

**C** orrections  
**O** f  
**P** ension  
**E** rrors

*By the League of Municipalities  
and Affiliated Groups*

**January 2006**

**Correction Of Pension Errors Reported  
by The Governor's Benefit Review Task Force**

*By The League of Municipalities & Affiliated Groups*

**Introduction**

Acting Governor Codey on May 25<sup>th</sup> created a Benefit Review Task Force by Executive Order #39. The Order directed the Task Force to examine the current laws, regulations, procedures and agreements governing the provisions of employee benefits to state and local workers. On November 21, 2005, the Benefit Review Task Force reported its findings to Acting Governor Richard J. Codey. The Task Force neglected to undertake a comprehensive review of pension and benefits impact affecting Local Governments. Therefore, their recommendations and findings resulted in the local governments' issues being skewed by problems which are confronting State government. The League recognizes that some elements are common, but there is a definite and distinct difference between the cost of benefit structure affecting local government and problems to be addressed by the State government. The purpose of this report submitted by the League of Municipalities and its Affiliated Groups is to identify the situation and supplement the work performed by the Governor's Task Force. The process of supplementation is twofold. It is to correct the errors of omission by the State Task Force and expand recommendations believed to be part of a workable solution to deal with funding problems.

## **Recommendations**

The Task Force commented that governments at all levels should cease political gimmicks and begin to be responsible through sound funding of their benefit obligations. This includes both pension and health benefit obligations. The Task Force suggests legislation be passed that would eliminate or stop the politically well connected from “gaming” the system by receiving enhanced benefits. Both of these recommendations in general are easy to agree with, but the League’s methodology of implementation is different and decisive.

First we draw everyone’s attention to the various Valuation Reports approved by the Board of Trustees for the different systems. This paper will deal with just three of the systems. They are PERS, PFRS and TPAF. The recommendations to be reported in the subsequent portion of this report would apply to all systems.

The League recognizes the three pension systems referred to above are mature systems which struggle with economic volatility, demographics and investment return. The funding formulas utilized to value the systems under statements released by the Governmental Accounting Standards Board (GASB) strive for an asset smoothing method in which gains and losses are phased in over a period of several years. This methodology permits mature systems to remain steady regardless of market performance and other factors provided employer and employee contributions are made in a timely manner. Employer and some employee contributions were withheld coupled with a temporary downturn in the stock market resulted in what has been reported as a structural deficit. It is a temporary situation which can be remedied in a few years by judicious and proper management. It will require honest budget appropriations by all levels of government. The Task Force neglected to differentiate between the “crisis” problem the State of New Jersey is confronted with relative to the funding problems (normal payments) local governments face. For example, utilizing GASB statement number 25 and 27 the valuation report for PERS develops the annual required contribution for funding by employer providing benefits. On page 40 Schedule B the latest valuation report indicates the State’s funding ratio of assets compared to liabilities is at 84.7% representing an unfunded accrued liability as a percent of covered payroll at 51.4%. The local government portion of PERS is funded at 96.1% and the unfunded accrued liabilities as a percent of covered payroll is only 10.8%. It is very easy to see from the ratios that the local portion of PERS must be considered well funded compared to the State’s obligations. Wilshire Research reports and other systems around the country face a much greater problem. If one looks into the various funding ratios a little further, they will see the local portion may be skewed because included in the accrued liabilities and assets are liabilities for those communities (local governments) that elected to implement Early Retirement Initiatives. Many local governments did not implement the ERIs. Therefore, many local governments almost have a 100% funding ratio while some municipalities which made decisions to provide for Early Retirement Initiatives are confronted with significantly larger employer required contributions. This problem confronts the State portion of PERS because they approved Early Retirement Initiatives which proved to be a fiscal fiasco. The State’s liability will continue to grow as their funding obligation will be significant because the Administrative and Legislative decisions that were made. The Governor’s Task Force neglected to recognize the difference in funding levels between State obligations and Local obligations for PERS.

When the benefit denominator for PERS was changed from N/60 to N/55 Chapter 133 of Public Laws of 2001 established a Benefit Enhancement Fund designed to fully fund the cost of benefits granted by the Legislature. Those assets were specifically set aside to cover the incremental cost for the accrued liability of the enhancement granted. The State in preparing their budgets and establishing the employer contribution to fund their portion of the PERS employer liability has utilized all assets that were set aside under the Benefit Enhancement Fund. This has compounded their fiscal problems by not providing a budget appropriation in a straightforward manner. Conversely, local governments have not confronted this problem and there are significant assets which remain in the Benefit Enhancement Fund representing full funding for the N/55 benefit granted to local government employees. The Benefit Task Force neglected to identify and differentiate funding levels between State and local obligations. The employers of local government through judicious budget appropriations are gradually working down their structural deficit as currently reported under GASB. Also the asset smoothing methodology built into the State law will permit local governments to realize the increases which have been realized through investments. Local governments do not have a PERS funding “crisis”, but they do have a large bill to pay. Yes, there are increased costs which employers must fund but the crisis level suggested by the Governor’s Task Force is different for each level of government. Therefore, if there is to be a legislative remedy one must know the degree of problem confronted by each system before any strategy is put forth.

Such recognition should apply to the Police and Fire Retirement System (PFRS). On page 27 Schedule B of the latest valuation, it shows the State’s funding ratio for their obligations under the PFRS is at 77.35%. The local funding ratio is at 84.79% and this funding ratio may again be skewed because of the Early Retirement Initiatives. Also the State continues to grant increased enhanced benefits to members of this system over the objections of the League, Affiliate Groups and Local Governments. Just look at this past “Lame Duck” legislative action as a small sample. All should recognize funding requirements for PFRS at the local level are significantly higher than the cost of funding PERS. PFRS is a very rich system when measured by benefits granted to employees. The cost to local government for one PFRS member is approximately three times more than the cost of a local government PERS member. Recognizing this significant cost differential is very important and is something with which the Task Force neglected to deal. For example, there is legislation on the books that would significantly increase the local governments’ liability for PFRS funding. The legislation has not taken effect because of the formula contained within the legislation. It was the League’s recommendation to the Task Force that provisions contained in Chapter 108 Public Laws of 2003 be legislatively corrected by reversing the law. This would save multi-millions of dollars of future liabilities for local taxpayers. By eliminating the provisions of Chapter 108 Public Laws of 2003 there would be no damage to any active or retired individual employee because the provisions have not yet taken effect. Based upon current economic projections, they will not take effect for a number of years, but the liability and damage to the property taxpayer is significant. This recommendation is relatively easy to implement. The Task Force neglected to deal with the most expensive and costly system confronting local governments today. We need to C.O.P.E. with this issue.

Funding costs for PFRS is skewed because of the Early Retirement Initiatives granted. Not all local governments approved ERIs, but the aggravated liability and assets are contained in the funding number. Therefore, the funding ratio at the local level of 84.79% is cumbersome for

some municipalities and less cumbersome for other municipalities. But the general fact is that this is a rich system, very expensive and costly to the local property taxpayers. Past valuation gimmicks were utilized by the State Legislature to grant enhanced benefits to the PFRS membership at the cost of the local property taxpayer. Had those gimmicks not been utilized, the funding ratio at the local level would be significantly higher today. But again it should be recognized that routine employer contributions plus increased market valuations should eliminate the structural deficit currently confronting PFRS if the Legislature takes corrective action. The State's funding obligation is a different story because inadequate state appropriations have compounded their problem.

The Teachers Pension and Annuity Fund (TPAF) reports a funding ratio of 85.63% based upon the latest valuation as reported on page 36 of the report. TPAF funding is reaching the crisis level because of increased retirements, Early Retirement Initiatives granted and the State has accepted obligation to fund TPAF payments. Lifting the pension obligations from the local budget to state funding has permitted local school boards to negotiate with teachers on salaries and staffing levels without measuring the roll up costs associated with pension benefits. The State Legislature relieved the local school boards of their funding obligation and assumed a State aid obligation for active and retired workers. The State has not appropriated its funding commitment causing the funding ratio to decline. Indeed, the State now confronts a crisis with regards to funding of pension obligations. Recognize there is no such commodity as a "free lunch". But many local school boards throughout the State have viewed pensions as a free lunch provided by the State Legislature. They face the question of affordability vs. political hazards.

The Task Force did not adequately reflect the nature and cause of the pension dilemma confronting the State. They assumed all systems were equal and therefore one remedy was suggested for PERS and TPAF, but PFRS was left out of the mix. They did not deal with the most expensive local government system. Their recommendation for modification of benefit structure and age is flawed and must be reconsidered in light of the actuarial data.

### **Health Benefits Costs**

The Benefit Task Force misunderstood the difference between health care costs, the State budget and most local governments. The State, through legislative action, has voluntarily assumed the cost of providing health care to active and retired employees that work for the State, many of its Authorities and post-retirement health benefits for TPAF and school PERS members plus a long list of higher education institutions. By assuming pyramiding liabilities, the State limited the ability for collective bargaining to be part of the contractual process. The overall health care obligations for which the State must fund current employees plus an ever expanding group of eligible retired employees is compelling. The Benefit Task Force recognizes the State's fiscal obligation will become more visible through the requirements of the Governmental Accounting Standard Board's Statements number 43 and 45. In fact, the projected cost of State health benefits for active employees is less than the State's obligation to fund post-retirement health benefits for retired employees in fiscal year 2007. The projected liability to the State is \$2,503,000,000 of which \$1,254,000,000 is for retired employees and \$1,249,800,000 is for the active workforce. The State, when adopting Early Retirement Initiatives compounded their

health benefit cost problem. Not only did they grant benefits across the board to State employees, but they encourage educational institutions around the State to adopt Early Retirement Initiatives. This so called “brain drain” created significant problems for the State operating agencies for minimal temporary savings. Based upon the latest valuation as reported for PERS and TPAF there are more than 13,000 State employees with 25 or more years of service who are eligible to retire immediately to receive post-retirement health benefits. Added are more than 28,000 members of TPAF which could retire immediately as a result of having 25 or more years of service and they would also receive post-retirement health benefits paid for by the State. Fortunately, not all of them will retire at one time. But the pyramid reflects a pending crisis which the State must confront. How will they fund health benefit obligations they have granted? Such a major problem is not an issued with most of the local governments. Local governments over the course of recent history have implemented many cost saving methods through collective bargaining negotiation. They have implemented employee co-pays, caps on obligations, restricted post-retirement health benefits to age 65 at which time Medicare provides coverage. There are many direct savings which local governments have realized to modify the cost of health benefits. The impending crisis for State health benefit funding is significant. This is not to minimize the funding problems which local governments are confronted with, but the Task Force should have recognized the difference between local and State in their report. To such an extent, Legislative remedies should be made available to all levels of government. All must help solve the cost issue. We recognize employees must become more responsible for their health, cost sharing, use of medical, dental and prescription benefits.

### **Recommendations (A Practical Listing)**

1. Additional collective bargaining tools with regards to health benefits should be provided to both State and local governments. Health care costs are pay as you go in new tax dollars each year. A cap must be placed on those items
2. The Task Force report recognizes a pension unfunded deficit of \$12.1billion of which 40% is the responsibility of local governments through PERS and PFRS. Of the 40% for which local governments are responsible, 60% of that unfunded liability is with the Police and Fire System representing roughly 45,000 active employees out of the 252,568 total local employees or 18%. The primary reason causing an unfunded liability for local employers under the PFRS system is because of State mandated legislation approved over the objections of the League of Municipalities. The Governor’s Task Force Report neglected to take this matter under advisement and provided no response. State mandated benefits must be rolled back.
3. The League recognizes the N/55 was a reasonable benefit granted at the time based upon sound actuarial principals and fully funded when adopted. The Task Force suggested N/55 was an imprudent political decision and unjustified benefit granted to members of PERS and TPAF. What the Task Force neglected to report is that when the benefits were provided, the actuarial soundness of the system reported assets in excess of liabilities. When the legislation passed, Benefit Enhancement Funds were established for PERS and TPAF fully funding the benefits granted thereby removing any responsibility or liability

from future generations of taxpayers. The assets specifically set aside to fund the benefits were deemed to be adequate based upon the actuary's analysis. The real political decision was made by the current Administration and Legislature by not adequately funding their normal employer costs. Instead they invaded the reserves set aside under the Benefit Enhancement Fund. The assets that were reserved for benefits granted to State employees of PERS has been fully expunged as the State used those assets to temporarily represent their normal contribution or a portion of their annual payment. They have taken the same approach with the assets set aside for TPAF. Rather than facing up to their responsibilities and financing their normal contributions, they invaded assets that were earmarked for the enhanced benefit thereby compounding the unfunded liability. The Benefit Enhancement Fund established for local governments under PERS was not invaded and those assets continue to be available to fund the N/55 enhancement granted to local public employees. This is one of the reasons why the local portion of PERS has less unfunded liability in spite of the holidays granted to employers from normal contributions coupled with the downturn in the stock market and lower investments. The Governor's Task Force inappropriately misrepresents the N/55 benefit granted while ignoring the rich benefits granted to PFRS at the expense of local employers. When PFRS benefits were granted by the State Legislature over the League's objection, they permitted retirement by members of the PFRS with 25 years of service regardless of age, at a 65% replacement ratio there was a commitment by the State to fund the liability they created. Only a few months after they passed the enhanced benefit, the State again adopted legislation changing the method of valuation of the PFRS assets and used local assets contributed by local taxpayers to fund the State mandate. This invasion of local assets caused in large measure the significant unfunded liability for which local governments are currently confronted thus causing high annual payments for PFRS. The Task Force neglected comment on such issues. They did not recommend correction of future pending liabilities provided by Chapter 108 Public Laws of 2003. The Task Force appeared to support an approach which would continue the gimmicks used by the Legislature and Administration to bypass their funding obligations. PFRS needs legislative changes in the age of retirement and the base upon which pensions are calculated. The League recognizes there is increased longevity among the general public and there should be a change in the retirement age on some prospective date. But a unilateral change for PERS and TPAF simply to temporarily solve the State's budget problem is inappropriate.

4. The Task Force correctly recognized Early Retirement Initiatives by government represent political decisions and fiscal poor planning. Early Retirement Programs can be effective when one has a constricting or reduced workforce. But State and Local governments, as well as educational institutions have an expanding workforce and therefore the implementation of an Early Retirement Initiative is simply a waste of taxpayer money seeking to have a short term economic gain at the expense of future taxpayers. The Early Retirement Initiatives offered by the State, Boards of Education, and Local Governments have proven to be an economic failure on a unilateral basis by all measures. A major portion of the funded crisis which confronts State and local employers is cause by Early Retirement Initiatives that were used as gimmicks. ERI rewarded people who were ready for retirement and open up new positions for political patronage.

The number of State, education and local employees has increased and positions were not reduced. The League concurs with the Task Force that Early Retirement Initiatives should not be considered by government. The high costs of ERI is reported in each valuation report by unit of government.

5. The League testified before the Task Force on the part time positions problem and the eligibility threshold for enrollment. Both should be changed from the current \$1,500 level and service time. The Task Force suggests a threshold of \$5,000 which is inadequate for full time credit because it constitutes part time work. The League recommends that part time positions receive part time credit toward their pension and the threshold be increased from the current \$1,500. Part time service should be prorated. Part time service should not receive full time credit towards retirement. One should receive a full year's credit for a full year's work and anything less should be prorated based upon a standard that can be established using average wages. The implementation of this measure by the Legislature would go a long way to eliminating gimmicks which have been used by many to work for a number of years in a minimal part time position while gaining full time credit and then during their last years of employment accepting a full time job at a significantly high rate of pay thereby enhancing their lifetime pension. The League recognizes this is incorrect and suggests that the Task Force did not adequately address the issue. The Legislature should correct this problem now.
6. The Task Force took a partial look at age of retirement without recognizing the basic problem. The Federal Social Security System years ago recognized extended longevity of individuals and changed the full retirement age. The fact that Americans are living longer is well recognized and something all pension systems should deal with on a prospective basis. Any recognition should apply across the board. For example, the State Police Retirement System permits officers to retire after 20 years of service at 50% pay regardless of age. The results of such a liberal and rich benefit program has resulted in 8.2 retired officers for every 10 officers working. In the next five years, there will be as many retired officers, for which the State must fund a full pension, as there are working officers. Most all of the retired State Police take another full time job after retirement while collecting a state pension. This same situation is resulting in the Police and Fire Retirement System. Without a minimum age before one is eligible for retirement, the accrued liabilities and funding problems continue to grow exponentially. The Task Force neglected to recognize the funding problems associated with the State Police Retirement System, the PFRS, Judicial and other retirement systems where the age restrictions if any at all are much lower than the age requirements for PERS and TPAF. The League suggests a new retirement age be established for all systems on a prospective basis. The Task Force which accused the Legislature of using gimmicks to solve problems attempted the same approach relative to PERS and TPAF while ignoring the other systems. The League believes there should be uniform and equal standards which apply and are implemented for all systems.
7. Pension abuse has been reported by the newspaper and recognized to exist for those who are politically well connected or hold high administrative positions. The Task Force suggests rules, regulations, legislation and changes be made to stop the abuse and

“gaming” of the systems. The League applauds their recommendations and believes a legislative approach is necessary to deal with the issues. The League would support a defined contribution plan be established for elected officials and appointed officials. Such a plan would recognize the valuable service individuals perform and at the same time allow one to be responsible for their own pension contributions. The Task Force also suggests the Division of Pensions have greater authority to deal with salary boosting during the last years of retirement, particularly for appointed positions. The League would support enhanced authority for the Division of Pensions to deal with such problems. While particular situations were highlighted in recent news articles, they do not represent the full universe of problems. At the same time, the majority of the rank and file employees do not “game” the system. But the rank and file would be punished if the unilateral proposal for PERS and TPAF made by the Task Force were to be adopted. Rather than dealing with the specific problems through regulatory control and legislative process, the Task Force takes a broad paintbrush and tries to make all public employees with guilt by association. The League does not support the Task Force’s use of such a broad paintbrush. They are wrong!

8. The Task Force suggests fiscal responsibility should apply to all levels of government. Who could disagree? The League in testifying before the Committee recognized one area of abuse has been the low interest loan programs which have been offered to public employees and below interest mortgage funding programs offered at taxpayers’ expense to public employees. The financial systems in the private marketplace are healthy and able to meet the needs of the general public as well as government employees for loans and mortgages. The League suggests the Legislature eliminate the ability of individuals to have below market loans from the various retirement systems and particularly eliminate the ability of individuals to receive favorable below market interest rates on long term mortgages. It is the responsibility of the Board of Trustees and those charged with the responsibility of investing employer assets to maximize the interest earnings on the taxpayers’ contributions. By permitting below market loans and below market mortgages, the Legislature guarantees a poor return on a large portion of the assets. This hidden or indirect subsidy falls on all taxpayers and contributes to an unfunded liability. Improved earnings on pension assets will be step one to fiscal solvency. The League recommends action. The mortgage program was passed over the League’s objections.
9. Part time positions for local government are an integral part of a cost effective method of providing services to the general public. Many municipalities share a certified Tax Assessor, Tax Collector, Chief Finance Officer or Construction Official. Those individuals working for a small community may serve two small communities by working part time in each community but constitute a full time job. The Task Force suggests such valuable functions be eliminated because they would now reduce the pension for said individuals based upon their recommendations. The League believes the Task Force had good intentions but incorrect information. The League supports certified part time individuals being permitted to serve more than one municipality and thereby having their collective earnings represent their pension base. Two part time jobs representing twenty hours per week at each constitutes one full time job and should be recognized by the systems. But part time professionals such as attorneys or engineers

who game the system by having minimal retainers in order to meet the threshold for enrollment in the pension system and then realize the bulk of their earnings based upon special contractual relationships through their corporation is something that should be addressed and eliminated. The League believes the Task Force was trying to deal with those situations as opposed to the valid shared responsibility. In fact, it has been a program supported by the State through the Department of Community Affairs to encourage interlocal cooperation and shared services of individuals on a technical basis. The League has supported that concept it has proven to be efficient. The League disagrees with the broad brush approach taken by the Task Force.

10. The League suggests the Division of Pensions and the Board of Trustees implement and follow their administrative procedures. An illustration of testimony provided by the League to the Task Force dealt with the concept of “credible salaries” under N.J.A.C. 17:4-4.1(a)2vi which does not permit uniformed personnel to roll into their pension base clothing allowance, holiday pay, vacation pay and many other fringe payments. These fringe payments are rolled into their salary base upon which they will receive 70% for the rest of their retirement. The League recognizes that uniformed personnel should be granted a uniform allowance while they are serving the public and wearing a uniform. But those same individuals should not receive 70% of their uniform allowance, holiday and sick pay for the rest of their life particularly when they on average are retiring at an age of 49 or 50 and living an additional 30 years. The Division of Pensions and the Board of Trustees for the Police and Fire Retirement System should address this issue. The Task Force did not!
11. The League would like to address the issue of pension bonding which resulted in a poor decision. The decision when initially provided was supported by the League because there were accrued liabilities that could be funded by a guaranteed annual amount through proper bonding. This would provide for level payments and would provide significant assets to the pension system for investment. Had the original plan been followed, pension bonding would have proven to be a very successful situation and the pension funds would not be confronted with a significant unfunded liability. The Legislature elected to bond the assets on the front end and once the pot of money was available they determined to spend it again on the other end by granting “holidays” (non-payment times) for the State and local employers. The spending of bonding assets through the granting of holidays simply compounded the funding problem. The lesson that has been learned from a good concept based upon sound principals is that one cannot grant to a political body a large amount of revenue, which without restrictions, could be used for gimmicks to offload their budget thereby permitting them to fund alternative programs which appear to be without cost. The fact is the cost is now double because there is interest and principal due on the original bond and the State is now confronted with an unfunded liability. This is abuse and gaming of the system as the Task Force correctly identifies. But their suggestion that Legislative and Administrative abuse of the assets be paid for by the rank and file employees through a change in their pension base from three to five years and their retirement age by an additional five years is incorrect. They looked at another way to game the system.

12. The Task Force suggests vesting in systems be changed from ten years to five years as a method of rewarding political appointees. There is a cost associated with enhancing the vesting privilege. The impact affects PERS and TPAF, but does not affect the other systems. The League believes this recommendation to be wrong at this time. The League supports no change in the vesting requirements. Why would one encourage additional costs and liabilities at a time when the State is facing a “crisis” as described by the Task Force? This suggestion is inappropriate.
13. The Task Force has suggested the pension system be modified to offer a long life survivor’s benefit for spouses based upon a formula. The League has suggested that any change to provide joint and survivor’s benefits be linked with modifications to the insurance provided under the Group Long Term Life insurance program. Currently the State operates the program as a self funded program and makes a profit on the offered program to employees. The proper merging of the two concepts could result in a smoothing and clarification of benefits without increased costs as suggested by the Task Force. The League believes more study is needed before this matter is implemented.
14. Health Care Strategies. The problems seem innumerable and the solutions seem to exist behind some big black curtain, if at all. There is little doubt health care is the number one issue confronting State government today. The increased cost of providing benefits for active employees is a major factor for local governments. Legislative help is needed and the proposals suggested by the Task Force are a good start. A major Task Force should be established to deal with this issue inclusive of State and local governments as well as experts. The League believes this to be a high priority.