Path to Prosperity

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The Cost of Doing Nothing:

Maine's Pension Payments are Crowding-Out Other Spending

By J. Scott Moody

Maine's annual public pension payment is on the threshold of explosive growth. Unlike other states, Maine has a Constitutional requirement to fully fund the pensions system by 2028—just 16 years from now. The Constitutional requirement brings some much needed transparency to the pensions system and has also exposed a legacy of chronic underfunding of the pension system. As the 2028 deadline looms, pension payments from the General Fund (GF) will grow 44 percent in the next biennium to $356 million in FY 2013 from $248 million in FY 2011.

Another reason for the higher pension payments is to make up for the investment shortfall due to the decline in the stock market stemming from the "Great Recession." Between FY 2003 and FY 2010, the unfunded pension liability has increased by 66 percent to $4.4 billion from $2.7 billion. While the stock market has improved since then, the state government will still be forced to make higher pension payments due to the higher unfunded pension liability.

As a consequence of the growing pension payments, all other state government spending will be crowded-out. Over the next biennium, the annual required pension contribution will consume 52 percent of all of the growth in General Fund revenue under the forecast from the Revenue Forecasting Committee (92 percent under a slow recovery growth rate of 2 percent). As shown in Chart 1, the growth in pension payments is steadily consuming more and more of the increase in GF revenue.

Additionally, Maine's budget process will, more and more, be held hostage by factors outside of the state such as the performance of the stock market. Comparing the 2009 and 2010 pension schedules shows that the burden on the General Fund fell by $16 million—leaving more room for other GF spending—thanks to a rebounding stock market. However, easy come, easy go as the chance of major decline in the stock market is increasing for 2011. A drop in the stock market would also reduce revenues (via capital gains), worsening the revenue situation at a time when pension payments are going in the opposite direction.

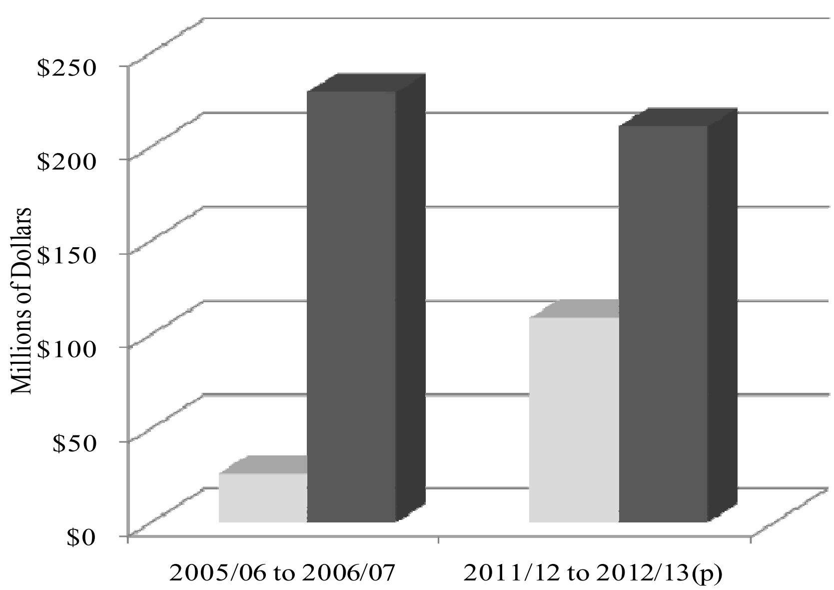


Chart 1
What a Difference Five Years Makes!
Biennium Growth in Annual Required Pension Contribution Projected to Consume More General Fund Revenue
2005/6 to 2006/7 versus 2011/12 to 2012/13

Source: Maine Public Employees Retirement Systems, Office of Fiscal and Program Review and The Maine Heritage Policy Center.

In the end, the pension burden is simply too great and only serious reforms of the system, such as the switch from a defined-benefit system to a defined-contribution system, will prevent this crowding-out.

Understanding Maine's Unfunded Retiree Liability

Maine's Public Employees Retirement System (PERS) consists of four separate retirement systems—the State Employee and Teacher Program, the Consolidated Plan for Participating Local Districts, the Judicial Retirement Program and the Legislative Retirement Program. The State Employee and Teacher Program is by far the largest component of Maine PERS with 84 percent of all benefit pay-outs in FY 2009.

The health of the Maine PERS system is based on two elements—assets held versus liabilities accrued:

Assets: The market value of stocks, bonds and other investments that are held by Maine PERS. Each year assets grow in one of two ways. First, the value of the assets change and, second, Maine state government pays an annual contribution.

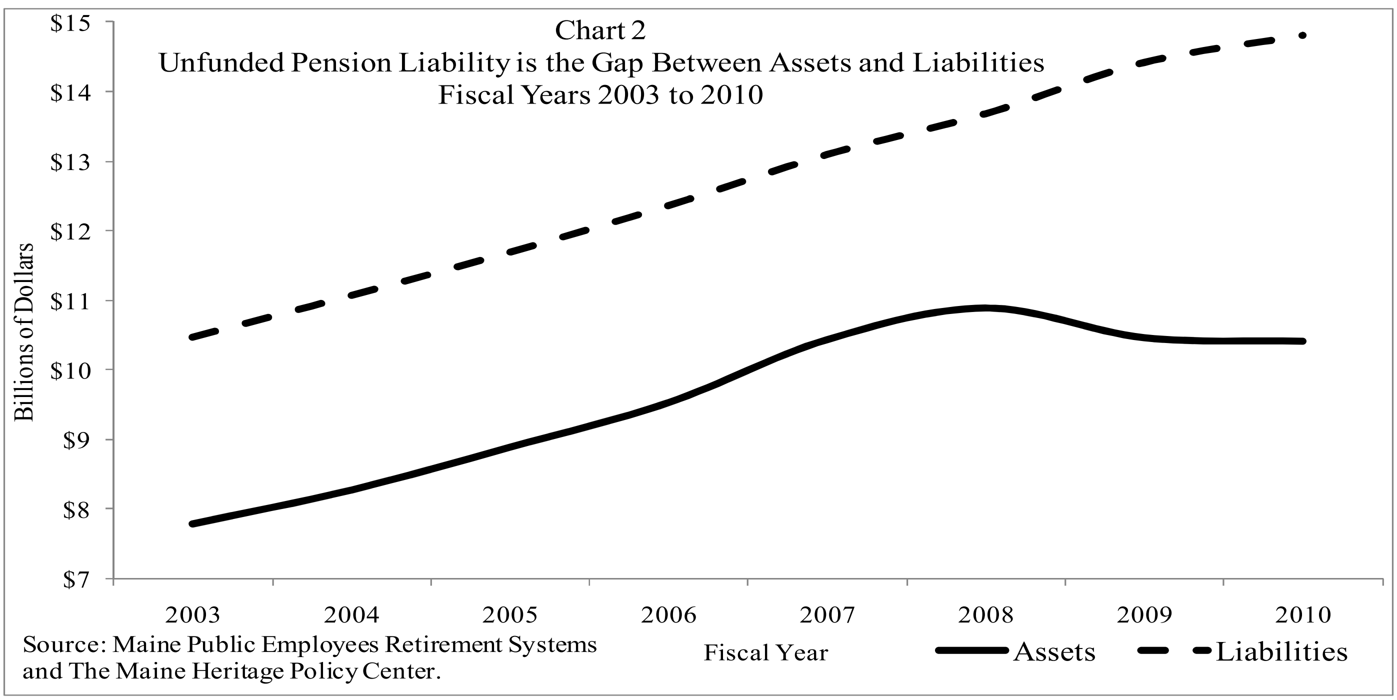
Liabilities: The present value of pension benefits to be paid out to current and future retirees. Each year liabilities grow based on a number of assumptions such as expected salary increases, mortality, turnover and other factors.

Table 1
Funded Ratios of Maine's Pension System
Fiscal Years 2003 to 2008
in Billions of Dollars

Actuarial Valuation Date as of June 30	Public Employees Retirement System (PERS)			
	Actuarial Value of Assets (AVA)	Actuarial Accrued Liability (AAL)	Unfunded Actuarial Accrued Liability (UAAL)	Funded Ratio (AVA/AAL)
2003	$7.787	$10.471	-$2.684	74.4%
2004	$8.274	$11.069	-$2.795	74.7%
2005	$8.888	$11.690	-$2.802	76.0%
2006	$9.531	$12.357	-$2.827	77.1%
2007	$10.437	$13.089	-$2.652	79.7%
2008	$10.893	$13.675	-$2.782	79.7%
2009	$10.467	$14.410	-$3.943	72.6%
2010	$10.415	$14.799	-$4.384	70.4%

Source: Maine Public Employees Retirement System and The Maine Heritage Policy Center.

For Maine PERS to be considered "fully funded," assets must equal liabilities. Unfortunately, Maine PERS is far from being fully funded and is currently running a large deficit called the unfunded liability. For example, in FY 2010, the PERS system had assets worth an estimated $10.4 billion while liabilities are estimated to be $14.8 billion. As Chart 1 and Table 1 shows, this leaves an unfunded pension liability (liabilities minus assets) of $4.4 billion with the gap increasing over time.



A common way to show the unfunded pension liability is the "funded ratio", which is assets divided by liabilities. Table 1 shows that the funded ratio for the Maine PERS has fallen 5 percent to 70.4 percent in FY 2010 from 74.4 percent in FY 2003.

Pension Payments Crowd-Out Other Spending

Table 2 shows how the growth in the pension payments over the next four fiscal years will crowd-out all other government spending in comparison with three revenue growth projections—the historical growth rate in General Fund revenue of 4 percent [1], the state Revenue Forecasting Committee General Fund revenue growth rate of 5 percent [2] and a slow recovery growth rate (2 percent—half of historical average).

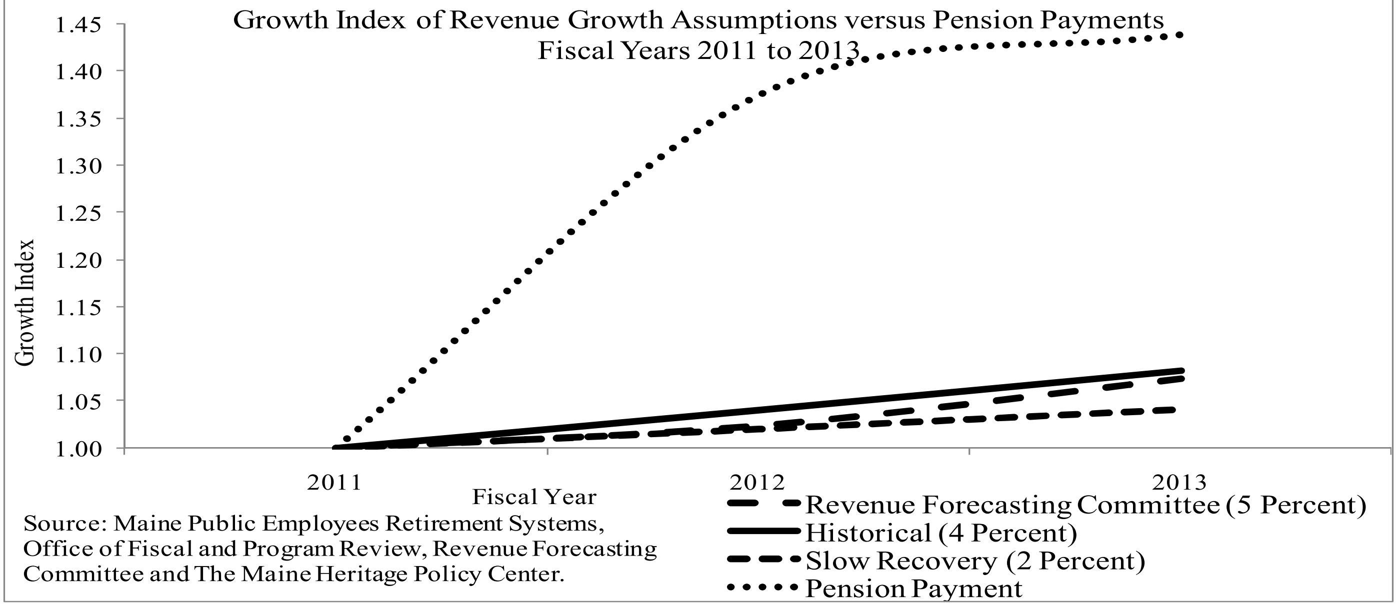
As shown in Table 2, between FY 2011 and 2013, the GF pension payment is scheduled to grow by $109 million, a 44 percent increase over FY 2011 levels.[3] On the other side of the coin, projections show General Fund revenue growing at: $237 million under the historical growth rate (4 percent), $210 million under the Revenue Forecasting Committee Growth Rate (5 percent) or $118 million under a slow recovery growth rate (2 percent).

Table 2
Remaining General Fund Revenue after Pension Payment under Different Revenue Growth Assumptions
Fiscal Years 2012 to 2015

		Growth in General Fund Revenue		
Fiscal Year	General Fund Pension Payment	Historical Growth Rate (4 percent)	Revenue Forecasting Committee Growth Rate (5 Percent)	Slow Recovery Growth Rate (2 Percent)
2011	$247,770,640	$2,885,475,055	$2,885,475,055	$2,885,475,055
2012	$340,480,000	$3,001,772,718	$2,953,273,850	$2,943,184,556
2013	$356,440,000	$3,122,757,701	$3,096,013,848	$3,003,220,010
Total	$944,690,640	$9,010,005,473	$8,934,762,753	$8,831,879,622
		Change in General Fund Revenue		
Fiscal Year	Change in Pension Payment	Historical Growth Rate (4 percent)	Revenue Forecasting Committee Growth Rate (5 Percent)	Slow Recovery Growth Rate (2 Percent)
2012	$92,709,360	$116,297,663	$67,798,795	$57,709,501
2013	$15,960,000	$120,984,983	$142,739,998	$60,035,454
Total	$108,669,360	$237,282,646	$210,538,793	$117,744,955
		Difference Between General Fund Revenue and Pension Payment		
Fiscal Year	Change in Pension Payment	Historical Growth Rate (4 percent)	Revenue Forecasting Committee Growth Rate (5 Percent)	Slow Recovery Growth Rate (2 Percent)
2012	N.A.	$23,588,303	-$24,910,565	-$34,999,859
2013	N.A.	$105,024,983	$126,779,998	$44,075,454
Total	N.A.	$128,613,286	$101,869,433	$9,075,595
	Growth Index			
Fiscal Year	Pension Payment	Historical Growth Rate (4 percent)	Revenue Forecasting Committee Growth Rate (5 Percent)	Slow Recovery Growth Rate (2 Percent)
2011	1.00	1.00	1.00	1.00
2012	1.37	1.04	1.02	1.02
2013	1.44	1.08	1.07	1.04

Source: Maine Public Employees Retirement Systems, Office of Fiscal and Program Review, Revenue Forecasting Committee and The Maine Heritage Policy Center.

Chart 3
Growth Index of Revenue Growth Assumptions versus Pension Payments
Fiscal Years 2011 to 2013



Source: Maine Public Employees Retirement Systems, Office of Fiscal and Program Review, Revenue Forecasting Committee and The Maine Heritage Policy Center.

As a consequence, the growth in all other General Fund spending will be crowded-out by the increasing pension payments. Under the forecast provided by the state Revenue Forecasting Committee (5 percent), over the next biennium years the General Fund will have over half (52 percent) of the revenue growth consumed by pension payments.[4] Under the slow recovery growth rate (2 percent) in General Fund revenue, the pension payment will nearly consume all of the growth in General Fund revenue (92 percent).

Table 2 and Chart 3 show the disparate rates of growth in the pension fund and GF revenue using a growth index. As is clearly shown in Chart 3, the rate of growth in pension payments is dramatically higher than for GF revenue.

Additionally, Maine's budget process will, more and more, be held hostage by factors outside of the state such as the performance of the stock market. Comparing the 2009 and 2010 (Table 2 and Table 3) pension schedules shows that the burden on the General Fund fell by $16 million—leaving more room for other GF spending—thanks to a rebounding stock market. However, easy come, easy go as the chance of major decline in the stock market is increasing for 2011.[5] A drop in the stock market would also reduce revenues (via capital gains) worsening the revenue situation at a time when pension payments are going in the opposite direction.

Table 3
Remaining General Fund Revenue after Pension Payment under Different Revenue Growth Assumptions (Based on 2009 Actuarial Study)
Fiscal Years 2012 to 2015

Fiscal Year	General Fund Pension Payment	Growth in General Fund Revenue: Historical Growth Rate (4 percent)	Revenue Forecasting Committee Growth Rate (5 Percent)	Slow Recovery Growth Rate (2 Percent)
2011	$247,770,640	$2,885,475,055	$2,885,475,055	$2,885,475,055
2012	$356,440,000	$3,001,772,718	$2,953,273,850	$2,943,184,556
2013	$373,160,000	$3,122,757,701	$3,096,013,848	$3,003,220,010
Total	$977,370,640	$9,010,005,473	$8,934,762,753	$8,831,879,622
Fiscal Year	**Change in Pension Payment**	**Change in General Fund Revenue: Historical Growth Rate (4 percent)**	**Revenue Forecasting Committee Growth Rate (5 Percent)**	**Slow Recovery Growth Rate (2 Percent)**
2012	$108,669,360	$116,297,663	$67,798,795	$57,709,501
2013	$16,720,000	$120,984,983	$142,739,998	$60,035,454
Total	$125,389,360	$237,282,646	$210,538,793	$117,744,955
Fiscal Year	**Change in Pension Payment**	**Difference Between General Fund Revenue and Pension: Historical Growth Rate (4 percent)**	**Revenue Forecasting Committee Growth Rate (5 Percent)**	**Slow Recovery Growth Rate (2 Percent)**
2012	N.A.	$7,628,303	-$40,870,565	-$50,959,859
2013	N.A.	$104,264,983	$126,019,998	$43,315,454
Total	N.A.	$111,893,286	$85,149,433	-$7,644,405

Source: Maine Public Employees Retirement Systems, Office of Fiscal and Program Review, Revenue Forecasting Committee and The Maine Heritage Policy Center.

Yet, reducing the exposure to volatile investments would require shifting into assets with a lower rate-of-return (fewer stocks and more bonds) also increasing the pension burden on taxpayers. At the end of the day, the current pension payment schedule is itself an optimistic forecast.

Conclusion

In the end, the pension burden, even under the official GASB 25 methodology, is simply too great for taxpayers to bear. Unofficially, the pension burden is even larger than portrayed in this study which means that only serious and significant reforms of the pension system, such as moving from a defined-benefit system to a defined-contribution system, will prevent this crowding-out of other General Fund Spending.[5]

Notes and Sources:

[1] Based on historical General Fund revenue growth between FY 1987 and 2011.

[2] The Revenue Forecasting Committee is projecting an average annual growth rate in revenue of 5 percent over their entire forecast to FY 2015.

[3] Not all of the annual required pension contribution (ARC) is paid from the General Fund (GF). Approximately 76 percent of the ARC comes from the GF. This study assumes this rate does not vary by year. As such, of the full ARC of $326 million for FY 2011 approximately $248 million was paid from the GF.

[4] The Revenue Forecasting Committee's projections now seem optimistic based on more recent economic projections. For example, Wells Fargo recently stated in their 2011 Annual Economic Outlook that: "...we forecast that the United States, which accounts for more than 20 percent of global GDP, will continue to grow at a sub-trend pace—only 2.6 percent in 2011, which is significantly below the annual average growth rate of 3.2 percent that was achieved between 1992 and 2007—as consumers continue to deleverage." (pg. 21). They go on to criticize many forecasts, especially government revenue forecasts, showing stronger growth due to "anchoring bias:" "Anchoring is a decision-making bias that blinds decision-makers to cyclical and structural change. Anchoring refers to the overemphasis on an initial reference point(s) that distorts estimates of the true value of a good or service . . . In economics and public finance, this anchoring bias is readily apparent and widely seen in the constitution of many strategic plans *[and budgets]*. In reality, picking a starting point in time and determining the range of values can give an observer a biased anchoring point to begin any analysis." (pg. 8) https://www.wellsfargo.com/downloads/pdf/com/research/market_strategy/Annual_12082010.pdf

[5] For example, The Value Line Investment Survey (January 21, 2011) recently concluded: "The market, as noted, is now richly valued and possibly ripe for some profit taking—or worse—in particular if earnings fail to deliver in 2011 the way they did during 2010."

[6] For more information on the unofficial, yet significantly, larger estimates of Maine's pension burden, see: J. Scott Moody, "More Bonds? Not with Maine's Ballooning Unfunded Retiree Liabilities," Path to Prosperity, Issue 17, May 18, 2010. http://maine.sarphi.com/wp-content/uploads/More-Bonds-Not-with-Maines-Ballooning-Unfunded-Retiree-Liabilities.pdf

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