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Weighing the Market's Effect on Vermont Pension Funds and Tax Revenues

by Steve Zind

In the past two days the stock market has rebounded from its dramatic decline earlier in the week, but the roller coaster ride may not be over. The ups and downs have many people looking anxiously at their retirement accounts, and the state is also watching market's machinations. Vermont has \$3.9 billion invested in the pension funds for teachers, state workers and municipal employees. More than 40 percent of that money is in the equity market, which has been in so much turmoil this week. The pension funds are the source of current or future retirement benefits for 48,000 Vermonters.

"Their benefits are safe," says State Treasurer Beth Pearce.

Market fluctuations don't change the defined benefits received by those enrolled in the pension plans, but they can change how much the state must contribute to the funds each year. If the pension investments don't perform well, it can mean increased state contributions. Pearce says periods when the funds' earnings are strong help buffer state contributions during leaner times.

"We do something called 'asset smoothing' so that we don't take advantage of all the gains in one year and are able to use those in a subsequent budget year," she says.

Pearce says it's premature to think about the impact of this year's overall stock market decline on the state's contribution to the pension funds. The Vermont Pension Investment Committee oversees the pension funds and monitors the performance of the investment managers hired to manage the funds. The volatility of the market was a topic of discussion at a committee meeting this week, but Pearce says no short-term action is anticipated.

"If this was a sustained process, we would likely make some small tweaks, but we're very comfortable we're in a good position to manage our investment portfolio with the volatility," says Pearce.

She says the state's pension fund investments are diversified and managed for long term gains.

"Over the long haul our expected assumed rate of return is about 7.95 percent," Pearce says.

Underfunding of the pension plans has been an issue in the past, but Pearce says the state is on track to fully fund the three plans over a period of years. Market changes can also have an impact on state tax revenues. A significant portion comes from capital gains, which includes taxes on non-retirement investment income.

In a year like this one when, so far, the stock market is down from the previous year, it might seem that lower investment earnings would translate into less state income tax revenue.

"State revenues tend to do better when the market's performing well, but it's not always the case," says economist Jeffrey Carr, who has served as a revenue forecasting consultant for successive administrations.

Carr, who is president of Economic and Policy Resources in Williston, says the tendency for revenues to follow the market has plenty of qualifiers and it's hard to predict the market's impact from year to year.

“So many other events that affect people’s tax liabilities, some of which have nothing to do with their holdings in the stock market,” says Carr.

Revenue sources like taxes on higher wages can offset losses in capital gains, and even when it comes to stock holdings, factors other than market performance come into play. In 2013 investors, anticipating a capital gains tax increase, began moving their money around. Carr says the sales of those assets resulted in record capital gains tax payments to the state, even though nothing unusual happened on the stock market. That might be happening now if people are reacting to the uncertain market by selling stocks that have increased in value in recent years.

One of Carr’s jobs is producing economic forecasts for the administration. He says he’s watching what’s going on in the market this week, but the forecasts only come out twice a year. If he had to produce them more frequently it would be harder to take the longer view and gauge whether the impact of this week’s events are lasting or fleeting.