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Connecticut Wants to Borrow $500 Million. In Return, It Promises Thrift.

In rare move in municipal debt world, state pledges to curb spending, cap future borrowing and funnel excess revenues into reserve fund

Connecticut is making a new promise to bondholders in exchange for $500 million: self-discipline.

The cash-strapped U.S. state is preparing to issue new debt that requires Connecticut to limit its spending, cap future borrowing and funnel excess revenues into a reserve fund. The $500 million bond issue priced Tuesday and will be delivered to investors June 20.

It is a rare step in the world of municipal debt. No other state has attached such fiscal austerity measures to an outstanding bond issue, according to analysts at S&P Global Ratings. The restrictions will stay in place for the next five years.

The unusual offer has the potential to lower borrowing costs for Connecticut in the near term and enforce fiscal discipline following a bitter state budget battle in 2017. The covenants helped win enough support to end the stalemate.

But the restrictions could also hamstring the state in the event of a future crisis. The only way to suspend certain covenants is with a three-fifths vote of the legislature and a declaration of fiscal emergency from the governor. The current governor, Dannel Malloy, is scheduled to leave office in January.

“If it goes badly the cost might be really high,” said Kim Rueben, senior fellow at the Urban Institute

Connecticut’s idea reinforces the predicament facing many U.S. states as they struggle to pay for core services like education and infrastructure at a time of soaring costs for debt, retirements and health care.

Pensions, retiree health insurance and Medicaid together consume about one out of every five tax dollars collected by state and local governments. Estimates of how much money they still need to pay for all future pension obligations vary from $1.6 trillion to $4 trillion. In Connecticut that shortfall is $34.8 billion, according to S&P.

A legislative standoff over how to balance pensions, debt and other liabilities with day-to-day operating costs delayed Connecticut’s budget last summer and froze aid to municipalities. The mayor of Hartford, the state’s capital, warned that he would seek bankruptcy protection if the city didn’t receive additional aid from the state.

Lawmakers and Mr. Malloy reached a deal in October that helped Hartford avoid bankruptcy. It included the new series of commitments attached to any bond offering over the next two years.

Spending has to be limited to 98% to 100% of revenues depending on the year and it can’t grow

faster than inflation. The state also has to limit new borrowing to no more than $2 billion a year and put excess revenues into a reserve fund. More reserves could improve the state's bond rating, ratings firm S&P Global said in a statement.

Connecticut has repeatedly overshot revenue predictions, leading to several contentious budget fights. But in April, state budget officials projected a $1.34 billion income-tax revenue surge above what was originally expected. About half of the windfall came from one-time payments from hedge-fund managers racing to beat a federal tax deadline on some past offshore earnings, according to the state budget office. The numbers also could have been boosted by residents cashing in stock in late 2017 to pay taxes on capital gains to take full advantage of the state and local tax deduction, which the new federal tax law capped.

The state used that excess revenue to fill a $717.5 million budget hole and add $556.4 million to its reserve fund.

The limits on borrowing and spending helped win support for the budget compromise at the final hour, said Connecticut House Speaker Joe Aresimowicz.

"We have faced now six or some could argue eight consecutive years of a very difficult budget," Mr. Aresimowicz said. "We want to take bold steps forward to ensure that if it's all of us back in the same room next year or whoever it may be, they're not facing the same situation that has allowed legislators to punt year after year on the difficult decisions."

Enshrining the rule in bond documents was quicker and easier than a constitutional amendment that requires a popular vote, said Democratic Sen. John Fonfara. Mr. Fonfara championed a provision of the covenant limiting the budget's reliance on certain income-tax collections.

"How do you bind future legislatures? The covenant was the means by which we intend to do this," Mr. Fonfara said.

But violating any of these covenants would amount to a default on the bonds and could prompt investor lawsuits. The new restrictions could also make it more difficult to act quickly if a new emergency arises. Lawmakers later reduced the length of the fiscal austerity covenants to five years from 10 years as a way of adding more flexibility.

Other states are watching Connecticut to see how its experiment fares and whether borrowing costs drop, analysts and government finance officers said. Price data late Tuesday showed the state paying less to borrow, relative to market rates, than it had in March, according to the Connecticut State Treasurer's Office.

"It's sort of putting your money where your mouth is by embedding it in the bond documents," said Florida bond director Ben Watkins. "It's a firmer commitment than just talk."

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By Heather Gillers

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—Joseph De Avila contributed to this article.

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