CONNECTICUT'S FISCAL GUARDRAILS

Risk Reduction for the Future

ECONOMIC LEADERSHIP

Connecticut Business Roundtable

Introduction

When evaluating economic competitiveness of state economies, factors associated with business climate, workforce, infrastructure and innovation are analyzed in detail, overlaid with risk—the factor most at play when decisions are made to invest, expand, or relocate to a state.

While Connecticut is a fairly low-risk state in terms of weather events, natural disasters, and crime, its fiscal health rate is historically one of the worst in the country, prohibiting the state from making transformational changes in policy and spending to increase domestic and global competitiveness while also improving the quality of life for current and future residents.

A key driver of Connecticut's risk profile is its long-term liabilities, which hurt the business climate. Any state with long-term liabilities is inherently less competitive than other states because it places an undue burden on any company or family considering a move.

Ask yourself this simple question: why would anyone move to a state and immediately subject their earnings to a 23% tax for benefits never received? Anyone moving a family or business to Connecticut will pay for years of political and economic mismanagement of existing pensions without deriving any benefit.

This is why governors across the country, regardless of party, are working to reduce unfunded pension liabilities. Doing so improves state fiscal health, saving billions of dollars of taxpayer money and paving the way for tax cuts and investments that improve competitiveness and make states more attractive to residents and businesses alike. As funding ratios improve, there are still risks of fluctuation due to various factors, including investment performance, changes in actuarial assumptions, and demographic shifts.

For Connecticut, the battle to be more competitive goes beyond overall fiscal health given the depth of its existing growth-related problems.

State Tax Competitiveness Ranking (2025)

BOTTOM STATES OVERALL

#50	New York
#49	New Jersey
#48	California
#47	Connecticut
#46	Maryland

Source: Tax Foundation

In addition to the unfunded pension crisis, data shows Connecticut is facing other significant challenges.

Despite modest recent growth, Connecticut's population is projected to continue to age and grow less than five percent over the next decade. Outmigration, especially that of young professionals, remains a major concern. In fact, Connecticut has one of the nation's oldest populations (only after Maine and New Hampshire), with more than 27 percent aged 55 and older, making it tougher and less appealing for businesses seeking employees to support expansion and growth in the state.

The state's cost of living and cost of doing business is high. CNBC's 2024 America's Top States for Business study ranks the state's cost of living 34th, while Connecticut remains the eighth costliest state in the country in which to run a business. These high-cost burdens pose a severe risk to any initiatives designed to attract and retain residents and businesses.

Beyond these previously mentioned challenges, the Northeast region of the United States is facing fierce competition from states in the Sun Belt, where state leaders are aggressively working to maintain a low cost of living and low cost of doing business while also marketing a better quality of life. Connecticut is not immune to the impacts of this threat.

These crises—**fiscal instability, population aging and loss, and a lack of affordability**—all present major risks to the state's competitiveness as a location to invest, do business, and live. Fiscal instability and unfunded pension debt have too often paralyzed the state in enacting tax reform legislation, something other states are doing rapidly to increase domestic and global competitiveness.

Overview

The conversation around the fiscal guardrails in Connecticut is the subject of great debate. Many in government, policy, the advocacy community and beyond have shared their opinions and logic for and against the continuation, termination, and modification of the fiscal guardrails and what these regulations have accomplished. While a recent poll conducted by CBRT indicates that 83% of respondents either 'strongly' or 'somewhat support' the fiscal guardrails, change may be on the horizon, nonetheless. The questions some are now asking are whether the guardrails are working too well? Are they capturing too much money beyond the original stated purpose thereby reducing spending on other programs in need? Does the state really need to put every dollar it can collect into reducing its long-term unfunded liabilities so the state can once again become competitive against other states?

> **"It absolutely has an impact on our search—that rating is part of our initial check of a state's business climate and a key factor in determining the risks associated with an investment or relocation.**
>
> **Site Selection Consultant (New York)**

The discussion breaks down into two points of view: one side wants to continue with the guardrails as is, while others want to make modifications to the formulas to redirect dollars to other programs. There does not appear to be any serious discussion about removing the guardrails in total, which is a welcome sign that key stakeholders recognize the foundational improvements this legislation has made to date.

The main point of contention with the guardrails appears to be how the Volatility Cap is funded. The Cap is often criticized for using a static "moment in time snapshot" of the economic situation in 2017 as a basis for savings. Proponents of an adjusted cap advocate for a more flexible approach like using a rolling average or sliding scale that captures more data. Another argument against the Cap is that the metrics initially used do not actually account for other sources of revenues that could be included, diversifying the base for calculation and mitigating risks that certain assets may or may not perform as predicted year to year.

Governor Lamont's proposed change to how the cap is calculated now takes into account the years of economic growth that followed 2017. According to the Governor, using this formula will honor the

Fiscal stability is one of eight categories driving the overall U.S. News & World Report Best States rankings, and encompasses metrics reflecting both the short-term and long-term fiscal stability of a state. According to the ranking's glossary, "the fiscal stability of a state's government is vital to ensuring the success of government-sponsored programs and projects, trickling down to affect the quality of life of state residents. In modern times, the rights and powers of states have been asserted through a broad range of services for their citizens—delivery of public education among them—and effective state administration and fiscal health have become increasingly important."

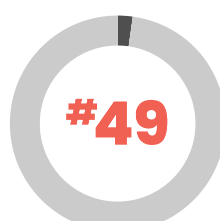
intent of the guardrails while allowing for more funding to other needed areas, like social services and early childhood education. The challenge is that the state legislature must approve this change by a three-fifths vote of both houses to avoid violating bondholder contracts. If the Governor can gain such support, then the guardrails may be loosened. All that will remain is to see how the market responds.

What is certain today is that the state has benefited from the fiscal guardrails. Connecticut has enjoyed a reduction in borrowing rates that resulted from improved credit ratings, lower unfunded balances in long-term pension obligations, and a general perception that the state's leadership is operating in bipartisan agreement to undo years of political errors that created this glaring liability. The choice facing the State is whether to deviate from its currently disciplined approach to savings and modify the guardrails, or to stay the course. After all, the problem that everyone initially set out to solve remains the State's single biggest financial challenge. **Despite its best efforts, the State of Connecticut still has one of the nation's most underfunded pension liability problems** that continues to impede its ability to compete against other states, locally and nationally.

Fiscal Stability Ranking (2024)

U.S. News & WORLD REPORT

RANKING



ATTRIBUTES

Long-Term Fiscal Stability	#48
Short-Term Fiscal Stability	#49

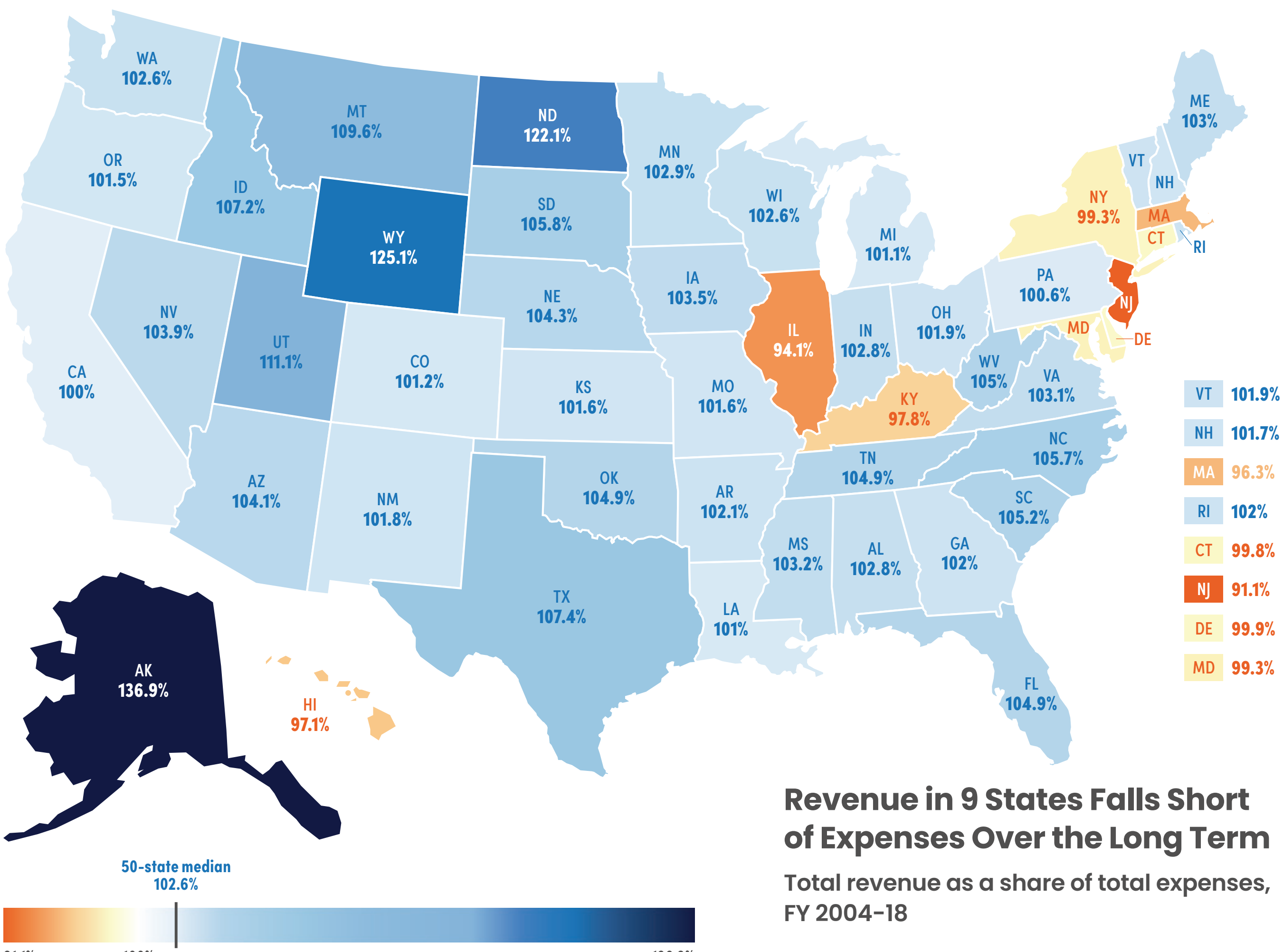
Source: U.S. News Best States 2024

Connecticut ranks #49 for "Fiscal Stability" and #43 on "affordability." The state has favorable rankings in healthcare, education and crime *(U.S. News Best States 2024)*

Credit Rating Agency History: One of the 'Worst States' in America

To fully understand the discussion of credit quality there must first be a review of how the credit rating agencies view state finances. For the purposes of this discussion, Moody's, Fitch, and Standard & Poor's (S&P) will be used as the three major credit rating agency datapoints. Each agency reviews the overall financial health of states, applying their own unique methodology to arrive at a credit rating that reflects the financial realities and creditworthiness of the state. In every case the agencies view pristine credit to be rated Aaa by Moody's, AAA and AAA by S&P and Fitch, respectively. The table on page 4 shows the comparable investment grade ratings of the three major rating agencies.

Since 2001, Connecticut's long-term debt rating has ranged from Aa2, AA and AA (from Moody's, Fitch, and S&P respectively) to its present-day ratings of Aa3, AA- and AA-. Looking at those data points might lead one to believe that the overall ratings have not



Revenue in 9 States Falls Short of Expenses Over the Long Term

Total revenue as a share of total expenses, FY 2004-18

Source: The Pew Charitable Trusts

changed significantly and even inspires the question: why haven't the fiscal guardrails led to major improvements in the state's overall credit rating?

To answer that question, the ratings must be looked at year by year, with a particular focus on the time leading up to the implementation of the fiscal guardrails where the state's credit rating dropped to its lowest point in decades, with Moody's rating the state at A1, S&P at A and Fitch at A-. In May of 2017, the three credit ratings agencies used in this analysis downgraded Connecticut based on economic trends and outlooks.

	MOODY'S	S&P GLOBAL	FITCH
Best Quality	Aaa	AAA	AAA
High Quality	Aa1 Aa2 Aa3	AA+ AA AA-	AA+ AA AA-
Upper Medium Grade	A1 A2 A3	A+ A A-	A+ A A-
Medium Grade	Baa1 Baa2 Baa3	BBB+ BBB BBB-	BBB+ BBB BBB-

The ratings cite eroding state income tax receipts, the impending depletion of state budget reserve funds, and huge unfunded liabilities with considerable cost increases to retirement plans. This drop in credit quality only drew attention to Connecticut's budgetary woes and was a call to action for leaders to address the most obvious issue at hand: unfunded pension debt.

Fiscal Guardrails: Purposeful or Prohibitive?

Today the leading arguments for changing the fiscal guardrails focus on the fact that the guardrails are collecting too much money, having exceeded their originally stated purpose resulting in programs like social services, education, and others to remain underfunded.

It is easy for one to quickly think this loosening of the guardrails would solve those problems. When comparing Connecticut to other states, it is critical to recognize that there are deep systemic issues that must be addressed before just providing additional funding for programs and services.

Volatile Revenues Continue to be Volatile

A common target for criticism with respect to the current guardrails has been the "Volatility Cap." This cap was created to address the persistent issue that Connecticut's income tax revenues are subject to large swings because of the state's reliance on capital gains. To combat this, a cap was set where only revenue that falls below the cap can be budgeted, while the rest is used to pay down long-term obligations reducing our reliance on these funds.

Originally set at $3.15 billion in fiscal 2018, that figure is adjusted annually by the five-year compound annual growth rate in the state's personal income and now stands at $3.929 billion for fiscal 2025. Money that comes above this figure is diverted to the Budget Reserve Fund (BRF) to pay down pensions. Since its inception, volatile revenues have exceeded the cap by an average of $1.41 billion per year, resulting in a full BRF and $8.5 billion in additional contributions to the pension system.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FINANCE

States With the Worst Pension Debt in the Nation

Fitch Ratings issued a report comparing the pension debt in each state to personal income. Connecticut had the highest ratio, at 23 percent, while Tennessee was the best at 1 percent.

Critics point to the recent pension contributions as evidence that these sources of funds are no longer as volatile and so the cap should therefore be set much higher. What this critique fails to acknowledge, however, is that while these revenues have been volatile to the upside resulting in large surpluses, they have been more volatile since fiscal 2018 relative to the preceding decades. Overall, the period between 2001 and 2024 saw volatile revenues exhibit a volatility of about 19.9%.

In other words, these revenues commonly saw year-to-year changes of up to 20% of their value. **In the seven years since the cap's inception, these revenues have seen one-year changes greater than 20% in four of those years.** While only three years saw year-over-year declines, those declines were large: -10.3%, -7.8%, and -24.4% in fiscal 2019, 2020, and 2023, respectively.

Projecting these revenues in the future remains challenging, but recent history should warrant caution if there are assumptions that these revenues will remain high. Volatile revenues are heavily influenced by capital gains and tax policy, both of which have seen abnormal changes in the past seven years. In the financial markets, the past seven years have seen three years (2019, 2021, and 2024) where the S&P 500 has seen annual gains greater than 25%. This level of market performance only happened on two other occasions between 2001 and 2024 (2003, 2013).

Further, tax changes in 2017 because of the Tax Cuts and Jobs Act resulted in significant onshoring of corporate profits in fiscal 2018, driving significant revenue growth in 2018 and subsequent decline in 2019. Ultimately, relying on these revenues going forward carries with it the risk that the current cap structure mitigates effectively.

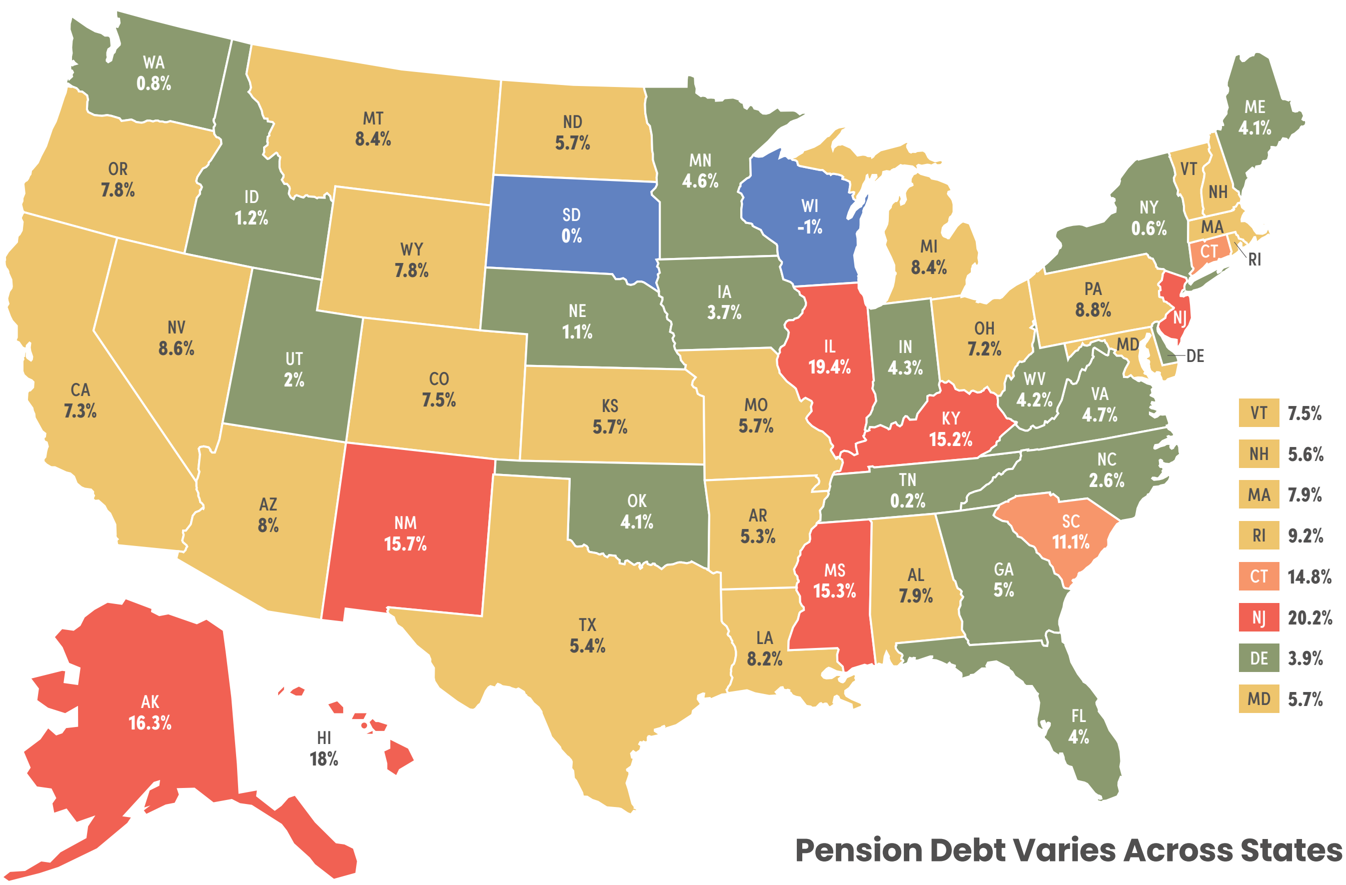
Changes to the cap structure would result in greater year-to-year uncertainty during the budgeting process and leaves the state vulnerable to deficits should capital gains or tax policy see significant adjustments. Given the new administration and recent strong market performance, it would not be unreasonable to see significant adjustments in the near term.

It is also important to note that not only have the fiscal guardrails saved taxpayers billions of dollars, but those so-called restraints actually freed up additional spending for programs and services—$738 million in fiscal 2025 alone.

Fixed costs, primarily state employee pension and retiree healthcare obligations, consume the greatest share of Connecticut's budget, siphoning away much needed funding for essential services and programs. The 2017 fiscal reforms are an essential tool for reducing that burden over the long term.

The spending cap is one of those tools playing a significant role in protecting and strengthening Connecticut's fiscal health. While Connecticut is in the top three states for per capita government spending—at $6,173, almost twice the national average—that has shifted since 2018.

Between 2017 and 2023, Connecticut per capita expenditures grew 24.3% while on average, states' expenditures per capita increased 33.2%. Compare that to the 2007-2017 period, where Connecticut's per capita spending increased 14.6% compared to an average increase of 14.8% across all states.



Pension Debt Varies Across States

Unfunded pension liabilities as a share of state personal income, 2019

-5 to 0% | 0.1-5.0% | 5.1-10% | 10.1-15% | >15%

Source: The Pew Charitable Trusts

Unfunded Pension Debt: Not Unique to Connecticut

Connecticut is not alone in facing the challenge of unfunded pensions. What matters is what states are doing about that debt.

In 2024, numerous states reported making supplemental governmental contributions to pension systems above statutorily or actuarially required. A Pew Research study reported that pension contributions across the 50 states have steadily increased since the Great Recession, growing 7% each year from 2008 to 2021. More recently, more than a dozen states have used post-pandemic budget surpluses and excess rainy day funds to supplement their annual contributions to their public pension systems.

Supplemental contributions help minimize risk to states during economic downturns and contributions also help achieve savings in future years, removing the burden to future generations of government leaders and residents.

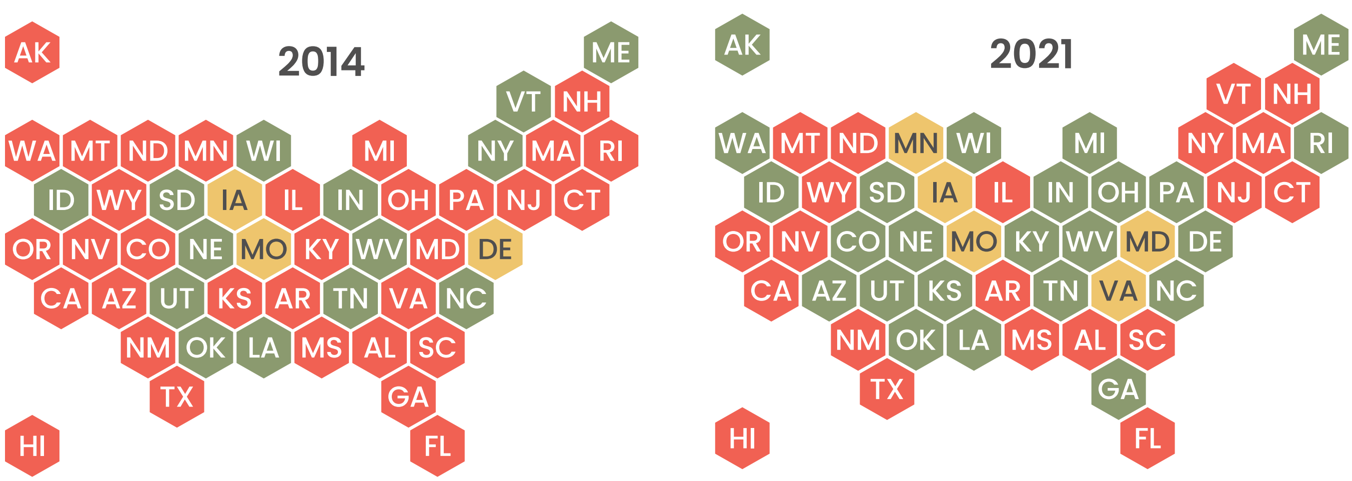
Legislative Momentum Builds Across the U.S.

States continued to build on this trend in 2024. Policymakers in Alaska, California, Louisiana, Minnesota, and others approved supplemental

14 States Improved Contributions Enough to Expect Stable or Shrinking Pension Debt

Net amortization by state, 2014 and 2021

- Negative amortization
- Stable amortization
- Positive amortization



Note: Positive amortization indicates states where the employer contribution exceeds the benchmark by 0.5% of covered payroll (the total salary of all employees participating in a pension plan). Negative amortization identifies states where the contribution falls below the benchmark by 0.5% of covered payroll. Stable amortization describes states in between.

Source: The Pew Charitable Trusts

contributions in budget and appropriations bills and previously enacted changes started to prove fruitful for states like Michigan, Maryland, and Colorado.

In March 2023, Michigan's credit rating improved for the first time in nearly a decade thanks to aggressive bipartisan budget reform at the state and local levels. Fitch noted that Michigan is "managing economic risks by improving budgetary flexibility through increased fiscal reserves, paying down liabilities and practicing conservative budgeting and revenue forecasting." Maryland adopted a policy in 2023 to "layer" the amortization of future pension debt as it's incurred, helping the state avoid spikes in required contributions as the retirement system nears full funding, Similarly, in 2018, Colorado legislators bridged their differences in a divided government to pass comprehensive reforms that increased employee and employer contributions, reduced cost-of-living adjustments, raised the retirement age, and expanded the use of defined-contribution plans for future employees to address the chronic structural underfunding of the state's main public pension system.

Northeast State Fiscal Ratings

#23	New York
#34	Maine
#35	Vermont
#38	New Hampshire
#39	Massachusetts
#47	Rhode Island
#49	Connecticut

Source: U.S. News & World Report: Best States Ranking

The current and future savings provided by these reforms pave the way for states to engage in other areas related to competitiveness including reducing taxes, investing in infrastructure and making overall improvements in business climate, ultimately providing savings to generations of taxpayers.

Case Study: Texas

Prior to the reforms, Texas faced substantial unfunded pension liabilities. The Employee Retirement System of Texas (ERS) had accumulated more than $14.7 billion in unfunded obligations, primarily due to lower-than-expected investment returns and systematic underfunding by the state. Similarly, the Teacher Retirement System (TRS) experienced funding shortfalls, with actual average rates of return consistently falling short of the eight percent target, leading to increased unfunded liabilities.

In 2017, Texas enacted Senate Bill 321, a comprehensive pension reform package targeting the ERS. This legislation introduced a "cash balance" retirement plan for new hires, offering a more sustainable and predictable benefit structure. **The reform also aimed to reduce the state's long-term pension costs by an estimated $15 billion over 30 years.**

Additionally, the Texas Pension Review Board (PRB) has played a crucial role in overseeing and recommending improvements to public pension plans statewide. Established in 1979, the PRB provides independent, unbiased support on pension issues, promoting transparency and adherence to best practices.

The pension reforms have contributed to improved fiscal stability in Texas by reducing unfunded liabilities, lowering long-term costs, and enhancing retirement security to offer a more predictable and

> You go to visit these states and meet with people from the public sector, and you just want to know that the leadership has the state's fiscal house in order—that you're not going to be surprised later on with new taxes or costs due to poor management of the budget.
>
> **Site Selection Consultant (South Carolina)**

secure benefit. These changes have collectively strengthened Texas's fiscal position, ensuring that ensuring that pension obligations are more manageable and sustainable in the long term.

There were also **voter-backed initiatives** that contributed to the ongoing pension system overhauls. In 2019, Texas voters approved a constitutional amendment that allowed the state to better manage pension obligations and provide more flexibility in funding pension systems. Appointed and elected public sector leaders have largely embraced pension reforms as a necessary step to maintain fiscal health while providing fair retirement benefits to public servants.

These changes not only improved the fiscal stability of the state but improved its economic competitiveness overall. Texas is one of the top-rated locations to live and do business in, experiencing a net gain of more than 130,000 new residents in 2023 and more than 200 corporate headquarters relocations in the last five years.

Case Study: Massachusetts

Massachusetts has implemented several reforms to enhance its pension system and reduce pension debt, ultimately improving its fiscal health. A significant milestone was the enactment of Chapter 21 of the Acts of 2009, signed into law by Governor Deval Patrick. These reforms marked a significant effort to improve the state's pension system, address growing pension liabilities, and ensure the long-term sustainability of the system. The legislation aimed to close loopholes and eliminate abuses within the pension system, thereby restoring public confidence and reducing long-term costs. In 2015, additional reforms were passed that reduced costs by increasing employee contributions and adjusting benefits.

Prior to this reform, Massachusetts had one of the worst-funded public pension systems in the country.

FitchRatings

Source: Fitch press release Nov. 2024

U.S. Pension Liability Burdens Rebound Even as More States Contribute

Wed 20 Nov, 2024 - 10:50 AM ET

At the state level, there were few material changes to rankings in fiscal 2023. Tennessee's long-term liability burden metric, which measures direct debt plus Fitch-adjusted net pension liabilities from 2023 state audits to calendar year 2023 personal income, remains the lowest, at just 1% of personal income, followed by Nebraska, South Dakota, Florida and Arizona. The rankings remain unchanged at the opposite end with Connecticut carrying the highest long-term liability burden, at 23% of personal income, and Illinois, Hawaii, New Jersey and Kentucky rounding out the top five.

As of late, Massachusetts has demonstrated a strong commitment to fiscal health through strategic budgeting and targeted investments. In 2022, the state's pension systems collectively achieved a funding ratio of approximately 99%, indicating that the assets are nearly equal to the liabilities. While the 99% funding ratio is commendable, it's important to note that funding ratios can fluctuate due to various factors, including investment performance and demographic changes—something states cannot always plan for.

In January 2024, Governor Maura Healey signed a balanced Fiscal Year 2025 (FY25) budget totaling $57.78 billion. This budget responsibly controls spending growth and protects taxpayer dollars, reflecting the administration's dedication to fiscal responsibility. Major allocations are focused on improving transportation systems, education, public aid, and housing to build on the competitive economic strengths of the state.

Summary: Investing Today in a More Competitive Connecticut

Those responsible for establishing Connecticut's fiscal guardrails deserve recognition for their foresight, leadership, and bipartisan commitment to addressing the state's most pressing financial challenge.

Their efforts have already yielded positive results: pension funding is improving, rating agencies have endorsed the fiscal guardrails, and Connecticut is on a stronger trajectory toward responsible liability management, **resulting in an estimated savings to taxpayers of roughly $18.4 billion over the next 20 years.**

These reforms demonstrate a critical step forward in securing the state's financial future, but Connecticut's fiscal challenges remain severe. Despite increased pension contributions, the system remains severely underfunded. Compared to neighboring states, Connecticut's fiscal position is only marginally better because New York, New Jersey, Rhode Island, and Massachusetts face similar challenges as the Northeast region of the U.S. struggles to remain competitive versus the Sun Belt and Intermountain West regions of the country.

To break free from this cycle, the state must maintain an unwavering commitment to fiscal discipline. Redirecting pension funds to other programs would be a catastrophic mistake, undermining progress and deepening the crisis. Every available dollar beyond essential services must be allocated to pension obligations if Connecticut is ever to regain its competitive standing.

No matter the tradeoffs with funding other needs, every penny taken away from paying down the pension liability is a lost opportunity for the future of Connecticut. The choice is clear: **either stay the course and secure long-term stability or repeat past mistakes and burden future generations with an even greater financial challenge**—a challenge future generations had no part in creating. Before making any changes to the pension system, policymakers must consider the competitive disadvantage this would perpetuate.

If you are a family or a company, why would you ever move to Connecticut knowing that more than 14% of your personal income, more than double the national average, will be taken to pay for benefits you never received?

Imagine how much worse the numbers will be and how much more financial harm Connecticut will face if the guardrails are modified. Connecticut must stay the course and maintain its funding of pension liabilities at the highest level.

Sources: *CNBC America's Top States for Business 2024; comptroller.texas.gov; Connecticut Mirror; CT News; CT.gov; an independent analysis; Education Data Initiative (July 2024); equable.org; Fitch Ratings; Mackinac Center for Public Policy (Michigan example, May 2024); federalreserve.gov; Mass.gov; Moody's; Pew Research; Reason.org; S&P; The Tax Foundation; Tax Policy Center; Texas.gov; U.S. News Best States 2024; U.S. Census Bureau*

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