Tier V: Two Steps Forward for Property Tax Reform, If...

by

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I. The Overview

This is not a rhetorical question: Why is education at the local level so expensive? Perhaps the answer to this question would unearth the reason driving tax levies statewide to their current annual growth rate of 8.19% since the recession of 2001.[1] The answer, I would respectively submit, is cost—*education at the local level simply costs too much*. And here is the mismatch—public policy to date continues to focus on structural issues, such as state funding, county funding, county opt-ins and opt outs, spending and income caps, direct, enhanced and senior rebates and the like. It's the cost that is the issue, not the delivery structure. Asking the right questions is critical to shaping the right solution. Asking the right question focuses attention on finding better ways to do things. It focuses attention on innovation, on trying out new ideas and on making processes more efficient and cost effective.

Asking questions around cost, of course, gets us grappling quickly with some highly charged issues. The cost of unfunded state and federal mandates add untold millions to school budgets statewide. The unconscionable lack of applying even the most basic tenets of logistical management to the purchase and transport of goods, services, and personnel that has so revolutionized the WalMarts, Targets, Kohls and Gaps of the retail world cost millions. The hidden costs that artificially inflate capital projects that are simply unheard of in the private sector, cost millions. These are but a few of the drivers of cost whose legislative origins create the numbing bureaucratic oversight and glaring economic inefficiencies that add millions to the cost of education each and every year.

Of course, no discussion about cost could possibly ignore the question of overhead. Without question, the delivery of education at any level is a labor intensive enterprise. According to US Census data, over 83% of educational cost derives from overhead—that is, salary, wages and benefits. Today, I would like to focus on one aspect of the benefit picture, namely, the defined benefit program for school district employees. The call is for the New York State Legislature to establish a Tier V and a defined contribution 401(k) pension plan for all future hires to both Teachers' Retirement System (TRS) and the New York State Retirement System.

II. A National Economic Sketch

To put it mildly, our current economic environment faces severe challenges moving forward. In mid-July 2007, problems in the sub-prime mortgage market began to appear in the back pages of financial newspapers and flash intermittently across Internet screens. By October, the trickle upgraded quickly to category five dimensions that saw the pillars of the financial industry announce, one after the other, billion dollar write-downs on mortgage based securities held in their investment portfolios. Esoteric financial instruments,[2] especially those tied to the sub-prime mortgage market, lost anywhere from 47%,

[1] New York State Comptroller data, through 2005.

[2] CDO's or collateralized debt obligations, are pools of debt instruments fashioned by risk into tranches and sold as securities. CLO's are collateralized loan obligations which do the same thing using corporate loans. MBS's specifically use mortgages as the underlying security which are repackaged and sold by risk as securities. SIV's, or structured investment vehicles borrow money short term to invest in longer term assets. It is this mismatch in duration which the current environment is most likely to close for foreseeable future. The result has forced billions of such debt obligations back onto balance sheets which, in turn, forces banks to match these debts against capital reserves. The combination of write-downs and reassuming these debt instruments on balance sheets have caused many financial institutions to scurry for capital infusions from mainly the sovereign wealth funds of China, Singapore, Kuwait, Abu Dhabi, and South Korea to the tune of some $69 billion by the end of January, according a recent report by Stephen Jen of Morgan Stanley. ARS's, or auction rate securities, constitute a $330 billion niche of the credit market. ARS's allow municipalities, student loan companies, hospitals, non profit entities, as well as closed end funds to tap long term debt obligations for short term liquidity needs. With ARS's the short term debt issues reset every 7, 28 or 35 days through bank managed auctions. When auctions began to fail for lack of bidders, interest rates have the potential to reset at significantly higher rates, depending on the underlying asset valuation..

to 74%.[3] As of February 2008, investment houses and brokerage firms had officially announced $146 billion of mortgage related write-downs—losses that could reach $300-500 billion according to some estimates before the malaise finally works its way out of the system. Structured financial instruments, which accounted for as much as 30% of big investment bank profits,[4] have now become the financial equivalent of toxic waste.

The Federal Reserve was not long in responding. The federal funds rate target, which stood at 4.25% in late October now stands at 3%, shed 2.25% in less than three months. At 3%, of course, the federal funds rate target largely mirrors the consumer price index (CPI). The 50 basis point on 22 January, followed by the 75 basis point drop on 30 January is the steepest rate cut in so short a period of time since 1982. By year's end, futures markets see rates falling to the 2-2.25% range. The current federal funds rate target is at its lowest point since November of 2003 when the target rate stood at 1%,--a 45 year low.

Fiscal policy, just as it did during the recession of 2001, will again place governmental checks into the hands of American consumers in hopes of juicing a stalled economy, at an estimated cost of $168 billion. The current stimulus package will also add temporary authorization for Freddie Mac and Fannie Mae to buy or guarantee mortgages well above the current limit of $417,000.[5] While the new limits are still being negotiated, the levels could be as high as $730,000. The intent is to add a much needed boost to the otherwise moribund housing market.

III. The Local Governmental Dimension

Nationally, the housing boom peaked in the second quarter of 2005 before falling off dramatically by the end of second quarter 2006. The inflation adjusted quarterly receipts available to local governments took a similar plunge, according to a new study released by the Rockefeller Institute of Government (see Table 1, below).

The technology meltdown of March 2000 through the end of 2002 erased $8.5 trillion of market value. By way of contrast, the second quarter of 2005, housing wealth on a national level was in the neighborhood of $18 trillion. The Federal Reserve estimated that a national 25% drop in house prices would shave about $4.5 trillion of personal wealth. At the street level, each dollar of spending power lost, the average consumer typically cuts back spending by about 3.5 cents. On a national scale, this decrease in spending was about 1.25% of total GDP.[6] In New York State, the median single family home sold for $265,000 in December of 2005. One year later, the median price fell to $227,950, according to the New York State Association of Realtors, a 16.3% drop in market valuation. By November 2007, the median price to $212,500, a drop of 7.3%. The overall market decline from December 2005 to November 2007 was indeed 25% statewide.[7] The legacies of the 2001-02 meltdown—falling asset prices, high

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CDO's, CLO's MBS.s and SIV's constitute a $2.4 trillion market and trade on the value derived by debt ratings provided to the seller, rather than through normal market mechanism such as an exchange. If the ratings fall due to some unforeseen change in value of the underlying assets, these financial vehicles can fall precipitously and without a great deal of warning. The possibility of loss simply proved much higher than the statistical programs employed by rating companies predicted. Over a third of the write-downs in these vehicles came from just three financial institutions: Citigroup, Merrill Lynch and UBS.

[3] See Carrick Mollenkamp and Katrina Bart, "UBS's Mortgage Woes Increase," *Wall Street Journal* (31 January 2008). p. C-1, quoting a JP Morgan Chase research report. Also see Tom Lauricella, "Citigroup Leeraged fund Falls Amid bond Market's Volatility,"*Wall Street Journal (*15 January 2008), p. A11

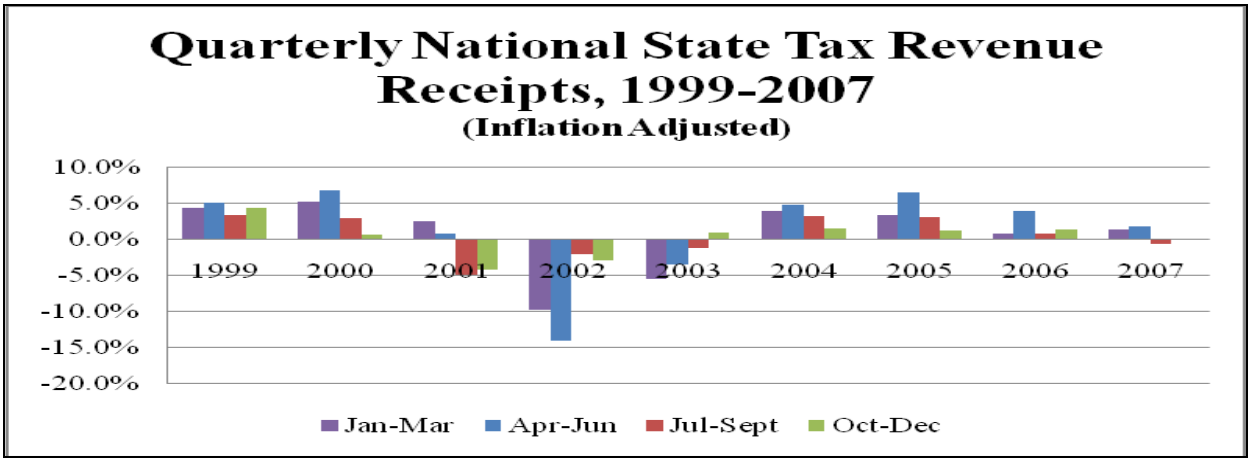
[4] CreditSights, (January 2008).

[5] The temporary authorization limit is currently set to expire on the 31st of December, 2008.

[6] See the comments of Janet L Yellen, the President and CEO of the Federal Reserve Bank of San Francisco in her remarks before the Portland Community Leaders' Luncheon in Portland, Oregon (29 July 2005).

[7] New York State Association of Realtors Monthly Housing Survey (December 2007). A note of caution always enters into the comparison of house prices over time. The National Association of Realtors measure houses actually

Table 1



Rockefeller Institute of Government, No. 70 (January 2008).

consumer debt and outsized bank losses will again tax the ability of both monetary and fiscal policy to keep the economy on an even keel.

For state, county and local governments, piloting the channels of public policy in the current economic environment has already become a Schylla and Charybdis exercise. While it is difficult to compare national and New York State wealth loss data, the twin swords of falling real property values and depressed discretionary spending have clear economic ramifications on state, county and local governments' ability to meet prevailing levels of services. After all, receipts from sales and property taxes provide the lion's share of local government revenue. With recession looming on the broader economic front, local governments throughout the State face the unpredictable ingredients of a perfect storm—rising costs matched against declining revenues, which increases dependence on property tax receipts statewide.

Luckily, not all local governments across the State face the same across the board financial predicament. Many geographic locales simply did not participate in the housing run, as Table 2 clearly illustrates. Many counties north and west of Albany, with the notable exceptions of high value, largely second home markets sprinkled throughout the State, never participated in the housing run up of 2003-05. In Allegany, Oswego, Broome, and Wayne counties, for example, median incomes and house pricings largely kept pace with historical averages. The unprecedented housing appreciation tended to confine itself to those counties within the economic reach of New York City. The median income of Westchester County in 2004, for example, was $61,835.[8] At the height of the housing boom, the median single family home in Westchester County was selling for $651,250, over ten times county's median income. Similar pictures appear in Rockland, Putnam, Suffolk, Nassau, counties, and to a lesser extent in Dutchess and Ulster counties. In Allegany County, by way of comparison, the median income in 2004

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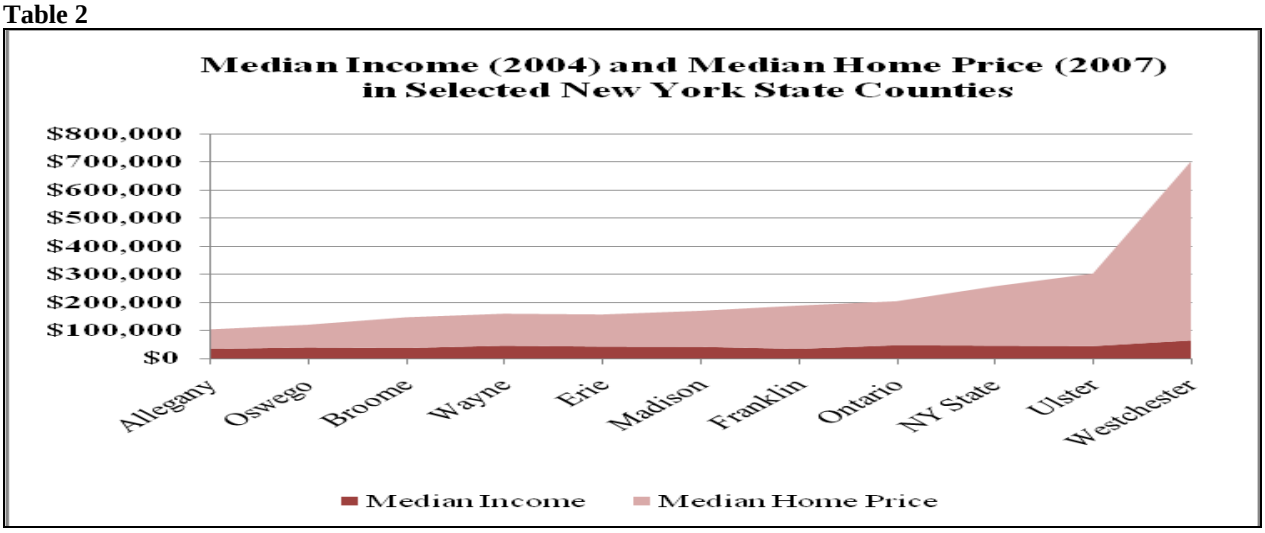
sold in a given month. Figures tend to rise when a lot of high end houses sell and fall when a lot of low-end houses sell. Other measures of house prices, such as the Office of Federal Housing Enterprise Oversite (OFHEO) and the S&P/Case-Shiller national index, provide different pictures of house price momements. OFHEO relies on data collected from Fannie Mae and Freddie Mac, the federally chartered housing agencies that OFHEO regulates. OFHEO figures exclude mortgages above $417,000. Accordingly, OFHEO figures for New York City saw a rise of 0.25% from the third quarter 2006-2007. The Case-Shiller index limits its data to 20 major markets and relies on property records for data, which may or may not reflect the breadth of the US housing market. The Case-Shiller index for New York City fell 3.64% between the third quarter 2006-2007.

[8] US Census Bureau data, 2004.

Table 2



New York State Association of Realtors, US Department of Agriculture.

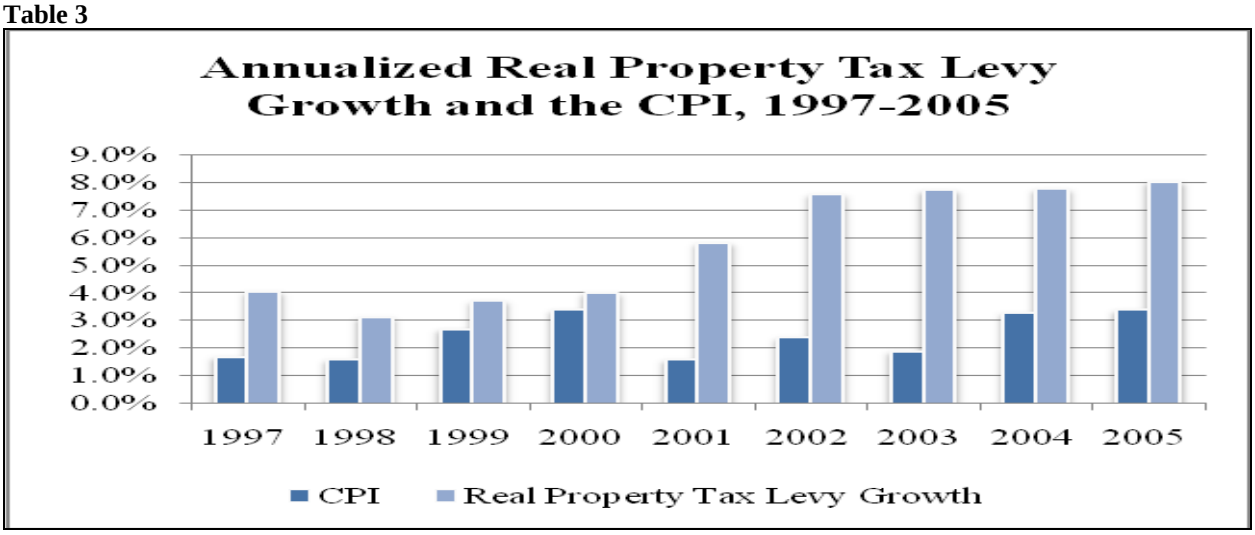
was $32,812. The median single family dwelling was selling in Allegany County at the height of the housing boom for $59,000—well within historical norms. Today, the median single family home in Westchester County sells for $610,000—a 6.7% drop from the peak selling price of 2005. While 2007 median income figures are not available, using a 3% annual inflator, we come to a 2007 median income estimate of about $67,568.[9] The median single family home is still nine times the estimated median income. Again, the same picture emerges for Rockland, Putnam, Suffolk, Nassau counties and to a lesser extent in Dutchess and Ulster counties. Table 2 is important by the sheer breadth of the housing boom in these down-state counties and the distance these counties still have to travel before the median housing prices and income revert to historical averages.

IV. Cost Structures Driving School District Spending

Juxtaposed against falling local government revenues is the dynamic rise of tax levies across the state, especially since the recession of 2001 to the peak of the housing boom of 2005. For the period 1996 through 2005, the average annual rate of growth of tax levies statewide was 5.32%, according to New York State Comptroller data (see Table 3). As a benchmark, the CPI for 1996-2005 had a mean of 2.53% and a median of 2.55%. The personal consumption expenditure (PCE), which excludes

[9] Figures from the New York State Association of Realtors, December 2007.

Table 3

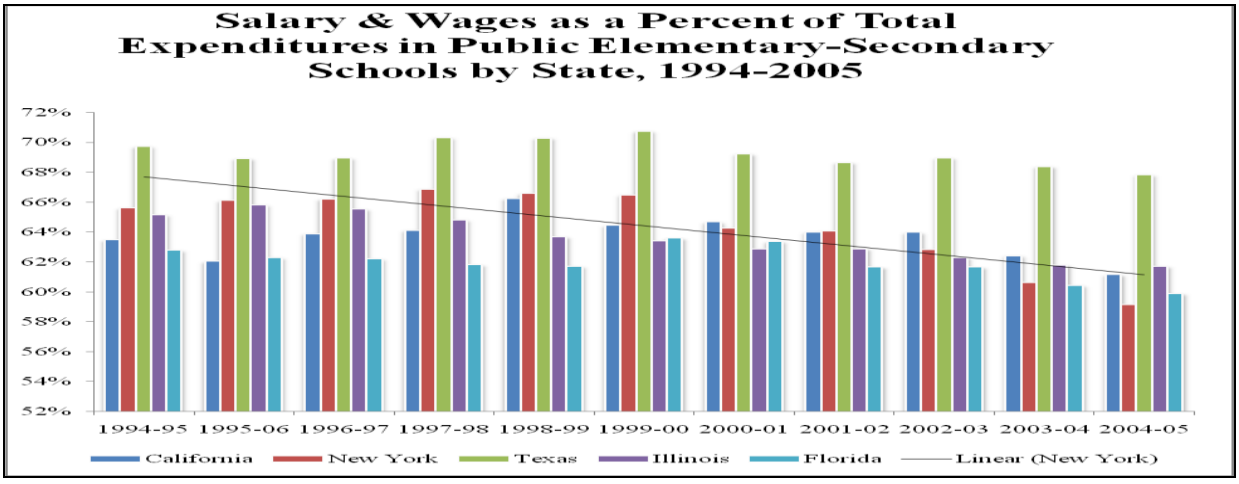


Federal Reserve, New York State Comptroller's Office, 1997-2005.

energy and food purchases, had a mean of 1.62% and a median of 1.60% for the period. Taking a measure from the recession of 2001 through 2005, however, the annual tax levy growth statewide jumped cumulatively by almost 54% to 8.19%. The mean CPI for 2001-05 was 2.52% and the median was 2.40%. The mean PCE reading for the period was 1.66% and the median was 1.50%. The tax levy was growing at a rate of three times the CPI and four times the PCE reading for the period.

The rise in the tax levies statewide from the recession of 2001 through the peak of the housing boom in the second quarter of 2005 correlates closely to the increased cost of providing education at the local level. One area, however, that might come as a surprise to the casual observer, is that wages and salaries appear ***not*** to be the main driver of increasing costs. According to US Census data, salary and wage expenditures in New York State peaked in the 1997-98 academic year at 66.86% of total expenditures, and have been falling ever since at an annual rate of 1.74% through 2005 (See Table 4).

Table 4

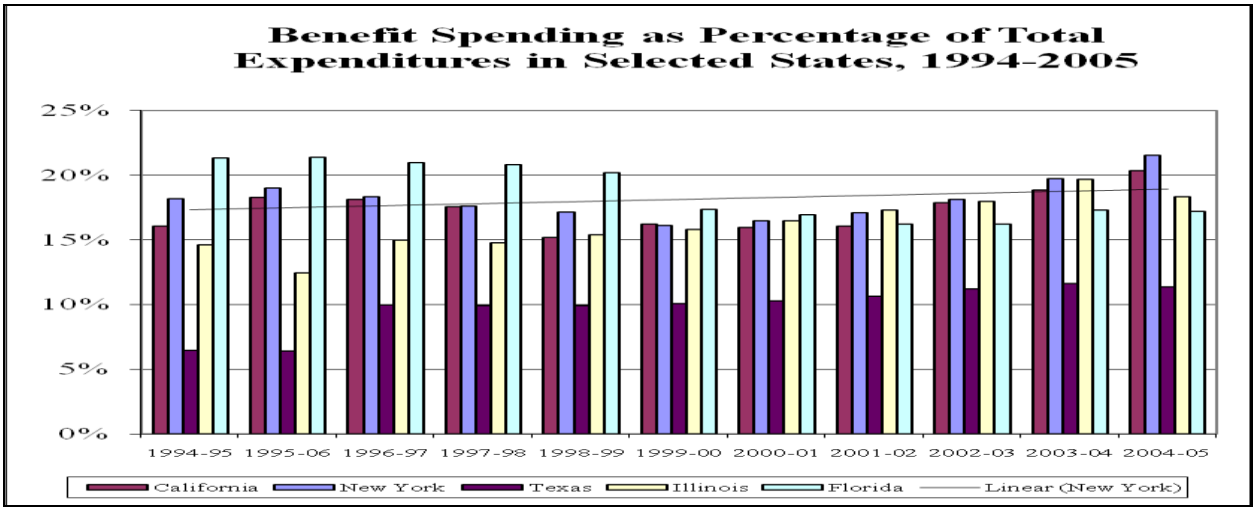


US Census Data, 1994-2005.

In 2005, salary and wage expense as a percent of total expenditures in the State of New York fell to 59.14%, a decline that appears to show continuity at least for the near future.

Unsurprisingly, benefit spending, as a percent of total expenditures in the State of New York, is on the rise. While the trend line for New York plotted against the spending histories of the five leading states in terms of total spending per pupil slopes slightly upward for the period 1994-2005, from 2001 through 2005, the annual growth of benefit spending was 5.94%. Almost 23% of total expenditures in New York go toward providing employee benefits in 2005 (see Table 5).

Table 5



US Census Bureau Data, 1994-2005

V. The Not So Hidden Costs of Defined Benefit Pension Plans

The most common features of any defined-benefit (DB) plan averages the three highest earning years of an employee's working career with a multiple that captures years of service to provide a retirement pension for life and, with a joint and survivor option, that of a spouse. In the private sector, DB plans commit the employer to put aside company profits to fund the future liabilities promised to their employees in retirement in accordance with actuarial calculations of present value costs of future pension benefits, measured against the risk free rate of 30-year US Treasury bonds. Required premiums are also paid to a little known governmental agency, the Pension Benefit Guaranty Corporation (PBGC) that guarantees the plan from default up to $45,000 of benefit per year. Public sector DB plans carry similar funding requirements based on actuarial assessment of future obligations. Instead of using company generated profits, public sector DB plans obligate state and local governments to commit funds at prescribed actuarial levels to fund benefits determined by prevailing legislative initiatives. Yet rather than paying premiums to a governmental agency to insure the plans in the event of default, the public sector relies on the taxing authority of government at all levels to guarantee the fiscal integrity a public retirement plan. And curiously, the actuarial calculations of present value costs of future pension benefits are measured not by the risk free rate of 30-year US Treasury bonds, but by an arbitrary, even contrived, discount rate of 8%.

As with private sector DB plans, public sector employers are required to make contributions to the state administered funds based on annual actuarial calculations of future

liabilities. Both public and private sector DB plans benefit from market appreciation and sound investment choices, and suffer proportionately when market and/or investment choices—or both—fail to produce the desired performance results. Prolonged market downturns wreak havoc on private sector employers as the forces of inflation and projected costs of future benefits ramp up pension contributions at the very time when underlying profits could be under severe pressure. In the public sector, prolonged market downturns press governments of all stripes to tweak available revenue sources just at a time when tax receipts could very well be falling dramatically, increasing dependence on property tax receipts.

Unbridled investment risk, the unpredictability of the future liabilities, increasing longevity of employees, and the growing cost associated with maintaining a DB plan have all had profound impacts on corporate retirement planning. According to a 2005 survey administered by the PBGC, the number of private sector DB plans peaked in the mid 1980s at roughly 112,000, which covered about one third of all American workers. The number of workers covered by DB plans in the private sector now stands at about 30,000. From 1986 to 2004, 101,000 single employer plans with about 7.5 million participants were terminated.[10] DB plans in the corporate world are fast winding down as the forces of investment risk and the uncertainty around quantifying future liabilities have made private sector DB plans untenable.

Public sector DB plans, by contrast, are far from waning as the pension option of choice by legislators across the country. In the corporate world, shareholders bear at least an indirect responsibility in checking corporate pension growth—with admittedly varying degrees of effectiveness. In the public sector, the shareholder role reverts to the taxpayer, who is almost universally unaware of legislative debates that take up the issue of public pension growth. Public employee union lobbyists, by contrast, weigh in heavily in these discussions. The taxpayer, with little due diligence, gets saddled with the financial responsibility.

VI. New York State Teachers' Retirement System

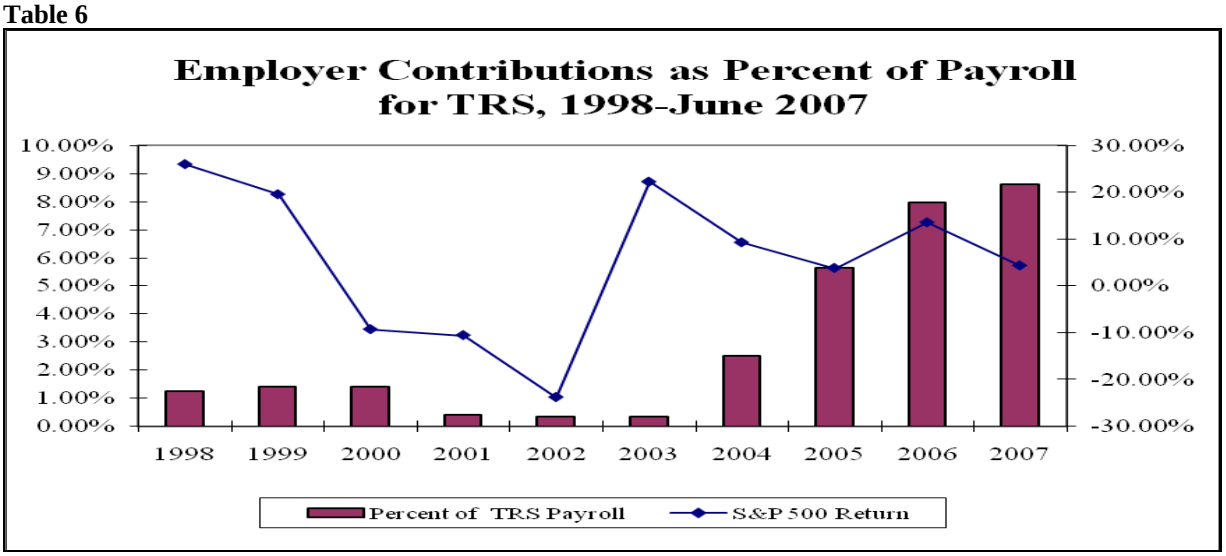
School district contributions statewide to TRS were 1% or less through 2003 as outsized investment gains of the 1990s continued to carry the fund through the market downturn that began in March of 2000 and the recession that officially began exactly one year later. By 2004, however, actuarial calculations called for dramatic increases in employer contributions to the TRS plan. In 2005, the contribution level jumped to 5.63% of total payroll, followed by 7.97% in 2006 and 8.60% in 2007. All told, the past four years logged a cumulative growth rate in excess of 35% (see Table 6).

The main source of such volatility, which runs like a red thread through DB plans of every stripe, is investment risk, or who picks up the tab for investment shortfalls. With an active DB program in the private sector, it's the employer and the shareholder. In a pension failure, investment risk reverts to the PBGC, and ultimately, the US taxpayer. In the public sector investment risk lays with the local, county and/or state taxpayer.

TRS investment strategy was all too dependent upon equities to withstand a peak to trough market drop of 36% for the period spanning 2000-2004. But TRS commitment to equities as an investment strategy is hardly unique. Equities have a long record of outpacing bonds over the course of market history. Large equity exposures in rising markets would, without doubt, be expected to minimize future pension contributions—in the private and public sectors alike.

[10] "An Analysis of Frozen Benefit Plans," Pension Benefit Guaranty Corporation (21 December 2005)

Table 6



NYS Teacher's Retirement System, 2007, Commodity Systems, Inc, 1998-2007.

However, future pension liabilities, regardless of sector, are more bond-like in character with payout schedules that span years, even decades, thus requiring predictable and ongoing cash flows and income streams. Equities, by contrast and definition, run the gamut of market surges and declines. The resulting mismatch is telling. The higher the level of equity exposure in a pension investment arrangement, the closer its fortunes become tied to those of the market. From 2003 onward, TRS performance returns fell well short of the actuarial requirements of 8%. The drop in share prices necessitated substantial inflows from state employers to replenish losses in the equity portion of the TRS portfolio.

On the corporate side, as we have seen, present value discount rates are set against risk free 30-year Treasury bonds. The yield on a thirty year Treasury bond is currently 4.42%[11], roughly half the discount rate in the public sector. While a lower discount rate drives present value contribution rates for corporate DB plans to much higher rates than similar plans in the public sector, there is much more flexibility in making up present value pension losses incurred during market downturns. Corporations can modify, freeze or even terminate their DB plans in accord with corporate profit projections. While ERISA funding, reporting and disclosure requirement do come into play, the rules are flexible enough to allow corporate boards to decide funding levels and ongoing funding commitments, especially during profit downdrafts. Nationally, a 2005 study estimated that corporate DB plans are under-funded by an estimated $450 billion, which, of course, fluctuates with market values of equity-based portfolios.[12]

While such board room flexibility is a rarity in public sector plans, the maintenance of appropriate funding levels is equally suspect. In the most recent Public Fund Survey compiled for FY 2006, 48 of the 118 public sector DB plans surveyed, or 41% of the total, were funded at 80% or lower. The median funding level for the 118 plans came to 83.5%, according to actuarial estimates. The funding rate range of the survey goes from a stated high of 109.2% (Maine Local) to a low of 31.6% (West Virginia Teachers).[13] The public sector, just as the corporate sector, is replete with funding horror stories. San Diego's overall financial woes forced the city

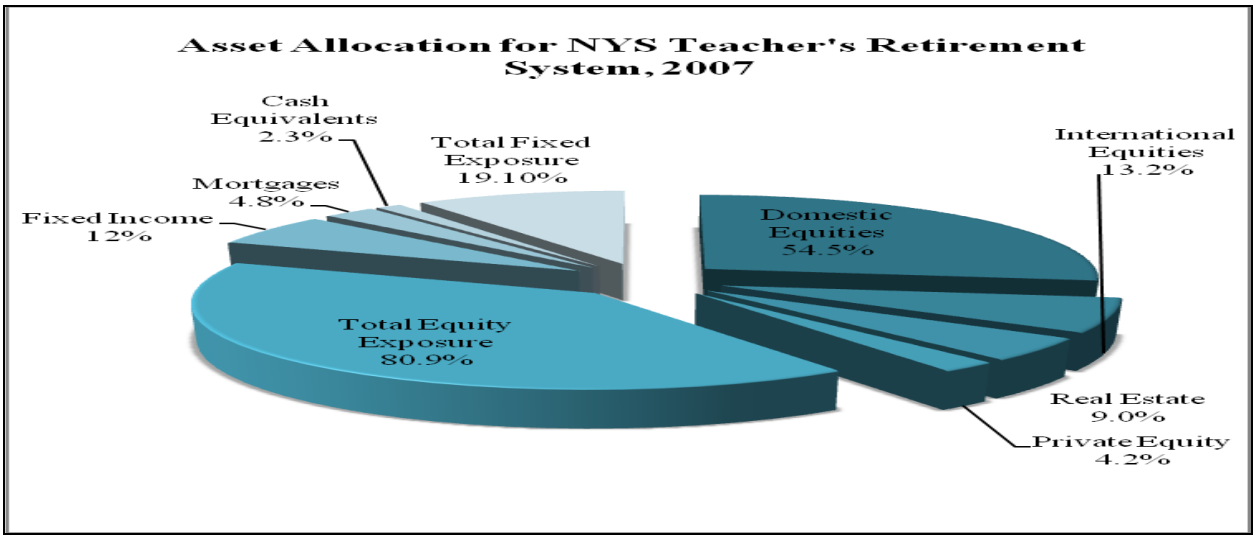
[11] As of 1 March, 2008.
[12] Theo Frances, "Legislation Weakens Pension Projections," *Wall Street Journal* (18 January 2006), p. D1.
[13] "Public Fund Survey Summary of Findings for FY 2006," *Public Fund Survey* (October 2006)

to commit 8% of the municipal budget in 2005 and subsequent years to meet the present value costs of legislative promises to its city employee retirement fund. Illinois was under-funded by estimates that topped $38 billion.[14] New Jersey recently faced an estimated $25 billion shortfall in pension contributions.[15] Yet, unlike the corporate sector, the funding of public pension plans is much more jurisdictional. San Diego city tax payers will fund the shortfall of the city's municipal retirement fund. Similarly, Illinois residents will most likely be called upon to make up the difference between assets on hand and future state obligations. And the same goes with New Jersey residents.

In New York State, contributions to the New York State Retirement System come from local governmental employers, which include school districts statewide. These contributions draw primarily upon a combination of sales and property tax receipts. When faced with severe market downturns and/or recessionary periods—or both—contributions to meet pension requirements, with few exceptions, continue even in the face of vastly reduced local governmental resources. In such times, local governments turn heavily to recession-proof property tax receipts, further pressuring the upward spiral of tax levies statewide.

How large is the TRS commitment to equities? According to their 2007 annual report, TRS committed over 80% of their pension dollars to equities (see Table 7), while the fixed or

Table 7



New York State Teacher's Retirement System Annual Report, 2007

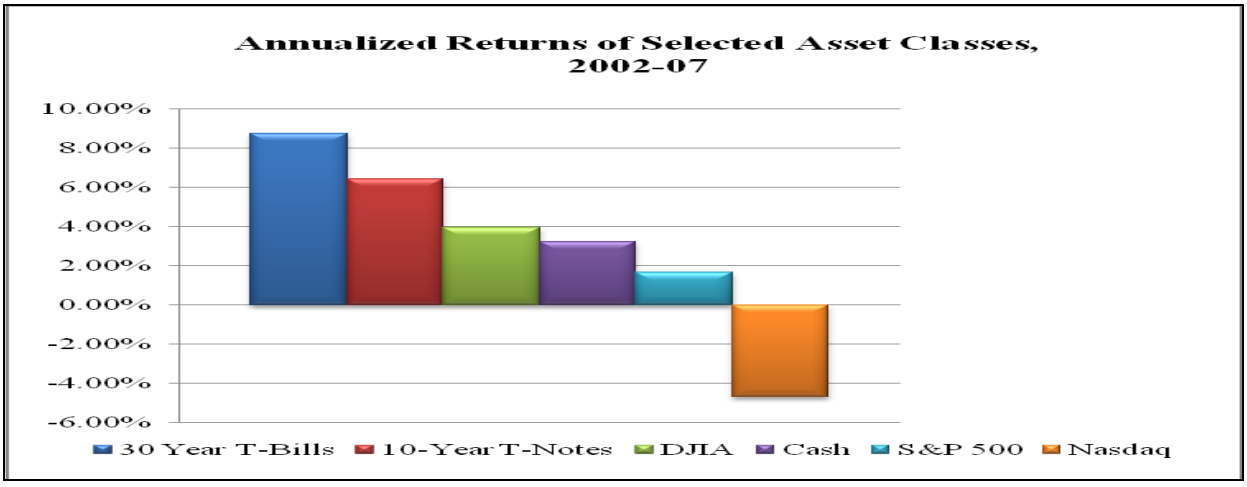
income generating investments constituted about 19% of the portfolio mix. Given the large commitment to an equity based asset allocation, the question becomes, can the portfolio generate enough of a return in up years to compensate the plan for down years—without resorting to substantial replenishment? Following market trends since the recession of 2001, contributions from school districts to TRS began to jump dramatically in 2003-04 from 0.36% to 2.52% of total payroll. From 2004 through June of 2007, the increase of payroll contributions increased cumulatively by over 35% to 8.60% of total payroll. From 1996-2007 these pension contributions logged an annual growth rate statewide 8.80%, according to the New York State

[14] Roger Lowenstein, "The End of Pension Plans?" *New York Times Magazine* (30 October 2005), p. 63.
[15] Steven Greenhouse, "Transit Strike Reveals National Pension Woes," *New York Times* (24 December, 2005)

Office of the Comptroller. The annual growth rate of pension contributions for the 11 year period is two to three times the CPI and about three to four times the PCE. The equity growth strategy of TRS appears not to be providing the reduction in local contributions that would otherwise justify such an investment mix.

Of course, one of the main reasons why the TRS portfolio is requiring ongoing capital replenishments amplifies the challenges faced by portfolio managers the world over. Investing in markets with peak and trough spans exceeding 36% is difficult by any stretch. Fashioning an investment mix that will perform to expectations requires both skill and fortitude, not to mention luck. Market conditions might call for a concentrated portfolio mix even though such a strategy flies in the face of most asset allocation models that fervently preach the gospel of diversification. The second quarter 2002 trough through the second quarter 2005 peak, coincidently represents the years of the recently concluded US housing boom. The Federal target rate stood at 1% in November of 2003, creating an investment environment for equities not seen since the post WWII era. And true to form, the S&P benchmark rose about 40% in

Table 8



Bloomberg, Morningstar

market value. Despite a doubling in market in the five years that ended in 2007, the annualized return of equities as measured by the performance of the S&P 500 were about a fourth of the yield of a 30-year Treasury bond (see Table 8).

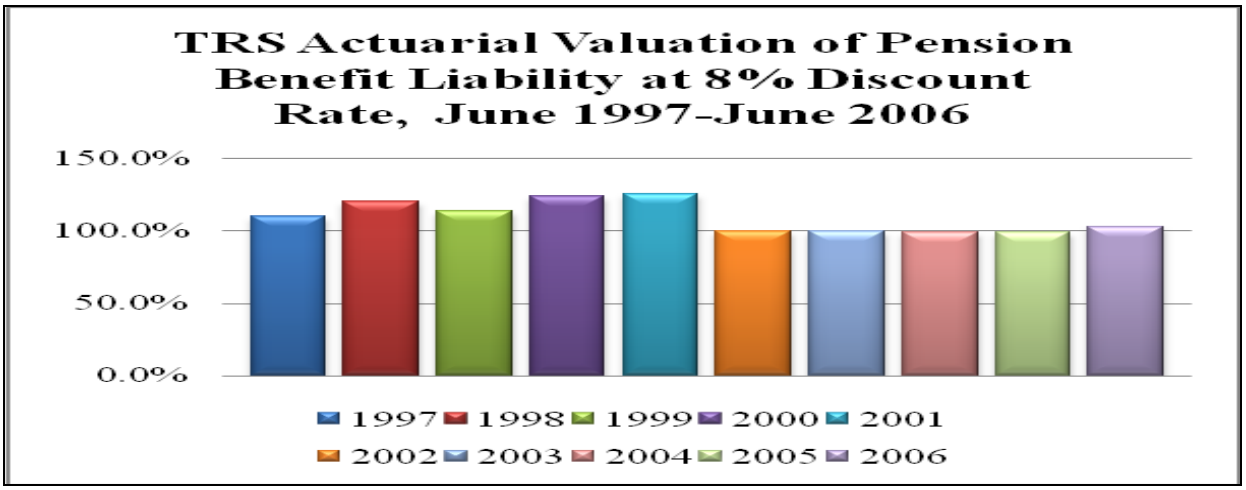
VII. Defined Benefit Discount Rates

As we have seen, there is a big difference in the present value discount rates used by corporate and public DB pension plans. The reasoning behind the difference is rather telling. The higher the discount rate, the lower the present value level of contributions required to maintain the projected viability of delivering future obligations. The idea is to substitute lower present value taxpayer contributions in hopes that market appreciation and rising markets will combine to provide the necessary funds to maintain a sustainable level of plan funding over time.

The tradeoff assumes a greater level of volatility when markets fall. Matching taxpayer contributions to a more bond-like portfolio mix would, without question, require a substantial increase in contributory rates, making such a policy option politically untenable. However, as annual actuarial adjustments attempt to smooth market ebbs and flows, greater taxpayer inputs to make the plan "whole" quickly become a foregone conclusion.

TRS falls neatly into this pattern. Using an eight percent discount rate to determine the viability of the plan over time, the period of 1997-June of 2006 saw the median funding level of

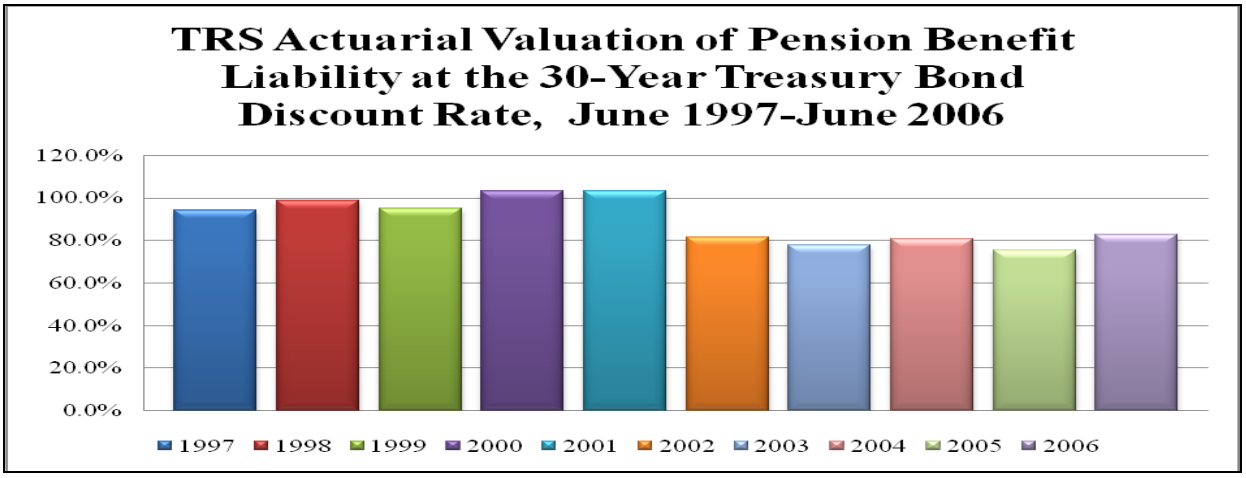
Table 9



NYS Teacher's Retirement System, 2007

106.45%. For 2002-2006, TRS funding level came in at 99.4% (see Table 9). Using a 30-year Treasury bond, as you might expect, lowers these funding levels considerably. The median

Table 10



New York State Teacher's Retirement System, 2007, Commodity System, Inc. 1997-June 2006.

funding level falls about 20% to 88.40% for the ten year period. Over 2002-2006, the median funding level drops even further to 80.50%, a difference of over 23% (see Table 10).[16] All things held equal, TRS investment strategy, especially in the current market turmoil, appears poised to draw heavily upon increasing taxpayer inputs for the foreseeable future.

VIII. What is to be Done?

Just as the New York State Legislature found economic necessity the mother of invention in the fiscally dark years of 1973, 1976 and again in 1983, 2008 needs to bring forth a new benefit tier—Tier V. Tier V should embrace the following characteristics:

- The New York State Retirement System, which includes TRS, should now offer *only* a defined contribution, 401(k) pension program to all new hires, with dollar matches to employee contributions to the plan up to a prescribed level;
- New York State Retirement Benefits for future hires should be fully taxable under the New York State Income System;
- All retirees drawing benefits from Tiers I-IV should continue to receive the pension payouts outlined by their respective tier benefit level;
- Current employees of Tiers II-IV should continue to accrue the benefits outlined by their respective tier benefit level;
- New York State Retirement System should sponsor comprehensive and on-going financial planning for all its employees.

Offering a new benefit tier gets around the constitutional mandate that proscribes "impairing or diminishing"[17] the pension benefits of current public employees. By offering only a defined contribution 401(k) program to all new hires, current public employees are neither impaired nor diminished by the new pension program as prescribed by current law. By allowing current tiered employees to continue to accrue benefits, Article 5 challenges to Tier V also appear to be mitigated.

Grandfathering all existing benefits is a constitutional necessity. While the expense of meeting the level of these benefits will remain high in the near term, attrition and retirement appears likely to cap further TRS growth. As we saw in TRS salary levels, the effect of attrition and retirement continues to place downward pressure on salary growth rates that approach two percent per year over the ten year period ending 2005. Accordingly, there is reason to believe that a similar pattern will emerge with respect to the accrual of pension benefits by current tiered TRS employees. For example, if attrition and retirement indeed replaces teachers at a 6% annual rate statewide as one study suggests,[18] TRS's transition to a DC pension plan for all current staff could largely be in place by 2020, about twelve years out. If you add a phased buyout of high

[16]Robert C. North, the chief actuary for the City of New York was roundly criticized for running a similar exercise using the New York City pension plan back in the summer of 2006. By using a treasury discount rate, he exposed a potential $49 billion pension funding gap, a sum that almost rivaled the entirety of the City's annual budget at the time. See Mary Williams Walsh, "City Gets a Sobering Look at Possible Pension Troubles," *New York Times* (20 August 2006)

[17] See Article 5, Section 7 of the New York State Constitution.

[18]One recent study by the *Citizens Budget Commission* estimated the attrition rate of the New York State Retirement System at roughly 6% annually. See Elizabeth Lynam, "The Myth of Uncontrollables,"(May 2005), p. 4.

service employees with discounted future benefits to the mix, the effective transition could happen even sooner.[19]

The benefits of a Tier V solution as a first step toward containing the cost of spiraling pension benefits are many.

I. *From a fiscal standpoint, DC benefits are now quantifiable and transparent*. The amount of money contributed to individual TRS accounts would be both determined and predictable annual payments. These committed funds would be matching funds—triggered by the tax-deferred salary reductions of the employee participant. The uncertainty of future value actuarial calculations would, over time, disappear completely as attrition and retirement completes the transition from a DB to a DC pension mix.

II. *The outsized costs of administering DB plans in general should diminish and eventually disappear completely over time.* The cost of retaining actuaries, the main cost inflator in, and a requirement of, DB plans is completely absent in the administrative costs of a DC plan, providing an immediate and not insignificant cost saving.

III. *The tax dollar outlay of matching employee contributions in a DC plan could be a fraction of the outlay an individual retirement account under the current TRS DB plan.* The expense associated with funding 60% of the final salary of a 30-year service employee retiring at age 55 over a life expectancy of thirty plus years is significant by any measure. Consider a TRS employee retiring at age 55 after 30 years of service with an accumulated salary level of $80,000 for pension purposes. Sixty percent of that ending salary comes to $48,000 per year.[20] The future value of the sum over the course of a thirty year expected lifespan, inflating at an annual rate of 1.5%[21] comes to total outlay of $1,801,856. While lacking precedent in the corporate world, let's say TRS sets up a dollar for dollar match on a sliding scale determined by overall pay scale up to the maximum limits allowable by law. For our example, the TRS employee contributes an annual sum $7,000, and TRS matches the contribution dollar for dollar. Over the thirty year tenure of the TRS employee, the match would total $333,027, assuming a 3% annual inflator. The TRS match would be a princely match by corporate standards, but would reduce taxpayer costs five times over.

IV. *A DC Plan largely equals the total payout of a DB plan at a fraction of the cost to taxpayers.* Let's consider a very simple future value calculation under the two plans. Lets use the same example outlined above, the DC employee investing $7,000 with a matching $7,000 TRS contribution. To equalize the two programs, the DC investor would need a 8.69% annual return to provide $1,801,856 outlay of the DB plan in thirty years. Consider another option. Under the DB plan, the benefit payout begins at age 55, for example, and spans the actuarial lifespan of the employee, say to age 85. The payout is an annuity

[19]Allowing current tiered employees to continue to accrue benefits poses a less radical solution than that tried in Michigan in 1997. The Michigan plan provided a window for employees to shift their personal DB contributions to their newly established DC accounts. Further, all future benefits were discounted into a lump sum and contributed to employee 401(k) accounts, which largely ended all of Michigan's DB obligations in a single legislative stroke. See the work by EJ McMahon and Peter Ferrara, "Defusing the Pension Bomb," *Manhattan Institute for Policy Research* #40 (November 2003).

[20] The fact that pension benefits are not exposed to New York State taxes provides a $3,288 annual addition to the benefit, bringing the total to $51,288. New York State pension benefits are fully taxable on the federal level.

[21] Cost of living computations are complicated and subject to both eligibility requirements and the rate of increase of the CPI on a March to March basis. For 2007, for example, the COLA rate is 1.40%. For simplicity, a 1.5% inflator should capture the flavor of the COLA calculations.

stream that guarantees $48,000 per year. With the 1.5% inflator, the future value of the benefit comes to $1,801,856. Under a DC plan, the example gets the thirty year in-service employee to age 55 with a future value benefit of $1,209,248, which assumes a 6.5% annual return on assets. At the age of 55, the 401(k) account rolls to a qualified annuity with a ten year surrender period. A ten year surrender option and a million dollar plus initial investment adds 3% to the investment, or $36,277, bringing the total sum to $1,245,525. Withdrawals above 10% during the first ten years, of course, trigger surrender charges of varying amounts. However, most industry experts agree that a retiree shouldn't withdrawal more than 4% of retirement income for sustainability purposes.[22] Using a 4% withdrawal rate on a lump sum investment of $1,245,525 yields an annual income of $49,821, which is a 62.3% income replacement rate. At a 6.5% annual return on assets and a 4% annual withdrawal rate over the 30 year lifespan of the retiree, the annuity account has a $425,295 balance. The available percent range of withdrawals available to the DC plan retiree is 4.00% to 4.78%, or an annual income range of $49,821 to $59,508. The higher the withdrawal rate, the lower the remaining balance at the end of the thirty year period, all other factors held equal. The annuity package, of course, comes with professional money management for the duration.

V. *The investment risk is no longer borne solely by the taxpayer*. Under a DC plan, the investment risk shifts to the employee. The taxpayer's responsibility under a DC plan is funding the matching dollars at whatever level the DC plan stipulates. The matching dollar costs of the program are legislatively fixed, annually determined, fiscally transparent—and totally predictable. There are no hidden costs or unexpected increases in the tax levies statewide to meet unexpected market downdrafts, investment strategy shortfalls or annual return deficits. The savings of local property tax dollars by homeowners appears sizable over time.

VI. *A DC plan could contribute significantly to stabilizing the local governmental budgetary process statewide.* When the cost of providing matching funding for education at the local level increases, the burden placed on governments to meet those rising costs create unpredictable budgetary pressures that are difficult to predict and manage effectively. Declining economic and market environments, such as those in 2001 and again here in 2008, exacerbate the problem. With falling receipts from sales taxes impacted by the fall in discretionary spending, the pressure on property tax receipts to plug budgetary holes becomes all the more intense. Lowering the present value pension costs through a DC plan could be a major first step toward adding stability to the budgetary process at the local level statewide. Again, the savings of local property tax dollars by homeowners appears sizable over time.

VII. *A DC plan could lower the long-term cost of government.* Switching from a DB to a DC plan could significantly lower the amount of debt that a local governments carry to meet its obligations. A lower debt load would have a positive effect on credit ratings, hence lowering the cost of bond issues for both capital projects as well as the costs of shorter term obligations where debt instruments are used.

VIII. *A DC plan is portable.* NYSSBA has already identified pension portability as a major problem in the delivery of benefits to its member employees. Currently, TRS's long vesting schedules usually preclude any benefit accruing to a non-vested employee except those made as required employee contributions. Once the TRS employee severs his/her

[22] Ibbotson Associates, AARP.

employment contract, the accumulated employee contributions and vested employer matching contributions contained in the DC account become eligible to roll into a personal IRA, without tax consequences.[23] Accordingly, TRS pension benefits become portable under a DC plan. Further, the ex-employee assumes full investment control over his/her retirement funds by rolling the funds into a personal IRA.

IX. Epilogue

The investment shortcomings and contradictions inherent in DB plans in general, and in public DB plans in particular, are far from imaginary and difficult to ignore. If you use realistic discount numbers, the sum total of obligations promised to the public employees of the State of New York simply exceed the ability of taxpayers to fund these future benefits by most reasonable measures. Public policy is simply kidding itself in thinking that the current DB pension system in the State of New York is economically sustainable. The question then becomes, when will public policy finally step up to the plate and pose a sustainable pension alternative that is better grounded in basic economic reality? A Tier-V program, duly outlined throughout the course of this paper, puts a face squarely on that reality. It's time we all embrace the issue at hand, gather the political will to act and boldly move forward. To do nothing is to profoundly burden future generations with the fiscal shortsightedness of generations past.

[23]Under the arrangement, a 1099 distribution is reported to the IRS by the state employer. The employee has a 60 day window to open a personal IRA to house the funds, thus avoiding ordinary income taxation and, if under the age of 59½, a ten percent tax penalty on the face amount of the transaction. The financial institution in receipt of the funds sends a second 1099 to the IRS which cancels the distribution notice sent by the state employer for tax purposes. The ex-employee now has the funds in a personal IRA without incurring taxes in the rollover transaction. The ex-employee also has the option to roll the proceeds into another 401(k) program at a new employer if the job separation did not entail active retirement from the workplace, again, without tax consequences.