Why Have Government Contributions to New York Pension Plans Soared since 2010?

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New York State's pension plans are among the best-funded plans in the nation (Pew Center on the States 2012), but they have become increasingly costly for taxpayers. Between 2002 and 2012, contributions by the state and local governments to public employment retirement plans rose more than 500 percent in New York, more than in any other state. This surge in government contributions has created financial problems for local governments and raised questions about the sustainability of the state's retirement plans, prompting some observers to advocate cutting retirement benefits for public employees (McMahon and Barro 2010).

To explore why government pension contributions in New York have risen so rapidly, this brief examines retirement benefits paid to members of the New York State and Local Employees Retirement System (ERS) and describes how they are financed. ERS covers general state and local government employees in New York, but it excludes public school teachers and public safety workers. New York City employees are covered by their own plan and thus do not participate in the state-administered plan. We found that recent hikes in government contributions to the plan have been driven primarily by plan investment losses as well as the plan's practice of adjusting government contributions to offset unexpectedly high or low investment returns. Although plan benefits are more generous than in other states, recent cutbacks will sharply curtail future retirement benefits for new hires. Additional information can be found in our related report (Johnson, Haaga, and Southgate 2015).

How Are Benefits Computed?

General state and local government employees in New York receive lifetime pensions equal to a share of final average salary multiplied by completed years of service. Plan rules have changed several times over the past four decades, but members already enrolled in the plan when changes were implemented are grandfathered under existing plan rules. As a result, the plan now includes six tiers with different benefit and member contribution rules. Tier membership depends on when employees were hired.

Employees hired after 2012 are enrolled in tier 6 of the plan. Final average salary is calculated over an employee's three highest-compensated years of service. For members with less than 20 service years, pensions are computed as 1.66 percent of final average salary per year of completed service. For members with 20 or more service years, the percentage equals 1.75 percent for each of the first 20 years and 2 percent for all subsequent years. Tier-6 members may begin collecting full benefits at age 63 if they have completed 10 years of service, the tier's vesting requirement. Reduced early retirement benefits are available at age 55 after 10 years of service. Retirees who are at least 62 years old and have been retired for at least five years receive cost-of-living adjustments equal to one-half the change in the consumer price index. However, the cost-of-living adjustment may never fall below 1 percent or exceed 3 percent.

Government employees hired before 2012 receive more generous pensions. For example, earlier hires may begin collecting their pensions at younger ages than tier-6 members, and benefits for employees hired before 2010 vest after only five years of service. In addition, the formula that determines pensions applies a smaller multiplier to certain years of service for tier-6 members than for members of earlier tiers and averages final salary over more years of service.

How Are Benefits Funded?

New York's pension benefits are funded by contributions from plan members and their employers and by earnings on plan assets. In 2014, the fund took in $23.1 billion, with $5.1 billion coming from employer contributions and only $274 million coming from employee contributions (New York State and Local Retirement System 2014). Except for the period between 1998 and 2002, income from employer contributions far exceeded employee contributions, which vary by tier. Tier-1 and tier-2 members do not contribute to the plan at all, and tier 3 and tier 4 members must contribute 3 percent of salary for their first 10 years of service but nothing in subsequent years. Tier-5 and tier-6 members must contribute to the retirement plan throughout their career. The contribution rate is 3 percent of salary in tier 5, but it varies with salary in tier 6, rising from 3 percent for employees earning less than

$45,000 per year to 6 percent for employees earning more than $100,000 per year. About four-fifths of plan members belong to tiers 3 and 4, which cover employees hired from the middle of 1976 to 2009. Only 9 percent belong to tier 5—covering employees hired in 2010 and 2011—and 10 percent to tier 6.

New York's relatively low reliance on employee contributions is apparent when compared to other states. According to 2012 US Census data on state and local government retirement systems, employee pension plan contributions to all public plans in New York—not just the state's ERS plan for general state and local government employees—equal only 3.3 percent of payroll, the fifth lowest rate in the nation. The national average is 7.4 percent, more than twice New York's rate. However, government contributions relative to payroll are higher in the New York plans (37 percent) than in any other state and more than double the national average of 17 percent.

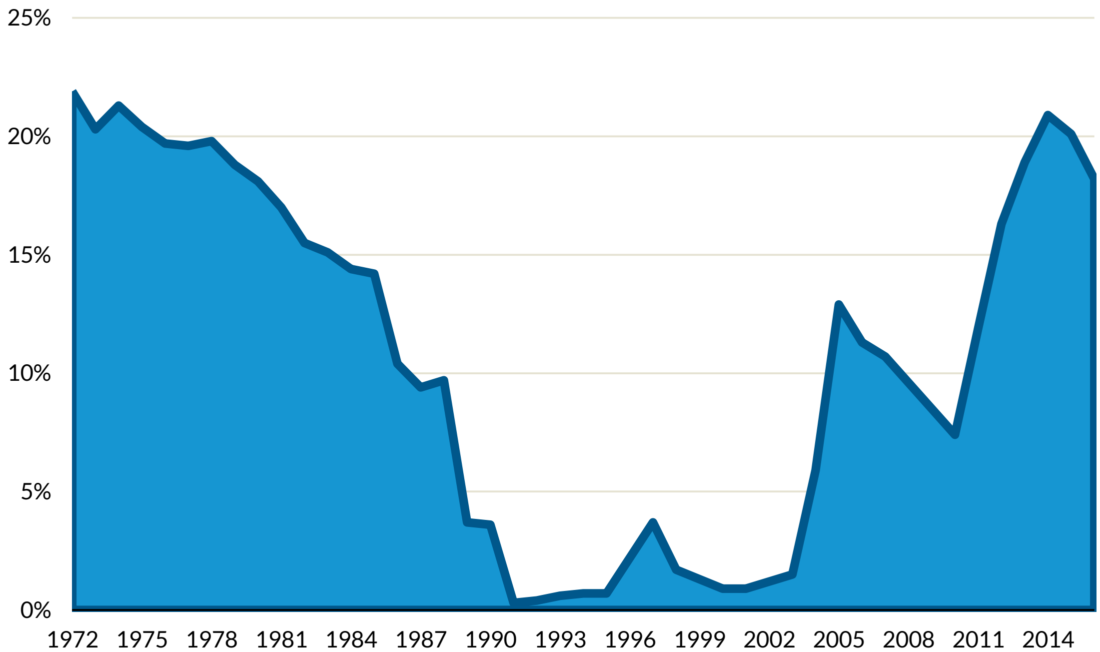
Although employer contributions cover a large share of paid benefits, income from existing assets and appreciation of those assets can easily exceed other sources of plan revenue when investment returns are strong. Annual investment gains or losses of more than $20 billion dwarf funding from employer contributions, which despite steady and dramatic growth since 2000 barely exceeded $5 billion in 2014. However, the plan assumes significant risk by investing in assets that, on average, generate high rates. ERS's annual investment rates have fluctuated significantly over the past 34 years, ranging from highs of 30 percent in 1998, 29 percent in 2004, and 26 percent in 2010 to lows of –26 percent in 2009, –10 percent in 2003, and –9 percent in 2001.

Historically, unexpected swings in the plan's asset returns have been largely offset by changes in employer contributions, which have varied dramatically over time (figure 1). The sharp drop in employer contribution rates in the 1980s and the sustained near-zero rates of the 1990s provided a windfall to the system's employers. Subsequent years, however, highlight the downside of asset volatility. Large—sometimes double-digit—increases in the required employer contribution as a share of payroll have proved much less palatable to employers than the equivalent sharp drops in contributions they experienced previously.

After the 2000 collapse of the dot-com bubble and the 2008 financial crisis, the state passed ad hoc legislation easing plan funding rules and allowing public employers to make up funding shortfalls gradually over time instead of in a single year. These measures depart from the plan's stated funding procedures and essentially enable public employers to borrow against plan assets. The most recent asset-smoothing exceptions credit the deferred balances at 5 percent interest, a significant subsidy for employers given that the plan trustees assume plan assets earn 7.5 percent annual returns. However, employers who take advantage of the new contribution smoothing rules must accept a contribution floor in the future. Had this provision been in place earlier, it would have prevented the rapid run-down, and subsequent run-up, of contribution rates. Smoothing changes in employer rates over time would limit sharp increases in pension plan outlays by the state and local governments.

FIGURE 1

Employer Contributions to the Plan as a Percentage of Payroll in New York ERS, 1972–2015



Source: Authors' calculations based on data from New York State and Local Retirement System (2014).

Conclusions

The recent surge in government contributions to New York's retirement plan for general state and local government employees was driven primarily by investment losses sustained by the plan as well as the plan's practice of adjusting government contributions to offset unexpected investment gains and losses. The sharp rise in state and local government contribution rates to the ERS plan between 2002 and 2014 followed dramatic declines in the equities market in the wake of the 2000 collapse of the dot-com bubble and the 2008 financial crisis. The impact was especially pronounced because government contribution rates were unusually low for much of the 1990s. Contribution rates in 2013 were similar to those in the early 1970s. The plan announced in late 2014 that government contribution rates will drop slightly in 2015, as the plan's investment returns have continued to improve.

The volatility in required employer contribution rates to New York's public employee retirement plan highlights the downside of investing pension funds in risky assets. Over the past three decades public pension plans across the nation have increasingly shifted away from fixed-income investments such as government and high-quality corporate bonds in favor of equities and alternative investments such as hedge funds, real estate, and commodities (Pew Charitable Trusts and Laura and John Arnold Foundation 2014). This strategy often allows plans to meet their target investment returns, but it increases the risk of investment losses in bad years. In New York, those losses forced the state and local governments to increase their contributions to maintain the plan's strong financial standing. Other states confronted with poor investment returns did not raise contributions to their retirement plans and instead allowed the plans' financial status to deteriorate. New York could help protect the budgets of municipalities in the state as well as the finances of the state-administered retirement plan by maintaining the level of required government contribution rates when investment returns are high so rates do not have to rise much when returns fall.

The plan benefit structure did not cause required government contributions to surge over the past decade. Although current retirees from New York's state and local governments receive more generous pensions than government employees in most states, recent cutbacks have significantly reduced pensions for new hires. The state-financed pension benefits received over a lifetime by employees hired since 2012 will be only 10 to 60 percent as large as the benefits they would have received if the benefits rules for 1973 were still in place. Further benefit cuts do not seem warranted.

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