State public pensions

Funding gap widens

Liability surge raises concerns

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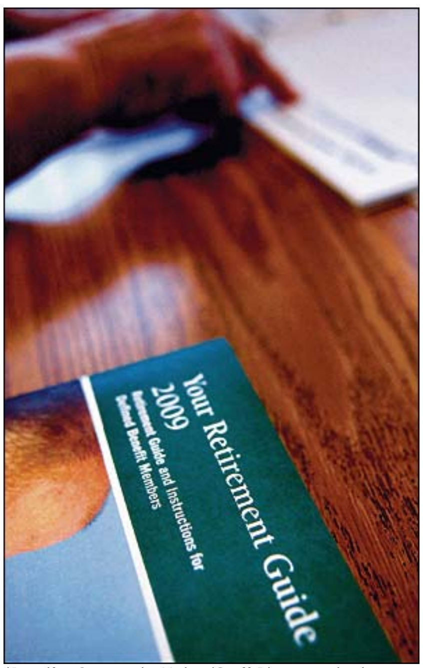
As local lawmakers brace for yet another round of budget cuts to make up for chronic shortfalls trickling down from Sacramento, some are pointing to burgeoning public pension liabilities as a looming financial disaster.

Over the past decade, California's unfunded public pension and health care liability has soared from zero to nearly $60 billion, and experts warn that unless costs are cut and policies change, that number could increase dramatically in coming years.

"We're long overdue on a challenge to the benefit laws on public employees," said Marcia Fritz, a California Foundation for Fiscal Responsibility board member.

While many public pension funds are self-sustaining, meaning they have sufficient assets to cover all liabilities, an increasing number of funds are finding themselves coming up short.



(Jennifer Cappuccio-Maher/Staff Photographer)

California's fund, for example, had assets equal to 118 percent of its liabilities in 1999. In 2008, however, its assets equaled only 89 percent of its liabilities, according to a February study by the Pew Center on the States.

To keep that number from rising, the state must contribute approximately $12.4 billion a year to its retirement fund.

Nationwide, the unfunded liability for states is somewhere in the neighborhood of $1 trillion.

Pension fund officials deflect criticism by pointing to the economy and noting that in tough times, benefits for public employees always come under more intense scrutiny.

They also contend that the benefits are warranted and that the real problem states face will manifest in the health care system as baby boomers with no retirement nest eggs age out of the work force and become dependent on Social Security and Medicare.

Indeed, health care benefits make up a huge part of the total public retirement liabilities in the United States, said Stephen Fehr, one of Pew's project directors.

In many cases, public retirement perks rank higher than what the private sector pays out for similar jobs - in some instances, much higher.

"In California, you have very strong employee unions, and they have a lot of support in the Legislature," Fehr said.

Taxpayers are footing the bill for these huge liabilities, which isn't anything new. They've been doing it for years.

"A lot of this got locked into place a decade ago in the mid- to late-'90s," said Chris Edwards, director of tax policy studies at the Cato Institute. "Now it's coming to fruition."

Not all public pension and health care funds face doom and gloom, but the number of troubled ones has grown by leaps and bounds over the past few years.

In late 2008, there was a $1 trillion gap nationwide between pension and health care obligations and the amount of money set aside to fulfill them, according to the Pew report.

By now, the problem is worse, Fehr said.

Because of accounting procedures, many pension funds are just now realizing the losses on their balance sheets from the stock market crash that started in late 2008 and bottomed out in March 2009.

The pension-health care liability problem, though, goes beyond the volatility of stock market investments.

"Far too many states have not responsibly managed the bill for their workers' retirement over the last decade," Fehr said. "When 2000 began, more than half the states had fully funded pension plans. Just eight years later, only four states had this."

In a recent Cato report, Edwards outlines exactly when this fiscal problem took root in many states.

From 1950 to 1980, the average compensation - wages, pre-retirement and retirement benefits - of public and private workers were about equal.

In 1980, the law creating the 401(k) provision of the tax code, after which the plans are named, went into effect.

By 1981, "public sector compensation growth began to outpace private sector compensation growth, and by the mid-1990s, public sector workers had a substantial advantage," according to the report.

In 2008, the average U.S. private sector compensation package, which includes salary and all benefits, was about $59,900 per year, with about $9,880 of this being pre-retirement and retirement benefits, the report shows.

Public workers grossed about $67,800, with about $15,760 of this in benefits.

"It partially has to do with which states have the most unionized work forces, but not totally," Edwards said. "But in California, over 60 percent of the (public) work force is unionized."

Public sector workers who are in unions netted "far higher wages and benefits, on average, than non-unionized public sector workers," Edwards' report states. "Their wages are 31 percent higher, on average, and their benefits are 68 percent higher."

The arguments against the public pension system are all over the road map.

Some say taxpayers are subsidizing golden retirement packages for retirees who deserve silver or bronze.

Others blame the government for diverting retirement pot money to other programs. They aren't saying public retirement benefits should come down a notch, but argue that lawmakers and public employers are mismanaging the funds.

Still others say pension checks aren't the real problem - instead, retiree health care costs are sucking the system dry.

The Pew Center's Fehr isn't arguing one way or the other, but he notes the financial debacles pressuring most states.

"They've been squeezed by other spending pressures, like corrections, education and the rising cost of Medicaid," he said.

Edwards says he thinks the Pew Center report's $1 trillion gap estimate is a low-ball forecast. The problem is more than $4 trillion, he says.

"Those ($1 trillion conclusions) are based on the Governmental Accounting Standards Board accounting measures," he said. "But it's nonsense. They're overestimating the assets earned (on investments) and underestimating the size of retirement liabilities down the road."

Fehr admits that the problem has grown past $1 trillion, but says it's not necessarily because of GASB accounting standards.

"California public pension funds have been doing a lot of reworking (of) their investments," Fehr said. "But states like California can't count on the stock market to dig them out of this hole."

Tim Barrett, chief investment officer for the San Bernardino County Employees Retirement Association, says public pension plans don't deserve the bad rap they're getting.

Generally speaking, about 75 percent of a public defined benefit plan's payout is drawn from investment earnings, with the remaining 25 percent coming from contributions by employees and/or employers, he says.

"So when you look at the true costs, those arguments of the taxpayers getting hurt falls apart," Barrett said.

Scott Adams agrees.

The Oakland-based public pension program coordinator for the American Federation of State, County and Municipal Employees - the nation's largest public employee union - argues that public worker retirement packages aren't excessive.

He says the average pension payout for local and state workers in California is $25,000 a year - slightly more than $2,000 per month.

"They only look really generous, because folks who are in a pension plan are about the only folks out there with a real retirement plan," Adams said. "It's unfortunate that the private sector has moved away from pensions to 401(k) plans."

Also, some public pension plans make retirees ineligible for Social Security checks. So even though they might look better off in retirement than your average private sector worker, that's not necessarily the case, Adams said.

Reform advocates espousing the unsustainability of public pensions should focus their attention on helping reform private sector retirement plans, he said.

"A lot of people talk about the tsunami public pensions are causing, but there's another train wreck coming," Adams said. "It's when baby boomers retire with nothing but Social Security and a really tiny 401(k) plan."

Reform advocates say the public pension and health care system is simply unsustainable.

"(Public plans) are incredibly generous when you compare them to the private sector," Fritz said. "For most public employees, they'll be receiving a pension (or health care benefits) for more years than they worked. That needs to be fought."

Local and state employers have been promising larger retirement checks and fatter health care plans over the past decade, Edwards said.

"Public sector workers retire at 55, and then they get 10 years of subsidized health care from former public employers before Medicare kicks in," Edwards said. "That doesn't happen in the private sector or is extremely rare."

In some cases, public workers aren't forced to divert pre-tax dollars into the investment fund because the employers make the contributions for them.

Many public plans do mandate a minimum annual contribution from workers. The San Bernardino County Employees Retirement Association is one such plan, with 19 contributing employers and 19,000 contributing workers, and is paying benefits to more than 8,500 retirees and beneficiaries.

The bottom line: Even if investments lose value, defined plans promise retirees a consistent fixed income. The investment risk is on the shoulders of the pension fund and its employer-contributors - and in many cases, the taxpayer.

Unlike most private-sector 401(k)s, public pensions are professionally managed to try to ensure a better return.

"Defined plans are almost universal for (full-time) public workers," Edwards said.

In the bigger picture, 86 percent of state and local government workers across the United States are participating in a retirement plan, versus 51 percent of private sector workers, according to the Pew report. Most private sector plans are 401(k)s, not pensions.

The gap is even wider for defined benefit plans.

Of all public employees in a retirement plan, 90 percent receive defined benefits, whereas only 20 percent of private sector workers with retirement plans have defined benefit plans.

"The 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," the Pew report states.

The Pew Center's Fehr says California is in a tight spot when it comes to reforming the system.

"Change is difficult - there's no quick fix," he said.

"But this is a solvable problem," Fehr added. "Even taking a modest step now will have a big impact over time."

The momentum for change is building.

Many public employers are considering raising the retirement age, which would reduce their pension burden.

"In 1989, Minnesota increased the age at which employees could retire by one year, and they saved $620 million," Fehr said. "Even doing something like that for future retirees or new hires could be a significant cost cutter."

He said a few public employers across the nation have already raised minimum employee contribution amounts, which is expected to reduce the burden on employer contributions over the long term.

Also, some pension boards are freezing or reducing cost-of-living adjustments, a movement in its infancy.

Other reform initiatives face uphill battles.

The McCauley Pension Recovery Act is one of them.

Paul McCauley, a Santa Monica-based CPA, wants a state progressive tax placed on public and private pensions to bridge the funding gap.

His proposed initiative seems radical, but he says the tax would only hit pensions that "no mortal being living is worthy of."

"The proposed tax is a back door to cutting excessive pensions, not all pensions," McCauley said in an e-mail response to questions.

Meanwhile, McCauley is trying to clear administrative procedures so that California's secretary of state can decide whether or not he can gather signatures. He would need more than 400,000.

According to his proposal, public and private retirees receiving pensions of less than $40,000 annually wouldn't be taxed, which he says shields more than 80 percent of all public employees throughout the state.

"Only the top 10 percent of (pension recipients) in California will feel its bite," McCauley says.

The progressive tax would max out at $150,000 in pension income, meaning any pension equaling that amount or higher would be subject to a 60 percent tax, in addition to the preceding tax brackets.

McCauley said the California Legislative Analyst's Office estimates that the initiative would recoup $6 billion to $8 billion per year from the current $13 billion being paid out by state and local governments in pension costs annually.

"I am aiming to recoup (from) excessive pensions, not fair and modest pensions," he added.

Adams, the public pension program coordinator, doesn't think McCauley's proposal is remotely fair.

"It's crazy," Adams said. "He's talking about (taxing) all the people who've played by the rules, both in the public and private sector. It's borderline socialist."

Adams wouldn't comment on whether the other public pension reform proposals seem fair, or whether the American Federation of State, County and Municipal Employees' chances of getting what it wants are slimmer because of the sluggish economy and growing tension over public pensions.

"Those issues will be addressed soon during collective bargaining," he said. "Everything will be on the table. We're going to represent the interests of our members - but at the same time, we're dealing with tough economic times."

Barrett says it's sad that most private sector workers aren't afforded a larger retirement package.

"They should call their Congress men and women so they can fix (retirement) laws," he said.

People don't realize that many large private sector corporations offer defined benefit plans because the investment vehicles behind them can pool huge amounts of money together to project a long-term sustainable return on investment, Barrett said.

"It's when you get down to the smaller companies, which over half our work force is made up of, that (the employers) can't afford defined benefit plans," he said. "401(k) plans are savings plans - they're not true retirement plans, whereas defined benefit plans have professional investment management behind them."

He says a common misperception is to blame pension funds for the taxpayers' enormous burden when in several cases it is retiree health care costs that are eating away at public budgets the most these days.

"The rate of increase in health care costs has gone through the roof," Barrett said. "The question is, where is that going in the next five years?"

Retirement plans

Public vs. private

A typical public retirement plan, which is a combined pension-and-health care package, offers a huge leg up over private sector plans.

About 86 percent of state and local government workers across the U.S. participate in a retirement plan, versus 51 percent of private sector workers, according to the Pew report. Most private sector plans are 401(k)s, not pensions.

The gap is even wider for defined benefit plans. Of all public employees in a retirement plan, 90 percent receive defined benefits, whereas only 20 percent of private sector workers - those who have retirement plans - have defined benefits.

Defined benefit plans have investments that are professionally managed and promise retirees a consistent fixed income even if investments go down in value.

Private 401(k)

Your average private sector employee isn't afforded a company-sponsored pension during employment or a health care plan when retiring, but his chances are higher if he has a union job.

The most popular retirement plan in the private sector is the 401(k), where a company contributes money only if an employee throws money in first. Private employers usually put in 50 cents for every pre-tax dollar a worker contributes, but in some cases employers match dollar for dollar.

An outside for-profit investment firm usually hosts 401(k) retirement funds for private employees, but most workers have to individually manage their 401(k) investment allocations themselves, with limited investment experience to draw from and limited investment choices to choose from.

Over 30 or 40 years, the retirement pot grows extensively.

Employees can hire professional money managers before or after they retire, but this pricey option usually only makes fiscal sense if their investment pot is near or over $1 million.

The grand total at retirement often depends on how well the employee managed his money within the 401(k), how many years he worked at the company or small business, and how much money he set aside annually from his paycheck during his career.

Public pension

Pensions and health care perks are almost standard for any public job, whether with a city, county, state, school district, transportation department or other public agency - and if you're in a union, the benefits are usually even better.

Many public employers mandate that employees contribute a minimum amount to the pension fund each year. The employers usually contribute much more to the fund on employees' behalf.

A board of directors oversees a professional not-for-profit financial manager group that invests incoming employer-employee contributions into stocks, public bonds, corporate bonds and other investments, diversifying the portfolio so they can project an average annual return over several years.

Having pros manage the money gives public workers an edge.

Instead of a worker taking on the investment risk of trying to get an 8 percent return each year - a common scenario with private sector 401(k)s - the risk is on the shoulders of both the pension board and employer-contributors who make up for any investment shortfalls when it comes time to send out pension checks.

When a fund loses market value, public employers step up their contributions to make up for the loss. When investments perform better, the contribution burden on employers isn't as heavy - instead, it's shared a little more evenly between employers and workers.

In some cases, employers carry almost the entire burden because their workers aren't mandated to contribute to the fund.

The pension fund's investment pie can change often since it's professionally managed.

Since several employers invest in the same fund, they are able to pull large amounts of money together to save on investment broker fees and other costs.

Any profit either stays in the portfolio to make more money or is pulled out to pay retirees what's due them.

By making smart investment moves, savvier fund managers have somewhat helped public employers dodge the higher-contribution bullet during the stock market's down cycles. The better their money management and the higher their cash reserves, the less of a toll their public employer-contributors face during the market's down cycles.

The important component to all of this: Even if investments go down in value, public pension plans usually promise a consistent fixed income for retirees.

And unlike most private sector 401(k)s, public pensions are professionally managed to try and ensure a better return.

The California Public Employee Retirement System (CalPERS)

Data from June unless otherwise indicated

ABOUT THIS FUND

1.6 million

Membership

492,513

Retirees, survivors and beneficiaries receiving a monthly allowance

1,5681,458

Public agenciesSchool districts

VALUE TRACKER

$200 billion (current)

$250 billion (peak)

FUNDED OR NOT?

89% funded

As of June 2008. That means the fund could meet 89 percent of its retiree pay-out obligations immediately if it was liquidated. The remaining 11percent, $30 million, is a liability.

CONTRIBUTIONS & PAYOUTS

$3.8 billion

Employee contributions in 2008-09

$6.9 billion

Employer contributions in 2008-09

$11.85 billion

Benefits paid in the 2008-09 fiscal year

AVERAGE PAYOUTS

$2,101/month

Average all retirees

$1,134/month

School miscellaneous members

$2,396/month

State miscellaneous members

AVERAGE TIME SPENT IN SERVICE

20 years

All retirees

16.7 years

School retirees

22.9 years

State retirees

RETIREMENT TALLIES

60 years old

Average age of retirement for all retirees

$36,000

78 percent of all service retirees receive less than this per year.

86 percent

Amount of CalPERS retirees, survivors and beneficiaries living in California

13

Number of retirement formulas

57

Number of optional contract provisions

25,150

Number of new retirees during the 2008-09 fiscal year

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