

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

3080 SCOMM 142: HOUSE SPECIAL COMMITTEE ON WAYS & MEANS 2005-2006

with a report if the type of entity that the business is registered under has a requirement to deliver a biennial report. In the event that a business has not paid the required fee, the State of Alaska can revoke its charter and dissolve the organization.

The rates vary and are based on the type of business structure and foreign or domestic classification. The fees listed below became effective on July 1, 1995.

Organizational Filing Fees

Domestic Corporation/
Limited Liability Partnership/
Limited Liability Company \$250

Foreign Corporation/
Limited Liability Partnership/
Limited Liability Company \$350

Domestic/Foreign
Limited Partnership \$150

Biennial Fees

Domestic Corporation/
Limited Liability Partnership/
Limited Liability Company \$100

Foreign Corporation/
Limited Liability Partnership/
Limited Liability Company \$200

Domestic/Foreign
Limited Partnership \$0

Most enterprises that engage in business activity in Alaska also have to obtain a business license. The cost of the standard business license is \$50. There is also an additional fee of \$25 for a tobacco sales endorsement.

The Alaska Department of Revenue does not charge any fees for processing taxpayers' returns.

TABLE 2: TAX FILING OPTIONS FOR ALASKA BUSINESSES

How Registered or Licensed with Alaska	How Classified Federally and with Alaska for Tax Purposes	Alaska Form Filing Requirements
C Corporation Limited Liability Company (LLC)	C Corporation	1120, AK 04-611 or AK 04-650
S Corporation	S Corporation	1120S, AK 04-611
Limited Partnership (LP) Limited Liability Partnership (LLP) Limited Liability Company (LLC) General Partnership (GP)	Partnership	1065 (If a partnership has a corporate partner (s), a separate return is required for that partner.)
Sole Proprietor Limited Liability Company (LLC)	Sole Proprietor	No Filing Required
Non-Profit	Exempt	990 and/or 990T, If 990T, Then AK 04-611

Tax Filing Options

The IRS and Alaska distinguish between an S corporation, C corporation, partnership, sole proprietor, and exempt.

Table 2 outlines the filing options for businesses in Alaska and the respective filing requirements. Entities like LPs, LLPs, and LLCs must fall into one of the existing tax categories and do not constitute a separate tax group.

Growth in Use of S Election

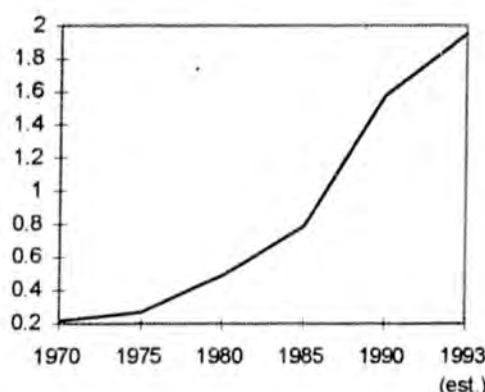
Historic Trends: S Corporations

Speakers at the 1991 annual conference of the National Tax Association—Tax Institute of America—reported that the dollar volume of assets held by S corporations doubled between 1986 and 1988, with states suffering huge revenue losses because of the wave of conversions to S status¹¹.

During the years 1970-1993 the Internal Revenue Service observed a rapid growth in the number of tax returns filed by S corporations.

As shown on the graph (see chart 2), their numbers have increased almost ten times since 1973, from approximately 200,000 to 2 million. In Alaska, the increase in the number of returns filed during the last several years can be attributed to the increase in the number of returns filed by S corporations, from 3,033

CHART 2: S CORPORATIONS, THE RISING TIDE¹²



S corporation returns filed (millions)

Table 3: RETURNS FILED WITH THE STATE OF ALASKA¹³

FY	S Corporation	C Corporation
92	3,033	7,071
93	3,388	6,873
94	4,106	7,163
95	4,541	6,774
96	4,619	7,318
97	4,849	7,196

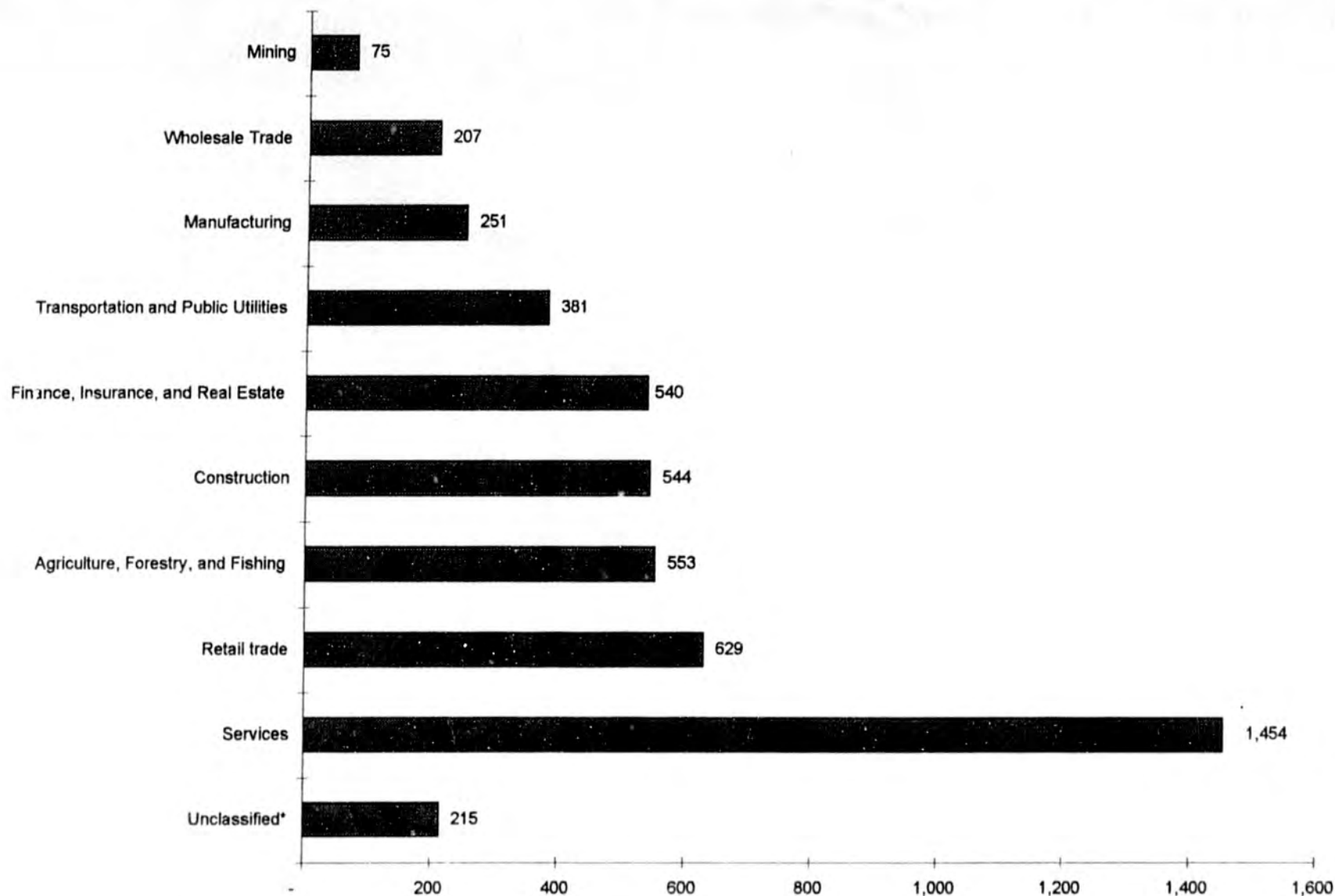
in FY 92 to 4,849 in FY 97, an increase of 38% (see table 3). However, because changes in filing activity also reflects changes in compliance efforts and how returns are filed, this does not necessarily imply an equally high growth rate in S corporations.

¹¹ State Tax Notes, Tax Analysts, Nov. 13, 1991, 91 TNT 232-9.

¹² Source: Journal of Accountancy, February 1994, p.29

¹³ Source: Alaska Department of Revenue, Income and Excise Audit Division

CHART 3: Principal Business Activity of S Corporations in Alaska in FY 97



* This category includes all companies that fall under "unclassified establishments" group of the business activity code as well as corporate taxpayers whose information on business activity is missing on their tax returns.

With the increased flexibility accorded to S corporations by the IRS, further popularity of this business structure type seems to be very likely.

Industry and Geographic Composition of S Corporations in Alaska

S corporations in Alaska are present in most major industries (e.g. fishing, construction, finance, real estate, services, manufacturing) and are most prevalent in the service sector. 30% of the total S corporation returns received by the Department of Revenue in FY 97 are from companies whose main business activity is the provision of services (see chart 3).

The service provider category includes a wide variety of businesses: from hotel and other lodging places to amusement and recreation services, from medical facilities to law firms, and from auto repair to accounting services.

Approximately 80% of Alaska S corporations are domestic. The other 20% are foreign companies who have nexus with Alaska and are headquartered in 47 different states. 50% of them are based in Washington state.



Not surprisingly, over 40% (or over 160 businesses) of Washington-based S corporations in Alaska are part of the fishing industry or agriculture.

Federal Regulations and Their Significance for Alaska Firms

Alaska generally follows the federal pattern pertaining to S corporations including eligibility requirements and tax policy on certain entity level taxes that apply to C corporations transferring to S status. For example, if an S corporation has passive investment income or built-in-gains subject to taxation under the Internal Revenue Code, Alaska taxes the same amount.

Subchapter S of the Internal Revenue Code

The history of S corporations started in 1958 when the federal government created Subchapter S of the Internal Revenue Code to stimulate the economy, promote small businesses, and provide an incentive for selecting the corporate form of business.

S corporations were created in 1958, but it was not until the 1980s that they became a popular way of structuring business.

Major changes pertaining to S corporation status and eligibility requirements were introduced in the 1980s and 1990s in the amendments to the S corporation rules. The 1982 act divided all corporations into two groups: (1) S corporations that make an election to be taxed under Subchapter S and (2) C corporations, which are all other corporations¹⁴.

Revenue Reconciliation Act of 1993

This legislation increased the maximum individual income tax rate to 39.6% (for taxable income over \$250,000) and the maximum corporate income tax rate to 35%.

¹⁴ 26 U.S.C. 6242 et seq.

(for taxable income over \$10 million). As a result, the maximum tax rate of S corporations became 39.6%, whereas C corporations had a lower maximum tax rate of 35%. Many S corporations revoked their S election after the passage of this act.

Small Business Job Protection Act of 1996

This act was more favorable to S corporation owners and shareholders than the previous amendments to S corporation rules and regulations. The following significant changes in the eligibility requirements were made by this act:

- The maximum number of S corporation shareholders was expanded to 75.
- Electing small business trusts were added to the list of trusts that are eligible to be S corporation shareholders.
- An S corporation was allowed to have C corporation and/or S corporation subsidiaries.
- Debt owed by an S corporation was not to be treated as a second class of stock; the eligible creditor requirement was expanded to include banks and other entities engaged in the business of lending money.

These changes allow businesses organized as S corporations much greater flexibility in conducting their operations than was available in prior years.

S Corporation Features

General observations

Deductibility of losses

Aside from avoiding tax at the corporate level, one of the primary advantages of using an S corporation election is the right of its members to use business losses to offset individual income. These losses pass through to the member's personal income tax return (IRC 1366 and 1374).

S corporation shareholders can write off their share of operating losses against their income only to the extent of their tax basis; that is, their investment in shares or loans to the corporation. Losses in excess of shareholders tax basis are carried forward to future tax years and applied against any profits earned by the corporation or against additional investments made by shareholders.

Deductibility of interest

Interest that is incurred when buying S corporation stock is potentially deductible as an investment interest expense.

Payroll taxes

Shareholders are subject to payroll withholding requirements. Any residual income is divided among shareholders and is subject to federal and state income tax, but not self-employment tax.

Restrictions on formation, operation, and disposition of the business

There are several restrictions imposed on S corporations (number of shareholders, class of stock, etc.). A corporation that does not satisfy any one of the requirements, cannot qualify for S election.

Existing S corporations that do not comply with the IRS or state rules are subject to S corporation election revocation. Limitations associated with S corporations status are stated in Subchapter S of the Internal Revenue Code and subsequent changes in S corporation rules.

Alaska-specific issues

The intent of Subchapter S creation was to free corporations from corporate income tax and to preclude double taxation. S corporations receive the same treatment on the

federal level but their treatment on the state level widely differs.

Alaska recognizes S corporations but imposes no personal income tax; so no income tax is collected on any level, be it corporate or shareholder.

Status and Tax Treatment of S Corporations in Other States¹⁵

Although S corporations are not taxable for federal corporate income tax purposes, their state treatment differs from state to state. Among the states, there are no uniform rules governing the taxation of an S corporation and its shareholders.

Following the federal pattern

Most states have adopted the federal approach to taxation of S corporations and recognize a valid federal S election. As a result, the net income of the corporation is taxable directly to the shareholders for federal and state income purposes. However, the recognition of S status by a state does not always imply that the corporation will be exempt from a business license, franchise, or income tax.

California, New Jersey, and New York recognize the S election, but for corporate income tax purposes its only effect is to subject the S corporation to a tax rate less than the C corporation rate. For example, California imposes a 1.5% surcharge on S

corporation income. The normal franchise tax rate is 9.3%.

In Massachusetts, S corporations with total receipts exceeding \$6 million are subject to the corporate income tax.

In many cases, states levy minimum income taxes that apply to all taxpayers, including S corporations. In the District of Columbia, S corporations are subject to a \$100 minimum tax. Minnesota subjects S corporations—whose payroll, property, and sales are not more than half a million dollars—to a minimum fee based on taxable income apportioned to Minnesota. This fee can be as much as \$5,000.

New York enacted a special corporate level tax on S corporation income at a rate equal to the difference between the maximum rate applicable to the individual income and the maximum rate applicable to corporation income. New York added a temporary 15% surcharge on corporate income tax liability which applies to S corporations with net incomes of more than \$200,000¹⁶.

Election not recognized

Some states—Connecticut, the District of Columbia, New Hampshire, Tennessee—do not recognize the S election with respect to the corporate income tax; therefore S corporations are taxed in those states like C corporations.

Texas, while recognizing a distinction between S and C corporations, imposes its franchise tax on both and does not tax

¹⁵ Source: Raabe, William A. and Karen J. Boucher, 1997 Multistate Corporate Guide, vol. 1, pp. 135-138. New York, NY: Panel Publishers, 1997.

¹⁶ Source: Willson, Prentiss and Mark Windfeld, Tax management multistate tax portfolios. State taxation of pass-through entities: general principles. Washington D. C.: Tax Management, Inc., 1994.

individual income, so the effect is similar to disregarding S status.

No corporate taxation

Nevada, South Dakota, Washington, and Wyoming form a special group. They do not have corporate taxes. However, several of them use other avenues for collecting taxes on the entity level.

For example, Washington state imposes a tax on gross income of corporations (C, S, and nonprofit), partnerships, and sole proprietors from their activities in the state. Called business and occupation (B&O) tax, it is the second leading tax source for Washington state. In FY 95, B&O tax collections totaled 1.59 billion dollars, which represented approximately 17% of all taxes levied by the state¹⁷.

State Revenue Effects of Subchapter S Corporation Election

In FY 97, Alaska lost an estimated \$17 million due to current nontaxable status of S corporations.

Approximately \$12 million of the total \$17 million loss is from Alaska-based businesses and \$2.5 million from foreign S corporations (see Appendix C).

When a company conducts business in more than one state, there is a question as to what share of its total income is taxed in a particular state. The amount of taxable income in Alaska

is calculated by using an apportionment formula to identify the corporation's total Alaska taxable income. The apportionment method employs a three-factor formula. These factors are payroll, property, and sales. Although there is no uniform apportionment formula in the US, most states, including Alaska, adopt the Uniform Division of Income for Tax Purposes Act (UDITPA) that uses a three-factor formula. In Alaska all three factors, payroll, property, and sales, are weighted equally¹⁸. (For a more detailed description of apportionment calculation, see Appendix D.)

In our computations, the major assumption is that S corporations will not change their expenditure pattern and/or their income in response to a change from nontaxable to taxable status.

Alaska S corporations are assigned an apportionment factor of 1 which means that all their business net income is taxable in the state. However, there may be some firms designated as Alaskan that have apportionment factors less than one. To estimate the apportionment factor of foreign S corporations, the FY 97 apportionment factors of foreign non-oil and gas C corporations are averaged.

Washington-based C corporations have a much higher average apportionment factor than C corporations from other states. This generally shows a high level of business activity and a large portion of net income being derived from Alaska. Additionally, considering that Washington-based S corporations represent almost half of all foreign S corporations in Alaska, gives us another reason to examine them separately. Their apportionment factor is 9 times greater

¹⁷ Source: Information on Washington's Tax Structure. Business and Occupation Tax. Washington Department of Revenue.

¹⁸ AS 43.19.010, 43.20.065

than the apportionment factor of S corporations based in other states. When projecting revenue loss from S election in Alaska we use three apportionment factors. They are applied to:

1. Alaska-based S corporations (1.00)
2. Washington-based S corporations (.27)
3. Other foreign S corporations (.03)

This three-tiered approach reflects the best distribution of business involvement in Alaska. Intentionally while averaging apportionment factors, foreign C corporations with 100% taxable income in Alaska are excluded from the sample. This exclusion eliminates overestimating revenue loss.

* * *

In this report we explored the current composition of businesses in Alaska and the structure of the state business income tax. Although we briefly examined all business structures, the focus of this report was S corporations. We provided historical background information on S corporation election, current information on the make-up of S corporations in Alaska, and estimate of projected revenue loss from S election.

With the popularity of new business structures, there will certainly be need for examining them. We hope we have provided a framework for future work in this area.

Appendices

APPENDIX A

FY 97 CORPORATION TAX LIABILITIES STATISTICS

Alaska Net Income	Oil and Gas Corporations			Other than Oil and Gas Corporations			All Corporations		
	# Filers	Amount	% Total	# Filers	Amount	% Total	# Filers	Amount	% Total
Above \$1 million	6	\$161,162,466	97.20%	4	\$7,236,689	17.68%	10	\$168,399,155	81.46%
\$500,000 - \$1 million	4	3,129,368	1.89%	15	10,737,397	26.23%	19	13,866,765	6.71%
\$100,000 - \$499,999	5	1,404,626	0.85%	53	11,949,087	29.19%	58	13,353,713	6.46%
\$50,000 - \$99,999	1	53,153	0.03%	53	3,636,859	8.89%	54	3,690,012	1.78%
\$10,000 - \$49,999	1	43,521	0.03%	206	4,720,318	11.53%	207	4,763,839	2.30%
\$1,000 - \$9,999	3	10,391	0.01%	658	2,277,593	5.56%	661	2,287,984	1.11%
\$100 - \$999	3	1,167	0.00%	816	331,666	0.81%	819	332,833	0.16%
\$1 - \$99	2	14	0.00%	1,301	39,954	0.10%	1,303	39,968	0.02%
Zero Tax	11	0	0.00%	10,431	0	0.00%	10,442	0	0.00%
Total	<u>36</u>	<u>\$165,804,706</u>	<u>100.00%</u>	<u>13,537</u>	<u>\$40,929,563</u>	<u>100.00%</u>	<u>13,573</u>	<u>\$206,734,269</u>	<u>100.00%</u>

Note: Amounts reflect tax liabilities reported on the taxpayer original returns. Liabilities may differ from amounts remitted by the taxpayer during the fiscal year due to timing differences resulting from estimated tax payments, credits, and final payment of taxes reported. Corporations include here Subchapter S, Subchapter C, Homeowner's Association, Exempt, Oil and Gas.

APPENDIX B

COMPARISON OF ENTITY STRUCTURES

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Entity Type	Offers Continuity of Life?	Managing Body	Levels of Income Tax	Deductibility of Losses Attributable to Entity Debt	Entity Taxed in Alaska?
<u>General Partnership</u>	No	Partners	Individual capacity	Partners may deduct partnership losses only to extent of basis ³ .	No ⁴
<u>Limited Partnership</u>	No, but the entity can be reconstituted by general partner or by agreement of all remaining partners.	General partner—limited partners may not participate in management.	Individual capacity	General partners only may deduct partnership losses to extent of basis ³ , unless limited partnership assumes liability.	No ⁴
<u>Limited Liability Partnership</u>	No, unless partnership agreement provides otherwise.	Partners	Individual capacity	Same as with general partnership	No ⁴
<u>Limited Liability Company</u>	No, unless regulations provide otherwise or members unanimously consent to continue business.	Managers, unless regulations reserve the right to members.	Individual capacity	Members may deduct the LLC's losses only to the extent of their basis ³ which includes their allocable share of LLC debt.	No ⁴ , if elects to be taxed as partnership.
<u>S Corporation</u>	Yes, unless it is terminated by the IRS due to a prohibited activity.	Board of Directors	Only shareholder level.	Shareholders may deduct the corporation's losses only to the extent of their tax basis ³ of their stock which does not include any portion of the corporation's debt.	No
<u>C Corporation</u>	Yes	Board of Directors	Corporate and shareholder level	Shareholders may not deduct any of corporation's losses.	Yes

³ A partner's basis (or member's in case of LLC) in his or her share of business includes money invested plus the adjusted basis of property contributed to an enterprise.

⁴ A C corporation that is a partner or a member of a business is required to report its income or loss.

APPENDIX D

APPORTIONMENT CALCULATION

The following is an example of how the tax liability of a C corporation in Alaska is calculated. This process can be broken down into three steps:

1. Calculate the apportionment factor
2. Compute the taxable income
3. Determine the applicable tax rate

Example:

	Alaska	Total US
Sales	\$300,000	\$500,000
Property	100,000	750,000
Payroll	150,000	300,000
Total	\$550,000	\$1,550,000

1. Apportionment factor

Computations:

Sales	$\$300,000 / \$500,000 =$	60.00%
Property	$\$100,000 / \$750,000 =$	13.33%
Payroll	$\$150,000 / \$300,000 =$	50.00%
Apportionment formula average (total / 3)		41.11%
Apportionment factor		.41

2. Taxable income in the state

Income apportioned to Alaska is computed by applying the apportionment factor to total business net income.

Assume that the business net income of our company is \$1,000,000 and apply the apportionment factor to that income. Then taxable income in our example equals \$410,000; that is $.41 \times 1,000,000$.

3. Tax rate and tax liability

On taxable income of more than \$90,000 in Alaska, the tax is \$4,500 plus 9.4% of the taxable income over \$90,000 which equals \$34,580. This is the amount that our hypothetical corporation has to pay in taxes to the State of Alaska.

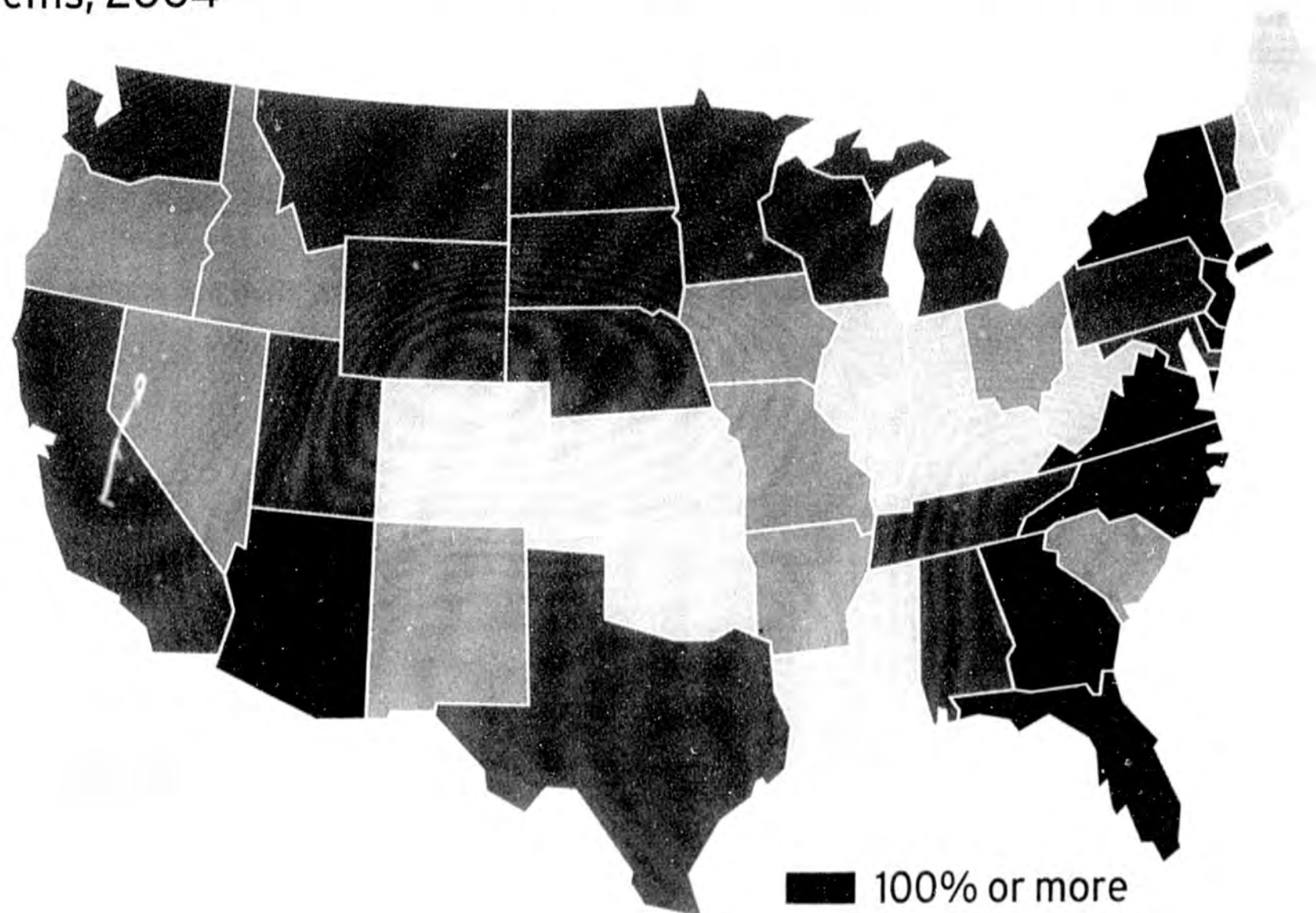
The same three-step process is used in estimating the FY 97 revenue loss due to S corporation election in Alaska.

SCOMM

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Punching Up Pensions

Average actuarial funding ratios of state and local public retirement systems, 2004



Source: National Association of State Retirement Administrators

 100% or more
 90-99.9%
 80-89.9%
 Less than 80%

ALASKA STATE LEGISLATURE

Representative Bruce Weyhrauch

HOUSE DISTRICT 4



June 15, 2005

ALASKA
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JUNEAU, ALASKA
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Representative Peggy Wilson
Representative Norman Rokeberg
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Representative Paul Seaton
Representative Carl Moses
Representative Max Gruenberg
Members of the Alaska House of Representatives Special Committee on
Ways and Means
State Capitol
Juneau, Alaska

Dear Committee Members:

When the Alaska House of Representatives formed the Special Committee on Ways in Means, it did so in recognition that state government could provide essential services while protecting the economic stability of the state. The House formed the committee, in part, to control state spending, identify ways to make state government programs more efficient, and bring state spending in line with revenues.

In light of this, it will be intent of the Chairman of the Ways and Means Committee to assess the implications of the unfunded liability of the State of Alaska's Public Employee Retirement System and the State of Alaska's Teachers' Retirement System. The reasons for this work are as follows:

1. Article XII, Section 7 of Alaska's Constitution provides the basis for State and political subdivision retirement systems. Those

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House Special Committee on Ways and Means

June 15, 2005

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systems constitute a contractual relationship with members of the systems and any benefits of those systems cannot be diminished or impaired.

2. It is generally understood that the State's PERS and TERS Retirement Systems are under-funded by roughly \$5.7 billion.
3. It is anticipated that in less than a decade, this unfunded liability will approach \$15 billion.
4. Because the State is constitutionally mandated to provide retirement benefits to its public employees and teachers, the obligation of retirement and health benefits may drain financial resources that must go to other essential state functions such as education, health services, public safety and natural resource management and development.
5. Alaska's retirement system is not alone in facing fiscal problems. According to the Government Accounting Office, the Pension Benefit Guaranty Corp, a federal agency that insures certain benefits of the 34 million defined benefit pension plan participants, has spiraled from a \$9.7 billion surplus at the end of fiscal 2000 to a \$23.3 billion deficit by September 2004, including a \$12.1 billion loss for fiscal 2004.
6. In 2006, the state will establish a defined contribution program that changes the retirement systems for public employees and teachers from a defined benefit program to a defined contribution program.
7. Because of the large and growing unfunded liability in the existing PERS/TERS systems, and the parallel defined contribution system that will affect future teachers and public employees, it is incumbent on the state to find a solution to the present unfunded liabilities of the PERS/TERS Systems to insure that these systems

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provide benefits that are constitutionally required, and to minimize impacts on other state financial needs and requirements.

Given the concerns and issues related to the State's PERS/TERS Systems, the House Ways and Means Committee will investigate and develop legislation to deal with the problems identified through the committee process. The tasks that the committee will undertake as part of its responsibilities will be to determine, among other things:

1. How did the PERS/TERS Systems end up with a deficit?
2. What role did PERS/TERS have, separately, in contributing to the deficit?
3. With respect to PERS, how are Tier I, Tier II, and Tier III contributing to the deficit.
4. With respect to PERS/TERS, what part of the unfunded liability of deficit is represented by health or retirement benefits?
5. What role, if any did the following have in contributing to the present PERS/TERS financial problems?
 1. Investment Consultants
 2. Actuaries
 3. General Counsel
 4. Custodians
 5. Investment Advisors
 6. The State Agencies managing these systems.
6. What roles should the new pension board and the existing PERS and TERS Boards play in dealing with long term solutions and how can problems the state faces now be avoided in the future?
7. Should the legislature adopt constitutional revisions to address the long term solution? Can the solutions be dealt with by

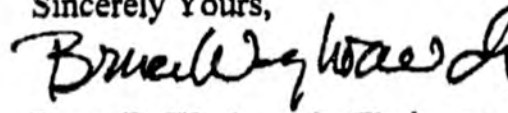
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appropriations alone, or should legislation be adopted that address the short and long term issues identified by the committee.

It is my hope that the committee can report legislation out of committee during the 2006 session that meets the constitutional requirements of the State's retirement systems, and ensure that the State's PEPS/TERS Systems are on solid financial grounds.

Thanks for working with me on this. If you want to discuss this, complain, or have any questions, concerns, or comments, please call me at 463-5566. I am certainly open to your input to make this Committee process productive. Thanks.

Sincerely Yours,



Bruce B. Weyhrauch, Chairman
Alaska House of Representatives Special
Committee on Ways and Means

<http://www.slcatlanta.org/Committees/FAGO/fago.htm>

This link will take you to the testimony of Sujit CanagaRetna of the Southern Legislative Conference.

Once you get to the page, scroll down to the bottom and click on "remarks" on the Alaska presentation line.

SUJIT M. CANAGARETNA

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EDUCATION

Columbia University, New York, NY

School of International and Public Affairs

Master of Public Administration (MPA), May 1992

Policy Concentration: Advanced Analytic Techniques

Master of International Affairs (MIA), May 1990

Specialization: International Political Economy

Regional Certificate: Southern Asian Institute, May 1990

Bennington College, Bennington, VT

Bachelor of Arts (BA), June 1987

Major: Economics and International Relations

PROFESSIONAL EXPERIENCE

The Council of State Governments' (CSG) Southern Office, the Southern Legislative Conference (SLC), Atlanta, GA

Regional Representative/Fiscal Policy Analyst [March 1998 to November 2003]

Senior Fiscal Analyst [December 2003 to Present]

- Serve as CSG's chief fiscal specialist by tracking international, national and regional economic trends and their impact on the finances of all 50 state governments
- Carry out presentations and provide testimony on state fiscal and economic development trends before federal (Federal Reserve Bank of Kansas City), state (Alabama, Kentucky and Mississippi Legislatures), local (Conference of Southern County Associations) and other policymakers
- Research, write and publish a variety of publications for SLC and CSG ranging in length and depth, including **Special Series Reports** (70+ pages), **Regional Resources** (10-40 pages), **South Scans** (single page snapshots) and articles for **Spectrum: The Journal of State Government** (bi-annual publication) and **State Government News** (monthly publication)
- Conduct interviews with members of the media (television, radio and print) on emerging state fiscal and economic trends as CSG's fiscal specialist
- Contact and secure national (such as the presidents of the Federal Reserve Banks of Atlanta, Dallas and St. Louis), regional and state-level experts as presenters for policy sessions on fiscal, economic development and transportation topics at various CSG and SLC meetings

- Staff the SLC's Fiscal Affairs and Government Operations Committee, the Economic Development, Transportation and Cultural Affairs Committee and CSG's Financial Services Working Group
- Monitor legislative activity and political developments in Maryland, Mississippi, North Carolina and Tennessee
- Respond to information requests on fiscal, economic and transportation issues from Southern state legislators and legislative staff
- Initiate contact and maintain links between the SLC and Southern state legislators and legislative staff
- Cultivate and strengthen relations with various international consulates in Atlanta and serve as the SLC's liaison and coordinator for a range of international activities

Office of the Comptroller, City of New York, New York, NY [July 1992 to September 1997]

Audit Manager (June 1997 to September 1997)

Managed a group of 19 professional auditors responsible for conducting operational, financial and investigative audits of New York City agencies and not-for-profit organizations under contract with the City of New York. Provided training and guidance to audit supervisors, senior and staff auditors. Briefed the Comptroller and other senior Executive Staff on audit findings before press conferences. Worked closely with the Press Office on media releases.

Senior Economist/Audit Supervisor (September 1995 to May 1997)

Economist/Auditor-in-Charge (August 1994 to August, 1995)

Senior Auditor (July 1992 to July 1994)

International Planned Parenthood Federation, New York, NY

Project Assistant [August 1991 to January 1992]

Private Sector Policy Support Unit, Colombo, Sri Lanka

Project Consultant - Research and Design [January 1991 to May 1991]

INTERNSHIPS

American International Group (AIG), Trade and Political Risk Division, New York, NY [Summer 1989, Fall 1989, Spring 1990]

Marga Institute, Colombo, Sri Lanka [January to August 1988]

Academy for Educational Development (AED), Washington, D.C. [Winter 1986, and June to December 1986]

United Nations Development Programme (UNDP), New York, NY [Winter 1985]

PUBLICATIONS

Reports:

- America's Public Retirement System: Stresses in the System, **SLC Special Series Report** (Atlanta, Georgia), October 2004
- The Drive to Move South: The Growing Importance of the Automobile Industry in the Southern Legislative Conference (SLC) Economies, **SLC Special Series Report** (Atlanta, Georgia), November 2003
- Unemployment Insurance in a Diminishing Economy: Recent Trends from the Southern Legislative Conference States, **SLC Special Series Report** (Atlanta, Georgia), June 2002
- Red Ink Rising: Fiscal Trends in the Southern Legislative Conference States, **SLC Special Series Report** (Atlanta, Georgia), November 2001
- Forging New Trade Relationships: Latin America and the Southern Legislative Conference States, **SLC Special Series Report** (Atlanta, Georgia), July 2001
- More than a Song and Dance: The Economic Impact of the Arts in the Southern Legislative Conference States, **SLC Special Series Report** (Atlanta, Georgia), November 2000
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- *Stresses in the System: Trends in Public Retirement Systems*, Testimony before a Joint Hearing of the Mississippi Senate and House Finance, Appropriations and Ways & Means Committees, April 27, 2005
- *State Budgets: Swimming Away from A Sea of Red Ink*, Presentation before the Association of Capitol Reporters and Editors (ACRE) Annual Meeting, Columbia, South Carolina, November 13, 2004
- *Ports in the South*, Presentation before the Warrior-Tombigbee Waterway Association's 54th anniversary meeting, Mobile, Alabama, April 30, 2004
- *Innovative Strategies: State Efforts to Stem the Tide of Red Ink*, Presentation before the Governor of Alabama's Commission on Efficiency, Consolidation and Funding, Alabama State House, Montgomery, Alabama, November 21, 2003
- *Awash in Red Ink: Fiscal Crisis Sweeping the States*, Presentation before the Federal Reserve Bank of Kansas City's Community Development Advisory Council bi-annual meeting chaired by Dr. Tom Hoenig, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, Omaha, Nebraska, March 12, 2003

- *The Fiscal Crunch Confronting the South*, Testimony before a Joint Hearing of the **Kentucky House and Senate Appropriations and Revenue Committees**, January 14, 2003
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America's Retirement Architecture: Strains in the System

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Testimony Before the
Alaska House of Representatives
Ways & Means Committee
(via Conference Call)

Alaska State Capitol
Juneau, Alaska
July 14, 2005

Introduction:

My thanks to Chairman Weyhrauch for extending this invitation to me and to The Council of State Governments to testify before the Ways and Means Committee of the Alaska House of Representatives. It is a great honor to be here.

My remarks this afternoon will deal with the challenges confronting state and local government retirement systems in recent years. Primarily, I will draw on my research in preparing a 50-state review of our nation's public retirement systems (published in October 2004) and my ongoing study of this issue. Lawmakers in almost every state grapple with unfunded pension liabilities and the urgent need to devise solutions to ensure the solvency of these retirement systems in an environment where state finances continue to be under stress. After providing a broad overview of the public retirement system landscape, including several emerging trends, I will detail a number of strategies adopted by states across the country to bolster the financial position of their respective pension plans.

Part I:

Any discussion of the financial position of public retirement systems has to be placed in the context of the overall health of state finances. States are finally seeing improved revenue numbers and for the just concluded fiscal year, 2005, revenues exceeded original budget projections in 42 states while three others met their targets. Revenue in only five states came in below projections. Sales, corporate and personal income tax flows have all performed admirably. This is a marked improvement from the prior four years when states battled a fiscal downturn termed the worst in six decades. Since fiscal year 2001, states closed a cumulative budget gap that surpassed \$235 billion by adopting a range of difficult choices.

While the revenue side of the balance sheet is now promising, unfortunately, the expenditure side continues to pose serious dilemmas. After several years of flat growth, state spending grew by 6.6 percent in fiscal year 2005; the annual average since 1979 is 6.5 percent even though the average over the last five years was only 3.9 percent. Healthcare costs lead the way here and in the next decade, just as it has in the last five years, Medicaid is estimated to grow by 9 percent to 10 percent a year.

In addition, expenses associated with education, including court-mandated costs, retirement systems, corrections, transportation, demographic changes and infrastructure needs will continue to burden state budgets.

Part II:

State retirement systems are one element in our nation's overall retirement architecture. There has been a great deal of discussion recently of the "graying" of America and the need to develop an infrastructure to absorb the retirement needs of all Americans. As Census Bureau figures indicate, the elderly population in every state will grow faster than the total population, and seniors will outnumber school-age children in 10 states in the next 25 years.

Financial planners often recommend the "three-legged stool" concept in planning for retirement. Each leg of the stool is supposed to represent a source of income in retirement, and the goal is to cumulatively attain a standard of living at least comparable to the one experienced prior to retirement. In this analysis, if the first leg of the stool is Social Security income, the other two legs of the stool refer to personal savings and retirement or pension income. Unfortunately, a close review of national financial and demographic trends reveals that all three legs of this metaphorical retirement stool remain wobbly, a development that threatens to seriously jeopardize the retirement plans of a majority of Americans.

As states emerge from the recent financial downturn, policymakers now face the daunting challenge of dealing with weaknesses in public retirement systems. These public retirement systems are underfunded at a time when the first wave of the nation's baby boomers is rapidly approaching retirement. As mentioned, other elements of the nation's retirement architecture remain extremely shaky as well. Specifically, the precarious financial position of corporate pension plans and the federal Pension Benefit Guaranty Corporation (PBGC); the looming shortfalls expected in Social Security and Medicare in coming decades; and, the low personal savings rates of most Americans, coupled with high rates of consumer and household debt.

Part III:

The employee retirement systems of state and local governments remain a critical component of our nation's government sector. Not only do these retirement systems cover millions of public sector employees and provide current and future income for these retirees and employees, they contain significant investment holdings as well.

After suffering steep losses—losses from which these public pension plans continue to reel—during the economic downturn of the early years of this decade and during the 2000-2002 stock market collapse, finally, most plans are seeing positive returns. Based on the latest federal data, the cash and investment holdings of state and local government employee retirement systems cumulatively reached \$2.2 trillion in 2003, a very slight increase (\$14 million) over the prior year. Just a decade ago, in 1993, total cash and investment holdings in these public pension plans amounted to about \$921 billion. Propelled by the tremendous gains in equity investments in the late 1990s, these holdings accelerated to about \$2.2 trillion by 2000 and have continued to hover at that level for the past four years.

In terms of receipts, comprising employee and government (both state and local) contributions and earnings on investments, after experiencing negative returns in both 2001 and 2002, these retirement systems saw positive gains in 2003. Interestingly, state government contributions to these retirement plans increased by \$2.4 billion to \$19.6 billion in 2003 after declining in 2002 and barely registering an increase in 2001; this is a reflection of the improved state fiscal picture. Yet, total receipts were less than half the amount secured in 2000 (\$148 billion in 2003 vs. \$297 billion in 2000).

During the recent fiscal downturn, a number of state and local governments slashed their regular contributions to their pension funds in order to balance budgets. For instance, North Carolina withheld \$144 million in payments for this purpose in 2002 and Texas cut its contribution to the Teacher Retirement System from 7.3 percent of employee pay to 6 percent. In Illinois, until 1995, the state's contribution to its pension funds was subject to an annual appropriation by the legislature; yet, in the last decade, Illinois lawmakers failed to allocate sufficient funds to cover liabilities. Since 1996, New Jersey contributed virtually nothing to its public employee retirement plan.

On the payment front (benefits, withdrawals and other), there were steady increases too; up from \$100 billion in 2000 to \$135 billion in 2003. Finally, in 2003, there were a total of 2,657 plans (serving 17.6 million members) of which 218 were state plans and 2,439 were local plans. Pennsylvania and Illinois had the highest number of plans while Maine and Hawaii had the lowest number.

Part IV:

My ongoing review of public retirement plans reveals several trends. First, the increasing move by these plans to invest in non-governmental securities (such as corporate bonds, stocks and foreign investments) away from government securities (such as U.S. Treasury bills). In fact, in 1993, public plans only had 62 percent of their total cash and investment holdings in non-governmental securities; ten years later in 2003, this percentage had ballooned to 77 percent. Several states made statutory changes to allow their pension plans to invest more heavily in the market; Georgia approved an increase from 50 percent to 60 percent and the South Carolina Senate approved an increase from 40 percent to 70 percent.

Second, in the last few years, payments from these retirement plans have far outpaced receipts into the plans. For instance, between 2000 and 2001, payments increased by 12 percent while receipts shrank by 59 percent. Similarly, between 2001 and 2002, payments expanded by 9 percent while receipts dwindled by 105 percent. A significant portion of these payments are related to health care expenditures, a spending category that has experienced substantial growth in recent years. According to the federal Centers for Medicare and Medicaid Services, the torrid pace of growth in national health spending reached \$1.7 trillion in 2003, the latest year available, and topped 15 percent of our nation's gross domestic product for the first time.

Third, given the spate of accounting and corporate scandals and the significant losses experienced by these public retirement systems, there is a great deal more activism on the part of the boards overseeing these plans and state lawmakers to monitor more closely the performance and management of their retirement plans. For instance, Connecticut, like several other states, citing "pervasive conflicts of interest and dismal company performance," decided to withhold voting for the head of Safeway and two other directors in May 2004.

Then, in Maryland, in the aftermath of the state's employee pension system losing a staggering one-fifth of its total portfolio in a 15-month period by September 2001, a development that ranked it last in an evaluation of similar plans, the Maryland General Assembly began a series of inquiries. These legislative explorations, along with a federal investigation, led to the criminal prosecution of a number of employees and the complete revamping of the plan's structure. As a result of management changes and other reforms, by the end of fiscal year 2004, this pension plan achieved the healthy growth rate of 16 percent.

Fourth, a number of research studies indicate that in the last few years, a vast majority of these public pension plans were underfunded to varying degrees, i.e., assets were less than their accrued liability. The farther a plan's funding level is below 100 percent, the greater the contributions required to finance its unfunded liability. For instance, according to the October 2004 Southern Legislative Conference pension report, 73 percent, or 68 of the 93 plans for which

information was secured, were unfunded to varying degrees. Then, according to the latest (2005) Wilshire Report on 125 state retirement systems, the funding ratio, or ratio of assets-to-liabilities, in both actuarial and market terms, has fallen dramatically. Specifically, the actuarial value funding ratio declined over the last five years from 103 percent in 2000 to 85 percent in 2004. Finally, according to the latest (April 2005) survey of 103 plans by the National Association of State Retirement Administrators (NASRA), the average funding level stood at 89 percent with a cumulative unfunded liability of \$267 billion.

Notwithstanding the fact that a majority of the plans reviewed were termed unfunded, several plans did secure an actuarial funding ratio greater than 100 percent. According to the NASRA survey, the North Carolina Teachers and State Employees System (112 percent), the Florida Retirement System (114 percent) and the New York State Teachers System (125 percent) were some of those plans. At the other end of the spectrum, Illinois' five retirement systems had the largest unfunded pension liability among the 50 states (\$43 billion in 2003). At the local level, the city of San Diego had a \$1.4 billion unfunded liability and the city of Houston faced a \$1.9 billion shortfall.

Fifth, the chilling effect of a Governmental Accounting Standards Board (GASB) ruling released last August on already teetering public pension plans. (GASB is the independent standard-setter for 84,000 state and local government entities.) According to this ruling, state and local governments have to place a value on "other post-employee retirement benefits"—consisting mostly of health care—they promise to employees. They will also have to record as an expense the amount—the annual required contribution—they would need to stash away to fully fund this long-term liability over 30 years. While the private sector has had similar rules since 1992, for the public sector, implementation will be phased in beginning December 15, 2006. Given the huge spikes in healthcare costs expected in upcoming years, the explosion in unfunded liabilities as a result of this ruling promises to be most alarming.

Part V:

In responding to the growing crisis associated with unfunded pension liabilities, lawmakers have pursued various strategies to bolster the finances of these systems.

- **Pension Obligation Bonds:**

A strategy adopted by states and localities in the last decade or so involves issuing pension obligation bonds. Given their increasing fiscal problems, several states and localities opt to issue debt to raise money to plough into their pension systems and pay off, in a lump sum in today's dollars, their unfunded liabilities. The fact that interest rates have been at historically low levels recently and the fact that raising taxes continues to be politically radioactive, the opportunity to raise funds via enhanced borrowing quickly loomed as an attractive strategy. A further twist to this approach surfaced in California where an effort was made by both Governors Davis and Schwarzenegger in 2003 and 2004 to issue pension obligation bonds to even pay for the state's annual retirement contribution. Formerly, the trend had been to completely retire the state's unfunded liability portion not just pay for an annual contribution.

Some of the states that pursued the pension obligation bond strategy recently to replenish their pension plans include California (\$2 billion), Illinois (\$10 billion), Kansas (\$500 million), Oregon (\$2 billion) and Wisconsin (\$1.8 billion). In June 2005, West Virginia voters, in a special election, rejected Governor Manchin's efforts to issue \$5.5 billion in bonds to bolster his state's ailing pension plans.

In selling these bonds, states are counting on the interest payable on the bonds being less than their pension investment earnings. If a state pension plan can earn 8 percent by investing money the state borrowed at 6 percent, the state is ahead of the

game. Another advantage is that states experience immediate budget relief because their current year contributions to a pension plan can be secured from the proceeds of the bond issue.

On the flip side, there is always the possibility that the market may not generate the returns to cover the interest rate. Furthermore, once a state issues a bond, it is locked into paying the debt whereas the state has much more flexibility in deciding on future pension contributions, including size, rate and regularity.

New Jersey's experience in 1997 offers a cautionary tale for states mulling the pension obligations bonds option. Then-Governor Christine Todd Whitman led an effort that resulted in the state issuing \$2.8 billion in bonds that promised to pay off its unfunded pension liability, solve all of its pension problems for the next 36 years, make the state's contributions to the plan for that year and free up \$623 million for tax cuts. The state banked on getting returns exceeding 7.6 percent, the interest it was paying on the bonds. For the first few years, while the economy surged ahead and the stock market roared, the gamble appeared to have paid rich dividends. Then, the economy slumped and the stock market collapsed, resulting in a severe drop in investment earnings. By mid-2003, even after the stock market had recovered, the state only saw returns of 5.5 percent, significantly lower than the required 7.6 percent. In 2003, New Jersey paid \$163 million in debt service costs for the bonds and these costs will soar to as high as \$508 million annually by 2022. The state will also have to inject \$750 million in contributions to the state pension plan over the next five years. Consequently, the state's costs, including interest, will escalate to \$10.3 billion. The city of Pittsburgh also suffered a fate similar to New Jersey's with its ill-timed pension bond offering in the late 1990s.

- **Trimming Benefits:**

Several strategies crop up under this category.

1. Moving workers hired in the future to 401(k)-style investment accounts away from the current format of a guaranteed pension based on years of service and highest salary. This entails moving future state employees away from the current defined benefit (DB) plan to a defined contribution (DC) plan. California Governor Schwarzenegger advocated this measure during his 2005 state of the state address but has since backed off from pursuing it given the howls of protest. Governor Sanford in South Carolina has also advocated this approach along with Governor Romney in Massachusetts and Speaker DeRochie in Michigan.
2. Linking the annual increases in retirees' pensions to cost-of-living increases (based on the Consumer Price Index) as opposed to an automatic percentage increase. The governors in Illinois and Rhode Island both advocate this approach along with a New Hampshire House Committee.
3. Capping the amount that end-of-career raises would contribute to a teacher's pension. In Illinois, the governor proposed restricting big raises teachers might receive towards the end of their careers, a step, he contends, inflates their pensions and adds to overall retirement debt.
4. Adjusting the age at which employees are paid full benefits. In Illinois, an individual who worked at least eight years for the state can retire with full benefits at age 60; the governor wants to raise the age to 65. He also proposes changing--from 60 to 65--the age at which state employees with 35 years service can retire with full benefits. Similarly, in Rhode Island, the governor sought to limit pensions to only those who are 65 and who have worked at least 10 years, or those aged 65 and up, and who have worked at least 30 years. Texas passed legislation that would require educators to be at least 60 before retiring with full

benefits. Louisiana proposed pushing the age at which teachers can get retirement benefits to 60; currently they can retire at 55 after 25 years or at any age after 30 years.

5. Reducing the percentage of pay a retiree gets for each year of work. According to a Rhode Island proposal, the maximum pension for a retired state worker or teacher would drop from 80 percent of an employee's three-year salary average after 35 years work to 75 percent after 38 years.
6. Eliminating programs like the Deferred Retirement Option Plan, or DROP, which allows state workers with 30 years on the job to continue working up to three years, for instance, while escrowing their retirement benefits at a guaranteed rate of return. A number of states and localities suffered huge financial setbacks recently since they had entered into these DROPs during the 1990s. When the economy nosedived and stock market buckled, these guaranteed rates were significantly more than what the public pension plans were generating in earnings.
7. Ending lucrative retirement plans where certain state employees serve a brief period in select positions and secure a significant boost in pension income. Missouri recently eliminated its administrative law judge retirement system which allowed this practice. A Louisiana lawmaker proposed halting the practice of granting new retirement breaks through special interest legislation. He cited recent bills to boost the retirement pay of nine members of the State Police, a single judge and 500 workers at the Legislature.
8. Placing salary caps on state and local government retirees who return to work in government jobs. New Mexico enacted such legislation.
9. Debating the ability of public sector systems to continue offering lucrative healthcare plans to retirees. In North Carolina and Michigan, currently, any state employee who puts in five years of service becomes eligible to receive free retiree health insurance for life.
10. Prohibiting school districts in Texas from offering early retirement incentives.

- **Increasing Costs:**

Minnesota proposed increased pension contributions by public workers as well as cities and counties. A proposal in Texas required retired teachers to pay more in health care premiums. Kentucky sought to increase the cost of retiree health care benefits too. Louisiana proposed increasing worker contributions to their retirement pay from 7.5 percent of salary to 8 percent. Nevada proposed ending benefit subsidies for future state retirees while both Arkansas and South Carolina, required higher retirement premiums from workers.

- **Consolidating Boards:**

West Virginia teachers will decide by 2006 whether to merge their two retirement systems to create greater efficiencies. Louisiana explored creating a single administrative board to oversee its retirement programs for teachers and state employees while Minnesota sought to merge the troubled Minneapolis teachers' pension fund with the larger, statewide fund. In Vermont, the governor and lawmakers agreed to combine the funds of its three state retirement systems for investment purposes.

- **Guaranteed Returns:**

In a contrarian approach that has hailed it as the first pension fund in the United States to do so, Maine adopted a strategy known as matching, i.e., deliberately aiming for low, but guaranteed, investment income to pay for the retirement benefits of its workers. In 2003,

Maine put a third of its assets into very conservative bonds. The bonds pay a low interest rate, but their values will rise or fall in conjunction with the value of the pensions the state must pay its retirees, regardless of the trajectory of the markets.

- **"Unorthodox Investments":**

The Retirement System of Alabama embarked on a series of unorthodox investments that enabled the fund to progress from \$500 million in assets in 1973 to \$26.6 billion in assets in 2004. Some of these acquisitions include New York City real estate, media outlets (television, newspapers), hotels, a cruise ship terminal, golf courses and most recently, becoming the largest stake holder of US Airways. Similarly, Massachusetts is considering a proposal to open the state's \$36 billion public employee pension fund to all state residents for investment purposes.

Conclusion:

In conclusion, almost every state continues to be plagued by unfunded pension liabilities, yet another force pummeling state finances warily recovering from the recent downturn. While in certain instances, the weakened pension outlook was the result of states skipping their required contributions, the severity of the recent fiscal downturn, demographic changes and the steep rise in healthcare costs are factors too. The implementation of the previously-mentioned GASB ruling could propel unfunded pension liability levels to new heights beginning in December 2006, a trend that could damage state bond ratings. Yet, the "graying" of America, the fact that states will have more retirees living longer in the coming years and the ability of the public sector to attract quality employees in an era of dwindling retirement benefits, requires innovative solutions. Further complicating the public pension outlook is the fact that the financial viability of the other elements of our retirement infrastructure remains shaky too. Ensuring both the short-term and long-term financial viability of the different elements in America's retirement systems, both private and public, remains of paramount importance. In fact, first resuscitating and then sustaining the financial health of our different retirement income flows provides the underpinnings for the foundation of the United States as an economic, political and military powerhouse in the global context.

America's Retirement Architecture: Strains in the System

Thank You

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America's Retirement Architecture: Strains in the System

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The Council of State Governments

Southern Office

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Testimony Before the

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**The Council of
State Governments**

Five Main Parts

1. State Fiscal Trends
 2. Different Elements in our Nation's Retirement Architecture
 3. Public Pension Plans – Current Status
 4. Key Emerging Trends – Public Pension Plans
 5. Strategies Adopted by Different States
-

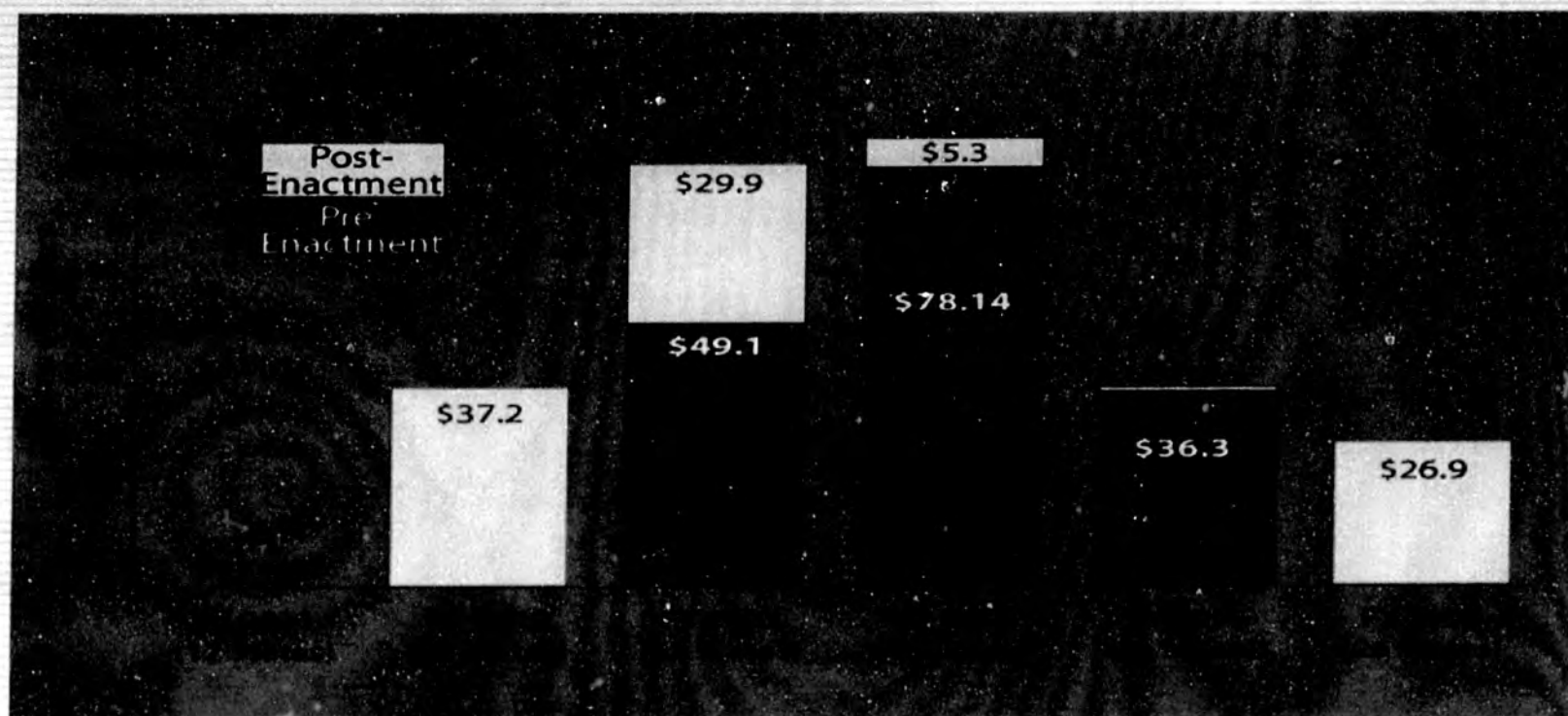


The Council of
State Governments

1. State Fiscal Trends

- ❑ State finances are finally improving: for FY 2005, revenues exceeded estimates in 42 states; met targets in 3 states; and only fell below projections in 5 states.
 - ❑ This is a marked improvement from recent years; in FY 2002, for instance, 42 states reported less revenue than budgeted.
 - ❑ Revenue flows into state general funds in FY 2005 totaled \$521 billion, a growth of 4.7 percent from the prior fiscal year.
 - ❑ For FY 2006, revenue growth is expected to be 5.2 percent
-

1. State Fiscal Trends



- ❑ Since FY 2001, states bridged budget shortfalls that exceeded \$235 billion.
- ❑ This fiscal downturn affected states more deeply and for longer than the 1990/91 recession.



The Council of
State Governments

1. State Fiscal Trends

- ☐ During the downturn, states solved their budget gaps by
 - Slashing Spending
 - Tapping Rainy Day Funds
 - Deploying Tobacco Settlement Monies
 - Raising Taxes and User Fees
 - Hiking Cigarette Taxes
 - Cutting Funds to Local Governments
 - Racking Up Debt
 - Generating Funds via Gaming
-



The Council of
State Governments

1. State Fiscal Trends

- ☐ Even though state revenues have improved, state expenditures have exploded at a faster pace.
 - ☐ In FY 2005, state spending grew by 6.6 percent.
 - ☐ Rising healthcare costs, spurred by Medicaid, continues to plague state finances; 24 states reported Medicaid shortfalls in FY 2005 compared to 20 in FY 2004.
 - ☐ Medicaid is expected to grow by an average of 9 to 10 percent a year in the next decade.
 - ☐ Enrollment increases and rising prescription drug costs continue to play a major role in increased Medicaid spending.
 - ☐ States also face higher expenses in K-12 education, pensions, corrections, transportation and infrastructure.
-

2. Retirement Architecture: Demographics

- ☐ Elderly population in every state will grow faster than the total population (3.5 times faster).
 - ☐ Seniors will outnumber school-age children in 10 states in the next 25 years.
 - ☐ 26 states will double their populations of people older than 65 by 2030.
 - ☐ FL, PA, VT, WY, ND, DE, NW, MT, ME and WV will all have fewer children than elderly.
 - ☐ Ratio of workers to retirees will decline in coming decades.
-

2. Retirement Architecture: Three Legged Stool Concept

- ☐ Social Security
- ☐ Pension Income (Private or Public Sector)
- ☐ Personal Savings

Unfortunately, all these elements
are currently on shaky ground

2. Retirement Architecture: Social Security



-
- ☐ At the end of 2004, 48 million people were receiving Social Security benefits
 - ☐ Costs will increase rapidly between about 2010 and 2030, due to the retirement of the large baby-boom generation.
 - ☐ Annual cost will exceed tax income starting in 2017 -- when the annual gap will be covered with cash from redeeming special obligations of the Treasury -- until these assets are exhausted in 2041
-

2. Retirement Architecture: Private Pensions

- The Pension Benefit Guaranty Corporation (PBGC), the federal organization that protects the pensions of over 45 million corporate workers, could be "on the hook for \$450 billion in corporate pension obligations, up from \$50 billion a mere three years ago."
- In three years, the PBGC has gone from having a \$7 billion surplus to a \$23 billion deficit.
- In April 2005, the PBGC took over all four of United Airlines' employee pension plans, with a shortfall of \$9.8 billion, the latest company to seek federal pension protection and making it the biggest pension failure since the government began insuring pension benefits in 1974.



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2. Retirement Infrastructure: Private Savings





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2. Retirement Infrastructure: Private Savings

Year	Disposable Personal Income (Billions of \$)	Personal Savings	Percent
1973	\$978.3	\$102.7	10.5%
1983	\$2,608.4	\$233.6	9.0%
1993	\$4,911.9	\$284.0	5.8%
2003	\$8,202.9	\$165.6	2.0%



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3. Public Pension Plans – Cash & Investment Holdings (Thousand Dollars)

Category	1993	2000	2001	2003
Cash and Short-Term Investments	\$66,192,708	\$121,141,060	\$117,392,073	\$99,812,039
Government Securities	\$203,452,928	\$271,551,952	\$246,787,978	\$222,534,967
Non-Government Securities	\$571,392,516	\$1,602,291,271	\$1,620,488,011	\$1,659,422,866
Other Investments	\$68,813,123	\$173,657,750	\$172,961,137	\$180,231,896
Total	\$920,571,814	\$2,168,643,033	\$2,157,629,168	\$2,172,001,788

3. Public Pension Plans – Receipts (Thousand Dollars)



Category	1993	2000	2002	2003
Employee Contributions	\$16,137,931	\$24,994,468	\$27,544,022	\$28,843,747
State Government Contributions	\$15,186,886	\$17,546,723	\$17,182,861	\$19,567,749
Local Government Contributions	\$19,804,798	\$22,608,391	\$21,609,170	\$26,644,540
Earnings on Investments	\$74,812,951	\$231,900,075	(\$72,456,581)	\$72,690,968
Total	\$125,942,566	\$297,049,657	(\$6,120,528)	\$147,747,004

3. Public Pension Plans – Payments (Thousand Dollars)

Category	1993	2000	2002	2003
Benefits	\$48,327,862	\$91,274,292	\$110,128,411	122,306,460
Withdrawals	\$2,477,142	\$4,431,876	\$4,079,492	4,891,041
Other Payments	\$1,793,697	\$4,751,715	\$7,772,328	7,647,415
Total	\$52,598,701	\$100,457,883	\$121,980,231	134,844,916



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4. Key Trends – Public Pension Plans

- ☐ Shift to Non-Governmental Securities (corporate stocks, corporate bonds, foreign stocks)
 - ☐ In 1993, public pension plans had only 62 percent of their total cash and investment holdings in Non-Governmental Securities
 - ☐ In 2003, this percentage had ballooned to 77 percent
-

4. Key Trends – Public Pension Plans



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Category	1993	2003
Cash and Short-term Investments	7%	5%
Government Securities	22%	10%
Ø Federal Government	22%	10%
Ø State and Local Governments	0%	0%
Non-governmental Securities	62%	57%
Ø Corporate Bonds	19%	15%
Ø Corporate Stocks	33%	37%
Ø Mortgages	2%	1%
Ø Funds Held in Trust	3%	3%
Ø Foreign Investments	0%	12%
Ø Other Non-governmental	8%	8%
Other Investments	1%	1%
Unallocated Assets	0%	0%
Unallocated Liabilities	0%	0%
Total	100%	100%



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4. Key Trends – Public Pension Plans

- ☐ Payments have clearly surpassed receipts, led by healthcare expenditures
 - ☐ Given the flurry of corporate scandals and the steep drop in asset values, greater activism by boards, controlling authorities and legislatures
 - ☐ Vast majority of the plans are unfunded, i.e., assets less than their accrued liabilities
-



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4. Key Trends – Public Pension Plans

- ☐ Majority of plans have unfunded liabilities
 - ☐ According to Sept. 2004 NASRA report:
 - OK Teachers (\$5.5 billion; 54%)
 - IL Teachers (\$23.8 billion; 49.3%)
 - IL SERS (\$10.1 billion; 42.6%)
 - IN Teachers (\$8.5 billion; 42.1%)
 - WV Teachers (\$5.1 billion; 19.2%)
-

4. Key Trends – Public Pension Plans

- ☐ GASB Statement 45 requires that state and local governments account for and report the annual cost of OPEB (*other post-employment benefits*) –mostly health care - and the outstanding obligations and commitments related to OPEB in the same manner as they do for pensions.
- ☐ Statement 45 is effective in three phases:
 - * Governments with revenue > \$100 Million = December 15, 2006
 - * Governments with revenue between \$10 Million and \$100 Million = December 15, 2007
 - * Governments with revenue < \$10 Million = December 15, 2008

4. Key Trends – Public Pension Plans

- ☐ Unfunded liabilities that will surface as a result of this ruling will eclipse the current pension deficits.
 - ☐ Mercer Consulting estimate that governments that have not set aside money for these obligations could face liabilities 40-60 times the current annual cost of retirees' health care.
 - ☐ CA could have an unfunded OPEB liability of \$36 billion; NC \$13-\$14 billion; LA County School District \$5 billion; NV up to \$4.4 billion.
 - ☐ If governments do nothing, "their credit rating could be damaged and their cost of borrowing could rise."
-



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5. Strategies Adopted: Pension Obligation Bonds

- ☐ Racking up debt to bridge budget shortfalls has been a popular strategy among states recently
 - ☐ According to a May 2005 Moody's report, state net-tax supported debt rose 12 percent in 2004, down from the record 17 percent in 2003, but still well above the 9 percent average experienced since 1989
 - ☐ Total state net-tax supported debt in 2004=\$340.2 billion
 - ☐ Recent bond issues have been very successful (CA, NJ, OR, IL, WI)
-



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5. Strategies Adopted: Pension Obligation Bonds

Pros:

- ☐ Interest rates currently at historic lows
- ☐ Funds raised via bonds relieves immediate pressures on budget
- ☐ Opportunity to reduce/eliminate state's unfunded liability level

Cons:

- ☐ Possibility of investment earnings being lower than interest rate
- ☐ Locked into making debt payments
- ☐ Increases the state's net tax-supported debt level
- ☐ Fiscally dangerous policy of borrowing to meet ongoing expenditures (possible credit rate lowering)

5. Strategies Adopted: Pension Obligation Bonds

- ☐ In 1997, New Jersey borrowed \$2.8 billion to, among other goals, clear its unfunded liability.
- ☐ Investment earnings that exceeded 7.6 percent required to cover interest payments.
- ☐ In June 2000, pension plan was worth \$83 billion; by June 2003, it had plummeted to \$55 billion.
- ☐ NJ's Public Employees Retirement System alone, now, has a projected deficit of \$2.7 billion, almost five times the \$593 million reported a year ago.
- ☐ City of Pittsburgh suffered similar fate too.



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5. Strategies Adopted: Trimming Benefits

- ☐ Moving workers away from DB plans to 401(k)-style, DC plans (CA, SC, MA, MI)
- ☐ Linking annual increases to CPI (IL, RI, NH)
- ☐ Capping amount end-of-career raises adds to pension (IL)
- ☐ Adjusting age at which retirees paid full benefits (IL, RI, TX, LA)
- ☐ Reducing percentage of pay retirees get each year (RI)
- ☐ Eliminating DROPs (LA)
- ☐ Ending practice of employees serving a short period in a position to boost overall pension (MO)
- ☐ Eliminating new retirement breaks through special interest legislation (LA)
- ☐ Placing salary caps on rehired retirees (NM)
- ☐ Debating the ability of plans to offer lucrative health plans to retirees (NC, MI)
- ☐ Prohibiting school districts from offering early retirement incentives (TX)



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5. Strategies Adopted: Other

- ☐ Increasing the costs to workers, counties and cities (MN, TX, KY, NV, AR, SC)
- ☐ Consolidating retirement boards (WV, LA, MN, VT)
- ☐ Matching, i.e., deliberately aiming for low, but guaranteed, investment income from conservative bonds (ME)
- ☐ Unorthodox investments (AL, MA)

Ginny Austerman

From: Sujit CanagaRetna [scanagaretna@csg.org]
Sent: Friday, July 08, 2005 6:48 AM
To: Ginny Austerman
Subject: Statement No. 43 also has applicability



Governmental Accounting Standards Board

Summaries / Status

Summary of Statement No. 43 *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans* (Issued 4/04)

In addition to pensions, many state and local governmental employers provide *other postemployment benefits* (OPEB) as part of the total compensation offered to attract and retain the services of qualified employees. OPEB includes *postemployment healthcare*, as well as other forms of postemployment benefits (for example, life insurance) when provided separately from a pension plan.

What This Statement Does

This Statement establishes uniform financial reporting standards for OPEB plans and supersedes the interim guidance included in Statement No. 26, *Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans*. The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, with modifications to reflect differences between pension plans and OPEB plans.

The standards in this Statement apply for OPEB trust funds included in the financial reports of plan sponsors or employers, as well as for the stand-alone financial reports of OPEB plans or the public employee retirement systems, or other third parties, that administer them. This Statement also provides requirements for reporting of OPEB funds by administrators of multiple-employer OPEB plans, when the fund used to accumulate assets and pay benefits or premiums when due is not a trust fund. A related Statement, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions* (referred to as the related Statement), addresses standards for the measurement, recognition, and display of employers' OPEB expense/expenditures and related liabilities (assets); note disclosures; and, if applicable, required supplementary information (RSI). The measurement and

disclosure requirements of the two Statements are related, and disclosure requirements are coordinated to avoid duplication when an OPEB plan is included as a trust or agency fund in an employer's financial report. In addition, reduced disclosures are acceptable for OPEB trust or agency funds when a stand-alone plan financial report is publicly available and contains all required information.

Summary of Standards

OPEB Plans That Are Administered as Trusts (or Equivalent Arrangements)

Financial Reporting Framework

The financial reporting framework for defined benefit OPEB plans that are administered as trusts or equivalent arrangements includes two financial statements and two multiyear schedules that are required to be presented as RSI immediately following the notes to the financial statements. The financial statements focus on reporting current financial information about plan net assets held in trust for OPEB and financial activities related to the administration of the trust. The *statement of plan net assets* provides information about the fair value and composition of plan assets, plan liabilities, and plan net assets held in trust for OPEB. The *statement of changes in plan net assets* provides information about the year-to-year changes in plan net assets, including *additions* from employer, member, and other contributions and net investment income and *deductions* for benefits and refunds paid, or due and payable, and plan administrative expenses.

Required notes to the financial statements include a brief plan description, a summary of significant accounting policies, and information about contributions and legally required reserves. In addition, OPEB plans are required to disclose information about the current funded status of the plan as of the most recent actuarial valuation date, and actuarial methods and assumptions used in the valuation.

The required schedules (RSI) provide actuarially determined historical trend information from a long-term perspective, for a minimum of three valuations, about (a) the funded status of the plan and the progress being made in accumulating sufficient assets to pay benefits when due and (b) employer contributions to the plan. The *schedule of funding progress* reports the actuarial value of assets, the actuarial accrued liability, and the relationship between the two over time. The *schedule of employer contributions* reports the annual required contributions of the employer(s) (ARC) and the percentage of ARC recognized by the plan as contributions. The required schedules are accompanied by notes regarding factors that significantly affect the identification of trends in the amounts reported.

Measurement (the Parameters)

Plans are required to measure all actuarially determined information included in their financial reports in accordance with certain parameters. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial

methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan's funding requirements meet the parameters, the same methods and assumptions are required for financial reporting by both a plan and its participating employer(s). However, if a plan's method of financing does not meet the parameters (for example, the plan is financed on a pay-as-you-go basis), the parameters apply, nevertheless, for financial reporting purposes.

For financial reporting purposes, an actuarial valuation is required at least biennially for OPEB plans with a total membership (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits) of 200 or more, and at least triennially for plans with a total membership of fewer than 200. The projection of benefits should include all benefits covered by the current *substantive plan* (the plan as understood by the employer and plan members) at the time of each valuation and should take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters require that the selection of actuarial assumptions, including the *healthcare cost trend rate* for postemployment healthcare plans, be guided by applicable actuarial standards.

Alternative Measurement Method

OPEB plans with a total membership of fewer than one hundred have the option to apply a simplified *alternative measurement method* instead of obtaining actuarial valuations. This alternative method includes the same broad measurement steps as an actuarial valuation (projecting future cash outlays for benefits, discounting projected benefits to present value, and allocating the present value of projected benefits to periods using an actuarial cost method). However, it permits simplification of certain assumptions to make the method potentially usable by nonspecialists.

OPEB Plans That Are Not Administered as Trusts or Equivalent Arrangements

Multiple-employer defined benefit OPEB plans that are not administered as trusts or equivalent arrangements should be reported as agency funds. Any assets accumulated in excess of liabilities to pay premiums or benefits, or for investment or administrative expenses, should be offset by liabilities to participating employers. Required notes to the financial statements include a brief plan description, a summary of significant accounting policies, and information about contributions.

Defined Contribution Plans

Defined contribution plans that provide OPEB are required to follow the requirements for financial reporting by fiduciary funds generally, and by component units that are fiduciary in nature, set forth in Statement 34 and the disclosure requirements set forth in paragraph 41 of Statement 25.

Effective Dates and Transition

The requirements of this Statement for OPEB plan reporting are effective *one year prior* to the effective date of the related Statement for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues, as defined in that Statement, in the first fiscal year ending after June 15, 1999—the same criterion used to determine a government's phase for implementation of Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. Plans in which the sole or largest participating employer is a *phase 1 government* (those with total annual revenues of \$100 million or more) are required to implement this Statement in financial statements for periods beginning after December 15, 2005. Plans in which the sole or largest participating employer is a *phase 2 government* (total annual revenues of \$10 million or more but less than \$100 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2006. Plans in which the sole or largest participating employer is a *phase 3 government* (total annual revenues of less than \$10 million) are required to implement this Statement in financial statements for periods beginning after December 15, 2007. If comparative financial statements are presented, restatement of the prior-year financial statements is required. Early implementation of this Statement is encouraged.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraphs 4, 7, and 8 discuss the applicability of this Statement.

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Ginny Austerman

From: Sujit CanagaRetna [scanagaretna@csg.org]
Sent: Friday, July 08, 2005 6:49 AM
To: Ginny Austerman
Subject: Implementation Status of Statement No. 43



Governmental Accounting Standards Board

Summaries / Status

Status of Statement No. 43 *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*

Status

Issued: April 2004

Effective Date:

The requirements of this Statement for OPEB plan reporting are effective *one year prior* to the effective date of the related Statement for the employer (single-employer plan) or for the largest participating employer in the plan (multiple-employer plan). The requirements of the related Statement are effective in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999.

- Plans in which the sole or largest employer is a phase 1 government—with annual revenues of \$100 million or more—are required to implement this Statement in financial statements for periods beginning after December 15, 2005.
- Plans in which the sole or largest employer is a phase 1 government—with total annual revenues of \$10 million or more but less than \$100 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2006.
- Plans in which the sole or largest employer is a phase 1 government—with total annual revenues of less than \$10 million—are required to implement this Statement in financial statements for periods beginning after December 15, 2007.

If comparative financial statements are presented, restatement of prior-period financial statements is required. Early implementation is encouraged.

Affects:

- Will supersede GASBS 25, fn3; GASBS 26; and GASBS 27, fn18
- Will amend NCGAI 6, ¶5; GASBS 14, ¶81; GASBS 25, ¶4, ¶26, ¶42, ¶44, fn5, and fn16; GASBS 27, ¶2; GASBS 31, ¶4; GASBS 34, ¶106–¶109, ¶140, ¶141, fn43, and fn44

Affected by: No other pronouncements

Primary Codification Section Reference: Will be codified in Pe5, Pe6, and Po50

Abbreviations for Accounting Pronouncements

GASBS - GASB Statements	NCAS - NCGA Statements
GASBCS - GASB Concepts	NCGA ¹ - NCGA Interpretations
GASBI - GASB Interpretations	SOP - AICPA Statements of Position
GASBTB - GASB Technical Bulletins	ASLGU - AICPA Audit Guide
BFC - Basis For Conclusions	

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Ginny Austerman

From: Sujit CanagaRetna [scanagaretna@csg.org]

Sent: Friday, July 08, 2005 6:45 AM

To: Ginny Austerman

Subject: Summary of Statement No. 45



Governmental Accounting Standards Board

Summaries / Status

Summary of Statement No. 45

Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions (Issued 6/04)

In addition to pensions, many state and local governmental employers provide *other postemployment benefits* (OPEB) as part of the total compensation offered to attract and retain the services of qualified employees. OPEB includes *postemployment healthcare*, as well as other forms of postemployment benefits (for example, life insurance) when provided separately from a pension plan. This Statement establishes standards for the measurement, recognition, and display of OPEB expense/expenditures and related liabilities (assets), note disclosures, and, if applicable, required supplementary information (RSI) in the financial reports of state and local governmental employers.

The approach followed in this Statement generally is consistent with the approach adopted in Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*, with modifications to reflect differences between pension benefits and OPEB. Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, addresses financial statement and disclosure requirements for reporting by administrators or trustees of OPEB plan assets or by employers or sponsors that include OPEB plan assets as trust or agency funds in their financial reports.

How This Statement Improves Financial Reporting

Postemployment benefits (OPEB as well as pensions) are part of an exchange of salaries and benefits for employee services rendered. Of the total benefits offered by employers to attract and retain qualified employees, some benefits, including salaries and active-employee healthcare, are taken while the employees are in active service, whereas other benefits, including postemployment healthcare and other OPEB, are taken after the employees' services have ended. Nevertheless, both types of benefits constitute compensation for employee services.

From an accrual accounting perspective, the cost of OPEB, like the cost of pension benefits, generally should be associated with the periods in which the exchange occurs, rather than with the periods (often many years later) when benefits are paid or provided.

However, in current practice, most OPEB plans are financed on a pay-as-you-go basis, and financial statements generally do not report the financial effects of OPEB until the promised benefits are paid. As a result, current financial reporting generally fails to:

- Recognize the *cost* of benefits in periods when the related services are received by the employer
- Provide information about the *actuarial accrued liabilities* for promised benefits associated with past services and whether and to what extent those benefits have been funded
- Provide information useful in assessing potential demands on the employer's future cash flows.

This Statement improves the relevance and usefulness of financial reporting by (a) requiring systematic, accrual-basis measurement and recognition of OPEB cost (expense) over a period that approximates employees' years of service and (b) providing information about actuarial accrued liabilities associated with OPEB and whether and to what extent progress is being made in funding the plan.

Summary of Standards

Measurement (the Parameters)

Employers that participate in *single-employer* or *agent multiple-employer defined benefit* OPEB plans (sole and agent employers) are required to measure and disclose an amount for annual OPEB cost on the accrual basis of accounting. Annual OPEB cost is equal to the employer's annual required contribution to the plan (ARC), with certain adjustments if the employer has a net OPEB obligation for past under- or overcontributions.

The ARC is defined as the employer's required contributions for the year, calculated in accordance with certain parameters, and includes (a) the normal cost for the year and (b) a component for amortization of the total unfunded actuarial accrued liabilities (or funding excess) of the plan over a period not to exceed thirty years. The parameters include requirements for the frequency and timing of actuarial valuations as well as for the actuarial methods and assumptions that are acceptable for financial reporting. If the methods and assumptions used in determining a plan's funding requirements meet the parameters, the same methods and assumptions are required for financial reporting by both a plan and its participating employer(s). However, if a plan's method of financing does not meet the parameters (for example, the plan is financed on a pay-as-you-go basis), the parameters nevertheless apply for financial reporting purposes.

For financial reporting purposes, an actuarial valuation is required at least biennially for OPEB plans with a total membership (including

employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retired employees and beneficiaries currently receiving benefits) of 200 or more, or at least triennially for plans with a total membership of fewer than 200. The projection of benefits should include all benefits covered by the current *substantive plan* (the plan as understood by the employer and plan members) at the time of each valuation and should take into consideration the pattern of sharing of benefit costs between the employer and plan members to that point, as well as certain legal or contractual caps on benefits to be provided. The parameters require that the selection of actuarial assumptions, including the *healthcare cost trend rate* for postemployment healthcare plans, be guided by applicable actuarial standards.

Alternative Measurement Method

A sole employer in a plan with fewer than one hundred total plan members (including employees in active service, terminated employees who have accumulated benefits but are not yet receiving them, and retirees and beneficiaries currently receiving benefits) has the option to apply a simplified *alternative measurement method* instead of obtaining actuarial valuations. The option also is available to an agent employer with fewer than one hundred plan members, in circumstances in which the *employer's* use of the alternative measurement method would not conflict with a requirement that the *agent multiple-employer plan* obtain an actuarial valuation for plan reporting purposes. Those circumstances are:

- The plan issues a financial report prepared in conformity with the requirements of Statement 43 but is not required to obtain an actuarial valuation because (a) the plan has fewer than one hundred total plan members (all employers) and is eligible to use the alternative measurement method, or (b) the plan is not administered as a qualifying trust, or equivalent arrangement, for which Statement 43 requires the presentation of actuarial information.
- The plan does not issue a financial report prepared in conformity with the requirements of Statement 43.

This alternative method includes the same broad measurement steps as an actuarial valuation (projecting future cash outlays for benefits, discounting projected benefits to present value, and allocating the present value of benefits to periods using an actuarial cost method). However, it permits simplification of certain assumptions to make the method potentially usable by nonspecialists.

Net OPEB Obligation—Measurement

An employer's net OPEB obligation is defined as the cumulative difference between annual OPEB cost and the employer's contributions to a plan, including the OPEB liability or asset at transition, if any. (Because retroactive application of the measurement requirements of this Statement is not required, for most employers the OPEB liability at the beginning of the transition year will be zero.) An employer with a net OPEB obligation is required to measure annual OPEB cost equal to (a) the ARC,

(b) one year's interest on the net OPEB obligation, and (c) an adjustment to the ARC to offset the effect of actuarial amortization of past under- or overcontributions.

Financial Statement Recognition and Disclosure

Sole and agent employers should recognize OPEB expense in an amount equal to annual OPEB cost in government-wide financial statements and in the financial statements of proprietary funds and fiduciary funds from which OPEB contributions are made. OPEB expenditures should be recognized on a modified accrual basis in governmental fund financial statements. Net OPEB obligations, if any, including amounts associated with under- or overcontributions from governmental funds, should be displayed as liabilities (or assets) in government-wide financial statements. Similarly, net OPEB obligations associated with proprietary or fiduciary funds from which contributions are made should be displayed as liabilities (or assets) in the financial statements of those funds.

Employers are required to disclose descriptive information about each defined benefit OPEB plan in which they participate, including the funding policy followed. In addition, sole and agent employers are required to disclose information about contributions made in comparison to annual OPEB cost, changes in the net OPEB obligation, the funded status of each plan as of the most recent actuarial valuation date, and the nature of the actuarial valuation process and significant methods and assumptions used. Sole and agent employers also are required to present as RSI a schedule of funding progress for the most recent valuation and the two preceding valuations, accompanied by notes regarding factors that significantly affect the identification of trends in the amounts reported.

Cost-Sharing Employers

Employers participating in *cost-sharing multiple-employer* plans that are administered as trusts, or equivalent arrangements, in which (a) employer contributions to the plan are irrevocable, (b) plan assets are dedicated to providing benefits to retirees and their beneficiaries in accordance with the terms of the plan, and (c) plan assets are legally protected from creditors of the employers or plan administrator, should report as cost-sharing employers. Employers participating in multiple-employer plans that do not meet those criteria instead are required to apply the requirements of this Statement that are applicable to agent employers.

Cost-sharing employers are required to recognize OPEB expense/expenditures for their *contractually required contributions* to the plan on the accrual or modified accrual basis, as applicable. Required disclosures include identification of the way that the contractually required contribution rate is determined (for example, by statute or contract or on an actuarially determined basis). Employers participating in a cost-sharing plan are required to present as RSI schedules of funding progress and employer contributions for the plan as a whole if a plan financial report, prepared in accordance with Statement 43, is not issued and made publicly available and the plan is not included in the financial report of a public employee retirement system or another entity.

Other Guidance

Employers that participate in *defined contribution* OPEB plans are required to recognize OPEB expense/expenditures for their required contributions to the plan and a liability for unpaid required contributions on the accrual or modified accrual basis, as applicable.

This Statement also includes guidance for employers that finance OPEB as insured benefits (as defined by this Statement) and for special funding situations.

Effective Dates and Transition

This Statement generally provides for prospective implementation—that is, that employers set the beginning net OPEB obligation at zero as of the beginning of the initial year. Implementation is required in three phases based on a government's total annual revenues in the first fiscal year ending after June 15, 1999. The definitions and cutoff points for that purpose are the same as those in Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*. This Statement is effective for periods beginning after December 15, 2006, for *phase 1 governments* (those with total annual revenues of \$100 million or more); after December 15, 2007, for *phase 2 governments* (those with total annual revenues of \$10 million or more but less than \$100 million); and after December 15, 2008, for *phase 3 governments* (those with total annual revenues of less than \$10 million). Earlier implementation is encouraged.

Unless otherwise specified, pronouncements of the GASB apply to financial reports of all state and local governmental entities, including general purpose governments; public benefit corporations and authorities; public employee retirement systems; and public utilities, hospitals and other healthcare providers, and colleges and universities. Paragraphs 4 and 6 discuss the applicability of this Statement.
