Bond Case Briefs

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Aging Baby Boomers: Implications For Munis.

By 2035, the elderly will outnumber young people for the first time in American history.i Or so say new projections released by the U.S. Census Bureau. This graying of the U.S. population is largely attributable to the aging baby boomer generation, which is retiring in ever-increasing numbers. The number of people over the age of 65 is growing by about 3% per year-four times faster than overall population growth.ii This developing demographic shift will likely have profound and far-reaching impacts on state pensions, healthcare, education, and more, and consequently on the municipal bond market as well.

State Pension Budget Pinch

As baby boomers retire, state budgets are likely to feel a significant financial pinch when it comes to pension obligations. It is simple math: with a shrinking proportion of working-age adults-to-retirees, there may simply not be enough revenue to support the generous pensions that many states' defined benefit plans have promised, the unfunded liabilities of which already stood at some $574 billion as of 2011.iii This will probably necessitate a reduction in services, an increase in taxes, pension reforms, or some combination of the three. States could look to address some of these issues by offloading funding obligations to local governments. This, in turn, could prove to be a major problem for municipalities, which, on average, depend on state governments for a third of their revenue.iv As state governments grapple with unfunded pension liabilities, local governments may need to raise property taxes to generate additional revenue as they are forced to shoulder an increasingly high share of the cost of delivering essential services to residents.

Looming Healthcare Gaps

Much has been made of the looming funding gaps facing Social Security and Medicare, and rightfully so, as demographic trends point to an eye-popping $100 trillion shortfall in funding for these federal programs over the coming decades.v However, there is another ticking time bomb that may prove far more relevant to state and local governments as the population ages, and has received far less attention: Medicaid, which helps pay for the healthcare of low-income citizens and their children, the disabled, and the elderly. As of 2014, Medicaid spending for those over 65 accounted for around 20% of all Medicaid costs, and this figure will probably grow in the coming years.

Thanks to Medicaid's status as a joint federal/state program, states' shares of the spending can range from 17% to a statutory maximum of 50%. However, while Social Security and Medicare are funded out of trust funds, state funding for Medicaid are drawn from the states' general revenues. It already accounts for roughly 17% of state general budget expenditures, on average, and are already the second-highest spending category.vi

Education Squeeze

Although Medicaid spending today is already a large line item, it is dwarfed by state spending on education. The 50 states devote an average of 35% of their respective budgets to education, making it the largest single category of expenditures in state budgets.vii Some states, such as Utah, where one in five residents is a student, spend upwards of 50%, while others, such as Illinois, with its unfunded pension obligations, spend significantly less than the average (in Illinois' case, just 25%).viii

What happens to education funding when state budgets are squeezed by ballooning Medicaid costs and unfunded pension obligations on a historic scale? After all, the two expenditures have already been chewing up the highest proportion of state budgets since the 1960s.ix States could be forced to cut education spending. Indeed, this is already happening. State funding for higher education and state revenue sharing has been in decline since 2008.x

These cuts to state education spending could also further exacerbate inequality in poor school districts that cannot rely on high property taxes to raise the funds necessary to cover a shortfall. Already, in 23 states, state and local governments are spending less in poorer school districts than they are in more affluent ones.xi In some states, the discrepancy in spending between the poorest and richest districts can reach as high as 33%.

Opportunities in ETFs

Individual investors in municipal bonds have long basked in the relative "security" of the overall credit quality and reliability of the income stream. But some of the underlying tremors identified here suggest that, without forgoing the opportunity for tax-free income, the allocation of investible resources in a municipal fund, such as an ETF, may offer added protection. Simply, a portfolio of 10 different bonds cannot provide the same level of security as an ETF with 1,000 different bonds. The challenges discussed are most certainly significant to the baby boom generation, as they are to the entirety of those investing in tax-free income, but ETFs can offer investors a way to access potential opportunities.

Post Disclosure

i NPR. "Projections Show an Aging U.S. Population." Mar. 14, 2018

ii Fuchita, Yasuyuki, et al. Growing Old: Paying for Retirement and Institutional Money Management after the Financial Crisis. Brookings Institution Press, Nomura Institute of Capital Markets Research, 2011.

iii Ibid.

iv Kiewiet, D. Roderick, and Mathew D. McCubbins. "State and Local Government Finance: The New Fiscal Ice Age." Annual Review of Political Science, vol. 17, no. 1, May 11, 2014, doi:10.1146/annurev-polisci-100711-135250.

v Ibid.

vi Ibid.

vii US Census Bureau. "State Government Finances Summary Table." 2016 Annual Survey of State Government Finances Tables, United States Census, Feb. 2, 2018.

viii Ibid.

ix The Wall Street Journal. "Why Are States So Strapped for Cash? There Are Two Big Reasons." Mar. 29, 2018.

x Ibid.

xi The Washington Post. “In 23 states, richer school districts get more local funding than poorer districts.” Mar. 12, 2015.

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