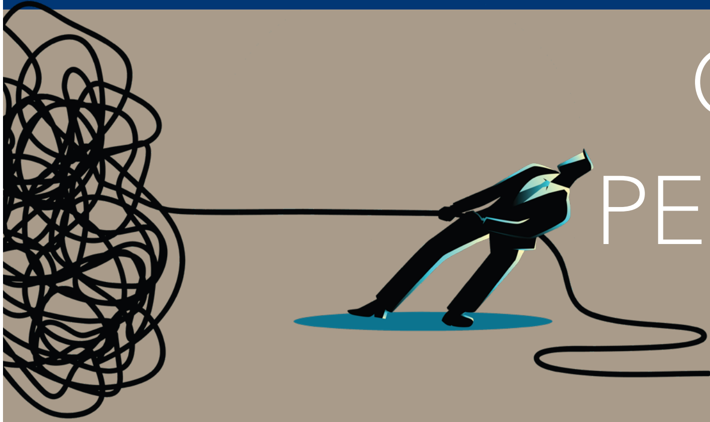
UNRAVELLING CONNECTICUT'S PENSION LIABILITY PREDICAMENT



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The State of Connecticut is in need of a more rigorous and immediate recovery plan in order to restore its fiscal stability, lift government performance and foster an improved business climate for its citizens. The State's unfunded pension liabilities are at the heart of the problem, and, unfortunately, these rapidly growing liabilities are the least understood and comprehended. Like Benjamin Franklin has said, compound interest is a miraculous vehicle to grow wealth over time; however, when you have a mandatory liability compounding, Franklin would have advised to quickly offset that liability or you will go broke in no time.

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The citizens of Connecticut are about to suffer a brutal jaw clenching financial shock because of the State's current underfunded public employee pension liability. Collectively, Connecticut's State Employees' and Teachers' pension funds list $28 billion in assets against $64 billion in liabilities, leaving a gaping hole of $36 billion or about $10,000 for each Connecticut resident. Making matters worse, the State's residents must recognize this liability is not static — it is growing, actually compounding higher, each and every minute of each and every day. The pension liability grows when more public employees are hired, cost of living adjustments made, pay raises implemented, pension benefit increases approved; and, as has happened way too much in the past, insufficient state contributions were made. With these on-going forces pushing pension payments higher, the incremental growth to the overall $64 billion pension liability is difficult to counteract, especially when this liability and its annual growth, smother the investment growth on the $28 billion of invested pension assets. Without sufficient investment assets, the plan currently has only two pension funding alternatives: employee pension contributions and, now, a "pie in the sky," State plan to substantially increase annual pension fund appropriations.

Connecticut's extremely ambitious multi-year pension funding plan must be weighed against the State's somewhat limited annual general fund resources, which have been mired in the $17 billion range over the last few years. Unfortunately, the State's Office of Policy and Management forecast little or no top line growth over the next five years unless new or higher taxes are deployed. In 2017 State pension contributions were about $2.1 billion absorbing over 12% of the State's budget. One can see how the flexibility to fund other state programs can potentially get squeezed by continually rising pension costs, especially when we throw in the rapidly growing acronym OPEB (Other Post-Employment Benefits — known as retirement health insurance) and the ever-growing State debt burden. The combination is overwhelming. In 2017, OPEB costs increased over 9% alone to $726 million and debt service expense ratcheted up 4.6% to over $2.0 billion. Combining just these three fixed expenditures for 2017, we find the State used up 28% of its tax revenues. The real challenge is going forward, and the trajectory for these three expenses — pension funds, OPEB and debt — show increases for the next 5 years that will likely top $1 billion with over $700 million of that increase attributable to the pensions. Bringing these higher costs into focus, we see that these expenses will likely consume over 34% of the State's general revenue budget and this does not take into consideration other hard-to-cut line items (and also ever-growing) like Medicaid.

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There is good reason for state budget analysts to be scared. The State barely recovered from last year's deficit and subsequent line by line paring of expenses. Now, another billion dollars of cuts are in the offing. The State's beleaguered citizens are already staring at bigger potholes such as swelling classrooms, further reductions in Metro North subsidies, and infrastructure projects put off until tomorrow's tomorrow. As the crowding out from growing pension claims, OPEB (health insurance) and the rising debt burden is felt — it only stands to reason that the not-so-immediate

cash needs of State pension contributions will be eyed for reduction. The pension restoration plan will be stalled yet again, at a time when liabilities are higher and the insidious compounding even greater. This surely is a recipe for human and financial disaster for Connecticut residents.

What must be done, and done soon, is to unleash State assets so that those assets can be invested in the pension plan and grow (get the compounding working for its citizens instead of against them) to offset the punitive budgetary effects caused by the growing pension fund liability. This will enable the State the chance to reduce its required contributions and free up cash to restore and maintain services. In order to accomplish this, the State should consider privatization of acceptable state assets. For example, the sale of the State Lottery System may generate $2 to $4 billion as it earns about $300 million per year. At an 8% capitalization rate, the State may realize as much as $3.75 billion. Perhaps the Hartford Airport (Bradley) could be monetized or a state highway sold with the ability of its buyers to put an electronic toll on it. The State should conduct an emergency review of what assets could be given up and sold to help fill the pension gap and boost the compounding of the pension investment assets. Obtaining $6 to $8 billion from asset sales would likely generate $400 to $600 million of additional investment income per year. When compounded, that income could easily double in 8 to 12 years thereby helping the State (its taxpaying citizens actually) escape from its current financial stranglehold. It should be emphasized that all proceeds from asset sales be placed in the pension fund and no proceeds from these sales should go into the State's general fund so that the financial integrity of those transactions are maintained and continue to work for the public pensions for years and years to come.

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Not generally known, or appreciated, is that the pension participants — teachers, police, firefighters and public works employees — are counting on these state pensions and are not eligible for social security. No social security

contributions are made by public employees participating in the state pensions, thus there is no back stop for them if we do not fulfill our obligations. Furthermore, why would any talented teacher or public servant embarking on a public career consider a state whose pension funding is suspect? To attract the most capable employees, we have to fund the pensions to reasonable levels, otherwise the good candidates are likely to find their jobs in New York, Washington and Wisconsin where the pensions are largely or close to fully funded. In addition, I am totally embarrassed to leave our children and their children saddled with our generation's debt. Our children haven't had much of a chance to vote, if at all, or voice their opposition to this unseemly and excruciatingly punitive cost which has been foisted upon them by our lack of fiscal discipline.

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The selling of State assets is neither pleasant nor palatable. However, due to our own neglect, the math is working against us in a rapid fashion and the zero hour is here. Action is now required or the slippery slope to financial ruin will be found. Fortunately, by fixing the pension funding problem, we will take a bold first step in easing the financial burden, freeing the State to do what it does best. At the same time, it will foster more confidence and vigor, reigniting its citizens' will to improve the commercial environment with increased investment and growing employment.

Let's begin to get this pension fund mess cleaned up now.

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About the Author:

R. Scott Richter is the Managing Director of Richter Bober Asset Management, and has over 35 years of municipal bond experience. He co-founded Richter Bober in July, 2002 and the firm, as of March 31, 2018, manages over $370 million of fixed income assets, most of which are municipal bonds for individuals. Prior to co-founding the company, he served as Managing Director and head of Weiss Peck & Greer's municipal securities division for 14 years, where he supervised over $7 billion in fixed income assets. He also was a municipal research specialist and portfolio manager at Ehrlich-Bober Advisors for eight years. He is a member of the Municipal Analysts Group of New York (MAGNY). Mr. Richter obtained an MBA from The George Washington University (1976) and a BBA from the University of Wisconsin-Madison (1974).

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