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Local government - Connecticut

State fiscal, demographic and economic hurdles pose risk for many municipalities

The State of Connecticut's (A1 stable) ongoing fiscal challenges will continue to pressure many cities and towns across the state. While Connecticut local governments have inherent strengths, their exposure to the fiscal uncertainties of the state and overall adverse economic and demographic trends will remain a persistent obstacle. Due to the significant variances in financial and economic strength, however, local governments will experience differing levels of credit stress.

» **State-level fiscal pressures underscores the importance of local government financial flexibility.** The vulnerability of municipalities to abrupt state aid cuts varies considerably, ranging from more insulated New York City (Aa2 stable) suburbs to highly susceptible cities such as Hartford (Caa3 developing). Towns and cities with healthy fund balances, lower property tax millage rates and a lesser reliance on state aid are more financially nimble. State on-behalf payments for teachers' pensions have been a significant source of state support for local governments, but a shift of these costs to towns and cities could have an adverse impact on municipal finances.

» **Sluggish economy and unfavorable demographic trends weigh on municipalities' credit profiles, though there are pockets of strength.** Connecticut's GDP and job growth have recently lagged the US. Though some local economies benefit from the defense industry and proximity to New York City, corporate out-migration remains a challenge. Connecticut's population loss (down annually from 2014-16) and its older median age are negative demographic trends.

» **Local governments in Connecticut have inherent strengths that mitigate some credit pressures.** Unlimited authority to raise property taxes for operations as well as strong resident wealth and median family incomes are a bedrock of credit strength for many local governments. Also, while many local governments are heavily exposed to state aid cuts, generally stable property tax revenues comprise a median 68% of municipal budgets (state aid is 20%).

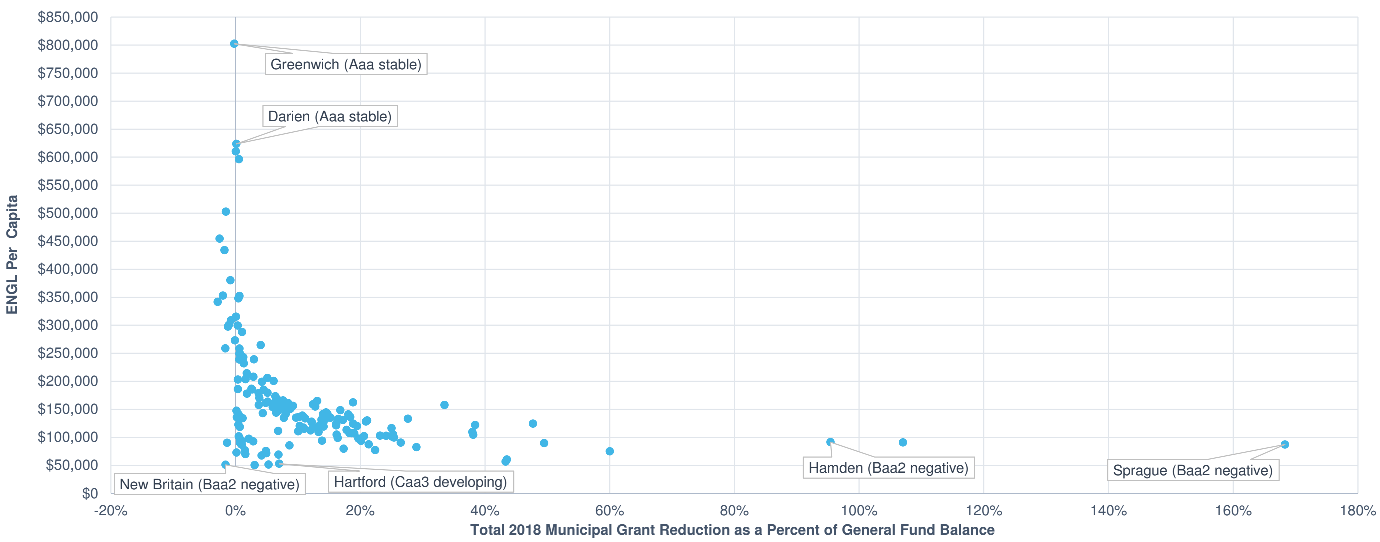
State-level fiscal pressures underscore the importance of local government financial flexibility

Cities with greater financial flexibility are better able to adapt to reductions in state aid. In order to close a budget gap in fiscal year 2018 (ending June 30, 2018) of $1 billion, the state implemented abrupt cuts to state funding of local governments. After a nearly four-month budget impasse in fall 2017, the adopted budget and subsequent midyear cuts reduced total municipal grants by 4.6% to $2.45 billion from the $2.57 billion in the previous fiscal year. However, the cuts were applied unevenly. The median reduction in state grant aid was 10.9%, but funding for high-need cities and towns was left largely intact.

From a state funding perspective, Connecticut's 169 cities and towns fall into three general categories: high-need cities that rely heavily on state funding and were protected in the recent budget cycle, such as Hartford, New Britain (Baa2 negative) and Waterbury (A2 stable); very wealthy communities with strong finances that rely minimally on state funding, such as New York City suburbs Greenwich (Aaa stable) and Darien (Aaa stable); and lastly communities that are neither extraordinarily wealthy nor have high needs that rely on state funding enough to be impacted when it is cut or disrupted. Exhibit 1 highlights the impact of the state cuts in relation to the equalized net grand list (ENGL), or full value per capita. Towns with very strong and very weak ENGL per capita lost a relatively small amount of state aid as a percentage of fund balance. However, cities and towns with moderate ENGL per capita experienced more substantial cuts to their state grants.

Exhibit 1

Cities and towns with particularly strong or weak wealth indicators were less impacted by state cuts as part of the recent budget activity



Sources: Moody's Investors Service, Connecticut Office of Policy and Management

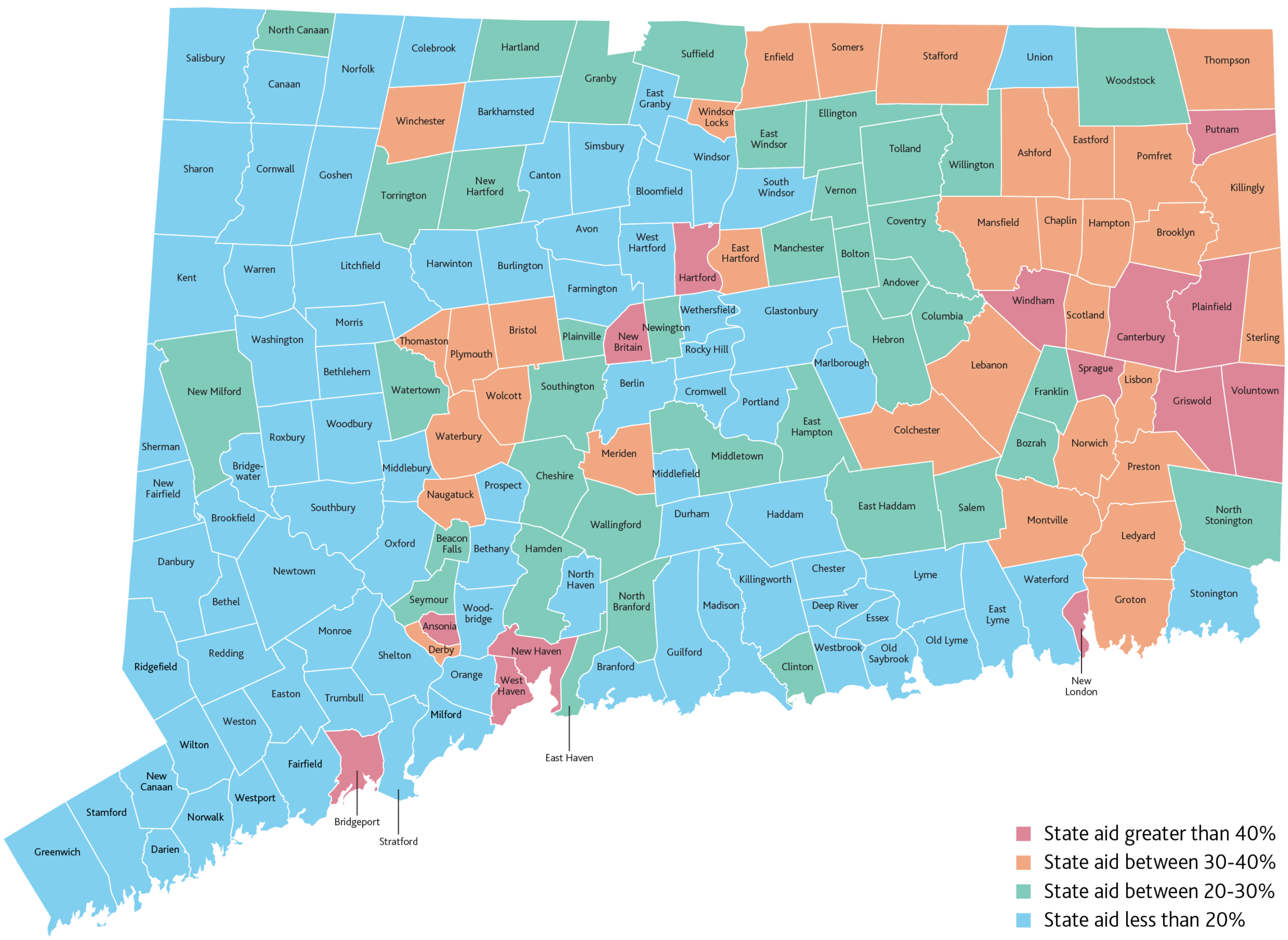
A recent gubernatorial proposal for the fiscal 2019 budget includes modest adjustments that would further reduce state grants by $32 million. The proposal would preserve or increase state aid for high-need municipalities while eliminating appropriated grant aid to the wealthiest communities in the state, those with a ENGL per capita above $200,000.

Connecticut local governments typically receive the majority of their revenues from highly predictable property taxes. While this can broadly be characterized as a credit strength for the sector, the revenue mix varies significantly. Connecticut local governments receive a median 68% of revenues from property taxes, 20% from the state and 12% from other sources. Towns and cities with less reliance on state funding are less vulnerable to the financial and political swings of the state and therefore have more financial flexibility than peers with a greater reliance on the state. Exhibit 2 highlights the variation in amounts of state aid received across all local governments.

Exhibit 2

Local governments receiving more state aid have greater exposure to the state's financial and political uncertainties

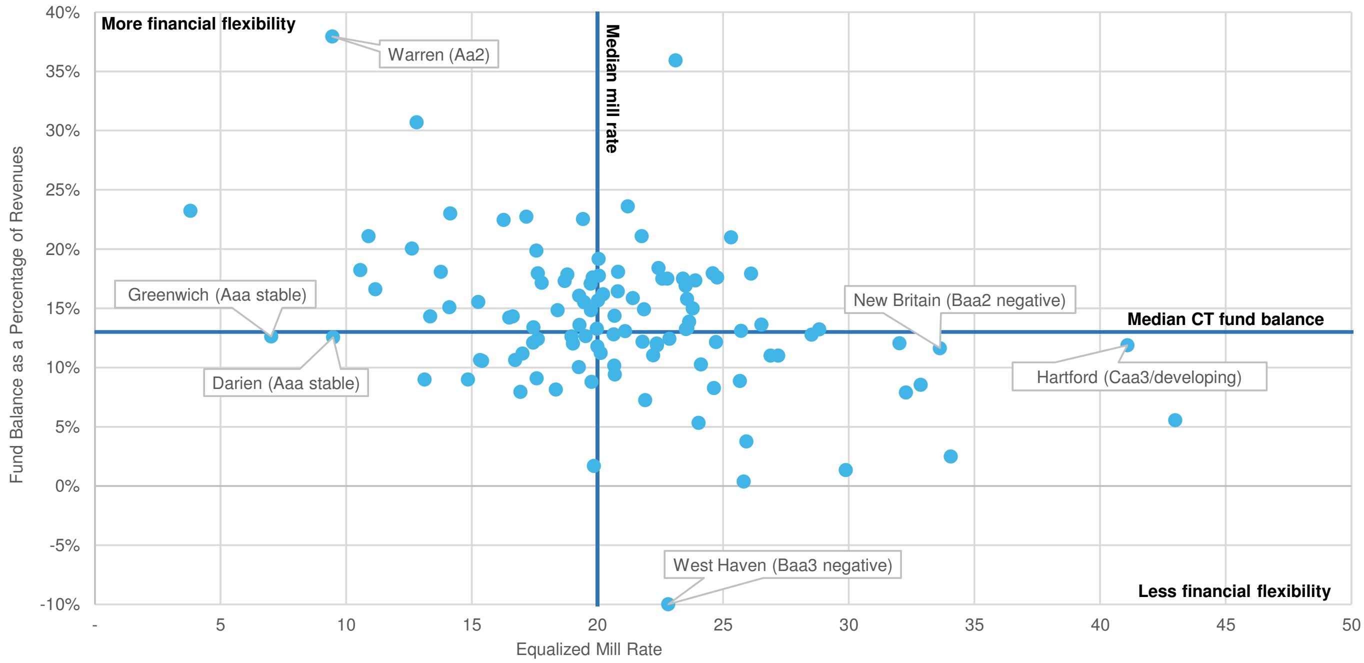
State aid as a percentage of operating revenues



Sources: Audited financial statements, Connecticut Office of Policy and Management

Local governments in Connecticut that maintain higher fund balances and have an easier time raising local revenues have more financial flexibility. The median local government fund balance in the state at 14% of revenues is significantly below the nationwide median of 25%. Although cities and towns in the state have unlimited legal authority to raise property taxes, municipalities with higher mill rates are likely less willing to raise taxes. Towns with a combination of lower fund balance and higher mill rates typically have less financial flexibility.

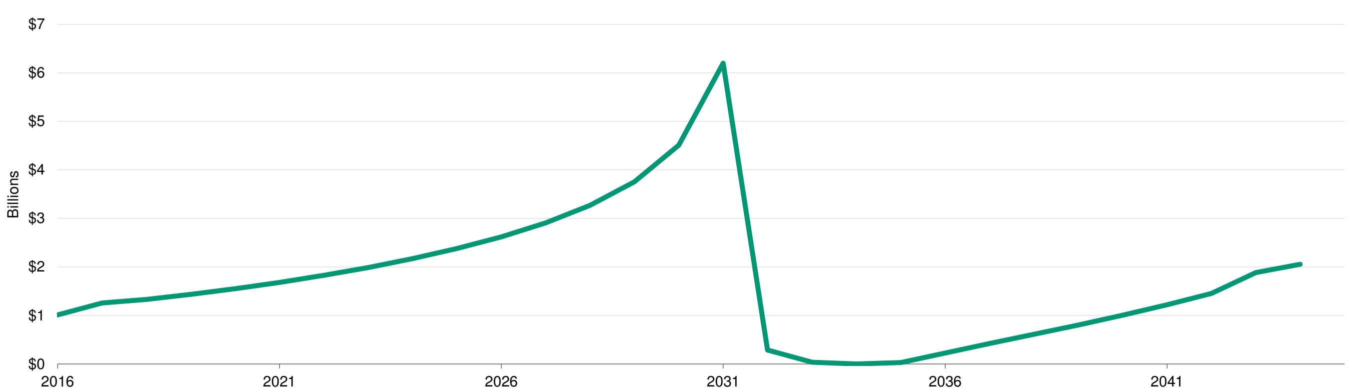
Exhibit 3
Local governments with higher mill rates and lower fund balances typically have less financial flexibility



Source: Moody's Investors Service

State contributions on behalf of municipalities to the state-administered Teachers' Retirement System (TRS) have historically been a significant source of support for local governments. The state is required by bond indenture to fully amortize the unfunded TRS liability by 2032, which will require a significant ramping up of contributions (see Exhibit 4) to meet the growing liabilities of the pension plan.

Exhibit 4
State contributions will need to increase significantly to fully amortize TRS liabilities by 2032



State TRS contributions assume 5.5% return.
Source: Center for Retirement Research at Boston College

During the 2018 budget process, the governor introduced multiple proposals calling for shifting a portion of the funding responsibility for TRS to local governments. These proposals failed to gain legislative support, and the state's complete funding of TRS on-behalf payments continues.

Establishment of Municipal Accountability Review Board (MARB) provides support for distressed cities

The recent creation of the state Municipal Accountability Review Board (MARB) provides additional administrative and financial support to municipalities experiencing various levels of fiscal stress. Several factors contribute to which tier a municipality may qualify for, ranging from tier I to tier IV, with progressively higher tiers corresponding with higher levels of fiscal stress.

As of March 2018, only Hartford and West Haven (Baa3 negative) have applied for MARB oversight, both as tier III municipalities. A municipality is eligible to apply for tier III status if it has a below investment grade bond rating (Hartford), or a combination of a low rating and either negative fund balance or a high equalized mill rate and an elevated dependence on state aid. A municipality may also apply for tier III MARB oversight if it has issued deficit obligation bonds (West Haven).

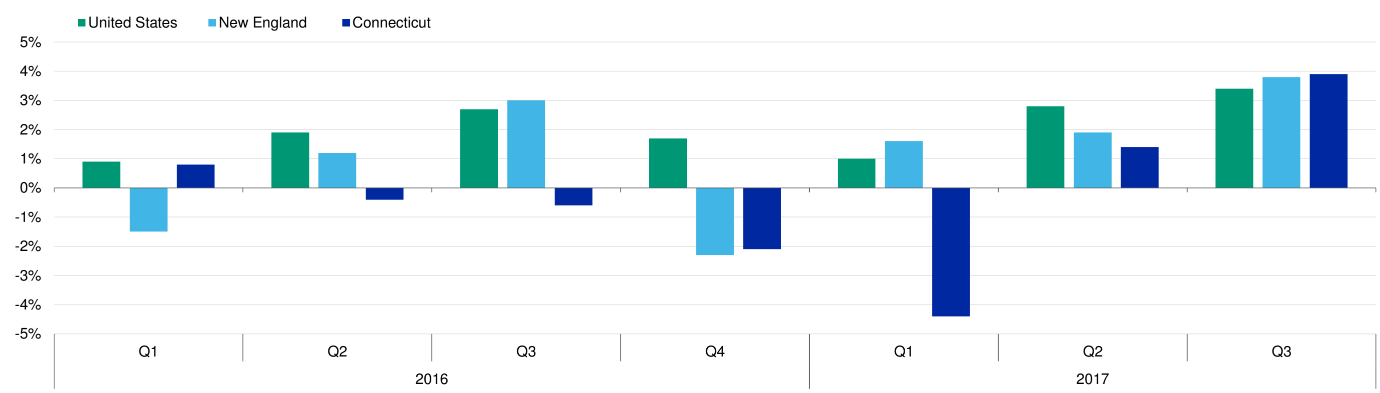
MARB oversight for local governments makes available municipal restructuring funds, provides guidance on budgets and city bond ordinances, and offers input regarding collective bargaining agreements. Hartford proposed a financial recovery plan in early February to the MARB. Part of the proposal calls for increased state support in order for the city to meet its operations and debt payments.

Sluggish economy and unfavorable demographic trends weigh on municipalities' credit profiles, though there are pockets of strength

Connecticut's economic recovery continues to lag the rest of the country. GDP growth trailed the US for six straight quarters until Q3 2017; the region also grew at a faster rate in four of the seven quarters over that time period (see Exhibit 5). A similar trend is seen in the Connecticut labor market, where employment growth trailed the US and other New England states in job growth from December 2016 to December 2017 (see Exhibit 6).

Exhibit 5

Connecticut quarterly GDP growth trails US and region

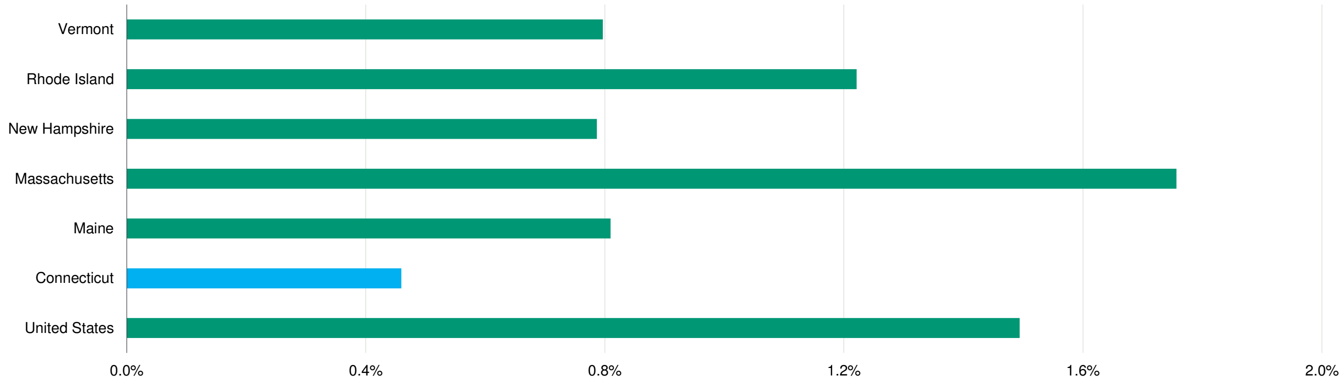


Sources: Moody's Investors Service, US Bureau of Economic Analysis

Exhibit 6

Connecticut job growth lags US and other New England states

Nonfarm employment growth from December 2016 to December 2017

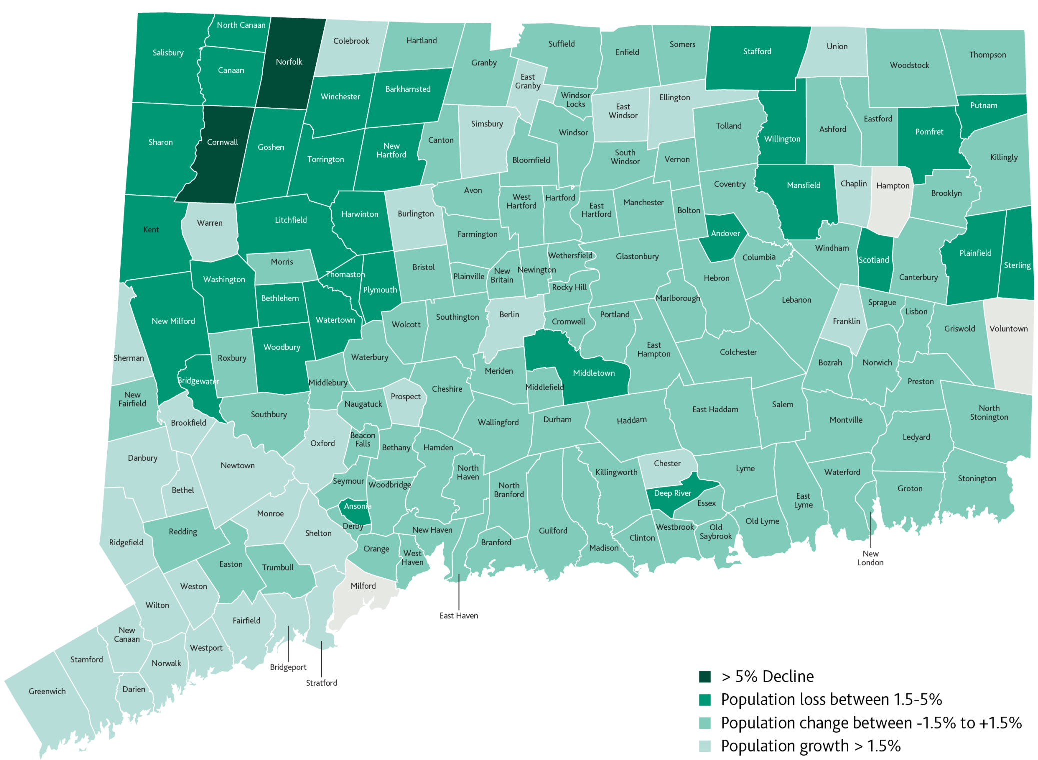


Source: US Bureau of Labor Statistics

Weak demographic trends will continue to pressure the state and local governments, potentially constraining economic growth and weakening tax revenue. The state's population has grown less than 1% since 2010 and declined in each year from 2014 to 2016. From 2010 to 2016, the nation's population grew 4.7%. The median Connecticut municipality lost 0.5% over the same period (see Exhibit 7).

Exhibit 7

Weak population trends are negative for local governments

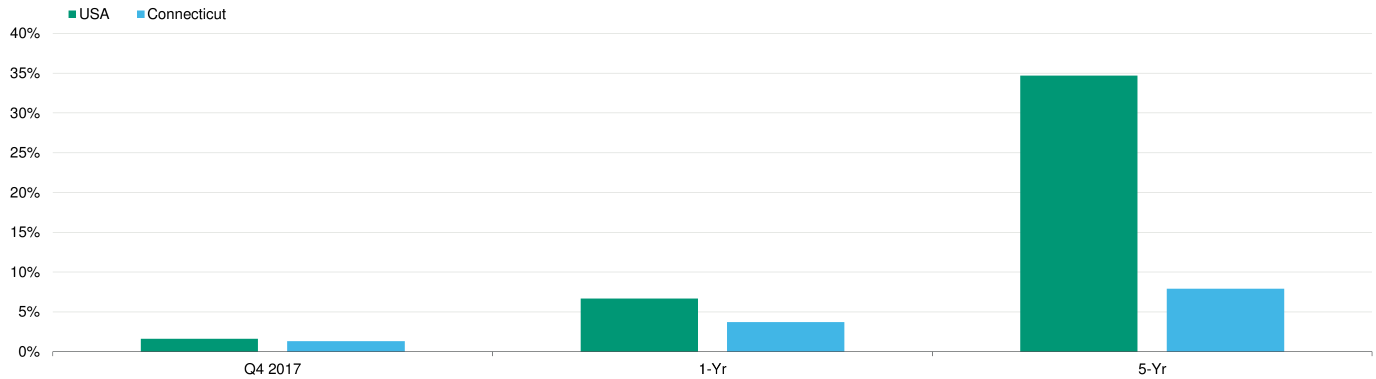


Source: US Census Bureau American Community Survey

The state's aging population will become an increasing challenge to the state and its local governments over the long term, as a smaller working age population can pressure tax revenue growth. The state's population is older and aging faster than the rest of the nation. Census data shows the state's median age increased to 40.4 from 37.4 from 2000 to 2015. This outpaced the increase in median age nationwide, which rose to 37.6 from 35.3.

Adverse demographic and labor trends continue to weigh on the state's housing market. According to the Federal Housing Finance Agency House Price Index, home prices in Connecticut increased 7.9% over the past five years, well behind the national rate of 34.7% (see Exhibit 8).

Exhibit 8
Connecticut home price growth trails the nation



Source: Federal Housing Finance Agency House Price Index

While Aetna Inc.'s (Baa2 stable) recent decision to relocate to New York City was reversed and the company decided to remain headquartered in Hartford, notable out-migrations of Alexion Pharmaceuticals and General Electric Company (A2 stable) underscore the challenges Connecticut faces in competing with nearby economically dynamic cities such as Boston (Aaa stable) and New York City.

Despite the broadly negative economic trends across the state, there are pockets of economic strength, particularly in communities anchored by aerospace and defense industries. Increased federal defense spending will support Electric Boat's presence in Town of Groton (Aa2 negative), United Technologies (A3 rating under review) in Farmington (Aaa stable) and East Hartford (Aa3), and Sikorsky in Stratford (A2 stable).

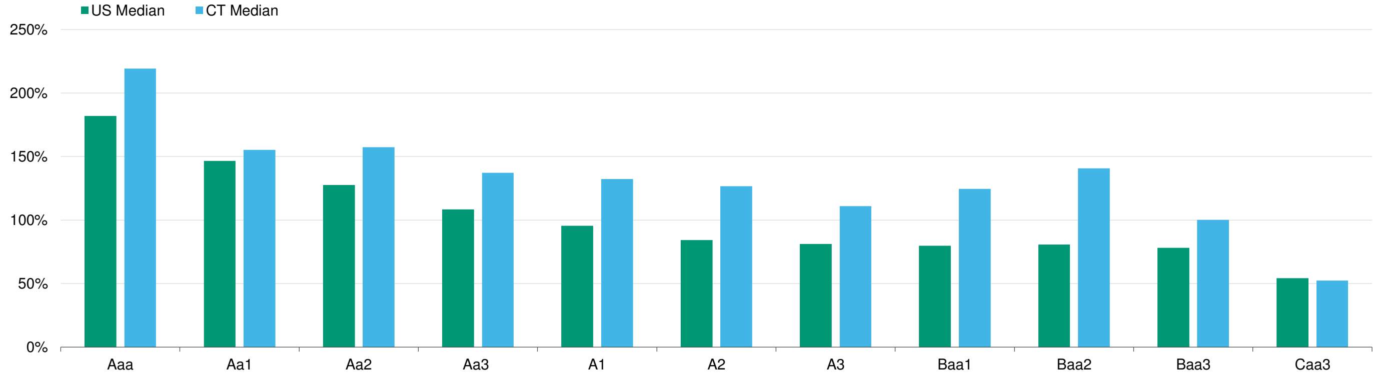
Many local governments in Connecticut have inherent strengths that mitigate some credit pressures

Unlimited authority to raise property taxes for operations combined with strong resident wealth and incomes are the bedrock of credit strength for many local governments across the state. As discussed previously, municipalities with high tax rates may face practical revenue-raising limitations. However, we continue to recognize local governments' unlimited ability to raise local revenues as a strength of Connecticut local governments. Furthermore, local governments are generally able to issue midyear supplemental property tax bills, which affords some additional flexibility.

Cities and towns typically rely on generally steady property tax revenue for approximately 70% of revenue. While a high reliance on state aid is a credit negative, a significant number of municipalities receive less than 20% of their revenues from the state, as reflected in Exhibit 2 (above), particularly wealthier communities closer to New York City.

Connecticut's statewide per capita income exceeds 143% of the nation, which is reflected in the above average resident incomes at the local level. Generally high-income and wealth levels compare favorably to US medians across all rating categories, as shown in Exhibit 9.

Exhibit 9
Connecticut median family incomes exceed national medians across rating categories
Median family income expressed as a percentage of the nation

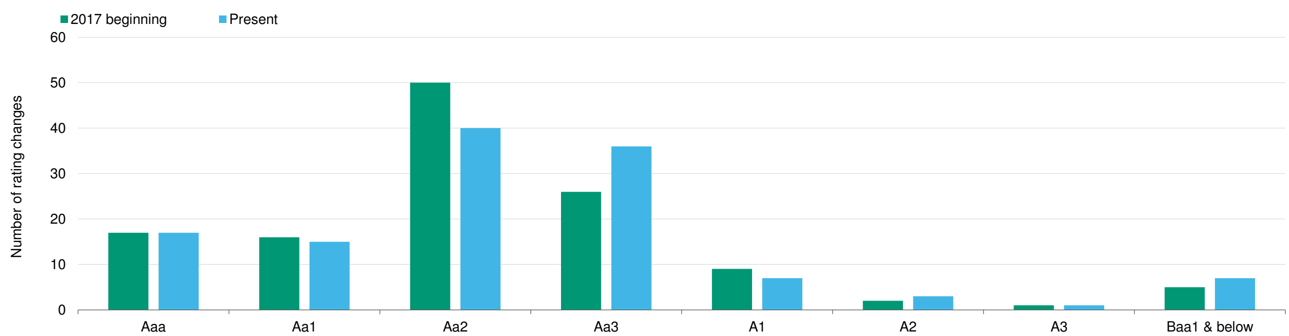


Source: Moody's Investors Service, US Census Bureau

Connecticut local government ratings remain strong, despite various credit pressures across the state

Despite several downgrades across the local government sector in the past year, local government ratings in Connecticut remain strong (see Exhibit 10).

Exhibit 10
Connecticut local government rating changes from 2017 to 2018 by rating category



2017 ratings as of January 1, 2017; present ratings as of March 1, 2018.
Source: Moody's Investors Service

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