Yankee Institute Policy Brief

Back On Track: Budget Reforms for the Long Run

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Summary

- **Five fiscal policy recommendations are outlined in this paper: priority-based budgeting, implementing the spending cap, pension reform, public employee pay and benefit realignment, and slowing the rate of borrowing.**

- **Connecticut faces a very large budget deficit. It is of similar size to Washington State's deficit from 2003-2005. Washington closed its $2.4 billion gap without raising taxes by implementing Priority-Based Budgeting and the Priorities of Government system.**

- **Despite the looming deficit, there is little appetite among constituents for tax increases. Controlling the growth of spending is a more viable and effective method.**

- **Connecticut's pension system, one of the nation's most in need of rehabilitation, would stand to shed billions in liabilities with the reforms proposed below.**

- **While these reforms are worthwhile in any fiscal climate, the need for reform is immediate, and there is still time in the current legislative session to adopt these recommendations.**

***Recommendation*:**

- ***Use the tools outlined in this paper to completely rethink how this state budgets and spends. Comprehensive, lasting reform is a better way forward than the cycle of tax increases and emergency line item cuts to services.***

Introduction

Connecticut faces a sizeable budget deficit. Anticipated to be $1.7 billion for FY ’18 and more than $3 billion for the biennium, this significant gap requires meaningful, immediate action. Rather than continuing the pattern of large deficits followed by service cuts and tax increases, the Yankee Institute is proposing reforms aimed at establishing long-term budget stability. Although line item cuts could serve as an immediate fix, process and rule reforms will provide the most lasting results. As such, this report will recommend a series of tools to put the state back on solid fiscal ground.

Tax increases should not be the first solution to a shortfall. The more responsible option is to make significant changes to the way taxpayer dollars are spent. For example, in order to close a $1.7 billion deficit through a sales tax increase, the existing sales tax rate would need to be 8.95%, assuming that individuals would not then respond by buying less. Lasting spending reform, meanwhile, is generally better for an economy. With two large tax increases in just the past five years, followed by large deficits, Connecticut is on an unsustainable path. State lawmakers have both raised taxes and cut spending, but the spending cuts have not led to sustained savings, so deficits persist.

The five recommendations for budget reform that follow are:

- Adopt **priority-based budgeting.** Comprehensively reforming the way government spends and prioritizing core services can close a deficit even larger than Connecticut’s (as shown in the Washington State case study below) without raising taxes.
- **Enact the spending cap.** Defining, adopting, implementing and obeying a strong cap on state spending would restrain the growth of future spending.
- **Reform teacher and state employee pensions.** Following a recent Yankee Institute study that outlines recommendations that save billions of dollars over the next few decades while assuring a secure retirement for Connecticut’s public employees.
- **Realign state employee pay and benefits.** Right-sizing public sector compensation to levels commensurate with the private sector would immediately save billions in payroll and benefit expenses.
- **Slow the rate of borrowing.** Growing debt and suboptimal credit ratings should make borrowing an option of last resort for now.

Priority-Based Budgeting

For Connecticut to achieve long-term fiscal stability, budgeting must become routine and predictable for the state’s executive and legislative branches. A sound budgeting process is necessary in order to reach that end. Priority-Based Budgeting (PBB) is the best tool available to control costs while simultaneously ensuring that constituents receive core government services.

The experience of Washington State highlights PBB’s effectiveness. For its 2003-2005 biennial budget, Washington was facing a projected $2.4 billion budget deficit, which represented approximately 10% of its budget.[i] In response, Governor Gary Locke, who would go on to serve in the Obama Administration as Secretary of Commerce, proposed the “Priorities of Government” (POG) process.

At its core, POG asks four questions:

- *How much money does the state have?*
- *What results do citizens want most from state government?*
- *How much money can be allocated to each result?*
- *How best can allocated funds be spent to achieve the results?*[ii]

To answer these questions, Locke had his agencies closely examine every activity they performed. Each agency was asked to prioritize activities into one of three categories: high, medium, and low, with the mandate that at least one-third of activities were deemed low priorities. The list of "most important" results had common elements, which became the basis for how to prioritize spending. They were:

- *Improve student achievement in elementary, middle and high schools*
- *Improve the quality and productivity of our workforce*
- *Improve the value of a state college or university education*
- *Improve the health of Washington citizens*
- *Improve the security of Washington's vulnerable children and adults*
- *Improve economic vitality of businesses and individuals*
- *Improve statewide mobility of people, goods, information and energy*
- *Improve the safety of people and property*
- *Improve the quality of Washington's natural resources*
- *Improve cultural and recreational opportunities throughout the state*[iii]

Programs and projects that did not achieve one of those goals were de-emphasized, and those that did were still required to be made the most cost-efficient possible. Locke described how those ten priorities would translate into real, measurable results:

> *We assembled 10 multi-agency teams, one team for each result. We've asked the teams to tell us how best to attain the desired result. What programs and services make the most difference? What can we consolidate? What programs and services aren't making as much of a difference? What criteria can guide us in assessing value and deciding what should be funded? What key indicators will tell us when we've achieved the result and given people what matters most?*
>
> *The teams have had free reign. No rules, no politics, no agenda imposed from above. One limit: they have to rely on existing financial resources in achieving the desired result. And this will result in some very, very difficult decisions because we cannot simply fund everything we have in the past.*[iv]

This completely new, comprehensive budgeting process was instrumental in closing Washington's budget deficit.[1] It is also an excellent tool to provide taxpayers a respite from tax increases. Since any high priority activity would be funded, tax increases would therefore only be for funding low-priority activity, and so are less likely to be necessary, or even requested.[v]

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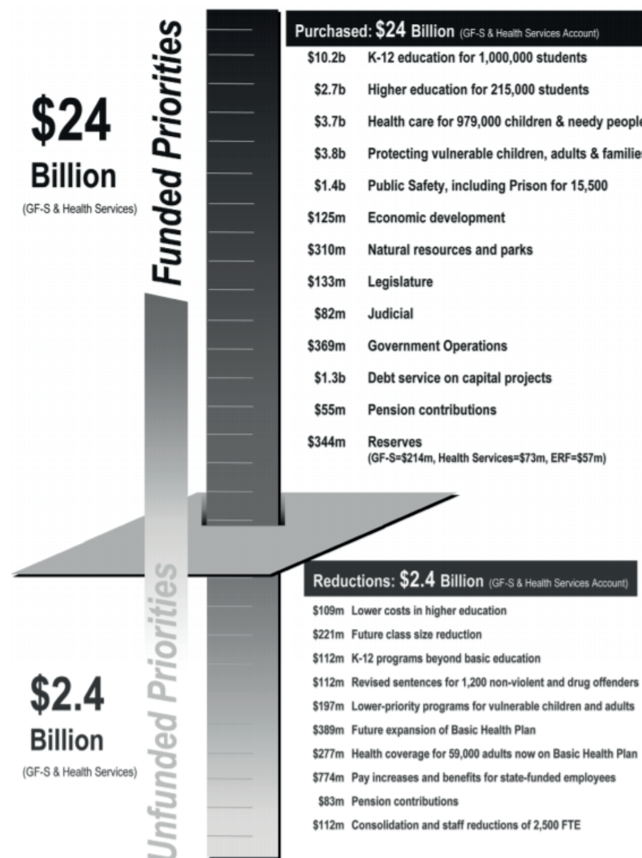
[1] But PBB is not, in and of itself, the only tool for ensuring sound budgeting. One criticism the Government Accountability Office had of POG was that its effectiveness as a budgeting tool was limited because it was not fully integrated with the formal budgeting process in Washington. An example of how to integrate PBB would be Texas, where "funds are appropriated by agency goals and strategies, which are defined in the agency's strategic plan. Strategies set forth actions to be taken by an agency to achieve its goals…Funding is provided at the strategy level.

Example of Washington State's Priorities of Government Framework



Source: Government Accountability Office

Improvements to the POG process were proposed by Governor Christine Gregoire in 2010, when she tasked her agencies with using the following criteria for their deliberations:[vi]

Fiscal responsibility
- *Is the activity an essential service?*
- *Does state government have to perform the activity, or can it be provided by others?*
- *Can the activity be eliminated or delayed in recessionary times?*
- *Does the activity need to be paid for with state general funds? Should users pay a portion of the costs?*
- *Are there federal funds or other fund sources available to support this activity?*

Efficiency
- *Are there more cost-effective, efficient ways to do the activity?*

Performance
- *Can the activity be the subject of a performance contract?*
- *Can the activity be the subject of a performance incentive?*

Ultimately, the PBB process plays an important role in first setting government priorities. Then, it helps determine how to allocate existing funds to pay for core services. This streamlines and facilitates fiscal decisions typically deemed too difficult to make. A full commitment to this process, among others, would be instrumental to establish long-term fiscal stability for Connecticut.

Spending Cap

In addition to budget process reforms like Priority-Based Budgeting, actual limits on the growth of spending and taxation are critical checks on future waste. Connecticut currently has a constitutional spending cap, but it must be strengthened, fully adopted, and rigorously enforced.

When the income tax was passed in 1991, Connecticut taxpayers were concerned that this new source of revenue for the state would lead to uncontrolled spending and undermine state officials' fiscal discipline. Therefore, a compromise was reached and more than 80 percent of voters approved the inclusion of a spending cap in the state's constitution.

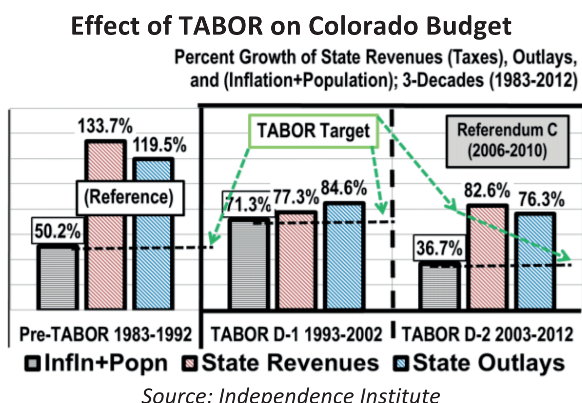
A 2015 poll of Connecticut residents conducted by the Yankee Institute showed that 82 percent of respondents still believe that the state should have a cap on state spending. Taxpayers see the connection between higher spending and higher taxes.

Recently, in order to fully implement the constitutional spending cap, the state legislature was charged with defining three key terms: Income, inflation, and government expenditures. Agreement on the definition of the terms has been elusive. A recent state commission formed to issue recommendations on definitions for the three terms did not achieve full consensus on the definition of government expenditures, although they did agree on definitions for income and inflation.

The purpose of a spending cap is to control state spending in order to reduce the need for higher taxes. Nearly every dollar spent by the state, no matter what it funds, comes from taxpayers. Deficiencies in any aspect of the budget will ultimately fall on the taxpayer. Therefore, a spending cap should be as strong and inclusive as possible. Pension costs and general expenditures should be included within the cap, and the cap should be indexed to personal earned income growth. This is a reasonable proposal in the spirit of what Connecticut voters supported in 1992, and today. Additionally, the state's spending cap is less restrictive, both than many other states' caps, and other states' proposed policies to limit spending.

For example, Colorado's Taxpayer Bill of Rights (TABOR) directly limits the state's spending based on a formula that factors in changes in population, previous levels of spending, and inflation. Further, revenue collected above that same threshold must be refunded to taxpayers. TABOR also prohibits various types of taxes altogether (or binds them to their current rate), and all tax increases are subject to voter approval.[vii]

Effect of TABOR on Colorado Budget



Source: Independence Institute

That said, the effect of TABOR is limited to the extent that Colorado state officials can designate certain types of spending as outside its provisions, a trend that has sharpened in the last few years. Note the window of time associated with Referendum C, colloquially known as the "TABOR Timeout," when the state did not abide by the limits. However, when followed as intended, TABOR has greatly controlled the growth of Colorado's spending and let taxpayers keep more of their own money.

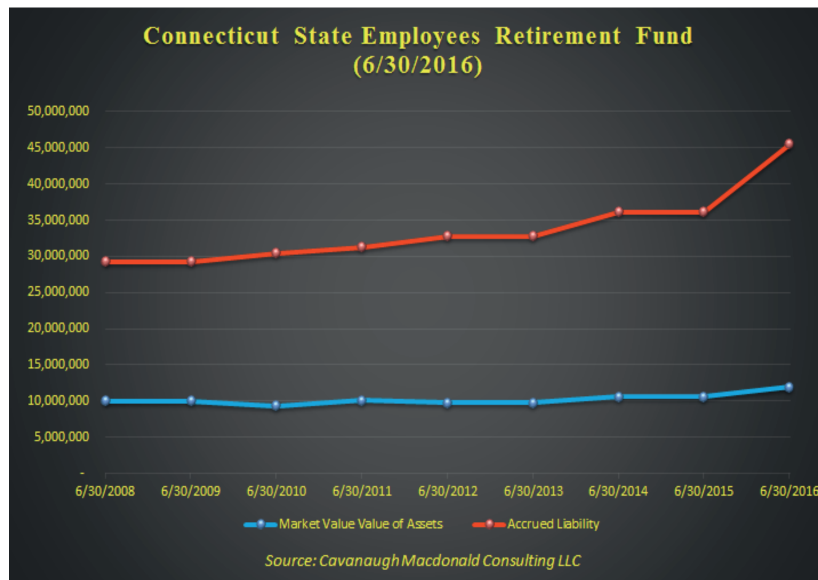
One proposal being weighed in Texas is also stricter than Connecticut's spending cap. Texas currently caps state spending based on personal income growth. As currently construed, the limit applies to less than half of the state's overall budget. The proposal, locally known as a "conservative spending cap," would enforce the limit on the entire budget. Additionally, spending would be limited to the smallest growth rate among three metrics: state population growth plus inflation, total state personal income, or total gross state product.

If Connecticut officials wanted the strongest possible limits on spending, and therefore taxation, TABOR and the new proposal from Texas are among the best models. Both impose stronger limits than Connecticut's spending cap. Regardless, the strongest definitions and standards possible should be adopted and followed. If the strongest possible mechanism is properly implementing the spending cap passed in 1992, then that would be a certain improvement.

Pension Reform

Connecticut is neither the first, nor the only, state to be weighed down by its pension obligations. Failing to meet actuarially determined employer contribution (ADEC), employing misleading accounting gimmicks, and the poor funding ratios that result are a nationwide problem. The 50-state aggregate amount of unfunded pension obligations changes based on how it is calculated, with estimates including $1.5 trillion,[viii] $4.8 trillion,[ix] and $5.6 trillion.[x]

However, although it is not alone in the nation's pension obligation crisis, Connecticut's pension underfunding is among the most dire in the nation. According to 2015 data from the U.S. Pension Tracker (a project of the Stanford Institute for Economic Policy Research), Connecticut is among the nation's most indebted to its state and local pensions. Under actuarial valuation methodology, Connecticut holds more than $24,000 in pension debt per household, the third-worst rate in the nation.[xi]



Without the smoothing from actuarial valuation, the market valuation of Connecticut's pension liabilities is the nation's fourth-highest, at more than $81,000 per household.[xii2]

The need to control unfunded pension obligations is not theoretical or ideological. Pension reforms that ensure long-term stability and sustainability are in the best interest of all parties involved. Without the "crowd-out" effect of an unmanageably large yearly contribution, state officials will have more flexibility to allocate the state's budget in accordance with constituent needs, and greater ability to provide core government services. Connecticut workers, as a result, will not bear higher tax burdens to subsidize a government that refuses to choose between programs and pensions.

Most importantly, pensioners benefit. The goal of pension reform is to secure workers' benefits for their future retirement, not to strip them. Most recommended reforms are applied to new workers only, not to current ones. Pension reform is a means to assure future payments to retirees by keeping the system solvent.

The State Employee Retirement System (SERS) needs reform. Examining SERS is particularly worthwhile because of its uncommon nature. Typically, other states do not collectively bargain state employee retirement benefits. Rather, they are set by statute, as is the case in all our neighboring states: Massachusetts, New York, and Rhode Island.[xiii]

SERS is suffering from insufficient funding, albeit for slightly different reasons than many other plans across the nation. In New Jersey, for example, the Securities Exchange Commission was forced to bring charges against the state on behalf of municipal bond holders because of the state's repeated attempts to under fund its pensions, while hiding the very fact that it did so.[xiv] Connecticut, on the other hand, has a recent track record of fully funding its ADEC. In research conducted for the state, Jean-Pierre Aubry and Alicia H. Munnell of Boston College University wrote:

> *Since 2001, the State has paid, on average, 90 percent of the annual required contribution (ARC) for SERS. For TRS, the State issued $2 billion in pension obligation bonds in 2008 and has paid 100 percent of the ARC since then. Prior to that, TRS funding was inconsistent; the State paid more than 80 percent of the ARC from 2001 to 2003, close to 70 percent in 2004 and 2005, and essentially 100 percent in 2006 and 2007.*[xv]

The most recent actuarial valuation for SERS indicates that its unfunded accrued actuarial liabilities (meaning the amount of liabilities the plan, and therefore taxpayer, must account for, less the plan's assets) is approximately $21.7 billion.[xvi] Though the state has largely paid its ADEC for the past decade, "the funded status for [SERS] declined by about 20 percentage points and, as of 2014…stood among the lowest in the nation."[xvii] SERS' current funding ratio is 35.5% if using actuarial assets, and 31.6% if using market assets.[xviii]

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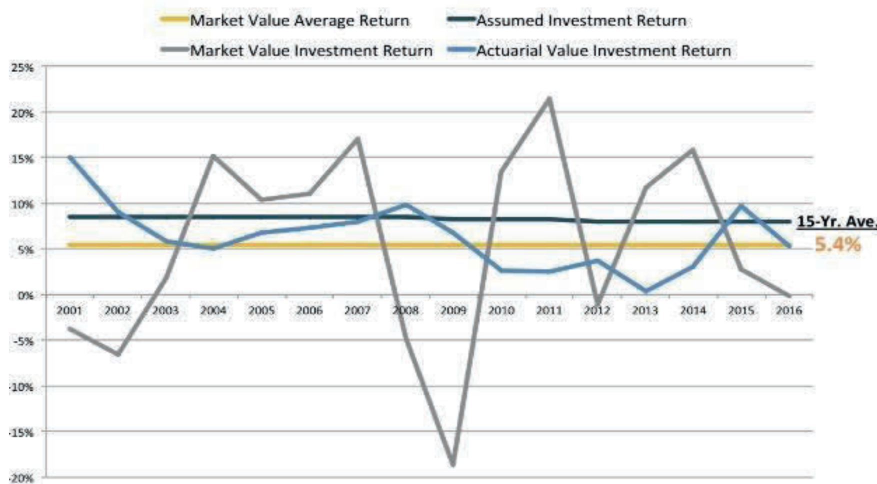
[2] Note: *Actuarial vs. Market Value of Assets*. Actuaries employ two methods of valuing a pension system's assets. Market valuation is the real-world value of a plan's assets, which typically include various forms of financial investment or real property. To make projections more predictable and account for market volatility, actuarial valuation employs "smoothing," in which a portion of losses or gains are spread out over several years.

Summary of Principal Results - SERS

Valuation Date	June 30, 2016	June 30, 2014
Number of active members	50,019	49,976
Annual compensation	$ 3,720,751,429	$ 3,487,576,617
Retired members and beneficiaries:		
Number	48,191	45,803
Annual allowances	$ 1,745,785,103	$ 1,576,606,022
Deferred Vested Members:		
Number	1,412	1,457
Annual allowances	$ 20,316,080	$ 20,956,362
Assets:		
Market Value	$ 10,636,702,645	$ 10,472,567,077
Actuarial Value	$ 11,922,965,860	$ 10,584,795,257
Unfunded actuarial accrued liability	$ 21,693,750,225	$ 14,920,814,520
Single Equivalent Amortization period (years)	25.1	17.0
Funded Ratio based on Actuarial Assets	35.5%	41.5%
Funded Ratio based on Market Assets	31.6%	41.1%
For Fiscal Year Ending	**June 30, 2018**	**June 30, 2016**
Actuarially Determined Employer Contribution (ADEC):		
Normal	$ 365,570,268	$ 278,812,817
Accrued liability	1,282,836,995	1,235,654,507
Total	$ 1,648,407,263	$ 1,514,467,324
Actuarially Determined Employer Contribution Rate (ADEC):		
Normal	9.83%	7.99%
Accrued liability	34.48%	35.43%
Total	44.31%	43.42%

Source: Cavanaugh Macdonald Consulting, LLC



The question these facts beg is how a plan's funding ratio can worsen *despite* the state fully meeting its required contributions. The answer lies with SERS' adopted discount rate. For many years, the plan assumed its assets would provide an eight percent rate of return or higher, and therefore its liabilities could be discounted by that amount. However, in the last 15 years, the plan averaged a return of 5.4 percent.[xix] Because of the plan's underperforming investments, liabilities have grown at a faster pace than payments could offset.

The Yankee Institute recently published research in conjunction with the Reason Foundation titled *Securing our Future: A Menu of Solutions to Connecticut's Pension Crisis*. The study offers a series of reforms that would potentially address Connecticut's growing unfunded pension obligations. The report's authors included a Connecticut-based actuary, and, where possible, the recommendations were fully modeled to estimate their benefit to the state's finances. Recommendations included:

- **Setting SERS' assumed rate of return closer to 5 percent.** This would more accurately reflect the recent performance of the plan's investments as well as the nature of the system's benefits as guaranteed regardless of investment performance.
- **Increasing employee contribution rates to 6% percent.** This recommendation would reduce state costs by $4.3 billion over 30 years. The 6 percent contribution is more in-line with both the national and regional levels for state employees.
- **Adopting a cap on compensation eligible for pension benefit determination.** This recommendation would apply only to new hires. This would mean that for the purposes of calculating pension benefits (but not for actual pay), salaries would be "capped" at $100,000. A cap of $100,000 is reasonable and would still provide a very generous retirement package. This would save the state $4.1 billion over 30 years.
- **Changing the formula for cost-of-living adjustments (COLA).** Indexing COLA to the rate of inflation, which is the current policy for social security benefits, but with a maximum of 2 percent, would reduce state costs by $1.3 billion over 30 years.
- **Amending the definition of "Compensation" to remove overtime.** This is a commonsense reform that is often introduced by members of the General Assembly, which would reduce the practice of unnecessary shift trading to artificially boost an employee's top-earning, pension-determining years.
- **Structure reform.** Beyond governance and certain benefit reforms, the structure of SERS must be updated to a more affordable model. For new hires, the plan should reflect one of the following: a new "Tier IV" defined benefit plan that is more cost effective, a cash balance plan, a defined contribution or 401(k)-style plan, or a hybrid defined benefit/defined contribution plan that has been a successful model in other states and municipalities.
- Although somewhat mutually exclusive with some of the structures outlined in the point above, it was recommended that **all new hires be given an option to choose between the hybrid plan and a pure defined contribution plan.** These options are both more affordable for the state and benefit the employee in that the plan is mobile if the employee chooses to change jobs.[xx]

Pay and Benefit Realignment

According to the office of the state comptroller, state expenses on employee payroll has been level each of the past two calendar years, with the state spending $4.76 billion and $4.71 billion in 2015 and 2016, respectively.[xxi] Thanks to the state's criminal justice reform agenda, payroll spending for the Department of Corrections is down, largely because of less demand for employees to work overtime. Likewise, payroll spending at the Department of Transportation and Department of Children and Families have remained relatively flat.[xxii]

Although spending has flattened recently, Connecticut is an outlier for public employee compensation historically. Using the most recent 50-state census data available (2012), Connecticut's state employee payroll expenses were the second-highest in the nation per full-time employee. The table below shows the 15 highest-spending states in that category.

Given the state's notoriously high cost of living, it might be expected that, dollar-for-dollar, the state would spend more per employee. To account for this discrepancy, the results were weighed against research by The Tax Foundation on the buying power of a dollar in every given state.[xxiii] The results show that, even when accounting for cost of living, Connecticut still spent the second most in the nation per full-time employee.

50-state Snapshot of State Payroll Expenses, 2012

State	Full-time employees	Payroll Expenses per FTE	Cost of Living Adj.
California	333,083	$80,263.19	$71,410.16
Connecticut	53,662	$78,145.57	$71,823.59
Iowa	40,053	$74,191.73	$82,159.92
New Jersey	130,261	$73,571.99	$64,257.78
New York	222,965	$72,159.36	$62,367.33
Illinois	102,078	$68,983.82	$68,500.93
Alaska	25,068	$67,770.63	$64,117.79
Michigan	113,140	$67,515.40	$71,748.62
Minnesota	68,042	$67,156.15	$68,808.19
Massachusetts	88,601	$67,144.88	$62,693.17
Rhode Island	17,073	$67,141.49	$68,027.76
Colorado	57,780	$64,579.31	$63,313.56
Ohio	109,085	$62,601.62	$70,101.29
Washington	99,079	$62,016.13	$59,746.34
Wisconsin	58,052	$61,503.30	$65,851.58

Source: U.S. Census Bureau

In addition to the state's high payroll expenses, benefits offered to state employees are unsustainably high. When using the compensation of comparable private sector workers as a baseline, it becomes clear that public sector workers are much better compensated. However, to be clear: it is not simply that public employees are overcompensated for their work. The issue at hand is whether taxpayers can afford to subsidize state employee pay at a higher rate than they earn themselves. The state is in deep deficit, and private sector workers are already subject to one of the nation's least competitive tax climates.

As Andrew Biggs, former deputy commissioner of the Social Security Administration and author of the Yankee Institute study titled *Unequal Pay: Public vs. Private Sector Compensation in Connecticut* wrote, "discussions of public sector pay are rarely informed by hard data. Many public sector employees are under the impression that they could earn higher pay and benefits 'on the outside.'"[xxiv] However, when taking both pay and benefits into account, state employees are better compensated than their private sector counterparts.[xxv]

CT Worker Compensation Breakdown (Per Dollar)

	Public Sector	Non-government (large company)
Average Salary	$70,970	$71,112
Benefits	$54,561 to $75,641	$29,371
Total	$125,531 to $146,611	$96,117

Source: Yankee Institute

Included in the overarching term "benefits" are health coverage, retiree health benefits, retirement plans and pensions, and fringe benefits like vacation time or employer premiums paid toward life and disability insurance.[xxvi] Note that benefits for public sector workers are in a range because pensions, which are now largely nonexistent in the private sector, have a range of value.

These levels of compensation contribute to the state's ongoing pension funding issues in two ways: the benefits themselves are expensive; and high salary levels in Connecticut contribute to the overall cost of employee pensions because they are the primary variable in the formula by which pension benefits are calculated. As concluded by Biggs in *Unequal Pay*, paying state employees at market levels would save the state between $1.4 billion and $2.5 billion in annual compensation costs.[xxvii] This information is particularly noteworthy for fiscal years in which public employee salaries are being negotiated, and should be considered when state employee contracts reach the General Assembly for review.

Slow the Rate of Borrowing

Connecticut is one of the most-leveraged states in the nation. According to the state's most recent Comprehensive Annual Financial Report, the state holds $25.3 billion in total bonded debt.[xxviii] Although the state is within its allowed borrowing limit, in 2018 debt service payments from the General Fund are projected to be $2.6 billion, or 13 percent of total General Fund expenditures.[xxix] Even though Connecticut is technically able to make its current debt service payments, holding bonded debt equal to ten percent of the state's gross domestic product is inadvisable.

In Connecticut, debt service payments have been climbing year after year. In 2013, debt service payments represented 11 percent of the budget. For every one percent increase, another approximately $200 million has to go toward debt service instead of funding another priority.
Connecticut's per capita debt is the highest in the country, at around $5,500 per person.[xxx] When state and local debt are taken into account, Connecticut's debt load ranks second highest at more than $9,000 per person.[xxxi] Even when state debt is considered as a percentage of personal income, Connecticut ranks third highest in the nation.

Several proposals recently brought before the legislature could address this problem, including instituting a hard cap on allowable debt. In fact, in 2000, New York adopted both a hard cap on its total debt and a hard cap on debt service as a percentage of general spending. Connecticut could follow this example.

However, it may be necessary in the near term to put a complete freeze on adding new debt, just to get current debt growth under control. Projects deemed necessities could move forward, but other borrowing should be put on hold.

A Way Forward

There is still time in the current session for lawmakers to adopt suggestions laid out in this paper. Closing a $1.7 billion budget gap is a daunting task, but the state will not start to grow again unless the status quo is changed.

Connecticut's challenges are formidable. They require from lawmakers an approach more comprehensive than simply changing the numbers on the state's balance sheet. Instead, Connecticut's officials must approach the budget and spending in new ways. Asking taxpayers for more of their hard-earned money is neither a popular, nor effective method. Along with further eroding confidence in state government, it would likely speed the outmigration of individuals and businesses. The state's challenges did not manifest overnight, and they will not be solved through traditional line item reforms or a piecemeal approach. If Connecticut lawmakers lead with the bold (yet responsible) solutions above, economic growth, job creation, and widespread opportunity will surely follow.

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