



## State Pension Plans in Peril: The Need for Reform

September 2010

*"[W]ith the retirement of state employees that are part of the baby-boom generation and the continued rise in health-care costs, states' retiree pension and health-care obligations will become even more difficult to meet in coming years."*  
—Federal Reserve Chairman Ben S. Bernanke, August 2, 2010

Pension plans of the combined 50 states have promised to pay future retirees at least \$3.35 trillion over the next 30 years.<sup>1</sup> Persistent funding gaps over the past decade have created financial uncertainty for current and future retirees. To make matters worse, pension-plan investments incurred losses during the financial crisis, and declining household and corporate incomes have reduced state tax revenue. In many states, these issues have pushed the likelihood of insolvency to an alarming level.<sup>2</sup> Specifically, some estimate that state pensions will be unable to deliver on \$1 trillion of promised payments to future retirees. State governments must make significant changes to avert a crisis.

A government pension is a savings device wherein government agencies (and sometimes their employees as well) make regular contributions during their employees' careers. The collective savings for all employees in a plan are invested in interest-bearing securities. Typically, retirees collect a predetermined monthly payment based on length of service and average wage toward the end of their careers. A funding gap develops if contributions to the plan plus investment earnings are less than the current and future benefits promised to retirees. Over the past decade, short-term budget pressures have led several states to consistently operate their pensions at a deficit—an alluring quick fix. These deficits, however, further expand the amount states need to raise to fulfill their pension obligations. As a consequence of the recent financial crisis and recession, unfunded obligations drastically increased as pensions suffered investment losses. For example, the Illinois Teachers' Retirement System lost 22.7 percent (\$8.7 billion) of its net funds in fiscal year 2009,<sup>3</sup> and the Indiana Public Employees' Retirement Fund lost 20.8 percent (\$3.1 billion).<sup>4</sup>

Solutions to put pensions on a path to solvency likely require difficult choices. One option is to require state employees to increase annual contributions. Another is to decrease retirees' cost-of-living adjustments, for example, as Colorado did, from 3.5 percent to 2 percent per year.<sup>5</sup> Reducing retirement benefits or even raising the retirement age are other options. Eight state plans have partly converted to a [defined contribution](#) structure, which is similar to a 401(k) plan.<sup>6</sup> As an alternative to restructuring pensions, however, states could raise taxes or decrease spending on other public programs. Ultimately, the long-term solution is to adopt and strictly adhere to a [fully funded](#) pension structure—that is, contributions to pension funds plus interest accumulated must equal current and future benefits. This solution will not only prevent the current \$1 trillion in unfunded pension promises from growing but also mitigate problems in the event of significant investment losses in the future.

—By Lowell R. Ricketts, Research Analyst

<sup>1</sup> The Pew Center on the States. "[The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform](#)," February 2010, p. 15.

<sup>2</sup> According to the Pew Center on the States, 19 states face serious risks of pension insolvency.

<sup>3</sup> Teachers' Retirement System of the State of Illinois. "[Essential Facts About TRS: Public Information Summary](#)." April 2010, p. 9.

<sup>4</sup> Mercer Investment Consulting. "[\[Indiana\] Public Employees' Retirement Fund: 2009 Comprehensive Annual Financial Report](#)." August 28, 2009, p. 74.

<sup>5</sup> Jeannette Neumann. *Wall Street Journal*, "[Pension Cuts Face Test in Colorado, Minnesota](#)," June 12, 2010.

<sup>6</sup> Jeannette Neumann. *Wall Street Journal*, "[States Shift to Hybrid Pensions](#)," July 10, 2010.

## Additional Articles on Public Pensions

[“Population Aging and State Pensions in New England,”](#) by Richard Woodbury, New England Public Policy Center, Research Report 10-1, June 2010.

This article focuses on the challenges that changing age demographics present to the public retirement systems of the New England states. It provides excellent examples of how different New England pension plans structure their retirement incentives.

[“Why Don’t Some States and Localities Pay Their Required Pension Contributions?”](#) by Alicia H. Munnell, Kelly Haverstick, Jean-Pierre Aubry, and Alex Golub-Sass, Center for Retirement Research at Boston College, *State and Local Pension Plans*, Number 7, May 2008.

This article examines some of the reasons public pension plans have not been making contributions that are equal to the benefits they promise to future retirees.

[“Pension Fund Assets Struggle to Return to Pre-crisis Levels,”](#) by the Organisation for Economic Co-operation and Development (OECD), *Pension Markets in Focus*, Issue 7, July 2010.

This issue provides an in-depth look at international pension funds and how they have been affected by the recession.

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## Free Data Sources and Reports

- Data:** “The Funding of State and Local Pensions: 2009-2013”
- Description:** Provides ratios of assets to liabilities for over 100 state and local public pensions from 2001-2008 with additional projections for 2009 in Appendix A.
- Published by:** Center for Retirement Research at Boston College (*State and Local Pension Plans*, Number 10, April 2010)
- Location:** [http://crr.bc.edu/images/stories/Briefs/slp\\_10.pdf](http://crr.bc.edu/images/stories/Briefs/slp_10.pdf)
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- Data:** “Quarterly Summary of the Finances of Selected State and Local Government Employee Retirement Systems”
- Description:** Provides tables and figures tracking the performance of various investment categories for the 100 largest public-employee retirement systems in the United States from the first quarter of 2006 to the first quarter of 2010.
- Published by:** U.S. Census Bureau (GOVS/10-7, July 2010 release)
- Location:** <http://www.census.gov/prod/2010pubs/govs10-7.pdf>
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- Data:** *The Fiscal Survey of States, June 2010*
- Description:** Provides a wealth of information on both state expenditure and revenue for all 50 states for fiscal years 2009 and 2010.
- Published by:** The National Governors Association and the National Association of State Budget Officers
- Location:** <http://www.nasbo.org/LinkClick.aspx?fileticket=gxz234BIUbo%3d&tabid=38>

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