

# Public Employee Pension and Health Benefits in New Jersey



Confronting the Crisis and Lessons Learned

# NJPRO

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## CONFRONTING THE CRISIS AND LESSONS LEARNED

### INTRODUCTION

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New Jersey is currently facing a funding crisis associated with two significant state expenditures— its public employee pension and health benefit plans. The problem is simple: generous state pension and health benefit plans provided to public employees cost a great deal of money that the state does not have. Today, conservative estimates report that the unfunded liability stemming from the state’s public employee pension system is in excess of \$51 billion.<sup>i</sup> The unfunded liability associated with state health benefit plans is estimated to be approximately \$66.8 billion.<sup>ii</sup> This leaves the state facing a potential bill of over \$100 billion to adequately fund these programs.

The state’s leaders are working to improve the economic climate of the state to facilitate an economic recovery, but these unfunded pension and health benefits liabilities pose a significant hurdle toward accomplishing that objective. This report seeks to shine a light on the problem, its origin, and how other states are dealing with similar issues as policymakers scramble to balance state budgets across the nation.

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### WHAT DOES THIS MEANS TO NEW JERSEY BUSINESSES AND TAXPAYERS

As taxpayers, business has a substantial stake in this public debate. New Jersey has one of the highest property tax burdens in the country<sup>iii</sup>, and business is responsible for paying approximately 40 percent of that tax levy. This tax burden has been identified as a major challenge to operating a business or company in the state as it increases the cost of doing business. From a competitive standpoint, the threat to business is that, if the current system is not changed, these obligations may require a substantial increase in future property taxes to make pension and health benefit payments. This is a reality the state cannot afford as it attempts to grow out of this economic slow-down.

Another point to consider is that these unfunded liabilities are considered debt in the financial community. While on paper, the unfunded liabilities represent potentially future costs, they are

having an impact right now in the form of higher interest rates because of the higher lending risk.

Just like a private corporation must account for its capitalization and debt to equity levels to shareholders, so too, the state and local governments should accurately account for its assets, revenues and liabilities accordingly. Operating with high levels of debt and unfunded liabilities is simply not sustainable in the long term for any effective entity operating in government or business.

While the state budget must match revenues with expenditures, growing debt obligations may force policy makers to make difficult spending decisions resulting in other key areas seeing lower funding levels. Simply put, the state budget could see cuts in other areas like education or economic development in order to meet these obligations.

Obviously, there are a myriad of reasons for business to get engaged on this issue. Without consequential reform, the public employee pension and health benefits crisis could seriously deteriorate the business climate and financial well-being of the state

### The Problem

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The New Jersey Division of Pensions and Benefits is responsible for the second largest public employee benefits program in the nation;<sup>iv</sup> however, the state cannot afford it.

In January of 2010, the state was facing an immediate \$10.7 billion budget gap for fiscal year 2011.<sup>v</sup> Today, New Jersey finds itself in a better fiscal situation than the previous fiscal year. According to recent prognostications of the Treasury Department's Office of Revenue and Economic Analysis, the state's total revenues for fiscal year 2012 will be approximately \$29.4 billion. This amounts to 4 percent above the revised fiscal year 2011 projections.<sup>vi</sup> The Office of Legislative Services has provided an estimate of fiscal year 2012 revenues in the amount of approximately \$29.32 billion.<sup>vii</sup>

While New Jersey is beginning to see some light at the end of the tunnel, there are still two substantial dedicated expenditures of public funds that will continue to plague the state's fiscal well-being: public employee pensions and health benefits. A startling number is that of the unfunded liability facing the state for total public employee retirement costs, including pension and health benefits costs: that sum ranges from approximately \$94 billion to upwards of \$100 billion, according to recent reports issued by the Council of New Jersey Grantmakers<sup>viii</sup> and the Pew Foundation<sup>ix</sup>. These levels of unfunded liabilities could put a significant strain on limited state resources. When government has limited funds and legal obligations to subsidize various programs, none of the options available are good ones. If the pension and health benefits funding crisis is allowed to persist, here is what taxpayers in New Jersey will be facing: increased costs, further borrowing, higher fees and taxes, less public services being provided or some combination of these fiscal remedies. This becomes problematic for one

additional reason: many citizens choose to live in New Jersey for its geographical location, level of government services, human capital, professional opportunities and high quality schools. By maintaining a public pension and health benefits system that is so drastically under-funded the state risks its financial viability and economic competitiveness. This seriously impairs the business and employer community of the state by the potential migration from New Jersey by current and potential employers and employees alike. Why choose to reside or base a company's business operations in a state that has high levels of taxation with diminishing returns in the form of essential public infrastructure and services utilized by business?

State government, as an entity, is not much different from a private corporation in this sense. As New Jersey's unfunded obligations associated with public employee pensions and health benefits are left unchecked, these liabilities only grow over time and impair the state's reputation and credit rating. In February 2011, Standard & Poor's (S&P) downgraded New Jersey's credit rating because of the state's unfunded pension and health benefit obligations and above-average debt burden.<sup>x</sup> Additionally, Moody's Investor Service considers future costs and liabilities in its state bond ratings, recalculating the debt burden of states to include post-employment pension and health benefits.<sup>xi</sup> Consequently, Moody's also recently downgraded New Jersey's bond ratings on account of a slow economic recovery and increased liabilities associated with public pensions and benefits.<sup>xii</sup>

The downgrade in ratings has the effect of increasing transaction costs and interest rates when the state is seeking to take on more debt or issue bonds for capital, thus increasing the costs of borrowing for the state.<sup>xiii</sup> For example, the state will have to pay \$2 million in additional interest payments each year for a \$600 million state bond offering to fund transportation infrastructure projects.<sup>xiv</sup> One analyst estimated that New Jersey is paying one-third of 1 percentage point more in interest on this offering due to the downgrading of the state's credit rating.<sup>xv</sup> In sum, the state cannot afford to have any further cost increases from these programs or else there is a risk of tax or fee increases to stay afloat.

New Jersey is facing an enormous challenge as policy makers must contend with benefit liabilities that could reach as high as \$100 billion.

## How Did We Get Here

For both public employee pensions and health benefits, the trajectory taken by New Jersey has been clear:

- continuous commitments to increase benefits without a requisite source of funding;
- refusal to demand sufficient contributions by public employees;
- escalating costs; and

- short-sighted fiscal management.

These corrosive ingredients collectively make up a recipe for fiscal disaster. Consequently, the state faces a crisis of confidence and performance in terms of its public employee pension and health benefit plans.

## PENSIONS

### A Historical Perspective of Mismanagement

Over the course of the last two decades, there were several reforms made that changed the manner by which the pension system was valued, which in turn led to lower pension contributions by the state. These reforms were generally enacted to help balance state budgets and reduce the level of required state and local contributions. In 1992, for instance, the Pension Revaluation Act (“PRA”) changed the interest rate assumption used to a higher market value rate of 8.75%.<sup>xvi</sup> These assumptions are utilized to assess and determine what an expected rate of return would be on these pension funds. Raising the anticipated rate of return allowed policy makers to increase the value of future pension assets and in turn, reduce current contributions while still being able to meet pension obligations. These higher rates of return turned out to be overestimated, leaving a gap between actual pension assets and what would be needed to meet obligations.

This practice has an inherent problem: in light of the fact that public employee pension benefits are guaranteed, the liability associated with them is almost certain. Therefore, a lower interest rate assumption should be utilized to determine plan liabilities going forward.<sup>xvii</sup> This accounting convention has led to lower contributions that have facilitated the underfunding of New Jersey’s pension plans.

Other pension changes in the mid 1990’s that have contributed to the current crisis include: requiring the state to switch fund valuation methods; resetting the amortization period for the unfunded liability from 30 to 40 years; a revision in the Cost of Living Adjustment (COLA) assumption; and a reduction in the “average salary scale.” These reforms allowed state and local government contributions to be reduced by \$547.4 million in Fiscal Year 1994 and \$946.8 million in Fiscal Year 1995.<sup>xviii</sup> In 1997, to close this funding gap, the state issued \$2.8 billion in pension obligation bonds, with the proceeds being deposited in the pension system. The bond proceeds, coupled with heavy investment in high technology stocks and subsequent boom in their value in the late 1990’s, gave the “appearance of a fully funded plan.”<sup>xix</sup>

Unfortunately, the pension fund returned to its underfunded status and local governments began to increase their contributions to the fund in 2003; but they did so in a gradual manner involving phase-ins that allowed these entities to defer full payment. Additionally, employee contribution rates in the Teachers’ Pension and Annuity Fund (TPAF) and Public Employee

Retirement System (PERS) plans were temporarily reduced from 5% to 3%, but were ultimately returned to the original contribution levels.<sup>xx</sup> There were also a series of benefit increases or enhancements that also played a significant role. In 1999, benefits were afforded to surviving spouses; this led to a \$500 million increase in liabilities.<sup>xxi</sup> In 2001, the state opted to change the percentage of salary utilized to calculate benefits, leading to an increase in benefits for current and retired public employees of approximately 9.12%.<sup>xxii</sup>

The changes to the pension system and accounting or actuarial conventions mentioned above, although done with the best of intentions, seriously harmed the financial viability of New Jersey's public employee pension system.

## Pensions in General

It is important to highlight a key categorical difference among pension and retirement plans. Most plans can be divided between two categories: defined benefit and defined contribution plans. In a traditional defined benefit pension plan, an employee periodically (usually once a month) receives a set amount of money, including COLAs, once retirement age is reached. That amount of money is defined and guaranteed to the retiree unequivocally by contract or promise of the employer. The sum of the benefits promised is usually determined based upon the retiree's salary and length of service.

A defined contribution plan, on the other hand, does not entail such guarantees. The retiree is not guaranteed a specific benefit amount upon retirement. A plan participant makes voluntary salary contributions into a retirement account and maintains control over the investment options available to maximize returns on these funds. These accounts typically grow tax-free until a withdrawal is made. The employer has the option to match or contribute funds to these accounts as well, but maintains no authority or control over the direction of investments or use of funds. Consequently, retirees are not guaranteed anything specific under these plans, aside from the ability to contribute and make investment decisions. This truly underscores the main difference between these plans: under a defined benefit plan, all of the risk and responsibility of plan funding and management lies with the employer; under a defined contribution plan, all of the investment and contribution risk is typically held by the plan participant or retiree.

Defined benefit retirement plans pose a significant challenge to local governments across the country. The reason for this is two-fold: benefit payouts under these plans are guaranteed by operation of state laws regardless of the financial status of the funds; and the pension plans are financed with a portfolio of investments that are subject to market risk. Thus, in troubled economic times or down market years, pension investments and asset values may be reduced, but there is no corresponding reduction in pension benefits paid or guaranteed by the states. Therefore, a defined benefit plan offered to state public employees could potentially amount to an unfunded mandate imposed by the state upon itself.

Another important consideration is the fact that if a private employer operates a defined benefit plan and is facing a shortfall in terms of funds, benefits are guaranteed by the Pension Benefit Guaranty Corporation; however public sector plans do not enjoy this luxury: local governments are expected to pass increased costs upon the taxpayers.<sup>xxiii</sup> As one can easily see, the operation of defined benefit plans by state and local governments is riddled with significant hurdles and costly pitfalls if fiscal discipline and appropriate financial planning are not incorporated into the policy making process.

In New Jersey, however, these challenges have been greatly exacerbated by the actions and decisions of elected and administrative officials over time. As part of its public employee retirement benefit structure, New Jersey currently operates five defined benefit plans and two defined contribution plans. The defined benefit plans are as follows: the Teachers Pension Annuity Fund (TPAF); the Police and Firemen Retirement System (PFRS); Public Employees Retirement System (PERS); State Police Retirement System (SPRS); and the Judicial Retirement System (JRS).<sup>xxiv</sup> These benefit plans cover approximately 770,869 public workers and in Fiscal Year 2010, these plans paid out approximately \$5.85 billion to about 265,296 beneficiaries.<sup>xxv</sup> This represents a substantial expenditure by the state that requires a sustainable source of funding. Unfortunately, as discussed above, state and local governments in New Jersey are facing an alarming level of unfunded liabilities for pension plans. This can be traced to generous benefit promises, poor fund management, inaccurate accounting principles and unrealistic projections for pension fund investment returns.

According to a recent report issued by the Mercatus Center of George Mason University, if “more stringent” accounting rules and standards were utilized by the state in terms of its management of the fund, there would have been more funding available to the system and “more restrained benefit growth.”<sup>xxvi</sup> However, this trend of mismanagement and poor financial decision-making can be traced throughout the years to a number of different administrations and legislative sessions. Today, those policy decisions are coming to the forefront due to the fiscal state which New Jersey finds itself in today.

## New Jersey’s Pension Today

The unfunded liabilities facing the state’s pension system are alarming. New Jersey’s unfunded pension liability ranges from approximately \$34.43 billion to \$37 billion.<sup>xxvii</sup> That does not even take into account the unfunded pension liability of \$16.7 billion currently facing the state’s municipal and county governments. This brings the total unfunded pension liability to above \$51 billion. Another study suggests that if the state were to utilize more appropriate and conservative accounting or actuarial conventions in its projections and valuation of pension assets and obligations, the unfunded liability in New Jersey’s state pension system increases to over \$173 billion, utilizing 2009 figures.<sup>xxviii</sup> This sum amounted to about 44% of the state’s GDP and 328% of explicit government debt.<sup>xxix</sup>

According to a recent report by the Pew Center on the States, in 2008 New Jersey's pension obligations were funded below the 80 percent mark.<sup>xxx</sup> According to recent estimates, the state's pension funding ratio ranks below those of its neighboring states of Delaware, New York and Pennsylvania and significantly lower than the federal ratio of 78.9%.<sup>xxxi</sup> New Jersey's combined pension and debt burden (per capita) ranks fourth highest in the country.<sup>xxxii</sup> Furthermore, in light of budgetary constraints and difficult economic times, New Jersey has only funded approximately 57.1% of its pension liabilities. Consequently, the Pew Center report gave New Jersey the lowest grades possible in terms of meeting its pension contribution obligations.<sup>xxxiii</sup>

According to estimates underlying Governor Christie's Fiscal Year 2012 Budget Proposal, if no steps are taken to reform New Jersey's broken public employee pensions system, the total unfunded liability will reach an astounding \$183 billion over the next three decades; this includes the state's share of about \$121 billion and that of local municipalities in the amount of \$62 billion. Furthermore, funding costs for the system will increase more than 370% or to about \$13 billion annually over the next thirty years.<sup>xxxiv</sup> These levels of liabilities are simply unsustainable for state and municipal budgets going forward.

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## HEALTH BENEFITS

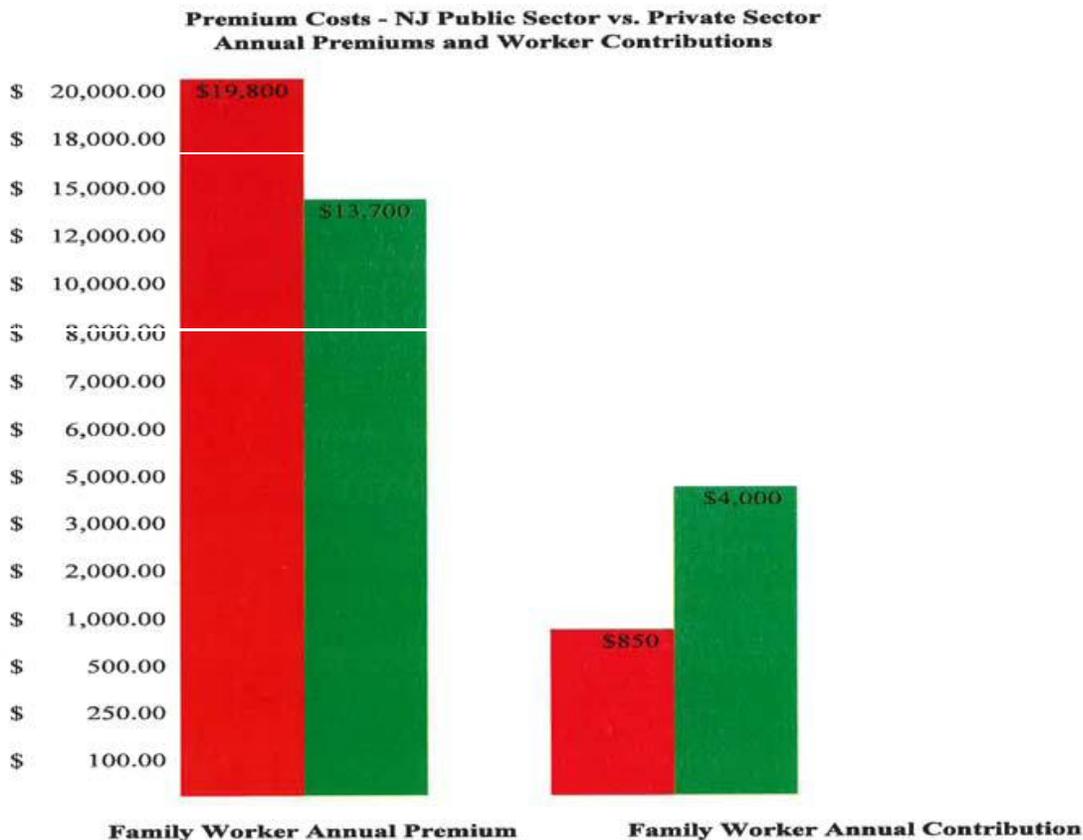
Similar to the pension system provided to public employees in New Jersey, the health benefits plans afforded to these workers are not fiscally sustainable. There are two main factors in determining the source of this unfunded obligation: low levels of employee contributions compared to contributions made by private sector and federal employees for their health benefits; and rising health care costs. New Jersey pays approximately 92 percent of its public employees' health care costs, while the federal government pays approximately 66 percent of the costs.<sup>xxxv</sup> Furthermore, the average cost per employee for health benefits in New Jersey has risen to about \$10,751, which is higher than the national average.<sup>xxxvi</sup>

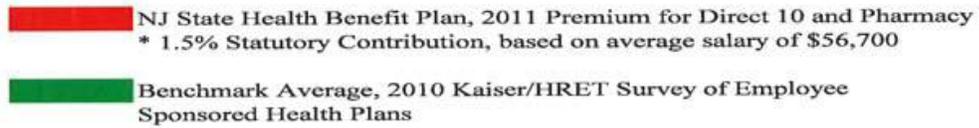
The state of New Jersey currently spends \$4.3 billion annually on health benefit costs for public employees and retirees, including \$2.5 billion from the state budget. As a percent of New Jersey's annual budget, the cost of health benefits has grown from approximately 4.5% in 2001 to nearly 9% in 2011.<sup>xxxvii</sup> Despite that level of spending, the state currently has an unfunded liability in the amount of \$56.8 billion for post-retirement medical benefits. On top of that, municipal and county governments in New Jersey are facing a \$10 billion unfunded liability for post-retirement health benefits costs for a total unfunded liability of \$66.8 billion.<sup>xxxviii</sup> The Pew Center on the States reports that its latest account of the unfunded liability facing New Jersey for "State Retiree Health Care and Other Non-Pension Benefits" totals approximately \$68.9 billion.<sup>xxxix</sup> These levels of unfunded liabilities are sure to dramatically affect the public debate over state and local budgets for years to come.

## Public Employee Pension and Health Benefits in New Jersey

Until there is some established mechanism or path towards public employee benefit reform, these costs will continue to seriously hamper the finances of the state. According to estimates put forward by the Christie administration, if no action is taken to rework this system, the overall cost to taxpayers will grow by more than 40% in four years. However, the average costs to active public employees will only see an increase of less than 10% over that time.<sup>xi</sup> This is a reality that cannot be maintained in these times of fiscal austerity.

In what has become widely talked about in recent months in the public discourse over public employee health benefits, the level of employee contribution is quite low. New Jersey pays a higher percentage of its employee health benefits costs than its counterparts in the private sector and Federal Government. As a point of comparison found in Governor Christie's FY 2012 Budget proposal, New Jersey pays approximately 92% of the health care costs for its public workforce: New York pays approximately 83%; and the Federal Government pays about 66% of its employee health care costs.<sup>xii</sup> In light of the state of the economy and the budget challenges facing New Jersey, it is difficult to continue the practice of requiring minimal contributions that public employees make towards their own health insurance and benefits; especially when financial difficulties are being felt by all employees across the state in both the private and public sectors.





Source: New Jersey Senate Democrats

Another factor that has exacerbated this budget and financing crisis is the dramatic increase of health care costs in recent years. The cost of public employee health benefits has grown from approximately 4.5% of the state budget in 2001 to nearly 9% today. This results largely from the rise in health care costs that the nation, along with New Jersey, has seen in the last decade. Most surveys and benefits forecasts have reported substantially higher health care costs to be shouldered by employers and employees alike.<sup>xiii</sup> According to a 2010 report issued by Pricewaterhouse Coopers, employers can expect a 9% increase in medical costs for 2011.<sup>xiii</sup> A survey by benefits consultant Mercer indicated that the cost of providing health care coverage to employees in the US rose 6.9% in 2010 to approximately \$9,562, representing the largest increase since 2004.<sup>xiv</sup> This closely resembles a projection put forth by the Towers Watson 2010 Health Care Cost Survey, which provides that the health care costs per employee totals about \$10,188; this is comprised of employer costs in the amount of \$7,896 and employee costs in the amount of \$2,292.<sup>xiv</sup>

Unfortunately, New Jersey is not immune to these cost increases. According to recent survey results, the average cost per employee for health benefits in New Jersey was \$10,751, which is higher than the national average.<sup>xvi</sup> This figure potentially increases when referring to public employee health benefits. For example, the city of Newark currently spends approximately \$17,000 per employee on these benefits.<sup>xvii</sup>

The choice of health plans that comprise the State Health Benefits Program (SHBP) is another factor in the cost of benefits. The state offers three benefit plans which all require the same employee contribution of 1.5% of salary. This offers no incentive or motivation to consider costs and make financially sound decisions when choosing a benefits plan as a public employee; thus employees will choose the best plan with the highest cost when it may not be necessary.<sup>xviii</sup>

## WHAT OTHER STATES ARE DOING:

Across the country, there are 222 defined benefit plans covering 90% of state public sector workforces. Additionally, there are 2,434 plans for public sector workers operated by local governments.<sup>xix</sup> Unfortunately, New Jersey is not the only state in the country facing a funding crisis in regards to public employee pension and benefits programs. Pension plans operated by state governments are currently facing a shortfall of \$452 billion, with total liabilities of \$2.8 trillion and total assets of \$2.3 trillion. However, it is estimated that if more appropriate

discount rates were utilized by states in valuing liabilities, the unfunded liability increases to about \$3 trillion.<sup>i</sup> Furthermore, the Pew Center on the States estimates that the total funding gap facing states for retirement benefits, including pensions and health benefits amounts to about \$1 trillion. However, on a positive note, because many states are facing similar challenges, there is an opportunity to learn best practices from different states.

## Pensions

Countless states across the country have already begun combating these budgetary ills. One obvious reform is to increase the contribution rates of public employees towards pension costs: California, Colorado, Iowa, Louisiana, Minnesota, Mississippi, Missouri, Vermont and Wyoming all are examples of states that raised contribution levels for employees.<sup>ii</sup> Another measure that has been popular among states is to temporarily eliminate, reduce or limit COLAs afforded to pension plans and participants. Some examples of states that have opted for this route are: Colorado, Illinois, Maryland, Michigan, Rhode Island, South Dakota and Virginia.<sup>iii</sup>

Also, Iowa, Minnesota and Missouri have all increased the length of time a public employee must work to be eligible to participate in the states' defined benefit plans, while Virginia and Rhode Island have increased the number of years utilized to calculate the final average salary from three years to five.<sup>iiii</sup> Other states have pursued alternative measures such as raising the retirement age for public employees, more fundamental reforms to benefit plans, strict investment standards for pension assets, new ethics rules or governance policies, and early retirement incentives to name a few.<sup>lv</sup>

A more fundamental change not mentioned above is the option of shifting from the defined benefit paradigm for retirement benefits to the defined contribution paradigm. This rests upon the notion that costs and the level of risk imposed upon government employers would be significantly diminished if employees or plan participants maintained control of their own retirement savings with no guarantee of a specific benefit level. A recent change to Michigan law provides that all newly hired school employees will be enrolled in a "hybrid defined benefit and defined contribution system." Age and service requirements will be increased for the defined benefit portion, while the defined contribution portion is optional.<sup>lv</sup> A change to Utah law closes the defined benefit plans of the Utah Retirement system and replaces them with the New Public Employees' Tier II Contributory Retirement Plans which provide the options of a defined contribution plan and a hybrid plan.<sup>lvi</sup>

These are just a sampling of the options available to states in reforming their public employee pension plans to contain costs and fill substantial shortfalls in financing these benefits. Furthermore, there is evidence to suggest that many of the reforms listed will not yield substantial savings individually<sup>lvii</sup>; therefore, a comprehensive approach for reform must be undertaken.

## Health Benefits

Numerous states have also taken the lead in beginning to tackle the funding issues associated with health benefits.

Connecticut recently enacted a new policy which would require all new public employees eligible for state health benefits to contribute 3% of their compensation to account for retiree health benefits provided by the state. The new law would also require public employees with less than five years of service to contribute 3% of compensation to the Retiree Health Fund until they complete ten years of service or qualify for retiree health benefits.<sup>lviii</sup> Michigan and Kentucky have also adopted policies requiring increased employee contributions.

Kentucky also recently adopted a new “advance-funding basis” for retiree health benefits for members of the Kentucky Teachers Retirement System. This system replaces the pay as you go system utilized by the state.<sup>lix</sup> A related reform was passed in Michigan where the new law creates irrevocable trusts for the “purpose of holding, investing, and distributing assets” to be used for retiree health care benefits.<sup>lx</sup>

These proposals and reforms are not the only answers; however, they provide some illustrations and examples of some of the methods used by other states throughout the country to remedy this issue.

## WHERE DO WE GO FROM HERE

New Jersey has countless options before it in terms of facing this problem head on to protect its residents and business community. States around the country have provided us with a myriad of tools to rectify the tremendous funding gaps facing our state today. If this crisis goes unaddressed, the businesses of the state will see increased costs/fees, higher taxes and potentially reduced state and local services. Furthermore, the state’s economic climate and competitiveness will be significantly hampered. This is a dark reality that New Jersey cannot afford today. Therefore, it is important for all of us to stay engaged and demand workable and reasonable solutions that put the state on a financially sustainable path going forward.

Endnotes

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## ABOUT THE NEW JERSEY POLICY RESEARCH ORGANIZATION

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The New Jersey Policy Research Organization (NJPRO) is an independent affiliate of the New Jersey Business & Industry Association. NJPRO is New Jersey's leading policy organization conducting innovative, timely and practical research on issues of importance to New Jersey employers.

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The authors alone bear responsibility for any factual errors. The recommendations in this report are those of the NJPRO Foundation and do not necessarily represent the views of our funders or those who reviewed drafts of this report.



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