

Connecticut's Fiscal Crisis Is a Cautionary Tale for New Jersey

by Steve Eide

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Executive Summary

New Jersey's 2017 election will result in the first change in gubernatorial leadership since the Great Recession. But the next governor will not be starting out with a blank slate. Many issues that have raged over the past decade, especially taxes and retirement benefits, are unresolved. And when state officials take office in January 2018, they will have to walk a tightrope between expanding government services—what many voters favor—and curtailing runaway costs. Campaign promises are certain to collide with fiscal reality.

Whatever course Trenton takes, it can learn a lesson from its peer states. Connecticut, in particular, has a similar social and demographic profile, and it faces similar challenges: severe pension underfunding, a high tax burden, and politically powerful government unions. Unlike New Jersey, however, Connecticut has taken a more consistently “big government” approach to fiscal policy. The state enacted three major tax increases—yet its pension system remains deeply underfunded, its budget deficits are unabated, and its economy has posted one of the worst track records of any state in recent years.

More precisely:

- ✔ Since 2009, Connecticut's top marginal income tax rate has risen from 5% to 6.99%. Though high earners have experienced the largest increases, the tax burden has also been felt by single filers making \$50,000 or more a year and by joint filers making \$100,000 or more a year. The state sales tax has climbed from 6% to 6.35%.
- ✔ Despite these substantial tax hikes, Connecticut has faced midyear deficits in each of the last three fiscal years. Its rainy-day fund is now around \$200 million, about 1% of the state budget.
- ✔ While some New Jersey politicians embrace a combination of tax increases and robust rates of economic growth, that hasn't been the experience of Connecticut, which didn't regain all the private-sector jobs that it lost during the Great Recession until June 2017. It has been one of the slowest-growing states in terms of GDP and personal income, and it has lost population in each of the last three years.
- ✔ Moody's Investors Service rates only two states lower than Connecticut (A1): New Jersey (A3) and Illinois (Baa3).
- ✔ Connecticut's public pension systems are among the most underfunded in the nation. Even so, the state has been more responsible than New Jersey in funding its pension systems at the rate recommended by actuaries. The cost of doing so, however, has been burdensome to the point that in early 2017 Connecticut restructured the payment schedule for one of its major systems. This move will rein in costs in the near term, while imposing over \$14 billion in additional taxpayer costs after 2033.

This report presents a comparative analysis of the fiscal struggles faced by Connecticut and New Jersey.

It concludes with five pivotal questions:

1. What effect will the resolution of New Jersey's fiscal crisis have on property taxes?
2. Is New Jersey state government capable of responsibly managing a defined benefit pension system?
3. In light of its deep pension underfunding challenges, what can New Jersey afford in terms of health benefits?
4. How should fiscal volatility be managed?
5. What effect will resolving New Jersey's fiscal crisis have on the middle class?

The lesson that emerges from this study is clear: for those who think that New Jersey's budgetary challenges are rooted in inadequate levels of taxation, Connecticut provides a cautionary tale.



Introduction

Connecticut and New Jersey have many similarities. They have two of the lowest statewide poverty rates in the nation: at 10.5%, Connecticut ranks fourth; and New Jersey, at 10.8%, ranks fifth. In terms of per-capita personal income, Connecticut ranks first among all states (\$71,033) and New Jersey is third (\$61,968). Both rank in the top 10 in productivity (economic output per worker) and educational attainment. Low poverty, an educated and productive workforce, and high income levels should be major advantages for grappling with their fiscal and economic challenges in coming years (**Figure 1**).

Each state is part of the New York City metropolitan area. About 370,000 New Jersey residents commute each day to New York City, and 39,000 commute from Connecticut.¹ Close proximity to New York is often considered an asset for both and a source of challenges. New York's recent revival has created many opportunities for New Jersey and Connecticut residents, but the city has also emerged as a viable competitor for jobs and businesses from both states.

Both states consist substantially of bedroom suburban communities and small and midsize cities. In Connecticut, 22% of the population lives in a poor city (poverty rate above the state average) with at least 60,000 residents. In New Jersey, this figure is 14%.² Suburbs in both states offer a high quality of life for middle-class families, centered on strong public school systems. However, some cities in both states have been fiscally challenged for decades. State government interventions have been required in Bridgeport and Waterbury, CT, and in Camden, NJ.³ New Jersey placed Atlantic City into state receivership in November 2016,⁴ and Connecticut's capital city, Hartford, recently hired a law firm to pursue financial restructuring.⁵

New Jersey and Connecticut share another characteristic: - measured against other states, government unions are strong, and tax burdens and levels of government spending are high (**Figure 2**).

FIGURE 1.

Tale of the Tape: New Jersey and Connecticut

	Connecticut	New Jersey
Poverty Rate, 2011–15	10.5%	10.8%
Rank Among States	4	5
Per-Capita Income, 2016	\$71,033	\$61,968
Rank Among States	1	3
Adult Population with a Graduate or Professional Degree, 2011–15	16.6%	14.0%
Rank Among States	3	8
2016 GDP per Worker	\$156,821	\$142,533
Rank Among States	3	8

Source: Author's calculations based on data from Census Bureau, 2011–2015 American Community Survey 5-Year Estimates (poverty; educational attainment); Bureau of Economic Analysis, SA1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income; and Bureau of Labor Statistics, State and Area Employment, Hours, and Earnings

FIGURE 2.

Two “Big Government” States

	Connecticut	New Jersey
Government Workers Represented by Unions, 2016	69.4%	58.4%
Rank Among States	2	4
Tax Foundation Ranking (Total State and Local Tax Burden, 2012)	2	3
Top Marginal Income Tax Rate	6.99%	8.97%
Rank Among States	12	6
Median Property Tax Bill, 2011–15	\$5,327	\$7,410
Rank Among States	2	1
K-12 per Pupil Expenditure, 2013–14	\$18,401	\$18,780
Rank Among States	4	2

Source: Barry Hirsch and David Macpherson, Unionstats.com; “State-Local Tax Burden Rankings FY 2012,” Tax Foundation, 2016, p. 1; “Revenues and Expenditures for Public Elementary and Secondary Education: School Year 2013–14 (Fiscal Year 2014),” National Center for Education Statistics, Oct. 2016, table 5; Census Bureau, 2011–2015 American Community Survey 5-Year Estimates

FIGURE 3.

Troubled Major Public Pensions, FY 2016*

	Funded Ratio	Net Pension Liability (millions)
Connecticut State Employees Retirement System (SERS)	39.2%	\$16,524
Connecticut Teachers’ Retirement System	59.5%	\$10,972
New Jersey Public Employees’ Retirement System (state share)	25.0%	\$23,722
New Jersey Police and Firemen’s Retirement System (state share)	29.1%	\$4,294
New Jersey Teachers’ Pension and Annuity Fund	28.7%	\$63,578
New Jersey State Police Retirement System	38.7%	\$2,954

*Both the “funded ratio” and “net pension liability” figures shown measure the debt-like obligations that Connecticut and New Jersey owe for the systems listed. The funded ratio measures the gap between the value of the benefits promised and the assets on hand in relative terms; the net pension liability does so in absolute terms.

Source: “State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016,” Office of the State Comptroller, Dec. 30, 2016, p. 78; “The State of New Jersey 2016 Fiscal Year Comprehensive Annual Financial Report,” Department of the Treasury and Office of Management and Budget, Mar. 15, 2017, pp. 96–97

Retirement Benefits in Connecticut and New Jersey

Since the Great Recession, pension reform has been at the forefront of public debate in both states. In the most recent survey of state pension obligations by the Pew Center on the States, New Jersey and Connecticut trail only Illinois and Kentucky in their low levels of funding.⁶ Figure 3 shows the funded ratios for Connecticut and New Jersey’s major pension systems that each state reports in its most recent audited financial statement.

As has been discussed in numerous studies, the leading cause of Connecticut’s and New Jersey’s rising pension debt levels was a bipartisan failure, over many years, to make adequate budgetary contributions.⁷ New Jersey, whose record of undercontributing was cited by the Securities and Exchange Commission in 2010,⁸ has continued this habit up into the present. Figure 4 shows how much of the annual required contribution (ARC) that Connecticut and New Jersey have made over the past decade.⁹ (New Jersey has also fallen short of the *statutorily* required contribution rate schedule that was put into place as part of the state’s 2011 pension reform law.) Connecticut has bolstered its rate of contribution. But in the case of the Teachers’ Retirement System (TRS), the state was placed under a legal obligation to do so as a condition of the issuance of \$2.3 billion in pension obligation bonds,¹⁰ a controversial¹¹ funding tactic that New Jersey availed itself of in the 1990s but more recently has repudiated.¹² As for the State Employees Retirement System (SERS), Connecticut’s other major system, the state reached a deal in February 2017 to restructure its payment plan.¹³ Concerned that annual costs could exceed \$6 billion within the next 15 years, the new plan—essentially a re-financing strategy—will smooth out the payment schedule, but at the expense of transferring \$14–\$21 billion in additional costs onto taxpayers between 2033 and 2047.

Both states passed pension reform legislation in the wake of the Great Recession.¹⁴ Some changes—such as New Jersey’s suspension of cost-of-living-adjustment benefits for all employees and retirees—realized immediate cost savings for government budgets. However, much of the reform packages in both states applied only to new employees, which means that the savings will not accrue for many years to come. Pension-related “crowd-out” is currently plaguing both states’ budgets, as costs continue to rise more rapidly than revenues.¹⁵

It is important to understand that in both states, the vast majority of their annual pension bill goes toward funding the *actuarial accrued liability*, the cost of benefit

FIGURE 4.

Employer Contributions to Major Public Pension Systems, 2006–16

	Connecticut State Employees Retirement System	Connecticut Teachers' Retirement System	New Jersey Public Employees' Retirement System (state share)	New Jersey Police and Firemen's Retirement System (state share)	New Jersey Teachers' Pension and Annuity Fund	New Jersey State Police Retirement System
FY06	100.0%	100.0%	47.9%	69.4%	51.6%	27.3%
FY07	100.0%	100.0%	41.9%	66.1%	4.8%	51.9%
FY08	99.2%	100.0%	38.6%	59.1%	4.1%	46.2%
FY09	92.8%	100.0%	33.2%	54.0%	0.0%	6.5%
FY10	80.3%	100.0%	24.7%	40.7%	14.3%	1.1%
FY11	87.5%	100.0%	20.7%	35.6%	28.6%	1.9%
FY12	100.0%	100.0%	14.2%	29.7%	18.2%	13.7%
FY13	99.9%	100.0%	13.0%	28.2%	21.9%	27.8%
FY14	100.0%	100.0%	12.1%	28.2%	30.0%	34.6%
FY15	99.5%	100.0%	10.4%	25.7%	40.0%	34.7%

Source: "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016," Office of the State Comptroller, Dec. 30, 2016, pp. 102–3; "The State of New Jersey 2016 Fiscal Year Comprehensive Annual Financial Report," Department of the Treasury and Office of Management and Budget, Mar. 15, 2017, p. 129

FIGURE 5.

Normal Versus Accrued Liability Costs, Major Public Pension Systems, 2016

	Normal Cost	Accrued Liability Cost	Total Cost	State Normal Cost as a Share of Payroll	State Actuarial Accrued Liability Cost as a Share of Payroll	Total Cost as a Share of Payroll
New Jersey Public Employees' Retirement System (state share)	\$117,196,765	\$1,207,117,064	\$1,324,313,829	2.7%	27.4%	30.0%
New Jersey Teachers' Pension and Annuity Fund	\$362,441,339	\$2,637,136,345	\$2,999,577,684	3.5%	25.3%	28.7%
New Jersey Police and Firemen's Retirement System (state share)	\$120,325,795	\$382,592,169	\$502,917,964	7.9%	46.5%	54.3%
Connecticut Teachers' Retirement System	\$180,116,626	\$1,018,685,915	\$1,198,802,541	4.6%	25.8%	30.4%
Connecticut State Employees Retirement System	\$365,570,268	\$1,282,836,995	\$1,648,407,263	9.8%	34.5%	44.3%

Source: "Public Employees' Retirement System of New Jersey, Sixty-Second Annual Report of the Actuary Prepared as of July 1, 2016," Conduent Human Resource Services, Feb. 3, 2017, pp. 2–3; "Teachers' Pension and Annuity Fund of New Jersey, June 30, 2016, Actuarial Valuation Report Prepared as of July 1, 2016," Milliman, Feb. 3, 2017, pp. 3, 32; "Report on the Annual Valuation of the Police and Firemen's Retirement System of New Jersey Prepared as of July 1, 2016," Conduent Human Resource Services, Feb. 3, 2017, pp. 19–20; "Connecticut State Employees Retirement System Report of the Actuary on the Valuation Prepared as of June 30, 2016," Cavanaugh Macdonald Consulting, LLC, Jan. 19, 2017, p. 1; "Connecticut State Teachers' Retirement System Actuarial Valuation as of June 30, 2016," Cavanaugh Macdonald Consulting, LLC, Nov. 2, 2016, pp. 1, 11

promises to past and current workers that were made years ago but have been insufficiently funded (Figure 5). The *normal cost* denotes employer spending on benefits accrued by current workers as part of the overall compensation package earned during the current year. The portion devoted to paying off the accrued liability is 10 times the size of the portion for current compensation.

New Jersey and Connecticut are, in effect, devoting billions in tax revenues to expenditures from which taxpayers will gain no benefit whatsoever.

Both states also owe substantial sums for retiree health care, a benefit that, over recent decades, has largely been phased out among private-sector employers.¹⁶ New Jer-

FIGURE 6.

Major State Tax Sources, 2002–17 (millions\$)

	Connecticut						New Jersey					
	FY02		FY14		FY16		FY02		FY14		FY16	
	\$	% of State Budget	\$	% of State Budget	\$	% of State Budget	\$	% of State Budget	\$	% of State Budget	\$	% of State Budget
Sales Tax	\$2,997.8	25.1%	\$4,100.6	23.3%	\$4,279.8	24.0%	\$5,996.8	29.1%	\$8,849.4	28.2%	\$9,267.7	28.2%
Corporate Income Tax	\$381.0	3.2%	\$782.2	4.4%	\$839.3	4.7%	\$1,171.5	5.7%	\$2,112.9	6.7%	\$2,299.0	7.0%
Personal Income Tax	\$4,265.9	35.7%	\$8,718.7	49.5%	\$9,452.5	53.0%	\$6,837.0	33.2%	\$12,311.7	39.3%	\$13,356.0	40.6%
Total	\$11,943.7	—	\$17,608.1	—	\$17,840.8	—	\$20,573.4	—	\$31,347.7	—	\$32,872.6	—

Source: For CT: "Report of the State Comptroller to the Governor for the Fiscal Year Ended June 30, 2002," Office of the State Comptroller, Dec. 31, 2002; "Report of the State Comptroller to the Governor for the Fiscal Year Ended June 30, 2014," Office of the State Comptroller, Dec. 31, 2014, p. 22; "Report of the State Comptroller to the Governor for the Fiscal Year Ended June 30, 2016," Office of the State Comptroller, Nov. 30, 2016, p. 24. For NJ: "New Jersey Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2002," Department of the Treasury and Office of Management and Budget, Nov. 27, 2002, p. 288; "New Jersey Comprehensive Annual Financial Report Fiscal Year Ended June 30, 2014," Department of the Treasury and Office of Management and Budget, Apr. 2, 2015, p. 324; "The State of New Jersey 2016 Fiscal Year Comprehensive Annual Financial Report," Department of the Treasury and Office of Management and Budget, Mar. 15, 2017, p. 346

sey's unfunded liability for OPEB (other post-employment benefits) totals \$67.5 billion and Connecticut's totals \$21.9 billion.¹⁷ Though also a defined benefit, retiree health care differs from pensions in that, in both New Jersey and Connecticut, it is almost completely unfunded.¹⁸ New Jersey and Connecticut may not have contributed enough for worker pensions over the years (Figure 3), but they have contributed *something*. Retiree health-care expenditures, by contrast, come directly from the annual budget, not trust funds built up through years of worker and employer contributions and investment returns.¹⁹

The degree of crowd-out that New Jersey is experiencing is artificially low, since pension payments that a government is *not* making cannot reduce funding for other services.²⁰ But these payments will have to be made even-

tually, and reducing contributions in the near term will only increase costs, due to lost investment earnings. A 2016 report by the New Jersey Pension and Health Benefit Study Commission projected that, without reform, pensions and retiree health care alone will constitute 27% of the state's budget by 2023.²¹ Even at current levels of spending, costs are not insignificant. In the governor's budget for the current fiscal year (FY18), over 70% of the increase in total appropriations is devoted to pensions.²² Nuveen Asset Management recently raised concerns about the growing portion of New Jersey's budget that is being devoted to "fixed costs"—pensions, debt service, and retiree health care.²³ Fixed costs also continue to plague Connecticut's budget, accounting for 53% of the general fund budget, up from 37% in 2006.²⁴

FIGURE 7.

High Earners' Share of Income Taxes Owed, 2002–14 (thousands\$)

	Connecticut		New Jersey	
	2002	2014	2002	2014
Income Taxes Owed by Filers Earning \$500,000 and More	\$678,405	\$4,069,843	\$1,506,400	\$4,404,800
Total Income Taxes Owed	\$2,859,499	\$9,112,163	\$5,817,200	\$10,945,100
Share	23.7%	44.7%	25.9%	40.2%

Source: "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2013," Office of the State Comptroller, Feb. 28, 2014, p. 146; "New Jersey Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2013," Department of the Treasury and Office of Management and Budget, Mar. 12, 2014, p. 330; "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016," Office of the State Comptroller, Dec. 30, 2016, p. 155; "The State of New Jersey 2016 Fiscal Year Comprehensive Annual Financial Report," Department of the Treasury and Office of Management and Budget, Mar. 15, 2017, p. 350

Taxes in Connecticut and New Jersey

The Tax Foundation ranks both Connecticut and New Jersey high in its most recent survey of total state and local tax burdens (Figure 2).²⁵ Their budgets have a similar structure in terms of the breakdown between sales, income, and corporate taxes (Figure 6). Both states' budgets rely heavily on a personal income tax, which, in recent years, has become, in both cases, increasingly reliant on high earners (Figure 7). New Jersey has a higher top rate (8.97% versus Connecticut's 6.99%). However, Connecticut's income tax system uses a "recapture" mechanism that phases out lower tax rates for high earners, thus "ensuring that the taxpayer's average effective tax rate . . . moves closer to the taxpayer's actual tax bracket rate as income increases."²⁶ It has been estimated that recapture effectively creates "shadow" marginal rates higher than 8% for Connecticut filers earning more than \$200,000.²⁷

In terms of their government finance system as a whole, both states' largest tax source is the property tax, according to data from FY15, the most recent year available (Figure 8); and property taxes in New Jersey and Connecticut are the highest in the nation (Figure 2). New Jersey has tightened its property tax cap;²⁸ Connecticut has no formal property tax cap. Though levied at the local level, high property taxes have significant implications for state tax systems. New Jersey's income tax is officially termed the "property tax relief fund" (technically separate from the general fund) because, in the 1970s, it was instituted in hopes of reining in ever-escalating property taxes.

Connecticut's Big Government Fiscal Model Under Strain

New Jersey and Connecticut are in financial trouble, reflected plainly by the credit ratings given to them by Moody's Investors Service: A3 and A1, respectively. Only Illinois, which is at risk of becoming the first state ever to be rated below-investment-grade, or "junk," is rated lower.²⁹ Low bond ratings make it more costly for governments to borrow. In June, Breckinridge Capital Advisors noted that, on a 10-year bond index, Illinois' borrowing costs differ from a benchmark AAA by 270 basis points, which would mean an additional \$2.7 million in interest costs over the life of a \$10 million, 10-year issuance.³⁰

FIGURE 8.

State and Local Government Revenues from Property, Personal Income, FY2015 (millions\$)

	Connecticut	New Jersey
Property Taxes	\$10,029	\$27,651
Personal Income Taxes	\$8,187	\$13,250
Sales Taxes	\$4,167	\$9,146

Source: "Municipal Fiscal Indicators, Fiscal Years Ended 2011–2015," Connecticut Office of Policy and Management, Jan. 2017, p. A-8; "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016," p. 153; "The State of New Jersey 2016 Fiscal Year Comprehensive Annual Financial Report," Department of the Treasury and Office of Management and Budget, Mar. 15, 2017, p. 346; New Jersey Department of Community Affairs, Property Tax Information

FIGURE 9.

Major Tax Changes, Connecticut, 2009–16

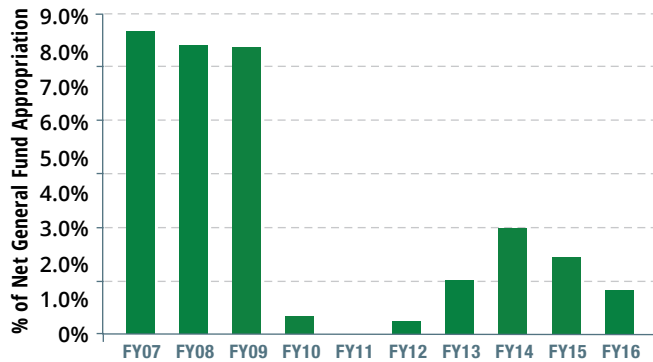
2009	Estimated Annual Revenue
Third income tax bracket added at 6.5% (for income over \$500,000 for single filers, over \$1 million for joint filers); corporate surcharge of 10% on businesses with \$100 million or more in adjusted gross income (AGI)	\$1 billion
2011	
Expanded number of brackets from three to six, top rate increased to 6.7%; sales tax increased from 6% to 6.35% and base broadened; corporate surcharge of 20% on businesses with AGI over \$100 million	More than \$1.8 billion
2015	
Top income tax rate increased to 6.99%	\$900 million

Source: "State of Connecticut Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2010," Office of the State Comptroller, Jan. 28, 2011, p. 4; "FY 2018–FY 2019 Biennium Economic Report of the Governor," Connecticut Office of Policy and Management, Feb. 8, 2017, p. 98; "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2011," Office of the State Comptroller, Feb. 28, 2012, pp. 4–5; "State of Connecticut Comprehensive Annual Financial Report, Fiscal Year Ended June 30, 2016," p. 28; Keith Phaneuf, "A Legacy of Debt: Whether Taxing or Cutting, CT Faces Painful, Contentious Fiscal Future," Connecticut Mirror, Feb. 1, 2017

Connecticut's fiscal situation is the most striking. The state raised billions in new revenues through a series of significant tax increases in 2009, 2011, and 2015 (Figure 9). Prior to the Great Recession, the state income tax had two brackets and a top rate of 5%. In January 2009, the state added a third bracket and a new top rate, 6.5%, applying to incomes of \$500,000 for single filers and \$1 million for joint filers. But Connecticut still faced budget deficits of \$3 billion in FY12 and FY13. In response, as of January 2011, the system was revised into a five-bracket structure, with the highest rate topping out at 6.7% on incomes of \$250,000 for single filers and \$500,000 for

FIGURE 10.

Connecticut Budget Reserve Fund, FY2007–16



Source: "Fiscal Accountability Report Fiscal Years 2017–2020," Connecticut Office of Policy and Management, Nov. 15, 2016, p. 11

joint filers. This was coupled with an increase in the sales tax from 6% to 6.35% and a 20% surcharge on corporations with incomes of \$100 million or more and a tax liability of more than \$250. State deficits continued to mount. In response to a projected \$1.1 billion shortfall for FY16, the 6.7% rate was raised to 6.9% as of January 2015, and another (seventh) bracket was imposed at 6.99%, applied to incomes of \$500,000 for single filers and \$1 million for joint filers.

Regardless of mounting taxes, Connecticut has experienced deficits in each of the last three fiscal years.³¹ Addressing its recurring deficits has required drastic reductions in the state's rainy-day or budget reserve fund (Figure 10). Connecticut closed FY17 with \$213 million in reserves, down from \$519 million in FY14.³² What credit rating agencies have called Connecticut's "minimal reserve levels" leave the state little fiscal flexibility to address future challenges.³³

Connecticut lawmakers are currently locked in a dispute over how to close a \$3.5 billion shortfall over the next two fiscal years.³⁴ While Republicans and Democrats have yet to agree on many questions, there has been little serious debate over enacting further tax increases on high earners. In the view of the state revenue department, "You can't go back to that well again. . . . The idea that there is yet another significant amount, in terms of long-term stability, to get out of that portion of the population is just not true."³⁵

These fiscal struggles have been accompanied by—and, in some ways, have intensified—growing concerns about the state's economy. Connecticut has ranked as one of the four slowest-growing states in four of the last seven years.³⁶ It has lost population in each of the last three years.³⁷ General Electric and Aetna, in January 2016 and June 2017, respectively, announced that they would be relocating their corporate headquarters from Connecticut.

FIGURE 11.

Connecticut, New Jersey, Pennsylvania, Massachusetts, and the U.S. Since the Great Recession

	CT	NJ	PA	MA	US
Average Annual Change in GDP, 2010–16	1.7%	2.7%	3.8%	4.0%	3.7%
Total Change in GDP, 2009–16	12.8%	20.5%	26.3%	31.7%	28.9%
Average Annual Change in Personal Income, 2010–16	2.4%	3.3%	3.5%	4.1%	4.1%
Total Change in Personal Income, 2009–16 (nominal\$)	18.0%	25.2%	27.2%	32.4%	32.6%
June 2017 Private-Sector Jobs	1,460,400	3,507,900	5,239,100	3,157,900	124,051,000
Pre-Recession Peak, Private-Sector Jobs	1,458,200	3,441,800	5,064,900	2,895,000	116,042,000
Pre-Recession Peak Month, Private-Sector Jobs	Mar-08	Feb-08	Jan-08	Apr-08	Jan-08
Recession-era Trough, Private-Sector Jobs	1,346,500	3,193,800	4,797,900	2,753,300	107,257,000
Trough Month, Private-Sector Jobs	Feb-10	Feb-10	Feb-10	Oct-09	Feb-10
Private Sector Job Recovery Month (passed pre-recession peak)	Jun-17	Feb-16	May-14	Jan-13	Mar-14
Private Sector Job Increase Since Trough #	113,900	314,100	441,200	404,600	16,794,000
Private Sector Job Increase Since Trough %	8.5%	9.8%	9.2%	14.7%	15.7%
Private Sector Job Increase Over Pre-Recession Peak	2,200	66,100	174,200	262,900	8,009,000
Private Sector Job Increase Over Pre-Recession Peak %	0.2%	1.9%	3.4%	9.1%	6.9%

Source: Bureau of Labor Statistics, State and Area Employment, Hours, and Earnings; Bureau of Economic Analysis, "SA1 Personal Income Summary: Personal Income, Population, Per Capita Personal Income" and "Gross Domestic Product (GDP) by State (Millions of Current Dollars)"

In both cases, concerns about the state's fiscal and economic outlook were a major factor.³⁸ As **Figure 11** shows, the Connecticut economy has recently been trailing the national economy and those of its nearest competitors (including New Jersey) with respect to jobs, personal income, and GDP. Only very recently (June 2017) did Connecticut's private-sector employment figures return to prerecession levels.

New Jersey's Big Government Fiscal Model Under Strain

New Jersey faced a budget stalemate over its spending plan for the current fiscal year, but officials reached a resolution within days after the conclusion of FY17.³⁹ New Jersey experienced massive deficits during the depths of the recession, reaching as high as \$10.7 billion, or 36% of the FY11 budget.⁴⁰ In recent years, though, its budget has been more stable than Connecticut's.

This is striking, given that, unlike Connecticut, New Jersey has not resorted to major tax increases to keep revenues in line with expenditures. Aside from a recent increase in the gas tax to fund transportation programs, taxes have generally remained stable and, in some cases, have gone down. A temporary "millionaire's tax" (10.75% on incomes above \$1 million, 10.25% on income over 500,000, and 8% on income over \$400,000) actually was allowed to expire in 2010, and, after a recent cut, New Jersey's sales tax is now 6.875%, set to reach 6.625% in January 2018.⁴¹ The property tax cap "2.0," which went into effect in FY12, has held the average residential tax bill to a 1.9% annual increase during its first five years (2012–16), compared with 3.8% during the preceding five years (2007–11).⁴² Coming out of the Great Recession, New Jersey has experienced much healthier economic growth rates (output, personal income, jobs) than has Connecticut (**Figure 11**).

Nevertheless, Garden State finances are still deeply troubled. New Jersey's budget is balanced on a cash basis but faces a massive structural deficit, mainly because of its pension obligations. One small state pension program, the Judges Retirement System, is projected to deplete its trust fund in 2022, with others to follow in subsequent years.⁴³ The current plan is for the state to gradually increase contributions to reach 100% of the actuarially required amount by 2023—\$6.2 billion—up from the current fiscal year's \$2.5 billion.⁴⁴ But, as Moody's recently explained, even under optimistic assumptions of economic growth and investment return, this funding plan would produce a \$3.6 billion deficit in 2023, "equivalent to

34% of sales taxes and 22% of gross income taxes, making it unlikely a sufficient tax increase would be politically feasible."⁴⁵ And, as has been detailed by the Pension and Health Benefit Study Commission, even if funding pensions via cuts to state programs were desirable, it would not be a legally viable course to pursue, since almost 90% of state revenues are already dedicated to a specific—in some cases, constitutionally mandated—purpose.⁴⁶

Conclusion: Five Questions About New Jersey's Future

New Jersey and Connecticut entered the Great Recession faced with structural fiscal challenges. Since then, Connecticut has pursued a more consistently "big government" approach to budgeting than has New Jersey, implementing policies that were, in fact, favored by Democrats in the New Jersey state legislature and other groups that view New Jersey's challenges as mainly revenue-related. The results are in, and they provide a striking lesson. Connecticut's willingness to raise taxes has probably kept its bond rating above New Jersey's, but it is still one of the lowest-rated states. Tough choices lie ahead for New Jersey. To provide the public with an honest explanation of what needs to be done, state officials should provide clear answers to the following questions:

What effect will the resolution of New Jersey's fiscal crisis have on property taxes? Though concern about excessive property taxes remains high in New Jersey, much of the public fails to grasp the connection between that issue and the crisis in the state's finances. One of the most controversial debates during Connecticut's recent budget season centered on a proposal by Governor Dannel Malloy's administration to shift \$407 million in annual teacher pension costs (one-third of the bill) onto localities. The proposal was vigorously opposed by affluent towns but also the state teachers' union, over fear that rising pension costs would reduce funds for salaries and jobs.⁴⁷

Though much of the administration's rhetoric targeted the unfairness of state funds being used to subsidize teacher benefits in wealthy school districts, others raised concerns about how Hartford and other distressed urban areas could be expected to shoulder their teachers' retirement benefit costs.⁴⁸ The entire episode recalled a failed attempt by officials in New Jersey in the early 1990s to shift some of the state's pension costs onto localities.⁴⁹ If state officials revisit this proposal, they are likely to face the same political opposition that assembled two decades

ago in New Jersey and this year in Connecticut. At the same time, it is implausible to think that New Jersey localities will be wholly unaffected by any serious plan to resolve the state's fiscal challenges. The sums are too large, and state and local finances are too intertwined. It is incumbent on state officials to be forthright about this reality. Many irresponsible decisions have been made by officials at the state level. But reining in local property taxes will have to require increased accountability for local officials.

Is New Jersey state government capable of responsibly managing a defined benefit pension system? New Jersey's and Connecticut's pension mismanagement stretches back many decades and should raise serious doubts about whether either state can *ever* be trusted to responsibly manage a defined benefit retirement system.

Defenders of New Jersey's defined benefit systems argue that, *if one leaves aside the underfunding*, the state retirement systems are quite affordable.⁵⁰ But while it is true that the "normal" cost—equivalent to 401(k) employer share—is a small portion of the required contribution (Figure 5), the underfunding is the point. Any honest assessment of a retirement benefit system's affordability must take into account that system's inherent risks and the management capacity of its employer sponsor.

Decades of underfunding the SERS left Connecticut facing unsustainable cost trends. As discussed above, the "solution" to that problem enacted earlier this year entailed, essentially, underfunding the system yet again: putting less in up-front and pushing more costs onto the next generation of taxpayers. If New Jersey officials do not want to reduce pension or health benefits to ensure funding for existing promises, they will almost certainly have to implement a similar refinancing strategy in order to keep the payment schedule on a reasonable⁵¹ footing. They will, as Connecticut officials just did, create a more expensive system and compound intergenerational unfairness. The structure of defined benefit systems will always lend itself to manipulation when politicians find it convenient.

In light of its deep pension underfunding challenges, what can New Jersey afford in terms of health benefits?

Though ordinarily eclipsed by the debate over pension reform, health benefits for active and retired workers also continue to grow at a rate above revenues. In Connecticut, the cost of retiree health care exceeds the cost of active employees' health care.⁵² As both the New Jersey Pension and Health Benefit Study Commission and Fund for New Jersey have pointed out, simply bringing health-care programs into alignment with private-sector norms—policy that's arguably important to enact for

reasons of taxpayer equity alone—would raise billions in savings that could then be rededicated to shoring up the pension systems.⁵³

How should fiscal volatility be managed? New Jersey's system of government finance seems likely to become more volatile in the near term. Levels of political support for instituting a millionaire's tax are strong. High earners derive proportionately larger shares of their income from investments. In 2014, the most recent for which data are available, the top 1% of New Jersey income tax filers derived 12.6% of their income from interest and dividends and capital gains, as opposed to 6.4% for all filers.⁵⁴ Though taxed at the same rate as ordinary income in both states, income from investments fluctuates more than ordinary wages and salaries do. Thus, shifting more of the tax burden to high earners will lead to greater revenue volatility for New Jersey's budget. In a 2014 analysis that characterized revenues derived from a proposed millionaire's tax as "highly volatile and subject to significant annual change," the Office of Legislative Services notes that income tax revenue from filers with income in excess of \$1 million increased 25% in 2007 and then fell by 25% the subsequent year.⁵⁵

Volatility from capital gains has been an abiding concern among Connecticut officials, as well.⁵⁶ On the spending side, volatility could be increased by proposals to reduce the state pension funds' reliance on certain "alternative" investment advisors because of their high fees.⁵⁷ The Center for Retirement Research at Boston College recently published a study finding that certain classes of alternative investments, such as hedge funds, *reduce* volatility in public pension portfolios.⁵⁸ New Jersey officials should lay out specific steps that they plan to take to mitigate the fiscal volatility that looms, such as by strengthening its reserve policy. Like Connecticut's, New Jersey's reserve levels are very low, relative to other states and to other eras in the state's own history.⁵⁹ However, devoting more funds to replenish the rainy-day fund will leave that much less for services or to pay off debt. In the public sector, it is critical to manage volatility because residents rely on the government to continue to provide services in good times as well as bad.

What effect will resolving New Jersey's fiscal crisis have on the middle class?

If New Jersey officials do not plan to secure funding for pensions through comprehensive benefits reform, they will have to raise taxes on the middle class to pay for pensions. This should be explained forthrightly. Property and sales taxes collectively take in far more than the income tax in New Jersey and Connecticut (Figure 8). The millionaire's tax touted by many New Jersey Democrats is projected to bring in about \$600 million, according to the New Jersey Office of Leg-

islative Services,⁶⁰ a sum far short of the billions that the state needs to adequately fund its pensions. Throughout Connecticut's recent series of tax hikes—which have raised *billions* in annual revenues (Figure 9)—officials found that they could not simply rely on taxing the 1% alone. They had to raise the sales tax rate, reduce or eliminate many exemptions, and raise income taxes on *all* single filers making more than \$50,000 and joint filers making more than \$100,000.⁶¹ Any government revenue system seeks to minimize distortions in the economy, which ordinarily means, first, a certain balance among its various revenue sources; and second, an avoidance of drastic changes.

New Jersey's fiscal needs are urgent. Trying to close New Jersey's multibillion-dollar structural deficit through taxes alone would run a great risk of distorting and weakening economic activity precisely at a time when the state fiscal outlook cannot tolerate Connecticut levels of growth. It will not be possible to stabilize New Jersey's budget through taxes on the 1% alone and still maintain a balanced revenue system. Fully funding current levels of employee benefits by raising income taxes on millionaires, according to the New Jersey Pension and Health Benefit Study Commission, would mean an average increase of over \$200,000 in the annual tax bill of affected filers, a change that is sure to have enormous unintended consequences in the unlikely event that it is implemented.⁶²

In New Jersey, many state officials and candidates for

office believe that the state's fiscal struggles can be alleviated through higher taxes and healthy economic growth rates. That is precisely the combination that Connecticut has *not* seen over the last several years. Up to a point, it is understandable, and certainly inevitable, that Connecticut and New Jersey are high-cost states. When governments raise taxes not to enhance services but to pay for the costs of the past, this not only weakens their advantage relative to low-tax jurisdictions but also to high-tax jurisdictions with a reputation for a high quality of life. If New Jersey had only to fund its employees normal retirement costs, it would have billions more to spend on any number of core priorities. Structural problems manifest themselves with greatest clarity during the good times. Fiscal strain during times of growth is a sure sign that a government is poorly prepared for the next recession.

Endnotes

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ABSTRACT

New Jersey's 2017 election will result in the first change in gubernatorial leadership since the Great Recession. But the next governor will not be starting out with a blank slate. Many issues that have raged over the past decade, especially taxes and retirement benefits, are unresolved. And when state officials take office in January 2018, they will have to walk a tightrope between expanding government services—what many voters favor—and curtailing runaway costs. Campaign promises are certain to collide with fiscal reality.

Whatever course Trenton takes, it can learn a lesson from its peer states. Connecticut, in particular, has a similar social and demographic profile, and it faces similar challenges: severe pension underfunding, a high tax burden, and politically powerful government unions. Unlike New Jersey, however, Connecticut has taken a more consistently “big government” approach to fiscal policy. The state enacted three major tax increases since 2009—yet its pension system remains deeply underfunded, its budget deficits are unabated, and its economy has posted one of the worst track records of any state in recent years.

In New Jersey, many state officials and candidates for office believe that the state's fiscal struggles can be alleviated through higher taxes and healthy economic growth rates. That is precisely the combination that Connecticut has not seen over the last several years. For those who think that New Jersey's budgetary challenges are rooted in inadequate levels of taxation, Connecticut provides a cautionary tale.



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