United States Government Accountability Office

GAO

Testimony
Before the Joint Economic Committee

For Release on Delivery
Expected at 10:00 a.m. EST
Thursday, July 10, 2008

STATE AND LOCAL GOVERNMENT PENSION PLANS

Current Structure and Funded Status

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security



July 2008

STATE AND LOCAL GOVERNMENT PENSION PLANS

Current Structure and Funded Status

GAO Accountability • Integrity • Reliability

Highlights

Highlights of GAO-08-983T, a testimony before the Joint Economic Committee

Why GAO Did This Study

Millions of state and local government employees are promised pension benefits when they retire. Although these benefits are not subject, for the most part, to federal laws governing private sector benefits, there is a federal interest in ensuring that all American have a secure retirement, as reflected in the special tax treatment provided for private and public pension funds. Recently, new accounting standards have called for the reporting of liabilities for future retiree health benefits. It is unclear what actions state and local governments may take once the extent of these liabilities become clear but such anticipated fiscal and economic challenges have raised questions about the unfunded liabilities for state and local retiree benefits, including pension benefits. GAO was asked to report on (1) the current structure of state and local government pension plans and how pension benefits are protected and managed, and (2) the current funded status of state and local government pension plans. GAO spoke to a wide range of public experts and officials from various federal and nongovernmental entities, made several site visits and gathered detailed information about state benefits, and analyzed self-reported data on the funded status of state and local pension plans from the Public Fund Survey and Public Pension Coordinating Council.

What GAO Recommends

GAO is not making recommendations at this time.

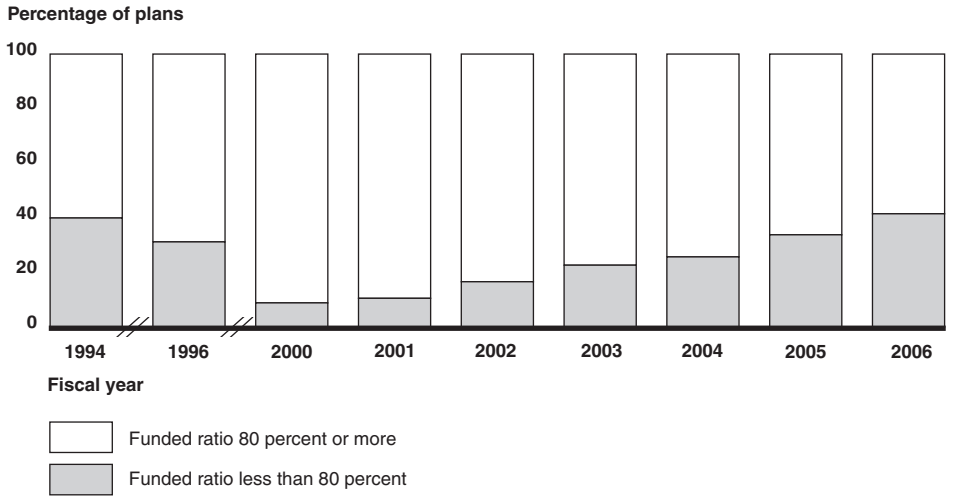
To view the full product, including the scope and methodology, click on GAO-08-983T. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

What GAO Found

State and local entities typically provide pension plans with defined benefits and a supplemental defined contribution plan for voluntary savings. Most states still have traditional defined benefit plans as the primary retirement plans for their workers. However, a couple of states have adopted defined contribution and other plans as their primary plan. State and local entities typically offer tax-deferred supplemental voluntary plans to encourage workers to save. State statutes and local ordinances protect and manage pension benefit and often include explicit protections, such as provisions stating that pensions promised to public employees cannot be eliminated or diminished. In addition, state constitutions and/or statutes often require pension plans to be managed as trust funds and overseen by boards of trustees.

Most state and local government pension plans have enough invested resources set aside to fund the benefits they are scheduled to pay over the next several decades. Many experts consider a funded ratio (actuarial value of assets divided by actuarial accrued liabilities) of about 80 percent or better to be sound for government pensions. We found that 58 percent of 65 large pension plans were funded to that level in 2006, a decrease since 2000 when about 90 percent of plans were so funded. Low funded ratios would eventually require the government employer to improve funding, for example, by reducing benefits or by increasing contributions. However, pension benefits are generally not at risk in the near term because current assets and new contributions may be sufficient to pay benefits for several years. Still, many governments have often contributed less than the amount needed to improve or maintain funded ratios. Low contributions raise concerns about the future funded status.

Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent



Source: GAO analysis of PFS, PENDAT data.

Mr. Chairman and Members of the Committee:

I am pleased to be here today as you consider the current structure and funded status of state and local government pension plans. Nearly 20 million employees and 7 million retirees and dependents of state and local governments—including school teachers, police, firefighters, and other public servants—are promised pensions. Although state and local pension plans are not subject, for the most part, to federal laws governing private sector pension plans, there is a federal interest in ensuring that all Americans have a secure retirement, an interest that is reflected in preferential tax treatment for contributions and investment earnings associated with qualified pension plans in both the public and private sectors.

Many pension benefits represent actuarial accrued liabilities[1] for state and local governments and ultimately the taxpayer. Typically, pension benefits are paid from a fund made up of assets from employers' and employees' annual contributions and the investment earnings from these contributions. Such a fund has an unfunded liability when the actuarial value of assets is less than actuarial accrued liabilities. Accounting standards have called for state and local governments to report their unfunded pension liabilities since 1986. Recently, new government accounting standards were issued, calling for the reporting of liabilities for future retiree health liabilities. The extent of these liabilities nationwide is not yet known, but some predict they will be very large, exceeding $1 trillion dollars nationwide in present value terms. It is unclear what actions state and local governments may take once the future costs of these liabilities become clear but such anticipated fiscal and economic challenges have raised questions about the unfunded liabilities for state and local retiree benefits, including pension plans.

My comments today are based on findings from our September 2007 report entitled State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs[2] and our January 2008 report entitled State and Local Government

[1] Actuarial accrued liabilities, referred to in this testimony as "liabilities," are the portion of the present value of future benefits that is attributable to employee services in past periods, under the actuarial cost method utilized.

[2] GAO-07-1156 (Washington, D.C.:Sept. 24, 2007).

Retiree Benefits: Current Funded Status of Pension and Health Benefits.[3] My remarks focus on (1) the current structure of state and local government pension plans and how pension benefits are protected and managed, and (2) the current funded status of state and local government pension plans.

To determine the structure of state and local pension benefits and protections, we spoke with experts, advocacy groups, and union officials from various national organizations and associations, various federal agencies, and nongovernmental entities that analyze government data and conduct surveys on these topics. We also conducted site visits and gathered detailed information about the benefits provided in three states, California, Michigan, and Oregon. To illustrate a wide range of retiree benefit system characteristics, in some instances we complemented information gathered during our site visits with information gathered about retiree benefits provided in other state and local jurisdictions. To determine the current funded status of state and local government pension plans, we analyzed self-reported data from the Public Fund Survey (PFS) as well as surveys by the Public Pension Coordinating Council (PPCC).[4] We conducted our performance audits from July 2006 to January 2008 in accordance with generally accepted government auditing standards, which included an assessment of data reliability. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions on our audit objectives.

In summary, we found that state and local entities typically provide a pension plan with defined benefits and a supplemental defined contribution plan for voluntary savings. As of 2007, most states still have traditional defined benefit plans as the primary retirement plans for their workers. Only two states (Alaska and Michigan) and the District of Columbia had adopted defined contribution plans as their primary plans for general public employees. Two other states (Indiana and Oregon) had

[3] GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[4] The PFS is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement. In 2005, the PFS data we used represented 58 percent of total assets invested in public pension plans nationwide, and 72 percent of total members. PFS data covered years beginning with 2001. PPCC data covered years 1994, 1996, and 2000.

adopted primary plans with both defined benefit and defined contribution components, while one state (Nebraska) had adopted a cash balance defined benefit plan as its primary plan. State statutes and local ordinances typically protect pension plan benefits, often including explicit protections such as provisions stating that pensions promised to public employees cannot be eliminated or diminished. State constitutions and/or statutes often require pension plans to be managed as trust funds and overseen by boards of trustees, which typically establish overall policies for the operation and management of the pension plans, including adopting actuarial assumptions for calculating liabilities, establishing procedures for financial control and reporting, and setting investment strategies. We also found that more than half of public pension plans reported that they have put enough assets aside in advance to pay for benefits over the next several decades. Although many experts consider a funded ratio of about 80 percent or better to be sound for government pensions, the percentage of pension plans with funded ratios below 80 percent has increased in recent years. Available data show that 58 percent of 65 large pension plans were funded to that level in 2006, a decrease since 2000 when about 90 percent of plans were so funded. A few plans are persistently and significantly underfunded, and although members of these plans may not be at risk of losing benefits in the near term, the unfunded liabilities will have to be made up in the future. Finally, a number of governments reported not contributing enough to reduce unfunded liabilities. Low contributions raise concerns about the future funded status, and may shift costs to future generations.

Background

Pension plans can generally be characterized as either defined benefit or defined contribution plans. In a defined benefit plan, the amount of the benefit payment is determined by a formula typically based on the retiree's years of service and final average salary, and is most often provided as a lifetime annuity. For state and local government retirees, postretirement cost-of-living adjustments (COLAs) are frequently provided in defined benefit plans. But benefit payments are generally reduced for early retirement, and in some cases payments may be offset for receipt of Social Security.[5] In a defined contribution plan, the key determinants of the benefit amount are the employee's and employer's contribution rates, and

[5] Unlike in the private sector, there are large groups of state and local government workers who are not covered by Social Security. According to data from the Social Security Administration, about 30 percent of all state and local government workers nationwide are not covered, although the extent of coverage varies widely by state and by occupation.

the rate of return achieved on the amounts contributed to an individual's account over time. The employee assumes the investment risk; the account balance at the time of retirement is the total amount of funds available, and unlike with defined benefit plans, there are generally no COLAs. Until depleted, however, a defined contribution account balance may continue to earn investment returns after retirement, and a retiree could use the balance to purchase an inflation-protected annuity. Also, defined contribution plans are more portable than defined benefit plans, as employees own their accounts individually and can generally take their balances with them when they leave government employment. There are no reductions based on early retirement or for participation in Social Security.[6]

Both government employers and employees generally make contributions to fund state and local pension benefits. For plans in which employees are covered by Social Security, the median contribution rate in fiscal year 2006 was 8.5 percent of payroll for employers and 5 percent of pay for employees, in addition to 6.2 percent of payroll from both employers and employees to Social Security. For plans in which employees are not covered by Social Security, the median contribution rate was 11.5 percent of payroll for employers and 8 percent of pay for employees. Actuaries estimate the amount that will be needed to pay future benefits. The benefits that are attributable to past service are called "actuarial accrued liabilities." (In this report, the actuarial accrued liabilities are referred to as "liabilities." Actuaries calculate liabilities based on an actuarial cost method and a number of assumptions including discount rates and worker and retiree mortality. Actuaries also estimate the "actuarial value of assets" that fund a plan. (In this report, the actuarial value of assets is referred to simply as "assets"). The excess of actuarial accrued liabilities over the actuarial value of assets is referred to as the "unfunded actuarial accrued liability" or "unfunded liability." Under accounting standards, such information is disclosed in financial statements. In contrast, the liability that is recognized on the balance sheet is the cumulative excess of annual benefit costs over contributions to the plan. Certain amounts included in the actuarial accrued liability are not yet recognized as annual benefit costs under accounting standards, as they are amortized over several years.

[6] There could, however, be federal tax penalties if funds are withdrawn before the employee reaches a certain age. 26 U.S.C. § 72(t).

State and local government pension plans are not covered by most of the substantive requirements, or the insurance program operated by the Pension Benefit Guaranty Corporation (PBGC), under the Employee Retirement Income Security Act of 1974 (ERISA), which apply to most private employer benefit plans. Federal law generally does not require state and local governments to prefund or report on the funded status of pension plans. However, in order to receive preferential tax treatment, state and local pensions must comply with requirements of the Internal Revenue Code. In addition, the retirement income security of Americans is an ongoing concern of the federal government.

Although ERISA imposes participation, vesting, and other requirements directly upon employee pension plans offered by private sector employers, governmental plans such as those provided by state and local governments to their employees are excepted from these requirements. In addition, ERISA established an insurance program for defined benefit plans under which promised benefits are paid (up to a statutorily set amount) if an employer cannot pay them—but this too does not apply to governmental plans. However, for participants in governmental pension plans to receive preferential tax treatment (that is, for plan contributions and investment earnings to be tax-deferred), plans must be deemed "qualified" by the Internal Revenue Service.[7]

Since the 1980s, the Governmental Accounting Standards Board (GASB) has maintained standards for accounting and financial reporting for state and local governments. GASB operates independently and has no authority to enforce the use of its standards. Still, many state laws require local governments to follow GASB standards, and bond raters do consider whether GASB standards are followed. Also, to receive a "clean" audit opinion under generally accepted accounting principles, state and local governments are required to follow GASB standards. These standards require disclosing financial information on pensions, such as the amount of contributions and the ratio of assets to liabilities.

Three measures are key to understanding pension plans' funded status: contributions, funded ratios, and unfunded liabilities. According to experts

[7] Contributions to qualified pension plans that meet certain requirements—whether defined benefit or defined contribution—are not counted as taxable income to employees when the contributions are made. However, when pension benefits are paid, amounts not previously taxed are subject to federal and perhaps state tax. This also applies to the interest income such contributions generate.

we interviewed, any single measure at a point in time may give a dimension of a plan's funded status, but it does not give a complete picture. Instead, the measures should be reviewed collectively over time to understand how the funded status is improving or worsening. For example, a strong funded status means that, over time, the amount of assets, along with future schedule contributions, comes close to matching a plan's liabilities.[8]

Under GASB reporting standards, the funded status of different pension plans cannot be compared easily because governments use different actuarial approaches such as different actuarial cost methods, assumptions, amortization periods, and "smoothing" mechanisms. Most public pension plans use one of three "actuarial cost methods," out of the six GASB approves.[9] Actuarial costs methods differ in several ways. First, each uses a different approach to calculate the "normal cost," the portion of future benefits that the cost method allocates to a specific year, resulting in different funding patterns for each.[10] In addition to the cost methods, differences in assumptions used to calculate the funded status can result in significant differences among plans that make comparison difficult. Also differences in amortization periods make it difficult to compare the funded status of different plans. Finally, actuaries for many plans calculate the value of current assets based on an average value of past years. As a result, if the value of assets fluctuates significantly from year to year, the "smoothed" value of assets changes less dramatically. Comparing the funded status of plans that use different smoothing periods

[8] For more extensive information on the three key measures see *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[9] The three most commonly used actuarial cost methods are the projected unit credit (projected benefits of each employee covered by the plan are allocated by a consistent formula to valuation years); entry age normal (the current value of future benefits of each employee is allocated on a level basis over the earnings or service of the employee between entry age and assumed exit age); and aggregate (the excess of the value of future benefits of all employees over the current value of assets is allocated on a level basis over the earnings or service of the group between the valuation date and assumed exit. This allocation is performed for the group as a whole, not as a sum of individual allocations).

[10] Actuarial cost methods are used to allocate the current value of future benefits into amounts attributable to the past, to the current year, and to future years. The cost of future benefits that are attributable to past years under the actuarial cost method is called the actuarial accrued liability (AAL), while the cost of benefits accrued under the cost method in the current year is known as the normal cost.

can be confusing because the value of the different plans' assets reflects a different number of years.[11]

We reported recently that state and local governments will likely face daunting fiscal challenges, driven in large part by the growth in health-related costs, such as Medicaid and health insurance for state and local employees. Our report was based on simulations for the state and local government sector that indicated that in the absence of policy changes, large and growing fiscal challenges will likely emerge within a decade.[12] We found that, as is true for the federal sector, the growth in health-related costs is a primary driver of these fiscal challenges.

State And Local Government Pension Plans Typically Include A Defined Benefit Plan And A Supplemental Voluntary Savings Plan And Laws Protect Benefits

State and local governments typically provide their employees with retirement benefits that include a defined benefit plan and a supplemental defined contribution plan for voluntary savings. However, the way each of these components is structured and the level of benefits provided varies widely--both across states, and within states based on such things as date of hire, employee occupation, and local jurisdiction. Statutes and local ordinances protect and manage pension plans and are often anchored by provisions in state constitutions and local charters. State and local law also typically requires that pensions be managed as trust funds and overseen by boards.

Defined Benefit Plans Provide the Core Benefits for Most Retirees

Most state and local government workers are provided traditional pension plans with defined benefits. About 90 percent of full-time state and local employees participated in defined benefit plans as of 1998.[13] In fiscal year 2006, state and local government pension systems covered 18.4 million members and made periodic payments to 7.3 million beneficiaries, paying

[11]For more extensive information on the actuarial cost methods and comparisons see *State and Local Government Retiree Benefits: Current Funded Status of Pension and Health Benefits*, GAO-08-223 (Washington, D.C.: Jan. 29, 2008).

[12] GAO, State and Local Governments: *Persistent Fiscal Challenges Will Likely Emerge within the Next Decade*, GAO-07-1080SP (Washington, D.C.: July 18, 2007).

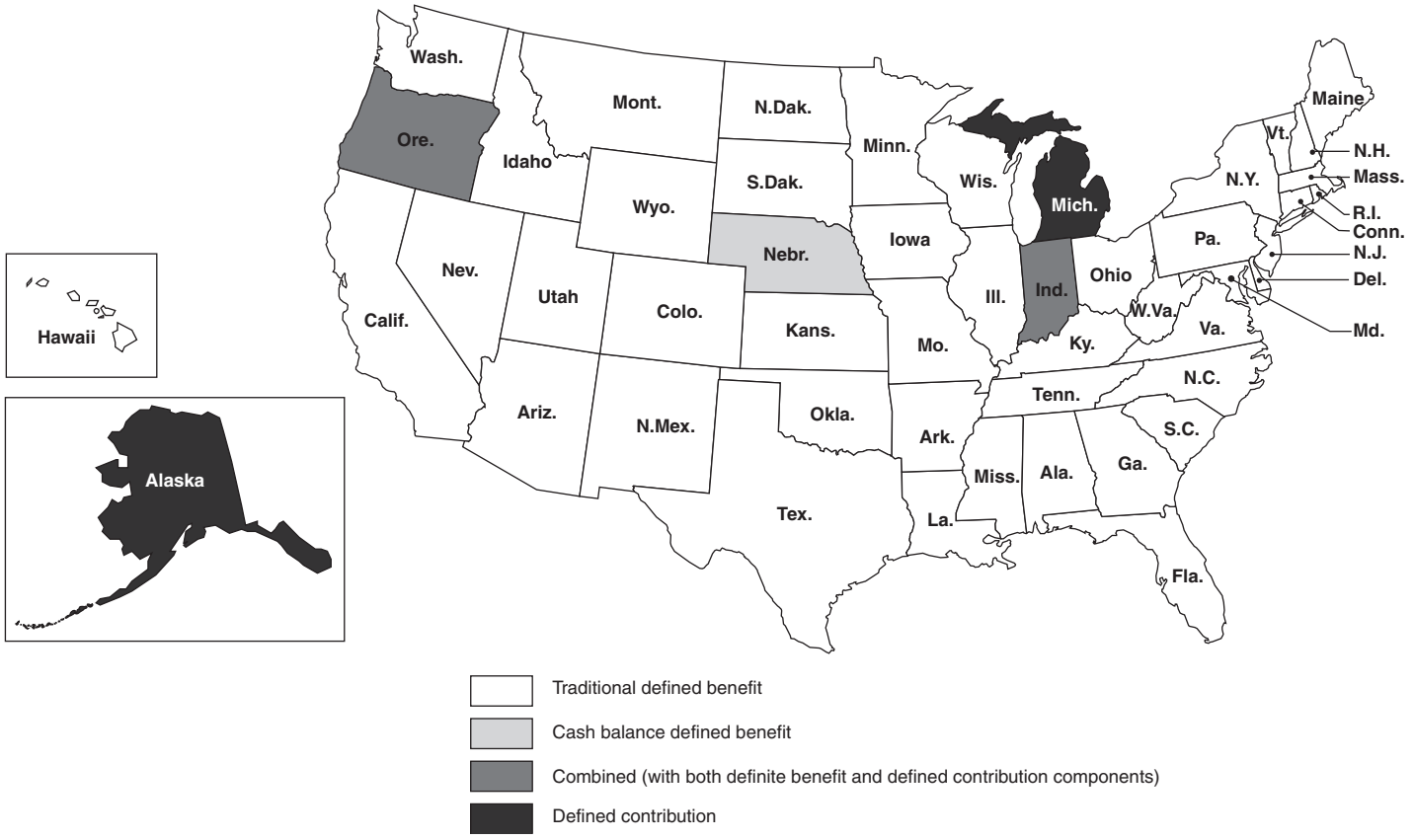
[13] The last year for which the Bureau of Labor Statistics published these data was 1998. U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in State and Local Governments, 1998* (Washington, D.C.: 2000).

out $151.7 billion in benefits. State and local government employees are generally required to contribute a percentage of their salaries to their defined benefit plans, unlike private sector employees, who generally make no contribution when they participate in defined benefit plans. According to a 50-state survey conducted by Workplace Economics, Inc., 43 of 48 states with defined benefit plans reported that general state employees were required to make contributions ranging from 1.25 to 10.5 percent of their salaries. Nevertheless, these contributions have no influence on the amount of benefits paid because benefits are based solely on the formula.

In 1998, all states had defined benefit plans as their primary pension plans for their general state workers except for Michigan and Nebraska (and the District of Columbia), which had defined contribution plans as their primary plans, and Indiana, which combined both defined benefit and defined contribution components in its primary plan.[14] Almost a decade later, we found that as of 2007, only one additional state (Alaska) had adopted a defined contribution plan as its primary plan; one additional state (Oregon) had adopted a combined plan, and Nebraska had replaced its defined contribution plan with a cash balance defined benefit plan. (See fig. 1.) Although still providing defined benefit plans as their primary plans for general state employees, some states also offer defined contribution plans (or hybrid defined benefit/defined contribution plans) as optional alternatives to their primary plans. These states include Colorado, Florida, Montana, Ohio, South Carolina, and Washington.

[14] See GAO, State and Pension Plans: Similarities and Differences Between Federal and State Designs, GAO/GGD-99-45 (Washington, D.C.:Mar. 19, 1999). Also, as of 1998, across all state and local employees nationwide, Bureau of Labor Statistics survey data indicate that 90 percent were covered by defined benefit plans.

Figure 1: Types of Pension Plans in Place for Newly Hired General State Employees, as of 2007



Source: GAO analysis of data from various national organizations and from individual states' reports and publications.

Note: Plans depicted are those in which newly hired general state employees in each state are required to participate as their primary pension plan. In some states, employees may opt to participate in alternative or supplementary defined contribution plans, but participation in these plans is not mandatory.

In states that have adopted defined contribution plans as their primary plans, most employees continue to participate in defined benefit plans because employees are allowed to continue their participation in their

previous plans (which is rare in the private sector).[15] Thus, in contrast to the private sector, which has moved increasingly away from defined benefit plans over the past several decades, the overwhelming majority of states continue to provide defined benefit plans for their general state employees.

Most states have multiple pension plans providing benefits to different groups of state and local government workers based on occupation (such as police officer or teacher) and/or local jurisdiction. According to the most recent Census data available, in fiscal year 2004-2005 there were a total of 2,656 state and local government pension plans. We found that defined benefit plans were still prevalent for most of these other state and local employees as well. For example, a nationwide study conducted by the National Education Association in 2006 found that of 99 large pension plans serving teachers and other school employees, 79 were defined benefit plans, 3 were defined contribution plans, and the remainder offered a range of alternative, optional, or combined plan designs with both defined benefit and defined contribution features.

In addition to primary pension plans (whether defined benefit or defined contribution), data we gathered from various national organizations show that each of the 50 states has also established a defined contribution plan as a supplementary, voluntary option for tax-deferred retirement savings for their general state employees. Such plans appear to be common among other employee groups as well.[16] These supplementary defined contribution plans are typically voluntary deferred compensation plans under section 457(b) of the federal tax code.[17]

While these defined contribution plans are fairly universally available, state and local worker participation in the plans has been modest. In a

[15] In the private sector, when a new plan is adopted, the previous plan is often frozen. Existing employees keep the benefits they have accrued to date, but cannot continue to participate in the previous plan from that point forward. In the public sector, when a new plan is adopted, existing employees generally are allowed to continue to participate in the previous plan. Generally only new employees, hired after adoption of the new plan, are required to participate in the new plan from that point forward.

[16] In addition, over the past 10 years, many public sector employers have established deferred retirement options plans (DROP). DROPs were created to retain experienced employees by permitting those eligible to retire to stay on the job and earn a lump-sum payment at retirement in addition to their defined benefit annuity.

[17] 26 U.S.C. § 457(b).

2006 nationwide survey conducted by the National Association of Government Defined Contribution Administrators, the average participation rate for all defined contribution plans was 21.6 percent.

One reason cited for low participation rates in these supplementary plans is that, unlike in the private sector, it has been relatively rare for employers to match workers' contributions to these plans, but the number of states offering a match has been increasing. According to a state employee benefit survey of all 50 states conducted by Workplace Economics, Inc., in 2006 12 states matched the employee's contribution up to a specified percent or dollar amount.[18] Among our site visit states, none made contributions to the supplementary savings plans for their general state employees, and employee participation rates generally ranged between 20 to 50 percent. In San Francisco, however, despite the lack of an employer match, 75 percent of employees

had established 457(b) accounts. The executive director of the city's retirement system attributed this success to several factors, including (1) that the plan had been in place for over 25 years, (2) that the plan offers good investment options for employees to choose from, and (3) that plan administrators have a strong outreach program. In the private sector, a growing number of employers are attempting to increase participation rates and retirement savings in defined contribution plans by automatically enrolling workers and offering new types of investment funds.[19]

Laws Protecting Pensions Are often Anchored in State Constitutions and Local Charters

State and local laws generally provide the most direct source of any specific legal protections for the pensions of state and local workers. Provisions in state constitutions often protect pensions from being eliminated or diminished. In addition, constitutional provisions often specify how pension funds are to be managed, such as by mandating certain funding requirements and/or requiring that the funds be overseen

[18] The Workplace Economics, Inc. 2006 survey instructed states to provide information on benefits that cover the largest number of employees, or that were otherwise deemed representative.

[19] GAO, *Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers*, GAO-07-355 (Washington, D.C.: Mar. 30, 2007).

by boards of trustees.[20] Moreover, we found that at the sites we visited, locally administered plans were generally governed by local laws. However, state employees, as well as the vast majority of local employees, are covered by state-administered plans.

Protections for pensions in state constitutions are the strongest form of legal protection states can provide because constitutions—which set out the system of fundamental laws for the governance of each state—preempt state statutes and are difficult to change. Furthermore, changing a state constitution usually requires broad public support. For example, often a supermajority (such as three-fifths) of a state's legislature may need to first approve proposed constitutional changes and typically if a change passes the legislature, voters must also approve it.

The majority of states have some form of constitutional protection for their pensions. According to AARP data compiled in 2000, 31 states have a total of 93 constitutional provisions explicitly protecting pensions.[21] (The other 19 states all have pension protections in their statutes or recognize legal protections under common law.) These constitutional pension provisions prescribe some combination of how pension trusts are to be funded, protected, managed, or governed. (See table 1.)

Table 1: Constitutional Protections for Pension Benefits

Constitutional provisions requiring	States	Number of states
Certain standards are to be in place for how the retirement system should be funded.	Arizona, Florida, Georgia, Louisiana, Maine, Michigan, Mississippi, Montana, New Hampshire, New Mexico, North Dakota, South Carolina, Texas, and Virginia	14
Assets in a trust fund are to be for the exclusive purpose of the retirement system.	Alabama, Arizona, California, Louisiana, Maine, Mississippi, Montana, New Hampshire, New Mexico, North Carolina, Oklahoma, Texas, Virginia, and Wyoming	14
Trust fund assets are not to be diverted for nonretirement uses.	Alabama, Louisiana, Maine, Mississippi, Montana, Nevada, New Hampshire, New Mexico, North Carolina, Oklahoma, South Carolina, Texas, and Virginia	13

[20]Given the ways in which defined contribution plans differ from defined benefit plans, these types of provisions may be less readily applicable or relevant to them.

[21] Although the AARP study focused on pension plans for a particular group of public employees (retired educators), our analysis revealed that the provisions identified in all but two states were applicable to pension plans for all state employees. In addition, we learned that subsequent to this study, Oregon adopted a constitutional provision in 2003 to authorize the issuance of pension obligation bonds.

Constitutional provisions requiring	States	Number of states
Retirement system boards of trustees are to be off limits to the legislature.	California, Montana, Nevada, New Mexico, and Texas	5
Participants in a retirement system have a guaranteed right to a benefit, and that accrued financial benefits cannot be eliminated or diminished.	Alaska, Arizona, Hawaii, Illinois, Louisiana, Michigan, Missouri, New Mexico, and New York	9
States have investment authority for their retirement systems.	Indiana, Michigan, Montana, Nebraska, South Carolina, Washington, and West Virginia	7
Retirement system money is to be held in a separate trust fund.	Arizona, California, Nevada, New Mexico, and Virginia	5
Retirement benefits may be increased.	Georgia, Nebraska, Pennsylvania, Washington, and Wisconsin	5
A retirement system is required.	Louisiana, Texas, and Virginia.	3
The payment of retirement benefits is authorized.	Georgia and Oklahoma.	2
Other protections are in place, such as prohibiting constitutional changes to the retirement system through the initiative process.	Mississippi, Missouri, Nebraska, and Nevada.	4

Source: AARP, 2000.

Pensions Benefits, Once Accrued, Are Generally Protected

In nine states, constitutional provisions take the form of a specific guarantee of the right to a benefit. In two of the states we visited, the state constitution provided protection for pension benefits. In California, for example, the state constitution provides that public plan assets are trust funds to be used only for providing pension benefits to plan participants.[22] In Michigan, the state constitution provides that public pension benefits are contractual obligations that cannot be diminished or impaired and must be funded annually.[23]

The basic features of pension plans—such as eligibility, contributions, and types of benefits—are often spelled out in state or local statute. State-administered plans are generally governed by state laws. For example, in California, the formulas used to calculate pension benefit levels for employees participating in the California Public Employees' Retirement System (CalPERS) are provided in state law.[24] Similarly, in Oregon, pension benefit formulas for state and local employees participating in the

[22] Cal. Const., art. XVI § 17.

[23] Mich. Const., art. IX §19 and 24.

[24] For example, see Cal. Gov't. Code § 21353 (Deering 2007).

Oregon Public Employees Retirement System (OPERS) plans are provided in state statute.[25] In addition, we found that at the sites we visited locally administered plans were generally governed by local laws. For example, in San Francisco, contribution rates for employees participating in the San Francisco City and County Employees' Retirement System are spelled out in the city charter.[26]

Legal protections usually apply to benefits for existing workers or benefits that have already accrued; thus, state and local governments generally can change the benefits for new hires by creating a series of new tiers or plans that apply to employees hired only after the date of the change. For example, the Oregon legislature changed the pension benefit for employees hired on or after January 1, 1996, and again for employees hired on or after August 29, 2003, each time increasing the retirement age for the new group of employees.

For some state and local workers whose benefit provisions are not laid out in detail in state or local statutes, specific provisions are left to be negotiated between employers and unions.[27] For example, in California, according to state officials, various benefit formula options for local employees are laid out in state statutes, but the specific provisions adopted are generally determined through collective bargaining between the more than 1,500 different local public employers and rank-and-file bargaining units. In all three states we visited, unions also lobby the state legislature on behalf of their members. For example, in Michigan, according to officials from the Department of Management and Budget, unions marshal support for or against a proposal by taking such actions as initiating letter-writing campaigns to support or oppose legislative measures.

Pensions Are Typically Managed as Trust Funds with Board Oversight

In accordance with state constitution and/or statute, the assets of state and local government pension plans are typically managed as trusts and overseen by boards of trustees to ensure that the assets are used for the sole purpose of meeting retirement system obligations and that the plans

[25] Or. Rev. Stat. § 238.300 (2005).

[26] San Francisco City Charter A8.525.

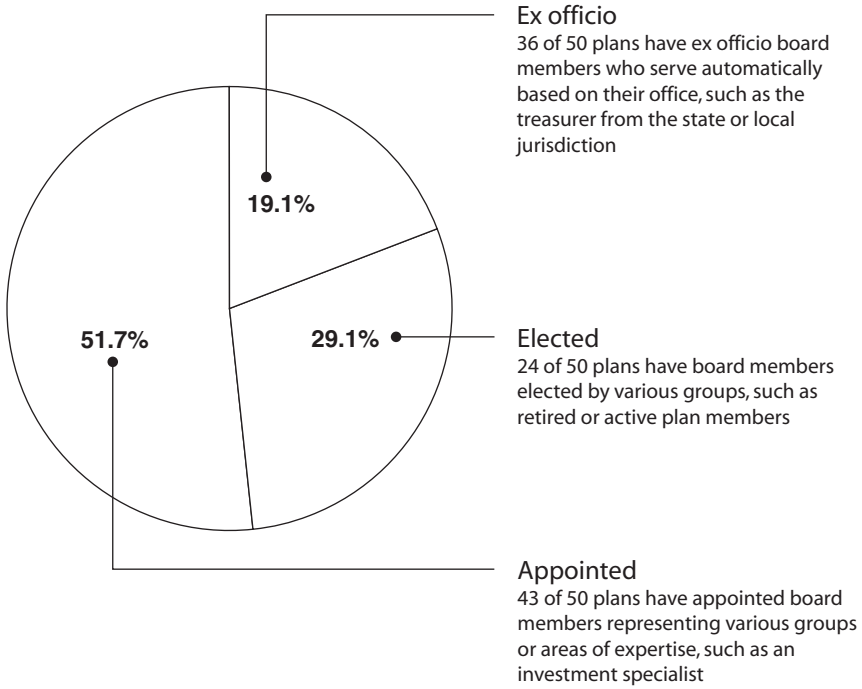
[27] The influence of unions on public employees benefits is stronger than in the private sector. Over 40 percent of public sector workers—including federal, state, and local government—are covered by union agreements, compared with about 10 percent of private sector workers.

are in compliance with the federal tax code.[28] Boards of trustees, of varying size and composition, often serve the purpose of establishing the overall policies for the operation and management of the pension plans, which can include adopting actuarial assumptions, establishing procedures for financial control and reporting, and setting investment strategy. On the basis of our analysis of data from the National Education Association, the National Association of State Retirement Administrators (NASRA), and reports and publications from selected states, we found that 46 states had boards overseeing the administration of their pension plans for general state employees.[29] These boards ranged in size from 5 to 19 members, with various combinations of those elected by plan members, those appointed by a state official, and those who serve automatically based on their office in state government (known as ex officio members). (See fig. 2.)

[28] A trust established by an employer for the exclusive benefit of its employees, and any income it generates, is exempt from federal income tax. 26 U.S.C. § 501(a).

[29] The four states that do not have boards overseeing the operation and management of their pension plans for general state employees are Florida, Iowa, New York, and Washington. (In addition, the District of Columbia does not have a board overseeing its pension plan for its general employees.)

Figure 2: Various Interests Represented on Boards of Each State's Pension Plan for General State Employees



Source: GAO analysis of board membership for the primary pension plans for general state employees in each state, based on data from various national organizations and from individual states' reports and publications.

Note: Percentages do not total 100 because of rounding.

Different types of members bring different perspectives to bear, and can help to balance competing demands on retirement system resources. For example, board members who are elected by active and retired members of the retirement system, or who are union members, generally help to ensure that members' benefits are protected. Board members who are appointed sometimes are required to have some type of technical knowledge, such as investment expertise. Finally, ex officio board members generally represent the financial concerns of the state government.

Some pension boards do not have each of these perspectives represented. For example, boards governing the primary public employee pension plans in all three states we visited had various compositions and responsibilities. (See table 2.) At the local level, in Detroit, Michigan, a majority of the board of Detroit's General Retirement System is composed of members of the system. According to officials from the General Retirement System, this is thought to protect pension plan assets from being used for purposes

other than providing benefits to members of the retirement system. Regarding responsibilities, the board administers the General Retirement System and, as specified in local city ordinances, is responsible for the system's proper operation and investment strategy.

Table 2: Composition and Responsibilities of Boards of Primary Public Employee Pension Plans in California, Michigan, and Oregon

State	Pension plan	Number of board members	Composition of board members	Board responsible for
California	California Public Employees' Retirement System (CalPERS)	13	3 appointed 6 elected 4 ex officio[a]	Management and control of CalPERS, including the exclusive control of the administration and investment of the retirement fund.[b]
Michigan	Michigan State Employees' Retirement System (MSERS)	9	4 appointed 5 ex officio[c]	Administering and managing the defined benefit plan by making investment decisions and arranging for an actuarial valuation.[d]
Oregon	Oregon Public Employees' Retirement System (OPERS)	5	5 appointed[e]	Managing the retirement system, including responsibilities such as arranging for actuarial services and publishing an annual report on the retirement system.

Source: Statutes, as cited below.

[a]Cal. Govt. Code § 20090 (Deering, 2007).

[b]Cal. Gov't. Code § 20120 (Deering, 2007).

[c]Mich. Comp. Laws § 38.3 (2007).

[d]Mich. Comp. Laws § 38.2 (2007). The defined contribution plan is administered and its assets invested by the state treasurer. Mich. Comp. Laws § 38.9 (2007).

[e]Or. Rev. Stat. § 238.660 (2005).

Pension boards of trustees typically serve as pension plan fiduciaries, and as fiduciaries, they usually have significant independence in terms of how they manage the funds. Boards make policy decisions within the framework of the plan's enabling statutes, which may include adopting actuarial assumptions,[30] establishing procedures for financial control and reporting, and setting investment policy. In the course of managing pension trusts, boards generally obtain the services of independent advisors, actuaries, or investment professionals.

[30]Actuarial assumptions are assumptions as to the occurrence of future events affecting pension costs, such as mortality, retirement, and rates of investment earnings.

Also, some states' pension plans have investment boards in addition to, or instead of, general oversight boards. For example, three of the four states without general oversight boards have investment boards responsible for setting investment policy. While public employees may have a broad mandate to serve all citizens, board members generally have a fiduciary duty to act solely in the interests of plan participants and beneficiaries. One study of approximately 250 pension plans at the state and local level found that plans with boards overseeing them were associated with greater funding than those without boards.[31]

When state pension plans do not have a general oversight board, these responsibilities tend to be handled directly by legislators and/or senior executive officials. For example, in the state of Washington, the pension plan for general state employees is overseen by the Pension Funding Council—a six-member body whose membership, by statute, includes four state legislators.[32] The council adopts changes to economic assumptions and contribution rates for state retirement systems by majority vote. In Florida, the Florida Retirement System is not overseen by a separate independent board; instead, the pension plan is the responsibility of the State Board of Administration, composed of the governor, the chief financial officer of the state, and the state attorney general.[Footnote 37] In New York, the state comptroller, an elected official, serves as sole trustee and administrative head of the New York State and Local Employees' Retirement System.[33]

Most Public Pensions Have Assets To Pay Benefits Over Several Decades, But Contributions Vary

Currently, most state and local government pension plans have enough invested resources set aside to pay for the benefits they are scheduled to pay over the next several decades. Many experts consider a funded ratio of about 80 percent or better to be sound for state and local government pensions. While most plans' funding may be sound, a few plans have persistently reported low funded ratios, which will eventually require the government employer to improve funding, for example, by reducing benefits or by increasing contributions. Even for many plans with lower funded ratios, benefits are generally not at risk in the near term because

[31] Marquerite Schneider and Fariborz Damanpour, "Public Choice Economics and Public Pension Plan Funding: An Empirical Test," *Administration and Society*, vol. 34, no. 1 (2002).

[32] Wash. Rev. Code §41.45.100 (2007).

[33] Fla. Stat. § 215.44 (2007).

current assets and new contributions may be sufficient to pay benefits for several years. Still, many governments have often contributed less than the amount need to improve or maintain funded ratios. Low contributions raise concerns about the future funded status, and may shift costs to future generations.

Most Public Pension Plans Have Enough Funds to Pay for Benefits over the Long-Term

Most public pension plans report having sufficient assets to pay for retiree benefits over the next several decades. Many experts and officials to whom we spoke consider a funded ratio of 80 percent to be sufficient for public plans for a couple of reasons.[34] First, it is unlikely that public entities will go out of business or cease operations as can happen with private sector employers, and state and local governments can spread the costs of unfunded liabilities over a period of up to 30 years under current GASB standards. In addition, several commented that it can be politically unwise for a plan to be overfunded; that is, to have a funded ratio over 100 percent. The contributions made to funds with "excess" assets can become a target for lawmakers with other priorities or for those wishing to increase retiree benefits.

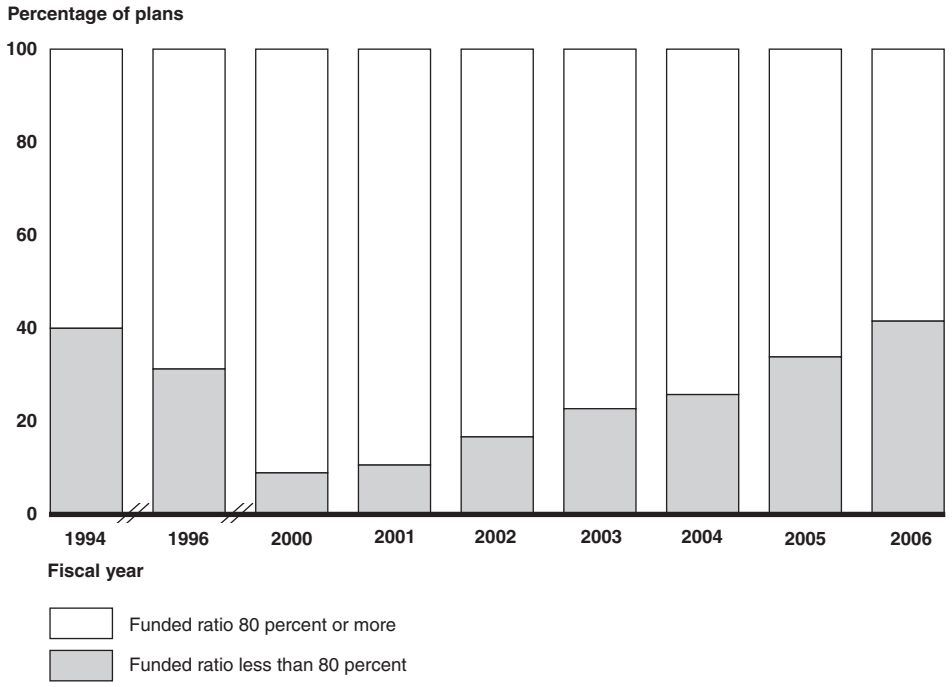
More than half of state and local governments' plans reviewed by the Public Fund Survey (PFS) had a funded ratio of 80 percent or better in fiscal year 2006, but the percentage of plans with a funded ratio of 80 percent or better has decreased since 2000, as shown in figure 3.[35] Our analysis of the PFS data on 65 self-reported state and local government pension plans showed that 38 (58 percent) had a funded ratio of 80 percent or more, while 27 (42 percent) had a funded ratio of less than 80 percent. In the early 2000s, according to one study, the funded ratio of 114 state and

[34] The Pension Protection Act of 2006 provided that large private sector pension plans will be considered at risk of defaulting on their liabilities if they have less than 80 percent funded ratios under standard actuarial assumptions and less than 70 percent funded ratios under certain additional "worst-case" actuarial assumptions. When private sector plans default on their liabilities, PBGC becomes liable for benefits. These funding standards will be phased in, becoming fully effective in 2011, and at-risk plans are required to use stricter actuarial assumptions that will result in them having to make larger plan contributions. Pub. L. No. 109-280, sec. 112(a), § 430(i), 120 Stat. 780, 839-42.

[35] In this section, we refer to our analysis of the PFS and PENDAT database. The PFS is sponsored by the National Association of State Retirement Administrators and the National Council on Teacher Retirement. These sources contain self-reported data on state and local government pension plans in years 1994, 1996, and 2000 to 2006. Each year, between 62 and 72 plans were represented in our dataset. In 2005, the 70 plans represented 58 percent of total assets invested in public pension plans nationwide in 2005, and 72 percent of total members

local government pension plans together reached about 100 percent; it has since declined. [36] In fiscal year 2006, the aggregate funded ratio was about 86 percent. Some officials attribute the decline in funded ratios since the late 1990s to the decline of the stock market, which reduced the value of assets. This sharp decline would likely affect funded ratios for several years because most plans use smoothing techniques to average out the value of assets over several years. Our analysis of several factors affecting the funded ratio showed that changes in investment returns had the most significant impact on the funded ratio between 1988 and 2005, followed by changes in liabilities.[37]

Figure 3: Percentage of State and Local Government Pension Plans with Funded Ratios above or below 80 Percent, by Fiscal Year



Source: GAO analysis of PFS, PENDAT data.

[36] K. Brainard, *Public Fund Survey Summary of Findings for FY 2006*, National Association of State Retirement Administrators (Georgetown, Tex.: October 2007).

[37] These findings may be unique to the time period examined (1988-2005). In other periods, other factors, such as changes to benefits, may account for more of the change in the funded ratio than the rates of return on the investment portfolio.

Although most plans report being soundly funded in 2006, a few have been persistently underfunded, and some plans have seen funded ratio declines in recent years.[38] We found that several plans in our data set had funded ratios below 80 percent in each of the years for which data is available. Of 70 plans in our data set, 6 had funded ratios below 80 percent for 9 years between 1994 and 2006. Two plans had funded ratios below 50 percent for the same time period. In addition, of the 27 plans that had funded ratios below 80 percent in 2006, 15 had lower funded ratios in 2006 than in 1994. The sponsors of these plans may be at risk in the future of increased budget pressures.

By themselves, lower funded ratios and unfunded liabilities do not necessarily indicate that benefits for current plan members are at risk, according to experts we interviewed. Unfunded liabilities are generally not paid off in a single year, so it can be misleading to review total unfunded liabilities without knowing the length of the period over which the government plans to pay them off. Large unfunded liabilities may represent a fiscal challenge, particularly if the period to pay them off is short. But all unfunded liabilities shift the responsibility for paying for benefits accrued in past years to the future.

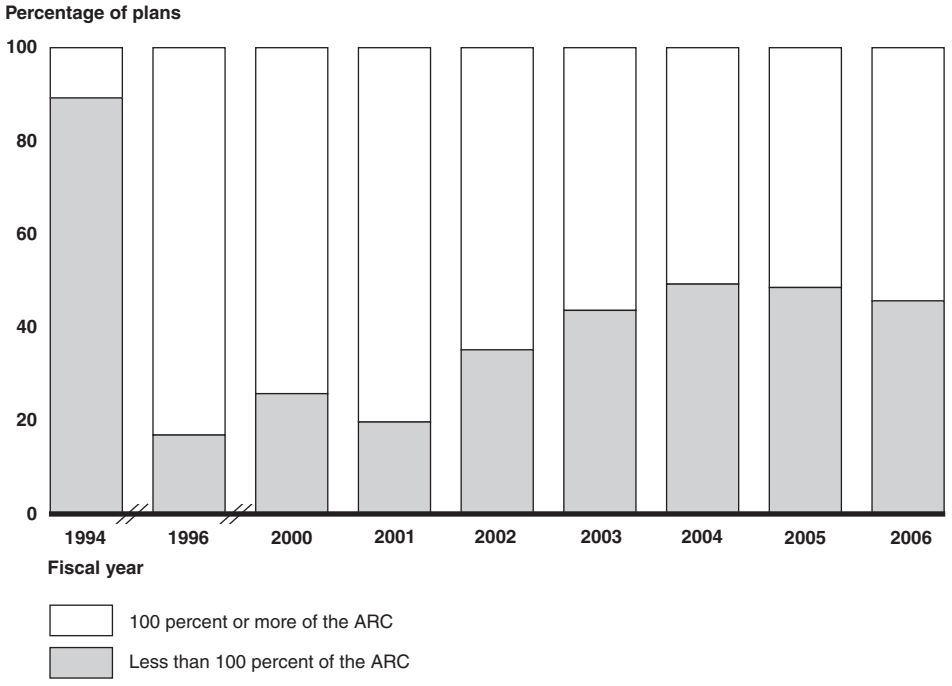
Unfunded liabilities will eventually require the government employer to increase revenue, reduce benefits or other government spending, or do some combination of these. Revenue increase could include higher taxes, returns on investments, or employee contributions. Nevertheless, we found that unfunded liabilities do not necessarily imply that pension benefits are at risk in the near term. Current funds and new contributions may be sufficient to pay benefits for several years, even when funded rations are relatively low.

[38] Reports estimate total unfunded liabilities for public pension plans nationwide between $307 and $385 billion, but the estimates do not cover all state and local government plans. One study by the National Association of State Retirement Administrators reviewed the funding status of 125 of the nation's large public pension plans in fiscal year 2006 and found total unfunded liabilities to be more than $385 billion. Another study reviewed state-only pension plans and found that in 2005, the most recent year for which substantially complete data was available, total unfunded liabilities for 108 plans were about $307 billion. Neither study is a random sample of state and local government pension plans that represents all public plans nationwide. NASRA *Public Fund Survey* (2006). This estimate represents 85 percent of public plan assets nationwide. Wilshire Consulting, *2007 Wilshire Report on State Retirement Systems: Funding Levels and Asset Allocation* (2007). This study includes only state plans, not local plans.

Some Pension Sponsors Do Not Contribute Enough to Improve Funding Status

A number of governments reported not contributing enough to keep up with yearly costs. Governments need to contribute the full annual required contribution (ARC) yearly to maintain the funded ratio of a fully funded plan or improve the funded ratio of a plan with unfunded liabilities.[39] In fiscal year 2006, the sponsors of 46 percent of the 70 plans in our data set contributed less than 100 percent of the ARC, as shown in figure 4, including 39 percent that contributed less than 90 percent of the ARC. In fact, the percentage of governments contributing less than the full ARC has risen in recent years. This continues a trend in recent years of about half of governments making full contributions.

Figure 4: Percentage of State and Local Government Pension Plans for which Governments Contributed More or Less Than 100 Percent of the ARC, by Fiscal Year



Source: GAO analysis of PFS, PENDAT data.

[39]The ARC is made up of the amount of future benefits promised to plan participants that accumulated in the current year, plus a portion of any unfunded liabilities. Although the ARC refers to the annual required contribution, the use of the word "required" can be misleading because governments can choose to pay more or less than this amount.

In particular, some of the governments that did not contribute the full ARC in multiple years were sponsors of plans with lower funded ratios. In 2006, almost two-thirds of plans with funded ratios below 80 percent in 2006 did not contribute the full ARC in multiple years. Of the 32 plans that in 2006 had funded ratios below 80 percent, 20 did not contribute the full ARC in more than half of the 9 years for which data is available. In addition, 17 of these governments did not contribute more than 90 percent of the full ARC in more than half the years.

State and local government pension representatives told us that governments may not contribute the full ARC each year for a number of reasons. First, when state and local governments are under fiscal pressure, they may have to make difficult choices about paying for competing interests. State and local governments will likely face increasing fiscal challenges in the next several years as the cost of health care continues to rise. In light of this stress, the ability of some governments to continue to pay the ARC may be questioned. Second, changes in the value of assets can affect governments' expectations about how much they will have to contribute. Moreover, some plans have contribution rates that are fixed by constitution, statute, or practice and do not change in response to changes in the ARC. Even when the contribution rate is not fixed, the political process may take time to recognize and act on the need for increased contributions. Nonetheless, many states have been increasing their contribution rates in recent years, according to information compiled by the National Conference of State Legislatures. Third, some governments may not contribute the full ARC because they are not committed to prefunding their pension plans and instead have other priorities.

When a government contributes less than the full ARC, the funded ratio can decline and unfunded liabilities can rise, if all other assumptions are met about the change in assets and liabilities.[40] Increased unfunded liabilities will require larger contributions in the future to keep pace with the liabilities that accrue each year and to make up for liabilities that accrued in the past. As a result, costs are shifted from current to future generations.

[40] When a government does not contribute at least the normal cost plus interest on the unfunded liability (which is an amount less than the full ARC), unfunded liabilities will increase.

Conclusions

The funded status of state and local government pensions overall is reasonably sound, though recent deterioration underscores the importance of keeping up with contributions. Since the stock market downturn in the early 2000s, the funded ratios of some governments have declined. Although governments can gradually recover from these losses, the failure of some to consistently make the annual required contributions undermines that progress and is cause for concern. This is especially important as state and local governments face increasing fiscal pressure in the coming decades.

The ability to maintain current levels of public sector retiree benefits will depend, in large part, on the nature and extent of the fiscal challenges these governments face in the years ahead. As state and local governments begin to comply with GASB accounting and reporting standards, information about the future costs of retiree health benefits will become more transparent. In light of the initial estimates of the cost of future retiree health benefits, state and local governments will likely have to find new strategies for dealing with their unfunded liabilities. Although public sector workers have thus far been relatively shielded from many of the changes that have occurred in private sector defined benefit commitments, these protections could undergo revision under the pressure of overall future fiscal commitments.

We are continuing our work on state and local government retiree benefits. We have two engagements underway; the first study will examine the various approaches these governments are taking to address their retiree health care liabilities, while the second examines the ways state and local governments allocate the assets in their pension and retiree health care funds. We are pleased that this committee is interested in our work and look forward to working with you in the future.

That concludes my testimony: I would be pleased to respond to any questions the committee has.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues at (202) 512-7215 or bovbjergb@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Tamara Cross (Assistant Director), Bill Keller (Assistant Director), Anna Bonelli, Margie Shields, Joe Applebaum, and Craig Winslow.

This is a work of the U.S. government and is not subject to copyright protection in the United States. It may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "E-mail Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, DC 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Ralph Dawn, Managing Director, dawnr@gao.gov, (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, DC 20548

Public Affairs

Chuck Young, Managing Director, youngc1@gao.gov, (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, DC 20548

PRINTED ON RECYCLED PAPER