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Connecticut Closes a \$3.7 Billion Deficit Without an Income-Tax Hike.

- **\$43 billion budget gets mostly positive reviews from investors**
- **'But the elephant in the room is still there,' analyst says**

Connecticut's \$43 billion two-year budget, which spares residents an income-tax increase, is getting mostly positive reviews from investors.

The budget, approved by the Democratic-controlled House on Monday and by the Senate late Tuesday, closes a \$3.7 billion gap. It maintains a hospital tax that generates \$1 billion over two years, raises or expands the sales tax on everything from digital downloads to prepared foods and cuts employee healthcare cost by \$185 million.

However, lawmakers largely avoided tackling the rising costs of debt service, pensions and healthcare that eat up more than 30% of state spending.

"It's positive that they closed the gap and didn't raise income taxes and increasingly push wealthier residents out of the state," said Richard Schwam, a municipal credit analyst at AllianceBernstein LP. "But the elephant in the room is still there."

Connecticut's finances are on the mend as a surge in income-tax revenue boosts the rainy day fund to a projected \$2.6 billion at the end of the fiscal year, providing a cushion for the next recession. Higher tax collections led S&P Global Ratings Inc. to raise its outlook on Connecticut's debt and ease pressure on the state to demand big concessions from public employees unions or cut spending.

Connecticut's borrowing costs relative to top-rated municipal debt has plunged by 0.4 percentage point since the beginning of the year as residents clamor for tax-exempt debt in the wake of the federal cap on state and local tax deductions.

Still, the fiscal stress that has pushed Connecticut's rating to the third-lowest among U.S. states is likely to continue. Lawmakers rejected Democratic Governor Ned Lamont's proposal to shift a quarter of teachers' pension costs to municipalities and haven't yet agreed to a 'debt diet' proposed by Lamont that would shrink state borrowing by 39% annually.

The state and public employee unions are still negotiating Lamont's proposal to tie cost-of-living increases for retirees to pension performance. A proposal by Lamont to toll state's major highways to pay for new roads, bridges and mass transit will be taken up in a special session of the Legislature.

The budget stretches repayment of the \$14 billion shortfall of its teachers' pension to 30 years instead of 12, while reducing the assumed rate of return on investments to 6.9% from 8%. The move will allow the state to avoid a 60% increase in annual pension payments by 2032, but will cost taxpayer an additional \$17 billion over the 30 year period, according to Nuveen, the investment firm.

"It kicks the can down the road," said Daniel Barton, co-manager of Mellon Investments Corp.'s Connecticut municipal bond fund. "While it helps the budget in the near term its now a long-term problem."

Lamont promised not to raise income taxes during his gubernatorial campaign last year and he kept that promise in his first budget. To the relief of Connecticut's wealthiest residents, a proposal by some Democrats to levy a 2% capital gains surtax wasn't in the budget.

And while the spending plan didn't increase the sales-tax rate, it extended the 6.35% tax to services like dry cleaning, interior design and parking. It also imposes a 1% tax on prepared foods and beverages, including restaurant meals, and increases taxes on partnerships and limited liability corporations.

"There is incremental improvement," said Andrew Clinton, president of Stamford, Connecticut-based Clinton Investment Management, which manages more than \$650 million municipal bonds. "They got a budget agreement in a fairly orderly fashion. They're setting aside a significant sum for the rainy day fund."

At this time last year, Clinton's firm didn't hold any debt issued by the state. Now, it's one of its biggest holdings across client portfolios, evidence of his confidence Connecticut's finances are turning around.

In order to restructure the teachers' pension and comply with a covenant in a \$2.1 billion pension bond issued in 2008, Lamont proposed establishing a special capital reserve fund using \$381 million of the state's surplus equal to the maximum annual debt service on the pension bond. The state will use another \$160 million of the surplus to settle litigation with the state's hospitals involving the state's provider tax.

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