Chapter 10
Causes and Ramifications of Public Pension Fund Underfunding:
A Case Study of the New Jersey Pension Funds

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ABSTRACT

The problem of public pension plan underfunding has grown increasingly acute in recent years for numerous states and cities including Illinois, New Jersey, Connecticut, Charleston, Chicago and Philadelphia. Underfunded pension systems have profound implications for state and local governments' ability to provide basic services to their citizens and calls into question the retirement security of their public employees. The history of the severely underfunded New Jersey pension funds will be examined in order to understand how the current crisis developed. Economic and demographic changes, conditions in the capital markets, political and budgetary priorities and pressures, and actuarial conventions will be examined in order to highlight how the crisis is the result of the complex interaction of social, political and economic forces. The primary focus will be on how the capital markets influence the funding levels of pension systems and the options for government action.

INTRODUCTION

In December 2014 Moody's announced that the two largest New Jersey pension funds, would completely expend their assets by 2024 and 2027, respectively. The announcement dramatically brought attention to a crisis that had festered under the surface for over two decades and was finally coming to a head (Magyar, 2014). The problem of public pension plan underfunding has grown increasingly acute in recent years for numerous jurisdictions including Illinois, Connecticut, Charleston, Chicago and Philadelphia.

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It has profound implications for state and local governments' ability to provide basic services to their citizens and calls into question the retirement security of their public employees. Either because of state constitutional provisions or legislation, unfunded state and local pension obligations must be met through increased contributions by state and local governments, usually from their operating budgets. As the amount of the required contribution for these state and local governments grows, if full payment were made, it would substantially impact the ability of the states and localities to finance other programs and meet other obligations. The problem, which has been a long time in the making, has been exacerbated by budgetary pressure resulting from the recent recession and the slow economic recovery which depressed tax revenues for many states and localities, and by reductions in federal aid. The increasing burden imposed by growing required payments to the state pension systems has called into question the ability of some states and localities to meet their debt obligations. For New Jersey, this has resulted in downgrades to the state's credit ratings, increasing the cost of borrowing. This is turn, is making it more expensive for the state to replace or repair outdated bridges, tunnels and other infrastructure which are generally financed though the sale of municipal bonds, without increasing taxes.

The remedies for underfunding will strongly impact the retirement security of current and future pension-eligible government employees, as well as the economies of the regions where they will choose to live in retirement. From the end of the Second World War until the close of the twentieth century, benefits provided by defined benefit public pension funds expanded dramatically, providing a high level of retirement security for eligible employees – a level of security which they would not have without their pensions. The National Retirement Risk Index (NRRI) found that in 2013 only slightly over half of American working families could maintain their standard of living in retirement (Munnell, Hou, & Webb, 2014). In contrast, only 20% of beneficiaries of defined benefit plans were deemed to be at risk (Munnell, Hou, & Webb,2014). Most pension plans for government employees, including New Jersey's, are defined benefit funds. Defined benefit plans guarantee that retirees receive a specified level of annual income, based on the number of years worked and the salary earned from the time of retirement until death, regardless of the status of the plan assets. Defined benefit plans promote social equality (Conference on Public Employee Retirement Systems, 2015, p. 12; Brown & Prus, 2003, p. 10). The recent erosion of these plans as governments try to deal with underfunding by decreasing the level of benefits to future retirees, not only undermines the retirement security of these employees, it contributes to America's increasing economic inequality.

The post-World War II growth of defined benefit public pension funds also impacted the structure of U. S. capital markets and influenced American economic growth. The rapid growth of the funds and the amount of accumulated capital seeking investment changed the role of commercial banks in the financial markets, increased market liquidity and stimulated the development of new forms of investment. In 2013, U. S. institutional pension funds had assets of $18.9 trillion, 113% of U. S. GDP (Towers Watson, 2014) The long-term nature of pension fund liabilities (future pension fund payments to retirees), and corresponding appetite for securities with long maturities, increased the demand for, and, supply of, long-term investment vehicles in the capital markets, growing "the supply of equities, long-term corporate bonds, and securitized debt instruments and [reduced]…bank deposits…Such overall shifts to long-term assets tend(ed) to reduce the cost and increase(d) the availability of equity and long-term debt financing to companies", encouraging corporate capital investment, growth and productive capital formation (Davis & Hu, 2013, p. 205). In recent years, institutional pension funds have increasingly searched for high yield investments, revising their asset allocations and moving from publicly traded securities to

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