THE PEW CENTER ON THE STATES

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Arizona's Pension Challenges
Phoenix, AZ
11/27/2012

ARIZONA PENSION PLANS – 2011 FUNDING LEVELS

The state's four pension plans had a combined shortfall of $13 billion in 2011 and were only 73 percent funded .

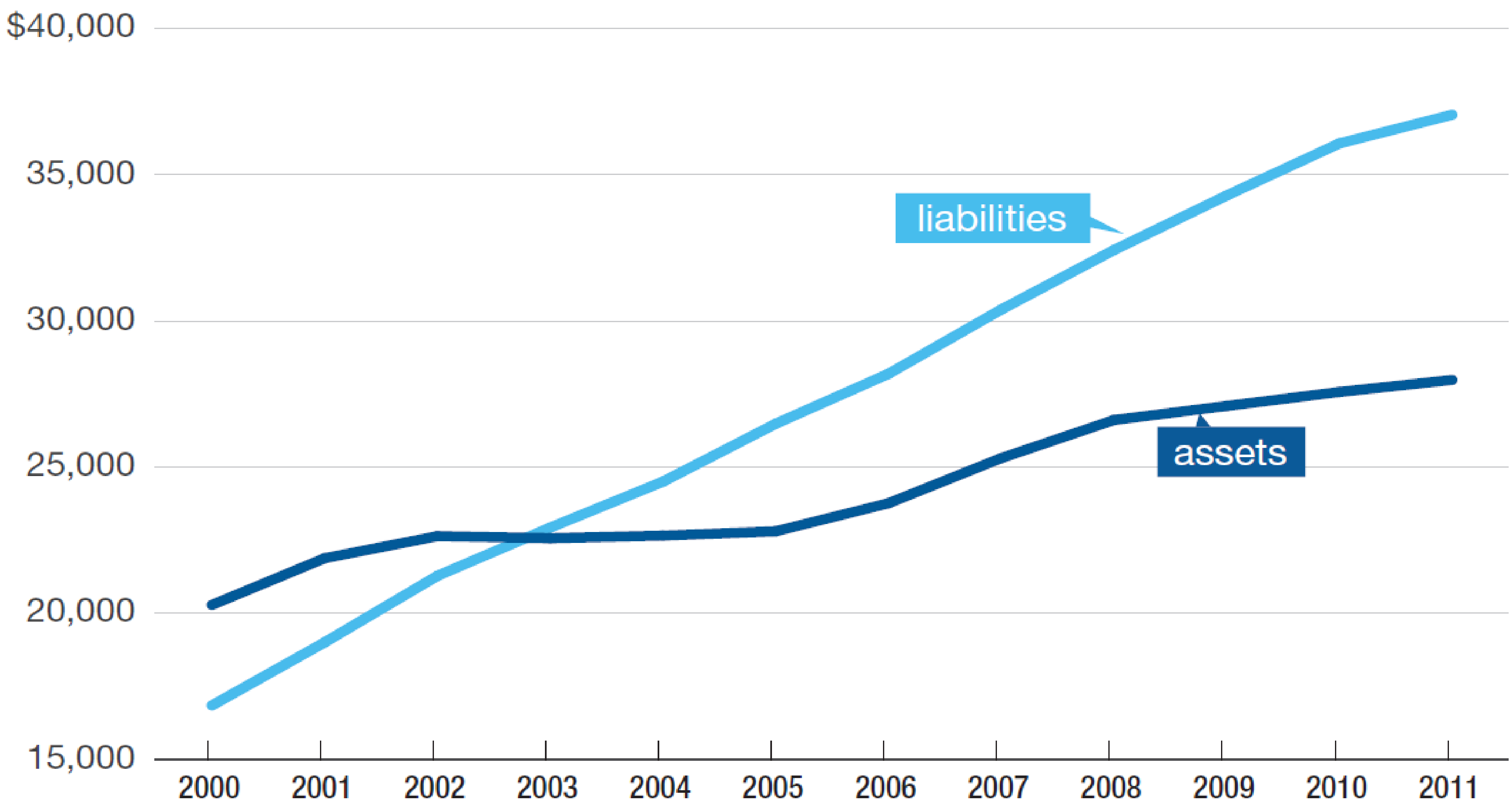
Plan	Assets	Liabilities	Unfunded Liability	Percent Funded	Share of Total Shortfall
Arizona State Retirement System	$27,984	$37,051	$9,067	76%	70%
Public Safety Personnel Retirement System	$5,796	$9,094	$3,299	64%	25%
Corrections Officer Retirement Plan	$1,467	$1,914	$448	77%	3%
Elected Officials' Retirement Plan	$366	$578	$211	63%	2%
Total	**$35,613**	**$48,637**	**$13,025**	**73%**	**100%**

All dollar figures in millions

Source: Pew Center on the States, 2012

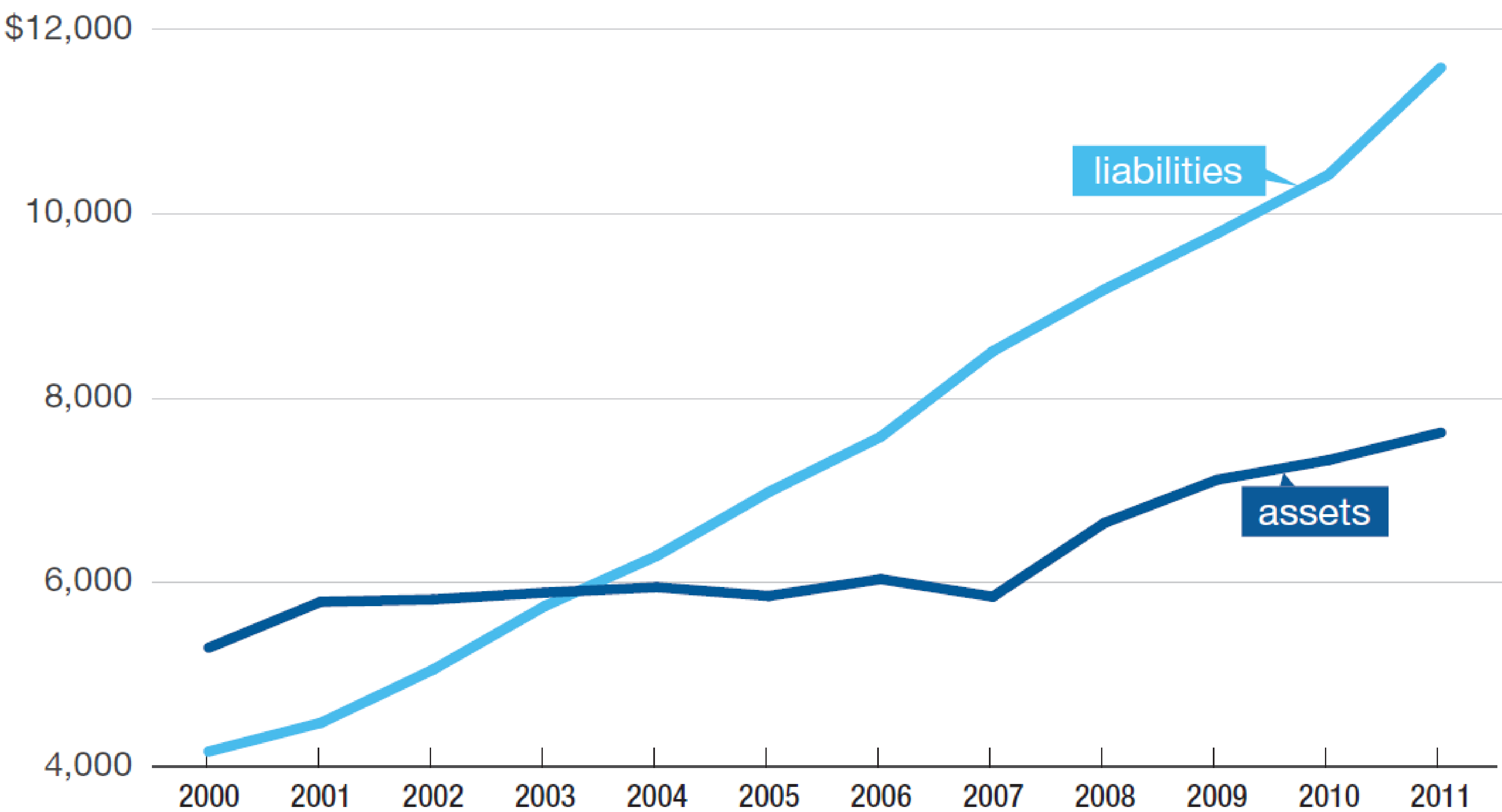
ARIZONA STATE RETIREMENT SYSTEM FUNDING LEVELS

All dollar figures are in millions



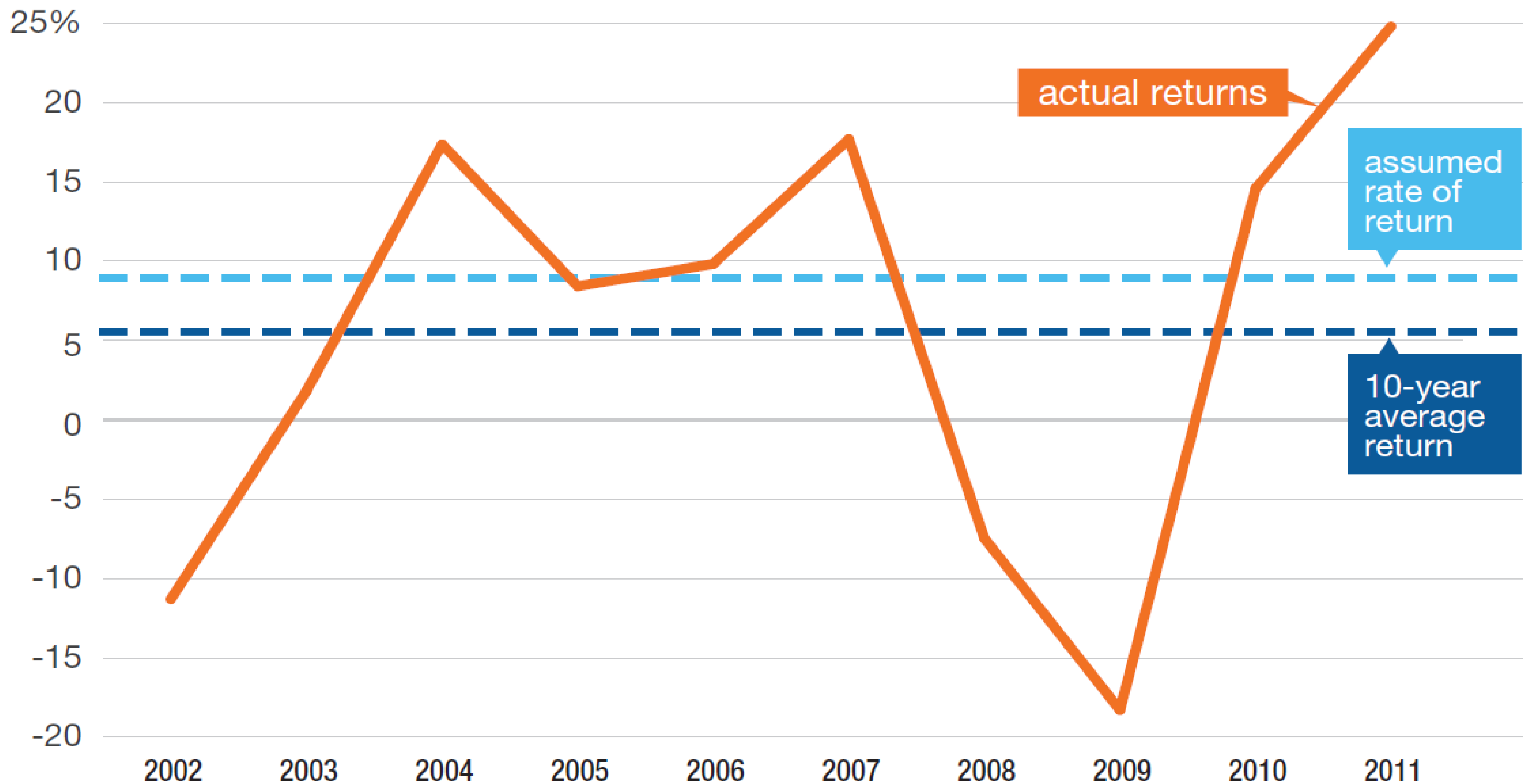
PSPRS, EORP, AND CORP FUNDING LEVELS

All dollar figures are in millions



SOURCE: FY 2011 and 2008 CAFRs for PSPRS, CORP, and EORP

ARIZONA STATE RETIREMENT SYSTEM INVESTMENT RETURNS



SOURCE: ASRS Actuarial Valuation, FY 2011

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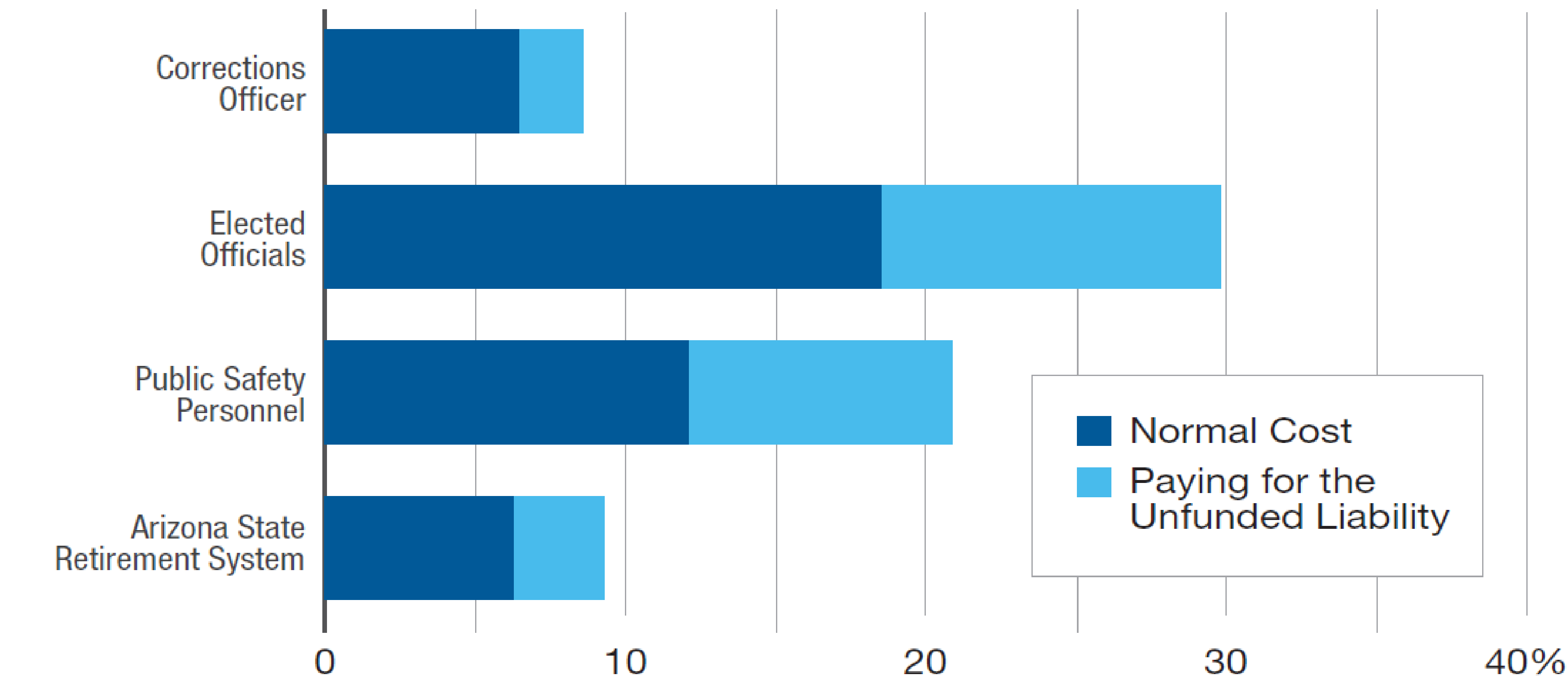
MORE THAN ONE-THIRD OF ARIZONA PENSION CONTRIBUTIONS GO TO PAY FOR PAST PROMISES INSTEAD OF BENEFITS FOR CURRENT WORKERS



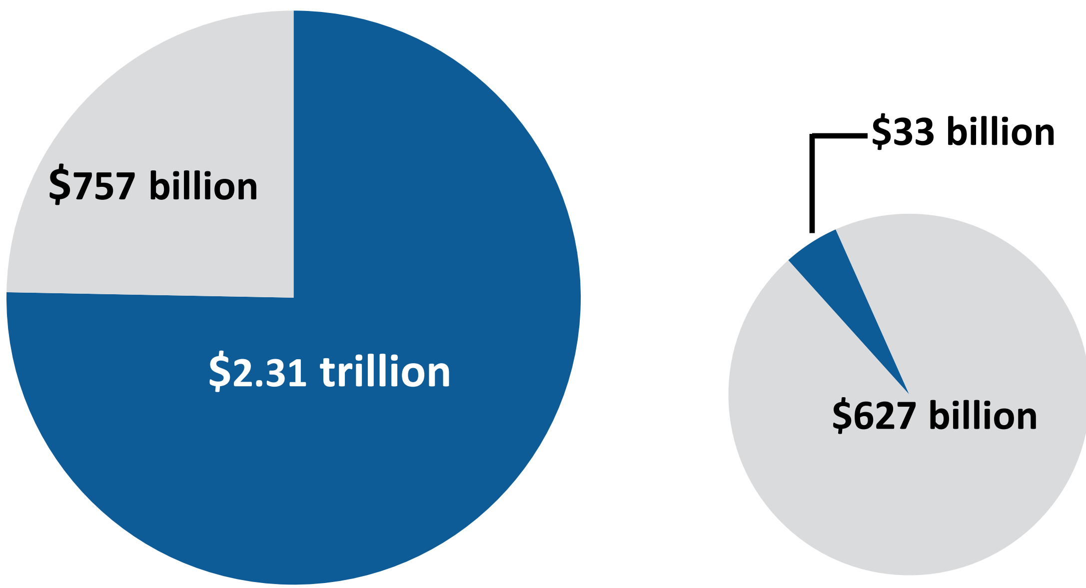
SOURCE: FY 2011 CAFRs for ASRS, PSPRS, CORP, and EORP

Widening Gap Update

In 2010, states faced a $1.38 trillion dollar gap for both pensions and retiree health promises

Funded

Unfunded



Total pension bill – $3.07 trillion

75 percent funded

Total retiree health bill – $660 billion

5 percent funded

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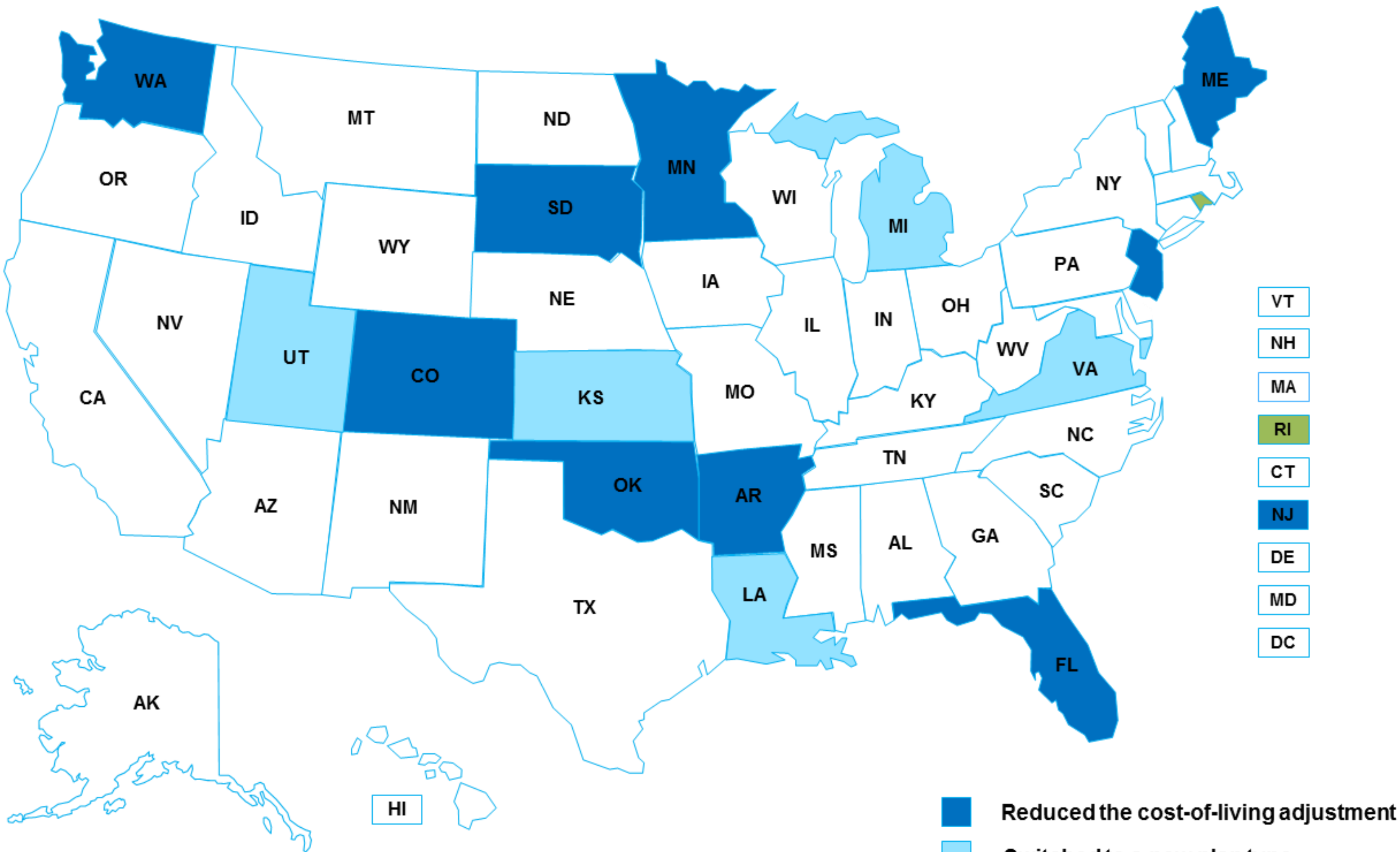
Many states have been forced to look for big fixes

Ten states reduced the cost-of-living adjustment for current workers and retirees and six states created new retirement plans for newly–hired workers. Rhode Island did both.



Source: Pew Center on the States, 2012

Pension Underfunding:

- Creates political and budgetary pressure to reduce public employee benefits,
- Crowds out other discretionary spending,
- Increases tax pressure, and
- Increases labor costs.

There is no magic bullet fix. Pension reform is difficult because the issue is:

- Politically Charged,
- Technically Complex, and
- Legally Uncertain.

State policy makers need to accomplish three main tasks:

1. Create a credible plan to reduce the funding gap over time in a fair way.

2. Make sure the plan is sustainable and doesn’t put the state at risk of future funding challenges.

3. Ensure that the compensation being offered helps the state recruit and retain a talented public sector workforce.

Different states are pursuing different solutions in an attempt to get to the same place: a fiscally-responsible, sustainable pension plan that can help recruit and retain a talented workforce.

1. **Create a credible plan to reduce the funding gap over time in a fair way.**

    - The unfunded liability should be viewed as government debt.

    - State pension plans must develop a plan to responsibly pay down this debt over a reasonable time horizon.

    - Some jurisdictions have an unfunded liability that is so large that making responsible payments would seriously jeopardize:
        - The provision of essential services,
        - The ability to competitively compensate new employees, and/or
        - Economic viability.

    - In these jurisdictions responsible steps must be taken to reduce the unfunded liability in a way that balances the interests of all parties.

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2. **Make sure the plan is sustainable and doesn't put the state at risk of future funding challenges.**

   - The state should improve pension cost transparency and predictability.
   - The state should ensure that cost estimates do not consistently under shoot reality and that they include measures of risk.
   - Contributions need to be made in full each year. In some cases, plans may choose to put aside extra when times are bad.
   - Benefits should never be offered or raised without policy makers having ensured that they are affordable and that money is in place to pay for them.
   - The state should manage or share risk so down markets do not create a funding crisis while it is also dealing with declining revenues and other fiscal stresses.

3. **Ensure that the compensation being offered helps the state recruit and retain a talented public sector workforce.**

- Benefits are an important part of compensation — a state should not rely solely on benefit cuts for new employees to balance its pension debt.
- Traditional pension systems backload benefits creating an incentive to work for a certain number of years and then to retire. But this backloading also creates a period of retirement insecurity for workers.
- There is evidence that workers value salary more than deferred compensation. Pension costs have the potential to crowd out both salary and employment.
- Policy makers need to think about what kind of workforce their state will need and what compensation structure would best incentivize those types of workers to come and stay.

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Traditional defined benefit pension plans have three structural problems:

1. Costs are uncertain and inherently unpredictable.

2. Policy makers face an incentive to underfund.

3. Benefits may be misaligned with workforce needs.

Cash-balance plans are becoming more popular—what are they?

- Workers get an individual retirement account that both the employee and employer contribute to.
- Benefits are based on what is in the account at retirement.
- The employer guarantees a minimum return—when actual returns exceed that, the employer keeps a portion and uses it to make up for down years. This pools risk among workers and shares it with the employer rather than letting individual employees bear all the investment risk.
- The plan will offer an annuity option to workers that want it—the annuity is based on how much is in the employee's retirement account.
- Nebraska and Texas currently offer these plans, Kansas and Louisiana just decided to implement these for new workers.

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Don't be distracted by transition cost arguments.

"Pension reform proposals should be evaluated on their own merits and not confused with amortization schedules. Amortization pays for past debts; pension reform lays a path toward a responsible future."

Dr. Robert Costrell

Source: Dr. Robert Costrell, "GASB Won't Let Me: A False Objection to Public Pension Reform", 2012

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2. Make sure the plan is sustainable and doesn't put the state at risk of future funding challenges.

3. Ensure that the compensation being offered helps the state recruit and retain a talented public sector workforce.

Different states are pursuing different solutions in an attempt to get to the same place: a fiscally-responsible, sustainable pension plan that can help recruit and retain a talented workforce.

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