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Fixing New Mexico's $25.8 Billion Unfunded Retiree System

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Executive Summary

This study is the third and final study that explores the problem of New Mexico's $25.8 billion unfunded pension and retiree health care liabilities. More specifically, this study will show how policymakers can begin to solve this crisis without resorting to the severe economic ramifications of raising taxes.

The solution is a four-step process:

Step 1—Fix the Public Sector Over-Employment Problem

Step 2—Transform Defined Benefit System into a Defined Contribution System

Step 3—Continue to Increase Employee/Retiree Contributions to the Retiree Healthcare System

Step 4—Expand the Private Sector

Without these changes, the state government will be in the awkward position of asking for greater sacrifices from citizens, such as higher taxes, to pay for the pension and retiree healthcare benefits of government workers at levels that most citizens themselves do not have. Not only is this bad public policy, it's also not fair.

Step 1—Fix the Public Sector Over-Employment Problem

In 2008, New Mexico's state and local governments employed 25.3 people for every 100 people employed in private sector versus the national average ratio of 16.72. If New Mexico's state and local government ratio was reduced to the national average, then the workforce would be reduced by 56,970 people.

For every position eliminated, state and local governments would immediately save an average of $49,711 in compensation which includes wages and salaries as well as benefits. Overall, state and local governments could save up to $2,596,600,137 in annual budget savings.

More importantly, every position eliminated would create savings through reduced pension and retiree healthcare liabilities. A conservative estimate can be made by dividing the total pension and retiree healthcare liabilities (29.8 billion) by the total number of state and local government employees (167,671) which yields $178,001 in retiree benefit liabilities per employee (in today's dollars).[1]

Overall, it is clear that reductions in over-employment provide significant budgetary savings now and in the future. One way to get a these employment savings is through a real hiring freeze which would gradually reduce employment levels through the normal turnover in the government workforce. This would also have to be accompanied by efforts to restructure the workforce to avoid having higher-value positions go unfilled just because the person in that position left.

Step 2—Transform Defined Benefit System into a Defined Contribution System

Due to the unsustainable cost of the defined benefit pension system, more and more states have been moving towards a defined contribution system—similar to the 401k system that is popular in the private sector. New Mexico should join this movement in order to reduce the long-term costs of the pension system. Currently, eleven states have moved to defined contributions in one of three ways with varying levels of cost savings.[2]

First, the largest cost savings can be achieved by moving all new government employees into a defined contribution system. Currently, two states (Michigan in 1997 and Alaska in 2006) and the District of Columbia fall into this category

Second, the next largest cost savings can be achieved by having both defined benefit and defined contribution system. Currently, two states (Indiana and Oregon) fall into this category.

Finally, many states allow for their employees to choose between a defined benefit plan or a defined contribution plan. However, depending on the specifics of each plan, there could be a lot of choice (both plans yielding very similar benefits) or very little choice (one plan yielding substantially greater benefits). As such, choice and, correspondingly, cost savings can vary by state. Currently, seven states (Washington, North Dakota, Montana, Florida, South Carolina, Ohio and Colorado) fall into this category.

Given New Mexico's large unfunded pension liabilities, the state should go directly to the most effective option which is to follow in the footsteps of Michigan, Alaska and the District of Columbia. At the very least, putting new employees into a defined contribution plan will not add to the unfunded pension liability.

Step 3—Continue to Increase Employee/Retiree Contributions to the Retiree Healthcare System

During the 2009 Legislative Session, the Legislature enacted HB 351 which increased the employer and employee contributions to the retiree healthcare system to 3 percent from 1.95 percent phased-in over 4 years. [3] This is an important first step in correcting the unsustainable retiree healthcare system without resorting to tax increases or budgetary gimmicks.

However, more reforms are needed since there are virtually no assets to offset the $3.1 billion unfunded retiree healthcare liability. If the problem is ignored, the unfunded liability will only worsen as it has in other states. In fact, West Virginia's Public Employees Insurance Agency recently took the unprecedented step of eliminating all retiree health care subsidies for new employees.[4] While this action may not hold as it is under various political and legal challenges, the agency's bold actions speak to the depth of the retiree healthcare problems.

Step 4—Expand the Private Sector

In the end, only the private sector can create new jobs and income. The decline in New Mexico's private sector as a percent of personal income is due to the crowding out created by higher government spending on personal current transfer receipts (Medicare, Medicaid, Social Security, etc.) and government employee compensation (federal, state and local).[5] In fact, in 2008, New Mexico had the 5th smallest private sector in the country at 62.2 percent of personal income.

States with larger private sectors will grow faster over time than states with smaller private sectors. For example, there is a large gap between the state with largest private sector share (Connecticut, 78.7 percent) having a per capita personal income of $56,272 versus the state (in the lower 48 states) with the smallest private sector share (West Virginia, 58.2 percent) having a per capita personal income of $31,641. To put it another way, Connecticut's per capita personal income is 79 percent larger than West Virginia's.

Finding ways to help New Mexico's private sector grow is a win-win for both the public and private sector. A larger private sector will generate higher tax revenues which could be used to tackle New Mexico's unfunded retiree system.

Conclusion

In the end, only four options are available to policy-makers to solve New Mexico's pension and retiree healthcare crisis: 1) Raise taxes; 2) Reduce other government spending; or, 3) Reform the pension and retiree healthcare systems and 4) Expand the private sector. Clearly, as demonstrated in part two of this series, raising taxes would only serve to weaken New Mexico's economy and jeopardize the state's ability to ever meet its obligations. The only option is to reduce other spending, especially over-employment, and reform retiree benefits. Longer term, boosting the private sector is also another way to tackle unfunded retiree system.

Without these changes, the state government will be in the awkward position of asking for greater sacrifices from citizens, such as higher taxes, to pay for the pension and healthcare benefits of government workers at levels that most citizens themselves do not have. Not only is this bad public policy, it's also not fair.

Notes and Sources:

[1] Keep in mind that retiree benefits savings would accrue over many years through lower annual required contributions by the state to the pension and retiree healthcare systems.

[2] Golub-Sass, Alex, Haverstick, Kelly, Munnell, Alicia H., Soto, Mauricio, Wiles, Gregory, "Why Have Some States Introduced Defined Contribution Plans?" Center for Retirement Research, Boston College, Number 3, January 2008. http://crr.bc.edu/images/stories/Briefs/slp_3b.pdf?phpMyAdmin=43ac483c4de9t51d9eb41

[3] For more information on HB 351, see: http://legis.state.nm.us/lcs/_session.aspx?chamber=H&legtype=B&legno=%20351&year=09

[4] Coggburn, Jerrell D. and McCall Jamie, "Prefunding Other Post Employment Benefits (OPEB) in State and Local Governments: Options and Early Evidence," Issue Brief, Center for State and Local Government Excellence, September, 2009. http://www.slge.org/vertical/Sites/%7BA260E1DF-5AEE-459D-84C4-876EFE1E4032%7D/uploads/%7BF7CBC101-1E69-4DE7-AEEC-ECFE6F41CAF5%7D.PDF

[5] For a more detailed explanation of the concept of "private sector share of personal income" based on data from neighboring Oklahoma, see: http://www.ocpathink.org/publications/perspective-archives/july-2009-volume-16-number-6/?module=perspective&id=2300