

KEY FINDINGS

- The unfunded liabilities of Oklahoma's public pension systems are among the state's most serious long-term fiscal challenges.
- The state's seven pension systems have total unfunded liability exceeding \$10 billion; the Oklahoma Teachers Retirement System faces the most serious problems, with the third worst funded ratio of any public pension system in the nation.
- At stake is not only the state's fiscal outlook, but also the retirement security of tens of thousands of current and future public retirees and their families.
- While the problems are fixable, real political will is needed to ensure that addressing our long-term fiscal obligations becomes a short-term policy priority.

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Issue Brief

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Oklahoma's Pension Systems Tomorrow's Problem Requires Attention Today

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Even as state governments bask in the warm glow of swelling revenue collections and growing budget reserves, most experts agree that states' long-term fiscal forecast is clouded by a cluster of looming threats and uncertainties. Many demographic and economic factors have been identified as leading towards state *structural deficits* that risk creating an ongoing imbalance between growing spending obligations and lagging revenue streams [Community Action Project 2006]. Among the most serious of states' long-term fiscal challenges concerns the status of public retirement systems administered by state and local governments.

A number of recent reports and statements from the financial industry, along with articles in the national media, have suggested that public pension systems are in a state of crisis resulting from inadequate funding that will lead to long-term drains of public treasuries [Standard and Poor's 2006; Deloitte Research 2006; Walsh 2006a; McMahon 2006]. A controversy over management of the San Diego pension system has also called into question the administration of some public pension plans and raised the specter of governments cutting back retiree benefits [Walsh 2006b]. Organizations representing public retirement systems and their members have responded by vigorously defending the soundness of public pension plans and rejecting proposals for radical changes to how public systems are funded or administered [NASRA 2006; NPERS 2006].

This national pension debate has been closely echoed locally. In March 2006, the Oklahoma Pension Oversight Commission issued a report declaring

that, "Oklahoma's pensions systems are in a state of serious financial crisis", and warning that "if the problem is left unaddressed, the systems will eventually require a cash infusion from the State of staggering proportions to meet current funding obligations" [OPOC 2006]. The report also signaled that the status of the state's pension systems is of concern to the major national credit rating agencies, which threatens a downgrading of the state's credit rating and increased borrowing costs.

"At stake is not only the state's fiscal outlook, . . . , but also the retirement security of tens of thousands of current and future public retirees and their families."

It appears likely that the status of state pensions systems will continue to receive growing public and legislative attention in the years ahead. At stake is not only the state's fiscal outlook, as solutions to address underfunded pension systems compete with other demands on scarce public dollars, but also the retirement security of tens of thousands of current and future public retirees and their families.

This issue brief is intended to shed light on the status of Oklahoma's public pension systems. We will first examine the funding situation of Oklahoma's seven public pension plans, with a particular emphasis on the largest and most seriously underfunded plan, the Oklahoma Teachers Retirement System. We will then explore some of the policy options that have been placed

on the table for improving the financial health of the pension systems, attempting to identify advantages and concerns with each approach.

While this brief does not advocate for any particular policy approach, we do contend that the basic principle guiding debate and policymaking in the coming years should be that real and pressing problems exist with parts of the state's public pension system. While the problems are fixable, real political will is needed to ensure that addressing our long-term fiscal obligations becomes a short-term policy priority, even at the expense of more politically expedient spending increases and tax cuts.

THE ABC'S OF OKLAHOMA'S PENSION SYSTEMS

Oklahoma currently administers seven pension systems serving different categories of state and local employees. Altogether the systems served 220,754 active and retired employees as of 2005.

- The two largest systems – the Oklahoma Teachers Retirement System (OTRS) and the Oklahoma Public Employee Retirement System (OPERS) – together cover 192,762 active and retired members as of 2005. They account for 88.6% of active members and 85.0% of retired members served by the total public pension system.
- The other five pension systems – the Oklahoma Firefighter's Pension and Retirement Systems (Fire), Oklahoma Police Pension and Retirement System (Police), Oklahoma Law Enforcement Retirement System (Law), Uniform Retirement System for Justices and Judges (Judges) and the Department of Wildlife Retirement Plan (Wildlife) – together cover 27,952 active and retired members, or 12.7% of the entire population in the public pension systems.

Consequently, while each of the seven systems has its specific features and issues, discussions of the overall

health of the state's pension systems tend to focus on the plans covering teachers and state employees.

One common feature of all seven public pension plans in Oklahoma is that each is a *defined benefit* plan. Under defined benefit plans, employers commit to pay retirement benefits for eligible employees based on the employee's age, period of service, and average salary. Participants in effect receive a lifetime annuity with a fixed benefit amount. This is unlike the *defined contribution* plans increasingly common in the private sector in which employers commit to contributing a determined amount of an employee's salary into a market-based account. A participant's benefit level under a defined contribution will vary based on the performance of their retirement accounts in the market. The U.S. Bureau of Labor Statistics reports that 88% of state and local government employees have a defined benefit plan as their *primary* retirement benefit [NASRA 2005].

Both the benefits and the funding of each of Oklahoma's public pension

plans are statutorily defined. On the benefit side, the main distinctions between plans involve the *normal retirement age* and the *benefit multiplier*. A teacher or state employee is eligible for retirement benefits if their age plus years of service equals 90 (or 80, if hired prior to 1992). Their annual benefit is typically 2% times final average salary times years of service. Members in the public safety worker systems are eligible for retirement upon 20 years of service. The multiplier for calculating annual benefits is higher in the smaller state systems (see Table 1).

In regards to funding, the common feature of the seven public pension plans in Oklahoma is that all are funded with mandatory contributions of both employers and employees. As seen in Table 1, the amount and mixture of contributions varies among the seven plans. Because public safety workers are eligible for retirement at an earlier age (20 years of service), their pension contributions during their working years are substantially higher.

Table 1 Oklahoma State Pensions Systems, 2005 (\$ in millions)

	Teachers (OTRS)	Public Employees (OPERS)	Fire (OFPRS)	Police (OPPRS)	Law (OLERS)	Judges (JRSJJ)	Wildfire (DWRP)	Total
Active members	84,286	43,918	10,780	4,016	1,201	266	322	144,789
Retired members	40,879	23,679	8,184	1,866	1,024	175	158	75,965
Benefit Multiplier	2%	2%	2.5%	2.5%	2.5%	4%	2.5%	
Normal Retirement	Rule of 80 or 90	Rule of 80 or 90	20 Years	20 Years	20 Years	Rule of 80 or 90	Rule of 85	
Employee Contribution	7%	3% or 3.5%	8%	8%	8%	8%	9%	
Employer Contribution	7.05%	10%	13%	13%	10%	3%	18%	
Dedicated State Revenue	Income, sales taxes, lottery	none	Ins. Prem. Tax	Ins. Prem. Tax	Ins. Prem. Tax	none	none	
Actuarial Assets	\$6,953	\$5,450	\$1,486	\$1,424	\$630	\$204	\$59	\$16,206
Actuarial Liabilities	\$14,052	\$7,575	\$2,333	\$1,812	\$752	\$186	\$79	\$26,782
Unfunded Liabilities	\$7,100	\$2,125	\$847	\$388	\$122	(\$18)	\$19	\$10,576
Funded Ratio	49.5%	72.0%	63.7%	78.6%	83.8%	108.7%	81.4%	60.5%

Source: Oklahoma Pension Oversight Commission, 2006 Report, March 24, 2006

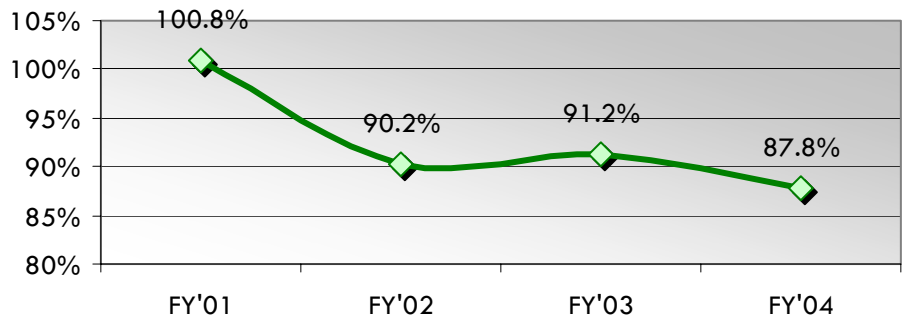
In addition to payroll contributions, the three public safety workers systems and OTRS are also partially funded by dedicated tax revenues. The three public safety worker systems receive a portion of the state *insurance premium tax*, while the Teachers Retirement System is allocated portions of the *income tax* and *sales and use tax* (4.5% in FY '07, 5% in FY '08) and of *lottery revenues* (5%).

Along with contributions from employers, employees, and, in some cases, state taxes, the remainder of the revenue used to fund public pension benefits comes from investment earnings. According to one recent national study, 63% of total state and local pension system revenue over the past two decades came from investment income, compared to 25% from employer contributions and 12% from employee contributions [NASRA 2005]. Oklahoma's seven retirement plan all invest their assets in a combination of market instruments, including equities, bonds, and fixed income accounts.

PUBLIC PENSION PLAN FUNDING-CRISIS? NOT?

For most analysts, the best measure of the health of a public pension plans is its actuarial *funded ratio*, or its ratio of actuarial *liabilities* to actuarial *assets*. The National Association of State Retirement Administrators explains that “a pension plan whose assets equal its liabilities is funded at 100% and is considered *fully funded*; any shortfall of assets is an *unfunded liability*, and a plan with an unfunded liability is considered *under-*

FIG. 1: Changes in Aggregate Actuarial Funding Levels of Major Public Pension Plans, FY '01 - FY '04 (National)



Source: NASRA 2005

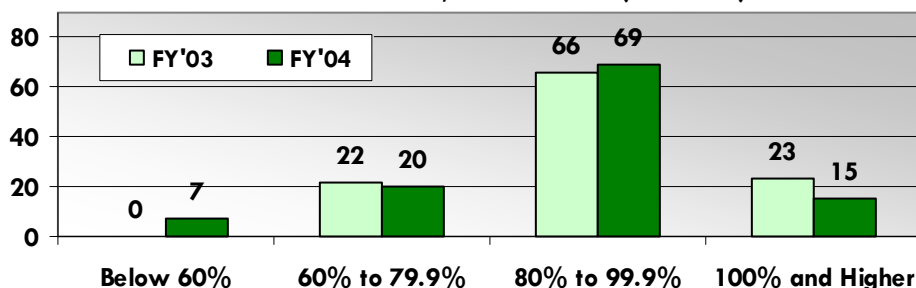
funded” (emphasis in original) [NASRA 2005]. It is important to note that assets and liabilities are calculated based on actuarial assumptions about future benefits, contributions, and investment returns. Funded ratios refer to a system's ability to meet all funding obligations over time.

At the beginning of this decade, the extended stock market boom had boosted most plans' funded ratios and generated optimistic — sometimes, unduly optimistic — assessments about the health of retirement systems. The market downturn of 2000-2002 led to declining funded ratios and growing unfunded liabilities that have in turn sparked increasing alarm from investment companies and policy-makers about public pension plans. A report by Deloitte Research, for instance, titled, “Paying for Tomorrow: Practical Strategies for Tackling the Public Pension Crisis” begins by

citing a survey (by Wilshire Consulting) that found that “of 123 state retirement systems ... more than 90 percent of them are underfunded, that is, the states have not set aside enough money to cover their pension obligations” [Deloitte Research 2006]. From 2001 to 2005, overall funding levels for 127 large public plans declined from 100.8% to 87.8% [Fig. 1] and total unfunded actuarial liabilities grew to \$293 billion. Meanwhile, credit rating agencies, such as Moody's and Standard and Poor's, have sent clear signals that underfunded pension systems are a cause for concern that can lead to downgrading in states' credit ratings and a corresponding increases in borrowing costs on state-issued bonds [Institutional Investor 2006; Standard and Poor's 2006].

At the same time, defenders of public pension plans, including the National Conference on Public Employee Retirement Systems (NCPERS), the National Council of Teachers Retirement (NCT) and the National Association of State Retirement Administrators (NASRA), counter that the overall funded ratio of 88% is well above the 80% threshold often cited by actuaries as a benchmark of a pension plans actuarial health, and that 71% of individual plans have an actuarial funded ratio above the 80% threshold [Fig. 2]. Proponents note that state and local retirement plans are professionally managed and subject to comprehensive oversight, including both statutory guidelines and industry accounting standards [NASRA 2006].

FIG 2: Distribution of Actuarial Funding Levels of Major Public Pension Plans, FY'03-FY'04 (National)



Source: NASRA 2005

Despite the blanket judgments coming from one side or the other, the reality is that evaluating the soundness of pension plan systems is complicated and resistant to simple conclusions. While skeptics sound alarms based on the number of plans that are underfunded, meaning a funded ratio below 100%, supporters employ the 80% funded ratio threshold to argue that *most* plans are in good shape. Moreover, the funded ratio is itself a highly imperfect measure:

Since the main source of funding for pension plans is investment income, funded ratios fluctuate with the ups and downs of the market. As NASRA notes, “most plans phase in investment gains and losses over several years, which delays the effects of a market’s decline on a plan’s funding conditions” [NASRA 2006]. It is likely that the market recovery than began in 2004 will translate into stronger plan performances in 2006 and beyond.

Funded ratios are based on a whole range of financial, demographic and policy assumptions looking far out into the future. Funded ratios can increase or decrease fairly significantly due simply to new actuarial assumptions about such factors as how long members will work, annual investment returns, the inflation rate, benefit changes (such as COLAs), or state revenue collections (in the case of systems receiving a share of tax revenues). As we shall see, in Oklahoma, the funded ratio of the Teachers Retirement System improved from 47.3% in 2004 to 49.5% in 2005 due primarily to new actuarial assumptions [OTRS 2005].

OKLAHOMA’S PENSION SYSTEMS FUNDING

According to the 2006 report of the Oklahoma Pension Oversight Commission, Oklahoma’s seven public pension systems have an overall funded ratio of 60.5%, with unfunded liabilities approaching \$10.6 billion. These disturbing numbers led the Oversight Commission to speak of the pensions systems as “in a state of

serious financial crisis” and “in grave need of attention”, and to warn that “without definitive action in the near future, the eventual cost of restoring the systems to financial health may be prohibitively expensive” [OPOC 2006]. Beyond the specter of the pension systems eventually requiring an infusion of public resources that would displace funding needed for many other vital public services, the Oversight Commission’s report also warned of the more imminent adverse fiscal consequences of failing to address the pension crisis in the form of downgraded bond ratings and increased capital costs.



Yet given that the Oklahoma public pension system consists of seven separate systems, operating subject to seven distinct statutes and Boards, it may be unhelpful to offer sweeping generalizations that attempt to encompass “the Oklahoma State Pensions” in their totality. From a funding perspective in particular, a closer look at the figures in Table 1 suggests a more nuanced situation. Of the seven pension systems:

- One system is fully funded at above 100% (URSJJ);
- Two systems are less than fully funded but are above the 80% funded ratio threshold (OLERS and Wildlife);

- Three systems are between 60% - 80% funded (OPERS, OPPRS and OFPRS); and
- One system is below 50% funded (OTRS).

Of the \$10.6 billion total unfunded liability in the state’s retirement systems, \$9.2 (87.2%) billion accrues to OTRS and OPERS. We will now look at these two systems in closer detail.

OPERS: IN RECOVERY

The Oklahoma Public Employees Retirement System (OPERS) is the state’s second largest pension system, covering 43,918 active members and 23,679 retired members. As of 2005, it had a funded ratio of 72.0% with unfunded liabilities of \$2.1 billion.

OPERS’ recent funding history provides an insightful example of how legislative action can affect the fiscal soundness of public pension plans – for better and for worse. In the late 1990’s, OPERS funded ratio comfortably exceeded 80%. However, in 1998, the Legislature approved a bill that significantly increased retiree benefits by removing a salary cap in the retirement formula and then lowered employer contributions to OPERS from 12.5% to 10.0% one year later. These policy changes, coinciding with the stock market plunge, set off a drop in the plan’s funded ratio that has lasted six consecutive years, with the funded ratio declining from 84.0% in 2000 to 72.0% in 2005 [OPERS 2005].

Nonetheless, there are several reasons to be cautiously optimistic about OPERS’ long-term health:

- In 2003, the Legislature, with strong support from the public employees union, stepped up to stop the bleeding and reverse the declining funded ratio by approving a substantial funding increase for the system. Employer contributions were mandated to increase by 1.5% in 2005 and by an additional 1% in each of the

next five years, eventually reaching 16.5% of salary in 2011. Along with the employee contribution of 3.5% (3.0% for employees earning below \$25,000), this will provide OPERS one of the strongest contribution bases in the nation.

- While OPERS' actuarial funded ratio continues to show slight declines, the plan has enjoyed growth in the *market value* of its assets exceeding 10% over the past two years. Due to its method for determining the *actuarial value* of assets, which smoothes out returns over a five-year period, this recent recovery has not yet been reflected in the plan's bottom line. In addition, OPERS builds its actuarial models based on relatively conservative assumptions about annual return on investment (7.5% compared to assumptions of 8% returns for most plans), which create a stronger likelihood that the plan will out-perform assumptions.
- The legislature's passage of SB 1894, the Oklahoma Pension Legislation Actuarial Analysis Act, in 2006 [see box on p.X] creates grounds for optimism that the Legislature will be less apt to enact unfunded benefit increases or other measures that will have adverse impacts on the pension systems' funding situation.

According to OPERS administrators, current policies will generate sufficient contributions to fund current benefits over time as well as a portion of the system's unfunded liabilities. However, annual contributions fall considerably short of what is needed to fully amortize the system's unfunded liability. OPERS calculates that contributions equal to an additional 9.63% of payroll is needed to fund current benefits as well unfunded liabilities if the system is to be fully funded over time.

OTRS: SITUATION REMAINS CRITICAL

The Oklahoma Pensions Legislation Actuarial Analysis Act of 2006: Tying Odysseus to the Mast?

In 2006, the Legislature quietly passed a pension reform bill, SB 1894, that has no immediate impact on the pension systems but which could have substantial and long-lasting benefits by changing the process for enacting state retirement system policies.

SB 1894, authored by Sen. Mike Mazzei and Rep. Chris Benge, is modeled on legislation in effect in Georgia. The bill imposes a unique process of review and oversight for any piece of retirement legislation that would have a fiscal impact on the teachers, public employees, or judges retirement systems by granting benefits, creating accrued liabilities, or otherwise increasing the cost of the system. Under SB 1894, any retirement bill would receive a special legislative designation (RB) and would be subject to an additional set of hurdles to attain legislative passage. In particular:

- Retirement bills with a fiscal impact can only be introduced in the first year of a two-year legislative session and can only be approved in the second year of the session (with emergency provisions);
- Retirement bills with a fiscal impact that receive initial committee approval must receive a comprehensive actuarial investigation that would be conducted during the interim between the two years of the session;
- The actuarial investigation will determine the impact of the proposed bill on the financial situation of the retirement system and if the bill fully funds any additional costs and liabilities;
- Amendments to retirement bills without a fiscal impact are prohibited if the amendment would create a fiscal impact;
- The Legislature can approve retirement bills with a fiscal impact only if the bill increases employer contributions or appropriations to the system so as to fully fund all new benefits and not increase a system's unfunded liability;
- Following passage of a retirement bill with a fiscal impact, the State Board of Equalization must certify that the bill has indeed been fully funded before the legislation can take effect

One glaring omission from the bill, however, is that it explicitly exempts tax cut bills which would reduce state revenues to a pension system from its oversight and review procedures. Given that the income tax cuts enacted by the 2005 and 2006 Legislatures will reduce funding to OTRS by up to \$40 million annually when fully phased-in, this exemption can prove very costly and disruptive to the retirement system's long-term health.

In light of the precarious funding status of the state's major retirement systems, the Actuarial Analysis Act offers a strong and promising mechanism to impose self-restraint on future Legislatures. It will be well worth the Legislature considering whether the model laid out in SB 1894 of requiring that legislators be fully informed of the fiscal consequences of the decisions they are weighing be used to guide consideration of broader state tax policy as well.

While global statements about problems with public pension plans may be overstated, the Oklahoma Teachers Retirement System is a genuine instance of a plan in trouble:

- OTRS' funded ratio was third worst in the nation among 119 systems surveyed by the National Association of State Retirement Administrators in 2004 [the last year for which we have national data]. OTRS was one of only three systems with a funded ratio below 50%;
- OTRS has \$7.7 billion in unfunded actuarial accrued liability;
- Its funding period – the number of

years that would be required under the current contribution schedule to amortize the systems' unfunded liability – is 37.4 years.

OTRS' funding situation actually improved slightly in 2005: its funded ratio rose to 49.5% and its accumulated unfunded liability declined by \$322 million. This improvement reflected the adoption of new actuarial assumptions about future retirees. In 2006, the funding ratio dipped to 49.3% and unfunded liabilities increased by an additional \$573 million as a result of legislative changes.

The roots of OTRS' funding difficulties run deep, reflecting a long history of public policies that failed to keep funding aligned with benefit commitments [Holmes 2003]. In 1980, OTRS' funded ratio stood at 33.8%, but over the next decade, the Legislature imposed a cap on gross production tax revenues dedicated to OTRS (1982) and then increased benefit caps for retiring teachers (1987). Until 1989, total contributions to OTRS equaled just 4% to 5% of salary, an amount that was "woefully inadequate" to properly fund the system [OPOC 2006, p. 6]

Over the past fifteen years, there have been repeated efforts to fix the teachers retirement system. While an effective solution has proven elusive,



the system has actually made some improvements in assuring adequate ongoing funding. The current funding sources for OTRS include:

- *Employee contributions* of 7.0% of salary and employer contributions of 7.05% of salary. As the Oklahoma Pension Oversight Commission's report noted, OTRS' combined contribution rate of 14.05% is well above the national average of 12.1%.
- *Dedicated state revenue* of 4.5% of state income, sales and use tax collections. This will rise to 5.0% in FY 2008. In FY 2005, OTRS received \$164 million in state

revenue.

- *Investment income.* OTRS' actuarial assumption are based on an average 8% return rate. For nine of the ten years from 1992 – 2001, the actuarial return rate outperformed expectations, averaging returns of 11.3%. Since 2002, actuarial returns have fallen below assumed rates for four consecutive years, averaging 4.75% over this period. The Oversight Commission's report expressed concern that OTRS has adopted an overly aggressive and risky investment strategy, noting that it has 11.6% more of its funds in equities than the average U.S. pension public fund [OPOC 2006].

A 2006 memo from OTRS' actuaries provides some information on the size of the funding hole in the system (Table 2). The actuaries calculated that under current contribution levels, the system will reach a funding level of 59.5% by 2015 and 80.6% by 2035. An additional \$50 million in annual contributions, which would require increasing employer contributions by 1.5%, would raise the funded ratio to 97.5% by 2035 and reduce the unfunded liability to just over \$1 billion. The system could be fully funded by 2035 by raising employer contribution rates to 9.27%, which would generate \$75 million in FY '07.

Table 2: OTRS: Projected Funding Ratios and Unfunded Liability Under Varying Employer Contribution Rates

<i>Employer Contribution Rates Effective for FY'07 and Thereafter</i>								
Contribution Increase (FY'07)	7.05%		7.79%		8.53%		9.27%	
	\$-		\$25 Million		\$50 Million		\$75 Million	
Valuation as of June 30,	Funded Ratio	Unfunded Liability (in \$billions)	Funded Ratio	Unfunded Liability (in \$billions)	Funded Ratio	Unfunded Liability (in \$billions)	Funded Ratio	Unfunded Liability (in \$billions)
2005	49.5%	\$7.10	49.5%	\$7.10	49.5%	\$7.10	49.5%	\$7.10
2015	59.5%	\$8.50	61.2%	\$8.20	62.9%	\$7.80	64.6%	\$7.40
2025	67.3%	\$9.60	71.8%	\$8.30	76.3%	\$6.90	80.8%	\$5.60
2035	80.6%	\$8.30	89.1%	\$4.70	97.5%	\$1.00	106.0%	(\$2.60)

Source: GR S Consultatns, Memo to OTRS, March 7, 2006

“Legislation passed in 2006 will, if anything, worsen the fiscal outlook of OTRS.”

With growing attention focused on the deep funding hole in OTRS, a number of proposals related to OTRS were considered during the 2006 legislative session. Ultimately, legislation passed in 2006 will, if anything, worsen the fiscal outlook of OTRS :

- HB 1179, the Education Employees Service Incentive Plan (EESIP), was a measure long sought after by education employees that can increase retirement benefits for teachers who were subject to certain benefit caps on earnings from 1988-1995. EESIP is calculated to have a \$25 million annual impact on OTRS. The law would fund EESIP by increasing the employer contribution rate for participating employers from 7.05% to 8.0% by 2009, but only if the Legislature appropriates the funds to cover increased contribution levels. If the Legislature fails to come through with funding, the new benefit would become another unfunded liability of the system.
- Retired teachers were granted a 2% cost-of-living adjustment (COLA) in HB 1179;
- The state income tax cuts passed in HB 1172x during special session will have a detrimental impact on OTRS, which receives a share of income tax collections. Calculations by the Oklahoma Tax Commission show OTRS losing \$4.2 million in FY '07, \$13.2 million in FY '08, \$17.0 million in FY '09 and \$22.9 million in FY '10. The fully phased-in annual impact of the 2006 tax cuts are expected to be close to \$25 million. This reduction is on top of annual revenue losses of some \$8 - \$10 million as a result of income tax cuts passed in 2005.

OPTIONS FOR REFORM

Although solutions to Oklahoma's unfunded pension liability problem

have proven elusive in recent years, a number of potential approaches have been put on the table and are likely to continue to be part of the discussion in the years ahead. As a way to help policymakers and concerned citizens better understand and evaluate possible solutions, we now look at four of these options and try to identify strengths and concerns associated with each. The options include: 1) increasing revenue contributions from existing sources; 2) issuing pension obligation bonds; 3) redirecting funds from the Commission of Land Office; 4) converting to a defined contribution system.

1. Allocate Other Revenue Sources

The most straightforward approach to correcting the fiscal imbalance in the teachers retirement system is simply to direct more revenue to the system from new or existing revenue streams. This could involve raising the percentage of revenues from existing taxes dedicated to OTRS beyond current levels; increasing contribution levels from employees and/or employers; or making straight legislative appropriations to OTRS. Governor Henry's FY '07 Executive budget, for example, proposed appropriating \$92 million in "surplus" Rainy Day Funds to OTRS, a proposal which the Oklahoma Pension Oversight Commission recommended be done on an ongoing basis [OPOC 2006].

While directing more funds from existing revenue sources to OTRS is the option least likely to stir strenuous objections as a solution for OTRS (and potentially other retirement systems facing funding shortfalls), some concerns and questions can be raised. Some policymakers are opposed on principle to earmarking tax revenue for specified purposes and programs, believing that this practice undermines the legislature's responsibility to determine policy and be held responsible for their decisions. More practically, to the extent that addi-

tional tax revenues are earmarked to shore up the teachers' retirement system, there is inherently less money available for other public priorities in the educational system and in other areas of government. If and when the moment of growing surpluses come to an end, competition for scarce dollars will become greater. There are also some who would question the level of public support for committing additional tax dollars for public employees' retirement at a time when retirement benefits in the private sector are being squeezed.



2. Pension Obligation Bonds

One possible new revenue source for the state's pension systems is to issue pension obligation bonds (POBs). Under this approach, the state would issue long-term tax-exempt bonds at a certain interest rate and then reinvest the bond proceeds into higher-yielding taxable investments. The difference, or spread, between the cost to the state of servicing the debt on the bonds and the revenue to the state created by investing the bond proceeds produces income that is allocated to the pension system [OPOC 2006; Deloitte Research 2006].

The 2006 report of the Oklahoma Pension Oversight Commission included a recommendation in favor of issuing pension obligation bonds, declaring that "given the proper market situations, POBs can greatly help the

funding level of Oklahoma State's pension system" [OPOC 2006]. The Commission estimated a spread of 2-3% between the interest paid to bond holders (typically 5-6%) and the return on the investment from the bond proceeds (7.5% to 8%), which could generate an additional \$20 million each year in funding for the system (based on a 2% spread on a \$1 billion, 30-year bond issue).

Critics of pension obligation bonds warn that it is a highly risky strategy that could actually worsen the state's financial situation if the market performs below expectations. As the recent report by Deloitte Research notes, the state of New Jersey issued \$2.7 billion in POBs in 1997; with the stock market collapse of 2001, returns on investment proceeds have performed well *below* the interest rate owed to bondholders [Deloitte Research 2006]. Supporters, however, point to other examples, such as Illinois, where market timing was favorable and led to a substantial reduction in the pension system's liabilities. With interest rates currently remaining low, the chance for a positive spread would be much greater.

Critics of POBs also worry about converting a *soft liability* (pension funding), that can be deferred or amortized, into a *hard liability* (bond payments) that must be paid. Supporters cite the same fact as an *advantage*: pension obligation bonds "require a state to be fiscally disciplined by systematically addressing its unfunded pension liability by making annual debt service payments" [OPOC 2006, p. 13].

The pension obligation bond proposal has proven to be highly contentious. The recommendation in favor of issuing POBs passed the Oklahoma Pension Oversight Commission by only a 4-3 margin. The vote was promptly denounced in a press release by Senator Kenneth Corn, a member of the Commission, who termed the proposal a "politically-motivated and short-term fix" and noted that the Senate had

defeated a pension obligation bond proposal on the Senate floor in 2004 [Oklahoma Senate 2006].

3. Redirecting CLO Funds

While the pension obligation bond idea has been around for several years and has been considered by numerous states, a newer and more distinctly Oklahoman approach to fixing the OTRS funding problem involves mineral lease revenues that currently accrue to the Commissioners of the Land Office (CLO).

Under the Oklahoma Constitution (Article XI, Sections 2 and 5), mineral leasing revenues from school lands, along with revenue from land sales, must be deposited into the permanent trust fund of the CLO. The principal of the Trust may never be spent or distributed. However, interest and dividends earned by the Trust are distributed annually to common schools and colleges. Earnings from investment in equities are returned to the Trust.

Thanks to booming oil and gas prices, revenues from the sale of mineral leases have been flowing into the Trust at near-record levels since 2001. The balance in the Trust's permanent fund has risen by close to \$200 million in just the past two years, to \$1,188 million at the end of FY '05. In FY '05, interest payments from the Trust totaled \$54 million, with \$39.5 million going to common schools and \$14.5 million to colleges and universi-

ties [Commissioners of the Land Office 2005].

These growing balances and payments led to a proposal promoted by House members of both parties in 2006 for a constitutional amendment that would have reallocated mineral lease revenues from the permanent trust fund of the CLO to the Oklahoma Retirement Teacher System until such time as OTRS reaches an 80% funded ratio. Since Congress insisted that proceeds from activities on school lands must be reserved for educational purposes at the time of the Oklahoma Enabling Act, the constitutional amendment deemed funding of the teachers retirement system consistent with Congress' intent.

For supporters of the CLO proposal, which passed the House on a bipartisan 92-3 vote during the 2006 special session (HB 1018X), it amounted to a feasible and responsible solution to the OTRS funding crisis. "A temporary diversion of funds from the trust is the only viable solution to funding our teachers' retirement system at this point", said Joe Dorman, the main Democratic sponsor of HB 1108x. According to a House press release, the plan would give an additional \$43 million to the retirement system while reducing funding to school districts by only \$3 million. Not only would the corpus of the permanent trust fund remain intact, but it would continue to grow from other revenue sources (land sales, investment earnings), albeit slightly less quickly than if it received mineral lease deposits (Oklahoma House of Representatives 2006).

The main argument against the mineral lease proposal is that while the plan would initially provide substantial benefits to OTRS at little expense to public schools, over time, the compounded impact to the Trust and its beneficiaries would be considerable. CLO has projected that over twenty years, the CLO permanent trust fund would be \$1.6 billion less under this proposal than if the mineral revenue were deposited to the fund. The smaller principal would reduce



payments to schools by \$634 million over 20 years, or by \$32 million per year, according to the CLO's calculations [Commissions of the Land Office 2006]. These calculations, however, were based on oil and gas revenues remaining at 85% of 2006 levels, which are more than double historical averages. In addition, some public school advocates point out that while OTRS serves both common and higher education employees, the interest from CLO mineral lease revenue goes exclusively to common schools. Therefore, common schools, in essence, would be subsidizing colleges and universities.

4. Convert to Defined Contribution Plans

The most controversial and far-reaching response to the funding problems in the state's pension systems is to shift state and local government employees – or at least new employees entering the system – from existing defined benefit plans (“DB” plans) to defined contribution (“DC”) plans.

Although the overwhelming majority of public pension systems are defined benefit plans, a strong and well-organized movement in recent years has encouraged state and local governments to switch to defined contribution plans. While most pension systems provide for a defined contribution 427B plan as a *supplement* to defined benefit plans, so far, DC, Michigan, and Alaska (for employees hired after June 2006) are the only jurisdictions to have adopted defined contribution plans exclusively (West Virginia and Nebraska adopted DC plans but have since switched back) [Pedrotty 2006]. However, DC proposals have been promoted in several states, most recently by the Governors of Massachusetts, Rhode Island and South Carolina.

For proponents, the main argument advanced in favor of defined contribution plans is that they offer employees the opportunity for larger contributions and greater benefits through investment earnings, along with greater portability for employees who change jobs [ALEC, 2006]. For policymakers, DC plans hold the promise of creating



greater fiscal certainty and reducing the state's exposure for future liabilities if funding levels plus investment earnings fail to cover obligated benefits. With defined contribution plans now the norm in the private sector – less than one-quarter of private-sector employees now enjoy defined benefit plans with guaranteed payouts [Deloitte Research 2006, p. 16] – public sector defined benefit plans can be portrayed as a vestige of a bygone era that governments can simply no longer afford to sustain.

Opponents of defined contribution plans marshal numerous arguments against this approach:

Switching to defined contribution plans would be more expensive for up to several decades. Assuming that the state would honor its obligations to existing employees – as a 1996 Oklahoma Attorney general opinion affirmed that it must – a pension system would be faced with significant *transition costs* once contributions from new employees could no longer be used to help fund the system's existing liabilities. The recent Deloitte Research report warns that “switching new employees to defined contribution plans can actually increase costs in the near term” and explains that the near-term costs will be greatest for systems that face the greatest

unfunded liabilities [Deloitte Research, p. 16]. This is precisely the quandary OTRS and OPERS would face – how to pay for accumulated unfunded liabilities without the contributions of new employees?

Defined contribution plans are more expensive to operate and do not yield higher investment returns. Studies have shown administrative and investment costs for DC plans to be up to four times higher than for DB plans. On average, DB plans have an average annual rate of return that is 0.8% to 2.0% higher than DC plans over extended periods [NCPERS, no date]. For an individual employee, higher fees and lower returns can amount to several hundreds of thousands less in retirement savings over the course of a lifetime. For many public employees, the increased financial risk and investment responsibility of a defined contribution plan would far outweigh any potential benefit of greater market returns.

Defined benefit plans promote recruitment and retention of qualified employees. The promise of a secure, adequate pension can be a major recruiting benefit allowing state and local government to attract and retain skilled and dedicated employees, especially when competing against higher salaries in the private sector. Abandoning defined benefit plans could put Oklahoma in a competitive

disadvantage compared to neighboring states in trying to attract and retain quality teachers and professors.

In Oklahoma, proposals to switch to a defined contribution system for new employees were advanced by both Governor Keating and Governor Henry but generated strong resistance from public employees and teachers and failed to generate much legislative support. While there has been little public discussion in Oklahoma of defined contribution plans in recent years, this approach is a favorite of free-market oriented think tanks and can be expected to loom as part of the policy debate in the future, especially if consensus on other solutions remains elusive

CONCLUSION

In order to be able to honor the state's commitments to current employees and keep the retirement systems solvent, Oklahoma policymakers will have to identify ways to find additional funding for OTRS and the other pension systems.

The challenges are real but not insurmountable. For instance, the OTRS actuary report cited earlier suggested that the infusion of an additional \$50 million per year into the system as of FY '07 would reduce the system's unfunded liability by \$7.3 billion and reduce the unfunded ratio by 17%

over 30 years. An infusion of an additional \$75 million per year would bring the system to full funding by 2027. These are substantial sums, but in the context of annual state appropriations exceeding \$6 billion, not monumental.

Yet identifying new funding to

"The more time that passes without solutions, the greater the problems become and the harder and more expensive they are to fix."

ensure the solvency of the pension systems will no doubt be difficult. All signs point to greater competition for scarce budgetary resources in years ahead, once the current revenue boom subsides and the state faces the looming fiscal pressures associated with demographic changes, rising health care costs, declining federal support and an archaic tax system. The actions of recent legislatures to enact steep, back-loaded income tax cuts further exacerbates the pension problem, both by shrinking the pot of revenue available for all state services and specifically by reducing one of the existing funding streams for OTRS. Even in the best budgetary times; however, it will always be a struggle to convince legislators to choose to

address long-term liabilities over pressing demands to invest in roads and bridges, teacher salaries, university operating costs, or other needs.

Nonetheless, the case for treating the pension problem as a top state policy priority is compelling. The more time that passes without solutions, the greater the problems become and the harder and more expensive they are to fix. A \$10 billion unfunded liability gap cannot be resolved with one-time dollars, but beginning to take action now will spread the funding requirements out over a longer time horizon and soften the ultimate impact on the state budget.

Ultimately, what is needed to fix the problems is leadership and long-term thinking that can bring practical-thinking people together to develop and implement a solution. Hopefully, the more people who are informed about the nature of the problem and the need to address it, the likelier it is that this leadership will emerge.

ENDNOTES

¹ Attorney General's Opinion 96-21

² Governor Henry proposed enrolling all new members of OTRS and OPERS into a defined contribution plan and giving existing members an option to convert to the new plan in his FY '04 Executive Budget [State of Oklahoma 2003, p. 136].

STATE FISCAL CHALLENGES AHEAD

Oklahoma's economy has experienced a resurgence following several years of economic downturn. The Oklahoma State Legislature responded to this short-term budgetary strength by enacting long-term, historic spending increases and tax cuts. The tax cuts enacted during the 2005 and 2006 sessions are projected to erode the state's revenues available for FY '08 alone by over \$200 million compared to FY '07, according to the Oklahoma Tax Commission's calculations. As the 2006 tax cuts phase-in, the revenue impact will continue to grow substantially with each successive year.

The budget and tax decisions made during this uniquely prosperous 2006 session will have shrunk the funds that will be available for future legislatures to deal with the inevitable and largely foreseeable funding demands on state government—rising health care costs for the Medicaid program and state employees, rising operating costs for schools, colleges, and state agencies, the salary needs of state employees, and a growing inmate population, among others.

Making matters worse is that Oklahoma, like all states, will face additional pressures in coming years associated with the looming retirement of the baby boom generation, declining federal support due to the federal budget crisis, and an eroding revenue base due to the growth of e-commerce and other factors.

There is little doubt that the budget and tax policies of the 2006 legislative session will have widened significantly the fiscal gap between the cost of funding state services and the revenues available for that purpose. It will be up to future Legislatures, and to the citizens of Oklahoma, to deal with the consequences of this year's choices.

Source: Community Action Project (2006). "Speeding Towards a Train Wreck?", Budget Brief #6, September 2006 at: www.okpolicy.org



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