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MISUNDERSTANDINGS REGARDING STATE DEBT, PENSIONS, AND RETIREE HEALTH COSTS CREATE UNNECESSARY ALARM

Misconceptions Also Divert Attention from Needed Structural Reforms

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Summary

A spate of recent articles regarding the fiscal situation of states and localities have lumped together their *current* fiscal problems, stemming largely from the recession, with *longer-term* issues relating to debt, pension obligations, and retiree health costs, to create the mistaken impression that drastic and immediate measures are needed to avoid an imminent fiscal meltdown.

The large operating deficits that most states are projecting for the 2012 fiscal year, which they have to close before the fiscal year begins (on July 1 in most states), are caused largely by the weak economy. State revenues have stabilized after record losses but remain 12 percent below pre-recession levels, and localities also are experiencing diminished revenues. At the same time that revenues have declined, the need for public services has increased due to the rise in poverty and unemployment. Over the past three years, states and localities have used a combination of reserve funds and federal stimulus funds, along with budget cuts and tax increases, to close these recession-induced deficits. While these deficits have caused severe problems and states and localities are struggling to maintain needed services, this is a cyclical problem that ultimately will ease as the economy recovers.

Unlike the projected operating deficits for fiscal year 2012, which require near-term solutions to meet states' and localities' balanced-budget requirements, longer-term issues related to bond indebtedness, pension obligations, and retiree health insurance — discussed more fully below — can be addressed over the next several decades. It is not appropriate to add these longer-term costs to projected operating deficits. Nor should the size and implications of these longer-term costs be exaggerated, as some recent discussions have done. Such mistakes can lead to inappropriate policy prescriptions.

Bond Indebtedness

Some observers claim that states and localities have run up huge bond indebtedness, in part to finance operating costs, and that there is a high risk that a number of local governments will default on their bonds. Both claims are greatly exaggerated.

- States and localities have issued bonds almost exclusively to fund infrastructure projects, not finance operating costs, and while the amount of outstanding debt has increased slightly over the last decade it remains within historical parameters. Recently, the Build America Bond provisions of the Recovery Act encouraged borrowing for infrastructure building as a way to improve employment; these bonds can only be used to finance infrastructure.

- Interest payments on state and local bonds generally absorb just 4 to 5 percent of current expenditures — no more than they did in the late 1970s.

- Municipal bond defaults have been extremely rare; the three rating agencies calculate the default rate at *less than one-third of 1 percent.*[1] Between 1970 and 2009, only four defaults were from cities or counties. Most defaults are on non-general obligation bonds to finance the construction of housing or hospitals and reflect problems with those individual projects; they provide no indication of the fiscal health of local governments.

- While some have compared the state and local bond market to the mortgage market before the bubble burst, the circumstances are very different. There is no bubble in state and local bonds, nor are there exotic securities that hide the underlying value of the asset against which bonds are being issued (as was the case with subprime mortgage bonds). Most experts in state and local finance do not expect a major wave of defaults. For example, a Barclays Capital December 2010 report states, "Despite frequent media speculation to the contrary, we do not expect the level of defaults in the U.S. public finance market to spiral higher or even approach those in the private sector."

Pension Obligations

Some observers claim that states and localities have $3 trillion in unfunded pension liabilities and that pension obligations are unmanageable, may cause localities to declare bankruptcy, and are a reason to enact a federal law allowing states to declare bankruptcy. Some also are calling for a federal law to force states and localities to change the way they calculate their pension liabilities (and possibly to change the way they fund those liabilities as well). Such claims overstate the fiscal problem, fail to acknowledge that severe problems are concentrated in a small number of states, and often promote extreme actions rather than more appropriate solutions.

- State and local shortfalls in funding pensions for future retirees have gradually emerged over the last decade principally because of the two most recent recessions, which reduced the value of assets in those funds and made it difficult for some jurisdictions to find sufficient revenues to

[1] Chris Hoene, "Crying Wolf about Municipal Defaults," National League of Cities blog, December 22, 2010, http://citiesspeak.org.

make required deposits into the trust funds. Before these two recessions, state and local pensions were, in the aggregate, funded at 100 percent of future liabilities.

- A debate has begun over what assumptions public pension plans should use for the "discount rate," which is the interest rate used to translate future benefit obligations into today's dollars. The discount rate assumption affects the stated future liabilities and may affect the required annual contributions. The oft-cited $3 trillion estimate of unfunded liabilities calculates liabilities using what is known as the "riskless rate," because the pension obligations themselves are guaranteed and virtually riskless to the recipients. In contrast, standard analyses based on accepted state and local accounting rules, which calculate liabilities using the historical return on plans' assets, put the unfunded liability at about a quarter of that amount, a more manageable (although still troubling) $700 billion.

- Economists generally support use of the riskless rate in valuing state and local pension liabilities because the constitutions and laws of most states prevent major changes in pension promises to current employees or retirees; they argue that definite promises should be valued as if invested in financial instruments with a guaranteed rate of return. However, state and local pension funds historically have invested in a diversified market basket of private securities and have received average rates of return much higher than the riskless rate. And economists generally are not arguing that the investment practices of state and local pension funds should change.

- A key point to understand is that the two issues of how states and localities should value their pension liabilities and how much they should contribute to meet their pension obligations are not the same. The $3 trillion estimate of unfunded liabilities does not mean that states and localities should have to contribute that amount to their pension funds, since the funds very likely will earn higher rates of return over time than the Treasury bond rate, which will result in pension fund balances adequate to meet future obligations without adding the full $3 trillion to the funds. In fact, two of the leading economists who advocate valuing state pension fund assets at the riskless rate have observed, "…the question of optimal funding levels…is entirely separate from the valuation question."[2] The required contributions to state and local pension funds should reflect not just on an assessment of liabilities based on a riskless rate of return, but also the expected rates of return on the funds' investments, as well as other practical considerations. As a result, it is mistaken to portray the current pension fund shortfall as an unfunded liability so massive that it will lead to bankruptcy or other such consequences.

- States and localities devote an average of 3.8 percent of their operating budgets to pension funding.[3] In most states, a modest increase in funding and/or sensible changes to pension eligibility and benefits should be sufficient to remedy underfunding. (The $700 billion figure implies an increase on average from 3.8 percent of budgets to 5 percent of budgets, if no other changes are made to reduce pension costs.[4]) However, in some states that have grossly underfunded their pensions in past years and/or granted retroactive benefits without funding

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[2] Robert Novy-Marx and Joshua Rauh, "Public Pension Promises: How Big Are They and What Are They Worth?" *Journal of Finance*, forthcoming (posted October 8, 2010 on Social Science Research Network), p. 5.

[3] Data are for 2008, the most recent year available from Census.

[4] Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, *The Impact of Public Pensions on State and Local Budgets*, Center for Retirement Research at Boston College, October 2010.

them — Illinois, New Jersey, Pennsylvania, Colorado, Kentucky, Kansas, and California, for example — additional measures are very likely to be necessary.

- States and localities have managed to build up their pension trust funds in the past without outside intervention. They began pre-funding their pension plans in the 1970s, and between 1980 and 2007 accumulated more than $3 trillion in assets. There is reason to assume that they can and will do so again, once revenues and markets fully recover.

- States and localities have the next 30 years in which to remedy any pension shortfalls. As Alicia Munnell, an expert on these matters who directs the Center for Retirement Research at Boston College, has explained, "even after the worst market crash in decades, state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15-20 years."[5] States and localities do not need to increase contributions immediately, and generally should not do so while the economy is still weak and they are struggling to provide basic services.

Retiree Health Insurance

Observers claiming that states and localities are in dire crisis typically add to unfunded pension liabilities about $500 billion in unfunded promises to provide state and local retirees with continued health coverage. These promises are of a substantially different nature than pensions, however, so it is inappropriate to simply add the two together.

- While pension promises are legally binding, backed by explicit state constitutional guarantees in some states and protected by case law in others, *retiree health benefits generally are not*. States and localities generally are free to change any provisions of the plans or terminate them entirely.

- States' retiree health benefit plans differ widely. For example, 14 states pay the entire premium for retirees participating in the health plan, while 14 other states require retirees to pay the entire premium. States clearly have choices in the provision of retiree health benefits.

- With health care costs projected to continue to grow faster than GDP and faster than state and local revenues, it is highly likely that current provisions for retiree health insurance will be scaled back. Many states are likely to decide that their plans are unaffordable.

- This would be a good time for states and localities offering the more generous plans to decide whether they want to maintain *and fund* these liabilities, or whether they want to substantially reduce their liabilities by changing the provisions of their plans.

Given the different origins, scope, and potential solutions to problems in each of these areas, calls for a "global" solution — such as recent proposals to allow states to declare bankruptcy[6] or to limit

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[5] Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "Public Pension Funding in Practice," NBER Working Paper 16442, October 2010.

[6] See, for example, David Skeel, "Give States a Way to Go Bankrupt," *The Weekly Standard*, November 29, 2010, http://www.weeklystandard.com/articles/give-states-way-go-bankrupt_518378.html and Grover G. Norquist and Patrick Gleason, "Let States Go Bankrupt," *Politico,* December 24, 2010.

their ability to issue tax-exempt bonds unless they estimate pension liabilities using a riskless discount rate — make little sense in the real world of state and local finances.[7] Indeed, some proposed solutions could *worsen* states' long-term fiscal picture by undermining their ability to invest in infrastructure and meet their residents' needs for education, health care, and human services. What are needed are targeted solutions that are appropriate to each state and to the nature of its fiscal problems.

State Structural Deficits

Moreover, the confusion between short-term cyclical deficits and debt, pensions, and retiree health insurance — and the overstatement of the magnitude of the latter set of problems — draw attention away from the need to modernize state and local budget and revenue systems and address structural problems that have built up over time in these systems.

States suffer from "structural deficits," or the failure of revenues to grow as quickly as the cost of services during healthy economic times; this makes it difficult for states to continue meeting their responsibilities each year. Structural deficits stem largely from out-of-date tax systems, coupled with costs that rise faster than the economy in areas such as health care. Fixing these structural problems would help states and localities balance their operating budgets without resort to one-time measures or gimmicks. It would also help states rebuild their rainy day funds before the next recession and meet critical needs for infrastructure investment and adequate funding of pension obligations. It is far more constructive to focus on fixing these basics of state and local finance than to proclaim a crisis based on exaggerations of imminent threats.

[7] A bill proposed by House of Representative members Paul Ryan, Darrell Issa, and Devin Nunes (H.R. 6484 in the 111th Congress) would require states and localities to report pension liabilities to the federal government using U.S. Treasury Bond rates to discount liabilities as a condition of issuing tax-exempt bonds.