

The State of Pensions



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By: [Lori Ann LaRocco](#)

CNBC Sr. Talent Producer

The fiscal challenges facing states is not new and the budget battles we saw in both Wisconsin and Ohio just showcases the problem. One of the biggest challenges states are facing when tackling their budget shortfalls is their pension deficits. States like California are so in the hole they're looking at over \$500 billion in shortages.

The Garden State—New Jersey— is staring down a \$46 billion dollar deficit and Illinois is faced with a \$78 billion of red ink. But in times of crisis, ingenuity and creativity can take a leading role. In Utah, Alaska and Michigan they are tackling their pension problems head on. I caught up with pension plan expert and lawyer Marica Wagner on what kind of options states can do to right their lopsided pension balance sheets.

LL: How many state pension funds are underfunded and when will they run out of money?

MW: According to a recent Fiscal Times article, about 44 states state pension funds are currently underfunded. While some states will run out of funds in 30 years, the overwhelming majority only 1 to 20 years left in their state pension funds.

If the states do not do anything, then Boston College Center for Retirement Research (CRR) has estimated that state retirement systems will run out of money in the next 15 to 30 years, with the exact time depending on the earnings rate assumption and the analytical methodology used in making the estimate.

LL: There are legal restraints preventing some states in properly tackling this issue. How hard it is to change this and what can be done?

MW: Even if a state has adopted the strongest version of the contract theory, it has the ability to override pension promises by the exercise of its police power, provided that the changes are reasonable and necessary to serve an important public purpose. A question that is currently being debated is whether solving a state's fiscal crisis would constitute such a purpose. States have other means of persuading employees to go along with a change.

Thus, while pensions might be legally protected, a state would generally be free to reduce salaries or eliminate jobs if it could not modify pension benefits. Alternatively, future pay raises could be made contingent on pension waivers. This explains why you sometimes see labor unions going along with moderate cutbacks in retirement benefits.

States have varying degrees of protection for public employee pensions. These protections are not necessarily embedded in a state's constitution and could also be reflected in a statute or a judicial decision. The strongest form of such protection characterizes a pension as a contractual right that vests upon acceptance of employment by the employee.

LL: Many options have been floated to address this underfunding issue. What are the best options?

MW: With a few exceptions, most states have adopted defined benefit ("DB") programs. Of the measures that may be taken to improve finances, the most direct would be to require greater contributions by participants to such a program.

Another option would be adopting a 401(k) style individual account plan as the state's primary retirement plan. This is called a defined contribution ("DC") plan. Currently, only Michigan and Alaska have DC plans as their primary plan. A participant's benefit under this type of plan consists of an account made up of employer and employee contributions.

Eliminating final pay, one of the evil aspects of the current system is another way to go. Among other things, final pay encourages spikes in pay just before retirement or last minute promotions to a higher grade that have the effect of dramatically increasing a participant's pension. Final average pay plans also have other unwelcome effects such as an uneven distribution of benefits to employees with the same tenure depending on their age.

LL: The debate over limiting a state's contribution to state employee salaries as a set percentage as well as limiting cost of living adjustments has been a hot topic. What is fair when you have double digit unemployment and states with ballooning deficits? Which states are leading the charge?

MW: Under the new Utah system, this percentage is 10 percent and the employee contributes the additional amount needed to fund a benefit equal to 1.5 percent (formerly 2.0 percent) of average salary over the employee's highest five years (formerly three years).

Utah also maintains an optional DC system under which the state will contribute 10 percent of pay as an alternative to the DB plan. As far as increasing the age for receiving full benefits and limiting cost of living adjustments ("COLAs"), Minnesota has reduced the COLAs of retirees until the Minnesota plan achieves a 90 percent funding level. This option is not just directed to new employees.