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An examination of state and local government pension underfunding – Implications and guidance for governance and regulation

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ABSTRACT

State and local government pension underfunding has become a major focus of public policy debate due in large part to recent Governmental Accounting Standards Board (GASB) actions that have brought national attention to the issue. The extent of these plans underfunding has been debated, along with the necessity for state government intervention and the level of regulatory actions that should be enacted by state legislatures. State and local public pension plans do not fall under the enumerated powers of the federal government in the Constitution and are therefore left to each individual state to regulate. The amount of plan underfunding and enacted public policy by state varies greatly. Additionally, in contrast to numerous state balanced-budget laws, legal directives for fully funding public pensions are virtually non-existent. This paper analyzes the state and local public pension crisis, examines current and long-term risk, studies public employee fiscal conditions, considers the societal impacts of these plans, considers the strengths and weakness of pension plan types, recommends public policy and regulation, and offers strategies for managers, board members, and public officials to adopt.

1. Introduction

Public pension plans date back to the 1870′s when New York City police officers were granted lifetime payments at age 55 after 21 years of service. In comparison, the first private sector plan was established in 1875 by the American Express Company. This plan created the framework for other pension plans to follow by including retirement age, longevity, and percentage of annual salary as a basis for providing retirement income. In their case, it was 60 years of age, with 20 years of continuous service, providing 50% of income level at retirement (Stone, 1984). In 1911, Massachusetts became the first state to create a pension plan for all general state employees (NCPERS, 2003). The growth of public plans continued through the 1960′s when virtually all public service employees were covered by some type of public retirement benefits. These payments generally came in the form of defined benefits (DB) that guaranteed a fixed income to the retired employee for life. This is in contrast to the newer form of pension plans called defined contribution (DC) which are 401(k) type plans where employees and employers contribute to employee-controlled investment accounts.

For nearly a century and a half, there has been little concern for or discussion regarding the solvency of public DB pension plans and payments to retirees have continued to flow. Over the years, many of these plans have not been managed properly, and now have large future pension liabilities for retirees without the assets to cover them. Recently, the GASB has required that any unfunded pension liabilities be reported on state and local government balance sheets and the expected rate of return used in calculating the liability.

These new requirements bring significant transformation to determining and reporting pension liabilities. It has been shown that bond investors have already adjusted and taken into account the unfunded pension liability in both the private sector (Shaw, 2008) and in the public sector (Foltin et al., 2017). Therefore, the bigger impact of these standards may be the heightened awareness GASB has brought to the public regarding underfunding and liability amount. Discount rate, assumptions regarding future returns, amount of benefits, and investment decisions have become a matter of public debate. Policy change and media coverage have greatly increased since GASB focused attention on the issue especially with the most troubled pension funds.

Several pension funds across the country experienced much publicized troubles with their plans. State plans in California, Illinois, New Jersey, and Kentucky, and municipal plans like Chicago, Detroit, and Dallas, have been forced to take action due to low funding levels. These events along with GASB's actions have turned a spotlight on the funding of public pensions. Fund management, board inaction, elected official indecisiveness, taxpayer funding,

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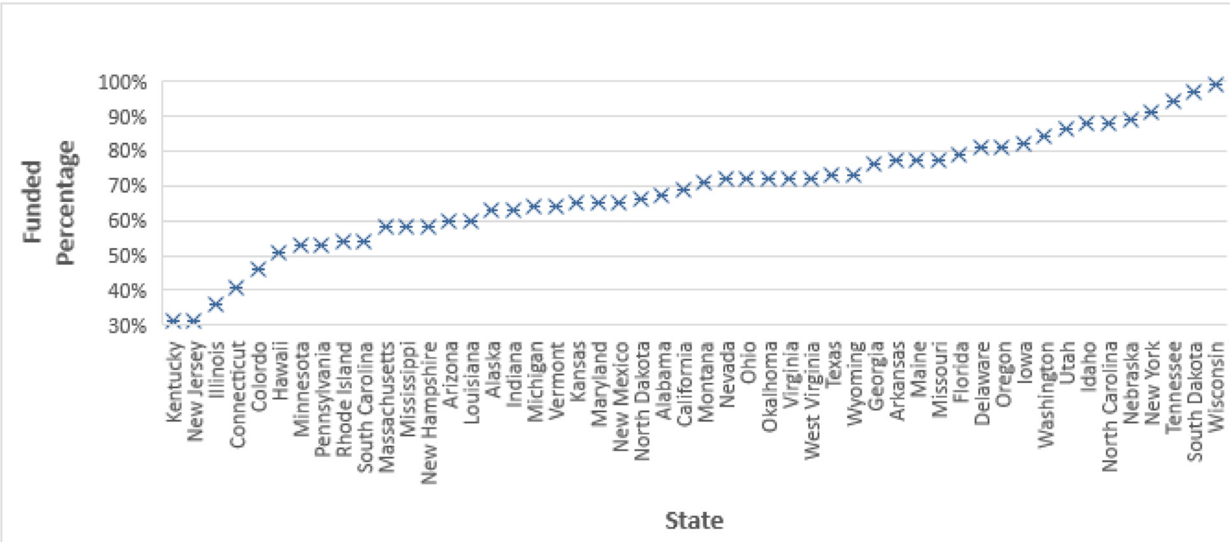

Exhibit 1. Funded Percentage Plan Assets in Proportion to Accrued Pension Liability.
Source: Pew Charitable Trusts (2018).

expected returns, investment decisions, and benefits to employees have all come under scrutiny. Actions to remedy these issues have so far largely dealt with benefit cuts by altering the mechanics of the plans, such as reducing cost of living adjustments (COLA), cutting benefit amounts, increasing retirement age, and even moving to DC plans (Foltin et al., 2018). However, the heart of the problem – policy, regulation, and governance – has remained untouched and virtually unmentioned.

2. Pension plan underfunding

Public pension underfunding amounts vary depending on the methodology used in calculating liabilities. Pew Charitable Trusts (Craig, 2018) estimates the deficit at $1.4 trillion based upon Comprehensive Annual Financial Reports, actuarial reports, and public financial statements. In contrast, Stanford University's Hoover Institution study (Rauh, 2017) places the amount at $3.8 trillion.

The difference in estimates is attributable to the long-range projected rate of return. It has been shown that discount rates can be manipulated to meet the needs of an entity through lowering the liability on the balance sheet or lowering pension expense on the income statement (Fried, Davis-Friday, & Davis, 2014). Pew used the actual rates of return applied by the pension funds: a 7.5% average rate. The Stanford study uses a weighted average, plan-by-plan rate tied to the treasury yield which generates a 2.7% annual projected rate of return. The most realistic discount rate and actual deficit most likely lies somewhere between these two figures and will continue to provide debate in state legislatures and on a national level.

Private sector research has studied the use of International Accounting Standards in which the long-term expected rate of return on pension plan assets has been eliminated. However, this has shown to have a great impact on firms with "extreme" levels of funded status (Bauman & Shaw, 2016). Using the Pew Data, Exhibit 1 lists all the states and their funded percentages.

Under both the Pew and Hoover Institute methodologies, pension deficits have been rising and funded percentages are decreasing. The 2018 Pew study shows 44 of 50 states experienced a decrease in their funded pension percentage, with Wisconsin being the only state with any improvement at 1%. Although 2017 numbers are expected to improve, most long-term forecasts predict continued strain on public pension funds (Foltin et.al, 2018).

3. Pension reforms and fiscal stability

The National Association of State Retirement Administrators (NARSA) (Brainard & Brown, 2016) reports that in the last decade, every state has passed pension reform legislation, with most legislative changes having a negative impact on the level of employee benefits awarded. Employees are now required to pay more than they have in the past. Forty states lowered benefits by either changing formulas used to calculate benefits, reducing COLA, and/or requiring employees to work longer. Increased contributions and cuts in benefits are even more dramatic for newly hired employees.

Five states: Michigan, Rhode Island, Tennessee, Utah, and Virginia, have created combination DB/DC plans. Kansas and Kentucky created cash balance plans for new employees where the employer puts in a percentage of employee salary and provides a nominal interest rate. Although cash balance plans are still considered DB plans, they are a big step closer to DC plans and another shift away from traditional DB plans. Arizona and Oklahoma closed their traditional DB plans for all new hires with DC being the only option. Many of these pension changes have been declared successful, have received praise from public officials, and have indeed made strides toward reducing governmental pension underfunding. The Manhattan Institute (DiSalvo, 2015) and the Brookings Institute (McGuinn, 2014) even use some of the above-mentioned states as best practice case studies for other governments seeking to reduce pension deficits.

Consensus by policymakers does not necessarily demonstrate success. Crisis has brought opportunity to make pension benefit cuts. Wong (2016) writes that keeping politics out of pension fund decisions will benefit fund performance. Whether politics or genuine concern for the financial stability of pension funds is the driving force behind policy changes, dramatic change is occurring. After reviewing pension reforms enacted by states, actions by public officials to increase employee contributions, cut benefits, and shift toward DC plans are having a positive impact on the stability of funds - at the very least, the decline is less.