America's Retirement Architecture: Strains in the System

Sujit M. CanagaRetna
The Council of State Governments
Southern Office, the Southern Legislative Conference (SLC)

Presentation before the
Association of Capitol Reporters and Editors (ACRE)
Seattle, Washington
August 21, 2005

capitolbeat
Association of Capitol Reporters and Editors

The Council of State Governments

Five Main Parts

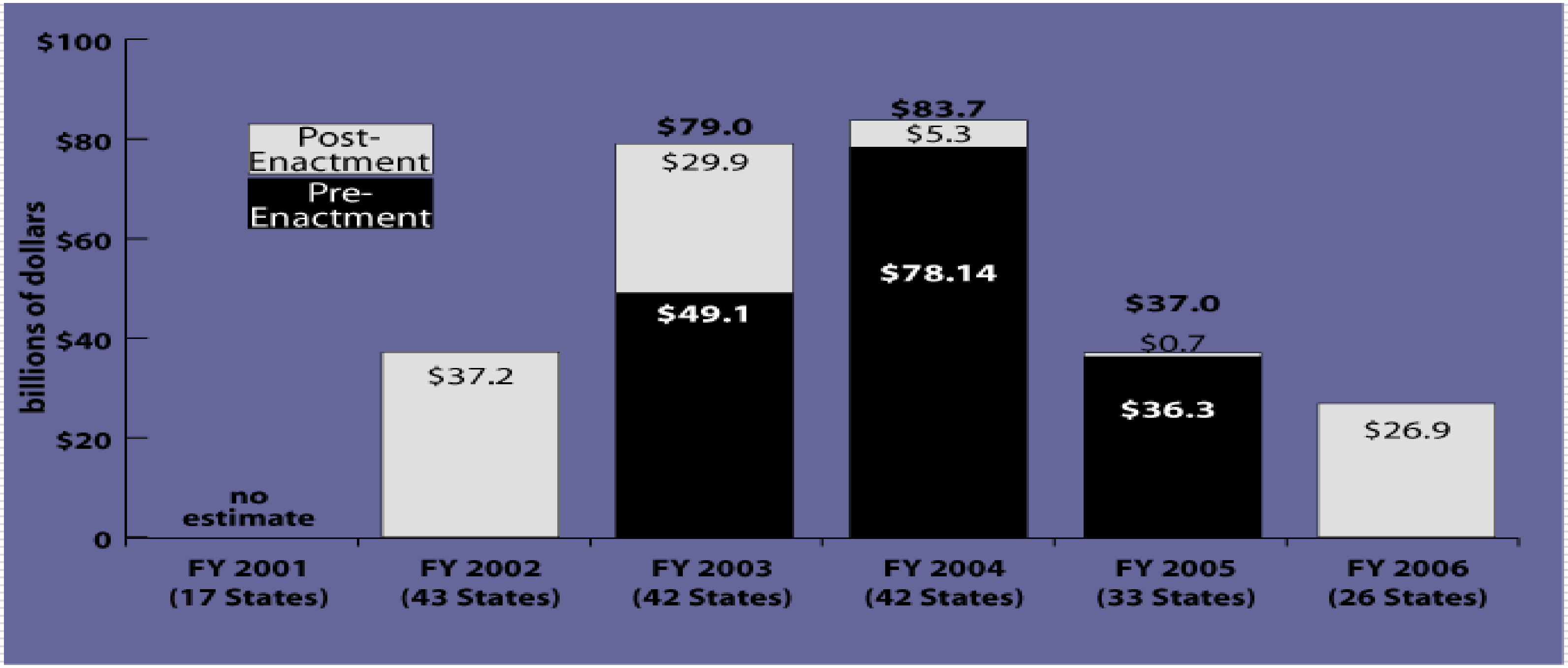
1. State Fiscal Trends
2. Different Elements in our Nation's Retirement Architecture
3. Public Pension Plans – Current Status
4. Key Emerging Trends – Public Pension Plans
5. Strategies Adopted by Different States

1. State Fiscal Trends

- State finances are finally improving: for FY 2005, revenues exceeded estimates in 42 states; met targets in 3 states; and only fell below projections in 5 states.
- This is a marked improvement from recent years; in FY 2002, for instance, 42 states reported less revenue than budgeted.
- Revenue flows into state general funds in FY 2005 totaled $521 billion, a growth of 4.7 percent from the prior fiscal year.
- For FY 2006, revenue growth is expected to be 5.2 percent.

1. State Fiscal Trends

The Council of State Governments



- Since FY 2001, states bridged budget shortfalls that exceeded $235 billion.
- This fiscal downturn affected states more deeply and for longer than the 1990/91 recession.

1. State Fiscal Trends

- During the downturn, states solved their budget gaps by
  - Slashing Spending
  - Tapping Rainy Day Funds
  - Deploying Tobacco Settlement Monies
  - Raising Taxes and User Fees
  - Hiking Cigarette Taxes
  - Cutting Funds to Local Governments
  - Racking Up Debt
  - Generating Funds via Gaming

1. State Fiscal Trends

- Even though state revenues have improved, state expenditures have exploded at a faster pace.
- In FY 2005, state spending grew by 6.6 percent.
- Rising healthcare costs, spurred by Medicaid, continues to plague state finances; 24 states reported Medicaid shortfalls in FY 2005 compared to 20 in FY 2004.
- Medicaid is expected to grow by an average of 9 to 10 percent a year in the next decade.
- Enrollment increases and rising prescription drug costs continue to play a major role in increased Medicaid spending.
- States also face higher expenses in K-12 education, pensions, corrections, transportation and infrastructure.

2. Retirement Architecture: Demographics

- Elderly population in every state will grow faster than the total population (3.5 times faster).
- Seniors will outnumber school-age children in 10 states in the next 25 years.
- 26 states will double their populations of people older than 65 by 2030.
- FL, PA, VT, WY, ND, DE, NM, MT, ME and WV will all have fewer children than elderly.
- Ratio of workers to retirees will decline in coming decades.

2. Retirement Architecture: Three Legged Stool Concept

The Council of State Governments

- Social Security
- Pension Income (Private or Public Sector)
- Personal Savings

Unfortunately, all these elements are currently on shaky ground

2. Retirement Architecture: Social Security

- At the end of 2004, 48 million people were receiving Social Security benefits.
- Costs will increase rapidly between about 2010 and 2030, due to the retirement of the large baby-boom generation.
- Annual cost will exceed tax income starting in <u>2017</u> when the annual gap will be covered with cash from redeeming special obligations of the Treasury until these assets are exhausted in <u>2041</u>.

2. Retirement Architecture: Private Pensions

The Council of State Governments

- The Pension Benefit Guaranty Corporation (PBGC), the federal organization that protects the pensions of over 45 million <u>corporate</u> workers, could be "on the hook for $450 billion in corporate pension obligations, up from $50 billion a mere three years ago."
- In three years, the PBGC has gone from having a $7 billion surplus to a $23 billion deficit.
- For instance, in April 2005, the PBGC took over all four United Airlines' employee pension plans, with a shortfall of $9.8 billion, the latest company to seek federal pension protection and making it the biggest pension failure since the government began insuring pension benefits in 1974.

2. Retirement Infrastructure: Private Savings

The Council of State Governments

Year	Disposable Personal Income (Billions of $)	Personal Savings	Percent
1973	$978.3	$102.7	10.5%
1983	$2,608.4	$233.6	9.0%
1993	$4,911.9	$284.0	5.8%
2003	$8,169.2	$172.8	2.1%
2004	$8664.2	$151.8	1.8%
2005 (Q2)	$9,020.1	$18.4	0.2%

3. Public Pension Plans – Cash & Investment Holdings (Thousand Dollars)

Category	1993	2000	2001	2003
Cash and Short - Term Investments	$66,192,708	$121,142,060	$117,392,023	$99,812,059
Government Securities	$203,452,928	$271,551,952	$246,787,978	$222,534,967
Non-Government Securities	$571,391,516	$1,602,291,271	$1,620,488,011	$1,669,422,866
Other Investments	$68,813,123	$173,657,750	$172,961,157	$180,231,896
Total	$920,571,814	$2,168,643,033	$2,157,629,168	$2,172,001,788

3. Public Pension Plans – Receipts (Thousand Dollars)

The Council of State Governments

Category	1993	2000	2002	2003
Employee Contributions	$16,137,931	$24,994,468	$27,544,022	$28,843,747
State Government Contributions	$15,186,886	$17,546,723	$17,182,861	$19,567,749
Local Government Contributions	$19,804,798	$22,608,391	$21,609,170	$26,644,540
Earnings on Investments	$74,812,951	$231,900,075	**($72,456,581)**	$72,690,968
Total	$125,942,566	$297,049,657	**($6,120,528)**	$147,747,004

3. Public Pension Plans – Payments (Thousand Dollars)

Category	1993	2000	2002	2003
Benefits	$48,327,862	$91,274,292	$110,128,411	122,306,460
Withdrawals	$2,477,142	$4,431,876	$4,079,492	4,891,041
Other Payments	$1,793,697	$4,751,715	$7,772,328	7,647,415
Total	$52,598,701	$100,457,883	$121,980,231	134,844,916

4. Key Trends – Public Pension Plans

- Shift to Non-Governmental Securities (corporate stocks, corporate bonds, foreign stocks).
- In 1993, public pension plans had only 62 percent of their total cash and investment holdings in Non-Governmental Securities.
- In 2003, this percentage had ballooned to 77 percent.

4. Key Trends – Public Pension Plans

Category	1993	2003
Cash and Short-term Investments	7%	5%
Government Securities	22%	10%
Ø Federal Government	22%	10%
Ø State and Local Governments	0%	0%
Non-governmental Securities	**62%**	**77%**
Ø Corporate Bonds	19%	15%
Ø Corporate Stocks	33%	37%
Ø Mortgages	2%	1%
Ø Funds Held in Trust	3%	3%
Ø Foreign Investments	0%	12%
Ø Other Non-governmental	8%	8%
Other Investments	7%	8%
Ø Real Property	3%	2%
Ø Miscellaneous Investments	5%	6%
Total	100%	100%

The Council of State Governments

4. Key Trends – Public Pension Plans

- Payments have clearly surpassed receipts, led by healthcare expenditures.
- Given the flurry of corporate scandals and the steep drop in asset values, greater activism by boards, controlling authorities and legislatures.
- Vast majority of the plans are unfunded, i.e., assets less than their accrued liabilities.

The Council of State Governments

4. Key Trends – Public Pension Plans

- According to Sept. 2004 NASRA survey:
  - OK Teachers ($5.5 billion; 54%)
  - IL Teachers ($23.8 billion; 49.3%)
  - IL SERS ($10.1 billion; 42.6%)
  - IN Teachers ($8.5 billion; 42.1%)
  - WV Teachers ($5.1 billion; 19.2%)
- According to August 2005 NASRA survey, the cumulative unfunded liability of public plans stood at $293.2 billion.

4. Key Trends – Public Pension Plans

- GASB Statement 45 requires that state and local governments account for and report the annual cost of OPEB (*other post-employment benefits*) –mostly health care - and the outstanding obligations and commitments related to OPEB in the same manner as they do for pensions.
- Statement 45 is effective in three phases:

  * Governments with revenue > $100 Million = December 15, 2006

  * Governments with revenue between $10 Million and $100 Million = December 15, 2007

  * Governments with revenue < $10 Million = December 15, 2008

4. Key Trends – Public Pension Plans

- Unfunded liabilities that will surface as a result of this ruling will eclipse the current pension deficits.
- Mercer Consulting estimate that governments that have not set aside money for these obligations could face liabilities 40-60 times the current annual cost of retirees' health care.
- CA could have an unfunded OPEB liability of $36 billion; NC $13-$14 billion; LA County School District $5 billion; NV up to $4.4 billion.
- If governments do nothing, "their credit rating could be damaged and their cost of borrowing could rise."

5. Strategies Adopted: Pension Obligation Bonds

- Racking up debt to bridge budget shortfalls has been a popular strategy among states recently.
- According to a May 2005 Moody's report, state net-tax supported debt rose 12 percent in 2004, down from the record 17 percent in 2003, but still well above the 9 percent average experienced since 1989.
- Total state net-tax supported debt in 2004=$340.2 billion.
- Recent bond issues have been very successful (CA, NJ, OR, IL, WI).

5. Strategies Adopted: Pension Obligation Bonds

Pros:

- Interest rates currently at historic lows
- Funds raised via bonds relieves immediate pressures on budget
- Opportunity to reduce/eliminate state's unfunded liability level

Cons:

- Possibility of investment earnings being lower than interest rate
- Locked into making debt payments
- Increases the state's net tax-supported debt level
- Fiscally dangerous policy of borrowing to meet ongoing expenditures (possible credit rate lowering)

5. Strategies Adopted: Pension Obligation Bonds

The Council of State Governments

- In 1997, New Jersey borrowed $2.8 billion to, among other goals, clear its unfunded liability.
- Investment earnings that exceeded 7.6 percent required to cover interest payments.
- In June 2000, pension plan was worth $83 billion; by June 2003, it had plummeted to $55 billion.
- NJ’s Public Employees Retirement System alone, now, has a projected deficit of $2.7 billion, almost five times the $593 million reported a year ago.
- City of Pittsburgh suffered similar fate too.

5. Strategies Adopted: Trimming Benefits

The Council of State Governments

- Moving workers away from DB plans to 401(k)-style, DC plans (AK, CA, SC, MA, MI)
- Linking annual increases to CPI (IL, RI, NH)
- Capping amount end-of-career raises adds to pension (IL)
- Adjusting age at which retirees paid full benefits (IL, RI, TX, LA)
- Reducing percentage of pay retirees get each year (RI)
- Eliminating DROPs (LA)
- Ending practice of employees serving a short period in a position to boost overall pension (MO)
- Eliminating new retirement breaks through special interest legislation (LA)
- Placing salary caps on rehired retirees (NM)
- Debating the ability of plans to offer lucrative health plans to retirees (NC, MI)
- Prohibiting school districts from offering early retirement incentives (TX)

5. Strategies Adopted: Other

- Increasing the costs to workers, counties and cities (MN, AK, TX, KY, NV, AR, SC).
- Consolidating retirement boards (WV, LA, MN, VT).
- Matching, i.e., deliberately aiming for low, but guaranteed, investment income from conservative bonds (ME).
- Unorthodox investments (AL, MA).

America's Retirement Architecture:

Strains in the System

Thank You

For more information, please contact

Sujit M. CanagaRetna
Senior Fiscal Analyst
404/633-1866
Or
scanagaretna@csg.org
www.slcatlanta.org