NASRA ISSUE BRIEF:
State and Local Government Spending on Public Employee Retirement Systems

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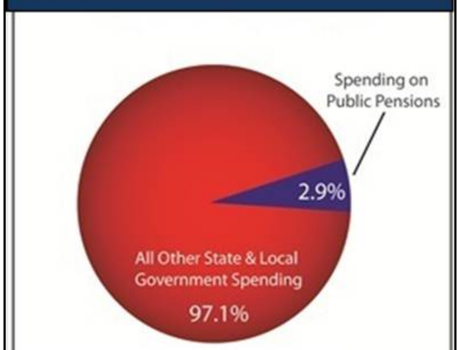
As states and cities continue to address the effects of the Great Recession, the cost of pension benefits for employees of state and local government remains a key point of discussion. On a nationwide basis, pension costs for state and local governments are roughly three percent of total spending (see Figure 1). Current pension spending levels, however, vary widely and are sufficient for some entities and insufficient for others.

In the wake of the 2008-09 market decline, over 40 states and many cities have taken steps to improve the financial condition of their retirement plans and to reduce costs. Although some lawmakers have considered closing existing pension plans to new hires, most determined that this would increase—rather than reduce—costs,[i] particularly in the near-term. Instead, states and cities have adjusted employee and employer contribution levels, restructured benefits, or both. Ultimately, the degree of needed change in pension plan costs will depend largely on the funding history of the plan and the type and magnitude of recent reforms.

Figure 1: State and local spending on public pensions as percentage of total government spending, 2009



Source: U.S. Census Bureau

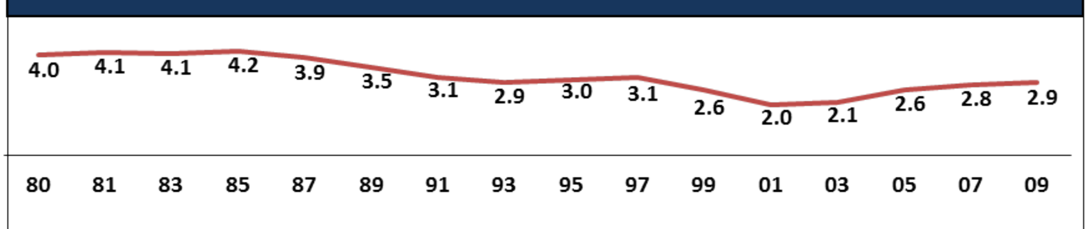
Three Percent Nationwide

Based on the most recent information provided by the U.S. Census Bureau, approximately three percent of all state and local government spending is used to fund pension benefits for employees of state and local government.[ii] As shown in Figure 2, pension costs since 1980 have been reliably stable, declining from around four percent to nearly three percent in 2009.

Although pensions are not the state-local budget-drain that some claim they are, as shown in Table 1, spending levels for states and cities do vary from the national average, from less than one percent to more than six percent. One study estimates that total required spending on pensions could consume as much as 13 percent of one state's budget,[iii] due partly to past failures to adequately fund pension costs and assuming a five percent investment return. The chronic failure by some pension plan sponsors to pay required contributions results in greater future contributions to make-up the difference.

Most of the variation in pension spending levels is attributable to three factors: different levels of effort by states and cities to make pension contributions; differences in benefit levels; and variations in the size of unfunded pension liabilities. As a percentage of total spending, pension costs for cities are higher than states by about 50 percent. This is due in part to the types of services that are delivered at the local level and the resulting larger share of municipal budgets that is committed to salaries. As with states, pension costs for municipalities can vary widely.

Figure 2: Pension costs as a percentage of all state and local government spending, 1980-2009



Source: U.S. Census Bureau

Cost and Financing Factors

Public pensions are financed through a combination of contributions from public employers (state and local agencies) and public employees, and the investment returns on those contributions.[iv] Since 1982, investment earnings have accounted for approximately 60 percent of all public pension revenue; employer contributions, 28 percent; and employee contributions, 12 percent.

Employee Contributions

Because the vast majority of public employees are required to contribute toward the cost of their pension benefit—typically four to eight percent of pay—most state and local government retirement plans are mandatory savings programs. Many states have increased required employee contributions in recent years. On a national basis, in fiscal year 2009, employee contributions accounted for 31 percent of all public pension plan contributions, with employer contributions making up the remaining 69 percent.

Employer Contributions

Most public retirement systems require employers to contribute what is known as the Annual Required Contribution (ARC). The ARC includes the sum of what employers must pay to finance new benefits accrued each year, and a payment to amortize unfunded liabilities from past years, minus required employee contributions.

The ARC varies among pension plans, depending on such factors as the level of benefits, the size of the unfunded pension liability, and a plan's actuarial methods and assumptions. Unfunded liabilities typically are financed over a number of years, similar to paying off a mortgage: just as the annual cost of paying down a 30-year mortgage will differ from a 15-year mortgage, the length of time to pay down unfunded pension liabilities also affects current plan costs. Although the long-term liability may be the same, the monthly payment will differ.

Many states have laws that require that pension plans be funded on the basis of the ARC, and some public retirement systems are authorized to require payment of the ARC. The average ARC received in recent years has been around 90 percent. Beneath this average ARC experience lies diversity: approximately 60 percent of plans in the Public Fund Survey consistently receive 90 percent, or more, of their ARC.[v] This means that although a majority of plans have been receiving their required funding, many plans have not been adequately funded, which will result in higher future costs.

Social Security Coverage

Twenty-five to thirty percent of state and local governments and their employees make contributions to their retirement plan instead of to Social Security. This is the case for substantially all of the state and local government workforce in seven states, 40 percent of the nation's public school teachers, and a majority of firefighters and police officers. Pension benefits—and costs—for those who do not participate in Social Security are usually higher than for those who do participate in order to compensate for the absence of Social Security benefits. This higher cost should be considered in the context of the 12.4 percent of payroll, or an estimated $31.2 billion annually,[vi] these employers and employees would otherwise be paying into Social Security.

Investments and Other Parts of the Financing Equation

The largest portion of public pension funding comes from investment earnings, which illustrates the major role this revenue source plays in determining pension costs. Other factors that affect pension costs include expectations for both wage and general inflation, rates of worker retirement and attrition, and mortality. Expectations for these and other economic and actuarial events typically are based on long timeframes, such as 20 to 50 years.

Although the market decline of 2008-09 lowered public pension fund asset values, macro-economic events are also affecting pension costs. Such events include public workers' retirement rates, attrition, wage growth and other factors, some of which can lower the rate of growth in liabilities. Adding to this trend, legislatures in over 40 states have made changes to pension benefits and/or financing, reducing plan costs and, in some cases, actually reducing liabilities.

Conclusion

State and local government pension benefits are paid not from general operating revenues, but from trust funds to which public retirees and their employers contributed while they were working. Over $200 billion is distributed annually from these trusts to retirees and their beneficiaries, who reside in virtually every city and town in the nation. These benefits serve as a source of economic stimulus to every state and local economy.[vii]

On average, public pension programs remain a small part of state and local government spending, although the costs, benefit levels, and funding levels vary widely. Changes to benefit levels and required employee contributions adopted by states and cities have also been diverse, dependent in part on such factors as the legal authority to make changes to benefits or required employee contribution rates; and the plan's financial condition prior to the 2008-09 market decline. Generally, states and cities with a history of paying their required pension contributions are in better condition and need adjustments to benefits or financing arrangements that are less far-reaching compared to those with a history of not adequately making their contributions.

Table 1: State and local government contributions to pensions as a percentage of all state and local government spending, by state, 2009

Alabama	3.18	*Louisiana*	3.83	Oklahoma	3.36
Alaska	6.35	*Maine*	2.80	Oregon	2.03
Arizona	2.39	Maryland	2.79	Pennsylvania	1.73
Arkansas	3.14	*Massachusetts*	3.37	Rhode Island	4.87
California	3.53	Michigan	2.47	South Carolina	2.32
Colorado	3.22	Minnesota	1.62	South Dakota	1.67
Connecticut	3.83	Mississippi	2.86	Tennessee	1.99
Delaware	2.21	Missouri	3.21	*Texas*	2.01
District of Columbia	1.47	Montana	2.38	Utah	2.72
Florida	2.65	Nebraska	1.42	Vermont	0.90
Georgia	2.14	*Nevada* [1]	5.39	Virginia	3.68
Hawaii	3.57	New Hampshire	2.30	Washington	1.93
Idaho	2.47	New Jersey	2.46	West Virginia	3.78
Illinois	4.80	New Mexico	3.09	Wisconsin	1.26
Indiana	2.81	New York	4.04	Wyoming	1.19
Iowa	1.70	North Carolina	1.06	United States	2.90
Kansas	1.98	North Dakota	1.44		
Kentucky	2.60	*Ohio*	2.88		

States where more than one-half of public employee payrolls are estimated to be outside of Social Security are italicized.
[1] *In addition to being a non-Social Security state, one-half of Nevada PERS employers' contribution is attributable to a non-refundable pre-tax salary reduction to fund the employees' portion of the contribution.*

Source: U.S. Census Bureau

See also

Center for Retirement Research at Boston College, "The Impact of Public Pensions on State and Local Budgets," October 2010, http://crr.bc.edu/briefs/the_impact_of_public_pensions_on_state_and_local_budgets.html

Center on Budget Priorities and Policies, "Misunderstandings Regarding State Debt, Pensions, and Retiree Health Costs Create Unnecessary Alarm," January 2011, http://www.cbpp.org/cms/index.cfm?fa=view&id=3372

National Association of State Retirement Administrators, Issue Brief: Public Pension Plan Investment Returns, October 2011, http://www.nasra.org/resources/InvestmentReturnBrief.pdf

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[i] Wikipension, "Costs of Switching from a DB to a DC Plan," http://www.wikipension.com/index.php?title=Studies_and_reports#State_Studies
[ii] A similar study conducted by the Center for Retirement at Boston College calculated the cost of pensions to be 3.8 percent, using a calculation that excluded capital spending
[iii] Center for Retirement Research at Boston College, "The Impact of Public Pensions on State & Local Budgets," supra
[iv] U.S. Census Bureau, http://www.census.gov/govs/retire/2009ret02.html - State and local government retirement system sources of revenue
[v] Public Fund Survey, http://www.publicfundsurvey.org/
[vi] Author's calculation based on 30 percent of state and local government employees not participating in Social Security
[vii] *Pensionomics: Measuring the Economic Impact of State and Local Pension Plans*, National Institute on Retirement Security, February 2009; see also "Economic Effects of Public Pensions," http://www.nasra.org/resources/economic.htm