

# Unfunded Retirement Liabilities

## IS CONNECTICUT'S POLICY WIMPY?

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**The mantra of J. Wellington Wimpy in Popeye comics was, "I'll gladly pay you Tuesday for a hamburger today". Sensational news reports of late suggest that many states have, Wimpy-fashion, been lax in paying the full cost of today's public employees' services. These reports single out Connecticut as one of the Wimpiest states. Our state's unfunded retiree liabilities have in fact swollen since we last addressed the topic in our Spring 2008 issue. And Connecticut is still a leading laggard in correcting the problem. But the sensational headlines miss two key points: (1) Most states, Connecticut included, had been making steady progress on funding liabilities, until (2) the economic and financial cataclysm of late 2008, struck. That said, Connecticut faces some serious heavy lifting.**

Before the Great Recession, states had been working on funding future public-retiree costs by investing in stocks and bonds. But when financial markets tanked, the values of their investments also fell (though actuarial multiyear smoothing reduced the hit at that point). Adding insult to injury, state revenues have slumped, at the very time the demand for state services to mitigate the recession's impacts has risen. That, plus the plodding recovery from the recession, have made it all the harder for states to stick to their payment schedules.

One bright(er) spot: The partial recovery in stock prices and the stabilization of debt markets have reversed some of the sharp drops in retirement fund values. But actuaries' habit of using 5-year smoothing means that

huge funding gaps will hang around a while, even as restored funding payments take effect.

Rather than jumping off a bridge, it would be best to try to understand the underlying structure and true dimensions of states' unfunded retiree liabilities. Nutmeggers, pay special heed: Connecticut's challenge is right up there at the top of the list.

### SOME BASICS

"Funding" retiree liabilities means setting aside money today to make good on today's promises to pay workers next Tuesday, after they retire. Not saving to fulfill those future promises shifts part of the burden of their total costs into later periods, long after the workers' services have been used.

The extent to which retiree liabilities are adequately funded varies with the number of retirees (the prior total, minus deaths, plus new retirees); actuarial assumptions (how many are expected to get sick or die); and changes in the fund's value (asset price changes and new investments, less payouts).

A useful indicator of funding policy is the "annual required contribution" (ARC). Actuaries calculate the ARC as the amount that must be set aside each year to fund the present value of future benefits accrued in the current year plus the amortized cost of any unfunded liabilities. An employer's actual contribution may then be compared with the ARC to see whether it is sticking to its promises.

All employers, private and public alike, must deal with the problem of funding pension and other post-employment benefits. Funding these obligations typically involves purchases

of stocks and bonds. The intention, or at least hope, is that they will yield not only dividends and interest payments but also capital gains before they have to be spent to cover retiree benefits. Private employers are subject to a fairly rigid set of restrictions (see the box below), but public employers operate under a different set of circumstances.

Most public retirement plans are of the "defined-benefit" rather than the "defined-contribution" variety. Unlike defined contributions, which are paid up once the state pays money into employees' retirement accounts, defined benefits don't come due until workers retire.

Public employees' also enjoy more generous pension and retiree-health-insurance coverage than do private employees, in part because public employers cannot offer stock-purchase

### FUNDING PRIVATE RETIREE LIABILITIES

- Market discipline on disclosing unfunded liabilities through share-price effects
- Financial disclosure regulated by the Securities and Exchange Commission (SEC)
- Employee Retirement Income Security Act (ERISA) restrictions since 1974
- Pension Benefit Guaranty Corp. (PBGC) under ERISA insures pension benefits.
- Firms have largely replaced defined-benefit with defined-contribution retirement plans.
- Most remaining defined-benefits plans do not use employee contributions to fund them.

or -option plans. And public-employer defined-benefit pension plans generally promise larger benefits than their private counterparts, but largely because public plans are more likely to require employee contributions than private plans.

For several reasons (the Constitution, or politics, or...), states are not subject to ERISA or the guarantees under the PBGC (see box). Financial disclosure laws vary from state to state. Absent common stock, the SEC does not regulate public retirement benefits; and there is no stock-price sensitivity to reflect unfunded liabilities. The issuance of public debt does, of course, subject state finances to open inspection and audit, and in recent years state governments have moved to increase the transparency of their obligations to pay pensions and retiree health insurance premiums. The influence of the GASB, though lacking the market-enforced clout of the Financial Accounting Standards Board (FASB), has grown.

Large unfunded retiree liabilities may have serious long-term consequences for economic growth and jobs, especially through effects on business location decisions. They may augur rising taxes and higher borrowing costs, making maintenance and improvement of public infrastructure more expensive. Yielding to temptation under budget duress to reduce or postpone payments meant to strengthen the funding of retiree obligations will only compound the problems. In effect, doing that is filling current-spending holes with material dug from future-spending holes.

## FROM PRETTY BAD TO REALLY BAD

According to State Office of Policy and Management (OPM) data, as of June 30, 2006, Connecticut faced total unfunded retiree liabilities of some \$34.9 billion, not quite twice the level of yearly state spending. Some \$13.8 billion of that, or 40%, was for pension benefits, and the remaining 60%, or \$21.1 billion, was for unfunded retiree non-pension (mainly health insurance) benefits (hereafter, “Other Post Employment Benefits” or OPEB in the lingo).

Two years later, as of June 30, 2008 (the date of the latest official State data), the Nutmeg State’s total unfunded retiree benefits had jumped to \$42.6 billion. That 22.1% increase consisted of a 14% increase in unfunded pension liabilities, to \$15.8 billion, but an alarming bounce in unfunded OPEB of 27%, to \$26.8 billion.

The prime source of the boost was, of course, the financial market meltdown. But more retirees (in part due to retirement incentives) and rising health care costs doubtless contributed. Note that the rise in unfunded retiree liabilities was despite \$2 billion in borrowed funds injected into the Teachers Retirement System (TRS) in 2007—see below.

The unfunded pensions are concentrated in the two biggest State plans, those of the State Employee Retirement System (SERS) and the Teacher Retirement System (TRS). As the two charts on page 10 show, for the most part both have experienced steadily declining funded ratios—rising unfunded liabilities—since 2000, the onset of the recession tied to the collapse of the dot.com boomlet. That

means that the State lost ground funding pension liabilities even during the good years between that recession and the current one.

The notable exception is the sharp increase of 10 percentage points in the TRS funded ratio between 2006 and 2008. The source was \$2 billion in State bonds in 2007 dedicated to funding the TRS. The bonds carried a draconian covenant that requires the State (to avoid default) to pay the full amount of the ARC to the TRS every year—a mandate that will loom large in closing projected State deficits totalling \$9 billion in FY 2012-2014 (see our Spring 2010 issue, page 6). Note that the dollar value of the unfunded TRS pensions declined by only \$0.4 billion between 2006 and 2008, so some \$1.6 billion of the bonding money disappeared (so to speak) into higher pension obligations (more retired teachers), a more generous teachers pension COLA, and the early stages of the stock market slump.

The two charts also show that, according to estimates by Alicia Munnell and her colleagues at the Boston College Center for Retirement Research (*The Funding of State and Local Pensions: 2009-2013*, April 2010, p. 12), the funding ratios of both SERS and TRS sustained big hits in 2009—by one-sixth and one-eighth, respectively. Here, the main culprit was the financial market meltdown.

## HOW CONNECTICUT STACKS UP

A glance at the unfunded retiree obligations of other states, apart from consoling those who take comfort in having lots of company even if the boat is sinking, can add some useful perspective. As the table on page

11 shows, southern New England is anchoring (in the wrong sense) the state rankings by the funded ratio of state pensions. The company we keep includes Illinois, Land of Blagojevich. We're not in the same class as the Middle Atlantic states, even New Jersey (Land of Corzine). And New York, the deserving butt of many jokes about its upstate politics, would be a takeover target were it a corporation, with its over-funded state pension system. Interestingly, even with its fat funding ratio, New York's ARC is still \$2.6 billion a year, because (unless you're shutting down a state) current employees keep earning pension benefits. And even at a funding ratio of 86.9%, California's ARC is about 3/5 of Connecticut's yearly budget.

So much for the good news—let's turn now to OPEB liabilities. Misery loves company, and company is one thing Connecticut has a lot of here. Even the Land of Good Government, Wisconsin, has an OPEB funded ratio of only 24.0%, and they're 7th from the top of the list (Arizona), according to the Pew Center on the States (PCOS), in a February 2010 report. A few states like Massachusetts and North Carolina have taken some tiny steps—perhaps by accident—toward funding their OPEB liabilities. The rest have scarcely begun to think

about this problem, and that includes Connecticut.

But the stunner in the table is the huge relative size of our OPEB unfunded liability, compared with those of other, more populous states. According to Census data, Connecticut boasted 3.5 million souls as of July 1, 2009, which works out to \$7,395 in unfunded OPEB per capita. Among other states with *de minimis* funded ratios for OPEB, New York had a per-capita liability of \$2,880, California had \$1,690, North Carolina, \$3,064, and closer to home, Massachusetts owed \$2,280.

The segue in this riff: Can anyone think of an area of Connecticut's State budget that is ripe for cuts?

### WHAT IS TO BE DONE?

The "solutions" open to Connecticut for coping with its bulging unfunded retiree obligations are not very appealing as a group. Political opposition from the oxen being gored is the least of the problems. Some measures would require renegotiation of collective-bargaining contracts. And the easiest ones to implement tend also be to the slowest—er, most gradual—in remedying the problems.

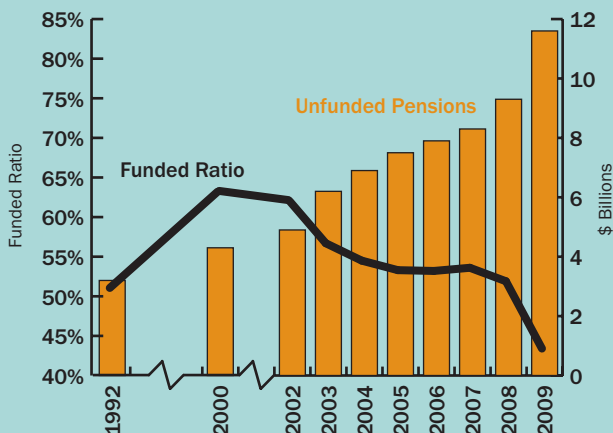
State lawmakers—representing the voters who elected them—have three broad choices: increasing State contri-

butions, reducing future costs (hence also liabilities), and achieving higher rates of return on funding assets.

**Increased contributions:** The State of Connecticut faces projected budget deficits of \$3.0 billion a year for the next three fiscal years (2012-2014). So raising current State contributions to make future retiree benefits more secure would face strong headwinds—more like head-gales, in fact. Issuing bonds would merely shuffle the forms of State liabilities that future taxpayers would have to pay for. With the latest use of more debt to help "balance" the FY 2011 budget, the State may have about tapped out its ability to persuade lenders to trade hard cash for our debt paper. And making the bonds more attractive by adding a covenant like that attached to the 2007 TRS bonds only brings us back to the pain of having to maintain the ARC payments out of current budgets. Absent State contributions, the only other stone to squeeze blood from here would be bigger employee contributions—a source other states have turned to.

**Reducing future costs:** To some extent, Connecticut has been moving in this direction for years, for instance, by whittling down its SERS pensions (from Tier I to Tier IB, IC, or II in 1984, and to Tier IIA in 1997, plus increasing employee contributions).

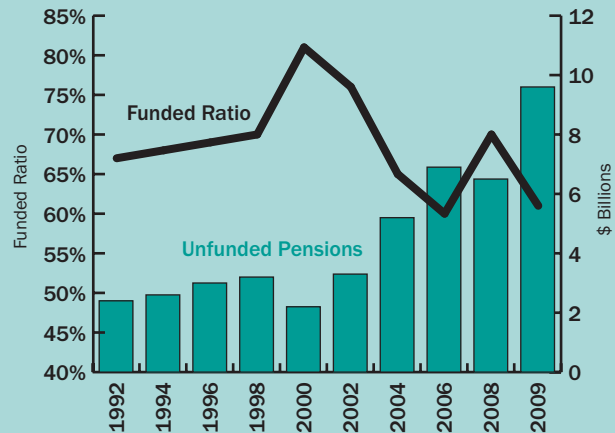
**UNFUNDED LIABILITIES AND FUNDED RATIOS OF THE S.E.R.S.\***



\* State Employee Retirement System

SOURCE: *The Connecticut Economy*, based on OPM; State Comptroller; (2009) A. Munnell et al., p. 11 (estimates).

**UNFUNDED LIABILITIES AND FUNDED RATIOS OF THE T.R.S.\*\***



\*\* Teachers' Retirement System

SOURCE: *The Connecticut Economy*, based on OPM; (2009) A. Munnell et al., p. 11 (estimates).

But such measures have always applied only to new employees, so the funded-liability gains arrive at a glacial pace. Even so-called two-tier measures have to be approved by the coalition of labor unions representing State employees, as would also moving from defined-benefit to defined-contribution pension plans (remember George Bush's failed attempt on Social Security, in part because of the transition hump in current spending), or making retiree health insurance options less luxurious. Connecticut would do well to look at measures taken by other states to trim future costs, without breaking or at least seriously renegeing on promises already made to retirees or those nearing retirement. To mention just one such measure, a lot of states have restricted employees' ability to raise pension benefits by "spiking" earnings in the last few years before retirement.

#### Achieving higher rates of return:

The problem with this ploy is that higher investment returns are always associated with higher risks. Can you see the State turning to the next Bernie

Madoff to let us in on some high-yield, can't-lose opportunities to bail us out of our unfunded liabilities hole? Also, the State should regularly review the management and administration of pensions, to keep costs as low as possible and prevent cozy relations with money managers from affecting decisions.

To end on a political note—for that's ultimately where the solutions have to come from—we repeat Wright's question from the last issue (on the State's budget crisis): Why are there so many candidates for Governor this election year?

*Connecticut's unfunded OPEB liability of \$7,395 per capita is 2.6 times New York's, 3.2 times Massachusetts', and 4.4 times California's.*

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### FUNDING OF ALL PUBLIC PENSIONS AND RETIREE OPEB FY 2008, SELECTED STATES (\$'000 EXCEPT %)

	PENSIONS					O.P.E.B.*			
	Rank (Pensions)	Unfunded Liability	A.R.C.**	Actual Contribution	Funded Ratio	Unfunded Liability	A.R.C.**	Actual Contribution	Funded Ratio
NY	1	(\$10,428,000)	\$2,648,450	\$2,648,450	107.4%	\$56,286,000	\$4,133,000	\$1,264,000	0.0%
FL	2	(\$1,798,789)	\$3,005,387	\$3,130,378	101.4%	\$3,081,834	\$200,973	\$87,825	0.0%
WA	3	(\$179,100)	\$1,545,600	\$967,900	100.1%	\$7,901,610	\$7,901,610	\$682,797	0.0%
WI	4	\$252,600	\$644,800	\$644,800	99.7%	\$1,700,396	\$205,116	\$90,134	24.0%
NC	5	\$504,760	\$675,704	\$675,056	99.3%	\$28,741,560	\$2,459,469	\$597,176	2.1%
PA	13	\$13,724,480	\$1,436,486	\$986,670	87.0%	\$9,956,800	\$823,500	\$745,000	0.9%
CA	14	\$59,492,498	\$12,376,481	\$10,469,213	86.9%	\$62,463,000	\$5,178,789	\$1,585,295	0.0%
NJ	36	\$34,434,055	\$3,691,740	\$2,107,243	72.6%	\$18,900,000	\$5,022,100	\$1,249,500	0.0%
MA	45	\$21,759,452	\$1,226,526	\$1,368,788	63.0%	\$15,031,600	\$838,700	\$701,992	1.8%
<b>CT</b>	<b>46</b>	<b>\$15,858,500</b>	<b>\$1,248,860</b>	<b>\$3,243,647</b>	<b>61.6%</b>	<b>\$26,018,800</b>	<b>\$1,718,862</b>	<b>\$484,467</b>	<b>0.0%</b>
RI	47	\$4,355,892	\$219,864	\$219,864	61.1%	\$788,189	\$46,125	\$28,378	0.0%
IL	50	\$54,383,939	\$3,729,181	\$2,156,267	54.3%	\$39,946,678	\$1,192,336	\$159,751	0.2%

\* Other Post Employment Benefits

\*\* Annual Required Contribution

SOURCE: *The Connecticut Economy*, based on Pew Center on the States, *The Trillion Dollar Gap* (Feb. 2010), pp. 4, 6.