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Connecticut, America's Richest State, Has a Huge Pension Problem.

The state with the richest population may not have enough money in its own pockets.

Connecticut has roughly half of what it needs to pay future retirement benefits for its workers, meaning the home to scores of hedge funds and some of the country's wealthiest towns is wrestling with financial distress rivaling that of Kentucky or Illinois.

Some investors concerned about the size of Connecticut's pension hole are backing away from bonds issued by the Constitution State or demanding bigger rewards to hold them. Investors in some Connecticut state bonds now get a premium of about half a percentage point above benchmark bonds from other states, up from 0.28 percentage point a year ago, according to Thomson Reuters Municipal Market Data. Only four other U.S. states are now priced as riskier bets.

Still, some in the state say Connecticut's affluence is making it difficult to overcome complacency about fiscal problems. Yields on the state's debt would be even higher and budget problems would be worse if not for a deep pool of wealthy in-state investors willing to gobble up Connecticut's tax-deductible debt, according to analysts.

"There's almost limitless money to buy Connecticut bonds," said Matt Fabian of research firm Municipal Market Analytics. Investors "are getting less of a risk premium than I think you deserve because of the high demand created by the wealth of the taxpayers in the state," added Paul Mansour, head of municipal research at Hartford, Conn.-based Conning.

Connecticut's surprising pension predicament shows how even the wealthiest parts of the U.S. are struggling to keep pace with ballooning retirement obligations that now amount to $1 trillion nationally.

Connecticut's unfunded pension liabilities more than doubled over the past decade to $26 billion as the state's retirement system reeled from inadequate state contributions, a subpar investment record and longer lifespans for its retirees.

The state, boosted by wealth concentrated in towns such as Greenwich and New Canaan, has a per capita income of $64,864, the highest in the U.S., according to a Fitch Ratings analysis of Bureau of Economic Analysis data. But the state still finished the fiscal year ended June 30 in the red as tax revenues fell below expectations, and has projected annual deficits of $650 million or more after its current two-year budget cycle ends, according to a report by the state's Office of Fiscal Analysis.

The state's pension problems represent "a ticking time bomb," said State Sen. L. Scott Frantz, a Republican whose district includes the wealthiest section of the state. He is worried residents will leave and Connecticut will "end up as another Detroit," a city that filed for bankruptcy protection in 2013, absent more dramatic changes.

Some Connecticut officials and union leaders said they are unfazed by the pension problems and pledge to reverse the deficit in the coming decades. Their strategy hinges partly on predictions the various state retirement systems will be able to earn 8% or more annually, a goal that is more optimistic than most public pensions across the U.S. The average target for all state plans is 7.68%, according to the National Association of State Retirement Administrators.

"The truth of the matter is that the state of Connecticut can afford to make up the difference over time," said Dan Livingston, a Hartford-based labor attorney who has negotiated on behalf of the state's public workers for decades.

Connecticut's pension gap developed as a result of decisions made over decades to scrimp on payments when the economy sputtered and to cut taxes, according to state leaders and public-finance experts. And there is a quirk: Connecticut officials contributed almost no money to the state's various public pensions from the late 1930s until the early 1980s, meaning little had been saved up because the state had chosen not to prefund the retirement system for future payouts.

The smaller base of assets hurt Connecticut during the 1990s when a run up in the stock market pushed most pensions around the U.S. to fully funded status—meaning they had more assets than liabilities, according to Gregory Mennis, director of Pew Charitable Trusts' public-sector retirement-systems project. Connecticut's ratio of assets to liabilities, meanwhile, was just 72% in 2001, according to Pew, which tracks pension-fund finances.

Furthermore, according to the Center for Retirement Research at Boston College, Connecticut's annual investing returns have trailed the national average by a full percentage point since 2000, because of a heavy allocation to stocks that inflicted deep losses first during the dot-com bust and then the 2008 financial crisis. Connecticut pensions eventually shifted some bets to nontraditional investments, like hedge funds, but those produced lower returns as the equity markets rallied in recent years.

Connecticut only has 51.9% of the assets it needs to pay future obligations to workers, lower than all states except for Illinois and Kentucky, according to the National Association of State Retirement Administrators.

Connecticut has scaled back pension benefits in recent years, reducing cost-of-living adjustments for retirees and pledging to make the appropriate annual payments to fully fund the system by 2032. State officials have raised taxes twice since 2011 as a way of covering some liabilities, reduced its workforce by more than 3% and held back on deeper spending on education and local aid.

Connecticut now allocates 10% of its budget to paying down unfunded pension obligations, up from about 7% four years ago, according to Connecticut Office of Policy and Management Secretary Ben Barnes, who oversees the budget.

"We have plenty of resources to address whatever shortfalls, or whatever fiscal crisis might develop in the short run," Mr. Barnes said.

But there are signs that the pressure on Connecticut could intensify absent deeper changes. Standard & Poor's Ratings Services lowered the outlook on Connecticut's bonds in March to negative from stable, meaning they could be downgraded from their current double-A rating. Moody's Investors Service already has placed Connecticut among the lowest-rated states. And Fitch Ratings, although it removed Connecticut's negative outlook in July, warned the state has a "narrow margin of flexibility."

States rarely default and generally carry higher ratings as a result. Moody's, which changed the way it calculates pension costs two years ago, has been more aggressive at downgrading states and cities with sizable unfunded obligations, while S&P and Fitch have generally taken a more optimistic view.

Fredrena deGraffenreaidt, a 61-year-old state retiree from East Hartford, is worried about whether future benefit cuts would force her to sell her house and move to a cheaper state, she said.

"Everyone sees us as this very wealthy state and yet our pension isn't 100% funded," Ms. deGraffenreaidt said. "How is that possible?"

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