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Abstract

State and local governments are grappling with huge unfunded liability costs centered on public sector pensions and other postretirement benefits (OPEBs). Payments to cover these liabilities are crowding out revenues for essential public services. The policies and practices that determine public sector pay and benefits have become a significant part of the national conversation in the United States and Europe. This article provides commentary and a summary of a book addressing this topic: *Rethinking Public Sector Compensation: What Ever Happened To The Public Interest?* Recent national reforms on public pay and benefits are documented as well as the subsequent legal challenges that have emerged in several jurisdictions. The article conclusion is that it is imperative that these unfunded liabilities be addressed in a timely, comprehensive and fair manner, and that public sector compensation must be sustainable and reflect the reality of a new emerging workforce. However, the outcome from current litigation in several states will either significantly expand or restrict the ability to manage these public retirement plans.

Keywords
public pay, pensions, reforms

Introduction

States and local governments are still struggling to recover and balance their budgets more than five years after the great recession began. As a result, officials were forced to lay off workers and make painful cuts in education, police and fire protection, safety-net programs, and other essential services to try to cope with plummeting tax revenues (Hoene and Pagano 2011; McNichol, Oliff, and Johnson 2011; The PEW Center on the States 2012).

While the poor economy has blown gaping holes in state, county, and city budgets, much attention has focused nationally on how public workers are compensated, particularly with regard to personnel benefits and the ability of state and local governments to fund them. The polices and practices that determine public sector pay and benefits have become a significant part of the national conversation in the United States and Europe. I wrote the book *Rethinking Public Sector Compensation: What Ever Happened To The Public Interest?* (ME Sharpe 2012) to provide not just a critique but background, context, analysis, and suggestions for reform on the subject of public pay and benefits.

Due to the importance of this topic to the field of public administration and how fluid the

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issue has been on the national scene, I was asked by the editors of *SLGR* to provide a summary of the book as well a review of what is being done to address the issue nationally.

Unfunded Pension and Other Postretirement Benefits

State and local governments are facing huge pension and retiree health care obligations that have significantly contributed to their financial woes. Nationwide unfunded liabilities for pension and retiree health care range anywhere from $1.4 to over $4 trillion, depending upon what assumptions one uses (see e.g., Eucalitto 2012; Novy-Marx and Rauh 2011; The PEW Center on the States 2011a). The Governmental Accounting Standards Board (GASB), which sets the accounting standards for the public sector, has adopted new rules that could increase the gaps further. These rules adopted in June 2012 by GASB will likely show that public pensions funds are in a weaker financial position than previously thought. States and local governments will now have to post their net pension liability—the difference between the projected benefits payments and the assets set aside to cover those payments up front on financial statements (Lambert and Byrnes 2012). These updated standards were adopted in an attempt to be more transparent and provide more information for policy makers. Most go into effect in June 2013, others in 2014. Under the rules, pension funds that are considered adequate could continue to forecast investment returns with their historic averages. Funds lacking sufficient cash to cover benefits must lower their projections to about 3 to 4 percent. According to Boston College, pension assets in 2010 covered only 67 percent of liabilities, and that under new accounting rules recommended by the GASB, assets would be measured as about 53 percent of liabilities for the same selection of plans (Munnell et al. 2012). Some analysts have suggested that states and local governments have significantly underestimated their pension costs since they do not use their investment assumptions to project future growth and measure what they will owe retirees in the future in today's dollars. This practice has been prohibited in the private sector since 1993 (Walsh and Hakim 2012). In addition, the typical public pension plan assumes its investments will earn average annual returns of 8 percent over the long term (Munnel et al. 2012). However actual experience has been much less, 5.7 percent over the last ten years (Brainard 2011).

Pension and health care costs for retirees have been rising faster than inflation. Low interest rates have reduced the returns on pension funds used to pay benefits, and retirees are living longer (Brainard 2011). Further, many of the promises made to public employees are simply not sustainable, and many jurisdictions are struggling to make payments into these systems, leaving less each year to spend on core governmental services (Reilly 2012). The recession was not the primary cause of the pension and retiree health care problem, but it contributed to it by reducing the value of investments (Little Hoover Commission 2011). In some cases, in order to balance their budgets and/or to increase services, state and local governments have failed to make the necessary contributions into the pension funds, and/or they borrowed from the funds at as the same time, creating deeper and deeper shortfalls (The PEW Center on the States 2010).

Rethinking Public Sector Compensation

The book *Rethinking Public Sector Compensation: What Ever Happened To The Public Interest?* extends beyond the troubled pension crisis we are facing in the United States and addresses how public workers are compensated as well as how they are rewarded and managed. What often gets lost in the heated debates about wages and benefits for public workers are where and how the public interest is served. The provision of effective and efficient government services is in the public interest. The role of government is to provide and/or facilitate the delivery of these services to the public in a responsive manner. How did we get to the point in this country where large portions of general funds budgets are being diverted to meet retirement promises to public employees? Such obligations crowd out essential services and safety-net programs for citizens.

The adoption of many pension and postretirement benefits has occurred within a tight circle of individuals (elected officials, public managers, and union/employee groups) largely out of the public view (Reilly 2012). These groups have often failed to insist upon transparency. Union and employee groups have enjoyed considerable influence with legislators on this issue and public managers often benefit from the very contracts they negotiate (Norcross 2011; Troy 2003). The practice of providing deferred compensation has been carried out in ways that often hide a full accounting of the costs from the public and push a significant amount of the costs onto future generations of taxpayers, elected officials and public managers. The result has been to transfer current fiscal deficits into future debt, with interest (The PEW Center on the States 2010).

Some of the suggested reforms I cover in the book include:

- *Restructuring public pay and benefits* by increasing retirement age and contribution rates, scaling back pension and other post-retirement benefits (changing the formula multiplier or service credit), and reducing or suspending cost-of-living adjustments;
  * *Moving public employees away from defined benefit pension plans* to portable hybrid and/or cash balance plans. These could include plans that combine existing defined benefit (DP) plans with a new 401-K style component where money is invested on behalf of the retiree, or pension plans that eliminate the DP component entirely and replace it with an individual retirement account that both the employee and the employer contribute to while the employer guarantees a minimum return;
  * *Increasing transparency* by mandating an independent analysis of the current cost of any pay or benefit increase as well as how future costs will be paid for and managed.
- *Reforming the civil service system by* emphasizing and rewarding performance, innovation, and entrepreneurial thinking rather than the current system that is focused too heavily toward time-served and job security.
- *Prohibit conflicts of interest* among elected officials, public managers, and employee unions in awarding compensation and benefits by ensuring boards overseeing pension and retiree health are independent; implementing independent citizen panels to represent the public in collective bargaining; require collective bargaining sessions to adhere to open meeting laws; and/or having voters approve increases in public pay and benefits.

Rethinking Public Sector Compensation provides a comprehensive overview and balanced analysis on a contentious subject. Additionally, practical and common sense solutions are provided to address the issue. Since the book identified how the problem developed and suggested reforms, it is useful to see what is currently being done to reform Public pay and benefits. The following section outlines some of these reforms as well as the subsequent legal challenges that have emerged in several jurisdictions.

National Reforms

The issue of public sector compensation has clearly been on the minds of legislators. Most states have recently passed some type of pension reform in the last several years. Lawmakers have enacted changes to increase employee contributions; increase age and service requirements for retirement; limit cost-of-living increase and cap benefits for new employees (Snell 2012). However, many of these fixes have fallen short of comprehensive reform (Barro 2012; The PEW Center on the States 2012). A significant number of local governments responsible for their own pension systems have failed to enact any meaningful reform, including, for example, eliminating basic anti-abuse provisions. Further, the majority of legislation has not included retiree health care reform and has focused only on new employees, which means most of the changes will not result in any budget relief for decades and will in all likelihood not be enough to address the long-term viability of public retirement systems.

Many pension experts and lawmakers have reached the conclusion that even with stronger market returns, public pension system will not be able to cover retiree benefits in the long term without some type of combination of raising taxes, significant benefit cuts, and/or changing how retirement plans are structured and designed (Barro 2012; The PEW Center on the States 2012). With the realization that reducing benefits for new employees will not be enough to keep pensions solvent, some states and local governments have turned to reducing benefits for current retirees and employees. Several states and local governments have passed laws restricting or eliminating future cost-of-living adjustments; others have redesigned pension plans that have impacted current employees; and voter-approved ballot initiatives have altered not only plans for new employees but for existing workers. Predictably, litigation has begun in these jurisdictions. Within the last several years, at least twenty-four jurisdictions have faced legal challenges alleging pension reform measures are unconstitutional (Buck 2013). The outcomes of these cases could have a dramatic impact nationally on how public retirement plans are managed. Further, municipal bankruptcies in California have set the stage for litigation on how pension and other postretirement obligations are treated when a government goes broke. Finally, right-to-work laws recently passed in two states coupled with an obscure U.S. Supreme Court decision may dramatically shift the political landscape on union membership.

Cost-of-living Adjustments

Although courts have generally held that increasing existing employees' contributions into pension and retiree health care is permissible; altering pension benefits for current employees and retirees have largely been deemed legally off-bounds since they are protected by most states. State statutes, constitutions, and case law consistently define a public pension as a contract between the state and its employees that cannot be impaired (Munnell and Quinby 2012). However, this is currently being tested. Since 2010, ten states have frozen, eliminated, or trimmed the annual cost of living (COLA) increase they pay current retirees. Arizona, Colorado, Florida, Maine, Minnesota, New Jersey, Oklahoma, Rhode Island, South Dakota, and Washington, along with the city of San Jose, California, have all recently suspended, restricted, or eliminated cost-of-living increases for current retirees (Buck 2013; The Pew Center on the States 2012). While many public pension plans are in fact created by statute, it is being argued that what a legislature may do by law, it may also undo. While a South Dakota judge recently ruled that cost-of-living increases could be suspended and are not contractually protected, the Colorado Court of Appeals ruled they were (Alberti 2012). Legal challenges are pending in some of the other states (The Pew Center on the States 2012).

Comprehensive State-wide Reform

Rhode Island passed one of the most far-reaching retirement-system overhauls last year by not only suspending cost-of-living increases for retirees but raising retirement ages for existing employees and switching them to a new designed pension plan. It changed its traditional system of a defined contribution plan, to a hybrid in which the state guarantees only a part of each pension with a 401(k)-style plan makes up the rest (The Pew Center on the States 2011b). Unlike what Governor Walker did in Wisconsin, which spared public safety, the Rhode Island plan affects all state employees equally. Unlike other states that applied reforms only to new employees, the Rhode Island plan extends to both new and current employees. Similar to the jurisdictions that have targeted reforms to current retirees, the Rhode Island plan is being challenged by employees and retirees in court.

Voter Approved Pension Reform

Two California cities attracting national attention for voter-approved public pension reforms are also on the same path to litigation. Recently, voters in San Jose and San Diego overwhelmingly approved ballot measures on public pension overhaul. The San Jose plan requires current workers to either switch to a lower pension or pay more to keep their existing pension. The San Diego plan places all new hires in a 401(k)-style investment plan. Both plans allow current workers to keep pension amounts already earned, only reducing future amounts. The supermajorities on these ballot initiatives suggest that there may not be much sympathy for preserving pensions and other retiree benefits for public employees when most private-sector taxpayers will never earn comparable benefits for their own retirements. As the public becomes aware of the more generous benefits packages that public workers receive, and cities and counties are forced to cut vital services to meet their pension obligations, taxpayers' resentment has grown. The ease in which these ballot initiatives passed may result in other municipalities following their lead.

Municipal Bankruptcies

The recent Chapter 9 bankruptcies in California, resulting from dwindling tax revenues and unsustainable pension and other postretirement obligations to public employees, could set precedent on how local governments deal with soaring pension costs. In particular, disputes between bondholders and bond insurers are brewing over how pension and other postretirement obligations are treated in a municipal bankruptcy. At issue is whether the pensions of government workers take precedence over other payments in a municipal bankruptcy. Unlike other cities such Central Falls, Rhode Island, that filed for bankruptcy, the California jurisdictions that have recently filed, San Bernardino, Stockton, and Vallejo, make their statewide pension contributions to the statewide plan, CalPERS. Public employees are also protected by state constitution. Since it declared bankruptcy, the county of San Bernardino has missed their biweekly payments into the state's retirement system. CalPERS maintains that contributions to its fund can never be suspended, even in a bankruptcy and has filed legal action. CalPERS also purports that under state law, bankrupt agencies cannot reject their contacts with CalPERS and it has priority over other creditors. Wall Street bondholders and insurers disagree, arguing the federal bankruptcy law trumps state authority and that CalPERS should be treated as an equal creditor. Both sides have vowed to appeal to the U.S. Supreme Court (Reid and Christie 2012; Reid 2012). Ultimately, the U.S. Supreme Court is probably going to render a decision as to whether or not federal bankruptcy law trumps not merely state law but also trumps the fact that a city is simply an operating unit of the state and can do what the state allows it to do. San Bernardino will be the first place where this gets litigated. Depending upon how the courts rule, it may open to window to local governments reneging on current pension and postretirement promises to their employees. The case will set important precedence as to who gets paid when a government runs out of money.

Right to Work

Finally, while Indiana and Michigan have received national attention for recently becoming the 23rd and 24th state, respectively, to adopt right-to-work laws (these laws prohibit unions from requiring employees to pay membership or union dues as a condition of employment), it is a recent U.S. Supreme Court decision, *Knox vs. SEIU Local 1000* (Knox v. California State Employee Assn. 2012) passed this summer that could have far-reaching consequences on whether unions can collect dues at all. The case involved a dispute over how public sector unions may bill nonunion members for services or for "special assessments" that benefit all employees. These "agency fees" are fees that a union may collect in non "right-to-work" states or "agency shops" from nonmember employees who receive benefits for union representation by virtue of being in a unit of employees on whose behalf the union negotiates. The Court ruled that an opt-out system is constitutionally inadequate and suggested that in future cases it may require an opt-in requirement not only for special assessments but also for annual assessments. While no party in the case questioned the constitutional legitimacy of agency arrangements in general, nor did any party ask the court to reconsider or overrule its prior cases involving agency fees, the Court's majority cast doubt on the long-standing precedent that permits unions to bill nonmembers in the first place and seem to extend an open invitation to challenge this. If the court were to convert that suggestion into a rule of constitutional law in some future case, then this could sustainably impact the ability of unions to operate and in essence make all state's operate as "right-to-work" states.

Reforming Civil Service

Ultimately, real reform needs to extend beyond the pension problem as to how we compensate, manage, and reward public employees. The deficits created in state and local budgets by unsustainable promises to public employees will continue to manifest themselves unless broader civil service reforms are enacted. The deferral of employee compensation costs to future generations results in a much more expensive system and creates significant challenges for service delivery, efficiency, and responsiveness. Legislation is needed to empower states and local governments to radically alter their civil service system.

An enormous problem with the defined benefit (DP) plan, which is the primary pension plan for public workers, is its lack of portability (Clark and McDermed 1990). It contributes to employees staying with one employer no matter how unhappy or unproductive they are, or how much they desire to move because they often want to maximize their retirement pay-out and/or are financially penalized by leaving early. Increasingly, younger employees tend to move around from job to job, city to city, and state to state in search of new opportunities, promotions, and experiences. Placing hybrid and cash balance plans allow for portability of their pensions plans and would significantly change the culture of public institutions. They would allow for a more flexible workforce, infuse new ideas and talent into the work setting, and reduce the incentive to stay at one job for an entire career.

Conclusion

It is imperative that the unfunded liability for pensions and other postemployment benefits be addressed in a timely, comprehensive, and fair manner. Further, public employee compensation must be sustainable and reflect the reality of a new emerging workforce. How successful will state and local governments be in getting a handle on reforming public benefits? Many states and local governments have found that reform legislation is exceedingly difficult. Public employee unions are powerful interest groups that have been successful in blocking pension overhaul legislation in many jurisdictions. For example, despite having one of the worst-funded pension systems in the nation, Illinois has been unable to overcome opposition from the influential labor unions to enact legislation (Yaccino 2013). Similarly, under fire from labor unions, former Los Angeles Mayor Riordan dropped his efforts for pension reform in Los Angeles metropolitan area (Zahnisert and Linthicum 2012).

According to Barro (2012), as the number of reforms has increased, so has their aggressiveness. Early reforms by state and local governments applied only to future hires (which did little to address current budget gaps); however, recent reforms have applied more to current workers and even retirees. However, he argues that while these recent reforms will address some of the immediate budget shortfalls, they have failed to remedy their pension systems. He advocates for federal intervention in establishing mandatory pension-funding requirements, similar to what exists in the private sector. In 1974, the federal government via the enactment of the Employee Retirement Income Security Act forced private firms that offer defined-benefit pensions to maintain adequate funding ratios.

Currently no corresponding legislation exists in the public sector and therefore, there is no requirement that state and local governments adequately fund their pension systems.

However, it will be the courts that have the most dramatic impact on the ability of state and local governments to reform public pay and benefits. The outcome from current litigation in several states will either significantly expand or restrict the ability to manage these public retirement plans and other postretirement benefits.

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