

States Can Pay **Now or** Pay **More Later**

by Mary Branham

for Employee Retirement, Benefits



Photography by Kate Williams

Girard Miller, an authority on the investment of public funds, believes states must make changes to pensions and other post-employment benefits now if they wish to sustain the programs in the future.

“The problem is every dollar you don’t pay toward your actuarial costs today will cost you \$2 or \$3 in the future ...”

—Girard Miller

1 What is the current condition of state retirement funds?

“The unfunded liabilities of pension plans have doubled from their 2007 levels. They were 85 percent funded and now that number is closer to 70 percent. So the result of that is that now the future budgets of states and local governments will have to double the amount of employer contributions that are required to pay for the deficits.”

2 So what does that mean in terms of state budgeting regarding pensions?

“The amount of total unfunded liability is somewhere in the range of \$500 billion to a trillion dollars, depending on where the market is at any given week. That money is going to have to be recaptured over the next 25 years or thereabouts, which puts an additional annual cost of pension funds to amortize that in the neighborhood of \$20 billion to \$40 billion of additional pension expense.”

3 And pensions aren’t the only problem?

“The problem in the (other post-employment benefits) area for retiree medical is far more significant, because most of the states have not funded it and so they’ve got another liability of approximately the same size. Again \$500 billion is probably a fair estimate. When you combine all of that, the state budgets going forward probably need to be paying an additional \$30 billion to \$40 billion a year for retirement expenses, and it could be as high as \$50 billion ... on top of what they are putting in now.”

4 What will happen if states don’t make that kind of investment?

“The problem is every dollar you don’t pay toward your actuarial costs today will cost you \$2 or \$3 in the future because you don’t earn investment income on the money that should be in the fund. ... Many states are required by law to make their contributions to the pensions, so they won’t have a choice. If they don’t have additional revenue they’ll have to cut other services or other funding in order to balance the budgets. They are not typically required to make the OPEB contributions ... so they could kick the can down the road to the next generation, but if they do so they will triple the costs in today’s dollars by doing so.”

5 How did we get to this point? Some states took holidays for making contributions to the funds in the flush years of the 1990s ...

“That is part of the answer. A second part of it is, the pension plans—whether they did it themselves or whether they did it with the political pressure from within the legislature in some cases—granted benefits increases retroactively in the expectation that financial markets would continue to earn 10 percent on stocks all of the way through 2000 to 2010. Instead, however, during that period, (the) stock market earned almost zero. There are literally hundreds of billions of investment gains that were expected to occur in the first decade of this century that never actually happened.”

6 What should states be doing to address the problem?

“A few of the states have begun to reduce retirement benefits for new employees. That’s politically the easiest thing to do because you don’t touch the incumbents ... The point is that most states have avoided making benefit reductions for current incumbent employees. They’ve tended to focus on the new employees. They’ve also, in some cases, increased the retirement age to make it closer to Social Security.”

7 Does reducing the benefits for new employees help?

“In the long run, those changes will eventually accumulate and they’ll become significant, but it’ll take us 10 to 15 years before the new employees outnumber the incumbent employees. ... It’s partly cosmetic and it’s hopeful and of course it’s better to do that than to do nothing, but it doesn’t really do anything to deal with the pension deficits.”

8 What about changes to the other benefits?

“A lot of states provide benefits for the employee and their spouse and dependents and survivors, and they’re finding they can’t do that. So they may change the benefits, may raise the retirement age and they may require an employee contribution. They also need to put a (consumer price index) cap rather than the cost of medical inflation, which seems to be going up three times as fast as the CPI.”

9 Are defined contribution plans a good option for states?

“Defined contribution plans do not necessarily reduce your costs. ... I’m an advocate of something like Washington state where they’ve gone to half defined benefit, half defined contribution ... In a defined benefit plan—the pension plan—the state bears all of the responsibility if investments underperform. In a defined contribution plan, the employee bears the investment risk if investments underperform. If you’re going to view this as a partnership, it makes sense that there be a combination of the two forms.”

10 What have states with lower unfunded liability in their pension plans done right?

“If there’s one single factor it’s the ones that did not give away the store in the late 1990s and 2000; (they) are probably the ones that have held up the best. On average they tend to have a slightly more frugal benefit formula. The ones that have required a larger employee contribution have tended to have better finances than the ones that have left the taxpayers paying the whole thing.”

6 Steps to Healthier Pensions

Girard Miller recommends states take these steps to reduce unfunded liabilities in state pension and other post-employment benefit plans.

- » Require a new or higher employee contribution—which will have the biggest financial impact.
- » Establish a consumer price index limit on other post-employment benefits, for retiree medical—which could be very significant.
- » Establish new lower benefit tiers for new employees. “That would probably be the third step that you have to do even though it will take longer to get an impact,” Miller said.
- » Raise the retirement age for unreduced retirement as close to the Social Security age as possible to increase contributions and reduce the time for retirement payout.
- » Eliminate spouse, dependent and survivor benefits for OPEB.
- » Limit OPEB benefits for retirees before they become eligible for Medicare. Those who retire before Medicare eligibility cost the state more than those who retire after they are eligible for Medicare.