

GARDEN STATE CROWD-OUT

How New Jersey's Pension Crisis Threatens the State Budget

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Before joining *City Journal*, Malanga was executive editor of *Crain's New York Business*, serving on the publication’s editorial board and writing a weekly column. Prior to that, he was managing editor of *Crain's*. During his tenure at the publication, it twice won the General Excellence Award from the Association of Area Business Publications. In 1995, Malanga was a finalist for a Gerald Loeb Award for Excellence in Financial Journalism for the series “Nonprofits: New York’s New Tammany Hall,” which he coauthored. In 1998, a series he coauthored, “Tort-ured State,” about the influence of trial lawyers in New York State, was voted best investigative story of the year by the Alliance of Area Business Publishers.

Malanga has written for the *Wall Street Journal*, *Los Angeles Times*, *New York Times*, *New York Daily News*, and *New York Post*. During 2007–13, he was a regular columnist for RealClearMarkets. He holds a B.A. in English literature and language from St. Vincent’s College, as well as an M.A., in the same subject, from the University of Maryland.



Josh B. McGee is a senior fellow at the Manhattan Institute and vice president of public accountability at the Laura and John Arnold Foundation. McGee was appointed in 2015 to chair the Texas Pension Review Board by Governor Greg Abbott, with his term ending in 2021. His research on retirement policy, K–12 education, and economic development has been published in various scholarly journals, including *Education Finance and Policy*, *Journal of Development Economics*, and *Education Next*. McGee’s popular writing has appeared in *National Affairs*, *Dallas Morning News*, *Philadelphia Inquirer*, *Atlanta Journal Constitution*, and *Houston Chronicle*. He has provided expert testimony and technical assistance in more than 50 jurisdictions and routinely speaks to the media on retirement issues and K–12 policy. McGee holds a B.S. and an M.S. in industrial engineering and a Ph.D. in economics, all from the University of Arkansas.

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Executive Summary

New Jersey is generally acknowledged to have one of America's worst-funded government-worker pension systems. An April 2017 report by the Pew Charitable Trusts found that the state's public-employee pension systems had the lowest funded ratio of any state.¹ A recent Standard & Poor's report estimated New Jersey's net pension liability—the amount it owes workers and retirees in excess of its assets—to be \$124 billion² and put the state's pension funding status at just 30% of the money that it needs to pay future obligations.

How New Jersey got to this point is a tale of elected officials willing to grant retirement benefits to workers without having the money to pay for them, as well as a tale of public-employee groups negotiating benefit enhancements even when it was clear that there was no funding source for them. When state leaders, urged on by voters, attempted to address this problem with reform legislation in 2010 and 2011, the new plans employed questionable accounting standards that painted an overly optimistic picture of the future of the state's pension system. A weak national economic rebound, which has constrained the recovery of state and local tax collections, has also made it difficult for New Jersey to stick to a schedule of fixing its pension system by increasing contributions to it.

Since 2014, it has become clear that New Jersey needs a new strategy to address its pension problems. A commission created that year recommended further cost-saving reforms, but political opposition stymied the proposals. With the state's pension debt continuing to grow, in 2017 New Jersey set out yet another plan to begin paying off its enormous pension debt. But adhering even to this latest plan will be enormously challenging:

- ✓ As this report demonstrates, to stay on pace to reach the new plan's required yearly contributions into the pension system by 2023, state government must increase the revenue that it dedicates to its pension system by more than threefold. At that point, pension payments could equal 12%–15% of New Jersey's budget.
- ✓ Based on the historical growth of New Jersey's revenues, rising pension payments alone will likely consume virtually all the state's additional tax collections over the next five years, even under an optimistic scenario where tax collections accelerate. That would leave little money for increasing funding of local schools, higher education, municipal services, or property-tax relief.
- ✓ If the economy were to experience even a mild recession, the resulting slowdown in tax collections would likely mean that New Jersey would fall short by at least an additional \$3.5 billion in meeting its pension obligations, sparking a more substantial rise in new pension debt.
- ✓ After years of relying on unrealistic investment assumptions, New Jersey recently cut its projected rate of investment returns to a more realistic 7%. Even so, this is higher than forecasts made by independent experts for pension fund performance over the next five to 10 years. If the outside experts are correct, the investment returns on the state's pension portfolio will fall significantly short, requiring New Jersey to dedicate further tax revenues to its pension system or allow additional new debt to pile up—a dangerous situation because the system's funding levels are already so low that some pension experts fear that fixing a system this poorly funded is nearly impossible.

New Jersey's governor-elect, Phil Murphy, who takes office in January 2018, pledged during the gubernatorial campaign that the state would fulfill its commitments to the pension fund. Yet he has not described how he would pay for those commitments. Murphy has proposed \$1.3 billion in new taxes, though he has already targeted some of that money for other new spending initiatives. Most important, Murphy has not pledged to seek further cost-saving reforms of the type recommended by the New Jersey Pension and Health Benefit Study Commission.

Absent some unexpectedly robust acceleration of the economy, it is highly unlikely that New Jersey will generate enough new revenues to meet its pension commitments without severely hobbling the rest of the state's budget. At the same time, allowing its pension system to continue to accumulate debt by not contributing adequately to it will push New Jersey toward a potentially catastrophic failure of its government pensions.

GARDEN STATE CROWD-OUT

How New Jersey's Pension Crisis Threatens the State Budget

Digging the Pension Hole

New Jersey established its first employee pension system, the Teachers' Retirement Fund, in 1919. From 1941 to 1965, it added state-administered pension programs for prison guards, local police and fire personnel, general government workers, judges, and state police.³ New Jersey designed these programs as defined-benefit pensions, which award a worker a stream of income in retirement based on a predetermined formula that takes into consideration an employee's years of service and earnings history. One purpose of these programs was to allow local governments that had created their own independent pension systems to close them and consolidate their operations into a centralized state-run system.

Once New Jersey centralized its various pension systems, the state legislature began enhancing benefits, starting in the late 1950s. Between 1958 and 1971, New Jersey increased benefits for one or more of the state's pension funds 10 times; during the rest of the 1970s, it enacted an additional four enhancements. Meanwhile, as New Jersey's government grew, membership in its pension system soared, rising by 134% from 1961 to 1971.⁴

In 1981, state treasurer Clifford Goldman, noting the "explosive growth" of pension costs, urged New Jersey to enact "fundamental change" in the benefits that it offered. Three years later, a pension study commission created by Governor Thomas Kean, noting that no items in the state budget had increased faster over the past 15 years than retirement and health-care costs, recommended a host of changes, including reductions in the pension formula; limits on cost-of-living adjustments; and mandatory employee-retirement savings plans to help workers save for retirement.⁵

Kean's reform proposals faced intense political opposition from employee groups, especially the New Jersey Education Association, which described the plan as "the most outrageous assault ever attempted on the state pension system."⁶ No substantive changes were enacted. Still, New Jersey's pension system could not escape economic reality.

The Hole Deepens

The slowdown in tax collections that accompanied the steep local recession of the early 1990s, combined with continued rising pension costs, placed new burdens on the state budget. Beginning in 1992 and continuing throughout the decade, elected officials turned to the pension system as a tool to help solve the state's budget woes. The Pension Revaluation Act of that year changed the method by which the state valued its pension assets, switching from book value (the initial purchase cost) to market value (the current value). The legislation also increased the projected rate of investment returns, from 7% to 8.75% annually.⁷

Both moves made the system appear better funded than it was. Subsequently, New Jersey reduced its pension contributions, as well as those of local governments, by \$733 million in 1992 and by \$785 million in 1993.⁸ The accounting gimmicks did not go unnoticed. Moody's cut its credit ratings on New Jersey debt, citing, in part, the changes wrought by the Pension Revaluation Act.

Along with other states in the mid-1990s, New Jersey turned to a relatively new funding technique, pension obligation bonds (POBs), which are debt instruments that states and localities issue to raise money for their pension systems. POBs carry considerable risk: pension systems essentially borrow money in the bond market and bet that they can earn more through investment returns than the interest that they have to pay on the debt. Between 1994 and 1997, state and local governments issued nearly \$27 billion in these bonds—13 times greater than the total that governments had previously raised in the entire history of POBs.⁹

New Jersey resolved to employ POBs to eliminate roughly \$3 billion in unfunded debt in its pension system. The 1997 law authorizing the borrowing, the Pension Security Act, also allowed the state to use any surplus pension assets that resulted from investment returns on the \$2.7 billion in borrowed money to further reduce state contributions into the system.

New Jersey's subsequent holiday from pension contributions was dramatic. In the 10 years beginning in 1997, the state made only three contributions to its Teachers' Pension and Annuity Fund. During the same period, the state skipped contributions, in nine of 10 years,

for its Public Employees' Retirement System.¹⁰ As part of a deal to earn support from employee unions, the Pension Security Act allowed workers to reduce their contributions into the system. Crucially, in exchange for union support, New Jersey also agreed to give workers a statutory guarantee against a change in benefits once a government employee was vested in the system.

The Center for Retirement Research at Boston College warns that one risk of POBs is that they can make a poorly funded system seem well funded, which may prompt "unions and other interest groups [to] call for benefit increases, despite the fact that the underfunding still exists."¹¹ This is precisely what happened in New Jersey.

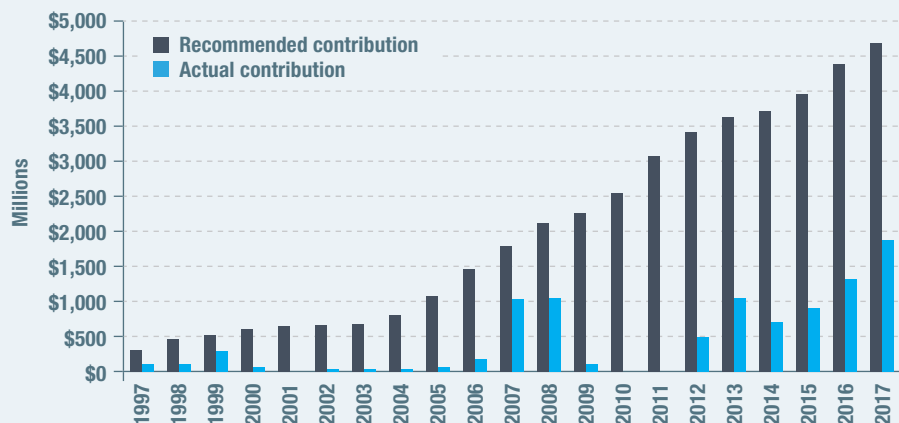
After selling the POBs, New Jersey officials expressed widespread optimism about the future of the state's pension system. The state deputy director of pensions and benefits wrote that the retirement system would remain in good shape "even if there is an economic slowdown in the near future. In fact, with current assets, the pension plans could pay out current annual benefits for over 20 years without another contribution or another dollar in investment earnings."¹²

One result of such assertions was that unions successfully lobbied for more benefits. From 1999 to 2001, New Jersey passed 17 pieces of legislation enhancing pension benefits, including a 9% increase in benefits in 2001. These enhancements added \$6.8 billion in new liabilities to the pension system.¹³

Trouble ensued almost immediately. Beginning with

FIGURE 1.

New Jersey's Pension-Funding Gap Explodes



Source: New Jersey Pension and Health Benefit Study Commission

the bursting of the dotcom bubble in 2000, stocks began a sharp two-year fall. New Jersey's pension fund portfolio registered investment declines of 10.4% in 2000 and 9% in 2001, followed by a gain of just 3% in 2002 (compared with a projected annual return of 8.75%). The combined shortfall of those years robbed the pension system of \$21 billion in assets, a 25% decrease.¹⁴ The system's surplus—\$7.5 billion heading into 2000—turned into a \$12.5 billion unfunded liability by 2005.

Those declines sharply increased the money that the system required during the economic slowdown of 2001–03, when state and local government could least afford it. In 2005 and 2006, annual required contributions were, respectively, \$1.1 billion and \$1.5 billion, up from \$500 million in 1999. By 2010, contributions that New Jersey needed to pay for pension credits that workers were earning, as well as to address the system's debt, reached \$2.5 billion.

Such contributions were well beyond the state's ability to pay—so it didn't (**Figure 1**). From 2001 to 2010, New Jersey contributed only \$1.6 billion of the \$12.7 billion that its actuaries estimated the system needed to fund current workers' pension credits and dig its way out of mounting liabilities.¹⁵

Reform Fails

Throughout this period, the state was aware that it was facing a crisis. In 2005, acting governor Richard Codey convened a commission headed by then-Goldman Sachs executive Phil Murphy to study the cost of New Jersey's retirement systems and health benefits. The study urged the state to immediately end pension holidays, eschew actuarial gimmicks, and eliminate pension bonding. It also recommended a series of reforms, including an end to pension "spiking" (by which employees boost their final salaries when they near retirement) and raising the age at which employees could retire with full benefits, from 55 to 60.¹⁶

The state legislature subsequently enacted a few reforms, including a defined-benefit contribution pension system for new legislators. But these changes had little impact on the state's portion of pension debt, which more than doubled during 2005–10, to \$25 billion. Meanwhile, the pension system's funding status declined, from nearly 80% to 65%.

In 2011, New Jersey attempted to dig the state out of its pension hole. Changes included raising the retirement age to 65, suspending annual cost-of-living adjustments,

increasing the period over which a new retiree's pension is calculated (from the last three years of service to the last five years), and lowering the multiplier used to calculate a final pension (from 1.81% to 1.67%).¹⁷ Alas, the 1997 guarantee obtained by employee unions (prohibiting changes to the rate of benefits for workers vested in the system) muted the impact of the 2011 reforms. Nearly nine in 10 workers were unaffected by most of the benefit reductions enacted in 2011, while total savings amounted to only \$11 billion.

Embedded in the 2011 reforms, moreover, were questionable changes to the pension system's accounting. The state, for instance, changed to a 30-year "open" amortization schedule to pay off the system's debt.¹⁸ In this format, a new 30-year debt schedule begins each year—analogueous to a homeowner with a 30-year mortgage refinancing every year into a new 30-year mortgage, thereby endlessly pushing out the full repayment date.

The 2011 reforms also set an unrealistic 7.9% annual investment target. New Jersey's actuary, Milliman, subsequently wrote: "Based on our most recent analysis, this assumption is outside our reasonable range."¹⁹ In response to such criticism, the state eventually reduced its investment target to 7.65%, and only recently cut it further to 7%, which now places its projected rate of return below the median for state pension funds.²⁰

Acknowledging the steep cost of fixing its pension system even with a generous investment target, New Jersey gave itself seven years to gradually ramp up to full contributions into the pension system. The goal: make one-seventh of the annual actuarially recommended contribution in year one, two-sevenths in year two, and so forth until 2018, which meant that the system would continue taking on new debt even as the state made its mandated payments.

Faced with a weak economic recovery and serious budget problems, New Jersey kept to the new funding schedule for only two years, contributing \$500 million of the \$3.4 billion actuarially recommended contribution in 2012, \$1 billion of the \$3.6 billion actuarially recommended contribution in 2013, and \$700 million of the \$3.7 billion actuarially recommended contribution in 2014.²¹

Recognizing the growing burden of the pension system on the state budget, Governor Chris Christie created, in August 2014, the New Jersey Pension and Health Benefit Study Commission to recommend further reforms. "The fact is that unless there are changes made to the system itself and the benefits that it promises, we cannot tax our citizens enough, even if we wanted to, to be able to pay for what's down the road,"²² said Christie.

In its first report, the commission acknowledged: “The public employee pension and health benefit systems of the State of New Jersey face problems that are dire and likely to worsen unless action is taken.”²³ In February 2015, the commission issued a second report, which noted that under new, more stringent, accounting rules issued by the Government Accounting Standards Board, the unfunded liability of New Jersey’s pension system was now \$83 billion.²⁴ The report estimated that it would cost the state \$8 billion annually to fully fund its promised retirement benefits, including health care for retirees. The commission declared the \$8 billion figure to be “unsustainable.”

Why the Latest Reform Will Fail, Too

New Jersey operates five pension plans for state and local workers with active members: the Public Employees’ Retirement System (PERS), the Police and Firemen’s Retirement System (PFRS), the Teachers’ Pension and Annuity Fund (TPAF), the State Police Retirement System (SPRS), and the Judicial Retirement System (JRS). PERS and PFRS also enroll workers employed by municipalities, which are responsible for funding the pension credits that those municipal workers earn.

Despite consistently failing to make its required pension contributions, New Jersey largely required its municipalities to meet their own required pension contributions. As a result, the municipal portion of New Jersey’s pension system is better funded than the state’s portion. Although municipalities still face increasing contributions in coming years because of the system’s unrealistic assumptions, it is the state that must deal with exponential increases in annual pension contributions that could prove ruinous to New Jersey’s budget. This report, therefore, focuses on the state’s funding problems.

Desperate Measures

Having failed to meet the schedule of pension contributions that it set for itself in 2011, New Jersey has adopted yet another contribution

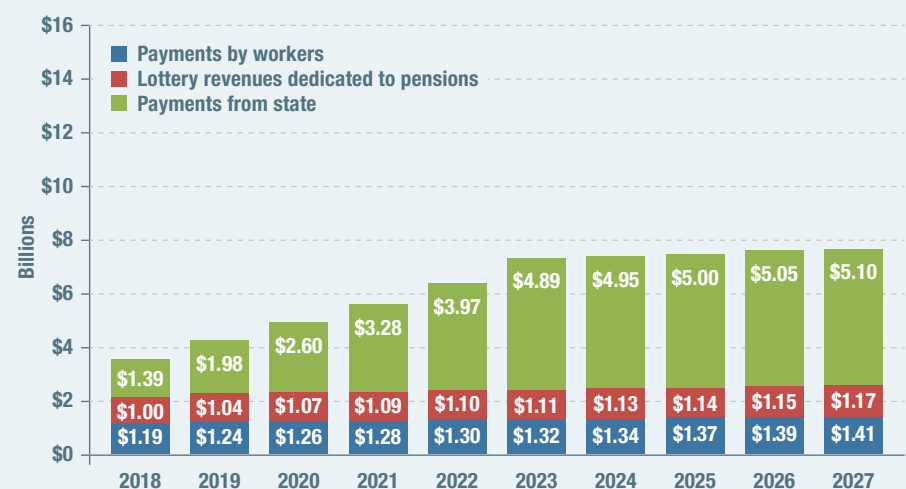
plan. As part of that effort, the state in 2017 passed the Lottery Enterprise Contribution Act, which dedicates the proceeds from New Jersey’s lottery to its pension system for the next 30 years.²⁵ The profits of the state lottery, which takes in about \$1 billion annually, were previously used to fund K–12 and higher education. As part of its latest pension contribution plan, New Jersey obtained a \$13.6 billion valuation for its lottery, based on projected future cash flow; the state then claimed that value as a new asset in its pension system.

By the state’s reckoning, the maneuver increased the funding level of the combined pension systems to 59% in 2016. Ratings agencies were less impressed. Municipal Market Analytics noted that the maneuver “places a roughly \$970 million burden on New Jersey’s general fund budget to pay for the programs formerly covered by the annual lottery proceeds.”²⁶ And Moody’s observed: “The lottery transfer does not change the state’s weak, albeit steeply rising, pension contribution schedule.... [T]here remains considerable risk that the state will be unable to afford rapidly growing pension contributions.”²⁷

One reason for the skepticism: New Jersey’s pension system remains so steeply underfunded that the annual contribution necessary to begin reducing the unfunded liability dwarfs the revenues generated by the lottery. Lottery profits constitute only about one-fifth of what New Jersey needs to contribute annually (**Figure 2**), and the state would need to maintain that required level of contributions for 30 years.

FIGURE 2.

Raiding the Lottery Will Not Fix the Crisis



Source: New Jersey Public Employees’ Retirement System



STATE LOTTERY

WINNING NUMBER

7

SUN

10
TEN

\$1,000

ONETHO

11
ELE

\$50

FIFTY

WINNING NUMBER

6

SIX

7

SUN

\$1

ONEBOL

THODOL

2290

1111

As a result, even with the new revenue stream, New Jersey admits that it will not be able to make a full contribution into the pension system, as recommended by its actuaries, until 2023—at the earliest. Thus, for the next five years, the system will continue to take on new unfunded debt even if New Jersey sticks to its plan to gradually increase contributions and even if the pension system hits its investment targets. Only if the state substantially surpasses its investment goals over the next five years will its pension debt decline.

Garden State Crowd-Out

Here is how the math works. For fiscal 2017, the state budget collected \$34.4 billion in revenues and contributed \$1.9 billion to pensions. That's just 40% of what the state's actuaries determined New Jersey needed to pay in order to fund new pension credits that employees were earning and begin to pay off the debt in the system; the amount the state did contribute represents 5.5% of state revenues.²⁸ By 2023, when the state has pledged to make full payments of its required contribution, New Jersey would have to put \$4.9 billion of state revenue into the retirement system—a figure that does not include the lottery contribution. Thus, under optimistic economic scenarios, required pension contributions could easily gobble up 12% of the state budget.

In the last 10 years, New Jersey's revenues have grown by less than 1% annually. Not only has the state been plagued by a steep decline in tax revenues that began in 2009 and extended through 2010, but its recovery, beginning in 2011, has been noticeably weak. In this, New Jersey is not alone. "U.S. states have entered a new era characterized by chronic budget stress," S&P Global Ratings noted in 2016. "Slower revenue growth, declining worker-to-beneficiary ratios in state retirement systems, and rising Medicaid enrollments are widespread and have meant that fiscal stress is no longer confined to recessionary times."²⁹

Adjusted for inflation, it has taken states' revenues nearly twice as long to recover from the Great Recession as it did during the previous two recoveries. Most worryingly, after a nine-year expansion, the next recession may not be far away. Unfortunately, New Jersey is particularly poorly positioned to absorb another economic downturn. Moody's recently ranked New Jersey as one of the states that is least prepared to weather another recession, even a mild one, based on its current finances.³⁰

While it's impossible to know precisely how much New Jersey's revenues will grow in the ensuing five years,

FIGURE 3.

Projected Revenue Growth and Required Pension Contributions (Millions of \$)

	1% Rev. Growth	2% Rev. Growth	3% Rev. Growth	Pension Increase
2019	\$356	\$712	\$1,068	\$589
2020	\$360	\$726	\$1,089	\$615
2021	\$363	\$741	\$1,111	\$679
2020	\$367	\$755	\$1,133	\$694
2023	\$370	\$771	\$1,156	\$922

Source: Author's projections based on data from the 2017–18 Budget of State of New Jersey

it is possible to make some estimates (**Figure 3**). If the state's financial resources were to increase in the next five years by the same rate that they've grown during the last five, which constitute the most robust years of the current recovery, New Jersey's revenues would reach about \$40.4 billion by 2023. At that level, a \$4.9 billion taxpayer contribution to pensions—what the state now promises it will make—would constitute nearly three times the share of the budget that pensions currently command. The pension contribution alone would virtually consume all the state's projected revenue growth over the next five years, leaving no money for other spending growth.

That's a startling fiscal scenario that would occur even if the current economic expansion continues more or less unabated. Under the unlikely scenario that the expansion not only continued for another five years but that the rate of revenue growth accelerated, averaging 3% compounded annually, pension costs would eat up almost two-thirds of all state revenue growth. In that unrealistically optimistic scenario, New Jersey would have just \$2 billion over five years (or an average of only \$400 million annually) in additional money to spend on pressing budget items, such as school aid, employee health-care costs, and capital projects.

If, more realistically, New Jersey experienced a modest recession sometime in the next five years, the situation would get much worse. Moody's predicts that New Jersey's tax revenue shortfall in a modest recession would amount to about \$3.5 billion.³¹ Under that scenario, the state would need to devote all its revenue growth plus another \$2 billion or so—presumably from tax increases or cuts to other spending—just to pensions to make up for the shortfall in revenues. That would mean no

additional money for employee health-care costs, for wages, for subsidized health care through Medicaid, or for local aid to municipalities and school districts. The only alternative: massive tax hikes or more rounds of delayed contributions to a pension system already facing decades of additional contributions in order to recover.

Governor-elect Murphy has proposed some \$1.3 billion in tax increases, which may figure into the fiscal picture. His proposals are speculative (he has suggested, for instance, that the state could raise \$300 million from taxing marijuana, which is not yet legal in New Jersey), and it's impossible to say precisely how any tax increase so large would affect the state's economy, potentially damping down economic activity. But even instituting what would be one of the largest set of tax increases in the state's history doesn't solve the huge pension-funding problem.

If New Jersey enacted \$1.3 billion in new taxes and the rest of its revenues continued to grow at the 1% rate that state revenues have averaged in the last decade, the state would see an initial extra \$1.1 billion after making its pension payments in the first year of the new taxes. But the money would quickly disappear after that, especially if New Jersey used the money to pay for new spending initiatives outside the pension system, as Murphy has promised. (He has pledged to direct some \$600 million in new tax money toward school aid.)

From 2019 to 2022, the surplus money from the tax

increase, if it were not spent on other items, would get eaten up by additional pension costs. By 2023, the growth in New Jersey's revenues would amount to only one-third of the scheduled rise in pension contributions, necessitating spending cuts or further tax increases (**Figure 4**).

Wishful Thinking

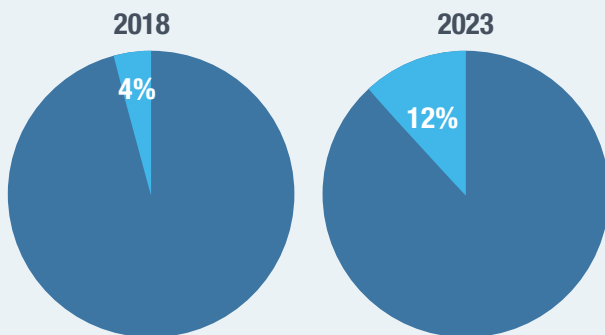
These unpalatable scenarios are all based on New Jersey's pension system achieving its own various assumptions, including its investment projections. As previously noted, until recently the state was estimating that it would earn an average of 7.65% a year in markets, better than most government retirement systems and some notable professional investors. The state's current plan for bailing out with the system with additional yearly contributions is based on that projection.

Now, however, in response to criticism, the state recently reduced its investment target to just 7% (**Figure 5**), compared to the median return rate projected by U.S. state and local government pension plans, which is 7.5%.³²

Yet even that return is optimistic. Based on the kinds of investments that public pension funds hold, Wilshire estimates that, on average, such funds might expect average investment returns of 6.4% over the next

FIGURE 4.

Pension Costs as Percentage of State Revenues*

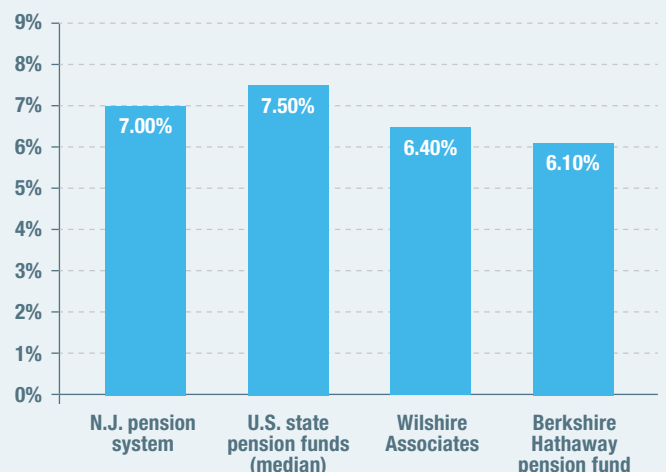


*Projections assume a 1% annual average growth in revenues

Source: Author's calculations based on data from the 2017–18 Budget of State of New Jersey and New Jersey Public Employees' Retirement System

FIGURE 5.

New Jersey's Investment Assumptions



Source: New Jersey Public Employees' Retirement System, Wilshire Consulting, Berkshire Hathaway

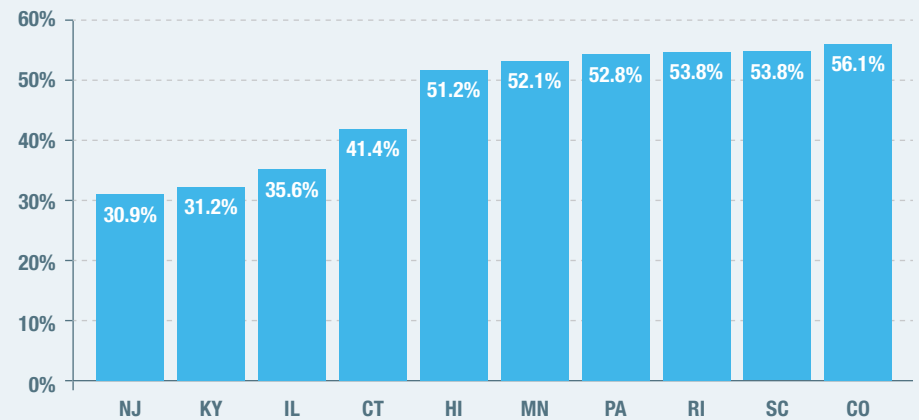
decade. Some top professional investors are still more conservative. Berkshire Hathaway, the giant conglomerate controlled by legendary investor Warren Buffett, has reduced the returns that it anticipates for its pension funds to 6.1% annually.³³ Such caution is partly a result of the fact that some market professionals see the likelihood of a decline in financial markets increasing over the short term because the current bull market is already nine years long.³⁴

The differences between these estimates and what New Jersey projects might seem small, but they are enormous in terms of the additional costs that they impose on the state. If New Jersey were to earn the average projected by Wilshire, it would need to contribute an additional \$2 billion of tax money into pensions over the next five years to make up for the slower growth in pension assets, and it would need to contribute nearly \$5 billion more over 10 years. The asset gap, over five years, would grow to nearly \$3 billion—and, over 10 years, it would grow to \$6 billion—in additional money that New Jersey would have to spend if its portfolio averaged a 6.1% return, the rate that Buffett projected for Berkshire's own pension system. The alternative would be to again fail to make contributions to the pension system adequate to bolster it, thus allowing the system's debt to continue growing.

Under any of these scenarios, the unfunded accrued actuarial liability (UAAL), i.e., the system's debt, would continue to grow at least until 2022. According to New Jersey's own calculations, even if the pension system were to hit its investment mark over the next five years, the UAAL would increase by another \$7 billion. If pension investment returns instead fell short and averaged Buffett's 6.1% target, the shortfall would increase by another \$3 billion.

FIGURE 6.

America's Worst-Funded State Pension Systems*

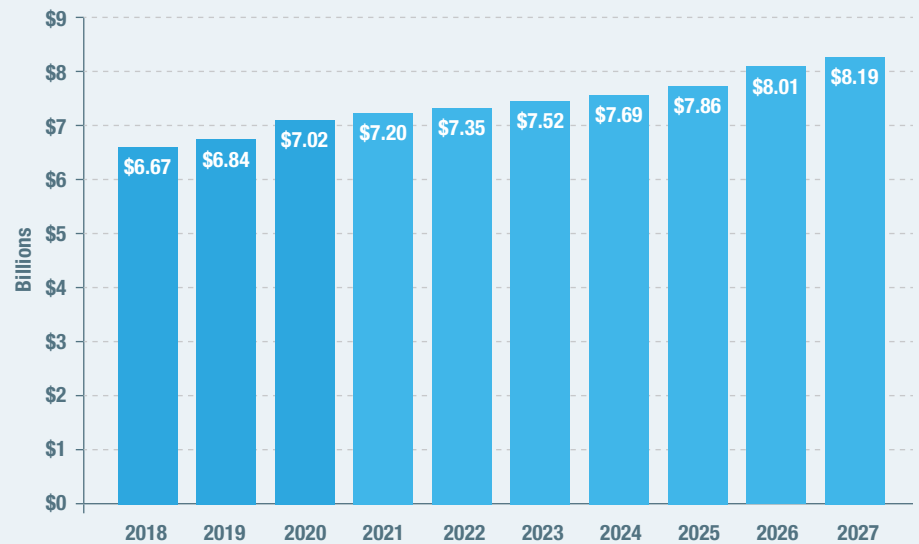


*Percent of future obligations funded

Source: S&P Global

FIGURE 7.

New Jersey's Ballooning Pension Payments, 2018–27 (Billions of \$)



Source: New Jersey Public Employees' Retirement System

Close to Tipping

At the (roughly) 30% funded level (Figure 6), as estimated in October 2017 by Standard & Poor's, New Jersey's pension system may have already reached an unfixable tipping point (Figure 7): the system is now missing so much money that even when it

achieves its investment goals, it falls far short of the money it needs to remain solvent over time.

In August 2015, officials at America's largest state pension fund, the California Public Employees' Retirement System (CalPERS), warned the fund's board members that because of the extreme volatility of financial markets, "if its [CalPERS's] investments drop below 50% of the amount owed for pensions, even with significant additional increases from taxpayers, catching up becomes nearly impossible."³⁵ A November 2015 *New York Times* article made a similar point. "You can't grow your way out [with higher investment returns]," observes a financial analyst in the article. "It's almost mathematically impossible to close the [funding] gap."³⁶

This is the huge risk that New Jersey now faces with its defined-benefit pension system that relies on investment returns to pay most of its obligations. While the pension credits that employees earn by coming to work every day are guaranteed, stock-market returns are not. That is one reason that critics of New Jersey's and other similar government pension systems urge more conservative assumptions that protect workers and taxpayers from risky projections that ultimately turn out to be too optimistic, which lead to underfunding that requires steep additional contributions.

Over the years, New Jersey legislators, often cheered on by the state's powerful unions, promised big benefits based on unrealistic assumptions.³⁷ When the state started falling short of its projections, rather than reform its system by lowering benefits and reducing its projections, New Jersey instead sailed forward on autopilot while its pension debt ballooned. The result: it is difficult to see an affordable fix for a system that is not only hugely underfunded but that takes on new debt every working day, as thousands of employees earn new pension credits.

Conclusion

Faced with the Garden State's ballooning pension costs, the New Jersey Pension and Health Benefit Study Commission ultimately recommended widespread changes to the state's pension system as well as additional cost-savings to employee health benefits.³⁸ The commission's recommendations included: replacing the defined-benefit plan with a new, less costly, cash-balance pension plan that is a hybrid of defined benefits and individual retirement accounts; reducing the cost of health-benefit plans provided to government workers to the same levels as those enjoyed by

private-sector workers at New Jersey's largest companies; and redirecting some of the resulting savings toward paying off the state's retirement debt. These changes, the commission estimated, would reduce combined pension and health costs for New Jersey by \$2 billion a year.

These sweeping proposals predictably provoked fierce resistance from public-sector unions and key Democratic lawmakers. Some New Jersey legislators instead proposed raising taxes to finance additional pension payments. Senate president Stephen Sweeney proposed lifting income taxes on those earning more than \$1 million, though the plan would have raised only \$675 million, far short of what would be needed to adequately meet the system's obligations. New Jersey has since made no progress toward finding a resolution to its pension problem; meanwhile, pension underfunding continues to grow.

The Rockefeller Institute of Government at the State University of New York defines a government pension system that's below 40% funded as in crisis.³⁹ New Jersey's pension system is well below that line, and the cost to fix the system, even under optimistic economic and financial-market projections, is already enormous. After a nine-year expansion, if America's economy turns down in the coming months, the price of fixing New Jersey's pension system will surge higher still. Yet even when the costs were considerably less, the state's political leaders balked at fixing the system. We've now reached the point where neglecting to construct an adequate and lasting fix pushes the pension system on a path toward failure, a catastrophic scenario for New Jersey's public employees and taxpayers.

Endnotes

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Abstract

The Rockefeller Institute of Government at the State University of New York defines a government pension system that's below 40% funded as in crisis. New Jersey's pension system is well below that line, and the cost to fix the system, even under optimistic economic and financial-market projections, is already enormous. After a nine-year expansion, if America's economy turns down in the coming months, the price of fixing New Jersey's pension system will surge higher still. Yet even when the costs were considerably less, the state's political leaders balked at fixing the system. We've now reached the point where neglecting to construct an adequate and lasting fix pushes the pension system on a path toward failure, a catastrophic scenario for New Jersey's public employees and taxpayers.