Protecting Workers and Taxpayers: Improving State & Local Retirement Policy

laura and john arnold foundation®

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Retirement benefits are an important and valued part of public workers' total compensation package.

However, governments have failed to responsibly manage their retirement systems. Policymakers have engaged in a number of practices that threaten the sustainability of these systems:

- Accounting gimmicks
- Insufficient contributions
- Retroactive/unfunded benefit increases

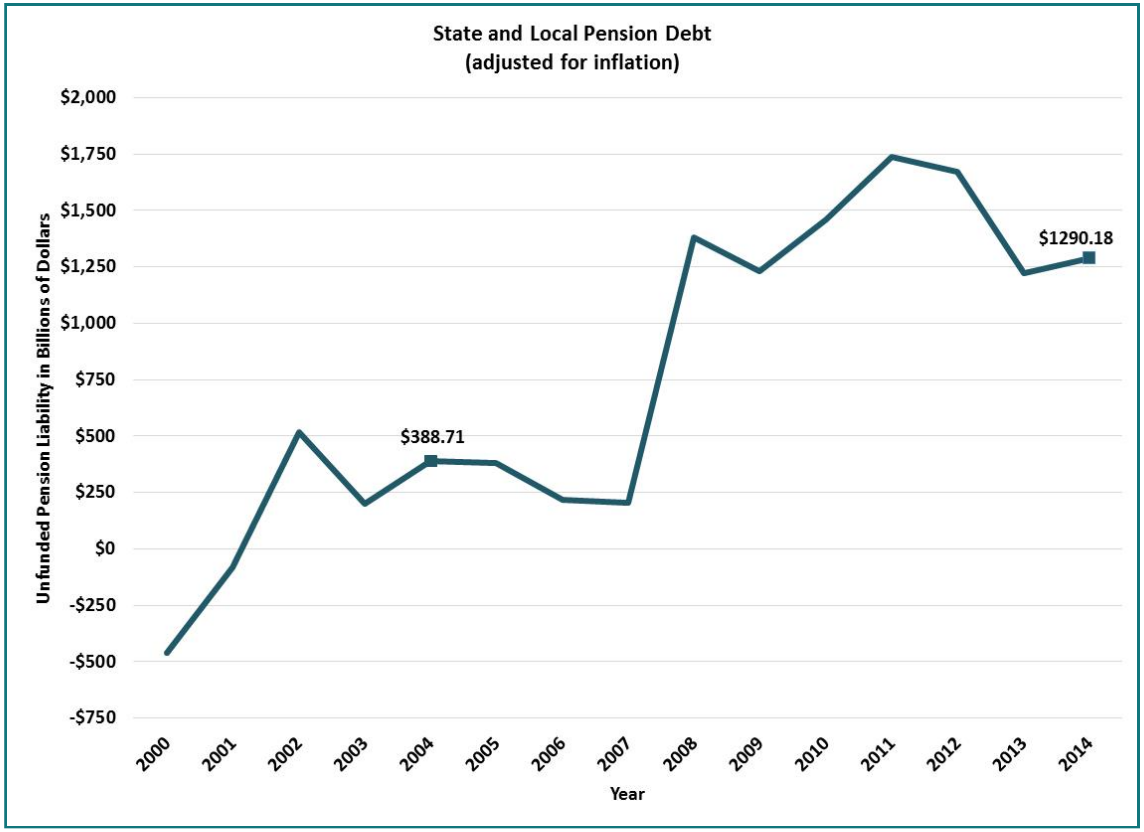
As a result, rising pension costs, particularly pension debt service costs, are straining state and local budgets. Services have been cut, and workers have been forced to endure benefit cuts, wage freezes, and job reductions.

By taking steps to address the issue today, we can prevent a crisis tomorrow.

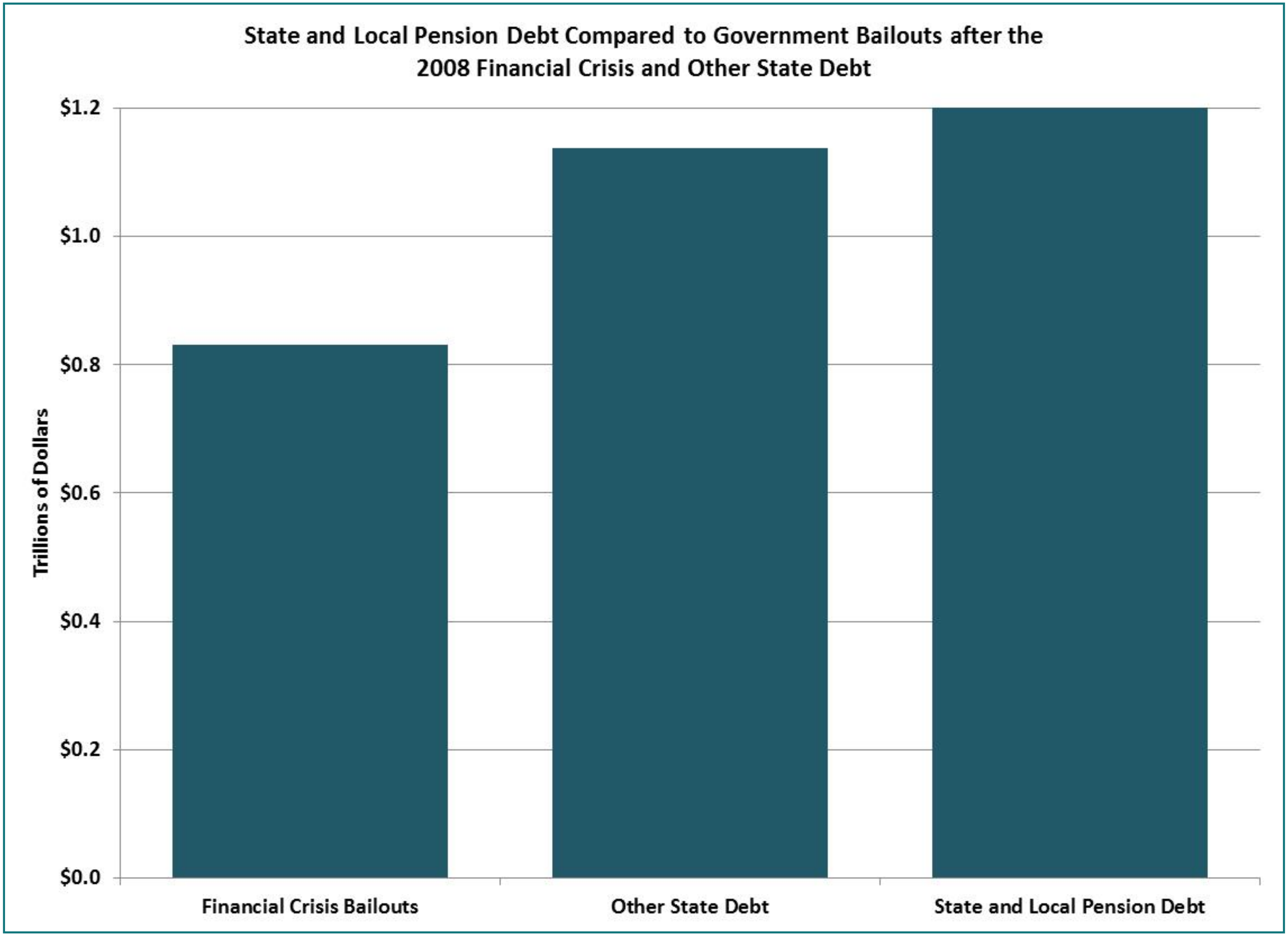
What is the current situation?

The plans' own estimates show that public pension debt has more than tripled over the last decade.

State and local governments owe public workers at least $1.29 trillion for retirement benefits they have already earned.

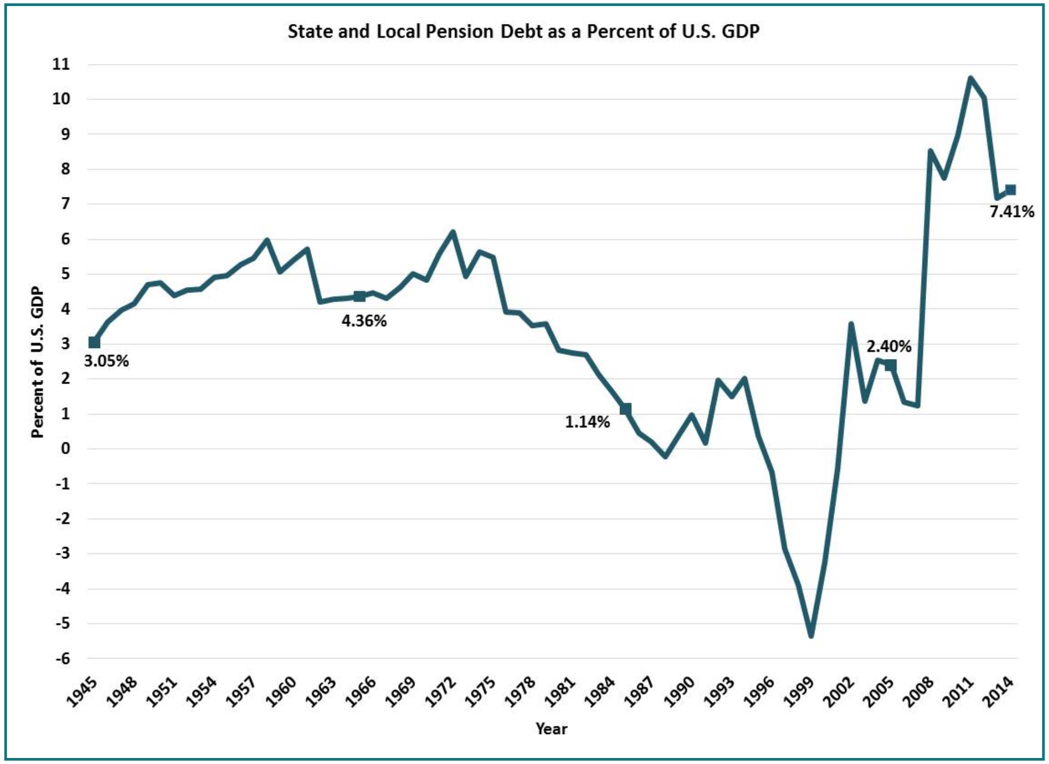


The plans' own estimates show that pension debt is now larger than all of the financial crisis bailouts and even other state debt.

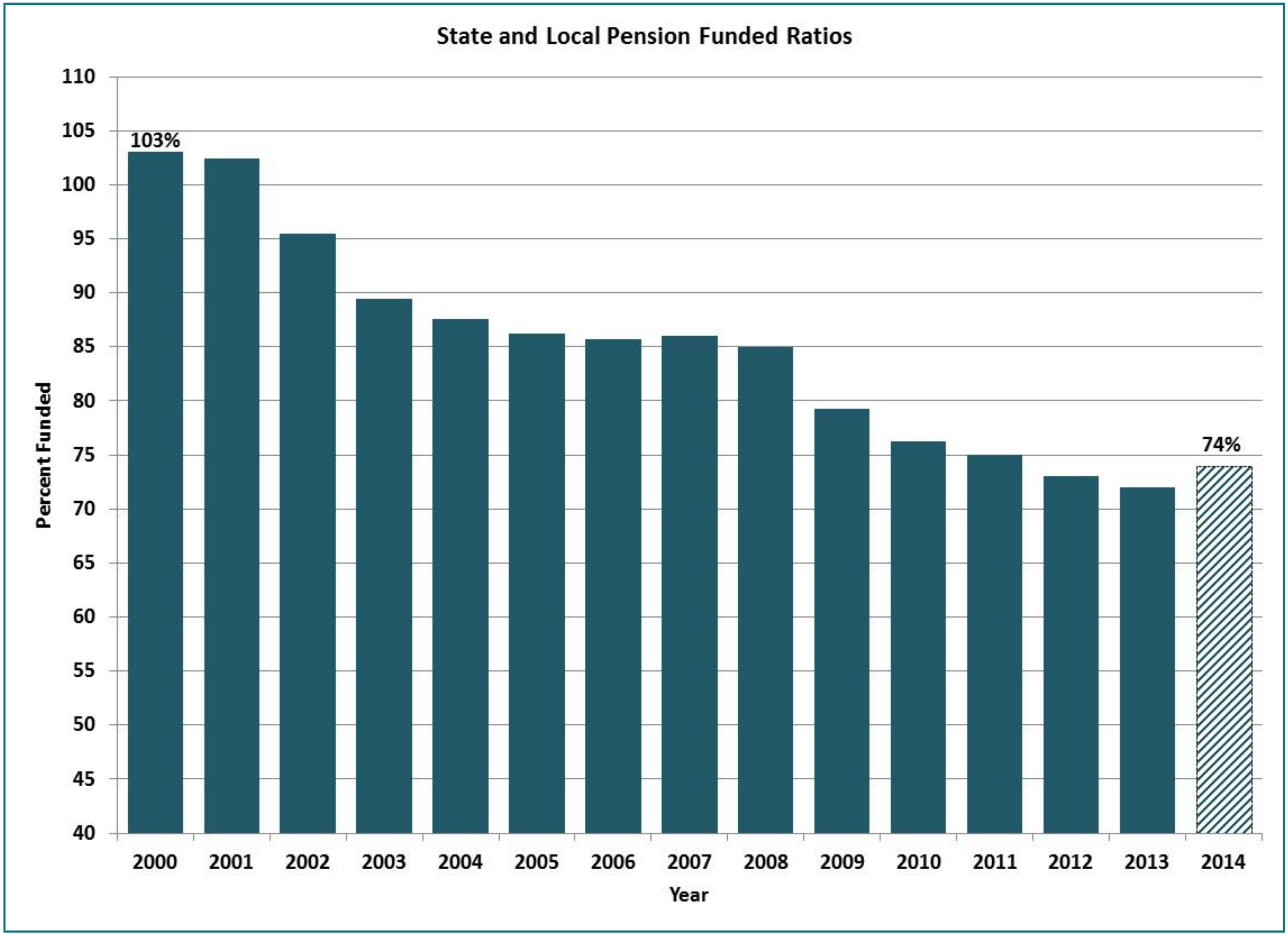


The plans' own estimates show that public pension debt is now larger than it has ever been.

Public pension debt is larger than it has ever been relative to the size of the U.S. economy even after the market recovery that followed the 2008 financial crisis. And the volatility of pension financing has increased dramatically since the mid 1990s.

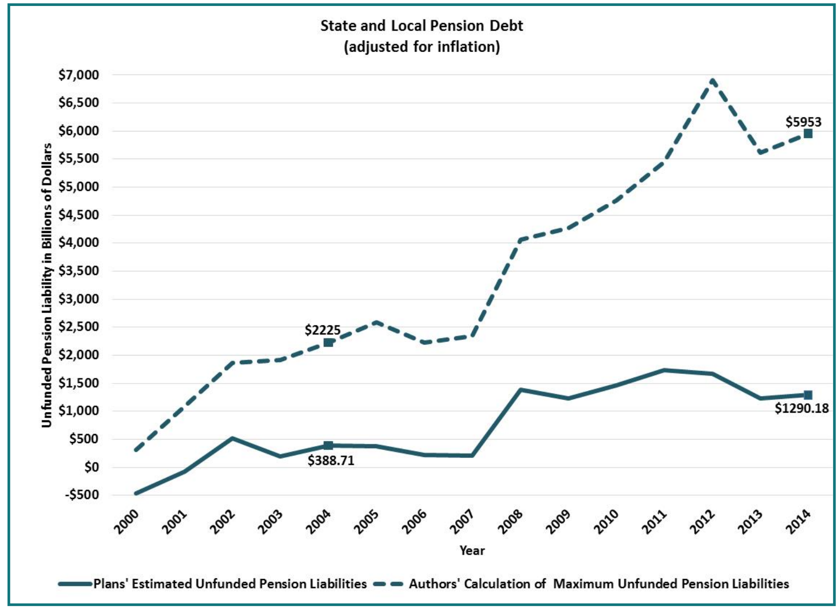


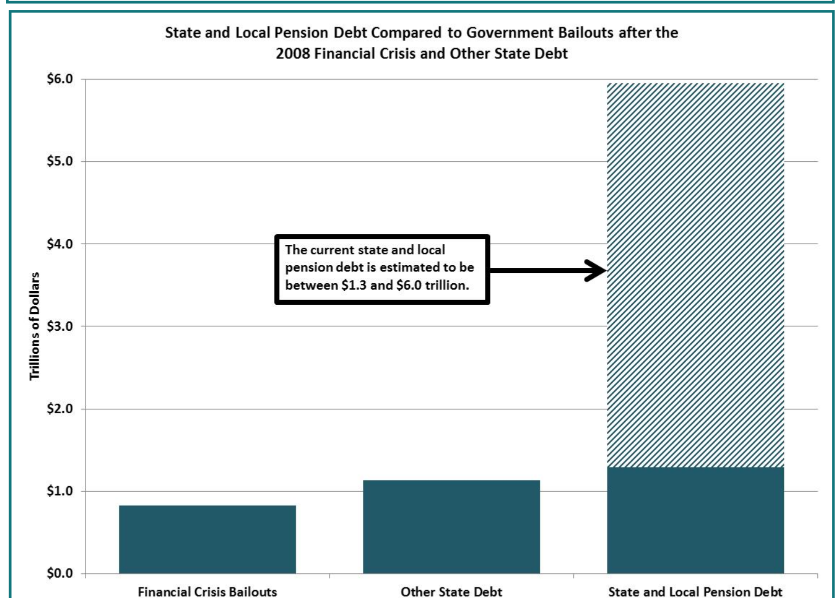
On average, public pension plans are only 74 percent funded, putting workers' retirement security at risk.



State and local governments' pension debt exposure could be much larger.

Pension accounting rules allow governments to discount liabilities using relatively high interest rates (e.g., 7 to 8 percent), but since the rate of return is uncertain, the cost of financing pension liabilities could turn out to be much higher. The true size of the current pension debt could be as high as $6.0 trillion if liabilities were discounted at the risk-free rate. And paying off the pension debt could cost up to 6.5 times more than all of the financial crisis bailouts or 4.5 times more than all other state debt.

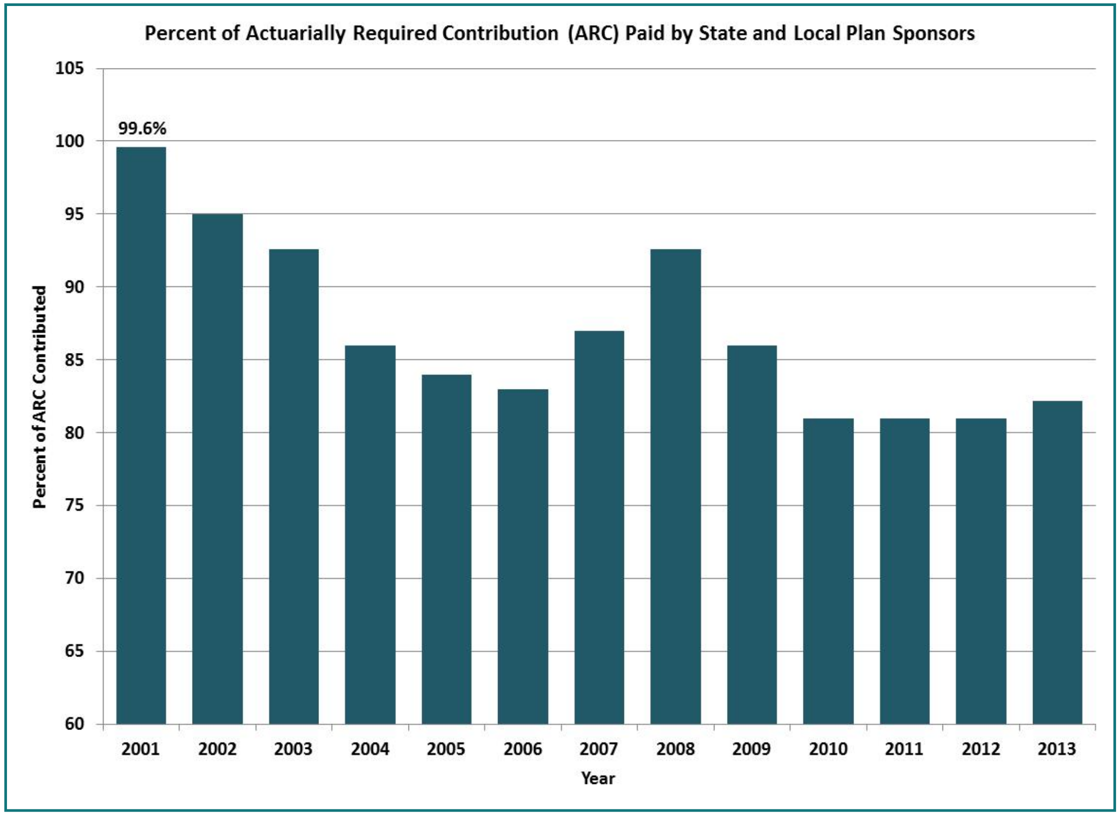




The current situation cannot all be blamed on the 2008 financial crisis. Other factors that governments control have played an even greater role in eroding pension plans' finances. These include poor funding practices and retroactive/ unfunded benefit increases.

Funded ratios are declining because governments are not adequately paying for their retirement promises.

Only 14 states paid at least 90 percent of their actuarially required contribution (ARC) between 2001 and 2012. Inadequate contributions and negative amortization account for at least $250 billion of the pension debt.

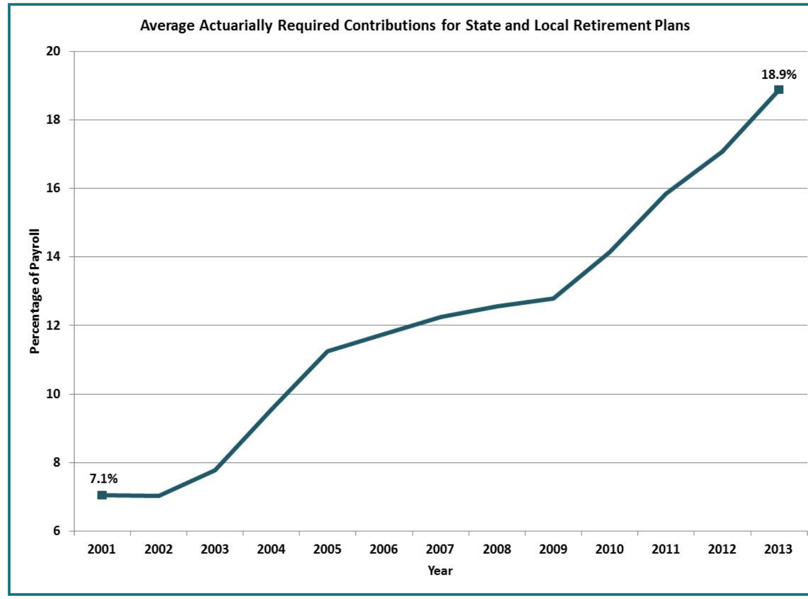


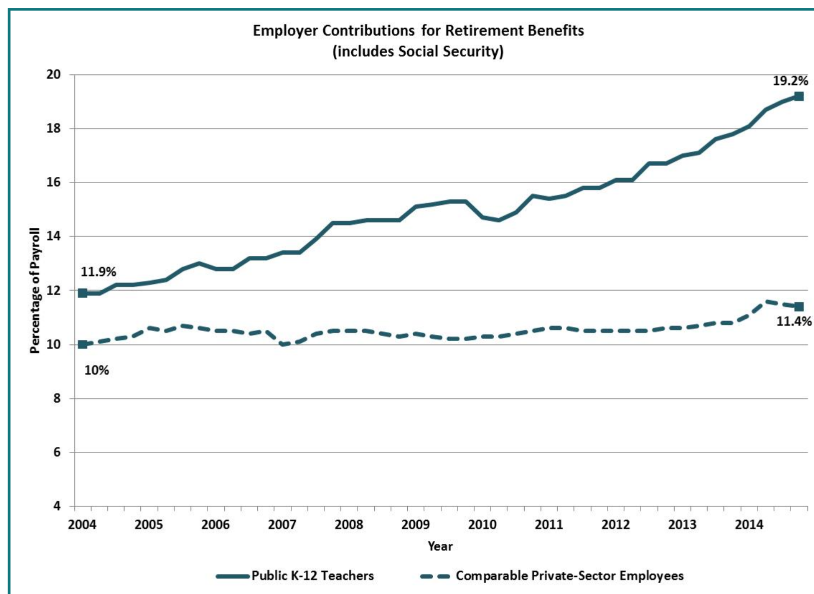
Throughout the 1990s, state and local governments increased benefits without credible plans to pay for the increases.

In 1999, CalPERS, the largest pension plan in the country, advocated for a large retroactive benefit increase claiming that it would not cost “a dime of additional taxpayer money.” Since 2000, CalPERS annual required contributions have increased by more than 20 fold, and the plan’s unfunded liability is more than $57 billion.

Rising retirement costs are making it difficult to adequately fund essential public services.

Retirement contributions have more than doubled, primarily for benefits workers have already earned, which leaves less money for public workers and services. This is especially true for public schools, where rising retirement costs are limiting the funds for today's classrooms and teachers' salaries.





Public leaders are voicing their concerns about the effects of rising retirement costs.

"… we coped with those rising {pension} costs by reducing our workforce … we cut services in every part of the city. There's no department that escaped the cuts … we laid off firefighters, we laid off cops, we laid off librarians. We cut, cut, cut for a decade…"
-San Jose Mayor Chuck Reed

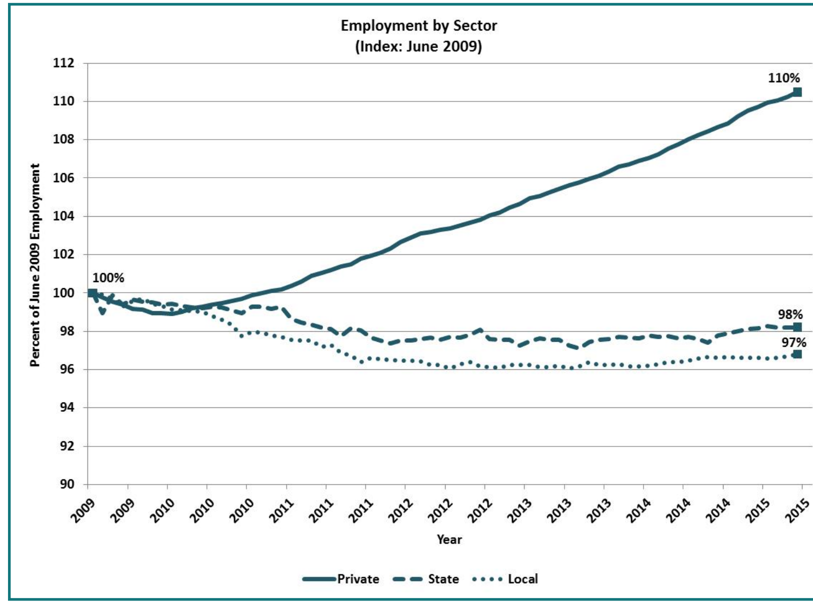
"We are not yet at the point where we are making decisions about {whether} we are going to pay for pensions or plow roads, but it is very close to that."
-Syracuse Mayor Stephanie Miner

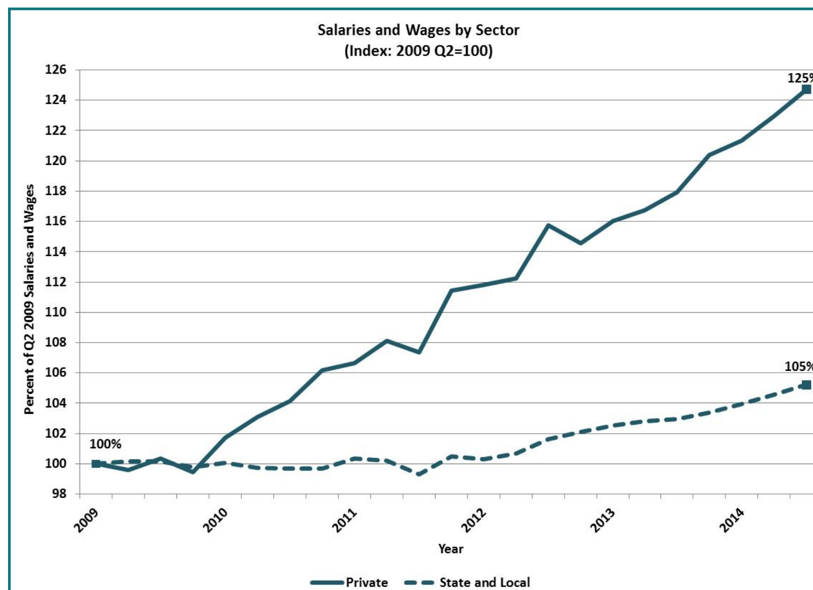
"Without {pension} reform, we cannot make the critical investments in our future and the future of our children. Without reform, we cannot be the city that we want to be."
-Chicago Mayor Rahm Emanuel

When public retirement systems are underfunded, workers pay the price.

Governments are paying more for legacy costs, leaving less money for current and future workers.

While private sector wages and jobs are growing, there are fewer teachers, police officers, firefighters, and other public workers in our communities today. And those that are on the job often have not received a pay raise in many years and have seen benefits reduced. These trends are at least partially explained by the downward pressure created by rising retirement costs.





In cases of extreme fiscal mismanagement, some cities have filed for bankruptcy.

Workers lose the most in these instances even if pensions are only a contributing factor and are not the primary cause of insolvency.

City	Consequences for workers and retirees
Vallejo, CA (filed 2008)[1]	Slashed salaries and retiree health benefits, raised employee contributions
Prichard, AL (filed 2009) [2]	Stopped providing retirees' benefits
Central Falls, RI (filed 2011) [3]	Cut retirees' current benefits by up to 55 percent
San Bernardino, CA (filed 2012) [4]	Ceased pension payments to CalPERS for an entire year
Stockton, CA (filed 2012)[5]	Trimmed retirees' health insurance, reduced the workforce, and eliminated senior centers, library programs, and recreational services
Detroit, MI (filed 2013) [6]	Cut retirees' benefits by 4.5 percent for general workers and diminished annual cost of living adjustments for retired police officers and firefighters

What does this mean for the future?

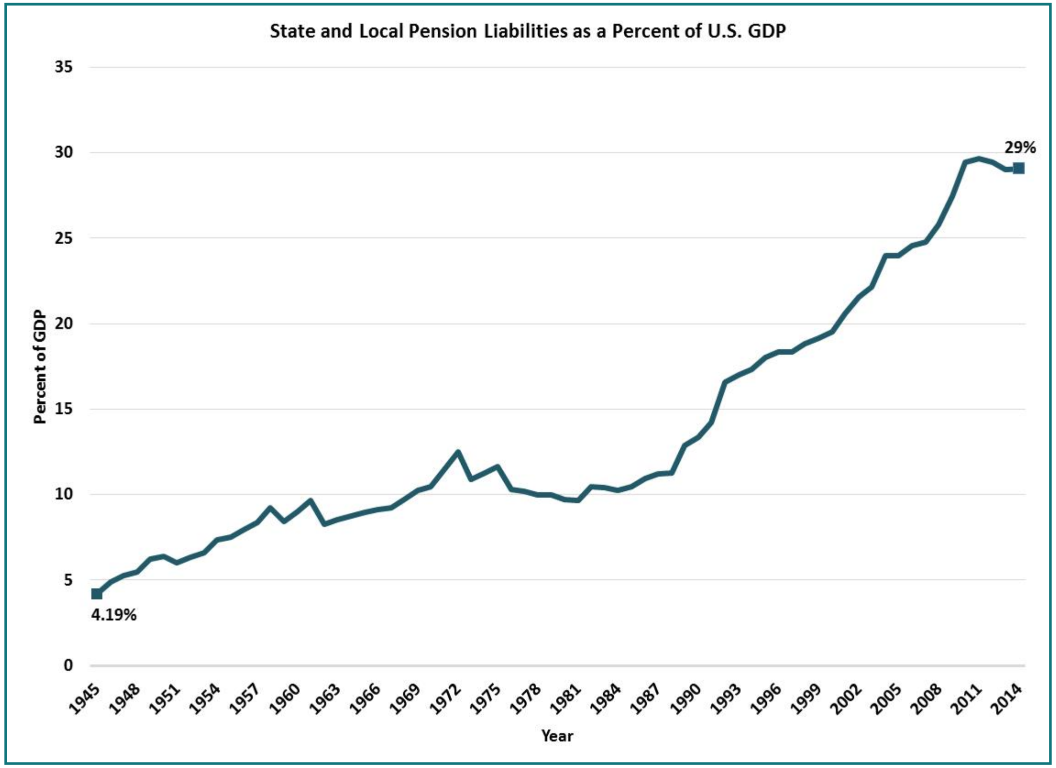
While recent pension reforms and strong market returns have produced improvements, public pension systems remain in a very precarious position.

Governments' plans to pay off the current pension debt do not cover principal and interest in the short term, and so the pension debt is anticipated to grow even larger over the coming decade.

In many cities and states, paying down the current pension debt could be manageable on its own, but it will be very difficult for governments to weather even a slight economic downturn.

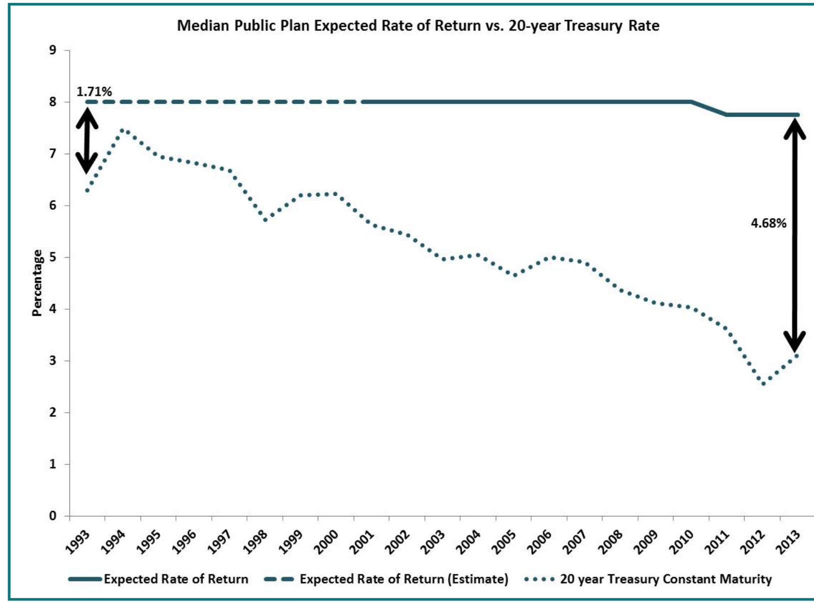
Government pension promises are now 29 percent of U.S. GDP.

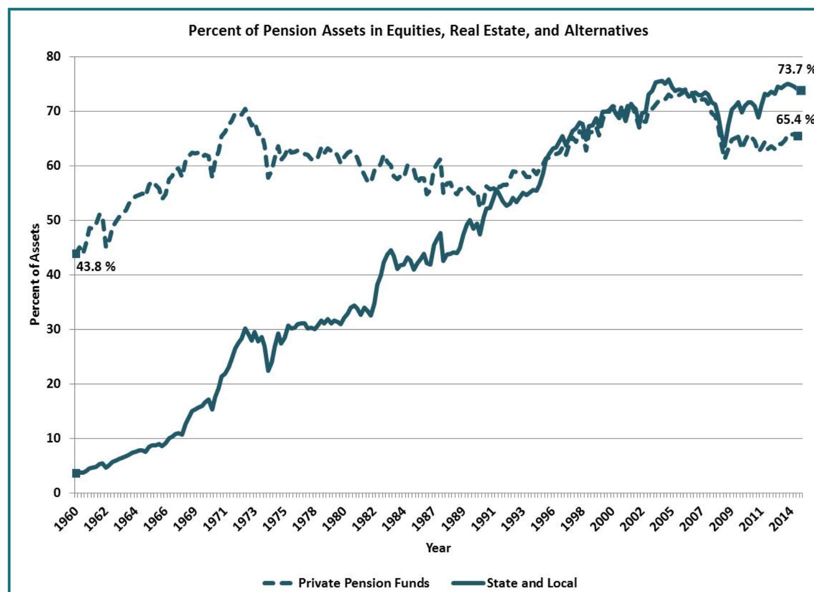
Public retirement promises are larger relative to the size of our economy than they have ever been, resulting in a reduced ability to pay for downside risk. So minor investment return shortfalls can translate into serious budgetary pressure.



Governments are making riskier bets with workers' retirement savings.

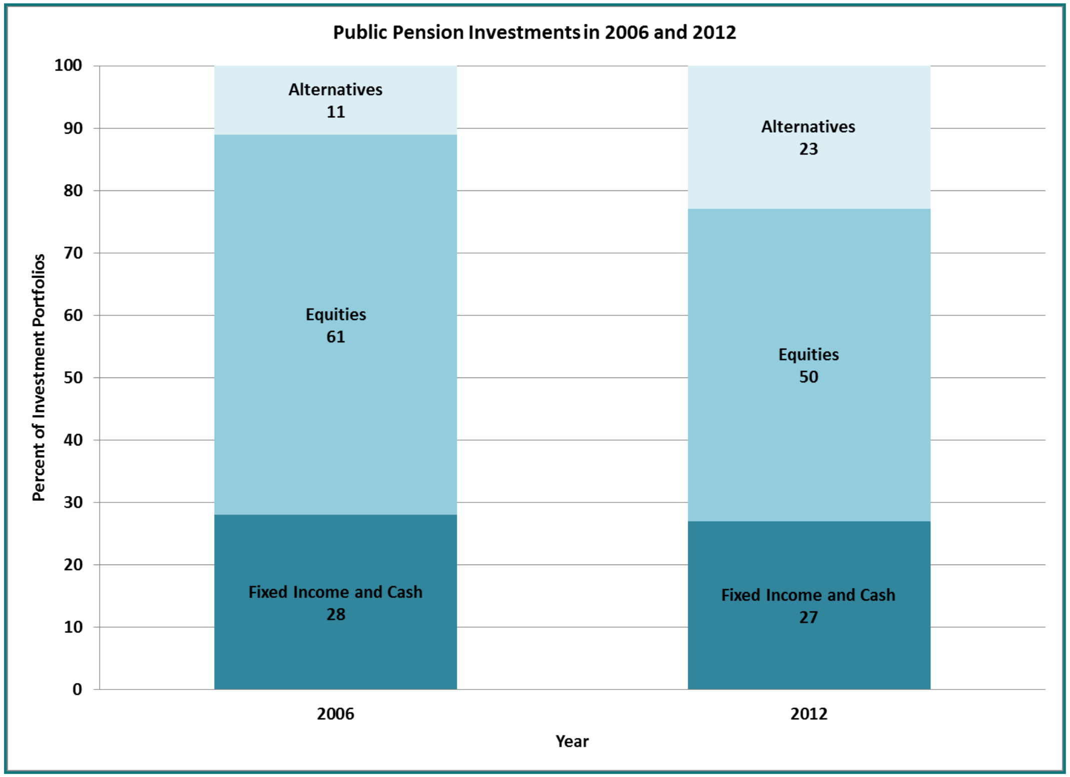
Public plans are expecting markets to yield a return that is almost three times larger than it was in the early 1990s relative to risk-free rates. To achieve this return, plans are investing in riskier assets. The share of assets invested in equities, real estate, and alternatives is close to the all-time high.





Since 2006, public retirement plans have more than doubled the share of assets invested in alternatives.

Alternatives, like hedge funds and private equity, are hard to value, have uncertain returns, and have higher fees. As plans have increased their holdings of risky assets, money management fees have increased by 30 percent.



The combination of a large and growing pension debt, governments' reduced ability to pay, and riskier investments will continue to strain state and local budgets.

If costs continue to rise, workers will bear a significant share of the pain just as they have over the past decade.

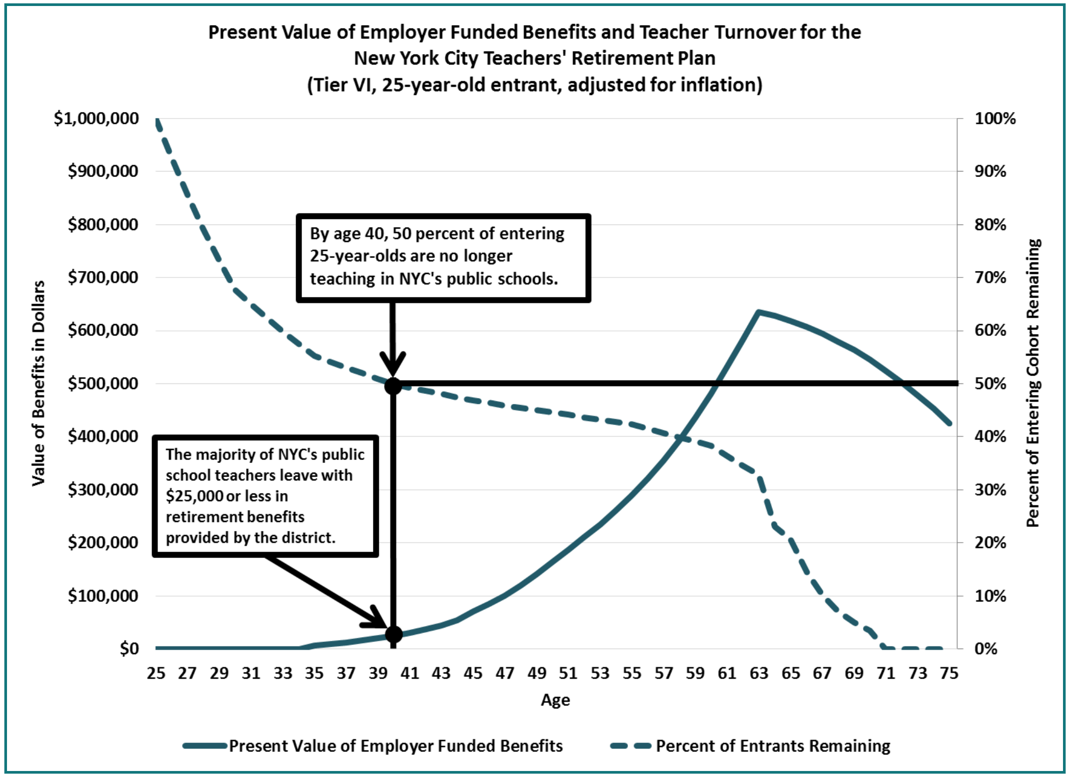
Is the structure of retirement benefits a problem?

The vast majority (91 percent) of public workers earn retirement benefits under a defined benefit system based on final average salary and years of service (FAS DB).

FAS DB plans generally provide a good benefit to workers who spend their entire career in the same industry and geographic area.

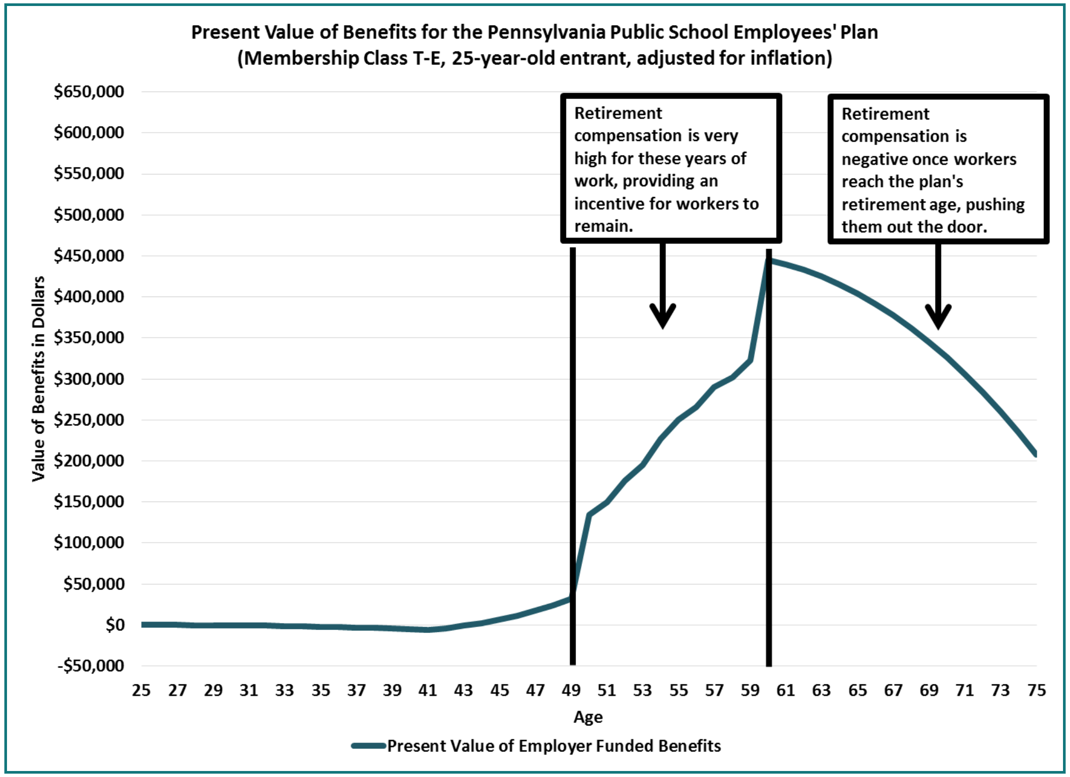
Under many plans, the majority of workers leave before earning a substantial benefit.

FAS DB plans leave many workers without enough savings for a secure retirement: those who work less than a full career in the public sector, take time off for family, or move to another city or state.



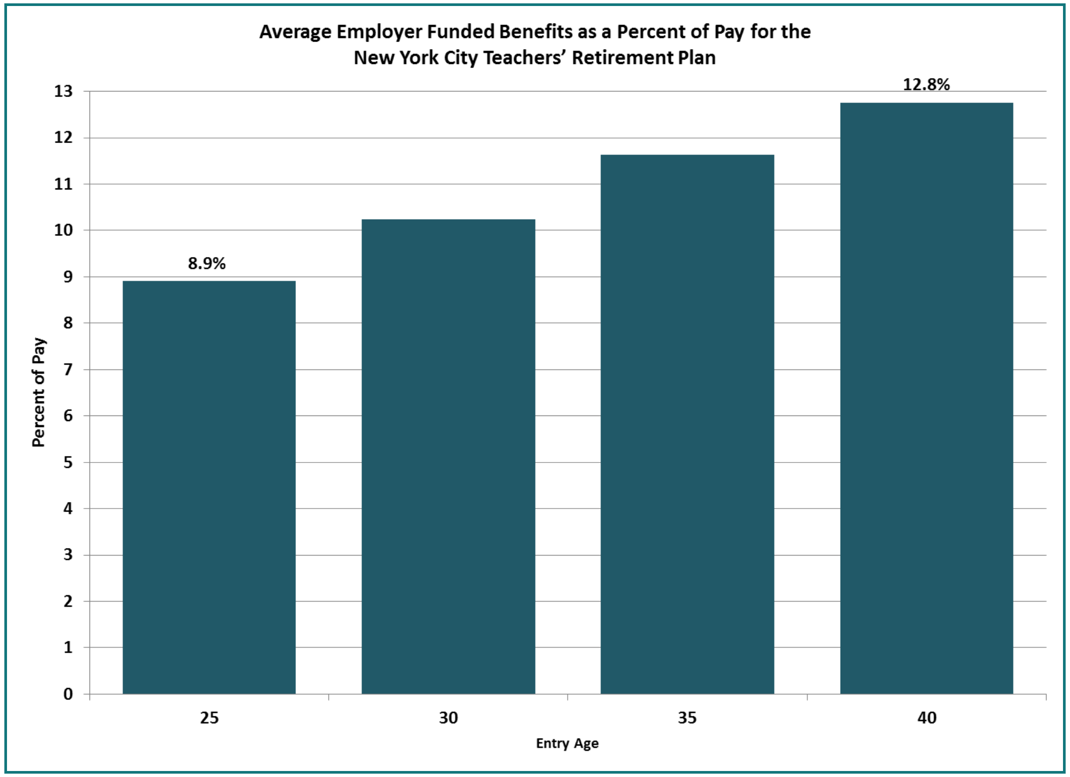
FAS DB plans pull workers into a plan's retirement age and push them out thereafter.

The FAS DB structure gives workers the incentive to work only until the plan's retirement age and then to retire regardless of their desire to keep working or performance.



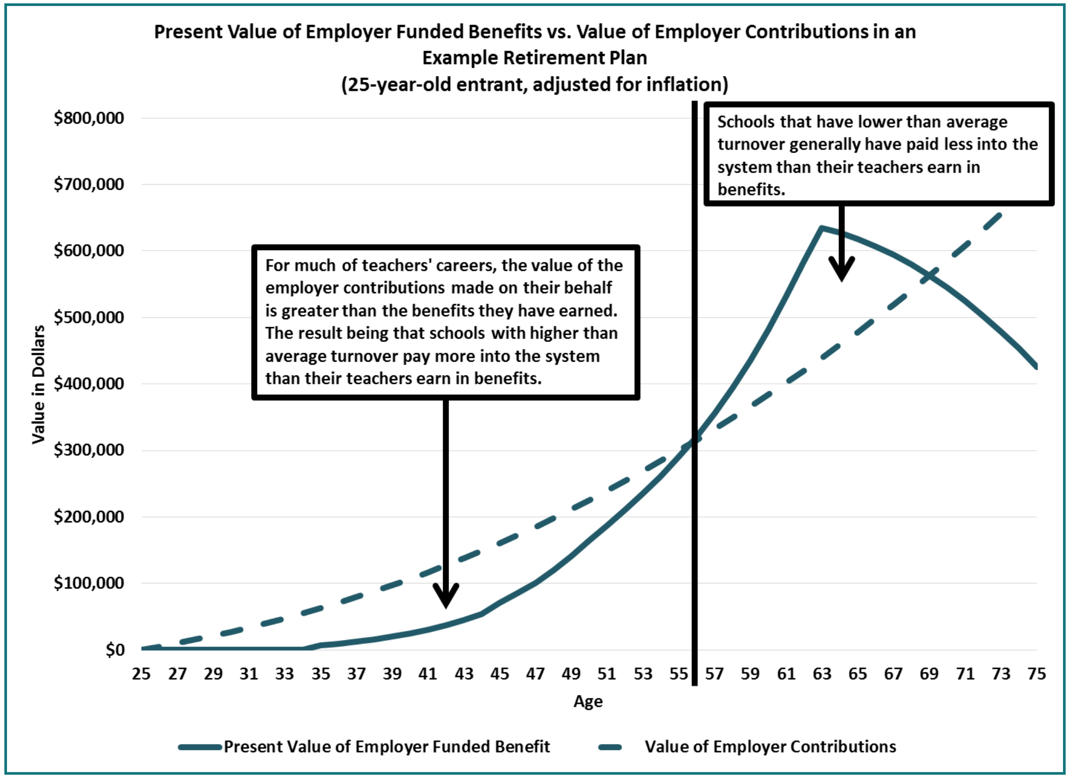
FAS DB systems give higher retirement compensation to workers who enter employment at older ages.

The FAS DB structure disproportionately rewards workers who begin their public service at older ages and those who move into highly paid, white-collar positions.



Schools/districts with higher-needs students often subsidize suburban teachers' retirements.

In many states, urban schools have a disproportionate number of new/ inexperienced teachers. As such, they pay more into current pension systems than their workers get back in benefits, while the opposite is true of their suburban neighbors.



FAS DB plans are challenging to manage sustainably because they are very complex, and cost is uncertain, hard to predict, and difficult to understand.

Given that benefits will be paid in the distant future, FAS DB plans give politicians the opportunity and incentive to avoid making responsible payments.

Although retirement planning will always involve uncertainty, governments can make public plans simpler and more transparent while also placing all workers on the path to retirement security.

What should pension reform seek to accomplish?

Pension reform should establish:

- A fair, workable plan to pay down the accumulated pension debt as quickly as possible.
- A retirement savings system that is affordable, sustainable, and secure.

LJAF's
retirement design principles
can be used to guide
responsible reform efforts.

Retirement savings plans should incorporate principles in three key dimensions:

- Retirement Security
- Fiscal Sustainability
- Transparency and Accountability

Retirement Security: Retirement savings plans should place all workers, regardless of tenure or when they were hired, on a path to a secure retirement.

Workers must:

- Accumulate adequate retirement savings across their entire careers.
- Have access only to professionally managed, low-fee investment options with appropriate asset allocation.
- Have access to lifetime income options (annuities) upon retirement.

Fiscal Sustainability: Retirement savings plans should remain financially sustainable across multiple generations of workers and taxpayers.

Plan sponsors must:

- Fully pay for their retirement promises in a responsible, sustainable way.
  - Establish a funding target of at least 100 percent.
  - Adopt closed amortization schedules of 20 years or less.
  - Adopt a discount rate for funding that is based on the risk-free rate plus an explicit risk premium.
- Pay the full actuarial cost every year.
- Use appropriate assumptions, which consider the sponsor’s ability to pay for future shortfalls.
- Be informed about the potential for and have an ex ante plan to deal with cost uncertainty.

Transparency and Accountability:

Retirement savings plans must have governance structures that ensure key decisions related to investment allocation, benefit design, and choice of actuarial assumptions represent the interests of all stakeholders and are made in a transparent and publicly accountable fashion.

Plans must have:

- Representative boards of trustees with a fiduciary duty to preserve plans' long-term sustainability.
- Independent boards of investment experts.
- A process to openly share data about the plan, its participants, and its fiscal condition.

Which plan design is best?

There is no one-size-fits-all solution. A variety of plans can be tailored to meet LJAF's design principles, including FAS DB, Hybrid, Cash Balance DB, and Defined Contribution.

Retirement plan design does not run on a smooth continuum from FAS DB to Defined Contribution, with the former offering workers the most protection and the latter the least.

All plan designs can incorporate important protections for workers including:

- Adequate savings/benefit accrual rates.
- Pooled, professionally managed, low-fee, and appropriately allocated investments.
- Limited lump sums and annuities upon retirement.

While all plan types can be designed to meet LJAF's design principles, Cash Balance and Defined Contribution represent the simplest, most transparent models for providing secure retirement benefits.

Cash Balance and Defined Contribution plans tie benefits more closely to contributions and investment returns, eliminate unnecessary variables from cost estimation, and allow governments to more flexibly and transparently offer workers investment and longevity protection.

Who is leading pension reform efforts?

Public pension reform is a bipartisan issue. Elected officials on both sides of the political aisle have recognized that reform is needed to protect workers and essential public services.

Notable champions of responsible pension reform include:

- Treasurer Gina Raimondo (D), Rhode Island
- Mayor Chuck Reed (D), San Jose, CA
- Governor Steve Beshear (D), Kentucky
- Mayor Rahm Emanuel (D), Chicago, IL
- Mayor Kasim Reed (D), Atlanta, GA
- Treasurer David Lillard (R), Tennessee
- State Senator Dan Liljenquist (R), Utah

Public workers and taxpayers deserve a public retirement system that places all workers on the path to retirement security, is fiscally sound, and is managed in a transparent and publicly accountable manner.

SOURCES AND NOTES

Slide 8:
Chart Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors.

Slide 9:
Chart Source: U.S Treasury Department (Financial Crisis Bailout), U.S, Census Bureau, 2012, Census of Governments: Survey of State Government Finance (State Debt), Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors (Pension Debt).

Slide 10:
Chart Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, U.S. Department of Commerce: The Bureau of Economic Analysis (BEA), and authors' calculations.

Slide 11:
Citation: Munnell, Alicia H., Jean-Pierre Aubry. 2015. The Funding of State and Local Pensions: 2014 – 2018. *Center for Retirement Research at Boston College,* Number 45.

Chart Source: Public Plan Database, Center for Retirement Research at Boston College, and authors' calculations.

Note: Authors estimate the weighted average across state and local plans. Sample consists of 109 state-administered plans and 17 locally administered plans.
2014 involves projections for about one third of plans.

Slide 12:
Citation: Novy-Marx, Robert, and Joshua D. Rauh. 2009. "The Liabilities and Risks of State-Sponsored Pension Plans." Journal of Economic Perspectives, 23(4): 191-210).

Chart 1 Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, Selected Interest Rates (H.15) release, Federal Reserve Board of Governors, and authors' calculations.

Chart 2 Source: U.S Treasury Department (Financial Crisis Bailout), U.S, Census Bureau, 2012, Census of Governments: Survey of State Government Finance (State Debt).

Note: Adjusted unfunded liabilities based on 15 year average liability duration rediscounted using the 20-year treasury bond yield.

Slide 14:
Citation: Munnell, Alicia H., Jean-Pierre Aubry. 2015. The Funding of State and Local Pensions: 2014 – 2018. *Center for Retirement Research at Boston College,* Number 45.

Text Source: The Pew Charitable Trusts' Public Pension Dataset and authors' calculations (ARC payments). The Public Plans Database at the Center for Retirement Research, and authors' calculations (inadequate contributions).

Chart Source: The Public Plans Database at the Center for Retirement Research, and authors' calculations.

Note: The Pew Charitable Trusts' Public Pension Dataset contains data from public plans' Comprehensive Annual Financial Reports (CAFR) and actuarial valuations.

Note: Authors' used data from the Public Plans Database to estimate the weighted average across State and local plans. Sample consists of 109 state-administered plans and 17 locally administered plans.

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Slide 16:
Text Source: Public Unions Take on Boss to Win Big Pensions, *The New York Times,* May 21, 2011, http://www.nytimes.com/2011/06/22/business/22union.html, the Pew Charitable Trusts' Public Pension Dataset and authors' calculations.

Slide 17:
Chart 1 Source: Public Plan Database, Center for Retirement Research at Boston College, and authors' calculations.

Note: Shown is the weighted average across state and local plans. Sample consists of 109 state-administered plans and 17 locally administered plans.

Chart 2 Source: University of Arkansas, Department of Education Reform, Bureau of Labor Statistics (BLS), National Compensation Survey, Employer Costs for Employee Compensations, BLS estimates of SS coverage, http://www.uaedreform.org/downloads/2013/12/quarterly-employer-contribution-chart-update.pdf.

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http://www.cityofchicago.org/city/en/depts/mayor/press_room/press_releases/2013/october_2013/mayor_emanuel_presentsbalanced2014budgetproposaltocitycouncil.html.

Slide 20:
Chart 1 Source: U.S. Department of Labor: Bureau of Labor Statistics, and authors' calculations.

Note: Seasonally Adjusted. Data indexed to the trough of the recession, declared as June 2009 by NBER.

Chart 2 Source: U.S. Department of Commerce: Bureau of Economic Analysis, and authors' calculations.

Note: Seasonally Adjusted. Data indexed to the trough of the recession, declared as June 2009 by NBER.

Slide 21:
Table Sources:
[1]: http://money.cnn.com/2014/03/10/pf/vallejo-pensions/
[2]:
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[3]: Text Source: State and Local Pensions: What Now? by Alicia Munnell, *The Brookings Institution*, 2012
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[5]: http://nation.time.com/2013/07/25/the-wages-of-bankruptcy-stocktons-cautionary-tale-for-detroit/
[6]: http://www.freep.com/story/news/local/detroit-bankruptcy/2014/11/07/rhodes-bankruptcy-decision/18648093/

Slide 24:
Text Source: Public Plan Database, Center for Retirement Research at Boston College, and authors' calculations.

Note: Initial total pension debt is assumed to be $1.29 trillion with 62 percent of plans using a level percent and 38 percent using a level dollar amortization schedule.

Slide 26:
Chart Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, U.S. Department of Commerce: The Bureau of Economic Analysis (BEA), and authors' calculations.

Slide 27:
Chart 1 Source: Selected Interest Rates (H.15) release, Federal Reserve Board of Governors, the Public Plans Database at the Center for Retirement Research, and authors' calculations.

Chart 2 Source: Financial Accounts of the United States (Z.1) release, Federal Reserve Board of Governors, and authors' calculations.

Slides 28:
Chart Source: State Public Pension Investments Shift Over Past 30 Years. 2014. *The Pew Charitable Trusts and Laura and John Arnold Foundation.*

Note: Data originate from "*the Public 100*," a dataset collected by *Pensions & Investments.*

Slide 32:
Text Source: Snell, Ron (2010). "Pension Reform: Not Easy, but Worth It," State Legislatures, July/August 2010, 32-34 (http://www.ncsl.org/research/labor-and-employment/pension-reform-not-easy-but-worth-it.aspx).

Slide 34:
Chart Source: 2012 NYC Teachers' Retirement Plan Comprehensive Annual Financial Report (CAFR), Actuarial Valuations, and authors' calculations.

Slide 35:
Chart Source: 2012 Pennsylvania Public School Employees' Plan Comprehensive Annual Financial Report (CAFR) Reports, Actuarial Valuations, and authors' calculations.

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Slide 37:
Chart Source: Authors' calculations.

Slide 46:
Text Source: Report of the Society of Actuaries' Blue Ribbon Panel on Public Pension Plan Funding (https://www.soa.org/blueribbonpanel/).