SPECIAL REPORT

TD Economics

February 11, 2014

STATE FINANCES IMPROVE, BUT LONG-TERM CHALLENGES PERSIST

Highlights

- State finances have come a long way since hitting rock bottom during the Great Recession. Helped by improving labor market conditions, rising home prices and corporate profits, tax collections ended fiscal 2013 on a high note, rising by 6.7%. Tax revenues have surpassed their pre-recession high in all but 12 states, and inflation-adjusted revenues are on track to be over the hump in fiscal 2014.
- However, as the TD State Vulnerability Index shows, the progress has been concentrated in the short-term – capturing cyclical economic improvements. Meanwhile, structural fiscal challenges have not eased their grip, with the long-term index posting a slight deterioration.
- While states have been busy plugging budget deficits that emerged during the recession, they have fallen behind on their pension obligations. As a result, pension funding gaps have yet to show any improvement, with the total shortfall between assets and liabilities adding up to a staggering $1 trillion.
- Policymakers have been taking actions aimed at putting pension obligations on a sustainable track. More than 40 states implemented pension reforms in the past several years, with Kentucky and Illinois the most recent additions. However, with many of these reforms affecting only new hires, their impact will not fully materialize for years.

While 2014 calendar year has just begun, the state governments' fiscal year, which for most states starts on July 1, is in full swing. With nearly half of a fiscal year still remaining, now is a good time to pause and look back at what has been accomplished and reflect on remaining challenges. Consequently, we have re-visited and updated the TD State Fiscal Vulnerability Index to shed light on the states' fiscal health from both the near-term (cyclical) and long-term (structural) perspectives (for full methodology description please see our original report).

We found that the near-term index showed the most improvement, with its reading decreasing by 8.6 points from the same period last year (a lower rating in the index corresponds to lower vulnerability score). This outcome is hardly surprising, as it reflects the ongoing cyclical upturn in the broad economy, a falling unemployment rate, rising property values and improving household balance sheets. Meanwhile, the long-term fiscal challenges – captured via unfunded pension liabilities, outstanding debt, and bond ratings – have not shown any signs of abating. In fact, the long-term index deteriorated by 0.3 points. This result is

10 STATES IN THE WORST AND BEST FISCAL SHAPE

MOST VULNERABLE		LEAST VULNERABLE	
STATE	TD INDEX	STATE	TD INDEX
Rhode Island	79.6	Washington	48.5
Connecticut	75.2	Minnesota	48.4
Illinois	74.3	North Carolina	48.3
New Jersey	73.9	Iowa	48.0
Kentucky	72.5	Utah	47.6
Massachusetts	69.6	Wyoming	47.1
Mississippi	68.3	South Dakota	46.1
Alaska	67.7	Texas	45.1
New Mexico	67.5	North Dakota	43.9
Michigan	66.8	Nebraska	43.7
All states average = 58.7			

Source: TD Economics

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10 MOST VULNERABLE STATES IN SHORT-TERM AND LONG-TERM							
SHORT-TERM VULNERABILTY				LONG-TERM VULNERABILITY			
RANK	RANK IN 2012	STATE	TD INDEX	RANK	RANK IN 2012	STATE	TD INDEX
1	1	Nevada	79.6	1	1	Rhode Island	86.8
2	2	Rhode Island	75.2	2	3	Illinois	85.4
3	6	Arizona	74.3	3	2	Kentucky	83.6
4	11	Connecticut	73.9	4	4	Connecticut	82.8
5	5	New Jersey	72.5	5	7	New Jersey	81.4
6	7	Georgia	69.6	6	6	Massachusetts	81.2
7	28	Tennessee	68.3	7	10	New Mexico	81.1
8	10	Delaware	67.7	8	5	Alaska	81.1
9	31	Illinois	67.5	9	9	Mississippi	80.9
10	4	Florida	66.8	10	8	Hawaii	79.0
		All states average	48.9			All states average	65.6

Source: TD Economics

consistent with the notion that structural changes take time. However, it is also worthwhile to note that our estimation does not capture the 2013 rally in the U.S. equity markets, as the latest data on pension assets and liabilities dates back to 2012. Next year, we anticipate to see more progress along the index' long-term dimension.

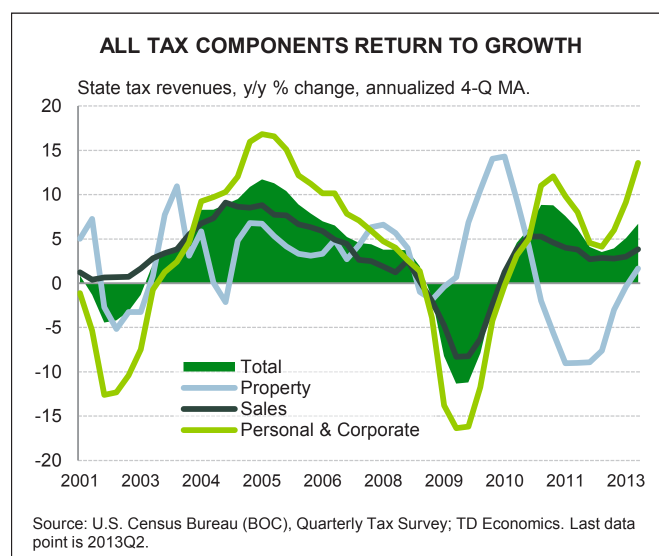
Putting the short- and long-term issues together, the aggregate index revealed little variation in the composition of states at the top and bottom of our ranking relative to a year ago. In this ranking, the desired position is to rank dead last (#50), which marks the lowest vulnerability score. Seven out of ten states retained their unenviable top 10 spots. Similarly, eight out of the ten most fiscally-sound states in the country remained "best in class", meaning they ranked 41 through 50, marking states with the lowest vulnerability score (see Appendix). One reason behind this persistence is the fact that the long-term index (where the change was fairly small) receives higher weight in the combined index than its short-term counterpart. Still, there were some notable changes on the field. In particular, fiscal affairs improved in New Hampshire, Nevada and California, which helped them escape the dreaded top 10 chart, with Massachusetts, New Mexico and Alaska taking their place. On the other end, North Carolina and Washington are now among the ten states with the least financial woes, displacing Tennessee and Wisconsin, whose rankings deteriorated by 8 and 3 positions, respectively. Only a handful of states have worsened along both the short- and the long-run dimensions. These include Illinois, Tennessee and Ohio.

Zooming on TD's Footprint, we find four states – Rhode Island, New Jersey, Connecticut and Massachusetts – among the ten laggard states with the worst finances. Meanwhile, North Carolina was the only state in TD's Footprint to get a best-in-class status.

We expect to see continued improvement in states' near-term finances in 2014 as the economic recovery runs its course, however the rate of change will slow. This is related to temporary factors, such as tax changes for high-income earners, which boosted collections last year, but also to broad normalization of state finances. Helped by strong performance in equity markets and wide-spread pension reforms, long-term liabilities will also ease somewhat, but it will take years to clean up the mess in state pension systems, particularly in regions with unfavorable demographics.

Short-Term Issues

As mentioned earlier, states' near-term fiscal vulnerability index showed the most improvement. Many factors contributed to this, with strong gains in tax revenue collections chief among them. In FY 2013 total tax receipts rose by 6.7%, with all revenue components posting positive annual growth for the first time since the onset of recovery. Growth in personal and corporate income tax receipts, which represent nearly half of all tax revenues, accounted for the bulk of the gain. Personal income tax collections advanced by 14%, while corporate income taxes rose by 9%. Sales taxes, which contribute nearly a third of all tax revenues to state coffers, also moderately increased, rising by 3.8% (see chart). Likewise, property tax collections eked out a



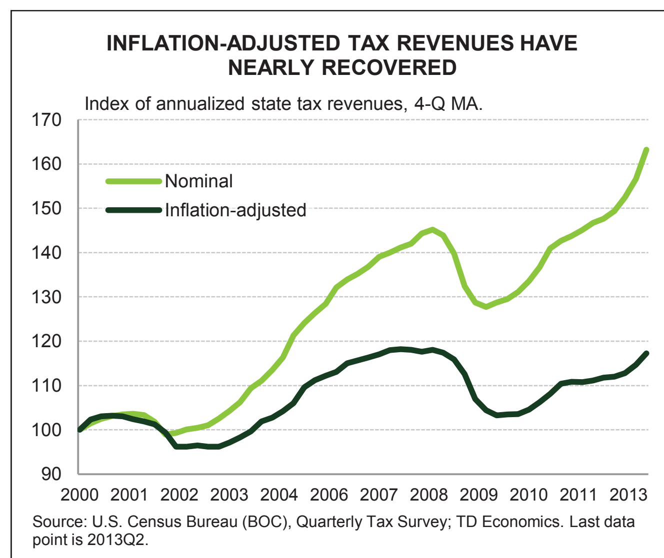
small gain of 1.6%. While it is certainly good news to see property tax revenues turning positive, this does little for state finances because property taxes generate less than 2% of all state revenues.

State finances will continue to improve in FY 2014, however a repeat performance is unlikely. During the last fiscal year, tax collection had exceeded original projections in 37 states (partially as a result of conservative expectations), while so far in fiscal 2014 only 14 states reported that revenues were on track to surpass their forecasts. Hefty gains in personal income tax collections in fiscal 2013 were in part a result of strengthening labor market conditions, but they were also influenced by changes in federal income taxes for high income earners. This event has inflated last year's income tax receipts because the high income taxpayers shifted capital gains into CY 2012. As the temporary impact from this one-time event dissipates, state tax collections are expected to grow more moderately over the next two years, advancing by 4-5% annually and closely tracking growth in nominal U.S. GDP (assuming there are no other significant policy changes).

On top of changes in federal tax policy, there were also some notable tax developments in some states. California, which accounts for roughly one-fifth of aggregate personal income tax revenues, is one such example. Last year voters approved an increase in the personal income tax (PIT) rate for high-income taxpayers. Given that 40-50% of all PIT revenues in California come from 1% of tax filers, there is no doubt that this policy change had a significant impact on tax receipts in the Golden State. PIT revenues surged by 33% last fiscal year, putting California among the leaders in terms of revenue growth. Tax reform also played a key role in California's return to balanced budget after several years of deficits, helping it to leap-frog from 3rd to 15th position in our near-term vulnerability index.

Tax Revenues: the Good, the Bad, and the Broke

Recent robust gains in tax collections have buoyed aggregate state revenues close to their pre-recession level in real, or inflation-adjusted, terms. Based on the four-quarter moving average, combined receipts of the 50 states in Q2 of 2013 were 1% below their peak level of Q3 2007 (due to government shutdown, the latest available data is Q2 2013). As far as the individual states are concerned, their progress to-date has varied. After adjusting for inflation, tax revenues have caught up or exceeded their pre-recession highs in 20 states. In the remaining states, tax revenues have yet to recover to their pre-recession levels, leaving them with less purchasing power than prior to the downturn.



Source: U.S. Census Bureau (BOC), Quarterly Tax Survey; TD Economics. Last data point is 2013Q2.

Among the states where tax revenues have surpassed their pre-recession level, oil-rich North Dakota takes the front seat, with its revenues nearly doubling relative to the pre-recession high. The runner-ups include Illinois, Minnesota, Iowa, Texas and New York, where revenues have exceeded the pre-recession peaks by anywhere between 7% (TX) and 18% (IL). Iowa, Texas, Minnesota retain their position in the near-term index among the 10 most fiscally sound states, and the Empire State's ranking has also improved slightly, but remained close to the middle (see Appendix). Helped by an income tax hike in 2011, Illinois' tax collections enjoyed swift recovery; however, this did not lead to an improvement in its ranking, as factors beyond

INFLATION-ADJUSTED TAX REVENUES
% from pre-recession peak

BOTTOM 10		TOP 10	
Alaska	-51.9%	North Dakota	89.6%
Wyoming	-27.9%	Illinois	18.2%
Florida	-23.2%	Minnesota	13.5%
New Mexico	-21.8%	New York	9.2%
Louisiana	-21.5%	Iowa	7.4%
Georgia	-18.9%	Texas	6.6%
Arizona	-16.2%	Colorado	4.2%
Idaho	-14.3%	Oregon	3.9%
Michigan	-14.2%	Hawaii	3.6%
New Jersey	-14.0%	Vermont	3.2%

Source: TD Economics

revenue growth affect the performance of individual states. In this particular case, the underperforming labor market was the key reason behind the soft reading. As such, Illinois has tumbled from the 31st to the 9th position, as its already high unemployment rate – the third highest in the nation – failed to show any improvement last year.

At the other end of the spectrum are states, such as Alaska, Wyoming, Florida, New Mexico, Louisiana, Arizona, Georgia, and a few others, where inflation-adjusted revenues are yet to catch up. Alaska is the furthest from peak – down 52% – weighed by declining oil and gas revenues, as companies re-locate production to Texas and North Dakota, which are experiencing shale oil and gas booms. Ditto for Wyoming, Louisiana, and New Mexico, which are also heavily dependent on oil and gas royalties.

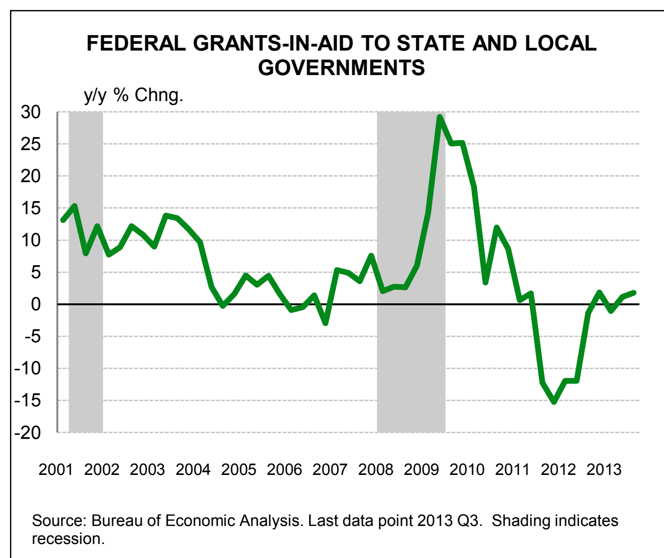
Among states hard-hit by the downturn in the housing market, such as Florida, Georgia, Arizona (along with New Jersey and Michigan), revenue recovery is progressing at a below-average pace and tax collections remain nearly 20% from their pre-recession peaks. This wide revenue gap explains why these states remain close to the top of our near-term term fiscal vulnerability index.

Connecticut, Pennsylvania, and Tennessee were also among the underperformers. In all three states the blame goes to rapidly declining budget balances, which points to the fact that the states are having difficulties balancing their books. This is particularly true for Pennsylvania and Connecticut, where modest revenue growth and mounting long-run liabilities made the task of attaining balanced budgets a challenging one. With no budget surplus and an empty rainy day fund, Pennsylvania operates essentially without a safety net. Moreover, projections by the Independent Fiscal Office suggest the state is facing a long-term structural deficit. In contrast, Tennessee's weaker tax revenue performance is somewhat self-inflicted. In 2012, the state introduced a number of tax cuts, which reduced the annual revenue from those sources by $165 million.

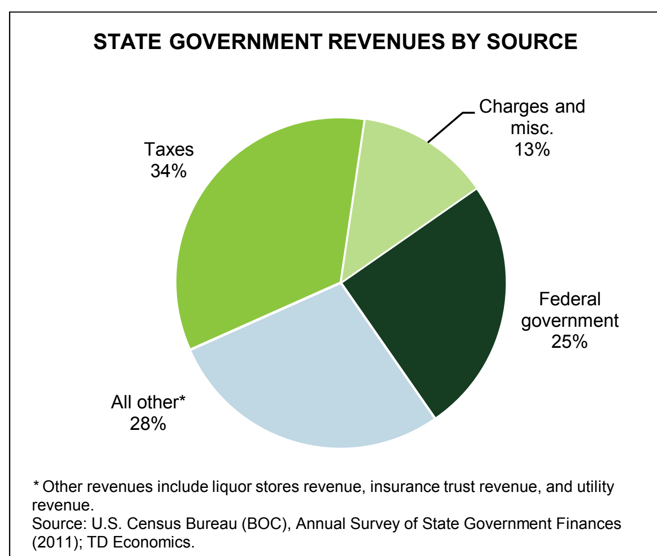
A Balancing Act: Revenues and Expenses

In spite of uneven performances among states, there is no denying that the revenue side of the ledger is broadly showing improvement. As such, governments are facing more pressure to restore program spending or to lower the tax burden. In fiscal 2014, forty-three states enacted higher spending levels relative to last year. Some states are restoring aid to local governments, while others are increasing funding for higher education. Florida, Washington, Massachusetts, and New Hampshire are among the latter group, which has earmarked some of the biggest increases in funding for public universities, with gains ranging from 28.6% in NH to 11% in FL.[1] Overall general fund expenditures are projected to increase by 3.8% in FY2014, slightly slower than 4.3% growth posted a year earlier, due to an anticipated moderation in tax revenue collections. Among states in TD's Footprint, Florida (+8.8%), Massachusetts (+5.4%), New Hampshire (+4.9%) and Virginia (+5%) budgeted the highest increase in discretionary spending, while Connecticut and West Virginia – were the only states projecting a reduction in their spending level.

Offering a counterbalance to the improvement in own-source revenues within states is a steep reduction in federal



Source: Bureau of Economic Analysis. Last data point 2013 Q3. Shading indicates recession.



* Other revenues include liquor stores revenue, insurance trust revenue, and utility revenue.
Source: U.S. Census Bureau (BOC), Annual Survey of State Government Finances (2011); TD Economics.

transfers, as sequester was triggered in 2013 alongside the exhaustion of American Recovery and Reinvestment funds (see chart). As a result, federal outlays to state and local governments in 2013 were 7% below their peak level in 2010.[2] Moreover, with roughly a quarter of all state funds coming from the federal government, ongoing fiscal battles in Washington have made budget planning at the state level difficult over the past few years. Hence, the recently approved federal budget, which sets discretionary spending levels for the next two years, will be a positive step for state finances. In addition to lowering fiscal policy uncertainty, it will moderate sequestration cuts by roughly $66 billion over the next two years.

Long-Term Challenges: A Slow-Moving Train

States' near- and long-term challenges are not independent of one another: a shortfall in tax revenues may lead to under-contribution to pension and health plans, thereby exacerbating long-term issues. Similarly, accumulation of significant long-term obligations can eventually put a strain on state's current finances, making it difficult to attain a balanced budget, contribute to rainy day fund or increase program spending. It is therefore not surprising, that some of the states with the worst near-term financial performance – Rhode Island, Connecticut, New Jersey, and Illinois – also do not fare well in our the long-term index. For these states the near-term challenges are just a symptom of structural long-term problems, such as underfunded pension plans, relatively high levels of debt and debt servicing costs. Tackling these issues often requires reforms, which take a long time to implement and to bear fruit. Therefore,

STATES WITH THE HIGHEST DEBT LEVEL AND SERVICING COSTS

DEBT-TO-GDP RATIO		DEBT SERVICING COST-TO-EXPENDITURES RATIO	
STATE	%	STATE	%
Hawaii	8.3	Hawaii	11.0
Massachusetts	8.2	Connecticut	9.8
Connecticut	7.9	New Jersey	8.7
New Jersey	7.1	Florida	8.3
Mississippi	5.2	Georgia	8.0
Kentucky	5.0	California	8.0
Illinois	4.8	Rhode Island	7.9
Wisconsin	4.8	Massachusetts	7.6
California	4.5	Illinois	7.4
Washington	4.5	Delaware	7.1
All state median	**2.25**	**All state median**	**3.7**

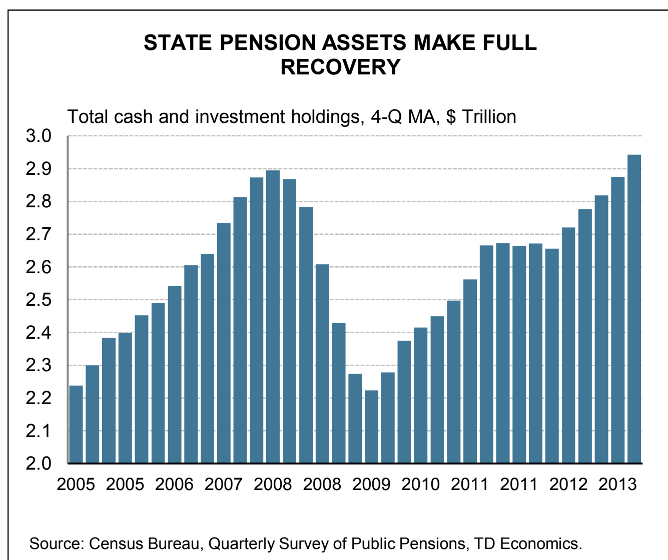
Source: Standard&Poor's

even as the states' current finances have shown marked improvement, the same cannot be said about their long-term obligations. In fact, our long-term vulnerability index has slightly deteriorated by 0.3 points relative to a year ago. The list of ten states whose finances are most vulnerable in the long-run remained unchanged from last year, with the above-mentioned four states having the worst scores. The rest of the "burdened ten" experienced only minor changes in relative ranking: New Jersey and New Mexico deteriorated, moving higher to 5th and 7th places respectively, while Alaska and Hawaii moved lower, taking the 8th and 10th place, respectively. Massachusetts and Mississippi's ranking remained unchanged, as 6th and 9th respectively.

A Trillion Dollar Question

States' long-term liabilities are made of two types of debt: 1) on-balance sheet debt, which reflects bond issuance to fund capital projects, and 2) off-balance sheet debt, such as unfunded retirement liabilities. Both of these obligations continued to mount both during the recession and the subsequent recovery. On balance-sheet debt – which in 2011 amounted to approximately $1.1 trillion – grew briskly during the downturn as the federal government ramped up its fiscal stimulus program to support the ailing economy.[i] In 2009 and 2010, ARRA encouraged states to take on more debt through Build America Bonds, on which the federal government agreed to pick up 35% of the interest costs. Since then, bond issuance has slowed as fiscal restraint set in. Overall, state debt burdens remain moderate, with median tax-supported debt amounting to 2.3% of aggregate state GDP.

However, debt-to-GDP ratios vary greatly across states, from 8.3% in Hawaii to 0.03% in Nebraska. Unlike sovereign debt, U.S. state debt is issued primarily for capital projects, and not to finance government operations.[ii] Therefore, this debt in itself does not necessarily constitute a negative development if it is directed toward productive uses that support long-term economic growth, such as public infrastructure development. Still, a high level of debt may begin to weigh on state finances, particularly if debt servicing costs are significant and begin to crowd out other program spending. For the three states with the highest debt-to-GDP ratios – Hawaii, Massachusetts, and Connecticut – debt servicing costs as a share of total expenses range from 7.6% (MA) to 11% (HI) (see table).



Source: Census Bureau, Quarterly Survey of Public Pensions, TD Economics.

STATE PENSION FUNDING: RATIO OF PENSION ASSETS TO LIABILITIES			
WORST FUNDED		**BEST FUNDED**	
STATE	**RATIO**	**STATE**	**RATIO**
Illinois	47.2%	Wisconsin	102.1%
Connecticut	48.6%	North Carolina	95.1%
Kentucky	50.5%	New York	93.2%
Alaska	53.4%	South Dakota	92.8%
New Hampshire	54.8%	Tennessee	88.8%
New Jersey	55.5%	Washington	88.8%
Pennsylvania	56.9%	Oregon	88.7%
Mississippi	56.9%	Florida	85.8%
Hawaii	57.4%	Idaho	85.3%
Kansas	58.7%	Delaware	84.7%
All states average = 71.5%			

Source: TD Economics

Mind the Gap

As for off-balance sheet debt, while states have been busy plugging budgetary shortfalls that emerged during the recession, they have fallen behind on their pension obligations. Large investment losses during the financial crisis and a deterioration in active-members-to-beneficiaries ratios have led to a rapid increase in states' required annual pension contributions. These additional obligations were often not met by the cash-strapped state governments. In Pennsylvania, annual required contributions to state employees' retirement system rose from $319 million in 2005 to $1,044 million in 2012, and the state was contributing less than half of the required amount for the past five years. At the same time, the ratio of active workers (those that make contributions) to retirees continued to gravitate lower. In 2012, the ratio of active members to retirees enrolled in the Pennsylvania state defined benefits plans stood at 1.2 – the third lowest in the country, after Alaska and Michigan (see table). Many other states were caught in the same vicious cycle. Consequently, funding gaps in state retirement programs grew wider, notwithstanding the full recovery in the value of their assets (see chart). The asset-to-liability ratio fell from 75% in 2011 to 71% in 2012 (the most recent data), with the total shortfall adding up to a staggering $1 trillion.

Several states in TD's Footprint are facing mounting pension liabilities as a result of demographic pressures, systematic under-contribution, and/or low revenue growth. Chief among them is Connecticut. It has the most underfunded pension system, with assets equal to only half of the liabilities – a shortfall equivalent to 190% of state's annual revenues. The state of affairs is not much better in New Hampshire, New Jersey, Pennsylvania, South Carolina and Rhode Island, where pension programs are approximately 55-60% funded (see table). In addition to managing pensions of state employees, some states – Illinois, Connecticut, New Jersey, Kentucky, Hawaii, Maryland, and Louisiana – are also on the hook to provide pension benefits for local government employees, such as teachers, which often far outnumber the state worker headcount. As of 2012, only four states in the country had fully or near-fully funded pension systems – South Dakota (93%), New York (93%), North Carolina (95%) and Wisconsin (102%). For comparison, back in 2000 more than half the states were 100 percent funded. Rating agencies generally consider pension funds with an 80% ratio as sound.[iii] Additional states, where funding levels meet this threshold are Georgia, Florida, Delaware, Idaho, Oregon, Tennessee and Washington.

STATE DEFINED BENEFIT PLANS WITH THE LOWEST RATIO OF ACTIVE MEMBERS TO RETIREES	
STATE	**RATIO**
Alaska	0.92
Michigan	0.97
Pennsylvania	1.21
Rhode Island	1.23
Maine	1.31
Louisiana	1.33
Connecticut	1.35
West Virginia	1.35
Oregon	1.40
New Jersey	1.43
50-states average	**1.7**

Source: Census Bureau, Annual Survey of Public Pensions (2012); TD Economics

Medicaid Expansion: Food for Thought

The Affordable Care Act mandated expansion of Medicaid to include childless adults with incomes up to 138% of federal poverty line also represents a major policy change for states. Medicaid is the single biggest expense item for state budgets, accounting for an estimated 24.5% of state total spending.[3] Similar to other safety net programs, Medicaid enrollment is countercyclical, with program participation rising during economic downturns and falling off thereafter. Between 2007 and 2012, an additional 11.5 million people have enrolled into Medicaid, with enrollment expanding by 7.8% in 2009 at the peak of the recession. As economic conditions improved, growth has gradually decelerated to 2.5% in 2012; however we expect that enrollment will pick up again over the next two years due to the ACA rollout. The Congressional Budget Office (CBO) projects that approximately 8 and 11 million will join Medicaid in 2014 and 2015, respectively.

Federal and state governments share the cost of running the program according to a formula, which provides a higher subsidy to states with lower per capital incomes relative to the national average, and vice versa. On average across all states the federal matching rate is 64%, ranging from 55.8% in New Jersey to 80.4% in Mississippi.[4] Currently, twenty-five states and the District of Columbia chose to expand their Medicaid coverage. For these states, the federal government will reimburse 100% of the cost for newly eligible adults until 2016, after which federal support will gradually decline to 90% by 2020, where it will remain thereafter. While it is clear that the expanding states will see a rise in Medicaid enrollment, the non-expanding states are also likely to see an increase in their Medicaid headcount, as people who were previously eligible but uninsured sign up for benefits as a result of awareness campaigns and simplified eligibility screening. For these enrollees non-expanding states will receive standard federal matching rate, and will have to cover the rest of the cost out of their coffers. Moreover, while being free to opt-out of Medicaid expansion, the states cannot opt out of taxes that were levied to help finance the program, effectively subsidizing states that are expanding their Medicaid coverage.

At this point it is hard to assess the full implications of Medicaid expansion on state long-term finances. The CBO has estimated that additional costs represent a 2.8% increase in what states would have otherwise spent on Medicaid between 2014 and 2022. This estimate does not take into account potential savings, such as a reduction in uncompensated care and other services provided to the uninsured, as well as reduction in emergency visits due to better preventative care. To sum up, the fiscal success of Medicaid expansion lingers on the ability of state and federal governments to contain health care inflation and realize potential savings elsewhere in the system.

10 STATES WITH THE HIGHEST FEDERAL SHARE OF MEDICAID SPENDING

STATE	FEDERAL SHARE	MEDICAID ENROLLMENT	EXPANDING MEDICAID?
	% of Medicaid spending	% of population	yes/no
Mississippi	80.4%	26.0%	No
West Virginia	78.6%	22.0%	Yes
Arkansas	76.9%	25.0%	Yes
New Mexico	76.9%	28.0%	Yes
Utah	76.6%	13.0%	Considering
Kentucky	76.5%	21.0%	Yes
Louisiana	75.2%	27.0%	No
South Carolina	74.9%	20.0%	No
Idaho	74.7%	15.0%	No
Montana	74.4%	13.0%	No
All states average	**63.7%**	**21%**	

Source: Henry J. Kaiser Family Foundation, State Health Facts; TD Economics

When discussing states long-term liabilities it is hard to ignore another elephant in the room – retiree health care obligations. While timely data on these obligations is difficult to come by, if previous years are of any indication, the problem of underfunding is even more acute now. As of fiscal year 2010, on average, assets represented only 5% of their total liabilities, leaving a $627 billion funding hole. Although retiree health care funding levels are much worse than pension funding levels, states do not seem to be alarmed. This is because health benefits have significantly less legal protection than pensions. Nevertheless, given the rising health care costs and ageing demographics, the burden of health care obligations will continue to escalate. Just like in the case of state pensions, eventually the states will need to address the funding gaps by either increasing employee contributions or, perhaps more likely, reducing benefits.

The Wind of Change

On the surface, this may give an impression that little has changed when it comes to state pensions. But, nothing is further from the truth. With varying degrees of success, more than 40 states implemented pension reforms aimed at reducing pension burdens over the past several years. However, most of these reforms have been applied to new hires, and thus will not substantially reduce outstanding pension liabilities for years. Nonetheless, it is a step in the right direction, as it will lower the rate at which future liabilities accumulate and reduce employer costs.

There are, however, some exceptions. Rhode Island – which had significant and growing pension funding gap – was able to pass a sweeping tax reform, which trimmed the pension benefits of current as well as new employees. The state increased the retirement age to 67 for all employees, froze the cost of living adjustment, and moved employees to a new hybrid pension plan. Although Rhode Island remains in the unenviable first place spot within our long-term vulnerability index, its ranking is poised to improve next year.

Kentucky and Illinois, with some of the worst-funded pension plans in the nation, also made efforts to put their pensions on a sustainable path. Illinois, which has the lowest credit rating of any state, passed comprehensive pension reform in December 2013. Assuming that the reform, which trimmed benefits for current and prospective employees, survives a challenge in court, it will immediately reduce Illinois' mammoth $100-billion unfunded pension liability by 20%. Reform is Kentucky was less drastic. Beginning 2014, all state and local employees would be on a defined contribution rather than defined benefit plan. The law also imposes fiscal discipline on the state, requiring it to make its annual pension contribution in full and identifies additional revenue sources for doing so. Progress has been mixed in other states with wide pension gaps, such as Connecticut, New Jersey and Pennsylvania. Connecticut and New Jersey made changes to their pension systems; however only time will tell whether they have gone far enough. Meanwhile, decision-makers in Pennsylvania are yet to face the truth about their runaway pension liabilities. In the absence of significant actions the trio will continue to experience budgetary pressures, with long-term liabilities consuming an increasing portion of their budgets.

Another reason for the lack of improvement in this year's long-term index is the fact that it uses 2012 data on pension assets and liabilities, which does not reflect rapid stock market growth in 2013. Back of the envelope calculations suggest that in the absence of other changes, incorporating this data would raise the average pension funded ratio from 71.5% to 74%. Consequently, the number of states whose pension systems are at least 80% funded would increase from 11 to 15 – something we should see next year.

Bottom Line

State finances have come a long way since hitting rock bottom during the Great Recession. Helped by improving labor market outcomes, rising home prices and corporate profits, nominal tax revenues have rebounded, surpassing their pre-recession high in all but 12 states. Inflation-adjusted tax collections are also finally expected to be over the hump this fiscal year. While this is an important milestone, it, nonetheless, means that in real terms most state governments have only as much resources as they did 5-6 years ago, despite bigger populations and still-elevated needs for many public services. Fortunately, state and local governments are learning to do more with less, by operating more efficiently. State and local government payrolls are 650k smaller than they were in 2008 and the number of public servants per capita is the lowest since 1989.

While the recession certainly did its damage, for most heavily indebted states, public pension troubles were long time in the making. Hence, there will be no quick and easy way out of it. Significant pension reforms are starting to take place as this realization sinks in. Many of them will affect only future employees and thus the immediate impact will be small, but it is a step in the right direction. For a handful of others, which made more drastic changes to their pension plans, the reduction in their long-term obligations is expected to materialize in our long-term index as soon as next year.

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Appendix

TD Economics
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TD Vulnerability Scorecards (as of January, 2014)

Overall Vulnerability Scorecard (From Worst to Best)

Rank	Rank in 2012	State	Today	Change Y/Y
1	1	Rhode Island	79.6	-6.2
2	4	Connecticut	75.2	0.1
3	5	Illinois	74.3	1.3
4	2	New Jersey	73.9	-4.4
5	3	Kentucky	72.5	-3.3
6	13	Massachusetts	69.6	0.0
7	8	Mississippi	68.3	-4.1
8	21	Alaska	67.7	2.2
9	12	New Mexico	67.5	-2.9
10	7	Michigan	66.8	-5.9
11	6	Nevada	66.3	-6.4
12	15	Arizona	66.0	-2.4
13	16	Pennsylvania	65.7	-2.7
14	9	New Hampshire	64.4	-7.8
15	17	Hawaii	63.6	-4.4
16	24	Ohio	63.6	1.6
17	20	Maine	63.5	-2.2
18	11	South Carolina	63.4	-7.0
19	18	West Virginia	62.9	-4.9
20	10	California	62.6	-8.5
21	14	Alabama	61.3	-7.3
22	22	Indiana	60.9	-3.8
23	25	Maryland	60.6	-1.4
24	19	Montana	59.7	-7.5
25	28	Louisiana	58.7	-2.4
26	26	Vermont	58.4	-3.4
27	23	Colorado	58.2	-6.1
28	33	Virginia	56.4	-1.5
29	29	Georgia	56.3	-3.7
30	30	Missouri	56.3	-3.2
31	32	Oklahoma	56.2	-1.9
32	35	Idaho	56.0	-0.4
33	39	Delaware	55.5	1.1
34	27	Florida	55.3	-5.8
35	31	Arkansas	54.1	-4.1
36	34	New York	54.0	-3.3
37	36	Kansas	53.7	-2.4
38	46	Tennessee	51.9	2.8
39	42	Wisconsin	49.7	-2.9
40	40	Oregon	49.0	-4.6
41	38	Washington	48.5	-6.0
42	44	Minnesota	48.4	-3.1
43	37	North Carolina	48.3	-6.8
44	45	Iowa	48.0	-2.5
45	43	Utah	47.6	-4.2
46	41	Wyoming	47.1	-5.9
47	47	South Dakota	46.1	-2.9
48	48	Texas	45.1	-3.4
49	49	North Dakota	43.9	-4.2
50	50	Nebraska	43.7	-1.5
		Average	58.7	-3.4

Source: TD Economics

Near-Term Vulnerability Scorecard (From Worst to Best)

Rank	Rank in 2012	State	Today	Change Y/Y
1	1	Nevada	71.9	-14.2
2	2	Rhode Island	68.6	-13.1
3	6	Arizona	66.9	-5.5
4	11	Connecticut	63.6	-1.1
5	5	New Jersey	62.7	-13.1
6	7	Georgia	62.1	-9.2
7	28	Tennessee	59.5	3.1
8	10	Delaware	58.5	-7.3
9	31	Illinois	57.8	1.3
10	4	Florida	56.1	-18.6
11	8	Michigan	56.0	-10.9
12	12	Kentucky	56.0	-6.5
13	17	Pennsylvania	55.5	-7.5
14	18	Indiana	55.3	-8.1
15	3	California	54.7	-23.3
16	25	Maryland	54.4	-3.6
17	9	North Carolina	52.2	-14.7
18	36	Massachusetts	52.1	-1.5
19	23	Maine	52.0	-7.1
20	16	Alabama	51.9	-8.1
21	22	Idaho	51.6	-4.2
22	38	Ohio	50.8	0.1
23	30	Virginia	50.5	-5.4
24	15	Mississippi	49.4	-12.4
25	21	New York	49.4	-9.9
26	34	Wisconsin	47.7	-5.4
27	48	Alaska	47.6	6.1
28	24	New Mexico	47.1	-9.7
29	14	Colorado	46.2	-14.8
30	27	Missouri	46.1	-9.3
31	19	South Carolina	44.6	-14.9
32	35	Arkansas	44.6	-9.0
33	37	Montana	44.2	-7.4
34	13	New Hampshire	43.9	-19.3
35	32	Louisiana	43.7	-6.3
36	33	West Virginia	43.4	-11.1
37	41	Oklahoma	42.1	-5.7
38	29	Wyoming	41.8	-12.3
39	20	Washington	41.1	-16.5
40	39	Hawaii	40.6	-9.5
41	26	Oregon	40.0	-15.8
42	42	Vermont	39.8	-8.0
43	47	Kansas	37.7	-4.9
44	45	Iowa	37.5	-7.1
45	46	Texas	37.1	-4.9
46	44	Minnesota	36.5	-9.6
47	49	Nebraska	35.8	-4.4
48	40	South Dakota	35.4	-13.4
49	43	Utah	33.3	-12.7
50	50	North Dakota	26.0	-4.1
		Average	48.9	-8.6

Source: TD Economics

Long-Term Vulnerability Scorecard (From Worst to Best)

Rank	Rank in 2012	State	Today	Change Y/Y
1	1	Rhode Island	86.8	-1.7
2	3	Illinois	85.4	1.3
3	2	Kentucky	83.6	-1.1
4	4	Connecticut	82.8	0.9
5	7	New Jersey	81.4	1.3
6	6	Massachusetts	81.2	1.0
7	10	New Mexico	81.1	1.7
8	5	Alaska	81.1	-0.5
9	9	Mississippi	80.9	1.5
10	8	Hawaii	79.0	-0.9
11	11	New Hampshire	78.2	-0.0
12	14	West Virginia	76.1	-0.5
13	12	South Carolina	75.8	-2.0
14	15	Michigan	73.9	-2.6
15	17	Pennsylvania	72.4	0.6
16	20	Ohio	72.2	2.6
17	19	Maine	71.1	1.1
18	18	Vermont	70.9	-0.2
19	13	Montana	70.1	-7.4
20	21	Louisiana	68.8	0.3
21	22	California	68.0	1.4
22	16	Alabama	67.5	-6.7
23	23	Colorado	66.2	-0.3
24	27	Oklahoma	65.6	0.6
25	24	Arizona	65.4	-0.3
26	25	Indiana	64.8	-0.9
27	28	Maryland	64.6	0.0
28	26	Kansas	64.4	-0.8
29	30	Missouri	63.1	0.9
30	29	Nevada	62.7	-1.1
31	31	Arkansas	60.4	-0.8
32	33	Virginia	60.3	1.1
33	34	Idaho	59.0	2.2
34	36	Utah	57.2	1.4
35	35	New York	56.9	1.0
36	37	Minnesota	56.4	1.3
37	32	North Dakota	55.6	-4.6
38	38	Iowa	55.0	0.6
39	45	Oregon	54.9	2.9
40	43	Florida	54.8	2.6
41	49	Delaware	53.6	6.9
42	41	Washington	53.5	1.0
43	46	South Dakota	53.2	4.1
44	40	Georgia	52.4	-0.1
45	42	Wisconsin	51.2	-1.2
46	44	Wyoming	50.6	-1.4
47	39	Texas	50.5	-2.3
48	47	Nebraska	49.0	0.5
49	50	Tennessee	46.9	2.6
50	48	North Carolina	45.8	-1.5
		Average	65.6	0.3

Source: TD Economics

Endnotes

i. Here we use Census Bureau definition of state debt which is more inclusive that the one used by the rating agencies. Rating agencies mostly report only the tax-supported debt.

ii. State revenues were hard-hit during the recession, which caused occasional departure from this general rule. For example, Illinois issued a total of $7.2 billion of debt in fiscal 2011 and 2012 to fund state's pension payments. Connecticut issued nearly $1 billion of deficit bonds for FY 2009 budgetary relief, extending the re-payment deadline by two years in its 2014-2015 budget. New Jersey and Kentucky have also refunded and restructured several debt issues to close budgetary gaps in the past few years.

iii. S&P defines pension funds which are 80% to 90% funded as "above-average". Fitch generally considers a funded ratio of 70% or above as adequate.

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