Trends in America

Issue Brief | The Council of State Governments | November 2007

PUBLIC PENSION PLANS

Very few topics generate as much interest among both policymakers and the general public as a discussion on the financial viability of the United States' retirement infrastructure. Research indicates that every element of our nation's retirement architecture, both private and public, remains tenuous—a development that demands the focus of policymakers at every level of government.

Public pension plans are an important component of the U.S. economic architecture. This issue brief highlights the need for policymakers to focus on retirement systems, the finances of state retirement systems, several key developments and strategies employed in states across the country to bolster the finances of their pension systems.

The States Respond

The Status of State Retirement Plans

Consensus is growing across the country that more attention needs to be directed at developing a retirement infrastructure with the capacity to meet the needs of all Americans. The financial future of state retirement systems requires the urgent attention of policymakers.

Though states are in considerably better financial shape than earlier this decade—when they faced their worst financial downturn in 60 years—there are ominous signs that point to another economic downturn. Current state revenues lag long-term historical trends, and a number of states are already signaling the onset of budget shortfalls. States now face surging expenditures for health care, education, retirement systems, corrections, transportation, emergency management and infrastructure. The unfunded liability in public pension plans remains yet another item on the menu of expenditure categories that will continue to haunt states in the coming years.

A review of national financial and demographic trends reveals that the U.S. retirement architecture faces serious challenges. The weaknesses in public retirement systems, combined with the looming shortfalls expected in Social Security and Medicare, and the precarious financial position of the federal Pension Benefit Guaranty Corporation create troubling situations for states. Also adding to the mix are corporate pension plans, the low personal savings rates of most Americans, and high rates of consumer and household debt.

Finances of State Retirement Systems

Recent research indicates the majority of public pension plans are underfunded or unfunded (i.e., assets are less than the accrued liabilities). According to a 2004 Council of State Governments Southern Legislative Conference 50-state report titled *America's Public Retirement Systems: Stresses in the System*, 68 of the 93 plans for which information was secured were underfunded. In 2006, Barclays Global Investments calculated the total value of the benefits promised by states would grow 22 percent to $2.5 trillion if state pension plans were required to use the same methods as corporations. States have set aside only $1.7 trillion to pay those benefits.

According to the 2007 Wilshire Report on 125 state retirement systems, the actuarial value funding ratio of plans declined from 103 percent in 2000 to 88 percent in 2006. Finally, according to the September 2007 survey of 125 plans by the National Association of State Retirement Administrators, the actuarial funding ratio of public pension plans stood at 86 percent with a cumulative unfunded liability of $381 billion, an increase from the $337 billion level recorded the year before. These different statistics cumulatively demonstrate that currently public pension plan liabilities currently exceed their assets.

However, it should be noted that in 2007 the assets in several public retirement plans did exceed their accrued liabilities. Specifically, according to a February 2007 Standard & Poor's report, five state retirement systems saw an actuarial funding ratio greater than 100 percent. These five state retirement systems were Florida (107 percent), North Carolina (106 percent), Oregon (104 percent), Delaware (102 percent) and Georgia (100 percent). At the other end of the spectrum, the five states with the lowest funded pension plans were West Virginia (47 percent), Oklahoma (57 percent), Connecticut (58 percent), Illinois (58 percent) and Rhode Island (59 percent).

Key Public Pension Trends

State plans are increasingly investing in nongovernmental securities, such as corporate bonds, stocks and foreign investments, and moving away from government securities such as U.S. Treasury bills. In 1993, only 62 percent of the total cash and investment holdings of public plans were in nongovernmental securities. That investment grew to 88 percent in 2006. Several states have moved to allow their pension plans to invest more heavily in nongovernment securities such as in the equity market, real estate and foreign securities. For instance, in the last few years, 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.

Given recent accounting and corporate scandals and the significant losses experienced by public retirement systems, state lawmakers are more closely monitoring the performance and management of these public systems. For instance, California's retirement plan, the largest public pension system in the U.S., announced in October 2007 that it was pressuring the Sara Lee Corporation to grant its shareholders more clout in changing company bylaws. In Maryland, after the state's employee pension system lost one-fifth of its total portfolio in a 15-month period, 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 a complete overhaul of the plan's structure. As a result of management changes and other reforms, Maryland's pension plan achieved the healthy growth rate of nearly 18 percent by the end of fiscal year 2007, the fourth consecutive year of growth.

The Governmental Accounting Standards Board Ruling 45 requires state and local governments to place a value on any "post-employee retirement benefits," such as health care. States and localities must also expense the annual contribution required to fully fund this long-term liability over 30 years. While the private sector has operated under similar rules since 1992, the provisions of the ruling took effect for state and local governments in 2007. Paired with rapidly rising health care costs, the explosion in unfunded liabilities as a result of this ruling is alarming. Experts project that cumulatively, state and local government liabilities for retiree health care amount to a staggering $1 trillion.

An increasing number of states have also either enacted legislation or are considering legislation prohibiting publicly managed funds, such as pension funds, to be invested in governments or companies associated with terrorism or other national security risks. In July 2006, Missouri became the first state to ensure that its public pension fund is "terror-free." Two dozen additional states either passed or considered similar legislation during the 2007 legislative sessions. In September 2007, California Gov. Arnold Schwarzenegger pledged to sign legislation forcing the state's two pension funds to shed holdings of all companies that have energy or military-related business in Iran.

State Pension Strategies

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

For instance, several states and localities have opted to issue pension obligation bonds to pay off their unfunded liabilities with a lump sum payment. Interest rates continue to hover at historically low levels and tax increases continue to be politically unpopular, so the opportunity to raise funds via enhanced borrowing quickly became an attractive strategy for several states. A number of states have deployed this strategy in the past few years and raised the following amounts via the pension obligation bond strategy to replenish their pension plans: California ($2 billion), Illinois ($10 billion), Kansas ($500 million), Oregon ($2 billion) and Wisconsin ($1.8 billion). The payable interest on the pension obligation bonds needs to be less than the pension investment earnings for states to benefit. For instance, if a state pension plan can earn 8 percent by investing money borrowed at 6 percent, the state comes out ahead. On the flip side, the market may not generate enough returns to cover the interest rate. In New Jersey, for instance, the state issued $2.8 billion in bonds to pay off its unfunded pension liability. But when the economy slumped and the stock market collapsed, the state experienced a severe drop in investment earnings. By mid-2003, even after the stock market had recovered, the state experienced returns of only 5.5 percent, significantly lower than the 7.6 percent it needed.

States are also dealing with the pension crisis by trimming benefits. Some states are moving employee benefits away from defined benefit plans. Alaska became the first state to move all state workers hired after July 2006 from defined benefit plans to 401(k)-style defined contribution accounts. Lawmakers in Illinois, Kentucky, Oregon and Virginia have introduced bills to adopt this strategy for state employees.

A few states are tinkering with the link between annual automatic percentage increases in pension payments and the

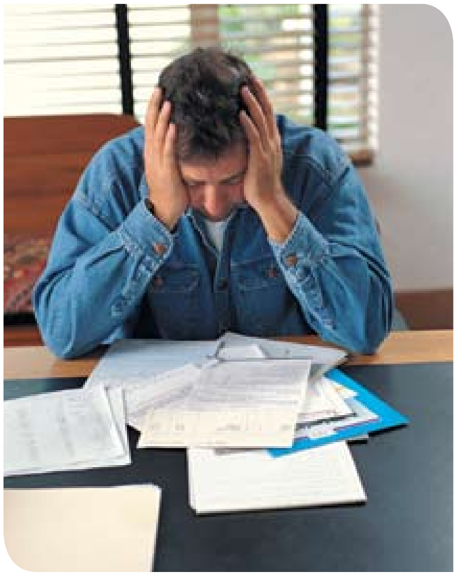
Cash & Investment Holdings of State & Local Government Employee Retirement Systems by State & Level of Government: Fiscal Years 1993, 1999 and 2006 (Dollars in Thousands)

	1993	1999	% Change 1993-1999	2006	% Change 1999-2006	% Change 1993-2006
United States	$920,571,814	$1,906,049,268	107%	2,896,965,114	52%	215%
State	$741,741,645	$1,581,779,624	113%	2,408,735,141	52%	225%
Local	$178,830,169	$324,269,644	81%	488,229,973	51%	173%
Alabama	$11,823,629	$21,677,232	83%	28,866,974	33%	144%
Alaska	$6,095,907	$9,782,827	61%	14,799,314	51%	143%
Arizona	$12,974,566	$30,317,176	134%	32,500,260	7%	151%
Arkansas	$5,412,022	$10,974,243	103%	17,616,485	61%	226%
California	$168,062,846	$323,298,333	92%	563,265,118	74%	235%
Colorado	$14,515,067	$22,785,624	57%	43,462,858	91%	199%
Connecticut	$11,089,818	$20,023,268	81%	28,562,577	43%	158%
Delaware	$2,236,158	$5,277,729	136%	6,135,813	16%	174%
DC	$2,136,629	$4,349,068	104%	6,494,734	49%	204%
Florida	$34,442,622	$82,561,986	140%	135,805,678	65%	294%
Georgia	$19,101,627	$42,870,979	124%	67,047,834	56%	251%
Hawaii	$5,036,156	$9,494,258	89%	12,681,533	34%	152%
Idaho	$2,190,558	$6,527,504	198%	9,618,449	47%	339%
Illinois	$42,889,924	$76,398,583	78%	126,956,280	66%	196%
Indiana	$7,909,641	$14,435,253	83%	27,672,065	92%	250%
Iowa	$6,484,147	$18,469,930	185%	23,449,948	27%	262%
Kansas	$4,246,029	$8,601,374	103%	13,627,374	58%	221%
Kentucky	$9,499,690	$22,162,266	133%	29,896,744	35%	215%
Louisiana	$11,265,735	$24,714,174	119%	33,165,473	34%	194%
Maine	$2,306,026	$6,901,936	199%	9,528,945	38%	313%
Maryland	$17,749,193	$39,078,626	120%	47,012,213	20%	165%
Massachusetts	$13,853,875	$38,626,867	179%	58,032,061	50%	319%
Michigan	$31,616,109	$68,579,060	117%	80,779,584	18%	156%
Minnesota	$18,702,864	$40,846,329	118%	52,089,647	28%	179%
Mississippi	$117,497	$13,294,761	11215%	24,081,088	81%	20395%
Missouri	$15,157,591	$32,002,742	111%	57,580,921	80%	280%
Montana	$2,181,531	$3,381,443	55%	7,068,244	109%	224%
Nebraska	$3,593,718	$6,689,440	86%	9,565,427	43%	166%
Nevada	$4,909,179	$11,126,568	127%	21,656,244	95%	341%
New Hampshire	$7,122	$3,991,857	55950%	5,251,746	32%	73640%
New Jersey	$27,282,124	$50,411,042	85%	57,430,047	14%	111%
New Mexico	$5,600,442	$11,499,926	105%	20,236,745	76%	261%
New York	$122,504,335	$204,568,749	67%	343,678,005	68%	181%
North Carolina	$21,316,986	$52,554,025	147%	67,729,781	29%	218%
North Dakota	$1,232,231	$2,531,824	106%	3,653,802	44%	197%
Ohio	$57,686,802	$94,330,530	64%	149,874,270	59%	160%
Oklahoma	$6,137,798	$14,188,085	131%	20,156,653	42%	228%
Oregon	$8,653,315	$17,479,470	102%	56,355,470	222%	551%
Pennsylvania	$39,689,227	$83,607,419	111%	103,314,191	24%	160%
Rhode Island	$515,963	$7,245,508	1304%	9,632,652	33%	1767%
South Carolina	$14,126,901	$18,565,873	31%	30,247,191	63%	114%
South Dakota	$1,901,500	$5,036,039	165%	7,300,075	45%	284%
Tennessee	$11,454,862	$28,382,345	148%	35,950,936	27%	214%
Texas	$45,964,742	$127,543,228	178%	167,531,478	31%	265%
Utah	$4,593,987	$11,398,687	148%	18,657,043	64%	306%
Vermont	$908,614	$1,997,292	120%	3,041,075	52%	235%
Virginia	$17,509,170	$43,470,398	148%	58,427,770	34%	234%
Washington	$17,195,454	$44,691,362	160%	59,593,696	33%	247%
West Virginia	$103,500	$3,792,905	3565%	3,894,750	3%	3663%
Wisconsin	$26,635,774	$60,063,438	126%	79,755,515	33%	199%
Wyoming	$1,950,611	$3,449,687	77%	6,232,338	81%	220%

Source: U.S. Department of Commerce, Bureau of the Census

Note 1: There were 2,213 public employment retirement systems in the 1993 survey, 2,209 systems in the 1999 survey and 2,654 systems in the 2006 survey.

Note 2: As of September 28, 2007, the 2006 (June 30, 2006) survey was the latest compilation of data on the cash and investment holdings of state and local government employee retirement systems.



Consumer Price Index (CPI). In 2006, Colorado agreed to maintain its defined benefit pension plan, but in turn employees agreed to forego scheduled cost-of-living raises—worth 3 percent of their income—and instead put the money into the pension fund. Also in 2006, Arizona informed thousands of its retired employees that they would not receive cost-of-living raises for the next five years.

Several states are adjusting the age at which employees are paid full benefits. Colorado increased its minimum retirement age by five years, from 50 to 55, in 2006. In Kansas, beginning July 1, 2009, the retirement age for state employees will increase to 60 with 30 years service or to 65 with five years service. Currently, Kansas employees can retire when their age plus years of service equals 85. In Illinois, the governor has proposed raising the age of retirement from 60 to 65. Similarly, Rhode Island Gov. Donald L. Carcieri has proposed instituting a minimum retirement age of 60 years at 30 years service or otherwise, at age 65. Texas passed legislation prohibiting school districts from offering early retirement and requiring educators to be at least 60 before retiring with full benefits. Louisiana has also proposed pushing back the age at which teachers can get retirement benefits. When states increase their retirement ages, they defer having to make pension payments while diminishing the growth rate of their accrued liabilities.

In a contrary approach, Maine became the first state to adopt a strategy known as matching, or deliberately aiming for low, guaranteed investment income to pay for the retirement benefits of state 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 how the markets fluctuate.

A few states are making unorthodox investments in an effort to generate greater returns for their pension plans. The Retirement System of Alabama embarked on a series of investments that enabled the fund to progress from $500 million in assets in 1973 to $28.1 billion by September 2006. Some of these acquisitions include New York City real estate, media outlets including television and newspapers, hotels, a cruise ship terminal and golf courses. The system also became the largest stakeholder of US Airways. Similarly, Massachusetts considered a proposal to open the state's public employee pension fund—$48.2 billion as of March 2007—to all state residents for investment purposes. And New Jersey considered shifting about a quarter of its $79.2 billion—as of June 30, 2006—pension fund from state employee control to professional money managers in 2006.

The Future of State Pensions

Unfunded and underfunded pension liabilities continue to plague nearly every state. Factors in the weakened pension outlook include skipped required state contributions, the severity of the recent fiscal downturn, demographic changes and the steep rise in health care costs. The implementation of the GASB ruling could propel unfunded pension liability levels to new heights beginning in 2007—a trend that could damage state bond ratings. Yet, the aging of American workers, the increased number of 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 actions by states. 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.

—Sujit CanagaRetna is a senior fiscal analyst at The Council of State Governments Southern Legislative Conference.

Trends in America

The most dominant characteristic of the 21st century is not just change, but the rate of change. Understanding change is the first step toward identifying and implementing effective responses. Trends in America Issue Briefs are designed to help state leaders promote positive change through forward-looking policies and strategic investments.