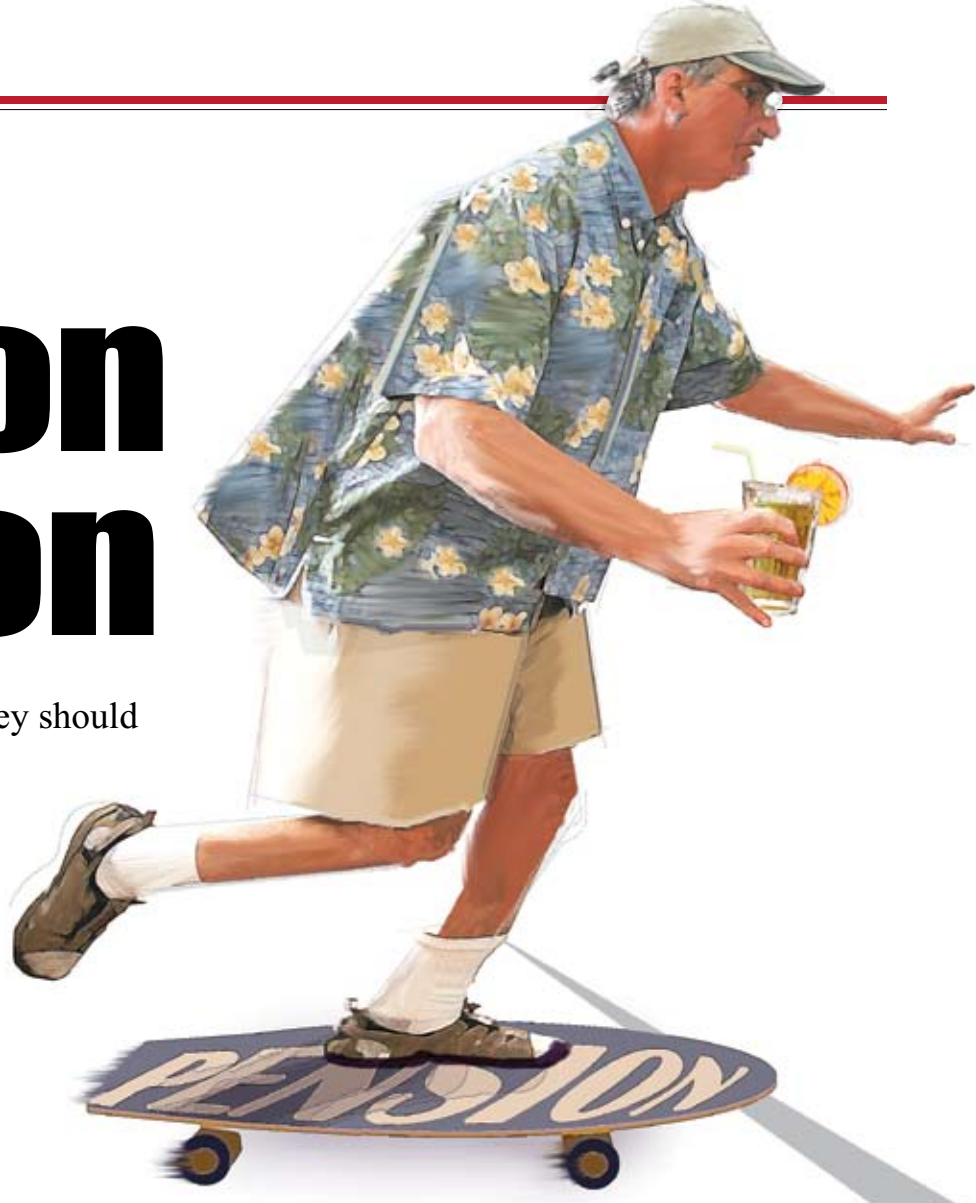


Pension Tension

Very few states hold all the assets they should for future retirement and health care benefits.



BY RON SNELL

Some have fame thrust upon them, as has Kathleen Casey-Kirshling of New Jersey. She was born one second after midnight on Jan. 1, 1946, making her the very first member of the baby boomer generation. She has drawn broad media attention as the herald of coming boomer retirements.

Casey-Kirshling received the personal attention of Michael Astrue, commissioner of Social Security, when she filed for her Social Security benefits last October. Astrue used the occasion to praise Social Security's ease of access and contributions to Americans' well-being. But if you search Casey-Kirshling's name in Google, you'll discover that others regard her as the first droplet in a tsunami of Social Security obligations about

Ron Snell is NCSL's pensions and retirement expert.

to crash on the American economy.

Less recognized has been her career as a public school teacher, which presumably means she's also entitled to retirement benefits from that employment. Legislatures aren't responsible for Social Security, but if Casey-Kirshling is entitled to a teacher's pension, a legislature somewhere is involved in providing for that, and possibly for retirement health benefits as well. It is well-known that the federal government is inadequately prepared for the Social Security costs boomer retirements will bring. How well are states prepared to meet the retirement commitments they have made?

In some ways, very well. State and local governments are custodians of an enormous pool of assets safeguarded for future retirees—\$3.24 trillion in cash and investments at the end of last October. In the fiscal year that ended on June 30, 2007, state and local

governments and their employees contributed \$91 billion to retirement funds, and the funds earned more than \$265 billion on their investments. Funding levels generally have been improving in recent years, as investments have recovered from their post-2000 lows.

In other ways, states are not so well prepared. Very few states hold all the assets they should have on hand to prepare for future retirement benefits. All states invest in order to meet future obligations, but even allowing for future investment return, some state trust funds hold less than half what they should. And a substantial number are below the 80 percent figure that the public retirement community regards as adequate. The Pew Center on the States recently estimated that state pension systems (not including locally run systems) are about \$360 billion short of the assets they should ideally hold for future retirees.



PROPOSITION 13 FOR CALIFORNIA PENSIONS

Californians who believe that public pension benefits will bankrupt the state coalesced last year for action under the leadership of former Assemblyman Keith Richman, now the president of the California Foundation for Fiscal Responsibility. Its new “Pension Proposition 13” may or may not make the ballot for 2008, but its ideas could make waves in the world of pensions. The proposals would apply to all governments in California, and would amend the state constitution to:

- ◆ Preserve the basic structure of a defined pension benefit based upon the final salary and years of service of public employees.
- ◆ Cap benefits below present levels.
- ◆ Increase eligibility ages, except for public safety employees, to Social Security levels, and increase the eligibility age as it increases for Social Security.
- ◆ Take Social Security benefits into account when calculating state or local pension payments.
- ◆ Replace the current base of pension calculation—the last year of employment for some California public employees—with an average of the last five years.
- ◆ Exclude overtime, bonus and severance pay, as well as pay for unused vacation and sick leave, from the base for calculating pensions.
- ◆ Provide medical insurance only to people who reach full retirement age.

Cumulatively, the foundation says, these proposals would save California more than \$500 billion over the next 30 years.

Its advocates learned from Governor Arnold Schwarzenegger's failed effort to replace state guaranteed retirement incomes with 401(k) look-alikes. The new proposals, in fact, may look like moderate reforms to voters who lack pensions themselves, or who themselves have 401(k) plans. And if actually added to the California Constitution, they could have as major an impact on state pensions policy as the original California Proposition 13 has had on state and local tax policy.

THE HEALTH CARE FACTOR

These generalizations hide enormous differences among the states. Some have stellar records. Delaware, Florida, North Carolina, South Dakota, Vermont and Wisconsin have for years maintained pension funding levels between 95 percent and 100 percent, even as high as 115 percent in Florida in 2002. Other states, however, struggle to make annual contributions and to make up for shortfalls carried over from the past. Indiana, Oklahoma and West Virginia have each seen a statewide pension fund dip below the 50 percent funding mark in recent years.

And there's another consideration. Often overlooked until recently, commitments state and local governments have made for retiree health care add up to far more than the shortfalls in pension funding. The size of this obligation remains uncertain, but the estimates keep increasing. Credit Suisse, an interna-

tional financial services company, puts the number at \$1.5 trillion for state and local governments—almost half as much as state and local governments have accumulated for pension benefits over the many years they have been saving and investing.

Interstate variations appear in retiree health care funding, too, because of program design. There are great differences in what health care states have promised to retired people. In states that allow early retirement and provide full or nearly full health care coverage in retirement, future obligations are huge. States like Minnesota that require retired public employees to purchase continued health coverage at their own expense tend to have a very small future obligation. The Credit Suisse report estimates that in a few states—Mississippi, Nebraska and Wisconsin—there is no future obligation at all for employee health care. In Colorado and North

Dakota, it's very low—the full future obligation is only between \$60 and \$80 per capita. But in Alaska, Connecticut and New Jersey, the potential per capita obligation for state residents is between \$6,000 and \$7,000.

OPTIONS LIMITED

How states with huge burdens will address them remains to be seen. So far, states have focused only on calculating the numbers, though Alabama, Delaware and Georgia have set aside extra money against future obligations. An important point for policymakers is that in most states, legislatures and governors have more options with retiree health care programs than they do with pensions.

It is very difficult or impossible to reduce pension benefit packages because of various constitutional and statutory guarantees and judicial decisions. Once granted, a pension is a contractual obligation of the employer, so

ARE PUBLIC EMPLOYEE SALARIES AND BENEFITS OUT OF LINE WITH THE PRIVATE SECTOR?

If you compare average public employees' compensation with average private sector compensation—meaning the average of everyone in one category or the other—you see a startling difference. Average employee compensation is 50 percent higher in the public sector than in the private sector, according to the Bureau of Labor Statistics.

AVERAGE COMPENSATION, PRIVATE AND PUBLIC SECTORS, SEPTEMBER 2007

	Average Hourly Salary	Average Hourly Benefits	Total
Private Sector	\$18.42	\$7.66	\$26.08
Public Sector	\$26.26	\$13.24	\$39.50

Averages, of course, bring together a lot of disparate information. For the private sector, the CEO of Microsoft is lumped with the guy who flips burgers at McDonald's, and for the public sector, the director of your state medical school is averaged with the lady who flips burgers at the Capitol Cafeteria—if that job hasn't been contracted out. When the numbers are broken apart by what people do, they look different.

AVERAGE COMPENSATION, PRIVATE AND PUBLIC SECTORS, SEPTEMBER 2007, BY CATEGORY OF EMPLOYMENT

	Average Hourly Salary	Average Hourly Benefits	Total
Private Sector Professionals	\$33.02	\$13.80	\$46.82
Public Sector Professionals (education and legal)	\$33.88	\$14.06	\$47.94
Private Sector Service Employees	\$11.09	\$4.61	\$15.70
Public Sector Service Employees	\$18.45	\$12.29	\$30.74

Salaries and benefits for professionals vary only a little between the public and private sectors, with public employees having a 2.4 percent advantage. That matters a lot in any comparison. The employees counted as professionals—instructional employees in K-12 education and higher education plus judicial and legal employees—make up 35 percent of all public employees (and this excludes other professionals working for governments, for whom there's no good count). This very high proportion of professionals in the public sector, as compared with the private sector, weights average public sector salaries toward the high end.

However, there is a significant difference in compensation for lower-paid employees in the public and private sectors. For service employees, the public sector advantage remains in the 50 percent range.

Some of the difference in service workers' compensation is explained by benefits, which are more widespread for lower-paid workers in government than in businesses, where some service employees may have no benefits other than Social Security, workers' compensation and unemployment insurance. The public sector tends to provide pensions and health insurance to all employees.

Part of the difference also is a higher average salary. What that means about specific occupations is hard to say, since the Bureau of Labor Statistics does not categorize government employees in as fine detail as private business employees. It's impossible to make an apples-to-apples comparison, and the bureau, in fact, warns against comparing compensation costs across the public and private sectors. Still, breaking the numbers apart to the extent possible is a guide for further questions about comparable pay, and it appears that those questions should focus on service employee compensation.



that in most cases in most states it is impossible to cut the promise of a future benefit, or even to increase the employee contribution to the pension fund. Exceptions exist, but generally, states have found it necessary to close existing retirement plans to new enrollment and create a new plan altogether in order to reduce benefits. This is not to be attempted lightly for many reasons—managerial and financial as well as political.

Only Alaska and Ohio have constitutional guarantees of health care benefits for retired employees. Some states' health care programs specify that benefits may be changed. Without many judicial decisions on the point, the general feeling is that state governments have the power to reduce their promises of future health care. Recent changes to state pension programs suggest that legislatures can make dramatic changes in employee benefits under some circumstances.

REDESIGNING PLANS

Alaska took this route. It closed its traditional pension plans for teachers and public employees and replaced them with a 401(k) type of plan in 2005. A traditional plan guarantees a lifetime annuity that is a percentage of a retired person's final salary. A 401(k) plan provides an individual account in which the employer's and employee's contributions accumulate with earnings over time, and are transferred to the retiree at the time of retirement as cash or an annuity, based on the total accumulated amount. It creates no obligation for the employer after the contributions are made, unlike traditional pension plans.

Such a change is often recommended to governments as a way of avoiding the growth of future pension obligations. But many public employees prefer the security of



traditional pension plans. That point can be argued, but what is clear is that such a change in structure does not reduce existing pension obligations. If a state has a large unfunded liability for its traditional plan, the liability remains, and there is no short-term saving from the change in plan design. That hard fact may have kept more legislatures from taking on the battle to make such a change.

What other legislatures have done is reduce the benefits of a traditional pension plan, or increase the contributions required from employees, or both. Colorado, Iowa, Rhode Island have done so in recent years. Kansas legislation enacted in 2007 includes all of the kinds of changes other states have been making, and adds some unique features.

The Kansas law preserves existing benefits for current employees, and even improves them in some relatively inexpensive ways to address long-standing grievances over when a person starts accruing benefits in the system. For people hired after the effective date of the legislation (July 1, 2009), it balances benefit guarantees for new employees against some costs.

New employees will retire with pensions that are a somewhat smaller percentage of their final salary than current employees. They will have to wait a few more years to retire. They will have to contribute 6 percent of salary to the system, not 4 percent like current employees. On the other hand, they will benefit from an automatic annual post-retirement cost-of-living adjustment, which is not provided for current employees. The law also provides that employer contributions will never fall below employee contributions, which means state and local governments will continue to contribute to the plan no matter how well-funded it may become. The

law also provides, unusually, for employee contributions to increase if necessary.

Addressing almost every feature of benefit design—as the Kansas legislation does—made it possible for each change to be relatively minor, and to offset every benefit reduction with a benefit gain. Higher employee costs, for example, are offset with guaranteed cost-of-living increases, and the prospect of even higher employee contributions in the future is balanced with the guarantee that employer contributions will keep step. These cost-sharing tactics suggest some ways for states to address future employee health care costs. The Kansas example suggests that marginal changes can have major consequences over time, which should be as true for health care costs as for pensions.

A BASIC QUESTION

Even if incremental change could preserve a form of long-term health benefits for public employees and deal with pension funding challenges where those exist, a major question remains. Why should governments guarantee retirement income and health benefits for their employees, at a time when such guarantees are disappearing from the private sector?

That question partly arises because the kind of pensions that are the most common among governments in the United States have been disappearing from the private sector. In 1988, 65 percent of government employees and 54 percent of private sector employees who were covered by pensions had traditional defined benefit plans, according to the Employee Benefit Research Institute. By 2003, 80 percent of public employees, but only 27 percent of private-sector employees, had these traditional plans. Private-sector coverage has moved toward plans with individual accounts, in which the balance at the time a person retires determines the person's retirement benefit, like 401(k) plans.

Such plans have advantages for employers. Once the employer's contribution is made, the employer's monetary obligations are met. Unlike defined benefit plans that promise a specific lifetime stream of payments, regardless of how much an employee has contributed, the employer faces no continuing financial obligation. As a rule, also, the plans are simpler to establish and administer, and are in fact easily contracted out for external management.


Such plans are termed “defined contribution” plans since they require a specific contribution level instead of defining a benefit. Advocates contend that such plans would save taxpayers money over time, allow employees to direct how their accounts will be invested, and provide advantages to mobile employees. Those who want smaller state governments tend to favor such changes.

They have not caught on in state government, however. Such plans serve as the primary retirement plan only for public employees in Michigan, public employees and teachers in Alaska, and some teachers in West Virginia. A few states offer a blend of defined contribution and defined benefit plans, and a few others, like Ohio and Florida, allow employees to choose one or the other as a primary retirement plan. Public employee unions and associations prefer the security of traditional pension plans, and legislators have been reluctant to override that preference.

WHAT'S AHEAD?

So where will pension plans head in the future? Probably along the lines of the Kansas legislation of 2007. Or perhaps, with somewhat sharper controls on benefits for future employees, like those proposed for California in a initiative that may make the state ballot this year. For most state and local employees (aside from public safety personnel), it would make benefits contingent upon reaching the Social Security age of retirement, benefits that would replace no more than about 67 percent of salary including Social Security, and tight limits on cost of living adjustments—all somewhat more severe, and thriftier, than the changes in Kansas. Unlike any other state plan's provisions, these would be written into the state constitution, limiting possibilities for future legislative generosity.

State legislation since 2000 has demonstrated a legislative unwillingness to enrich pension benefits for public employees. We may be entering a period when the promises made in the past are reduced out of simple fiscal necessity.

 **CHECK OUT** more information on state pension policies, funding levels, coverage, requirements for contributions, eligibility and more at www.ncsl.org/magazine.