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STATE AND MUNICIPAL DEBT: THE COMING CRISIS?
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Chairman McHenry, Ranking Member Quigley, and distinguished members of the subcommittee, thank you for inviting me to testify today on the important fiscal issues facing state and local governments. The duration and depth of the recent recession exposed several long-standing problems in state budgets. These problems, if left unaddressed, are certain to worsen states' future prospects for fiscal stability and sustainable economic growth. However, by making the necessary structural reforms today, states can mitigate the worst while meeting promises to both public employees and taxpayers.

Since the start of the 2008 recession much focus has been given to the fiscal future of state and local governments. In aggregate, states have closed $530 billion in budget gaps through a combination of tax increases, spending cuts and stimulus dollars.[1] States have also used a variety of accounting maneuvers to achieve budgetary balance including trust fund transfers, debt issuances and IOUs to vendors.[2]

Revenues are starting to recover, but are short of 2008 levels.[3] The situation varies in individual states, with some states projecting more robust revenues and other states anticipating a more modest and slower

[1] National Conference of State Legislatures, "Projected Revenue Growth in FY 2011 and Beyond," http://www.ncsl.org/documents/fiscal/Projected_Revenue_Growth_in_FY_2011_and_Beyond.pdf

[2] For a catalog of recent fiscal maneuvers used by states to balance their budgets see, Eileen Norcross "Fiscal Evasion," Mercatus Center Working Paper No. 10-39 July 2010 http://mercatus.org/sites/default/files/publication/Norcross.Fiscall%20Evasion.%20State%20Budget%20Gimmicks.%20Updated%208.23.10.pdf

[3] The Fiscal Survey of the States, National Governors Association, National Association of State Budget Officers, June 2010. http://nasbo.org/Publications/FiscalSurvey/tabid/65/Default.aspx

recovery. This year, state operating deficits are projected to be $125 billion, and in some states are anticipated to continue into 2014.[4] But as the National Conference of State Legislatures (NCSL) notes, even if revenues recover to pre-recession levels, state and local governments will continue to face fiscal pressures due to a combination of factors including the stimulus phase-out, depletion of one-time revenues, expiration of tax increases, and the mounting pressure from rising caseloads and deferred spending.[5] The Government Accountability Office (GAO) projects without any policy changes the state and local government sector will face a $9.9 trillion "fiscal gap" between FY 2009 and FY 2058.[6]

These yearly gaps and the spending pressure presented by Medicaid, K-12 education, and the uncertainty presented by the recently enacted health care bill, must be considered together with the growing funding instability in state and local pension plans. Economists estimate that the unfunded liability faced by state and local government pensions amounts to $3.5 trillion and that without significant reform, plans many plans will begin to run out of assets, beginning with Illinois in 2018.[7] Vested pension benefits are considered contractual obligations, the equivalent of general obligation debt.

States must act today to stabilize and reform their pension systems if they are to meet these obligations to workers. Avoiding reforms today ensures that states will have to confront even more difficult and unpopular budgetary choices than they have faced during the past recession.

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[4] National Conference of State Legislatures, "State Budget Update: November 2010" http://www.ncsl.org/LinkClick.aspx?fileticket=AqSBWjZkwK8%3D&tabid=21829

[5] NCSL, "Projected Revenue Growth in FY 2011 and Beyond," p. 10.

[6] Government Accountability Office, "State and Local Governments: Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs," GAO-10-899, July 2010. http://www.gao.gov/new.items/d10899.pdf

[7] Rauh, Joshua D., Are State Public Pensions Sustainable? Why the Federal Government Should Worry About State Pension Liabilities (May 15, 2010). Available at SSRN: http://ssrn.com/abstract=1596679. According to Rauh, five pension plans including Alaska, Florida, Nevada, New York and North Carolina never run out of assets to pay benefits.

In my testimony I will address what drives budget gaps, and the size and impact of public employee pensions on state budgets. I will conclude with recommendations for reform.

WHY STATES STRUGGLE TO BALANCE THEIR BUDGETS

The recent downturn is only one cause for state budget gaps. Pressure has been building in the states over a much longer period. Simply, put, in the aggregate, state and local spending has grown faster than the private economy in real terms.[8] Between 2000 and 2009, state and local government spending grew nearly twice as fast as the private sector.

What does this mean for state budgets? State spending grew faster than state own-source revenues in 47 states between 1977 and 2007.[9] The fastest growing area in state budgets is Medicaid. In 1987 Medicaid represented 10 percent of state spending on average. In 2009 it represented 21 percent.[10]

While state spending grew faster than state revenues during the period, states mainly showed surpluses. The reason is that states, in addition to relying on own-source revenues, also fund expenditures with federal funds and state debt. GAO finds that the state and local sector in aggregate remained in surplus over this 30 year period in part due to growth in federal funds.[11] Some states avoided showing deficits in part because federal funds grew slightly faster than states' own-source revenues.[12] In addition, between 1995 and 2007, state and

[8] Matthew Mitchell, "State Spending Restraint: An Analysis of the Path Not Taken," Mercatus Center Working Paper, No. 10-48, August 2010 p. 2. http://mercatus.org/publication/state-spending-restraint

[9] Government Accountability Office, "Fiscal Pressures Could Have Implications for Future Delivery of Intergovernmental Programs," GAO-10-899, July 2010. http://www.gao.gov/new.items/d10899.pdf

[10] Ibid., Matthew Mitchell
[11] GAO 10-899, p. 14.
[12] Ibid.

local governments became increasingly reliant on debt to finance capital projects, freeing up revenues for current spending. [13]

In sum, many states have been able to show budgetary balance while revenues failed to keep pace with spending growth partly due to federal funds and debt. In addition some states have made a habit of deferring —in part or in full—their contribution to pension plans, by not funding health care benefits, and by issuing bonds to make pension payments.[14] These techniques helped states show budgetary balance, grow spending, and pass the cost of funding plans onto future taxpayers.

States are now looking to a future with slower economic growth and dramatically increased federal deficits and debt. States will have to rethink how they are budgeting. GAO anticipates that without any change in current policy, state and local governments will require a sustained reduction in spending, or increase in revenues of 12.3 percent annually to close an anticipated $9.9 trillion fiscal gap between FY 2009 and FY 2058.[15]

The federal government plays a significant role in state budgets, largely through the Medicaid program. Medicaid is one of the main spending drivers in state budgets. In 2009 the stimulus increased the FMAP to states on the condition that states maintain or expand enrollment. With stimulus funding spent by the end of this year, states are left with a permanently larger program unless they can make adjustments. This has led several states to ask the federal government for a waiver to the newly enacted health care bill that would allow states to reduce Medicaid enrollment between now and 2014. There will be a large but currently unknown fiscal responsibility placed on the states with the enactment of the health care bill which will seriously constrain states in their ability to maintain their current budgets, and fund future obligations.

[13] Ibid.
[14] Eileen Norcross, "Fiscal Evasion", p. 16-18.
[15] Ibid, GAO

That is, the growing fiscal pressure in state budgets due to rising health care costs must be considered alongside the shortfalls in state and local pension plans which will require greater revenues in the near term to ensure these plans remain funded. The choice by some governments to defer obligations and treat pensions as a future problem has exacerbated plans' underfunded status.

PUBLIC SECTOR PENSIONS AND THE EFFECTS ON STATE BUDGETS

State and local governments report an estimated pension shortfall of $1 trillion. However, when using methods that economists agree are correct, the shortfall increases to $3.5 trillion. In either case, many state and local governments face a very significant obligation beginning in the near term. Meeting this obligation requires that state and local governments institute pension reform now.

The magnitude of pension underfunding stems from how pension obligations have been valued which has informed how governments have managed plan funding and benefit levels. The dramatic downturn in the market in recent years is harmful but is not the primary cause for plan underfunding.

Pension plans have been systematically weakened by interactions between actuarial practice and the tendency for governments to make unrealistic promises to employees, and the choice of governments to contribute less than what plan actuaries recommend to fund plans over a period of years.

Current government actuarial practice assumes that plan assets can earn high rates of return, leading actuaries to calculate employer contributions that are lower than needed to fund plan liabilities. Actuarial practice is based on guidance provided by two government accounting standards Government Accounting Standards

Board (GASB) 25 and Actuarial Standards of Practice (ASOP) 27 which state that a liability may be discounted according to what the assets are expected to return when invested.

On average states have assumed an annual return of 8 percent and have used this to measure their pension liabilities. This principle is misguided. According to economic theory and practice how a liability is valued is independent from how it is financed.[16] Instead, the discount rate used to value the liability should reflect the relative safety (or risk) of what is being valued, in this case, a risk-free, government-guaranteed pension. Thus economists recommend the discount rate used should reflect the safety of a government-guaranteed pension, such as the yield on Treasury bonds, currently at 4 percent.

Several things result from the discount rate approach currently used by state and local governments.[17] First, plan managers have an incentive to take on more investment risk to realize higher expected returns on plan assets. This has led public plans to change the mix of their investments and move towards higher-risk equities.[18] In 1990, 40 percent of public sector pension assets were held in equities, rising to 70 percent in 2006, roughly 10 percent higher than the allocation of pension assets to equities in private pension systems.[19]

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[16] For a discussion see, Eileen Norcross and Andrew Biggs, "The Crisis in Public Sector Pensions: A Blueprint for Reform in the States," Mercatus Center Working Paper, No. 10-31, June 2010. http://mercatus.org/sites/default/files/publication/WP1031-%20NJ%20Pensions.pdf

[17] Discounting allows one to value a future benefit in today's dollars, it asks, "how much is needed to be set aside today to pay a promised amount in the future?" The discount rate is the interest rate selected to perform this calculation. Discounting, is essentially, reverse compounding.

[18] Before the 1980s, most systems held their assets mainly in fixed-income securities, investment choices were restricted by legal lists. In the 1980s legal lists were replaced by the "prudent person" rule. This allowed pension plans to hold larger percentages of equities and capture the higher returns being generated in a booming market, See, Olivia S. Mitchell, David McCarthy, Stanley C. Wisniewksi and Paul Zorn, "Developments in State and Local Pension Plans," Chapter 2 in Pension and the Public Sector, eds. Olivia S. Mitchell and Edwin C. Hustead, University of Pennsylvania Press, Philadelphia 2001, p.14.

[19] Andrew G. Biggs, "The Market Value of Public Pension Deficits," Retirement Policy Outlook, No. 1, American Enterprise Institute for Public Policy Research, April 2010, p. 2.

In fact, as a result of the market downturn, some plans are taking on even more risk to make up for losses, exposing funds to greater losses when the stock market performs poorly. California's state pension plan, CalPERS lost $500 million in the financial collapse of the Stuyvesant Town-Peter Cooper Village real estate venture in 2009. In spite of this, to avoid raising the contribution rate for state agencies, CalPERS has expanded its equities holdings from 49.1 percent of 53.1 percent, exposing the portfolio to more volatility in the short-run.

Effectively, public pension accounting implies it is possible to guarantee a certain benefit with volatile investments. This lessens the likelihood there will be enough in the plan to pay benefits when they are due. The majority of a plan's obligations are payable over the next 15 years, so even if plans accurately predict market returns over a long period, they must pay out benefits over the short term when average market returns are more uncertain.[20] Thus there is a significant probability that a "fully funded" plan would be unable to meet its obligations even if the plan accurately projected average market returns. In sum, discounting pensions at the expected rate of return on investments implies that the entire return is available to pay future benefits and makes no allowances for losses. It implies that by taking on more investment risk the plan's funded status is improved.[21]

Secondly, the flawed discount rate assumption has led to the systematic underfunding of pension plans, as the higher discount rate reduces the amount needed to be set aside today to fund the plan. Even where plans are making their full contribution, they are contributing too little. And it has led governments enhance benefit formulas during boom years, since the flawed discount rate assumptions makes plans appear low-cost to the government to fund. When plans look overfunded on paper, legislators grant benefit increases which are then

[20] M. Barton Waring, "Liability-relative investing," Journal of Portfolio Management, 30 (4), 2008. Waring finds that the mid-point of a public pension's stream of benefit payments is around 15 years in the future. Thus, a lump-sum payment 15 years hence can be treated as an approximation of the annual benefit liabilities owed by a plan.
[21] Alicia Munnell, Rickard W. Kopcke, Jean-Pierre Aubry and Laura Quinby, "Valuing Liabilities in State and Local Plans," Center for Retirement Research at Boston College, Number 11, June 2010.

difficult to reverse. The discount rate assumption has also has encouraged states to defer or reduce their payments when plans appeared overfunded or when assets returns were high.

The Stanford Institute for Economic Policy Research finds that the funding policy adopted by the University of California Retirement System (UCRS) allowed contributions to the system to be suspended, "when the fund value is deemed sufficiently high relative to liabilities." The result is that since UCRS was overfunded [on paper] in 1991, contributions fell to 1 percent of covered payroll per year between 1994 and 2007. [22]

While all state and local governments suffer from the same flawed discount rate assumption there is variation in the size of pension shortfalls and the timing of when plans can expect to run out of assets necessitating a move to a pay-as-you-go system.

Two studies that estimate the budgetary impact of pension plan underfunding on individual states. Both rely on different models and assumptions. But together these studies offer some parameters as to what the worst-funded plans can expect.

It must be stressed that these scenarios can and should be generated by state and local governments and made available to the public, as economist Joshua Rauh notes, "it would be useful if states presented complete forecasts of the stream of cash flows they owe to beneficiaries under different assumptions…unfortunately, public pension plans do not present forecasts of long-horizon benefit payments. Instead they present an Accrued Actuarial Liability (AAL), a present value of the cash flows under a discount rate rule chosen to conform with GASB 25."[23]

[22] Howard Bornstien, Stan Markuze, Cameron Percy, Lisha Wang and Moritz Zander, "Going for Broke: Reforming California's Public Employee Pension Systems," Stanford Institute for Economic Policy Research, Stanford University, April 2010.
[23] Rauh, "Are State Public Pensions Sustainable?" p. 5

The most comprehensive estimate of when states can expect to run out of assets to pay pension benefits is provided by Dr. Rauh based on the data made available by state pension reports. He estimates that with 3 percent annual revenue growth and under the states' current average discount rate assumption of 8 percent, eight states will run out of assets to pay pensions by 2020.

By 2018 Illinois will run out of plan assets which will require that the state begin contributing $11 billion annually from revenues between 2019 and 2023. Currently, the state contributes $3.5 billion annually, and has often bonded its contributions. Using less generous assumptions, this scenario is much worse. Indeed, as Dr. Rauh notes this will present a "catastrophic shock" to Illinois' current revenue needs.

The situation is not much better in New Jersey. Dr. Rauh estimates New Jersey will require $10 billion annually out of its revenues to pay for pension benefits it has already made beginning in 2020, which represents one-third of the state's current budget. Other plans have a longer time horizon but face even more difficult scenarios. In 2031, Ohio will require 55 percent of its projected revenues, or roughly $13.8 billion annually to pay for existing liabilities.

A less dire scenario is offered by Alicia Munnell, Jean-Pierre Aubry and Laura Quinby of the Center for Retirement Research at Boston College. They estimate for several states, the percent of budgets that will need to be set aside to ensure pension systems can continue paying workers.[24] Accordingly by 2014, New Jersey and Illinois will have to raise their annual pension contribution to 8 percent of their budget in order

[24] Alicia Munnell, Jean-Pierre Aubry, and Laura Quinby, "The Impact of Public Pensions on State and Local Budgets," Center for Retirement Research at Boston College, Number 13, October 2010. http://crr.bc.edu/images/stories/Briefs/slp_13.pdf

to remain funded, under a generous discount rate assumption of 8 percent. However, when using a lower-risk discount rate of 5 percent, that annual amount would rise to between 12 and 13 percent of their budgets, respectively. In the case of Illinois if they were to run out of assets, this would have to rise to over 16 percent of their budget by 2027.

In the Munnell, Aubry and Quinby scenario, the pension crisis is more manageable, but will still entail difficult choices in these states. New Jersey has grown accustomed to deferring, or partially paying, its pension payment since 2003. Jumping from this year's anticipated contribution of $500 million to nearly $4 billion in three years will mean that New Jersey will have to find savings in other parts of its budget.

Illinois has often relied on bonding its contribution instead of drawing on revenues. In 2003, the state issued $10 billion in Pension Obligation Bonds (POBs).[25] In FY 2010, Illinois issued a $3.5 billion in POBs to make its pension contribution. For FY 2011, the Illinois legislature authorized new pension borrowing of up to $4.1 billion.[26]

Such annual and sustained contributions as suggested by Munnell, Aubry and Quinby will require actions these states have avoided to date. As Alicia Munnell notes, in 2008, 43 percent of state and local governments skipped their pension contribution, and a further 28 percent of governments contributed less than 80 percent of the annual payment.

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[25] Alicia Munnell, Thad Calabrese, Ashby Monk and Jean-Pierre Aubry, "Pension Obligation Bonds: Financial Crisis Exposes Risks," Center for Retirement Research at Boston College, Number 9, January 2010. http://crr.bc.edu/briefs/pension_obligation_bonds_financial_crisis_exposes_risks.html

[26] Institute for Illinois' Fiscal Sustainability at the Civic Federation, "Some Pension Bond Proceeds Could End up in the General Fund," January 24, 2011. http://civicfed.org/iifs/blog/some-pension-bond-proceeds-could-end-general-funds. They note a provision is attached to the borrowing that would allow the state to use the bond proceeds in the general fund rather than to fund the pension. This provision is subject to the Governor's veto.

These two studies use different methods and assumptions. In addition there are several other recent studies that have estimated when plans are likely to run out of assets to pay plan beneficiaries.[27]

Ultimately it is incumbent on State Governors, Treasurers and actuaries to stress test their pension systems[28].This should be done under a range of assumptions with the methodology and data made publicly available. Only when states generate future cash flows will policymakers have a clear sense of when they are likely to run out of assets and what they need to do today to manage their liabilities. Short of an accurate accounting and thorough forecasting state policymakers have an incentive to ignore the estimates and warnings of economists, thus delaying the very reforms that can help stabilize these systems today.

RECOMMENDATIONS

States must take responsibility for the promises they have made to their workers on behalf of taxpayers. The federal government can help alleviate the growing fiscal stress present in state budgets, largely driven by increasing health care costs, through Medicaid reform. To put states on stable footing requires public pension reform.

I have two recommendations:

1. Make accounting transparent and accurate. State and local governments must accurately account for what is owed and model future cash flows to determine what will be need to be set aside annually to pay beneficiaries. While acknowledging current assumptions, states must also apply the risk-free discount rate and stress test pension plans under a range of assumptions. The data, methods and assumptions should be made public. Economists and occasionally plan actuaries have presented plan funding

[27] See Andrew G. Biggs, "An Options Pricing Method for Calculating the Market Price of Public Sector Pension Liabilities," AEI Working Paper 164, February 26, 2010. http://www.aei.org/docLib/Biggs-WP-164.pdf

scenarios that show a very serious picture. The effects of plan underfunding can only be mitigated when states and the public are presented with a complete picture of the tradeoffs that are going to be necessary to ensure plan funding.

2. Make pensions fiscally responsible and stable. In our analysis of New Jersey's pension system, Andrew Biggs and I develop several recommendations for how the state can tackle its growing liability. To increase the probability of paying benefits to workers, states can do the following:

Freeze or reduce the Cost of Living Adjustment, increase the retirement age, increase contributions from workers, and, importantly close the defined benefit plan to new hires. This last reform will allow states to focus their resources on paying what is owed. Together, these reforms can cut the size of the liability in half while increasing the likelihood that states can ensure benefits are paid. These reforms will help minimize the impact on taxpayers and the economy. Moving younger workers to a defined contribution plan – which can be designed to fit the needs of public sector workers – allows younger workers more career flexibility, shifts the risk of plan underfunding away from taxpayers, and I would argue most importantly, ends the political and fiscal manipulation of worker benefits which has turned what was intended to be a safe investment for public sector workers into a gamble for both public employees and taxpayers.

CONCLUSION

Some state officials have begun to take steps in the right direction and are advancing some of the reforms mentioned including Governor Christie in New Jersey, Governor Scott in Florida, and State Senator Dan Liljenquist in Utah. They and others are forwarding a variety of reforms that will help states meet these promises. In some cases, public sector unions have shown a willingness to work together with states to find a solution to the funding problem. Unfortunately, in other cases, states are doing the bare minimum, all but ensuring that what is a serious problem today becomes a crisis in several states by decade's end.

With accurate pension accounting and modeling, state and local governments will be able to make better choices. Part of this however requires this accounting and data be made public for evaluation. Voters and workers must also be made aware of the sacrifices that will be necessary to pay what is owed, while at the same time undertaking retirement reform for state and local workers. Short of this, governments unfortunately, have every incentive to continue modeling their pensions based on circular logic, while taking on greater investment risks, and avoiding the kind of reforms that are needed today, to ensure retirees are paid tomorrow.

With the exception of federal spending, states have the tools they need to reform their budgets, and in some cases, it's a question of whether they want to use them. Tough choices need to be made today. Those choices will only become more difficult and economically harmful the longer governments wait. Thank you for the opportunity to testify today. I look forward to answering your questions.