Yankee Institute for Public Policy

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Connecticut Borrowed $1.7 Billion for Economic Development and Its Economy Shrank

By Marc Fitch

Since 2011, Connecticut has bonded nearly $1.8 billion for economic development, but the effort has produced little effect on the state's economy.

During the seven year period from 2011 through 2017, Connecticut's gross domestic product declined 1.6 percent when adjusted for inflation, according to figures from the Bureau of Economic Analysis.

The term "economic development" can include brownfield remediation and some municipal projects meant to spur economic growth.

But borrowing for economic development also includes money the state provides for companies to either relocate to Connecticut, expand operations, purchase new equipment, or provide seed money for businesses to grow through several state-run programs.

2011 marked a major increase in state borrowing for economic development as Gov. Dannel Malloy launched both his First Five Program -- which provides loans, grants and tax credits to major companies -- and the Small Business Express program, which serves small businesses.

From 2003 through 2010, Connecticut only bonded $329 million for economic development, even as the state struggled through 2008 recession, according to figures at CTStateFinance.org.

Borrowing for economic development increased suddenly in 2012, growing from $67 million to $260 million.

Since then, Connecticut has consistently borrowed hundreds of millions each year for the purpose of economic development. The forgivable loans, grants and tax credits are mostly made through the Department of Economic and Community Development.

According to the DECD's 2017 annual report, the agency has made $1.1 billion in loans and grants to 278 companies.

The First Five Program has provided, thus far, $321 million in direct state assistance, $160 million in tax credits, $99 million in grants to fifteen large businesses like ESPN, CIGNA, and Bridgewater Associates, according to the DECD's 2018 First Five report.

The state will spend $20 million servicing the First Five debt this year. The tax credits cost an additional $13 million, increasing to $21 million by 2021.

Not including interest on the debt, Connecticut doled out $580 million to create 4,668 jobs — a total of $124,250 per new job through the First Five Program.

The DECD counts retained jobs in their calculations, which lowers the per job cost to 27,292.

Connecticut's investments in those companies, however, appear to have mixed results and little to no effect on the economy as a whole: state GDP contracted, job and wage growth has remained stagnant, some First Five businesses like ESPN laid off employees, and Alexion Pharmaceuticals relocated to Massachusetts and had to repay the state loan.

Donald Klepper-Smith, chief economist and director of research at DataCore Partners, says Connecticut's priorities might be misplaced.

"In theory, state investment should add to economic growth depending on where it is focused. However, the current First Five initiative is, I think, counterproductive because it creates a strata of haves and have-nots," Klepper-Smith wrote in an email. "The role of state government with respect to business growth is to create an environment that is conducive to business growth for all, not just a select few."

The First Five Program is not the state's only program offering loans and businesses incentives, although it is the most talked about.

The Small Business Express program offers a combination of loans and grants up to $400,000 for small businesses in the state.

Between 2011 and 2017, Small Business Express awarded $254 million to small businesses, according to a report by the Hartford Business Journal.

Connecticut also provides business loans, grants and tax credits through its Manufacturing Assistance Act, which predates the Malloy administration.

The governor, however, also created the Connecticut Manufacturing Innovation Fund in 2014, which has since invested $43.7 million in smaller manufacturing businesses.

Connecticut Innovations — which acts as a quasi-public venture capital firm -- is not controlled by DECD, but receives money bonded by the state to invest in technology based companies.

CT Innovations recently forgave a $165 million of a loan to Jackson Laboratories ahead of schedule because the company had already met and surpassed its goal of employing 300 people. The forgiven portion of the loan equaled $430,909 per employee.

According to the DECD, however, the investment of taxpayer money creates revenue for the state through increased economic activity and new jobs. The same 2016 First Five report estimated Connecticut would net $62 million for the state.

Jim Watson, spokesman for DECD, said that although Connecticut's economy has been slow to recover since the 2008 recession, the state's investments are paying off.

"We have had four straight quarters of GDP growth and the jobs picture has improved as well," Watson said. "In fact, we have more private sector jobs now than we did just before the Great Recession. At the same time, government became smaller and more efficient."

In it’s annual reports, the DECD claims state investment leveraged private capital to the tune of $3.36 per every one dollar of state funding.

However, the effectiveness of tax incentives and loans to corporations and businesses has been questioned by recent studies. A massive study on state business incentives between 1990 and 2015 by the W.E. Upjohn Institute for Employment Research found the effects of state business subsidies were negligible.

Another study by the Institute on Taxation and Economic Policy found state incentives had “extremely limited economic benefits.”

State Comptroller Kevin Lembo pushed for an audit of Connecticut’s business investments in 2017, backed by Republicans and a diverse group of supporters ranging from state employee union leaders to the Yankee Institute.

A bill to audit the DECD passed and in 2018 the State Auditors released their first report, which found the DECD reported inaccurate job numbers and costs. The auditors found DECD overstated the cumulative net state revenue for the Manufacturing Assistance Act by $259 million.

The Malloy administration’s expansion of forgivable loans, grants and tax credits to businesses has been the source of considerable criticism, particularly in light of the state’s ongoing budget crises, ballooning debt costs, and a stagnant — if not shrinking — economy.

Rather than improving the economy, Klepper-Smith says the governor’s economic development policies may have had the opposite effect.

“His economic development policies appear to have redirected capital that might have come into CT to other more business friendly states,” Klepper-Smith said. “There have been sizable ‘opportunity costs’ that have kept our job recovery rate the lowest in New England, and one of the slowest rates of average annual job growth in the nation.”

New Haven Patch

Sep 12, 2017

Malloy Responds To Alexion Pharmaceuticals Moving To Boston

By Rich Scinto

Alexion Pharmaceuticals has announced that it's moving its corporate headquarters to Boston. The move is calling into question the state's "First Five" business initiative that provides grants and loans to help companies relocate or grow in the state.

Alexion will turn its New Haven location into a research center in mid-2018 and will have about 450 employees there. There will be about 400 positions in Boston. The company said the reason for the move is a large biopharmaceutical talent pool and a variety of life-sciences partners that can help it grow. The departure comes on the heels of GE announcing it would move its corporate headquarters to Boston.

"Alexion's 25 year history began in New Haven, and Connecticut remains a critical part of our future," said Ludwig Hantson, CEO of the company. He went on to say the company values its relationship with Connecticut.

The company specializes in the treatment of ultra rare diseases. Its banner drug Soliris is often called the most expensive drug in the world with a cost of $500,000 a year, according to the Boston Business Journal.

Connecticut officials have demanded the company return its "First Five" money which includes a $6 million grant, $20 million loan. The loan was forgivable if Alexion hit certain job creation numbers. The money was made available to move the company from Cheshire to New Haven and establish a large downtown headquarters. Tax credits of up to $25 million were also offered. The company moved to New Haven in March 2016.

"Alexion's decision to move its headquarters out of the state is very disappointing, especially in light of how supportive the state has been to the company over the years as it has grown into what it is today," said state Department of Economic and Community Development Commissioner Catherine Smith in a statement. "While Alexion will maintain a significant number of employees in state, we are requiring that all of the $20 million loan and $6 million grant be repaid—with interest and penalties—to the department in accordance to the terms of our agreement."

Gov. Dannel Malloy said the state would move to get its money back. Even with the move Alexion will have more Connecticut-based employees than it did prior to the agreement with the state, he said. Alexion will also close its Smithfield, RI plant and some 250 people will lose their jobs.

Malloy said the company has gone through some difficult times lately, but that it doesn't pertain to research which is what will remain in state.

In a letter obtained by the Courant, Hanston wrote that it acknowledges repayment obligations in the agreement with the state and will work with the state on the repayment process and timing.

Alexion is under investigation by the U.S. Department of Health and Human Services Office of the Inspector General. It is related to an investigation into the company's charity support that aids Medicare patients, according to Bloomberg.
Last year the company's CEO and top financial officer resigned amid allegations of shady sales practices.

It isn't the first time the First Five program has come under fire. A bill was raised earlier this year that would require legislative approval of any funds under the program. The bill didn't make it to a vote.

In total the state has offered $125 million in tax credits, $256.6 million in direct assistance, $140.5 million in forgivable loans and $92 million in grants under the First Five program to 13 companies as of August 2016, according to a financial report. The state investment is accompanied by company investment. For the 13 companies it was estimated that more than 13,300 jobs would be retained and between 2,608 and 5,264 jobs would be created.

ESPN, another First Five recipient also announced layoffs earlier this year. Other businesses that has received money include NBC Sports, hedge fund Bridgewater Associates, Pitney Bowes and Synchrony Financial.

The move is part of a company restructuring that will reduce its global workforce by about 20 percent. The decisions are expected to save $270 million annually and allow the company to reinvest $100 million a year into research and development.

U.S. Rep. Rosa DeLauro criticized the company's decision.
"Alexion's decision to move their headquarters out of New Haven is shocking and shameful," she said. "New Haven is home to some of the most talented and brightest minds in the world, and Alexion will be worse off for leaving, both financially and intellectually."

Republican gubernatorial candidate Tim Herbst said the company's move to Boston is another blow to the state that follows GE's departure.

"This news is particularly discrediting for the Malloy administration since Alexion was a participant in the governor's 'First Five' program that attempted to bribe companies into loo

Hartford Courant

April 24, 2018

Audit: Economic Development Agency Erred On Tax Credits, Job Creation Numbers

By Stephen Singer

The state Department of Economic and Community Development understated tax credits for several projects and provided inaccurate data about job creation, state auditors said in a report released Tuesday.

The report by the Auditors of Public Accounts found fault with numerous DECD programs, including assistance to small businesses and manufacturers, industrial site cleanup, airport development and job retention.

Only a small percentage of companies received funding several times or under multiple programs, the auditors said. Still, it would result in the overstatement of thousands of jobs that were saved, the report said.

"DECD uses the amount of retained jobs as a statistic to demonstrate the success of its business assistance and incentive programs. Therefore, it is important that DECD reports accurate job retention amounts," the auditors said.

In an emailed statement, DECD Commissioner Catherine Smith said agency officials "set a high bar for the quality of our work."

"Unquestionably, this report highlights areas where we did not meet that bar and we are committed to taking meaningful and necessary steps to maintain the integrity of our reporting mechanisms," she said.

"We can — and will — make the necessary adjustments to ensure accuracy so that the annual report properly reflects the overall effectiveness of our programs," Smith said.
Democratic Gov. Dannel P. Malloy, frequently criticized by Republicans, has used bond funding and leveraged private money to try to reverse Connecticut's sluggish economic and labor force growth.

Sen. Len Fasano, R-North Haven and Senate GOP leader, said the report is "disturbing yet indicative of Gov. Malloy's continued misrepresentation of Connecticut's economy."
"The errors uncovered are beyond acceptable," Fasano said.

State Comptroller Kevin Lembo, who has sought state legislation that would make economic development aid more transparent, said the report "finally gives the legislature independent and actionable information so that Connecticut can make informed decisions about its economic future."

Despite significant spending in incentive programs to spur economic growth, the state "has failed to independently and accurately analyze which ones are working and which ones are not," he said.

The report said that on a few occasions, DECD overstated the number of jobs that were created in relation to economic development aid and understated the number of new jobs that were to be created or saved.

DECD understated tax credits related to investments in industrial sites by $71 million, or 12 percent of the total, and overstated total credits earned by $14.9 million, or 5 percent, according to the auditors.

In addition, the agency understated a tax credit intended to promote movie production in Connecticut by $7.2 million, the auditors said. DECD also understated the amount of aid in the state's Small Business Express program, intended to promote small business development, by nearly $16.5 million, or 7 percent, because it failed to include 80 projects.

And it understated the amount reported in assistance to manufacturers by $73.8 million, or 9 percent, because it did not include 14 projects, the report said.
Auditors said DECD understated the number of new manufacturing jobs to be created by 1,500 and understated the number of jobs to be retained by nearly 2,000.

The audit report included responses from the agency, which said tax credits were omitted because various dates were used in economic models. The agency promised to note earlier cut-off dates used for economic analysis.

The agency said errors found by the auditors in the small business support program were discrepancies in data used to calculate economic impacts.

And DECD said funding agreements with manufacturers are accounted for properly in internal records. "The discrepancy noted by the auditors is only in data used for our calculations for various economic impacts for this report," the agency said.
The agency did not rely on "consistent sources of data" in its reporting, which it promised will be corrected.

Yankee Institute for Public Policy

Jun 13, 2017

Farmington Voters will Decide Thursday Whether to Spend $135 million on a New High School

By Marc Fitch
The town of Farmington, population 26,000, will have a vote Thursday on a school construction project that has sparked debate with its price tag of $135 million.

The plan to construct an entirely new high school will take four years to complete but Connecticut's dire fiscal situation has some town officials and members of the public concerned about the scope and size of the project.

According to the town's "statement of need" the current high school building needs to be rebuilt to improve walking distances for staff and eliminate hallway congestion for students. The plans also include expansion the cafeteria and auditorium, adding a second floor to parts of the school and security upgrades.

The town council approved $135 million in bonding on May 23 but the true cost of the project amounts to $184 million over 20 years, according to figures presented at a special town meeting.
Proponents of the project believe the construction will enhance the learning environment for students and be a long-term investment for the town.

In an open letter published on Facebook, five former town council chairmen wrote "we believe that quality education is significantly enhanced by adequate and efficient facilities. Farmington High School in its present condition is neither an adequate nor efficient building."

Farmington High School is highly rated in national and statewide surveys and ranked as the 8th best high school in Connecticut and the 495th in the nation, according to U.S. News.

Justin Bernier who served on the Farmington High School Building Committee says the project is too big and too expensive. "We don't want this crazy project but we do want an overhaul and to get things fixed," Bernier said.

The project has become a contentious issue in the town, sparking the formation of a group called ResponsibleFHS, which has voiced opposition to the massive construction project through a website, flyers and signs posted around town. Minutes from the June 5th town meeting showed residents split between supporting the construction and concern over the high cost and tax impact.

But the state of Connecticut's fiscal problems are trickling down into the debate.

The plans to fund the Farmington High School construction include a $25 million grant from the state of Connecticut, which may not be guaranteed during a time of major budget deficits.

The state has already begun cutting back funds for school projects, particularly to wealthier towns, and any budget deal is expected to have a major impact on municipal finances through decreased state aid for town projects.

Beth Kintner, a supporter of the high school project and chairperson of Farmington Future, an advocacy group dedicated to investing in town services, told the town council "the chances of State Grant reimbursement would be greatly diminished after July 1st," according to town meeting minutes.

The state bonded $562 million last year for school construction projects and the Department of Administrative Services has added another $450 million in school construction grants to the 2017 priority list. The school construction grant program currently has "in excess of 600 construction projects in various stages of completion," according to a 2016 bond analysis.

Debt service is one of the fast-growing fixed costs that is driving the state's ongoing deficits. Debt service payments for 2016 amounted to $1.68 billion, according to the state comptroller's website.

School construction grants must be approved the state legislature, which is almost evenly divided between the two parties and faces a $5.1 billion deficit over the next two years.

All three major credit rating services recently downgraded Connecticut's bond rating and neighboring Hartford verges on bankruptcy, a fact that has at least one town councilman worried about the future of Farmington if the project goes through.

"Our Capitol city and neighbor next door is on the verge of bankruptcy and is knocking on our door and our neighbors doors looking for a hand out," Councilman Jon Landry wrote in a statement. "The headlines aren't favorable for the financial climate of Connecticut and haven't been for years. This proposed project is simply not prudent or sound planning at this time."

The Farmington school system serves 3,935 students and according to a study commissioned by the town council, student enrollment has declined 6.8 percent since 2004, similar to the rest of the state. The same study projects the number of students to increase slightly to 4,023 by 2020.

The school had expanded in 2003, adding additional wings just as school enrollment peaked. The 2003 renovations included building a new cafeteria, which will be replaced in the new plans.

Bernier believes that the state's reimbursement program is incentivizing towns to take on big school construction projects.

The state uses a scale for determining the amount of reimbursement a town will get for remodeling or construction of a new school. The state reimburses towns 10 to 70 percent for a brand new construction and 20 to 80 percent for a renovation. The amount of the reimbursement is determined by the town's wealth.

The Farmington High School project is technically new construction, as 86 percent of the existing building is being torn down and rebuilt. The town estimates the state will reimburse 19 percent of the project.

"We're tearing down perfectly good classroom wings because we might get more state funds to gut it," Bernier said. "The 2003 wing isn't even paid for yet," he added, noting that the town took out 20 year bonds to pay for the previous additions.

Part of the problem with the existing school is the cafeteria which was part of the 2003 renovations and has to serve its first lunch at 10 a.m. in order to get all the students served. Proponents of the plan say the school does not have a large enough cafeteria to serve the needs of its 1,201 students.

The construction is expected to add 10,000 more square feet to the school and bring Farmington High School in line with state standards. The plans include adding additional space to the cafeteria but the addition would not have much of an impact on the lunch schedule.

According to town meeting minutes, the principal of Farmington High School said the expanded cafeteria would allow the lunch time to be moved up to 10:35 a.m.

Bernier says the school lunch problem could be solved with scheduling changes like using a half-period for lunch rather than a full-period.

Construction plans also include removal of tennis courts built three years ago. Under the proposed plans, the eight tennis courts installed in 2014 would be torn up to make a bus turnaround area. Six new tennis courts would be built in another area of the school grounds.

The debate in Farmington has become a familiar one in wealthier towns across Connecticut.

In Wilton, a $50 million renovation to the Miller-Driscoll Elementary School resulted in the formation of the group Sensible Wilton, which opposed the project, which originally had a $3 million price tag. In Fairfield, the $21 million renovation and expansion of Holland Hill Elementary was opposed by a town watchdog group called Fairfield Taxpayer.

In both cases, critics pointed to high costs, declining school enrollment and uncertainty due to the state's fiscal problems which could ultimately impact property taxes.

But the former councilmen, including Jeff Hogan and Mike Clark, feel the cost will ultimately be positive for the town, even if it comes with property tax increases. "High quality education systems in any community will influence property values in a very positive manner," they wrote.

The referendum is scheduled for Thursday, June 15.

Town Manager Kathleen Eagen did not return our request for comment.

The Connecticut Mirror

Dec. 9, 2016

A Building Boom, Pensions Lock in Big Costs

By Jacqueline Rabe Thomas

Last spring Connecticut lawmakers decided the state would provide $40 million to help enlarge and improve the high school in urban Danbury and $11 million to help add preschool classrooms and make other improvements down the road in tony Wilton.

The costs were part of $562 million in authorized bonding added this year to a robust school construction program in which virtually every project that local districts apply for gets state aid, though at a level that heavily favors poorer districts. The state is currently paying off more than 600 projects.

All this borrowing has added up – and the state is now spending about $700 million each year to pay off debt from construction projects. Coupled with well over $1 billion the state must contribute each year toward teachers' pensions, about 40 percent of the state's annual education spending is locked in for years to come.

Whether the state has spent wisely on school construction is disputed. And in a time of increasing state budget duress, questions are being raised about whether it should be reined in or reallocated.

"We have to contain those costs," state Sen. Beth Bye, the co-chairwoman of the legislature's powerful budget-writing committee, said during an interview. "It needs to be looked at, fixed, and improved… We need a systemwide approach, that's what's missing."

In a recent trial over whether the state meets its educational obligations under the state constitution, a coalition of educators and others suing the state said Connecticut's massive construction program still unfairly left some poor-district schools in tough shape. But attorney's defending the state said the plaintiffs' evidence amounted to nothing more than a few anecdotes and not proof of a systemic problem with the condition of Connecticut schools.

'A state of disrepair' or a 'building boom'?

In a small number of schools, conditions are rough.

At Smalley Academy in New Britain, students are taught in the cafeteria, hallway or auditorium when the air conditioning or heat stops working. It's a huge disruption, the principal told the Superior Court judge presiding over the school funding trial.

"A brain does not function in a place where you are freezing," testified Principal Elsa Saavedra-Rodriguez. "You just don't concentrate. Your 100 percent is not there. You are focusing on taking care of a basic need – being warm."

At Edison School in Bridgeport, gym class is in the parking lot. In winter desks are pushed back to make space in classrooms. When the heating system fails, students wear coats and mittens during class.

"We can't have kids in mittens learning to write," testified Jacqueline Simmons, the school's principal until 2015.

Social worker Catina Caban-Owen counsels elementary students in the locker room off the gym at crowded North Windham School. At times there's no heat so students have to wear coats, the roof leaks and "there is excruciating noise of children playing next door," she testified.

At New London High School, some teachers apply duct tape to their windows to keep wind and snow out, Principal William Thompson said. Trash cans catch rain leaking into the building, and the boilers work intermittently. The New England Association of Schools cited concerns with the facility dating back to 1988. In 2008 it concluded the building was "in a state of disrepair."

After years of waiting for a new building, Thompson said, the project finally won the nod of local taxpayers and is moving forward. The school is expected to open in 2020, with New London residents covering 20 percent of the bill and the state the rest.
"Hope is not a strategy," said Thompson of the years of waiting.

The state spent $5.9 billion on school construction and capital projects between the 2006 and 2015 fiscal years.

Of that, $2.1 billion (36 percent) went to the state's seven poorest districts, including the state's four largest – Bridgeport, Hartford, New Haven and Waterbury. Another $1.2 billion (21 percent) went toward projects in charter, regional magnet and vocational schools largely aimed at improving education for low-income students. The state's 30 wealthiest communities got $355 million – 6 percent of all school construction aid from the state. The bulk of this spending, 92 percent, went to renovate or expand existing schools and the remainder to build new schools.

The portion of a project a local district must finance is based on town wealth and its ability to cover the cost locally. For the poorest district, which is Hartford, the state covers 80 percent of a project's cost. For the wealthiest district, Greenwich, the state covers 20 percent. A 10 percent bonus is provided for regional schools that enroll students from multiple districts and for suburban districts that enroll city students.
Throughout the funding trial, neither side offered any sort of system-wide review or analysis of the condition of Connecticut school buildings.

"I don't know how you can possibly draw any conclusions beyond the roof of this school, or this social worker's office in this school…" said Joseph Rubin, the state's lead attorney from the attorney general's office. "So, I don't know how you can possibly generalize, and I submit that you can't generalize from one incident."
However, a survey the state does every three years of Connecticut's 1,400 public schools provides some perspective.

In 2013, it found that one out of every 40 elementary schools needed asbestos remediation and the local district had no immediate plans to address it. One out of every 25 elementary or high schools and one out of every 29 middle schools had a roof problem and had not scheduled repairs to fix the underlying issue. One in 13 schools had poor air conditioning and one in 70 had a poor heating system.

In the state's most impoverished districts – Bridgeport, Hartford, New Haven, New London, New Britain, Waterbury, Windham – a lower percentage of the schools had areas of their buildings rated as being in fair or excellent condition, according to the survey.

In the most affluent districts – Darien, Easton, New Canaan, Redding, Ridgefield, Weston, Westport, and Wilton – 88 percent of the schools either had been built in the last 20 years or had had a major renovation compared to 71 percent in the high-poverty districts.

In an era of declining enrollment in many communities, the survey also found that 71 percent of high schools were less than 90 percent full and less than 85 percent of middle and elementary schools were full.

State officials testified at the trial, however, that state aid for school construction or renovation has been provided to all comers.

"The only hurdle I cannot overcome is if a district wants to cancel a project," testified Linda Dixon, who oversees school projects at the Connecticut Department of Administrative Services. "I don't think that I have ever said that you are not approved. I have said you are missing documentation."

Local educators are quick to point out, however, that the state might be capable of funding its share of a project, but the amount they must raise from local taxes, though often a small proportion, is at times too much.

In East Hartford, the town must pick up one-quarter of the cost.

"The reality is the 25 percent stops these programs from moving forward," testified East Hartford Superintendent Nate Quesnel. "That's a roadblock."

In Hartford, local officials turned down $54.4 million in state aid to renovate Martin Luther King Jr. School because city government could not finance its $13.6 million share of the project. The amount of debt looming over Hartford amounts to 15.1 percent of the value of its taxable property – by far the largest rate in the state, reports the governor's budget office.

The school was built 92 years ago, and it has been 30 years since sections of it were renovated.

So now, the district is considering closing some schools.

"There is a universal recognition that we do a disservice to our kids by spreading scarce resources across too many schools with low enrollment and poor facilities," Hartford Mayor Luke Bronin wrote his school board in October. "We should all feel a fierce urgency to ensure that no child in Hartford should have to attend a school that is falling apart or failing to provide students with the education they deserve."

Despite the obstacles, many projects have managed to make it to the finish line in low-performing communities.

For example, the new $44.7 million Roosevelt Elementary School in Bridgeport opened for the 2015-16 school year. In Stamford, local officials held a ribbon cutting in September for a new $61.8 million elementary school. The state picked up 80 percent of the tab for both schools.

Judge Thomas Moukawsher, the Hartford Superior Court judge who spent five months hearing evidence during the school-funding trial, wasn't convinced that the condition of schools in Connecticut is a systemic problem.

"There is anecdotal evidence of physical deficiencies in some schools – a leaky roof here, an unreliable boiler there – but nothing to suggest a statewide failure to provide adequate facilities, including classrooms which provide enough light, space, heat and air to permit children to learn," Moukawsher ruled in September.

Magnet school mandate

State spending to build and operate new regional magnet schools has skyrocketed, a trajectory only partially within lawmakers' control.

The growth of magnet schools represents the state's attempt to address the requirements of a state Supreme Court school desegregation ruling – the 1996 decision in the Sheff v. O'Neill case, which focused on Hartford area schools. The ruling called the state's use of town lines to set school district boundaries "the single most important factor" in the concentration of minorities in segregated schools, which it said had "devastating effects."

Instead of redrawing school districts, state lawmakers decided to build and open themed regional magnet schools in an effort to attract white students from the suburbs to voluntarily attend schools with city residents. While the majority of the new magnet schools opened in the Hartford region to comply with the Sheff order, some also have opened in other parts of the state.

The more than 80 magnet schools that enroll about 40,000 students statewide cost the state billions to build or renovate and now cost $313 million each year to operate. Over half of Hartford's students still attend segregated schools.

"That was the result of judicial intervention that continues to this day. No one in the General Assembly has control over that spending," Rep. Andy Fleischmann, the House chairman of the legislature's Education Committee, said of the cost of magnet schools.
Pressure to slow spending

Borrowing for school construction traditionally has received favored treatment at the Capitol, partly because it funds high-profile local projects and partly because it is typically paid off over many years.

"It's a capital budget," Fleischmann said. "You can't treat it the same way" as operational spending.

But now that the annual bill to pay off past projects has ballooned to almost $700 million, lawmakers may be forced to rethink whether the annual ritual of placing new projects in the queue is appropriate – especially as they work to close yet another large state budget deficit.

Malloy, a Democrat, on several occasions has publicly questioned the need for the state to fund projects in wealthy communities.

"We contribute mightily to the building of school projects and programs," Malloy said during the Sept. 30 meeting of the State Bond Commission before the panel approved funding for school projects. "I think if the legislature, led by a Republican discussion, are going to take on these issues, then you have to be willing to take all of them on – including the fact that we contribute mightily to building schools in districts where the mill rate is substantially less than it is in most other communities in the state."

Earlier this year, state legislators passed legislation to give Greenwich – the wealthiest community in the state – more money to finish adding a music wing to Greenwich High School, setting the town up for $9.2 million in state aid, 20 percent of the cost.

However, even if lawmakers were to reduce how much new spending they put onto the credit card for school projects, it would take some time for substantial operating budget savings to show up as the state pays off what it already has borrowed.

For example, facing a massive budget shortfall in 2011, legislators considered a moratorium on funding school construction projects. Such a move, however, would not have saved the state any money in the first fiscal year and a mere $9.5 million the following year, reported the legislature's nonpartisan fiscal office. Similar conclusions were made in prior years.

The judge gave the state a mixed review for all this construction spending.

While unconvinced that schools are in disrepair, the judge, who is a former state legislator from Groton, ruled that the way the state is pouring money into school construction projects is irrational, and therefore unconstitutional.

"Experts for both sides in this case rated physical facilities at the bottom of their lists of things that help students learn… Still Connecticut keeps on spending and does so without any rational criteria for what should be built or renovated and what shouldn't," he wrote. "This building boom has happened while the state's student population has been shrinking considerably. It also goes on amidst a legislative free-for-all where… every year legislators with enough clout swoop in and change school construction spending priorities or reimbursement rates to favor projects in their districts without any consideration of relative needs across the state."

The legislature has often granted individual school projects exemptions from various state requirements.

In his 90-page ruling, the judge ordered the state to craft a spending approach that "rationally, substantially and verifiably connects education spending with educational need."

His order has been put on hold, however, until the Connecticut Supreme Court rules on an appeal from the state's attorney general.

Pension spending also locked in

Unlike most other state education aid, the state contribution to teacher pensions does not factor in a town's wealth or ability to raise local revenue. Rather, teachers pay a portion of their salaries into the fund, and the state and investment earnings cover the remainder of the costs.

The average annual pension of Connecticut teachers who retired in fiscal 2016 was $59,364, plus guaranteed annual cost of living increases. Connecticut teachers, however, do not participate in Social Security, and neither they nor the state contribute to the program. As a result teachers do not accrue Social Security benefits for their time as teachers.

More than a billion dollars each year goes to pensions for the close to 36,000 retired public school teachers – a fast-rising, locked-in chunk of state spending. It has increased by an average of $80 million since 2005, and represents half of the $1.6 billion increase in Connecticut's annual education spending over the past decade.

And those retirement costs will continue to skyrocket, largely because legislators and governors promised teachers the benefits but did not save to pay for them for decades. The teachers pension contribution will cost the state $1.43 billion next fiscal year, a $297 million increase over the current year.

In 2008, trying to make up for some of the years of underfunding, the legislature and then-Gov. M. Jodi Rell borrowed $2 billion through bonding to shore up the pension system. As part of the deal, the state made the bond investors a promise, known as a "covenant," that the state would contribute whatever actuaries said was necessary each year to put the system on a path to fiscal health.

"Defined benefits are considered to be rich benefit programs," Darlene Parez, the administrator of the Connecticut Teachers' Retirement Board, testified during the school-funding trial. "There is a covenant to the bond that makes it very difficult for the General Assembly to get out of."

State legislative leaders say they are not trying to get out of the pension obligation, saying the state has made a promise in statute to the state's teachers and they are reluctant to break it.

Very little time was spent during the school-funding trial on pension costs, and the judge did not single out this area for a critique in his decision, except to point out that retirement benefits for Connecticut teachers are "far above the national rate for private-sector professionals."

Yankee Institute for Public Policy

Oct 11, 2016

$94 Million School Renovation Nearly Double the National Cost of Brand New Construction

By Marc Fitch

As the Connecticut Department of Education mulls whether to close two technical high schools to deal with an expected $1.2 billion deficit, the state recently showcased a massive renovation project at the Emmett O'Brien Technical High School at a cost of $94 million, nearly double the national cost of constructing a brand new high school.

According to School Planning & Management, an online information resource for education professionals and administrators, the median cost of constructing a new high school is nearly half the cost of the Emmett O'Brien renovation.

"The median high school cost $45 million and provided 173,727 square feet. It was designed to accommodate 1,000 students. The median high school provides 180 square feet per student at $49,000 for each student. The cost per square foot was $235.29."

In comparison, the renovated Emmett O'Brien school serves 574 students and expanded from 172,000 square feet to 220,000 at a cost of $427.27 per square foot, including the existing square footage.
The cost equals $163,763.06 per student.

The renovations and additions to the school includes a new "academic wing" and a "state-of-the-art kitchen for the culinary arts program." The school also received a new design to its main entrance, which some have compared to "a space odyssey."

Jeffrey Beckham, spokesman for the Department of Administrative Services, says the state has spent $77 million so far and that renovations "are not yet complete." Technical schools like Emmett O'Brien are owned by the State of Connecticut and operated by the State Department of Education.

The Department of Education faces a cut of 10 percent - or $82 million - next year in order to close the expected $1.2 billion budget deficit. The agency would also have to make cuts to a number of programs that focus on the lowest performing schools and end athletic programs at all of its vocational technical high schools.

In September Superior Court Judge Thomas Moukawsher ruled in the Connecticut Coalition for Justice in Education Funding vs. Rell lawsuit, that Connecticut’s education funding was unconstitutional.

Moukawsher stated in his decision that while school "enrollment has been declining for over a decade," Connecticut continues to spend billions per year in school construction. "The state basically never turns down a project."

The Connecticut Mirror

Dec. 9, 2016

He's Among 1,800 on the Waiting List for a Place to Live

By Paul Marks

Twenty-seven-year-old Dan Fiorentino grew up in West Hartford and graduated from Hall High School, just like both of his parents. He has a job, a supportive family and a passion for the Boston Red Sox. But because he has Down Syndrome, there's no telling when he'll be able to live on his own.

Whether he lands in a group home or his own supervised apartment depends on the waiting list of about 1,800 Connecticut families hoping to see a bed open in a state-supported group home or congregate living facility.

Right now, Fiorentino's life is well organized, with plenty of parental support. A part-time job in a dermatologist's office keeps him busy three mornings a week. One of his parents drives him there and picks him up. There are art classes and workout sessions at a gym in Hartford with his father that keep him occupied, busy and productive.

For a developmentally disabled person, Fiorentino is "high-functioning." He talks in brief sentences, responds to questions, plays Password, and can use a computer to vote for his favorite Major League All-Star.

He has successfully learned his job as a sort of escort for medical patients, dermatologist Dr. Jennifer Pennoyer said. She found that building an electronic system of medical records placed more demands on her clerical staff, so she hired Fiorentino to usher patients into the examining rooms. He positions the "flag" markers indicating to the doctor and physician's assistants which patients are ready to be seen. He cleans up discarded gowns and magazines after a patient leaves.

Pennoyer said Fiorentino got intensive training by job coaches provided by a nonprofit agency, and has fit in well to the office routine. In many ways, he's a model employee. When something goes wrong and he has to make a correction, Pennoyer said, "he doesn't get upset, he just redirects and tries harder."

Taking advantage of a 2014 federal law, Fiorentino's parents Tom Fiorentino and Shelagh McClure helped Fiorentino set up a tax-advantaged savings account for his earnings. Framed examples of his paintings hang throughout the family home on a quiet street just off Mountain Road.

Tom Fiorentino is a retired attorney who serves as president of the board of The Arc Connecticut, the state's leading advocacy organization for those with intellectual and developmental disabilities. He knows his son is thriving, but many like him are not. He has little patience for the way Connecticut spends its social services resources.

That begins with the costly maintenance of Southbury Training School, an institution built in the 1930s that the state began phasing out in the mid-1980s. Now only 200 residents remain in a facility that once housed thousands. Three years ago, the General Assembly ordered closure plans drawn up for Southbury and the remaining regional centers run by the Department of Developmental Disabilities. Due at the end of 2016, it has not been completed.

"By now, 15 U.S. states have no institutions," Fiorentino said. "But Connecticut is wed firmly to the past. It's more than inertia: I think there are constituencies out there" pressing to keep open the outmoded training school.

Tom Fiorentino acknowledged that relatives of the aging residents of Southbury understandably worry about seeing their loved ones forced to leave a familiar setting where they've lived for decades. But he says Southbury along with the smaller, regional residential centers, are just cost-prohibitive.

"The states that have done away with institutions have figured out a way to keep those people safe outside institutions," he said.

It's been a decade now, he noted, since the state Department of Developmental Services declared that funding for virtually all residential placements would be reserved to emergency cases. Those are instances where the last family caregiver for an intellectually disabled person either dies or becomes permanently incapacitated.

That's the situation he and his family may someday face, he said, along with so many others. It's vexing, he said, that approaches that make better use of scarce social services dollars are only slowly being adopted. These include "shared living" arrangements that pair developmentally disabled clients with roommates who are not disabled. Another promising tactic involves using digital monitoring technology that allows mentally disabled people to live more independently – without costly 24/7 staff supervision.

At a time when $12 an hour is the typical wage of direct-care staff at private nonprofit organizations offering programs for the developmentally disabled, Tom Fiorentino has trouble understanding how DDS can justify paying employees with similar duties upwards of $50,000 a year. Staffing just the fire department at Southbury Training School costs the state more than half a million dollars in overtime alone, he said.

With no end to the budget cuts in sight, it's hard not to lose hope, Fiorentino said. "There are better ways where we could serve more people within the available appropriations," he said. "We need to realize that the way we've been doing things is not sustainable, and our job is to show what that change looks like, what we could be doing."

CT *Viewpoints*

Jul. 5, 2017

Budget solution: Change the way Connecticut provides services

By Gian-Carl Casa

As Connecticut residents enjoyed the Independence Day holiday and its barbecues, parades and vacations, thousands of people with mental health issues, substance abuse addictions, developmental disabilities, homelessness and those striving for a second chance post-incarceration were facing the loss of the help they need.

For them, the days past July 1 – when the state fiscal year began with no budget in place — are not a time to celebrate. However, much of their suffering can be avoided if elected officials build on areas of agreement and make human services their priority.

Let's start with the harsh reality: beginning the new fiscal year without a state budget will result in human services agencies across Connecticut cutting services and closing doors.

Yet since January, leaders of community nonprofits have offered a way to save $300 million over the biennium while re-investing that savings to people in need, by shifting more services from more expensive state government agencies into the nonprofit sector.

The estimated savings are real. We calculated the difference in the per-person cost when services are delivered by the state rather than nonprofits.

Here are two examples: for group homes serving the developmentally disabled it's $152,000 per person. If half of the 888 people still in state care that's a difference of almost $100 million over the next two years. For Local Mental Health Authorities, the cost difference is $7,300 per person, for a total possible savings of $68 million over two years.

This change would not be new – more than 86 percent of people receiving state services for developmental disabilities are getting them through community-based nonprofits, and the majority of mental health and substance abuse services are also provided in the nonprofit sector.

By supporting the more expensive status quo over new ways to deliver services, the state chooses to deprive people of care they need. There are more than 2,000 people on the waiting list at the Department of Developmental Services and they may never receive services if we maintain the current inefficient and expensive service delivery system.

As legislators grapple with proposals for a new budget, they primarily wrestle between spending cuts and tax increases. Community nonprofits have offered a tangible and high-quality alternative to both routes, at least for provision of human services. To people who claim it is "too complicated," nonprofits with experience say that is simply not the case. Nonprofits have shown time and again they can do a high-quality job, less expensively.

We understand the budget disagreements are difficult to reconcile and that leaders may need time to get to the kind of compromise that will put a two-year budget in place. We know there is a balance to be struck between revenues and spending cuts.

But all the budgets proposed to date, by people in both parties, have recognized to different degrees that the nonprofit alternative can work. If they can agree on that, and that the priority of the state should be caring for the most vulnerable among us, maybe while they work on a two-year budget they can enter into a "separate peace," passing legislation that earmarks the savings to address the urgent needs of vulnerable children, families, seniors and individuals with complex needs – now.

People in need of help can't wait until Labor Day. And if they are not the priority, who is?

CNBC News

Jul. 15, 2015

Officials: Connecticut is most expensive place to die in US

Celebrities and business tycoons with multimillion-dollar estates in Connecticut are getting some unwelcome news: Their state has become the most expensive place to die in the U.S. because of hefty new fees for settling estates, according to state officials.

In fact, probate officials are warning that some invoices they will be sending out shortly could top $100,000 or even $1 million in a few cases, when the maximum fee in the past was $12,500.

The fees took effect July 1 as part of the new state budget approved by Democratic Gov. Dannel P. Malloy and the Democrat-controlled legislature. They're also retroactive to all deaths dating back to Jan. 1.

The budget cut all state government funding to the probate court system, a total of $32 million over two years. To make up for the loss of that money, Malloy and lawmakers eliminated the $12,500 cap on probate court fees and doubled the fee on estates worth more than $2 million to 0.5 percent of the value. They also increased fees for most probate court filings from $150 to $225.

"It's outrageous," said Westport attorney Amy Day. "We always had a cap on probate fees of $12,500. Now it's not going to be unusual for people to pay upward of $50,000."

The probate court system surveyed all 50 states and determined that the 0.5 percent fee on the value of estates of at least $2 million was the highest in the country, surpassing the 0.4 percent fee charged by both New Jersey and North Carolina, said Vincent Russo, a spokesman for the state probate court system. New Jersey also has no cap on probate fees, while North Carolina has a maximum fee of $6,000, he said.

Russo said many states don't charge fees based on total estate value. He said it was difficult to determine which states have the least expensive probate costs because of differences in law and policy.

The very wealthy often protect their assets by forming trusts, which helps them avoid some probate costs.

Connecticut also has an estate tax on all estates worth more than $2 million, with rates ranging from 7.2 percent to 12 percent.

Malloy spokesman Devon Puglia said Tuesday that the probate fee increases were among difficult budget decisions that had to be made this year.

Judge Paul Knierim, Connecticut's probate court administrator, said if the new fees were applied last year, two estates worth more than $200 million apiece would have paid more than $1 million in probate costs and about a dozen worth over $20 million would have paid more than $100,000.

"I think the fundamental problem is that the change in decedents' estate fees imposes the burden of running the probate court system on a very small portion of the population," Knierim said.

Knierim and some state lawmakers say they plan to urge the General Assembly next year to dump the new fees and go back to the old system.

Vincent Carissimi, a Philadelphia lawyer who is executor of his uncle's estate in Westport, Connecticut, said the new fees will increase probate costs for the estate by about $2,000, bringing the total to over $8,000.

"You usually expect to pay a nominal or moderate fee but you don't expect to get soaked," Carissimi said. "The most surprising thing is it's a function of the funding being cut. That doesn't make a whole lot of sense to me. I've never heard a state not providing funding to its courts."

Yankee Institute for Public Policy

Mar 6, 2017

Estate-planning attorney warns of “deluge” to New York

By Marc Fitch

Attorneys who handle estate planning for wealthy Connecticut residents told lawmakers Friday that Connecticut’s estate and gift taxes are driving out the very people the state needs in these difficult times.

Lawmakers on the finance, revenue and bonding committee held a public hearing on proposals to reform Connecticut's estate tax and possibly eliminate the gift tax.

Supporters of estate tax reform believe the ongoing tax revenue from keeping wealthy residents in Connecticut would outweigh the lost revenue from the estate tax. Opponents of the proposal don't believe people leave Connecticut because of taxes.

Joseph Pankowski Jr., law partner with the Stamford-based firm Wofsey, Rosen, Kweskin & Kuriansky, said that Connecticut’s “trickle” of wealthy people relocating to New York will become a “deluge” if the estate tax exemption is not raised to match both the New York and federal exemption.

New York is raising its estate tax exemption to meet the federal standard by 2019. Pankowski warned that Connecticut will start lose more high income residents to New York because they can avoid Connecticut’s estate tax and still see grandchildren who remain in Connecticut.

The committee was considering several bills dealing with Connecticut’s estate and gift taxes. Sen. Martin Looney, D-New Haven, introduced a bill to raise Connecticut’s estate tax threshold to match the federal standard, while Sen. L. Scott Frantz, R-Greenwich, has proposed bills eliminating the estate and gift taxes altogether.

Pankowski began his public hearing testimony by assuring the committee that he was politically left-leaning and supported numerous Democratic and Progressive issues.

However, he said that when Connecticut’s wealthier citizens leave for other states they take all their money with them, including any revenue that would be paid to the state in income and sales taxes, as well as philanthropic donations.

"For more than 25 years I have watched clients change their domicile to Florida to avoid the Connecticut estate tax," Pankowski said. "Connecticut, of course, is the big loser whenever this has happened."

Likewise, Kelly Galica Peck of Cummings & Lockwood in West Hartford, warned that wealthier residents will "vote with their feet" and that she regularly deals with the loss of clients to other states to avoid Connecticut's estate and gift taxes.

Peck argued that Connecticut should eliminate the gift tax and reform the estate tax.

"Connecticut has the ignominious distinction of being the only state in the nation with a gift tax," Peck told the committee. "Most states over the past decade have eliminated their estate and gift tax because they have determined ultimately that it is bad fiscal policy."

The estate tax and gift tax bills also drew testimony from the Connecticut Business & Industry Association because the taxes apply to business owners as well. The estate tax can make it difficult for even small business owners and farmers to pass on the business to their children.

But not everybody was enamored with the idea of raising the estate tax exemption. Derek Thomas, a fiscal policy fellow with Connecticut's Voices for Children, denied that there was an outmigration trend in Connecticut and worried that revenue lost from the estate tax would hurt state services.

Data from the Internal Revenue Service and U.S. Census Bureau, however, show otherwise. According to the IRS, Connecticut lost 27,541 people and $3.8 billion in adjusted gross income from 2011 to 2013.

Similarly, the Census Bureau found that Connecticut has seen a net decline in population for three years in a row.

As a compromise, Thomas offered the idea of off-setting the loss of estate tax revenue with an increase in other taxes such as the income or capital gains tax on top earners.

Thomas claimed the revenue loss from raising the estate tax exemption would be $74 million. The average revenue from the estate tax is $147 million, according to figures provided by the Office of Policy and Management, which averaged out revenue from the estate and gift taxes between the years 2006 and 2015.

The change in average revenue would be $28 million lower if the estate tax exemption were raised to match the federal level.

The gift tax during that time period fluctuated between $8.5 and $218.4 million and averaged $41 million.

But the loss of revenue may pale in comparison to the loss of businesses and families that pay state income and sales taxes, along with their philanthropic donations.

Yankee Institute President Carol Platt Liebau pointed out that the revenue from the estate and gift taxes is “highly volatile” and has contributed to CNBC labelling Connecticut “the most expensive place to die.”

“This is not a designation we can accept with pride,” Liebau told the committee. “You can make our state a place where people are sure that the money they worked for, earned and saved is left to the people they love most, or to the charities they choose.”

Cipparone & Zaccaro

Dec. 2018

New State Budget Increases the Connecticut Estate Tax Exemption

By Jack Reardon

The new Connecticut state budget, signed by Governor Malloy on October 31, 2017, increased the individual exemption for Connecticut estate and gift taxes over the next three years. In 2017, the exemption in Connecticut was $2,000,000. Under the new law, the exemption increased to $2,600,000 in 2018 and then to $3,600,000 in 2019. In 2020 and beyond, the Connecticut exemption will match the federal estate and gift tax exemption. From 2018 to 2025, the federal estate and gift tax exemption is $11,200,000. The exemption is indexed for inflation each year. A married couple with proper planning will be able to shield up to $22.4 million from federal estate tax.

Additionally, the new Connecticut law lowers the cap on the maximum estate and gift tax payable, from $20 million to $15 million, starting in 2019. The law also modifies the marginal rate schedule for Connecticut estates and gifts over $5.1 million, by raising the initial rate to 10%, with graduated increases of 10.4%, 10.8%, 11.2% and 11.6% for each million dollar increase, until reaching the top rate of 12% for a taxable estate or gift over $10,100,000 (see the tax rate schedule at the end of this article).

The most important factor that no one seems to discuss is that both bills in Congress do not disturb the powerful step-up in basis at death. To compensate for the estate tax, Congress allowed assets subject to estate tax to increase their basis to fair market value. For example, if you bought a commercial property for $100,000 in 1980 and it rises in value to $1M at the time of your death, the basis will step up to $1M. When your children sell the commercial property after you die for $1M, they will pay no income tax because the sales price does not exceed the tax basis. By raising the exemption while retaining the step-up in basis, most people with highly appreciated assets will never pay any tax on the appreciation.

Given the new estate tax exemptions, the Connecticut estate tax has become irrelevant for most of Connecticut's citizens. By 2020 an individual would have to own property worth more than $11M to incur estate tax. Connecticut does not have portability but an exemption in excess of $11M will exempt most Connecticut residents from estate taxation.

In addition to the increasing estate tax exemption, the annual exclusion amount for gifts is $15,000 in 2018, after remaining at $14,000 since 2013. As a result, starting in 2018 gifts of $15,000 or less to any number of recipients (or $30,000 or less, if made by a married couple who elect to split the gift on a properly filed gift tax return) in a calendar year will have no gift tax consequences.

As with any change to increase estate tax exemptions, many clients will want to consider simplifying their estate plans. For instance, if your current estate plan contains special trusts to avoid estate tax, you may want to consider whether you want to use such trusts. Trusts have many useful purposes besides estate tax planning, however. They can keep assets in the family, preserve property for children of a prior marriage, supplement public benefits, and protect assets in a divorce or a legal dispute. If you have any questions on the current estate tax landscape and its potential effect on your estate plan, please contact the estate planning attorneys at Cipparone & Zaccaro, PC.

New York Times

Feb. 2018

Heirs Inherit Uncertainty with New Estate Tax

By Brian J. O'Connor

Critics of the estate tax like to call the federal levy on assets passed on by the wealthy to their heirs the "death tax." But the better nickname might be the "zombie tax."

Despite repeated attempts by conservative lawmakers to kill it — and a 2016 campaign-trail vow by Donald J. Trump that "no family will have to pay the death tax" because "we will repeal it" — the estate tax remains a surprisingly resilient part of the United States tax code.

The tax law passed by Congress in December certainly keeps it alive — on more generous terms. Instead of taxing any amount above $5.49 million per person at a rate of 40 percent, the new law raises that exemption to $10 million, which, when indexed for inflation, allows individuals to pass on $11.2 million and couples to transfer twice that amount without paying a penny of tax.

But leaving the estate tax in place means America's richest families now face the prospect of scurrying to tax lawyers to revise older estate plans, and may need to do so again before the end of 2025. The new exemption is on the books for only eight years, and if Congress doesn't change the law again, estates could face tax bills after 2026 for moves made under the new, temporary limits.

"Some of the wealthier clients are happy" with the changes, said Brian Jenney, a partner with Kemp Klein in Troy, Mich. "But when you tell them it ends in 2025, they're frustrated because they're still going to be alive."

Despite these complications, what's clear is that even though Congress didn't kill the estate tax, the new limits come close.

"The estate tax used to cover a lot more people even in recent decades, up to 2 percent of all estates. Now we're down to less than one-tenth of 1 percent," said Chuck Marr, director of federal tax policy for the Center on Budget and Policy Priorities in Washington. "The estate tax is hanging on by a thread."

According to IRS figures, 12,411 estates filed Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return, for 2016. Of those filers, fewer than half — 5,219 estates — owed anything, paying $18.3 billion on assets of $108 billion, for an effective tax rate of 17 percent. Even among estates valued at more than $50 million, 133 managed to avoid paying any estate tax.

If the new exemption had been in place that year, it would have trimmed those estate-tax bills by an amount between $2.3 billion and $6.2 billion. No more than 2,204 estates would have exceeded the individual $10 million baseline exemption in 2016. And under the new $20 million baseline exclusion for married filers, the tax would have hit just 911 estates.

Section A.1

Besides the generous exemption, the estate tax always has provided another big benefit to inheritors: Those assets are passed on at their market value at the time of death. This allows stocks, real estate and other holdings that may have appreciated to be sold with no tax ever paid on those gains.

That's the prime reason that anyone with an estate valued between the old and new exemption limits needs to consider rewriting his or her plans to bring the maximum amount of assets back into the estate. The problem is that one vehicle that's often used is an irrevocable trust, which, as the name implies, isn't easily reversed.

"Every estate planner has a handful of files where we now want to bring those assets back into the estate to get that step-up in basis, but it's not that easy," Mr. Jenney said. "We've got to petition the probate court, show that circumstances have changed, go to court and terminate the trust."

Another time bomb in older estate plans could lurk in trusts that move assets out of the estate to future generations, called generation-skipping transfers. These transfers are taxed in coordination with the estate tax and gift tax and count toward the estate tax exemption amount. Often, those trusts use a formula that automatically removes the maximum exemption amount from the estate and places that money in the trust, said Melissa Langa, managing partner of Bove & Langa in Boston.

"If you had an $11 million estate before the new act, $5 million would go to the trust for future generations, $6 million would be held for the spouse, and that would have been a great plan," Ms. Langa said. "Now it might be that all $11 million is held for the benefit of the children and grandchildren and the spouse is left with nothing."

An added sting for families forced to rewrite their estate plans (a process that can cost between $2,000 and $10,000) is that unless the work is a business expense, they can't deduct that cost. The new tax law eliminated the allowance for tax preparation fees.

But it's the sunset provision of the new law that creates the most potential problems, according to estate planners, many of whom are unimpressed with the hasty, late-December tax-law rewrite.

"We're lucky it's as tame as it is, because the legislation is just idiotic," said James Spica, an estate tax specialist with Dickinson Wright in Detroit. "I don't think there even was a handful of people working on it who understand how it works."

Mr. Spica pointed out that the estate of a spouse who died under the older, lower exemption would benefit if the surviving spouse died between now and the end of 2025. Estates of any amount pass untaxed to a spouse and are taxed only after the surviving spouse dies. So even if the first spouse died when the estate exemption was $11 million for a couple, that estate enjoys a $22 million exemption — but only if the surviving spouse dies before Dec. 31, 2025.

Meanwhile, someone who dies today under the $22 million exemption could see that allowance cut in half if the surviving spouse passes away in 2026, when the exemption drops back to the earlier limit.

"You'll get half the benefit if the second spouse dies outside this new regime," Mr. Spica said.

Another issue Congress left hanging concerns how to handle gift taxes after the higher exemption expires. Because the tax on large gifts works in concert with the estate tax, the estate of someone who gives away more than the lower exemption could be hit with a "claw back" tax bill for several million dollars when the law reverts to the lower limit, said James Blase of Blase & Associates in St. Louis.

"If you make a very large gift before 2026 and die afterward, there's absolutely no law," Mr. Blase said. "Congress left it totally up to the I.R.S. to issue regulations, and that's a big deal. There's a lot of uncertainty."

The one place where estate-tax certainty does exist is within the very wealthiest families, who continue to face a 40 percent maximum tax rate on their estates.
"For the uber-wealthy, a $5 million change in the exemption doesn't really make a difference," Ms. Langa said, adding: "It's a huge thing for people in the $10 million to $20 million range, but if you're in the $200 million range, it's a drop in the bucket."

Tax Foundation

April 2018

Kentucky Legislature Overrides Governor's Veto to Pass Tax Reform Package

By Morgan Scarboro

Facing one of the worst-funded pension systems in the country and a bleak budget outlook, legislators in Kentucky overrode Governor Matt Bevin's veto to pass HB 366, a tax reform package, in the last few days of the session. Ultimately, HB 366 raises $395.8 million in revenuefor the state and increases Kentucky's ranking on the *State Business Tax Climate Index* from 33rd to 18th.

The final passage of HB 366 has been a multistep process that resulted in some unlikely political coalitions. The House and Senate passed the bill on April 2nd, but Governor Bevin (R) vetoed it and the budget bill a week later on April 9th, citing concerns that it does not make the state more financially stable and expressing a desire for more comprehensive reform. Budget Director John Chilton also expressed concerns that the revenue estimate for HB 366 was overestimated by approximately $87 million.

After a heated debate, however, the legislature voted to override the governor's veto, with the Senate voting 20-18 and the House voting 57-40.

Here's how HB 366 changes Kentucky's tax code:

- Replacing the current six-bracket individual income tax, which has a top rate of 6.0 percent, with a 5 percent single rate individual income tax;
- Broadening the starting income tax base by removing most deductions and repealing the personal exemption credit ($10 per filer, $20 per dependent);
- Decreasing the amount of pension income excluded from income tax from $41,110 to $31,110;
- Replacing the current three-bracket corporate income tax, with its top rate of 6.0 percent, with a 5 percent flat rate;
- Phasing out the inventory tax using a tax credit;
- Adopting single-sales factor apportionment and conforming to the federal Internal Revenue Code as of December 31, 2017;
- Suspending several business tax credits;
- Expanding the sales tax base to include select services (landscaping; janitorial services; pet care and grooming, and small animal veterinary services; fitness

and recreational sports; laundry, dry cleaning, and linen supply; nonmedical diet and weight loss centers; limousine services; bowling; overnight trailer campgrounds; extended warranties; and other personal services); and
- Raising the cigarette tax from 60 cents to $1.10 per pack.

The legislature then quickly shifted its focus to HB 487, the "revenue cleanup bill," where several changes and minor drafting corrections were made to the original tax reform bill. The cleanup bill restores several tax credits, decouples from the federal pass-through deduction, and exempts manufacturing business inputs from the sales tax base expansion.

There is still work to be done. Kentucky imposes an antiquated local gross receipts-style tax called the Limited Liability Entity Tax (LLET), is one of only six states to levy an inheritance tax, and using a tax credit to phase out the inventory tax has proven to be a headache in some states.

However, the changes in this tax reform package dramatically improve the state's tax climate. By broadening bases while lowering rates, starting to correct the inequities in the sales tax base, and taking steps to make the state more friendly to investment, policymakers in the state took a responsible approach to comprehensive tax reform.

Tax Foundation

Jul 2018

Enhancing Tax Competitiveness in Connecticut

By Jared Walczak

Introduction

Connecticut's population is shrinking. From year to year the decline is not dramatic, but the trend is there—and the effects are beginning to be felt. They have been noticed, too: in 2017, The Atlantic asked, "What on Earth Is Wrong with Connecticut?" At Slate, it was "Something has gone wrong with Connecticut." The Hartford Courant is keeping tabs on the number of billionaires leaving the state. Business journals are fretting about sustained outmigration. Even the state itself is getting into the act, producing a 2017 study on population and migration trends.

That migration is not limited to people: companies are leaving, too. While CVS Health's acquisition of Aetna kept the company–which had planned a relocation to New York City–in Hartford, there was no such reprieve with General Electric or Alexion Pharmaceuticals, both of which decamped to Boston. Corporations headquartered elsewhere, like Caterpillar, Motorola, and Kraft Heinz, reduced the size of their Connecticut workforces—and that's just the companies that shifted jobs to one city, Chicago. The biggest companies garnered the most headlines, but for every General Electric or Alexion, there are many more small businesses that have pulled up stakes.

These companies did not relocate to the Sun Belt. That might have been worrying enough. Instead, companies are being pulled toward New York City, Boston, and Chicago. For some, taxes are the clear culprit, with proponents of this theory pointing to the statements of companies and individuals making their exodus. For others, taxes are at most incidental to the main story, particularly given that Boston and New York City are not exactly known as oases of low taxation.

The truth, as is often the case, likely lies somewhere in between. High (and rising) tax burdens have contributed to stagnation. So has the revitalization of major urban centers. So, too, have broader economic and demographic trends, greater mobility, and a shift in the entrepreneurial center of gravity in the country. Younger workers increasingly want to move back into the cities their parents and grandparents abandoned for the suburbs. Lifestyles have changed; industry balances have shifted. Connecticut can address some of these problems, but not all. What it can do, though–what it must do–is make its tax code more competitive.

Taxes, after all, are within policymakers' authority in a way that the weather, or the rising appeal of big cities, really aren't. Cities and states with enough cachet can often thrive despite high costs of living, including high tax costs, but states that are losing ground enjoy no such luxury. If policymakers wish to arrest the outmigration of jobs and people to more welcoming climes, they will need to do something about a tax code that increasingly penalizes those who might otherwise be inclined to stay.

Connecticut's Economy

At $70,121, Connecticut has the highest per capita income of any state in the country—an unusual preface to a tale of a state in a snowballing fiscal crisis. Nor does the state lack for resources, at least by conventional measures: Connecticut has the third-highest state and local tax collections per capita, at $7,410 per person.

As a wealthy state, Connecticut receives less federal funding than average, since fewer residents are beneficiaries of state-administered programs with federal funding sources. Therefore, while the state's $7,410 per capita tax collections is substantially higher than the national average of $4,875, its total revenue per capita of $9,121 is just slightly above the national average. This should, however, also come with fewer demands on that revenue, since higher levels of federal assistance typically imply substantial low-income populations which create additional financial pressures on the state treasury as well.

But Connecticut has historically prioritized relatively high provision of government services. Generous public pensions, meanwhile, are beginning to catch up with the state, particularly as the population declines. Some of the traditional engines of economic activity in Connecticut are slowing, and in some cases businesses and individuals are going elsewhere.

The state benefits from a strong manufacturing base and an educated workforce. Its geography is advantageous for multinational firms which require an East Coast presence but not a big city headquarters. For many years, it has proven an attractive alternative to New York City and Boston. Increasingly, however, the state is struggling. Connecticut's high and distortive taxes are part of the problem, and their reform can be part of the solution.

Corporate Taxes

Connecticut's corporate tax has two components: a traditional tax on net income and an alternative minimum tax on net assets. Businesses pay the greater of 7.5 percent of net income (no cap) or 3.1 mills on the value of their capital stock up to a cap of $1 million in capital stock tax liability. Companies with at least $100 million in gross income also face a surtax of 10 percent, down from 20 percent prior to 2018.

Corporate Net Income and Capital Stock Taxes

Imagine a company with $20 million in net assets and $3 million in net taxable income. This company would owe $225,000 in corporate income taxes under the net income calculation and $62,000 under the capital stock calculation, so the company would remit the higher of the two

($225,000). If, however, the next year the company posted a loss, it would still face positive tax liability, now paying against its assets. This illustrates one of the shortcomings of capital stock taxes: they are levied without regard to ability to pay, imposing burdens even when a business is losing money.

Capital stock taxes are also nonneutral, as different industries and business structures have vastly different asset mixes. Finally, capital stock taxes penalize investment and expansion. Most established, profitable companies in Connecticut have little reason to be concerned with the state's capital stock tax, since it functions as a minimum tax within the corporate income tax, but new and expanding companies can be penalized by it, as can businesses that are struggling to survive. The tax favors the status quo to the detriment of less established businesses, and thus holds back Connecticut's economy.

Meanwhile, the surtax, while applicable to very few businesses, imposes an unusually high corporate rate on some of the state's largest employers. At 10 percent, the surtax brings the corporate net income tax rate to 8.25 percent for businesses with more than $100 million in gross income, which is on the high side nationally, though about in line with regional peers.

Net Operating Loss Provisions

Connecticut's net operating loss provisions are slightly less generous than those of many peer states. Although corporate income tax liability is determined on an annualized basis, business cycles do not follow the calendar. This can be problematic for corporations with cyclical income, enjoying high profitability one year and losses the next. To mitigate this reality, states (along with the federal government) allow corporations to deduct losses from previous and future years to offset current taxes owed. These net operating loss (NOL) "carrybacks" and "carryforwards" smooth out tax obligations over time, ensuring that industries with cyclical income are not at a competitive disadvantage against industries with more consistent and stable revenue streams.

Under a well-designed system of net operating losses, businesses which experience a period of negative income but return to profitability have the opportunity to deduct their losses against future taxable income. The NOL deduction helps ensure that, over time, the corporate income tax is a tax on average profitability. Without the NOL deduction, corporations in cyclical industries pay much higher taxes than those in stable industries, even assuming identical average profits over time.

There are two important variables of a state's NOL provisions: the number of years allowed for carrybacks and carryforwards, and caps on the amount of carrybacks and carryforwards. The maximum that any state allows for carrybacks is three years, with no cap (that is, an unlimited dollar amount allowed up to the entirety of current year taxable income). Among the states that allow carrybacks, the most common time span is two years with no cap. Most states offer a 20-year uncapped carryforward, and under the Tax Cuts and Jobs Act, the federal government now permits losses to be carried forward indefinitely but limits them to 80 percent of pre-NOL taxable income.

Connecticut disallows net operating loss carrybacks. Furthermore, while the state permits a 20-year carryforward, the deduction is limited to 50 percent of net income in any given year. Among neighboring states, New York has 20-year uncapped carryforwards and a three-year uncapped carryback period, and Massachusetts offers 20-year uncapped carryforwards but no carrybacks. Neighboring Rhode Island has an uncommonly stingy approach to net operating losses, only permitting them to be carried forward for five years.

Unitary Combined Reporting

Since 2016, Connecticut has mandated unitary combined reporting for corporations, requiring companies with common ownership that are engaged in a unitary business to calculate their tax liability on a combined basis. Functionally, this means that all related businesses are treated as a single entity for tax purposes, rather than filing separately.

Taxing all affiliated businesses as if they constitute a single legal entity is designed to undermine tax planning, where companies shift income to some subsidiaries and park losses in others to minimize tax exposure. Opponents point to high compliance costs, increased complexity, and taxation of legitimate business activity in no way associated with the state or not otherwise subject to corporate taxes.

Unitary combined reporting shifts tax liability among related firms in ways that have no connection to ability to pay. It assumes that all member companies have the same level of profitability per dollar of sales, an assumption which cannot be borne out in the real world. Just because two companies are affiliated does not mean that each entity is in similar shape financially; increasing the tax burden on one company, which may be struggling, because a related company elsewhere is doing well, can be economically devastating.

Where differences in profitability are the result of tax planning, those strategies can be adjusted; where, as is more often the case, they represent the actual financial standing of each company, splitting tax liability this way can be uniquely burdensome for some operations.

The challenges associated with combined reporting do not end–or even begin–with an inequitable distribution of tax burdens. The first step is calculating that tax liability, which can be complex, costly, and controversial under combined reporting. There is often no easy answer to the question of which affiliated businesses should be considered as part of the unitary group; in fact, answers to this definitional question can vary from state to state and even year to year, meaning that just because a company is already subject to combined reporting in other states does not mean that Connecticut’s requirements create no additional burden. Disputes can take years or even decades to untangle. In 2010, California (which used combined reporting) was still processing tax cases from the 1970s, and General Electric had just closed its 1982 California tax return.

Combined reporting increases complexity and can misallocate tax burdens. Statistical analyses demonstrate that combined reporting reduces gross state product.15 Expectations of higher state revenue, meanwhile, have not always panned out.

Other Issues in Corporate Taxation

Revenue volatility is a frequent complaint in Connecticut, and the state's reliance on a high-rate corporate income tax contributes to that revenue uncertainty. Since 2008, 16 states and the District of Columbia have cut corporate income taxes. Reductions in corporate rates elsewhere reflect a trend toward decreased reliance on the highly volatile tax, which is imposed on an ever-declining amount of taxable income. Furthermore, a number of states have undertaken efforts to simplify the tax structure by broadening the base and lowering the rate. Corporate income tax revenue is in decline across the country as more businesses choose to structure as S corporations and limited liability corporations (LLCs), single sales factor apportionment schemes become more common, and states give away more of their tax base in special credits and deductions.

Like most states, Connecticut relies on tax incentives to reduce liability for select industries and economic activities. Some of the state's business tax credits have unlimited carryforward periods, while others are capped, most frequently at five years of carryforwards. Tax incentives are a patch for an otherwise uncompetitive tax code, and Connecticut policymakers should explore paring back incentives in exchange for rate reductions or other structural reforms. They should not, however, reduce the value of credits already issued by further limiting their carryforward periods or otherwise capping claims, as this constitutes retroactive taxation.

Corporate income taxes tend to be complex and impose substantial administrative burdens for both payers and the government, and this complexity has not abated as the tax base has eroded. Finally, revenue volatility necessarily follows from the nature of the tax, since in periods of economic distress, many companies may post losses and thus be exposed only to the capital stock portion of the tax— significant for some, but negligible for others. As such, collections tend to be highly unstable, spiking sharply in good years and collapsing in bad ones.

Individual Income Taxes

Connecticut's individual income tax is of a recent vintage. Implemented in 1991, it is the newest state income tax in the country. Touted as a way to diversify the state's revenue stream and take the pressure off other taxes, it has expanded at a rapid clip and accounts for a far larger share of the state's total collections than was originally envisioned.

Connecticut's individual income tax has a top rate of 6.99 percent, which is above the national average, and it is imposed on a broad base of income. State income tax collections consume 3.05 percent of personal income in the state, a percentage only exceeded by five states and the District of Columbia. Collections per dollar of personal income are about 41 percent higher than the national average, reflecting the state's above-average top rate and broad definition of taxable income. As a wealthy state, Connecticut also sees an above-average share of state income exposed to the top rate.

Adopted as a way to improve revenue stability, it has proved the opposite. Capital gains are a significant source of income for high earners, but investment income is inherently volatile. A graduated-rate tax in a high-income state results in heavy reliance on income streams which may change sharply from year to year. Capital gains are taxed upon realization, meaning that taxes are only owed once an asset is sold. They are, moreover, offset by capital losses, and in some years, many more people will be cutting their losses than taking their gains.

Nationally, capital gains realizations soared 91 percent in the tax reform year of 1986, then plummeted 55 percent the next year. They slid 71 percent between 2007 and 2009, during the Great Recession. They slipped 55 percent in 1987 and 46 percent in 2001. Other sources of tax revenue showed volatility in these years as well, but at nowhere near the intensity of capital gains.

Capital gains are taxed upon realization, meaning that you only owe the tax once you sell the asset. And of course, capital gains are offset by capital losses. In some years, many more people will be cutting their losses than taking their gains.

Connecticut acknowledges this problem, which served as the motivation for the state's volatility cap. Recognizing that a sizable share of capital gains income is reported by individuals who file quarterly returns, the state set a $3.15 billion cap on collections from quarterly filers and sweeps any additional amounts into the budget reserve fund, part of which can be transferred to help pay down unfunded pension liabilities.23 This policy represents a meaningful step in the right direction, but can only partially remedy the tax's underlying instability.

Revenue stability can also be undermined if people choose to vote with their feet. Taxes are only one of many factors in deciding where to live and work, but especially for high-income taxpayers–who enjoy greater mobility–an uncompetitive individual income tax has the potential to drive people away faster than the state can attract new residents.

In fiscal year 2016, more than 82,000 people left for another state, while 63,000 moved to Connecticut from another state, representing a net outflow. Even more significantly, however, the newcomers of fiscal year 2016 had a cumulative adjusted gross income (AGI) of $3.2 billion, while those departing had a cumulative AGI of $5.8 billion. This represents a net loss of $2.6 billion of AGI from departures that year alone.

Initially a 4.5 percent single-rate tax, the individual income tax's rate structure has changed five times since the income tax's adoption in 1991. The tax became a graduated rate tax in 1996, but its current status as a highly progressive income tax only dates to 2009. When the state first shifted from a flat income tax to a two-rate tax, the former flat rate was adopted as the new flat rate (on income above $10,000), making the change a small net tax cut. The top rate crept up to 5 percent in 2003, but it was not until 2009 that the tax's character changed, with a new top rate of 6.5 percent on income above $500,000.

Two tax increases later, 6.5 percent is the rate on income between $200,001 and $250,000, while the top rate stands at 6.99 percent. All income above $10,000 is taxed at higher rates than it was under the initial 4.5 percent flat-rate tax. The income tax had expanded to include seven brackets by 2015.

Aggressive increases in recent years contribute to a sense that the state's desire for additional revenue is insatiable. In conversations with leaders of traditional C corporations, we found that the individual income tax was cited frequently as a consideration for businesses making location decisions. Even though the businesses themselves pay corporate, not individual, income taxes, the individual income tax drives up the cost of living in Connecticut and makes the state less attractive overall.

The last budget adopted prior to the adoption of an individual income tax ran $7.15 billion. In the fiscal year 2019 budget, total appropriations reached $20.86 billion. Had Connecticut's budget merely kept pace with inflation, appropriations would stand at $13.67 billion. Instead, state spending burgeoned, driven in large part by an expanding individual income tax.

Once championed as a way to diversify revenue sources and reduce volatility, with additional revenues as a secondary consideration, the income tax has transformed Connecticut's budget through a dramatic expansion in revenue capacity. Unfortunately for taxpayers, even this remarkable rate of revenue growth has proven incapable of keeping up with the demands of an ever-costlier state government.

Sales Tax

First adopted in 1947, the sales tax long held pride of place as Connecticut's most important source of tax revenue. As the state's spending soared, the sales tax rate peaked at 8 percent in 1989, which helped build support for the adoption of an individual income tax in 1991. The sales tax rate was rolled back to 6 percent, and the new income tax initially yielded slightly less revenue than the 6 percent sales tax. Changes to the income tax since then, however, have caused the two taxes to diverge sharply, and today the income tax raises more than twice as much as the sales tax.

If the sales tax were still at 8 percent, it would raise an additional $1.06 billion each year. The income tax that occasioned the rate reduction generates $9.86 billion a year.

One of the great advantages of the sales tax is its stability. All tax revenue is subject to economic cycles, but consumption taxes experience considerably less volatility than income taxes. Over time, however, Connecticut's sales tax base has eroded as the economy becomes increasingly service oriented. Lawmakers have also carved certain goods out of the sales tax for policy reasons.

The exemption for groceries, for instance, reduces collections by an estimated $451 million each year. The prescription drug exemption costs $412 million, while the state forgoes another

$31 million by exempting nonprescription drugs. Most services go untaxed by default, as the state tax base includes tangible goods unless otherwise exempted, but only includes such services which are directly mentioned in statute.

Accordingly, the state does not provide estimates for the exclusion of many services from the base. However, a first-order estimate of amount forgone by not taxing personal services alone is $150 million. The following table delineates just a few of the major exemptions within the sales tax code, together worth $2 billion in forgone revenue. To place the magnitude of these exemptions in context, if they were included in the base, the sales tax would raise the same amount of revenue with a 4.3 percent rate as it currently does at a 6.35 percent rate.

The Supreme Court's decision in Wayfair v. South Dakota, eliminating physical presence as a requirement for collecting sales taxes on transactions involving out-of-state sellers, gives states new opportunities to collect additional revenue as well. However, the size of this windfall should not be overestimated. The federal General Accountability Office provides low- and high-end estimates of potential revenue gains through remote sales tax collection authority, giving Connecticut a range from $128 to $194 million. For simplicity's sake, this paper will use a midpoint estimate of $161 million, but this figure–as with estimates from sales tax base broadening–should be considered a rough estimate only. Adding remote sales authority to the above base-broadeners would be enough to permit a revenue-neutral 4.2 percent rate.

Connecticut does not, however, need a 4.2 percent sales tax rate. (Earlier this year, a state tax commission recommended raising the sales tax rate from 6.35 to 7.25 percent to help pay down reforms elsewhere in the code.) What it needs is reforms to other elements of the tax code, and sales tax base-broadening can help pay down rate reductions and reforms elsewhere. If Connecticut wanted to restore its old 6.0 percent sales tax rate, this could be accomplished with about $289 million in base-broadeners; any revenue beyond that could be put toward other reforms.

Property and Wealth Taxes

Business Tangible Property Taxes

Connecticut's property taxes extend to both real and tangible personal property. Real property includes land, buildings, improvements, fixtures, minerals, and other property attached to the land itself, including rights and interests. Tangible personal property encompasses other physical objects, including business equipment—often colloquially defined as property that can be touched and moved. In Connecticut, household goods are exempt from the tangible personal property tax, and automobiles are taxed separately, rendering the tangible personal property tax primarily a tax on machinery and equipment (except when used in manufacturing), trade fixtures, and even some software owned by businesses.

Connecticut has reduced its reliance on tangible personal property taxes over the years, adopting exemptions for inventory and manufacturing machinery and equipment. These reforms are part of the reason why personal property taxes declined from 14.3 to 5.5 percent of the property tax base from 1991 to 2013.

Several of Connecticut's regional competitors forgo tangible personal property taxes. New York, Pennsylvania, and New Hampshire exempt tangible personal property, while collections in Vermont are minimal. This gives businesses in those states an advantage over their Connecticut-based competitors, as tangible personal property taxes reduce capital investment.

In addition to the actual tax burden, tangible personal property taxes impose substantial compliance and administration costs because the tax levy is "taxpayer active." This means that businesses must fill out forms identifying all of their personal property subject to taxation and detailing relevant attributes including, but not limited to, a physical description, the year of purchase, the purchase price, and any identifying information (e.g., serial numbers). The tax is to be remitted upon the depreciated value of each article of personal property.

The direct and indirect costs of tangible personal property taxes have made such taxes a target for reduction or elimination in a growing number of states, as they are a barrier to economic growth. According to the Council on State Taxation, nearly 34 percent of state and local business taxes remitted in Connecticut are property taxes (almost four times as much as is paid in corporate income taxes), and nearly a quarter of it ($590 million a year) is due to personal property taxes. A direct tax on capital formation, tangible personal property taxes are also distortionary, as they apply to some business inputs but not to others. Taxes and machinery and equipment create incentives for mobile capital to flow out of high-tax areas into low-tax areas.

Removing manufacturing machinery and equipment from the base was an important step, but the state should have the ultimate goal of repealing this uncompetitive tax. In the interim, Connecticut policymakers have several options for tangible personal property tax reform.

The state could gradually reduce reliance on tangible personal property taxes by creating a de minimis exemption. Simply exempting taxpayers with $10,000 or less in taxable personal property would eliminate liability for 46 percent of current taxpayers at a cost of 0.014 percent of property tax revenue. The costs of compliance and collections are far too high to justify collecting such a negligible amount of revenue. Setting a higher threshold, such as $200,000 in assessed value, would exempt almost 93 percent of current filers while retaining 88.5 percent of the tax base.

The state could also phase out the tax over time by exempting new property from taxation, as Maine and Kansas have done. This has the advantage of limiting the immediate impact on local bases, while at the same time encouraging economic growth by keeping new and expanding business from entering the system in the future. Over time, taxable old equipment is replaced with new equipment that is exempt from the tax, while local governments avoid steep and sudden reductions in tax revenue, instead relying on gradual cuts that could be absorbed by real property or other taxes over time without large rate increases.

Estate Tax

Connecticut is one of 13 states which levies an estate tax, and one of 18 states with some sort of tax on transfers at death.

Until recently, the federal government provided a credit against state death taxes paid (CSDT), up to a certain amount. Consequently, all 50 states adopted estate taxes designed, at the very least, to capture all revenue up to this threshold (commonly called the “pick-up tax”), since they could do so without increasing anyone’s tax liability. With the elimination of the credit, most states have repealed their estate taxes—some immediately, and some in the intervening years. Connecticut remains one of a dwindling number of holdouts.

In recent years, Connecticut’s nine-bracket estate tax, with rates ranging from 7.2 to 12 percent, has yielded above-average burdens on estates valued at less than $5 million, but below-average burdens for the largest estates. The state is currently phasing in conformity with the federal exemption level, however, which will ultimately exempt from taxation all estates valued under $11.2 million.

This reform will eliminate liability for most taxpayers currently subject to the estate tax, and will make compliance and administration easier by mirroring federal law. Even a tax limited to the largest of estates, however, can have detrimental economic effects, as it can encourage tax avoidance activities or even drive wealthy older taxpayers out of state, potentially depriving the state of income tax and other tax collections (and broader economic activity) in their final years.

Spending Cap

Since 1991, Connecticut’s constitution has imposed a spending cap, ratified by the voters in tandem with the individual income tax. Ostensibly, the cap prohibits the state budget from increasing faster than the percentage increase in personal income or inflation (whichever is higher), subject to supermajority overrides or an emergency finding by the governor. In practice, however, the requirement is largely ineffectual, with the legislature and governor repeatedly redefining the base for the authorized budget or leaning on enabling legislation to exclude elements of the budget from the capped general budget expenditures. And now, according to the Office of the Attorney General, the cap is not only ineffectual but unenforceable.

The constitutional amendment requires that the General Assembly define the terms “increase in personal income,” “increase in inflation,” and “general budget expenditures” in statute, all of which are necessary to the operation of the cap. Prior to the amendment’s ratification, the legislature adopted a stopgap statutory spending cap, but never proceeded to adopt legislation defining terms for the new constitutional requirement. Accordingly, the Attorney General contends that the constitutional cap is not in operation, and that while the statutory cap also imposes a supermajority requirement, it is legally unenforceable, and could be suspended by a simple majority vote.

Previous Attorneys General came to a different conclusion, opining that the statutory caps provided the required definitions for purposes of the constitutional amendment.49 Policymakers have long evaded the cap by shifting costs outside it, but under the new interpretation, they are spared even this hurdle. When voters ratified an income tax and a spending cap side-by-side, it is reasonable to assume that they wanted real spending restraint. Instead, they got a nearly toothless measure, and now no constraint at all. Maintaining faith with the public requires fixing the spending cap.

Conclusion

Connecticut has failed to live up to the expectations of 1991. Changes intended to make tax collections more stable, combined with constraints intended to promote fiscal prudence, have strayed far wide of the mark. In recent years, policymakers have pursued a range of tax hikes which have created uncertainty and undermined the state's competitiveness, without addressing structural shortcomings which become more pronounced with time. The time has come to rebalance and restructure the tax code, and perhaps to cast a more critical eye upon the rising expenditures that helped bring the state to this point.

There will be hard choices. But as the state's finances falter and its people and businesses look for the exits, the status quo is no choice at all.

Yankee Institute for Public Policy

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Back On Track: Budget Reforms for the Long Run

By Joe Horvath

Connecticut faces a sizeable budget deficit. Anticipated to be $1.7 billion for FY '18 and more than $3 billion for the biennium, this significant gap requires meaningful, immediate action. Rather than continuing the pattern of large deficits followed by service cuts and tax increases, the Yankee Institute is proposing reforms aimed at establishing long-term budget stability. Although line item cuts could serve as an immediate fix, process and rule reforms will provide the most lasting results. As such, this report will recommend a series of tools to put the state back on solid fiscal ground.

Tax increases should not be the first solution to a shortfall. The more responsible option is to make significant changes to the way taxpayer dollars are spent. For example, in order to close a $1.7 billion deficit through a sales tax increase, the existing sales tax rate would need to be 8.95%, assuming that individuals would not then respond by buying less. Lasting spending reform, meanwhile, is generally better for an economy. With two large tax increases in just the past five years, followed by large deficits, Connecticut is on an unsustainable path. State lawmakers have both raised taxes and cut spending, but the spending cuts have not led to sustained savings, so deficits persist.

The five recommendations for budget reform that follow are:

- Adopt priority-based budgeting. Comprehensively reforming the way government spends and prioritizing core services can close a deficit even larger than Connecticut's (as shown in the Washington State case study below) without raising taxes.
- Enact the spending cap. Defining, adopting, implementing and obeying a strong cap on state spending would restrain the growth of future spending.
- Reform teacher and state employee pensions. Following a recent Yankee Institute study that outlines recommendations that save billions of dollars over the next few decades while assuring a secure retirement for Connecticut's public employees.
- Realign state employee pay and benefits. Right-sizing public sector compensation to levels commensurate with the private sector would immediately save billions in payroll and benefit expenses.
- Slow the rate of borrowing. Growing debt and suboptimal credit ratings should make borrowing an option of last resort for now.

Priority-Based Budgeting

For Connecticut to achieve long-term fiscal stability, budgeting must become routine and predictable for the state's executive and legislative branches. A sound budgeting process is necessary in order to reach that end. Priority-Based Budgeting (PBB) is the best tool available to control costs while simultaneously ensuring that constituents receive core government services.

The experience of Washington State highlights PBB's effectiveness. For its 2003-2005 biennial budget, Washington was facing a projected $2.4 billion budget deficit, which represented approximately 10% of its budget. In response, Governor Gary Locke, who would go on to serve in the Obama Administration as Secretary of Commerce, proposed the "Priorities of Government" (POG) process

At its core, POG asks four questions:

- How much money does the state have?
- What results do citizens want most from state government?
- How much money can be allocated to each result?
- How best can allocated funds be spent to achieve the results?

To answer these questions, Locke had his agencies closely examine every activity they performed. Each agency was asked to prioritize activities into one of three categories: high, medium, and low, with the mandate that at least one-third of activities were deemed low priorities. The list of "most important" results had common elements, which became the basis for how to prioritize spending. They were:

- Improve student achievement in elementary, middle and high schools
- Improve the quality and productivity of our workforce
- Improve the value of a state college or university education
- Improve the health of Washington citizens
- Improve the security of Washington's vulnerable children and adults
- Improve economic vitality of businesses and individuals
- Improve statewide mobility of people, goods, information and energy
- Improve the safety of people and property
- Improve the quality of Washington's natural resources
- Improve cultural and recreational opportunities throughout the state

Programs and projects that did not achieve one of those goals were de-emphasized, and those that did were still required to be made the most cost-efficient possible. Locke described how those ten priorities would translate into real, measurable results:

We assembled 10 multi-agency teams, one team for each result. We've asked the teams to tell us how best to attain the desired result. What programs and services make the most difference? What can we consolidate? What programs and services aren't making as much of a difference? What criteria can guide us in assessing value and deciding what should be funded? What key indicators will tell us when we've achieved the result and given people what matters most?

The teams have had free reign. No rules, no politics, no agenda imposed from above. One limit: they have to rely on existing financial resources in achieving the desired result. And this will result in some very, very difficult decisions because we cannot simply fund everything we have in the past.

This completely new, comprehensive budgeting process was instrumental in closing Washington's budget deficit.1 It is also an excellent tool to provide taxpayers a respite from tax increases. Since any high priority activity would be funded, tax increases would therefore only be for funding low-priority activity, and so are less likely to be necessary, or even requested.

Improvements to the POG process were proposed by Governor Christine Gregoire in 2010, when she tasked her agencies with using the following criteria for their deliberations:

Fiscal responsibility

- Is the activity an essential service?
- Does state government have to perform the activity, or can it be provided by others?
- Can the activity be eliminated or delayed in recessionary times?
- Does the activity need to be paid for with state general funds? Should users pay a portion of the costs?
- Are there federal funds or other fund sources available to support this activity?

Efficiency

- Are there more cost-effective, efficient ways to do the activity?

Performance

- Can the activity be the subject of a performance contract?
- Can the activity be the subject of a performance incentive?

Ultimately, the PBB process plays an important role in first setting government priorities. Then, it helps determine how to allocate existing funds to pay for core services. This streamlines and facilitates fiscal decisions typically deemed too difficult to make. A full commitment to this process, among others, would be instrumental to establish long-term fiscal stability for Connecticut.

Spending Cap

In addition to budget process reforms like Priority-Based Budgeting, actual limits on the growth of spending and taxation are critical checks on future waste. Connecticut currently has a constitutional spending cap, but it must be strengthened, fully adopted, and rigorously enforced.

When the income tax was passed in 1991, Connecticut taxpayers were concerned that this new source of revenue for the state would lead to uncontrolled spending and undermine state officials' fiscal discipline. Therefore, a compromise was reached and more than 80 percent of voters approved the inclusion of a spending cap in the state's constitution.

A 2015 poll of Connecticut residents conducted by the Yankee Institute showed that 82 percent of respondents still believe that the state should have a cap on state spending. Taxpayers see the connection between higher spending and higher taxes.

Recently, in order to fully implement the constitutional spending cap, the state legislature was charged with defining three key terms: Income, inflation, and government expenditures. Agreement on the definition of the terms has been elusive. A recent state commission formed to issue recommendations on definitions for the three terms did not achieve full consensus on the definition of government expenditures, although they did agree on definitions for income and inflation.

The purpose of a spending cap is to control state spending in order to reduce the need for higher taxes. Nearly every dollar spent by the state, no matter what it funds, comes from taxpayers. Deficiencies in any aspect of the budget will ultimately fall on the taxpayer. Therefore, a spending cap should be as strong and inclusive as possible. Pension costs and general expenditures should be included within the cap, and the cap should be indexed to personal earned income growth. This is a reasonable proposal in the spirit of what Connecticut voters supported in 1992, and today. Additionally, the state's spending cap is less restrictive, both than many other states' caps, and other states' proposed policies to limit spending.

For example, Colorado's Taxpayer Bill of Rights (TABOR) directly limits the state's spending based on a formula that factors in changes in population, previous levels of spending, and inflation. Further, revenue collected above that same threshold must be refunded to taxpayers. TABOR also prohibits various types of taxes altogether (or binds them to their current rate), and all tax increases are subject to voter approval.vii

Effect of TABOR on Colorado Budget

That said, the effect of TABOR is limited to the extent that Colorado state officials can designate certain types of spending as outside its provisions, a trend that has sharpened in the last few years. Note the window of time associated with Referendum C, colloquially known as the "TABOR Timeout," when the state did not abide by the limits. However, when followed as intended, TABOR has greatly controlled the growth of Colorado's spending and let taxpayers keep more of their own money.

One proposal being weighed in Texas is also stricter than Connecticut's spending cap. Texas currently caps state spending based on personal income growth. As currently construed, the limit applies to less than half of the state's overall budget. The proposal, locally known as a “conservative spending cap,” would enforce the limit on the entire budget. Additionally, spending would be limited to the smallest growth rate among three metrics: state population growth plus inflation, total state personal income, or total gross state product.

If Connecticut officials wanted the strongest possible limits on spending, and therefore taxation, TABOR and the new proposal from Texas are among the best models. Both impose stronger limits than Connecticut’s spending cap. Regardless, the strongest definitions and standards possible should be adopted and followed. If the strongest possible mechanism is properly implementing the spending cap passed in 1992, then that would be a certain improvement.

Pension Reform

Connecticut is neither the first, nor the only, state to be weighed down by its pension obligations. Failing to meet actuarially determined employer contribution (ADEC), employing misleading accounting gimmicks, and the poor funding ratios that result are a nationwide problem. The 50-state aggregate amount of unfunded pension obligations changes based on how it is calculated, with estimates including $1.5 trillion, $4.8 trillion, and $5.6 trillion.

However, although it is not alone in the nation’s pension obligation crisis, Connecticut’s pension underfunding is among the most dire in the nation. According to 2015 data from the U.S. Pension Tracker (a project of the Stanford Institute for Economic Policy Research), Connecticut is among the nation’s most indebted to its state and local pensions. Under actuarial valuation methodology, Connecticut holds more than $24,000 in pension debt per household, the third-worst rate in the nation.

Without the smoothing from actuarial valuation, the market valuation of Connecticut’s pension liabilities is the nation’s fourth-highest, at more than $81,000 per household.

The need to control unfunded pension obligations is not theoretical or ideological. Pension reforms that ensure long-term stability and sustainability are in the best interest of all parties involved. Without the “crowd-out” effect of an unmanageably large yearly contribution, state officials will have more flexibility to allocate the state’s budget in accordance with constituent needs, and greater ability to provide core government services. Connecticut workers, as a result, will not bear higher tax burdens to subsidize a government that refuses to choose between programs and pensions.

Most importantly, pensioners benefit. The goal of pension reform is to secure workers’ benefits for their future retirement, not to strip them. Most recommended reforms are applied to new workers only, not to current ones. Pension reform is a means to assure future payments to retirees by keeping the system solvent.

The State Employee Retirement System (SERS) needs reform. Examining SERS is particularly worthwhile because of its uncommon nature. Typically, other states do not collectively bargain state employee retirement benefits. Rather, they are set by statute, as is the case in all our neighboring states: Massachusetts, New York, and Rhode Island.

SERS is suffering from insufficient funding, albeit for slightly different reasons than many other plans across the nation. In New Jersey, for example, the Securities Exchange Commission was forced to bring charges against the state on behalf of municipal bond holders because of the state's repeated attempts to under fund its pensions, while hiding the very fact that it did so. Connecticut, on the other hand, has a recent track record of fully funding its ADEC. In research conducted for the state, Jean-Pierre Aubry and Alicia H. Munnell of Boston College University wrote:

> "Since 2001, the State has paid, on average, 90 percent of the annual required contribution (ARC) for SERS. For TRS, the State issued $2 billion in pension obligation bonds in 2008 and has paid 100 percent of the ARC since then. Prior to that, TRS funding was inconsistent; the State paid more than 80 percent of the ARC from 2001 to 2003, close to 70 percent in 2004 and 2005, and essentially 100 percent in 2006 and 2007."

The most recent actuarial valuation for SERS indicates that its unfunded accrued actuarial liabilities (meaning the amount of liabilities the plan, and therefore taxpayer, must account for, less the plan's assets) is approximately $21.7 billion. Though the state has largely paid its ADEC for the past decade, "the funded status for [SERS] declined by about 20 percentage points and, as of 2014...stood among the lowest in the nation. SERS' current funding ratio is 35.5% if using actuarial assets, and 31.6% if using market assets.

The question these facts beg is how a plan's funding ratio can worsen *despite* the state fully meeting its required contributions. The answer lies with SERS' adopted discount rate. For many years, the plan assumed its assets would provide an eight percent rate of return or higher, and therefore its liabilities could be discounted by that amount. However, in the last 15 years, the plan averaged a return of 5.4 percent.

Because of the plan's underperforming investments, liabilities have grown at a faster pace than payments could offset.

The Yankee Institute recently published research in conjunction with the Reason Foundation titled *Securing our Future: A Menu of Solutions to Connecticut's Pension Crisis*. The study offers a series of reforms that would potentially address Connecticut's growing unfunded pension obligations. The report's authors included a Connecticut-based actuary, and, where possible, the recommendations were fully modeled to estimate their benefit to the state's finances. Recommendations included:

- Setting SERS' assumed rate of return closer to 5 percent. This would more accurately reflect the recent performance of the plan's investments as well as the nature of the system's benefits as guaranteed regardless of investment performance.

- Increasing employee contribution rates to 6% percent. This recommendation would reduce state costs by $4.3 billion over 30 years. The 6 percent contribution is more in-line with both the national and regional levels for state employees.
- Adopting a cap on compensation eligible for pension benefit determination. This recommendation would apply only to new hires. This would mean that for the purposes of calculating pension benefits (but not for actual pay), salaries would be “capped” at $100,000. A cap of $100,000 is reasonable and would still provide a very generous retirement package. This would save the state $4.1 billion over 30 years.
- Changing the formula for cost-of-living adjustments (COLA). Indexing COLA to the rate of inflation, which is the current policy for social security benefits, but with a maximum of 2 percent, would reduce state costs by $1.3 billion over 30 years.
- Amending the definition of “Compensation” to remove overtime. This is a commonsense reform that is often introduced by members of the General Assembly, which would reduce the practice of unnecessary shift trading to artificially boost an employee’s top-earning, pension-determining years.
- Structure reform. Beyond governance and certain benefit reforms, the structure of SERS must be updated to a more affordable model. For new hires, the plan should reflect one of the following: a new “Tier IV” defined benefit plan that is more cost effective, a cash balance plan, a defined contribution or 401(k)-style plan, or a hybrid defined benefit/defined contribution plan that has been a successful model in other states and municipalities.
- Although somewhat mutually exclusive with some of the structures outlined in the point above, it was recommended that all new hires be given an option to choose between the hybrid plan and a pure defined contribution plan. These options are both more affordable for the state and benefit the employee in that the plan is mobile if the employee chooses to change jobs.

Given the state’s notoriously high cost of living, it might be expected that, dollar-for-dollar, the state would spend more per employee. To account for this discrepancy, the results were weighed against research by The Tax Foundation on the buying power of a dollar in every given state. The results show that, even when accounting for cost of living, Connecticut still spent the second most in the nation per full-time employee.

In addition to the state’s high payroll expenses, benefits offered to state employees are unsustainably high. When using the compensation of comparable private sector workers as a baseline, it becomes clear that public sector workers are much better compensated. However, to be clear: it is not simply that public employees are overcompensated for their work. The issue at hand is whether taxpayers can afford to subsidize state employee pay at a higher rate than they earn themselves. The state is in deep deficit, and private sector workers are already subject to one of the nation’s least competitive tax climates.

As Andrew Biggs, former deputy commissioner of the Social Security Administration and author of the Yankee Institute study titled *Unequal Pay: Public vs. Private Sector Compensation in*

Connecticut wrote, “discussions of public sector pay are rarely informed by hard data. Many public sector employees are under the impression that they could earn higher pay and benefits ‘on the outside.’” However, when taking both pay and benefits into account, state employees are better compensated than their private sector counterparts.

CT Worker Compensation Breakdown (Per Dollar)
Included in the overarching term “benefits” are health coverage, retiree health benefits, retirement plans and pensions, and fringe benefits like vacation time or employer premiums paid toward life and disability insurance. Note that benefits for public sector workers are in a range because pensions, which are now largely nonexistent in the private sector, have a range of value.

These levels of compensation contribute to the state’s ongoing pension funding issues in two ways: the benefits themselves are expensive; and high salary levels in Connecticut contribute to the overall cost of employee pensions because they are the primary variable in the formula by which pension benefits are calculated. As concluded by Biggs in *Unequal Pay*, paying state employees at market levels would save the state between $1.4 billion and $2.5 billion in annual compensation costs. This information is particularly noteworthy for fiscal years in which public employee salaries are being negotiated, and should be considered when state employee contracts reach the General Assembly for review.

Slow the Rate of Borrowing
Connecticut is one of the most-leveraged states in the nation. According to the state’s most recent Comprehensive Annual Financial Report, the state holds $25.3 billion in total bonded debt. Although the state is within its allowed borrowing limit, in 2018 debt service payments from the General Fund are projected to be $2.6 billion, or 13 percent of total General Fund expenditures. Even though Connecticut is technically able to make its current debt service payments, holding bonded debt equal to ten percent of the state’s gross domestic product is inadvisable.

In Connecticut, debt service payments have been climbing year after year. In 2013, debt service payments represented 11 percent of the budget. For every one percent increase, another approximately $200 million has to go toward debt service instead of funding another priority.

Connecticut’s per capita debt is the highest in the country, at around $5,500 per person. and local debt are taken into account, Connecticut’s debt load ranks second highest at more than $9,000 per person. Even when state debt is considered as a percentage of personal income, Connecticut ranks third highest in the nation.

Several proposals recently brought before the legislature could address this problem, including instituting a hard cap on allowable debt. In fact, in 2000, New York adopted both a hard cap on its total debt and a hard cap on debt service as a percentage of general spending. Connecticut could follow this example.

However, it may be necessary in the near term to put a complete freeze on adding new debt, just to get current debt growth under control. Projects deemed necessities could move forward, but other borrowing should be put on hold.

A Way Forward

There is still time in the current session for lawmakers to adopt suggestions laid out in this paper. Closing a $1.7 billion budget gap is a daunting task, but the state will not start to grow again unless the status quo is changed.

Connecticut's challenges are formidable. They require from lawmakers an approach more comprehensive than simply changing the numbers on the state's balance sheet. Instead, Connecticut's officials must approach the budget and spending in new ways. Asking taxpayers for more of their hard- earned money is neither a popular, nor effective method. Along with further eroding confidence in state government, it would likely speed the outmigration of individuals and businesses. The state's challenges did not manifest overnight, and they will not be solved through traditional line item reforms or a piecemeal approach. If Connecticut lawmakers lead with the bold (yet responsible) solutions above, economic growth, job creation, and widespread opportunity will surely follow.

Yankee Institute for Public Policy

May 2018

Senate Approves Pension Revocation for State Employees Convicted of Sexual Assault on the Job

By Marc Fitch

A late night amendment to the Senate's sexual harassment bill -- passed in the early morning hours of May 4 -- would require the attorney general to initiate court proceedings to remove a state employee's pension if they are convicted of sexual assault while on the job.

Sen. Art Linares, R-Westbrook, called for the Republican amendment in response to reports confirming former state employees convicted of sexual assault and rape in the course of their duties are still eligible to receive their state pension.

Linares said the amendment was a "logical addition to the bill."

"I can't fathom that state employees could be convicted of aggravated sexual assault on the job and still retire with their pension," Linares said in an interview. "This change would prohibit that."

The amendment passed 30 - 6 in the Senate, with Sen. Mae Flexer — a self-described outspoken advocate for women's rights and co-sponsor of the new harassment legislation — one of six Democrats who voted against the language.

On the Senate floor Flexer said she worried the amendment would limit statutory language from 2008 which allows pension revocation for the conviction of any crime on the job.

The Attorney General's office has repeatedly affirmed that pension revocation is only limited to financial crimes, according to state statute.

Linares answered by pointing out current law continues to allow those convicted of sexual assault while on the job to receive their pensions.

Linares cited Ellis K. Hagstrom, who was convicted of raping two disabled women for years while employed by Connecticut's Department of Developmental Services. Both the State Comptroller's Office and the Attorney General's Office have confirmed Hagstrom remains eligible for his pension.

The Attorney General’s office said Hagstrom’s convictions “do not qualify as predicate convictions” in a 2016 article by Yankee Institute, and said they are barred from pursuing any action to revoke his pension.

Flexer also questioned why the amendment wasn’t more expansive to include other crimes. “We can’t just be having knee-jerk proposals,” Flexer said. “And I’m concerned that this is not looking at a broader set of felony crimes.”

Linares said the provisions of the bill could be expanded in the next session.

Although the language of the bill does not automatically revoke a state employee pension if there is a conviction, it provides guidance for the court in determining whether or not a pension should be revoked or reduced.

According to the amendment, the court will revoke or reduce a pension based on the severity of the crime related to their state office; the amount of money lost by the state or quasi-public agency; the severity of the violation of public trust; whether or not the crime was part of a fraudulent scheme and any other factors the court deems necessary to achieve justice.

The passage of the amendment — part of a bill expanding sexual harassment training and eliminating statutes of limitation for the victims of sexual assault — comes amidst the national #MeToo movement, and finishes what Senator Richard Blumenthal attempted in 2008 when he was Connecticut’s attorney general.

Blumenthal tried to revoke pensions for state employees convicted of sexual assault, but the changes limited pension revocation to financial crimes only.

Sen. Duff, D-Norwalk, questioned the legality of revoking a pension which is part of a labor contract between the state and the employee and expressed concern the measure would be challenged in court.

Linares responded that the legislation passed in 2008 set a precedent and this amendment would expand on that precedent.

“It seems like it was a good bi-partisan idea then and it’s a good bipartisan idea now,” Linares said. “The attorney general should have this responsibility incumbent upon them.”

Duff voted in favor of the amendment.

The bill now goes to the House for a vote.

"My hope is that there will be no changes to the amendment prohibiting pensions for employees convicted of sexual assault," Linares said.

Yankee Institute for Public Policy

Jan. 2017

State Retirement Commission blocks towns from real pension reform

By Marc Fitch
Welcome to the Connecticut Municipal Employee Retirement System (CMERS), a state-run pension plan for local public employees that's a little like the Hotel California: Once you're in, good luck getting out.

Take the case of Hamden. Hamden had one of the worst funded pension plans in the country. The pension was only 10 percent funded and owed $400 million toward the fund.

In an effort to reduce future liability, starting in 2007, Hamden moved all new police and fire hires to the CMERS plan, and finally their civilian hires in 2009. This closed the old pension plan to new hires.

This improved their net pension fund's outlook, but former Mayor Scott Jackson – who now works for the state Department of Labor – wanted to go a step further to save the town money by moving new hires into a defined contribution, 401(k)-style plan, and he secured agreement from the union representing town employees.
But Jackson learned that CMERS doesn't allow you to opt out. Despite agreement by both Hamden officials and unions, they were unable to move new hires to a defined contribution plan because state statute doesn't allow it.

CMERS does not allow for only part of a town's workforce to be enrolled. It is an "all-in or all-out" scenario. So the town cannot make a new retirement plan for new employees unless they withdraw all employees from CMERS and cover the full liability costs for all employees.

As a result, the state statute stands between the town of Hamden and the retirement benefits reform they not only want, but need.

Actuaries say this law is necessary because if towns were able to opt out for new employees it would raise the contribution costs for all participating municipalities. Regardless, the contribution costs are growing anyway. Scott testified before the Labor and Public Employees Committee that Hamden's contribution was expected to grow from $1 million per year to $20 million by 2040.

Meanwhile, the town's yearly payments to CMERS are projected to grow dramatically over the next thirty years.

Hamden's attempted shift is part of a much larger trend of reforming retirement benefits within the public sector. Towns in Connecticut are coming to accept that projecting future pension costs is difficult and taxpayers suffer when the assumptions are incorrect.

And this is true as well for other towns that belong to CMERS. Despite the rising cost, they cannot leave the program unless they follow the state's strict constraints. Half of Connecticut towns are shackled by this rule.

In 2015, the Labor and Public Employees Committee raised a bill that would change this, H.B. 6931. The bill would have allowed towns like Hamden to switch new hires over to a defined contribution program.

As Jackson wrote in his testimony to the committee, "The cost of the defined contribution plan would be less than the cost of placing new employees in CMERS and provide the parties with more flexibility at the bargaining table. … This approach also benefits the state of Connecticut, as ultimately CMERS would be responsible for making pension payments to a smaller number of municipal employees."

Unfortunately, the bill went nowhere.

CMERS has underperformed in recent years. Since 2009, CMERS has accrued $300 million in unfunded liability, dropping from a 103 percent to an 85 percent funded ratio. The primary reason for this gap is that assets failed to grow as quickly as expected. This highlights the main problem with defined benefit plans – even the best operated pension plans can experience difficulty or even fail because they are based on assumptions that may or may not be correct.

This state restriction on towns in CMERS forming new plans for their new employees stands in the way of reforms that would make retirement benefits for municipal employees safer and more sustainable – and it should be repealed.

This is a common sense reform – if your town's elected officials and unions come to an agreement on sustainable retirement reform, they should be able to enact it. The state shouldn't intervene in local finances to block fiscal responsibility.

Yankee Institute for Public Policy

Nov. 2017

When One Unelected Bureaucrat Decides the Finances of a City

By Marc Fitch
In 2017, the City of Hartford faced a $65 million deficit and was teetering on the edge of bankruptcy. Mayor Luke Bronin was trying to reach concessions deals with the city's various government employee unions to save money, but at that point had only been able to reach a deal with the city's firefighters.

In the midst of this, Hartford received an unexpected blow to its finances thanks to the decision of an arbitrator -- an unelected bureaucrat who makes final, binding decisions in contract disputes between municipalities and unions.

Contract negotiations between the city and the Hartford Municipal Employees Association had been ongoing since 2013. Unable to reach an agreement, the parties ended up in arbitration. The union demanded 7.75 percent retroactive pay increases for its 181 members, some of whom are among the highest paid municipal employees in the state, according to the arbitratiors' analysis.

The arbitration board consisted of James Ferguson representing the interests of the union, John M. Romanow representing the interests of the city, and Mark E. Sullivan, who was the designated neutral voice in the room -- and ultimately the one person who would decide whether Hartford would have to pay out millions in back pay when it already couldn't afford to pay its bills.

Sullivan is a retired University of Connecticut professor, where he was head of the Mediation Certificate Program. He serves as a neutral alternate, but has spent time working with labor organizations in the past. Members of the state mediation and arbitration board, including alternates, are appointed by the governor.

Per state statute, the arbitration panel considered a number of different factors: contracts in other municipalities as well as labor agreements between Hartford and its other labor unions; Hartford's ability to pay; the financial well-being of the city; the economic condition of the state; the welfare and interest of the employees and, finally, whether or not such changes are in the public interest.

The disputed issue revolved around two retroactive pay increases of 1.25 percent dating back to 2013 and 2014. On the rest of the pay increases, the city and union agreed.
The arbitration panel knew that Hartford's financial situation was dire. They noted that Hartford was facing "an unparalleled financial crisis which is often termed catastrophic," and is one of the poorest municipalities in the state. At the time of the decision, Hartford had a negative cash flow of $19 million.

However, in a decision that Bronin decried as "stunning," the arbitration panel awarded a pay increase of 6.25 percent retroactive to 2014, costing the city an additional $1.1 million and pushing it further down the road toward bankruptcy.

Bronin had previously attempted to bypass the arbitration process by supporting the creation of a panel which would have had final say on Hartford's union contracts, but his idea was derided by union officials and eventually shot down by state lawmakers. Bronin serves on the board of directors for the Connecticut Conference of Municipalities, which pushed for municipal binding arbitration reform during the 2017 state budget negotiations.

In a similar case, with another big payout, the City of Waterbury in 2017 went to arbitration with its firefighters union. The union was demanding, among other things, retroactive wage increases totaling 7.75 percent, while the city was offering 4 percent.
Once again, the three person arbitration panel consisted of two members who had already agreed to disagree - the arbitrators representing labor and management.
The final deciding vote would come down to the designated neutral: Leslie A. Williamson, a retired state employee who worked as an attorney with the State Department of Education.

The financial history of Waterbury played a major role in a number of decisions made by the panel. Waterbury had nearly gone bankrupt and was placed under the control of a state oversight board between 2001 and 2006. The board was created to help the city get out from under a massive amount of debt and to improve its junk bond rating.

The union argued that the city had "indisputably rebounded from the economic conditions which promoted the intervention of the Oversight board," according the arbitration decision. The union claimed the city's grand list had expanded by $50.5 million between 2013 and 2014 and said Waterbury's "effort to attract and expand businesses has been quite successful." They noted the city had budget surpluses for several years and now had a 15 percent reserve fund.

After reviewing reports by Standard & Poor's and Fitch Ratings, the arbitrators largely agreed with this finding, although they noted the state of Connecticut was reducing payments to the city in the amount of $3 million.

When the final decision was reached, the city of Waterbury came out a little worse off. The firefighters received a 7 percent increase in pay, with retroactive increases going back to 2014, totaling $2.4 million.

Wage increases were just one of more than twenty contract issues heard by the arbitration panel.

Waterbury Mayor Neil O'Leary - who also serves on CCM's board of directors - said the decision was favorable for the city because Waterbury had enough money in reserves to cover the wage increases and was able to prevent costly pension changes demanded by the union.

Nevertheless, during the 2017 budget negotiations, Mayor O'Leary called for reforms to municipal binding arbitration.

When the budget passed, it included a small reform to the binding arbitration process: from now on 15 percent of a town or city's reserves would be exempt from consideration as to whether or not a municipality can pay for a contract.

That may be some consolation to Waterbury, which has reserves, but it is of little comfort to Hartford, which will be facing financial hardship for years.

Section A.2 History of Binding Arbitration

Arbitration over contracts for both municipal employees and teachers began in 1975 as a way to expedite contract disagreements without resorting to the court system or strikes by public sector unions. The State Department of Education has its own arbitration panel to handle education contracts, while the state maintains an arbitration board for other municipal contracts.

There are two types of arbitration - interest arbitration, which focuses on collective bargaining disputes, and grievance arbitration, which involves workplace disputes or interpretation of the labor agreement. These are handled by different sets of arbitrators.
Most arbitration cases are handled by a three person panel of designated arbitrators, but in some cases a single arbitrator decides the case. Although it is not required that an arbitrator be an attorney, most of them are, and often the city and the union will hire attorneys to make their case before the panel.

Each side selects their representative on the panel, and then both must agree on who will be the designated "neutral." So, when choosing a neutral, both sides examine the individual's history of making decisions before accepting or rejecting them.

Both the town and the union will make their last best offer on each separate issue. Although the arbitrators are not allowed to split the difference between the two offers or agree to anything other than the last best offer from either side, they can often find a work-around by accepting the town's final offer on one issue and the union's final offer on another.

An arbitration award can be overturned by a 2/3 vote of the town or city's legislative body. At that point, the award is reviewed by a new panel composed entirely of neutral arbitrators. Their decision is final and binding on the municipality, which must also pay for their services. This doesn't happen often.

A 2006 study by the Legislative Program Review and Investigations Committee found that just 4.5 percent of municipal arbitrator decisions went to a second review hearing. Only 9 percent of the issues that went to a review hearing were reversed.

In rare situations, the municipality can take their case to court, although it is usually unsuccessful.

Section A.3 Controversy Over Binding Arbitration

Municipal leaders have been advocating for reforms to the binding arbitration process for years, claiming it leads to higher costs for local taxpayers. Unions increase the number of their demands, confident that an arbitrator will grant at least some of them.

With binding arbitration, the last best offer -- put forward by elected leaders of a municipality -- can be superseded by an unelected panel, which really comes down to a decision by the single neutral arbitrator.

A study by the Cato Institute said that arbitration is a boon for government unions "because an arbitrator will never award a settlement that is anything less than management's final offer, so the union is guaranteed to obtain at least some of its demands and will never come out worse than the status quo ante."

In the case of Waterbury and the firefighters, the union was guaranteed at least a 4 percent raise because that was the city's final offer. Taking the issue to arbitration and making each year's wage increase a separate issue almost guaranteed they would receive more than the bare minimum.

The report by the Legislative Program Review and Investigations Committee found that in most cases, there was a 1 percent per year difference in the wage offers between municipalities and unions. Because contract negotiations can take years, wage increases are often retroactive, compounding the costs to the municipality.

The Investigations Committee also reported that arbitrators sided with towns on 62 percent of the issues when it came to municipal labor contracts, and 51 percent of the time when it came to teachers' issues.

But those statistics only tell half the story.

Arbitration decisions generally involve multiple issues. Even wages are not considered a single issue because each wage increase for each year is considered separate. If the arbitration panel sides with the town on 2 out of 3 wage increases, the majority of the panels' decisions would be in favor of the town, but the union still walks away with a better deal, and the taxpayers have to pay more.

This is part of the problem with municipal binding arbitration, according to Betsy Gara, executive director of the Connecticut Council of Small Towns. In testimony before the state Labor Committee, Gara said that the arbitration process leads to a “one for you, one for him” outcome, rather than arbitrators picking one full final package.

The process “encourages extreme game playing in putting together the final offers package,” Gara wrote. “There is little incentive for either side to come together.”
It’s a “game” in which the union side has little to lose and can secure a better deal.

A 2015 arbitration decision in a contract dispute between the City of New Haven and the city’s attorneys’ union provides an example.

The union was demanding a 9 percent retroactive wage increase, while the city was offering a non-retroactive 6 percent raise. The city argued that it had virtually nothing in reserves to pay out retroactive wages.

Between the three years of wage increases and whether or not they would be awarded retroactively, there were 5 separate issues for the arbitration panel to decide:

1. If wage increases would be retroactive to 2013.
2. If the 2013 wage increase would be 2.5 percent or 3 percent.
3. If wage increases would be retroactive to 2014.
4. If the 2014 wage increase would be 2 percent or 3 percent.
5. If current wages going forward would be increase 2 percent or 3 percent.

In the end, the arbitrators decided in favor of the city on issues 1, 3, and 5 and with the union on issues 2 and 4 resulting in a non-retroactive 8 percent raise.

While the city won most of the decisions, it still had to raise wages 2 percent over their final offer. The city didn’t have to pay a lump sum in retroactive wages, but still had to pay more going forward.

Section A.4 State Budget Problems

As budgetary problems at the state level trickle down to cities and towns, municipalities find themselves struggling to pay for wage increases for employees and teachers. Sometimes a few percentage points can make a big difference, particularly because towns face contract negotiations with multiple bargaining units, all looking for a bigger piece of the pie.

During Connecticut's 2017 budget crisis, Gov. Dannel Malloy temporarily cut education funding to 139 towns and cities, leaving some towns on the verge of insolvency. Although funding was mostly restored through the budget agreement, Malloy cut another $90 million from education funds when he had to make an additional $180 million in cuts.

The Empire Institute's study of New York's binding arbitration decisions for public-safety employees - the only employees allowed to use binding arbitration in New York - found that wages increased three times faster for police and firefighters than for other public-sector employees. An arbitration decision raising wages in one municipality essentially sets the bar higher for other towns and cities when negotiating with their unions.
Binding arbitration can also set up fiscally responsible towns for difficulty, as the arbitrators consider what a town has in savings as fair game when deciding whether or not wages and benefits can be increased under a new contract.

Connecticut municipalities, on average, have about 12 percent of their budget in reserve.

In testimony before the Labor and Public Employees Committee, Gara argued that allowing arbitrators to consider a town's fund balance essentially puts a town's credit rating at risk.

"Requiring towns to lower fund balance reserves to pay for increased employee benefits will adversely impact a municipality's bond rating," Gara said in her written testimony. "This can be very costly to municipalities and their taxpayers."

Education costs are generally the largest expense in any municipality's budget, so binding arbitration for teachers, administrators and paraprofessionals can end up costing a town big money out of its reserves, particularly when it involves a payout of retroactive wages.

The 2006 study by the Investigations Committee found that when it came to wage increases, arbitration panels found in favor of teacher wage increases 58 percent of the time, and for administrators 78 percent of the time.

Education costs - the majority of which are pay and benefits for employees - increased 32 percent on average between 2006 and 2016, much faster than the rate of inflation. Those increases came despite declining student populations.

Contract negotiations almost always include raises for employees, increasing payroll costs for municipalities, even when there may not be any increased revenue. If a city or town is not expanding, growing its grand list or receiving more money from the state, it may have to resort to property tax increases to support wage or benefit increases.

In a 2012 arbitration decision between the Town of Westport and its public works union over an 8 percent wage increase, the town argued that its grand list had actually decreased by 12.4 percent and state funds were decreasing, putting the burden of the wage increase on taxpayers.

“Thus, the Town’s only option to meet increased expenses, and presumably what the Union expects the Town to do in order to fund their salary and benefit increases, is to further burden Town taxpayers,” Westport argued. The town also pointed out that its reserve funds had been used to balance the budget in the past.

In this case, the arbitration panel sided with Westport on the wage increases, limiting the increase to 6.5 percent.

Arbitration can also inhibit a municipality’s ability to change its benefit structure in a timely manner. In 2014, the Town of Cheshire attempted to move eight new police officers onto a 401(k) style retirement plan. The town had already moved all its other new employees onto the new system. A contentious arbitration fight between the town and the police union resulted in four of the officers receiving the old pension plan and four being moved onto the new defined contribution plan.

Under the decision, all officers hired in the future would be part of the defined contribution system, but Vice Chairman of the town council, David Schrumm, said the decision “will cost taxpayers for years to come.”

“I don’t begrudge us going to arbitration because there are times when you have to stand up for something, not just lay down and take it,” Schrumm told the New Haven Register. “This is another example of public employees and our state’s political system being joined at the hip.”

The composition of the panel has also been scrutinized because the arbitrators representing labor and management will always vote in favor of their side. Even instances in which the town and union agree, the arbitrators will choose one side for the award and the arbitrator representing the other side will dissent.

Essentially the designated neutral is the only vote that matters. Gara claimed that the neutrals are a “good old boys” list and “are essentially political appointees.”
The process can take years and can become expensive for taxpayers. The City of Waterbury spent $135,000 on legal fees during one arbitration process.

However, one of the most consistent criticisms about the binding arbitration process is that it takes control of a municipality’s finances away from elected officials and puts it in the hands of an unelected panel.

Section A.5 Small Reforms Part of the New Budget

Unlike other states, some of which only use binding arbitration for public safety workers, Connecticut requires arbitration for all collective bargaining units, whether they are New Haven attorneys, librarians in Wethersfield, or paraprofessionals in Monroe. Any and all bargaining units can take a town to binding arbitration for a chance to increase their pay and benefits.

Municipal leaders have been calling for binding arbitration reform for years and this year they got one small reform as part of the budget.

Under the new law, arbitrators can only consider 85 percent of a municipality's reserve funds when deciding whether or not a municipality has the ability to pay for increased costs. In the case of Waterbury and its firefighters, the arbitrators considered Waterbury's $13.9 million In reserve funds. Under the new law, that number would have been $11.8 million.

In an op-ed for the Hartford Courant, Connecticut Conference of Municipalities Director Joe DeLong wrote, "This provision alone would allow towns to maintain healthy reserves for bonding and necessary capital projects without fear of the money being diverted into increased salaries and benefits."

It was a small victory. Critics point out that even a healthy reserve fund of 15 percent of the town budget could be quickly depleted to nearly nothing. Fifteen percent of fifteen percent doesn't add up to much, after all.

It is not unheard of that an arbitration decision can ruin a city. A 2011 arbitration decision against the City of Scranton, Pennsylvania cost the distressed municipality $17 million in retroactive pay increases to police and firefighters. The city had to pay all its other employees minimum wage in a scramble to meet the increased costs.

When the city was unable to come up with the funds, a judge ordered the amount of back pay increased to $21 million and the unions threatened to seize the city's assets.
In Connecticut, recognition of the need for reform comes from both sides of the political aisle. Gov. Malloy pushed for binding arbitration reform as part of his budget package, possibly to tempt municipal leaders and organizations into accepting his proposal to shift part of the state teacher pension costs onto municipalities.

Part of the governor's reforms also included making the selection of a neutral arbitrator random, similar to the way court judges are appointed, but this reform was left out of the final budget agreement. COST has called for the arbitrators to be chosen from an unbiased organization such as the American Arbitration Association.

Republicans had long advocated for reforms to the arbitration system for municipalities, but their Democratic counterparts also put forward the idea of reforming binding arbitration laws in order to better help towns and cities manage their budgets.

Some other states have taken on binding arbitration reforms more aggressively. New Jersey instituted a wage increase cap of 2 percent for binding arbitration, making the process less palatable for unions seeking large wage increases.

New York, Massachusetts and Rhode Island only allow binding arbitration for public safety workers like police and firefighters, although that didn't prevent Boston from being forced to give 25 percent wage increases to its police officers, costing the city $80 million and a 19 percent raise to its firefighters, which cost $74 million

Section A.6 Moving Forward

As Connecticut's fiscal problems continue and state deficits add up, towns and cities may continue to see less revenue coming in from the state, while employees and teachers continue to demand higher wages.

This year's state budget agreement resulted in less money flowing to cities and towns, while those municipalities struggle to meet growing expenses and end up draining their budget reserves.

These difficulties will lead to further examination of the state's binding arbitration laws, and lawmakers will have to decide whether this process is best for taxpayers and the state moving forward.

Hartford has been placed under the control of an oversight board similar to the board which took over Waterbury's finances in 2001, in exchange for receiving an additional $40 million from the state. The board will have greater power to negotiated contracts with the city's unions.

Although contract negotiations with employees continually ratchets up employee costs, it appears likely that in the future a municipality's ability to pay is going to become a bigger and bigger consideration for arbitrators — namely, because some towns won't be able to.

The next article, written by our policy director in conjunction with the Mercatus Center, focuses on the pension-funding crisis in New Jersey, but the issues it addresses are concerns that will weigh heavily on your administration as it attempts to repair Connecticut's finances and revive its economy. Like Connecticut, New Jersey has made excessively generous pension promises without funding them; simultaneously, it has run up some of the highest debts, lowest credit ratings, highest tax rates, lowest citizen satisfaction rates, and highest out-migration rates of any state. Like Connecticut, New Jersey's pension crisis has been exacerbated by a surfeit of government-worker representation on the state's pension boards, and a dearth of independent members representing taxpayer interests. And like New Jersey, Connecticut is in no position to address its pension crisis with additional tax increases.

The following article, of similar provenance, considers the state-court cases in California that are reviewing the "California Rule," which has been understood to forbid, under that state's law, efforts to revise benefits for current workers for work not yet performed. Connecticut, like California, has thus far shown an unwillingness to take this vital step. Connecticut, like California, is ill-advised in that reluctance, for the reasons detailed in that paper.

Yankee will be addressing Connecticut's pension-funding crisis and solutions to it in deep detail in the new year. For now, we include these studies in this appendix in the hope that the administration will recognize the insights applicable to the Connecticut pension crisis that are contained in them.

The New Jersey Pension Crisis

Flailing in Deep Waters

Scott Andrew Shepard

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Abstract

New Jersey has a deep pension-funding crisis. It has made excessively generous pension promises without funding them; simultaneously, it has run up some of the highest debts, lowest credit ratings, highest tax rates, lowest citizen satisfaction rates, and highest out-migration rates of any state. Its responses have proven futile or counterproductive. While the pension crisis has arisen largely from a lack of citizen oversight, the state has recently increased governmentworker control. While it has failed to fund its pensions, it has recently made a cosmetic dedication of lottery revenues that will only serve to hide—not correct—underfunding. And while the state already shows signs of tax-base flight, it contemplates enormous tax increases. New Jersey's future likely requires its officials to reduce pension promises for work not yet performed and to trim some already-granted pensions that run in excess of earnings during working years and reasonable New Jersey compensation levels.

JEL codes: H10, H11, H12, H3, H550, H71, H72, H74, H75, H77, J5, J58, K1, K12, K31

Keywords: pension reform, public pensions, state finances, government finance, public employees, public-employee unions, government employees, government-employee unions, vicious cycle, taxpayer flight, tax-base flight, employee benefits, public choice theory, government oversight, fringe benefits

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The New Jersey Pension Crisis: Flailing in Deep Waters Scott Andrew Shepard

Though one of the wealthiest states in the Union,[1] New Jersey faces one of the country's deepest budget crises. A 2017 Mercatus Center report ranked the state's financial condition as the worst in the nation;[2] other good judges reach similar conclusions.[3] It has the highest taxes, the worst business climate (or one of the very worst),[4] the second-lowest credit rating,[5] and one of the most sclerotic state governments[6] of any US state.

In common with most of the states now in the worst fiscal shape, New Jersey's woes arise largely from the financial burdens created by decades of underfunded, overgenerous government-employee pension promises.[7] For many years, the state and municipal office holders have been able to make pension promises to government workers, satisfying influential

[1] *See, e.g.*, *BEA Fact Sheets: New Jersey* (US Department of Commerce, Bureau of Economic Analysis, Mar. 28, 2017) (third-highest personal income per person).

[2] *See* Eileen Norcross & Olivia Gonzalez, *#50: New Jersey*, *in* RANKING THE STATES BY FISCAL CONDITION 41 (2017 ed.).

[3] *See, e.g.*, Volcker Alliance, *New Jersey*, *in* TRUTH AND INTEGRITY IN STATE BUDGETING (Nov. 2, 2017). The Volcker Alliance is slightly less bleak. It has given New Jersey D or D-minus grades over the last three years for budget forecasting, "budget maneuvers," and legacy costs, but B grades for reserve funds and transparency. *See also* Mike Lilley, *New Jersey Is Dying: A Special-Interest-Dominated Status Quo Is Hurting the State's Economy*, *in* AEI LEGAL CORRUPTION SERIES V (Nov. 2017); Jared Walczak, Scott Drenkard & Joseph Bishop-Henchman, *2018 State Business Tax Climate Index*, TAX FOUNDATION (Oct. 17, 2017), https://taxfoundation.org/state-business-tax-climate -index-2018/ (worst business taxes in the country); Arthur B. Laffer, Stephen Moore & Jonathan Williams, RICH STATES, POOR STATES 32 (ALEC-Laffer State Economic Competitiveness Index, 10th ed., 2017) (47th for economic performance; 48th for economic outlook); Dale Buss, *CEOs Rank 2017 Best & Worst States for Business*, CHIEF EXECUTIVE (Apr. 26, 2017).

[4] *See* all sources cited in note 3, *supra*.

[5] *See, e.g.*, Elise Young, *Christie's Final Budget, and No Repair for Worst-in-U.S. Pension*, BLOOMBERG.COM (Feb. 27, 2017), https://www.bloomberg.com/news/articles/2017-02-27/christie-s-final-budget-and-no-repair-for-worst -in-u-s-pension.

[6] *See, e.g.*, Eileen Norcross & Frederic Sautet, *Institutions Matter: Can New Jersey Reverse Course?* (Mercatus Center at George Mason University, Working Paper No. 09–30, 2009).

[7] "Expenditure growth is driven primarily by the State's required public employee pension contribution, which represents an increase of $554.5 million over the fiscal year 2016." Office of Management and Budget, *Section C, Summaries of Revenues, Expenditures and Fund Balances*, *in* FISCAL YEAR 2017: THE STATE OF NEW JERSEY DETAILED BUDGET C-2 (Feb. 16, 2016); Elise Young, *Whoever Replaces Chris Christie Faces Lingering Fiscal Headache*, BLOOMBERG.COM (Oct. 30, 2017), https://www.bloomberg.com/news/articles/2017-10-30/whoever -replaces-chris-christie-faces-lingering-fiscal-headaches (NJ pensions the worst funded in the country).

government-employee lobbies,[1] without themselves facing any negative consequences. They would safely have retired or moved on to different positions long before the vast cohort of the baby boomer generation would begin to retire and to present the bill for their largesse—while they themselves, as government employees and public officials, gained personally and professionally from their generosity with taxpayer funds. Now, however, the baby boomers are retiring. The pension-payment bills have begun to come due and will continue to arrive every month for decades to come.

Those bills, when properly calculated, are and will continue to be staggering. New Jersey's annual budget runs to approximately $35 billion.[2] A variety of state constitutional provisions, state supreme court mandates, and obligations under federal programs such as Medicaid render most of the state's budget automatic—earmarked and essentially untouchable.[3] The state can spend only a relatively small fraction of that $35 billion with discretion.[4] From this fraction the state must fund any number of obligations, including worker salaries, general operations, facilities maintenance—and government-worker pensions and retiree healthcare costs. New Jersey almost certainly cannot meet its present pension promises out of these funds nor raise enough new revenue to meet them.

The "normal costs" (i.e., the amount required to fully fund the current year's governmentworker pension and healthcare costs), when added to each year's annualized liability for accumulated funding deficits, already impinge heavily on this discretionary budget, while the state's Pension and Health Benefit Study Commission looks for retiree-benefit costs to double by 2022 unless changes are made.[5] In other words, unless pension and healthcare benefits are cut significantly, New Jersey will soon find itself unable to fund these benefits even were it to dedicate the whole of the state's discretionary budget to the effort. While this is obviously impossible, the full scene grows darker still. The figures already considered arise using a discount rate (i.e., the rate the state expects to earn on the funds that have been set aside to meet these bills) on pension assets already collected—a rate that most observers recognize as significantly too high; the official rate was reduced in 2017 from 7.9 percent to 7.65 percent,[6] and it will be reduced again to 7.5 percent in 2018.[7] But this number must fall further—arguably

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[1] *See, e.g.*, Mike Lilley, *Job Number One: The New Jersey Education Association's Role in New Jersey's Disastrous Pension and Benefits Crisis, in* AEI LEGAL CORRUPTION SERIES III (Nov. 2017) [hereinafter Lilley III] (describing power of the NJEA, the state's largest government-employee union and largest political donor).

[2] *See, e.g.*, Lilley, *supra* note 3, at 1.

[3] *See, e.g.*, Norcross & Sautet, *supra* note 6.

[4] *See id.* at 71.

[5] *See* NEW JERSEY PENSION AND HEALTH BENEFIT STUDY COMMISSION, SUPPLEMENTAL REPORT ON HEALTH BENEFITS (Feb. 11, 2016) (the most recent report generated by the commission).

[6] *See, e.g.*, John Reitmeyer, *Unfunded Liability of Public-Employee Pension System Closes In on $50 Billion*, NJSPOTLIGHT.COM (Mar. 6, 2017), http://www.njspotlight.com/stories/17/03/05/unfunded-liability-of-public -employee-pension-system-closes-in-on-50-billion/.

[7] *See, e.g.*, Samantha Marcus, *Christie Move Will Force a Big Boost in Pension Price Tag for Phil Murphy*, NJ.COM (Dec. 20, 2017), http://www.nj.com/politics/index.ssf/2017/12/christie_accounting_change_drives_pension _price_ta.html; Andrew Coen, *New Jersey Zigzags on Pension Fund Discount Rate*, BOND BUYER (Mar. 2, 2018), https://www.bondbuyer.com/news/murphy-administration-in-new-jersey-zigzags-on-pension-fund-discount-rate. New Jersey has done more than most states to comply with GASB 67, which "advises plans to value the funded portion of liability based on the higher-risk discount rate and value any unfunded portion of the liability based on the low-risk return on tax-exempt municipal bonds. . . . In New Jersey, actuaries projected an earlier run-out date for plan assets, resulting in the fullest use of the blended rate out of all state plans. As a result, New Jersey's pension liability increased by 107 percent owing to the application of the new standard. By contrast, other state plans with significant unfunded liabilities did not apply the more conservative blended rate, but continued to use more generous assumptions." Sheila Weinberg & Eileen Norcross, *GASB 67 and GASB 68: What the New Accounting Standards*

to the risk-free rate that US treasury bonds pay.[15] Even a much smaller cut, as to the average actual return earned over the past 10 years, would add significantly to the state's annual pensionfunding obligations.

Meanwhile, these figures fail to account for the fact that the state has never paid its full normal costs, plus full annualized deficit-reduction contribution, in any year and has no plausible plan to do so.[16] The real pension-funding shortfall already runs to about $200 billion (or closer to $300 billion if healthcare benefit promises and local-government obligations are included) if the state uses a risk-free rate matched against current "closeout" obligations.[17] And as ludicrous as these numbers are now, they compound every year, while something less than the full amortized underfunding payments are made.

And so we reach the crisis: it is hard to imagine a scenario under which the current pension and healthcare promises could be honored. Cutting them appears to be the only option.

15 *See, e.g.*, Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSPECTIVES 191, 193, 195, and *passim* (2009) (risk-free rate most appropriate, matched against the present value of the liabilities, known as the "accumulated benefit obligation"); John A. Turner et al., *Determining Discount Rates Required to Fund Defined Benefit Plans*, ACTUARIES.ORG (Mar. 2015), http://www.actuaries.org/oslo2015 /papers/PBSS-Turner&GO&McC&B-P.pdf (preferred "rule would be to select a discount rate that is less than the expected rate of return on assets but greater than the risk free rate, with the discount being greater the higher the percentage of the portfolio invested in equity and the longer the duration of the liabilities"); Alicia H. Munnell, *Appropriate Discount Rates for Public Plans Is Not Simple*, MARKETWATCH.COM (Oct. 5, 2016), https://www.marketwatch.com/story/appropriate-discount-rate-for-public-plans-is-not-simple-2016 -10-05 (6 percent). *See also* Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?* 66 J. FINANCE 1211 (2011) (determining public debt using accumulated benefit obligation method); Alicia H. Munnell et al., *The Funding of State and Local Pensions 2012–2016* (Ctr. for Retirement Research at Boston Coll., Issue In Brief No. 32, July 2013), http://crr.bc.edu/wp-content/uploads/2013 /07/slp_32.pdf (same); SOCIETY OF ACTUARIES, REPORT OF THE BLUE RIBBON PANEL ON PUBLIC PENSION PLAN FUNDING 23 (Feb. 2014); Jed Graham, *50 States of Gray: Aging America Faces Retiree Battles, Even Slower Growth*, INVESTOR'S BUSINESS DAILY (Aug. 18, 2017), https://www.investors.com/news/50-states-of-gray-aging - america-faces-retirement-benefit-battles-even-slower-economic-growth/ (governments outside the United States tend to adopt a discount rate of around 3 percent, broadly tracking the risk-free return thesis).

16 *See, e.g.*, Steve Eide, *Connecticut's Fiscal Crisis Is a Cautionary Tale for New Jersey* (Garden State Initiative, Working Paper No. 11, undated) ("As Moody's recently explained, even under optimistic assumptions of economic growth and investment return," the current plan to achieve full annual funding by 2023 will in fact produce only a little more than half of what would be necessary in that year.).

17 *See, e.g.*, Bob Williams et al., *Unaccountable and Unaffordable 2016: Unfunded Public Pension Liabilities Near $5.6 Trillion* (Am. Legislative Exch. Council, Working Paper, Oct. 2016) (using a risk-free discount rate, derived from an average of 10- and 20-year Treasury bond returns, of 2.344 percent); Lilley, *supra* note 3, at 1 (Stanford researchers put the state's unfunded pension and healthcare liabilities at $253 billion [$186 billion for pensions, the remainder for healthcare benefits] and local liabilities at $41 billion).

The state's own pension commission has recognized flatly that "[a]ny attempt to fully fund the existing pension benefits, whether under the terms of the proposed pension funding amendment or any other schedule, will inevitably force cuts in essential services such as education, infrastructure and public safety," while "[t]he tax increases which have been

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Mean for Public Pension Reporting 1–3 (Mercatus Center at George Mason University, Mercatus on Policy, June 2017). New Jersey's adoption of the GASB recommendation does not affect its determination of its total unfunded pension liability using its established discount rate, for policy purposes, however. *Cf.* "Does the Net Pension Liability Affect the Unfunded Liability for the Defined Benefit Program," *GASB 67–68 Frequently Asked Questions, General Information*, CALSTRS.COM (2018), https://www.calstrs.com/general-information/gasb -67-68-frequently-asked-questions.

discussed to date as the answer to the funding crisis would only raise a small percentage of the revenue needed."[8]

But most of New Jersey's public officials want nothing to do with cutting these benefits. The New Jersey teachers' union has, by far, the best-funded and most powerful lobby in the state.[910] It and the other government-employee unions have had great and sustained influence on New Jersey politics and policy. As a result, one of the first acts of the new administration of Governor Phil Murphy has been to enact legislation shifting control over pension investments and benefits—but not responsibility for losses or underfunding—to the uniformed-employees' union.[20] Murphy has further promised to honor all of the state's pension promises in their entirety while raising taxes significantly.[11] His task has been complicated, however, by the federal tax bill that became law in 2017.[12] Among other provisions, it has limited the federal deduction for state and local taxes paid ("the SALT deduction") to $10,000.[13] This limitation will raise taxes for a significant group of higher-end earners in high-tax, high-cost New Jersey.

The government of New Jersey, then, has shown no inclination to begin limiting or reducing pension benefits—likely the only effective solution available to it. Rather, it has focused only on patches. These include dedicating the state's lottery profits to pension funding for 30 years, a plan to which Governor Chris Christie and the general assembly had agreed in 2017; raising taxes (ostensibly, for now, preponderantly on wealthier taxpayers); and the alreadyreferenced transfer of additional authority, without responsibility, to government-worker unions. None of these proposals, though, are even real patches—the type that hold things together for a little while until some permanent solution can be reached. Rather, they are either essentially cosmetic (which is the best possible face to put on the lottery-revenue dedication) or they are actively harmful, like the other two proposals. They are political expedients that obscure the

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[8] NEW JERSEY PENSION AND HEALTH BENEFIT STUDY COMMISSION, SUPPLEMENTAL REPORT ON HEALTH BENEFITS i (Feb. 11, 2016). The commission calls for significant cuts to government-employee healthcare benefits as the measure necessary—and in the commission's view, sufficient—to permit the state to pay all of the pension benefits already accrued for work already performed. The cuts and reforms are wise and necessary, but they are insufficient. They would bring in about $2.25 billion per year. *See id.* Exhibit 11 and explanatory text. If all of that savings were dedicated to paying down the state's current accrued pension fund shortfall, then it would come within $250 million or so of closing the annual retirement-benefit funding gap, but only at the 7.65 percent discount rate that the state had already abandoned. If an even more realistic rate than the new 7 percent rate were used, then even these significant reforms would fall far short of closing the funding gap. Solving the problem, then, requires not only this healthcare benefit reform and shifting benefits for work not yet performed to a defined-contribution system, but also the sort of reform to already-accrued benefits that is proposed in the final section of this paper.

[9] *See infra* notes 20 and 60.

[20] *See, e.g.*, Joe Mysak, *New Jersey Police and Firefighters Aggravate Pension Mess*, BLOOMBERG.COM (Mar. 27, [10]), https://www.bloomberg.com/news/articles/2018-03-27/new-jersey-police-firefighters-aggravate-pensions -mess-mysak; Samantha Marcus, *Phil Murphy Takes Action on Bill Giving Police, Firefighters Control over Pensions*, NJ.COM (May 10, 2018) (Murphy has conditionally vetoed the bill for now. The condition relevant to the considerations of this paper is that the bill be amended to remove from the union-dominated oversight board the power to set its own discount rate. This is a wise condition, but it still leaves the oversight board with power to increase its own benefits. The legislature has indicated that it will make the required changes in its June 7 session, and thus enact the bill.).

[11] *See infra* note 50.

[12] *See, e.g.*, Shannon Pettypiece, *Trump Signs $1.5 Trillion Tax Cut in First Major Legislative Win*, BLOOMBERG.COM (Dec. 22, 2017), https://www.bloomberg.com/news/articles/2017-12-22/trump-signs-1-5 -trillion-tax-cut-in-first-major-legislative-win.

[13] Howard Gleckman, *What the Tax Bill's Curbs on the SALT Deduction Would Mean for Itemizers*, FORBES (Dec. 21, 2017).

problem and deter its genuine resolution for as long as possible. And each of them demonstrates a fundamental, structural flaw in New Jersey's government-employee benefit system that the state needs to confront—but that these initiatives not only ignore but also exacerbate.

This paper will consider the possibility of New Jersey's imposing a "millionaires' surtax" on its 17,000 to 20,000 or so highest-income-generating families and will conclude that the likely effect of such a tax will be to exacerbate a capital and income flight from New Jersey that appears already to have begun. This flight threatens to set off a vicious spiral into economic decay that will do little to pay off the state's pension promises while greatly injuring the state's financial condition. It will look at the recent transfer of additional control over pension investments, accounting, and benefits to the state's uniformed government-employee unions and will determine that this move will only deepen a serious and crippling problem of New Jersey's pension governance—that government-employee interests are already significantly overrepresented in pension decision-making, while the interests of economy and the protection of taxpayers and the private sector are underrepresented.

This paper will review the recent dedication of state lottery funds to pension funding and conclude that, because the dedicated funds were not replaced by other revenue streams or spending cuts, the change is effectively cosmetic and possibly even obscurantist, rather than meaningfully effective. New Jersey faces no real choice but to begin to revise and reduce some of its pension promises; it would be well for the state to act quickly, as further delay only increases the likelihood of more pervasive and less equitable cuts later on. Suggested limitations on pension promises include switching from defined-benefit to defined-contribution pension benefits for work not yet performed (by both current and future employees), installation of payment caps on the largest pension payments, and related cost-cutting measures—all designed with both affordability and equity to all parties in mind.

1. The Millionaires' Surtax, General Tax Increases, and the Vicious Cycle

New Jerseyans appear conflicted about how to respond to this wave of pension-funding obligations. In an early 2017 poll by Quinnipiac University, half of the state's voters approved of raising taxes to—as the pollsters rather opaquely put the question—"fix public employee pensions."[14] Two-thirds of those voters, though, objected to across-the-board tax increases for this purpose.[15] Rather, a slightly higher number supported raising taxes on residents earning more than $1 million a year.[16] This millionaires' tax, proposed by State Senate president Stephen Sweeney in 2015, would have targeted 17,000 New Jersey families, ostensibly to raise an additional $675 million per year.[27] A more recent proposal by Governor Murphy would go further, raising the highest rate to 10.75 percent—the third-highest rate in the country.[17]

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[14] *See* Samantha Marcus, *N.J. Voters Would Raise Taxes on the Rich to Fund Public Worker Pensions, Poll Finds*, NJ.COM (Mar. 21, 2017), http://www.nj.com/politics/index.ssf/2017/03/poll_finds_nj_voters_would_raise_taxes_on_the_rich.html.

[15] *See id.*

[16] *See id.* [27] *See id.* The tax is popularly referred to as a "millionaires'" tax even though the term millionaire usually refers to those who own more than a million monetary units (e.g., dollars, pounds), rather than to those who earn more than a million of those units per year. *See, e.g.*, *Millionaire Definition,* MERRIAM-WEBSTER.COM, https://www.merriam -webster.com/dictionary/millionaire (last visited June 13, 2018).

[17] *See, e.g.*, James Nash & Dustin Racioppi, *Murphy Wants $1.6 Billion in New Taxes to Fund Schools, Transit*, NORTHJERSEY.COM (Mar. 13, 2018), https://www.northjersey.com/story/news/new-jersey/2018/03/13/nj-phil -murphy-tax-increase/418479002/.

One way to make sense of these numbers is this: many New Jerseyans are in favor of *other* taxpayers—namely the highest-earning few thousand—paying more to fund pension promises but are unwilling to pay more themselves.[18] The poll results themselves do not allow this interpretation to be tested; the pollsters failed to ask how many of the voters questioned were themselves millionaires who would be subject to the surtax (though we can reliably presume that the number was fairly small, if the survey was random).[19]

This is a shame, as the question is vital. If the Quinnipiac poll fundamentally demonstrated that most New Jerseyans are not themselves willing to pay materially higher taxes to fund the state's pension promises to current workers and retirees, then the state legislature faces a profound and fundamental crisis. If the 17,000-odd families that would be targeted by the surtax are not willing to pay it, they—or at least many of them—are free to decamp to states that tax income less heavily and that have lower taxes in general.

These families are spoiled for opportunity. New Jersey has one of the highest state income-tax rates in the country already,[20] as well as one of the highest overall state tax burdens,[21] making most states relatively attractive destinations even before the addition of a millionaires' surtax.[33] New Jersey, though wealthy, is not particularly large and has many neighbors, making a move more feasible for many New Jersey families than would be the case in many other American locales. States with no income tax and warmer weather than New Jersey, such as Florida and Texas, also appear to be popular destinations for outgoing New Jerseyans.[22] And of course, the families that would be affected by any millionaires' tax would by definition constitute the highest earners in the state—those in the best position to pay relocation costs and to recoup, and more than recoup, those costs in future tax savings.

If New Jersey's high earners (or a substantial number of them) *are* willing to move rather than pay the proposed surtax (or pay materially higher taxes generally), a series of potential consequences follows. First, as some of the targeted families decamp, the amount expected to be recouped from the surtax itself falls, because fewer families will be available to pay it. (If a tax on 17,000 families is expected to bring in an additional $675 million per year, then the average surtaxed family in New Jersey is expected to contribute an additional $40,000 per year [approximately]. Should only 1,000 of those 17,000 choose to move rather than pay, the expected surtax revenues would fall by $40 million annually.[23]) Meanwhile, the state will also lose all of the other tax revenues—income, sales, property, and other—contributed by those

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[18] As Senator Russell B. Long (son of Huey P.) used to put it, "Don't tax you, don't tax me; tax that man behind the tree." John H. Cushman Jr., *Russell B. Long, 84, Senator Who Influenced Tax Laws*, N.Y. TIMES (May 11, 2003) (obituary). *See also* Nash & Racioppi, *supra* note 28 ("Murphy and his aides said . . . that higher taxes on millionaires is an idea broadly popular among those who don't have to pay it.").

[19] *See* Marcus, *supra* note 24.

[20] *See supra* note 3.

[21] *Id.* [33] Pennsylvania and New York, to which New Jersey is already losing significant numbers of relatively young and affluent citizens, have personal income-tax rates of 3.07 percent (flat) and 8.82 percent, respectively, and propertytax rates of 2.95 percent and 4.6 percent, respectively, to New Jersey's 5.4 percent. *See* Lilley, *supra* note 3 at 9–10.

[22] *See, e.g.*, Jeff Goldman, *People Are Fleeing N.J. Faster Than Any Other State, Moving Company Says,* NJ.COM (Jan. 5, 2015), http://www.nj.com/news/index.ssf/2015/01/people_are_fleeing_nj_faster_than_any_other_state_moving_company_says.html.

[23] Research suggests that an even larger effect should be expected. *See, e.g.*, Pavel A. Yakovlev, *State Economic Prosperity and Taxation* (Mercatus Ctr. at Geo. Mason Univ., Working Paper, July 10, 2014) (showing that higher marginal state taxes reduce gross state product growth by nearly double the size of the tax increase, with increasing progressivity of tax rates working a smaller decrease in growth; increased total state taxation leads to outmigration).

high-earning families, reducing net state income and requiring some portion of the surtax raised by the millionaires' tax to be used to replace the net revenues lost.

Not many of New Jersey's highest earners have to move out of state for the surtax to end up producing far less net revenue than expected. The result is that if the state remains committed to meeting its pension-funding crisis by increasing taxes rather than decreasing (at least some) benefits, then taxes will have to be raised on a less wealthy tranche of families—perhaps those earning over $500,000 per year.[24] Yet some of these families will be unwilling to pay the surtax as well and will themselves move away. So the process will continue—and will be magnified because of the growth lost to the state as families or companies that might otherwise have moved to New Jersey elect to move to a different state or to stay where they are.

This process is referred to as a vicious cycle: a cycle because of its repeating quality; vicious because its results are so dire. Once vicious cycles have begun, they tend to continue until they burn or tire themselves out. The way this particular vicious cycle would burn itself out would be by expanding the surtax to include more and more families who earn less and less income every year, with a certain number of families affected each year (or realizing that they will soon be affected) moving to lower-tax jurisdictions. Finally, everyone who could be surtaxed would be surtaxed, and yet the unfunded pension promises would remain unfunded— with no possible means remaining for the state to fund them. Even if this cycle were to "tire" before it burned out, it would leave the state poorer by the tax revenues and innovative spirits of all the taxpaying families that had moved away or had chosen to move to (or stay in) a state other than New Jersey. In other words, once a spiral of this type kicks off, the best possible outcome is permanently lower growth and diminished prospects.

One potential way to avoid a vicious tax-burden cycle would be to fund the pension promises by cutting spending on other government-provided services. In one sense, this is merely a different aspect of the same danger, as families also face increased incentive to leave New Jersey (and others *not* to come) if their taxes remain at the same level but their children's schools deteriorate, their neighborhoods grow less safe, the state's bureaucracy becomes additionally inefficient, and so on. Another complication arising in New Jersey is that most of the state's budget is (as noted above) mandated spending.[25]

The common term to describe entities that face more obligations than they have resources is insolvency. Should the state's political branches set off a vicious cycle of this sort, insolvency will follow almost inevitably.

Of course, vicious cycles of this sort are not common occurrences. Moving is expensive, time consuming, frustrating, and, practically, difficult and emotionally fraught. But the cycles do happen and currently appear to be unwinding in Puerto Rico and in Chicago specifically and

[24] New Jersey is particularly susceptible to a vicious cycle of the sort described above because its income tax structure is already so progressive. Already, for instance, the top 10 percent of wage earners pay 72 percent of the state income tax. *See* Lilley, *supra* note 3 (citing Andrew Sidamon-Eristoff, *Opinion: When Not Losing Is Winning—Competition's Impact on NJ's Tax Policies*, NJSPOTLIGHT.COM (Mar. 29, 2016), https://www.njspotlight.com/stories/16/03/27/opinion-when-not-losing-is-winning-the-impact-of-competition-on -nj-s-tax-policies/). The top 1 percent of taxpayers pay one-third or more of the total take. Robert Frank, *One Top Taxpayer Moved, and New Jersey Shuddered*, N.Y. TIMES (Apr. 30, 2016). This means that if only one in 10 of these top earners were to leave for lower-tax jurisdictions, the result would be a 1 percent loss of population—but a 7 percent or greater loss of income tax revenue alone. Only a couple thousand of the famed 1 percent would have to depart to blow the same hole in the state's finances and utterly cancel out the expected revenue increase from a millionaires' tax.

[25] *See supra* p. 4.

perhaps in Illinois generally (and in response to conditions that are in many ways very similar to those now besetting New Jersey).[26]

There is some evidence that a vicious cycle has already begun in New Jersey, even without imposition of a millionaires' tax. For more than a decade, New Jersey has lost more citizens to other states than almost any other state.[27] While its absolute population has remained fairly stable because of immigration from outside of the country, the native-born citizens it is losing to other states are on average far wealthier than either the foreign immigrants or the average remaining New Jersey population.[28] Meanwhile, taxpayers who remain in New Jersey express more eagerness to leave than those in just about any other state.[41]

In fact, the emigration of just one single wealthy citizen from New Jersey, who took his tax dollars with him, proved enough to make a deep dent in the state's budget projections. Early in 2016 David Tepper, a hedge-fund billionaire, moved to Florida, which has no state income tax—thereby saving himself nearly 9 percent a year in income taxes alone. His relocation simultaneously cost New Jersey just as much. Given that Tepper appears to have earned more than $6 billion in the four years preceding his move, this single migration cut the state's revenues by about $150 million per year.[42] (Note that if the original proposed millionaires' surtax were to trigger just four such relocations, the tax would end up causing a net decrease in state revenues; the same effect would be achieved if only 40 families earning one-tenth as much as Tepper behaved accordingly.)

The threat to the state's finances is so great that the state's budget director made a special point of warning the state senate's finance committee about the development. Concerns about the effects of future tax flight have become strong enough that the state has begun to develop plans for monitoring the state's highest earners to seek out early intelligence of their possible departure and to ensure against any attempts to protect their assets while they remain citizens of New Jersey.[29] The state's public officials have perhaps incompletely comprehended the potential effects flowing from the imposition of an additional millionaires' surtax combined with heightened scrutiny of millionaires' financial dealings and personal behavior.

Meanwhile, the state's growth rates have begun to fall below those of its neighbors in almost every category.[44] Of states in New Jersey's neighborhood, only Connecticut has, in recent years, put up worse numbers.[30] Both states are careening toward disaster.[31]

A related vicious cycle seems to have gathered significant momentum in the concomitant arena of government-funding costs. New Jersey's credit rating has been reduced 11 times in the last

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[26] *See, e.g.*, Scott Andrew Shepard, *The Lead Lemming: Illinois on the Pension-Crisis Brink*, 14 J. L. PUB. POL'Y 151 (2018).

[27] *See, e.g.*, Lilley, *supra* note 3, at 10–11 (summarizing data from the Cato Institute, the American Community Survey, and United Van Lines); Steven Malanga, *Budget Balloon*, CITY J. (Aug. 25, 2017) (citing study by Boston College's Center on Wealth and Philanthropy noting $70 billion net wealth migration out of New Jersey from 2004 to 2008); Young, *supra* note 7.

[28] *See* Lilley, *supra* note 3. 41 *See, e.g.*, Malanga, *supra* note 39 (citing various polls to suggest that nearly half of New Jerseyans would like to move out of state, and that half of those who want to leave are motivated by the state's already high taxes). 42 *See* Frank, *supra* note 36.

[29] *See id.* 44 *See, e.g.*, Lilley, *supra* note 3, at 4; Young, *supra* note 36 (NJ job growth expected to be half that of national average for next decade).

[30] *See, e.g.*, Eide, *supra* note 16.

[31] *Id.*

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Salvador Rizzo, *N.J. Credit Rating Cut for 11th Time uUnder Christie*, NORTHJERSEY.COM (Mar. 27, 2017), https://www.northjersey.com/story/news/new-jersey/2017/03/27/nj-credit-rating-cut-11th-time-under - christie/99708996/.

eight years. (Two of the major credit-rating agencies have decreased the rating four times; the third had reduced it three times.[47]) Every time the credit rating sinks, the state's running costs rise with no concomitant gain to the state's services. In other words, taxes must ultimately rise to no benefit. This works to accelerate the taxpayer-flight process and increase the danger of a vicious cycle and insolvency. The concern is particularly pressing in New Jersey, one of the most deeply indebted states in the United States.[32] It inspires no confidence that New Jersey's credit rating has fallen to the lowest of any state except Illinois.

The recent federal tax law adds to the concerns that a vicious cycle of tax flight might be instigated or enlarged. That legislation caps federal deductions of taxes paid to state and local governments at $10,000.[33] This means that not only would the tax deduction not apply to any additional levies occasioned by a millionaires' tax, but many New Jersey taxpayers who make quite a bit less than a million dollars are going to see significant tax increases in 2018 even without any new state taxes being levied.

New Jersey's new governor, Phil Murphy, chaired a committee that attempted unsuccessfully to solve the pension problem in 2005.[50] He has acknowledged that the problem has grown significantly since then but has promised to honor all current pension promises.[34] His plans for funding this guarantee were, during the 2017 gubernatorial campaign, to adopt and extend Sweeney's plans. He calls for an increase in the top income-tax rate to 10.75 percent—a $300 billion per year increase in business taxes—and the legalization and taxation of marijuana.[52] He has not yet addressed the concern that even if these taxes were all passed, even if they brought in as much additional revenue as anticipated (all without setting off or accelerating the tax-flight cycle in New Jersey), and even if every penny from these revenue increases were dedicated to retiree-benefit (pension and healthcare) funding, they would fail—by a wide margin—to cover the pension-funding shortfall expected by 2023.[53]

If New Jersey has not begun to rotate through the vicious cycle, it may well expect to commence soon. If the process has already begun, it will pick up speed. Every additional cycle will compound the depth and breadth of the state's crisis while decreasing the assets that will be available to the state when it finally faces economic reality.

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[32] *See, e.g.*, Norcross & Gonzalez, *supra* note 2, at 41; Truth in Accounting, *New Jersey Taxpayer Burden Highest in Nation*, *in* FINANCIAL STATE OF THE STATES 2016 128–29 (Sept. 2017).
[33] *See supra* note 23.
[50] *See* Mark Lagerkvist, *The Ticking Time Bomb Faced by Next NJ Governor*, WNYC.COM (Oct. 10, 2017), https://www.wnyc.org/story/ticking-time-bomb-faced-next-nj-governor/.
[34] *See id*. [52] Steven Malanga, *Budget Balloon*, CITY J. (Aug. 25, 2017). It may highlight the despair—and desperate wishes of the states most critically endangered by their pension obligations—that so many of them are looking to marijuana taxes as almost magical revenue generators that can print money to throw at their funding problems. *See, e.g., id.*; Chris Williams, *GOP Leader Still Believes in Marijuana as Pension Solution*, WHAS11.COM (Nov. 15, 2017), https://www.whas11.com/article/news/politics/gop-leader-still-believes-in-marijuana-as-pension-solution /492133533; Patrick McGreevy, *High Taxes on Legal Pot in California Could Mean Black Market Will Thrive*, L.A. TIMES (Oct. 30, 2017). As the California case illustrates, however, marijuana taxes, while not insubstantial, are limited. Significant production, transportation, and sale facilities and networks already exist for pot and set a very real market price for the product, even if it is a black market price. Taxes that force the price of legal marijuana much higher than the existing black market prices will keep most purchasers in the black—rather than the taxed— market. This caps fairly firmly the amount that can be raised by taxing legal marijuana. *See, e.g.*, McGreevy.

Section A.7 2. Underrepresenting Taxpayer Interests at the Negotiating Table

In 2018, the general assembly passed—nearly unanimously—an act transferring control of pension funding and pension policy for uniformed state workers (police officers and firefighters, primarily) into the hands of those workers' union officials, by establishing a policy-making committee for those pensions with a permanent majority of union officials.[54] This committee will be responsible for making pension-fund investment decisions and will have the power to change the level of uniformed-worker benefits and their relative responsibility for pension-fund contributions.[55]

Government-employee union representatives obviously have every incentive to increase benefits for their represented employees while minimizing contributions by those members. In a private setting, this impetus would be governed and restrained by economic necessity; the overriding goal of a pension plan's control committee would necessarily be to keep the pension

53 *See supra* pp. 6–7.

54 *See, e.g.*, Andrew Seidman, *Police, Firefighters Would Control Own Pension Plan Under N.J. Bill*, PHILLY.COM (Mar. 23, 2017), http://www.philly.com/philly/news/politics/Police-firefighters-control-own-pension-plan-under-NJ-bill-.html; Samantha Marcus, *Pension Fund May Soon Be Turned Over to Police, Firefighters*, NJ.COM (Mar. 15, 2017), http://www.nj.com/politics/index.ssf/2017/03/nj_senate_passes_bill_turning_pension_fund_over_to.html. The page including the legislation appears here.

55 *See* Seidman, *supra* note 54; Marcus, *supra* note 54.

fund solvent over the long term—a goal that would necessarily limit the committee's impulses toward generosity.

That natural check will not apply to this union-dominated committee, though. While it has been granted the authority to make pension-fund investments and to alter (which, given the committee's composition, means "to raise") government-worker benefits, the committee faces no adverse incentives. Rather, if it invests poorly, or increases benefits or reduces contributions recklessly, the state's taxpayers are still entirely on the hook to make up any difference.

This is a mistake. Not only does it leave the committee unconstrained to act on its natural predisposition to increase benefits and decrease employee contributions, but it also creates incentives for the committee to make inappropriately risky investments. Any windfall benefits deriving from the dangerous investment risks taken will redound, under the committee's ministrations, to the union members' benefit, while any "windfall losses" will be laid at the ever more debt-burdened feet of the taxpayers.

Even before this enactment, New Jersey pension law has been studded with features that partake—to varying degrees, if not comprehensively—of this serious incentive mismatch and failure to meaningfully represent the interests of New Jersey's private-sector taxpayers. Already, the structures of collective bargaining overrepresent government workers at the expense of taxpayers—overrepresentation that has fueled the large increases in government-employee pension benefits since the adoption of government-employee unionization throughout the country.[35]

[35] *See, e.g.*, Brigham R. Frandsen & Michael Webb, *Public Employee Pensions & Collective Bargaining Rights: Evidence from State & Local Government Finances* 3 (Hutchins Ctr., Working Paper No. 35, Oct. 2017) ("[C]ollective bargaining requirements significantly and substantially increase government contributions to pensions, while reducing employee contributions.").

Consider, for instance, the 2011 New Jersey Pension and Health Benefit Reform Law.[36]

The law was a bipartisan effort at curbing the already-explosive growth in pension liabilities. The reforms increased employees' pension contributions from 5.5 percent to 6.5 percent of salary immediately, with contributions rising to 7.5 percent over the following seven years.[37] It also created a fifth tier of reduced benefits for new hires and suspended cost-of-living increases for all retirees until funding ratios improved significantly.[38] Sweeney's support of the measure earned him the undying and deep-pocketed enmity of the New Jersey Education Association (NJEA)—the public teachers' union that is also the big-footed lobbying powerhouse in the state.[60] The law increased employee contributions to the pension fund but also included a provision that ultimately undercut the value of that increased contribution obligation. The law is a more constrained version of the power-without-consequences provision that was just enacted. Under this provision, once various retirement systems (i.e., pension funds) achieved a "targetfunded ratio" of 75 percent, the governor was instructed to establish pension-planning committees for those funds. The committees, consisting half of government-employee union representatives and half of appointees meant to represent public employers, were empowered to reinstate cost-of-living increases, decrease employee contributions, and otherwise increase government-worker benefits.

In two important ways, these committees are more constrained, and thus less dangerous to taxpayer interests and state solvency, than the uniformed-employee control committee now instituted. First, the committees were designed ostensibly to include as one-half of their membership representatives of taxpayer interests, with the other half representing the unions. In other words, the committees would not be—structurally and necessarily—controlled by a majority of union officials.[39] Second, the committees faced some restraint on their generosity: they could increase benefits only once pension assets reached the level of 75 percent funded, and they could do so only in ways that would leave funding above 75 percent.[62]

Despite these topical differences, however, vast arenas for mischief nevertheless remained built into these committees. For instance, the balance on the committees between representatives of the unions and those of the taxpayers could never arise above the notional. In every instance, the government-employee unions may appoint half of the committee. The unions have a narrow and nonconflicted interest: to maximize the benefits flowing to their members while minimizing the contributions that those members have to make to the solvency of the pension funds. The

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[36] *See New Jersey Division of Pensions & Benefits, Pension and Health Benefits Reform, Pension Reform Provisions*, NJ.GOV, http://www.nj.gov/treasury/pensions/reform-2011.shtml.
[37] *See id*.
[38] *See id.*
[60] *See, e.g.*, Susan Deile, *Letter: Long-Term Fix Needed for State Pension*, NORTHJERSEY.COM (Nov. 16, 2017), https://www.northjersey.com/story/opinion/readers/2017/11/16/letter-long-term-fix-needed-state-pension/867791001/ (An NJEA member attacks Sweeney in a letter to the editor for his support of the 2011 reform act and for failing to get onto the ballot in New Jersey a constitutional amendment that would have guaranteed full payment of all of New Jersey's pension promises, dropping the state into exactly the impasse that faces Illinois.); Brent Johnson, *Teachers' Union Battle Against Top Democrat Is Costing a Fortune*, NJ.COM (Nov. 3, 2017), http://www.nj.com/politics/index.ssf/2017/11/sweeney_vs_njea_battle_sparks_historic_spending.html (NJEA targeted Sweeney in 2017 election, making the race the most expensive general-assembly race in state history); Lilley, *supra* note 8.
[39] *See supra* note 57.
[62] *See id.*

unions have only that job and that interest. Half of the votes on the committee, then, will always lean toward expanding pension benefits for union members and thus expanding costs to taxpayers.

Putatively sitting across the table from them, meanwhile, are an equal number of committee members assigned to represent taxpayers' interests. This representation of interest, though, is far more complicated than the one on the other side of the table. Taxpayers do not have the same clear and undivided interest that the employee unions do. Some taxpayers are themselves government employees and so probably prefer that everyone's taxes rise to some degree so that their benefits can be increased a relatively large amount. Some taxpayers are uninformed about or uninterested in pension policy. Some would not mind paying more taxes to benefit government employees—even though they are not themselves public employees—or have been convinced by various politicians that someone else will end up paying the taxes, and not them. So the taxpayers do not speak with one voice.

Even if taxpayers were to speak unanimously, they could still speak only through their representatives. Those representatives can be expected to represent the true antithesis to the government-union interest—maximizing contributions and minimizing benefits, thus minimizing taxpayer obligations (i.e., making them the equivalent of representatives of a private employer and therefore a coherent adversary in the sort of one-on-one, face-to-face negotiations that are established by these committees)—but only if the governor, who assigns the taxpayer representatives, is both programmatically opposed to increases in pension obligations and uninfluenced by government-employee union contributions. In practice, in New Jersey, this means never. As has been considered, the public-employee unions—especially the teachers' union—are both powerful and strategic; they permit no Democratic Party divergence from strict support for the union position and have sometimes thrown their weight behind Republicans to punish straying Democrats—sometimes to great effect.[40] So while in New Jersey a Democratic Party victory—and particularly an undivided Democratic Party government, as has recently been installed—ensures deep political-branch attachment to union interests, no New Jersey executive can dare stray too far in opposition to those interests. The practical effect is that an "evenly divided" control committee is really, unavoidably, one already stacked in favor of union interests against taxpayer interests.

The final potential conflict of interest may be the most adverse to fiscal responsibility and genuine representation of taxpayer interests. Though assigned to represent taxpayers, any committee members who are themselves government employees simply cannot unreservedly represent the taxpayer interest, as they themselves will profit if the government-worker unions against whom they argue win the negotiations. If all of the governor's appointees on the board are government employees, then no one in the room—no member of the committee—wholly and without conflict represents the taxpayer's expense-minimizing position. This structure cannot be expected to do justice to New Jersey's taxpayers, and it manifestly has not.

As a result, these committees can be expected to favor increased benefits or decreased contributions any time a conclusion of 75 percent funding can be reached. They—and the political branches generally, especially given the current government configuration—can also be counted on to agree that the 75 percent funding has been reached quite generously. One method of overestimating the funding ratio has already been considered: the unjustifiably

[40] *See* Lilley, *supra* note 8.

generous discount rate that the state uses to estimate future returns on current capital.[41] Similar sympathetic valuations of the expected costs of benefit increases or contribution reductions can likewise reduce the efficacy of this 75 percent funding minimum. Perhaps most dangerous are the artificial budgeting gimmicks—the most extravagant of which may well be the lotteryrevenues dedication of 2017, considered just below—that have for so long characterized and distorted New Jersey's budgeting process in addition to endangering its long-term solvency.[42]

Meanwhile, a 75 percent funding target itself hardly sets a financially responsible threshold. Even in states that have otherwise achieved general financial stability, responsible parties should not entertain sticky (i.e., hard to withdraw, once granted) benefit increases until the current promises have been fully (i.e., 100 percent) funded. Even then, the state should agree to increases only if a number of other factors obtain. The state should ensure that full funding is stable and protected against the next inevitable downturn, rather than the mere result of a shortterm high point on the business cycle. It should block any increases until it has achieved full funding, using a theoretically and historically appropriate discount rate. It should move only if the state's budget is not already strained to breaking and its taxpayers not already pushed to the wall, so that any temporary miscalculations about the actual funding level of the pension programs or about the cost of the proposed benefit increases will not result in crisis. Finally, it must design any benefit increases so that its bounty is contingent; these benefit increases should continue only so long as all of the assumptions and presumptions that underlie its grant remain in place. Should funding slip below the necessary threshold, for whatever reason, the benefit increases ought immediately to decrease as necessary to restore full funding and stability. The 2011 control-committee provisions meet none of these standards.

3. The New Jersey Lottery Dedication and Alternative Income Streams

In 2017, Governor Christie and the general assembly agreed to dedicate the proceeds from the New Jersey state lottery, currently running at about $1 billion a year, to partial fulfillment of pension obligations for the next 30 years.[43]

This move was sold as an essentially costless way of firming up pension financing without cutting benefit promises for any worker.[67] The governor ensured the public that investors and

[41] While the Christie administration had scheduled the discount rate to fall in 2018 from 7.65 percent to 7 percent, the Murphy administration immediately raised the discount rate to 7.5 percent again, with promises to begin reducing again soon. *See, e.g.*, Coen, *supra* note 14.

[42] *See* Norcross & Sautet, *supra* note 6, at 17–38.

[43] *See, e.g.*, Samantha Marcus, *Christie May Not Like What Wall Street Just Said About His Plan to Ease Pension Pain*, NJ.COM (Aug. 16, 2017), http://www.nj.com/politics/index.ssf/2017/08/lottery-pension_plan_doesnt_ease_njs_pension_pain.html.

rating agencies would eagerly endorse the move, thus reducing the costs of borrowing for the

[44]state and improving its overall financial position.[45]

In fact, none of this happened.[46] None of the credit agencies retracted any of their reductions to New Jersey's creditworthiness; in fact, the kindest interpretation of the move by the markets was to find it "'slightly credit positive,' as it 'remove[d] the prospect of a complete pension contribution holiday going forward.'"[70] Most analysts thought the exercise essentially meaningless.[47]

Given the content of the lottery-revenue dedication, "meaningless" is the best interpretation available. While it does remove the prospect of a complete pension-contribution holiday *if* the provision is not suspended for any year in the next 30 years, a suspension would require nothing more than a provision in a budget agreement. The state has already demonstrated its willingness to suspend its pension-funding laws in just this way. In 2010, Governor Christie agreed with the legislature to begin addressing the state's accumulated pension underfunding, but only eventually. The plan called for the state to contribute one-seventh of the annualized (over 30 years) funding deficit (or 1/210 of the total unfunded liability), two-sevenths in 2012, and so forth. In other words, not until 2018 did the state intend to fund a full one-thirtieth of the debt and so begin getting the underfunding slowly under control.[48] Since 2014, however, the state has given up on even this gradual effort and has suspended portions of its scheduled repayment obligations.[49] Dedicating the lottery profits to pension funding could have had a significant positive value if, say, the proceeds had been dedicated to paying down the state's unfunded pension debt more quickly than has been required under the amortization schedule, while the state still credibly committed to full annual funding of actual normal costs and the alreadyscheduled reductions in amassed underfunding. In light of its failure, year after year, to even fully fund the latter costs, the move could even have been meaningful if it had been used along with other contributions from state revenue collections to fund these alreadyestablished obligations.

This latter accomplishment would have required the state to increase other revenues or decrease other spending enough so that it had the funds available to honor its scheduled pledge. It would also have required the state to increase other revenues or decrease other spending by enough to replace or eliminate the bills that the lottery had been paying before its dedication to pension funding.

The state did none of this. Rather, it just shifted the pocket from which it pulled the money for the (partial) payments of normal costs and amortized underfunding reductions that it already

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[44] *See id.*; John Reitmeyer, *Gov Touts Lottery as Answer to NJ's Pension Problems, but Critics Deride Plan*, NJSPOTLIGHT.COM (July 6, 2017), http://www.njspotlight.com/stories/17/07/05/christie-touts-lottery-transfer-as-answer-to-state-s-pension-problems-but-critics-deride-plan/.

[45] *See id.*; Liz Farmer, *States Get Creative on Pension Funding*, GOVERNING (July 19, 2017).

[46] *See, e.g.*, Marcus, *supra* note 66. [70] *Id*. (quoting Moody's Investors Service, which also asserted in a report reviewing the pension-revenue dedication that, overall, it did "not alter the burden of pensions on the state's credit profile").

[47] *See id.*; Farmer, *States Get Creative*, *supra* note 68.

[48] *See, e.g.*, Jarrett Renshaw, *Christie's Overhaul May Not Save N.J. Pension System*, [NEWARK N.J.] STAR-LEDGER (Oct. 23, 2011).

[49] *See* Reitmeyer, *supra* note 67.

intended to make.[50] It did not add to its anticipated funding levels, which still lag far below its 2011 statutory promise of full funding[51]—because, as we have seen, the state likely cannot afford to pay normal costs plus actuarially appropriate reductions of previous underfunding while remaining a going concern.[52] It did not make any attempt at paying more than the normal costs and the already-required amortized back payments each year. And, most importantly, it made no new provisions for additional revenue or decreased spending to make up for the shifted lottery revenues.[53] The lottery dedication merely robbed Peter to (partially) pay Paul. Its financial position was not changed at all; the debts and deficits are just in Peter's name now. Debt markets were not fooled—or impressed. But even this neutral, "merely cosmetic" evaluation of the lottery-revenue dedication may be overly optimistic. The funding dedication may materially worsen the state's position for two reasons. First, even though the move does nothing to alter the state's overall financial condition, it has allowed the state to claim that the market value of the lottery receipts over the next 30 years is an asset of the pension funds—one that can be used to boost the headline figures about how funded the pension accounts are (or, more correctly, to reduce the "book value" of the state's pension underfunding).[54]

This increase in the notional book value of the funds has two effects. First, because the value of the next 30 years of lottery revenues will be highest in early years of that period,[55] this change in notional value will give the state cover to continue, and perhaps even to increase, its deficiencies in paying even the annual normal costs plus amortized back payments of its pension promises. Evidence so far suggests that this was an intended consequence of the lottery-fund diversion—one that is already being taken advantage of.[56]

The second effect of the increased book value of total funding—described in greater detail above—is that without doing anything to solve the pension-funding crisis in New Jersey, it puts funds closer to the 75 percent notional-funding trigger that would allow the pension oversight boards actually to increase government-worker pension and healthcare benefits in coming years, such as by reinstating the cost-of-living adjustment or otherwise increasing retirement benefits or decreasing worker contributions.[57] This presents a possibility worth monitoring, given the natural conflicts of interest built into these boards and the urgent need to reduce some classes of net benefit for some workers and retirees.[82]

The danger is enhanced because, when estimating the additional revenue that the lottery proceeds will bring to pension funding (and thus the amount by which the dedication increases

[50] *See* Allan Sloan, *Why Gov. Chris Christie's Big Plan to Shore Up N.J. Pensions Is All Wet*, WASH. POST (July 14, 2017).
[51] *See, e.g.*, Reitmeyer, *supra* note 13.
[52] *See infra* pp. 5–7.
[53] *See* Reitmeyer, *supra* note 67; Farmer, *supra* note 68.
[54] *See* Reitmeyer, supra note 67 (the book value of the pension funds' funded status increased from 45 percent to nearly 60 percent as a result of the revenue dedication); Marcus, *supra* note 66; Farmer, *supra* note 68 (quoting Municipal Market Analytics' Matt Fabian: "We believe that, at best, this transaction delays honestly confronting the pension liability problem.").
[55] *See, e.g.*, Sloan, *supra* note 74.
[56] *See id*.; Reitmeyer, *supra* note 67.
[57] *See infra* p. 21. [82] Broader evidence suggests that this concern is neither limited to New Jersey nor trivial. Thad Calabrese concludes that dedicating revenue streams to pension funding tends to result, for reasons consistent with those that have characterized New Jersey's recent efforts, in benefit increases and in government claims of sounder funding unsupported by any real improvement in funding. *See* Thad Calabrese, *The Use of Locally Imposed Selective Taxes to Fund Public Pension Liabilities*, *in* FOR YOUR OWN GOOD: TAXES, PATERNALISM AND FISCAL DISCRIMINATION IN THE TWENTY-FIRST CENTURY 263 (Adam Hoffer and Todd Nesbit, ed., 2018).

the pension-funding level), the state has used the still-inflated discount rate of 7.5 percent.[58] A more realistic rate would result in the cosmetic effect of the dedication decreasing significantly.[59] Even assuming that the inflated discount rate were realistic, lottery revenues have declined a bit in recent years but are projected by the state to grow consistently in coming years.[60]

In short, the dedication of the lottery proceeds in New Jersey for 30 years to pension funding was at best an empty, cosmetic gesture. At worst, it facilitates additional underfunding by the state and raises the risk of further unaffordable retirement-benefit increases—increases that, once granted, have proven immensely difficult to withdraw.

4. The Painful but Necessary Reforms to Come

Disinterested parties generally agree that New Jersey will be extremely hard pressed to fulfill the pension promises it has already made, even to the employees already covered.

Nevertheless, the new administration appears set to continue on the current path for as long as it can. Delaying the reckoning will not soften it, however; it will only increase the likelihood of a still greater crash a bit farther down the road.

Good—if incomplete—proposals for real reform abound. New Jersey should, for instance, follow its neighbor across the Delaware River in moving new workers from the open obligations of current defined-benefit pension plans to defined-contribution 401(k) plans of the type that long ago became the norm in the private sector and the federal government. Because the taxpayers' inputs are defined in advance, such plans allow for coherent planning and funding of the sort that is simply impossible under defined-benefit plans. New Jersey will almost surely need to go further than did Pennsylvania's recent reforms, though. In its 2017 legislation, the Commonwealth made defined-contribution plans a partial option for current nonuniformed employees and a full option for new employees.[61]

New Jersey's funding deficit will likely require it to take broader action. It should, for instance, move all current workers—not just new hires—to defined-contribution plans for all work not yet performed by those employees after the date of the relevant legislation. Even this broader legislation will not address the already-accrued pension promises that, as the state itself has recently recognized, are unmeetable. It would, however, at least stabilize and cap any new obligations at—presumably—a manageable amount. It would also ensure that similarly situated employees accrue the same benefits for the same work done at the same time. Anything else does an obvious injustice and, given the significantly different demographics between older and younger workers, runs the risk of violating civil rights law. This would be a good first step.

And yet, it can only be a first step. Because the previously made promises have already grown unpayable, they will likely have to be trimmed back. The state probably cannot avoid this harsh and dreary necessity. If it acts soon, it may minimize the reductions and the pain to the neediest

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[58] The Christie administration attempted to lower the rate to 7 percent—effective upon the instillation of Christie's successor, but the Murphy team reversed the decision and raised the rate back to 7.5 percent. *See* Coen, *supra* note 14.

[59] *See, e.g.*, Bob Williams, *Gambling with Lottery Revenue: The Faux New Jersey Pension Reform*, HUFFINGTON POST (July 31, 2017), https://www.huffingtonpost.com/entry/gambling-with-lottery-revenue-the-faux-new -jersey_us_597f4eace4b09982b737665b.

[60] *See, e.g.*, Daniel Takash & Anthony Randazzo, *Shifting New Jersey Lottery to Pension Is a Gamble*, REASON FOUNDATION: COMMENTARY (May 31, 2017), https://reason.org/commentary/shifting-new-jersey-lottery-to-pens/; Farmer, *supra* note 68 (quoting S&P Global Ratings analyst David Hitchcock for the proposition that "the state runs the risk of assuming its assets 'are better than what they really are'").

[61] James Comtois, *Pennsylvania Governor Signs Pension Reform Bill*, PENSIONS & INVESTMENTS (June 12, 2017).

workers and retirees by targeting cuts carefully. If it waits until it has triggered a vicious cycle of taxpayer flight or it has otherwise narrowed its remaining options, the state will oblige itself to take more drastic and less equitable steps.

New Jersey enjoys—compared to Illinois and some of its fellow deep-crisis states—one advantage in its efforts to trim already-accrued pension promises. Some of these states, including Illinois, have tied themselves in merciless constitutional and legal knots that—according to their state supreme courts—forbid them to reduce any benefits for current workers, whenever those benefits are or were earned. New Jersey, despite the best efforts of the NJEA,[62] lacks any such confusion. The New Jersey Supreme Court has held as recently as 2015 that

> each year's appropriations act will reflect the present legislative and executive judgment as to the budgetary priority of this pressing need for which those branches will be answerable to the public and to the financial marketplace. It is not the place of this Court to dictate that judgment, for the Constitution has left such budgetary and political questions to the other two branches.[63]

In New Jersey, then, the only bars to comprehensive pension reform—i.e., reform to bring benefit promises in line with financial possibility and voter tolerance—are statutory. And what statute grants, later statutes can withdraw.

The state must focus on two considerations when reducing benefits that have already been promised for work that has already been performed. Those considerations are equity and misfeasance (whether intentional or unintended but structural) arising from conflicts of interest and inappropriate union-favoring bargaining procedures established by past pension and benefit laws. The two considerations will often interrelate: overly generous pension benefits that take clear advantage of taxpayer funding will often provide the clearest evidence that past bargaining processes were wrongly skewed in favor of certain government employees, so that adjusting for equity will effectively correct—as far as is still possible—for any such negotiating imbalances. Equitable considerations, then, are considered first below.

When contemplating reducing benefits for work already completed, the highest consideration must be equity. Equity demands above all that elderly and infirm individuals, who have already served a career in government work, not be impoverished. On the other hand, equity forbids the state, in close negotiations with government-employee unions, to impoverish New Jersey's taxpayers, to denude those taxpayers of government-provided services, or to dissolve the state as a functioning concern as a result of taxpayer flight or outright insolvency, in order to fund extravagant government-employee pensions—pensions that will in very many cases far exceed those that private-sector taxpayers can ever hope to accumulate.

These competing considerations counsel for adopting comprehensive pension limitations and reductions that first cut across accidents of negotiation or other contingent circumstances to ensure that savings arise in the fairest ways possible. One reform might be to cap all pension

[62] Ryan Hutchins, *With Collapse of Pension Amendment, NJEA Dives into Dem Politics,* POLITICO: NEW JERSEY (Aug. 8, 2016), https://www.politico.com/states/new-jersey/story/2016/08/with-pensions-amendment-collapse-njea -dives-into-dem-politics-104586.

[63] Burgos v. New Jersey, 118 A.3d 270, 275 (N.J. 2015). *See also* Spina v. Consol. Police & Firemen's Pension Fund Comm'n, 197 A.2d 169, 176 (1964) (pension promises neither a gratuity nor an enforceable contractual right. "We think it more accurate to acknowledge the inadequacy of the contractual concept.").

benefits for all current and future retirees collecting under the defined-benefit formula at some absolute figure. This could be a fixed number, such as $125,000 per year (as New Jersey has a particularly high relative cost of living), perhaps then adjusted for inflation or cost-of-living considerations. The cap could also take the form of a formula, such as twice the average cost of living in the state for each relevant payment year. In either case, the cap could be prorated for workers who spent only part of their careers working for the state of New Jersey or its municipalities.

A more sophisticated version of either of these caps could float depending upon what might be required to allow the state to fully fund the normal costs of its pension obligations for a given year, while making that year's actuarially appropriate contribution to paying down the pension-fund deficit that has accumulated for past years. The disadvantage of the floating-cap proposal is that it would leave pension beneficiaries relatively unsure of their income for future years, though of course they could always use the floor of the range as their expectation for planning purposes, treating the rest in any year as windfall.

This cap, however constituted, would at a stroke save the taxpayers from funding the state's greatest extravagances while simultaneously placing the first burden for bringing the pension program back into balance on parties most able to assume it.

In addition to this overall cap, the state might institute additional savings. It might add a further limit, capping any government employees or retirees at an annual pension limit equal to—at most, and independent of accumulated sick days, vacation days, or overtime pay—an average of their annual pay in each of their last, say, three years of work. This secondary cap would stop employees from making more in retirement than they did while they were working— a cap that wholly meshes with considerations of equity. The limitations arise to minimize the effects of "pension spiking," a practice of including in a final year's salary the cash-out value of that employee's unused vacation and other leave or significant overtime payments—all of which inappropriately inflate the final salary figure upon which pension benefits are based. (Of course, spiking could also be forbidden explicitly by statute.) This secondary cap could also be indexed to inflation. Additional savings could be achieved by subtracting from each year's pension ceiling the amount that pensioners will earn in Social Security benefits for that year, thus more tightly binding their pension income to their actual, uninflated final years' earnings and avoiding unaffordable overgenerosity of payment.

These twin caps would ensure that any savings achieved by decreasing previously promised benefits for previously accomplished work would occur carefully and fairly, with firm guarantees that no employees who had dedicated a career to government work and who had not gamed the system would find themselves living in penury—or, in fact, in conditions any worse than any honest employee could reasonably expect. A secondary advantage of these caps is the work they do to diminish benefits flowing to bad-faith employee behaviors without having to undertake massive individualized investigations or even to impute bad faith to almost any present or retired government employees. They achieve this effect by curbing the benefits that would otherwise have flowed to those who had gamed the system for their own benefit or had taken advantage of gaming opportunities established on their behalf (as by pension spiking or by collecting significant pension benefits from more than one position) merely as a by-product of doing equity.

These caps might contain additional provisions expressly designed to catch as many fishy situations as possible—for example, by setting the second, salary-specific cap at the maximum amount made by any given employee to the one highest-paid eligible position, to eliminate the problem of double-dipping. The state might also forbid any pension benefits to be paid out to employees who are still earning full-time government salaries in New Jersey to stop the fairly pervasive practice of employees working the required number of years at one position, earning a pension and "retiring," and then taking a separate government position for the rest of their working careers, allowing them to collect pension benefits before they had really retired from state work and to milk inordinately generous annual public support from heavily burdened taxpayers.[64] The state might adopt other rules—independent of the comprehensive caps—aimed at radically reducing or stripping away pensions from those reliably proven to have acted by fraud or collusion. By and large, though, equitably and thoughtfully devised pensioncompensation caps will do the work of justice—unwinding the worst abuses enacted under what can at best be characterized as a deeply conflicted policy-development system. This system is fraught with disproportionate union representation and thoroughgoing agency problems—largely as a by-product of achieving equity for pension beneficiaries and taxpayers alike, while returning the state—at least as regards pension funding—to some sort of financial stability.

5. Conclusion

New Jersey faces an immediate and dire pension crisis. Over decades, it has mismanaged its pension policy and funding in myriad ways, such that it is extremely unlikely to be able to meet the promises it has already made to retirees and current workers for work already performed, much less extend these promises to work not yet performed or employees not yet hired. As a result, the state will likely have to move all workers to defined-contribution pensions for work not yet performed and make careful reductions in already-promised benefits to some classes of beneficiaries—namely, those best able to absorb the reductions and those who would otherwise have enjoyed, at taxpayer expense, pension benefits greater than the best normal salaries they had ever earned.

These unpleasant tasks likely cannot be avoided. They can be delayed for somewhat longer, but delay will likely increase the costs of reform while rendering the eventual cuts less equitable. Further tax increases on the already-groaning taxpayers of New Jersey are likely to slow the state's economy further while setting off further waves of taxpayer flight to less heavily taxed

[64] *See, e.g.*, "Burypensions," *$1 Billion to NJ Double-Dippers*, BURYPENSIONS BLOG (Aug. 17, 2017), https://burypensions.wordpress.com/2017/08/17/1-billion-to-nj-double-dippers/ (listing current and former government workers who either collect two or more pensions from the state or who collect a pension while continuing to draw a salary from the state. The article claims that should double-dipping be outlawed, the state would save nearly $600 million in salaries not paid and over $400 billion in pensions unpaid each year. The article itself, however, notes that the analysis undertaken by the authors is rough, and the authors do not seem to account for the fact that some retirees, if not permitted to collect pension benefits and salary at the same time, would elect to resign from their jobs in order to collect their pensions, meaning that others would have to be hired at some unspecified expense to fill those positions, thus decreasing the savings to be achieved by eliminating these doubledipping opportunities. Nevertheless, the author's conclusion that this practice is flawed and should be corrected by any comprehensive reform efforts is sound.).

(and better governed) jurisdictions. The lottery-revenue dedication (to the extent that it is not a meaningless gesture) actively threatens to stimulate a last round of pension-benefit increases, thereby compounding the eventual pain when cuts can no longer be avoided. And any moves to put even more pension-policy authority in the hands of already overrepresented government-employee unions represent a dereliction of fiduciary duty on the part of elected government officials and should perhaps be deemed an effective, even if not technically a legal, fraud and collusion against the people of New Jersey.

The state's political branches must face their hard task. They must seriously consider comprehensive pension reform, applicable to the whole of the government-employee pension system. The state's political branches, and New Jersey, have no time to lose.

The California Rule and Its Potential Abolition

Scott Andrew Shepard

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Abstract

California faces a significant pension-funding crisis. It has increased government-worker pension benefits repeatedly since the 1980s. Meanwhile, a California Supreme Court doctrine—the California Rule—has been understood to forbid cutting benefits for any currently employed government workers, even for work they have not yet performed. The state has also maintained a high discount rate (i.e., an assumed investment-return rate) in the teeth of the recessions and low interest rates. The result has been consistent and now parlous underfunding. A trio of cases awaits California Supreme Court consideration. In each of these cases, the circuit courts have concluded that the common interpretation of the California Rule is incorrect, though they disagree sharply about the real content of that rule. This paper proposes that the Supreme Court follow the circuit courts in permitting cuts to benefits not yet earned and careful cuts to benefits already earned in narrow cases.

JEL codes: H10, H11, H12, H3, H550, H71, H72, H74, H75, H77, J5, J58, K1, K12, K31

Keywords: pension reform, public pensions, state finances, government finance, public employees, public-employee unions, government employees, government-employee unions, taxbase flight, employee benefits, public choice theory, government oversight, fringe benefits, Contract Clause, California Rule, state constitutional law

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The California Rule and Its Potential Abolition

Scott Andrew Shepard

Introduction

The California Rule, or its equivalent, has proved a challenge to the numerous states that have adopted it. The rule, as commonly understood, forbids the state from reducing pension benefits once they have been offered at any point during the tenure of a worker employed at the time the offer was made.

This rule does not comport with contract law or quasi-contract equity and does not spring from any coherent interpretation of the federal Contract Clause. The flaws in the California Rule have been demonstrated in recent years. California, among other states, has promised far more in pension benefits than its taxpayers have proved willing (or possibly able) to pay, and while many parties broadly agree that a first step toward remedy would be to start reducing future benefits not yet earned by current or future employees, the rule has stood in the way.

In the wake of practical necessity has come a wave of revisionist argument. According to these claims, the California Rule has been misunderstood all along. It does not really forbid all net reductions in benefits for current workers (and possibly some retirees) but permits them—sometimes. Accord has not been reached among the analysts, however, who now include the California appellate courts and the administration of Governor Jerry Brown, as well as a bevy of independent sources, as to just when and under what conditions such reductions may be made.

This paper constitutes an attempt to answer the question of when and under what conditions benefits to current workers and retirees can be reduced without corresponding benefits being offered. It concludes that the answer to the question is to divide such benefits into three types. The first of these types, benefits that have already been earned for work already done, is the most protected type of benefits and can only be reduced with the most careful scrutiny and under only a narrow set of justifications, including real or constructive fraud against the taxpayer or explicitly proven financial necessity. The second type of benefits is those that have not been earned but have been explicitly contracted to continue until some certain date. Reduction of these benefits should receive significant scrutiny, though they may perhaps be invaded under conditions that are less strictly restricted than the first type of benefit. The third type of benefits is those that have not yet been either earned or contracted. These benefits—for which no promises have been made by the civil power and which constitute at law and in equity not obligations but only the hopes of current employees—deserve no particular protection and may be reduced without any Contract Clause–based oversight of any kind. This third category of benefits is a large one, as it encompasses all work that will be performed by all current workers after their current contracts or collective bargaining agreements—if any—end.

The California Supreme Court will in the coming months be hearing appeals of three decisions of the circuit courts and will have the opportunity to explain what it has really meant in its precedent or even to abandon previous positions as error and state new ones. However it styles its decision, it should embrace the tripartite structure elaborated in this paper. The structure gives full respect to all of the relevant interests involved in the review of pension promises:

insulation of government-worker contract rights, respect for the legislative power of the state to make laws about its future actions, protection of taxpayers against overgenerous and insupportable grants of benefits by government employees to government employees and their representatives, and recognition of the state's need to maintain its solvency in the face of limits to taxpayer willingness and ability to pay its obligations.

The first section of this paper reviews the content and development of the California Rule as generally understood. The next section reviews the cases that now wend their way toward the California Supreme Court and the Brown administration's intervention in them. The paper then suggests a model of how the California Supreme Court should decide these cases and the content that any "new California Rule" should take. This section expands on the tripartite structure outlined above. The paper's last section predicts the developments that will follow a happy decision by the court in these matters.

How the California Supreme Court decides these cases and refines the California Rule will have a significant effect on California's future. A thoughtful and careful definition or revision of the California Rule may also have significant nationwide implications—especially in some of the states joining California in facing the most serious pension-funding crises.[65]

[65] *All Eyes on California Court System as It Weighs Pension Benefit Cases*, PENSIONS & INVESTMENTS (Jan. 22, 2018) ("Such is California's status that an affirmative ruling would also likely influence courts and legislatures in other states with similar prohibitions on the reduction of promised benefits for public employees."). The decisions of

The Crisis

California, along with a number of other American states, faces a severe and in many ways crippling government pension-funding crisis. By the state's own current calculations, it now has more than $250 billion in unfunded pension liabilities, and that figure is growing.[2] The state was obliged to dedicate 6.5 percent of its general-fund spending in 2016–2017 to pension funding, more than triple the figure that it spent in 2002–2003, and it is still rising.[66] This represents a significant budget item by any estimate, but it has a far greater practical impact on the budget than is initially apparent. Because of obligations attached to federal grants to the state, unfunded federal mandates, sequesters established by California voters in initiatives, and other restrictions, only 12 percent of California's general-fund budget is "discretionary" or nonmandatory, down from 21 percent six years ago.[4] The rapid increases in pension liabilities over the last 15 years have been a primary driver in constraining California's spending, government services, and options.[5]

As bad as things are at the state level, they are worse for municipalities. A significant

League of California Cities study recently revealed, among other disheartening details, that "between FY [fiscal year] 2018–19 and FY 2024–25, cities' dollar contributions" to CalPERS, to pay for pension promises, "will increase by more than 50 percent. For example, if a city is required to pay $5 million in FY 2018–19, the League expects that it will pay more than $7.5 million in FY 2024–25."[6] While the pain will not spread evenly, it will flow everywhere. No cities face increases of less than 20 percent over the next few years, while some will face

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David Crane, *For Whom the California Budget Tolls*, FOX & HOUNDS (Jan. 10, 2018). As Crane explains in detail,

> Assume General Fund revenues this fiscal year are $100. The first $40 plus unpaid balances (if any) goes to
> K-14 education as a result of constitutional protection (Proposition 98). The next $7 goes to General Obligation bond debt service as a result of constitutional and contractual protection and another $7 goes to pensions and retiree healthcare as a result of contractual protection. . . . Medi-Cal, a statutory entitlement, takes 15% of the General Fund (plus additional amounts from Special Funds) and another 7% is consumed in part by entitlements administered by the Department of Social Services. Together, those protected obligations (ie, K-14, debt service, pensions, OPEB, Medi-Cal and DSS) will consume 78% of the General Fund this fiscal year, up from 69% just six years ago.
>
> That leaves only 22% (ie, 100–78) for everything else, but that 22% must also cover Corrections, CHP and CalFire, all involving public safety and politically protected by powerful government employee unions. Public safety takes 10+% of the General Fund, leaving only 12% for UC, CSU and other discretionary

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the California Supreme Court have no precedential effect in other states, but its rulings often carry influence beyond its borders. 2 *See, e.g.*, Judy Lin, *Understanding California's Public Pension Debt: The Gap Between Money Available and Promises Made Is Huge and Growing*, L.A. TIMES (Sept. 18, 2016) ($241.3 billion in 2014).

66 *See* Joshua D. Rauh, *Can California Save Itself from a Pension Disaster?*, 1801 EUREKA (THE UNSTATED STATE OF THE NATION-STATE) (Jan. 25, 2018).

categories not protected by contract, statute or the constitution. That's down from 21% just six years ago; ie, the share of the General Fund available for discretionary items declined 43% in just six years.

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Id.
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Retirement System Sustainability Study and Findings, LEAGUE OF CALIFORNIA CITIES, 4 (Jan. 2018).

increases in excess of 60 percent.[67] These massive increases come on top of a baseline that has already grown approximately fourfold in the past 15 years.[68]

Meanwhile, these figures, however grim, still represent an overly rosy scenario. They are reached using the state's assumed discount rate of 7 percent.[9] This rate is an unrealistically high return assumption for current financial conditions and has been for some time.[10] In fact, it is generally agreed among economists that it is the wrong measure entirely.[69] Rather than guessing what returns the state might happen to make in the market in any given year, depending on how its risky investments pan out, the state should be matching its current "wind-up" pension obligations (i.e., what it would owe if it shut down its pension today and paid everyone what it currently owes, when it owes it) against its current saved pension assets discounted by the riskfree federal Treasuries rate. As Joshua Rauh, the chief exponent of this calculation method, has

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[67] *See id.* The year 2018 rang in with an explosion of local news articles about extensive increases in pension-funding costs throughout the state's municipalities and the struggles of those municipalities to continue to provide a minimum level of services to citizens. There were, in fact, far too many articles to cite here.

[68] *See, e.g.*, Joe Nation, *Pension Math: Public Pension Spending and Service Crowd Out in California, 2003–2030* (Stanford Institute for Economic Policy Research, Working Paper No. 17-023, Oct. 2, 2017). This is a highly informative study, containing additional depths of information about the wide, negative effects of pension overpromising in California. 9 The discount rate is, in effect, the rate that the state assumes it will earn on the money that it has saved in order to pay off future pension benefits. 10 *See, e.g.*, Scott Andrew Shepard, *The Lead Lemming: Illinois on the Pension Crisis Brink*, 14 J. L. PUBL.

POL'Y 151 (2018) § I (*available at* https://ssrn.com/abstract=2921474) ("Because the rate-of-return includes a return for inflation, this discount rate is a nominal rate (i.e., it includes both the real return on investment and the result of inflation). When inflation is perceived as being particularly low, as it has been since 2008, nominal rates of return fall precipitately below historical averages. If pension funds assume a discount rate based on historical averages, this assumed discount rate proves not only irrelevant but straightforwardly disastrous: relying on it results in the sort of underfunding multiplication described in the text above."). *See also* citations in note 11.

[69] *See, e.g.*, Robert Novy-Marx & Joshua D. Rauh, *The Liabilities and Risks of State-Sponsored Pension Plans*, 23 J. ECON. PERSPECTIVES 191, 193, 195, and *passim* (2009) (risk-free rate most appropriate, matched against the present value of the liabilities, known as the "accumulated benefit obligation"); John A. Turner et al., *Determining Discount Rates Required to Fund Defined Benefit Plans* (Mar. 2015), *available at*

http://www.actuaries.org/oslo2015/papers/PBSS-Turner&GO&McC&B-P.pdf (preferred "rule would be to select a discount rate that is less than the expected rate of return on assets but greater than the risk free rate, with the discount being greater the higher the percentage of the portfolio invested in equity and the longer the duration of the liabilities"); Alicia H. Munnell, *Appropriate Discount Rates for Public Plans Is Not Simple*, MARKETWATCH.COM (Oct. 5, 2016) (6 percent). *See also* Robert Novy-Marx & Joshua D. Rauh, *Public Pension Promises: How Big Are They and What Are They Worth?*, 66 J. FINANCE 1211 (2011) (determining public debt using accumulated benefit obligation method); Alicia H. Munnell et al., *The Funding of State and Local Pensions 2012–2016* (Ctr. for Retirement Research at Boston Coll., Issue In Brief No. 32, July 2013) (same).

discovered, this method would set California's true unfunded pension liabilities at more than $750 billion—triple the current recognized liability.[70]

In an important sense, California's pension authorities have already implicitly recognized that Rauh's formula for determining unfunded liability is correct. They demonstrate this concurrence by using that very formula to calculate the cash-out liability of California municipalities that wish to leave CalPERS.[71] Jeremy Bulow has developed a useful narrative explanation of the flaws in using a discount rate based on the state's (generous) projections of what it hopes to make on its investments rather than a riskless cash-out rate,[72] and particularly why CalPERS's use of the higher discount rate for its own liabilities while using the lower rate for departing municipalities is so disingenuous.

> The way to think of it is this: Employees lend part of their compensation to employers in return for the promise of a future payment. Let's say that the payment is $200 twenty years from now. What is the amount of the debt that the employer has incurred that should be taken into account as part of the employee's compensation if the benefit is highly likely to be paid, as with the debt of a highly rated insurance company or corporation? Under current market conditions economists, insurance companies, and the Pension Benefit Guaranty Corporation would say that something like $100 is appropriate, with the employer borrowing from the employee at 3–4 percent interest. CalPERS has said to state and local governments, "We will say instead that the loan is for $50 at 7.50 percent interest, so that you only have to report a $50 current cost. But if tomorrow you want to pay off your loan (by making a lump sum payment to CalPERS which will then be responsible for paying the benefit) we will calculate it the same way as an insurance company, and you will have to pay $100." Even though cities and the state use CalPERS accounting as reporting their annual pension costs the reality is that CalPERS' calculation is more akin to the minimum payment that a credit card company will charge. Just making your minimum payment does not mean you have really balanced your budget; it just kicks the can down the road.[73]

In support of using the higher rate, states have argued that they should be excluded from normal investment valuations because the debtor in the case of government-employee pensions is not a private entity but—ultimately—the state itself, which cannot enter bankruptcy even if it wished to[74] and which can always raise taxes to cover its obligations. This argument, though, is undermined to the very extent that states carry "structural" unfunded pension liabilities—that is, pension liabilities that are unfunded even if the assumed discount

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[70] *See* Rauh, *supra* note 3; *Interactive Map of Pension Liability by State and City*, POLICYED.ORG, *available at* https://www.policyed.org/pension-pursuit/pension-liability-state/map (California) (last visited Jul. 16, 2018).

[71] *See, e.g.*, Steven Greenhut, C*alPERS Is Shocked—Just Shocked—to Find Cities Reeling Under Growing Pension Debt*, REASON (Nov. 24, 2017).

[72] CalPERS currently uses a termination (riskless) rate of 3.25 percent. Jeremy Bulow, *The "California Rule" and Public Pensions* 9 (Stanford Institute for Economic Policy Research, Working Paper No. 17-018, Sept. 2017).

[73] Bulow, *supra* note 14, at 4.

[74] Shepard, *supra* note 10, at § III.B.

rate is applied to the funds reserved for pension payments by the state government. These unfunded liabilities are themselves the embodiment of the state's unwillingness or inability to pay for all of the pension promises that it has already made. In other words, *any* material, structural underfunding— especially under the generous assumptions that states have been allowing themselves— undermines the case for using those generous assumptions and suggests use of the Rauh formula, which then radically underscores the true unwillingness of the taxpayers to underwrite their politicians' generosity.[75]

The dangers of using the higher discount rate to determine current unfunded liabilities are demonstrated particularly starkly in California. By employing a 7 percent discount rate to determine overall liability and municipalities' mandatory contributions to CalPERS while dropping the discount rate to the risk-free rate, CalPERS is in effect extorting municipalities to continue to act with fiscal irresponsibility. If a municipality continues to make promises that it doubts it will be able to meet to employees who rely on its assertions, then it can get the higher rate and minimize its payments. If, though, it acts on a belief that it has made and is making promises it no longer thinks it can keep, then its current unfunded obligations are calculated using the lower, risk-free rate, and this vastly larger bill is presented all at once.[76] And so municipalities are left with no choice but to continue on their present course.[77]

California can ill afford these funding problems. While once world renowned as the land of milk and honey, California now faces harder times. Despite massive spending on social welfare programs,[78] California now has the highest poverty rate in the United States.[79] Its citizens spend more than a third of their income to house themselves, the third-highest rate in the United States.[22] Energy prices are some of the highest in the country.[23] Taxes are already some of the highest in the country,[24] with income taxes already some of the most progressive in the country,[80] which is resulting in an accelerating exodus of the middle class.[26] The state's

[75] Other arguments made in defense of the higher, risky discount rate are examined, and found wanting, by Bulow, *supra* note 14, at 17–20.

[76] *See, e.g.*, Bulow, *supra* note 14, at 10 ("CalPERS will take the same promise that an insurance company will say is worth $100 at 4 percent and call the amount of the loan $60 at 7 percent, but with a $40 prepayment penalty. This allows the public employer to account for the cost of incurring the new liability as only $60"—unless it wants to leave the system, at which point the prepayment penalty kicks in.).

[77] Two recent events suggest that CalPERS is fully aware of both the unsustainability and the duplicity of its, in effect, dual bookkeeping, and actively using its duplicity to protect its short-term ability to maintain its remaining reputation without officially joining the calls for cuts in present pension promises. *See, e.g.*, Greenhut, *supra* note 13 ("In one case, it decided to seek a legislative sponsor for a bill that would enable it to shift the blame to local agencies whenever such agencies decide to stop making their payments to the fund and retiree pensions are cut as a result. In the second case, at the urging of cities CalPERS decided to delay a vote on a more actuarially sound means of paying off pension debt—rather than risk a fifth rate hike to local governments, and risk a mutiny among hardpressed local governments.").

[78] *See* Kerry Jackson, *California, Poverty Capital*, CITY J. (Winter 2018) ("California state and local governments spent nearly $958 billion from 1992 through 2015 on public welfare programs, including cash-assistance payments, vendor payments, and 'other public welfare,' according to the U.S. Census Bureau.").

[79] *See id.* (citing the Census Bureau's Supplemental Poverty Measure, "which accounts for the cost of housing, food, utilities, and clothing, and which includes noncash government assistance as a form of income.") 22 *Id.* 23 *Id.* ("Extensive environmental regulations aimed at reducing carbon-dioxide emissions make energy more expensive, also hurting the poor. On some estimates, California energy costs are as much as 50 percent higher than the national average.") 24

See Income Tax Rates by State, 2018 TAX-RATES.ORG, *available at* http://www.tax-rates.org/taxtables/incometax-by-state (last visited Jul. 16, 2018).

[80] *See* *id.* 26

education system, once a national model, has fallen in state rankings to the embarrassing side of

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See, e.g., Joel Kotkin & Wendell Cox, *Leaving California? After Slowing, Trend Intensifies*, SAN JOSE MERCURY NEWS (Apr. 24, 2017); Thomas C. Frohlich & Alexander Kent, *States Where the Middle Class Is Dying*, 24/7 WALL ST. (Jan. 22, 2015).

mediocre.[81] As Gavin Newsom, the state's lieutenant governor, gubernatorial candidate, and former mayor of San Francisco, has recently recognized, "California is both America's richest state, and its poorest. We need growth and inclusion—an economy that shares the energy and diversity of this state and works for every Californian."[82] Fixing the pension-funding crisis in a manner equitable to both government workers and taxpayers generally can help to ensure that goal.

The California Rule

This crisis has many contributing factors, including generous legislatures, governors, and administrators; aggressive government-employee unions; and underrepresentation of the interests of private-sector taxpayers in the pension negotiation process. In California, significant responsibility also lies with the state's courts. Over the years, those courts have generally been thought to have developed what has come to be called, rather aptly, the "California Rule" of pension benefits. This set of precedents has been interpreted to forbid the state to reduce any pension benefits offered to any workers employed at the time the benefits were offered, for any work performed by those employees at any time during their employment with the state or its municipalities, such as counties, cities, and school districts.[83] Put another way, the California Rule has been interpreted to stop government entities from

[81] *Education Rankings: Measuring How Well States Are Educating Their Students*, U.S. NEWS & WORLD REP'T, *available at* https://www.usnews.com/news/best-states/rankings/education (last visited Jul. 16, 2018) (26th overall, but 44th in K–12 provision); Sharon Noguchi, *In National Rankings, California Schools Not Exactly Ahead of the Class*, SAN JOSE MERCURY NEWS (Jan. 5, 2017) (41st out of 51 US jurisdictions). *See also* John Woolfolk, *Study: California Governments Pay More, Have Lower Staffing,* OROVILLE MERCURY REGISTER (Jan. 28, 2018) ("In K–12 education, the Golden State's top spending priority, the analysis showed California spending per resident on K–12 schools was about average among the states, but while teacher pay was among the highest, the state trailed others in teachers and support staff per student. . . . The National Center for Education Statistics tells a similar staffing story using more recent figures and also shows California's math, reading, writing and science scores are below average. In higher education, the Urban Institute ranked California among the biggest spenders per resident, but also showed the state had among the fewest professors and other staff per student, even though they were the highest paid."); David Crane, *California's Own Shutdown: Schools Are Open but Shelves Are Barren*, MEDIUM (Jan. 20, 2018) ("Public schools in Los Angeles, Oakland, San Francisco, San Diego, San Jose and other urban centers are providing just a fraction of full services, resulting in understaffed classrooms, underpaid teachers, and fewer arts, science, math, and other classroom offerings. One result is that the poor and minority students that make up a large share of those urban districts underperform poor and minority students in other states that spend much less per student.").

[82] Gavin Newsom (@GavinNewsom), TWITTER (Feb. 16, 2018), *available at* https://twitter.com/GavinNewsom/status/964554242252947462. Newsom's tweet includes an embedded video that calls for "portable benefits" for Californians but fails to call for a migration to defined-contribution, 401(k)-style pensions for work not yet performed by California's government employees that would provide the only portable sort of pension benefits available.

[83] *See, e.g.*, Marin Association of Public Employees v. Marin County Employees' Retirement Association, 2 Cal. App. 5th 674, 693–94 (Aug. 17, 2016) (Plaintiffs' essential position is clearly set out in their opening brief: "Public employees earn a vested right to their pension benefits immediately upon acceptance of employment and . . . such benefits cannot be reduced without a comparable advantage being provided." "A corollary of this approach is that public employees are also entitled to any increase in benefits conferred during their employment, beyond the pension benefit in place when they began. . . . Since they are performing work under the improved pension system, the terms of that system become an integral part of their compensation, and they immediately become vested in the improved benefit." "Because A.B. [Assembly Bill] 197 has resulted only in the exclusion of payments from pension benefits, with no new benefit to offset the decreased pensions, this infringes employees' vested rights.").

lowering pension benefits for current workers—even for work that those employees have not yet performed and may not perform for years or even decades to come.

The California Rule in effect has created a one-way ratchet of pension-benefit increase. Every benefit grant made either in good times or by union-friendly politicians has become semipermanent so that when the good times have turned bad, or less union-friendly officials have replaced their more accommodating colleagues in office, no diminutions of the previous largesse could be enacted, whatever the financial need or public support for such adjustments. This mechanism has helped to facilitate the current crisis. Virtually all parties except the government-employee unions themselves are united on this point.[84] A 2011 study by the stateauthorized Little Hoover Commission rang the fire bell in the night.[85]

> California's pension plans are dangerously underfunded, the result of overly generous benefit promises, wishful thinking and an unwillingness to plan prudently. Unless aggressive reforms are implemented now, the problem will get far worse, forcing counties and cities to severely reduce services and layoff employees to meet pension obligations. . . . In this report, the Commission confronts the elephant in the room: The legal obstacles that limit the options of state and local pension plans to reduce future, asyet-unearned pension benefits promised to current workers.[86]

The Commission's recommendations were sweeping and ecumenical, including transferring employees to (partial) defined-contribution pension plans for future work,[87] decreasing formulas for capping already-earned benefits,[34] putting absolute caps on defined benefits,[35]

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[84] The unions are united that the California Rule must remain in place as currently interpreted, and that the state cannot restrict any options for already-employed government workers, including spiking pensions by larding their last year(s) of service with abnormal compensation that gets rolled into the pension award (called "pension spiking") or purchasing "extra years" of notional service (called "airtime") so as to bump up the pension-award formula. *See,*
e.g., Adam Ashton, *California Should Be Able to Reduce Public Employees' Pension Benefits, Jerry Brown Argues*, SACRAMENTO BEE (Nov. 22, 2017) ("'You have to twist yourself up pretty good' to believe the air time and spiking changes will hold up in court despite the 'California rule,' said Terry Brennand, pension director for SEIU California. 'You're taking away a benefit that is part of my program without offering me anything. I get removing it for future employees, but going backwards was a political move.'"). *See also* Ed Mendel*, New Ruling Called "Existential Threat" to Pensions*, CALPENSIONS (Sept. 19, 2016).

[85] *Cf.* Thomas Jefferson to John Holmes, Letter (Monticello, Apr. 22, 1820).

[86] Daniel W. Hancock, Chairman, Little Hoover Commission, to Edmund G. Brown Jr., Governor of California, et al., Letter (Feb. 24, 2011), *in* LITTLE HOOVER COMMISSION, PUBLIC PENSIONS FOR RETIREMENT SECURITY (Feb. 2011) (letter appears as preface to report).

[87] *Id.* ("Public agencies must have the flexibility and authority to freeze accrued pension benefits for current workers, and make changes to pension formulas going forward to protect state and local public employees and the public good. The Commission further urges the Legislature to pursue structural changes that realign pension costs and expectations of employees, employers and taxpayers. A hybrid model, which combines a lower defined-benefit pension with an employer-matched defined-contribution plan, is a model that must be made available to public agencies.") 34 *Id.* ("The state needs to collapse unsustainable pension formulas and create a lower defined-benefit formula to facilitate this approach.") 35 *Id.* ("A cap also must be put in place on the maximum salary that can be used to determine pension payments, or on the maximum pension that an employee can earn. The cap should protect pensions for lower-wage earners, but it is not the government's burden to exclusively fund the retirement of public employees and executives earning high salaries. Earnings that exceed the threshold should be steered into a portable defined-contribution plan, with the ability of employers to match employees' contributions, to encourage workers to remain employed, and to serve a mobile and professional workforce.")

ending pension-contribution holidays and increasing employee contributions,[88] and reducing government-employee (and thereby increasing taxpayer) control of their own pensions.[37] Very recently, the League of California Cities renewed the alarm. "Pension costs for California Cities are approaching unsustainable levels, and . . . cities need more tools and options to ensure they are able to retain and attract public sector employees and continue to deliver high

[88] *Id.* ("All parties must pay a fair share. Contribution holidays from employers should be allowed only in rare cases of fiscal emergency—not when pension assets appear inflated by temporary market surges. Employees must contribute equally to their pensions.") [37] *Id.* ("More independent members should be added to retirement boards to add needed perspectives about the public's tolerance for risk when setting aggressive assumptions for investment returns. Voters, too, deserve a say in benefit increases that they ultimately have to pay.")

quality municipal services to residents."[89] The CalPERS chief actuary likewise pointed out the unsustainability of the present pension promises almost a decade ago.[90]

The parties recognizing the unsustainability of the current situation and the state's inability to meet its current pension promises as presently interpreted under the California Rule include Governor Brown and his administration. In recent public comments he indicated his belief that the current interpretation of the rule will not last much longer. "'There is more flexibility than there is currently assumed by those who discuss the California rule,' Brown said during a briefing on the budget in Sacramento. He said that in the next recession, the governor 'will have the option of considering pension cutbacks for the first time.'"[91] He has supported this "hunch" that the California Supreme Court would soon "modify" the rule[92] by replacing the state attorney general's office in representing the state in one of the three cases recently decided by California appellate courts, and now before the supreme court, that offer the court just that opportunity. His administration argued forcibly for modifying the rule.[42]

The Cases

Three appellate decisions addressing the question of the California Rule now await California Supreme Court review. Each of these three cases was catalyzed by county efforts to apply the Public Employees' Pension Reform Act of 2013 ("PEPRA").[93] The statute represented a tentative first step to trim back the growth rate of pension-funding obligations.[94] The questions raised by these cases for the California Supreme Court is what its California Rule precedent really has been, whether it cares to maintain or to revise that precedent, and how the lower courts and the legislature should now proceed as a practical matter.

Of the cases, *Marin Association of Public Employees v. Marin County Employees' Retirement Association*[95] (referred to below as *Marin*) was decided first, in August 2016. The supreme court delayed review of that decision, though, while a sister case, *Alameda County Deputy*

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[89] *League Survey Confirms Need for More Tools to Sustain Pension System and Local Services*, LEAGUE OF CALIFORNIA CITIES (Feb. 1, 2018).

[90] *See* Ed Mendel, *When Do CalPERS Rates Become 'Unsustainable'?*, CALPENSIONS (Feb. 12, 2018) ("'I don't want to sugarcoat anything,' [then CalPERS chief actuary Ron] Seeling said. 'We are facing decades without significant turnarounds in assets, decades of—what I, my personal words, nobody else's—unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan . . . unsustainable pension costs. We've got to find some other solutions.'").

[91] Romy Varghese, *California's Brown Raises Prospect of Pension Cuts in Downturn*, BLOOMBERG POLITICS (Jan. 10, 2018).

[92] *Id.* [42] *See* further discussion in the following section. Brown seems to have a fairly clear-eyed understanding of the parlous state of pension funding in California. In the same press conference in which he made the comments noted above, he predicted that "'at the next downturn when things look pretty dire, [pensions] will be on the chopping block.'" Adam Ashton, *Pensions Will Be 'on the Chopping Block' in Next Recession, Jerry Brown Says*, SACRAMENTO BEE (Jan. 12, 2018). His legislative efforts to reform the state's pension promises reach back to 1982, at the end of his first service as governor. *See, e.g.*, Ed Mendel, *Pension Reform: Brown Picks Up Where He Left Off,* CALPENSIONS (Jul. 31, 2010) (The 1982 effort, to limit pension promises for new workers then, was unsuccessful.).

[93] *See* Cal. Stat. § 7522 *et seq*.; Stats. 2012, ch. 296; *Marin*, 2 Cal. App. 5th 674, 679, 682–82 (2016); *Cal Fire*, 7 Cal. App. 5th 115, 120 (2016); *Alameda*, 19 Cal. App. 5th 61, 75 (2018).

[94] *See Marin*, 2 Cal. App. 5th at 681–82.

[95] 2 Cal. App. 5th 674 (Aug. 17, 2016).

Sheriff's Association v. Alameda County Employees' Retirement Association[96] (referred to below as *Alameda*), awaited decision.[47] That decision was issued on January 8, 2018. The cases are now headed together for supreme court review but have not yet been scheduled.

The third case, *California Fire Local 2881 v. California Public Employees' Retirement System*[97] (referred to below as *Cal Fire*), was issued between *Marin* and *Alameda*, at the end of 2016. Because it was not encumbered by a mate, it has already proceeded to the high court and has been fully briefed on the state's behalf by the Brown administration's legal affairs office rather than (as is usual) by the attorney general's office[9899] or CalPERS counsel, which handled it in the courts below.[50] Because the *Cal Fire* decision relies in part on the opinion issues in *Marin*, however, while the *Alameda* decision responds to *Marin*, and because it is unclear in what order the supreme court will ultimately rule in these cases (though *Cal Fire* will likely be heard first[100]), consideration here will begin with *Marin* and follow the chronological order of the cases' issuance by the appellate courts.

In the first of these cases, Marin County, facing daunting pension-funding liability, implemented PEPRA after its 2012 passage in time for the county's new provisions to become effective as soon as PEPRA did, on January 1, 2013.[101] By January 18, the governmentemployees' union had challenged the statute and Marin County's implementation.[102]

The *Marin* court reviewed the bundle of precedent that has led to current understanding of the California Rule and concluded that the California Supreme Court really has not staked out the extreme position generally ascribed to it. It noted that the court had asserted that "public employment gives rise to certain obligations which are protected by the contract clause of the [US] Constitution, including the right to the payment of salary which has been earned,"[103] but

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[96] 19 Cal. App. 5th 61 (Jan. 8, 2018). [47] *See* California Supreme Court Case S237460, *Marin Association of Public Employees v. Marin County Employees' Retirement Association (State of California)*, Appellate Courts Case Information, *available at* http://appellatecases.courtinfo.ca.gov/search/case/mainCaseScreen.cfm?dist=0&doc_id=2155980&doc_no=S2374 6 0&request_token=NiIwLSIkXkw9WzApSCMtXEtIQFQ0UDxTICMuVzxTMCAgCg%3D%3D (last accessed Feb. 18, 2018).

[97] 7 Cal. App. 5th 115 (Dec. 30, 2016).

[98] *See* Intervenor and Respondent State of California's Answer to Amici Curiae Briefs, *California Fire Local 2881 v. California Public Employees' Retirement System*, No. A142793, 2015WL 3894586 (Cal. App. 1 Dist.) (Jun.

[99] , 2015). [50] *See* CalPERS's Notice of Intent to Reply on Brief Filed in the Court of Appeal, *California Fire Local 2881 v. California Public Employees' Retirement System*, S239958 (Jul.14, 2017).

[100] Briefing has already been completed in *Cal Fire. See* California Supreme Court Case S239958, *California Fire Local 2881 v. California Public Employees' Retirement System*, Appellate Courts Case Information, *available at* http://appellatecases.courtinfo.ca.gov/search/case/mainCaseScreen.cfm?dist=0&doc_id=2176751&doc_no=S2399 5 8&request_token=NiIwLSIkXkw9WyAtSCNdTEhJUEQ0UDxTICBOIz9RMCAgCg%3D%3D.

[101] *See Marin* at 682–86.

[102] *See id.*at 687.

[103] *Id.* at 694, *citing* Miller v. State of California, 18 Cal. 3d 808, 815 (1977).

then concluded that "'earned' in this context obviously means in exchange for work already performed."[104]

It went on to conclude that the California Supreme Court had determined that even with regard to this already-earned but not yet paid compensation—i.e., pension benefits accruing to work already performed—"pension rights are not immutable. For example, the government entity providing the pension may make reasonable modifications and changes in the pension system. This flexibility is necessary 'to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy.'"[105] In fact, however vested pension rights might be, they remain subject to ex post alteration by the legislature: "before the pension becomes payable . . . the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension."[106]

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[104] *Id.* at 694. As the *Marin* court elaborated, "In accordance with this view, a pension is treated as a form of deferred salary that the employee earns prior to it being paid following retirement. In *Miller*'s classic formulation: 'It is true that an employee does not earn the right to a full pension until he has completed the prescribed period of service, but he has actually earned some pension rights as soon as he has performed substantial services for his employer. [Citations.] He is not fully compensated upon receiving his salary payments because, in addition, he has then earned certain pension benefits, the payment of which is to be made at a future date. While payment of these benefits is deferred, and is subject to the condition that the employee continue to serve for the period required by the statute, the mere fact that performance is in whole or in part dependent upon certain contingencies does not prevent a contract from arising, and the employing governmental body may not deny or impair the contingent liability any more than it can refuse to make the salary payments which are immediately due.'" *Id.* at 695 (internal footnote omitted).

[105] *Id.* at 695 (*quoting Miller*, 18 Cal. 3d at 815–16).

[106] *Id.* (*quoting Miller*, 18 Cal. 3d at 816). The *Marin* court expanded:

> What the Supreme Court stated in Kern deserves more than the excerpt quoted in Miller: "The rule permitting modification of pensions is a necessary one since pension systems must be kept flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system and carry out its beneficent policy. . . . Thus it appears . . . that an employee may acquire a vested contractual right to a pension but that this right is not rigidly fixed by the specific terms of the legislation in effect during any particular period in which he serves. The statutory language is subject to the implied qualification that the governing body may make modifications and changes in the system. The employee does not have a right to any fixed or definite benefits, but only to a substantial or reasonable pension. There is no inconsistency therefore in holding that he has a vested right to a pension but that the amount, terms and conditions of the benefits may be altered." *Id.* at 696 (*quoting* Kern v. City of Long Beach, 29 Cal. 2d 848, 854–55 (1947)) (internal footnotes omitted).

The *Marin* court considered, but ultimately rejected, the possibility that the California Supreme Court had effectively undermined these protections of the legislature's ability materially to revise the value of unpaid pension benefits by a statement in *Allen v. Board of Administration*[107] that "any modification of vested pension rights must be reasonable, must bear a material relation to the theory and successful operation of a pension system, and, when resulting in disadvantage to employees, must be accompanied by comparable new advantages."[108] It concluded, essentially, that this use of "must" was accidental for a variety of reasons,[60] including that the *Allen* case itself would have come out differently if that court had actually meant "must" instead of "should."[109]

According to the *Marin* court, then, while the legislature could not abolish governmentemployee pensions, it could—in PEPRA or otherwise—diminish pension benefits without a corresponding concomitant benefit increase as long as the diminution, and the remaining pension benefits, remain "reasonable."[62] It concluded that stopping government employees from "pension spiking"—from artificially inflating their total income in their last year(s) of service to inflate their pension benefits by increasing the base amount to which the multiplier is applied[110]—could not constitute an unreasonable denial of substantial pension benefits and so could not violate either the US Contract Clause or California precedent.[111]

In the *Cal Fire* case the operative issue was not pension spiking but "airtime," the practice by government workers of "purchasing" years they did not work to include in their pension

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[107] 34 Cal. 3d 114 (1983).

[108] *Id.* at 120. [60] *See Marin*, 2 Cal. App. 5th at 698–99 ("First . . . only the least authoritative of the three sources cited actually supports the word 'must,' while the two Supreme Court decisions employ 'should.' Second, barely a month later, the Supreme Court—speaking through the same justice—filed another decision, which used the 'should' formulation from the 1955 *Allen* decision as quoted in *Abbott* [*v. City of Los Angeles*, 50 Cal. 2d 438 (1958)]. Third, the 1983 *Allen* decision involved retirees . . . who historically receive a heightened degree of judicial protection. Fourth, and most significantly, the 'must' formulation has never been reiterated by the Supreme Court, which has instead uniformly employed the 'should' language from the 1955 *Allen* decision." (internal citations omitted)).

[109] *See id.* at 699 ("The issue in *Allen* was whether pension payments to retired legislators could be reduced pursuant to new statutory and constitutional language. The trial court had concluded that reduction would be contrary to the contract clauses of both state and federal Constitutions. The Supreme Court reversed, holding that the reduction was not constitutionally improper. There is nothing in the opinion linking the reduction to provision of some new compensating benefit. If the court intended 'must' to have a literal meaning, the retirees would have won. They lost." (internal citations omitted)). [62] *See id.* at 702 ("Thus, short of actual abolition, a radical reduction of benefits, or a fiscally unjustifiable increase in employee contributions, the guiding principle is still the one identified by *Miller* in 1977: "'the governing body may make *reasonable* modifications and changes before the pension becomes payable and that until that time the employee does not have a right to any fixed or definite benefits but only to a substantial or reasonable pension.'" (*Quoting Miller*, 18 Cal. 3d 808, 816 (italics added [in *Marin*])).

[110] *See also infra* notes 65 (discussion of airtime), 103 (discussion of base pension multipliers).

[111] *See Marin*, 2 Cal. App. 5th at 704 ("We conclude" that Marin County's "implementation of [PEPRA] does not qualify as a substantial impairment of plaintiffs' contracts of employment with its right to a 'reasonable' and 'substantial' pension. Thus there is no violation of the state and federal Constitutions.").

calculations.[112] The *Cal Fire* court, relevantly,[113] relied explicitly on the *Marin* court's analysis to conclude that the California Rule is not what it has been taken to be, and that California Supreme Court precedent did not bar PEPRA's withdrawal of the airtime option.[114]

In the *Cal Fire* case, the Brown administration took over the writing of the state's brief before the supreme court rather than leaving it to the California Department of Justice or to CalPERS counsel.[115] In that brief, Governor Brown put into legal action his concomitantly expressed "hunches" and expectations about the real contours of the California Rule and the course the California Supreme Court might be expected to take.[116] The administration's brief cited the Little Hoover Commission's warning of impending disaster and its call for reform (if not endorsing any of the Commission's specific recommendations),[117] cited with approval a seminal article by Professor Amy Monahan critical of the standard interpretation of the California Rule,[118] and itself expressly rejected that standard interpretation. Rather, it contended that "the absence of comparative new advantages is not dispositive in every case involving the [reduction] of vested [pension] rights of current employees."[119] It then essentially endorsed (or tracked, anyway) the *Marin* court's arguments.

First, the Brown administration looked back to the guiding principles espoused by the United States Supreme Court in applying the federal Contract Clause.[120] Turning to California precedent, it asserted that "the absence of comparable new advantages has been [only] one of *multiple* factors to be considered in determining whether modifications are reasonable and justified. What *is* indispensable is that modifications of pension rights 'bear some material relation to the theory of a pension system and its successful operation.'"[121] Such considerations

[112] Here is a simple example of airtime: Assume a worker has 28 years of service. She wants to retire with a larger retirement benefit than 28 years of service would bring her. She thus "buys," say, two years of service with a payment to her employer, thus bringing her up to 30 years. The 30-year figure is then employed in the calculation described above to determine the employee's initial annual pension benefit. *See Cal Fire*, 7 Cal. App. 5th 115, 120 (2016).

[113] "Relevantly" because the court also found the airtime withdrawal to be constitutional on independent grounds that do not implicate the examination of the California Rule that the *Marin* court undertook and that is the burden of this paper's analysis. This independent ground is that the "airtime" option was meant to be revenue neutral, not a benefit designed to allow employees to amplify their overall total compensation, and that to the extent that it has become the latter, it represented an illegitimate and unauthorized pension benefit that could be stopped even under the broadest understanding of the California Rule without requiring the state or its instrumentalities to offer any compensatory increase in other benefits. *See Cal Fire*, 7 Cal. App. 5th at 120, 130–32.

[114] *See id.* at 131.

[115] *See supra* notes 49, 50.

[116] *See supra* page 14.

[117] *See* Intervenor and Respondent State of California's Answer Brief on the Merits 17, *Cal Fire Local 2881 v. CalPERS*, Case No. S239958 (submitted Nov. 6, 2017) (hereinafter "Brown Administration Brief").

[118] *See id*. at 38 n.12 (*citing* Amy Monahan, *Statutes as Contracts? The "California Rule" and Its Impact on Public Pension Reform*, 97 IOWA L. REV. 1029 (2012)).

[119] *See* Brown Administration Brief at 36.

[120] *See id*. (The California Supreme Court's "precedent requires looking more broadly at the reasonableness and necessity of the impairment, not just at whether there are comparative new advantages. 'An impairment may be constitutional if it is reasonable and necessary to serve an important public purpose.'" (*quoting* US Trust Co. of New York v. New Jersey, 431 U.S. 1, 25 (1977)).

[121] *Id.* at 38 (*quoting* International Assn. of Firefighters v. City of San Diego, 34 Cal. 3d 292, 301 (1983); Allen v. City of Long Beach, 45 Cal. 2d 128, 131 (1955)).

permit pension reductions "if the impairment is limited and does not meaningfully alter an employee's right to a 'substantial or reasonable pension'" of the sort that concerned the *Marin* court.[122] Under this understanding, "to evaluate necessity, courts look to whether a 'more moderate course' would have served the State's 'purposes equally well,' and whether the State considered the impairment 'on par with other policy alternatives,'"[123] but they must pay "at least some deference to legislative policy decisions" to reduce pension benefits.[124]

The final case in this series is *Alameda*.[125] The *Alameda* court concluded that some portions of PEPRA had at least potentially made material reductions to government employees' pension benefits[79] and so reviewed the content and applicability of the California Rule.[126] It undertook this analysis in direct contemplation of—and, in effect, in doctrinal agreement with but practical divergence from—the *Marin* court's decision.[81]

The *Alameda* court accepted a core piece of the *Marin* court's analysis: it agreed that the California Rule, whatever else it means, should be read only to suggest that pension-benefit reductions *should*, rather than *must*, be counterbalanced by comparable benefit increases.[82] In short, it agreed with the *Marin* court that the California Rule is "in effect, 'a recommendation,

[122] *Id.* at 39 (*quoting Miller,* 18 Cal. 3d at 816).
[123] *Id.* at 45 (*quoting US Trust Co.,* 431 U.S. at 30–31).
[124] *Id.* (*quoting* Baltimore Teachers Union, Am. Fed'n of Teachers Local 340, AFL-CIO v. Mayor & City Council of Baltimore, 6 F.3d 1012, 1019 (4th Cir. 1993)).
[125] 19 Cal. App. 5th 61 (Jan. 8, 2018). [79] *See id.* at 79 ("We believe that the trial court erred in refusing to determine whether legacy members have a vested right to be free from this uncertainty. In sum, since we conclude that subdivision (b)(1) represents a change to prior CERL law, it must be subjected to a vested rights analysis to determine whether legacy members have the right to have their pensions calculated without reference to its new prescriptions.").
[126] *See id.* at 79–101. [81] *See id.* at 114 ("Recently, our colleagues in Division Two addressed this same issue with respect to legacy members of the Marin CERA [County Employees Retirement Association] and concluded that the amendment of section 31461 did not amount to an unconstitutional impairment of vested pension rights. As this issue is crucial to the resolution of our case, we will discuss the Marin holding in some detail. Preliminarily, however, we review precedent, specific to our high court, delineating the scope of a public employee's vested pension rights." (internal citations omitted)). [82] *See id.* at 93–94 ("After tracing the origin of the 'must' language to a 1969 appellate court decision and establishing that it has never again been reiterated by the Supreme Court, Marin makes, we feel, a convincing argument that the use of 'must' in *Allen II* was not 'intended to herald a fundamental doctrinal shift.' Thus, according to Marin, the high court's vested rights jurisprudence generally requires only that detrimental pension modifications should (i.e., ought) to be accompanied by comparative new advantages. . . ." (internal citations omitted)). The press broadly treated *Alameda* as a victory for the government-employee union position, but the unions themselves understood it to be the sort of win King Pyrrhus would have recognized and rued. The union petitioned the Supreme Court for review of the *Alameda* decision*,* arguing that "the Court should grant review because the appellate court flatly refused to follow this Court's longstanding precedent requiring that any detrimental changes to pension rights 'must' be offset by new advantages." Petition for Review, *Alameda County Deputy Sheriff's Assn. et al. v. Alameda County Employees' Retirement Assn., et al.*, Case No. A141913 (submitted Feb. 2018).

not . . . a mandate.'"[127] It diverged with the *Marin* court, however, in its understanding of what this "should" means. "As the *Marin* court, itself, acknowledged, should does not mean 'don't have to.' It means 'really ought to.' Thus, when no comparative new advantages are given, the corresponding burden to justify any changes with respect to legacy members [i.e., government employees employed before the date of the pension benefit changes, whether those changes are prospective, retrospective, or mixed] will be substantive."[128]

This is where the practical distinction arises. The *Alameda* court admits that "total pension system collapse may be a sufficiently weighty concern to meet" its standard of substantive justification.[85] Nevertheless, when considering "the fiscal justification for application of the pension modifications at issue to legacy members, the court [must] specifically weigh[] the financial implications for [an individual municipal pension plan] if legacy members were exempted from those modifications, rather than impermissibly focusing on the unfunded pension liability crisis in general."[129] The *Alameda* court continued:

> In the end, we simply do not think that it is possible to engage in the individualized balancing test mandated by the Supreme Court's vested rights jurisprudence—and thereby determine whether it is reasonable to apply the pension modifications at issue to legacy members—without a specific analysis of the changes that have been effected by the new law; consideration of the impact of those changes on the legacy members at issue; and an evaluation of the legislative rationale for the change in the context of the facts of each specific CERL (County Employees Retirement Law of 1937) system. We therefore decline to follow *Marin*.[87]

Instead, the *Alameda* court remanded its case to the trial court for the individualized justification it considered necessary under its interpretation of the California Rule.

There is, obviously, a meaningful split between the lower-court opinions working their way to the California Supreme Court. The divergence is of practical significance, for if every unilateral pension reduction authorized by the legislature must be proved uniquely necessary to the continued functioning of the individual CalPERS "branch" when applying in any way to any "legacy" government employees, the process of reform may be stalled into meaninglessness. On the other hand, to the extent that pension reductions decrease already-earned or contracted-for compensation, something more than merely noting the existence of a generalized pension crisis really should be required.

The Decision: How the California Court Should Rule

These cases provide the California Supreme Court an excellent opportunity to disavow—or, if it prefers, to clarify—the California Rule. Both *Marin* and *Alameda*, in particular, include insights that can, despite the divergence in result between the two opinions, be synthesized in a

[127] *Alameda,* 19 Cal. App. 5th at 94 (*quoting Marin,* 2 Cal. App. 5th 674, 699).
[128] *Id.* [85] *Id.* at 97. The "may" in this sentence is startling. A standard that demonstrates that total system collapse awaits the failure of pension reduction, and yet says that may still not be enough evidence to justify the reduction, is a facially erroneous standard.
[129] *Id.* [87] *Id.* at 97–98.

coherent and satisfying way that will allow California to address its pension crisis in a manner expeditious, comprehensive, *and* respectful of the individual contract rights of each government employee.

A decision from the court that expressly retreats from the rule as currently understood, and that gives governments in California a free hand to reduce or otherwise materially change future benefits, will allow those governments to respond to the pension-funding crisis in equitable ways that comport with traditional rules about sovereign power, contract rights, and quasi-contractual doctrines such as reliance and performance.

To achieve all these ends, the court should distinguish between three categories of pension benefits: (1) benefits applying to work already performed; (2) benefits applying to work yet to be performed but explicitly promised to accrue to that future work by statute or contract; and (3) benefits applying to work yet to be performed and not explicitly promised to apply in the future.

The government-employee unions have supported their maximalist position by asserting that the courts have only a toggle option available to them.[130] They can treat pensions as "mere gratuities," as they were treated everywhere early in the last century, that are subject to complete revision, reduction, or withdrawal at the sole discretion of legislative or executive whim.[131] Alternately, they can be treated as immutable facts extending forward through the employment of each government worker, never to be modified or reduced.[132]

This toggle-switch approach misses the opportunity to make important legal and policy distinctions, however. The most important distinction to be drawn is between benefits that have already accrued (i.e., benefits earned by work that has already been performed) and benefits that have not yet accrued because the work by which they will be earned has not yet been performed. When work has already been done, then the benefits promised for that work, whether pay or fringe benefits or the deferred compensation that is a pension benefit, ought to be paid except in extraordinary circumstances—such as fraud or other misdeed by the party owed or insolvency and inability to pay by the payor. (These already-accrued benefits will sometimes be referred to below as Type 1 benefits.)

These are basic principles of the law of contract, and they are supported by the equitable doctrines that in large part underlie contract law and inform the field of quasi-contract.[133]

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[130] *See Marin*, 2 Cal. App. 5th 674, 694 ("Plaintiffs candidly admit, 'In practice, this means that for existing employees, any changes must generally be neutral with regard to the overall benefit provided and cannot represent a net decrease in the pension benefit.' Less ambiguously, they assert 'neither Marin CERA nor the Legislature can now curtail those benefits.' Plaintiffs insist that if their position is not vindicated on this appeal, California will have returned to 'the view that public employee pensions are mere 'gratuities' to be granted or taken away at the whim of the employer.'" (internal footnote omitted)).

[131] *See id.*; Shepard, *Lead Lemming, supra* note 10, at § II.C.1 (citing Eddy v. Morgan, 75 N.E. 174 (Ill. 1905)); Dodge v. Bd. of Educ., 302 U.S. 74, 78–79 (1937); Andria L. Bentley, Comment, *The New York State Comptroller as Sole Trustee of the Common Retirement Fund: A Constitutional Guarantee?*, 72 ALBANY L. REV. 763, 767 (2009) (citing Roddy v. Valentine, 197 N.E. 260, 262 (N.Y. 1935) (reviewing the mutation of pension protections in New York from pure gratuities to something approaching quasi-contract, but recognizing that even as of 1935, such pension benefits could be stripped entirely away even after an employee's retirement); Note, *Public Employee Pensions in Times of Fiscal Distress*, 90 HARV. L. REV. 992, 994–1003 (1977).

[132] *See Marin*, 2 Cal. App. 5th at 694.

[133] Consider, for example, the unilateral contract, wherein the promisor makes a promise that the promisee accepts by performing per the promisor's wishes. Performance creates in the promisor the obligation to pay per the promise. *See, e.g.*, *Contract*, BLACK'S LAW DICTIONARY 224–27 (abridged 6th ed. 1991). With regard to principles that inform quasi-contract, consider promissory estoppel, or "that which arises when there is a promise which

Contract law could not function if the paying party could slash payment after the contracted goods or services had already been provided or performed. The only sorts of transactions that could proceed would be those between parties who already trust one another so much that a contract would not be necessary. Meanwhile, the most basic rules of equity will not permit one party to change the terms of a deal after the other party has relied on those terms and has performed, and so cannot respond to the changing offer.

The fact that the contracting party paying these benefits is a government should not alter this analysis except in rare cases. While the legislative power must be free to make new rules by which the polity is to function in the future, and must be free in making these rules to react to changing economic circumstances and evolving political moods among the majority of voters, it need not as a matter of policy be free to reach backward in time to change already-fixed arrangements for already-completed work. In fact, it cannot be: if it were, it would be an unreliable contracting partner, which would either make government contracting impossible or at least raise the cost of that contracting exorbitantly.

This is not to say that there are no circumstances in which not-yet-paid benefits for work already performed might be adjusted. One justification for post hoc adjustment is practical: inability to pay. In the private-contract context, this inability to pay arises with insolvency and bankruptcy. If a private entity promises more payments than it can make, then some payees will of necessity not get paid in full; in fact, bankruptcy law exists in part to try to ensure that all creditors of a bankrupt entity get paid the same fraction of what they are owed out of the assets remaining.

The details of this process differ in government contracts. States, for instance, are not even permitted to declare bankruptcy.[134] The details aside, though, circumstances can develop in which governments have made promises so extravagant, or where financial reality has changed so radically, that the governments cannot reasonably honor their promises—or, at least, cannot honor their promises without abandoning their fundamental responsibilities to the rest of their citizens. In these circumstances, the governments neither can nor should honor the insupportable promises in full, and both must and should be permitted by the courts to alter them.

Very different considerations obtain with regard to benefits that have not yet been earned, however. The key distinction, of course, is that no performance has occurred. Moreover, and crucially, while some reliance may have been placed, and some investments made, by contracting parties in the expectation that the benefits previously earned will continue into the future, that reliance and those investments can be justified, and need be respected at law or in equity, only if there is some sort of contractual justification for the reliance and the investments.

With regard to benefits that have not yet been accrued for work that has not yet been performed, then, the vital question is whether the state has explicitly contracted to continue the benefits into the future. This can occur in two ways: by employment contract or by a

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promisor should reasonably expect to induce action or forbearance of a definite and substantial character on part of promise, and which does induce such action or forbearance, and such promise is binding if injustice can be avoided only by enforcement of promise." *Promissory Estoppel*, BLACK'S LAW DICTIONARY 843.

[134] *See, e.g.*, Shepard, *Lead Lemming*, *supra* note 10, at § III.B (citing David A. Skeel Jr., *States of Bankruptcy*, 79 U. CHI. L.R. 677, 679–80 and *passim* (2012)).

statute that includes language expressly committing to maintain a certain set of benefits through a certain fixed date. The former occurs fairly regularly, particularly in the form of collective-bargaining agreements with government-employee unions. The latter, though, is rare and plays no role in the court's upcoming analysis. (This second category of benefits, those not yet earned but explicitly promised by contract or statute to continue into some future period, are sometimes called Type 2 benefits.)

When government employees have either express contracts or explicit contractual provisions that extend their benefits, then they are wholly justified in relying on those promises, and great weight should be given to the commitment to honor those promises. Because their contracting partner is a sovereign government, they cannot rely completely on the totality of the promises—in extremis, the legislative power will still allow some alteration of the contractual relation between government and employee in order to maintain the integrity of the government entity and at least minimal respect for the equitable relationship between the interests of government employees and interests of nonemployee taxpayers. Because, despite the contractual protections, the work has not yet been performed, the performance interest does not apply (or does not apply as strongly) to these benefits, and thus the judicial constraints against reducing the benefits are somewhat lower than in the case of retroactive reduction of already-earned benefits. In other words, it should be somewhat easier for the legislature to reduce this category of benefits, but not much—and only upon careful scrutiny by the legislature and evidentiary demonstration of serious need. (Any sort of evidence that the relevant contract had been inappropriately negotiated would, of course, to the extent of the demonstration, mitigate in favor of permitting reduction to this category of benefit.)

It is these Type 1 and Type 2 benefits to which the analysis by the lower courts in the cases considered above—particularly *Alameda*—and the Brown administration brief in *Cal Fire*[135] rightly applies. Here, "the . . . burden to justify any changes with regard to legacy members [should] be substantive."[136] For these types of benefits, "the court [must] specifically weigh[] the" unique characteristics of the proposed reductions, and either the justifications for them or the potential effect on the employees whose benefits are to be cut, or both, as appropriate.[137]

The final, third category of benefits (sometimes referred to below as Type 3 benefits), then, is comprised of those that are not covered by contract and that have not been extended to future work by explicit statutory provision. Nothing less than such an explicit commitment can restrain a legislature from altering any benefits it has conferred for work not yet performed. For if a legislature has not bound itself, then by the very nature of legislative power it maintains the right to alter its offer to current or future government employees just as it has the right to change the terms under which it will offer other future government contracts or to legislate generally. "The contract clauses do not foreclose government action which reflects changing concepts of public policy, concomitantly granting government the power to make illegal that which was previously legal."[96]

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[135] *See* Brown Administration Brief, *supra* note 70, at 36–45.
[136] *Alameda*, 19 Cal. App. 5th 61, 94.
[137] *Id.* [96] *Marin*, 2 Cal. App. 5th 674, 703.

This right to reduce Type 3 benefits is essentially complete. It includes even the power to abolish, from the date of the legislation, all pension benefits for all Type 3 work and therefore includes all lesser changes or reductions, including a switch from defined-benefit pensions to defined-contribution pensions[138] for all Type 3 work or any changes within a defined-benefit system.

This legislative autonomy does no injustice to government employees. Those employees, like private employees, train for the work they wish to do (as by schooling or apprenticeship) without knowing whether they will be able to get jobs in their fields, much less how much they might be paid or what their benefits will be. They, like their private-sector counterparts, take the jobs offered to them because they are willing to exchange their work for the pay and benefit package offered to them. If that package is changed—if the pay or benefits offered for the coming year are reduced—then they are free to go out into the market to seek better wages and benefits, as and if they can.

If they *can't*—if no one will offer them the higher benefit package that the government employer is no longer offering—this is a fairly good indication that the government-benefit package had been too generous initially and ought to be reduced. The wage and benefits package that government employers should be offering is one that leaves government workers relatively indifferent between holding a government or a private-industry job. If government jobs are special, highly compensated plums in an industry, then the government compensation for those jobs is too high—higher than the market will properly bear.

Two problems arise if the government is compensating employees more than the market will bear. The first is that this is an obvious inequity to privately employed taxpayers. They are paying more tax than they should, or receiving fewer government benefits than they should, so that some lucky neighbors can make more than they would be able to make in non-taxpayerfunded positions. The second is that these overcompensated government jobs then become comfortable prizes that government officials, whether elected or appointed, can hand out to friends, relatives, contributors, or otherwise-connected "insiders." This is the very heart and touchstone of government corruption.

Finally, the California courts' long-standing misinterpretation of government workers' contract rights should not be used to itself justify the continuation of that interpretation. That is to say, workers should not be found to have developed cognizable reliance interests in the maintenance of current levels of pension benefits for Type 3 work simply because courts have in the past required that such levels be maintained. A rule of interpretation that stopped courts from correcting past doctrinal error *for future application* because interested parties expected that the error would never be corrected would effectively stop courts from correcting any doctrinal mistakes. The best way to respect worker reliance on the courts'

[138] "'Defined-contribution' (DC) pensions are retirement benefit plans in which [regular] payments are made by management into personal accounts owned by employees. Once those payments are made, the employer has no further financial obligations. The eventual pension payouts will be a function of the market performance of whatever investments are chosen by individual employees. This stands in contrast to 'defined-benefit' (DB) programs. . . . Under DB programs, employees are promised various levels of retirement payments calculated through arcane formulas that leave management mostly uninformed as to the level of funding obligation to which they have agreed. In many cases, those liabilities turn out to be much larger than expected." Scott Shepard, *Following in TriMet's Tracks: Defined-Contribution Pensions a Necessary First Step to Oregon's Fiscal Health* (Cascade Pol'y Inst., Working Paper, Feb. 2018).

previous interpretations is to respect Type 1 benefits (i.e., benefits that have already been earned) and not—under ordinary circumstances—to retroactively adjust those benefits downward on the basis of a current change in doctrine.

The California Rule, then, as currently understood, perpetrates an inequity on all taxpayers who are not themselves government workers by conflating Type 3 benefits with Types 1 and 2. Barring Type 3 benefits from reduction in the current conditions, when pension-funding payments are having such a significant effect on local governments' ability to provide basic services, endangers the residents of those localities.

The current ban against Type 3 benefit reductions is also inequitable to younger workers. Under the current interpretation, older workers hired in more flush—or foolish—times have locked-in benefits. To pay for these benefits, cuts are being made everywhere—including to the pay and benefits of newer employees. The result is that these newer employees, the ranks of whom are likely—particularly in California—to contain more women and minority-group members, make less in benefits than their older colleagues make and will never be able to catch up. This pay and benefit structure seems to violate particularly topical modern mores and basic considerations of fairness.[139]

For all of these reasons, the California Supreme Court should plainly declare that no statutory or contractual changes to Type 3 benefits create any constitutional problems or merit any judicial review of their content. In the language of the appellate court rulings, this declaration could take the form that *no* reductions, however significant, to Type 3 benefits constitute material changes to (accrued) employee pension benefits, properly understood. Alternatively, or additionally, the court might declare that no such changes can deprive any employee of a reasonable pension and therefore need not be balanced by any offsetting pensionbenefit increases. Or it might abandon the language of the appellate courts and the accreted language of the California Rule and speak anew. (It is, after all, the court of final determination on questions of California law; it can speak anew, and it should do so, if clarity requires.) The key from a policy perspective is that it frees California's lawmakers to adjust Type 3 benefits as they see fit.[99]

The Aftermath

Significant positive results can be expected to follow a decision on the model suggested above. All of the state's subsidiary pension systems will initially be permitted and obliged to enact the provisions of PEPRA, which will bring some instant initial savings. Then, though, the legislature will be obliged to act again to give the pension systems throughout the state additional room to reduce their benefits.[100]

The legislature would be wise to craft this legislation carefully to take full advantage of the license offered by the California Supreme Court's ruling, while avoiding instant, colorable

[139] Another way that the current reading of the California Rule hurts younger workers—and previously hurt workers who now have retired or are nearing retirement—is by tying government workers to their jobs (or, at least, to continuous government work in the state in which they start) and by deferring so much of their income into retirement. Chad Aldeman and Kelly Robson discovered in a recent study that "states' own assumptions show that on average, more than half of teachers do not receive any employer pension benefits because they leave before they are eligible. Just one in five stays on the job long enough to receive full benefits at retirement." Chad Aldeman & Kelly Robson, *Why Most Teachers Get a Bad Deal on Pensions*, EDUCATION NEXT (May 16, 2017).

[99] There is an additional complication that could be thought to create a fourth type of pension reduction: a reduction that has some effect on already accrued benefits and some effect on benefits yet to be accrued. The *Marin* court asserts that the withdrawal of pension-spiking opportunities, because it applies only after a certain date and does not reach back to take away already-granted pensions based on spiked calculations, is purely prospective. *See Marin*, 2 Cal. App. 5th 674, 704–5. By one definition, this is literally and self-evidently true. By another, the question is less clear. Assume, for instance, that pension spiking had been explicitly blessed by California state law, rather than merely tolerated, prior to 2013. If this were true, then its curtailment in and after 2013 would at least arguably retract a benefit that had already been earned—the right to pension spike with regard to that portion of the pension already accrued in and before 2012.

Another example helps to clarify the problem. Imagine that in 2019 the California legislature reduced the multiplier for pension calculations back down to 2, from the 3 to which it was raised in 2001. *See infra* notes 103, 104. If the legislature limited the effect of this change to benefits accrued after the legislation passed, this would constitute only a Type 3 change. To the extent the reduction applied to benefits that had already been accrued, i.e., to work performed before the passage of the legislation, it would be a Type 1 change. This example presents few problems, however, and need not implicate a fourth category of analysis, because it is so easily divisible. The wholly prospective effects should be ratified by the courts without further analysis. The retrospective effects should be analyzed as a Type 1 change. Should the prospective move pass muster while the retrospective portion fails of it, the prospective portion should be maintained even while the retrospective is struck down, unless such a division has been forbidden expressly by the legislature, in respect for the forward-looking rulemaking authority that is central to the legislative power. *See, e.g.*, *Marin*, 2 Cal. App. 5th 674, 703. The practical application of this conclusion will be to apply a "blended" multiplier between 2 and 3 based on the number of years in which the employee accrued benefits under each legislative rule.

As the second example illustrates, there will be fewer real potential "Type 4" situations than might initially be expected. Where they arise, though, as arguably in the *Marin* pension-spiking analysis, then the best course is to analyze the whole reduction using the more careful Type 2 scrutiny, in respect for the fact that a plausible claim that some—but no plausible claim that all—of the reduction implicates benefits that have already been earned.

[100] *See, e.g.*, *Court Renders Ventura County Pension Reform Measure Dead on Arrival*, CALIFORNIA COUNTY NEWS (Aug. 11, 2014) (pension reform ballot measure in Ventura County canceled, despite getting requisite number of voter signatures to make the ballot, because withdrawal from CalPERS structure requires legislative approval).

objections by the unions to its efforts and yet building a record for further action should it be needed. Toward this end, the legislation should have four primary goals.

- First, it should forbid, statewide, some of the worst excesses that have marked the state pension system in recent decades.
- Second, it should empower subsidiary pension organizations, or voters by referendum at the state or municipal level, to make deeper cuts.
- Third, it should restrict the changes in these first two categories entirely to Type 3 reductions—the type that the California Supreme Court should render effectively unreviewable by the courts. This is necessary for two reasons: to make sure that the reductions will not be subject to long delay and possible defeat in the courts, and to provide a practical illustration as to whether these Type-3-only cuts are sufficient to save the system in an equitable manner.
- Fourth and finally, the legislation should require CalPERS to undertake a comprehensive study to determine the full extent of the state's unfunded pension liability assuming the baseline established by the legislation itself and under a variety of discount-rate scenarios. The legislation should mandate extremely detailed and comparative analysis and should include details such as how much funding would be spent to fully satisfy

double-dip pensioners;[140] pensioners who already collect, or stand to collect, annual benefits in excess of certain threshold amounts;[141] and pensioners who already collect, or stand to collect, annual benefits higher than various multiples of some inflation-adjusted percentage of their final years' salary.

This fourth step is not academic; it is critical. It is unclear whether the pension-funding crisis can be solved only by Type 3 benefit reductions. It is also unclear whether the pensionsetting process that has dominated in recent decades bears the exterior hallmarks of good-faith, arm's-length bargaining in the interests of the general taxpayer rather than insider negotiations between parties dominated by those whose personal interests were to benefit from overgenerous pension promises. Either of these eventualities would be demonstrated by the sort of study recommended here, and either, if competently demonstrated, should allow for measured and equitable reductions of Type 1 and Type 2 benefits.

Another possible area of benefit reduction—one that might nominally, but functionally does not, qualify as either Type 1 or 2 benefits—would be of benefits that were themselves granted retroactively and so could not have arisen as a result of a contractual arrangement or created expectational or reliance interests in workers at any time, because they were never in any real sense "earned" but only granted—genuinely as a gratuity—after the work had been performed. An instance of such retroactive gratuities arises in the post-2000 decision to raise retroactively the pension-benefit multiplier[142] from 2 to 3.[143] As benefit increases such as these were no more than a boon of the legislature, they should be provided none of the protections that must otherwise be accorded to Type 1 or 2 benefits. On the other hand, though, equity should not permit the courts to sweep away even retroactively granted gratuities upon which citizens, over a number of years, have come to reasonably rely and which they have no means of replacing. The legislature should limit itself accordingly in reducing or eliminating these gratuitous benefits, but it should be vigorous in withdrawing gratuitous pension benefits that do not fall within this narrow equitable exception.

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[140] Cuts that look to trim pensions that exceed the Internal Revenue Service's standard public-pension limit—a limit that already exceeds $200,000 per year—should fall within this ambit. *See, e.g.*, Ed Mendel, *"Excess" Pension Payments Grow then Phase Out*, CALPENSIONS (Jan. 8, 2018).

[141] *See id.* Transparent California hosts information about individual government-employee pension benefits, *available at* https://transparentcalifornia.com.

[142] Here is how the benefit multiplier works. An employee takes the number of years she has worked and multiplies that number by the multiplier. The resulting number is turned into a percentage. Then that percentage is multiplied by the employee's final-year salary, or an average of the salaries of the worker's last three years, or whatever the formula dictates. This final number is the retiree's initial annual pension benefit. An example: Assume a worker has worked for 30 years and that the multiplier is 3. These numbers, multiplied, make 90. When 90 is converted into a percentage, it makes 90 percent, or 0.90. Now assume that the employee made an average $100,000 salary over the employee's final three years. $100,000 × 0.90 = $90,000, which would be that employee's initial pension benefit.

[143] *See, e.g.*, Daniel Borenstein, *Appellate Court Issues Major Pension Reform Ruling*, SAN JOSE MERCURY NEWS (Apr. 20, 2017). As the calculation in the previous footnote suggests, this retroactive grant massively increased pension benefits—increased them by 50 percent, in fact, in the standard case—just at a time when the high-powered economy of the late 1990s was slowing considerably. It, and the contrived barrier to its swift repeal in the face of changed economic conditions that is the current California Rule, is significantly responsible for the funding crisis that exists today.

Conclusion

The common understanding of the California Rule has always been an anomaly. Guaranteeing government employees that once they are hired, their pension benefits for the rest of their time with the state can only rise, regardless of political or fiscal conditions within the state, always set those employees apart from private-sector employees and from other government beneficiaries in ways not coherently justified in precedent. Now three California circuit courts and the current administration have all argued that the California Supreme Court has, in fact, never really asserted this incoherent rule—that it has all been a terrible misunderstanding. The California Supreme Court should embrace this opportunity and should disclaim the California Rule. It should then explicitly import into California precedent the commonsense distinction between benefits that have already been earned or contracted for, and thus are staunchly (though not inviolably) protected by the courts, and benefits that have not yet been earned or contracted for, and thus can merit no protection. The circuit courts have provided the supreme court the tools to do so. Should the court act now, California may begin to take material strides to defuse its pension-funding crisis and make its future pension payments equitable to taxpayers as well as to employees and retirees. It may not be the case that full flexibility with Type 3 benefits will be enough fully to defuse California's pension-funding crisis, but it would represent a useful start.

Homeschool CPA

Feb 2016

Tax Breaks for Education in Some States

By Carol Topp

I'm frequently asked about tax deductions for homeschooling expenses. The US federal government does not have any tax deductions or tax credits for K-12 education expenses, but some states do offer tax credits or deductions.

This document has a description of state tax breaks for educational expenses. The document is dated 2011.

There is a 2014 update to the document it states:

> "To date, 14 states in addition to Minnesota provide income tax benefits for education-related expenses.
>
> Alabama, Arizona, Florida, Georgia, Indiana,Iowa, Kansas, Louisiana, New Hampshire, Oklahoma, Pennsylvania, Rhode Island, South Carolina, and Virginia all provide tax credits for contributions to nonprofit school tuition organizations that operate like charities; Puerto Rico also allows a similar credit.
>
> Kansas, New Hampshire, Pennsylvania, and Rhode Island allow their credits only for corporate taxpayers; the Florida credit is allowed against corporate, insurance premiums, severance, alcoholic beverage taxes, and sales taxes for certain taxpayers; and Alabama, Arizona, Georgia, Indiana,Iowa, Louisiana, Oklahoma, South Carolina, and Virginia allow credits for both individual and corporate taxpayers.
> Arizona also allows credits for individuals who pay extracurricular public school fees and who contribute to character education programs at public schools, and Pennsylvania also allows a corporate credit for contributions to innovative public school programs.
>
> Louisiana allows individuals to claim a tax deduction for qualified education expenses.
>
> Illinois, Iowa and Wisconsin provide individuals with nonrefundable tax credits for qualified education expenses, and Alabama allows a refundable credit for tuition expenses of students leaving state-designated low-performance schools. Iowa's credit applies to tuition for children attending accredited not-for-profit K-12 schools, and Louisiana's deduction applies to public, private, and homeschool expenses.

Courts in Arizona, Illinois, Indiana, Iowa and New Hampshire have upheld the permissibility of these education credits."

A2Z Homes Cool

Aug 2017

How Many Children are Home Schooled in the United States?

Home school statistics. This is the most current estimate on homeschooling families in the U.S. The list of homeschooled kids by state is a work in progress, updated frequently with additional home education statistics as they are discovered. *Homeschool statistics can be fraught with errors*. A discussion of the miscounting of homeschoolers is appended below. This is an early estimate, and will be updated frequently as new numbers of homeschoolers are reported and the Census updates its numbers of school-aged children.

This is pulled from the census data from the Census to get state populations, and PEPSYASEX-Annual Estimates of the Resident Population by Single Year of Age and Sex for the United States, States, and Puerto Rico Commonwealth: April 1, 2010 to July 1, 2015 for the number of children in each state ages 5-17 to calculate the number of school-aged children in each state. This database is included in the Excel file. Note that the current spreadsheet only uses the 2015 data, as there was no more recent estimate available from the Census Bureau.

(a) How Many Children are Homeschooled?

I then used what data I had on registered homeschoolers from those states that require registration to figure out what percentage of the school-aged population in those states were homeschooled and that the average percentage of those states was 2.70% in 2016-17. See my Demographics page for what exact data I do have.

My numbers are based on the 11 states that currently or in the past have posted the numbers of homeschoolers on their official sites, so I am using their average growth rate, and assuming it applies in other states. This probably isn't accurate to assume, but is all I have to use. If you would like to "play around" with these numbers, add new data, etc., here is my updated Excel Spreadsheet, DemographicStateComparison-2017.xls.

(b) Miscounting of Homeschoolers

These numbers are just a statistical estimate. Many things seem to *influence how many home schooled children are educated at home in each US state, and a variety of influences will make the numbers a little high or a little low:*

- Perception of whether or not schools in state are good or bad;
- Ease of complying with homeschool laws in a state;
- In a number of states homeschoolers do not register, either because they need not or will not. California and Texas are two of them;

- I include all students ages 5-17. Many families homeschool children younger or older than the compulsory age range in their states. These students would not be counted on official homeschool demographics reports;
- Some states and cities have better support organizations and more outreach than others;
- States with a higher ratio of children to adults will have more homeschoolers;
- I cannot say that this data will age well. Homeschooling grew during good economic times. Whether or not this trend will continue to hold true during the economic ups and downs remains to be seen;
- A 2.71% growth probably does not hold true for each grade level in every state;
- The 2.71% growth rate is only used to calculate states with unverifiable numbers. Eleven states use real data, or numbers based on growth from past data. See the spreadsheet;
- We cannot all agree on what constitutes a "real" homeschooler! What sort of homeschoolers are tracked by each state may vary considerably.

(c)

(d) Fewer School-aged Children

Does this mean families are less interested in homeschooling than before? No, only that there are fewer school age children than in previous years.
Notice how the number of children in elementary school starts to dip in 2005, and how the total number has rather leveled off in recent times? That homeschooling is growing when there are even fewer children, is in itself amazing! Our growth rate in 2013 (from 2012) averaged around 7.6%, while public school enrollment was nearly stable.
Home schooled numbers change in the rate of growth, however, has been declining, right along with the birth rates. But it took a sudden turn upward when the economy tanked. Many families can no longer afford private schools, and so have turned to homeschooling. Others may have decided to home school when one parent lost their job and could stay home and teach. Why homeschooling has taken a sharp increase in 2013, I don't know.

Three percent of American students — about 1.5 million children — are homeschooled, according to the 2012 Statistical Abstract recently released by the U.S. Census Bureau. The Census, which relies on data from 2007, also offers a sense of what kind of families choose homeschooling: Compared to the American school parents as a whole, homeschool parents are more likely to be white and have a four-year college degree, and have a household of two parents and at least three children. (Note: my estimate is based on the number of children, ages 5-17, in each state in the summer of 2012.)

Yankee Institute for Public Policy

Feb. 2018

Connecticut Teacher Pension Discount Rate Remains High Compared to the Rest of the Country

By Marc Fitch

Connecticut's discount rate for its teacher pension system remains higher than most other states, according to a report by the National Association of State Retirement Administrators.

States across the nation, including Connecticut, have lowered their assumed rate of return for pension funds as investments have consistently failed to live up to expectations.

Connecticut lowered the discount rate of the teacher's retirement system from 8.5 percent to 8 percent in 2016, but it still remains higher than most other states. According to NASRA the median discount rate has dropped to 7.5 percent.

"Among the 129 plans measured, nearly three-fourths have reduced their investment return assumption since fiscal year 2010, resulting in a decline in the average return assumption from 7.91 percent to 7.36 percent," the report said. "If projected returns continue to decline, investment return assumptions are likely to also to continue their downward trend."

Discount rates assume a pension fund will earn a particular rate of return and use that assumption to discount how much the state has to pay into the pension fund.
A higher rate of return means the state can make lower annual payments — but it comes with some significant risks and hides the true extent of a pension fund's liabilities.

Over the past 10 years, the teacher pension fund has only returned 4.8 percent, according to a 2017 study on the teacher retirement system by Eric Halpern. This discrepancy does not bode well for the retirement fund.

Yankee Institute for Public Policy

The Connecticut Teachers' Retirement System: How can it be stabilized?

By Eric Halpern

Introduction

Few Connecticut residents are aware that public school teacher pensions are administered by the state rather than local districts. This centralization, under the Connecticut State Teachers' Retirement System, means that taxpayers from across the state are accountable for any underfunding and shortfalls. As of 2016, the system was only 56% funded, with an outstanding gap of over $13 billion – an amount which has grown considerably in recent years and is likely to continue its upward trajectory if interest rates stay low. These ballooning costs threaten to crowd out other state spending priorities – including spending on present educational needs – as current taxpayers shoulder financial burdens for promises made long ago.

Governor Malloy has recently observed that the highest benefits have accrued to teachers who have worked in some of the state's most wealthy communities, and has proposed that those localities pay more to help close the gap.1 However, that approach fails to consider the fact that the cost of living in these areas is higher, and that most state income tax revenues already come from residents in those places. More importantly, this approach fails to address the systemic issues that created the crisis in the first place. Long-term stability of the plan – which should matter both to plan members (teachers) and plan funders (taxpayers) – requires addressing the system's structural problems.

Why Are State Contributions Going Up?

The CTRS is a defined benefit plan.2 This means that participating teachers are entitled to a retirement benefit amount that has been defined in advance. The standard benefit is calculated by taking years of service, multiplying by 2%, and then multiplying that factor by the teacher's average salary over the prior three years, with a 75% of salary cap. A cost- of-living adjustment (COLA) is applied annually once a teacher begins receiving benefits. Benefits are actuarially adjusted for various factors, such as early retirement.

Teachers contribute 6% of salary toward the plan; the state is responsible for funding the rest, and manages the assets that are set aside to pay benefits when they come due.

Even by the standards of public employee plans, the CTRS is quite generous. Financial planners generally recommend a retirement income goal of approximately 70% of salary, achieved through a combination of Social Security benefits, employer pension, and personal savings. A teacher who spends his or her career in the system (say, from age 23 to age 60 1/2) will receive 75% of salary – without even considering any private savings. Moreover, the financial planners' rule of thumb is intended to account for the risks of inflation and health care costs, whereas in the case of Connecticut's teachers, they receive protection against these risks through COLA and retiree health benefits, respectively.

Participants in the CTRS do not receive Social Security, so it is reasonable that the CTRS should be more generous to compensate. Even so, Social Security participants pay 6.2% of salary into that system, and individuals may pay more into their employer pension programs. That Connecticut's teachers pay only 6% makes the system all the more generous, and compares favorably with what teachers pay in other similar state systems – 8% on average.

The amount that the state needs to contribute each year depends on a number of factors. An outside actuarial firm produces a report every other year in which future benefits are projected and then discounted with interest to find their present value. In other words, any contributions made today should grow with interest, so that there will be enough available to pay benefits when they come due. The actuarial analysis includes calculation of a level contribution percentage that the state must make each year in order to fund the benefits. As of June 30, the present value of liabilities was calculated at $29,840 million, while the market value of assets was $15,585 million.

The biennial analysis incorporates important assumptions about the future. These include demographic and mortality assumptions, which affect the future benefits to be paid; salary and payroll growth, which affect both future income to the plan and future benefits the teachers earn; and the investment income on assets. If past investment returns or teacher contributions were below the assumption, or plan benefits exceeded projections, the required state contribution could increase significantly.

In theory, if the assumptions are approximately correct over the long term, the program's financing will be stable. Reality, however, is rarely stable, and this has deleterious consequences for defined benefit plans. With regard to the CTRS, there are three areas in particular where a failure to match assumptions have put the system's funding under pressure. As a result, the state's annual contributions have ballooned, even as the program's solvency has worsened – and as we shall see, the standard solvency measure may understate the extent of the problem.

Problem 1:
Paying Today For Past Mistakes

The CTRS was established in 1917, and this is not the first time the system's solvency has come under scrutiny. Indeed, even in the recent past, state officials have tried to put the system on a stable trajectory with more or less level annual state contributions.

In 1979, legislators passed a number of reforms. Before then, the state did not set aside money to pay a teacher's benefits until that teacher retired. This approach resulted in large and variable state contributions, because the state passed up the benefits of earning investment income on obligations accrued while the teacher was working. The new law funded liabilities while teachers were still working. There were also adjustments in 1992 to the COLA formula – though limited to newly hired teachers only – which had previously been over-generous.

Unfortunately, the 1979 law did not result in the desired stability for two main reasons. First, the law phased in funding of active member liabilities over a 30- to 40-year schedule. This schedule was not fast enough to keep up with the pace at which liabilities have grown – the state would still be paying down such a schedule today even under ideal conditions. And conditions have not been ideal: Connecticut fell short of its funding obligations in nearly all the subsequent years, paying its required contribution consistently only since 2006. In that time, while the liability grew, the state continued to pass up the ability to earn investment income on a corresponding amount of assets. Each year the gap persists, it compounds, increasing the costs of future remediation.

In 2008, Connecticut floated a $2 billion bond offering to help shore up the system. Since the CTRS has no borrowing authority, the state borrowed from the financial markets with the goal of reducing the outstanding CTRS unfunded liability. Although lawmakers hoped to earn more from the CTRS investment portfolio than was paid in interest on the bonds, this has not been the case over the past few years (illustrating the phenomenon, noted below, that higher rates are earned only by assuming commensurately higher risk). In effect, the bond offering shifted $2 billion of the state's future obligations from retirees to borrowers, and without any financial benefit so far. The bond offering did, however grant CTRS members some security: a covenant in the offering commits the state to paying the annual actuarially determined employer contribution in full each year.

Problem 2:
Slowing Workforce Growth
The CTRS was designed assuming that the workforce would grow at a stable rate. Under this assumption, contributions (both employee and state) can be set at percentages of payroll, and the percentages will not fluctuate much over time. However, in recent years, as the state's population has declined,4 the number of active teachers has leveled off. Payroll growth has thus fallen short of assumptions.

If the system were fully funded and investment returns matched assumptions, this would not be a problem. In that case, lower teacher contributions would correspond to lower future liabilities for teacher pensions.

Unfortunately, though, slow payroll growth compounds the underfunding problem. Current obligations to retirees and beneficiaries are paid first, meaning current teacher contributions are being used to pay for past promises. When the number of retirees grows faster than the number of active teachers, the slowing teacher contributions put additional strain on an underfunded system. Also, when expressed as a percentage of current payroll, state contributions necessarily increase because the payroll figure is lower. And because the required state contributions are calculated as a level percentage of expected future payroll, they too fall short of the amounts required to stabilize the system.

Problem 3: Assumed Investment Returns

The most significant problem driving the growing gap between assets and liabilities, however, is the difference between assumed and realized investment returns.

The 2016 actuarial valuation discounts future obligations at an 8% interest rate, revised downward from the 8.5% assumption used for many years. This rate is intended to reflect the expected long term average earned rate on the asset portfolio. Investment income on the asset portfolio helps fund future benefits. But if actual earned rates are below those assumed, required state contributions must be higher to make up the difference.

In recent years, investment earnings have fallen well below the 8.5% assumption, and even below the revised 8%. Although 2016 earnings were 8% overall, the 10-year return on the assets is only 4.8% (see Table 2). Figure 3 shows the difference in compounded returns between the assumed rate and actual earnings; since 2000, the portfolio has yielded only half of the assumption.

As a result, the current reported funding status understates the extent of the problem. If liabilities were discounted at more realistic rates of interest, their present value would be even higher, and the assets available would cover much less than 56% of them. According to a 2015 research report5 by the Center for Retirement Research at Boston College, each percentage point reduction in the valuation rate translates to a 12% increase in the liability and a 22% increase in normal cost. Table 1 shows what this would mean for the plan's funding status.

Although the state's method for determining the proper discount rate is consistent with traditional actuarial practice, actuarial thinking on the matter has evolved in recent years. Rather than basing valuation rates on investment returns, modern financial theory indicates that valuation rates should correspond to the likelihood of payment. In other words, the state's promises to retirees should be treated similarly to the state's promises to bondholders. Two plans – one investing conservatively, the other aggressively – should not have the same promises valued differently. Rather, it is the creditworthiness of the plan sponsor that should matter.

Changes enacted under then-President George W. Bush, reflecting this approach, require corporate pension plans to use interest rates corresponding to high-quality corporate bonds; 2012 legislation allowed those plans to use average bond rates over a longer time horizon. Even so, public pension plans were not affected. Consequently, Connecticut still values its CTRS liabilities using an assumed rate on investments.

To boost investment returns, Connecticut invests in diverse asset classes with greater expected returns, including private equity, emerging market stocks, hedge funds, and so on. But the higher returns are not free. They are compensation for taking additional risk – and risk swings both ways. As Figure 3 shows, the CTRS investment fund has not only underperformed the valuation assumption, its performance has been considerably more volatile.

Regardless of how Connecticut invests plan assets, a discount rate that reflected Connecticut's creditworthiness (approximately US Treasury rates + 0.6%, shown in Figure 3) would be considerably lower than the current valuation rate. It would indicate a much greater value of promises made, and point to a worse funding situation than is being reported. A discount rate assumption of 3%, for example, would indicate that today's assets are adequate to meet only 35% of the state's true obligation to teachers.

What Can Be Done?
These problems took many years to develop. Consequently, it is not possible to address them either easily or quickly. Regardless of what steps are taken to stabilize the system, doing so will be costly – and it may take years before the system reaches equilibrium.
Possible solutions fall into a number of categories. Not all of them are mutually exclusive, and a number of them can be implemented concurrently.

1. DO NOTHING
If no action is taken, the current demographic strains on the program are likely to continue. As a result, required state contributions will continue to increase. Moreover, although it is possible that a stock market boom and/or higher interest rates could boost investment returns, relying on such a large increase is not realistic. What's more likely is that returns will continue to lag overly aggressive assumptions, putting ever-larger strains on state budgets. Pension costs will crowd out other spending, or lead to tax increases. Notably, the financial drain created by the CTRS will reduce the available resources for meeting the educational needs of current students.

2. TRANSPARENCY/REPORTING CHANGES
Changing the valuation interest rate to match the interest rate on Connecticut bonds,would be theoretically justifiable. If this were implemented, however, the sharply lower rates would increase liability valuations significantly (see Table 1). By law, the state would then need to make commensurately higher contributions – perhaps double what it pays today. So although such an approach might be justifiable in theory, it may be impractical at present.

Regardless of the minimum disclosures required by law, though, plan actuaries can be directed to offer additional data alongside the information they currently provide. The plan's funding status should be reported under alternative sets of assumptions, including more realistic scenarios and worst- case ones. In particular, the plan value should be calculated using a discount rate assumption equal to the yield on Connecticut general obligation bonds. It should also be presented using more conservative assumptions on payroll growth and mortality.

Separately, investment managers should be directed to provide greater disclosure of investment risks. Regardless of whether risk-return tradeoff is reasonable, it should be disclosed. Both plan trustees and plan participants should be informed of potential volatility that could affect funding levels.

These changes should be fairly inexpensive to implement. However, such changes are merely a preliminary step. They do little beyond raising awareness of the potential magnitude of the state's true obligation and risks.

3. INVESTMENT CHANGES

It is common for plans to try to close the gap by investing more aggressively to increase investment income. However, as noted above, the increases in income under such a strategy are not free; they are actually compensation for additional investment risk. Such risk may actually reduce funding levels by introducing volatility and a mismatch between assets and liabilities. Even when long-term assumptions are realized, the path that investments take may cause contributions to be higher and more volatile. (For example, consider a year in which emerging market stocks and interest rates both fall.)

For this reason, more aggressive investing is not recommended. If anything, investments should be better tailored to the interest rate sensitivity and benefit payment patterns of the plan, even if it lowers the long-term expected returns.

4. FUNDING CHANGES

A straightforward change that would reduce the strain on state finances would be to increase teacher contribution levels. Perhaps the current contribution rate was reasonable when it was first established, in light of the investment environment and demographic trends. But given what we know now, 6% is not sufficient to keep the system in equilibrium. Bringing the system in line with other states would require a contribution level of 8% of payroll. The state could consider even greater increases, in light of the 50% state income tax exclusion for teacher pension income. All told, however, the benefits of such a strategy would be modest, since the state's annual contribution exceeds 30% of payroll.

Governor Malloy and Connecticut's Democrats have focused on stabilizing the system by increasing revenue from new sources. Specifically, the governor's proposal seeks a contribution from towns of 10% of payroll, which would reduce the state contribution by about one third in the short run.

Making towns partners in pension funding does have some structural advantages, by helping to align incentives on teacher pay. Towns that pay greater salaries would no longer entirely escape the consequences of the resulting higher pensions. However, this proposal – though couched in the language of "fairness" – introduces new inequities into the system. Towns across the state are just recovering from the 2008 financial crisis, and would need to tax their property owners to make up the new strain on their budgets. Since less wealthy towns already receive state aid, they would not need to pay; rather, the burden would fall on towns whose residents are already funding the bulk of state spending through their income taxes. At best, the proposal would act similarly to an increase in state income taxes, only less efficiently collected; at worst, it will chase overtaxed property owners out of state, exacerbating Connecticut's retiree exodus.

The 2015 CRR report recommended a number of funding changes, such as switching to a level dollar cost rather than level percentage of payroll, rolling amortization of the funding of pre-1979 liabilities, and segregating pre-1979 liabilities – the bulk of the underfunding – into a separate trust to protect current teachers. These changes are sensible and should be considered. But these changes merely affect the timing of payments. They make future payments more predictable, and improve the current funding status by moving backloaded payments closer to the present time. The CRR's recommendations do nothing to make it easier to meet the state's generous past and present commitments.

5. BENEFIT CHANGES

Ultimately, the benefit structure of the CTRS may exceed the resources available to the state and its capacity to pay. It may be necessary, therefore, to consider changes to what the state promises its teachers.

One approach would be to tweak the existing structure. Instead of paying 2% of salary for each year of service, a lower amount could be considered. The state might also consider eliminating cost-of-living adjustments, which are expensive to guarantee.

Alternatively, the state might think bigger. Over the past 100 years, we have learned much about retirement security, and the solutions devised in 1917 may be inferior to more modern ones.7 Most corporate retirement plans are defined contribution plans, like a 401(k) or 403(b) plan. This means that the plan sponsor's contributions are fixed.

Although DC plans shift investment risk to each employee, it would give teachers portable accounts that would, by definition, be fully funded as the match is paid with each paycheck. A teacher would not be left to wonder whether Connecticut, which has never fully funded the CTRS in the system's 100 years, is actually capable of making good on its commitments.

Teachers who leave the workforce early, for whatever reason, are also often better served by a DC plan,8 because much of a DB plan's benefit accrual is backloaded into the later years. (Although CT's teachers can withdraw their own contributions with interest when they leave, CTRS benefits vest only after 10 years, and the vesting schedule is much less generous in the early years, ramping up sharply toward retirement age.) And a DC plan would facilitate better integration and alignment with towns, which could be induced to offer their own plans and/or matching systems in place of state contributions.

The state might also consider hybrid DB/DC plans. These are less common in the private sector, but have shown some success in the public sector and in teachers' plans in other states. Hybrid plans share many of the characteristics of DC plans, including more rapid accrual of benefits in the early years, greater portability, and a more predictable contribution schedule for the plan sponsor. Investment decision making, however, remains in the hands of the plan sponsor. This type of plan can be popular among members who are less comfortable managing investment risk on their own.

Shifting to a DC plan or a hybrid DB/DC plan would be a large and complex effort. The CTRS would either need to be frozen – entitling current participants to what they have earned, but not allowing them to accrue future benefits in it – or, alternatively, it would need to be closed – allowing current hires to stay in the old plan but placing all new hires in a new plan. But the short-term pain should be balanced against the benefits of a predictable, sustainable system for teachers and taxpayers alike.

Looking Forward

The challenges facing the CTRS are significant. Absent reform, the system will place increasing financial strain on the state and its taxpayers, and reduce the funds available for addressing today's educational needs. Placing additional financial burdens on towns, without addressing the structural challenges, is unlikely to serve as much more than a band-aid. Indeed, such a move is likely to make the state less attractive either to individuals or businesses, ultimately creating greater stresses on the system and the state. Connecticut already implicitly recognizes this truism, by exempting 50% of teacher pension income from state taxes in order to induce retired teachers to retire in-state.

Ultimately, teachers and taxpayers share interest in making the teacher pension system more sustainable and financially secure. Reform will be neither easy or quick, especially in light of past policy. But viable options exist that will allow Connecticut's lawmakers to reform the teacher pension system in a fair and responsible manner.

Home

S.B. 102 Report

The Effects of the Exemption of School Construction Projects from Ohio's Prevailing Wage Law

Staff Research Report No. 149

Ohio Legislative Service Commission State House
Columbus, OH 43215

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This publication is a report of the research staff of the Legislative Service Commission required by Senate Bill 102 of the 122nd General Assembly. The report consists solely of information relating to the subject matter as prepared by the research staff. It does not purport to represent the findings and opinions of any member of the Legislative Service Commission. The Commission has taken no position in regard to the material contained in the report.

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Section One Introduction and Overview

Senate Bill 102 of the 122nd General Assembly created the Ohio School Facilities Commission, transferred responsibility for the Classroom Facilities Assistance program from the State Board of Education to the Commission, and exempted construction undertaken by school districts from Ohio's prevailing wage laws. Section 13 of Senate Bill 102 states that:

> During the five-year period that begins on the effective date of this section, the Legislative Budget Office of the Legislative Service Commission shall monitor and study the effects of the prevailing wage exemption created by the amendment in Section 1 of this act to section 4114.04 of the Re vised Code. In the study, the Legislative Budget Office shall evaluate the following:
>
> (A) The amount of money saved by school districts and educational service centers due to the exemption;
>
> (B) The impact of the exemption on the quality of public school building construction in this state;
>
> (C) The impact of the exemption on the wages of construction employees working on the construction of public school buildings in this state;
>
> (D) Other subjects as determined by the Legislative Budget Office.
>
> Not later than five years after the effective date of this section, the Legislative Budget Office shall submit a report on its study to the Speaker and Minority Leader of the House of Representatives and the President and Minority Leader of the Senate.

The Legislative Service Commission (LSC) found indications of $487.9 million in aggregate school construction savings during the post-exemption period, an overall savings of 10.7 percent. Estimated savings on new construction projects was $24.6 million (1.2 percent). Estimated savings on school building additions was $408.0 million (19.9 percent). Estimated savings on school building alterations was $55.2 million (10.7 percent). Estimated savings in urban counties totaled $310.5 million while savings in rural counties totaled $177.4 million.

While it may be reasonable to conclude that these savings are at least partially attributable to the prevailing wage exemption, the extent to which this is the case cannot confidently be stated.

LSC found indications that the exemption had little impact on the quality of public school building construction. Measuring quality is difficult due to the subjective nature of quality and the length of time it may take for quality differences to appear. Using one measure of quality, the satisfaction of users' needs, LSC surveyed school districts to determine the extent to which they were satisfied with the quality of public school building construction. The surveys indicate that the users of the buildings are generally satisfied with the buildings and provided no evidence that the exemption decreased the quality of school construction.

LSC found indications that the exemption had little impact on the wages of construction employees working on the construction of public school buildings. The search for an impact was complicated by a number of factors: (1) school construction accounts for a small percentage of construction activity, (2) most workers do not specialize in one category of project, such as school construction, but specialize in a craft or activity and move between types of projects that include that activity, and (3) demand for construction workers, particularly for school construction, has been high for most of the time since the exemption went into effect.

The remainder of the report is organized as follows. Section Two provides background information. Section Three covers the evaluation of the amount of money saved by school districts and educational service centers due to the exemption. Section Four covers the evaluation of the impact of the exemption on the quality of public school building construction. Section Five covers the evaluation of the impact of the exemption on the wages of construction employees working on the construction of public school buildings. Section Six summarizes the findings and discusses the limitations of the findings.

Section Two Background Information

The nation's first prevailing wage law was passed in Kansas in 1891. The federal prevailing wage law, the Davis-Bacon Act, was passed in 1931, the same year in which Ohio's prevailing wage law was enacted. These laws, and similar ones in other states, require that workers on government sponsored construction projects be paid "prevailing wages."

In Ohio, prevailing wages are based on collective bargaining agreements. Prevailing wages are union wages. If there is no collective bargaining agreement in the immediate locality in which construction is taking place, then the prevailing rates of wages in the nearest locality in which a collective bargaining agreement is in effect is used. In addition to wages being set by union collective bargaining agreements, contractors are subject to work rules (such as apprentice to skilled worker ratio) contained in the collective bargaining agreement used to determine the prevailing wage.

The stated intent of prevailing wage laws is to protect local wage rates in the construction industry. Many historians have argued that during the Great Depression, these wages needed protection from itinerant contractors using lower wage labor and from the monopsony (single buyer) power of governments. The continued need for these laws is subject to great debate.

(i) Arguments For Prevailing Wages

Prevailing wage laws protect both the wages and jobs of local workers by preventing "wage dumping" by outside contractors. This was the original stated purpose of Davis-Bacon. Congressman Robert J. Bacon of New York, during House debate, referred to "certain itinerant, irresponsible contractors, with itinerant, cheap, bootleg labor."[1] It was argued these contractors, and their workers, were successfully bidding on projects and denying local contractors and workers the opportunity to compete for projects. Thieblot, in his book on prevailing wage laws, writes that prevailing wage laws had the purpose of "protecting local wage scales from the consequences of competitive pressures on contractors to submit the low bid" and that this was a valid concern because

[1] U.S. Department of Labor, Division of Wage Determinations, Office of the Solicitor, The Legislative History of the Davis-Bacon Act, p.1 quoted in John P. Gould and George Bittlingmayer, The Economics of the Davis-Bacon Act: An Analysis of Prevailing Wage Laws, American Enterprise Institute for Public Policy Research, Washington D.C., 1980.

workers were willing to accept "almost any wage, thus driving down the already meager pay rates."[2]

Prevailing wage laws reduce total construction costs by encouraging the use of more qualified and productive (presumably union) workers. To the extent that worker skill is correlated with the wage the worker receives, lower wages will result in the use of less skilled workers. Less skilled workers may result in a lower quality product. Additionally, the cost of production may actually be greater because the less skilled workers may take longer to complete the job.

Union workers may be more expensive on a per-hour basis, but their greater productivity may result in a lower total cost. The higher wage mandated by a prevailing wage requirement induces contractors to hire only the best workers. Higher wages result in a superior work force. This superior work force is able to complete projects more quickly, resulting in a lower labor cost.

A 1979 study by Allen found that union workers were more productive than non-union workers and that their productivity advantage may be as great as 45 percent.[3] The same study estimated that union wages were 43 percent higher than non-union wages. The productivity differential offsets the wage differential, according to this study, so using union labor resulted in lower cost.

Prevailing wage laws assure quality construction and reduce delays and overruns. This argument is also based on the assumption that union workers are more skilled and productive. Because of their greater skill, union workers are not only able to complete projects in less time, but they also require less supervision, and perform work of higher quality. If lower wages are paid and less skilled workers are used, the result will be "low quality, flawed work, and unnecessary accidents."[4] Prevailing wage proponents also maintain that the higher quality workmanship also results in lower future maintenance and repair costs. Paying lower wages and using less skilled labor may result in "inferior construction requiring more repairs, revisions, and lengthy delays."[5] A study in Utah after the

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[2] *Armand Thieblot, Jr., Prevailing Wage Legislation, University of Pennsylvania Press, Philadelphia, 1986, p. 28.*

[3] *Stephen G. Allen, "Unionized Construction Workers Are More Productive," Quarterly Journal of Economics, May 1984, p. 11.*

[4] *"Prevailing Wage Laws," Position Paper, The Mechanical Electrical Sheet Metal Alliance, March 1995.*

[5] *Ibid.*

repeal of its prevailing wage law found that "prevailing wage laws save taxpayers money by providing quality and efficiency for the construction dollar."[6]

Prevailing wage laws help maintain local tax bases. As the workers are paid and spend their higher wages, the amount of local taxes paid is larger than it would have been in the absence of the payment of prevailing wages. The "Utah study" claims that the state of Utah suffered millions of dollars in lost tax revenues when it repealed its prevailing wage law.[7] That is, prevailing wage laws may help a locality's budget by increasing tax revenues and holding down costs.

Prevailing wage laws provide stability in the construction industry. Reducing wage-based competition may help maintain a degree of stability. Prevailing wage laws "take wage competition out of the contract bidding process" so that "competition is focused on management, quality, timeliness, and productivity." Because of prevailing wage laws the bidding process presumably accentuates "contractor efficiency, worker skill, and project quality." [8]

The 1995 "Utah study" presented the following scenario of events following the 1981 repeal of Utah's prevailing wage law. Larger and more experienced union contractors saw their competitive edge reduced. The number of union contractors and the number of union construction workers decreased. As union strength decreased, non-union contractors appeared and began to compete for government contracts. These new non-union firms were smaller, weaker, and less experienced than the union firms they replaced. Competition in the construction industry increased, resulting in an "overheated bidding process." Because of the intensity of the competition, wages were driven down to below market levels.[9]

Prevailing wage laws also have been viewed as a way to promote stability in the construction industry by supporting union training programs. The study by Phillips, *et. al.*, concluded "the repeal of prevailing wage laws had the effect of reducing training and retraining as well as directly hindering the formation of a skilled labor force."[10] Dr. Bernard Anderson, Assistant Secretary of Labor for Employment Standards Administration, stated in Senate testimony that "without

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[6] Peter Phillips, Garth Mangum, Norm Waitzman, and Anne Yeagle, "Losing Ground: Lessons from the Repeal of Nine 'Little Davis-Bacon' Acts," University of Utah, February 1995.

[7] Ibid.

[8] The Mechanical Electrical Sheet Metal Alliance, op. cit.

[9] Phillips, Mangum, Waitzman, and Yeagle, op. cit.

[10] Ibid.

the prevailing wage statutes, it may be significantly more difficult to maintain a sufficient pool of skilled construction workers."[11]

(ii) Arguments Against Prevailing Wages

Prevailing wage laws increase project costs. Fraundorf, Farrell, and Mason, in their study of the effect of the Davis-Bacon Act on construction costs in rural areas, concluded that "a project subject to the Act would cost on average 26.1% more than the same project not subject to the Act."[12] Analyses in Florida, Iowa, Kentucky, Louisiana, Maryland, Minnesota, and New Hampshire, done in conjunction with the repeal or attempted repeal of the prevailing wage laws of those states, estimated that repeal would result in average expected construction savings of 9.4 percent.[13] The General Accounting Office found that the Davis- Bacon Act increased construction costs by 3.4 percent.[14]

Prevailing wage laws impose unnecessary regulatory burdens and heavy paperwork requirements. Fraundorf, Farrell, and Mason note that a prevailing wage law may "raise costs through its effect on how workers are utilized."[15] Prevailing wage laws will be especially troublesome for "non-union construction companies which do not follow traditional union craft lines in assigning work."[16] These requirements may force contractors to either pay a high wage to an unskilled worker or pay a high wage to a skilled worker for menial work. Some contractors may not bid on a project subject to prevailing wage requirements because winning the contract would disrupt their normal practices and wage scales. Fraundorf, Farrell, and Mason note that "some contractors think that disruption and loss in morale result from raising wages for one project only. Consequently, they may not bid on public construction projects to which the

[11] *Dr. Bernard E. Anderson, Department of Labor, Employment Standards Administration, Testimony before the Labor and Human Resources Committee, U.S. Senate, February 15, 1995, referenced in The Mechanical Electrical Sheet Metal Alliance, op. cit.*

[12] *Martha Norby Fraundorf, John P. Farrell, and Robert Mason, "The Effects of the Davis-Bacon Act on Construction Costs in Rural Areas," The Review of Economics and Statistics, 66 (Feb. 1983), pp. 142-146.*

[13] *104th Congress, 1st Session, Senate Committee on Labor and Human Resources, Report 104- 80, "Repeal of the Davis-Bacon Act," footnote 30, p. 7.*

[14] *Ibid., p. 7.*

[15] *Fraundorf, Farrell, and Mason, op. cit., p. 6.*

[16] *Ibid., p. 6.*

prevailing wage laws apply."[17] The decreased competition in bidding may result in higher construction costs.

Prevailing wage laws also may create additional administrative work for contractors. Contractors must create and file statements of compliance and payroll reports. General contractors must make sure that their subcontractors comply with prevailing wage requirements. According to testimony of contractors and their responses to surveys, the cost of this additional administrative work is significant. Some have maintained that the costs are significant enough to keep them from bidding on projects subject to prevailing wage requirements.

Prevailing wage laws reduce competition. Goldfarb and Metzger note that many arguments in support of prevailing wage laws "begin with the implicit or explicit premise that union construction workers need job protection."[18] By requiring that contractors pay higher (usually union) wages and follow union work rules, union contractors are given an advantage in project bidding. As mentioned above, non-union contractors may choose to not bid on a project that is subject to prevailing wage requirements, reducing competition for union contractors.

Prevailing wage laws discriminate against minority and small contractors. By requiring the payment of higher wages than they normally pay, minority and small contractors may be discouraged from bidding on contracts. Any additional administrative costs that prevailing wage requirements may place on winning contractors may also act to keep smaller contractors from bidding on projects. Larger contractors may be able to more easily absorb the higher administrative costs than a smaller contractor.

Although supporters of prevailing wage laws state that union training and apprenticeship programs help minorities, a 1995 federal report on S. 141, a bill to repeal the Davis-Bacon Act, concluded that prevailing wage laws may reduce training opportunities and entry-level jobs. These laws reduce incentives to hire lower skilled workers. The requirement that contractors pay the union wage scale "creates a disincentive to hire entry-level workers and train them on-the-job."[19]

Prevailing wage laws hurt rural contractors and workers. Although prevailing wage laws were intended to protect local contractors from outside

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[17] *Ibid., p. 18.*

[18] *Robert S. Goldfarb and Michael Metzger, "Do Davis-Bacon Minimum Wages Raise Product Quality?" Journal of Labor Research, Summer 1988, p. 265.*

[19] *104th Congress, 1st Session, Senate Committee on Labor and Human Resources, Report 104-80, op. cit., p. 9.*

competition, this is sometimes not the result, especially in rural areas. As wage rates are "imported" into a locality, contractors and workers may follow. [20] The report on S. 141 concludes that prevailing wage laws make it more likely that outside contractors will be successful in bidding.[21] A GAO report was quoted, "the increased costs [due to Davis-Bacon] may have had the most adverse effect on local contractors and their workers--those the act was to protect--by promoting the use of nonlocal contractors on Federal projects. We [the GAO] found that nonlocal contractors worked on the majority of these projects, indicating that the higher rates may have discouraged local contractors from bidding."[22] The GAO report found that local contractors often would not bid on projects because they did not want to disrupt their wage structures and worker classification practices. Similarly, Fraundorf, Farrell, and Mason found that, "There appears to be some validity to the charge that the way the Davis-Bacon Act as now administered puts local contractors at a disadvantage instead of insuring local firms and residents their share of jobs as the law apparently intended."[23]

Prevailing wage laws do not guarantee quality. Goldfarb and Metzger note that supporters of prevailing wage requirements use an improvement in quality as a counter to any increase in costs. However, "government financed construction is, in fact, subject to a great many standards and strictures. The argument that Davis-Bacon ought to be supported as a quality-raising device starts from the assumption that these standards are not completely successful (or could not at low cost be made completely successful) in achieving desired quality levels."[24] The authors stated that "the 'construction quality' argument for the Davis-Bacon Act is seriously flawed, since quality may in fact fall because of Davis-Bacon coverage."[25] Product quality may fall even though contractors use higher quality labor because they may, in an effort to offset higher wage costs, also use fewer units of this higher quality labor or substitute materials of lower quality. They conclude their paper by declaring that "any argument in favor of

[20] *Wage importing occurs when the wage scales or collective bargaining agreements of one locality are applied to another. This frequently happens in rural areas.*

[21] *104th Congress, 1st Session, Senate Committee on Labor and Human Resources, Report 104-80, op. cit., p. 6.*

[22] *U.S. General Accounting Office, "The Davis-Bacon Act Should Be Repealed," HRD79-18, April 27, 1979.*

[23] *Fraundorf, Farrell, and Mason, op. cit., pp. 17-18.*

[24] *Goldfarb and Metzger, op. cit., footnote 10, p. 272.*

[25] *Ibid., p. 265.*

Davis-Bacon as a quality-assuring device should be treated with considerable skepticism."[26] The Kentucky Legislative Research Commission notes that

> There was substantial evidence that prevailing wage laws do increase the initial costs of construction. It is unclear, however, whether the requirements result in higher quality construction. To the extent that quality is increased, prevailing wages are an inefficient method to increase quality. The wage requirement results in contractors paying higher wages with no guarantee that the additional wages would result in quality improvements.[27]

Prevailing wage laws do not increase local tax bases. While it is true that increases in income within a jurisdiction (local, state, or national) generally lead to increases in tax revenues, it is also generally the case that the higher wages on government sponsored projects are being paid out of existing tax revenues.[28] Opponents of prevailing wage laws argue that spending more of the jurisdiction's tax revenues for construction in order to maintain tax revenues may be viewed as a misallocation of revenue. This argument maintains that if the same product can be purchased for a lower cost, then spending more for that product is wasteful. The savings could be spent elsewhere and this spending would help maintain the jurisdiction's tax base. Prevailing wage opponents, for example, propose returning any government savings to the taxpayers to spend as they choose. This spending would also maintain the local tax base. The report on S. 141 concludes that the "goal of boosting local demand cannot justify paying artificially high Federal construction costs."[29]

(iii) *Cost Studies*

Thieblot (1975) took advantage of a one-month suspension of the Davis- Bacon Act in 1971 to study the potential costs of prevailing wage requirements.[30]

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[26] *Ibid., p. 272.*

[27] *Kentucky Legislative Research Commission, "An Analysis of Kentucky's Prevailing Wage Laws and Procedures," (Dec. 2001), p. ix.*

[28] *In rural areas, spending may actually be done in other localities where the workers live. This is especially true if workers are "imported" from outside the locality. Any taxes will be collected by the locality in which the workers live and spend. The locality paying for the project may therefore "export" benefits to another locality.*

[29] *104th Congress, 1st Session, Senate Committee on Labor and Human Resources, Report 104-80, op. cit., p. 16.*

[30] *Armand J. Thieblot, The Davis-Bacon Act, Labor Relations and Public Policy Series, Report No. 10. Philadelphia: University of Pennsylvania Press 1975.*

Projects that were bid but not awarded were bid again without the prevailing wage requirement. Thieblot compared the bids with prevailing wages to the bids without prevailing wages and found that Davis-Bacon increased costs by less than one percent. Gould and Bittlingmayer (1980) re-evaluated Thieblot's analysis and adjusted the estimates to account for inflation and new information available to bidders.[31] They found that Davis-Bacon increased costs by four to seven percent.

Other studies of the effect of prevailing wage laws on construction costs use regression analysis. Regression analysis estimates the relationship between one variable (the dependent variable) and one or more other variables (the independent or explanatory variables). The technique allows an analyst to estimate the effect that one independent variable has on the dependent variable while controlling for the effect of the other independent variables. Regression analysis is a powerful and useful technique, but its power and usefulness depends on assumptions made by the analyst employing the technique, whether these assumptions are satisfied, and the variables included in the analysis.

Construction costs are a function of many factors. The presence or absence of prevailing wage laws is just one of many factors that will influence the cost of a project. Many of the factors influencing cost are project specific. Projects differ in size and location. Projects of the same size may differ in specifications. Similar projects built at different times may face shortages or surpluses of labor or materials due to the state of the economy. Analysis of construction costs should take into account as many of the factors that influence construction costs as possible. Omitting relevant variables from a regression may statistically bias the estimates of the coefficients of the included variables. The bias may be positive or negative depending on the relationships between the included variables and the omitted variables. The papers described below and the LSC analysis described in the next chapter all suffer from omitted variables. When variables are not included in regression analysis it is usually because the data needed to include them are not available.

Fraundorf, Farrell, and Mason (1983) used regression analysis to estimate the effect of Davis-Bacon on construction costs in rural areas.[32] The analysis compared public construction costs to private construction costs and included variables that influence costs. The authors found that Davis-Bacon increased costs

[31] *John P. Gould and George Bittlingmayer, The Economics of the Davis-Bacon Act: An Analysis of Prevailing Wage Laws, American Enterprise Institute for Public Policy Research, Washington D.C., 1980.*

[32] *Martha Norby Fraundorf, John. P. Farrell, and Robert Mason, "The Effects of the Davis- Bacon Act on Construction Costs in Rural Areas," The Review of Economics and Statistics, 66 (Feb. 1983), pp. 142-146.*

by 26 percent. However, although the analysis included variables that influence costs, the authors noted that public projects and private projects are often held to different standards. Any higher standards set for public projects may increase the cost of public projects with or without a requirement to pay prevailing wages. To the extent that this may have happened, the study's estimated impact of Davis- Bacon would have been biased upward.

Prus (1996) used regression analysis and data from F.W. Dodge to estimate the effect of prevailing wage laws on construction costs.[33, 34] The analysis included various types of public and private construction projects from 1990 through 1994. The analysis included the following variables that affect cost: project size, structure type, material type, number of stories, project type (new, alteration, addition), and the state in which the project was located. The author found that prevailing wage laws increase construction costs by five percent, but that the increase was not statistically significant.[35]

Prus (1999) used regression analysis and data from F.W. Dodge to estimate the effect of prevailing wage laws on new school construction costs in Delaware, Maryland, North Carolina, Virginia, and West Virginia.[36] The analysis included the following variables that affect cost: project size, school type, material type, number of stories, and the state in which the project was located. The author found that prevailing wage laws increased school construction costs by 3.8 percent, but that the increase was not statistically significant.

Phillips (1999) used regression analysis and national data from F.W. Dodge to estimate the effect of prevailing wage laws on school construction projects (new construction, additions, and alterations).[37] The analysis included the following variables that affect cost: project size, type of school, material type, number of

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[33] *Mark J. Prus, "The Effect of State Prevailing Wage Laws on Total Construction Costs," (Jan. 1996).*

[34] *F.W. Dodge, a part of the McGraw-Hill Construction Information Group, is a provider of project news, plans, specifications, and analysis services for construction professionals in the United States and Canada.*

[35] *Statistical significance is concerned with the probability that a result would have occurred by chance if the assumptions are true. Results with low probabilities (usually less than five percent) are said to be statistically significant.*

[36] *Mark J. Prus, "Prevailing Wage Laws and School Constructio n Costs: An Analysis of Public School Construction in Maryland and the Mid Atlantic States," (Jan. 1999).*

[37] *Peter Phillips, "Kentucky's Prevailing Wage Law: Its History, Purpose, and Effect" (Oct. 1999).*

stories, project type (new, alteration, addition), unemployment rate, season, and the state in which the project was located. Although Phillips found that prevailing wage laws increase costs by 2.4 percent, the increase was not statistically significant.

Bilginsoy and Phillips (2000) used regression analysis to estimate the effect of prevailing wage laws on school construction costs in British Columbia.[38] The analysis included the following variables that affect cost: school type, number of bidders, contractor size, district location, stage of construction cycle, and time. The authors found that prevailing wage laws did not have a statistically significant effect on construction costs.

Phillips (2001) used regression analysis and data from F.W. Dodge to estimate the effects of prevailing wage laws on the cost of new school construction in Ohio, Michigan, and Kentucky.[39] The analysis included the following variables that affect cost: project size, location (urban/rural), season, and whether the project included a swimming pool. Phillips found that costs were increased by less than one percent, but that the increase was not statistically significant.

The savings estimates found in the papers reviewed are presented in Table 1. Although the studies indicate savings from the removal of prevailing wage requirements, none of the estimated savings meet the standards of statistical significance. The estimated savings are considerably lower than the 20 to 30 percent savings that some opponents of prevailing wage laws have claimed. The studies may be providing some evidence in support of the claim that higher wages encourage the use of more productive workers that may at least partially offset the direct effect of higher wages on cost.

(iv) Table 1: Estimated Savings

Author(s)	Year	Savings
Thieblot	1975	0.6 percent
Gould and Bittlingmayer	1980	4 to 7 percent
Prus	1996	5.1 percent
Prus	1999	3.8 percent
Phillips	1999	2.4 percent
Phillips	2001	0.7 percent

[38] Cihan Bilginsoy and Peter Phillips, "Prevailing Wage Regulations and School Construction Costs: Evidence from British Columbia," Journal of Education Finance, 24 (Winter 2000), pp. 415-432.

[39] Peter Phillips, "A Comparison of Public School Construction Costs in Three Midwestern States that Have Changed Their Prevailing Wage Laws in the 1990s: Kentucky, Ohio, and Michigan," (Feb. 2001).

The Kentucky Legislative Research Commission's analysis of Kentucky's prevailing wage laws includes an excellent summary of the difficulty of estimating the effect of prevailing wage laws on construction costs.

> Empirical estimates of the effects vary greatly, due largely to the difficulty in separating the effects of prevailing wage laws from other factors that affect construction costs. Ideally, to measure any cost effect from prevailing wage laws, it is necessary to compare the costs of projects under the prevailing wage law to the costs of the same exact projects in the absence of a prevailing wage law. Unfortunately, it is not possible to see what construction costs would be in the total absence of prevailing wage law. Therefore, several alternative methods have been developed over the years in an attempt to estimate the effects. Some studies compare construction costs in prevailing wage states to construction costs in non-prevailing wage states. Others compare the Davis-Bacon wages to other, more representative, measures of wages. These methods are discussed in a number of studies. There is little agreement between the studies as to whether prevailing wage laws increasecosts, because a commonality in all of them is that there is always some technical issue that could substantially affect the results.[40]

[40] *Kentucky LRC Report, pp. 45-46.*

Impact on Construction Costs

Senate Bill 102 of Ohio's 122nd General Assembly required an evaluation of the impact of the prevailing wage exemption on the amount of money saved by school districts and educational service centers. Testimony on and discussion of Senate Bill 102 indicated that the expected primary source of any potential savings would be reduced construction costs.

Proponents of prevailing wage laws maintain that these laws reduce total construction costs by encouraging the use of more qualified and productive (usually union) workers. Their reasoning is that these workers may be more expensive on a per-hour basis, but their greater productivity results in a lower total cost. Prevailing wage laws may induce contractors to hire only the best workers, potentially resulting in a superior work force that is able to complete projects more quickly and, possibly, at a lower labor cost. Even if initial construction costs were greater, prevailing wage proponents argue that the long-term costs would be lower due to the superior quality of construction.

Opponents of prevailing wage laws argue that these laws increase project costs by constraining the choices available to contractors and ultimately to the payer. Opponents also believe cost is increased by changing how workers are utilized. In addition, they believe cost may be increased by the effect the laws may have on labor distribution. For instance, non-union contractors may be faced with the choice of paying a high wage to an unskilled worker or paying a high wage to a skilled worker for menial work. Additionally, some contractors may choose to not bid on projects which could reduce competition and result in higher construction costs. Additional paper work may also add to the overall cost of a project.

(v) <u>Contractor Surveys</u>

During testimony on Senate Bill 102, claims about the effect of the exemption on construction costs ranged from a possible 60 percent savings to unspecified increases in costs. Opponents of prevailing wage laws claimed significant savings would result from the exemption. Supporters of prevailing wage laws claimed low savings, no savings, or even increased costs. Supporters also claimed that if savings did result, they would prove to be short term because they would be offset by long term maintenance and repair costs that would result from the presumed lower quality of construction.

LSC conducted an exploratory survey to obtain initial estimates of the effect of the exemption on construction costs. Every school district in the state was contacted and asked to have every contractor that bid on a project fill out a simple survey. Contractors were asked to provide the following information: school district name, project name, company name, trades involved with the project, bid price, and bid price had the project been bid with prevailing wages. The last piece of information was key to the survey. For union companies, providing the information was not a problem, both prices were the same. However, non-union companies were asked to assume that they were still subject to prevailing wage requirements and then recalculate their bids. The responses were their estimates of what would happen in a hypothetical situation.

The hypothetical bids must be used with caution. Non-union companies may have had an incentive to overstate the prevailing wage price in order to show greater savings. The hypothetical bids could also be in error if they did not take into account any behavioral changes in response to having to pay the prevailing wages. If having to pay the prevailing wages would induce a contractor to use a different combination of workers and hours, but the contractor simply substituted higher wages into the bid estimation equation in calculating the hypothetical bid, then the hypothetical bid could be too high or too low. Additionally, contractors may have bid differently due to factors such as the expected number and kind of bidders. It is possible that a responding firm would not have bid at all under prevailing wage requirements, but did in the absence of the requirements.

LSC hoped to receive responses from every contractor, both union and non-union, that bid on every school project. The responses from union companies could be used as a "check" on the prevailing wage based estimates of the non- union contractors. However, many school districts and companies instead chose to not participate in our exploratory survey. Despite the lack of participation, the received responses were analyzed. The results of the exploratory surveys were never intended to be interpreted as conclusive estimates of the effect of the exemption on construction costs, but rather to narrow the range of the possible savings that may result from the exemption.

Additionally, LSC hoped to use the exploratory survey to obtain data to confirm or contradict the results of the serendipitous "experiment" that occurred when the Westlake City School District required that contractors submit two bids: one subject to prevailing wage requirements and one exempt from prevailing wage requirements. Information for this one district provided an example of the bidding outcomes both under and exempt from prevailing wage requirements and the savings (at least at the time of bidding) that resulted from the exemption. This information is presented and discussed in the appendix, *Case Study: Westlake City School District*.

In spite of the overall lack of sufficient responses to enhance validity, the difference between the bid price and the estimate of the bid price had the project been bid with prevailing wages was calculated for each respondent to provide an estimate of the savings resulting from the exemption of school districts from the state's prevailing wage laws. Each calculated difference is an estimate of the savings in a particular trade on a particular project for a particular contractor. The difference was then expressed as a percentage of the estimated prevailing wage bid. This percentage estimates the percentage savings resulting from the exemption of school districts from the state's prevailing wage laws. For most union contractors both the estimated savings and the percentage savings were zero. If, even in the absence of a prevailing wage requirement, a union contractor wins a bid, then the prevailing wage exemption results in no reported savings to the school district. However, if the lack of a prevailing wage requirement resulted in lower bids from union contractors because of increased competition, then the exemption produced savings that the surveys could not determine.

The exploratory surveys were processed in three rounds. The first two rounds were processed for two interim reports (September 1998 and January 2000) and the third round was processed for this final report. The results are summarized in Tables 2 and 3. N is the number of responses. The estimated percentage savings reported are weighted averages calculated using the prevailing wage bids as weights.[41]

(vi) Table 2: Estimated Savings Based on Contractor Surveys (all responses)

	Round 1		Round 2		Round 3		Combined	
	N	Savings	N	Savings	N	Savings	N	Savings
Statewide	379	6.12%	203	5.09%	192	9.04%	774	7.24%
Urban	202	5.71%	147	4.68%	140	8.84%	489	6.85%
Rural	177	7.09%	56	5.86%	52	9.36%	285	8.02%
Appalachian	54	4.70%	19	5.99%	8	7.37%	81	5.60%
Non-Appalachian	325	6.34%	184	4.96%	184	9.14%	693	7.42%
Electrical	80	8.02%	42	7.79%	67	12.36%	189	10.52%
General	39	5.11%	10	3.33%	16	8.63%	65	6.19%
Masonry	22	8.95%	24	12.28%	0	xxx	46	10.44%
Plumbing, etc.	61	7.41%	36	-0.76%	46	5.75%	143	5.38%
Roofing	66	9.33%	39	1.00%	16	13.93%	121	8.09%
Other	111	4.45%	52	5.16%	47	9.47%	209	6.38%

[41] The weighted average took into account the size of the project when calculating the average, rather than treating each project equally.

(vii) Table 3: Estimated Savings Based on Contractor Surveys (responses reporting savings)

	Round 1		Round 2		Round 3		Combined	
	N	Savings	N	Savings	N	Savings	N	Savings
Statewide	241	10.20%	83	10.51%	155	10.85%	479	10.58%
Urban	129	9.30%	52	10.38%	113	11.56%	294	10.49%
Rural	112	12.48%	31	10.71%	42	9.92%	185	10.73%
Appalachian	34	16.12%	8	15.09%	6	9.29%	48	12.90%
Non-Appalachian	207	9.78%	75	9.87%	149	10.95%	431	10.41%
Electrical	44	11.74%	19	10.94%	65	13.16%	128	12.55%
General	28	8.72%	4	8.08%	14	8.67%	46	8.67%
Masonry	13	12.20%	16	14.99%	0	xxx	29	13.53%
Plumbing, etc.	29	11.23%	6	5.62%	17	10.79%	52	10.77%
Roofing	53	13.53%	3	10.99%	16	13.93%	72	13.52%
Other	74	9.13%	35	8.35%	43	10.01%	152	9.48%

The estimates presented in Tables 2 and 3 should be used with caution for a number of reasons. Participation in the surveys was voluntary and the responses received may not be representative of school construction in Ohio.[42] As previously discussed, the accuracy of the key piece of information, what the bid price would have been if the contract had been bid under prevailing wage requirements, may be questionable. A contractor may have provided, either intentionally or accidentally, inaccurate information. Additionally, the information is for bids, not final project costs. The information includes bids that may not have been accepted.

The estimates in Table 2, based on all responses, are the better estimates of possible overall average savings. The estimates in Table 3 may be taken as an upper limit on possible overall average savings. The surveys indicate that the savings, if any, resulting from the exemption of school construction from Ohio's prevailing wage requirements are likely to be less than the amounts mentioned in testimony during hearings on Senate Bill 102. Instead of 30, 40, or even 60 percent savings, the contractor surveys indicate a range of savings between five and ten percent. Of course, an individual project may have a larger or smaller level of savings and specific school districts may benefit more or less.

[42] The estimates were affected by the mix of responses. Union contractors accounted for 38.1 percent of all the responses received. The union share of responses was 36.4 percent in the first round processed, 59.1 percent in the second round, and 19.3 percent in the third round. The mix of responses may have been influenced by efforts of both supporters and opponents of prevailing wage laws to encourage the submission of the survey forms.

Responses were grouped according to whether the district is located in an urban or rural county. The rural counties include all counties that are not in a metropolitan statistical area (MSA) plus the following counties that are in a MSA but are more rural in nature: Ashtabula, Auglaize, Brown, Carroll, Columbiana, Fulton, Jefferson, Lawrence, and Washington. Under this criterion, 30 counties were classified as urban.[43] Estimated savings were slightly higher in rural counties than in urban counties. This is consistent with other studies of prevailing wage that found greater savings in rural areas than in urban areas. One reason for this is that under prevailing wage laws, wages from urban areas are often "imported" into rural areas. Urban wages tend to be higher than rural wages, so when the prevailing wage requirement is removed, lower rural wages may be used, resulting in savings. Some school districts commented on being able to use lower wage local labor since they no longer had to require the payment of prevailing wages. The estimated savings difference has gotten smaller over time. This may be due to the mix of responses or due to changes in the overall economy. A second grouping of counties into Appalachian and non-Appalachian yielded no consistent pattern of savings differences.[44] Again, this may be due to the mix of responses received or changes in the overall economy. Even within the groupings, an individual project may have a larger or smaller level of savings and specific school districts may benefit more or less.

Conclusions: Possible savings due to the exemption of school construction from Ohio's prevailing wage law are likely to be less than the levels mentioned during testimony on Senate Bill 102. The contractor surveys, which are suggestive but not conclusive, indicate that average savings are more likely to range between five and ten percent instead of between 30 and 60 percent. Not all districts will experience savings. A district may have chosen to continue to require the payment of prevailing wages. A project may be in an area where the labor market has essentially equalized union and non-union wages. Even where there are savings, districts cannot all expect to achieve the average rate of savings. Some districts will enjoy greater than average savings and others will experience below average rates of savings.

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[43] The counties classified as "urban" are: Allen, Belmont, Butler, Clark, Clermont, Crawford, Cuyahoga, Delaware, Fairfield, Franklin, Geauga, Greene, Hamilton, Lake, Licking, Lorain, Lucas, Madison, Mahoning, Medina, Miami, Montgomery, Pickaway, Portage, Richland, Stark, Summit, Trumbull, Warren, and Wood.

[44] The countie s classified as Appalachian are: Adams, Athens, Belmont, Brown, Carroll, Clermont, Columbiana, Coshocton, Gallia, Guernsey, Harrison, Highland, Hocking, Holmes, Jackson, Jefferson, Lawrence, Meigs, Monroe, Morgan, Muskingum, Noble, Perry, Pike, Ross, Scioto, Tuscarawas, Vinton, and Washington.

The answer to the question, "How much can a district expect to save because of the prevailing wage exemption?" is "It depends." It depends on the district's policies. It depends on where the district is located. It depends on the state of the construction and labor markets in which the district operates.

(viii) Analysis of Dodge Construction Data

School construction was exempted from Ohio's prevailing wage requirements on August 19, 1997. In an effort to compare the costs of school construction before the exemption with the cost of construction after the exemption, LSC obtained data on school construction activity from F.W. Dodge.[45] The data was used to estimate the cost of construction with and without a prevailing wage requirement. Any difference between the estimated costs may be interpreted as an estimate of cost savings. Details on the methodology employed in obtaining the estimates are provided in an appendix.

The analysis yielded estimated aggregate savings of $487.9 million. Additions accounted for 84 percent of the estimated savings, alterations accounted for 11 percent, and new construction accounted for the remaining five percent. A distribution of estimated savings by county indicates that 36 percent of the savings occurred on projects located in rural counties and 64 percent occurred on projects located in urban counties.

The estimated aggregate savings are summarized in Table 4 and broken down according to project type in Table 5. Savings percent is defined as the estimated dollars savings compared to the estimated cost under prevailing wage requirements.

[45] *F.W. Dodge, a part of the McGraw-Hill Construction Information Group, is the largest provider of project news, plans, specifications, and analysis services for construction professionals in the United States and Canada.*

F.W. Dodge collects data for private and public construction projects. The data measures the value of contracts awarded to private firms and do not include expenditures for land, acquired buildings, or architect and engineering design activities.

(ix) Table 4: Summary of Estimated Saving (dollar amounts in thousands of 2001 dollars)

	Combined		
Year	Projects	Savings	Percent
1997	35	$14,843.0	12.6%
1998	315	$82,094.7	13.3%
1999	280	$115,282.7	11.7%
2000	230	$97,333.5	9.4%
2001	264	$178,318.4	9.9%
Total	1,124	$487,872.4	10.7%

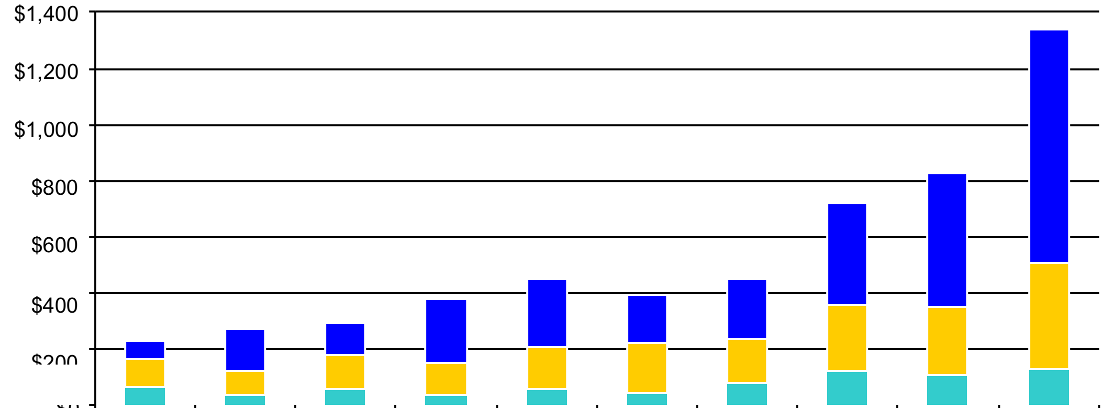
(x) Table 5: Summary of Estimated Saving (dollar amounts in thousands of 2001 dollars)

	New Construction			Additions			Alterations		
Year	Projects	"Savings"	Percent	Projects	"Savings"	Percent	Projects	"Savings"	Percent
1997	9	$1,388.2	2.2%	14	$12,664.5	25.6%	12	$790.3	12.7%
1998	29	$4,095.5	1.8%	68	$65,501.0	21.7%	218	$12,498.2	13.0%
1999	39	$2,856.2	0.7%	91	$95,928.9	20.8%	150	$16,497.7	11.5%
2000	48	$4,380.9	0.9%	67	$79,949.7	19.4%	115	$13,002.9	10.5%
2001	74	$11,918.6	1.4%	82	$153,987.1	18.6%	108	$12,412.8	8.6%
Total	199	$24,639.4	1.2%	322	$408,031.1	19.9%	603	$55,201.9	10.7%

Estimated percentage savings were greater for additions than for alterations and new construction. This supports comments made in response to surveys sent to school districts that indicated a belief that savings woul d be greater on additions and alterations than on new construction. Although the trend was not consistent across project types, percentage savings appear to have decreased over time. For most of the time since the exemption went into effect, the construction industry experienced healthy growth and increased demand for workers. Year-over-year growth in construction employment was positive until September 2001. High and increasing demand for workers may have decreased the difference between union and non-union wages and worked to reduce the possible savings from the exemption. One reason for the high and increasing demand for construction workers was the increase in school construction activity that started in 1997. Factors contributing to this increase include the creation of the School Facilities Commission and increased state appropriations for school construction. The increase in school construction activity is pictured in Chart 1.

Chart 1: Ohio Public School Construction Expenditures

(bid amounts in millions of dollars; based on F.W. Dodge data



	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total	$228.1	$275.2	$293.8	$380.6	$451.5	$396.2	$446.9	$719.8	$824.5	$1,341.9
New	$64.6	$153.4	$110.6	$225.6	$242.7	$172.7	$208.5	$363.8	$474.2	$832.4
Addition	$95.1	$80.4	$120.9	$113.4	$146.0	$181.8	$160.1	$234.5	$241.3	$377.7
Alteration	$68.4	$41.5	$62.3	$41.5	$62.8	$41.7	$78.2	$121.5	$109.0	$131.8

The estimated savings by location are presented in Table 6. Rural counties had 36 percent of the aggregate estimated savings compared to 64 percent for urban counties. Estimated percentage savings were greater in urban counties than in rural counties. This is possibly due to differences in the mix of project types between the two location categories. Rural counties had a larger percentage of new construction projects and a smaller percentage of alterations compared to urban counties.

(xi) Table 6: Estimated Savings by Location (dollar amounts in thousands)

	Rural			Urban		
Year	Projects	"Savings"	Percent	Projects	"Savings"	Percent
1997	11	$5,650.3	14.5%	24	$9,192.7	11.6%
1998	145	$23,785.8	12.2%	170	$58,309.0	13.8%
1999	112	$34,506.4	8.4%	168	$80,776.4	13.9%
2000	73	$24,807.2	5.8%	157	$72,526.3	12.0%
2001	91	$88,659.8	10.3%	173	$89,658.6	9.6%
Total	432	$177,409.5	9.2%	692	$310,462.9	11.9%

A Word of Caution: Construction costs are a function of many factors. The presence or absence of prevailing wage laws is just one of many factors that will influence the cost of a project. Many of the factors influencing cost are project specific. Projects differ in size and location. Projects of the same size may differ in specifications. Similar projects built at different times may face shortages or surpluses of labor or materials due to the state of the economy. Analysis of construction costs should take into account as many of the factors that influence construction costs as possible. The above analysis included the factors available, but was not able to include all the factors that may influence construction costs. For example, LSC was unable to obtain information regarding the division of cost between labor and materials. Omitting relevant variables from regression analysis may statistically bias the estimates of the coefficients of the included variables. The bias may be positive or negative depending on the relationships between the included variables and the omitted variables. Any effects on the estimated coefficients will affect any calculations that make use of the coefficients.[46]

The results reported are for the specific exemption of school construction in the Ohio economy between 1997 and 2001. The effect of an expanded exemption in a different economic environment may not necessarily be the same.

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[46] *In one estimation attempt, LSC included a dummy variable to indicate funding by the Ohio School Facilities Commission. This attempt is described in Appendix 3.*

Section Four

Impact on Construction Quality

Senate Bill 102 required an evaluation of the impact of the prevailing wage exemption on the quality of school building construction in Ohio. Proponents of prevailing wage laws assert that the laws assure quality construction by encouraging the use of more qualified and productive workers. Opponents of prevailing wage laws assert that contractors may substitute lower quality or prefabricated materials to offset the cost of high priced labor and that wage savings due to the repeal of prevailing wage laws may allow school districts to afford higher quality materials or build larger facilities for the same cost. Opponents also argue that higher wages may not be an indication of higher quality or more skilled workers. Union wages may be higher than non-union wages due to productivity differences, union market power, or a combination of the two. Prevailing wage laws may not necessarily assure that higher quality workers are hired. The Kentucky Legislative Research Commission found instances of the same workers being paid more on prevailing wage projects than on private projects. If these workers did the same quality of work on each type of project, then the payment of prevailing wages potentially increased costs without improving quality. The Kentucky Legislative Research Commission noted that prevailing wage laws ensure that "higher wages are paid, but do not ensure an associated improvement in quality or productivity."[47]

Although a bit dated, "Maryland's Prevailing Wage Law: A Study of Costs and Effects," released by the Maryland Department of Fiscal Services in January 1989, contains a good commentary on the issue of quality of construction.

> To determine whether prevailing wages encourage higher quality construction, industry quality indicators were sought through discussions with building and contractor organizations, union affiliates, and state personnel. No quantitative measures of quality could be found to compare state projects subject to prevailing wages with those exempted under current regulations. The use of contractor "call-backs," corrective actions needed after building completion, was examined as a possible measure. However, agency, contractor, and labor representatives stated that many call-backs result from design flaws and thus could not be attributed to contractor error.

[47] *Kentucky Legislative Research Commission, op. cit., p. 65.*

> Absent any numerical indicators of quality, those interviewed were asked whether prevailing wage policies influenced quality. Results were mixed. The labor affiliates generally believed that prevailing wages did encourage higher quality, while some contractors dismissed any qualitative difference between prevailing and non-prevailing wage projects. Union representatives indicated that their sponsorship of formal apprenticeship programs, funded in part through employer benefit contributions, provided a much better trained and productive work force. Some contractors, even some non-union contractors, indicated that union labor was generally superior to non-union workers.[48]

The Building Research Board,[49] in its report *Inspection and Other Strategies for Assuring Quality in Government Construction*, noted that "quality is a value-laden term that depends on one's point of view" and defined a quality building as one "whose characteristics create an environment where the occupant or user can accomplish his purpose effectively, efficiently, and comfortably."[50] Quality was defined as "conformance to adequately developed requirements" and the "satisfaction of users' needs" was described as "the ultimate measure of quality."[51]

LSC adopted the Building Research Board's concept of measuring quality and conducted two surveys in which school districts were asked about the quality of school construction before and after the exemption of school construction from Ohio's prevailing wage laws. The responses to the surveys provide an indication of the extent to which the users' (school districts') needs were satisfied. The surveys are subjective assessments. They may be measuring quality or they may be measuring the responders' preconceived opinions on prevailing wage. In the survey responses, quality is in the "eye of the beholder" and what is in the eye of a beholder may be what is in the mind of the beholder. The survey responses may

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[48] *Maryland Department of Fiscal Services, "Maryland's Prevailing Wage Law: A Study of Costs and Effects," (January 1989).*

[49] *The Building Research Board of the National Research Council of the National Academy of Sciences provides technical assistance to the U.S. government on building technology, private sector competitiveness, and building design.*

[50] *Building Research Board, "Inspection and Other Strategies for Assuring Quality in Government Construction," National Academy Press, Washington D.C., 1991, pp. 7-8.*

[51] *Ibid., p. 43.*

be reflecting a district's satisfaction with having a new school building, particularly if it replaces a dilapidated old building.

Quality is a subjective concept and differences in quality may not become apparent without the passage of a sufficient amount of time. Estimates of the effect of the prevailing wage exemption on the quality of public school building construction are difficult, if not impossible to make. This is especially true for small variations in quality, which may not show up in the surveys. However, if a quality difference is serious, significant, and large, then it may be detected on satisfaction surveys like the ones LSC conducted.

(xii) January 1999 Survey

In January 1999, LSC mailed a survey to each of the 611 Ohio school districts and received responses from 187 districts (a 31 percent response rate). The surveys were sent to the district superintendent assuming that the superintendent would forward the questions to the individuals best able to answer them and that the superintendent would have been made aware of any problems. The survey included the following open-ended questions about construction quality.

> Have you noticed any difference in the quality of construction? Please comment on both the process of construction and on the finished product. Compared to similar projects undertaken before the exemption, has the frequency of delays and change orders changed?

The responses are summarized in Table 7.

(xiii) Table 7: 1999 Quality Survey

Response	Frequency	Percent
No Response to Quality Question	121	65%
No Change / Quality Improved	65	35%
Quality Worse	1	1%

Of the districts that commented on the quality of construction, 98 percent reported either no change in quality or an improvement in quality. The results are not necessarily representative of all districts that had projects. Comments on the quality of construction are presented below.

I am not convinced PW makes any difference in the quality of the project. What truly matters is the quality of the foreman/superintendent assigned to the project. That person may be union or non-union. We have had tremendous union contractors and bad ones. Same with non-union.

Comments made to me by the contractors on the roof projects lead me to believe that the contractors have made adjustments to the bidding process. Both of the contractors used on our jobs traditionally bid projects as prevailing wage. However, on these projects, they felt that they would be underbid if they did so and so they bid based on other considerations. They also indicated to me that the workers were the same ones they would have used on a prevailing wage job, just paid less. Due to the reputation of the contractors, my opinion is that we received a first rate job at a reduced cost.

There has been no difference in the quality of construction. There haven't been any more delays or change orders than when we had prevailing wages.

All contractors except one that are under contract are union firms; therefore, it is difficult to comment. We have had a number of delays but that was not because of the prevailing wage exemption; it was because of a very tight and costly structural steel market.

The perceived quality of construction has not diminished; if anything, the quality of work performed during this last construction season was markedly improved over prior periods. We can observe no apparent change in the bidding process, change order process, or frequency of delays (if anything, the jobs this last season were completed well ahead of targeted completion dates with no change orders!).

We have experienced several instances of decreased quality in construction following prevailing wages exemption. However tempting it might be to attribute our (or any) experiences to the demise of prevailing wages, correlation does not necessarily denote causation. We have also had less than satisfactory experiences with prevailing-wage- paying bidders. It is problematic whether the prevalence of these occurrences is even statistically significant.

At this time I can't say the quality is any different since the completed projects used the same contractor just applying the prevailing wage rate. One contractor (drop ceilings) commented that having to pay prevailing wage created some tension within his organization since employees assigned to our project were paid at a higher rate than others within the company who worked other projects of the same nature, but were paid at the lower rate.

The quality has been good. The project is not completed. All change orders were initiated by us not the contractor. The delays have been weather and the ability of the contractor to attract laborers.

There has been no change in the quality of construction. Overall, the quality of construction on all these projects has been particularly good whether prevailing wages were required or not.

Compared to earlier projects when prevailing wage was required, I see no difference in the quality of work or time involved.

I cannot answer this question at this time. Quality is usually discovered after a period of time. It takes a while before shoddy work and poor quality work begins toshow.

We have been very pleased with the quality of construction and the timely progress being made by the contractors at this time. We were able to open the junior high school on time this fall and anticipate opening the new elementary on time this fall. We have had no delays and the change orders have been reasonable in quantity and subject.

In most cases, the contractors have been the same as we have had in the past and the quality of work has not changed.

No, we have not noticed much difference in the process of construction or on the finished product. We have noticed a bit more willingness to work with us regarding changes.

No, the quality of construction and the finished product remain the same as projects done prior to the exemption taking effect. I believe this is a function of how well the specifications are written, the reputation of the company doing the work, the quality of the product used, and the amount of supervision of the project by the owner and the architect. We have seen no change order increase nor additional delays with projects after the exemption went into effect. Specifications on all projects included a completion date.

(xiv) *August 2000 Survey*

In August 2000, LSC sent out another survey to all school districts. As before, the questions were sent to the district superintendent on the assumption that the superintendent would forward the questions to the individuals best able to answer them and that the superintendent would have been made aware of any problems that might have arisen. In the seven-question survey, six of the questions were closed-ended in order to make processing easier, but the last question was an open-ended question asking for the superintendent's general opinion of the prevailing wage exemption. Additionally, superintendents were free to comment on any of their answers to the six closed-ended questions.

LSC received responses from 357 districts, including responses from 227 districts that indicated they had construction or renovation projects between January 1999 and September 2000 that required competitive bidding. Of these 227 districts, 196 answered the following question about quality:

> Compared to projects subject to prevailing wage requirements, non-prevailing wage projects
>
> (a) are of higher quality
>
> (b) are of about the same quality
>
> (c) are of lower quality

These responses are summarized in Table 8.

(xv) Table 8: 2000 Quality Survey

Response	Frequency	Percent
Higher quality	12	6%
About the same quality	179	91%
Lower quality	5	3%

Although LSC sent questions to every district, not all districts replied and LSC did not follow-up to determine the reasons for not replying. Therefore, the survey results cannot be interpreted as conclusive evidence of the statewide effect of the prevailing wage exemption on the quality of school construction in Ohio. Based on the responses received, most (but not all) school districts, the ultimate users of the finished construction product, do not appear to have major concerns about the quality of construction. The comments that mentioned the quality of construction are presented below.

> I think we should make every effort to reduce construction costs to school districts. As long as we don't give up quality and safety, we should continue.
>
> Little impact on $'s and/or quality.
>
> Has it reduced cost to schools? Has it improved quality/workmanship?
>
> I like the exemption. It lowers the cost of renovations and I haven't experienced any decrease in quality.
>
> Getting rid of the prevailing wage is one of the smarter things Ohio has done. The quality of work is as good. We have the same contractor bidding on our jobs. The amount of paperwork was ridiculous as well as the responsibility that went with it. Prevailing wage just artificially inflated the price. The market should decide wages--not the government. Prevailing wage kept a lot of good quality small companies out of the market. Don't bring prevailing wage back. It's a waste of taxpayer money.
>
> We are doing 2 H. B. 264 energy conservation projects that allow us to secure contractors without going thru competitive bidding. Even with that, we are getting at least 3 quotes on the jobs to be done. We are still getting quality work done at competitive prices.
>
> I support it. Need to save money anytime we can if we aren't compromising quality.
>
> It is like many other decisions, it is a balance of what is good for everyone vs. good for a small group. The public benefits from the exemption but the laborer's quality of life is diminished. I would rather see the laborer make a fair wage. I am also not sure the quality of the job doesn't suffer when cheaper labor is employed.
>
> Think it is a good idea. We are using public funds for these projects, so why not be allowed to negotiate (bid) for the best prices as long as the labor is of a similar quality.

Excellent-- lot less paperwork and on smaller projects, $50,000-$150,000, do not think quality is an issue on big projects. There may be a quality issue, but I doubt it. Private enterprise is exempt so we should be also.

It should save money across the state. I believe "all" our workers are being paid prevailing wage. At this point, we're satisfied with the quality of work.

I think it is good for our school district, save money, same quality.

Would probably be better off hiring union workers & contractors. We received very poor quality work. I am sure we used non-prevailing wage to save money.

Helps school districts by providing more budget money to extend or add additional projects. Frees up funds to apply toward higher quality equipment or more material that would normally be spent on exceptionally higher wages. It also adds more people to the work force at a reasonable wage in which projects finish as scheduled or with little or no time extension.

I am totally supporting the exemption. I don't mind paying for quality work when I get it but unfortunately the unions today are more interested in keeping sub par people on the payroll then they are about the quality of the work.

It has been a definite plus. I don't care if the contractor is union, non-union, or Martian. What I care most is that a quality job is completed at a competitive price.

Places more contractors in a position to bid. Quality is the answer not--union or non- union.

This legislation has saved school districts both time and money by exempting us from prevailing wages. At the same time, it has hurt the quality of work we have received. It should be noted that we do not ask a company whether they are union (prevailing wage) company or not. But, it has probably been a 50/50 split between union and non- union companies doing our jobs.

I strongly believe that the exemption is beneficial to school projects. It provides for a more open and competitive bid process and for us, has not affected our quality of construction.

I favor the exemption for school districts. It enables districts to get quality work done quicker than they normally would be able to, and at a reasonable price.

This has been great for schools and taxpayers. We are still getting a quality product.

Overall, the exemption has made a favorable impression on projects, from a cost standpoint, without significantly reducing quality.

Just finishing a project of almost 18 million that wasn't prevailing wage. I am extremely pleased with the pricing and quality I received.

We want to keep the prevailing wage exemption. We feel it less costly projects, time savings to us (less monitoring) and equal quality of work done.

We finished a building project ($19 million) that required prevailing wage. Strong union influence in our district besides. Probably increased bids, not necessarily better quality work. All but one contractor was union.

This exemption has provided us with a better quality addition because of the lowering of cost.

School dollars are very hard to come by. The prevailing wage exemption saves money and does not sacrifice quality.

In our area, there are strong unions; all these unions have been very supportive of our district. I continue to think it best to pay prevailing wage rates. I also become concerned of the quality we may get if less than prevailing wage contractors get contracts.

Excellent idea to exempt schools from this. Quality of work is just as high or higher. In fact, several local contractors will not bid prevailing wage jobs because of paperwork, etc.

Excellent legislation--increase competition resulting in higher quality-- lower cost--and projects are completed more efficiently and sooner. Don't let the unions prevail in over turning this exemption!

> The prevailing wage exemption has been very important to schools. It has saved huge sums of money at no apparent loss of quality of work. It has allowed us to spend more money on education and less on maintenance.
>
> I feel it allows school districts to obtain quality contractors at a reduced cost.
>
> The prevailing wage exemption provides contractors an opportunity to use labor that may not be the quality we want for our public building projects. Depends on the supervisor that monitors the projects. Still believe "you get what you pay for." However, on this project we were fortunate to have a local contractor awarded the bid.
>
> I still believe that without mandatory prevailing wage the cost of projects overall are lower. I also believe that there is no loss of quality. We have worked with both union and non-union shops and have many success stories using both.
>
> Quality firms and individuals do quality work! This is irregardless of prevailing wage!
>
> Can't really tell if it made a difference. Quality of construction has been excellent.

(xvi) *Conclusion*

Quality is a subjective concept. In seeking to evaluate the impact that the prevailing wage exemption had on the quality of school construction, LSC assumed a definition of quality meaning "conformance to adequately developed requirements" and that "the ultimate measure of quality" was the "satisfaction of users' needs." Surveys of school districts indicate that the users of the buildings are generally satisfied with the buildings. As perceived by responders, the exemption does not appear to have decreased the quality of school construction by that definition.[52]

[52] *However, other definitions of "quality" could be affected by the exemption. LSC was unable to measure, for example, the longevity or future maintenance requirements of the buildings being constructed by workers being paid less than prevailing wages.*

Section Five

Impact on Construction Wages

Senate Bill 102 required an evaluation of the impact of the prevailing wage exemption on the wages of construction employees working on the construction of public school buildings in Ohio. To the extent that prevailing wage laws increase wages in the construction industry, the repeal of prevailing wage laws would be expected to decrease wages in the construction industry. Kessler and Katz (2001) used individual data on blue-collar construction and non-construction workers obtained from the census and the Current Population Survey to analyze wages in repeal and non-repeal states.[53] They conclude that a repeal of a state's prevailing wage law leads to a slight decrease in the relative wages of both union and non- union construction workers and a sizeable reduction in the union wage premium.

Senate Bill 102 did not totally repeal Ohio's prevailing wage law. Only school construction and renovation projects were exempted from the requirements. Other public construction projects are still subject to Ohio's prevailing wage requirements.[54] Because Ohio "repealed" the prevailing wage for only a specific category of construction, the potential exists for affected workers to change to some other category of construction and minimize any negative impacts the exemption might have on individual workers. Because school construction is a relatively small part of Ohio's construction industry, trends and events in the rest of the industry may overwhelm any effects of the prevailing wage exemption. At the time the exemption went into effect, demand for construction workers was high. The high demand for workers may have counteracted any negative effect the exemption may have had on individual workers. The impact of the exemption on

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[53] *Daniel P. Kessler and Lawrence F. Katz, "Prevailing Wage Laws and Construction Labor Markets," Industrial and Labor Relations Review, Volume 54, Number 2, January 2001, pp. 259- 274.*

[54] *Ohio's prevailing wage law applies, with certain exemptions, to any public authority authorized to contract for a public improvement estimated to cost above specified threshold amounts. In addition to the exemption for primary and secondary schools, other projects exempt from the prevailing wage law include projects subject to the federal Davis-Bacon Act, projects utilizing participants in specified types of employment programs or work experience programs when a public authority uses a participant's labor to construct a public improvement, the construction or renovation of certain publicly funded multifamily residential projects, the construction of specified county ditch projects, public improvements constructed by full-time nonprobationary employees of a public authority who are classified in the civil service, and public improvements undertaken by or under contract for soil and water conservation districts and certain county hospitals.*

the wages of construction employees working on the construction of public school building in Ohio is not likely to show up in the available statistics for the construction industry as a whole.

(xvii) *School Construction Relative to Total Construction*

School construction accounts for a small, but significant, share of the overall construction industry in Ohio. The 1997 Census of Construction indicated that in Ohio the value of construction work on educational buildings accounted for 5.0 percent of the total value of construction, 6.4 percent of the value of building construction, and 10.5 percent of the value of nonresidential building construction.[55, 56] The prevailing wage exemption created by Senate Bill 102 affected only this small segment of the Ohio construction industry. Because school construction is such a small part of the overall construction industry, trends and events in the rest of the industry may overwhelm any effects of the prevailing wage exemption and hamper the identification of these effects through the analysis of overall industry data. This may change as school construction begins to account for an increasing share of overall construction activity. Additionally, workers may find it easier to move from the relatively small segment of the industry directly affected by the exemption to the remainder of the industry that was not directly affected by the exemption. This is especially true if the demand for workers is high in the remainder of the industry.

(xviii) *Analysis of Data from the Bureau of Labor Statistics*

This section examines recent activity in the construction industry using statistics from the U.S. Bureau of Labor Statistics. The data used in this section are for the construction industry as a whole, not just for that segment involved in school construction. The available data are organized by trade rather than project type. A worker may be employed on more than one type of project during a given period. Prus (1999) commented on this same limitation of the available data, noting that "workers in school construction cannot be distinguished from workers in other market segments" and that "it is not possible to draw any direct inference

[55] *1997 Economic Census, Construction, Geographic Area Series, U.S. Department of Commerce, U.S. Census Bureau, Washington DC.*

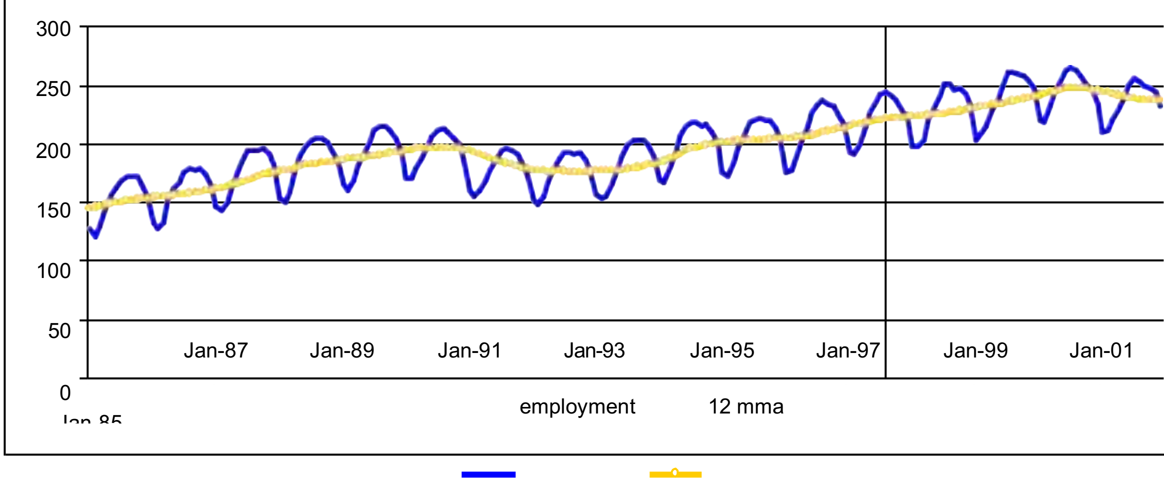
[56] *In the Census of Construction, the category "educational buildings" includes all buildings that are used directly in administrative and instructional activities such as colleges, universities, elementary and secondary schools, correspondence, commercial, and trade schools. Libraries, museums, and art galleries, as well as laboratories that are not a part of a manufacturing or commercial establishment, are also included.*

about the impact that the inclusion or exclusion of school construction from prevailing wage requirements might have on construction workers' wages."[57]

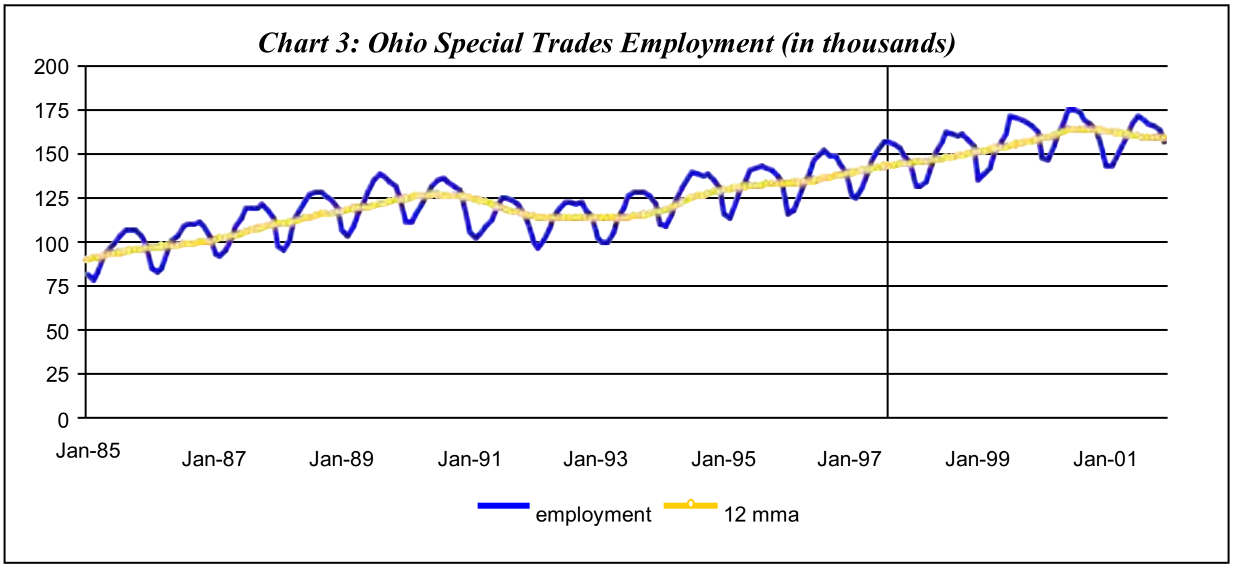
(xix) Employment

School construction was exempted from Ohio's prevailing wage requirements on August 19, 1997. It is tempting to compare September 1997 employment with August 1997 employment and attribute any change to the prevailing wage exemption. However, doing so ignores the seasonal pattern inherent in the construction industry, any general trends in the industry, and the fact that it often takes time for individuals to react to policy changes. Also, it would take several years to turn over contracts so that all the contracts were adopted under the new law rather than the prior law. Charts 2 and 3 present information on construction employment in Ohio. The seasonal pattern of construction activity is shown by the regular up and down pattern in the lines labeled "employment." A cyclical pattern can also be discerned from the trend in the ups and downs of the line. Using a 12-month moving average (12 mma) removes the seasonal pattern and presents a better picture of the trend over time.

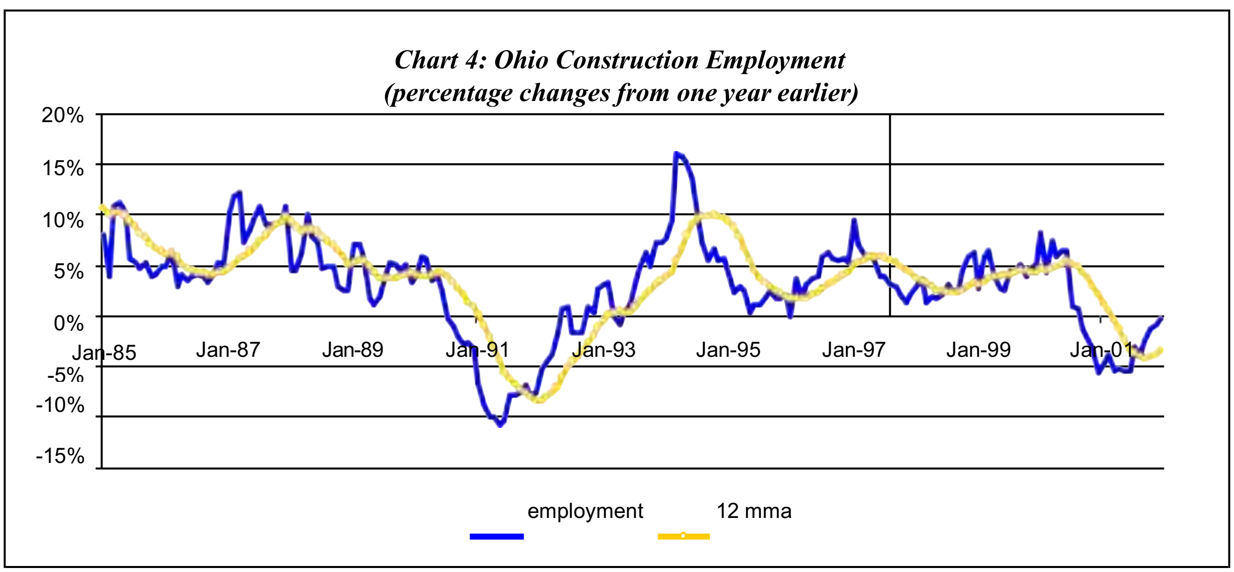
Chart 2: Ohio Construction Employment (in thousands)

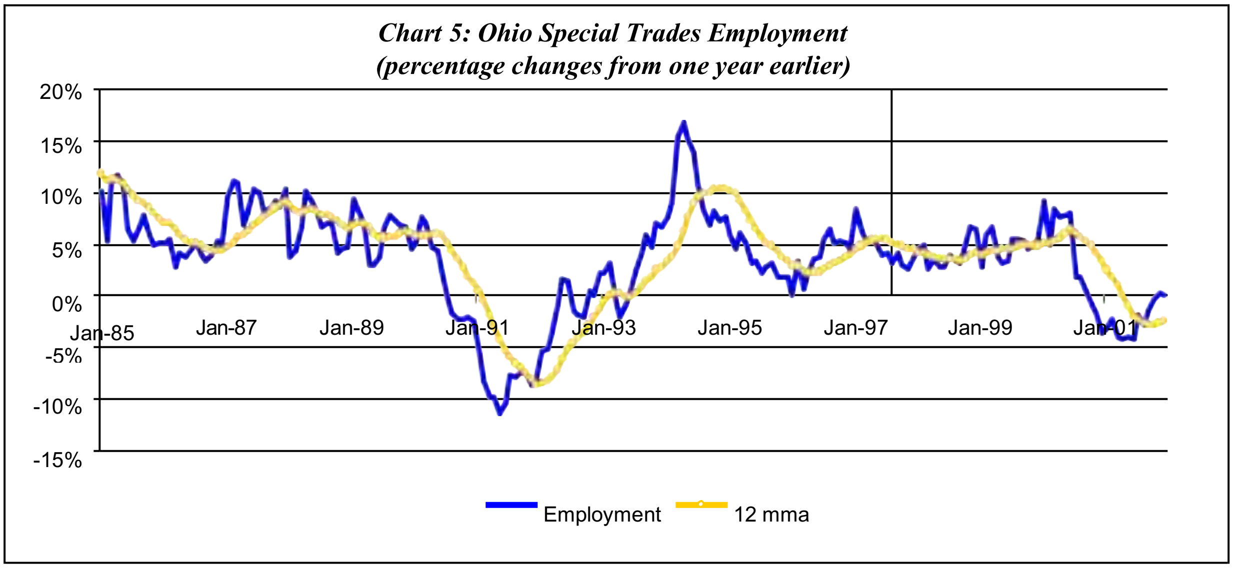


[57] *Prus (1999), p. 32.*



Another indicator of changes in the industry is a year-to-year comparison. September 1997 is compared with September 1996; October 1997 is compared with October 1996. This type of comparison is one method of adjusting for the seasonal pattern of construction employment. Charts 4 and 5 present year-to-year percentage changes in employment for the Ohio construction industry and for special trade contractors. Growth in the construction industry is demonstrated by positive year-to-year percentage changes. Also presented are changes in the 12- month moving averages of employment.





Employment in the Ohio construction industry was growing before the prevailing wage exemption went into effect in August 1997 and it continued to grow after the exemption of school construction from the state's prevailing wage requirements. In the 53 months before the exemption went into effect (April 1993 through August 1997) year-over-year employment growth averaged 5.2 percent for construction and 5.4 percent for special trades contractors. In the 53 months since the exemption went into effect (August 1997 through December 2001) employment growth averaged 3.5 percent for construction and 4.1 percent for special trades contractors. For comparison, Table 9 presents these growth rates along with those of other industries.

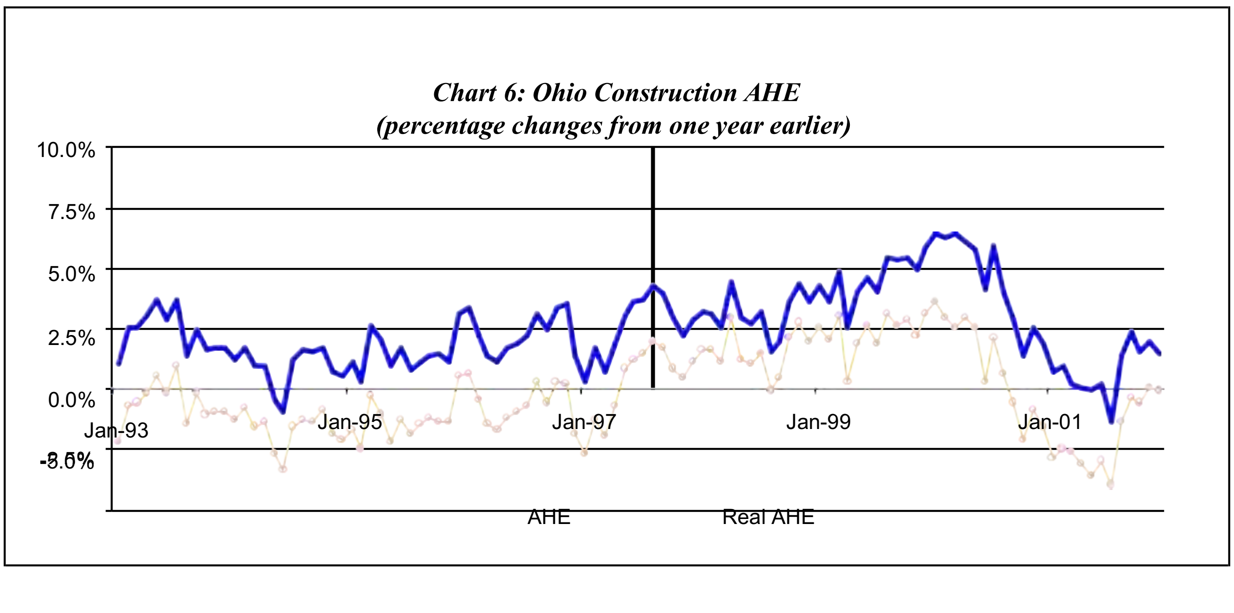
(xx) Table 9: Employment (average percentage changes from one year earlier)

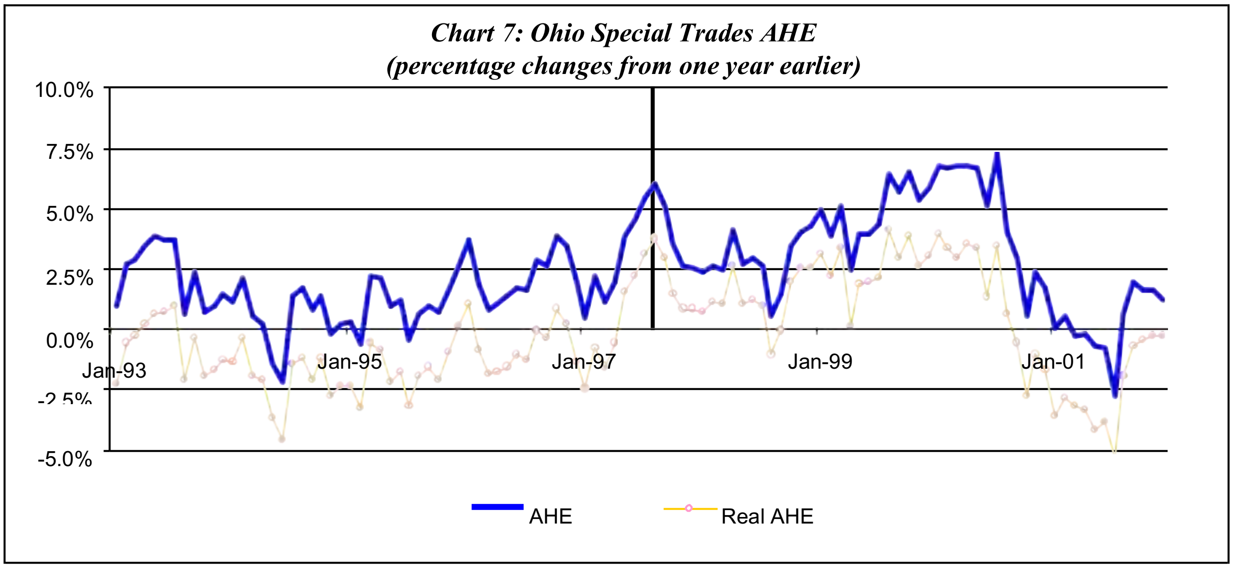
	April 1993 - August 1997	August 1997 - December 2001
Ohio Construction	5.2%	3.5%
Ohio Special Trades	5.4%	4.1%
U.S. Construction	4.7%	5.5%
U.S. Special Trades	5.3%	6.6%
Ohio Manufacturing	-1.3%	0.9%
Ohio Retail Trade	0.6%	2.6%

The changes in employment growth rates cannot be adequately explained solely by the exemption of school construction from prevailing wage requirements. The 1993-1997 period corresponds to the recovery period from the 1991 recession. The 1997-2001 period corresponds to a slower growth plateau period at the beginning of which unemployment was low and which ended with the 2001 recession. As the economy grew, construction employment grew. When the economy slowed down, construction growth slowed. Additionally, as mentioned above, school construction is a small segment of the overall construction industry. Any effects of the exemption were likely overshadowed by industry-wide influences.

(xxi) Average Hourly Earnings

Year-over-year percentage changes can also be used to evaluate average hourly earnings (AHE) before and after the exemption of school construction from the state's prevailing wage requirements. Charts 6 and 7 present year-over-year percentage changes in the average hourly earnings of workers in the overall construction industry in Ohio and for special trades contractors. Also presented are the year-over-year percentage changes in real (inflation adjusted) average hourly earnings.





The charts show that average hourly wages have generally increased. As the economy grew, average hourly earnings grew. When the economy slowed, growth in average hourly earnings slowed and turned negative for a short period. In the 53 months before the exemption, growth in average hourly earnings averaged 1.8 percent for construction and 1.7 percent for special trades contractors. In the 53 months since the exemption, growth in average hourly earnings averaged 3.2 percent for overall construction and for special trades contractors. For comparison, Table 10 presents these growth rates along with those of other industries.

(xxii) Table 10: AHE (average percentage changes from one year earlier)

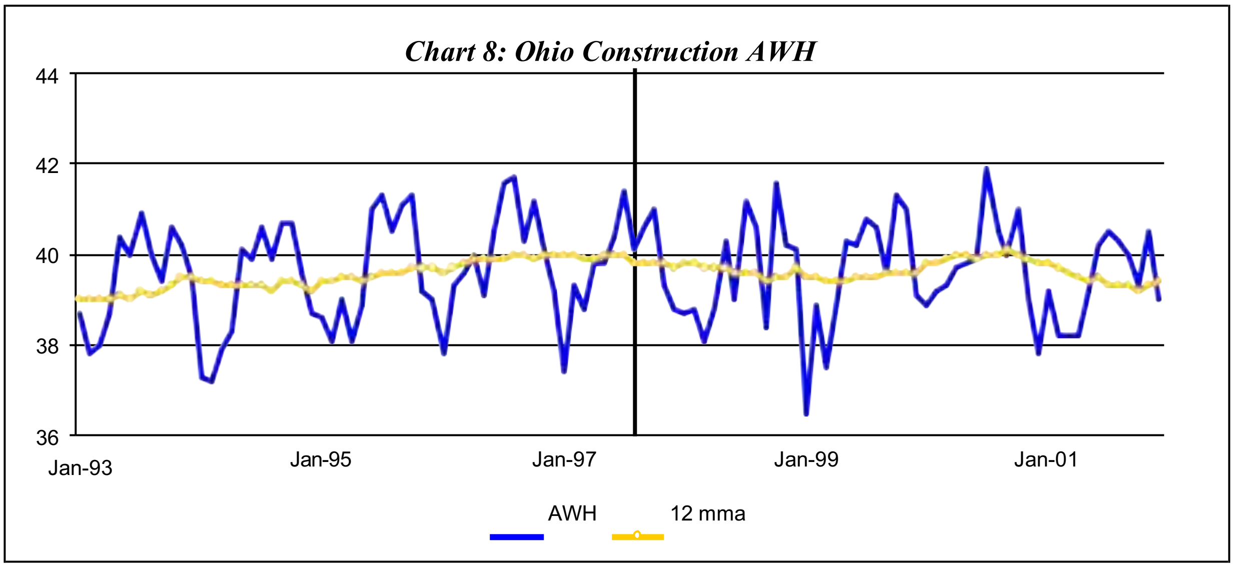
	April 1993 - August 1997	August 1997 - December 2001
Ohio Construction	1.8%	3.2%
Ohio Special Trades	1.7%	3.2%
U.S. Construction	3.5%	2.5%
U.S. Special Trades	3.4%	2.5%
Ohio Manufacturing	3.1%	2.2%
Ohio Retail Trade	3.7%	4.0%

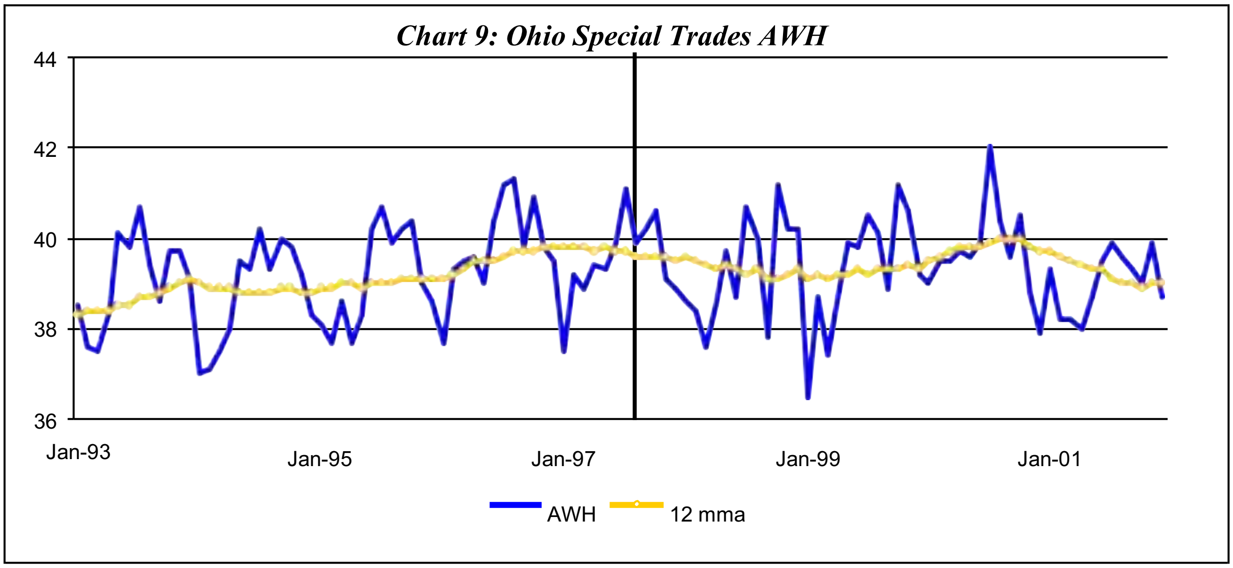
Adjusting for inflation shows that real average hourly earnings for construction grew at an average rate of 0.7 percent in the 1997-2001 period compared to a rate of –0.9 percent in the 1993-1997 period. For special trades contractors, real average hourly earnings averaged 0.8 percent growth in the 1997- 2001 period compared to –1.0 percent in the 1993-1997 period.

Although growth in average hourly earnings, both before and after adjusting for inflation, was greater after the prevailing wage exemption, because school construction is a small segment of the overall construction industry, the change in growth cannot be adequately explained by the exemption alone. The growth may be explained by the growth in the overall economy. As the economy grew, construction average hourly earnings grew; when the economy slowed down, growth in average hourly earnings slowed.

(xxiii) *Average Weekly Hours*

Average weekly hours (AWH) vary with the seasons. Charts 8 and 9 provide pictures of average weekly hours in the Ohio construction industry as a whole and for special trade contractors. The seasonal pattern is adjusted for with a 12-month moving average (12 mma).





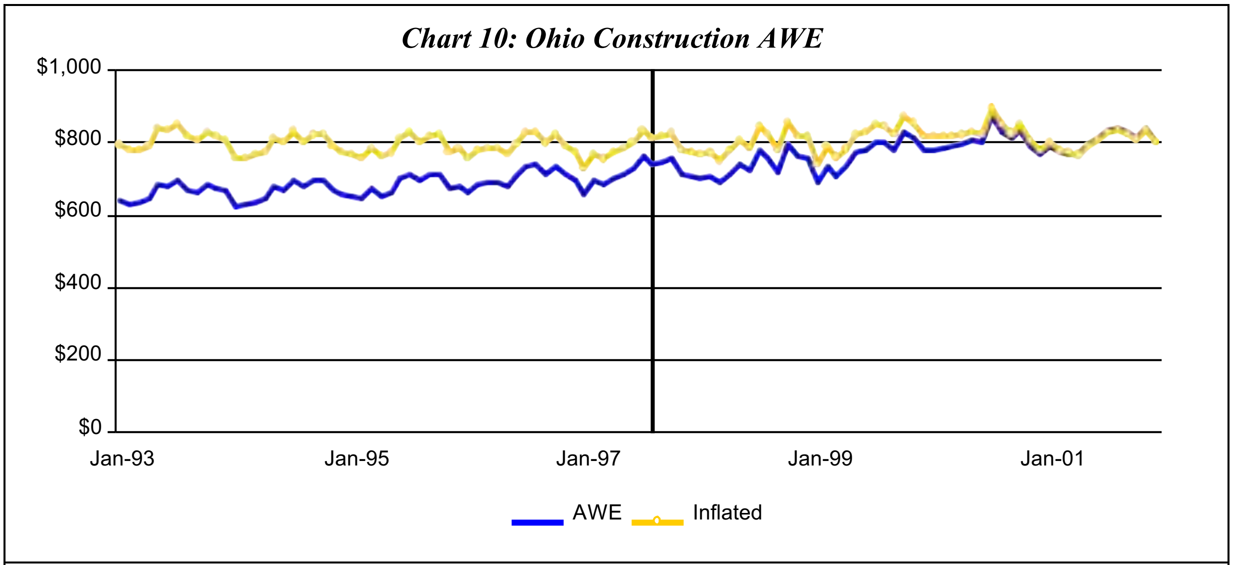
There is little difference in average weekly hours between the post- exemption period (August 1997-December 2001) and the pre-exemption period (April 1993-August 1997). In the pre-exemption period, average weekly hours in construction averaged 39.70 hours. The post-exemption average decreased slightly to 39.62 hours. For special trade contractors the pre-exemption average was 39.31 hours and the post-exemption average was 39.62 hours. For comparison, Table 11 presents these averages along with those of other industries.

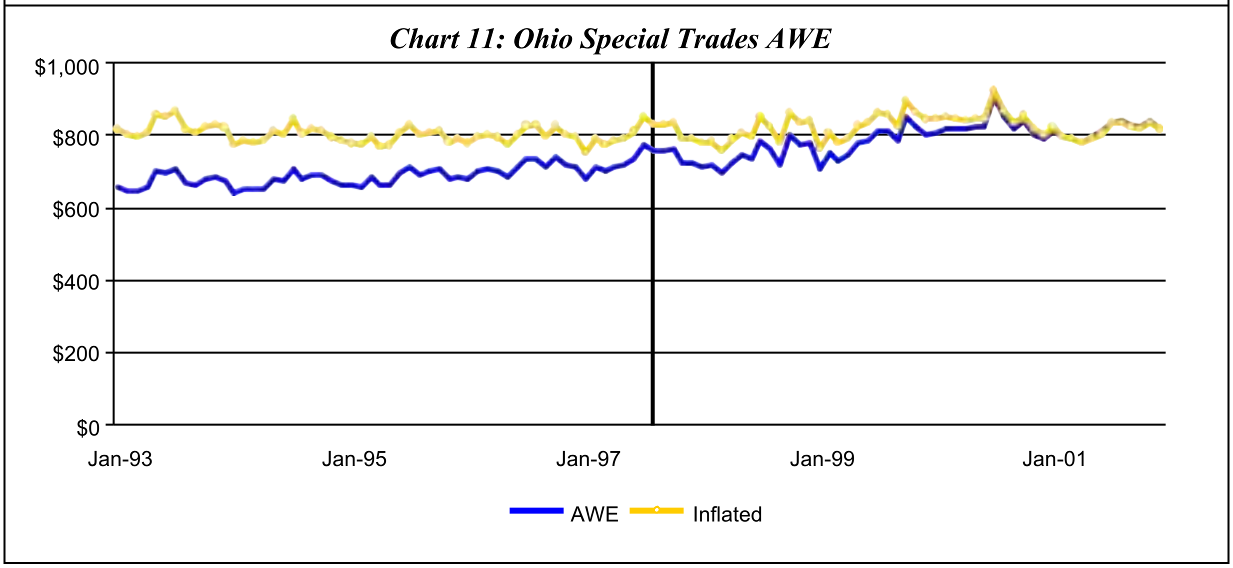
(xxiv) Table 11: AWH (averages)

	April 1993 - August 1997	August 1997 - December 2001
Ohio Construction	39.70	39.62
Ohio Special Trades	39.31	39.62
U.S. Construction	38.84	39.08
U.S. Special Trades	38.18	38.48
Ohio Manufacturing	43.42	42.75
Ohio Retail Trade	28.53	28.17

(xxv) Average Weekly Earnings

Average weekly earnings (AWE) are the product of average hourly earnings and average weekly hours. Both of these components are subject to seasonal fluctuation and general variability, so their product is also seasonal and variable. In order to compare earnings in the pre-exemption and post-exemption periods, the dollar amounts were inflated to December 2001 dollars using the Consumer Price Index for Urban Co nsumers. Charts 10 and 11 provide pictures of both the current dollar and inflated average weekly earnings for the Ohio construction industry as a whole and for special trade contractors.





Average weekly earnings in construction grew at an average year-over-year rate of 2.3 percent in the 1993-1997 period and 2.9 percent in the 1997-2001 period. For special trades contractors, average weekly earnings grew at an average year-over-year rate of 2.4 percent in the 1993-1997 period and 2.9 percent in the 1997-2001 period. For comparison, Table 12 presents these growth rates along with those of other industries.

(xxvi) Table 12: Nominal AWE

(average percentage changes from one year earlier)

	April 1993 - August 1997	August 1997 - December 2001
Ohio Construction	2.3%	2.9%
Ohio Special Trades	2.4%	2.9%
U.S. Construction	3.1%	3.6%
U.S. Special Trades	3.3%	3.5%
Ohio Manufacturing	2.8%	2.2%
Ohio Retail Trade	3.9%	3.2%

However, using the inflated values (which is the same as adjusting for inflation), the average year-over-year rate of change in average weekly earnings in construction was –0.5 percent in the 1993-1997 period and 0.5 percent in the 1997-2001 period. For special trade contractors, the average year-over-year rate of change in inflation adjusted average weekly earnings was –0.3 in the 1993-1997 period and 0.4 percent in the 1997-2001 period. For comparison, Table 13 presents these growth rates along with those of other industries.

(xxvii) Table 13: Real AWE

(average percentage changes from one year earlier)

	April 1993 - August 1997	August 1997 - December 2001
Ohio Construction	-0.5%	0.5%
Ohio Special Trades	-0.3%	0.4%
U.S. Construction	0.3%	1.1%
U.S. Special Trades	0.5%	1.0%
Ohio Manufacturing	0.0%	-0.3%
Ohio Retail Trade	1.1%	0.8%

Inflated average weekly construction earnings averaged $796.97 in the 1993-1997 period and $811.75 in the 1997-2001 period. The $14.78 weekly difference is the equivalent of $768.56 annually. For special trade contractors, inflated average weekly earnings averaged $804.63 in the 1993-1997 period and $824.14 in the 1997-2001 period. The $19.51 weekly difference is equivalent to $1,014.52 annually. For comparison, Table 14 presents these differences along with those of other industries.

(xxviii) Table 14: AWE (averages in December 2001 dollars)

	April 1993 - August 1997	August 1997 - December 2001	Annualized Difference
Ohio Construction	$796.97	$811.75	$768.56
Ohio Special Trades	$804.63	$824.14	$1,014.52
U.S. Construction	$679.76	$710.14	$1,579.76
U.S. Special Trades	$684.39	$713.62	$1,519.96
Ohio Manufacturing	$732.16	$732.89	$37.96
Ohio Retail Trade	$247.63	$263.43	$821.60

Although causality cannot be determined, the "average construction worker" appears to have been better off, at least in terms of average weekly earnings, in the post-exemption period.

(xxix) Conclusion

This section discussed the potential impact that the exemption of Ohio school construction from the state's prevailing wage law had on the wages of construction employees working on the construction of public school buildings in Ohio. Kessler and Katz (2001) reported that a full repeal of the prevailing wage law would be expected to decrease the relative wages of construction workers and decrease the union wage premium. An exemption (or "partial repeal") such as Ohio's could have similar effects, but a partial repeal leaves open the possibility of shifting to other projects still covered by the prevailing wage law. This shifting would reduce the effect the partial repeal would have on wages. School construction is a small, but important, segment of the construction industry. Contractors and workers may be able to shift out of school construction to other types of construction. This is especially true if demand for construction workers is up as it was during most of the time after the exemption went into effect. This shifting would also reduce any effect the partial repeal would have on wages. Increased demand for construction labor may offset any negative effect the exemption might have on wages.

A review of data from the Bureau of Labor Statistics indicates that the exemption of school construction from Ohio's prevailing wage law did not have a discernable negative effect on the overall construction industry. For most of the time after the exemption, the economy and the construction industry were healthy and growing.[58] As the economy slowed, construction activity slowed.

[58] Indications are that this is still the case for school construction. The Ohio School Facilities Commission (SFC) estimates that SFC expenditures for school construction will be up substantially in FY 2002 over FY 2001. Based on this it would appear to be highly improbable for total school construction to fall in FY 2002. In addition, school bond levy approvals were

Employment growth continued after the exemption went into effect and slowed only when the economy slowed. Average hourly earnings continued to grow until the economy slowed. Average weekly earnings also continued to grow. Inflation- adjusted average weekly earnings were higher on average after the exemption than before the exemption. Although the industry as a whole continued to do well after the exemption, some individuals may have done better than others and some may have done worse.

very high in CY 2000 and CY 2001. This indicates that local money for school construction over the next few years will be substantial and probably will continue to rise along with the state funding through at least CY 2002 and probably beyond.

Section Six

Conclusion

Senate Bill 102 exempted school construction from Ohio's prevailing wage requirements and required an evaluation of the effects of the exemption on construction costs, construction quality, and construction wages.

LSC found indications of $487.9 million in aggregate savings, an overall savings of 10.7 percent. Estimated savings on new construction projects was $24.6 million (1.2 percent). Estimated savings on additions was $408.0 million (19.9 percent). Estimated savings on alterations was $55.2 million (10.7 percent). Evidence was not available as to the portion of the estimated savings, if any, that could be directly and conclusively attributed to the prevailing wage exemption.

LSC found indications that the exemption had little impact on the quality of public school building construction. Using the satisfaction of users' needs as a measure of quality, LSC surveyed school districts to determine the extent to which they were satisfied with the quality of public school building construction. The surveys indicate that the users of the buildings are generally satisfied with the buildings and that, in the opinion of the users, the exemption does not appear to have decreased the quality of school construction.

LSC found indications that the exemption had little impact on the wages of construction employees working on the construction of public school buildings. The search for an impact was complicated by a number of factors. School construction accounts for a small percentage of construction activity. Most workers do not specialize in one category of project, such as school construction, but specialize in a craft or activity and move between types of projects that include that activity. Demand for construction workers has been high for most of the time since the exemption went into effect.

The effects reported are for the specific exemption of school construction in the Ohio economic environment of the late 1990's. A different exemption in a different economic environment may have different effects.

Section A.8 Appendix 1

(a) Case Study: Westlake City School District

In November 1996, the Westlake City School District, located in Cuyahoga County, passed a bond issue for a $27 million facilities improvement program. The project consisted of additions and renovations to seven buildings and all work was scheduled to be completed by December 1998.

In October 1997, bids were received for the fourth and largest ($8.5 million) phase of the project. This phase included additions and renovations to Lee Burneson Middle School, Parkside Middle School, and Westlake High School. The project required that contractors submit two bids: one subject to prevailing wage requirements and one exempt from prevailing wage requirements. The construction manager for the project provided bid information to the Ohio School Facilities Commission. The School Facilities Commission forwarded a copy of this information to the LSC.[59]

(i) Analysis of the Overall Project

The tables below provide summaries of the bids for the overall project in total and by trade area. The requirement that bids be submitted as prevailing wage and non-prevailing wage allowed LSC to estimate the effect of the prevailing wage exemption on project bid cost. Estimated savings are presented as both dollar amounts and percentages.

(ii) Table 15: Overall Project

School	*Prevailing Wage Low Bid*	*Non-Prevailing Wage Low Bid*	*Savings*	*Percent Savings*
Parkside Middle	$ 2,046,900	$ 1,872,946	$ 173,954	8.5%
Burneson Middle	$ 2,126,100	$ 2,074,978	$ 51,122	2.4%
Westlake High	$ 4,546,600	$ 4,267,500	$ 279,100	6.1%
TOTAL	**$ 8,719,600**	**$ 8,215,424**	**$ 504,176**	**5.8%**

[59] *Although the construction manager for the project provided information to the Ohio School Facilities Commission, the project was not a School Facilities Commission project.*

(iii) Table 16: General Trades

School	Prevailing Wage Low Bid	Non-Prevailing Wage Low Bid	Savings	Percent Savings
Parkside Middle	$ 1,257,000	$ 1,105,000	$ 152,000	12.1%
Burneson Middle	$ 1,324,000	$ 1,315,000	$ 9,000	0.7%
Westlake High	$ 3,040,000	$ 2,865,000	$ 175,000	5.8%
TOTAL	**$ 5,621,000**	**$ 5,285,000**	**$ 336,000**	**6.0%**

(iv) Table 17: HVAC

School	Prevailing Wage Low Bid	Non-Prevailing Wage Low Bid	Savings	Percent Savings
Parkside Middle	$ 339,000	$ 339,000	$ 0	0.0%
Burneson Middle	$ 488,200	$ 474,200	$14,000	2.9%
Westlake High	$ 688,600	$ 668,600	$ 20,000	2.9%
TOTAL	**$ 1,515,800**	**$ 1,481,800**	**$ 34,000**	**2.2%**

Table 18: Plumbing

School	Prevailing Wage Low Bid	Non-Prevailing Wage Low Bid	Savings	Percent Savings
Parkside Middle	$ 105,900	$ 105,900	$ 0	0.0%
Burneson Middle	$ 118,900	$ 110,500	$ 8,400	7.1%
Westlake High	$ 275,000	$ 230,900	$ 44,100	16.0%
TOTAL	**$ 499,800**	**$ 447,300**	**$ 52,500**	**10.5%**

Table 19: Electrical

School	Prevailing Wage Low Bid	Non-Prevailing Wage Low Bid	Savings	Percent Savings
Parkside Middle	$ 345,000	$ 323,046	$ 21,954	6.4%
Burneson Middle	$ 195,000	$ 175,278	$ 19,722	10.1%
Westlake High	$ 543,000	$ 503,000	$ 40,000	7.4%
TOTAL	**$ 1,083,000**	**$ 1,001,324**	**$ 81,676**	**7.5%**

Estimated overall savings for the project were 5.8 percent. Savings vary by school and by trade. The largest dollar savings are associated with the largest project, Westlake High School. However, the largest percentage savings were associated with the smallest project, Parkside Middle School.

Plumbing had the largest average percentage savings (10.5%), followed by electrical (7.5%), general trades (6.0%), and HVAC (2.2%). These are average percentage savings for these trade areas. Work in the same trade area at different schools had different savings rates. The savings rates for plumbing ranged from 16 percent at Westlake High School to 0 percent at Parkside Middle School. The low bid on plumbing for Parkside Middle School came from a union contractor.

Savings may vary by project and by trade. For some combinations of project and trade, savings may be high, while for others they may be low or zero. Even without the requirement of the payment of prevailing wages, union contractors may submit the low bid. The exemption of school construction from the state's prevailing wage requirements does not guarantee that union contractors will no longer win contracts. Union contractors can compete and win without the prevailing wage requirement.

(v) Analysis of Bidding Competition

From the information obtained concerning the bids submitted in 12 bidding competitions (3 schools multiplied by 4 trade areas), it was possible to simulate bidding with and without the requirement of the payment of prevailing wages. Twenty-one contractors submitted a total of fifty-eight bids. Twelve of the contractors were non-union, seven were union contractors, and two classified themselves as union or non-union. If the bidding were subject to prevailing wage requirements, analysis indicated that union contractors would have won two of the bidding competitions (17%) and a self-described union/non-union contractor would have won three of the bidding competitions (25%). The seven remaining competitions (58%) would have been won by non-union contractors. In bidding not subject to prevailing wage requirements, union contractors won two of the bidding competitions (17%) and a union/non-union contractor won one of the bidding competitions (8%). The remaining nine competitions (75%) were won by non-union contractors. The removal of the prevailing wage requirement caused the winning contractor to change in five of the bidding competitions.

(vi) Conclusions

In a letter accompanying the information provided to the School Facilities Commission, the construction manager for the project concluded that

> *The results show saving due to the use of non-prevailing wage rates for this project. If this type of savings can be realized in a heavily unionized area such as greater Cleveland, more significant savings may be realized in some of the more rural and non-union settings.*

The letter also included the following comment.

> *Surprisingly, there was a lack of union contractor bids, particularly given the strength of the unions in the area. This invokes thoughts that union contractors may begin to shy away from school projects without the prevailing wage in place. While this could limit competitiveness, it could also increase competitiveness. The market for schools may consist of an entirely new group of contractors, potentially resulting in more, lower cost, bidders. With a market shift, however, quality and availability of skilled tradesmen*

This case study indicates that, in this instance, the presence or absence of the prevailing wage requirement did affect the outcome of bidding competitions and that the removal of the requirement may lead to savings. However, the absence of the prevailing wage requirement did not guarantee a non-union winner to bidding competitions. Union contractors were able to compete and win even in the absence of prevailing wage requirements, and non-union contractors were able to compete and win even when prevailing wages were required.

Section A.9 Appendix 2

(a) Regression Analysis of Dodge Construction Data

LSC obtained data on school construction activity from F.W. Dodge.[60] The data purchased covered the years 1992 through 2001. The information obtained covered all types of school construction activity (new construction, addition, or alteration) for all types of projects (primary schools, junior high schools, senior high schools, vocational schools, community colleges, or colleges and universities other than community colleges) undertaken by all types of owners (federal, state, county, or private).

The variables in the data set include: Starting Date, General Contract Value, Square Feet, Stories, Project Type, Structure Type, Owner, and County. "Starting Date" is the month and year in which a project started, generally the bid acceptance date. "General Contract Value" is the initial bid cost of the project in thousands of dollars. "Square Feet" is the size of the project in thousands of square feet. "Stories" is the number of stories in the project. "Project Type" classifies the project as new construction, addition, or alteration. "Structure Type" classifies the project as primary school, junior high school, senior high school, vocational school, community college, or college and university. The variable "Owner" classifies the project as county, state, federal, or private depending on who is paying for the project. For the "Owner" variable, county corresponds to local school districts. The variable "County" is the county in which the project is located.

From the data obtained, LSC selected projects of structure type primary school, junior high school, senior high school, and vocational schools with county or state ownership. This data set was separated into three subsets based on project type: new, addition, and alteration. The alteration subset did not have values for the "Square Foot" variable.

General Contract Value was inflated to December 2001 dollars using an average of the *Engineering News Record* (ENR) Construction Cost and Building Cost Indices.[61] County was used to create a dummy variable "Rural" equal to 1

[60] F.W. Dodge, a part of the McGraw-Hill Construction Information Group, is the largest provider of project news, plans, specifications, and analysis services for construction professionals in the United States and Canada.

[61] ENR is a magazine providing business and technical news about the construction industry.

The Building Cost Index is based on: 66.38 hours of skilled labor at the 20-city average of bricklayers, carpenters and structural ironworkers rates, plus 25 cwt of standard structural steel for rural counties and 0 for urban counties.[62] Dummy variables were also created for junior high school, senior high school, and vocational school.

School construction was exempted from the state's prevailing wage requirements on August 19, 1997. To account for this in the analysis, a dummy variable "PW" was created equal to 1 for "Starting Date" months before September 1997 and equal to 0 for September 1997 and later. A project may have been bid before but started after August 19. A value of 1 indicates that a project was undertaken during the time period in which school construction was subject to Ohio's prevailing wage law.

Inflation-adjusted cost per square foot ($SQFT) was calculated by dividing the inflation-adjusted values of General Contract Value by the corresponding value of the Square Feet variable. Regression analysis was used to estimate equations describing $SQFT for the new and addition groups. $SQFT was used as the dependent variable. Explanatory variables were PW, Rural, JHS, SHS, VOC, interactions between PW and Rural, and a variable to represent the passage of time.[63]

The rural dummy variable was included to allow for the possibility that costs may be different in these areas. The school type (JHS, SHS, VOC) dummy variables were included to allow for the possibility that costs may differ depending on the type of school. The passage of time was included in the regression equations to account for changes in what is included in schools. Time was represented by the variable Trend equal to one in January 1992 and increasing by one with each month. The PW dummy variable was included to allow for the

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shapes at the mill price prior to 1996 and the fabricated 20-city price from 1996, plus 1.128 tons of portland cement at the 20-city price, plus 1,088 board-ft of 2 x 4 lumber at the 20-city price.

The Construction Cost Index is based on: 200 hours of common labor at the 20-city average of common labor rates, plus 25 cwt of standard structural steel shapes at the mill price prior to 1996 and the fabricated 20-city price from 1996, plus 1.128 tons of portland cement at the 20-city price, plus 1,088 board-ft of 2 x 4 lumber at the 20-city price.

The 20 U.S. cities that ENR maintains cost data on are: Atlanta, Baltimore, Birmingham, Boston, Chicago, Cincinnati, Cleveland, Dallas, Denver, Detroit, Kansas City, Los Angeles, Minneapolis, New Orleans, New York, Philadelphia, Pittsburgh, St. Louis, San Francisco, and Seattle.

[62] *The rural counties include all counties that are not in a metropolitan statistical area (MSA) plus the following counties that are in a MSA but are more rural in nature: Ashtabula, Auglaize, Brown, Carroll, Columbiana, Fulton, Jefferson, Lawrence, and Washington.*

[63] *The variables PW, Rural, JHS, SHS, and VOC are "dummy" or binary variables, i.e., variables defined to have a value of either 0 or 1.*

impact of a prevailing wage requirement on cost. The interaction with the location variable (PW-rural) was included because of the possibility of the "wage importing" effect of a prevailing wage requirement.

The dummy variables included in the regression equations permit the regression results to be used to create two equations: one equation with PW = 0 and another equation with PW = 1. The equation based on PW = 0 represents the absence of a prevailing wage requirement. The equation based on PW = 1 represents the presence of a prevailing wage requirement. These two equations can be used with the explanatory variables to calculate estimates of the dependent variable ($SQFT) in both the presence and absence of a prevailing wage requirement. The estimated values of $SQFT were multiplied by the corresponding values of the "Square Feet" variable to obtain estimates of General Contract Value in both the presence and absence of a prevailing wage requirement. Any difference between these estimates may be interpreted as estimates of the effects of a prevailing wage requirement.

New Construction: The data set for the analysis of new construction projects contained 450 observations. Preliminary analysis of the data found a large number of small projects. Many of these small projects were modular or portable classrooms that are not typically thought of as new construction. The data was divided into two groups based on a break in the distribution of projects when ordered by area. The "small" group contained projects for which the variable Square Feet had a value equivalent to less than 13,500 square feet. The "large" group contained the remaining projects. The results of the two regressions are presented and discussed below.

(i) Table 20: New Construction – large projects

Regression Statistics		*Variable*	*Coefficients*	*Standard Error*	*t Stat*	*P-value*
Observations	256	Intercept	86.64	8.86	9.78	0.00
R Square	0.06	Trend	0.14	0.08	1.72	0.09
Adjusted R Square	0.03	Rural	0.98	3.41	0.29	0.77
Standard Error	20.79	JHS	6.78	3.32	2.04	0.04
F	2.27	SHS	1.52	3.21	0.47	0.64
Significance F	0.03	VOC	15.17	8.82	1.72	0.09
		PW	3.99	6.25	0.64	0.52
		PW--Rural Interaction	-5.54	5.65	-0.98	0.33

The estimated equation for new construction – large projects explains a small percent of the variation and variance in the dependent variable, $SQFT. The positive coefficient for the trend variable indicates that $SQFT has increased over time in excess of inflation. The positive coefficient for the rural dummy variable indicates that $SQFT is greater in rural counties. The coefficient for the prevailing wage dummy variable indicates that the prevailing wage requirement acts to increase $SQFT. However, the prevailing wage – rural interaction variable indicates that a prevailing wage requirement acts to decrease $SQFT in rural counties.

(ii) Table 21: New Construction – small projects

Regression Statistics		*Variable*	*Coefficients*	*Standard Error*	*t Stat*	*P-value*
Observations	194	Intercept	106.50	12.71	8.38	0.00
R Square	0.05	Trend	-0.14	0.12	-1.20	0.23
Adjusted R Square	0.01	Rural	-14.49	10.33	-1.40	0.16
Standard Error	29.38	JHS	0.96	7.65	0.13	0.90
F	1.33	SHS	-2.00	6.26	-0.32	0.75
Significance F	0.24	VOC	9.18	7.95	1.15	0.25
		PW	-11.45	9.42	-1.22	0.23
		PW--Rural Interaction	5.50	11.49	0.48	0.63

The estimated equation for new construction – small projects explains a small percentage of the variation and variance in the dependent variable, $SQFT. The coefficient on the trend variable indicates a decrease in $SQFT over time. This may be due to the presence of a large number of modular trailers in this data subset. The trailers are pre-fabricated buildings where the majority of the labor is off-site and probably non-union and out of state both before and after the exemption.

Additions: The results of the regression run using the additions data subset are presented and discussed below.

(iii) Table 22: Additions

Regression Statistics		*Variable*	*Coefficients*	*Standard Error*	*t Stat*	*P-value*
Observations	676	Intercept	28.88	65.82	0.44	0.66
R Square	0.02	Trend	1.54	0.64	2.39	0.02
Adjusted R Square	0.01	Rural	10.42	33.00	0.32	0.75
Standard Error	288.07	JHS	80.37	34.46	2.33	0.02
F	2.27	SHS	10.06	24.74	0.41	0.68
Significance F	0.03	VOC	-43.18	53.08	-0.81	0.42
		PW	46.47	48.30	0.96	0.34
		PW--Rural Interaction	8.73	45.74	0.19	0.85

The estimated equation for additions explains a small percentage of the variation and variance in the dependent variable, $SQFT. The positive coefficient for the trend variable indicates that for additions $SQFT has increased over time in excess of inflation. The coefficient on the rural dummy variable indicates that costs may be higher in rural counties than in urban counties. The coefficient for the prevailing wage dummy variable indicates that the prevailing wage requirement acts to increase $SQFT. Furthermore, the prevailing wage – rural interaction variable indicates that a prevailing wage requirement acts to increase
$SQFT in rural counties.

Alterations: The alteration data subset did not have information on project size. In an attempt to work around this limitation in the data, the alteration data subset was analyzed using the estimated percentage savings by project for the new and additions data subsets. The two subsets were combined, and a regression was run with estimated percentage savings as the dependent variable. The independent variables were the inflation-adjusted values of General Contract Value, the trend variable, the location variable (Rural), and the project type variables (JHS, SHS, VOC). The results of the regression are presented and discussed below.

(iv) Table 23: Alterations

Regression Statistics		*Variable*	*Coefficients*	*Standard Error*	*t Stat*	*P-value*
Observations	1,126	Intercept	-0.251916	0.012707	-19.82	0.00
R Square	0.14	ENR Value	0.000004	0.000001	4.58	0.00
Adjusted R Square	0.13	Trend	0.001496	0.000157	9.52	0.00
Standard Error	0.18	Rural	0.005441	0.010698	0.51	0.61
F	29.28	JHS	0.026332	0.015585	1.69	0.09
Significance F	0.00	SHS	-0.067186	0.012403	-5.42	0.00
		VOC	-0.089969	0.024703	-3.64	0.00

In the regression for alterations, the dependent variable was the estimated percentage savings due to the absence of a prevailing wage requirement. A negative value indicated savings and a positive value indicated that the exemption increased costs. Thus, a negative coefficient on an explanatory variable indicates that the variable was associated with increased savings and a positive coefficient indicates that the variable was associated with decreased savings. The equation explains a small percentage of the variation and variance in estimated percentage savings. The coefficient on the inflation-adjusted values of General Contract Value (ENR Value) indicates that as project size increases, estimated percentage savings decreases. The coefficient on the trend variable indicates a decline over time in percentage savings. The coefficient on the rural dummy variable indicates a smaller savings percentage in rural counties than in urban counties. The coefficients on the project type variables indicate that compared to primary schools, savings percentages are lower for junior high schools and higher for senior high schools and vocational schools.

Variable Selection: LSC chose to include the same explanatory variables in each of the three equations that estimated $SQFT. Because of this choice, each equation has one or more variables that are not "statistically significant" in that equation. Table 24 presents the P-values (or probability values) for the explanatory variables for each equation. The column "Minimum" contains for each variable the minimum P-values from the three equations. Although the estimated coefficients generally do not satisfy the frequently used (and arbitrary) standard of 5 percent, the equations need not be discarded.

(v) Table 24: P-values for Regressions

Explanatory Variable	New-large	New-small	Addition	Minimum
Intercept	0.0000	0.0000	0.6609	0.0000
Trend	0.0870	0.2304	0.0171	0.0171
Rural	0.7730	0.1625	0.7523	0.1625
JHS	0.0423	0.8998	0.0200	0.0200
SHS	0.6370	0.7499	0.6843	0.6370
VOC	0.0866	0.2502	0.4162	0.0866
PW	0.5243	0.2256	0.3363	0.2256
PW--Rural Interaction	0.3273	0.6331	0.8487	0.3273

One interpretation of P-values is the probability that the coefficient is zero. Using this interpretation, one minus the P-value is the probability that the coefficient is not equal to zero.

(vi) Table 25: 1-P-values for Regressions

Explanatory Variable	New-large	New-small	Addition	Maximum
Intercept	1.0000	1.0000	0.3391	1.0000
Trend	0.9130	0.7696	0.9829	0.9829
Rural	0.2270	0.8375	0.2477	0.8375
JHS	0.9577	0.1002	0.9800	0.9800
SHS	0.3630	0.2501	0.3157	0.3630
VOC	0.9134	0.7498	0.5838	0.9134
PW	0.4757	0.7744	0.6637	0.7744
PW--Rural Interaction	0.6727	0.3669	0.1513	0.6727

The question of variable significance may be a non-issue. The data analyzed may be thought of as a population, not a sample. Significance tests deal with sampling error. If an analyst is working with the population of data, there is no sample and no sampling error. Therefore, significance tests are not necessary. This may be acceptable if inference is not the goal of the analysis. The results apply to the data set analyzed and that data set only. If the results are to be applied outside of the data set used to calculate the regression equation, then the data set must be treated as a sample and statistical significance is a relevant concern.

Section A.10 Appendix 3

(a) Background Statistics on School Construction
(based on data from F.W. Dodge)

(i) Table 26: General Contract Value by Project Type (dollars in millions)

	New Construction		Additions		Alterations		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	24	$64.6	58	$95.1	125	$68.4	207	$228.1
1993	34	$153.4	60	$80.4	154	$41.5	248	$275.2
1994	50	$110.6	73	$120.9	153	$62.3	276	$293.8
1995	42	$225.6	52	$113.4	150	$41.5	244	$380.6
1996	61	$242.7	63	$146.0	119	$62.8	243	$451.5
1997	49	$172.7	62	$181.8	102	$41.7	213	$396.2
1998	29	$208.5	68	$160.1	218	$78.2	315	$446.9
1999	39	$363.8	92	$234.5	150	$121.5	281	$719.8
2000	48	$474.2	67	$241.3	115	$109.0	230	$824.5
2001	74	$832.4	82	$377.7	108	$131.8	264	$1,341.9
Total	450	$2,848.4	677	$1,751.2	1,394	$758.8	2,521	$5,358.5

(ii) Table 27: General Contract Value by Project Type (shares of totals)

	New Construction		Additions		Alterations	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	11.6%	28.3%	28.0%	41.7%	60.4%	30.0%
1993	13.7%	55.7%	24.2%	29.2%	62.1%	15.1%
1994	18.1%	37.6%	26.4%	41.2%	55.4%	21.2%
1995	17.2%	59.3%	21.3%	29.8%	61.5%	10.9%
1996	25.1%	53.8%	25.9%	32.3%	49.0%	13.9%
1997	23.0%	43.6%	29.1%	45.9%	47.9%	10.5%
1998	9.2%	46.7%	21.6%	35.8%	69.2%	17.5%
1999	13.9%	50.5%	32.7%	32.6%	53.4%	16.9%
2000	20.9%	57.5%	29.1%	29.3%	50.0%	13.2%
2001	28.0%	62.0%	31.1%	28.1%	40.9%	9.8%
Total	17.9%	53.2%	26.9%	32.7%	55.3%	14.2%

(iii) Table 28: General Contract Value by Location (dollars in millions)

	Urban		Rural		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	141	$130.9	66	$97.2	207	$228.1
1993	189	$243.7	59	$31.6	248	$275.2
1994	200	$208.2	76	$85.5	276	$293.8
1995	177	$340.9	67	$39.7	244	$380.6
1996	181	$297.5	62	$154.0	243	$451.5
1997	168	$312.6	45	$83.6	213	$396.2
1998	198	$332.0	117	$114.9	315	$446.9
1999	192	$462.5	89	$257.3	281	$719.8
2000	172	$551.4	58	$273.2	230	$824.5
2001	186	$851.1	78	$490.8	264	$1,341.9
Total	1,804	$3,730.8	717	$1,627.7	2,521	$5,358.5

(iv) Table 29: General Contract Value by Location (shares of totals)

	Urban		Rural	
Year	Projects	General Contract Value	Projects	General Contract Value
1992	68.1%	57.4%	31.9%	42.6%
1993	76.2%	88.5%	23.8%	11.5%
1994	72.5%	70.9%	27.5%	29.1%
1995	72.5%	89.6%	27.5%	10.4%
1996	74.5%	65.9%	25.5%	34.1%
1997	78.9%	78.9%	21.1%	21.1%
1998	62.9%	74.3%	37.1%	25.7%
1999	68.3%	64.3%	31.7%	35.7%
2000	74.8%	66.9%	25.2%	33.1%
2001	70.5%	63.4%	29.5%	36.6%
Total	71.6%	69.6%	28.4%	30.4%

(v) Table 30: General Contract Value
Urban Projects by Type (dollars in millions)

	New Construction		Additions		Alterations		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	13	$25.8	34	$43.3	94	$61.8	141	$130.9
1993	24	$135.9	45	$70.2	120	$37.5	189	$243.7
1994	32	$65.4	52	$93.4	116	$49.4	200	$208.2
1995	31	$208.5	39	$100.2	107	$32.2	177	$340.9
1996	38	$148.3	44	$108.4	99	$40.7	181	$297.5
1997	38	$137.5	41	$136.3	89	$38.9	168	$312.6
1998	19	$152.4	48	$131.4	131	$48.2	198	$332.0
1999	24	$209.2	63	$172.1	105	$81.2	192	$462.5
2000	30	$286.5	48	$190.8	94	$74.1	172	$551.4
2001	45	$525.9	51	$241.2	90	$84.1	186	$851.1
Total	294	$1,895.4	465	$1,287.3	1,045	$548.1	1,804	$3,730.8

(vi) Table 31: General Contract Value
Urban Projects by Type (shares of totals)

	New Construction		Additions		Alterations	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	9.2%	19.7%	24.1%	33.1%	66.7%	47.2%
1993	12.7%	55.8%	23.8%	28.8%	63.5%	15.4%
1994	16.0%	31.4%	26.0%	44.9%	58.0%	23.7%
1995	17.5%	61.2%	22.0%	29.4%	60.5%	9.5%
1996	21.0%	49.9%	24.3%	36.4%	54.7%	13.7%
1997	22.6%	44.0%	24.4%	43.6%	53.0%	12.4%
1998	9.6%	45.9%	24.2%	39.6%	66.2%	14.5%
1999	12.5%	45.2%	32.8%	37.2%	54.7%	17.6%
2000	17.4%	52.0%	27.9%	34.6%	54.7%	13.4%
2001	24.2%	61.8%	27.4%	28.3%	48.4%	9.9%
Total	16.3%	50.8%	25.8%	34.5%	57.9%	14.7%

(vii) Table 32: General Contract Value
Rural Projects by Type (dollars in millions)

	New Construction		Additions		Alterations		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	11	$38.8	24	$51.7	31	$6.7	66	$97.2
1993	10	$17.5	15	$10.2	34	$3.9	59	$31.6
1994	18	$45.2	21	$27.5	37	$12.9	76	$85.5
1995	11	$17.1	13	$13.2	43	$9.3	67	$39.7
1996	23	$94.4	19	$37.6	20	$22.0	62	$154.0
1997	11	$35.3	21	$45.5	13	$2.8	45	$83.6
1998	10	$56.1	20	$28.7	87	$30.1	117	$114.9
1999	15	$154.6	29	$62.4	45	$40.3	89	$257.3
2000	18	$187.6	19	$50.6	21	$34.9	58	$273.2
2001	29	$306.5	31	$136.6	18	$47.7	78	$490.8
Total	156	$953.0	212	$464.0	349	$210.7	717	$1,627.7

(viii) Table 33: General Contract Value
Rural Projects by Type (shares of totals)

	New Construction		Additions		Alterations	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	16.7%	39.9%	36.4%	53.2%	47.0%	6.9%
1993	16.9%	55.4%	25.4%	32.2%	57.6%	12.4%
1994	23.7%	52.8%	27.6%	32.1%	48.7%	15.1%
1995	16.4%	43.2%	19.4%	33.4%	64.2%	23.4%
1996	37.1%	61.3%	30.6%	24.4%	32.3%	14.3%
1997	24.4%	42.2%	46.7%	54.5%	28.9%	3.4%
1998	8.5%	48.8%	17.1%	25.0%	74.4%	26.2%
1999	16.9%	60.1%	32.6%	24.2%	50.6%	15.7%
2000	31.0%	68.7%	32.8%	18.5%	36.2%	12.8%
2001	37.2%	62.4%	39.7%	27.8%	23.1%	9.7%
Total	21.8%	58.5%	29.6%	28.5%	48.7%	12.9%

(ix) Table 34: General Contract Value

New Construction by Location (dollars in millions)

	Urban		Rural		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	13	$25.8	11	$38.8	24	$64.6
1993	24	$135.9	10	$17.5	34	$153.4
1994	32	$65.4	18	$45.2	50	$110.6
1995	31	$208.5	11	$17.1	42	$225.6
1996	38	$148.3	23	$94.4	61	$242.7
1997	38	$137.5	11	$35.3	49	$172.7
1998	19	$152.4	10	$56.1	29	$208.5
1999	24	$209.2	15	$154.6	39	$363.8
2000	30	$286.5	18	$187.6	48	$474.2
2001	45	$525.9	29	$306.5	74	$832.4
Total	294	$1,895.4	156	$953.0	450	$2,848.4

(x) Table 35: General Contract Value

New Construction by Location (shares of totals)

	Urban		Rural	
Year	Projects	General Contract Value	Projects	General Contract Value
1992	54.2%	39.9%	45.8%	60.1%
1993	70.6%	88.6%	29.4%	11.4%
1994	64.0%	59.2%	36.0%	40.8%
1995	73.8%	92.4%	26.2%	7.6%
1996	62.3%	61.1%	37.7%	38.9%
1997	77.6%	79.6%	22.4%	20.4%
1998	65.5%	73.1%	34.5%	26.9%
1999	61.5%	57.5%	38.5%	42.5%
2000	62.5%	60.4%	37.5%	39.6%
2001	60.8%	63.2%	39.2%	36.8%
Total	65.3%	66.5%	34.7%	33.5%

(xi) Table 36: General Contract Value Additions by Location (dollars in millions)

	Urban		Rural		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	34	$43.3	24	$51.7	58	$95.1
1993	45	$70.2	15	$10.2	60	$80.4
1994	52	$93.4	21	$27.5	73	$120.9
1995	39	$100.2	13	$13.2	52	$113.4
1996	44	$108.4	19	$37.6	63	$146.0
1997	41	$136.3	21	$45.5	62	$181.8
1998	48	$131.4	20	$28.7	68	$160.1
1999	63	$172.1	29	$62.4	92	$234.5
2000	48	$190.8	19	$50.6	67	$241.3
2001	51	$241.2	31	$136.6	82	$377.7
Total	465	$1,287.3	212	$464.0	677	$1,751.2

(xii) Table 37: General Contract Value Additions by Location (shares of totals)

	Urban		Rural	
Year	Projects	General Contract Value	Projects	General Contract Value
1992	58.6%	45.6%	41.4%	54.4%
1993	75.0%	87.4%	25.0%	12.6%
1994	71.2%	77.3%	28.8%	22.7%
1995	75.0%	88.3%	25.0%	11.7%
1996	69.8%	74.3%	30.2%	25.7%
1997	66.1%	75.0%	33.9%	25.0%
1998	70.6%	82.1%	29.4%	17.9%
1999	68.5%	73.4%	31.5%	26.6%
2000	71.6%	79.0%	28.4%	21.0%
2001	62.2%	63.8%	37.8%	36.2%
Total	68.7%	73.5%	31.3%	26.5%

(xiii) Table 38: General Contract Value Alterations by Location (dollars in millions)

	Urban		Rural		Total	
Year	Projects	General Contract Value	Projects	General Contract Value	Projects	General Contract Value
1992	94	$61.8	31	$6.7	125	$68.4
1993	120	$37.5	34	$3.9	154	$41.5
1994	116	$49.4	37	$12.9	153	$62.3
1995	107	$32.2	43	$9.3	150	$41.5
1996	99	$40.7	20	$22.0	119	$62.8
1997	89	$38.9	13	$2.8	102	$41.7
1998	131	$48.2	87	$30.1	218	$78.2
1999	105	$81.2	45	$40.3	150	$121.5
2000	94	$74.1	21	$34.9	115	$109.0
2001	90	$84.1	18	$47.7	108	$131.8
Total	1,045	$548.1	349	$210.7	1,394	$758.8

(xiv) Table 39: General Contract Value Alterations by Location (shares of totals)

	Urban		Rural	
Year	Projects	General Contract Value	Projects	General Contract Value
1992	75.2%	90.3%	24.8%	9.7%
1993	77.9%	90.5%	22.1%	9.5%
1994	75.8%	79.3%	24.2%	20.7%
1995	71.3%	77.6%	28.7%	22.4%
1996	83.2%	64.9%	16.8%	35.1%
1997	87.3%	93.2%	12.7%	6.8%
1998	60.1%	61.6%	39.9%	38.4%
1999	70.0%	66.8%	30.0%	33.2%
2000	81.7%	67.9%	18.3%	32.1%
2001	83.3%	63.8%	16.7%	36.2%
Total	75.0%	72.2%	25.0%	27.8%

Section A.11 Appendix 4

(a) Wage Data from the Current Population Survey

An earlier section discussed trends in the Ohio construction industry using information from the Bureau of Labor Statistics. Information was available for the broad categories "Construction" and "Special Trades Contractors." This section makes use of information collected through the Current Population Survey to provide some detail about wages for specific trades.

The Current Population Survey (CPS) is a monthly survey of about 50,000 households conducted by the Bureau of the Census for the Bureau of Labor Statistics. The survey is conducted through a scientifically selected sample designed to represent the civilian noninstitutional population. The survey provides estimates for the nation as a whole and serves as part of model-based estimates for individual states and other geographic areas. Estimates obtained from the CPS include employment, unemployment, earnings, hours of work, and other indicators. They are available by a variety of demographic characteristics including age, sex, race, marital status, and educational attainment. They are also available by occupation, industry, and class of worker.

LSC was able to obtain micro-level data from the CPS using the Federal Electronic Research and Review Extraction Tool (FERRET). Through FERRET, LSC was able to extract information from the survey responses of Ohio construction workers. Data was obtained for the years 1994 through 2001. Although the data obtained was from a scientifically selected sample designed to represent the national civilian noninstitutional population, the data obtained is not a representative sample of Ohio construction workers. Nevertheless, the data does provide information about Ohio construction wages by trades before and after the prevailing wage exemption.

The information obtained included the individual's hourly pay rate, union membership status, and industry code. Hourly pay rate was inflated to December 2001. Tables 40, 41, and 42 present a breakdown of inflation adjusted pay rates by union status and industry code before (pre exemption) and after (post exemption) August 1997. Table 43 presents a similar breakdown of the union wage premium.[64]

No claims of causality can be made, but the tables are generally in line with the findings of the Kessler and Katz paper. The data indicate a decline in real (inflation adjusted) construction wages. Construction wages were 5.7 percent

[64] *The union wage premium is the percent by which the wages of union members in a given occupation exceed the wages of non-members.*

lower in the post-exemption period. Union wages were 7.8 percent lower and non-union wages were 1.2 percent lower. The average union wage premium fell from 57.8 percent to 47.3 percent.

Table 44 provides information on the number of observations used in constructing the other tables. As mentioned above, the data obtained through the FERRET was from a scientifically selected sample designed to represent the national noninstitutional population. The data obtained is not a representative sample of Ohio construction workers. This accounts for the difference between the growth in real wages reported in the BLS data and the decline in real wages reported in the data obtained through the FERRET. Additionally, many of the cells in Table 44 have small numbers indicating that the averages in the other tables are based on a small number of observations. The data provide some information, but are not without weaknesses, so any conclusions are tentative and must be interpreted with caution.

The data extracted from the CPS is not a representative sample of Ohio construction workers, but it does describe the experiences of some Ohio construction workers before and after the exemption. The data indicate a general decline in real (inflation adjusted) construction wages. This is different from the evidence presented in the Ohio data from the Bureau of Labor Statistics. That data is from surveys designed to yield results representative of Ohio. The CPS data obtained by LSC is not representative of Ohio, but indicates the experiences of some individuals in Ohio. In the CPS data, workers indicating a union affiliation experienced a greater decline, although this was not necessarily true for specific union workers. The union wage premium for Ohio construction workers in general also declined; although, again it did not decline for workers in all trades. As with the data from the Bureau of Labor Statistics, it is not possible to discern a specific impact on school construction workers.

(i) Table 40: Hourly Pay Rate for All Construction Workers

	Pre Exemption	Post Exemption	Percent Difference
Supervisors, carpenters and rel. workers	$14.98	$19.68	31.4%
Supervisors, electricians and power transmission installers	$19.90	$21.62	8.7%
Supervisors, painters, paperhangers, and plasterers	$11.62	$10.99	-5.5%
Supervisors, plumbers, pipefitters, and steamfitters	$23.36	$26.04	11.4%
Supervisors, construction, n.e.c.	$17.96	$16.84	-6.2%
Brickmasons and stonemasons	$16.60	$16.10	-3.0%
Brickmason and stonemason apprentices	$15.57	$22.74	46.0%
Tile setters, hard and soft	$14.01	$6.83	-51.3%
Carpet installers	$10.34	$12.79	23.7%
Carpenters	$14.06	$15.00	6.6%
Carpenter apprentices		$9.66	
Drywall installers	$12.51	$11.07	-11.5%
Electricians	$18.35	$17.64	-3.9%
Electrician apprentices	$8.44	$12.45	47.5%
Electrical power installers and repairers	$5.78	$13.20	128.4%
Painters, construction and maintenance	$10.63	$16.08	51.3%
Paperhangers	$10.58	$24.01	126.9%
Plasterers	$14.49	$16.86	16.4%
Plumbers, pipefitters, and steamfitters	$19.72	$18.88	-4.2%
Plumber, pipefitter, and steamfitter apprentices	$9.24	$10.83	17.1%
Concrete and terrazzo finishers	$18.51	$15.35	-17.1%
Glaziers	$9.00	$23.10	156.5%
Insulation workers	$17.16	$17.41	1.4%
Paving, surfacing, and tamping equipment operators		$14.26	
Roofers	$12.70	$13.35	5.1%
Sheetmetal duct installers	$14.12	$20.37	44.3%
Structural metal workers	$19.91	$20.79	4.4%
Drillers, earth		$14.80	
Construction trades, n.e.c.	$13.92	$15.10	8.5%
Construction laborers		$12.25	
Overall Average	$15.59	$14.71	-5.7%

(ii) Table 41: Hourly Pay Rate for Union Workers

	Pre Exemption	Post Exemption	Percent Difference
Supervisors, carpenters and rel. workers	$16.01		
Supervisors, electricians and power transmission installers	$19.90	$27.89	40.2%
Supervisors, painters, paperhangers, and plasterers			
Supervisors, plumbers, pipefitters, and steamfitters	$29.11	$27.63	-5.1%
Supervisors, construction, n.e.c.	$19.45	$22.39	15.2%
Brickmasons and stonemasons	$20.27	$20.75	2.4%
Brickmason and stonemason apprentices			
Tile setters, hard and soft	$15.37	$8.93	-41.9%
Carpet installers			
Carpenters	$18.12	$20.05	10.7%
Carpenter apprentices		$10.03	
Drywall installers	$17.14	$13.95	-18.6%
Electricians	$21.12	$22.55	6.8%
Electrician apprentices	$9.18	$11.10	20.9%
Electrical power installers and repairers			
Painters, construction and maintenance	$10.27	$14.59	42.1%
Paperhangers			
Plasterers	$22.28	$21.88	-1.8%
Plumbers, pipefitters, and steamfitters	$25.46	$20.53	-19.4%
Plumber, pipefitter, and steamfitter apprentices	$10.65	$10.83	1.6%
Concrete and terrazzo finishers	$23.33	$19.24	-17.5%
Glaziers		$23.10	
Insulation workers	$21.94	$20.98	-4.3%
Paving, surfacing, and tamping equipment operators		$22.74	
Roofers	$18.31	$17.68	-3.4%
Sheetmetal duct installers	$16.46	$26.95	63.8%
Structural metal workers	$20.61	$23.09	12.0%
Drillers, earth		$17.29	
Construction trades, n.e.c.	$17.59	$16.47	-6.4%
Construction laborers		$16.20	
Overall Average	$20.24	$18.67	-7.8%

(iii) Table 42: Hourly Pay Rate for Non-Union Workers

	Pre Exemption	Post Exemption	Percent Difference
Supervisors, carpenters and rel. workers	$14.46	$19.68	36.1%
Supervisors, electricians and power transmission installers		$18.49	
Supervisors, painters, paperhangers, and plasterers	$11.62	$10.99	-5.5%
Supervisors, plumbers, pipefitters, and steamfitters	$17.61	$21.26	20.7%
Supervisors, construction, n.e.c.	$17.06	$15.61	-8.5%
Brickmasons and stonemasons	$14.23	$14.32	0.6%
Brickmason and stonemason apprentices	$15.57	$22.74	46.0%
Tile setters, hard and soft	$13.11	$5.78	-55.9%
Carpet installers	$10.34	$12.79	23.7%
Carpenters	$12.77	$12.81	0.3%
Carpenter apprentices		$9.28	
Drywall installers	$11.66	$10.62	-9.0%
Electricians	$12.80	$14.10	10.2%
Electrician apprentices	$7.95	$14.48	82.1%
Electrical power installers and repairers	$5.78	$13.20	128.4%
Painters, construction and maintenance	$10.66	$16.41	53.9%
Paperhangers	$10.58	$24.01	126.9%
Plasterers	$11.89	$14.35	20.7%
Plumbers, pipefitters, and steamfitters	$13.24	$16.01	21.0%
Plumber, pipefitter, and steamfitter apprentices	$7.83		
Concrete and terrazzo finishers	$12.90	$13.89	7.7%
Glaziers	$9.00		
Insulation workers	$12.39	$10.26	-17.1%
Paving, surfacing, and tamping equipment operators		$12.56	
Roofers	$10.29	$12.67	23.1%
Sheetmetal duct installers	$12.95	$18.18	40.4%
Structural metal workers	$15.70	$16.19	3.1%
Drillers, earth		$13.55	
Construction trades, n.e.c.	$12.08	$13.18	9.1%
Construction laborers		$10.38	
Overall Average	$12.82	$12.67	-1.2%

(iv) Table 43: Union Wage Premium

	Pre Exemption	Post Exemption	Difference	Percent Difference
Supervisors, carpenters and rel. workers	10.7%			
Supervisors, electricians and power transmission installers		50.8%		
Supervisors, painters, paperhangers, and plasterers				
Supervisors, plumbers, pipefitters, and steamfitters	65.3%	29.9%	-35.3%	-54.1%
Supervisors, construction, n.e.c.	14.0%	43.5%	29.5%	210.7%
Brickmasons and stonemasons	42.4%	44.9%	2.5%	5.9%
Brickmason and stonemason apprentices				
Tile setters, hard and soft	17.3%	54.7%	37.4%	216.0%
Carpet installers				
Carpenters	41.9%	56.6%	14.7%	35.1%
Carpenter apprentices		8.1%		
Drywall installers	47.0%	31.4%	-15.6%	-33.2%
Electricians	65.0%	59.9%	-5.1%	-7.8%
Electrician apprentices	15.4%	-23.4%	-38.8%	-252.0%
Electrical power installers and repairers				
Painters, construction and maintenance	-3.7%	-11.1%	-7.4%	199.2%
Paperhangers				
Plasterers	87.4%	52.5%	-34.9%	-40.0%
Plumbers, pipefitters, and steamfitters	92.3%	28.2%	-64.1%	-69.5%
Plumber, pipefitter, and steamfitter apprentices	36.0%			
Concrete and terrazzo finishers	80.9%	38.5%	-42.3%	-52.4%
Glaziers				
Insulation workers	77.1%	104.4%	27.4%	35.5%
Paving, surfacing, and tamping equipment operators		81.0%		
Roofers	78.0%	39.5%	-38.4%	-49.3%
Sheetmetal duct installers	27.1%	48.3%	21.1%	77.8%
Structural metal workers	31.3%	42.7%	11.4%	36.5%
Drillers, earth		27.6%		
Construction trades, n.e.c.	45.6%	24.9%	-20.6%	-45.3%
Construction laborers		56.0%		
Overall Average	57.8%	47.3%	-10.5%	-18.1%

(v) Table 44: Number of Observations

	Pre-exemption			Post-exemption		
	Union	Nonunion	Combined	Union	Nonunion	Combined
Supervisors, carpenters and rel. workers	1	2	3		1	1
Supervisors, electricians and power transmission installers	3		3	1	2	3
Supervisors, painters, paperhangers, and plasterers		2	2		1	1
Supervisors, plumbers, pipefitters, and steamfitters	1	1	2	3	1	4
Supervisors, construction, n.e.c.	23	38	61	8	36	44
Brickmasons and stonemasons	9	14	23	5	13	18
Brickmason and stonemason apprentices		2	2		1	1
Tile setters, hard and soft	2	3	5	1	2	3
Carpet installers		6	6		1	1
Carpenters	30	94	124	43	99	142
Carpenter apprentices				2	2	4
Drywall installers	2	11	13	3	19	22
Electricians	34	17	51	31	43	74
Electrician apprentices	2	3	5	3	2	5
Electrical power installers and repairers		1	1		2	2
Painters, construction and maintenance	2	24	26	7	32	39
Paperhangers		1	1		1	1
Plasterers	1	3	4	1	2	3
Plumbers, pipefitters, and steamfitters	26	23	49	28	16	44
Plumber, pipefitter, and steamfitter apprentices	2	2	4	3		3
Concrete and terrazzo finishers	7	6	13	3	8	11
Glaziers		1	1	1		1
Insulation workers	4	4	8	6	3	9
Paving, surfacing, and tamping equipment operators				1	5	6
Roofers	12	28	40	5	32	37
Sheetmetal duct installers	1	2	3	1	3	4
Structural metal workers	12	2	14	8	4	12
Drillers, earth				1	2	3
Construction trades, n.e.c.	7	14	21	21	15	36
Construction laborers				85	180	265
Total	181	304	485	271	528	799

Section A.12 Appendix 5

(a) An Example of an Omitted Variable Regression Analysis Including SFC Funding

LSC used information available in the Annual Reports of the Ohio School Facilities Commission to create a dummy variable equal to 1 if a project received SFC funding and equal to 0 if it did not. Including this variable allows for the possible effect that receiving such funding may have on project cost. The Annual Report contained information on amounts distributed to school districts each year. The information included the county in which the district was located. The data LSC obtained from F.W. Dodge did not include district names, but did include county. The attempt to match-up the two sources of information was made difficult because the amounts distributed by SFC to a district may be used on more than one project that may have more than one starting date. Because of the possibility of over-identifying (designating a project as receiving SFC funding when it did not) or under-identifying (designating a project as not receiving SFC funding when it did) SFC projects, the results of the regression run with this variable were not used in the body of this report. They are presented here as an example of the effects of an omitted variable.

The regression including the SFC dummy variable was run on the new- large data subset only. Table 45, below, presents the coefficient estimates from that regression along with the estimates from the regression on the same data set without the SFC variable. The positive coefficient on the SFC variable indicates that School Facilities Commission funding is associated with higher project costs.

(i) Table 45: Effect of Including SFC Variable

	without SFC	*with SFC*	*Change*
Intercept	86.64	86.43	-0.21
Trend	0.14	0.14	-0.01
Rural	0.98	-0.41	-1.40
JHS	6.78	6.70	-0.09
SHS	1.52	1.22	-0.29
VOC	15.17	15.48	0.31
SFC		3.56	
PW	3.99	4.50	0.51
PW - Rural Interaction	-5.54	-4.13	1.41

Including the SFC variable had small negative effects on the estimated coefficient for trend variable and the JHS variable and larger negative effects on the estimated coefficient for the Rural and SHS variables. Including the SFC variable increased the estimated coefficients on the PW variable and the interaction of the PW and Rural variables. These increases will act to increase the estimated savings due to the prevailing wage exemption. Table 46, below, presents the effect of the change in estimated coefficients on estimated savings.

(ii) Table 46: Effect of Estimated Savings

Year	without SFC	with SFC	Change
1997	$1,451.5	$1,992.5	$540.9
1998	$4,282.3	$6,462.8	$2,180.5
1999	$3,131.4	$7,972.4	$4,841.0
2000	$4,622.3	$10,654.0	$6,031.7
2001	$12,204.0	$20,717.8	$8,513.8
Total	$25,691.5	$47,799.4	$22,107.9

If the SFC variable is omitted, 85 out of the 164 new-large projects undertaken after the prevailing wage exemption are estimated to have savings. If the SFC variable is included, all 164 projects are estimated to have savings. This analysis suggests that omitting the SFC variable from the regression used in the main body of the report results in a savings estimate that is downwardly biased.

ABOVE the LAW:

How Government Unions' Extralegal Privileges Are Harming Public Employees, Taxpayers and the State

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Yankee Letter

Connecticut has so many advantages — including an educated population, a prime location midway between Manhattan and Boston, and a quality of life that's hard to beat. Why, then, is the Constitution State mired in debt, and shedding both residents and jobs? The primary reason: Outsized power wielded by government unions.

Government unions' dominance in Hartford has led to a two-tiered system of laws — one that unfairly advantages government unions at the expense of ordinary citizens, and erodes the legitimate power of elected lawmakers.

As a result, Connecticut suffers from a litany of ills including high taxes; high debt; the worst pension liabilities in the nation; the highest differential between private and public sector pay; and the slowest job growth in the nation.

This report details the laws and practices that have created this disparity between government unions and the rest of us. It also compares Connecticut to our neighboring states - and the comparison is not a flattering one. Even in a union-friendly region, Connecticut is an outlier in how much power it cedes to its government unions.

We hope this paper illustrates the types of changes that Connecticut needs to make to get back on track. Common sense reforms can help Connecticut realize its potential once again, with thriving residents and a flourishing state economy.

The Sinking State of Connecticut

After a combative legislative season in 2017, Connecticut took two steps forward and one step back in the area of public sector labor law. In a victory for taxpayers, legislators repealed a unique provision that had allowed new government worker contracts to go into effect without legislative action— the "deemed approved" provision. However, at the same time, the General Assembly changed elements of binding arbitration — the procedure used to overcome negotiation impasses on contracts — to favor already-privileged government unions.

Although it is encouraging to see the state address long-standing, costly issues in labor law, much work remains to be done. Connecticut is still falling behind due to numerous laws that advantage state and local government unions at the expense of ordinary citizens. This reality is reflected in the high fixed costs in the state's budget. In 2006, fixed costs constituted only 37 percent of the state's budget; by 2018, that amount was 53 percent.[1] Most of these fixed costs – including payroll, state employee and teacher pensions, and retiree health care costs - pertain to employee compensation. The high cost of government in Connecticut has spawned a poor business climate, high taxes, and the outmigration of residents. Below is a glimpse of the state's ebbing fortunes.

Borgeson Universal Steering Components is a small business that manufactures parts for the automotive, aerospace, military and other industries. A pillar of its community, Borgeson has employed 43 full-time workers. But in 2015, its owner Gerald Zordan decided he had no choice but to uproot the century-old business in the modest city of Torrington—population 35,000—and relocate to South Carolina.[2]

A small business leaving a small town barely registers as news, except for local residents. But then a year later, in 2016, General Electric relocated to Boston.[3] And in 2017, Alexion Pharmaceuticals—which had been offered $26 million in state aid—also decided to move its headquarters to Boston.[4] Connecticut is bleeding tax-paying, job-creating businesses; the main reason is the state's business and economic climate, according to GE, Alexion, and Borgeson Universal. Zordan, who once served as Torrington's interim mayor, said: "Taxes up here are getting outrageous and it's not just Torrington, it's the whole state."

Indeed, during Governor Dannel P. Malloy's first term, taxes increased in 2011 by a record $2.5 billion, which included a 20 percent surcharge on corporate profits.[5] In 2015, another $1

1 Connecticut Office of Fiscal Analysis. Fiscal Accountability Presentation. November 30, 2016, https://www.cga.ct.gov/ofa/Documents/year/ FF/2017FF-20161130_Fiscal%20Accountability%20Presentation%20FY%2017%20-%20FY%2020.pdf.

2 *The Register-Citizen*, "Borgeson Universal Leaving Torrington for South Carolina," August 27, 2015, http://www.registercitizen.com/news/article/Borgeson-Universal-leaving-Torrington-for-South-11993741.php.

3 Patrick Gleason, "General Electric Shipping Up to Boston, and Connecticut Only Has Itself to Blame," *Forbes*, January 17, 2016, https://www.forbes.com/sites/patrickgleason/2016/01/17/ge-departure/#5a06d3c450a1.

4 Stephen Singer, "Alexion Exits New Haven For Boston, Agrees To Repay Millions In State Aid," *Hartford Courant,* September 12, 2017, http://www.courant.com/news/connecticut/hc-alexion-moving-new-haven-boston-20170911-story.html.

5 Tami Luhby, "Tax Hikes on the Way for Connecticut Residents," *CNN Money*, May 6, 2011, http://money.cnn.com/2011/05/04/news/economy/connecti- cut_raises_taxes/index.htm.

billion hike followed.[6] Connecticut's taxes are so onerous that the Tax Foundation ranks it a dismal 44th in the nation for tax burden, and the second-worst—49th—for property taxes.[7] Astronomical taxes feed into high living costs, and drive people from the state. According to the Census Bureau, Connecticut was one of only eight states in 2016 to lose population, and that out-migration is increasing in pace. Between July 2015 and July 2016, nearly 30,000 people left— more than double the figure just five years earlier.[8]

Population loss, exorbitant taxes, and other factors are now impeding the state's ability to raise funding for government programs. A joint analysis by the Office of Policy and Management and the Office of Fiscal Analysis showed a combined downward revision of $1.6 billion in projected tax revenues for fiscal years 2018 and 2019, compared to estimates provided just five months earlier.[9]

By mid-October 2017, the repeating crisis of how to fund Connecticut's unaffordable government costs culminated in a state budget impasse that spanned well over 100 days. At least one school district was forced to postpone opening day; another started laying off teachers and staff. Others have been delaying hiring and deferring repairs. Lawmakers were tasked with closing a $5.1 billion deficit for the 2018 and 2019 fiscal years.[10] Just since a budget was passed in late October 2017, a $200 million gap has already opened up for fiscal year 2018. And a $4.6 billion deficit is projected for the FY 2020 and 2021 budget.[11] In short, after two record-breaking tax increases, there is not enough public money for the state to operate its schools, fire and police departments, and to provide other basic services. A telling reminder of the state's dwindling resources came in Gov. Malloy's fourth budget proposal calling for a cut of $132 million in state education funds, which would have likely forced local authorities to raise property taxes to make up the shortfall.[12]

Connecticut's capital may be a harbinger of what is in store for the state. Hartford barely avoided a bankruptcy filing this fall after receiving a bailout from the state.[13] The city - like the state - is plagued by high per-employee labor costs and high debt, leading to high taxes.[14] A September 7, 2017 letter from the city's mayor and fellow officials to the Governor and others, warning of bankruptcy, noted that city officials "cannot tax our way out of this crisis. Our property taxes on commercial property are the highest in the State and may be the highest in the nation. With a mill rate of 74.29, our long-term growth and sustainability depends on reducing, not raising, the property tax."[15] The letter cites a Moody's Investors Service FAQ report, which warned

6 Keith Phaneuf, "Legislators Vote to Roll Back a Share of CT Business Tax Hikes," *CT Mirror,* June 29, 2015, https://ctmirror.org/2015/06/29/ct-lawmakers-begin-final-process-of-rolling-back-business-tax-hikes/.

7 Jared Walczak *et al.,* "2018 State Business Tax Climate Index," *Tax Foundation,* October 17, 2017, https://files.taxfoundation.org/20171016171625/SBT-CI_2018.pdf, p. 3.

8 Mara Lee, "Census Bureau Says State Population Decline is Accelerating," *Hartford Courant,* December 25, 2016, http://www.courant.com/news/connecti- cut/hc-connecticut-population-fallingrecovered-wed-dec-21-105241-2016—20161220-story.html.

9 Author calculations comparing the January 17, 2017 Office of Policy and Management and Office of Fiscal Analysis joint report, "Total Taxes Less Refunds" line in Fiscal Years 2018 and 2019, http://www.ct.gov/opm/lib/opm/budget/consensusrevenue/fy2017/final_consensus_jan17_2017.pdf, to the updated report released May 1, 2017, http://www.ct.gov/opm/lib/opm/budget/consensusrevenue/fy2017/final_consensus_may1_2017.pdf.

10 Christine Stuart, "Connecticut Would Run A $94M Deficit Without a Budget In Place," *CTNewsJunkie.com,* http://www.ctnewsjunkie.com/archives/entry/connecticut_would_run_a_94m_deficit_without_a_budget_in_place/

11 Keith Phaneuf, "Big deficits two years from now could undercut tax cut promises," *CTMirror,* https://ctmirror.org/2017/11/02/big-deficits-two-years- from-now-could-undercut-tax-cut-promises/.

12 Marc E. Fitch, "Gov. Malloy Unveils Fourth Budget Proposal Amid Multiple Lawsuit Threats," *Yankee Institute,* October 16, 2017, http://www.yankeein-

stitute.org/2017/10/governor-malloy-unveils-4th-budget-proposal-amid-multiple-lawsuit-threats/.

13 Jenna Carlesso, "Moody's: Threat of Bankruptcy Removed But Hartford Remains 'High Risk,'" November 1, 2017, Hartford Courant, http://www.courant.com/community/hartford/hc-news-hartford-moodys-bankruptcy-20171101-story.html

14 Eide, Stephen, "Connecticut's Broken Cities," January 2017, Yankee Institute, http://www.yankeeinstitute.org/policy-papers/connecticuts-broken-cities-lay- ing-the-conditions-for-growth-in-poor-urban-communities/.

15 http://www.hartford.gov/images/mayors/news/Sept2017/2017.09.07%20City%20of%20Hartford%20Letter.pdf

that Hartford has "very little room for further cuts," and has already reduced services. The reportwentontocautionthatifbudgetswerec ut further, "Hartford would likely be eliminating, rather than reducing, core services."[16]

The warnings about Connecticut's financial health are coming from multiple sources. According to J.P. Morgan, Connecticut would have to devote 35 percentof its tax revenues over 30 years to pay for retiree pensions, health care, anddebtservicing.[17] Citingtherevenueproblems and growing economic weakness of the state, all three credit-rating agencies downgraded Connecticut's rating in May 2017 to single-A.[18] This gives the state one of the lowest ratings in the country, similar to Illinois and New Jersey. Truthin Accounting, whichassessesstatesusing their financial and actuarial reports, ranked Connecticut 48th, and estimated that $63.6 billion in mostly pension and retiree health care liabilities amounts to an eye-watering $49,500 in debt per taxpayer.[19]

In fact, Connecticut's pension liabilities for state and municipal government workers places it near the bottom nationally for the health of its public pension systems. According to the state's latest available numbers, Connecticut hasover $21.1 billion in unfunded pension liabilities for state employees, with the system just 36 percent funded as of 2017.[20]

Additionally, Connecticut's four major poor cities—Hartford, New Haven, Bridgeport and Waterbury—are burdened with about $1.5 billion in unfunded retirement liabilities. Add to that another $500 million in pension bonds that Bridgeport and Waterbury issued in a misguided attempt to meet those obligations, and the gap grows to $2 billion for the four cities. Those pension obligations are growing faster than tax revenues.[21]

16 Hartford Mayor Bronin, L. A., Treasurer Cloud, A. M., & President, Court of Common Council Clark, T. J., II. "City of Hartford's Finances" [Letter written September 7, 2017 to Honorable Dannel P. Malloy and Legislative Leaders]. Retrieved from http://www.hartford.gov/images/mayors/news/Sept2017/2017.09.07%20City%20of%20Hartford%20Letter.pdf

17 Michael Cembalest, "The ARC and the Covenants, 2.0: An Update on the Long-Term Credit Risk of US States," *J.P. Morgan*, May 19, 2016. https://www.jpmorgan.com/jpmpdf/1320702681156.pdf, p. 1.

18 Hillary Russ, "With S&P Downgrade, Connecticut Now Cut By All Three Rating Firms," *Reuters,* May 17, 2017, http://www.reuters.com/article/us-connecticut-downgrade/with-sp-downgrade-connecticut-now-cut-by-all-three-rating-firms-idUSKCN18D2N6.

19 Truth in Accounting, "Financial State of the States 2016," September 2017. http://www.truthinaccounting.org/library/doclib/FSOS-BOOKLET.pdf, p. 124.

20 Connecticut Office of Fiscal Analysis, "OFA Fact Sheet: State Employees Retirement System," August 2017, https://www.cga.ct.gov/ofa/Documents/year/SMF/2017SMF-20170817_State%20Employees%20Retirement%20System%20(August%202017).pdf.

21 Stephen D. Eide, "Connecticut's Broken Cities: Laying the Conditions for Growth in Poor Urban Communities," *Yankee Institute*, January 2017, http://www.yankeeinstitute.org/wp-content/uploads/2017/01/Broken-Cities-FINAL-for-WEB.pdf, p. 5.

Connecticut’sPension Liabilities

CONNECTICUT’S PENSION LIABILTIES [22]						
	2014 ($)	2015 ($)	2016 ($)	2017 ($)	Percent funded 2017(%)	Discount Rate (%)
SERF	16	16.5	23	21.1	36.25	6.9
TRF	10.8	10.8	13.1	13.1	56	8
JRF	0.16	0.18	0.24	0.24	46.91	6.9
OPEB	19.5	19.5	18.9	18.9	1.2	5.7*
Total	46.71	47.19	55.53	53.64		
* OPEB discount rate is blended based on 8.25% expected rate of return on assets and 4.5% return for cash holdings.						

So how did things get so catastrophic in Connecticut? Follow the threads of distressed cities, underfunded public pension systems, teacher layoffs, and overstretched government budgets, and one soon arrives at a common culprit: powerful government unions whose legal privileges permit them enormous clout over how Connecticut spends its tax dollars.

Pension, health care, and similar worker costs — along with a host of other government union privileges — are driving the deficits; it’s necessary to examine how those benefits get awarded in the first place—that is, through labor contract negotiations with several state, public safety, and other government unions. Examine the collective bargaining framework under which these unions operate in Connecticut, and it becomes quickly apparent that the government unions are not only a primary instigator of state and municipal fiscal woes, but a special interest grouping that works against the best interests of the public—and often, of public employees themselves.

22 All dollar figures in billions. Sources: State Employees’ Retirement Fund (SERF): http://www.osc.ct.gov/rbsd/reports/CT%20SERS%20GASB%2067%202017%20Report.FINAL.pdf; Teachers’ Retirement Fund (TRF): http://www.ct.gov/trb/lib/trb/formsandpubs/actuarial_valuation_rep_2016.pdf; Judges’ Retirement Fund (JRF): http://www.osc.ct.gov/rbsd/reports/11-14-17%20CT%20JFSMC-CRS%20GASB%2067%20Report%20-%202017%20FINAL.PDF; Other Post Employment Benefits/Re- tiree Health Care (OPEB): http://www.osc.ct.gov/empret/OPEBActuarialReports/OPEBreport2016.pdf.

A Common Culprit: Government Unions

Like its New England neighbors, New York, and much of the northeast, Connecticutisaforced-unionstate.Evengovernmentworkerswhochoose not to join must nonetheless pay "agency fees" to their workplace union, whichthegovernmenttakesdirectlyoutoftheirpaychecksandgivesinone lump sum to the union.

That means Connecticut has more government workers who are "represented" and pay a union than are actually members—69.4 percent of all public employees are represented by a government union with 67.1 percent as dues paying members, second only to New York state in the country.[23] Connecticut is also similar to other states regionally in that government entities are required by law to collectively bargain with the officially recognized union in their workplace over wages, hours and other work conditions.

One way to assess Connecticut's cost of government on a national scale is to look at its state and local tax burden. The Tax Foundation ranks states on that measure every year, and the latest report, from early 2016, deals with Fiscal Year 2012 numbers. While the U.S. average state and local tax burden is 9.9 percent of income, Connecticut's is 12.7 percent of state income – the nation's second-highest burden. New York has the dubious distinction of being number 1, and indeed, union-friendly states such as California, Illinois, and Maryland all have similarly high tax burdens.[24]

According to U.S. Census data from 2015, Connecticut had about 150,000 local employees and 78,000 state employees. The monthly cost per state citizen to support these workers is $313 when counting state and local government, or $198 when looking at local government only. That places Connecticut fifth in the nation in government employee costs and second among the seven states comprising New England and New York. Even considering that federal worker costs factor into those figures, the finding is significant: there are relatively few federal workers in Connecticut. Of the 190,948 full-time equivalent government employees[25] in the state, there were only 7,942 full-time, permanent federal employees among them.[26]

Not only are Connecticut's government employee costs a weighty taxpayer burden, they also exceed those of other states. A 2014 study from the American Enterprise Institute found that Connecticut's state workers' total compensation was 42 percent higher than that of similar private-sector workers—the highest differential in the country. New York's was 34 percent higher, while Rhode Island was at 24 percent. Maine's was 20 percent higher, and Massachusetts' 19 percent higher. New Hampshire and Vermont were 10 percent and 2 percent higherrespectively.[27]

A follow-up study examining Connecticut's state worker compensation determined that

23 Barry Hirsch and David Macpherson, "Union Membership, Coverage, Density, and Employment by State and Sector, 2016," unionstats.com.
24 TaxFoundation, "State-Local Tax Burden Rankings: FY 2012," 2016, https://files.taxfoundation.org/legacy/docs/State-Local_Tax_Burden_FY2012.pdf, p. 1.
25 U.S. Census Bureau, "State & Local Government and Employment Data," 2015, https://www.census.gov/data/tables/2015/econ/apes/annual-apes.html.
26 United States Office of Personnel Management, "Common Characteristics of the Government, Fiscal Year 2015," June 2016. https://www.opm.gov/poli- cy-data-oversight/data-analysis-documentation/federal-employment-reports/common-characteristics-of-the-government/ccog2015.pdf, p. 10.
27 Andrew Biggs and Jason Richwine, "Overpaid or Underpaid? A State-by-State Ranking of Public Employee Compensation," *American Enterprise Institute,* April 2014, http://www.aei.org/wp-content/uploads/2014/04/-biggs-overpaid-or-underpaid-a-statebystate-ranking-of-public-employee-compensa-tion_112536583046.pdf, p. 67.

retirement, healthandotherbenefitsconstituted the bulk of the costs—comparable private- sector salaries were, in fact, slightly lower for government workers. For example, the average state government worker receives $70,970 in salary and between $54,561 and $75,641 in retirement benefits, totaling between $125,531 and $146,611 in compensation. By contrast, a similarly educated and experienced private sector employee receives, on average, $71,112 in salary and only $29,371 in benefits each year, totaling $100,483 in compensation.[28]

But the advantages enjoyed by government unions aren't just financial — they also enjoy significant political dominance. Even in a region that is considered labor-friendly, Connecticut is consistently an outlier in how much authority it gives to government unions to achieve beneficial outcomes for themselves. The result is a state that is barely hanging on: Connecticut, once one of the nation's most economically vibrant and prosperous states, is now routinely beset by eroding tax receipts, declining population, and job losses.

Government Unions In Connecticut Are Above the Law

For decades, Connecticut's pro-government-union lawmakers have built a superstructure of state laws and regulations that provide government unions with special privileges that other states do not offer (and that taxpayers certainly do not enjoy).

Four main provisions place Connecticut government unions above the law:

- the ability to negotiate over pensions and other benefits;
- a wider scope of binding arbitration allowing unelected arbitrators to write contracts that have the force of law;
- new municipal contracts can be passively enacted without legislative approval, which also existed at the state level until fall 2017; and
- contract provisions that supersede state or local law.

Thanks to changes in the budget in late 2017, state union contracts can no longer be "deemed approved" without a vote. Unfortunately, however, in many cases the legislature still will not have the final say. Unelected arbitrators now have the power to impose contracts singlehandedly — even those rejected by Connecticut's representatives — and those contracts could still have the force of law.

28 Andrew Biggs, "Unequal Pay: Public Vs. Private Sector Compensation in Connecticut," *Yankee Institute,* September 2015, http://www.yankeeinstitute.org/policy-papers/unequal-pay/.

Five Major Privileges GovernmentUnions Enjoy That Harm Taxpayers and Public Employees

1 | BROADERCOLLECTIVEBARGAINING.

Although state legislatures in New England are generally union- friendly compared to other regions in the US, Connecticut is unique in New England in permitting unions to negotiate the level of pension, health and other benefits they receive. Every other state in the region sets the level of retirement benefits in state statute, or otherwise limits unions' ability to bargain over them (see chart in Appendix A).

(b) Pension benefits are particularly vulnerable to political manipulation because the bill doesnot come due for years or decades: officials promise benefits that are unsustainably high in the future, and then add insult to injury by underfunding pension systems year after year.

Indeed, only 16 states in 2015 had pension systems that were at least 80 percentfunded, resulting in an expected shortfall of about
$1.3 trillion across the nation.[29] Connecticut's latest available funding ratio of 37 percent, or $20.4 billion in unfunded liabilities as of June 2016,[30] puts it in the bottom five of states nationally.

Benefitcostscanbecome so unpredictable andonerous thatstates have begun experimenting with limiting the collective bargaining privileges that secure them. In 2011, for example, Massachusetts even restricted how much municipal employees could bargain over healthcare, in the face of spiraling benefit costs. As a result, by 2014, the cost savings of nearly $250 million for some 250 municipalities had exceeded projections.[31]

29 The Pew Charitable Trusts, "The State Pension Funding Gap: 2015," April 20, 2017, http://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2017/04/the-state-pension-funding-gap-2015. 30 Connecticut Office of Fiscal Analysis, "OFA FACT SHEET: STATE EMPLOYEES RETIREMENT SYSTEM," August 2017, https://www.cga.ct.gov/ofa/Documents/year/SMF/2017SMF-20170817_State%20Employees%20Retirement%20System%20(August%202017).pdf

31 Massachusetts Municipal Association, "Municipal Health Insurance Reform Yields $247M in Savings," June 10, 2014, https://www.mma.org/labor-and-personnel/13397-municipal-health-insurance-re- form-yields-247m-in- savings.

2 | WIDER BINDING ARBITRATION RULES.

When unions and government entities reach an ongoing impasse in negotiations in Connecticut, state law requires the sides to go to binding arbitration. Until new legislation was signed into law on October 31, 2017, state employee unions and/or the state could elect to go to binding arbitration, but if the award were rejected by a two-thirds majority of the General Assembly on grounds of insufficient funds, the matter returned to negotiations.[32]

The new changes actually worsen the law from a democratic perspective; now, the General Assembly may reject an initial agreement and send it to arbitration. If the legislature rejects the subsequent arbitration decision, it returns to arbitration yet again. But this time the second arbitrator's award is "deemed approved" by the General Assembly without a vote — and without even the two-thirds safeguard that existed in the previous "deemed approved" language. So even against the wishes of Connecticut's elected representatives, the provisions in a single arbitrator's award can carry the full force of law.[33]

The revisions to the law governing state workers means it more closely resembles statutes that cover other types of local and municipal public employees. At the municipal level, it is arbitrator(s) —not elected officials or taxpayers—who ultimately decide what labor agreement terms go into effect.

In one curious quirk that seems intended to offer local legislative bodies the illusion of authority, in the case of laws for municipal workers and teachers[34] (who comprise about 146,000, or nearly two-thirds, of the state's public employees),[35] the local legislative body does initially decide whether or not to approve an arbitrator's decision. But if the arbitrator's decision is rejected, the rejected issues then return to arbitration, where the unelected and unaccountable arbitrator makes the final, binding decision on the controversial provisions.

On the bright side, some positive adaptations to the binding arbitration process for municipal workers were also included in the 2017 budget bill. First, arbitrators must assume that 15 percent of a municipal employer's savings is unavailable to pay for cost items in any ensuing arbitration award. Second, the state has created a new 11-member Municipal Accountability Review Board to help oversee fiscal planning in distressed cities. In its purview is the same authority that local legislative bodies have to reject twice any arbitration award, a measure that may allow for more protection against unaffordable arbitration decisions.

Consistent with its other laws governing the public sector, Connecticut's binding arbitration laws are also more labor-friendly than similar laws in other states — binding arbitration is automatically triggered for municipal employees in the state if both parties cannot agree on a contract for an existing unit within 30 days or if there is no contract with a newly formed union in 180 days.[36] States that also

32 Collective Bargaining for State Employees, Conn. Gen. Stat. §§ 5-276a and 5-278, https://www.cga.ct.gov/current/pub/chap_068.htm. 33 June 2017 Special session Public Act 17-1 p.246 https://www.cga.ct.gov/2017/ACT/pa/pdf/2017PA-00001-R00HB-07501SS1-PA.pdf
34 Teacher Negotiation Act, Conn. Gen. Stat. §10-153f(c)7, http://www.ctdol.state.ct.us/csblr/stat10-153a.pdf; Municipal Employees Relations Act, Conn. Gen. Stat. §§ 7-473c(12)-(15), http://www.ctdol.state.ct.us/csblr/stat7-467.pdf.
35 U.S. Census Bureau, "Local Government: Employment and Payroll Data By State and By Function," March 2015, https://www.census.gov/data/tables/2015/ econ/apes/annual-apes.html.
36 Municipal Employees Relations Act 7-473c(b)1

have automatically-triggered binding arbitration limit it to narrower classes of employees: in Rhode Island, it is for public safety employees only such as police,[37] 911 dispatchers,[38] and firefighters;[39] Vermont provides the option of including it in contracts for judiciary employees.[40] New York,[41] Maine,[42] and Massachusetts[43] provide for binding arbitration when one or both sides request it; in New York's case, it can also be initiated by the state's Public Employment Relations Board for public safety and certain metropolitan transit workers.[44]

Even where there is binding arbitration, its scope is limited in other New England states: In Maine, it excludes salaries, pensions and insurance—basically any major monetary issue;[45] similarly, in Rhode Island, state and municipal employees have arbitration that is binding only on non-pecuniary matters.[46] New Hampshire does not even require any form of binding arbitration.[47] In short, Connecticut's binding arbitration rules are far more expansive than in other states in the region.

3 | "DEEMED APPROVED."

Another collective bargaining provision unique to Connecticut limits the exercise of legislative (and therefore citizen) power. For municipal workers and teachers, the relevant legislative body is required by state laws to approve new contracts with government workers and appropriate the funds necessary to execute those labor agreements. But language in the same statutes creates a

37 Municipal Police Arbitration Act, 28 R.I. Gen. Laws § 28-9.2-7, http://webserver.rilin.state.ri.us/Statutes/TITLE28/28-9.2/28-9.2-7.HTM.
38 911 Employees' Arbitration Act, 28 R.I. Gen. Laws § 28-9.6-7, http://webserver.rilin.state.ri.us/Statutes/TITLE28/28-9.6/28-9.6-7.HTM.
39 Firefighters' Arbitration Act, 28 R.I. Gen. Laws § 28-9.1-7, http://webserver.rilin.state.ri.us/Statutes/ TITLE28/28-9.1/28-9.1-7.HTM.
40 Judiciary Employees Labor Relations Act, Vt. Stat. Ann. tit. 3, § 1017(b), http://legislature.vermont.gov/statutes/section/03/028/01017.
41 Public Employees Fair Employment Act (Taylor Law), N.Y. Civil Service Law §§ 209 (4)(c) and (5)(a), http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO:.
42 Municipal Public Employees Labor Relations Law, Me. Stat. tit. 26, § 965(4), https://legislature.maine.gov/legis/statutes/26/title26sec965.html; State Employees Labor Relations Act, Me. Stat. tit. 26,
§ 979-D(4), https://legislature.maine.gov/legis/statutes/26/title26sec979-D.html; University of Maine System Labor Relations Act, Me. Stat. tit. 26, § 1026(4), http://legislature.maine.gov/legis/statutes/26/title26sec1026.html; Judicial Employees Labor Relations Act, Me. Stat. tit. 26, § 1285(4), http://legislature.maine.gov/legis/statutes/26/title26sec1285.html.
43 Labor Relations: Public Employees, Mass. Gen. Laws ch. 150E § 9, https://malegislature.gov/Laws/GeneralLaws/PartI/TitleXXI/Chapter150E/Section9.
44 See New York citation above.
45 See Maine citations above.
46 Organization of State Employees, 36 R.I. Gen. Laws § § 36-11-9(c), http://webserver.rilin.state.ri.us/Statutes/TITLE36/36-11/36-11-9.HTM; Municipal Employees' Arbitration Act, 28 R.I. Gen. Laws, § 28-9.4-13(a), http://webserver.rilin.state.ri.us/Statutes/TITLE28/28-9.4/28-9.4-13.HTM.
47 Public Employee Labor Relations, N.H. Rev. Stat. Ann. § 273-A:12, http://www.gencourt.state.nh.us/rsa/html/XXIII/273-A/273-A-12.htm.

significant loophole: if the local school district or municipal entity fails to act either way on new contracts, those agreements are "deemed approved" — they automatically go into effect.[48]

Promisingly, during budget negotiations in late 2017, lawmakers repealed the "deemed approved" provision for state workers, who are governed under their own statute. Now, if the General Assembly fails to vote on a new contract or arbitration award, it is "deemed rejected" instead of approved.[49] But as noted above, another troubling change threatens that reform: a collective bargaining agreement with the force of law can be imposed by an arbitrator if the legislature rejects it twice — and this second arbitration award is considered "deemed approved"bythe General Assemblywithouteven a vote. On the plus side, the General Assembly must now approve all new contracts, and future SEBAC agreements cannot exceed four years.[50] The automatic "deemed rejected" provision is a welcome and long-overdue reform for taxpayers. The General Assembly's Office of Legislative Research found that between 2002 and 2017, 124 of 189 collective bargaining agreements, arbitration awards, and contract revisions had passed through the "deemed approved" process. The Senate approved a further 10 agreements on which the House took no action.[51]

No other New England state has done so much to permit government unions to bypass the political and democratic process in order to appropriate scarce tax dollars. For Maine,[52] Massachusetts,[53] New Hampshire,[54] New York[55] and Vermont,[56] after the legislature rejects items requiring funding in a collective bargaining agreement, the measures or the contract itself must be renegotiated. Only Rhode Island gives authority to an unelected government agency that has the power to enact a collective bargaining agreement outside the legislative process.[57]— effectively what Connecticut has done in a more convoluted manner.

48 Teacher Negotiation Act, Conn. Gen. Stat. § 10-153d(b), http://www.ctdol.state.ct.us/csblr/stat10-153a.pdf; Municipal Employees Relations Act, Conn. Gen. Stat. § 7-474(b), http://www.ctdol.state.ct.us/csblr/stat7-467.pdf.

49 Collective Bargaining for State Employees, Conn. Gen. Stat. § 5-278(b)(3), https://www.cga.ct.gov/current/pub/chap_068.htm#sec_5-278.

50 Public Act 17-2, Connecticut General Assembly , Session Year 2017. https://www.cga.ct.gov/asp/CGABillStatus/cgabillstatus.asp?selBillType=Bill&bill_num=SB1502

51 Office of Legislative Research, "Collective Bargaining Agreements Presented to the General Assembly 2002-2017," May 23, 2017, https://www.cga.ct.gov/2017/rpt/pdf/2017-R-0111.pdf.

52 State Employees Labor Relations Act, Me. Stat. tit. 26, § 979-D (1)(E)(3), https://legislature.maine.gov/legis/statutes/26/title26sec979-D.html; University of Maine System Labor Relations Act, Me. Stat. tit. 26, § 1026 (1-A), http://legislature.maine.gov/legis/statutes/26/title26sec1026.html; Judicial Employees Labor Relations Act, Me. Stat. tit. 26, § 1285 (1)(E), http://legislature.maine.gov/legis/statutes/26/title26sec1285.html.

53 Labor Relations: Public Employees, Mass. Gen. Laws ch. 150E, § 7 (b) and (c), https://malegislature.gov/Laws/GeneralLaws/PartI/TitleXXI/Chapter150E/Section7.

54 Public Employee Labor Relations, N.H. Rev. Stat. Ann. § 273-A:3 (II) (b) and (c); http://www.gencourt.state.nh.us/rsa/html/XXIII/273-A/273-A-3.htm.

55 Public Employees Fair Employment Act (Taylor Law), N.Y. Civil Service Law § 204-a, http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO:.

56 State Employees Labor Relations Act, Vt. Stat. Ann. tit. 3, § 982 (c) and (d), http://legislature.vermont.gov/statutes/section/03/027/00982; Judiciary Employees Labor Relations Act, Vt. Stat. Ann. tit. 3, § 1036 (c), http://legislature.vermont.gov/statutes/section/03/028/01036; Independent Direct Support Providers, Vt. Stat. Ann. tit. 21, § 1639 (a), http://legislature.vermont.gov/statutes/section/21/020/01639; Early Care And Education Providers Labor Relations Act, Vt. Stat. Ann. tit. 33, § 3610 (a), http://legislature.vermont.gov/statutes/section/33/036/03610.

57 No legislative process is prescribed for approving contracts in Rhode Island's eight collective bargaining statutes.

4 | SUPERSEDENCE.

Connecticut's government unions enjoy one final, significant special privilege: wherever a conflict exists between a statute and a collective bargaining agreement, the collective bargaining agreement prevails.[58] Essentially, the collective bargaining agreementcarries the force of a duly-enacted law, even though the General Assembly has never voted on it or has outright rejected it. Only Massachusetts' government unions enjoy a similar special deal.[59] Maine, New Hampshire, Rhode Island, and New York do not address the issue explicitly in their collective bargaining laws. In Vermont, when state law conflicts with a labor contract involving municipal employees, the law prevails. If the contract conflicts with local code or regulation, the local legislative body can simply vote to approve the agreement, thereby superseding the law.[60] In this last case, however, elected representatives must intervene—as is appropriate—to allow such supersedence.

Ideally, state statute should determine the terms of a labor agreement, not vice versa. Where, as in Connecticut, a collective bargaining agreement always takes precedence over a statute, it allows an interest group (in the form of a government union) to circumvent the lawmaking process and win monetary or other privileges unavailable to other citizens. In other words, a special interest is essentially rewriting laws to its liking — in a deliberate subversion of the legislative (and democratic) process.

58 Collective Bargaining for State Employees, Conn. Gen. Stat. § 5-278(e), https://www.cga.ct.gov/current/pub/chap_068.htm#sec_5-278; Teacher Negotiation Act, Conn. Gen. Stat. § 10-153d(b), http:// www.ctdol.state.ct.us/csblr/stat10-153a.pdf; Municipal Employees Relations Act, Conn. Gen. Stat. § 7-474(f), http://www.ctdol.state.ct.us/csblr/stat7-467.pdf.

59 Labor Relations: Public Employees, Mass. Gen. Laws ch. 150E, § 7 (d), https://malegislature.gov/Laws/GeneralLaws/PartI/TitleXXI/Chapter150E/Section7.

60 Vermont Municipal Labor Relations Act, Vt. Stat. Ann. tit. 21, § 1725 (c), http://legislature.vermont.gov/statutes/section/21/022/01725.

5 | INDIVIDUAL WORKER RIGHTS AND UNION TRANSPARENCY.

No state in New England or New York does much to protect individual workers' First Amendment freedom of association rights. Although it is not explicitly set out in each state's law, each of the seven states permit unions to negotiate a resignation window into labor contracts. That means that once employees become union members, they cannot resign until a designated time period—often set at the end of a multi-year contract.[61]

Such a provision is also easy for unions to enforce because of another privilege all states in the region provide at the bargaining table: the automatic payroll deduction of union dues. No other private organization that may use its main source of funding (in this case, union dues) for political activities enjoys such a privilege;[62] in a very real sense, the state has become the bill collector for a single special interest.

In addition, every state except New Hampshire allows or mandates unions to organize a workplace by "card check,"[63] a process by which employees sign cards designating a particular union as their exclusive workplace representative. The process is not anonymous, which makes employees vulnerable to union intimidation. Generally, to decertify, or remove a union as workplace representative, at least 30 percent of employees must petition the state labor relations board for an election.[64]

Instead, employees should be protected in both instances: there should be an initial secret ballot election to select a particular union organization as representative, and then periodic elections to re-certify the same union. Another state changed the law in this respect by requiring annual elections wherein a majority of public employees in a bargaining unit—not just a majority of ballots—is required for a union to maintain its privilege of representing workers.[65]

Such a measure ensures that workers are able to select a union fairly, and remove that union promptly if it fails to address worker needs appropriately. America's elected representatives stand for reelection every two to six years; union organizations representing tens of thousands of publicly-funded workers should be held to the same standard.

Should the public want to attend contract negotiation sessions — perhaps to understand what terms officials are placing into collective bargaining agreements — they're often out of luck. In Connecticut[66] and New Hampshire,[6]

61 Author examination of several local- and state-level collective bargaining agreements by state that represent thousands of workers.

62 Collective bargaining laws for Connecticut and New York authorize government agency deduction of union dues. For Maine, Massachusetts, New Hampshire, Rhode Island and Vermont, the author examined several local- and state-level collective bargaining agreements by state.

63 Conn. Agencies Regs. §7-471-8 to 7-471-18, http://www.ctdol.state.ct.us/csblr/Regs-MERA.pdf; Conn. Agencies Regs. §5-273-9 to 5-273-21, http://www.ctdol.state.ct.us/csblr/Regs-StateEmployee.pdf; Bargaining Unit Composition and Representation Matters, 12 180 Me. Code R. 11 § 1-82, http://www.state. me.us/mlrb/mlrb_rules/chapter11.htm; Questions of Representation, 456 Mass. Code Regs. 14.01 to 14.21, http://www.mass.gov/lwd/labor-relations/regula- tions/456-cmr-table-of-contents.html; Bargaining Unit Certification, N.H. Code Admin. R. Lab. 301.01 to 301.04, https://www.nh.gov/pelrb/rules/301.htm; Rules of Procedure, N.Y. Comp. Codes R. & Regs. tit. 4, § 201-202, http://www.perb.ny.gov/PERBRules.asp#rep.; Rhode Island State Labor Relations Board, "General Rules and Regulations," January 1, 2016, http://www.rislrb.ri.gov/pdfs/rulesregs2016final.pdf.; Labor Relations for Teachers and Administrators, Vt. Stat. Ann. tit. 16, § 1992 (a), http://legislature.vermont.gov/statutes/chapter/16/057; State Employees Labor Relations Act, Vt. Stat. Ann. tit. 3, § 941, http://legislature.vermont.gov/statutes/chapter/03/027; Judiciary Employees Labor Relations Act, Vt. Stat. Ann. tit. 3, § 1021, http://legislature.vermont.gov/statutes/ chapter/03/028; Vermont Municipal Labor Relations Act, Vt. Stat. Ann. tit. 21, § 1724, http://legislature.vermont.gov/statutes/chapter/21/022; Independent Direct Support Providers, Vt. Stat. Ann. tit. 21, § 1635, http://legislature.vermont.gov/statutes/chapter/21/020; Early Care and Education Providers Labor Relations Act, Vt. Stat. Ann. tit. 33, § 3607, http://legislature.vermont.gov/statutes/chapter/33/036.

64 *Ibid.*

65 Wis. Stat. § 111.70(4)(d)3.b, https://docs.legis.wisconsin.gov/statutes/statutes/111/IV/70/4/d/3/b.

66 Freedom of Information Act, Conn. Gen. Stat. §§ 1-200 (C)(2) and 1-210 (b) (9), https://www.cga.ct.gov/current/pub/chap_014.htm. 67 Meetings Open to the Public, N.H. Rev. Stat. Ann. § 91-A:2 (I)(a), http://www.gencourt.state.nh.us/rsa/html/VI/91-A/91-A-2.htm.

such sessions are exempt from open meeting laws. Maine,[68] Massachusetts,[69] New York,[70] and Rhode Island[71] are only slightly better; they allow unions and government officials to close the meetings, but do not mandate it.

Transparency in collective bargaining should be an essential piece of sunshine laws and open records acts. Labor contracts commit taxpayers for several years to spend millions on worker compensation. In Connecticut's case, that time period turns into decades because unions may also bargain over retirement benefits.

While state law does require that government unions file annual financial reports with the Labor Commissioner, they may choose to file reports that comply either with provisions in the federal Labor-Management Reporting and Disclosure Act or with the Internal Revenue Code. The reports are unavailable to the public. Even union members may view them only at the union hall.

The current standard in Connecticut requires reform for several reasons. First, government union employees should have the same rights as their private sector counterparts. Private sector unions file LM-2 forms for larger unions and LM-3s and 4s for smaller unions as required by the federal Labor Management Reporting and Disclosure Act (LMRDA). Government unions should be held to the same standard and should not have the option to follow any other regime.

What's more, like private sector forms, these documents should be easily accessible to union members and the public alike. Finally, the forms should be stored for the foreseeable future. Currently the law permits the state labor commissioner to destroy the forms after two years.[72]

One final reform should be considered in conjunction with the issue of transparency: the lengthoflaborcontractsforgovernmentworkers at the local level. Agreements may typically run for two to five years, but government unions may also negotiate "evergreen" clauses. These allow contracts to renew automatically if negotiations for a new contract do not occur.[73]

For example, the Hartford area employs about 75,000 government workers.[74] The seven active union contracts listed for the City of Hartford, including those for police and firefighters, all include such clauses.[75] It should be noted, however, thatwhile agreementsremain in effect, at least the annual increments (raises) that are in the expired contract are excluded.[7]

68 Public Records and Proceedings, Me. Stat. tit. 1, § 405(6)(D), http://legislature.maine.gov/legis/statutes/1/title1sec405.html.

69 Meeting of Public Body in Executive Session, Mass. Gen. Laws ch. 30A, § 21 (a)(3), https://malegislature.gov/Laws/GeneralLaws/PartI/TitleIII/Chapter30A/Section21, Meeting of Public Body in Executive Session.

70 Open Meetings Law, N.Y. Public Officers Law § 105 (1)(e),http://public.leginfo.state.ny.us/lawssrch.cgi?NVLWO:.

71 Open Meetings, 42 R.I. Gen. Laws § 42-46-5 (a)(2), http://webserver.rilin.state.ri.us/Statutes/TITLE42/42-46/42-46-5.HTM.

72 559 CT. Sec. 31-77. Annual reports https://www.cga.ct.gov/current/pub/chap_559.htm#sec_31-77

73 68 CT. Sec. 5-278a https://www.cga.ct.gov/current/pub/chap_068.htm#sec_5-278a

74 U.S. Bureau of Labor Statistics, "Hartford, CT, Area Economic Summary," September 27, 2017, https://www.bls.gov/regions/new-england/summary/blssummary_hartford.pdf.

75 City of Hartford Department of Human Resources, "Labor Contracts," accessed Nov. 1, 2017, http://www.hartford.gov/humanresources/laborcontracts. 76 68 CT. Sec. 5-278a

Connecticut Union Leaders: Comfortable With a Cozy Status Quo

Armed with the array of legal privileges described above, Connecticut's union leaders have wasted no time seeking and defending spending decisions that wreak havoc on state and local budgets. Lori Pelletier, head of the Connecticut AFL-CIO, admitted in 2016 legislative testimony that government unions had repeatedly agreed to underfund pensions, even though it was "not a good idea."[77]

Modest pension reform proposals in 2017 — such as putting employees on 401(k)-style defined contribution plans like those in the private sector or preventing the use of overtime pay to calculate retirement benefits — triggered union protests that legislators were "attacking blue- collar workers" and "turning back the clock" in Connecticut. According to Dan Livingston, the government union's lawyer who negotiates state employee contracts, "previously unthinkable ideas are being treated seriously."[78]

Meanwhile, Connecticut's fiscal position deteriorates: health care costs for retired state employees alone were set to balloon from $645 million in 2016 to $731 million in 2017—dwarfing health care costs for current workers.[79] In addition, over 1,000 retired state workers are drawing annual pensions worth more than $100,000 each, with more retirees joining the club as cost-of-living increases accrue. In fact, 11 state retirees now receive more than $215,000 a year,[80] which violates Internal Revenue Service regulations on defined benefit plans.[81] In some cases, fringe benefits can reach over 80 percent of payroll.[82]

Much-touted recent concessions from the 15-union coalition of state workers, SEBAC, will improve Connecticut's fiscal situation, but only at the margins. Employees will be required to contribute something more toward their own healthcare premiums and pay two percent more of salary toward their own retirement plans; a new "Tier IV" hybrid plan will have both a 401(k)-style defined contribution plan along with a traditional defined-benefit pension.[83] The estimated savings are projected at $1.5 billion over two years.[84]

77 Marc E. Fitch, "Union Leaders Approved Underfunding of Connecticut Pensions," *Yankee Institute,* October 4, 2016, http://www.yankeeinstitute.org/2016/10/union-leaders-approved-underfunding-connecticut-pensions/.

78 Marc E. Fitch, "Pension Reform Gets a Public Hearing, Union Leaders Fear Connecticut Will Become Arkansas," *Yankee Institute,* March 27, 2017, http://www.yankeeinstitute.org/2017/03/pension-reform-gets-a-public-hearing-union-leaders-fear-connecticut-will-become-arkansas/.

79 Marc E. Fitch, "State Retiree Healthcare Costs Now Exceed Healthcare Costs for Current Employees," *Yankee Institute,* April 5, 2017, http://www.yankee-institute.org/2017/04/state-retiree-healthcare-costs-now-exceed-healthcare-costs-for-current-employees/.

80 Marc E. Fitch, "1,030 State Retirees Have Pensions Over $100,000," *Yankee Institute,* April 7, 2017, http://www.yankeeinstitute.org/2017/04/1030-state- retirees-have-pensions-over-100000/.

81 Internal Revenue Service, "Retirement Topics—Defined Benefit Plan Benefit Limits," https://www.irs.gov/retirement-plans/plan-participant-employee/ retirement-topics-defined-benefit-plan-benefit-limits, accessed October 10, 2017.

82 http://www.osc.ct.gov/2017memos/numbered/201710r.htm; see also http://www.yankeeinstitute.org/2017/08/fringe-benefits-for-state-employees-cost-up- to-86-percent-of-payroll/

83 SEBAC 2017 Agreement Between State of Connecticut and State Employees Bargaining Agent Coalition (SEBAC), July 2017, http://ctsenaterepublicans.com/wp-content/uploads/2017/07/SEBAC-Agreement-7.18.17.pdf.

84 Christopher Keating, "House Narrowly Approves State Worker Labor Concessions," *Hartford Courant*, July 24, 2017, http://www.courant.com/politics/hc-house-sebac-and-housing-20170724-story.html.

Although Gov. Dannel Malloy avoided having to lay off as many as 4,200 employees,[85] almost half of the savings in the concessions come from unrealized pay increases, significantly diminishing their value.[86] And these ballyhooed savings gloss over the fact that the SEBAC agreement will have spanned 30 years without being fully re-negotiated when it expires in 2027.

Even though Connecticut ended fiscal year 2017 with a $22.7 million general fund deficit[87] and the state retirement system is desperately underfunded, state worker unions have continued to thrive — especially compared to their counterparts in several surrounding states. For example, the current 1.5-6.5 percent retirement contribution Connecticut state workers make is much lower than the 5-9 percent that state workers contribute in Massachusetts,[88] the 6.65 percent in Vermont (with about 8.5 percent for police),[89] the 7.56 percent in Maine,[90] or the 7 percent in New Hampshire (where police also chip in more than 11 percent of pay towards their pensions).[91]

Ironically, even people on government assistance may be subject to harassment and intimidation from the government unions that purport to represent them. For example, Connecticut allows the unions to "skim" dues from the most vulnerable. In 2014, the Service Employees International Union succeeded in "unionizing" Connecticut's personal care assistants — who are paid through government assistance programs, and many of whom are actually caring for sick friends and relatives.[92] In 2014, the Supreme Court in Harris v. Quinn[93] ruled that unions could not force these care assistances to pay union dues – yet in 2016, the Department of Social Services was investigating workers' claims that union dues were still being deducted without their permission.[94]

Pauline, a 20-year personal care attendant, told Yankee Institutethat, becausesherefusedtosign a union membership card at a training session, government union organizers began phoning her regularly—at the home of her sickly 89-year- old client. "They started calling two, three times a day…They're calling at 10 o'clock at night. That is not the way you approach people."[95]

In the meantime, SEIU Healthcare 1199NE, the union that represents Pauline and other home care assistants, has seen its membership—and coffers—grow substantially, in no small part because of coercive unionization tactics like those in Connecticut. In 2014, the union said it had 18,000 members in its mandatory annual financial report to the U.S. Department of Labor. By 2017, that number had grown to 25,654, while totalassetsclimbedby$262,000 to$15.3 million.

85 Max Reiss, "4,200 State Layoffs Possible if No Union Concessions: Governor," *NBC Connecticut*, April 20, 2017, http://www.nbcconnecticut.com/news/local/4200-State-Layoffs-Possible-if-No-Union-Concessions-Governor-419987053.html.

86 The Pew Charitable Trusts, "Overview and Analysis of the Pension and Retiree Healthcare Provisions of the Tentative 2017 SEBAC Agreement," https://www.documentcloud.org/documents/3900216-Pew-SEBAC-Analysis.html.

87 State of Connecticut Comptroller, "FY Letter to the Governor," September 29, 2017, http://www.osc.ct.gov/reports/monthly/2017/Sept30LtrFY17.htm. 88 Massachusetts State Retirement Board, "Benefit Guide for the Massachusetts State Employees' Retirement System," http://www.mass.gov/treasury/docs/ retirement/retguide2015.pdf, p. 3.

89 Vermont Office of the State Treasurer, "Vermont State Employees' Retirement System (VSERS)," http://www.vermonttreasurer.gov/content/retirement/ state, accessed October 11, 2017.

90 Maine Bureau of Human Resources, "11.2A RETIREMENT—MAINE PUBLIC EMPLOYEES RETIREMENT SYSTEM," *Human Resources Policy and Practices Manual,* http://www.maine.gov/bhr/rules_policies/policy_manual/11_2a.htm, accessed October 11, 2017.

91 New Hampshire Retirement System, "NHRS 2017 Fact Sheet," December 2016, https://www.nhrs.org/docs/default-source/brochures/nhrs_2017_bro- chure_12_16-final.pdf?sfvrsn=10, accessed October 11, 2017.

92 Keith Phaneuf and Arielle Levin Becker, "CT Legislative Panel OKs Contract with Personal Care Attendants," *The CT Mirror*, April 15, 2014, https://ct-

mirror.org/2014/04/15/ct-legislative-panel-oks-contract-with-personal-care-attendants/.
93 Harris v. Quinn, 573 U.S.____(2014)
94 Marc E. Fitch, "Personal Care Assistants Claim Union Dues Are Deducted Without Authorization," *Yankee Institute,* October 4, 2016, http://www.yan-keeinstitute.org/2016/10/personal-care-assistants-claim-union-dues-are-deducted-without-authorization/.
95 Marc E. Fitch, "Unions Exert Pressure at State-Mandated PCA Orientation," *Yankee Institute,* October 22, 2016, http://www.yankeeinstitute.org/2016/10/ unions-exert-pressure-at-state-mandated-pca-orientation/.

A large portion of that increase appears to have gone into beefing up the government union's "political activities and lobbying." Over the course of one year ending in June 2017, the union poured $177,353 of members' union dues into the parent organization's Washington, DC- based political action committee, SEIU COPE,[96] which in the 2015-16 election cycle made $49 million in contributions to U.S. presidential hopefuls and congressional candidates across the country.[97]

Within Connecticut state and local races, government unions also spend lavishly. From 2012 to 2016, SEIU Healthcare 1199NE donated more than $162,000, while AFSCME Council 4 provided nearly $127,000. The Connecticut Education Association and the Connecticut Federation of Teachers gave about $42,000 and $55,000 respectively.[98] Such financial support buys plenty of political clout for unions when legislators vote on state-level collective bargaining issues, or locally when new labor agreements must be negotiated.

In addition, Connecticut unions are the largest donor to the state's Working Families Party, and all the party's national board members from Connecticut are union officials.[99] Theparty—alongwitha staterepresentativeithelpedtoelect — has threatened to run extreme candidates against incumbents in local primaries in 2018.[100]

Nothing illustrates the government unions' unrivalled insider status better than when now- Speaker of the House Joe Aresimowicz was caught on tape during a 2014 speech, assuring his friends at the Connecticut Employees Union that, "Yes, I do have a position as House majority Leader as a state rep from Berlin and Southington. I have a great job. I'm able to help people in my district on a daily basis and help people statewide, but more importantly I'm a 23-year member and dues-paying member of AFSCME….That's the most important aspect of my career. I would give up the political side of it in a minute and keep working to protect union workers' rights on a daily basis in Connecticut." He further promised, "I will never allow an anti-collective bargaining bill to be called to the House floor. I'm the majority leader, I can make that guarantee. If I'm the minority leader, not so much."[101]

Aresimowicz is one of five Connecticut state lawmakers who work full-time for unions outside the legislature. Four of the five are employed by government unions, while one works for a private sector union. Despite the inherent conflicts of interest, union employees have never recused themselves when voting on union contracts or state laws governing union behavior. What's more, several other current lawmakers worked for unions before being elected, and former lawmakers have left public service and been hired by government unions, creating an unseemly revolving door.[102]

96 U.S. Department of Labor, File 513-846, 2014 and 2017, https://olms.dol-esa.gov/query/getOrgQry.do.
97 Federal Election Commission, SEIU COPE 2015-2016 election cycle report, https://www.fec.gov/data/committee/C00004036/?tab=spending&cycle=2016, accessed October 11, 2017.
98 Author calculations from Connecticut state and local data at FollowtheMoney.org. 99 http://workingfamilies.org/national-advisory-board/
100 Mark Pazniokas, "A liberal grades his colleagues: 'I'm not here to make friends,' *CTMirror,* December 29, 2017. https://ctmirror.org/2017/12/29/a-liberal- grades-his-colleagues-im-not-here-to-make-friends/
101 https://www.facebook.com/groups/1814361382126010?view=permalink&id=2051290541766425&ref=content_filter
102 Jacqueline Rabe Thomas, "Former House Speaker Lands Job At Teachers' Union," December 15, 2014, CTMirror, https://ctmirror.org/2014/12/15/former- house-speaker-lands-job-at-teachers-union/.

Perks and Privileges Government Unions Enjoy inConnecticut

As noted above, government unions wield an effective veto over legislation through arbitration awards, even after the General Assembly has rejected the terms of a labor contract; unelected arbitrators can likewise override elected representatives at the municipal level. The results of this one-sided system are apparent in extravagant collective bargaining agreements. Total compensation for Connecticut's public-sector workers significantly exceeds that of their private-sector counterparts, even as promised pension benefits cripple the state's budget.

But the imbalance of power and influence isn't limited just to dollars and cents. Within Connecticut law and in negotiated collective bargaining agreements, government unions enjoy special perks at the expense both of Connecticut taxpayers and, ironically, of the very public employees they claim to represent.

Beyond exercising their special legal privileges to the fullest, union leaders are taking advantage of the taxpayers' generosity through a practice called "release time." This practice requires taxpayers to pay for public employees doing union work during work hours, while collecting their government salary. In some cases, these public employees may be working full-time on union business while receiving their taxpayer funded salaries.[103] A 2015 Yankee Institute study showed that "in FY 2015, this subsidy cost the state more than 121,000 work hours and $4.12 million, according to information provided by the state."[104]

Because Connecticut is not a right-to-work state, unions can have employees fired for not paying them. Public employees are required to pay a union even if they are not members. Rather than dues, these payments are called "agency fees,"[105] and they are meant to cover the cost of union representation, but not direct political spending. In one case, a state trooper actually had to sue to stop the deduction of union dues, and also to learn how those dues were being spent. The union claimed in that case that only 14 percent of his dues were assigned to political activity meaning the trooper still had to pay the unwanted union 86 percent of the dues in agency fees.[106]

Further, as previously noted, the government itself can be conscripted to serve as the bill collector for those forced dues and fees. Connecticut allows "dues check-off," which means the state or municipality automatically deducts dues and fees from public employees' paychecks and sends them to the union.

103 http://www.yankeeinstitute.org/policy-papers/union-time-on-the-taxpayer-dime/ ;see also. State Police[NP-1] Bargaining Unit Contract Between State of Connecticut and Connecticut State Policy Union, Article 7 Section Seven http://www.ct.gov/opm/lib/opm/olr/contracts/np-1_cba_2015-2018_contract.pdf 104 Trey Kovacs, "Union Time on the Taxpayer Dime," Mach 2016, *Yankee Institute,* http://www.yankeeinstitute.org/wp-content/uploads/2016/03/Union- Time-on-the-Taxpayer-Dime-web.pdf, p. 4.

105 Maintenance and Service Unit (NP-2) Contract Between State of Connecticut and Connecticut Employees Union Independent Affiliated Local 511 Service Employees International Union AFL-CIO, CLC Article 6 Union Security Section Four http://ceui.org/files/2017/06/np2-contract-tentative-agree-06232017.pdf

106 Connecticut State Police Union v Marc Lamberty before the state Department of Labor, Connecticut State Board of Labor Relations, Decision No. 4696, April 4, 2014, https://www.ctdol.state.ct.us/csblr/decisions-pdf/2014/4696CORRECTED.pdf

What's more, new public employees are at a significant disadvantage in Connecticut. No matter how hard-working, talented, or competent a new public employee is, he or she will lose out to more senior workers.[107] Connecticut allows "last-in, first-out," in which layoffs are executed — not on the basis of productivity or retaining the best workers — but primarily on the length of a public employee's service. Therefore, in a system designed to serve long-time government workers rather than the best interests of the state and recent employees, a newer employee will be let go and a more senior employee will get to keep his job, even if he or she is not as productive.[108]

One collective bargaining agreement gives a caveat where an employee with an "unsatisfactory" performance ranking will lose one year of seniority. However, even under that framework, an unsatisfactory employee with seven years of service will squeeze out satisfactory employees with only five years.[109] Even in the event of a tie in seniority, there is still no weight given to merit. The layoff in that case depends on names being drawn out of a hat.[110]

Another contract does give a little more weight to employee competence and affirmative action but still with strict restrictions: "If layoffs according to seniority have an adverse impactonaffirmativeactiongoalsorifthemostsenioremployee s do not have the requisite skills and ability to perform the work remaining, then the State and the Union shall meet to discuss the issue. If no agreement is reached within the time limits of Section Four (a), the State shall lay off employees in the manner it deems appropriate, and the Union has the right to submit the issue to expedited arbitration."[111]

Several state-level union contracts forego questions of competence and merit altogether, guaranteeing "superseniority" for union officers. One provides that "For the purpose of layoff selection, up to two hundred and fifty (250) Union stewards shall have the highest seniority in their classification series."[112]

107 The recent SEBAC agreement provided that permanent employees hired prior to July 1, 2017 would not lose their employment between July 1, 2017 and June 30, 2021.
108 State Police, Article 13
109 State Police, Article 13 Section 1(c);
110 State Police, Article 13 Section 1(d);
111 Maintenance and Service Unit, Article 13 Section 9
112 American Federation of State County and Municipal Employees, Article 8 Section 3

How to Restore Democracy to the Constitution State and Secure Fairness for Taxpayers

First and foremost, Connecticut's elected representatives must regain full control over agreements affecting the public workforce. This requires reform of Connecticut's default approach — which has enabled anti-democratic measures like "deemed approved" and supersedence. Necessary incremental changes have begun, with future SEBAC agreements limited to four years, and the General Assembly required to approve each one (unless, of course, lawmakers reject the agreement twice; then, an unelected arbitrator's opinion will have the force of law).

In short, power must be restored to the people's elected representatives. As noted above, unelected, unaccountable arbitrators should not be able to dictate the terms of contracts that will bind taxpayers for years to come, and essentially write the law. Unfortunately, the 2017 budget agreement took a step back in this case, granting more powers over state employee contracts to unelected arbitrators.

Moving forward, Connecticut must be freed from the procedural stranglehold that results when collective bargaining impasses at the state and local level must be resolved through binding arbitration. Contracts between unions and state or local governments are public policy, replete with consequential spending decisions that are the essence of the legislative function, even more so because they can actually supersede Connecticut law. Elected leaders across the state should have the final say on public policy, not arbitrators who are not accountable on election day for their decisions.

There are additional ways that Connecticut can institute comprehensive collective bargaining reforms:

- End supersedence of labor contracts over state law: If the legislature wants to change a law concerning government employees, it should do so by normal legislative means, wherein a bill passes both chambers and is signed into law by the governor. Enacting changes or privileges through collective bargaining agreements erodes the legitimate power of Connecticut legislators and undermines the people's right to self- government.
- Prohibit unelected arbitrators from writing law. Because of the supersedence of labor contracts, as noted above, arbitrators have the power to write legislation. These contracts - with the force of law - can be imposed by arbitrators even after the General Assembly twice rejects them. Agreements of such scope, expense, and consequence should not be implemented without the explicit approval of the people's elected representatives.
- Enact a law requiring unions to undergo regular

recertification elections by workers. Not only is it just and sound public policy, it is a reform supported by voters in Connecticut: 86 percent favor allowing "public employees to regularly vote on whether a union should continue to represent them in the workplace."[113]

- Enact legislation for government union financial transparency. Unions nationwide with any private sector members must submit detailed annual financial reports to the U.S. Department of Labor, called the LM-2, LM-3, or LM-4, pursuant to the Labor-Management Reporting and Disclosure Act (LMRDA) of 1959. At the state level, Connecticut has annual financial disclosure rules (although they may be much less detailed) for unions not required to file reports under the federal law. But these unions' reports are off-limits to the public—they may be examined only by union members. Furthermore, the state Labor Commissioner may destroy any such report that has been on file for two years.

  According to the Connecticut law requiring these annual reports, "each labor organization functioning in the state and having twenty-five or more members in any calendar or fiscal year shall, annually…file with the Labor Commissioner and make available to its membership a written report either in the form required by (the LMRDA) or the Internal Revenue Code."[114] At the very least, Connecticut should amend the law to make such government union reports public records and preserve them.

  Further, the state should mandate the same transparency from government unions as that required of their private sector counterparts. This can be done by eliminating the option for unions to file reports that conform to the less specific IRS code, and instead require forms similar to the more detailed LMRDA's LM-2, LM-3, or LM-4.

  The measure is both to allow workers to keep their unions accountable, and for citizens to have a sense of how well government unions—which are subsidized by millions of dollars in taxpayer spending—are being run. Again, voters support such measures: 85 percent in a Public Opinion Strategies poll would like to make "government union spending, specifically their spending on union contracts, union negotiations and political campaigns, more transparent."[115]

  Fully 63 percent of Connecticut voters want to "reform the law so that taxpayers no longer pay the salaries of government employees who take leave from their jobs in government to work directly for the unions."

- Limit collective bargaining to wages only, so that government employers can more easily fund worker compensation without deficits or rampant pension underfunding.

- Prohibit government employee layoffs based solely on level of seniority — the so-called "last in, first out" policy. Instead, employee performance should also be considered.

- Allow all government workers to opt into union membership every year, rather than forcing existing members who want to leave to comply with a limited resignation window.

113 Public Opinion Strategies poll of 500 registered Connecticut voters, conducted by phone October 28-30, 2017. The poll has a margin of error of +/-4.38%.
114 Labor Organizations—Annual Reports, Conn. Gen. Stat. § 31-77, https://www.cga.ct.gov/current/pub/chap_559.htm#sec_31-77.

115 *Ibid.*

- Enact Worker's Choice, which would allow workers to refuse union membership altogether in favor of representing themselves, and would also remove the requirement that unions represent all workers in a bargaining unit, including agency fee payers.[116] The Public Opinion Strategies poll found that fully 67 percent of Connecticut voters support allowing "public employees to opt out fully from their union and represent themselves and negotiate their own contracts with their employer."

- Enact Right-to-Work for private-sector employees. There are now 28 states that are right-to-work, meaning that they do not require workers to pay into a workplace union through agency fees as a precondition to starting or keeping a job. Indeed, from 2005 to 2015, right- to-work states have outperformed forced-union states in creating both more jobs and more personal disposable income. The cost-of-living- adjusted, per-capita income in right-to-work states is $42,814, comparedto$40,377inforced- union states.[117]

- Eliminate card check as a way of authorizing unions to represent state and municipal workers.[118] Instead, make secret ballot elections the only method by which workers may first select or vote out a union.

- Implement meaningful and long-term public pension reform. Pension reform that reduces the future pension liabilities that are choking Connecticut should include either putting new hires on a defined contribution plan, or else creating an overall hybrid defined-benefit/ defined-contribution system that places a greater emphasis on the defined-contribution portion. Employee contributions must rise, and the assumed rate of return on pension investments should be a realistic 5 percent. Pension calculations should exclude overtime payandincludeacaponhowmuchcompensation can be used to determine retirement payments.

Such measures would save the state billions of dollars[119] — and, what's more, they would create a freer, fairer, more prosperous state, where public- and private-sector workers could thrive, side by side.

116 Supreme Court of the United States Blog, "Janus v. American Federation of State, County, and Municipal Employees, Council 31," http://www.scotusblog.com/case-files/cases/janus-v-american-federation-state-county-municipal-employees-council-31/accessed November 20, 2017.
117 National Institute for Labor Relations, "Right to Work States Benefit from Faster Growth, Higher Real Purchasing Power," Fall 2017, http://www.nilrr.org/wp-content/uploads/facts/2017-nilrr-benefits-update-web.pdf.
118 Conn. Agencies Regs. §7-471-8 to 7-471-18, http://www.ctdol.state.ct.us/csblr/Regs-MERA.pdf; Conn. Agencies Regs. §5-273-9 to 5-273-21, http://www.ctdol.state. ct.us/csblr/Regs-StateEmployee.pdf.
119 Anthony Randazzo, Daniel Takash, and Adam Rich, "Securing Our Future: A Menu of Solutions to Connecticut's Pension Crisis," *Yankee Institute*, February 2017, http://www.yankeeinstitute.org/wp-content/uploads/2017/02/Securing-Our-Future.pdf, p. 3.

Addendum 1:
New England Collective Bargaining State Comparison

Scope of Collective Bargaining	
Connecticut	Wages, pensions, fringe benefits, hours and other employment conditions. Educators' unions may not negotiate over the establishment or provisions of retirement incentive plans contained within the teachers' retirement system.
Maine	Wages, hours, fringe benefits, contract grievance arbitration and working conditions.
Massachussets	Wages, hours, fringe benefits, standards, productivity/performance and other terms and conditions of employment. In 2011, Massachusetts limited the scope of bargaining over health care for municipal workers. State employees are already barred from bargaining over health care.
New Hampshire	Wages, hours, fringe benefits, and other employment conditions.
Rhode Island	Wages, hours, some benefits, working conditions, and terms and conditions of employment. Retirement benefits are excluded for state and school employees; health care for school district employee must comply with separate statutory benefit requirements to be included in collective bargaining agreements.
Vermont	Generally, salaries, fringe benefits, hours and other working conditions. Mandatory subjects of bargaining for family child care providers are limited to reimbursement rates for care, union dues/agency fee collection, grievances and professional development.
New York	Wage, hours, fringe benefits, and other terms and conditions of employment. Retirement benefits are explicitly excluded.

Legislative Process for Approving Contracts	
Connecticut	Until Fall 2017 amendments reversed the law for state employees, the CT general assembly had to approve or reject a new contract within 30 days of its filing. If the legislature failed to act either way, the contract was automatically "deemed approved." Now if the General Assembly fails to act, a contract or arbitration award is "deemed rejected." However, a rejected collective bargaining agreement goes to arbitration instead of fresh negotiations, and the General Assembly must vote to accept or reject the resulting arbitrated contract. If they reject the contract a second time, the contract returns to arbitration—but this time, the arbitrator's decision, not the legislature's—is final. For teachers, no active approval is required either, but to reject a new contract, the legislative body of a local or regional school district must convene a meeting within 30 days of the contract filing and officially reject it by majority vote. For a labor contract with a municipal body, funding for the new agreement, along with any provisions that conflict with local rules or general law, must be submitted for approval or rejection within 14 days. Rejected contracts return to negotiations. However, if no action is taken within 30 days after that period, the contract is deemed approved. However, new changes to the municipal law through the 2017 budget bill offer taxpayers more say. Arbitrators must assume that 15 percent of a municipal employer's budget is unavailable to pay for cost items in any ensuing arbitration award. Second, the state has created a new 11-member Municipal Accountability Review Board to help oversee fiscal planning in distressed cities. In its purview is the same authority as local legislative bodies to reject twice any arbitration award, a measure that may allow for more protection against unaffordable arbitration decisions
Maine	For state, judicial, and community college employees, any "cost items" or funding appropriations required in a new contract must be approved by the state legislature; if any are rejected, all cost items return to the bargaining table
Massachussets	Cost items must be approved by the relevant state or local legislature, and if rejected, return to negotiations. For several state entities, such as the lottery commission, University of Massachusetts, and for bargaining with family child care providers, the legislature must approve incremental cost items for each fiscal year. If the governor fails to refer such items for approval within 45 days, they return to negotiations. Teacher contracts do not need funding approval, as they are simply subject to what is available through general public education appropriations (https://malegislature.gov/Laws/GeneralLaws/PartI/TitleXII/Chapter71/Section34).
New Hampshire	Cost items in a collective bargaining agreement at state or local level must be approved by the relevant legislature. If any are rejected, either agency or union reopen negotiations on the whole agreement.
Rhode Island	None; contracts go into effect once signed by parties.
Vermont	For state and judiciary employees, and home care and early care and education providers, new contracts are effective only if the state legislature appropriates the full funding necessary to implement the agreement. If the amount differs, the affected items must be renegotiated to fit with the actual appropriation.
New York	An agreement goes into effect only if any provisions requiring a change of law or appropriation of funds is approved by the relevant legislative body.

Supercedence	
Connecticut	For both state and municipal employees (which include teachers), the terms of a collective bargaining agreement prevail over law or regulations where there is a conflict.
Maine	Not addressed in law.
Massachussets	For items within the scope of collective bargaining that conflict with law, the contract supersedes the law.
New Hampshire	Not addressed in law.
Rhode Island	Not addressed in law
Vermont	For municipal employees, where a contract conflicts with state law, the law prevails. If the contract conflicts with local ordinances, a vote approving the agreement by the relevant legislative body allows the contract to supersede law.
New York	Not addressed in law.

Binding Arbitration	
Connecticut	Binding arbitration is automatically triggered and mandatory for municipal employees, teachers, family child care providers and personal care attendants. For municipal employees and teachers, the arbitrators' decision is first subject to approval by the local legislative body. If not approved, the matter goes to arbitration for a second time, and the arbitrator makes a final, binding decision with regards to each rejected issue. For family child care providers and personal care attendants, the arbitrator is limited to selecting the complete proposal of either union or the state on any unresolved issue, and the award is subject to final approval by CT legislature. State employee unions and/or the state may elect to go to binding arbitration, but if the award is rejected by a two-thirds majority of the General Assembly on grounds of insufficient funds, the matter, as of law changes in Fall 2017, go to arbitration. Now, if the General Assembly rejects an arbitration decision, instead of returning to negotiations, the matter goes back to arbitration. Any subsequent award is then "deemed approved."
Maine	Either employer or union in an impasse may request arbitration, which is final and binding on issues other than salaries, pensions and insurance.
Massachussets	The union and employer may mutually request arbitration. Once the arbitration process is authorized by the relevant legislative body or school committee, arbitration decisions are binding and final.
New Hampshire	None
Rhode Island	Yes, required for firefighters, municipal police, state police, 911 employees, and state correctional officers. Binding arbitration for state and municipal workers exists only for non-monetary matters. Once both sides in teacher bargaining agree to arbitration, it is binding on all issues in question.
Vermont	For certain classes of employees. Mandatory for judiciary employees when there is an unresolved impasse. Exists for teachers and municipal employees if both sides submit to it.
New York	Final and binding arbitration exists for essential and public safety workers including firefighters, local and state police, and corrections officers at the request of either the union or government agency, or if initiated by the state's Public Employment Relations Board. Binding arbitration also exists for New York City Transit Authority and certain Metropolitan Transportation Authority workers upon joint request of union/agency or if the Board finds a voluntary resolution cannot be reached.

Sources

Collective bargaining statutes for each state. Summaries for scope of collective bargaining and binding arbitration are taken from state profiles available at https://www.commonwealthfoundation.org/state%5Flabor%5Flaws/.

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