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AT THE

NATIONAL CONFERENCE ON

PUBLIC EMPLOYEE RETIREMENT SYSTEMS

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[Comments on

I AM PLEASED TO BE HERE TODAY TO DISCUSS WITH YOU THE GENERAL ACCOUNTING OFFICE REPORT, "FUNDING OF STATE AND LOCAL GOVERNMENT PENSION PLANS: A NATIONAL PROBLEM,"] I WILL TOUCH BRIEFLY ON WHY WE UNDERTOOK THIS STUDY AND HOW WE CARRIED IT OUT. BUT MAINLY, I WILL TALK ABOUT WHAT WE FOUND OUT AND OUR CONCLUSIONS AND RECOMMENDATIONS.

CONGRESS HAS LONG BEEN CONCERNED ABOUT THE CONDITION OF STATE AND LOCAL PENSION PLANS. THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 CALLED FOR STUDIES OF WHETHER SIMILAR LEGISLATION WAS NEEDED FOR PUBLIC PENSION PLANS. SINCE THEN, A NUMBER OF BILLS HAVE BEEN INTRODUCED TO REGULATE STATE AND LOCAL PENSION PLANS, THE LATEST PROPOSAL BEING H.R. 6525, INTRODUCED IN FEBRUARY BY CONGRESSMEN THOMPSON AND ERLINBORN.

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One function of the General Accounting Office is to assist Congress by providing information, and Congress has asked us to study various aspects of State and local government pension plans. Accordingly, we undertook this study to provide information on the condition of pension plan funding to assist the Congress in their deliberation on the need for legislation.

PENSION PLAN FUNDING PRESENTED AN EXTRAORDINARILY DIFFICULT ISSUE. THERE IS NO CLEAR AGREEMENT ON HOW PENSION PLANS SHOULD BE FUNDED, HOW LARGE A FUND SHOULD BE CREATED, HOW FUNDING REQUIREMENTS SHOULD BE MET.

IT HAS BEEN ESTIMATED THAT THE UNFUNDED ACCRUED LIABILITIES OF ALL STATE AND LOCAL GOVERNMENT PENSION PLANS WERE AS MUCH AS $175 BILLION IN 1975, AND THESE LIABILITIES HAVE GROWN SINCE THEN.

ALMOST ALL PUBLIC AND PRIVATE PENSION PLANS HAVE UNFUNDED ACCRUED LIABILITIES AND WILL CONTINUE TO HAVE SUCH LIABILITIES FOR MANY YEARS. THE CENTRAL ISSUE IN FUNDING IS WHETHER A COMMITMENT EXISTS TO ACCUMULATE ASSETS EQUAL TO THE ACCRUED LIABILITY IN AN ATTEMPT TO ELIMINATE THIS LIABILITY.

THE MAJOR PROBLEM POSED TO STATE AND LOCAL GOVERNMENTS BY ANY STANDARD FOR FUNDING, ESPECIALLY FEDERAL STANDARDS LIKE THOSE IMPOSED UPON PRIVATE EMPLOYEES, WOULD BE: HOW MUCH MORE THEY WOULD HAVE TO PAY EACH YEAR DURING THE AMORTIZATION PERIOD TO FINANCE THE UNFUNDED ACCRUED LIABILITY.

SCOPE OF STUDY AND APPROACH

OUR PURPOSE WAS TO INVESTIGATE THE POTENTIAL FINANCIAL IMPACT OF PENSION FUNDING REFORM. TO THAT END, WE LOOKED AT A BROAD SPECTRUM OF PENSION ACTIVITY IN STATE AND LOCAL GOVERNMENTS. THE SELECTION OF PENSION PLANS WAS JUDGMENTAL AND THEREFORE WAS NOT REPRESENTATIVE OF ALL EXISTING PLANS. WE USED THE ERISA STANDARD FOR FUNDING PRIVATE PLANS AS THE CRITERION IN ANALYZING THE SELECTED STATE AND LOCAL PLANS. HOWEVER, WE DO NOT TAKE A POSITION ON WHAT THE FUNDING STANDARD FOR STATE AND LOCAL PENSION PLANS SHOULD BE.

WE LOOKED AT THE FUNDING OF 72 PENSION PLANS ADMINISTERED BY 8 STATES AND 26 LOCAL GOVERNMENTS WITHIN THOSE STATES. THE PLANS EXAMINED COVER ABOUT 1.4 MILLION ACTIVE MEMBERS AND PAY PENSIONS TO ABOUT 425,000 RETIREES OR BENEFICIARIES. THE 72 RETIREMENT SYSTEMS HAD ASSETS VALUED AT $18.3 BILLION AND UNFUNDED LIABILITIES OF ABOUT $29 BILLION. THE GOVERNMENTS CONTRIBUTED $2.4 BILLION TO THE PLANS DURING THE FINANCIAL YEAR SELECTED FOR REVIEW.

CALIFORNIA, DELAWARE, FLORIDA, ILLINOIS, MASSACHUSETTS, OKLAHOMA, PENNSYLVANIA, AND WISCONSIN WERE THE STATES SELECTED FROM DIFFERENT PARTS OF THE NATION AND REPRESENTING DIFFERENT APPROACHES TO PENSION FUNDING. IN EACH STATE WE REVIEWED THE PENSION PLANS OF SELECTED LOCAL GOVERNMENTS WITH LARGE, MEDIUM, AND SMALL POPULATIONS. GENERALLY, WE EXAMINED AT LEAST ONE PLAN ADMINISTERED BY THE STATE GOVERNMENT AND ALL OF THE PLANS UNDER THE SELECTED LOCAL GOVERNMENTS.

For the 34 government entities in our review, we used the plans' financial data for the most recently completed fiscal year. For most plans we obtained the most recent actuarial studies, made a cursory evaluation, and found that they were generally prepared in accordance with recognized actuarial procedures, although these procedures did not necessarily comply with those required of private plans under ERISA. Where actuarial studies for the pension plans were not available, our actuaries estimated the unfunded accrued liabilities.

RESULTS OF STUDY

State and local officials are generally aware of the need for sound actuarial funding of pension systems, but they view with apprehension the financial impact of imposing ERISA-type funding standards on public pensions. An ERISA-type minimum funding standard for public pensions would require an annual contribution to cover the normal costs plus the amount needed to amortize the existing unfunded liabilities over a specified future period. For existing private pension plans, ERISA requires the amortization in 40 equal annual installments.

Of the 72 State and local pension plans we reviewed, 19 met the ERISA minimum funding standard for private pension plans. The other 53 plans were not receiving large enough contributions to satisfy the ERISA funding standard. If the 53 pension plans—11 State and 42 local government systems—adopted an ERISA-type funding standard, it would require an additional $1.4 billion annually. Many of them would have to raise their contributions to some of their plans by more than 100 percent, a few by more than 400 percent.

THE COSTS UNDER ERISA, IN ADDITION TO EXISTING PENSION COSTS, WOULD REQUIRE THE EQUIVALENT OF UP TO 49 PERCENT MORE OF THE TAX REVENUES OF THE AFFECTED JURISDICTIONS. FOR EXAMPLE, TO MEET THE ERISA FUNDING STANDARD IN PITTSBURGH, PENSION COSTS WOULD REQUIRE ABOUT 33 PERCENT OF TAX REVENUES, COMPARED WITH THE 13 PERCENT NOW GOING FOR RETIREMENT COSTS. ACCORDING TO A PITTSBURGH OFFICIAL, FUNDING OF THE CITY'S PENSION PLANS UP TO THE ERISA STANDARD COULD LEAD TO BANKRUPTCY. IN READING, PENNSYLVANIA, PENSION FUNDING UNDER ERISA WOULD TAKE AN AMOUNT EQUAL TO ABOUT 40 PERCENT OF TAXES, COMPARED WITH THE 15 PERCENT CURRENTLY CONTRIBUTED. A READING CITY OFFICIAL BELIEVED THAT THE CITIZENS WOULD RESIST ANY TAX INCREASE FOR PENSION FUNDING. CLEARLY, ADDED PENSION COSTS TO MEET AN ERISA-TYPE AMORTIZATION STANDARD WOULD BE A DEVASTATING DRAIN ON THE INCOMES OF SOME JURISDICTIONS.

THE MANY LOCAL RETIREMENT SYSTEMS THAT ARE NOT ACTUARIALLY FUNDED THREATEN CITIES WITH SEVERE FUTURE FINANCIAL DIFFICULTIES, WHICH IN TURN WOULD AFFECT THE STATE GOVERNMENTS. A SYSTEMATIC FUNDING PLAN FOR AMORTIZING THE UNFUNDED LIABILITY OVER A SPECIFIED PERIOD COULD HELP AVERT FISCAL DISASTER FOR A NUMBER OF STATE AND LOCAL GOVERNMENTS.

TO ILLUSTRATE THE NEED FOR SYSTEMATIC LONG-TERM FUNDING, WE SELECTED THREE PENSION PLANS NOW ON A PAY-AS-YOU-GO BASIS, ONE IN BOSTON, ONE IN PITTSBURGH, AND THE DELAWARE STATE POLICE PENSION PLAN. WE PROJECTED THEIR PENSION COSTS FOR 41 YEARS, BOTH UNDER THE PAY-AS-YOU-GO METHOD AND UNDER ACTUARIAL FUNDING AS PRESCRIBED BY ERISA.

THE PROJECTIONS FOR ALL THREE PLANS SHOW THAT ANNUAL COSTS FOR PAY-AS-YOU-GO FUNDING ARE INITIALLY LESS THAN THOSE FOR ACTUARIAL FUNDING. HOWEVER, PAY-AS-YOU-GO FUNDING COSTS EVENTUALLY EXCEED THE ANNUAL COSTS OF ACTUARIAL FUNDING. UNDER ACTUARIAL FUNDING, AFTER 40 YEARS THE INITIAL UNFUNDED LIABILITY WILL HAVE BEEN COMPLETELY AMORTIZED, SO THE ANNUAL CONTRIBUTION WILL DROP TO THE AMOUNT NEEDED TO COVER NORMAL COSTS. UNDER PAY-AS-YOU-GO FUNDING, ON THE OTHER HAND, AFTER 40 YEARS THE UNFUNDED LIABILITY WILL HAVE GROWN TO ENORMOUS PROPORTIONS, AND THE ANNUAL PAYOUT WILL CONTINUE TO INCREASE.

FOR EXAMPLE, THE DELAWARE STATE POLICE PLAN AS OF SEPTEMBER 1976 HAD AN ACTUARIALLY CALCULATED UNFUNDED LIABILITY OF OVER $80 MILLION, AND WAS ON A PAY-AS-YOU-GO BASIS. PROJECTION OF PENSION COSTS FOR THIS PLAN SHOWS THAT PAY-AS-YOU-GO YEARLY CONTRIBUTIONS WOULD EXCEED ACTUARIAL CONTRIBUTIONS BY THE 17TH YEAR, ASSUMING A 40-YEAR AMORTIZATION PERIOD.

ON THE PAY-AS-YOU-GO BASIS, THE UNFUNDED LIABILITY IS PROJECTED TO INCREASE AFTER 40 YEARS BY ABOUT 3-1/2 TIMES--FROM $80 MILLION TO $286 MILLION. AMORTIZATION AT THE END OF 40 YEARS OF THE INCREASED LIABILITY OVER A 40-YEAR PERIOD AND THE PAYMENT OF NORMAL COSTS WOULD REQUIRE A YEARLY PAYMENT OF ABOUT $43 MILLION, AN AMOUNT ALMOST FIVE TIMES GREATER THAN THE AMOUNT REQUIRED TO START AMORTIZING THE SEPTEMBER 1976 UNFUNDED LIABILITY.

State and local officials have often found it expedient to postpone pension reform, leaving it to future office-holders to raise taxes and increase government contributions to retirement trust funds. Also, the constituency of the greatly expanded body of State and local employees has brought pressure for enlarging fringe benefits, including pensions. Hence, pensions are often increased without providing adequate funding, a concession that does not raise current costs significantly, but <u>does</u> raise unfunded liabilities.

However, a number of State and local governments have begun to tackle the problem of pension funding. Pension reform actions taken range from attempting to identify the problem, to adopting and implementing measures to solve it.

A major obstacle to pension reform is the immediate cost impact. Because of voter opposition to tax increases, State and local governments are using or considering other approaches to finance pension reforms. Some jurisdictions are reexamining their pension provisions and looking for ways to control or reduce pension costs.

NATIONWIDE VOTER RESISTANCE TO TAX INCREASES HAS BEEN SPOTLIGHTED BY THE MUCH PUBLICIZED PROPOSITION 13, THE INITIATIVE OVERWHELMINGLY PASSED BY CALIFORNIA VOTERS IN JUNE 1978. PROPOSITION 13 DRASTICALLY CUT BACK AND LIMITED LOCAL PROPERTY TAXES, A MAJOR SOURCE OF REVENUES FOR PENSION FINANCING BY LOCAL GOVERNMENTS. IN LOS ANGELES, FOR EXAMPLE, OVER 53 PERCENT OF THE PROPERTY TAXES COLLECTED IN 1977 WENT INTO CONTRIBUTIONS TO RETIREMENT SYSTEMS. LOS ANGELES AND OAKLAND OFFICIALS SAID THAT PROPOSITION 13 WOULD SEVERELY HAMPER ANY COMPLIANCE WITH AN ERISA-TYPE FUNDING REQUIREMENT. IN BOTH CITIES, SERVICES AND PERSONNEL WOULD HAVE TO BE CUT IN ORDER TO FUND PENSION COSTS.

FOR FUNDING PENSIONS, LOCAL GOVERNMENTS EVERYWHERE LOOK TO THE STATE FOR RELIEF. FOR EXAMPLE, LOCAL OFFICIALS IN MASSACHUSETTS DO NOT FEEL ABLE TO INSTITUTE PENSION REFORM WITHOUT STATE FINANCIAL HELP.

OFFICIALS OF THE THREE CITIES WE VISITED IN MASSACHUSETTS WERE NOT WILLING TO BEGIN FUNDING THEIR PENSION SYSTEMS ON A VOLUNTARY BASIS, AND THEY SAID THAT, WITHOUT STATE OR FEDERAL FINANCIAL SUPPORT, THE BURDEN OF FUNDING WOULD RAISE LOCAL PROPERTY TAX RATES THAT WERE ALREADY TOO HIGH. THE POINT WAS UNDERSCORED BY MASSACHUSETTS VOTERS ON NOVEMBER 7, 1978, WHEN THEY OVERWHELMINGLY PASSED AN INITIATIVE TO PREVENT SHARP INCREASES IN RESIDENTIAL PROPERTY TAXES.

THE DEPUTY MAYOR OF BOSTON VIEWED THE PROBLEM OF PENSION REFORM IN LIGHT OF THE PRINCIPLE OF POLITICAL AND FISCAL ACCOUNTABILITY: THAT THOSE WHO MANDATE COSTLY MEASURES SHOULD BEAR SOME OF THE COSTS THAT THEY WOULD IMPOSE ON LOCAL GOVERNMENTS. THE DEPUTY MAYOR POINTED OUT THAT, BECAUSE THE STATE WROTE THE PENSION LAW THAT MANDATED PAY-AS-YOU-GO FINANCING IN THE PAST, IT SHOULD HELP LOCAL GOVERNMENTS WITH THE RESULTING FINANCIAL BURDEN.

GIVEN THE OBSTACLES TO OVERT TAX INCREASES, SOME STATES ARE USING OR CONSIDERING OTHER APPROACHES TO FINANCE PENSION REFORMS, INCLUDING EXTENDING EXPIRING TAXES, SUBSTITUTING USER CHARGES FOR TAXES, AND USING FEDERAL REVENUE SHARING FUNDS.

SOME JURISDICTIONS, IN LOOKING FOR WAYS TO SOFTEN THE FUTURE IMPACT OF UNFUNDED PENSION BENEFITS, HAVE REEXAMINED THEIR PENSION PROVISIONS AND FOUND THAT THEY CAN REDUCE PENSION COSTS BY (1) CONTROLLING BENEFITS SUBJECT TO ANNUAL ADJUSTMENT, SUCH AS COST-OF-LIVING INCREASES, (2) IMPOSING TIGHTER ELIGIBILITY STANDARDS, (3) ESTABLISHING NEW PLANS WITH LOWER BENEFITS FOR NEW HIRES, AND (4) INTEGRATING PENSION PLAN BENEFITS WITH SOCIAL SECURITY BENEFITS.

FEDERAL REGULATION OF PUBLIC PENSION PLANS

WITH RESPECT TO FEDERAL REGULATION OF PUBLIC PENSION PLANS, THERE IS A QUESTION AS TO THE EXTENT OF THE FEDERAL GOVERNMENT'S AUTHORITY TO REGULATE STATE AND LOCAL GOVERNMENT PENSION PLANS, PARTICULARLY IN VIEW OF THE SUPREME COURT'S DECISION IN NATIONAL LEAGUE OF CITIES V. USERY. THIS DECISION RAISED REAL BUT UNRESOLVED QUESTIONS ABOUT WHETHER THE FEDERAL GOVERNMENT CAN REGULATE SUCH PENSION PLANS UNDER ITS AUTHORITY TO REGULATE INTERSTATE COMMERCE UNDER THE COMMERCE CLAUSE OF THE U.S. CONSTITUTION. ALTHOUGH THIS DECISION DOES NOT APPEAR TO PRECLUDE FEDERAL REGULATION OF STATE AND LOCAL GOVERNMENT PENSION PLANS UNDER OTHER SOURCES OF CONSTITUTIONAL AUTHORITY, SUCH AS THE TAXING POWER, THE SPENDING POWER, AND THE POWERS TO PROTECT PROPERTY RIGHTS, THE QUESTION WHETHER SUCH AUTHORITY MAY BE USED HAS NOT YET BEEN RESOLVED.

NOTWITHSTANDING THIS UNCERTAINTY, THE FEDERAL GOVERNMENT DOES HAVE A DIRECT INTEREST IN STATE AND LOCAL GOVERNMENT PENSION PLANS THROUGH ITS GRANT PROGRAMS. GAO ESTIMATES THAT ABOUT $1 BILLION IN RETIREMENT CONTRIBUTIONS IS BEING REIMBURSED YEARLY TO STATE AND LOCAL GOVERNMENTS UNDER FEDERAL GRANT PROGRAMS. THIS AMOUNT WOULD INCREASE CONSIDERABLY IF THE STATE AND LOCAL GOVERNMENTS WERE REQUIRED TO ADHERE TO THE FUNDING STANDARDS OF PRIVATE PLANS.

CONCLUSIONS

GAO CONCLUDED THAT PENSION REFORM AT THE STATE AND LOCAL LEVELS IS MOVING SLOWLY, AND THE PROSPECTS FOR SIGNIFICANT IMPROVEMENT IN THE FORESEEABLE FUTURE ARE NOT BRIGHT.

IT IS CLEAR THAT, TO PROTECT THE PENSION BENEFITS EARNED BY PUBLIC EMPLOYEES AND TO AVERT FISCAL DISASTER, STATE AND LOCAL GOVERNMENTS SHOULD FUND THE NORMAL OR CURRENT COST OF THEIR PENSION PLANS ON AN ANNUAL BASIS AND AMORTIZE THE PLANS' UNFUNDED LIABILITIES.

ALTHOUGH SPONSORING GOVERNMENTS ARE RESPONSIBLE FOR SOUND FUNDING OF STATE AND LOCAL GOVERNMENT PLANS, THE FEDERAL GOVERNMENT HAS A SUBSTANTIAL INTEREST IN THESE PENSION PLANS. MANY JURISDICTIONS HAVE RELIED MORE AND MORE ON FEDERAL GRANT FUNDS AND REVENUE SHARING TO HELP MEET PENSION PLAN COSTS. THESE PLANS DIRECTLY AFFECT THE CONTINUED WELL-BEING AND SECURITY OF MILLIONS OF STATE AND LOCAL GOVERNMENT EMPLOYEES AND THEIR DEPENDENTS.

IT MIGHT BE IN THE NATIONAL INTEREST FOR THE CONGRESS TO ASSURE, THROUGH LEGISLATION, THE LONG-TERM FINANCIAL STABILITY OF THESE PENSION PLANS THROUGH SOUND FUNDING STANDARDS. BUT THE FEDERAL GOVERNMENT'S AUTHORITY TO REGULATE STATE AND LOCAL GOVERNMENT PLANS HAS NOT BEEN RESOLVED.

RECOMMENDATION TO THE CONGRESS

ACCORDINGLY, GAO HAS RECOMMENDED THAT THE CONGRESS SHOULD CLOSELY MONITOR ACTIONS TAKEN BY STATE AND LOCAL GOVERNMENTS TO IMPROVE THE FUNDING OF THEIR PENSION PLANS TO DETERMINE WHETHER AND AT WHAT POINT CONGRESSIONAL ACTION MAY BE NECESSARY IN THE NATIONAL INTEREST TO PREVENT FISCAL DISASTER AND TO PROTECT THE RIGHTS OF EMPLOYEES AND THEIR DEPENDENTS.

COMMENTS OF STATE AND LOCAL GOVERNMENTS, FEDERAL AGENCIES, AND OTHER INTERESTED PARTIES

THE CONSENSUS AMONG THOSE WHO COMMENTED ON OUR REPORT WAS THAT FUNDING OF PUBLIC PENSION PLANS IS A SERIOUS PROBLEM; HOWEVER, THERE IS NO CLEAR AGREEMENT ON WHAT THE SOLUTION SHOULD BE. MANY BELIEVE THAT ANY FUNDING STANDARD FOR PUBLIC PLANS SHOULD BE LESS DEMANDING THAN THE STANDARD IMPOSED ON PRIVATE PLANS. THE PERCENT-OF-PAYROLL APPROACH TO PENSION FUNDING WAS THE ONE FAVORED BY MANY OFFICIALS.

THERE WAS GENERAL OPPOSITION TO A FEDERAL ROLE IN ESTABLISHING A FUNDING STANDARD FOR STATE AND LOCAL GOVERNMENT PENSION PLANS. MOST OFFICIALS ARGUE THAT THE FEDERAL GOVERNMENT HAS NOT DEALT ADEQUATELY WITH ITS OWN PENSION FUNDING PROBLEMS, AS EVIDENCED BY THE POORLY FUNDED SOCIAL SECURITY SYSTEM AND THE PENSION PLANS FOR FEDERAL PERSONNEL.