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300 Hedge Funds Not Enough as Tax Fails Connecticut: Muni Credit.

Four months after becoming Connecticut's first Democratic governor in two decades, Dannel Malloy signed a budget that raised taxes by a record amount. He vowed the revenue would stabilize a reeling economy.

"It's a tough vote — it's also the right vote," Malloy said in May 2011. "The budget is balanced, honest and contains none of the gimmicks that helped get us into this mess."

More than three years later, the wealthiest U.S. state, home to as many as 300 hedge funds, is still struggling to rebound from the recession that ended in 2009. While tax revenue has risen faster than any other state, growth in jobs, personal income and home prices ranks in the bottom 10 and trails neighboring New York and Massachusetts, according to data compiled by Bloomberg.

Malloy, 59, won re-election last month, enduring a rematch with Republican Tom Foley, who campaigned on a narrative of Connecticut trailing the U.S. recovery. The Democrat painted his challenger, who founded a private-equity firm, as out-of-touch with voters.

A week after his victory, Malloy ordered hiring limits and spending cuts to close a projected deficit. He also faces the third-most underfunded state pension system and the most debt per resident.

'Much Weaker'

"Connecticut's financial position is much weaker than people realize," said Tom McLoughlin, head of muni fixed-income in New York at UBS Wealth Management Americas, which oversees \$1 trillion. "The pension-funding ratio is going to be a persistent problem for Malloy and his successors. The state is really going to have to address its issues in the near future."

Connecticut's economy contracted in 2011 by more than all but three states, prompting a credit downgrade in 2012. Its unemployment rate has exceeded the U.S. figure each month since May 2012 as jobs shrink in the finance industry, the biggest contributor to the state economy.

Malloy's plight shows how a struggling economy saddled with debt and pension costs can strangle even the wealthiest governments. Connecticut ranked first with per-capita personal income of about \$61,000 last year, Bureau of Economic Analysis data show.

Digging Out

Samaia Hernandez, a spokeswoman for Malloy, referred questions for the governor to the budget office.

"We're competitive on taxes and doing the responsible thing to control the long-range costs of government," Benjamin Barnes, head of the budget office in Hartford, said in a telephone interview. "It did take us a long time to get into this mess, and it's taking us a little while to dig out. But we're

doing it in the right way.”

The budget shortfalls and underfunded retirement plan mirror nearby New Jersey, which ranks fourth in per-capita income and has had its credit rating cut a record eight times under Governor Chris Christie. Malloy has described himself as the antithesis of the Republican.

While Christie has refused to raise taxes, Malloy signed a two-year budget in 2011 that increased them by \$2.6 billion to tackle deficits, boosting levies on incomes of more than \$50,000 a year and on sales of previously exempt goods and services. Republicans who opposed the plan said lawmakers would use the revenue to boost spending.

More Cuts

Instead, the tepid recovery has spurred more cuts. Malloy’s administration curtailed hiring and told agencies to reduce spending in a Nov. 12 memo, which outlined a projected \$59 million deficit for the fiscal year through June, out of \$17.5 billion in expected general-fund revenue.

“Connecticut is still in a struggle to get on sustainable footing while other states are not having these problems,” said Paul Mansour, head of municipal research at Conning in Hartford. “They’re still dealing with budget deficits when they should be having surpluses.”

Conning, which oversees \$11 billion in munis for insurers, ranks Connecticut’s economic health 45th among states. The standing makes Conning less likely to invest there, Mansour said.

With the \$3.6 trillion municipal market rallying the most in three years, investors haven’t demanded higher yields.

Connecticut sold 10-year bonds Nov. 21 to yield 2.51 percent, data compiled by Bloomberg show. That compared with 2.26 percent for benchmark munis. The 0.25 percentage-point spread matched the average on its five deals since March.

Extended Rally

The bonds extended their rally today. Debt from last month’s sale due in November 2033 traded at an average yield of 2.82 percent, down from 3.09 percent when it last changed hands Nov. 25.

Malloy won last month with 50.7 percent of the vote, to 48.2 percent for Foley, outpolling his rival by about 27,000 ballots — after a margin of almost 7,800 votes in 2010, Associated Press data show.

“My first year in office was really hard,” Malloy said in a Nov. 7 interview on MSNBC. “I had to raise revenue. I had to renegotiate contracts. I had to trim some services.”

“It continues to be a tough environment,” he said a day earlier on the news channel. “Election Night showed that. But here in Connecticut, a race that Republicans had been claiming they were going to win for the better part of two years, I was re-elected.”

Malloy has also signed into law bills that repeal the death penalty and raise the minimum wage, and oversaw a measure that tightened gun laws in April 2013, four months after the Newtown shootings.

Debt Constraint

He enters his second term with a lower rating from Moody’s Investors Service than when he began in 2011. Connecticut’s Aa3 grade, fourth-highest, is below all states but Illinois and New Jersey.

The rank is partly a result of its \$5,457 of tax-supported debt per resident, the most nationwide and five times the median, according to the New York-based credit rater.

That number is inflated because the state assumes debt for school construction, while localities pay that tab elsewhere in the U.S., Barnes said.

The money still comes from state coffers, limiting efforts to revitalize the economy, said Douglas Offerman, an analyst at New York-based Fitch Ratings, which gives Connecticut a negative outlook.

Pension Pinch

"The state has not had an easy time of it in this recovery because the economy has not come back as strongly," he said in a telephone interview. "That's not unusual, but the difficulty for Connecticut is it is carrying high fixed costs for labor and retirees, and there's a lot of debt outstanding."

Connecticut is falling behind on retirement promises. The state has 49.1 percent of assets to cover obligations, Bloomberg data show. Only Illinois and Kentucky have lower ratios among U.S. states.

Malloy announced a plan to boost contributions above the annually required amount in January 2012 so the systems would be fully funded by 2032. The approach would save \$5.8 billion over 20 years, the state's actuary projects.

"We are working to pay down the debts we owe for past sins," Barnes said. "We've done all the things we need to do to control pension funding. It's going to take a while for it to show in our funded ratio, but we're pretty sure we're on the right track."

Greenwich Appeal

Connecticut's wealth is concentrated in Greenwich. The city and surrounding Fairfield County have more than 95 percent of the state's 250 to 300 hedge funds, according to Bruce McGuire, president of the Connecticut Hedge Fund Association.

"You talk to people in New York about Connecticut, and they think Greenwich," said Tom Metzold, co-director of munis in Boston at Eaton Vance Management, which oversees about \$27 billion in local debt. That doesn't mean the rest of the state is doing so well, he said.

Greenwich has lost some appeal, said Julia Chiappetta, who grew up there and runs a consulting business in the town. She returned to Connecticut after a five-year consulting job in Florida through 2006. Her friends are going in the opposite direction.

Connecticut's population grew 0.1 percent from 2011 to 2012, among the 10 slowest rates nationwide, while Florida's increased 1.2 percent, Census data show.

"I see a lot of friends leaving Connecticut because they can no longer afford to live here," she said by phone. "It makes me sad because it used to be a thriving economic community."

'Insurance Capital'

Bond documents refer to Connecticut as the "insurance capital of the world," citing companies such as Aetna Inc. (AET), Cigna Corp. (CI) and Hartford Financial Services Group Inc. (HIG)

Hartford Financial ranked eighth among nongovernmental employers in 2013, with 7,700 workers in Connecticut, according to the state's annual financial report. That's down from 12,000 in 2004,

when it ranked third.

United Technologies Corp. (UTX) is the top employer, with 27,000 workers in the state, the same as in 2004. Yale University is second-biggest.

United Technologies' count includes the headquarters of divisions Pratt & Whitney, which designs and produces aircraft engines, and Sikorsky Aircraft Corp., which makes helicopters. The units will stay in the state as part of the Connecticut Aerospace Reinvestment Act that Malloy signed in September, which provides tax incentives.

UBS Incentive

The governor has also acted to retain finance jobs.

In October, the state extended through 2021 an agreement with UBS AG that gave the bank a \$20 million loan that doesn't have to be repaid if it keeps at least 2,000 employees in Connecticut.

UBS in 1997 merged with Swiss Bank Corp., which built a trading floor in Stamford that's the size of two football fields. Zurich-based UBS still has people working in the space, said Marsha Askins, a spokeswoman in New York.

While finance — which includes insurance and real estate — accounted for almost 31 percent of gross state product in 2012, those jobs are becoming scarcer. Financial-services employment fell in 79 of the past 87 months, according to state data.

Last year, finance and insurance exerted the biggest drag on the economy, which expanded 0.9 percent, or half the nation's pace, according to June data from the Bureau of Economic Analysis. The 6.4 percent October jobless rate compared with 5.8 percent (USURTOT) nationally.

Tax Challenge

"We're a high-income, high-value-added state, with an educated workforce — our jobs are more difficult to create," Barnes said.

Higher taxes make Connecticut less attractive to fund managers, said Stephen McMenamin, executive director of Greenwich Roundtable, a nonprofit that educates alternative investors and hedge funds.

Tax collections surged 58.6 percent in Connecticut in the three years through June, the most nationwide, according to the Bloomberg Economic Evaluation of States.

Connecticut's 2014 business-tax climate is ninth-worst in the U.S., according to the Tax Foundation in Washington. The rank is based on levies on individual income, sales, corporations, property and unemployment insurance.

"When a manager calls me and says I'm looking to come up to Connecticut, I say keep going," McMenamin said in a telephone interview. "It's just a horrible tax situation here."

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