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STATEMENT OF
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UNITED STATES GENERAL ACCOUNTING OFFICE
BEFORE THE
PRESIDENT'S COMMISSION ON PENSION POLICY
ON
THE [FUNDING OF STATE AND LOCAL
GOVERNMENT PENSION PLANS]

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Mr. Chairman and Members of the Commission:

We are pleased to appear here today to discuss the two reports we have issued on the funding of State and local Government pension plans.

On February 26, 1980, we provided "An Actuarial and Economic Analysis of State and Local Government Pension Plans" to the Joint Economic Committee. Our report (PAD-80-1) presented estimates of the annual cost of future benefit payouts, in the aggregate, to such plans. Our analysis was not intended to be a substitute for a detailed actuarial analysis of the more than 6,600 State and local Government pension plans, but rather concentrated on identifying emerging trends that should be brought to the attention of policymakers.

Based on what would happen if current benefit and financing provisions were continued, our analysis indicates that, in the aggregate, the plans' assets will grow throughout this century but at a much lower rate after the year 2000. The plans' benefit payments will exceed estimated contributions after 2012 with the ratio of assets to benefits declining steadily until benefits exceed the sum of asset growth and contributions in 2049. This indicates that the plans in the aggregate will not be able to meet obligations from current income. The aggregating of plans, however, masks the difference among them. The few fully funded plans should remain in good shape, but the numerous poorly funded plans can expect financial difficulty in this century.

Previously, on August 30, 1979, we reported to the Congress that the funding of State and local Government pension plans is a national problem. In that report (HRD-79-66), we disclosed the results of our in-depth review of the funding of 72 pension plans administered by 8 States and 26 local governments within those States. We used the Employee Retirement Income Security Act (ERISA) standard for funding private plans as the criterion in analyzing the selected State and local Government plans.

The plans we examined covered about 1.4 million active members and paid 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. 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 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 pension plans under ERISA. Where actuarial studies for the pension plans were not available, our actuaries using data obtained from the plans estimated the unfunded accrued liabilities.

RESULTS OF STUDY

Of the 72 State and local pension plans we reviewed, 19 met the ERISA minimum funding standard for private pension plans. That is annual contributions included amounts sufficient to cover the normal annual costs and to amortize the existing unfunded liabilities over a specified future period of not more than 40 years. 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 the State and local governments would have to raise their contributions to some of the 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 pension 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.

However, 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. 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 does raise unfunded liabilities.

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.

Officials of the three cities we visited in Massachusetts were not willing to begin funding their pension systems on a voluntary basis. 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. More recently, just last week, Massachusetts voters passed a referendum--referred to as proposition two and one half--in which property taxes for towns and cities were severely restricted to

2-1/2 percent of the assessed value of property. This restriction will be phased in over a period of years.

The Deputy Mayor of Boston viewed the problem of pension reform in the light of the principle of political and fiscal accountability. He 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 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

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 practicality of using such authority 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

In conclusion, we believe 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. Therefore, 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. However, the constitutional question of the Federal Government's authority under the Commerce Clause and the practicality of using other sources of authority has not been resolved. An ERISA-like funding standard would have a substantial fiscal impact on State and local governments. But, in the long term, the alternative to adopting sound pension funding practices can be fiscal disaster and possible loss of employees' earned benefits.

RECOMMENDATION TO THE CONGRESS

Accordingly, we recommended that the Congress 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.

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Mr. Chairman, this completes my statement. We would be happy to respond to any questions you or members of the Commission may have.