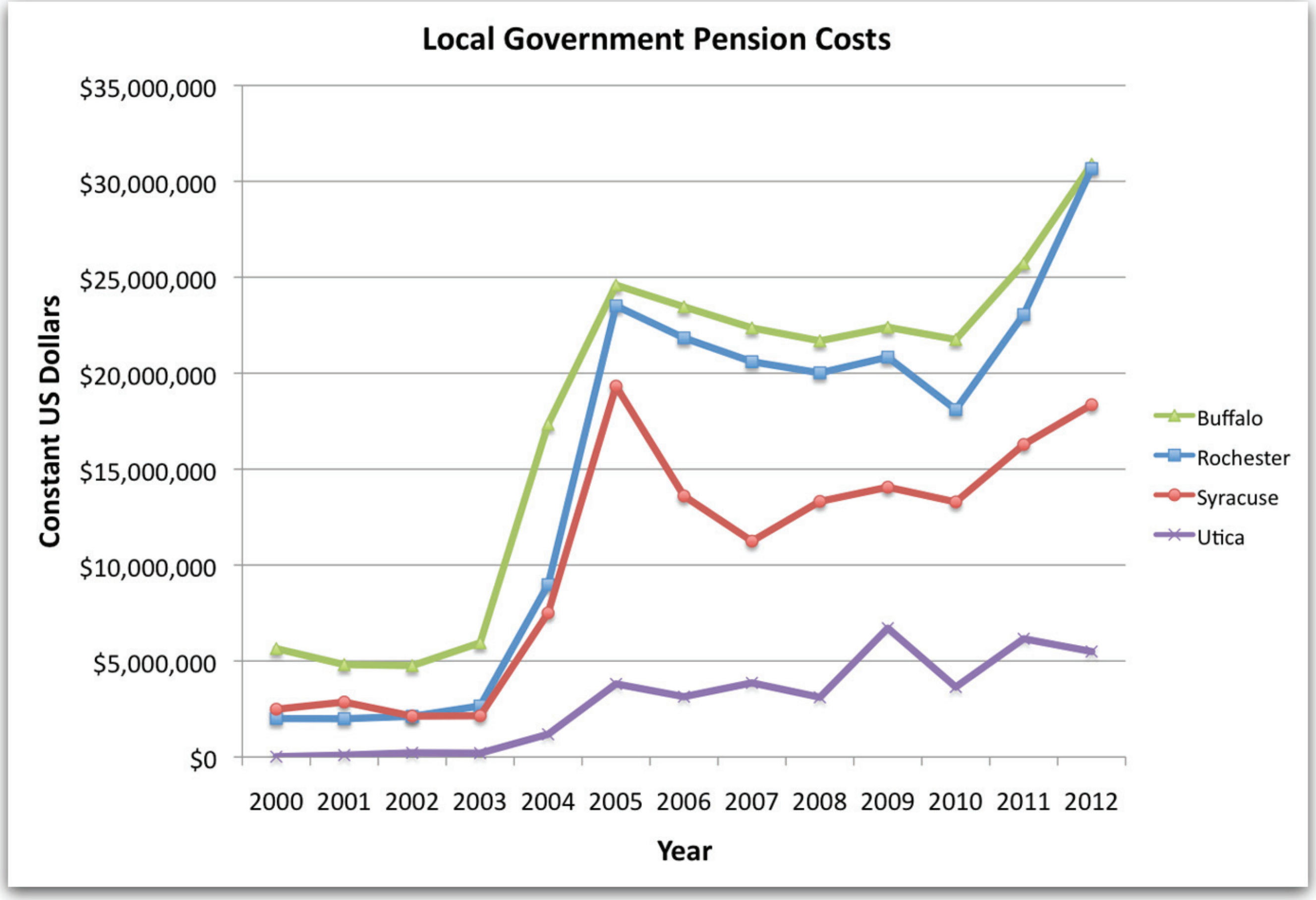
state of new york cities

CASE STUDY 5 - MARCH 2014

THE PENSION PROBLEM: MYTH OR REALITY?

The State of Public Pensions in Upstate New York



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Executive Summary

Media and popular culture have described public pensions as an enormous threat to local government fiscal health. Are public pensions the problem? This report investigates the claims about public pensions with a focus on New York State. We find that New York State's public pension fund is not running out of money, not overestimating rate of return, and not underfunded. However, the combination of low contribution rates in the past and external pressures, such as the stock market crash, tax cap, and state mandated spending have intensified the effect of public pensions on local government budgets.

Although the New York State pension system is closely monitored and one of the most well funded systems in the country, the media often presents a counter narrative of impending doom. Using research drawn from Comptroller's Office data and interviews with key sources, this paper explores some common pension myths found in popular debates and assesses their validity in New York State.

Research supports the following conclusions:

- Fact #1: Public pensions are *not* running out of money. The system is well funded in New York State.
- Fact #2: Public pension funds are *not* overestimating returns on investment in New York State.
- Fact #3: Defined benefit plans are cheaper than defined contribution plans – and they are better for retirees and the economy.
- Fact #4: While employees pay a significant portion of pension costs from their own salaries, pension obligations do put pressure on the budget for current services.
- Fact#5: Pension obligations are escalating as a result of the financial crisis and will continue to increase as the Baby Boomer generation retires.
- Fact #6: Public sector pensions are not overly generous.
- Fact #7: Public pensions can stimulate local economies.

Over the last couple of years the media has focused on public pension systems, raising concerns about underfunding and escalating liabilities. Although, inflated pension benefits have received media attention, the majority of workers receive a modest package after retirement. The average pension for all Employees' Retirement System retirees in fiscal year 2013 was $20,766 and $43,844 for Police and Fire Retirement System members (Office of the State Comptroller, 2014). The Great Recession has contributed to the pension problem by reducing returns below historical levels. However, not all pension systems are equal, each state pension system has different structures and characteristics. New York State's pension fund is well managed.

While pensions are not the cause of fiscal stress, they do add to the fiscal burden faced by local governments. Pension obligations are a considerable expenditure for upstate cities struggling to provide services with resource constraints. For example, across the cities of Buffalo, Rochester, Syracuse and Utica, pensions averaged 6% of total annual spending in 2012 (Office of the State Comptroller, 2014). Reforms, such as the amortized payment scheme and the new Tier VI, may help address pension stress, but they are not enough. As society ages, pensions have an important economic impact of ensuring income security for retirees and stimulating the local economy. The challenge is to balance current obligations and future needs so that public workers, local governments and society at large all benefit.

Abbreviated Terms

NYSLRS: New York State and Local Retirement System
PFRS: Police and Fire Retirement System
ERS: Employees' Retirement System
DB: Defined Benefit
DC: Defined Contribution

1

Recessions, Bankruptcies, and Pensions

Five years ago nobody paid much attention to public pensions. Today it is one of the most debated topics in the news, drawing media fire. This push of public pensions into the spotlight is connected to the 2008 Recession. Current arguments over public pensions often begin with a reminder of the Recession's impact. But how exactly do these two - public pensions and economic recession - connect? How did we get from "Wall Street Crash" (Boggs, 2008) to "pension tsunami"?

Private corporations were not the only entities struggling with debt after the Recession; local governments also faced severe fiscal constraints. While municipal bankruptcy is very rare,[1] fiscal stress is common (Hoene, 2012; Warner 2012; Congressional Budget Office, 2010). Instead of focusing on the impacts of recession on local government finances, pensions became the target for blame as the leading cause of fiscal stress. These efforts were led by mass media as well as think tanks and scholars who pointed their fingers at government employees and retirees and their unions (Snell, 2011). The media fire shifted the blame from Wall Street to public sector employees. Several states responded with public pension reform plans. States that have enacted pension reform include New York, California, Florida, Georgia, Illinois, Massachusetts, Michigan, New Jersey, North Carolina, Ohio, Connecticut, Texas, Virginia, New Mexico, and Wisconsin (Center for Research Retirement at Boston College, 2013; Mitchell, 2012).

Public sector workers have resisted the blame arguing that they have been contributing pension payments every month over the years of their career and that the benefits are rightfully theirs. Some critics of pension reform argue that public workers are used as scapegoats in the games that Wall Street bankers and politicians play[2]. In the midst of this blame shifting, local governments are struggling with the consequences. Cities like Syracuse, Buffalo, and Rochester are responsible for providing vital services with tighter budgets. Pension obligations and employee benefits represent a significant expenditure for local governments struggling to remain solvent.

This report explores the facts around pensions in upstate New York[3]. We investigate the pension system by looking at the numbers and listening to a wide variety of voices from local governments to public unions to academic experts. We start our investigation with a brief explanation of the history of New York State public pensions. Where did public pensions come from? What is their structure and how do they operate? Next, we examine the charges that have been brought against public pensions. Here we draw from financial data published by the Office of State Comptroller, legal documents, and interviews with key informants. Lastly, we conclude our investigation by providing an overall assessment of the state of public pensions in upstate New York and highlight challenges for the future.

1 Examples of bankruptcies are Vallejo, California in 2008, Jefferson County, Alabama in 2011, Stockton, California and San Bernardino, California in 2012, and Detroit, Michigan in 2013.

2 See National Public Pension Coalition website – http://www.truthaboutpensions.org

3 It is important to recognize that each of the fifty states has a different public pension system. Talking about public pensions in the nation as a whole will mask over the differences among these systems. As such, this report does not make any universal claims but focuses on upstate New York. When necessary, we include data about all of New York State (either including or excluding New York City), and explicitly state it.

2

Public Pensions: Where did they come from? What do they look like?

Public Pensions in the U.S.

The public pensions system in the U.S. existed before the signing of the U.S. Constitution (1787) in the form of disability and retirement benefits for military personnel. After 1850, some large cities began to offer disability and retirement benefits to police and fire departments, and later added teachers to this group. However, the expansion of public pensions for civilian employees would take another fifty years.

The first state administered civilian employee public pensions program started in Massachusetts in 1911, and by 1929 six states (New York, Pennsylvania, Maine, Connecticut, Massachusetts, New Jersey) had a civil service pension plan. Today, all 50 states have at least one retirement system for public employees[4]. At the federal level, the Civil Service Retirement Act was passed in 1920, creating a comprehensive pension system for all federal civil service employees. In 1986, this system was replaced with the Federal Employees Retirement System (Craig, Clark, and Wilson, 2003).

The first formal, nonmilitary, employer-provided pension plan was established in 1875 by the American Express Corporation. A few large companies, such as U.S. Steel Corp. (1911), General Electric Company (1912), Goodyear Tire and Rubber Co. (1915), and Eastman Kodak (1929) followed, but these pension programs were designed in such a way that benefit levels and payouts could be terminated by the sole decision of the employer (Employee Benefit Research Institute, 1998). In 1974, the Employee Retirement Income Security Act (ERISA) was enacted, setting the minimum standards for pension plans in the private sector.

Historically, coverage of private sector workers was lower compared to public sector workers in the first three decades of the 1900s (Craig, Clark, and Wilson, 2003). This characteristic has remained the same with 98% of public sector employees covered with a pension plan[5] and 33% of private sector employees in 2005 (National Institute on Retirement Security, FAQs). The latest data from 2011 shows 78% of state and local government employees maintain coverage, and 18% of private sector employees have coverage (Wiatrowski, 2012). As Baby Boomers continue to age, the consequences of this drop in coverage will be realized as fewer Americans will be able to retire and more elderly will be entirely dependent on Social Security.

The Public Pension System is Sound in New York State

The New York State and Local Retirement System consists of the Employees' Retirement System (ERS), which was established in 1921, and the Police and Fire Retirement System (PFRS), which was created in 1966. This system

[4] See AFSCME website for a full list: http://www.afscme.org/union/retirees/resources/retiree-tools-and-information/public-employee-retirement-systems

[5] The public pension coverage here refers to defined benefit pension plans only and does not consider 401(k)

does not include New York City; the City has its own public pension system. The pension fees collected from public employees and employers (i.e. local governments) are placed in the New York State Common Retirement Fund of which the State Comptroller is the sole trustee and manager.

The New York State Comptroller is the administrative head of the entire Retirement System. The Department of Financial Services requires an independent review of the fund every three years. In February 2013, a review by Funston Advisory Services determined the fund, "is well-run, operates with an industry-leading level of transparency and invests effectively on behalf of its members" (Funston Advisory Services LLC, 8).

Pensions for public sector employees are guaranteed by Article 5 Section 7 of the NY State Constitution—"After July first, nineteen hundred forty, membership in any pension or retirement system of the state or of a civil division thereof shall be a contractual relationship, the benefits of which shall not be diminished or impaired" (New York State Constitution, Article V Section 7). By law the pensions for public sector employees cannot diminish. Because of this Constitutional Guarantee, the fund must be able to meet the obligations of all retirees despite the economic crisis. The public pension system is both sound and closely supervised.

NYS Taylor Law and the Triborough Amendment

Pensions are not only guaranteed by the State Constitution; labor law in New York State provides more protections for public sector employees. Enacted in 1967, The New York State Public Employees Fair Employment Act, commonly referred to as The Taylor Law, is the state's first comprehensive labor relations law that covers most public employees. The Taylor Law grants public employees the right to organize, elect union representatives, and collectively bargain with employers. One of the controversial elements of the Taylor Law is that it prohibits unionized workers from going on strike. To avoid strikes, the Taylor Law establishes procedures for mediation and arbitration in the case of collective bargaining disputes.

One controversial element of the Taylor Law is the Triborough Amendment. Because public employees are prohibited from striking, the Triborough Amendment requires that the terms of the old contract must be upheld until a new contract is negotiated. If there is an impasse between public sector workers and their employers, the terms of the previous contract must be upheld throughout the negotiation process. While union members support the amendment as a fair exchange for giving up the right to strike, some critics believe the Triborough Amendment should be repealed. They argue that because the Triborough Amendment guarantees continuance of previous terms, it may incentivize unions to resist changes and engage in stalling agreements in order to maintain costly pay raises and employee benefits (Sykes, 2012). Unions argue the Triborough Amendment is an essential protection for public workers because they have given up their right to strike. However, stalling agreements can harm union interests as well. The Triborough Amendment sets the terms of labor contracts when agreements are stalled. Whether this is beneficial to the public workers or the local government depends on the elements of the previous contract and current conditions.

3

A Closer Look at New York Public Pensions

As of March 31, 2013 the invested assets of the New York State Common Retirement Fund were $160.7 billion. Audited net assets held in trust for pension benefits are $164.33 billion, making it the third largest pension plan in the U.S. Employers contributed approximately $5.34 billion to the system in fiscal year 2013; employees contributed $269.1 million (Office of the State Comptroller, 2013). The pension system is fully funded. Overall, there are about 1.06 million members in the system with 95% in the Employees' Retirement System (ERS) and 5% in the Police and Fire Retirement System (PFRS). The average pension for all ERS retirees in fiscal year 2013 was $20,766 and $43,844 for PFRS. These averages, however, are rarely discussed in the media debates. The extreme cases of padded pensions over a hundred thousand dollars are more newsworthy than the modest retirement benefit of the average employee.

Balancing Budgets--Local Governments and Pension Obligations

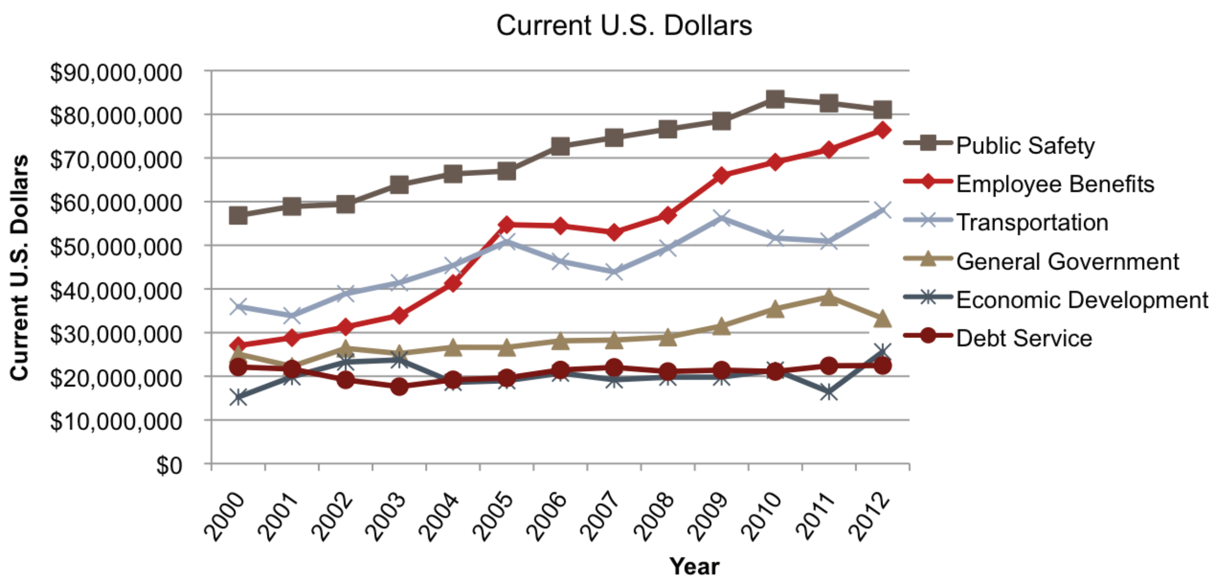
While recent pension reforms enacted by New York State (Tier VI and Pension amortization program) were designed to help local governments struggling to balance their budgets, the full impact will not be realized for decades. Local governments in upstate New York need help now. Pension obligations represent a sizeable expenditure for upstate municipalities. Escalating pension costs are a source of fiscal stress. While local governments have adopted a variety of innovative measures to cut costs and generate revenue, expenditures like pension obligations make it difficult to maintain a balanced budget while providing essential services. In an address to the New York State Legislature's Joint Legislative Hearing on local governments, Syracuse Mayor Stephanie Miner described the effects of rising pension costs on her city. From the years 2000 to 2010 pension contributions in Syracuse have increased from $2.4 million in 2000 to $19.9 million in 2010.

Figure 1 shows the city's top 6 expenditures from 2000 to 2012. Employee benefits have been steadily rising since 2000. In 2012, $72 million of the city's budget was spent on employee benefits including both pensions and health insurance costs.

> *Pensions are by far the biggest uncontrollable cost the City is challenged with paying. The Pension System is a New York State benefit. Pensions are a State controlled, State run and State authorized fund--local governments simply receive a bill. Your decisions dictate vesting, retirement eligibility, benefits and employee contributions. This is not a case where local Syracuse officials made bad decisions and we are now looking to you to help rectify the results of those decisions. People in your positions--in fact, well-meaning people--made decisions regarding the pension benefits that have put all of us in the eye of the fiscal storm. (Mayor Stephanie Miner, Joint Budget Hearing, January 28, 2013)*

While Mayor Miner hopes for State relief from pension costs, she questions the long-term sustainability of the Tier VI reforms. Since these reforms have been in place, Syracuse has hired 24 replacement employees saving the city $38,000. While any savings are beneficial, this amount is not enough to address the broader fiscal challenge Syracuse faces. And Syracuse is not alone.

FIGURE 1: City of Syracuse Top 6 Expenditures 2000-2012



Source: Author analysis based on data from the Office of the New York State Comptroller, 2014
www.osc.state.ny.us/localgov/index.htm

Author Analysis of Data From Office of the New York State Comptroller, 2014 www.osc.state.ny.us/localgov/index.htm

4

Recent Reforms to the New York State & Local Retirement System

With limited resources and fiscal constraints, upstate cities are struggling to provide essential services. Pension contributions seem burdensome in the midst of budgetary constraints. In response to calls for help from local municipalities, Governor Cuomo pushed an agenda of pension reform. Some highlights of pension reforms announced by the Comptroller's Office since 2007 include (Office of the State Comptroller, 2013):

- Ban on pay-to-play practices, which are payments to elected officials in order to influence contracts for managing government investment accounts;
- Ban on the involvement of placement agents, paid intermediaries, and lobbyists;
- Creation of pension fund task force;
- Expansion of internal and external vetting, review and approval of all investment decisions;
- Formation of a special commission to review operations of the Office of State Comptroller;
- Creation of mandatory ethics training program for all staff, including the Comptroller;
- Draft legislation to codify pension fund reforms to avoid future abuse of the system;
- Hired an outside law firm and an independent investment consulting firm to review investments with firms under investigation by the New York Attorney General and the SEC;
- Creation of Inspector General position to monitor and review investment transactions;
- Hired special counsel for ethics.

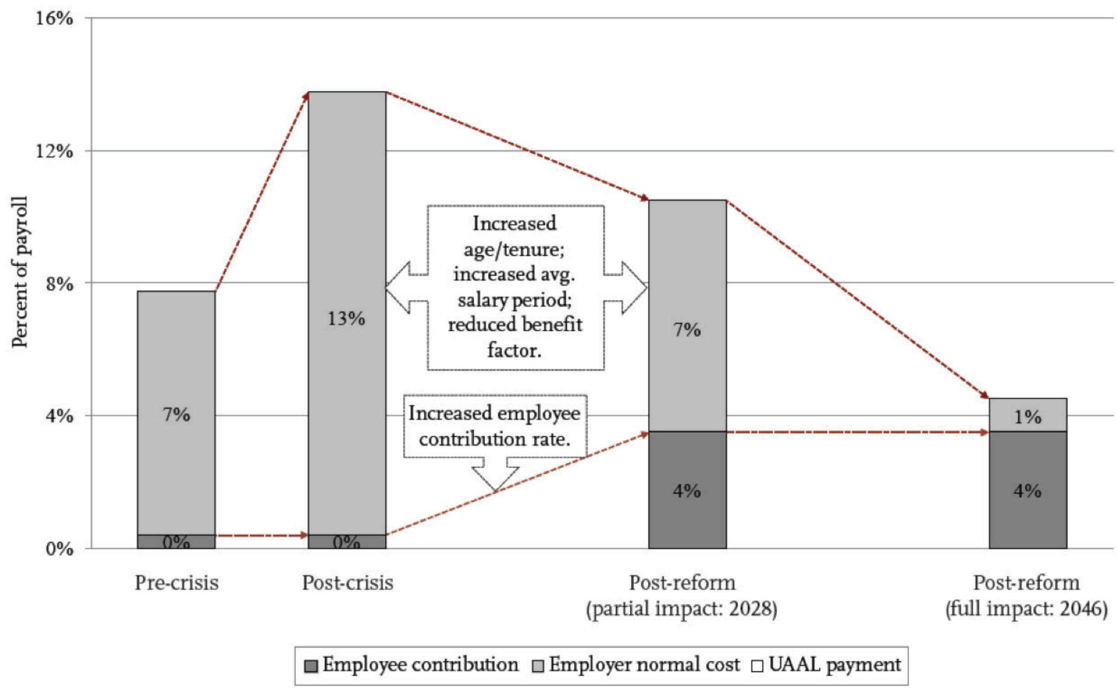
As indicated by these examples the focus is on increased transparency and a more competitive management of the fund. However, the most publicized element of these reforms is the creation of a new tier.[6]

The Tier VI reforms were supposed to provide relief for local governments. Elements of the Tier VI reform include a reduction in the annual benefit multiplier and an increase in the retirement age from 62 to 65 (Fiscal Policy Institute, 2012). These reforms are controversial because the changes entail severe cuts in benefits for new hires. According to a report by the Fiscal Policy Institute (2012), benefits to Employees Retirement System members are cut by 39.8% compared to Tier V members. The age and tenure required to receive retirement benefits increased as well as the salary averaging period. Not only was the benefit factor reduced, employee contributions also increased.

While new hires are detrimentally affected by these changes, employers benefit. Employer contributions as a percent of payroll will decrease over the long term. According to a study on New York State's pensions by the Center for Retirement Research at Boston College, employer contributions will fall from 18 percent to 2 percent of payroll for ERS and from 25 percent to 7 percent of payroll for PFRS for new hires in Tier VI. According to the study, the full impact of these reforms will not be realized until 2046. Although it may help local governments in the long run, the Tier VI reforms do little to help municipalities in the short term. Figures 2 and 3 illustrate the change and expected impact of these reforms. The charts illustrate the expected

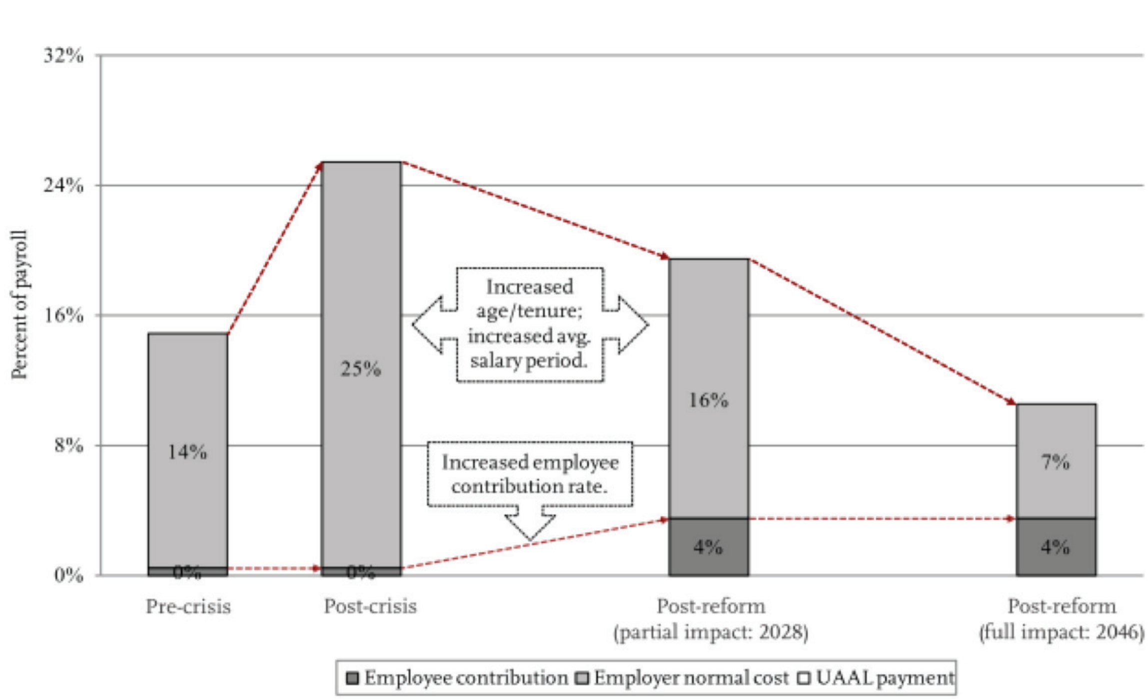
6 A note on tiers: since the State Constitution prohibits public employee benefits from being diminished, the State gets around this by creating new tiers. New tiers are applicable to new hires in the future.

FIGURE 2: Pension Costs as Percent of Payroll: Pre-Crisis, Post-Crisis, and Post-Reform of ERS



Source: Center for Retirement Research at Boston College. 2013. Profile of Pension Reforms-The State of New York. Page 3

FIGURE 3: Pension Costs as Percent of Payroll: Pre-Crisis, Post-Crisis, and Post-Reform of PFRS



Source: Center for Retirement Research at Boston College. 2013. Profile of pension reforms-The State of New York. Page 5 decrease to employer normal cost as a result of increasing age and tenure eligibility, increasing average salary period, and increasing employer contributions for both systems.

The restructuring of public sector employee benefits and compensation has far reaching impacts. Critics of these reforms point to the unintended negative economic impact of such changes. Government employees may spend less money in the local economy, which will reduce local tax revenue. These changes may also lead to decreased motivation among staff, which may contribute to inefficient operations (Levine and Scorsone, 2011).

Another reform is the Contribution Stabilization program, which is an optional pension amortization plan that allows employers to reduce annual contributions in exchange for payments with interest in the long term. The purpose of this program is to "smooth" pension costs for public employers (Office of the State Comptroller, 2013). Critics claim this program will cause annual contributions to increase even higher in the future and is a strategy to avoid implementing feasible solutions now. Proponents argue this program will help local governments facing fiscal stress in their recovery from the recession's impacts (Hakim, 2012).

5

The New York State Pension Story

Although the New York State pension system is fully funded and closely monitored, the media often presents a counter narrative of impending doom. Below are the facts regarding the claims about public pensions found most often in popular debates.

Fact #1: Public pensions are not running out of money. The system is well funded in New York State.

> *By standard accounting methods, some state pension funds will run out of assets within as little as five years (Brady and Demint, 2012: p 1).*

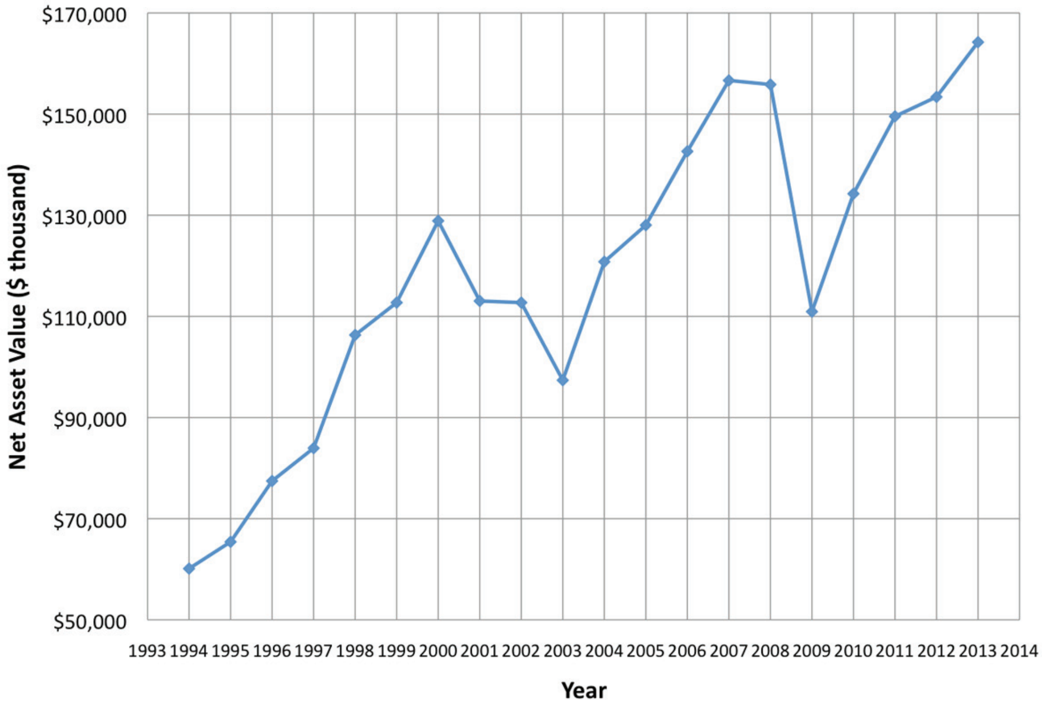
> *All public pension systems are not equal. The advantage we have in New York is that we have a well-funded, strong public pension system (DiNapoli in Office of State Comptroller Video, n.d.).*

> *...NYSLRS [is] "fully funded" by government actuarial standards, but we estimate they have combined funding shortfalls of $120 billion when their liabilities are measured using private-sector accounting rules (McMahon and Barro, Manhattan Institute, 2010: p i).*

The New York State Common Retirement Fund (NYSCRF) is not running out of money. In fact, it is the third largest pension plan in the U.S. at a value of $164.22 billion (as of March 31, 2013). Figure 4 shows the trend of net asset value for NYSCRF from 1994 to present in current dollars. The fund showed increasing asset values up to $128.889 billion in year 2000 and then decreased by a total of $31.516 billion in three years. These decreases were primarily due to the net depreciation in the Fund's investment portfolio (Office of the New York State Comptroller, 2000). The fund again showed increasing net asset values up to $156.652 billion in 2007. This increase mostly reflects the net appreciation of the fair value of the investment portfolio (Office of the New York State Comptroller, 2007). The dip in 2009 reflects the stock market crash, but since then the net asset value has been back on an increasing trend with yearly increases of 21.0 %, 11.4 %, 2.6%, and 7.1% (in 2010, 2011, 2012 and 2013 respectively).

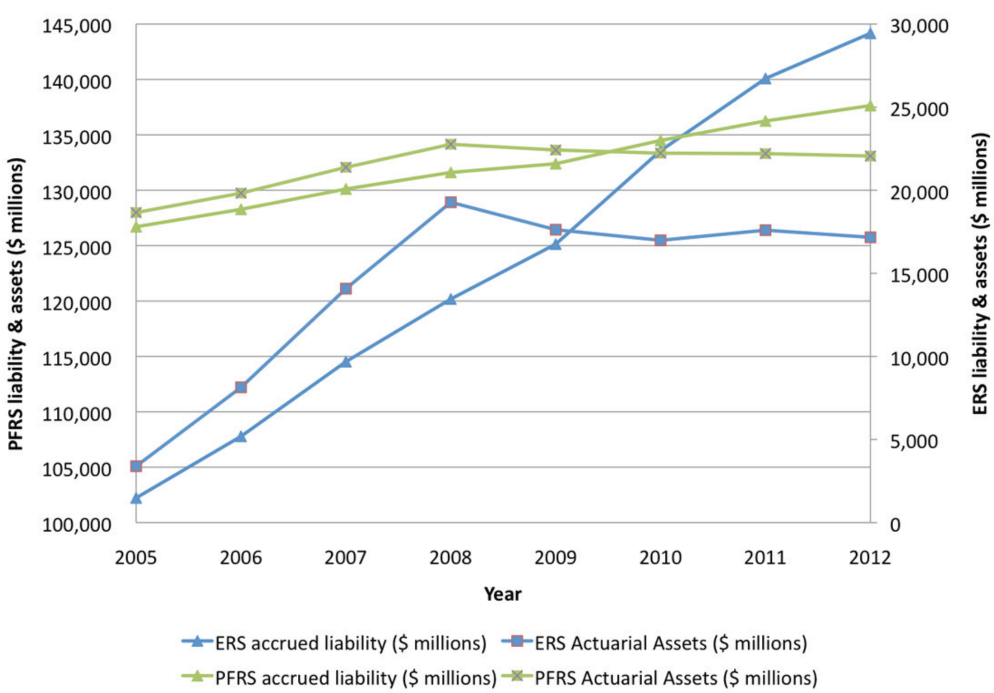
When a pension plan is described as overfunded or underfunded, this refers to funding levels. A funding level is an indicator of how "healthy" a pension plan is, defined as the ratio of assets ("what you have") over liabilities ("what you owe"). Figure 5 shows the accrued liabilities and assets for ERS and PFRS from 2005 to 2012. The difference between liabilities and assets were lowest for both systems in 2005 and then widened until 2008 when the gap for ERS was $8,733 million and PFRS was $1,695 million. In 2009, the gap narrowed sharply to $1,302 million in ERS and $826 million in PFRS. Afterwards the gap returns to a widening trend, but this time the levels of liabilities and assets are flipped, such that liabilities are exceeding assets. The latest data, from 2012, shows a gap of -$18,419 million for ERS and -$3,038 million for PFRS.

FIGURE 4: Trend of New York State Common Retirement Fund Net Assets, 1994-2013[7]



Author Analysis Based on Data From 2013 New York State and Local Retirement System Comprehensive Annual Financial Report

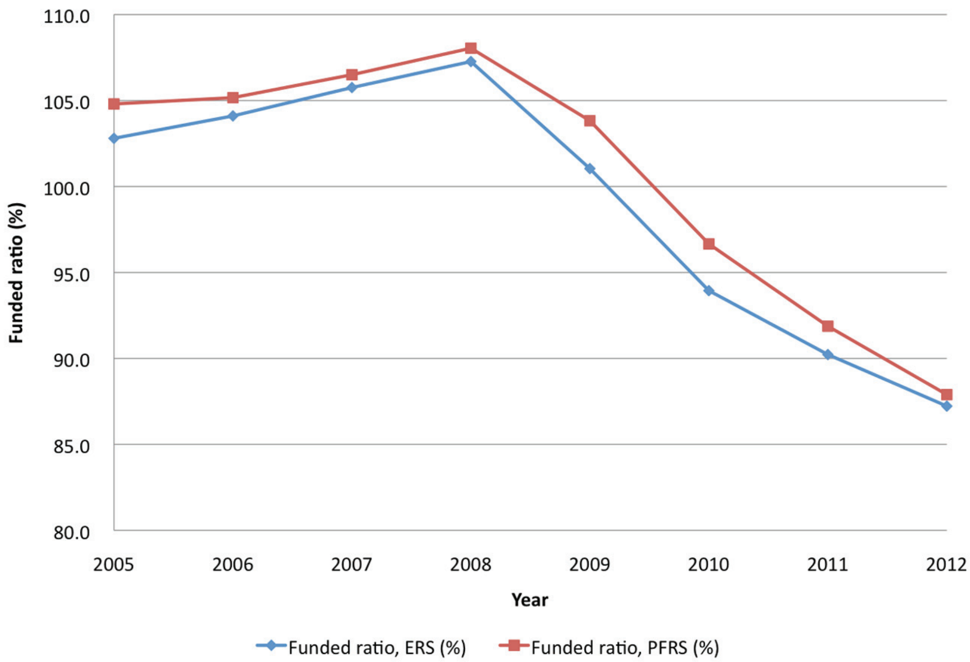
FIGURE 5: Accrued liabilities and actuarial assets for NYSLRS, 2005-2012



Author Analysis Based on Data From 2013 New York State and Local Retirement System Comprehensive Annual Financial Report
Note: These numbers are based on values assessed on April 1st of each year.

[7] All financial data is calculated by fiscal year in current dollars, unless noted otherwise. For example, data for 2013 applies to fiscal year ending on March 31, 2013.

FIGURE 6: Funded ratios of ERS and PFRS, 2005-2012.



Author Analysis Based on Data From 2013 New York State and Local Retirement System Comprehensive Annual Financial Report
Note: These numbers are based on values assessed on April 1st of each year.

Figure 6 shows the funded ratios from 2005 to 2012, and is calculated by dividing each year's assets by the corresponding liabilities. A ratio greater than 100% indicates more assets than liabilities, while a ratio smaller than 100% indicates fewer assets than liabilities. The increase and decrease of funding ratios correspond with investment gains and losses. In 2012 the funded ratios of the two systems have become nearly identical at 87.2% for ERS and 87.9% for PFRS. The rates for both systems increased until 2008 and have been decreasing thereafter, falling below 100% in 2010 due to investment losses caused by the Great Recession.

Pension funds need to be examined with a long-term view; funding levels simply show how the fund is looking at a specific moment in time. This point has been emphasized by the American Academy of Actuaries in a recent report that criticized the use of a "golden rule" for funding levels. The report writes,

> *Funded ratios are a point-in-time measurement. The movement or trend of the funded ratio is as important as the absolute level....An 80% funded ratio often has been cited in recent years as a basis for whether a pension plan is financially or "actuarially" sound. Left unchallenged, this misinformation can gain undue credibility with the observer, who may accept and in turn rely on it as fact, thereby establishing a mythic standard.... (American Academy of Actuaries, 2012: p 1).*

The report goes on to emphasize that funding levels need to be considered with other factors to give a true picture of fiscal soundness of a pension plan, such as funding or contribution policy and investment strategy. Instead of reacting to funding levels at a specific moment in time, it is necessary to take these factors into account when assessing the stability of a pension system. Through an annual actuarially determined payment, NYSLRS has the mechanisms in place to achieve a funding ratio of 100%.

A recent report from Moody's Investors Service confirms that New York's pension system is well funded compared to other states. The report documents each state's ratio of net pension liabilities to annual revenues for fiscal year 2011. For all 50 states, the median ratio value was 45%. New York State had one of the lowest net pension liabilities to revenue ratios, 16.6%, ranking 46 out of the 50 states (Moody's Investors Services, 2013). New York State's pension system is well funded.

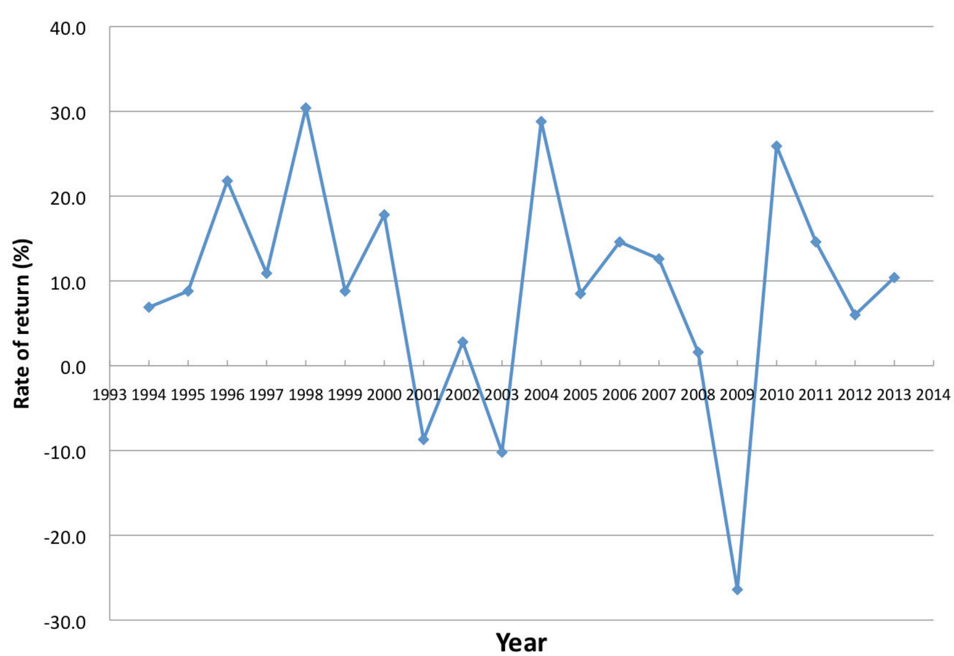
Fact #2: Public pension funds are not overestimating returns on investment in New York State.

> *The typical public pension plan assumes its investments will earn average annual returns of 8 percent over the long term....Actual experience since 2000 has been much less, 5.7 percent over the last 10 years....Worse, many economists say, is that states and cities have special accounting rules that have been criticized for greatly understating pension costs (Walsh and Hakim, 2012).*

The estimated rate of return on pension funds matters because these rates are used to calculate how much the employers, or local governments, have to contribute to the fund each year. This rate of return is also used to calculate the pension system's actuarial assets and liabilities, the ratio of which shows how "healthy" the system is. Since actuarial accounting is a type of "estimated or rationally guessed bookkeeping" it requires some assumptions. The NYSCRF currently uses an 8% interest rate assumption[8]. In order to assess whether this assumption is realistic or not, the actual rates of return on investment must be examined. Figure 7 shows the System's rate of return on investments since 1994. The rate of return was highest in 1998 at 30.4% and lowest in 2009 at -26.4%, reflecting the financial market crash. The graph shows a "roller coaster" type pattern with rate of returns changing from year to year, but in general, the rate of returns have been above the assumed 8% (average rate of return for 1994-2013 is 9.3%) (New York State and Local Retirement System Annual Financial Report, 2013).

Actuarial assumptions are not random numbers that the Comptroller's Office can lower or increase at whim. These rates of return are calculated at market value, following Governmental Accounting Standards Board 25 with the exception of 1994 data as the System adopted these standards the following year.

FIGURE 7: Trend of New York State Common Retirement Rate of Return, 1994-2013



Author Analysis Based on Data From 2013 New York State and Local Retirement System Comprehensive Annual Financial Report

[8] Some critics have pointed to New York State as an example of officials increasing assumed rate of returns so that they can report "reduced" budget deficits (See for example, Mitchell and Smith, 1994). However, these critics are referring to the old standards (8.75%) used from 1989 to 1996. The Comptroller's Office changed these assumptions to 8.5% in 1997-2000, and since 2001 has continuously used the current 8% rate assumption.

Fact #3: Defined Benefit Plans are Cheaper than Defined Contribution Plans – and they are better for retirees and the economy.

> *…the public pension systems are a ticking time bomb with potentially catastrophic consequences….Quite simply, cities and states need to consider switching from the prevailing "defined benefit" pension plans to the "defined contributions" plans common in the private sector (Brouillette, 2013).*

As we reviewed in Part II, NYSLRS is a defined benefit (DB) plan, as are the majority of public pension plans. Critics of this system have argued that it is too costly and a reform to switch to a defined contribution plan is necessary. However, a recent report from the Fiscal Policy Institute (2013) finds that for a given amount of monthly pension, defined benefit pensions cost 48% less than a defined contribution plan. Another report on Illinois reached the same conclusion (Picur and Weiss 2011). Then why do some argue defined contribution plans are much cheaper? The answer can be found in looking at the balance sheets when the transition from DB to DC plans occur. Several studies have found that when employers switch from DB plans to DC plans, they accompany this switch with decreases in levels of benefits. So the savings are not a result of the DC plan, but due to cutting benefit levels. Moreover, economists have found that DB plans are more economically efficient and that *given the same level of benefits*, the costs of DB plans are lower than DC plans (Almeida & Fornia, 2008).

A study by the National Institute on Retirement Security (2008) reports that DB plans allow longevity risk pooling, maintenance of portfolio diversification, and superior investment returns, leading to a total cost savings of 46%. Another study by the same institution found that DB plans play a significant role in reducing poverty among older households. The results show that "older households with DB pension income were far less likely to experience food, shelter, and health care hardships. In addition, DB pension recipient households were less reliant on means-tested cash and non-cash public assistance" (Almeida & Fornia, 2008:1). While some critique DB plans for rewarding public employees who stay in their job for a longer time, others recognize the value of a public system that rewards public employees who have accumulated the know-how of public services and policies (Levine & Scorsone, 2011).

Fact #4: While employees pay a significant portion of pension costs from their own salaries, pension obligations do put pressure on the budget for current services.

> *The run-up in pension costs threatens to divert scarce resources from essential public services during a time of extreme fiscal and economic stress for every level of government. New York needs to enact fundamental pension reform to permanently eliminate the risks and unpredictability inherent in the traditional pension system….New York State's public pension system is "a ticking fiscal time bomb" The bomb is now exploding—and New Yorkers will be coping with the fallout for years to come (McMahon and Barro, Manhattan Institute, 2010: p i).*

While absolute values of pension costs have been increasing since 2003, one must study historical trends in employer contributions to understand why this is happening. Figure 8 shows employer contribution rates from 1974 to 2013. The contribution rates were at approximately 33% in the 1970s for PFRS and 20% for ERS (the higher rates for PFRS are due to the earlier retirement age of police and firefighters). These contribution rates then begin to drop steeply until in 1991 they hit a low of 7.8% for PFRS and 0.3% for ERS. Public employees have pointed out that these low rates of contribution signal irresponsible choices on the part of government managers and the State during the 1990s. When the economy was booming, the State did not require employers to contribute annually as the fund accumulated high rates of return. Contributions began to rise steeply in 2004 and 2005, but then turned down again to 2009. Rates have been rising sharply since 2010, exactly when local governments are facing the affects of the economic recession and feeling even more fiscal stress.

Public employees and public unions are aware of the financial hardships of local governments. In fact, there are cases in which public unions and local governments were able to come to an understanding to help local governments deal with the fiscal crisis. For example, in Glen Falls City, NY firefighters recently went to arbitration court over disputes on wage increases with the local government. The case has been cited by critics of public unions as a case of outrageous wage increases in a time of fiscal stress. This claim, however, disregards key facts and previous history. These firefighters were originally scheduled to receive a 4% raise in 2010. The arbitration report states that the firefighters "deferred to the City's claim of fiscal exigency and accepted a 0% increase, the greatest concession of any unit in the City." (NYS Public Employment Relations Board, 2012)

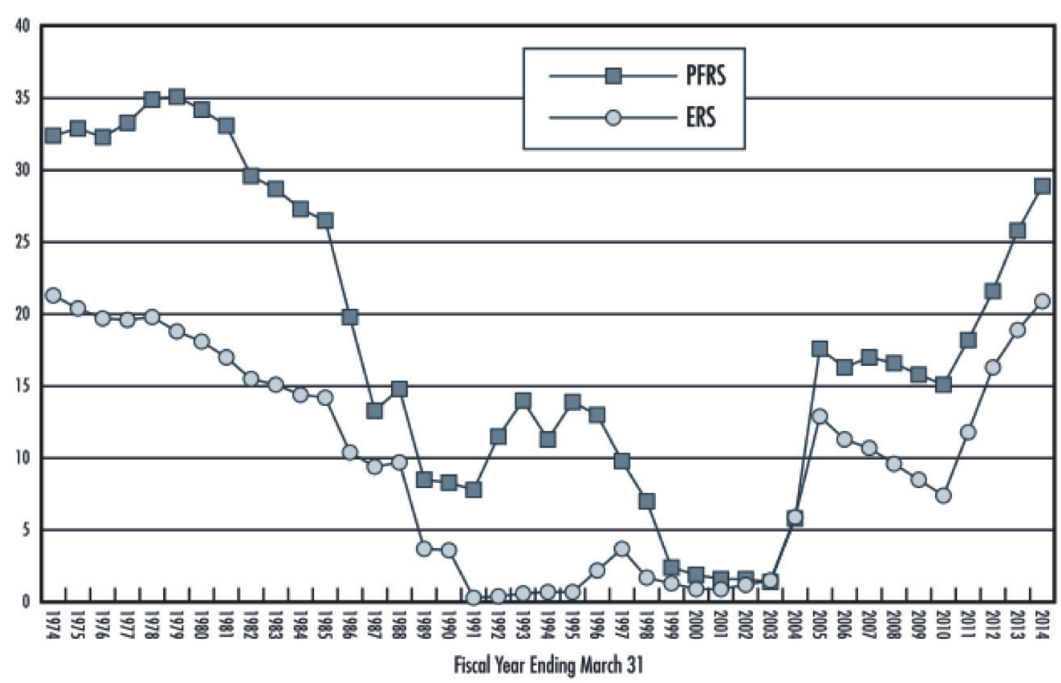
From 1993 to 2009 about 69.86% of pension fund receipts came from investment earnings while 23.58% came from employer contributions, and 6.57% from employee contributions. Retired public employees are not depending on tax money for the majority of their pension.

Fact #5: Pension obligations are escalating as a result of the financial crisis and will continue to increase as the Baby Boomer generation retires.

> *States continue to lose ground in their efforts to cover the long-term costs of their employees' pensions and retiree health care, according to a new analysis by the Pew Center on the States, due to continued investment losses from the financial crisis of 2008 and states' inability to set aside enough each year to adequately fund their retirement promises. (The Pew Center on the States, 2012: pg 1)*

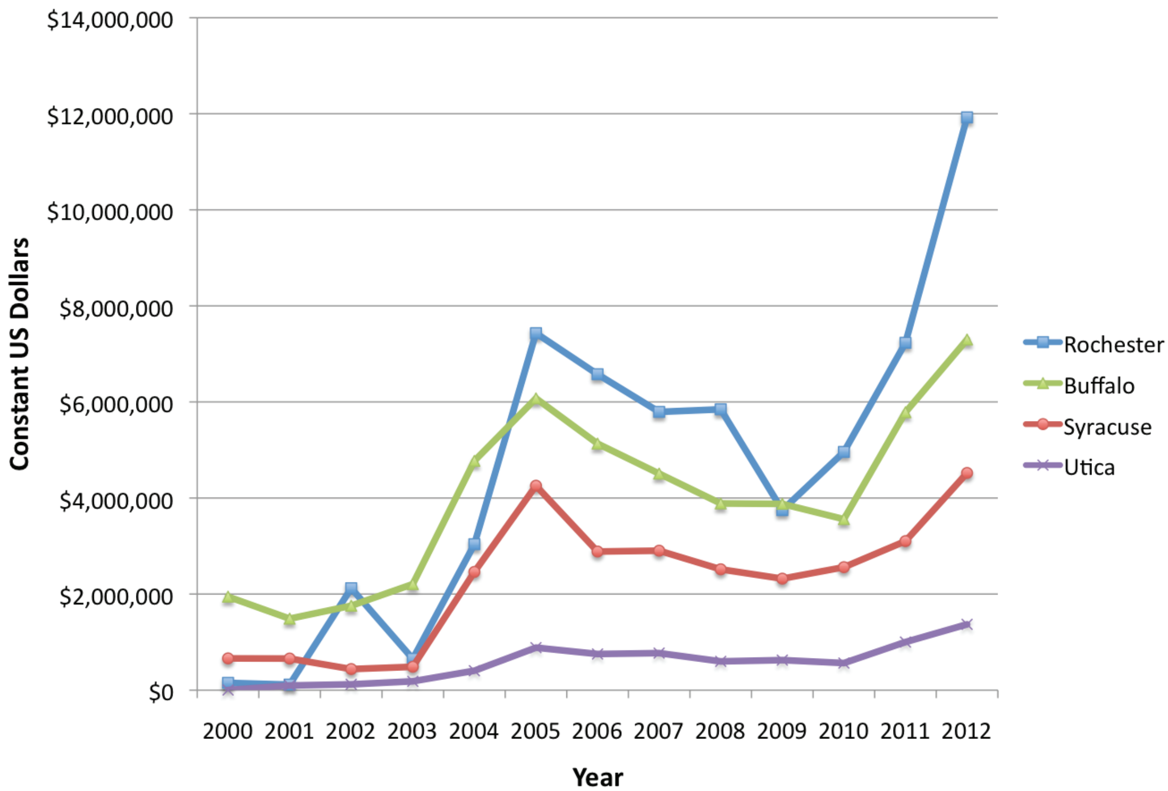
Pension obligations show uneven rates of growth for local governments. Figures 9 and 10 show pension costs rose fastest from 2003-2005 as a result of low contributions in the 1990s compounded by both investment loss during the economic downturn as well as benefit enhancements for Tier IV members, which increased rates for employers. Increases in pension costs from 2011-2014 are a direct result of the Great Recession. Because employee contribution

FIGURE 8: Trends in Employer Contributions



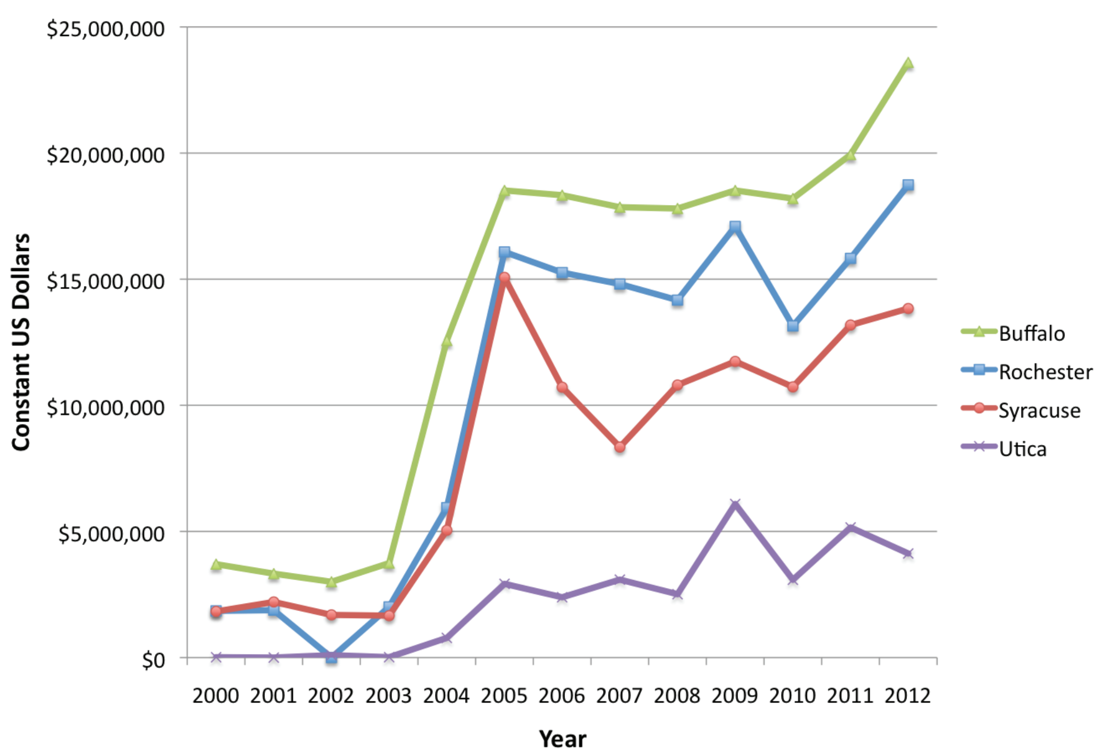
Source: 2013 New York State and Local Retirement System Comprehensive Annual Financial Report; Page 122 Vertical Axis: Employer Contributions as a Percent of Payroll
Note: These numbers are based on fiscal year (ending March 31 each year)

FIGURE 9: Total Local Government Pension Costs, ERS



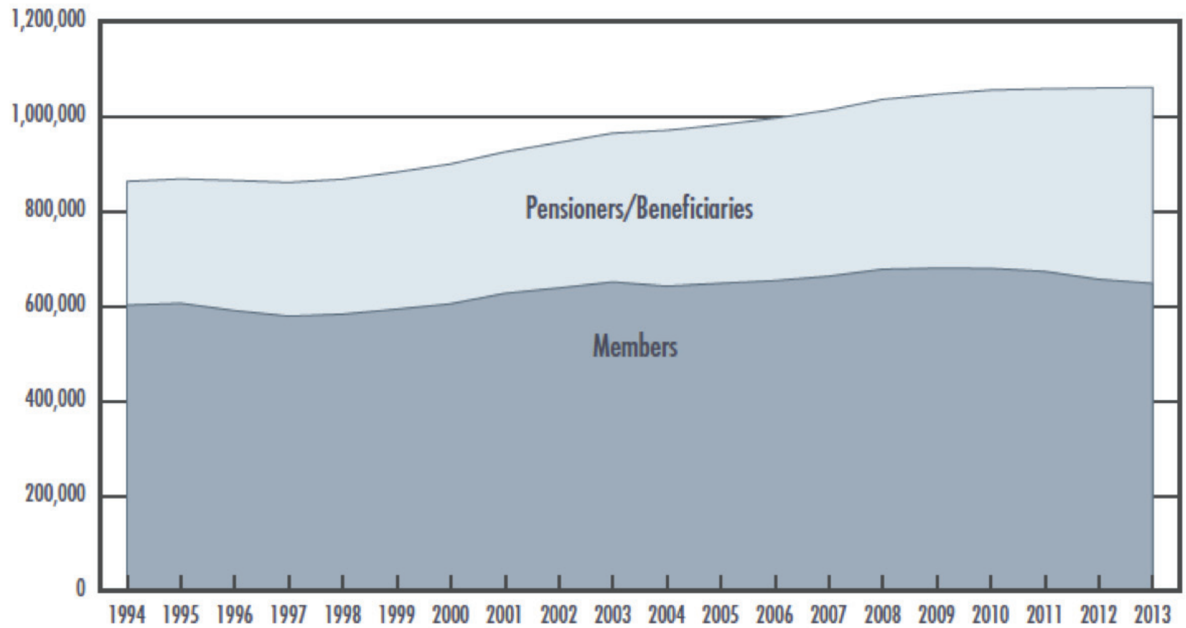
Author Analysis Based on Data From the Office of the State Comptroller. 2014. www.osc.state.ny.us/localgov/index.htm

FIGURE 10: Total Local Government Pension Costs, PFRS



Author Analysis Based on Data From the Office of the State Comptroller. 2014. www.osc.state.ny.us/localgov/index.htm

FIGURE 11: NYSLRS System Participants



Source: 2013 New York State and Local Retirement System Comprehensive Annual Financial Report. Page 149

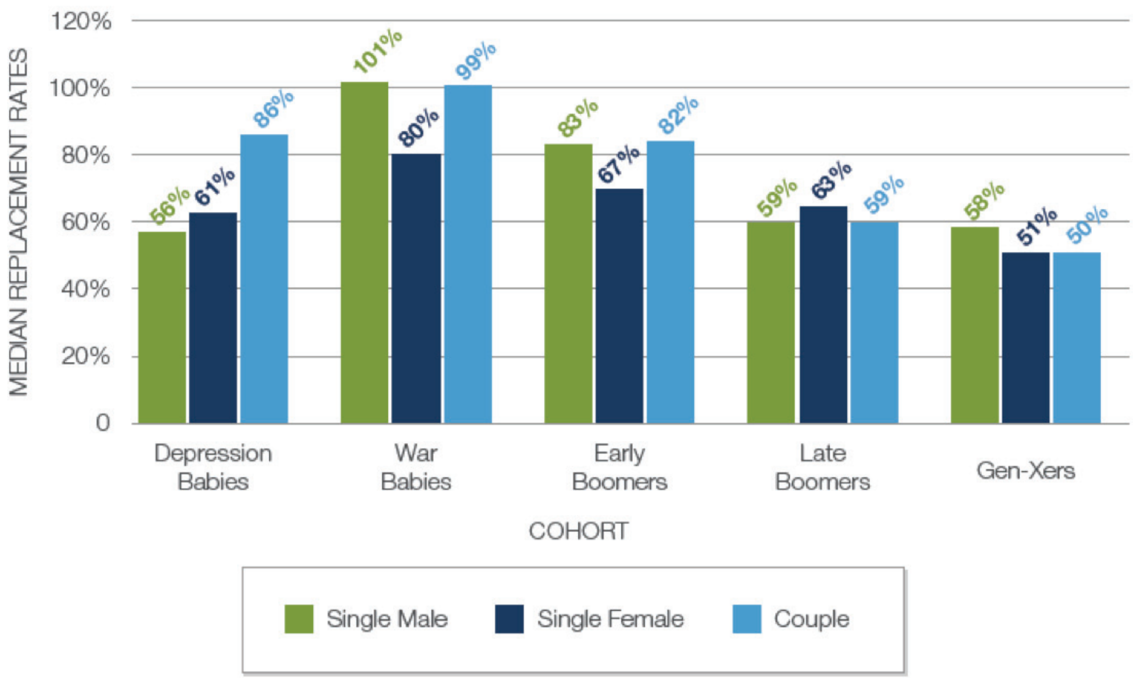
rates are fixed, in periods when returns are less than the assumed rate of return, employers must make up for this funding through higher contributions. According to local government data from the Office of the New York State Comptroller, pension costs since 2010 vary by city but most cities have returned to their 2005 levels by 2011. In constant dollars – 2011 expenditures for ERS are actually lower than in 2005 for most cities except for Utica and for PFRS are lower for Syracuse and Rochester, but higher for Buffalo and Utica (Office of the New York State Comptroller, 2014).

The impact of the Great Recession contributed to rising pension costs, however, this is not the sole reason for escalating obligations. As more Baby Boomers retire and collect benefits, pension obligations will continue to increase. In 1994, 70% of NYSLRS participants were current employees and 30% were retirees. In 2013, 61% of NYSLRS participants were current employees and 39% were retirees. Figure 11 shows the increasing number of beneficiaries compared to employees over time. The demographic reality is unavoidable. For local governments, as the ratio of retirees to current employees grows, pension obligations will as well. Ironically, efforts to trim the current workforce will only make this ratio worse.

As a result of the recession, future retirees may face financial insecurity in retirement. The study *Retirement Security Across Generations: Are Americans Prepared for Their Golden Years?* conducted by the Pew Charitable Trust found that as a result of the recession and decreased pension benefits, Late Boomers and Gen-Xers may face downward mobility in retirement. Figure 12 shows replacement rate calculations by generation cohort and household type. If an individual or family is projected to have exactly the same amount of money in retirement as they had in preretirement, then the replacement rate is 100%. While the ideal replacement rate is a subject of debate, financial planners advise individuals to replace 70 to 100 percent of their annual income in retirement (The Pew Charitable Trust, 2013). The chart highlights that Late Boomers and Gen-Xers lack adequate resources for retirement.

As pension reforms like Tier VI cut benefits for new hires, future generations will face financial insecurity in retirement. Defined benefit plans may help mitigate the

FIGURE 12: Replacement Rates by Cohort and Household Type



Source: Retirement Security Across Generations: Are Americans Prepared for Their Golden Years? Pew Charitable Trust. 2013. Page 23.

impending downward mobility of future retirees. In 2006, 4.7 million older households avoided falling below the poverty line due to income from their DB plans (National Institute on Retirement Security, FAQs).

Fact #6: Public sector pensions are not overly generous.

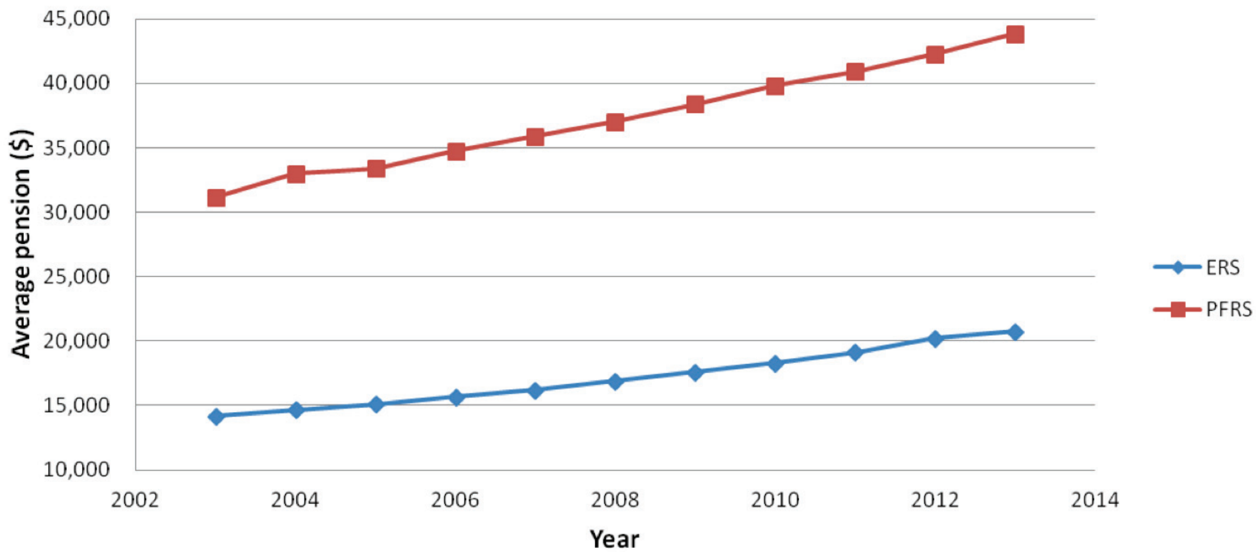
...Politicians gave away the store to public employee unions (New York Daily News, 2012)

In Yonkers, more than 100 retired police officers and firefighters are collecting pensions greater than their pay when they were working. One of the youngest, Hugo Tassone, retired at 44 with a base pay of about $74,000 a year. His pension is now $101,333 a year (Walsh and Schoenfeld, 2010).

The story of six figure public pensions makes great news but belies reality. The average pension received for ERS retirees in fiscal year 2013 was $20,766 and $43,844 for PFRS retirees. Figure 13 shows the trend of average public pension rates since 2003. The benefit levels, in terms of current dollars, have been on an increasing trend. Accounting for inflation they also show a steady increase. However, pension and union experts point out that this does not indicate that a retiree in 2013 is significantly better off than a retiree in 2004.

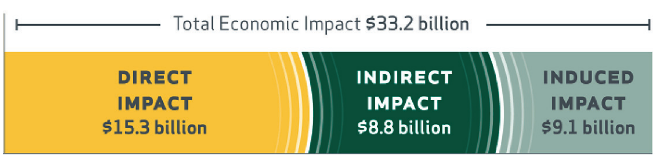
Another criticism is the spiking and padding of firefighter and police pensions. Yet, even in these claims, it is important to examine the details closely. For example, the firefighter union of Rochester complains that recent cuts in firefighter staff have left them with fewer firefighters in the city. Fewer firefighters try to do the same amount of work, which results in more overtime work. Overtime pay is often 1.5 times more than regular pay levels and this can result in "spiking" without the explicit intention to do so.

FIGURE 13: Average pension benefits paid during year, 2003-2013



Author Analysis Based on Data From 2013 New York State and Local Retirement System Comprehensive Annual Financial Report
Note: Average Pension in Current Dollars

FIGURE 14: Results of an economic impact analysis of pension benefits in New York State



Source: Boivie, Ilana. National Institute on Retirement Security. Pensionomics 2012: Measuring the Economic Impact of DB Pension Expenditures. Page 1

Recent New York State pension reforms have limited the use of overtime to pad pensions in the final years before retirement by capping pensionable overtime at $15,000 and increasing the final average salary calculation from 3 to 5 years (Governor's Press Office, 2012).

Fact #7: Public pensions can stimulate local economies.

While they may be a significant expenditure for local government, public pensions are a stimulus for local economies. An economic impact analysis of New York State conducted by the National Institute on Retirement Security shows that in 2009 expenditures stemming from state and local pensions supported 200,106 jobs, $33.2 billion in total economic output, $5.1 billion in federal, state, and local tax revenues (Boivie, 2012). In New York State public pensions had a direct impact of $15.3 billion in 2012. Pension expenditures stimulated businesses to buy more goods and services creating an indirect impact of $8.8 billion. Businesses also hired more employees who spent their earnings in the local economy and yielded an induced impact of $9.1 billion. As retirees form an increasingly large share of our population, pension income will become even more important to the regional economy.

6

Looking Ahead

We examined seven facts about public pensions, public unions, and their effect on local government fiscal crisis. To summarize, New York State's public pension fund is not running out of money; is not overestimating rate of returns; and is not underfunded. There is nothing inherently unsustainable about the defined benefit structure, and in fact these forms are more efficient than defined contribution programs. Public pensions are a considerable part of local government budgets and because these are state mandated contributions they certainly constrain local governments' financial decisions. However, the average employee is not getting overly generous pension benefits and indeed, pension benefits are injected back into the region's economy and generating jobs and sales tax revenues.

The recent media and popular discourse has exaggerated the problem. The cause of fiscal stress is not pension contributions, but is a result of the Great Recession. Not all pension systems are equal, each state pension system has different structures, and characteristics. New York state's pension fund is well managed. Furthermore, not all public employees are equal. The majority receive a modest package after retirement.

The pension crisis is a result of prior state decisions regarding contributions in the 1990s and early 2000s, and the financial crisis since 2008. While pensions should not be blamed as the cause of fiscal stress, they certainly add to the fiscal burden faced by local governments. Pension obligations are a considerable expenditure, up to 6% of annual total spending for upstate cities struggling to provide services with resource constraints (Office of the State Comptroller, 2014). While reforms such as the new Tier VI, pension amortization and reducing padding will help, the long term solution is to ensure a regular pattern of payment in all years. The Great Recession and financial crash contributed to the problem, but so too, did lower than average contribution rates in the 1990s. State policymakers must work with local officials to find a point of balance where local governments are able to meet pension obligations while maintaining the services that citizens need.

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