



Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

Pensions: Climbing Out

State Treasurer Ken Miller is finalizing his recommendations to correct Oklahoma's huge unfunded pension liability and expects to make them public within the coming days.

Miller, chairman of the Pension Oversight Commission, said he will first meet with Governor Mary Fallin and then with the commission at a special meeting.

"The severity of Oklahoma's pension crisis is well established. Most policymakers recognize the seriousness of the problem and the need for action," Miller said. "The solutions will not be complex, but they will be politically challenging."

Miller said no one expects the state to reverse overnight a problem that has been decades in the making.

"Our citizens, public employees, pensioners and ratings agencies all expect state officials to chart a course to solvency and long-term stability," he said.

Miller said his recommendations will likely include a two-step approach to reforming the systems.

"Step one is to correct the immediate problem," he said. "Step two is to develop a cost-effective pension system designed to meet the demands

of a modern workforce and a leaner government."

Miller said step-one reforms would stop unfunded mandates and restore fiscal health to the pension systems:

- Eliminate all unfunded mandates on state pension systems
- Establish a minimum age for retirement eligibility for all new, non-public safety employees
- Dedicate future surplus revenues and one-time funds to the fiscal restoration of the state's pension systems

Step-two reforms would center around designing a cost-effective pension system that would:

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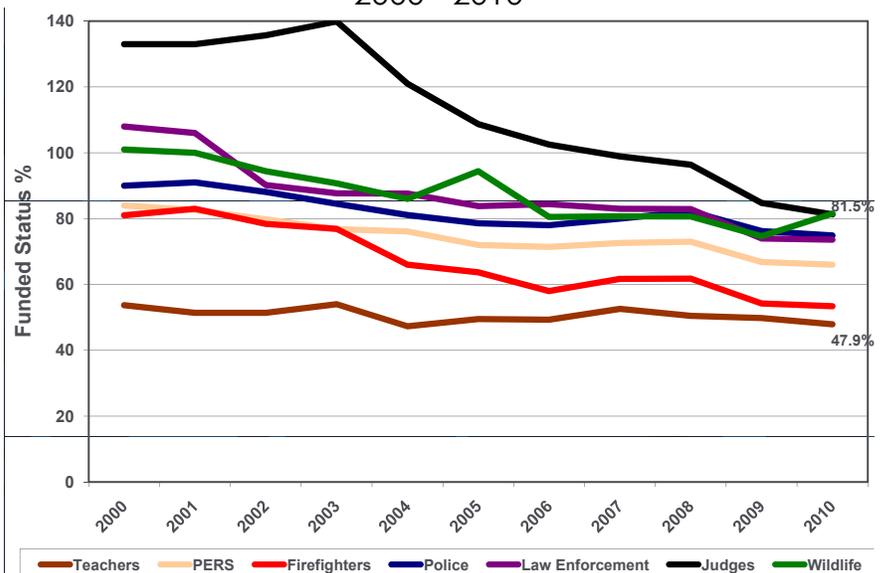
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Funded Status of Oklahoma's Public Pensions 2000 - 2010



Sources: 1999 and earlier: R.V. Kuhns & Associates,
2000 and later: Buck Consultants, Milliman Consultants and Actuaries, and Gabriel, Roeder, Smith & Company
2010: Buck Consultants, Cavanaugh Macdonald Consulting, and Gabriel, Roeder, Smith & Company



Treasurer's Commentary By Ken Miller, Ph.D.

No more (inefficient) spending

The new normal throughout the public sector is that receipts do not cover expenditures. Governments face increased demand for safety net services, inflationary pressures in health care, dilapidating transportation infrastructure, expensive prison populations and mounting public pension problems among others.

Solutions to these problems may depend on one's political perspective. While some argue revenues need to be increased, others say the answers lie on the opposite side of the equation with calls for "no more spending." Lacking constitutional constraints, federal policymakers have responded by entertaining tax increases, accumulating mountains of debt and passing the baton of austerity to future generations.

In contrast, voters have consistently strengthened

Oklahoma's constitution to mandate balanced budgets, allow only 95% of general revenues to be appropriated, cap annual spending increases, and require a 15% emergency fund. But even with these safeguards, many are rightfully frustrated with government spending.

How does this happen in a representative democracy where elected leaders' jobs are dependent on pleasing the electorate? Research shows voters are against government spending generally, but more supportive of it specifically. In other words, people have a negative view of spending in the aggregate, but positively view individual items like education, public safety, transportation infrastructure and health care, which comprise more than 80 percent of state budgets.

This should tell policymakers that better prioritization and fiscal discipline are required so nonessential programs do not siphon funds from core areas critical to our state's success. Simplistic incremental budgeting tactics, whereby funding levels are based on the prior year and then matched to available revenue, need to be stopped.

Across-the-board budget approaches that contain minor tweaks meant to show prioritization must be replaced with long-term strategic plans built around core responsibilities, priorities and outcomes.

Taxpayer resources must be concentrated into necessary state-provided goods and services and eliminated from those items which may be nice, but are not proper functions of the state nor responsibilities of the public treasury. Government should do what it must to the best of its ability and eliminate the rest.

Rather than funding well the core responsibilities on which the majority of our citizens depend, our state has used limited resources to fund a top-heavy education bureaucracy, duplicative social services, numerous nonprofits, municipal museums, cultural centers and theatres, overpaid government lawyers, community organizers and ineffective business incentives.

"Government should do what it must to the best of its ability and eliminate the rest."

In trying to be all things to all special interests, we have insufficiently funded our classrooms, roads, bridges and law

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Pensions

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- Offer choice, flexibility and portability to future workers
- Provide uniformity among existing systems.

Unfunded Mandates

Miller said the centerpiece of the plan to address the immediate problem would be to eliminate unfunded cost-of-living adjustments, or COLAs.

“This annual increase is the single biggest strain to the system and has led to the pension hole the state has dug itself into,” he said. “Ending this practice would effectively set down the shovel.”

Miller said banning unfunded COLAs alone would immediately raise the funded status of the state’s seven pension systems. This change would allow the state’s second largest plan, the Public Employees Retirement System (OPERS), to reach 100 percent funded status in 17 years.

The largest and most indebted of the plans, the Teachers’ Retirement System (OTRS), cannot estimate a time it would be able to meet obligations if unfunded COLAs were to continue. With the unfunded COLA ban, the system can become fully funded within 35 years.

OTRS has unique elements that have contributed to its status as the worst-funded plan. Of the state systems that allow employees to convert unused sick leave for additional service credit, the teachers’ plan is the only one that awards this benefit without requiring employer funding. This practice drains approximately \$25 million each year from the pension’s balance.

“As with COLAs, our state cannot continue to grant pension benefits without funding them,” Miller said.

Another strain on the systems is caused by members returning to work after retiring. This practice, commonly referred to as “double-dipping,” lengthens the years that benefits are paid out of the system due to the financial incentive of drawing full retirement benefits in addition to a salary.

“...good stewardship requires addressing debts first.”

Many members in OTRS retire as soon as eligible then immediately re-enter the classroom. Approximately one-third of all teachers who retired in 2008 were re-employed with a school the following calendar year.

Minimum Retirement Age

Adopting a minimum age for retirement eligibility would reduce system outlays and provide better predictability of cost. Currently, some members can retire as young as 50 with the right combination of age and years of service. With life expectancies climbing, a retiree could feasibly collect benefits for a third of their life. For new, non-public safety hires, the state should establish a minimum retirement age; one that reflects a healthier workforce with more productive years.

Commit Excess Funds to Debt Reduction

Some surplus revenues, such as cash reserves and those in excess of the rainy day fund cap, could be dedicated to the

state’s pension systems until all plans reach a minimum 80 percent funded status, the level at which systems are considered actuarially sound.

“While budget writers will be pressured to return to pre-recessionary spending levels, good stewardship requires addressing debts first,” Miller said.

He said the state could also dedicate a portion of profits from the sale of non-essential state assets to help pay down our pension debt.

Consideration of Future Plan Design

Miller said that once public pension plans are on a path to solvency, policymakers should re-evaluate the pension structure to see if current defined-benefit plans are in the best interest of tomorrow’s retirees and taxpayers.

“With an increasingly mobile workforce and an overtaxed state budget, policymakers should consider the merits of a defined contribution or hybrid model that would offer choice, flexibility and portability to new hires,” he said.

Step two of the reform process should seek additional uniformity in contribution rates, benefits and investment return assumptions among the defined benefit plans currently in place, Miller continued.

At risk are increased borrowing costs for the state, which will result in less availability of funds for critical services, and potential damage to the state’s credibility.

“Failure to enact reforms will not just affect public workers; the repercussions of the state’s unfunded debt will be felt by businesses and taxpayers alike,” he said.



Gross Receipts & General Revenue

A comparison of the Treasurer's April 4 Revenue Report and State Finance's April 11 General Revenue (GR) Fund report reveals key differences.

Analysis shows the data subset contained in the GR report has value for state budget writers, but has relatively little value as an economic indicator compared to gross receipts.

The OST Revenue Report is more appropriate for analytical purposes because the GR Report excludes more than half of the state's economic activity.

March gross receipts totaled \$923.26 million, while GR received \$438.5 million — a difference of \$484.76 million or 52.5 percent.

This is due to the transfer of funds for rebates, remittances and dedicated funding.

In March, the GR Fund received:

- 38.08 percent of personal income tax
- 69.12 percent of corporate income tax
- 44.66 percent of sales tax receipts
- 52.55 percent of gross production tax on natural gas
- 77.44 percent of gross production tax on crude oil
- 33.96 percent of Motor Vehicle tax collections.

The Unsinkable Oklahoma Economy

Oklahoma's economy can be knocked down, battered and beaten, but it can't be broken. After weathering the deepest economic downturn since the Great Depression, the clouds have begun to clear over the state's business climate and the forecast is for brighter days.

"Like its people, Oklahoma's economy is tough and resilient," said State Treasurer Ken Miller.

On April 4, the treasurer's office issued an analysis of the state's economic performance based upon gross receipts to the state treasury. The OST report is state government's broadest measure of the Oklahoma economy.

Outlook Mostly Positive

The March revenue report from the treasurer's office shows measured improvement across virtually all sectors of our economy.

Treasurer Miller said the outlook is positive but not guaranteed.

"Our analysis of all major sources of revenue deposited into the Treasury through March confirms Oklahoma's economy is expanding at a relatively good pace, which should lead to continued job growth provided external shocks do not intercede," he said.

Expanding on his "external shock" comment, Miller said major disruptions in the Middle East and Japan are potential concerns for the local economy.

"We are seeing some effect of these events today," he said. "Certainly the rise in crude oil prices can be attributed to international events."

"Like its people, Oklahoma's economy is tough and resilient."

Miller explained that higher energy prices are generally positive for Oklahoma, but can have a negative impact on family budgets and spending as disposable income is redirected.

"It's a double-edged sword," Miller said.

"March collections of gross production taxes were 4.3 percent above March of last year and 43.6 percent higher than February receipts," he continued.

"That means Oklahoma's energy industry, mainly crude oil extraction, is doing well. More people are gaining employment and fueling the economic engine.

"On the other hand, family budgets are being stretched as the impact of higher gasoline prices filters down into food and other goods."

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Unsinkable

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Miller said his office will be keeping a close eye on revenues in the coming months to see how the sharp rise in fuel prices affects producers and consumers.

The impact on producers could be seen in production costs and corporate profits. For consumers, the impact would be observed through sales tax receipts.

“If we see input prices go up and consumer purchases go down, that would indicate higher fuel prices are impacting the recovery,” Miller said.

March Collections Show Growth

The four primary revenue streams showed growth from March 2010.

In addition to the growth in Gross Production collections, tax collections from income, sales and motor vehicles

showed improvement.

Net income taxes, a combination of personal and corporate income taxes, were \$347.46 million in March, a \$31.31 million or 9.9 percent increase from the prior year.

However, personal income tax collections were 4.4 percent below the prior year. Corporate collections, however, increased by 77.9 percent.

Sales tax, often viewed as a measure of consumer confidence, generated \$289.23 million, which is \$20.33 million or 7.6 percent more than the prior year.

Motor vehicle taxes generated \$64.62 million, an increase of \$5.31 million or 8.9 percent from last March.

12-Month Collections Show Recovery

The 12-month running total of state collections closely tracks changes in

U.S. Gross Domestic Product over the same time span.

Utilizing a rolling 12-month tally of gross receipts shows the last peak in Oklahoma’s economy occurred in the 12-months that ended in December 2008, when collections totaled \$11.283 billion.

The bottom was reached in January 2010 when 12-month collections totaled \$9.364 billion, reflecting a \$1.919 billion or 17 percent drop.

Since then, however, 12-month collections have improved by \$534 million or 5.7 percent for a total of \$9.898 billion.

“Our data show Oklahoma’s economy continues to mend, but full recovery from the Great Recession lies many months away,” Miller said.

Spending

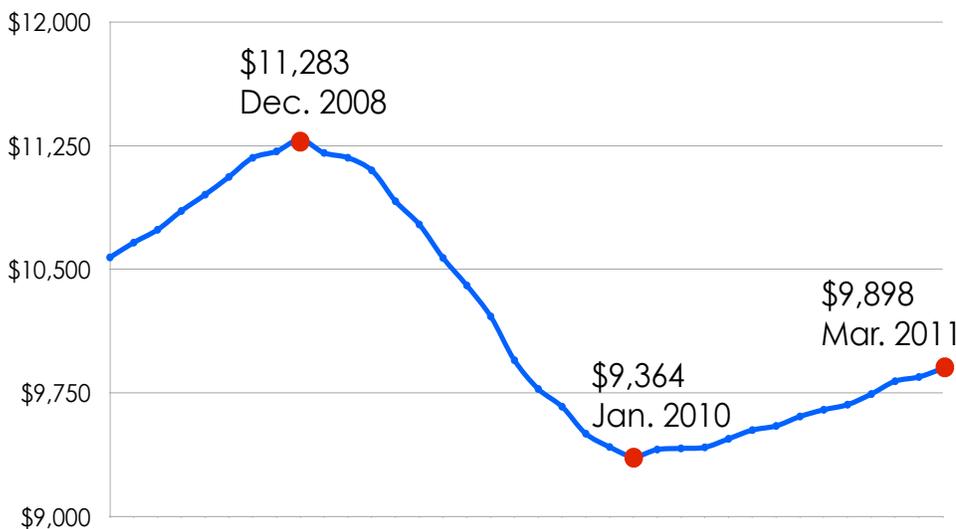
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enforcement while allowing state assets to deteriorate. Certainly, all government spending is not equal. Some public spending facilitates the private sector and too much detracts from it.

To lay the foundation for economic growth and prosperity, Oklahoma policymakers must budget with reason, not emotion, protectionism or politics. They should drive resources toward items with the highest return on investment. Yes, governments must spend, but they are duty bound to do so wisely and efficiently. Perhaps the call should be for, “No more *inefficient* spending,” instead.

12-Month Gross Receipts (in millions)

April 2008 - March 2011



Source: Office of the State Treasurer



Economic News Briefs

U.S. Economy

Estimates for first quarter GDP growth are being revised downward because exports and consumer spending will be weaker than had been anticipated. Estimates that had been in the 3-3 ½% range are now a percentage point lower. This is another reminder that this cyclical expansion is significantly less robust than past cycles. That should be keeping inflation at bay, but until food and gasoline prices stop rising, not many consumers will be convinced that inflation is not trending higher.

The effective corporate tax rate in the U.S. is 22.5%, second highest among major nations. Japan is first at 33.6%. France, U.K. and Germany are in the 20% to 21.5% range, Canada at 16.8% and Taiwan at 16%. Sweden has a low rate of 13.5%. A recent study found that a high tax rate has “a large adverse impact” on investment and entrepreneurial activity.

Goldman Sachs issued a report late last week saying it was time to cash in some of the winning bets on crude oil, copper, cotton and platinum. That, plus a smaller than expected increase in the core CPI prompted the futures market to drop the probability of a Fed rate hike in late January to below 50% from 70% a week ago.

The Fed

Minutes from the FOMC, the main policy board of the Fed, suggested that there was an extended discussion of the merits of the QE2 asset purchases, but that only a few members thought that

it might become “appropriate to reduce the pace or overall size of the purchase program.” Most members apparently do not favor changes to the program before its completion. There were, however, no members suggesting the program might need to be extended, as there were in previous minutes. It seems very clear, therefore, that QE2 will end on schedule in June.

The other extended discussion was regarding inflation. While some members were worried that higher energy and food prices were pushing inflation expectations higher, most expected the effects of higher commodity prices on inflation “would prove transitory.”

Inflation fears appear to be replacing default fears as the primary reason why individuals are avoiding bond funds. If Fed Chairman Bernanke is correct when he describes the recent energy-food price increases as transitory, those inflation fears should also diminish in the months ahead.

Perhaps the strongest support for the argument that the Fed need not hurry to change policy comes from the relatively slow growth in the money supply. The M2 version is up a moderate 4% from a year ago, at the lower end of the 3% to 10% range that has prevailed over the past 15 years. Thus far, the massive creation of bank reserves has not produced a surge in the money supply, probably because credit growth has been so weak.

Reprinted from Baird Fixed Income Commentary, April 10 & 18, 2011

Wake up call!

Just as the rating agencies have threatened to downgrade state bond ratings for failing to act on unfunded pension liability, the federal government has also been put on notice.

On Monday, April 18, Standard & Poors affirmed its AAA long-term and A1+ short-term ratings for US government debt, but revised its outlook on the long-term rating to negative from stable.

In announcing its change, S&P stated, “...more than two years after the beginning of the recent crisis, U.S. policymakers have not agreed on a strategy to reverse recent fiscal deterioration or address longer-term fiscal pressures.”

This is only the second time rating agencies have warned the federal government about the ratings. In 1996, Moody's placed some U.S. debt on review for possible downgrade.

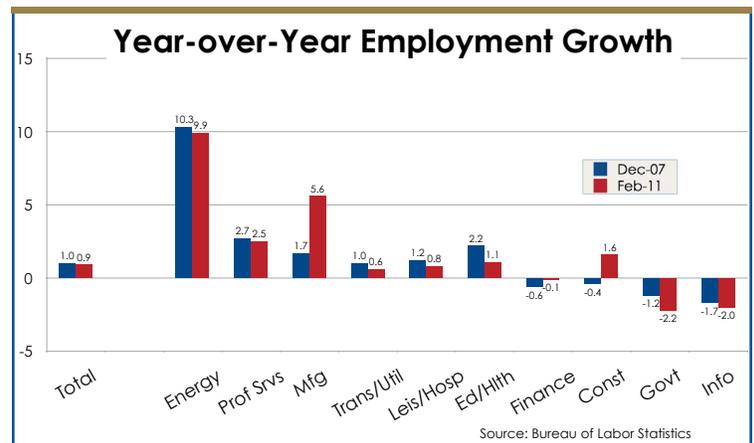
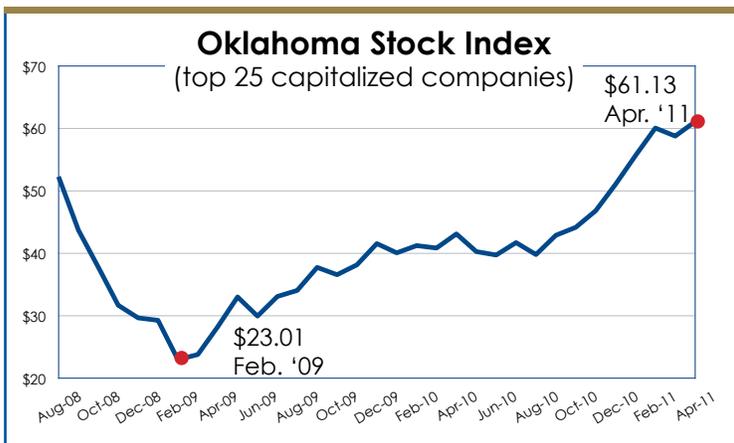
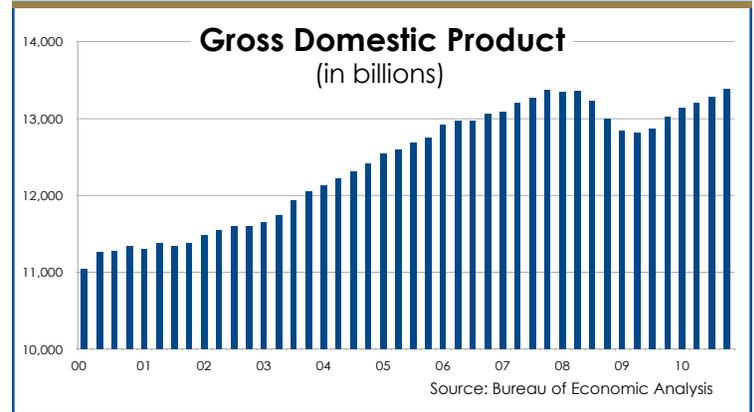
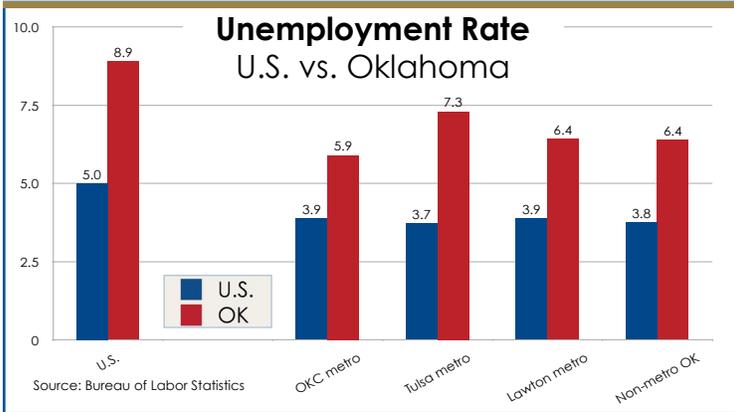
The immediate impact of S&P's announcement was a drop in the equity and bond markets. Market watchers will be keeping a close eye on the intermediate- and longer-term effects.

The real question is whether Washington DC policymakers will finally pay attention and whether they'll break through the partisanship by taking appropriate action to prevent this catastrophic event.

Even a small revision might harm America's ability to borrow to finance its deficit.



Economic Indicators



Interest Rate Forecast

	2Q 2011	3Q 2011	4Q 2011	1Q 2012	2Q 2012
58 Economists					
Fed Funds Target	0.25%	0.25%	0.25%	0.50%	1.00%
3-M LIBOR	0.36%	0.44%	0.55%	0.75%	1.15%
Treasury Notes					
2-Year	0.84%	1.00%	1.20%	1.46%	1.86%
10-Year	3.60%	3.72%	3.90%	4.08%	4.20%
Treasury Bonds					
30-Year	4.65%	4.78%	4.91%	5.00%	5.10%
Economic Indicators					
	2011		2012		
Real GDP	3.1%		3.05%		
Unemployment	8.8%		8.3%		

Source: Median forecasts for key economic indicators as surveyed by Bloomberg April 4 - 11

