GOBIERNO DE PUERTO RICO
LA FORTALEZA
SAN JUAN, PUERTO RICO

Boletín Administrativo Núm. OE-2010-10

ORDEN EJECUTIVA DEL GOBERNADOR DE PUERTO RICO PARA ESTABLECER LA COMISIÓN PARA LA REFORMA DE LOS SISTEMAS DE RETIRO DEL GOBIERNO DE PUERTO RICO

POR CUANTO: Los Sistemas de Retiro de los Empleados del Gobierno de Puerto Rico, el Sistema de Retiro de la Judicatura y el Sistema de Retiro para Maestros (en adelante “Sistemas de Retiro”) se encuentran en una situación fiscal crítica. Por un lado, los tres sistemas tienen un déficit actuarial combinado que excede los 23 mil millones de dólares. Por otro, los tres sistemas están operando con déficits de caja significativos, pagando aproximadamente 679 millones de dólares más al año de lo que reciben en aportaciones. Ante esta doble insuficiencia, los Sistemas están liquidando sus activos a un ritmo acelerado meramente para poder cumplir sus obligaciones con nuestros pensionados. En ausencia de medidas correctivas, los Sistemas podrían quedarse sin fondos en o antes de diez años.

POR CUANTO: Esta situación es el resultado de años de prácticas irresponsables de administración pública: la aprobación de beneficios sin la asignación correspondiente de recursos para financiarlos; el incumplimiento con la obligación de remitir las aportaciones patronales a los Sistemas de Retiro; la proliferación de ventanas de retiro temprano sin la debida consideración de su impacto en la solvencia de los sistemas; proyectos de financiamiento e inversión de alto riesgo y pobre desempeño; y decisiones administrativas que han socavado la solvencia y liquidez de los Sistemas.

POR CUANTO: Este Gobierno está comprometido con salvar los Sistemas de Retiro para garantizarle un retiro digno a nuestros pensionados y servidores públicos. Este esfuerzo requiere la colaboración de representantes de los distintos sectores interesados en la solvencia de los Sistemas--los pensionados, los empleados públicos, la Rama Legislativa y la Rama Ejecutiva--para desarrollar y proponer medidas que puedan rescatar los Sistemas.

POR TANTO: YO, LUIS G. FORTUÑO, Gobernador de Puerto Rico, en virtud de los poderes que me confiere la Constitución y las leyes de Puerto Rico, por la presente decreto y ordeno lo siguiente:

SECCIÓN 1ra. Se establece la Comisión para la Reforma de los Sistemas de Retiro del Gobierno de Puerto Rico (la “Comisión”). El propósito de esta Comisión es asesorar al Gobernador sobre posibles medidas para remediar la situación fiscal crítica de los Sistemas de Retiro.

SECCIÓN 2da. La Comisión estará constituida por nueve miembros. El Secretario del Departamento del Trabajo y Recursos Humanos será miembro *ex officio* y presidirá la Comisión. Los ocho miembros restantes serán nombrados por el Gobernador: un representante de los pensionados; un representante de la Comisión Especial Permanente sobre los Sistemas de Retiro; dos representantes del sector laboral público; un representante del Senado de Puerto Rico; un representante de la Cámara de Representantes de Puerto Rico; y dos representantes de las agencias de la Rama Ejecutiva. El Gobernador consultará con los distintos sectores sobre las personas a nombrar en representación de los mismos y a los Presidentes Legislativos sobre los representantes de sus respectivos cuerpos.

SECCIÓN 3ra. El Gobernador designará un Director Ejecutivo para coordinar los trabajos de la Comisión.

SECCIÓN 4ta. Los miembros a ser nombrados a la Comisión deberán ser expertos en materia de sistemas de pensiones como, por ejemplo, actuarios, contadores públicos autorizados o asesores financieros.

SECCIÓN 5ta. Los miembros de la Comisión ejercerán su cargo a la discreción del Gobernador.

SECCIÓN 6ta. Cada uno de los ocho miembros nombrados a la Comisión preparará un informe escrito con sus recomendaciones específicas sobre cómo atender y remediar la situación de los Sistemas de Retiro. Estos informes serán sometidos al Presidente de la Comisión dentro de los sesenta días a partir de la fecha en que el Administrador de la Administración de los Sistemas de Retiro de los Empleados del Gobierno y la Judicatura haga entrega a la Comisión de un paquete de información sobre la condición financiera de los Sistemas de Retiro. Dentro de los sesenta días siguientes a recibir estos informes, la Comisión preparará y aprobará un informe general con sus recomendaciones. Este informe final será presentado al Gobernador.

SECCIÓN 7ma. La Administración de los Sistemas de Retiro de los Empleados del Gobierno y la Judicatura y el Departamento del Trabajo y Recursos Humanos ofrecerán el personal de apoyo y los recursos que sean necesarios para la operación de la Comisión. Todas las agencias deberán cooperar con la gestión de la Comisión y proveer la información necesaria para que la Comisión y sus miembros puedan desempeñar sus funciones de asesoría.

SECCIÓN 8va. DEFINICIÓN DEL TÉRMINO AGENCIA. Para fines de esta Orden Ejecutiva, el término "agencia" se refiere a toda agencia, instrumentalidad, oficina o dependencia de la Rama Ejecutiva del Gobierno de Puerto Rico, incluyendo las corporaciones públicas, independientemente de su nombre.

SECCIÓN 9na. DEROGACIÓN. Esta Orden Ejecutiva deja sin efecto todas aquellas órdenes ejecutivas que en todo o en parte sean incompatibles con ésta hasta donde existiera tal incompatibilidad.

SECCIÓN 10ma. SEPARABILIDAD. Las disposiciones de esta Orden Ejecutiva son independientes y separadas unas de otras y si un tribunal con jurisdicción y competencia declarase inconstitucional, nula o inválida cualquier parte, sección, disposición u oración de esta Orden Ejecutiva, la determinación a tales efectos no afectará la validez de las disposiciones restantes, las cuales permanecerán en pleno vigor.

SECCIÓN 11ma. NO CREACIÓN DE DERECHOS EXIGIBLES. Esta Orden Ejecutiva no tiene como propósito crear derechos substantivos o procesales a favor de terceros, exigibles ante foros judiciales, administrativos o de cualquier otra índole, contra el Gobierno de Puerto Rico o sus agencias, sus oficiales, empleados o cualquiera otra persona.

SECCIÓN 12ma. VIGENCIA. Esta Orden Ejecutiva entrará en vigor inmediatamente. La Comisión completará sus funciones el 30 de septiembre de 2010, a menos que su encomienda sea extendida por el Gobernador.

SECCIÓN 13ma. PUBLICACIÓN. Esta Orden Ejecutiva debe ser presentada inmediatamente en el Departamento de Estado y se ordena su más amplia publicación.

EN TESTIMONIO DE LO CUAL, expido la presente Orden Ejecutiva bajo mi firma y hago estampar el gran sello del Gobierno de Puerto Rico, en La Fortaleza, en San Juan, Puerto Rico, hoy 12 de marzo de 2010

LUIS G. FORTUÑO
GOBERNADOR

Promulgada de conformidad con la ley, hoy día 12 de marzo de 2010.

Kenneth D. McClintock

KENNETH McCLINTOCK HERNÁNDEZ
SECRETARIO DE ESTADO

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12 de marzo de 2010

PRESENTAN CUADRO FISCAL DE LOS SISTEMAS DE RETIRO DE EMPLEADOS DEL GOBIERNO

Gobernador firma Orden Ejecutiva para crear la Comisión de Reforma de los Sistemas de Retiro del Gobierno de Puerto Rico

SAN JUAN, PR – El presidente de la Junta de Síndicos de la Administración de Sistemas de Retiro de los Empleados del Gobierno y la Judicatura, Carlos M. García, anunció hoy la firma por parte del Gobernador de Puerto Rico, Luis Fortuño de una Orden Ejecutiva creando la Comisión de Reforma de los Sistemas de Retiro del Gobierno de Puerto Rico para atender la precaria situación fiscal que hoy confrontan dichos sistemas.

Según dijo García, por décadas, los sistemas de retiro del Gobierno de Puerto Rico han acumulado déficits actuariales gigantescos que hoy totalizan casi $23,800 millones. Déficit actuarial quiere decir que, a no ser que se hagan ajustes, el Sistema no tendrá suficiente dinero para poder pagar en el futuro todos los beneficios que tendría que pagar a todos los pensionados, y esa deficiencia al presente totaliza $23,800 millones.

García explicó que estos déficits se han acumulado porque a través de los años se han ido aprobando mayores beneficios para los pensionados sin proveer los fondos necesarios para pagarlos.

Así mismo, indicó que aunque estos déficits se han ido acumulando por años, prácticamente se han duplicado del 2007 al presente. Por ejemplo, ya para el 2007, el Sistema de Retiro de los Empleados del Gobierno Central tenía dinero para cubrir sólo $2 de cada $10 que debería pagar en beneficios a los pensionados en el futuro, y en sólo dos años—al 30 de junio del 2009—esa cantidad se había reducido a menos de $1 de cada $10 dólares.

“La situación de caja de todos los sistemas es deficitaria, es decir, se paga anualmente más en pensiones que lo que se recibe por concepto de aportaciones patronales, aportaciones de los empleados y asignaciones legislativas para leyes especiales como bono de navidad, medicinas, entre otras”, explicó García.

García explicó que la situación fiscal de los Sistemas de Retiro se agravó en los últimos años de la administración anterior debido, entre otras, a la decisión de aumentar el límite de préstamos de $3,000 a $15,000 y reducir el período de renovación de dos años a un año, lo cual ha tenido el efecto de reducir significativamente el dinero que el Sistema mantiene en caja para poder pagar beneficios a los pensionados. Esto, porque aunque son préstamos, la realidad es que en la mayoría de los casos los mismos no se repagan, sino que se siguen renovando indefinidamente.

Además, García señaló que la Administración anterior permitió que el Sistema cogiera prestados casi $3,000 millones en una estrategia de inversión bien riesgosa que resultó negativa para el Sistema.

García explicó que los expertos han estimado que, de no tomarse acciones para mejorar la situación fiscal de los sistemas de retiro, la vida útil de los mismos se extenderá solamente hasta el cierre del año fiscal 2019, o sea dentro de menos de una década. Esto quiere decir que, a partir de entonces, los sistemas no tendrán el dinero necesario para pagar todos los beneficios de retiro a todos los empleados pensionados.

García recordó que esta situación, lejos de ser nueva, ha sido ampliamente reseñada por la prensa—particularmente la prensa de negocios—por los pasados 10 años. “El récord periodístico está ahí y todos lo pueden examinar. Los expertos llevan alertando sobre esta situación por años y la prensa, muy responsablemente, ha estado reseñando esa alerta. Lo que hay que preguntarse es por qué los que han estado en posición de atender con seriedad este problema en el pasado no lo han hecho”, señaló García.

A su vez, García negó que la implantación de la Ley 7 de Emergencia Fiscal haya sido la causa del gigantesco déficit actuarial que confrontan los Sistemas de Retiro del Gobierno.

“La deficiencia actuarial de 90.7% que tiene el Sistema fue acumulada antes de cualquier cesantía por concepto de la Ley 7. De hecho, la mayoría de los empleados afectados por Ley 7 pertenecen a Sistema 2000”, aclaró García. Según el ejecutivo, el efecto de la salida del sistema de los empleados afectados bajo la Ley 7 en los activos del sistema de retiro del gobierno central— si todos los empleados afectados retiraran su dinero del sistema al terminar su empleo en el gobierno—sería de apenas 3%, mientras que el impacto en el flujo de caja—por razón de que habiendo terminado su empleo en el gobierno ya no aportan al sistema—ha sido de sólo 3.1%

En cuanto al caso específico del Sistema de Retiro de Maestros, García recordó que los maestros estaban excluidos de las cesantías bajo la Ley 7 y solamente hubo 953 maestros que se acogieron a las renuncias voluntarias, los cuales en su mayoría estaban a sólo 3 años para su retiro. El impacto de esas renuncias voluntarias de maestros sobre el flujo de caja xes de sólo un 0.4%.

"Estos son los números reales, y demuestran de manera definitiva que el problema del gigantesco déficit de casi $23,800 millones que confrontan los sistemas de retiro del Gobierno NO ha sido causado por la implantación de la Ley 7 de Emergencia Fiscal. Afirmar lo contrario es pura demagogia que no es conducente a darle a este asunto la consideración seria y responsable que requiere y que nuestros pensionados se merecen", afirmó García.

Para atender esta situación, el Gobernador de Puerto Rico, Luis Fortuño, firmó en el día de hoy una Orden Ejecutiva creando la Comisión para la Reforma de los Sistemas de Retiro del Gobierno de Puerto Rico. Esta Comisión, presidida por el Secretario del Departamento del Trabajo y Recursos Humanos, estará integrada además por ocho peritos expertos en el tema de sistemas de pensiones: dos representantes del sector laboral público; dos representantes de las agencias de la Rama Ejecutiva; un representante del Senado de Puerto Rico; un representante de la Cámara de Representantes de Puerto Rico; y un representante de la Comisión Especial Permanente sobre los Sistemas de Retiro.

La Comisión deberá presentar al Gobernador, en un plazo de seis meses, recomendaciones concretas sobre cómo resolver el problema fiscal de los Sistemas de Retiro que el Gobierno de Puerto Rico ha estado arrastrando por décadas.

Por su parte el Secretario del Trabajo, Miguel Romero expresó que "la crisis en los sistemas de retiro requiere soluciones concretas que garanticen que nuestra clase trabajadora del sector público tenga un sistema de retiro solvente que atienda las necesidades de nuestros pensionados presentes y futuros. Con la creación de esta comisión se demuestra el espíritu de inclusión y apertura de esta Administración al buscar soluciones reales con la colaboración de todos los sectores. Por nuestra parte proveeremos el liderato necesario para que la Comisión cumpla en tiempo su encomienda y el Gobernador tenga las opciones que puedan salvar el sistema de retiro de nuestros empleados públicos".

García reiteró lo dicho por el Gobernador Fortuño en el día de ayer a los efectos de que hasta que no se tengan las recomendaciones de esta Comisión, no se implantará ningún cambio que afecte a los pensionados, incluyendo la posibilidad de tomar préstamos tal cual lo han estado haciendo hasta ahora.

"La solución a la situación fiscal de los Sistemas de Retiro tiene que ser una solución integral, que tome en cuenta los intereses de todos los participantes en el sistema y muy particularmente los pensionados. Lo que estamos buscando es darle a este problema una solución justa y responsable que proteja el bienestar de todos los pensionados, los que están jubilados ya y los que se habrán de jubilar en el futuro. Por décadas, las administraciones anteriores no sólo han pospuesto darle una solución definitiva al problema sino que lo han agravado. Aquí lo que estamos buscando es darle una solución definitiva al problema por el bien de todos los pensionados", concluyó García.

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Presentation to the Investment Committee
Asset Liability Study

January, 2010
Armand Yambao, FSA, Principal
Kristine L. Ford ,CFA, Principal
Satya Kumar, CFA, Associate
Maritza Martinez, Investment Analyst

ASR

SRM Estado Libre Asociado de Puerto Rico Sistema de Retiro para Maestros

Commonwealth of Puerto Rico

Contents

Section 1: Circumstances, Goals and Conclusions

Circumstances and Goals

- The purpose of this report is to provide an analysis of the current investment policy allocation in the context of expected liabilities and to recommend potential modifications
- Our thoughts and recommendations are framed in the context of providing the ERS and TRS with an investment portfolio that is expected to earn a reasonable return within an acceptable risk tolerance range
  - Particular emphasis is placed on the ability to pay the annual benefit obligations for the defined benefit plans
- In addition, this report examines new areas of potential investment
  - The goal of any "new" investment strategy is to further diversify the overall portfolio as well as provide potential down-side protection in times of market stress

Circumstances and Goals (cont'd)

- This study reviews potential investment strategies that might be conducive to providing the pension assets with a more stable (and smoother) return pattern
- This report also examines potential allocations to the following asset classes / strategies:
  - Global Tactical Asset Allocation
  - Commodities

Asset Allocation Comparison

	Current ERS	Current TRS	Taft – Hartley	Public Funds	Foundation & Endowment
U.S. Equity	**25.0%**	**45.0%**	42.7%	36.5%	28.4%
Non-U.S. Equity	**10.0**	**18.0**	12.6	18.8	15.5
Real Estate	**0.0**	**0.0**	9.0	7.3	4.8
Private Equity	**1.0**	**1.0**	1.8	6.6	11.5
Other	**0.0**	**0.0**	4.7	2.0	4.1
Fixed Income (and internally managed loans)	**64.0**	**36.0**	26.6	27.2	20.5
Hedge Funds	**0.0**	**0.0**	2.6	1.7	15.3

Source: 2008 Greenwich Market Dynamics Report

- Greenwich Associates does not specifically break-out global equity and other asset classes
- The ERS Asset allocation is as of 6/30/2009
- The TRS Asset Allocation is as of 9/30/2009

Conclusions

- Our asset liability model provides support for a considerable allocation to equity-like assets
- Changes in the benefit structure and higher contributions can have a more meaningful impact to help prolong the life of the pension assets than the asset allocation decision alone
- Each examined asset class / investment strategy carries with it benefits and potential concerns
- Global Tactical Asset Allocation (GTAA) strategies and commodities can be considered to help improve the plan assets' diversification and improve the risk profile of the total portfolio
- A benefit of these strategies comes in the form of low correlations to the existing portfolio
  - Ultimately, it is expected that an allocation to any of these strategies will result in a lower total fund risk level
  - Our modeling suggests a modest improvement in expected return
- Since the loans to participants are a part of the total fixed income assets, the role of the fixed income portfolio should be re-defined

Section 2: Asset Liability Study

Retirement Plan Finance

Ultimately

Contributions + Investment Income = Benefit Payments

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Total Portfolio Risk and Return Statistics (Current)

Asset Allocation:	Current ERS As of 6/30/2009	Current TRS As of 9/30/2009
U.S. Equity	25%	45%
Non-U.S. Equity	10	18
Private Equity	1	1
Bonds (includes Loans)	64	36
Geometric Return	5.9%	6.7%
Risk	8.1%	11.6%

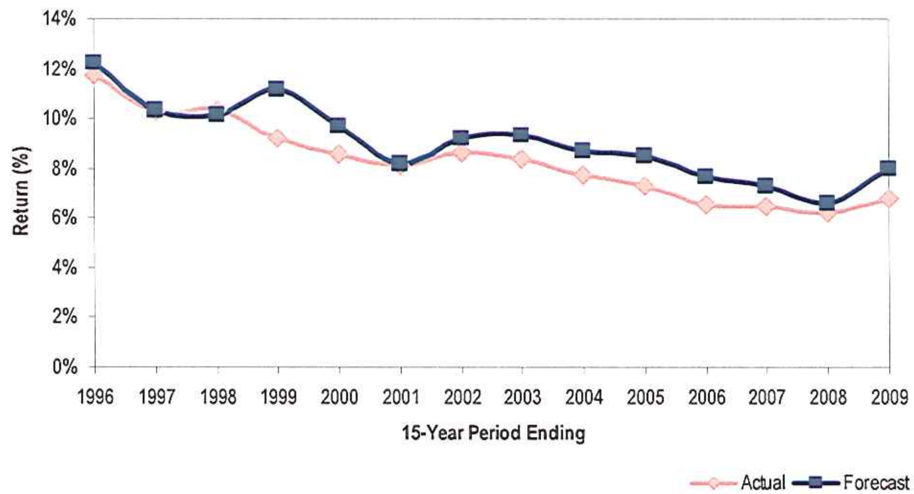
CAPM – Individual Asset Class / Strategy Expected Risk and Return Statistics

	Asset Allocation:	Arithmetic Return	Risk	Geometric Return
Equity-like Assets	U.S. Equity	8.5%	17.1	7.0%
	Non-U.S. Equity	8.7	19.7	6.8
	Real Estate	6.7	12.3	6.0
	Private Equity	14.4	32.3	9.2
	Fixed Income	4.9	6.6	4.6

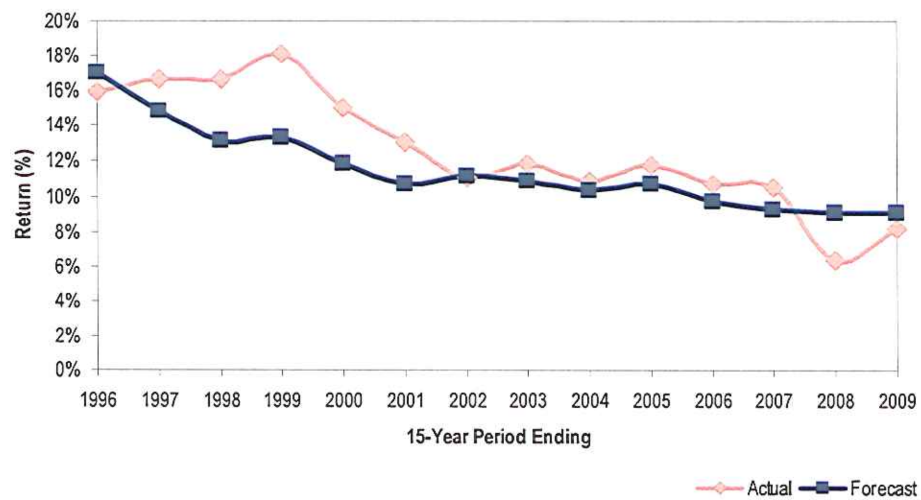
- The analysis separates the portfolio into two basic parts:
  - Fixed Income/Risk reducing assets = fixed income, which is represented by the Barclays Capital Aggregate Bond Index and other bonds
  - Equity/Risky assets = equity and other risky assets such as private equity, real estate and alternatives

A Reality Check on the Assumptions

U.S. Bond Returns Over 15 years



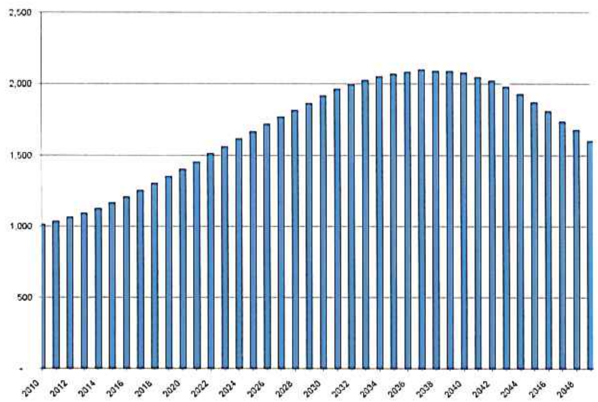
U.S. Stock Returns Over 15 years



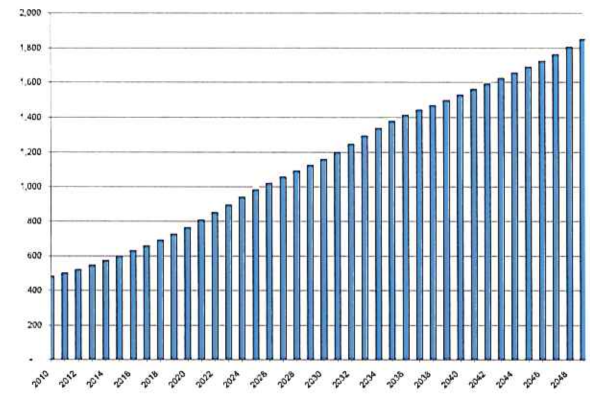
Policy Analysis Tool
Benefit Completion

- A "perfect" outcome would deliver 100% of all the benefits shown in the chart

Projected Benefit Payments for ERS



Projected Benefit Payments for TRS



- In this case, the benefit completion ratio would be 100% overall (assume a 40-year timeframe)
- Benefit Completion Ratio represents the percentage of the benefit cash flows that can be paid over the next 40 years
  - A benefit completion ratio of 50% indicates that only half of the benefits over the next 40 years are actually paid
- The success of any other outcome can be measured by the percentage (less than 100%) of the total benefits that are delivered, overall and within each tranche
  - Each of the 1,000 scenarios has its own benefit completion results
  - The distribution of outcomes can be summarized
  - Policy choices will affect these distributions

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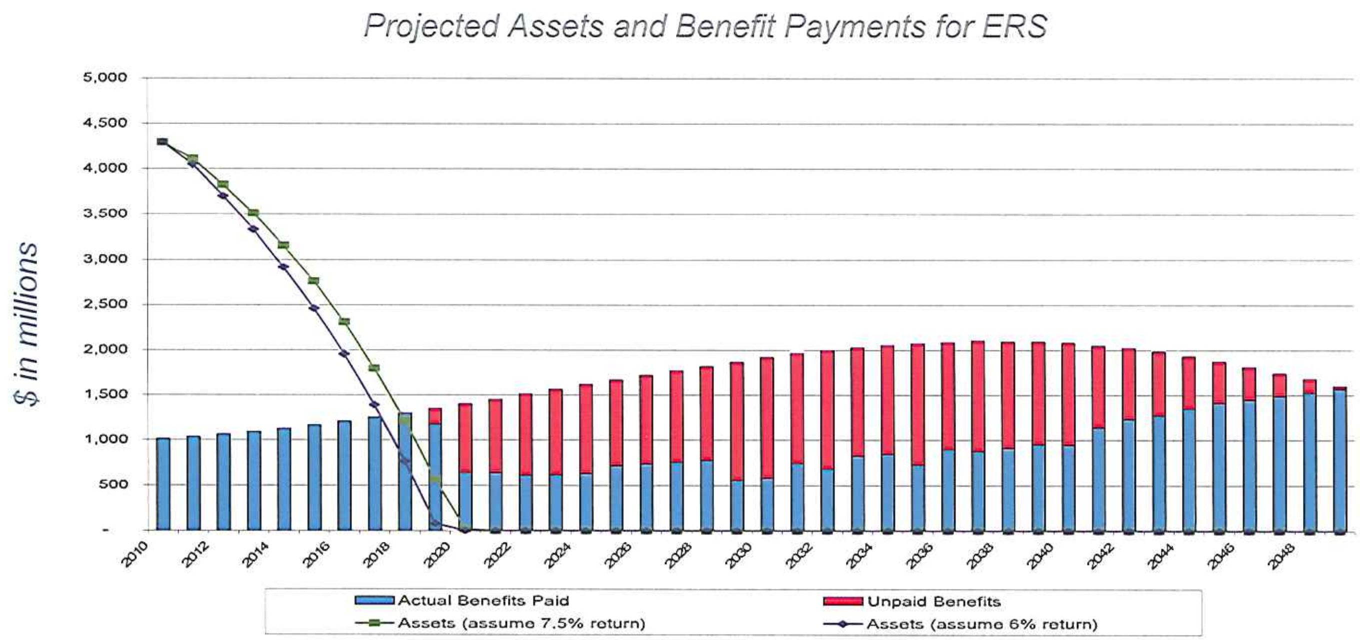
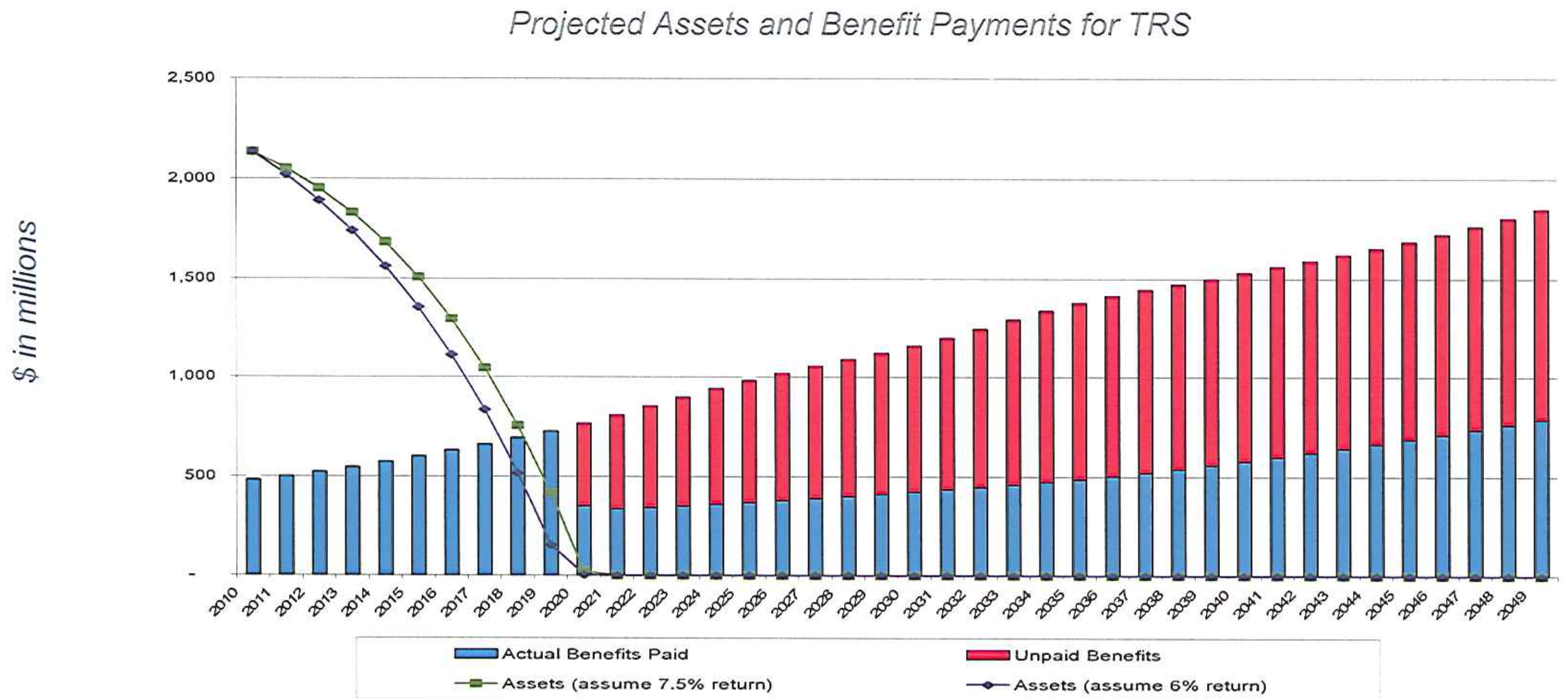
Current Circumstances (ERS)



- Assuming assets earn 7.5%, the plan assets will be depleted by year 2019
  - Over the next 40 years, the benefit completion ratio is 64% (i.e., 64% of the original benefits can be paid)
- Assuming assets earn 6.0%, the plan assets will be depleted by year 2019
  - Over the next 40 years, the benefit completion ratio is 63% (i.e., 63% of the original benefits can be paid)

Current Circumstances (TRS)



- Assuming assets earn 7.5%, the plan assets will be depleted by year 2020
  - Over the next 40 years, the benefit completion ratio is 56% (i.e., 56% of the original benefits can be paid)
- Assuming assets earn 6%, the plan assets will be depleted by year 2019
  - Over the next 40 years, the benefit completion ratio is 55% (i.e., 55% of the original benefits can be paid)

Range of Benefit Completion Ratio for Various Allocation to Equity/Risk Assets (ERS)

Benefit Completion Ratio	40% Risk Alloc.	50% Risk Alloc.	60% Risk Alloc.	70% Risk Alloc.	80% Risk Alloc.	90% Risk Alloc.
Percentile:						
95%	67.1%	68.4%	70.1%	72.0%	74.3%	77.2%
75%	65.2%	65.9%	66.7%	67.4%	68.2%	69.2%
50%	64.1%	64.4%	64.7%	65.0%	65.4%	65.7%
25%	62.6%	62.5%	62.4%	62.3%	62.1%	61.9%
5%	60.1%	59.5%	58.9%	58.3%	57.7%	57.1%
1%	58.7%	57.9%	57.3%	56.8%	56.2%	55.6%
Average all 1,000	63.9%	64.2%	64.6%	65.0%	65.6%	66.2%
Average worst 200	60.7%	60.2%	59.7%	59.2%	58.8%	58.3%
Incremental risk-reward ratio		1.41	1.22	1.02	0.87	0.68

- Higher allocations to equity-like assets can improve the benefit completion ratio during average economic scenarios
- However, during bad economic scenarios, the benefit completion ratio can be lower under higher equity allocations

Range of Benefit Completion Ratio for Various Allocation to Equity/Risk Assets (TRS)

Benefit Completion Ratio	40% Risk Alloc.	50% Risk Alloc.	60% Risk Alloc.	70% Risk Alloc.	80% Risk Alloc.	90% Risk Alloc.
Percentile:						
95%	59.5%	60.8%	62.6%	64.8%	67.3%	70.7%
75%	57.6%	58.3%	59.0%	59.8%	60.7%	61.6%
50%	56.4%	56.7%	57.1%	57.4%	57.8%	58.1%
25%	55.1%	54.9%	54.8%	54.7%	54.4%	54.2%
5%	52.6%	52.0%	51.5%	50.9%	50.4%	49.8%
1%	51.3%	50.5%	49.9%	49.3%	48.8%	48.3%
Average all 1,000	56.3%	56.6%	57.0%	57.5%	58.1%	58.8%
Average worst 200	53.1%	52.7%	52.2%	51.8%	51.3%	50.9%
Incremental risk-reward ratio		1.27	1.10	0.93	0.77	0.60

- Higher allocations to equity-like assets can improve the benefit completion ratio during average economic scenarios
- However, during bad economic scenarios, the benefit completion ratio can be lower under higher equity allocations

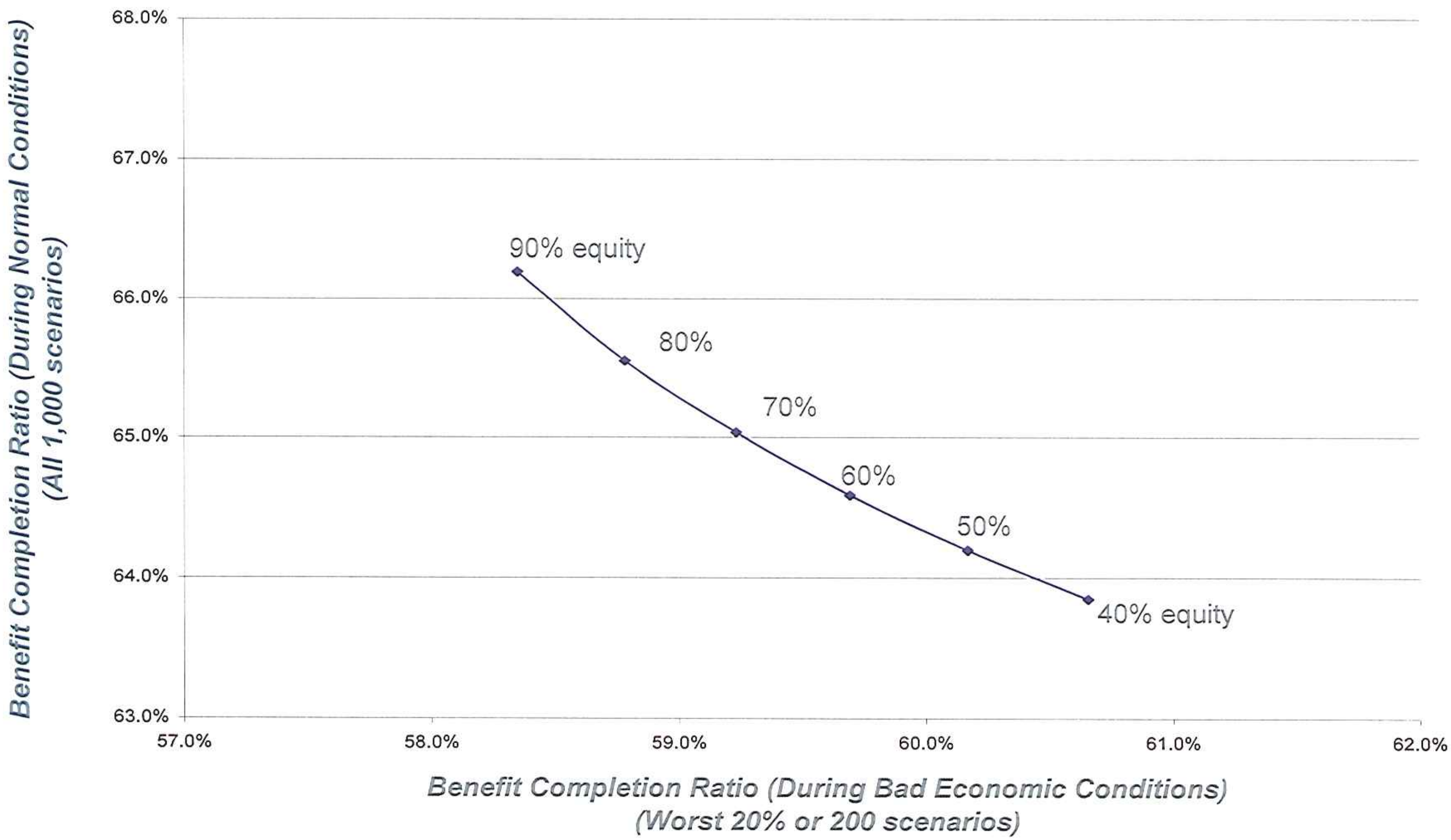
Contribution and Benefit Policy

- Increase in Contributions
  - For ERS, if POB payments are paid by the Commonwealth (instead of the System), this is effectively an increase in contributions
  - For TRS, the impact of increasing the total contributions from 17.5% to 25% of payroll is considered
- Benefit adjustments
  - For ERS, the impact of changing the benefit structure (as illustrated by the plan's actuary, Milliman) is considered

Risk / Reward Analysis

- Based on a comprehensive success measure – "benefit completion ratio"
- Reward = average benefit completion ratio of all 1,000 simulated scenarios
- Risk = average benefit completion ratio of the worst 200 simulated scenarios
- Risk / reward analysis
  - Analyzes risk / reward trade-offs among different asset allocation strategies
  - Plots the changes in risk and reward measures vs. a selected benchmark strategy

Risk / Reward Analysis (ERS)



Observations: High equity allocations provide favorable results

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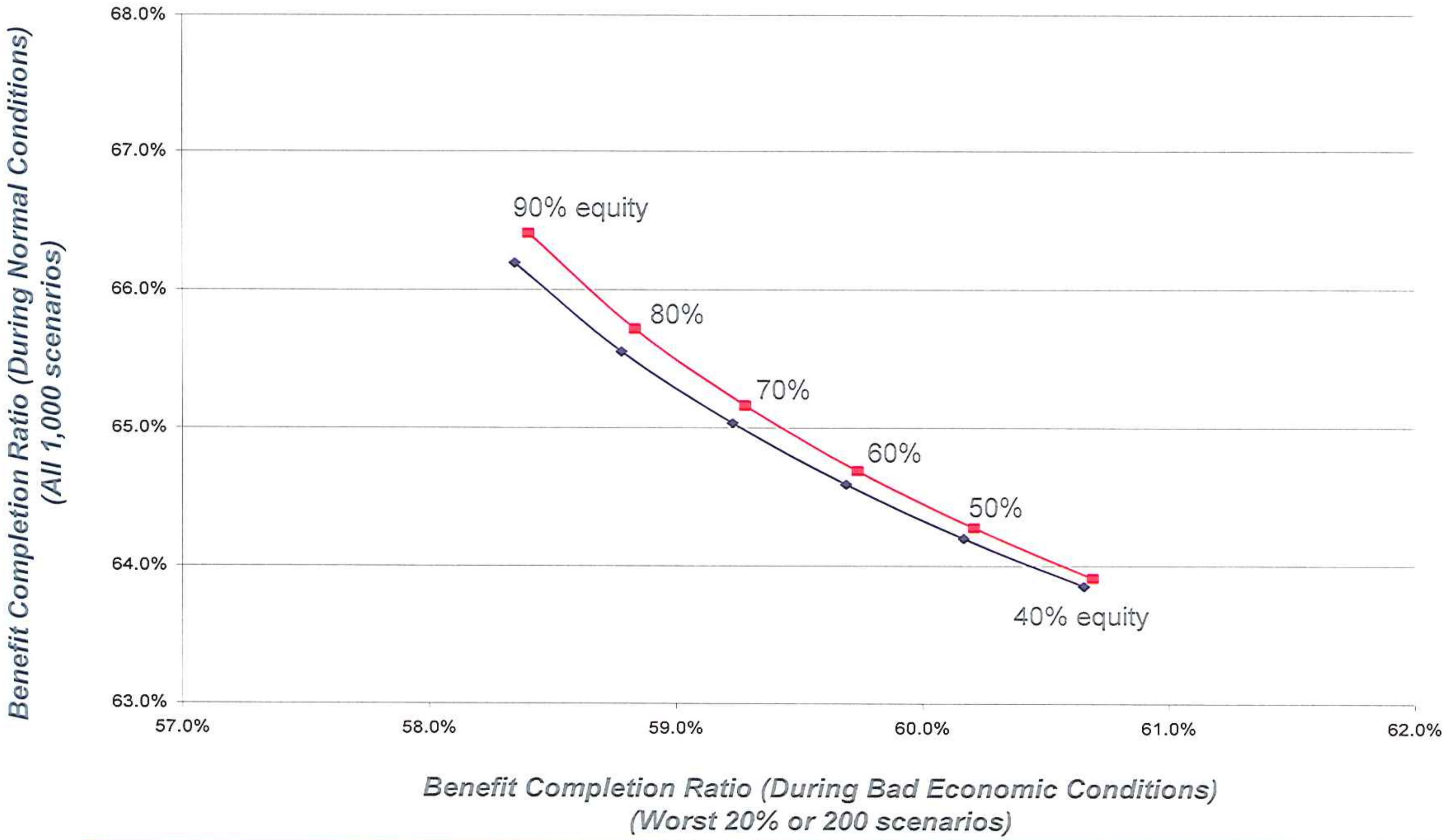
Risk / Reward Analysis (ERS) – Impact of Adding GTAA and Commodities



Observations: Including GTAA and Commodities within the equity allocation provides some improvement (represented by the red line)

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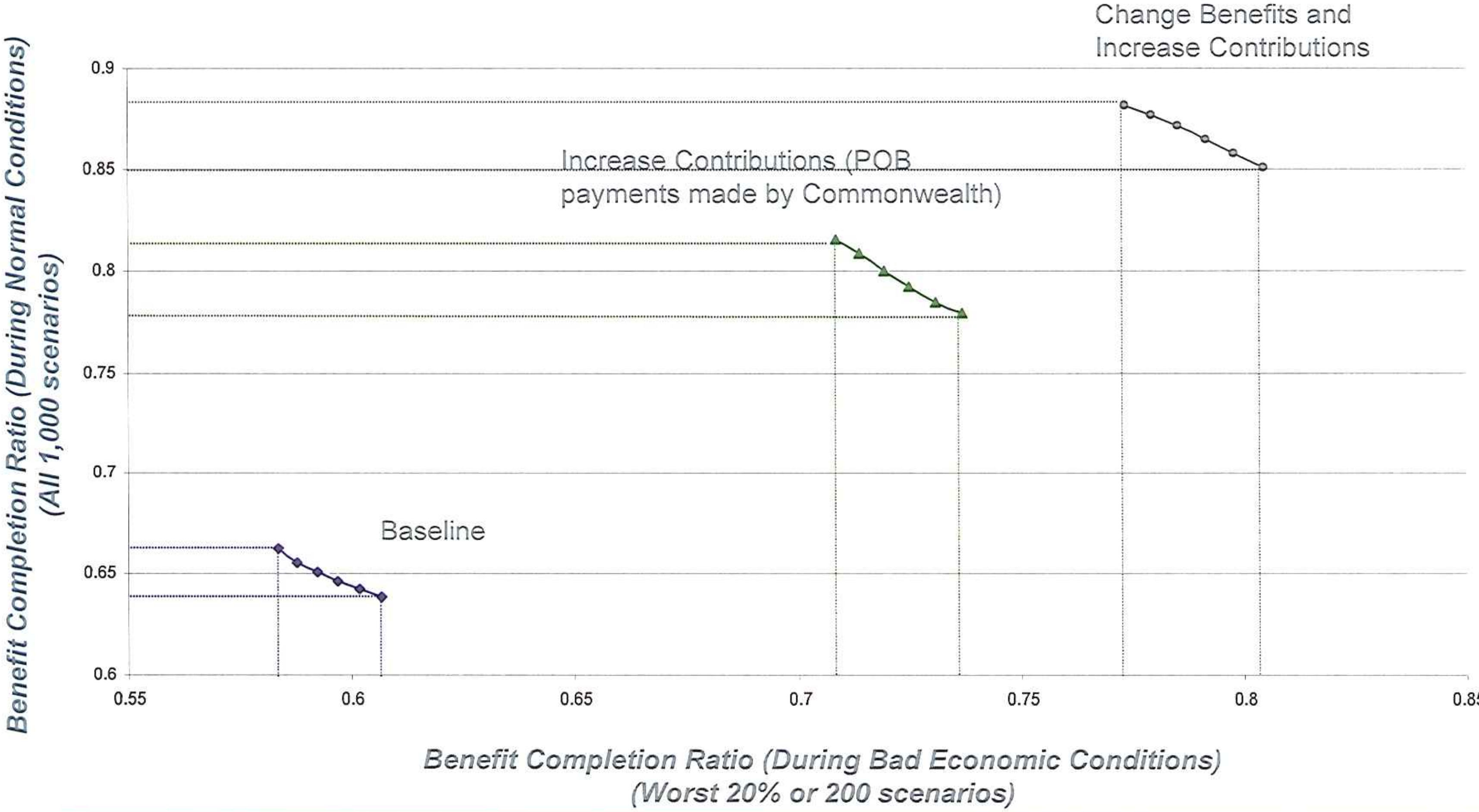
Risk / Reward Analysis (ERS) – Impact of Increasing Contributions and Changing Benefits



Observations: Increasing the equity allocations can improve the benefit completion ratio from 64% to 66% while increasing contributions can further increase the ratio to 82% and changing benefits can further increase the ratio to 88%.

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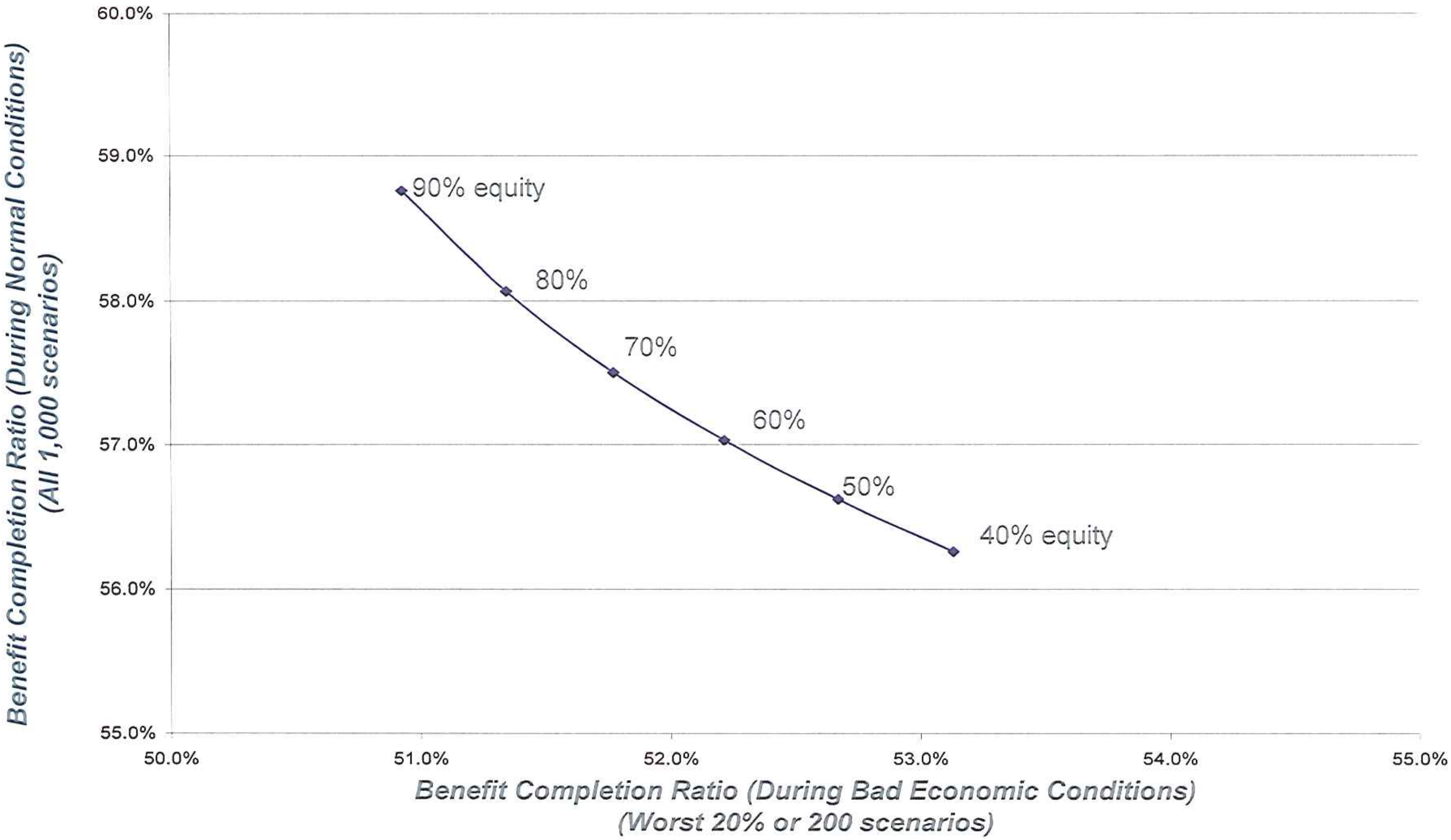
Risk / Reward Analysis (TRS)



Observations: High equity allocations provide favorable results

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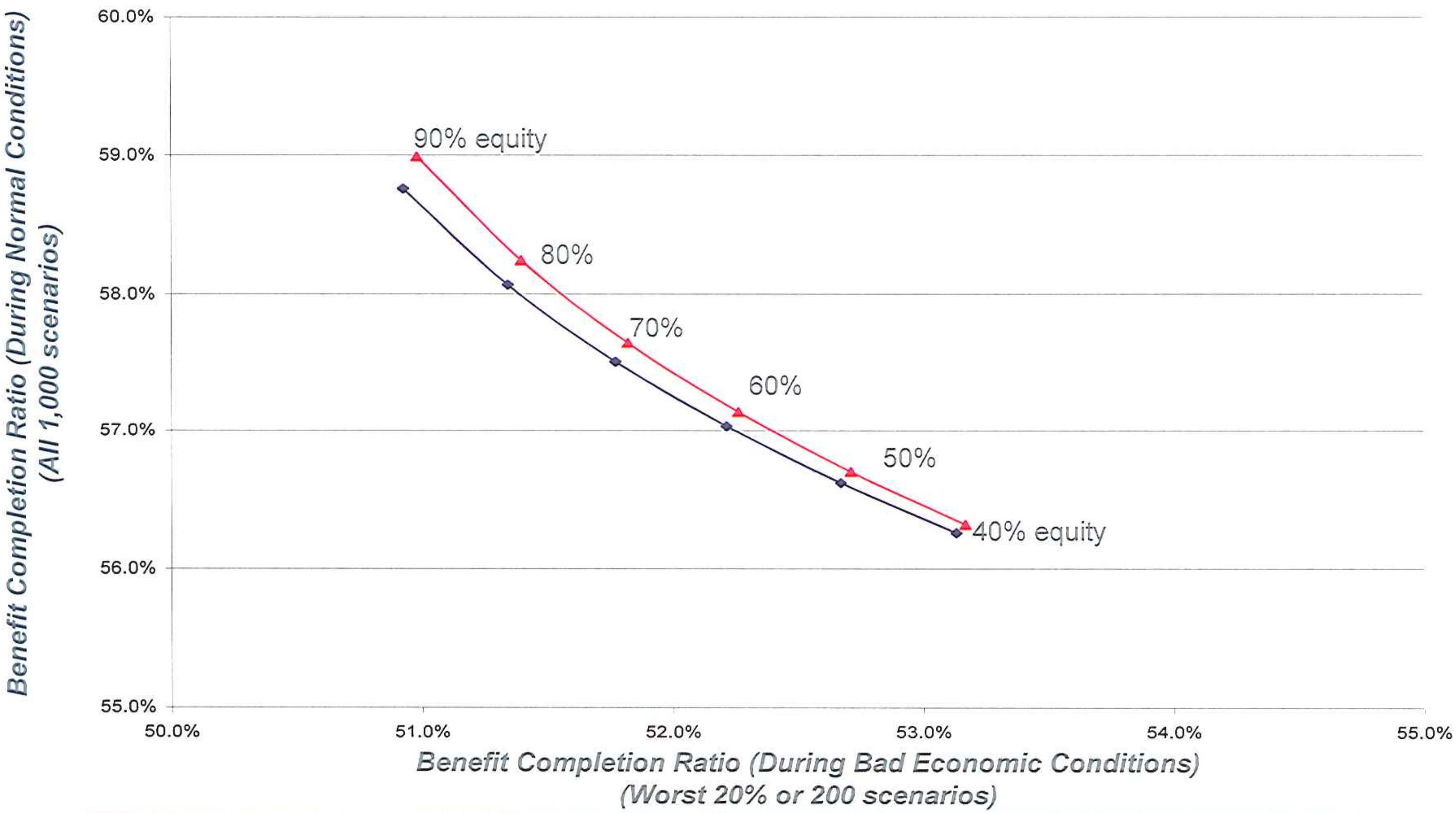
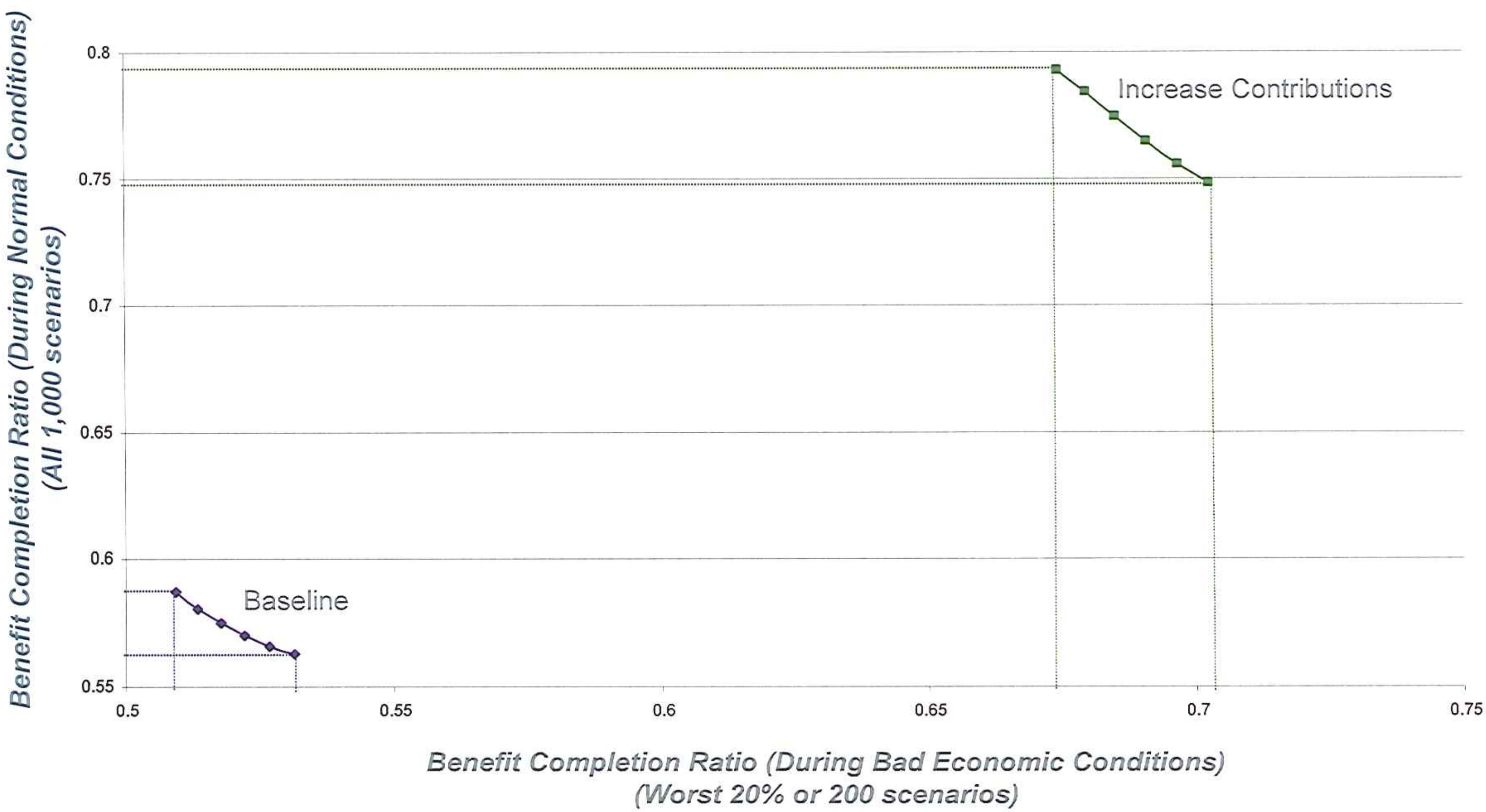
Risk / Reward Analysis (TRS) – Impact of Adding GTAA and Commodities



Observations: Including GTAA and Commodities within the equity allocation provides some improvement (represented by the red line)

Risk / Reward Analysis (TRS) – Impact of Increasing Contributions



Observations: Increasing the equity allocations can improve the benefit completion ratio from 56% to 59% while increasing contributions can further increase the ratio to 79%.

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Total Portfolio Risk and Return Statistics (Current and Proposed)

Asset Allocation:	Current ERS	Current TRS	Proposed (Near Term)	Proposed (Long Term)
U.S. Equity	25%	45%	35%	40%
Non-U.S. Equity	10	18	25	35
Private Equity	1	1	--	--
Commodities	--	--	5	5
Global Tactical Asset Alloc	--	--	5	5
Fixed Income (includes Loans)	64	36	30	15
Equity/Fixed Income Split	36% / 64%	64% / 36%	70% / 30%	85% / 15%
Geometric Return	5.9%	6.7%	6.6%	6.9%
Risk	8.1%	11.6%	11.3%	13.6%

- In the near term, a significant allocation to bonds is inevitable since the loans represent 20% to 25% of total assets
- Ideally, in the long term, the outstanding loans would represent a smaller portion of the total asset allocation

Capital Asset Pricing Model (CAPM): Individual Asset Class / Strategy Expected Risk and Return Statistics

Asset Allocation:	Arithmetic Return	Risk	Geometric Return
U.S. Equity	8.5%	17.1	7.0%
Non-U.S. Equity	8.7	19.7	6.8
Real Estate	6.7	12.3	6.0
Private Equity	14.4	32.3	9.2
Fixed Income	4.9	6.6	4.6
GTAA	6.6	9.9	6.1
Commodities	5.4	16.0	4.1

Asset Liability Study Observations

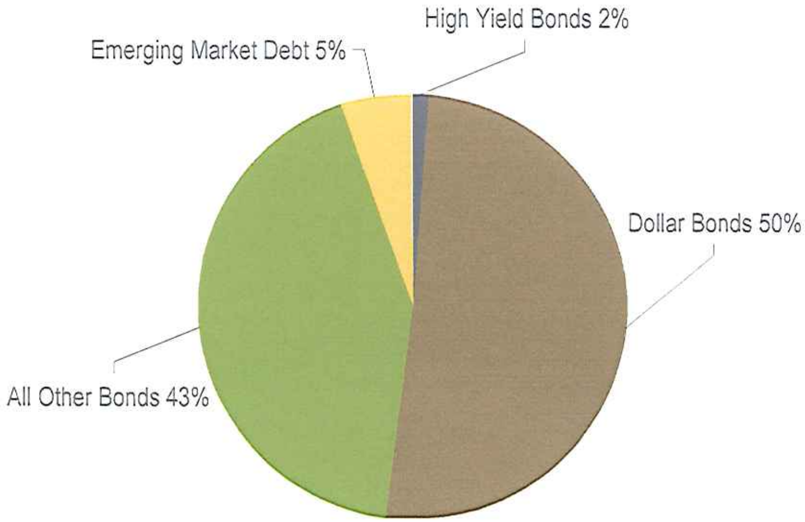
- An allocation of 80% to 90% to equity-like assets is reasonable
- However, the short-term risks of higher equity allocations in terms of potentially lower benefit completion ratios during bad economic times needs to be considered
- Other investment strategies (GTAA and Commodities) can help improve diversification
- Changes to the benefit structure and changes to contributions have a more significant impact than changes in the asset allocation
- For the long term success, there should be a reduction in the personal and mortgage loan portfolios

Section 3: Asset Review

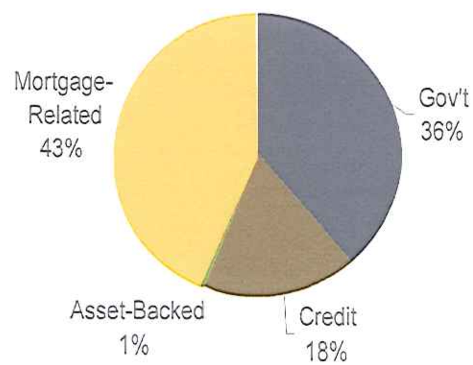
Fixed Income Opportunity Set

- Barclays Capital Aggregate Bond Index represents one-fifth of the global fixed income investable universe
- Active managers aim to exploit opportunities in non-Index segments, e.g., EMD or HY

Global Fixed Income Investable Opportunity Set
As of 12/31/2008



Total Global Fixed Income Opportunity Set
$53.3 trillion



Barclays Capital Aggregate, $11.4 trillion
21% of Global Opportunity Set

Source: UBS Global Asset Management, Venture Economics, EnnisKnupp, Barclays Capital

Role of Fixed Income

- Total Return Orientation: *Core Plus*
  - Core "plus" achieved through active management
  - Active decisions regarding duration, yield curve, sector allocations, security selection that may differ, sometimes significantly, from the composition and characteristics of the benchmark
  - Exposure to non-dollar bonds, emerging market debt and high yield (non-investment grade)
  - Seldom hold meaningful allocations to U.S. Treasury securities
  - Capital appreciation is a component of the mandate, not solely income
  - Performs well in periods of risk-taking and spread tightening

- Downside Protection: Portfolio Anchor
  - Higher-quality bias, and significant U.S. Treasury exposure to be effective
  - Dampens overall portfolio volatility
  - Avoids non-investment grade
  - Performs well in periods of stress and flight to quality, but lags in normal and rising markets

Summary Thoughts for Fixed Income Assets

- Since there is a significant allocation to participant loans (20% to 25% of assets are in loans) which can be deemed as a portion of the total fixed income assets, the role of the bonds should be more to anchor the portfolio. This means that the bonds should be invested mostly in high quality assets as a protection to downside scenarios.

- Thus, the role of the Fixed Income portfolio should be re-defined.

- Over time, the allocation to loans can be reduced so that the total fixed income assets represent only 10% to 20% of the portfolio

Global Tactical Asset Allocation (GTAA) Overview

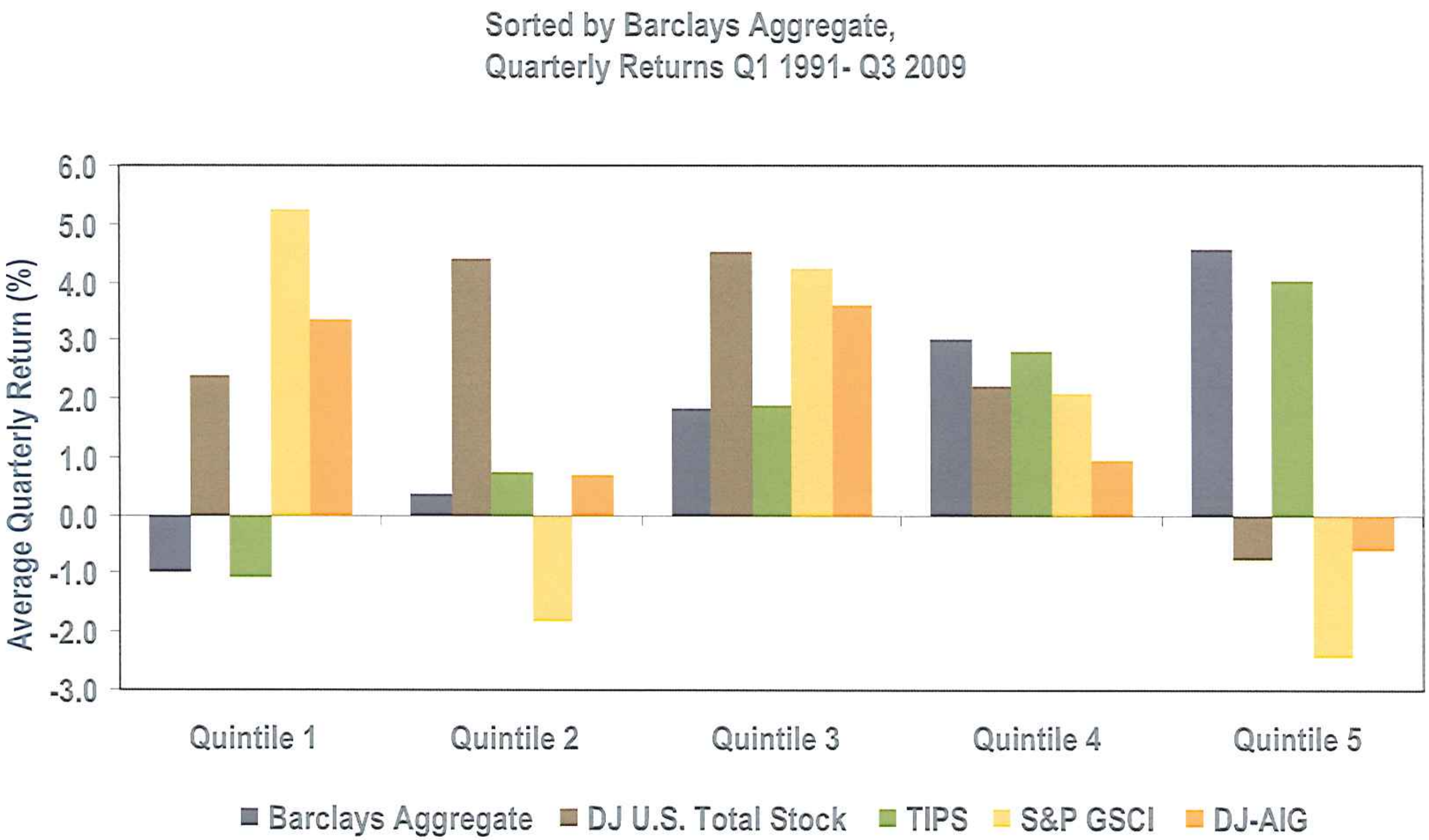
- Global tactical asset allocation (GTAA) takes positions on broad asset classes – stocks, bonds and currencies, among others – based on the relative attractiveness of these asset classes
- Investing in this strategy requires one to accept that inefficiencies exist in at the broad asset class level
  - Although most strategies have a security selection component, a manager adds the most value by correctly timing investments in asset classes
- GTAA strategies are usually entirely invested among stocks, bonds, and cash, with gross and net total exposure close to 100%; they attempt to match or outperform stocks with lower volatility

GTAA Returns

Performance Table (Through October 2009)		
Year	GTAA	60 / 40 Mix
2001	-3.6%	-1.4%
2002	6.7	-1.3
2003	22.4	16.0
2004	14.6	9.1
2005	11.8	6.1
2006	8.6	10.8
2007	7.5	8.8
2008	-19.9	-16.4
2009 (9 Months)	20.4	19.2
Trailing Five-Year	5.5%	5.5%
Trailing Ten-Year	7.1	5.1
Trailing 15-Year	8.5	6.7

Note: 60 / 40 Mix consists of 60% MSCI GIMI and 40% Barclays Capital Aggregate; GTAA represents a composite of five "favored" managers

Commodities Outperform in Weak Bond Markets



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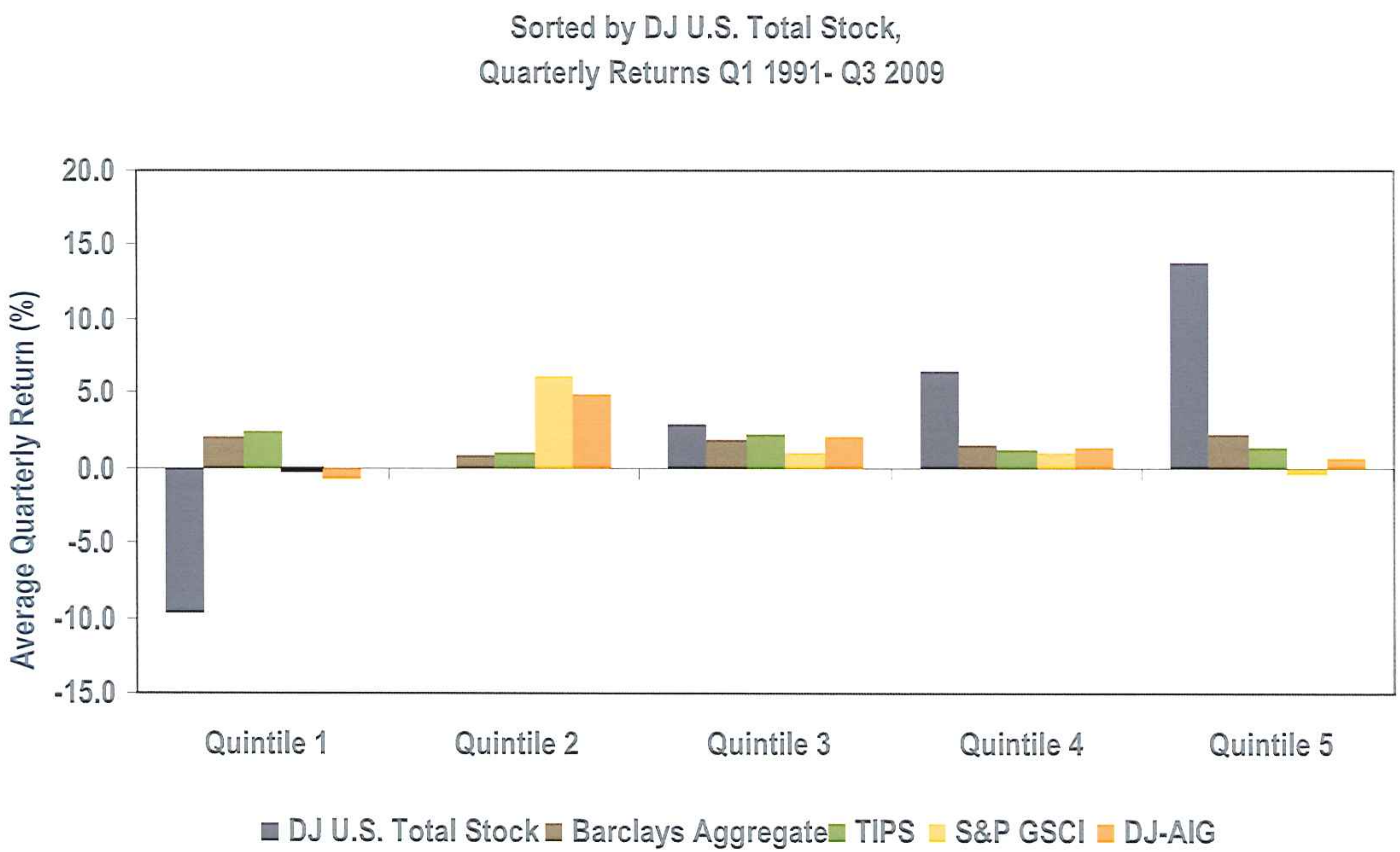
Commodities Preserve Value in Weak Equity Markets



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Section 4: Recommendations and Next Steps

Asset Liability Study Recommendations

- Increase the allocation to equity-like assets to 85% through the adoption of the proposed long term asset allocation targets below for ERS, TRS and JRS
- Include specific allocations to GTAA strategies and Commodities under the category Alternative Investments

Asset Allocation:	Current ERS	Current TRS	Proposed (Near Term)	Proposed (Long Term)
U.S. Equity	25%	45%	35%	40%
Non-U.S. Equity	10	18	25	35
Private Equity	1	1	--	--
Commodities	--	--	5	5
Global Tactical Asset Alloc	--	--	5	5
Fixed Income (includes Loans)	64	36	30	15
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Geometric Return	5.9%	6.7%	6.6%	6.9%
Risk	8.1%	11.6%	11.3%	13.6%

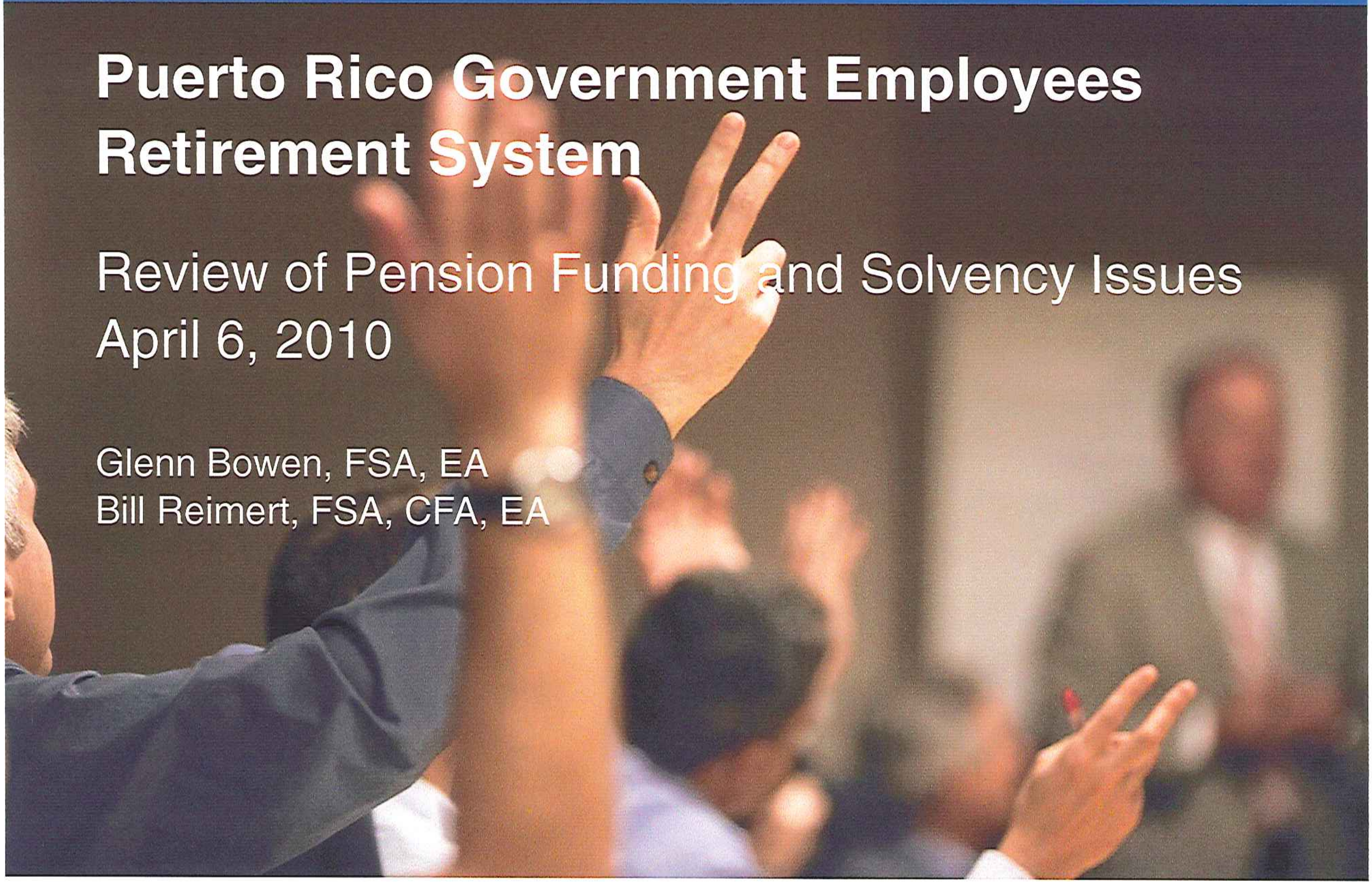
Next Steps

- Develop an Implementation Plan to execute the asset allocation recommendations from the Asset Liability Study. As part of the implementation:
  - Review the investment structures of the U.S. and Non-U.S. Equity portfolios to improve or enhance return (with consideration for risk)
  - Redefine the role of Fixed Income
- Explore ways to reduce the participant loan exposure

Puerto Rico Government Employees Retirement System

Review of Pension Funding and Solvency Issues
April 6, 2010

Glenn Bowen, FSA, EA
Bill Reimert, FSA, CFA, EA



Milliman

PRGERS Actuarial Valuation Results

Comparison of 2007 and 2009 Valuation Results for Basic System Benefits

($ in billions)

	2007	2009
Actuarial Accrued Liability	$14.6	$16.7
Assets (Net)	2.9	1.9
Unfunded liability	11.7	14.8
Annual Required Contribution (employer portion)	1.0	1.3
Employer Contribution	0.4	0.4

2009 PRGERS Actuarial Valuation

A. Summary of Principal Results of June 30, 2009 Actuarial Valuation *($ amounts in thousands)*

	Basic System Pension Benefits only	System Administered Pension Benefits only	GASB 25 & 27 Accounting (Basic System and System Administered Pension Benefits)	GASB 45 Accounting (Other Postemployment Benefits)
Actuarial Accrued Liability	$16,691,197	$2,252,389	$18,943,586	$1,633,159
Actuarial Value of Assets	1,851,223	0	1,851,223	0
Unfunded Actuarial Accrued Liability	14,839,974	2,252,389	17,092,363	1,633,159
Normal Cost				
(A) Gross Normal Cost	333,517	10,493	344,010	32,187
(B) Expected Member Contributions	340,903	0	340,903	0
(C) Administrative Expenses	32,250	0	32,250	0
(D) Net Employer Normal Cost (D) = (A) – (B) + (C)	24,864	10,493	35,357	32,187
Annual Required Contribution (ARC)				
(A) Normal Cost	24,864	10,493	35,357	32,187
(B) Amortization of Unfunded Liability	1,236,711	187,706	1,424,417	96,107
(C) ARC (A) + (B)	1,261,575	198,199	1,459,774	128,294
Employer Contributions *(estimated)*	440,873	149,869	590,742	85,487

2009 PRGERS Actuarial Valuation

C. Projected Cash Flows for Basic System Benefits

Plan Year Ending	Estimated Payroll	Estimated Member and Employer Contributions	Estimated Benefit Payments and Administrative Expenses	Net Cash Flow	Estimated Net Plan Assets at Year-End
06/30/2010	4,293,000,000	753,000,000	1,181,000,000	(428,000,000)	1,546,305,000
06/30/2011	4,400,000,000	772,000,000	1,191,000,000	(419,000,000)	1,227,849,000
06/30/2012	4,510,000,000	792,000,000	1,210,000,000	(418,000,000)	886,546,000
06/30/2013	4,623,000,000	811,000,000	1,231,000,000	(420,000,000)	517,572,000
06/30/2014	4,739,000,000	832,000,000	1,258,000,000	(426,000,000)	114,704,000
06/30/2015	4,857,000,000	852,000,000	1,292,000,000	(440,000,000)	(332,895,000)
06/30/2016	4,978,000,000	874,000,000	1,330,000,000	(456,000,000)	(830,653,000)
06/30/2017	5,102,000,000	895,000,000	1,370,000,000	(475,000,000)	(1,385,443,000)
06/30/2018	5,230,000,000	918,000,000	1,415,000,000	(497,000,000)	(2,004,651,000)
06/30/2019	5,361,000,000	941,000,000	1,464,000,000	(523,000,000)	(2,697,258,000)
06/30/2020	5,495,000,000	964,000,000	1,513,000,000	(549,000,000)	(3,468,768,000)

Notes:
- Estimated Net Plan Assets at Year-End assumes that the investment return assumption of 7.5% is met.
- Estimated Payroll is assumed to grow 2.5% annually.
- Member and Employer Contributions were estimated to be 17.55% of Estimated Payroll for plan year ending 06/30/2010 and each year thereafter.
- The Estimated Benefit Payments do not include amounts expected to be made to future participants, such as:
  - refund of contributions to terminated nonvested participants,
  - disability benefits,
  - death benefits,
  - retirement benefits due to service purchase,

  and thus are slightly understated.
- Administrative Expenses are assumed to grow 2.5% annually.
- Contributions on behalf of and benefit payments to members of System 2000 are included in the table above

2009 PRGERS Actuarial Valuation

B. Accumulated Member Contributions for Active Members as of June 30, 2009

	Contribution Account Balances
Government	
Act 447	814,575,000
Act 1	903,146,000
System 2000	350,562,000
	2,068,283,000
Corporation	
Act 447	299,117,000
Act 1	220,033,000
System 2000	84,139,000
	603,289,000
Counties	
Act 447	120,393,000
Act 1	199,080,000
System 2000	99,919,000
	419,392,000
Total	
Act 447	1,234,085,000
Act 1	1,322,259,000
System 2000	534,620,000
	3,090,964,000
Market Value of Assets as of June 30, 2009	1,851,223,000

Observations on PRGERS

- Accumulated active member contribution balances exceed System net assets.
- A significant portion of System net assets are illiquid in nature.
- Current member and employer contribution rates are inadequate to satisfy the System's pension obligations.
- Without significant additional funding and/or benefit cuts, the System is projected to deplete net assets in 5 years! At that time the System will be using Pension Obligation Bond proceeds to pay retirees their pensions and will not have a funding source to pay future debt service or principal on the bonds.

Based on the above, we recommend that the System and the Commonwealth inform all stakeholders of the projected exhaustion of the fund and take immediate action to ensure future solvency.

Basis for Analysis

Future actuarial measurements may differ significantly from the current measurements presented in this report due to factors such as the following:

- Plan experience differing from the actuarial assumptions;
- Future changes in the actuarial assumptions;
- Increases or decreases expected as part of the natural operation of the methodology used for these measurements (such as potential additional contribution requirements due to changes in the plan's funded status); and,
- Changes in the plan provisions or accounting standards.

Due to the limited scope of our assignment, we did not perform an analysis of the potential range of such measurements.

The June 30, 2007 and June 30, 2009 valuation reports form an integral part of the analysis contained in this presentation and should be consulted for additional detail.

#	State	Plan	Actuarial Funding Ratio	Active Participants	Annuitants	Employer Contribution Rate	Employee Contribution Rate	Normal Retirement (age/svc)	Early Retirement (age/svc)	% of Salary if Retirement at 30 years	SS ?	Salary Calculation
1	PR	Puerto Rico ERS	17	104,399	98,950	9.28%	8.28%	55/30	55/25	75.00%	No	Highest 3 years or last 5 years
2	PR	Puerto Rico Law 447	11.0*	46,062	96,843	9.28%	8.28%	55/30	55/25	75.00%	No	Highest 3 years
3	PR	Puerto Rico Law 1	71.4*	58,337	2,107	9.28%	8.28%	65/10	55/25	45.00%	No	Last 5 years
4	PR	Puerto Rico TRS	25	46,295	33,224	8.50%	9.00%	50/30	47/25	75.00%	No	Highest 3 years
5	AL	Alabama ERS	76	228,233	105,656	10.26%	5.00%	any/25, 60/10	na	60.30%	Yes	Highest 3 years in last 10
6	AZ	Arizona SRS	82	227,730	92,673	9.10%	9.10%	65/any, 62/10, Rule of 80	50/5	63.75%	Yes	Highest 3 consecutive years in last 10
7	CA	California PERF	87	836,914	408,026	15.35%	5.00%	60/5	50/5	60.00%	Both	Highest 1 or 3 consecutive years
8	CO	Colorado School	70	118,547	45,919	11.15%	8.00%	50/30, Rule of 80 at age 55, 65/5	50/25, 55/20	75.00%	No	Highest 3 years
9	CO	Colorado Municipal	76	17,379	4,396	11.00%	8.00%	65/5, 50/30, Rule of 80	60/5, 55/20, 50/25	75.00%	No	Highest 3 years
10	FL	Florida RS	105	683,811	274,842	8.62%	0.00%	62/6, any/30; 55/6	any/6	48.00%	Yes	Highest 5 years
11	GA	Georgia Teachers	95	225,024	78,633	9.28%	5.00%	60/10, any/30	any/25	60.00%	Yes	Highest year
12	HI	Hawaii ERS	68	65,251	35,324	13.75%	6.00%	62/5, 55/30	55/20	60.00%	Yes	Highest 3 years
13	IA	Iowa PERS	89	167,850	87,490	6.05%	3.90%	65/any, 62/20, Rule of 88	55/any	60.00%	Yes	Highest 3 years
14	IL	Illinois Municipal	82	181,678	90,170	9.47%	4.50%	55/35, 60/8	55/8	52.00%	Yes	Highest 4 years in last 10
15	IL	Illinois Teachers	56	165,572	91,462	12.73	0.094	62/5, 60/10, 55/35	55/20	0.567	No	Highest 4 years
16	MA	Massachusetts SERS	89	85,403	51,058	6.64%	9.00%	65/10, any/20	55/10	75.00%	No	Highest 3 consecutive years
17	MD	Maryland Teachers	80	199,255	112,422	12.62%	4.00%	any/30, 62/5, 63/4, 64/3, 65/2	55/15	42.00%	Yes	Highest 3 years
18	NY	New York City ERS	83	178,741	128,863	16.10%	3.00%	62/5	55/5	60.00%	Yes	Highest 3 consecutive years
19	OH	Ohio Teachers	79	173,327	126,506	14.00%	10.00%	65/30	any/30, 55/25, 60/5	66.00%	No	Highest 3 years
20	OR	Oregon PERS	112	167,452	105,721	13.84%	0.00%	60/5	50/5	50.10%	Yes	Highest 3 years
21	PA	Pennsylvania State ERS	89	110,866	108,146	4.04%	6.25%	60/3, any/35	any/5	75.00%	Yes	Highest 3 years
22	PA	Pennsylvania School Employees	86	264,000	168,000	7.13%	7.50%	62/1, 60/30, any/35	55/25	75.00%	Yes	Highest 3 years
23	SC	South Carolina RS	70	225,014	115,310	8.05%	6.50%	65/5, any/28	60/5, 55/25	54.60%	Yes	Highest 3 consecutive years
24	TN	TN State and Teachers	96	136,329	70,598	13.11%	0.00%	60/5, any/30	55/5, any/25	45.00%	Yes	Highest 3 consecutive years
25	TN	TN Political Subdivisions	90	76,396	27,632	9.36%	5.00%	60/5, any/30	55/5, any/25	45.00%	Yes	Highest 5 consecutive years

Public Fund Survey Summary of Findings for FY 2008

Prepared by Keith Brainard
Research Director
National Association of State Retirement Administrators
October 2009

Table of Contents

Abstract

The Public Fund Survey is an online compendium of key characteristics of the nation's largest public retirement systems and is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement for the purpose of increasing knowledge and understanding of the public pension community. A Summary of Findings is conducted annually to provide an objective overview of overall plan financing, membership and design within these systems. This year's Summary is the first following the sharp drop in global investment markets that occurred in 2008.

As expected, State and local retirement systems have sufficient assets set aside, even after the market downturn, to continue paying promised benefits for decades. However, in the wake of this unprecedented decline, most are in the process of examining benefit levels, financing structures and asset allocations to rebuild reserves and ensure sustainability well beyond that time period. While State and local government employee retirement systems have a long time horizon that allows for a patient and metered approach, the uniqueness in plan design, benefit structure, and governance arrangement between systems will require diversified responses among them.

The fall in asset values has caused aggregate funding levels to move downward from 86.7 percent in FY 07 to 85.3 percent in FY 08. Because public pension actuarial methods are designed to temper the effect of market volatility, public pensions will recognize the investment losses incurred in 2008 over several years. During this recognition period, funding levels are expected to decline, although losses may be partially offset with investment gains. Future funding levels will also be influenced to the extent sponsoring state and local governments consider adjustments to benefit levels and financing arrangements, such as reduced benefits for future hires, reduced future accruals, and/or higher contributions for both employers and employees.

About the Public Fund Survey

The Public Fund Survey is an online compendium of key characteristics of most of the nation's largest public retirement systems. The Survey is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement.

Beginning with fiscal year 2001, the Survey contains data on public retirement systems that provide pension and other benefits for 13.5 million active (working) members and 6.65 million annuitants (those receiving a regular benefit, including retirees, disabilitants and beneficiaries). Based on the latest information published in annual financial reports, systems in the Survey hold assets of $2.6 trillion. The membership and assets of systems included in the Survey comprise approximately 85 percent of the entire state and local government retirement system community.

The primary source of Survey data is public retirement system annual financial reports. Data also is taken from actuarial valuations, benefits guides, system websites, and input from system representatives. The Survey is updated continuously as new information, particularly annual financial reports, becomes available. This report focuses on fiscal year 2008, which is reported for 93 of the 101 systems in the survey.

The Public Fund Survey captures key information from public retirement systems that account for some 85 percent of all public pension assets and participants in the U.S.

A key objective of the Survey is to increase the transparency and understanding of the public pension community and public pension funding concepts, by providing a factual and objective basis on which to discuss many issues related to retirement benefits for public employees. The Public Fund Survey is accessible online at www.publicfundsurvey.org.

This Summary of Findings provides objective descriptions and perspective regarding key areas of public pension activity, such as changes in plans' funding condition, investment returns, membership, contribution rates, and others.

Overview of the public pension community

According to a 2007 study by the U.S. Government Accountability Office, employees of state and local government comprise 12 percent of the nation's full-time workforce. These employees perform a broad range of functions in such roles as public school teachers and administrators, firefighters, judges, police officers, public health officials, correctional officers, transportation workers, game wardens, nurses, engineers, health inspectors, bus drivers, procurement specialists, computer programmers, custodians, and many others.

Retirement benefits play a key role in attracting and retaining qualified employees needed to perform essential public services. These pension plans also provide stable and adequate income replacement in retirement for long-term workers, and ancillary casualty benefits related to disability and death before retirement. Unlike government programs funded out of general revenues, state and local government retirement systems generally are funded in advance, by investing employee and employer contributions during employees' public service. These benefits are distributed in the form of a lifetime payout in retirement. This allows for long-term financing and the majority of revenues to be generated from investment earnings and employee contributions, while also ensuring retirees do not outlive their retirement assets.

The long-term nature of the financing requires funding and asset allocation to be evaluated regularly to ensure that plans and benefits are sustainable over a long time horizon and continue to accommodate the changing needs of the workforce and policy goals of the sponsoring government.

Like most investors, public pension funds have experienced exceptional market volatility in recent years, punctuated by the sharp decline in equities and other asset classes in 2008. The market decline in 2008 resulted in a median investment return for public pension funds of -25.3 percent for the year,[i] and is estimated to have reduced the aggregate market value of all public pension funds by more than $800 billion.

Public pension plans are designed to withstand market volatility. Even after the market decline, through the use of strategies such as portfolio diversification, long investment and funding horizons, actuarial smoothing of investment gains and losses, and risk-pooling, the vast majority of public pension plans are able to pay promised benefits to retirees for decades into the future. While significant, the loss in assets was less severe than the losses experienced by many individual investors, particularly those with defined contribution plans as their primary retirement benefit, and has been partially offset with strong investment gains to-date in 2009.

Most individuals nearing retirement age who experience a decline in assets similar to that seen by public pension funds likely would be forced to postpone retirement, requiring additional years of work to make up for the losses. A recent study by the Employee Benefits Research Institute (EBRI) found that "nearly one in four (401(k) plan participants) ages 56-65 had more than 90 percent of their account balances in equities at year-end 2007, and more than two in five had more than 70 percent (in equities)."[ii] As a result, EBRI concluded, depending on several factors (e.g., age, salary, future investment returns), many 401(k) plan participants would be required to work up to several additional years to recoup the losses from 2008.

Even after the 2008 market decline, with no changes in benefits or financing structures, pension funds covering the vast majority of public employees are able to continue to pay benefits as promised, for decades. This difference between public pension funds and individual retirement accounts is a result of public pension methods and strategies that temper the effects of market volatility, and helps illustrate the important role defined benefit plans play in promoting retirement security.

With no changes in benefits or financing structures, pension funds covering the vast majority of public employees are able to continue to pay benefits as promised, for decades.

Effects of the 2008 market decline

The 2008 market decline, combined with other factors, will increase unfunded liabilities—and the cost of amortizing them—for most public pension plans. The extent of cost increases will vary by plan and will depend on several factors, especially the plan's funding condition prior to the market decline; the adequacy of contributions to the plan by employers and employees; and the plan's demographic composition. The cost to amortize unfunded liabilities also will be affected by the plan's actuarial methods, assumptions, and past and future investment returns.

The timing of required cost increases also will vary by plan and will be affected mostly by the date of the plan's actuarial valuation. Roughly three-fourths of the systems in the Public Fund Survey have a fiscal year-end date of June 30; most of the remaining systems have a fiscal year- end of 12/31. Because the steepest portion of the market decline occurred in October and November 2008, public pension plans with an actuarial valuation date prior to that period have not yet begun to incorporate those investment losses. Moreover, for many plans, the actuarial valuation date lags the system's fiscal year-end date. In these cases, the process of recognizing investment losses will be delayed further, typically by one year. In the interim, the performance of investment markets will offset or exacerbate the investment experience of the last few years. (Through the first three quarters of 2009, global equities experienced a robust recovery.)

The lag time between an actuarial event and a plan's actuarial valuation date, combined with other strategies employed to cushion the effects of market volatility, serves as an early warning signal of the future direction of the plan's funding level and required costs, giving plan administrators and policymakers an opportunity to plan and budget for changes to a pension plan's contribution rates and, if necessary, to its design and financing arrangements. In addition to contribution rate adjustments, these changes might also include some combination of lower benefits for future participants, or lower future benefit accruals for current participants, or both; and modifications to actuarial methods, assumptions, and processes.

Authority to revise benefit and financing arrangements varies widely among states, depending on a combination of constitutional and statutory provisions, and case laws. In some cases, policymakers may modify future benefit accrual patterns for existing plan participants. In other cases, once an employee has begun participating in the pension plan, that employee is entitled to continue to accrue benefits throughout her or his employment with the plan sponsor, with little or no change permitted.

Most plans use a five-year smoothing period (see Figure H on page 9); for these plans, incorporating the full effect of the 2008 market decline will last at least through 2013. The effects of the 2008 decline will take longer to incorporate for plans using a longer smoothing period, as well as for those whose actuarial valuation dates lag their fiscal year-end date.

Modifying plan designs, financing arrangements, and actuarial methods is not new among public pension plans. Defined benefit plans are flexible and are structured to accommodate such changes while retaining their core elements: a) a benefit that cannot be outlived; b) a benefit based on the participant's salary and length of service; and c) assets that are pooled and professionally managed. The higher costs associated with increased unfunded liabilities caused by the sharp declines in 2008 are, however, likely to spur an increase in the number of plan sponsors considering adjustments. In fact, in 2009, a handful of states have approved modifications to the pension plan design for existing participants or future hires, or both; to financing arrangements, including higher contribution rates for employers, employees, or both; and to actuarial methods and processes.

Pensions and retirement security

The retirement security of working Americans presently appears shaky outside the public sector, due not only to the nation's heavy use of a retirement plan model that has been found to be undependable in its ability to provide reliable retirement income, but also due to low relative rates of participation in employer-sponsored retirement plans. According to the U.S. Bureau of Labor Statistics, fewer than one in five workers outside the public sector has access to a defined benefit plan, and many private sector employers offer no retirement benefit to their employees. Even when employees have access to an employer-sponsored retirement benefit, nearly one-fourth elect to not participate.

Of those private sector employees who do have access to an employer-sponsored retirement benefit, the vast majority of retirement plans offered are defined contribution (DC) plans, such as a 401(k). The composite picture is one in which many workers outside the public sector are not participating in their employer-sponsored plan, and of those who are, the dependability of the available plan to produce an adequate stream of income for life, is questionable.

For most states and local governments, retirement security of retired workers is a policy that is being achieved. This is due chiefly to the provision by most public employers of a defined benefit plan featuring elements known to advance retirement security. Namely:

- mandatory participation
- mandatory annuitization, meaning that retiring participants must take their benefit as a lifetime annuity
- pooled assets that are professionally invested
- cost-sharing of contributions by employees and employers.

These plan design features promote retirement security by: a) helping ensure that workers not only have access to, but also participate in the employer-sponsored retirement plan; b) increasing the number of retiring workers who take their retirement assets as a lifetime annuity; c) keeping administrative and investment costs low; and d) maintaining the fund's stream of revenue and reducing taxpayers' costs.

Also, according to one study, by pooling assets and risk and generating higher investment returns for all plan participants, defined benefit plans deliver the same retirement benefit at nearly one-half of the cost of a defined contribution plan.[iii] DB plans also are designed to assist public employers to attract and retain workers needed to perform essential public services; to promote an orderly turnover of workers, particularly among those who have reached an age at which they may be unable to perform the duties required of their position; and to enhance the retirement security of a large segment of the nation's workforce.

The Meaning and Implications of Actuarial Funding Ratios

The most recognized measure of a public retirement plan's ability to meet current and future obligations is its actuarial funding ratio, derived by dividing the actuarial value of a plan's assets by the value of its liabilities. Pension benefits for public employees usually are funded in advance, meaning that a significant portion of the assets needed to fund pension liabilities is accumulated during an employee's working life, which is paid during the participant's years in retirement.

Such "pre-funding" is one way of financing a pension benefit. The opposite of pre-funding is pay-as-you-go, an arrangement under which current benefit obligations are paid with the pension plan sponsor's current revenues. In most cases, a pay-as-you-go pension plan eventually becomes too expensive to support with only current receipts and contributions. By contrast, investment earnings account for most revenue generated by a pre-funded pension plan, reducing required contributions from employees and employers (taxpayers).

Funded status is a spot measure of the degree to which a plan is on course to meet a distant goal. A pension plan whose assets equal its liabilities at one point in time, is funded at 100% and considered to be *fully funded.* A plan with assets less than its accrued liabilities at one point in time is considered *underfunded*.

Underfunding is a matter of degree, not of kind: the status of a plan whose funding level declines from 101 percent in year one to 99 percent the following year, changes from overfunded to underfunded. Yet despite this diametric shift in terminology, the reality of the plan's funding condition has changed little. The fact that a plan is underfunded is not necessarily a sign of fiscal or actuarial distress; many pension plans remain underfunded for decades without causing fiscal stress for the plan sponsor or reducing benefits to current beneficiaries. The critical factor in assessing the current and future health of a pension plan is whether or not funding its liabilities creates fiscal stress for the pension plan sponsor.

Although a pension plan that is fully funded is preferable to one that is underfunded, other factors held equal, a plan's funded status is simply a snapshot in a long-term, continuous financial and actuarial process. A plan's funding level is akin to a single frame of a movie that spans decades. Because public pensions are "going concerns," operating essentially as perpetual entities, there is nothing particularly important about being fully funded at any particular point. Likewise, the fact that a plan is underfunded does not necessarily present a fiscal or actuarial challenge to the plan sponsor.

The effect of the 2008 market decline was sufficient to prompt most plans to evaluate whether adjustments are required with respect to their level of benefits and financing structure in order to regain long-term actuarial solvency. Yet even with no changes to funding policies or plan design, based on current contribution levels and projected benefit obligations, most public pension plans are positioned to continue paying promised benefits for decades. Public pension liabilities typically extend years into the future, during which the pension fund can accumulate the assets needed to fund its liabilities.

Attaining full funding of a pension plan has been likened to a mortgage. At the end of the process, when fully paid, the mortgage would be considered fully funded. Although at any point during the 30-year mortgage, the outstanding liability may be considered an unfunded liability, more relevant considerations are a) whether the mortgage holder has the resources to continue making payments until the obligation is resolved; and b) whether the obligation is indeed being amortized. The size of a mortgage-holder's outstanding obligation reveals little about the holder's financial condition. The length of the mortgage and the ability of its owner to amortize the obligation without financial hardship are more relevant indicators.

Likewise, more pertinent considerations with regard to funding a public pension plan are the ability of the plan sponsor to continue to pay promised benefits and to make required contributions without causing fiscal stress, and whether the plan's unfunded liability is being amortized.

The critical factor in assessing the current and future health of a pension plan is whether or not funding its liabilities creates fiscal stress for the pension plan sponsor.

All plans, underfunded and fully funded alike, that are open to newly hired workers, rely on future contributions and investment returns. A key difference between underfunded and fully funded plans is that underfunded plans require additional revenue to amortize the shortfall between assets and accrued liabilities. The degree of underfunding and its associated cost to the plan sponsor are key considerations in assessing a plan's overall condition.

Other factors indicative of a pension plan's health include the:

- length of the funding amortization period
- required current and future contribution rates

- plan's demographics
- plan's actuarial assumptions
- sustainability of the plan design
- plan's governance structure
- fiscal health of the plan sponsor
- commitment of the plan sponsor to continue funding the plan

Information about these factors is provided in annual reports and other material published by most public retirement systems.

Past and Current Funding Levels

The aggregate public pension funding level declined in FY 08, from 86.7 percent to 85.3 percent. Figure A summarizes aggregate assets and liabilities and the resulting actuarial funding ratio for plans in the Public Fund Survey. The bar graph reflects assets and liabilities for 110 plans for which data is available for all the years in the period.

Following the market decline of 2000-2002, the aggregate funding level fell from FY 01 to FY 06, rising again in FY 07 due chiefly to investment gains that began in 2003, and to lower rates of liability growth. In response to declining investment markets beginning in October 2007, funding levels dropped in FY 08.

As described previously, public pensions are designed to absorb the shock of volatility in actuarial experience, including variations from expected levels of investment performance. This is achieved through the use of actuarial smoothing methods, which phase in investment gains and losses; funding amortization periods (that average approximately 25 years for plans in the Survey); and through use of a discount rate that is based on historic and projected long-term investment returns for individual asset classes and for the fund as a whole.

Figure B shows the change in the aggregate public pension funding level since 1990. Responding chiefly to changes in equity values, funding levels improved sharply during the 1990s, then declined beginning in 2002.

Figure A: Change in aggregate actuarial value of assets, liabilities, and funding levels, FY 01 to FY 08

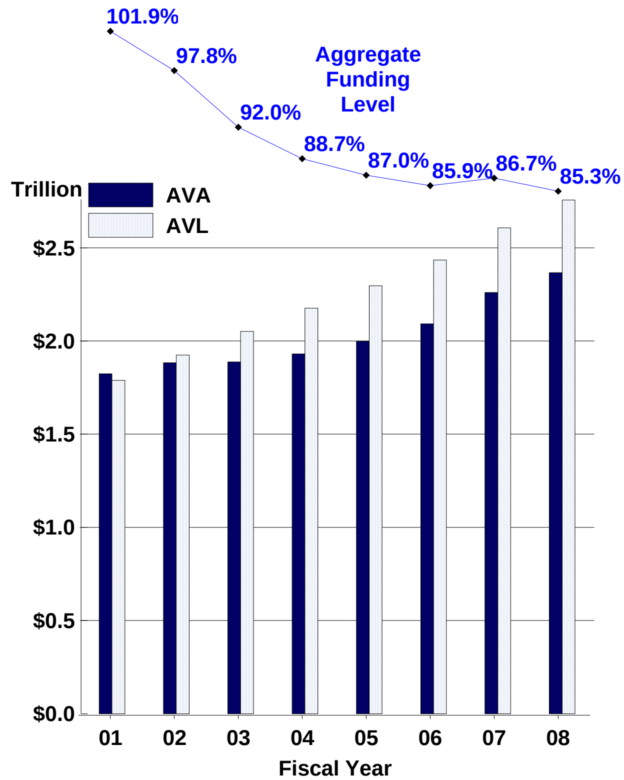
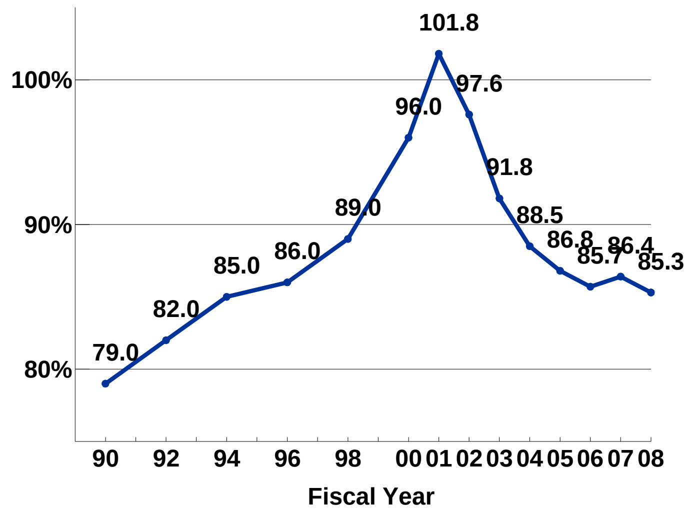


Figure B: Change in aggregate public pension funding level, FY 90 to FY 08



Standard & Poor's and Public Fund Survey

Operating under federal regulations known as ERISA, corporate pension plans are limited in their ability to moderate the effects of market volatility and required changes in plan costs. This difference in regulatory oversight is due chiefly to the fact that, unlike public sector entities, corporations can be acquired or declare bankruptcy and their pension plans can be terminated. As a result of ERISA, the aggregate funding level and required employer costs of corporate plans is significantly more volatile than that of public plans.

Figures C and D illustrate the contrast in funding levels and contributions between corporate and public pension plans. The volatility and uncertainty surrounding required costs for corporate pensions has been identified as a major factor in the decision by many corporations to freeze or terminate their pension plan. By contrast, public pension plan funding levels and contributions are designed to absorb change more slowly, due to their status as "going concerns." As a result, public plans experience less dramatic year-to-year changes in funding levels and costs.

Figure C: Comparison of corporate and public pension funding levels, FY 00 to FY 08

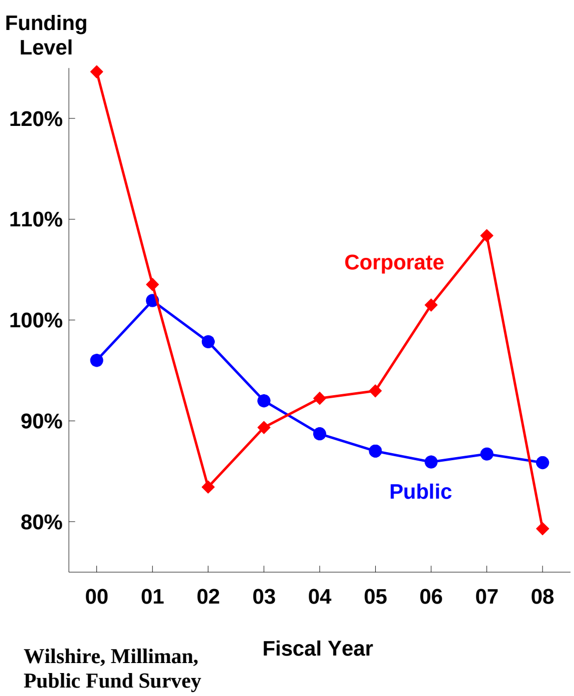
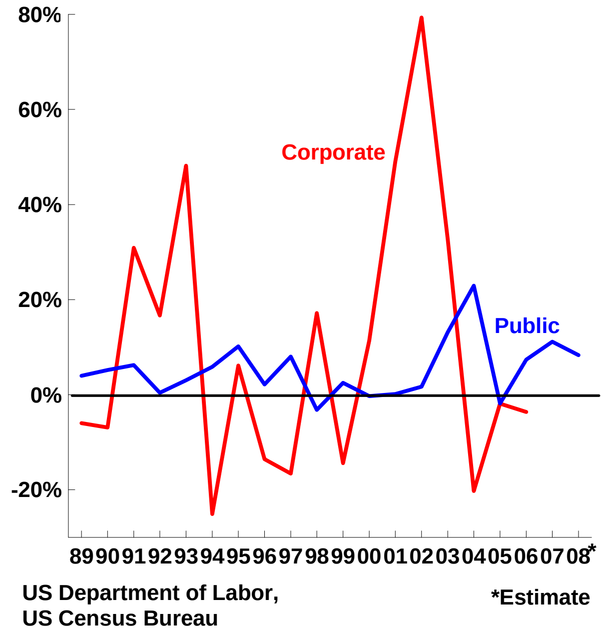


Figure D: Comparison of change from prior year in corporate and public pension contributions, 1989-2006



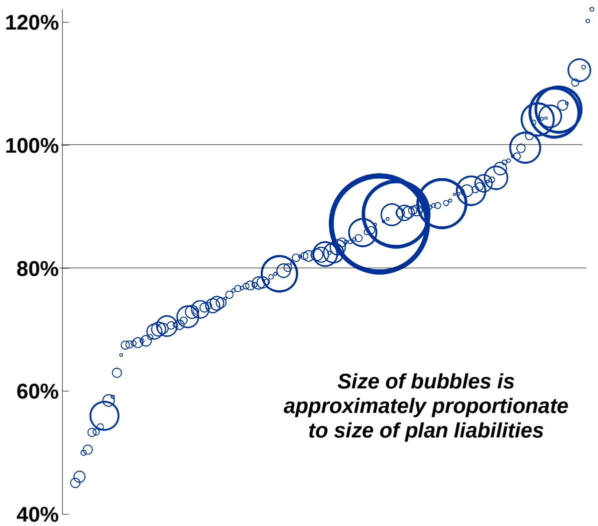
(Corporate pension contribution data, supplied by the U.S. Department of Labor, is available only through 2006.)

Figure E plots funding levels of the 125 plans in the Survey. The size of each circle on the chart is roughly proportionate to the size of the plan's liabilities: larger bubbles signify larger plans, and smaller bubbles notate smaller plans.

The funding level for most plans is based on FY 08 data. Roughly three-fourths of systems in the Survey use a fiscal year-end date of June 30, most other plans have a FY-end date of 12/31, and the others have FY-end dates in-between.

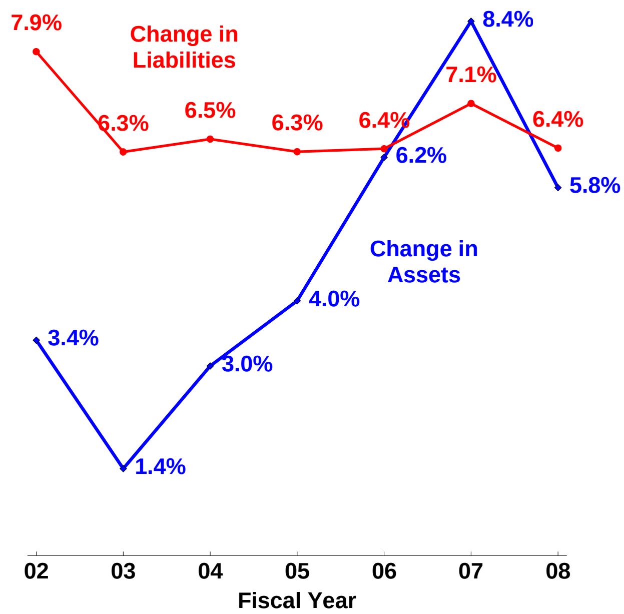
Actuarial valuation dates for nearly one-half of the plans lag behind the system's fiscal year-end date, usually by one year. Only 10 plans in the Survey had an actuarial valuation conducted at the end of 2008, which incorporated the steepest portion of the 2008 market decline.

Figure E: Distribution of actuarial funding levels for plans in the Public Fund Survey, based on latest available data



Generally, larger plans in the Survey have higher funding levels than smaller ones: plans funded above 80 percent comprise nearly three-fourths of the actuarial assets of all plans in the survey. The median funding level is 82.5 percent, down from 84.3 percent in FY 07.

Figure F: Median change from prior year in actuarial value of assets and liabilities



For a plan's funding level to improve, the rate of growth in assets must exceed the rate of liability growth. Growth in liabilities is affected by a variety of factors, including salary growth, changes in benefits, and economic and demographic changes. As Figure F shows, FY 08 median liability growth exceeded growth in assets, a change that is consistent with the decline in the aggregate funding level.

Although comparing public pension funding levels against other plans may be tempting, such a comparison must also recognize the limitations of doing so, as important differences among plans can render comparisons misleading. Some of these differences are the:

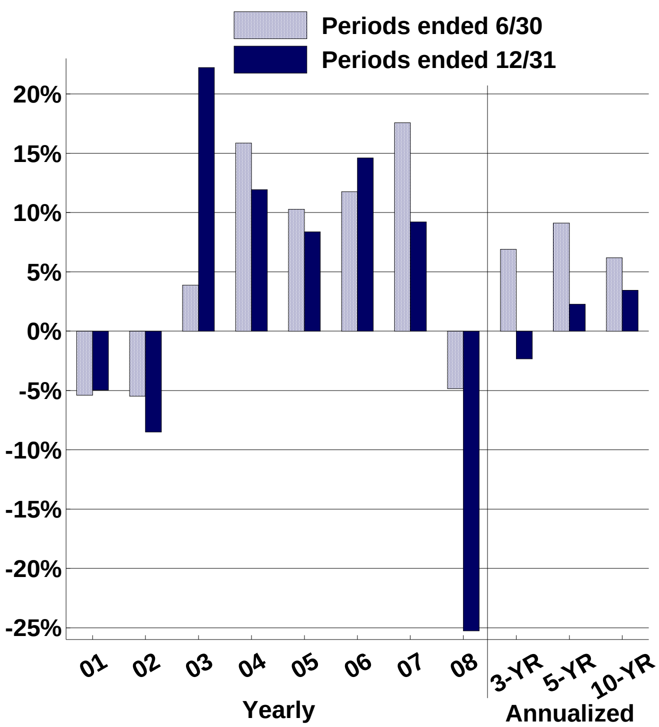
- level of required employee and employer contributions;
- plan sponsor(s)' commitment and ability to make required contributions;
- fiscal condition of the plan sponsor;
- plan's demographic makeup;
- level of benefits provided by the plan;
- plan's governance structure, including the ability (or inability) to modify the plan design and financing structure;
- plan sponsor's level of support for the pension plan;
- plan's amortization period(s);
- required benefit payments in the current and future years relative to the plan's asset base; and
- the pension fund's investment performance, risk tolerance, and expected investment return.

Any analysis of a public pension plan's financial or actuarial condition must take these and other factors into account, and failure to do so creates a risk of misunderstanding or misrepresenting the plan's true condition.

Investment returns and future funding levels

Over time, investment earnings account for the majority of public pension fund revenues. From 1982 through 2008, investment earnings accounted for 58 percent of all public pension revenue.[iv] The prominence of investment earnings in the financing arrangement magnifies the role of a pension fund's investment return on its funding condition.

Figure G: Median annual public pension fund investment returns (in percent) for years ended 6/30 and 12/31, 2001 to 2008



Source: Callan Associates

Figure G plots median public pension fund investment returns for the most-used fiscal year-end dates (6/30 and 12/31) for FY 01 to FY 08.This chart also illustrates the volatility in public pension investment returns in recent years. The chart also depicts the sharp contrast between returns for periods ended June 30 and December 31, 2008 resulting from the sharp market decline during the second half of 2008. As actuarial valuations incorporate more of the market decline, regardless of the date of the valuation, funding levels for nearly all plans will decline.

As with most investors, public pension funds experienced major losses during the decline in global investment markets that occurred from October 2007 until March 2009. As these losses are incorporated into public pension plan actuarial valuations, funding levels will decline and unfunded liabilities will grow. The extent of the decline in funding levels will vary widely among plans, based especially on the plan's funding condition prior to the market decline and its investment returns in 2008 and in subsequent years.

Although funding levels in FY 09 and the next few years are projected to be lower, the market declines experienced in 2008 have been partially offset by improving investment markets through the third quarter of 2009. Market volatility is a primary reason that most public pension plans employ techniques to phase in their investment gains and losses, rather than basing funding levels (and required costs) on a single, point-in-time market value figure.

Figure H: Distribution of smoothing periods used to calculate actuarial value of plan assets

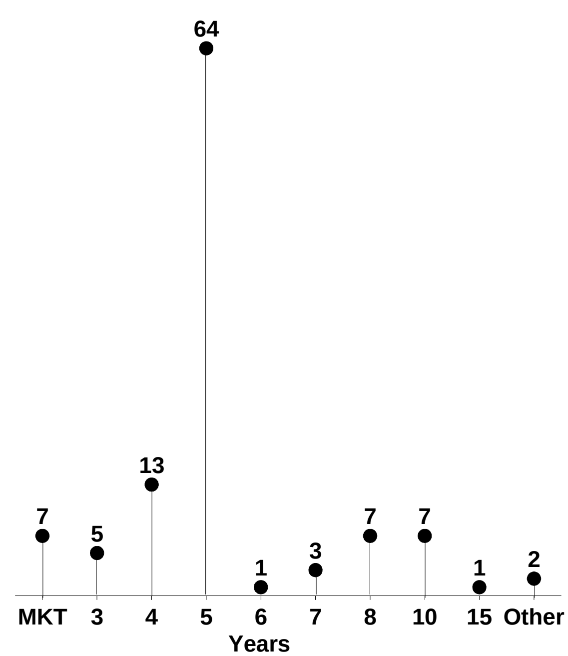
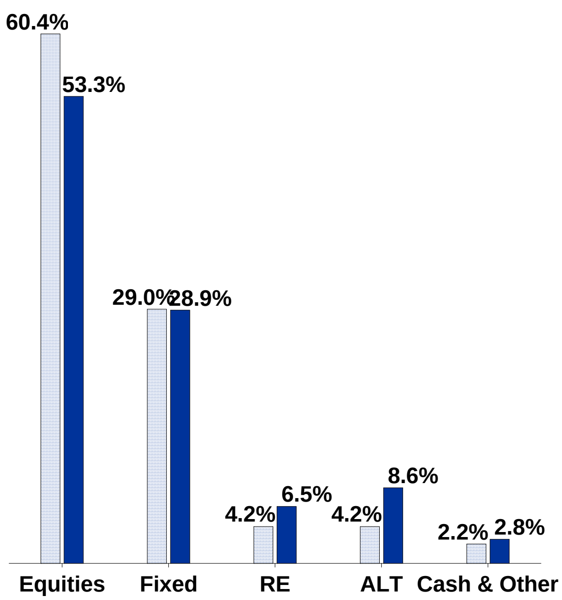


Figure H presents the distribution of periods used to determine plans' actuarial value of assets. Five years remains the predominant length of smoothing periods, although more plans are now using periods longer than five years than were several years ago. All plans that use eight years are part of the Washington State Department of Retirement Systems.

Asset Allocation and Investment Expenses

Figure I compares average asset allocations between FY 04 and FY 08 for systems in the Survey. While the fixed income allocation has barely changed, increased allocations to real estate and alternatives (chiefly private equity and hedge funds) have occurred via a reduction in equity allocations. This increased diversification reflects an effort by most public funds to retain expected returns at lower levels of risk, or to increase projected returns at the same level of expected portfolio risk.

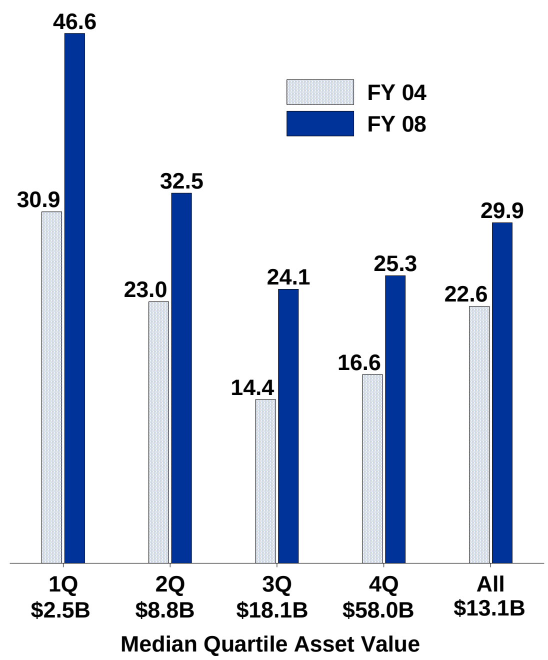
Figure I: Comparison of average asset allocation, FY 04 and FY 08



Investment management expenses paid by public funds have been rising in recent years, as evidenced in Figure J, which compares FY 04 and FY 08 median investment expenses, by quartile, for the 90 funds in the Survey for which this data is available. Median costs in each quartile are higher in FY 08 than they were in FY 04, likely due to increased use of real estate and other alternatives. Anecdotal evidence indicates that many large funds are working to negotiate lower fees for these types of investments.

Larger funds usually are able to use their size to negotiate lower asset management fees than smaller funds and individual investors. Perhaps because larger funds are more likely to be invested in alternative classes (which typically cost more to manage than other asset classes), expenses for the largest quartile are higher than those for the third quartile of funds.

Figure J: FY 04 and FY 08 median investment management expenses, by quartile



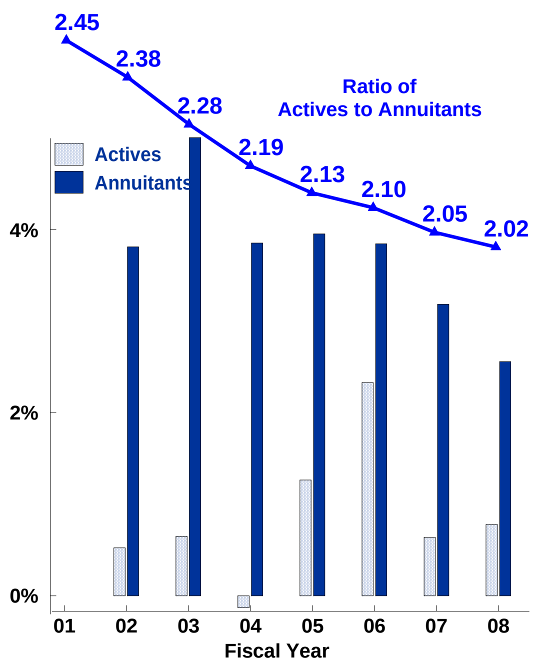
The median cost to administer plans in the Survey is under 10 basis points, or 0.10 percent of assets. Combined with investment management costs, the total cost of administering a typical public pension plan is considerably lower than that of a typical defined contribution plan, whose costs generally are 1.25 percent to 2.0 percent of assets.

Membership Changes

The Survey tracks two groups of members: actives, who are working and currently receiving service credit in their retirement plan; and annuitants, which includes any member receiving a regular benefit from the system: retirees, beneficiaries and disabilitants.

Figure K summarizes the percentage changes from the prior year in these membership groups from FY 01 to FY 08. Due largely to the aging of the nation's workforce, the rate of growth in annuitants has been outpacing the rate of growth in active (working) members. As the chart shows, the ratio of actives to annuitants has declined from 2.45 in FY 01 to 2.02 in FY 08. The number of annuitants among plans in the Public Fund Survey has increased since FY 01 by some 30 percent.

Figure K: Percentage change over prior year in active members and annuitants, FY 01 to FY 08, and change in ratio of actives to annuitants



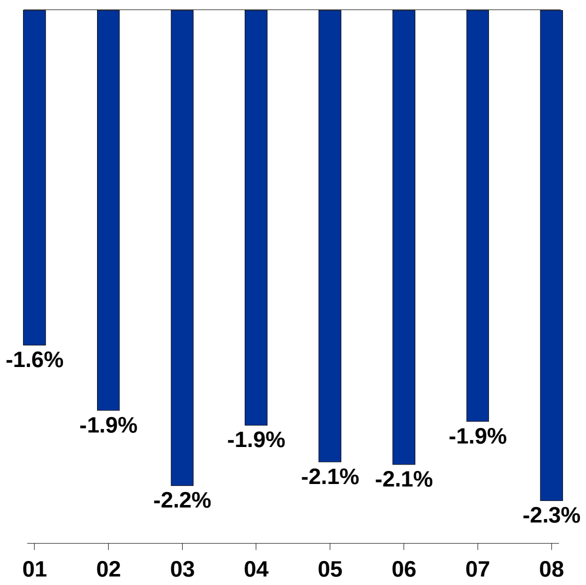
By itself, a declining ratio of actives to annuitants does not pose a problem to a public pension plan's actuarial condition, because most public pensions fund the cost of their benefits in advance. However, to the extent that a plan is underfunded, a low or declining ratio of actives to annuitants can complicate the plan's ability to move toward full funding, as fewer active, contributing workers, relatively, are available to amortize the plan's unfunded liability. An extreme example of this is evident in the case of pension plans that are closed. If a closed plan has an unfunded actuarial liability, its cost, as a percentage of payroll, will rise, often precipitously, as the liability is distributed among a diminishing pool of active participants.

A declining ratio of actives to annuitants also can have financial and operational effects on a retirement system. For example, fewer active members create a larger negative cash flow (contributions minus benefit payments and administrative expenses). At a certain point, a negative external cash flow can require a pension fund to allocate a larger percentage of its assets to more liquid securities, or to make other adjustments to its asset allocation which may reduce long-term investment returns. In addition, as a group, annuitants tend to require more time and attention than actives from the retirement system staff. This is likely because annuitants are reliant, to some degree, on current income from the system, and are more attuned to the system's activities and operations.

Figure L displays the median external cash flow among systems in the Public Fund Survey. External cash flow is the difference between a fund's revenue from non-investment earnings sources (chiefly contributions), and the fund's required expenditures (chiefly benefits and administrative expenses). Eighty-four of the 91 systems (92 percent) whose external cash flow was measured in FY 08, had a negative external cash flow.

External cash flows for most systems are expected to become increasingly negative over time. This is a normal development for a pension plan in an aging society, and the degree of the negative cash flow will also be affected by the 2008 decline in market values.

Figure L: Median external cash flow for systems in the Public fund Survey, FY 01 to FY 08



Contribution rates

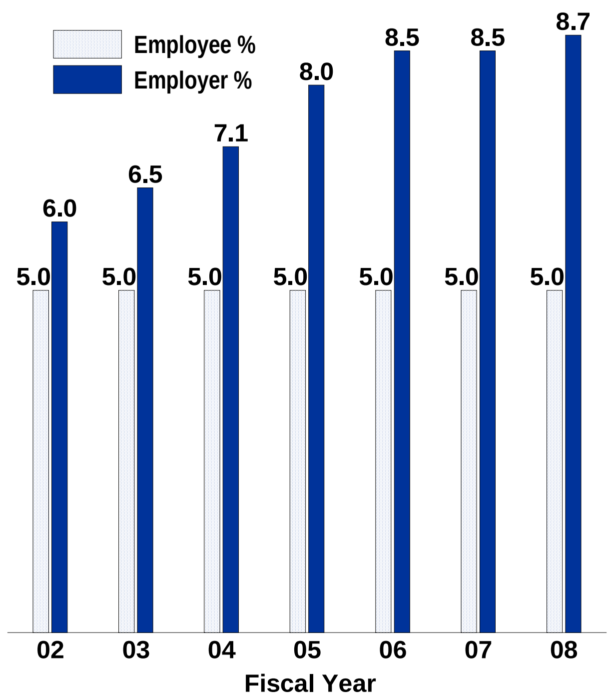
Nearly all employees of state and local government are required to make contributions to defray the cost of their retirement benefit. According to the U.S. Census, from 1982 to 2006, contributions from employees and employers accounted for approximately 14 and 28 percent, respectively, of public pension fund revenues (investment earnings make up the difference).[v] Contribution rates for employees usually are set as a fixed percentage of pay. The treatment of employer contributions varies by system: some also are fixed, others vacillate on the basis of actuarial results or the plan sponsor's fiscal condition. Although employee contributions are the smallest of the three main public pension sources of revenue, they also are the most steady and reliable, providing a predictable stream of revenue that typically is used to help fund plan benefits.

Figure M plots median contribution rates for employers and employees since FY 02 for general employees and school teachers who also participate in Social Security. This data does not include public safety personnel, such as firefighters and police officers, or narrow employee groups, such as legislators or judges.

Median employer contribution rates for workers who participate in Social Security rose to 8.7 percent of pay. The median and modal employee contribution rate for this group remained five percent of pay.

Approximately one-fourth of all employees of state and local government do not participate in Social Security, including nearly one-half of public school teachers, a majority of firefighters and police officers, and most or substantially all public employees in Alaska, Colorado, Louisiana, Maine, Massachusetts, Ohio, and Nevada. Contribution rates usually are higher for non-Social Security eligible employers and workers, because benefits usually also are higher to offset the lack of Social Security.

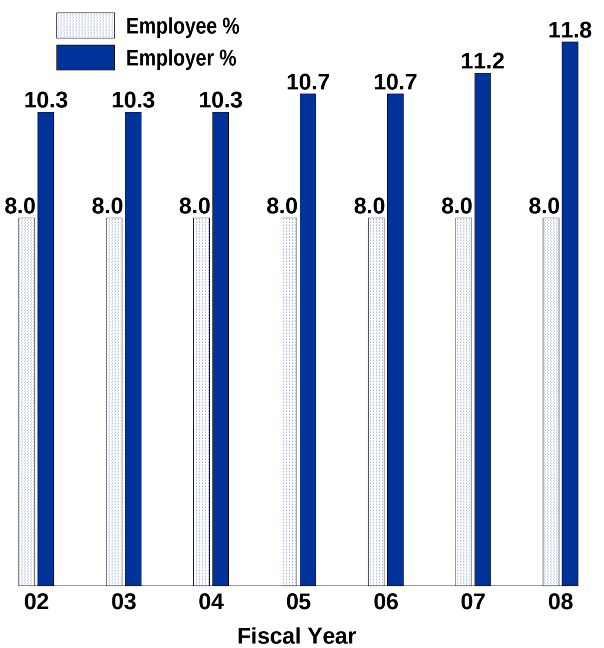
Figure M: Median employee and employer contribution rates as a percentage of pay, Social Security-eligible workers, FY 02 to FY 08



As shown in Figure N, median employer contribution rates for non-Social Security-eligible workers rose in FY 08 to 11.8 percent of pay, up from 11.2 percent in FY 07. Depending on the plan, higher employer rates may be a result either of higher required costs or additional resources available to plan sponsors to make required contributions, or both.

Employers and employees participating in non-Social Security plans each avoid the 6.2 percent contribution used to fund Social Security, but they are required to pay the 1.45 percent Medicare contribution.

Figure N: Median employee and employer contribution rates as a percentage of pay, non-Social Security-eligible workers, FY 02 to FY 08



Annual Required Contributions

A plan's annual required contribution, or ARC, is calculated by an actuary and reflects the amount needed to fund benefits accrued in the current period (the normal cost) plus the amount needed to retire the plan's unfunded liability over the plan's funding period. Failure to make required contributions is a major contributor to public pension plans' unfunded liabilities. Although many plan sponsors consistently make their full ARC, some consistently fail to make their ARC. In a recent study of public pensions, the Government Accountability Office stated that many of the plan sponsors failing to pay their ARC also had plans in relatively poorer funding condition. "[T]he failure of some [plan sponsors] to consistently make the annual required contributions undermines [funding] progress and is cause for concern, particularly as state and local governments will likely face increasing fiscal pressure in the coming decades. While unfunded liabilities do not generally put benefits at risk in the near-term, they do shift costs and risks to the future." [vi]

Figure O: Average annual required contribution paid and percentage of plans paying at least 90 percent of their ARC, FY 01 to 08

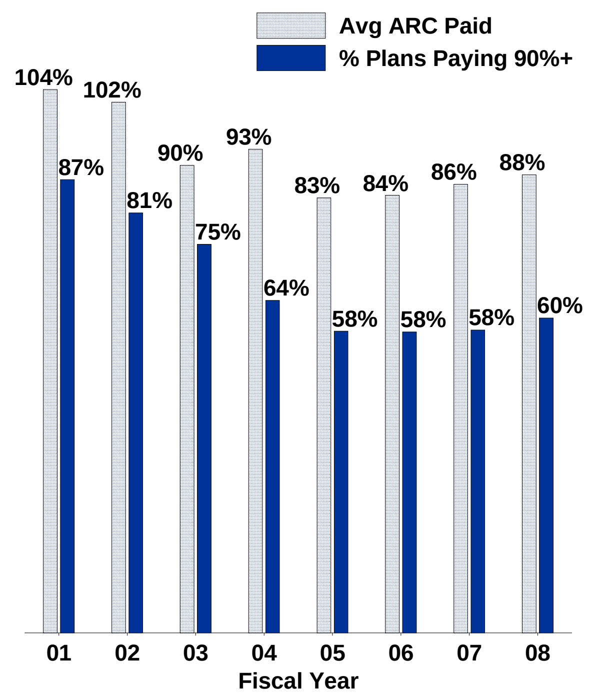


Figure O plots ARC history for plans in the Survey on the basis of two measures: the overall average ARC paid, and the percentage of plans receiving at least 90 percent of the ARC. Each plan in the Survey is equally weighted and these results are not weighted by plan size. At 88 percent, the overall average ARC paid by public plan sponsors in FY 08 was marginally higher than in previous years, but still below the 100+ percent level of FY 01. At 60 percent, the percentage of plan sponsors paying at least 90 percent of their ARC was slightly higher in FY 08 than in the last few years.

The method for setting employer contribution rates varies; some plan sponsors set the rate on the basis of the ARC; others pay a fixed percentage of employee pay; and still others base their contribution on how much funding is available.

Although employer pension contributions are estimated to have roughly doubled from 2002 to 2008, the average ARC paid in FY 08 remains below that of FY 02. This is because the ARC for most plans has increased faster than the increase in employer contributions, primarily due to increased costs required to amortize unfunded liabilities that resulted from the 2000-2002 market decline.

Assumptions for Inflation and Investment Return

Among the many actuarial assumptions used to calculate a plan's liabilities, rates of inflation and investment return exert a major effect on plan costs. The assumed inflation rate affects actual and projected wage growth, which is a major driver of benefit levels. Inflation also is one component of the investment return assumption; the other is the assumed real return, which is the investment return net of inflation.

Figure P plots the distribution of inflation assumptions among plans in the Public Fund Survey based on the latest available data. Many plans have reduced their inflation assumptions in recent years, resulting in a median and modal assumption of 3.5%. Most plans in the Survey use an inflation assumption between 3.0 percent and 3.5 percent. For the 25-year period ended in 2008, the average rate of inflation, based on the most-recognized inflation indicator published by the U.S. Bureau of Labor Statistics, was 3.0 percent.[vii]

Figure N: Distribution of inflation assumptions, (most are as of FY 08)

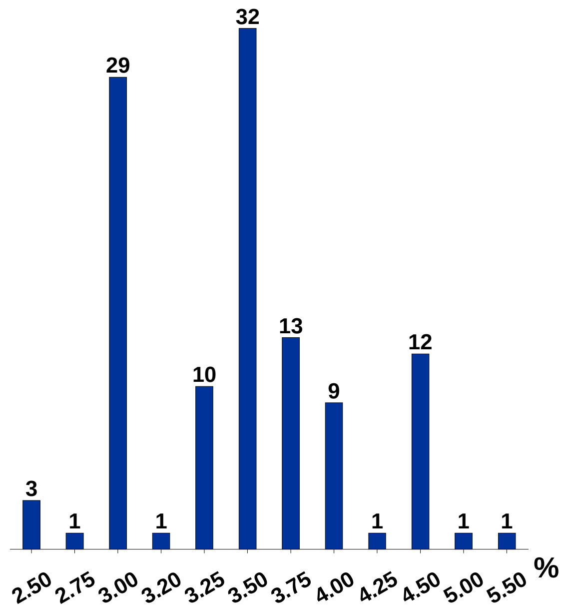
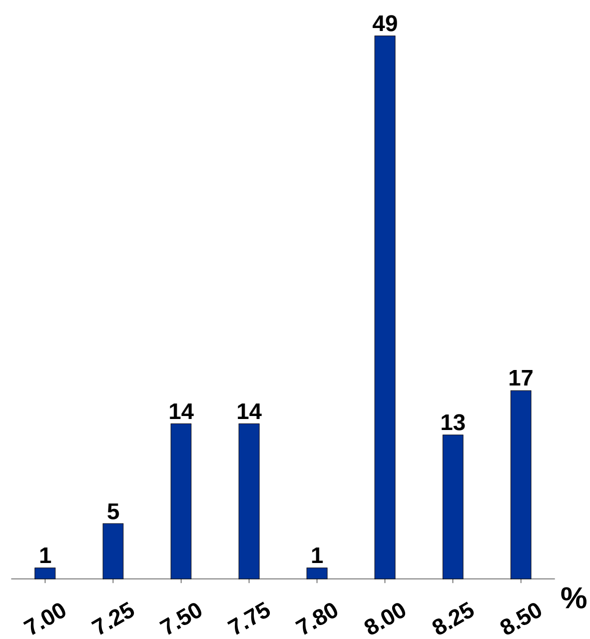


Figure Q plots the distribution of investment return assumptions. As with inflation assumptions, investment return assumptions for many plans have been reduced in recent years. In particular, all investment return assumptions in the Public Fund Survey above 8.5 percent have been reduced. The median and modal assumption remains 8.0 percent.

Figure Q: Distribution of investment return assumptions, FY 08



Conclusion

Although the overall funding level of plans in the Public Fund Survey declined only slightly in FY 08, the sharp drop in asset values in 2008 will drive funding levels for most plans lower in the next few years. The impact of the decline will depend on multiple factors, particularly the plan's funding condition entering 2008, its investment experience in 2008 and in subsequent years, and the fiscal condition of the plan sponsor(s).

The timing of lower funding levels will be affected largely by the date of plans' actuarial valuations, and also by the length of plans' smoothing period. Absent dramatic improvements in investment markets, public pension funding levels will be lower in FY 09 and the ensuing three to five years, and costs for most plans will be higher. Employee contributions will play a role, to some degree, in blunting higher required costs, and the delay between the market declines and the implementation of higher costs gives plan sponsors an opportunity to prepare. Strong growth in global equity markets to-date in 2009 will help to offset a portion of the 2008 declines.

End Notes

[i] Callan Associates, "Plan Sponsor Universe, Median Returns for Periods Ended 12/31/08"
[ii] Employee Benefits Research Institute, "The Impact of the Recent Financial Crisis on 401(k) Account Balances," February 2009
[iii] National Institute on Retirement Security (Almeida, Fornia), "A Better Bang for the Buck," August 2008
[iv] U.S. Census Bureau, "State and Local Government Employee Retirement Systems,"
[v] Ibid.
[vi] Government Accountability Office, "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits," January 2008
[vii] Bureau of Labor Statistics, CPI-All Urban Consumers

Related Resources

Center for Retirement Research, Boston College (Munnell, Aubrey, Muldoon), "The Financial Crisis and State/Local Defined Benefit Plans," November 2008

Center for State & Local Government Excellence, (Munnell, Haverstick, Soto), "Why Have Defined Benefit Plans Survived in the Public Sector?," December 2007

Government Accountability Office: "State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits," January 2008

______________ "Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs" September 2007

Moody's Investors Service, "Pension funding may suffer from 2008 stock market declines" November 2008

National Association of State Retirement Administrators/National Council on Teacher Retirement, "Market Declines and Public Pensions," December 2008

National Conference of State Legislatures, "Pension Enactments in State Legislatures"

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Standard & Poor's (Hitchcock, Prunty), "No Immediate Pension Hardship for State and Local Governments, But Plenty of Long-Term Worries," February 2009

U.S. Department of Labor, Bureau of Labor Statistics (Wiatrowski), "The Structure of State and Local Government Retirement Benefits, 2008," February 2009

Appendix A

State	System Name	Market Value of Assets ($000s)	Actives	Annuitants	As of FYE
AK	Alaska Public Employees Retirement System	6,935,808	29,431	24,063	6/30/2008
AK	Alaska Teachers Retirement System	3,550,798	8,682	9,992	6/30/2008
AL	Retirement Systems of Alabama	26,969,908	228,233	105,656	9/30/2008
AR	Arkansas Teachers Retirement System	11,018,088	70,172	26,801	6/30/2008
AR	Arkansas Public Employees Retirement System	5,638,452	44,427	23,679	6/30/2008
AZ	Arizona State Retirement System	24,962,358	227,730	92,673	6/30/2008
AZ	Arizona Public Safety Personnel Retirement System	5,019,281	21,093	8,241	6/30/2008
AZ	Phoenix Employees Retirement System	1,810,669	9,624	4,497	6/30/2008
CA	California Public Employees Retirement System	238,748,973	838,518	409,318	6/30/2008
CA	California State Teachers Retirement System	161,498,193	455,693	215,641	6/30/2008
CA	Los Angeles County Employees Retirement Association	38,724,671	94,492	52,350	6/30/2008
CA	San Francisco City and County Retirement System	15,832,521	35,396	21,048	6/30/2008
CA	San Diego County Employees Retirement Association	8,389,810	18,041	12,991	6/30/2008
CA	Contra Costa County Employees Retirement Association	3,749,699	9,385	7,012	12/31/2008
CO	Colorado Public Employees Retirement Association	29,320,585	190,684	81,248	12/31/2008
CO	Denver Public Schools Retirement System	2,453,577	7,560	6,186	12/31/2008
CO	Denver Employees Retirement Plan	1,455,545	9,324	6,869	12/31/2008
CT	Connecticut Teachers Retirement Board	12,227,995	53,546	28,042	6/30/2007
CT	Connecticut State Employees Retirement System	8,146,302	48,919	36,705	6/30/2005
DC	District of Columbia Retirement Board	3,734,480	10,482	4,082	9/30/2008
DE	Delaware Public Employees Retirement System	7,059,372	42,119	22,472	6/30/2008
FL	Florida Retirement System	124,466,800	683,811	274,842	6/30/2008
GA	Georgia Teachers Retirement System	50,063,600	225,024	78,633	6/30/2008
GA	Georgia Employees Retirement System	15,144,483	115,761	49,148	6/30/2008
HI	Hawaii Employees Retirement System	11,462,417	65,251	35,324	6/30/2007
IA	Iowa Public Employees Retirement System	22,370,594	167,850	87,490	6/30/2008
ID	Idaho Public Employee Retirement System	10,695,358	66,765	30,912	6/30/2008
IL	Illinois Teachers Retirement System	38,430,723	165,572	91,462	6/30/2008
IL	Illinois Municipal Retirement Fund	18,022,055	181,678	90,170	12/31/2008
IL	Illinois State Universities Retirement System	14,586,325	73,086	45,346	6/30/2008
IL	Chicago Public School Teachers Pension and Retirement Fu	12,772,609	32,968	23,623	6/30/2007
IL	Illinois State Employees Retirement System	10,995,366	66,237	56,111	6/30/2008
IN	Indiana Public Employees Retirement Fund	15,737,079	151,770	63,081	6/30/2008
IN	Indiana State Teachers Retirement Fund	8,563,959	114,237	41,253	6/30/2008
KS	Kansas Public Employees Retirement System	13,193,064	153,804	68,151	6/30/2008
KY	Kentucky Teachers Retirement System	14,076,692	75,539	40,739	6/30/2008
KY	Kentucky Retirement Systems	12,955,383	148,865	81,847	6/30/2008
LA	Louisiana Teachers Retirement System	14,996,250	82,840	61,070	6/30/2008
LA	Louisiana State Employees Retirement System	8,957,888	61,780	37,575	6/30/2008
MA	Massachusetts State Employees Retirement System	22,538,610	85,403	51,058	12/31/2007
MA	Massachusetts Teachers Retirement Board	17,311,137	89,636	50,024	12/31/2008
MD	Maryland State Retirement and Pension System	36,613,710	199,255	112,422	6/30/2008
ME	Maine Public Employees Retirement System	10,849,423	51,402	34,182	6/30/2008
MI	Michigan Public School Employees Retirement System	39,065,741	278,642	167,265	9/30/2008
MI	Michigan State Employees Retirement System	9,781,239	28,568	48,078	9/30/2008
MI	Municipal Employees Retirement System of Michigan	4,512,261	37,135	23,995	12/31/2008
MN	Minnesota Teachers Retirement Association	18,106,966	76,515	46,981	6/30/2008
MN	Minnesota Public Employees Retirement Association	18,064,823	158,233	71,392	6/30/2008
MN	Minnesota State Retirement System	10,143,209	54,522	29,582	6/30/2008
MN	Minneapolis Employees Retirement Fund	1,282,717	552	4,981	6/30/2004
MN	St. Paul Teachers Retirement Fund Association	1,023,640	4,121	2,851	6/30/2008
MN	Duluth Teachers Retirement Fund Association	271,617	1,140	1,243	6/30/2008

Appendix A

State	System Name	Market Value of Assets ($000s)	Actives	Annuitants	As of FYE
MO	Missouri Public Schools Retirement System	30,010,701	129,301	60,026	6/30/2008
MO	Missouri State Employees Retirement System	8,011,371	54,542	30,132	6/30/2008
MO	Missouri Local Government Employees Retirement System	3,962,817	31,424	13,356	6/30/2008
MO	MoDOT & Patrol Employees Retirement System	1,718,675	8,581	7,345	6/30/2008
MO	St. Louis Public School Retirement System	810,631	5,021	4,456	12/31/2008
MS	Mississippi Public Employees Retirement System	19,739,790	166,576	76,496	6/30/2008
MT	Montana Public Employees Retirement Board	4,692,647	34,049	19,734	6/30/2008
MT	Montana Teachers Retirement System	2,993,393	18,292	11,788	6/30/2008
NC	North Carolina Retirement Systems	77,544,817	607,389	202,649	6/30/2008
ND	North Dakota Teachers Fund for Retirement	1,846,113	9,651	6,317	6/30/2008
ND	North Dakota Public Employees Retirement System	1,816,811	19,464	7,186	6/30/2008
NE	Nebraska Retirement Systems	8,726,932	54,245	13,226	6/30/2008
NH	New Hampshire Retirement System	5,425,204	50,988	22,870	6/30/2008
NJ	New Jersey Division of Pension and Benefits	85,836,770	523,749	236,541	6/30/2008
NM	New Mexico Public Employees Retirement Association	12,094,973	60,077	25,506	6/30/2008
NM	New Mexico Educational Retirement Board	8,770,044	63,698	31,192	6/30/2008
NV	Nevada Public Employees Retirement System	22,198,009	106,123	38,130	6/30/2008
NY	New York State and Local Retirement Systems	155,845,869	621,917	358,109	3/31/2008
NY	New York State Teachers Retirement System	95,769,336	269,938	136,706	6/30/2008
NY	New York City Employees Retirement System	39,716,826	178,741	128,863	6/30/2008
NY	New York City Teachers Retirement System	32,297,864	109,992	67,576	6/30/2008
OH	Ohio State Teachers Retirement System	66,837,412	173,327	126,506	6/30/2008
OH	Ohio Public Employees Retirement System	49,451,761	374,002	166,516	12/31/2008
OH	Ohio School Employees Retirement System	10,646,564	124,370	64,818	6/30/2008
OH	Ohio Police & Fire Pension Fund	7,757,630	28,864	24,878	12/31/2008
OK	Oklahoma Teachers Retirement System	8,945,859	88,678	45,238	6/30/2008
OK	Oklahoma Public Employees Retirement System	6,255,208	45,120	26,033	6/30/2008
OR	Oregon Employees Retirement System	58,010,291	167,452	105,721	6/30/2008
PA	Pennsylvania Public School Employees Retirement System	62,473,426	264,000	168,000	6/30/2008
PA	Pennsylvania State Employees Retirement System	22,795,813	110,866	108,146	12/31/2008
RI	Rhode Island Employees Retirement System	8,508,799	35,646	22,927	6/30/2007
SC	South Carolina Retirement Systems	26,633,045	225,014	115,310	6/30/2008
SD	South Dakota Retirement System	7,312,107	37,707	19,321	6/30/2008
TN	Tennessee Consolidated Retirement System	31,634,129	212,725	98,230	6/30/2008
TX	Teacher Retirement System of Texas	104,910,498	823,154	275,228	8/31/2008
TX	Texas Employees Retirement System	22,384,273	135,171	79,470	8/31/2008
TX	Texas Municipal Retirement System	14,636,084	100,459	36,863	12/31/2008
TX	Texas County & District Retirement System	12,054,818	120,347	36,509	12/31/2008
TX	Houston Firefighters Relief and Retirement Fund	3,029,159	3,876	2,421	6/30/2008
TX	Austin Employees Retirement System	1,234,496	8,643	3,835	12/31/2008
UT	Utah Retirement Systems	15,886,067	106,261	42,040	12/31/2008
VA	Virginia Retirement System	53,599,632	345,737	136,394	6/30/2008
VA	Educational Employees Supplementary Retirement System	1,858,572	19,599	8,354	6/30/2008
VT	Vermont Teachers Retirement System	1,501,320	10,685	5,555	6/30/2008
VT	Vermont State Employees Retirement System	1,282,494	8,442	4,555	6/30/2008
WA	Washington Department of Retirement Systems	58,061,969	294,201	122,527	6/30/2008
WI	Wisconsin Retirement System	80,390,755	262,856	137,117	12/31/2006
WV	West Virginia Consolidated Public Retirement Board	8,024,034	72,797	50,387	6/30/2008
WY	Wyoming Retirement System	4,621,174	40,687	20,393	12/31/2008
		2,594,869,805	13,515,957	6,651,893	

Appendix B

State	Plan Name	Actuarial Funding Ratio (%)	Actuarial Value of Assets ($000s)	Actuarial Value of Liabilities ($000s)	UAAL ($000s)	Actuarial Valuation Date	As of FYE
AK	Alaska PERS	77.8	6,739,004	8,662,324	1,923,320	6/30/2007	6/30/2008
AK	Alaska Teachers	68.2	3,441,867	5,043,448	1,601,581	6/30/2007	6/30/2008
AL	Alabama Teachers	77.6	20,812,477	26,804,117	5,991,640	9/30/2007	9/30/2008
AL	Alabama ERS	75.7	9,905,766	13,078,687	3,172,921	9/30/2008	9/30/2008
AR	Arkansas Teachers	84.9	11,319,000	13,334,000	2,015,000	6/30/2008	6/30/2008
AR	Arkansas PERS	89.7	5,866,000	6,543,000	677,000	6/30/2008	6/30/2008
AZ	Arizona SRS	82.2	27,851,855	33,870,865	6,019,010	6/30/2008	6/30/2008
AZ	Arizona Public Safety Personnel	68.8	5,095,645	7,405,397	2,309,752	6/30/2008	6/30/2008
AZ	Phoenix ERS	79.1	1,908,414	2,413,365	504,951	6/30/2008	6/30/2008
CA	California PERF	87.2	216,484,000	248,224,000	31,740,000	6/30/2007	6/30/2008
CA	California Teachers	88.8	148,427,000	167,129,000	18,702,000	6/30/2007	6/30/2008
CA	LA County ERS	93.8	37,041,832	39,502,456	2,460,624	6/30/2007	6/30/2008
CA	San Francisco City & County	110.2	14,929,287	13,541,388	(1,387,899)	7/1/2007	6/30/2008
CA	San Diego County	94.4	8,236,926	8,722,294	485,368	6/30/2008	6/30/2008
CA	Contra Costa County	89.9	5,016,137	5,581,048	564,911	12/31/2007	12/31/2008
CO	Colorado School	70.1	21,733,329	31,000,202	9,266,873	12/31/2008	12/31/2008
CO	Colorado State	67.9	13,914,371	20,498,668	6,584,297	12/31/2008	12/31/2008
CO	Denver Schools	84.3	2,944,292	3,493,011	548,719	1/1/2009	12/31/2008
CO	Colorado Municipal	76.4	2,933,296	3,838,083	904,787	12/31/2008	12/31/2008
CO	Denver Employees	98.2	1,950,011	1,985,651	35,640	1/1/2008	12/31/2008
CT	Connecticut Teachers	63.0	11,781,338	18,703,793	6,922,455	6/30/2006	6/30/2007
CT	Connecticut SERS	53.3	8,517,677	15,987,547	7,469,870	6/30/2005	6/30/2005
DC	DC Police & Fire	102.4	2,877,463	2,809,858	(67,605)	10/1/2008	9/30/2008
DC	DC Teachers	102.4	1,502,237	1,466,942	(35,295)	10/1/2008	9/30/2008
DE	Delaware State Employees	103.7	6,751,949	6,549,856	(202,093)	6/30/2008	6/30/2008
FL	Florida RS	105.3	130,720,547	124,087,214	(6,633,333)	7/1/2008	6/30/2008
GA	Georgia Teachers	94.7	52,099,171	54,996,570	2,897,399	6/30/2007	6/30/2008
GA	Georgia ERS	89.4	14,017,346	15,680,857	1,041,490	6/30/2008	6/30/2008
HI	Hawaii ERS	67.5	10,589,773	15,696,546	5,106,773	6/30/2007	6/30/2007
IA	Iowa PERS	89.1	21,857,423	24,522,517	2,665,094	6/30/2008	6/30/2008
ID	Idaho PERS	92.8	10,402,000	11,211,800	(573,400)	7/1/2008	6/30/2008
IL	Illinois Teachers	56.0	38,430,723	68,632,367	30,201,644	7/1/2008	6/30/2008
IL	Illinois Municipal	82.2	21,061,054	25,611,199	4,550,145	12/31/2008	12/31/2008
IL	Illinois Universities	58.5	14,586,300	24,917,700	10,331,400	6/30/2008	6/30/2008
IL	Chicago Teachers	80.1	11,759,699	14,677,184	2,917,485	6/30/2007	6/30/2007
IL	Illinois SERS	46.1	10,995,366	23,841,280	12,845,914	6/30/2008	6/30/2008
IN	Indiana PERF	98.2	12,220,934	12,439,798	218,864	7/1/2007	6/30/2008
IN	Indiana Teachers	45.1	8,476,559	18,815,812	10,339,253	6/30/2007	6/30/2008
KS	Kansas PERS	70.8	13,433,115	18,984,915	5,551,800	12/31/2007	6/30/2008
KY	Kentucky Teachers	68.2	15,321,325	22,460,304	7,138,979	6/30/2008	6/30/2008
KY	Kentucky County	77.1	7,482,370	9,707,340	2,224,970	6/30/2008	6/30/2008
KY	Kentucky ERS	54.2	5,820,925	10,747,701	4,926,776	6/30/2008	6/30/2008
LA	Louisiana Teachers	70.2	15,507,834	22,090,516	6,582,682	6/30/2008	6/30/2008
LA	Louisiana SERS	67.6	9,167,170	13,562,214	4,395,044	6/30/2008	6/30/2008
MA	Massachusetts Teachers	73.9	22,883,553	30,955,504	8,071,951	1/1/2008	12/31/2008
MA	Massachusetts SERS	89.4	20,400,656	22,820,502	2,419,846	1/1/2008	12/31/2007
MD	Maryland Teachers	79.6	23,784,404	29,868,705	6,084,301	6/30/2008	6/30/2008
MD	Maryland PERS	77.2	13,599,717	17,609,769	4,010,052	6/30/2008	6/30/2008
ME	Maine State and Teacher	73.9	8,245,520	11,157,770	2,912,250	6/30/2007	6/30/2008
ME	Maine Local	108.8	2,001,714	1,838,975	(162,739)	6/30/2007	6/30/2008
MI	Michigan Public Schools	88.7	45,335,000	51,107,000	5,772,000	9/30/2007	9/30/2008
MI	Michigan SERS	86.2	11,344,000	13,162,000	1,818,000	9/30/2007	9/30/2008
MI	Michigan Municipal	77.3	5,973,000	7,723,900	1,750,900	12/31/2007	12/31/2008
MN	Minnesota Teachers	82.0	18,226,985	22,230,841	4,003,856	7/1/2008	6/30/2008
MN	Minnesota PERF	73.6	13,048,970	17,729,847	4,680,877	6/30/2008	6/30/2008
MN	Minnesota State Employees	90.2	9,013,456	9,994,602	722,788	6/30/2008	6/30/2008
MN	Minneapolis ERF	92.1	1,513,389	1,643,140	129,751	7/1/2004	6/30/2004
MN	St. Paul Teachers	75.1	1,075,951	1,432,040	356,089	6/30/2008	6/30/2008
MN	Duluth Teachers	82.1	298,067	363,044	64,977	7/1/2008	6/30/2008
MO	Missouri Teachers	83.4	28,751,241	34,490,452	5,739,211	6/30/2008	6/30/2008
MO	Missouri State Employees	85.9	7,838,496	9,128,347	1,289,851	6/30/2008	6/30/2008
MO	Missouri Local	97.5	3,957,069	4,058,829	143,425	2/28/2008	6/30/2008
MO	Missouri PEERS	82.5	2,703,762	3,278,602	574,840	6/30/2008	6/30/2008

Appendix B

State	Plan Name	Actuarial Funding Ratio (%)	Actuarial Value of Assets ($000s)	Actuarial Value of Liabilities ($000s)	UAAL ($000s)	Actuarial Valuation Date	As of FYE
MO	Missouri DOT and Highway Patrol	59.1	1,783,902	3,019,634	1,235,732	6/30/2008	6/30/2008
MO	St. Louis School Employees	87.6	1,014,900	1,158,900	144,000	1/1/2008	12/31/2008
MS	Mississippi PERS	72.9	20,814,720	28,534,694	7,719,974	6/30/2008	6/30/2008
MT	Montana PERS	90.2	4,065,307	4,504,743	439,436	6/30/2008	6/30/2008
MT	Montana Teachers	76.8	3,159,100	4,110,800	951,700	7/1/2008	6/30/2008
NC	North Carolina Teachers and State Empl	104.7	55,283,121	52,815,089	(2,468,032)	12/31/2007	6/30/2008
NC	North Carolina Local Government	99.5	16,791,984	16,868,147	78,588	12/31/2007	6/30/2008
ND	North Dakota Teachers	81.9	1,909,500	2,330,600	421,100	7/1/2008	6/30/2008
ND	North Dakota PERS	92.6	1,609,800	1,737,600	127,800	6/30/2008	6/30/2008
NE	Nebraska Schools	90.6	6,932,919	7,654,536	673,972	7/1/2008	6/30/2008
NH	New Hampshire Retirement System	67.8	5,302,034	7,821,316	2,519,282	6/30/2008	6/30/2008
NJ	New Jersey Teachers	72.1	36,541,084	50,658,278	14,117,194	6/30/2008	6/30/2008
NJ	New Jersey PERS	73.3	29,503,522	40,245,886	10,742,364	6/30/2008	6/30/2008
NJ	New Jersey Police & Fire	74.3	22,747,975	30,620,225	7,872,250	6/30/2008	6/30/2008
NM	New Mexico PERF	93.3	12,836,217	13,761,750	925,533	6/30/2008	6/30/2008
NM	New Mexico Teachers	71.5	9,272,800	12,967,000	3,694,200	6/30/2008	6/30/2008
NV	Nevada Regular Employees	77.7	18,638,028	24,001,041	5,363,013	6/30/2008	6/30/2008
NV	Nevada Police Officer and Firefighter	70.8	4,599,624	6,494,850	1,895,226	6/30/2008	6/30/2008
NY	NY State & Local ERS	105.8	121,116,000	114,525,000	(6,591,000)	4/1/2008	3/31/2008
NY	New York State Teachers	104.2	82,858,900	79,537,200	(3,321,700)	6/30/2007	6/30/2008
NY	New York City ERS	82.5	38,367,100	46,478,800	8,111,700	6/30/2006	6/30/2008
NY	New York City Teachers	70.6	33,854,200	47,958,300	14,104,100	6/30/2007	6/30/2008
NY	NY State & Local Police & Fire	106.5	21,379,000	20,074,000	(1,305,000)	4/1/2006	3/31/2008
OH	Ohio Teachers	79.1	69,198,008	87,432,348	18,234,340	6/30/2008	6/30/2008
OH	Ohio PERS	92.6	67,151,000	69,734,000	2,583,000	12/31/2007	12/31/2008
OH	Ohio School Employees	82.0	11,241,000	13,704,000	2,463,000	6/30/2008	6/30/2008
OH	Ohio Police & Fire	81.7	11,213,000	13,728,000	2,830,000	1/1/2008	12/31/2008
OK	Oklahoma Teachers	50.5	9,256,800	18,346,900	9,090,100	6/30/2008	6/30/2008
OK	Oklahoma PERS	73.0	6,491,928	8,894,287	2,402,359	7/1/2008	6/30/2008
OR	Oregon PERS	112.2	59,327,800	52,871,200	(6,456,600)	12/31/2007	6/30/2008
PA	Pennsylvania School Employees	85.8	57,057,800	66,495,800	9,438,000	6/30/2007	6/30/2008
PA	Pennsylvania State ERS	89.0	30,636,000	34,437,000	3,801,000	12/31/2008	12/31/2008
RI	Rhode Island ERS	53.4	5,651,068	10,575,852	4,924,784	6/30/2006	6/30/2007
RI	Rhode Island Municipal	87.1	945,876	1,085,648	139,772	6/30/2006	6/30/2007
SC	South Carolina RS	69.7	23,541,438	33,766,678	10,225,240	7/1/2007	6/30/2008
SC	South Carolina Police	84.7	3,160,240	3,730,544	570,304	7/1/2007	6/30/2008
SD	South Dakota PERS	97.2	6,784,300	6,976,800	192,500	6/30/2008	6/30/2008
TN	TN State and Teachers	96.2	26,214,995	27,240,151	1,025,156	7/1/2007	6/30/2008
TN	TN Political Subdivisions	89.5	4,897,974	5,475,620	577,646	7/1/2007	6/30/2008
TX	Texas Teachers	90.5	110,233,000	121,756,000	11,523,000	8/31/2008	8/31/2008
TX	Texas ERS	92.6	23,511,918	25,403,280	1,891,362	8/31/2008	8/31/2008
TX	Texas Municipal	74.4	15,149,700	20,360,800	5,211,100	12/31/2008	12/31/2008
TX	Texas County & District	89.0	14,931,600	16,767,900	(1,506,037)	12/31/2008	12/31/2008
TX	Houston Firefighters	91.0	2,633,006	2,892,300	342,000	7/1/2007	6/30/2008
TX	City of Austin ERS	65.9	1,481,400	2,246,900	765,500	12/31/2008	12/31/2008
TX	Texas LECOS	92.0	774,509	842,135	67,626	8/31/2008	8/31/2008
UT	Utah Noncontributory	84.2	15,257,243	18,127,048	2,869,805	12/31/2008	12/31/2008
VA	Virginia Retirement System	82.3	47,815,000	58,116,000	10,301,000	6/30/2007	6/30/2008
VA	Fairfax County Schools	88.0	1,924,886	2,186,801	261,915	12/31/2007	6/30/2008
VT	Vermont Teachers	80.9	1,605,462	1,984,967	379,505	6/30/2008	6/30/2008
VT	Vermont State Employees	94.1	1,377,101	1,464,202	87,101	6/30/2008	6/30/2008
WA	Washington PERS 2/3	101.5	14,888,000	14,661,000	(227,000)	6/30/2007	6/30/2008
WA	Washington PERS 1	70.7	9,715,000	13,740,000	4,025,000	6/30/2007	6/30/2008
WA	Washington Teachers Plan 1	76.7	8,302,000	10,826,000	2,524,000	6/30/2007	6/30/2008
WA	Washington LEOFF Plan 1	122.1	5,298,000	4,340,000	(958,000)	6/30/2007	6/30/2008
WA	Washington Teachers Plan 2/3	112.7	5,277,000	4,682,000	(595,000)	6/30/2007	6/30/2008
WA	Washington LEOFF Plan 2	120.2	4,360,000	3,626,000	(734,000)	6/30/2007	6/30/2008
WA	Washington School Employees Plan 2/3	106.8	2,133,000	1,998,000	(135,000)	6/30/2007	6/30/2008
WI	Wisconsin Retirement System	99.6	73,415,300	73,735,800	320,500	12/31/2006	12/31/2006
WV	West Virginia Teachers	50.0	4,133,800	8,269,400	4,135,600	6/30/2008	6/30/2008
WV	West Virginia PERS	84.3	3,939,060	4,670,696	731,636	7/1/2008	6/30/2008
WY	Wyoming Public Employees	78.6	4,835,875	6,152,122	1,316,247	1/1/2009	12/31/2008
		85.3	2,578,068,581	3,020,689,271	437,408,925		

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
Retirement Systems of Alabama				Increase statutory max amortization period from 20 years to 30		
Arizona SRS	Employee and employer contributions are matched and adjusted annually based on actuarial results; they will rise from 9.0% to 9.6% on 7/1/10; this includes the retiree health insurance benefit.	For new hires: • Change from Rule of 80 to Rule of 85 • Change FAS from high 3 years to high 5 • Eliminate access to ER contributions for terminating participants Also, • Made service purchases cost-neutral • Decreased interest rate paid on refunds • Requiring ERs to pay ASRS for early retirement incentives • Rescinded modified DROP Program	Early retirement provisions revised commensurate with change in normal retirement eligibility			
Colorado PERA	Employee and employer contribution rates will rise incrementally for several years.	• Lower auto-COLA for existing retirees, to lesser of CPI-W or 2.0% • Require future retirees to be retired for 1 year before receiving a COLA • 5-year service credit required on 50% employer match on contribution refunds, effective 1/1/11	Increased actuarial reduction for early retirement		Proposed changes were preceded by a statewide listening tour	A group of retirees has filed suit opposing the COLA reduction; bill also includes an anti-spiking provision.
Illinois statewide		For new hires as of 1/1/11: • Normal retirement age	Early retirement provisions revised			Suspends pension benefits for those

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
plans (except judges and legislators)		increases to 67, from 60 • Minimum retirement age set at 62 • FAS basis is now highest 8 of last 10 years, up from final 4 • Limits pension benefit to 75% of FAS or $106,800, indexed to the lesser of 3% or half of CPI • COLAs will be lesser of 3% or half of CPI, non-compounded, from current auto 3% compounded • COLAs begin at age 67	commensurate with change in normal retirement eligibility			who return-to-work for another public employer in the state.
Iowa PERS	EE and ER contributions will rise incrementally, from 4.7% to 5.3% for employees and 7.25% to 8.15% for employers. Thereafter, the board has authority to adjust the total rate by up to 1%	• Vesting period for those not vested (currently 4 years) on 7/1/12 will increase to 7 years. • Increased FAS period from 3 years to 5	Increased actuarial reduction for early retirement			
Michigan Public School ERS		New school system hires will have a hybrid plan instead of the current DB plan				Reform bill includes an early retirement incentive, creating a window during which retiring school EEs will receive a bump in retirement benefit and payments toward a retiree health care benefit.

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
Mississippi PERS	Raised contribution rates for all employees by 1.75%.					Statute requires increase in EE rate to be accompanied by commensurate benefit increase; because approved benefit improvement was minor, a legal challenge is likely
Minnesota PERA	Employer contribution rates will rise from 7.0% to 7.25% and employee contributions will rise from 6.0% to 6.25%, on 1/1/11.	• Reduction in COLA for existing retirees from 2.5% to 1.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5			Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC, and other plans, and report back by 6/11.	A lawsuit has been filed against the COLA reduction.
Minnesota SRS		• Reduction in COLA for existing retirees from 2.5% to 2.0%, until funding ratio=90% • Reduction in interest paid on inactive and terminating accounts. • Increase in vesting period, from 3 years to 5		Extended amortization period from 2020 to 2040.	Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC, and other plans, and report back by 6/11.	A lawsuit has been filed against the COLA reduction.
Minnesota Teachers	Employer and employee contributions will rise by 0.5% each year, from 5.5% each to 7.5%, phased over 4 years. After the phase-in, the TRA board has authority to adjust future rates	• For existing retirees, 2-yr suspension of COLA followed by permanent reduction in COLA from 2.5% to 2.0%, until funding ratio=90% • Reduction in interest paid on inactive and			Directors of the 3 statewide systems were directed to conduct study of cost, benefits, and feasibility of DB, DC, and other plans, and report back by 6/11.	A lawsuit has been filed against the COLA reduction.

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
	(within limits) should the system have a contribution deficiency or sufficiency.	terminating accounts.				
Nevada PERS		For new hires as of 7/1/10: • New minimum retirement age • Lower multiplier • Anti-spiking provision	Increased actuarial reduction for early retirement			Changes were made in 2009 and reflected a consensus among affected stakeholders. Changes apply to all participants, including public safety officers.
New Jersey Division of Pension and Benefits	Requires, for the first time, contributions of 1.5% from current participants for retiree health care benefits	• Rescinds 9% across-the-board benefit increase approved in 2001. • For new hires, limits use of sick leave payouts for pension benefits and limits access to DB plan for part-time workers.				
New York State & Local RS	Most new hires must now make contributions of 3% their entire career, instead of only first 10 years.	For new hires as of 1/1/10: • 10-year vesting, up from 5 • Limit on use of OT in benefit calculation	Increased actuarial reduction for early retirement			
New York State TRS	New hires must now make contributions of 3.5% their entire career, instead of only first 10 years.	For new hires as of 1/1/10: • 10-year vesting, from 5 • Full retirement factor of 2.0% after 25 years of service, up from 20 • Normal retirement at age 57 with 30 years of service, up from age 55 • Limit on use of OT in	Increased actuarial reduction for early retirement			

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
		benefit calculation				
North Carolina RS					Blue ribbon study commission is taking a bottom-up look at retirement benefits; results scheduled for November	NCRS benefits and costs are modest already
Rhode Island		Reduced benefits for state EEs, teachers and judges not eligible to retire on or before 9/30/09, by increasing retirement age to 62 with a methodology that proportionally changes age requirement based on years of service, so the closer one is to retirement, the less the impact. Also, increased FAS period from 3 years to 5 and reduced COLA to lesser of CPI or 3.0%.				A group of public employee unions has filed suit against the benefit reductions.
South Dakota RS		• New COLA format, affecting existing retirees, based on plan funding level • Eliminate first-year pro-rated COLAs • Reduce refunds of ER contributions				New limits on return-to-work
Texas ERS		For new hires, retirement eligibility increases to age 65 with 10 years of service, from 60 and 5				Changes made in '09 and are similar to those made in '07 for the TRS of Texas

Selected approved changes to state public pensions to restore or preserve plan sustainability

System	Contributions	Benefits	Early retirement	Actuarial methods/processes	Study commission	Notes
Utah RS	Plan currently is non-contributory. New hybrid plan is projected to cost 7.5%. ERs will fund first 10% of the hybrid or the DC plan. Difference between the cost of the hybrid and 10% is deposited into EEs' DC account. If the cost of the hybrid exceeds 10%, EEs will pay the difference.	• New hires as of 7/1/11 will have their choice of DC or hybrid, and employers will fund the first 10% of either.			State will be studying projected costs of approved changes and may make additional changes	
Vermont TRS	Raises contributions for current employees from 3.54% to 5.0%.	For current teachers 5 years or more from normal retirement eligibility: • raises normal retirement to 65 or Rule of 90, from 62 or any/30 • increases max benefit to 60% of FAS, from 50% • increases multiplier for those w/20 years of service, to 2.0 from 1.67	Increases penalties for early retirement			Also increases limits on maximum permissible benefit and includes anti-spiking provision.
Virginia RS	New hires as of 7/1/10 will be required to make contributions, of 5%	For new hires as of 7/1/10: • Normal retirement age tied to Social Security retirement age, from 65 • Lower auto-COLA • FAS of 5 years, up from 3	Early retirement provisions revised commensurate with change in normal retirement eligibility			Will continue as non-contributory for existing employees

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
AK					
AL					Legislature is expected to consider the following changes when it convenes in January: a 1% increase in employee contributions, effective immediately; benefit based on highest 5 of 10 years of service, rather than highest 3; for new hires, minimum retirement age of 60 rather than any age with 25 years of service; for new hires, eligibility for DROP at age 60 with 25 years of service; extend amortization period from 20 to 30 years.
AR					
AZ	Employee and employer contribution rates will rise from 9.0% to 9.6% as of 7/1/10. These rates include the health insurance benefit supplement.				The ASRS has suggested the legislature consider the following for new hires a) increasing normal retirement eligilibility from Rule of 80 to 85; b) raising FAS from 3 years to 5; c) limiting refunds for terminating members to 25% of employer contributions (current law permits up to 100% after 10 years of service). These changes have been suggested previously to the legislature but have not been approved.
CA	CalPERS adjusted state, local and school employer contribution rates via modifications described in Actuarial Methods/Processes.		CalPERS added an employer rate smoothing methodology for local governments and school employer rates. The technical changes include: 1) Expanding the current rate smoothing corridor from 80% to 120% of market value of assets (MVA) to 60% to 140% of MVA in the first year, to 70% to 130% in the second year, then back to 80% to 120% of MVA in the third year. 2) Isolating and amortizing investment gains and losses in the next three years using a fixed and declining 30-year period as opposed to the current rolling 30-year amortization period.		A taxpayer rights group has filed ballot initiatives that would establish a new tier of pension benefits for all public employees in the state. Among other provisions, the changes would 1) impose maximum multipliers on new hires, such as 2.3 for police and fire, 1.25 for general employees, and 1.65 for general employees outside Social Security; 2) impose minimum retirement ages of 58 on police and fire, and the Social Security retirement age for general employees; 3) place a cap on pensions of 75% of workers' pay; 4) exclude from the pension benefit overtime, bonuses, unused sick and vacation leave; 5) require that future benefit changes be subject to public vote; and 6) require that full costs of retiree health care benefits be paid by employees and employers, to end the accumulation of unfunded liabilities. The initiative must receive the requisite number of valid signatures to appear on the November 2010 ballot.
CO	The CO Legislature eliminated for fiscal years 08-09, 09-10, and 10-11 the state's annual contribution to the fire and police pension association (FPPA), to assist in amortizing the unfunded accrued liability of old hire pension plans; resumes the state's annual contribution to the FPPA beginning in FY11-12, and extends the contribution through FY 14-15.				CO PERA Board recommended to legislature revisions that include: increases to employee and employer contribution rates; reduced (from 3.5% to max of 2.0%) auto-COLAs for current and future retirees; delay onset of COLA to 12 months after retirement; revising return-to-work rules to, among others, require retirees returning to work to make contributions that do not accrue a benefit nor are available to the member; increase the final average salary period from 3 years to 5; adopt Rule of 90 with minimum age 60 for all employees unvested on 1/1/11; adjust early retirement reduction for those ineligible to retire by 1/1/11 to reflect true actuarial cost; and other changes as described at www.copera.org. Also, the CO Fire & Police Pension Assn. Board recommended legislation to allow its members and employers to vote to increase employee contributions to the main DB plan from the current 8% (employer contributions would remain unchanged at 8%).
CT					
DC					
DE	The state's contribution rate will increase in FY11 from 6.01% to 7.4%				Legislature is likely to consider reducing retirement multiplier for new hires, from 1.85% to 1.67%.
FL		The legislature terminated eligiibility of retired members to receive a second benefit by returning to work and increased the required break-in-service from 1 month to 6.			

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
GA	TRS increased employee rates effective 7/1/09 from 5.0% to 5.25%, and employer rates from 9.28% to 9.74%. Effective 7/1/10, TRS employee rates will increase again, to 5.53%, to 10.28% for employers.	Legislature approved prohibition of COLAs to members of ERS and the judges retirement system hired after 6/30/09. Also, passed legislation designed to limit spiking: for new hires, limited the increase in retirants' final year's salary to 5%; for existing members, the employer must pay ERS of GA for the present value of the impact of any increase above 5% to the system.			
HI					
IA					A legislative committee has proposed the following: raising contribution rates from 11.95% to 13.45%, which are paid 60% by employers and 40% by employees; raising the vesting period for new hires from 4 years to 7; raising FAS period to 5 years from 3; and a higher reduction for early retirement, intended to reflect the true actuarial cost.
ID	The Idaho PERS Board elected to phase in contribution rate increases, shared 1/3 by employees and 2/3 by employers, as follows: 1.5% each on 7/1/11 and 7/1/12, and 2.31% effective 7/1/13. By 7/1/13, employer rates for general employees and teachers will be 13.65% and 8.19% oremployees; employer rates for public safety will be 13.99% and 10.04%.	Idaho law requires that the Board implement a negative COLA if the August to August CPI-U is negative. The CPI-U was negative 1.48%. Thus the Board initially established a COLA of that amount. The Board had to consider rate increases before they could consider any retro COLA (i.e. the UAL amortization period must be at or below 25 years after the COLA.) After approving statutorily-required contribution rate increases (see Contribution Rates), the board approved a COLA of 2.48%, effectively increasing benefits for most retired members by 1%.			
IL	Legislature authorized issuance of $4.3 B in pension bonds to fund contributions to the state retirement systems in FY10, which may be issued in 1/10. Contributions will rise for employers in the IL Municipal Retirement Fund.		IMRF Board increased funding corridor from 10% to 20%; revised amortization period from a closed 22-year period (which would have declined to 10) to a rolling 30-year; and employers were given an option to pay the ARC or to phase in contribution rate increases. Also, legislature approved conversion from market value of assets to five-year smoothing for SURS, SERS, and TRS, effective with the valuations dated 6/30/09. No funding corridor was specified. Remaining 80 percent of 2009 losses will be recognized in subsequent actuarial valuations.	Pension Modernization Task Force met over summer and fall; components of report were adopted by task force sub-committees, but report in its entirety was not adopted. The report provides background on covered topics and appendices with individual opinions. The report is accessible at the task force's website: http://www.illinois.gov/gov/pensionreform/	For the SERS, TRS, and SERS, the legislature is expected to consider various proposals when it convenes in 2010, including: lower defined benefit formulas (different formulas for SS coordinated and noncoordinated); higher retirement ages; longer vesting periods; lower maximums; caps on salaries that could be used for retirement purposes; elimination of the survivor benefit program; and elimination of early retirement programs.
IN	Upon recommendation of the actuary, the IN PERF Board approved an employer contribution rate increase for the state from 6.5% for FY10 to 7.0% for FY11. As an agency plan, the average contribution rate for local units also increased, from 7.143% to 7.552% for the same years.				
KS				The Kansas Legislature's Joint Committee on Pensions, Investments and Benefits is studying a wide range of options, including: increasing employer and employee contribution rates, lowering the multiplier for future service, issuing bonds in lieu of an employer contribution increase, and a mandatory defined contribution plan for new employees. The Committee expects to make recommendations for statutory changes in the 2010 legislative session.	
KY	Based on recommendations from its actuary, the KRS board requested employer contribution rates that are sharply higher for several plans above current levels; the General Assembly will approve the actual rates during its 2010 session. The GA in 2008 established a schedule for reaching the ARC by 2024; the GA may or may not comply with that schedule in FY 11.	The General Assembly approved, and the governor signed in 2008 a number of changes affecting KRS participants, including reduced pension benefits for new hires, higher employee contributions for all participants, and modifications to the auto-COLA by limitiing it and authorizing the General Assembly to suspend it.		A working group appointed by the governor met and produced a report in 2008; no other study commissions are in place.	KRS expects during the 2010 General Assembly attempts to define "full funding" as 80% funded (based on a January 2008 Government Accountability Office report entitled, "State and Local Government Retiree Benefits"): http://www.gao.gov/new.items/d08223.pdf

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
LA	The employer rate is scheduled to rise to 22% in FY 11 from 18.6% in FY 10.	Legislature modified COLA provisions for statewide systems to retain more assets in the trust funds to amortize the unfunded liability, limiting future COLAs and changing the terminology from "cost-of-living" to "permanent benefit increase." COLAs also are limited to those retired at least one year and who have reached age 60. Also, approved bill allowing a member of any statewide retirement system who retires after 7/1/09 to self-fund a guaranteed 2.5% annual COLA through an actuarial reduction of benefits. Any COLAs provided supplement the self-funded annual 2.5%.	Legislature authorized the refinancing of unfunded liabilities for LASERS and TRS of LA over a 30-year period beginning in FY10.	The Commission on Streamlining Government was created to reduce the cost of state government, through all means available, including efficiencies, economies, and greater effectiveness. The commission inquired about LASERS' retirement incentive programs and cost saving measures.	The Commission on Streamlining Government recommended a defined contribution plan for new employees. The Commission also recommended allowing the purchase of air time for eligibility and closing the DROP program effective 1/1/2015. Legislation is required to implement any of these recommendations.
MA					A commission has been studying pension benefits during 2009 and is expected to submit recommendations for consideration by the 2010 general assembly. Also, a gubernatorial candidate has proposed pension reforms that include an annual pension cap of $90k and pension benefit based on lifetime earnings.
MD					
ME		Legislature approved a bill amending existing statutes to provide that if the inflation rate in a given year is less than zero, benefit levels for current retirees will not be reduced.		Legislature established a task force to study creation of a new unified plan that would require all new hires to be enrolled in Social Security and Medicare, would coordinate retiree health benefits with the new plan, and provide a defined benefit plan. The combined actuarial costs of the new plans are to be divided equally between employers and employees. The task force is to report no later than 3/1/10.	
MI	Some MERS employers increased rates in 2008 and MERS has advised others that higher rates may be forthcoming.	MERS adopted a bridged or tiered benefit system, allowing a municipality to lower the benefit multiplier on a prospective basis.	MERS temporarily suspended a declining amortization schedule. For 08 and 09 valuations, the amortization period will remain at 28 years for unfunded accrued liabilities, then to resume declining in 10 at 1-year increments until reaching 20 years in 17. Also, revised actuarial assumptions to reflect increases to employer contributions for assumptions for turnover, retirement and FAS.	MERS is working with the state on fiscal responsibility for plan design changes.	MERS Board is evaluating raising the retirement age, lowering the discount rate for service credit purchases, and prohibiting use of overtime in FAS.
MN					The TRA Board is recommending a shared sacrifice approach, via the following legislative package: 1) A phased increase in employer and employee contributions, from 5.5% each to proposed 7.5%, phased in over 4 years, rising by 0.5% each year. After the phase-in, TRA is requesting authority for an auto contribution stabilizer that provides the board with authority to set future contribution rates (within boundaries) should the system have a contribution deficiency. 2) A 2-year suspension on annual benefit increases followed by a more permanent reduction in the COLA from 2.5% to 2% until the funding ratio reaches 90%. 3) Reduction in the interest rate paid on refunds of contributions from 6% to 4%. 4) Reduction in the annual increase for deferred benefits to 2%. Deferred benefits are paid to members who terminate, leave their money on deposit with TRA, and later collect a benefit. The deferral interest rate is applied to the member's benefit beginning from the member's termination date to collection of the benefit. Also, the PERA Board adopted a legislative position supporting: 1) a reduction in annual benefit increases from 2.5% to 1.0% until the funding ratio reaches 90%; 2) an increase of 0.25% in both employee and employer contribution rates; 3) a reduction in the interest rate paid on refunds of contributions from 6% to 4%; 4) reduction in the annual increase for deferred benefits to 1%; and 5) increase in vesting period for new hires, from 3 years to 5.

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
MO	The MOSERS employer contribution rate will rise 7/1/10 from 12.75% to 13.81%; MOSERS is non-contributory for employees. The PSRS/PEERS Board voted to increase the contribution rates for 09/10 and 10/11. PSRS was increased by 1% each year (the maximum annual increase allowed by law). The rate for PEERS increased by 0.5% in 09/10 and 0.26% in 10/11 (the maximum annual increase allowed by law). Contributions are paid equally by employers and employees of both systems.		MOSERS temporarily widened the funding corridor, from 120% to 130%, to moderate required increase in contribution rates.		
MS	MS PERS board approved increased employer contribution rates, from 12.0% to 13.56%, effective 7/1/10.			The MS PERS Board voted to establish a commission to study legal issues associated with increasing the employee contribution rate; this commission will remain in place to review the plan's benefit structure, with possible recommendations to legislature in 2011.	Governor has proposed higher employee contributions, lower employer contributions, and rolling back recent benefit enhancements, including an auto-COLA.
MT				Legislature established an interim committee to examine and recommend funding and benefit changes in the statewide public employees' and teachers' retirement systems.	
NC	In line with the historical funding policy of always contributing the ARC, the employer contribution for the state system is due to increase from 3.57% in FY10 to 6.71% in FY11. The employer contribution for the local system is due to increase from a base rate of 4.80% to 6.35% as of 7/10.			NC Retirement System Board established the Future of Retirement Study Commission to recommend the retirement benefits that should be provided to future hires of state and local government. The commission is scheduled to begin meeting 1/10.	
ND				Legislature directed the HR Management Services to study how to retain state workers who are nearing retirement; relates to workforce recruitment and retention.	
NE	Legislature increased school employees' contribution rate by one percent, from 7.28% to 8.28%, effective through 2014. Employer rates will rise also, from 7.35% to 8.36%. The state also committed to paying $20 million annually to the school pension fund for 5 years. Also, increased employee rate to the state patrol fund, from 13% to 15%, to match the employer rate.				
NH	Legislature increased employee contribution rate from 5% to 7% for those hired after 6/30/09. Increased employer contribution rate for non-state government employers from 65% of the annual required contribution in FY09 to 70% in FY10 and to 75% in FY11 (state government contributes the remainder).				Actuary has recommended sharply higher employer contribution rates that would take effect 7/1/11.
NJ	Legislature reduced required contributions of municipal employers by one-half; remainder may be paid over a 15-year period.				
NM	For the two-year period beginning 7/1/09, legislature increased employee contribution rates for all public employees, including teachers, by 1.5%, and reduced the contribution rate for all employers by the same amount.	Legislature in 2009 created new retirement plans for state and municipal general members of the PERA other than peace officers. Retirement eligibility under the new plans is any age and 30 of service, age 67 and five years of service, or the "Rule of 80". The bill also contains a new retirement plan for members of the Education Retirement Board (ERB), in which eligibilty for retirement is the same as under the new PERA plans, except benefits are reduced for a member retiring under the rule of 80 if the member is under 60 years old. The new retirement plans are effective 7/1/11 and will apply to employees hired on or after 7/1/10.		Legislature created the retirement systems solvency task force, to study the actuarial soundness and solvency of the state retirement plans and the health care plan of the retiree health care authority, and to prepare a solvency plan for each entity. The solvency plans are to include analyses and recommendations that address: 1) employer and employee contributions; 2) retirement eligibility; 3) the number of retirement plans; 4) retirement benefits; 5) investment policy and asset allocation; 6) disability retirement and benefits; 7) actuarial assumptions; 8) health insurance plan benefits and eligibility; 9) the costs of health insurance plans; and 10) member services.	The legislature is planning to increase the size of the PERA board from 12 to 16 by adding 3 outside investment professionals (to be appointed by our board) and the State Auditor. This stems from the poor returns last year and the legislature's view that the PERA board lacks investment expertise that may have lessened the losses. The legislature also is proposing creation of an Alternative Investment Advisory Committee should PERA investments in Alternative assets reach $500 million. This group would oversee and advise the board on the investments in that asset class. These committees will be made up of both board members and outside investment professionals with experience in that particular asset class. Each committee will be made up of 5 members.

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
NV		Legislature approved changes for those hired after 1/1/10. For non-public safety members, eligibility for current members is 65/5, 60/10 or 30 years of service. This bill changes 60/10 to 62/10. For public safety officers, eligibility of current members is 65/5, 55/10, 50/20 or 25 years of service. This bill removes the 25-and-out option. For current members, the actuarial reduction for early retirement is 4% per year, prorated for months short of a year; for those joining on or after 1/1/10, it will be 6% per year, prorated. For current members, the benefits formula is 2.5% of FAC times years of service before 7/1/01, plus 2.67% for years of service earned thereafter. This bill removes the higher benefit factor for service after 7/1/01 for new hires. For new hires, FAS will exclude increases in compensation to 10% per year for the 60-month period that begins 24 months before the 36 months used in the calculation of FAC. Employees so limited are entitled to a prorated refund of their contributions for the appropriate period. Also, the legislature reduced the COLA for new hires, from the current method that provides a gradually-increasing COLA up to 5% annually for those retired 14 years. New hires will receive a COLA that rises to 4% annually after 12 years of retirement.			
NY	As of 1/1/10, employee rate for new hires rises from 3.0% for the first 10 years and 0% thereafter to 3.0% lifetime for State employees and 3.5% lifetime for teachers.	The legislature approved a new tier for those hired on or after 1/1/10, featuring a) 10-year vesting (up from 5); b) a cap on the portion of the retirement benefit that can come from overtime pay; and 3) larger reductions for early retirement (pre-62). For state employees, no unreduced retirement permitted prior to age 62. For teachers, unreduced retirement is permitted prior to age 62 if at least age 57 and 30 years of service. For teachers, benefit multiplier of 2.0% starts at 25 years of service instead of 20.			
OH					The Ohio Retirement Study Council directed statewide plans to submit proposals for restoring sustainability, which the legislature is expected to consider in 2010. Proposals vary by system. For example, the STRS, P&F, and Highway Patrol Systems proposed higher contribution rates for employees and employers. All but the Highway Patrol system proposed more stringent eligibility criteria for both normal and early retirement, thru either higher age or more years of service, or both. All but STRS proposed reducing payments to retiree health care funds. For detail on each systems' proposal, see the comparative grid at the Ohio Retirement Study Council website: http://www.orsc.org/uploadpdf/Updated_Comparative_Summary.pdf
OK					
OR	Under current actuarial methods (including fair market value of assets), employer contribution rates generally would increase from 12% to 18% on 7/1/11. This increase is capped by a rate collar policy adopted by the PERS board, which limits biennial employer contribution rate increases to 6% of covered payroll if the employer's individual or pooled funded status falls below 80% (excluding pension obligation bond side accounts). Most PERS employers would be below this level, although some employers may still have an individual funded status above 80%, so their rate increase would be limited to 3% of covered payroll. Member contributions are fixed in statute at 6% of covered salary.				The PERS board is considering revising its rate collaring policy. For example, they may choose to revise the upper limit on employer rate increases so they would slope from a 3% maximum increase at 80% funded to a 6% maximum at 70% funded, instead of rising from 3% to 6% in one step if funded status falls below 80%. Alternatively, they may impose an ad hoc limit on employer rate increases for the 11-13 biennium at 3% or 4.5% of covered payroll, instead of having them rise the full 6% (assuming the employer's funded status falls below 80%).
PA	Legislature approved bill permitting City of Philadelphia to raise sales tax to fund cost of pension benefits.		Legislature approved bill permitting City of Philadelphia to extend funding amortization period to reduce near-term costs.		

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
RI		Reduced benefits for state employees, teachers and judges not eligible to retire on or before 9/30/2009, by increasing retirement age to 62 with a methodology that proportionally changes age requirement based on years of service, so the closer one is to retirement, the less the impact. Also, increased FAS calculation period from 3 years to 5, and reduced COLA to lesser of CPI or 3.0%. Also, allows purchased credit to count toward total service time but not toward vesting (as in current law), and provides that credit must be purchased at full actuarial cost after 6/16/09.			
SC					
SD			Reduced assumption for expenses and increased funding period from 20 to 30.		In November 2009, the SDRS board proposed a reduction in the auto-COLA, from 3.1% to 2.1%, linking COLA to plan funding level, and a reduction in the benefit for terminating plan participants. Also, the legislature is expected to stiffen return-to-work provisions, including reducing retirement benefit and eliminating benefit accruals for employees who have returned to work.
TN	Effective 7/1/10, employer contribution rate for teachers will increase from 6.43% to 9.05%, and for state employees from 13.02% to 14.91%.		Adjusted funding period to 20 years, from 18.		
TX	Legislature increased state employee contribution rate from 6.0% to 6.45%. The State may increase its contribution to 6.95% based on interpretation of the appropriations bill and an AG opinion. If the state contribution increases, the employee contribution will rise to 6.5%. Also, the state contribution (employer) rate to TRS was increased from 6.58% to 6.644% after the Attorney General ruled a $500 13th check was not structured properly by the Legislature.	For state employees hired after 9/1/09, normal retirement eligibility increases to 65/10 or the Rule of 80 at age 60, with a reduction for each year of age under 60. Current provisions are 60/5 or the Rule of 80 with no minimum age. Also, new hires may no longer apply unused annual leave or sick leave toward retirement eligibility, but may continue to use in determining the annuity amount. FAS period increases from highest 36 to highest 48 months. Annuity will be reduced 5% for each year short of age 60, with a maximum reduction of 25%. Similar provisions apply to newly-hired law enforcement and custodial officers, who have a normal retirement age of 55. Also, return-to-work changes require employers who hire an employee who retires after 9/1/09 to pay the ERS trust fund a surcharge equal to the retirement contribution that the employer would make for an active employee, and to wait at least 90 days before hiring an employee who retires after 5/1/09.	Actuarial cost method for funding purposes was changed such that the total liability is based on the benefit provisions for each member and the normal cost rate is based on the benefit in effect for members hired after August 31, 2009		
UT			Board approved broadening funding corridors from 80/120 to 75/125. Also, the amortization period was moved from 20-year open to 25- year fixed, but moving each year over the next 5 years to a 20-year open period again.		Legislature is expected to consider freezing the existing DB plan and providing a different plan for new hires. The new plan will be either a pure DC plan or a hybrid plan which will include a DB plan with a 1% multiplier combined with a DC contribution. Retirement eligibility will be based upon Social Security eligibility. The new plan would be for all public employees, including public safety, firefighters, judges, teachers, and others. Existing employees may have their 30-year at any age retirement moved incrementally to 35-year eligibility, and public safety and firefighters may move from 20- to 25-year retirement eligibility. Since the existing plans are noncontributory, members cannot be asked to pay into the system. The new plan will have a contributory element.
VA			Temporarily suspended 120/80 funding corridor; "substantial asset losses have been recovered since the valuation date, and a 5-year projection of contribution rates shows little difference with or without the corridor."	The legislative watchdog agency, JLARC, issued a study on state employee compensation in December 2008, which devotes a chapter to retirement benefits and presents a number of changes in plan design that would produce either short or long-term savings.	The VRS Board is requesting an increase in contribution rates for state employees and school teachers, currently funded at 11.26% and 13.81% respectively, to 13.46% and 17.91%. Requested rates are unlikely to be funded, however, due to major budget reductions. When the General Assembly convenes in January, numerous proposals are expected. Among those that will gain most attention are 1) phase in a mandatory employee contribution that was eliminated in the 1980's; 2) revise the COLA formula to change the manner in which it matches the CPI; and 3) increase the age at which new members can qualify for an early unreduced retirement benefit.

Responses to 2008 market decline and rising pension costs

State	Contribution Rates	Benefits	Actuarial Methods/Processes	Study Commissions	Proposed Changes
VT			Legislature extended funding period of the VRS from 2018 to 2039.	Legislature created a commission to review and report on the design and funding of retirement and retiree health benefit plans for state employees and teachers. The commission is charged with making recommendations about plan design, benefit provisions, and appropriate funding sources, along with other recommendations it deems appropriate for consideration, consistent with actuarial and governmental accounting standards, as well as demographic and workforce trends and the long-term sustainability of the benefit programs. The joint fiscal committee may provide benchmark targets reducing the rate of expenditure growth for retirement and retiree health benefits to the commission to guide the development of recommendations.	
WA			Legislature directed reduction in salary growth assumption, from 4.25% to 4.0%; postponed adoption of revised mortality tables and minimum required contribution rates; and directed that new funding method be phased in, saving an estimated $450 million over the biennium.		
WI	The WRS governing board increased the 2010 contribution rates by 0.6% for general category employees, of which 0.3% is on the employer portion and the other 0.3% is on an employee-related portion (which the employer can agree to pay). The rates for general category employees were 10.4% of salary in 2009 and will be 11.0% of salary in 2010.	Generally, monthly annuities on the Core Fund component of plan benefits decreased 2.1% effective May 1, 2009 as a result of the 2008 market decline. In addition, monthly annuities on the Variable Fund (a voluntary all-stock option) portion of plan benefits decreased 42% effective May 1, 2009 as a result of the 2008 market decline.			
WV		Legislature established new, consolidated statewide plan for new public safety hires, featuring lower benefits and 40-year funding basis.			
WY					Legislature is expected to consider higher employer and employee contributions. Also, a closed plan for firefighters is considering increasing its amortization period from 10 years to 20.

Promises with a Price

Public Sector Retirement Benefits

THE PEW CENTER ON THE STATES

Dear reader:

$2.73 trillion. That is a conservative estimate of what states will spend on pensions, health care and other retirement benefits for their employees over the next 30 years. It is an enormous investment of taxpayer dollars—so the stakes are extraordinarily high. Across the country, state policy leaders are trying to strike the right balance between controlling costs and recruiting and retaining talent in the public sector.

This groundbreaking report, *Promises with a Price*, provides first-of-its-kind data about the long-term costs of public sector benefits. It highlights which states are prepared to pay the significant bill coming due, which are not, and why it matters to state lawmakers and citizens alike.

States' fiscal health depends greatly on policy makers' ability to wisely manage their bills coming due—and The Pew Charitable Trusts' Center on the States (PCS) is tracking their efforts across a range of issues. For instance, last year we published a report on states' efforts to rein in ballooning Medicaid costs while ensuring high-quality health care for citizens in need. This year we issued a 50-state assessment forecasting that, without data-driven policy reforms, many states will see significant growth in their prison populations and corrections spending in the next five years.

Equally important is whether states have the right policies in place to be competitive in a global, 21st-Century economy. In July, PCS and the National Governors Association joined forces to produce a governors' guide on states' research and development funds, aimed at stirring innovation and creating new jobs. In January 2008, PCS and *Governing* magazine will publish a report on whether states' tax structures encourage or impede states' economic vitality.

Finally, in March, our Government Performance Project will release a 50-state report card on how efficiently and effectively states are managing their budgets, employees, information and infrastructure—all critical to ensuring that state policies ultimately deliver the results lawmakers and taxpayers expect.

Researching emerging topics, developing 50-state comparisons, identifying innovative approaches among states to complex problems, and, when the facts are clear, advocating for nonpartisan, pragmatic solutions—these are the signature efforts of PCS.

The Pew Charitable Trusts applies the power of knowledge to solve today's most challenging problems, and PCS, a division of Pew, identifies and advances effective policy approaches to critical issues facing states. We hope all of our work, including this report, helps states make sound, data-driven policy choices on a wide range of issues.

To learn more about Pew and our Center on the States, please visit www.pewcenteronthestates.org.

Sincerely,
Susan Urahn
Managing Director, Pew Center on the States

Acknowledgments

The Pew Charitable Trusts applies the power of knowledge to solve today's most challenging problems. Our Pew Center on the States identifies and advances effective policy approaches to critical issues facing states.

PEW CENTER ON THE STATES

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- Richard Keevey, director, Policy Research Institute for the Region, Woodrow Wilson School at Princeton University. Keevey previously was director of the New Jersey Office of Management and Budget, as well as state budget director and state comptroller.
- Girard Miller, commentator and consultant on public finance issues. Miller previously was president and chief operating officer of Janus Capital Group and president and CEO of ICMA Retirement Corporation.
- Parry Young, commentator and consultant on public finance issues, with a focus on pension and retiree health care benefits. Young previously was director of Standard & Poor's Ratings Services.

While these experts have screened the report for methodology and accuracy, neither they nor their current or former organizations necessarily endorse its findings or conclusions.

For additional information on Pew and our Center on the States, please visit www.pewcenteronthestates.org.

Executive Summary

FOR MANY AMERICANS, POST-RETIREMENT BENEFITS—principally pensions and health care—for state government employees is an obscure topic. But because of how they can affect state budgets, these benefits have become an issue of critical importance. Research by Pew's Center on the States shows states' retiree pensions and other benefits represent a bill coming due over the next few decades that can be conservatively estimated at $2.73 trillion. That includes about $2.35 trillion for a wide range of employee pensions, including those for teachers, and an additional $381 billion for retiree health care and other non-pension benefits for state employees only, excluding those for teachers and a handful of other groups.

The bill coming due over the next few decades can be conservatively estimated at $2.73 trillion.

To their credit, states have socked away enough to cover about 85 percent of the pension bill. But there is very little put aside for non-pension benefits. All told, states face about $731 billion in unfunded bills coming due. (See Exhibit 1-1.)

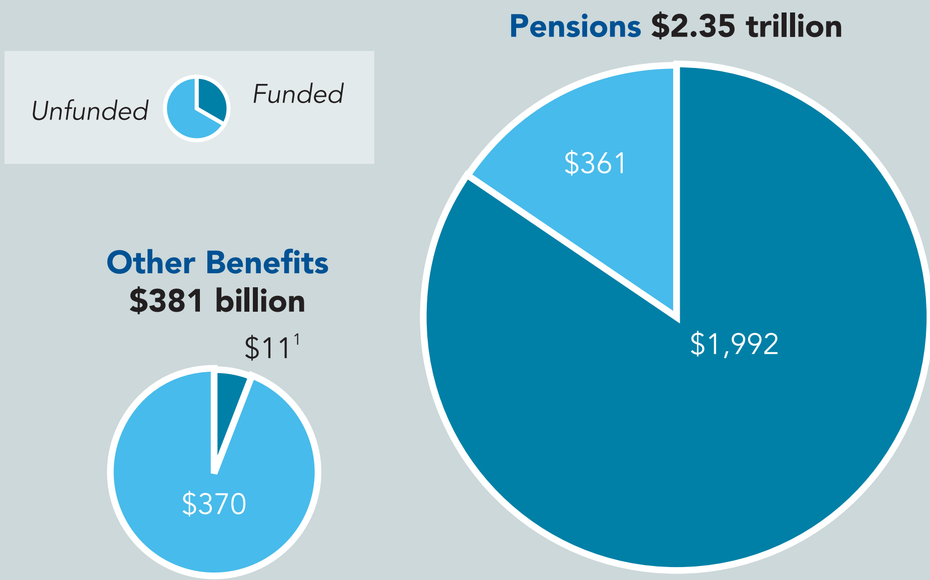
The way in which states provide retirement benefits, and at what levels, to their employees has become the subject of increasingly volatile debate. Several important developments have drawn attention to the issue, including the precipitous drop in public pension funding levels in the early years of the decade and new accounting rules that identify, for the first time, the large obligations that many governments have incurred for retiree health care and other non-pension benefits.

States' liabilities and their ability to cover those costs are affected by a variety of factors, including the strength of their economies, shifts in their populations and their tax capacity. But policy decisions are equally critical. In some states, retiree benefits have been vulnerable to a buy-now, pay-later mentality. In bad budget times, retirement benefits become easy substitutes for salary increases because states can put off the bills. In good times, feelings of legislative largesse can create new retirement benefit policies that have costly long-term price tags.

Today, the need to intelligently control and manage the cost of post-retirement benefits is integral to states' capacity to fund competing needs, such as adequate roads, bridges, water systems and high-quality public education. But at a time when states are competing with the private sector and other nations for the best and the brightest, many fear that reducing benefits could make public sector employment less attractive. "Addressing this issue now is responsible public policy," said Robert N. Campbell III, vice chairman, Deloitte & Touche USA, LLP, which provides financial, human resource and technological services to business and government. "It is in the public interest to

1-1 50-STATE RETIREE BILL: $2.73 TRILLION

The pension bill is much larger than that of other benefits, but it is 85 percent funded; the bill for other benefits is only 3 percent funded (in billions).



1 This number is an estimate of assets for state employees only. According to actuarial valuations, which include cost-sharing plans, the assets total $18 billion.

NOTES: Numbers are the totals of the states' 30-year obligations as calculated in 2006. Other benefit costs only include state employees. The "Other Benefits" number is based on actuarial valuations from the states, which include some cost-sharing plans (i.e., Arizona, North Carolina and Ohio).

SOURCE: Pew Center on the States; Based on States' Comprehensive Annual Financial Report and Actuarial Valuation Data

ensure that qualified, skilled and capable individuals continue to be attracted to careers in public service."

The issues surrounding retirement benefits are highly technical, involving complex calculations and arcane financial terms; in general, the public doesn't pay nearly as much attention to them as they do to education, health care and other topics. This lack of public awareness is part of the reason some states now find themselves in trouble. But the complexity of public sector retirement benefits belies their potential consequences for everyday citizens. Even seemingly modest changes can have significant impacts on public employees, taxpayers and states' fiscal health.

Given the amount of public funds invested, it is more important than ever that states be informed by the best available data, analysis and practices when making decisions about post-retirement benefits.

This report, by the Pew Center on the States (PCS), seeks to provide such information to state policy makers across the country. The report is divided into three sections. This executive summary highlights key findings of the report, describes current forces driving up costs in both pensions and other post-employment benefits (primarily health care), and explains why state budgets will be affected for years to come. The second section focuses on pensions, offering 50-state data illuminating different ways states have handled these obligations and opportunities for states to control future costs. The last section examines other post-employment benefits, providing groundbreaking data on states' liabilities for retiree health care and profiling initial measures some states have taken to manage the issue.

PCS's analysis flows from an intensive review of data compiled and reported by the states—information that is publicly available but not always easily accessed by policy makers. To examine pension funding trends, PCS aggregated all the pension data that were available in states' comprehensive annual financial reports, including plans for teachers, state employees, law enforcement personnel, elected officials, judges and, in some cases, municipal employees whose benefits are administered through state plans. To assess the impact of health care and other non-pension benefits, PCS collected actuarial valuations that have now been completed by most of the states and which calculate long-term costs of retiree health and other benefits that have previously been unknown. In this case, to offer a consistent comparison among states, information was collected for state employees only. Non-pension benefits for teachers will be the topic of a subsequent report. (For a more detailed explanation of our methodology, see page 17.)

Key Findings

Pensions

State of the States:

- From a national perspective, states' pension plans seem to be in reasonable shape. Looking at all pension plans covered in the states' financial reports, there were $2.35 trillion in long-term liabilities at the end of fiscal year 2006, of which $361 billion was unfunded. Data collected by PCS show that, in the aggregate, states' systems were 85 percent funded for fiscal year 2006.

- But the national perspective masks important variations across the states. Twenty states had less than 80 percent of the funds necessary to cover their long-term pension obligations—the level most experts consider to be healthy. Given shifts in funding levels caused by volatility in the stock market and other forces, underfunding could leave states in a very precarious position. And several states, including Connecticut, Illinois, Hawaii, Kentucky and New Hampshire, have experienced particularly troubling drops in their funding ratios.

- While the overall story about states' pension plans seems generally positive, policy makers should be cautious about this news. Past experience indicates that good times may become perilous for the long-term health of pension systems. In the late 1990s and early 2000s, when half the states' pension plans were fully funded, many states reacted by increasing benefits. In the years that followed, funding levels for state pension plans dropped substantially, some by as much as 30 to 40 percentage points.

- In the past 10 years, only about a third of the states have consistently contributed the full annual amount their own actuaries said was necessary. In 2006, 20 states contributed less than 95 percent of the amount their actuaries targeted to meet their annual contribution for pension funding, and 10 states contributed less than 80 percent. States that have consistently fallen short in recent years include Colorado, Illinois, Kansas, Michigan, New Jersey, Oklahoma and Washington.

Promising Approaches:

- States should fully fund their liabilities each and every year. And they should be sure that any new benefits promised are genuinely affordable—once given, pension benefits are very difficult to take away. Both Georgia and Oklahoma require that any proposed benefit increase be accompanied by actuarial calculations of long-term affordability.

- A number of states are taking additional steps to reduce their long-term costs. At least five states now offer hybrid plans that combine elements of both defined benefit and defined contribution plans. (The former promises recipients a set level of benefits; with the latter, the employer contributes a defined amount to the plan.) According to a September 2007 report by the U.S. Government Accountability Office (GAO),[1] Oregon officials estimate that a new hybrid program adopted by the state in 2003 contributed to $400 million in pension reform savings.

- Some states are closing loopholes within pension systems that allow employees to increase the amount they collect after retirement, such as inflating the number of years counted toward retirement or final salary during the last years of employment.

- Some states are strengthening how they govern their pension systems so the funds will be better managed and less volatile. A number of states also are requiring faster, more accurate financial reporting so that policy makers will have the best and most up-to-date information when making decisions about pension plans.

Other Post-Employment Benefits

In response to a 2004 rule from the Governmental Accounting Standards Board (GASB), most states have now completed their calculations of the long-term cost of the non-pension retiree benefits they offer to their own state employees. Of these benefits, the biggest by far is health care, but benefits can also include such coverage as dental care and life insurance.

State of the States:

- The long-term price tag for retiree health care and other benefits for state employees alone is about $381 billion, according to PCS's analysis. About 97 percent—$370 billion—of that 30-year bill was unfunded at the end of fiscal year 2006. And this is a conservative estimate because it doesn't include obligations for teachers or local government workers.

- When it comes to states' total liabilities for employee retirement, pensions represent a far bigger portion than retiree health care and other non-pension benefits. But states are doing a far better job socking away money to cover pension costs. That means that non-pension liabilities make up a disproportionate share—more than half—of what states haven't yet funded.

- States differ tremendously in the kinds of non-pension benefits they offer to retirees. Half the states account for almost 94 percent of the liabilities—largely the result of decisions that governments have made about how large or small these retirement benefits should be and who should receive them. Per capita costs for other post-employment benefits range from less than $200 in states like North Dakota, South Dakota and Wyoming to more than $5,000 in Delaware, Hawaii and Connecticut.

- At the end of fiscal year 2006, just six states—Arizona, North Dakota, Ohio, Oregon, Utah and Wisconsin—were on track to have fully funded their non-pension obligations during the next 30 years. Of the five largest states—California, Texas, New York, Florida and Illinois—none had put aside money for non-pension benefits. Eleven states face long-term liabilities in excess of $10 billion, led by New York at $50 billion, California at $48 billion, and Connecticut and New Jersey at $22 billion each. (Illinois does not have an official valuation yet, but estimates put its liability at $48 billion.)

Promising Approaches:

- At least 13 states have set up irrevocable trusts to pay for retirement benefits in years to come, ensuring that none of the funds are diverted to other purposes.

- States can cut their long-term costs substantially if they start fully funding their annual required contribution for other post-employment benefits. For example, Massachusetts would face $13.3 billion in long-term costs if it didn't put aside funds for retiree health care and other non-pension benefits. If the state consistently funds its required contribution every year—as it is doing in 2008—the long-term costs will be reduced to $7.6 billion. Why? Because the interest the state is likely to earn when it invests more money over the long term can be applied to paying down the bill.

- Many states owe so much that they may find it cost-prohibitive to fully fund their non-pension liabilities—the median annual contribution required is almost three times what they currently are paying. So a growing number of states are both setting aside some money and restructuring benefits to reduce costs. (In general, states have more flexibility to make changes to retiree health care than to pensions—although this subject is likely to be litigated as governments test their latitude for making changes.)

- States can reduce costs by raising the retirement age, increasing employee and retiree premiums and co-pays, increasing the number of years of employment required for lifetime or fully subsidized benefits, requiring new retirees to pay a percentage of their base salary at retirement for health care costs, and requiring retirees to join a Medicare advantage prescription drug plan.

- Some states also are reducing retiree health costs by promoting wellness programs and other preventive measures, and by managing their benefit plans more cost efficiently—for instance, by joining with localities to bundle their plans under a single administrative umbrella.

- States can, in fact, lower their long-term liabilities. For example, after setting up a trust fund for its other post-employment benefits and adopting several reforms, including increased co-pays and requirements for retirees to join a Medicare advantage prescription drug plan, West Virginia reduced its long-term liability by more than half, from an estimated $7.8 billion at the end of June 2006 to $3.4 billion in April 2007.

Why It Matters

Today it is more important than ever that decision-makers—state policy leaders, boards of trustees, agency and union heads, and others—pay serious attention to decisions about post-employment benefits for public sector employees and that they strike the right balance between managing costs and recruiting and retaining good talent. Five key forces significantly affect post-employment benefits and states' ability to pay for them.

1. Pension funding levels are volatile

Pension investment practices have shifted dramatically in the past 30 years. Federal Reserve Board data from June 2007 indicate that 70 percent of state and local pension investments are in equities, broadly defined, up from 62 percent in 2000 and 38 percent in 1990.[2] Because equity investment was a relatively new phenomenon for a lot of states in the 1990s, decision-makers may have ignored the idea that what goes up also comes down.

By 2000, about half the states' pension systems were fully funded, due to strong and sustained stock market growth. Legislatures responded in 1999 and 2000 by shortening vesting periods, increasing the multipliers used in determining benefit amounts, decreasing the age at which employees could receive full retirement benefits and shortening the years of service needed to qualify. New York, New Jersey, Illinois, Pennsylvania, Kentucky, California, Colorado and other states increased benefits.[3] Some also decreased required employer contributions to the plans (see Exhibit A-2 in Appendix A).

But the rosy investment picture of the late 1990s was already starting to wilt in 2000, with the dot.com bust followed by the 9/11 attacks and weakening economy beginning in 2001.

Added benefits increased accrued liabilities while shortfalls in contributions ate into asset growth. In the early years of the decade, as poor investment returns caused funding levels to dip, it became even more difficult for states to make the employer contributions required to keep up. By 2006, only five states—Florida, New York,[4] North Carolina, Oregon and Wisconsin[5]—had pension funding ratios at a 100 percent or greater level. A handful of others—Delaware, Georgia, South Dakota, Tennessee and Utah—were moving close to that point.

This story provides a cautionary tale for policy makers today.

Most states employ a multiyear smoothing process, which evens out gains and losses over time, to calculate the value of their assets. For that reason, pension funding levels have continued to experience the effects of poor returns in fiscal years 2001 and 2002,[6] even though investment returns have done well recently. States have responded to their lowered pension funding levels with caution, enacting relatively few benefit increases in the past several years. States such as Rhode Island, Kansas and Illinois have implemented reforms to try to reduce long-term costs.[7]

But in the next year, there is a chance that pension funding levels will start to rise again, as the bleak returns of the early 2000s are removed from the picture. The big question is whether state leaders will learn the lessons of the past decade or whether they will respond to rising funding levels as many did in the period between 1999 and 2001.

One basic fact significantly affects all retiree benefit equations: While funding levels may rise and fall with the economy, once given, a defined benefit is very difficult to take away.

2. Retiree health care costs are rising dramatically

Retiree health benefits have been offered to public sector employees for decades, but their long-term costs have received relatively little attention. That changed in 2004, when the Governmental Accounting Standards Board (GASB) adopted new standards that ask governments to calculate the long-term actuarial liabilities for non-pension benefits, called "other post-employment benefits" (OPEB), using an approach similar to the one they take for pensions.[8] For the largest governments, including all states, these numbers will be reported for the first time in fiscal year 2008 financial reports.[9]

In some states, the actuarial unfunded liability for non-pension benefits just for state employees is greater than the aggregate unfunded liability for all their pension plans. This is because states have long set aside money for future retirees in their pension systems, but most states have paid for other post-retirement benefits on a pay-as-you-go basis. Each year, as the number of retirees grows and medical costs go up, so does the bill that must be paid out of current revenues.

Exhibit 1-2 shows eight of the 15 states in which the unfunded actuarial accrued liability (UAAL) for retiree health and other post-employment benefits for state employees is greater than the aggregate unfunded actuarial liability for pensions.

1-2 A DOUBLE BILL (THOUSANDS)

States	OPEB UAAL	Pension UAAL	States	OPEB UAAL	Pension UAAL
California	$47,878,000	$46,673,644	Hawaii	$6,791,000	$5,132,028
Connecticut	$21,681,000	$14,914,600	Maryland	$14,543,000	$7,634,087
Delaware	$4,410,000	$207,635	Pennsylvania	$13,501,000	$12,223,300
Georgia	$4,905,000	$2,503,741	Tennessee	$2,305,000	$366,114

NOTE: PCS assembled these data from 2006 Comprehensive Annual Financial Reports for all 50 states, and their respective pension plans. Additional data were obtained from 2006 actuarial valuations of state pension systems and actuarial valuations of other post-employment benefits when available.
SOURCE: Pew Center on the States

3. The gap between private and public sector benefits is expanding

Private sector retiree benefits differ greatly, depending on the size of companies, the level of unionization and the industry.[10] But in general, the private sector never offered the level of benefits that have been traditionally available in the public sector. At its high point in 1980, only about 35 percent of private sector workers had defined benefit pension plans.[11] That number is expected to drop to 13 percent by 2016, according to Dallas Salisbury, chief executive officer of the Employee Benefit Research Institute (EBRI).

As Exhibit 1-3 shows, public sector employees are far more likely to receive retirement benefits—and the gulf between private and public sectors continues to grow. While there are signs that governments are instituting some reforms to scale back benefits, particularly for new employees, the pace of change is dramatically slower than in the business world.

In spring 2007, EBRI and Mercer Human Resource Consulting surveyed private sector defined benefit sponsors and found that more than 35 percent had made changes to their plan in the past two years. About a quarter had closed the plan to new hires, while nearly 13 percent had frozen their plans for all members.[12]

About a third of the organizations that had not changed their plans said they intended to do so in the next two years. And 19 percent said they were considering closing the plans to new hires. The vast majority of private sector companies that intend to shift away from defined benefit systems also say they will increase contributions to defined contribution plans.[13]

The same phenomenon has taken place with retiree health benefits. According to the Kaiser Family Foundation, only a third of big companies offer retiree health insurance. The number has been cut in half since 1988.[14] Of those that do offer benefits, they tend to be considerably less generous than those offered by state government. The Citizens Budget Commission in New York took a look at employers that offer retiree health coverage and found that 10 percent pay the full premium, compared with 32 percent in the states.[15]

The gap between public and private sector benefits fuels the political debate, as taxpayers notice that they are contributing to government employee retirement benefits that are increasingly unavailable in the private sector. This disparity—and resulting pension envy among private sector employees—has generated a wide variety of political reactions, with some calling for a reduction in government benefits and others decrying the declining benefits in the private sector and citing the public sector as an example of how long-term employees should be treated. "The larger issue of what working people are entitled to in our society needs to be considered too," wrote Jon Shure, president of the New Jersey Policy Perspective in a commentary in the New Jersey section of the *New York Times* on November 26, 2006. "Is one group getting plush benefits at the expense of the other? Or, rather, is it government's responsibility to set an example for what the private sector should do as well?"

4. The number of retirees increases every year

The number of retirees will continue to grow as the baby boomer generation reaches retirement age—a massive demographic shift that will affect government on all levels and across sectors. The number of Americans over age 65 increased eleven-fold from 1900 to 1997. Steady increases have continued since then, but the growth in the elderly population will accelerate even more with the aging of the baby boom generation, with a projected increase of 80 percent between 2010 and 2030.[16] By 2030, 71 million Americans—one of every five people—will be over 65, according to projections from the Social Security Administration.[17]

Meanwhile, the public sector will face an escalating number of retirements sooner than the private sector because of the older average age of public employees. In Illinois, for example, the state comptroller reports that in fiscal year 2006, 65 percent of public employees were in their 40s and 50s—up from 41 percent in 1986.[18]

As the number of retirees multiplies, the enormous variation in states will become more pronounced. States with large unfunded actuarial liabilities either in health benefits or pensions will face increasingly large annual costs to provide benefits that were promised. California provides a telling example: The Center for Government Analysis reports the $4 billion required to pay for California's annual state and local retiree health costs in 2006 will escalate to $6 billion in 2009, almost $10 billion in 2012 and $27 billon by 2019.[19]

1-3 A PICTURE OF PRIVATE AND PUBLIC RETIREMENT BENEFITS

Compensation/Benefit	Private Sector Employees	Public Sector Employees
Defined benefit plan	20%[1]	90%[2]
Median pension in 2005	$7,692[3]	$17,640[4]
Retiree health benefit of any kind	33%[5]	82%[6]

1 Data from the U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States", (March 2007):7, http://www.bls.gov/ncs/ebs/sp/ebsm0006.pdf
2 Data from Employee Benefit Research Institute, "Fundamentals of Employee Benefit Programs, Part Five: Public Sector," 2005:16.http://www.ebri.org/pdf/publications/books/fundamentals/Fnd05.Prt05.Chp40.pdf
3 Data from Debra Whitman and Patrick Purcell, "Topics in Aging: Income and Poverty Among Older Americans in 2005," Congressional Research Service, September 21, 2006.
4 Ibid.
5 A little more than a fifth of large employers that offer retiree health pay no part of the premium, according to the Citizens Budget Commission in New York. New York's Citizen Budget Commission, "The Case for Redesigning Retirement Benefits for New York's Public Employees," April 29, 2005.
6 The 82 percent figure pertains to state and local governments that have more than 200 employees.
SOURCES: Defined benefit data from BLS/EBRI; median pension data from Congressional Research Service; and Retiree health data from Kaiser Family Foundation.

California's annual state and local retiree health costs of $4 billion in 2006 will escalate to $6 billion in 2009, almost $10 billion in 2012 and $27 billon by 2019.

5. People are living longer

Life expectancy has trended upward for the U.S. population, from 69.7 years in 1960 to a projected 79.2 years in 2015, according to the National Center for Health Statistics. Some of this change stems from a drop in infant mortality, but it also reflects improvements in health care for adults.[20]

Given the financial pressures that result from increased longevity, the Social Security Administration is gradually shifting its retirement age upward, based on birth year. For people born before 1943, full Social Security benefits will kick in at age 65, but the retirement age will escalate. For example, a person born in 1967 or later will have to wait until age 67 to qualify for full Social Security. Some observers predict that when Social Security is next reformed, the retirement age will go up even further.

Many private sector companies that offer retirement benefits conform their retirement ages to those provided by the federal government. But for states and localities, the eligibility age for receiving full benefits has traditionally been much lower. A December 2005 study from Wisconsin's Legislative Services Council noted that only Minnesota had conformed to Social Security's practice of increasing retirement age over time. Of 87 plans studied across the 50 states, 85 allowed retirement with full benefits at age 62 or earlier for individuals with long service, and 57 provided retirement at age 62 or lower with only 10 years or fewer of service. Only two plans stipulated that it was necessary to reach age 65 to receive full benefits.[21]

In addition, some public sector employees (for example, police and corrections officers) who are in hazardous jobs or in jobs that require heightened physical strength or agility are eligible for full retirement benefits at even earlier ages. Offering benefits at an early age greatly affects health care costs because Medicare coverage has not yet kicked in. For this reason, it is generally much more expensive for governments to provide retirement benefits for pre-Medicare retirees.

The Wisconsin report noted that at the end of 2005, states were still moving toward earlier retirement ages; nine plans had reduced normal retirement provisions since 2000 and 10 had reduced the minimum age or years of service required for early retirement. Since 2005, however, some states, presumably preparing for the significant demographic shifts on the horizon, have started to reverse course.[22]

Endnotes

1 United States Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate (September 2007).

2 Total assets of retirement plan and their allocation are based on Federal Reserve Board. *Flow of Funds Accounts of the United States*, Z1, Release June 7, 2007.

3 A list of pension and retirement legislation for the 50 states for each of the last nine years is available at the National Conference of State Legislatures (NCSL) Web site at http://www.ncsl.org/programs/fiscal/all_pensun.htm.

4 Up through 2006, New York has used a method of accounting for its pension benefits that doesn't yield a funding ratio. The Governmental Accounting Standards Board (GASB) has implemented a new standard that requires governments that use this aggregate cost method to employ the more common entry age normal method to provide funding information. New York officials say their internal calculations, based on an entry age normal approach, indicate that in 2006, their pension funds were more than 100 percent funded.

5 Wisconsin's pension system is funded at 99.57 percent, and rounded up for the purposes of this study.

6 Forty-six states use a fiscal year that starts July 1 and runs through June 30. Fiscal year 2001 refers to the year that ended June 30, 2001.

7 See NCSL Web site, "Pension and Retirement Plan Enactments," http://www.ncsl.org/programs/fiscal/all_pensun.htm.

8 These standards are dubbed GASB 43 and GASB 45. GASB 43 addresses reporting on other post-employment benefit plan assets by a trustee or plan administrator, while GASB 45 addresses accounting and reporting of these benefits by the employers themselves—for example, the state governments. These benefits are dominated by retiree health care, but also may include life insurance, dental, disability or other non-pension benefits.

9 These standards have sparked considerable controversy and a small rebellion in Texas, where Governor Rick Perry signed a bill in spring 2007 that gives the state and local governments the option of accounting for OPEB using standards developed by its own comptroller in place of the GASB standards. The argument against GASB's approach, first articulated in Travis County, was that Texas governments offered retiree benefits on a year-to-year basis, that these benefits were entirely dependent on the current budget situation and that there was no implied promise of future benefits, according to Paul Maco, a partner with the law firm Vinson and Elkins, which was involved in the initial Travis County study of this issue.

10 Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005," *Employee Benefit Research Institute Issue Brief*, no. 299 (November 2006): 8-9.

11 Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2005,* no. 10 (Summer 2006): 60, http://www.pbgc.gov/docs/2005databook.pdf.

12 Jack VanDerhei, "Retirement Income Adequacy After PPA and FAS 158: Part One, Plan Sponsors Reactions," *Employee Benefit Research Institute Issue Brief*, no. 307 (July 2007).

13 Ibid.

14 Henry J. Kaiser Family Foundation and Hewitt, *Retiree Health Benefits Examined: Findings from the Kaiser/Hewitt 2006 Survey on Retiree Health Benefits*, by Amy Atchison et al., (December 2006).

15 Citizens Budget Commission, *Old Assumptions, New Realities: The Truth about Wages and Retirement Benefits for Government Employees*, (2006).

16 Population Resource Center, *The Demographics of Aging in America*, (2004), http://www.prcdc.org/summaries/aging/aging.html.

17 Population Reference Bureau, *The Future of Social Security*, by Christine Himes, (June 2005), http://www.prb.org/Articles/2005/TheFutureofSocialSecurity.aspx.

18 Illinois Comptroller's Office, *State Government Workforce Getting Older, Fiscal Focus* (January-February 2007): 4.

19 California HealthCare Foundation, *Snapshot: Benefits in the Balance: The Uncertain Future of Public Retiree Health Coverage*, (2006): 6.

20 Centers for Disease Control and Prevention and National Center for Health Statistics, *Health, United States*, 2006, (2006): 176.

21 Wisconsin Legislative Council, 2004 Comparative Study of Major Public Employee Retirement Systems, by William Ford, senior staff attorney (December 2005).

22 William Ford, senior staff attorney for the Wisconsin Legislative Council, is currently working on the 2007 version of the Wisconsin report. In collecting the 2006 data, he said he is seeing "markedly fewer states that are reducing their normal retirement date requirements or early retirement ages."

23 (See page 16 of this report.) National Association of State Retirement Administrators, *Public Fund Survey Summary of Findings for FY 2006,* prepared by Keith Brainard, research director (October 2007): 1.

Glossary

ACTUARIAL ACCRUED LIABILITY (AAL) – The total value of pension benefits owed to current and retired employees or dependents based on past years of service.

AMORTIZATION PERIOD – The span of time set to fully pay for actuarial accrued liabilities. To adhere to generally accepted accounting principles (GAAP), governments must use a period of 30 years or less to calculate their net pension or other post-employment benefits obligation and their expense on an annual basis. Some states, which are not in compliance with GAAP, choose longer periods for funding purposes to reduce current contributions.

ANNUAL REQUIRED CONTRIBUTION or ACTUARIALLY REQUIRED CONTRIBUTION (ARC) – The amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period. (This calculation assumes the employer will continue contributing the ARC on a consistent basis.) The ARC is made up of "normal cost" (sometimes referred to as "service cost")—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period.

ASSETS – The amount of money that a pension fund has on hand to fund benefits. The assets (also known as plan assets) build up over time, generally from three sources: employee contributions, employer contributions and investment returns. Plan assets generally are expended to pay pension benefits when due, refund contributions of members who leave the plan before qualifying for benefits and cover the plan's administrative expenses.

ASSUMPTIONS – Estimates made by actuaries about the future behavior of various economic and demographic factors that will impact the amount of pension benefits owed over time. These estimates, of factors such as investment returns, inflation rates and retiree life spans, are used by actuaries to calculate the AAL and the ARC.

DEFINED BENEFIT PLAN – A plan that promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a "defining" formula that usually includes the number of years served and an employee's salary multiplied by a preset figure (e.g., 30 years x $40,000 x 1.75). In the case of retiree health, the promised benefit is typically the payment of a portion of (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses.

DEFINED CONTRIBUTION PLAN – A plan to which the employer, and often the employee, contributes a defined amount (e.g., 8 percent of salary) to an individual account in the employee's name while the employee is in active service, but which does not guarantee any set benefit. The amount available for retirement is based solely on the amount of money that has been saved, along with investment income credited to the employee's account. When these funds are used up by the retiree, the benefit is exhausted.

NORMAL COST – The cost of benefits earned by employees in any given year.

OTHER POST-EMPLOYMENT BENEFITS (OPEB) – Benefits other than pension benefits that an employer provides to former employees as a deferred form of compensation for their services. OPEB is defined by GASB as including (1) post-employment health care benefits and (2) other types of post-employment benefits—for example, life insurance—if provided separately from a pension plan.

PAY-AS-YOU-GO – A method of financing pension benefits or OPEB in which the amount contributed by the employers or employees each year is approximately the amount needed to pay the benefits currently due and payable to retirees (or the premiums currently due and payable to provide for health care coverage or other non-pension benefits for retirees for the current period). Under this method, the source of financing for current benefits often is the employer's current collections.

SMOOTHING – To counter the natural volatility of the stock market, the vast majority of states do not measure the funded status of pension benefits using the current market values of plan assets. Instead, most use methods of determining the actuarial value of plan assets that average out the effects of increases or decreases in market values each year over several years (generally four or five). The effect of this approach is to mute the immediate impact during a severe market drop or spike in growth and to spread it out over time.

UNFUNDED ACTUARIAL ACCRUED LIABILITY (UAAL) – The difference between the actuarial accrued liability and the actuarial value of plan assets on hand. This is the unfunded obligation for past service.

The Basics of Funding

The following principles apply to both pensions and post-employment health care benefits, based on a general consensus of experts in the field:

- The long-term costs of retiree benefits are based on a passel of variables, the future values of which are unknown. Actuaries try to pin down these variables through the use of best or at least reasonable "assumptions" and a professional methodology developed to manage multiple uncertainties. If all the actuaries' projections were correct over time, governments funded benefits earned by employees every year and no new benefits were added, then pensions and retiree health benefits would be fully funded by the end of the amortization period.

- When a state has an unfunded actuarial liability, it is often because over time those "ifs" did not happen. To pay for the unfunded liability, governments add another chunk of money to their annual contribution to spread the unpaid costs over the amortization period, which is usually 30 years. Generally, when funding ratios decline, employer contributions need to increase.

- Overly optimistic assumptions, benefit increases and underfunded contributions all put greater demands on future government payments.

- Inaccurate assumptions also can result in a situation where funding levels rise unexpectedly. This occurred in the late 1990s when most investments earned higher than anticipated returns, which prompted some governments to skip the ARC payment during a so-called funding holiday. However, as the recession in the early half of this decade demonstrated, bad years often follow good ones and the contribution holidays aggravated the impact of market losses.

- In a mature pension plan that is reasonably well funded, most of the total additions to plan assets each year will come from investment returns of assets that have been set aside over decades. In a poorly funded plan (pensions or OPEB), more future money comes from direct state contributions and from the same state coffers that fund education, economic development and health care.

- A poorly funded plan or one that is moving in the wrong direction may also eventually cause trouble for an organization's credit rating. This could increase the cost of borrowing money, which will make it more expensive for governments to pay for infrastructure improvements such as bridges and roads that typically are supported through borrowing.

- Although states aspire to having fully funded pensions, it is important to recognize that "underfunding is a matter of degree," said Keith Brainard, research director for the National Association of State Retirement Administrators (NASRA).[23] The important point is not whether states have reached 98 percent or 101 percent funding; it is the direction in which they are heading and the distance they have to travel to get there.

Methodology

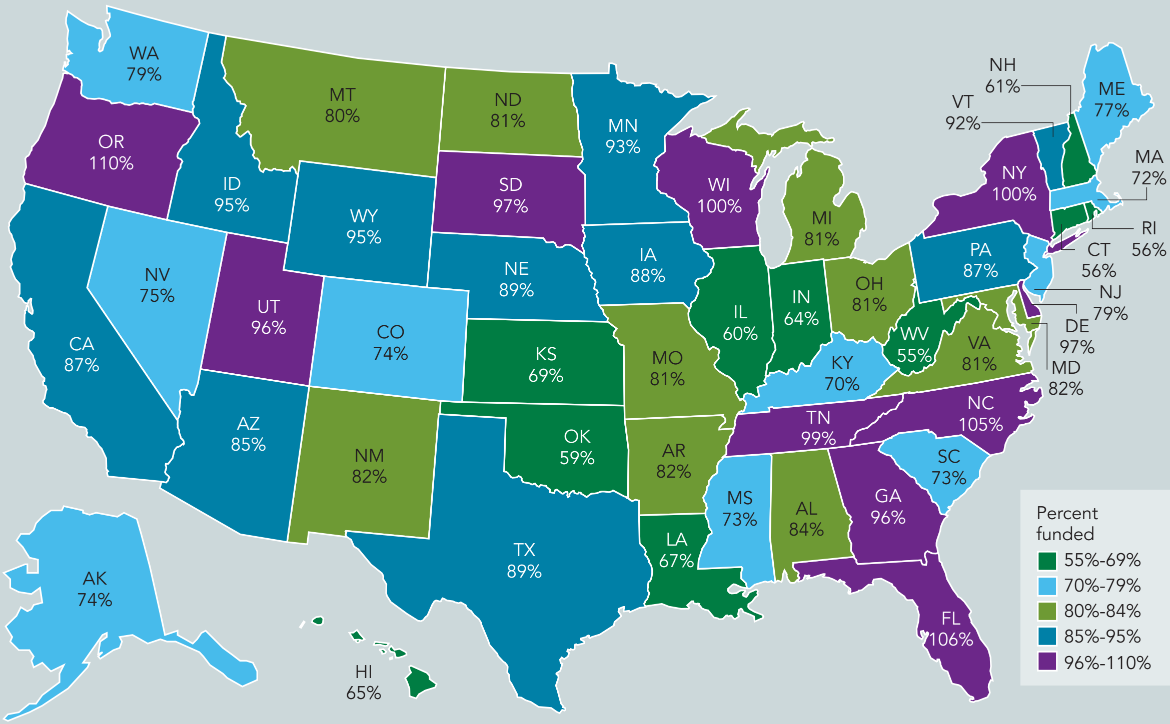
This report is the product of an extensive data collection effort, a review of the literature, a thorough analysis of actuarial studies and evaluations, and interviews with experts and individuals knowledgeable about particular states.

To analyze states' pension systems, PCS examined state annual reports with information over a 10-year time period. Data in the pension section of this report were obtained from State Comprehensive Annual Financial Reports (CAFRs) as well as CAFRs from state pension systems. The numbers aggregate multiple plans in the state pension system and include, in many instances, municipal workers and teachers. PCS did not attempt to disaggregate municipal workers because this could not be accomplished for every state.

To analyze states' other post-employment benefits, PCS reviewed CAFRs and the preliminary actuarial assessments of state non-pension liabilities over the next 30 years. In this case, PCS focused the analysis on state employees alone, in order to achieve a more consistent comparison, because states vary greatly in whether non-pension retiree benefits for teachers are funded at the state or local level. Armed with those preliminary assessments, gathered from a variety of government offices at the state level, PCS assembled a comprehensive and up-to-date compilation of these liabilities, the amounts the states are currently paying for retirement benefits and their funding practices. PCS collected actuarial valuations in spring and summer 2007, continuing through the fall to pursue valuations from states that had not been completed previously. One caveat: Many of these calculations are preliminary and are likely to change as health plans are altered and actuaries re-examine the subject. A handful of states had not finished actuarial valuations by the completion of this report. Where feasible this research was augmented with interviews with actuaries, economists, state controllers, auditors, legislative analysts and other experts in the field.

The expert statements included in this report come directly from interviews conducted by PCS between September 2006 and October 2007, unless otherwise noted. A complete list of resources can be found on PCS's Web site at www.pewcenteronthestates.org.

2-1 STATE PENSIONS: FUNDING LEVELS, 2006



Figures are in thousands.

State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006
Alabama[1]	$33,961,978	$5,522,322	$684,861	$684,861
Alaska	13,090,657	3,369,759	423,666	259,496
Arizona	34,353,623	5,274,143	640,199	640,199
Arkansas	19,114,280	3,409,290	463,786	500,475
California[1]	355,483,412	46,673,644	6,342,208	6,265,138
Colorado	49,490,604	12,803,562	978,924	609,853
Connecticut	34,190,000	14,914,600	1,031,000	1,031,000
Delaware	6,416,275	207,635	122,914	118,950
Florida	110,977,831	-6,181,784	2,193,928	2,106,171
Georgia	65,994,177	2,503,741	1,117,742	1,117,742
Hawaii	14,661,399	5,132,028	423,446	423,446
Idaho	9,951,100	525,200	244,600	262,800
Illinois	103,073,463	40,732,132	3,085,601	1,025,341
Indiana	28,953,950	10,565,887	947,890	955,620
Iowa	21,651,122	2,507,086	387,542	324,677
Kansas	17,552,000	5,364,000	471,424	298,883
Kentucky	30,659,476	9,303,806	564,361	483,740
Louisiana	33,358,313	10,978,703	1,066,311	1,075,547
Maine	12,357,418	2,826,820	294,888	312,017
Maryland	43,537,681	7,634,087	874,079	716,745
Massachusetts	50,431,974	14,055,201	1,320,178	1,242,751
Michigan	63,268,000	12,155,000	1,564,557	1,292,741
Minnesota	30,787,259	2,111,112	284,372	280,874
Mississippi	25,680,550	6,865,090	537,721	537,580
Missouri	43,856,576	8,426,945	1,048,125	852,530
Montana	$8,584,710	$1,675,759	$157,078	$239,822
Nebraska	7,395,639	832,377	210,977	210,977
Nevada	25,794,627	6,482,437	1,058,892	1,015,757
New Hampshire	6,402,875	2,474,605	170,578	170,578
New Jersey	109,610,983	23,141,602	2,180,913	591,342
New Mexico	22,544,980	4,076,390	484,506	439,274
New York[2]	140,150,000	0	2,782,147	2,782,147
North Carolina	61,827,530	-2,954,470	516,570	516,689
North Dakota	3,673,500	681,600	81,586	54,089
Ohio	139,251,460	26,200,600	2,604,033	2,433,921
Oklahoma	27,839,660	11,468,080	1,053,336	763,719
Oregon	51,254,000	-5,362,000	488,500	492,408
Pennsylvania	91,494,400	12,223,300	1,877,118	652,231
Rhode Island[3]	9,822,437	4,329,104	193,394	193,394
South Carolina[1]	33,712,394	9,134,923	689,400	690,374
South Dakota[4]	5,903,592	197,808	81,620	81,620
Tennessee	28,117,127	366,114	665,879	665,879
Texas	132,087,713	15,140,379	2,315,721	1,944,441
Utah	18,783,454	689,963	535,152	535,152
Vermont	3,195,421	256,358	102,681	78,358
Virginia[1]	51,683,000	9,934,000	988,662	857,660
Washington[1]	29,074,500	5,984,300	1,421,200	396,100
West Virginia	11,774,772	5,330,649	484,234	879,888
Wisconsin	73,735,800	320,500	569,000	569,000
Wyoming	6,215,540	316,168	78,257	117,024

1 2005 data were used to report on the state's liability and unfunded liability, as 2006 data were not available from the state.
2 See n.4, page 13
3 2005 data were used to report on the state's liability and unfunded liability, as 2006 data were not available from the state. Rhode Island did not have financial reporting on its specific pension plans after 2004 at the time of this report.
4 South Dakota has two plans; 2006 data were only available for its major retirement plan and 2005 figures for its smaller plan were used in the total calculation.
NOTE: States in bold represent pension systems below 80 percent funded.
Actuarial liability is the total value of pension benefits owed to current and retired employees or dependents based on past years of service.
Annual required contribution is the amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period, which is typically 30 years or less.
SOURCE: Pew Center on the States

Section 2:

Pensions

Saving for the Bill Coming Due

FOR THE SAKE OF SIMPLICITY, it may be tempting for the press and policy makers to paint a one-size-fits-all portrait of state pensions. But each state has its own complicated story to tell. From 2000 to 2006, for example, New Hampshire's pension funds took a tumble, while North Carolina's funding status was nearly unchanged. Kansas[24] set aside only about two-thirds of its annual required pension contribution in 2006, while neighboring Nebraska set aside the full amount.[25] About half the states have troubling unfunded liabilities in some of their pension plans and the other half do not, at least at the moment.

Overall, the national pension "balance sheet" is in relatively decent shape,[26] with 30 state pension systems more than 80 percent funded (Exhibit 2-1). Almost half of those are over 90 percent funded, according to PCS research. However, the remaining 20 states have funding ratios of less than 80 percent, meaning that their proportion of assets to liabilities may create fiscal stress if unaddressed, according to many experts in the field (see Exhibit 2-1—the 20 states are in bold).

> *20 states have funding ratios of less than 80 percent*

All told, states have contributed enough money—about $1.99 trillion—to cover roughly 85 percent of their $2.35 trillion[27] long-term liability for their retirees' pensions over the next 30 years. Still, that leaves them with about $361 billion in unfunded liabilities.

Large underfunded long-term liabilities put future budgets—and taxpayers—at risk. For years, West Virginia has had difficulty putting sufficient money into education or health care because of its need to cover huge pension liabilities the state accrued decades ago, according to Governor Joe Manchin III.[28] And while West Virginia has been aggressive and responsible in overfunding its annual pension contribution over the past decade—the state's system is now 55 percent funded, compared with a 39 percent funding level in 2003—the funding mistakes of the past make catching up extremely difficult (see Appendix Exhibits A-1 and A-2).

States can delay action to deal with an underfunded pension, but only temporarily. The share of the population aged 65 or older will grow to 20 percent in 2030, according to the U.S. Census Bureau. In 1950, the number of workers relative to retirees was 16.5 to 1; today the ratio is 3.3 to 1, and it will move down to 2 to 1 during the next 40 years, according to Census estimates.[29] When a pension system is fully funded, the ratio of workers to retirees matters little, because the money for retirees is already in the bank.[30] But when a plan is underfunded, making the payouts can become extremely burdensome for states.

PCS's research highlights two important rules for states to follow if they are to address their long-term pension obligations cost-effectively. Agreement on these points is nearly universal, and they have been voiced by experts ranging from researchers at rating agencies such as Standard & Poor's and academic institutions such as the University of Pennsylvania, the University of Michigan and Harvard University to retirement administrators in a number of states. Following these sound financial principles allows states to evenly spread out the costs of long-term benefits over time, rather than have low costs now and a substantial—and potentially budget-breaking—cost spike later.[31]

FULL FUNDING. First, it is critical for a state to diligently meet its own yearly goal for funding its long-term pension liability (known in actuarial terms as the actuarial required contribution, or ARC) and to base that goal on accurate assumptions.

Florida's legislature is displaying a high degree of fiscal caution that has presumably helped the state achieve the fully funded status it has held since 1998. The state passed legislation that basically reserved a portion of the pension surplus to serve as a safeguard against unexpected increases in liabilities, providing the state with extra financial security.[32] North Carolina has also had consistently high levels of funding, even when the stock market dropped or the state was under fiscal stress. The state has been disciplined about paying its annual bill and maintaining the financial health of its pension system. Illinois and New Jersey are examples of poor financial decision-making as both states have actively reduced contributions to their plans over the past 10 years, leading to chronic underfunding.

AFFORDABILITY OF NEW BENEFITS. Second, a state must make sure it can afford new promises, as once a benefit increase is made it is extremely difficult to take back. This means the state must carefully consider the long-term impact of benefit changes, including shifts in vesting periods, early retirement programs, cost-of-living adjustments, salary calculation methods, and a host of other factors that affect pension amounts and the states' own long-term fiscal health. States, in general, have become more careful about adding benefits in the last few years and several have enacted legislation that establishes safeguards against benefit increases enacted in haste. A 2007 Hawaii law, for example, bars benefit enhancements between January 2, 2008 and January 2, 2011 if the plan has an unfunded accrued liability. A 2007 Missouri law prevents pension plans in the state from increasing benefits if they are less than 80 percent funded.[33]

Finally, states can take additional steps to reduce their long-term pension obligations. Among other measures, they can close loopholes in pension systems that allow employees to inflate the amount they collect after retirement. They can consider creating hybrid plans that combine elements of defined contribution and defined benefit plans. And they can improve oversight and governance of their system so that decisions are well informed by up-to-date, accurate and reliable data, and to ensure the funds are well managed.

The detailed analysis that follows seeks to help state policy makers and the public answer these critical questions:

- What differences are there among the states in how they manage their pension plans?

- What are the fundamental reasons for these differences?
- What tools can troubled states bring to bear to prevent problems in the future, and what can they do to ameliorate the problems of today?

Pension Funding Levels: The State of Play

Generally, the money to pay for pensions comes from three sources: employees' contributions; employer contributions, and investment returns. Employee contributions, which are required in the vast majority of states, must be paid annually. But in many states, governments—the employers—are able to put off some of their own required payments. These payments include the cost of benefits earned by their employees in any given year, as well as contributions that will help make up for past underfunding and lead to full funding of the plan over the amortization period (typically 30 years). If the government's contribution falls short, the costs for services rendered in that year will be shifted to future taxpayers and the state also will forego the advantage of investment returns on those dollars.

Exhibit 2-1 shows how well, or how poorly, the 50 states are doing at funding their long-term pension obligations, and shows the great variation in the level of funding of states' pension plans. These aggregate figures, which include all pension plans that states listed in their latest comprehensive annual financial reports, give a snapshot of funding status as of June 30, 2006.

According to PCS research, the average funding level in 2006 was 82 percent, a drop from the high point in 2000 when the mean ratio of pension assets to pension liabilities was 97 percent.

Note that the 82 percent average is lower than the 84 percent average funding level reflected in the 2006 Public Fund Survey data compiled by the National Association of State Retirement Administrators. That survey includes the largest public retirement systems in the United States, focusing chiefly on systems for general employees, public school teachers and public safety personnel. PCS's report includes all pension funds covered in the state comprehensive annual financial reports. Teacher and state employee funds dominate in numbers, but the reports also include plans for elected officials and judicial, public safety, corrections and university employees, and, in some cases, municipal plans operated by the state.

What Drives Differences in Funding Levels?

Our analysis shows that states have considerable control in either moderating the bad times through effective planning or diminishing the good times through poor decision-making. The 1990s were a time of growth for pension plans as a healthy economy and a booming stock market enabled swift rises in pension funding levels. In 2000, half of the states were fully funded. But in that year, dot.com problems were already having a negative impact. The 9/11 attack and continuing stock market drop in 2002 devastated the asset levels of many pension plans. Between 2000 and 2002, the average

A Word about Pension Funding Levels

The data in Exhibit 2-1 and Appendix Exhibits A-1 and A-2 are derived from the work of actuaries, who develop a variety of assumptions[34] tailored to the particular situation of individual states. Tiny variations in these assumptions cascade like numerical snowballs into dramatic differences between states. For example, New Hampshire calculated its actuarial accrued liability assuming it would receive a return of 9 percent on the funds it had invested—higher than any other state. If it used the same 7.5 percent assumption used by West Virginia, its unfunded liability would rise considerably.[35]

An important caveat to these exhibits: A major difference among states is the way they smooth out the impact of market changes over time. Currently, only a handful of states, including Idaho, Illinois, Oregon and West Virginia, use a fair market value approach for valuing their largest funds. Because they are looking at the current value, these states respond more dramatically to year-to-year shifts, but their numbers do not retain the impact of bad or good years over time. Otherwise, smoothing periods generally range from four years (for example, in Colorado, Louisiana and Ohio) to as many as 15 years in California. Not surprisingly, states with shorter smoothing periods will currently appear to have better funding levels than those with longer periods, because the down years in the early part of the decade are no longer reflected in their averages. Funding in Louisiana and Colorado has been on an upward trend since 2005, and Ohio started to show upward motion in 2006.

In addition, a few states use the "aggregate cost method" of accounting, which does not provide an unfunded liability amount. Washington and New Hampshire supplied notes in their annual reports that allowed researchers to derive this ratio. New York did not supply notes, but provided its internal calculations to PCS. A new standard from the Governmental Accounting Standards Board, GASB 50, stipulates that states provide unfunded liability calculations by using one of the five permissible actuarial cost methods other than aggregate cost.

A final concept to mention is the treatment of summary statistics. In calculating average funding rates for states in this report, we have simply taken all the state funding levels and taken the mean. However, one can also look at national funding levels by adding up the assets of all 50 states and dividing them by the liabilities of all 50 states. That number also reflects an aggregate picture of pension funding levels. Using this method generates substantially higher aggregate funding levels than simply averaging state funding levels, because the larger states have better funded pension plans than the smaller states.

pension funding level dropped from 97 percent to 89 percent, resulting in an increase of unfunded liabilities of $166 billion. Furthermore, due to smoothing, many states were still feeling the effect of those bleak years up through 2006.

In general, states that are poorly funded have done a combination of three things over time: failed to annually pay their own actuarially required contribution; increased benefits, or made overly optimistic actuarial predictions. States with large underfunded pension plans will be forced to eventually meet those obligations, which will require increases in taxes or reductions in other spending. Thus, the states with unfunded liabilities are the ones that will face increased financial stress in the future to pay for obligations incurred in the past.

Over the long term, states control whether their pension plans will be appropriately funded. But decision-makers may have to grapple with tough choices that stem from previous policy decisions. In general, this is not necessarily an issue of pensions being too generous. States offer pensions and other benefits in part to attract and retain skilled workers despite the lower salaries offered in the public sector.[36] The important consideration is that when states, for whatever reason, decide to incur an expense like employee benefits, they also should have a plan for how to pay for that expense. This is what some states have failed to do.

States have considerable control in either moderating the bad times through effective planning or diminishing the good times through poor decision-making.

A Two-State Comparison

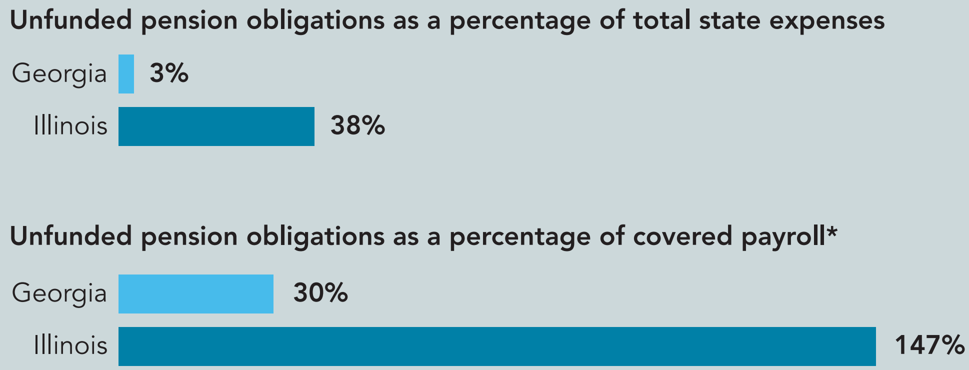
Comparing states is always a tricky business. The details of how pension benefits and costs are calculated vary tremendously. Averages can be misleading, and a huge number of factors, such as the underlying financial assumptions, have an impact on the costs of the system and the benefits received.

But putting aside the kinds of calculations that leave even experts scratching their heads, a very simple comparison of two states, Illinois and Georgia, is illustrative.[37] These two large states—ranked fifth and tenth in total population, respectively—have relatively similarly sized state employee plans but have taken very different approaches to funding their pensions. As a result, in 2006 Georgia's pension fund was 96 percent funded, while the Illinois system was 60 percent funded.

Georgia's unfunded pension obligation, or UAAL, during the next 30 years is 30 percent of covered payroll, whereas the unfunded pension bill for the Illinois plan is 147 percent (Exhibit 2-2). The unfunded liability is 38 percent of 2006 total operating expenditures in Illinois and just 3 percent of total expenses in Georgia. The annual required contribution is 10 percent of payroll for both Illinois and Georgia; however, while Georgia was able to pay the contribution in full, Illinois paid only 33 percent of its required contribution in 2006.

2-2 GEORGIA AND ILLINOIS: COMPARING PENSION APPROACHES

While Georgia is fully funding its pension contributions, Illinois is failing to meet its obligations, leading to a big difference in the health of the two pension systems.



NOTE: Covered payroll includes all employees participating in the state's pension plan.
SOURCE: Pew Center on the States

The problems with the Illinois pension system do not stem from unusual generosity to average employees. In fact, Illinois asks most employees to contribute 4 percent of their salary,[38] while Georgia's employee contribution is 1.25 percent.[39] The average pension in Illinois state government is on the low end compared with other states, according to an analysis by the Illinois Comptroller's office last winter. According to these figures, given a final salary of $45,000 in each place and 30 years of service, the Georgia pension would pay out $28,938 per year and the Illinois pension would be $22,545 annually.[40]

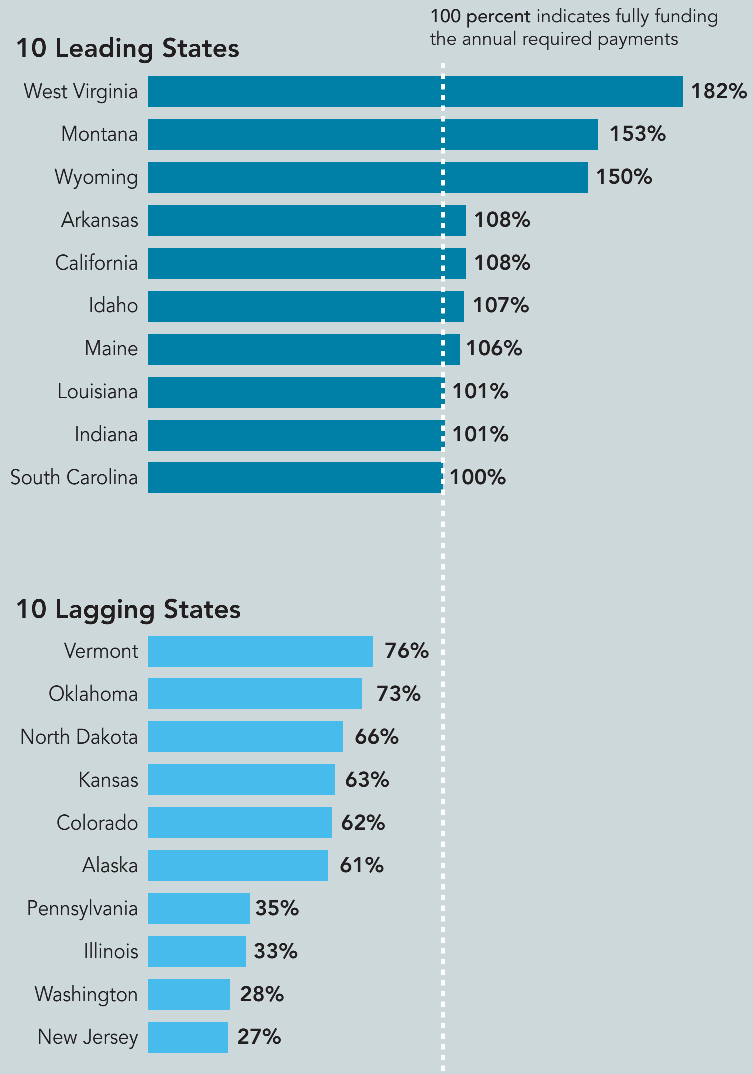
According to a 2007 study by the Illinois Center for Tax and Budget Accountability, "The data make it clear that the state's unfunded pension liability accrued to date was not caused by overly generous benefits, high head counts, excessive costs or even poor investment returns. Instead, the real culprit has been and continues to be the repeated failure of the state to make its full annual employer contribution to the system."[41]

Sound Principles and Promising Practices

Key to achieving a fully funded pension plan is a commitment to pay the actuarial required contributions (ARC) in full each year. The annual pension cost, which is calculated every year, is the amount of funding needed to pay for new liabilities accrued in that year as well as to pay off a portion of the unfunded liabilities accrued in previous years. States that are able to pay the full ARC each year will experience a gradual reduction in unfunded liabilities until they are fully funded, provided that assumptions are accurate over the long term and calculations take into account any additional benefits that have been granted.

Recently, the split between states meeting their funding requirements and those failing to do so is about 50-50. Exhibit 2-3 shows 10 leading states that have more than fully funded their annual pension costs in 2006 and 10 states that failed to contribute what actuaries said they should. This annual pension cost is generated using one of the GASB-approved actuarial funding methods and is designed to distribute costs for worker benefits over the course of the workers' employment.

2-3 PAYING THE ANNUAL PENSION BILL, 2006 – 10 LEADING STATES, 10 LAGGING STATES



SOURCE: Pew Center on the States; Based on States' 2006 Comprehensive Annual Financial Report Data.

A single year of adequate funding, however, does not add up to a properly maintained pension plan.[42]

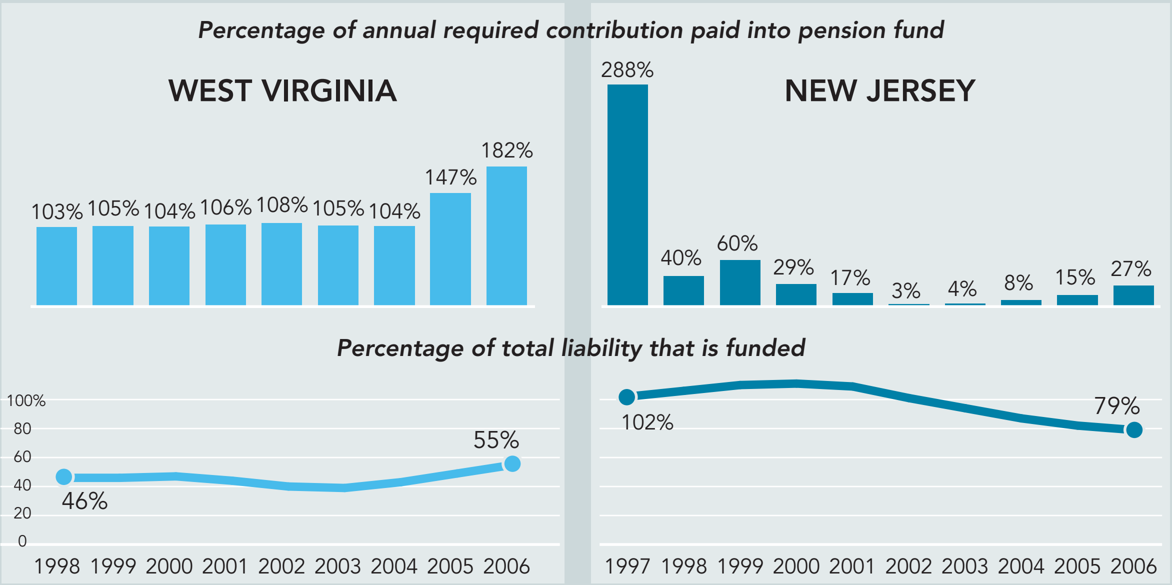
States such as Alabama, Arkansas and North Carolina, which fully fund each year, seem to have established an ethos that mandates this fiscally sensible practice. Others, such as Virginia, Kansas and Massachusetts, have more erratic records.

However, states that fund their required contributions at 100 percent each year—beginning as far back as 1997—could still have a dramatic unfunded liability today. Unfortunately, short-changing plans in decades past can have ripple effects many years later. In addition, if actuarial assumptions missed the mark, even a 100 percent contribution may fail to move the state toward a fully funded position.

Nonetheless, a commitment to pay the ARC year after year is good practice, and it can substantially improve the position of even a poorly funded state like West Virginia. As Exhibit 2-4 demonstrates, West Virginia's performance in paying the annual pension cost over the past decade has improved vastly, and it is starting to pay dividends in addressing the state's unfunded liability. In a short time, from 2003 (its low point) to 2006, the state shrank its unfunded liability by 17 percent and $1.1 billion.

2-4 PAYING THE BILL ... OR FALLING BEHIND

West Virginia's pension fund is improving thanks to diligence in making its required annual payments, while years of not paying enough has diminished New Jersey's pension system funding level.



NOTE: 1997 data unavailable for West Virginia.

SOURCE: Pew Center on the States; Based on States' Comprehensive Annual Financial Report Data

Other states, however, have proven unable or unwilling to raise the necessary funds to pay an actuarially sound amount into their pension fund. In New Jersey, for example, leaders skipped some required pension contributions that resulted in an $8 billion shortfall between 1998 and 2003.[43] The low point came in 2002 when the state contributed $16 million out of the $560 million actuarially recommended amount, resulting in only 3 percent of the ARC being put into the pension fund. New Jersey's funded ratio stands at 79 percent in 2006 after being fully funded only four years before. New Jersey is an extreme example but, as Exhibit 2-4 shows, it is highly illustrative of how critical consistent contributions can be to a state's pension system.

Decisions to skimp on annual contributions have taken a dramatic toll on pension funding levels in other states as well. A few examples:

- ILLINOIS. The decision to cut pension contributions sharply in 1982 and 1983, followed by only moderate increases through 1995, are cited by the Illinois Comptroller as the root of the state's pension problems.[44] Although the state recently passed several long-term reforms to its pension system, the pattern of underfunding actuarially required contributions has not abated. The state used $2 billion from a 2003 pension bond offering to make payments in fiscal years 2003 and 2004 and cut pension payments by $2.3 billion in fiscal years 2006 and 2007, according to the Civic Federation of Chicago. The rationale was that savings to the pension system from the bond sale and funding reforms adopted by the legislature made those payment cuts possible, but longtime observers of the state's troubled pension system were dismayed. "These partial pension holidays are short-sighted and ill-considered," said Civic Federation Vice President Lise Valentine. "You have to examine the pension holidays in the context of the overall budget, where we see expansions of other state programs and discretionary spending at the same time that pension contributions are cut. This demonstrates an unwillingness to fully fund the pension obligations and to pay for the true cost of employee benefits."

- HAWAII. Hawaii's budget director told Pew's Government Performance Project in 2000 that the state, facing enormous budget pressures, had failed to make pension contributions of $44.1 million in 1999 and $155.8 million in 2000. Data from the state's comprehensive annual financial reports show that pension contributions stood at about 83 percent of what actuaries required in 1999. In 2000, actual contributions met only 13 percent of the required amount. The following year, the state held back even further, contributing only about 5 percent. Since that time, Hawaii has solidly funded its pensions. But the three-year hiatus from full funding, coupled with investment losses, took a severe toll on the funding status of the

"These partial pension holidays are short-sighted and ill-considered."

— Civic Federation Vice President Lise Valentine

state employee plan, which dropped from its high of about 94 percent funded in 2000 to 65 percent funded at the close of 2006.

- KENTUCKY. Kentucky also had one of the most dramatic descents in funding levels, from about 111 percent funded in 2000 to about 70 percent funded in 2006. Employer contribution rates for both the Kentucky Employees Retirement System and the State Police Retirement System have fallen short in nine of the past 15 years. According to the Legislative Research Commission, the pattern of reduced contributions continued for the past six straight years, including fiscal year 2007, resulting in "more than $744 million in lost contributions and investment opportunities."[45]

Additional Strategies for Ensuring Sound Pension Plans

Fully funding pension contributions each year requires a great deal of political fortitude and the kind of long-term thinking that is hard to come by, particularly in difficult economic times.

The good news is that there are additional measures states can take to have an impact on their long-term pension liabilities. These measures include:

PLUGGING THE LEAKS: Auditor reports are full of examples of loopholes within pension systems that allow individuals to inflate the amounts they collect after retirement. But states can close the loopholes and stem possible abuses.

EVALUATING THE FISCAL IMPACT OF BENEFIT CHANGES: Even tiny changes in benefits can result in very large long-term liabilities. Some states have started to require that a careful actuarial assessment of long-term costs accompany any proposed pension benefit increase.

CONSIDERING HYBRID PLANS: Despite legislative initiatives in some states to convert state pension plans to defined contribution systems (in which recipients are promised only that a set amount of cash will be put aside for them each year), the defined benefit plan format (in which recipients are promised a specified package upon retirement) remains the dominant and most popular form. Most professionals expect that defined benefit plans will remain the core retirement benefit for many years to come, in most states. But some states have begun experimenting with hybrid plans, which are a mix of defined benefit and contribution plans.

REQUIRING FASTER, MORE ACCURATE FINANCIAL REPORTING: Pension systems are extremely complex and difficult to compare due to the wide variety of choices that actuaries make when determining asset value, calculating actuarial liability, and setting funding and recommended contribution levels. Faster, clearer financial reporting among plans could improve the accuracy of actuarial projections and would provide policy makers and other state officials with the most current data to inform their decisions.

IMPROVING PENSION OVERSIGHT: Although the states have resisted suggestions that the federal government step in to provide more accountability for state and local pension plans, many are starting to improve governance practices and provide greater oversight of their own plans. Commissions that pay attention to pension funding levels, benefits and practices can promote sustained, consistent attention on an issue that tends to float in and out of public awareness with changes in the economy.

Plugging the Leaks

States can pull back on the amount of money that goes out in pension benefits without attacking the general principles of a defined benefit plan or the pension benefits on which the average employee relies. Here are a handful of issues to target, drawn from a PCS review of recent reports from auditors, legislative task forces, independent government watchdog groups, universities, pension systems and special commissions in the 50 states. The examples are representative of problems that have surfaced in multiple states.

FINAL-SALARY INFLATION. In general, the way pension benefits are calculated requires that "final salary" be multiplied by a preset formula based on the number of years employed. In several states and local governments, this practice has resulted in employees hiking up their salaries during the last years of their employment by any method allowed.

This is a particular problem in states such as Kentucky, where overtime pay is allowed to be included in the calculation,[46] and in New Hampshire, where accrued sick leave and vacation time can be used to increase final income.[47]

The fewer the number of years used to determine final salary, the greater the possibility that the figure can be manipulated. For this reason, several states have moved—or are trying to move—from a three-year average to a five-year average. Kansas and North Dakota passed legislation to change to five-year averaging in 2007,[48] and a change in Kentucky is scheduled to go into effect in 2009.[49] New Hampshire considered some reforms to its system in 2007, including changing from a three-year to a five-year average and preventing the use of accrued sick leave and vacation time in salary calculations, but the reforms did not pass.[50]

A related problem occurs when employees change jobs in the last years of their career so that the pension determination is based on a salary that is far from typical of their career. For example, in Iowa, former legislators often move into executive branch positions with salaries that pay two to three times the amount they received as a part-time legislator. "This is a bipartisan ploy that has played out regardless of the party in control of the executive branch for at least the last 20 years," said Randy Bauer, former Iowa budget director.

INFLATING YEARS OF SERVICE. Since the number of years worked is generally part of the formula for determining a pension, another ploy for increasing the payout is to bulk up the number of years counted toward retirement. Until 2007, New Jersey made this easy for employees and elected and appointed officials by allowing pension credit for any year in which a minimum of $1,500 was earned.[51] This allowed people to relatively easily add extra years of service to their pension calculation. In 2006, the New Jersey legislature considered but did not pass a change in the law to increase the threshold to $5,000.[52] In May 2007, Governor Jon Corzine signed a law that abolished the practice for elected and

appointed officials.[53] This was one of 41 recommendations by the Joint Legislative Committee on Public Employees Benefits Reform.[54] Prior to this change, individuals had remained active in the state's pension system by earning minimal amounts, sometimes at "no show" jobs.[55]

Sometimes states allow workers to count time served in jobs outside of state government toward the determination of their pension, contributing a percentage of salary as they would on a state job. As long as the rate of payment is appropriate, this may cause little difficulty. But sometimes it's not. In Massachusetts, for example, an employee can add years of service spent in a volunteer job—for example, serving as an unpaid town alderman—to add to his pension benefits. Because volunteer jobs do not pay a salary, the state has set a proxy rate of $2,500 as a base for employee contributions. In these cases, the employee would need to contribute 7 percent of $2,500—$175—for each year of service added. According to a study by Ken Ardon at the Pioneer Institute for Public Policy Research, that payment is a pretty good deal, because it buys about $1,000 in additional lifetime pension benefits for each year purchased.[56]

EARLY RETIREMENT PROGRAMS. Often, early retirement programs allow individuals to retire before the normal retirement age by buying service credits for additional "years." So, for example, if the government has a rule of 80—meaning that a person's age and years of service must add up to that number to qualify for full retirement benefits—a prospective retiree who is 55 and has worked 20 years could buy five additional years to qualify for full benefits immediately.

This practice can work fine if the price of the additional years of service is calculated with careful attention to actuarial needs. But often, in the zeal to cut the workforce through an early retirement program, the details are not well thought out.

That is what happened in the late 1990s and the early 2000s in Colorado. According to information provided to Pew's Government Performance Project (GPP), practices in the late 1990s allowed employees to buy five to 20 years of service at "fire sale prices."[57] Although the program certainly cut the workforce, it added significant costs to the pension system and contributed to the dramatic drop in funding levels from about 105 percent funding in 2000 to about 73 percent funding at the end of fiscal year 2005. "It was not an actuarially sound price," one Colorado finance official told the GPP in 2005. "People got a bargain, and everyone knew they were getting a bargain and that's why everyone was flocking over there to purchase extra years."

States have embarked on far fewer early retirement programs recently, compared with the early part of the decade, according to the Public Fund Survey, *Summary of Findings for FY2006*. As longevity increases and the gap between public and private retirement ages widens, they are looking for ways to add years to the normal retirement age as well. Often changes are targeted just at new employees to avoid legal challenges that may result from shifting the rules on current workers. In Colorado, a rule of 80 was changed to a rule of 85 for anyone joining the workforce after January 1, 2007. In North Dakota, a similar change moved the teachers' plan from a rule of 85 to a rule of 90.[58] In California, an initiative that was filed this year to control pension costs would require the state to conform to the U.S. Social Security age for new civilian employees and age 55 for law enforcement.[59]

ELIGIBILITY FOR ENHANCED RETIREMENT BENEFITS. Some jobs have physical requirements that make it sensible to offer retirement at a younger age. State police and corrections workers often qualify for enhanced benefits due to the difficulty and danger of their jobs. The problem in many states is that over time there tends to be an expansion in the number of people covered in these special plans. In California, for example, a third of the workforce receives public safety pensions compared with one in 20 in the 1960s, according to a Deloitte Research Study published in 2006.[60]

In Illinois, Governor Rod Blagojevich told *Business Week* that one in three state employees receive "hazard rate" pension benefits that were originally intended for state police.[61] It is a matter of states' own public policy to determine which jobs should qualify for these enhanced benefits. The important thing is for policy makers to recognize the financial costs associated with these expansions. In Massachusetts, a blue ribbon panel on the state's public employees' pension classification systems noted that the pension benefits available for "hazardous" jobs had been extended to district attorneys and supervisors at MassPort, a public authority that manages transportation infrastructure in the state.[62]

In its two-year session that concluded in 2006, the Pennsylvania legislature gave "enforcement officer" status to game commission officers, which would have allowed retirement at age 50 instead of 60. This was one of 130 retirement-related bills introduced during this period, many asking for benefit expansions. Governor Edward Rendell vetoed the bill.[63]

POWER WITHOUT ACCOUNTABILITY. When there is a disconnect between those who have the power to increase pension benefits and those who have the responsibility of funding those increases, fiscal responsibility can get lost. Illinois, for example, took note of this problem in 2006 when its legislature capped end-of-career salary hikes at 6 percent for teachers, school administrators and university personnel. Prior to this, there was a fear that school districts and universities "may have been inflating payments to employees in their last years of employment," because the pension costs were carried by the state budget and not their own budgets, according to the Illinois Comptroller.[64]

The new law requires school districts that grant raises of more than 6 percent to fund pension benefit costs associated with those raises. The law also requires employers who grant sick leave "in excess of the member's normal annual sick leave allotment" to fund related pension benefit increases.[65]

Evaluating the Fiscal Impact of Benefit Changes

It is far easier to increase benefits than to take them away. That is why legislatures need to carefully consider the long-term impact of any proposed increases. But when state coffers are full and the benefits appear to have little immediate cost to the state, increases can be difficult to resist. In addition, in states where salaries and benefits are the subject of labor negotiations, retirement benefits, which make workers happy but require fewer current dollars, are offered in place of bigger salary increases.

Although states generally require that fiscal impact statements accompany legislation that is expected to have a financial effect, this is not always done rigorously and benefit increases can sneak through without adequate attention. "Municipal governments and pension fund managers have long complained that legislative pension proposals often feature inadequate or even inaccurate forecasts," according to E.J. McMahon, senior fellow at the Center for Civic Innovation at the Manhattan Institute. In a fiscal memo, he cites a number of examples of benefit increases in New York that have been justified in the legislature based on severely outdated information. For example, a reduction in the

Remember: Promises Come With a Price

Good times may be the most hazardous for pension plans. This is a particularly important point, because many pension plans are likely to show an increase in funding levels in 2007. State investment returns have been very good in the past few years and the majority of states use five-year smoothing periods, which will no longer factor in the bleak investment returns of 2002.

Some pension observers worry that the upturn in funding levels may lead legislators to focus only on the most recent figures and ignore the inevitable pendulum swings of any stock market-related investments. "Good times are dangerous if you raise benefits, because you're adding another commitment that will increase the burden when interest rates fall and your liabilities surge," said Alicia Munnell, director of the Center for Retirement Research at Boston College.[68]

This is particularly true because a pension benefit, once given, is very difficult to take away. The majority of states have some form of constitutional protection for their pensions, according to a September 2007 report by the U.S. Government Accountability Office (GAO).[69] And although state interpretations of constitutions may vary, courts generally have held that pensions belong to employees and benefits cannot be withdrawn or altered in a way that is detrimental or contrary to past agreements.

number of years—from 30 to 25—required to receive benefits passed the legislature in 2005. But the "justification" section of the support memo provided outdated stock market data from the year 2000.[66]

To help ensure that adequate attention is given to long-term consequences of decisions about pension benefits, Oklahoma passed the Actuarial Analysis Act in 2006. Modeled on a similar law in Georgia, the act requires that specific review and oversight actions accompany any legislation that could have a long-term impact on the retirement system. For example, bills with a fiscal impact can only be introduced in the first year of a two-year session and can only be approved in the second year—to make sure that there is no rush to action. If a bill will have an impact on costs, it has to be accompanied by an increase in employer contributions or another appropriation to fully fund the benefits.[67]

Georgia's legislation has been in effect about eight years. It requires the legislature's retirement committee to send for an actuarial study whenever any change to the benefit structure is suggested. Here, too, the requirement for additional study results in a year "cooling off period" between the introduction of a bill and any vote that's taken. "It's had a very salutary effect on us," said Tom Hills, the chief financial officer in Georgia. "If someone says, 'Let's triple the retirement benefit for any state employee who served in Iraq,' you might do that in the emotion of the moment. This allows you to drop back and study it."

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— Tom Hills, chief financial officer of Georgia

Considering Hybrid Plans

In the past 10 years, two states have shifted to defined contribution plans for new employees. In Michigan and Alaska, employees who started work after 1997 and 2006, respectively, are no longer promised a set benefit when they retire. Instead, they have savings plans to which they make annual contributions, which are supplemented by contributions from the state government.

Leaders in other states including California, South Carolina, Massachusetts, Illinois and Virginia have tried to make a similar switch, but have been unsuccessful to date.[70] The controversy surrounding defined contribution plans should not be much of a surprise. Nebraska, for example, moved to a defined contribution plan in 1964. But between 1983 and 1999, state and county workers averaged a 6 percent return on their individual accounts, compared with an 11 percent return for teachers and judges who had a defined benefit plan.[71] Testifying before the House Committee on Pensions and Investments in 2000, Anne Sullivan, director of the Nebraska Public

Employees Retirement System, said, "We have had over 35 years to 'test' this experiment and find generally that our defined contribution plan members retire with lower benefits than their defined benefit plan counterparts."[72]

Employees' preference for defined benefits can also be seen in the states that have offered a primary defined contribution plan as an alternative to a defined benefit plan. (These include Colorado, Florida, Montana, North Dakota, Ohio and South Carolina.) In those states, employees still overwhelmingly pick the defined benefit plan, according to a recent study of state experience by Mark C. Olleman, a consulting actuary and principal at Milliman, Inc.[73]

There are several key differences between defined benefit and defined contribution plans. Some states have found that their annual costs for their defined benefit plans have become burdensome due to past funding decisions, increased longevity among state employees, and in some cases the capacity of both state employees and employers to abuse the system. Cost containment/control is a major benefit of defined contribution plans. The other key difference between the two types of pension systems is risk. In a defined benefit plan the financial risk is borne by the state, while in a defined contribution plan the employee bears the risk. This is of special concern for state employees who are not part of the Social Security system and thus do not have that safety net. As states consider utilizing defined contribution plans, they will need to ensure that adequate funds are available to support retirees either by providing annuities through defined contribution plans or simply heavily encouraging adequate employee contribution rates.

Potentially more promising are hybrid plans, which incorporate parts of both types of plans. At least five states offer hybrid plans, according to the Kentucky Legislative Research Commission.[74] In Ohio and Washington, for example, employees have the option of signing up for a combined plan in which employer contributions fund a lower but guaranteed retirement benefit, while employee contributions are invested separately in a defined contribution plan. Oregon officials estimate that a new hybrid program adopted by the state in 2003 contributed to more than $400 million in pension reform savings.

Washington has further improved individual investment returns on the employee side by giving employees the option of investing in a portfolio that mirrors the investments of the state's defined benefit plan. About 70 percent of defined contribution assets are now invested in this way, according to Olleman.[75]

In 2003, moved at least in part by the evidence cited above, Nebraska offered state employees another choice instead of a defined contribution plan. The so-called "cash balance plan" is a hybrid of a defined benefit plan, in which employees and the state both make annual contributions, according to Phyllis Chambers, director of the Nebraska Public Employees Retirement System. Employees are guaranteed a 5 percent annual rate of return, although successful investments may push the rate even higher.[76]

"We think this plan is working well," Chambers said. "Since 2003, the returns have been good and we have been giving a dividend to employees above the credited rate. For those employees that do not want the volatility of a defined contribution plan, the cash balance is a good option because they know that there will be a minimum return of 5 percent. Also, they don't have to worry about what to invest in because it is done for them."

Requiring Faster, More Accurate Financial Reporting

Corporations must disclose timely information about their pension plans to investors and file information with the Securities and Exchange Commission. There are no similar requirements for public pensions. Although many of them do an excellent job of reporting to members and the public, a number of states have significantly late annual financial reports.

In March of each year, Wilshire Associates, an investment consulting and management firm, reports on pension funding status of the largest public pension plans. One of the issues it perennially faces is the delay of financial reports. In March 2007, for instance, 17 out of 125 state pension funds examined had a financial report issued prior to June 30, 2005. Another 61 reports were released prior to June 30, 2006.[77]

Timely financial reporting has obvious benefits in delivering important information to policy makers, managers and citizens. It also may be a sign that other aspects of a system are running effectively. An analysis of a database of public pension plans from 1990 to 2000, at Wharton's Pension Research Council, revealed pension systems with stellar financial reporting practices also had annual investment returns that were 2.1 percent higher than funds with lesser financial reporting practices.[78]

The issue of timeliness also applies to actuarial valuations, which are now required every two years (compared with an annual requirement in the private sector). Jim Rizzo, an actuary with Gabriel Roeder Smith, said many states opt to do actuarial valuations more frequently, but they don't have to. "The numbers you put in a comprehensive annual financial report could be so old and stale that they're not useful to the reader," Rizzo said. "If the year ends September 30, 2007, then that year began on October 1, 2006, and you could be using an actuarial valuation for the year that began in 2004. By the time the Comprehensive Annual Financial Report gets published, it could be three years since the valuation."

The Governmental Accounting Standards Board (GASB) continues to look into ways that accounting and financial reporting for retirement benefits could be improved. In 2007, GASB issued a standard that will provide improved transparency for state and local government pension activities. Among the changes is a requirement for those plans that use the aggregate method in determining actuarial funding requirements to provide funding status information using another method.[79]

Section 2: Pensions

In addition, GASB is conducting a research project that will assess the effectiveness of current pension standards in meeting financial statement user needs. Issues that will be addressed include the overall approach to calculate annual pension costs and pension liabilities and detailed issues, including the discount rate, amortization methods and amortization periods, and actuarial cost methods.

The initial research phase of the project will be completed by April 2008. After consulting with its advisory committee, GASB is scheduled to decide whether a pension project should be added to the current technical agenda.

Improving Pension Oversight

One concern voiced by critics of government pension systems is that they are not subject to adequate oversight. This worry, expressed by Senators Charles Grassley and Max Baucus, ranking members of the U.S. Senate Finance Committee, led to the launch of a 15-month exploration of state and local retirement benefits by the GAO in July 2006. The GAO recently released a report on this topic and another is due in the coming months.

The senators expressed their concerns in a letter to David Walker, the Comptroller General of the United States, in which they argued that public pensions are held to a lower level of scrutiny than those in the private sector.[80] Most states, watchful of increased federal regulation, have reacted with alarm to the idea that the GAO study might spark more federal oversight. The National Association of State Retirement Administrators and the National Council on Teacher Retirement responded to the senators with a letter that defended the status and security of state and local funds.[81] This was followed with another letter from 28 national organizations emphasizing the soundness of public funds and the importance of recognizing the difference in the public and private sectors.[82] In fact, when the first GAO report was released, it conveyed a generally positive tone about the health of state and local pension systems.

Whatever happens on the federal level, there are abundant signs that increased oversight by the states is coming. This issue is explored in depth in the October 2007 *Governing* magazine article, "Who's Minding the $3 Trillion Store," which was researched under the auspices of PCS in conjunction with this report.[83] The Civic Federation of Chicago has also done valuable work on the subject of pension governance.[84]

Many states have standing legislative committees devoted to pensions and a number of states also have oversight commissions that keep an eye on pension fund operations. According to the National Conference of State Legislatures, these include:

- Indiana - Pension Management Oversight Commission
- Louisiana - Commission on Public Retirement

- Massachusetts - Public Employee Retirement Administration Commission
- New Jersey - Pension and Health Benefits Review Commission
- Ohio - Retirement Study Council
- Oklahoma - State Pension Commission
- Pennsylvania - Public Employee Retirement Study Commission
- Texas - Pension Review Board
- Washington - Office of the State Actuary; Pension Funding Council; Select Committee on Pension Policy

In early 2007, Texas's Attorney General Greg Abbott also stepped into the action, taking a look at the state's 96 state and local pensions.

Abbott's concerns largely centered on pension governance. He noted that a number of local pension funds were using amortization periods longer than stipulated by GASB,[85] and in a June 2007 speech to the Pension Review Board, he complained of unbalanced board membership, a lack of transparency in financial reporting and poor decisions in setting actuarial assumptions.[86] Abbott said he was particularly concerned about the possibility of conflicts of interest after discovering situations in which investment managers had hired board members after these firms had contracted with the retirement boards on which they sat. "They develop a chummy relationship," he said. "These job offers can be seen as a reward or inducement to shift the board member's allegiance to that particular investment manager."

Abbott says he hopes other attorneys general will also start to look at this issue, working on compliance with the law, while legislatures and boards of trustees focus on reforms needed to improve pension governance systems.

Conclusion

The strategies discussed in this section can help states reduce government pension costs and improve current pension management and future decision-making. However, these strategies will not eliminate the fundamental issue—that some states have liabilities they have not adequately funded. For the states that have fallen behind, there is no easy fix. Achieving an improved position requires the political will and discipline necessary to begin funding their pension plans at actuarially adequate levels. Even states that are currently in a good position in terms of pension funding should heed the lessons in this report to help avoid the poor decision-making that led to the problems other states now face. When states delay action, the problem grows exponentially and the costs of a solution grow right along with it.

Endnotes

24 Kansas established a number of pension reforms in 2007. One new provision requires that employer contributions equal the actuarially required amount (and not be less than employee contributions).

25 See Table A-2 in Appendix A. Information in this report aggregates financial data from all pension funds listed in states' 2006 comprehensive annual financial reports.

26 This PCS conclusion generally tracks with the findings of a September 2007 report by the U.S. Government Accountability Office. See GAO, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate (GAO-07-1156) (September 2007). The GAO report cites the opinion of "public sector experts, union officials and advocates" that 80 percent is a responsible funding ratio for pension systems. There is some disagreement on this point, however. It is useful to regard funding levels as a snapshot and recognize that they are always changing and are also extremely dependent on the health of the economy, and affected by a wide variety of individual practices relating to how they are calculated. A funding level of 80 percent, following a recession, is very different from a funding level of 80 percent following an economic expansion.

27 The actual total of actuarial assets in state pension funds, as calculated by PCS, is $1.992 trillion.

28 Interview with PCS, December 2006.

29 Sujit M. CanagaRetna, "State Retirement Systems: Recent Trends," (presentation at the Fall Southern Legislative Issues Conference, Savannah, Ga., November 12, 2006).

30 There is no guarantee, of course, that a pension that appears to be fully funded will stay that way. Benefit increases are often retroactive and will add to the actuarial accrued liability. Assumptions are also constantly readjusted as actuaries reexamine past projections and experience.

31 Pre-funding also has the benefit of addressing intergenerational equity issues. The idea behind intergenerational equity is that the taxpayers paying for government employee benefits should have been the ones who received services from those employees; however, if states put off funding their obligations, future generations will be on the hook for past and future bills.

32 An important note, Florida's surplus is not amortized as the GASB expects. The Florida legislature essentially ensured that this set aside would remain for longer than the GASB approved 30-year period. This is an extremely cautious approach, but it illustrates that if a state is serious about being fully funded, it can make certain it stays that way.

33 National Conference of State Legislatures, *Pension and Retirement Plan Enactments in 2007 State Legislatures*, by Ronald K. Snell (October, 2007).

34 See glossary in Section 1.

35 There are many other variations that can cause difficulties in comparing states. The Pew Center on the States Web site provides a state-by-state listing showing how assumptions and amortization periods vary. A resources section provides readers an opportunity to call up financial reports of individual states and check out the assumptions themselves. Even within a state, assumptions may vary from plan to plan.

36 There have been conflicting studies on this point. Public and private sector jobs are difficult to compare because many of the categories of employment tend to be different. The most recent compensation survey of public-sector employees, the *AFT Public Employees 2007 Compensation Survey*, reports that most state employees earn less than their private-sector counterparts, though the median increase in average salaries across the 45 jobs surveyed was 5.7 percent, "the highest increase recorded in the last five years."

37 For this illustration, PCS is using the unfunded liabilities and annual required payment figures from only the respective state employee plans for Georgia and Illinois.

38 As with much pension information, there is considerable variation even within one state. Employees of the Illinois State Employees Retirement System (SERS) pay 8 percent if they are not in Social Security and 4 percent if they are in Social Security, unless they get the "Alternative Formula" for higher-risk jobs. Then they pay 9.5 percent or 6 percent according to information provided by the Civic Federation in Chicago. Employee contribution rates are listed in the financial statements of each of five state pension funds in Illinois. There is also a summary in the Illinois Division of Insurance's biennial reports, http://www.idfpr.com/DOI/Pension/Pension.asp.

39 PCS interview with Tom Hills, chief financial officer, State of Georgia, September 2007.

40 Illinois Comptroller's Office, "Illinois Pension Benefits Lower Than Most States," *Fiscal Focus* (January-February 2007).

41 Illinois Retirement Security Initiative, Center for Tax and Budget Accountability, *The Illinois Public Pension Funding Crisis: Is Moving from the Current Defined Benefit System to a Defined Contribution System an Option That Makes Sense?*, by Jourlande Gabriel and Chrissy A. Mancini (Chicago, 2007), 8.

42 See Table A-2 in Appendix A, which goes back 10 years to show the extent to which each state has kept up with the amount its actuaries believe is necessary to maintain or move toward full funding.

43 New Jersey Legislature, Joint Legislative Committee, *Public Employee Benefits Reform; Final Report, 2006 Special Session* (Trenton, December 1, 2006), 37-38. The $8 billion reflects the UAAL, however, the ARC was shorted by only $3.2 billion over that time period.

44 Illinois Comptroller's Office, "Illinois State Pensions Continue to Put Pressure on State Budget," Fiscal Focus (January-February 2007).

45 Legislative Research Commission, *Issues Confronting the 2007 Kentucky General Assembly; An Update of Informational Bulletin No. 218 (2006)*, Informational Bulletin no. 221 (Frankfort, October 2, 2006). In its other pension systems, Kentucky has done a better job of funding the Annual Required Contribution. For example, the full contribution for the teachers' system has been made in each of the last 10 years. This has contributed to a more positive appearance of ARC funding for the state as a whole. See www.pewcenteronthestates.org for state pension tables.

46 Dan Hassert, "The Public Pension Squeeze," *Kentucky Post*, 14 April 2007.

47 "State Workers Needn't Rush into Retirement," *Concord (New Hampshire) Monitor*, 13 May 2007.

48 National Conference of State Legislatures, *Pension and Retirement Plan Enactments in 2007 State Legislatures*, by Ronald Snell (Washington DC, October 2007). The NCSL provides summary information on legislative changes in retirement benefits for the last nine years at http://www.ncsl.org/programs/fiscal/all_pensun.htm.

49 Hassert, "The Public Pension Squeeze."

50 "State Workers Needn't Rush into Retirement," *Concord Monitor*.

51 Charles Stile, "New Law Will Remove Many From Public Pension System," *(New Jersey) Record*, 11 May 2007.

52 Gregory J. Volpe, "Many Staffers Qualified for Pension Credit," *Cherry Hill (New Jersey) Courier Post*, 29 April 2007.

53 Stile, "New Law Will Remove Many From Public Pension System."

54 New Jersey, Joint Committee, *Public Employee Benefits Reform,* Final Report (December 2006). The list of recommendations is on pages 59 to 153. The document, which covers both pensions and other post-employment benefits, is available at http://www.njleg.state.nj.us/PropertyTaxSession/OPI/jcpe_final_report.pdf.

55 Legislation in 2007 removes new elected and appointed officials from the defined benefit system, shifting them to a defined contribution plan. Going forward, it also prevents professional service contractors - like lawyers and engineers - from being part of the defined benefit plan.

56 Ken Ardon, "Public Pensions: Unfair to State Employees, Unfair to Taxpayers," Public Employee Benefits Series: Part 1," *White Paper* no. 30, Pioneer Institute for Public Policy Research, (May 2006): 12.

57 Government Performance Project interview with Miller Hudson, executive director of the Colorado Association of Public Employees, August 2004.

58 *See* NCSL, "Pension and Retirement Plan Enactments," http://www.ncsl.org/programs/fiscal/all_pensun.htm.

59 The initiative was filed in 2007, with supporters aiming for it to appear on the November 2008 ballot. As of September 2007, signature collection had not yet begun.

60 Rick Davenport et al., *Paying for Tomorrow: Practical Strategies for Tackling the Public Pension Crisis*, A Deloitte Research Study, (July 2006): 7.

61 Nanette Byrnes and Christopher Palmeri, "Sinkhole! How Public Pension Promises Are Draining State and City Budgets," Special Report - Public Pensions, *Business Week*, 13 June 2005.

62 Alicia H. Munnell, et. al., *Report of the Blue Ribbon Panel on Massachusetts Public Employees' Pension Classification System*, presented to the senate and house chairs of the Joint Committee on Public Service, (Massachusetts, July 2006), 9.

63 Mark Scolforo, "Sweet Pension Deal Turns Sour," *Pittsburg Post-Gazette*, 17 December 2006, http://www.10000friends.org/downloads/Sweet_Pension_deal_turns_sour_part_1_Pgh_Post_Gazette_121706.pdf.

64 Illinois Comptroller's Office, "Illinois Pensions Continue."

65 Tim Phoenix and Lance Weiss, Deloitte Consulting LLP, "The Impending Pension and Health Plan Crisis and the Impact of an Aging Workforce on Talent Management,"(presentation at the States & Local Government Pension Forum, Chicago, IL, February 28, 2006).

66 E.J. McMahon, "Legislators Still Aim to Sweeten Public Pensions," *Fiscal Watch Memo*, Manhattan Institute for Public Policy Research, (revised 15 July 2005), http://www.nyfiscalwatch.com.

67 David Blatt, "Oklahoma's Pension System; Tomorrow's Problem Requires Attention Today: 'The Oklahoma Pension Legislation Actuarial Analysis Act of 2006: Tying Odysseus to the Mast?'," Issue Brief, Community Action Project (January 2007).

68 In the past, the Center for Retirement Research has generally focused its research on pensions in the private sector, but it recently began a two-year project to establish a database on state and local pension systems and explore funding status and economic impact. This work is funded by a $1.5 million grant from the Center for State and Local Government Excellence.

69 United States Government Accountability Office, *State and Local Government Retiree Benefits.*

70 CanagaRetna, "State Retirement Systems," 5-6.

71 Illinois Retirement Security Initiative, *The Illinois Public Pension Funding Crisis*, 11.

72 House Committee on Pensions and Investments, Texas House of Representatives, *Interim Report 2000: A Report to the House of Representatives 77th Texas Legislature*, (Austin, November 2000), 26.

73 Mark C. Olleman, "Defined Contribution Experience in the Public Sector," *Benefits & Compensation Digest*, International Foundation of Employee Benefit Plans (February 2007).

74 Legislative Research Commission, *Issues Confronting the 2007 Kentucky*, 58.

75 Olleman, "Defined Contribution Experience," 23.

76 PCS interview, October 2007.

77 Julia Bonafede, et al., Wilshire Consulting, *2007 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation*, Wilshire Associates Incorporated,(March 5, 2007), http://www.wilshire.com/BusinessUnits/Consulting/Investment/2007_State_Retirement_Funding_Report.pdf.

78 Tongxuan (Stella) Yang and Olivia S. Mitchell. "Public Pension Governance, Funding, and Performance: A Longitudinal Appraisal," *Pension Fund Governance: A Global Perspective*. Ed. John Evans and John Piggott. Edward Elgar. Forthcoming.

79 The aggregate cost method does not produce a number for the unfunded liability, thus the funded ratio is always 100 percent.

80 United States Senate Committee on Finance, "Grassley, Baucus Seek GAO Review of Public Pension Plans Funding," press release, (July 10, 2006), http://www.senate.gov/~finance/press/Bpress/2005press/prb071006.pdf.

81 Letter to the Hon. Charles E. Grassley, Chairman, and the Hon. Max Baucus, ranking member, United States Senate Committee on Finance, July 14, 2006 http://www.nasra.org/resources/NASRANCTR%20Grassley-Baucus%20Ltr%20RE%20GAO.pdf.

82 Letter to the to the Hon. Charles E. Grassley, Chairman, and the Hon. Max Baucus, ranking member, United States Senate Committee on Finance and the Hon. David M. Walker, Comptroller General of the United States, (August 2, 2006), http://www.nasra.org/resources/Grassley-Baucus%20Joint%20Letter.pdf.

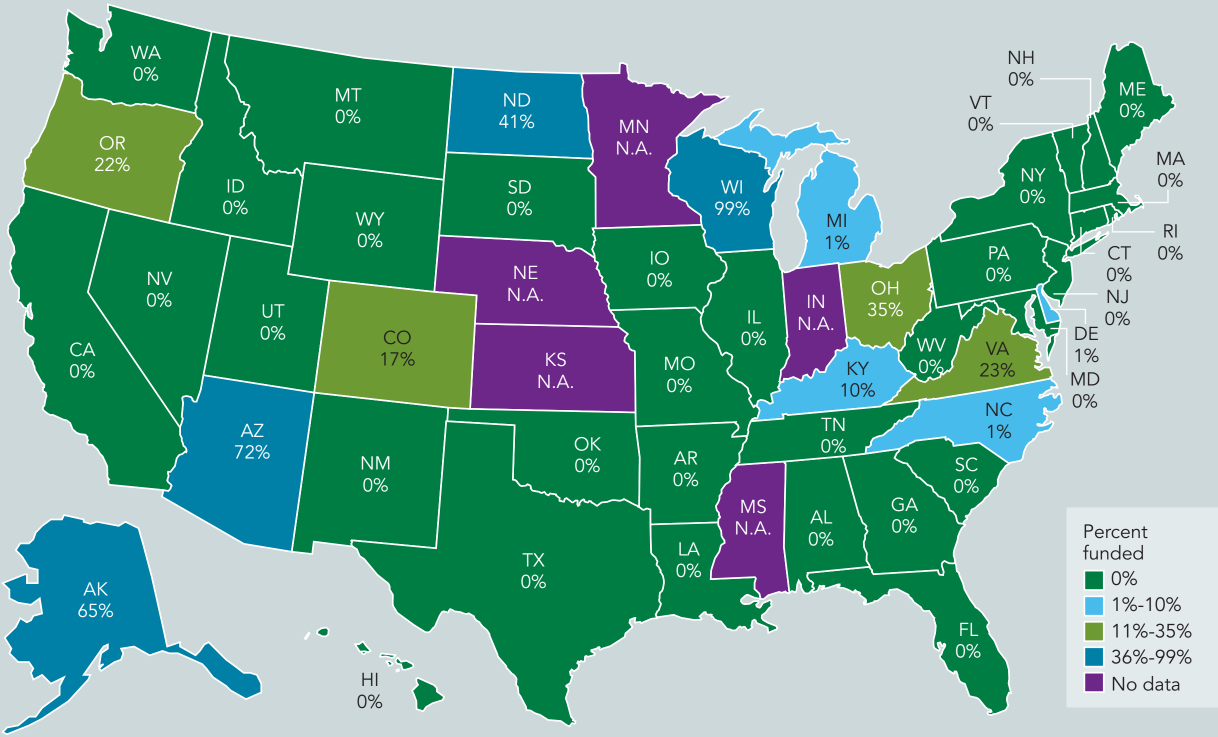
83 Katherine Barrett and Richard Greene, "Who's Minding the $3 Trillion Store," *Governing* Magazine, Washington, D.C.: Congressional Quarterly, Inc., (2007).

84 Civic Federation, "Civic Federation Calls For Public Pension Board Reform" (Chicago, February 13, 2006), http://www.civicfed.org/articles/civicfed_203.pdf.

85 A handful of state pension plans don't meet the Governmental Accounting Standards Boards guideline that amortization periods should be 30 years or less. This is because they have chosen to spread out payments over a longer period and thereby pay less in any given year. States with 40-year amortization periods at the end of 2006 included Illinois, Kansas, Michigan and Oklahoma. Whatever the length of time, the number of years in an amortization period can have a significant impact on the required contribution. For example, in January 2006, the Nebraska Retirement Systems Committee of the legislature quite candidly examined the merits of changing from a 25-year amortization period to a 30-year amortization period as a way of reducing contribution rates for the Nebraska school pension plan. That change alone, it concluded, would reduce the required contribution from $12.8 million to $6.6 million. A full list of amortization periods used by states is available at the PCS Web site.

86 Pamela Yip, "Watch Those Government Pension Plans," *Dallas Morning News*, 2 July 2007.

3-1 STATE OTHER POST-EMPLOYMENT BENEFITS: FUNDING LEVELS, 2006



Figures are in thousands.

State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006
Alabama	$5,290,000	$5,290,000	$344,000	$76,000
Alaska	3,415,000	1,206,000	152,000	97,000
Arizona[1]	421,300	94,800	93,000	93,000
Arkansas	2,130,000	2,130,000	--	185,000
California	47,878,000	47,878,000	3,593,000	1,363,000
Colorado	1,248,000	1,033,000	71,000	21,000
Connecticut	21,681,000	21,681,000	1,597,000	393,000
Delaware	4,435,000	4,410,000	475,000	136,000
Florida	3,628,000	3,628,000	213,000	57,000
Georgia	4,905,000	4,905,000	368,000	173,000
Hawaii	6,791,000	6,791,000	488,000	141,000
Idaho	486,000	486,000	38,000	2,000
Illinois[2,4]	48,000,000	48,000,000	--	578,000
Iowa	220,000	220,000	23,000	20,000
Kentucky	9,019,000	8,090,000	130,000	66,000
Louisiana	7,344,000	7,344,000	967,000	190,000
Maine	2,297,000	2,297,000	177,000	73,000
Maryland	14,543,000	14,543,000	1,114,000	236,000
Massachusetts	13,287,000	13,287,000	1,062,000	354,000
Michigan	8,028,000	7,968,000	631,404	394,000
Missouri	2,186,000	2,186,000	159,000	78,000
Montana	525,000	525,000	51,000	8,000
Nevada	4,100,000	4,100,000	273,000	41,000

State	Actuarial liability	Unfunded liability	Annual required contribution	Actual payments in 2006
New Hampshire	$2,906,000	$2,906,000	$226,000	$45,500
New Jersey	21,587,000	21,587,000	1,881,000	313,000
New Mexico[3]	4,990,000	4,990,000	467,000	83,000
New York	49,663,000	49,663,000	3,810,000	934,000
North Carolina[1]	11,400,000	11,400,000	2,390,000	230,000
North Dakota	83,000	49,000	6,000	6,000
Ohio[1]	10,784,959	6,500,000	1,597,000	1,597,000
Oklahoma	814,000	814,000	87,000	18,000
Oregon[3]	832,000	645,000	75,000	75,000
Pennsylvania	13,778,000	13,501,000	1,125,000	519,000
Rhode Island	696,000	696,000	53,000	18,000
South Carolina	4,252,000	4,252,000	320,000	122,000
South Dakota	127,000	127,000	--	62,000
Tennessee	2,305,000	2,305,000	156,000	64,000
Texas[2,4]	26,817,000	26,817,000	--	411,000
Utah	749,000	749,000	47,000	47,000
Vermont	552,200	552,200	41,000	15,000
Virginia	3,001,500	2,320,000	311,500	150,000
Washington	3,800,000	3,800,000	314,000	68,000
West Virginia[3]	7,761,000	7,761,000	824,000	133,000
Wisconsin	1,823,000	17,000	52,000	52,000
Wyoming	72,000	72,000	6,000	3,000

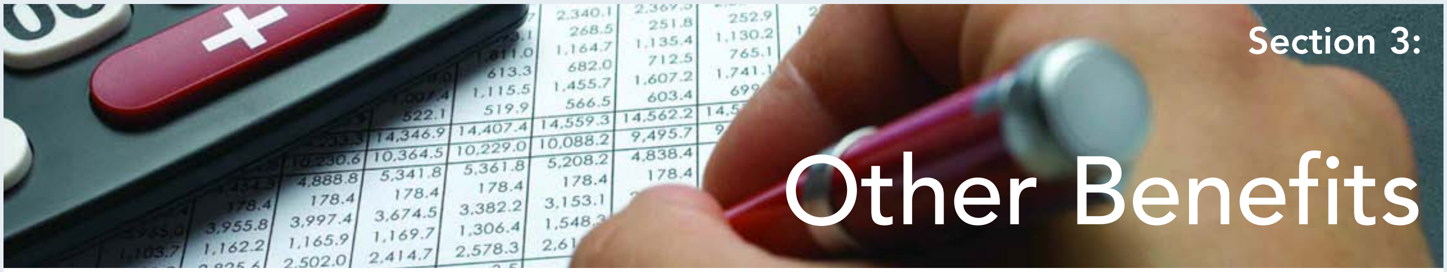
1 States with combined state and local systems where PCS was able to estimate the state actuarial liability and unfunded liability of other post-employment benefits. PCS was unable to isolate the annual required contribution and 2006 actual payments for state employees only, and these numbers reflect the combined state and local system. Combined AAL and UAAL figures, respectively, from the actuarial valuations include: Arizona–$1.5 billion, $420 million; North Carolina–$23.9 billion, $23.7 billion; Ohio–$31.6 billion, $20.5 billion.
2 No actuarial valuation exists at this time.
3 Combined state and local systems where isolating the state component of other benefits may not be possible.
4 Actuarial liability and unfunded liability estimates for Illinois and Texas are from the Civic Committee of the Commercial Club of Chicago and Credit Suisse (2007), respectively.

NOTES: States in bold are moving toward fully funding their non-pension obligations. The actuarial accrued liability and unfunded actuarially accrued liability are based on short-term discount rates, which presume no pre-funding of the obligation. The amounts decrease if the annual required contribution is consistently funded each year.

Actuarial liability is the total value of benefits owed to current and retired employees or dependents based on past years of service.

Annual required contribution is the amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of the amortization period, which is typically 30 years or less.

SOURCE: Pew Center on the States



Section 3:

Other Benefits

Rising Costs and Unfunded Obligations

LAST YEAR, THE STATES PAID ABOUT $9.7 BILLION in retiree benefits other than pensions, according to PCS's study of data collected from comprehensive annual financial reports. Health care is by far the most significant of these other post-employment benefits (OPEB), but they also include dental care, life insurance and other promised benefits that provide economic security to retirees. What is most significant, however, is not the amount states are spending on these benefits today. The real impact on states' fiscal health—and on the public sector employees counting on these benefits—comes from the dramatic and unrelenting growth of the annual costs of OPEB.

For many years, the fiscal challenges and complexity of retirement benefits were barely noticed in many states. But new accounting standards, established in 2004 by GASB, are finally bringing the issue front and center.

States and other large governments (those with annual revenues greater than $100 million) will first report on these liabilities in their fiscal year 2008 financial reports, which will generally come out sometime between December 2008 and March 2009. But actuaries for most states have already completed preliminary assessments of the bill that will come due for retirement benefits during the next 30 years. Armed with these and other documents gathered from a number of state governments, PCS has developed a complete and up-to-date compilation of states' long-term liabilities for those benefits.[87] These numbers are likely to be refined over the coming year—but they are reasonably accurate and the best available figures at this time.

According to PCS data, the total actuarial accrued liability for state employees' retiree health care and other post-employment benefits is about $381 billion.[88] About 97 percent—$370 billion—of the obligations for state employees over an amortization period that usually runs about 30 years was unfunded at the end of fiscal year 2006 (see Exhibit 3-1). The $381 billion figure is a conservative number that does not reflect the full extent of the long-term cost, as some states face large bills for teachers as well. Cities, counties and school districts also are totaling up their own liabilities and will continue to do so over the next several years. (Credit Suisse, which published a report on OPEB liabilities last March, estimated the total liability for states and local governments at about $1.5 trillion.[89])

"The evolution in states dealing with post-retirement health care costs is calculation, surprise and shock."

— Keith Brainard, director of research for the National Association of State Retirement Administrators

In an ideal world, states would fund retiree health care and other non-pension benefits as they're earned, as they generally do with pensions. This would reduce intergenerational inequity and would also lessen the total amount owed. (This is because a state that puts money aside for the future in a qualified irrevocable trust can earn higher interest rates over time.) But because states generally have not pre-funded retiree health and other non-pension benefits, there's a lot of catching up to do. Moving to full funding is a daunting task, because the annual required contribution is, on average, about three times what states currently pay each year to meet costs for current retirees.

So what are states doing to address current and future obligations to their employees as they try to balance competing pressures to build a strong workforce and control spending? Some are embarking on the pre-funding road and are putting money aside in trust funds. Others are redesigning the benefits themselves, using accrued sick leave to set up retiree health care savings accounts or shifting retirees to Medicare advantage drug prescription programs. Some states are already cutting back in various ways that will whittle down costs—for instance, by elevating retirement ages for new or non-vested employees or by increasing retiree contributions to premiums. At least one state, Illinois, has attempted to buy out some employees by offering a lump sum, as General Motors has done in the private sector.[90]

As the shock of identifying the long-term costs of retiree health care and other non-pension benefits ebbs, many questions remain about how cuts in benefits or other changes may affect employee behavior and the bottom line. States and other governments have embarked on a multiyear process in which they surely will be watching each other to see what works and what does not. This is just the beginning.

How Retiree Health Care Benefits Differ from Pensions

In 2004, after almost 20 years of study on the issue, GASB established new standards of accounting and financial reporting by public entities for other post-employment benefits, amending generally accepted accounting principles related to those transactions. (These same standards have been in place for private sector companies since the early 1990s.) Governments were given a few years to phase in the new standards. For state entities, that meant coming up with an actuarial accrued liability figure for their 2008 annual reports.

For governments and actuaries, developing long-term liability figures for retiree health care and other non-pension benefits can be complicated because several new assumptions must be built into the equation. These new assumptions include the annual rise in health care costs and the number of retirees who will actually take the state up on its offer of benefits (sometimes an employee chooses a spouse's coverage over the state's plan).

The greater uncertainties involved nearly guarantee that the valuations of long-term liabilities will rise and fall, particularly during the next few years, as states and actuaries evaluate plan characteristics, modify some plans to make them affordable, and decide how to manage benefits going forward.

States face a number of other big unknowns. Will the nation's health care financing system change substantially in the next 30 years? How will any changes affect retiree benefits? How far will courts allow governments to go in reducing benefits, as has happened in the private sector? These are just a few of the questions governments will be considering in the coming years.

Highlights From the Data

Exhibit 3-1 provides data for 45 states: 43 states have produced actuarial valuations of their OPEB; the data include estimates for Illinois and Texas. The figures in the exhibit assume that the state is paying for these benefits on a pay-as-you-go basis.[91] The long-term costs drop considerably if states consistently pay their annual required contribution (ARC) and deposit it in a qualified irrevocable trust. The savings come from the higher investment return that results from long-term savings and earnings that build up over time. As of the end of fiscal year 2006:

- Only six states—Arizona, Ohio, Oregon, North Dakota, Utah and Wisconsin—were on track to have fully funded OPEB obligations during the next 30 years. A few other states have moved in that direction since fiscal year 2006.

- Only three states had funded more than 50 percent of their actuarial liability: Wisconsin at 99 percent, Arizona at 72 percent and Alaska at 65 percent.

- Of the five largest states—California, Texas, New York, Florida and Illinois—none had put aside any money for other post-employment benefits.

- Eleven states had estimated liabilities in excess of $10 billion, led by New York with $50 billion, California with $48 billion and New Jersey and Connecticut with $22 billion each. Illinois is also included on this list with $48 billion in liabilities, according to estimates by the Civic Committee of the Commercial Club of Chicago.[92]

- Most of the states with large liabilities relative to their size are located in the East: New Jersey, New York, Connecticut, Maryland, Delaware and New Hampshire.

- Four states had put aside at least $1 billion for future OPEB expenses: Ohio, with $11.1 billion; Alaska, with $2.2 billion; Wisconsin, with $1.8 billion, and Arizona with $1 billion.

The Challenge of Rising Costs

This report does not attempt to evaluate the virtues or flaws of states' decisions to offer larger or smaller benefit packages to their employees. Instead, the analysis focuses on the real world as it exists today—one in which many states will see the price tag on retirement benefits rise significantly well into the future.

New Jersey, for example, paid $200 million—a systemwide total—for the health care costs of its current retirees in fiscal year 2000. By fiscal year 2005, this amount had mushroomed by 355 percent to $911 million. In the years since 2005, and for the foreseeable future, the costs are rising far faster than the rest of the budget. The state's 2007 retiree health costs were $1.2 billion, and the 2008 bill will be 25 percent higher than that. By contrast, state spending generally will rise 7.2 percent from fiscal year 2007 to fiscal year 2008, according to the New Jersey Treasury Department.[96]

States that pay a large portion of retirees' health care costs have generally struggled with rising

Understanding the Numbers

The data used for this report include information from 45 states. The data for 43 states are based on actuarial computations produced by the states themselves. As of mid-October 2007, the remaining seven states had not finished producing actuarial valuations. Five of those—Indiana, Kansas, Minnesota, Mississippi and Nebraska—are likely to show relatively small liabilities because they are among the 10 states where retirees pay their own health insurance premiums. In these states, the governments' cost is limited to an "implicit subsidy," which comes from allowing retirees to participate in the same insurance pool as younger and generally healthier state employees.

Of the states with substantial OPEB obligations, only Illinois and Texas were missing an actuarial valuation. A 2006 report from the Civic Committee of the Commercial Club of Chicago estimated that number at $48 billion for Illinois, a figure that includes state employees only.[93] The Texas legislature passed a law last spring that gave state and local governments a choice of following GASB standards or standards developed by its own comptroller. Governments that chose the latter course of action would still need to include a projection of long-term non-pension costs as supplementary information to the financial statement, but this would not be considered a liability. No publicly available actuarial valuation existed yet for Texas state government when this report went to press. The Legislative Budget Board has estimated the total liability as more than $50 billion after 10 years, including local governments.[94] Credit Suisse has estimated the state portion at $26.8 billion.[95]

In an effort to ensure consistency among the states, PCS has limited its analysis to state employees, with OPEB obligations for teachers and local employees removed whenever possible. As a result, the figures in Exhibit 3-1 may not match with unfunded liability figures that have appeared in local newspapers. For example, New Jersey's most recent actuarial valuation shows a total of $68.8 billion in liabilities. Of this amount, however, $36.5 billion covers school teachers and another $10.8 billion covers municipal and county employees. The portion for state employees is $21.6 billion.

When states were unable to break out the data that applied exclusively to state employees, the inclusion of either teachers' plans or local plans is noted on the table. The source of each figure, and the date of the calculation, can be found on the PCS Web site (www.pewcenteronthestates.org). In some cases, the valuations used were preliminary and states are currently working on updated versions. The actuarial valuations used for this table were supplemented with information from comprehensive annual financial reports. In cases where PCS researchers needed help isolating state data, they contacted state officials.

Even if benefits remain the same, however, it is highly likely that some of the figures shown in Exhibit 3-1 will change significantly in future valuations. Calculating the long-term cost of retiree benefits is new to the states and adjustments in their calculations are not unusual. Maine, for example, had a valuation in 2003 that put its long-term OPEB actuarial liability at $1.2 billion. As of January 2007, it determined the liability to be about $3.2 billion. That amount includes the state's obligations for both retired state employees and retired teachers, according to Frank Johnson, executive director of Maine's employee health and benefits department. (The amount listed in Exhibit 3-1 represents state employees only.)

These calculations require sophisticated actuarial projections that take into account many hard-to-predict variables such as the rate of retirements, the lifespan of retirees, the increase in health costs and the interest earned on money set aside as benefits are earned. Changes in any of the assumptions over time will alter the data.

bills. In Maine, benefit payments were 6.7 percent of payroll for fiscal year 2007, but will rise to at least 11.2 percent of payroll in fiscal year 2016, according to state figures.[97] California's Legislative Analyst's Office pegged growth in retiree health care costs at nearly 11.8 percent between 2007 and 2008. By contrast, other state spending grew less than 1 percent.

In Nevada, pay-as-you-go costs were projected to rise 20 percent from 2008 to 2009, according to information presented to the legislature in January 2007. If the state were to fund its ARC in 2008, the payment would be four times the pay-as-you-go cost.[98]

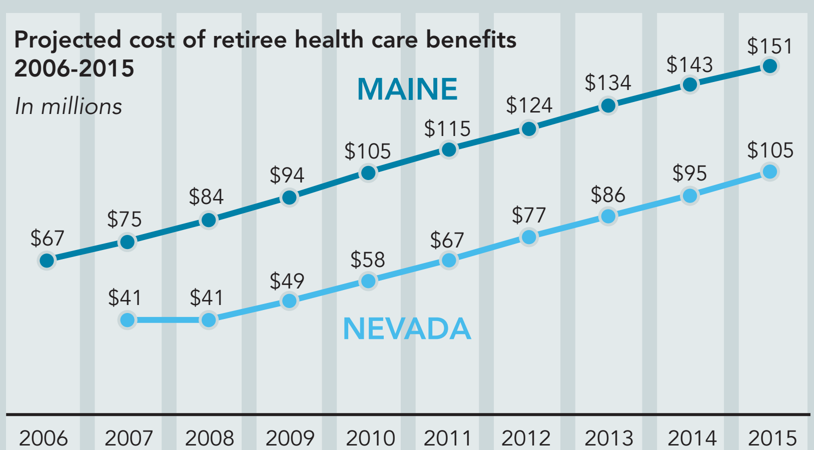
If states persist on the pay-as-you-go path, the bills for retiree benefits other than pensions will continue to grow quickly. Nevada and Maine, two very different states socioeconomically and geographically, are largely in the same boat when it comes to bills coming due for OPEB, as Exhibit 3-2 illustrates. That is why these and other states are thinking hard about what mix of actions to take. Without appropriate attention and planning, these obligations only get bigger and more difficult to manage.

Until recently, most states have permitted their OPEB obligations to grow with little or no consideration for how to pay for them. As noted earlier, our analysis revealed that about 97 percent, or $370 billion, of these 30-year obligations were unfunded at the end of fiscal year 2006. By sharp contrast, all states attempt to set aside large pools of assets to fund long-term pension liabilities, albeit with varying success.

However, a few states, including Utah, Maine and Michigan, have been estimating the costs

3-2 PAYING THE MINIMUM IS NOT ENOUGH

The rising costs of health care benefits for retirees will be felt most acutely by states on the pay-as-you-go* path, as illustrated by Nevada and Maine.



* "Pay-as-you-go" is defined as paying only the amount needed to pay for benefits currently due and payable to retirees. Often this means financing for current benefits comes from current employees' contributions.

NOTE: 2006 data unavailable for Nevada.

SOURCES: Leslie Johnstone, Memorandum to Nevada Joint Ways and Senate Finance Subcommittee, RE: GASB 43 and 45 Supplemental Information, January 24, 2007; Nevada CAFR pp. 69-70.; John Bartel and Steven Glicksman, State of Maine: Retiree Healthcare Plan Actuarial Valuation, January 2007.

"I hope the experience with retiree health makes people realize that we have some pretty significant fiscal challenges over the long term."

— Scott Pattison, executive director of the National Association of State Budget Officers

of their non-pension benefits for some time. Others, such as Alaska, Kentucky and Arizona, have included retiree health care as part of pension funding. As a result, although these states' pension funding levels may have appeared somewhat deflated compared with other states in the past (when few states were paying attention to long-term retiree health care costs), they now have a jump on many other states.[99]

At the end of fiscal year 2006, 13 states had some funding set aside, although most of the amounts were minimal. Ohio stands out in the amount of money socked away: $11.1 billion at the end of fiscal year 2006, a sum that grew to $12.8 billion by the end of fiscal year 2007, according to the Ohio Public Employee Retirement System. But even Ohio's retiree health benefits are only 39 percent funded, up from 35 percent in 2006.

The job is all the tougher because of the many other long-term costs emerging as states' populations and infrastructures age. States face retiree OPEB bills simultaneously with rising pension costs; expanding budgets for prisons; and demands for more money for schools, maintenance backlogs for bridges, roads and water systems and other needs. At the same time, governments are under pressure to keep taxes low.

The underlying problem, said Elizabeth Keating, a professor at Boston College's Carroll School of Management, has been fiscal systems based on an annual cash budget, which does not hold decision-makers responsible for the results of their choices down the road. She and others maintain that governments need to focus attention on the long-term ramifications of their decisions. Meanwhile, state budgets, employees, retirees and taxpayers are likely to face tough times ahead. "I hope the experience with retiree health makes people realize that we have some pretty significant fiscal challenges over the long term," said Scott Pattison, executive director of the National Association of State Budget Officers. "I hope this changes the dynamic in which we make policy decisions over the short term without a realization of the costs that are going to grow over the next five, 10, 15 years and beyond."

How the States Stack Up

PCS's analysis shows how strikingly different the states are from one another. Half the states account for almost 94 percent of the total unfunded OPEB liabilities. "The diversity of the states is far more dramatic on the retiree health issue than many others," said Pattison. "We have some members who see this as almost a crisis and others have no problems."

Much of the difference is directly tied to the decisions that governments have made about how large or small retirement benefits should be and who should receive them. Even neighboring states, which may well be drawing employees from the same group of applicants, have made remarkably different choices about the benefits they provide their retirees. For example, Virginia's unfunded liability is $2.3 billion, while Maryland's is $14.5 billion, according to the states' own disclosures.[100] Maryland offers a more substantial premium subsidy and provides assistance to retirees with fewer years of service.

In general, the largest states have the largest liabilities. Of the 10 states with the highest populations, only Florida stands out as having a relatively small actuarial accrued liability. That is not surprising because Florida's cash subsidy for health insurance is limited, providing a $5

The Other Post-Employment Benefits Menu

All states that offer post-retirement health care benefits to employees do so in different ways. A few of the key differences include:

- The nature of the benefits. While standard major medical coverage tends to receive the most attention, life insurance, dental and vision coverage and other benefits can be included.

- Divisions of contribution. In some states, the government contributes most or all of the monthly premiums for retiree health benefits. In others, the government contribution is capped and employees make up the rest. In still other states, the government pays only the implicit rate subsidy (the cost incurred by allowing retirees, who are generally older and less healthy, to participate in the same plan as active employees).

- Eligibility. In many states, employees become eligible for these benefits based on a combination of age and years of service. For example, an employee turning 55 with 10 years of service to the state may be eligible to continue receiving the same health benefits after retirement. Retiree health plans are frequently tiered so that benefits increase after more years of service.

- Coverage. Some plans cover only employees, while others include spouses and other dependents. States also differ widely in whether or not they provide coverage to early retirees who do not yet qualify for Medicare.

- Basic plan structure. As in the private sector, virtually all OPEB plans fall into one of two categories: defined benefit or defined contribution. Defined benefit plans specify the amount of benefits to be provided to the employees after their employment ends. Defined contribution plans stipulate only the amounts to be contributed by a government employer to a plan member's account, but do not promise a certain amount of benefits employees will receive after their employment ends.

- The number of participating governments. So-called single-employer plans involve only the state government; multiple-employer plans include more than one government, often localities.

- Varieties of multiple-employer plans. When multiple governments pool or share the costs of financing benefits and administering the plan and the assets, the plan is called a cost-sharing multiple-employer plan. In agent multiple-employer plans, states still share the administrative costs and pool investments, but separate actuarial calculations are made for each participating government, and separate accounts are maintained to ensure that each employer's contributions are used only to provide benefits for employees of that government. The goal of these plans is to spread risk and administrative costs while providing centralized expertise.

monthly subsidy toward health insurance coverage for every year of employment up to 30 years. On the other hand, California, North Carolina and Texas often pay retirees' entire premiums, according to the Workplace Economics 2006 State Employee Benefits Survey.[101]

States' liability amounts are determined not only by the size of states' contribution to retirees' insurance premiums, but also by such factors as the number of retirees covered, the vesting period, the type of health plan, and dependent and spousal coverage. (See "The OPEB Menu" for a more thorough description of the most important variables that come into play.)

Retirement age is a particularly pertinent factor. All states' retirees are living longer and so remain beneficiaries for a longer time. Beyond that, the age at which states permit various employees to retire and collect benefits varies greatly. The retirement age is critical because the cost of covering an individual retiree who has not yet become eligible for Medicare can be much greater than the cost of covering a retiree who is Medicare eligible. In New Jersey, for instance, spending for the average pre-Medicare retiree is $573 a month, 189 percent of the cost for a retiree who is covered by Medicare, according to the most recent State Health Benefits Survey from the Segal Company.[102] A study by Alaska's actuary analyzed retiree health care costs and found that 75 percent of the state's OPEB spending came from employees who retired before 65. This information helped convince the Alaska legislature to cut off benefits to pre-Medicare retirees as part of its substantial retirement reforms of 2005.[103]

States Attempt to Move Forward

GASB's role is to establish accounting and financial reporting standards—not to require governments to make any particular policy or management decisions. But on the verge of disclosing their liabilities for retirement benefits, many governments confront the need to take action. "There are two ways to address the issue," said Jason Dickerson, a legislative analyst in California who has been following the topic there and in other states. "You can put money aside to fund benefits or you can change benefits so as to reduce future costs."

A January 2007 Aon Consulting survey of governments of all sizes shows many leaders are still unsure of where to turn.[104] The survey, released in July, showed that fewer than half the governments surveyed had developed a plan of action to handle the new accounting standards. Ninety percent did not know how they would get the money to fund the long-term obligation, although more than half were considering long-term funding options. A third of the respondents were contemplating plan modifications—either revising eligibility requirements, increasing cost sharing, cutting coverage for future employees or moving to a defined contribution approach, which would shift the risk of medical inflation to retirees.

In fact, a hybrid approach seems increasingly likely for a number of states. "Initially, a lot of our clients were looking at this in black and white: pay for it all or reduce all the benefits," said Tim Nimmer, an actuary at Aon, which performed the actuarial valuations for non-pension benefits in eight states. "I'm guessing that almost all of them will land in that gray area of a combination of the two. They're looking for what's politically palatable and what is fiscally palatable."

To see what states are doing at this early stage, PCS analyzed survey responses from Pew's Government Performance Project and legislative data from the National Conference of State Legislatures (NCSL).

Fully Funding the Long-term Obligations

According to NCSL's legislative tracking, at least 13 states in 2007 set up state trust funds or provided enabling legislation for local trust funds. A handful of other states had already taken these actions. These irrevocable trusts require that all the money that goes in is used in a predetermined way—in this case, to pay for retirement benefits in years to come. The stipulation prevents budget raiders from siphoning off these funds for current needs. Ohio (see "States to Watch") has used such a mechanism to hold the funds it has been setting aside for OPEB obligations since 1974. Utah also established an irrevocable trust for its OPEB costs and appropriated the full actuarially required contribution of about $47 million for both fiscal years 2007 and 2008. Alabama, Delaware, Georgia and West Virginia (see "States to Watch") are among the states that have also set up irrevocable trusts.

Some states are considering earmarking revenue streams to fund their long-term liability, such as a portion of lottery proceeds or tobacco settlement dollars, according to the National Association of State Comptrollers, which has set up an OPEB Implementation Network.[105]

Massachusetts passed irrevocable trust legislation for fiscal year 2008 and is fully funding its $1.1 billion anticipated annual required contribution for 2008 with approximately $340 million of general fund dollars and most of its accumulated unspent tobacco settlement receipts. Governor Deval Patrick proposed dedicating up to 90 percent of future tobacco settlement proceeds to at least partially fund OPEB costs in the irrevocable trust. The legislature rejected the proposal, but created a commission to study future funding with a report due in December in time for the fiscal year 2009 budget debate.

Other states may be looking at the option of bonding out their OPEB obligations. One state that selected this option is Wisconsin. In 2003, it issued $600 million in OPEB bonds as part of a larger transaction that also included the issuance of $729 million in pension bonds. The OPEB portion of this transaction was the first time a bond had been used to pay for the actuarial liability for other post-employment benefits at the state level. It has enabled the state to come close to fully funding its fairly modest OPEB obligation.[106]

However, there is an inherent risk in bonding to meet retiree obligations, based on the timing of the transaction. For example, New Jersey implemented a $2.8 billion pension bonding plan in 1997, and it fell victim to bad timing when the market turned sour and the interest paid on the bond exceeded what the state earned on its pension investments. Other governments that sold pension obligation bonds in the late 1990s also lost money in the early part of this decade.

The appeal of irrevocable trusts goes beyond the obvious desire to provide security for retirees and protection for future taxpayers. If states start funding their retiree benefits through this vehicle, their actuaries can actually decrease the total actuarial liability. That's because it is presumed that invested money will earn more interest if it is set aside for the long haul, reducing the long-term cost of benefits. (See "Other Benefits of Full Funding.")

However, government officials wonder what will happen to money that has been "irrevocably" dedicated to retiree health care if the federal government passes some kind of universal health insurance. "A lot of people are resistant to putting that money aside because tax laws aren't clear on their ability to take that money out," said Dickerson of the California Legislative Analyst's Office.

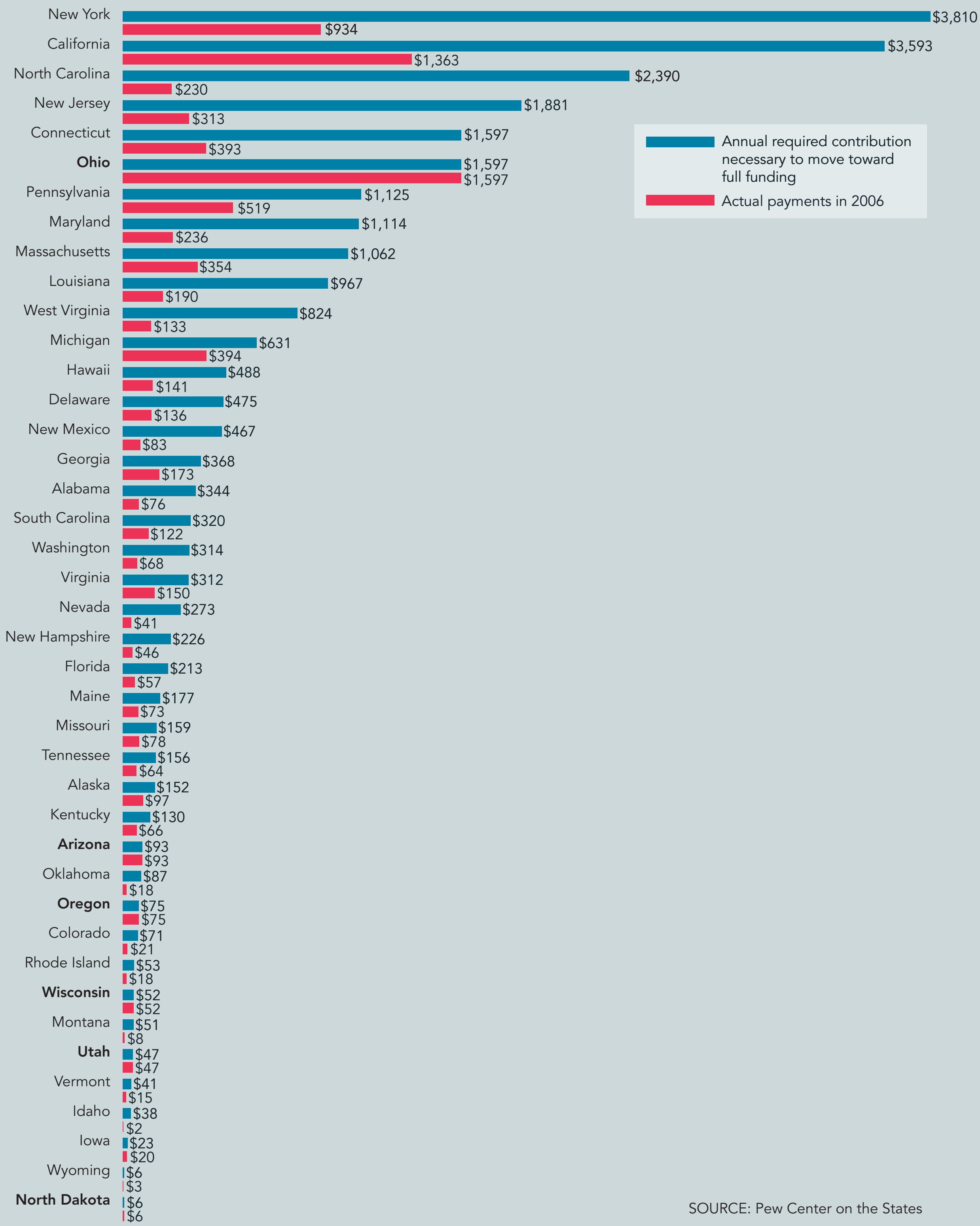
In any case, for most if not all states, the option of fully funding these liabilities in the near future is not feasible because of the dramatic rise in costs. Exhibit 3-3 compares the costs states spent in 2006 with the amount determined by actuarial valuations as necessary to move toward full funding. The states where the red and blue lines are closest have already started moving toward funding these benefits.

In fact, based on data from 40 states with explicit OPEB liabilities, PCS has calculated that the median annual required contribution states would need to move toward full funding of their plans can be almost three times what they are paying right now: $314 million compared with $110 million, respectively.

An effort to begin funding for the future is worth considering for a variety of reasons. However, given the size of their long-term liabilities, many states are going to be supplementing that effort with other steps to reduce the bill coming due.

3-3 FALLING SHORT ON PAYING THE ANNUAL BILL FOR OTHER BENEFITS

Almost all states need to pay more into their retiree health care plans if they want to move toward full funding. States in bold paid their annual required contribution in 2006. Data shown are for the 41 states with available figures. Numbers are in millions.



SOURCE: Pew Center on the States

3-4 THE BENEFITS OF CONSISTENTLY PAYING THE ANNUAL BILL

State	Expected Return on Pay as You Go	Expected Return if Funded
Alabama	4.00%	6.00%
California	4.50%	7.75%
Massachusetts	4.50%	8.25%
Nevada	3.80%	8.00%
S. Carolina	4.50%	7.25%
West Virginia	4.50%	7.75%

NOTE: If the annual required contribution were funded consistently each year, a higher interest rate could be used and the dollar amounts would be reduced.

SOURCE: Pew Center on the States

Scaling Back on Benefits

In general, states have far more flexibility to make changes to retiree benefits like health care than they do to pensions. But it gets more complicated when it comes to individual states, in part because of how they make their decisions about benefits. One might assume, for instance, that in heavily unionized states, benefits would be determined by labor negotiations. But that's not always true. At the state level in California, for example, retiree health benefits are not a topic open to union negotiation. These decisions are the province of the pension systems' board, according to Dickerson of the California Legislative Analyst's Office. On the other hand, in California's local governments, labor negotiations have already started to have

Other Benefits of Full Funding

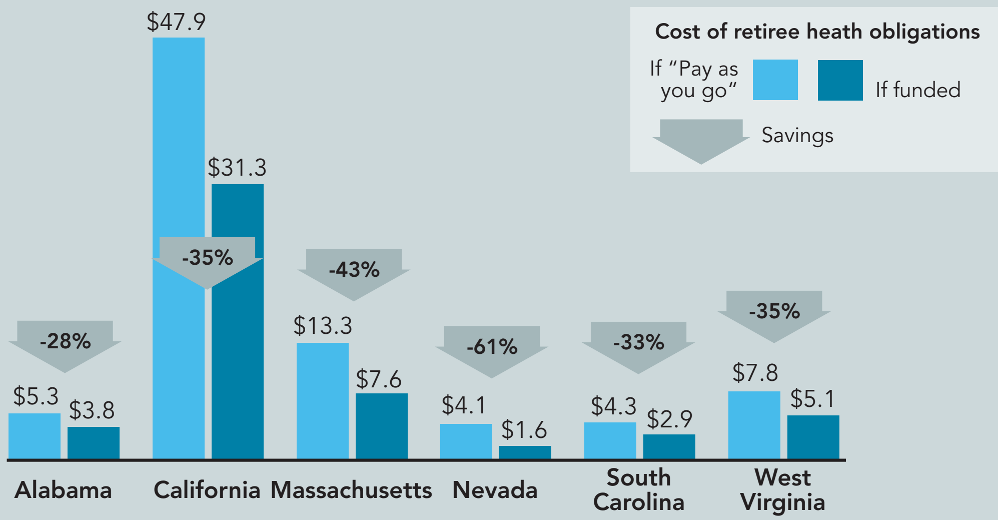
The benefit that comes from putting money in a trust is that it starts to earn interest and, over time, that interest becomes another funding source for the benefits, replacing some of the contribution that would otherwise come from future taxpayers.

In fact, states that move toward full funding of their benefits will see an immediate impact on the actuarial accrued liability because there is an increase in the discount rate that is used to calculate this amount. Exhibits 3-4 and 3-5 highlight a sampling of states, the impact of discount rates when they simply pay the benefits out of current monies, and the impact of the higher discount rate that would be permitted if they establish a qualified trust and begin providing consistent long-term funding. Most states that provide long-term funding likely will provide a portion and not the whole thing, which will enable them to use a discount rate somewhere between the two options shown.

For example, in California, actuaries have calculated the long-term obligation for state employees at $48 billion. One important element in that calculation is the "discount rate"—the interest rate assumption the state is allowed to apply to current assets used to pay future bills. With that bill paid for on a pay-as-you-go basis, the actuaries assume a 4.5 percent interest rate, similar to what the state earns in its short-term cash accounts. But if California were to start putting aside sufficient money each year in a qualified trust, higher interest earnings could be achievable. So the actuaries would use a 7.75 percent interest rate—the same rate used in its pension system—reducing the total amount owed to $31 billion.

3-5 REDUCING COSTS BY CONSISTENTLY PAYING THE ANNUAL BILL

The examples below demonstrate the financial benefits of a qualified trust that is consistently funded. (In billions)



SOURCE: Pew Center on the States

an impact. This has also been the case in the private sector (see "A Harbinger?").

In other states the decisions may fall to the legislature or collective bargaining with unions, and the flexibility to make changes depends on state law and past labor agreements. For example, in 1997 in Connecticut, the administration of then-Governor John Rowland reached a 20-year agreement with the state's labor unions, which prevents any significant changes from being made until 2017. "That's tied our hands," said Nancy Wyman, state comptroller.

A smattering of states have made changes over the last several years—but experts predict that this kind of activity will be ever more common as states move from the head-scratching phase to more clear-cut plans.

This topic is so new that there is little or no evidence that any one of the approaches that states have taken thus far is necessarily superior to others. Here are examples of what's been happening across the country in the last several years:

- In 2005, Pennsylvania started requiring new retirees to pay 1 percent of their annual base salary at the time of retirement for health care costs. In addition, as of July 1, 2008, 20 years of state service will be required for lifetime health benefits in Pennsylvania compared with 15 years in the past.[107]

- In 2006, North Carolina increased the time that new employees need to work to qualify for full subsidization of benefits.[108] (See "States to Watch.")

A Harbinger?

In September, the United Auto Workers union and General Motors reached an agreement that some observers point to as a useful example for the public sector. Faced with a $50 billion actuarial accrued liability for post-retirement benefits and ongoing intense competition from international carmakers, GM and the union agreed to end the company's defined benefit plan for non-pension benefits and shift to a Voluntary Employee Beneficiary Association deal in which the automaker pays an annual amount to a union-run medical benefit plan.

This defined contribution approach removes the risk to GM of dealing with health care inflation. The unions were willing to accept this option, faced with the potential of more drastic cuts in the future or layoffs if the company couldn't afford to pay the benefits promised.[112]

For states in which retiree benefits are the subject of labor negotiations, this topic is highly likely to be a prominent part of future discussions. At the local level, for example, several unions have negotiated changes in benefits or benefit structure over the last year. One theme, particularly in California, has been for a union to protect benefits of current employees while allowing benefits to be diminished for new employees. Unions in Orange County went a step further, negotiating a pay increase for current employees while substantially reducing non-pension benefits for future hires and retirees. It is likely that this case will be litigated, said Dickerson.

- In 2006, Maryland increased co-payments on prescriptions and increased employee and retiree premium payments.[109]

- In 2005, Alaska ended early retiree health coverage for new employees, limiting retiree coverage to those who are 65 and older.[110] (The state also shifted new employees from defined benefit pension plans to defined contribution plans.)

- In 2006, Illinois began offering 15,000 state retirees not covered by Medicare the option of dropping their state-subsidized health insurance in exchange for a $150 monthly payment. Only those who had another source of insurance were eligible. The state pays $834 per month to insure the health of a retiree not covered by Medicare. As of September 30, 2007, 124 employees had accepted this offer, according to Timothy Blair, executive secretary for the State Employees' Retirement System of Illinois.[111]

States to Watch

West Virginia

Having experienced the bitter toll that underfunded pensions take on a state budget, West Virginia was one of the states that moved most rapidly to deal with a $7.8 billion unfunded liability for its other post-employment benefits. Among other things, the state increased retiree co-payments, set up an irrevocable trust for funding and shifted retirees to a Medicare advantage prescription drug plan.

According to Ted Cheatham, executive director of West Virginia Public Employees Insurance, the actions reduced the state's long-term liability by more than half, to $3.4 billion. Part of the savings stems from a reduction in medical cost inflation, with the state shifting from the 8 percent inflation rate it expected in the next few years to a 6 percent inflation rate, based on health care cost growth that mitigated substantially in fiscal year 2007.

"Had we not made these changes to reduce the liability we would have had to do something more drastic to retiree benefits in the future."

— Ted Cheatham, executive director of West Virginia Public Employees Insurance

The following describes the state's health care benefits for retirees before and after the reforms.

BEFORE. The state required co-payments from active employees but not from retirees. Retirees paid a premium based on years of service and date of hire, but it was considerably discounted from what the state actually spent. Retiree health care costs were covered on a pay-as-you-go basis, with the premiums from active employees providing a $100 million subsidy for retiree costs every year. Supplemental Medicare coverage was provided on a fee for service basis. Meanwhile, the number of retirees was growing at a net rate of 1,000 a year.

AFTER. Co-pays were set for retirees at $10 for primary care, $20 for specialists and $50 for emergency room visits, with retirees expected to pay 20 percent of hospital expenses not covered by Medicare. Out of pocket expenses were capped at $500. All retirees were required to join a Medicare advantage prescription drug plan. These actions reduced per capita costs from $300 per member per month to $121 per member per month. In addition, the West Virginia Retiree Health Benefits Trust Fund was set up. It currently has $39 million with another $63 million deposit expected by year's end. Finally, to relieve some pressure on retirees' wallets, the state reduced premium costs by a flat $22 per Medicare member per month.

A number of retirees are unhappy with the change, but it could have been worse; the state's original proposal in fall 2006 was considerably more expensive for retirees. In adopting the new plan, the state—heavily unionized—worked with a number of labor groups. Although they vary in their level of acceptance, Cheatham said "most are satisfied with where we ended up." At this point, there has not been any litigation regarding the changes. "Had we not made these changes to reduce the liability we would have had to do something more drastic to retiree benefits in the future," said Cheatham.

Cheatham added that by changing to the Medicare drug prescription plan, the state was able to take advantage of federal dollars that directly fund that program. By contrast, if the state had continued to provide its own prescription drug benefits, the subsidy provided by the federal government under Medicare Part D could not be used to reduce the other post-employment benefits liability, according to GASB rules.

Ohio

Only a small number of states have accumulated significant assets to offset their OPEB obligations. Ohio, which had $11.1 billion saved as of fiscal year 2006, has accumulated much more than even the next closest state (Alaska at $2.2 billion).

Ohio began offering health care to its retirees in 1969 and started paying their health insurance premiums in 1974.[113] Managers initiated the first round of restructuring in 1986 by raising eligibility from five years of service to 10. The state introduced wellness programs and choice of plan during the 1990s. And it continued to restructure further by placing a cap on the lifetime benefit an individual retiree can receive as well as increasing deductibles and co-payments and tightening definitions of dependents.

The solvency test measures how long any dedicated funds will last given the expected level and timing of expenditures. Because Ohio has partially funded its OPEB obligation, the solvency test can be used to gauge its progress. In 2005, officials with the Ohio Public Employees Retirement System estimated the solvency period at 17 years. It grew to 18 years in 2006 and is estimated at 27 years for 2007, according to state officials.

Utah

Utah is noteworthy because it has a relatively modest long-term liability of $750 million or $488 million, respectively, for its non-pension benefits, depending on whether the state follows a pay-as-you-go approach or continues to pay the annual required contribution, as it has done in 2007 and 2008. Yet it has taken steps to restructure its benefits as a result of requirements to disclose these obligations.

During its 2005 session, the Utah legislature passed a bill, effective January 1, 2006, allowing retiring employees to receive 25 percent of the value of unused sick leave as a contribution into a 401(k) account.[114] (Those who retired before January 1, 2006, were able to cash out this amount of unused sick leave.) The value of any unused sick leave earned after this date is converted into a health reimbursement account. A prior provision allowing employees to receive health and life insurance coverage for up to five years or until they turned 65 is being phased out.

Employees have not accepted these changes without a fight. Utah was sued by the Utah Public Employees Association on behalf of five anonymous plaintiffs who charged that the legislature had illegally changed the rules of vesting and contributions.[115] The state Supreme Court held that the legislative change was not an unconstitutional taking and that the plaintiffs did not have a property interest in the specific use of unused sick leave.

North Carolina

North Carolina offers other post-employment benefits to retired state employees, its universities and community college faculty and teachers who are members of the Teachers' and State Employees' Retirement System, as well as to other systems covering the judicial and legislative branches of government. The plan is the same as the one covering active employees.

In 2006, the North Carolina legislature overwhelmingly passed a bill that increased OPEB vesting periods from five to 20 years for employees hired after September 30, 2006. Those retiring with fewer than 20 years' service will have to pay between 50 percent and 100 percent of their health insurance premium, depending upon the number of years served.[116]

Because this reform is prospective, the state will not realize any financial benefits until 2011, when its OPEB obligation is likely to be somewhat reduced.[117] Figuring out the impact of the change is highly complex. While it certainly cuts back on the number of individuals who are eligible for full benefits, it will also result in a phenomenon economists call "adverse selection," which occurs when plan members who pay more in premiums than they consume in services exit the plan. Because those retiring with fewer than 20 years of service will now have to pay a significant portion of their premiums, many employees are expected to obtain health insurance from a lower cost provider. This loss of premium payments partially offsets the positive fiscal impact. It also means the resulting pool of plan members will be older and sicker, which could have a similar effect.

The net result of this reform is still anticipated to save money. But states should thoroughly investigate all restructuring options to ensure that the unintended consequences of changes to OPEB plans are not greater than the anticipated benefits.

Innovation in Management

Two factors lead to the large year-to-year increases in retiree health care benefits: the increasing number of retirees and the inflation of medical costs. States' estimates of liabilities vary somewhat depending on their assumptions about these two variables. Pinning down medical inflation is particularly tricky. Analysts in California and elsewhere have expressed concern that assumptions paint a way-too-optimistic portrait of what will happen over time. Still, governments have used a variety of management tools to whittle away at what they're spending on health care. Practices that have proven particularly useful include establishing preferred drug lists, pushing the use of generics rather than brand-name drugs, shifting to managed care, and providing preventive services.

Here are three particularly hot areas of focus for governments to bring down retiree health costs:

Savings through consolidation

States can help their localities and themselves by bundling their plans under a single administrative umbrella. This can have immediate benefit because when risk is spread over a larger population, premiums tend to decline. Also, the so-called "big pencil" approach makes it far easier to bargain effectively with health care providers. Groups of employees can potentially also lower administrative costs as investment costs and overhead decline per member.

Missouri has been resolutely attempting to use consolidation to check health care costs for retirees. As of February 2007, the Missouri Consolidated Health Plan (MCHCP) claimed 104,545 members, or about 24 percent of all government workers in the state.[118] The plan's comprehensive annual financial report points to an extremely moderate increase of 1.7 percent in medical costs from fiscal year 2005 to fiscal year 2006 and an overall increase in operating expenses of only 3.3 percent during that period.[119]

In March 2006, a Missouri Foundation for Health report called on the state to expand eligibility for the plan to include non-governmental entities, seeing an opportunity to provide affordable health care coverage for all citizens using this successful structure. The report stated, "Because MCHCP already provides coverage not just for state employees but also for a variety of municipal employers, it is logical to consider it as a candidate to serve small non-governmental employers as well." [120]

Wellness programs

Many governments are promoting smarter choices for employees and retirees in four categories: health assessments and monitoring; health insurance incentives; healthy work environment initiatives, and physical fitness programs. Governments can use these programs to lower costs and get beneficiaries more involved in managing their care.
Texas offers among the most comprehensive wellness programs. In its plan year ending August 31, 2006, the Texas Blue Connection Preventive Care Intervention program sent nearly 92,000 women over age 40 "birthday cards," encouraging them to be screened for cancer and osteoporosis. Nearly 50,000 men over age 50 were sent similar cards encouraging prostate exams.[121]

Aggressive health care management

California's public employee retirement system recently initiated a purchasers' coalition to work with hospitals to increase the quality of service while managing costs. Called a "Partnership for Change," the program promotes performance measurement and public reporting. It strives to increase competition by negotiating rates with hospitals based on performance and value, while providing reliable data for purchasers to help make decisions. Benchmarking is used to increase transparency.

In summer 2003, the Massachusetts Group Insurance Commission (GIC) embarked on a multiyear effort called the Clinical Performance Improvement Initiative.[122] The initiative, which has become central to the GIC's strategy for health care coverage, seeks to deliver high-quality and cost-efficient health care to the GIC's 289,000 members. Now in its third year of implementation, the initiative relies on a database of over 150 million claim lines supplied by the six health plans currently providing coverage to GIC members. All of the claims are de-identified, which means that personal information is protected. The database is used to make quality and resource efficiency comparisons among physicians. The GIC's health plans use the results of the analysis to rank their doctors and stratify them into different groups or tiers. The health plans use modest co-pay differentials as incentives to encourage members to utilize higher tiered, more cost-efficient providers. This approach also seeks to encourage providers to improve their care delivery so as to "lift all the boats."

Conclusion

As states begin to report on the costs of health care and other non-pension benefits for public sector retirees, the long-term liabilities appearing on their "balance sheets" are likely to generate significant attention. A handful of states have been coping with how to pay for other post-employment benefits for some time, and these examples highlight the benefits of consistent funding, reasoned policy decisions and good management. At this point, most states are just beginning to understand the problem, which is an important first step. The challenge of averting a funding crisis is daunting—but it will get exponentially larger if ignored.

Endnotes

87 Currently 43 states have completed at least preliminary actuarial valuations for their other post-employment benefit liabilities. Although efforts have been made to confine research to state employees, some states are unable to isolate state employee benefits from teacher or local benefits included in cost-sharing plans.

88 The PCS analysis centers on OPEB obligations for state employees, due to the wide range of practices regarding state involvement with other post-employment benefits for teachers or municipal employees.

89 David Zion and Amit Varshney, "You Dropped a Bomb on Me, GASB," Credit Suisse (March 22, 2007). *Credit Suisse* estimated the unfunded liabilities for states at $558 billion, but included calculations for teachers in the total. It estimated the liability for localities at $951 billion to arrive at the $1.5 trillion. For the 16 states for which it had no estimates, Credit Suisse used a formula calculation in which it multiplied the number of employees by $100,000.

90 Michelene Maynard and Jeremy W. Peters, "GM to Offer Buyout Deal to More Than 125,000 Workers," *The New York Times*, 22 March 2006.

91 For definitions of these terms, see the Glossary in Section 1.

92 There was no actuarial valuation for Illinois' other retiree benefits.

93 Civic Committee of the Commercial Club of Chicago, *Facing Facts: A Report of the Civic Committee's Task Force on Illinois State Finance* (Commercial Club of Chicago, December 6, 2006), http://www.civiccommittee.org/initiatives/StateFinance/FacingFacts.pdf.

94 Legislative Budget Board staff, *Texas State Government Effectiveness and Efficiency: Selected Issues and Recommendations*, submitted to the 80th Texas Legislature (Austin, January 2007), 129.

95 Zion and Varshney, "You Dropped a Bomb on Me," 10.

96 New Jersey Legislature, Office of Legislative Services, *Analysis of the New Jersey Budget: Fiscal Year 2007-2008,* (New Jersey: New Jersey Department of the Treasury, 2007).

97 John E. Bartel of Bartel Associates, Inc., and Steven Glicksman of Glicksman Consulting, LLC, "State of Maine, Retiree Healthcare Plan, Actuarial Valuation, June 30, 2006," January 2007.

98 Leslie Johnstone, "Public Employees' Benefits Program" (presentation to the Joint Ways and Means and Senate Finance Subcommittee, Carson City, Nv., January 24, 2007), 37.

99 Alaska is 65 percent funded, Arizona is 72 percent funded and Kentucky is 10 percent funded.

100 These numbers reflect state obligations for state employees only.

101 Workplace Economics, Inc, *2006 State Employee Benefits Survey*. (The premium subsidy for retiree health benefits is very difficult to summarize as there are often multiple plans and tiered benefits depending on years served. The two-page chart on health benefits provided by Workplace Economics in its survey is followed by 13 pages of footnotes.)

102 Segal Group, Inc., *2003 Segal State Health Benefits Survey: Medical Benefits for Employees and Retirees*, (2003). Segal is currently updating this survey, in partnership with the National Association of State Personnel Executives.

103 Rich Saskal, "Despite Squabbles, They're Ahead of the Game on GASB," *Bond Buyer* 355, no. 32350 (March 30, 2006).

104 Aon Consulting, *Navigating the GASB OPEB Standards*, Aon Consulting 2007 GASB OPEB Survey (July 2007).

105 Survey results from the National Association of State Comptrollers OPEB Implementation Network can be found at http://nasact.org/techupdates/techpubs.cfm. The most recent survey was conducted in May 2007.

106 Frank R. Hoadley, "Observations on Pension-Related Liabilities and Disclosure," (Presentation to Milwaukee County Task Force, Milwaukee, Wi., October 4, 2006).

107 Mark Scolforo, "Health Tab for Public Pa. Retirees Nears $34 Billion," *Pittsburg Post-Gazette*, 20 December 2006, http://www.post-gazette.com/pg/06355/747768-85.stm.

108 North Carolina General Assembly, *Fiscal Note to Senate Bill 837*, June 30, 2006. [0]

109 Saskal, "Despite Squabbles."

110 Ibid.

111 Doug Finke, "Few state retirees choosing cash over health insurance. Option for those with other coverage, not eligible for Medicare," State Capitol Bureau, *State Journal Register*, 30 August 2006.[0]

112 Girard Miller, "A Lesson from Detroit, UAW's New VEBA and Your OPEB," *Governing: Governing Management Letter* (October, 2007), http://www.governing.com/articles/10gmillera.htm.

113 Information provided by Richard Baker, Ohio Public Employees Retirement System, December 13, 2006.

114 Utah State Legislature, *Utah House Bill 213: Unused Sick Leave At Retirement Amendments*, sponsored by David Clark (January 2006), http://www.le.state.ut.us/~2005/htmdoc/hbillhtm/HB0213.htm.

115 Supreme Court of the State of Utah, Utah Public Employees Association v. State of Utah, 2006 UT 9 (Salt Lake City, February 2006), http://www.utcourts.gov/opinions/supopin/UPEA021606.pdf.

116 North Carolina General Assembly, *Senate Bill* 837.

117 Ibid.

118 Email from Ron Meyer, Executive Director, Missouri Consolidated Health Plan, received July 16, 2007.

119 Bi-State Development Agency of the Missouri-Illinois Metropolitan District St. Louis, Missouri, Financial Division, *Missouri Consolidated Health Care Plan, 2006; Comprehensive Annual Financial Report,* (Fiscal Year ended June 30, 2006): 20.

120 Missouri Foundation for Health and Urban Institute, *Cover Missouri Project: Report 7: Expanding Coverage Through the Missouri Consolidated Health Care Plan (MCHCP)*, by Elliot Wicks, March 2006: 1-3.

121 Employees Retirement System of Texas, *Controlling Costs and Preventing Fraud in the Texas Employees Group Benefits Program Fiscal Year 2006: The Key to Cost Containment*, by Ann. S. Fuelberg (Austin 2006).

122 This explanation came from Dolores Mitchell, Executive Director of the Massachusetts Group Insurance Commission.

Appendix A

A-1 A MOVING PICTURE - HOW STATE PENSION FUNDING LEVELS HAVE CHANGED, 1997-2006

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Alabama		84%	90%	93%	97%	101%	103%	102%	101%	111%
Alaska	74%	64%	67%	70%	73%	99%	100%	104%	103%	101%
Arizona	85%	86%	90%	99%	108%	118%	122%	118%	120%	117%
Arkansas	82%	82%	86%	90%	96%	100%	101%	101%	100%	97%
California		87%	86%	84%	96%	106%	116%	118%	114%	105%
Colorado	74%	73%	71%	76%	88%	99%	105%	103%	96%	92%
Connecticut	56%	59%	60%	66%	69%	72%	72%	65%	65%	64%
Delaware	97%	97%	98%	101%	103%	105%	108%	107%	100%	97%
Florida	106%	107%	112%	114%	115%	118%	118%	113%	106%	91%
Georgia	96%	98%	100%	101%	102%	103%	103%	98%	96%	90%
Hawaii	65%	69%	72%	76%	84%	91%	94%	94%		
Idaho	95%	93%	90%	82%	83%	95%	113%	109%	106%	94%
Illinois	60%	60%	64%	49%	54%	63%	75%	73%	72%	70%
Indiana	64%	65%	67%	67%	64%	67%	67%	64%	61%	
Iowa	88%	89%	89%	90%	93%	97%	98%	97%	95%	94%
Kansas	69%	69%	70%	75%	78%	85%	88%	86%	83%	83%
Kentucky	70%	76%	83%	88%	94%	102%	111%	105%	97%	94%
Louisiana	67%	64%	63%	68%	74%	78%	79%	75%	73%	68%
Maine	77%	76%	75%	74%	77%	78%	79%	75%	69%	63%
Maryland	82%	88%	92%	93%	94%	98%	101%	97%	90%	86%
Massachusetts	72%	73%	75%	70%	83%	84%	87%	81%	81%	75%
Michigan	81%	79%	84%	87%	93%	99%	101%	101%	99%	103%
Minnesota	93%	98%	100%	102%	105%	108%	107%	107%	107%	102%
Mississippi	73%	72%	75%	79%	83%	87%	82%	82%	84%	79%
Missouri	81%	81%	80%	81%	93%	96%	100%	98%	96%	95%

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Section 4:
Appendices

A-1 A MOVING PICTURE - HOW STATE PENSION FUNDING LEVELS HAVE CHANGED, 1997-2006 *CONTINUED*

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Montana	80%	78%	80%	91%	91%	103%	103%	83%	83%	79%
Nebraska	89%	88%	89%	92%	96%					
Nevada	75%	76%	79%	81%	82%	84%	85%	82%	78%	76%
New Hampshire	61%	60%	71%	75%	82%	85%	90%	89%	108%	110%
New Jersey	79%	82%	87%	94%	101%	109%	111%	110%	106%	102%
New Mexico	82%	84%	87%	92%	98%	99%	96%	90%	84%	82%
New York[1]	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
North Carolina	105%	106%	106%	106%	109%	110%	108%	104%	99%	99%
North Dakota	81%	82%	86%	91%	97%	103%	108%	97%	99%	100%
Ohio	81%	80%	81%	79%	81%	96%	96%	94%	92%	89%
Oklahoma	59%	60%	60%	66%	65%	66%	68%	65%	64%	58%
Oregon	110%	104%	96%	97%	91%	107%	98%	99%	93%	93%
Pennsylvania	87%	87%	93%	100%	106%	115%	127%	121%	111%	106%
Rhode Island		56%	60%	64%	73%	78%	81%	83%	78%	75%
South Carolina		73%	81%	83%	86%	88%	89%	98%	94%	91%
South Dakota		96%	98%	97%	97%	96%	96%	97%	96%	95%
Tennessee	99%	99%	99%	99%	98%	98%	99%	99%	99%	99%
Texas	89%	88%	93%	95%	97%	121%	107%	104%	105%	100%
Utah	96%	93%	92%	95%	93%	103%	105%	103%	96%	91%
Vermont	92%	95%	94%	94%	94%	92%	92%	91%	90%	86%
Virginia		81%	89%	95%	100%	106%	104%	94%	87%	79%
Washington		79%	85%	88%	93%	98%	102%	96%	88%	81%
West Virginia	55%	49%	43%	39%	40%	44%	47%	46%	46%	
Wisconsin	100%	99%	99%	99%	97%	96%	96%	96%	95%	95%
Wyoming	95%	95%	86%	92%	92%	103%	115%			
US Average	**82%**	**82%**	**83%**	**86%**	**89%**	**95%**	**97%**	**94%**	**92%**	**90%**

1 See n. 4, page 13.
NOTE: Missing cells indicate that data were unavailable.
SOURCE: Pew Center on the States

A-2 PAYING THE ANNUAL BILL - KEEPING UP WITH ANNUAL REQUIRED PAYMENTS, 1997-2006

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Alabama	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Alaska	61%	47%	92%	118%	120%	109%	99%	105%	91%	93%
Arizona	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Arkansas	108%	110%	101%	102%	102%	101%	102%	101%	101%	101%
California	108%	110%	101%	102%	102%	101%	102%	101%	101%	101%
Colorado	62%	49%	52%	69%	100%	100%	100%	100%	100%	100%
Connecticut	100%	88%	89%	94%	99%	94%	94%	94%	66%	70%
Delaware	97%	93%	91%	88%	80%	80%	84%	85%	85%	85%
Florida	96%	102%	92%	98%	97%	110%	111%	100%	100%	100%
Georgia	100%	100%	100%	100%	100%	100%	101%	101%	100%	100%
Hawaii	100%	100%	100%	100%	100%	5%	13%	83%		
Idaho	107%	102%	98%	110%	131%	131%	117%	100%	99%	99%
Illinois	33%	44%	111%	67%	78%	80%	114%	98%	96%	74%
Indiana	101%	85%	78%	103%	108%	123%	125%	120%	92%	85%
Iowa	84%	86%	91%	99%	100%	100%	101%	104%	101%	103%
Kansas	63%	69%	69%	79%	80%	78%	77%	77%	74%	72%
Kentucky	86%	93%	94%	100%	104%	101%	101%	101%	104%	99%
Louisiana	101%	101%	93%	97%	102%	107%	105%	107%	103%	100%
Maine	106%	105%	112%	109%	165%	100%	102%	108%	109%	108%
Maryland	82%	83%	89%	92%	100%	100%	100%	100%	100%	100%
Massachusetts	94%	101%	63%	67%	101%	116%	99%	120%	156%	174%
Michigan	83%	78%	65%	78%	89%	126%	111%	99%	123%	109%
Minnesota	99%	115%	114%	148%	172%	156%	162%	152%	137%	131%
Mississippi	100%	100%	100%	100%	101%	101%	100%	100%	100%	115%
Missouri	81%	77%	84%	96%	100%	100%	100%	100%	99%	99%
Montana	153%	91%	94%	99%	100%	130%	129%	101%		
Nebraska	100%	91%	100%	99%	100%	100%				
Nevada	96%	100%	99%	90%	96%	100%	97%	95%	94%	100%
New Hampshire	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
New Jersey	27%	15%	8%	4%	3%	17%	29%	60%	40%	288%
New Mexico	91%	96%	100%	100%	100%	99%	99%	99%	99%	99%
New York	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
North Carolina	100%	100%	100%	100%	100%	82%	100%	100%	100%	100%
North Dakota	66%	67%	81%	97%	101%	101%	101%	100%	100%	100%
Ohio	93%	98%	97%	100%	100%	100%	100%	100%	100%	100%

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A-2 PAYING THE ANNUAL BILL - KEEPING UP WITH ANNUAL REQUIRED PAYMENTS, 1997-2006 *CONTINUED*

State	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Oklahoma	73%	58%	60%	64%	71%	77%	71%	74%	81%	78%
Oregon		101%	100%	100%	97%	95%	95%	97%	100%	100%
Pennsylvania	35%	46%	100%	117%	219%	112%	100%	100%	100%	100%
Rhode Island	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
South Carolina	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
South Dakota	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Tennessee	100%	100%	100%	100%	100%	100%	100%	100%	100%	
Texas	84%	83%	83%	86%	104%	138%	102%	103%	97%	101%
Utah	100%	100%	100%	100%	100%	100%	100%	100%	100%	100%
Vermont	76%	75%	67%	86%	96%	96%	96%	94%	85%	78%
Virginia	87%	83%	85%	64%	71%	100%	93%	85%	71%	62%
Washington	28%	20%	22%	27%	57%	164%	104%	287%	114%	80%
West Virginia	182%	147%	104%	105%	108%	106%	104%	105%	103%	
Wisconsin	100%	100%	100%	100%	100%	100%	96%	100%	100%	100%
Wyoming	150%	113%	75%	69%	127%	469%	189%			

NOTE: Missing cells indicate that data were unavailable in order to calculate the percent of the annual required contribution funded.

SOURCE: Pew Center on the States

Appendix B

The Stand-Out States

To identify the degree of challenge states face in meeting their non-pension obligations to retirees, PCS turned to means used by GASB, Standard & Poor's and Moody's Investor Services for adjusting comparisons of states. We looked at the 40 states for which actuarial valuations are now available and for which we could isolate the state contribution for state employees only. Exhibits B-1 through B-4 put retiree benefit liabilities in context based on population, personal income and payroll.

For those 40 states, the mean per capita costs of their accrued liabilities is $1,283.[123] Since there's a wide range of benefits offered, the median is $774. Looking at the unfunded liabilities as a percentage of total state personal income, the mean is 3.4 percent and the median is 2.5 percent,[124] and when viewed as a percent of covered payroll, the mean is 191 percent and the median is 135 percent.[125] The following section provides tables showing the states that stand out from the pack. These figures assume that the states are not pre-funding the obligation. Once again, if the ARC is paid consistently over time, the AAL and UAAL drop considerably.

Per capita

Exhibit B-1, which is based on population data from the U.S. Bureau of the Census and the U.S. Department of Commerce, shows the 10 states with the highest per-capita unfunded actuarial accrued liability (UAAL) for their state employees. This indicates the fiscal burden each state's citizens are carrying because of the UAAL, although it does not assess their ability or capacity to pay.

The top three states all have per-capita unfunded accrued liabilities over five times the median, suggesting a relatively heavy burden. Illinois does not appear in Exhibit B-1 because an actuarial valuation was not available. However, as previously noted, the Civic Committee of the Commercial Club of Chicago estimated the liability for state employees at $48 billion. Using this information, PCS estimates Illinois' per capita liability at $3,741, which would make it among the top five states in liabilities per state resident.

B-1 UNFUNDED RETIREE HEALTH BILL PER CAPITA

States	UAAL/Capita	States	UAAL/Capita
Connecticut	$6,186	New Hampshire	$2,210
Hawaii	$5,283	Massachusetts	$2,064
Delaware	$5,167	Kentucky	$1,923
Maryland	$2,590	Alaska	$1,800
New York	$2,572	Median	$774
New Jersey	$2,474	Mean	$1,283

SOURCE: Pew Center on the States; Based on Actuarial Valuations

As a percentage of personal income

Per-capita statistics, however, do not tell the whole story because they do not take into account the differences in wealth or ability to pay. Measures of personal income in the states, as reported by the U.S. Department of Commerce, help get at that factor. Subject to this further level of analysis, the 10 states with the largest liabilities do not change dramatically. But the order shifts a bit. Hawaii climbs to the top, and Kentucky appears as its burden rises when measured by its ability to pay. If Illinois data were included, it would appear in Exhibit B-2—again in the top five—at 9.8 percent.

B-2 UNFUNDED RETIREE HEALTH BILL AS A PART OF PERSONAL INCOME

States	UAAL/Personal Income	States	UAAL/Personal Income
Hawaii	14.6%	New Hampshire	5.6%
Delaware	13.2%	Louisiana	5.5%
Connecticut	12.4%	Maine	5.4%
Kentucky	6.6%	New Jersey	5.3%
New York	6.1%	Median	2.5%
Maryland	5.9%	Mean	3.4%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

As a percentage of payroll

Another measure used to gauge relative burden—and one that GASB will ask states to produce in their financial reporting—involves the size of the obligation compared to the size of the payroll being covered. Covered payroll is a tricky statistic because some states report the covered payroll for the state portion of their retiree benefits while others report only the amount for the entire plan. For purposes of this calculation, PCS has excluded the data for those states reporting the latter. For the 34 states where both UAAL and covered payroll data for the state only were available, the median ratio is 135 percent. The 10 states with the highest ratio are reflected in Exhibit B-3.

B-3 UNFUNDED RETIREE HEALTH BILL AS A PART OF PAYROLL

States	UAAL/Covered Payroll	States	UAAL/Covered Payroll
Connecticut	690%	Louisiana	362%
New York	552%	Maryland	362%
Kentucky	422%	California	347%
Alabama	410%	New Jersey	333%
Hawaii	395%	Median	135%
Maine	377%	Mean	191%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

Note the rise of New York and the appearance of Alabama, Maine and California. Again, if Illinois data were considered, its unfunded liability as a share of payroll would be ranked first at 709 percent. Why did these states rate so high on UAAL/covered payroll? One plausible explanation according to a number of sources, including New York's Citizens Budget Commission, is that employees in some of those states may have received wage increases that were relatively low in exchange for better post-retirement benefits over the years.[126]

States at the Other End of the Spectrum

Until recently, Indiana and Nebraska were the only two states that offer no benefits for retirees over age 65 (although both do have some provisions for retirees who are not yet eligible for Medicare).[127] Oregon also eliminated its coverage for Medicare eligible retirees who were hired on or after August 29, 2003, according to the GAO.[128] Eight additional states—Idaho, Iowa, Kansas, Minnesota, Mississippi, Montana, South Dakota and Wyoming—pay no premiums for retirees, but do allow all eligible retirees to sign on to the state plan.[129] This type of benefit provides an "implicit subsidy," which comes from allowing retirees to participate in the same pool as younger and generally healthier state employees. Because retirees are much older than the average participant in state plans, they are more expensive to cover, bringing up the average costs of the entire plan. In Wyoming, for example, although the retirees pay for benefits themselves, the inclusion of these older men and women in the insured pool increases the costs to the state by some $72 million over a 30-year period.[130]

Exhibit B-4 shows states that have the smallest long-term obligations relative to the state's population and as a share of personal income.[131]

In Kansas, Indiana, Minnesota, Mississippi and Nebraska—five of the seven states where actuarial valuations were unavailable—the unfunded actuarial liabilities are likely small.

B-4 UNFUNDED RETIREE HEALTH BILL PER CAPITA AND AS A SHARE OF PERSONAL INCOME

States	UAAL/Capita	UAAL/Personal Income
Wisconsin[132]	$3	0.0%
Arizona	$15	0.0%
Iowa	$74	0.2%
North Dakota	$77	0.2%
Wyoming	$140	0.3%
Median	$774	2.5%

SOURCE: Pew Center on the States; Based on Actuarial Valuations

Section 4: Appendices

Endnotes

123 Of the 43 states that have completed an actuarial valuation, 40 states were used in this calculation. These numbers do not reflect Oregon, New Mexico and West Virginia because their valuations did not disaggregate state only data. PCS was able to calculate the state employee portion of OPEB UAAL for Arizona, North Carolina and Ohio.

124 Similar to the per capita calculations, Oregon, New Mexico and West Virginia were not included because their valuations did not disaggregate state only data.

125 PCS was only able to gather covered payroll for state employees in 37 of the 40 states where we have actuarial valuations and were able to disaggregate state data.

126 New York's Citizen Budget Committee, *The Case for Redesigning Retirement Benefits for New York's Public Employees*, (April 29, 2005).

127 Workplace Economics, Inc, *2006 State Employee Benefits Survey*.

128 United States Government Accountability Office, 2007.

129 Workplace Economics, Inc, *2006 State Employee Benefits Survey*.

130 *Report on the State of Wyoming Retiree Health Insurance Study and GASB 45 Liability* (presented by Buck Consultants to the State of Wyoming Joint Appropriations Committee, November 1, 2005), http://personnel.state.wy.us/EGI/Buck%20Retiree%20Study.pdf.

131 Once again, these figures are only for the 40 states which have actuarial valuations and where state employees could be isolated.

132 Wisconsin took care of its modest unfunded liability for other post-employment benefits by bonding it out. See p. 50 in Section 3, Other Benefits. The $600 million in other post-employment benefit bonds may not take care of the full amount, however, as costs are outpacing projections.

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Promises with a Price Public Sector Retirement Benefits

EMBARGOED UNTIL 12:01 A.M. EST, THURSDAY, FEBRUARY 18, 2010

The trillion dollar gap

Underfunded state retirement systems and the roads to reform

THE PEW CENTER ON THE STATES

FEBRUARY 2010

The Pew Center on the States is a division of The Pew Charitable Trusts that identifies and advances effective solutions to critical issues facing states. Pew is a nonprofit organization that applies a rigorous, analytical approach to improve public policy, inform the public and stimulate civic life.

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For additional information on Pew and the Center on the States, please visit *www.pewcenteronthestates.org*.

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February 2010

Dear Reader:

A $1 trillion gap. That is what exists between the $3.35 trillion in pension, health care and other retirement benefits states have promised their current and retired workers as of fiscal year 2008 and the $2.35 trillion they have on hand to pay for them, according to a new report by the Pew Center on the States.

In fact, this figure likely underestimates the bill coming due for states' public sector retirement benefit obligations: Because most states assess their retirement plans on June 30, our calculation does not fully reflect severe investment declines in pension funds in the second half of 2008 before the modest recovery in 2009.

While recent investment losses can account for a portion of the growing funding gap, many states fell behind on their payments to cover the cost of promised benefits even before the Great Recession. Our analysis found that many states shortchanged their pension plans in both good times and bad, and only a handful have set aside any meaningful funding for retiree health care and other non-pension benefits.

In the midst of a severe budget crisis—with record-setting revenue declines, high unemployment, rising health care costs and fragile housing markets—state policy makers may be tempted to ignore this challenge. But they would do so at their peril. In many states, the bill for public sector retirement benefits already threatens strained budgets. It will continue to rise significantly if states do not bring down costs or set aside enough money to pay for them.

The good news? While the economic downturn has exposed serious vulnerabilities in states' retirement systems, it also appears to be spurring policy makers across the country to consider reforms. This report illustrates that a growing number of states are taking action to change how retirement benefits are set, how they are funded and how costs are managed.

Retirement benefits are an important part of how states can attract and retain a high-caliber workforce for the twenty-first century—and the bill coming due for these promises is an increasingly crucial issue affecting states' fiscal health and economic competitiveness. Later this year, Pew will release a study of cities' public sector retirement benefit obligations and their impact on states. And in the coming months, we will offer additional research on states' budgets and economies—from the main factors driving fiscal stress to policy options that could help states weather the storm.

Sincerely,

Susan Urahn
Managing Director, Pew Center on the States

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Executive Summary

Of all of the bills coming due to states, perhaps the most daunting is the cost of pensions, health care and other retirement benefits promised to their public sector employees. An analysis by the Pew Center on the States found that at the end of fiscal year 2008, there was a $1 trillion gap between the $2.35 trillion states and participating localities had set aside to pay for employees' retirement benefits and the $3.35 trillion price tag of those promises.[1]

To a significant degree, the $1 trillion gap reflects states' own policy choices and lack of discipline: failing to make annual payments for pension systems at the levels recommended by their own actuaries; expanding benefits and offering cost-of-living increases without fully considering their long-term price tag or determining how to pay for them; and providing retiree health care without adequately funding it.

Pew's figure actually is conservative, for two reasons. First, it counts total assets in state-run public sector retirement benefit systems as of the end of fiscal year 2008, which for most states ended on June 30, 2008—so the total does not represent the second half of that year, when states' pension fund investments were devastated by the market downturn before recovering some ground in calendar year 2009. Second, most states' retirement systems allow for the "smoothing" of gains and losses over time, meaning that the pain of investment declines is felt over the course of several years. The funding gap will likely increase when the more than 25 percent loss states took in calendar year 2008 is factored in.[2]

Many states had fallen behind on their payments to cover the cost of promised benefits even before they felt the full weight of the Great Recession. When Pew first delved into the realm of public sector retirement benefits in December 2007, our report, *Promises with a Price: Public Sector Retirement Benefits*, found that only about a third of the states had consistently contributed at least 90 percent of what their actuaries said was necessary during the previous decade.[3] Since that time, pension liabilities have grown by $323 billion, outpacing asset growth by more than $87 billion.[4] Pew's analysis, both then and now, found that many states shortchanged their pension plans in both good times and bad. Meanwhile, a majority of states have set aside little to no money to pay for the burgeoning costs of retiree health care and other non-pension benefits.

As pension funding levels declined over the past decade from states' failures to fully pay for their retirement obligations as well as investment losses from the bursting of the dot-com bubble, states found their annual required contributions going up. In 2000, when pension systems were well funded, states and participating local governments had to pay $27 billion to adequately fund promised benefits. By 2004, following the 2001 recession, their annual payment for state-run pensions should have increased to $42 billion. In fiscal year 2008, state and participating local governments were on the hook for more than $64 billion, a 135 percent increase from 2000. In 2009 and going forward, that number is certain to be substantially higher. Similarly, to have adequately funded retiree health care benefits in fiscal year 2008, state and local governments would have needed to contribute $43 billion, a number that will grow as more public employees retire and as health care costs increase.

In sum, states and participating localities should have paid about $108 billion in fiscal year 2008 to adequately fund their public sector retirement benefit systems. Instead, they paid only about $72 billion.

In states with severely underfunded public sector retirement benefit systems, policy makers often have ignored problems in the past. Today's decision-makers and taxpayers are left with the legacy of that approach: high annual costs that come with significant unfunded liabilities, lower bond ratings, less money available for services, higher taxes and the specter of worsening problems in the future.

Although investment income and employee contributions help cover some of the costs, money to pay for public sector retirement benefits also comes from the same revenues that fund education, public safety and other critical needs—and the current fiscal crisis is putting a tight squeeze on those resources. Between the start of the recession in December 2007 and November 2009, states faced a combined budget gap of $304 billion, according to the National Conference of State Legislatures (NCSL)—and revenues are expected to continue to drop during the next two years.[5] Given these circumstances—and the certainty that the challenges will worsen if they are not addressed—a growing number of states are considering reforms that can put their public sector retirement benefit systems on better fiscal footing.

To help policy makers and the public understand these challenges and their implications, Pew graded all 50 states on how well they are managing their public sector retirement benefit obligations.

Pew's analysis comes from an intensive review of data compiled and reported by the states—information that is publicly available but not easily accessible. Pew collected data on all state-administered retirement plans directly from states' own Comprehensive Annual Financial Reports (CAFRs), pension plan system annual reports and actuarial valuations. Once the information was assembled, researchers sent the data back to the states' pension directors to verify their accuracy.[6] In addition, interviews were conducted with representatives of pension plans in 50 states to provide perspective, case studies and an understanding of the trends and themes underlying the data. Pew researchers analyzed these data to assess the funding performance of 231 state-administered pension plans and 159 state-administered retiree health care and other benefit plans, including some plans covering teachers and local employees.

States have a lot of leeway in how they compute their obligations and present their data, so three main challenges arise in comparing their numbers. First, states vary in their smoothing practices—that is, how and when they recognize investment gains and losses. While most states acknowledge them over a number of years, several show their full impact immediately. Second, most states conduct actuarial valuations on June 30, but 15 perform them at other times, such as December 31. The severe investment losses in the second half of 2008 mean that states that do not smooth and that conduct their asset valuations in December will show pension funding levels that will appear worse off than states that did so on June 30. However, this also means that such states' numbers are likely to show a faster recovery than other states. (In addition, when investments were doing extremely well, their data reflected the full gains immediately, while other states smoothed those gains over time.) Finally, other factors also can impact states' asset and liability estimates, such as assumptions of investment returns, retirement ages and life spans. (See Appendix A for a full explanation of our methodology.) Pew attempted to note these differences whenever possible.

Key Findings

Public sector retirement benefits provide a reliable source of post-employment income for government workers, and they help public employers retain qualified personnel to deliver essential public services. Some states have been disciplined about paying for their policy choices and promises on an ongoing basis. But for those that have not, the financial pressure builds each year.

Among the key findings of Pew's analysis:

Pensions

- In fiscal year 2008, which for most states ended on June 30, 2008, states' pension plans had $2.8 trillion in long-term liabilities, with more than $2.3 trillion socked away to cover those costs (see Exhibit 1).
- In aggregate, states' systems were 84 percent funded—a relatively positive outcome, because most experts advise at least an 80 percent funding level.[7] Still, the unfunded portion—almost $452 billion—is substantial, and states' overall performance was down slightly from an 85 percent combined funding level, against a $2.3 trillion total liability, in fiscal year 2006. These pension bills come due over time, with the current liability representing benefits that will be paid out to both current and future retirees. Liabilities will continue to grow and, as more workers approach retirement, the consequences of delayed funding will become more pronounced.
- Some states are doing a far better job than others of managing this bill coming due. States such as Florida, Idaho, New York, North Carolina and Wisconsin all entered the current recession with fully funded pensions.
- In 2000, slightly more than half the states had fully funded pension systems. By 2006, that number had shrunk to six states. By 2008, only four—Florida, New York, Washington and Wisconsin—could make that claim.
- Many states are struggling. While only 19 states had funding levels below the 80 percent mark in fiscal year 2006, 21 states were funded below that level in 2008:[8]

Alabama	Massachusetts
Alaska	Mississippi
Colorado	Nevada
Connecticut	New Hampshire
Hawaii	New Jersey
Illinois	Oklahoma
Indiana	Rhode Island
Kansas	South Carolina
Kentucky	West Virginia
Louisiana	Wyoming
Maryland	

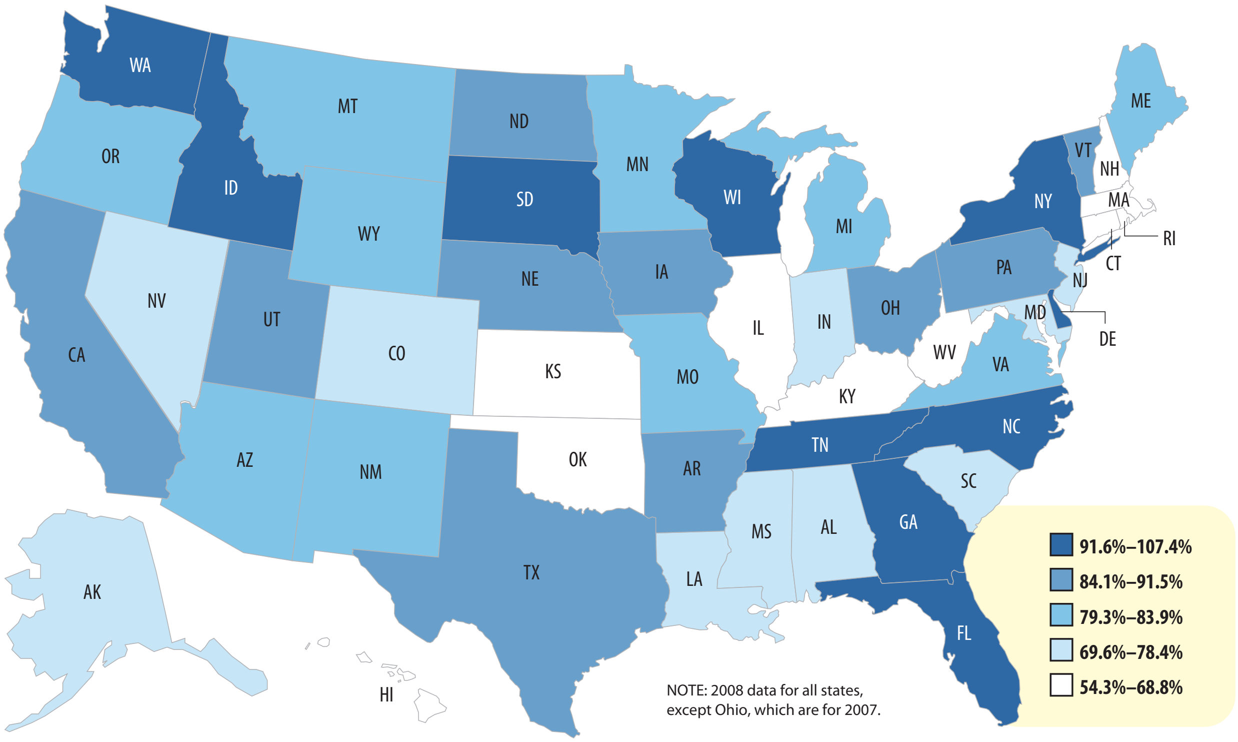
In eight states—Connecticut, Illinois, Kansas, Kentucky, Massachusetts, Oklahoma, Rhode Island and West Virginia—more than one-third of the total liability was unfunded.

Two states had less than 60 percent of the necessary assets on hand to meet their long-term pension obligations: Illinois and Kansas. Illinois was in the worst shape of any state, with a funding level of 54 percent and an unfunded liability of more than $54 billion.

- While states generally are more cautious about increasing benefits than they were in the early part of this decade, many have been lax in providing the annual funding that is necessary to pay for them. During the past five years, 21 states failed to make pension contributions that average out to at least 90 percent of their actuarially required contributions—the amount of money, determined by actuaries, that a state needs to pay in a current year for benefits to be fully funded in the long term.

Exhibit 1

STATE PENSION FUNDING LEVELS



NOTE: 2008 data for all states, except Ohio, which are for 2007.

Figures are in thousands.

State	Latest liability	Latest unfunded liability	Annual required contribution	Latest actual contribution
Alabama	$40,206,232	$9,228,918	$1,069,214	$1,069,214
Alaska	14,558,255	3,522,661	282,656	300,534
Arizona	39,831,327	7,871,120	1,023,337	1,035,557
Arkansas	21,551,547	2,752,546	555,147	556,755
California	453,956,264	59,492,498	12,376,481	10,469,213
Colorado	55,625,011	16,813,048	1,141,081	779,644
Connecticut	41,311,400	15,858,500	1,248,860	3,243,647
Delaware	7,334,478	129,359	149,614	144,358
Florida	129,196,897	-1,798,789	3,005,387	3,130,378
Georgia	75,897,678	6,384,903	1,275,881	1,275,881
Hawaii	16,549,069	5,168,108	488,770	510,727
Idaho	11,526,600	772,200	256,400	285,400
Illinois	119,084,440	54,383,939	3,729,181	2,156,267
Indiana	35,640,073	9,825,830	1,232,347	1,275,191
Iowa	24,552,217	2,694,794	453,980	389,564
Kansas	20,106,787	8,279,168	607,662	395,588
Kentucky	34,094,002	12,328,429	859,305	569,913
Louisiana	38,350,804	11,658,734	1,160,051	1,337,933
Maine	13,674,901	2,782,173	305,361	305,361
Maryland	50,561,824	10,926,099	1,208,497	1,077,796
Massachusetts	58,817,155	21,759,452	1,226,526	1,368,788
Michigan	70,354,300	11,514,600	2,150,509	2,388,840
Minnesota	57,841,634	10,771,507	1,036,509	767,295
Mississippi	29,311,471	7,971,277	662,900	643,356
Missouri	52,827,423	9,025,293	1,219,871	1,072,027
Montana	$9,632,853	$1,549,503	$201,871	$211,914
Nebraska	8,894,328	754,748	169,068	169,068
Nevada	30,563,852	7,281,752	1,262,758	1,174,837
New Hampshire	7,869,189	2,522,175	251,764	189,134
New Jersey	125,807,485	34,434,055	3,691,740	2,107,243
New Mexico	26,122,238	4,519,887	667,691	591,279
New York	141,255,000	-10,428,000	2,648,450	2,648,450
North Carolina	73,624,027	504,760	675,704	675,056
North Dakota	4,193,600	546,500	80,928	59,900
Ohio	148,061,498	19,502,065	2,632,521	2,369,045
Oklahoma	33,527,899	13,172,407	1,245,646	986,163
Oregon	54,260,000	10,739,000	707,400	707,400
Pennsylvania	105,282,637	13,724,480	2,436,486	986,670
Rhode Island	11,188,813	4,353,892	219,864	219,864
South Carolina	40,318,436	12,052,684	902,340	902,365
South Dakota	7,078,007	182,870	95,766	95,766
Tennessee	32,715,771	1,602,802	838,259	825,259
Texas	148,594,953	13,781,228	1,871,409	1,854,968
Utah	22,674,673	3,611,399	641,690	641,690
Vermont	3,792,854	461,551	83,579	78,743
Virginia	65,164,000	10,723,000	1,486,768	1,375,894
Washington	54,322,900	-179,100	1,545,600	967,900
West Virginia	13,642,584	4,968,709	481,703	510,258
Wisconsin	77,412,000	252,600	644,800	644,800
Wyoming	6,989,764	1,444,353	163,994	108,017

NOTE: All figures listed above for Ohio are for 2007. The 2008 contribution figures for Ohio are $2,263,766 (actuarially required) and $2,262,847 (actual).

SOURCE: Pew Center on the States, 2010.

Health Care and Other Non-pension Benefits

- Retiree health care and other non-pension benefits create another huge bill coming due: a $587 billion total liability to pay for current and future benefits, with only $32 billion—or just over 5 percent of the total cost—funded as of fiscal year 2008. Half of the states account for 95 percent of the liabilities.
- In general, states continue to fund retiree health care and other non-pension benefits on a pay-as-you-go basis—paying medical costs or premiums as they are incurred by current retirees. For states offering minimal benefits, this may cause little problem. But for those that have made significant promises, the future fiscal burden will be enormous.
- Only two states had more than 50 percent of the assets needed to meet their liabilities for retiree health care or other non-pension benefits: Alaska and Arizona (see Exhibit 2). Only four states contributed their entire actuarially required contribution for non-pension benefits in 2008: Alaska, Arizona, Maine and North Dakota.
- Both health care costs and the number of retirees are growing substantially each year, so the price tag escalates far more quickly than average expenditures. States paid $15 billion for non-pension benefits in 2008. If they had started to set aside funding to pay for these long-term benefits on an actuarially sound basis, the total payments would have been $43 billion.

Investment Losses and Future Implications

- The recession, which officially began in December 2007, dealt a severe blow to all state pension systems. In calendar year 2008, public sector pension plans experienced a median 25 percent decline in their investments.[9] These losses generally are not fully reflected in the fiscal year 2008 data, because most state pension systems use a fiscal year that ends on June 30.
- A look at the 2008 investment losses for a selection of states suggests that despite the improvement in the market in 2009, the financial picture for states' retirement systems in fiscal year 2009 and beyond will be considerably worse (see Exhibit 3).
- All but three states—Idaho, Oregon and West Virginia—use a smoothing process in which investment gains and losses are recognized over a number of years.[10] Smoothing is a way of managing state expenditures by preventing contribution rates from suddenly jumping or dropping. The number of smoothing years varies, with five years being the most common. Because only a portion of the 2008 losses will be recognized each year, there is a great likelihood that pension funding levels will be dropping for the next four to five years. This is what happened after state pension systems sustained the less extreme investment losses associated with the market downturn of 2001-2003.[11] Although investment returns were generally very good in 2004, 2005 and 2006, the funding levels for most pension systems continued on a downward path until 2007, when investment returns were strong and the bad years began to drop out of the calculations.
- Given the experience of the past decade, pension plan investment losses in 2008 raise the question of whether it remains reasonable for states to count on an 8 percent investment return over time—the most common assumption for all 231 state-administered pension plans examined for this report. Some experts in the field suggest that an assumed 8 percent yield is unrealistic for the near future.[12] In addition, it will take consistently higher levels of investment returns over a number of years for states to make up their losses from 2008 and 2009.

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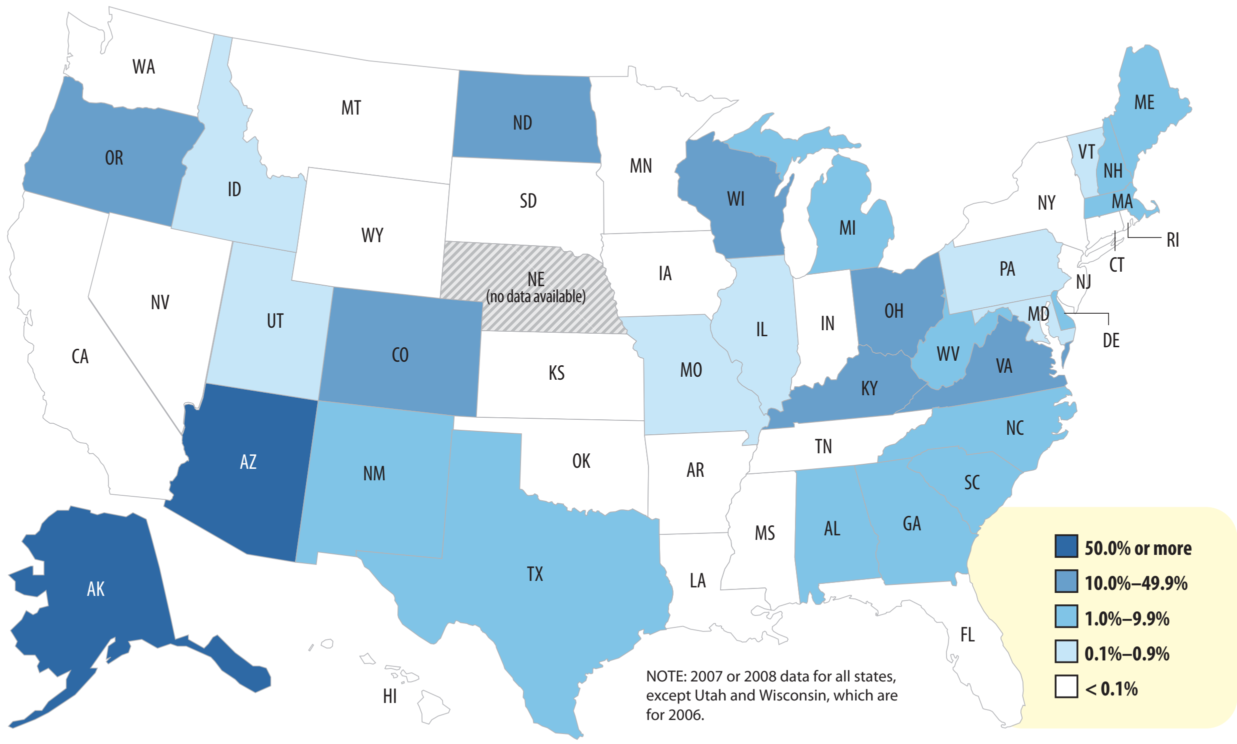
Exhibit 2

STATE RETIREE HEALTH CARE AND OTHER NON-PENSION BENEFITS



Figures are in thousands.

State	Latest liability	Latest unfunded liability	Annual required contribution	Latest actual contribution
Alabama	$15,950,194	$15,549,411	$1,313,998	$1,107,831
Alaska	9,146,629	4,032,052	558,041	600,003
Arizona	2,322,720	808,818	146,198	146,198
Arkansas	1,822,241	1,822,241	170,177	38,119
California	62,466,000	62,463,000	5,178,789	1,585,295
Colorado	1,385,954	1,127,179	81,523	25,877
Connecticut	26,018,800	26,018,800	1,718,862	484,467
Delaware	5,489,000	5,409,600	464,600	176,548
Florida	3,081,834	3,081,834	200,973	87,825
Georgia	19,100,171	18,322,123	1,583,008	422,157
Hawaii	10,791,300	10,791,300	822,454	299,466
Idaho	493,746	489,421	45,494	17,695
Illinois	40,022,030	39,946,678	1,192,336	159,751
Indiana	442,268	442,268	45,963	10,218
Iowa	404,300	404,300	42,991	16,613
Kansas	316,640	316,640	16,039	5,105
Kentucky	13,008,572	11,660,245	1,051,372	259,912
Louisiana	12,542,953	12,542,953	1,168,087	269,841
Maine	4,399,800	4,347,702	164,045	196,053
Maryland	14,842,304	14,723,420	1,086,240	390,319
Massachusetts	15,305,100	15,031,600	838,700	701,992
Michigan	40,668,800	39,878,500	3,946,416	1,207,746
Minnesota	1,011,400	1,011,400	109,982	46,677
Mississippi	570,248	570,248	43,627	0
Missouri	2,867,472	2,851,826	262,215	151,629

State	Latest liability	Latest unfunded liability	Annual required contribution	Latest actual contribution
Montana	$631,918	$631,918	$58,883	$0
Nebraska does not calculate its liability for retiree health care and other benefits.				
Nevada	2,211,439	2,211,439	287,217	59,167
New Hampshire	3,229,375	3,054,188	268,848	112,038
New Jersey	68,900,000	68,900,000	5,022,100	1,249,500
New Mexico	3,116,916	2,946,290	286,538	92,121
New York	56,286,000	56,286,000	4,133,000	1,264,000
North Carolina	29,364,734	28,741,560	2,459,469	597,176
North Dakota	123,776	81,276	6,085	6,450
Ohio	43,759,606	27,025,738	2,717,364	855,937
Oklahoma	359,800	359,800	48,200	0
Oregon	868,393	609,793	67,126	45,385
Pennsylvania	10,048,600	9,956,800	823,500	745,600
Rhode Island	788,189	788,189	46,125	28,378
South Carolina	8,791,792	8,638,076	762,340	241,383
South Dakota	76,406	76,406	9,429	3,505
Tennessee	1,746,879	1,746,879	167,787	63,140
Texas	29,340,584	28,611,584	2,236,952	592,507
Utah	677,499	672,843	53,969	53,289
Vermont	1,618,245	1,614,581	107,506	17,776
Virginia	3,963,000	2,621,000	541,163	446,321
Washington	7,901,610	7,901,610	682,797	156,294
West Virginia	6,362,640	6,108,398	174,842	143,582
Wisconsin	2,237,204	1,700,396	205,116	90,134
Wyoming	174,161	174,161	19,292	7,324

SOURCE: Pew Center on the States, 2010.

How States Have Responded

For many years, lawmakers in a number of states put off dealing with the challenges posed by their public sector retirement systems. But for many governors and state legislators, a convergence of factors has made the issues too critical to ignore. Policy makers that have underfunded their states' liabilities in the past now find they owe far more annually as a result—and if they postpone paying the bill any longer, the debt will increase even more significantly. This will leave their states, and tomorrow's taxpayers, in even worse shape, since every dollar needed to feed that growing liability cannot be used for education, health care or other state priorities. Steep investment losses in pension plan funds in the past two years signal that states cannot simply sit back and hope the stock market delivers returns large enough to cover the costs. Meanwhile, more and more baby boomers in state and local government are nearing retirement, and many will live longer than earlier generations—meaning that if states do not get a handle on the costs of post-employment benefits now, the problem likely will get far worse, with states facing debilitating costs.

Momentum for reform is building. Fifteen states passed legislation to reform some aspect of their state-run retirement systems in 2009, compared with 12 in 2008 and 11 in 2007. States similarly enacted a series of reforms following the 2001 recession, with 18 states making changes in 2003, compared with only five in 2002 and nine in 2001.[13] And many states are likely to explore options in their 2010 legislative sessions. At least a third of the states have study commissions, task forces or other research initiatives to examine the possibilities for reform.

Because there are legal restrictions on reducing pensions for current employees in most states, the majority of changes in the past two years were made to new employee benefits. Ten states increased the contributions that current and future employees make to their own benefit

Exhibit 3

INVESTMENT LOSSES IN 2008 FOR SELECT STATE PENSION PLANS

State	Plan name	2008 percentage investment loss
Pennsylvania	Pennsylvania State Employees' Retirement System	–28.7%
Ohio	Ohio Public Employees Retirement System	–26.8%
Pennsylvania	Pennsylvania Public School Employees' Retirement System	–26.5%
California	California Public Employees' Retirement System	–23.0%
Illinois	Teachers' Retirement System of the State of Illinois	–22.3%
Oregon	Oregon Public Employees Retirement System	–22.2%
Indiana	Indiana Employees' Retirement Fund	–21.0%
Virginia	Virginia Retirement System	–21.0%
Maryland	State Retirement and Pension System of Maryland	–20.0%
Missouri	Missouri Public School Retirement System	–19.3%
New Jersey	New Jersey Division of Pensions and Benefits	–19.0%
North Carolina	North Carolina Retirement Systems	–14.0%
Georgia	Georgia Teachers Retirement System	–13.1%

SOURCE: Pew Center on the States, 2010.

systems, while ten states lowered benefits for new employees or set in place higher retirement ages or longer service requirements.[14] (See Exhibit 4.)

Reforms largely fell into five categories: 1) keeping up with funding requirements; 2) reducing benefits or increasing the retirement age; 3) sharing the risk with employees; 4) increasing employee contributions; and 5) improving governance and investment oversight.

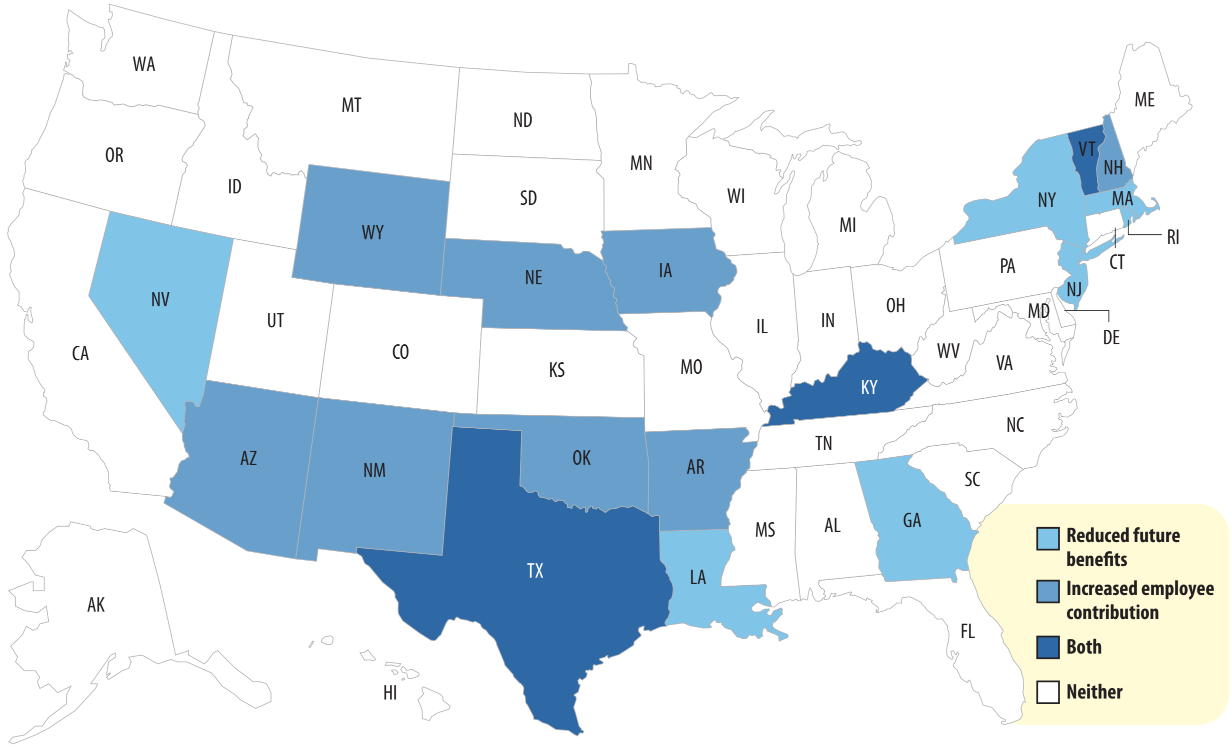
Keeping up with funding requirements

Generally, the states in the best shape are those that have kept up with their annual funding requirements in both good times and bad. In some states, such as Arizona, a constitutional or statutory requirement dictates that this payment is made. In early 2008, Connecticut issued a $2 billion bond to help fund the teachers' pension system, with a covenant that required the state to fully fund that plan based on actuarial assessments.

Making the payment required by actuaries is only part of the battle. States also need to make sure the assumptions used in calculating the payment amount are accurate—for example, estimating the lifespan of retirees or the investment returns they expect. As noted earlier, some states are now questioning whether, over the long term, investment return assumptions have been too optimistic. In 2008, Utah reduced its investment assumption from 8 percent to 7.75 percent,[15] and in 2009 the Pennsylvania State Employees Retirement System lowered its assumption from 8.5 percent to 8 percent.[16] Although the median investment return for pension plans over the past 20 years averaged over 8 percent, some experts in the field, including

Exhibit 4

STATE PENSION POLICY REFORMS, 2008–2009



SOURCE: Pew Center on the States, 2010.

renowned financier and investor Warren Buffett, believe even those assumptions are too high.[17] By comparison, the Financial Accounting Standards Board requires that private sector defined benefit plans use investment return assumptions based on the rates on corporate bonds. As of December 2008 the top 100 private pensions had an average assumed return of 6.36 percent.[18]

Reducing benefits or increasing the retirement age

Several states reduced benefits for new employees either by altering the pension formula or raising retirement ages.

In 2008 and 2009, Kentucky, Nevada, New Jersey, New York, Rhode Island and Texas reduced benefits offered to new employees or raised the retirement age, according to NCSL.[19]

For example, in Nevada, employees hired after January 1, 2010, will have their annual pension benefits calculated using a new formula. In the past, the state multiplied the number of years of service by 2.67 to derive the percentage of salary to be replaced by pension benefits. That number has dropped to 2.5 percent. Nevada's employees also will have to work until age 62, instead of age 60, to retire with 10 years of service.

New York lawmakers in December raised the minimum retirement age from 55 to 62 for new hires, increased the minimum years of service required to draw a pension from five years to 10, and capped the amount of overtime used in calculating benefits. Teachers have a separate benefit structure that raises the minimum retirement age from 55 to 57, boosts the employee contribution rate from 3 percent to 3.5 percent of annual wages and increases the 2 percent multiplier threshold for pension calculations from 20 to 25 years.[20]

Rhode Island went a step further than other states by applying its change in retirement age to current workers, not just new ones. New workers will have a retirement age of 62, up from 60, while the minimum retirement age for current workers will depend on their length of service.

Overall, four states took legislative action to reduce retiree health care and other non-pension benefits for employees in 2008, and seven did so in 2009. Vermont, for example, changed the vesting period for receiving full health care benefits so that a new employee now has to work 10 years to receive 40 percent coverage on health premiums and 20 years to get the full 80 percent coverage. Employees hired before July 1, 2008, only have to work five years to qualify for 80 percent coverage.[21]

Some additional states reduced retiree health care benefits through administrative or executive branch actions. For instance, West Virginia's Public Employees Insurance Agency decided last summer that it would no longer pay its share of the premium for employees hired after July 1, 2010. It paid 71 percent of the costs for employees hired before that date. Several lawsuits have been filed in response.

In the past, some states such as Georgia, North Carolina and Tennessee required that any proposals that will affect pension benefits or costs receive a full actuarial analysis to determine its long-term price tag.[22] This goes for changes in retirement ages, cost-of-living adjustments, any change in the time needed to vest in a system, or any adjustment to the pension formula. In 2008, California passed a law that requires both state and local decision-making bodies to review potential future costs before increasing any non-pension benefits. It also requires actuaries to be present when pension benefit increases are discussed.

Forcing policy makers to responsibly identify the cost and potential funding sources for benefit increases can help states avoid offering unfunded benefit hikes. State and local governments still can offer or increase benefits, but this additional step ensures that costs will be thoroughly considered in advance. Although such reforms will not reduce existing liabilities, they can keep state policy makers from making the funding situation worse.

Sharing the risk with employees

A few states have taken a step toward sharing more of the risk of investment loss with employees by introducing benefit systems that combine elements of defined benefit and defined contribution plans. These hybrid systems generally offer a lower guaranteed benefit, while a portion of the contribution—usually the employees' share—goes into an account that is similar to a private sector 401(k). For example, Nebraska's "cash balance" plan, enacted in 2003, is described by one state official as a "defined benefit plan, with a defined contribution flair."[23] As in a traditional defined contribution account, the employee's payout on retirement is based on what is in the account, not on a set benefit. But some protection is offered to employees through a guaranteed annual investment return of 5 percent.

In 2008, Georgia introduced its own hybrid system for new employees hired after January 1, 2009. The defined benefit portion provides about half the benefit of the plan for employees hired before that point, but there also is a defined contribution portion in which the state matches employee contributions in a 401(k)-style savings plan. New employees automatically are enrolled in the savings plan at a 1 percent contribution rate, but may opt out at any time.[24]

No states moved completely away from defined benefit plans in the past two years.[25] The last two that took any steps in this direction were Alaska, which moved new employees to a defined contribution plan in 2005, and Michigan, which moved new state employees to a defined contribution approach in 1997. In light of severe investment losses in 2008 and 2009 that resulted in decreased pension funding levels, policy makers are once again openly discussing defined contribution plans. Louisiana lawmakers, for instance, are looking at the recommendations of a pension panel that studied making this switch.[26] Other states where this has been mentioned by policy makers include Florida, Kansas and Utah.[27] Because unions and other employee representatives often have vigorously opposed defined contribution plans, it is unclear whether any state will find such a switch viable, or if such plans are primarily being proposed as a starting point for hybrid plans or other compromises.

Increasing employee contributions

Employees already contribute about 40 percent of non-investment contributions to their own retirement. But states are looking toward their workers to pay for a larger share. In many states, the employee contribution is fixed at a lower rate than the employer contributions. But some states have more flexibility. In Arizona, for example, the pension system is designed so that general (non-public safety) employees and employers each pay equal shares of the annual contribution. If the employer contribution goes up, so does the employee's. According to Arizona pension officials, this tends to increase the attention that employees give to the health of the pension system and increases pressure to keep it well funded.[28]

Some states, such as Iowa, Minnesota and Nebraska, have the ability to raise employee pension contributions if needed. Iowa and Minnesota have been raising employee contribution rates in the past several years, and in 2009, Nebraska increased its employee contribution rates for individuals in its defined benefit plans. Last year, New Mexico temporarily shifted 1.5 percent of the employer's contribution to employees.[29] New Hampshire and Texas increased payroll contributions required from new employees.[30]

Several states also began asking employees and retirees to start making contributions for their retiree health care benefits. In 2008, Kentucky required new employees to contribute 1 percent of their pay to help fund their post-retirement health care and other non-pension benefits. In 2009, New Hampshire established a $65 monthly charge for retired employees under 65 who are covered by retiree health insurance. And Connecticut will now require new employees, and current employees with fewer than five years of service,[31] to put in 3 percent of their salaries.[32]

Governance and investment oversight

In recent years, some states have sought to professionalize the complex task of pension investments by shifting oversight away from boards of trustees to specialized bodies that focus on investment. For example, Vermont moved investment oversight from its pension boards to an entity called the Vermont Pension Investment Committee, which includes a representative elected by each of three boards and the state treasurer as an ex-officio member.[33] The change was designed to bring a higher level of expertise to the body responsible for investing the pension assets, to combine the assets of the three retirement systems to realize administrative savings, and to be able to act more quickly when making changes to the actual investment allocations.

Pension systems also have continued to improve governance practices to ensure that the board of trustees is well trained, that the division of responsibilities between board and staff makes sense, and that the composition of the board is balanced between members of the system and individuals who are independent of it. Several pension reform commissions are considering reforms similar to those enacted by Oregon in 2003, heightening qualifications for trustees and shifting membership so that boards are not dominated by pension recipients.

In 2009, some reforms grew out of specific problems that states had with investment practices or because of ethical questions that were raised. Illinois, for instance, put in place a number of protections to ensure that pension trustees, employees and consultants are barred from benefiting from investment transactions. More competitive processes for procuring consulting and investment services were introduced, and the state's pension systems were required to review the performance of consultants and managers and to establish ways of comparing costs.[34]

Grading the States

Based on all of this information, Pew graded all 50 states on how well they are managing their public sector retirement benefit. (See individual fact sheets for each of the 50 states at www.pewcenteronthestates.org/trilliondollargap.)

Pensions

Pew assessed states' pension systems on three criteria and awarded each state up to four points: two points for having a funding ratio of at least 80 percent; one point for having an unfunded liability below covered payroll; and one point for paying on average at least 90 percent of the actuarial required contribution during the past five years.

States earning four points were solid performers. Those earning two or three points were deemed in need of improvement. And those earning zero or one point were labeled as meriting serious concerns.

Overall, 16 states were solid performers, 15 states were in need of improvement and 19 states were cause for serious concerns (see Exhibit 5). All 16 states that were assessed as solid performers had funding levels over the 80 percent threshold, had manageable unfunded liabilities, and had contributed on average at least 90 percent of the actuarially required contribution during the past five years. Eight states—Alaska, Colorado, Illinois, Kansas, Kentucky, Maryland, New Jersey and Oklahoma—received no points, having failed to make any meaningful progress toward adequately funding their pension obligations.

Exhibit 5
HOW ARE STATES DOING?

PENSIONS

Grade	Number of states	
SOLID PERFORMER	16	AZ, AR, DE, FL, GA, ID, ME, MT, NE, NY, NC, OH, SD, TN, UT, WI
NEEDS IMPROVEMENT	15	AL, CA, IA, MI, MN, MO, NM, ND, OR, PA, TX, VT, VA, WA, WY
SERIOUS CONCERNS	19	AK, CO, CT, HI, IL, IN, KS, KY, LA, MD, MA, MS, NV, NH, NJ, OK, RI, SC, WV

RETIREE HEALTH CARE AND NON-PENSION BENEFITS

Grade	Number of states	
SOLID PERFORMER	9	AK, AZ, CO, KY, ND, OH, OR, VA, WI
NEEDS IMPROVEMENT	40	AL, AR, CA, CT, DE, FL, GA, HI, ID, IL, IN, IA, KS, LA, ME, MD, MA, MI, MN, MS, MO, MT, NV, NH, NJ, NM, NY, NC, OK, PA, RI, SC, SD, TN, TX, UT, VT, WA, WV, WY

NOTE: Nebraska does not provide any estimates of its retiree health care and other non-pension benefits obligation.

SOURCE: Pew Center on the States, 2010.

Health Care and Other Non-pension Benefits

Pew's criteria for grading states' retiree health care and other non-pension benefit obligations were much simpler and more lenient than those used for the pension assessment. This is because states generally have set aside little funding to cover the costs of these obligations and because they only recently began to report on their non-pension assets and liabilities. In fact, states have an average funding rate of 7.1 percent—and 20 states have funded none of their liability.

Because most states have only recently begun to account for and address these liabilities, Pew's grades measure the progress they are making toward pre-funding future benefit obligations. As a result, a "serious concerns" grade was not included. Pew rated as solid performers states that were above average at setting aside funds to cover the bill coming due. States below average were identified as needing improvement.

Nine states earned the designation of being solid performers: Alaska, Arizona, Colorado, Kentucky, North Dakota, Ohio, Oregon, Virginia and Wisconsin. Only two of those—Alaska and Arizona—have set aside at least 50 percent of the assets needed. Forty states were in need of improvement, having put away less than 7.1 percent of the funds needed—and, as noted above, half of these have not set aside any funds at all. (Nebraska subsidizes retiree health benefits however the state has not calculated the amount of this obligation and therefore was not graded. See Exhibit 5.)

NOTES

[1] Pew Center on the States analysis of 231 state-administered pension plans and 159 retiree health care and other benefits plans. See Appendix A for more details on how data were collected and calculations were conducted.

[2] Keith Brainard, "Public Fund Survey Summary of Findings for FY2008," National Association of State Retirement Administrators, October 2009, p. 2. www.publicfundsurvey.org/publicfundsurvey/index.htm. (accessed January 29, 2010).

[3] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits*, December 2007, p. 6.

[4] At the time of publication of the 2007 report, a full set of figures for 2006 was not available. As noted in the methodology, "latest available" is the plan year ending in 2008 for all states except for Ohio, which were not available at the time of publication.

[5] National Conference of State Legislatures, *State Budget Update: November, 2009*. December 2009. Investment returns comprise between 70 percent and 80 percent of pension plan funding when times are good, with employee and employer contributions making up the rest. In bad investment years, such as 2002 and 2008, investment returns are negative and employees and employers contribute all the money that goes to cover pension plan costs. In general, approximately 60 percent of non-investment contributions to pension plans comes from employers and 40 percent comes from employees." Employee Benefit Research Institute, "Public Pension Plan Asset Allocation," Notes 30, no. 4. April 2009, p. 2; at http://www.ebri.org/pdf/notespdf/EBRI_Notes_04-Apr09.PblcPnsPlns1.pdf. (accessed on January 25, 2010).

[6] Pew Center on the States researchers also took the extra step of cross checking our data with the Public Fund Survey (see www.publicfundsurvey.org/publicfundsurvey/index.htm), which collects pension data directly from the states.

[7] U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate, September 2007.

[8] The funding levels in Alabama and Maryland were above 80 percent in 2006 but fell below 80 percent in 2008.

[9] Keith Brainard, "Public Fund Survey Summary of Findings for FY2008," National Association of State Retirement Administrators, October 2009, p. 2. www.publicfundsurvey.org/publicfundsurvey/index.htm. (accessed on January 29, 2010).

[10] Through 2008, Illinois also was among the small group of states in which asset value was assessed on a fair market basis. It shifted to a five-year smoothing period in 2009. Also, South Dakota smoothes its investment gains but accounts for its losses based on market value.

[11] *Economic Report of the President: 2009 Report Spreadsheet Tables*, Tables B95 and B96; accessed January 4, 2010, at http://www.gpoaccess.gov/eop/tables09.html. The market started to rebound by the end of calendar year 2003.

[12] "Warren Buffett Says That Pension Accounting Encourages Cheating," Bloomberg.com, July 17, 2009, accessed on December 4, 2009, at www.bloomberg.com/apps/news?pid=10000103&sid=aCb9PTevRP3g&refer=news_index.

[13] National Conference of State Legislatures, "Pension and Retirement Plan Enactments in State Legislatures," (2000 through 2009). www.ncsl.org/?tabid=13399.

[14] Pew Center on the States analysis based on National Conference of State Legislatures, "Pension and Retirement Plan Enactments in State Legislatures," for 2008 and 2009, and a review of governors' and state legislative Web sites (October 1, 2009, to December 3, 2009), as well as interviews conducted June 1, 2009, to December 31, 2009.

[15] This sounds like a minor change, but the impact is significant. This simple action reduced the state's funding level from 101 percent funded to 95 percent funded. An increase in the interest rate assumption to 8.5 percent would have caused the funding level to rise to 113 percent. The new interest rate assumption will cause contributions to go up in the short term, but Utah officials believe this is a more accurate portrayal of what the state will earn on its investments over time.

[16] Pew Center on the States interview with Leonard Knepp, executive director, Pennsylvania State Employee Retirement System, June 24, 2009.

[17] Median investment returns for public retirement plans between 1989 and 2008 are provided Callan Associates, a large investment consulting firm based in San Francisco, CA. "Warren Buffett Says That Pension Accounting Encourages Cheating," Bloomberg.com, July 17, 2009, accessed on December 4, 2009, at www.bloomberg.com/apps/news?pid=10000103&sid=aCb9PTevRP3g&refer=news_index. Mr. Buffett was referring to private sector pension assumptions.

[18] Watson Wyatt, "Insider: Watson Wyatt Pension 100—2008 Disclosures of Funding, Discount Rates, Asset Allocations and Contributions," April 2009. www.watsonwyatt.com/us/pubs/insider/showarticle.asp?ArticleID=20764.

[19] Pew Center on the States interview with Cynthia Webster, Vermont State Employees Retirement System, November 2, 2009.

[20] Governor David A. Paterson, news release, December 2, 2009, accessed December 4, 2009, at http://www.state.ny.us/governor/press/press_1202092.html.

[21] National Conference of State Legislatures, "State Pensions and Retirement Legislation 2009," accessed December 4, 2009, at www.ncsl.org/?tabid=17594; *Pensions and Retirement Plan Enactments in 2008 State Legislatures*, accessed December 4, 2009, at http://www.ncsl.org/default.aspx?tabid=13313.

[22] Pew Center on the States interviews with Michael Williamson, director, North Carolina Retirement System, September 2, 2009; Tommy Hills, chief financial officer, Georgia, November 18, 2009; and Jill Bachus, director, Tennessee Consolidated Retirement System, September 3, 2009.

[23] Pew Center on the States interview with Phyllis Chambers, director, Nebraska Public Employees Retirement Systems, October 6, 2009.

[24] E-mail from Pamela Pharris, executive director, Georgia Employees Retirement System, December 15, 2009.

[25] National Conference of State Legislatures, "State Pensions and Retirement Legislation 2009," accessed December 4, 2009, at www.ncsl.org/?tabid=17594; "Pensions and Retirement Plan Enactments in 2008 State Legislatures," accessed December 4, 2009, at http://www.ncsl.org/default.aspx?tabid=13313.

[26] Ronald K. Snell, "State Pensions and Retirement Legislation 2009," National Conference of State Legislatures, August 17, 2009. www.ncsl.org/?tabid=17594. (accessed on January 29, 2010).

[27] Bill Cotterell, "Fasano Says Goodbye Pensions, Hello Savings," *Tallahassee Democrat*, November 16, 2009; "Parkinson Puts Major KPERS Changes on the Table," *Lawrence (Kan.) Journal World* (Associated Press), September 10, 2009; "Lawmaker: Utah's Retirement System Must Change," *The Salt Lake City Tribune*, November 13, 2009; Barry Poulson and Arthur Hall, "The Funding Crisis in the Kansas Public Employee Retirement System," Center for Applied Economics, University of Kansas, September 2009.

[28] Pew Center on the States interview with Paul Matson, executive director, Arizona Retirement System, June 25, 2009.

[29] Pew Center on the States interviews with Donna Mueller, chief executive officer, Iowa Public Employees Retirement System, August 4, 2009; David Bergstrom, executive director, Minnesota State Retirement System, September 8, 2009; Phyllis Chambers, executive director, Nebraska Public Employee Retirement Systems, October 6, 2009; Terry Slattery, executive director, New Mexico Public Employees Retirement Association, September 14, 2009.

[30] National Conference of State Legislatures, "Pension and Retirement Plan Enactments in State Legislatures," accessed December 4, 2009, at http://www.ncsl.org/default.aspx?tabid=13313.

[31] For employees with fewer than five years of service as of July 1, 2009, the 3 percent contribution will begin July 1, 2010.

[32] E-mail from William Morico, Connecticut Retirement and Benefit Services coordinator, Healthcare Policy and Benefit Services Division, November 18, 2009.

[33] Pew Center on the States interview with Cynthia Webster, Vermont State Employees Retirement System, November 2, 2009.

[34] National Conference of State Legislatures, "State Pensions and Retirement Legislation 2009," accessed December 4, 2009, at www.ncsl.org/?tabid=17594.

The Bill Coming Due: A Trillion Dollar Gap

The Challenge

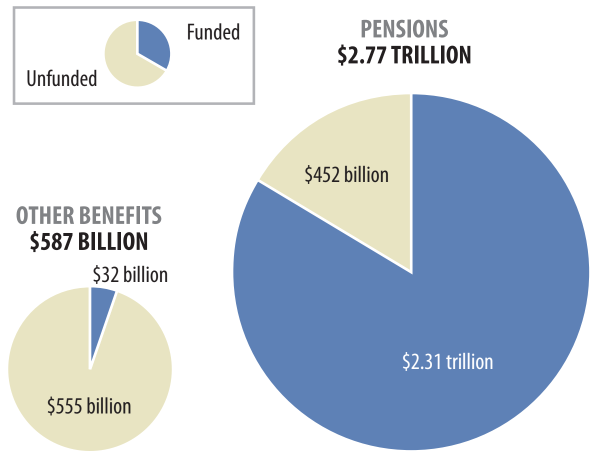
An analysis by the Pew Center on the States shows that states and participating local governments face a collective liability of more than $3.35 trillion for the pensions, health care and other retirement benefits promised to their public sector employees. They have put away $2.35 trillion in assets to pay for those promises—leaving a shortfall of more than $1 trillion that state and local governments will have to pay in the next 30 years.[35] That amounts to more than $8,800 for every household in the United States.[36] (See Exhibit 6.)

Pew's figure actually is conservative for two reasons. First, it counts total assets in states' public sector retirement benefit systems at the end of fiscal year 2008, which for most states ended on June 30, 2008—so the total does not represent the second half of that year, when states' pension fund investments were devastated by the collapse of the financial markets. Second, most states' retirement systems allow for "smoothing" of gains and losses over time, meaning that the pain of investment declines will be recognized over the course of several years. The funding gap will likely increase when that loss—more than 25 percent in calendar year 2008—is factored in.[37]

Exhibit 6

50-STATE RETIREE BILL

The pension bill is much larger than that of other benefits, but it is 84 percent funded; the bill for other benefits is only 5 percent funded.



SOURCE: Pew Center on the States, 2010.

Pensions

States' pension bills come due over time, including both benefits that will be paid out next year and those that will be provided several decades in the future. These long-term liabilities represent obligations to current employees and retirees that will keep growing over time—which is why assets need to be put aside now to cover them.

Actuarially Required Contribution

Also known as the annual required contribution, this is the amount of money that actuaries calculate the employer needs to contribute to the plan during the current year for benefits to be fully funded by the end of a span of time of up to 30 years, known as the amortization period. This calculation assumes the employer will continue making the actuarially required contribution on a consistent basis and that actuarial assumptions, such as investment returns and rates of salary growth, will be reasonably accurate. This contribution is made up of the "normal cost" (sometimes referred to as the "service cost")—the cost of benefits earned by employees in the current year—and an additional amount that will enable the government to reduce unfunded past service costs to zero by the end of the amortization period. Making the full or almost full actuarially required contribution in any given year signifies that a state is making a serious effort to pay its bill coming due. The total actuarially required contribution for all state-run retirement plans for fiscal year 2008 was $64.4 billion. States paid 89.6 percent of that payment.

States know how much money they should be putting away each year to cover pension obligations for current and future public sector retirees. The "actuarially required contribution" is the amount of money that the state needs to pay to the plan during the current year for benefits to be fully funded in the long run, typically 30 years. Although it is called a "required" contribution, in many states funding is at the discretion of the legislature. In fiscal year 2008, states should have committed $64.4 billion to their pension plans. They ended up paying just $57.7 billion, or 89.6 percent, of that amount.

Pew's analysis shows that in fiscal year 2008, states' pension plans had $2.8 trillion in long-term liabilities. Total liabilities have grown over $323 billion since 2006, outpacing asset growth by more than $87 billion. Pew found that, in the aggregate, states' systems in fiscal year 2008 were 84 percent funded. This is relatively good news: Many experts in the field, including the U.S. Government Accountability Office, suggest that a healthy system is one that is at least 80 percent funded.[38] However, this is slightly down from an 85 percent funding level in fiscal year 2006. The actual shortfall, almost $452 billion, is substantial.

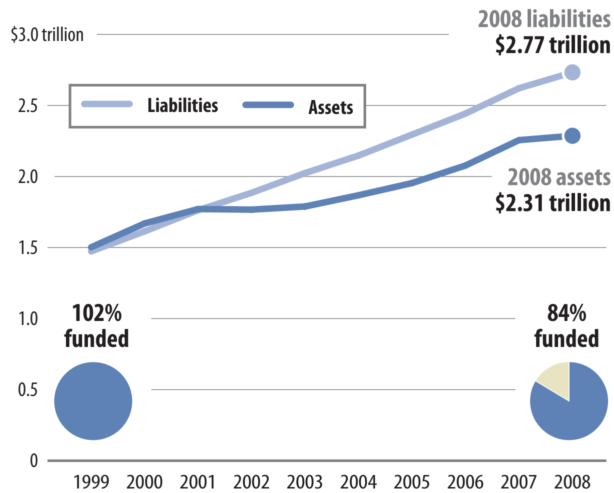
One way to understand the magnitude of the unfunded liability is to compare it to the current annual payroll that is covered by the plan. States with a higher degree of excess are considered to have a higher burden. For fiscal year 2008, the unfunded liability exceeded covered payroll in 22 states. In four of these states, the excess was less than 10 percent. In seven states, the unfunded liability was more than twice the covered payroll.

The current pension shortfall reflects an overall downward trajectory in pension funding. In 2000, state-run pension plans were actually running a $56 billion surplus. From 2000 to 2008, growth in pension liabilities had outstripped growth in assets by more than $500 billion. In 2000, more than half the states were fully funded. By 2006, that number had shrunk to six states. By 2008, only Florida, New York, Washington and Wisconsin could make that claim. Furthermore, based on how investments have performed as well as on states' continuing shortfalls in making annual contributions, this trend will continue and the funding gap will grow if changes are not made (see Exhibit 7).

Exhibit 7

PENSION FUNDING OVER TIME

Funding was strong in 1999 and 2000, but has since been declining.



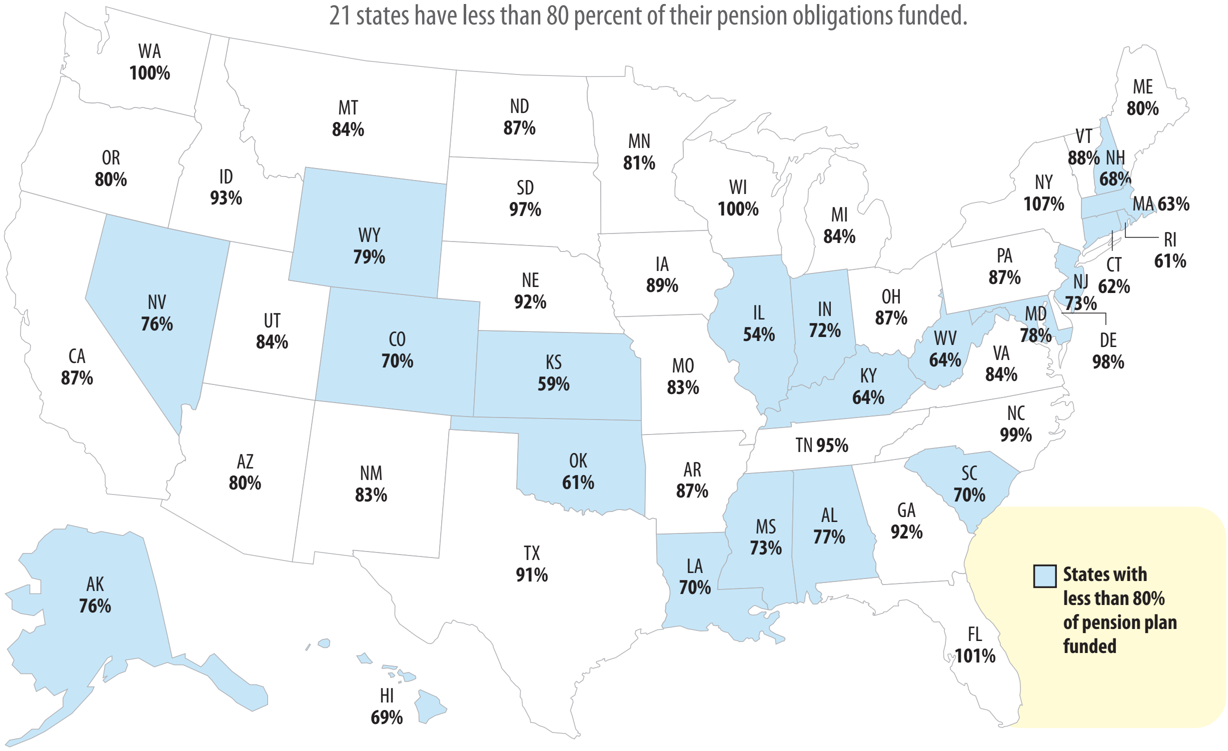
SOURCE: Pew Center on the States, 2010.

The aggregate numbers, while impressive, do not tell the whole story. States are performing dramatically differently in managing this bill coming due. States such as Florida, Idaho, New York, North Carolina and Wisconsin all entered the current recession with fully funded pensions. As a result, these states will be in a better position to keep their plans on a solid financial footing in the immediate future. But many other states are struggling. At the end of fiscal year 2008, 21 states had funding levels below the 80 percent mark, compared with 19 below that level in 2006 (see Exhibit 8).

Exhibit 8

LAGGARDS IN STATE PENSION FUNDING

21 states have less than 80 percent of their pension obligations funded.



SOURCE: Pew Center on the States, 2010.

In eight states—Connecticut, Illinois, Kansas, Kentucky, Massachusetts, Oklahoma, Rhode Island and West Virginia—more than one-third of the total liability was unfunded. Two states—Kansas and Illinois—had less than 60 percent of the necessary assets on hand to meet long-term pension obligations at the end of 2008.

Here is a snapshot of some of the states that had profound difficulties even before the Great Recession:[39]

- **Illinois.** The state in the worst shape in fiscal year 2008 was Illinois. With a combined funding level of 54 percent, the five pension systems of Illinois had accumulated a total liability of $119 billion, $54 billion of which was unfunded. To start closing that gap and covering future expenses, the state should have made an actuarially required payment of $3.7 billion in 2008. Instead, it contributed a little less than $2.2 billion, meaning that the state will face a bigger gap in 2009 even apart from investment losses. For Illinois, the unfunded liability is more than three times annual payroll costs.

- **Oklahoma.** The seven state-administered pension systems had a combined funding level of 60.7 percent in fiscal year 2008, a total liability of $33.5 billion and an unfunded liability that was 219 percent of total payroll. During the 1980s and 1990s Oklahoma increased benefits, but did not boost contributions enough to offset those increased liabilities.[40] By pushing the costs into the future, the state's actuarially required contribution has risen to almost 21 percent of payroll, annually. In addition, the state has lagged in making the required contributions, so funding levels would likely have continued on a downward path even without investment losses.

- **Rhode Island.** The four pension systems administered by Rhode Island had a combined funding level of 61.1 percent in fiscal year 2008, with a total liability of $11.2 billion and an unfunded liability that is close to three times payroll. While the state has made its actuarially required contributions in recent years, it is still trying to catch up. Rhode Island essentially operated its pension systems on a pay-as-you-go basis for nearly 40 years, ending that practice in the late 1970s.[41] The state recently increased the retirement age, instituted a new tier of lower benefits for new employees and tightened up requirements for disability pensions, among other changes.

- **Connecticut.** With a combined funding level of 61.6 percent, Connecticut's three pension systems had a total liability of $41.3 billion in fiscal year 2008 and an unfunded liability that is nearly four and a half times its annual payroll cost. Its current funding level reflects an improvement in the teachers' pension system, which received an infusion of cash in 2008 from a $2 billion, 24-year pension bond that was issued that year.[42] The state's current collective bargaining agreement lasts until 2017, which limits reform options.

- **Kentucky.** Kentucky's six pension systems had a combined funding level of 63.8 percent, and a total liability of $34 billion in fiscal year 2008. The Bluegrass State had an unfunded liability that was 234 percent of payroll. In 2000, the plans were well funded at 110 percent, but years of the state substantially underfunding its actuarially required contribution, plus significant benefit increases, led the funding level to plummet. This problem was compounded by unfunded, automatic cost-of-living adjustments for retirees' pensions and incentives that were offered for early retirement.[43]

- **Hawaii.** The Hawaii Employees Retirement System had a funding level of 68.8 percent, a total liability of almost $16.6 billion in fiscal year 2008 and an unfunded liability that was about one and one-third times its payroll. Hawaii had several problems that contributed to its underfunded pension status. Its legislature diverted about $1.7 billion from annual contributions in the early years of this decade. Also, until 2006, all employees were in a non-contributory system, which means they did not pay anything for their pensions. This system is being phased out, with a new contributory plan that began in 2006.

Retiree Health Care and Other Non-pension Benefits

Retiree health care and other non-pension benefits represent the other half of the challenge facing states: a $587 billion long-term liability, with only 5.44 percent of that amount, or almost $32 billion, funded as of fiscal year 2008.

Pew found that only two states have more than 50 percent of the assets needed to meet their liabilities for retiree medical or other non-pension benefits: Alaska and Arizona. An additional 19 states have funded between 1 percent and 50 percent of the assets needed to pay for these benefits (see Exhibit 9). Only four states contributed their entire actuarially required contribution for non-pension benefits in 2008: Alaska, Arizona, Maine and North Dakota.

For many years, states offered their retirees health care benefits without ever identifying the long-term costs. That changed in 2004 when the Governmental Accounting Standards Board created statements 43 and 45 that required governments to report on their long-term liabilities for retiree health care and other non-pension benefits.[44] Pew's 2007 report, *Promises* *with a Price*, provided the first 50-state assessment of the cost of these benefits by compiling valuation figures for large state plans.

As much as state pension systems vary, the range of liabilities for non-pension benefits is even greater. Some states, including Iowa, Kansas, North Dakota, South Dakota and Wyoming, have very minimal obligations. They generally do not provide retirees with help in paying premiums, but such states may allow retirees to be on the same plan as active employees, thereby incurring some costs associated with having older plan members who are likely to have more health problems. Other states, such as Arizona, Florida, Oklahoma and Virginia, have controlled costs by capping the amount of benefits paid.[45] Still others have developed different ways of handling this issue. For example, Iowa allows retiring employees to use a sick leave balance to buy into the employee health plan for the period before they are eligible for Medicare.[46]

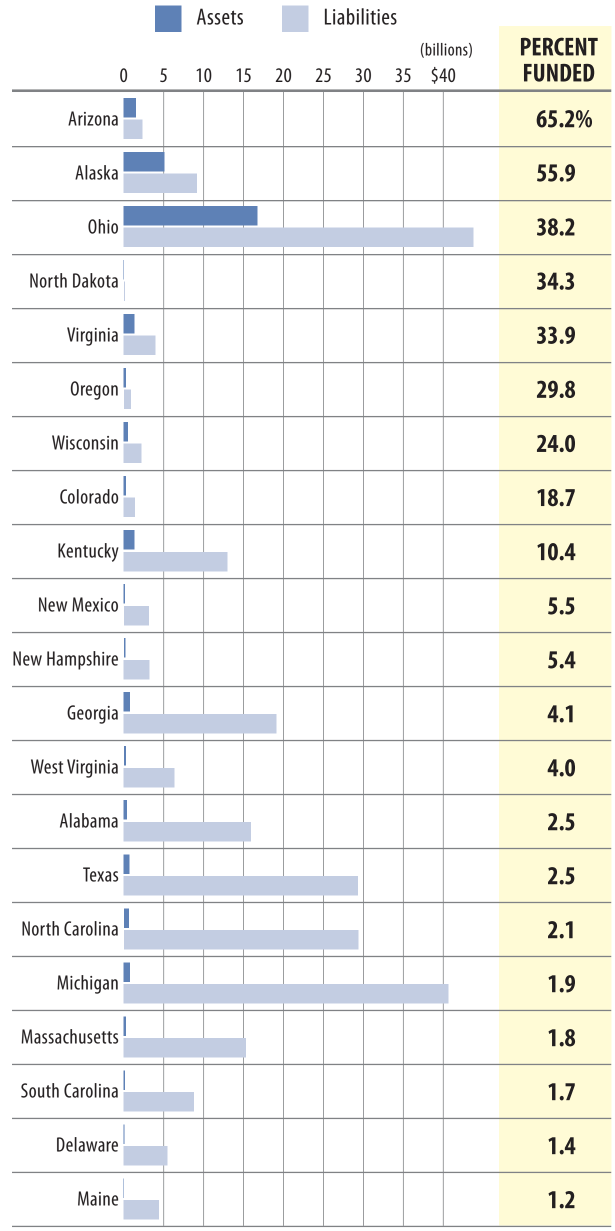
Some states have liabilities that are very large. In fact, a couple of the states with the largest retiree health liabilities also have the most underfunded pension systems. Connecticut has a $26 billion retiree health care liability with no funding set aside as of 2008 to deal with that long-term bill, and Hawaii has an unfunded $10 billion liability. Illinois has a nearly $40 billion liability with only $75 million in funding set aside.

Unlike pensions, states generally continue to fund retiree health and other non-pension benefits on a pay-as-you-go-basis—paying health care costs or premiums as they are incurred by current retirees. Some state officials argue that these liabilities are not as daunting as the pension bill, because there are fewer legal barriers to changing benefits or increasing employee contributions for retiree health care benefits. Still, because both medical costs and the number of retirees grow substantially each year, costs escalate far more quickly than average expenditures. States paid $15 billion for non-pension benefits in 2008. If they had funded these benefits on an actuarially sound basis by putting away adequate money to pay for future benefits, the total payments should have been $43 billion.

Exhibit 9

RETIREE HEALTH CARE AND OTHER NON-PENSION BENEFITS FUNDING

For all states that are at least 1 percent funded.



SOURCE: Pew Center on the States, 2010.

While paying more now may sound like an unattractive option to states, it will keep costs from jumping substantially in the future. A 2007 study found that if Nevada continued to follow a pay-as-you-go approach, the $49 million annual cost in 2009 would grow to $105 million a year in 2015.[47] Similarly, barring any change in benefit structure, Maine's $94 million annual payment in 2009 would grow to $151 million a year in 2015.[48] New Jersey's retiree health benefit plans were expected to pay out $1.4 billion in 2009 for medical care and drug costs; this would more than double to $3.1 billion in 2017 assuming no major reforms occurred.[49]

The Implications

In states with severely underfunded public sector retirement benefit systems, policy makers often have ignored the problem in the past. Today's decision-makers and taxpayers are left with the legacy of that approach: high annual costs that come with significant unfunded liabilities, lower bond ratings, less money available for services, higher taxes and the specter of worsening problems in the future.

To some extent, even with significantly underfunded systems, problems still can be put off. But policy makers who choose this course will leave their states—and tomorrow's taxpayers—in even worse shape. Each year that lawmakers delay taking action aggravates the problem in the future, putting the state at risk of major increases in annual costs.

Rhode Island's auditor general vividly illustrated the problems with a severely underfunded pension system in an audit released several years ago.[50] The report pointed out that the City of Cranston's Police and Fire Employees Retirement System had paid $21.7 million in 2006 for 505 individuals, the vast majority already retired. By contrast, the 110 local units of Rhode Island's Municipal Employees Retirement System collectively paid $20 million that year for plans that covered more than 14,000 individuals. Cranston's system was only 15 percent funded in 2006, while the units in the Rhode Island municipal system were 87 percent funded on average. At that point, the Cranston plan had run out of options. It had 98 active members and 407 retirees who legally had to be paid. By putting off payments for so long, the city eventually faced a debilitating annual bill.

To prevent situations like this, actuarially sound pension systems ensure that employees and employers contribute sufficient money on an annual basis to cover benefits that are earned that year. Those payments—"normal costs"—are calculated by actuaries using a variety of assumptions about investment rates, retiree life span, salary growth and many other factors.

In the rare instances where a plan has little or no unfunded liability, these normal costs make up the entirety of the actuarially required contribution. In those cases, as long as pension benefits are moderate, the annual contribution to the plan is a relatively low percentage of the plan's covered payroll. In North Carolina, for example, the actuarially required contribution was $675.7 million or 3.2 percent of payroll in fiscal year 2008. In Wisconsin, it was $644.8 million or 5 percent of payroll.

Unfunded liabilities develop when governments fail to provide funding as benefits are earned and also when inaccurate assumptions are used to calculate payment amounts. For states with underfunded pension systems, those annual costs become more expensive. That is because a second payment is added to the actuarially required contribution that is intended to eliminate the unfunded liability over a period of no more than 30 years, according to rules set by the Governmental Accounting Standards Board. In Connecticut, with its large unfunded liability, the aggregate actuarially required contribution for the three state-administered pension systems was nearly

$1.25 billion or 35.3 percent of payroll in fiscal year 2008. For Nevada's three systems, it was almost 1.3 billion or just over 24 percent of payroll.

When states do not meet the actuarially required contribution, the unfunded liability continues to rise (see Exhibit 10), and required payments in future years grow even larger.

The latest figures show that collectively states fell significantly short of their actuarially required contributions, skipping some $6.6 billion in pension payments and almost $28.2 billion in payments for retiree health care and other non-pension benefits. At the same time, unfunded pension liabilities went up by $87.8 billion. To cover this added amount during the next 30 years, assuming 8 percent investment returns, states will have to pony up an additional $7 billion in payments each year.

As the number of retirees increases over time, extremely underfunded systems confront an additional problem: their assets need to be kept more liquid to pay benefit checks. As a result, investment opportunities that can prove advantageous to a large investor with a long horizon are closed off. In Kentucky, the pension system's cash flow problems "definitely impact our ability to recover," said Mike Burnside, executive director of the Kentucky Retirement Systems. "If you have to focus on shorter-term investments and more liquid assets, you can't take advantage of the longer yield over the longer period of time."[51]

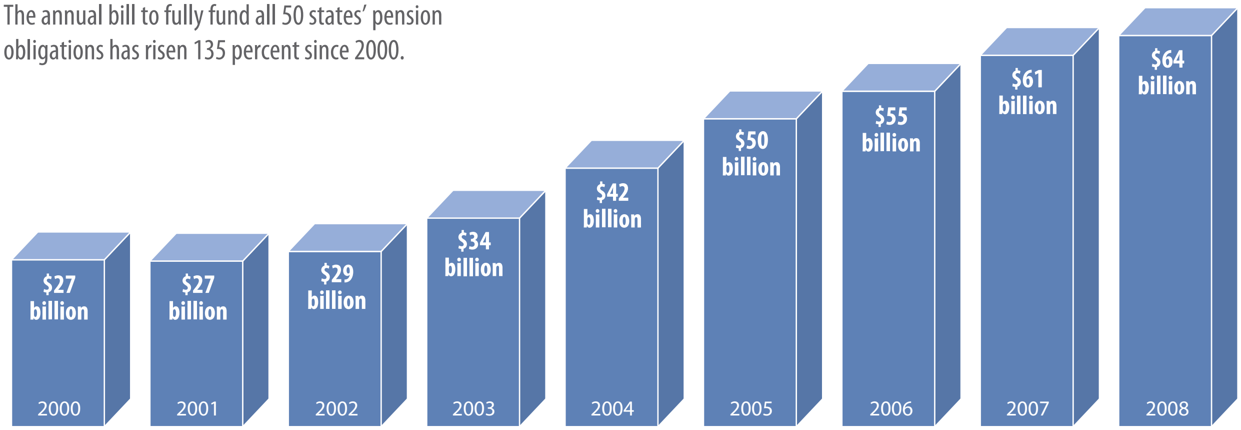
The Pressure Mounts

Some underfunded pension systems already were straining to increase contributions prior to the Great Recession. These increased contributions fall on the state and other public sector employers. For Oklahoma's state employers, for example, the state's pension contribution rates have been going up about 1 percentage point a year for the past five years. They are still falling short of what is necessary to meet actuarial demands. By 2010, the contribution reaches 15.5 percent of payroll, and current law has it topping out at 16.5 percent in 2011.[52] Illinois was able to contribute only about 58 percent of the $986.4 million it should have set aside in fiscal year 2008—and the burden continues to grow. For fiscal year 2010, Illinois' employer contribution went from 21.5 percent to 28.4 percent of payroll for the State Retirement Systems, which include state employees, judicial employees and the General Assembly.[53]

Exhibit 10

A GROWING BILL: 50-STATE TOTAL REQUIRED CONTRIBUTION

The annual bill to fully fund all 50 states' pension obligations has risen 135 percent since 2000.



SOURCE: Pew Center on the States, 2010.

In the vast majority of states, the effect of significant investment losses from 2008 and early 2009 have not yet been fully factored into contribution rates. But given the extent of the losses, it is likely that even states that have funded their pension plans well in the past will face large increases in annual payments.

Oregon provides a unique early warning of the impact of the dramatic drop in pension investments. It is one of 15 states in which the 2008 asset valuations for at least some of the plans were calculated as of the end of the calendar year and, as a result, show the effects of the devastating second half of the year. In addition, Oregon, like Idaho and West Virginia, calculates its pension assets based on fair market value. All the other plans smooth out their investment gains and losses over a set number of years, recording only a portion of the impact each year.[54] This means that Oregon took the full brunt of its 27 percent loss in 2008—while other states' funding levels will likely continue to drop for the next four or five years, as the major losses experienced in 2008 and the first quarter of 2009 are gradually incorporated.[55]

Oregon's loss contributed to a massive drop in its pension funding level, from 112 percent in 2007 to 80 percent in fiscal year 2008. While the state's pension liabilities went up by almost $1.4 billion, the state's assets dropped by $15.8 billion. Oregon went from having a pension surplus of $6.5 billion to having an unfunded liability of $10.7 billion. Paul Cleary, executive director of the Oregon Employees' Retirement System, expects that because of investment losses, its employer contributions will rise from 12 percent of payroll paid in the state's current biennium to 18 percent[56] of payroll in the 2011–2013 biennium, about a $750 million increase.[57] "When we look at cumulative investment returns over the last 10-year period, it was worse than the decade that included the Great Depression," said Cleary.

The critical question for states is whether the investment returns of the past two years are anomalous or whether they signal a fundamental change in how the markets will be operating.[58] As with other state systems, Oregon's returns in 2009 have been considerably better, at 13.8 percent as of September 30, 2009.[59] But even if their returns continue to improve, states will take a very long time to recover the ground they lost. Barry Kozak, an actuary and faculty member of the Center for Tax Law and Employee Benefits at the John Marshall Law School in Chicago, was asked to determine how long it would take for a pension fund to recover from a one-time, 24 percent loss in value. Kozak said the fund would have to make 16 percent in annual investment returns for the next five years to accumulate as much as would have been accrued if they had consistently received the historically anticipated 8 percent rate of return over the same period of time.[60]

Montana provides a good example of what states are up against in trying to recover using investment returns alone. The investment loss for the state's Public Employees' System was 20.7 percent in fiscal year 2009 and 4.9 percent in fiscal year 2008, said Carroll South, executive director of the Montana Board of Investments. But because the pension fund also did not make its expected 8 percent rate of return, the shortfall is really almost 28.7 percent and almost 12.9 percent for each of those fiscal years respectively.[61]

The almost unavoidable upcoming increases in employer contributions could not come at a worse time. These actuarial demands have hit just as states' revenues have been squeezed by the recession. Employer contributions come out of the same pot of money that funds education, Medicaid, public safety and other critical needs. Between the start of the recession in December 2007 and November 2009, states faced a combined budget gap of $304 billion, according to the National Conference of State Legislatures (NCSL).[62] Budgets have continued to deteriorate in the current fiscal year,[63] with more than half of the states scaling back spending in response to ongoing shortfalls.[64] And revenues are expected to continue to drop still more during the next two years.[65] Under these conditions, many states have been and will continue to be forced to make difficult decisions about where to invest their limited resources.

The Roots of the Problem

The recession exacerbated the challenges—but many states entered the recent downturn with fundamental weaknesses in their retirement systems that stemmed from earlier mistakes and decisions. States that were prudent in the past might ride out this financial storm without being forced to make drastic changes, but those that were not likely will have to make some painful choices.

A number of factors contributed to the problems states now face. Pew examined four of the most significant: (1) the volatility of pension plan investments; (2) states falling behind in their payments; (3) ill-considered benefit increases; and (4) other structural issues.

The Volatility of Pension Plan Investments

As noted earlier, in calendar year 2008, the median investment loss for public pension funds was 25.3 percent.[66] For the vast majority of states, this extensive loss was not fully factored into the fiscal year 2008 financial documents used for Pew's analysis. The gap between assets and liabilities when data from fiscal year 2009 are released will be even more alarming.

In fiscal year 2009, retirement systems in such states as Tennessee, New Jersey, North Carolina, Oklahoma and West Virginia lost between 14 percent and 16 percent;[67] the California Public Employees Retirement System's (CalPERS) investments declined by 24 percent;[68] the Louisiana Teachers System lost nearly 23 percent;[69] and New Mexico's Public Employee Retirement Association lost more than 24 percent. These losses represent massive drops in asset levels; CalPERS' 24 percent loss, for instance, equated to a $57 billion drop.[70] "There was no place to hide," said Terry Slattery, executive director of the New Mexico fund.[71]

FOCUS ON:
PENNSYLVANIA

Pennsylvania offers a useful case study of a state affected by the volatility of pension plan investments. In the 1990s, Pennsylvania had robust investment returns, which encouraged leaders to dramatically raise retirement benefits. This amounted to a 25 percent increase for Pennsylvania employees and teachers in 2001, with subsequent cost-of-living increases for retirees.[72] At the time, Pennsylvania's pension system was funded at more than 126 percent, so it appeared that the increases could easily be absorbed. But the dot-com bust, 9/11 and the attendant stock market drop occurred from 2001 to 2003, all of which led to a decline in pension assets. To prevent a major increase in annual contributions, state leaders decided to account for investment losses and gains on two different time frames. The gains from the 1990s were spread out over 10 years while the losses and the costs for increased pension benefits were spread out over the next 30 years.

Pennsylvania officials were optimistic that strong investment returns would diminish and perhaps erase entirely the impact of the spike in employer payments that was expected.[73] For a while, that looked as if it were happening. By the close of 2007, both the state employees' and school systems had four years of good investment returns, including a more than 17 percent yield in calendar year 2007.[74] Then came 2008 and enormous across-the-board investment declines. The Pennsylvania State Employees Retirement System lost more than 28 percent of its assets in that year. As a result of these investment losses as well as the state's unorthodox funding approach, officials in Pennsylvania's state employee pension system are projecting a jump in contribution rate from 4 percent of payroll today to 28.3 percent in the fiscal year that begins July 1, 2012, and 31.3 percent the following year.[75] If Pennsylvania were required to make that jump today, the state would need to find an extra $1.38 billion to pay the 2012 rate and an extra $1.55 billion to pay the 2013 rate.

Back in the 1970s, state pension systems generally relied on conservative investments that delivered a low but relatively consistent rate of return. During the next several decades, however, pension systems loosened up their restrictions on making investments in equity, real estate and, more recently, private equity. In 1990, 38 percent of pension plan assets were invested in equities, broadly defined. By 2007, equity investments accounted for 70 percent of all state pension plan assets, according to Federal Reserve Board data.[76]

In the 1990s, states enjoyed strong returns and pension assets shot up so dramatically that by 2000, some pension funds began to lower contribution rates because they were over-funded. But the experience of the early part of this decade and the past two years, in particular, provided state officials with a vivid view of the downside of the more aggressive investment strategies that many states adopted.

The double blows of negative investment returns in 2008 and the first quarter of 2009 shattered expectations and sent pension boards and staff into waves of self-examination even after returns began to resuscitate after March 2009. Are investment expectations, typically around 8 percent, set too high? Are investment portfolios properly diversified? Has the drive for greater returns subjected pension systems to excessive risks? Solid, data-based answers are still few and far between.

Falling Behind in Payments

A new pension system can make a variety of attractive promises at what appears to be a relatively low cost because, at first, the number of retirees who collect benefits is small.

Pension systems with really severe problems often started out as "pay-as-you-go" plans in which retirees derived their benefits from current state revenues, not any pool of accumulated cash. Inevitably, the number of retirees grew relative to the number of current employees, and the checks going out the door took up a larger and larger portion of state revenues. Indiana's State Teacher Retirement fund is a good example. In 2007, when it had its latest actuarial valuation, it was only about 45 percent funded. Before 1996, there was no intent to fund this plan. Only after that year was a new pension system designed that was based on actuarially sound practices.[77] The same problem affects Rhode Island's severely underfunded Employees Retirement System, which operated essentially on a pay-as-you-go basis from 1936 to the late 1970s. It still is only about 57 percent funded even though it has made 100 percent of its actuarial contributions since the early 1980s. "You're paying for the sins of the past," said Frank Karpinski, executive director of the Rhode Island system. Little attention was paid in the early years to actuarial questions; in those days, you passed legislation and asked questions later, Karpinski said.[78]

As state pension systems matured, they moved away from a pay-as-you-go approach to one in which benefits are funded as they are earned. As noted above, actuaries in each system calculate the annual required contribution based on the normal cost and a portion of the unfunded liability. But in the vast majority of states, legislatures set the amount that is paid, which may differ substantially from the actuarially required contribution. In tough economic times, this may be one of many decisions a legislature makes in prioritizing expenditures. But states also made limited contributions when times were flush. During the past five years, 21 states failed to make pension payments that averaged out to at least 90 percent of their actuarially required contributions. "You need to make contributions in all market environments," said Michael Travaglini, executive director of the Massachusetts Pension Reserves Investment Management Board.[79]

States often have given themselves a funding holiday in response to favorable investment returns. By 2000, fully half of the states had reached 100 percent funding of their pension systems, due to the strong market performance of that decade. At the time, it seemed as if pension funding could only go in one direction: up. Governments such as Kentucky, New Jersey and Oklahoma began to pull back on their contributions. "Maybe a decade ago the system was over 100 percent funded," said Burnside, executive director of the Kentucky Retirement Systems. "It is easy when you're building government budgets to say, 'We don't need to contribute to the retirement plan because they have all the money they need,' and you start backing off of your retirement contribution."[80]

FOCUS ON: OKLAHOMA AND NEW JERSEY

In the late 1990s, Oklahoma's Public Employees Retirement System's 12.5 percent employer contribution rate exceeded its actuarially required contribution. The legislature wanted to find a way to finance a state across-the-board pay increase—so it cut the employer contribution to 10 percent of payroll, providing money for raises for state agencies. Investments turned sour in the early 2000s, costing the state assets it had counted on. The contribution rate stayed at 10 percent through fiscal year 2005, while liabilities continued to go up.[81] In 2004 and 2005, the state's payments covered less than 60 percent of the required contribution.

In New Jersey, with a pension system that was about 106 percent funded in 1998, the state legislature began to dramatically underfund its annual contributions. Between 2000 and 2006, the state never exceeded 30 percent of the required contribution. By 2008, the total funding level had fallen below 73 percent. Recently defeated Governor Jon Corzine (D) emphasized the need to improve the state's pension situation and increased funding in 2007 and 2008, but during the financial crisis, the resolve to do a better job of supporting the pension system all but vanished. According to Frederick Beaver, director of the New Jersey Division of Pensions and Benefits, New Jersey was supposed to pay about $2.3 billion in 2009 but contributed just $105 million. For 2010, the amount required was about $2.5 billion, but just $150 million was budgeted. "There was just not money to go around for everything," said Beaver. "Any time that I see less than a fully funded contribution I get really worried, but all we can do is emphasize our concerns."[82]

Until the Governmental Accounting Standards Board set a new standard for financial reporting in 2004, most governments did not even calculate the long-term impact of offering retiree health care and other non-pension benefits, and only a few were actually putting aside any funding.[83] As noted earlier, Pew's 2007 report, *Promises with a Price*, was the first to report the assets and liabilities of all 50 states' non-pension benefit systems. Pew's current analysis found that in fiscal year 2008, only Alaska, Arizona, Maine and North Dakota met their actuarially required contributions for these systems.

Unfunded Benefit Increases

Once a state promises a retirement benefit, it is extremely difficult to take it away. This is true in every state in the country, albeit to varying degrees. In general, pension benefits that already have been earned have strict constitutional or contractual protections, although the right to continue to accrue benefits going forward is slightly less certain, according to Keith Brainard, research director for the National Association of State Retirement Administrators.[84] In some states, retiree health benefits also are protected.[85] Even in states that have more flexibility to change benefits for current employees, the political difficulties are formidable. No legislature wants to antagonize government employees who, at the least, vote in elections and, at worst, can turn into powerful political foes. There also is a question of fairness. Should employees who have been counting on retirement benefits and who have considered them to be part of ongoing compensation suddenly discover that those benefits have disappeared?

Despite the difficulty of retracting benefits once they are given, some states made the commitment to significantly increase benefits, particularly in the 1990s and in the early part of this decade. There are various reasons for this; for instance, some states have raised employee benefit levels in lieu of raising salaries but they were inattentive to the cost of added benefits.

For instance, when Oklahoma increased benefits in the 1980s and 1990s, leaders simply did not focus on the size of the unfunded liability that was building up, according to Tom Spencer, executive director of the Oklahoma Public Employees Retirement System. "Frankly, I don't think our legislature was paying attention to the actuarial statistics when passing legislation. It is obvious that in some local plans and some state plans, the benefits have just gone way too high," Spencer said. "[E]very government needs to be able to afford the pensions they've promised. In Oklahoma, there's been a gigantic disconnect between what's been promised and what they're willing to pay."[86]

From 1999 to 2002, Mississippi increased its pension benefits substantially without putting in place a funding mechanism. "A lot of people were riding that wave of euphoria from investment returns," said Pat Robertson, executive director of the Mississippi Public Employee Retirement System.[87] Much of the increase in benefits came in the form of unfunded cost-of-living increases to retirees. Retirement formulas also were changed for current employees, effectively providing an unfunded retroactive benefit increase. By 1998, the Mississippi Public Employee Retirement System was about 85 percent funded, with full funding envisioned in a little less than 10 years. In 2008, the funding level had dropped to about 73 percent, with full funding now almost 30 years away. The actuarially required contribution vaulted from $362 million in 2000 to nearly $637 million in fiscal year 2008.

Increasing Benefits

There are several ways in which benefits can be raised. Most of them are tied to altering one of the factors involved in the calculation of the amount retirees receive. This formula includes some measurement of an employee's final average salary, the number of years worked and a pension multiplier (for each year worked, employees receive a certain percentage of their final salary as an annual benefit). The cost of the benefits also is affected by the age at which employees are allowed to retire, the length of time it takes to vest in the system, and the state's policy toward cost-of-living increases. Any unplanned increase will throw off past actuarial calculations of the funding necessary to support the system.

For a long time, New Mexico periodically granted benefit increases in lieu of salary increases, creating a benefit structure that became one of the most generous in the country. One notable aspect of New Mexico's pension systems has been its early retirement age: general employees can retire with full pensions after 25 years of service at any age, and law enforcement personnel can retire at any age with only 20 years of service.[88] New Mexico's funding level has dropped from 96 percent in 2000 to nearly 83 percent now. The actuarially required contribution was about $334 million in 2000; today it is more than $667 million. In addition, a significant lobbying push by the state's municipalities led to the removal of the cap on what individuals could earn if they retired and returned to government work. Without the cap, workers could earn both a full salary and a full pension simultaneously. The case to permit retirees to return to work was strengthened by shortages in police departments. But the legislation was not limited to public safety—the income caps for retirees who returned to work were removed for everyone.[89]

Similar stories abound in the realm of non-pension benefits. In Vermont, back in the 1970s, employees had to work for 10 years before they qualified for either pensions or retiree health care. But the vesting period was lowered to five years in 1981. In 1991, the state began to allow employees to retire at age 62 with no vesting requirement. This meant an employee could work for the state a few months, and as long as he or she retired directly from state employment, Vermont would pay 80 percent of medical premiums for the employee and spouse for the rest of their lives and for other dependents until they reach an age at which they are no longer covered, according to Cynthia Webster, director of the Vermont State Employees Retirement System.[90]

Vermont went back to a five-year vesting period in 2004 and, in 2008, put reforms in place that further pulled back on retiree health care offerings for new employees. Individuals hired after July 1, 2008, now must work 10 years before they receive retiree health benefits, and the state will pay 40 percent of the premium at that point, escalating to 60 percent at 15 years, and finally 80 percent after 20 years of service. Employees hired before the reforms are still covered under the old arrangement.[91]

The urge to provide benefit increases has abated a good deal, following the sobering increase in unfunded liabilities after the 2001–2003 stock market downturn. But given that the market will eventually recover, there will likely come another day when states are tempted to increase benefits again. The lessons learned in the past provide important considerations for policy makers.

FOCUS ON: COLORADO

In 2008, Colorado's aggregate pension funding level—the combined results for state, school, judicial and local employees that are part of the state-administered system—dropped to just under 70 percent from slightly more than 75 percent the previous year. Like most states, Colorado smoothes out investment losses—in its case, over four years. So the state's 2008 funding figure takes into account only about 25 percent of the losses sustained in 2008, with the rest to be factored in over the next three years.[92] Even if the state has reasonably solid returns going forward, it is likely that its funding level will continue to drop through 2012 at least.

Before the economic downturn, the state developed a plan to reach full funding within 30 years, which included a gradual increase in actual contributions, but the decline in state revenues coupled with the loss of investment income derailed those plans.

The dramatic decline from Colorado's 105 percent funding level in 2000 can be attributed to three factors:[93]

1. **Increased benefits.** In the late 1990s, Colorado made several benefit enhancements, including automatic cost-of-living increases for retirees and a drop in the age of normal retirement from 55 to 50 with 30 years of service.[94] Colorado's liabilities increased by 115 percent since 1999, rising from nearly $26 billion to almost $56 billion in fiscal year 2008. Meanwhile, the state's assets increased by only 45 percent, growing from nearly $27 billion in 1999 to almost $39 billion in fiscal year 2008.

2. **Missed contributions.** Up until 2002, the state paid its contributions regularly. But the dot-com bust and investment losses in the early part of this decade led to a jump in required contributions that the state could not meet. Over the past six years, the state paid only between 50 percent and 70 percent of its actuarially required contribution, for a total of $2.4 billion in payments that were skipped.[95] These missed payments are added to future payments with the result that the contribution requirement goes up. The required contribution was more than 11 percent of payroll in 2004 and had grown to about 17.9 percent of payroll in 2008. While the plans paid $2.8 billion in actual benefits to retirees in 2008, contributions that came in from employers and employees amounted to only $1.6 billion.[96]

3. **Investment losses.** In calendar year 2008, Colorado's investment losses were 26 percent, generally on par with other retirement systems. On a fair market basis, the state's pension funds had a decline of $11 billion. But all of the calculations that are made by the state's actuaries—including the estimate of the annual funding needed—are based on the idea that the state will see returns of 8.5 percent annually. This means, in effect, that the state lost not only $11 billion, but also the $3.46 billion it was expecting to earn that year to stay even.

Other Structural Issues

A number of other factors—many of them self imposed by states—have made it even more difficult for states to keep up with the needs of current workers and retirees.

Pew examined five significant factors—early retirement, cost-of-living adjustments, sharing excess returns, double dipping, and spiking final salaries—that impact states' current challenges.

1) Early retirement

In tough times, governments often offer incentives to encourage early retirement to reduce the size of the workforce. In 2009, this action was taken by Vermont, Maine and Connecticut.[97] While this may cut personnel costs in the short term, the positions often end up being filled again, while the retirement system ends up with increased expenses over time. Special early retirement programs turn pension plan enrollees into beneficiaries sooner than expected or may offer additional benefits as an enticement to leave. This disrupts actuarial assumptions and adds years of retirement benefits for each individual who signs up.

Connecticut has had a series of early retirement programs, allowing employees with at least 10 years of service to retire at age 52 instead of 55, or providing employees with credit for three extra years of service if they were already at least 55. "These incentive programs really whacked the system," said Jeanne Kopek, assistant director of the Connecticut Comptroller Retirement Services Division. The state ran early retirement programs in 1991, 1997, 2003 and again in 2009. It added an additional 3,800 people to the pension payroll this year that had not been planned. "This may save money on the normal budget, but it is on the back of the retirement system," said Kopek. "You're not really saving anything. You're taking from Peter to pay Paul."[98]

2) Cost-of-living adjustments

States that offer a regular cost-of-living adjustment to retirees often will incorporate the annual increase into their actuarial calculations. This may be expensive, but at least actuaries know it is coming and have factored the increased pension checks into their calculations of liabilities and adjusted funding requirements to cover the additional amount. Some states, however, offer cost-of-living adjustments on an ad-hoc basis, introducing an additional strain on the pension system because it has not been accounted for. For example, a 2 percent cost-of-living increase in 2008 in Georgia added $188 million of unfunded liability into the pension system, according to Pamela Pharris, executive director of the Georgia Employees Retirement System. The Georgia legislature passed a law this past year that ends cost-of-living adjustments for newly hired state employees when they retire. "If you're coming in the door and you know you won't get a COLA [cost-of-living adjustment] when you retire, you won't be planning on it," said Pharris.[99]

3) Sharing excess returns

Some pension systems have run into trouble because their retirement systems were designed to credit employees with additional retirement earnings when times were good, but did not take any money away when times were bad.[100] That was the idea behind Oregon's now frozen money match system, in which employees' 6 percent contributions were placed in a member account and guaranteed an 8 percent annual return. If the actual return from state pension investments was more than 8 percent, the increased amount was credited to their account.[101]

If the state had not credited the accounts with the surplus returns, then good years and bad years should even one another out, and the state could hope to have sufficient cash in reserve to fund the 8 percent guarantee in bad years. But when returns that exceeded the 8 percent annual return assumption were credited to member accounts rather than reserved, there was no way to balance the down years with good years. In the robust years of the late 1990s, Oregon's 30-year career retirees got a windfall, with many ending up with pensions that exceeded their final salaries. The pension system itself was well funded until the market downturn of 2001–2003 sent investment returns into a tailspin. In early 2003, state projections showed the pension system dropping from 100 percent funded to 65 percent funded. At that time, substantial reforms were introduced, the state took out a pension bond to cover some of its unfunded liability, and the money match system was frozen. Subsequent member contributions were diverted to new accounts, and the state ended the practice of crediting amounts above an 8 percent return to members and began to put excess returns from good years in reserve instead.[102] While Oregon's reforms were challenged legally, the state prevailed on most points.[103]

4) Double dipping

One of the major issues that is likely to surface in state legislatures in the next two years centers around retirees who are given their pensions and then come back to work for a new salary.[104] This practice, often dubbed "double dipping," has attracted a lot of attention in the press and has become a public relations issue for many state governments.

In Utah, the legislative auditor released a report in November 2009 saying that the number of state retirees who were returning to work had grown from 125 individuals in 1995 to 2,166 in 2008.[105] The report identified a $401 million cost impact on the state stemming from retirees returning to work between 2000 and 2008 and identified an $897 million impact during the next 10 years if laws are not changed.[106]

Utah, however, is not alone in wanting to retain experienced and talented staff eligible for retirement. States have created Deferred Retirement Option Plans (DROP) in an attempt to avoid the rise in costs with paying both a pension and salary to a worker. DROPs are designed to help retiring employees stay in their jobs for a fixed amount of time, perhaps a year or two, to train and transfer knowledge to other employees. These programs keep them on salary and allow them to save in special accounts the pension benefits they would have been earning if not working. DROP plans can be hard to design and controversy has ensued regarding the ways these programs are used. In Arizona, for instance, the legislature passed a DROP about seven years ago, but repealed it a year or two later, before it ever went into effect, after a study demonstrated that the new program would require a $45 million annual increase in employer contributions.[107]

5) Spiking final salaries

Another issue that has caused concern is the way final salaries—a key element of the pension formula—are calculated. Pension benefits are supposed to reflect the employee's salary level and are thus based on the worker's wages in the final years of his or her employment. Workers have found ways to boost their salaries in those final years, greatly increasing the level of benefits to which they are entitled. Common ways to boost salaries include ensuring that overtime goes to the most senior workers, saving sick leave and getting temporary promotions or last-minute raises. When states allow such actions to occur, retirees who manipulated the system get a higher benefit and states suddenly face an increased liability. In Delaware in 2008, newspaper reports detailed ways in which correctional officers' overtime payments led to higher pension benefits.[108] Georgia recently cracked down on agencies that were giving large raises to employees at the end of employment as a way of increasing pension benefits.[109]

The Road to Reform

Factors Driving Change

A convergence of factors is creating growing momentum for reforms to states' public sector retirement systems. In the past two years, states have suffered from enormous budgetary troubles. As noted in Pew's November 2009 report, *Beyond California: States in Fiscal Peril*, every state except for North Dakota and Montana encountered budget shortfalls in fiscal year 2010.[110] In the last quarter of fiscal year 2009, state tax collections were 16.6 percent below the same period in 2008. In total, tax collections dropped $63 billion or 8.2 percent from the previous year, according to the Nelson A. Rockefeller Institute of Government.[111] Through the fall, revenues in 31 states were coming in below already lowered expectations.[112]

As noted earlier, states' pension systems will suffer from their recent investment losses for many years to come. These losses affected virtually every large state pension system in the country,[113] sending assets plummeting and leading some policy makers and experts in the field to question longstanding assumptions about asset growth.[114]

The financial pressures add to other forces that are creating a groundswell for reform. One impetus for change comes from increasing public awareness of the gulf between retirement benefits in the public and private sector—a gap that continues to grow. According to the Bureau of Labor Statistics, 86 percent of state and local government employees participate in a retirement plan compared with 51 percent of private sector workers.[115] Defined benefit plans also are far more prevalent in the public sector. While only 20 percent of private sector employees have access to defined benefit plans, 90 percent of public sector employees do.[116]

This gap in coverage, and the fact that taxpayers are asked to fund benefits that they often lack themselves, has created a politically potent push to alter the status quo. In the midst of the budget crisis facing states, several business groups and organizations advocating for smaller government have sought to generate public outrage around what they perceive to be largesse for government workers. The California Foundation for Fiscal Responsibility, for example, launched a campaign in 2009 to publicize the benefits of 5,115 public sector employees whose pension benefits top $100,000.[117] (The California Public Employees Retirement System countered the resultant onslaught of newspaper stories by arguing that the average annual payment was $23,820.[118]) In Illinois, the Civic Committee of the Commercial Club of Chicago came out with a series of reform ideas in summer 2009 centered around lowering pension benefits, requiring pension and retiree health contributions from all employees, requiring retirees to pay a greater share of health plan costs and increasing the retirement age.[119] The Civic Committee pointed out that many companies have turned away from defined benefit plans and that "state retirees currently receive more generous pension benefits than those available to Illinois taxpayers."[120]

Public opinion polls in several states indicate these arguments might be finding traction. A poll last fall in California, for instance, showed that a majority of registered voters supported reducing pension benefits for new workers.[121] In Illinois, the percentage of voters in favor of cutting state spending on worker pensions was nearly 40 percent in 2009, an increase of more than 15 percentage points since 2008.[122]

At the same time, the media focus on public sector retirement systems has sharpened. One analysis identified 524 newspaper articles written in 2008 on state pensions compared with 399 in 2007 and only 169 in 1998.[123] A particular focus of these articles has been on scandals and abuses in state systems. While there is no evidence of rampant abuse through the retirement systems of the 50 states, specific incidents have received significant press attention. Recently, stories have appeared on alleged pay-to-play arrangements in New York,[124] and salary spiking in Massachusetts[125] and California.[126]

Some factors driving interest in reform are the same ones that Pew described in its *Promises with a Price* report in December 2007. The explosion of the baby boom generation into the ranks of retirees is causing a major demographic shift. By 2030, one in five Americans will be over 65.[127] People also are living longer. Life expectancy at birth was 70 for an American born in 1960 and 78 for someone born in 2005. A 65-year-old in 1950 could expect to live 14 more years. Someone of that age in 2005 could expect to live 19 more years.[128]

This increased lifespan has dramatic effects on the expense of retiree benefits. For example, when Hawaii reviewed and analyzed the data and actuarial assumptions used for the five-year period ending June 30, 2005, it found that retirees were living longer and employees were retiring earlier than projected. This information, coupled with higher salary growth than expected, meant that even with 100 percent of the actuarially required contribution funded, the state still would fall behind on the money needed to fund its pension system. The Board of Trustees requested that the legislature increase the employer contribution rate from 13.75 percent to 15 percent of payroll for general employees and from 15.75 percent to 19.7 percent for police officers and firefighters. In 2007, the legislature agreed to make the change, effective July 1, 2008. At the time, the legislature also passed a three-year moratorium on benefit increases until 2011.[129] With these kinds of accumulated pressures, many states are considering reforms. This is a topic that can no longer be put off until some uncertain tomorrow. Policy makers, particularly those in states with extremely underfunded systems, are increasingly concerned about their problems now.

It is not an easy topic to tackle. In 2008, nearly four of every 10 state and local government employees belonged to unions, a rate higher than any other workplace sector in the nation.[130] Historically, unions have fought hard against any infringement to the compensation they have received, although there may be signs of compromise in the air. (See "Unions and Reform" sidebar on page 32.)

In addition, state constitutions and statutes generally protect pension benefits, and judges frequently have held that states cannot modify pension contracts with existing employees. "[O]nce granted, a pension is a contractual obligation of the employer, so that in most states it is impossible to cut the promise of a future benefit," said Ron Snell, director of the State Services Division at the National Conference of State Legislatures in Denver.[131]

While these prohibitions appear to be ironclad in most states, some pension officials noted areas in which there is distinct uncertainty. "There are some pretty gray areas in the legal environment," said Meredith Williams, executive director of the Colorado Public Employees Retirement Association. "If you have someone with a number of years in the system, can you change their accrual of benefits going forward? Good question. Can you change the rate at which they contribute going forward? That's also an interesting question. There are significant gray areas in the legal thinking and not a lot of case law."[132]

UNIONS AND REFORM

In a number of states, notably those with strong unions, public sector retirement benefit reform has been a struggle, whether the obstacles come directly from the unions or through elected officials who are committed to defending state workers' benefits.

In New Mexico, for example, public employee unions filed a lawsuit after state lawmakers in 2009 hiked existing employee contributions to their pension fund and reduced the state's share of the cost to save $43 million a year. Arcy Baca, president of the American Federation of State, County and Municipal Employees (AFSCME) Local 477 in Santa Fe, said that while the union understands the state's budget predicament, the additional 1.5 percent in pension contributions taken from employee paychecks amounted to a tax increase on state employees.[133] Similarly, at least seven of Rhode Island's public employee unions have threatened to challenge the pension reforms enacted by the state legislature in 2009, which established a minimum retirement age of 62 and changed the way final salary is calculated for workers eligible to retire October 1, 2009. The reforms are supposed to save the state $59 million in the budget year that ends June 30, 2010. The unions objected that the new provisions apply to employees who are vested with more than 10 years in the system.[134]

But some experts say there may be a greater willingness among unions to accept pension plan changes now than any time in the recent past. Gary Chaison, a professor of industrial relations at Clark University in Massachusetts, said he believes state employee unions eventually will accept reforms especially because most of them apply to new hires. "During hard times, there's a greater union flexibility on pensions," he said. "Workers are pragmatic in their judgment about what they agree to change for future retirees before changing for themselves."[135]

Nevada is an example of a heavily unionized state that was able to overcome objections to alterations in the pension plan. For about 15 years, unions had blocked attempts by business leaders to persuade the legislature to trim retirement and health benefits for new hires,[136] but the state's $3 billion budget gap for the 2009–2011 biennium helped set the stage for change.[137]

In Fall 2008, Clark County Commission Chairman Rory Reid (D) convened a meeting of top union officials in Las Vegas to tell them current labor costs were unsustainable.[138] At the same time, the 7,000-member Las Vegas Chamber of Commerce, the state's largest business group, mobilized to persuade lawmakers to overhaul the pension system. Kara Kelly, the chamber's executive director, said business leaders believed Nevada had one of the most generous plans in the nation but needed an outside expert "to see if our hunches were true."[139] The analysis that followed, by Hobbs, Ong and Associates and Applied Analysis, a Las Vegas-based consulting firm, concluded that Nevada public employees had among the nation's highest average salaries and favorable retirement benefits.[140] The chamber presented the study to a legislature already looking at deep cuts to programs and services and the prospect of tax increases.

The path to reform was eased as different sides of the political spectrum gave ground. The Chamber of Commerce dropped its longstanding support of a defined contribution plan for public sector employees and endorsed a broad tax increase package to help balance the state budget. Republican lawmakers said they would support a tax increase but only if Democrats agreed to tighten the pension system for new hires. The budget passed.[141] Under the reform, new workers cannot begin receiving benefits until age 62, while current employees can retire at 60 with 10 years' service or at any age with 30 years. The plan also reduces the cost-of-living adjustment and the multiplier used to calculate benefits after an employee retires.[142] Union officials also played a role in negotiating this deal.[143]

Nevada Senate Majority Leader Steven Horsford (D) called the pension reforms "a major shift" for new state employees. Asked how hard it was to oppose unions by agreeing to the reforms, Horsford said, "We can't protect all sacred cows. Otherwise, you can't meet all essential government services such as education and health care."[144]

This deal was possible because concerns related to retirement security of workers were addressed along with the need to control costs. Union officials say that other states often fail to ask hard questions about how the systems are managed or what led to the unfunded liabilities before they turn to unions for givebacks or major alterations. The real test, said Gerri Madrid Davis, director of the National Public Pension Coalition, is whether states are willing to look for solutions that address both employees' needs and pension funds' sustainability.[145]

Promising Approaches: Setting the Stage for a More Secure Future

A growing number of states are showing interest in exploring policy options to address the bill coming due for their public sector retirement benefit obligations. Given the size of the bill and the challenges to reform, there are no quick fixes—but there is considerable momentum for change. This momentum stems not only from the fiscal and social pressures described earlier, but also from the track record of states that have moved forward to reduce the cost of their systems while still providing retirement security to their employees.

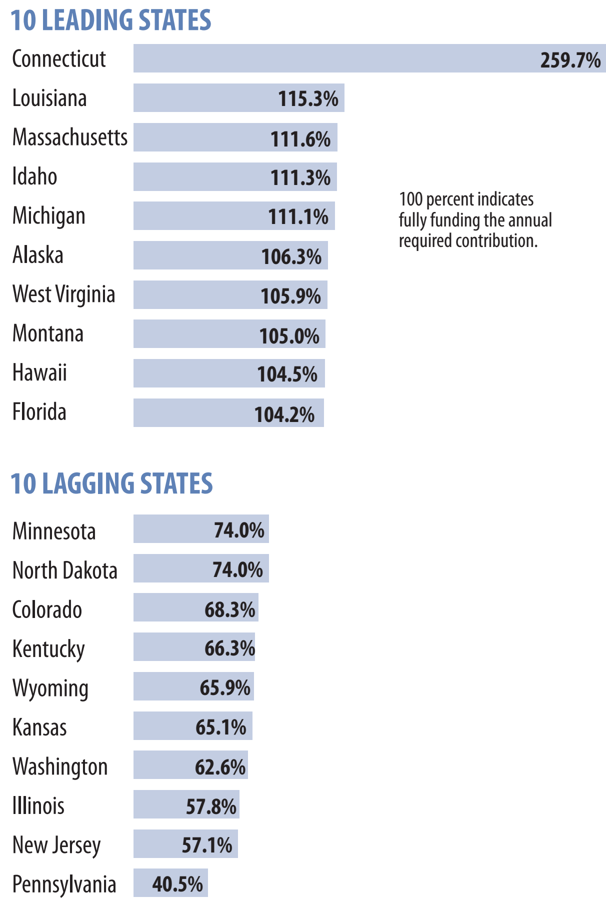
A Menu of Reforms

States have several different ways to improve their retirement systems and more than one viable path to success. In 2009, 11 states, established a task force or study commission or asked an existing entity to examine options and make recommendations for reform.[146] Other groups previously set up were finishing their work—for example, a special pension commission in Massachusetts released its final report in October,[147] and a Maryland commission on retiree health care is expected to release its final report in December 2011.[148] At least five other states were exploring changes through ad-hoc studies in the legislature or the pension administration or through reviews of benefits and pension structure by boards of trustees.[149] "We want legislators and stakeholders to understand the set of choices they have," said North Carolina Treasurer Janet Cowell, who launched such a commission. "What would a good system look like? What's a reasonable amount of money for retirement? Can we support 40-year retirements? What should the retirement age be? Then, how do we fund it?"

Exhibit 11

PAYING THE BILL, OR NOT

The 10 states that most recently paid the highest percentage of their annual required contribution for pension plans—and the 10 states that paid the lowest percentage.



SOURCE: Pew Center on the States, 2010.

Based on an examination of states' policy changes and practices over time, Pew identified five key reforms that largely have proven politically feasible and that offer the opportunity to improve the performance of public sector retirement systems in both large and small ways.

Keeping Up with Funding Requirements

The make or break factor for keeping a retirement system well funded is to pay the actuarially required contribution consistently (see Exhibit 11).

Several of the states that pay the full amount required each year for their pension systems have statutes or even constitutional requirements that dictate this practice. Arizona, for example, has a constitutional requirement that provides for full funding of the pension system each year.[150] Tennessee has a similar statute in place.[151] In Alaska, where many employees are still on a defined benefit plan, employer contributions are set in statute at 22 percent of payroll for the Public Employees Retirement System and at 12.6 percent for the Teachers Retirement and Pension System. Funding contributions go both to pensions and retiree health care, making Alaska one of the few states to provide ongoing funding for non-pension long-term obligations. When the statutorily set employer contribution rates fall short of what actuaries require, another Alaska law requires the state to make up the difference.[152]

In 2008 and 2009, in the midst of a severe budget crisis, other states were unlikely to create new rules requiring themselves to make full payments. Connecticut was an exception—in early 2008, the state issued a $2 billion bond to help support the underfunded teachers' pension system, with a covenant that required the state to fully fund that plan based on actuarial assessments as long as the bonds are outstanding.[153]

PENSION OBLIGATION BONDS

One of the options many states consider when their pension obligations appear to be careening out of control is the use of pension bonds. With these instruments, a state or local government can borrow money from investors in the bond market for up to 30 years and put it in its pension fund. The lump sum the government receives from the sale of the bonds is then invested with the intent of generating a high-enough return to adequately fund the pension plan and perhaps even raise additional cash. (Similar bonds can be used to pay for retiree health care benefits.) Of course, states run the risk that their actual returns will be lower than expected—and lower than their borrowing costs. In that case, they may end up losing billions on these deals.

Alaska, Illinois and Wisconsin authorized either their state retirement system or localities to issue such bonds to pay for retiree benefits in 2008 and 2009.[154] Other states authorized the use of bonds in earlier years. As a result of the pressures caused by dwindling investment returns and looming budget gaps, a number of states likely will be considering pension obligation bonds. For these states to make sensible decisions about the use of such instruments, they must avoid the temptation to use the bonds as a way to paper over their recent investment losses and make their plans appear to be in good shape. The Government Finance Officers Association recommends that "state and local governments use caution when issuing pension obligation bonds."[155]

Simply put, states need to muster convincing evidence that the timing is right. According to Girard Miller, a senior strategist for retirement plans and investments with the PFM Group, retirement bonds "should only be issued during recessions or during the early stages of economic recovery, when stock prices are depressed."[156] Based on Miller's analysis, state governments that want to use retirement obligation bonds should be ready to issue them in the near future to ride out the eventual recovery.

Pension obligation bonds are sensitive to market conditions, and the net return can vary from year to year. Illinois, for example, sold $10 billion in pension obligation bonds in 2003. Following four years of robust returns, it looked like the state had made a wise investment decision. But as returns have faltered, the decision appears somewhat more questionable. Based on results through March 2009, the return on the money invested from the bonds falls short.[157] While it will be impossible to assess the ultimate success or failure of the bonds without knowing what future investment returns will be, the experience of Illinois and other states illustrates the risky nature of these financial instruments.

Some states have viewed pension bonds as an opportunity for reform. Connecticut issued $2 billion in pension obligation bonds for its teachers' retirement system in early 2008. These bonds came attached with a strict covenant binding the state to adequately fund the plan. This approach has the potential to improve how states and municipalities manage their retirement obligations by making sure appropriate contributions are consistently made.

In a related issue, several states moved to change their assumptions of returns on their investment funds to more accurately estimate their long-term funding needs. For example, in 2008, Utah shifted from an 8 percent interest rate assumption to 7.75 percent, and in April 2009, the Pennsylvania State Employees Retirement System lowered its assumption from 8.5 percent to 8 percent.[158] As noted earlier, some experts believe even those reduced rates are still unrealistically high. Assuming a lower rate of return increases the actuarially required contribution because the state expects investments to cover less of the cost. More conservative investment assumptions protect states from sudden increases in contributions when investment returns fail to meet expectations. Plans vary in how risky or conservative their investment assumptions are. The assumed rates of return of the largest plan in each state ranges from 7.25 percent to 8.5 percent (see Exhibit 12).

Pension officials interviewed by Pew generally agreed about the desirability of keeping contributions consistent from one year to the next.

Exhibit 12
INVESTMENT RETURN ASSUMPTIONS

Rate	Number of states at that rate	
7.25%	2	NC, SC
7.50%	7	GA, IN, IA, KY, TN, VA, WV
7.75%	7	CA, FL, ID, ME, MD, SD, UT
7.80%	1	WI
8.00%	22	AL, AZ, AR, DE, HI, KS, MI, MS, MO, MT, NE, NV, NM, NY, ND, OH, OK, OR, PA, TX, WA, WY
8.25%	6	AK, LA, MA, NJ, RI, VT
8.50%	5	CO, CT, IL, MN, NH

SOURCE: Pew Center on the States, 2010.

A state that has accomplished this—and put itself on much better fiscal footing—is Ohio. The state's maximum pension contribution was set in statute at 14 percent of payroll for general employees in the Ohio Public Employees Retirement System—one of five statewide systems. In many years, this has exceeded the actuarially required contribution. But the state took the extra money and put it aside to fund future retiree health care benefits.[159] While most other states were ignoring the long-term liability for those obligations, Ohio was continuing to save. The result is that its non-pension liabilities were 38 percent funded in 2008, one of the best performances among states that provide meaningful post-retirement benefits other than pensions. Still, like most states, Ohio's public pension funds suffered double-digit investment losses after the Wall Street collapse in 2008, and lawmakers are discussing a series of cost-cutting reforms this year, including reduced benefits and higher employer contributions.

While the recession kept many states from their plans to follow through on funding of non-pension benefits, Pew's research shows that a handful began to set aside money between 2006 and 2008. New Mexico increased its funding from $0 to $170 million or 5.5 percent of its actuarial liability. New Hampshire increased its funding from $0 to $170 million or 5.4 percent of its actuarial liability. Georgia went from $0 to 4 percent funded with contributions of $778 million. Virginia now has 33 percent of its modest long-term needs in hand, compared with 23 percent in 2006.

Lowering Benefits and Increasing the Retirement Age

Even small changes to the benefits offered can have significant effects on liabilities over the long term. For example, in 1989, when Minnesota raised the retirement age by one year, from 65 to 66, for its three major retirement systems—moving in the opposite direction of many other states—it saved

$650 million over the next 20 years. The savings accelerated over time; while the change affected only new employees, 70 percent of the current workforce was hired after 1989.[160] If states want to realize substantial savings through changing the benefits for new employees, they need to enact these policies sooner rather than later.

According to NCSL, in 2008 and 2009 Kentucky, Nevada, New Jersey, New York, Rhode Island and Texas reduced benefits offered to new employees or raised the retirement age. In Nevada, employees hired after January 1, 2010, will have their annual pension benefits calculated using a new formula. In the past, the state multiplied the number of years of service by 2.67 to derive the percentage of final salary to be replaced by pension benefits. That "multiplier" has been dropped to 2.5 percent. Nevada's employees will have to work until age 62 with 10 years of service, instead of age 60.[161] In 2008, the Kentucky legislature passed a series of reforms to the pension benefits of new employees. Salaries no longer will be calculated based on the highest five years of pay, but rather, the final five years. The legislature also implemented a graduated tier system for new employees that establishes a sliding scale of multipliers for calculating benefits, ranging from 1.1 percent for 10 years of service to 2 percent for 30 or more years, and rewards employees for staying with the state.

In West Virginia, the Finance Board of the Public Employees Insurance Agency decided last summer to stop paying part of the health premium for retirees in the future. This would affect anyone hired after July 1, 2010. The agency picks up 71 percent of retirees' health premiums for employees hired before that point. The American Federation of Teachers of West Virginia and the West Virginia Education Association have filed lawsuits contesting this action.[162]

Another reform is aimed at ensuring that the financial ramifications of any future benefit increases are thoroughly considered. This includes cost-of-living increases, adjustments to retirement ages, vesting periods, employee contributions and multiple other changes that can affect long-term pension or retiree health liabilities. Georgia, North Carolina and Tennessee, for example, require that any proposal that will affect pension benefits or costs receive a full actuarial analysis to determine the long-term price tag.[163] Last year, a two-pronged request for an increase in benefits for members of the Tennessee Retirement System was rejected by the state legislature. A fiscal note revealed a $114 million first-year cost and a long-term tab of $1.7 billion.[164]

In 2008, California passed a law that requires both state and local decision-making bodies to review potential future costs before increasing any non-pension benefits. It also requires actuaries to be present when pension benefit increases are discussed. Other states, such as South Dakota and West Virginia, have established laws that prohibit adding benefits unless the pension system reaches a pre-set level of funding.[165]

Sharing Risk with Employees

Some of the states in which pension systems are in better fiscal shape have developed ways to share at least some of the risk of investment volatility with employees. Wisconsin, for instance, has substituted a dividend process for standard cost-of-living increases. If the investment returns are positive in a year, the system can declare a dividend that gets paid to retirees. But this is not guaranteed. If a good year is followed by a year with poor investment returns, retirees can see their pensions reduced.[166] In fact, in May 2009, pensions were reduced by 2.1 percent in Wisconsin for all members who had received prior dividends. The only guarantee is the base benefit. "We spent a long time educating our members that they are at risk. They understand it," said Dave Stella, secretary of the State of Wisconsin Department of Employee Trust Funds. "They understand the risk and reward feature. They're more than happy to take the gains, and they know they also have to take the reductions."[167] Wisconsin's system was nearly 100 percent funded as of fiscal year 2008.

States also share risk through hybrid systems that combine elements of defined contribution and defined benefit plans. While defined contribution plans place all investment risk in the laps of employees, these hybrid plans share the risk. They provide a lower guaranteed benefit to retirees, but accompany that defined benefit element with a defined contribution element that does not guarantee any returns—similar to the 401(k) programs that are common in the private sector.

Nebraska provides one example with its cash balance system (see sidebar, "States to Watch"). Georgia lawmakers voted in 2008 to establish a hybrid retirement plan for state employees hired after January 1, 2009. The program offers a defined benefit plan that provides about half of the benefit of the existing plan. New employees also will be automatically enrolled in the 401(k)-style plan at a 1 percent contribution rate, but may opt out at any time.[168]

In 2003, Oregon shifted to a hybrid pension plan for individuals hired after August 29 of that year, which provides substantially less than what the state offers employees hired before that date. All employees bear the risks for investments on the 6 percent salary contribution they make to the pension account. Before the change, pension system liabilities grew at 10 percent to 12 percent a year. The new plan has cut that to 3 percent a year. Of course, there has been a tradeoff, as employees have had to bear stock market losses. The $2.2 billion that had been set aside in member investment accounts—the defined contribution part of the benefit—dropped to $1.6 billion in 2008.[169]

Another option for states is to switch entirely to a defined contribution plan, although in recent years states have shied away from moving in this direction. With this arrangement, employee and employer contributions are invested, usually according to choices made by employees. Upon retirement, employees receive the cash that has accrued instead of a guaranteed set of benefits. In defined contribution plans, employers may still make generous contributions but employees bear the risk of how investments fare.

In recent years, only two states have exchanged the defined benefit approach for defined contribution: Alaska and Michigan. Michigan shifted its state public employees (though not teachers) to a defined contribution plan in 1997. At the time, this affected only new employees, but by 2009, about 50 percent of the Michigan state employee workforce was in defined contribution rather than defined benefit plans.[170] Alaska put all of its new employees in a defined contribution plan in 2005. With the recent losses in individual employee portfolios this continues to be a controversial and emotionally charged issue, and a number of bills were introduced in Alaska's legislature last year to repeal the decision. Pension officials say the move to defined contribution has had no apparent impact on Alaska's ability to retain or recruit employees, but solid data on the effect of the switch are still years away. "One of the challenges facing us in this conversation is bringing the data back to the table and showing what the facts are rather than the emotions," said Pat Shier, executive director of the Alaska Public Employees Retirement System.[171]

Increasing Employee Contributions

In many state systems, the employee contribution is fixed at a lower rate than the employer contribution. But in some states, contributions vary for employees as well as the employer. This is the case in Arizona, where the contribution rate for general (non-public safety) employees' pension plan is split equally between both employees and employers and can vary depending on the funding needs of the system. In the view of Paul Matson, executive director of the Arizona Retirement System, this method works well because employees have a direct interest in maintaining a well-funded pension plan. "It makes both the employer and employee very interested in the equity and cost of the program. If you do not split them equally and make them variable, it is more difficult to obtain mutual concern," Matson said.[172]

Some states have the ability to raise employee pension contributions if needed. In the past several years, Iowa and Minnesota have been raising employee contribution rates along with employer contribution rates, and in 2009, Nebraska increased its employee contribution rates for individuals in its defined benefit plans. In reaction to the state's fiscal difficulties, the New Mexico legislature passed a bill in 2009 that affects all employees who make annual salaries greater than $20,000, shifting 1.5 percent of the employer contribution to employees for the next two years. A lawsuit on this action is pending.[173] New Hampshire and Texas increased payroll contributions required from new employees.

Several states also have asked employees to start making contributions for their retiree health care benefits. Kentucky, for instance, requires that new employees put in 1 percent of their pay. New Hampshire established a $65 monthly charge for retired employees under 65 who are covered by retiree health insurance. And Connecticut now will require new employees, and current employees with less than five years service,[174] to put in 3 percent of their salaries.[175]

Improving Governance and Investment Oversight

Over the long term, states also can help protect their public sector retirement benefit systems by ensuring strong oversight by their legislatures and consistent governance practices. Thoughtful polices help guide the selection and performance of pension fund boards and establish clear and distinct roles for trustees and staff.

Some states have rules in place to ensure that boards are not dominated by individuals who receive benefits. In Idaho, for example, three of the five positions cannot be members of the pension fund.[176] In Utah, the seven-member board is made up of the state treasurer, four financial professionals who are independent of the pension system and two individuals within the system—a public employee and an educator.[177] This stands in contrast to a state such as New Mexico, in which every member of the 12-member board is in a position that is eligible for a pension.[178]

Oregon in 2003 made some dramatic changes to its pension board, reducing it from 12 to five members and requiring that three members be independent. The actuarial services manager in Oregon, Dale Orr, has been with the system since 1992, and said he sees a dramatic change in the behavior of the board since the reform went into effect. "The important thing is that the new board members have some experience in financial matters," said Orr. "They've taken a much more financial focus on the system, rather than a member-benefit focus, which the previous board tended to have. They're engaging the actuary a lot more to do special studies and 'what if' scenarios to see what the cost of the current system is."[179]

In recent years, some states have been professionalizing oversight by shifting the complex task of pension investment from more general boards of trustees to specialized boards that focus on the topic. For example, Vermont in 2005 moved investment oversight from its pension boards to an entity called the Vermont Pension Investment Committee, which includes a representative elected by each of three boards, two gubernatorial appointees, and the state treasurer as an ex-officio member.[180] The change was designed to bring a higher level of expertise to the body responsible for investing the pension assets, to combine the assets of the three retirement systems to realize administrative savings, and to be able to act more quickly when making changes to the actual investment allocations.

In 2005, the South Carolina legislature created the South Carolina Retirement System Investment Commission and spelled out the level of education and experience needed by individuals to serve. A previous board had advisory responsibility but no authority or real oversight of the investments, which were entirely the province of the state treasurer and the board he or she sits on. Now there are four members on the investment commission besides the treasurer—"[I]ndividuals who have the skills and expertise to invest our funds," said Peggy Boykin, director of the South Carolina Retirement System. She said this was critical in moving forward with a diversified portfolio.[181]

In 2009, Illinois set up a number of protections to make sure that pension trustees, employees and consultants are barred from benefiting from investment transactions. More competitive processes for procuring consulting and investment services were introduced, and the state's pension systems were required to review the performance of consultants and managers and establish ways of comparing costs.[182]

In both New York and California, pension fund scandals involving placement agents—intermediaries who connect investment managers with the states—provoked some action. New York Attorney General Andrew Cuomo has proposed a series of governance reforms, including strict limits on political contributions, extensive disclosures from investment fund personnel, the creation of a code of conduct, a requirement that any licensed professional report conflicts of interest, and a prohibition on investment firms from using placement agents or lobbyists to get business from the state pension fund. He also proposed changing supervision of the pension fund from a sole trustee to a 13-member board of trustees. Only New York, Connecticut and North Carolina have pension funds with a sole trustee.[183]

California lawmakers, meanwhile, are considering similar legislation cracking down on placement agents. The legislation, drafted by two state officials who sit on CalPERS' board, would require agents to register as lobbyists. It also would prohibit investment firms from paying agents a commission or contingency.[184] In addition, in 2009, California passed a law that will improve and speed up financial reporting for its pension systems. The state also created the California Actuarial Advisory Panel to provide best practices and impartial input on retiree benefits to public agencies.[185]

STATES TO WATCH: MODELS FOR SUCCESS

Pew has identified four states that demonstrate different successful approaches to designing and managing retirement systems: Florida, Nebraska, Iowa and Georgia.

FLORIDA: PROVIDING CONSISTENT FUNDING

As of fiscal year 2008, Florida's pension system had assets that were over 101 percent of its liabilities, resulting in a surplus of $1.8 billion. The state consistently has funded its actuarially required contribution and follows conservative policies in managing its obligations.

Since 2000, Florida has managed to pay at least 90 percent of its actuarially required contribution each year. While the state failed to pay the entire contribution in four of the past 12 years, it over-contributed in other years, averaging 102 percent of what it was required to pay. Florida is not the only state that has created a well-funded pension system by consistently funding its actuarially required contributions. New York, for example, has a funding level of more than 107 percent, while Wisconsin is nearly 100 percent funded.

Florida's method for calculating annual contribution rates exemplifies the state's careful approach to funding its retirement promises. When states have an unfunded liability in their pension system, they are obligated to incorporate a portion of it into upcoming actuarially required contributions so that the bill is paid off over time. Similarly, when states have a surplus, some typically use it to reduce future annual contributions. However, Florida has legally mandated that pension surpluses of less than 5 percent of total liabilities will be reserved to pay for unexpected losses in the system—and even if the surplus is greater than 5 percent of total liabilities, only a fraction can be used to reduce the state's contributions.[186] This policy has helped Florida offer a traditionally structured defined benefits plan while maintaining funding at sustainable levels.

NEBRASKA: REDUCING RISK THROUGH A CASH BALANCE PLAN

In 2003, Nebraska instituted a relatively new concept for state pensions called a cash balance plan. It was mandated for new workers, but state and county employees hired prior to 2003 were given the option of joining that year and again in 2007. The cash balance plan was set up as an alternative to a defined contribution plan that the state put in place in the 1960s for state and county employees. Currently, 65 percent of the employees are covered through the cash balance plan while 35 percent remain in the defined contribution plan. Annually, workers contribute 4.8 percent of their salaries to the plan and employers put in a 6.8 percent salary match. This money is invested by the state for the benefit of retirees. (Nebraska educators, judges and state patrol employees participate in separate defined benefit plans.[187])

The Nebraska plan is similar to a defined contribution plan in that employees receive a payout upon retirement based on the actual amount of money in their account. The big difference is that Nebraska has dramatically cut the risk to employees by guaranteeing a 5 percent annual investment return.[188] It also provides dividends to employees when funding exceeds 100 percent and the investments do particularly well. That dividend amounted to a distribution of an additional $41 million to workers' accounts in October 2006, $13.5 million in 2007 and $21 million in October 2008. (Those amounts were based on investment account balances at the end of the previous year, which meant that the most recent payout stemmed from information that preceded the stock market decline.) Cash balance plan members did not receive a dividend in 2009.

Unlike defined benefit plans, the cash balance plan uses no pension formula, so there is no calculation of final salary and, thus, no incentive for spiking. Employees can take the retirement sum in the form of a protected annuity with a 2.5 percent annual cost-of-living increase. Employees also have the option of receiving a rollover or lump sum distribution when they retire.

STATES TO WATCH: MODELS FOR SUCCESS

Nebraska's shift to the cash balance plan stemmed from research that it conducted on its defined contribution approach. In 2000, the state compared the retirement income of its state and county employees in the defined contribution plan with state teachers, who have a defined benefit plan. The results were bleak, showing that employees in the defined contribution plan tended to invest extremely conservatively, amassing dramatically fewer dollars by retirement than the state's investment team generated for the defined benefit teacher fund. The cash balance approach was established as a compromise, offering employees the higher returns and greater security of a defined benefit plan and the flexibility of a defined contribution plan, while protecting the state from the risks inherent with a defined benefit plan.

IOWA: BENEFIT CAPS AND ADJUSTABLE EMPLOYEE CONTRIBUTIONS

Iowa has put a number of protections in place to keep its pension fund in good shape. That job has been somewhat easier because the state's constitution does not guarantee retirement benefits. Iowa's practices are instead governed by statute, providing the state with more flexibility in making adjustments.[189]

For example, several years ago, Iowa's legislature reduced employees' ability to increase their pensions by artificially buoying income in the last several years on the job—the years on which pension benefit payouts are usually calculated. One change was to remove bonuses and car or housing allowances from the calculation of final salary; another was to put in place a cap on salary growth, so that a "final average salary," computed with the three highest years, cannot be greater than 121 percent of the fourth highest year. That change was put into effect in 2007 for all employees (not just new workers) and so far has resulted in 241 pensioners seeing reductions in the benefits they otherwise would have received. Iowa's flexibility also allows it to adjust the contribution rates paid by employees—a factor that is set in stone in many other states. The rate was established at a combined 9.45 percent in 1979, with employers paying 60 percent and employees paying 40 percent. But in 2004, when the state's actuarially required contribution began to climb, officials started to increase the combined rate by half a percent each year. In 2010, it had moved up to 10.95 percent. When employees share a significant part of pension costs, it reduces the incentive for them to continuously push for greater benefits.[190]

With investment returns for the Iowa Public Employee Retirement System down by 16.1 percent in fiscal year 2009, an advisory committee has been set up to figure out how to manage the funding drop.[191] "Everything is on the table," said Donna Mueller, the system's chief executive officer. Iowa may consider changes that could reduce benefits for non-vested employees—a gray area in the law. If undertaken, the move would be closely watched by other states. "We just have to keep the mission in mind," said Mueller, "to provide a secure retirement for public employees in a cost-effective way."[192]

GEORGIA: UNDERSTANDING THE IMPACT OF REFORM

For more than 20 years, Georgia has had laws in place that require any legislation affecting retiree benefits—whether a reduction or increase—to undergo an actuarial study to determine the long-term financial impact on the system. This practice has helped the state avoid the kinds of costly and irreversible benefit changes that have made pension systems more expensive in other states.

The initial legislation followed the development of a new Georgia constitution that called for "funding standards that would ensure the actuarial soundness of any pension or retirement system supported wholly, or partially, from public funds."[193] Tommy Hills, the state's chief financial officer, said he believes that the law has helped the state greatly. "There's essentially a year lag on retirement bills," said Hills. "It provides a cooling off period."

This practice forces legislators to consider how any change could affect the state for the next 30 years, Hills said.[194] Recent legislation that has passed the Georgia Senate, though not the House, goes a step further, mandating that all changes be fully funded at inception.[195] Several other states have similar requirements for actuarial analysis in place. In North Carolina, every retirement-related bill must contain actuarial notes from both the General Assembly's actuary and the North Carolina Retirement System.[196] In 2006, Oklahoma passed its own Actuarial Analysis Act, modeled on Georgia's system.[197]

Grading the States

To help policy makers and the public understand these challenges and their implications, Pew graded all 50 states on how well they are managing their public sector retirement benefit obligations, assessing how well they are handling their bills coming due both for pensions and retiree health care and other benefits.

Pensions

Pew assessed states' pension systems on three criteria and awarded each state up to four points: two points for having a funding ratio of at least 80 percent; one point for having an unfunded liability below covered payroll; and one point for paying on average at least 90 percent of the actuarially required contribution during the past five years. (See Appendix A for a more detailed description of the grading criteria.)

States earning four points were solid performers. Those earning two or three points were deemed in need of improvement. And those earning zero or one point were cause for serious concerns (see Exhibit 13).

Solid performers. Sixteen states received a perfect score of four out of four points and earned the label of solid performer. One example is Georgia—its state pension plans are well funded (at 92 percent) with an unfunded liability that is only 49 percent of covered payroll, and the state has consistently made its actuarially required contributions. All states that earned the grade of solid performer had adequately funded pension plans, had a manageable unfunded liability and were able to consistently pay their required contributions as of 2008. Of course, being a solid performer does not mean a state has solved all of its pension and other fiscal challenges.

In need of improvement. Fifteen states were deemed in need of improvement. California is an example. The state's pension funding levels are not dangerously low, its plans are more than 80 percent funded and the unfunded liability is less than covered payroll. However, California has failed to consistently pay the actuarially required contribution, spurring a funding decline from a $9 billion pension surplus in 2000 to a $53 billion unfunded liability in 2007, based on the most recently available data. Alabama is another example. The state consistently has made its required contributions in full and its unfunded liability is manageable. However, Alabama's pension plans are under the minimum 80 percent funding threshold that the Government Accountability Office says is preferred by experts.

Meriting serious concerns. Nineteen states were rated as meriting serious concerns. Illinois—the worst-performing state—was one of eight to earn zero points toward its pension grade. (The other seven were Alaska, Colorado, Kansas, Kentucky, Maryland, New Jersey and Oklahoma.) The state's pension plans are underfunded (at 54 percent), have high unfunded liabilities (340 percent of covered payroll) and have insufficient contributions (less than 60 percent of the actuarially required contribution was paid in 2008). All in all, Pew's research found serious concerns with Illinois and 18 other states' lack of progress with taking the necessary steps to ensure their pension plans are financially secure.

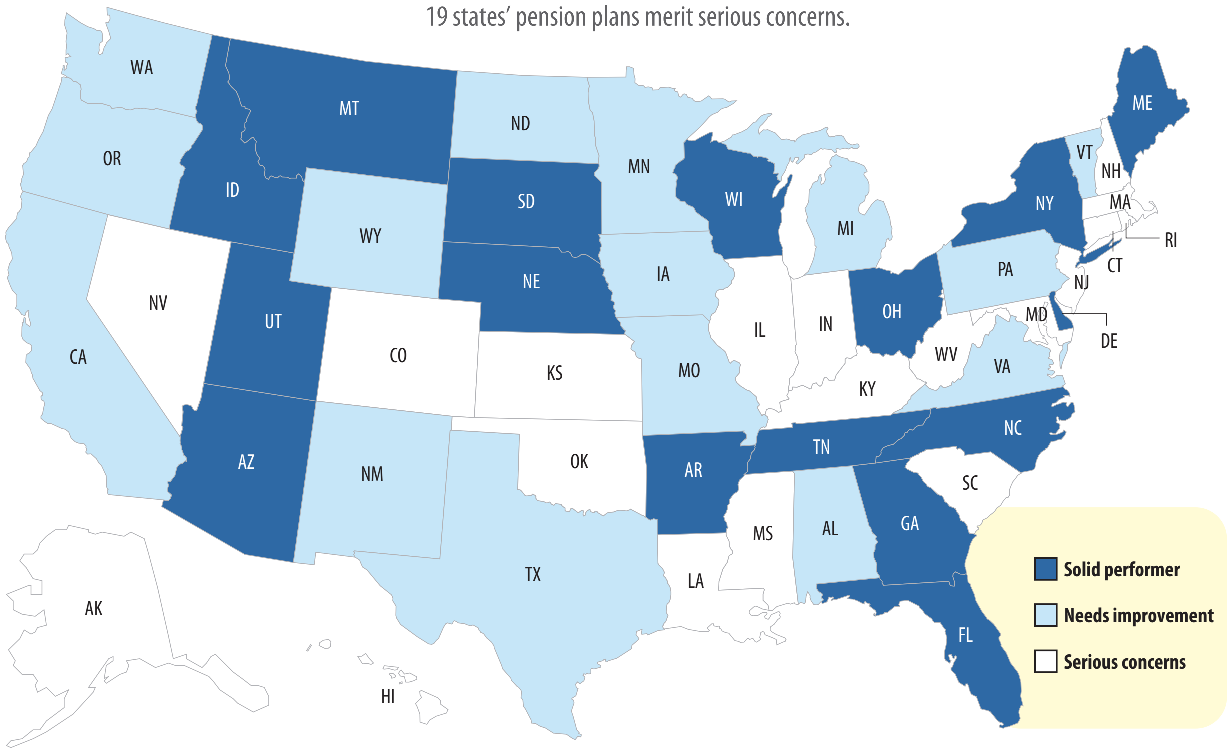
Health care and Other Non-pension Benefits

Pew's criteria for grading states' retiree health care and other non-pension benefit obligations were much simpler and more lenient than those used

Exhibit 13

HOW WELL ARE STATES MANAGING THEIR PENSION OBLIGATIONS?

19 states' pension plans merit serious concerns.



SOURCE: Pew Center on the States, 2010.

for the pension assessment. This is because most states have only recently begun to recognize these liabilities and many still have not put aside any assets to pay for these bills coming due. The Governmental Accounting Standards Board's (GASB) Statements 43 and 45, which were released in 2004 and first went into effect in 2006, marked the first time that states had to acknowledge and report their retiree health and other benefit obligations. States have started putting aside money for these benefits, but for most, the work has just begun. On average, states have only put aside 7.1 percent of the assets needed to adequately fund their retiree health care liabilities. Twenty states have not set aside any funds.

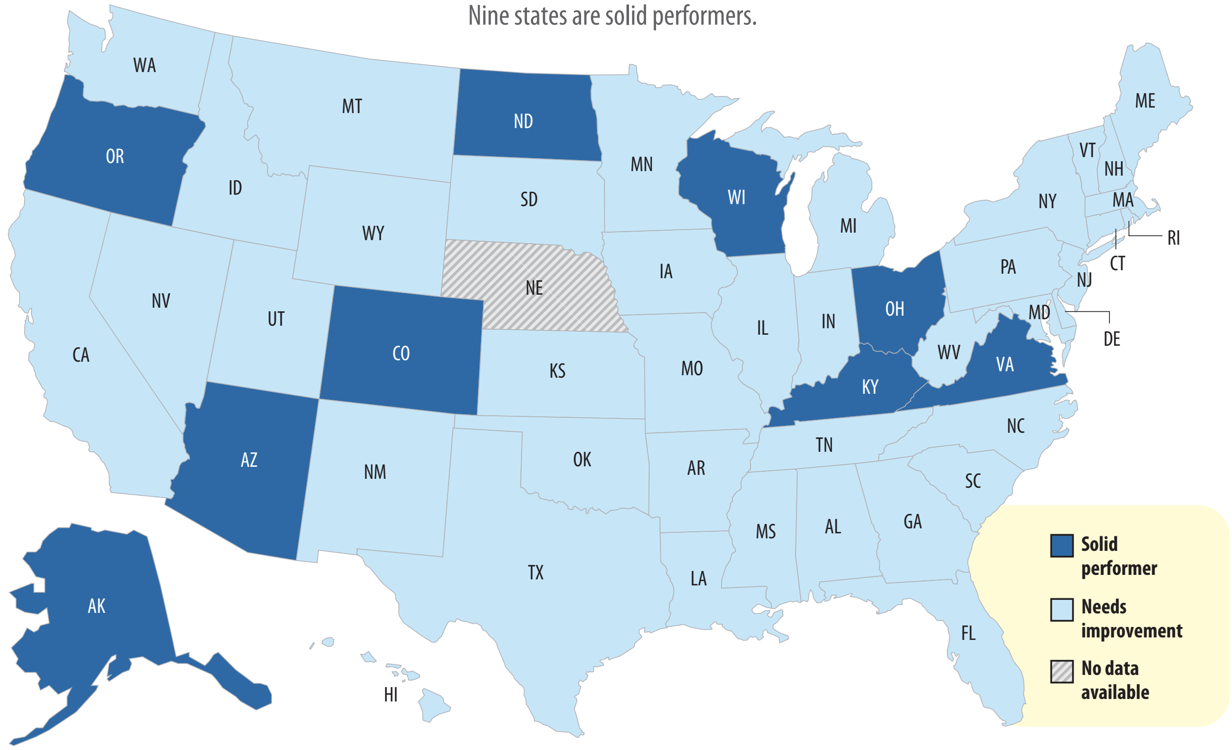
Because most states have only recently begun to account for and address these liabilities, Pew's grades measure the progress they are making toward pre-funding. As a result, a grade indicating serious concerns was not included. Pew rated as solid performers those states that had set aside more than 7.1 percent, the state average, of funds to cover the bill coming due. All states that had set aside less than that amount were identified as needing improvement. This allowed Pew researchers to highlight and give credit to states that have begun to fund their retiree health care and other non-pension benefits while acknowledging that it is still too soon to expect states to have made meaningful progress. Pew made no distinction between states with implicit (e.g., health care subsidies) and explicit (e.g., health care plans) liabilities because GASB does not do so, requiring states to report on these obligations in exactly the same way.

Nine states earned the grade of solid performer. Forty states were in need of improvement—with

Exhibit 14

HOW WELL ARE STATES MANAGING THEIR NON-PENSION OBLIGATIONS?

Nine states are solid performers.



SOURCE: Pew Center on the States, 2010.

half of those failing to set aside any funds, as noted above. Nebraska had a long-term liability for retiree health care and other benefits, but this obligation is likely to be relatively small. The state does not provide not provide an actuarial valuation of its retiree health care liabilities and as a result Nebraska did not receive a grade regarding those obligations (see Exhibit 14).

Irrespective of the size of the liabilities—whether small or large, implicit or explicit—there was a great deal of variation among states and how they handled their bill coming due for retiree health care and other non-pension benefits. For example, New Jersey's liability of $68.9 billion was the largest of any state and wholly unfunded. Virginia's bill coming due was nearly $4 billion and almost 39 percent funded. Kansas' obligations totaled $316 million, a fraction of New Jersey's, but Kansas had not set aside any funding either.

Solid performers. Only two states—Arizona and Alaska—had set aside 50 percent or more of the assets needed to cover their future health care and other non-pension benefit obligations. Arizona was 65 percent funded, leading all states, and Alaska had nearly 56 percent in assets to cover its liabilities. Another seven states—Colorado, Kentucky, North Dakota, Ohio, Oregon, Virginia and Wisconsin—were also solid performers, ranging from 10.4 percent to 38.2 percent.

Needs improvement. Forty states were deemed in need of improvement, having set aside less than 7.1 percent of the funds needed to cover future health care and other non-pension benefit obligations. Twenty states had failed to put aside any assets.

Conclusion

With most 2010 legislative sessions under way, the encouraging news is that many state officials grasp the depth of the funding challenges for their public sector retirement benefit systems and the need to respond. But the pressure in an election year to channel money to competing priorities such as education may tempt lawmakers to neglect the problem. That will only widen the gap between what states have promised their employees and what they have set aside to pay the costs—and make the bill coming due even larger.

The states that are meeting their commitments have demonstrated that public sector retirement benefits can be adequately funded during good and bad times, with care taken to identify the long-term costs of short-term decisions. Due to mounting financial pressures, other states have been on an unsustainable course and will be forced to make tough choices. As lawmakers consider proposals to deal with the bill coming due, they have an opportunity to enact reforms that will have a lasting impact on their states' fiscal health.

Endnotes

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[37] Keith Brainard, "Public Fund Survey Summary of Findings for FY2008," National Association of State Retirement Administrators, October 2009, p. 2.

[38] U.S. Government Accountability Office, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections and Fiscal Outlook for Funding Future Costs*, report to the Committee on Finance, U.S. Senate, September 2007.

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[41] Pew Center on the States interview with Frank Karpinksi, executive director, Rhode Island Employees Retirement System, September 3, 2009.

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[43] Pew Center on the States interview with Mike Burnside, executive director, Kentucky Retirement Systems, July 28, 2009.

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[48] Pew Center on the States, *Promises with a Price: Public Sector Retirement Benefits*, December 2007, p. 45

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[50] Rhode Island Office of the Auditor General, "Status of Pension Plans Administered by Rhode Island Municipalities," audit summary, July 2007. www.oag.state.ri.us/reports/Local_Pensions0707summ.pdf.

[51] Pew Center on the States interview with Mike Burnside, executive director, Kentucky Retirement Systems, July 28, 2009.

[52] Pew Center on the States interview with Tom Spencer, Oklahoma Public Employees Retirement System, June 23, 2009.

[53] Pew Center on the States interview with Timothy Blair, acting executive secretary of the State Retirement Systems of Illinois, October 11, 2009.

[54] The median time period that states use to "smooth" investment returns is five years.

[55] Oregon Public Employees Retirement System, "Quarterly Investment Report," December 31, 2008.

[56] Oregon also has a "collar" on its rates. This means that rates cannot go up or down more than 3 percentage points between one biennium and the next if the pension funding level is between 80 percent and 120 percent. If funding falls below 80 percent (as pension actuaries expect in 2009), then the contribution cannot go up more than 6 percentage points. That is why the actual rise will be from 12 percent to 18 percent.

[57] Pew Center on the States interview with Paul Cleary, executive director, Oregon Employees Retirement System, June 29, 2009.

[58] Ibid.

[59] Oregon Public Employees Retirement System, "Quarterly Investment Report," September 30, 2009.

[60] E-mail, interview with Barry Kozak, John Marshall Law School, November 11, 2009.

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[77] Pew Center on the States interview with Terren Magid, executive director, Indiana Public Employees Retirement Fund, July 24, 2009.

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[90] Pew Center on the States interview with Cynthia Webster, director, Vermont State Employees Retirement System, November 17, 2009.

[91] Ibid.

[92] Colorado is one of the states in which 2008 results reflect the full calendar year. The Colorado Public Employees Retirement Association experienced a 26 percent loss, according to Executive Director Meredith Williams.

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[139] Pew Center on the States interview with Kara Kelly, executive director, Las Vegas Chamber of Commerce, October 2009.

[140] Las Vegas Chamber of Commerce, "An Overview and Comparative Analysis of the Nevada Public Employees' Retirement System," *Fiscal Analysis Brief* (1)3, September 2008.

[141] Pew Center on the States interview with Kara Kelly, October, 2009; Steven Horsford, Nevada Senate majority leader, September 18, 2009.

[142] Pew Center on the States interview with Dana Bilyeu, executive officer, The Public Employees Retirement System of Nevada, September 9, 2009.

[143] Cathy Bussewitz, "Public employee reform bill advances," *Associated Press*, May 29, 2009.

[144] Pew Center on the States interview with Steven Horsford, majority leader, Nevada Senate, September 18, 2009.

[145] Pew Center on the States interview with Gerri Madrid Davis, director of the National Public Pension Coalition, November 13, 2009.

[146] National Conference of State Legislatures, *State Pensions and Retirement Legislation 2009*, accessed December 4, 2009, at www.ncsl.org/?tabid=17594.

[147] "Final Report of the Special Commission to Study the Massachusetts Contributory Retirement Systems," accessed January 4, 2010, at http://www.mass.gov/mtrs/commission.pdf.

[148] "Blue Ribbon Commission to Study Retiree Health Care Funding Options," *Maryland Manual On-Line*, July 2006. http://www.msa.md.gov/msa/mdmanual/26excom/html/31retiree.html. Email from Michael Rubenstein, principal policy analyst and staff, Blue Ribbon Commission to Study Retiree Health Care Funding Options, January 5, 2010.

[149] According to interviews with pension officials: the board for Colorado's Public Employees Retirement Association embarked on an "eight-stop listening tour" around the state to gather input from plan participants and the public on pension reform; an advisory committee was set up to work with the Iowa Public Employees Retirement System to study potential actions that can help the state deal with large investment losses, including possible benefit changes; Minnesota's State Employee Retirement System Board has been looking at questions of sustainability; the Ohio Public Employees Retirement System has embarked on a strategic planning process to re-examine its benefits structure; Utah has engaged in an ad hoc exploration, with the legislature holding hearings to invite employees and employers to provide impact on the topic of pension reform.

[150] Pew Center on the States interview with Paul Matson, executive director, Arizona Retirement System, June 25, 2009.

[151] Pew Center on the States interview with Jill Bachus, director, Tennessee Consolidated Retirement System, September 3, 2009.

[152] Pew Center on the States interview with Pat Shier, Alaska Public Employees Retirement System, September 11, 2009.

[153] "Treasurer Nappier announces unprecedented bond sale," news release, Connecticut Office of the State Treasurer, April 8, 2008.

[154] National Conference of State Legislatures, *State Pensions and Retirement Legislation 2009*, accessed December 4, 2009, at www.ncsl.org/?tabid=17594; *Pensions and Retirement Plan Enactments in 2008 State Legislatures*, accessed December 4, 2009, at http://www.ncsl.org/default.aspx?tabid=13313.

[155] Government Finance Officers Association, "Evaluating the Use of Pension Obligation Bonds (2005)" Recommended Practice. http://www.gfoa.org/downloads/debtevalusepensionobligbonds.pdf.

[156] Girard Miller, "Bonding for Benefits: POBs and 'OPEB-OBs,'" *Governing*, January 15, 2009. www.governing.com/column/bonding-benefits-pobs-and-%E2%80%98opeb-obs%E2%80%99.

ENDNOTES

[157] Based on a Pew Center on the States analysis using information on the 2003 Illinois bonds available through the Illinois State Comptroller, available at http://www.comptroller.state.il.us/FiscalFocus/article.cfm?ID=286, and based on investment returns for Illinois available at the Illinois State Board of Investments, available at http://www.isbi.illinois.gov/pdf/ISBI_Annual_Report_2008.pdf and http://www.isbi.illinois.gov/pdf/ExecutiveSummary.pdf.

[158] Pew Center on the States interview with Leonard Knepp, executive director, Pennsylvania State Employee Retirement System, June 24, 2009.

[159] Pew Center on the States interview with Chris DeRose, executive director, Ohio Public Employees Retirement System, September 17, 2009.

[160] E-mail from David Bergstrom, executive director, Minnesota State Retirement System, September 22, 2009.

[161] The state did not change the 65/5 provision, allowing employees to retire at age 65 with at least 5 years of service. Police and firefighters eligibility remains at 65/5, 55/10, 50/20, but a 25-and-out option was removed.

[162] Pew Center on the States interview with Ted Cheatham, director of the West Virginia Public Employees Insurance Agency, December 15, 2009.

[163] Pew Center on the States interviews with Michael Williamson, director, North Carolina Retirement System, September 2, 2009; Tommy Hills, chief financial officer, Georgia, November 18, 2009; Jill Bachus, director, Tennessee Consolidated Retirement System, September 3, 2009.

[164] Tennessee Senate Fiscal Note, SB1826. http://www.capitol.tn.gov/Bills/106/Fiscal/SB1826.pdf, accessed February 20, 2009.

[165] Pew Center on the States interviews with Anne Werum Lambright, executive director, West Virginia Consolidated Public Retirement Board, September 10, 2009; and Rob Wylie, executive director, South Dakota Retirement System, September 8, 2009.

[166] Wisconsin's system contrasts with other states that ran into trouble from sharing gains from good years with employees. The difference is that Wisconsin shares losses as well as gains. When Minnesota and Oregon shared "excess returns" with retirees, they ran into trouble because the states took on all the risk in years when returns were low or negative.

[167] Pew Center on the States interview with Dave Stella, secretary, Wisconsin Retirement System, September 1, 2009.

[168] E-mail from Pamela Pharris, executive director, Georgia Employees Retirement System, December 15, 2009.

[169] Pew Center on the States interview with Paul Cleary, executive director, Oregon Employees Retirement System, June 29, 2009.

[170] Pew Center on the States interview with Phillip Stoddard, director, Michigan State Employees Retirement System, June 21, 2009.

[171] Pew Center on the States interview with Pat Shier, Alaska Public Employees Retirement System, September 11, 2009.

[172] Pew Center on the States interview with Paul Matson, executive director, Arizona Retirement System, June 25, 2009.

[173] Pew Center on the States interview with Terry Slattery, executive director, New Mexico Public Employees Retirement Association, December 14, 2009.

[174] For employees with fewer than five years service as of July 1, 2009, the 3 percent contribution will begin July 1, 2010.

[175] E-mail from William Morico, Retirement and Benefit Services Coordinator, Healthcare Policy and Benefit Services Division, State of Connecticut, November 18, 2009.

[176] Pew Center on the States interview with Don Drum, executive director, Idaho Public Employees Retirement System, September 26, 2009.

[177] Pew Center on the States interview with Robert Newman, executive director, Utah Retirement Systems, October 5, 2009.

[178] The 12 members include two ex officio members—the State Treasurer and the Secretary of State. The other 10 are elected by the Public Employees Retirement Association membership and include four state members, four municipal members and two retirees. Pew Center on the States interview with Terry Slattery, executive director of the New Mexico Public Employees Retirement Association, September 14, 2009.

[179] Pew Center on the States interview with Dale Orr, actuarial services manager, Oregon Public Employees Retirement System, June 29, 2009.

[180] Pew Center on the States interview with Cynthia Webster, Vermont State Employees Retirement System, November 2, 2009.

[181] Pew Center on the States interview with Peggy Boykin, director, South Carolina Retirement Systems, July 2, 2009.

[182] National Conference of State Legislatures, State Pensions and Retirement Legislation 2009, accessed December 4, 2009, at www.ncsl.org/?tabid=17594.

[183] News release, New York Attorney General Andrew Cuomo, October 8, 2009. http://www.ag.ny.gov/media_center/2009/oct/oct8a_09.html.

[184] News release, California Public Employees Retirement System, November 23, 2009. http://www.calpers.ca.gov/index.jsp?bc=/about/press/pr-2009/nov/placement-agents-lobbyists.xml.

[185] California Senate Bill 1123, August 29, 2008. http://info.sen.ca.gov/pub/07-08/bill/sen/sb_1101-1150/sb_1123_bill_20080831_enrolled.pdf.

[186] Florida Legislature, "Florida Retirement System Pension Plan Fully Funded and Valuation Met Standards," Office of Program Policy Analysis and Government Accountability, February 2004, p. 22. http://www.oppaga.state.fl.us/MonitorDocs/Reports/pdf/0413rpt.pdf.

[187] Pew Center on the States interview with Phyllis Chambers, executive director, Nebraska Retirement System, October 6, 2009.

ENDNOTES

[188] Participants are guaranteed a 5 percent return, but they also can receive a higher return if the Federal Mid-term rate (as published by the Internal Revenue Service) plus 1.5 percent is greater than 5 percent.

[189] Pew Center on the States interview with Donna Mueller, chief executive officer, Iowa Public Employees Retirement System, August 4, 2009.

[190] Ibid.

[191] *Iowa Public Employees' Retirement System Comprehensive Annual Financial Report, FY2009*, p. 4 http://www.ipers.org/publications/misc/pdf/financial/cafr/cafr.pdf.

[192] Pew Center on the States interview with Donna Mueller, chief executive officer, Iowa Public Employees Retirement System, August 4, 2009.

[193] *Georgia Constitution*, Section X, Retirement Systems, Paragraph V, http://www.sos.ga.gov/elections/constitution_2007.pdf.

[194] Pew Center on the States interview with Tommy Hills, chief financial officer, Georgia, November 18, 2009.

[195] Pew Center on the States interview with Pamela Pharris, director, Georgia Employees Retirement System, December 14, 2009.

[196] Pew Center on the States interview with Michael Williamson, director, North Carolina Retirement System, September 2, 2009.

[197] Ronald K. Snell, "Pension and Retirement Plan Enactments in 2006 State Legislatures," National Conference of State Legislatures, October 2006.

Methodology

Data Sources

The main data source used for this project was the Comprehensive Annual Financial Report (CAFR) produced by each state for fiscal year 2008. The CAFR is an annually released publication that details the financial situation and key data for the state. The Governmental Accounting Standards Board (GASB) stipulates that the CAFR should include certain disclosures regarding pension and retiree health finances. Because CAFRs contain standard information in a consistent format, they are a valuable source for data on state-run retirement systems.

In addition to the state CAFR, many pension plans also release their CAFRs. In most cases, Pew staff found the plan CAFRs to offer more detailed and useful data than the state CAFRs and tried to use the plan documents when available. Another key information source was actuarial valuations. These are documents outlining the calculations made to assess the current and future costs of pension plans and retiree health plans. Finally, in some instances data were not available and we contacted state pension officials directly.

Scope of Data Collection

Plans included in the data collection were limited to the pension plans and retiree health and other benefit plans listed in the state CAFR. In some cases, a state will include a plan in its CAFR while indicating that it has no financial interest in that plan; such plans were excluded from this study.

Many states allow local governments to participate in the same plans set up for their own government agencies. As a result, this study includes plans for municipal workers or teachers when those plans are run by the state and the state maintains a financial interest. Locally run pension plans were excluded. While this means that the data for some states includes local workers while the data for others states do not, this does not affect the analysis in this report. Pew's assessment is based on indicators that scale with the size of the system; if a state's retirement system is only 50 percent funded, it is graded as meriting serious concerns regardless of whether municipal workers are included.

Another limit of the data collection is that it includes only defined benefit plans and cash balance plans. A defined benefit plan promises its recipients a set level of benefits, generally for life. In the case of pension benefits, it is based on a "defining" formula that usually includes the number of years served and an employee's salary multiplied by a preset figure (e.g., 30 years x $30,000 x 1.75). In the case of retiree health care, the promised benefit is typically the payment of a portion of the (or the entire) medical insurance premium. However, it can also be based on a defined formula much like a pension. In this case, a certain monthly income is promised that must be used for health expenses. A cash balance plan requires the employer and employees to make annual contributions, and, as with a defined benefit plan, they are assured a preset payment. Employees are guaranteed a 5 percent yearly rate of return, although successful investments may push the rate even higher.

Pew's data collection focused on the schedule of funding progress and the schedule of employer contributions. The schedule of funding progress indicates how well funded a pension or retiree health plan is and includes the actuarial value of assets, the actuarial value of liabilities, the unfunded liability and the percentage of the liability that has been funded. The schedule of employer contributions shows the actuarially required contribution—the amount of money that the employers sponsoring the plan need to contribute annually to pay for future benefits as they are earned by employees, and to pay for previously earned benefits that remain unfunded. The schedule of funding progress also includes the actual annual contributions that the employers made and the percentage of the actuarially required contribution that was actually made. Together these data give a basic impression of the financial status of a retirement plan.

In the case of pension plans, Pew researchers also collected other key data points: membership numbers, covered payroll and actuarial assumptions.

- Membership numbers show the size of a plan and its composition—the number of currently active members who are accruing benefits and paying into the plan and currently retired members who are drawing benefits from the plan.
- Covered payroll helps show the scale of a pension plan. Large plans can afford greater liabilities and, in fact, comparing the covered payroll to the unfunded liability is a highly effective way of determining whether the unfunded liabilities of a plan are reaching dangerously high levels.
- Actuarial assumptions are the building blocks for estimating future liabilities. Pew staff collected each pension plan's actuarial cost method, estimated rate of return and use of smoothing methods. Each of these assumptions, along with others that Pew did not collect from the CAFRs, is used by the actuaries to estimate how much money would be needed to pay for future liabilities. Among the most important is the assumed rate of return, which is the annual expected gain on investments. When actual experience differs from actuarial assumptions, plans can find themselves facing unexpectedly high or low liabilities. For example, a state could have higher than expected pension liabilities because employee life spans turned out to be greater than anticipated or investment returns came in lower than predicted.

Pew was able to obtain fiscal year 2008 data for all major state pension plans for all states except for Ohio. For that state, we used fiscal year 2007 data. The data collection stretches back to 1997 for most states, allowing Pew to look at changes over time. In the case of retiree health plans, data have only recently become available because of a 2004 ruling by the Governmental Accounting Standards Board (Statements Nos. 43 and 45) that mandated that states collect and present data on their actuarial liabilities for retiree health and other benefits. Because of this, past data for most states are unavailable. Many states also lack the infrastructure to regularly release data on retiree health and other benefits, so only data from 2007 or 2006 are available for many state-run retiree health plans. Because of the dearth of data, Pew also was unable to consistently collect supplementary information for most retiree health plans such as membership numbers or covered payroll.

Accuracy and Comprehensiveness

To ensure the accuracy of the data presented in this report, Pew staff implemented numerous quality control measures. First, Pew identified and double-checked all instances where data changed dramatically over time as a means of identifying potential errors in transcribing or interpreting data. Second, all data were compared when possible with pension data included in the Public Fund Survey, a survey of public pension plans run by the National Association of State Retirement Administrators, or with retiree health data included in the Center for State and Local Government Excellence report, *At a Crossroads*. Pew staff checked for discrepancies and made adjustments as necessary. Finally, retirement and finance officials in each state were given the opportunity to review Pew's data for accuracy and in many cases offered useful feedback.

Data Analysis

Pew's analysis focused on the funding level of retirement plans. The percent of a plan that is funded is the single best indicator of a retirement plan's fiscal health. States should try to ensure that the retirement plans that they run are 100 percent funded—that enough assets have been put into the plan to match the actuarially accrued liability. While Pew collected data on 231 pension plans and 159 retiree health and other benefit plans, each state's plans were aggregated to provide one set of pension numbers and one set of retiree health plan numbers for each state. Thus Oregon, which runs one pension plan for state and local employees, can be easily compared with Washington, which runs 12 different pension plans.

States have a lot of leeway in how they compute their obligations and present their data, so three main challenges arise in comparing their numbers. First, states vary in their smoothing practices—that is, how and when they recognize investment gains and losses. While most states acknowledge them over a number of years, several show their full impact immediately. Second, most states conduct actuarial valuations on June 30, but 15 perform them at other times, such as December 31. The severe investment losses in the second half of 2008 mean that states that do not smooth and that conduct their asset valuations in December will show pension funding levels that will appear worse off than states that did so on June 30. However, this also means that such states' numbers are likely to show a faster recovery than other states. (In addition, when investments were doing extremely well, their data reflected the full gains immediately, while other states smoothed those gains over time.) Finally, other factors also can impact states' asset and liability estimates, such as assumptions of investment returns, retirement ages and life spans. Conceivably , Pew could have recalculated all states' information using a standard set of assumptions—but we concluded that using states' own data and assumptions was the most objective, transparent and defensible approach to this analysis. In any instance in which a state's assumptions or practices vary in a meaningful way from others and significantly affect our findings, we attempt to explain these circumstances in the report, the state's fact sheet or both.

To measure how well states are managing their public sector retirement benefit obligations, Pew assigned each state two grades. One grade assessed the state's pension plans and the other rated its retiree health and other benefit plans. For the pension grade, a state could either be a solid performer, in need of improvement or meriting serious concerns. The retiree health care grade only included the "solid performer" and "needs improvement" categories. Because states have historically treated pension plans very differently than retiree health benefits, the two grades are based on different criteria.

Pensions grade. The pension grade was based on up to four possible points. States with four points were labeled solid performers, those with two or three points were deemed as needing improvement, and those with only one or zero points were classified as meriting serious concerns. The points were distributed as follows:

- Two points for having a funding ratio of at least 80 percent. The percentage funded is the best indicator of whether a pension plan is in healthy shape and thus is given more weight than the other criteria. The benchmark of 80 percent has been identified by the Government Accountability Office and other experts as the threshold for adequate pension funding.
- One point for having an unfunded liability totaling less than covered payroll. The payroll of all employees in a state's pension plan is a good proxy for the state's overall spending capacity, and an unfunded liability that is too high relative to an employer's ability to pay indicates a plan in fiscal trouble. Additionally, pension plans with very high unfunded liabilities relative to covered payrolls tend not only to be poorly funded but also generous relative to the state's willingness and capacity to pay.
- One point for paying on average at least 90 percent of the actuarially required contribution during the past five years. States that have paid the actuarially required contribution for a sustained period are on the right track toward being adequately funded.

Health care and other non-pension benefits grade. Pew's criteria for grading states' retiree health care and other non-pension benefit obligations were much simpler and more lenient than those used for the pension assessment. This is because most states have only recently begun to recognize these liabilities and many still have not put aside any assets to pay for these bills coming due. On average, states have only put aside 7.1 percent of the assets needed to adequately fund their retiree health liabilities.

Because most states have only recently begun to account for and address these liabilities, Pew's grades measure the progress they are making toward pre-funding. As a result, a "serious concerns" grade was not included. Pew rated as solid performers those states that had set aside more than 7.1 percent of funds to cover the bill coming due. All states that had set aside less than that amount were identified as needing improvement. This allowed Pew researchers to highlight and give credit to states that have begun to fund their retiree health care and other benefits while acknowledging that it is still too soon to expect states to have made meaningful progress.

An additional concern in grading state retiree health care and other benefit liabilities was the variation in the generosity of benefits offered. States vary much more in the level of non-pension benefits they provide than they vary with pension benefits. Moreover, for states with minimal (or implicit) benefits, it may be less of a financial necessity to pre-fund, and such states potentially could sustain a pay-as-you-go approach. However, it is still good financial practice to pre-fund, future liabilities. Additionally, in requiring that states assess their obligations for retiree health care benefits, GASB made no distinction in the size of retiree health benefits. We decided to follow that approach in deciding which benefits to include in our analysis.

Exhibit B1. Bridging the Gap—State Pension Grades

State	Grade	Points	Percentage of accrued liabilities funded	Unfunded liability as percentage of covered payroll	Percentage of actuarially required contribution made, 5-year average
Alabama	Needs improvement	2	77%	93%	100%
Alaska	Serious concerns	0	76%	158%	76%
Arizona	Solid performer	4	80%	67%	101%
Arkansas	Solid performer	4	87%	72%	104%
California	Needs improvement	3	87%	83%	86%
Colorado	Serious concerns	0	70%	243%	58%
Connecticut	Serious concerns	1	62%	449%	127%
Delaware	Solid performer	4	98%	7%	94%
Florida	Solid performer	4	101%	-7%	100%
Georgia	Solid performer	4	92%	49%	100%
Hawaii	Serious concerns	1	69%	137%	100%
Idaho	Solid performer	4	93%	30%	106%
Illinois	Serious concerns	0	54%	341%	60%
Indiana	Serious concerns	1	72%	101%	97%
Iowa	Needs improvement	3	89%	43%	85%
Kansas	Serious concerns	0	59%	133%	66%
Kentucky	Serious concerns	0	64%	234%	83%
Louisiana	Serious concerns	1	70%	181%	102%
Maine	Solid performer	4	80%	14%	105%
Maryland	Serious concerns	0	78%	102%	85%
Massachusetts	Serious concerns	1	63%	207%	93%
Michigan	Needs improvement	3	84%	97%	85%
Minnesota	Needs improvement	3	81%	91%	84%
Mississippi	Serious concerns	1	73%	143%	98%
Missouri	Needs improvement	2	83%	102%	83%
Montana	Solid performer	4	84%	86%	113%
Nebraska	Solid performer	4	92%	37%	98%
Nevada	Serious concerns	1	76%	140%	97%
New Hampshire	Serious concerns	1	68%	109%	95%
New Jersey	Serious concerns	0	73%	137%	33%
New Mexico	Needs improvement	2	83%	101%	89%
New York	Solid performer	4	107%	-41%	100%
North Carolina	Solid performer	4	99%	2%	100%
North Dakota	Needs improvement	3	87%	51%	70%
Ohio	Solid performer	4	87%	85%	96%
Oklahoma	Serious concerns	0	61%	220%	70%
Oregon	Needs improvement	2	80%	132%	86%
Pennsylvania	Needs improvement	3	87%	78%	52%
Rhode Island	Serious concerns	1	61%	277%	100%
South Carolina	Serious concerns	1	70%	139%	100%
South Dakota	Solid performer	4	97%	13%	100%
Tennessee	Solid performer	4	95%	20%	100%
Texas	Needs improvement	3	91%	35%	87%
Utah	Solid performer	4	84%	80%	100%
Vermont	Needs improvement	3	88%	41%	81%
Virginia	Needs improvement	3	84%	71%	87%
Washington	Needs improvement	3	100%	-1%*	37%
West Virginia	Serious concerns	1	64%	188%	164%
Wisconsin	Solid performer	4	100%	2%*	100%
Wyoming	Needs improvement	2	79%	82%	101%

*While Washington and Wisconsin are approximately 100 percent funded, Washington has a slight surplus and Wisconsin has a slight unfunded liability.
NOTE: When states run a pension surplus, they have a negative unfunded liability and thus the unfunded liability as a percentage of covered payroll is negative.
SOURCE: Pew Center on the States, 2010.

Exhibit B2. Bridging the Gap—State Retiree Health Care and Other Non-pension Benefit Grades

State	Grade	Points	Percentage funded
Alabama	Needs improvement	0	2.5%
Alaska	Solid performer	1	55.9%
Arizona	Solid performer	1	65.2%
Arkansas	Needs improvement	0	0.0%
California	Needs improvement	0	0.0%
Colorado	Solid performer	1	18.7%
Connecticut	Needs improvement	0	0.0%
Delaware	Needs improvement	0	1.4%
Florida	Needs improvement	0	0.0%
Georgia	Needs improvement	0	4.1%
Hawaii	Needs improvement	0	0.0%
Idaho	Needs improvement	0	0.9%
Illinois	Needs improvement	0	0.2%
Indiana	Needs improvement	0	0.0%
Iowa	Needs improvement	0	0.0%
Kansas	Needs improvement	0	0.0%
Kentucky	Solid performer	1	10.4%
Louisiana	Needs improvement	0	0.0%
Maine	Needs improvement	0	1.2%
Maryland	Needs improvement	0	0.8%
Massachusetts	Needs improvement	0	1.8%
Michigan	Needs improvement	0	1.9%
Minnesota	Needs improvement	0	0.0%
Mississippi	Needs improvement	0	0.0%
Missouri	Needs improvement	0	0.5%

State	Grade	Points	Percentage funded
Montana	Needs improvement	0	0.0%
Nebraska does not measure its retiree health or other benefits			
Nevada	Needs improvement	0	0.0%
New Hampshire	Needs improvement	0	5.4%
New Jersey	Needs improvement	0	0.0%
New Mexico	Needs improvement	0	5.5%
New York	Needs improvement	0	0.0%
North Carolina	Needs improvement	0	2.1%
North Dakota	Solid performer	1	34.3%
Ohio	Solid performer	1	38.2%
Oklahoma	Needs improvement	0	0.0%
Oregon	Solid performer	1	29.8%
Pennsylvania	Needs improvement	0	0.9%
Rhode Island	Needs improvement	0	0.0%
South Carolina	Needs improvement	0	1.7%
South Dakota	Needs improvement	0	0.0%
Tennessee	Needs improvement	0	0.0%
Texas	Needs improvement	0	2.5%
Utah	Needs improvement	0	0.7%
Vermont	Needs improvement	0	0.2%
Virginia	Solid performer	1	33.9%
Washington	Needs improvement	0	0.0%
West Virginia	Needs improvement	0	4.0%
Wisconsin	Solid performer	1	24.0%
Wyoming	Needs improvement	0	0.0%

SOURCE: Pew Center on the States, 2010.

Data Collection

Pension Plans Included in Pew's Data Collection

Alabama: Teachers' Retirement System, Employees' Retirement System, Judicial Retirement Fund.

Alaska: Public Employees' Retirement System, Teachers' Retirement and Pension System, Employee's Retirement and Pension System, Alaska National Guard and Naval Militia Retirement System, Elected Public Officials' Retirement Plan.

Arizona: Arizona State Retirement System, Public Safety Personnel Retirement System, Elected Officials' Retirement Plan, Corrections Officer Retirement Plan.

Arkansas: Arkansas Public Employees' Retirement System, Arkansas Teachers' Retirement System, Judicial Retirement System, Highway and Transportation Retirement System, State Police Retirement System.

California: Public Employees' Retirement System, Legislative Retirement Fund, Judicial Retirement Fund, Judicial Retirement Fund 2, Volunteer Firefighters Fund, State Teachers' Retirement Fund, State Teachers' Retirement Fund Cash Balance, State Teachers' Retirement Fund Defined Benefit Supplement.

Colorado: State and School Division, State Division, School Division, Judicial Division, Local Government Division.

Connecticut: State Employees' Retirement System, Teachers' Retirement System, Judicial Retirement System.

Delaware: State Employees' Pension Plan, New State Police Pension Plan, Judiciary Pension Plan, State Police Retirement System (Closed), Diamond State Port Corporation, County and Municipal Police Firefighters, County and Municipal Other Employees, Volunteer Firemen.

Florida: Florida Retirement System, Florida Retiree Health Insurance Subsidy.

Georgia: Employees' Retirement System, Teachers Retirement System, Public School Employees' Retirement System, Legislative Retirement System, Judicial Retirement System, Georgia Military Pension Fund.

Hawaii: Employees' Retirement System.

Idaho: Public Employees' Retirement Fund Base Plan.

Illinois: State Employees' Retirement System, Judges' Retirement System, General Assembly Retirement System, Teachers' Retirement System, State Universities Retirement System.

Indiana: State Police Retirement Fund, Public Employees' Retirement Fund—State, Excise Police, Gaming Agent and Conservation Enforcement Officers' Retirement Fund, Judges' Retirement System, Prosecuting Attorneys' Retirement Fund, Legislators' Retirement System, State Teachers' Retirement Fund, 1977 Police Officers' and Firefighters' Pension and Disability Fund.

Iowa: Iowa Public Employees' Retirement System, Peace Officers Retirement, Accident and Disability System, Iowa Judicial Retirement System.

Kansas: Kansas Public Employees' Retirement System

Kentucky: Kentucky Employees' Retirement System—Non-hazardous, Kentucky Employees' Retirement System—Hazardous, State Police Retirement System, Judicial Retirement Fund, Legislators' Retirement Fund, Kentucky Teachers' Retirement System.

Louisiana: Louisiana State Employees' Retirement System (LASERS), Teachers Retirement System of Louisiana (TRSLA), Louisiana School Employees Retirement System (LSERS), Louisiana State Police Retirement System (LSPRS).

Maine: Maine Public Employees Retirement System.

Maryland: Teachers' Retirement and Pension System, Employees' Retirement and Pension System, Judges' Retirement System, State Police Retirement System, Law Enforcement Officers' Retirement Pension System, Maryland Transit Administration Pension Plan.

Massachusetts: State Employees' Retirement System, Teachers' Retirement System, State-Boston Retirement System.

Michigan: Legislative Retirement System, State Police Retirement System (SPRS), State Employees' Retirement System (SERS), Public School Employees' Retirement System (PSERS), Judicial Retirement System (JRS), Military Retirement Plan (MRP).

Minnesota: Correctional Employees' Retirement Fund, State Employees Retirement Fund, Elective State Officers Fund, Judicial Retirement Fund, Legislative Retirement Fund, State Patrol Retirement Fund, Public Employees Retirement Fund, Police and Fire Fund, Public Employees' Correctional Fund, Teachers' Retirement Fund.

Mississippi: Public Employees' Retirement System, Mississippi Highway Safety Patrol Retirement System, Municipal Retirement System, Supplemental Legislative Retirement Plan.

Missouri: Missouri State Employees' Plan, Public School Retirement System, Missouri Patrol Employees' Retirement System, Public Education Employees' Retirement System, Judicial Plan, University Plan.

Montana: Public Employees' Retirement System—Defined Benefit Retirement Plan, Sheriff's Retirement System, Highway Patrol Officers' Retirement System, Game Warden and Peace Officers' Retirement System, Firefighters' Unified Retirement System, Municipal Police Officers' Retirement System, Judges' Retirement System, Teachers' Retirement System.

Nebraska: State Employees' Retirement, County Employees, Schools, Judges, State Patrol.

Nevada: Public Employees' Retirement System, Legislative Retirement System, Judicial Retirement System.

New Hampshire: Employees Group, Teachers Group, Police Officers Group, Firefighters Group, Judicial.

New Jersey: Public Employees' Retirement System, Teachers' Pension and Annuity Fund, Judicial Retirement System, Consolidated Police and Firemen's Pension Fund, Police and Firemen's Retirement System, Prison Officers' Pension Fund, State Police Retirement System.

New Mexico: Public Employees' Retirement System, Judicial Retirement System, Volunteer Firefighters Retirement Fund, Magistrate Retirement System, Education Employees' Retirement System.

New York: Employees' Retirement System, Police and Fire Retirement System.

North Carolina: Teachers' and State Employees' Retirement System, Consolidated Judicial Retirement System, Legislative Retirement System, Firemen's and Rescue Squad Workers' Pension Fund, National Guard Pension Plan, Registers' of Deeds' Retirement System, Local Governmental Employees' Retirement System.

North Dakota: Public Employees' Retirement System, Highway Patrol Retirement System, Retirement Plan for the Employees of Job Service North Dakota, Teachers' Fund for Retirement.

Ohio: Ohio Public Employees Retirement System, State Teacher Retirement System, State Highway Patrol Retirement System.

Oklahoma: Oklahoma Firefighters Pension Retirement System, Oklahoma Public Employees' Retirement System, Uniform Retirement System for Judges and Justices, Police Pension and Retirement System, Teachers' Retirement System, Oklahoma Law Enforcement Retirement System, Wildlife Conservation Retirement Plan.

Oregon: Public Employees Retirement System.

Pennsylvania: State Employees' Retirement System, Public School Employees' Retirement System.

Rhode Island: Employees' Retirement System—State Employees, Employees' Retirement System—Teachers, State Police Retirement Benefits Trust, Judicial Retirement Benefits Trusts.

South Carolina: South Carolina Retirement System, Police Officers' Retirement System, General Assembly Retirement System, Judges' and Solicitors' Retirement System, National Guard Retirement System.

South Dakota: South Dakota Retirement System, South Dakota Cement Pension Trust Fund, Department of Labor Employee Retirement System.

Tennessee: State Employees, Teachers, and Higher Education Employees Pension Plan (SETHEEPP), Political Subdivision Defined Benefit Plan (PSPP).

Texas: Employees Retirement System of Texas Plan, Law Enforcement and Custodial Officer Supplemental Retirement Fund, Judicial Retirement System of Texas Plan One, Judicial Retirement System of Texas Plan Two, Teacher Retirement System of Texas, Texas Statewide Emergency Services Retirement Act (TSESRA) Fund.

Utah: Public Employees Noncontributory Retirement System (Noncontributory System), Public Employees Contributory Retirement System (Contributory System), Firefighters Retirement System, Public Safety Retirement System, Judges Retirement System, Utah Governors and Legislators Retirement Plan.

Vermont: Vermont State Retirement System (VSRS), State Teachers' Retirement System (STRS), Vermont Municipal Employees' Retirement System (MERS).

Virginia: Virginia Retirement Systems, State Police Officers' Retirement System (SPORS), Virginia Law Officers' Retirement System (VaLORS), Judicial Retirement System (JRS).

Washington: Public Employees' Retirement System Plan 1, Public Employees' Retirement System 2/3, Teachers' Retirement System Plan 1, Teachers' Retirement System 2/3, School Employees' Retirement System, Law Enforcement Officers' and Fire Fighters' Retirement System—Plan 1, Law Enforcement Officers' and Fire Fighters' Retirement System 2, Public Safety Employees' Retirement System, Washington State Patrol Retirement System (WSPRS), Judicial Retirement System, Judges' Retirement Fund, Volunteer Fire Fighters', Reserve Officers' Relief and Pension Fund.

West Virginia: The Public Employees' Retirement System (PERS), Teachers' Retirement System (TRS), The Public Safety Death, Disability, and Retirement Fund (PSDDRF); State Police Retirement System (SPRS), Judges' Retirement System (JRS).

Wisconsin: Wisconsin Retirement System.

Wyoming: Public Employees Pension Plan, Wyoming State Highway Patrol, Game and Fish Warden and Criminal Investigator Retirement Plan; Volunteer Firemen's Pension Plan, Paid Firemen's Pension Plan A, Paid Firemen's Pension Plan B, Wyoming Judicial Retirement Plan, Wyoming Law Enforcement Retirement Plan (effective 2002).

Retiree Health and Other Benefit Plans in Pew's Data Collection

Alabama: Retired State Employees' Health Care Trusts, Retired Education Employees' Health Care Trust.

Alaska: Public Employees' Retirement System Other Post-employment Benefit (OPEB), Teachers' Retirement System OPEB, Elected Public Officials' Retirement Plan OPEB, Judicial Retirement System OPEB.

Arizona: Health Insurance Premium Benefit, Long Term Disability Program, Health Insurance Premium Subsidy—Public Safety Personnel Retirement System, Health Insurance Premium Subsidy—Elected Officials Retirement Plan, Health Insurance Premium Subsidy—Corrections Officer Retirement Plan.

Arkansas: Arkansas State Employee Health Insurance Plan, Arkansas State Police Medical and Rx Plan,19 state run plans for public colleges and universities.

California: State of California OPEB, University of California Retiree Health Plan, Medicare Premium Payment Program.

Colorado: Public Employees' Retirement Association (PERA) Health Care Trust Fund, University of Colorado OPEB, Retiree Medical Premium Refund Plan, Retiree Medical Premium Subsidy for PERA Participants, Umbrella RX Plan.

Connecticut: State Employee OPEB Plan, Retired Teacher Healthcare Plan.

Delaware: Delaware OPEB Fund Trust.

Florida: Florida OPEB.

Georgia: Board of Regents Retiree Health Benefit Fund, Georgia Retiree Health Benefit Fund, State Employees' Assurance Department.

Hawaii: Employer-Union Health Benefits Trust Fund (EUTF), Voluntary Employees' Benefit Association Trust.

Idaho: Retiree Healthcare, Long-Term Disability, Life Insurance, University of Idaho—Medical, Dental, Life.

Illinois: Health, Dental, Vision, Life, Community College Health Insurance Security Fund, Teacher Health Insurance Security Fund (excluding Chicago.)

Indiana: State Personnel Healthcare Plan, Legislatures' Healthcare Plan, Indiana State Police Healthcare Plan, Conservation and Excise Police Healthcare Plan.

Iowa: Medical Insurance and University Funds (Medical, Dental, Life).

Kansas: Health Insurance.

Kentucky: Kentucky Retirement Systems Insurance Fund—Non Hazardous, Kentucky Retirement Systems Insurance Fund—Hazardous, Kentucky Legislators Retirement Plan-Insurance, Kentucky Judicial Retirement Plan—Insurance, State Police Retirement System—Insurance, Kentucky Teachers' Retirement System.

Louisiana: Office of Group Benefits Plan, Definity Health Plan.

Maine: State Employees, First Responders, Teachers, Life Insurance Plan.

Maryland: State Employee and Retiree Health and Welfare Benefits Program.

Massachusetts: State Retiree Benefits Trust Fund.

Michigan: Legislative Retirement System (LRS), State Police Retirement System (SPRS), State Employees' Retirement System (SERS), Public School Employees' Retirement System (PSERS), Judges' Retirement System (JRS), Life Insurance.

Minnesota: State Plan, Metropolitan Council Plan, University of Minnesota Plan.

Mississippi: Medical and Life Insurance Plan.

Missouri: Missouri Consolidated Health Care Plan (MCHCP), Healthcare and Life Insurance: Missouri State Employees' Retirement System (MOSERS), Missouri Department of Transportation and Missouri State Highway Patrol Medical and Life Insurance Plan (MHPML), Conservation Employees' Insurance Plan (CEIP).

Montana: State of Montana, Montana University System.

Nebraska: Nebraska does not provide any data regarding its liability for retiree health care or other non-pension benefits.

Nevada: Retirees' Fund.

New Hampshire: Employee and Retiree Benefit Risk Management Fund, Group II—Police Officers and Firefighters, Group I—Teachers, Group I—Political Subdivision Employees, Group I—State Employees.

New Jersey: State OPEB, Local OPEB.

New Mexico: Retiree Health Care Authority.

New York: New York State Health Insurance Program, State University of New York OPEB, City University of New York OPEB.

North Carolina: Retiree Health Benefit Fund, Disability Income Plan.

North Dakota: Retiree Health Insurance Credit Fund, Retiree Health Insurance Health Care, Job Service North Dakota OPEB.

Ohio: Retiree Medical Account—Healthcare, State Teacher Retirement System—OPEB, SHPRS—OPEB.

Oklahoma: The Oklahoma State and Education Employee Group Insurance Board (OSEEGIB).

Oregon: Retirement Health Insurance Account (RHIA), Retiree Health Insurance Premium Account (RHIPA), Public Employees' Benefit Board—Medical, Dental, Vision; SAIF Healthcare, Oregon Health and Science University Healthcare.

Pennsylvania: Retired Employees Health Program, Retired Pennsylvania State Police Program, Pennsylvania Judiciary, Pennsylvania House of Representatives, Pennsylvania Senate.

Rhode Island: Rhode Island Retiree Health Care Benefit Plan-State Employees, Rhode Island Retiree Health Care Benefit Plan—Teachers, Rhode Island Retiree Health Care Benefit Plan—Judges, Rhode Island Retiree Health Care Benefit Plan—State Police, Rhode Island Retiree Health Care Benefit Plan—Legislators.

South Carolina: South Carolina Retiree Health Insurance Trust Fund (SCRHITF), Long Term Disability Insurance Trust Fund (LTDITF), South Carolina Retirement System Retiree Life Insurance, Police Officers' Retirement System Retiree Life Insurance.

South Dakota: South Dakota OPEB.

Tennessee: Employee Group Plan, Teacher Group Plan, Medicare Supplement: State, Medicare Supplement: Teachers.

Texas: University of Texas System Employee Group Plan ("UT Plan"), A&M Care Health and Life Plan ("A&M Plan"), Employees Retirement System (ERS), Teachers Retirement System.

Utah: Other Postemployment Retirement Plan, Utah Retirement Employees Post Employment Healthcare Plan.

Vermont: Vermont State Retirement System, State Teachers' Retirement System.

Virginia: Group Life Insurance Fund, Retiree Health Insurance Credit Fund, Disability Insurance Trust Fund, Line of Duty Death and Disability, Pre-Medicare Retiree Healthcare.

Washington: State OPEB, K-12 OPEB, Political Subdivision OPEB.

West Virginia: Retiree Health Benefit Trust Fund (RHBT).

Wisconsin: State's Health Insurance Plan, Duty Disability Fund, Retiree Life Insurance Fund.

Wyoming: Retiree Health Insurance Plan.

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Reports & Studies

Greenspan Commission

REPORT OF THE

NATIONAL COMMISSION ON SOCIAL SECURITY REFORM

JANUARY 1983

The National Commission on Social Security Reform (informally known as the Greenspan Commission after its Chairman) was appointed by the Congress and the President in 1981 to study and make recommendations regarding the short-term financing crisis that Social Security faced at that time. Estimates were that the Old-Age and Survivors Insurance Trust Fund would run out of money possibly as early as August 1983. This bipartisan Commission was to make recommendations to Congress on how to solve the problems facing Social Security. Their report, issued in January 1983, became the basis for the 1983 Social Security Amendments which resolved the short-term financing problem and made many other significant changes in Social Security law.

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1983 Greenspan Commission on Social Security Reform

Appendix C of the 1983 Greenspan Commission on Social Security Reform

Chapter 2

FINDINGS AND RECOMMENDATIONS

The National Commission was assigned the critical job of assessing whether the OASDI program has financing problems in the short run and over the long-range future (as represented by the 75-year valuation period) and, if so, recommending how such problems could be resolved.

The National Commission has agreed that there is a financing problem for the OASDI program for both the short run, 1983-89 (as measured using pessimistic economic assumptions) and the long range, 1983-2056 (as measured by an intermediate cost estimate) and that action should be taken to strengthen the financial status of the program. (1) The National Commission recognized that, under the intermediate cost estimate, the financial status of the OASDI program in the 1990s and early 2000s will be favorable (i.e., income will significantly exceed outgo) -- see Table 7A in Appendix K. The National Commission also recognized that, under the intermediate cost estimate, the financial status of the HI program becomes increasingly unfavorable from 1990 until the end of the period for which the estimates are made -- see Table 7B in Appendix K.

(1) The assumptions underlying these cost estimates are summarized in Tables 12 and 13 of Appendix K.

The National Commission makes the following recommendations unanimously:

(1) The members of the National Commission believe that the Congress, in its deliberations on financing proposals, should not alter the fundamental structure of the Social Security program or undermine its fundamental principles.* The National Commission considered, but rejected, proposals to make the Social Security program a voluntary ones or to transform it into a program under which benefits are a product exclusively of the contributions paid, or to convert it into a fully-funded program, or to change it to a program under which benefits are conditioned on the showing of financial need.**

* See additional views of Commissioner Archer in Chapter 4.
** See additional views (with regard to the last point) of Commissioners Archer, Fuller, and Waggonner in Chapter 4.

(2) The National Commission recommends that, for purposes of considering the short-range financial status of the OASDI Trust Funds, $150-200 billion in either additional income or in decreased outgo (or a combination of both) should be- provided for the OASDI Trust Funds in calendar years 1983-89.

(3) The National Commission finds that, for purposes of considering the long-range financial status of the OASDI Trust Funds, its actuarial imbalance for the 75-year valuation period is an average of 1.80% of taxable payroll.(2)

(2) This figure is the actuarial lack of balance according to the intermediate (Alternative II-B) cost estimate in the 1982 Trustees Report, after adjustment for the effects of legislation and the actual benefit increase for June 1982.

The National Commission was able to reach a consensus for meeting the short-range and long-range financial requirements, by a vote of 12 to 3. The 12 members voting in favor of the "consensus" package were Commissioners Ball, Beck, Conable, Dole, Fuller, Greenspan, Heinz, Keys, Kirkland, Moynihan, Pepper, and Trowbridge; the 3 members voting against the "consensus" package were Commissioners

Archer, Armstrong, and Waggonner.

The 12 members of the National Commission voting in favor of the "consensus" package agreed to a single set of proposals to meet the short-range deficit (with Commissioner Kirkland dissenting on the proposal to cover newly hired Federal employees). They further agreed that the long-range deficit should be reduced to approximately zero. The single set of recommendations would meet about two-thirds of the long-range financial requirements. Seven of the 12 members agreed that the remaining one-third of the long-range financial requirements should be met by a deferred, gradual increase in the normal retirement age, while the other 5 members agreed to an increase in the contribution rates in 2010 of slightly less than one-half percent (0.46%) of covered earnings on the employer and the same amount on the employee, with the employee's share of the increase offset by a refundable income-tax credit (see the statements in Chapter 4 for a presentation of these approaches).

Various possible short-range and long-range financing options are displayed in the Commission's Background Book entitled <u>Old-Age, Survivors, and Disability Insurance and Hospital Insurance Programs -- Actuarial Cost Estimates for OASDI and HI and for Various Possible Changes in OASDI and Historical Data for OASDI and HI</u>, revised version, December 1982 (which is included in this report as Appendix K). The derivation and underlying basis of the additional financial resources needed in 1983-89, as stated in item (2), are described in detail on pages 16-21 of Appendix J.

<u>Provisions of "Consensus" Package</u>

Recommendations Nos. (4) to (16) describe the provisions of the "consensus" package. Table A presents the actuarial cost data for this package for both the short range (1983-89 in the aggregate) and the long range (the 75-year valuation period, ending with 2056). Table B gives the year-by-year actuarial cost data for the short-range period. The cost estimates underlying these figures are based on economic assumptions which have been developed in recent weeks and which assume significantly lower levels of both price and wage inflation than does the Alternative III estimate in the 1982 OASDI Trustees Report (and even somewhat lower than in the Alternative II-B estimate).

Table A: SHORT-RANGE AND LONG-RANGE COST ANALYSIS OF OASDI PROPOSALS

Proposal	Short-Term Savings, 1983-89 (billions)	Long-Range Savings (percentage of payroll)
Cover nonprofit and new Federal employees (c)	+$20	+.30%
Prohibit withdrawal of State and local government employees	+3	--
Taxation of benefits for higher-income persons	+30	+.60
Shift COLAs to calendar-year basis	+40	+.27
Eliminate windfall benefits for persons with pensions from noncovered employment	+.2	+.01
Continue benefits on remarriage for disabled widow(er)s and for divorced widow(er)s	-.1	--
Index deferred widow (er)'s benefits based on wages (instead of CPI)	-.2	-.05
Permit divorced aged spouse to receive benefits when husband is eligible to receive benefits	-.1	-.01
Increase benefit rate for disabled widow (er)s aged 50-59 to 71 1/2% of primary benefit	-1	-.01
Revise tax-rate	+40	+.02

schedule		
Revise tax basis for self-employed	+18	+.19
Reallocate OASDI tax rate between OASI and DI	--	--
Allow inter-fund borrowing from HI by OASDI	--	--
Credit the OASDI Trust Funds, by a lump-sum payment for cost of gratuitous military service wage credits and past unnegotiated checks	+18	--
Base automatic benefit increases on lower of CPI or wage increases after 1987 if fund ratio is under 20%, with catch-up if fund ratio exceeds 32%	--	--
Increase delayed retirement credit from 3% per year to 8%, beginning in 1990 and reaching 8% in 2010	--	-.10(a)
Additional long-range changes (b)	--	+.58
Total Effect	**+168**	**+1.80**

(a) This cost estimate assumes that retirement patterns would be only slightly affected by this change. If this change does result in significant changes in retirement behavior over time, the cost increase would be less (or possibly even a small savings could result).

(b) Alternate methods for obtaining this long-range savings are presented in the Additional Statements of the members (in Chapter 4).

(c) Includes effect of revised tax schedule.

NOTE: See text for complete description of the proposals.

Table B: YEAR-BY-YEAR SHORT-RANGE

COST ANALYSIS OF OASDI PROPOSALS

The "consensus" package would provide an estimated $168 billion in additional financial resources to the OASDI program in calendar years 1983-89. This amount is very close to the midpoint of the $150-200 billion range stated in Recommendation No. 2. Actually, because the economic assumptions which are used for this package involve a lower inflation rate as to both prices and wages than those which had been used earlier in the deliberations, the resulting $168 billion of additional financial resources is really relatively near the upper end of the desired range.

(4) The National Commission recommends that coverage under the OASDI program should be extended on a mandatory basis, as of January 1, 1984, to all newly hired civilian employees of the Federal Government.(3)/* The National Commission also recommends that OASDI-HI coverage should be extended on a mandatory basis, as of January 1, 1984, to all employees of nonprofit organizations.

It is important to note that covering additional groups of workers such as those specified in this recommendation not only results in a favorable cash-flow situation in the short run, but also has a favorable long-range effect. The additional OASDI taxes paid on behalf of the newly-covered workers over the long run will exceed, on the average, the additional benefits which result from such employment(4), assuming that the program is in long-range actuarial balance.

(3) Under present law, temporary Federal civilian employees are covered by the OASDI-HI program, and all other Federal civilian employees are covered under the HI program, beginning January 1, 1983. All persons in the armed forces are covered by the OASDI-HI program.

** See additional views of Commissioner Archer and additional views of Commissioner Kirkland in dissent, in Chapter 4.*

The National Commission believes that an independent supplemental retirement plan should be developed for the Federal new hires, which would be part of the Civil Service Retirement system (just as private employers have plans supplementing the OASDI program). It is important to note that present Federal employees will not be affected by this recommendation (and that the financing of their benefits over the long run will not be adversely affected).

(5) The National Commission recommends that State and local governments which have elected coverage for their employees under the OASDI-HI program should not be permitted to terminate such coverage in the future -- specifically, termination notices now pending would be invalid if the process of termination is not completed(5) by the enactment date of the new legislation.

(4) The vast majority of the individuals involved would have qualified for sizable OASDI benefits as a result of other employment even if coverage were not extended to these two categories of workers. Also, they tend to have higher-than-average wages and, therefore, are entitled to less-heavily weighted benefits.

(5) Current law provides that withdrawal can occur, after advance notice of at least 2 years, at the end of the calendar year specified in the withdrawal notice. For example, a withdrawal notice filed in February 1981 would (if not withdrawn earlier by the State or local government entity) result in the process of termination being completed on January 1, 1984.

(6) The National Commission is concerned about the relatively large OASDI benefits that can accrue to individuals who spend most of their working careers in noncovered employment from which they derive pension rights, but who also become eligible for OASDI benefits as a result of relatively short periods in covered employment with other employers. Accordingly, the National Commission recommends that the method of computing benefits should be revised for persons who first become eligible for pensions from non-covered employment, after 1983, so as to eliminate "windfall" benefits.

The result of such a work history is to produce OASDI benefits that contain "windfall" elements

-- the benefits payable are relatively high compared to the proportion of time spent and the OASDI taxes paid during covered employment. This results from the weighted benefit formula, which treats these individuals in the same manner as if they were long-service, low-earnings workers. Specifically, the National Commission believes that these individuals should receive benefits which are more nearly of a proportionate basis than the heavily-weighted benefits now provided.

There are various methods of eliminating the "windfall" portion of benefits (while still providing equitable, proportional benefits). One method would be to modify the benefit formula for determining the Primary Insurance Amount by making the second percentage factor (32%) be applicable to the lowest band of Average Indexed Monthly Earnings (instead of the 90% factor), but the reduction in benefits would not be larger than the pension from non-covered employment. Another method would be to apply the present benefit formula to an earnings record which combines both covered earnings and also non-covered earnings in the future for the purpose of determining a replacement rate (i.e., the ratio of the benefit initially payable to previous earnings); then, that replacement rate would be applied to the average earnings based solely on covered employment. The short-range cost effect of these proposals -- applied only prospectively for new eligibles -- would be relatively small. The long-range cost effect would depend on the procedure used and on whether the recommended extension of coverage is adopted.

(7) <u>The National Commission recommends that, beginning with 1984, 50% of OASDI benefits should be considered as taxable income for income-tax purposes for persons with Adjusted Gross Income (before including therein any OASDI benefits) of $20,000 if single and $25,000 if married. The proceeds from such taxation, as estimated by the Treasury Department, would be credited to the OASDI Trust Funds under a permanent appropriation</u>.*

** See additional views of Commissioner Archer in Chapter 4.*

It is estimated that about 10% of OASDI beneficiaries would be affected by this provision. The National Commission noted that a "notch" is present in this provision in that those with Adjusted Gross Income of just under the limit of $20,000/$25,000 would have a larger total income (including OASDI benefits) than those with Adjusted Gross Income just over the limit. The National Commission points out the presence of this "notch" and trusts that it will be rectified in the legislative process.

(8) The National Commission recommends that the automatic cost-of-living adjustments of OASDI benefits should, beginning in 1983, be made applicable to the December benefit checks (payable early in January), rather than being first applicable to the June payments. The National Commission also recommends that the amount of the disregard of OASDI benefits for purposes of determining Supplemental Security Income payment levels should be increased from $20 a month to $50.

The increase in the CPI for purposes of the automatic adjustments for any particular year is currently measured from the first quarter of the previous year to the first quarter of that particular year. This procedure should continue to apply for the adjustment in benefit amounts for 1983 (payable in early January 1984). However, for subsequent years, the comparison should be made on a "third quarter to third quarter" basis.

The recommended increase in the amount of the disregard of OASDI benefits for SSI purposes is estimated to have an initial cost of about 5750 million per year.

(9) The National Commission recommends that the following changes in benefit provisions which affect mainly women should be made:

(a) Present law permits the continuation of benefits for surviving spouses who remarry after age 60. This would also be done for (1) disabled surviving spouses aged 50-59, (2) disabled divorced surviving spouses aged 50-59, and (3) divorced surviving spouses aged 60 or over.

(b) Spouse benefits for divorced spouses would be payable at age 62 or over (subject to the requirement that the divorce has lasted for a significant period) if the former spouse is eligible for retirement benefits, whether or not they have been claimed (or they have been suspended because of substantial employment).

(c) Deferred surviving-spouse benefits would continue to be indexed as under present law, except that the indexing would be based on the increases in wages after the death of the worker (instead of by the increases in the CPI, as under present law).

(d) The benefit rate for disabled widows and widowers aged 50-59 at disablement would be the same as that for non-disabled widows and widowers first claiming benefits at age 60 (i.e., 71~2% of the Primary Insurance Amount), instead of the lower rates under present law (gradually rising from 50% at age 50 to 71 1/2% for disablement at age 60). Such change would not only be applicable to new cases, but would also be applicable to beneficiaries of this category who are on the rolls on the effective date of the provision.

(10) The National Commission recommends that the OASDI tax schedule should be revised so that the 1985 rate would be moved to 1984, the 1985-87 rates would remain as scheduled under present law, part of the 1990 rate would be moved to 1988, and the rate for 1990 and after would remain unchanged. The HI tax rates for all years would remain unchanged. The resulting tax schedule would be as follows:

Employer and Employee Rate (each)				
	OASDI		OASDI-HI	
Year	Present Law	Proposal	Present Law	Proposal
1983	5.4%	5.4%	6.7%	6.7%
1984	5.4	5.7	6.7	7.0
1985	5.7	5.7	7.05	7.05
1986	5.7	5.7	7.15	7.15
1987	5.7	5.7	7.15	7.15
1988-89	5.7	6.06	7.15	7.51
1990 and	6.2	6.2	7.65	7.65

after				

For 1984, a refundable income tax credit would be provided against the individual's Federal income-tax liability in the amount of the increase in the employee taxes over what would have been payable under present law.*

** See additional views of Commissioner Archer in Chapter 4.*

(11) The National Commission recommends that the OASDI tax rates for self-employed persons should, beginning in 1984, be equal to the combined employer-employee rates. One-half of the OASDI taxes paid by self-employed persons should then be considered as a business expense for income-tax purposes (but not for purposes of determining the OASDI-HI tax).*

** See additional views of Commissioner Archer in Chapter 4.*

Under present law, self-employed persons pay an OASDI tax rate which is approximately equal to 75% of the combined employer-employee rate (exactly 75% for 1985 and after) and an HI tax rate which is 50% of the combined employer-employee rate. Also, under present law, self-employed persons cannot deduct, as business expenses, any OASDI-HI taxes paid. The reduction in income taxes payable by the self-employed during 1984-89 as a result of considering one-half of their OASDI taxes as a business expense is estimated to be about $12 billion.

(12) The National Commission recommends that the proposed OASDI tax rates should be allocated between the OASI and DI Trust Funds in a manner different from present law, in order that both funds will have about the same fund ratios.

(13) The National Commission recommends that the authority for inter-fund borrowing by the OASDI Trust Funds from the HI Trust Fund be authorized for 1983-87.

(14) The National Commission recommends that a lump-sum payment should be made to the OASDI Trust Funds from the General Fund

of the Treasury for the following items:

(a) The present value of the estimated additional benefits arising from the gratuitous military service wage credits for service before 1957 (subject to subsequent adjustments if the experience deviates from the estimates).

(b) The amount of the combined employer-employee OASDI taxes on the gratuitous military service wage credits for service after 1956 and before 1983 (which were granted as a recognition of non-cash remuneration, and the cost of which is met, under present law, when additional benefits derived therefrom are paid). The payment would include interest, but would be reduced for any costs therefor which were paid in the past to the OASDI Trust Funds from the General Fund of the Treasury. In the future, the OASDI Trust Funds would be reimbursed on a current basis for such employer-employee taxes on such wage credits for service after 1982.

(c) The amount of uncashed OASDI checks issued in the past (which were charged against the trust funds at time of issue), estimated at about $300-400 million. (The problem of uncashed checks in the future has been corrected as a result of changed procedures of the Treasury Department with regard to checks which are uncashed for a long time.)

(15) The National Commission recommends that, beginning with 1988, if the fund ratio(6) of the combined OASDI Trust Funds as of the beginning of a year is less than 20.0% (except that, for 1988, the fund ratio to be considered would be that estimated for the end of that year), the automatic cost-of-living (COLA) adjustments of OASDI benefits should be based on the lower of the CPI increase or the increase in wages. If the fund ratio is 32.0% or more at the beginning of a year, payments will be made during the following year as supplements to monthly benefits otherwise payable to make up to individuals for any use of wage increases instead of CPI increases in the past, but only to the extent that sufficient funds are available over those needed to maintain a fund ratio of 32.0%.(7)

(6) The fund ratio is the balance in the fund, exclusive of any outstanding loan from the HI

Trust Fund, as a percentage of the estimated outgo from the fund in the year.

(7) When the fund ratio at the beginning of a particular year exceeds the trigger level of 32.0%, there would be a "catch-up" for those individuals on the benefit rolls at the time of the next COLA for whom some benefits in the past had been increased on the basis of wage increases instead of CPI increases. For each such person, the cumulative percentage benefit reduction up to the beginning of that particular year would be recorded. Such percentage reduction would be applicable as a percentage increase for the benefits payable for the first 12 months following the next COLA. If there were not sufficient funds available to provide a complete "catch-up", then the percentage increase in the benefits for the 12-month period would be pro-rated so that the estimated cost of this "catch-up" would equal the funds available.

This provision will serve as a stabilizer against the possibility of exceptionally poor economic performance over a period of time.

The increases in wages would be determined from the "SSA average wage index", the series used by the Social Security Administration in determining such elements of the program as the maximum taxable earnings base and the "bend points" in the formula for the Primary Insurance Amount. As an example, assuming that this new indexing method were applicable for 1995 (for the December checks), the COLA percentage would be the <u>smaller</u> of (1) the percentage increase in the CPI from the third quarter of 1994, to the third quarter of 1995 or (2) the percentage increase in the "SSA average wage index" from 1993 to 1994.

(16) <u>The National Commission recommends that the Delayed-Retirement Credit should be increased from the present 3% (for persons who attained age 65 after 1981) to 8%, to be phased in over the period 1990-2010.</u>

Under present law, persons who do not receive benefits after age 65 (essentially because of substantial employment of any kind) receive increases in their benefit (and in their widowed spouse's benefit, but not in any other auxiliary benefit) at the rate of 3% for each year of delay in receipt of benefits from age 65 through age

71.(8) Under the proposal, the Delayed Retirement Credit for months in 1990 would be at the rate of 3 1/4%, those for 1991 would be at the rate of 3 ½%, etc. until an 8% rate would be reached in 2009 and after.

(8) A technical error in the law results in age 71 being stipulated, rather than age 69; this provision should not be applicable after age 69, because the earnings test no longer applies beyond that age. This error should be corrected when the recommended change is legislated.

Coverage of Payments Under Salary-Reduction Plans

(17) The National Commission recommends that, in the case of salary-reduction plans qualifying under Section 401(k) of the Internal Revenue Code, any salary reduction thereunder shall not be treated as a reduction in the wages subject to OASDI-HI taxes.

Section 401(k) of the Internal Revenue Code permits employers to install "salary-reduction" plans, under which employees may elect to forego a salary increase or have part of their pay set aside in a tax-sheltered fund. Such salary is neither subject to Federal income tax currently, nor is it subject to the OASDI-HI tax. The National Commission believes that, for both OASDI-HI tax and benefit credit purposes, any salary deferred under a plan meeting the requirements of Section 401(k) should be considered in exactly the same manner as cash remuneration.

This proposal will not produce significant additional income to the OASDI and HI programs currently, because not many of these salary-reduction plans have yet been put into effect. However, if the recommendation is not followed, it is quite probable that many such plans will be instituted and that, in the absence of the action recommended, considerable decreases in OASDI-HI tax income to the trust funds and in benefit credits would result.

Fail-Safe Mechanisms

(18) The National Commission believes that, in addition to the stabilizing mechanism of Recommendation (15), a fail-safe mechanism is necessary so that benefits could continue to be

paid on time despite unexpectedly adverse conditions which occur with little advance notice.(9) Several types of fail-safe mechanisms are possible other than the one currently being used -- inter-fund borrowing; there is strong disagreement among the members as to which type of mechanism should be used. A combination of these types of mechanisms would, of course, be possible.

A number of mechanisms were considered. One would be to borrow, for a limited period, from the General Fund of the Treasury. Such limitation would prevent this procedure from being a part of the permanent method for financing the program. Another possibility along this line would be to permit the trust funds to issue their own bonds for sale to the general public.

A second mechanism would be to reduce, temporarily, the benefits payable. Alternatively, such a result could be accomplished indirectly, by reducing the amount of the next benefit increase which would occur as a result of the automatic-adjustment provision for benefits in eligibility status.

The third mechanism would be to increase, temporarily, the OASDI tax rates and/or the maximum taxable earnings base.

(9) It is most unlikely that such a situation would, with proper actuarial guidance, happen with shorter notice than a year or so.

The National Commission makes a number of recommendations in addition to those discussed previously. Although these additional recommendations are of importance, they will not likely have any significant financial effects, on the average over the long run.

Investment Procedures

(19) The National Commission recommends that the investment procedures of the OASI, DI, HI, and SMI Trust Funds be revised so that (1) all future special issues would be invested on a month-to-month basis, (i.e., without fixed maturity dates, as under present law), at an interest rate based on the average market rate

of all public-debt obligations with a duration of four or more years until maturity (not including "flower bonds"(l0)); (2) all present special issues would be redeemed at their face amount; (3) all "flower bonds"(10) would be redeemed at their current market values; (4) all other current holdings would be held until maturity (unless disposed of sooner, if needed to meet outgo); and (5) only special issues would be purchased by the trust funds in the future.

There has been widespread public discussion about the investment procedures of the four Social Security trust funds. The view has frequently been expressed that the investments have not been made on a proper basis and that sufficiently high rates of return have not been obtained, because the average rate of return has, in recent years, been far lower than that on newly issued Government obligations. This is not a valid comparison, because it compares the new-issues rate with the average portfolio rate, which includes the effect of the lower interest rates on long-term obligations bought some years ago (at rates which were equitable and proper at that time). The same situation as to a higher

(10) "Flower bonds" are certain series of government bonds that were issued in the past (but which are no longer issued) which contain a provision that if the purchaser holds them for a certain length of time, then for inheritance-tax purposes, they are redeemable at par (regardless of the market value) interest rate on new issues than on the total portfolio, as of recent years, has also been present for private pension funds and insurance companies.

The National Commission believes that the investment procedures followed by the trust funds in the past generally have been proper and appropriate. The monies available have generally been invested appropriately in Government obligations at interest rates which are equitable to both the trust funds and the General Fund of the Treasury and have not -- as is sometimes alleged -- been spent for other purposes outside of the Social Security program.

Nonetheless, the National Commission makes this recommendation in order to improve the level of public understanding of the operations of the trust funds. On the whole, and over the long-range future, it is likely that such a change in investment procedure will have little (if any) effect on the financial status of the Social Security program. It will probably result in a slightly higher average rate of return in the immediate future. The long-range effects are not determinable and, in any case, are not of great significance with regard to the overall financing of the program.

Although the National Commission has not considered the Medicare program in depth, it believes that the same investment procedures should apply for the HI and SMI Trust Funds as for the OASDI Trust Funds.

Public Members on Board of Trustees

(20) The National Commission recommends that two public members be added to the Board of Trustees of the OASDI Trust Funds. The public members would be nominated by the President and confirmed by the Senate. No more than one public member could be from any particular political party.

The National Commission believes that increasing the membership of the Board of Trustees of the OASDI Trust Funds by including two individuals from outside the Executive Branch, on a bi-partisan basis, would be desirable from the standpoint of confidence in the integrity of the trust funds. The presence of such public members would inspire more confidence in the investment procedure (even though it is recommended that the procedure should be placed on a more or less automatic basis, as under the previous recommendation) and would help to assure that the demographic and economic assumptions for the cost estimates of the future operations of the program would continue to be developed in an objective manner. Although the National Commission is not generally making recommendations in connection with the Medicare program, it would seem reasonable that the same procedure of having two public members on the Board of Trustees should also apply for the HI and SMI Trust Funds.

Social Security and the Unified Budget

(21) A majority of the members of the National

Commission recommends that the operations of the OASI, DI, HI, and SMI Trust Funds should be removed from the unified budget. Some of those who do not support this recommendation believe that the situation would be adequately handled if the operations of the Social Security program were displayed within the present unified Federal budget as a separate budget function, apart from other income security programs.

Before fiscal year 1969, the operations of the Social Security trust funds were not included in the unified budget of the Federal Government, although they were made available publicly and were combined, for purposes of economic analysis, with the administrative budget in special summary tables included in the annual budget document. Beginning then, the operations of the Social Security trust funds were included in the unified budget. In 1974, Congress implicitly approved the use of a unified budget by including Social Security trust fund operations in the annual budget process. Thus, in years when trust-fund income exceeded outgo, the result was a decrease in any general budget deficit that otherwise would have been shown -- and vice versa.

The National Commission believes that changes in the Social Security program should be made only for programmatic reasons, and not for purposes of balancing the budget. Those who support the removal of the operations of the trust funds from the budget believe that this policy of making changes only for programmatic reasons would be more likely to be carried out if the Social Security program were not in the unified budget. Some members also believe that such a procedure will make clear the effect and presence of any payments from the General Fund of the Treasury to the Social Security program. (Under present procedures, such payments are a "wash" and do not affect the overall budget deficit or surplus).

Those who oppose this recommendation believe that it is essential that the operations of the Social Security program should remain in the unified Federal budget because the program involves such a large proportion of all Federal outlays. Thus, to omit its operations would misrepresent the activities of the Federal Government and their economic impact.

Furthermore, it is important to ensure that the financial condition of the Social Security program be constantly visible to the Congress and the public. Highlighting the operations of the Social Security program as a separate line function in the budget would allow its impact thereon to be seen more clearly.

Social Security Administration as an Independent Agency

(22) The majority of the members of the National Commission believes -- as a broad, general principle -- that it would be logical to have the Social Security Administration be a separate independent agency, perhaps headed by a bi-partisan board. The National Commission recommends that a study should be made as to the feasibility of doing this.*

The Social Security Administration is now part of the Department of Health and Human Services. Its fiscal operations and the size of its staff are larger than those of the remainder of the Department combined.

The National Commission has not had the time to look into the various complex issues involved in such an administrative reorganization and, therefore, recommends that a study group should be formed to look into this matter. Issues involved include whether the leadership of such an independent agency should be assigned to a single individual or whether there should be a governing board of several members, selected on a bi-partisan basis, and whether the operations of the Medicare program should be included in such an independent agency, or whether they should remain as a subsidiary agency within the Department of Health and Human Services, as at present.

** See additional views of Commissioners Ball, Keys, Kirkland, Moynihan, and Pepper in Chapter 4.*

Coverage of State and Local Government Employees

Although the National Commission believes that coverage of all persons who are in paid employment is desirable, some members do not favor mandatory coverage of employees of

State and local governments.

A majority of the members is concerned about the constitutional problem of covering State and local government employees under Social Security on a mandatory basis because the Federal Government may not have the power to compel State and local governments to pay the employer share of the OASDI-HI tax. Other members believe that, regardless of the constitutionality question, the Federal Government should not do so because the two levels of government have equal roles and status. Some members point out that many State and local governments already have adequate, well-financed retirement systems for their employees, so that they do not need OASDI-HI coverage(11); others point out that many State and local systems have serious financing problems and that protection of the benefits under such systems against inflation (and often protection against other risks) is not as adequate as under the OASDI program.

(11) A relatively small number of State and local government employees do not have either OASDI-HI coverage or public-employee retirement systems.

<u>Benefit Provisions Primarily Affecting Women</u>

In recent years, there has been widespread discussion as to whether the basic structure of the Social Security program should be altered in view of the changes in the role of women in our society and economy.*

** See additional views of Commissioner Fuller and additional views of Commissioners Ball, Keys, Kirkland, Moynihan, and Pepper, in Chapter 4.*

Some members of the National Commission believe that there should be a comprehensive change in the program to reflect the changing role of women, for example, by instituting some form of earnings sharing for purposes of the Social Security earnings record. Simply stated, earnings sharing means that all covered earnings received by a couple during the period of marriage would be pooled and half would be credited to each of their earnings records. Some other members believed that such comprehensive changes were outside of the scope of the charge of the National Commission.

Social Security Cards

The National Commission commends a recent decision of the Social Security Administration to use banknote-quality paper for new and replacement Social Security cards. The Senate Permanent Subcommittee on Investigations estimated in June 1982 that fraud involving identification cards, of which Social Security cards are the vast majority, cost the Federal Government between $15 and $24 billion per year.

STANDARD & POOR'S

PUBLIC FINANCE

U.S. States' OPEB Liabilities and Funding Strategies Vary Widely

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A graying population and a continuing recession are focusing more attention on U.S. states' other postemployment benefits (OPEB) liabilities. Recent changes in accounting rules, under Government Accounting Standards Board (GASB) 43 and GASB 45, require states to report their total OPEB liabilities, and not just how much they pay out each year. The latest Standard & Poor's Ratings Services research has found that, in accordance with these requirements, all states have now completed an actuarial valuation of their OPEB liabilities, which exceed $400 billion—a significant amount, in our view.

OPEB liabilities are just one of the many credit factors Standard & Poor's evaluates in the ratings process, and how issuers manage their OPEB liabilities, along with a government's capacity to fund these obligations annually—either on a pay-as-you-go or an accrual basis—is an important element of our credit review. Nearly all states fund their OPEB costs on a pay-as-you-go basis, and GASB 45 does not require funding of the liability.

While some states have developed strategies to begin to manage these long-term funding requirements, Standard & Poor's believes that the current economic downturn could affect budget performance for years, which in turn could impede OPEB funding progress (see "Recession's. Effect on Revenues Dominates U.S. States' Budget Deliberations," published March 31, 2009, on RatingsDirect. In addition to the difficult budget decisions most states face, we expect that poor investment performance in 2008 will have an adverse effect on state pension funds, which will require additional annual contributions to compensate for those losses (see "Market Declines Will Shake up U.S. State Pension Funding Stability," published Feb. 26, 2009, on RatingsDirect.

Nevertheless, we believe that state governments will eventually come up with workable strategies over time to manage this liability without weakening their credit quality in the near term. While fiscal stress from OPEB in the next year or two is unlikely, there could be some credit pressures possibly as early as the next three to five years, due to the increasing costs that governments face for health care and from a growing retiree population. If unmitigated, OPEB costs (which in some cases could be several multiples larger than what governments currently pay to cover retirees) are in our view likely to strain some state budgets and balance sheets in the long term.

Liabilities Quantified, Funding Progress Uncertain

The amounts of recorded state OPEB liabilities range from zero for Nebraska (the state doesn't fund any retiree health care costs) to $51 billion for New Jersey. Given the variation in actuarial methods and assumptions, however, comparisons are extremely difficult in our opinion. OPEB liabilities also factor in future health care cost-inflation assumptions, which we believe can vary significantly. For these reasons, the absolute liability a government reports is less important in our view than the burden that OPEB costs have on a state's annual budget. There is also variability in what liabilities each state includes in its report, and reported liabilities might not all be payable from a state's general fund or be a direct funding responsibility of the state.

States have focused on a range of approaches to begin managing these liabilities. The OPEB strategies for most states have not significantly altered the liability but have focused on their ability to maintain current benefit levels or to begin incrementally increasing appropriations. A number of states have established a task force or commission to review all benefits and funding options and to develop a long-term solution. Some states (such as Alabama, Connecticut, Delaware, Georgia, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Ohio, Rhode Island, South Carolina, Utah, Vermont, and West Virginia) have established trust funds to accumulate assets. Here's how other states are responding:

- North Carolina has increased vesting periods and changed benefit levels for new employees to manage future liability.
- In addition to capping and eliminating certain benefits, Utah has moved to full actuarial required contribution (ARC) funding, which will eliminate a net OPEB obligation from accumulating on its balance sheet.
- Virginia has made progress in ARC funding for three of its five OPEB plans.
- Delaware has addressed its liabilities in several ways. In addition to appropriations to a trust fund, the state deposits 0.3% of the state payroll to the trust annually. A state statute also requires annual savings from health care cost-containment initiatives to be deposited to the trust fund.
- Pennsylvania increased contributions from individuals retiring after July 1, 2007, which helped reduce its OPEB liability to $8.5 billion from $13.8 billion.
- Ohio is one of the few states that has actively managed OPEB costs and liabilities and has accumulated about $12.8 billion in assets for its public employees liability and $4.0 billion for the liability associated with teachers in the state.
- Rhode Island's general assembly increased the amount of eligible service for employees and increased retiree co-share for employees to begin to manage the liability.

- In 2009, New Mexico tightened the eligibility requirements to receive health benefits and increased the employer and employee contributions.

Local Considerations for States

In addition to their own liabilities and funding requirements, local issues relating to OPEB will in our view likely require state attention, as information becomes more broadly available. We believe state legislative action might be necessary to provide local governments the range of options they need to manage their OPEB liabilities, including authorizing trust funds, allowing for reserves, and managing benefit levels. In many states, this process is already underway. We also believe the fiscal health of local governments, school districts, community colleges, and other local entities are also likely to demand state interest. Education is a constitutional obligation in most states, and most school districts rely on state aid. A school district's ability to manage its expenditures, including OPEB liabilities, is in our view an important element of fiscal stability. If an educational program is in jeopardy, state intervention or assistance might be necessary. While states have different approaches to local government funding, and their levels of support in distress situations vary widely, we believe the fiscal health of all local government entities could require closer scrutiny if significant liabilities exist.

Long-Term Liabilities Differ From Debt

Standard & Poor's views OPEB and pension obligations as long-term liabilities that must be funded over time. They represent future payments that usually have some legal basis for funding: constitutional, statutory, or contract-based. However, a postretirement liability is subject to significant variation based on the actuarial methods and assumptions used to calculate it, as well as the performance of any fund assets. OPEB liabilities are likely to be more volatile than pension liabilities because they include future health care cost inflation assumptions, which vary widely. Because of this inherent variability, pension or OPEB liabilities differ significantly from debt obligations, which are fixed. For this reason, pension and OPEB liabilities do not appear on the debt statements we use to analyze and report on debt ratios in our public finance credit reports unless pension obligation bonds or OPEB obligation bonds have been issued. While the funding schedule for these long-term liabilities can be more flexible than a fixed debt repayment schedule, in our opinion these liabilities can also be more volatile and could lead to fiscal stress if not managed.

Liability Management

OPEB liabilities and the costs associated with funding them on an annual basis are key credit factors in Standard & Poor's review of state governments. We expect state budgets to absorb OPEB costs and address them along with other service costs. How a government manages this liability, along with its capacity to fund these obligations annually—either on a pay-as-you-go or an accrual basis—are important elements of our credit review (see, " OPEB Liabilities Pose Some Risk for State and Local Governments," published Jan. 30, 2008, on RatingsDirect). While we believe the economy is likely to improve at some point, the population will continue to age, and states' OPEB liabilities will call for further attention.

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies

Alabama

In a special session on Feb. 26, 2007, the state legislature passed a law directing the State Employees Insurance Board and Public Education Employees Health Insurance Board to create irrevocable trust funds to help fund future retiree health care costs. Initial contributions were funded from each respective board's excess reserves. The Public Education Employees Health Insurance Board has established its trust fund and transferred more than $400 million from its reserves to its trust in fiscal 2007 and an additional $200 million in fiscal 2008. The Sept. 30, 2007, actuarial study for the state's public education retiree health benefits estimated a long-term unfunded liability of $12.6 billion, which is $2 billion less than the September 2005 estimate. The total fiscal 2008 annual required contribution (ARC), assuming a 5% discount rate, is $962.8 million. The discount rate assumption was changed to 5% from 4% for the Sept. 30, 2006, valuation ($12.5 billion) due to contributions to the trust, which decreased the accrued liability from September 2005 ($14.6 billion). The State Employees Insurance Board made an initial transfer of $57 million into its trust fund in fiscal 2008. As of Sept. 30, 2007, the actuarial study available for other state employees' retiree health benefits reflected a $3 billion unfunded liability, which was down from an estimated $5.3 billion in September 2005. Similar to the Public Education Employees Health Insurance Board's trust, the discount rate assumption for the State Employees Health Insurance Board's trust was changed to 5% from 4% for its Sept. 30, 2006, valuation ($3.1 billion) because of contributions to its trust. The change in the discount rate, along with a change in plan benefits, decreased the accrued liability by more than $2 billion. The ARC for fiscal 2008 is $343.7 million.

Alaska

Alaska's Public Employees Retirement System (PERS), a defined benefit plan, had an unfunded other postemployment benefits (OPEB) balance of $2.09 billion as of a June 30, 2006, actuarial valuation date. Effective July 1, 2006, the PERS defined benefit plan was closed to new members, in favor of a separate defined contribution plan. Employees hired before June 30, 1990, receive postemployment health care benefits at age 60 without cost, and those hired afterward may receive health care benefits upon payment of premiums. PERS retains the risk of loss of major medical claims, although medical benefits are paid from the Alaska Retirement Health Care Trust Fund (ARHCT). The state intends for ARHCT to be self-funded. In fiscal 2008, the state paid 106% of the actuarially required OPEB contribution. Likewise, the state closed the Teachers Retirement System (TRS) to new members in 2006, in favor of a defined contribution plan. TRS has an OPEB of $1.3 billion, paid through ARHCT, and likewise a claim against TRS.

Arizona

Three major systems provide OPEB benefits for eligible employees at the state level in Arizona: the Arizona State Retirement System (ASRS) a cost-sharing, multi-employer plan that benefits state employees, political subdivisions, and public schools; Public Safety Personnel Retirement System (PSPRS), an agent, multi-employer system that serves firefighters and police employed by the state and subdivisions; and Corrections Officer Retirement Plan (CORP), an agent, multi-employer plan that services corrections employees at the state and county level. For ASRS, the OPEB liability is made up of two components: a health insurance premium benefit program and a long-term disability program. As of the most recent actuarial valuation date (June 30, 2007), the unfunded actuarial accrued liability (UAAL) for the health insurance premium benefit program was $438 million with a 73% funded ratio. For the same period, the long-term disability program's UAAL was $372 million with a 38% funded ratio. Arizona's share of this ASRS liability has not been calculated and it does not include an estimate of the state portion of the liability in its annual financial statements. In fiscal 2008, the agent plans of PSPRS and CORP were required to contribute at actuarially determined rates. Annual OPEB costs for PSPRS and CORP were $2.4 million and $4.3 million, respectively, and OPEB contributions made were $1.8 million (75% contributed) and $1.7 million (40%), respectively. The structure of these two plans means that contributions in excess of the health insurance subsidy are listed as excess pension contributions in the overall pension plan. As such, the UAAL for PSPRS and CORP in fiscal 2008 was $30.6 million and $40.6 million, respectively. Finally, the state has an implicit subsidy of premium rates for retirees in its Arizona Department of Administration (ADOA) benefit plan. A preliminary 2006 actuarial study estimated the ADOA's actuarial unfunded liability for postretirement health benefits between $323 million and $400 million.

Arkansas

The state pays for OPEB-related expenses under two separate plans. The primary plan is for state employees, with a smaller plan for uniformed police. Combined, there are currently about 8,000 covered retirees and beneficiaries. The state's annual OPEB cost is based on the ARC and is projected to cover normal costs each year and to amortize any unfunded liability over 30 years. At the end of fiscal 2008, the annual OPEB cost was about $145 million. Combined, the UAAL for the two plans is $1.54 billion.

California

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
A 2008 state actuarial report calculates the value of California's OPEB at what we consider a large $48.22 billion. The amount of the OPEB liability largely depends on the assumed discount rate and, to a lesser extent, on the state's assumption that the medical inflation rate will decrease during a 10-year period. The actuarial report's estimated ARC to cover the OPEB was $3.72 billion, including an estimated employer contribution of $1.36 billion for fiscal 2009. A state commission has recommended fully funding the OPEB ARC on an actuarially sound basis; however, it is Standard & Poor's understanding that it is unlikely that the state will implement this recommendation in the near term, particularly given the current budget situation.
Colorado
Colorado's OPEB plan is funded through the Public Employees Retirement Association (PERA) and is a cost-sharing, multi-employer plan with a health care trust fund in place. PERA has released a report on OPEBs for state employees, some school district employees, some local districts, and judicial employees with an estimated liability of $1.05 billion. PERA says total liability is 19.9% funded, using the historical difference between pay-as-you-go billed to the state, school districts, and others, and the actual pay-as-you-go costs. Colorado's share of this liability has not been calculated and it does not include an estimate of the state portion of the liability in its annual financial statements. There have been no significant changes to PERA allocations or amended benefits in the past year.
Connecticut
On Feb. 16, 2009, the state received an interim valuation of its OPEB liabilities for the State Employees Retirement System (SERS). The actuarial assumptions are the same as the March 2007 report but reflect actual increases in the state's medical and dental costs between April 2006 and June 20, 2008. The actuarial accrued liability as of June 30, 2008, is estimated to be $24.6 billion (compared with $21.7 billion as of April 1, 2006), which assumes no prefunding of costs and no assets available to offset the liabilities. Connecticut funds OPEB on a pay-as-you-go basis and we understand that the cost of this was $480 million in fiscal 2009. This compares with the actuarial required contribution of $1.66 billion based on a projected unit credit actuarial cost method and level percent of payroll contributions. The legislature voted to set aside $10 million from the fiscal 2007 surplus to establish a trust fund to begin addressing this obligation. An additional $14.5 million was planned for fiscal 2009. The state makes a general fund appropriation to the Teachers Retirement Fund to cover one-third of the retiree health insurance costs plus other amounts required pursuant to statute. An actuarial valuation of the state's liability has been prepared that indicates and actuarial accrued liability of $2.3 billion as of June 30, 2008, which assumes no prefunding.
Delaware
Pursuant to Executive Order No. 67, the state conducted a comprehensive study of the potential effects of the Government Accounting Standards Board (GASB) 45 OPEB accounting disclosure. As of June 30, 2008, the most recent actuarial valuation date, the plan was 1.4% funded. The actuarial accrued liability for benefits was $5.5 billion and the ARC was estimated at $475 million for fiscal 2008. The actuarial assumptions included a 5% investment rate of return. Delaware, through legislation effective July 1, 2007, created an OPEB trust fund and currently has $79.4 million accumulated. The state funds OPEB on a pay-as-you-go basis but has funded additional amounts to prefund benefits on an ad hoc basis. The state's pay-as-you-go OPEB contribution was $184 million (3.2% of governmental funds expenditures) in fiscal 2008.
Florida
Florida recently conducted a full assessment of its postretirement benefits. The state funds a retiree health insurance subsidy, which is a cash payment, directly to retirees to offset the cost of health insurance. State law permits a reduction or elimination of this payment. It is currently funded at 1.11% of payroll. In consultation with GASB, this will now be recorded as a pension benefit under GASB 27. The unfunded actuarial accrued liability for this benefit is estimated at $4.67 billion as of July 1, 2007. The Florida Retirement System was overfunded and had assets in excess of liabilities totaling $6.7 billion as of July 1, 2007. State law allows retired employees to participate in the State Employees Health Insurance Program and they are required to pay a premium cost for these benefits. The premium cost is a legislated amount and is comparable to the premium for active employees. Retiree health care costs increase with age so the premium charged to retirees does not match the full cost of benefits. We understand this differential will be the implicit rate subsidy for Florida. The UAAL of this benefit after deducting for retiree contributions is estimated at $2.4 billion as of July 1, 2007.
Georgia

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
Georgia provides OPEB to its retirees through the State Health Benefit Plan (SHBP), a cost-sharing, multiple-employer plan for state employees, teachers, and noncertificated personnel, and through the board of regents' plan for state employees of the higher education system. Georgia's OPEB UAAL was estimated at $16.5 billion for the SHBP and reflects the rollout of Consumer Driven Health (CDH) plans and Medicare Advantage plans in 2008 and 2009, which reduced the liability by $2.7 billion. The ARC for the fiscal 2009 SHBP is $1.68 billion and for fiscal 2010 it's $1.43 billion. Although the state had planned to make additional contributions to the trust fund in fiscals 2009 and 2010, Georgia will only fund the pay-as-you-go portion. Total OPEB trust fund contributions were $194.6 million as of June 30, 2008. In the past two fiscal years, the state has been implementing strategies to reduce its current and future OPEB liability. These include capping enrollment in the Indemnity Plan, a 10% increase in employee premiums, movement to two statewide health plan vendors, and strategic premium pricing to encourage enrollment in the CDH plan. In addition, the state has implemented additional strategies that it estimates will reduce SHBP costs by $360 million by fiscal 2012 and OPEB liability by as much as $856 million. The most significant change to Georgia's OPEB liability, however, is based on legislative changes to accounting practices at the state level. The general assembly passed SB 122, which enables the state accounting office to separate liability for school system retirees from state employee retirees, and removes the OPEB liability for the school system employees from Georgia's financial statements. It is unclear if this liability will be reflected on a school district's financial statements or how it will affect funding for this liability. The board of regents' (higher education) UAAL totals $1.99 billion, with an ARC of $231.6 billion as of June 30, 2008. Although the board has an irrevocable trust fund, to date it has only deposited Medicare Part D subsidies into the trust fund.
Hawaii
The state of Hawaii's liabilities include benefits provided to state employees, teachers, and the voluntary employee beneficiary trust. Assuming no prefunding (5% discount rate), the state's UAAL is $8.8 billion and the ARC is $656.6 million. This ARC represents 27% of the state's payroll. Assuming prefunding (allowing for an 8% discount rate), the UAAL is $5.6 billion and the ARC is $468.9 million, or 19% of payroll. The estimated pay-as-you-go amount for fiscal 2008 was $214 million. Hawaii has no definitive plans to fund its OPEB liability.
Idaho
We believe that the recession's effects on Idaho's revenue outlook could have played a role in recent revisions to retiree health benefits, which we understand have significant implications for its OPEB liability. House Bill 173, which was signed by Idaho's governor in April 2009 and took effect immediately, restricts health benefits eligibility under most circumstances to retirees hired before the end of the current fiscal year, and who retire directly from state service with at least 10 years of tenure. Starting in fiscal 2010, Idaho will no longer allow Medicare-eligible retirees to participate in the state-sponsored health benefit and state support for retirees' premiums will be fixed at $1,860 per year rather than the previous practice of changing adjustments each year to match changes to benefits Idaho provides to current employees. Based on its most recent actuarial valuation attributable to July 1, 2006, the state estimates fiscal 2010 pay-as-you-go savings of about $5.1 million per year (about half of which is attributable to the general fund), which we consider to be insignificant relative to annual general fund expenditures. More substantial, in our view, are foregone compounded future costs; the state calculates that these revisions will bring its unfunded actuarial liability down to less than $100 million, from an estimated $514.9 million at the end of fiscal 2010.
Illinois
Illinois provides health, dental, vision, and life insurance benefits for retirees and their dependents for two of its retirement systems—the SERS and the State Universities Retirement System (SURS). According to an actuarial valuation done by an independent consulting firm that was released in February 2008, the state's UAAL for health care and other OPEBs for SERS and SURS retirees totaled $24.2 billion as of July 1, 2007. The state believes that it is not responsible for OPEBs for retirees under the TRS or the remaining two state-sponsored retirement systems. In fiscal 2007, the cost of these benefits, which are paid on a pay-as-you-go basis, was $599.3 million, or 2.0% of Illinois' general fund expenditures.
Indiana
Indiana has completed an actuarial study for its four single-employer defined benefit health care plans in compliance with GASB Statement 45. As of June 30, 2008, the UAAL for each fund was as follows: state personnel health care plan: $62.19 million; legislature's health care plan: $7.95 million; Indiana state police health care plan: $329.292 million; and conservation and excise police health care plan: $42.836 million. The total UAAL was $442.268 million. The funded ratio as of June 30, 2008, for all four plans was 0%. Indiana also has a defined contribution OPEB plan.
Iowa

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
Iowa does not pay for health care benefits for retirees, who are allowed on their own to buy into the same health insurance that covers active employees. Under GASB 45, however, the state reports a liability for its retiree health care benefits due to the implied subsidy that is deemed to exist when retired workers pay the same for health insurance as younger active workers. According to an actuarial study done for Iowa in 2007, the state's fiscal 2007 UAAL subsidy was $219.7 million.
Kansas
The state appropriates funds annually for the costs associated with retirement benefits. In 2008, Kansas contributed $5.1 million, while plan members contributed $15.5 million. The actuarial accrued liability as of June 30, 2008 was $316.6 million. The state's policy is to fund the benefits on a pay-as-you-go basis. The UAAL is being amortized over a 30-year period.
Kentucky
The actuarial value of Kentucky's unfunded OPEB liability on its retirement system was $5.4 billion as of June 30, 2008. The actuarial accrued value of the TRS's unfunded OPEB liability was $6.3 billion.
Louisiana
Complying with GASB's new disclosure rule, Louisiana revealed that it has an estimated unfunded OPEB actuarial liability for retiree health care benefit programs of $12.09 billion as of June 30, 2008. In the 2008 legislative session, the state approved the creation of an OPEB trust. Currently, elected officials are discussing how to fund the trust. The state's actuarially recommended ARC to amortize the unfunded liability over 30 years is $1.34 billion in fiscal 2009. Louisiana budgeted $259.7 million for the expected pay-as-you-go cost of retiree medical and life insurance benefits, and the state has historically paid eligible retiree medical benefits on a pay-as-you-go basis. Using the assumptions of Louisiana's outside actuaries, Mercer, the state's OPEB was derived by assuming no change in the current programs. The OPEB calculation depends on a number of actuarial assumptions, the most critical being a 4% discount rate for an unfunded system.
Maine
Maine funds retiree health benefits for retired state employees and funds a portion of the health premiums for retired teachers. As of June 30, 2008, the UAAL was $1.1 billion for state employees and $1 billion for teachers. The fiscal 2008 valuation has improved by $2 billion due to the irrevocable trust fund the state created to fund its OPEB liability. Maine made an initial $100 million deposit into the trust fund in fiscal 2008 and state officials intend to make another $10 million deposit in fiscal 2009. For fiscal 2008, Maine's contribution of $166 million for state employees was more than the $111 million ARC (1.7% of governmental fund expenditures).
Maryland
As of June 30, 2008, the actuarial accrued OPEB unfunded liability was $14.7 billion. The ARC was estimated at nearly $1.1 billion in fiscal 2008. Maryland's general fund has historically provided for 60% of the annual pay-as-you-go costs of OPEB. Chapter 355 of the Laws of 2007 created the Postretirement Health Benefits Trust Fund (trust fund) as an irrevocable trust. In fiscals 2008, $100 million in general funds was transferred to the trust fund. The amount held in for OPEB as of June 30, 2008, was $124.4 million.
Massachusetts
The commonwealth's accrued OPEB liability as of December 2008 was $15.64 billion, assuming no prefunding of the liability. If partial prefunding is assumed, the liability is reduced to $11.6 billion. The State Retiree Benefits Trust Fund was created and received a one-time transfer of $400 million in fiscal 2008. A special commission was created and released a report in July 2008 that recommended that a strategy be developed to fund the liability. Three funding sources were identified: tobacco settlement funds, budgetary surpluses, and legislative appropriations. No funding is included in the fiscal 2009 budget but the governor has proposed a funding plan that begins in fiscal 2011.
Michigan
The state provides health, dental, and vision benefits, as well as life insurance coverage, to retirees of all pension plans to which it makes contributions, except the military retirement plan. Benefits are funded on a cash flow basis. The majority of Michigan's retiree benefits payments go toward retirees under the SERS, with retirees in the state police retirement system making up most of the remainder. For 2007 (the most recent audit available), actuarial valuations found that the state's accrued liabilities for these benefits totaled $13 billion for SERS, $918 million for the state police system, $6 million for the judges retirement system, and $118 million for the legislative retirement system. In 2008, Michigan did not make the full ARC for the state employees, state police, or legislative retirement systems.
Minnesota

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
The state had an actuarial valuation to determine the impact of implementing GASB Statement No. 45, "Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions," required for fiscal 2008. Based on this actuarial valuation, the estimated UAAL at the beginning of the year is $659 million, which will be amortized over 30 years. The estimated ARC for the period ended June 30, 2008, was $66 million.
Mississippi
Mississippi has one closed and three active public retirement systems to provide retirement, disability retirement, and survivor benefits that are direct liabilities of the state. The state complied with the fiscal 2008 deadline for U.S. states to implement GASB 45. State officials completed and released their report on the GASB 45 implementation alongside the publication of the fiscal 2008 audit. Mississippi's annual $43.6 million required contribution represents nearly 1.1% of covered payroll. The estimated UAAL as of June 30, 2008, is $570 million, which will be amortized over 30 years.
Missouri
The state updated its actuarial valuation released in December 2008 for the Missouri Consolidated Health Care Plan. The UAAL for fiscal 2008 was $1.2 billion (80.1% of payroll) assuming payment of the full $104.5 million ARC.
Montana
As of Dec. 31, 2007, the actuarial accrued liability for state employees was $449.321 million, with no actuarial value of assets. For the Montana University System, the liability is $182.6 million. For both plans, the employees may participate in the health plan at their cost so these liabilities represent the "implied rate subsidy." There is no contractual basis for providing these benefits and Montana does not fund the annual cost.
Nebraska
Nebraska's liability for OPEB is immaterial because benefits end at age 65, thereby only creating a modest implicit liability and no material effect on the state's financial statements.
Nevada
In 2007, the Nevada legislature created the "Retirees' Fund," a trust fund to account for the state's OPEB liability, and began making contributions to the fund in fiscal 2008. The state put $59.3 million into the fund in fiscal 2008, which includes the required contribution of $39.6 million and $19.7 million to prefund benefits. The UAAL is $2.2 billion based on audited June 30 2008, financial statements.
New Hampshire
New Hampshire state law provides health care benefits for some retired employees. As of the June 30, 2008, valuation, the unfunded OPEB liability was $2.55 billion. The fiscal 2008 ARC was $207.1 million, and the state's actual contribution was $50.3 million, which included no amortization of the UAAL. Most of the state's employees who were hired on or before June 30, 2004, may become eligible for these benefits if they reach normal retirement age while working for New Hampshire, have 10 years of state service, and receive their pensions on a periodic basis rather than a lump sum. Legislation passed in 2004 increased the qualifying amount of state service to 20 years. These and similar benefits for active employees are provided through the Employee Benefit Risk Management Fund, which finances the state's self-funded employee and retiree health benefit program. Payments from New Hampshire of actuarially determined working rates finance the fund. The state paid approximately $28.2 million to fund health care benefits for about 10,421 state retirees (and their covered dependents) receiving a periodic pension benefit for fiscal 2008. Of the amount paid, $12.9 million was received from self-supporting state agencies. An additional major source of funding for retiree benefits was the New Hampshire Retirement System's medical subsidy program for certain employees, which totaled approximately $15.4 million for fiscal 2008.
New Jersey

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
New Jersey provides postretirement medical benefits for certain state and other retired employees meeting the service credit eligibility requirements. To be eligible, members of the state's pension plans must retire with 25 or more years of pension service credit or be on a disability pension. The benefits provided include medical, prescription drug, mental health/substance abuse, and Medicare Part B reimbursements for covered retirees, spouses, and dependents. In fiscal 2008, the state paid these benefits for 102,681 retirees. The state funds OPEB benefits on a pay-as-you-go basis. For fiscal 2008, New Jersey expended $1.073 billion for such benefits. The fiscal 2009 budget appropriates $1.145 billion to cover these costs. As of July 1, 2007, the UAAL was $50.65 billion with a funded ratio of 0%. The UAAL came down from the prior year valuation of $58.06 billion a result of more favorable trends in the State Health Benefits Program experience, combined with savings from benefit and vendor changes that were implemented in April 2008, in which the state negotiated more favorable financial arrangements with vendors including lower administrative fees, higher provider discounts, and larger prescription drug rebates.
New Mexico
The state completed a revised actuarial valuation and review of OPEB for the New Mexico Retiree Health Care Authority as of June 30, 2008. Assuming a 5% discount rate and 30-year amortization, the study estimated New Mexico's total long-term unfunded liability at $2.9 billion as of June 30, 2008, compared with an unfunded liability estimate of $4.1 billion as of June 30, 2006. The liability was primarily reduced due to an assumed increase in retiree self-pay rates including offsets for retiree prescription drug plan federal subsidies. The actuarial report estimates the ARC at $287 million for fiscal 2008. In 2009, the legislature increased the eligibility requirements to receive retiree health care benefits by increasing the required years of service to 30 years from 25 years. In addition, legislators mandated an increase in the employer and employee contribution to the New Mexico Retiree Health Care Fund to 3.0% from 1.95% over a four-year period. State officials expect to begin addressing the OPEB liability funding in fiscal 2011.
New York
New York State used an independent actuarial firm to complete its valuation for the GASB 45 accounting for OPEB disclosure; the information was disclosed in the state's fiscal 2008 audit. The actuarial accrued unfunded OPEB liability is approximately $41.4 billion, with another $8.5 billion for the State University of New York (SUNY). The estimates are developed using the level percent of projected payroll approach under the frozen entry age actuarial cost method. The liability was calculated using a 4.2% annual discount rate. The division of budget expects that the present value of the actuarial accrued total liability for benefits as of March 31, 2009, for the state and SUNY might increase by $9 billion. The actuarially determined ARC totals $3.097 billion. New York State paid $998 million in benefits in fiscal 2008 leaving a net OPEB obligation of $2.099 billion. We understand the state's financial plan does not reflect the assumption of prefunding the unfunded OPEB liability.
North Carolina
North Carolina has regularly evaluated its OPEB costs. An updated actuarial valuation of retiree health care benefits (OPEB) liability was calculated in 2007. The accrued liability for benefits earned as of Dec. 31, 2007, is an estimated $28.9 billion. The actuarial assumptions reflect a short-term discount rate of 4.25%, which is on par with previous studies. The ARC is $2.7 billion. Employers included in the retiree health care benefit plan include state agencies, local education agencies, the University of North Carolina, community colleges, and some local governments. State law requires that health care benefits for retirees be consistent with benefits for full-time employees. The state legislature made many statutory changes in 2006 relating to vesting periods and benefit levels for new employees that will begin to mitigate future liabilities. There is no formal funding plan in place for OPEBs at this time. North Carolina's moderate debt burden and well-funded pension system, however, would offset cost pressures relating to this liability.
North Dakota
An updated actuarial valuation of the retiree health plans for the North Dakota public employees' retirement system, in conjunction with required GASB 45 OPEB determinations, was completed as of June 30, 2008. The state's total accrued liability as of 2008 was approximately $87.6 million; the unfunded liability was assessed at $45.1 million. Standard & Poor's considers this to be a very manageable number. Payments of $6.2 million in 2008 were above the actuarially required employer contribution of $5.7 million. There are a total of 23,600 participants in the program.
Ohio

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)

The state's pension plans fund retiree health insurance, and will comply with GASB 43, "Financial Reporting for Postemployment Benefits Other Than Pension Plans," in fiscal 2008. Ohio has assessed its OPEB liabilities regularly and has been one of the few states to begin to manage this liability and accumulate assets to fund the liability. For the PERS, the UAAL is $17 billion, and the state had accumulated assets of $12.8 billion as of Dec. 31, 2007 (42.9% funded ratio). Although the state TRS is not funded on an actuarial basis, steady employer contributions have accumulated assets of nearly $4 billion as of Jan. 1, 2008. The UAAL is $8.1 billion and the funded ratio is 33.2%. At June 30, 2008, the School Employees' Retirement System plan had $392.7 million of assets (8% funded ratio). At Jan. 1, 2008, the Ohio Police & Fire Pension Fund had an unfunded actuarial accrued liability of $3.1 billion (14.5% funded ratio). The Highway Patrol Retirement System had a UAAL of $224 million (33% funded ratio).

Oklahoma

The state has three cost-sharing multi-employer retirement systems. Postemployment benefits are limited to $105 monthly for retirees who maintain their employer-provided health insurance, and this total liability accounts for a very small portion of the overall actuarial liability. For fiscal 2008, the contributions paid by the retirement systems to the OPEB plan totaled $48.6 million. The ARC was determined as part of the Dec. 31, 2007, actuarial valuation. As of that date, the UAAL was $359.8 million.

Oregon

Oregon's most recent valuation put its unfunded actuarial OPEB liability at $264.3 million on Dec. 31, 2007. This liability primarily reflects the implicit cost of allowing retirees, whose per person cost to the system actuarially exceeds that of the average employee, to pay into the state's pooled health care benefit. We understand that in the upcoming biennium Oregon intends to continue to make the actuarially required contribution sufficient to amortize this liability by 2027.

Pennsylvania

Pennsylvania's most recent estimate of its OPEB valuation was significantly lower than initially estimated. As of Feb. 1, 2008, the commonwealth's OPEB liability was estimated at $8.529 billion, compared with a previous estimate of $13.778 billion. The reduction is partially attributable to recently completed bargaining agreements that resulted in increased contributions from individuals who retire on or after July 1, 2007, as well as other measures taken by management to control costs. The estimated ARC for fiscal 2008 was reduced to $705 million from $1.125 billion. The reduced ARC was fully funded from pay-as-you-go funds.

Rhode Island

In September 2008, the state updated its OPEB unfunded liability as of June 30, 2005, and is in the process of updating the valuations as of June 30, 2006, and June 30, 2007. The unfunded OPEB liability as of June 30, 2005, is approximately $643.6 million, based on a 3.6% investment rate of return. The unfunded liability would be $364.7 million with an 8.25% rate of return. These figures do not include recent changes to retiree health benefits adopted by the general assembly that increased the amount of eligible state service and increased the retiree co-share for employees who retired after Oct. 1, 2008. The general assembly also adopted legislation that authorized the creation of a trust fund and required that the state's obligation be funded on an actuarial basis. We understand the plan is being funded on an actuarial basis for fiscal 2009, using the most recent valuation, and Rhode Island intends to adjust the contribution once the valuation is updated.

South Carolina

South Carolina provides postemployment health, dental, and long-term disability benefits to retired state and school district employees with 10 years or more of qualified service as well as to their covered dependents. Benefits are funded through annual appropriations for active employees and participating retirees. The state's net estimated OPEB obligation at June 30, 2008, was $113.6 million. This OPEB obligation is not recorded in the state's financial statements because South Carolina's annual OPEB expense is based on the pay-as-you-go funding level. In May 2008, the state established two trust funds for OPEB. The South Carolina Retiree Health Insurance Trust Fund is primarily funded through the payroll surcharge. Other sources of funding include state-appropriated dollars ($63.5 million), accumulated Employee Insurance Program reserves ($248.7 million), and income generated from investments. The Long-Term Disability Insurance Trust Fund is primarily funded through investment income and employer contributions. As of June 30, 2007, the actuarial accrued liability for the Retiree Health Insurance Trust Fund was $8.58 billion and the actuarial accrued liability for the Long-Term Disability Insurance Trust Fund was $28 million. Both funded ratios are at 0%.

South Dakota

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)
South Dakota allows its eligible pre-Medicare retirees to buy into the active employees' health care plans with an implicit contribution from the state. According to a recent actuarial report, the state's UAAL was $76.4 million for fiscal 2008. The ARC for 2008 was $9.4 million, which was substantially higher than South Dakota's $3.5 million pay-as-you-go contribution. All numbers are based on a 3% discount rate.
Tennessee
The state has completed its initial OPEB actuarial study, which has identified a preliminary total $2.4 billion liability, including the teachers' and state employees' funds. We believe officials are likely to use pay-as-you-go financing in the short term while the state performs additional OPEB actuarial analysis.
Texas
Texas has elected not to adopt GASB 45 based on state legislation approved in 2007 (House Bill 2365). House Bill 2365, however, gave the state comptroller authority to issue reporting requirements for state retirement systems. The comptroller developed and issued reporting requirements for the TRS and the Employees Retirement System (ERS). As a result, TRS and ERS recently completed actuarial valuations that determined their respective OPEB unfunded liability. The TRS's unfunded actuarial accrued OPEB liability was $19.1 billion as of Aug. 31, 2007, assuming no prefunding of the liability. If prefunded, the liability for TRS is significantly reduced to $12.6 billion. The ARC to meet this obligation is $1.7 billion assuming no prefunding, and $1.2 billion if prefunded. Current retirement health care costs reached $534.9 million. The difference between the value of prefunded and nonprefunded OPEB liabilities is due to the discount rate used in the calculation. In the absence of prefunding, the discount rate must approximate the state's rate of return on nonpension (liquid) investments in the long term, estimated at 5.25% for the purpose of this study. In the event of prefunding, the discount rate would increase to a standard return on long-term investments, estimated at 8% for the purpose of this study. The actuarial valuation for the ERS reflects an unfunded OPEB liability of $17.6 billion, and an ARC of $1.4 billion, compared with $438 million in fiscal 2007 retired health care contributions.
Utah
Having capped OPEB two years ago, Utah's estimated unfunded liability is $669.6 million on an actuarial basis, which has an annual actuarially required contribution of approximately $53 million, which was essentially fully contributed by the state in 2008. The Utah legislature has expressed its intention to continue fully funding the actuarial annual contribution. State-defined benefit pension systems are actuarially sound in our view, with a funded ratios ranging from 96.8%-127.9% across the various plans. The most recent actuarial report is dated Dec. 31, 2006, and the state anticipates releasing an updated report later this year that will be dated December 2008.
Vermont
The state's OPEB liability for both the state employees' and teachers' systems for June 30, 2008, estimated the unfunded liability at approximately $1.61 billion (assuming no prefunding). The assumed rate of return under the no-prefunding scenario was increased to 4.00% from the previous assumption of 3.75%. The employee system's unfunded liability was estimated at $754.7 million, with a $58.7 million ARC for fiscal 2009. The unfunded liability for the TRS's OPEB costs is higher at $863.6 million, and the fiscal 2009 ARC is $59.1 million. Vermont officials have yet to make a decision on when or how they will fund the ARC. However, management has already taken several steps to do this, including establishing an irrevocable trust in fiscal 2007 in which the state treasurer will manage OPEB-specific assets, and the depositing of Medicare-D subsidies received for state employees' health programs into the state employees' trust fund.
Virginia
The commonwealth estimates its OPEB liability under GASB 45 to be $2.1 billion with an ARC of $345 million. Funding scenarios are currently being evaluated. Three of Virginia's five OPEB plans fully funded the ARC as of June 30, 2008.
Washington

Table 1

U.S. States' OPEB Liability Assessments And Funding Strategies (cont.'d)

According to an August 2008 actuarial valuation study, the statewide total unfunded OPEB liability was $7.9 billion as of Jan. 1, 2008, assuming a 4.5% discount rate. The state's OPEB includes an implicit liability from allowing retired employees to purchase health insurance in the same pool as current employees at a subsidized rate. The explicit benefit subsidizes retired members' monthly premiums for enrollment in Medicare parts A and B. On an actuarial basis, the state employer's portion of the $683 million ARC was $332 million for inactive and active members, of which $256 million represents Washington State's explicit subsidy and $73 million is in the form of an implicit rate study. As of June 30, 2008, the state contributed $68 million for current pay-as-you-go expenses of the retiree benefits. Washington State has no current plans to fully fund the ARC.

West Virginia

West Virginia's OPEB plan is a cost-sharing multiple-employer plan that covers state government and its agencies, state-related colleges and universities, county boards of education, county and municipal governments, and other employers allowed under statute. The Public Employees' Insurance Agency (PEIA) funds retiree health benefits. The West Virginia legislature created the West Virginia Retiree Health Benefits Trust Fund in 2006, which PEIA will administer. There is approximately $309 million in deposit in the trust fund. In the past several years, West Virginia has been carefully evaluating its OPEB liability and implementing strategies to reduce costs. An initial actuarial valuation was done in 2006 and provided a baseline UAAL that was an estimated $7.8 billion, using a 4.5% investment rate assumption. In fiscal 2007, PEIA accepted a bid from Coventry Health Care to implement its Advantra Freedom plan for Medicare-eligible retirees. This is a Medicare Advantage Prescription Drug Plan licensed by the federal government through the Centers for Medicare and Medicaid Services. This shift, along with increased retiree co-pays, substantially reduced the total unfunded liability to $3.08 billion as of June 30, 2007. As of June 30, 2008, the UAAL is estimated at $6.3 billion. The change in the liability reflects several program changes but is primarily driven by a change in the discount rate to 3.72% from 5.22% and changes in capitation rates and trend assumptions. Although there has been some fluctuation, West Virginia has lowered its liability from its baseline estimate of $7.8 billion to $6.3 billion as of June 30, 2008.

Wisconsin

Wisconsin does not pay for retiree health care directly, but allows retirees to participate in the state health care, which creates an implicit rate subsidy for those under age 65. According to a report released by the state in August 2008, Wisconsin's UAAL for retiree health care totaled $1.47 billion as of Jan. 1, 2007, which consists of $935 million for the retiree health care implicit rate subsidy and a $538 million Medicare Part D implied subsidy, an amount that the state projects will eventually be received from the federal government. Wisconsin paid $44.3 million for retiree health care in 2008; the state's annual required contribution is $148.5 million.

Wyoming

Wyoming completed an actuarial valuation of OPEB as of June 30, 2008, which had a UAAL is $174 million. The state funds its retiree health care on a pay-as-you-go basis. The cost of this in fiscal 2008 was $7.3 million, while the ARC was $19.2 million.

Table 2

State OPEB Liabilities

State	*Rating*	*OPEB liability (mil. $)*	*Analyst*
Alabama	AA	15,600	Brian Marshall
Alaska	AA+	3,400	Dave Hitchcock
Arizona	AA (ICR)	1,100-1,200	Matt Reining
Arkansas	AA	1,540	James Breeding
California	A	48,220	Gabe Petek
Colorado	AA (ICR)	1,050	Matt Reining
Connecticut	AA	24,600	Robin Prunty
Delaware	AAA	5,500	Robin Prunty
Florida	AAA	2,400	John Sugden
Georgia	AAA	16,500	John Sugden
Hawaii	AA	5,600-8,800	Paul Dyson
Idaho	AA (ICR)	515	Chris Morgan

Table 2

State OPEB Liabilities (cont.'d)

State	Rating	OPEB liability (mil. $)	Analyst
Illinois	AA-	24,200	Robin Prunty
Indiana	AAA (ICR)	442	Steffanie Dyer
Iowa	AAA (ICR)	220	Helen Samuelson
Kansas	AA+ (ICR)	317	Sarah Smaardyk
Kentucky	AA- (ICR)	11,700	Helen Samuelson
Louisiana	A+	12,090.00	Sarah Smaardyk
Maine	AA	2,100	Jen Rosso
Maryland	AAA	14,700	Richard Marino
Massachusetts	AA	11,600-15,640	Robin Prunty
Michigan	AA-	13,000	Jane Ridley
Minnesota	AAA	659	Corey Friedman
Mississippi	AA	570	Brian Marshall
Missouri	AAA	1,200	Corey Friedman
Montana	AA	449	Paul Dyson
Nebraska	AA+ (ICR)	0	Helen Samuelson
Nevada	AA+	2,200	Ian Carroll
New Hampshire	AA	2,550	Henry Henderson
New Jersey	AA	50,600	Karl Jacob
New Mexico	AA+	2,900	Sussan Corson
New York	AA	49,900	Robin Prunty
North Carolina	AAA	28,900	Richard Marino
North Dakota	AA+ (ICR)	88	Jane Ridley
Ohio	AA+	32,944	Robin Prunty
Oklahoma	AA+	360	James Breeding
Oregon	AA	264	Chris Morgan
Pennsylvania	AA	8,529	Richard Marino
Rhode Island	AA-	365-644	Henry Henderson
South Carolina	AA+	8,580	Karl Jacob
South Dakota	AA (ICR)	76	John Kenward
Tennessee	AA+	2,400	Ted Chapman
Texas	AA	30,200-36,700	Horacio Aldrete
Utah	AAA	670	Misty Newland
Vermont	AA+	1,610	Henry Henderson
Virginia	AAA	2,100	Karl Jacob
Washington	AA+	7,900	Sussan Corson
West Virginia	AA-	6,300	John Sugden
Wisconsin	AA	1,470	John Kenward
Wyoming	AA+ (ICR)	174	Dave Hitchcock
Total liabilities		459,817-473,936	
Median liability		2,400	
Average liability		9,196-9,479	

Table 2

State OPEB Liabilities (cont.'d)

State	Rating	OPEB liability (mil. $)	Analyst

ICR—Issuer credit rating.

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Public Pension Plan Reform: The Legal Framework

Amy B. Monahan

Public Pension Plan Reform: The Legal Framework

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1. Introduction

Public pension plans[1] hold a vast amount of assets,[2] are responsible for contributing to the retirement security of many Americans, and are a significant source of strain for state governments in times of market decline and decreasing revenue. They also can have significant labor market effects, influencing who enters public service and how long they remain employed (Costrell and Podgursky 2009). Interest in reforming public pension plans is significant, driven both by the high costs associated with such plans and concerns about a changing labor market, where it is no longer the norm to remain employed by a single employer for a thirty year career. This paper provides an overview of the legal limitations on the ability of states to amend their existing pension plans with respect to current participants. While this paper attempts to provide an overview of the primary legal approaches taken by states in protecting public pension benefits, it is not a comprehensive 50-state survey.

The legal protection of public pensions has undergone significant change in the last century. Historically, public pensions in this country were viewed as mere gratuities that could be withdrawn or amended by the state at any time. Unsatisfied with a legal rule that allowed states to freely abrogate pension obligations, the vast majority of states have rejected the gratuity theory and instead protect public pensions under contract or property rights theories. Under

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[1] The term "public pension plan" is used to indicate a retirement plan of a state or one of its subdivisions. The term will be used interchangeably with "public retirement plan," "state retirement plan," and "state pension plan."

[2] As of the end of 2007, public pension plans held $3.2 trillion in assets, although that amount declined by $1 trillion by October 2008 (Munnell, Aubry and Muldoon 2008).

nearly all interpretations, these theories protect previously accrued pension benefits. In many cases, they are also interpreted to protect future pension accruals, although the extent of the protection of future accruals varies significantly by state. This article will first briefly describe federal regulation of retirement plans, before describing the different approaches to public retirement plan protection adopted by the states. Finally, the article critiques the various theories of state pension protection and suggests a different approach that states should take in balancing the interests of participants and the state.

2. Federal Limits on Retirement Plan Amendments

There are two federal laws that govern employer-provided retirement plans, the Internal Revenue Code of 1986 (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA, while very broad in reach, exempts governmental plans from its authority (29 U.S.C. sec. 1003(b)(1) (2000)). Governmental plans include any plan established or maintained "by the government of any State or political subdivision thereof, or by any agency or instrumentality of any of the foregoing" (29 U.S.C. sec. 1002(32) (2000)). As a result, public pension plans are exempt from ERISA's provisions, and need only comply with federal tax code requirements.

The tax code specifies requirements employer-provided retirement plans must meet in order to qualify for favorable federal tax treatment, such as nondiscrimination requirements, vesting and benefit accrual requirements, and various rules regarding plan distributions (I.R.C. sec. 401(a)). Participants in plans that meet these requirements are not taxed on the benefits that accrue under such plans until such amounts are distributed. In addition, employers who sponsor qualifying plans are allowed an immediate deduction from their taxable income for contributions to such plans, even though such amounts are not included in an employee's taxable income until many years later.

One requirement plans must meet to qualify for this favorable tax treatment is that the plan not be amended in any way that decreases the accrued benefit of any participant (I.R.C. sec. 411(d)(6)). This provision is commonly referred to as the "anti-cutback rule." The Code therefore protects benefits accrued to date under the terms of a qualified plan, but does not prevent reductions in or elimination of yet-to-be-accrued future benefits.[3] In other words, changes to private retirement plans are permitted, as long as they operate prospectively. State plans, however, are specifically exempted from the anti-cutback rule (I.R.C. sec. 411(e)(1)). The functional result is that each state's law is responsible for setting the applicable limits on changes to its own public pension plans. An overview of the principle approaches taken by the states to such regulation are discussed in more detail below. As we will see, state approaches are generally far less clear than the federal approach, often provide less flexibility than the federal approach, and are often administratively unwieldy.

3. State Limits on Retirement Plan Amendments

In the absence of federal limits on the ability of states to amend their retirement plans, state law is responsible for providing protection to state employees' retirement benefits. Historically, most states viewed public pensions as mere gratuities that could be withdrawn or amended at any time (*Public Employee Pensions in Times of Fiscal Distress* 1977). Today, nearly every state has abandoned the gratuity theory in favor of some other approach that provides significantly more protection to participants in public pension plans. In some cases, the

[3] Employers who reduce the rate of future benefit accruals under a pension plan must notify participants in advance of the change, pursuant to section 204(h) of ERISA (29 U.S.C. sec.1054 (2000)).

shift away from the gratuity approach was policy-driven. Courts simply could not tolerate the absurd result of the gratuity approach, which allowed states to retroactively amend or terminate pension benefits at any time and for any reason. In other states, the move away from the gratuity approach was required by state constitutional provisions that prohibit the state from making gifts to individuals. After all, if the state constitution prohibits state gifts to individuals, and pensions are gifts, paying a pension benefit would be unconstitutional and the state, even if it desired to do so, could not pay the benefit (see, e.g., Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965)). States generally protect public pensions under either a contract-based theory or a property-rights theory, while one state does so under principles of promissory estoppel. After briefly summarizing the continuing adherence to the gratuity approach in two states, the subparts below will address the contract-based, promissory estoppel, and property rights approaches in turn.

a. The Gratuity Approach

The so-called gratuity approach to public pensions holds that the pensions of public employees are mere gratuities that do not vest and can be amended or modified at any time by the state (*Public Employee Pensions in Times of Fiscal Distress* 1977). This approach has been rejected by a majority of states either on policy grounds, or because of state constitutional requirements prohibiting a state from making a gift to an individual. Today it is followed only by Indiana (Ballard v. Bd. of Tr. of Police Pension Fund of Evansville, 324 N.E.2d 813, 815 (Ind. 1975)) and Texas (Kunin v. Feofanov, 69 F.3d 59, 63 (5th Cir. 1995)).[4] In Indiana, the gratuity approach is followed only with respect to involuntary or compulsory plans, where the employee

[4] Even though the gratuity approach grants Texas significant flexibility in amending its state retirement plans, recent changes to the Texas Employee Retirement System were made only for new hires in the system. Benefits remain unchanged for current system members (see 2009 Texas H.B. 2559).

has no choice regarding whether to contribute to the plan or keep the compensation (*Ballard*, 324 N.E.2d at 815).[5]

b. Public Pensions as Contracts

In rejecting the gratuity approach to public pensions, many states have embraced public pension plans as contractual in nature. In some states, a constitutional provision specifically provides that public pension plans create a contract between the state and participant. In other states, courts have inferred legislative intent to create a contract through an examination of the relevant facts and circumstances.[6]

When a state's constitution provides explicit protection to state pension plans, that state's courts must interpret what protection is granted by the state constitution and apply it. In states where a contract for pension benefits is created by statute or implied by facts and circumstances, courts must analyze any proposed changes to public pension plans under the Federal Constitution's Contract Clause or the relevant state constitution's contract clause.[7] The Contract Clause prohibits a state from passing a law that impairs existing contracts, whether public or private (U.S. Const. art. I, sec. 10, cl. 1; U.S. Trust Co. v. New Jersey, 431 U.S. 1, 17 (1977)). Because most state constitutional contract clauses mirror the Federal Constitution's Contract Clause, the legal analysis is generally the same whether the state or federal constitutional clause

[5] Arkansas strongly hints that it may also follow the gratuity approach with respect to involuntary plans (see Robinson v. Taylor, 29 S.W.3d 691 (Ark. 2000)).
[6] It is possible for a statute to contain explicit language regarding the creation of a contractual relationship (see, e.g., N.J. Stat. Ann. §43:13-22.33 (2009)), but this is quite rare.
[7] In most states, there is a state constitution contract clause that mirrors the federal constitutional language. For example, Article I, section 9 of the California constitution provides, in part, "A…law impairing the obligation of contracts may not be passed."

is at issue.[8] Courts undertake a three-part analysis to determine whether state actions are unconstitutional under the Contract Clause. The first step is to determine whether a contractual relationship exists. Where the statute at issue is ambiguous, the court looks to whether "the language and circumstances evince a legislative intent to create private rights of a contractual nature enforceable against the State" (*U.S. Trust Co*., 431 U.S. at 17, n.14). The second step in a Contract Clause analysis is to determine whether the state action constitutes a substantial impairment of a contractual relationship (ibid., p. 23). An impairment occurs if it alters the contractual relationship between the parties (Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978)) and is substantial "where the right abridged was one that induced the parties to contract in the first place, or where the impaired right was one on which there had been reasonable and especial reliance" (Baltimore Teachers' Union v. Mayor and City Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993)). If the answer to step two is affirmative, the change to the relevant contract may still be constitutional if it is justified by an important public purpose and if the action undertaken to advance the public interest is reasonable and necessary (*U.S. Trust Co*., 431 U.S. at 25). A reviewing court does not completely defer to the state legislature's determination of what is reasonable or necessary in the circumstances (ibid.). In determining reasonableness, it is relevant whether the circumstances that necessitated the change "were unforeseen and unintended by the legislature" when the contract was formed (ibid., p. 27). In order for an action to be considered necessary, (1) no other less drastic modification could have been implemented and (2) the state could not have achieved its goals without the modification (ibid., pp. 29-30).

[8] One notable exception is Oregon, which uses a slightly different legal test in applying its own contract clause than the standard three-part test used in federal contract clause analysis (see Oregon State Police Officers Ass'n v. State, 918 P.2d 765 (Or. 1996)).

As will be discussed in more detail below, once a state's pension system is found to be contractual in nature, it is relatively easy to establish impairment of that contract, while it is quite difficult to establish that the impairment is reasonable and necessary to achieve an important public purpose. As a result, a contractual approach to public pension protection often significantly limits a state's pension reform options. However, state courts adopting a contractual approach to public pension protection differ greatly in (1) when a contract is deemed to be created and (2) what is included in the "contract." The end result is that, even among states adopting a contract-based approach, the changes to public pension plans that can legally be made differ significantly from state to state. It is important to note that no matter what the exact contours of the contractual approach taken by a given state, the state *always* retains the power to amend the contract in accordance with the state's police power.[9] The subsections below review the primary approaches taken by states that have adopted contract-based pension protections.

i. Constitutional Protection of Past and Future Benefit Accruals

A handful of states provide through specific constitutional provisions that state retirement plans cannot be amended in any way that results in a participant receiving a lower retirement benefit than that which would be payable under the plan terms in effect as of the date the employee first became eligible to participate in the plan. New York and Illinois' constitutions specifically provide that rights are fixed as of the date the employee enters the retirement system and cannot thereafter be diminished or impaired (N.Y. Const. art. V, sec. 7; Ill. Const. art. XIII,

[9] "Police power" refers to the "inherent and plenary power of a sovereign to make all laws necessary and proper to preserve the public security, order, health, morality, and justice. It is a fundamental power essential to government, and it cannot be surrendered by the legislature or irrevocably transferred away from government" (Black's Law Dictionary (8th ed. 2004)). A state cannot divest itself of police power, but such power is tempered by the requirements of the contract clause (Higginbotham v. City of Baton Rouge, 183 So. 168 (La. 1938), *aff'd by* 306 U.S. 535 (1939); Allied Structural Steel Co. v. Spannaus, 438 U.S. at 241)).

sec. 5). Unlike federal retirement plan protections for private employer plans, which protect only the benefit accrued to date, this type of state protection is significantly more generous. Once an employee is eligible to participate in the retirement plan, her retirement benefit cannot be less than it would be if calculated under the terms of the plan as they existed on the date of initial eligibility for the plan.[10] The reservation of the right to amend the plan does not permit the state in these circumstances to change the terms of the plan in any way that diminishes benefits (Civil Serv. Employees Ass'n Inc., Local 1000 v. Regan, 525 N.E.2d 1 (N.Y. 1988)). For example, adopting new actuarial factors for use in calculating benefits is impermissible if the result for a single participant is that she receives fewer dollars than she would have received under the actuarial factors in place at the time of her initial eligibility for the plan (Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958)). However, in interpreting this constitutional protection, New York courts have held that it does not protect changes in employment conditions, nor changes to statutes or regulations that may incidentally have an adverse effect on benefits payable upon retirement (Lippman v. Bd. of Educ. of the Sewanhaka Cent. High Sch. Dist., 487 N.E.2d 897 (N.Y. 1985)). For example, an employee’s salary level could be diminished, which would in turn decrease that employee’s pension, without violating the constitutional protection of the employee’s pension benefit.

Alaska offers protections to public retirement plans similar to those of New York and Illinois, although the language of its constitutional protection is significantly different: “Membership in employee retirement systems of the State or its political subdivisions shall be a contractual relationship. *Accrued benefits* of these systems shall not be diminished or impaired.”

[10] See, e.g., McCaffrey v. Bd. of Ed. of E. Meadow Union Free Sch. Dist., 48 A.D.2d 853 (N.Y. App. Div. 1975) (even where plan amendment benefits the majority of participants, individuals who would receive a lower retirement benefit as a result of the amendment must be provided a benefit calculated under the terms of the plan at the time of their enrollment). See also Kraus v. Bd. of Tr. of Police Pension Fund of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979).

(Alaska Const. art. XII, sec. 7 (emphasis added)). While the language is specific to accrued benefits, Alaskan courts have interpreted the provision to protect the benefits of employees from the time they are employed and enrolled in the system (Hammond v. Hoffbeck, 627 P.2d 1052, 1057 (Alaska 1981); Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997)). As a result, Alaska's constitutional protection has been interpreted in a manner similar to New York's (see, e.g., Sheffield v. Alaska Pub. Employees' Ass'n, 732 P.2d 1083 (Alaska 1987)). While Alaskan courts have protected pension benefit formulas in place as of the date of hire, they have also stated that this protection "does not preclude modifications of the system;… however… any changes in the system that operate to a given employee's disadvantage must be offset by comparable new advantages to that employee" (*Hammond,* 627 P.2d at1057). The functional result appears similar to New York, in that no changes to a public pension plan can be made that in any way diminish the retirement benefit the participant would have been entitled to under the benefit formula in effect as of the employee's date of hire.[11]

Arizona approved a constitutional amendment in 1998 that provides "Membership in a public retirement system is a contractual relationship…and public retirement system benefits shall not be diminished or impaired" (Ariz. Const. art. 29 sec. 1). While the text of the amendment is not clear regarding exactly what is protected, court rulings prior to the adoption of this amendment suggest that it is likely intended to protect pension benefits from the date employment commences and covers both past and future benefit accruals (Yeazell v. Copins, 402 P.2d 541 (Ariz. 1965)). No court, however, has ruled on the exact protections offered by Arizona's constitution.

[11] When Alaska converted its state retirement plan from a defined benefit system to a defined contribution system, it did so for new hires only (see 2005 Alaska S.B. 141, codified at Alaska Stat. sec.14.25.001 et seq.).

Reform options in New York, Illinois, Alaska, and Arizona are quite limited. The only option for reform would be to amend the retirement plan with respect to newly-hired employees. Employees who are already in the system could not be subject to any plan amendment that results in a lower benefit than that calculated under the terms of the plan at their date of enrollment. The only possibility for changing existing employees' retirement benefits would be to have each such employee voluntarily agree to plan changes, or for changes to be made pursuant to the state's inherent police power.[12]

ii. Constitutional Protection of Past Benefit Accruals

Michigan and Hawaii have state constitutional provisions that have been interpreted as protecting pension benefits accrued to date, mirroring the approach taken by the federal government. For example, Article IX, section 24 of the Michigan Constitution states, "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby." Hawaii's constitution contains substantially similar language (Haw. Cont. art. XVI, sec. 2). While this is the same language that is contained in the Alaskan constitution, both Michigan and Hawaii courts have interpreted their respective constitutions as granting contractual rights to pension benefits that have already been earned, but not to retirement benefits that have yet to be earned through services rendered (Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986); Kaho'ohanohano v. State,

[12] See, e.g., Vill. of Fairport v. Newman, 90 A.D.2d 293, 295-6 (N.Y. App. Div. 1982) (clarifying that while unilateral amendments were prohibited under the constitution, the parties were free to negotiate and agree on changes). The case Rosen v. New York City Teachers' Ret. Bd., 282 A.D. 216 (N.Y. App. Div. 1953) *aff'd*, 116 N.E.2d 239 (N.Y. 1953), offers another potential avenue. In that case, the Board of Education offered employees temporary increases in salary, but the payments were conditional on non-inclusion in the employees' pension salary. The court held that such conditional payments were permissible under New York's constitutional provisions.

162 P.3d 696 (Haw. 2007)). As a result, in Michigan and Hawaii retirement benefits related to service already performed cannot be diminished, but plan amendments can be made prospectively.

Louisiana also constitutionally protects accrued benefits of state public pension plan participants, but the Louisiana Supreme Court has interpreted accrued benefits to mean “in the sense of due and payable; vested” (Smith v. Bd. of Tr. of La. State Employees’ Ret. Sys., 851 So.2d 110, 1105 (La. 2003) (internal citations omitted)). As a result, the conservative interpretation of Louisiana’s constitutional protection is that it protects only past benefit accruals, and only once a participant is vested under the plan.

iii. Non-Constitutional Contract Protection

The majority of states that protect public pensions under a contract theory do not have a constitutional provision to rely upon, but rather imply the existence of a contract from the surrounding circumstances or rely on statutory language establishing a contractual relationship between the state and pension plan participants.[13] Often, courts focus on the fact that pension benefits are a form of deferred compensation in finding that a contract exists. Deferred compensation arrangements lead to reasonable expectations on the part of participants and such reasonable expectations are protected under the law of contracts (Halpin v. Nebraska State Patrolmen’s Ret. Sys., 320 N.W.2d 910, 914 (Neb. 1982)). Alternatively, courts have found a contract to exist because pension benefits are part of the bargained-for consideration of the employment relationship (Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956)). Finding that a contract exists does not end the inquiry. State are free to modify the terms of a contract to

[13] Many public employees are unionized and have agreed-to benefit provisions contained in a collective bargaining agreement. In such circumstances, the collective bargaining agreement serves as the contract and any unilateral state changes to the terms are analyzed under the state and federal contract clauses.

which it is a party, provided that such modification is permissible under the state and federal contract clauses.[14] The Supreme Court has interpreted the contract clause to prohibit only substantial impairments of contract and, even then, substantial impairments may be constitutional where they are reasonable and necessary to achieve an important public purpose. While all states that protect public pensions under contract principles apply the same general legal standard, they reach significantly different results based on when the contract is deemed to be formed and what terms and conditions the contract is found to include.

A. The Existence and Scope of a Contract

The first step in applying a contract clause analysis is to determine whether a contract exists and what terms and conditions it includes. The importance of these determinations cannot be overstated. If a contract is found to exist only when a participant retires and begins receiving benefits, a state would be free to amend its pension plan for all participants not yet retired. On the other hand, if the contract is found to be formed at the time employment commences, any detrimental plan changes could likely only apply to new hires.

1. Is There a Contract?

State statutes creating retirement plans typically are silent with respect to the creation of a contract. The first step must therefore be finding that a contract exists, generally through legislative intent and an examination of the surrounding circumstances. This is not an easy task, and many states that adopt a contractual approach do not spend much time explaining how they have come to find the existence of a contract. Courts typically do not have difficulty in rejecting the gratuity approach as absurd, but their reasoning often seems less surefooted when it comes to

[14] This is true even in states where courts have held that pension plan contracts cannot be modified. A state always retains the ability to modify a contract under its police power (see U.S. Trust Co. v. New Jersey, 431 U.S. 1, 23 (1977) (internal citations omitted)).

establishing the existence of a contract. Some courts have explicitly acknowledged the difficulty of this position. As Massachusetts has explained, "'Contract' (and related terms such as rights, benefits, protection) should be understood here in a special, somewhat relaxed sense" (Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973)). "When…the characterization 'contract' is used, it is best understood as meaning that the retirement scheme has generated material expectations on the part of employees and those expectations should in substance be respected. Such is the content of 'contract.'" (ibid., p. 328). The court goes on to explain that this view of contract "protects…the core of [the member's] reasonable expectations." (ibid.). Many states agree with Massachusetts and appear to rely on the concept of reasonable expectations to find the existence of a contract.[15]

2. When is the Contract Formed?

Once a contract is found to exist, the next question is *when* the contract is formed and what it therefore protects. Some states have held that contractual protection does not begin until the participant has actually retired and begun receiving benefits, or is at least eligible to retire.[16] Other states have held that contractual protection begins at some point prior to retirement, but have not specified precisely when that protection begins,[17] and still other states protect retirement benefits from the time employment commences.[18] The relationship between the time

[15] See, e.g., Police Pension & Relief Bd. of Denver, 366 P.2d 581, 584-85 (Colo. 1961); Nash v. Boise City Fire Dept., 663 P.2d 1105, 1107 (Idaho 1983); Halpin v. Nebraska State Patrolmen's Ret. Sys., 320 N.W.2d 910, 915 (Neb. 1982); Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956).
[16] See, e.g., Jones v. Cheney, 489 S.W.2d 785, 789 (Ark. 1973) (participant's rights vest upon fulfilling service requirements); Petras v. State Bd. of Pension Trustees, 464 A.2d 894, 896 (Del. 1983) (no rights until participant vests); City of Louisville v. Bd. of Educ. of Louisville, 163 S.W.2d 23 (Ky. 1942) (no vested rights until individual is a beneficiary); Atchison v. Ret. Bd. of Police Ret. Sys. of Kansas City, 343 S.W.2d 25 (Mo. 1960) (no rights until age and creditable service requirements met and participant has applied for and was granted a pension) (internal citations omitted); Driggs v. Utah State Teachers Ret. Bd., 142 P.2d 657 (Utah 1943) (rights vest upon completing all conditions precedent to receipt of pension).
[17] See, e.g., Nash v. Boise City Fire Dept., 663 P.2d 1105, 1109 (Idaho 1983); (internal citation omitted); Halpin v. Nebraska State Patrolmen's Ret. Sys., 320 N.W.2d 910, 915 (Neb. 1982)
[18] See, e.g., Police Pension & Relief Bd. of Denver, 366 P.2d 581 (Colo. 1961);, Brazelton v. Kansas Public Employees Ret. Sys., 607 P.2d 510 (Kan. 1980); Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686

of contract formation and the protection of benefit accruals that results will be discussed further below.

3. What Terms and Conditions Does the Contract Include?

Generally the pension contract includes the statutory provisions relevant to the retirement plan at issue. It is sometimes found to include longstanding administrative practices related to the retirement plan (See, e.g., Washington Fed. of State Employees v. State, 658 P.2d 634, 687-88 (Wash. 1983)). It is well settled, however, that it does not include other conditions of employment that may affect retirement benefits, such as changes to salary levels or employment termination.[19]

B. Has the Contract Been Substantially Impaired?

Once a contract has been found to exist, the next step is to determine if the action taken by the state is a substantial impairment of that contract. There is relatively little guidance regarding what constitutes a substantial contractual impairment. Legislation impairs a contract if it alters the contractual relationship between the parties (Allied Structural Steel Co. v. Spannaus, 438 U.S. 234, 240 (1978)). “Legislation which deprives one of the benefit of a contract, or adds new duties or obligations thereto, necessarily impairs the obligation of the contract (Northern Pac. Ry. Co. v. State of Minnesota, 208 U.S. 583, 591 (1908)). Legislation that reduces the value of a contract has also been found to be an impairment (see, e.g., Retired Public Employees of Wash. v. Charles, 148 Wash. 2d 602, 625 (2003)). An impairment appears to be substantial

(Vt. 1988); Bakenhus v. City of Seattle, 296 P.2d 536, 539 (Wash. 1956); Opinion of the Justices, 303 N.E.2d 320 (Mass. 1973); Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978).

[19] Opinion of the Justices, 303 N.E.2d at 330, n. 22 (citing Hoar v. City of Yonkers, 67 N.E.2d 157 (N.Y. 1946); Gorman v. City of New York, 280 A.D. 39 (N.Y. App. Div. 1952) *aff'd*, 109 N.E.2d 881 (1952).); United Firefighters of Los Angeles v. City of Los Angeles, 210 Cal. Ap. 3d 1095, 1103 (Cal. Ct. App. 1989) (internal citations omitted) (“the fact that a pension right is vested will not, of course, prevent its loss upon occurrence of a condition subsequent such as lawful termination of employment before completion of the period of service designated in the pension plan.”).

"where the right abridged was one that induced the parties to contract in the first place…or where the impaired right was one on which there had been reasonable and especial reliance" (Baltimore Teachers' Union v. Mayor and City Council of Baltimore, 6 F.3d 1012, 1017 (4th Cir. 1993)).

Cases indicate that this is a relatively easy test to satisfy; many legislative changes to public pension plans are found to be impairments. For example, benefit formula changes (see, e.g., Betts v. Bd. of Admin., 582 P.2d 614 (1978)) and changes in funding sources or methodology (see, e.g., Valdes v. Cory, 139 Cal. App. 3d 773 (Cal. Ct. App. 1983); Bd. of Admin. v. Wilson, 52 Cal. App. 4th 1109, 61 Cal. Rptr. 2d 207 (Cal. Ct. App. 1997)) have each been found to be impairments of the pension contract. Similarly, state action eliminating cost-of-living supplemental payments has been found to be a substantial impairment (Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)), as has offsetting pension benefits by the amount of workers' compensation benefits received (Deonier v. State, 114 Idaho 721 (1988)).

Typically, changes to pension plans that are found to not substantially impair the pension contract do not involve changes that were expected to have an effect on participant benefits or on the rights and responsibilities of employers. [20] Examples of changes that were found to not rise to the level of substantial impairments include reducing the amount of employer contributions to

[20] For example, while changes in actuarial factors that reduce benefits have been found to be an impermissible impairment of contract, changes in actuarial factors affecting employer contributions, not benefit calculations, have been found to be permissible (Strunk v. Pub. Employees Ret. Bd., 108 P.3d 1058 (Or. 2005); Int'l Assn. of Firefighters v. City of San Diego, 667 P.2d 675 (Cal. 1983)). One case that does not meet this characterization is Lyon v. Flournoy, 271 Cal. App. 2d 774 (Cal. App. 1969). In that case, a widow was receiving a pension that was calculated based on the current salary for state legislators and, as such, was increased when legislator's salaries increased. After the widow began receiving benefits, the state passed a law dramatically increasing state legislators' salaries, but stating that the newly increased salary levels could not be used to increase pension payments. Instead, current retirees would have benefits adjusted according to cost of living indexes. The court found the change was not a substantial impairment of the pension contract, in large part because the widow could be found to have no reasonable expectation of the windfall that would result if the newly increased salaries applied to pension payments. This case is consistent with later Supreme Court precedent that provides "state regulation that restricts a party to gains it reasonably expected from the contract does not necessarily constitute a substantial impairment" (Energy Reserves Group, Inc. v. Kansas Power & Light Co., 459 U.S. 400, 411 (1983)).

the pension plan where there was no evidence that doing so would render the pension system actuarially unsound (Retired Public Employees of Wash. v. Charles, 148 Wash.2d 602, 627 (Wash. 2003)), investing pension assets in a state prison construction project (State ex rel. West Virginia Reg'l Jail & Corr. Facility Auth. v. West Virginia Investment Mgmt. Bd., 508 S.E.2d 130 (W. Va. 1998)),[21] and accounting changes (State ex rel. Ira Dadismon v. Capterton, 413 S.E.2d 684 (W. Va. 1992)). Additional cases found that state law changing the default rules for plan beneficiary designations did not result in a substantial impairment of the pension contract (Buchholz v. Storsve, 740 N.W.2d 107 (S.D. 2007)) and that state pension plan reform that protected accrued benefits and allowed participants a choice of continuing to accrue benefits under the old formula or moving to a new accrual structure did not substantially impair the pension contract (Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353 (D. Md. 1983)).

C. Is the Impairment Reasonable and Necessary to Satisfy and Important Public Purpose?

Even where a contract exists and has been substantially impaired by legislation, such legislation may nevertheless be constitutional if it is reasonable and necessary to serve an important public purpose (U.S. Trust Co. v. New Jersey, 431 U.S. 1, 2, 25 (1977)).[22] Reasonableness is to be judged in the light of whether the prior state contractual obligations "had effects that were unforeseen and unintended by the legislature" when the contract creating those obligations and rights was created (ibid., p.31). In determining reasonableness, the degree of impairment is taken into account (ibid., p. 27). To be considered necessary, the state must establish that (1) no less drastic modification could have been implemented to accomplish the state's goal; and (2) the state could not have achieved its public policy goal without the

[21] In the case cited, the court found that the investment did not implicate the plan's ability to pay promised benefits.
[22] See also Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398 (1934) ("The question is…whether the legislation is addressed to a legitimate end and the measures taken are reasonable and appropriate to that end").

modification (ibid., pp. 29-30). According to the Supreme Court, “a State is not free to impose a drastic impairment when an evident and more moderate course would serve its purposes equally well” (ibid., p. 30). Saving money is not, by itself, sufficient justification. As the Supreme Court has explained:

> Merely because the governmental actor believes that money can be better spent or should now be conserved does not provide a sufficient interest to impair the obligation of contract. If a State could reduce its financial obligations whenever it wanted to spend the money for what it regarded as an important public purpose, the Contract Clause would provide no protection at all. (ibid., p. 26)

For example, in *Calabro v. City of Omaha*, 531 N.W.2d 541 (Neb. 1995), the City of Omaha sought to eliminate a supplemental pension plan that paid cost-of-living increases to participants. The Supreme Court of Nebraska found such a change to be an unconstitutional impairment of contract, even where third-party financial reports warned that “continued funding of the supplemental benefit would cause serious fiscal problems for the city.” (Calabro v. City of Omaha, 531 N.W.2d at 552). In reaching its conclusion, the court focused on the fact that the same third-party financial reports emphasized the need for a new, alternative funding source for the benefits, not the elimination of the plan. As a result, the court was unconvinced that terminating the plan was the “only viable alternative for correcting its alleged fiscal woes” (ibid.).

California, and several other states that have adopted California’s approach, interpret the reasonable and necessary requirement as allowing certain changes under a test specific to public pension plans. As California courts have explained,

> the employee does not obtain, prior to retirement, any absolute right to fixed or specific benefits, but only to a substantial or reasonable pension… ‘An employee’s vested contractual pension rights may be modified prior to retirement for the purpose of keeping a pension system flexible to permit adjustments in accord with changing conditions and at the same time maintain the integrity of the system. Such modifications must be reasonable, and it is for the courts to

> determine upon the facts of each case what constitutes a permissible change. To be sustained as reasonable, alterations of employees' pension rights must bear some material relation to the theory of a pension system and its successful operation, *and changes in a pension plan which result in disadvantage to employees should be accompanied by comparable new advantages.'* (Betts v. Bd. of Admin., 21 Cal. 3d 859, 864 (1978) (internal citations omitted) (emphasis in original)).

In analyzing whether the comparable new advantage standard has been met, California courts have stated that, "[t]he comparative analysis of disadvantages and compensating advantages must focus on the particular employee whose own vested pension rights are involved" (ibid. (internal citations omitted)). California courts have also clarified that "[t]he saving of public employer money is not an illicit purpose if changes in the pension program are accompanied by comparable new advantages to the employee" (Claypool v. Wilson, 4 Cal. App. 4th 646, 665-66 (Cal. Ct. App. 1992)). This approach muddies the waters a bit, because it essentially sets up two tests for determining whether a contractual impairment is nevertheless constitutional: it may be constitutional if it is reasonable and necessary to achieve an important public purpose under "standard" contract clause jurisprudence, or it may be constitutional as reasonable and necessary under the California standard where disadvantages are accompanied by comparable new advantages. Case law under both standards is explored below.

1. Standard Contract Clause Cases

Justifying an impairment under the general "reasonable and necessary to achieve an important public purpose" standard is quite difficult. Most cases that rely on this standard are trying to rely on a state's dour financial situation to justify reductions in pension benefits or costs. For example, many states had historically exempted retirement benefits of state workers from state income tax. Following a Supreme Court ruling that held that states could not discriminate against federal employees by providing this favorable tax treatment only to state employees, many states amended their tax provisions to make retirement benefits for state workers taxable. Such a change was found by North Carolina to be a significant impairment of the pension contract that was not reasonable and necessary to achieve an important public purpose (Bailey v. State, 500 S.E.2d 54 (N.C. 1998)). In particular, the court found that taxing state retirement benefits was not "necessary" because there were numerous ways the state could have complied with the Supreme Court ruling, such as exempting the retirement benefits of federal employees from taxation (ibid.).

Other examples where a substantial impairment has been found not to be reasonable and necessary include a case where a city, faced with potential bankruptcy, eliminated a cost-of-living supplemental benefit plan. While the bankruptcy threat was well documented, the court held the change to be unnecessary, relying heavily on a third party report detailing the city's financial trouble that did not mention or suggest eliminating the benefit as a solution (Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995)). Sometimes proposed changes are unconstitutional because they fail the "important public purpose" prong of the test. In one case, a law change that prevented re-hired employees from receiving retirement payments that were previously allowed in an effort to prevent so-called "double-dipping"[23] was held to be a substantial impairment that was not justified as satisfying an important public purpose (Wiggs v. Edgecombe County, 643 S.E.2d 904 (N.C. 2007)). On the whole, these cases suggest that it is difficult to prove that the changes made to a state retirement plan are the least drastic solution available (see, e.g., Andrews v. Anne Arundel County, Md., 931 F. Supp. 1255, 1265 (D. Md. 1996) *aff'd*, 114 F.3d 1175 (4th Cir. 1997)).

[23] "Double-dipping" refers to an individual drawing retirement benefits while at the same time receiving a salary from an employer that participates in the retirement system.

The only public pension plan cases identified that found substantial impairments to be reasonable and necessary to serve an important public purpose were in cases where the court first held that no substantial impairment occurred. They then went on to discuss, even if the changes were substantial impairments, whether they were reasonable and necessary. These cases were previously mentioned in the substantial impairment discussion. One involved changing the default rules for designating a beneficiary under the public pension plan. The court found that the change was reasonable and necessary and served the important public purpose of uniform estate administration (Buchholz v. Storsve, 740 N.W.2d 107 (S.D. 2007)). In the other case, public pension plan reform that protected participants' accrued benefits and gave them choices regarding whether to continue accruing benefits under the old formula or switch to the new formula, was reasonable and necessary due to the system's threatened financial position and changing financial conditions that did not exist at the time the system was implemented (Maryland State Teachers Ass'n v. Hughes, 594 F. Supp. 1353 (D. Md. 1983)).[24]

2. Comparable New Advantages Cases

The "comparable new advantages" standard is applied on a participant-by-participant basis (Amundsen v. Public Employees' Ret. Sys., 30 Cal. App. 3d 856 (Cal. App. 1973)). It is not always entirely clear in judicial decisions applying this standard whether they are in fact finding that a contractual impairment does not exist because disadvantages have been offset by comparable new advantages, or whether they are holding that a substantial impairment exists but that it is justified as reasonable and necessary. Regardless, the functional result is the same. In

[24] For an example of a contractual impairment outside the public pension plan context that was found to be reasonable and necessary, see Buffalo Teachers Federation v. Tobe, 464 F.3d 362 (2nd Cir. 2006). In that case, a repeal of a contractually agreed to wage increase was found to be reasonable and necessary where the city was in severe financial crises, and had both raised taxes and laid off hundreds of employees prior to suspending the wage increase.

states that use the “comparable new advantage” standard, changes that satisfy the standard are permissible.

Often, but not always, the comparable new advantage is an increased pension amount. For example, in one case the court found that changing retirement eligibility requirements to include five years of service, where there had previously been no length of service requirement, was offset by the fact that required employee contributions had been decreased and the participant would, in the end, receive a substantially higher pension (ibid.). In another case, the court found that a new requirement that pension participants contribute two percent of salary to the plan was offset by the fact that the change would result in an insolvent plan becoming solvent (Houghton v. City of Long Beach, 330 P.2d 918 (Cal. App. 1958)).

iv. Net Result under Contract Approach

The contract approach does not provide a great amount of clarity in identifying which pension modifications may legally be made. There does appear to be consensus that the benefits of individuals who have already retired may not be diminished or impaired. The legal situation is less clear for currently employees. Under the contract approach, the ability of states to modify their pension plans for current employees varies directly with the time at which a contract is deemed to exist. For states that find a contract to exist at the time of employment, states have little ability to amend their pension plans for current employees. This protection appears to apply to both accrued benefits and the rate of future accruals, although this is less than clear in many states. Essentially, in states that find a contract is formed upon commencement of employment, the state can only change the terms of the pension plan if the change provides a pension benefit that is at least equal to the benefit the participant would have earned under the plan in effect at their time of hire or if the change is justified as reasonable and necessary to achieve an important public purpose. States that find a contract to exist only after the participant is eligible for retirement under the plan have significantly more flexibility to make changes, as presumably large numbers of current employees would not yet be protected under a contract approach. Unfortunately, in states that do not have clear guidelines as to when a contract is deemed to exist, it is unclear what pension modifications would be permitted.

c. Promissory Estoppel

Minnesota has joined the majority of states in rejecting the view that public pensions are mere gratuities. However, instead of embracing a contract approach it finds that the interest that a public employee has in her pension is "best characterized in terms of promissory estoppel" (Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983)). Promissory estoppel is a legal principle providing that a promise that is otherwise not legally binding "may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment" (Black's Legal Dictionary, 8th ed. 2004). In explaining why it chose promissory estoppel over convention contract analysis, the court explained "A conventional contract approach, with its strict rules of offer and acceptance, tends to deprive the analysis of the relationship between the state and its employees of a needed flexibility" (Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d at 747). Promissory estoppel, on the other hand, serves to imply a contract where none in fact exists. "The effect of promissory estoppel is to imply a contract from a unilateral or otherwise unenforceable promise coupled by detrimental reliance on the part of the promisee" (ibid., p. 748). In applying promissory estoppel, the court must determine what has been promised by the state and to what degree and to what aspects of the promise the employee has reasonably relied (ibid., p. 749). The court goes on to explain that "estoppel applies only to avoid injustice" (ibid.). Even where promissory estoppel applies, the promise remains subject to the state's police power, as is true with contractual rights (ibid.).[25] It is therefore somewhat difficult to distinguish Minnesota's promissory estoppel approach from the more conventional contract approach. The Minnesota Supreme Court explains the distinction:

> Promissory estoppel…focuses on the reasonableness of the employee's reliance to create a contractual obligation, while the contract clause assumes the existence of a contract and determines whether the state may alter its terms, based on the reasonableness of the state's actions when balanced against the employee's interests. (ibid., p. 750)

Minnesota courts require three elements to be present in order to prevent a public pension plan modification under a theory of promissory estoppel: (1) the existence of a clear and definite promise, (2) the promisor intended to induce reliance, and such reliance occurred, and (3) the promise must be enforced to prevent injustice (Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 336 (Minn. 2005)).[26] This test necessitates case by case analysis and potentially difficult fact finding in order to establish reliance by the participant or beneficiary. If the conditions for promissory estoppels are satisfied, the terms of the promise are then enforceable as a contract and a state's actions must be permissible under state and federal contract clauses in order to be upheld. This approach is theoretically more appealing than a

[25] "Police power" refers to the inherent and plenary power of a sovereign to make all laws necessary and proper to preserve the public security, order, health, morality, and justice. It is a fundamental power essential to government, and it cannot be surrendered by the legislature or irrevocably transferred away from government (Black's Law Dictionary, 8th ed. (2004)). This is the reason why contracts may be amended, even though the Contract Clause states that the government may not impair contracts (see U.S. Trust Co. v. New Jersey, 431 U.S. 1, 23 (1977) (internal citations omitted)).

[26] The Minnesota Supreme Court clarified that, where an actual contract exists, such as a collective bargaining agreement, a contract-based approach, rather than promissory estoppel, is the appropriate framework to analyze claims for benefit (Hous. & Redevelopment Auth. of Chisholm v. Norman, 696 N.W.2d 329, 337 (Minn. 2005)).

traditional contract-based approach, in that it acknowledges that a contract has not actually been formed and is grounded instead in justifiable reliance. However, the detailed, case-by-case fact finding that it necessitates makes this approach undesirable as a practical matter.

d. Public Pensions as a Property Interest

A handful of states have rejected a contract-based approach to public pensions in favor of a property-based approach.[27] To the extent that rights in a public pension plan are considered property, they are protected under the Fifth and Fourteenth Amendments to the U.S. Constitution from deprivation without due process of law. In addition, the Fifth Amendment to the U.S. Constitution prohibits the taking of property without just compensation. Before examining the application of these constitutional provisions to public pension plans, this section will first provide a brief overview of the grounds on which states recognizing a property interest find that public pensions do not create contractual rights.

In rejecting a contract approach to public pension plan protection, courts have been critical of creating or implying creation of a contract through the passage of legislation where the statute does not contain a clear statement of legislative intent to do so (Pineman v. Oechslin, 488 A.2d 803, 808 (Conn. 1985)). As the Maine Supreme Court explained, “a statute will not be presumed to create contractual rights, binding future legislatures, unless the intent to do so is clearly stated” (Spiller v. Maine, 627 A.2d 513, 515 (Me. 1993)). They further explained, “to

[27] Connecticut, Wisconsin, Wyoming, Maine, New Mexico and Ohio courts have all ruled that public pension plans create protectable property interests. See Pineman v. Oechslin, 488 A.2d 803, 810 (Conn. 1985); Ass'n of State Prosecutors v. Milwaukee County, 544 N.W.2d 888, 889 (Wisc. 1996); Bilda v. Milwaukee County, 722 N.W.2d 116 (Wis. Ct. App. 2006) (recognizing a property interest in the security of the retirement system); Peterson v. Sweetwater County Sch. Dist. No. One, 929 P.2d 525, 530 (Wyo. 1996) (“legitimate retirement expectations may constitute property rights that may not be deprived without due process of law.”); Spiller v. State, 627 A.2d 513, 515 (Me. 1993); Pierce v. State, 910 P.2d 288 (New Mexico 1995). See also Parker v. Wakelin, 123 F.3d 1 (1st Cir. 1997); State ex rel. Horvath v. State Teachers Ret. Bd., 697 N.E.2d 644 (Ohio 1998). Just to confuse matters, some states find that pension rights are contractual, and that these contractual rights are protectable property rights.

construe laws as contracts when the obligation is not clearly and unequivocally expressed would be to limit drastically the essential powers of a legislative body" (ibid.). The Supreme Court of Connecticut points out that if "promises" are sufficient to create a contractual relationship between state and employee, "the state would be powerless to reduce the pay or shorten the tenure of any state employee without posing a possible contract clause violation" (*Pineman*, 488 A.2d at 809). However, courts adopting a property rights approach have noted that employees have legitimate retirement expectations, and that these expectations may constitute property rights that the legislature cannot deprive them of without due process of law (see, e.g., ibid., p. 810).

The Supreme Court has found that protected property interests extend well beyond traditional forms of property such as real estate, chattels, or money. (Bd. of Regents v. Roth, 408 U.S. 564 (1972)). The Court further explains, "to have a property interest in a benefit, a person clearly must have more than an abstract need or desire for it. He must have more than a unilateral expectation of it. He must, instead, have a legitimate claim of entitlement to it" (ibid., p. 577). Several state courts have found that state laws establishing public pension plans create such a legitimate claim of entitlement, and benefits under such plans are therefore entitled to constitutional protection as property (see, e.g., Pineman v. Oechslin, 488 A.2d 803 (Conn. 1985); Pierce v. State, 910 P.2d 288 (N.M. 1995) (property interest is created when participant vests and "matures" once participant has attained the age necessary to begin receiving benefits)).

Once a property interest has been found to exist, any changes to a public pension plan must comply with the requirements of the due process and, to the extent the property is "taken" the owner must be provided with just compensation. Due process has two separate components: procedural due process and substantive due process. Procedural due process dictates the procedures the government must follow before it deprives an individual of property. Typically, the government must provide notice of the proposed change and an opportunity for the individual to respond. Standard legislative processes typically satisfy this requirement and, as a result, procedural due process requirements have not limited changes to public pension plans (see, e.g, Pierce v. State, 910 P.2d 288 (New Mexico 1995)).

Most challenges to public pension plan changes are made on substantive due process grounds, and successful challenge on such grounds is difficult. As one court has explained, "in order to make out a substantive due process claim, a plaintiff must show a fundamental right protected by the Constitution, a deprivation of that right, and "arbitrary" and "outrageous" state conduct that…'shocks the conscience'" (Walker v. City of Waterbury, 601 F. Supp.2d 420, 424 (D. Conn. 2009) (internal citations omitted)). To survive, the pension plan changes "need only be rationally related to a legitimate state interest" (Parker v. Wakelin, 937 F.Supp. 46, 58 (D.Me. 1996)). Courts seem skeptical that vested pension benefits involve a "fundamental right" (see, e.g., *Walker*, 601 F.Supp. at 425), and even where they assume that vested pension benefits involve a fundamental right, the "rational basis" level of scrutiny that applies to public pension plan changes is easy to satisfy. Actions to deal with state financial crises easily have been found to be related to legitimate state interests (see ibid.), as have actions to correct disparate retirement ages based on gender (Pineman v. Fallon, 842 F.2d 598 (2^{nd} Cir. 1988)). Under this standard, state courts have found plan amendments changing the retirement age for participants more than five years away from retirement eligibility to be permissible (ibid.), as well as changes to the definition of compensation, and increasing the penalty for withdrawal prior to retirement age for employees who had not yet fully vested (Spiller v. Maine, 627 A.2d 513 (Me. 1993)).

Finally, in states where a participant's interest in her public pension benefit is considered a property interest, challenges to changes to such plans are sometimes made under the takings clause of the Fifth Amendment to the Constitution. To date, such challenges have been uniformly unsuccessful.[28] In determining whether property is taken by regulation, courts weigh three factors: (1) the economic impact of the regulation on the claimant, (2) the extent to which the regulation has interfered with distinct investment-backed expectations and (3) the character of the governmental action (Penn Cent. Transp. Co. v. City of New York, 438 U.S. 104, 124 (1978)). The primary problem for pension plan participants is that, without possessing contractual rights to such benefits, courts have found that they cannot have any investment-backed expectations (Parker v. Wakelin, 937 F.Supp. 46 (D. Me. 1996; Pineman v. Fallon, 842 F.2d 598 (2nd Cir. 1988)). As a result, courts have found amendments to public pension plans to represent "an adjustment to the benefits and burdens of economic life" rather than a taking of private property without just compensation (ibid.).[29]

e. Summary of State Protections

The table below briefly summarizes the legal protections granted by many states to public pension plans. It is by necessity a general summary of state approaches and cannot account for the many factual variations that may arise in public pension cases.

State	**Which Accruals are Protected?**	**Legal Basis**	**Representative case**

[28] The New Mexico Supreme Court seemed favorably inclined toward such claims when it stated "any action by the legislature that serves to terminate, diminish or alter the value of pension benefits must be compensated for by providing an equal or greater benefit" (Pierce v. State, 910 P.2d 288, 304 (N.M. 1995)). The court did not, however, rule on such grounds.

[29] None of the cases involved changes to a participant's benefit once they had retired and begun receiving benefits. Presumably changes to participants already receiving benefits could be successfully challenged under the takings clause.

Alaska	Past and future[30]	State constitution	Municipality of Anchorage v. Gallion, 944 P.2d 436 (Alaska 1997).
Arizona	Past; likely future as well, but untested.	State constitution	None
Arkansas	Past	Contract, once participant is vested under plan terms	Jones v. Cheney, 489 S.W.2d 785 (Ark. 1973).
California	Past and future	Contract, upon commencement of employment	Betts v. Bd. of Admin., 21 Cal. 3d 859, 863 (1978).
Colorado	Unclear[31]	Contract, at some time prior to eligibility for retirement	Police Pension & Relief Bd. of Denver, 366 P.2d 581 (Colo. 1961).
Connecticut	Unclear[32]	Property	Pineman v. Oechslin, 488 A.2d 803 (Conn. 1983).
Hawaii	Past	State constitution	Kaho'ohanohano v. State, 162 P.3d 696 (Haw. 2007)
Illinois	Past and future	State constitution	Kraus v. Bd. of Trustees of Police Pension Fund of Niles, 390 N.E.2d 1281 (Ill. App. Ct. 1979)
Indiana	Unclear[33]	Gratuity approach for involuntary plans; contract approach for	Bd. of Tr. of the Pub. Employees' Ret. Fund v. Hill, 472 N.E.2d 204

[30] The reported cases in Alaska dealing with the protection of future accruals all pre-date Alaska's adoption of a defined contribution plan for state employees. However, based on the language in the relevant decisions it seems likely that Alaskan courts would also find the rate of future accruals to be protected in the defined contribution plan, which would prevent Alaska from reducing such rate for any current participants.
[31] Cases have not addressed the distinction between past and future benefits to a sufficient degree to be able to summarize. Colorado courts have held that prior to eligibility to retire, plan changes can be made if the changes "strength or better" the retirement plan, or if they are actuarially necessary (Police Pension & Relief Bd. of Denver, 366 P.2d 581, 584-85 (Colo. 1961)).No cases have been found applying this standard to changes in future benefit accruals.
[32] No Connecticut cases have dealt with changes to past and future rates of accrual. Presumably, state action to diminish past, vested accruals would be impermissible under the property approach and changes to future accruals would be permitted provided the state action was not arbitrary or irrational. However, no Connecticut cases have directly addressed this issue.
[33] In Indiana, benefits from involuntary plans are not protected until the participant retires. In voluntary plans, which are given contractual protection, it is unclear when the contract is formed and therefore whether future accruals are protected.

		voluntary plans	(Ind. 1985).
Kansas	Past and future	Contract, upon commencement of employment	Singer v. City of Topeka, 607 P.2d 467 (Kan. 1980).
Louisiana	Past	State constitutional protection once vested	Smith v. Bd. Of Tr. of La. State Employees' Ret. Sys., 851 So.2d 1100 (La. 2003)
Massachusetts	Past and future	Contractual, upon commencement of employment	Opinion of the Justices, 303 N.E.2d 320, 327 (Mass. 1973).
Michigan	Past	State constitution	Ass'n of Prof'l & Technical Employees v. City of Detroit, 398 N.W.2d 436 (Mich. Ct. App. 1986).
Minnesota	Fact-specific	Promissory estoppel	Christensen v. Minneapolis Mun. Employees Ret. Bd., 331 N.W.2d 740, 747 (Minn. 1983).
Nebraska	Past and future	Contract, upon commencement of employment	Calabro v. City of Omaha, 531 N.W.2d 541 (Neb. 1995).
New Mexico	Past, unclear whether protection applies to future accruals	Property, once vested	None
New York	Past and future	State constitution	Birnbaum v. New York State Teachers' Ret. Sys., 152 N.E.2d 241 (N.Y. 1958).
North Carolina	Past	Contract, once vested	Faulkenberry v. Teachers' & State Employees' Ret. Sys. Of N.C., 483 S.E.2d 422 (N.C. 1997).
Oklahoma	Past; some informal indication that prospective changes would be permitted	Contract, once vested	Taylor v. State and Education Employees Group Insurance Program,

	in some circumstances		897 P.2d 275 (Okla. 1995).
Oregon	Past and future	Contract, upon commencement of employment	Oregon State Police Officers Ass'n v. State, 918 P.2d 765 (Or. 1996).
Texas	None[34]	Gratuity	Kunin v. Feafanov, 69 F.3d 59 (5th Cir. 1995).
Vermont	Past and future	Contract, upon making mandatory contributions to the plan	Burlington Fire Fighters' Ass'n v. City of Burlington, 543 A.2d 686 (Vt. 1988).
Washington	Past and future	Contract, formed at the time of employment	Bakenhus v. City of Seattle, 296 P.2d 536 (Wash. 1956).
West Virginia	Past and future	Contract, prior to eligibility for retirement	Booth v. Sims, 456 S.E.2d 167 (W.Va.1994).

4. Discussion: The Shortcomings of Current Theories

Each of the current theories used by state courts to protect public pensions – property rights, contractual rights, and promissory estoppel – are each deeply problematic. Construing a participant's right to pension benefits as a property right potentially provides too little protection for participants in public pension plans. States often adopt a property rights approach to public pensions where they cannot find evidence in the statute, legislative history, or surrounding circumstances that the legislature intended to create a contract. Where no contract can be found to exist, a court that desires to protect public pension benefits is left either to characterize the interest as a property interest, or protect participants based on promissory estoppel. Under the Constitution, property rights cannot be diminished or impaired without due process of law, and

[34] There is an exception for certain non-statewide public retirement systems. The accrued benefits in such systems are protected by a constitutional amendment (see Tex. Const. art. XVI, sec. 66).

may not be taken without just compensation. However, all that substantive due process requires is that the state's action not be arbitrary or irrational (see, e.g, Flemming v. Nestor, 363 U.S. 603 (1960)).[35] This standard appears to allow significant changes to public pension plans, provided there is a rational basis for the amendment. The exact contours of this protection are difficult to discern. For example, a state's dire financial circumstances might provide a sufficiently rational basis under a property rights theory to allow not only prospective, but also a retroactive amendment to pension benefits. While characterizing the right to pension benefits as a property right may prevent the state from taking a retiree's benefits without just compensation, changes to the benefits of current participants can be relatively freely made.

While property-based protections do too little to protect public pension benefits, characterizing a public pension statute as a contract that begins at the time employment commences often provides greater protection than is reasonable. Leaving aside state constitutional protections specific to public pensions, which were enacted by the citizens of a state and presumably reflect voter intent, the court-developed protections based on the implied existence of a contract are problematic. In general, courts must infer the existence of a contract from the legislative history and surrounding circumstances. As previously mentioned, most courts that find a contract to exist do not spend much time on this fundamental, threshold issue. They tend to start with a premise that few would dispute: when an employer makes an offer of employment that includes both salary and deferred compensation in the form of pension benefits, the contract of employment includes both the salary and deferred compensation. When an employee accepts the offer of employment by performing services, the employer is bound to pay the promised salary and promised benefits. What is surprising is that courts find that the contract,

[35] Procedural due process is of little help in public pension cases, because it typically requires only notification of a change that might affect an individual's right, and the opportunity to be heard (see, e.g., Fuentes v. Shevin, 407 U.S. 67, 80 (1972). Standard legislative processes typically satisfy procedural due process requirements.

as it relates to pension benefits, is of an indefinite duration. In other words, the employer's offer of pension benefits is deemed to be binding for as long as the employee remains employed. It is the duration of the pension contract, then, that is problematic. Even though an offered salary is clearly part of the employment contract, and an employer cannot fail to pay a promised salary once services have been rendered, an employer is not prevented from changing the salary prospectively, prior to the time services as performed. Why is the result different for pension benefits?

Courts often focus on the concept of reasonable expectations when finding a contract to exist. The idea is that the employer promised certain pension benefits in exchange for services, the employee rendered the services, and now reasonably expects the promised pension. Again, this idea is non-controversial with respect to pension benefits for services already performed. But it does not explain why the rate of future benefit accruals would be protected. How can an individual have a reasonable expectation to future benefit accruals if they cannot have a reasonable expectation regarding the factors that determine the amount of that benefit, such as salary level and length of employment? Any reasonable expectation of a pension would have to be limited to the structure of the plan itself, rather than the dollar amount of any resulting pension. In other words, while you can't have any expectation of what your salary will be from year to year, and you can't have any expectation of how many years you will be employed, you do have a reasonable expectation that for every year you are employed you will accrue a certain percentage of your salary in the form of deferred pension benefits. This seems to be both an odd expectation to have, and an odd expectation to legally protect, when the economic value of the benefit can vary so dramatically. While no court has directly acknowledged this, it may be that the early, precedential cases finding a contract to exist at the time employment commences and to be of open duration were a response to the perceived injustice of long vesting periods in public pension plans.[36] For example, assume an individual was hired when a state pension plan required 20 years of service in order to be eligible for a benefit. Further assume that when the individual has worked for the state for 15 years, the state amends the terms of the pension plan to provide for a significantly reduced rate of accrual than that which was in place when the individual was hired. Even if the benefit accrued in years 1 – 15 is preserved, the individual is forced to continue working for 5 years in order to become eligible for any pension benefit at all. Even if the current compensation package is far inferior to what the employee could achieve by seeking employment elsewhere, she will likely agree to the new terms in order to avoid forfeiting the deferred compensation she earned in years 1 – 15. By finding a contract to exist at the time employment commences for an open duration, it protects an employee from a situation like the one just described where the state can very effectively change the terms of the bargain and leave the employee with no choice but to accept the diminished employment terms or forfeit her accrued pension benefit. Today, of course, with Code requirements that specify participants in qualified retirement plans must be fully vested after no more than seven years of service (with partial vesting occurring earlier), such concerns are substantially alleviated. Discussion of reasonable expectations, then, may have arisen from a desire to protect an employee from the state's outsized power that results from long vesting periods, rather than an effort to determine what is actually reasonable for an employee to expect.

There may, however, be an exception to this view of reasonable expectations in the case of tenured teachers. Generally speaking, tenured status decreases significantly the likelihood that a teacher will be involuntarily terminated. While a tenured teacher can be fired, it can only be for

[36] Extended vesting periods were common prior to the time the qualification requirements of the Code included limitations on vesting periods.

the limited reasons specified in the applicable tenure statute. In some states, tenured status also protects salary levels (see, e.g., Mo. Rev. Stat. §168.104(2)).[37] Perhaps, then, there are some states that protect a tenured teacher's employment and salary levels to a degree sufficient to cause expectations about future pension accrual to be reasonable. The problem is that, from a legal perspective, protected employment and salary levels are not sufficient to confer protected status on the rate of pension accrual. Even if we assume that reasonable expectations are sufficient to create protectable contract interests in public pension benefits, we still have not established the basis for the reasonable expectations for pension benefits. A tenure statute might very well create reasonable expectations regarding employment and salary, but they do not speak to pension benefits. And unless there is a specific, contractual agreement regarding such benefits (such as one contained in a collective bargaining agreement) an employee with a stable job and salary still does not appear to have a reasonable expectation that a particular employee benefit will be continued unchanged throughout the duration of employment. In other words, while it seems unreasonable to suggest that an employee has a reasonable expectation that pension benefits will remain unchanged for the duration of employment when they can be terminated at any time or have their salary changed even legal protection of job and salary levels is insufficient to create a reasonable expectation of future rates of pension benefit, absent an explicit agreement to the contrary.

This is not to argue that pension benefits are not entitled to contractual protection. Indeed, it is consistent with the theory of pensions as a form of deferred compensation to protect pension benefits already accrued. That can be done by finding a contract to exist, but specifying that the contract is formed on an ongoing basis as services are performed. When an employee accepts

[37] Generally, tenured status does not protect salary levels (68 Am. Jur. 2d Schools §196 (2009) (internal citations omitted)).

employment with a state at a certain salary level and with certain promised benefits, and then performs services in reliance thereon, she becomes entitled to the promised salary and benefits. However, the terms of the contract can be modified by either party. The state may change employment conditions such as salary or benefits, and the employee may choose whether or not to accept such changes by either continuing to work for the state or electing instead to seek employment elsewhere. Similarly, the employee may choose to terminate employment at any time if she desires a different salary and benefit package than the one being offered. However, once service has been performed in reliance on a state's offer, the state should not be free to retroactively change the terms upon which service was performed. Deferred compensation in the form of pension benefits should be protected, just as the right to receive a promised current salary is protected. Protecting public pension benefits under a contract theory can do just that, provided that courts are precise about the duration of the contract.

Protecting public pensions based on promissory estoppel seems to focus on the correct issue, which is the legitimate expectations of plan participants, without straining to find the existence of an actual contract. However, the approach is cumbersome to administer as it requires individual factual finding of actual reliance. This creates uncertainty, inefficiency and expense and seems for that reason to be an undesirable model for other states to follow.

5. What's a State to Do?

Many states are likely dissatisfied with current approaches to public pension protection because the end result is either an inability to modify future accruals, an inability to recruit and retain valued employees, or an inability to determine what changes can legally be made to public pension plans. In states whose courts have adopted a contract-based approach, the state often ends up locked into an economic relationship that cannot be adjusted for changing market conditions.[38] In states that do not find a contract to exist and instead characterize public pension plans as property, states may have a difficult time recruiting and retaining employees given that accrued pension benefits can be eliminated with relative ease prior to actual retirement. And finally, in states that use the theory of promissory estoppel to protect pension benefits, lawmakers would undoubtedly like to know, prior to the outcome of litigation, whether changes can be made to the state's retirement plan or plans. The options for changing such legal protections are explored below.

In states that protect future accruals under a constitutional provision, the only option would be a constitutional amendment changing that protection for new hires or to attempt to justify any desired plan amendments as a valid exercise of the state's police power.[39] At the other end of the spectrum, in states that fail to clearly protect even a participant's accrued benefit, either under a contract theory or a property theory, the legal reform options are somewhat less daunting. Property rights are typically relied on where a court could not find evidence that the state intended to form a contract and, similarly, contractual protections that do not protect benefits prior to retirement are found because of an absence of evidence of the creation of an earlier contract. In either case, a change to the statutory language could clarify that public retirement systems create a contract between the state and employee at the time the employee first becomes eligible to participate in the plan, and that the contract protects the monetary value of a participant's accrued benefit but not future rates of accrual. Alternatively, the state constitution could be amended to provide such protection.

[38] Of course, given that other economic benefits of employment, such as salary and other fringe benefits, can be modified, a state can always adjust the total economic value of compensation even if it cannot change future pension benefit accruals. The problem is that it does not allow the state to structure compensation in the manner it finds most efficient. Instead, it locks in the amount of deferred compensation, and as a result might push current salary and other fringe benefits to a lower-than-ideal economic value.

[39] Alaska might be the one exception, where the language of the constitutional provision protects "accrued benefits," but courts have interpreted that language very broadly. As a result, in Alaska it might be possible to argue successfully in state court that previous interpretations of "accrued benefits" are incorrect and should be overturned.

In states that find a contract to exist at the time employment commences or shortly thereafter, advocates for reform can challenge as inaccurate previous characterizations of the contract. Advocates would need to convince the court that, to the extent a contract is formed, it is formed on an ongoing basis to protect accrued benefits, not the rate of future accruals. This argument could be strengthened by making the distinction that past holdings often dealt with public pension plans with vesting periods significantly longer than is permitted today. Advocates could also argue that, given the number of times the average American is expected to change jobs during her working life, it is disingenuous to suggest that she has a reasonable expectation of continued future benefit accruals. An ongoing contract would therefore protect the reasonable expectations of participants.

There is some hope that courts will respond to changing market conditions because this is what happened when states rejected the previously adopted gratuity approach to move to contract or property-based theories. In rulings rejecting the gratuity approach, courts focused on the changing pension landscape. The Minnesota Supreme Court noted, "In the past the gratuity theory may have been justified by the fact that promised benefits were insignificant in amount….But times have changed…pension coverage has increased while at the same time, particularly in the last two decades, increasing numbers of public employees are reaching retirement age and finding that pension funding is not always adequate to provide what has been promised" (Christensen v. Minneapolis Mun. Ret. Bd., 331 N.W.2d 740, 746 (1983)). In rejecting the gratuity approach, the court continued:

> [Referring to public pensions as a bounty springing from the graciousness and appreciation of sovereignty] is at best quaint, and at worst, demeaning. Retirement plans are now an accepted and expected part of one's employment, whether public or private. To attract and retain good employees, employers need to provide competitive retirement programs. (ibid.)

Advocates for reform could similarly argue for jurisprudential changes based on changing conditions. Public sector plans have not kept pace with the market as a whole, in large part because state jurisprudence has fixed such plans in time. By holding states to pension plan structures that were conceived many years ago in different financial and labor market conditions, we are significantly impeding the ability of the state to function efficiently and are giving public employees an advantage not found elsewhere in the labor market.

The likely success of any of these arguments would differ significantly by state, and I do not mean to suggest that distinguishing or overruling prior precedent would be an easy task. The first step would be to propose legislation that would change the rate of future benefit accruals. In some states, an advance ruling could be sought from the state's supreme court regarding the constitutionality of the change. In other states, the legislation would have to be passed, challenged by a participant, and then successfully defended by the state. Not only would the successful defense be an uphill battle, but gathering sufficient political support to propose or pass pension legislation impairing future accruals would likely be very difficult. However, given the dire financial condition of many states and many state pension plans, perhaps now is the right moment to attempt such reforms.

6. Conclusion

The legal regulation of public pension plans leaves much to be desired. The gratuity approach fails to adequately protect plan participants, the contract-based approach often fails to give states needed flexibility to adapt their plans to changing circumstances, promissory estoppel is too individualized to be administratively feasible, and the property rights approach appears to give participants too little protection.

An approach that protects only currently accrued benefits has the advantages of being clear and allowing flexibility in response to changing conditions. State courts could adopt such an approach under a contract theory by holding that a contract is formed when the participant performs service, but that it creates a contract on an ongoing basis (as service is performed). More specifically, courts could focus on reasonable expectations as a rationale for finding a contract exists, but be clear that a participant has a reasonable expectation only in their currently accrued benefit. This approach would leave states free to set new contract terms for services not yet rendered and would be entirely consistent with the current focus on reasonable expectations. This approach has the added advantage of being more clear and explicit than current jurisprudence, and also not fact-specific or individualized.

It is time for state courts to revisit their public pension plan jurisprudence. Just as courts recognized many years ago that the gratuity theory of pensions was premised on a reality that no longer existed, it is time for courts to once again revisit the premises that underlie both contract and property-based theories of pension protections. Retirement benefits remain an important part of an employee's compensation and need to be protected. What needs to be protected, however, are the benefits that have already been earned with respect to services already performed. Doing less is patently unfair to employees and retroactively changes the terms of the bargain struck between employer and employee. Doing more is unfair to employers (and, perhaps, to state taxpayers), locking them into an economic bargain that cannot be changed to respond to financial or labor market conditions, even when all other aspects of the employment relationship can be renegotiated.

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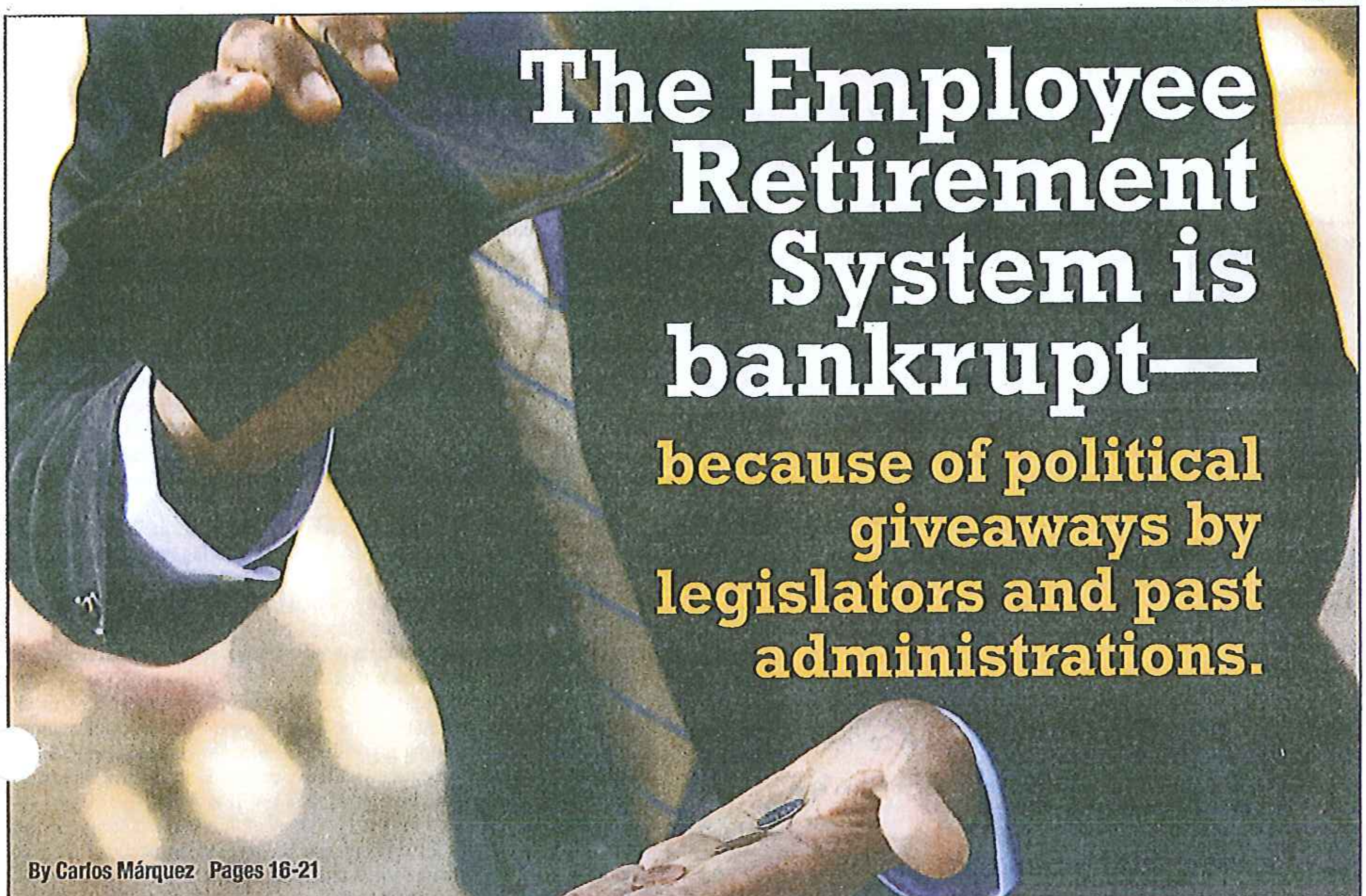

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Scotiabank could increase its stake in FirstBank to 49%
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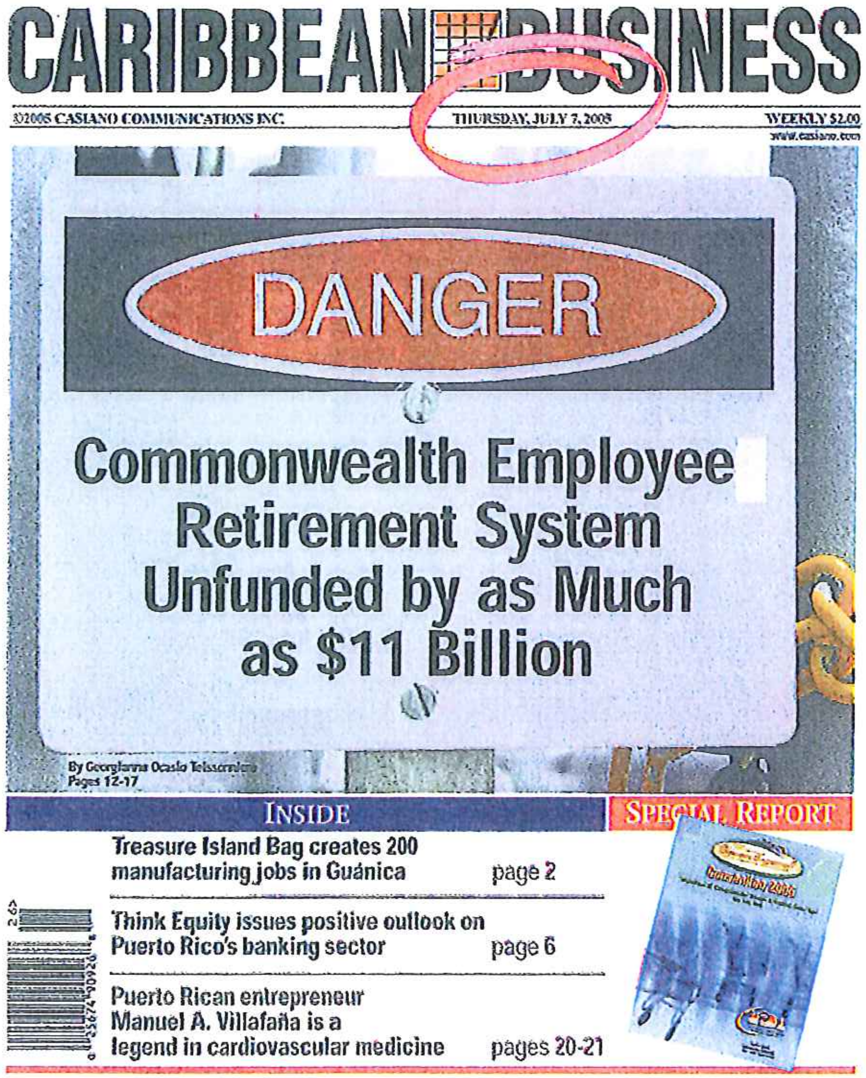
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DANGER

Commonwealth Employee Retirement System Unfunded by as Much as $11 Billion

By Georgianna Ocasio Teissonniere
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Treasure Island Bag creates 200 manufacturing jobs in Guánica page 2

Think Equity issues positive outlook on Puerto Rico's banking sector page 6

Puerto Rican entrepreneur Manuel A. Villafaña is a legend in cardiovascular medicine pages 20-21

SPECIAL REPORT

"The buck stops here."

Gov. Luis G. Fortuño commits to tackle now the $17 billion unfunded obligation of the Employee Retirement System

BY CARLOS MÁRQUEZ
cmarquez@caribbeanbusinesspr.com

Gov. Luis Fortuño's warning last month about the critical condition of the Government Employee Retirement System's (ERS) fiscal situation came as no surprise to CARIBBEAN BUSINESS readers. We have been raising red flags about an impending public-pension crisis with front-page stories dating back the last five years (CB July 7, 2005; Sept. 6, Sept. 28 and Oct. 26, 2006).

What may have caught some by surprise was Fortuño's pledge to defuse this pension problem he characterized as a "time bomb" even as his administration is still struggling to plug deep budget gaps and jumpstart the ailing island economy.

"For too many years politicians and administrators have decided to pass the buck on this one, oblivious or indifferent to the fact that in doing so they were mortgaging away the economic well-being of future generations. Well, the buck stops here," Fortuño said.

The ERS has a total pension obligation of $18.9 billion and only $1.85 billion in available net assets to pay for it. That is a funded ratio of 9.8%, by far the lowest of any state. The average funded ratio of state pension plans is 84% with the lowest being Illinois with 54%.

A do-nothing scenario projects the ERS will run out of resources to pay for its obligations to pensioners by 2019. That is assuming the use of all assets of the ERS, but if only available net assets are considered the timeframe for insolvency is slashed by about five years.

"Even as we continue to implement our Fiscal & Economic Reconstruction Plan to fix the finances of the central government and public corporations, we've decided to tackle now the most serious challenge to our long-term financial and economic stability: the huge unfunded liability of the ERS and the other retirement systems (Judiciary Retirement System and Teachers Retirement System)," Fortuño said.

One of the principal fiscal challenges that Puerto Rico has faced is the funding of its public-employee retirement systems, and the situation is most critical at the ERS, the largest of the island's public-employee retirement systems with 265,024 participating employees, retirees and

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beneficiaries as of June 30, 2009, the of the previous fiscal year.

er the years, the ERS has accumulated a huge unfunded liability, currently estimated at $17 billion as of June 30, according to a preliminary report by international investment and actuarial consulting firm Milliman, the current ERS actuary. That means the system is short by that amount if it were to pay out all the retirement benefits it will owe pensioners over the years. That situation has prompted credit and financial experts to warn that unless Puerto Rico fixes its retirement system, it could face very serious financial difficulties.

"For too many years politicians and administrators have decided to pass the buck on this one, oblivious or indifferent to the fact that in doing so they were mortgaging away the economic well-being of future generations."

Luis G. Fortuño,
Governor of Puerto Rico

"For decades, prior administrations have not only, postponed a definitive solution to the problem but have made the situation worse."

Carlos M. García,
Government Development Bank chairman of the board & president

Fortuño said the crisis has long been building due to a range of factors including "years of irresponsible practices of public administration."

Among the other factors he cited are: the approval of benefits without funding sources; failure of government agencies, municipalities and public corporations to remit their contributions on time to the ERS; proliferation of early retirement windows without proper consideration of their impact on the retirement system's finances; the implementation of high-risk financing and investment projects; and administrative decisions that have deteriorated the solvency and liquidity of the system.

Last month, the Governor issued an Executive Order creating a Commission for the reform of the retirement systems. This Commission faces a daunting task: reforming the government retirement system in a way that is fair to all stakeholders, including the government, public employees and taxpayers. The eight-member commission is chaired by Labor Secretary Miguel Romero and will be rounded out by representatives from the Legislature, labor, executive branch and the Special Permanent Commission for the Retirement Systems. A report with specific recommendations on how to revamp the public-pension system "to make sure that we safeguard the financial viability of the central government in the years to come and honor the commitments that we've made to our retired public workers" must be submitted to the governor within six months, according to Fortuño's executive order.

"The retirement system's crisis requires specific and tangible solutions to guarantee that government employees have a financially sound retirement system able to address the retirement needs of current and future pensioners," Romero said.

"It must be an integral solution that takes into consideration all stakeholders in the system. We are looking for an equitable and responsible solution that protects the well-being of present and

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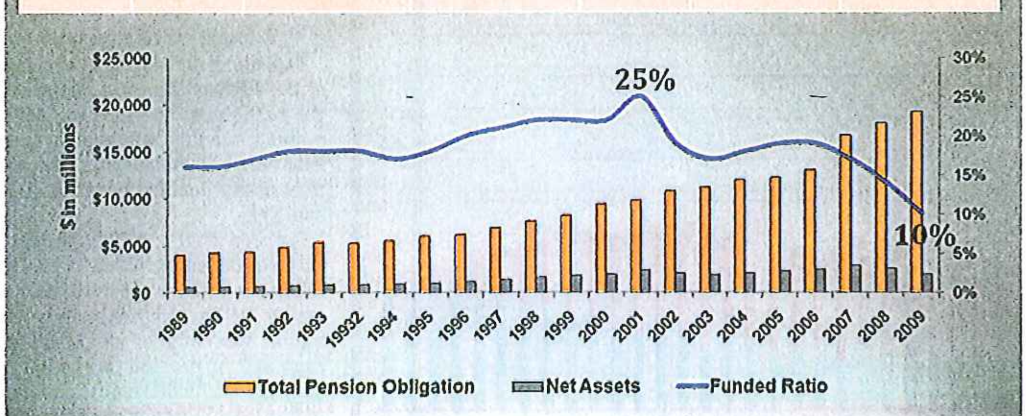
The ERS has the lowest funded ratio among all U.S. states with 9.78% versus 84%*; in 2001 it was 25% funded

($ in billions)	Net Assets Available	Accumulated Actuarial Obligation	Actuarial Deficit	Coverage	Required Actuarial Contribution	Actual Employer Contribution
ERS	$1.852	$18.944	$17.091	9.78%	34.37%	9.28%



*Average funded ratio of states' retirement plans in the U.S.
Pew Center of the States. February 18, 2010

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future retirees. For decades, prior administrations have not only postponed a definitive solution to the problem, but have made the situation worse," said Government Development Bank President Carlos García.

García, who is also chairman of the ERS Board of Trustees, noted that the ills of the public pension system are well-documented.

"The press record is there for all to examine. Experts have been alerting about the situation for years and the press—especially the business press—has responsibly reported it. What we have to ask is why those who have been in a position to address the situation in a responsible manner didn't do so," García said.

"All the government retirement systems show cash-flow deficits. Every year the system pays out more in pensions than what is received in contributions from employers, employees and legislative appropriations to cover the cost of basic pensions and other benefits approved in special laws— such as increases in the Christmas Bonus, summer bonus and prescription drug coverage among many others," added García. (See side bar.)

Special laws cost the central government, municipalities, public corporations and the ERS upward of $336 million a year.

"The retirement system's crisis requires specific and tangible solutions to guarantee that government employees have a financially sound retirement system able to address the retirement needs of current and future pensioners."

Labor Secretary Miguel Romero

"The cash deficit forces the ERS to sell assets to cover the pension benefits of retirees, and although we are cutting administration expenses, such costs by themselves will not be enough to cover the deficits."

Héctor M. Mayol, ERS executive director

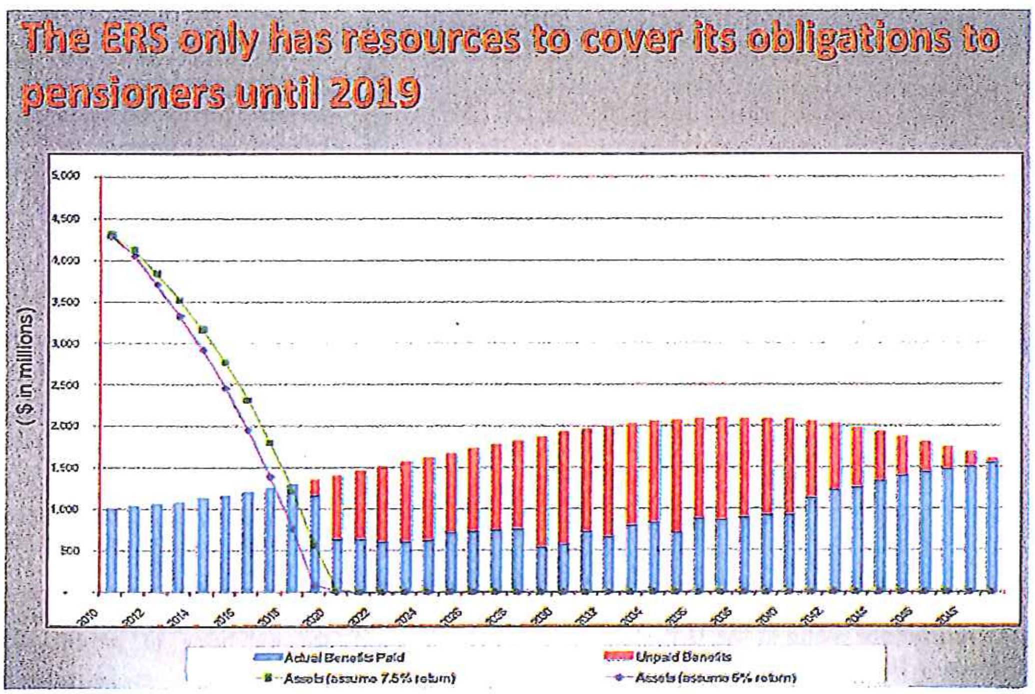
POLITICS AND PENSIONERS IN PLAY

The more than 265,000 retired and active government employees covered by the ERS are an irresistible voting bloc for politicians to court.

"It is a familiar mistake, slathering on billions of dollars worth of new promises to public employees. Elected officials determine ERS pensions and other benefit provisions, and government employees and retirees vote. Politicians like to reward voters; public employees vote," noted one observer.

Policymakers have repeatedly approved higher pension benefits for short-term political gain while deferring the cost of those benefits to future generations of taxpayers.

Besides the politicians, public-employee unions have used their growing power to dramatically enhance pension benefits. They also engage in full-court-press lobbying at all levels of government to secure unaffordable benefits.



A PROBLEM OF NUMBERS

Explaining that the fiscal situation at the ERS is the most critical of the public pension systems, García pointed out that although deficits have been accumulating for decades, they nearly doubled between 2007 and 2009.

Between 2007 and 2009, the ERS actuarial deficit increased by $3.214 billion, or 23%, while available net assets fell by approximately $1 billion. Coverage of almost $2 for each $10 of pension obligation in 2007 (a 17% funded ratio) had fallen to less than $1 of coverage for each $10 (9.8% funded ratio) by last June. (See chart.)

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"The proliferation of personal loans since 2003 has also impacted the liquidity of the ERS by $736 million. The decision to increase the ceiling for personal loans from $3,000 to $15,000 and the reduction in the loan renewal period from 18 months to 12 months reduced the funds the ERS has to pay the pensioners," said García.

Another blow to the ERS was the multiple early-retirement windows opened between 2005 and 2008, which carried a cost of $293 million. Early-retirement windows allowed public workers to retire before reaching the minimum age and years of service. Positions that opened when a government employee retired were filled instead of being left vacant, meaning the problem was multiplied.

The ERS had a cash-flow deficiency of $380 million in fiscal 2009. These deficiencies have been covered by loans from financial institutions and sale of ERS assets throughout the years. For example, the ERS used more than $700 million from the sale of Telecomunicaciones de Puerto Rico Inc. (Telpri) stock to pay bank overdrafts, repay loans, fund personal loans and make payments to the Treasury Department. Telpri was a corporation created in 1999 to facilitate the sale of the Puerto Rico Telephone Company. Puerto Rico Telephone Authority, a GDB subsidiary, issued and assigned its noncumulative, nonvoting preferred stock to the ERS. This stock entitled the system to receive all benefits generated by Telpri stock dividends or sale of stock. Telpri stock dividends over the 2001-2005 period averaged 2.97% per year.

In 2007, the administration of then-Gov. Aníbal Acevedo Vilá entered into the highly risky program of bond issues with the expectation to invest the proceeds of the bonds at yields that equaled or exceeded the interest rate on the bonds. The board approved up to $7 billion and in 2008, the ERS issued $2.961 billion in Pension Obligation Bonds (POBs) in the local market. The difference, expected to be issued in the global markets, was postponed due to the global financial crisis which started in 2008.

"...before retirement, the government can amend the terms of the retirement system as long as the amendments are reasonable and with the purpose of improving the actuarial solvency of the system ..."

Then-Associate Justice Federico Hernández Denton wrote in a 1987 opinion. He is now chief justice of the Puerto Rico Supreme Court.

The issuance, instead of improving the ERS financial position, further deteriorated it, according to a 2008 report by the Fortuño administration's transition committee.

The Fortuño administration canceled the remaining issues of nearly $4 billion.

"It didn't work and is costing the ERS an annual average of $300 million in debt service," García said.

The system also faces a cash deficit of approximately $500 million and has had to request advances on the approximately $1.3 billion from the POBs issue proceeds deposited in the GDB. There will be just $850 million left at the GDB by the end of this fiscal quarter, according to Héctor M. Mayol, ERS Executive Director.

"The cash deficit forces the ERS to sell assets to cover the pension benefits of retirees, and although we are cutting administration expenses, such costs by themselves will not be enough to cover the deficits," he added.

ERS administration expenses are estimated at $32 million a year, of which $25 million, or 78%, goes to cover payroll.

The warning signs date back more than half a century, but there has been little effort to remedy the situation as politicians with this giveaway mentality to get more votes have passed the buck and continued to approve more pension benefits for short-term political gain. The ERS has reached a tipping point and there is no margin to pass the responsibility to future administrations. The ERS is near bankrupt because of political giveaways and poor management by Government administrations.

POTENTIAL FIXES FOR THE ERS

Government officials are remaining mum on potential fixes until the commission presents its report to the governor. However, it is clear that the options are limited, unpopular and politically risky.

The government and future pensioners alike face tough choices. Telling future retirees they have to make a choice between lower benefits or no benefits at all is a huge political gamble. Telling taxpayers that a greater share of their taxes would go to cover politicians' promises

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Participants in the ERS

	Active	Retired	Family Beneficiaries	Disabled	Total
Covered under:					
Law 447 (1951)	38,249	73,836	12,200	16,836	141,121
Law 1 (1990)	56,991	1,861	1	237	59,090
System 2000 (1999)	64,813	--	--	--	64,813
Total	160,053	75,697	12,201	17,073	265,024

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to pensioners rather than funding essential government services may also be politically unacceptable.

Corrective measures would have to be implemented to stop pension-liability growth, grow assets, or both. Increasing contributions from the commonwealth and/or the employees can increase assets. Taking away promised benefits could reduce liabilities.

States, including New York, Nevada, Nebraska, Rhode Island and New Jersey, are attempting reforms such as raising retirement ages, cutting pension-benefit formulas, boosting employee contributions, curbing income "spiking" and partially switching employees to less costly defined-contribution plans.

Among the options the commission may consider are:

INCREASE CONTRIBUTIONS TO THE ERS:

For years, actuaries have been pointing out that the government-required contribution to the ERS should be much higher than it has been. "We recommend that the statutory funding requirements be significantly increased in excess of … the 9.275%," reads the latest ERS actuarial report prepared by Milliman. To close the huge actuarial deficit Milliman says that the employer-required actuarial contribution should be 34.37%.

Due to the government's fiscal woes, a gradual annual increase in contributions to the ERS by both employers and employees could be explored with the assistance of the actuaries. Employee contributions haven't increased for almost 20 years, however pension benefits have continued to increase. The ERS benefit disbursements now exceed the sum of contributions and investment income the ERS receives.

REDUCE BENEFITS:

A reduction in benefits could also contribute to reducing the actuarial deficit. Many believe benefits to retirement-system participants can't be changed, reduced or eliminated. But that is not the case, according to a decision by the Puerto Rico Supreme Court.

In Fernando Bayrón Toro v. University of Puerto Rico Retirement System (RE-85-568), the island's top court decided: "Once an employee retires and has complied with the conditions of the retirement, the pension is not subject to change. Nevertheless, before retirement, the government can amend the terms of the retirement system as long as the amendments are reasonable and with the purpose of improving the actuarial solvency of the system and strengthening its structure."

"Variations in conditions and requirements such as years of service, contributions to the system and retirement age are essential to maintain the solvency of the system. This flexibility is vital for the system to face unexpected conditions and keep up with improvements in actuarial science. Recognizing to the government (el Estado) the ability to adopt modifications to the retirement system within the parameters herein expressed is indispensable for the plans to operate successfully," then-Associate Justice and current Chief Justice, Federico Hernández Denton wrote in a 1987 opinion.

Reduce or eliminate benefits granted by special laws: The special laws benefits are provisions granted by giveaway, vote-seeking legislation and funded on a pay-as-you-go basis that amounts to approximately $336 million a year. (See side bar.)

INCREASE THE RETIREMENT AGE:

Currently, active participants covered under Law 447 of 1951 (the original structure of the retirement program) can retire with full benefits at age 55 and the government (taxpayers) provides them with a lifelong pension.

PLACE A CEILING ON PENSIONS:

Capping pensions would eliminate the practice of increasing salaries for employees as they are reaching retirement for the purpose of increasing the amount of the pension they will receive disproportionably to the contributions made during the years of their government employment.

WARNINGS FROM THE ACTUARIES UNHEEDED

Throughout the years, various actuaries have raised red flags about the island's public pension system, including an advance warning that the ERS would have to start liquidating assets early in this new century (as it has had to).

The actuaries went a step further, pointing out the moment when the ERS no longer had the financial solvency to meet its obligations; that it would have to start making annual appropriations to the system from the budget, creating an additional financial burden on the government. But, ignoring these warnings, the Legislature, with the consent and approval of the sitting governor, continued amending to the law to provide additional pension benefits to government employees through the approval of special laws that did not identify funding sources. ■

ERS structure

BY CARLOS MÁRQUEZ
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The Employee Retirement System (ERS) is a trust funded by the contributions of active participants (government employees), employers and the interest and profit earned from the investment portfolio to pay pensions and other benefits to government retirees.

The ERS is divided into three structures (Law 447 of 1951, Law 1 of 1990 and Law 305 of 1999, also known as System 2000). The ERS operates as a single fund where the contributions it receives are used to finance the current obligations to pensioners or their beneficiaries.

The ERS administers two separate retirement plans: a defined benefit plan and a defined contribution plan. In the defined benefit plan, participants are entitled to retirement benefits which are defined and determinable. Members who entered the system on or before December 31, 1999 participate in the defined benefit plan. The defined contribution plan, on the other hand, is a retirement plan that provides an individual account for each participant of the plan and for benefits based solely upon the amounts contributed to such participant account. Members who entered the ERS on or after January 1, 2000 participate in the defined contribution plan.

Government employees who became participants of the system after this date participate only in a defined contribution plan that is funded solely by employee contributions. Although government employers are required to continue making employer contributions with respect to all participating employees, whether these employees participate in the defined benefit plan or in the defined contribution plan, all employer contributions are used to fund benefits provided to beneficiaries of the defined benefit plan.

Contributions to the ERS are set by legislation. The current employer contribution rate is 9.275% of the amount earned by the employee and the individual member contribution is 8.275% of pay.

The ERS has 160,053 active participating employees and 104,971 retirees and other beneficiaries of deceased retirees for a total of 265,024 participants. There are 210 participant employers in the ERS, including the central government and its agencies, municipalities and most public corporations. The system does not include the Puerto Rico Electric Power Authority (Prepa), University of Puerto Rico professors, judges or public school teachers.

Employers' contributions are mainly funded from government revenue and other taxes deposited in the general fund, funds provided by the federal government, internally generated funds (in the case of public corporations) and other sources.

Annual administrative expenses of the ERS are approximately $32 million, of which $25 million is for payroll.

Actuarial studies are conducted to establish the financial situation of the fund and make recommendations to maintain the financial solvency of the system. ■

Cost of special laws tops $336 million a year

BY CARLOS MÁRQUEZ
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So-called "special laws," or Other Post Employment Benefits (OPEBs), to provide additional retirement benefits have been approved throughout the years with total disregard for identifying funding sources to pay for them.

The special laws benefits cost approximately $336 million annually and play a big role in the fiscal crises plaguing both the government's general fund and its Employee Retirement System (ERS).

In fiscal 2010, which started July 1, 2009, the general fund is expected to pay approximately $237 million, municipalities $20.6 million, public corporations $28.6 million and the ERS another $50 million for a total of $336.2 million.

These special laws by vote-hungry legislators and governors, have been approved by every administration even before the creation of the ERS in 1951 and include a wide range of annually recurrent benefits, among them:

Cost-of-living allowance

A 3% increase in cost-of-living allowances (COLA) every three years has become almost standard procedure at the Legislature since 1992.

Law 10 of 1992 originally provided this increase followed by Law 207 of 1995, which approved a 3% increase for the next three years. The cost to the general fund of these two laws for FY '10 is approximately $7.1 million.

The practice continued with the approval of Law 40 of 2001, Law 157 of 2003, and Law 35 of 2007, which hiked pensions by another 3% in January 2007 and provided for an additional increase of 3% to pensions less than $1,250 effective in July 2008. The cost to the general fund of these laws for FY '10 is approximately $33.8 million.

If House Bill 1728, now being considered by vote-hungry legislators, which provides for another 3% increase for the next three years starting in 2010, is approved it will carry an additional cost of $41.250 million and impact 83,091 pensioners.

In addition, Law 134 of 1996 increased COLA by 3% to high-risk pensioners at a cost of $462,000.

COLA benefits will cost the general fund approximately $41.3 million in FY '10.

Basic pension increase

Various laws have also been approved to increase basic benefits at a cost to the general fund in FY '10 of $19.5 million.

Law 124 of 1973 increased pensions at a cost of $386,000 for government workers who had retired before July 1973. Law 23 of 1983 hiked pensions of less than $300 a month at a cost of $1.328 million. Law 208 of 2000 established an increase of $200 for police officers up to a maximum of $1,000. The law carries a price tag of $6.153 million in FY '10. Law 156 of 2003 increased pensions to a minimum of $300, which will cost $11.6 million in FY '10.

Pensions to surviving beneficiaries

Law 158 of 2003 increased pensions to surviving pensioners' beneficiaries from 30% to 50% at a cost of $9.5 million.

Law 524 of 2004 increased the minimum payment to beneficiaries for death of the pensioner from $500 to $1,000. The cost is $473,000 annually and it impacts approximately 1,200 beneficiaries. Law 169 of 1968 provided benefits to the surviving spouse of police officers not covered by federal Social Security, impacting 2,200 beneficiaries at a cost of $8.5 million.

Law 82 of 1941 provided a pension to the widow of the Senate president or House speaker. The current cost for one beneficiary is $12,000. Law 2 of 1965 provided a lifelong annuity of $25,000 to former governors prior to 1992 and $10,000 to the surviving spouse at cost of $51,000.

Christmas bonus

Various laws have been approved to establish and provide periodic increases in Christmas bonuses to all retired pensioners at a total annual cost to the general fund of $35.3 million.

These laws include Law 98 of 1980, which created a Christmas bonus of $100 for all pensioners. Law 14 of 1987 increased it by $50. Law 109 of 1997 increased the Christmas bonus to $200 in 1997, $250 in 1998 and $300 in 1999 and future years. The holiday bonuses cost $13 million in FY '10.

In 2003, Law 159 increased the Christmas bonus to $400. A year later, Law 433 raised it to $500. Law 144 of 2005 increased the Christmas bonus to $550 in 2006 and $600 in 2007. These laws have an impact of an additional $22.3 million for the current fiscal year.

Disability benefits for high-risk participants

Law 127 of 1958 provided additional benefits to high-risk participants such as police officers, firefighters, prison guards, National Guard members, Special Investigation Bureau agents and Natural & Environmental Resources Department rangers. This law impacts 1,350 pensioners at a cost of $17 million.

Summer bonus

Not content with just a Christmas bonus, Law 37 of 2001 approved a $100 summer bonus for pensioners and beneficiaries effective in July of each year at a cost of $10.4 million.

Medicine bonus

Law 155 of 2003 provided for an annual tax-free $100 medicine (prescription drug) bonus to 80,000 pensioners at a cost of $8 million.

Contribution to health insurance plans

Amendments to Law 95 of 1963 provided for an increase in government contributions for pensioners' health insurance from $60 to $100 effective January 2004. The cost is about $86 million per year since then.

Loans for cultural trips abroad

Amendments to Law 72 of 1956 authorized the use of ERS funds to provide loans for cultural trips to active participants and pensioners. The government pays the ERS 50% of the interest on the loans at an expected cost in fiscal 2011 of $521,000.

The costs detailed above include just the share of special laws covered by the general fund and don't include the cost to municipalities, public corporations and the ERS.■

Giveaway attitude has seriously endangered government pensions

No matter how you choose to describe it, the retirement fund that covers the vast majority of government employees in Puerto Rico is, well, broke. While this situation should come as no surprise, it is no less alarming. Since 2005, CARIBBEAN BUSINESS has provided in-depth coverage about the critical financial state of the government Employee Retirement System (ERS). But now, the situation is so grave that the present administration will no longer be able to pursue the customary do-nothing strategy of past administrations to deal with the problem.

Last month, Gov. Luis Fortuño announced the creation of a special commission to reform the public pension system. When that announcement was made, it was reported that the ERS' actuarial deficit was an astonishing $14 billion. The governor then referred to the ERS as a "time bomb" that would face insolvency well before 2020.

As it turns out, however, the situation is actually worse. The actuarial deficit is not $14 billion, but rather $17 billion. This means that while the ERS' pension obligations are $18.9 billion, the assets available to pay benefits are only $1.85 billion. This yields a funded ratio for the system of 9.8%, less than one dollar for every 10 dollars needed, by far the lowest of any state (the national average ratio is 84% and the lowest of any state is 54%). In addition to the actuarial deficit, the ERS also has a cash-flow problem, which means that every year the system pays out more in pension benefits than it receives in contributions.

The cause of this state of affairs is no mystery. For years, politicians from both parties have treated the ERS in a way that can only be described as reckless. In bids to capture votes, lawmakers from both parties have passed "special laws" increasing retirement benefits for government employees with complete disregard for the fact that there were no financial resources identified to pay for these new benefits.

While everyone in government is refusing to advance a position on how to fix the problem until the commission renders its report and recommendations, one thing is clear: The solution will require bold actions that will be deemed unfair by everyone. Since the government will not be in a position to increase contributions for employees in the foreseeable future and it will also be very difficult for the employees themselves to pay more, the only alternative will be to reduce benefits and change eligibility requirements for those who are not yet receiving a pension from the ERS. While this will indeed be bitter medicine to swallow, we can no longer continue to ignore reality. Even before the current economic recession, companies across the board in the private sector in Puerto Rico had to take proactive actions to manage and preserve the economic viability of their pension plans. Such actions included changing eligibility requirements, reducing benefits and switching from defined-benefits models to defined-contribution systems. Why should the ERS be managed any differently?

In the ERS, we have a pension system that simply does not have the resources to pay the benefits that government employees have accrued. As a result, we either have to undertake drastic and unpopular reforms or run the risk of destroying the system in its entirety. One thing should be clear though: The burden of fixing the ERS cannot be placed, as is customary, on middle class, non-government taxpayers. This group already carries a heavy load, paying for governmental services that they, by and large, do not use or receive. It is time, for once, to act responsibly and pay for pension benefits that we can actually afford. ■

Right's anger could backfire

BY CLARENCE PAGE

Talk about sore losers. Just when you think the healthcare debate can't sink any lower, somebody manages to punch through the floor.

The ink of President Obama's signature was hardly dry on his healthcare overhaul legislation before reports of vandalism and death threats against congressmen on both political sides threatened to upstage the bill that apparently sparked the anger.

The FBI was investigating vandalism or threats related to the healthcare bill against 10 Democrats and two Republicans. They included the closing Thursday of Democratic Rep. Anthony Weiner's New York City office because of an envelope that reportedly contained a threatening letter and white powder.

Police investigated a broken window at the congressional office of Rep. Gabrielle Giffords a few hours after the Tucson Democrat voted for the bill to overhaul the nation's healthcare system.

On the Republican side, Rep. Eric Cantor, the number-two House GOP leader, and Rep. Jean Schmidt of Ohio also reported receiving menacing messages. A bullet broke a window of Cantor's office in Richmond, Va., although police said it probably was not related to Cantor. It appeared to have fallen through the glass after somebody fired it into the sky, according to news reports.

Yet there was no question about the steaming anger and frustration in the broadcast excerpts of vocal threats left on answering machines in congressional offices. Why all the anger?

Why, I wondered, is there so much viciousness in the backlash against a bill designed to expand health insurance coverage to the uninsured? Are people that angry over a safety net to those who worry about their current coverage being taken away—including many of those who probably are protesting against it?

Republicans allege that Democrats are making political hay out of the recent wave of crackpot threats and vandalism, most of which appears to be aimed at Democrats. But the Dems don't really have to exploit such ugliness. It speaks for itself. It speaks in ways that don't help Republicans win the support their party needs from moderate swing voters, if the GOP is to have any hope of taking back either house of Congress in the fall.

Polls confirm that anger and confusion over congressional debating and deal making has energized the right and demoralized the left as midterm elections approach. But polls also show broad support for many provisions of the bill that go into effect this year. They include expansion of prescription drug coverage for the elderly and new limits on the ability of insurance companies to deny coverage for pre-existing conditions. Most of the least popular provisions, such as the mandate for the uninsured to obtain coverage, go into effect years later.

So why is so much of the right so angry? Much of it, I suspect, is not out of concern that most Americans won't like what this bill provides but that most of us will like it. We surely will want to make improvements in it, but basically there's a good chance we're not going to want to repeal it, as many conservatives are hoping.

Today's conservative coalition, like the Democrats of the 1960s, appears to be subdividing between the angry and the angrier. House Minority Leader John Boehner quite properly condemned those who threaten or vandalize and told them to "take that anger and channel it into positive change" in political campaigns and the voting booth. Good advice.

But who will tell Sarah Palin that it is not helpful, especially in light of recent events, to post a map on her Facebook page that puts crosshairs on 20 House Democrats in heavily Republican districts? Elisabeth Hasselbeck, conservative co-host on The View, called the imagery "despicable." Good for her. But she's not running for office. ■

Retirement Systems Administrator Héctor Mayol welcomes reform commission

Group may have to consider increases in employer and employee contributions, changes in benefits structure to meet pension obligations

BY JOSÉ L. CARMONA
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Retirement Systems Administrator Héctor Mayol welcomed Gov. Luis Fortuño's announcement last week that he would create a special commission to reform the public pension system, which the governor described as a "time bomb" facing a $14 billion unfunded actuarial liability and insolvency well before 2020.

To resolve the public pension system's $14 billion unfunded actuarial liability, Mayol said the government must first make sure there's enough cash flow every year to meet its pension obligations.

"To think that we're going to resolve the actuarial deficit in its totality is illusory. It's a huge amount of money that certainly no government can face head-on. But we know the cash flow needs, and currently we face a $400 million deficit. Therefore, we need to increase the revenue or reduce payments by that amount over time to make sure that we can meet all of our obligations," he said.

Mayol said the commission will surely have to look at increasing employer (government) and employee contributions to the pension plan as well as a restructuring (possible reduction) of benefits in order to meet obligations.

"This commission will add a much-needed weight to the discussion, and I totally agree with the governor's statements. Government Development Bank President Carlos García made it very clear, stating this is an issue that needs to be addressed if we want to stabilize the credit of Puerto Rico and improve its credit rating," Mayol told CARIBBEAN BUSINESS during the two-day 2010 Puerto Rico Credit Conference last week.

Mayol, who oversees the Commonwealth Employees Retirement System and the Teachers Retirement System, compared having an independent commission to reform the public pension system with the commission recently named by Fortuño to reform the tax system.

"One of the governor's top priorities in his political platform was to undertake an integrated tax reform that would benefit taxpayers in general. Here we're talking about the pensioners of the public sector who have contributed many years of service and also deserve our protection," Mayol said.

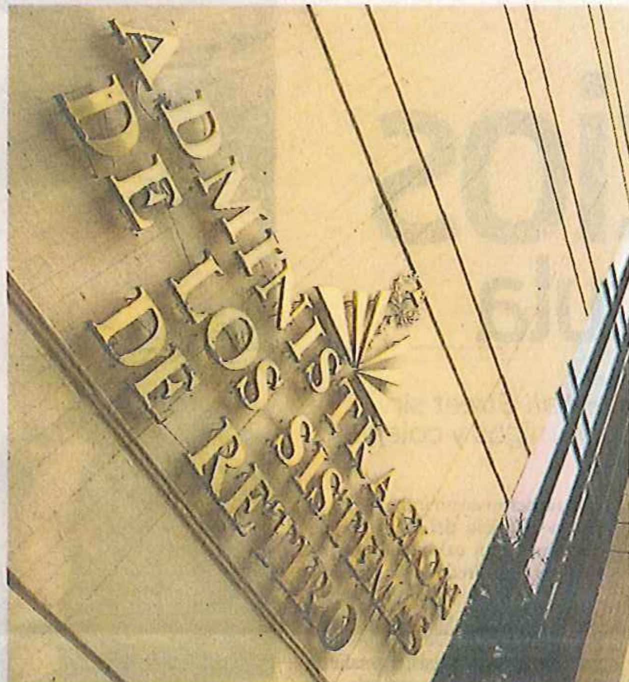
Since taking the reins of the retirement systems last year, Mayol said his office has been working with actuarial and investment experts.

"We have visited several states, some with solid financial conditions and others facing difficult situations, and looked at their solutions to see how they can be implemented in Puerto Rico," Mayol explained. "We have the information, and we're ready to begin working with this commission."

The commission will have six months to complete a report and present it to the governor. ■

Problema de $17,000 Millones

Urge afrontar el serio déficit en el Sistema de Retiro



EL NUEVO DÍA / JUAN A. ALICEA MERCADO

Los actuarios advierten que el Sistema de Retiro de Puerto Rico se podría quedar sin activos en el 2014.

El Sistema de Retiro de Puerto Rico cubre a todos los empleados del gobierno central, corporaciones públicas, y los municipios, con la excepción de los maestros, y los empleados de la Autoridad de Energía Eléctrica, la Universidad de Puerto Rico, y la Judicatura, quienes participan en sistemas de retiro separados.

Desde sus comienzos, el Sistema careció de planificación adecuada. El problema principal era, y en gran parte todavía es, que las aportaciones de los empleados y de los patronos son relativamente bajas y no fueron determinadas actuarialmente; mientras los beneficios se estipulados por ley y no guardan relación con el nivel de aportaciones al Sistema o con el rendimiento de las inversiones del mismo.

De acuerdo con el informe actuarial más reciente, el Sistema tiene una obligación actuarial acumulada de $18,943 millones y activos de $1,851 millones. Por tanto, el Sistema tiene un déficit actuarial de $17,092 millones. Para poner esta cifra en perspectiva, el déficit del sistema de pensiones del gobierno central de Francia suma unos $14,000 millones.


Por: Sergio M. Marxuach

El Sistema también tiene un grave problema de flujo de efectivo. Esto se debe a que los pagos de beneficios y gastos administrativos del Sistema exceden las aportaciones anuales y el Sistema tiene que usar ingresos producto de inversiones para cubrir esta deficiencia.

En la medida en que este flujo negativo de efectivo continué y exceda el rendimiento de las inversiones del sistema, los activos se reducirán. Los actuarios advierten que el Sistema se podría quedar sin activos en el 2014, aún asumiendo un rendimiento anual de 7.5% en sus inversiones.

Este problema tiene dimensiones financieras, políticas, legales, y morales de una complejidad extrema. La dimensión financiera es de una magnitud enorme. Las obligaciones del Sistema equivalen a 27% del producto nacional bruto de Puerto Rico. Una obligación de esta magnitud no se resuelve con trucos financieros o de contabilidad. Simplemente, el dinero tiene que aparecer o hay que recortar beneficios.

En términos políticos, los pensionados son un grupo bien organizado y simpático, y a los políticos les encanta complacerlos. Por otro lado, podemos esperar que las generaciones más jóvenes protesten el tener que pagar esta cuenta gigantesca. Puerto Rico, colectivamente como sociedad, le debe casi el 30% de su ingreso a 4% de su población. Transferencias de riqueza de esta magnitud no ocurren sin consecuencias políticas. Además, cada dólar que se utiliza para saldar esta deuda significa un dólar menos para atender la educación, la salud, la seguridad pública y otras necesidades sociales apremiantes.

Por el lado legal, usualmente se asume que los beneficios de las personas ya retiradas no se pueden reducir debido a la protección constitucional de los contratos. Sin embargo, el estado de Colorado aprobó legislación, recientemente, recortando beneficios a personas ya retiradas. Esta por verse si los tribunales de Estados Unidos avalan esta acción.

En el plano moral, se han hecho promesas a miles de personas, quienes planificaron su retiro contando con una serie de beneficios.

Por otro lado, las generaciones jóvenes argumentarán que es injusto que tengan que cargar con los errores del pasado.

Nos parece que una solución justa a este problema va a requerir sacrificios de cada uno de esos grupos. Los retirados tendrán que aceptar alguna reducción en sus beneficios, los empleados del gobierno tendrán que aumentar sus aportaciones, y todos nosotros tendremos que pagar algún impuesto especial dedicado exclusivamente a reducir el déficit del Sistema. Cada cual tiene que poner de su parte.

El autor es director de política pública del Centro para la Nueva Economía

SERGIO M. MARXUACH
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¿De quién depende el futuro?

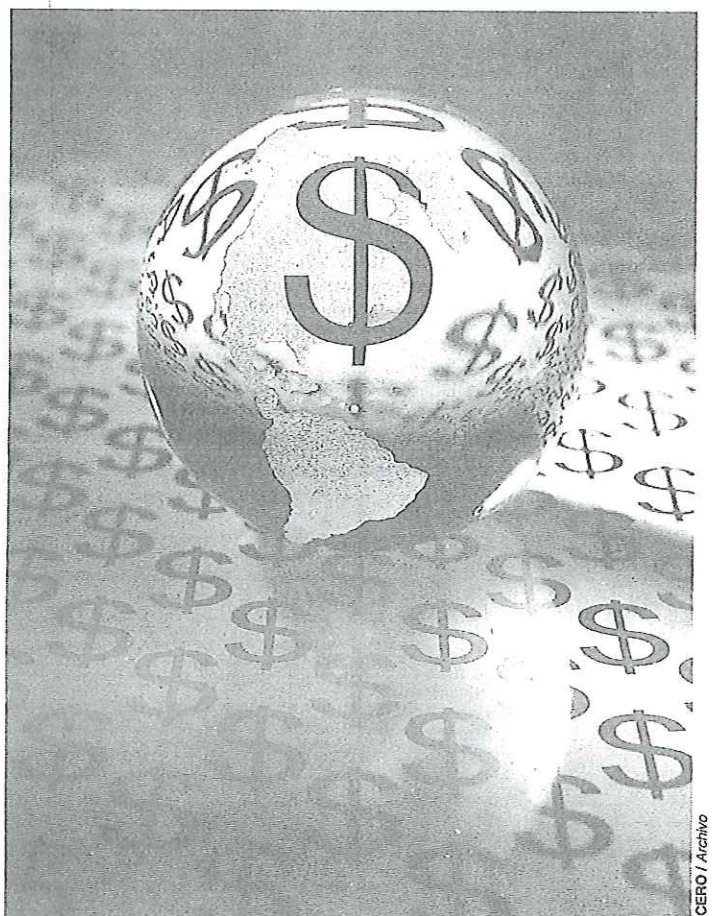
Bonistas, contribuyentes, y pensionados

Economistas especializados en economía internacional han concluido que un país no puede simultáneamente mantener una tasa de cambio fija, el movimiento libre de capital, y una política monetaria independiente. En cualquier momento dado se pueden lograr dos de estos tres objetivos, pero nunca los tres a la misma vez.

De manera similar se está conjugando otro "trilema" en la economía interna de muchos países, producto del conflicto entre los reclamos de los bonistas, los contribuyentes, y los pensionados sobre el patrimonio fiscal del estado. Dadas las condiciones fiscales y financieras prevalecientes, se vislumbra que será muy difícil para muchos países cumplir las obligaciones con sus bonistas y pensionados sin imponerle una carga adicional relativamente alta a sus contribuyentes. Por otro lado, si se descarta la imposición de impuestos nuevos entonces no será posible cumplir con las obligaciones contraídas con los bonistas y los pensionados.

Esa es la conclusión de un estudio hecho por Arnaud Marès, analista de Morgan Stanley en Londres. El análisis tradicional de las finanzas públicas se basa en la relación entre la deuda pública y el producto interno bruto; mientras más alta la deuda en relación al PIB más difícil será para un gobierno cumplir con sus obligaciones. Marès, sin embargo, considera que este análisis es inadecuado porque: no incluye todas las obligaciones públicas (por ejemplo, la deficiencia acumulada en las pensiones públicas); toma en consideración solamente el tamaño relativo de la deuda y no los ingresos gubernamentales disponibles para su repago; y es un indicador retrospectivo, que sólo toma en consideración la acumulación de deficiencias pasadas cuando el problema principal es la capacidad de pago en el futuro.

En lugar del análisis tradicional, Marès propone que se construya un estado de situación para cada gobierno y se calcule el patrimonio neto gubernamental. Para esto es necesario calcular el valor de los activos y pasivos (obligaciones), tanto fiscales como financieros, del gobierno. Por el lado de los activos se incluyen el valor presente de los impuestos a cobrarse en el futuro, el valor de los activos reales del estado (edificios, maquinaria, etc.) y el valor de sus activos financieros. Por el lado de los pasivos se incluye el valor presente



EL VOCERO / Archivo

de los servicios gubernamentales a ofrecerse en el futuro (educación, salud, seguridad pública, etc.) y el valor de la deuda pública bruta existente.

La diferencia entre los activos y los pasivos constituye el patrimonio neto del pueblo y es el indicador de solvencia gubernamental. Si el valor de los activos excede el valor de los pasivos, entonces el patrimonio neto es positivo y el gobierno podría reducir los impuestos sin incumplir ninguna de sus promesas. Por otro lado, si el valor de los activos es menor al valor de los pasivos, entonces el patrimonio neto es negativo y el gobierno se encuentra insolvente. En este caso alguien tendrá que sufrir una pérdida: ya sea los contribuyentes (a través de aumentos en los impuestos); los pensionados y otros beneficiarios de servicios públicos (a través de recortes); o los bonistas (a través de un evento de incumplimiento.)

Aplicando esos criterios, Marès encuentra que Italia, Alemania, Francia, Portugal, Estados Unidos, Reino Unido, España, Irlanda, y Grecia todos tienen un patrimonio neto negativo y eventualmente tendrán que tomar decisiones bastante difíciles.

Esta no es la primera vez que se reseña la apretada situación financiera de estos países, pero el análisis de Marès es importante porque pone de relieve de manera clara y sencilla el conflicto inherente entre los bonistas, contribuyentes, y pensionados. Estos grupos compiten entre sí por una cantidad limitada de recursos gubernamentales que actualmente, y esta es la clave de este asunto, no es suficiente para satisfacer todos los reclamos existentes. Simplemente, no hay dinero para tanta gente.

Es muy probable que este conflicto se manifieste en Puerto Rico de una manera particularmente virulenta. Primero, aunque el gobierno central ha recortado sus gastos, Hacienda todavía depende excesivamente de fondos no recurrentes para cuadrar sus libros y está por verse si Hacienda podrá aumentar los recaudos recurrentes en el futuro. Por lo tanto, es razonable asumir que el déficit estructural no va a desaparecer, por lo menos a mediano plazo.

Segundo, la deuda pública de Puerto Rico suma $62,206 millones (principal solamente) y si bien es cierto que una porción significativa de ese total son obligaciones de las corporaciones públicas, también es cierto que los mercados de capital actualmente asumen una garantía implícita por parte del Banco Gubernamental de Fomento en caso de que alguna de ellas no pueda cumplir con sus obligaciones, como ya lo hizo con Acueductos en los años noventa. Por eso no podemos ignorar esa deuda al calcular las demandas sociales sobre el patrimonio neto del estado.

Tercero, la obligación actuarial acumulada del Sistema de Retiro del gobierno central y del Sistema de Retiro de los Maestros suma $23,656 millones y no se vislumbra que se amortice en su totalidad ni siquiera en un periodo de 30 años.

Por último, es previsible que la demanda por servicios gubernamentales como educación, salud, y seguridad pública siga en aumento dado los cambios sociales, demográficos, y económicos que están ocurriendo en Puerto Rico.

En resumen, es razonable concluir que actualmente las obligaciones del gobierno de Puerto Rico excedan los recursos disponibles para satisfacerlas. Resolver los conflictos entre reclamos sociales conflictivos es el objetivo de los procesos políticos, los cuales, como dijera Harold Lasswell, determinan quién recibe qué, cuándo, y cómo. De la resolución efectiva de los conflictos entre bonistas, contribuyentes, y pensionados depende el futuro y la paz social de Puerto Rico.