of this Commission. We respectfully seek your consideration of the proposals set forth above, so that Connecticut may once again be a state known throughout our nation for offering opportunity for all -- and a place where everyone is truly free to succeed.

²⁰ National Institute for Labor Relations, "Right to Work States Benefit from Faster Growth, Higher Real Purchasing Power," Fall 2017, <http://www.nilrr.org/wp-content/uploads/facts/2017-nilrr-benefits-update-web.pdf>.