Advisory Commission on Intergovernmental Relations

Legislative Office Building, Hartford, Connecticut

Friday, February 1, 2019

Note: A video of this meeting can be viewed at http://ct-n.com/ctnplayer.asp?odID=15976.

Members Present: Carl Amento, Tom Banisch (alternate), Maureen Brummett, John Filchak, Sam Gold, Martin Heft, Marcia Leclerc, James O'Leary, Leo Paul, Lon Seidman, Scott Shanley, Joyce Stille, Ron Thomas, Lyle Wray (Vice Chair)

Members Absent: Sen. Stephen Cassano, Kathleen Demsey, Barbara Henry, Neil O'Leary (Chair), Lee Sawyer, Jim Watson

Others: Bob Patricelli

ACIR staff: Bruce Wittchen

1. **Call to Order**

   Commission vice-chair Wray noted that Commission-chair Neil O'Leary is ill and unable to attend today, so chair the meeting and called the meeting to order at 10:35.

2. **Consideration of the draft minutes of the November 2, 2018 meeting**

   A motion was made and seconded to approve the 1/4/2019 minutes and the motion was approved unanimously, with Commission member Stille abstaining because she had not attended the meeting.

3. **Commission on Fiscal Stability & Economic Growth Report 2.0**

   Commission vice-chair Wray introduced Bob Patricelli of the Commission on Fiscal Stability and Economic Growth (CFSEG). Mr. Patricelli said CFSEG co-chair Jim Smith is unable to attend this morning because he is appearing with Gov. Lamont at an announcement of Jim's appointment to be co-chair of the CT Economic Resource Center. He noted that there has been an effort to revitalize CERC as a partner with DECD to energize the outreach to new companies and the business community in general.

   Mr. Patricelli provided a brief background regarding the CFSEG and its 3/1/2018 report that was prepared in accordance with Section 250 of June Special Session PA 17-2. He said the commission no longer acts in an official capacity, but the members stayed together to produce Report 2.0, which we will discuss today. He thinks its recommendations have a better shot with a full legislative session and a new Governor and legislature. Mr. Patricelli pointed out that the focus is on fiscal stability and economic growth. Those touch on just about everything, but the group didn't study educational cost sharing, intergovernmental relations, or health care in great detail. The focused on sustainable budgeting and reigniting the state's growth.

   Mr. Patricelli proceeded to Slide 5 and highlighted that we had a terrible decade. CT's economy is shrinking and ACIR members will be familiar with the concerns about the state's fixed costs, which are getting worse. He added that those fixed costs, including Medicaid, health entitlements, state employee benefits, and interest on debt, are eating everybody's lunch. Mr. Patricelli said this has to change. The state has a terrible balance sheet and pointed out that there is $100 billion of debt and unfunded liabilities, equivalent to a $100,000 mortgage on each of the state's 1 million homes. He noted that the $100 billion total is based on a more appropriate rate of return than the state uses and provided a brief overview of the rate of return considerations that go into estimating the present value of the state's liabilities.

Mr. Patricelli said that when we talk about economic growth, the business community understands the fiscal issues. He noted that his co-chair Jim Smith has said that fiscal stability is the chicken and economic growth is the egg. If we do not fix the chicken, businesses will not want to move here because the tax situation is completely unstable and the state is unstable. He said the state was still ranked very highly in its attractiveness for businesses in 2000, but the Tax Foundation now ranks CT as 47th in state business tax competitiveness. We have lost our mojo. Mr. Patricelli said he believes CT has great strengths but, if we do not start with a common understanding of the harsh realities, we are not going to the kinds of things that are necessary.

Mr. Patricelli said the group reduced its original 35 recommendations to six and those are listed on the next slides. Commission member O'Leary said the state's fiscal issues are not new to him and asked if it is new to legislators. Mr. Patricelli said it is not new to the legislative leadership, but he is not sure the rank and file have a broad understanding of the depth of the fiscal hole. They produce a balanced budget every year, but don't recognize the other issues.

Mr. Patricelli said the 1st recommendation is for the state to reduce the deficit by $1 billion through spending cuts and revenue optimization, but not increased tax rates. That is about 3% of the state's spending including the special transportation fund. He pointed out that CT only receives 58% of sales tax, charges, and assessment, while the average state collects 63%. Each percentage point being equal to $70 million, so bringing the state's collection rate up to average can yield $350 million. It does not require raising the sales tax, only collecting it better. The state uses a paper-based system for merchants to report credit card transactions.

Mr. Patricelli questioned why the state owns John Dempsey and why is a 400-person medical group on the state's books? He said that the hospital and medical group have an operating loss of $150 million per year. He mentioned that the state instructed the health center to seek a joint venture partner. That process is underway. The state cannot save the full $150 million because it would retain responsibility for unfunded pension liabilities even if it were to sell the system.

Mr. Patricelli said the next recommendation is to pause the growth in state employee wages and benefits and increase their contributions. He has nothing but respect for the state's employees as a group, but said he considers their pensions and health care are a big part of the states fixed cost problem and he was surprised to learn they are out of line with the employees of other states. He pointed out that the inclusion of hospital and medical group employees distorts wage data, but some other states include comparable operations. He said CT's employee and retirement benefits are better and employee contributions are lower. He added that the comparison for CT teachers is also valid when considering only the other states where teachers do not have Social Security.

Mr. Patricelli said the people of the state have to have a shared understanding of the equities for tax payers. Commission member Paul said most municipalities have negotiated defined contribution pension plans. Is that part of the CFSEG recommendations? Mr. Patricelli noted that the state's retirement benefit plan for new employees offers only a 1% state contribution and said it is too low for the state recruit employees. The state contribution should be 2%.

Mr. Patricelli also mentioned the state's Other Post-Employment Benefits (OPEB) obligations. He noted that the state and many towns have promised to reimburse what Medicare does not pay for. The state has wrapped a defined benefit, open-ended commitment around a Medicare core, which will almost certainly shrink over time. He noted that OPEB is pay-as-you go and the current unfunded liability is $21 billion. He said that has to change, even for retirees, in a slow and measured way.

Revenue and asset transfer are being explored to support the State Employee Retirement System (SERS) and Teachers' Retirement System (TRS). One of those is a proposal to dedicate 30 years of lottery proceeds to TRS, which would amount to ~$7 billion. That fund has about $20 billion of unfunded liabilities and the addition would bring it to slightly above the national average. Nobody is entirely pre-funded. He said one approach to the SERS unfunded liability problem could be to raise the state sales tax by 0.5%, which could be dedicated to the state employee pensions, but that the Commission had not made that proposal.

The final point on the 6th slide is that changes to the tax system should be revenue-neutral and realigned to be pro-growth. There are three things that are critical to economic growth: the tax structure, transportation, and the labor supply. We have to do all three. Mr. Patricelli added that, on the tax side, there should be a selective lowering of business taxes. Governor Lamont has endorsed some of that. Mr. Patricelli also noted that a new company not yet generating revenue must pay taxes on venture capital it receives. He said the state should handle net operating losses the same way as the US government. He also said the state's estate and gift taxes are a poke in the eye for not a lot of revenue. He added that their report also recommends 100 – 200 million of property tax relief through increased income tax credits for people with middle incomes.

Mr. Patricelli pointed out that what he has spoken of so far are all costs, so where does the money come from? He said the suggested tax reductions can be balanced by broadening the sales tax. He said few people understand that CT has the 4th narrowest sales tax in the country. We don't tax enough stuff. He pointed out that the economy has shifted from goods to services and said the CT tax code taxes all goods unless specifically exempted, while taxing no services unless they are specifically taxed.

Mr. Patricelli said CT hasn't caught up with changes in the economy, which used to be 70% goods and 30% services, but is now almost completely reversed. Sales tax exemption total about $3 billion per year. He said the CFSEG identified 11-12 options to help rebalance the sales tax. The suggested 2% tax on groceries would provide $130 million and if the state does not want to do that, it can tax more services.

The first recommendation on Slide 7 is to jump-start transportation improvements. The CFSEG believes tolls are inevitable and Mr. Patricelli highlighted that CT is the only state on the East Coast without tolls. He said the state needs $1 billion and gas tax revenues tail off with electric cars. There is middle ground. States are allowed to impose tolls for certain projects and said that the creation of a revenue source can enable the state to enter into P3s – public private partnership contracts to access private funding for infrastructure. He noted that legislation would be required in order to do so.

The 2nd recommendation on Slide 7 is for the state to fund 4000 scholarships for $5000 per year for students majoring in science, technology, and math (STEM) programs. Mr. Patricelli said most STEM graduates stay in the state and the state should eliminate the prohibition on using such funding for private colleges. Mr. Patricelli said we would bond for this and the state should do less school construction if it has to. We need to invest in the workforce.

Commission vice chair Wray said the state has a shortfall of talent and described efforts underway in states such as Colorado and Washington to fill their gap. They are our direct competitors. He mentioned the Silver Tsunami – the expected retirement of many workers in a short period of time – and said the state will lack people with the right talent to replace those retiring. We have 6000 vacancies, but are cutting the budget for Asnuntuck Community College, where people can get the needed training. Mr. Patricelli said this part of the proposal is getting little opposition or support, but the state can afford it. It would pay for itself. Commission vice chair Wray said Rhode Island spends much more on this on a *per capita* basis.

Commission member James O'Leary mentioned the manner in which employees approaching retirement are able to work overtime in the years before retirement to boost pensions. Mr. Patricelli said that is fixed to some extent for new employees in the most recent SEBAC agreement. He pointed out that Governor Malloy predicted that 40% of employees will retire prior to cost of living and co-pay changes that go into effect in 2022. That is an invitation for people to retire early, but we want our employees to stay as long as they like and are physically able, without facing a financial penalty if they stay. Correcting that would require re-opening SEBAC, but that runs through 2027.

Commission vice chair Wray said UConn's Hartford Branch will host an event on March 7 that focuses on Silver Tsunami. He said options include automating jobs. People are concerned about automation, but we are not going to have people. We have to get smarter about using technology. We need to reduce the resistance to technology. He noted a recent experience with a state agency that wanted something typed up in triplicate. What century are we in? We need to get smarter about digital government with a hold harmless for labor.

Commission member Filchak said there has already been a dramatic decline in the number of state employees and in agency capacity. It already is impacting the delivery of services. Mr. Patricelli said former OPM Secretary Barnes had recommended that somebody do a serious study of state civil service because we haven't done one in 25 years. Commission member Stille pointed out that retirement of state police officers can impose a greater cost on smaller towns that rely on resident state troopers. We need to introduce a new system to replace them, possibly by regional policing. It is a transfer of costs from the state to the towns.

Mr. Patricelli said the initial CFSEG report did not include a thorough review of intergovernmental relation, but next slide reflects Report 2.0's effort to rationalize the state's intergovernmental structure. He pointed out that there already are a number of intergovernmental proposals this legislative session. The first recommendation on the 8th slide is to reallocate municipal aid. Mr. Patricelli questions the state's make-up-the-loss approach in providing municipalities with funding through payments in lieu of taxes (PILOT) for a not-for-profit hospital when a town could bill for the services it provides to the hospital.

The CFSEG is in favor of charging not-for-profits for the services they receive. Mr. Patricelli noted that if municipal aid were to be reallocated as suggested by the CFSEG, perhaps the richest 1/3 of towns might receive none, the middle 1/3 might receive some, and 1/3 might receive more. Develop a formula considering the grand list per capita so aid can be focused on towns where the local tax basis is insufficient to support the delivery of services.

Mr. Patricelli said we should get serious about local user fees and charges and questioned why we do not hear more about this from towns. He mentioned the 2015 report, *Diversifying Municipal Revenue in Connecticut*, prepared for the CT Tax Study Panel. The difference between what CT towns receive in local fees and charges and what the average state's towns receive amounts to $500 million per year.

Mr. Patricelli said CT is either first or second in its reliance on property taxes and recommended municipalities be allowed to increase local revenues from user fees and other charges to a level comparable to the national average. Mr. Patricelli said an increase in aid to cities must be accompanied by a showing of financial discipline. He noted the slide's recommendation to expand the Municipal Accountability Review Board (MARB) oversight mechanism, which should be required for the bottom 10% of municipalities. It could help municipalities to take hard looks at contracts that would be hard to reopen without the state involvement. He added that the rest of the recommendations, with the exception of extracting OPEB from collective bargaining, had also been included in Report 1.1 and mentioned again that OPEB is a serious threat.

Mr. Patricelli closed by saying that the ACIR is the only state-based body he knows that can play a role in re-examining the state's municipal structure. The CFSEG did not do a thorough job with intergovernmental issues. Commission member Gold asked if the CFSEG considered the potential impact of the federal tax law's changes to deductions and potential changes in how we tax. Mr.

Patricelli said they did not. Commission member Gold also asked if retirees have enough incentive to remain in the CT. He pointed out that pension checks sent to SC and FL are economic development for those states and a loss for us. Mr. Patricelli mentioned PA 18-26, which provides a significant exemptions for lower income pension or annuity income beginning in Fiscal Year 2020. He thinks it is a grand idea, but noted that most states do not do it and he added that the legislature passed it without knowing how they will pay for it. He also said property taxes in particular are pricing retirees out of state.

Commission member James O'Leary said the ACIR has looked at a number of these same issues, but there has been no traction to get the legislature or the Governor to act on these issues. He said we had one bill pass – authorizing multiple towns to do what a single town is allowed to do. He asked what strategy or tactic can the ACIR employ to bring about movement.

Mr. Patricelli pointed out that his commission's Report 1.0 did not gain traction either and proceeded to the 11th slide, titled, *The Key Battles Ahead*. He said the CFSEG's Report 2.0 seems to be gaining traction with the new administration, but noted that the Governor will not agree with everything, such as recommended income tax changes that would be beneficial for upper levels. He wants to leave the top levels alone.

The question is how successful the Governor can be in pursuing the changes with the General Assembly. Mr. Patricelli said it could depend on whether we will have a Democratic government shaped by a progressive coalition or if we will have a coalition government of moderates of both parties that can come together with the Governor. Mr. Patricelli added that he is optimistic and that some recommendations, such as sales tax broadening, are getting air time. The question is where the money will go: will it go towards reducing liabilities or towards encouraging economic growth? There does seem to be traction on P3s in transportation and recommendations for STEM. Mr. Patricelli also said the Governor is being appropriately cautious about re-opening SEBAC. Coalition thinking will be required and that seems to be the approach the Governor is taking.

Commission vice chair Wray said Helen Ladd of Duke University is a national expert on the targeting of municipal aid and he mentioned her work with a Need Capacity Gap Model in a dozen states. He said the analysis begins with measurements of municipal need and capacity and the state aid is a percentage of that gap, such as 60% or 80% of the gap. There is a very thorough literature. CT's targeting is scattershot. Referring to the presentation's mention of CRDA, he noted that his region includes 17 rail and rapid transit stations, but largely smaller communities. Commission vice chair Wray mentioned Enfield as an example of a town without the horsepower to develop a station on its own, so CRDA is very valuable. He added, however, that it is important to not stretch CRDA too thin.

Commission member Shanley said state aid to municipalities is separated into various categories of municipal and education aid, but it's all the same. Manchester has a $200 million budget and receives $35 million from the state and, whether it's called PILOT or ECS, state aid is support for local property tax payers. The vast majority is raised from the local tax payer. He added that Bill Cibes wrote an article for the CT Mirror saying that if fees and other local assessments were considered "taxes", CT's ranking as a heavily-taxed state would drop considerably. We rely on taxes, not what other states rely on.

Mr. Patricelli pointed out that Manchester ranks 136th in net grand list per capita and East Hartford ranks 157th, so those are municipalities that might benefit from a more thoughtful gap-based analysis. Commission Paul pointed out that a significant reduction in state aid to his or other towns would increase mill rates, reducing property values. Mr. Patricelli said he shares that concern and thinks it might be something the ACIR should look into.

Mr. Patricelli said CT does not have a workable system of property tax circuit breakers and, if the state were to make significant reductions in aid to some towns, towns would need a way to cushion the impact on their lower income taxpayers. He noted that his group did not have time to study those, but the 2015 tax panel had some excellent papers on property tax circuit breakers. Commission member Paul said Litchfield and other small towns do offer circuit breakers for people with lower incomes. He said Litchfield does have its wealthy areas and big-name residents, but most of the town's residents are farmers, machinists, policemen, the Middle American folks. He is concerned with the state taking a general approach to determining need in communities.

There was further discussion of potential property tax circuit breakers and, reading from a 2015 report, Mr. Patricelli said 14 of 38 available property tax relief options are not used by any CT municipality and most are used by six or fewer municipalities. It is a dysfunctional system of options and Mr. Patricelli added that the ACIR is the place to fix it. Commission member Seidman asked if the CFSEG considered how the tax structure comes into play. He described how his and neighboring towns are required to deliver services, such as special education, that now fall to municipalities. Students have achieved tremendous things through the towns' investment, but they often move out of town or out of state. The towns help students become self-sufficient, removing a burden from the state's taxpayers, but the underlying funding structure is so archaic.

Mr. Patricelli said the commission considered issues arising from the state having 169 towns and a strong tradition of local self-determination and said it is an inefficient mechanism for service delivery. He noted that he lives in a small town and said the group respects the historic connection with self-determination. He recommended the ACIR to take it on. This group can do it in a balanced way. The ACIR should develop guiding principles; do not leave it to the legislature. They need somebody above the political fray to help them think about what makes sense. Take it on and write a report. Commission vice-chair Wray added: if not us, who?

Council member Paul said he appreciates the thoughtfulness that has gone into this, but implementation will require caution. Mr. Patricelli said he will brief Jim Smith on this morning's discussion and the feedback ACIR members have provided. Members thanked Mr. Patricelli for the presentation and Commission member Leclerc said municipalities should not be parochial within their boundaries and she looks forward to further shared services.

4. Old Business

a. ACIR Role/Responsibilities

Commission vice-chair Wray asked for detailed minutes to be prepared for discussion next month. He mentioned that the state is targeting municipal aid and interest in an income tax circuit breaker for low incomes.

Commission member Thomas noted that, at last month's meeting, Sen. Cassano had expressed his and the Planning & Development Committee's interest in re-invigorating the ACIR. The Governor is interested too. ACIR members should be prepared to review any such proposals.

Commission vice-chair Wray said there needs to be a review of potential losses in the state and local civil service, especially due to the expected number of retirements. He mentioned that civil engineers are important for many public ventures, but only earn $80,000, while engineers going into other branches of engineering can earn much more. He noted that students interested in engineering can do that math.

b. 2019 Legislative Session

Commission vice-chair Wray said we are waiting for budget proposals from the Governor, House, and Senate.

c. Other Municipal, Regional, or State Matters

Commission member James O'Leary said the ACIR's research initiative with the University of St Joseph came to an end, without a report. He explained that the faculty member overseeing the work left the university and no one else is able to step in to complete it. Commission vice-chair said he has discussed possible opportunities with UConn's Mohamad Alkadry.

5. New Business

a. Future Meeting Topics and/or Invitations

The CFSEG report and presentation should be included on the agenda for the next meeting. Members asked Bruce Wittchen to recirculate the ACIR statutes, the transition shared services committee's recommendations, and the current ACIR roster. Commission member Filchak said he will send Bruce the suggestions he had provided to the shared services committee for circulation to ACIR members. He said the ACIR should look at how the state provides services and what might be done differently.

Commission member Shanley said we need a vision. He said the state is structured as an agrarian society. Fire departments and education continue to be provided at the same scale. How would they look if we were designing them for now? Are our efforts to retain the agrarian scale harming us?

Commission member Thomas said the ACIR has a great opportunity and the spotlight is on us. There is interest in changing the ACIR and we should develop our own vision so we can testify. Commission vice-chair said the March agenda will include a discussion of vision and principles.

b. Other

6. Adjournment

The meeting was adjourned at 12:00

Minutes prepared by Bruce Wittchen, OPM