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Defusing the Pension Bomb: Making Retirement Plans Solvent for All Public Workers

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INTRODUCTION

Arizona's current public pension systems are costly, present needless risk to taxpayers, and drain tax resources from other potential uses. If policies are not changed, taxpayers will be on the hook to pay for these bloated plans far into the future, and other government programs may have to go on the chopping block to pay for pension benefits. Young employees, part of whose salaries are funding current pensions, are also at risk of never receiving the benefits they've already paid for if pension funds collapse under the weight of poor policy.

These risks are already understood by the Arizona legislature, as evidenced by the passage of Senate Bill 1609. This bill limits abuses such as "double-dipping" when retirees go back to their same jobs while receiving a pension. It also requires current employees to contribute more to their own retirements. However, the real risk is in the nature of pension systems themselves. Benefits guaranteed at future taxpayers' expense have to be funded even when economic times are bad. Benefits that are granted to retirees when economic times are good and pension funds' portfolios are flush cannot be rolled back when portfolios collapse with the pop of an economic bubble.

One way to see how Arizona's pension systems stack up is to compare them to a private employer's 401(k) contributions to employees. The average private employer's contribution to an employee's 401(k) is 3 percent of salary.[1] Taxpayers are currently contributing about 9.8 percent of state government employees' salaries to their pensions, amounting to $173.6 million per year.[2] If the public contribution fell to 3 percent of government employees' salaries, the annual contribution would be $53.1 million, saving $120.5 million, or more than 10 percent of Arizona's projected $1.1 billion budget shortfall for 2012. But the current level of public funding of pension plans is likely to remain the same into the foreseeable future as pension fund portfolios are rebuilt to make the systems financially sound.

Arizona's pension systems are "defined benefit" systems, meaning a retiree receives a set pension each year after retirement determined by multiplying the retiree's salary level near the time of retirement by years of government employment and a multiplier of about 2 percent. Pensions are paid from funds accumulated through mandatory

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contributions by employees and taxpayers. Contributions are a percentage of current salary levels, and can vary from year to year according to the financial needs of the funds from which pensions are paid.

In 1998, the Arizona State Constitution was amended to include Article 29, Section 1(C), which states, "Membership in a public retirement system is a contractual relationship that is subject to article II, section 25, and *public retirement system benefits shall not be diminished or impaired*" (emphasis added). Before 1971, Arizona's retirement benefit was a defined contribution plan wherein the only guarantee was how much taxpayers were obligated to contribute; not how much they are required to pay out. The state managed employees' retirement investments and lifetime annuities were not guaranteed.[3] This is more like the business-sector 401(k) plans.

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Today, Arizona's public retirement systems have first priority in state funding since the funds come from general revenue sources but are not appropriated. The boards of the respective pension plans determine the level of contributions and state and local taxpayers are obligated to pay for them through their respective governments. This is in contrast to the defined contribution systems adopted in Alaska and Michigan, which are basically 401(k) retirement plans. There, taxpayer liability is limited to a contribution to a retirement account that the employee owns and controls. The Alaska and Michigan systems provide useful models for Arizona to follow as it works to stabilize its employee retirement benefit obligations.

Arizona's Financially Troubled Pension Systems

Arizona's pension systems' annual reports overstate their financial health. The Arizona State Retirement System (ASRS) assumes the lowest rate of return on investment at 8 percent. This is ridiculously high given the current market realities. Even with a slightly more reasonable 7 percent rate of return amortized over 30 years, Arizona's public employee retirement plans would all be in or near "red zone" status.

The federal government monitors the financial health of private pension plans. Generally, when a plan's funding level falls to 65 percent or less, it is classified as in critical or red zone status. The plan must then take action to improve its financial position, including suspending cost of living adjustments and tempering benefit payouts wherever it can.[4] One remedy is to increase contribution rates, just as has been done with the state's pension plans. However, contribution rates today are very high, and there is little room for the state's contribution rates to go any higher given the state's fiscal realities. All of the plans would undoubtedly be in red zone status if a risk-free rate of return of 5 percent or less were applied. One reason pension assets have suffered so profoundly in the recession is that the pension funds were over-invested in risky assets in pursuit of high rates of return to justify their actuarial practices.[5]

Arizona's retirement systems pool state and local government employees; none of the systems are exclusively for state employees or local employees. Total required taxpayer contributions for all levels of government and for all of the retirement plans in Fiscal Year 2010 amounted to $1.1 billion. This contribution level is more than five times higher than in 2003, an absolute difference of $921 million. That means the average Arizona household is paying $370 more per year into Arizona's public employee retirement systems today than in 2003. If the contribution level were lowered to 3 percent—in line with private pension contributions—Arizonans would be paying about $70 more per household than 2003 levels.[6]

Arizona's pension systems include the following:

- The Arizona State Retirement System (ASRS), under which most state and local government employees retire. ASRS requires a taxpayer contribution equal to 9.6 percent of salaries. Next year, it will be 10.5 percent.[7] Contribution rates are expected to rise yearly for the next 10 years to over 11 percent and could reach even higher by 2020, with employees covered by ASRS paying the same rate as taxpayers.[8] Taxpayer and employee contribution rates have been as low as 2 percent but lower than 3 percent for only five of the 31 years since 1980. ASRS assumes an unrealistically high rate of return of 8 percent on investments in calculating its net asset value and, based on this, is currently 79.3 percent funded.[9]

- The Public Safety Personnel Retirement System (PSPRS) covers firefighters and police, who pay a fixed 7.65 percent of salary into the system. The current aggregated average contribution of all state and local government employers is 20.89 percent of salaries and will increase in July to 22.68 percent. The current funding ratio for PSPRS is 65.8 percent and is expected to fall. This is despite using a high assumed rate of return of 8.5 percent to calculate net assets.[10] The state pays close to 30 percent of salaries for its participating employees.[11]

- The Corrections Officers Retirement Program (CORP) covers corrections officers (prison guards). They currently pay a fixed 7.96 percent of salary into the system, a reduction from 8.5 percent in 2007. The current aggregated average contribution of all government employers, including the state, is 8.59 percent of salaries and will increase in July to 9.5 percent. Due to 10-year averaging of assets, CORP's funding level is over 80 percent, which is considered healthy. If measured by actual assets, however,

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CORP's funding level would be at only 65 percent. CORP's assumed rate of return for valuation purposes is a high 8.5 percent.[12]

- The Elected Officials Retirement Program (EORP) covers elected officials in the state, including the governor, state senators, representatives, and other elected officials at the state level, county level, and some cities and towns, including Phoenix and Tucson. It too uses an assumed rate of return of 8.5 percent. EORP's funding level is at only 66.7 percent, but this is due to smoothing, wherein an average value of assets over the last few years is the basis for comparison liabilities. Current assets would put it at only 52 percent funded. The employer contribution rate is expected to increase to a whopping 32.99 percent of salaries in July. The current rate for employee contributions is fixed at 7 percent of salary and has been at this rate for the last 10 years.[13]

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Reforming Arizona's Pension Systems

Perhaps the single biggest impediment to real reform of the state's government employee retirement systems is the state constitution. Article 29, Section 1(C) of the Arizona Constitution states, "Membership in a public retirement system is a contractual relationship that is subject to article II, section 25, and *public retirement system benefits shall not be diminished or impaired*" (emphasis added). This section is currently interpreted to mean that once someone is hired into government service in Arizona, that person is guaranteed taxpayer contributions into a guaranteed pension retirement plan until he or she retires. This means government employees have the right to earn a pension for the duration of their employment and basic factors that determine their pension in retirement cannot be altered except in the employees' favor.

While the Arizona Constitution presents a challenge to changing current benefits, it does not eliminate all possibility of reform to the state's pension systems. Following are some suggested reforms, all but the last of which can apply to public employees right away without a change to the Arizona Constitution:

1. **New government employees should be placed in a defined contribution (401(k)) plan. At the very least they should be given the option of joining the pension plan or choosing a defined contribution plan, but not both.**

   The way of the future is to allow individual employees to own their retirement savings. Since 1997 all new employees of the State of Michigan are placed in a defined contribution plan.[14] In Alaska, all state employees hired after 2006 are placed on a defined contribution plan.[15]

A defined contribution plan is not a collective plan; each employee would have his or her own individual retirement account. In a 401(k), an employee owns his personal retirement fund and directs its investments. The state could define a range of possible investments as long as the employee continues their government employment. The employee could determine the amount of his salary deposited into his retirement account according to federal limits. Income deposited into and investment gains from the account would not be taxed. Income taxes would apply only to withdrawals after retirement. Withdrawals prior to retirement would be taxed and penalties would be assessed as well. As owner of the account, the employee would be able to bequeath balances to heirs or others as they see fit, an option that does not exist in pension systems. Accounts could also be used as collateral for personal loans, such as homes or cars.

Policymakers should make some provision for employees to obtain financial advice. Employees could be required to make minimum contributions to their retirement accounts. This recommended reform would shift investment risk from taxpayers to government employees. But government employees would face no more risk than do the vast majority of taxpayers working in private industry today.[16]

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2. **Require the retirement plan actuaries to present multiple discount-rate scenarios rather than using a single optimistic rate.**

As noted earlier, in determining their financial positions, the pension plans use unrealistically high discount rates of 8 and 8.5 percent. Effectively, they are assuming that their rate of return on investments will minimally match these rates. The last decade proves the folly of such an assumption; had the stock market risen at 8 percent per year since 2000, it would be at 24,000 rather than the current 12,000 level. At least two less optimistic scenarios should also be presented in reports to policymakers. Discount rates should be no higher than 5 percent.[17]

3. **A condition of the acceptance of a promotion should be to place the promoted employee in a defined contribution (like a 401(k)) retirement plan, while allowing the employee to retain any pension already earned.**

This would not violate Article 29, Section 1(C) of the Arizona Constitution since the contract is legally renegotiated with the promotion acceptance.[18] Promotion is a good time to switch to a defined contribution plan, staggering the adoption of the new plans. In addition, the pension that has already been earned will still go to the employee upon retirement.

4. **Adjust contribution rates of all systems to require greater employee contribution shares.**

   An equal contribution rate encourages more circumspect decision-making regarding pension funds since current employees take a more active role in governance of the fund.

   In the last seven years, taxpayers have contributed double the rate of elected officials covered by EORP.[19] Also in the last seven years, taxpayers have contributed more to the retirements of police and firefighters than police and firefighters themselves and will soon double employee contributions.[20] On the other hand, it has been only in the last two years that taxpayers have contributed more to the corrections officers' pensions than the officers themselves.[21] ASRS is already at a 50-50 share; that is, employees and taxpayers pay the same percentage.

5. **Require that retirement benefits be calculated on only the base salary, not to include overtime and other enhanced pay in the last few years of employment.**

   The state should require that retirement benefits be calculated on only the base salary, not to include overtime and other enhanced pay in the last few years of employment.

   It is not uncommon for overtime pay and other pay for extra services provided by an employee to count toward the total compensation computation that helps determine a retiree's pension. This pads a retiree's pension for life even though income is unusually enhanced, and contributions to retirement accordingly made, only for a few years. The state should not allow any practices that artificially enhance a retiree's income.

   Making the playing field level by requiring all retirement benefits to be calculated on base salary alone would lessen the financial risk to taxpayers substantially.

6. **Eliminate or severely curtail "double-dipping."**

   Double-dipping occurs when a retiree is re-hired into effectively the same position from which that person retired while still receiving pension payments (i.e. early retirement/rehire and the Deferred Retirement Option Program (DROP) in PSPRS). On the books, state and local governments save money with the most common double-dipping scheme by effectively using a retiree/employee's pension as partial compensation. The retiree/employee's total income increases while the cost of the retiree/employee to an agency is reduced in the short term. This puts unanticipated pressure on the retirement system by encouraging earlier retirements than would otherwise occur, and in the end it costs taxpayers more money. The types of policies currently in place encourage employees to take advantage of the system.

Minimally, rehiring of an employee already receiving a taxpayer-funded pension should be permitted only after the former employee received a pension for at least a year. Proper policy would be to require the employer to pay a standard salary and the employee to stop drawing a pension while employed. The employee should not be allowed to skirt this requirement by acting as an employee of a contractor. DROP should be eliminated.[22]

7. **Increase transparency by including a statement of how much potential funding in the general appropriations act will be used for retirement funds and by having breakdowns in other appropriations reports.**

In their annual reports, the pension funds report how much funding they receive from all employer entities in one lump sum. There are no breakdowns of funding from the state, specific cities, counties, or other governmental units. State appropriation reports do not break out contributions to pension funds and no historical context is provided. State contributions to pensions are not appropriated. The boards of the respective pension funds determine the appropriate contribution rates and the state is obligated to provide the funding. This lack of information makes it difficult for policymakers to make informed decisions.

In annual reports for each pension program, there should be detailed breakdowns of exactly where funding comes from. Reports should also provide historical context. State contributions should be appropriated so taxpayers have some say in what their contribution rates and liability will be.

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8. **Prohibit the subsidy of any retirement plan special taxes and repeal taxes on fire insurance premiums that help fund PSPRS.**

Firefighters are local government employees and the most transparent way to fund their retirements is to fully account for government contributions at the local level. Statewide taxes, especially obscure ones paid on insurance premiums, are not transparent. In 2010, Arizonans paid $12 million in fire insurance premium taxes to PSPRS. In 2009, they paid almost $25 million.[23] If taxes are to be levied to specifically subsidize a retirement plan, they should be designated specifically for this purpose in a very transparent way.

9. **Set aside surplus pension funds during bull markets in pension "rainy day" funds to weather market downturns; do not increase benefits; do not reduce contributions to unsustainably low levels.**

   Contribution rates to ASRS have been as low as 2 percent in years past when the fund was flush with cash from the technology investment bubble of the 1990s. If defined benefit systems are to be retained, it is time to establish constitutional rules to impose some discipline. Contribution rates should not fall below 5 percent. Benefits for current and future retirees should not increase unless the funded level is well above 100 percent. There should be a substantial level of over funding during good economic times for the inevitable rainy day like the recent recession. Current practice is to increase benefits during good economic times, making it necessary to substantially increase taxpayer and employee contributions when downturns occur. This cycle must stop.

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10. **Allow local governments that have opted into ASRS to opt out with new employees.**

    When ASRS was created, local governments were given the option of whether to join the new system or to independently determine retirement benefits for their employees. Local governments have now been informed by ASRS that they may not opt out of the system in any way, even if they would like to go a different direction with new employees. Local governments should be allowed to leave the pension systems with new employees, but the decision must be final. They should not be able to change back and forth.

11. **For new employees, increase the retirement age to 70 for most government jobs, doing away with experience-plus-age early retirement rules. For law enforcement, do not allow collection of annuities until age 65, adjusting annuities accordingly.**

    Police and firemen can retire after 20 years of service with 50 percent of their pay. That means a policeman or fireman who began work at age 22, worked for 20 years, and passed away in his 90s could have received a retirement annuity for 50 years or more. Employees in ASRS can retire with full pension benefits according to the Rule of 80 or Rule of 85. This means that if age of the employee and years of service total to 80 or 85 (depending on when the employee was hired), that employee can retire with full pension benefits. A teacher who began work at 22 could retire after 29 years with a pension as early as age 51 under Rule of 80 and pass away in his 90s having received an annuity for over 40 years. No one would be-grudge a dedicated firefighter or teacher a retirement, but paying full benefits for more years than an employee ever worked was never the purpose of these systems. It puts too much pressure on taxpayers to fund benefits for so many years.

12. Under ASRS, the retirement multiplier should be a fixed number no higher than 2.1.

This change could only apply to new employees. At its simplest, a retirement annuity under ASRS is calculated by first multiplying an employee's number of years of service by a fixed percentage (multiplier) determined in statute. This result is then multiplied by a retiring employee's average salary from the last few years before retirement. Automatically, a retiree's annuity grows with salary increases and with years of service. Arizona statute also grows the annuity in stair-steps by increasing the multiplier from 2.1 percent to 2.3 percent between 19 and 30 years of service in 5-year incremental steps. This was likely done to encourage longer service. However, the fact that the annuity grows by 2.1 percentage points for every additional year of service is enough incentive to continue working.[24] Current policy encourages marginal increases in employee tenure in order to gain a large payoff that is costly to taxpayers and current, less-tenured employees.

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13. If Article 29, Section 1(C) of the Arizona Constitution is repealed, then current employees' retirement benefits should be changed as follows:

A) Pensions already earned should be retained, and

B) Going forward, any retirement benefit will be in the form of a defined contribution (i.e. a system similar to a 401(k)).

A defined contribution system gives employees control over their own wealth. An employee who decides to retire early can do so without sacrificing the wealth he has accumulated. Alternatively, if he decides to retire at 70 and work overtime for additional retirement income, he can do so without subsidizing the retirement of others and without others subsidizing him. A retiree can annuitize his wealth and shift investment risk to others, similar to a reverse mortgage. The possibilities for someone who owns his own retirement fund wealth are numerous. For those in a pension system, the choices are very limited.

Conclusion

Arizona's current pension systems overstate their financial health by assuming unrealistically high rates of return. Arizona has promised to pay out $50.1 billion in benefits but currently only has $29.4 billion in the bank. Moreover, the existing system enables abuse through double-dipping. While the Arizona Constitution makes wholesale reform difficult, there are several important reforms that can be taken now to put Arizona's pensions back in the black. The most critical reform is to follow the examples of Michigan and Alaska and place all new government employees in a defined contribution retirement system similar to a 401(k) plan in a private business.

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These reforms will help stabilize public pensions and give individual workers, who are in the best possible position to plan for and invest in their own retirement, more control over their retirement assets. Moreover, taxpayers, most of whom are responsible for their own financial planning and retirement, would not bear the additional risk of government employees' retirement portfolios. These are positive steps that can be taken now to the benefit of public employees and taxpayers alike.

Appendix I

Arizona Retirement Funds: Summary of Financial Facts

Retirement System/Plan	Funded Level	Current Taxpayer Contribution	Next Year's Taxpayer Contribution	Assumed Rate of Return	Employee Contribution
ASRS	79.3%	9.6%	10.5%	8%	9.6%
CORP	80.0%	8.59%	9.5%	8.5%	7.96%
EORP	66.7%	26.25%	32.99%	8.5%	7%
PSPRS	65.8%	20.89%	22.68%	8.5%	7.65%

NOTES

1 See *Benchmark Your 401k Plan – 2008*, 401khelpcenter.com, http://www.401khelpcenter.com/benchmarking.html. The maximum allowable employer 401(k) contribution is 6% of salary.

2 See http://openbooks.az.gov, under category of expenditures, see "personal services" for salary costs and "employee related expenditures" for retirement contribution costs. This percentage is calculated from total retirement contributions for all state employees and the total "personal services" number posted in Openbook.az.gov.

3 When most state employees opted for a defined benefit system in 1970, some maintained their defined contribution accounts. As of 2009, there were still 1,700 individuals with these types of accounts. However, recent policy treats these accounts more like defined benefit accounts than defined contribution accounts. See ASRS, *Special Notice: Update for Members*, December 31, 2009, https://www.azasrs.gov/content/pdf/Spec_Note_SysMem_Update.pdf. See also Arizona State Senate, *Issue Brief: Arizona State Employee Retirement*, (Phoenix: State of Arizona, November 7, 2006), http://www.azleg.gov/briefs/Senate/ARIZONA%20STATE%20EMPLOYEE%20RETIREMENT.pdf.

4 Bureau of National Affairs, "BNA Tax Management Analysis of PPA '06, Part I: Pension Bill Makes Sweeping Changes To Plan Funding Rules and Administration," August 18, 2006, http://subscript.bna.com/pic2/ppa.nsf/id/BNAP-6SSMGF?OpenDocument.

5 Andrew Biggs, *$50 Billion Tidal Wave: How Unfunded Pensions Could Overwhelm Arizona Taxpayers* (Phoenix: Goldwater Institute Policy Report no. 236, March 31, 2010), http://www.goldwaterinstitute.org/article/4577.

6 Contributions numbers derived from the 2010 *Comprehensive Annual Financial Reports* for ASRS, PSPRS, CORP, and EORP. See subsequent individual citations. Average household size comes from the table, "Average Household Size (most recent) by state" on Statemaster.com, http://www.statemaster.com/graph/lif_ave_hou_siz-lifestyle-average-household-size.

7 *Special Notice: Contribution rates set for FY 2012, PBI to remain constant*, letter to ASRS members and employer participants, December 17, 2010 https://www.azasrs.gov/content/pdf/Spec_Note_Contrib_Rates_PBI_Info_2012.pdf.

8 Arizona State Retirement System, *Actuarial Report on the Value of the Plan as of June 30, 2010*, (Phoenix: State of Arizona, January 25, 2011), 2, https://www.azasrs.gov/content/pdf/system/Plan_Valuation.pdf.

9 Arizona State Retirement System, *Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2010*, (Phoenix: State of Arizona, December 3, 2010), 3, 13, 24, https://www.azasrs.gov/content/pdf/financials/2010_CAFR.pdf.

10 Public Safety Personnel Retirement System, *42nd Annual Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010*, (Phoenix: State of Arizona, December 3, 2010), 11, http://www.psprs.com/Admin_Investments_and_Finance/CAFR2010/PSPRS%20CAFR%202010.pdf.

11 Facsimile from Arizona State Representative Debbie Lesko dated June 9, 2010.

12 Corrections Officer Retirement Plan, *24th Annual Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010*, (Phoenix: State of Arizona, December 3, 2010), 7, 8, 79, http://www.psprs.com/Admin_Investments_and_Finance/CAFR2010/CORP%20CAFR%202010.pdf.

13 Elected Officials' Retirement Plan, *29th Annual Comprehensive Annual Financial Report for the Fiscal Year Ended June 30, 2010*, (Phoenix: State of Arizona, December 3, 2010), 7, 8, 77, http://www.psprs.com/Admin_Investments_and_Finance/CAFR2010/EORP%20CAFR%202010.pdf.

14 See the State of Michigan, Office of Retirement Services website at http://www.michigan.gov/ors/0,1607,7-144-6183---,00.html.

15 See "PERS/TRS Defined Contribution Retirement Plan," Alaska Department of Administration, Retirement and Benefits website at http://doa.alaska.gov/drb/dcrp/index.html.

16 For information on Michigan's 401(k) and 457 plans, see https://stateofmi.ingplans.com/einfo/planinfo.aspx?cl=MICHIGAN&pl=640002PU&page=plan_informationplanhighlightsimportanceand&domain=stateofmi.ingplans.com&s=0cvcbi45r0nlzc453kzeos32&d=64081bdb65ece25026919445eee0fbfec00cb93d

17 Andrew Biggs, *$50 Billion Tidal Wave: How Unfunded Pensions Could Overwhelm Arizona Taxpayers* (Phoenix: Goldwater Institute Policy Report no. 236, March 31, 2010), http://www.goldwaterinstitute.org/article/4577.

18 *Cranford v. Wayne County*, 402 N.W.2d 64, 156 Mich. App. 655 (1986) held that employees who voluntarily accepted promotions within the sheriff's office consented to changes in pension benefit

rights, so any resulting diminution in benefits did not violate the Michigan Constitution. Michigan has a pension provision in its constitution that is similar to Arizonas, and was on the books at the time *Cranford* was decided. MCLS Const. Art. IX, § 24 (1963): "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof which shall not be diminished or impaired thereby. Financial benefits arising on account of service rendered in each fiscal year shall be funded during that year and such funding shall not be used for financing unfunded accrued liabilities."

19 Elected Officials' Retirement Plan (2010), 77.

20 Public Safety Personnel Retirement System (2010), 79.

21 Corrections Officer Retirement Plan (2010), 79.

22 For details on DROP, see http://www.psprs.com/FAQ/cato_DROP_FAQ_PS%20(3).htm.

23 Public Safety Personnel Retirement System (2010), 78.

24 Arizona State Retirement System, *Getting Ready for Retirement: A Guide for Members of the Arizona State Retirement System Defined Benefit Plan Nearing Retirement* (Phoenix, State of Arizona, July 2010), 10, 11, https://www.azasrs.gov/content/pdf/Get_Ready_Retire.pdf.

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