State Retirement Systems: Recent Trends

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This presentation was given by Sujit M. CanagaRetna, Fiscal Policy Manager at the Southern Legislative Conference (SLC), before the SLC Fall Legislative Issues Conference in Savannah, Georgia, November 12, 2006. It deals with a topic that has enormous implications for state finances: under-funded and unfunded state pensions.

The presentation remarks also are included below.

Remarks

Introduction:

My presentation this afternoon deals with a topic that has enormous implications for state finances: under-funded and unfunded state pensions. This is a topic that the SLC has been exploring for some years with reports issued in May 2000 and October 2004. The SLC continues to study and highlight this critical issue in presentations and publications before legislative and other audiences.

Broadly, my presentation comprises four interconnected parts. Part I presents why it is important for policymakers to focus on the financial position of state retirement systems. Part II looks at the finances of state retirement systems and Part III provides a snapshot of several key developments. Finally, Part IV describes the various strategies deployed in states across the country to bolster the finances of their pension systems.

Part I:

There is growing consensus across the country that more attention needs to be directed toward retirement planning and developing a retirement infrastructure with the capacity to absorb the needs of all Americans. In this context, there are four major reasons why the financial future of state retirement systems requires the urgent attention of policymakers.
One, even though states are in considerably better financial shape compared to the early years of this decade when the worst fiscal crisis in 60 years swept over states, the current high revenue growth is taking place from a substantially depressed base. Analysis indicates that state revenues would have to grow by more than 9 percent per year between now and 2008 in order to generate enough funds simply to restore the level of services that prevailed in fiscal year 2000, the year before the downturn. There are a number of expenditure categories that will plague state finances in the upcoming years. Healthcare costs lead the way here and in the next decade, Medicaid is estimated to grow by 9 percent to 10 percent a year. In addition, substantial expenses associated with education, pensions, corrections, transportation, infrastructure and emergency management will continue to burden state budgets.

Two, a close review of national financial and demographic trends reveals that every element of our nation’s retirement architecture faces serious challenges. Alongside the weaknesses in public retirement systems, the other strands in our retirement architecture—given the looming shortfalls expected in Social Security and Medicare in coming decades; the precarious financial position of corporate pension plans and the federal Pension Benefit Guaranty Corporation (PBGC); and, the very low personal savings rates of most Americans, coupled with high rates of consumer and household debt—remain very troubling.

Three, our society is an aging one and Census Bureau figures indicate that the number of people in the United States 65 years and older will grow from about 13 percent of the total population in 2000, to 20 percent in 2030, and remain above 20 percent for at least several decades thereafter; in contrast, it was about 6 percent in 1935. Furthermore, in 2008, our nation will have to contend with the wave of baby boomers turning 62 and claiming Social Security and then Medicare benefits.

Four, along with the wave of baby boomers nearing retirement, experts point to the fact that people are living longer. According to the latest statistics, the annual number of deaths in the United States experienced its biggest decline in nearly 70 years in 2004, with American life expectancy inching up to 77.9 years. Coupled with this trend, low national birth rates have led to a steadily declining worker-to-beneficiary ratio: from 16.5-to-1 in 1950, to 3.3-to-1 today, to 2-to-1 in the next 40 years. In fact, while the U.S. population hit 300 million a few weeks ago—the 15-24 age group—the one entering the workforce, has been shrinking proportionally for more than 30 years. U.S. Census data indicates that by 2006, there would be only one worker entering the workforce for every two workers leaving it.

These four reasons cumulatively amount to a fiscal tsunami looming over our nation’s financial horizon and require the urgent attention of policymakers at all levels of government.

Part II:

A number of recent studies indicate that a majority of public pension plans are under-funded or unfunded to varying degrees, i.e., assets are less than their accrued liability. The farther a plan’s funding level is below 100 percent, the greater the contributions required to finance its unfunded liability. According to the 2004 50-state SLC report, 73 percent, or 68 of the 93 plans for which information was secured, were unfunded to varying degrees. Then, according to the 2006 Wilshire Report on 125 state retirement systems, the actuarial value funding ratio of plans declined from 103 percent in 2000 to 87 percent in 2005. Barclays Global Investments calculates that if America’s state pension plans were required to use the same methods as corporations, the total value of the benefits they have promised would grow 22 percent, to $2.5 trillion; only $1.7 trillion has been set aside to pay those benefits. Finally, according to the September 2006 survey of 102 plans by the National Association of State Retirement Administrators (NASRA), the average funding level stood at 87 percent with a cumulative unfunded liability of $337 billion.
Notwithstanding that a majority of the plans reviewed were termed under-funded or unfunded several plans did secure an actuarial funding ratio greater than 100 percent. According to a February 2006 Standard & Poor’s report, three SLC states—Florida (at 112 percent), North Carolina (at 108 percent) and Georgia (at 101 percent)—alongside New York and South Dakota, both just below 100 percent, were the five states with the best funded pension plans. At the other end of the spectrum, two SLC states, West Virginia at 44 percent and Oklahoma at 57 percent alongside Rhode Island, Connecticut and Illinois (all just below 60 percent) were the five states with worst funded pension plans.

Part III:

My ongoing review of public retirement plans reveals several trends. First, the increasing move by state plans to invest in non-governmental securities (such as corporate bonds, stocks and foreign investments) away from government securities (such as U.S. Treasury bills). In fact, in 1993, public plans only had 62 percent of their total cash and investment holdings in non-governmental securities; 12 years later in 2005, this percentage had ballooned to nearly 80 percent. Several states allowed their pension plans to invest more heavily in the market: Georgia approved an increase from 50 percent to 60 percent; the South Carolina Senate approved an increase from 40 percent to 70 percent; and, Arkansas voted to double its Teacher Retirement System’s investments in real estate.

Second, in the last few years, payments from these retirement plans have far outpaced receipts into the plans. For instance, between 1999 and 2000, both payments and receipts increased by 12 percent and 13 percent, respectively. In striking contrast, between 2004 and 2005, while payments expanded by 7 percent, receipts dwindled by 14 percent. A significant portion of these payments are related to health care expenditures. According to the federal Centers for Medicare and Medicaid Services, the torrid pace of growth in national health spending reached $1.9 trillion in 2004, the latest year available, and topped 16 percent of our nation’s gross domestic product for the first time.

Third, given the spate of accounting and corporate scandals and the significant losses experienced by these public retirement systems, there is a great deal more activism by the boards overseeing these plans and state lawmakers to monitor the plans more closely. For instance, in Maryland, in the aftermath of the state’s employee pension system losing a staggering one-fifth of its total portfolio in a 15-month period by September 2001, a development that ranked it last in an evaluation of similar plans, the Maryland General Assembly began a series of inquiries. These legislative explorations, along with a federal investigation, led to the criminal prosecution of a number of employees and the complete revamping of the plan’s structure. As a result of management changes and other reforms, by the end of fiscal year 2006, this pension plan achieved the healthy growth rate of 10 percent, the third consecutive year of solid growth.

Fourth, the chilling effect of a Governmental Accounting Standards Board (GASB) ruling on already teetering public pension plans. (GASB is the independent standard-setter for 84,000 state and local government entities.) According to this ruling, state and local governments have to place a value on “other post-employee retirement benefits”—consisting mostly of health care—they promise to employees. They will also have to record as an expense the amount—the annual required contribution—they would need to fully fund this long-term liability over 30 years. While the private sector has had similar rules since 1992, for the public sector, implementation will be phased in beginning December 15, 2006. Given the huge spikes in healthcare costs expected in upcoming years, the explosion in unfunded liabilities as a result of this ruling promises to be most alarming.

Fifth, a June 2006 50-state SLC report explored pension portability among public health officials given the fact that there is a growing awareness that states should offer incentives to retain and attract an adequate supply of well-trained healthcare workers to respond to both natural and manmade emergencies. In this regard, enhancing pension portability at both the intrastate and interstate levels
has been presented as an important consideration. According to this SLC report, even though state and local governments have initiated a variety of measures to both retain and recruit additional workers into the different healthcare categories, offering added retirement benefits have not cropped up as a strategy. Specifically, only four states (Connecticut, Indiana, New Hampshire and West Virginia) have agreements that permit the purchase of credits for out-of-state service.

Part IV:

In responding to the growing crisis associated with their pension liabilities, lawmakers around the country have either proposed or adopted the following strategies to buttress the finances of these systems.

- **Pension Obligation Bonds:**

Several states and localities opted to issue debt in the form of pension obligation bonds to raise money to plough into their pension systems and pay off, in a lump sum in today’s dollars, their unfunded liabilities. Since interest rates have been at historically low levels recently and because raising taxes continues to be politically radioactive, the opportunity to raise funds via enhanced borrowing quickly loomed as an attractive strategy. A further twist to this approach surfaced in California where an effort was made by both Governors Davis and Schwarzenegger in 2003 and 2004 to issue pension obligation bonds to even pay for the state’s annual retirement contribution. Formerly, the trend had been to completely retire the state’s unfunded liability portion not just pay for an annual contribution.

Some of the states that pursued the pension obligation bond strategy recently include California ($2 billion), Illinois ($10 billion), Kansas ($500 million), Oregon ($2 billion) and Wisconsin ($1.8 billion). In June 2005, West Virginia voters, in a special election, rejected Governor Manchin’s efforts to issue $5.5 billion in bonds to bolster his state’s ailing pension plans.

In selling these bonds, states are counting on the interest payable on the bonds being less than their pension investment earnings. If a state pension plan can earn 8 percent by investing money the state borrowed at 6 percent, the state is ahead of the game. Another advantage is that states experience immediate budget relief because their current year contributions to a pension plan can be secured from the proceeds of the bond issue.

On the flip side, there is always the possibility that the market may not generate the returns to cover the interest rate. Furthermore, once a state issues a bond, it is locked into paying the debt whereas the state has much more flexibility in deciding on future pension contributions, including size, rate and regularity.

New Jersey’s experience offers a cautionary tale for states mulling the pension obligations bonds option. Then-Governor Christine Todd Whitman led an effort that resulted in the state issuing $2.8 billion in bonds that promised to pay off its unfunded pension liability, solve all of its pension problems for the next 36 years, make the state’s contributions to the plan for that year and free up $623 million for tax cuts. The state banked on getting returns exceeding 7.6 percent, the interest it was paying on the bonds. For the first few years, while the economy surged ahead and the stock market roared, the gamble appeared to have paid rich dividends. Then, the economy slumped and the stock market collapsed, resulting in a severe drop in investment earnings. By mid-2003, even after the stock market had recovered, the state only saw returns of 5.5 percent, significantly lower than the required 7.6 percent.

Since New Jersey had skipped pension contributions for years, its fiscal year 2007 budget’s $1.1
billion pension contribution exceeded the state’s cumulative contribution in the last 10 years. The huge strains on the state’s finances posed by pension costs, reputed to be $18 billion in unfunded pension liabilities and $20 billion in unfunded healthcare liabilities, has prompted a series of reform efforts and a task force has recommended several cost cutting measures. The city of Pittsburgh also suffered a fate similar to New Jersey’s with its ill-timed pension bond offering in the late 1990s.

**Trimming Benefits:**

Several strategies crop up under this category.

1. Moving workers hired in the future to 401(k)-style investment accounts away from the current format of a guaranteed pension based on years of service and highest salary. This entails moving future state employees away from the current defined benefit (DB) plan to a defined contribution (DC) plan. Alaska became the first state in the country to switch all state workers hired after July 2006 to 401(k)-type accounts. California Governor Schwarzenegger advocated this measure during his 2005 state of the state address but has receded from pursuing it given the howls of protest. Governor Sanford in South Carolina has also advocated this approach along with Governor Romney (and more substantively, Lt. Gov. Healey) in Massachusetts, Governor Corzine in New Jersey and Speaker DeRoche in Michigan. Lawmakers in Illinois, Kentucky, Oregon and Virginia also introduced bills this year to adopt this strategy.

2. Linking the annual increases in retirees’ pensions to cost-of-living increases (based on the Consumer Price Index) as opposed to an automatic percentage increase. The governors in Illinois and Rhode Island both advocated this approach along with a New Hampshire House Committee. In Colorado, this spring, the state agreed to maintain its DB plan and in turn, employees, agreed to forego scheduled cost-of-living raises worth 3 percent of their income and channel that money into the state pension fund. Arizona informed thousands of its retired employees this spring that they would not be receiving cost-of-living raises for the next five years.

3. Earlier this year, California closed a pension loophole that allowed some retiring fire fighters to receive pensions that were larger than the salaries they earned while working.

4. Capping the amount that end-of-career raises would contribute to a teacher’s pension. In Illinois, the governor proposed restricting big raises teachers might receive towards the end of their careers, a step, he contended inflated their pensions and added to overall retirement debt.

5. Adjusting the age at which employees are paid full benefits. Colorado increased its minimum retirement age from 50 to 55 this spring. Under a proposal considered by Kansas this summer, public employees would be unable to retire with full benefits until age 65. Earlier this year, Governor Pataki in New York, vetoed a bill that would have allowed some state workers to retire early with full benefits. In Illinois, an individual who worked at least eight years for the state can retire with full benefits at age 60; the governor proposed raising the age to 65. He also proposed changing—from 60 to 65—the age at which state employees with 35 years service can retire with full benefits. Similarly, in Rhode Island, pensions are limited to only those who are 65 and who have worked at least 10 years, or those aged 65 and up, and who have worked at least 30 years. Texas passed legislation that would require educators to be at least 60 before retiring with full benefits and prohibited school districts from offering early retirement incentives. Louisiana proposed pushing the age at which teachers can get retirement benefits to 60.

6. Reducing the percentage of pay a retiree gets for each year of work. In Rhode Island’s proposal, the maximum pension dropped from 80 percent of an employee’s three-year salary average
after 35 years work to 75 percent after 38 years.

7. Eliminating programs like the Deferred Retirement Option Plan, or DROP, which allows state workers with 30 years on the job to continue working up to three years, for instance, while escrowing their retirement benefits at a guaranteed rate of return. A number of states and localities suffered huge financial setbacks since they had entered into these DROPs during the 1990s. When the economy nosedived and stock market buckled, these guaranteed rates were significantly more than what the public pension plans were generating in earnings.

8. Ending lucrative retirement plans where certain state employees serve a brief period in select positions to secure a significant boost in pension income. Missouri eliminated its administrative law judge retirement system which allowed this practice. A Louisiana lawmaker proposed halting new retirement breaks through special interest legislation.

9. Idaho announced in October 2006 that it would cut back the health and life insurance benefits for certain state retirees. Montana announced in September this year that the state would decrease benefits for some new employees.


11. Debating the ability of public sector systems to continue offering lucrative healthcare plans to retirees. In North Carolina and Michigan, a state employee with five years service becomes eligible for free retiree health insurance for life. In January this year, Indiana ended lifetime health insurance for lawmakers subsidized by taxpayer dollars.

12. Lawmakers in Washington State discussed eliminating “gain-sharing,” the practice of beefing up retirement checks when pension fund investments do better than expected.

• Increasing Costs:

Minnesota proposed increased pension contributions by public workers as well as cities and counties. An Alaska proposal called for an annual 5 percent increase from current workers in order for them to receive the same level of retirement benefits. In addition, local governments paying into the Alaska system will see their contribution rates jump, on average, from about 22 percent of money paid out in salaries to about 40 percent. In Ohio earlier this year, the pension fund for state employees increased the premiums paid by government agencies and workers, primarily to fund rising healthcare costs. A proposal in Texas required retired teachers to pay more in health care premiums. Kentucky sought to increase the cost of retiree health care benefits too. Louisiana proposed increasing worker contributions to their retirement pay from 7.5 percent of salary to 8 percent. Nevada proposed ending benefit subsidies for future state retirees while both Arkansas and South Carolina required higher retirement premiums from workers.

• Consolidating Boards:

West Virginia teachers merged their two retirement systems to create greater efficiencies. Louisiana explored creating a single administrative board to oversee its retirement programs for teachers and state employees while Minnesota merged the troubled Minneapolis teachers’ pension fund with the larger, statewide fund. In Vermont, the governor and lawmakers agreed to combine the funds of its three state retirement systems for investment purposes.

• Guaranteed Returns:
In a contrarian approach that has hailed it as the first pension fund in the United States to do so, Maine adopted a strategy known as matching, i.e., deliberately aiming for low, but guaranteed, investment income to pay for the retirement benefits of its workers. In 2003, Maine put a third of its assets into very conservative bonds. The bonds pay a low interest rate, but their values will rise or fall in conjunction with the value of the pensions the state must pay its retirees, regardless of the trajectory of the markets.

- “Unorthodox Investments"

The Retirement System of Alabama embarked on a series of unorthodox investments that enabled the fund to progress from $500 million in assets in 1973 to $29.1 billion by 2005. Some of these acquisitions include New York City real estate, media outlets (television, newspapers), hotels, a cruise ship terminal, golf courses and becoming the largest stake holder of US Airways. Similarly, Massachusetts considered a proposal to open the state’s public employee pension fund to all state residents for investment purposes. New Jersey considered shifting about a quarter of its $72 billion pension fund away from the control of state employees to professional money managers this year.

Conclusion:

In conclusion, almost every state continues to be plagued by unfunded and under-funded pension liabilities, yet another force pummeling state finances warily recovering from the recent downturn. While in certain instances, the weakened pension outlook was the result of states skipping their required contributions, the severity of the recent fiscal crisis, demographic changes and the steep rise in healthcare costs are factors too. The implementation of the previously-mentioned GASB ruling could propel unfunded pension liability levels to new heights beginning in December 2006, a trend that could damage state bond ratings. Yet, the “graying” of America, the fact that states will have more retirees living longer in the coming years and the ability of the public sector to attract quality employees in an era of dwindling retirement benefits, requires innovative solutions. Further complicating the public pension outlook is the fact that the financial viability of the other elements of our retirement infrastructure remains shaky too. Ensuring both the short-term and long-term financial viability of the different elements in America’s retirement systems, both private and public, remains of paramount importance. In fact, first resuscitating and then sustaining the financial health of our different retirement income flows provides the underpinnings for the foundation of the United States as an economic, political and military powerhouse in the global context.

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