

THE NEW JERSEY PENSION AND HEALTH BENEFIT STUDY COMMISSION

COMMISSION MEMBERS

December 6, 2017

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Dear Governor Christie:

On behalf of the entire Commission, please accept the enclosed fourth and final Report of the New Jersey Pension and Health Benefit Study Commission, as well as our thanks for the opportunity to have served the people of New Jersey in this endeavor.

For the Commission

A handwritten signature in black ink, appearing to read "Thomas J. Healey", written in a cursive style.

Thomas J. Healey

Final Report

New Jersey Pension and Health Benefit Study Commission

December 6, 2017

In August 2014, when this Commission was formed, public sector pension and health benefits costs were at the center of a budget crisis that threatened not only the continued availability of these benefits, but also the State's fiscal health and the property taxes of every State homeowner. There was a sense that urgent action was needed, even if political gridlock made it difficult to discuss solutions, let alone implement them.

Unfortunately, this acute crisis has come to be accepted by some as a chronic condition. Recent reforms have slowed its progression, but, due to the reluctance to control costs, have not effected a cure. This Report updates our review of the condition of the State's benefit programs. To use just one measure, at the time of our initial 2014 Status Report, the State's unfunded pension liability, as measured by the now-current methodology of the Government Accounting Standards Board (GASB 67), was roughly \$80 billion.¹ Despite unprecedented levels of funding, and the dedication of the value of the State lottery to the pension plans, the State's estimated GASB 67 unfunded liability, as reported by the State, is now roughly \$90 billion.² New Jersey is now dead last in the Mercatus Center's ranking of states by fiscal health.³

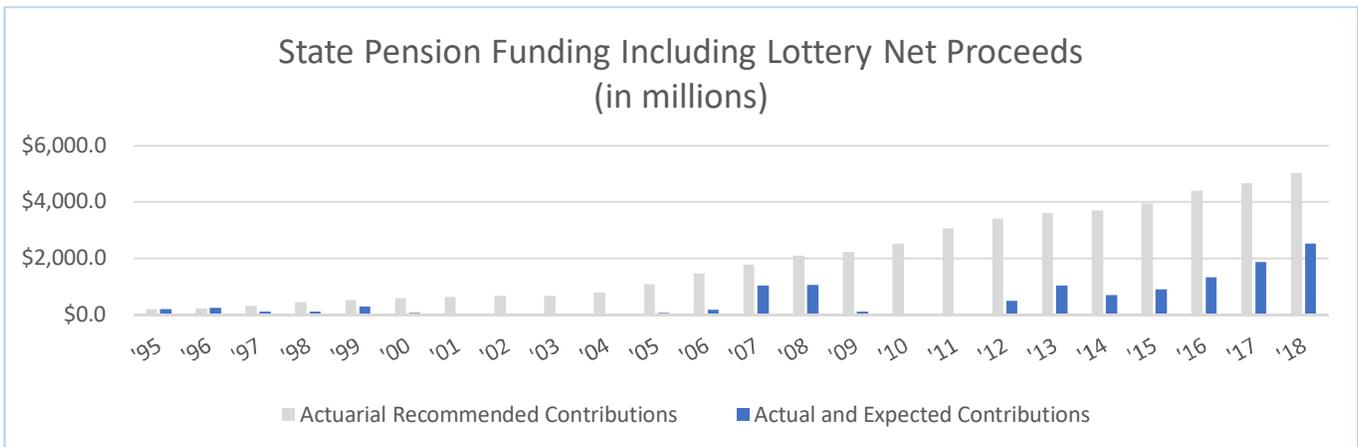
What is different from 2014 is that the elements of a viable solution are now understood. In our second and third Reports, the Commission⁴ outlined the means to stabilize the State pension plans over 30 years by reforming the State's extremely generous employee and retiree health benefits and devoting the savings to pension funding. This would permit the State to fund all pension benefits earned to date while providing competitive retirement and health benefits going forward. It would also make it possible to keep these benefits' share of the State budget to roughly 15% without increasing State or local tax burdens.

The bottom line of this, our fourth and final Report, is that while some progress has been made, it has not been enough. The new Governor, the Legislature, public employees and the citizens of the State as a whole need to act to effect the comprehensive reform required to make these benefits both affordable and secure.

The Current Status of Reform

As the Commission has stressed, for far too long, elected officials of both parties were willing to provide, expand and maintain public sector benefits so long as doing so did not involve asking taxpayers to pay for them. While two decades of kicking the can down the road have let the problem grow too large to be cured by increased funding alone, some recent progress has been made. The fiscal year ("FY") '15-'18 budgets have included ~\$6.6 billion in pension funding, almost \$1 billion more than the *previous 20 years combined*. An additional positive development has been the dedication of the State lottery to the pension plans. This has reduced the unfunded liability by \$13.5 billion and will generate over \$1

billion annually to pension funding. This, in turn, has improved the State’s overall reported statutory funded ratio from 45% to 59%.⁵



The problem, however, is that the State can only dedicate the lottery once, and there are no other readily available assets to give to the pension plans. In an already tight budget, it is becoming progressively harder to find revenue to ramp-up pension funding without these costs consuming an unmanageable share of the State budget and crowding out other priorities. A key concern is that revenues needed to continue the ramp-up of pension funding are also needed for property tax relief to defray local budget growth that otherwise must be paid for with higher property taxes.

Another front on which some, but not enough, progress has been made is health benefits costs. As outlined in the Commission’s second and third Reports, these benefits are substantially more generous and expensive than is prevalent in the private sector and have, over time, developed many features whose cost to the State far exceed their value to employees. Health benefits costs are the only item in the budget with the potential to yield savings of the magnitude needed to make room for enhanced pension funding.

Predating the Commission’s work, Ch. 78, by requiring employees to bear a greater share of coverage costs, created a shared interest in efficiency. Unfortunately, the will to act on this shared interest has been slow to develop in the employee-management deadlocked Plan Design Committees (PDC) of the two State-run health benefits programs. The employee representatives on the School Employees’ Health Benefits Program PDC in particular have been resistant to change.

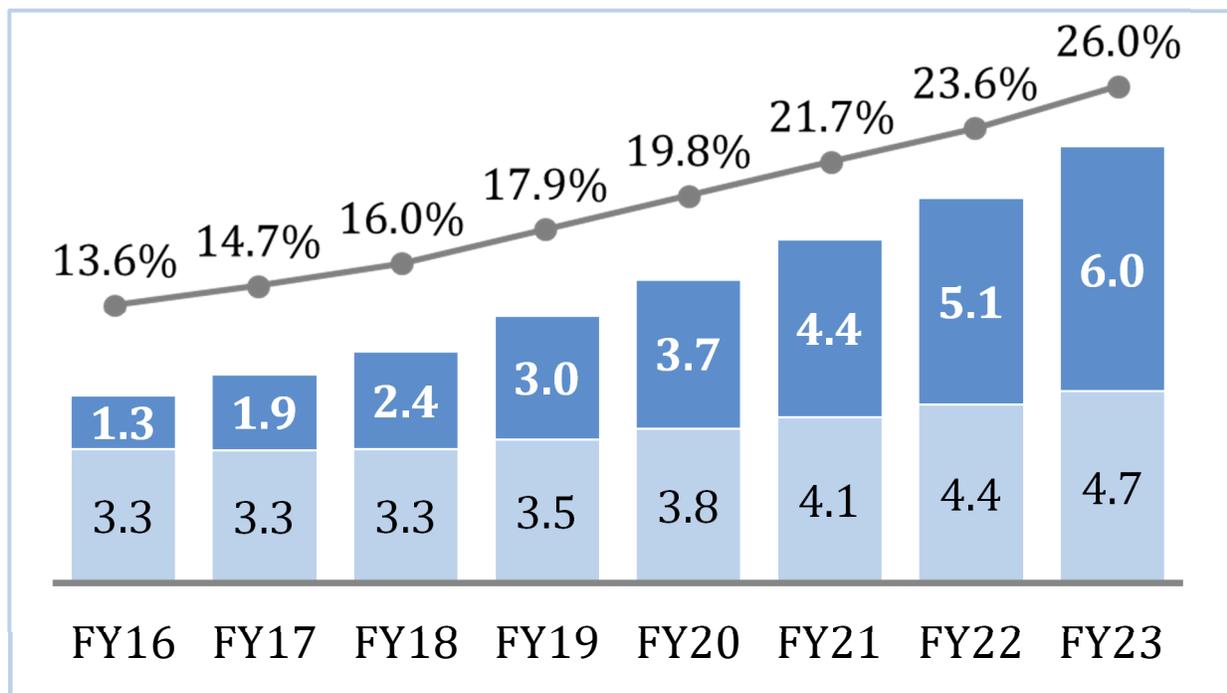
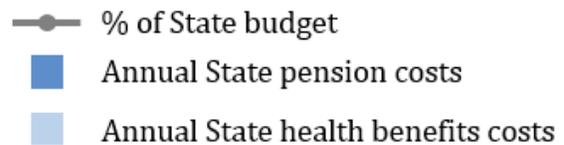
The Commission envisioned breaking this impasse through a top-to-bottom revision of all elements of the plans. In practice, what has evolved, primarily through the efforts of the State Health Benefits Program PDC, is a bottom-up approach focusing on individual issues such as moving some retirees to a Medicare Advantage plan, changing drug formulary elements and co-pays, and improving the State’s contracts with vendors such as

its pharmacy benefits manager. These piecemeal efforts, many of which address issues identified by the Commission, have begun the process of bringing public sector benefits more in line with private sector norms. The cumulative savings from these reforms have been sufficient to hold health benefits costs essentially flat for two years.

As is the case with pension funding, however, the problem with this incremental approach to fixing health benefits is that the cupboard of relatively easy reforms is now bare. Health benefits costs will resume their rise at a time the State will desperately need additional savings to achieve the second half of its planned ramp-up of pension funding.

State benefits spend

\$ Billions



Reforms To Date Have Not Been Enough

The Commission believes that to maintain the budget flexibility needed to address other priorities, the State should hold benefits costs to roughly 15% of its budget. Our 2016 Report stressed the need to control this ratio, projecting that, without reform and assuming 3% annual revenue growth, pension and health benefits costs would consume 27% of the budget by 2023. The reforms discussed above, based on the most recent published projections,⁶ have only reduced this projected share of benefits costs to 26%.

This is not enough progress to save the pension plans or the State budget. Moody's has reported that the State's rate of revenue growth is inadequate to fund increased

benefits costs and still be able to respond to other needs,⁷ noting that loss of budget flexibility would further undermine the State's credit rating. The State also cannot simply tax its way out of this problem. Even adding \$1.3 billion in new taxes in FY '19 would only decrease the current benefits' share of the 2023 budget to 25%.

A Practical Solution

In compliance with our charter, we conducted a careful review of the current benefits programs and consulted with actuaries and health benefits experts. We met, repeatedly, with key stakeholders to hear their views and encourage a broader dialogue. Based on these discussions, we determined, and continue to believe, that any solution fair to both public employees and taxpayers in general should:

- 1) Preserve public employees' benefits at or above private sector levels;
- 2) Fully fund all pension benefits earned to date;
- 3) Provide for a revised retirement program going forward;
- 4) Accomplish 1-3 while devoting no more than roughly 15% of the State budget to public employees' health and retirement benefits; and
- 5) Accomplish 1-4 without increasing property taxes.

The Commission also continues to believe meeting these goals requires reductions in benefits costs beyond the needed initial steps taken in the 2010-11 reforms. With the exception of the suspension of COLA payments, which reduced unfunded liabilities by \$11 billion, the 2010-11 pension reforms are incremental long-term changes that will take decades to have any effect. Neither the 2010-11 reforms, nor the limited initiatives taken since then, will do anything to stop benefits from consuming 26% of the budget five years from now. Something more is needed, and quickly.

Piecemeal reform tends to emphasize improvements without regard to the magnitude of the solution needed. To keep benefits costs anywhere near 15% of the budget, it will be necessary to reduce the level of health benefits coverage offered by the State to something less than its current platinum-plus level. Reforms that defer the need to make this change for a year or two do not make the problem go away. Similarly, treating the lottery dedication as a stand-alone reform misses the point that it is intended to ease, not pay for, the planned ramp-up schedule. That schedule is premised on the assumption that cost-saving reforms will make room in the budget to permit the ramp-up. The first half of the ramp-up has occurred without the reforms needed to make the second, much harder half possible. Finally, like the lottery dedication, health benefits savings can only be spent once. Pension and health benefits reforms should be linked to ensure health benefits savings are used where they are most needed: to save the pension plans.

Reaching a consensus on how to do this is essential, as engaging in brinksmanship over pension plan failure would be beyond irresponsible. The public is equally at risk if either side overplays its hand. No one knows whether retirees receiving pensions, or current employees making contributions, have the better claim to the last dollar in a failed pension plan. Once the money is gone, no one knows the extent of the State's obligation to pay, out of annual revenues, the pensions of State-funded retirees. This is currently a \$6.7 billion expense that is projected to increase to \$7.5 billion by 2023.⁸

Before digging in their heels against any changes, employees and retirees, some of whom have been led to believe their pension benefits are absolutely safe as contractual obligations of the State, need to realize that this is an untested legal theory that could be resolved either way – and in any event would not protect health benefits. In addition, even enforceable State contractual obligations are subject to impairment if they would impede the State's sovereign duty to protect the general public welfare of its citizens. On the other hand, with the State currently struggling to find the money in the budget to make even a \$2.5 billion partial pension payment, lawmakers and taxpayers need to fear the same legal uncertainties that could result in the State having to pay \$7.5 billion in benefits out of annual revenues. Looming over all of these potential sources of fiscal hardship and credit downgrades is the possibility the State will need to control benefit costs by reducing headcount, and with it the vital public services public employees provide.

Given the bleak alternatives, addressing issues systemically, taking into account pensions, health benefits, and State and local taxes, is the only way to secure pension funding and provide attractive benefits going forward while keeping benefits' share of the State budget at a reasonable level *without* shifting the net impact to local taxpayers.

The Commission's proposed systemic approach is to:

- Reform State health benefits in a manner the Commission's health benefits consultant, McKinsey & Co., confirmed would have reduced 2016 costs by \$1.4 billion while preserving an overall package of health benefits that would still be more generous than those in the private sector.
- Commit the State, by constitutional amendment, to a set payment schedule intended to stabilize, over 30 years, funding of State pension benefits earned to that date. Most of the added cost of the scheduled payments can be realized from health benefits reforms.

Crucially, this commitment should *only* be made in exchange for reforms making benefits affordable to the State's taxpayers. Constitutionalizing funding without first ensuring the funding is sustainable is an invitation to fiscal chaos. It would repeat, in an irrevocable manner, the cycle of extending benefits beyond taxpayers' funding tolerance that led to the current crisis.

- Provide that, going forward, retirement benefits would be earned through a modern, sustainable cash-balance program, with provisions for additional transition funding for certain employees for whom this exchange would occur in mid-career.
- Reform local health benefits costs in the same manner as State employee benefits. This would have reduced local 2016 health benefits costs by \$2.7 billion, providing sufficient savings to defray any further erosion of State property tax relief funding and enable a meaningful reduction of property taxes.
- Hold benefits costs to roughly 15% of the State budget, a figure the Commission believes marks the threshold for sustainable benefits funding.

While the details of our approach are always open to refinement, during the Commission’s work no other framework has been advanced which both stabilizes the pension plans and identifies a viable source of funding. Moody’s reported that the Commission’s proposed reforms would give the State “budgetary flexibility to make larger pension contributions and resolve a significant portion of New Jersey’s long-standing structural imbalance.”⁹ Fitch Ratings similarly concluded that the reforms “could provide notable annual state cost savings and thus improve prospects for future budget sustainability.”¹⁰

HEALTH-SPECIFIC RECOMMENDATIONS

- Public employee health benefits should be aligned with those in the private sector at an Affordable Care Act (ACA) gold level, with meaningful incentives for employees to select cost-effective plans. Consideration should be given to creating health savings accounts (HSAs), and permitting employees who desire a higher level of coverage to do so at their own expense. The reduction in premiums will lower employee premium contributions, particularly for those employees hard-pressed by the contribution requirements under Chapter 78.
- Early retirees would purchase coverage through a private exchange funded through Retirement Reimbursement Accounts (RRAs) covering the cost of a gold-level plan. This mechanism would increase flexibility and insurer choice while avoiding potential ACA “Cadillac Tax” issues.
- Medicare-eligible retirees would continue to receive their current level of coverage without additional costs to them, but at lower cost to employers through a Medicare Advantage Prescription Drug program paid through employer-funded RRAs.

- Focus on root causes of excessive cost of care:
 - Fix the out-of-network reimbursement problem;
 - Encourage use of tiered networks of high-quality, cost-effective providers;
 - Discourage use of emergency rooms for non-emergent care;
 - Provide incentives for beneficiaries to be educated consumers;
 - Increase use of generic and mail-order drugs; and
 - Empower primary-care physicians to focus on patient outcomes.

Reforms of this nature do not shift costs, but reduce them for employers and employees alike. Of the \$1.4 billion in savings projected from the Commission's proposals, less than \$0.2 billion reflected cost shifts to beneficiaries, an amount which would be subject to further potential mitigation through HSA funding.

- Re-examine the role of early retirement in the public sector. Early retirement health benefits are extremely expensive, and their availability is a key enabler of double-dipping abuses that have a corrosive effect on the system as a whole. The availability of early retirement health benefits should be limited to where they are necessary to facilitate early retirements that are truly in the public's interest.

PENSION-SPECIFIC RECOMMENDATIONS

- Use health benefits savings to bolster pension funding. It is the only available source of funds of the magnitude necessary to address the pension funding shortfall.
- Stop the accrual of new benefits under the existing pension plans. This will prioritize resources to preserving benefits already earned to that point without affecting pensions of existing retirees.
- Provide future retirement benefits for current and new employees under cash balance plans, with supplemental transition funding for existing mid-career employees. Cash balance plans combine account features of a 401(k) with benefit guarantees associated with defined benefit plans. Account balances will grow each year through employer "pay credits" based on salary, employee contributions, and interest credits tied to market returns, subject to a minimum guarantee. The guaranteed benefits and directed investment elements of cash balance plans would address the primary criticisms of 401(k) plans, while also minimizing investment return risk.

A Call to Action

While since 2010 a start has been made on benefits reform, much more remains to be done. Intransigence, inaction, apathy and denial are habits the State can no longer afford when it is at risk of losing the budget flexibility necessary to respond to emerging challenges and crises. This is dangerous for everyone. As events in both Flint, Michigan and Puerto Rico show, financial stress can lead governments to make bad decisions with unexpected, catastrophic consequences. New Jersey is not at that point yet, but should do everything in its power to ensure it does not get there.

Everyone needs to be invested in finding a solution. The fact that tough bargainers representing the State and the members of the State Health Benefits Program have been able to find the way to “yes” on some reforms suggests that a more comprehensive deal on health benefits is possible for both State-run health programs. We would encourage the new Governor, coming to this problem with fresh eyes, to appoint a bipartisan commission of his own choosing to pursue this possibility.

All the good ideas in the world, however, mean nothing if not met with a willingness to work together. The optimal solution involves significant legislative and constitutional action. Given the stakes involved, the focus needs to be on making the best deal now, not posturing for later. Elected officials and other stakeholder representatives need to be given room to reach agreement, and have faith that the silent majority of their constituents will support a sensible solution. All parties have to accept the reality that the current situation is untenable and change is necessary. Finally, the public as a whole has to be better informed, and hold elected officials accountable for producing a workable solution. As set forth above, we believe a workable solution is one that preserves benefits earned to date and provides competitive benefits going forward, while keeping benefits’ share of the State budget at a reasonable level without increasing the burdens on taxpayers. Such a solution is possible, as long as there is the will to achieve it.

The New Jersey Pension and Health Benefit Study Commission

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¹ <http://www.state.nj.us/treasury/pensions/pdf/financial/gasb-67-nplchart-2014-rev.pdf>. Since 2014, GASB's reporting standards have changed. The \$80 billion figure is a retrospective restatement by the State of what the 2014 GASB 67 figure would have been.

² Official Statement, New Jersey Economic Development Authority, \$350,000,000 School Facilities Construction Bonds, 2017 Series DDD. <https://emma.msrb.org/ES1050206-ES820532-ES1221770.pdf> at I-62. (Bond Disclosure). This figure, \$89.6 billion as of June 2017, after the liabilities of local PERS and PFRS are removed, reflects both the lottery dedication, *id.* at I-53, and an adjustment in the State's GASB 67 calculation. Without the lottery dedication and calculation adjustment, the GASB 67 figure would be \$117.9 billion. *Id.* at I-61.

³ Eileen Norcross and Olivia Gonzalez, Mercatus Center Ranking the States by Fiscal Condition 2017 Edition. Available at: <https://www.mercatus.org/statefiscalrankings>.

⁴ Commission Members Ethan Kra and Lawrence J. Sher are pension actuaries serving on the Commission as concerned citizens. They were not involved in preparing, and are not responsible as actuaries for, any costs or savings projections set forth in this Report, which reflect State disclosures or projections made for prior reports.

⁵ See Bond Disclosure at I-58. The annual required contribution to the pension funds (ARC) is not determined by GASB, but by a State statute which defines a separate statutory ARC, funded ratio and unfunded liability. Due to different assumptions, the statutory figures make the plans look healthier than GASB figures. For example, as of July 2016, TPAF, the teachers' pension fund, has a 47% statutory funded ratio and \$30.7 billion statutory unfunded liability, <http://www.state.nj.us/treasury/pensions/pdf/financial/gasb-67-statutory-funded-ratio-2016.pdf>, but a 22.3% funded ratio and \$79 billion unfunded liability under GASB. See Bond Disclosure at I-61.

⁶ Pension costs are from the Bond Disclosure at I-49, and health benefits costs are from the proposed FY '18 budget. <http://www.nj.gov/treasury/omb/publications/18bib/BIB.pdf> at 15.

⁷ https://www.moodys.com/research/State-of-New-Jersey-Pension-and-Transportation-Decisions-Loom-as-Issuer-In-Depth--PBM_1011277 p. 5 (Jan. 20, 2016).

⁸ See Bond Disclosure at I-49.

⁹ https://www.moodys.com/research/State-of-New-Jersey-Pension-and-Transportation-Decisions-Loom-as-Issuer-In-Depth--PBM_1011277 (Jan. 20, 2016).

¹⁰ <https://www.fitchratings.com/site/fitch-home/pressrelease?id=989633>.