The $2 Trillion Black Hole

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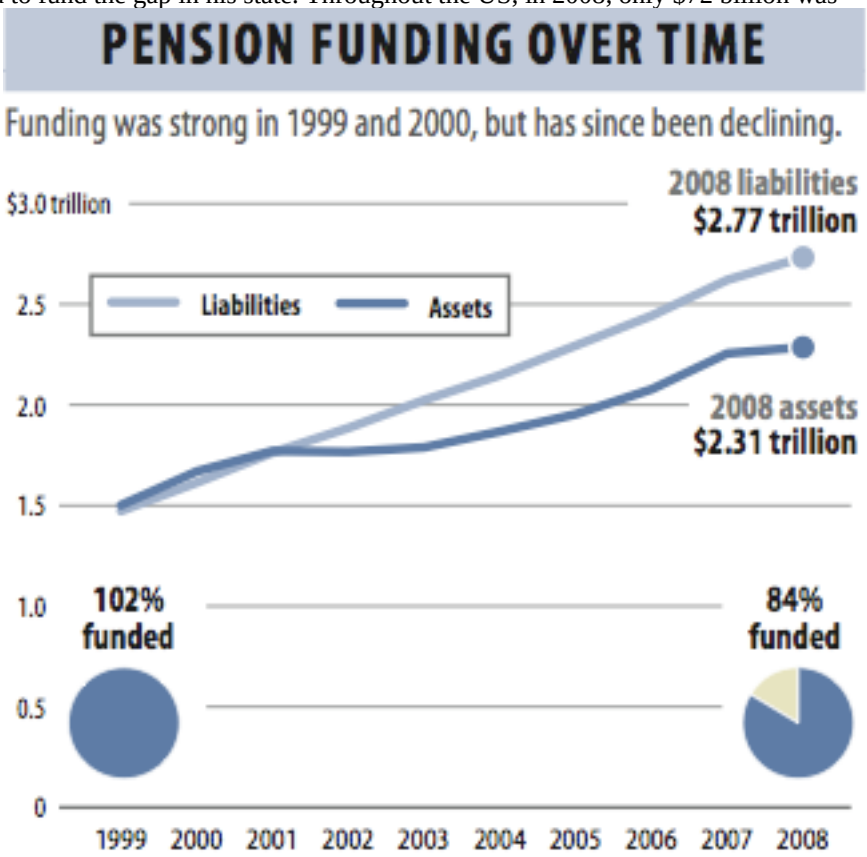
Summary

It is impossible to stay solvent with increasing liabilities and decreasing assets. State and Municipal governments are faced with a crucial problem; how to pay off public sector pension plans which have been left underfunded for years. Adding insult to injury, the market values of the portfolios used to fund these pensions plans have been crippled in the Great Recession. Even more troubling, these defined pension plans, by law, are guaranteed for nearly 80% of public officials no matter the performance of the underlying assets used to finance them. Legislatures are faced with few options; raise taxes, cut spending elsewhere or default on their GO debt.

The Problem

Guaranteed pension plans have gone underfunded for years. Just last year, John Corzine of New Jersey contributed a mere $105 million, or only 4.5% of the $2.3 billion needed to fund the gap in his state. Throughout the US, in 2008, only $72 billion was contributed to the $108 billion needed to fund these plans. Underfunding has been a problem dating back over two decades ago. Under certain laws, state and local governments are allowed up to 30 years to close funding gaps. With the time span to close the gaps extending way beyond legislatures' terms in office, it became so easy for them to place these deficits on the back burner. For example, it was assumed in the 1990's that the stock market boom would cover any exposure in the funding gap. This, however was not the case as seen by the tech bubble crash of the early 2000s. It is even more unsettling that state legislatures did not learn from this mistake and continued these practices well into this decade.



In addition to increasing liabilities on pension payments. Retiree health benefits are threatening to overburden the system. According to a 2010 report by the Pew Center for the States, as of 2008 only 5.44% of the $587 billion needed to fund retiree health care and non-pension benefits was contributed nationwide.

These shortfalls in funding can also be blamed on increasing incentives to public employees. Such incentives include early retirement benefits offered in contractionary years, cost-of-living increases and pension systems offering retirees excess returns on investment assets during boom years.

Hall of Shame

Here are the states ranked worst to first in percentage of pension liabilities that are funded. Some states that do OK here, such as California and New York, are struggling with other fiscal woes. The bond ratings reflect states' overall strength.

State	Unfunded Liability (bil)	% Funded	RATING S&P	RATING Moody's	RATING Fitch
Illinois	$54.4	54%	A+	A2	A
Kansas	8.3	59	AA+	Aa1	AA-
Oklahoma	13.2	61	AA+	Aa3	AA
Rhode Island	4.4	61	AA	Aa3	AA-
Connecticut	15.9	62	AA	Aa3	AA
Massachusetts	21.8	63	AA	Aa2	AA
Kentucky	12.3	64	AA-	Aa2	AA-
West Virginia	5.0	64	AA	Aa3	AA-
New Hampshire	2.5	68	AA	Aa2	AA
Hawaii	5.2	69	AA	Aa2	AA
Colorado	16.8	70	AA	Aa2	F1+
Louisiana	11.7	70	AA-	A1	AA-
South Carolina	12.1	70	AA+	Aaa	AAA
Indiana	9.8	72	AAA	Aa1	AA
Mississippi	8.0	73	AA	Aa3	AA
New Jersey	34.4	73	AA	Aa3	AA-
Alaska	3.5	76	AA+	Aa2	AA
Nevada	7.3	76	AA+	Aa2	AA
Alabama	9.2	77	AA	Aa2	AA
Maryland	10.9	78	AAA	Aaa	AAA
Wyoming	1.4	79	AA+	NR	F1+
Arizona	7.9	80	AA-	A1	NR
Maine	2.8	80	AA	Aa3	AA
Oregon	10.7	80	AA	Aa2	AA
Minnesota	10.8	81	AAA	Aa1	AAA
Missouri	$9.0	83%	AAA	Aaa	AAA
New Mexico	4.5	83	AA+	Aa1	NR
Michigan	11.5	84	AA-	Aa3	A+
Montana	1.5	84	AA	Aa2	AA
Utah	3.6	84	AAA	Aaa	AAA
Virginia	10.7	84	AAA	Aaa	AAA
Arkansas	2.8	87	AA	Aa2	NR
California	59.5	87	A-	Baa1	BBB
North Dakota	0.5	87	AA+	Aa2	NR
Ohio	19.5	87	AA+	Aa2	AA
Pennsylvania	13.7	87	AA	Aa2	AA
Vermont	0.5	88	AA+	Aaa	AA+
Iowa	2.7	89	AAA	Aa1	AA+
Texas	13.8	91	AA+	Aa1	AA+
Georgia	6.4	92	AAA	Aaa	AAA
Nebraska	0.8	92	AA+	NR	NR
Idaho	0.8	93	AA	Aa2	AA-
Tennessee	1.6	95	AA+	Aa2	AA+
South Dakota	0.2	97	AA	NR	AA-
Delaware	0.1	98	AAA	Aaa	AAA
North Carolina	0.5	99	AAA	Aaa	AAA
Washington	(0.2)	100	AA+	Aa1	AA
Wisconsin	0.3	100	AA	Aa3	AA-
Florida	(1.8)	101	AAA	Aa1	AA+
New York	(10.4)	107	AA	Aa3	AA-

NR=Not rated

Sources: Pew Center on the States; Standard & Poor's; Moody's, Fitch

Abuses of the System

In addition to under-funding from fiscal contributions and revenue shortfalls, public officials receiving these benefit plans have been finding ways to abuse the system. With pension contribution formulas using the retiree's final year's salary as the basis for pay, public workers tend to rack up over time in their final years to boost their pensions, post-retirement. Other employees have also discovered "double dipping" where after retiring, they return to the public sector and earn contributions towards an additional pension.

Implications and Reform

State and municipal governments are over burdened and are seeing their budgets being eaten away by these liabilities. For example, the city of Vallejo, CA has 90% of its budget paying off pension liabilities. As a means to cope, the city has proposed a three year moratorium on all of its $53 million in municipal debt all while maintaining payments on all of its $84 million in pension liabilities. Other governments are left with few options:

- ***Raise property, sales and income taxes***
- ***Cut spending on programs such as emergency services , healthcare, education and infrastructure***
- ***Default on GO debt***

Reform in some states, such as New York, Nevada, Nebraska, Rhode Island, and New Jersey are causing legislatures to raise retirement ages, cut pension-benefit formulas, increase employee contributions, reform laws to curb income spiking and employee "double dipping" and switch to less costly defined-contribution plans to help cope in the future. However, action is needed now to close the gap the exists.

References

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