New Jersey Pension Options Are Limited

April 14, 2014

MarketWatch Blog by Alicia H. Munnell

Alicia H. Munnell is a columnist for ***MarketWatch*** and director of the Center for Retirement Research at Boston College.

The state will need to put more money in to cover unfunded liabilities.

Governor Christie is to be commended for allocating $2.25 billion of his FY 2015 budget to New Jersey's state-administered pension funds. He is indeed correct that this amount – while far short of the actuarially required contribution – is large for New Jersey.

But the governor is misguided in his conclusion that further benefit cuts are the only way to handle "exploding" pension costs. First, the annual costs for accruing pensions – that is, the benefits earned each year by current workers – are not exploding. What is exploding are the costs associated with having not funded pensions for the last 12 years. As a result, New Jersey owes $56 billion to pay off promised benefits – three quarters attributable to the state government and one quarter to local governments. Second, there are no feasible benefit cuts that could reduce this amount. If the state wants to confront this problem, the Governor will have to back away from his no-tax pledge to produce the revenues to pay promised benefits.

Let's take a closer look. Before the financial crisis, benefits provided by New Jersey's three large state-administered systems – covering general

employees, teachers, and police and fire – were near the national average. After the crisis, New Jersey sharply reduced its costs for these systems. In 2010, legislation increased employee contributions from 5.5 to 6.5 percent (8.5 to 10 percent for police and fire) and established an additional 1 percent increase to be phased-in. The legislation immediately eliminated the cost-of living adjustment (COLA) for current and future retirees – roughly equivalent to a 20-percent benefit cut.

For new hires, benefits were further reduced by lowering the benefit factor (the percentage applied to final earnings to calculate benefits), increasing the period for calculating average salary, and increasing the retirement age for teachers and general employees. Once new hires replace current employees, the annual pension cost for general employees will be about 9 percent of payroll, with the employee contributing 7.5 percent. The cost for teachers will be about 10 percent with an employee contribution of 7.5 percent. For police and fire, the cost will be about 20 percent with an employee contribution of 10 percent. These provisions mean that, based on the system's assumed investment return, most employees will pay for the bulk of their pension benefits.

If the cost of accruing annual benefits is not exploding, then what's the problem? The problem is that the state's unfunded liability has risen from roughly zero in 2002 to $56 billion in 2014. This increase occurred despite an $18 billion cut in the liability from eliminating the COLA. And the amount required to pay off this unfunded liability has indeed exploded.

How did New Jersey move from zero to $56 billion? Part of the explanation is the financial crisis, which sharply reduced assets. But nearly half of the increase is due to the state failing to make its required contributions. If

contributions do not cover the cost of accruing benefits and the interest on the existing unfunded liability, the unfunded liability will grow.

When the legislature reduced benefits in 2010, it did not immediately shift to full funding of benefits. Instead, it allowed for a seven-year ramp up. Thus, the continued growth of the unfunded liability since then should be no surprise; it is due to the legislated underfunding. New Jersey may see some improvement as the strong stock market returns are incorporated into actuarial asset values, but a large unfunded liability will remain.

What to do? Further benefit cuts do not seem right on practical or policy grounds. For one thing, the only practical way to reduce unfunded liabilities – eliminating COLAs – has already been taken. To go further, the governor would have to cut core benefits already earned by employees. But paying retirees and current workers, say, 70 cents on the dollar is not realistic. Yes, in Detroit, the executive manager has proposed cuts to existing benefits, but Detroit has filed for bankruptcy, and federal bankruptcy law trumped state constitutional provisions that protect pension benefits. New Jersey cannot declare bankruptcy.

The option remains to cut *future* benefits for current workers. Such cuts also face legal hurdles, although Ohio and Rhode Island have overcome such hurdles. The argument against such a change is that New Jersey benefits for current employees are now significantly below the national average and employees pay most of the costs. In any case, while such changes would reduce the cost of accruing benefits going forward, they would not reduce today's unfunded liability by a single penny.

The only real option – given the existing pressure on educational and other spending – is for Governor Christie to walk back his no-new-tax pledge so

that New Jersey can start paying its pension bills.