A Union of Professionals

Strengthening Retirement Security and Building a Better America

Final Report of the AFT Ad Hoc Committee on Revenues and Retirement Security

American Federation of Teachers
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Acknowledgements

This report is the culmination of months of committee work undertaken since November 2010 by the AFT executive council's Ad Hoc Committee on Revenues and Retirement Security. The committee was appointed by AFT president Randi Weingarten in October 2010 and is composed of 20 elected leaders, staff and teacher pension trustees from around the country. The 20 committee members debated and discussed the issues presented in this report, providing invaluable insight into the workings of their own state and local pension plans, while ensuring that this report captures the foundation for a national consensus on retirement security for all Americans. Teacher trustees from CalSTRS, Illinois SURS, NYSTRS and TRSNYC were especially helpful in crafting this report.

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The AFT acknowledges and thanks the 20 committee members who devoted their time and energy to this important work. Their names and affiliations follow below:

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1. OUR PRINCIPLES

The AFT created the Ad Hoc Committee on Revenues and Retirement Security at our October 2010 executive council meeting, initially to look at the effect of the 2008-09 recession on state and local budgets. The committee was particularly focused on the impact of services our members provide, and the long-term health and stability of the public pension funds that are so instrumental to the compensation of public employees. We asked ourselves what fiscally responsible activities could be undertaken to ensure the vitality of public services and the stability of the pension funds. What became clear immediately were two overarching phenomena. First, for most Americans, retirement security is uncertain. Second, much of the public discourse about public pensions is just plain wrong. Most systems are relatively well-funded and the benefits are modest.

Public pension benefits are earned over time and are often provided in lieu of up-front wages. These systems have not been the cause of the state funding crisis, and indeed should be seen as part of the solution—a model for retirement security. While there is a pressing need to modernize public pensions, it is far more critical that we take steps to ensure that *all* Americans have a secure retirement.

Sadly, retirement insecurity is the new normal. As the *Wall Street Journal* recently reported ("Retiring Boomers Find 401(k) Plans Fall Short," Feb. 19, 2011), 401(k) plans for those close to retirement age fall far short of the amount needed to maintain living standards in retirement. Similarly, a recent *New York Times* article ("Making the Most Out of Less," March 2, 2011) cited a retirement specialist's conclusion that the baby boom generation will be the first generation to do worse in retirement than their parents. Survey results indicate that 84 percent of Americans are concerned that current economic conditions are affecting their ability to achieve a secure retirement. And those fears are not unfounded—just three out of 10 private sector workers participate in a traditional plan today, compared with almost nine of 10 Americans only about 20 years ago.

Our union's experience with mandatory 401(k) type plans,[1] while limited, has not led to retirement security—quite the opposite. In 1991, West Virginia closed its defined-benefit pension program to new educators and created a 401(k)-style plan for them. Over the years, about 20,000 West Virginia educators found themselves stuck in the 401(k). According to a study by the West Virginia Retirement Board, the average account balance in 2008 was only about $34,000, and only a handful of educators age 60 and older had amassed more than $100,000 in their accounts—a fraction of what is needed to retire in dignity. In 2008, the West Virginia Legislature agreed to let these educators vote to go back into the defined-benefit pension plan, provided that at least 65 percent of educators elected to change over. Nearly 80 percent of eligible voters, across all age and experience spectrums, voted to reject the 401(k) system and move into the defined-benefit system. Besides forfeiting their 401(k) accounts, educators agreed to pay a higher contribution for their future benefits and either give up one-quarter of their service earned under the 401(k) plan or make an extra contribution to cover the cost.

Our vision as a union extends beyond maintaining the modest, hard-won retirement benefits that too few workers currently have. The debate about public pensions needs to move past short-term fixes and focus on long-term solutions—how to ensure retirement security for all, and how to ensure that local and state governments manage pensions and pension costs in a rational, predictable way. The terms of the debate should be based on reality, not on misconceptions about workers' pensions. And the goal is not to pit one group of Americans against another, but to ensure that *all* workers can look forward to a decent and dignified retirement.

[1] TIAA-CREF provides nationally voluntary/optional retirement plans to a majority of public higher education institutions. These plans are designed to provide fully portable benefits to professors and other professionals who move between different employers throughout their employment careers. These plans have risk-management features including adequate contribution levels, investment risk controls and lifetime income options that allow accounts to be converted to an annuity at retirement.

Retirement security is a shared responsibility for employers, workers and our country. Workers, after a career of hard work and service, should be able to live an independent, dignified life. The three-legged stool of Social Security, an employer-sponsored defined-benefit pension, and individual voluntary savings has stood as our national model for retirement security for decades. But even before the recent recession, fewer employers, for a number of reasons, were providing livable retirement security for workers, and employees themselves were changing jobs multiple times in a career. Since the recession—the worst economic downturn since the Great Depression—more Americans have been left unemployed or, at the very least, underemployed. Even those still working are less able to set aside money for retirement. For all these reasons, we need to create a new national compact to put pensions on a strong and secure path for all Americans.

In order to meet this challenge, the AFT Ad Hoc Committee on Revenues and Retirement Security has undertaken this effort to set the record straight on the experience of public pension plans, offer some meaningful reforms to better stabilize them, develop a set of principles that achieve retirement security for all, and help strengthen America's infrastructure. These are our guiding principles:

- Universal retirement coverage;
- Shared responsibility;
- Portability;
- Governance that ensures adequate funding and risk management;
- Public employee pension reforms; and
- Participation in voluntary savings and Social Security.

2. SETTING THE RECORD STRAIGHT

Before turning to the specific proposals, it is important to identify the strengths and weaknesses of the current pension plan funding, and to dispel certain myths about public pensions. The fact is many headlines and stories about the funding status of pension plans are alarmist and misleading. Typically, these stories fail to mention that the global financial crisis—not the level of benefits—was the primary cause of the recent drop in the asset-to-liability ratio of public pensions.

Despite the recent market collapse, public pension plans, in aggregate, are reasonably well-funded. Even with the recent ups and downs of the stock market, most states have continued to fund public pensions in a steady, responsible way. As before, the future funded status of each plan will depend largely on whether employers meet their annual required contribution, how quickly and consistently investment returns rebound, and, in some cases, whether meaningful reforms are adopted.

A. Employee Facts. As a rule, public employees contribute significantly to their pensions and receive modest benefits. Their overall compensation, when education and age are taken into account, is lower than private employees'. Even a modest defined-benefit pension provides some measure of security, as well as protection from the ups and downs of the stock market.

- **Public employee pensions provide modest retirement benefits.** Of the 7.7 million retired state and local government workers in 2008, the average retirement benefit was $23,653.[2] Pensions are not extravagant in states where politicians recently have been waging war against workers and public

[2] U.S. Census Bureau, State & Local Retirement Systems, Tables 1 and 5a.

pensions. According to the latest annual reports from New Jersey, Wisconsin and Florida, the equivalent average benefit for existing retirees is $28,361, $24,531 and $17,496, respectively.

- **Public employees pay a fair share of their retirement costs.** The vast majority of public employees are required to contribute a part of their income toward their retirement benefit. For workers who participate in Social Security, the average employee contribution was 5 percent of pay in fiscal year 2006.[3]

- **In many cases, public employees are not eligible for Social Security.** About one-quarter of all state and local public workers are not covered by Social Security. For them, the pension benefit is *the* major source of retirement income.[4] In states that exclude workers from Social Security, the average employee contribution is even greater—8 percent of pay in fiscal year 2006.[5]

- **Public sector workers earn less than their private sector counterparts.** Teachers, nurses, sanitation workers, police and firefighters serve the public and are not a privileged class of workers. A recent academic study shows public sector workers earn 11-12 percent less than their private sector counterparts. Even when health, pension and other benefits are considered, the total public employee compensation still lags behind private sector compensation by about 7 percent.[6]

B. Employer Facts. State and local governments pool contributions into a trust, creating an efficient and effective way to provide a reasonable benefit for employees. Pensions, which represent a very small fraction of budget outlays, help state and local governments attract and retain a high-quality workforce. Over time, pension funding levels have been bolstered by two factors: the commitment of employees and most public employers to pay their required contributions, and the plans' history of long-term investment success. In those cases where employers have not consistently made their full annually required contribution (ARC), the slippage in funding has been most severe. A review of employer contributions to each of the seven statewide pension funds in New Jersey shows that the state has met its required contribution to all plans only one time in the last 14 years. For the past two years, state contributions have been recklessly low—for most of the funds, including the teachers', less than 10 percent of the recommended amount.

- **A government's history of making its required contribution is a key predictor of a plan's financial status.** One of three criteria used by the Pew Center on the States in assessing the financial status of state pensions was whether the state paid, on average, at least 90 percent of the required annual contribution during the past five years. According to Pew, states like Illinois, Kansas and New Jersey have grossly underfunded their pensions in the past, which is a key reason—not the benefit level—for their poor financial status.[7]

- **Employer (taxpayer) contributions to employee pensions are a small part of state budgets.** State and local employers spend about 3 percent of their operating budgets on pension funding.[8] In many states, a modest increase in funding and/or sensible changes to plan design should be sufficient to

[3] "State and Local Government Pension Plans: Current Structure and Funded Status," U.S. Government Accountability Office (GAO-08-983T), July 10, 2008.
[4] "Characteristics of Large Public Education Pension Plans," Table 2, NEA Collective Bargaining and Member Advocacy, 2010.
[5] "State and Local Government Pension Plans: Current Structure and Funded Status," U.S. Government Accountability Office (GAO-08-983T), July 10, 2008.
[6] "Out of Balance? Comparing Public and Private Sector Compensation over 20 Years," Keith A. Bender and John S. Heywood, April 2010.
[7] "The Trillion Dollar Gap: Underfunded State Retirement Systems and the Roads to Reform," February 2010, Pew Center on the States.
[8] NASRA Issue Brief: "State and Local Government Spending on Public Employee Retirement Systems," January 2011.

remedy underfunding over time. Even if no changes are made, a modest rise in budget allocations of 1.2 percent to a total allocation of 5 percent of budgets would fully fund the benefits.[9]

C. Pension Plan Facts. Public pension plans have been in existence for more than 100 years, and pension managers have made necessary adjustments during depressions, world wars, periods of strong economic growth—and during the most recent recession. Today, AFT members across the country are fully engaged in legislative and bargaining discussions. We will continue to do our part to ensure the long-term viability of public pension plans.

- **Most pension money comes from employee contributions and investment returns, not from state and local budgets.** Nearly 73 percent of public pensions are financed through investment returns and employee contributions.[10]

- **The extraordinary 2008-09 financial market meltdown largely led to pension fund shortfalls in both the public and private sectors.** Prior to the 2008-09 economic collapse, public pensions were generally considered well-funded. However, the economic crisis resulted in a loss of about 25 percent[11] for public pension plans, while 401(k) plans lost about 40 percent[12] of their value. Before the financial crisis, the median asset-to-liability ratio was about 85 percent—a funding ratio considered healthy by most pension professionals. However, in 2009, it dropped to about 80 percent.[13]

- **States are adapting.** The National Conference of State Legislatures reports that more than 20 states made changes to their pension plans in 2010, more than ever before. The most common changes include increased employee contributions to pensions, caps or changes to cost-of-living allowances (COLAs) and vesting provisions, and the creation of different benefit structures for new hires.[14]

- **The long-run rate of return assumption is being met.** Many pension plans assume an annual 8 percent return on their investments. Some analysts and politicians have been critical of the 8 percent assumption, which may seem difficult to attain in these volatile times. However, according to the investment consulting firm Callan Associates, public plans earned an average investment return of 9.25 percent over the last 25 years—a period that includes not only times of strong economic growth but also recessions and sharp market losses.[15]

3. OUR RECOMMENDATIONS

As we have demonstrated, public employees contribute to their pensions, generally retire with a modest income, and in many states have agreed to higher contributions and other cost-saving changes due to the economic and fiscal crises. Further, much of the rhetoric around public pensions has exaggerated or mischaracterized the problems. Even with these facts in mind, though, it is undeniable that the problems facing pension funds are real. So, it is vital that we act now to change pension plans and enact other measures to build a foundation for retirement security for all American workers in the 21st century. The specific recommendations that follow, which are designed to achieve these ends, rely on the principles laid out above.

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[9] "Misunderstandings Regarding State Debt, Pensions and Retiree Health Costs Create Unnecessary Alarm," Iris J. Lave and Elizabeth McNichol, Center on Budget and Policy Priorities, January 20, 2010.
[10] Source: NASRA Issue Brief, "Public Plan Investment Return Assumptions," March 2010.
[11] Public Fund Survey of Findings for FY08, Keith Brainard, Research Director, NASRA, October 2009.
[12] "Making the Most Out of Less," New York Times, March 2, 2011.
[13] Public Fund Survey Summary Findings for FY09, NASRA, November 2010.
[14] "Pensions and Retirement Plan Enactments in 2010 State Legislatures", Ronald K. Snell, NCSL, November 23, 2010.
[15] "Investment Return Assumptions for Public Funds: The Historical Record," Callan Associates, June 2010.

Universal Retirement Coverage

Every worker should be covered by retirement arrangements that provide consistent income replacing enough of his or her pre-retirement income to secure a reasonable standard of living throughout his or her entire retirement.

Shared Responsibility

Retirement security should be the shared responsibility of employers, employees and the government. Employers and employees should both contribute to fund retirement benefits. The government should ensure that low-income workers are able to fully participate.

Portability

Earned pension benefits should be retained for retirement. Specifically, pension accruals should be portable when workers change jobs, and no withdrawals should be permitted before retirement except for severe disabilities.

Governance that Ensures Adequate Funding and Risk Management

- States and other employers should pay their annual required contribution every year.
- All future changes to benefits should be reviewed for their impact on the plan's long-term financial health.
- Pensions should establish a reserve fund to assist in offsetting market volatility.
- Financial risks and costs should be minimized through pooling assets in a trust, governed by one or more fiduciaries/trustees who represent the plan's stakeholders. The trustee(s) should be empowered to develop and implement investment and funding policies, use trust assets to pay for their budgets, and hire and fire professionals as appropriate to manage the trust.

Public Employee Pension Reforms

To sustain a pension program, in the days ahead, it must be designed to be affordable and fair. New approaches are required, as well as the elimination of design options that may negatively affect costs. While it is important to make meaningful changes to existing plans, circumstances may exist in different states that dictate alternative approaches to achieve these goals.

- Eliminate spiking at the end of a career, which artificially increases the pension benefit.
- Eliminate double-dipping. Responsibly limit the payment of both a pension and a salary to any employee who is rehired after retirement by the same employer.
- Establish a maximum benefit ceiling on the employer-sponsored defined-benefit portion of an employee's pension. The purpose of the ceiling is to guard against any excessively high defined-benefit payment.
- Establish nonemployment restrictions. Prohibit pension fund senior staff and trustees from accepting employment from fund service providers for five years after leaving a fund.

Participation in Social Security and Voluntary Savings

- For many Americans, the three-legged stool of Social Security, employer-based defined-benefit pension, and private savings has stood as a model for retirement security. However, many public employers do not participate in Social Security. It is time to have an open discussion to consider the inclusion of public employees in the program. The AFT will convene a summit of public employee organizations to discuss this concept. The summit will also include discussion of the Windfall Elimination Provision and the Government Pension Offset.

- Because voluntary employee savings are an important component of individuals' retirement security, employers should encourage and facilitate voluntary tax-favored savings.

4. RESPONSIBLE INVESTMENTS TO BUILD A BETTER AMERICA

Our principles will strengthen retirement security for all Americans—and we believe pension assets could help strengthen the country's infrastructure. The nation's public pension plans have assets in excess of $3 trillion, and are key fixtures in the world's capital markets. Indeed, public pension plans provide the type of long-term patient capital that a modern economy like ours needs to keep its capital markets functioning in good times and bad. Because of their long-term investment horizon, public pension plans can and should help build the necessary economic and social infrastructure to ensure that the United States' economy is able to compete in the globalized economy of the 21st century. In fact, pension plans in many industrialized countries already participate in their respective country's infrastructure development.

The American Society of Civil Engineers, for instance, has written that the United States needs to invest more than $2.2 trillion in economic and social infrastructure over the next five years to meet critical infrastructure needs. In order to meet part of that goal, we propose that the nation's public pension plans explore pledging a portion of their assets, in a prudent manner, to create a national pool of resources to help finance the rehabilitation and new construction of the nation's infrastructure assets. These investments would be undertaken at the risk-adjusted market rate of return. Examples of the types of infrastructure investment that public pensions could consider include: a smart electric grid, expanded access to high-speed and wireless communications, a high-speed rail system and clean energy sources.

We believe the nation's pension funds can devise investment vehicles that meet their fiduciary responsibilities to the current and future members of the retirement system by earning a competitive rate of return and minimizing the risk of loss for any one plan, while still fostering economic recovery, playing a part in revamping our infrastructure needs, and helping put America back to work.

5. LOOKING AHEAD

The AFT will use these principles in a variety of different ways. For example, state and local affiliates can rely on them in their legislative and bargaining efforts. They will be used to ensure the stability and improve the governance of public pension funds, and, to the extent possible, employ the assets of these funds for job creation and infrastructure development. We'll also utilize these principles in our work with pension trustees, pension fund administrators, pension fund advisers, governors, legislatures and the investment community. Nationally, we'll apply them in our advocacy role to improve retirement security for all Americans.