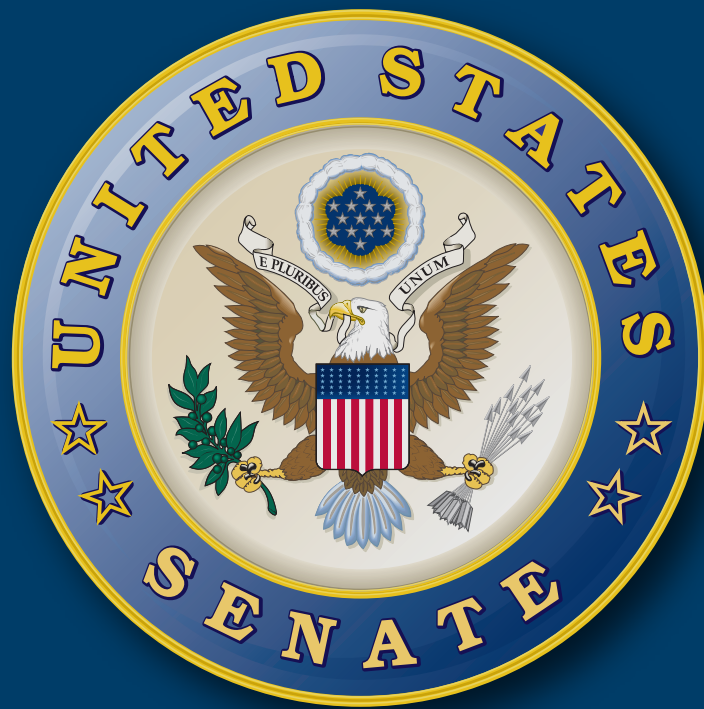


United States Senate Committee on Finance

State and Local Government Defined Benefit Pension Plans: The Pension Debt Crisis that Threatens America



A Report By Ranking Member Orrin Hatch (R-Utah)

January 2012

U.S. Senate Committee on Finance



Report of the Ranking Republican Member

Senator Orrin G. Hatch

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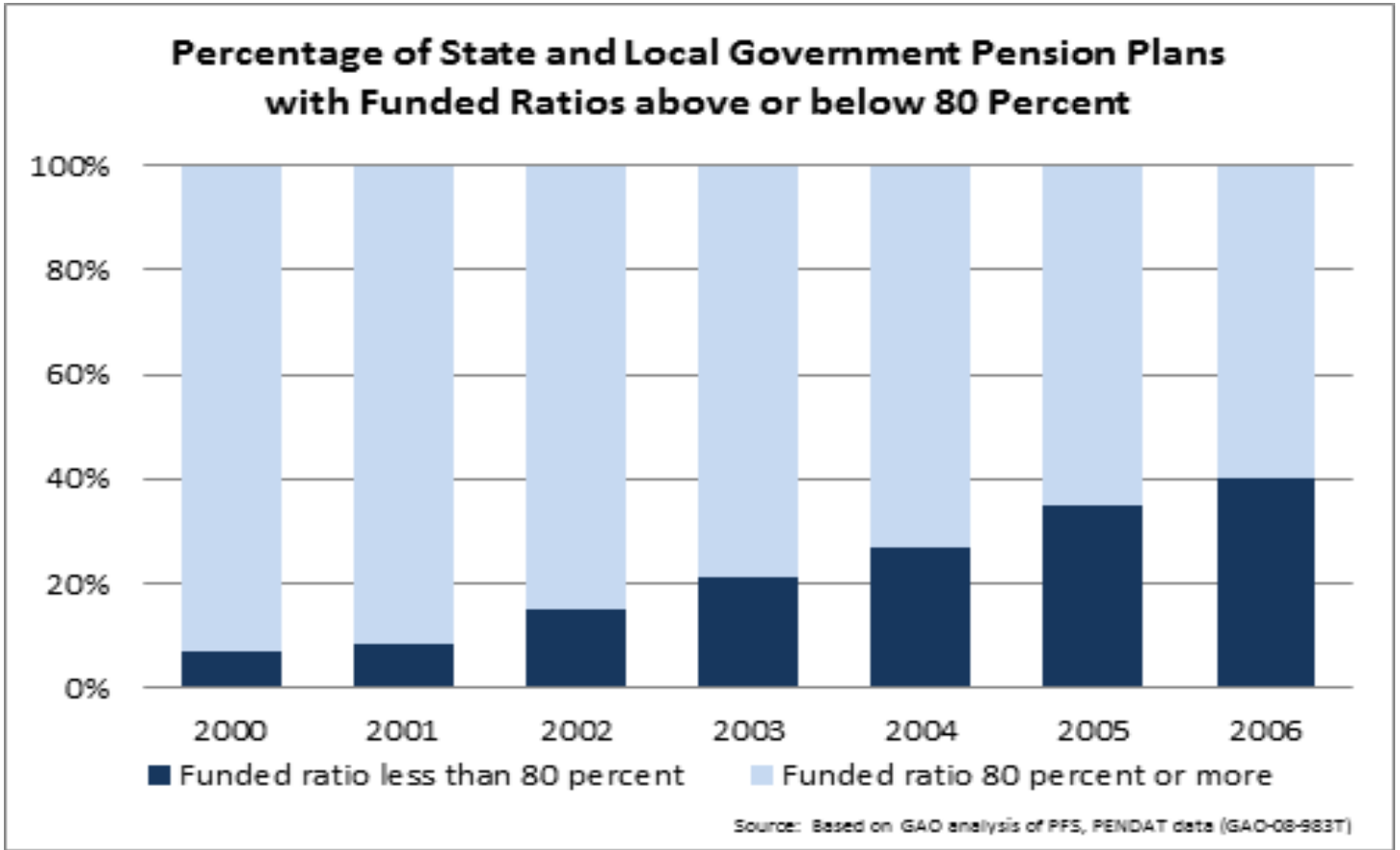
Pension Liabilities Are Contributing to Our Nation's Debt Crisis

The pension funding crisis facing state and local governments has been widely reported.¹ Vested pension benefits are a fixed financial obligation of governments, and to the extent the assets that have been set aside to pay for the benefits are inadequate, the pensions represent an unfunded financial obligation. Unfunded obligations are implicit government debt, although not as transparent as explicit debt such as municipal bonds. It has been estimated recently that aggregate underfunding of state and local defined benefit pension plans may exceed \$4 trillion.² Aggregate municipal bond debt totals \$2.9 trillion, by comparison.³ Thus, although the debt associated with underfunded pension plans is not as transparent to the public as municipal bond debt, it represents the greater portion of aggregate municipal debt. This crushing debt load is ravaging state and local government budgets, and there are few options available to them for addressing this crisis – cuts in services, reductions in benefits, higher taxes, or some combination of the three.⁴

Some have argued that the public pension underfunding crisis was caused by the collapse of the housing bubble and subsequent global financial meltdown in 2008, suggesting that pension underfunding is a temporary problem that will be corrected by the states over time.⁵ This analysis severely understates the character of the crisis. Unfunded public pension liabilities are a longstanding problem that existed well before the current economic downturn. Over 30 years ago, the Government Accountability Office (“GAO”) warned Congress that poorly funded public pension plans could lead to a “fiscal disaster and possible loss of employees’ earned benefits.”⁶ The current pension debt crisis began not in 2008, but at least a decade ago. According to the GAO and the Congressional Budget Office (“CBO”), as well as Standard & Poor’s (“S&P”), the funding levels of municipal pension plans have

been declining since 2000.⁷ A funding ratio of pension assets to liabilities of 80 percent is generally considered the indicator of a sound government pension plan.⁸ As shown in Table 1 below, 40 percent of state and local government pension plans had already dropped below the 80 percent funding level before the 2008 recession began.

Table 1



Advocates of the public pension status quo also acknowledge this downward funding trend.⁹ Based on post-recession data, thirty-one states now have funding ratios lower than 80 percent.¹⁰ Worse still, many states have severely underfunded plans, holding less than 60 percent of the assets needed to pay pension liabilities. In fact, the pension plans of 11 states are projected to have exhausted all of their assets by 2020.¹¹

There are several reasons for the current crisis. Some states and local governments have lacked fiscal discipline, some have promised overly generous benefits, and many have failed to make the annual contributions necessary to maintain an actuarially sound pension plan. States have not been entirely at fault, as they had no control over the recent precipitous drop in interest rates or the volatile stock market. But regardless of the reason for the current pension crisis, the need for action can no longer be denied.

State and Local Governmental Pension Debt is a Matter of Federal Concern

Many states have clearly recognized pension underfunding for the fiscal crisis that it is. In the last two years 40 state legislatures have enacted a total of 48 significant pension reform laws addressing the pension debt crisis, an unprecedented level of state legislative activity in this area.¹² Given these efforts, and the states' legal and moral responsibility to correct these pension underfunding liabilities, some might question whether this crisis in state and local pension plan funding is a proper concern for the federal government. Yet funding shortfalls at the state or local level are not only a matter of concern to that particular state or locality. The potential effect of state and municipal pension debt on state insolvency or default is significant, and such an event is a possible contagion that could infect even responsible jurisdictions. Unfunded pension liabilities of state and local governments also affect the Federal government's credit rating, and municipal insolvency or default threatens to place significant additional burdens on the federal government, which already spends trillions on anti-poverty programs.

Large State Insolvency Risk

A crisis at the state level - or in a large municipal setting - could worsen an economic downturn in the rest of the nation. The insolvency or default of a large state could have a contagion effect on other states or regions. The economy of California is nearly the size of Italy.¹³ Just as economic difficulties in Italy have stressed the European Union, fiscal problems in a large state such as California or Illinois could damage the fiscal health of the United States.

In the event of insolvencies, the demand for a Federal bailout or bailouts would certainly follow. A Federal bailout of the states must be avoided at all costs. Responsible states that have prudently managed their pension plans and pose no risk of financial contagion to their neighbors, and the American taxpayer, cannot be asked to bailout states that have underfunded pension liabilities for public employees.

S&P Downgrade Risk

When S&P downgraded United States debt in August, 2011, one of the key factors taken into account was underfunded government pensions at the federal, state and local level.¹⁴ It is not well known that public pension debt is a key factor in credit rating agency analysis of United States debt. The credit rating agencies know that the Federal government has no legal obligation to bailout a state, but the agencies assume that the pressure for the Federal government to step in during a state or municipal default or solvency crisis would be so great that a bailout could not be avoided.

Regardless of the likelihood of a bailout — and bailouts of the states cannot be permitted to happen — the unfunded pension liabilities of state and local governments are a key factor in the Federal credit rating. As such, to the extent unfunded pension liabilities could

contribute to a potential future downgrade they will contribute to increased borrowing costs for the Federal government.

Federal Poverty Programs

The public pension crisis also presents the risk that retirees and employees will not receive the full pensions they have been promised. Unfortunately this is not a mere theoretical possibility. Public employees and retirees in Vallejo, California; Pritchard, Alabama; and Central Falls, Rhode Island all face the loss of retirement benefits due to municipal bankruptcies caused by underfunded pension plans.¹⁵ In some cases, it is possible that the individuals affected will not even have social security retirement to fall back on, because 27.5% of state and local workers are not covered by social security.¹⁶ Additional demands will be placed on the resources of Federal programs such as Medicaid, The Emergency Food Assistance Program (“TEFAP”), the Supplemental Nutritional Assistance program (“SNAP” or Food Stamps) and the HUD Public Housing Assistance Program, just to name a few. The projected growth of these entitlement programs contributes significantly to the federal government’s fiscal problems. Thus, the growth of state and local governmental pension debt is unquestionably a legitimate Federal concern.

It is simply unrealistic to presume that no state or local pension plan will fail or that such failure will have no effect on federal spending or revenue.

State Legislative Efforts

State legislatures have taken steps to address the pension underfunding problem. Forty state legislatures enacted forty-eight separate pension reform laws in 2010 and 2011. Twenty-seven states increased the level of employee contributions paid toward pensions; fifteen states increased the retirement age; eighteen states modified the annual cost of living adjustment (“COLA”); and fourteen states adjusted the final-average-pay pension calculation formula.¹⁷ While these laws represent improvement, they leave the basic defined benefit pension structure in place, and, therefore, underfunded pension plans will continue to be a problem for state and local governments.

Defined Contribution and Other Plan Designs

A few states have established or have considered establishing a defined contribution plan for new or existing employees.¹⁸ In a 401(k)-type defined contribution plan, each employee has an individual account into which are deposited employer contributions and pre-tax employee deferrals. The employee’s retirement is dependent on the amount of contributions, deferrals and earnings in the account, not on a monthly payment based on a fixed pension formula. Despite their prevalence in the private sector, public employee unions have vigorously opposed the move toward 401(k)-type plans by public employers.¹⁹

Some states have innovated by adding new plan designs such as cash balance plans.²⁰ Cash balance plans are an improvement over the traditional defined benefit plan but still require states and municipalities to attain a certain level of investment success which can never be guaranteed. In an effort to address the shortcomings of traditional defined benefit plans, some states have moved to hybrid plan designs that combine a defined benefit feature and a defined contribution feature in the same plan.

Despite the establishment of defined contribution plans in many states, and the efforts of some to innovate with new plan designs, defined benefit plans remain prevalent in the public sector and unfunded pension liabilities continue to grow each year.

Closed Plans

Several states have taken stronger steps and have closed, or frozen, their defined benefit pension plans to new employees. Closing plans has become common in the corporate sector in recent years, but it is not yet common among public employers.²¹ There are two basic types of plan freezes: a “hard” freeze and a “soft” freeze. In a hard freeze, the plan is closed to new employees, and both new and existing employees are transferred to a new plan. In a soft freeze, new employees are placed in the new plan but existing employees *continue to accrue benefits* in the closed plan. To date, all public plans that have taken the step of freezing their defined benefit plans have implemented the soft freeze.

Closing a plan does not eliminate the underfunding. In fact, all closed plans must be funded to cover liabilities for existing retirees and vested benefits already earned by current and former employees and payable in the future. In addition, in a soft freeze the plan also must be funded to pay for pension accruals existing employees will continue earning under the closed plan for future service, drastically increasing the time it takes to fully resolve the underfunding problem.

Federal Legislative Efforts

In the past, Congress has considered addressing the pension underfunding problem by imposing funding requirements on state and local government pension plans. Several proposals were introduced to require reporting and disclosure of pension plan information, and impose fiduciary duties on government plan administrators. None of the proposed legislation was enacted.

PERISA and PEPPRA.

When the Employee Retirement Income Security Act of 1974 (“ERISA”) (P.L. 93-406) was being considered, there was an unsuccessful attempt to make its provisions, including the minimum funding rules, fully applicable to governmental plans. Although governmental plans were excluded under ERISA, section 3031 of the Act directed a congressional study of the issue. The House Pension Task Force of the Labor Standards Subcommittee of the House Education and Labor Committee conducted a comprehensive survey of governmental plans and presented the findings in a March 1978 report.²² Following publication of the 1978

report a number of bills were introduced. The most notable legislation introduced was the Public Employee Retirement Income Security Act (“PERISA”), introduced in 1981, and the Public Employee Pension Plan Reporting and Accountability Act (“PEPPRA”), introduced in 1984.²³

PERISA would have established Federal reporting and disclosure requirements and fiduciary standards, including personal liability, for state and local government retirement plans. The legislation would have established a new Federal agency, the Employee Benefit Administration (“EBA”), and plan administrators would have been required to submit registration statements to the Board of Directors of the EBA, along with annual reports including a financial statement. Plans subject to substantially similar state law requirements would have been exempt from the new Federal rules. Plans would have been required to provide participants and beneficiaries with summary plan document descriptions, summary descriptions of any material modifications to the plan, information regarding accumulated plan benefits, including the extent to which, and the expected earliest date on which, such benefits would become vested, and the total accumulated contributions made by the employee. The legislation also would have established an 11-member Advisory Council on Governmental Plans, to be appointed by the President, to advise and make recommendations to the Board with respect to its functions under the Act. PERISA was amended to eliminate the EBA and reported to the House on September 28, 1982.²⁴ The full House did not act on the legislation.

PEPPRA focused on reporting and disclosure. The legislation would have applied to all government employee pension plans and would have required disclosure of summary plan documents, annual benefit statements to be provided to participants and beneficiaries, and an annual report to be filed with the Department of Labor which included financial and actuarial statements. Plans also would have been required to name a fiduciary. States could bypass the new requirements if the Governor certified that the state law imposed substantially similar requirements, that the state could adequately enforce the law and that it collected the required annual reports. PEPPRA was reported to the House on October 4, 1984.²⁵ The full House did act on the legislation.

In the Senate, the Committee on Finance, Subcommittee on Savings, Pensions and Investment Policy, held an extensive hearing in March 1982 on S. 2105 and S. 2106, legislation introduced by Subcommittee Chairman John Chafee (R-RI). The subcommittee heard testimony from twenty witnesses including the leading House proponent of reform legislation, Representative John Erlenborn (R-IL). Despite the extensive attention paid to the issue in the subcommittee, the full committee took no official action on the legislation.

Opponents of the House and Senate bills argued that states had addressed the shortcomings identified in the 1978 Task Force Report and that the impetus for ERISA - bankruptcies and defaults in the private sector - did not exist in the public sector. Further, opponents contended that states, unlike a business, would have the ability to raise taxes to close any shortfall. Faith in the untrammelled ability of governments to raise taxes was

misplaced. The ability to tax is limited by the ability and willingness of taxpayers to pay. The 1978 Task Force Report found that state and local governments “can and will renege on past or future pension commitments when the pension costs become too burdensome, or threaten the governmental unit’s financial stability.”²⁶

Opponents of required funding for state and local pension plans also reasonably argued that the Federal government did not possess the authority to impose funding requirements on the states.²⁷

Current Proposals

Recognizing the threat that underfunded state and local public employee pensions pose to the nation’s fiscal position, a number of members of Congress are considering legislation that would require additional liability disclosures and improved transparency.

Disclosure and Transparency

Congress is considering requiring enhanced disclosure and transparency by state and local pension plans in legislation introduced in the current Congress. H.R. 567, the “Public Employee Pension Transparency Act,” was introduced in the House of Representatives by Representative Devin Nunes (R-CA) and is pending in the House Ways and Means Committee. Companion legislation, S. 347, was introduced in the Senate by Senator Richard Burr (R-NC), and is pending in the Senate Finance Committee. The legislation would amend the Internal Revenue Code to deny tax benefits to investors in municipal bonds issued by a state or political subdivision during any period in which the governmental entity fails to comply with public employee pension plan reporting requirements. Plans would be required to file annual reports with the Secretary of the Treasury including, among other things, disclosure of their plan liabilities using a current market, risk-free rate of return.²⁸ In addition, the Secretary of the Treasury would be directed to develop model reporting statements and create and maintain a publicly accessible website to which plan information would be posted. On May 5, 2011, the House Ways and Means Committee, Subcommittee on Oversight, held a hearing on H.R. 567.

GASB Disclosure

The Government Accounting Standards Board (“GASB”) has voluntary standards that address disclosure of pension information by public employee retirement systems. GASB disclosure standards are designed to provide information necessary to assess the funding status of a public pension plan on a going-concern basis, the degree of progress made in accumulating assets sufficient to pay benefits when due, and whether state and local governments are making the actuarially determined contributions. GASB standards also require the computation and disclosure of a standardized measure of the pension obligation based on the actuarial present value of projected benefit liabilities.²⁹ Thus, one possible approach to improved disclosure would be to make the GASB standards mandatory.

Improved disclosure and transparency are necessary and would be a significant improvement in public pension administration. However, disclosure alone will not force funding, nor will it prevent interest rate risk or market volatility - key factors in determining funding levels. As such, while improved disclosure is necessary and certainly advisable, more needs to be done to solve the underlying funding problem and protect taxpayers.

Private Pension Funding

The Pension Protection Act of 2006 (“PPA”) amended ERISA to establish new and more stringent minimum funding standards for corporate defined benefit pension plans. The PPA requires employers to fully fund the pension liabilities earned by employees in the current year, and to amortize liabilities related to earlier years over a shorter, more aggressive schedule.³⁰ The PPA also sets forth rules governing the valuation of plan assets and liabilities. At-risk plans are subject to special rules based on whether they are underfunded, including an actuarial assumption that participants will retire at the earliest possible date. Underfunded plans - plans with less than 80 percent funding - are prohibited from adopting amendments that increase plan liabilities, providing lump sum distributions, or other accelerated forms of benefits. Plans less than 60 percent funded are prohibited from future benefit accruals.³¹

Application of the PPA funding requirements to public pension plans is not a promising approach to reform, however. First and foremost, a Federal pension funding mandate directed at the states would pose serious Constitutional concerns. In addition, the PPA funding rules are exceedingly complex and enforced by the Internal Revenue Service (“IRS”). Administering the new requirements would add significant costs to state budgets at a time when state budgets are already severely constrained. In addition to high administrative costs, the imposition of Federal funding requirements raises questions of an unfunded Federal mandate.³² Further, although designed to strengthen pension plans, the PPA funding rules have not worked particularly well in definitively remedying the underfunding problem in some parts of the corporate sector. Corporate defined benefit pension plans continue to face underfunding problems and have regularly sought relief from the rules. Thus, it is not clear that imposing corporate funding rules on governmental plans would actually solve the underfunding problem.³³

GASB Funding

Another alternative would be to require public plans to follow GASB’s voluntary funding standards. GASB establishes standards for the measurement, recognition, and presentation of pension assets and liabilities. The GASB standards provide for the measurement and disclosure of the annual pension cost on the accrual basis of accounting, regardless of the amount recognized. Under GASB standards the annual pension cost should be equal to the employer's annual required contribution (“ARC”) to the plan.³⁴

Making GASB funding and disclosure standards mandatory could lead to better, more consistent information and funding. However, as with corporate minimum funding,

contributing the ARC is no guarantee of pension plan solvency. For example, the Pew Center for the States reports that twenty-two states contributed 100 percent of their ARC in 2009, and yet over 50 percent of the plans that contributed the full ARC were less than 80 percent funded. Six more were less than 70 percent funded, and one was less than 60 percent funded.³⁵ Further, a recent survey of 126 large public pension plans indicates that in 2010 sixty-four plans received contributions equal to 100 percent or more of their ARC. However, sixteen of the plans were less than 70% funded and five were less than 60% funded.³⁶ One of the states that contributed 100 percent of the ARC to its plan, Rhode Island, experienced a high-profile pension funding crisis in in 2011 requiring extraordinary legislative action.³⁷ Thus, it is not clear that mandating funding at the GASB ARC level will actually solve the pension debt problem.

Defined Benefit Plans are Inappropriate for State and Local Governments

Many of the legislative proposals and enactments at the state and federal level are good ideas that would improve the defined benefit pension structure. However, it is becoming increasingly apparent that defined benefit pension plans will never be financially sound enough over the long term for use by state and local governments. The financial risk associated with the defined benefit pension structure may be appropriate in the corporate setting, but it is inherently flawed in the state and local government setting. When defined benefit pension liabilities explode unexpectedly for a private corporation, the harm is usually limited to the corporation's shareholders, employees and customers. In the public sector, by contrast, the harm goes beyond the public employer and employee, and is inflicted directly on taxpayers either through higher taxes, additional borrowing or reduced services. For this reason, the financial risks associated with the defined benefit pension structure are uniquely inappropriate for state and local governments.

Prudent Action Does Not Ensure Solvency.

The recent recession is just the latest event that demonstrates the financial danger for state and local governments posed by the defined benefit pension structure. Simply put, a governmental entity can do everything right with regard to the operation of its pension plan and still experience a dramatic increase in pension liability and underfunding. For example, Utah has long been recognized as a well-run state with a properly funded public employee pension plan. The Pew Center for the States gave Utah and fifteen other states its highest ranking for public pension management.³⁸ Despite this record, and despite contributing 100 percent of the ARC to its six pension plans, the aggregate unfunded liability of the Utah Retirement System increased from \$793 million in 2006 to \$3.45 billion in 2010, a 336 percent increase.³⁹ This serious financial setback for Utah taxpayers was not caused by mismanagement or a lack of fiscal discipline on the part of Utah. It was caused by asset volatility and an unexpected drop in interest rates, factors over which Utah, like other states, had no control.

When a prudently managed pension plan can create a financial crisis for the taxpayers of a state or municipality, it is time to question whether the risk to taxpayers associated with the defined benefit pension structure is appropriate. Defined benefit pension plans pose unacceptable financial and service degradation risks for taxpayers and retirees.

A New Public Pension Plan Structure is Necessary

What can policymakers do to arrest the dangerous growth of public pension debt? Before a solution can be found, the goals must be identified. There are four essential goals for public pension reform. First, public pension plans must be affordable to public employers and taxpayers. The cost to taxpayers should be transparent. Second, plans must be structured so that taxpayers in the future have no liability to the plan for past years of employee service. Third, public plans should provide retirement income security for employees. And finally, a federal bailout of the states must be avoided at all costs. These goals cannot be accomplished through the existing pension structures available to public employers. Therefore, a new pension design for public plans is needed: one that provides cost certainty for state and local taxpayers, retirement income security for state and local employees, and does not include an explicit or implicit guarantee by the federal government.

It is not necessary at this juncture to assess blame for the public pension debt crisis. Regardless of the cause of the crisis, the current public defined benefit pension system is not sustainable for taxpayers or retirees. A solution is needed. A legislative solution for consideration by Congress will be introduced in the Senate in the near future. It will be a serious proposal to solve what has become an intractable problem. The proposal will warrant serious consideration and, hopefully, the support of Congress and the states.

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³⁷ Burton, Paul. “Rhode Island Makes Reform Happen: Treasurer Shapes Up Pension System,” *The Bond Buyer*. 14 Dec. 2011. Web. 18 Dec. 2011. <http://www.bondbuyer.com/issues/120_239/rhode-island-pension-1034196-1.html>.

³⁸ “The trillion dollar gap: Underfunded state retirement systems and the road to reform.” *The Pew Center on the States*, (February 2010): 13 December 2011. <http://www.pewcenteronthestates.org/report_detail.aspx?id=56695>.

³⁹ Schedules of Funding Progress, Comprehensive Annual Financial Report For the Year Ended December 2010, Utah Retirement Systems. <<http://www.urs.org>>.