

Hearing
“The Role of Public Employee Pensions in Contributing to State Insolvency and the Possibility
of a State Bankruptcy Chapter”

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Subcommittee on Courts, Commercial and Administrative Law

Committee on Judiciary

House of Representatives

Testimony of

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Chairman Coble, Ranking Member Cohen, and Members of the Subcommittee: thank you for the opportunity to submit written testimony on this important matter.

As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, the accuracy and integrity of information is more vital than ever. The condition of pension plans for employees of state and local government has become the focus of unprecedented attention from the media and policymakers in recent months. Unfortunately, much of this interest seems drawn either to those who lack sound knowledge and understanding of how these plans work, or who rely on methods and assumptions that are inappropriate and inapplicable to the way these plans operate.

A careful review of the operations and funding of public pensions, their share of the overall budget picture at the state and local level, and the steps state and local governments are taking to bring their pension plans into long-term solvency, reveals that on the whole, state and local pensions are weathering the financial crisis and making measured changes to ensure their long-term sustainability.

Public pension plans have a rich history; many predate Social Security, and some were established even before the turn of the 20th century. These plans have evolved, migrating from simply making single distributions to certain disabled or retired classes of employees, to retirement, survivor and disability programs for substantially all state and local government workers. Plan financing has also changed dramatically. Only 30-40 years ago, most public plans were financed primarily on a pay-as-you-go basis. Since then, states and localities have endeavored to advance-fund pension benefits by requiring public employees and their employers to contribute to a pension trust during employees' working years that is enough to pay for their pensions during their retirement years. This was done without federal intervention and has, by and large been a success story: “The miraculous aspect of the funding of state and local pensions is that it occurred without any national legislation.” (Center for Retirement Research, “The Miracle of Funding by State and Local Pension Plans,” April 2008)

By 2000, assets in most public pension trusts equaled or exceeded expected pension payments. Like all investors, recent market shocks, particularly in 2008, have affected asset values. Unlike many other investors, however, public pension trusts are designed to weather market volatility and have done so repeatedly, including during the S&L crisis, the bursting of the technology bubble, Enron, 9/11, the housing bubble and the Great Recession. Even after the most recent and

unprecedented financial downturn, most state and local government pension trusts have plenty of assets to continue to pay promised benefits for years, and values already have rebounded sharply since the market low. Many states nonetheless have been making changes to benefits and financing structures to strengthen reserves and ensure the trusts are sustainable for the very long term.

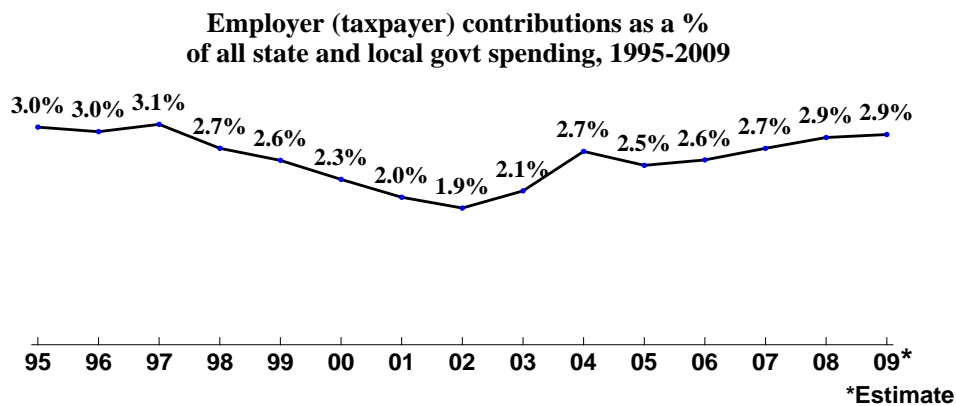
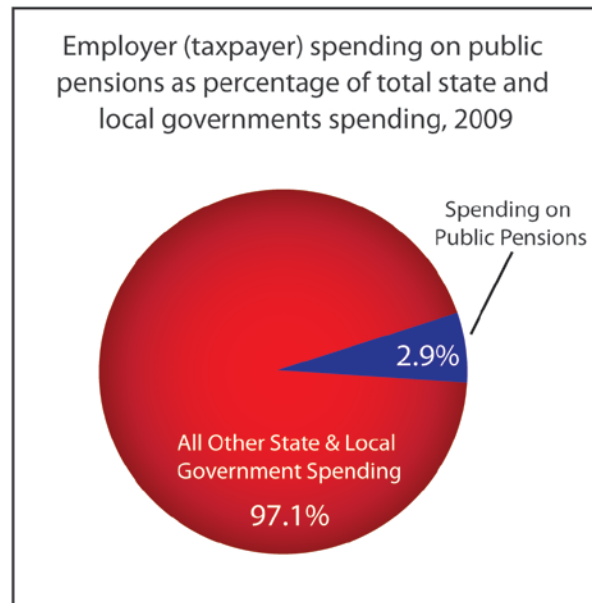
Pensions are a Relatively Small Portion of State and Local Budgets

State and local pensions' long-term financing strategy, which takes place over decades, often seems to be not understood and is mistakenly juxtaposed against current annual revenues and expenditures of state and local governments. Central to understanding public pension financing is to know that public pension benefits are *not* paid out of general operating revenues, but rather, from trusts fund to which retirees and their employers were required to contribute while they were working. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and, with investment earnings, these contributions comprise the majority of public pension fund revenues. The average retirement benefit for public employees is \$22,600, and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security.



State and local spending on public pensions is the employers' annual contribution to the pension trust – not the amount paid out of the trust each year to retirees. The percentage of all state and local government spending on pensions has hovered around three percent during the last decade.

The requirement that states balance their budgets is often a formidable task in difficult fiscal periods, such as now. However, the extent to which pension costs are impacting these budgets appears to be misunderstood and misreported in many cases. While the impact of the financial crisis on state and local pensions will likely require spending to increase, the most recent studies find that the share of state and local budgets dedicated to pension contributions would likely need to rise to about five percent on average, and to about eight to 10 percent for those with the most seriously underfunded plans. (Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "The Impact of Public Pensions on State and Local Budgets," Center for Retirement Research, October 2010). However, many state and local governments have enacted or are considering changes to benefit levels and financing structures to lower these projections.



Significant Financing and Benefit Changes Already Underway or Enacted

Pension funds hold \$2.8 trillion in trust from which they pay benefits, roughly 14 times the amount they distributed in benefits last year. Pension funds representing the vast majority of public employees have assets to continue to pay benefits for decades, if not into perpetuity. My own calculations, which I'm happy to provide to the Committee upon request, find that using even conservative estimates, the median state pension fund is able to pay benefits until 2030, enough time for states to make necessary adjustments.

Assuming a rate of asset growth consistent with historic market norms, most funds will never run out of money. The Center on Retirement Research at Boston College said last October, "even after the worst market crash in decades, state and local plans do not face an immediate liquidity crisis; most plans will be able to cover benefit payments for the next 15-20 years" (Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "Public Pension Funding in Practice," NBER Working Paper 16442, October 2010).

This is not to say that long-term pension costs are of no concern. The market shocks of the Great Recession lowered funding for all investors. While public pension trust funds are not in immediate crisis, most state and local governments are making changes to strengthen financing reserves and further enhance long-term solvency.

Among plans that have found their long-term sustainability in question, plan administrators and policymakers are aware of the problem. Adjustments have been made in many states, and more states are in the process of doing so. Last year, according to the National Conference of State Legislatures, an unprecedented number of states made changes to their pension benefits, contribution requirements, or both. Many more states are expected to follow suit this year. These changes are reducing both current costs and long-term liabilities. In fact, more states made significant changes to retirement benefits and financing in 2010 than in any year in recent history. (“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ronald K. Snell, National Conference of State Legislatures, October 10, 2010).

Solvency Confirmed, Measured Approach Urged to Long-term Solutions

Although some states have accumulated significant unfunded liabilities, pension benefits are paid out over many years, not all at once. These are long-term funding issues, and most thorough analyses by those familiar with governments and public finance find patient and measured responses are required:

- In a 2008 report, the Government Accountability Office said, “[U]nfunded liabilities are generally not paid off in a single year, so it can be misleading to review total unfunded liabilities without knowing the length of the period over which the government plans to pay them off.” (U.S. Government Accountability Office, “State and Local Government Pension Plans; Current Structure and Funding Status,” July 2008 GAO-08-983T).
- Bond rating agency Fitch recently said, “[M]ost state and local governments have been making payments towards their projected long-term liabilities for decades, resulting in sizable pension trust balances and significant actuarial funding for most plans. Broadly speaking, significant adjustments to plan benefits and contributions will be required, and in some instances such changes are already underway. Since unfunded obligations in most cases are not due for many years, issuers have the opportunity to make these difficult adjustments.” (FitchRatings, “U.S. State and Local Government Bond Credit Quality: More Sparks than Fire,” November 16, 2010).
- Standard & Poor’s said last month, “[P]ension and other retirement liabilities ... in most cases, are not immediately jeopardizing the debt-paying capacities of the governments we rate. ... [W]e continue to believe that most governments are likely to make the difficult tradeoffs ... so they may preserve funding for important (sometimes legally required) programs and to protect their credit and market access.”(Standard & Poor’s, “U.S. State and Local Governments Must Navigate Turbulent Conditions to Maintain Credit Stability,” January 24, 2011)
- In July 2008, just before the most recent market decline, the Government Accountability Office said, “Most state and local government pension plans have enough invested resources set aside to fund the benefits they are scheduled to pay over the next several decades.” (U.S. GAO, *ibid.*). Although that report preceded the market decline, investment markets have rebounded and pension funds have regained much of the assets lost.

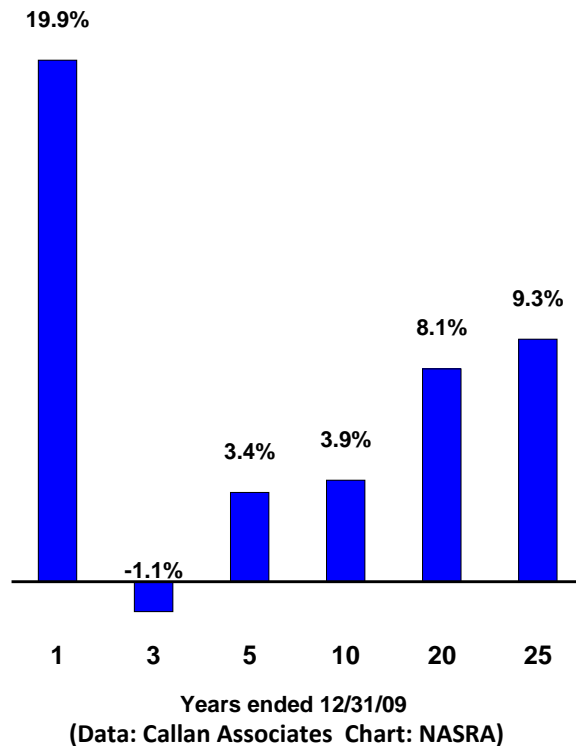
Faulty Analysis is Unhelpful to State and Local Recovery Efforts

Reports that inappropriately calculate and intermingle unrelated long-term obligations with short-term budget issues can be misleading. Much misinformation regarding state debt and pensions is being circulated, mostly based on dramatic and improbable conclusions, but which nonetheless creates the mistaken impression that drastic and immediate measures are needed. A closer look at the suppositions on which many of these reports are based, finds the use of overly pessimistic assumptions that simply are not in line with historical practice. In certain cases, these distortions compound each other. The result is a mischaracterization of public pensions vis-à-vis state fiscal arrangements that obfuscates and misleads more than informs and enlightens.

- Recent studies estimated public pension unfunded liabilities of more than \$3 trillion are based on a measure—current interest rates, which are near record lows—that reflects the dynamics of bond yields rather than the fundamental characteristics of the plan. These studies also use asset values from 2009, near their recent low points, and they project liabilities using current low interest rates, inflating the value of the obligations.
- Studies authored by Joshua Rauh promote confusion by mixing apples with oranges. For example, his report “Are State Public Pensions Sustainable?,” compares, for many states, local governments’ unfunded pension liabilities with the tax effort of only the state. This is akin to measuring the mortgage capacity of a working couple, yet considering the income of only one of them. Excluding local sources of revenue when local governments are responsible for funding pension liabilities, produces a distorted and misleading measure.
- This and other studies by Joshua Rauh compare unfunded pension liabilities with “state tax revenues,” excluding the state and local government revenues from fees and charges for services such as utilities, tuition, vehicle registration, etc. These non-tax funding sources finance government operations as much as tax revenues, yet the reports ignore them. This results in a misleading characterization of unfunded liabilities that is intended to present state and local government funding conditions in an unrealistically negative manner.
- A study authored by Joshua Rauh and Robert Novy-Marx, “Public Pension Promises: How Big Are They and What Are They Worth?,” is based on asset values in June 2009, near their recent market low point, and using interest rates when they were at near-record lows. Since June 2009, US equity markets have risen by 40 percent and public pension asset values have grown by some 25 percent. The Rauh-Novy-Marx study’s reliance on depressed asset values produces an outdated—but dramatic—calculation of unfunded liabilities.
- Regarding the use of interest rates to calculate public pension funding conditions, the National Institute for Retirement Security said in recent testimony to the American Academy of Actuaries: “Plans sponsored by long lived entities that face a low risk of insolvency are best evaluated on a going basis, which is captured well by actuarial methods currently in use for state and local plans. Moreover, to the extent that such measures would drive funding policy, the volatility they introduce would either create untenable, counter cyclical funding burdens for public entities or force plans into so-called “liability driven” investment strategies that would involve greater taxpayer costs. Thus, termination or liquidation basis measures do not serve the public interest. Even disclosure of these misleading measurements poses risks. In light of the public’s knowledge gap about public pensions, the introduction of termination like liability measures would create new opportunities for politically motivated interest groups to

mislead the public about the health of these plans and exaggerate their cost. This kind of misrepresentation is already a serious problem when it comes to state and local pensions.”

Like all investors, public pension funds have been affected by the unprecedented market downturn in 2008. However, since 1985—a period that has included three economic recessions and four years of negative median public fund investment returns—public pension investment returns have exceeded their targeted eight percent return on investments. For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%. For the year ended 6/30/10, this return was 12.8 percent. The chart below shows median public fund returns for periods ended 12/31/09, illustrating the volatility in short-term market returns and the inappropriateness of basing long-term policy decisions on a snapshot in time, particularly at the market low:



Federal Intervention Unwarranted

Given the differing plan designs and financial pictures across the country, a different range of solutions will be required for each plan to best secure their viability for the very long-term. **State and local government retirement systems do not require, nor are they seeking any Federal financial assistance.** A fact sheet recently released by 10 national state and local government organizations—the National Conference of State Legislatures, National Association of Counties, United States Conference of Mayors, National League of Cities, International City/County Management Association, National Association of State Auditors Comptrollers and Treasurers, Government Finance Officers Association, International Public Management Association for Human Resources, National Council on Teacher Retirement and the National Association of State Retirement Administrators—notes that, “[T]he great strides made in the ability of state and local government retirement systems to ensure that more than 20 million working and retired public employees have financial security in retirement have been achieved

without Federal intervention. One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.”

A recent letter, signed by the leaders of the National Governors’ Association and the National Conference of State Legislatures, reminds members of Congress that:

[F]or the last three years, states have faced growing budget deficits and in each of those years, we have closed those deficits by spending cuts and when necessary increasing taxes. Governors and legislators have had to make tough and politically unfavorable decisions to be fiscally responsible and balance our budgets. Throughout this process, our colleagues never contemplated walking away from our obligations to our constituents or to the bond markets by requesting that the federal government allow states to receive bankruptcy protection. While a number of states continue to face budget deficits over the next few years, we will continue to use our sovereign authority to balance our budgets and meet our obligations.

State and local leaders are interested in working with their federal partners to improve the fiscal stability of government at all levels. We call on Congress and the Administration to work with our members to eliminate unfunded mandates, provide greater flexibility to use federal funds more efficiently and avoid federal restrictions such as maintenance-of-effort provisions that hinder state and local authority to control their own finances. These are difficult times in which to govern, but the challenges also provide us with the opportunity to work more closely together to find common solutions. We look forward to working with you to address the financial needs of the country and ensure our prosperity for the future.

Like all investors, public retirement systems have been affected by the recent unprecedented market decline. Governments, their plans and their employees, working through State and local legislative and regulatory structures, are aggressively engaged in the process of examining benefit levels and financing structures in order to strengthen reserves. Given the differing plan designs and financial pictures across the country, a different range of solutions will be required for each in order to best secure their viability for the very long-term. Hyperbole and distortion are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems. State and local government retirement systems do not require, nor are they seeking any Federal financial assistance, which is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.

Again, I thank you for inviting me here today. I would be happy to discuss various strategies being explored in numerous jurisdictions around the country, and I look forward to answering any questions.

I am attaching for the record the following documents to accompany my statement:

- NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems
- Facts on State and Local Government Pensions
- Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts
- NGA/NCSL Letter to Congress

Bio

Keith Brainard has served as research director for NASRA since 2002. Previously, he served as manager of budget & planning for the Arizona State Retirement System, and he provided fiscal research and analysis for the Texas and Arizona legislatures. He is co-author of the Governmental Plans Answer Book, 2nd Edition, and created and maintains the Public Fund Survey, an online compendium of public pension data. He has a master’s degree from the LBJ School of Public Affairs, University of Texas at Austin.

NASRA ISSUE BRIEF:

STATE AND LOCAL GOVERNMENT SPENDING ON PUBLIC EMPLOYEE RETIREMENT SYSTEMS



January 2011

Employer (taxpayer) spending on pension benefits for employees of state and local government has been the object of growing attention. A closer look reveals that a relatively small portion of all state and local government spending goes to public pensions. According to the latest estimates,ⁱ *less than three percent* of all state and local government spending was used to fund public pension benefits. Figure A. illustrates spending on public pensions as a percentage of all state and local government spending. Although public pension costs have risen due to the loss of pension assets during the 2008 decline in capital markets, and are likely to rise further, this cost should be considered in the context of a) the benefits retirement systems

distribute each month to more than 7.5 million retired public employees, their beneficiaries and survivors; and b) the economic effects these benefits generate in local and state economies. In 2008, public retirement systems distributed more than \$175 billion in pension benefits, an amount more than double the amount paid in by taxpayers through employer contributions. These benefits reach every city of every state in the nation, and their economic effects are well documented.ⁱⁱ

The vast majority of public employees are required to contribute a portion of their wages—typically five to 10 percent—to their state or local pension fund; some share pension costs equally with their employers. An estimated 30 percent of employees of state and local government do not participate in Social Security, including substantially all of them in seven states, approximately one-half of all of the nation’s public school teachers, and two-thirds to three-fourths of firefighters and police officers. In most of these cases, employers and employees are contributing to the pension fund *in lieu of* contributions to Social Security, reducing state and local taxpayer costs by an estimated \$15.6 billion annually.ⁱⁱⁱ On a national basis, as shown in Figure B, employer (taxpayer) contributions to pension plans have remained fairly steady. Since 1995, employer contributions as a percentage of all state and local government spending have remained around three percent, providing most employers with a fairly predictable expenditure for attaining retirement security.

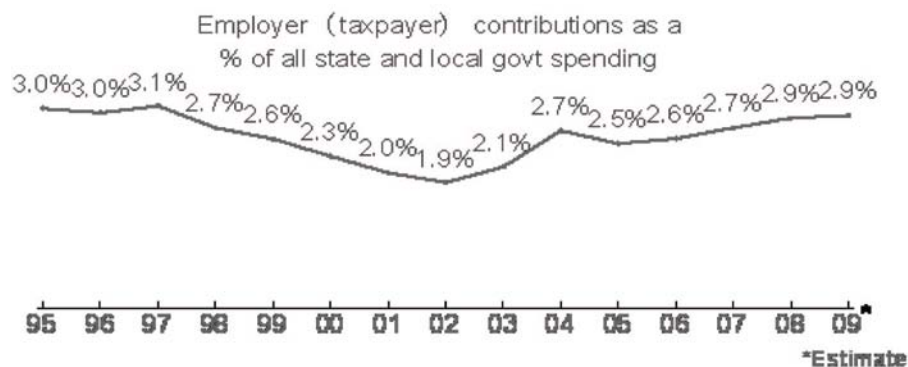
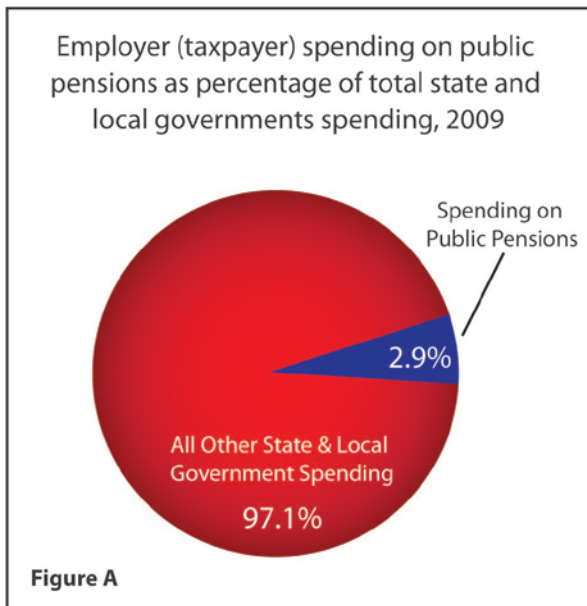


Figure B

**Employer (taxpayer) contributions to pensions
as a percentage of all state and local government spending, by state, 2008**

Alabama	2.93	Louisiana	3.46	Oklahoma	3.68
Alaska	2.33	Maine	2.85	Oregon	2.47
Arizona	2.41	Maryland	2.81	Pennsylvania	1.61
Arkansas	3.07	Massachusetts	3.35	Rhode Island	4.65
California	3.83	Michigan	2.46	South Carolina	2.26
Colorado	2.16	Minnesota	1.60	South Dakota	1.72
Connecticut ¹	4.07	Mississippi	2.82	Tennessee	2.15
Delaware	1.50	Missouri	3.29	Texas	1.95
District of Columbia	1.24	Montana	2.27	Utah	2.69
Florida	2.37	Nebraska	1.36	Vermont	1.03
Georgia	2.02	Nevada ²	5.44	Virginia	3.83
Hawaii	3.70	New Hampshire	1.97	Washington	1.51
Idaho	2.55	New Jersey	2.84	West Virginia	3.91
Illinois	3.40	New Mexico	3.06	Wisconsin	1.35
Indiana	2.82	New York	3.96	Wyoming	1.28
Iowa	1.74	North Carolina	0.92	United States	2.89
Kansas	2.01	North Dakota	1.40		
Kentucky	2.43	Ohio	2.92		

1/ Excludes \$2 billion in pension bonds issued by the state in 2008.

2/ In addition to being a non-Social Security state, one-half of Nevada PERS employers' contribution is attributable to a non-refundable pre-tax salary reduction to fund the employees' portion of the contribution.

Sources:

<http://www.census.gov/govs/estimate/> - Total spending by states and local governments

<http://www.census.gov/govs/retire/2008ret02a.html> - State and local government retirement system sources of revenue

See also: *The Impact of Public Pensions on State and Local Budgets*, Center for Retirement Research at Boston College, October 2010 (The CRR measure excludes capital spending in its calculation of pension contributions as a percentage of all state and local government spending.)



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ⁱ Estimated by applying normal annual growth rates to 2008 data.

ⁱⁱ For example, *Pensionomics: Measuring the Economic Impact of State and Local Pension Plans*, National Institute on Retirement Security, February 2009; see also "Economic Effects of Public Pensions," <http://www.nasra.org/resources/economic.htm>

ⁱⁱⁱ Author's calculation based on 30 percent of state and local government employees not participating in Social Security.



FACTS ON STATE AND LOCAL GOVERNMENT PENSIONS

Retirement systems remain a small portion of state and local government budgets. State and local government pensions are not paid out of general operating revenues, but instead, a trust that public retirees and their employers contributed to while they were working. The portion of state and local government spending dedicated to retirement system contributions is about three percent.¹ While some pension trusts are fully funded (they have enough assets in the trust now for all pension obligations), following the recent market decline, plans will need to increase their contribution levels to five percent on average to return to full funding.² The unprecedented number of benefit and financing changes in public plans over the last few years will help to keep any required increases to a minimum.

Public pension plans are not in crisis. Most state and local government employee retirement systems have substantial assets to weather the economic crisis; those that are underfunded are taking steps to strengthen funding. It is important to understand that pensions are funded and paid out over decades. There is currently \$2.7 trillion already set aside in pension trusts for current and future retirees. Further, state and local government retirees do not draw down their pensions all at once. Employees must reach certain age and/or years of service before they are eligible for a pension; once retired, they must receive their pension in installments over their retirement years (as an annuity).

State and local governments are already taking steps to secure their pensions for the long-term. More state and local governments enacted significant modifications to improve the long-term sustainability of their retirement plans in 2010 than in any other year in recent history. In the past few years, nearly two-thirds of states have made changes to benefit levels, contribution rate structures, or both; many local governments have made similar fixes to their plans.³

Public employees share in the financing of their pension, which in many cases is in lieu of Social Security. The vast majority of public employees are required to contribute a portion of their wages—typically five to ten percent—to their state or local pension, and these contribution rates are being raised in many state and local governments. Employee contributions along with investment returns comprise the majority of public pension fund revenues. The average retirement benefit for public employees is \$22,600 and for many of them, including nearly half of all teachers and over two-thirds of firefighters and public safety officers, it is in lieu of Social Security. State and local salaries on which these pensions are based are lower than those for private sector employees with comparable education and work experience, even when benefits are included.^{4, 5}

Pension dollars help the economy of every jurisdiction. Public employees live in every city and county in the nation; more than 90 percent retire in the same jurisdiction where they worked. The over \$175 billion in annual benefit distributions from pension trusts are a critical source of economic stimulus to communities throughout the nation, and act as an economic stabilizer in difficult financial times. Recent studies have documented public retirement system pension distributions annually generate over \$29 billion in federal tax revenue, more than \$21 billion in annual state and local government tax revenue, and a total economic impact of more than \$358 billion.⁶

Long-term investment returns of public funds continue to exceed expectations. Since 1985 – a period that has included three economic recessions and four years of negative median public fund investment returns – actual public pension investment returns have exceeded assumptions.⁷ For the 25-year period ended 12/31/09, the median public pension investment return was 9.25%.⁸ Moreover, for the year ended 6/30/10, this return was 12.8%.⁹ These actual returns exceed the 8% average public pension investment assumption, as well as the average assumed rate of return used by the largest corporate pension plans.¹⁰

State and local government retirement systems do not require, nor are they seeking, Federal financial assistance. The great strides made in the ability of state and local government retirement systems to ensure that more than 20 million working and retired public employees have financial security in retirement have been achieved without Federal intervention. One-size-fits-all Federal regulation is neither needed nor warranted and would only inhibit recovery efforts already underway at the state and local levels.

ENDNOTES

- ¹ [NASRA Issue Brief: State and Local Government Spending on Public Employee Retirement Systems](#)
- ² [The Funding of State and Local Pensions](#), Center for State and Local Government Excellence
- ³ [Pensions and Retirement Plan Enactments in 2010 State Legislatures](#), National Conference of State Legislatures
- ⁴ [The Wage Penalty for State and Local Government Employees](#), Center for Economic and Policy Research
- ⁵ [Out of Balance? Comparing Public and Private Sector Compensation Over 20 Years](#), Center for State and Local Government Excellence/National Institute on Retirement Security
- ⁶ [Pensionomics: Measuring the Economic Impact of State and Local Pension Plans, National Institute on Retirement Security](#)
- ⁷ [Investment Return Assumption for Public Funds: The Historical Record](#), Callan Investments Institute Research
- ⁸ [NASRA Issue Brief: Public Pension Plan Investment Return Assumptions](#)
- ⁹ [The Public Fund Survey](#)
- ¹⁰ [Milliman 2010 Pension Funding Study](#)

OTHER RESOURCES:

- [The Impact of Public Pensions on State and Local Budgets](#), Center for Retirement Research at Boston College
- [Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts](#), National Association of State Retirement Administrators
- [Frequently Asked Questions About Pensions](#), National Institute for Retirement Security
- [Research Brief on America's Cities](#), National League of Cities

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GOVERNMENT FINANCE OFFICERS ASSOCIATION (WWW.GFOA.ORG)

INTERNATIONAL PUBLIC MANAGEMENT ASSOCIATION FOR HUMAN RESOURCES (WWW.IPMA-HR.ORG)

NATIONAL COUNCIL ON TEACHER RETIREMENT (WWW.NCTR.ORG)

NATIONAL ASSOCIATION OF STATE RETIREMENT ADMINISTRATORS (WWW.NASRA.ORG)

Faulty Analysis is Unhelpful to State and Local Pension Sustainability Efforts

October 2010



As state and local governments lead efforts to address the unprecedented fiscal challenges created by stagnant economies, in the face of aging populations and workforces, the accuracy and integrity of information is more vital than ever. Authors of a new paper, *The Crisis in Local Government Pensions in the United States*, would be more constructive, as well as provide more accurate municipal pension information, if their assumptions were based on historical experience and their methodology appropriate for the government sector. Robert Novy-Marx and Joshua Rauh – who also earlier this year authored, *Are State Public Pensions Sustainable?* – again vastly underestimate projected future contributions to public pension plans and expected investment returns to draw dramatic and improbable conclusions regarding the solvency of these plans.¹ Both papers are based on pension fund assets values as of 2009, prior to the recent improvement in financial markets. Further, their method used to determine future pension liabilities of states and localities is not recognized by governmental accounting standards. The authors additionally ignore changes already underway at the state and local levels to restore long-term pension sustainability, and they make recommendations that would only serve to worsen the financial condition of these plans.

Assumptions of Future Behavior Are Not Supported by Past Practice

The reports' findings are premised on two key suppositions: 1) state and local governments will contribute nothing to amortize past pension liabilities, and 2) funds will generate rates of return commensurate with highly conservative, "risk-free" all-bond portfolios, rather than the diversified portfolios actually in use. These two assumptions are inconsistent with plans' actual experience, as most governments have a history of paying their pension contributions. In fact, according to the Public Fund Survey, from FY 01 to FY 09, on average, pension plan sponsors paid 91 percent of their required contributions. Regarding investment returns, the standard assumption is that pension fund portfolios will earn a real (after inflation) return of 4.5 percent annually, based on the mix of assets they typically hold, and more reasonable given the current ratio of stock prices to trend earnings.² Further, analysis shows that public pension funds' actual long-term investment returns still exceed this assumption, even after incorporating losses from the 2008 market collapse.³

Projections Are Based on Asset Values Near Their Market Low Point

The authors base their financial analysis on pension asset values as of June 30, 2009, at the end of a 12-month period when the S&P 500 had a return of -26.2%, and prior to much of the market increase that took place the following year. Pension fund asset values have been growing since March 2009, and for the year ended June 30, 2010, median public pension fund investment returns were 12.8 percent, well above plans' typical assumed investment return of eight percent. In addition, historical investment experience over 20-, 25- and 30-year time periods, a more appropriate measure of the long-term investment horizon of public funds, also exceed this assumed rate of return.⁴

The Method Used to Value Future Liabilities Is Inconsistent With Accounting Standards

Another factor driving the authors' findings is the method used to value future pension liabilities, which is not compliant with public sector accounting standards. In fact, the Governmental Accounting Standards Board, which has been reviewing these standards over the past three years, recently affirmed its support for the use of a long-term expected rate of return, rather than the use of current interest rates. In its Preliminary Views, published last June, GASB specifically "considered but rejected" an interest rate-based method for valuing future liabilities (the approach used in the Novy-Marx-Rauh paper), stating instead that, "The rate used should be a reasonable estimate of the rate at which plan net assets are expected to grow, over a term commensurate with the accounting measurements for which the rate is used, as a result of investment earnings."

¹ [Based on original analysis prepared by Paul Zorn and Mita Drazilov at Gabriel, Roeder, Smith & Company, Paul Angelo at The Segal Company, and Keith Brainard at NASRA.](#)

² ["More Scare Stories About State Pensions at the NYT," Dean Baker, Center for Economic and Policy Research, June 20, 2010.](#)

³ ["NASRA Issue Brief: Public Pension Plan Investment Return Assumptions," National Association of State Retirement Administrators, March 2010.](#)

⁴ ["Investment Return Assumption for Public Funds: The Historical Record," Callan Investments Institute Research, June 2010.](#)

Analysis Does Not Account for Recent State/Local Pension Changes

More state and local governments have enacted significant modifications to their retirement plans in 2010 than in any other year in recent history.⁵ Since 2006, nearly two-thirds of the states have made changes to benefit levels, contribution rate structures, or both⁶ and many more local governments also have made adjustments. Ignoring these alterations results in a gross mischaracterization of the current situation and disregards the measured approach that can be and has been taken to *realistically* and responsibly close pension funding gaps.

The Authors' Recommendations Do More Harm Than Good

In response to their dire projections, the authors have suggested that state and local governments should no longer offer pensions to new hires, recommending instead that such employees be covered with Social Security and a 401(k) plan, and that states and cities should issue debt – possibly at a federally subsidized rate – to pay off the added cost of closing pension plans. These recommendations ignore the significant cost and disruption that would be imposed by such changes:

- **Mandatory Social Security Adds Billions in Expenses.** Conservative estimates of the added expense of mandating newly hired public workers into Social Security are over **\$44 billion in the first five years alone**,⁷ which would worsen the financial condition of the sponsoring governments and their pension systems.
- **Putting New Hires Into a 401(k) Increases Costs.** Recent studies have shown that closing pensions to new hires can have several serious, unintended consequences, including increasing administrative costs associated with running two plans, forgoing or undermining economic efficiencies of traditional pension plans, accelerating pension costs for employees in the closed plan, worsening retirement insecurity, and potentially damaging employer recruitment and retention efforts.⁸ Moreover, although 401(k)-type plans are a useful means of supplementing pension benefits, they are inherently not as effective or efficient as a primary source of retirement income. By pooling mortality and investment risks, traditional pensions reduce participants' risk of outliving retirement assets and can provide the same benefit at nearly half the cost of a defined contribution plan.⁹ Unlike a traditional pension plan, a 401(k) does not include provisions for disability and death benefits, which are especially important for employees in hazardous occupations such as firefighters and police officers, who face higher risks in the line of duty. Without a pension, these benefits would have to be provided through commercial insurance, likely at significantly higher costs to the employer.
- **Issuing Debt and/or Asking for Federal Involvement Adds Risk.** Proposing that state and local governments should issue debt to fund their pension benefits adds risk to the funding equation. Such debt would become a liability for the sponsoring government. If the markets fall after the funds are invested, the government now has two sets of liabilities: the outstanding debt and the pension liability. Even with a federal subsidy – which is unlikely given current federal government budget constraints and which raises additional challenges – this is a risky approach.^{10, 11}

In the wake of the Great Recession, states and cities are examining and adjusting pension benefit levels and financing structures to restore reserves and long-term sustainability. Hyperbole and distortion, as presented in the referenced academic papers, are not helpful to these efforts or to the long-term fiscal health of state and local governments and their retirement systems.

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⁵ [“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ronald K. Snell, National Conference of State Legislatures, October 10, 2010.](#)

⁶ [“Pensions and Retirement Plan Enactments in 2010 State Legislatures,” Ron Snell, National Conference of State Legislatures, May 17, 2010.](#)

⁷ [“The Cost Impact of Mandating Social Security for State and Local Governments,” Cathie Eitelberg, Alexander Sussman, F.S.A., and Leslie Thompson, Revised 2005.](#)

⁸ [“Look Before You Leap: The Unintended Consequences of Pension Freezes,” Ilana Boivie and Beth Almeida, National Institute on Retirement Security, October 2008.](#)

⁹ [“A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans,” Beth Almeida, William B. Fornia, FSA, National Institute on Retirement Security, August 2008.](#)

¹⁰ [“Evaluating the Use of Pension Obligation Bonds,” *Government Finance Officers Association Advisory* \(1997 and 2005\).](#)

¹¹ [“Issue Brief: Pension Obligation Bonds: Financial Crisis Exposes Risks,” Alicia H. Munnell, Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry; Center for State and Local Government Excellence, January 2010.](#)



NATIONAL CONFERENCE
of STATE LEGISLATURES
The Forum for America's Ideas

February 4, 2011

The Honorable John Boehner
Speaker of the House
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Harry Reid
Majority Leader
United States Senate
Washington, D.C. 20501

The Honorable Nancy Pelosi
Minority Leader
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Mitch McConnell
Minority Leader
United States Senate
Washington, D.C. 20510

Dear Mr. Speaker, Ms. Pelosi, Senator Reid and Senator McConnell:

The nation's governors and legislators do not support proposals to provide states with bankruptcy protection.

Allowing states to declare bankruptcy is not an authority any state leader has asked for nor would they likely use. States are sovereign entities in which the public trust is granted to its elected leaders. The reported bankruptcy proposals suggest that a bankruptcy court is better able to overcome political differences, restore fiscal stability and manage the finances of a state. These assertions are false and serve only to threaten the fabric of state and local finance.

For the last three years, states have faced growing budget deficits and in each of those years, we have closed those deficits by spending cuts and when necessary increasing taxes. Governors and legislators have had to make tough and politically unfavorable decisions to be fiscally responsible and balance our budgets. Throughout this process, our colleagues never contemplated walking away from our obligations to our constituents or to the bond markets by requesting that the federal government allow states to receive bankruptcy protection. While a number of states continue to face budget deficits over the next few years, we will continue to use our sovereign authority to balance our budgets and meet our obligations.

State and local bonds and fiscal instruments remain some of the safest investments in the world. State leaders are keenly aware of their responsibility to manage their finances and repay their obligations. In contrast, the mere discussion of legislation, let alone the existence of a law allowing states to declare bankruptcy would only serve to increase interest rates and create more volatility in bond markets.

State and local leaders are interested in working with their federal partners to improve the fiscal stability of government at all levels. We call on Congress and the Administration to work with our members to eliminate unfunded mandates, provide greater flexibility to use federal funds more efficiently and avoid federal restrictions such as maintenance-of-effort provisions that hinder state and local authority to control their own finances.

These are difficult times in which to govern, but the challenges also provide us with the opportunity to work more closely together to find common solutions. We look forward to working with you to address the financial needs of the country and ensure our prosperity for the future.

Sincerely,



Governor Christine O. Gregoire
Chair, National Governors Association



Senator Richard T. Moore
Massachusetts Senate
President, National Conference of State
Legislatures



Governor Dave Heineman
Vice Chair, National Governors Association



Senator Stephen R. Morris
Senate President, Kansas
President-Elect, National Conference of State
Legislatures