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ARIZONA

Arizona's Pension Challenges: The Need for an Affordable, Secure, and Sustainable Retirement Plan

The funding level of Arizona's public employee retirement systems has declined every year since 2003. Though the state's pension plans collectively ran a surplus as recently as 2002, by 2011 they had just 73 percent of the assets on hand necessary to meet their long-term pension obligations for state and local government employees and teachers.

This rapid descent occurred despite the significant sums that Arizona spent recently to cover these obligations. In 2011 alone, about $1 billion of taxpayer funds went into the four statewide plans for pension costs. That is more than 10 percent of payroll for members of those pension plans.*

Today, Arizona faces a $13 billion shortfall between what should have been set aside to pay future pension benefits and what the state's pension plans have on hand. That sum is over $1 billion more than the revenue delivered by Arizona's entire tax system in 2011.

EXHIBIT 1:

PENSION FUNDING LEVELS BY PLAN, 2011

Plan	Assets	Liabilities	Unfunded Liability	Percent Funded	Share of Total Shortfall	Annual Required Contribution	Actual Contribution	Percent Funded
Arizona State Retirement System	$27,984	$37,051	$9,067	75.5%	69.6%	$782	$782	100.0%
Public Safety Personnel Retirement System	$5,796	$9,094	$3,299	63.7%	25.3%	$272	$286	104.9%
Corrections Officer Retirement Plan	$1,467	$1,914	$448	76.6%	3.4%	$49	$52	105.5%
Elected Officials' Retirement Plan	$366	$578	$211	63.4%	1.6%	$21	$21	101.8%
Total	**$35,613**	**$48,637**	**$13,025**	**73.2%**	**100%**	**$1,124**	**$1,141**	**101.5%**

All figures are in millions of dollars.

SOURCE: FY 2011 CAFRs for ASRS, PSPRS, CORP, and EORP

* Pension contributions often are measured as a percentage of the total salary added up for every active member in a pension plan. This calculation helps states allocate costs across employers.

What Went Wrong?

Arizona has consistently made its annual contribution to the Arizona State Retirement System. However, contribution rates and the plan's unfunded liability continue to increase. In 2002, the last year the plan had a surplus, state and local governments contributed $131 million. That contribution increased six fold, to $782 million in 2011. During that same period, the funding level decreased from 106 percent to 76 percent.

Although the state has engaged in several pension system reforms in the past six years, the funding gap has continued to grow. From 2006 to 2011, the unfunded liability for one plan—the Arizona State Retirement System—increased by about $4.6 billion. Since the plan first dropped below a 100 percent funding ratio in 2003, the funding ratio has continued to decline despite the state making its full contribution. The unfunded liability increased for a number of reasons:

- Following devastating stock market losses in 2001 and 2002, the state changed how it smoothed out gains and losses—switching from a five-year to a 10-year phase-in. This means that the state was still acknowledging investment losses from 2001 and 2002 when the financial crisis hit in 2008 and 2009 and added to the retirement system's financial burden.

EXHIBIT 2:

ARIZONA STATE RETIREMENT SYSTEM FUNDING LEVELS

All dollar figures are in millions

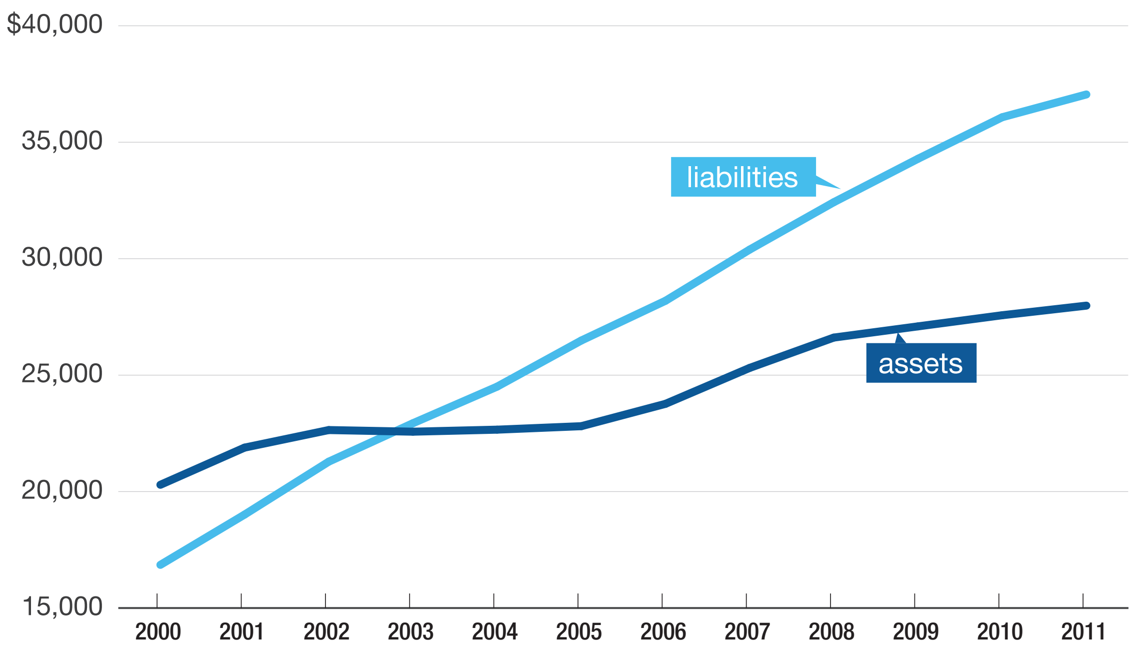
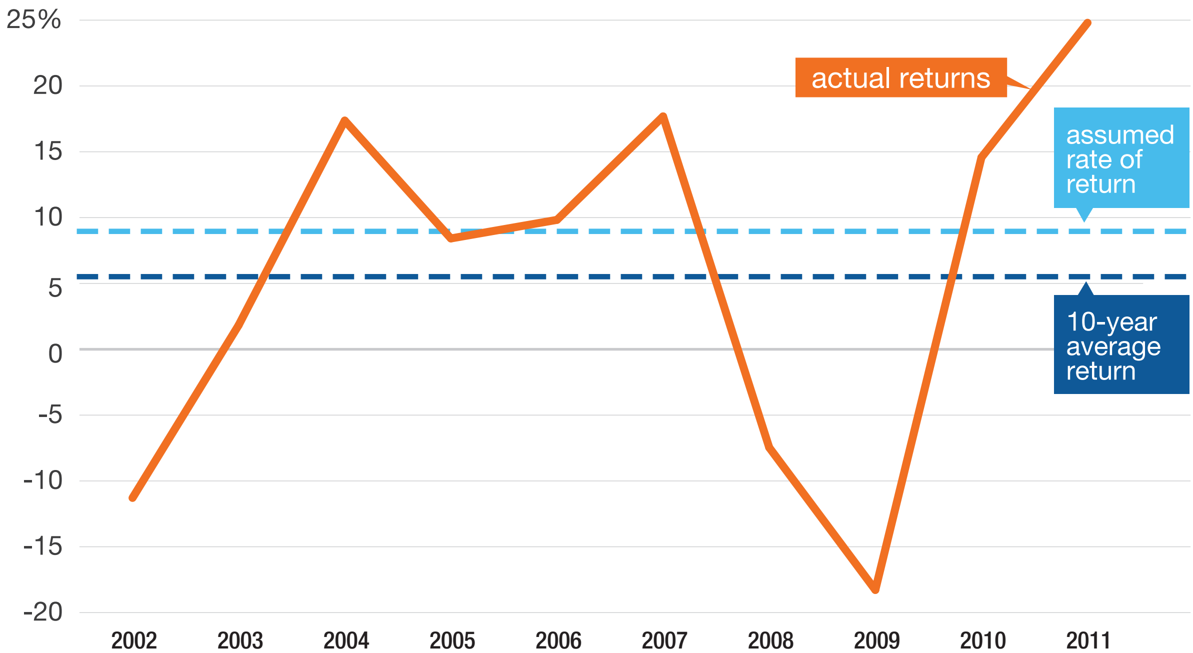


EXHIBIT 3:

ARIZONA STATE RETIREMENT SYSTEM INVESTMENT RETURNS



SOURCE: ASRS Actuarial Valuation, FY 2011

- The state's annualized return on investments over the past 10 years has been 5.2 percent, below its 8 percent assumed rate of return.
- The Arizona State Retirement System found that actuarial assumptions that weren't met, including investments that fell short, resulted in a total increase in unfunded liabilities of $9.8 billion from 2002 to 2010. This is why funding levels continued to drop in this period, even as public employers made the full recommended contributions.

In addition to the Arizona State Retirement System, the state administers: the Public Safety Personnel Retirement System (PSPRS), Elected Officials' Retirement Plan (EORP), and the Corrections Officer Retirement Plan (CORP).The three additional plans are collectively administered under one board of trustees with pooled investments. Like the Arizona State Retirement System, these plans have consistently received their required annual contribution from the state while their aggregate funding ratio decreased from 115 percent in 2002 to 66 percent in 2011.

Under Arizona's current retirement system, the state can encounter unexpected cost increases that can be difficult to absorb. Because pension plans depend

EXHIBIT 4:

PER DOLLAR BREAKDOWN OF 2011 CONTRIBUTIONS TO ARIZONA PENSION FUNDS

	Amount of every dollar going to fund current benefits	Amount of every dollar going to fund past promises	Additional contribution per dollar funding past promises	ARC Contributed, %
Public Safety Personnel	$0.59	$0.41	$0.05	104.9
Elected Officials	$0.63	$0.37	$0.02	101.8
Corrections Officer	$0.78	$0.22	$0.06	105.5
Arizona State Retirement System	$0.67	$0.33	$0.00	100.0

SOURCE: Pew Charitable Trusts, based on data from FY 2011 CAFRs for ASRS, PSPRS, CORP, and EORP

on investments to fund the majority of employee benefits, retirement costs increase when the economy struggles. Policy makers are asked to contribute more when they also are facing declining tax revenue and budget cuts. Currently 33 cents of every taxpayer dollar that goes into the Arizona State Retirement System pays for past promises rather than for new benefits.

Similar to the Arizona State Retirement System, the aggregate funding levels of PSPRS, EORP, and CORP have decreased yearly since 2004 and sustained investment losses during periods of economic recession. Together, the three plans accounted for 30 percent of the state's total unfunded liability in 2011.

When looking across the three plans, PSPRS and EORP have the highest amount of their contribution paying for past promises compared to current year benefits. In 2011, 41 cents of every required dollar that went into PSPRS and 37 cents of every required dollar that went into EORP paid for past promises compared with 22 cents of every required dollar for CORP. However, the state has been working to close this funding gap, setting aside additional contributions every year since 2007 to help pay off the plans' unfunded liabilities.

Poor investment earnings also impacted the state's ability to offer cost-of-living-adjustments—called permanent benefit increases (PBIs) in Arizona. In order for Arizona State Retirement System retirees to receive a PBI, there must be excess investment returns on the assets in the retirement fund. Due to low returns since 2001, the last Arizona State Retirement System PBI was in 2005. PSPRS distributed a PBI in 2010, but legislation enacted May 2011 changes future PBIs to be determined based on fund earnings and its overall funding ratio.

Escalating annual payments have put ever increasing pressure on the state's already strained budget. Without more substantial and comprehensive reform, the state faces the challenging choice of increasing taxes or cutting back on services to afford the retirement benefits it has promised.

The Road to a Sustainable Pension System

Policy makers now need to make hard choices to secure the state's retirement plans for current and future generations of workers and taxpayers. Changes that took place in 2005 and 2010 provided some help, but not nearly enough.

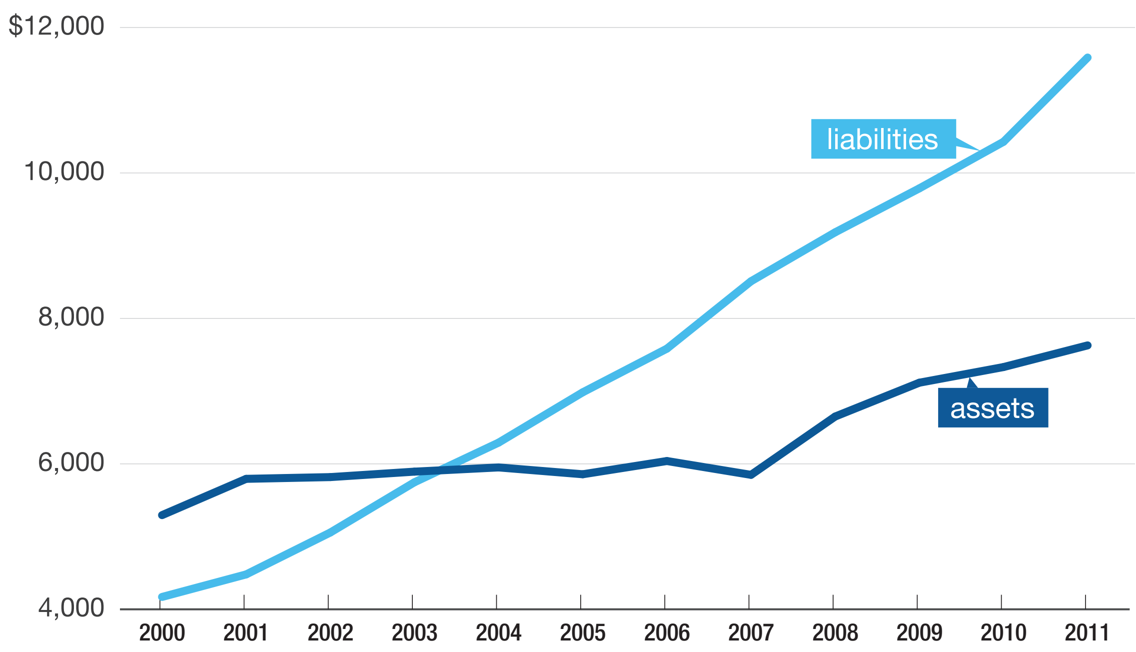
The 2010 reforms adjusted the pension formula for new employees, including an adjustment in the rules for retirement eligibility and for how final salary is calculated. While these alterations have led to modest long-term cost reductions, pension costs are still set to rise to unmanageable levels in relatively short order.

The most significant attempt to reduce the state's financial burden was in 2011. At that time, the state approved shifting 3 percent of the employer contribution to the employee. However, a Superior Court judge overturned this law the following year for violating the state's constitution and the legislature approved changes to revert to the even contribution split between workers and taxpayers.

EXHIBIT 5:

PSPRS, EORP, AND CORP FUNDING LEVELS

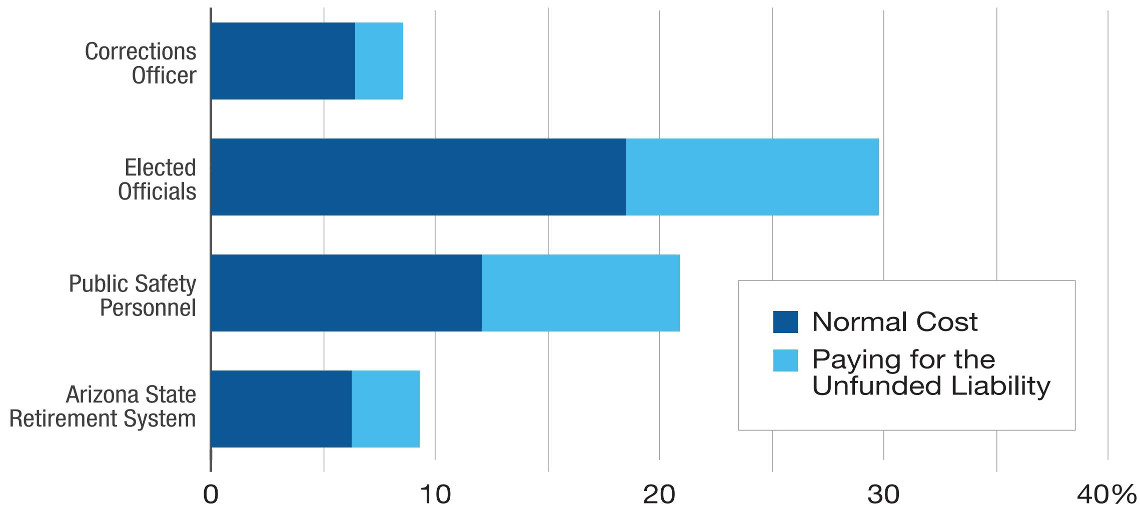
All dollar figures are in millions



SOURCE: FY 2011 and 2008 CAFRs for PSPRS, CORP, and EORP

EXHIBIT 6:

MORE THAN ONE-THIRD OF ARIZONA PENSION CONTRIBUTIONS GO TO PAY FOR PAST PROMISES INSTEAD OF BENEFITS FOR CURRENT WORKERS



SOURCE: FY 2011 CAFRs for ASRS, PSPRS, CORP, and EORP

Changes to retiree benefits for PSPRS, CORP, and EORP were also enacted in 2011. The legislation adjusted benefit calculations for new hires beginning in 2012. Contribution rates will also increase annually for PSPRS and EORP members so that employees pay one-third of pension costs by 2016 with the remaining two-thirds covered by employers.

While the anticipated cost of benefits for new employees is lower, the state is still taking on substantial risk, particularly investment risk, and it lacks the flexibility to manage that risk should predictions miss the mark. Making costs manageable may require current employees and retirees to further share the load by accepting reduced retirement benefits going forward or may require the state to either raise taxes or cut spending. The Arizona State Retirement System currently has employees and employers equally share in the contribution for benefits, and therefore share an equal portion of the risk, but there may be other ways for the state to manage its risk.

However policy makers choose to do it, the state needs to pay down its retirement shortfall and have the fiscal discipline to make the required payments in good times and bad. Without this discipline, no system is sustainable. Beyond responsibly paying for employee benefits, pension reform must also meet workforce needs, provide retirement security, and fairly share risk between taxpayers and employees. States such as Georgia, Nebraska, and North

Carolina have shown that it is possible to provide an affordable, sustainable pension benefit that delivers solid retirement security. And Rhode Island's recent adoption of comprehensive reform demonstrates that even states in the most dire of circumstances can find solutions.

Through this process, Arizona must confront the challenges that result from its current retirement system. First and foremost, the state's current pension plans do not clearly show the price tag of benefit promises and they allow costs to be pushed to future years indefinitely. As a result, past policy makers were able to offer a benefit without adequately funding it.

Second, the pension plans have exposed the state to more risk than is prudent. Closing the funding gap is an important step, but reform would be incomplete if it did not also ensure that, going forward, Arizona's pension plans not experience unmanageable cost increases and accumulate additional unfunded liabilities that would threaten workers' benefits or the state's fiscal health.

Third, the traditional defined benefit plan offered by the state backloads benefits, meaning that employees earn most of their pension benefits late in their career. This creates an inherent inequity for short- and medium-term workers who are placed on a savings path that is unlikely to provide a secure retirement.

The incentives in a traditional pension encourage workers to stay until they reach retirement age and provide an incentive for experienced workers to leave at that point. As they shape reforms, state leaders should examine whether the current compensation package, including the pension, is best suited to getting and retaining the workforce that Arizona needs now and in the future.

A Framework for Reform

Pension reform is not easy. While Rhode Island's recent reforms demonstrate that dedicated policy makers can find solutions to serious pension problems, workers and retirees ultimately experienced real sacrifice and taxpayers remain on the hook for substantial contributions for decades. But what policy makers in Rhode Island and other states have realized is that delaying adjustments only makes problems larger and more intractable.

Arizona's leaders have an opportunity to further improve their retirement system, fully secure the benefits promised to workers, and protect taxpayers. Additionally, any changes should honor benefits that already have been earned, as accrued benefits are legally protected. In the end, comprehensive pension reform must accomplish three goals:

1. Develop a plan to responsibly pay down the unfunded liability over a reasonable time frame. Ideally, the plan should not impinge on funding

for services and the state's overall economic viability. Policy makers need to be held accountable to sticking to that plan so that over time, Arizona's pension obligations are fully funded.

2. Adopt a reformed retirement system that is affordable, sustainable, and secure. This system should ensure a secure retirement for workers and should reduce the potential for unforeseen cost increases or missed payments that create future funding crises, threatening public employees and taxpayers. The reformed plan should reasonably guarantee full funding, so the state will not miss a payment even if costs rise.
3. Ensure that whatever plan the state offers enhances its ability to recruit and retain a talented public-sector workforce. Retirement savings are just one piece of total compensation, and policy makers must be thoughtful about how they allocate their limited dollars.

There is no one-size-fits-all solution. Every state has a unique set of policy preferences, political dynamics, and budgetary challenges. Real change requires hard choices, good information, and thoughtful analysis. The Pew Center on the States and the Laura and John Arnold Foundation stand ready to help Arizona pursue real, comprehensive reform through our data and analysis on retirement systems, through help understanding the legal and actuarial issues surrounding public-sector retirement systems, and through help in creating an effective and fair process for making these tough choices.

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