America's Retirement Architecture: Strains in the System

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Introduction:

My thanks to Chairman Weyhrauch for extending this invitation to me and to The Council of State Governments to testify before the Ways and Means Committee of the Alaska House of Representatives. It is a great honor to be here.

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 study of this issue. 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 for the just concluded fiscal year, 2005, revenues exceeded original budget projections in 42 states while three others met their targets. Revenue in only five states came in below projections. 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. After several years of flat growth, state spending grew by 6.6 percent in fiscal year 2005; the annual average since 1979 is 6.5 percent even though the average over the last five years was only 3.9 percent. Healthcare costs lead the way here and in the next decade, just as it has in the last five years, Medicaid is estimated to grow by 9 percent to 10 percent a year.

In addition, expenses associated with education, including court-mandated costs, retirement systems, corrections, transportation, demographic changes and infrastructure needs will continue to burden state budgets.

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 an infrastructure to absorb the retirement needs of all Americans. As Census Bureau figures indicate, 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 recent financial downturn, policymakers now face the daunting challenge of dealing with weaknesses in public retirement systems. These public retirement systems are underfunded at a time when the first wave of the nation's baby boomers is rapidly approaching retirement. As mentioned, 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 Social Security and Medicare in coming decades; and, the low personal savings rates of most Americans, coupled with high rates of consumer and household debt.

Part III:

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 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. For instance, North Carolina withheld $144 million in payments for this purpose in 2002 and Texas cut its contribution to the Teacher Retirement System from 7.3 percent of employee pay to 6 percent. In Illinois, until 1995, the state's contribution to its pension funds was subject to an annual appropriation by the legislature; yet, in the last decade, Illinois lawmakers failed to allocate sufficient funds to cover liabilities. Since 1996, New Jersey contributed virtually nothing to its public employee retirement plan.

On the payment front (benefits, withdrawals and other), there were steady increases too; 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.

Part IV:

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; Georgia approved an increase from 50 percent to 60 percent and 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 is a great deal more activism on the part of the boards overseeing these plans **and** state lawmakers to monitor more closely the performance and management of their retirement plans. For instance, Connecticut, like several other states, citing "pervasive conflicts of interest and dismal company performance," decided to withhold voting for the head of Safeway and two other directors in May 2004.

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 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. Then, according to the latest (2005) Wilshire Report on 125 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. Finally, according to the latest (April 2005) survey of 103 plans by the National Association of State Retirement Administrators (NASRA), the average funding level stood at 89 percent with a cumulative unfunded liability of $267 billion.

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.

Fifth, the chilling effect of a Governmental Accounting Standards Board (GASB) ruling released last August 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 stash away 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.

Part V:

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

- Pension Obligation Bonds:
  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 opt to issue 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 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 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, 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 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 **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. 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, 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.

- **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. 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 and Speaker DeRoche in Michigan.
  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. 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 contends, inflates their pensions and adds to overall retirement debt.
  4. 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 proposes changing--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 sought 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 passed legislation that would require educators to be at least 60 before retiring with full

benefits. Louisiana proposed pushing 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.

5. 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.
6. 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.
7. 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. A Louisiana lawmaker proposed halting the practice of granting new retirement breaks through special interest legislation. He cited recent bills to boost the retirement pay of nine members of the State Police, a single judge and 500 workers at the Legislature.
8. Placing salary caps on state and local government retirees who return to work in government jobs. New Mexico enacted such legislation.
9. Debating the ability of public sector systems to continue offering lucrative healthcare plans to retirees. In North Carolina and Michigan, currently, any state employee who puts in five years of service becomes eligible to receive free retiree health insurance for life.
10. Prohibiting school districts in Texas from offering early retirement incentives.

- **Increasing Costs**:
  Minnesota proposed increased pension contributions by public workers as well as cities and counties. 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 will decide by 2006 whether to merge 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 sought to merge 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 $26.6 billion in assets in 2004. 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, 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.