GULF COAST
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Pension Bomb

Jay Brady **February 18, 2011**

REVIEW SUMMARY

What. Gulf Coast city pension plans.
Issue. Will a legislative fix be enough to rescue police and firefighter pension plans?
Impact. City budgets could be overwhelmed by pension liabilities.

Municipal pension programs are reaching crisis proportions, and several Gulf Coast cities rank among the state's worst.

Gulf Coast taxpayers in 19 cities the Business Review examined could be on the hook for nearly $1 billion in police and firefighter pension costs. Those dollars may be needed to make up for city officials acquiescence to union demands over the years, and now the fallout of lower investment returns.

In short, municipal governments all around the country, the state and the Gulf Coast promised to pay retirees millions more than they've put aside. The Pew Center on the States highlighted the national pension problem at the state level a year ago when it documented a nearly $1 trillion funding gap.

The National Center for Policy Analysis claims the unfunded state and local unfunded pension liability is more than $1 trillion. The July study also notes that all states underestimate the unfunded pension liability by using an unrealistically high assumed rate of return — often 8% or higher — in calculating the value of pension plans.

The question for cities and other levels of government is whether they will count on financial markets to save pension portfolios, raise taxes, or — in the face of union opposition — make contracts more realistic. State mandates that limit the flexibility of cities to fund pension plans efficiently are also a key part of Florida cities' 2011 legislative agenda.

All of the above may be the ultimate savior, though cutting costs is the only sure-fire way to rein in it all in.

That's the tactic Gov. Rick Scott employed in his budget recommendations requiring state workers to contribute to their pensions for the first time — as most private workers have done for years.

As the pension picture looks now, it's not pretty.

"At the local municipal level, I'm scared of the Armageddon," says state Sen. Jeremy Ring, R-Margate, chairman of the government oversight and accountability committee assigned to come up with a pension reform bill.

The Florida League of Cities warned in a report last year: "Runaway pension costs for police and firefighters threaten to put Florida's cities on a road to ruin." The League's report concludes, "The Florida Legislature must act now to curb runaway pension costs before it's too late."

Ring has reason for nervousness, and he's also got plenty of company from Scott on down to officials in places like Fort Myers, Longboat Key, Cape Coral, St. Petersburg, Venice, Sarasota and New Port Richey, to name a few.

Pension liabilities rising

Buried in the recently released 2010 annual report from the state's department of management services, Florida Local Government Retirement Systems, are hundreds of pages of figures of obscure data with terms like unfunded actuarial accrued liability, covered payroll and funded ratio.

For the 31 police and firefighter pension plans in the 19 Gulf Coast cities, the total unfunded actuarial liability for those plans is nearly $631 million. But when the lower market value of those assets is considered, the unfunded liability rises to nearly $958 billion. (See table.)

All other things equal, that means that pension assets will need to achieve even higher rates of return, and perhaps assume more risk to do so, to meet pension obligations.

On average, the 31 plans assume an already aggressive assumed rate of return on investments of 8.1%. To make up for market value losses, those plans will now need to return an average of 9.1% annually. Fort Myers' police pension plan will need to earn 10.0% a year, and Tampa's police and fire plan will need to return 10.8% annually.

But those needed investment return figures may be conservative. A pension expert recently told Longboat Key town commissioners that the town's contributions to its police pension plan would need to increase further unless investment returns approach 13%.

That's because losses in the plan are "smoothed" over a four-year period meaning that recent big losses from 2008 will soon be factored into the calculation that determines the town's required contributions. The expert's presentation showed that most public pension plans had investment losses of 10%-15% for fiscal year 2008, and modest gains the year after.

Required city contributions, as a percentage of payroll, for police and fire pension plans in those 31 cities is more than double for that of the cities' general employee plans: an average of 35.4% of payroll for police and firefighters versus 16.6% for general employees. (See table.)

Using demographic and economic assumptions, pension actuaries come up with projections for the level of assets needed to pay future liabilities. Based on the projections, they calculate the annual required contribution (ARC) needed from the plan sponsor to balance the fund over the long term, typically 30 years.

Of the 31 plans, 14 have contribution rates for police and firefighters that exceed that 35.4% average. Even worse for comparison purposes, according to a recent report of The Center for State and Local Government Excellence, the average annual contribution is only about 11% of payrolls.

For the town of Longboat Key, the rate is six times this benchmark, and nearly double this group's average: 66.2% for its police pension plan compared to 28.4% for its general employees' plan. Says Ring, "There isn't an economist in the world who would say you can keep your retirement at over 50% of payroll."

A ratio at or above 100% indicates that a plan can cover its long-term obligations to current and future retirees. According to a Jan. 26 state agency report to Ring's committee, "Most experts recommend that a public pension operate at or above an 80% funding ratio, and suggest those below 80% are in danger of experiencing near-term liquidity issues."

Of the 31 plans, 22 have actuarial funded ratios below this 80% benchmark. Longboat Key is at 45.6%. Worse, though, based on the lower market value method, Longboat Key's ratio is only 39.9%.

The market funded ratio could become a critical factor in determining cities' contributions to pensions in the near future. The state annual report recommends that a plan sponsor's payments to the fund be based on "the lesser of the fair market value and the value determined according to the plan's asset valuation method."

With market values typically much less than actuarial values these days, that means even more dollars that already revenue-challenged cities and their taxpayers will have to come up with to fund pension plans.

'Not sustainable'

In large part, the problem stems from changes the Legislature made to police and firefighter pension requirements in 1999, according to Kraig Conn, deputy general counsel and legislative counsel for the Florida League of Cities. Those changes, which Conn says are "not sustainable," cost cities $400 million on new pension costs that previously could have funded current pension liabilities.

“The biggest issue we have is how the state requires cities to use a revenue source, the premium tax on [property and casualty] insurance premiums,” says Conn. He explains that the 1999 legislation redirected the funding source that had helped cities set up police and fire pensions, and forced cities to use the excise tax dollars to pay for new and “extra” pension benefits for police and firefighters.

The problem is that cities with police and fire pension plans are able to use up to a fixed, or “frozen” amount of premium tax revenue. But when it falls below that level, as it has in recent years with the economic slowdown, the cities have to make up a growing difference when they are least able to afford it.

Extra benefits include an increased benefit multiplier, cost of living adjustments, a lower retirement age, a shorter vesting period, a 13th monthly check and other supplemental benefits.

According to the report, if cities refused to offer the extra benefits, they would forfeit the revenue, “… creating an overwhelming short-term political incentive to promise new pension benefits whose long-term costs are set to explode.”

Those explosions are being heard across the state and the Gulf Coast. Cities and towns, like Longboat Key, may now consider whether to abandon the premium tax revenue as part of their own pension reform plans unless the Legislature reforms the system first.

Cities fight back

The Florida League of Cities will support legislation that provides comprehensive municipal firefighter and police officer pension reform. Pension mandates directly conflict with the Legislature’s desire to limit government spending. Any comprehensive pension-reform package should:

- Require that determinations of average final compensation include salary only, and do not include pay for overtime, unused leave time or any other additional payments;

- Allow recipients (cities and special districts) of insurance premium tax revenues to use these funds to pay for the costs of current plans;

- Allow cities to convert firefighter and police officer defined-benefit pension plans to the Florida Retirement System (FRS) or another type of plan without losing insurance premium tax revenues;

- Allow deviation from state requirements if agreed to by the employees or their union;

- Change the governance structure of pension boards of trustees to move away from having plan participants serve on the boards; and

- Provide flexibility to local governments in the FRS to allow them to include contribution plans, also.

By contrast, the world's oil market is diverse, with dozens of countries producing oil for export. In 2009, the United States imported oil or oil products from 90 different countries.

Recently, China has proven willing to use their near monopoly on the rare earths to extract favorable political outcomes from foreign nations.

In September 2010 a Chinese trawler collided with a Japanese coast guard vessel in a disputed portion of the East China Sea. The Japanese arrested the captain of the fishing boat. When Japan refused to release the Captain, China retaliated by first limiting and eventually halting exports of rare earth elements to Japan. Japan eventually relented and sent the captain home.

Closer to home, production of photovoltaic cells for energy relies on the rare element tellurium. However, the only tellurium mine that exists on Earth is in China, which is increasingly dominating the market for solar manufacturing.

Whereas, in 2003, China produced only one percent of the world's solar panels by 2009 its share had grown to 38 percent – and in 2010 its share rose to 43 percent. Over the same time period, the U.S.'s share of world solar panel production fell from accounted for 14 percent in 2003, to just four percent today.

Similarly, rare earths are essential to the newest generation of batteries, critical for fuel-efficient hybrid and electric vehicles, and the magnets used in wind turbine production. This means that U.S. auto companies and wind turbine manufacturers like GE are, in part, placing their hopes improving their companies' fortunes on China's good will.

Sadly, this dependence on China is driven purely by politics not consumer demand. Absent huge government subsidies, grants and mandates, green energy, being more expensive and less reliable than traditional energy production, would not be so much in demand, and thus China would not be in the catbird seat.

The push to replace fossil fuels with renewable energy technologies brings to mind the old saying, "out of the frying pan into the fire." On a more positive note here's another, "Drill Baby Drill" Sarah Palin.

American ingenuity trumps that of most if not all countries in the world. There is absolutely no reason that future energy saving technologies should not be pursued with the same vengeance of the Manhattan Project during WWII or following the direction of JFK who led the U.S. to become the first nation to land on the moon.

What is needed is for the federal government to step aside, quit attempting to pick winners and losers; they have shown their propensity of picking losers with taxpayer dollars and let Adam Smith's invisible hand guide the market with the ingenuity of the US entrepreneur leading the way.

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