



ISSUE ANALYSIS

Essential Elements of Public Employee Pension Reform

INTRODUCTION

Public employee pensions were originally intended to supplement the retirees' Social Security benefits and other sources of retirement income. The promise of pensions helped governments recruit skilled employees while also ensuring that retired public employees need not spend their "golden years" in a state of poverty and deprivation.

However, such pensions were *never* intended to enable retired public employees to enjoy a lavish lifestyle at public expense for several decades while the taxpayers and the governments from which the public employees had retired struggled to sustain services while also meeting the pension plans' unsustainable costs.

THE PROBLEM

In many of Florida's local jurisdictions, public employees' salaries, benefits, and pensions now far exceed those available to most employees in comparable jobs in the private sector whose taxes support the government. As a result, many of Florida's cities, counties, and special districts face serious fiscal problems that could lead to ruinous tax hikes and draconian service cuts -- or even to insolvency and defaults on debts. Such defaults not only would hurt the credit rating of the local governments involved, but they could also seriously erode the excellent reputation and superior credit rating of Florida's state government.

Indeed, as Florida's state leaders discovered when the City of Miami teetered on the brink of insolvency in the mid-1990s, if a city in Florida were to go broke and default on its obligations, the entire state's reputation for meeting its financial obligations could suffer serious damage, including a costly lowering of the credit rating that is so vital to the ability of the state and its local governments to borrow for infrastructure improvements and other purposes typically funded through bond issues.

An example of what occurs can be found in California, where the City of Vallejo declared bankruptcy in order to escape its untenable fiscal situation. The fact that California's state government, whose own fiscal problems have been well documented and widely publicized, allowed this to occur caused further damage to the ability of California and its local governments to borrow at interest rates typically available to fiscally responsible governmental entities. The credit rating of California and many of its local governments is equivalent to junk-bond status.

STATE GOVERNMENT'S INTEREST

As Florida's local governments face the tough choices brought on by imprudent pension obligations, the state government may be in a lose-lose position no matter which course local officials decide to take. If they raised taxes, setting property-tax rates at the

maximum allowed by law and piling on local-option sales taxes and a host of other taxes and fees, they would compromise the ability of the state government to rely on some of the same sources of revenue for the support of K-12 schools and general government.

If, on the other hand, local governments reduced services, there are also serious potential consequences for the state government. For example, if a city cannot afford to staff its police department adequately because it's paying an inordinate amount of its current year's budget to fund the pensions of law-enforcement officers, then the reduction in police presence and response times could lead to an increase in crime. That, in turn, poses a problem not only for those Floridians who become victims of those crimes, but also for the state government, which funds the courts and prisons that are at the receiving end of the criminal-justice pipeline.

Therefore, the state government has ample reason to act to reform public employee pensions at the state and local level. Moreover, acting sooner rather than later will make future problems more manageable.

The pension problem involves a complex mix of economic and political judgments. Moreover, court decisions and simple fairness limit the ability of governments retroactively to alter abruptly the terms of longstanding pension arrangements stipulated in contracts negotiated in good faith through collective bargaining.

Nonetheless, significant progress can be made toward pension reform. Meaningful reform ought to include at least five essential elements: (1) salary restraint/redefinition, (2) pension formula adjustments for longevity, (3) employee participation, (4) actuarial review, and (5) additional state oversight of pension fund investments.

SCOPE OF THE PROBLEM

STATE: According to *The Trillion Dollar Gap: Underfunded State Retirement Systems and the Road to Reform*, a study that the Pew Center on the States released on February 18, 2010, Florida is one of only four states whose pension plan for state employees is adequately funded to meet its future obligations. Despite the recent volatility in stocks, bonds, real estate, and the other types of investments typically used by pension funds, Florida's state government has avoided most of the pitfalls currently being experienced by state and local governments where the labor unions representing public employees arguably have wielded an inordinate influence over investment decisions and the size of benefits. Even so, the *St. Petersburg Times* recently reported that the state-managed pension funds on which roughly 1 million retirees depend "slipped into the red in 2009 for the first time in a dozen years." For the most part, however, the status of the Florida Retirement System is the least of the state's pension worries.

LOCAL: Unfortunately, many of the more than 480 Florida cities and special districts that do not participate in the FRS have entered into collective bargaining agreements that include pension obligations that are fiscally unsustainable – especially since the downturn in property values severely impacted local governments that steeply raised their level of spending during the real-estate boom. These pension obligations are now causing the elected officials in these cities and districts to face difficult choices in order to meet the contractual obligations they previously agreed to. Do they look for sources of additional revenue? Or do they reduce public services? Two of Florida's most populous cities, Jacksonville and Miami, provide instructive examples of the dilemma that local officials now must face.

Jacksonville: Encompassing most of Duval County, Jacksonville is Florida's most populous city and has been hailed as an example of the efficiencies derived from the consolidation of the municipal and county governments. Nonetheless, Jacksonville is now facing serious financial problems attributable to its mounting pension obligations. According to the March 17, 2010 edition of the *Financial News & Daily Record*, the city's three pension plans together have an *unfunded* liability of \$1.3 billion. Moreover, according to J.F. Bryan IV, who chaired the Jacksonville Community Council Inc. (JCCI) Finances Steering Committee, which looked into the problem, "***Five of the top seven metropolitan areas in Florida are in the same ditch we are in.***" Indeed, in dozens of other cities and special districts, the pension plans are inadequately funded. Among them: the City of Miami.

Miami: The situation is equally dire in the City of Miami, Florida's second-largest municipality and arguably its best-known. Miami has had a history of dubious financial practices. Indeed, in 1996, during a time of relative prosperity, the city experienced a fiscal meltdown that required state intervention. Gov. Lawton Chiles dispatched Lt. Gov. Buddy MacKay to lead a team of fiscal experts to rescue the city from the throes of egregious mismanagement. Now, according to an article in the March 18, 2010 edition of *Miami Today*, the city's *unfunded* pension liabilities total at least \$892 million, possibly more. Worse, to restore the city's pension funds back to an actuarial balance sufficient to meet its obligations, its return on its pension-fund investments would need to exceed 12 percent a year – hardly a realistic rate to expect.

HEIGHTENED RISK

When the overpromising of lavish pensions puts pressure on the fund managers to pursue higher rates of return by making riskier investments, it also raises the risks of ruinous losses. It must be noted that for cities such as Jacksonville and Miami, the pension crisis is not a far-off problem that won't manifest itself until the distant future; rather, as the *Miami Herald* noted in a March 13, 2010 editorial, "to balance this year's budget, Miami had to pay almost \$60 million to the pension plan. This year the cost is expected to escalate to \$101 million, meaning that one in every five dollars of property tax goes toward the retirement of its workers." When 20 cents of each tax dollar in the current year's budget must go to cover pension costs, including those for former employees who no longer provide any services for the taxpayers, officials face a difficult problem when it comes time to set their priorities.

ESSENTIAL ELEMENTS OF A PENSION-PROBLEM SOLUTION

Salary Restraint/Redefinition: The state needs a mechanism to enforce Article X, Section 14, of the state Constitution, which reads as follows:

State retirement system benefit changes. – A governmental unit responsible for any retirement or pension system supported in whole or in part by public funds shall not after January 1, 1977, provide any increase in the benefits to the members or beneficiaries of such system unless such unit has made or concurrently makes provision for the funding of the increase in benefits on a sound actuarial basis.

Inasmuch as the pension formulas are based in part on earnings, which are one of the principal factors in determining retirees' pensions, salary oversight is essential to the enforcement of Article X, Section 14. When a weekly newspaper, *Miami New Times*, can accurately report that more than 200 of the 367 non-executive officers ("street cops") in

the Miami Beach Police Department are paid more than \$100,000 – including one sergeant who was paid almost \$230,000 -- it is obvious that many of the municipal officials who negotiate collective-bargaining agreements with public employee unions are inordinately grateful for the political support they receive. The unions' endorsements, campaign contributions, and "troops on the ground" can be decisive in local elections often characterized by extremely low turnouts. To prevent local governments – especially municipalities – from entering into collective-bargaining agreements that arguably violate Article X, Section 14, the State Board of Administration should be empowered to approve or reject such agreements, much as the Florida Department of Community Affairs currently has the statutory authority to review, approve, reject, or revise local governments' decisions on major development projects.

Moreover, the compensation factored into the pension calculation should be limited to the base salary and should not include overtime, accrued sick leave, or accrued vacation time. This is necessary to avoid the kind of "salary spiking" that has enabled some retirees to game the system and retire with pensions that are higher than their salary at the time of their retirement.

Pension Formula Adjustments for Longevity: Florida's pension planners can learn from the experience of the federal Social Security system, even though it is different in many ways from the state and local approaches to pensions. This year Social Security began paying out more to retirees than it is taking in from active workers – even though workers and their employers contribute, even though the retirement age has been advanced to 67, and even though pensions are based on a lifetime (35 years) of earnings, adjusted for inflation, rather than the highest years. Moreover, Social Security's calculations of earnings do not reflect total earnings but only those that were subject to withholding for Social Security. Now, despite all of these restraints, the Social Security system has a huge unfunded obligation.

Is it any wonder, then, that governments' pension plans are in trouble when they allow employees to work for as few as 10 or 20 years, draw a pension for many more years than they worked, and have that pension based not on an inflation-adjusted calculation of their earnings throughout their career but rather on a single year or on a select number of high-earnings years – with their "base salary" frequently augmented for pension-calculation purposes by copious amounts of overtime, accrued vacation time, and accrued sick leave?

Florida's state and local pension plans must implement reforms to take into account the fact that retirees are living longer; that the increased longevity in many cases is a byproduct of the fact that they are staying healthier longer, and that, therefore, they are capable of working longer before retiring on a full pension. Those who choose to retire earlier than the retirement age for Social Security should have their government pensions reduced commensurately to account for the likelihood that they will be collecting for many additional years. The fact that public employees who retire younger will have fewer years of service in their pension-calculation and will therefore receive less than they would have had they worked longer is not a sufficient offset for the increased longevity that is increasing the number of years the average retiree will collect a pension.

Employee Participation: As many private-sector businesses have done, governments can and should place their new employees under separate, less-generous plans. All public employees, new and old, should be given an opportunity to opt out of the traditional defined-benefit plan and instead set up private retirement accounts akin to the 401k plan

widely used by private-sector employees. The state already offers such an option; employee participation at the state and local levels could increase with an informational campaign pointing out the advantages. These include portability. Employees need to be reminded that with such private investment accounts, “It’s your money.” That has a broader appeal in an era when changing jobs or even careers is far more common than it was in the past, when lengthy tenure with the same employer were the norm.

However, those public employees who do not wish to have their future retirement income depending on a private account still ought to have “some skin in the game” by contributing a small percentage of their income to help undergird the system’s soundness.

Actuarial Review: As mentioned under Salary Restraint/Redefinition, the state needs to set up a process whereby the State Board of Administration can review the actuarial soundness of all public employee pension plans in Florida, whether the governmental entity participates in the Florida Retirement System or has its own retirement plan.

Additional State Oversight of Pension Fund Investments: Given the fact that many of the pension plans of Florida’s local governments are not adequately funded to meet their future obligations, there may be a temptation for the fund managers to seek a higher rate of return by making riskier, higher-yield investments. However, a collapse in the value of these investments could exacerbate the funds’ inability to meet their future obligations. Therefore, the State Board of Administration should be empowered to ensure that those who manage public pension funds do not make inordinately risky investments.

SUMMARY AND CONCLUSION

Although maintaining the health of the Florida Retirement System must remain the principal focus of state officials, including the Legislature, the state government cannot be unmindful of the declining fiscal health of those local governments that entered into binding collective bargaining agreements that include ruinously unsustainable pension costs. To the extent that these problems are remediable by statute, the Legislature needs to act this year to place those local governments on a glide path to fiscal responsibility.

Given that the Florida Supreme Court has ruled that public employees in this state have a constitutional right to organize and to engage in collective bargaining, what can the state government do to address the pension problems? First, a note on what the state government should *not* do: It should make clear that those Floridians who reside in jurisdictions where elected officials have been prudent and where local governments are well-managed will *not* be forced to subsidize the profligacy of those jurisdictions that have been reckless.

Nonetheless, to protect the reputation and credit-worthiness of the State of Florida and its local governments, the state government cannot sit by idly while local governments founder under the weight of their pension obligations. The state cannot absolve local governments of the pension obligations that they rashly assumed in the past, nor should it break faith with state retirees – particularly those with modest pension incomes already reduced by health-insurance rate increases. However, the state can and must enact laws and create procedures that would gradually ease the situation and prevent a recurrence in the future.