

*Thanks for the opportunity to present my ideas about ways to achieve fiscal stability and economic development in Connecticut. At my presentation on January 24<sup>th</sup>, you specifically asked for my suggestions as to how to achieve those ends in a revenue-neutral way.*

*This paper elaborates my thoughts on these topics. Many of them are supported by 1000 Friends of Connecticut, but not all have been reviewed and approved by that organization.*

***Bill Cibes***

## **Executive Summary**

### **I. Critical Needs**

#### **A. Revitalizing cities**

Although the productivity of Connecticut metro areas is very high, revitalizing the cities by reducing the gap between their objectively measured need and their capacity to provide the revenue to meet that need provides the opportunity to propel economic development even higher.

The overall state and local tax structure should be rebalanced to reduce the property tax burden which is infected with vertical and horizontal inequities, and is, in the words of the State Tax Panel, “detrimental to the state’s economic competitiveness.”

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#### **B. Investing in education**

Quality education for all is the second critical prerequisite for economic growth. STEM (Science, Technology, Engineering and Mathematics) education is especially important in an age when technological innovation is the hallmark of a growing economy. And education for those who are current underachievers is necessary because that segment of the population will soon be the majority of the future workforce.

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#### **C. Improving transportation infrastructure**

There should be stable funding for transportation infrastructure. There is widespread agreement that a critical prerequisite for economic growth is a superb infrastructure which facilitates the movement of people to jobs, and goods

to where they are used or sold. Sporadic transfers and raids of other funds to support that infrastructure is not sufficient.

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#### **D. Bring stability to business taxes**

The current corporate income tax is highly volatile, is subject to erosion from a substantial system of tax credits, which add complexity and are subject to frequent policy changes that lead to instability and uncertainty in business tax liabilities. In addition, there are justifiable concerns that expenditures for some programs may spike, producing a demand for increased business taxes to meet the spending requirements. There should be an effort to stabilize the tax regime for businesses.

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## **II. Sources of Funding**

Chairman Smith asked me at the time of my presentation to offer suggestions as to how the state's revenue system might be restructured to provide funding for the above priorities without increasing overall state and local revenue.

In all candor, reaching the standard of revenue neutrality might be impossible, given the chronic underfunding of transportation, education and property tax relief over the years. However, a comprehensive, coherent, integrated program could include the following actions.

### **A. Budget Savings**

#### **1) Smooth out funding for past service liability in the Teachers Retirement System pension**

Level off the required funding for the unpaid past service liability in the Teachers' Retirement System – and provide the necessary upfront funding to reach the necessary new level. This action will avoid the spike in required funding which would otherwise occur in the late 2020s and early 2030s, which would create untenable instability in state budgeting at that time.

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**2) Continue on the path to downsize prisons through reform of bail, pre-trial release, and recidivism risk reduction**

One of the great policy achievements of the last few years has been the development of programs that provide support services to offenders being released from incarceration, as well as pre-trial diversion and alternatives to incarceration. The result of these and other programs has resulted in the reduction of the incarcerated population to about 13,850. Additional savings should be possible.

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**3) Reduce debt service costs by limiting bonding**

**a. Bonding for school construction should be reduced**

Reducing school construction bonding authorizations from \$480 million per year to \$300 million could saving \$14.8 million in debt service annually. (and increasing over time)

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**b. Loans and grants for economic development from bond sources should be reduced**

Bonding for economic development loans and grants just shifts support for economic development into future budgets in the form of increased debt service. The state has authorized more than \$1.4 billion for such purposes. Loans and grants should be carefully reviewed before they are made, and each subsidy should be reviewed to make sure that the terms and conditions of the aid have been satisfied.

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**c. Operating expenses (like Town Aid Roads) should not be bonded**

Bonding should be reserved for capital projects which have a useful life as long as the bonds issued to support those projects. Most Town Aid Roads goes for maintenance. Shifting this assistance back into the operating fund will save on interest costs (although admittedly causing appropriations to increase).

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**B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)**

**1) Reduce or eliminate tax credits for economic development**

Several tax credits that erode the corporate income tax base could be revised to ensure that they are achieving their intended objective or jettisoned entirely. Chief among those that should be targeted are the three film tax credits, which will cost \$86.5 million in FY 2019. Whatever credits are eliminated will result in increased revenue.

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**2) Reduce the number of other “tax expenditures” among those detailed in the latest “Connecticut Tax Expenditure Report” by the Office of Fiscal Analysis**

Although not all of the recommendations of the State Tax Panel consultants were accepted by the Panel, it appears to me that tax expenditures totaling more than \$430 million could be eliminated: ending the break from the full sales tax rate extended to digitized downloads to consumers, abolishing the state tax holiday, and ending the exemption on sales of food for home consumption (offset by a refundable personal income tax credit for low income families).

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**3) Extend the sales and use tax to additional services**

As consumption has shifted from goods to services (now up to 66% or more of all consumption) in the economy, the sales tax base in Connecticut – which has been focused on goods – has fallen. Although the General Assembly has been increasing the number of services taxed, there appear to be opportunities to tax additional services.

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**4) Aggressively implement the use tax on out-of-state sales for in-state use**

At least \$70 million, and perhaps as much as \$150 million, in revenue from the use tax is now not being collected. The Department of Revenue Services continues to innovate ways to ensure that consumers pay what they owe. If the U.S. Supreme Court makes the right decision in *South Dakota v. Wayfair*, now before the court, the lost revenue might soon be available.

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**5) Eliminate the corporate and business entities tax, and shift to a commercial activities tax (CAT)**

Because of the many failings of the corporate tax – as fully detailed in analyses by consultants for the State Tax Panel – the consultants recommended replacing the corporate income tax with a gross receipts or commercial activities tax (at a very low rate (0.22%), which would raise substantially the same amount of revenue as the corporate income tax. And it would be much more stable than the corporate income tax.

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**6) Impose a low-level statewide property tax to pay for part of the past service liability in the Teachers' Retirement System**

Although increasing property taxes in general should be avoided, it might make sense to impose a statewide property tax and dedicate the revenue to pay for part of the cost of the past service liability in the Teachers Retirement System. The total grand list assessment in the state is \$370 billion. A property tax at 1 mill would generate \$370 million to free revenue from other sources to be used – among other things – to close the need-capacity gap or to increase aid to education.

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**7) Increase the rate of the sales and use tax**

Securing additional revenue from the sales and use tax, whether from reducing tax expenditures, or taxing additional services, or collecting the full amount of the use tax, or raising the rate of the tax, is – according to the State Tax Panel consultant who analyzed Connecticut's competitiveness – likely to be the best way to fund critical needs. Raising the rate from 6.35% to 7% could generate \$400 million in new revenue.

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**8) Aggressively seek additional federal revenue**

New language in the revised spending cap now exempts all federal revenue from the cap. In the past Connecticut has apparently left as much as \$1.5 billion on the table. Given the policy bent of the current national administration, it may not be possible to be successful in seeking to retrieve federal dollars. But the state should try.

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**C. Add additional revenue (not net revenue neutral) to meet transportation infrastructure needs**

Either increasing the gasoline tax, or introducing electronic tolling on major highways, or both, are necessary to fund critical infrastructure needs (highway, bus, and rail).

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**D. What NOT to do**

**1) Do NOT privatize state assets**

Both the sale-leaseback of existing state buildings, and the sale of a future revenue stream (such as tolls) are bad ideas. “Paying for the state’s annual costs of running . . . programs with a one-time sale of critical state assets is poor fiscal policy.” The proceeds of such a sale – as one-shot revenue – does nothing to solve the long-term structural deficits facing the state, because future expenditures continue, while the revenue to pay for them would no longer be there.

Moreover, terms and conditions in the sale agreement often foreclose future policy options.

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**2) Do NOT collect additional coins from under the couch cushions, and use to pay for operating expenses**

Raiding separate, non-lapsing accounts not only frustrates achieving the objectives for which those accounts were established, but the use of this one-shot revenue only guarantees a shortfall in ensuing budgets.

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**3) Do NOT routinely use the resources of the Rainy Day Fund to pay for operating expenses**

Like sweeping funds from non-General Fund accounts, using money from the Rainy Day Fund as one-shot revenue also damages fiscal stability.

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**4) Do NOT move from defined benefit pension systems to defined contribution systems**

The high cost of the current DB systems (SERS and TRS) are almost entirely due to past failure to fund the actuarially required contributions to pay for past service. The unfunded liability that is owed under both SERS and TRS cannot be extinguished even if the current DB plan were to be changed to a defined contribution plan. It makes more sense to tweak the existing DB systems than to shift to DC plans.

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### **III. Recommend revision of the newly adopted spending cap to exempt grants to distressed municipalities from the spending cap**

If distressed municipalities, primarily central cities, are to be revitalized, additional grants to close the “need-capacity” gap in those cities must be supplied. Those grants must come from appropriated funds.

But the new language in the state’s spending cap, by placing grants to distressed municipalities under the spending cap, makes it very difficult to target additional assistance to the most distressed municipalities in the state. The new spending cap language effectively freezes high property tax rates in cities, making them unattractive to businesses, and relegating them as losers in the multi-state competition to attract businesses looking for vibrant, dynamic centers of innovation.

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### **IV. Recommend repeal of the ill-advised “bond lock”**

If retained, the ill-advised “bond lock” will effectively prevent future legislatures from maintaining fiscal stability in the face of changes in the economy, changes in national policy, and changes in services required to meet the needs of Connecticut’s residents.

As Atty. Alex Knopp has eloquently stated, the “bond lock” effectively transfers control of policy in the state to bondholders, and locks in the status quo absent an overwhelming consensus which has almost always been missing.

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## I. Critical Needs

### A. Revitalizing cities

The Hartford metro area not only ranks No. 4 in the nation in “digitalization,”<sup>1</sup> it also ranks No. 3 in the WORLD in terms of productivity per capita. And there is a not-to-be squandered opportunity to support additional economic development by revitalizing Connecticut’s central cities.

In 2016, the Brookings Institution and JPMorgan Chase published a study of the 123 largest metropolitan economies in the world. Data from that study show that, with nominal GDP per capita of \$84,029, the Hartford metro area ranks No. 3 in the world, after only San Jose (at \$91,437) and Singapore (at \$84,309).<sup>2</sup> And GDP per worker (\$158,428) ranks No. 4 in the world, after San Jose (\$171,288), Houston (\$166,808), and San Francisco (\$164,521) – **ahead** of New York (\$158,339), Los Angeles (\$158,165), and Boston (\$139,160).<sup>3</sup> (Connecticut as a whole ranked #3 in the country (\$64,511), slightly behind Massachusetts (\$65,545) and New York (\$64,579), in GDP per capita in 2016.<sup>4</sup>)

The Hartford metro is classified as one of the 19 “Knowledge Capitals,” which according to the authors of the study, “are the world’s leading knowledge creation centers. They compete in the highest value-added segments of the economy, relying on their significant stocks of human capital, innovative universities and entrepreneurs, and relatively sound infrastructure capacity.”<sup>5</sup>

But the central cities at the heart of Connecticut’s metro areas are still missing what has been identified as a critical factor in future economic growth. Syracuse University Professor Michael Wasylenko, who authored an analysis of “Connecticut’s Competitiveness” for the State Tax Panel which met during 2015, observed that growth in urban area economies depends on “technological change and innovation,” taking the form of “new knowledge created through interaction of educated, skilled and innovative

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<sup>1</sup> Muro, Liu, Whiton and Kulkarni, “Digitalization and the American Workforce,” Brookings Institution, November 2017, page 30. <https://www.brookings.edu/research/digitalization-and-the-american-workforce/>

<sup>2</sup> Jesus Leal Trujillo and Joseph Parilla, “Redefining Global Cities: The Seven Types of Global Metro Economies,” Brookings and JP Morgan Chase, Global Cities Initiative, September 29, 2016. The data for 2015 for all 123 metros are on pages 18, 21, 24, 27, 30, 33, and 36 of the PDF report, which may be downloaded via a link at <https://www.brookings.edu/research/redefining-global-cities/>

<sup>3</sup> Jesus Leal Trujillo and Joseph Parilla, “Redefining Global Cities: The Seven Type of Global Metro Economies,” Brookings and JP Morgan Chase, Global Cities Initiative, September 29, 2016. The data for 2015 for all 123 metros may be accessed by hovering over charts for the seven types of metros at <https://www.brookings.edu/research/redefining-global-cities/>

<sup>4</sup> <https://www.statista.com/statistics/248063/per-capita-us-real-gross-domestic-product-gdp-by-state/>

<sup>5</sup> Trujillo and Parilla, pp. 2, 30.



workers. The most productive of the interactions are those that occur frequently and in face-to-face encounters.”<sup>6</sup>

The cross-fertilization of ideas maximizes innovation when firms and people locate near one another in cities and industrial clusters. Unfortunately, companies like General Electric, Aetna and Alexion announced they were leaving Connecticut because they desired to locate in metro areas where the central cities have a “great innovation ecosystem.” “I want to be in the sea of ideas,” GE’s CEO Jeff Immelt said. They all concluded that this advantage is still missing in Connecticut’s cities.<sup>7</sup>

Why? There is a structural impediment standing in the way of Connecticut cities being “sufficiently attractive magnets for millennials, young families and economic growth in general,” as Jim Loree of Stanley Black and Decker identified the issue for all of you on this Commission.

That structural defect is the penalty businesses and housing developers must pay for locating in cities. High property taxes in cities are a disincentive to locate there. While business owners and developers of housing for millennials must pay 74.29 mills on the assessed value of their property in Hartford, property tax rates in towns such as Simsbury, Bloomfield, Windsor, Wethersfield, Rocky Hill and Newington are less than 40 mills.<sup>8</sup>

Moreover, taking into account how property is assessed, the commercial property tax rate in Boston is less than half that of Hartford.<sup>9</sup>

If the revitalization of Connecticut’s cities is to occur, the disincentive occasioned by the horizontal inequity of property taxes must be rectified.

Some critics say that high property taxes are the result of bad management or wasteful spending or political pandering by city officials. But analysts at the New England Public Policy Center at the Federal Reserve Bank of Boston have found that there is a real gap between the objective underlying costs of providing non-educational services in Connecticut’s distressed municipalities and the capacity of those jurisdictions to raise revenue to pay for those costs. Their study, “Measuring Municipal Fiscal Disparities in

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<sup>6</sup> Michael Wasylenko, “Competitiveness: Connecticut’s Economy and the Role of Fiscal Variables in Growth,” presentation to the State Tax Panel, September 30, 2015, p.11. See [https://www.cga.ct.gov/fin/tfs/20140929\\_State\\_Tax\\_Panel/20150930/wasylenko\\_competitiveness\\_ppt\\_9-30-2015.pdf](https://www.cga.ct.gov/fin/tfs/20140929_State_Tax_Panel/20150930/wasylenko_competitiveness_ppt_9-30-2015.pdf)

<sup>7</sup> Jon Chesto, “GE CEO tells Boston’s business leaders why he’s moving to Boston,” [bostonglobe.com/business](http://bostonglobe.com/business), March 24, 2016.

Kenneth Gosselin and Dylan McGuinness, “Aetna Will Move Headquarters To New York City, Says Hartford Must Become a ‘Vibrant City Once Again,’” [courant.com/business](http://courant.com/business), June 29, 2017.

Stephen Singer, “Alexion Exits New Haven For Boston, Agrees to Repay Millions in State Aid,” [courant.com/business](http://courant.com/business), September 12, 2017

<sup>8</sup> OPM, “Municipal Fiscal Indicators, December 2017, revised to 2/6/18,” pages B-18-20. Available through a link at <http://www.ct.gov/opm/cwp/view.asp?a=2984&q=383170>

<sup>9</sup> Commercial property in Boston is assessed at 100% of market value. The commercial property tax rate in Boston is 25.2 mills.

Connecticut,” calculated “need” based on five key cost factors outside the control of local officials: the unemployment rate, population density, private-sector wages, miles of locally maintained roads, and the number of jobs located within the community relative to its population. “Capacity,” on the other hand, was determined by the equalized net grand list in the community.<sup>10</sup>

For the six municipalities with the greatest difference between need and capacity, the gap ranged from \$849 per capita to \$1,330 per capita. For the next 19 towns, the gap was \$369 to \$771 per capita. Another 53 towns had gaps between \$14 and \$367 per capita. Ninety-one towns, on the other hand, had the capacity to fund more than their need.<sup>11</sup>

Having looked at the evidence presented by the NEPPC, the State Tax Panel concluded without dissent that “the property tax system is detrimental to the state’s economic competitiveness,” so state grant policies should be re-examined in order to “relieve pressure on the property tax and to equalize fiscal disparities,” using a distribution formula which addresses “closing the ‘need-capacity gap.’”<sup>12</sup>

Such a distribution formula for non-educational grants should be targeted to focus on those municipalities with the greatest gap, after taking into consideration other state grants in aid. The existing Payment in Lieu of Taxes grants (PILOTs) attempt to level the playing field between towns with tax-exempt state property and college and hospital property and those without. If fully funded, those grants could reduce the need-capacity gap in the most distressed municipalities. By and large, however, the NEPPC study concluded, “existing non-school grant programs do not substantially reduce the state’s fiscal disparities.”<sup>13</sup> Accordingly, apart from the PILOT programs, I suggest that the state should focus not on tweaking existing municipal aid grants, but on reducing the need-capacity gap with a formula deliberately tailored to do so.<sup>14</sup>

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<sup>10</sup> New England Public Policy Center at the Federal Reserve Bank of Boston (NEPPC), “Measuring Municipal Fiscal Disparities in Connecticut,” Spring, 2015. See the full discussion on pp. 1-8. <https://www.bostonfed.org/publications/new-england-public-policy-center-research-report/2015/measuring-municipal-fiscal-disparities-in-connecticut.aspx> A PDF of the report is available directly at: <https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/economic/neppc/researchreports/2015/neppcrr1501.pdf>

<sup>11</sup> See NEPPC report, Data Appendix, pp. 6-10. A PDF of data appendices for the report is at: <https://www.bostonfed.org/-/media/Documents/neppc/neppcrr1501-appendices.pdf?la=en>

<sup>12</sup> Report of the State Tax Panel, volume 2, p. 12. The Panel also recommended preserving the PILOT programs for state property and non-profit colleges and hospitals, which help fill the need-capacity gap. See p. 13 if the Report.

<sup>13</sup> NEPPC report, pp. 12-13.

<sup>14</sup> When the NEPPC analyzed the need-capacity gap in Massachusetts, one possible recommendation was to avoid political controversy by leaving in place the other state grants (a “hold harmless” approach). See Bo Zhao, “Does Springfield Receive Its Fair Share of Municipal Aid? Implications for Aid Formula Reform in Massachusetts, NEPPC Working Paper 10-4 (2010), pp. 10 et seq., available at <https://www.bostonfed.org/publications/new-england-public-policy-center-working-paper/2010/does->

Closing this gap would not have a negligible effect. Nearly 45 percent of all taxes paid to local and state government in Connecticut are property taxes, (Income taxes are 28 percent, sales and use taxes 16 percent, and corporate income taxes 2 percent.)<sup>15</sup> The greatest share of taxes paid by business are property taxes (33.7 percent).<sup>16</sup>

Unfortunately, the property tax burden tends not to be addressed when talking about state tax reform, with the focus instead on income, sales and corporate taxes. Those taxes, however, do not constitute a disproportionately high share of revenue. The real need lies in state level policies to redress local tax disparities. In Sections II.A and II.B below, I recommend some possible net-revenue-neutral possibilities for doing so.

In creating this Commission, the General Assembly asked it to recommend ways to revitalize cities, reflecting the frequent statements by the state's citizens and its public officials that cities must be revitalized to be more attractive to business. If they truly MEAN what they say, then the overall tax system must be rebalanced to reduce the disincentive to locate in places that can maximize innovation.

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[springfield-receive-its-fair-share-of-municipal-aid-implications-for-aid-formula-reform-in-massachusetts.aspx](#) In Connecticut, political feasibility might indicate a similar approach.

<sup>15</sup> Connecticut Department of Revenue Services, "Tax Incidence Report," 2014 [www.ct.gov/drs/lib/drs/research/drstaxincidencereport2014.pdf](http://www.ct.gov/drs/lib/drs/research/drstaxincidencereport2014.pdf), p. 2.

<sup>16</sup> Ernst and Young, for the Council on State Taxation, "Total State and Local Business Taxes for fiscal 2016," 8/30/17. <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=96735>, p. 22.

## I. Critical Needs

### B. Investing in Education

Providing sufficient funding to enable all municipalities to provide an adequate education for students within their jurisdictions is also required to support the interests of families and businesses, and support economic growth and competitiveness.

As Syracuse Professor Wasylenko, the author of the analysis of Connecticut competitiveness for the State Tax Panel, concluded, “elementary and secondary education produce value for residents and favorably influence economic growth.”<sup>17</sup> Education is essential to build the skills of the current and future workforce, giving them opportunities to find and keep a job and earn more pay. In addition, companies benefit by having more productive workers who are able to learn quickly and adjust to changing workforce conditions. “Knowledge industries rely extensively on a continuing flow of highly educated and innovative workers in a state or region,” Wasylenko says. The entire state benefits by being able to attract firms and investment because it has a skilled workforce.

Overall, the state has been able to produce a knowledgeable workforce capable of adapting to the requirements of the future economy. See the Brookings Institution study, “Digitalization and the American Workforce,” November 2017,<sup>18</sup> which finds that the Hartford metro area ranks #4 in the country on a “digitalization” scale, while the Bridgeport metro ranks #7 and New Haven metro ranks # 39 (among the 100 most populous metros). However, the study “concludes by stressing the importance of improving digital education and training, both to expand the high-skill talent pipeline and ensure that underrepresented groups can connect to an increasingly digital economy. In addition, the discussion notes how important it is becoming for all workers to cultivate durable “soft” or human skills as a way to get better at being “what we are that computers aren’t.”<sup>19</sup> In short, the state must continue to invest in education for ALL.

The Connecticut Supreme Court’s recent decision in *CCJEF v. Reil* reinforced that requirement. To be sure, the majority ruled “that courts simply are not in a position to determine whether schools in poorer districts would be better off expending scarce additional resources on more teachers, more computers, more books, more technical staff, more meals, more guidance counselors, more health care, more English instruction, greater pre-school availability, or some other resource. Such judgments are quintessentially legislative in nature.” Nevertheless, it urged the state “to do all that it reasonably can to ensure not only that all children in this state have the bare opportunity to receive the minimally adequate education required by article eighth, § 1, of the

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<sup>17</sup> Wasylenko, “Competitiveness: Factors that Contribute to Economic Growth in States with Special Reference to State and Local Spending and Taxes,” in Report of the State Tax Panel, volume 2, at page 229.

<sup>18</sup> Muro, Liu, Whiton and Kulkarni, “Digitalization and the American Workforce,” Brookings Institution Metropolitan Policy Program, November 2017, page 30.  
<https://www.brookings.edu/research/digitalization-and-the-american-workforce/> Appendix B, also available at the linked site, provides the rankings for all 3 Connecticut metros, at p. 19 of the appendix.

<sup>19</sup> Page 4.

Connecticut constitution, but also that the neediest children have the support that they need to actually take advantage of that opportunity.”<sup>20</sup>

So even if the educational system in the aggregate whole across the state might be considered to provide a constitutionally minimally adequate education, it would make sense for the legislature to take into account the special needs of particular local school systems. As the separate opinion in the case noted,

the state, in designing an educational system and delivering educational services, must make at least some reasonable effort to account for the distinct learning challenges that confront many of our state’s least fortunate children. Although it may be assumed that many if not most of the students in Connecticut’s more affluent towns have had their basic needs satisfied and arrive at school ready to learn, the same cannot be said for children who have spent their entire lives in poverty. Residents of our poorest communities, even those hungry to learn, may have to overcome a host of obstacles before they are able to attend to fractions and Fitzgerald. These run the gamut from homelessness, malnutrition, and illness, to violence in the home and in the community, to the pervasive and pernicious effects of racism. Some students struggle to learn in a non-native tongue; others wrestle with undiagnosed disabilities, whether physical, academic, or emotional/psychological.<sup>21</sup>

To be sure, Wasylenko judged that already “Connecticut’s educated workforce and core of knowledge workers is a major resource for growth.”<sup>22</sup> But given the fact that the workforce of Connecticut’s future is likely to be increasingly composed of young people who are currently residents of cities with high levels of poverty, are of color, who have special education needs, and/or are English language learners, it would behoove the legislature, in the exercise of its judgment, to focus additional resources in school districts where students with additional needs are located. In that way, the “strong primary and secondary education system” that Wasylenko deems necessary for competitiveness can be maintained.<sup>23</sup>

How should those additional resources be directed? Although all of the Supreme Court justices, as did Superior Court judge Moukawsher, declined to create an aid formula, a number of analysts have found that there are ways to estimate the foundation funding level that move in the right direction, based on various factors of need. For instance, consultants for the plaintiffs in *CCJEF v. Rell* have produced a study (which needs to be updated) that considers a number of factors that should be weighted in order to

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<sup>20</sup> Chief Justice Rogers, *CCJEF v. Rell*, January 17, 2018, p. 1 of the slip opinion.

<sup>21</sup> Justices Palmer, Robinson and Sheldon, concurring in part and dissenting in part, *CCJEF v. Rell*, slip opinion, page 5. These justices rightly observe that nothing in the majority opinion contradicts

<sup>22</sup> P. 6 of the PowerPoint presentation.

<sup>23</sup> P. 21 of the PowerPoint presentation.

estimate the costs of providing a minimal foundation.<sup>24</sup> A copy of that study was provided to the Commission during my presentation on January 24..

Because of the great need for adequate education for all, I urge the Commission to recommend that the state create and implement a principled educational cost-sharing formula to provide the foundation for an adequate education for every PK-12 student in the state. A “rational, substantial and verifiable” formula, the standard Judge Moukawsher established,<sup>25</sup> is surely not too much to ask.

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<sup>24</sup> Plaintiff's Trial Exhibit 715 in *CCJEF v. Reli*: Augenblick, Palaich 2014 update to 2005 Cost of Adequacy in Education in Connecticut, which may be found at <https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=7&ved=0ahUKEwjoeaTk5bUAhWo5YMKHeiiBdsQFghFMAY&url=https%3A%2F%2Fassets.documentcloud.org%2Fdocuments%2F3452501%2FAdequacy-Study-Update-in-2014-Exhibit-715.pdf&usq=AFQjCNG0daNsfswHVR4Rb1h3hBHqvl831g&cad=rja>

<sup>25</sup> See the judge's opinion in the Superior Court, *CCJEF v. Reli* (September 7, 2016), pp. 43, 44.

## I. Critical Needs

### C. Investing in transportation infrastructure

David Osborne and Peter Hutchinson, in The Price of Government, published in 2004, observed that, in the Information Age, in addition to education and quality of life, a third key to economic success is “connectivity” – “the ability to reliably move information, goods and people.”<sup>26</sup>

I do not need to go into detail about the need for improving the transportation infrastructure in Connecticut, since several members of the Commission have been involved, for two decades, in pointing out the strategic role of transportation as a prerequisite for economic growth. In 1999, Michael Gallis warned, in a report to the Connecticut Regional Institute for the 21<sup>st</sup> Century, that major transportation improvements were vital to economic growth.<sup>27</sup> Twelve years later, the Transportation Strategy Board reiterated that “congestion and transportation deficiencies are adversely affecting our economy.”<sup>28</sup> And most recently, the draft of “Connecticut’s Statewide Long-Range Transportation Plan 2018-2050” reiterated that transportation “directly affects the state’s economic health and the quality of life of residents.”<sup>29</sup>

It is clear from the detailed analysis in the latest transportation plan that all aspects of the state’s transportation infrastructure – highway systems, rail and freight, bicycle/pedestrian, air, maritime, and public bus systems – need significant improvement. Section 2 of the plan goes into the benefits that will accrue from prudent investment. Later sections provide details of the less-than-good status of roads, bridges, and rails, as well as the spending necessary to upgrade those conditions.

It would be folly to ignore the needs.

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<sup>26</sup> David Osborne and Peter Hutchinson, “The Price of Government,” pp. 57-58.

<sup>27</sup> Gallis, “Connecticut: A Strategic Economic Framework,” 1999, still available online at either <https://ctregionalinstitute.wordpress.com/reports-presentations/> or <https://www.google.com/search?q=Gallis+Connecticut+A+Strategic+Economic+Framework&ie=utf-8&oe=utf-8&client=firefox-b-1>

<sup>28</sup> “Strategic Framework for Investing in Connecticut’s Transportation: Economic Growth – Infrastructure Preservation – Sustainable Communities.” January 2011, [www.ct.gov/opm/lib/opm/tsb/reports\\_tsb/strategic\\_needs\\_statement\\_final.pdf](http://www.ct.gov/opm/lib/opm/tsb/reports_tsb/strategic_needs_statement_final.pdf) , page 2.

<sup>29</sup> Draft, “Connecticut’s Statewide Long-Range Transportation Plan 2018-2050,” released December 18, 2017, available at <http://www.ct.gov/dot/cwp/view.asp?a=3531&q=259760> After public hearings and comments, a final version of the plan will be released in Spring 2018.



## I. Critical Needs

### D. Bring Stability to Business Taxes

Overall, taxes on business in Connecticut are consistently among the lowest in the nation. The Council on State Taxation annually releases a study of total state and local business taxes in all fifty states. The most recent report, completed in August 2017 based on taxes in FY 2016, found that

- total state and local taxes in Connecticut, as a share of private sector Gross State Product, was in fact the lowest in the country.
- Moreover, the business share of all state and local taxes was also the lowest in the country.
- And business taxes per dollar of net government spending that benefits business (assuming that 50% of every dollar spent on education benefits business) was tied with two other states (Maryland and Alaska) for lowest in the country – at 80 cents.<sup>30</sup>

Nevertheless, there is considerable fear in the business community that fiscal demands might generate a destabilizing spike in business taxation.

As Jim Smith stated in a presentation to the Spending Cap Commission, there was a great deal of “uncertainty regarding taxes.” He commented further that stability and predictability in business taxation were much to be desired. “Volatility and changeability are anathema to business investment,” he said.

“Businesses need to have to have confidence in the state’s policy direction. In recent years, the state has made repeated changes to the tax code that penalize businesses or create uncertainty as to tax structure and rates. Recent actions to limit the research and development tax credit, adopt the unitary tax, and restrict the use of net operating loss carry-forwards are prime examples of the whipsawing policy that unnerves businesses and discourages investment.”<sup>31</sup>

Because of this concern, it makes sense for the Commission to review options that would produce greater stability and promote investment and economic growth. From smoothing out the required funding for teachers’ pensions, to avoiding use of one-shot revenues which create built-in future deficits, to reducing or eliminating tax credits which cause fluctuations in the revenue base, to moving to an entirely new business tax regime based on a stable and predictable commercial activities tax, many alternatives are explored in the rest of this report.

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<sup>30</sup> Ernst and Young, the State Tax Research Institute and the Council on State Taxation, “Total state and local business taxes: state-by-state estimates for fiscal year 2016,” August 2017. Pp. 11-12, 13-14, and 18, respectively. Linked at <http://www.cost.org/state-tax-resources/cost-studies-articles-and-reports/>

<sup>31</sup> Jim Smith, “Spending Cap Written Testimony,” September 7, 2016, pp. 2, 9, at [https://www.cga.ct.gov/app/tfs/20160330\\_Spending%20Cap%20Commission/20160907/Jim%20Smith%20Testimony.pdf](https://www.cga.ct.gov/app/tfs/20160330_Spending%20Cap%20Commission/20160907/Jim%20Smith%20Testimony.pdf)



## **II. Sources of Funding**

### **A. Budget Savings**

#### **1. Smooth out funding for past service liability in the Teachers Retirement System pension, as was done for the State Employees Retirement System<sup>32</sup>**

In 2017, the State and the State Employee Bargaining Coalition (SEBAC) collectively bargained, and the legislature approved, a resolution to the unsustainable spikes in the State's required contribution to the state employee retirement system caused by the unfunded past service liabilities. The 2017 agreement replaced the untenable increases in the State's annual required contributions (ARC) during the closed amortization period ending in 2032 with achievable and predictable annual contributions. It adopted a "level dollar" funding mechanism, instead of a back-loaded "level percent of payroll" method. And it requires the state to make the ARC payment in full every year. It achieved this by lengthening the payment plan for a portion of the unfunded liabilities from 15 years to 30, allowing the State to pay slightly more in the beginning but maintaining a level payment over the years, rather than facing a budget busting spike in 12-15 years. The negotiated agreement also adopted a more reasonable, lower assumed rate of return, reducing it from 8% to 6.9%. [This last change increased the projected nominal liability, but reduced the likelihood that the plan would in the future fall short of its projected return, requiring a drastic, unexpected spike in the ARC to cover the shortfall.]

After the outline of the SERS agreement was announced, in December 2016, a bond-rating agency, Moody's Investor Services, quickly termed the agreement a "credit positive" for the state.<sup>33</sup> And the state's business community, which had been very concerned that the prospective spike in future pension payments might lead to unpredictable tax increases, appeared to be pleased with the action: Mr. Smith, the Co-chair of this Commission, was reported to have said at a business meeting that it brings the type of stability that business leaders are looking for. "It will be better to manage"<sup>34</sup> because it avoids "the deadly spike in ARCs by terming out the obligation and resetting the actuarial investment return to something more reasonable that can be levelled out and funded over time."<sup>35</sup>

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<sup>32</sup> My comments here are based both on my presentation to the Commission on January 24<sup>th</sup>, and the presentation to the Commission by Leo Canty on January 29<sup>th</sup>.

<sup>33</sup> <http://ctmirror.org/2016/12/15/wall-street-agency-gives-ct-pension-deal-a-credit-positive/>

<sup>34</sup> Russell Blair, "Malloy Touts Long-Term View," Hartford Courant, December 13, 2016, page B3, quoting Jim Smith of Webster Bank.

<sup>35</sup> See the CT-N on-demand video, MetroHartford Alliance Rising Star Breakfast with Governor Malloy, December 12, 2016, minutes 21-22, <http://ct-n.com/ctnplayer.asp?odID=13525>

The Teachers' Retirement System (TRS) should do the same. TRS still has a full funding date of 2032, an assumed rate of return of 8.5%, and an untenable spike of State contributions for past service liability that are locked in by bond covenants that run to 2032. Changing that system is extremely difficult, because of the terms of bond covenants agreed to when the state issued 2 billion dollars in pension obligation bonds in 2008. Nevertheless, essential revisions can and must be achieved. A strong statement by this Commission concerning the necessity of change would focus the state's attention on this matter.

#### A brief history of the unfunded liability in TRS

The Boston College Center on Retirement Research looked back at our two largest state-wide pension systems in its Report issued in 2015.<sup>36</sup> TRS has been providing retirement benefits to its members since at least 1939. And, like SERS, for much of TRS' history, benefits were paid as they came due, directly from annual appropriations by the State. Retirement benefits earned by teachers prior to 1979 were completely unfunded by the State (although partially pre-funded through teachers' contributions). When the State first decided to pre-fund benefits in 1979, it was immediately presented with an unfunded liability for benefits earned by employees during the pay-go years. And, starting immediately thereafter, the state did not fully fund its actuarially required contributions. The State's underpayment of the ARC began as soon as the State decided to pre-fund. At the outset, state law provided for a ramp-up schedule in the State's funding requirement. In 1979, the state was only required to pay 35 percent of the ARC. This percentage was scheduled to gradually increase each year until 1993, when the State would be required to pay the full ARC. But, even after 1993, the state did not make its full required contributions.

The unfunded liability that is owed to TRS cannot be extinguished even if the current defined benefit plan were to be changed to a defined contribution plan, with both the state and the individual teacher contributing to the plan. INDEED, the unfunded liability that is owed to TRS cannot be extinguished even if every single active teacher in the State went to a completely self-funded IRA. The focus on cutting benefits, removing retirement benefits from collective bargaining, and/or changing to a defined contribution plan is completely unrelated to how the State addresses its overhanging unfunded liability. The generosity of benefits and collective bargaining are neither the cause of the growth in the State's unfunded liability nor a solution to it.

As reported in the Boston College Center on Retirement Research study, there are three factors behind the current unfunded liability of TRS: 1) legacy costs due to benefits promised before TRS was pre-funded, 2) a history of inadequate contributions

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<sup>36</sup> Jean-Pierre Aubry and Alicia Munnell, "Final Report on Connecticut's State Employees Retirement System and Teachers' Retirement System," Center for Retirement Research at Boston College, November 2015, available at <http://crr.bc.edu/special-projects/final-report-on-connecticut-state-retirement-systems-sers-and-trs-2/>

once the State decided to pre-fund, and 3) poor investment experience relative to expectations since the turn of the century. Since 1983, the UAAL has grown by \$10.5 billion – from an initial value of \$2.5 billion to a value in 2017 of \$13 billion. The two largest contributors to the growth in the UAAL have been inadequate contributions and lower than expected investment returns. The Pension Obligation Bond (POB) issued by the State in 2008 lowered the UAAL by \$2 billion, but simultaneously increased the State's overall indebtedness by \$2 billion. The bond covenant achieves what collective bargaining achieved in SERS by binding the State to making its full ARC payment each year but, unfortunately also locked in the unreasonable assumed rate of return to 8.5% and required the UAAL be paid in full by 2032.

Like SERS, the main driver of contributions to TRS is the unfunded liability, not the level of benefits or the cost of current benefit accruals. The total normal cost as a percent-of-payroll (employee contributions plus employer normal cost) permits a clear comparison among plans. The cost of benefits provided to members of TRS actually falls below that of teachers' plans nationally, and the State's normal cost (3.7% of payroll) is half of the national average (7.4%). Teachers in Connecticut already contribute 6% of their pay to TRS, more than the national average of 5.6%.<sup>37</sup>

The laws and bond covenants currently governing the TRS are irresponsible and undisciplined. Simply put, to do nothing to change those unbearable restrictions on prudent pension management will be destructive to Connecticut's long-term fiscal health, budget stability, and economic growth. Fortunately, this issue has been recognized by major policy-makers in the Executive Branch, although they propose different solutions.<sup>38</sup> Ultimately, it is necessary to create a means to establish a more predictable and manageable payment schedule moving forward.

It is understood that any reform must necessarily extend amortization for a portion of the unfunded liabilities from the current 14 years to something closer to 30 years in order to avoid the extreme spikes in state contributions presently facing us. It also must adopt a more conservative and realistic assumption about the rates of return the pension fund investments will achieve in the financial markets each year. At the same time, the state's obligation to pay both the normal cost and the cost of amortizing past service liability must not be diminished.

Over the long term, avoiding the projected budget-busting spike can make funds available for addressing critical needs identified above.

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<sup>37</sup> Aubry and Munnell, p. 39.

<sup>38</sup> See Keith Phaneuf, "Napier, Malloy Divided Over How to Fix Teacher Pension Fund," CTMirror, February 8, 2018, at <https://ctmirror.org/2018/02/08/napier-malloy-divided-over-how-to-fix-teacher-pension-fund/>

## II. Sources of Funding

### A. Budget Savings

#### **2) Continue on the path to downsize prisons through bail reform, pre-trial diversion, and recidivism risk reduction**

After reaching a peak incarcerated population of nearly 20,000 in early 2008, total prisoner count dropped back to about 18,400 in 2010. During Governor Malloy's administration, a concentrated effort to pursue correctional reforms produced a further decrease in the number of inmates to about 13,850 in February 2018.<sup>39</sup> The budgetary consequence of this change has been a reduction of appropriations for the Department of Correction from about \$661 million in FY 2011 to a newly recommended \$587 million in FY 2019 – even as the total General Fund spending increased by about \$1.3 billion over this time frame.<sup>40</sup>

A continuation and expansion of the coherent policy program<sup>41</sup> – across the entire criminal justice system, including the Department of Correction and the Judicial Branch – of releasing offenders into community supervision programs near the end of their sentences, anti-recidivism efforts for those re-entering the community, pre-trial diversion, alternative incarceration programs, community support services, and bail reform should be able to reduce expenditures even further.<sup>42</sup> Indeed, these programs are showing some signs of success.<sup>43</sup>

As a consequence, it should be possible to reduce spending on Corrections by \$10 million annually.

[A caveat, however: perhaps it would make more sense, and be more constructive, to apply any savings to strengthening the anti-recidivism and alternative incarceration programs.]

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<sup>39</sup> See information on the website of OPM's Criminal Justice Policy and Planning Division, at [http://www.ct.gov/opm/cwp/view.asp?a=2967&Q=382106&opmNav\\_GID=1797](http://www.ct.gov/opm/cwp/view.asp?a=2967&Q=382106&opmNav_GID=1797)

<sup>40</sup> See the budget documents on the website of OPM's Budget Division at [http://www.ct.gov/opm/cwp/view.asp?a=3011&Q=382930&opmNav\\_GID=1793](http://www.ct.gov/opm/cwp/view.asp?a=3011&Q=382930&opmNav_GID=1793)

<sup>41</sup> An early outline of such a program was provided by Blum Shapiro, "Assessment of Connecticut's Correction, Parole and Probation Systems," Final Report to the Connecticut Regional Institute for the 21<sup>st</sup> Century, July 2010. [ctregionalinstitute.files.wordpress.com/2010/10/prisonreportppt.pdf](http://ctregionalinstitute.files.wordpress.com/2010/10/prisonreportppt.pdf).

<sup>42</sup> One possibility for additional savings is to find a way to reduce the number of "unsentenced" personnel confined to correctional institutions awaiting trial or sentencing. Of the 13,850 total prison population, 3,794 were in this "unsentenced" category. Another 1,000 or so inmates were serving sentences of less than one year. See data at the OPM CJPPD website, cited above.

<sup>43</sup> See <https://ctmirror.org/2017/11/07/enfield-prison-to-close-as-inmate-population-falls/> And <https://ctmirror.org/2018/02/19/new-crime-recidivism-rates-continue-to-show-modest-improvement/>

## II. Sources of Funding

### A. Budget Savings

#### 3) Reduce debt service costs by limiting bonding

##### a. Bonding for school construction should be reduced

Since the General Assembly made the wise move to stop bonding to pay for interest costs on eligible school construction in the state's municipalities, it has bonded to pay directly for its share of school construction costs. The total so far is \$11.776 billion, including \$110 million for school building improvements in Alliance Districts.<sup>44</sup> For FY 2019, the legislature has authorized \$480 million for this purpose. The authorization<sup>45</sup> for each of the last eight fiscal years has been:

FY	12	13	14	15	16	17	18	19
Millions of dollars	\$523	\$584	\$510.3	\$469.9	\$580	\$610	\$480	\$480

If, in the future, bond authorizations and subsequent allocations were reduced to \$300 million per year, annual debt service savings (down from the \$480 million level), assuming a future interest rate of 5.5%,<sup>46</sup> would be \$14.858 million. Those dollars could be redirected to pay for critical needs.

##### b. Loans and grants for economic development from bond sources should be reduced

##### c. Other operating expenses (like Town Aid Roads) should not be bonded

Bonding should be reserved for capital projects which have a useful life as long as the bonds issued to support those projects; those who benefit from the project in the future would incur an appropriate share of the cost. Unfortunately, utilizing what I believe to be a bad practice, legislators in past sessions have authorized bonds for some grants that appear to support current operating expenses – including economic development grants and loans [for example, for the Manufacturing Assistance Act and the Small Business Express Act <sup>47</sup>], and for some operating expenses in municipalities.

<sup>44</sup> See Governor's Budget Revisions, FY 2019, Capital Program, p. D-4.

<sup>45</sup> See OFA Budget Books for the last 4 biennial budgets, with 2<sup>nd</sup> year adjustments. Available at <https://www.cga.ct.gov/ofa/add-bb.asp>

<sup>46</sup> See interest rate projections, OFA Fiscal Accountability Report, FY17-FY20, p. 25. Available through a link at <https://www.cga.ct.gov/ofa/>

<sup>47</sup> The Manufacturing Assistance Act is authorized in Chapter 588L of the General Statutes, and the Small Business Express Act is authorized in Sections 32-7g and 32-7h.

That means, in part, that the state must not only pay for the original operating expense, it must pay interest on the moneys borrowed to pay the original expense.

So if \$50 million is bonded in one year, at 4.5% interest, the total debt service, over 20 years, will be about \$75.9 million. Each year, debt service would be about \$3.8 million. If a total of \$1 billion is bonded over a period of 20 years – and the bonds are still outstanding – annual debt service on that total amount would be \$76 million. That \$76 million is buried in the “debt service” line item in the annual budget. It uses up revenue that might otherwise go to pay for appropriated expenditures. If the debt had not accumulated, that \$76 million could be used to pay for other critical needs, or if rated highly enough in the competition for scarce dollars, for direct appropriation for economic development assistance.

Unfortunately, since bonding is often viewed as “free money,” it is usually not subject to the same scrutiny as is given to appropriated expenditures. It’s just used to “kick the can down the road” by backloading the cost of a particular program: we’ll use this money now, but pay for it, with interest, over the long term.

Although DECD has constructed a transparent report of grants and loans under the MAA and the SBEA, for which it has received national praise,<sup>48</sup> it is astounding that very few, if any, legislators are apparently aware of the magnitude of those expenditures.

Since the MAA and the SBEA were enacted, the legislature has authorized a total of \$1,405,300,000 in bonds to pay for loans and grants made under their auspices.<sup>49</sup> That’s a billion with a “b.” DECD reports that about 260 grants and loans were made under the Manufacturing Assistance Act, totaling \$149 million in grants and \$700 million in loans, and about 1650 grants and loans were made under the Small Business Express program, totaling about \$97 million in grants and \$165 million in loans.<sup>50</sup> Included in the “Manufacturing Assistance Act” category are the companies in the “First Five” program, to which (after the February 16, 2018 State Bond Commission meeting) a total of \$263.5 million in bonding for loans and grants to 16 companies has actually been allocated.<sup>51</sup>

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<sup>48</sup> Good Jobs First has high praise for Connecticut’s subsidy tracker:

<https://clawback.org/2014/04/01/connecticuts-open-data-website-leads-nation-in-adopting-economic-development-transparency-best-practices/>

<sup>49</sup> Section 32-235 of the General Statutes.

<sup>50</sup> See the Open Data tables for the Manufacturing Assistance Act, available at <https://data.ct.gov/Business/Manufacturing-Assistance-Act-Tabulated-Data/a9eq-56kb>, for the Small Business Express Program at <https://data.ct.gov/Business/Small-Business-Express-Tabulated-Data/565g-b4i4>, and for the entire Business Assistance Portfolio, including the First Five program (updated through February 7, 2018) at <https://data.ct.gov/Business/Department-of-Economic-and-Community-Development-B/xnw3-nytd/data>

<sup>51</sup> A very useful review of the First Five program is included in the OFA “Analysis of State Bond Commission Agenda Items for February 16, 2018, Meeting,” at Item #42, available through a link on the OFA website at <https://www.cga.ct.gov/ofa/allreportsdocs.asp>. The review observes that bonding originally allocated for three companies (Alexion, TicketNetwork and ESPN) has been, or will be, reallocated. In addition, some companies receiving bonding under the First Five program are also eligible for tax credits.

It is not clear that there has been sufficient staff time available among the 89 staff members in the DECD to follow up on these grants and loans to determine if the terms and conditions under which they were distributed have been satisfied by the recipients; the reports list “pending” as the status of jobs under many of the line items.

A second category of bonding which is used to pay for operating expenses involves grants for specific operating expenses in municipalities – such as Town Aid Roads.

The relevant provisions of the statute authorizing Town Aid Roads states that in addition to capital expenditures such as the construction of highways, the money may also be used for “maintenance” of highways and bridges, including “.the plowing of snow, the sanding of icy pavements, the trimming and removal of trees, the installation, replacement and maintenance of traffic signs, signals and markings, and for traffic control and vehicular safety programs, traffic and parking planning and administration.” And since 2013, the Secretary of OPM “may approve the use of funds by a town for purposes other than those enumerated” above.<sup>52</sup>

For all such types of bonding for current expenses, it would make sense for the General Assembly to adopt procedures that provide for the creation of a “bond budget,” which explicitly provides for a review of the reasons for initiating a bond project and a systematic periodic review of projects for which bonds have been authorized but not allocated. This procedure would help to distinguish the use of bonding for capital purposes from the use of bonding for operating expenses – and perhaps highlight that operating expenses should be funded by appropriations.

(Of course, if after review it is determined that a project is of sufficiently high priority that it should be funded through appropriations, the only savings would be in interest cost over the long term.)

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<sup>52</sup> Sec. 13a-175a



## II. Sources of Funding

### B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)

#### 1) Reduce or eliminate tax credits for economic development

In addition to sales and use “tax expenditures,” (see below) there are several tax credits, especially those that erode the corporate income tax base, that could be revised to ensure that they are achieving their intended objective, or jettisoned entirely. As the State Tax Panel noted, if tax credits “are intended to provide general tax reduction, then phase out the credits and lower the statutory rate. If credits are intended to promote economic development, then efforts [should] be made to identify alternative transparent policies that can promote economic growth at lower revenue costs to the state.”<sup>53</sup> Any additional revenue garnered by elimination of such tax credits could be used for property tax relief.

Elimination of corporate income tax credits could well improve the ranking of the state in some business climate indexes. The Tax Foundation’s State Business Climate Tax Index, for example, downgrades Connecticut because it offers a number of corporate tax credits. According to the Tax Foundation, “Policymakers create these deals under the banner of job creation and economic development, but the truth is that if a state needs to offer such packages, it is most likely covering for a bad business tax climate. Economic development and job creation tax credits complicate the tax system, narrow the tax base, drive up tax rates for companies that do not qualify, distort the free market, and often fail to achieve economic growth.”<sup>54</sup>

Luna and Murray, the State Tax Panel consultants on business taxation, who are more objective analysts than the Tax Foundation, recommended the elimination of the “proliferation of tax credits.” They found that the credit system “narrows the base, is complicated, and subject to ongoing change which creates tax liability and tax revenue uncertainty.”<sup>55</sup> There are frequently “perceptions of unfairness” by taxpayers who do not receive credits.

Moreover, there are ongoing concerns that tax-based incentives are simply not effective means of promoting economic development.<sup>56</sup> In some instances,

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<sup>53</sup> Report of the State Tax Panel, Volume 2, p. 10. This recommendation is the result of research conducted for the Panel by LeAnn Luna and Matthew Murray, “General Business Taxation: An Evaluation of Connecticut’s Corporate Income Tax and Its Alternatives,” in Report of the State Tax Panel, Volume 2, pages 389-450. Specific analysis of tax credits is at pages 393-396, 401, 405, 410-411, and 420-430.

<sup>54</sup> Walczak, Drenkard, and Bishop-Henderson, “2018 State Business Tax Climate Index,” October 17, 2017, Tax Foundation, p. 26. Linked at <https://taxfoundation.org/state-business-tax-climate-index-2018/>

<sup>55</sup> Luna and Murray, pp. 394-95.

<sup>56</sup> Here Luna and Murray provide a footnote summarizing economic literature on this point.



credits may simply reward firms for decisions that they would have made even in the absence of credits. Because the business response to taxes is generally small, significant revenues can be lost with little or no economic development benefit being realized.

Among the challenges involved in evaluating the effectiveness of economic development incentives, including tax credits, is “the inability to observe the counterfactual: what would have happened in the absence of the incentive? The fact that a firm utilized an incentive provides no evidence that the incentive actually stimulated new economic activity.”<sup>57</sup>

In addition, the whole system appears to extend a false promise to corporations: “The state continues to implement tax credits that erode corporate [tax] revenue performance while at the same time placing restrictions on their use.”<sup>58</sup> At the very least, this internal inconsistency in practice “creates an uncertain business climate and can affect returns on previously-made investments.”<sup>59</sup>

The problems involved with the use of tax credits generally are exacerbated in the case of some credits that appear to produce little or no economic return – like film tax credits.

Despite the withering criticism directed at film tax credits during the period from 2008 through 2011,<sup>60</sup> and the limits that have been subsequently placed on their usage, credits for the categories of “digital animation production,” “film production” and “film production infrastructure” still totaled a projected \$86.5 million for FY 2019.<sup>61</sup> Every dollar used to reduce corporate tax revenue, or revenue from the insurance premiums tax, or the public service companies gross earnings tax is a dollar that could be better used elsewhere. So if the 3 film tax credits listed are repealed, the freed-up revenue gain in FY 2019 could be used – in a revenue-neutral way – to revitalize cities via a targeted formula to close the need-capacity gap, as described above.

Other tax credits that diminish tax payments by businesses are projected to total about \$300 million in FY 2019 alone against the corporation tax, \$55 million against the insurance premiums tax, and \$90 million against the public service companies gross

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<sup>57</sup> Luna and Murray, p. 429.

<sup>58</sup> Luna and Murray, p. 395.

<sup>59</sup> Luna and Murray, p. 420.

<sup>60</sup> See the review of the literature and further analysis by Robert Tannenwald, “State Film Subsidies: Not Much Bang for Too Many Bucks,” Center on Budget and Policy Priorities, updated December 9, 2010, pp. 1-2. Still available at <https://www.cbpp.org/research/state-film-subsidies-not-much-bang-for-too-many-bucks>

<sup>61</sup> Office of Fiscal Analysis, “Connecticut Tax Expenditure Report,” February 2018, pp. 11, 13, where OFA provides a chart showing, in addition to the projected amount of credits, the revenue gain if the credits were to be repealed in FY 2019. OFA provides a very useful summary of the changes in these tax credits in its analysis of them on pages 112-115, 136-139, and 166-168. This report is available at a link on OFA’s home page: <https://www.cga.ct.gov/ofa/>

earnings tax.<sup>62</sup> Moreover, during the past seven years, tax credits provided under the “First Five Plus” initiative have totaled another \$160 million.<sup>63</sup>

In general, Robert Tannenwald, the author of the very critical analysis of film tax credits, says that the indiscriminate use of tax credits means that, since Connecticut has a balanced budget requirement, “the state government will have to either cut spending or increase other taxes to offset the loss in tax revenues attributable to the credit.”<sup>64</sup> The impact on the state’s budgeting and accountability can be pernicious because the credits may not be claimed until years after they were “earned,” when they magically appear unannounced to diminish revenue.<sup>65</sup>

At the very least, given the significant overhang of unclaimed tax credits – some estimates are as high as \$2.5 billion<sup>66</sup> -- an institutional review process should be established to provide an assessment of the value of each and every tax credit, and whether or not it should be continued.

This process for reviewing tax credits should be analogous to that used to adopt budget appropriations. Specifically, it should provide for adoption of a comprehensive Tax Expenditure budget which requires legislative approval before a tax credit or tax expenditure is initiated. The review process could be reinforced by sunseting each and every tax credit, and requiring such reviews to justify re-authorization.<sup>67</sup> And if there is no express expiration date on a tax credit or expenditure, there should be a process for legislative review and approval every five years.

At the federal level, the GAO has recommended a review of federal tax expenditures that appears to be equally applicable to Connecticut tax expenditures.<sup>68</sup>

The following questions are among those suggested by GAO that could be answered if tax expenditures were subject to the same kind of review as appropriated programs:

- What is the tax expenditure’s intended purpose?

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<sup>62</sup> OFA Tax Expenditure Report, pp. 11, 13.

<sup>63</sup> See Connecticut DECD, “First Five Plus Program Summary,” January 2018, p. 11, at [www.ct.gov/ecd/lib/ecd/first\\_five\\_plus\\_program\\_summary\\_-\\_updated\\_jan\\_2018.pdf](http://www.ct.gov/ecd/lib/ecd/first_five_plus_program_summary_-_updated_jan_2018.pdf) \$10 million of the \$160 million appears to be for “digital media” companies. And another \$25 million of the \$160 million was allocated to Alexion. Although Alexion repaid its separate loan, it is unclear whether it repaid the \$25 million it received in tax credits.

<sup>64</sup> Memorandum from Jennifer Weiner (Policy Analyst for NEPPC) to Ellen Scalettar (Policy Director, Connecticut Senate Democrats), “Cost-benefit analysis of Connecticut’s film tax credit,” January 19, 2009, p. 5. Still available at <https://www.bostonfed.org/-/media/Documents/neppc/weiner011609.pdf>

<sup>65</sup> Tannenwald, p. 4.

<sup>66</sup> Luna and Murray, p. 420, stated that the value of credits carried forward to the 2013 tax year from 2012 was \$2.5 billion. I have not seen a more recent projection.

<sup>67</sup> Institute on Taxation and Economic Policy, “Five Steps Toward a Better Tax Expenditure Debate,” October, 2012, [http://www.itep.org/pdf/fivesteps\\_1012.pdf](http://www.itep.org/pdf/fivesteps_1012.pdf)

<sup>68</sup> U.S. Government Accountability Office, “Tax Expenditures: Background and Evaluation Criteria and Questions,” (GAO-13-167SP) November 29, 2012, p. 2. <http://www.gao.gov/products/GAO-13-167SP>

- Have performance measures been established to monitor success in achieving the tax expenditure's intended purpose? (similar to RBA)
- Does the tax expenditure succeed in achieving its intended purpose?
- Does the tax expenditure generate net benefits for society?
- Is it fair or equitable?
- Is it simple, transparent and administrable?
- Is it coordinated with other state government activities?
- Does it duplicate or overlap another governmental effort?
- Would an alternative to the tax expenditure more effectively achieve its intended purpose?
- Are there options for limiting the tax expenditure's revenue loss?<sup>69</sup>

As the Legislative Program Review and Investigations Committee stated in 2003, in its comprehensive review of the state's budget process,

Unlike a direct appropriation, a tax expenditure does not need to be reenacted each budget period. It continues indefinitely until amended, repealed, or a sunset date is placed upon it. Therefore, a tax expenditure is typically not revisited or reviewed after passage.

The Committee observed that although state law (Section 12-7b(e)) requires the preparation of a tax expenditure report every two years, which has historically included a description of each tax expenditure, the year it was enacted, its purpose, an estimate of revenue loss, and the number of taxpayers that benefit,

The report does not evaluate the expenditures, make conclusions or recommendations regarding whether a provision should be continued, repealed, expanded, or restricted.

And although the Committee noted that the report "is made available to all legislators, and "state law requires the finance committee to meet and analyze the report," it damningly noted that, at the time, "It does not appear that this has ever occurred." Hence its recommendation:

The program review committee believes Connecticut's tax expenditures should be analyzed periodically to ensure they still make fiscal sense with the changing economy or policy priorities, or continue to be in the state's best interests. The analysis would promote greater transparency and accountability in the enactment and continuation of tax expenditures as well as the development and adoption of the state budget.<sup>70</sup>

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<sup>69</sup> Ibid.

<sup>70</sup> Legislative Program Review and Investigations Committee, "Connecticut Budget Process," (December 2003), pages 64-65. This report is now available in the LPRI archives, available through a link at <https://www.cga.ct.gov/pri/2003.asp>

In the fifteen years since the LPRI report was published, required committee meetings may well have occurred. But there is need for improvement.

Both prior and subsequent reviews can be facilitated in the future because of the newly implemented disclosure requirements of GASB, embodied in GASB 77, which took effect for fiscal years beginning after December 15, 2015. Although Statement 77 does not require a projection of how much revenue will be lost in future years, and does not require the identification of recipients, it does require an estimate of the revenue lost for each program in the reporting year, and disclosure of the provisions, if any, for recapturing abated taxes.<sup>71</sup> The General Assembly should take full advantage of the information provided pursuant to GASB 77, and build on it.

It appears that PA 17-226 took a major step forward in developing the evaluation of business tax incentives, including tax credits.<sup>72</sup> In the future, that assessment might be very helpful in determining whether – and how much – revenue currently lost through tax credits might be better used to support the critical needs of the state.

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<sup>71</sup> See Good Jobs First, “GASB Launches a New Era of Subsidy Transparency,” <http://www.goodjobsfirst.org/blog/gasb-launches-new-era-subsidy-transparency>

<sup>72</sup> The provisions of PA 17-226 appear to have been based on those presented in Nick Defiesta, “Reviewing Tax Expenditures: Improving Transparency and Accountability in Over \$7 Billion of Off-the-Books Public Spending,” Connecticut Voices for Children, April 2016, pages 3-4. For further analysis and recommendations of “best practices” concerning review of tax expenditures, see NCSL, “Tax Expenditure Budgets and Reports, Best Practices,” August 18, 2014, at [http://www.ncsl.org/documents/task\\_forces/Tax\\_Expenditure\\_Report.pdf](http://www.ncsl.org/documents/task_forces/Tax_Expenditure_Report.pdf) and Pew Charitable Trusts, “Tax Incentive Programs: Evaluate Today, Improve Tomorrow,” January, 2015, linked at <http://www.pewtrusts.org/en/projects/economic-development-tax-incentives>

## II. Sources of Funding

### B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)

#### 2) Reduce the number of other “tax expenditures” among those detailed in the latest “Connecticut Tax Expenditure Report” by the Office of Fiscal Analysis

The most recent comprehensive report of Tax Expenditures published by the Office of Fiscal Analysis estimates that the grand total of exemptions, exclusions, deductions or credits created by public act which results in less tax revenue to the state than it would otherwise receive will be \$6.346 billion in FY 2018 and \$6.451 billion in FY 2019.<sup>73</sup>

This estimate – in actual practice -- is both too large and too small.

The current sales and use tax applies to all sales of goods, except those goods that are specifically exempted. But it does not apply to sales of services, except those that are specifically named. In the “goods” category, there are numerous exemptions that could be taxed. But many of those exemptions, such as machinery used in manufacturing and aircraft repair, would be harmful to economic development if they were ended. So the overall estimate of probably too large. In the “services” category, although the economy is becoming increasingly service-oriented, especially digital and technology services, only a few services are enumerated as taxable, so the overall estimate is probably too small.<sup>74</sup>

Many of those exemptions and exclusions that are specified, however, should be carefully reviewed to determine if the dollars that are devoted to them could be more productively employed elsewhere – in helping to revitalize cities, or to support education or to improve infrastructure. The consultant to the State Tax Panel focusing on the sales and use tax recommended

- Adopting the presumption that the sales tax on final consumption should be broadly applied to all goods and services sold at retail

He also developed fifteen specific policy options with respect to those exemptions, including

- Imposing the sales tax on all food purchases
- Eliminating the sales tax holiday
- Broadening the base to include more services to consumers [see subsection 3) below]

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<sup>73</sup> Office of Fiscal Analysis, “Connecticut Tax Expenditure Report,” February 2018, p. 15.

<sup>74</sup> A complete review of the sales and use tax is in a study completed for the State Tax Panel in 2015. See William Fox, “Sales and Use Taxation in Connecticut,” Report of the State Tax Panel, Volume 2, pages 343-388. Available through a link at [https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929\\_State%20Tax%20Panel](https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929_State%20Tax%20Panel)

- Limiting the exemption for sales to not-for-profit organizations
- Imposing the sales tax on sales to government entities
- Taxing digitized downloads to consumers at the full sales tax rate
- Ensuring that the sharing economy (E.g., AirBnB, Lyft, Uber) is taxed similarly to the traditional economy<sup>75</sup>

The State Tax Panel accepted the general presumption and the specific recommendations concerning digital downloads, sales tax holidays, and the sharing economy.<sup>76</sup> But I believe that your Commission should take a more comprehensive approach. The total revenue loss associated with just those specific bulleted exemptions recommended by the sales tax consultant is about \$1.75 billion.<sup>77</sup>

One of the most discussed tax expenditure change was the consultant's recommendation to apply the sales tax to all food purchases (with the exception of food purchased with SNAP (Food Stamps), based on the principle that all consumption should be taxed, and food, as a household purchase, is an item of consumption.

Exemption of food is usually justified as a way to reduce regressivity, since low-income people spend more of their income on necessities like food. But the exemption of food is poorly targeted to low-income households, since all households purchase food. As the consultant says, much of the tax savings "accrues to higher income households." Moreover, many low-income households receive food stamps. And any regressivity could be offset by credits against the personal income tax.<sup>78</sup>

Eliminating the exemption for food purchased for home consumption could result in a revenue gain of about \$425 million in FY 2019, according to the Office of Fiscal Analysis.<sup>79</sup>

<sup>75</sup> Fox, pp. 346-350.

<sup>76</sup> Report of the State Tax Panel, Volume 2, page 8.

<sup>77</sup> See the OFA Report on Tax Expenditures, pp. 5-10.

<sup>78</sup> Fox, pp. 348, 358, 363.

<sup>79</sup> OFA Report on Tax Expenditures, p. 5.

## II. Sources of Funding

### B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)

#### 3) Extend the sales and use tax to additional services

Over the last 30 years, the sales tax base in Connecticut as a percentage of personal income has been falling: it was 35 percent of personal income in 1990, but as of 2012 was about 28%. Part of the reason for the shrinkage is the movement of consumption away from goods and toward services. Nationally, services represented about 47% of consumption in 1979, but were about 66% in 2012.<sup>80</sup> So if the sales tax is focused on the purchase of goods, rather than services, an erosion of the base is occurring, and will likely continue. It makes sense to try to stem that erosion to gain additional revenue, especially if services to final consumers are targeted.<sup>81</sup>

Because Connecticut law provides that all sales of goods are subject to sales tax except where specifically exempted, it is easy to compile a list of those “tax expenditures.” But the law does not tax services unless specifically enumerated, so it is rather difficult to compile a list of services that are not taxed. However, the Federation of Tax Administrators has a now somewhat outdated (2010) list of services subject to sales tax in at least one state.<sup>82 83</sup>

The list below includes services not taxed in Connecticut at the time it was compiled in 2010. It should be reviewed to evaluate whether any or all should be taxed in the state. However, the sales tax consultant to the State Tax Panel points out that, as of 2016, Connecticut taxes more services than any other state in the Northeast. Nevertheless, he does point out that there some opportunities for broadening the base of the sales tax to additional services might enable the state to reduce the rate, or at least not increase it.<sup>84</sup> Or alternatively, to direct the additional revenue to meet critical needs.

Veterinary services
Horse boarding and training
Pet grooming
Intrastate courier service

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<sup>80</sup> Fox, p. 355.

<sup>81</sup> Fox, pp. 365-366.

<sup>82</sup> This list is taken from the summary spreadsheet developed by the Federation of Tax Administrators, accessible by clicking on the link “Actual Survey Data – 2007” (which was actually updated in 2010), at <https://www.taxadmin.org/sales-taxation-of-services>. The list printed here does not contain services that were at the time already subject to the sales tax in Connecticut.

<sup>83</sup> Another list is contained in Appendix N to “Connecticut’s Tax System” at pp. N-1 to N-3 of [www.cga.ct.gov/2005/pridata/Studies/pdf/CT\\_Tax\\_System\\_Final\\_Appendix.pdf](http://www.cga.ct.gov/2005/pridata/Studies/pdf/CT_Tax_System_Final_Appendix.pdf).

<sup>84</sup> Fox, pp. 365-366. Fox cites a DRS list of TAXABLE services in Connecticut, updated through April 2015. See <http://www.ct.gov/drs/cwp/view.asp?a=1477&Q=269930&drsPNavCtr=>

Automotive storage
Food storage
Fur storage
Cold storage
Travel agent services
Packing and crating
Service charges of banking institutions
Fishing and hunting guide services
Gift and package-wrapping services
Laundry and dry-cleaning services
Personal instruction (dance, golf, tennis, etc.)
Shoe repair
Water softening and conditioning
Commercial linen supply
Interior design and decorating
Marketing
Process server fees
Telemarketing services on contract
Automotive road service and towing services
Billiard parlors
Bowling alleys
Coin operated video games
Pinball and other mechanical amusements
Limousine service (with driver)
Custom meat slaughtering, cutting and wrapping
Taxidermy
Accounting and bookkeeping
Architectural services
Legal services
Dental services
Engineering services
Land surveying
Medical test laboratories
Nursing services out-of-hospital
Physician and other medical services



## II. Sources of Funding

### B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)

#### 4) Continue to seek automatic application and remission of the sales and use tax to sales in other states for goods and services used in Connecticut.

The General Assembly has sought numerous methods of circumventing the barrier to such automatic taxation which was erected by the U.S. Supreme Court in *Quill Corp. v. North Dakota*, 504 U.S. 298 (1992), but the efforts have not been sufficient to gather all taxes due. The Supreme Court is now reconsidering the principle it established in *Quill*,<sup>85</sup> so there is hope that additional revenue might soon be available.

Apart from the added revenue for the state, which could be used, among other purposes, to close the need-capacity gap in a revenue-neutral way, or to invest in education or transportation infrastructure, there are good reasons why it would be good for the *Quill* ruling to be overturned. Placing out-of-state merchants under the same taxation regime as in-state brick-and-mortar retailers should be supportive of instate businesses (which are currently disadvantaged by the 6.35% difference in final bills paid by their customers as opposed to bills from out-of-state merchants). Property and income tax revenue might be higher because of increased local retail commerce. And a state might be less likely to respond to the revenue loss to out-of-state sales by raising the sales tax rate – which would only exacerbate the discriminatory impact of the differential.<sup>86</sup>

How much revenue is being lost because of *Quill*? It might be \$70 million<sup>87</sup> and it might be more. The issue involves more than mail-order retail sales (which totaled \$35.5 billion nationally in 1992); e-commerce (internet) transactions are exploding. In 2016, web retail sales were up 15.6% from 2015, totaling \$394.86 billion, slightly under 12% of all retail sales.<sup>88</sup> Extrapolating that growth to 2018, it could well be that total web retail sales would be up 33% from 2015, to over \$500 billion.

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<sup>85</sup> On January 12, 2018, the U.S. Supreme Court agreed to review *South Dakota v. Wayfair, Inc.*, which involves the same issue as *Quill*.

<sup>86</sup> William F. Fox, "Inability to Collect Sales Tax on Remote Sales Still Harms the Economy," State Tax Notes, November 6, 2017, pp. 575-582, at p. 578. Available at <http://cber.haslam.utk.edu/PDFDocs/STN06NOV17.pdf>

<sup>87</sup> The Courant reported that an estimated \$70 million in use tax is evaded annually. See "Connecticut Hunting Down Online Shoppers Who Didn't Pay Sales Tax," *Hartford Courant*, February 14, 2018, at <http://www.courant.com/politics/hc-pol-online-sales-tax-20180214-story.html>

<sup>88</sup> Data from Stefany Zaroban, "US e-commerce sales grow 15.6% in 2016," Internet Retailer, February 17, 2017, <https://www.digitalcommerce360.com/2017/02/17/us-e-commerce-sales-grow-156-2016/?sessionId=1518304488670&referrer=&lastReferrer=www1.avalara.com>

Back in 2009, three professors at the University of Tennessee published a widely-cited analysis which projected that sales tax revenue losses from retail electronic commerce (business-to-consumer) would total \$11.4 billion in 2012, of which Connecticut's share would be \$63.8 million (or 0.56% of the total).<sup>89</sup> In 2012, the Tennessee researchers updated their study, projecting a massive increase in total losses by 2015, to \$17.4 billion.<sup>90</sup> Using that as a base number, back-of-the envelope calculation would indicate that Connecticut's share of the total loss in 2015 to be \$97.4 million.<sup>91</sup>  $[(17.4/11.4) \times \$63.8 \text{ million} = 1.53 \times \$63.8 \text{ million}]$

Further, assuming that revenue losses would have grown from 2015 to 2018 in proportion to the growth of retail ecommerce sales, (15.6% to 2016, and 33% to 2018), it is possible that Connecticut's total revenue loss from out-of-state retail ecommerce sales in 2018 could be as high as \$150 million.  $[1.156 \times 1.33 \times \$97.4 \text{ million}]$

Obviously, these assumptions could be incorrect, and thus might overstate the projected revenue losses. For example, Connecticut has in fact taken steps over the years to try to recover this out-of-state sales revenue, from requiring income tax payers to estimate and pay their use tax as part of their income tax filing, to negotiating with Amazon to collect use tax on its own sales to Connecticut consumers, and remit it to the state – on the grounds that it now has a physical nexus in Connecticut. [But Amazon still does NOT collect and remit use taxes from sales by its affiliated small merchants.] In its latest effort, DRS is requesting customer lists from out-of-state retailers and combing through the data to see if the customer paid the required use tax.<sup>92</sup>

On the other hand, the estimates of losses by the University of Tennessee researchers back in 2009 might have been too low because they underestimated the business-to-consumer share of e-commerce. As most recently observed, more recent data shows that 15.6% of all e-commerce in 2015 was business-to-consumer, and hence use taxable, while the original 2009 estimate by the researchers was that only 9.1% of e-commerce was business-to-consumer.<sup>93</sup>

The General Assembly's Office of Fiscal Analysis may have better estimates than I. But this source of additional revenue – whatever its magnitude – should be considered.

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<sup>89</sup> Bruce, Fox and Luna, "State and Local Government Sales Tax Revenue Losses from Electronic Commerce," University of Tennessee, April 13, 2009, p. 11. Available at a link at <http://cber.haslam.utk.edu/ecommerce.htm>

<sup>90</sup> Fox, "Inability to Collect Sales Tax on Remote Sales Still Harms the Economy," State Tax Notes, November 6, 2017, pp. 575-582, at p. 580.

<sup>91</sup> Fox, in "Sales and Use Taxation in Connecticut," an analysis prepared for the State Tax Panel in 2015, estimated that the loss to the state might be over \$100 million in 2015. See State Tax Panel, Volume 2, pp. 343-388, at p. 371. This report also provides an overall review of the use tax in Connecticut, esp. at pp. 357-58, and 370-377.

<sup>92</sup> "Connecticut Hunting Down Online Shoppers Who Didn't Pay Sales Tax," *Hartford Courant*, February 14, 2018, at <http://www.courant.com/politics/hc-pol-online-sales-tax-20180214-story.html>

<sup>93</sup> Fox, State Tax Notes, pp. 575-582, at p. 580.

## **II. Sources of Funding**

### **B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)**

#### **5) Eliminate the corporate and business entities tax, and shift to a commercial activities tax (CAT) like that levied in Ohio**

In a report prepared for the State Tax Panel in 2015, consultants reviewing the state's business tax structure proposed that the state consider replacing the corporate income tax with a gross receipts tax at a very low rate (00.22%) that would raise substantially the same amount of revenue as the corporate tax.<sup>94</sup>

The current corporate income tax is highly volatile, is subject to erosion from a substantial system of tax credits, which add complexity and are subject to frequent policy changes that lead to instability and uncertainty in business tax liabilities.

Moreover, the corporate tax does not apply to all business entities, especially pass-through entities like S Corporations, LLCs, LLPs, partnerships, etc., which increasingly dominate the marketplace. Many types of these entities, some of which are quite large, benefit from limited liability protections that were originally extended only to C corporations, but pay only a small business entity tax in return for that privilege.

There are some downsides to moving to a commercial activities tax like a gross receipts tax, especially the potential problem of pyramiding taxation in business-to-business transactions. The issue of pyramiding is minimized, however, because of the very low rate at which the CAT would be imposed. This alternative is clearly superior to a continuation of the corporate income tax.

As observed in an article published subsequently to the work for the State Tax Panel, the consultants concluded that the corporate income tax failed

to capture trends in the nation's economy, demography, and the changing structure of business organization. Moreover, . . . the CIT has become the political playground of tax base erosion ranging from the proliferation of economic development incentives to the abandonment of the once nearly uniformly applied, evenly weighted three-factor apportionment formula in favor of the single sales factor. The result is a general business tax that departs from the rationally broad-based taxation of the business enterprise and violates nearly

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<sup>94</sup> Lee Ann Luna and Matthew Murray, "General Business Taxation: An Evaluation of Connecticut's Corporate Income Tax and Its Alternatives," Report of the State Tax Panel, Volume 2, pages 389-450. Available through a link at [https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929\\_State%20Tax%20Panel](https://www.cga.ct.gov/fin/taskforce.asp?TF=20140929_State%20Tax%20Panel)

every principle of a high-quality state tax system. Indeed, the only case for the state CIT appears to be fiscal expediency — because the other states do it.”<sup>95</sup>

This analysis was probably the reason why the State Tax Panel unanimously recommended that the Department of Revenue Services conduct a comprehensive study of the alternatives to the corporate income tax.<sup>96</sup>

This Commission should also recommend further exploration of this option. It could result in far greater stability in business taxation.

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<sup>95</sup> Ebel, Luna and Murray, “State General Business Taxation One More Time: CIT, GRT or VAT?” *National Tax Journal*, December 2016, 69(4), pp.730-762, at p. 757. An abstract and a link to the full article may be found at <http://www.ntanet.org/NTJ/69/4/ntj-v69n04p739-762-state-business-taxation-CIT-GRT-VAT.html>

<sup>96</sup> See the recommendation of the State Tax Panel at page 15 of Volume 2 of its Report.

## **II. Sources of Funding**

### **B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)**

#### **6) Impose a low-level statewide property tax to pay for part of the past service liability in the Teachers' Retirement System**

As noted above, one major component of appropriated expenditures, now and in the future, is the cost of amortizing past service liability in the Teachers' Retirement System. Even if future spikes are avoided, the levelled-out cost of funding is still significant.

One way to pay for that cost is to levy a statewide property tax on all assessed property in the state.

According to OPM, the total grand list assessment in the state for October 1, 2015 is \$370,290,579,847 <sup>97</sup> If the state levied a 1 mil tax on that property, it would produce \$370 million.

If those funds were dedicated to pay for part of the past service cost in the Teachers' Retirement System, \$370 million in other revenues (from a miscellany of income, sales, and corporation taxes) would be freed to partially fund a formula to close the need-capacity gap.

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<sup>97</sup> OPM, "Municipal Fiscal Indicators, December 2017, revised to 2/6/18," page B-24. Available through a link at <http://www.ct.gov/opm/cwp/view.asp?a=2984&q=383170>

## II. Sources of Funding

### B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)

#### 7) Increase the rate of the sales and use tax

Increasing the rate of the sales and use tax from 6.35% to 7.0% could bring in up to an additional \$400 million in FY 2019, without adjusting the base.

Based on the optional sales tax tables for 2017, provided by the IRS for taxpayers who choose to deduct state sales taxes instead of state income taxes, the additional cost -- exclusive of sales taxes on motor vehicles, aircraft or boats -- for taxpayers of various income levels and numbers of exemptions is shown in the following table.

Computed Sales and Use Tax at 7%													
Income		Exemptions											
	But less than												
At least		1		2		3		4		5		Over 5	
(in thousands)		Dollar value											
		current 6,35%	if increased to 7%	current 6,35%	if increased to 7%	current 6,35%	if increased to 7%	current 6,35%	if increased to 7%	current 6,35%	if increased to 7%	current 6,35%	if increased to 7%
0	\$ 20	303	334	327	360	343	378	354	390	363	400	376	415
\$ 20	\$ 30	469	517	507	559	531	585	549	605	563	621	582	642
\$ 30	\$ 40	557	614	602	664	631	696	652	719	669	738	692	763
\$ 40	\$ 50	633	698	685	755	718	792	742	818	761	839	788	869
\$ 50	\$ 60	702	774	760	838	796	878	823	907	844	930	873	962
\$ 60	\$ 70	765	843	827	912	867	956	896	988	919	1013	951	1048
\$ 70	\$ 80	822	906	890	981	932	1027	964	1063	989	1090	1023	1128
\$ 80	\$ 90	876	966	948	1045	993	1095	1027	1132	1054	1162	1090	1202
\$ 90	\$ 100	927	1022	1003	1106	1051	1159	1087	1198	1115	1229	1154	1272
\$ 100	\$ 120	995	1097	1077	1187	1128	1244	1166	1285	1197	1320	1238	1365
\$ 120	\$ 140	1084	1195	1173	1293	1229	1355	1270	1400	1304	1438	1349	1487
\$ 140	\$ 460	1166	1285	1263	1392	1323	1458	1368	1508	1404	1548	1452	1601
\$ 160	\$ 180	1243	1370	1346	1484	1410	1554	1458	1607	1496	1649	1548	1707
\$ 180	\$ 200	1316	1451	1425	1571	1493	1646	1543	1701	1584	1746	1639	1807
\$ 200	\$ 225	1392	1535	1507	1661	1579	1741	1633	1800	1676	1848	1734	1912
\$ 225	\$ 250	1474	1625	1595	1758	1672	1843	1729	1906	1774	1956	1836	2024
\$ 250	\$ 275	1551	1710	1679	1851	1759	1939	1819	2005	1867	2058	1932	2130
\$ 275	\$ 300	1625	1791	1759	1939	1843	2032	1906	2101	1956	2156	2025	2232
\$ 300	or more	2065	2276	2237	2466	2344	2584	2424	2672	2488	2743	2575	2839

For families with federal AGI of less than \$100,000 per year, the additional cost per year would be less than \$120, or less than \$10 per month. For families with federal AGI of less than \$50,000 per year, the additional cost per year would be less than \$81 per year, or less than \$6.75 per month.

Like other options that produce greater revenue from the sales and use tax, increasing the rate of sales taxation and investing the revenue in education is, according to Professor Wasylenko, likely to be more favorable to economic growth than other forms of taxation.<sup>98</sup>

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<sup>98</sup> Wasylenko, "Competitiveness: Factors that Contribute to Economic Growth in States with Special Reference to State and Local Spending and Taxes," in Report of the State Tax Panel, volume 2, at page 258-259..

## **II. Sources of Funding**

### **B. Restructure revenue sources to provide additional funding to offset the costs of meeting critical needs (net revenue neutrality)**

#### **8) Aggressively seek additional federal revenue<sup>99</sup>**

It may seem like a fool's errand to seek additional federal revenue in an era when the federal government appears to be bent on reducing assistance to states. But the potential gain from such a strategy merits major efforts.

Although there are some aspects of the revised spending cap incorporated into the 2018-2019 budget bill (Section 709), a very positive aspect of the new language is that "expenditures of any federal funds granted to the state or its agencies" shall not be considered as general budget expenditures under the spending cap.

Under the previous language of the statutory spending cap, a large share of federal revenue to the state was included in appropriations that were subject to the spending cap. As Fred Carstensen has pointed out, that meant that Connecticut "systematically avoided securing federal dollars to which it was entitled or for which it would have been competitive," because "those federal dollars came with requirements on how those monies were to be spent." Because "spending Connecticut taxpayer dollars had no such constraints, . . . there was a clear preference for those dollars in the budget process."<sup>100</sup>

The new spending cap language has resulted in a complete reversal of the reasoning. It now makes sense to aggressively seek additional federal revenue.

#### **Background**

For years, if not decades, funds received from the federal government have been treated by Connecticut in inconsistent and disparate ways: some federal funds were received and spent for specified purposes without being appropriated, and some federal funds were treated as reimbursements for a portion of total state appropriated expenditures for programs funded in part by state funds and in part by federal funds. Most Medicaid programs fell into the second category: the full cost of a Medicaid service was budgeted as a state expenditure, even though some or all of it was covered with federal money. This was commonly called a "gross appropriation" approach. The dollars from Washington showed up as revenue.

Most states, however, followed a "net appropriation" approach. The appropriations budget showed only the expenditure of state funds for a program: the federal

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<sup>99</sup> The analysis in this section is mainly taken from the Report of the Chairpersons of the Spending Cap Commission.

<sup>100</sup> Carstensen, presentation to the Commission, February 9, 2018, at p. 2.



reimbursement was subtracted from the total program cost, and was not reported as revenue offsetting the total program cost.<sup>101</sup>

In 2013, faced with a major influx of federal funds associated with the implementation of the Affordable Care Act, under which states could receive 100% reimbursement (for a few years) for an expanded Medicaid program<sup>102</sup> which the state agreed to put into place, legislators were faced with the options of continuing the practice of ‘gross appropriation’ of this class of Medicaid funding, or switching to a “net appropriation” approach, which by removing a substantial sum of federal dollars from appropriated expenditures to non-appropriated funding would remove those federal funds from the spending cap. The General Assembly chose the latter.

This action was certainly not without precedent. A number of programs funded with federal dollars were in 2013, and through 2017 remained, “off-budget,” non-appropriated. They range from block grants to Pell grants to research grants. Many, but not all, are enumerated in a report from Connecticut Voices for Children in 2013. The partial listing of these off-budget federal funds totaled \$540 million for FY 2012.<sup>103</sup>

On the other hand, many other federal funds were “gross appropriated” and thus remained under the spending cap. The Voices report projected that \$1.5 billion in federal funds in FY 2016 would still be in this category. There appears to be no good reason for doing so. As the Voices report notes, “Not only is the inclusion of federal funds under the spending cap counterintuitive, but also it is unusual: only two of the 24 other states with expenditure limits include federal funds under their limits.”<sup>104</sup>

There is this to be said in favor of leaving the \$1.5 billion under the cap. If some of those dollars are for federally mandated programs, they were exempt from the existing 1991 cap in the first fiscal year in which they were authorized, but then were considered to be under the cap for the purpose of determining general budget expenditures for the ensuing fiscal year. If they did not increase from year to year, or increased only minimally, their slow growth would mean that there would be more room under the cap for other programs.

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<sup>101</sup> Keith Phaneuf and Arielle Levin Becker provided a concise explanation of the two approaches. See “Democrats may sidestep spending cap,” CTMirror, May 22, 2013, <http://ctmirror.org/2013/05/22/democrats-may-sidestep-spending-cap/>

<sup>102</sup> This expanded program was not mandated. The state had the option to decline the dollars. And under the 1991 statutory spending cap, “expenditures for program or service components which are optional under federal law or regulation shall be considered general budget expenditures.”

<sup>103</sup> Wade Gibson, “Removing the Quirks in Connecticut’s Treatment of Federal Funds,” Fiscal Policy Center at Connecticut Voices for Children, October 2013, <http://www.ctvoices.org/sites/default/files/bud13federalfunds.pdf>

<sup>104</sup> Ibid., page 1. The legislature’s Office of Legislative Research is the source of the assertion that only two of the other 24 states with spending caps include federal funds under the caps. See Daniel Liston, “OLR Backgrounder: State Spending Caps Analysis,” Office of Legislative Research, May 30, 2013. <https://www.cga.ct.gov/2013/rpt/2013-R-0244.htm>

However, if any federal funds remain subject to appropriations, there is certainly the possibility – and the possibility has in fact occurred – that the spending cap may cause the state to turn down these dollars.

And while the dollars are not “free,” they come from revenue raised by taxpayers all across the country, only some of whom are from Connecticut. And, in general, Connecticut receives back from the folks in Washington only some of the dollars it sends there.<sup>105</sup> So why should Connecticut turn down any federal grants to the state government that the federal government is willing to send our way to support programs the state finds desirable?

It certainly appears that federal grants to Connecticut state government make up a far smaller share of total state revenue than the national average, and a smaller share than surrounding states. The National Priorities Project reported that in FY 2013, “Connecticut got \$6.1 billion dollars from the federal government, which is 23.4% of its total revenue.” The national average was 30%.<sup>106</sup> The Pew Charitable Trusts recently updated the data to FY 2014, and found that federal funds constituted 24.6% of state revenue in that year – third lowest in the country – as opposed to the national average for states of 30.8%.<sup>107</sup> Assuming that 24.6% was \$6.1 billion (as Pew estimated for FY 2013), simply moving to the national average share of 30.8% would have meant a roughly estimated additional \$1.5 billion<sup>108</sup> in federal funds.<sup>109</sup> If Connecticut would be able to receive, on a consistent basis, its fair share of federal funds which Connecticut taxpayers have paid federal taxes to support, those additional funds could mean the creation of thousands of additional jobs, raised household incomes and, as a consequence of additional jobs and income, improved state revenues. Receiving those federal funds could also potentially mean that critical public service programs and strategic investments in education and infrastructure could be funded without additional Connecticut state taxes.

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<sup>105</sup> The National Priorities Project, State Smart, estimates that Connecticut residents and businesses paid \$53 billion in taxes to the federal government in 2014. It also estimates that “Connecticut receives about \$45 billion dollars from our federal budget over the course of a year, between federal grants and contracts to business and governments, federal assistance going right to its residents, and federal employees working there.” So for every dollar Connecticut residents and businesses pay in federal taxes, they receive about 85 cents back. <https://www.nationalpriorities.org/smart/connecticut/>

<sup>106</sup> Ibid.

<sup>107</sup> Anne Staufer and Justin Theal, “Federal Funds Supply 30.8 Cents of Each State Revenue Dollar,” Pew Charitable Trusts, July 28, 2016. <http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/07/28/federal-funds-supply-308-cents-of-each-state-revenue-dollar> A complete data table for all fifty states going back to FY 2000 is linked at this site. In addition, the Pew Charitable Trusts has provided a visualization tool which enables comparison of one state to the national average, and to other states. See <http://www.pewtrusts.org/en/multimedia/data-visualizations/2014/fiscal-50#ind0> Data in the table and on the visualization tool show that the corresponding shares were 27.8% in Massachusetts, 32.8% in New York, 34.7% in Rhode Island, 28.1% in New Hampshire, 33.6% in Vermont, and 36.6% in Maine.

<sup>108</sup> To be clear, this ballpark \$1.5 billion is different from the \$1.5 billion in federal funds already received, and at least until 2017 had been “gross appropriated.”

<sup>109</sup> Fred Carstensen’s estimate is “as much as \$1 billion or more annually.” Carstensen, presentation to the Commission, p. 1.

These potential outcomes are just, at this time, potential opportunities. It may be that the low poverty rate in Connecticut will mean that the federally determined low reimbursement rate for traditional Medicaid will continue to be the lowest in the country. Given the prospective shift in policy in the new national administration, it may be that federal funding for all programs in all states will be reduced. But without thorough investigation of the possibilities, we will never know if the state would qualify for additional funding for existing and other programs.

And now, with the new spending cap language, there is no penalty associated with seeking additional federal dollars.

## II. Sources of Funding

### C. Add additional revenue (not net-revenue neutral) to meet transportation infrastructure needs

One alternative is to Increase the gasoline tax by 4 cents per gallon (per year).

Let's look at two scenarios:

- a. Assume that a car owner regularly drives 30,000 miles per year,<sup>110</sup> and that his/her car gets 20 miles to the gallon. That owner would then purchase 1500 gallons of gasoline per year. Adding 4 cents per gallon to the current gas tax would cost the driver an additional \$60 per year.
- b. Assume that a car owner regularly drives 12,000 miles per year,<sup>111</sup> and that his/her car gets 20 miles to the gallon. That owner would then purchase 600 gallons of gasoline per year. Adding 4 cents per gallon to the current gas tax would cost the driver an additional \$24 per year.

Either scenario is likely less costly to the car owner than the cost of repairing damage to the vehicle caused by potholes on poorly-maintained roads. Or the cost of congestion caused by traffic jams on outdated roads with not enough capacity for current levels of traffic.

Given the fluctuations in the base price of gasoline, such an increase would generally not be noticeable. A minimal increase in the gas tax is dwarfed by the highly volatile changes in the price of gasoline imposed by oil companies – largely reflecting speculative changes in the market – the benefits of which accrue only to the oil companies, not the users of the transportation system.

Moreover, an increase in the gasoline tax of 4 cents per gallon is less than the 8 to 10 cents per gallon surcharge typically charged to those who purchase gas using a credit card, as opposed to paying cash.

Increasing the gasoline tax – gradually – has many attractive aspects.

- Does not just apply to vehicles in one region of the state, but to all vehicles statewide.
- Revenue can be used anywhere in the state.
- Because the total tax varies with fuel consumption, there is some incentive to drive more fuel-efficient vehicles.

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<sup>110</sup> Assuming a commute of 100 miles per day, round-trip, for 250 work days, in addition to local trips for shopping, leisure, etc.

<sup>111</sup> The number of miles a leased car is typically estimated to be driven.

- Total tax is automatically proportional to all road usage, not just on major highways.
- Total tax is automatically proportional to the number of vehicle miles traveled (without the need for a complicated measurement system required to assess a VMT tax).

A second option for raising revenue to meet transportation infrastructure needs is to introduce electronic tolling on major highways.

Critics of this option observe that although using electronic tolls has some benefits (chiefly in enabling congestion pricing to divert traffic flow to hours other than heavy commuter times, and to redirect traffic to alternative means of transportation (trains) along a corridor), there are also some obstacles. Border tolls, though politically popular, would likely run afoul of interstate commerce regulations. Revenue from tolls applied to highways built with federal dollars would likely be usable only for transportation improvements in those corridors. And because most of the major highways in the state have entrance/exits every few miles, multiple tolling points would be necessary. There is also the potential that electronic tolling on major highways would divert vehicle traffic to local side roads, overloading them. Especially if the toll is high.<sup>112</sup>

It might be possible to overcome some of those obstacles. Tolls at the state's borders and tolls on river crossings, if imposed on a non-discriminatory basis, could produce the right amount of revenue to pay for needed major improvements at those locations, in those corridors. This could eliminate the need for multiple tolls every few miles, and thus avoid pushing traffic to side roads. And congestion pricing for classes of vehicles (think trucks) might still be possible, and effective in reducing tie-ups at heavy traffic times.

The main point is that additional revenue is required to meet the need to invest in transportation infrastructure. Either/or/both alternatives should be considered.

#### **Side comment:**

**While it makes sense to add revenue (on a non net-revenue neutral basis) to pay for a critical need like transportation infrastructure, why does it not make sense to add revenue (on a non net-revenue neutral basis) to pay for other critical needs like the revitalization of cities, and investing in education?**

<sup>112</sup> The toll for a single occupant using the HOV lane on the Capital Beltway in Virginia at 8:30 a.m. on February 13, 2018, was \$46.50. See [https://www.washingtonpost.com/news/dr-gridlock/wp/2018/02/13/the-toll-on-i-66-inside-the-beltway-hit-46-50-on-tuesday/?utm\\_term=.6e0c222ebf5c](https://www.washingtonpost.com/news/dr-gridlock/wp/2018/02/13/the-toll-on-i-66-inside-the-beltway-hit-46-50-on-tuesday/?utm_term=.6e0c222ebf5c)

## II. Sources of Funding

### D. What NOT to do

#### 1) Do NOT privatize state assets.

##### Scenario One: Sale – Leaseback

It may make sense for the state to sell some of its property that is no longer serving any public purpose. One thinks, for example, of the Newtown Hospital or the Norwich Hospital, both of which have been abandoned for years, with the buildings collapsing. Even in situations like these, however, there might be reason to ask if the underlying property should be retained for possible future use. And it should be recognized that the proceeds of such sale – as one-shot revenue – does nothing to solve the long-term structural deficits the state faces. The expenditures would remain in future years, while the one-shot revenue would no longer be there to pay for them.

But it makes absolutely no sense for the state to sell buildings that are currently being used for office space, and then lease them back from the new owners.

The most comprehensive analysis of a proposal like this was conducted by the Legislative Analyst's Office (LAO) of the State of California, when Governor Arnold Schwarzenegger proposed to sell eleven state-owned office buildings and then lease the buildings back.<sup>113</sup>

The LAO pointed out that a simple way to conceive of this transaction is to “think of the sale-leaseback as a loan with interest.”<sup>114</sup> At the heart of the deal is the payment of debt service on the funds the new owners used to buy the buildings. And since the new owners do not have access to tax-exempt bonds, the interest cost would be higher than any state-issued general obligation bonds. This cost alone, passed on to the state as part of the lease payment, makes the proposal non-cost-effective.

Just as has occurred in recent years in Connecticut (where many state agencies are being relocated from leased space to newly-purchased and upgraded space), California “originally invested in these buildings because it was determined that owning state office space would save money compared with leasing.” The LAO determined in its analysis that because the long-term cost of leasing back the buildings for many years exceeded the sale revenue, that original conclusion continued to be valid.

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<sup>113</sup> Legislative Analyst's Office of the State of California, “Evaluating the Sale-Leaseback Proposal: Should the State Sell Its Office Buildings,” April 27, 2010, PDF available for download at <http://www.lao.ca.gov/Publications/Detail/2261>

<sup>114</sup> LAO Report, p. 14.

It tellingly did NOT consider “the sale-leaseback a reasonable budget solution” since “it would add to the structural deficit in order to address the current budget shortfall. Paying for the state’s annual costs of running its programs with a one-time sale of critical state assets is poor fiscal policy.”<sup>115</sup>

### Scenario Two: Selling a future revenue stream

One alternative is to sell or lease current revenue-generating property to a private owner. The new owner pays an upfront sum, and in return is allowed to charge fees or tolls for a specific number of years. A couple of examples: A) The long-term lease (75 years) of Chicago’s parking meters to a private vendor for \$1.15 billion, who acquired the right to set parking meter rates for the period of the lease; B) The long-term lease of the Indiana toll road to a consortium which could set toll rates for the future, for an upfront payment of \$3.8 billion.

#### *Chicago Parking Meters*

The Inspector General of Chicago, after reviewing the process of cutting the deal as well as its substance, concluded that there was no independent analysis of the terms of the deal before it was finalized, and no meaningful opportunity for public input. Moreover, he found that “the City was paid, conservatively, \$974 million less for this 75-year lease than the City would have received from 75 years of parking-meter revenue had it retained the parking-meter system under the same terms that the City agreed to in the lease.”<sup>116</sup>

But not only was the deal unexamined and fiscally unsound, it also foreclosed public policy options that the City might want to undertake in the future.<sup>117</sup>

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<sup>115</sup> LAO Report, p. 16.

<sup>116</sup> Office of the Inspector General, City of Chicago “An Analysis of the Lease of the City’s Parking Meters,” June 2, 2009, p. 2, available through a Google search at <http://webcache.googleusercontent.com/search?q=cache:0BuEirPFkCEJ:chicagoinspectorgeneral.org/wp-content/uploads/2011/03/Parking-Meter-Report.pdf+&cd=1&hl=en&ct=clnk&gl=us&client=firefox-b-1>

<sup>117</sup> See the summary memorandum by a student at the Maxwell School at Syracuse University in 2015, which noted that “Under the lease contract, Chicago Parking Meters LLC is entitled to all of their parking spots, and the city must pay fair market valuation when they are closed (Clawson, 2013). For instance, if a road is temporarily closed for an event or construction, the city must pay Chicago Parking Meters LLC the amount of revenue those meters would have been expected to earn for the entirety of the closure. If a parking spot is permanently removed, the city would have to pay what that meter would have earned over the remainder of the 75 year lease. This creates major financial disincentives for city planning efforts to construct bicycle lanes or add new bus lines, as their development would necessitate the removal of many parking spaces (Cohen, 2014). This dynamic greatly limits Chicago’s ability to develop into a “green” city in the coming decades.” Moreover, the student cited a study by Bloomberg Business in 2010, which concluded that the Chicago Inspector General had been far too conservative in estimating the revenue loss: Bloomberg Business “projected that Chicago Parking Meters LLC would earn \$11.6 billion

## *Indiana Toll Road*

The U.S. Government Accountability Office prepared a report on “Highway Public-Private Partnerships” (often called “P3” deals) in 2008.<sup>118</sup> The GAO pointed out both benefits and costs potentially associated with such partnerships, which involved either the sale or long-term lease of existing highways for an upfront payment in return for the right to collect tolls on the road, or the right to construct a new highway with the right to collect tolls on the project when completed. One example the GAO examined was the 75-year lease of the Indiana Toll Road (originally constructed with very few federal dollars, which were repaid before the lease began) in 2006 for \$3.8 billion, giving the right to the private company to collect tolls on the road.

Although the GAO agreed that there were some potential benefits to the arrangement, it also noted some potential costs:

- a) “there is no ‘free money’ in highway public-private partnerships. Rather, this funding is a form of privately issued debt that must be repaid.” (p. 31)
- b) “it is possible that the net present value of the future stream of toll revenues (less operating and capital costs) given up can be much larger than the concession payment received.” The GAO cited one study which concluded that Indiana had left about \$7 billion on the table. (p. 33)
- c) “non-compete clauses” could prevent the public from building competing facilities within a certain distance of the road in question, or improving surrounding roads if high tolls diverted traffic to those facilities (pp. 45-47)

Critics of entering into any of these kinds of public-private partnerships observe that “governments actually may take on all kinds of new risk they didn’t face before—like the implications of entering into long-term deals that can constrain lawmakers’ policymaking options for decades.”

In a famous case, the California Department of Transportation used a P3 to build and operate express lanes that opened in the center of California State Route 91 in Orange County in 1995. When the government wanted to expand parts of the roadway to alleviate congestion, it was blocked by a “non-compete” clause in the 35-year contract. Following litigation, the government ultimately bought out the private partner. Just seven years after the express

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in total revenue during the 75 year lease, more than ten times what they paid, with \$9.58 billion of that revenue as profit.” <http://faculty.maxwell.syr.edu/jyinger/classes/PAI735/studentpapers/2015/Dale.pdf>

<sup>118</sup> GAO, “Highway Public-Private Partnerships,” GAO-08-44, February 2008. Linked at <https://www.gao.gov/products/GAO-08-44>



lanes opened, the county's transportation authority paid \$207.5 million for the \$130 million project.<sup>119</sup>

In the case of the Chicago parking meters, "whenever it temporarily closes a street the city must compensate the private partner for the lost revenue. When Indiana faced flooding in 2008, tolls were waived to evacuate people quickly, but the state had to pay the Indiana Toll Road's private concessionaire \$447,000 for the lost revenue."<sup>120</sup>

McKinsey and Company takes a different view, arguing that implementation and execution of P3 projects is far superior than projects undertaken by public agencies.<sup>121</sup> However, many of these advantages depend on the competent upfront delineation of requirements and effective oversight by government. If government is so bad at implementation and execution of projects, why does McKinsey believe that it will be that much better at delineation of contract requirements and effective oversight? In my experience, the ability of a government agency to draw up sufficiently specific contract requirements that anticipate future problems and control for them is sadly lacking. It's probably better to recognize that the public agencies can more effectively respond to future problems when they arise, as long as they are not limited by ill-considered contract provisions.

The McKinsey report also paints a rosy picture of an example of a successful project – a picture that is not supported by other analysts. The example is the construction of the George Deukmejian Courthouse in Long Beach, California, which is lauded as an award-winning project that came in on time and under budget. The Legislative Analyst's Office in California, was more skeptical of the project: "Our analysis indicates that utilizing a different set of assumptions than those discussed above (such as excluding the assumed federal tax adjustment and leasing costs) would result in the cost of the Long Beach courthouse project being less—by as much as \$160 million in net present value terms—in the long run under a traditional procurement approach than the chosen P3 approach."<sup>122</sup>

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<sup>119</sup> Ryan Holeywell, "Public-Private Partnerships are Popular, But Are They Practical?" *Governing Magazine*, November 2013, at <http://www.governing.com/topics/transportation-infrastructure/gov-public-private-popular.html>

<sup>120</sup> Ibid.

<sup>121</sup> Michael Della Rocca, "The rising advantage of public-private partnerships," McKinsey and Company, July 2017, at <https://www.mckinsey.com/industries/capital-projects-and-infrastructure/our-insights/the-rising-advantage-of-public-private-partnerships>

<sup>122</sup> Legislative Analyst's Office, "Maximizing State Benefits from Public-Private Partnerships," November 8, 2012, [http://www.lao.ca.gov/reports/2012/trns/partnerships/P3\\_110712.aspx](http://www.lao.ca.gov/reports/2012/trns/partnerships/P3_110712.aspx)

## II. Sources of Funding

### D. What NOT to do

#### **2) Do NOT collect additional coins from under the couch cushions, and use to pay for operating expenses**

In recent years, the General Assembly and Governor have “balanced” the budget by raiding funds originally set aside in non-appropriated accounts (usually called “separate, non-lapsing” accounts) and using those funds to offset an overall deficit in the appropriated General Fund. But this “one-shot” revenue only guarantees a shortfall in the out years, because the spending will remain, but the revenue will have disappeared.

For example, as recently reported by Keith Phaneuf in the *Connecticut Mirror*, \$175 million in total was “stripped in the new two-year budget from three energy efficiency programs, including \$63.5 million taken this fiscal year and next from the Energy Efficiency Fund, \$14 million taken annually from the Connecticut Green Bank, and \$10 million taken each year from the conservation fund used to support the Regional Greenhouse Gas Initiative.” The money for these purposes was raised from a surcharge on monthly utility bills, and directly deposited in the respective accounts for designated purposes.<sup>123</sup>

These accounts were not the only ones from which funds were “swept” in the 2018-2019 budget bill. Sections 681 through 697 of the bill raided a total of \$242.3 million<sup>124</sup> in either “one-shot” (for FY 2018 only) or “two-shot” (for both FY 2018 and FY 2019) revenues to pay for General Fund expenses that presumably will be ongoing. Not only were the programs from which the funds were raided prevented from achieving their goals, the use of these funds now to balance the current budget ensures that there will be General Fund deficits in the future amounting to \$132.6 million and \$109.7 million, respectively.

A system such as this just guarantees future budgetary deficits. Tolerating it as a routine practice does not contribute to fiscal stability. The Commission should accordingly express its disapproval of its use.

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<sup>123</sup> <https://ctmirror.org/2018/02/13/lawmakers-urge-reversing-clean-energy-cuts-but-lack-budget-fix/>

<sup>124</sup> See the table summarizing the sweeps from Sections 681 through 697 in the OLR Bill Analysis for SB 1502 (June 2017 Special Session), at [https://www.cga.ct.gov/2017/BA/2017SB-01502-R00SS1-BA.htm#P2512\\_257867](https://www.cga.ct.gov/2017/BA/2017SB-01502-R00SS1-BA.htm#P2512_257867)

## **II. Sources of Funding**

### **D. What NOT to do**

#### **3) Do NOT routinely use the resources of the Rainy Day Fund to pay for operating expenses**

Using money in the Rainy Day Fund to balance each year's budget is also fiscal malpractice. It may be justifiable if the economy goes south, or some other temporary event causes an unexpected shortfall in revenue. But if, every year, the powers that be draw down the resources of the Rainy Day Fund to close a deficit simply because they are not willing to use straightforward means of raising revenue – like raising taxes to pay for what they decide are necessary programs – they are essentially using “one-shot” revenues. Like sweeping funds from non-General Fund accounts, this is damaging to fiscal stability.

## II. Sources of Funding

### D. What NOT to do

#### 4) Do NOT move from defined benefit pension systems to defined contribution systems

Many critics of the SERS and TRS defined benefit pension (DB) systems have called for switching to defined contribution (DC) systems – because of the apparent high cost of funding the current systems. But these critics almost without exception fail to recognize that the high cost of the current DB systems are almost entirely due to past failure to fund the actuarially required contributions to pay for past service.

In fact, it makes more sense to fix the existing DB systems than to shift to DC plans.

- A. Switching to a DC plan does not remove the employer's responsibility to pay for the overhanging unfunded liabilities caused by past underfunding. As referenced above, the unfunded liability that is owed to both TRS and SERS cannot be extinguished even if the current defined benefit plan were to be changed to a defined contribution plan, with both the state and the individual employee contributing to the plan. INDEED, the unfunded liability that is owed to both TRS and SERS cannot be extinguished even if every single active employee in the State went to a completely self-funded IRA.
- B. A new plan only addresses pension costs going forward – it does not address the current funding problem associated with the failure to pay for past service liability.
  - 1. The pension systems must still cover the cost of accrued benefits for past service.<sup>125</sup>
  - 2. A new DC plan, instituted after closing a DB plan, may actually increase short-term costs.<sup>126</sup>
    - a. Closed plans<sup>127</sup> using the “level percent of payroll” method for calculating the ARC must acknowledge that the covered payroll is decreasing (GASB 25)
    - b. A “level dollar” funding method for a closed plan frontloads the ARC compared to ARC under the old, ongoing plan

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<sup>125</sup> Alicia Munnell, “State and Local Pensions. What Now?” Brookings Institution Press, 2012, pp. 189, 208. See also the “Final Report of the Connecticut Post-Employment Benefits Commission,” October 28, 2010, (link available at [www.ct.gov/opm/cwp/view.asp?a=2998&q=457846](http://www.ct.gov/opm/cwp/view.asp?a=2998&q=457846)) p. 51

<sup>126</sup> See Munnell, p. 190n, in which she summarizes points 2 and 3.

<sup>127</sup> “Closed plans” here refers to plans which have been closed to new participants. The term does not refer to a closed amortization period used in calculating the ARC.

- the cost increases because the period of time to spread the cost is continually shrinking without new younger employees joining the plan
3. "Market gains from future new hire contributions that would have been used to offset the unfunded liability [in the old (closed) DB plan] would now be sequestered" in the new DC accounts
  4. As the participants in the old DB "closed" plan grow older, funds invested in the closed plan would need to be shifted away from equities (more volatile) towards more fixed income (less volatile) to support a population of mostly retirees. So the government would have to increase contributions to the fund to make up for lower investment returns.<sup>128</sup>
  5. A DC plan would probably not save money for a given level of benefits<sup>129</sup>
    - a) because a DC plan has higher administrative costs (~ 1% vs. ~ 0.4%)
    - b) to the extent that employees are currently making contributions to the old DB plan, the employer contribution for normal cost is already pretty low (and might be higher with a DC plan – as with the CT Higher Education Alternative Retirement Plan)<sup>130</sup>
    - c) the employer contribution in a DC design that is expected to deliver the same benefit at retirement as the current DB plan is likely to be significantly greater than the current normal cost in the DB plan, as a percent of payroll.<sup>131</sup>
- C. A DC plan essentially just shifts risk from the employer to the employee. These risks include investment risk, longevity risk and inflation risk. Most employees are not prepared to manage these risks.
- D. The supposed lower cost of DC plans is often just a result of cutting employer contributions to the DC plan, not greater economic efficiency.<sup>132</sup>

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<sup>128</sup> CT PEB Study, p. 51. The Minnesota Retirement Plan Design Study (published June 1, 2011, available at <http://www.msrs.state.mn.us/pdf/Study6-1-2011web.pdf>) puts this a slightly different way: "Relative to an open ongoing DB plan, a closed DB requires higher cash outflow, meaning benefit payouts are high relative to contribution revenue. As a result, plan assets will be spent down and thus, must be invested in a lower risk investment allocation." (p. 3)

<sup>129</sup> Munnell, pp. 190-91

<sup>130</sup> See CT PEB Study, pp. 50-51.

<sup>131</sup> The reasons, according to a study by the National Institute on Retirement Security in 2008: 1) no longevity risk pooling, 2) less balanced portfolio, 3) higher management fees, 4) lower returns [individual investment choices usually less knowledgeable than those of a professionally managed pension plan]. Almeida and Fornia, "A Better Bang for the Buck," National Institute on Retirement Security, August 2008, linked at <http://www.nirsonline.org/index.php?option=content&task=view&id=121>

<sup>132</sup> See National Institute on Retirement Security (2008), p. 13.

### **III. Recommend revision of the newly adopted spending cap to exempt grants to distressed municipalities from the spending cap**

If the Commission is to fulfill its mandate, which requires it to recommend actions to revitalize the major cities, to support the interests of families and businesses, and to promote economic growth, it is absolutely necessary that – as elaborated in Section I of this presentation – it recognize that additional funding is needed to assist the most distressed municipalities in the state to close the “need-capacity gap” and to support an adequate education for the residents of those municipalities.

Meaningful additional funding, however, is unlikely to be forthcoming if grants to distressed municipalities are limited by the spending cap. The “framers” of the statutory spending cap adopted in 1991 recognized that distressed municipalities were in their distressed condition in large part because the limited property base required assistance from the state in order to provide basic services. So they provided that “current or increased expenditures for statutory grants to distressed municipalities, provided such grants are in effect on July 1, 1991” would be exempt from the cap.

When the Spending Cap Commission considered revisions to the statutory spending cap, a majority of its members recognized that to limit the grants eligible for exemption only to those in place on July 1, 1991 was a quarter-century out-of-date. Some 1991 grants are no longer in use. Some new grants to meet contemporary needs had been developed since that time – and in some cases, the formulas for distribution of those grants had been distorted in order to make it appear that they were just extensions of 1991 grants, so that the distributions to distressed municipalities under those grants would qualify for exclusion from the spending cap.<sup>133</sup>

The majority members of the Spending Cap Commission accordingly recommended that the ALL grants to distressed municipalities, not just those in effect in 1991, be exempt from the spending cap. They reasoned that

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<sup>133</sup> See the discussion in the Report of the Chairpersons, Spending Cap Commission, at page 31. A primary example of initiating a new grant in such a way as to make some grants eligible for grants to distressed municipalities is the Mashantucket Pequot and Mohegan Fund (Section 3-55i and 3-55j). When initiated in 1993, the method of distribution invoked a number of grants that had been in place in 1991. See Section 3-55j. In recent years, a series of specific block grants to towns has replaced the original distribution plan. See, for example, Section 23 of PA 16-2 (May Special Session).

Also, the many revisions of the Educational Cost Sharing Formula might be said to be distortions of the original formula. Since at least 2013, the ECS formula originally set out in Section 10-262h of the General Statutes has not been followed. Instead, a series of specific block grants to towns has been included in the appropriated budgets. See, for example, Section 20 of PA 16-2 (May Special Session). A history of the changes to Section 10-262h is appended to the section in the Connecticut General Statutes. For a general background, see Connecticut School Finance Project, “School Finance 101,” updated January 2, 2017, page 59 et seq. <http://ctschoolfinance.org/assets/uploads/files/School-Finance-101-Current.pdf>

- There is likely to be a need, at some time in the near future, for there to be a new formula for distributing **non-educational** funding to towns. They cited the analysis of The New England Public Policy Center (NEPPC) at the Federal Reserve Bank of Boston, as reviewed above in Section I.A., which concluded that the existing grants-in-aid were not sufficient to address the need-capacity gap. They also noted that a new distribution formula for grants to municipalities had been recommended by the State Tax Study Panel, which had concluded – again as reviewed in Section I.A. above – that “State grant policies should be re-examined in an effort to further relieve pressure on the property tax to address fiscal disparities across municipalities,” recommending specifically that “the State needs to look at the distribution formula which addresses closing the ‘need-capacity gap.’”
- There is likely to be a need to develop a new formula to distribute **educational** assistance to towns. The majority members believed that such a formula would not be the result of a court order – and that belief was confirmed when the Supreme Court decided in January 2018 that the courts were not in a position to decide if educational funding was constitutionally adequate – so the exemption of court-ordered programs from the spending cap would not exempt additional educational funding from the cap.<sup>134</sup>

Despite the recommendation of the majority of the Spending Cap Commission, when the General Assembly revised the language of the cap in Section 709 of the budget bill, it removed not just the “grants . . . in effect on July 1, 1991” from the exemption, it removed all of the language exempting grants to distressed municipalities from the cap.

Some anecdotal commentary from some of the parties involved in drafting this new language indicated, variously, that

- The new language may have been a drafting error. The intent was to remove just the 1991 language, but the whole phrase was mistakenly removed.<sup>135</sup>
- The new language may have reflected the belief that grants to municipalities would grow only slowly, or not at all, over the next few years, so that if they were under the cap, their slow growth would leave room under the cap for the growth of other programs.

Whatever the intent, the overwhelming vote for the budget bill, including this new language, meant that the new language implemented the constitutional spending cap, so revision of the language now requires not just a simple majority of the General Assembly, but a 3/5 vote.

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<sup>134</sup> Report of the Chairpersons, Spending Cap Commission, pp. 30-33.

<sup>135</sup> This interpretation is given some credence by the OLR Bill Analysis of Section 709, which says in part that the new language “Eliminat[ed] the exclusion for statutory grants to distressed municipalities if the grants were in effect on July 1, 1991.”

The result is that the new language in the state's spending cap, by placing grants to distressed municipalities under the spending cap, makes it very difficult to target additional assistance to the most distressed municipalities in the state. The new spending cap language effectively freezes high property tax rates in cities, making them unattractive to businesses, and relegating them as losers in the multi-state competition to attract businesses looking for vibrant, dynamic centers of innovation.

It also makes it very difficult to target additional educational assistance to cities with large numbers of students with high need – depriving those cities of the means to educate knowledge workers required for the future workforce – despite the call by all the justices on the Supreme Court that such aid be provided.

For those reasons, the Commission should recommend very strongly that the new language of the spending cap should be revised to exempt all aid to distressed municipalities from the cap.



#### **IV. Recommend repeal of the ill-advised “bond lock”**

I fully support Atty. Alex Knopp’s trenchant analysis<sup>136</sup> of reasons why the “bond lock” should be repealed before its implementation creates major fiscal problems for the state.

I add only the following considerations:

The consequences of the bond covenant included in the pension obligation bonds for the TRS in 2008 should demonstrate to everyone that – whatever the good intent underlying covenant language – there are always future circumstances that arise that create a need for revision. Clearly the authors of the 2008 bond covenant did not anticipate that there would be a completely unaffordable spike in the required funding of the system in the late 2020s and early 2030s. How can anyone predict what policy changes the federal government might make which will affect the finances of the state? How can anyone foresee what will happen in the economy at some time during the period that the bonds are outstanding? How can anyone anticipate natural events, like hurricanes, climate change, and pyrrhotite in concrete foundations, that may require extraordinary responses by state government? How can anyone project what will be needed to invest in infrastructure and economic development to make the state more attractive to business?

Although the defenders of this “bond lock” language say that they wanted to make the legislature “accountable,” presumably to the people of the state, the “bond lock” in fact makes the legislature accountable only to the bondholders – who probably do not much care about the people and their needs. If the projected covenants go into effect, the people will have assigned their power to control public policy to the holders of the bonds.

Language in bond covenants is not analogous to collective bargaining contracts. The experience of the last 30 years has demonstrated that labor and management can renegotiate contracts – because both parties are concerned about the consequences of the contract.

This Commission is presumably concerned with maintaining fiscal stability. But stability does not just mean retaining all the elements of the status quo. Stability sometimes requires adjustment in the face of external changes. But the “bond lock,” if retained, will effectively prevent future legislatures from maintaining fiscal stability in the face of changes in the economy, changes in national policy, and changes in services required to meet the needs of Connecticut’s residents.

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<sup>136</sup> Alex Knopp, “Testimony of Alex Knopp, Commission on Fiscal Stability and Economic Growth,” January 24, 2018. See also Knopp, “6 Reasons to Repeal the ‘Doomsday Bond Covenant,’” February 2, 2018, [http://www.ctnewsjunkie.com/archives/entry/20180202\\_op-ed\\_six\\_reasons\\_to\\_repeal\\_the\\_doomsday\\_bond\\_covenant/](http://www.ctnewsjunkie.com/archives/entry/20180202_op-ed_six_reasons_to_repeal_the_doomsday_bond_covenant/)

It is also possible that the “bond lock” could adversely affect the future credit rating of both the state and its municipalities. Municipalities could be downgraded because they might not receive state assistance to help them meet their needs. And the state itself could be downgraded if the lock is so inflexible that it prevents reasonable responses to changing circumstances.

Please heed the call to recommend repeal of the “bond lock” before it causes major damage to the state.