S&P Global
Ratings

RatingsDirect®

Connecticut Budgetary Pressures And Dim Economic Growth Dampen Local Government Credit

Primary Credit Analyst:
Timothy W Little, New York (212) 438-7999; timothy.little@spglobal.com

Secondary Contacts:
Victor M Medeiros, Boston (1) 617-530-8305; victor.medeiros@spglobal.com
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@spglobal.com

Table Of Contents

Current State Of The Connecticut Economy

Dim Economic Growth Prospects Are Likely Through 2019

Property Tax Burden Puts Connecticut At A Comparative Disadvantage

Education Costs Pressure State And Local Budgets

Local Pension Pressures Are An Ongoing Credit Concern

Local Credit Ratings Under Pressure

Connecticut Budgetary Pressures And Dim Economic Growth Dampen Local Government Credit

Credit conditions in Connecticut are stable, although there are substantial headwinds creating budgetary challenges, particularly for larger cities and towns with high service costs, reliance on state revenue, or limited budgetary flexibility.

Connecticut boasts some credit strengths, including its high income levels. At 141% of the national average, the state has the highest per capita income level of all the states--substantially above the second, the Commonwealth of Massachusetts, at 128%. Even excluding wealthy Fairfield County, Connecticut estimates its per capita income would still be 125% of the nation. While the large share of state income derived from the financial industry and capital gains creates some economic cyclicality, local municipalities have historically weathered recessions without much deterioration in credit quality.

Overview

- Credit quality for local governments is generally stable, but state budgetary pressures and dim economic growth may affect credit quality.
- A high property tax burden puts the state at a comparative disadvantage, hurting cities and large towns.
- Projected state budget deficits and financial strain may lead to cuts in municipal aid.
- In our view, local governments that lack forward-looking policies on budgetary planning and reserves will be the most vulnerable to potential downgrades.

For more information, see the related article "Medians And Credit Factors: Connecticut Local Governments," published Oct. 20, 2016, on RatingsDirect.

Current State Of The Connecticut Economy

For local governments, the stability of revenue streams (primarily property taxes) and the underlying strength of the tax base have largely shielded cities and towns from the worst of past recessions. Even following the Great Recession, credit deterioration on the local level was minimal as cities and towns were willing to adjust millage rates to keep revenues neutral despite tax base declines. Municipal aid, particularly for school funding, was largely unscathed, which allowed many local governments the capacity to adjust budgets and maintain reserves without significantly reducing service levels. (In Connecticut, municipalities provide local school services.)

The state had a slow recovery from the last recession, and many of the new post-recovery jobs pay less than the jobs that were lost. The state calculates that only 17% of jobs lost in the last recession paying over $80,000 per year have been regained, while the state has regained 133% of the jobs paying under $50,000 per year, and 140% of those

making between $50,000-$80,000 per year. The job picture may be improving. Despite the loss of General Electric's (GE) headquarters to Boston, Connecticut has recently announced plant expansions at Electric Boat, Sikorsky's helicopter operations, and Pratt & Whitney, some of which was induced by state tax incentives and union labor concessions.

Dim Economic Growth Prospects Are Likely Through 2019

The announcement earlier in the year by GE that it would move its headquarters to Boston from Fairfield underscores the economic challenges facing the state. Connecticut is New England's second-largest economy (after Massachusetts) and, like its regional neighbor, maintains some of the weakest employment growth prospects nationally. This is due to well-established demographic factors, including static population growth and lower labor force growth rates.

Following the Great Recession, real GDP bottomed in 2013, and growth has been fairly muted since, totaling 1.7% through 2015. Projections show growth remaining well below average with annual gains of 0.8% in 2016, 1.6% in 2017, and 1.8% in 2018. This is compared to an average of 2.4% nationally over the same period. Employment gains are projected to remain bleak, with projections of just 1% growth, or just 17,000 jobs through 2019.

Looking ahead, increased competition from neighboring states and the state's ability to retain its predominant industries in insurance and various manufacturing sectors given a high cost of doing business will remain key risks.

On the bright side, new construction and housing starts is projected to grow 14% in 2016 and 6.1% in 2017. New construction, in addition to its associated economic activity, will hopefully provide some marginal boosts to taxable values and bolster local government fees and other revenues to an extent, although this will vary from town to town.

Property Tax Burden Puts Connecticut At A Comparative Disadvantage

Connecticut municipalities rely on property taxes as their primary source of revenue. Unlike other states, local governments in the state are not bound to any property tax or tax levy caps. We view this as a credit strength in our analysis, particularly when we evaluate the local government's institutional framework. This has also led to the state having one of the largest property tax burdens in the country. A December 2014 state Department of Revenue report found that over 40% of a household's tax burden is due to property taxes.

For the state's largest cities, the lack of diversified revenue has been problematic. For example, Hartford's millage rate is the highest in the state at 74.29 mills (a mill is equal to $1.00 of tax revenue for each $1,000 of assessed value), followed by the Waterbury at 60.21, Bridgeport 54.37, and New Haven at 41.55. This high tax burden has constrained budgetary flexibility, in our view, because many of these communities have demonstrated limited capacity to raise revenues or have faced political resistance in this area. In addition to having fairly high tax burdens, these municipalities also contend with high service costs and have sizable pension and other postemployment benefit liabilities. They also rely on state aid for additional funding, which we note is pressured, making budgetary planning more difficult.

Education Costs Pressure State And Local Budgets

The largest source of municipal aid is the state's Education Cost Sharing (ECS) grant totaling over $2 billion. Not including funding for charter schools, the state's revised 2017 budget reduced ECS by $32.1 million, or 1.6% from what was originally adopted. The legislature has largely held municipalities harmless from ECS cuts in the past. The change in funding priorities underscores the stress of the state and the potential for future changes to municipal aid which could affect municipalities unable to adapt to changing circumstances mid-fiscal year. The state has projected significant budget gaps that need to be closed in fiscal 2018 and beyond that could lead to further overall cuts in state aid. A recent superior court ruling found that while Connecticut is adequately funding education, it ruled that it was producing inequitable standards across the state. The case is under appeal with the state supreme court and the timeframe for an expected decision is unknown. In our opinion, the ultimate outcome will likely not have a major credit impact. Wealthy communities are likely to absorb increased costs through property tax increases. However, it is unclear to what extent the potential increased aid would be significant enough to provide material credit improvement to poorer communities.

Fiscal 2017 total statewide municipal revenue sharing is budgeted at $185 million; local general governmental aid $440 million; state contributions for teachers' pensions, postretirement health care, and debt service $1.152 billion; and total education aid $3.328 billion. The fiscal year 2017 combined local aid of $5.085 billion has increased very slightly in the last two years, and we do not anticipate significant cutbacks when the fiscal 2017-2018 state biennium budget is proposed. However, we believe strained state finances could create the potential for future cutbacks in local aid should a recession develop or major pressure emerge in the state budget. The state currently projects that fixed costs will grow $1.2 billion more than state general fund revenue in fiscal 2018, which will loom large in upcoming budget negotiations.

Local Pension Pressures Are An Ongoing Credit Concern

New England is well known for pension pressures related to locally administered, single-employer plans, and Connecticut municipalities are not immune from these pressures. Despite the state establishing a cost-sharing retirement system in 1947 solely for municipalities, most local governments have chosen to keep local control. The Connecticut Municipal Employees' Retirement System reported a plan fiduciary net position as a percentage of the total pension liability of 87.47% with an 8% long-term expected rate of return (June 30, 2015 measurement date). Despite what we see as an assumed investment rate of return somewhat higher than average, the plan's funded ratio is good, in our opinion, which should lead to relatively predictable annual contribution requirements. However, few of the state's 169 municipalities participate in the plan.

At the onset of the last recession a number of local governments took advantage of their local control and took pension holidays to balance their budgets with some prolonged deferral of required payments. Even as some towns and cities are now reducing rates of return and raising their annual contributions, the costs are proving sizable as they phase in these increases. Well-managed communities have proven their ability to manage these costs, but also have acknowledged the increased budgetary burden, which may crowd out some services over time.

Local Credit Ratings Under Pressure

While there are a number of factors that suggest credit conditions may remain stable, particularly for those governments with higher reserves and budgetary flexibility and limited dependence on state revenues, we are observing that the ongoing weak GDP growth and labor productivity, as well as historically weak economic demographics, are beginning to significantly hamstring many of the larger cities and towns that have long depended on state revenues to support structurally balanced budgets.

This has been evident with the recent downgrade of Hartford, and the continued budgetary challenges faced by New Haven and other similar communities. Higher rated municipalities are not immune from weaker economic growth prospects and state aid reductions. Looking ahead, all local governments in the state will have to depend on a greater percentage of local source revenue to balance budgets, as the state is unlikely to provide substantial additional aid to localities, which may prove challenging for some communities. In our view, local governments that lack forward-looking policies and budgetary planning and reserves will be the most vulnerable to potential downgrades.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

Copyright © 2016 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.