It is a great honor to be here at the 2012 Alabama Legislative Symposium and my thanks to Lisa Woodard and the School Superintendents of Alabama for extending this invitation to me and to The Council of State Governments (CSG). CSG, established in 1933, serves all three branches of state government by fostering the exchange of insights and ideas. While I work for CSG's Southern Office, the Southern Legislative Conference (SLC) in Atlanta, CSG is headquartered in Lexington, Kentucky with regional offices in California, Illinois, New York and Washington, D.C. A number of Alabama legislators have been actively engaged in CSG and SLC for many decades and we greatly value their support and participation.

My presentation deals with a topic that has enormous implications for state finances: public pensions. Broadly, my presentation comprises five interconnected parts. Part I explores how the overall condition of state finances impacts state retirement systems. Part II reviews why it is important for policymakers to focus on the financial position of state retirement systems. Part III looks at where we stand in terms of state pensions and Part IV provides a snapshot of several key developments related to these plans. Finally, Part V describes the various strategies deployed in states across the country to bolster their pension systems.

Part I: State Fiscal Position and State Retirement Systems

The U.S. economy continues its cautious recovery from the Great Recession, the longest, broadest and most severe downturn since the Great Depression. Across a broad range of indicators—gross domestic product; national unemployment; housing and construction; stock market; corporate profits; consumer confidence; and manufacturing, the U.S. economy faced incredible challenges during the height of the Great Recession. However, as grim as the current economic situation is, particularly for the millions of unemployed and under-employed Americans and those facing foreclosure and "underwater mortgages," there are a number of positive signs that—compared to 2009 and 2010—the U.S. economy is moving in the right direction.

At the state level, the effects of the Great Recession have been crushing: between fiscal years 2009 and 2013, states have either closed or will close an estimated $581 billion in shortfalls, the largest on record. Fiscal year 2010 was particularly harsh with states slashing $191 billion from their budgets. While the state revenue picture has improved in the last year or so, they still lag the revenue intakes from four years ago. For instance, state revenues in the current fiscal year, 2012, are expected to crest at $659 billion, considerably lower than the $680 billion reached in fiscal year 2008, the last year before the Great Recession. On the positive side, fiscal year 2012 revenue inflows are estimated to be higher than the amounts recouped in fiscal years 2010 and 2011. In terms of additional economic criteria, both state unemployment and foreclosure rates, while still high, have improved from the heights reached in 2009 and 2010.

In the last decade or so, states have struggled through the recession of 2001 and then the Great Recession, events that resulted in huge budget shortfalls in practically every state. Given the constitutional requirement in 49 of the 50 states to balance their budgets, states deployed a number of strategies to meet this condition. Chief among these strategies was slashing spending. Hence, in an effort to reduce their expenditures, a number of states opted to forego paying the full amount of the annual required contribution (or ARC) towards their state employee retirement systems in the last decade. Some of the states that opted to skip making the full ARC included Alaska, Indiana, Louisiana, Massachusetts, Michigan, New Jersey, Pennsylvania and Washington. In North Carolina, in response to the intensity of the 2001 recession, the governor reduced the contribution to the state's retirement system by $129.9 million;

importantly, this amount was repaid in subsequent years through lump sum appropriations. In New Jersey, in 2011, all three credit rating agencies lowered the state's bond rating because the state had skipped or greatly reduced its payments into its public pension fund for over a decade, a lapse that contributed to the state's massive unfunded pension liability. In 2010, New Jersey's $10.9 billion budget gap was closed, in part, by foregoing $3.1 billion in pension contributions. Hence, in a tough fiscal environment and with the enormous pressure to balance budgets, states often sacrifice making their required pension contributions as a way to lower their overall annual expenditures.

Part II: Why Policymakers Should Focus on State Retirement Finances?

Even before the onset of the Great Recession, there was growing consensus across the country that more attention needed to be directed toward retirement planning and developing a retirement infrastructure with the capacity to absorb the needs of all Americans. Reforming public pensions was an important element of these discussions and many states had or were in the process of initiating remedial measures. This included setting aside funds to pay for "other post-employee retirement benefits," OPEB, comprising mostly retiree healthcare. Even though these remedial efforts were displaced by the need to bridge significant budget shortfalls during the Great Recession, in the last two years, states have re-initiated measures to bolster their public pensions.

There are four major reasons why the financial future of state retirement systems should command the undivided attention of policymakers.

One, public pensions are only one in a list of sizable expenditure categories that policymakers are grappling with currently. In the aftermath of the Great Recession, states also face huge expenditures in such areas as healthcare, education, emergency management, corrections, infrastructure, unemployment insurance, transportation and of course, public pensions.

Two, a close review of national financial and demographic trends reveals that every element of our nation's retirement architecture faces challenges, a development that threatens to jeopardize the retirement plans of a majority of Americans. Alongside the weaknesses in public retirement systems, other strands in our retirement architecture—the looming shortfalls expected in Social Security and Medicare; the precarious financial position of corporate pension plans and the federal Pension

Benefit Guaranty Corporation (PBGC); and, the low personal savings rates of most Americans, coupled with high rates of consumer and household debt—remain very troubling.

Three, our society is an aging one and federal statistics indicate that in 2030, 19.3 percent of the U.S. population will be 65 years or older. In comparison, in 1900 only 4.1 percent of the U.S. population was 65 years or older and in 2000, the percentage was 12.4 percent. In 2011, 40 million people in the U.S. were 65 and older, but this number is projected to more than double to 89 million by 2050. In terms of a state-by-state breakdown, by 2030, the 60 years and over age cohort as a percent of total population will be less than 20 percent in a mere 2 states; the 60 years and over population as a percent of total population will between 20 and 30 percent in 39 states; and, it will be more than 30 percent in 9 states.

Four, along with the wave of baby boomers that were eligible to retire in 2008, experts point to the fact that people are living longer. According to the latest Statistical Abstract, life expectancy at birth in the U.S. hit a new record of 78.3 years in 2010. In contrast, life expectancy in 1970 was 70.8 years. In Alabama, the 2010 Census recorded 24,940 people 90 years or older, a 7.5 percent increase from 2000. This trend has led to a steadily declining worker-to-beneficiary ratio in terms of workers paying into Social Security: from 16.5-to-1 in 1950, to 3.4-to-1 in 2000, to 2.9-to-1 in 2010 and to a projected 1.9-to-1 in 2035.

These four reasons cumulatively amount to a fiscal tsunami looming ahead on our nation's financial horizon that requires the urgent attention of policymakers at all levels of government.

Part III: Where Do State Retirement Systems Stand?

Before the onset of the Great Recession, a number of research studies, including several SLC reports, had indicated that a majority of public pension plans were under-funded or unfunded to varying degrees, i.e., assets were less than their accrued liability. Many experts consider a funded ratio (actuarial value of assets divided by actuarial accrued liabilities) of about 80 percent or better to be an adequate level for government pensions. The farther a plan's funding level is below this optimal amount, the greater the contributions the government will eventually be required to make to finance its unfunded liability.

A number of recent national studies highlight some of the financial difficulties confronting public pension plans. For instance, a very comprehensive February 2010 report from the Pew Center on the States noted that there was a $1 trillion gap between the $2.35 trillion states had set aside to pay for employees' retirement benefits and the $3.35 trillion price tag of those promises. The report attributed several reasons for this gap: states failing to make annual payments at levels recommended by their own actuaries; expanding benefits without fully determining how to pay for them; and, providing healthcare without adequately funding it. A February 2011 report by Wilshire Consulting noted that the ratio of assets-to-liabilities, or *funding ratio*, in the 126 plans studied was 69 percent in 2010, an improvement from the 65 percent reported in the prior year. In contrast, a decade ago, in 2001, the funding ratio for the 126 plans was an impressive 95 percent. Then, a March 2011 report from Standard & Poor's documented that public pension plans had a mean funding ratio of 75 percent in 2009, down from 80 percent in the previous year. S & P added that while state pension liabilities were not jeopardizing any state's ability to meet their debt obligations, the failure to initiate remedial measures could result in adverse long-term fiscal consequences. Finally, the latest 126-plan survey from the National Association of State Retirement Administrators (NASRA) showed that the actuarial funding ratio for these plans was 77.1 percent.

It should be noted that given the extended time lag involved in the reporting of pension plan data, the findings in the studies listed above included the unprecedented losses experienced by state pension plans during the financial meltdown of fall 2008 and portions of 2009. More recent reports from individual plans reflect that with the comeback of the equity markets, the financial fortunes of state pension plans have improved from those dark days. In fact, in April 2011, Pew issued a report with analysis of fiscal year 2010 data for just 16 states with the finding that six of these states (Delaware, Tennessee, Texas, Florida, Iowa and Minnesota) had funded ratios that exceeded 80 percent, quite an achievement given the sharp drop in investment earnings during 2008 and 2009.

Part IV: Key Recent Trends Associated with Public Pension Plans

My ongoing review of public retirement plans reveals several trends. First, the increasing move by state plans to invest in non-governmental securities (such as corporate bonds, stocks, foreign investments, hedge funds and real estate) away from government securities (such as U.S. Treasuries). According to the latest federal data, in 1993, state and local government retirement plan investments in non-governmental securities amounted to 74 percent as a percent of total cash and investment holdings;

by 2009, this percentage had escalated to 90 percent. As expected, while pension plans enjoyed above-average investment returns when the equity markets soared, they experienced steep declines when they disintegrated.

Second, in the last decade, given a spate of accounting and corporate scandals and revelations of “pay-to-play” incidents, there is a great deal more activism on the part of the boards overseeing public pension plans and state lawmakers to monitor their performance more closely. A number of state pension plans (California, Maryland, New York, Iowa and North Dakota, among others) were plagued by financial scandals leading to policymakers in those states initiating reviews and reforms.

Third, the impact of a Governmental Accounting Standards Board (GASB) ruling on public pension plans. (GASB is the independent standard-setter for 84,000 state and local government entities.) According to this ruling, state and local governments have to place a value on “other post-employee retirement benefits”—comprising mostly health care—they promise to employees. They have to record as an expense the amount—the annual required contribution—they would need to stash away to fully fund this long-term liability over 30 years. This is because nearly all governments pay for health benefits for their retired employees on a pay-as-you-go basis each year and generally, do not set aside funds to address future benefit obligations. Given that healthcare costs in the United States are rising so rapidly, this GASB ruling is designed to provide a complete and reliable reporting on the costs of future financial obligations such as retiree healthcare.

Four, the unprecedented decline in government jobs in the wake of the Great Recession, a trend with a direct impact on public pensions. In the last three calendar years (2009, 2010 and 2011), government employment declined by 2.6 percent, a remarkable number not experienced in decades. State employment fell 1.2 percent in 2011 — the largest percentage for any year since counting began in 1955; it is down 2.2 percent over the last three years. Local government jobs, usually considered 'super safe,' declined in each of the last three years; since the federal government began tracking this statistic in 1955, there have been only six years when local government employment declined: 1981, 1982 and 1983 and 2009, 2010, 2011. Cumulatively, local government jobs declined by 3.5 percent over the last three years but local education jobs alone are down 3 percent. At the federal level, employment fell 1.3 percent in 2011. These unprecedented declines have multiple effects: not only do they lower payroll costs they also reduce pension costs and liabilities.

Part V: Strategies Deployed by States to Bolster Pension Plans

In responding to the growing crisis associated with their pension liabilities, lawmakers around the country have either proposed or adopted a number of strategies to buttress the finances of their systems.

- Pension Obligation Bonds:

Given their increasing fiscal problems, states and localities opted to issue debt to raise money to plough into their pension systems and pay off, in a lump sum in today's dollars, their unfunded liabilities. A number of factors propelled this trend: one, the low interest rate environment, a development that has been in place for a number of years; two, the increasing proportion of equity holdings in pension funds, a development that generated higher returns in boom years and allowed actuaries to assume higher future returns; and, three, the fact that raising taxes continues to be politically radioactive, a development that thrust raising funds via enhanced borrowing as an attractive strategy.

Since the city of Oakland, California, issued the first pension obligation bond in 1985, this strategy has been pursued in nearly three dozen states. California (nearly $15 billion), Illinois (nearly $13 billion), Oregon (about $5 billion), New Jersey (about $4 billion) and Connecticut (about $3 billion) rank among the largest issuers in the last decade or so. Kansas lawmakers are expected to decide very shortly on a $5 billion pension obligation bond issue to shore up that state's retirement system, the largest "loan" in state history.

In selling these bonds, states are counting on the interest payable on the bonds being lower than their pension investment earnings. If a state pension plan can earn 8 percent by investing money the state borrowed at 4 percent, the state is ahead of the game. Another advantage is that states experience immediate budget relief because their current year contributions to a pension plan can be secured from the proceeds of the bond issue.

On the flip side, there is always the possibility that the market may not generate the returns to cover the interest rate. Furthermore, once a state issues a bond, it is locked into paying the debt whereas with the usual annual required contribution, the state has much more flexibility in deciding on future pension contributions, including size, rate and regularity.

New Jersey's experience in the 1990s offers a cautionary tale for a state or locality mulling this option. Then-Governor Christine Todd Whitman led an effort that resulted in the state issuing $2.8 billion in bonds that promised to pay off its unfunded pension liability, solve all of its pension problems for the next 36 years, make the state's contributions to the plan for that year and free up $623 million for tax cuts. The state banked on getting returns exceeding 7.6 percent, the interest it was paying on the bonds. For the first few years, while the economy surged ahead and the stock market roared in the 1990s, the gamble appeared to have paid rich dividends. Then, in 2000 and 2001 the economy slumped and the stock market collapsed resulting in a severe drop in investment earnings. By mid-2003, even after the stock market had recovered, the state only saw returns of 5.5 percent, significantly lower than the required 7.6 percent. The state's pension plan was in deep trouble. New Jersey's current pension troubles may be traced to this move, a development further compounded by the state's decision to skip annual pension contributions in several subsequent years. Hence, New Jersey's experience offers a warning of a pension obligation bond offering that could go horribly wrong.

In the last decade or so, states have worked on improving the funding positions of their pension plans. These reform efforts gathered a sense of urgency in the last two calendar years. Consequently, some 40 states have made a range of legislative and policy changes to their public retirement plans in an effort to improve the actuarial viability of their systems. In 2010, some 21 state enacted reforms while in 2011, 27 states revisited their pension plan policies. The expectation is that this trend will continue in 2012 with more states making revisions to reinforce their pension systems. Here are some of the reforms that were enacted in 2011:

- Increasing employee contributions: While 16 states increased employee contributions, the increase applied to current employee in 12 states and new employees in the remaining states. In eight of the 16 states, the increased employee contribution will be offset by reduced employer contributions. For instance:
    - Delaware employee contributions increased from 3 percent to 5 percent of annual compensation;
    - Hawaii employees contributions rose from 7.8 percent to 9.8 percent of compensation;

- All members of the Florida Retirement System (FRS) will now make an annual contribution of 3 percent of salary.

- Cost of Living Allowance (COLA) Increases: State pension payments had routinely included an automatic COLA increase, usually pegged to the Consumer Price Index, as a mechanism to stave off the eroding effects of inflation. In 2011, 10 states revised their automatic COLA provisions with most of the reforms impacting employees who will retire in the future or future hires. For instance:

  - Connecticut retirees after 2011 will receive a minimum COLA of 2 percent instead of the previous rate of 2.5 percent;
  - COLA increase for Maine retirees were "frozen" for three years and then capped at 3 percent in future years;
  - In Oklahoma, the COLA increase has to be fully paid for by the Legislature every year if it is to be provided;
  - In 2009, Minnesota enacted a guaranteed minimum COLA and in 2010 repealed that provision and replaced it with lower COLA amounts for current retirees until 90 percent funding is achieved for the entire pension plan. This was immediately challenged in court; however, the court ruled that retirees have "no reasonable

expectation of a particular COLA and that there was no contract for a particular COLA based on statutory language;"

- Also, in 2010, Colorado enacted broad pension reforms that, among other things, capped COLAs at 2 percent for current retirees. Once again, this was challenged and the court ruled that retirees have "no contractual right to the specific COLA formula in place at retirement" and that there was "no 'clear and unmistakable' right to an unchangeable COLA for the rest of their lives."

- Age and Vesting Requirements: Some 15 states increased age and vesting restrictions in 2011, restrictions that covered mostly future hires but non-vested employees in a few states. Typically, the retirement age was moved up to 65 years and the minimum vesting period was increased to between eight and ten years. For instance:
  - North Carolina increased the vesting requirement for new employees from five years to 10 years;
  - New employees in New Jersey will need 30 years of service and be 65 years for early retirement without reduced benefits;
  - For new employees, Florida increased the retirement age from 62 to 65 years and increased the creditable service from 30 to 33 years.

- Calculating Final Salary: Six states lengthened the period that determines the final average salary for pension benefits. In most cases, this involved an increase from the highest 36 months to highest 60 months. Florida was the exception, increasing it from the highest 60 months to the highest 96 months.
- Defined Contribution and Hybrid Plans: While switching employees to defined contribution (DC) plans from defined benefit (DB) plans was the rage a few years ago, this trend has abated recently. Only two states – Michigan state employees since 1997 and all Alaska public employees since July 2005 – have made a complete switch to DC plans. However, states are offering employees a choice and in 2011, Rhode Island switched most active members to a hybrid plan with lower defined benefits combined with mandatory participation in a DC plan. Indiana established a DC plan as an option for new state employees.
- DROP Restrictions: Arizona limited eligibility for the state's deferred retirement option plan (or DROP) for certain members to those who joined before January 1, 2012. Florida reduced the rate of interest to

1.3 percent (from 6.5 percent) for members who entered the DROP on or after July 1, 2011.

- Consolidating Pension Boards: West Virginia and Vermont did this a few years ago and in 2011, Minnesota merged two municipal pension funds into the statewide Public Employees Retirement Association.

Conclusion:

In conclusion, as states emerge from the Great Recession, among the major expenditure categories they will have to contend with include unfunded and under-funded pension liabilities. Even before the Great Recession, public pensions faced challenges and state policymakers had begun enacting significant reforms to raise funding levels, a trend that continues today. These changes will result in public employees working longer, paying more for benefits, seeing reduced benefits and finally, governments partially relinquishing responsibility for an employee's pension by moving them to hybrid plans.

The weakened public pension outlook was the result of states skipping their required contributions, granting pension benefits without funding them and the severity of the 2001 recession and the Great Recession while demographic changes and the steep rise in healthcare costs were contributory factors too. Meeting the latest OPEB requirements is vital and failure to act on this issue could damage state bond ratings. Notwithstanding these myriad challenges, states have initiated – and will continue to -- introduce measures to get a handle on their pension systems. It is also important to note that the shortfalls in these public pension plans do not have to be solved overnight but over a period of decades though the presence of a long-term plan towards solvency is critical.

The “graying” of America, the fact that states will have more retirees living longer in the coming years and the ability of the public sector to attract quality employees in an era of dwindling retirement benefits, requires innovative solutions. Further complicating the public pension outlook is the fact that the financial viability of every other element of our retirement infrastructure remains shaky. Ensuring both the short-term and long-term financial viability of the different elements in America’s retirement systems, both private and public, remains of paramount importance. In fact, first resuscitating and then sustaining the financial health of our different retirement income flows provides the foundation of the United States as an economic, political and military powerhouse in the global context.