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D.C. PENSIONS

Plans Consuming Growing Share of District Budget

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SUMMARY

The District's overall financial status is affected annually by the increasing demand on city revenues caused by its underfunded pension plans for police and fire fighters, teachers, and judges. In 1991 the District's contribution for these plans was about 8 percent of revenues, and unless remedial action is taken, the contribution could increase to about 15 percent of revenues in 2005. Currently, pension costs are running over 50 percent of payroll and will grow to 70 percent after 2004.

The Congress instituted defined benefit pension plans for the District's police officers and fire fighters in 1916, for teachers in 1920, and for judges in 1970. Benefits for these three plans were basically provided on a pay-as-you-go basis. When the Congress granted Home Rule to the District of Columbia the responsibility for administering the pension plans for police and fire fighters, teachers, and judges and paying benefits on a pay-as-you-go basis passed to the District. The law also transferred to the District the unfunded liability for these plans.

In 1979 the Congress passed the District of Columbia Retirement Reform Act, which President Carter signed into law. The act established, for the first time, separate retirement funds for (1) police and fire fighters, (2) teachers, and (3) judges. It also created the D.C. Retirement Board and provided for annual federal contributions of $52 million to these funds. Upon the enactment of this legislation, the combined unfunded liability for the three plans was about $2 billion.

Through fiscal year 1993 the unfunded liability increased to an estimated $5 billion. Currently, the District's retirement costs are about 54 percent of payroll for employees covered by the three plans. However, under the act's funding provisions, after fiscal year 2004, federal contributions will end, and the District will contribute over 70 percent of payroll. In comparison, most local governments pay between 20 and 30 percent of payroll for pension costs.

The bill currently before this Subcommittee--H.R. 3728, the District of Columbia Pension Liability Funding Reform Act of 1994--would increase the current obligations of the federal government and participants of the respective plans, and level the District's contributions as a percentage of pay. In terms of the federal contribution, H.R. 3728 would significantly increase and extend the federal payments to the District. The increased present value of this obligation will be $1.5 billion in 1995. It should be noted that while the current employees' share of pension costs would rise under the bill's provisions, their retirement benefits would remain the same. We propose that a flat dollar contribution, as in the current law, for the 40-year period 1996 through 2035 would bring the fund toward full funding faster and would cost less over the 40-year amortization period.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here to provide a brief history and overview of the current unfunded liability confronting the District of Columbia pension plans for police and fire fighters, teachers, and judges. I will also comment on H.R. 3728, the District of Columbia Pension Liability Funding Reform Act of 1994, which seeks to eliminate the District's financial liability for these plans.

THE ISSUE

The District's overall financial status is affected annually by the increasing demand on city revenues caused by its underfunded pension plans for police and fire fighters, teachers, and judges. In 1991 the District's contribution for these plans was about 8 percent of revenues, and unless remedial action is taken, the contribution could increase to about 15 percent of revenues in 2005. Currently, pension costs are running over 50 percent of payroll and will grow to 70 percent after 2004. Since we issued our November 1992 report on the financial status of the District's pension plans,[1] there has been much discussion about how to address the underfunding issue, and H.R. 3728 has been proposed as a means to resolve it.

Mr. Chairman, my testimony today will address three main topics. First, I will provide a brief historical overview of the unfunded liability in the District's pension plans for police and fire fighters, teachers, and judges. Second, I will outline the plans' current funding provisions. And third, I will discuss the effects of H.R. 3728 on the unfunded liability for these plans as well as the responsibilities of the federal government, the District, and the plans' participants.

DISTRICT EMPLOYEES ARE COVERED BY SEVERAL RETIREMENT SYSTEMS

There are three separate pension systems for District employees. For the District's police and fire fighters, teachers, and judges, each group has its own pension plan. Other District employees hired before October 1, 1987, are covered under the federal Civil Service Retirement System (CSRS). Legislation establishing the Federal Employees Retirement System (FERS) excluded District employees hired on or after October 1, 1987, from enrolling in CSRS. Consequently, all permanent full-time District employees hired on or after this date are covered under Social Security, and after 1 year of service are also covered by a defined

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[1]For further explanation, see District's Pensions: Billions of Dollars in Liability Not Funded (GAO/HRD-93-32, Nov. 30, 1992).

contribution plan.[2] The District is responsible for contributing to the CSRS plan, the defined contribution plan, and the three plans for police and fire fighters, teachers, and judges. Most importantly, the District is responsible for the unfunded liability in the latter three plans.

HISTORY OF THE PLANS' UNFUNDED LIABILITY

The Congress instituted defined benefit pension plans for the District's police officers and fire fighters in 1916, for teachers in 1920, and for judges in 1970. Benefits for these three plans were basically provided on a pay-as-you-go basis. This meant that plan contributions only paid current obligations for the pension plans but did not accumulate any monies with which to meet the constantly accruing future retirement liabilities for its beneficiaries.

Effective January 2, 1975, the Congress granted Home Rule to the District of Columbia. Under Home Rule a number of functions formerly administered by the federal government were moved to the control of the District government. Among these was responsibility for administering the pension plans for police and fire fighters, teachers, and judges and paying benefits on a pay-as-you-go basis. The law also transferred to the District the unfunded liability for these plans.

After some years of deliberation regarding the financial status of the three plans, in October 1978 the Congress passed H.R. 6536, legislation that would have infused money into the retirement funds through annual federal and District contributions. This act committed the federal government to contribute $65 million annually over 25 years to these retirement funds as the federal share of the participants' retirement benefits for those who had retired as of the date of Home Rule. However, in November 1978 President Carter vetoed H.R. 6536 on the grounds that it overstated the federal government's liability and did not take into account federal contributions for District employees covered by CSRS. The Carter administration argued that

-- a large portion of the existing unfunded liability was due to abuses of the disability retirement statutes, and

[2] A defined contribution plan pays benefits based on the amount of funds in an employee's account at retirement. A defined benefit plan pays a specific retirement benefit based on years of service, earnings, or both.

-- the bill undervalued or ignored the significance of federal assistance through the federal funding of benefits for thousands of District employees who participate in CSRS.[3]

In 1979 the Congress passed a modified bill, S. 1037, the District of Columbia Retirement Reform Act, which President Carter signed into law. In the act, the Congress recognized that

-- the retirement benefits for the District's police officers, fire fighters, teachers, and judges had not been financed on an actuarially sound basis, and

-- neither federal payments to the District nor District contributions for pensions had taken into account the long-term financial requirements of the District's retirement plans.

Consequently, the act established, for the first time, separate retirement funds for (1) police and fire fighters, (2) teachers, and (3) judges. It also created a board, the D.C. Retirement Board, to manage the funds and provided for $52.1 million annual federal contributions to these funds to partially finance the liability for retirement benefits incurred before January 2, 1975. Upon the enactment of this legislation, the combined unfunded liability for the three plans was about $2 billion.

Thus, the act committed the federal government to pay $52.1 million annually to the retirement funds for 25 years through fiscal year 2004. Under the act, the federal payments through the year 2004 represented 80 percent of the unfunded liability as of October 1, 1979, for normal retirements before January 2, 1975, and 33-1/3 percent of the unfunded liability for disability retirements during the same time period.

STATUS OF THE RETIREMENT FUNDS UNDER CURRENT LAW

Through fiscal year 1993 the unfunded liability increased to an estimated $5 billion. This growth occurred because the contributions to the fund had been less than the amounts needed to maintain the unfunded liability at a constant level.[4] From the

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[3]A letter dated April 1, 1976, from the Comptroller General to the Chairman of the House Committee on District of Columbia notes that the federal government was subsidizing the District through CSRS. GAO estimated the subsidy for fiscal year 1975 at about $55 million.

[4]The annual District contribution to the funds, specified by the formula laid out in the act, is the sum of three items: (1) the lesser of (a) the net pay-as-you-go cost or (b) the net normal cost

District's perspective, the amounts contributed were low because the act precluded the District from amortizing the unfunded liability beyond a specified percent of the net pay-as-you-go cost. In operation, the District's contributions under the formula have been based on pay-as-you-go costs.

Currently, the District's retirement costs are about 54 percent of payroll for employees covered by the three plans. However, under the act's funding provisions, after fiscal year 2004, federal contributions will end, and the formula guiding the District's contribution will change.[5]

This change will require the District to contribute an amount equal to net benefits earned by the plan participants during the year, in addition to paying the interest on the unfunded liability. In 2005 the amount going for pension contributions would rise to 70 percent of payroll. In comparison, most local governments pay between 20 and 30 percent of payroll for pension costs.[6] As mentioned in my opening remarks, the District's rising contributions will consume an ever-growing share of its budget revenues.

I would like to emphasize that under this legislatively established funding scheme the unfunded liability will never be eliminated, although it will stop growing, assuming the District makes the required contributions under the funding formula. In November 1992 we reported that the estimated unfunded liability

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plus interest on the unfunded liability; (2) an amount necessary to amortize (pay off in equal installments) over 10 years the difference of (a) the actuarially projected unfunded liability in the year 2004 if no such amortization payments were made and (b) the 1979 unfunded liability increased by the anticipated rate of inflation during the interim. Any additional amount specified by the D.C. Retirement Board under this amortization provision may not exceed 10 percent of the net pay-as-you-go cost for the Fire and Police Fund or 30 percent for the Teachers' or Judges' Funds; and (3) an amount necessary to amortize over 25 years any liability due to plan changes.

[5]When the District of Columbia Retirement Reform Act was passed in 1979, it was determined that the amount equal to the normal cost plus interest on the unfunded liability of the three funds (and nothing additional to amortize the unfunded liability) would not be affordable in District budgets in the near future. Therefore, another method was adopted for the 25 years before 2005, providing for substantially lower contributions.

[6]For a comparison of other provisions, see D.C. Pension Benefits: Comparison With Selected State and Local Government Pension Plans, (GAO/HRD-94-18, Nov. 4, 1993).

through the year 2004 would reach $7.7 billion. Because of favorable actuarial experience during the past few years, current projections put the unfunded amount at $6.1 billion in 2004.

PROVISIONS AND EFFECTS OF H.R. 3728

The bill currently before this Subcommittee--H.R. 3728, the District of Columbia Pension Liability Funding Reform Act of 1994--proposes several changes to current law. This bill is a companion to, and should be considered in conjunction with, District Bill 10-515, introduced by the District Council Chairman. A study of the bills, conducted by Milliman & Robertson, Inc., the D.C. Retirement Board's actuarial consultant, concluded that the bills would eliminate the unfunded actuarial liability in the three plans by the end of fiscal year 2035. To accomplish this, the bills would increase the current obligations of the federal government and participants of the respective plans and level the District's contributions as a percentage of pay.

Changes in Federal Obligation

In terms of the federal contribution, H.R. 3728 would significantly increase and extend the federal payments to the District. Specifically, the $52.1 million annual payment would increase by 5 percent each year (beginning in fiscal year 1996) and would be extended through fiscal year 2035. The ever-growing federal payments would rise to $370 million in the 40th year (see fig. 1). The present value of the obligation for this stream of payments is $1.5 billion in 1995.

Changes in Participant Obligations

The bills would increase contributions of the funds' participants. Active participants would be required to contribute an additional 1 percent of pay (from 7 to 8 percent). Police officers and fire fighters who retired before February 15, 1980, would receive cost-of-living adjustments based on the consumer price index rather than on the active participants' pay raises. In addition, the number of cost-of-living adjustments to retirees would be reduced from twice annually to once.

Changes in District Obligation

Finally, the bills also require several changes in the provisions governing the District's responsibilities. In particular, the formula for computing the District's payment would be changed to one that is actuarially based and is most commonly used by public sector plans. Under this formula, the District's unfunded liability would be fully amortized in the year 2035. The District's contributions would decline slightly in the first few years, then increase in step with payroll. The percentage of payroll for these groups will gradually fall from the current 53.8

percent to 44.4 percent after 2005. The contributions from 1996 through 2020 would be less than the current law requires, and would be greater thereafter. The bill also makes technical changes concerning revisions of plan benefits and actuarial requirements.

CONCLUSIONS

To summarize, our historical analyses suggest that the Congress recognized some degree of federal responsibility for the unfunded liability in the pension plans for police and fire fighters, teachers, and judges given to the District at the inception of Home Rule. However, our analysis of the funding provisions under the current law indicates that the Congress required the unfunded liability to increase with the cost of living, but did not intend for the unfunded liability to be amortized.

We believe it is imperative that something be done to limit the deterioration of the District's finances due to its pension burdens. We applaud the fact that H.R. 3728 deals with the underfunding issue now, and puts the District's payments on an actuarially sound basis. The proposed legislation, in concert with the Clarke bill, would effectively eliminate the unfunded liability for these plans by the year 2035 by requiring additional contributions from the federal government and plan participants. It should be noted that while the current employees' share of pension costs would rise under the bill's provisions, their retirement benefits would remain the same. The District would assume more responsibility to pay for the unfunded liability over the 40-year period, 1996-2035, but the payments would stabilize at a lower percentage of payroll.

One element of the proposed legislation is to extend and increase the federal government's contribution to the three plans. The proposed legislation asks for the federal government to contribute $1.5 billion, in present value terms, to the pension funds. However, we are concerned about the pattern of the federal contribution over the 40-year funding period and the shifting of the burden to future federal budgets. The contributions would escalate each year for 40 years, leaving future budgets burdened by this commitment. We propose that a flat dollar contribution, as in the current law, for the 40-year period, 1996-2035, would bring the fund toward full funding faster and could cost less over the 40-year amortization period. For example, a federal contribution of $20 million over the current $52.1 million (a total of $72.1 million) would lower the federal commitment to $1 billion, in present value terms. We would be glad to work with you to determine the cost of other proposals for a federal contribution to the District's pensions.

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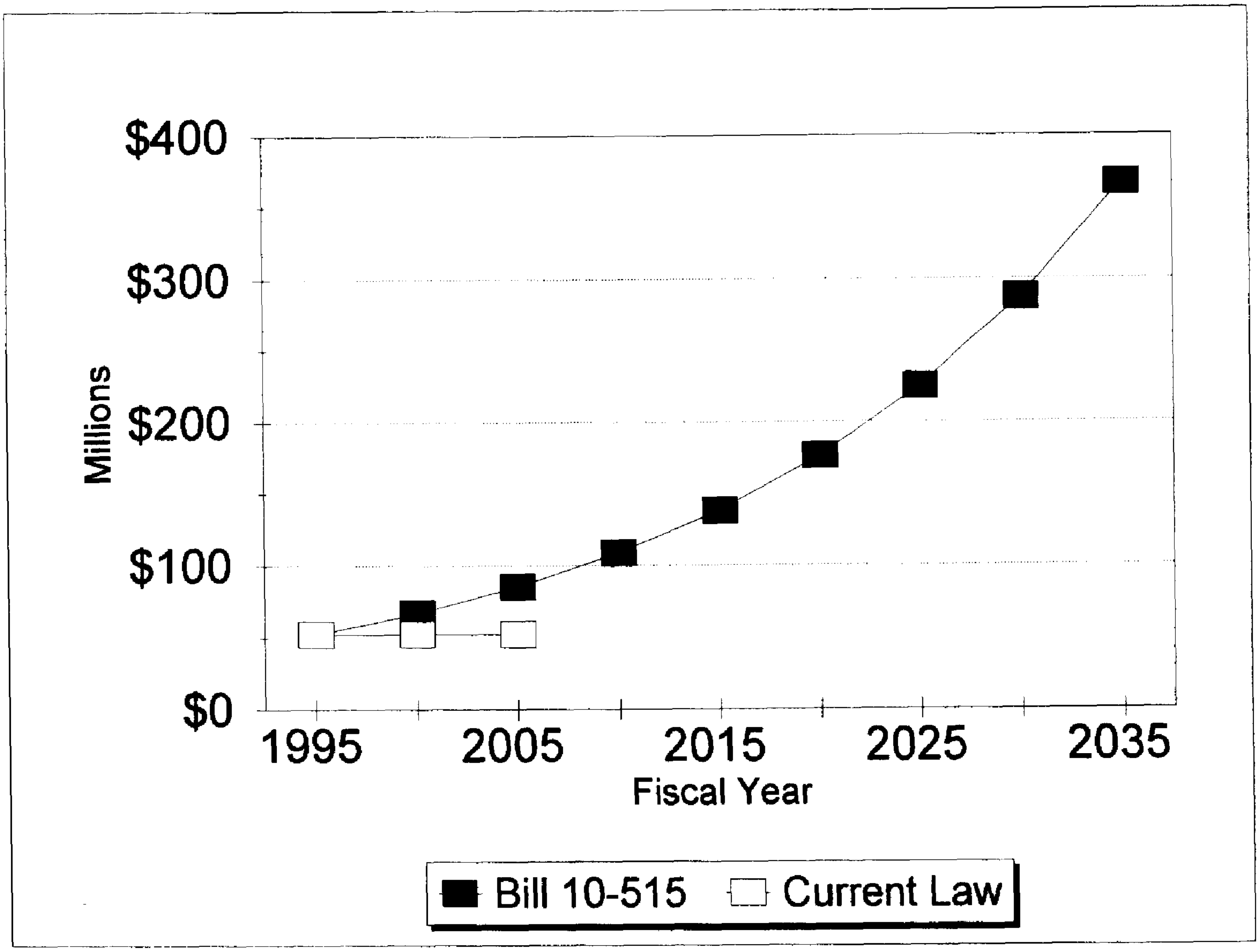
Mr. Chairman, this concludes my statement. I will be happy to answer any questions you or other Subcommittee members may have.

Figure 1: Federal Payments Under H.R. 3728



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