State of Connecticut

Issuer: State of Connecticut		
Assigned	**Rating**	**Outlook**
General Obligation Bonds (2019 Series A)	AA-	Negative
Taxable General Obligation Bonds (2019 Series A)	AA-	Negative
Affirmed	**Rating**	**Outlook**
General Obligation Bonds	AA-	Negative
Issuer: Connecticut Innovations, Incorporated		
Affirmed	**Rating**	**Outlook**
State of Connecticut General Fund Obligation Bonds 2014 Series A	AA-	Negative

Methodology:

U.S. State General Obligation

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Rating Summary: The AA- rating reflects high wealth levels that provide strong support to above average debt and pension burdens. The Negative Outlook results from the State's past difficulty in maintaining structural balance due to volatile revenues. Recent personal income tax (PIT) collections, however, have improved. Unlike the last several fiscal years where the State experienced ongoing shortfalls in collections, PIT collections in FY 2018 were $1.6 billion higher than budgeted. This windfall was primarily due to one-time income tax revenues related to repatriation of hedge fund profits as well as changes in taxpayer behavior. Should the favorable fiscal trends continue, KBRA notes the Outlook could be changed to Stable in the near term.

This revenue performance allowed the Budget Reserve Fund (BRF) to grow from 1.2% of General Fund expenditures in FY 2017 (BRF of $213 million) to 6.5% in FY 2018 (BRF of $1.20 billion). The BRF balance is estimated to improve further to a strong level of 10.4% of estimated FY 2019 expenditures ($2.0 billion) by the end of the current 2019 fiscal year ending June 30, although KBRA notes that a degree of uncertainty for year-end results will remain until month of April actual collections for the PIT are tabulated. In KBRA's view, this level of reserves if achieved significantly strengthens the financial condition of the State.

Under the State's Volatility Cap, effective beginning in FY 2018, any final and estimated income tax collections over $3.15 billion are required to be deposited in the BRF. In FY 2018, based on the Volatility Cap, most of the income tax collections received above budget were deposited in the BRF. Under midterm budget revision legislation, the General Assembly used a portion of the BRF to balance FY 2018 operations. In addition, the General Assembly did not address the outyear budget gaps starting in FY 2020, which stem from a number of revenue enhancements (approximately $1.2 billion) that are included in the FY 2019 budget but are scheduled to expire in FY 2020. In KBRA's view, the Volatility Cap significantly reduces the budget volatility historically experienced by the State caused by the difficulty in estimating income tax revenues.

Newly elected Governor Lamont and his administration have put forth a recommended budget that addresses the outyear structural imbalance largely through a proposal to continue existing revenue policies, through broadening the sales and use tax, and individually minor but numerous revenue enhancements. The Governor's proposed FY 2020-2021 biennium budget for the State's General Fund is balanced, but legislative approval is pending. Absent legislative remediation, the baseline budget gaps over the FY 2020-2021 biennium is an estimated $3.7 billion.

In KBRA's view, the State economy continues to grow at a slower pace than regional and national growth trends. Since 2010, the State has also generally lagged the New England region and the United States in growth in total employment and reduction of the unemployment rate.

Key Rating Strengths

- Strong wealth levels with State per capita income the highest in the nation.
- Budget Reserve Fund balance has increased and this trend is expected to continue.
- Strong financial management framework for tracking revenues and monitoring budget performance as well as an established mechanism for adjusting budgeted expenditures during the fiscal year that is supported by proactive management.

Key Rating Concerns

- Increasing budgetary burdens for debt service, pension contributions, and Medicaid.
- Continued lack of significant growth in employment levels across the State.
- Debt burden and the level of pension liabilities are high, compared to other states, on a per capita basis and as a percentage of personal income and GSP.

Drivers for Rating Change	
• Trend of structurally balanced operations and accurate revenue projections in the General Fund accompanied by sustained increase in the funding level of State's Budget Reserve Fund. • Significant improvement in the funded ratios for the State's pension systems.	+
• Structural operating deficits in the General Fund. • Continued pressure on personal income tax collections resulting from difficulty in projecting final and estimated tax collections, further shifts in the State's employment base or decline in economic activity.	-

KBRA's **Negative Outlook** reflects the State's past difficulties accurately projecting revenues and maintaining structural balance. KBRA's view incorporated in the Negative Outlook could change should recent favorable fiscal trends continue, particularly regarding revenue performance and the budgetary outlook.

Key Ratios

Rating Highlights	
Per Capita Personal Income (2017) (in dollars)	$71,823
as a % of U.S.	*139%*
Population (2017)	3,588,184
Growth 2010 to 2017	*0.2%*
Real GDP, % Change 2010 to 2017	
Connecitcut	-3.4%
New England	8.1%
United States	15.7%
Budget Reserve Fund Balance (dollars in millions)	
at FYE 2017	$213
at FYE 2018	$1,185
at FYE 2019 (Estimated)	$1,968
Total Direct Pro Forma Debt (dollars in millions)	$25,591
Net Pension Liability (6/30/2017 Measurement Date) (dollars in millions)	$34,811
Fixed Costs as a % of Governmental Expenditures (FY 2018)	20.4%

Rating Determinants (RD)	
1. Management Structure, Budgeting Practices and Policies	AA+
2. Debt and Additional Continuing Obligations	A+
3. Financial Performance and Liquidity Position	A+
4. State Resource Base	AA-

Key Rating Determinants

RD 1: Management Structure, Budgeting Practices and Policies

KBRA views Connecticut's management structure and policies as providing a very strong framework for managing its financial operations and debt issuance compared with other states. This framework is established by the State Constitution, Statutes, and administrative practices. Within this framework, the prior administration achieved good financial results in FY 2018 and this trend is continuing thus far through FY 2019. The newly elected Governor, Ned Lamont, has identified fiscal stability as one of his top priorities.

Constitutional Provisions

Under Connecticut's Constitution, the State is divided into three distinct branches: The Legislative, Executive, and Judicial. The executive power of the State is vested in the Governor. Governor Ned Lamont was elected in November of 2018 for a term beginning in January 2019 succeeding two-term Governor Dannel Malloy. Treasurer Shawn Wooden was also elected November 2018 succeeding Treasurer Denise Nappier, who had served in the role since 1999. The Treasurer is primarily responsible for receiving and disbursing monies of the State, and is the sole fiduciary of the State's retirement funds. The Treasurer also has the responsibility for carrying out the issuance of debt. The Comptroller is required to issue monthly budgetary reports on the State's financial condition, in conjunction with the Office of Policy and Management (OPM). OPM is directly responsible to the Governor for policy development in the areas of budget and financial management and prepares the State budget.

The State's Constitution provides that the General Assembly may not authorize general budget expenditures in excess of estimated revenues. The Constitution also includes a spending cap on annual growth in expenditures which limits the increase in expenditures to the greater of the five-year average growth in personal income or inflation over the previous year. The cap excludes debt service for general obligation debt. The cap may be exceeded if the Governor declares a fiscal emergency, and both houses of the legislature support such action by a three-fifths vote.

Under the State Constitution, the Governor has the power to veto any line item of any itemized appropriation bill, while at the same time approving the remainder of the bill. The General Assembly may override the Governor's veto by two thirds vote of each legislative house.

Statutory Provisions

State law requires that total net appropriations for each fund shall not exceed estimated revenues for each respective fund.

Under State statute, the State is required to monitor its financial performance monthly and the Governor is empowered to take action, under statutory limitations, to maintain budget balance. State statutes require consensus revenue forecast to be developed on a regular basis three times a year. The State's statutes allow for broad revenue raising ability.

Financial Management Policies

The State operates under a strong and comprehensive framework of financial management policies, most of which are codified in statute. The State's framework for financial management includes the following planning and reporting components:

- <u>Monthly Reports on Financial Performance</u>— By statute, OPM is required to provide the State Comptroller with a letter with monthly updates to revenue and expenditure projections for the General Fund in the current fiscal year, along with projections for end of fiscal year surplus or deficits. Based on the OPM letter, the Comptroller prepares a monthly letter on financial performance. Both the OPM and the State Comptroller's monthly letter is available on the state's website. KBRA views the Comptroller's and OPM's monthly monitoring and projection of the year-end financial position as an extremely valuable tool in managing the State's finances.

- Annual Report to Legislature— By statute, each November, OPM and the Office of Fiscal Analysis (OFA) is required to submit a Fiscal Accountability report to the Legislature which projects revenues, expenditures, and ending balances of each fund for the current biennium and the next three fiscal years.
- Three Year Out Report— As part of the budget process, the Governor must annually submit a separate report to the Legislature which sets forth the estimated revenues and expenditures for the current biennium and the next three fiscal years.
- Consensus Revenue Estimates— OPM and the OFA are required by statute to issue consensus revenue estimates each year by November 10, January 15, and April 30 that cover the current biennium and the next three fiscal years. The development of consensus revenue forecasts utilizes both in house analytic staff and external economic forecasting services. Economic trends are monitored and factored into monthly updates on revenue projections.

The Treasurer has investment responsibility for all funds of the State and functions as the trustee of all State pension, retirement, and trust funds. The Treasurer is required to report annually on investment activities by December 31 to the Governor and the State's Investment Advisory Council.

State Budget Process

The State's fiscal year begins on July 1 and ends on June 30. The Governor is required to transmit a budget document to the General Assembly in February of odd numbered years setting forth a separate budget for each of the biennium years. Under State Statute, the Governor has the ability to run the State under Executive Order to maintain essential services in the absence of a budget.

In each even numbered year, the Governor must prepare a report (Mid Term Budget Report) on the status of the budget enacted in the previous year with any recommendations on adjustment and revisions for the coming year. All budget recommendations incorporate the consensus revenue estimate process. If a budget surplus or deficit is projected, the Governor will recommend how the deficit will be mitigated or how the surplus will be used.

Ability to Adjust Expenditures and Deficit Mitigation

Under State statute, the Governor is empowered during the fiscal year to reduce the budget allotment, or expenditure request, by up to 5.0% of any specific appropriation to an agency, except for aid to municipalities, up to 3% of the total appropriations of any fund under certain circumstances without Legislative approval in order to maintain balanced financial operations. Such reductions to expenditures are also referred to as rescissions. Such budget allotments are subject to further modification by the Governor throughout the fiscal year if necessary. Beyond these limits, the General Assembly must act to reduce expenditures.

If the monthly status letter on financial performance issued by the Comptroller indicates a projected General Fund deficit greater than 1% of total General Fund appropriations, the Governor is required within thirty days to submit a report to the General Assembly that outlines a plan that the Governor shall implement to reduce expenditures to prevent a deficit.

Over the last several years, the Governor has adjusted the State's operating budget through the rescission process a number of times in response to projected deficits identified as part of the monthly monitoring of financial performance.

Budget Reserve Fund

State statutes dictate that unappropriated surpluses left in the General Fund shall be transferred to the Budget Reserve Fund until the Fund reaches an amount equal to 15.0% of the net General Fund appropriations. The Budget Reserve Fund may only be transferred into the General Fund to fund a deficit in the immediately preceding fiscal year. The Revenue Volatility Cap requires that estimated and final payments of the personal income tax in excess of $3.15 billion be deposited into the Budget Reserve Fund beginning in FY 2018.

State Debt Limit

State statutes impose a ceiling on the amount of General Fund supported debt which may be authorized by the Legislature. The limit is 1.6x net General Fund tax receipts as projected by the Finance, Revenue and Bonding Committee of the General Assembly for the fiscal year in which the bonds are authorized. Certain types of debt are excluded from this cap, including cash flow borrowings and emergency financings. The cap currently permits the issuance of up to $25.4 billion and there is now $21.9 billion outstanding, guaranteed or authorized leaving a debt incurring margin of $3.4 billion.

General obligation debt is issued under State debt statutes and specific bond authorizations. These statutes provide that the bonds will be general obligations of the State and that the full faith and credit of the State is pledged for repayment. As per the State's contract with the owners of the bonds, all amounts necessary for payment of principal and interest is appropriated without need for legislative approval. There are no express statutory provisions establishing any priorities in favor of general obligation bondholders over other claims against the State. Connecticut is not a voter initiative state.

Municipal Accountability Review Board (MARB)

Statutes passed by the General Assembly as part of the FY 2018-FY 2019 budget process established a Municipal Accountability Review Board (MARB) to provide oversight and assistance to municipalities experiencing fiscal distress. The State has assumed the annual debt service obligations of the City of Hartford under this program. KBRA has added Hartford's outstanding debt of $516 million to the State's aggregate outstanding debt.

The State is also providing support to the City of West Haven under MARB. The support for West Haven currently amounts to about $8 million per year and is expected to be short-term.

Bankruptcy

Under Chapter 9 of the U.S. Bankruptcy Code, State governments are not permitted to petition courts for protection from creditors, including holders of their general obligation debt.

Based on the foregoing, KBRA views Connecticut's management structure, budgeting practices, and policies as continuing to be consistent with a AA+ rating determinant rating.

RD 2: Debt and Additional Continuing Obligations

State Tax-Supported Debt

Connecticut has a tax-supported debt burden of $25.6 billion including $18.9 billion in general obligation debt inclusive of the currently offered bonds, $6.0 billion in special tax debt secured by a pledge of transportation related taxes and fees, and $277 million in various other obligations. Also included in this figure is $515.9 million in City of Hartford debt. The State has assumed Hartford's debt service payments on this debt under a Contract for Financial Assistance executed in April 2018 as part of a plan to stabilize the financially distressed city. In comparison with other states, Connecticut's state tax-supported debt burden is high. These high debt levels result in part from the State's practice of issuing general obligation debt for certain university projects and for purposes that municipal entities and counties fund in other states, including local school construction. Connecticut has not had a county form of government since October 1960.

FIGURE 1

Pro Forma Direct Tax-Supported Debt
Principal Amount Outstanding
(dollars in thousands)

	2/1/2016	2/1/2017	2/15/2018	2/1/2019
General Obligation Bonds	13,529,951	14,090,513	14,038,169	14,007,964
Currently Offered GO Bonds	-	-	-	*850,000*
General Obligation Bond Anticipation Notes	-	-	400,000	0
Pension Obligation Bonds (GO)[1]	2,346,499	2,351,187	2,369,532	2,367,505
UConn 2000 Bonds (GO)	1,059,285	1,532,895	1,420,535	1,635,125
Total General Obligation Debt	16,935,735	17,974,595	18,228,236	18,860,594
Special Tax Obligation Bonds	4,519,700	5,041,800	5,540,495	5,957,600
Other[2]	320,463	326,883	302,343	256,706
State Guaranteed City of Hartford Debt	-	-	-	515,910
Total Direct Tax-Supported Debt	**21,775,898**	**23,343,278**	**24,071,074**	**25,590,810**

Source: Historic State of Connecitcut General Obligation Bond Official Statements.

[1]Includes accreted value of Capital Appreciation bonds.

[2]Includes lease financing, tax increment financings, CHFA Supportive Housing Bonds and CHFA Emergency Mortgage Assistance Program Bonds.

Connecticut's state tax-supported debt burden is high relative to population, personal income and GSP, ranking among the very highest in the Country by all three metrics. The State's debt burden compares more favorably however when analyzed on the basis of aggregate state and local borrowings. By this more inclusive measure, the State's debt burden falls to the top 30% of states compared to personal income and to the top 20% of states compared to GSP (Figure 2).

FIGURE 2

Debt Ratios (in dollars)	Connecticut[1]	Average of U.S. States	Connecticut Rank Among the 50 States
Tax-Supported Debt:			
Per Capita	$7,132	$ 1,599	Highest 10%
as a % of Personal Income	9.9%	3.1%	Highest 10%
as a % of GSP	9.7%	2.7%	Highest 10%
Aggregate State and Local Debt:			
Per Capita	$13,319	$9,167	Highest 10%
as a % of Personal Income	19.2%	18.4%	Highest 30%
as a % of GSP	18.2%	15.8%	Highest 20%

Source: U.S. Census Bureau, U.S. Bureau of Economic Activity, Credit Scope, and Annual Disclosures

(1)Connecticut Tax-Supported Debt is as of July 1, 2018.

Connecticut has a relatively small level of exposure to variable rate debt or derivative financings; hence these types of transactions do not pose a significant risk to the State's liquidity position. As of March 1, 2019, the State has $1.25 billion in variable rate general obligation bonds, which represents approximately 7.5% of long term GO debt. Approximately $542 million are SIFMA index based bonds (no put option) and another $690 million are VRDB and direct placement bonds. The State has one outstanding GO swap with the notional amount of $20 million that will mature June 1, 2020. Under the swap agreement, the State controls termination unless its rating falls below the BBB level.

Debt Amortization

Connecticut's debt amortization parameters are conservative, with GO debt generally required to be amortized over 20 years on a level principal basis, which generates a declining debt service schedule. Speed of amortization of direct general obligation debt, is above average with 69% of principal retired over the next 10 years. In FY 2018, debt service on long term direct GO Bonds represented 8.2% of total governmental expenditures (on a GAAP basis) for FY 2018.

Capital Improvement Plan

The State's net new general obligation bond authorizations for capital projects decreased from $2.8 billion in FY 2015 to approximately $1.4 billion in FY 2019 and the Governor's proposed budget calls for authorizations slightly below $1.0 billion in FY 2020 and FY 2021 as a belt tightening measure reflective of the State's ongoing budget pressure.

State of Connecticut Retirement Systems

Connecticut administers two major pension plans: the State Employees' Retirement System (ERS) and the State Teachers' Retirement System (TRS). It also administers the Judicial Retirement System (JRS) which is much smaller in scope and not discussed in detail. The State's level of funding for its pension plans remains among the lowest for US states. The funded ratio for ERS is 36.4% and for TRS is 57.7%. The State has contributed to these funds at the full Actuarially Determined Employer Contribution (ADEC) in recent years.

<u>State Employees' Retirement System (ERS)</u>

ERS is a single-employer defined benefit pension plan that provides retirement, disability, and death benefits to plan members and their beneficiaries. The ERS system covers State employees. Employees also contribute. Full actuarial valuations are performed by a third-party consultant as of June 30 of each even numbered year, with the last full valuation completed as of June 30, 2018.

On July 31, 2017, the General Assembly approved an agreement between the State and State Employee Bargaining Agent Coalition (SEBAC) which made substantial changes to pension and healthcare benefits for State employees and retirees. These changes included a three-year wage freeze, increased employee pension contributions for existing ERS members, reduced COLA formula and change in timing for post 2022 retirees, revisions to the healthcare design plan, and cost sharing for current employees. The State agreed to extend the expiration date of the existing agreement with SEBAC on pension and healthcare from 2022 to 2027.

<u>Teacher's Retirement System (TRS)</u>

TRS is a single-employer defined benefit pension plan administered by the Teachers' Retirement Board (TRB) for teachers, principals and other education supervisors employed in public school districts. Connecticut also pays the entire required annual employer contribution to its pension plans on behalf of participating school districts and public universities statewide. The teachers also contribute.

In April 2008, Connecticut issued $2.3 billion in taxable Pension Obligation Bonds (POB) which was deposited into the Teachers' Retirement Fund. As part of the POB issuance, the bond documents included a covenant requiring the State to contribute 100.0% of the actuarially determined employer contribution based upon a closed amortization period ending in 2032. However, the State plans to extend the amortization period 17 years. As an alternative to this closed amortization provision, the State is establishing a Special Capital Reserve Fund and funding it with $380.9 million from the Budget Reserve Fund. In addition, net lottery revenues (which are projected to be $371 million in FY 2020) are proposed to be pledged to replenish the SCRF in the event of a draw. Furthermore, the assumed investment rate of return on the TRS has been reduced from 8% to 6.9% (a level that KBRA considers more realistic). The State Attorney General has opined that these changes provide adequate protection to the POB bondholders.

FIGURE 3

Pension Funded Status
as of June 30, 2018 (dollars in millions)

	ERS	TRS	Total
Market Value of Assets	12,453	17,947	30,400
Actuarial Accrued Liability	34,214	31,111	65,325
Unfunded Actuarial Accrued Liability	21,223	13,159	**34,382**
Funded Ratio (based on the market value of assets)	36.4%	57.7%	46.5%
FY 2018 Actuarially Determined Employer Contribution (ADEC)	1,443	1,271	**2,714**
% of ADEC Contributed	100%	100%	

Source: State of Connecticut Annual Information Statement dated February 20, 2019.

Net Pension Liability

The State's net pension liability, based on GASB 68 reporting requirement, represents a combined liability for all of the State pension funds, ERS, TRS and JRS. The net pension liability begins with the total actuarial pension liability for all funds based upon the entry age normal actuarial method. From this amount, the market value of invested pension fund assets is deducted and the balance is the net pension liability. The combined NPL for the State measured as of June 30, 2017 and included in the Statement of net position in the State's FY 2018 audited financial statements is $34.8 billion. This NPL ranks among highest in the country when compared to population, personal income, and GSP (Figure 4). In FY 2018, the State's combined contribution toward pensions was $2.74 billion including $1.44 bn to ERS, $1.27 bn to TRS, and $25 million to JRS. This total contribution was equivalent to 8.2% of FY 2018 total governmental expenditures.

FIGURE 4

Net Pension Liability (NPL) Ratios
(in dollars)

	Connecticut 2018	Average of U.S. States 2017	Connecticut Rank Among the 50 States
Net Pension Liability:			
Per Capita	$9,633	$2,045	Highest 10%
as a % of Personal Income	13.4%	3.9%	Highest 10%
as a % of GSP	13.1%	3.5%	Highest 10%

Source: Credit Scope, FY 2017 Data. All figures represent the Net Pension Liability as reported in the Statement of Net Position per GASB 68.

The State has fully funded the actuarially recommended contribution for the ERS plan since 2012 and on the TRS plan since 2006. More current unfunded pension liability figures as of the June 30, 2018 measurement date, which are available only for ERS and TRS, indicate a total unfunded pension liability of $34.4 billion. Seen below, contributions to ERS and TRS have grown consistently in recent years and are anticipated to increase to $3.17 billion in FY 2020.

FIGURE 5

Actuarially Determined Employer Contributions for ERS and TRS FYE June 30 (dollars in millions)							
	2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
ERS	$1,269	$1,379	$1,515	$1,569	$1,443	$1,575	$1,773
TRS	$949	$984	$976	$1,012	$1,271	$1,292	$1,392
Total	**$2,217**	**$2,363**	**$2,490**	**$2,581**	**$2,714**	**$2,867**	**$3,166**
% Δ YOY		*6.6%*	*5.4%*	*3.7%*	*5.1%*	*5.6%*	*10.4%*

Source: State of Connecticut Annual Information Statement dated February 20, 2019.

Other Post-Employment Benefits (OPEB)

Connecticut provides healthcare and life insurance benefits to eligible state employees who retire from State employment. The State funds the cost of these benefits on a pay as you go basis, as do most states, through a transfer from the General Fund to its OPEB trust fund. The OPEB Trust was established for the payment of post-retirement benefits and for the accumulation of assets for future payment of retiree benefits. The State has phased in payment by all employees of 3% of annual salary to the OPEB trust fund for a period of ten years. It is not expected that the OPEB trust will contribute a significant amount to funding post-retirement healthcare benefits, although the Governor's proposed FY 2020-2021 budget includes for each year, in accordance with the 2011 SEBAC agreement, an appropriation of around $120 million to match State employee contributions to the OPEB trust. Changes related to the most recent SEBAC labor agreement, specifically relating to the implementation of the Medicaid Advantage with Prescription Drug program, is expected to reduce OPEB healthcare liabilities significantly. In FY 2018, the State's contribution to retiree healthcare and life insurance costs was $821 million, which represents 2.8% of FY 2018 total governmental expenditures.

Total Fixed Costs

If certain fixed costs are aggregated, including debt service, pension contributions and pay-as-you-go OPEB costs, the total amount paid by the State in FY 2018 represented 20.4% of total governmental expenditures for FY 2018.

Based on the foregoing, KBRA views the State's debt and additional continuing obligations as continuing to be consistent with the A+ rating determinant rating.

RD 3: Financial Performance and Liquidity Position

The State's financial position trended favorably in FY 2018 and is outperforming projections in FY 2019 YTD, lifted by markedly better than budgeted personal income tax (PIT) receipts in the General Fund. Lower than budgeted PIT collections had historically weighed on the State's operating performance. Effective in FY 2018, however, there was a swing to substantially better than projected PIT collections. This has allowed the BRF to grow from 1.2% of General Fund expenditures in FY 2017 (BRF of $213 million) to 6.5% in FY 2018 (BRF of $1.20 billion). The BRF balance is estimated to improve further to a strong 10.4% of estimated FY 2019 expenditures ($2.0 billion) by the end of the current 2019 fiscal year ending June 30, although KBRA notes that a degree of uncertainty for year-end results will remain until collections for the typically outsized month of April are tabulated.

The newly seated Lamont administration released a proposed FY 2020-2021 biennium budget in February that identifies a baseline $3.7 billion revenue gap (9.4% of baseline biennium expenditures) that will need to be addressed in the current legislative session. In discussion with KBRA, the Governor identified fiscal stability as one of his top three priorities. The governor's proposal calls for closing this gap and adding to reserves by renewing the hospital user fee on a permanent basis, renewing certain expiring revenue initiatives and or eliminating future tax cuts, and expanding the breadth of the sales tax base. The proposal is based on consensus revenue estimates and does not rely one-shot revenues, but legislative approval is pending.

FY 2018 Financial Results

Under the State's Volatility Cap included in the FY 2018 – 2019 biennium budget (Public Act 17-2), any final and estimated income tax collections over $3.15 billion are required to be deposited in the BRF. The final and estimated income tax collections are highly volatile, and the legislation helps insulate General Fund operations. FY 2018 was the first year of the required transfers.

In the State's comprehensive annual financial report, the BRF is shown as part of committed fund balance in the General Fund. On a GAAP basis the General Fund unassigned deficit declined to -$241 million, from -$821 million at the close of FY 2017, largely reflecting the improved BRF balance (Figure 6).

FIGURE 6

General Fund Summary Statement of Income and Fund Balances FYE June 30 (GAAP Basis) (dollars in millions)	2014	2015	2016	2017	2018
Revenues	17,400	17,954	18,215	18,502	20,663
Expenditures	16,591	16,936	17,444	17,138	18,077
Excess (Deficiency) of Rev. Over Exp.	809	1,018	771	1,364	2,586
Other Financing Sources (Uses)	(262)	(1,166)	(1,195)	(1,243)	(940)
Net Change in Fund Balance	**547**	**(148)**	**(424)**	**121**	**1,646**
Fund Balance (Deficit) - Beginning	(589)	(41)	(190)	(614)	(494)
Change in Reserve for Inventories	0	(1)	(0)	(1)	(0)
Fund Balance (Deficit) - Ending	(41)	(190)	(614)	(494)	1,151
Ending Fund Balance					
Nonspendable	50	51	53	54	56
Committed for:	-	-	-	-	-
Continuing Appropriations	86	65	97	60	134
Budget Reserve Fund	**519**	**406**	**236**	**213**	**1,201**
Future Budget Years	31	81	-	-	-
Unassigned	(727)	(793)	(999)	(821)	(241)
Fund Balance (Deficit) - Ending	(41)	(190)	(614)	(494)	1,151
Budget Reserve Fund as a % of Expenditures	*3.1%*	*2.4%*	*1.4%*	*1.2%*	*6.6%*
Unassigned Fund Balance as a % of Expenditures	*-4.4%*	*-4.7%*	*-5.7%*	*-4.8%*	*-1.3%*
Total Fund Balance as a % of Expenditures	*-0.2%*	*-1.1%*	*-3.5%*	*-2.9%*	*6.4%*

Source: State of Connecticut CAFRs FY 2014 to FY 2018.

As presented in the State's audited budgetary based financial report, the General Fund incurred a $483 million operating deficit in FY 2018 (Figure 7). This result is net of a $1.47 billion transfer to the BRF. The operating deficit was eliminated by a transfer from the BRF. The net effect of the two transfers was a $1.2 billion ending BRF balance. The BRF ending balance was 6.5% of expenditures. The volatility of the State's income tax collections necessitates an ample cushion against difficult to predict declines. The Comptroller's office recommends the BRF reach a level of 15% to protect against a future economic downturn.

FIGURE 7

General Fund Statement of Revenues, Expenditures, and Net Surplus Budgetary Modified Cash Basis (FYE June 30) *(dollars in millions)*	2014	2015	2016	2017	2018
Operating Revenues[1]	17,009	17,282	17,781	17,703	18,199
Operating Expenditures	16,980	17,420	17,921	17,763	18,611
Other Resources	29	25	(30)	37	(71)
Net Operating Surplus (Deficit)	58	(113)	(170)	(23)	(483)
Transfers (to) from Budget Reserve Fund	(248)	113	170	23	483
Reserved for Subsequent Years Expenditure	-	-	-	-	-
Reserved for Prior Years Resources	191	-	-	-	-
Net Surplus (Deficit)	**-**	**-**	**-**	**-**	**-**
Beginning Budget Reserve Fund Balance	271	519	406	236	213
Transfers from (to) General Fund	248	(113)	(170)	(23)	(483)
Volatility Cap Deposit[2]	-	-	-	-	1,471
Ending Budget Reserve Fund Balance	**519**	**406**	**236**	**213**	**1,201**
as a % of Operating Expenditures	*3.1%*	*2.3%*	*1.3%*	*1.2%*	*6.5%*

Source: Annual Financial Reports of the State Controller

[1]FY 2018 revenue is reported net of a $1.47 billion deposit to the BRF.

[2]Per Public Act 17-2 of the June 2018 Special Session, estimated and final income tax collections above $3.15 billion are transferred to the BRF. FY 2018 estimated and final income tax collections totaled $4.62 billion, resulting in a $1.47 billion BRF deposit.

Overall, FY 2018 General Fund revenue performance was exceptionally strong as personal income taxes (PIT) exceeded budget by $1.59 billion. Withholding taxes outperformed budget by 1.8%, while estimated and final taxes were 47.2% over budget. Changes in federal tax law are believed to have influenced taxpayer behavior, including an increase in capital gains reporting and accelerated tax payments to maximize deductions prior to the expiration of uncapped state and local tax deductions. Additionally, there was a one-time unbudgeted payment of income taxes on the repatriation of overseas profits of hedge fund managers that the IRS required be brought back to the US by the end of calendar year 2017 (Section 457A of the IRS code, enacted in 2008).

Other revenue categories experienced weakness, including sales and use tax (-$18.3 million), corporations tax (-$12.5 million), public service corporations (-$34 million), cigarette taxes (-$17.8 million). General Fund federal grant revenue was $623.2 million below budget due in part to a delay in approvals for Medicaid reimbursements related to supplemental hospital payments. These federal payments were received in FY 2019.

General Fund expenditures increased 4.8% in FY 2018. This elevated increase is largely driven by a revision to policies regarding hospital funding. Supplemental hospital payments increased $562 million, although a portion of the cost is expected to be offset by higher federal Medicaid payments which were received in FY 2019. Other sizable cost growth areas were teacher pension funding ($258.9 million) and debt service ($182.3 million). KBRA notes the state achieved a negotiated labor agreement which helped contain state employee labor costs.

FIGURE 8

General Fund Revenues
Budgetary Modified Cash Basis (FYE June 30)

(dollars in millions)	2014	Δ YOY (%)	2015	Δ YOY (%)	2016	Δ YOY (%)	2017	Δ YOY (%)	2018
Personal Income Tax	8,719	5.0%	9,151	0.3%	9,182	-2.1%	8,989	19.8%	10,770
Federal Grants	1,244	-0.2%	1,241	4.9%	1,302	1.8%	1,325	-13.7%	1,143
Sales and Use Tax	4,101	2.5%	4,205	-0.6%	4,182	0.2%	4,192	0.2%	4,202
Corporate Income Tax	782	4.2%	815	8.1%	880	17.8%	1,038	-11.3%	921
Excise Taxes (Alcohol and Cigarettes)	437	-3.9%	420	3.9%	437	1.8%	445	-1.1%	440
Indian Gaming Payments	280	-4.2%	268	-0.8%	266	1.5%	270	1.1%	273
Statutory Transfers from Other Funds	874	-84.5%	135	31.4%	178	-33.5%	118	-7.3%	110
Other	573	82.6%	1,046	29.5%	1,355	-2.1%	1,326	-74.4%	340
Total Revenues	**17,010**	1.6%	**17,282**	2.9%	**17,781**	-0.4%	**17,703**	2.8%	**18,199**

Source: Annual Financial Report of the State Controller FY 2014 to 2018.

FIGURE 9

General Fund Expenditures
Budgetary Modified Cash Basis (FYE June 30)

(dollars in millions)	2014	Δ YOY (%)	2015	Δ YOY (%)	2016	Δ YOY (%)	2017	Δ YOY (%)	2018
General Government	606	9.1%	661	-5.1%	627	-6.8%	585	10.7%	648
Public Safety	278	3.4%	287	0.5%	289	-4.9%	274	-5.3%	260
Conservation and Development	221	-6.8%	206	-5.3%	195	-7.1%	181	0.0%	181
Health and Hospitals	1,827	-2.3%	1,785	-1.1%	1,766	-32.6%	1,190	-2.2%	1,163
Human Services	3,216	-3.7%	3,096	0.2%	3,102	16.9%	3,625	18.4%	4,292
Education, Libraries and Museums	4,695	7.0%	5,025	1.9%	5,122	-2.3%	5,004	0.4%	5,025
Corrections and Judicial	2,023	2.3%	2,070	-0.5%	2,061	-5.4%	1,949	-2.0%	1,911
Debt Service	1,646	-5.6%	1,554	17.8%	1,831	5.7%	1,935	0.9%	1,951
Other	2,467	10.9%	2,735	7.1%	2,929	3.1%	3,020	5.3%	3,180
Total Expenditures	**16,980**	2.6%	**17,420**	2.9%	**17,921**	-0.9%	**17,763**	4.8%	**18,611**

Source: Annual Financial Report of the State Controller FY 2014 to 2018.

Fiscal 2019

The Budget Reserve Fund is expected to close FY 2019 with an improved balance, as personal income taxes, while declining YOY, are estimated to outperform budget. As of the January 15, 2019 consensus forecast, the State's estimate for personal income taxes reflects a 9.7% decline from the prior year. If taxpayer behavior changes in the balance of the fiscal year and affects estimated and final portion of PIT collections, the state expects the impact will not be evident until the April 30 consensus estimate. Most recently, in the March 2019 Comptroller's announcement, FY 2019 income taxes are expected to be about $100 million lower than the January 2019 consensus forecast, as the federal tax changes and the stock market's negative performance in 2018 may impact estimated and final collections for the balance of the year.

Sales tax collection growth is estimated at 2.1%, a strong positive revision from the November 2018 estimate. The improvement reflects increased collection from online sales, partially due to the U.S. Supreme Court decision Wayfair, Inc. v. South Dakota.

The projected General Fund operating surplus of $516 million is net of the estimated $648 million volatility transfer to the BRF (Figure 10). Of the estimated $516 million operating surplus, $381 million is proposed to be transferred to the Teachers Retirement System Special Capital Reserve Fund with the remaining $135.1 million deposited to the BSF. The year-end BRF balance is projected at $1.97 billion or approximately 10.4% of FY 2019 estimated General Fund expenditures. The TRS Special Capital Reserve Fund is being established to comply with the adequate provision requirement of the 2008 GO pension obligation bonds. The Governor has proposed changing the actuarial funding methodology for the TRS; to make this change requires meeting the adequate provision covenant.

FIGURE 10

General Fund Estimated and Proposed Budget Operations and BRF Balance
FYE June 30 ($ in millions) (Budgetary Basis)

	FY 2019	FY 2020		FY 2021	
	Estimated 2019	**Baseline Estimate**	**Proposed Budget**	**Baseline Estimate**	**Proposed Budget**
Prospective Operations					
Revenues[1]	19,473	17,993	19,268	18,140	19,887
Expenditures	18,957	19,528	19,259	20,348	19,867
Surplus (Deficit)	**516**	**(1,535)**	**9**	**(2,208)**	**20**
as a % of Expenditures	2.7%	-7.9%	0.0%	-10.9%	0.1%
Budget Reserve Fund Balance					
Beginning Budget Reserve Fund Balance[2]	1,185		1,968		2,354
Operating Surplus (Deficit)	516		9		20
Volatility Cap Deposit	648		280		269
Revenue Transfer Cap	-		97		150
Proposed Transfer to TRS SCRF	(381)		-		-
Estimated Ending BRF Balance	**1,968**		**2,354**		**2,794**
as a % of Budgeted Expenditures	*10.4%*		*12.2%*		*14.1%*

[1] Net of amounts for volatility transfer and revenue transfer cap.

[2] Beginning FY 2019 BRF balance differs slightly from the $1.20 billion GAAP balance due to differences in accounting

Source: State of Connecticut

Governor's Biennium Budget

Absent policy changes, baseline estimates for General Fund are operating deficits of -$1.5 billion and -$2.2 billion in FYs 2020 and 2021, respectively, as reported in the Governor's proposed budget (Figure 10). The outyear gaps are projected to grow larger, with a FY 2023 gap of $3.7 billion projected by the Office of Fiscal Analysis's in their annual General Fund Budget Projections prepared in May 2018.

To close the gaps over the biennium, the Governor's recommended budget increases General Fund revenues over the baseline, largely through continuation of current policies, with new GF revenues totaling $254 million and $652 million in FYs 2020 and 2021. Most notably, the budget proposes to retain the FY 2019 structure of hospital user fees charged by the state. Public Act 17-4 reduced the hospital user fee beginning in FY 2020, which would have a net impact of -$406 million to the State in FY 2020. The FY 2019 structure, reflects a $900 million hospital user fee, federal reimbursement for approximately half of the fee, and corresponding supplemental payments by the State to the hospitals.

The Governor's budget also seeks to maintain the current 10% corporate tax surcharge ($60 million in FY 2020). Expansions to the sales and use tax (SUT) base are expected to generate $371 million and $653 million in FYs 2020 and 2021, respectively. Larger components of additional SUT in FY 2020 are derived from freezing the diversion of the car sales tax to the Special Transportation Fund ($91 million), repeal of the exemption for trade in vehicles ($60 million) and expansion of the tax to include legal services ($35 million).

Appropriation initiatives to close the gap include labor savings ($182 million and $95 million in FYs 2020 and 2021, respectively) and a reduction in the teachers' pension costs ($183 million and $189 million in FYs 2020 and 2021, respectively).

Liquidity Position

The State's liquidity position remains strong. Available cash balances have averaged $3.74 billion thru February 23, 2019, relative to a $2.76 billion average balance in FY 2018. FY 2019 available cash balances have consistently exceeded estimated balances. The common cash pool represents the State's operating cash. Available cash includes bond funds and other balances which can be made available to the common cash pool through temporary transfers under long established State practice. The State's level of cash in the common cash pool at a given point in the fiscal year reflects the seasonality of cash flow. The level of total available cash is impacted both by the rate of bond issuance and the rate of spending from those bond funds. The State has no plans to issue cash flow notes.

FIGURE 11

Available Cash Balance
FYE June 30 (dollars in millions)

	6/30/2014	6/30/2015	6/30/2016	6/30/2017	6/30/2018	1/26/2019
Common Cash Pool	$941	$1,092	$821	$1,101	$1,871	$3,226
Total Available Cash	$1,781	$2,218	$1,764	$2,657	$3,399	$4,605

Source: State of Connecticut Treasurer's Office - Cash and Debt Monthly Reports.

Based on the foregoing, KBRA views the State's financial performance and liquidity position as continuing to be consistent with the A+ rating determinant rating.

RD 4: State Resource Base

The State's resource base is highly developed but has experienced slow growth in recent years. Per capita personal income ranks first among the 50 States and high levels of educational attainment and low levels of poverty position the State well relative to peers in several areas. Population growth however has been flat since 2010 as the New England region and U.S. have growth rates of 2.4% and 5.3%, respectively. Per capita personal income levels have additionally grown slowly in recent years and real Gross State Product (GSP) through 2017 has contracted since 2010.

The State however continues to benefit from a diverse and highly productive economic base. In 2018, 16 "Fortune 500" companies were headquartered in Connecticut, including United Technologies Corporation (UTC), Cigna, Praxair, Stanley Black & Decker and Hartford Financial Service Group. KBRA notes that the defense industry is an important component of the State's economy and has demonstrated renewed strength since 2002 and this trend is expected to continue. Major defense companies include UTC and its Pratt and Whitney Aircraft Division, Sikorsky Aircraft (a division of Lockheed Martin), and General Dynamics Corporation's Electric Boat Division. In July of 2018 the State announced that KPMG would be adding 110 new jobs to its Stamford office over the next five years. In addition to KPMG, Seven Stars Cloud Group is establishing its global headquarters for technology and innovation at the University of Connecticut's former campus in West Harford and expects to create 330 jobs over the next five years. Additionally, digital services and consulting firm Infosys opened a technology and innovation hub in Hartford in December 2018 with plans to expand the facility to 1,000 jobs by 2023.

FIGURE 12

	2017 Population	Chg. from 2010	2017 Age Dependency Ratio[1]	Chg. from 2010[2]	2017 Population w / B.A. Degree of Higher[4]	Chg. from 2010[2]	2017 Poverty Level	Chg. from 2010[2]
Connecticut	3,588,184	0.2%	59.9%	1.2%	38.7%	3.1%	9.6%	0.4%
New England[3]	14,810,001	2.4%	58.3%	2.2%	39.7%	4.1%	10.2%	-0.1%
United States	325,719,178	5.3%	61.8%	2.9%	32.0%	3.8%	13.4%	-0.4%
Connecticut as a % of New England	N/A		103%		97%		94%	
Connecticut as a % of U.S.	N/A		97%		121%		72%	

Source: U.S. Census Bureau

	2017 Personal Income ($ billions)	Chg. from 2010	2017 Per Capita Personal Income	Chg. from 2010	2017 Real Gross State Product ($ billions)	Chg. from 2010	2017 Real GSP Per Capita (2012 dollars)	Chg. from 2010
Connecticut	$258	15.8%	$71,823	15.5%	$239	-3.4%	$66,592	-3.7%
New England[3]	$952	26.2%	$64,303	23.3%	$942	8.1%	$63,615	5.6%
United States	$16,820	34.1%	$51,640	27.4%	$18,051	15.7%	$55,418	9.9%
Connecticut as a % of New England	N/A		112%		N/A		105%	
Connecticut as a % of New England	N/A		139%		N/A		120%	

Source: U.S. Bureau of Economic Analysis

[1]Age dependency ratio is the sum of the population under 18 yrs and over 65 yrs divided by persons age 18 to 64 yrs.

[2]Year over year change shown as nominal change in percentage points.

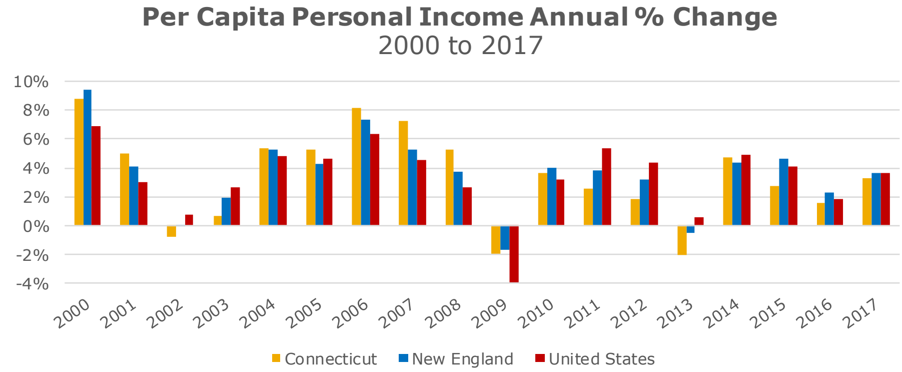
[3]New England region is defined as Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont.

[4]Percent of the population aged 25 and over.

Per Capita Personal Income

Per capita personal income at $71,823 in 2017 is the highest in the county reflecting the concentration of the state's economy in high value-added industries. Historically, income growth has been more cyclically sensitive in the State than in the New England region and the U.S.

FIGURE 13

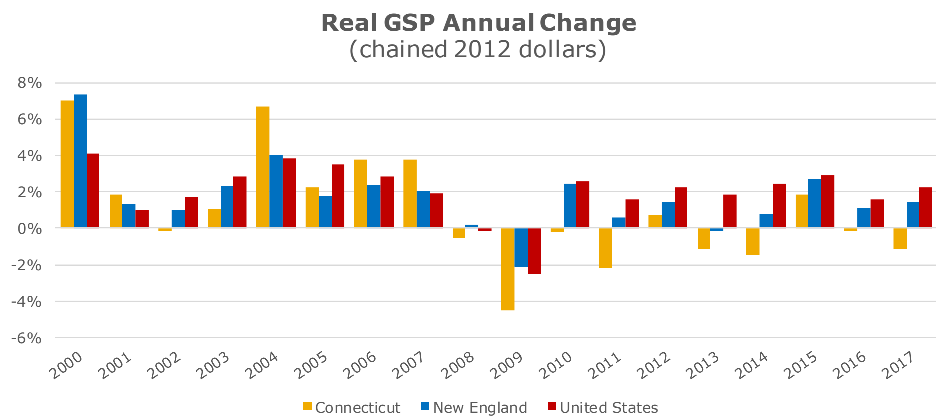


Source: U.S. Bureau of Labor Statistics

Real Gross State Product

Connecticut's real (inflation adjusted) gross state product (GSP) experienced a more pronounced decline and weaker recovery following the Great Recession than the region and U.S. overall, contracting in seven of the last ten years. In KBRA's view, the decline reflects poor performance in from State's pharmaceuticals and financial activities sectors, both of which were outsized contributors to growth in the decade preceding the Great Recession. The financial activities sector has declined from 31.4% of real GSP in 2009 to 26.4% in 2017 as various types of financial institutions have reduced risk-taking activities. Pharmaceutical sector activity has additionally declined due to the withdrawal of Pfizer, Bayer, and Bristol Myers Squib from the State since 2007. This drag is evidenced by the decline in chemical manufacturing as a share of total real GSP from 9.4% in 2007 to 1.6% in 2016.[1]

FIGURE 14



Source: U.S. Bureau of Economic Activity

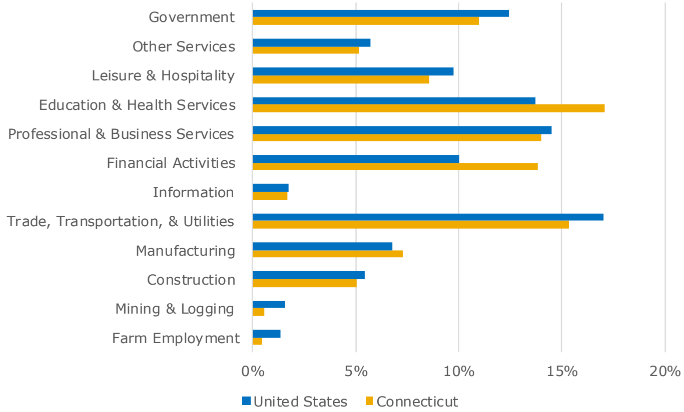
Employment

Connecticut's employment base is broad and benefits from specialization in value added sectors including advanced manufacturing, education/health services and financial activities (Figure 15). Employment growth has been slow through the current economic cycle with 2018 employment exceeding the prior 2008 pre-crisis peak by about 3.0% compared to U.S. jobs 6.7% above this prior high-water mark. Since 2000, the State's employment concentration in education/health services and financial activities has intensified while manufacturing employment has declined (Figure 16). KBRA views the decline in manufacturing employment as consistent with the reduced pharmaceuticals activity discussed previously. Financial activities employment, inclusive of insurance, real estate, and other rental and leasing activity in turn is about 5.1% above its prior 2009 high as of 2017 even as its corresponding share of GSP has declined.

[1] Granular GSP data for chemical manufacturing sector was not disclosed subsequent to 2016.

FIGURE 15

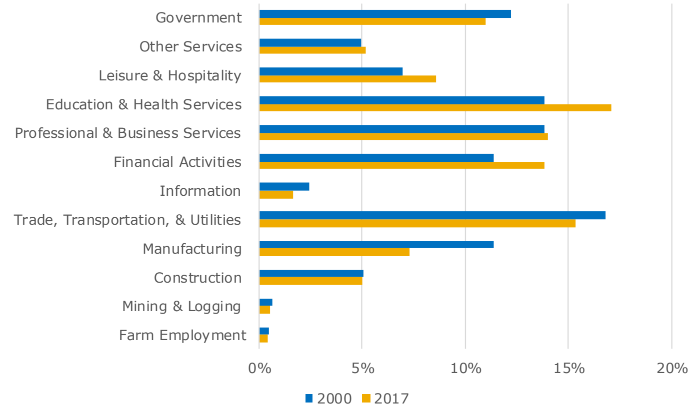
Employment by Sector
Connecticut vs. United States (2017)



Source: U.S. Bureau of Economic Analysis

FIGURE 16

Connecticut Employment by Sector
2000 vs. 2017

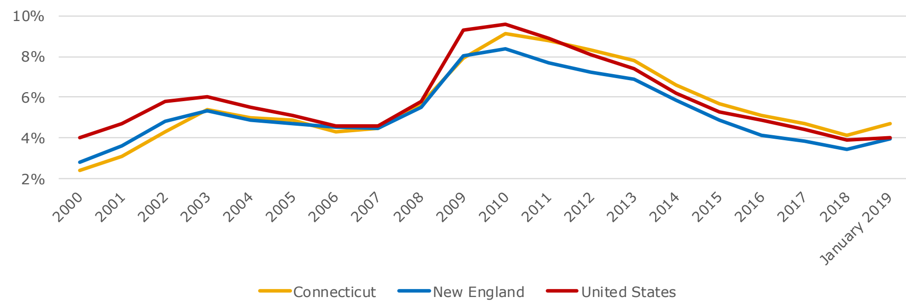


Source: U.S. Bureau of Economic Analysis

Unemployment has tracked closely with the U.S. over the last decade but trailed the performance of the region. The State unemployment rate was 4.7% as of January 2019 which was somewhat higher than the New England region and U.S. at 3.9% and 4.0%, respectively.

FIGURE 17

Unemployment Rate
2000 to January 2019



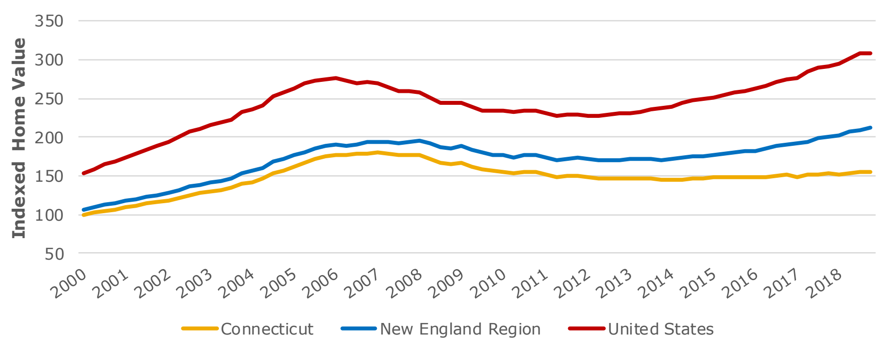
Source: U.S. Bureau of Labor Statistics

Home Value

State home value appreciation has lagged the region and the U.S. by a significant margin since the year 2000. As of Q4 2018, home values are 14.0% below their prior Q1 2007 peak while region and U.S. values have appreciated to 9.4% and 14.4% above their prior peaks, respectively.

FIGURE 18

Home Values
All Transaction Home Price Index Data 2000 Q1 to 2018 Q4



Source: Federal Housing Finance Agency

Based on the forgoing, KBRA views the state resource base as continuing to be consistent with the AA- rating determinant rating.

Conclusion

KBRA has assigned a long-term rating of AA- with a Negative outlook to the State of Connecticut's General Obligation Bonds (2019 Series A) and Taxable General Obligation Bonds (2019 Series A). Additionally, KBRA has affirmed the long-term rating of AA- with a Negative outlook on the State of Connecticut's outstanding General Obligation Bonds. KBRA has also affirmed the long-term rating of AA- with a Negative outlook on the State of Connecticut General Fund Obligation Bonds 2014 Series A issued by Connecticut Innovations, Inc.