The Challenge of Financing Public Pensions in an Era of Limited Means

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Funding of Pensions Is Part of Overall Challenge of Paying for Employee Benefits

- Pensions
- Employee Health Care
- Retiree Health Care

Employee Benefits Are Consuming Ever Larger Shares of Municipal Budgets

- Health care and pension benefits grew from 13.5 percent of local budgets in 2001 to 20 percent in 2010.
- Left unchecked, employee benefits will consume 30 percent of local budgets by 2020.
- This does not include the billions that communities should be paying each year—but are not—to address retiree health care liabilities.

Benefits as a Percent of Municipal Budgets

Year	Total Expenditures	Health Care	Medicare	Pensions	Percent
2001	13,311,013,187	906,432,171	111,792,799	773,092,826	13.5%
2002	14,110,131,357	1,087,085,181	116,489,111	817,215,738	14.3%
2003	14,707,247,566	1,273,724,664	120,406,220	863,856,888	15.4%
2004	15,027,038,534	1,410,995,523	121,286,614	913,160,000	16.3%
2005	15,671,935,302	1,535,537,683	124,300,598	965,277,000	16.8%
2006	16,450,271,310	1,714,082,947	126,182,193	1,017,394,000	17.4%
2007	16,472,478,089	1,843,453,502	131,523,215	1,086,000,000	18.6%
2008	17,332,194,178	1,945,601,520	136,378,066	1,145,500,000	18.6%
2009	17,569,752,714	2,048,984,407	141,609,625	1,208,125,000	19.3%
2010	18,307,682,328	2,270,889,418	146,835,021	1,262,490,625	20.1%
2011	19,076,604,986	2,516,826,742	152,253,233	1,319,302,703	20.9%
2012	19,877,822,395	2,789,399,078	157,871,377	1,378,671,325	21.8%
2013	20,712,690,936	3,091,490,999	163,696,831	1,440,711,534	22.7%
2014	21,582,623,955	3,426,299,474	169,737,244	1,505,543,553	23.6%
2015	22,489,094,161	3,797,367,707	176,000,548	1,573,293,013	24.7%
2016	23,433,636,116	4,208,622,629	182,494,969	1,644,091,199	25.8%
2017	24,417,848,833	4,664,416,460	189,229,033	1,718,075,303	26.9%
2018	25,443,398,484	5,169,572,763	196,211,584	1,795,388,692	28.1%
2019	26,512,021,220	5,729,437,493	203,451,792	1,876,181,183	29.5%
2020	27,625,526,111	6,349,935,574	210,959,163	1,960,609,336	30.8%

Sources: Division of Local Services; PERAC. Highlighted data are estimates based on 2001 – 2009 growth rates except pensions which are increased by 4.5 percent annually.

Defined Benefit Pensions Are Largely a Public Sector Holdover

- Nationally, 38 percent of private sector workers were covered by defined benefit plans in 1980, but that dropped to 20 percent by 2010.
- 84 percent of state and local government workers were covered by defined benefit plans in 2010.
  - Some states—Michigan, Alaska, and Nebraska—have switched to defined contribution plans.
  - Several others offer hybrid plans or allow employees to choose defined contribution plans instead of defined benefit plans.

Source: Bureau of Labor and Statistics; U.S. Department of Labor

Most Massachusetts Pension Plans Face Large Unfunded Liabilities

- 91 of the state's 100 local and regional pension systems are funded below 80 percent; 19 are less than 50 percent funded.
- The total unfunded liability for these 100 systems is $12.9 billion—funding is just 59 percent of the total liability.
- By comparison, a July 2011 study of 97 locally administered plans across the country found that they were 77 percent funded in the aggregate.

Extending the Funding Schedule Has Serious Consequences

- The state and municipalities can now extend their pension funding schedules to 2040.
  - The state has gone to 2040; at least 33 local systems have extended their schedules beyond 2030.
- The impact of extending funding:
  - increases total costs,
  - extends the burden on taxpayers,
  - constrains funding for schools, public safety, and local services, and
  - limits the ability of municipalities to address retiree health care liabilities.

Extending Payment Schedules Adds a Huge Burden on Taxpayers

- It will cost the state $30 billion in foregone interest to extend the payment schedule to 2040.[1] In current dollars, that is $11.7 billion—eight times the state's $1.478 billion fiscal 2012 pension payment.
- Under the new schedule, the state will pay approximately $68 billion to fund its liability between now and 2040, almost double the $38 billion needed to fund it by 2025.
- The impact will be just as harsh, relatively, for local systems that extend their payment schedules—the longer the extension, the higher the costs. In many cases, local systems have poorer funding ratios than the state and may face even more severe consequences.

1. This is the amount the state would have earned on approximately $13 billion in payments that will be deferred until 2026 and later, assuming an 8.25 annual rate of return.

Pension Reform Must Accompany the Funding Extension

- The state risks a credit downgrade for extending the funding schedule *unless* it also enacts pension reform to control the long-term liability.
- The Governor has proposed reforms that would save $5 billion in pension costs, including $2 billion for municipalities.

Governor's Pension Reform Bill

(applies to new hires)

- Increase the retirement age, as Social Security has done, to reflect longer life expectancies.
  - Raise the minimum retirement age from 55 to 60 and the full retirement age from 65 to 67 for most employees.
- Eliminate the advantage of early retirement by increasing the discount for retiring early.
- Extend the number of years for calculating the pension benefit – from the average of the highest consecutive three years to the highest consecutive five years.
- Eliminate Section 10 early termination benefits for all.
- Pro-rate benefits according to the number of years in each group classification (for current employees and new hires).

Vast Majority of States Have Adopted Pension Reforms

- In fiscal years 2010 and 2011, 39 other states enacted pension reforms:
  - 23 states increased the age and service requirements for new members.
  - 13 states extended the period used to calculate the final average salary.
  - 12 states increased vesting requirements for new members.

Source: National Conference of State Legislatures, June 2011

Investment Return Assumptions Pose an Added Risk

- The state assumes an 8.25 percent annual rate of return, while most local systems use 8.0 percent.
- Most experts consider it unlikely that pension plans will achieve the same level of returns over the next 25 years that they did during the last 25 years.
- The employer, not the employee, bears this risk.

Public and Private Sector Employers are Lowering Assumptions

- Rhode Island, Colorado, New York, Illinois, and Virginia have all lowered their assumed rates of return to between 7.0 and 8.0 percent.
- Many more states—such as California, Maryland, North Carolina, and Florida—are already below 8.0 percent.
  - Actuaries in California and Florida recommended lowering of rates further.
- Private corporations that still offer defined benefit plans generally use an assumed rate between 5.0 percent and 6.0 percent.

Falling Short of Assumptions Would Be Very Costly

- If the state earns 7.75 percent, it would add approximately $3.1 billion—or 5 percent—to its liability. According to the Pew Center on the States, earnings of 5.2 percent would add $26 billion, or more than 40 percent, to the state's liability.[1]
- Though many factors affect the exact numbers for municipalities, earning even a slightly lower rate of return would have a major impact on liabilities.

1. Pew used the 5.2 percent rate according to the Financial Standards Accounting Board guidelines for private plans. The estimate is based on the Commonwealth's 1/1/2010 actuarial valuation for the state and teachers plans.

Retiree Health Care is an Enormous—and Largely Ignored—Problem

- Unfunded liabilities for retiree health care are staggering, estimated to be between $40 and $45 billion for the state and municipalities—and growing every year.
  - By comparison, the unfunded pension liability for the state and municipalities is approximately $30 billion.

Virtually No Progress on Tackling Retiree Health Care Liabilities

- Only a handful of communities have set aside any funding and even fewer have definite, long-term plans to fund these liabilities.
- With many communities already struggling to fund pensions, addressing retiree health care liabilities will be virtually impossible.

Conclusion

- Municipal health reform will give local officials greater ability to control the growth of employee health care costs, achieving major savings for cities and towns.
- As challenging and costly as it may be, the state and municipalities will almost certainly meet their pension obligations for current employees and retirees.
- On the other hand, the obligations for retiree health care are so enormous that the state and most municipalities cannot fund them, which will almost certainly require changes in eligibility requirements and benefit levels for future retirees.