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Legal Issues Facing Public Pensions (panelist)

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Legal Issues Facing Public Pension Plans
A Decade of Scrutiny

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by Jonathan Barry Forman

Most state and local government employees are covered by traditional final-average-pay pension plans. State and local government employers typically fund those pension plans through a combination of employer and employee contributions, and with help from investment returns on already-accumulated assets. Unlike private sector pension plans, however, public pension plans are not subject to strict minimum funding standards like those in the Employee Retirement Income Security Act of 1974 (“ERISA”). To be sure, many public pensions are nevertheless fairly well funded. Unfortunately, however, the recent meltdown of financial markets, the decline

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in the stock market, and the recession are putting tremendous pressure on both public pensions and the state and local governments that fund them.

I. Operation and Funding Status of State and Local Government Pension Plans

A. Overview of State and Local Government Pension Plans

There are 50 state governments and 87,525 local governments in the United States. Compensation of state and local government employees is a large share of the cost of providing services to citizens. Almost twenty million employees and seven million retirees and dependents of state and local governments have been promised pensions. Over the next thirty years, it has been estimated that states will spend around $3.35 trillion on pension benefits for their workers.

B. Funding Public Plans
Defined contribution plans, by their nature, are always fully funded. On the other hand, defined benefit plans are often underfunded. Nowhere is this more apparent than in the public sector.

Extraordinary declines in U.S. and worldwide stock markets in recent years have meant huge investment losses for most investors, and public pensions have shared in those investment losses. According to one estimate, the median investment return for public pension funds in 2008 was a negative 25%.

Not surprisingly, “25 U.S. states contributed less money to their retirement funds in 2009 than actuaries calculated was needed to support the plans, up from 23 a year earlier.”

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All in all, state pensions are underfunded by about a trillion dollars.\(^3\) According to recent estimates by Wilshire Consulting, the average funded ratio for the 125 state retirement systems that Wilshire surveyed was 65\% in 2009, down sharply from an estimated 85\% in 2008, although funding ratios have presumably improved in recent months.\(^4\)

States with the lowest funding levels included Illinois at 51\% funded and Kansas, Oklahoma and New Hampshire, all coming in at 59\%.

II. LEGAL LIMITATIONS ON PUBLIC PENSION PLAN REFORM

Clearly reforms are needed. Pertinent here, however, state and local workers typically have better legal protections for their pensions than their private sector counterparts. Through state constitutional provisions and court interpretations of


property and contract rights, most states essentially guarantee that their public workers will get the pensions that they were promised when they were hired. The effect of this “anti-reduction” rule is that public employers can rarely cut pension benefits for current workers or retirees. Instead, pension and benefit changes typically only apply to newly hired workers. Insert worker, and wait 30 or 40 years to see any financial savings.

On the other hand, the benefit-protection rule that covers private sector workers seems more realistic for promises that can last for decades. ERISA’s so-called “anti-cutback” rule protects pension benefits that have already been earned, but it does not guarantee that an employee will receive future benefit accruals. More specifically, in the private sector, employers are
generally free to cut future benefit accruals, or even terminate their pension plans, but they cannot take away an employee’s already accrued benefits. Needless to say, we have seen a remarkable number of freezes and terminations of private sector plans in recent years.

State and local governments were unwise to promise generous pensions without adequately funding them, or at least reserving the right to cut future benefit accruals. But state and local governments did make those generous pension promises, and now they will probably have to honor them.

Of course, as states have grappled with the rising cost of public-sector employee pensions and retiree health care benefits, many have taken steps to cut those benefits, legal or not. At least 19 states took action to reduce their pension liabilities in
2010, either through reducing benefits or increasing employee contributions.⁵

For example, in February, Colorado lawmakers passed a bill that reduced the pension system’s cost-of-living adjustment from a fixed 3.5% a year to a maximum of 2%—but possibly less for current and future retirees. The new law also increased contributions from employees and employers.”⁶

Minnesota also passed a law that trim benefits and COLAs even for current retirees.⁷

“In response, Colorado and Minnesota have been hit by lawsuits filed by retirees, who claim the changes violate state law. Those retirees have "lived up to their end of the bargain,

⁶ http://online.wsj.com/article/SB10001424052748704463504575301032631246898.html#printMode.
and the state is not living up to theirs," says Stephen Pincus, a
Pittsburgh lawyer representing plaintiffs in both states."

III. HOW TO ENSURE ADEQUATE FUNDING
If you find yourself in a hole, the first thing to do is to stop
digging. Next you need to climb out. Finally, you need to avoid
falling into holes in the future.

A. STOP DIGGING: STOP PROMISING BENEFITS
WITHOUT PAYING FOR THEM

First, state and local governments need to stop digging;
they need to stop enhancing benefits without paying for them.
To be sure, until this recession, it has been difficult for
legislators to resist enhancing the benefits of current workers at
the expense of future taxpayers. One approach would be to
require strict actuarial review of pension legislation as a way to
achieve some measure of fiscal self-discipline in the short term.

8 Id.
For example, in 2006 Oklahoma enacted actuarial limits on pension benefit increases. Under this approach, which followed earlier legislation in Georgia, retirement bills with a fiscal impact can only be introduced in the first year after an election, and those bills can only be enacted in the following year, after actuarial review.

Moreover, no amendments that increase the cost of the bill can be made after the bill has been actuarially reviewed. Furthermore, if no specific provision is made to fund the legislation, the bill is automatically repealed. The Georgia legislation went even further: Georgia is required to maintain minimum funding standards for its pension plans, and each year it must contribute the pension plan’s normal cost plus the amount needed to amortize the plan’s unfunded liability. Along

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the same lines, a handful of states have constitutional provisions that require actuarial funding of their state retirement plans.

**B. CLIMB OUT: MAKE THE ACTUARIAL REQUIRED CONTRIBUTIONS EACH YEAR**

Of course, the best way to ensure that public pension plans are fully funded would be to require them to pay the actuarial required contributions (“ARC”) in full each year. This annual pension cost is the amount of funding needed to pay for the new liabilities that accrue each year (i.e., normal cost), and pay off a portion of the plan’s unfunded liabilities accrued in previous years (i.e., its unfunded actuarial accrued liability). As already mentioned, these days, only about half of state pension plans are making their actuarial required contributions.

**C. AVOID FUTURE HOLES: RESTRUCTURE PUBLIC PENSIONS**
Finally, to avoid future holes, state and local governments should think about completely restructuring their pension plans, at least for new workers.

Whatever the outcome of those Colorado and Minnesota lawsuits, in the long run, it would make sense for the states to adopt constitutional amendments or statutes that embrace an ERISA-style anti-cutback rule for new state and local government workers. New workers should be able to count on pension benefits as they earn them, but state and local governments should be free to cut future benefit accruals for those new workers.

State and local governments should continue to provide adequate retirement incomes for their workers, but workers should have to work longer to earn those benefits. In that
regard, most state and local governments will want to increase the age and service requirements for pension benefits, and many will want to increase employee contributions. States should also correct any abuses, such as the pension “spiking” that occurs when workers are able to artificially inflate their final-average-pay in order to jack up their pension benefits. Similarly, it would make sense to require actuarial neutrality for early retirement benefits and for dependent and survivor benefits.

Of course, more dramatic restructuring of public pension plans is probably necessary. Many analysts have suggested replacing the traditional defined benefit plans with defined contribution plans, which, by their nature, are fully funded. In that regard, a few states have replaced their primary pension
plans with defined contribution plans, and many states have added supplemental defined contribution plans.

But I think there is a better approach: state and local governments should gradually shift from traditional final-average-pay defined benefit plans to cash balance plans. A cash balance plan is a defined benefit plan that looks like a defined contribution plan. Like defined contribution plans, cash balance plans provide workers with individual accounts (albeit hypothetical accounts). Like traditional final-average-pay defined benefit plans, however, the assets would be pooled and managed by professional investors, and benefits should be paid out in the form of lifetime annuities.
To be sure, state and local governments should honor the traditional final-average-pay pension promises that they have made to current public employees. Having paid relatively lower salaries to public employees when they were young, state and local governments need to provide the generous pensions that were promised to those workers when they are old.

But it would certainly make a lot of sense for state and local governments to adopt a more rational compensation system for their new employees. That is where cash balance plans come in. State and local governments should amend their pension plans so that new workers earn pension accruals under the cash balance approach. At the same time, state and local governments need to adopt laws to ensure that they make contributions that are adequate to fully fund their liabilities to
current and past workers and to fully fund their benefit promises to new workers.

**D. OTHER DEVELOPMENTS**

A bill introduced in the U.S. House – the Public Employee Pension Transparency Act – would require better disclosure of pension funding. In particular, it would require plans to use the risk-free Treasury bond rate to value pension liabilities. Offending State and local governments would lose their ability to issue tax-exempt bonds. The legislation is sponsored by Republican: Reps. Devin Nunes of California, Paul Ryan of Wisconsin, and Darrell Issa of California.

Adequate disclosure by pension plans is also a budding regulatory issue. Last week, the *New York Times* reported that the Securities and Exchange Commission is investigating
whether California violated securities laws and failed to provide adequate disclosure about CALPERS. This follows last year’s first ever enforcement action against a state, when, last year, the SEC accused New Jersey of securities fraud for misleading bond investors about the condition of its pension fund.  

And finally, on January 10, 2011, Pensions and Investment magazine reported that Newt Gingrich is pushing for legislation that will allow insolvent states to file for bankruptcy. They could use the bankruptcy courts as a tool for them to be able to renege on their pension and health benefit promises to state workers.  

IV. CONCLUSION

The recent economic downturn will present challenges for state and local government pension plans. These plans were

underfunded before the downturn, and the recession has, and will, exacerbate their funding shortfalls. The silver lining in this otherwise dark economic cloud is that state and local governments will finally have the political motivation to restructure their traditional pension systems.