# Beware Those 'Sleeper Taxes'

## UNFUNDED PUBLIC RETIREE BENEFITS

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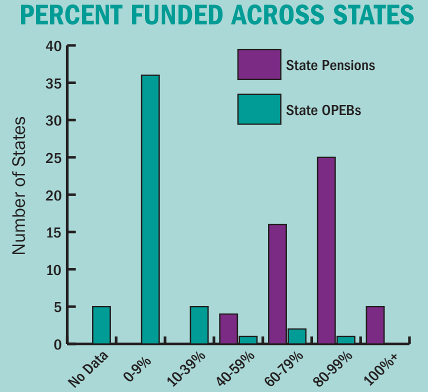
*Connecticut-today has already committed Connecticut-tomorrow to collecting extra taxes.*

**Avid watchers of Fox Network's serial "24" will have heard of terrorist "sleeper cells", which lie dormant until a mastermind like Osama Bin Laden awakens them. Sleeper problems of a different sort lie in wait for Connecticut and other states: sums they will someday have to pay today's public employees in the form of pensions and other benefits, mainly health insurance. For a long time, those "unfunded" liabilities have lain dormant. Of late, though, their growing magnitude has compelled accountants and auditors to begin flagging them in public reports.**

How bad is this problem? The total of the 50 states' liabilities may look scary: as of mid-2006, nearly $2.5 *trillion* (in the same range as a year's worth of Federal-government revenues) for state-employee pensions, and almost $400 billion for "other post-employment benefits" (OPEB).

But things aren't all that bleak for state-employee pensions, some 85% of which are already "funded" by financial assets in state-owned accounts. Bleaker, though smaller, are the OPEB liabilities, which are only 3% funded. Indeed, the dollars due on the other benefits exceed those on the pensions: $370 billion *vs.* $353 billion.

**PERCENT FUNDED ACROSS STATES**




SOURCE: Pew Center on the States, *Promises with a Price* (2007), pp. 18-40. Data for FY 2006.

But what about Connecticut? Bleak understates the case. As of mid-2006, our unfunded state-pension liability was $14.9 billion, about a year's worth of State spending. Compared with other states, we would have come in last, at 56% funded, were it not for West Virginia, one point lower (see chart). On OPEB, things were even worse, by nearly half: the total liability was an estimated $21.7 billion, all of it unfunded. In other words, as of mid-2006, Connecticut had not really begun to set aside current tax dollars to cover its future health-insurance commitments to current State employees. There is some solace in having a lot of company—in OPEB, we're at the bottom nationally with 35 other states.

### BIG WHOOP?

But do future pension or health insurance liabilities really matter all that much? Alas, the answer is yes, and the reason is that future State taxes matter. The liabilities at issue here represent claims against future State revenues, which derive primarily from State taxes, which in turn will have to be levied against future incomes and asset values.

In a real sense, Connecticut-today has already committed Connecticut-tomorrow to collecting extra taxes, unless the latter opts to cut services—education, economic development, social services—and the State jobs involved in providing them.

True, future generations will have the benefit of rising per capita incomes from continued economic growth. But should we be committing taxes on those *future* incomes to pay for State services consumed by the *current* generation? Promised future payments to public employees are for work they perform *today*. When tomorrow happens, the State will need to pay other employees to provide services to its then-current residents.

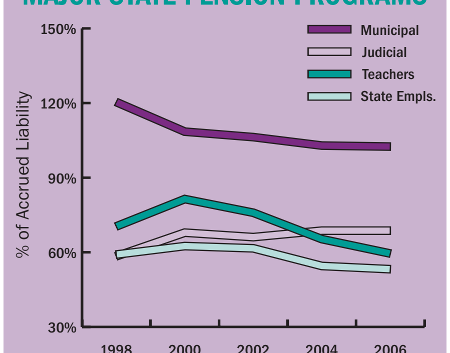
And what if price increases for promised future payments outpace the growth of real incomes, as may well be the case for retirees' health insurance?

It gets worse. Piling up a slug of future tax commitments may itself cut into future income growth. Expected future taxes affect a state's current debt rating, hence also its cost of borrowing for capital projects such as roads, bridges, and airports that are key to a state's competitive position. Similarly, business decisions about locating new facilities or even staying in a state depend on "sleeper" as well as current taxes.

Sound financial practice dictates "funding" at least a high proportion of the future payments promised to public employees in return for their present-day work. "Funding" means setting aside enough extra tax dollars today to cover the promises of future benefits paid to current workers.

So Connecticut has its work cut out.

**"FUNDED RATIOS", MAJOR STATE PENSION PROGRAMS**




SOURCE: Connecticut State Comptroller, *CAFR*, FY 2006, p. 86.

## CONNECTICUT'S PUBLIC-EMPLOYEE PENSION LIABILITIES

Let's begin with State pension liabilities. The line graph below (taken from the Comprehensive Annual Financial Report, or *CAFR*, published each fiscal year by State Comptroller Nancy Wyman), shows the funding status of the four largest State retirement programs between fiscal years 1998 and 2006. (The only other program, for Probate Judges, is essentially fully funded and has been self-sustaining since FY 2000.)

The chart shows that three of the four programs were substantially underfunded as of mid-2006. Moreover, in the two largest funds—state employees and teachers—the funded ratio deteriorated over the 8-year span. (So did the funded ratio for municipal employees, but as of mid-2006 it was still slightly overfunded.)

Was that deterioration due to gross negligence, or to something more benign such as mistaken assumptions? Arguably, "negligence" applies to the teachers' pensions, and "mistaken assumptions" to state employees.

The key here is what actuaries call the "annual (or actuarially) required contribution" (ARC), the amount that must be set aside annually to fully fund a liability over a given number of years. For a given unfunded "accrued actuarial liability" (AAL), the ARC will be smaller, (a) the higher the funded ratio is to begin with; (b) the higher the assumed rate of return on the financial assets in the fund; or (c) the longer is the "amortization period" for eliminating unfunded liability.

Every year from 1998 through 2006, the State contributed 100% of the ARCs for the judicial and municipal retirement systems. Further, only in 1998 was the State's contribution below 100% to the state employee system. Contributions to the teachers system, though, fell short of the ARC in every year but 2006; little wonder, then, that its "funded ratio" fell by nearly 11 percentage points over the period. Doubtless, that helped spur budget officials at the Office of Policy and Management (OPM) to ramp up contributions to the teachers system (including commitments of $100-200 million per year from budget surpluses) beginning in fiscal 2006. Further, 2007 saw a successful push by State Treasurer Denise Nappier to bolster the funding of teachers' pensions through the Pension Obligation Bond Act, Public Act 07-186.

Note, however, that funding pension obligations by issuing State bonds simply changes the form of the liability, not its size. But it is not just a ruse: The case for bond-funding of pension liabilities is that state governments can usually borrow at lower rates than they can earn on the financial investments bought to fund the pension liabilities. The maneuver does, of course, add risk to a state's financial position, and could therefore adversely affect the state's debt rating, which could raise its borrowing costs, which…

But how can the funded ratio for the state employees system have dropped by nearly 6 points, if the ARC was 100% in eight of nine years? It must be that one or more of the assumptions used to calculate the ARC were wrong. Perhaps the expected rate-of-return assumptions were conservatively low in 1998-2001 but too liberal later on. In any case, the string of five straight declines in the funded ratio, 2002-2006, calls for new assumptions—or new actuaries (and in

*(continued on page 14)*

## BEWARE THOSE SLEEPER TAXES *(continued from page 11)*

Hartford, of all places, the Insurance Capital).

In fiscal 2006, the State of Connecticut scored 100% of the ARCs in all four of its major State public pension systems. The tab was a bit more than a billion dollars, according to the Pew Center On the States (PCOS—see the source of the first graph above), out of General Fund expenditures of about $15 billion.

Turns out that's just for openers.

### CONNECTICUT'S O.P.E.B. BLUES

Pension obligations present fairly well-defined targets. In contrast, "other post-employment benefits" (OPEB), of which health insurance obligations are by far the biggest component, are beset by uncertainties: future cost increases, the fate of the Medicare program, and what (if anything) a Democratic administration in Washington come 2009 might do about the nation's broader health care problem. (See Dennis Heffley and Raymond Salani's piece on page 15.) One certainty, of course, is that this and other health-care-driven spending programs will command a steadily rising share of State outlays.

At the moment, the Government Accounting Standards Board (GASB) requires only that state governments *report* their unfunded non-pension retiree liabilities. According to its November 2007 *Fiscal Accountability Report* to the General Assembly (p. 51), OPM expects the GASB to add a funding *requirement* shortly.

Judging by the data OPM cites, it will be none too soon. But beginning to fund OPEB liabilities, on top of sustaining the funding effort on public pensions, will put a large dent in Connecticut's annual budgets.

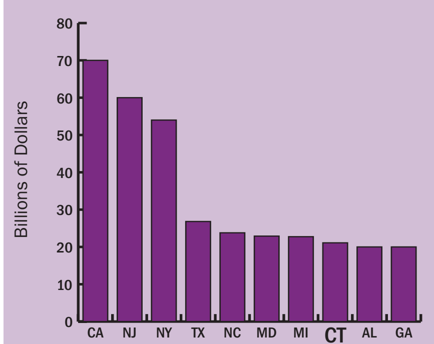
The first graph below shows that, effective with the end of fiscal year 2006, the Nutmeg State ranked 8th among the 50 states in total OPEB liabilities, with $21.1 billion; PCOS puts the figure at $21.7 billion. Tiny Connecticut is the smallest state, by population, in the highest ten.

Per capita (see the second graph), Connecticut ranked even worse, in 3rd place at $6,020 per person, behind Alaska ($7,047) and New Jersey ($6,877). For perspective, the median for state per capita unfunded OPEB in the U.S. is all of $1,581. It may be some comfort—albeit cold—that Connecticut (and New Jersey) at least rank 1st (and 2nd) in per capita income.

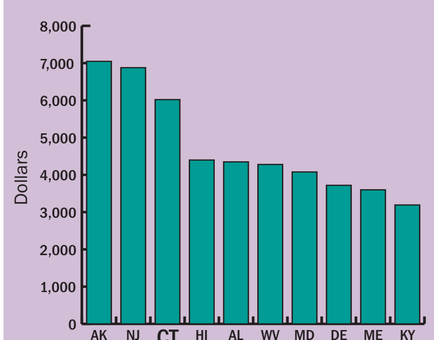
Alaska deserves an A for effort to fund OPEB liabilities, with a funded ratio of 65% through FY 2006, according to PCOS. But the only other state in the top ten, on a per capita basis, to have made any significant effort is Kentucky, with a 10% funded ratio through FY 2006; Delaware had managed just 1%. The rest: nada, beyond token payments in FY 2006; in Connecticut's case, $393 million, about a quarter of what PCOS estimated was an ARC of $1.6 billion per year. The full payment would have amounted to more than 10% of Connecticut's budgeted expenditures for that year.

The arithmetic is compelling: $1 billion a year to fund State pensions, and another $1.6 billion to fund State OPEBs, makes $2.6 billion a year. I make that to be 15.2%, or more than 1/7 of the "enacted" budget for next fiscal year, 2008-2009.

#### TOTAL UNFUNDED O.P.E.B. LIABILITIES




#### PER CAPITA UNFUNDED O.P.E.B. LIABILITIES




SOURCE: Credit Suisse, per Connecticut OPM, *Fiscal Accountability Report*, 11/15/07, p. 51.

### "IT COULDN'T HAVE HAPPENED AT A WORSE TIME"?

Is there ever a "good time" to put a 15% bite on State budgeted spending? If it has to happen, better that it be during a spell of State budget surpluses. Indeed, in December 2006 State Comptroller Nancy Wyman proposed creating a trust fund for up to a third of the health-insurance tab for today's State employees after they retire, using funds from then-projected and future State fiscal surpluses.

And OPM has recommended assigning a top priority for budget surpluses to the reduction of unfunded liabilities for OPEB liabilities along with state employees' and teachers' pensions—but only *after* the budget-reserve (or "rainy-day") fund reached 10% of net General Fund appropriations (see p. 74 in the OPM source for the two graphs). Unfortunately, the 10% target is proving elusive. Looks like funding the State's huge public-retiree benefits obligations may be facing…well, a rainy day.

Feelin' the budget blues yet? The OPM's projected budgets for fiscal 2009-2010 through 2011-2012 show deficits totaling $1.3 billion over the three years. A gamblin' man might well bet against Connecticut being able to make much progress toward raising the funded ratios on its pension and OPEB obligations over the next five years. In fact, I (a non-gamblin' man) would bet that those ratios will get worse before they get better.

If only we'd taken fuller advantage of the good times, when they were in full swing, to upgrade and maintain the State's efforts to reduce its unfunded public-retiree liabilities.