Citizens Budget Commission
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540 Broadway, 5th Floor
Albany, NY 12207

February 25, 2013

Honorable Thomas P. DiNapoli
Comptroller
Office of the New York State Comptroller
110 State Street
Albany, NY 12236

Dear Comptroller DiNapoli:

I am writing to share the views of the Citizens Budget Commission on Governor Andrew Cuomo's proposal to allow local governments to opt into a "fixed rate" contribution plan to fund their public employee pension obligations. *We believe this proposal would endanger the future financial viability of the pension plans and recommend you reject it.*

The proposal would allow local governments to make pension payments equivalent to 12 percent of payroll for members of the Employees' Retirement System, 12.5 percent for the Teachers' Retirement System and 18.5 percent for the Police and Fire Retirement System. These rates would be fixed for at least five years; the rates are expected to be continued for another 20 years but would be subject to review in the later period to reflect changing conditions. These "fixed" rates are below the rates projected to be required over the next six years under current practices. After 2020, when contribution rates might fall due to the savings from the new tier of benefits for future employees adopted in 2012, the anticipated contribution rate under the proposal would continue to be fixed. The fixed rate in the later years is designed to "repay" the pension funds for the nearer-term underfunding.

The Context

We recognize the context for this proposal is that local governments in New York face severe fiscal challenges due to rapidly rising personnel and other costs and a property tax cap that, without override, limits tax levy growth to two percent. Yet we also recognize that another option for short-term savings – the pension "amortization" plan adopted in 2010 – already exists. It allows governments to pay only a portion of their annual pension bill and repay the deferred amount over a ten-year period with accrued interest. Although the CBC opposed this legislation, it was approved and has been used by 137 local governments and the State to lower short-run pension costs. Additional underfunding options are not advisable.

Another aspect of the current context is New York's historic practice of fully funding its pension obligations on an annual basis. The full funding of New York's

pension systems is a nationally recognized strength. The Pew Center on the States ranked New York 5th among states for its healthy funding ratio, with assets covering 94 percent of liabilities in 2010. Proposals to permit lower contribution rates, no matter how well intentioned, can lead New York to slide down the rankings to join states facing crippling unfunded pension liabilities such as Illinois and Rhode Island.

The Critical Flaw

Briefly put, the Governor's proposal endangers the pension funds by promising a stable rate of contributions over a 25-year period, but the State is unlikely to be able to keep that promise. The very nature of a defined benefit pension plan is that its costs vary with changes in investment returns and other factors that impact benefit costs over time. Adjustments to contribution rates are, therefore, inherent to defined benefit plans; pretending otherwise by "fixing" an arbitrary rate that is unlikely to hold five or ten years from now does a disservice to the public by creating the impression of assisting local governments with their fiscal problems. In fact, the plan will merely push a larger problem off to later years.

There is no dispute that the actuarially required contribution rates for the State's pension plans are above the proposed fixed rates for the next six years. The adverse impact of the lower near-term contributions will compound as investment income is diminished. Therefore, the funded ratio of the plans will decrease throughout that period, unless the plans earn more than the assumed rate of return. Higher returns are unlikely; the 7.5 percent assumed rate of return is on par with long-term trends, but more recently the ten-year earnings average is 6.4 percent. And most recently the five-year returns have averaged 2.9 percent, substantially off the mark. Under the proposal, instead of annual adjustments to make up for investment shortfalls and other changes, the Comptroller would be permitted to increase the fixed rate only at the five- and ten-year marks and by only two percentage points each time. In 2020, when repayment of the accrued obligations begins, local governments will be on the hook for pension funds that are less financially sound than they are now, and there is a significant risk that the allowable rate increases will not be sufficient to return them to a fully funded status in the 25 year period. Since benefit payments to retirees are guaranteed by the state constitution, if the funds are not returned to the pension systems as planned, then future taxpayers will have to fill the gap. Simply put, the safest bet for meeting the benefit obligations is to pay what is due when it is due.

Although the motivation for pension contribution "stabilization" is understandable, the Governor's proposal does not provide meaningful, long-term relief for localities in fiscal distress and endangers the viability of the pension funds. It would undermine the culture and history of paying the pension bills when they are due that characterizes New York. We urge you to reject the proposal.

Sincerely,

Carol Kellermann, President, Citizens Budget Commission

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February 25, 2013

R. Michael Kraus
President
New York State Teachers' Retirement System Board
10 Corporate Woods Drive
Albany, NY 12211-2395

Dear Mr. Kraus:

I am writing to share the views of the Citizens Budget Commission on Governor Andrew Cuomo's proposal to allow local governments to opt into a "fixed rate" contribution plan to fund their public employee pension obligations. *We believe this proposal would endanger the future financial viability of the pension plans and recommend you reject it.*

The proposal would allow local governments to make pension payments equivalent to 12 percent of payroll for members of the Employees' Retirement System, 12.5 percent for the Teachers' Retirement System and 18.5 percent for the Police and Fire Retirement System. These rates would be fixed for at least five years; the rates are expected to be continued for another 20 years but would be subject to review in the later period to reflect changing conditions. These "fixed" rates are below the rates projected to be required over the next six years under current practices. After 2020, when contribution rates might fall due to the savings from the new tier of benefits for future employees adopted in 2012, the anticipated contribution rate under the proposal would continue to be fixed. The fixed rate in the later years is designed to "repay" the pension funds for the nearer-term underfunding.

The Context

We recognize the context for this proposal is that local governments in New York face severe fiscal challenges due to rapidly rising personnel and other costs and a property tax cap that, without override, limits tax levy growth to two percent.

Yet another aspect of the current context is New York's historic practice of fully funding its pension obligations on an annual basis. The full funding of New York's pension systems is a nationally recognized strength. The Pew Center on the States ranked New York 5th among states for its healthy funding ratio, with assets covering 94 percent of liabilities in 2010. The TRS funded ratio has also been consistently high, most recently declining from

100 percent in 2010 to 97 percent in 2011. Proposals to permit lower contribution rates, no matter how well intentioned, can lead New York to slide down the rankings to join states facing crippling unfunded pension liabilities such as Illinois and Rhode Island.

The Critical Flaw

Briefly put, the Governor's proposal endangers the pension funds by promising a stable rate of contributions over a 25-year period, but the State is unlikely to be able to keep that promise. The very nature of a defined benefit pension plan is that its costs vary with changes in investment returns and other factors that impact benefit costs over time. Adjustments to contribution rates are, therefore, inherent to defined benefit plans; pretending otherwise by "fixing" an arbitrary rate that is unlikely to hold five or ten years from now does a disservice to the public by creating the impression of assisting local governments with their fiscal problems. In fact, the plan will merely push a larger problem off to later years.

There is no dispute that the actuarially required contribution rates for the State's pension plans are above the proposed fixed rates for the next six years. The adverse impact of the lower near-term contributions will compound as investment income is diminished. Therefore, the funded ratio of the plans will decrease throughout that period, unless the plans earn more than the assumed rate of return. Higher returns are unlikely; the 8 percent assumed rate of return is on par with long-term trends, but more recently the ten-year earnings average is 6.6 percent. And most recently the five-year returns have averaged 1.1 percent, substantially off the mark. Under the proposal, instead of annual adjustments to make up for investment shortfalls and other changes, the TRS Board would be permitted to increase the fixed rate only at the five- and ten-year marks and by only two percentage points each time. In 2020, when repayment of the accrued obligations begins, local governments will be on the hook for pension funds that are less financially sound than they are now, and there is a significant risk that the allowable rate increases will not be sufficient to return them to a fully funded status in the 25 year period. Since benefit payments to retirees are guaranteed by the state constitution, if the funds are not returned to the pension systems as planned, then future taxpayers will have to fill the gap. Simply put, the safest bet for meeting the benefit obligations is to pay what is due when it is due.

Although the motivation for pension contribution "stabilization" is understandable, the Governor's proposal does not provide meaningful, long-term relief for localities in fiscal distress and endangers the viability of the pension funds. It would undermine the culture and history of paying the pension bills when they are due that characterizes New York. We urge you to reject the proposal.

Sincerely,

Carol Kellermann, President, Citizens Budget Commission