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The State Public Pension Crisis: A 50-State Report Card

By Eli Lehrer and Steve Stanek[1]

1. Introduction

Table of Contents

1. Introduction 1
2. The Public-Sector Pension Crisis . . 3
3. How to Grade Public Pensions . . . 11
4. A 50-State Report Card 19
5. Directions for Reform 21
6. Conclusion 27

Appendix 29
About the Authors 36

Taxpayers in almost every U.S. state owe large and possibly unpayable retirement pensions to the men and women who work for the government. The deep recession of 2008-2009 has moved up the day of reckoning, requiring immediate action by many states to avoid financial catastrophe.

While no one doubts that the people who police the streets, teach school, fight fires, plan roads, and administer government benefits deserve fair compensation for their labors, current public policy almost everywhere grants many public employees overly generous pensions that pose a large and growing burden on taxpayers. Even as many private employers have reduced or eliminated traditional pensions, they remain the norm for state government workers.

If large government pensions were part of a package that also included lower wages, they might be justified. But, on balance, government employees make more money than those in the private sector. According to the Bureau of Labor Statistics, average total compensation (wages and benefits) for government employees stands at $39.83 an hour, while private-sector workers

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receive an average of $29.40 an hour.[2] The average government employee, in other words, receives compensation worth almost $83,000 a year, while the typical private-sector worker's compensation comes out to about $61,000.

The largest single cause of this disparity is not wages (although they are higher in the government sector) or even health insurance but, rather, the size of public-sector pensions. Only about a fifth of private-sector workers qualify for any sort of pension, while nearly 80 percent of government workers do. And governments spend nearly five times more on pensions than their private-sector counterparts.[3]

One analysis puts the unfunded collective burden of these pensions at between $750 billion and $1.75 trillion.

Public employee pensions are expensive. One analysis puts the unfunded collective burden of these pensions at between $750 billion and $1.75 trillion.[4] Unfunded liability is a measure of the shortfall between promised pension benefits and the ability of the pension fund to pay those benefits. For example, if the accrued liability is $5 billion and the value of assets is $4 billion, the unfunded liability is $1 billion. Dealing with these pension obligations represents a major challenge for the nation, its states, and its future.

With all this in mind, the present report has three goals:

- To draw attention to the enormous burdens public employee pensions pose in some locations;
- To create an objective way to measure and rank states according to the operation and relative disposition of the pension plans in the 50 states; and
- To suggest ways that states facing problems with their pension systems might go about solving these problems.

Part Two reviews the nature of the public-sector obligations and gives some evidence as to their size and fiscal risk. Part Three reviews and justifies the criteria we use to compare state pension plans. Part Four ranks all 50 states and every major public employee pension plan in the U.S. Part Five describes some reforms states could adopt to avoid the looming crisis. Part Six is a brief summary and conclusion. An Appendix contains tables showing enrollment of individual pension plans and how each plan scores on the six variables in the report card.

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[2] Bureau of Labor Statistics, "Employer Costs for Employee Compensation," March 2010, http://www.bls.gov/news.release/ecec.nr0.htm.

[3] Ibid. Private-sector companies spend 1.5 percent of payroll, on average, on defined benefit pensions, while governments spend an average of 7.3 percent.

[4] Robert Novy-Marx and Joshua D. Rauh, "The Intergenerational Transfer of Public Pension Promises," National Bureau of Economic Research, September 2008, http://www.nber.org/papers/w14343.

2. The Public-Sector Pension Crisis

The challenge posed by rising public-sector pension costs is much larger than is commonly acknowledged; so large in fact that California, Illinois, New York, and other states face almost certain insolvency unless they adopt major reforms. Robert Novy-Marx and Joshua D. Rauh, in a paper for the National Bureau of Economic Research published in 2008, estimated the value of pension promises already made by U.S. state governments will grow to $7.9 trillion in just 15 years.[5]

"We conservatively predict a 50% chance of aggregate underfunding greater than $750 billion and a 25% chance of at least $1.75 trillion (in 2005 dollars)," Novy-Marx and Rauh wrote. "Adjusting for risk, the true intergenerational transfer is substantially larger. Insuring both taxpayers against funding deficits and plan participants against benefit reductions would cost almost $2 trillion today, even though governments portray state pensions as almost fully funded."

Data Delusions

California, Illinois, New York, and other states face almost certain insolvency unless they adopt major reforms.

Bloomberg News reporter David Evans has highlighted the accounting games government pension funds play to make themselves look stronger than they really are. "Public pension funds across the U.S. are hiding the size of a crisis that's been looming for years," he writes. "Retirement plans play accounting games with numbers, giving the illusion that the funds are healthy. The misleading numbers posted by retirement fund administrators help mask this reality: Public pensions in the U.S. had total liabilities of $2.9 trillion as of Dec. 16 [2008], according to the Center for Retirement Research at Boston College. Their total assets are about 30 percent less than that, at $2 trillion."[6]

Novy-Marx and Rauh, in a paper published in 2009, describe the source of the problems Evans highlighted: "Government accounting rules currently obscure the true extent of public pension underfunding in the United States. In particular, Government Accounting Standards Board (GASB) ruling 25 and Actuarial Standards of Practice (ASOP) item 27 stipulate that public pension liabilities are to be discounted at the expected rate of return on pension assets. This procedure creates a major potential bias in the measurement of public pension liabilities. Discounting liabilities at an expected rate of return on the assets in the plan runs counter to the entire logic of financial economics: financial streams of payment should be discounted at a rate

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[5] Ibid.

[6] David Evans, "Hidden Pension Fiasco May Foment Another $1 Trillion Bailout," Bloomberg News, March 3, 2009, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=alwTE0Z5.1EA.

that reflects their risk (Modigliani and Miller (1958)), and in particular their covariance with priced risks (Treynor (1961), Sharpe (1964), Lintner (1965)).”[7]

They continue:

> Our estimates focus on two primary measures, a taxpayer obligation measure and a default-free measure. We find the pension promises already made to state workers are underfunded by at least $1.31 trillion as far as taxpayers are concerned, under the strong assumption that the state can default on these promises to the same extent that it can default on its general obligation debt. This is a conservative estimate because most state constitutions suggest that pension promises are higher in priority than general obligation debt. Furthermore, this estimate looks only at benefits accrued up until now under the ABO [accumulated benefit obligation], a narrow measure of the accrued liability. From the perspective of our default-free measure, which does not credit states for the ability to default, state pensions are underfunded by $3.23 trillion.[8]

The difference between Novy-Marx and Rauh’s estimates and those reported by the states is largely (but not entirely) due to the use by most states of an 8 percent discount rate, a rate that Novy-Marx and Rauh call “far too high.”

California: Lavish Benefits and Soaring Costs

According to public databases, more than 5,000 retired California government workers receive annual pension benefits exceeding $100,000.

Local and state governments across the country are already feeling the strain of trying to keep up with their pension obligations. One of the most stressed states is California, where the state’s annual pension fund contribution has jumped from $321 million in 2000–01 to $7.3 billion in 2008-09. According to public databases, more than 5,000 retired California government workers receive annual pension benefits exceeding $100,000.[9] And with pension benefits pegged to ever-rising salaries, future retirees can expect to receive far more than today’s retirees.

Ten California retirees currently receive more than $220,000 a year in pension benefits. Topping the list is Bruce Malkenhorst, who retired in 2006 after a 27-year run as Vernon city

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[7] Robert Novy-Marx and Joshua D. Rauh, “Public Pension Promises: How Big Are They and What Are They Worth?” National Bureau of Economic Research, July 10, 2009, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1352608.

[8] Ibid.

[9] Ed Mendel, “CalPERS Actuary: Pension Costs Unsustainable,” *Calpensions,* August 10, 2009, http://calpensions.com/2009/08/10/calpers-actuary-pension-costs-unsustainable/.

administrator. He receives $41,639 a month – $499,674 this year.[10] Not bad for having run a town of just 92 people that has no school, park, library, or grocery store. This "city" near Los Angeles is made up almost entirely of industrial properties. Malkenhorst was being paid $600,000 a year when he retired. Local prosecutors later charged him with misappropriating $60,000 of city money for personal use. That case is still working its way through the courts.[11]

Many California cities allow employees to accrue a pension benefit of 3 percent of their final year's salary for each year worked. So employees who spend 30 years on the job can retire with pensions that pay 90 percent of their final year's salary. Most police and firefighters may retire at age 50. Similar retirement benefits are offered in most states.

San Diego teetered on the brink of insolvency in large part because of its lavish pensions, and last year Vallejo, California went into bankruptcy because of its lavish pay and perks. Ten Vallejo firefighters earned more than $200,000 apiece last year, nearly four times Vallejo's median family income of $56,805, and they will be able to retire with 90 percent of their final year's salary after 30 years of service. The city has a $16 million annual budget and an unfunded pension liability of $135 million.[12]

Ten Vallejo firefighters earned more than $200,000 apiece last year, nearly four times Vallejo's median family income of $56,805.

At a seminar hosted by the *Public Retirement Journal,* the chief actuary for CalPERS, which runs California's state pension system, told attendees: "We are facing decades without significant turnarounds in assets, decades of – what I, my personal words, nobody else's – unsustainable pension costs of between 25 percent of pay for a miscellaneous plan and 40 to 50 percent of pay for a safety plan (police and firefighters). ... We've got to find some other solutions."[13]

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[10] "Indicted Vernon official collecting $500,000 annual pension," *Los Angeles Times,* May 7, 2009, http://latimesblogs.latimes.com/lanow/2009/05/for-years-bruce-malkenhorst-sr-reigned-as-the-highest-paid-city-official-in-california-riding-in-limousines-and-making-m.html.

[11] Evan Hessel, "Welcome to Paradise," Forbes.com, February 27, 2007, http://www.forbes.com/forbes/2007/0226/104.html.

[12] Steve Stanek, "High Labor Costs, Housing Slump Drive Calif. City into Bankruptcy," *Budget & Tax News,* July 2008, http://www.heartland.org/budgetandtax-news.org/article/23324/.

[13] Quoted by Ed Mendel, supra note 9.

New York's Mayor: "That Defies Common Sense"

In a letter published in the *New York Post* in December 2008, New York City Mayor Michael Bloomberg noted: "New York City is spending so much money on pensions – $6.3 billion, a 10-fold increase from the $695 million we spent in 2000 – that we have far less to spend on core services, such as public safety, education, parks, and senior centers. That defies common sense, and it's hurting our city. For instance, the city now has to spend more money on pensions and fringe benefits for firefighters than we pay in salaries for firefighters."[14]

> "The city now has to spend more money on pensions and fringe benefits for firefighters than we pay in salaries for firefighters."
>
> – Michael Bloomberg
> Mayor of New York City

Bloomberg's point about having less to spend on core services must be stressed. Local and state governments cannot print money. Every dollar they spend on pensions is a dollar they cannot spend on something else ... and a dollar they must take from taxpaying citizens and businesses.

This summer former New York governor Eliot Spitzer noted that in New York State, "where the state pension fund lost $44 billion, or about 28 percent of its value, during the last year, local government contributions to the pension fund are going to have to triple over the next six years to make up the shortfall. Local governments will have to supply an extra $5.5 billion per year. That tax burden alone – traditionally derived to a great extent from the property tax – could break the backs of many communities."[15]

On paper, New York State's pensions appear among the nation's most financially healthy in that they are fully funded. Nonetheless, they pose a significant burden on a struggling state. New York Gov. David Paterson repeatedly called for pension reform because pensions will cost the state almost $50 billion over the next 30 years.[16] A New York think tank has referred to the pension system as a "bomb" with a fundamentally flawed structure.[17]

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[14] Michael Bloomberg, "Why Pension Reform Is Fair & Vital," *New York Post,* December 18, 2008, http://www.nypost.com/seven/12182008/postopinion/opedcolumnists/why_pension_reform_is_fair__vital_144747.htm.

[15] Eliot Spitzer, "State of Fear," *Slate,* July 13, 2009, http://www.slate.com/id/2222776/.

[16] Reuters News Service, "New York Governor Urges Overhaul of State Pension System," June 3, 2009, http://www.reuters.com/article/idUSN0356905520090603.

[17] E.J. McMahon, "Defusing New York's Pension Bomb," The Manhattan Institute, June 7, 2006, http://www.empirecenter.org/Special-Reports/2006/06/defusing_new_yo.cfm.

Illinois: A $219.1 Billion Unfunded Liability

In Illinois, the state's unfunded pension liability calculated under GASB procedures exceeds $85 billion. Novy-Marx and Rauh contend the GASB accounting method enables Illinois and other states to lowball liabilities. They put Illinois' true unfunded pension liability at an astonishing $219.1 billion in 2009.[18]

Jeffrey Brown, writing for the Center for Business and Public Policy at the University of Illinois-Champaign, noted: "If the state of Illinois wanted to be certain it had enough money set aside today so that it could meet all public pension benefit obligations that have already been accrued, it would need to set aside an additional $219.1 billion. For perspective, that is about 1/3 of Illinois GDP, about 1/3 of state revenues, and about four times the outstanding state debt."[19]

The Chicago-based Civic Federation studied 10 Chicago-area pension funds and the five state funds and concluded, "Data from the most recent audited financial statements of Illinois' state and local government pension funds show that the total unfunded liabilities for pensions supported by the taxes of Chicago residents reached $10,037 per capita for fiscal year 2008."[20]

> The lavishness of pension promises is driving Chicago-area and state pension systems to take big risks with their investments.

In a separate report issued earlier in 2009, the Civic Federation noted how lavish pension promises are driving Chicago-area and state pension systems to take big investment risks:

> Due to underfunding, pension plans have become overly dependent on high investment returns in an attempt to bridge funding shortfalls. High levels of equity exposure make local funds exceedingly vulnerable to market declines such as the current worldwide bear market. The major Chicago-area local governments' statutory pension contributions are set by state statute and are unrelated to how much money the funds need to cover their annual expenses. Thus, even good stock market returns such as those experienced in 2003-2006 have not been able to compensate for insufficient employer contributions. The funds' combined unfunded liability grew during each of those years and now stands at $17.1 billion.[21]

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[18] Novy-Marx and Rauh, supra note 7.

[19] Jeffrey Brown, "Why the Illinois Pension Funding Hole Is Even Deeper than You Think," October 13, 2009, http://businesspublicpolicy.com/?p=226.

[20] "Chicagoans, can you spare $10,037?" Civic Federation, September 30, 2009, http://www.civicfed.org/civic-federation/blog/chicagoans-can-you-spare-10037.

[21] "Local Public Pensions in Trouble Before Recession and Stock Market Crash: Civic Federation," Civic Federation, March 30, 2009, http://www.civicfed.org/press-room/local-public-pensions-trouble-recession-and-stock-market-crash-civic-federation.

New Jersey: Recent Reforms a Good Sign

New Jersey, one of the most union-heavy states in the country, has taken a leadership role in reforming employee benefit and pension systems. In March 2010, the New Jersey Legislature approved a package of state benefit cuts that increased employee contributions for health benefits, eliminated part-time employees' eligibility for pensions, and rolled back a series of expensive benefit increases approved in comparatively flush 2001.[22] The state had little choice but to make these changes: Its unfunded pension liability stood at $46 billion, the state had skipped a payment to the system, and the state pension fund lost $17 billion in the fiscal year that ended in June 2009.[23] The changes, made after the data for this report card were complied, aren't reflected in New Jersey's grade.

> There are 22.5 million public-sector workers and retirees, most of them promised generous wages and benefits with payment guaranteed by state constitutions.

New Jersey's overall plan, which included underfunding its pension system by skipping contributions, won't necessarily serve the interests of all taxpayers in the long term, since any skipped contributions will have to be made up through higher taxes or more debt in the future. That said, the reforms do show that even states with strong government unions can and do make sometimes-painful changes in their pension systems. While the state may not be a model in every respect, New Jersey's actions could represent the beginning of a positive trend.

A National Problem

The problem may be most acute in states like California, Illinois, and New York, but it is truly a national problem. *Forbes'* Stephanie Fitch observes there are 22.5 million public-sector workers and retirees, most of them promised generous wages and benefits with payment guaranteed by state constitutions. At the present time of economic distress, their retirement benefits present a genuine issue of fairness. Fitch writes:

> In private-sector America your job, assuming you still have one, hangs on the fate of the economy. If your employer ever offered a pension for life, like young officer Goss is receiving, odds are it has stopped doing so, or soon will. Those retirement accounts you scrimped and saved to assemble? Unless they are invested in Treasurys, they aren't doing too well. In private-sector America the math leads to the grim prospect of working longer and living poorer.

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[22] Gina Chon, "New Jersey Cuts Workers' Benefits," *The Wall Street Journal*, March 24, 2010.

[23] Ibid.

> In public-sector America things just get better and better. The common presumption is that public servants forgo high wages in exchange for safe jobs and benefits. The reality is they get all three. State and local government workers get paid an average of $25.30 an hour, which is 33% higher than the private sector's $19, according to Bureau of Labor Statistics data. Throw in pensions and other benefits and the gap widens to 42%.[24]

The difference in retirement and health benefits between public- and private-sector workers is striking. In February 2009, the Chicago Federal Reserve Bank and the Civic Federation, a public policy organization in Chicago, hosted a forum that examined the differences in wages and benefits between the government sector and private sector and discussed best practices in workforce sustainability. The subsequent paper on that forum cited the U.S. Bureau of Labor Statistics' September 2008 Employer Costs for Employee Compensation (ECEC) survey, which showed the employer cost per hour for benefits is $7.93 in the private sector and $13.41 in the government sector.[25]

Public-sector retirement benefits, unlike their private-sector counterparts, almost everywhere involve "defined benefits" rather than "defined contributions." A defined benefit plan guarantees workers a specific sum of money, often paid monthly, after working for an employer for a certain period of time. A defined contribution plan, on the other hand, involves the employer (usually with a required employee "match") giving employees a specific "up front" sum for a retirement account and leaving the employee to manage it. In the private sector, defined contribution pensions are typically called 401(k)s (for profit-making companies) and 403(b)s (for non-profits.)

Public-sector retirement benefits, unlike their private-sector counterparts, almost everywhere involve "defined benefits" rather than "defined contributions."

Both plan types have advantages and disadvantages for workers and taxpayers. Defined benefit plans are often better and easier to manage for government workers who plan to stay in the same job for a long time. For public-sector employees who work in professions (police officer, firefighter, corrections officer, government benefits administrator) that have few or no equivalents in the private sector, staying put in the same job is often a given. For these workers, a defined benefit pension can guarantee them a sizeable portion of their pre-retirement income while requiring no personal effort or risk. At least in the short term, taxpayers may appear to be better off under a system of defined benefit pensions since defined benefit pensions don't have to be paid until some point in the future. A government that provides them can underfund them and tax less or provide more services.

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[24] Ibid.

[25] "Public and Private Sector Compensation: What Is Affordable in this Recession and Beyond? – A Conference Summary," *Chicago Fed letter,* Number 262a, May 2009, http://www.chicagofed.org/publications/fedletter/cflmay2009_262a.pdf.

On balance, defined benefit pensions pose a significant risk to taxpayers. Since the benefits are guaranteed (and, almost everywhere, are protected under either state constitutions or union contracts), taxpayers are liable for paying the pensions whenever contributions and pension fund earnings fail to cover the benefits owed to current retirees.[26] Workers don't always benefit from defined benefit pensions either. With a few exceptions, defined benefit pensions don't vest – become eligible to pay employee benefits – until an employee has spent a significant amount of time on the job. In many states, employees who spend less than 10 years in a government job walk away with nothing or eligibility for a "cash-out" that leaves them with less than they would receive under a defined contribution system.

How did the gap between private and government pension benefits become so wide?

How did the gap between private and government pension benefits become so wide? Some types of government work, particularly in the public safety realm, may appear particularly deserving of generous wages and pensions. Police officers and firefighters, for example, do jobs that often require significant physical skills that fade with age and have few identical employment opportunities in the private sector. But it is worth noting that firefighters do not appear, and police officers rank only tenth, in the list of 10 occupations most likely to result in serious injury or death, behind cab drivers, lumberjacks, professional fishermen, farmers, and iron workers, among other not-uncommon occupations.[27] Most government workers work indoors, face no more job-related risks than workers in the private sector, and perform services similar to private-sector workers.

The most likely causes for the disparity are incentives faced by elected officials and government department heads.[28] Defined benefit plans allow them to give in to worker demands for more generous benefits without having to ask taxpayers to pay more, at least not *right away.* When the bill comes due, many of the department heads who granted the increases and the elected officials who approved them expect to be retired or out of office. It is a temptation that too few government officials have been able to resist.[29]

Adding to government officials' incentive to promise lavish retirement benefits is the power of public-sector unions. According to U.S. Department of Commerce data, 37.4 percent of public-sector employees were represented by labor unions in 2009, compared with only 7.2 percent of

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[26] Darryl B. Simko, "State Constitutional Contract Protections and Fiscal Constraint of Public Pensions," *Temple Law Review,* 1996: 1059.

[27] "Ten Most Dangerous Jobs," Safety Services Company, July 27, 2009, citing Bureau of Labor Statistics, http://www.safetyservicescompany.com/blog/10-most-dangerous-jobs-3.

[28] See "The Impact of Surplus Sharing on the Portfolio Mix of Public-Sector Defined Benefit Pension Plans: A Public Choice Approach," *Public Choice* (2009) **140**: 161-184.

[29] Leslie E. Papke and J. Fred Giertz, "Public Pension Plans: Myths and Realities for State Budgets," *National Tax Journal,* June 2007, http://www.britannica.com/bps/additionalcontent/18/25977867/Public-Pension-Plans-Myths-and-Realities-for-State-Budgets.

private-sector employees.[30] The Employee Benefits Research Institute observes that public-sector unions exercise their influence "directly where bargaining over benefit issues is allowed, but it is also exercised indirectly through the legislative process."[31] Union campaign contributions, volunteers, and votes undoubtedly influence the decisions of elected officials, once again rewarding those who vote for generous benefits today and leave taxpayers to foot the bill *after* they leave office.

3. How to Grade Public Pension Systems

Although structures and eligibility differ from state to state, the single most common structure consists of a Teachers Retirement System (TRS) and an Employee Retirement System (ERS), sometimes called a Public Employee Retirement System (PERS). Most states maintain separate, much smaller, pension systems for judges and elected officials. Likewise, larger localities often have their own pension systems independent of state pension systems. This report does not evaluate these smaller statewide and non-statewide systems.

We were limited to the data that could be compared nationally, which meant using data based on the state of pension plans in 2008 and not including 2009 data. We relied heavily on data collected by the Wisconsin Legislative Council and presented in "2008 Comparative Study of Major Public Employee Retirement Systems," published in December 2009.[32] This remarkably thorough report has been prepared every two years since 1982 and (since 2008) includes data from 85 public employee retirement systems.

We chose six variables to compare, score, and then rank all 50 state plans:

(1) Employee contribution
(2) Choice of retirement plan
(3) Taxable benefits
(4) Time before vesting
(5) Earnings basis for pensions
(6) Fund solvency

We chose six variables to compare, score, and then rank all 50 state plans:

(1) *Employee contribution,* the amount employees must contribute to their own pensions relative to the taxpayer subsidy.

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[30] David Denholm, "Unions Flood Public Sector, Drain Away from Private Sector," *Budget & Tax News,* forthcoming June 2010, http://www.heartland.org/budgetandtax-news.org/article/27226/.

[31] "The Public-Sector Environment," Employment Benefits Research Institute, http://www.ebri.org/pdf/publications/books/fundamentals/2009/41_Environ_PUB-SCT_Funds-2009_EBRI.pdf.

[32] Daniel Schmidt, "2008 Comparative Study of Major Public Employee Retirement Systems," Wisconsin Legislative Council, December 2009, http://www.legis.state.wi.us/lc/publications/crs/2008_retirement.pdf.

(2) *Choice of retirement plan,* whether employees have a choice of defined benefit or defined contribution plans.

(3) *Taxable benefits,* whether states tax public pension benefits as income when they are paid.

(4) *Time before vesting,* how many years workers must serve before they are entitled to pensions.

(5) *Earnings basis for pensions,* which years or how many years of earnings are used as the basis for determining the size of pensions.

(6) *Fund solvency,* reported funds on hand as a percentage of expected liabilities, relative to other states.

The first five variables concern the kinds of promises states make to public-sector workers. The final variable, fund solvency, concerns the ability of states to keep the promises they make. In each category, plans that take actions we consider good for taxpayers and states' fiscal futures receive bonus points, while plans that take actions we consider bad for taxpayers and financially unsustainable for states have points taken away.

The first five variables concern the kinds of promises states make to public-sector workers. The final variable, fund solvency, concerns the ability of states to keep the promises they make.

The greatest weight went to variables most likely to affect taxpayers: the size of the contributions made from tax dollars and the overall funding of the plan. On most variables, most states fall in the 10-point range between +5 and -5 and the modal score (the score assigned to the largest number of states) is zero. We give one variable, the earnings basis for pensions, double weight and another variable, fund solvency, quadruple weight. (We weight by assigning additional points to the variables in the base scores.) We single out these two variables because the earnings basis for pensions is the single most important promise made to employees in terms of determining cost, and a state's solvency measures a state's ability to keep the promises it makes.

The rest of this chapter summarizes why we picked these variables and how we rewarded or withdrew points.

1. Employee Contribution

Defined benefit pensions are funded by contributions from both the employer and the employee. Pension experts generally recommend that employers and employees contribute roughly equal amounts to the pension system. Girard Miller, a senior strategist for retirement plans and

investments at the PFM Group, wrote recently for *Governing* magazine:

> The ideal ratio of employer-employee cost shares for retirement benefits is a number close to 50-50. There is no automatic best answer, because sustainable retirement benefits may be affordable for some employers with a lower rate of employee contributions. But generally speaking, there is no justification for any public employee paying less than one-third of his true costs of retirement plan benefits.[33]

Miller also notes, "few public employers have insisted on equal shares, and many have drifted mindlessly in the opposite direction. In some cases, the employers are paying the entire employees' share of pension costs, as well as the employer contributions, and requiring nothing for retiree medical (OPEB) benefits either."[34]

For this report, we reward plans with five points if they require employees to pay even a small amount more than taxpayers, treat neutrally (zero points) those that have dollar-for-dollar matches, and penalize by up to 15 points those that require significant taxpayer subsidies. For each plan, we divided the employer cost by the employee cost to determine the ratio of taxpayer subsidy to employee contribution. Table 1 summarizes the scoring method.

Table 1.
Variable 1 – Employee Contribution

Points	Measurement
-15	Taxpayer subsidy more than 2 times the employee contribution
-10	Taxpayer subsidy is modest contribution but no employee contribution required
-8	Taxpayer subsidy more than 1.5 times the employee contribution but less than 2 times the employee contribution
-5	Taxpayer subsidy less than 1.5 times the employee contribution but more than 1.1 times the employee contribution
0	Taxpayer subsidy essentially equal to the employee contribution (between .9 and 1.1 times the employee contribution)
+5	Taxpayer subsidy less than .9 percent of the employee contribution

A few states presented special cases: For plans that offered a range of possible contributions, we averaged the range and used that to determine the final score. Where statutes, legislative choices, or yearly investment returns decide the size of the employer contributions, we assigned a score

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[33] Girard Miller, "Employer Paid Humbug," *Governing Magazine,* December 3, 2009, http://www.governing.com/column/employer-paid-humbug.

[34] Ibid. OPEB stands for "other post-employment benefits."

of zero. Plans to which we've assigned zero in this manner may not have employee contribution levels that are comparable to those of other plans with the same score.

2. Choice of Retirement Plans

No single type of retirement plan is most appropriate for every employee or would be the best deal for taxpayers. Although we contend taxpayers generally get the best deal from defined contribution plans, we recognize that obstacles exist to changing plans in some cases and that savings to taxpayers could take many years to materialize. (This is discussed in more depth in Part Five.) At a minimum, though, states ought to give employees a choice of defined benefit or defined contribution plans as their primary pension plan.

We scored plans that do not offer a choice of primary pension plan "0" and those that offer a choice of primary pension plan +5. Table 2 summarizes the scoring method.

Table 2.
Variable 2 – Choice of Retirement Plan

Points	Measurement
0	Does not offer a choice of defined contribution or defined benefit plans
+5	Offers a choice of defined contribution or defined benefit plans

3. Taxable Benefits

The federal government and virtually all states tax income from private pensions. Fairness dictates that states should do the same to income from public pensions. Failing to do so amounts to a hidden increase in public-sector compensation, another way for elected officials and department heads to avoid accountability for expensive concessions to public-sector workers.

We reward states that tax public pension benefits like other income and penalize states that grant them tax exemptions. So as not to unfairly penalize states that have no income tax, we give them a score of +1 rather than -5. Table 3 summarizes the scoring method.

Table 3. Variable 3 – Taxable Benefits	
Points	**Measurement**
-5	Plan benefits exempt from all state income taxation
-3	Plan benefits partly exempt from state income taxation with a deduction of $10,000 or more
0	Plan benefits partly exempt from state income taxation with a deduction less than $10,000
+1	State has no income tax
+5	Plan benefits fully taxable

4. Time Before Vesting

If governments offer defined benefit pensions, they should offer them to employees who spend a sizeable portion of their career with the government. Taxpayers shouldn't be liable for lifetime benefits paid for people who work for the government only a short time. Most private-sector employers who offer pension plans allow employees to "vest"– become eligible for a pension – after five years on the job, with the amount of the pension then increasing with years of service.

For this report, we penalize states that allow employees to vest immediately and reward those that have longer vesting periods. Table 4 summarizes the scoring method.

Table 4. Variable 4 – Time Before Vesting	
Points	**Measurement**
-5	Plan vests immediately
-3	Plan vests in 3 years
-1	Plan vests in 4 years
0	Plan vests in 5 years, is pure defined contribution, or uses a varying scale where most participants vest in 5 years
+3	Plan vests in more than 5 years but less than 10 years
+5	Plan vests in 10 years

5. Earnings Basis for Pensions

Most defined benefit pensions base a pension on some fraction of employees' earnings during their careers. A common abuse of public-sector pension plans is "spiking" pensions by deferring vacation, working extra overtime, and gaining last-minute promotions to artificially inflate salary in a worker's final year, a practice that can add hundreds of thousands of dollars to the cost of a single worker's retirement benefits.[35]

The way to avoid "spiking" without discouraging hard work and legitimate late-career promotions is to base pension amounts on the average salary over a relatively long period, say five years or longer. The worst policy is to base pensions on the single highest year's earning. We therefore penalize states that facilitate spiking and reward those that discourage it, using the scoring method shown in Table 5.

Table 5.
Variable 5 – Earnings Basis for Pensions

Points	Measurement
-10	Plan bases pension on highest single year's earnings
-8	Plan bases pension on highest three years out of 10 years' earnings
-5	Plan bases pension on highest three years straight
0	Plan bases pension on highest four years (in any manner)
+5	Plan bases pension on highest five or more years

6. Fund Solvency

Well-run pension plans should be capable of paying the benefits they promise. Because of poor policy choices (captured, we hope, by the first five variables), most public pension plans will have to either increase mandatory contributions, greatly improve investment returns, take more from taxpayers, or reduce benefits if they are to remain solvent.

To determine the plans' relative solvencies, we relied on the plans' own reports of "funding ratios" (funds on hand as a percentage of the promised benefits they could reasonably expect to pay) under Government Accounting Standards Board (GASB) criteria. We ranked plans by quintiles, with the first quintile being the closest to fully funded and the fifth being the farthest from solvency. We gave additional points to plans that were 100 percent or more funded and penalized plans that were less than 50 percent funded. Table 6 presents the scoring method.

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[35] Ed Mendel, "Public pension 'spiking' targeted in new legislation," *Capitol Weekly*, February 25, 2010, http://www.legis.state.wi.us/lc/publications/crs/2008_retirement.pdf. See also Ted Costa's "30 ways to spike your pension" list at http://www.pebc.ca.gov/images/files/TedCosta070828.pdf.

Table 6. Variable 6 – Fund Solvency	
Points	**Measurement**
-25	Plan is less than 50 percent funded under GASB calculations or is defined contribution
-15	Plan is in the fifth quintile of funding
-7	Plan is in the fourth quintile of funding
0	Plan is in the third quintile of funding
+7	Plan is in the second quintile of funding
+15	Plan is in the first quintile of funding but less than 100 percent funded
+20	Plan is 100 percent or more funded

Limitations of This and Any Report Card

In principle, we would have liked to penalize plans that allow employees to retire "too early" with "too many" benefits, but we couldn't find a good way to quantify this. We faced three problems:

- With two exceptions – both in Nebraska – plans don't have a uniform "retirement age" but rather separate and often-conflicting formulas for different classes of workers as well as "normal" and "early" retirement programs. Thus, there was no clear retirement age we could compare among plans.

- What "too early" means differs by profession, and there is an enormous diversity of professions of people eligible for government pensions. Few 60-year-olds can perform the physical feats necessary to work as firefighters, while those who teach school or do social work may well be at the top of their professional abilities at that age. Private employers in different sectors have different retirement ages (although, with a few exceptions, mandatory retirement is forbidden in the private sector) and, in concept, it's appropriate that governments can and should do the same.

- The question of what constitutes "too many" benefits was difficult to judge in the context of early retirement. By giving rewards and penalties to plans based on their salary calculation rules, we think we've captured this aspect of the problem of overly generous states.

Many evaluations of public-sector pension plans have cast doubt on the Government Accounting Standards Board methods used by the plans to report funding ratios and other relevant financial

information.[36] These methods differ from the Generally Accepted Accounting Principles private businesses use, and they may understate the true size of the obligations. Short of doing a full study of each pension fund's internal controls, there's no way to evaluate whether a given pension plans' accounting assumptions are accurate. By awarding points to plans that offer a choice of a defined contribution plan, this report favors plans that make no accounting assumptions at all. But the report makes no effort to reward (or punish) individual plans for their underlying accounting assumptions.

Some states have exacerbated existing pension plan ills through mismanagement of disability benefit systems, poorly structured buyout proposals, and badly designed retention mechanisms. There's no way to capture the flaws in the design of these mechanisms and no national data that allow objective comparisons among states.

Moreover, this report doesn't attempt to assess the quality of pension fund managers or re-audit the data on which the report is based. Insofar as some pension fund managers might falsify data, engage in fraud, or simply fail to fulfill their fiduciary duties, our study does not capture it.

Plans that we rank poorly may not pose imminent problems for the states that run them, while some plans with middling rankings may pose enormous problems due to the state's overall financial health.

Finally, but very importantly, this ranking attempts to evaluate retirement plans themselves, not the context in which they operate. Plans that we rank poorly may not pose imminent problems for the states that run them, while some plans with middling rankings may pose enormous problems due to the state's overall financial health. A state with a good bond rating, few burdensome public employee contracts, and no constitutional prohibitions on changing its pension system may be able to fix a seriously broken pension system rather easily, while a state in different circumstances may face major problems with a system that appears less bad on paper.

A comparison of two states can help illuminate this limitation. Notoriously troubled California, where pensions are a major political issue, receives a "B" grade in our report card. While the state's pension system needs reform, its problems are particularly severe and worthy of attention now because the state's other fiscal problems are so severe. California has some of America's highest taxes, has already cut a number of services deeply, has an enormous gap in its budget, and has the nation's worst bond rating. As a result, fraud and waste in its public-sector pensions pose a major problem for the state even though the state's pension system, analyzed in isolation by our measures, is slightly better than the norm.

[36] George Passantino and Adam B. Summers, "The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank and Strategies for Reform," Reason Foundation, June 16, 2005, http://reason.org/news/show/127599.html, 9-11.

Utah, on the other hand, receives a "D" grade (on the verge of an "F") even though state employee pensions have not been a major issue there. While Utah faces a budget gap just like other states, it's a well-governed state with a AAA bond rating and modest taxes. While Utah needs to do something about its public-employee pensions, it has many more options than California does.

In short, pension reform matters for all states, but it's not as urgent or as easy in every state, something this report card cannot capture.

4. A 50-State Report Card

To calculate each plan's score, we added together the points awarded or subtracted for each variable. The raw numbers scored were weighted equally, since we weighted the factors by assigning more points to some and less to others.

Where states have more than one pension system, the state's ranking is based on an average of the systems with each plan weighted by the fraction of the state's total number of public pension plan participants it enrolls. As a result of this method, some states with troubled pension plans that need reform can still receive above-average grades if their other pension plans are particularly well-administered and solvent.

To assign grades to states, we calculated the standard deviation (the average distance from the mean) and assigned grades (without pluses and minuses) to states based on their distance from the mean. By grading on a curve in this manner, we award grades from "A" to "F." For the data we compiled, the standard deviation was 14.13 and the mean was -4.47. This grading system is summarized in Table 7.

Table 7.
Grades and Scores

Grade	Score	Measurement
A	9.66 or higher	More than one standard deviation above the mean
B	-4.47 to 9.65	Above the mean by less than one standard deviation
C	-18.6 to -4.47	Below the mean by less than one standard deviation
D	-26.66 to -18.6	Below the mean by more than one standard deviation but less than 1.5 standard deviations
F	less than -26.66	Below the mean by more than 1.5 standard deviations

Table 8 reports the states' scores, ranks them from highest to lowest, and assigns them letter grades. Two tables in the appendix identify the scores for each of the six variables recorded by

each state pension plan and the enrollment data used to weight plans in states with two or more public pension plans.[37]

Table 8. 50-State Public Pension Report Card					
State	**Letter Grade**	**Score**	**State**	**Letter Grade**	**Score**
Alaska	A	+26.00	Rhode Island	C	-5.00
Florida	A	+24.00	Massachusetts	C	-7.00
North Carolina	A	+23.70	Kentucky	C	-9.85
Washington	A	+21.00	Georgia	C	-9.87
North Dakota	A	+18.24	Iowa	C	-10.00
Oregon	A	+15.00	Nevada	C	-11.00
Nebraska	A	+12.50	Wyoming	C	-12.00
Delaware	A	+12.00	Virginia	C	-13.00
Texas	B	+7.60	New Jersey	C	-13.41
Minnesota	B	+6.13	Mississippi	C	-17.00
South Dakota	B	+5.00	Arkansas	C	-17.12
Wisconsin	B	+5.00	Alabama	D	-18.16
Ohio	B	+4.50	Connecticut	D	-18.28
Indiana	B	+2.65	West Virginia	D	-18.76
Montana	B	+2.19	Utah	D	-19.00
Michigan	B	+1.93	Maine	F	-20.00
Vermont	B	0.33	New Hampshire	F	-20.00
California	B	0.12	Maryland	F	-23.00
Idaho	B	-1.00	Colorado	F	-23.00
New Mexico	B	-2.23	South Carolina	F	-23.00
Pennsylvania	B	-2.28	Oklahoma	F	-24.31
New York	B	-2.73	Illinois	F	-24.50
Tennessee	B	-3.00	Hawaii	F	-25.00
Missouri	B	-4.33	Louisiana	F	-25.16
Arizona	C	-5.00	Kansas	F	-28.00

[37] An Excel spreadsheet containing all of the data and formulas used to generate the scores is available from the authors upon request.

Some highlights from the "report card" include the following:

- The five states with the highest-scoring public pension systems are Alaska, Florida, North Carolina, Washington, and North Dakota. Three other states (Oregon, Nebraska, and Delaware) also received "A" grades.

- The five states with the lowest-scoring public pension systems are Kansas, Louisiana, Hawaii, Illinois, and Oklahoma. Five other states (South Carolina, Colorado, Maryland, New Hampshire, and Maine) also received "F" grades.

- New York and California – states where concern over the status of public pensions runs high – both receive "B" grades. Illinois received an "F" grade. As explained earlier, financial problems in states such as New York and California have magnified the consequences of pension systems that are, on the basis of this review, slightly better than average.

- States at both ends of the grade spectrum defy characterization as mostly urban or rural, large or small, high-tax or low-tax, or even "Red" or "Blue." This suggests those factors don't determine or predict a states' pension policies, and are neither excuses for nor defenses against poor public-pension policies.

Given the precarious nature of almost all state pension plans, it's important to note that a good grade should not be considered a clean bill of health for a state's pension systems. Although we feel confident in saying the systems that receive "A" grades are reasonably well-run and unlikely to imperil their states' overall fiscal health, we believe nearly all of the pension systems graded B and below are unsustainable and need some sort of reform. Many states that receive good grades still underfund their pension systems and operate them under rules that hurt taxpayers.

We believe nearly all of the pension systems graded B and below are unsustainable and need some sort of reform.

5. Directions for Reform

Public employee pensions imperil the fiscal health and future of many states. They impose great and perhaps un-payable costs on taxpayers. How should they be changed to protect taxpayers while still providing fair and sufficient retirement benefits for government workers?

Limiting public-sector retirement benefits isn't a silver bullet for solving the current financial problems facing states such as California, Illinois, and New York. State constitutions and union contracts can make changing pension systems difficult, and the financial benefits of reform can be slow to arrive while transition costs can occur immediately. However, there are several things

states can do to improve their pension systems to provide long-term, if not short-term, relief to taxpayers and avoid what would otherwise be almost certain bankruptcy.

For obvious reasons, the reform recommendations that follow track our choice of variables used to rank and then grade states. States that adopt these reforms would see their ranking on this report card rise.

The specific steps necessary to implement reform will be different for each state.

We emphasize these are general directions for reform. The specific steps necessary to implement reform will be different for each state. In some states, reform would require only directing the public's attention to the problem and finding the political will to address it. In other states, statutory or perhaps even constitutional changes might be required. Though we might wish it were otherwise, there's no single set of steps we can recommend.

1. Increase Employee Contributions

It seems that a fair rule of thumb would be that government workers should contribute at least as much toward their retirement as taxpayers. In reality, plans in Illinois, Georgia, Maryland, and Oklahoma require taxpayers to put up *four or more times* as much as government workers. New York has a plan that makes taxpayers put up three times as much, and at least eight other plans require taxpayers to put up twice as much as workers. These estimates are probably low because amounts designated as employee contributions for accounting purposes are sometimes actually paid by the employer.[38]

We have acknowledged that if government workers were paid less than their private-sector counterparts, or if years of service in government left them unsuited for jobs in the private sector, then generous taxpayer contributions to public pensions might be justified. But government workers in fact generally receive higher wages than their private-sector counterparts, and the practice of offering generous pensions extends far beyond those professions that lack private-sector positions that require comparable skills and experience.

Roughly half of all pension plans require taxpayers to contribute more than employees. This is unfair and needs to change. Employees should pay, at minimum, half the cost of their own pensions.

2. Move to Defined Contribution Plans

Reason Foundation researchers George Passantino and Adam Summers note, "Over the past several decades, the private sector has rapidly shifted away from defined-benefit plans and

[38] Wisconsin Legislative Council, supra note 32, p. 19.

toward defined-contribution plans for good reason – traditional plans are expensive, unpredictable, and unsustainable in the long run."[39]

Defined benefit plans put virtually no risk on the workers or retirees, because taxpayers must make up any funding shortfalls. In contrast, defined contribution plans such as 401(k)s require the employee to set aside money (often, but not always, with contributions from employers) and determine how the money should be invested. The amount available for retirement depends on how much money was set aside and the success of the investments. The risk is on the workers.

The number of U.S. businesses that offer defined benefit plans has dropped to about 38,000 compared with more than 114,000 in 1983, according to the IRS. Yet they remain the standard benefit for government workers.

The number of U.S. businesses that offer defined benefit plans has dropped to about 38,000 compared with more than 114,000 in 1983, according to the IRS.[40] Yet they remain the standard benefit for government workers.

Nevertheless, Alaska, the District of Columbia, Michigan, and West Virginia now have defined contribution plans as primary plans for at least some state and local workers, such as teachers. Nebraska had a defined contribution plan as the primary retirement vehicle from 1967 to 2002. It was closed to new employees in 2003 and replaced with a cash balance plan. According to a recent report from the National Conference of State Legislatures (NCSL),

> In the Nebraska cash balance plan, employees contribute between 4.3% and 4.8% of salary and the employer contributes about 7.5% of salary to an employee account. The employee cannot control investment of the account but is guaranteed an annual return of at least 5% a year. The account can receive a higher return, depending on investment earnings. At retirement, the employee may buy an annuity, or withdraw the balance in a lump sum or in installments. Principal differences from a defined contribution plan are the employer's guarantee of a minimum investment return and control of investments.[41]

In Colorado, Florida, Montana, North Dakota, Ohio, and South Carolina, new employees have the option of joining a defined contribution plan or a defined benefit plan. There is limited ability to switch from one to the other. Florida, Georgia, Indiana, Ohio, Oregon, and Washington also offer hybrid plans that combine elements of defined contribution and defined benefit plans. All

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[39] Passantino and Summers, supra note 36.

[40] "Choosing a Retirement Plan: Defined Benefit Plan," Internal Revenue Service, http://www.irs.gov/retirement/article/0,,id=108950,00.html.

[41] Ronald Snell, "State Retirement System Defined Contribution Plans," National Conference of State Legislatures, September 2009, www.ncsl.org/Portals/1/Documents/.../StateGovtDCPlansSept2009.pdf.

states offer optional deferred compensation plans to augment primary pension coverage.[42]

Advantages of defined contribution plans to workers include the ability to move money they put into the plan into a new plan if they switch jobs, more control over how much money is taken from their paychecks to fund the plans, access to retirement funds immediately rather than after several years until the worker is "vested," and no risk of losing money contributed to a retirement account if a person goes into a new career before he or she is vested and eligible for retirement benefits.

> The advantages of defined contribution plans are many, but shifting to such plans is not a silver bullet.

Actuarial and employee benefits consulting firm Milliman, Inc. reports where new hires have the choice of defined benefit (DB) or defined contribution (DC) plans, "the percentage of new employees electing DC plans ranges from 3 percent in the Ohio Public Employee Retirement System to 26 percent in Florida."[43] The Milliman report adds, "many of the members going into a DB plan never submit an election and are placed in the DB plan by default. However, based on survey data, Florida found that 'up to 45% of the defaulters may be using this option as their active election in the belief that by defaulting there could be no mistakes made in their plan choice.'" In the Washington retirement system – the only one where defined benefit is not the default option – more than 60 percent of new members have enrolled in the defined benefit plan.

Shifting to defined contribution plans is not a silver bullet. The Milliman report notes that in 1991 the underfunded teachers pension system in West Virginia was closed to new members and new hires were put into a defined contribution plan. In 2005 the state flipped and started putting all new hires into the defined benefit system. Among other problems, unfunded obligations for existing members are not reduced when new members go into a defined contribution plan, and contributions from new members do not come in. Also, the battering the stock market took when the dotcom bubble burst in 2000-2001 hurt the ability of several thousand teachers to afford retirement, putting pressure on lawmakers to protect teachers from investment losses.

West Virginia projects a $1.2 billion savings over 30 years from moving new hires from the defined contribution to defined benefit plans. But that projection relies on a 7.5 percent investment return.[44] As we've already noted, many analysts believe projections of such long-term gains are too rosy.

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[42] Ibid.

[43] Mark Olleman, "Public plan DB/DC choices," *PERiScope* newsletter, Milliman, Inc., January 2009, http://www.milliman.com/expertise/employee-benefits/publications/peri/pdfs/PERi-01-01-09.pdf.

[44] Ibid.

On the other hand, many analysts support moves to put government employees into defined contribution plans in the belief they bring lower and more predictable costs. In Illinois, for example, the Governor's Pension Commission in 2004 recommended additional study of a plan to replace all or part of the state's defined benefit plans with defined contribution plans.

"Defined contribution plans can significantly reduce unfunded liabilities," the commission report noted. "Once the State gets the current pension debt levels under control, a Defined Contribution Plan should be strongly considered in the near term for newly hired employees and current employees who voluntarily opt out of defined benefit programs."[45]

"Defined contribution plans can significantly reduce unfunded liabilities."

– Illinois Governor's Pension Commission

3. Tax Public Pension Benefits

Public pension benefits are subject to state income taxation, and no specific amount of retirement benefits is tax exempt, in 23 of the 87 plans covered by the Wisconsin Legislative Council survey.[46] Twenty-one plans are totally exempt from state income taxation, and 11 plans are in states with no state income taxes.

Exempting public pension benefits from state taxes often seems at the time to be an easy way to help "underpaid" government workers and perhaps to attract qualified people to the public sector. The favor does not show up in personnel budgets as an expense, and the true cost of the decision isn't realized for many years. But from the standpoints of both fairness and state fiscal solvency, the tax exemption is no different from boosting public pensions by the income tax rate. In states with high income taxes, such as New York, this is equivalent to boosting pensions by 10 percent or more.

The state tax exemption for public pension benefits is often a "perk" not guaranteed by contracts or the state constitution. It should be the "first thing to go" as states tighten their fiscal belts and bring public pension spending under control.

4. Extend Vesting Periods

The idea of lifetime employment by a single employer disappeared from the private sector many years ago as both employers and employees realized it was inefficient and unfulfilling. It lives on in the public sector, however, at considerable expense to taxpayers.

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[45] "Pension Reform Report and Recommendations," Governor's Pension Commission [Illinois], www.state.il.us/.../Pension%20Commission%20Final%202.11.05.pdf.

[46] Wisconsin Legislative Council, supra note 32, page 32.

The average worker in the U.S. today changes jobs about every four years, a phenomenon that has advantages and disadvantages but is an undeniable fact of contemporary life.

As the nation moved from agriculture to manufacturing, then to the service economy, and most recently to the so-called "digital economy," people realized that the pace of change in technology and consumer demand made more-flexible workforces necessary and desirable. The average worker in the U.S. today changes jobs about every four years, a phenomenon that has advantages and disadvantages but is an undeniable fact of contemporary life.

People who spend a short time working for the government have not earned a lifetime taxpayer subsidy. Even five years, the vesting term required by the majority of public pension systems, is too short in light of the need for workforce flexibility and the growing transferability of skills from public to private sectors.

According to the Wisconsin Legislative Council, "in 2008, a total of 64 plans, or 73.6% of the 87 plans in the report, require five or less years of service to vest."[47] Switching to defined contribution plans properly makes the vesting issue irrelevant. Insofar as defined benefit plans remain, they should serve workers who give most of their careers to government service by being an option only for those who have worked for, say, 10 years or longer.

5. End Benefit "Spiking"

Probably the largest single source of abuse of public pensions is manipulation of the earnings basis for calculating pension benefits to dramatically increase or "spike" the cost of retirement benefits. Legislators in California have grappled with this problem probably as much as or more than any other state, and their limited success is a cautionary lesson for leaders who seek reform in this area.[48]

Once again, switching to defined contribution plans would solve this problem. But where defined benefit plans remain, requiring that pension benefits be based on the average compensation of the last three years of employment, rather than the last year, is one important but only partial remedy. Double-dipping can be banned, penalized, or capped; benefits can be capped at no more than 75 percent of salary; health benefits can be limited and retiree contributions toward health insurance premiums required or increased.

[47] Ibid., p. 20.

[48] Ed Mendel, supra note 35.

6. Insist on Fund Solvency

Since defined benefit pensions by definition obligate taxpayers to make payments long after government officials leave office, they will always tempt elected officials and department heads to put short-term political and management objectives ahead of long-term solvency. This hazard will not be eliminated until and unless states move to defined contribution pensions. However, the temptation can at least be reined in by insisting that state legislatures fully fund their public pension funds.

Private companies, lacking the power to use forced taxation to fund their plans, had to choose between maintaining expensive pension systems or bankruptcy. In some instances, companies kept their pension plans and ended up in bankruptcy, forcing the end of their defined benefit pension plans.

> The only good news is that the bill for years of under-funding public pensions has now come due, and every change to pension laws going forward must be evaluated in light of its impact on fund solvency.

San Diego has teetered on the brink of bankruptcy because of its defined benefit pension system, and in 2008 Vallejo, California, a San Francisco Bay-area city of about 120,000 persons, went into bankruptcy, largely because of its $135 million unfunded pension liability. Even with the power of taxation, governments can go bankrupt.[49]

Tax increases and borrowing are no guarantee of solvency. Illinois borrowed $10.1 billion in pension obligation bonds in 2003 at 5.05 percent interest, and the pension situation has grown steadily worse. The only good news is that the bill for years of under-funding public pensions has now come due, and every change to pension laws going forward must be evaluated in light of its effect on fund solvency. Reforms that would have been considered too radical or politically impossible just two years ago must now be on the table, since nothing less than the bankruptcy of cities, public school districts, and even states is the only alternative.

6. Conclusion

Public-sector employee pensions have become too expensive, too cumbersome, and too burdensome for taxpayers. Massive unfunded liabilities are now devouring rapidly growing parts of state and local governments, causing spending to be cut on essential services. Current policies are financially unsustainable in many states.

Current pension policies are also unfair and cheat taxpayers. They deliver benefits that are much more generous than those of typical private-sector workers. They sometimes reward workers

[49] Steve Stanek, supra note 12.

who have worked for only brief times in the public sector, and who collect pensions from two, three, or even more positions. The benefits are often disproportionate to the sacrifices and investments that government workers make.

> States can end the public pension crisis by putting government retirement benefits on par with those in the private sector.

A root cause of the public pension crisis is the decision made years ago to make defined benefit pension systems a standard perk for state and local government workers, and then to not move toward defined contribution plans as times changed and the rationale for defined benefit plans began to disappear. The private sector made that transition, shifting more responsibility and risk onto employees for their retirement planning, and it has a more flexible workforce and lower long-term financial burdens as a result.

No two states have identical pension systems, but it is possible to compare and rank states according to several plan features that most affect the cost, fairness, and solvency of the plans. This report identifies six such features and ranks all 50 states according to how they compare with other states. Those factors are: (1) employee contribution, (2) choice of retirement plan, (3) taxable benefits, (4) time before vesting, (5) earnings basis for pensions, and (6) fund solvency.

Using these six variables, we identified the "worst" and "best" states, based on what would best serve the interests of taxpayers and the goal of state fiscal solvency. The five states with the highest-scoring public pension systems are Alaska, Florida, North Carolina, Washington, and North Dakota. The five states with the lowest-scoring public pension systems are Kansas, Louisiana, Hawaii, Illinois, and Oklahoma.

States can end the public pension crisis by putting government retirement benefits on par with those in the private sector. Specifically, we recommend making employees contribute more to their retirement, moving from defined benefit to defined contribution plans, making benefits taxable, increasing the number of years of service required before vesting and used to determine pension benefits, and making full funding of pension funds the highest objective of pension reform.

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Appendix

Table 9. State Pension Funds, Enrollment, and Enrollment as Percent of Total State Enrollment				
State	**Fund Name**	**Enrollment**	**Total State Enrollment**	**Percent of Total State Enrollment**
Alabama	TRS	208,456	329,878	63.19%
Alabama	ERS	121,422	329,878	36.81%
Alaska	PERS	52,932	71,489	74.04%
Alaska	TRS	18,557	71,489	25.96%
Arizona	SRS	320,403	413,076	100.00%
Arkansas	TRS	96,973	164,868	58.82%
Arkansas	PERS	67,895	164,868	41.18%
California	TRS	685,346	1,991,158	34.42%
California	PERS	1,305,812	1,991,158	65.58%
Colorado	PERA	271,332	352,297	100.00%
Connecticut	SERS	91,289	171,814	53.13%
Connecticut	TRS	80,525	171,814	46.87%
Delaware	SEPP	52,820	70,876	100.00%
Florida	FRS	959,554	1,235,806	100.00%
Georgia	TRS	303,657	414,529	73.25%
Georgia	ERS	110,872	414,529	26.75%
Hawaii	ERS	100,575	135,899	100.00%
Idaho	PERS	97,677	128,589	100.00%
Illinois	TRS	257,034	654,831	39.25%
Illinois	SERS	127,050	654,831	19.40%
Illinois	MRF	270,747	654,831	41.35%
Indiana	PERF	199,195	318,268	62.59%
Indiana	TRF	119,073	318,268	37.41%
Iowa	PERS	255,132	342,441	100.00%
Kansas	PERS	217,992	282,180	100.00%
Kentucky	TRS	116,278	344,862	33.72%
Kentucky	ERS	90,189	344,862	26.15%
Kentucky	CERS	138,395	344,862	40.13%
Louisiana	SERS	99,355	250,164	39.72%

State	Fund Name	Enrollment	Total State Enrollment	Percent of Total State Enrollment
Louisiana	TRSL	150,809	250,164	60.28%
Maine	PERS	85,584	119,766	100.00%
Maryland	SRPS	311,677	424,099	100.00%
Massachusetts	SERS	137,402	277,062	49.59%
Massachusetts	TRS	139,660	277,062	50.41%
Michigan	MERS	61,130	583,683	10.47%
Michigan	PSERS	445,907	583,683	76.40%
Michigan	SERS	76,646	583,683	13.13%
Minnesota	MSRS	73,707	405,497	18.18%
Minnesota	PERA	207,662	405,497	51.21%
Minnesota	TRA	124,128	405,497	30.61%
Mississippi	PERS	239,273	312,813	100.00%
Missouri	PSRS	120,174	249,628	48.14%
Missouri	SERS	84,674	249,628	33.92%
Missouri	LAGERS	44,780	249,628	17.94%
Montana	PERS	44,920	75,000	59.89%
Montana	TRS	30,080	75,000	40.11%
Nebraska	SEPP	17,610	78,679	22.38%
Nebraska	CEPP	7,898	78,679	10.04%
Nebraska	SPP	53,171	78,679	67.58%
Nevada	PERS	139,682	173,161	100.00%
New Hampshire	NHRS	73,858	96,728	100.00%
New Jersey	TPAF	211,366	663,565	31.85%
New Jersey	PERS	452,199	663,565	68.15%
New Mexico	PERA	77,417	172,307	44.93%
New Mexico	ERA	94,890	172,307	55.07%
New York	TRS	411,607	1,268,768	32.44%
New York	ERS	857,161	1,268,768	67.56%
North Carolina	TSERS	484,345	654,712	73.98%
North Carolina	LGERS	170,367	654,712	26.02%
North Dakota	TRF	15,878	42,010	37.80%
North Dakota	PERS	26,132	42,010	62.20%
Ohio	STRS	299,833	840,351	35.68%
Ohio	PERS	540,518	840,351	64.32%
Oklahoma	TRS	133,916	205,069	65.30%

State	Fund Name	Enrollment	Total State Enrollment	Percent of Total State Enrollment
Oklahoma	PERS	71,153	205,069	34.70%
Oregon	PERS	296,692	394,758	100.00%
Pennsylvania	SERS	219,012	665,242	32.92%
Pennsylvania	PSERS	446,230	665,242	67.08%
Rhode Island	ERS	58,470	81,889	100.00%
South Carolina	SCRS	288,865	389,762	100.00%
South Dakota	SRS	57,028	76,349	100.00%
Tennessee	CRS	310,955	409,185	100.00%
Texas	ERS	207,304	1,418,569	14.61%
Texas	TRS	1,076,683	1,418,569	75.90%
Texas	MRS	134,582	1,418,569	9.49%
Utah	SRS	125,307	157,038	100.00%
Vermont	SRS	12,997	29,237	44.45%
Vermont	TRS	16,240	29,237	55.55%
Virginia	SRS	482,131	618,525	100.00%
Washington	TRS	103,030	332,296	31.01%
Washington	PERS	229,266	332,296	68.99%
West Virginia	PERS	56,403	120,144	46.95%
West Virginia	TRS	63,741	120,144	53.05%
Wisconsin	WRS	407,219	551,252	100.00%
Wyoming	WRS	51,296	67,571	100.00%

Note: Almost all states in the study maintain smaller pension systems not evaluated in this study. Thus, 100% in column 5 means that particular plan enrolls 100% of the employees enrolled in a major public-sector pension plan in the state.

Table 10. Scores for State Pension Plans								
State	**Fund Name**	**Score**	**Contributions**	**Vesting**	**Earnings Basis**	**Taxable Benefits**	**Solvency**	**Choice of Plans**
Alabama	TRS	-20	-5	5	-8	-5	-7	0
Alabama	ERS	-15	0	5	-8	-5	-7	0
Alaska	PERS	26	5	0	0	1	20	0
Alaska	TRS	26	5	0	0	1	20	0
Arizona	SRS	-5	5	-5	-5	0	0	0
Arkansas	TRS	-20	-15	0	-5	0	0	0
Arkansas	PERS	-13	-15	0	-5	0	7	0
California	TRS	-13	-8	0	-10	5	0	0
California	PERS	7	0	0	-5	5	7	0
Colorado	PERA	-23	-5	0	-5	-3	-15	5
Connecticut	SERS	-30	-15	0	-5	5	-15	0
Connecticut	TRS	-5	5	5	-5	5	-15	0
Delaware	SEPP	12	0	0	-5	-3	20	0
Florida	FRS	24	-10	3	5	1	20	5
Georgia	TRS	-8	-8	5	-9	-3	7	0
Georgia	ERS	-15	-15	5	-9	-3	7	0
Hawaii	ERS	-25	0	0	-5	-5	-15	0
Idaho	PERS	-1	-8	0	-5	5	7	0
Illinois	TRS	-42	-15	3	0	-5	-25	0
Illinois	SERS	-20	0	0	0	-5	-15	0
Illinois	MRF	-10	-8	3	0	-5	0	0
Indiana	PERF	15	-15	5	5	5	15	0
Indiana	TRF	-18	-8	5	5	5	-25	0
Iowa	PERS	-10	-8	-1	-5	-3	7	0
Kansas	PERS	-28	-8	5	-5	-5	-15	0
Kentucky	TRS	-23	0	0	-5	-3	-15	0
Kentucky	ERS	-8	5	0	5	-3	-15	0
Kentucky	CERS	0	5	0	5	-3	-7	0
Louisiana	SERS	-33	-8	0	-5	-5	-15	0
Louisiana	TRSL	-20	0	5	-5	-5	-15	0
Maine	PERS	-20	-15	0	-5	0	0	0
Maryland	SRPS	-23	-15	0	-5	-3	0	0
Massachusetts	SERS	-7	5	5	-5	-5	-7	0

State	Fund Name	Score	Contributions	Vesting	Earnings Basis	Taxable Benefits	Solvency	Choice of Plans
Massachusetts	TRS	-7	5	5	-5	-5	-7	0
Michigan	MERS	-22	-10	5	-5	-5	-7	0
Michigan	PSERS	-2	0	5	5	-5	-7	0
Michigan	SERS	-20	-8	5	-5	-5	-7	0
Minnesota	MSRS	14	0	-3	5	5	7	0
Minnesota	PERA	7	0	-3	5	5	0	0
Minnesota	TRA	0	0	-3	5	5	-7	0
Mississippi	PERS	-17	-8	3	0	-5	-7	0
Missouri	PSRS	-18	-10	0	-5	-3	0	0
Missouri	SERS	17	0	0	5	-3	15	0
Missouri	LAGERS	-8	0	0	-5	-3	0	0
Montana	PERS	7	0	0	-5	0	7	5
Montana	TRS	-5	0	0	-5	0	0	0
Nebraska	SEPP	12	-5	-3	-5	5	20	0
Nebraska	CEPP	17	-5	-3	0	5	20	0
Nebraska	SPP	12	0	0	0	5	7	0
Nevada	PERS	-11	0	0	-5	1	-7	0
New Hampshire	NHRS	-20	0	5	-5	-5	-15	0
New Jersey	TPAF	-10	0	5	-5	-3	-7	0
New Jersey	PERS	-15	-5	5	-5	-3	-7	0
New Mexico	PERA	22	5	0	5	5	7	0
New Mexico	ERA	-22	-15	0	-5	5	-7	0
New York	TRS	2	-8	0	-5	-5	20	0
New York	ERS	-5	-15	0	-5	-5	20	0
North Carolina	TSERS	25	5	0	0	0	20	0
North Carolina	LGERS	20	5	0	0	0	15	0
North Dakota	TRF	17	0	0	5	5	7	0
North Dakota	PERS	19	0	-3	-8	5	20	5
Ohio	STRS	0	-5	0	-5	5	0	5
Ohio	PERS	7	-5	0	-5	5	7	5
Oklahoma	TRS	-25	-15	3	5	-3	-15	0
Oklahoma	PERS	-23	-5	0	-8	-3	-7	0
Oregon	PERS	15	-5	0	-5	5	20	0
Pennsylvania	SERS	-11	-8	0	-5	-5	7	0
Pennsylvania	PSERS	2	5	0	-5	-5	7	0

State	Fund Name	Score	Contributions	Vesting	Earnings Basis	Taxable Benefits	Solvency	Choice of Plans
Rhode Island	ERS	-5	5	5	-5	5	-15	0
South Carolina	SCRS	-23	-5	0	-5	-3	-15	5
South Dakota	SRS	5	0	-3	-8	1	15	0
Tennessee	CRS	-3	-10	0	5	-5	7	0
Texas	ERS	-11	0	0	-5	1	-7	0
Texas	TRS	13	0	0	5	1	7	0
Texas	MRS	-7	-8	0	0	1	0	0
Utah	SRS	-19	-10	-1	-5	-3	0	0
Vermont	SRS	7	0	0	-5	5	7	0
Vermont	TRS	-5	-5	0	-5	5	0	0
Virginia	SRS	-13	-5	0	-5	-3	0	0
Washington	TRS	21	-10	0	5	1	20	5
Washington	PERS	21	-10	0	5	1	20	5
West Virginia	PERS	-23	-15	0	-8	0	0	0
West Virginia	TRS	-15	-5	0	5	0	-15	0
Wisconsin	WRS	5	0	-5	-5	0	15	0
Wyoming	WRS	-12	0	-1	-5	1	-7	0

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