Stresses in the System: Trends in Public Retirement Systems

Introduction

It is a great honor to be here and my thanks to Chairman Robertson for extending this invitation to me and to The Council of State Governments' Southern office, the Southern Legislative Conference (SLC).

My remarks this afternoon will deal with the challenges confronting state and local government retirement systems in recent years. Primarily, I will draw on my research in preparing a 50-state review of our nation's public retirement systems (published in October 2004) and my ongoing research in this area. Lawmakers in almost every state grapple with unfunded pension liabilities and the urgent need to devise solutions to ensure the solvency of these retirement systems in an environment where state finances continue to be under stress. After providing a broad overview of the public retirement system landscape, including several emerging trends, I will detail a number of strategies adopted by states across the country to bolster the financial position of their respective pension plans.

Part I

Any discussion of the financial position of public retirement systems has to be placed in the context of the overall health of state finances. States are finally seeing improved revenue numbers and according to the latest data, revenue inflows in 23 states have exceeded estimates in the first eight months of the current fiscal year, 2005. Sales, corporate and personal income tax flows have all performed admirably. This is a marked improvement from the prior four years when states battled a fiscal downturn termed the worst in six decades. Since fiscal year 2001, states closed a cumulative budget gap that surpassed $235 billion by adopting a range of difficult choices.

While the revenue side of the balance sheet is now promising, unfortunately the expenditure side continues to pose serious dilemmas. In fact, the most recent data indicates that more than half the states, 31 specifically, are already reporting spending overruns for the first eight months of the current fiscal year. Medicaid and healthcare costs lead the way here and 23 states report that spending is exceeding appropriations in this category. In addition, expenses associated with education, including court-mandated expenditures, retirement systems, corrections, transportation and infrastructure needs are some of the areas continuing to burden state budgets.

Given the fact that state revenues plunged to such serious depths during the recent downturn and the fact that revenue increases trail the growth in expenditures, states will continue to face grim choices in the next few years. In fact, as states prepare their fiscal year 2006 budgets, 26 are already reporting shortfalls, totaling almost $25 billion cumulatively.

Part II

State retirement systems are one element in our nation's overall retirement architecture. There has been a great deal of discussion recently of the "graying" of America and the need to develop a retirement infrastructure to absorb the retirement needs of all Americans. As the Census Bureau figures released last week indicated, the elderly population in every state will grow faster than the total population, and seniors will outnumber school-age children in 10 states in the next 25 years.

Financial planners often recommend the "three-legged stool" concept in planning for retirement. Each leg of the stool is supposed to represent a source of income in retirement, and the goal is to cumulatively attain a standard of living at least comparable to the one experienced prior to retirement. In this analysis, if the first leg of the stool is Social Security income, the other two legs of the stool refer to personal savings and retirement or pension income. Unfortunately, a close review of national financial and demographic trends reveals that all three legs of this metaphorical retirement stool remain wobbly, a development that threatens to seriously jeopardize the retirement plans of a majority of Americans.

As states emerge from the severe financial downturn, policymakers now face the daunting challenge of dealing with weaknesses in public retirement systems. In many cases, these public retirement systems are underfunded at a time when the first wave of the nation's baby boomers are rapidly approaching retirement. In addition to weaknesses in these public retirement systems, as noted, other elements of the nation's retirement architecture remain extremely shaky as well. Specifically, the precarious financial position of corporate pension plans and the federal Pension Benefit Guaranty Corporation (PBGC); the looming shortfalls expected in the Social Security and Medicare programs in coming decades; and the low personal savings rates of most Americans, coupled with high rates of consumer and household debt.

<u>Part III</u>

The employee retirement systems of state and local governments remain a critical component of our nation's government sector. Not only do these retirement systems cover millions of public sector employees and provide current and future income for these retirees and employees, they contain significant investment holdings as well.

After suffering steep losses--losses from which these public pension plans still continue to reel--during the economic downturn of the early years of this decade and during the 2000-2002 stock market collapse, finally, most plans are seeing positive returns. Based on the latest federal data, the cash and investment holdings of state and local government employee retirement systems cumulatively reached $2.2 trillion in 2003, a very slight increase ($14 million) over the prior year. Just a decade ago, in 1993, total cash and investment holdings in these public pension plans amounted to about $921 billion. Propelled by the tremendous gains in equity investments in the late 1990s, these holdings accelerated to about $2.2 trillion by 2000 and have continued to hover at that level for the past four years.

In terms of receipts, comprising employee and government (both state and local) contributions and earnings on investments, after experiencing negative returns in both 2001 and 2002, these retirement systems saw positive gains in 2003. Interestingly, state government contributions to these retirement plans increased by $2.4 billion to $19.6 billion in 2003 after declining in 2002 and barely registering an increase in 2001; this is a reflection of the improved state fiscal picture. Yet, total receipts were less than half the amount secured in 2000 ($148 billion in 2003 vs. $297 billion in 2000).

During the recent fiscal downturn, a number of state and local governments slashed their regular contributions to their pension funds in order to balance budgets. In September 2002, North Carolina withheld $144 million in payments for this purpose. In Texas, the state cut its contribution to the Teacher Retirement System from 7.3 percent of employee pay to 6 percent.

On the payment front (benefits, withdrawals and other), there were steady increases; up from $100 billion in 2000 to $135 billion in 2003.

Finally, in 2003, there were a total of 2,657 plans (serving 17.6 million members) of which 218 were state plans and 2,439 were local plans. Pennsylvania and Illinois had the highest number of plans while Maine and Hawaii had the lowest number.

<u>Part IV</u>

My ongoing review of public retirement plans reveals several trends. First, the increasing move by these 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; ten years later in 2003, this percentage had ballooned to 77 percent. Several states made statutory changes to allow their pension plans to invest more heavily in the market; in 1999, Georgia approved an increase from 50 percent to 60 percent and just recently, the South Carolina Senate approved an increase from 40 percent to 70 percent.

Second, in the last few years, payments from these retirement plans have far outpaced receipts into the plans. For instance, between 2000 and 2001, payments increased by 12 percent while receipts shrank by 59 percent. Similarly, between 2001 and 2002, payments expanded by 9 percent while receipts dwindled by 105 percent. A significant portion of these payments are related to health care expenditures, a spending category that has experienced substantial growth in recent years. According to the federal Centers for Medicare and Medicaid Services, the torrid pace of growth in national health spending reached $1.7 trillion in 2003, the latest year available, and topped 15 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 was a great deal more activism on the part of the boards overseeing these plans <u>and</u> state lawmakers to monitor more closely the performance and management of state retirement funds. For instance, the California Public Employees' Retirement System (CalPERS), the nation's largest public pension plan, announced last year that it would withhold its vote for the chairman and two directors of Safeway (the grocery store chain) seeking re-election at the company's annual meeting. In explaining its rationale, CalPERS indicated that it was a reflection of the failure of the grocery chain's board to make shareholder-friendly moves such as expensing stock options and Safeway's $20 billion loss in shareholder value since 2001.

Then, 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 2004, this pension plan achieved the healthy growth rate of 16 percent.

Fourth, a number of research studies indicate that in the last few years, a vast majority of these public pension plans were underfunded to varying degrees, i.e., assets were 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. For instance, according to the latest (2005) Wilshire Report on state retirement systems, the funding ratio, or ratio of assets-to-liabilities, in both actuarial and market terms, has fallen dramatically. Specifically, the actuarial value funding ratio declined over the last five years from 103 percent in 2000 to 85 percent in 2004. Then, according to the latest (September 2004) survey of the National Association of State Retirement Administrators (NASRA), the average funding level for public plans stood at 88 percent. Finally, according to the October 2004 Southern Legislative Conference pension report, 73 percent, or 68 of the 93 plans for which information was secured, were unfunded to varying degrees.

Notwithstanding the fact that a majority of the plans reviewed were termed unfunded, several plans did secure an actuarial funding ratio greater than 100 percent. According to the NASRA survey, the North Carolina Teachers and State Employees System (112 percent), the Florida Retirement System (114 percent) and the New York State Teachers System (125 percent) were some of those plans. At the other end of the spectrum, Illinois' five retirement systems had the largest unfunded pension liability among the 50 states ($43 billion in 2003). At the local level, the city of San Diego had a $1.4 billion unfunded liability and the city of Houston faced a $1.9 billion shortfall.

<u>Part V</u>

In responding to the growing crisis associated with unfunded pension liabilities, lawmakers have pursued various strategies to bolster the finances of these systems.

- <u>Pension Obligation Bonds</u>: A strategy adopted by states and localities in the last decade or so involves issuing pension obligation bonds. Given their increasing fiscal problems, several states and localities issued debt to raise money to plough into their pension systems and pay off, in a lump sum in today's dollars, their unfunded liabilities. The fact that interest rates have been at historically low levels recently and the fact that 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 pay only 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 to replenish their pension plans include California ($2 billion), Illinois ($10 billion), Kansas ($500 million), Oregon ($2 billion) and Wisconsin ($1.8 billion). In June 2005, West Virginia voters will decide whether to approve a $5.5 billion pension bond offering. Former Governor Wise had sought to carry out this measure back in 2003 and the matter was referred to the courts, which ruled that voter approval was necessary.

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 in 1997 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 <u>and</u> 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. In 2003, New Jersey paid $163 million in debt service costs for the bonds and these costs will soar to as high as $508 million annually by 2022. The state will also have to inject $750 million in contributions to the state pension plan over the next five years. Consequently, along with repaying the $2.8 billion, the state's costs, including interest, will escalate to $10.3 billion. The city of Pittsburgh also suffered a fate similar to New Jersey's with its ill-timed pension bond offering in the late 1990s.

- <u>Trimming Benefits</u>:

  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. California Governor Schwarzenegger advocated this measure during his 2005 state of the state address but has since backed off from pursuing it given the howls of protest. Governor Sanford in South Carolina has also advocated this approach along with Governor Romney in Massachusetts. The Senate in Alaska also recently approved a shift to a DC plan.
  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 advocate this approach along with a New Hampshire House Committee.
  3. Adjusting the age at which employees are paid 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 wants to raise the age to 65. He also wants to change--from 60 to 65--the age at which state employees with 35 years service can retire with full benefits. Similarly, in Rhode Island, the governor wants to limit pensions 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 is considering legislation that would require workers to be at least 60 before retiring with full benefits. Louisiana has a proposal to push the age at which teachers can get retirement benefits to 60; currently they can retire at 55 after 25 years or at any age after 30 years.
  4. Reducing the percentage of pay a retiree gets for each year of work. According to a Rhode Island proposal, the maximum pension for a retired state worker or teacher would drop from 80 percent of an employee's three-year salary average after 35 years work to 75 percent after 38 years.
  5. 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 recently 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.

6. Ending lucrative retirement plans where certain state employees serve a brief period in select positions and secure a significant boost in pension income. Missouri recently eliminated its administrative law judge retirement system which allowed this practice.
7. Placing salary caps on state and local government retirees who return to work in government jobs. New Mexico recently enacted such legislation.

- Increasing Costs: A Senate proposal in Alaska calls for an annual increase of 5 percent of salary that current workers would have to pay into the system to receive the same level of benefits. In Minnesota, legislation has been introduced requiring increased pension contributions by public workers as well as cities and counties. A proposal in Texas would require teachers after retirement to pay more for their health care premiums. Kentucky sought to increase the cost of retiree health care benefits too.
- Consolidating Boards: West Virginia teachers will vote in June on whether to merge their two retirement systems to create greater efficiencies. Similarly, a Senate proposal in Alaska calls for consolidating three boards into one. Louisiana is also exploring combining its retirement programs for teachers and state employees into one, staffed by professional money managers.
- 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 $26.2 billion in assets in 2003. Some of these acquisitions include New York City real estate, media outlets (television, newspapers), hotels, a cruise ship terminal, golf courses and most recently, becoming the largest stake holder of US Airways. Similarly, Massachusetts is considering a proposal to open the state's $36 billion public employee pension fund to all state residents for investment purposes.

Conclusion

In conclusion, almost every state continues to be plagued by unfunded 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 downturn and the steep rise in healthcare costs are factors too. Yet, the "graying" of America and the fact that states will have more retirees living longer in the coming years requires innovative solutions. Further complicating the overall retirement outlook is the fact that the financial viability of all elements of our retirement infrastructure remains shaky. 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.