



**BNA, INC.**

# PENSION & BENEFITS



**DAILY**

Reproduced with permission from Pension & Benefits Daily, 109 PBD, 06/07/2011, 06/07/2011. Copyright © 2011 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

## Public Pension Plans and the Retirement Gap: Understanding the Crisis and Possible Solutions



By **MARCIA S. WAGNER**

**T**his article explores issues related to the retirement gap and public pension funds. In particular, the article discusses how many state pension funds are underfunded, when the crisis will reach a critical stage and whether taxpayers would be required to bail out those public systems that are in trouble. With regard to fixing the problem, the article discusses whether

*Marcia S. Wagner ([www.erisa-lawyers.com](http://www.erisa-lawyers.com)) is a principal of The Wagner Law Group, Boston. She specializes in the full range of employee benefits matters concerning retirement plans, welfare plans, and executive compensation, including plan design, administration, compliance, dispute resolution, government audits, and corporate and employment transactions.*

switching to a tax code Section 401(k) design would help and if there are other changes that could be made to address the underfunding issue. In addition, the article discusses what legal restraints apply in dealing with this issue.

These questions have interweaving financial, political, and legal aspects that are not often discussed in concert. Moreover, the phrase “aggregate data hides substantial variation” certainly applies to the discussion of public retirement systems, so that generalization is dangerous.

### Underfunding

The *Wall Street Journal* reports that average households consisting of individuals age 60-62 had saved less than 25 percent of the amount needed for retirement with an estimate calculated by the Boston College Center for Retirement Research (CRR) that the aggregate funding level for public plans was 78 percent. The *Journal* therefore concludes that the public plans were in much better shape than private households. The use of these two percentages is very misleading.<sup>1</sup>

The 78 percent figure is the funding ratio, as of 2009, for a sampling of 126 state plans selected by the CRR and, as such, represents the value of plan assets held by such plans divided by the present value of the state’s liability for benefits. This ratio, which is frequently cited in the press, is not a measure of what is needed for retirement, but is simply an estimate of the extent to

<sup>1</sup> *The 401(k) Generation Is Beginning to Retire And It Isn’t a Pretty Sight*, “The Wall Street Journal,” March 14, 2011; *The Funding of State and Local Pensions: 2009-2013*, A.H. Munnell, J. Aubrey, and L. Quinby, Boston College Center for Retirement Research, April 2010.

which benefits that have already accrued (not benefits that will be earned in the future) have been paid for. It is said to represent a \$700 billion deficit.

The 78 percent funding ratio, which declined from 84 percent in 2008 as a result of the recent financial crisis, does not look too bad, but it is misleading in several ways. First, the decline resulted largely from losses in public plans' equity portfolios in 2008 and 2009 which, for funding purposes will be phased in over the period 2009–2014. Therefore, we have not seen the full effects of losses on stock investments incurred in the financial crisis.

In addition, the denominator of the fraction, i.e., the present value of the plans' liability for benefits has been calculated with a discount rate of 8 percent. A higher discount rate results in a smaller liability and, hence, makes the funding ratio look better. The 8 percent figure is justified by some as representing the average annual investment earnings that can be expected on a portfolio over a long period of time, say 20 years.

The appropriateness of this discount rate is the subject of fierce debate that is just now emerging into public view. There are those who think it should be closer to 5 percent, which is the rate on U.S. Treasury debt. The reasoning for this position is that state retirement benefits are a risk-free obligation and that the discount rate should also be derived from a risk-free obligation, such as Treasuries.

If the discount rate is reduced to 5 percent, then the funding ratio for the CRR sample declines to 50 percent. Conservatives who want to scale back state benefits think that the lower funding ratio represents the true state of affairs. Liberals who would like benefits to remain at current levels and hope that a recovery in the financial markets will allow state plans to earn their way out of the crisis favor the higher discount rate.

The third factor that makes the author uneasy about the current funding ratio of state plans is that the figures quoted herein are aggregate numbers. Inevitably, some plans are better funded than others. Because they have not kept up with annual required contributions, public systems in California, Illinois, and New Jersey are in particularly bad shape and we can expect that their funding percentage is well below 50 percent.

## What Happens When the Money Runs Out

It is commonly stated that, in the aggregate, states contribute about 3.8 percent of their annual budget to their retirement plans. Contributions by individual states have ranged from 3 percent to 6 percent.<sup>2</sup> The author does not know how reliable these numbers are, but for purposes of discussion, the author accepts them as a baseline. In order to meet the funding deficit and avoid running out of money, states will need to step-up contributions to their retirement systems.

The amount of the step-up as a percentage of a state's annual budget depends, to a large extent, on the level of the discount rate or, to put it another way, the projected investment earnings of the fund. Recall that there is disagreement on the issue of whether this rate should be set at 8 percent or 5 percent.

<sup>2</sup> *The Impact of Public Pensions on State and Local Budgets*, A.H. Munnell, J. Aubrey, and L. Quinby, Boston College Center for Retirement Research, April 2010.

If the higher of these figures is assumed as the earnings rate, CRR has calculated that the states would need to increase the level of their contributions to 5 percent of their annual budget for the next 30 years. In other words, if one can count on relatively high investment returns, states still need to increase contributions but not by such a big amount.

If the lower earnings assumption is used, an annual contribution equal to 9.1 percent of the state's overall budget would be required. This use of what might be regarded as the more realistic earnings assumption of 5 percent demands a much higher level of contributions to achieve full funding.

If the states do not do anything, then the CRR has estimated that state retirement systems will run out of money in the next 15 to 30 years, with the exact time depending on the earnings rate assumption and the analytical methodology used in making the estimate.

The question then becomes, if a state retirement system runs out of money, what happens next. Most people assume that a state would fulfill its obligation on a pay as you go basis, effectively transferring the burden of paying for retirement benefits to a future generation of taxpayers. This would be very expensive, since it is estimated that such payments would have to be as much as 16 percent of a state's budget and would be required for as long as 20 years.

As noted above, California, Illinois, and New Jersey may face the dilemma posed by running out of money. Systems in Connecticut, Kentucky, Louisiana and Rhode Island are also at risk.

## State Law Protection of Pensions

States have varying degrees of protection for public employee pensions. These protections are not necessarily embedded in a state's constitution and could also be reflected in a statute or a judicial decision. The strongest form of such protection, whether derived from the state's constitution, a statute, or case law, characterizes a pension as a contractual right that vests upon acceptance of employment by the employee.

Among those states that have adopted the contract theory, there are significant variations as to how it is applied and what elements of each state's pension system are considered part of the contract. As a practical matter, this affects the question of whether prospective changes can be made to the system.

For example, New York's constitution prohibits reducing pension benefits whether earned or merely expected to be earned in the future. Illinois and Pennsylvania are also states with very strong contract rights that prevent contribution rates from being changed for the duration of a plan participant's life. Reform options in these states are limited.

As recently as April 13, 2011, the California Supreme Court rejected an attempt by Orange County to rescind a grant of past service credit to the county's deputy sheriffs on the basis of the contract theory.<sup>3</sup> While California is a contract state, its courts have held that benefits are not immutable and that even vested benefits can be modified as long as a new and advantageous

<sup>3</sup> *County of Orange v. Association of Orange County Deputy Sheriffs*, No. BC389758, (Cal. Ct. App. Jan. 26, 2011)(20 PBD, 1/31/11; 38 BPR 233, 2/1/11), *cert. denied* (Cal. April 13, 2011).

benefit is substituted in place of the benefit that is eliminated.

On the other hand, courts have interpreted constitutional contract protections in Michigan and Hawaii to protect only earned benefits.<sup>4</sup> Accordingly, these states allow prospective changes even as applied to existing employees.

The legislature in Minnesota, with a quasi-contract theory according to its leading judicial precedent, has made numerous changes to the benefits of both active employees and retirees, including reduction of cost of living adjustments for retirees. These changes are currently the subject of litigation, as are changes made to the public plans of Colorado and South Dakota.

Other states treat public pensions under a property theory (Connecticut and New Mexico) or a gratuity theory (Texas, Arkansas). In the property states, legislatures are free, subject to due process, to make changes to their pension systems as long as the changes are not arbitrary or outrageous. Gratuity states have an even freer hand to scale back benefits.

Even if a state has adopted the strongest version of the contract theory, it has the ability to override pension promises by the exercise of its police power, provided that the changes are reasonable and necessary to serve an important public purpose. A question that is currently being debated is whether solving a state's fiscal crisis would constitute such a purpose. States have other means of persuading employees to go along with a change.

Thus, while pensions might be legally protected, a state would generally be free to reduce salaries or eliminate jobs if it could not modify pension benefits. Alternatively, future pay raises could be made contingent on pension waivers. This explains why you sometimes see labor unions going along with moderate cutbacks in retirement benefits.

## Design Changes to Stabilize Systems

Changes to state retirement systems may focus solely on steps to improve finances or may seek more fundamental reform that remedy abusive aspects of the current system. With a few exceptions, most states have adopted defined benefit programs which deliver a lifetime pension determined by a formula consisting of final average salary measured over a short period (e.g. three years), years of service, and a multiplier that varies from state to state but is frequently in the neighborhood of 2 percent.

Of the measures that may be taken to improve finances, the most direct would be to require greater contributions by participants to such a program. This could be problematic if applied to existing employees in a state with the strongest version of the contract theory discussed above, since in these states all aspects of the existing program are guaranteed. If applied only to new employees the desired relief would be significantly delayed.

The most frequently discussed design change involves adopting a tax code Section 401(k) style individual account plan as the state's primary retirement plan. Currently, only Michigan and Alaska have defined

contribution (DC) plans as their primary plan. A participant's benefit under this type of plan consists of an account made up of employer and employee contributions and the earnings thereon. Once the account runs out of money, a retiree may have no resources on which to live. This is a negative feature of DC plans, but it can be mitigated by providing for an actuarial conversion of the account balance to a lifetime annuity.

It is said that the investment costs of such a system make it more expensive to run than a DB system, which benefits from economies of scale and does not have the regulatory costs associated with DB plans in the private employer system. On the other hand, in a DC system a state's liability for each year of participation will not expand after it makes its annual contribution. Investment risk and the risk of longevity (i.e., how long the participant will live and continue to receive benefits) will have been transferred to the employee.

A money saving compromise that has been proposed would be to cap the earnings taken into account under a DB plan at \$50,000. University presidents and other high flyers would get the same annual lifetime benefit as the maintenance man. Earnings above \$50,000 would be covered by a DC plan. Under such a "stacked" arrangement, the DB plan would be maintained as the base and DC coverage would be provided for earnings above the cutoff.

One of the pernicious aspects of the current system is its focus on final pay. Among other things, this encourages spikes in pay just before retirement or last minute promotions to a higher grade that have the effect of dramatically increasing a participant's pension. Final average pay plans also have other unwelcome effects such as an uneven distribution of benefits to employees with the same tenure depending on their age. The stacked arrangement discussed above eliminates some of this. An alternative that also could achieve these goals would be to retain a DB system, but base the earnings component on career average pay (as opposed to final average) indexed for inflation.

Another technique for limiting the cost of a DB system is to limit the state's contribution to a set percentage of the employee's compensation. Under the new Utah system, this percentage is 10 percent and the employee contributes the additional amount needed to fund a benefit equal to 1.5 percent (formerly 2 percent) of average salary over the employee's highest five years (formerly three years). Utah also maintains an optional DC system under which the state will contribute 10 percent of pay as an alternative to the DB plan.

Other techniques for saving money include increasing the age for receiving full benefits and limiting cost of living adjustments. The former essentially involves eliminating subsidies for retiring early. An early retiree costs the state more money because it must pay his benefit under a DB plan for a longer period. Requiring a full actuarial reduction of the benefit to account for this extra cost will have the effect of encouraging employees to work longer, which may or may not be desirable depending on the nature of the employee's job.

Limiting COLAs is often a measure directed only at new employees. However, this is not always the case. In 2010, the Minnesota legislature reduced the COLAs of current retirees from 2.5 percent to a rate ranging from 1 to 2 percent until such time as Minnesota plans achieve a 90 percent funding level. Colorado and South Dakota have enacted similar COLA reductions. How-

<sup>4</sup> *Association of Professional & Technical Employees v. City of Detroit*, 398 N.W. 2d 436, 8 EBC 1110 (Mich. Ct. App. 1986); *Kaho'ohanohano v. State*, 162 P.3d 69 (Haw. 2007).

ever, retirees in all three states have filed lawsuits challenging the COLA reductions.

### **Conclusion**

State and local governments must address the funding problems of their retirement systems at a time of increasing pension coverage, increasing numbers of public employees commencing the receipt of benefits after attaining a liberal retirement age, and lowered expectations as to investment returns and the availability of

general revenues to make up funding shortfalls. In this new environment, it is to be hoped that legislatures and the courts will recognize the new realities and adjust or eliminate overly generous and inefficient features currently found in public plans as well as outmoded legal theories that inhibit change.

A necessary first step in this effort would be to allow changes to future benefit accruals of all employees as under the federally-regulated private-employer system. If public systems do not adjust, the financial burdens they impose may well prove to be unsustainable.