

State and Local Pensions: What Now?

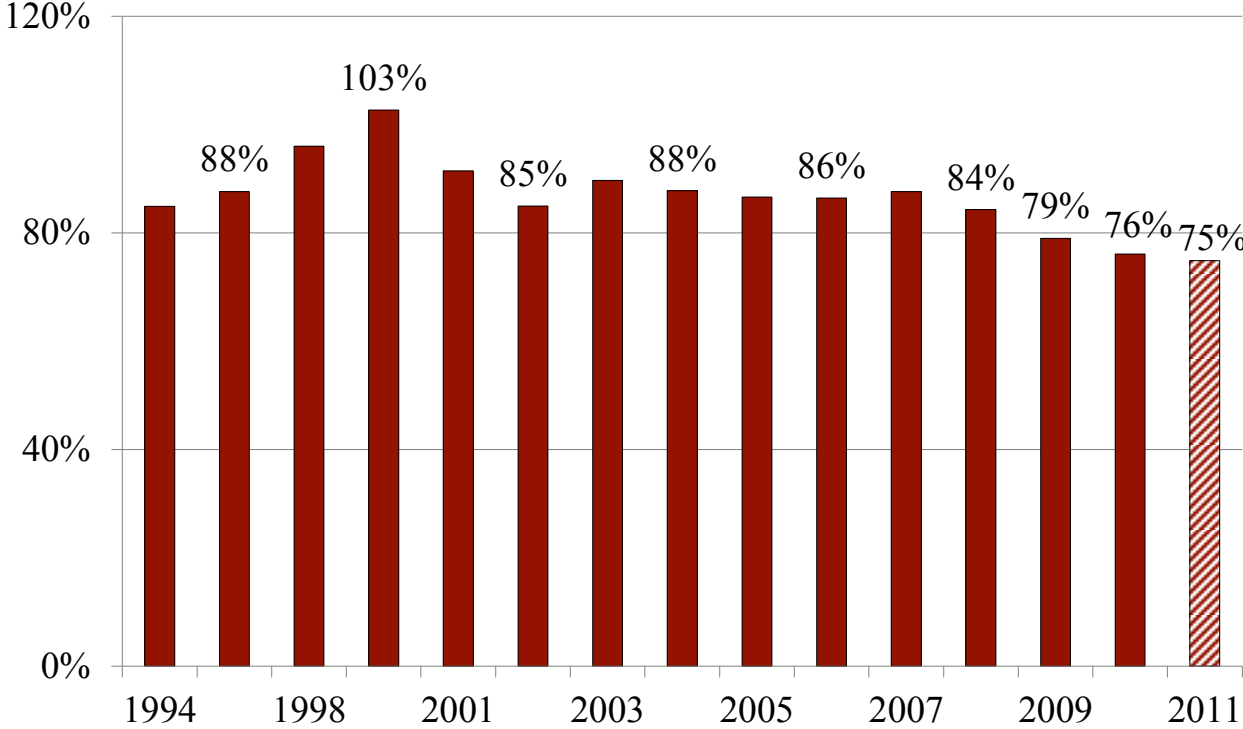
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Two financial crises in a decade caused a significant drop in pension funding...

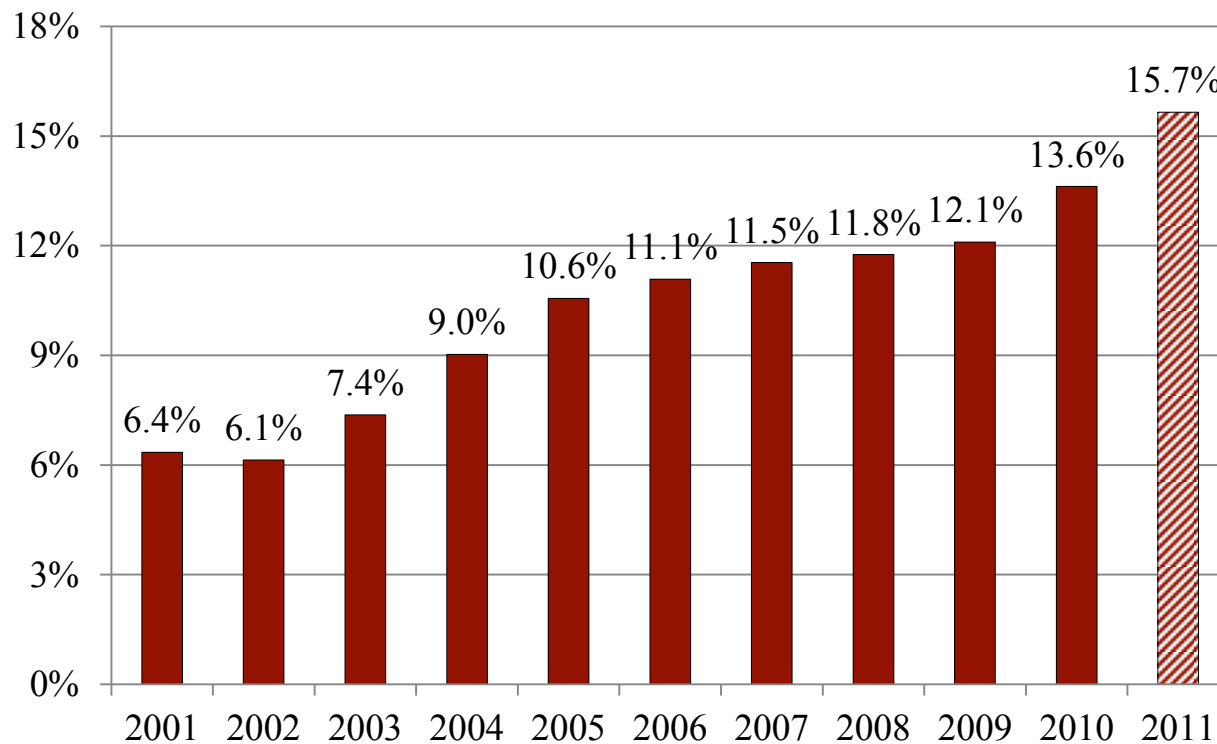
State and Local Funded Ratios, 1994-2011



Sources: *Public Plans Database*. 2001-2011. Center for Retirement Research at Boston College and Center for State and Local Government Excellence; and Paul Zorn. 1994-2000. *Survey of State and Local Government Retirement Systems: Survey Report for Members of the Public Pension Coordinating Council*. Government Finance Officers Association.

...and a more than doubling of the ARC.

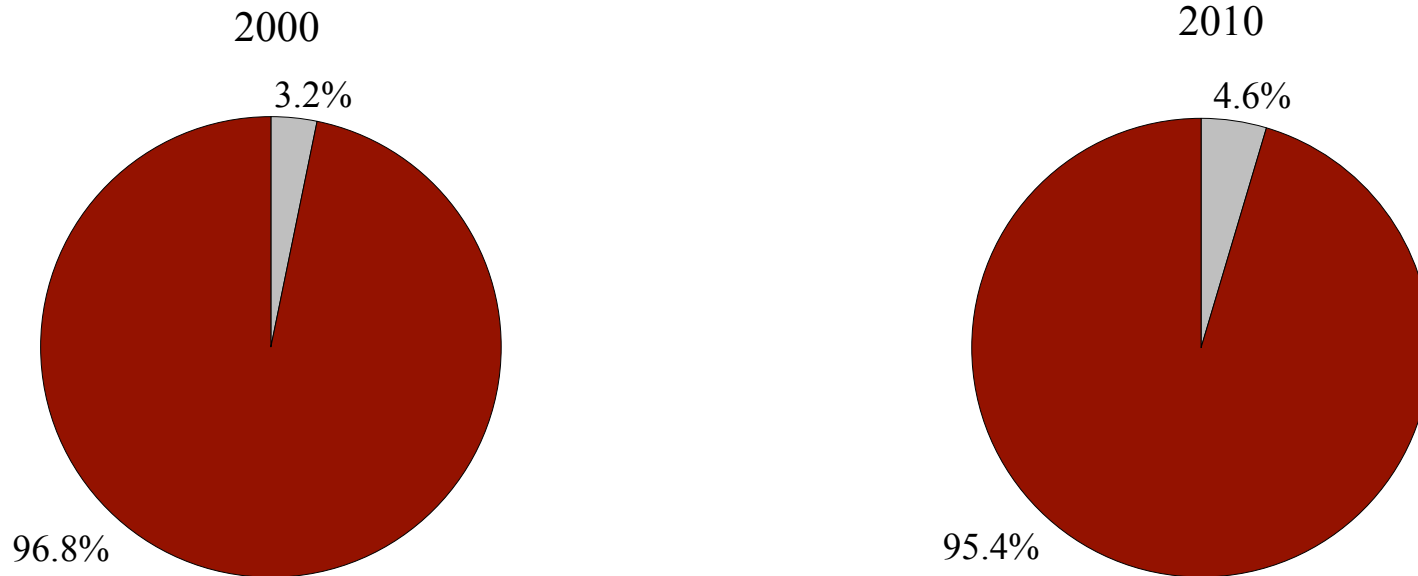
Annual Required Contributions as a Percentage of Payroll, 2001-2011



Sources: *Public Plans Database*, 2001-2011. Center for Retirement Research at Boston College and Center for State and Local Government Excellence; and author's estimates.

Nevertheless, pension costs are only 4.6 percent of state/local budgets.

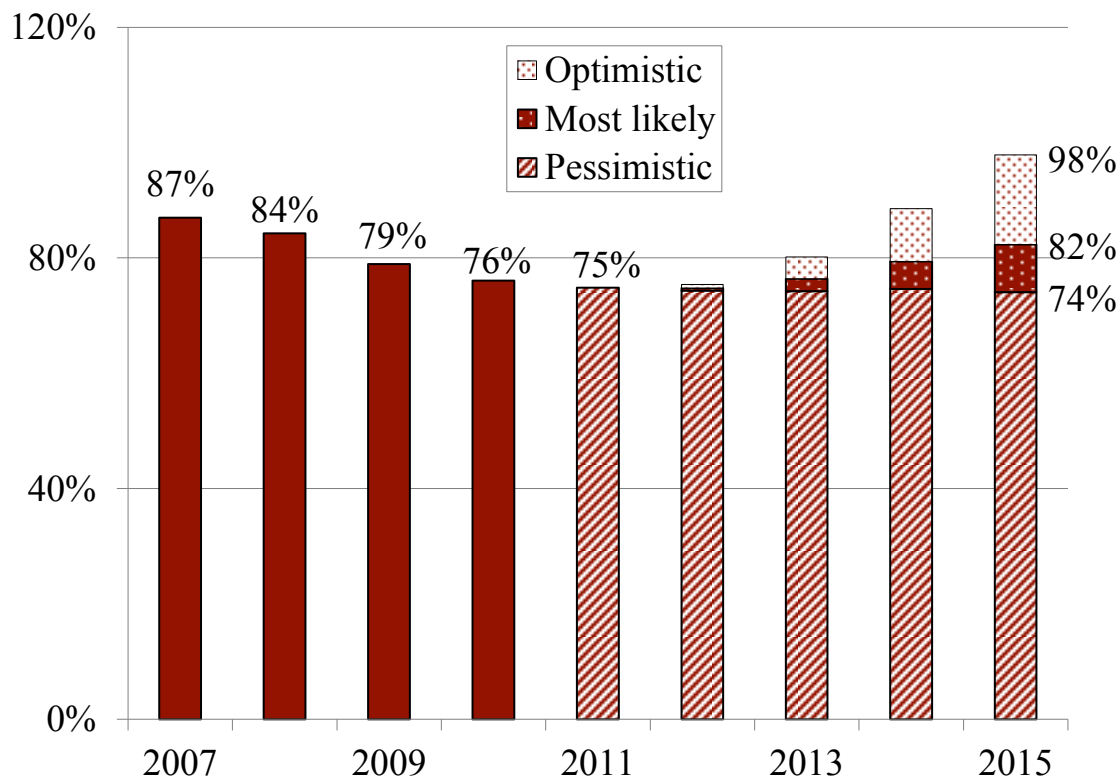
Pension Costs as a Percentage of State and Local Own-Source Revenues



Sources: U.S. Census Bureau. 2005-2006. *Employee-Retirement Systems of State and Local Governments*; and U.S. Census Bureau. 2000 and 2010. *State and Local Government Finances*.

Absent a new crisis, funding should stabilize and the budget burden remain modest.

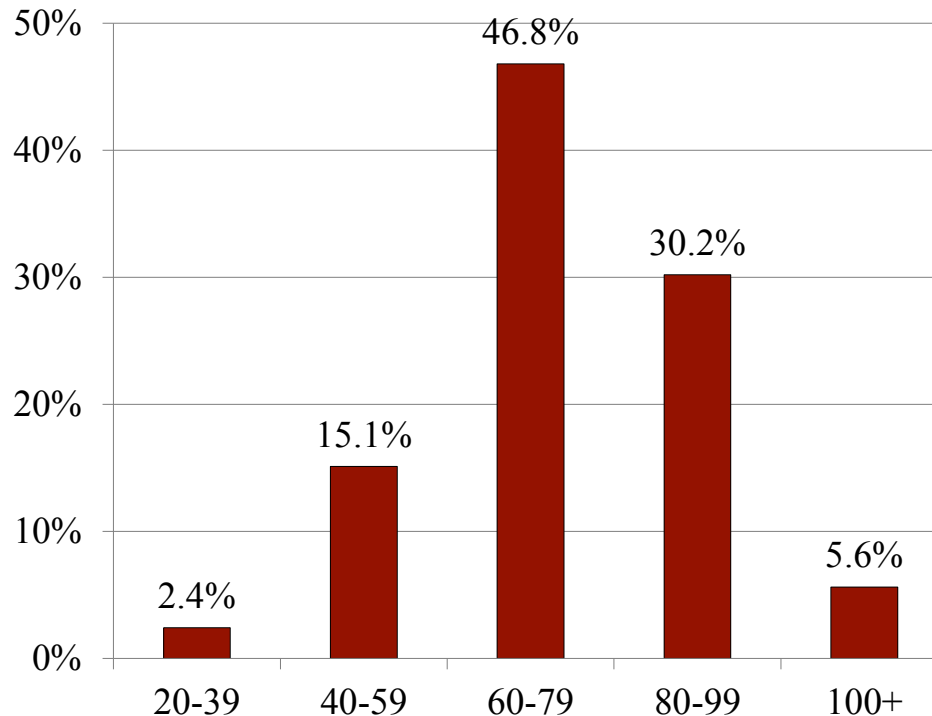
Projected State and Local Funded Ratios under Three Scenarios, 2011-2015



Sources: Author's estimates for 2011-2015; and *Public Plans Database*. 2007-2011. Center for Retirement Research at Boston College and Center for State and Local Government Excellence.

But aggregate numbers hide enormous heterogeneity in the public sector.

Distribution of Funded Ratios for Public Plans, 2011



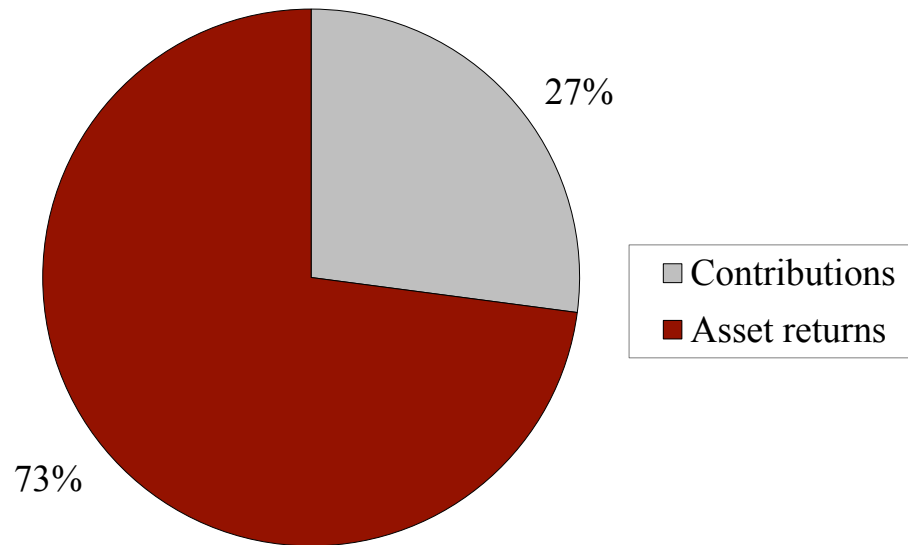
Source: *Public Plans Database*, 2011. Center for Retirement Research at Boston College and Center for State and Local Government Excellence.

Moving from the short term to the longer term, the burden on states and localities will depend on:

- 1) returns on plan assets; and
- 2) the generosity of the benefit package.

Returns are important; today's mature plans receive bulk of revenue from investments.

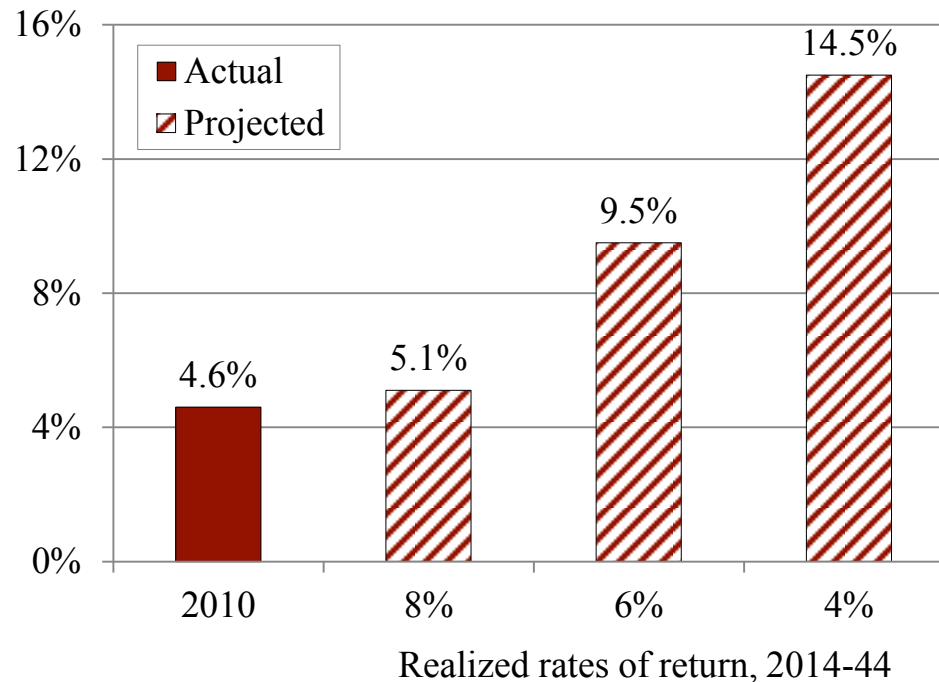
Asset Returns and Contributions as a Percentage of Total Plan Revenues for 2005-06



Source: U.S. Census Bureau. 2005-2006. *Employee-Retirement Systems of State and Local Governments*.

Long-term returns are the key driver of the pension budget burden.

Pension Contributions as a Percentage of State and Local Own-Source Revenues, 2010 and 2014-44



Sources: Public Plans Database. 2010. Center for Retirement Research at Boston College and Center for State and Local Government Excellence; U.S. Census Bureau. 2010. State and Local Government Finances; U.S. Census Bureau. 2010. State and Local Public-Employee Retirement Systems; and author's calculations.

Again, heterogeneity is important.

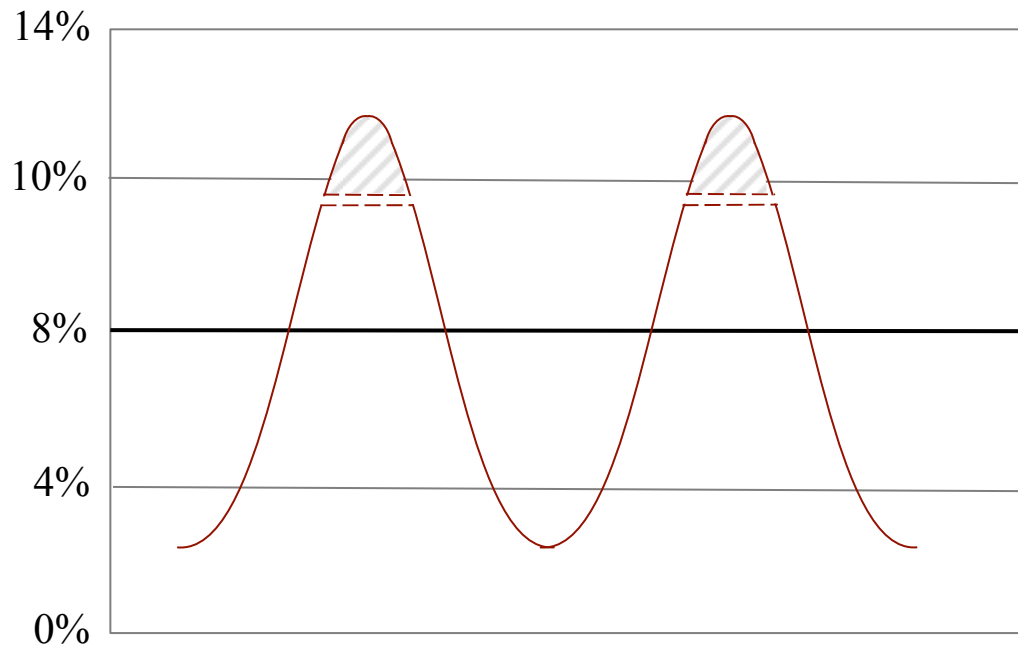
Plan Characteristics and Contributions as a Percentage of State and Local Own-Source Revenues, 2010 and 2014-44

Government	Contributions/revenue			
	2010	Rate of return 2014-44		
		8%	6%	4%
U.S. total	4.6%	5.1%	9.5%	14.5%
<i>Well run</i>				
Florida	3.9	3.6	6.7	10.3
Delaware	3.0	2.4	5.5	9.3
<i>Poorly run</i>				
Illinois	8.4	9.6	14.2	20.4
New Jersey	3.1	6.1	9.8	14.5
<i>Expensive</i>				
California	6.2	7.2	14.3	21.7
New York	6.0	5.9	11.9	24.6

Sources: Public Plans Database. 2010. Center for Retirement Research at Boston College and Center for State and Local Government Excellence; U.S. Census Bureau. 2010. State and Local Government Finances; U.S. Census Bureau. 2010. State and Local Public-Employee Retirement Systems; and author's calculations.

Plans need high returns, high returns involve risk, but politics make risky investing tricky.

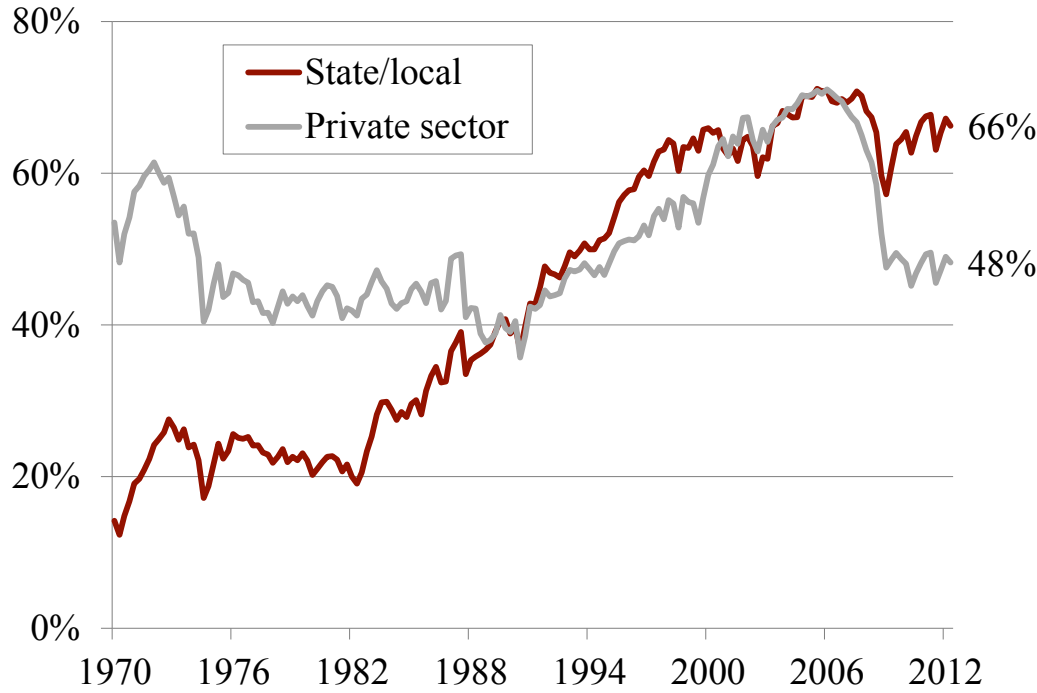
Public Plans Tend to Spend Surplus



Source: Author's illustration adapted from Cheiron. 2012. Presentation at Enrolled Actuaries meeting.

Yet, public plan investments in risky assets are near an all-time high.

Percentage of State and Local and Private Pension Fund Assets Invested in Equities, 1970-2012

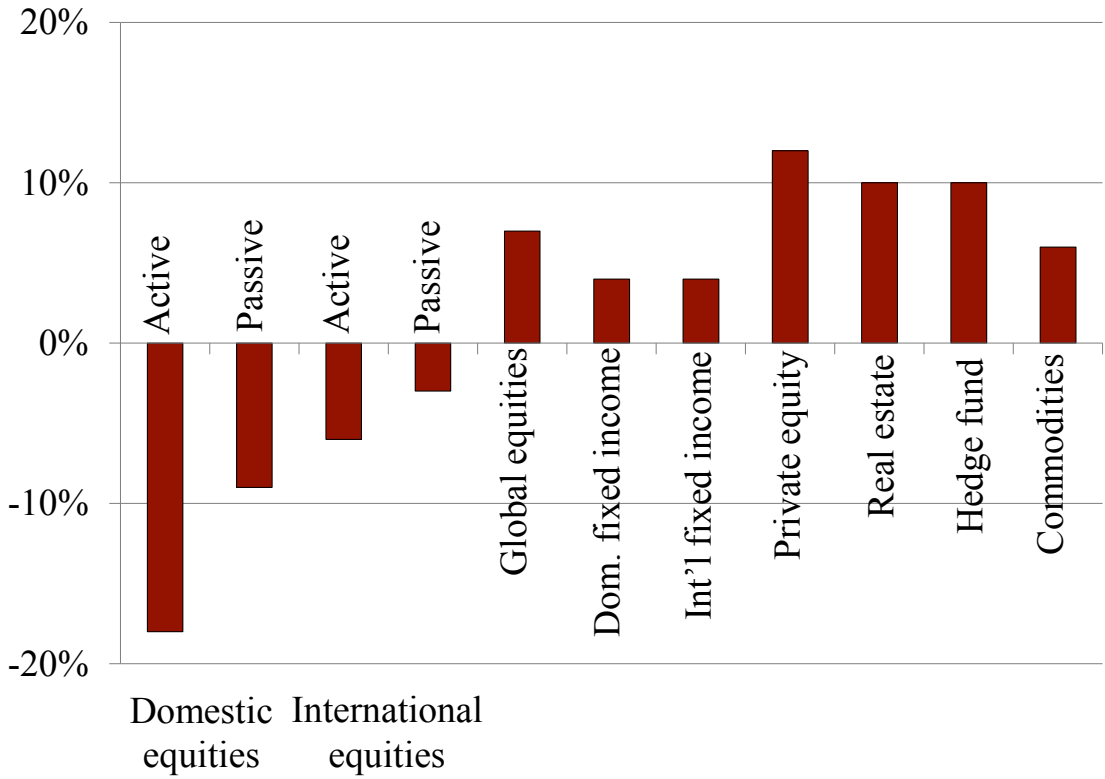


Notes: Assumes that equities account for approximately 80 percent of assets held in mutual funds. Before 1984, private sector pension funds include both defined benefit and defined contribution accounts.

Source: Author's calculations from U.S. Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*. 1970-2012.

And plan sponsors appear to be shifting from conventional to more complex assets.

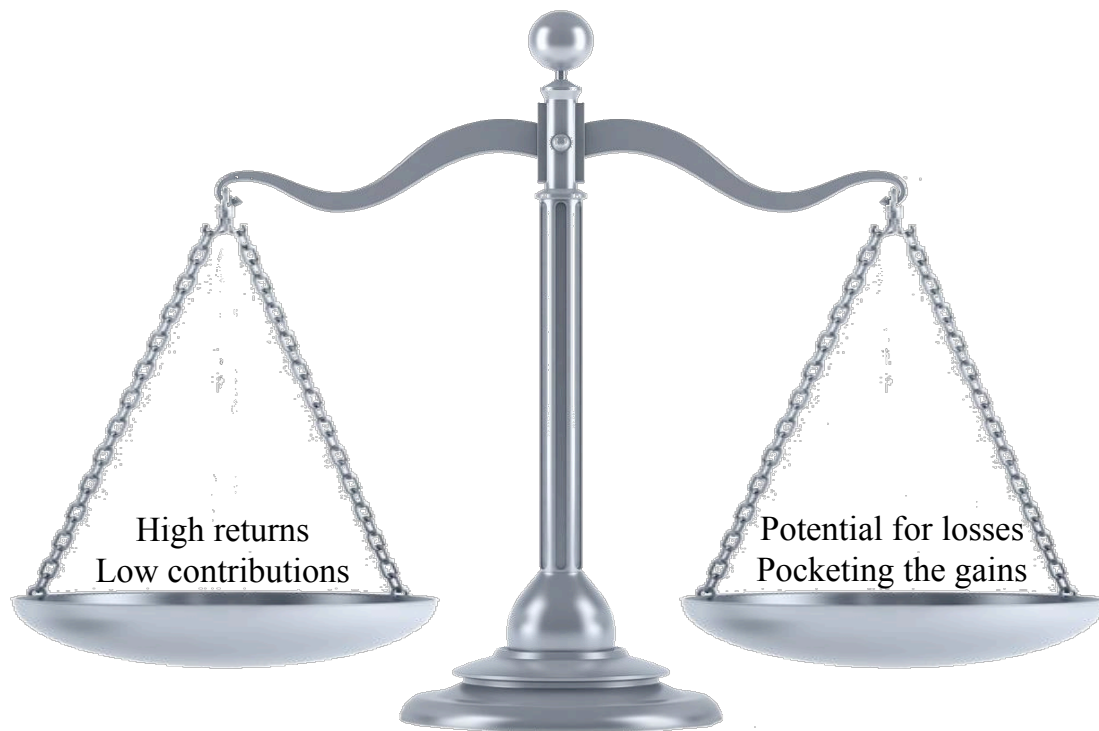
U.S. Defined Benefit Pension Sponsors:
 Net Share Planning to Significantly Increase Exposure Over the Next Three Years



Source: J.P. Morgan Chase and Co. 2012. "Eye on the Market." New York, NY.

So tension exists between earning needed returns and getting into trouble.

Risky assets

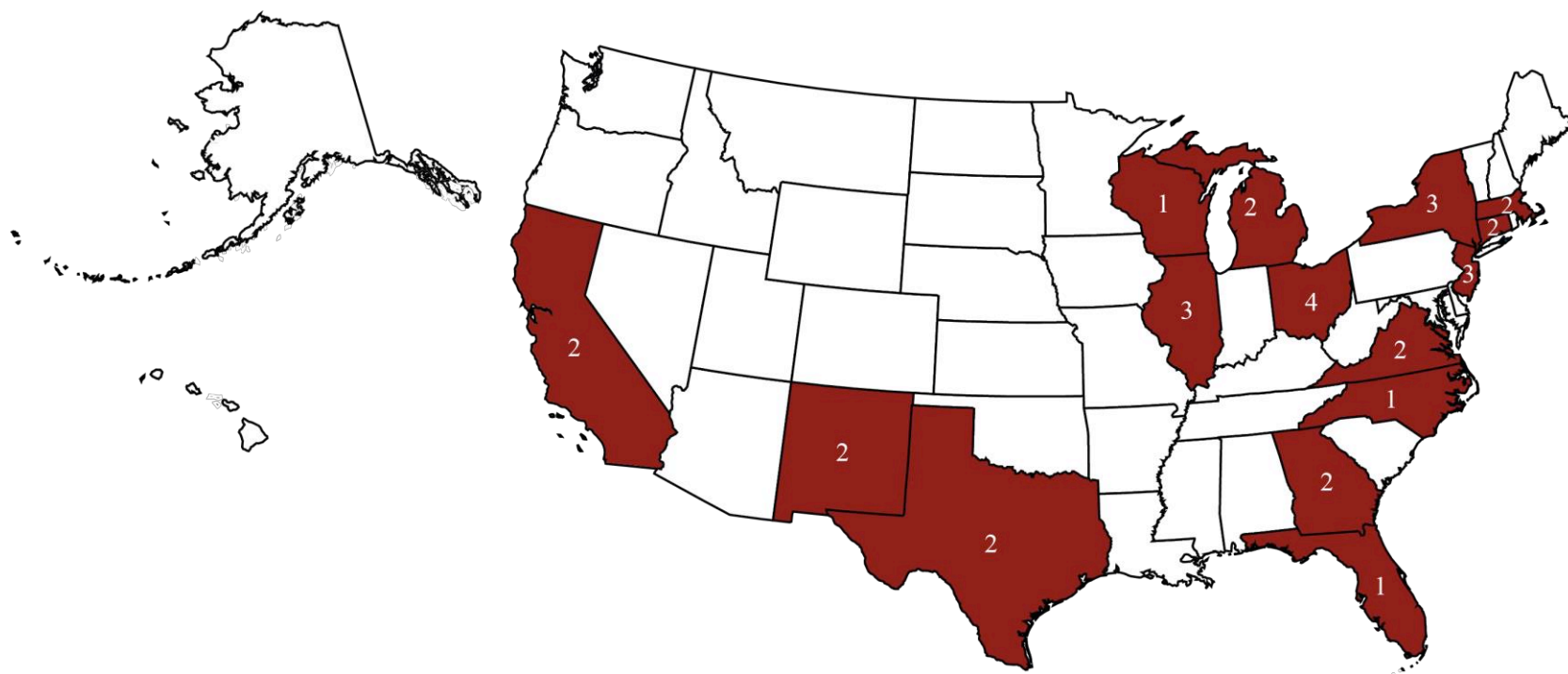


The other main determinant of cost is the generosity of the benefit package.

- Core benefits
 - Age/tenure requirements
 - Average salary period
 - Benefit factor
- COLA
- Employer contribution

CRR analyzed the long-term costs for 32 plans in 15 states.

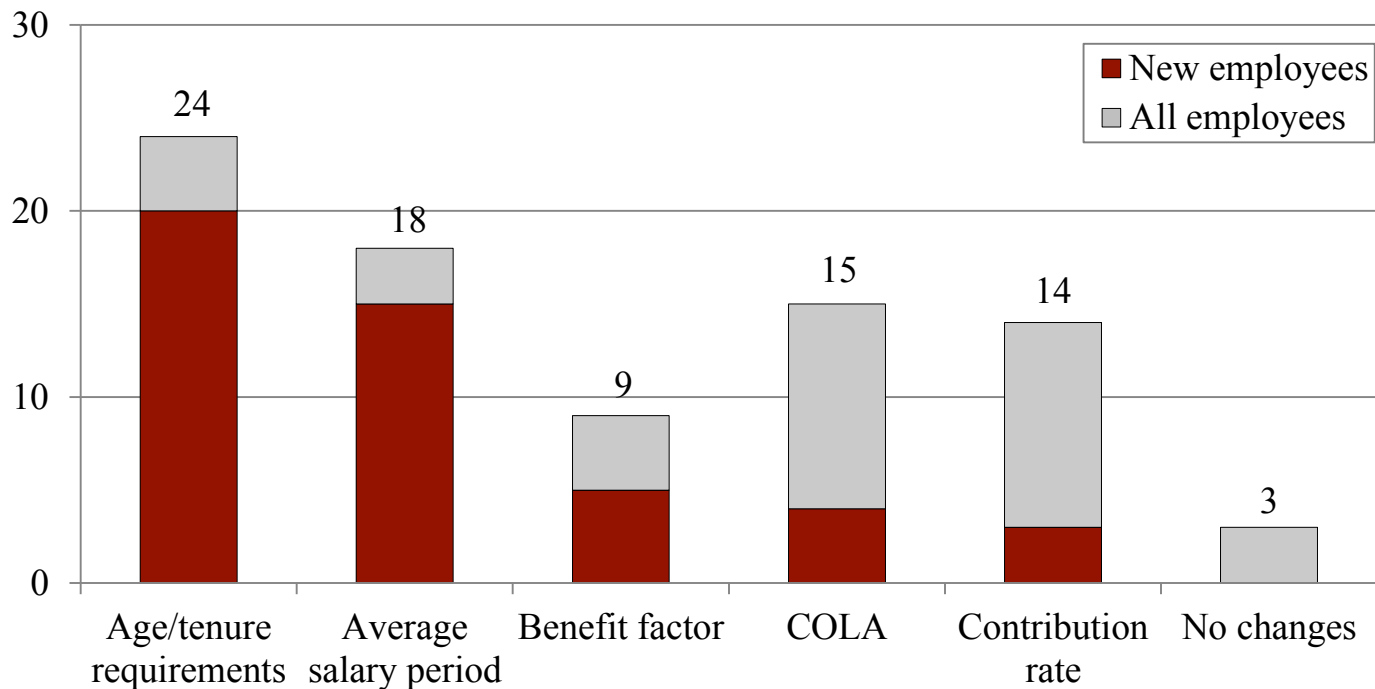
Sample States and Number of State-Administered Plans



Source: Author's illustration.

29 of the 32 plans have responded to the crisis by reducing their benefit package.

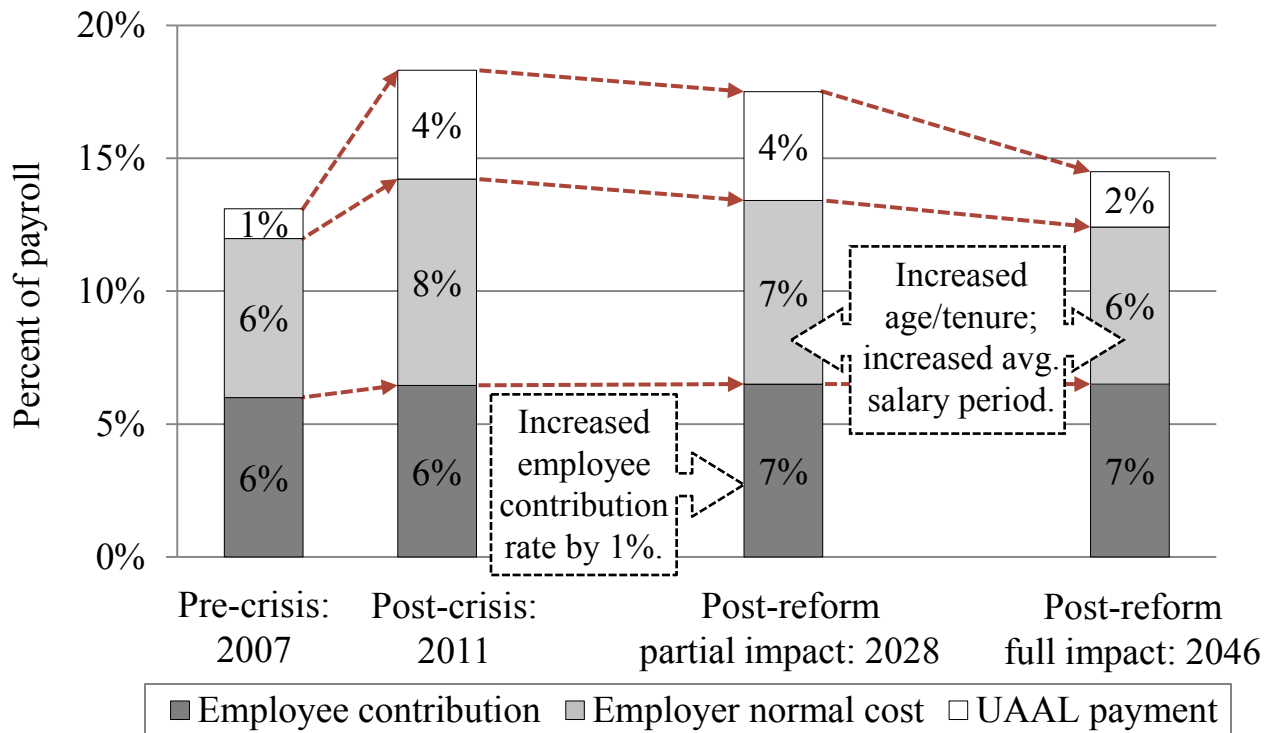
Sample Plans Making Pension Changes, by Type of Change



Sources: Actuarial valuation reports; National Conference of State Legislatures. 2008-2012. "Pensions and Retirement Plan Enactments;" and National Conference of State Legislatures. 2011. "State Pensions and Retirement Legislation: 2011."

For many, cuts should reduce the employer's normal cost over the long term.

Plan-Level Projections of the ARC as a Percentage of Payroll for Texas Employees Retirement System: 2011-2046

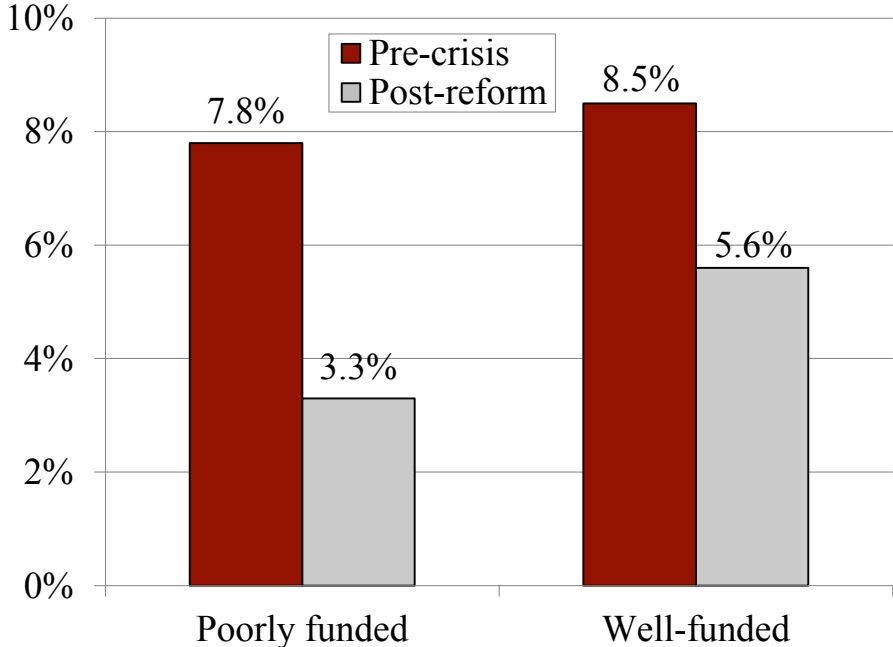


Sources: Author's projections based on plan actuarial valuations and *Public Plans Database*, 2009-2012. Center for Retirement Research at Boston College and Center for State and Local Government Excellence.

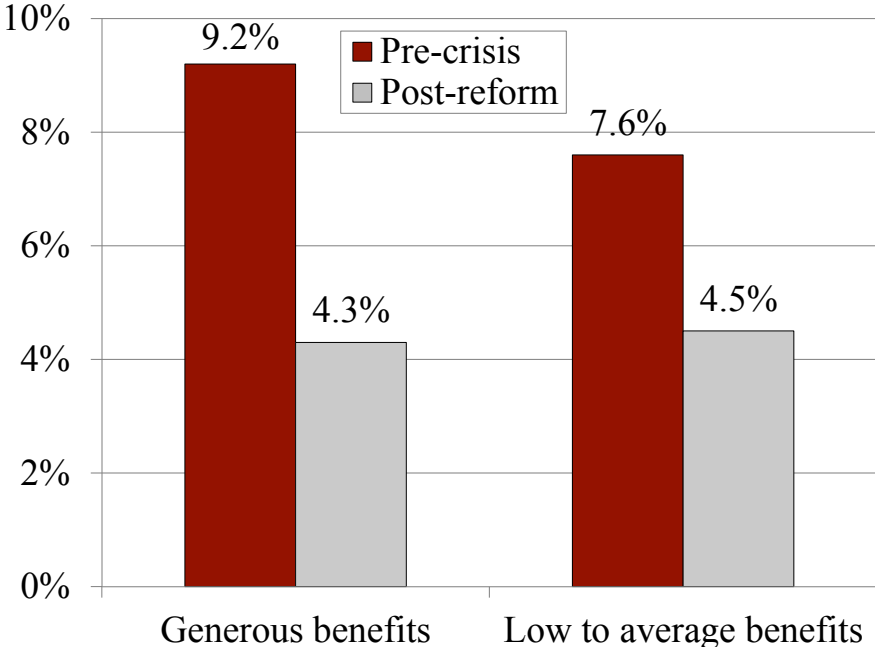
Poorly funded plans and expensive plans have taken the most dramatic actions.

Employer Normal Costs as a Percentage of Payroll, Pre-Crisis and Post-Reform

By Plan Funded Status



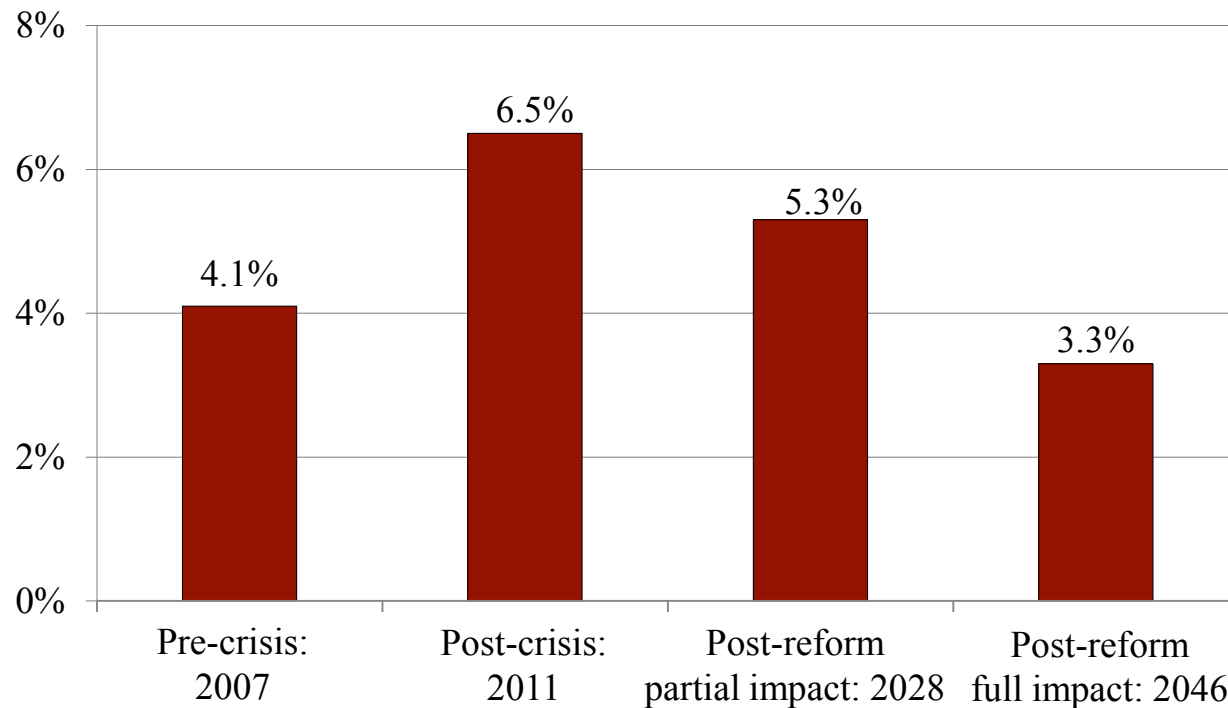
By Plan Generosity



Source: Alicia H. Munnell, Jean-Pierre Aubry, Anek Belbase, and Joshua Hurwitz. 2013. "State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform. *State and Local Plans Issue in Brief* 30. Center for Retirement Research at Boston College.

Reductions should eventually reduce pressure on sponsor budgets to below pre-crisis levels.

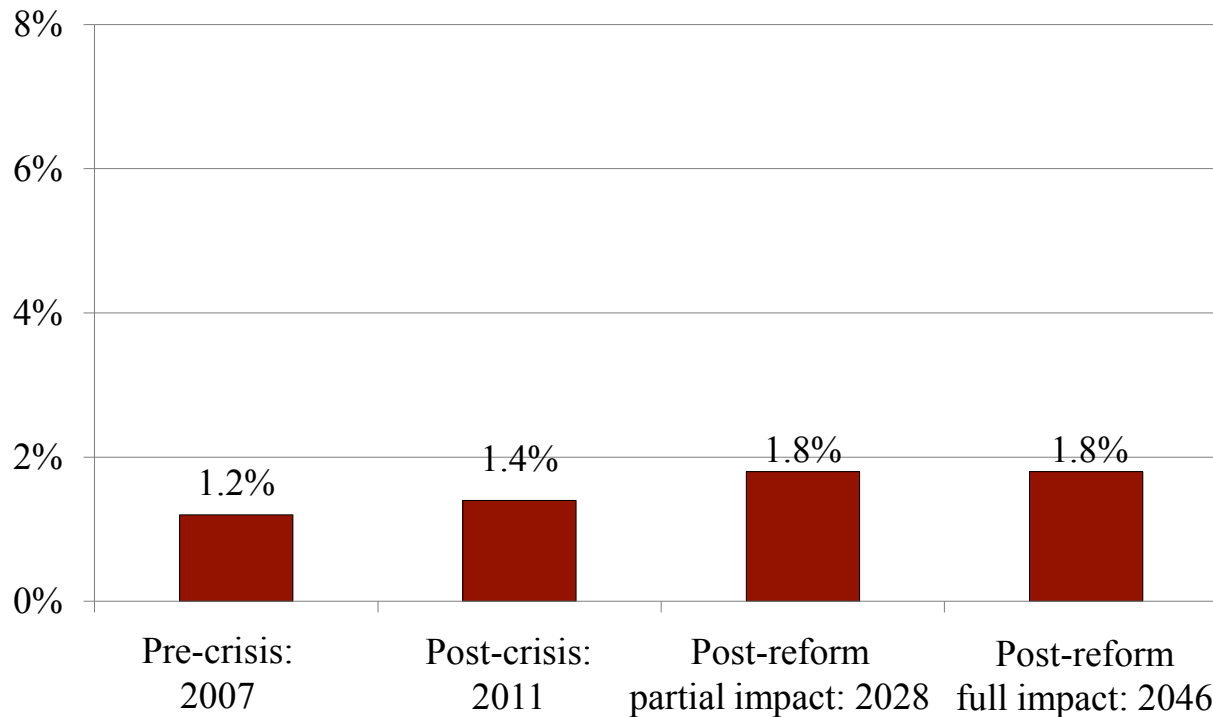
Pension Costs as a Percentage of State and Local Own-Source Revenues, Sample Average, Pre-Crisis through Post-Reform



Source: Alicia H. Munnell, Jean-Pierre Aubry, Anek Belbase, and Joshua Hurwitz. 2013. "State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform." *State and Local Plans Issue in Brief* 30. Center for Retirement Research at Boston College.

Retiree health spending is projected to rise but is still relatively modest share of budget.

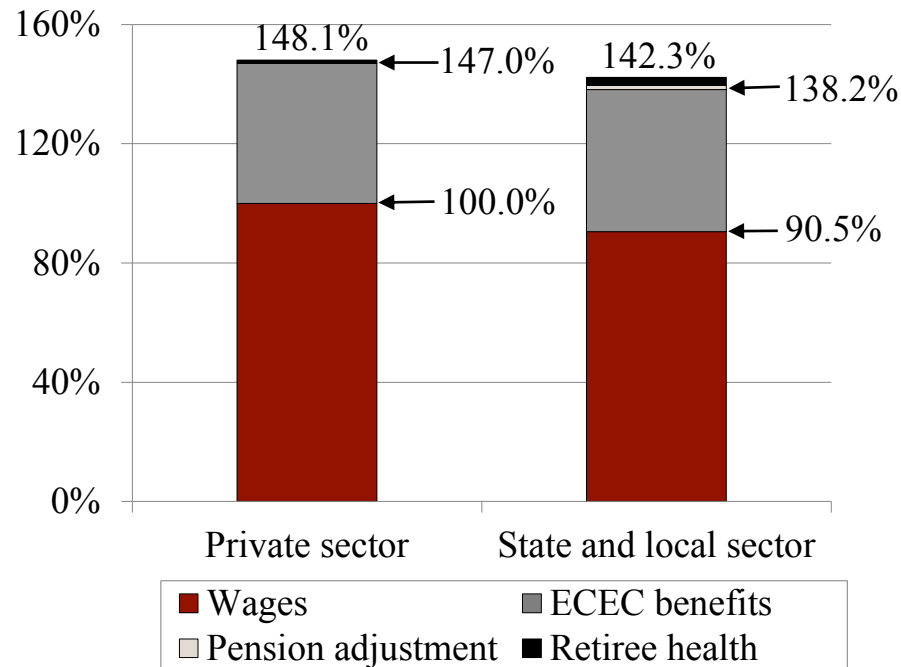
Retiree Health Costs as a Percentage of State and Local Own-Source Revenues, Sample Average, Pre-Crisis through Post-Reform



Source: Alicia H. Munnell, Jean-Pierre Aubry, Anek Belbase, and Joshua Hurwitz. 2013. "State and Local Pension Costs: Pre-Crisis, Post-Crisis, and Post-Reform. *State and Local Plans Issue in Brief* 30. Center for Retirement Research at Boston College.

But cutting pension benefits is not costless; they are a key part of total compensation.

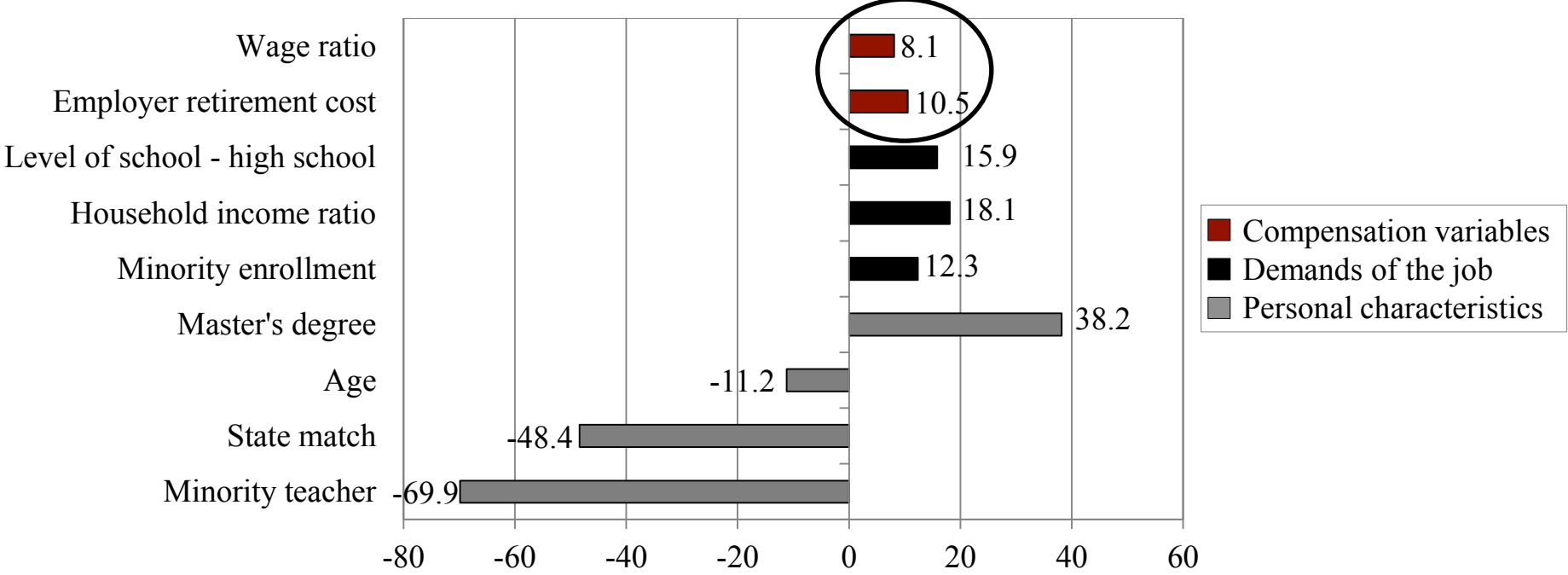
Total Compensation of State and Local and Private Sector Workers, as a Percentage of Private Sector Wages, 2010



Source: Alicia H. Munnell, Jean-Pierre Aubry, Joshua Hurwitz, and Laura Quinby. 2011. "Comparing Compensation: State and Local versus Private Sector Workers." *State and Local Plans Issue in Brief* 20. Center for Retirement Research at Boston College.

Reducing compensation below private sector levels will reduce the quality of new hires.

Impact of Selected Factors on Teacher Undergraduate Institution SAT Score



Notes: Changes are one standard deviation for continuous variables and 0/1 for dichotomous variables. All variables displayed are significant at the 5-percent level or better. The SAT score in this equation is for the 25th percentile.

Source: Alicia H. Munnell and Rebecca Cannon Fraenkel. 2012. Compensation Matters: The Case of Teachers. *State and Local Plans Issue in Brief* 28. Center for Retirement Research at Boston College.

Conclusion

- Two financial crises in a decade hurt public plans, but pension spending is still a modest share of government budgets.
- If plans can overcome political challenges and earn historical returns *and* if cuts to benefits stick, pensions will not be main source of budget squeeze.
- But returns are uncertain and benefit cuts can come undone, so pension expense merits careful monitoring.