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States Taking Steps to Shore Up Public Pension Funds

To address unfunded liability of public pension systems, some states are making changes, including moving new employees from a defined benefits plan to a defined contribution plan, similar to a 401(k).

By Mary Brannam Dusenberry

Stephen Sweeney makes no bones about it: The New Jersey state employee pension system is failing.

In the current financial crisis — and even before — Sweeney knows his state isn’t alone. But as his state’s Senate majority leader, Sweeney can do something about the New Jersey pension problem. And he can tell you just how it got into this situation, the recent stock market collapse notwithstanding.

“They legislated a whole bunch of enhancements without any money,” he said. “They gave workers more without paying for it.”

That came during the flush years of the 1990s; the state’s pension funding level was at 101 percent as late as 2002, but has since dropped to 79 percent in 2006, according to a Pew Center on the States report, “Promises with a Price: Public Sector Retirement Benefits,” released in December 2007.

So the state — and its workers — cut their payments when times were good.

Consider this: In 1997, the level of funding from what the state and its employees put in was 288 percent; that dropped to as low as 3 percent in 2002, but has slowly increased to 27 percent in 2006, according to the Pew report.

Now, Sweeney said, New Jersey is facing a dire situation. “I think the only way to save the pension system in New Jersey now is to eliminate it,” he said. “We do not have the money, nor will we ever have the money, to fund the pension the way it’s structured.”

That means scrapping the defined benefits formula for new workers and shifting to a defined contribution plan, he said.

Alaska Leads the Pack on Change

And some states, like Alaska, are leading the way in this shift. In fact, there are at least 10 states that have a defined contribution plan in their retirement system.

It’s a trend more states are considering, according to Sujit CanagaRetna, senior fiscal analyst for The Council of State Governments’ Southern region, the Southern Legislative Conference.

“It’s less onerous; it’s less of a financial responsibility for the states,” CanagaRetna said. “At the same time, people are going to be more nervous about investing in the market.”

In 2005, Alaska was facing a nearly $6 billion shortfall in its pension fund. In an effort to stop the bleeding, the legislature passed a bill to move any state employee hired after July 1, 2006, from the defined benefits plan, which would pay a guaranteed income after retirement, to a defined contribution plan, which, like a 401(k), is based on employee and employer contributions over the years.

State Rep. Mike Kelly was one of the leaders in Alaska’s House of Representatives pushing for the change. “It became absolutely obvious that the unsustainable defined benefits plan had set us up for this liability,” Kelly said.

Since Kelly entered the legislature four years ago, the unfunded liability of the pension system doubled from an estimated $5 million to about $10 million, he said. As a state legislator, Kelly could have enrolled in the state pension system. He chose not to because he knew he would be critical of it.

“The move to a defined contribution system, he said, will help the long-term security of state employee retirement and will help the state address the unfunded liability problem.

“It has put in place a system that will not create billions of unfunded liability going forward and allowed us to strike a line under the unfunded liability and begin to pay it off,” he said. “If the boat’s got a hole in the bottom and it’s going down, you probably ought to fix the hole before you proceed.”

In addition to moving new employees to the defined contribution plan — existing employees as of July 1, 2006
could join the new plan and some did—Senate Bill 141 also included provisions to sock away money for the defined benefits plan. Starting in 2009, the state will put $450 million toward the unfunded pension liability, Kelly said. At that rate, Kelly predicts it will take 25 years to shore up the old pension system.

**Retirement Plans’ Mission, Design**

That’s a key point for states considering a shift to defined contributions, Roderick Crane told attendees at The Council of State Governments’ policy session, “Buy Now, Pay Later: Transforming Public Retirement Systems” in December.

“Moving to a defined contribution plan leaves untouched the funding obligations of the prior defined benefit plan,” Crane, director of Strategic Sales for TIAA-CREF, said. “The legacy costs of defined benefit plans are what they are. Having the defined contribution plan doesn’t change that equation.”

But the change can lower risks in the future for states and their employees, according to Crane. The key, he said, is the plans must be designed properly.

“Retirement plans should focus on providing adequate and secure income throughout retirement,” Crane said. “In contrast, the corporate world 401(k) plan is primarily aimed at wealth accumulation.”

The need for a solid mission, as well as proper design, isn’t limited to defined contribution plans, according to Keith Brainard, research director for the National Association of State Retirement Administrators.

“If you design and govern a traditional pension benefit properly, you can accomplish the objectives of all relevant stakeholders with a traditional pension plan,” he said. “There is nothing that says a traditional pension plan, a defined benefits plan, is more expensive than a defined contribution plan.”

But that’s only if rules are set and enforced.

That means states must pay their actuarially required contributions, according to Girard Miller, a senior strategist for Public Financial Management Group who is considered an expert on public pensions.

“That’s just saying we can’t continue to push these costs off to the next term of office,” Miller said at the CSG meeting. “And we can’t continue to push these costs off on our children and grandchildren, because it will blow up on the American society eventually.”

States haven’t met those obligations over the past few years, according to the Pew report. Co-authors Katherine Barrett and Richard Greene found a wide disparity in the amount of contributions states were making. Some states—Maine, Louisiana and Indiana—consistently made full contributions, while others—including New Jersey, Illinois, Colorado, Pennsylvania and Vermont—were making considerably lower payments into the system, according to Barrett.

Miller predicted that if the problem is not addressed soon, the magnitude of problems with public pensions could rival those facing Social Security.

The dire situation calls for some pretty drastic measures, he said. But states shouldn’t make changes to the benefits promised to existing employees, Miller said.

That could mean tiered benefits—giving new employees less under a new plan than existing employees, Crane said.

“It’s not pretty, but it may be a reality for many public employees,” he said. “The price of having made the prior defined benefit promises may be borne by the future, not just taxpayers, but employees as well.”

**Promises Come with a Price**

Across the country, states have made promises of about $2.35 trillion for state employee and teacher pensions. And that doesn’t include $381 billion for retiree health care and other non-pension benefits, according to Barrett. On average, she said, states had funded at levels around 85 percent in 2007. As the stock market has taken a hit over the past few months, that figure has probably dropped to around 65 percent, according to Miller.

Even in 2007, the average funding level included 19 states that were at less than 80 percent. Some states were severely underfunded, including Connecticut at 56 percent, Illinois at 60 percent, New Hampshire at 61 percent, Hawaii at 65 percent, and Kentucky at 70 percent. In contrast, only five states—Florida, North Carolina, Oregon, New York and Wisconsin—were considered fully funded when Barrett and Greene wrote their report.

“We hit the states at a point where they had been doing fairly well for the last few years, but were still feeling the effects of the downturn in the early part of this decade,” Barrett said.

Half the states were fully funded in 2000, according to Barrett. The markets were doing well, and that got state officials feeling generous. Many states, Barrett said, gave benefit increases to retirees at that time.

“The idea that what goes up must come down escaped a lot of people,” she said.

When the market started declining in 2001, pension funds were in trouble because of those benefit increases and pension holidays. Barrett ticks off examples of that trouble: Between 2000 and 2003, the pension bill coming due for Illinois jumped $20 billion; and Pennsylvania went from having a $16.6 billion surplus to a $12 billion shortfall.

Investment rules had changed during this time period and states began taking on more risk in their pension funds.

“In the last 15 years or so, states have moved aggressively away from the staed, conservative Treasury bills, in terms of their investment portfolio, to more esoteric instruments,” Canagaratna of CSG said. Those investments include the stock market, real estate market, international equities and hedge funds, he said. West Virginia, for instance, had 98 percent of its investments in 2006 in nongovernmental equities, according to Canagaratna.

“It’s almost like a gambler … You’re hoping the next roll of the dice is going to be the big jackpot,” he said.

That can be good when the markets are doing well. But the recent freefall of the stock market has exposed the danger of that mentality. California pension funds, for instance, are tens of billions of dollars in the hole because of the stock market correction, Canagaratna said.

Miller would agree. “Pension funds have been clobbered by this because asset values have fallen by 45 percent,” he said.

And that, he said, makes it imperative for states to act now.
“Revenues will come up off this recession, but not at the levels we’ve seen before,” Miller said. “This is a credit implosion and it will retard the capacity for future growth for state and local government budgets and because of that, there won’t be enough money in the good years to come—and there will be good years—to pay for all the problems we’ve got now.

“The pension benefits and OPEB benefits that have been committed to are fundamentally unsustainable for the long run,” he said.

Finding Political Will to Address Problems

But just because the need is there doesn’t mean action will follow.

Sweeney, for instance, has fought for reforms in the New Jersey pension system, but getting them passed hasn’t been easy. In July, the legislature raised the retirement age from 60 to 62 and the threshold for pension eligibility from $1,500 per year to $7,500 per year. The pension threshold, he said, hadn’t been changed in 50 years.

Those were moderate changes, but Sweeney, who is a union leader in private enterprise, faced harsh criticism by the state employee labor unions. Therein lies the problem, Sweeney believes.

“There’s not the willpower or the stomach to do the right thing. It just doesn’t exist,” he said.

Slowly but surely, though, some states are taking steps to address the problem:

- Just this month, Illinois State Treasurer Alexi Giannoulias suggested merging the investment functions of the state’s five pension systems. He believes that action could save the state up to $82 million annually in administrative costs and management fees.
- In Kentucky, Gov. Steve Beshear’s Work Group on Pension Reform suggested selecting experienced pension board trustees, selling bonds to reduce health care costs and diversifying investment assets to address the state’s unfunded liability.
- And in New York, lawmakers approved legislation in October that closes loopholes allowing some public employees to collect six-figure salaries on top of six-figure pensions. The new law, pushed by Attorney General Andrew Cuomo, increases penalties for pension fraud, requires greater accountability from agencies seeking to hire public retirees, and bars public-sector retirees from returning to the same or similar jobs for a year.

Most changes come with opposition, as Sweeney and Kelly know well.

“There’s been a lot of pressure and it’s been a thankless job,” Kelly said. “The goal was, I think, certainly a noble goal and that is one to recognize an absolutely terrible situation that existed with that unfunded liability.”

Continued inaction, Crane said, will cost states in the long run. Either states cover the pension benefits now, or they’ll be covering their retirees in social welfare systems down the road, he said.

“There’s no free lunch for governments not having effective retirement plans,” said Crane.

Getting that message out in order to make real reform is difficult, Sweeney believes.

“What I found out through the process is that people really don’t care,” he said. “They just want to kick the can down the road and leave it for the next guy. Eventually you’re going to get to the end of the road and you’re not going to be able to kick it any further.”

—Mary Branham Dusenberry is managing editor of State News magazine.

Public Pension Facts

- In 1950, the worker to retiree ratio was 16.5-to-1. It’s at 3.3-to-1 now, and is expected to drop to 2-to-1 in the next 40 years.
- In 1993, public pension plans had only 62 percent of total cash and investment holdings in nongovernmental securities. That had ballooned to nearly 80 percent by 2005.
- 12 percent of the nation’s work force is employed by state and local governments.
- About 90 percent of those employees have a traditional or defined benefit plan.
- The combined assets of public pension funds is about $2.35 trillion.

Sources: Sujit CanagaRetna, senior fiscal analyst for The Council of State Governments, and Keith Brainard, research director for the National Association of State Retirement Administrators.
States Struggle to Pay Promised Retiree Health Benefits

By Mikel Chavers

Even though states have saved an estimated 85 percent—some estimates put that as low as 65 percent since the market crash—needed to cover the collective pension bill, there is very little put aside for other post-employment benefits like retiree health insurance, according to the latest report on state pension plans from The Pew Center on the States.

The trouble is states are promising retirees health care, dental care, vision care and other long-term care benefits they may not be able to pay for.

These are called other post-employment benefits and are commonly referred to as OPEBs.

Now that states are required by the Governmental Accounting Standards Board Standard 45 to account for the costs of those other post-employment benefits, it is becoming increasingly obvious that states are struggling to pay for the health care benefits they’ve promised.

In fact, the culture has been buy now and pay later.

“In bad budget times, retirement benefits become easy substitute salary increases because states can put off the bills,” the Pew report, “Promises with a Price,” said. “In good times, feelings of legislative largesse can create new retirement benefit policies that have costly long-term price tags.”

Basically, state governments are now making the calculations today on what they’ve promised. And in doing that, some states are recognizing they can’t afford those promises, according to David Bean, director of research and technical activities for the Governmental Accounting Standards Board.

The new financial and accounting rule—nicknamed GASB 45—was issued in 2004, but states are just now beginning to implement it because of the rule’s phased-in implementation period. The latest phase-in period for the rule was just last month. Now all state and local governments must begin reporting what they’re promising in the way of other post-employment benefits.

“We’ve seen a shift in the past—because this is something where (state government officials) can offer a benefit and (they) don’t have to worry about it because it’s going to be paid 20 years from now,” Bean said at The Council of State Governments “Buy Now, Pay Later—Transforming Public Retirement Systems” policy workshop in Omaha, Neb., Dec. 2.

According to the Pew report, the bill for other post-employment benefits is only 3 percent funded nationwide in all state plans.

So states—now that they’re required to—are taking a hard look at these promised retiree health benefits.

“Until recently, if you work for the state of North Carolina for five years, quit and go to work in the private sector, when you retire, you get free retiree health care. Not anymore. They took that away,” said Sujit CanagaRetna, senior fiscal analyst with The Council of State Governments Southern region, the Southern Legislative Conference.

In a “perfect storm of having America’s deepest economic crisis … governments are having to face up to the fact that they haven’t been paying enough to their OPEB plans,” said Girard Miller, senior strategist for Public Financial Management Group, at the CSG session.

The recession, he said, will likely make the situation worse, and unfunded liability in these benefits will likely grow.

And, Miller warns, even if states continue to pay as they go for these retiree benefits, “the hole gets deeper. The myth that even if we pay as we go, we’ll continue to stand still … in fact, that isn’t mathematically correct,” he said.

But going into 2009, some states may borrow their way out of part of the problem by issuing what are called OPEB bonds, Miller said.

“It is actually smart economics,” Miller said. “It may be the most cost-efficient way in a recession period for people to fund OPEB obligations.” But, he said, “The only successful time they’re used is in a recession period or shortly thereafter.”

OPEB bonds typically fund all or a portion of the unfunded liability of the benefits, much like pension bonds fund the unfunded liability of a state’s pension plan. But, according to the American Bar Association, the future liabilities of retiree medical plans depend on factors that aren’t present in pension plan calculations. That means they’re more difficult to accurately predict, the association said. It’s like predicting the cost of medical care more than four decades down the road—not an easy calculation.

Minnesota allows the sale of OPEB bonds by law now and the state did some other things to address the underfunded retiree health benefits issue.

Miller calls Minnesota the clear leader in OPEB laws, but mostly because the state is one of only a few taking action on the issue at all.

Minnesota’s 2008 statute, Trusts for Postemployment Benefits (Section 471.6175), basically creates an investment authority, a tax authority and a bond financing authority, Miller said. Unique about the law is that it gives public entities—such as counties—the ability to create revocable and irrevocable OPEB trusts, or trust funds used to accumulate resources to pay for those other post-employment benefits.

An irrevocable trust cannot be changed or canceled once set up without the consent of the beneficiary. Irrevocable trusts also offer some tax advantages that revocable trusts don’t.

But Minnesota also allows revocable OPEB trusts because some public enti-
ties in the state believe the federal government will become involved in health care in the next 30 years and if national health care becomes a reality, the retiree health care benefits states promise to their workers could be reduced or done away with all together. And because the calculations to fund these plans are made over a 30-year time period, some folks in Minnesota didn’t want large amounts of money to be trapped in irrevocable OPEB trusts.

“Even though public entities cannot improve their financial statements with a ‘revocable’ trust, many feel that being able to get some of the money returned if some form of national health care is adopted is worth whatever discomfort will be associated with having a large net OPEB liability on their annual financial statements,” Minnesota State Auditor Rebecca Otto wrote in June in an article published in Minnesota Counties.

Miller, however, doesn’t like this part of Minnesota’s law. “I think it’s a fatal flaw,” he said.

Another problem with the Minnesota statute is that it allows local agencies to sell OPEB bonds—to bond their way out of the problem, Miller said, “which is pure madness.”

There are school districts in Minnesota that are selling OPEB bonds, he said. “School districts have been encouraged to borrow their way out of the problem.”

Wisconsin law also created an OPEB trust investment authority while Virginia law created an OPEB trust authority that Miller believes relies unnecessarily on existing governance structures.

But, Miller warns, OPEB bonding should be timed correctly to be helpful.

“There’s only one window in the business cycle where this should be done, and when that window closes, we need to shut them down.”

—Mikel Chavers is associate editor of State News magazine.

### Public Pension Trends

States have been taking action to address the problems with their public pension funds over the past few years. Sujit CanagaRetna, senior fiscal analyst for The Council of State Governments, addressed these trends in a 2006 presentation. Those trends still hold true today, CanagaRetna said.

Among the actions states have taken:

- Moving workers away from defined benefit plans to defined contribution plans;
- Linking annual increases to the consumer price index;
- Preventing workers from securing pensions larger than their salaries;
- Capping the amount of end-of-career raises that add to pensions;
- Adjusting the age at which retirees are paid full benefits;
- Reducing percentage of pay retirees get each year;
- Ending practice of employees serving a short period in a position to boost the overall pension;
- Cutting back and increasing health and life insurance costs;
- Placing salary caps on rehired retirees;
- Debating and ending states offering lucrative health plans to retirees;
- Eliminating gain sharing, increasing pension checks when investments expand;
- Increasing the costs to workers, counties and cities;
- Consolidating retirement boards;
- Deliberately aiming for low but guaranteed investment income from conservative bonds; and
- Making unorthodox investments.