

T H E T E X P E R S



PENSION OBSERVER

THE OFFICIAL PUBLICATION OF THE TEXAS ASSOCIATION OF PUBLIC EMPLOYEE RETIREMENT SYSTEMS

Spring 2003

Tax Free 529 College Savings Plan

By Nancy Enomoto

College costs have been rising at a rate of between 5% and 12% annually. According to LIMRA, the estimated average total cost for a four-year college education is \$52,000 for a public college or in-state university and \$112,000 for a private college or university. By 2019, the total cost for four years of college could range from \$95,000 for a public university to \$240,000 for a private university assuming college costs increase 5% per year over the next 18 years.

As we look to the future so that our children and grandchildren may be afforded the benefits of a college education, one of the avenues you may want to consider is a 529 college savings plan. A 529 college savings plan is a state-sponsored college savings option that offers families tax advantages, flexibility and control that many other college savings alternatives do not.

Some of the benefits are:

- Federally tax-free withdrawals for qualified distributions — Earnings grow tax-deferred. Any funds

The Stock Market In a Period of Uncertainty

By Austin, Calvert & Flavin, Inc.

After three successive years of declines in the stock markets, there was hope that the first months of 2003 would bring a strong economy, an increase in corporate earnings, and a significant improvement in the market for equities. Instead, during the first quarter of this year the economy has experienced anemic growth, there has been a significant loss of jobs, corporate earnings have been below expectations, and most segments of the equity market declined.

The Economy: War And Disease Although the economy probably did not slip into recession during the first quarter, there has been a noticeable slowing of growth. Personal consumption expenditures, by far the largest component in the gross national product, held up reasonably well early in the quarter, but showed some weakness in February and March. There was a significant decline in spending on large durable goods such as autos. Several reasons are given for the slowing in consumer spending. First, the impact on spending from the massive amount of mortgage refinancing is beginning to diminish. Second, the consumer was influenced by severe weather in parts of the country. Third, concern about the reality and the consequences of military conflict in Iraq has caused the consumer to delay spending. There is considerable debate as to whether the consumer, after the military conflict ends, will have both the ability and the desire to spend. There is very little evidence of pent-up consumer demand at this time.

The economy has been hit by what one analyst has called a “strike in capital spending” by the business sector. It is possible that business investment spending will increase once uncertainty about Iraq diminishes and there is a clearer picture concerning immediate geo-political realities. It is clear, however that many firms (especially in telecommunications) will not increase capital spending until there is a change in the regulatory environment and an increase in demand. Despite record-low interest rates, there will

withdrawn for qualified higher education expenses (typically tuition, fees, room and board, supplies and equipment) will be free of federal income taxes at least through 2010.

- As the account owner, you stay in control of the account at all times.

- If the child doesn't go to college or doesn't use the 529 plan, the owner may be able to roll any unused funds to another beneficiary or simply leave the account intact and designate a new beneficiary. The owner can even change his mind and reclaim the money, providing he pays federal income taxes plus an additional 10% federal tax penalty on earnings.

- There are no income or age restrictions, and anyone of legal age can open an account and contribute.

- 529 plans allow individuals to make contributions up to \$55,000 (\$110,000 for married couples) per beneficiary in one year without having to pay federal gift tax, provided no further gifts are given in the next five-year period. Contributions may reduce the contributor's federal taxable estate.

- Contributions are considered a gift and may be removed from your taxable estate. You can make contributions until the total value for that beneficiary equals \$177,000.

- Proceeds can be used at most qualified institutions. This includes two- and four-year colleges and universities, graduate schools, many trade and technical schools, and some schools abroad.

Two good websites are:

www.fafsa.ed.gov and
www.savingforcollege.com.

not be a major increase in capital spending until there is an increase in demand for output. The problem may be excess industrial capacity and not the uncertainty caused by the war in Iraq. Government spending at the federal level has been a major source of strength for the economy. Although federal spending has increased, especially for war-related purposes, this has been partially offset by declines in state and local government spending caused by the weak economy. The increase in federal spending has resulted in a sharp increase in the federal budget deficit. Most state and local governments are not allowed to run budget deficits, and have been forced to cut expenditures in response to declining tax revenues.

The export sector has been aided by the depreciation of the dollar. As the dollar declines relative to other currencies, U.S. goods and services are cheaper for the rest of the world and imports are more expensive for U.S. consumers. Despite slow economic growth in much of the rest of the world, we should see a modest gain in exports because of the decline in the dollar.

In addition to the fear of both war and post-war political turmoil, a new fear has emerged on the international scene. Severe Acute Respiratory Syndrome (SARS), a flu-like and potentially fatal illness, has spread from Southern China to other locations. Since there is no known cure for the illness, the spread of the disease has caused panic. There has been a sharp decline in travel to Asia in recent weeks. Although the number of cases reported is still relatively small, the fear of the illness has caused a reduction in the estimated rate of economic growth in Asia, and is a major negative factor for the already seriously damaged airline and tourist industries.

A Policy Debate It now appears that the military conflict in Iraq is arriving at a favorable resolution. Once this issue begins to diminish, the question arises whether the economy has sufficient strength to increase both employment and corporate earnings. Or, does the economy need an additional stimulus from a proposed tax cut and/or a further reduction in interest rates?

The Bush administration has proposed, and the House of Representatives has approved, a major program of fiscal stimulus that would reduce taxes by more than \$725 billion over the next ten years. The centerpiece of the proposal is the immediate elimination of the tax on dividends. The program also includes an acceleration of the tax rate cuts scheduled to go into effect in 2004 and 2006. Support for the President's proposal was reduced by the administration's request for a more than \$70 billion supplemental appropriation to finance the first phase of military expenditures for the Iraq war. The sharp increase in military spending has caused some Republicans in the Senate to be very concerned by the rising level of the federal deficit. The Republican deficit hawks joined

Two Types of 529 Plans:

Prepaid Tuition Plan

- Restricted enrollment period (Many programs have a specified enrollment period each year.)
- Most programs require state residency
- Limited duration
- Restricted to tuition and fees
- May be limited to undergraduate costs
- Attracts risk adverse investors
- Financial aid impact—
– Considered to be the student's resource, thus reduces financial aid dollar-for-dollar

College Savings Plan

- Open enrollment period (Accepts new accounts and contributions any time)
- Open to residents of any states
- No limit on account duration (The account remains open indefinitely as long as there's a designated beneficiary on the account.)
- Not restricted to tuition and fees only
- Includes graduate education costs
- Attracts risk tolerant investors
- Financial aid impact—
– Considered to be the parents' resource

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most Democrats in the Senate to reduce the size of the program to \$350 billion. A conference committee is now attempting to reconcile the differences between the House and Senate bills.

The Federal Reserve has decided to hold the policy line for the immediate future. The Fed wants further evidence on the strength of the economy before making any change in monetary policy. Chairman Alan Greenspan is on record that there is no need for additional tax cuts to stimulate the economy. However, he does favor the elimination of the tax on dividends as part of desirable long-term tax reform. The impact of a reduction (or elimination) of the tax on dividends will have little short-term impact on the demand for goods and services: However, there would be a substantial positive impact on the market for equities.

The Market In The First Quarter As mentioned earlier, the market for equities in the first quarter remained weak. Both the S&P 500 Composite Index and the Dow Jones Industrial Index declined by more than 3 percent during the period. Growth stocks outperformed value stocks by a substantial margin. The NASDAQ 100, an index of the 100 largest stocks in the NASDAQ market, increased by almost 3.5 percent during the quarter. Although investors were supposedly concerned about the risks of war and a weak economy, they apparently had an appetite for "riskier" stocks as opposed to stocks with safer valuations. The market also demonstrated great volatility. From March 12 - 21, the market experienced a dramatic percentage increase in response to favorable news from Iraq. However, during the last week in March, the market gave back most of the previous increase; the month ended with only modest gains.

The current environment provides opportunities to buy the stocks of good companies at fair prices. Given the likelihood for some action on the proposal to eliminate the tax on dividends, the stocks of companies that generate substantial free cash flow and have potential for good revenue growth will perform well in the current economic environment.

Austin, Calvert & Flavin, Inc. is a Large Cap Core Equity Manager based in San Antonio, Texas, and is a new Associate Advisor of TEXPERS.

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Washington Outlook

By Matt Aukofer

As Congress Watches, Social Security and Medicare Face Serious Financial Challenges

Today, 3.3 workers pay Social Security payroll taxes for every one person who collects Social Security benefits. That number will decline to 2 to 1 in less than 40 years, largely due to changing demographics: people are living longer; the first baby boomers are just five years from retirement; and the birth rate is low.

At this ratio there will not be enough workers to pay scheduled benefits for retirees at current tax rates, according to the 2003 report from the Social Security Board of Trustees. "The trustees also once again have delivered a sobering message — Social Security, in its present form, is unsustainable for the long term," President Bush said March 17. While he was encouraged by the number of reform proposals put forward by members of Congress to strengthen Social Security, Bush said he was especially happy with those that would give workers the ability to invest a portion of their wages in personal accounts.

The trustees' Social Security report amended the previous year's report by concluding that:

- The projected point at which tax revenues will fall below program costs will come in 2018 —one year later than the previous estimate;
- The projected point at which the trust funds will be exhausted will come in 2042 —one year later than the previous estimate; and
- The trust funds will need another \$3.5 trillion in today's dollars, earning interest at U.S. Treasury rates, to pay all scheduled benefits over the next 75 years. This obligation grew \$200 billion from last year.

Sen. Jon S. Corzine (D-N.J.) juxtaposed this \$3.5 trillion shortfall over 75 years with the president's tax cut proposal, which would shave between \$11.8 trillion and \$13.9 trillion in budget income over the same period.

President's Corner

By Randy Stalnaker

This column comes at a time that is a high water mark for TEXPERS. We have recently concluded our most successful conference. It set records for attendance and had as its centerpiece a thrilling internationally recognized speaker, Mayor Rudy Giuliani.

TEXPERS is also currently working effectively on its most important piece of legislation ever, in my opinion. We have proposed a state constitutional amendment that would correct unjust Depression-era case law that allows earned public pension benefits in Texas to be reduced or eliminated altogether. Public employees in 41 other states already have legal protection from such draconian actions and we feel it is time for Texas workers to enjoy the same protection.

As I write this column, we expect the constitutional amendment to move to the floor of the House of Representatives within days, having been successfully

Corzine said the trustees' report "shows the utter foolishness of the president's tax proposals. With about a third of the money he is setting aside as a giveaway to America's most fortunate, we could ensure the retirement security of America's seniors."

But other members of Congress said this shortfall would be offset if workers had a chance to earn a better return on their money by using personal retirement accounts.

"These accounts will ease the financial pressures on the program and empower all Americans with ownership, independence, and wealth," Rep. Jim DeMint (R-S.C.) said.

While both sides said they hoped for "an open and honest discussion" about the future of Social Security, the battle lines were drawn. The trustees' report also said the news was bad for the Medicare program. The financial outlook of the program declined from last year's estimate, due to lower-than-expected revenues and higher-than-expected hospital spending in 2002.

"As healthcare costs skyrocket and the rate of retirement increases, the drain on Medicare funds will outweigh the program's ability to bolster the funds," Rep. Phil English (R-Pa.) said. "At the current rate ... Medicare will hit ground zero by 2013."

The trustees also said that the projected point at which the Medicare's Hospital Insurance (HI) Trust Fund will be exhausted will come in 2026 — four years earlier than last year's estimate. HI taxable payroll in 2002 was about 4 percent lower than previously estimated. At the same time, hospital expenditures increased about 2 percent more than estimated, primarily as a result of higher inpatient hospital admissions and a faster increase in the average complexity of these admissions.

Members of Congress have known for some time that Social Security and Medicare must be reformed in order to avoid bankruptcy. The longer reform is deferred, the greater the tax increase will have to be to keep these programs solvent.

The long-term financing problems of these programs "will not be fixed by wishful thinking alone," Jo Anne Barnhart, Commissioner of Social Security, said. "Doing nothing will have serious consequences for our children and grandchildren."

Rep. E. Clay Shaw, Jr. (R-Fla.), chairman of the House Ways and Means Subcommittee on Social Security, said he introduced H.R. 75, the Social Security Guarantee Plus Act of 2003, "to revive and secure Social Security without reducing benefits or forcing a tax hike on the American people." The legislation would establish individual worker accounts, he said, and "guarantee full, promised, current law benefits

reported out of the House Pensions & Investments Committee. By the time you read this, we may know whether we have been successful in getting this matter to the voters of Texas for their consideration.

TEXPERS is widely recognized for the quality of its publications. In addition to the Pension Observer, TEXPERS produces both state and national reports that keep our members informed on timely issues. TEXPERS has helped us all to be better trustees and administrators through its constant educational efforts.

TEXPERS continues to be financially sound. Our annual financial review by an external audit firm was recently completed and it shows a stable and healthy organization. The Board of Directors has been hard at work enhancing its processes so that it can improve its governance of TEXPERS. We held a workshop in February and tackled a wide variety of issues. I am pleased to be able to say that the Board agreed to make a number of refinements that will enable it to be more effective and TEXPERS to be an even better organization. Among the changes agreed upon by the Board were:

- Establishing a strategic plan for TEXPERS
- Development of an

for all workers” regardless of age. Just as companies must back pension plans with real assets, the Guarantee Plus Plan would set aside real assets, not IOUs, to pre-fund benefits, he added. More information is available at:
www.socialsecurity.gov/OACT/TR/TR03/index.html.

“I am willing to consider adjustments to this essential legislation,” Shaw added, “and I also encourage Democrats to offer a plan of their own to help move us closer to a bipartisan solution. We must work together to save Social Security.”

“Workers and retirees shouldn’t have to go to court to enforce their rights under the law,” Rep. Bernard Sanders (I-Vt.) said. “This is the IRS’ job and they need to get it done ... These cash balance pension raids must be brought to an end.”

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orientation package for new Board members

- Changes to the budgeting and financials reporting process
- Development of an expanded policy and procedure manual
- Holding quarterly Board meetings
- Periodic audits of TEXPERS’ finances

TEXPERS publishes its Board minutes on its website. If you would like to review Board actions in detail, the information is available there.

TEXPERS has been of enormous benefit to public pension plans in Texas. The organization has guided helpful legislation, prevented adverse regulation, educated trustees and staff, generated favorable publicity and fostered the development of a network of pension plan stakeholders that benefits every public employee in the state. When it comes to TEXPERS, the future’s so bright, I gotta wear shades.

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State Capitol Report

By Neal T. "Buddy" Jones

The 78th Session of the Texas Legislature is in full swing. The Legislature is focusing on several big issues this session including the overall budget shortfall, tort reform, and education reform just to name a few. These issues are being debated heavily and committee hearings and discussions are occurring to decide the future course for Texas.

A big issue this session has been tort reform. HB 4, the tort reform bill, has been at the heart of partisan politics in the House for the last few weeks. The House spent more than 60 hours in debate on tort reform over a two-week period. Some House Democrats aligned with consumer groups and trial lawyers that opposed the legislation, offered hundreds of amendments, and raised numerous points-of-order and parliamentary inquiries. Because a constitutional amendment was linked to the tort reform bill, a two-thirds vote was required for passage. The proposed constitutional amendment was adopted by a vote of 102 to 45. All Republicans and 12 Democrats voted in favor of the legislation. There were over 300 amendments on HB 4 but no amendments passed that the author, Joe Nixon (R-Houston), opposed.

Another big issue this session is the budget shortfall. Comptroller Carole Keeton Strayhorn announced that the State faces a \$9.9 billion budgetary shortfall for the upcoming 2004 - 2005 biennium. This amount includes a \$7.4 billion projected shortfall in the next biennium, a \$1.8 billion deficit from the current biennium, and what is needed to maintain current services. She said the estimate is based on an economic forecast that the State will rebound in the next biennium, rising from an average annual growth rate of 2.7% in 2002 - 2003 to 4.2% in 2004 - 2005.

In responding to the Comptroller's revenue estimate, Governor Rick Perry said, "In tough economic times, the focus must be on government spending less, not on taxpayers paying more. I believe the financial outlook presents us with the opportunity to re-examine the core responsibilities of government and how every tax dollar is spent. We must, and will, set priorities and ensure that every dollar is spent efficiently and appropriately." Lt. Governor Dewhurst echoed the theme of no new taxes. He said, "The sluggish economy will make it even more difficult than we expected, as a state government, to protect essential services while living within our means— but that is exactly what we must do, just as any Texas family would under similar circumstances. The focus should now be on cutting spending. I intend to recommend a zero-based budget, under which we start with no guaranteed expenditures and then set out the essential services for the people of Texas."

The budget is a serious problem for Texas this session. The projected shortfall has grown as the session has progressed. Comptroller Strayhorn originally said the state would be short \$4.3 billion. That figure has grown to \$9.9 billion and many feel it will go higher by the end of the session. This projected shortfall is leading to reductions in all agency budgets and other serious cuts. State agencies have been asked to permanently reduce their budgets a minimum of 7% going forward. These budget constraints will affect all Texans, all agencies, and every aspect of what we do as a state.

There have been many suggestions on how to balance the budget. Some of the suggestions presented are: the 7 percent reduction in the 2003 budget, moving dedicated funds within the treasury, delaying textbook purchases, delaying federal motor fuels tax payments, and suggestions to transfer the Economic Stabilization Fund where the state would tap all or part of the \$1.1 billion balance to get through what many regard as the "rainy day" envisioned when the fund was created. Tapping into the "rainy day" is an idea that has caused heated discussion and will be further explored.

The House was expected to debate the budget the week before Easter. The House Appropriations Committee was still working out details on HB 1 but was expected to have it ready for debate on the Monday before the Easter holiday. The Senate Finance Committee started mark-up on their version of

the bill, so they would be ready to substitute their bill when HB 1 reached the Senate. The ultimate state budget will be hammered out in a Senate-House Conference Committee. Education reform is another important issue this session. Education efforts to sunset Robin Hood have been stalled. Lt. Governor Dewhurst was still saying education reform can be dealt with during this session, but House leaders do not agree. Many think education issues will be dealt with in a special session. We could see education reform issues debated in a Special Session as early as September.

Pension and Investments issues are also important matters being addressed this session. In the House, pension-related bills generally go to the Pension and Investment Committee. This seven-member committee is made up of all new members with the exception of veteran Barry Telford, who is Vice Chairman of the Committee. The House Committee on Pensions and Investments is chaired by Representative Allan Ritter from Nederland. The other members that make up the House Committee are Ruth Jones McClendon (D-San Antonio), Kent Grusendorf (R-Arlington), Trey Martinez Fisher (D-San Antonio), Aaron Pena (D-Edinburg), and Patrick Rose (D-Dripping Springs).

A constitutional amendment affecting pensions has been introduced this session to protect local employees' retirements. Current state law poses a threat, especially during these tough economic times, to local employee pension funds and to the retirement security of local employees across the state. Even if a local employee has fulfilled all obligations required to collect full benefits at the time of his retirement, and even when he has contributed his own money through paycheck deductions toward this pension, he may not receive the full benefits he has earned through a lifetime of public service.

This property-rights issue is important to all Texans, not just local employees. It dramatically affects the security of the men and women who provide police and fire protection to our state citizens. It also affects those that run our cities and provide city services. The current legal standing of local employee pension funds is due to Depression-era case law that gives the Texas Legislature the right to modify, reduce, or abolish the fund. In 1937, the Texas Supreme Court reasoned that since the Legislature created public employee pensions by statute, the Legislature's right to amend or abolish such funds supersedes the pensioner's rights to collect benefits. As a result of this case law, the Legislature can—at its will—modify local employees' pension plans, reduce accrued benefits or abolish the pension funds altogether.

Texas remains far behind states such as Oklahoma, Louisiana, Florida, Kentucky and Illinois—41 states in all—which have taken steps to protect the retirement interests of their public employees. The only completely reliable way to assure the sanctity of local employee pension benefits is to pass an amendment to the Texas Constitution ensuring that the benefits are inviolable contracts, unalterable by new legislation to modify or reduce them.

The constitutional amendment proposed by Senate Joint Resolution 38 and House Joint Resolution 54 seeks to secure employee pensions. HJR 54 was introduced and referred to committee on House Pensions and Investments on March 3, 2003. The joint resolution was heard in the House Pensions and Investments Committee and voted favorably out of committee on March 31. The bill was in House Calendars at mid April and due to be on the floor in late April. HJR 54 will ensure municipal employees have secure retirements. The Committee for Secure Retirement, made up of leaders of several local pension funds, continues to educate legislators on the constitutional amendment to protect the retirement benefits promised to local employees at their retirement.

Neal T. "Buddy" Jones, attorney and industry consultant, is based in Austin, Texas.

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MARK YOUR CALENDARS!**Upcoming Conferences****TEXPERS Summer Educational
Forum**

August 24-25, 2003 - San Antonio, TX

TEXPERS 15th Annual Conference

March 26 - 31, 2004 - Houston, TX

**TEXPERS Summer Educational
Forum**August 22 - 23, 2004 - San Antonio,
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