New Jersey: Pensions, Promises, and Fiscal Options

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Psychotherapists often say they try to help their patients by giving them options. That concept applies to fiscal challenges as it does to personal ones, and that's what I want to discuss as it applies to the state of New Jersey.

While the topic of my talk is pensions, it is also about options that the Garden State has for coping with its retirement funding needs as well as a host of other demands, such as education and transportation, to name two. So bear with me while I go into a little recent history that may help explain why the state has gotten itself into its current fix.

First, however, a word about the Volcker Alliance.

The Alliance is a nonprofit organization set up in 2013 by former Federal Reserve Board Chairman Paul Volcker, with the goal of improving the effectiveness of government. We're currently pursuing work in the areas of financial services regulatory reform, public administration education and service excellence, and my area, state and local fiscal performance.

I joined the Alliance in 2013 after more than 40 years at Bloomberg News, Business Week, the Associated Press, and other journalistic outlets, including our own Star-Ledger. When I came to the Alliance, my main mission was to build on the work of the State Budget Crisis Task Force, which was founded by Mr. Volcker and Dick Ravitch. Dick is an alliance director and former New York State lieutenant governor. But he is perhaps known best for his work in helping craft the fiscal rescue and recovery in New York City in the 1970s.

(An aside here: not for nothing has New York City avoided a repeat of the 1975 crisis for 41 years and counting. Two of the conditions for state and federal aid were a fiscal control board and the adoption of GAAP, or modified accrual accounting, for budgeting as well as financial reporting. The US Constitution would seem to preclude control boards for sovereign states (although Congress saw fit to impose one on Puerto Rico under the Territories Clause).

New York City remains the only large US municipal or state government to use GAAP budgeting, this according to the city comptroller's office. Others continue to use cash accounting, where, as you well know, the definition of "balance" is not fully defined and borrowings and fund transfers, as well as other techniques I'll discuss shortly… Well, they can all count as revenue for budget purposes. So remember not to get too excited every time a governor proclaims that she or he balanced the budget. In 49 states, that's required by law and the lone exception—which is Vermont—follows the example of its peers.)

Now back to our work at the Volcker Alliance, including New Jersey. Our initial project in the fiscal area is a project called Truth and Integrity in Government Finance. It's a 50-state study, which we're doing in partnership with eleven public administration and policy schools around the country. We are examining the states because they're so darn important. Consider this, if you will:

State governments generate more than $2 trillion in annual expenditures, accounting for eleven percent of US gross domestic product. In so doing, they play a central role in the provision of public services that are vital to maintaining GDP growth and ensuring that all Americans have opportunities to advance economically.

The states' responsibilities include supporting primary, secondary, and post-secondary education; administering public safety, health, and income-support programs; building and maintaining infrastructure; and creating a business climate conducive to economic growth. Sound fiscal practices are important to ensure that states can fulfill these vital obligations. Yet many continue to balance their budgets using accounting and other practices that obscure rather than clarify spending choices. These practices make budget trade-offs indecipherable, lead to poorly informed policymaking, pass current costs on to future generations, and weaken the fiscal capacity of states to support the cities and counties that depend on their aid.

Political leaders who fail to pay for their current spending commitments are leaving the challenges of funding those decisions until well after they have left office. The Alliance in 2014 launched Truth and Integrity in Government Finance to advocate for transparency in these trade-offs and, ultimately, to drive improvements in such critical decisions.

The ultimate goal of the project is to help improve budgeting and fiscal sustainability in states, both through identifying procedures that need improvement and by providing concrete examples of best practices for all to follow.

Our team is examining how all the American states put their budgets together—whether they use one-time revenue and expenditure techniques to balance budgets, how—and for how far out—they forecast revenue and expenditures, how they disclose budget information, and other indicators. You can find the details at our website, *www.volckeralliance.org*.

We are asking the same questions in all the states, and when we are done with examining budgets for fiscal 2015, '16, and '17, we expect to grade each state on its performance.

Hopefully, the laggards will be prodded to improve and will also learn from the best leaders. But as we found in some preliminary reports based on our research and methodology, even states with the most stellar reputations have areas that can be improved—and, likewise, even some of the most fiscally challenged states have some practices that are worth emulation nationally. We hope to bring out both in our subsequent reporting.

In our initial report, *Truth and Integrity in State Budgeting: Lessons from Three States*, we examined California, Virginia, and New Jersey. A team from the Illinois Institute of Government and Public Affairs subsequently looked at their state's budgeting using the Volcker Alliance screen. We made a set of recommendations, in an Agenda for Budget Reform, which I will summarize briefly for you before turning to New Jersey. The recommendations included:

1. Complete budgetary information, including how balance was achieved and whether onetime revenue sources were tapped, should be easier to find and interpret.
2. Short-term revenue forecasts should be transparent and supportable by historic growth trends. Past projections should be assessed for accuracy to help improve forecasting methods.
3. Recurring costs should be paid with recurring revenue.
4. The proceeds of borrowings should not be used to cover operating expenses.
5. States should move away from strictly cash budgeting and toward the type of accounting, used in their audited comprehensive annual financial reports, which shows the true present value of future spending obligations.
6. And states must build rainy day funds to safeguard essential services during economic downturns. The size of the funds should be adjusted for revenue volatility, and they should be replenished consistently after they are tapped.

As for the Garden State, when we looked at New Jersey's budget practices for the fiscal years of 2013, '14, and '15, what we found was a long history of bipartisan avoidance of obligations in the name of budgetary balance. To quote from the *Truth and Integrity* report:

"The Garden State's budget practices under both Republican and Democratic administrations dating back at least to the 1990s have produced repeated structural imbalances and deterioration in fiscal flexibility and credit quality."

Indeed, that was a main cause of rating agencies downgrading New Jersey's general obligation bonds nine times since 2010.

Moreover, the report stated:

"To produce a balanced budget, New Jersey has counted on shifting resources intended for other programs to the general fund and has increased its reliance on borrowing. It does not issue multiyear budget forecasts, and repeated optimistic revenue estimates have resulted in midyear adjustments that are not subject to the usual legislative budgeting process."

We also found that the state had used bond premiums as a source of revenue and that New Jersey had regularly passed on the Government Finance Officers Association's own recommendation for consistently maintaining the balances in the state's Surplus Revenue Fund—or rainy day fund—at no less than two months of regular general fund operating revenue.

Figure 1

Evaluating 3 State Budgets, 2013-2015

A PRELIMINARY BUDGET REPORT CARD: How the States Are Trending

● Followed best practices ● Needs improvement ● Followed practices to be avoided NA Fiscal 2015 yearend data not available

	CALIFORNIA			NEW JERSEY			VIRGINIA		
BUDGET PRACTICE	2013	2014	2015	2013	2014	2015	2013	2014	2015
Used consensus revenue forecasts	● red	● red	● red	● red	● red	● red	● green	● green	● green
Adequately funded annual pension contribution that actuaries say is required	● red	● red	● red	● red	● red	● red	● red	● green	● green
Provided advance funding of other postemployment benefits (OPEB) obligation*	● red	● red	● red	● red	● red	● red	● green	● green	● green
Increased rainy day fund balance as economy recovered**	● green	● green	NA	● red	● red	NA	● green	● green	NA
Provided easy online access to budget and necessary supplemental data	● yellow	● yellow	● yellow	● yellow	● yellow	● yellow	● yellow	● yellow	● yellow
Avoided delaying payments to third parties to reduce general fund deficit or address liquidity issues	● red	● green	● green	● red	● green	● red	● green	● green	● green
Avoided moving future revenue into current fiscal year or current expenses into next fiscal year	● red	● green	● green	● green	● green	● green	● yellow	● yellow	● red
Avoided selling assets to raise cash for general fund or address liquidity issues	● green	● green	● green	● red	● red	● green	● green	● green	● green

* Principally retiree health care ** California funds include Special Fund for Economic Uncertainties, Reserve for Liquidation of Encumbrances, and Budget Stabilization Account. New Jersey made no rainy day fund contributions in fiscal 2013-15 because state failed to meet revenue threshold, which excludes personal income taxes. **SOURCE:** Survey of material practices in state budget and financial reports.

New Jersey's enacted fiscal 2017 budget shows some signs of improvement both in procedures and revenues–thanks in no small measure to a national economic recovery entering an almost-unprecedented eighth straight year. Yet one-time revenue actions remain. And the big question of legacy obligations hangs heavy over the state: The failed effort to put before voters this fall a constitutional amendment mandating a long-term pension-funding formula speaks to this dilemma. So does the current standoff between the Legislature and Governor over raising motor fuel taxes to finance the all-but-broke state part of the Transportation Trust Fund. (The American Society of Civil Engineers found that 35 percent of New Jersey roads were "poor" condition, and almost as high a percentage of its bridges were structurally deficient or functionally obsolete.)

(On September 30, New Jersey's governor and legislative leaders announced an agreement, subject to House and Senate approval, to increase motor-fuel taxes by 23 cents per gallon to fund transportation investments over eight years.)

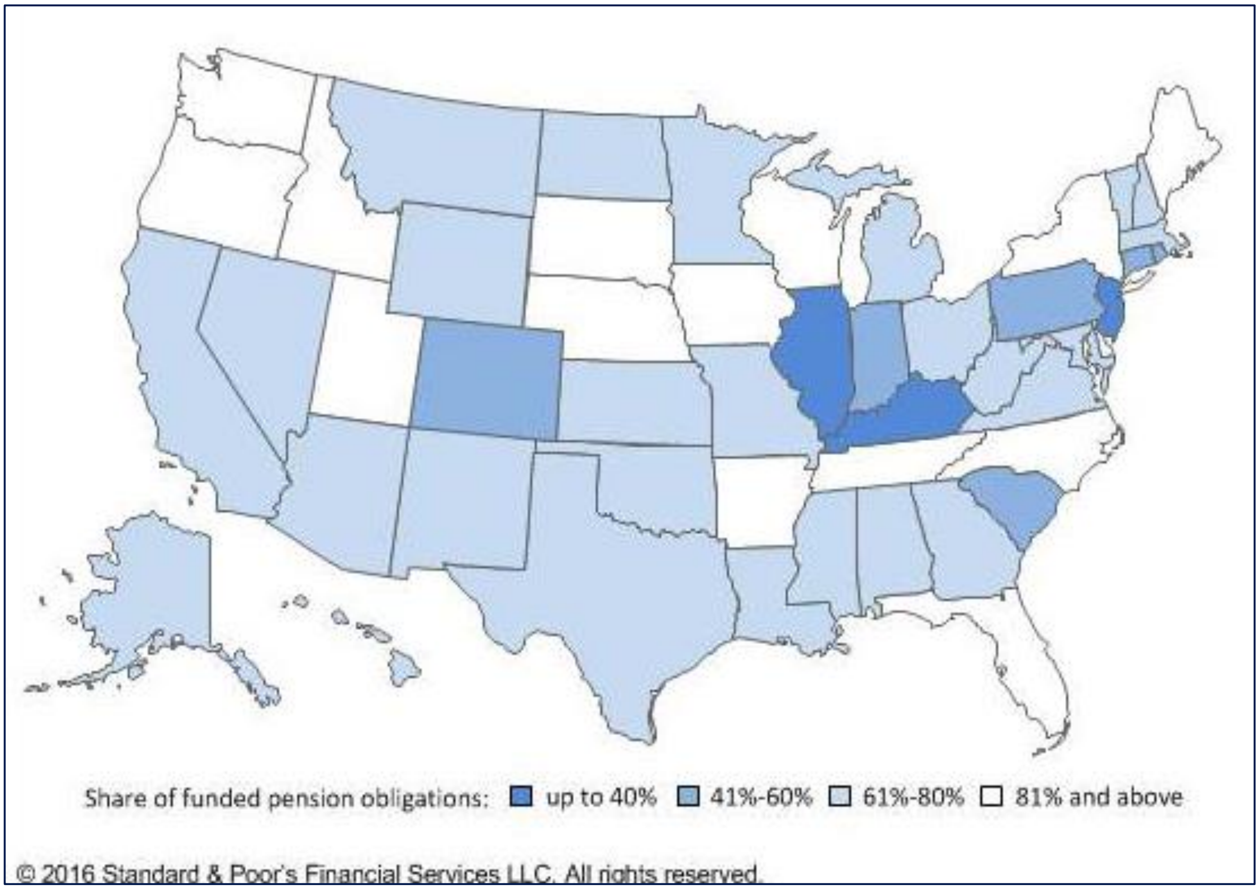
As for pensions, it was repeated actions by governors and legislators of both parties over almost two decades to maintain or increase benefits while at the same time not providing adequate funding that left state-funded pension plans where they are today. (I say state-funded, because New Jersey insists that localities provide adequate funding for their part of the state employee retirement system, even at the cost of some fiscal pain.

According to Moody's Investors Service, the state is on the hook for about 42 percent of the liabilities of NJ PERS, the largest plan.)

So, let's look at how New Jersey compares to other state plans in the view of a number of different authorities:

Figure 2

Pension Funded Ratios



Using the NEW GASB 67 and 68 reporting guidelines now in effect, Standard & Poor's, for example, earlier this month estimated that the state part of NJ PERS was only 37.8 percent funded as of 2015. That is, the fund had 37.8 percent of the assets needed to meet obligations to current and future retirees at its current assumed rate of return and discount rate for future liabilities. This is about half the median funding level for state plans nationwide. That is a problem, as unfunded liabilities are a state debt that compounds at the plan's discount rate, which is 4.9 percent per year, according to the 2015 Comprehensive Annual Financial Report.

While this rate is considerably lower than the 7.5-to-8 percent used by many states and localities, it still means the unfunded liability will double every 14.7 years unless addressed. To some commentators, this is equivalent to a non-voter-authorized general obligation debt, albeit one with no set maturity or payment schedule. Considering that New Jersey is making only 40 percent of its actuarially determined pension contribution (according to S&P), this debt is sure to continue rising.

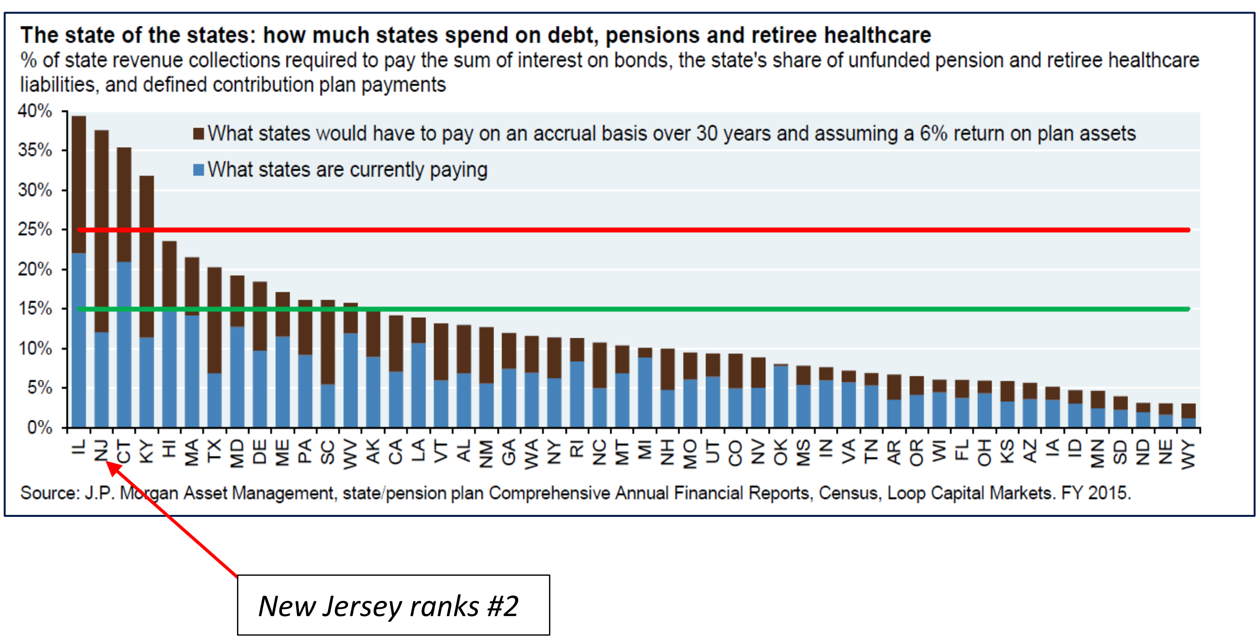
Turning again to that 37.8 percent funding figure, S&P also estimates that this translates into $10,648 per capita; in other words, each New Jersey resident is sharing a burden of more than $10,000 for pension liabilities – and that doesn't include additional thousands for OPEB, or Other Post-Employment Benefits, which are principally retiree health care. Unions and the Christie administration are locked in a painful struggle over cost savings in this area. I am also not including per-capita bond debt but will return to both in a minute.

At $10,648 per capita, the Garden State's pension liability is more than 13 times the median for all states and only slightly greater than that for Illinois, another poor performer in Volcker Alliance and Illinois Institute of Government and Public Affairs studies of state budget processes last year. Using slightly different figures from Moody's Investors Service for fiscal 2014, the net pension liability translates to about 15.5 percent of New Jersey Gross State Product, a little more than double the national mean but considerably less than the leader, Illinois, at 26.2 percent.

So what do all these numbers mean? First and foremost, balancing budgets for years, if not decades, by pushing current spending commitments to the future eventually will catch up with you. The cost is certainly in the reduced flexibility a state has to manage through fiscal or natural crises.

Figure 3

Paying for Promises



You can see this reduced resiliency expressed in a couple different ways. Michael Cembalest of JP Morgan Asset Management recently published a study called "The ARC and the Covenants 2.0" in which he looked at what states would have to spend on debt, pensions, and retiree healthcare and what they are currently paying.

By the way, in case you think this research was done with the goal of helping states and localities repudiate their retirement obligations, I would like to quote from Cembalest's report:

"Public sector workers form a critical part of American civil society," he wrote. *"They rescue and protect us when we're in danger; they make our lives safer, cleaner and more efficient; they educate our children; they enforce the rule of law and provide remedies when laws are broken; they ensure access to clean air, water and food; and they heal us when we're sick. The legal, medical, environmental and educational problems sometimes found in other countries are a reminder of what life might be like without them. They earned the benefits they accrued and which were granted by state legislatures, and have the right to expect them to be paid."*

Of course, bondholders also expect to be paid—in accordance with the covenants and language in the Official Statements for their investments. Now, this chart on the screen assumes a 6 percent return on plan assets, by the way, and New Jersey ranks as second-worst, behind Illinois and alongside Connecticut and Kentucky. By Cembalest's reckoning, there is no way for New Jersey to solve this conundrum by depending on investment returns alone to meet its commitments and, I might add, balance its budget honestly. Yet tax increases and steep spending cuts in New Jersey are problematic at best. You do the math!

Now, another way to look at reduced resiliency is to examine the volatility of a state's revenue, the level of its rainy day fund and other reserves, and its revenue and spending flexibility. When Moody's did this, it concluded that in a hypothetical recession, New Jersey's ability to cope is moderate at best, hampered especially by relatively high revenue volatility (that's due in no small part to the state's ties to Wall Street's cycles) and high fixed costs. At 22.6 percent of revenues, they are the third-worst in the US. Retirement costs, along with Medicaid, are principal drivers here.

Amidst all this gloomy talk, New Jersey does have some considerable strengths. New Jersey has a highly educated work force, innovative companies, and excellent universities and transportation (trust fund issues notwithstanding).

New Jersey is also comparatively wealthy. It boasts the second-highest personal income per-capita, trailing only Connecticut with its hedge-fund billionaires. The Garden State can also borrow at extremely low interest rates even with its fiscal strains. Bloomberg data show that a New Jersey general obligation bond maturing in June 2017 traded in mid-September to yield about 2.4 percent, which was 93.7 basis points over AAA-rated debt. That is actually down from a yield of 3 percent and a spread of almost 110 basis points over AAA at the start of the year.

These attributes give New Jersey and its leaders and citizens some breathing room, but certainly not an infinite amount. The Nelson A. Rockefeller Institute of Government estimates that for the US as a whole, state tax revenues grew by only 1.9 percent over the previous year in the first quarter of calendar 2016. That continued a slowdown which began in 2015 after a couple of quarters of more than 5 percent expansion.

A two percent pace for state revenue—about in line with GDP—seems more in line for the next year or two. That doesn't give burdened states such as New Jersey a lot of options if and when Wall Street or the economy should turn down. Perhaps it's finally time to draw on our strengths to begin to craft solutions not just for pensions, but also for all the other spending promises made but not kept. And for budgets balanced more in name than in reality.

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