# A Roadmap to Resolution

# Report of the New Jersey Pension and Health Benefit Study Commission

February 24, 2015

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As members of the New Jersey Pension and Health Benefits Study Commission, we have worked diligently and collaboratively over the last several months as a non-partisan Commission to discover a cure for the problems plaguing New Jersey's public employee pension and health benefits system.

This Report proposes a solution. It requires shared sacrifice and the willingness to let go of a failed *status quo*. If adopted, it would stabilize the public employee pension system for at least 35 years—and longer if the lessons are learned from the past mistakes that caused this crisis.

The approach outlined in this Report involves the following steps:

- Freeze the existing pension plans; benefits earned to date would not be affected, but taxpayers cannot afford additional benefits to be earned under the existing plans
- Align future public employee retirement benefits with private-sector levels; this is the sensible thing to do on its own merits and the savings will make funding more secure for employees and less painful to taxpayers
- Also align public employee health benefits with private-sector levels; get ahead of the curve in controlling these staggering costs before they crowd out retirement benefits from State and local budgets
- Fairly realign State and local responsibility for new and sustainable pension and health benefits; this will produce the best result from the perspective of employees and the State's taxpayers as a whole
- Lock in fixed and certain pension funding with a constitutional amendment; this will protect employees and retirees from the vagaries of politics and the annual budget process, improve the State's financial condition, and make clear to all that the people of New Jersey have taken ownership of the problem and the solution
- Transfer the assets, liabilities and risks of the existing pension and new retirement plans to employee entities willing and able to assume this obligation; allow those who receive the benefits to have the power and

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assume the risk of managing the plans to ensure that the available funds are sufficient to pay for the provided benefits.

As part of our effort, in addition to meeting with persons across the spectrum of interested stakeholders, Commission members engaged in extensive discussions with the leaders of the New Jersey Education Association, the public-sector union with the greatest impact on State finances. Those discussions led to a conceptual framework for moving forward and an accord on some but not all elements of the Commission's proposal.

Most significantly, while there are details remaining to be worked out, there is agreement on the concept of "freezing" the existing pension plans, replacing them with new plans going forward, and transferring the existing and new plans to new entities in a form that will permit the greatest degree of employee control consistent with federal regulatory constraints for retirement plans for public employees. There is recognition that one of the key open issues, the nature and extent of health benefit reforms, has a role to play in making available funding for secure retirement benefits, and a shared commitment to a timetable for continuing to explore potential means of resolving the remaining open issues. Most importantly, the discussions have led to a consensus that meaningful, innovative and immediate measures must be taken to provide for the pension and health benefits for hundreds of thousands of hard-working public employees while preserving the State's fiscal integrity.

We recognize that there are elements of this approach that are likely to be unpopular at first, but believe in time they will be viewed as the best way to move forward. Under the circumstances, continued inaction is the same as conceding failure, and failure should not be an option when the future of the State and its employees is on the line. The need for urgency in adopting a solution cannot be overstressed. The already narrow window for a reasonable solution is closing fast. Only decisive action *now* can preserve a solid foundation of public employee benefits before the ever-growing hole the State has dug itself into becomes too deep for the State to dig itself out of without crushing tax increases and deep cuts to employee benefits and public services. The citizens of our great State—public and private employees, employers, State and local officials, voters and taxpayers alike—need to join together to make this solution possible. Let's secure the benefits for public employees and the financial future of the State of New Jersey.

## I. OVERVIEW

The Commission's September 25, 2014, Status Report outlined in some detail the dire condition of the State's public employee[1] pension and health benefits system. This Report proposes a workable solution.. In concept, the proposed approach is simple: reset the retirement and health benefits that public-sector employees will receive in the future to private-sector levels and use the resulting savings going forward to pay off the existing pension deficit. While some of the details of implementation will require flexibility and shared sacrifice, the Commission believes that the resulting mixture of benefit adjustments, additional funding and structural changes offers the State its best chance to avoid the painful collapse of its public employee benefits system.

If the State's citizens take one message away from this Report, it is that given the gravity of this crisis no part of the *status quo* is acceptable. The situation is not only getting worse, but is also fast approaching the point at which it will be beyond remedy. By 2016—the first year in which reforms could realistically be implemented—the State's annual required contribution to its share of pension funding will have increased[2] from the 2014 figure of $3.7 billion[3] to $4.3 billion.[4]

> Given the gravity of this crisis, no part of the *status quo* is acceptable

Moreover, since the release of our Status Report, which reported 2013 data, the State has released 2014 data reflecting new standards issued by the Government Accounting Standards Board ("GASB").[5] Combined, the decrease in reported asset values[6] and the increase in reported liabilities[7] under the new standards result in the State's reported unfunded pension liability increasing from $37 billion for 2013 to $83 billion for 2014.

> Based on new reporting standards, the State's unfunded pension liability, $37 billion for 2013, is reported at **$83 billion** for 2014

On the basis of these figures, TPAF,[8] the teachers' pension fund, has a projected "depletion date,"[9] the year in which it is projected to be unable to cover its projected payments, of 2027.[10] The projected depletion date for PERS,[11] the primary fund covering State employees, is 2024. JRS,[12] the judicial pension fund, is projected to reach its depletion date in 2021.[13] This is not just a concern for public employees, as it affects the State's credit rating and costs taxpayers millions of dollars in higher interest rates on government borrowing.

The focus on pension liabilities in ongoing litigation should not distract attention from the fact that it is the cost of pension and health benefits *combined* that has pushed benefits funding beyond the State's means. Public employee health benefits costs have always been high: New Jersey's public-sector health benefits are the third-costliest in the nation.[14] These costs, projected to increase from $3.1 billion[15] in 2014 to $3.7 billion for 2016 for State-paid groups alone,[16] place a significant drag on the State budget and have done so for decades.[17] The same is true at the local level, where annual health benefits costs, without reform, could approach $10 billion by 2016.[18]

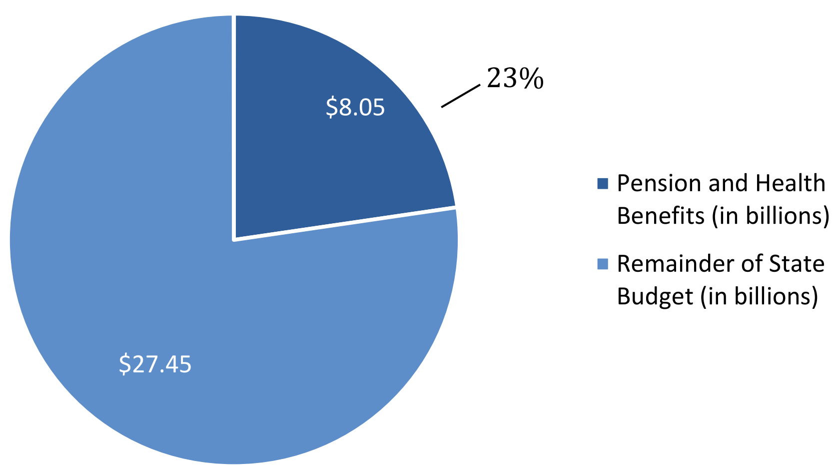
> Just as the problem is due to the combined effect of pension *and* health benefits funding, any solution *must* address both issues

If health benefits costs had been kept in check, some of the budget pressure that led to pension underfunding would have been relieved, and the hole from which the State must now dig itself out might be much less deep. Going forward, while there are different avenues to explore in how to reform health benefits, significant reduction of health benefits costs at the State and local levels is an essential element of any effort to provide public-sector employees with adequate, sustainable and certain retirement benefits funding.

## The Need for Action Now

The silver lining in the GASB figures is that they reflect reporting conventions,[19] not destiny. They are a warning that the time for action is now. Absent reform, in 2016 the State would be required to dedicate $3.728 billion for health benefits and $4.326 billion for pensions (for the 2016-17 fiscal year) to fully fund its existing obligations.[20] This $8.054 billion total would consume an unsustainable 23% of a $35.5 billion budget—and a greater percentage of a smaller budget.[21]

**Table I: Allocation of Potential $35.5 Billion 2016 State Budget**




Absent reform, in 2016 the State could spend 23% of its budget on pension and health benefits

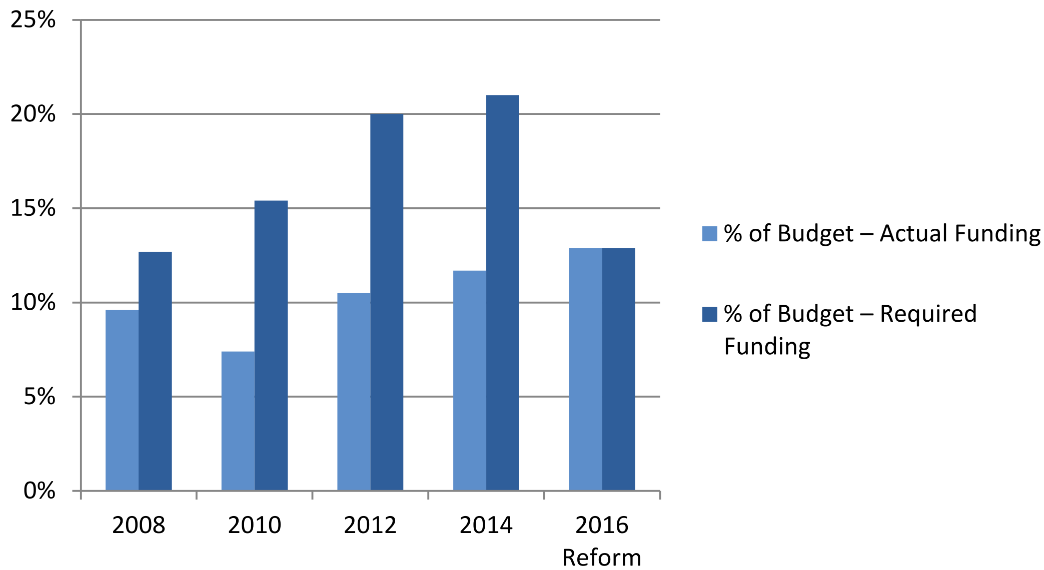
As set forth in our Status Report, this crisis has been brewing at least[22] through the terms of each of the State's six most recent Governors and the Legislatures that sat during their terms of office. The State granted benefits that it could afford only under optimistic assumptions. When reality fell short of those assumptions, the State—for years at a time—failed to fund the resulting liabilities *or* effectively reform the programs creating them.

The essence of the Commission's proposal is for the State and local governments to set retirement and health benefits at high-quality private-sector levels and to dedicate the health benefits savings to help fund the pension deficit

The time has come to break this cycle. The Commission proposes to hit the "reset" button. The essence of this approach is to more closely align public retirement and health benefits with levels they would be at in the private sector. The resulting savings, particularly those from health benefits reforms, would be used for pension funding. While there will be circumstances in which considerations of fairness or the need to mitigate disproportionate impact during the transition may require some exceptions, the Commission believes that the focus has to be on ensuring a solid, sustainable and fully funded system going forward, not perpetuating the *status quo* of a failing system.

Under this approach, the longstanding gap between funding required and funding provided will finally be closed by reducing funding requirements to a set schedule of payments at a sustainable level. Because the Commission has sought to minimize initial revenue demands in light of the current tightness of the State budget, the first year of the Commission's approach would require approximately 13% of the State budget be devoted to State employee and retiree benefits. Going forward, as costs invariably rise, every effort should be made to limit these obligations to no more than 15% of the budget.

**Table II: Actual and Required Pension and Health Benefits Funding as Percentage of Budget: 2008–2016**




The Commission's proposal to achieve this goal involves six elements:

- freezing existing State and local pension plans, which would stop the accrual of future benefits under those plans but would not reduce benefit credits earned through service prior to the freeze;
- creating new retirement plans to provide future retirement benefits;
- aligning State and local public employee health benefits with high-quality private-sector coverage;
- adopting a unified State/local approach to benefits funding that would permit the use of benefits savings at the local level to help fund the State-level pension gap, in a manner that is cost-neutral to local government;
- putting in place, by constitutional amendment, an adequate, sustainable and certain funding mechanism for the benefits as revised; and
- transferring the assets, liabilities and full responsibility for the existing pension and new retirement plans to employee entities willing and able to assume this obligation.[23]

Because of the already tenuous condition of the State's public finances and uncertainty over how quickly and fully the savings that are contemplated in this proposal can be realized, the Commission has striven to limit the immediate need for revenue. Our approach has been to look at the amount of projected pre-reform State and local pension and health benefits costs for 2016[24] as an initial funding source and then determine if this amount would be sufficient to fund pension benefits earned to date and to provide a baseline of quality private-sector health benefits and retirement benefits going forward. Based on the significant level of savings that would result from benefit reforms, we believe that, subject to how costs and savings are allocated between State and local governments, it would be possible to meet this goal within projected pre-reform costs. Indeed, we believe that it should be possible, while staying within projected pre-reform costs, to provide a higher level of benefits than the baseline figures used to determine the feasibility of this approach. The ultimate level of benefits, however, will turn on final cost savings, which will in turn depend on plan design and State/local funding allocation decisions.

Tables III and IV model the finances of the Commission's proposal from the perspective of the State. The table depicts a scenario in which, as we believe would be the case, local savings resulting from these proposed reforms would be more than sufficient to permit local governments, within their existing budgets, to fund the costs of local education retiree health benefits (currently a State obligation) and the new retirement plan for local education employees. In this scenario, the manner in which State and local obligations fall would still require at least $179 million in additional funding at the State level. This would be on top of the $621 million increase in State-responsible health benefits costs from 2014 to 2016 that are included in the projected pre-reform 2016 costs. Furthermore, the anticipated payment schedule for the State's funding of the frozen pension benefits contemplates the payments increasing by 3% to 4% annually, which will result in a need for approximately $500 million in additional revenue by 2020.[25] While the Commission's proposal involves reduction of benefits, it also requires substantial additional revenue. While there is reason to hope that this revenue will become available through natural growth in the State budget and capture of a modestly disproportionate share of that growth for benefits funding, there are no guarantees. The obligation to raise this revenue and make the required payments is a burden that the State and its taxpayers would assume by committing to fund the benefits outlined in the Commission's proposal.

**Table III: Proposed Uses of State Benefits Funding – 2016** (in billions)

| | |
|---|---|
| Reduced Projected 2016 State Health Benefits Payments | $1.722[26] |
| Payments to Frozen Pension Plans | $2.600 |
| Payments to New Retirement Plans | $0.266[27] |
| Total Uses | $4.588 |

**Table IV: Proposed State Benefits Funding Sources – 2016** (in billions)

| | |
|---|---|
| 2014 State Health Benefits Payments[28] | $3.107[29] |
| Projected Increase in Health Benefits Payments by 2016 | $0.621[30] |
| Current 2016 State Projected Normal Pension Payment[31] | $0.681[32] |
| Initial Additional Funding | $0.179[33] |
| Total Sources | $4.588 |

## The Future Without Reform

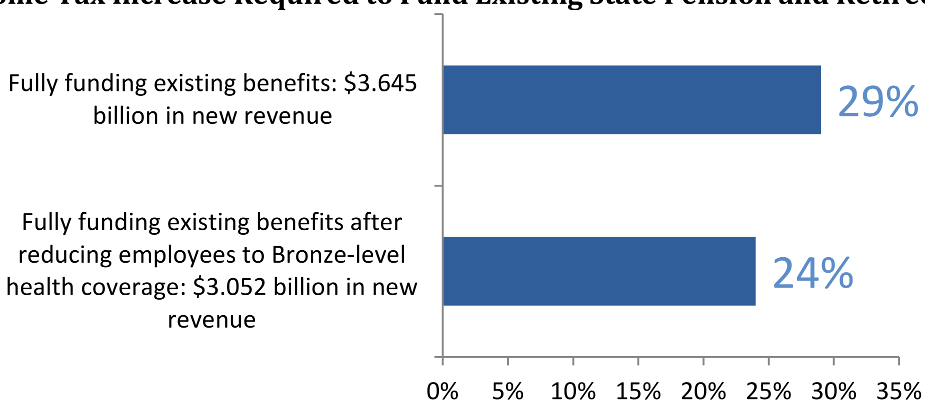
One possible response to this crisis is, "the State should just pay what it owes." Given a $3.6 billion annual gap in pension funding at the State level that absent reform will continue to grow, along with even higher increases in health benefits costs, this is not realistic.

There are no plausible solutions for closing the pension funding gap without comprehensive benefits reform. As shown in Tables V and VI, raising an additional $3.6 billion annually would require increasing the sales tax to 10% or increasing the income tax by 29%.[34] Aside from their crushing impact on taxpayers, such measures would face significant obstacles from State constitutional mandates on the use of specific revenue sources for particular purposes, such as the dedication of all income taxes to property tax relief. In addition, the State must obey federal mandates, honor bonded obligations and meet other funding demands. As a result, roughly 87% of State revenues are effectively committed to specific purposes[35] before the budgeting process begins. The remaining funds—$4.3 billion in the current budget—are counted on for vital functions such as law enforcement, public safety, the judiciary, and executive department offices.[36]

Even spreading a tax increase this size among multiple revenue sources would do little to mitigate its impact. A "millionaires' tax" imposing an average $50,000 additional annual tax on each millionaire, for example, would make only a small dent in the funding shortfall. It would still require the State to impose a 23% income tax increase on every other taxpayer.[37] As a matter of political reality, potential tax increases of this magnitude would first be preceded by substantial benefit reductions. If existing pension and retiree health benefits are considered beyond reach, the remaining options would involve actions such as reducing active employees' health benefits to the equivalent of Bronze-level[38] coverage under the Patient Protection and Affordable Care Act ("ACA") and eliminating retirement benefits for employees hired after 2010.[39]

There are no realistic solutions for closing the pension funding gap if existing pension and health benefits are considered beyond reach

**Table V: Income Tax Increase Required to Fund Existing State Pension and Retiree Health Benefits[40]**




The inequities that would result are obvious. Active employees would be reduced to Bronze-level coverage to permit retirees to continue to enjoy Platinum-plus health benefits, and new employees would be deprived of all retirement benefits to permit employees with more tenure to continue to accrue benefits at unsustainable levels. And, as shown in Table V, the taxpayers would still face the need to provide $3 billion[41] in additional annual revenue, the equivalent of a 24% income tax increase.

Table VI below sets forth the effect on various sources of raising the additional revenue needed to fund the scenarios described above. In each case, the table projects the impact of raising the required revenue from one source. That is, the additional $3.6 billion required to fully fund all existing benefits could be paid for either by an increase in the sales tax to 10% or by devoting 85% of the portion of the budget not already committed to existing obligations to employee benefit funding.

**Table VI: Potential Impact on Revenue Sources of Funding 2016 Benefits Without Reform**

| Amount of Additional Revenue Needed | Full funding of existing benefits through additional revenue alone. | Full funding of existing benefits after reducing employees to Bronze-level health coverage. |
|---|---|---|
| New Sales Tax Rate; or[42] | 10% | 9.54% |
| Additional Annual Tax per Millionaire; or[43] | $228,062 | $190,750 |
| Percent of Uncommitted Portion of Budget[44] | 85% | 71% |

That, in brief, is New Jersey's future without meaningful public employee benefits reform—a future that is bleak, burdensome and unacceptable to everyone.[45]

## Elements of the Commission's Proposed Reset

There is a better way. As set forth below, under the Commission's proposal pensions of existing retirees would not be affected, and existing employees would keep pension credits earned through the effective date of the freeze. The new retirement program would treat both new and existing employees more equitably, and active employees and retirees would enjoy quality health benefits comparable to what they would receive from a large private-sector employer.

### 1. Freezing the Existing Plans

Freezing existing pension plans at the State and local levels means that the plans would be closed to new members and that existing members would no longer accrue additional benefits under those plans. Existing plan assets and future State contributions would be used fund the benefits of existing retirees and the benefits accrued by employees through the date of the freeze. The plan-funded[46] pension benefits of existing retirees would not be affected, and no one would lose a benefit credit for service before the freeze. What would change is that employees would no longer earn future benefit credits under the terms of the current plans or contribute to these plans. As implemented in this reform, even providing for funding of new retirement plans, freezing the plans would reduce State and local governments' pension-funding costs by over $2 billion in 2016 alone.

> Freezing the existing pension plans would preserve benefit credits earned to date while saving over $2 billion annually

Freezing existing pension plans strikes a delicate balance. It permits current members of the plans to keep credits earned through service before the freeze, but relieves taxpayers of the burden of funding continued accruals under terms that have proven unsustainable. As the current assets of the plans are insufficient to fund even the benefits earned to date, the frozen plans would still require contributions by public employers estimated at $3.1 billion in 2016. Annual payments of this magnitude, increased pursuant to an escalating payment schedule, would continue for decades.

### 2. Creating New Retirement Plans

Once the existing pension plans are frozen, new plans would be needed to provide employees with the means to earn future retirement benefits. The Commission believes that what is known as a "cash balance" plan provides the best model for the new plans. A cash balance plan is a hybrid defined benefit plan that expresses the employee's benefit as an account balance that, as proposed by the Commission, grows by "pay credits" based on an employee's salary, and by periodic "interest credits" based on the account's balance and some defined measure of investment performance. Under the form of a cash balance plan envisioned by the Commission, an employee would be guaranteed both the contributions based on pay credits made to his or her account and interest credits based on a minimum interest–crediting rate over the years of participation in the plan.

The cash balance design envisioned by the Commission would result in greater cost control and more equitable risk sharing between the plans and employees while still providing employees with a significant level of security in their retirement savings. Obviously, to be an effective reform, the new plans must also cost less going forward than the old plans would. As a starting point, the Commission has assumed that the employer and employee contributions would each be 4% of salary, with 8% employer and employee contributions for employees who, like many firefighters and police officers, do not participate in Social Security. Based on a total State/local government payroll of $26.637 billion,[47] the Commission estimates the employer cost of the new plans would be $1.23 billion. The Commission believes that this is an affordable initial baseline for contributions, subject to augmentation in the event that quantification of costs and savings establishes the affordability of a higher level of employer contributions.

### 3. Aligning Public Employee Health Benefits with Private-Sector Levels

Under the Commission's proposal, significant reduction of State and local governments' health benefits costs is essential to secure the funding necessary to fund the frozen pension plans and the new retirement plans. The average New Jersey public employee is enrolled in a health plan with an "actuarial value" of 95%, meaning that the plan pays approximately 95% of the cost of essential benefits,[48] with an average employee contribution of 18% of premium costs. In contrast, while there is some variation, plans offered by large private-sector employers typically fall within a range of 80% to 85% actuarial value,[49] toward which employees typically contribute 24% of premium costs.[50]

Setting public-sector health benefits at private-sector levels could save State and local public employers over $2 billion annually to be dedicated to pension funding

The Commission anticipates that the exact level of coverage will be determined through a plan design process with significant input from stakeholders. To establish that it would be possible to provide private-sector-level health benefits while also adequately funding the frozen pensions and the new retirement plans, this Report bases initial cost projections on an 80% actuarial value plan. As set forth in the Implementation Issues section, applying this level of health benefits reform system-wide, combined with other State and local reforms, would produce substantial savings. For this reason, the Commission believes that it could be possible, within the existing level of local budgets, to provide a higher level of health benefits than the baseline used to establish the fiscal viability of the Commission's approach.

Since the level of savings is uncertain and the same savings can only be spent once, however, the Commission believes that the best analytical approach for defining health benefits is to conceptually reset health benefits to a benchmark 80% actuarial value level and then explore how these benefits can be augmented, given competing funding demands.

Going forward, the Commission envisions health benefits funding based on costs of a benchmark plan that corresponds to private-sector level coverage. While the details would be defined through a plan design process, the Commission anticipates that a meaningful choice of plans would be offered. For purposes of modeling reform impact, it has been assumed that employees' required contributions towards premiums would continue to vary based on income in a manner similar to the current Chapter 78 schedule, but that the distribution of contribution levels within this range would be adjusted to increase average employee contributions to 25% in an equitable manner that will not impose undue burdens on lower-income employees. The Commission's proposal assumes retirees would receive employee-level benefits without any contribution requirement in addition to those imposed under current law. This approach will align public sector health benefits with those in the private sector and provide employees with an incentive, absent in the current system, to embrace cost-control efforts.

### 4. Applying a Unified State/Local Approach to Benefits Funding

Consistent with its charge to look at the funding crisis from the perspective of the State, the Commission initially considered pension and health benefits reforms only for State employees and retirees. It soon became clear, however, that this was an artificial distinction. For a number of reasons, including the State's assumption of education retiree expenses, the State and local employee benefits systems were effectively intertwined from a fiscal perspective. It became equally clear that reform of local benefits, particularly health benefits, would avoid the local benefit system going the way of the State system.

> There are obvious benefits to an approach that remedies a State-level $1.5 billion funding deficit while creating a local surplus

Furthermore, because local health benefits costs are so high, even moderate reforms would result in huge local savings. If aggregated, these savings could permit a higher overall level of post-reform benefits and more equitable State/local allocation of benefit obligations at no additional cost to local taxpayers. In contrast, as illustrated in Table IX in the Implementation Issues section of this Report, a State-level-only reform would generate a need for over $1.5 billion in new revenue at the State level. Given the dire need, the extent to which State funds already play a significant role in funding local benefits,[51] and the fact that local savings would not exist but for statutory and constitutional reforms intended to address the State-level crisis, the Commission believes that it is appropriate to dedicate these local savings to help close the State and local pension funding gaps. At the same time, the Commission is sensitive to the existing burdens on municipalities and believes that the local impact of this approach should be limited to aggregating local *savings* for use in funding the pension deficit. As a result, this reform would be cost-neutral to local governments.

### 5. Enactment of an Adequate, Sustainable and Certain Funding Mechanism.

Reducing benefits and providing certain funding are inextricably intertwined. For both fiscal and political reasons, it is inconceivable that one would occur without the other. Achievement of each of these goals would be enabled by amendment of the State Constitution.

This Report differs from other reform proposals in recognizing that some existing benefits must yield to put in place a program that is affordable, sustainable and fair to all. A particular source of difficulty for adjusting benefits is a 1997 statute that, for over a decade, extended to vested employees a "nonforfeitable right" to receive pension benefits as provided under the laws governing the retirement system at the time they reached five years of service.[52] As events have transpired, employees with sufficient length of service—currently 89% of all employees participating in PERS at the State level and in TPAF—have been spared any reduction in their right to future pension benefit accruals. This has kept pension costs unsustainably high and has impaired the effectiveness of almost all[53] subsequent reforms of pension benefits, as these reforms have been limited to employees who lacked the seniority at the time of the reform to claim nonforfeitable rights.

> It is unfair to continue to preserve unaffordable benefits for some employees at the expense of other employees and taxpayers as a whole

Because of claims of constitutional protection, the ability of the Legislature to reduce pension benefits for individuals claiming nonforfeitable rights protection has been questioned. As a result, the Commission believes that the best means of ensuring the freedom to effect meaningful reform would be to amend the State Constitution to confirm, notwithstanding anything in the Constitution or laws of the State of New Jersey to the contrary, the power of the State to reduce existing pension and health benefits. If sufficient health benefits savings can be achieved to permit funding of the reduced pension obligations, it would be possible to include in the amendment a guarantee of the pension funding specified in the payment schedule.

The amendment process requires approval by the voters in a general election. Given the public's stake in the issue, having the public agree to the terms of this solution should be seen as a virtue.

> Given the public's stake in the issue, the fact that a constitutional amendment will require voter approval should be seen as a virtue

**6. Transferring Benefit Plans to Employee Entities**

The preceding elements of the Commission's approach would reduce the State's obligation to fund the existing pension plans to a predetermined sum each year. This would, in turn, facilitate transfer of the assets and liabilities of these plans and of the new retirement plans[54] to employee entities willing and able to assume these obligations.[55] If this were done, employees would control their own destiny with respect to these benefits - and assume the risk of managing the plans to ensure that the available funds are sufficient to pay for the provided benefits. This transfer would permit the State to provide the bond market with a much greater degree of cost certainty.

### Expected Investment Return Risks

As discussed in more detail in our Status Report,[56] the pension data discussed in this Report are the State's official figures, which are based on an assumption that plan assets will earn an average 7.9% annual rate of return. This assumption has been questioned by some of the plans' own actuaries.[57] The Commission would prefer to see it set at a rate no higher than 7.0%. For purposes of consistency, however, this Report uses the State's figures. The public should be aware that rate-of-return assumptions affect the probability that, over time, a particular level of funding will in fact prove adequate. A 7.0% expected rate of return (rather than 7.9%) would result in a higher projected unfunded liability and in correspondingly higher contribution requirements. Assuming that those higher contributions were in fact made, this would result in less risk that funding would prove inadequate to meet the plans' actual obligations. Whatever the actual experience turns out to be, however, the State will be in far better fiscal shape under the approach outlined in this Report than if the current state of affairs is allowed to continue.

### The Implementation Task Force and Time Schedule for Reforms

In the course of the Commission's work, it has learned that getting the details right in defining the terms of health benefits plans and the provisions of new retirement programs, coordinating them with each other, and managing the transition from existing programs are major technical undertakings. As such, they cannot be the responsibility of an appointed Commission with limited resources and a limited time in which to act. For this reason, the Commission recommends that the Governor establish an Implementation Task Force to assume this responsibility and that the Task Force have all the resources necessary, including staff and legal and actuarial support, to address these complex implementation and transition issues.

Because the funding gap grows larger every year that goes by without reform, the Task Force's schedule will be driven by the need to adopt a constitutional amendment in time to permit reforms to be implemented in 2016. Each house of the Legislature would need to approve a proposed amendment by a three-fifths majority by August 3, 2015, for the amendment to be published three months prior to the November 3, 2015, general election. The work of the Task Force that will be necessary to frame the terms of the constitutional amendment and to at least outline the implementing legislation must be completed well before the deadline for legislative action and publication, with the work of detailed plan design and drafting of implementing legislation continuing, pending the vote on the amendment.

## II. HEALTH BENEFITS

The Commission's Status Report highlighted health benefits as an area with the potential for substantial cost savings.[58] Without reforming health benefits and using the savings to help pension funding, it is simply impossible to provide adequate, sustainable and certain employee benefits funding at a cost that the State's citizens can bear.

### Overview

Without reforming health benefits and using the savings to help pension funding, it is simply impossible to provide adequate, sustainable and certain employee benefits funding at a cost that the State's citizens can bear

The foundation for the Commission's proposed reform is the use of a benchmark plan with coverage equivalent to that provided by major private-sector employers in the State. This benchmark would be used as the starting point for a collaborative plan design process intended to result in the adoption of health benefit reforms providing quality benefits while also yielding sufficient savings to provide funds for the existing pensions and warrant adoption of a constitutional amendment creating a certain pension funding obligation.

If the plan design process involves the Plan Design Committees ("PDCs") of the State Health Benefits Program ("SHBP") and School Employees Health Benefits Program ("SEHBP"), it will be necessary for these entities to improve substantially upon on what has been a disappointing record to date. In theory, the PDCs, which by statute must have equal labor/management membership, were created as a forum for employer–employee collaboration. In practice, this built-in mutual veto has blocked reform efforts proposed by either side and has had the effect of locking in above-Platinum-level health benefits for public employees.[59] Both labor and management have expressed acute frustration with the workings of the PDCs. How the PDCs respond to this crisis will determine whether they should have a continued role in defining employee health benefits.

For reasons of efficiency and general equity, the Commission believes that distinctions among different employee groups should be minimized. There are, however, grounds to make some distinctions, such as those for pre-Medicare retirement health benefits for groups such as police officers and firefighters with normal retirement ages that are lower than the age for Medicare eligibility. Similarly, for certain employees and retirees, fairness may call for transitional assistance or funding allowances for instances of individual hardship. This could take the form of a phase-in period and/or temporary funding supplements—details to be resolved through statutory drafting and plan design.

### The Benchmark Plan

At present, the typical State or local employee is enrolled in a plan that has an actuarial value— the measure of the average percentage of the cost of essential benefits that the plan pays for, as opposed to out-of-pocket costs paid by the covered individual—that is far above the 90% level of a Platinum plan under the ACA.[60] Given existing budget constraints, this is far too heavy a burden for the taxpayers to bear. Public employers could satisfy the ACA coverage requirements by providing Bronze-level coverage to employees. The Commission's guiding principle, however, whenever possible and appropriate, is to set public employee benefits at least as high as they would be in the private sector.

Table VII illustrates a cross-section of provisions of plans offered by some of the State's largest private-sector employers.[61] The table illustrates several important points. One is that there is a range of plan values, even among the large private-sector employers who tend to offer higher-value plans than the private sector does as a whole. A second is that there are many different ways to combine plan provisions to come to the same basic actuarial value.

**Table VII: Medical Coverage Elements of Selected New Jersey Private Sector Health Benefits Plans**[62]

| | Employer A | Employer B | Employer C | Employer D |
|---|---|---|---|---|
| Actuarial Value | 79% | 81% | 83% | 90% |
| Employer Premium Contribution | 60% Overall | 75% Employee 65% Dependent | 80% Overall | 87%–95% Overall |
| HRA/HSA Amount (Single/Family) | none | none | $250/$500 | none |
| **Medical** | | | | |
| Deductible (Single/Family) | $1,500/$4,500 | $1,250/$2,500 | $1,350/$2,800 | $150/$300 |
| Out-of-Pocket Maximum (Single/Family) | $5,000/$10,000 | $4,125/$8,250 | $4,500/$9,000 | $1,000/$2,000 |
| In-Network Member Coinsurance | 30% | 20% | 15% | 20% |
| Primary Care | $30 | 20% coinsurance | 15% coinsurance | $15 |
| Specialist | $30-$60 | 20% coinsurance | 15% coinsurance | $15 then 20% |
| Inpatient Facility | $300 then 30% coinsurance | 20% coinsurance | 15% coinsurance | 20% coinsurance |
| Emergency Room | $300 copay (waived if admitted) | 20% coinsurance | $150 copay (waived if admitted) | $50 copay (waived if admitted) |

A third consideration is that factors other than actuarial value affect the overall "richness" of a plan. For example, two plans can have the same actuarial value but different employer premium contributions. Similarly, some could apply the same premium contribution across the board while others could require different contributions that are based on income, family size or employment status. In particular, even under the Commission's proposed reforms, public-sector employers would bear the cost of providing a level of retiree health benefits that is substantially higher than is typical in the private sector. This systemic cost and lifetime benefit needs to be taken into account when comparing private-sector plans, which more likely than not do not offer this benefit or have to bear the associated expense. The cost of an individual plan is also sensitive to a particular employer's claims experience and decisions by the employer on how to price options within its plan menu.

Because there is a wide range of options that can be combined in an almost infinite variety of ways to balance scope of coverage and employer and employee costs, the Commission has not attempted to design a specific plan. At present, the average plan sponsored by a large employer, both nationally and in New Jersey, falls roughly within the range of a Gold-level plan under the ACA.[63] As a baseline for determining financial viability, the cost estimates in this Report are based on an 80% actuarial value plan, a level of reimbursement that the Commission believes is affordable and would continue to attract and retain a qualified workforce.

The key to formulating the actual benchmark plan to be used for quantifying employer contributions will be selecting the best mix of plan elements to align coverage with the private sector, yield sufficient savings to permit sustainable funding of pension and retirement obligations, and provide quality care. Given the existing generous level of benefits, these goals will inevitably result in some increased costs to beneficiaries. To minimize this impact, the plan design process should fully explore approaches such as wellness programs and other initiatives that focus on beneficiaries' health rather than pay-per-service compensation of providers. It is unlikely, however, that wellness initiatives alone will be enough to achieve the necessary levels of reform. There will also be a place in the process for traditional plan design techniques of adjusting in-network and out-of-network deductibles, copays, and maximum out-of-pocket expense limits. Applied properly, these techniques do not merely shift costs, but can reduce costs for both employers and employees by encouraging utilization of strong networks of efficient providers utilizing cost-effective means of providing care. These same approaches can be used to deter unnecessary and costly behavior, such as the use of emergency rooms for routine care. The plans should embrace other means, such as greater use of generic drugs and prescriptions by mail, and provider reimbursement strategies that encourage utilization of research-proven best practices, to achieve equal or better care at less cost to both employers and employees. The "Additional Thoughts" section at the end of this Report discusses a number of approaches worthy of consideration.

> To minimize increased costs to employees and retirees, the plan design process should place a premium on elements that reduce costs for both employers and employees

A final consideration in plan design is the Affordable Care Act. The Commission believes that taxpayer funds dedicated for employee health benefits should be used only to pay for benefits, not for penalties for failing to provide required coverage or ACA excise taxes on high-cost coverage.[64] As set forth in our Status Report, many of the most popular existing health plans would immediately be subject to the ACA excise tax on "Cadillac" plans when that tax goes into effect in 2018.[65] While the Commission anticipates that employees and retirees will be given a choice of plans, the legislation enacting the proposed reforms should do everything possible to ensure that individual employees selecting plans that are subject to ACA excise taxes bear the cost of any such excise tax, not taxpayers.

### Active Employees

Under the health benefits funding model envisioned by the Commission, for active employees, the employer contribution would be 75% of the average cost of providing coverage under the benchmark plan. We also anticipate that the distribution of active employee contributions will be adjusted in an equitable manner within the current 3% to 35% range to increase the average employee contribution from approximately 18% to 25% without having an undue impact on low-wage workers. Seventy-five percent of the cost of providing coverage under the benchmark plan, however, is what public employers would pay.

### Early Retirees

For the purposes of this discussion, an "early retiree" is someone who, for reasons other than disability, has retired or who will retire before becoming eligible for Medicare. These individuals represent a "perfect storm" for health benefits funding. Like active employees, early retirees require full coverage, not just Medicare supplements, until they become old enough to be eligible for Medicare. Like normal-age retirees, however, early retirees do not currently contribute to the cost of their coverage.[66] Due to their age and other factors, their coverage costs also tend to be high. As a result, while the average annual employer cost to provide family coverage for an active public employee is approximately $16,000,[67] it costs a public employer, on average, $26,000 a year to provide family coverage for an early retiree until they become eligible for Medicare.[68] Early retirees thus represent a substantial expense that is borne entirely by State and local governments and will likely be subject to significant ACA excise taxes in 2018.

Federal law does not mandate provision of any retiree health benefits, which are governed by a variety of State statutes and labor agreements.[69] It would be inequitable and unaffordable for early retirees to continue to receive above-Platinum-level coverage without a retiree cost contribution while employee benefits are reduced.[70] Nationally, the average early retiree fortunate enough to have access to employer-provided health benefits (many employers do not offer this benefit at all) pays 40% of the cost of coverage.[71] The essence of the benefit system currently in place, however, is that early retirees receive the same coverage active employees do, but without a contribution requirement.[72] The Commission's cost projections assume continuation of this practice.

### Medicare-eligible Retirees

Similar to the proposal for early retirees, the Commission recommends that the cost of a high-quality Medicare supplemental plan be used as a funding benchmark. This would result in substantial savings while still preserving noncontributory Medicare supplemental coverage, a benefit that is increasingly rare in the private sector.[73] It would also begin to correct an imbalance caused by retirees ignoring the law of diminishing returns. Medicare already covers 80% of expenses. There is a steep increase in marginal cost to close successively smaller increments of the remaining gap. Public-sector retirees, insulated from the resulting costs, have generally chosen State Medicare supplemental plans with a 98% actuarial value that cost almost 80% more than Medicare supplemental plans available on the open market with a 92% actuarial value.

An additional $244 million in the first year[74] could be saved system-wide by eliminating Medicare Part B reimbursement,[75] an anachronism dating to an era when incentives were deemed necessary to encourage what is now near-universal enrollment in Medicare. Not surprisingly, private employers are increasingly declining to offer this benefit to new retirees and are capping it or eliminating it for existing retirees.[76]

### Total Health Benefits Savings

Subject to the caveats set forth above, the private-sector template used by this Report as the starting point for the plan design process would result in savings of almost $1.9 billion in the first year attributable to State and local participants in the State's health benefits plans.

**Table VIII: Total Health Savings from SHBP/SEHBP Participants – 2016** (in billions)

| | |
|---|---|
| Active Employees | $1.074 |
| Early Retirees | $0.247 |
| Medicare Retirees | $0.309 |
| Medicare Part B | $0.244 |
| Total | $1.874 |

A fact crucial to understanding the finances of the Commission's proposal is that the projections in Table VIII do not reflect savings attributable to employees whose employers[77] have exercised the option of providing parallel benefits outside the SHBP or SEHBP. Only 48% of school districts, comprising 65% of education employees, are enrolled in the SEHBP, and just 60% of local employers, comprising 20% of local active employees and retirees, are enrolled in the SHBP.[78] The Commission anticipates that, as has been the case with other cost-control initiatives, its proposed reforms would apply to local entities regardless of their participation in the State health benefits system.[79]

It will be crucial to quantify the full savings resulting from local health benefits reform and decide how best to use the funds that would be made available by these reforms

As discussed in the text accompanying Table IX in the Implementation Issues section, there could be as much as *another* $1.8 billion in health benefits savings attributable to local employees not enrolled in the SHBP or SEHBP. One of the most important tasks of the Implementation Task Force will be to quantify these savings and determine the best way to use these funds, including as a potential means of bolstering benefits above the baseline figures used in this Report.

## III. PENSIONS

The Commission envisions retirement benefits reform as a two-part process: freezing the accrual of benefits under the existing pension plans, and creating new retirement plans under which employees will accrue future retirement benefits. This approach would enable both current and new employees to accrue future benefits that are secure and affordable —adjectives that cannot be used to describe the current plans.

### Freezing the Existing Plans

Freezing the existing pension plans would end accrual of new benefits and employee contributions under those plans. The State's taxpayers would be freed from having to fund accrual of future benefits at levels that have proven to be unsustainable, while retirees,[80] vested former employees and current employees would retain all benefits earned through the date of the freeze. Under this approach, an individual employee's retirement benefit would consist of pre-freeze and post-freeze components. The pre-freeze component would be determined by the terms of an employee's existing plan, with the exception that post-freeze service would count towards satisfying an employee's service requirements for vesting or retirement eligibility without increasing the amount of the frozen benefit. The post-freeze component would be determined by the benefits under the new plan.

The benefits of freezing the plans are two-fold. First, this would stop all new accruals, which in turn would eliminate the need to fund these accruals and reduce the unfunded liability.[81] Second, by fixing the plans' obligations, their liability can be paid down through a more manageable payment schedule than would be required for plans in which benefits continued to accrue. If the plans are frozen as contemplated by this proposal, the $5.9 billion payment for the State and local government pension obligations in 2016 would be reduced to $3.1 billion, a reduction of roughly $2.8 billion.[82]

A freeze would not solve all the existing plans' problems. As obligations that accrued prior to the freeze must still be paid, a freeze, by definition, has no impact on current retirees—except to facilitate more secure funding of the benefits earned to date. Since the existing plans have insufficient assets to fund their current obligations, they would continue to require substantial contributions for many decades. Those obligations would, however, be smaller than they would be if the plans are not frozen.

### Creating New Retirement Plans

If the current plans are frozen, new plans would be needed to provide future retirement benefits. Based on its review of alternatives,[83] the Commission believes that an appropriate model for the new plans would be a cash balance plan. A cash balance plan is a hybrid form of defined benefit plan that in some ways resembles a 401(k)-style defined contribution plan. Like a defined contribution plan, benefits in a cash balance plan are expressed as individual accounts. Unlike a defined contribution plan, however, the employee's account is a bookkeeping amount, not an actual segregation of assets. The account is credited with an amount during each year of employment; the amount, usually based on the employee's salary, is often described as a "pay credit." The cash balance account also receives periodic "interest credits" that are based on the account's balance and either on the plan's investment performance or on the change in value of one or more investment indices specified in the plan.

Under the form of cash balance plan envisioned by the Commission, an employee would be guaranteed both the pay credits made to his or her account and interest credits that are based on the plan's actual investment returns with a minimum interest-crediting rate over the years of participation in the plan.[84] The interest guarantee mitigates the employee's exposure to investment risk, a crucial distinguishing feature between the proposed cash balance plan and a defined contribution plan. At the same time, the employer's exposure to investment risk is minimized as a result of only being obligated to pay a defined minimum benefit with a shared upside, rather than having to fund a final-average-salary pension in which the benefit is defined without regard to investment returns.

Another critical distinction between a cash balance plan and a defined contribution plan is that lifetime annuities would continue to be provided from the plan, unlike distributions from typical defined contributions plans that are paid as lump sums or annuities over fixed numbers of years. The proposed cash balance plan would provide a middle ground between the current final–average-salary defined benefit plan, in which the employer costs are uncertain and all risks are borne by the employer, and a defined contribution plan in which the cost to the employer is certain but the employee bears all the risks.

A final distinction between a cash balance plan and a typical defined contribution plan is that the cash balance plan's sponsor and investment managers, not individual employees, retain responsibility for investment decisions. The Commission views this as an additional factor weighing in favor of the cash balance model, as studies have repeatedly shown that plans with professionally managed investments outperform plans in which individual employees are left to direct their own investments.[85]

The Commission envisions that the new cash balance plans' pay credits would include both employer and employee pretax contributions,[86] which would address an unfortunate characteristic of the current plans.[87] The required employee contribution for new benefits has steadily increased, as available funding has proven inadequate to cover the cost of generous benefits accrued at a time when employees made lower contributions. At the same time, the benefits for newly hired employees have been steadily reduced. As a result, for employees hired after required contributions were increased, their entire pension benefit is essentially funded only by their own contributions. The proposed new cash balance plan would result in a significant leveling of the playing field; newer employees would begin to accrue meaningful employer-provided benefits in the early years of service in addition to the benefits provided by their own contributions, which reverses the recent trend in which they have taken the major brunt of prior reform efforts.

A less generous plan that is fully funded and treats all employees equitably is preferable to an unfunded plan that denies benefits to new employees

While resolving the exact contribution levels will be an issue for the Implementation Task Force to determine, given that the State's budget will remain under extreme pressure while these reforms are enacted and cost-control efforts take effect, funding the new retirement plans should be approached with caution. In developing cost estimates for this Report, the Commission used as a baseline that State and local governments would contribute 4% of payroll to the new plans for employees enrolled in Social Security, and 8% for employees not participating in Social Security. Most typically, employees not enrolled in Social Security are firefighters and police officers who have different contribution levels, retirement ages and years of service requirements under the current plans, factors that would not be changed by the Commission's proposal. These baseline assumptions would result in an annual cost for the new retirement plans cost of $1.23 billion on a State and local payroll of $26.637 billion.[88] Although in a cash balance plan employee and employer pay credits do not have to be set at the same level, the Commission assumes, as a default position, that employee contributions would also be set at the same level as employer contributions are. As is the case with health benefits, final quantification of costs and savings might permit higher levels of employer contributions, but these are the figures that the Commission has used to evaluate the financial viability of its proposal.

Although the proposed plans are likely to be less generous to long-tenured employees as compared with the current plans, a less generous plan that is funded is preferable to a more-generous plan that isn't. The new plan would be a significant improvement for employees hired more recently and new hires who have borne the brunt of previous pension reforms to the point that they are virtually self-funding their own retirement benefits. The Commission's proposed reset would restore some needed intergenerational equity in the benefits program.

While we believe that the Implementation Task Force will be best positioned to make judgments on the details of plan design, we believe the following plan elements warrant consideration for inclusion in the new cash balance plans.

- ***Supplemental pay credits for midcareer employees***. When employees move from a defined benefit plan to a cash balance plan, midcareer employees (generally between ages 40 and 50) can be caught in the transition. They lose the high-accrual years that occur at careers' end in final-average-salary defined benefit plans but are left with less than the length of a full career in which to accrue the amount of benefits contemplated by a cash balance plan. Temporary supplemental pay credits for such employees are one way to ameliorate this concern. The Implementation Task Force can also consider other transition approaches.

- ***Potential additional employee contributions***. The Commission anticipates that employee contribution rates would be set at lower level than under current law. Consideration should be given to creating some mechanism to permit and encourage employees to engage in additional retirement savings.

- ***Graduated pay credit scale***. Final-average-salary defined benefit plans are typically "back-loaded," with benefits earned in the final years of service representing a disproportionate share of the total benefit, while cash balance plans typically spread accruals more evenly over time. If there is a desire to reward long-term service, pay credits can be graduated on a scale that provides larger credits for longer service. For example, pay credit rates might equal 3% of pay during the first 10 years of service, 4% for the next 10 years, and 5% for years of service over 20. A graduated scale would tend to lessen the need for supplemental pay credits for midcareer employees.

## IV. IMPLEMENTATION ISSUES

### Implementing a Unified State/Local Approach to Benefits Funding.

A question many stakeholders have asked is, "why should local employees be involved in the solution to a State-level problem?" The answer is that this is not a State-level only problem. It is merely a matter of time before the increased health benefits costs that crowded out State pension funding have the same effect at the local level.[89] The State's current troubles serve as an object lesson why it would be better for local governments to act now to get ahead of this curve.

Moreover, the condition of local benefits cannot be viewed in isolation from the State's payment of education retirement costs, which has long been used as a means of stemming the growth of local property taxes, particularly after the *Abbott* school funding decisions mandated redistribution of State aid to local school districts.[90] The State's assumption of this burden did not benefit only local taxpayers. It also benefitted teachers, who were able to collectively bargain for salaries with local school districts freed from the need to consider the impact of the resulting salaries on pension costs. It also benefitted all other local public employees, as the municipalities employing them did not have to account for funding education retirement benefits out of the same property tax base in reconciling local budgets with salary and benefits demands of police, firefighters and other municipal workers.

At one time, this was viewed as a manageable solution. It has now become a major source of the State's budget crisis. Funding of education retirement benefits has ballooned into a $2.5 billion annual obligation for local education pensions (if paid in full in 2016) and, absent reform, a projected $1.4 billion burden in 2016 for local education retiree health benefits. In addition, the $750 million annual obligation for local education employers' contributions to Social Security *is also paid by the State*. The condition of local benefits is merely the flip side of the State subsidizing what otherwise would be a $4.6 billion annual local obligation.

> The condition of local benefits is merely the flip side of the State subsidizing what otherwise would be a multi-billion annual local obligation for education retirement benefits

A State-level-only solution would also be unnecessarily painful. As set forth in Table IX below, it would require taxpayers to raise over $1.5 billion in additional revenue at the State level. This burden could only be reduced by pushing current State-paid groups to sub-private-sector-level benefits. It would be unfair for this to happen while local public employees continued to enjoy Platinum-plus-level health benefits and their existing pension plans. It would also be unlikely that local benefits would remain at existing levels if the State-level reforms were implemented. In many instances, State law dictates that the terms governing State employee benefits also govern benefits for local public employees. State benefit levels also serve as a template or point of comparison, even where local benefits are not legally required to follow form. The reductions will occur. The question is how to use the savings.

In light of the property tax burden already borne by New Jersey residents, any use of local savings for retirement funding should be limited to *savings.* The Commission is mindful of the lessons of history from prior attempts to return education retirement costs to local governments without providing local governments with the means to pay for this obligation.[91] As set forth below, a premise of the Commission's advocacy of a unified State/local approach is that it be implemented in a manner that would be no worse than cost-neutral to local governments, a goal that should be possible, given the magnitude of local health benefits savings available. It would make little sense to solve the employee benefits funding problem by exacerbating the property tax problem. Table IX shows that applying the proposed reforms to local public employees and retirees enrolled in the SHBP and education employees enrolled in the SEHBP would produce a local surplus far in excess of the State-level deficit:

**Table IX: State and Local Costs *Before* Shifting Certain Education Retiree Costs – 2016** (in billions)

| Obligation | Projected 2016 State Costs Post-Reform, Pre-Shift | Projected 2016 Local Costs Post-Reform, Pre-Shift |
|---|---|---|
| Health Benefits Costs[92] | $2.673 (includes education retirees) | $7.057[93] |
| Pension Costs | $2.600 | $0.500 |
| New Retirement Plans | $0.668 (includes new education retirement plan) | $0.563 |
| Total Costs | $5.941 | $8.120 |
| Projected Pre-Reform 2016 Cost | ($4.409[94]) | $10.954[95] |
| Funding Deficit/Surplus | $1.532 Deficit | $2.834 Surplus |

As set forth in Table X, the savings that would be realized by applying the benefits reforms proposed for State employees and retirees to their local-level counterparts would be more than sufficient to permit local governments to assume the $950 million post-reform expense of education retiree health benefits and the $402 million cost of the new education retirement plan within existing spending levels and without any need to increase property taxes.

**Table X: State and Local Costs *After* Shifting Certain Education Retiree Costs – 2016** (in billions)

| Obligation | Projected 2016 State Costs Post-Reform, Post-Shift | Projected 2016 Local Costs Post-Reform, Post-Shift |
|---|---|---|
| Health Benefits Costs | $1.722 | $8.007(includes education retirees) |
| Pension Costs | $2.600 | $0.500 |
| New Retirement Plans | $0.266 | $0.965(includes new education retirement plan) |
| Total Costs | $4.588 | $9.472 |
| Projected Pre-Reform 2016 Cost | ($4.409) | $10.954 |
| Funding Deficit/Surplus | $0.179 Deficit | $1.482 Surplus |

Even after financing these expenses, there would be a substantial surplus.[96] As set forth in the Health Benefits section of this Report, because of the existence of these substantial but not readily quantifiable savings, the baseline benefits used for cost projections in this Report are intended as a starting point. From this point, the Task Force, through the plan design process, can increase benefit levels to the extent permitted by the availability of savings and other employee benefit funding demands.

There are obvious benefits to an approach that, at no cost to local governments, avoids the need to raise over $1.4 billion in State-level revenue while making additional funds available to augment post-reform benefits above baseline levels and for other government uses. These benefits, however, can only be realized if these local savings are realized, aggregated and dedicated to the State's most pressing fiscal problem, not spread across 565 municipalities, 590 school districts, and a host of other local governmental entities. The people of the State cannot afford to miss this one-time chance to not only reset, but realign benefit obligations in a way which produces the greatest benefit to all.

> Tapping the savings from otherwise needed reform of local benefits can reduce the need for new revenue at the State level by almost $1.4 billion at no cost to local governments

There are at least two possible mechanisms for aggregating local savings, either of which the Commission anticipates would be included within the terms of the constitutional amendment in order to resolve any conflict with the State Constitution's unfunded local mandate amendment.[97] As set forth above, one would be for local districts to assume responsibility for the cost of education retiree health benefits and for the new education retirement plan. This would obviate the need for a savings transfer mechanism and would naturally match the amount of a local entity's effective contribution to pension deficit funding to the size of the benefits obligation generating the savings.

A second mechanism would be for the State to draw, from income tax revenues prior to the distribution of these dedicated revenues to local governments, an amount equal to the difference between what local governments would spend on employee benefits absent reform in a reference year and what they would spend in that year under the proposed reforms. This is the most comprehensive mechanism for aggregating savings at the State level but would require a great deal of accounting to achieve local cost neutrality, particularly given potential disparities between an individual local entity's State funding and local savings.

### Transferring Pension and Retirement Plans to Employee Entities

Limiting the State's role in providing retirement benefits to providing the funding on a set payment schedule would enable the assets and liabilities of the existing pension plans, and new retirement plans, to be transferred to employee entities. As employees, collectively, would be bearing the risks of these plans going forward, it is only fair that they have a greater collective say in how the amount of funding provided is managed and how benefits will be matched with available resources. Employees have long desired a greater degree of control over these issues, and the State, to protect its credit rating, has long desired to reduce the uncertainty inherent in the current process of defining and funding employee benefits. Assuming the consent of all parties, the transfer to employee entities of the assets and liabilities of the existing pension plans, with governmental employers providing fixed levels of funding to the pension and retirement plans, would realize both objectives.

Accomplishing such a transfer in a manner that satisfies the requirements of tax and regulatory requirements, however, will involve a demanding exercise in employee benefit plan design. Moreover, in almost all instances, each existing plan draws membership from more than one union and/or includes nonunion employees. Since breaking up the existing plans into smaller units to separate these constituencies could present legal and fiscal difficulties, a more practical alternative might be to set up entities to receive each plan, with each entity governed by a board of trustees reflecting the makeup of the trusts' beneficiaries. The Task Force should also weigh the benefits (in terms of economies of scale) and complications (in terms of increasing difficulty in defining fair control mechanisms for entities with increasingly diverse groups of beneficiaries) of combining some of the existing plans.

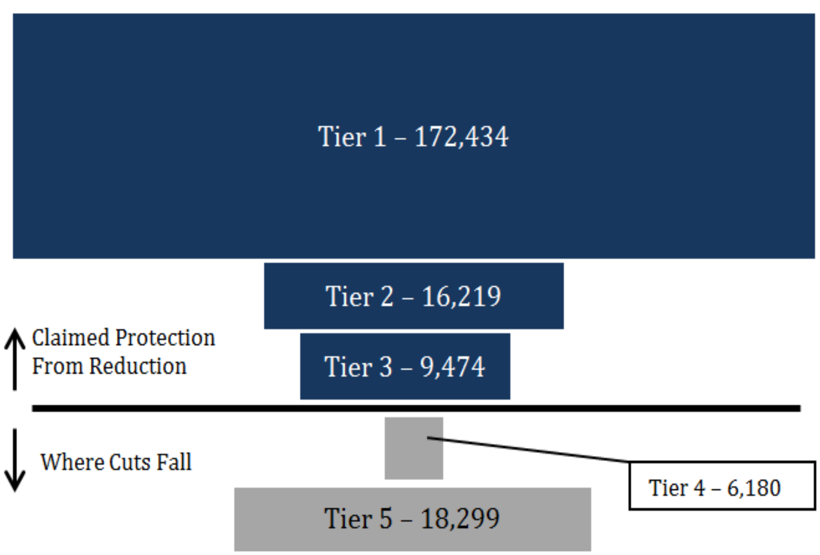
## The Proposed Constitutional Amendment

As a matter of political reality, reform will not be possible without an exchange of significant benefit reductions for certainty in pension funding. Both elements are necessary for effective reform. Neither, however, can be achieved with certainty under the current State Constitution.

### 1. Modification of Existing Benefits

Amending the State Constitution to permit changes to existing benefits would merely reset the law to what it was until relatively recently. Traditionally, due to restrictions imposed by the State Constitution's Appropriations Clause[98] and/or the Debt Limitations Clause[99] on the Legislature's ability to create binding, long-term obligations, New Jersey courts have construed grants of public employee benefits,[100] like other contracts[101] and statutes[102] that impose significant financial obligations beyond a fiscal year, as being binding only within the confines of the fiscal year in which they were made.[103]

**Table XI: The Effect of Nonforfeitable Rights** (number of TPAF and State PERS employee members in each tier)




Given the State's desire to treat its employees fairly, and the employees' ability to protect their interests through the political process, the State rarely exercised this power to alter benefits, but its existence provided an important safeguard. This safeguard was impaired by the 1997 enactment of the "nonforfeitable rights" statute, which has effectively insulated from reform all existing employees with sufficient years of service to claim the statute's protection. As employees subject to one reform gained more years of service, they were in turn excluded from the next reform, which created an upside-down-wedding-cake system of benefit "tiers."

While the Supreme Court of New Jersey has never addressed the issue, in the years after 1997, the argument has frequently been advanced that the nonforfeitable rights statute created contractual rights[104] protected from legislative revision by the Contracts Clause[105] of the State Constitution. In 2010, the Legislature stopped extending nonforfeitable rights to employees hired in the future.[106] By then, however, almost 90% of current employees were covered by the nonforfeitable rights statute.[107]

Experience has shown that meaningful reform must involve all employees, not just those who were most recently hired. It is simply impossible, not to mention unfair, to continue to preserve the benefits of 198,000 employees at the expense of the 24,000 newer employees in the bottom two service tiers. On the basis of discussions with stakeholders, we believe that many employees would prefer to avoid the possibility of winning a Pyrrhic victory by preserving some exceedingly generous benefits at the cost of draconian cuts to others. To avoid this outcome, the State's power to alter these benefits must be clear. An amendment to the State Constitution that expressly authorizes the State, notwithstanding any provision of the Constitution or laws of the State of New Jersey to the contrary, to modify existing benefits to the extent necessary to effect the Commission's proposed reforms would provide this clarity and the flexibility necessary to craft a workable, long-term solution.

Although used sparingly, states as sovereign entities have the inherent power in their constitutions to determine which rights their laws will recognize and to use this power to adjust government obligations.[108] In fact, New Jersey recently *did* amend its constitution to eliminate a claimed constitutionally protected benefit. In 2012 the State Supreme Court held that Art. VI. Sec. VI ¶ 6 of the State Constitution, which prohibited reduction in pay of sitting judges, locked benefit contribution rates in place at the time of a judge's appointment and prohibited subsequent increases.[109] This outcome was promptly reversed by a constitutional amendment excepting employee benefits from the scope of the claimed constitutional protection. The proposed amendment would follow the general pattern used to extinguish the judges' claim that their existing benefits could not be changed.[110]

### 2. Creating a Sustainable and Certain Pension Funding Obligation

If benefit obligations, particularly health benefits costs, can be reduced to a sustainable level, the Commission believes that a constitutional amendment should provide a mechanism to guarantee the pension funding obligations defined in this proposal. A constitutional amendment permitting the reduction of benefits and implementation of these reforms, and also compelling compliance with the payment schedule intended to fund these obligations, would provide an enforcement mechanism that beneficiaries could trust. This would be a far better outcome than a judicial decision ordering full funding of existing benefits, a result which would likely trigger the "bleak, burdensome and unacceptable" consequences described in the "The Future Without Reform" section of the Overview of this Report.

Because no one knows the future, there is a risk in locking the State into any particular level of pension benefit funding. The key to managing this risk will be to define the payment mandate in terms adequate to cover obligations without being unduly burdensome to the State's taxpayers. Whatever funding level is selected, it must leave sufficient room in the budget for meeting other growing demands on the State's limited funds.

## V. THE IMPLEMENTATION TASK FORCE

An appointed Commission with limited time and logistical support is ill-positioned to define in detail the terms of health benefits plans and retirement programs for several hundred thousand State employees and then to reduce these reforms to statutory and constitutional language. As a result, the Commission has limited its comments to providing direction. In places, it has suggested issues to consider in working out details, but resolution of these issues is best left to the Implementation Task Force.

Preferably, one Task Force will address both health and retirement issues. The fiscal impacts of reforming both areas of benefits have to be considered together. There also may be instances in which reforms in one area, such as retiree health benefits, may affect employee behavior in ways that impact other areas, such as incidence of early retirement. The Task Force needs to have command and control of the big picture.

Finally, given the need for immediate decisive action, the Task Force's schedule should be defined by the deadlines to amend the State Constitution this year. Missing the window for a vote in 2015 would delay urgently needed reform for another year. Given that pension and health benefits costs combined are growing by approximately $600 million a year, the people of New Jersey cannot afford another year's delay. Article IX of the State Constitution, which governs the amendment process, would require that an amendment approved by three-fifths of each house of the Legislature be published statewide not less than three months prior to the November 3, 2015, general election, or by August 3, 2015. Our estimate is that early June would be a realistic deadline for the Task Force and interested stakeholders to resolve the health benefits funding issue and to define the implementing legislation that would be necessary to place the constitutional amendment on the ballot. This would provide sufficient time for the legislative process to run its course in time to put the amendment on the ballot for the November 2015 general election. Consistent with the need for urgency, detailed plan design and even drafting and conditional enactment of laws putting the reforms in place can begin in the interim.

## VI. ADDITIONAL THOUGHTS

The Commission has devoted the previous sections of this Report to outlining the essential elements of a viable solution. In the course of its work, the Commission has considered a variety of issues that, while not essential to outline its proposal, warrant discussion. What follows are our thoughts on some of these issues.

### Structural Reform

Our six months of navigating New Jersey's public employee benefits system have led us to the conclusion that it is in desperate need of fundamental structural reform. The current system is the product of more than a century of *ad hoc* expansion, historical accidents, and scattershot efforts at reform. No one given a clean slate would produce a system consisting of seven pension plans with five tiers of membership and two health benefits programs, with various degrees of State and local funding, various degrees of participation, local-level opt-outs and an overlay of various collective bargaining agreements. In some ways, transfer of the pension and retirement plans to employee entities would add additional layers to this system as a whole, while greatly simplifying it from the perspective of the State. If the State retains control of these programs, however, movement towards a single retirement plan and a single health benefits program, reflecting where necessary the varying circumstances of different employee groups, would provide a much more manageable and transparent structure.

> No one given a clean slate today would design an employee benefits system with two health benefits programs and seven pension plans with five tiers of membership

### Health Benefits

Combined, the SHBP and SEHBP provide health benefits to 885,000 employees, retirees, and their dependents, or 10% of the State's population, with even more public employees and their dependents enrolled in government-funded plans outside of the State programs.[111] This is a market share sufficiently large to warrant thinking about how the State health benefits systems can be both innovators and "price makers," rather than "price takers," when it comes to securing quality, cost-effective health care for public-sector employees and retirees.

One obvious approach is an increased focus on wellness. Programs with this focus seek to improve health-related behavior over time through education and financial incentives, which in turn have the effect of improving productivity and reducing health-related expenses. New Jersey has had a wellness program for retirees since 2007 and a program for active employees, NJWELL, that commenced in 2014. For active employees, participants receive incentive awards (gift cards); the incentives are based on the activities that they complete in a given year, such as completing on-line health assessments and getting biometric screenings, which increase awareness of health and have the potential to identify health issues in time for earlier, more cost-effective intervention. Active participants also can earn points by getting flu shots and for participating in screening programs and on-line and over-the-phone coaching and disease-management activities for participants identified to be at-risk. At later stages in the program, a participant can earn credits by achieving goals, such as becoming a nonsmoker, reducing cholesterol and glucose levels, and reducing body mass index.

The Commission does not view NJWELL (which to date has experienced low participation) in particular or wellness programs in general as a panacea for the immediate funding crisis, as even programs with high rates of participation usually have to operate for years to have noticeable effects. There is also a tension between focusing a program on "carrots" (financial incentives for better behavior) or "sticks" (additional charges for unhealthy behavior). Carrots tend to take longer to work and have costs of their own, while sticks may be perceived as sin taxes imposed by plan sponsors acting like Big Brother.[112] Used correctly, however, wellness plans can produce measurable results in terms of both improved employee health and health benefits cost savings. Just as importantly, they can create a more proactive tone to both employers' and employees' approaches to managing health care costs.

Another approach that shares some of the same goals as wellness programs is value-based insurance design, which reduces or eliminates employees' out-of-pocket expenses for certain treatments that are considered "high value" because they reduce the cost of care over time. For example, making certain low-cost but highly-effective blood-pressure management medications even more affordable can increase compliance with their use and over time can reduce the need for much more costly treatment of events such as heart attacks and strokes. Regular dental cleaning and diabetes medication management are two other examples of the types of care that may be covered by such programs. Like wellness programs, value-based insurance designs tend to take a long time to yield noticeable savings but can be cost-effective for public employee programs such as the SHBP and SEHBP whose beneficiaries frequently remain in the system for life.[113]

A more systemic approach involves creation of patient-centered "medical homes" and accountable-care organizations. Both mechanisms involve creating financial incentives to encourage beneficiaries to use in-network primary health care providers who, in turn, receive financial incentives to practice preventive medicine and to manage and coordinate care in ways that keep patients healthy and that limit unnecessary and duplicative tests and treatments.[114] An important part of this approach is encouraging referrals for care and services to in-network providers who are included in the network as a result of having established that they provide high-quality, cost effective care. Horizon's network, for example, includes over 3,700 doctors at more than 900 locations.[115] Some such programs only provide coverage for in-network providers, while others reduce reimbursement for out-of-network providers. While this can increase costs for beneficiaries who persist in utilizing out-of-network providers, the goal of these programs is to reduce costs for both employers and employees by directing patients to providers who will provide the same quality care at less cost.

Reference-based pricing programs also work to reduce costs for employers and employees by directing care for certain routine services (such as hip replacement) where variations in provider costs are wide but bear little relation to patient outcome. For these treatments, reference-based pricing determines the costs charged by high-quality, cost-effective providers for these routine treatments and limits reimbursement to those amounts, with employees picking up the difference in cost of a provider who charges more. This not only encourages utilization of providers who can provide care within the reference price, but it also tends to drive down the cost for these services as a whole. The California Public Employees' Retirement System has had success using this approach to reduce costs for covered procedures.[116]

Other reforms that have been proposed to the Commission include medical malpractice reform to address the costs resulting from defensive medicine, and utilization of on-site clinics or existing commercial urgent-care centers to resolve routine medical issues and reduce the need for more expensive emergency room visits.

Finally, excessive use of out-of-network providers can be the result of inadequate provider networks or inadequate information about the existing networks. Almost all of the approaches highlighted above rely on improving network utilization, which in turn requires networks broad enough to provide meaningful choice among convenient, cost-effective, high-quality providers. Moreover, if employees are expected to be educated consumers of medical services, the system will work better for all involved if the employees are empowered with easy-to-access, transparent information about providers' costs, network status and quality of care.[117]

### Pensions

Before suggesting that the new retirement plans take the form of a cash balance plan, the Commission considered whether to retain a final-average-salary defined benefit plan with significant modifications. It also considered whether a 401(k)-type defined contribution plan would be a better alternative. In the right circumstances, either model can be effective in the public or the private sector.

Retaining a final-average-salary defined benefit plan would maintain a familiar structure that protects employees from investment risk and provides a strong incentive and reward for long-term service. However, given the extent of modifications that would be needed to make such a plan affordable,[118] the Commission does not believe that replacing one final-average-salary defined benefit plan with another would be the best approach.[119] The certainty provided to employees by such plans—a fixed retirement income determined independently of the investment performance of the assets funding it—is created by the plan sponsor bearing virtually all risks.

Given the inevitable fluctuations in investment results, the annual contributions necessary to fund final-average-salary defined benefit plans are variable and unpredictable. The final average salary used to define the benefit is not known until after the benefit it defines has been earned, and the total underlying obligation cannot be known with precision until the last participant has died. Until then, the obligation must be estimated by using a complex set of demographic and economic assumptions. Since all of the elements of the formula that are used to define final pension benefits are multipliers, even small deviations between actual and assumed figures can have large impacts, and these impacts are multiplied over hundreds of thousands of participants. The entity operating such a plan must be extremely disciplined over periods of decades in restricting benefit grants to sustainable levels and then in consistently funding them. For a long time, this has not been the case with the State's operation of the plans. And if the State has had difficulty managing the risk of this model, an employee entity operating such a plan with a set amount of funding and no control over salaries would be even more challenged.

The Commission also explored the alternative of a defined contribution plan.[120] In this 401(k)-style approach, public employers would contribute a fixed percentage of payroll, with employees enjoying significant flexibility in investing the funds in their accounts. The cost-control features that make a defined contribution plan attractive to employers, however, make it unattractive to employees, who alone bear all the risk. Employees who are too aggressive risk catastrophe if the market crashes; employees who are too conservative risk missing out on good equity returns and facing retirement with insufficient assets. Many employees may not have sufficient investment expertise to navigate the array of investment options available in a typical 401(k)-type of plan. They may not fully understand the risk/return trade-off in every investment decision[121] or appreciate the very real chance that they will live significantly longer than life expectancy charts indicate. Since a cash balance plan mitigates these risks while providing a significant degree of certainty and cost control to employers, the Commission believes that a cash balance plan is a particularly appropriate means of providing retirement benefits going forward.

## Early Retirement

The Commission believes that serious consideration should be given to reforming early retirement. Early retirement is an expensive benefit in a system with strained resources. Aside from the cost of the pension benefits themselves, the related health benefits costs are staggering. Even after reform, the $1.124 billion projected cost to provide health benefits for 46,000 early retirees enrolled in the SHBP/SEHBP is *higher* than the $848 million these programs are projected to spend on 132,000 Medicare-eligible retirees. A model originally designed for police and firefighters engaged in arduous and dangerous physical activity has now evolved into a State-subsidized lifestyle choice for many public employees. The terms under which this very expensive benefit remains available should be the result of due deliberation and conscious choice, not of inertia.

> The State now spends more on health benefits for 46,000 early retirees than it does on 132,000 Medicare-eligible retirees

One issue related to early retirement that has attracted numerous comments is "double-dipping," and "triple-dipping," the practice of early retirees quickly moving into one or more public positions related to their former employment and drawing pensions and/or health benefits from more than one position.[122] Prior pension reforms have already greatly reduced the opportunities for employees to engage in this conduct. The reforms proposed in this Report would also have the effect of limiting this conduct.

The Commission's sense is that, given the size of the system and the extent of its other problems, the double-dipper issue may not be financially material. It has great symbolic importance, however, as the double-dippers have become the "face" of a dysfunctional public pension system. For this reason, the Task Force should consider ways to further limit this practice. For example, existing law gives former public employees who take a public-sector job after retirement a choice between receiving health benefits as employees, who must contribute towards the cost of coverage, or as retirees, who receive the same coverage for free. This choice should be eliminated. Reemployed retirees receiving State health benefits should be required to contribute toward their cost of care, just like their coworkers do.

## Funding

The Commission received numerous suggestions concerning potential funding sources. Out of deference to the political process, the Commission is not recommending any particular source if and to the extent raising additional revenue is necessary. The suggested sources have ranged from drawing on lottery or New Jersey Turnpike revenues, legalizing sports betting, permitting other forms of gambling at race tracks, authorizing casinos in the Meadowlands, taxing the benefits of retirees who have moved out of state, and instituting complicated bonding/life-insurance plans. In most cases, there were questions about the legality and/or efficacy of these proposals, but the Commission is prepared to share these and other suggestions with the Task Force.

A different type of funding suggestion would involve requiring the State to make pension fund payments according to some payment schedule within a fiscal year sensitive to variations in the State's cash flow, rather than the current practice of making this contribution as a lump sum at the end of the fiscal year. This would have a small but real impact on the plans' finances, since at least some of the money would be earning interest throughout the year, albeit at a corresponding interest cost to the State. It would also avoid situations in which the State has already spent its funds on other priorities before the time comes to make its pension contribution.

## Constitutional Amendment Considerations

While the New Jersey Constitution is far more amenable than its federal counterpart to amendment to address practical problems of this magnitude,[123] the amendment process is still a tool best reserved for situations in which there is no other adequate option. The Commission believes that this is such a case.

In theory, it should be possible, without a constitutional amendment, to modify some benefits as to which protection is claimed. Some benefit claims may not even be contractual in nature and thus would not be subject to Contracts Clause protection. Even if certain rights are deemed contractual, some changes might not be sufficiently substantial to be legally actionable. And even where a protection is deemed contractual and a change is considered substantial, the State and federal constitutional Contracts Clauses do not function as absolute prohibitions. Due to its overarching duty to protect the public, the State may substantially impair a contractual relationship so long as the impairment serves a significant and legitimate public purpose and is not based on unreasonable conditions or is otherwise unrelated to appropriate governmental objectives.[124]

The problem with attempting to adjust benefits within the context of a Contracts Clause analysis is that it requires litigation involving unpredictable, fact-intensive, time-consuming judicial balancing and the involvement of the courts in the most political of decisions: the allocation of State resources through the appropriations process. Courts that have considered Chapter 78–related Contract Clause claims to date[125] have conducted their analysis of whether an impairment is justified on a short-term, even on a year-by-year, basis. A retirement system cannot be run with this degree of perpetual uncertainty. One of the reasons cited by Fitch for maintaining a "Negative Outlook" on its already low "A" rating for New Jersey's bonds is the risk that litigation will defer or dilute reforms.[126]

Even if successful, however, litigation cannot lead to an optimal solution. In the Commission's discussions with stakeholders, it has become clear that any viable political resolution of this crisis requires putting in place a means to compel State pension funding. At the same time, that obligation has to be defined so as to be sustainable. The existing benefits are not. A constitutional amendment would permit these trade-offs to be made with precision. Litigation is a blunt instrument that cannot accomplish this kind of fine tuning.

A constitutional amendment would also have greater political legitimacy. By design, the New Jersey Constitution, unlike the constitutions of some other states, does *not* provide constitutional protection to public employee benefits. The Legislature's efforts to create the equivalent of this by, for example, conferring "nonforfeitable rights," have been attempts to do indirectly something that the people declined to do when they voted in favor of the 1947 Constitution. There are strong arguments that some degree of protection is appropriate, but the means of providing that protection, including the modification of existing benefits that is necessary to make that protection practicable, involve sovereign powers vested in the people as a whole. Given its potential, the necessity of paring back existing benefits, and the limitations of other alternatives, the Commission believes that effecting reforms within the context of an enabling constitutional amendment is preferable.

## Periodic Reconsideration of Reforms

Finally, the Task Force should consider including in the final form of this solution a mechanism for evaluating its effectiveness after implementation. This process will have many moving pieces, and it would be unrealistic to expect every issue to be resolved exactly right the first time. A three-year review, particularly of the portions of the system remaining under State control, would provide an opportunity to refine the approach in the light of experience.

## VI. CONCLUSION

The State now stands at a crossroads and must choose one of two paths. The first is the road to ruin. It leads to a future of either crushing tax increases or draconian benefit cuts *plus* crushing tax increases.

> Effective reform *now* can avoid a future of choices between crushing tax increases or draconian benefit cuts *plus* crushing tax increases

The second path is one that leads to a more sustainable future. Because a situation as dire as the present one can only be solved through collective effort, we have not hesitated to propose a solution that requires collaboration. Our discussions with NJEA and others have encouraged us that such collaboration is possible. Reducing both pension and health benefits, despite potential claims by affected employees, and committing the State to a certain funding obligation are only possible if all stakeholders agree to move beyond the past and focus on putting in place the best solution going forward. This Report is a first step. The work of the Implementation Task Force will be the next step. Adoption of the statutory and constitutional provisions that will be necessary to implement this solution will require still bigger steps. These steps, however, will lead to a result that provides public-sector employees with secure retirement and quality health benefits at a cost within the means of the State's already hard-pressed taxpayers.

Finally, as with any set of recommendations by a Commission, the proposal outlined in this Report represents numerous trade-offs and compromises with respect to accommodating different priorities, ensuring fairness to various stakeholders, and balancing a "perfect" solution with difficulty (or ease) of execution and the need for consensus. Individual Commission members might strike these balances slightly differently if asked to define their own optimal proposed solution but have put personal preferences aside to formulate an approach that can be embraced by all. The Commission urges the people of the State and their elected representatives to proceed with the same resolve and dedication to practical compromise and to move quickly before the growing gap becomes too wide to bridge.

## ACKNOWLEDGEMENTS

The Commission wishes to acknowledge and thank many individuals and organizations for their assistance and support in preparing this Report. Matthew King served as the Commission's Executive Director and his financial acumen and energy were invaluable to the Commission. Drinker Biddle & Reath, LLP, led by George H. Kendall, Kenneth J. Wilbur and Thomas F. Campion, served as the Commission's Special Counsel and provided advice to the Commission on numerous issues and diligently assisted the Commission in the research and preparation of this Report. The Governor's Office, the Department of Treasury and the Attorney General's Office provided the Commission with all information requested and spent a great deal of time responding to questions and requests for further information. In particular, Jennifer Duffy, Chief of Staff at the Department of Treasury, was the Commission's primary liaison with the State and was unfailingly very responsive, very professional and a pleasure to work with. The Commission also consulted with and relied extensively on reports and other materials provided by the State's health benefits consultant, Aon Consulting, and pension actuaries, Milliman and Buck Consultants. Edward A. Hartnett, The Richard J. Hughes Professor of Law at Seton Hall Law School, provided the Commission with advice on State and federal constitutional law issues. Finally, the Commission consulted with and received comments from numerous stakeholders and experts on pension and health benefits and is very grateful for the advice provided by all interested parties.

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## APPENDIX 1 – BIOGRAPHIES OF COMMISSION MEMBERS, STAFF AND COUNSEL

### Commission Members

**Thomas J. Healey, Partner, Healey Development LLC**

Tom Healey is coordinating the work of the Study Commission. He is a Senior Fellow at Harvard University's John F. Kennedy School of Government, where he taught a course in Financial Institutions and Markets. In 2010 he received the Mossavar-Rahmani Center for Business and Government's Distinguished Service Award. He is a retired partner of Goldman, Sachs & Co. While at Goldman Sachs, he created the Pension Services group, the first of its kind in financial services, which services the top 100 leading Pension and Endowment Clients globally. Tom also chaired Goldman Sachs's own Pension Plan and served as CIO of the Central States Teamsters Pension Plan. Prior to joining Goldman Sachs, he served as Assistant Secretary of the US Treasury for Domestic Finance under President Ronald Reagan. Tom is a chartered financial analyst, and he graduated from Georgetown University and Harvard Business School.

**Margaret S. Berger, FSA, EA, FCA, Principal, Mercer**

Margaret Berger is a consulting actuary and Principal in Mercer's Retirement Practice. She manages actuarial project teams and provides actuarial consulting on defined benefit plans, nonqualified plans, and retiree medical and life insurance plans. Based in Princeton, Margaret is also a member of Mercer's Actuarial Resource Network, which helps consultants solve complex technical actuarial problems and recommends and implements pension valuation standards throughout the firm. Margaret has 24 years of experience consulting in the area of retirement benefits. She has helped clients on a wide range of assignments, such as performing annual actuarial valuations of pension and post-retirement welfare plans, including the review and development of actuarial assumptions and methods, preparing financial statement footnote disclosure information, and designing and redesigning retirement benefits. Margaret is a member of the American Academy of Actuaries Pension Committee and the Actuarial Standards Board Pension Committee. Margaret received a BA in Mathematics from Yale University. She is an Enrolled Actuary, a Fellow of the Society of Actuaries, and a Fellow of the Conference of Consulting Actuaries.

**Tom Byrne, Managing Member, Byrne Asset Management LLC**

Tom Byrne is managing member of Byrne Asset Management LLC in Princeton, an investment advisory firm that manages $150 million for a variety of clients. In the 1990s and before, he worked at two major New York law firms and later in the securities industry in Manhattan. He has served in a number of volunteer and nonprofit capacities as well. He is currently acting ++chairman of the New Jersey State Investment Council. He is also a trustee and treasurer of The Fund for New Jersey. Tom served as chairman of the New Jersey Democratic State Committee in 1994–97. He also served on the staff of The Presidential Task Force on Market Mechanisms, which reported to President Reagan on the causes of the 1987 stock market crash. He is a 1976 graduate of Princeton University's Woodrow Wilson School and has served on its graduate advisory board. He has a law degree from Fordham University.

**Raymond G. Chambers**

Ray Chambers is a philanthropist and humanitarian who has directed most of his efforts toward helping children. Ray serves as chairman of the MCJ Amelior Foundation. Formerly, he was the Chairman of Wesray Capital and began his career as a CPA with PriceWaterhouseCoopers. He is the founding Chairman of the Points of Light Foundation and cofounder, with Colin Powell, of America's Promise – Alliance for Youth. He also cofounded the National Mentoring Partnership and the Millennium Promise Alliance. Ray is the Cofounder of Malaria No More. He is the Founding Chairman of the New Jersey Performing Arts Center.

**Leonard W. Davis, CFO, Revelation Holdings, Inc.**

Len Davis has organized and managed private equity, technology, and natural resource companies. He has been the principal financial manager in a private equity company and has been the Chief Financial Officer to the lead investor of a natural resource company active in metals and energy. His experience spans a wide range of businesses, including private equity, investment banking, leveraged buyout, and M&A. His management experience includes due diligence on acquisition investments, acquisition and exit strategy, and investment analysis. Before entering private equity, Len was a CPA in public practice at Price Waterhouse, LLP ("PW") in New York (now PriceWaterhouseCoopers), in their Personal Financial Services Group. He provided tax planning and general business advice to wealthy individuals and to their companies while at PW. Prior to joining PW, he was employed in the Private Banking Group of J.P. Morgan Services, Inc. He received his BS in Accounting from Spring Garden College.

**Carl A. Hess, FSA, CERA, Managing Director, Towers Watson**

Carl Hess has served as Managing Director, The Americas of Towers Watson since February 1, 2014, and is a member of the firm's Executive Committee. Prior to that, he served as the Managing Director of Towers Watson's investment business since January 1, 2010. Before that, he worked in a variety of roles over 20 years at Watson Wyatt, lastly as Global Practice Director of Watson Wyatt's investment business. Carl is a fellow of the Society of Actuaries and of the Conference of Consulting Actuaries and is a Chartered Enterprise Risk Analyst. He has a BA *cum laude* in Logic and Language from Yale University and is a director of HLC Holdings and its subsidiaries and affiliates.

**Ethan Kra, Ph.D., FSA, EA, CERA, Ethan E. Kra Actuarial Services**

Dr. Ethan Kra is an independent and highly respected consulting actuary. Previously, he was a Senior Partner and Chief Actuary-Retirement of Mercer. He specializes in analyzing the economic and accounting implications of financing strategies and vehicles for employee and executive benefits. For over 17 years, he chaired Mercer's Actuarial Resource Network, a committee of the senior technical actuaries throughout the United States. Ethan is a Fellow of the Society of Actuaries, a Member of the American Academy of Actuaries, a Fellow of the Conference of Consulting Actuaries, a Member of ASPPA, an Enrolled Actuary, and a Chartered Enterprise Risk Analyst. He has served on the American Academy of Actuaries Board of Directors, as its Vice President, Pensions, and as Chair of its Pension Practice Council. He is a *summa cum laude* graduate of Yale University, where he earned his BA in Mathematics and was elected to Phi Beta Kappa. He holds MA and PhD degrees in Mathematics from Yale University, where he was both a Woodrow Wilson Fellow and a National Science Fellow.

**Kenneth F. Kunzman, Partner, Connell Foley**

Kenneth F. Kunzman was Chairman of the Connell Foley Executive Committee from 1995 to 2002. He has been a partner in the firm since 1968 and has been responsible for a variety of areas of law. Ken is a graduate of The College of the Holy Cross and Fordham University Law School. He is Chairman of the Board of the Bonner Foundation, former Chairman of the District Ethics Committee, Trustee Emeritus of Caldwell College, former Trustee of St. Peter's Prep, and Cochairman Emeritus of the Seton Hall University Pirate Blue Fund. He served as Captain, US Air Force from

1962–1965. Since 1978, Ken has been Co-counsel of the Pension and Welfare Funds for Locals 472 and 172 Heavy and General Laborers Fund of New Jersey. He has been elected to the Super Lawyers and Best Lawyers of America since inception.

**Lawrence J. Sher, Partner, October Three**

Lawrence J. Sher is a partner, consulting actuary, and member of the Senior Leadership Team at October Three, which is a full-service actuarial, consulting, and technology firm that is a leading force behind the reemergence of defined benefit plans across the country. With over 35 years of consulting experience, Larry has served as chief actuary at other leading consulting firms, has frequently advised government officials on retirement issues, and has been a speaker at numerous professional and industry conferences. As a nationally recognized expert on cash balance and other hybrid pension plans, he is a highly sought-after consultant and advisor to retirement plan sponsors. In addition, he provides critical support as a consulting and testifying expert in disputes related to cash balance plans and other retirement programs. Larry is a Fellow of the Society of Actuaries (FSA), a Fellow of the Conference of Consulting Actuaries (FCA), a member of the American Academy of Actuaries (MAAA), and an Enrolled Actuary (EA) under ERISA. He has been a Board Member and Vice-Chair of the Actuarial Standard Board, a Board Member of the American Academy of Actuaries and of the Conference of Consulting Actuaries, and he was recently President of the Conference of Consulting Actuaries.

**Raj Tatta, Retired Senior Partner, PricewaterhouseCoopers LLP**

During his 30-year career at PricewaterhouseCoopers LLP, Raj Tatta served some of the firm's largest global clients and managed different businesses, including serving as the partner-in-charge of Europe for the US Tax practice. Raj took early retirement from PwC to volunteer for organizations focused on the mentoring and development of inner-city youth, such as the Big Brothers Big Sisters and the All Stars Project. Raj has also been involved in global health issues: he was part of the senior leadership team charged with restructuring the Geneva-based Global Fund to Fight AIDS, Tuberculosis and Malaria; and more recently, he assisted the UN Secretary General's Special Envoy for Financing the Health Millennium Development Goals. Raj serves on a few corporate and volunteer boards, including as President of the Park Avenue Club in Florham Park, which benefits 10 local charities. Raj holds CPA and MBA qualifications.

## Staff

**Matthew W. King**

Matthew W. King is a private investor who volunteered to function as the Commission's Executive Director. Previously, he was a Director at Kohlberg, Kravis, Roberts and Co. as well as at KKR Capstone, where he focused on building new lines of business for KKR, on due diligence on new investments, and on improving the operating performance of KKR's portfolio companies. He previously served on the Board of Directors for Sealy Corporation and on that of Corporate Capital Trust. He received a BS *summa cum laude* from North Carolina State University in Mechanical Engineering and Economics.

## Special Counsel

**George H. Kendall, Partner, Drinker Biddle & Reath LLP**

George H. Kendall is a partner in Drinker Biddle & Reath LLP's Florham Park, New Jersey office. George serves as the Vice Chair of Drinker Biddle's Health Care Practice Group. He represents hospitals; hospital systems; home health agencies; physician groups; and pharmaceutical, medical device, and medical equipment companies in a broad range of transactional and regulatory matters. George received his AB from Franklin & Marshall College and his JD from the Villanova University School of Law. He has been recognized by Chambers USA as one of the top health care lawyers in New Jersey.

**Kenneth J. Wilbur, Partner, Drinker Biddle & Reath LLP**

Kenneth J. Wilbur is a partner at Drinker Biddle & Reath LLP's Florham Park, New Jersey office. He represents a variety of life science and real estate clients in commercial, products liability, and appellate litigation. He received a BA *summa cum laude* from Lehigh University and a JD *cum laude* from the University of Pennsylvania School of Law, and he clerked for the Hon. Alan B. Handler, Associate Justice, Supreme Court of New Jersey.

**Thomas F. Campion, Partner, Drinker Biddle & Reath LLP**

Thomas F. Campion is a partner at Drinker Biddle & Reath LLP's Florham Park, New Jersey office. He specializes full-time in litigation at the trial and appellate levels for life science companies and other businesses and professions. He received his AB *egregia cum laude* from Fordham University and his LLB from Cornell Law School.

## END NOTES

[1] Except where context dictates otherwise, in this Report the term "employee" refers to both active employees and retirees.

[2] To put these figures in the context of the $3 billion gap as of 2014 discussed in our Status Report, that gap, absent reform and with the same funding assumption that the State would continue in 2016 its 2014–2015 practice of paying health benefits expenses in full but only the "normal" portion of the statutory pension payment for that year, will increase to $3.6 billion by 2016.

[3]This figure reflects approximately $700 million in "normal" costs to fund new pension accruals and over $2.9 billion toward amortizing the existing unfunded liability.

[4] Due to the focus of this Report on future funding, virtually all the figures in this Report are projections based on data from the State's Department of the Treasury ("Treasury") or from its consultants, or on calculations that the Commission has made on the basis of these projections. As is the case with all projections, these figures are subject to change. Furthermore, no inference should be drawn as to relative reliability of figures on the basis of the number of decimal places used. In general, figures in text are expressed to one decimal place for simplicity, while figures in tables are expressed to three decimal places to minimize the effects of rounding in calculations. The Commission believes that the figures that are used are sufficiently reliable for the planning context of this Report.

[5] State of New Jersey November 25, 2014, Supplement to Preliminary November 19, 2014, Bond Disclosure, I-1-1.

[6] The actuarial values had reflected average values over time compared to market values at a particular point in time.

[7] The GASB figures use discount rates as low as 4.29% for post-depletion date obligations in the New Jersey plans. The 2013 figures had used a 7.9% discount rate. A lower discount rate results in a higher present value of a future obligation.

[8] Teachers' Pension and Annuity Fund.

[9] GASB depletion dates are based on the assumption that future State contributions will be made at the level of the average of contributions over a period of years. This average is significantly (and arguably disproportionately) affected by funding shortfalls in recent years, thus skewing long-term projections.

[10] The Commission explored but did not resolve what would happen when a pension plan runs out of money. The legal and financial uncertainties of this nightmare scenario are considerable. The process may not play out in the simple form of retirees exhausting plan assets, leaving nothing for current employees. It is possible that existing employees may have a claim to at least their own contributions, with some interest, meaning the plans would never completely run out of funds as long as employees make contributions. If the employee contributions are reserved, however, the plans would cease to be able to pay retiree benefits in full long before what would be the case if retirees could tap the last dollar of plan assets. All that can be said for sure is that while the timing and sequence of events in a pension plan's death are uncertain, they would be painful and contentious.

[11] Public Employees' Retirement System.

[12] Judicial Retirement System.

[13] State of New Jersey November 25, 2014, Supplement to Preliminary November 19, 2014, Bond Disclosure, I-1-1.

[14] The Pew Charitable Trusts and the MacArthur Foundation, *State Employee Health Plan Spending Report* (August 2014) ("Pew Report"), pp. 2, 38 available at: http://www.pewtrusts.org/~/media/Assets/2014/08/StateEmployeeHealthCareReportSeptemberUpdate.pdf

[15] The lower figure for 2014 reported in our Status Report did not reflect Medicare Part B reimbursement expenses.

[16] Aon Data.

[17] High health benefit and pension costs manifest themselves differently. Health benefits are funded through annual premiums that must be paid from current expenses. There is no prefunding to create a pool of assets that can be drawn on in lean years. The only options are to pay the premiums or deny employees health coverage. Pensions, on the other hand are prefunded and, therefore, "required" contributions can be deferred without immediate adverse consequences. As a result of having "first call" on available funding, increased health benefit costs ultimately manifest themselves in the form of increased pension funding deficits.

[18] *See* Table IX and related text, *infra*.

[19] For example, the GASB figures do not directly affect how the annual required contributions to the pension plans are calculated. *See* State of New Jersey November 25, 2014, Supplement to Preliminary November 19, 2014 Bond Disclosure, I-1-1.

[20] A potential source of confusion in discussing budget projections is that the State runs on a fiscal year ("FY") from July 1 to June 30, so FY 2017 actually begins on July 1, 2016. An additional potential source of confusion is that data on health benefits is kept on the basis of plan years ("PY") which begin on January 1 of the year in question, when new plan terms typically go into effect. The Commission assumes that the proposed health benefit reforms would go into effect on January 1, 2016 (technically in FY 2016), the start of the first plan year after the constitutional amendment enabling the reforms would be adopted. Similarly, the funding schedule for the new frozen pension plans would go into effect on July 1, 2016 (technically in FY 2017), the first year for which additional pension funding could be budgeted after approval of the constitutional amendment.

[21] $35.5 billion would reflect a 3% increase from FY 2015 levels. FY 2016 budget figures were not available at the time of issuance of this Report.

[22] Arguably, the roots of the current crisis date back to the 1987 decision to tap what was then perceived to be a surplus in TPAF to provide free health benefits for education retirees.

[23] The "employee entities" holding the plans may have to be structured as "government plans" to comply with ERISA and other regulatory requirements and tax considerations. In this Report, "employee entities" refers to plan structures that satisfy these requirements while providing employees with the greatest permissible degree of

ownership and control over the assets and liabilities of the plans. Determining the exact form of entity that would satisfy these requirements will be one of the tasks to be undertaken by the Implementation Task Force discussed in this Report.

[24] *See* note 2,3.

[25] Assuming one possible payment schedule of an initial $2.6 billion payment increasing by 3% annually for three years and 4% thereafter.

[26] Aon Data.

[27] Commission estimate derived from Treasury Data of State pensionable payroll of $5.775 billion.

[28] The State is responsible for the health benefits costs of its own employees and retirees and for the health benefits costs of education retirees.

[29] Aon Data.

[30] Aon Data.

[31] Just as the State is responsible for health benefits for education retirees, it is also responsible for the pension benefits for active and retired education employees.

[32] Treasury Data for 2015.

[33] Commission estimate derived from Treasury and Aon Data.

[34] *See* Tables III, IV.

[35] Treasury Data.

[36] http://www.state.nj.us/treasury/omb/publications/14bib/BIB.pdf, p. 69

[37] Assumes that an average of $50,000 per 16,000 millionaires would raise $800 million. Raising the remaining $2.845 billion through income tax would involve increasing the current $12.6 billion income tax revenues by 22.6%.

[38] Assuming $1.555 billion total 2016 cost for active State employee health benefits, reducing this figure by 60% (the actuarial value of a Bronze-level plan) and taking from this the current 18% average employee contribution would result in a net State expense for providing Bronze coverage to employees of $962 million, a $593 million savings.

[39] Because these employees essentially self-fund their benefits, the immediate impact on the statutory pension payment of eliminating retirement benefits for new employees would be negligible.

[40] This assumes that income tax revenues could be used for this purpose, despite the constitutional dedication of income tax revenues to property tax relief. Current income tax revenues are $12.6 billion. Raising an additional $3.645 billion would require total income tax revenues of $16.25 billion, a 29% overall increase. This is an average

increase, as many filers pay little if any income tax. The corresponding figure for a $3.052 billion increase would be a 24% increase.

[41] See notes 14, 15.

[42] New Jersey's current 7.0% sales tax raises $8.4 billion. For it to raise an additional $3.645 billion, or $12.045 billion in total, the sales tax would have to increase to 10% on the same sales, although it is unlikely that sales would stay constant given that New Jersey's current sales tax already compares unfavorably to rates in neighboring Delaware (0%) and Pennsylvania (6%). A 10% sales tax would compare unfavorably to the 8.875% rate in Manhattan. The corresponding figure for a $3.052 billion increase would be 9.54%.

[43] Raising $3.645 billion through a millionaires' tax—a proposal frequently made to the Commission—would result in an annual tax *increase* of over $228,062 for each affected taxpayer with reported income in excess of $1 million, based on 16,000 filed returns for FY 2013. The corresponding figure for a $3.052 billion increase would be a $190,750 increase per millionaire.

[44] Assuming 87% of the State's $33 billion budget is dedicated, the remaining balance is $4.3 billion.

[45] *Burgos v. State of New Jersey*, Docket No. L-1267-14 (Law Div., Mercer County). *Burgos* seeks to require the State to ramp up to full payment of the existing benefits by 2018.

[46] The cost of living adjustments (COLAs) at issue in *Berg v. Christie*, 436 N.J. Super. 220, 241 (App. Div. 2014) are not funded by the existing plan and would not be preserved or restored under the Commission's proposal.

[47] Figures reflect pensionable salary figures for 2013, the most recent figures available. 2016 figures are not expected to be materially different for the purposes of this Report.

[48] "Actuarial value" is the average percentage of the cost of essential benefits paid for by the plan, as opposed to out-of-pocket costs paid by the covered individual. This statistic reflects the *value* of coverage provided by a plan, not the details of plan design. The actuarial value of a specific plan depends on its mixture of copays, deductibles, exclusions and other provisions. Plans can reach the same actuarial value in different ways that are tailored to be more responsive to particular groups of insureds.

[49] Aon Data. *See also* http://www.pwc.com/us/en/health-industries/health-research-institute/assets/pwc-hri-health-insurance-premium.pdf

[50] The 2014 Towers Watson NBGH Employer Survey on Purchasing Value in Health Care found that for the average $12,535 premium, employees paid an average of $2,975, or 24%. http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2014/05/full-report-towers-watson-nbgh-2013-2014-employer-survey-on-purchasing-value-in-health-care

[51] Even while substantially underpaying education pension funding obligations, in 2014 the State paid approximately $1.3 billion for local education employees' pension benefits and retiree health benefits, and another $750 million for what otherwise would be local school districts' obligation to pay the employer Social Security contribution for local education employees.

[52] The nonforfeitable rights statute, N.J.S.A. 43:3C-9.5(a), (b) lets vested employees have it both ways. They can claim the benefits of enhancement of pension benefits after their nonforfeitable rights attach, but they are exempt from any effort to reform those terms, even with respect to their future accrual of benefits.

[53] Chapter 78's suspension of COLAs is an exception, as this reform of a retirement (not necessarily pension) benefit was imposed on all employees and retirees without regard to length of service. The COLA reduction was immediately challenged in the *Berg* litigation, which threatened to negate the primary savings on which the reforms in Chapter 78 were premised.

[54] Depending on circumstances, responsibility for retiree and possibly for active employee health benefits could be transferred as well.

[55] The same concerns of ensuring compliance with ERISA and other tax and regulatory requirements that are applicable to the transfer of the existing plans would also apply to formation of the new retirement plans.

[56] Status Report pp. 3-5, 14, 31.

[57] Status Report, p. 15.

[58] Status Report, p. 24.

[59] Status Report, p. 25.

[60] Actuarial values of representative plans according to Horizon Blue Cross/Blue Shield, based on the federal Minimum Values calculator.

| Plan | Actuarial Value |
|---|---|
| NJ Direct 15 | 96.4% |
| 1525 | 94.6% |
| 2030 | 93.9% |
| ACA Platinum Level | 90% |
| 2035 | 86.2% |
| HD1500 | 83.5% |
| ACA Gold Level | 80% |
| ACA Silver Level | 70% |
| HD4000 | 65.9% |
| ACA Bronze Level | 60% |

[61] For reasons of confidentiality, the names of the employers are not disclosed. In addition, the employer premium contributions shown are an average of all employer plans and therefore are not necessarily specific to the plan listed in this chart.

[62] The same variations in plan design affect prescription drug benefits, which also have a substantial impact on health benefits costs. The following table shows the prescription drug benefits for the plans in Table VII:

| | Employer A | Employer B | Employer C | Employer D |
|---|---|---|---|---|
| **Prescription Drugs** | | | | |
| Deductible | none | Included with medical | Included with medical | none |
| Out-of-Pocket Maximum (Single/Family) | $1,250/$2,500 | Included with medical | Included with medical | none |
| Retail Tier 1 | 20% | $8 | 10% | $25 |
| Retail Tier 2 | 20% + MPD | $34 + MPD | 25% with $25 min and $200 max + MPD | $50 |
| Retail Tier 3 | 60% + MPD | $63 + MPD | 50% with $50 min and $200 max + MPD | $70 |
| Mail Tier 1 | 20% | $17 | 10% | $30 |
| Mail Tier 2 | 20% + MPD | $67 + MPD | 25% with $50 min and $500 max + MPD | $60 |
| Mail Tier 3 | 60% + MPD | $125 + MPD | 50% with $100 min and $500 max + MPD | $90 |

[63] *See* Aon Data; http://www.pwc.com/us/en/health-industries/health-research-institute/assets/pwc-hri-health-insurance-premium.pdf

[64] A full explanation of the laws governing the ACA employer mandate is beyond the scope of this report. On a very general level, an employer must provide coverage of "minimum value" (actuarial value of 60%) that is "affordable" ("cost of no more than 9.5% of an employee's household income). *See, e.g.,* https://www.healthcare.gov/small-businesses/what-is-the-employer-shared-responsibility-payment/.

[65] As set forth in our Status Report, if the bulk of individuals for whom the State is responsible remain in their current Platinum-level plans and the ACA excise tax remains in place, the annual excise tax for 2018 has been estimated at $58 million, rising to $284 million by 2022.

[66] L. 2010 c. 2 requires newly hired employees, upon retirement, to pay 1.5% of retirement benefits to health care coverage. It will be years before employees covered by this provision retire in material numbers.

[67] Projected 2016 cost is based on dividing the projected overall 2016 cost by 96,142 active employees as of 2015.

[68] Projected 2016 cost is based on dividing the projected overall cost by 37,088 early retirees as of 2015.

[69] The right of the State to make substantial changes to these benefits under existing law is unclear. While statutes dating to 1997 provide State and education retirees with health benefits without contribution, *see* N.J.S.A. 52:14-17.28b, 17.46, the contemporaneous nonforfeitable right statute, with respect to pensions, expressly provides that the rights it created do ***not*** extend to post-retirement medical benefits provided by law, N.J.S.A. 43:3C-9.5(a). Arguably, this reflects a legislative intent to preserve greater latitude in setting retiree health benefits to meet future exigencies. There is also case law indicating that the Legislature, on a going-forward basis, may withdraw early retiree health benefits as a subject of future collective bargaining. *See, e.g., Powell v. State of New Jersey*, A-3651-12T2 (App. Div. 2014).

[70] Experience in the ACA exchange for New Jersey has been that 65% of enrollees making their own coverage elections have chosen Silver coverage, and another 20% have elected Bronze. http://aspe.hhs.gov/health/reports/2014/MarketPlaceEnrollment/Apr2014/ib_2014Apr_enrollment.pdf

[71] 2014 Towers Watson NBGH Employer Survey on Purchasing Value in Health Care.

[72] Reforms already enacted as part of Chapter 78 will phase in contribution requirements for early retirees.

[73] Aon Data.

[74] Aon Data.

[75] At present, some retirees receive full reimbursement of this premium, which is currently $104.90/mo. Others receive a capped reimbursement of $46.10/mo. Some also receive reimbursement of the surcharge imposed by Medicare on high-income individuals. *See* Status Report, p. 23, n. 57.

[76] 2014 Towers Watson NBGH Employer Survey on Purchasing Value in Health Care.

[77] Roughly 40% of municipalities (consisting of 80% of local employees) and 52% of school districts (consisting of 35% of education active employees) have elected to opt out of the State health benefits programs. Curiously, these numbers suggest that smaller than average municipalities but larger than average school districts participate in the State systems.

[78] Treasury Data. The participants and opt-outs break down as follows:

| | Education Employees | Local Employees | Local Retirees |
|---|---|---|---|
| Enrolled in State Health Benefits System | 95,678 | 47,297 | 27,898 |
| Not Enrolled | 57,780 | 180,487 | 113,356 |
| Total | 153,458 | 227,784 | 141,434 |

[79] As a precedent, Chapter 78 applied to all local public employers regardless of their participation in the State health programs. *See* N.J.S.A. 40A:10-21.1(d); N.J.S.A. 18A:16-17.1(c).

[80] Vested former employees would also have their pensions frozen.

[81] A freeze reduces pension costs by eliminating the "normal" portion of the pension payment that reflects the present value of new benefits accrued in that year. A freeze, however, also reduces a plan's unfunded liability and the corresponding portion of the pension payment otherwise needed to pay off that liability over time. This is because some prepayment of benefits expected to accrue in the future is included in the calculation of each year's normal pension contribution (among other factors, this prepayment reflects that final average salary will likely be higher than an employee's current salary). If the annual required contribution is not made in full, the unpaid contribution for expected future accruals increases the unfunded liability. The freeze means these expected future accruals will never occur. As a result, the portion of the unfunded liability attributable to not having funded benefits that now will no longer accrue also disappears.

[82] Treasury Data.

[83] An issue discussed *infra* in the Additional Thoughts section.

[84]There are a number of combinations of downside protections and sharing of upside returns that could be considered. For example, one approach would be to provide interest credits in any given year based on the greater of a fixed rate (e.g., 3%) or a portion (e.g., 50%) of the average return on the plan's assets over the preceding five years. Another approach would be to provide account balances on two different interest crediting bases and the employee would be entitled to the greater of the two balances: one balance would be determined using a fixed crediting rate (e.g., 3%) and the other using a portion of the return on the plan's assets each year (e.g., 50%). Whatever approach is adopted would need to be structured to avoid essentially shifting most of the investment risk back to the employer.

[85] http://www.asppa.org/Portals/2/PDFs/White%20Papers/wp_Participantdirectedplansfinal.pdf

[86] A private-sector cash balance plan generally involves only employer contributions because, in the private sector, only in true 401(k)-style defined contribution plans can employees make pretax contributions.

[87] The accounts in the cash balance plan would reflect both employer and employee pay credits, each of which would receive interest credits, thus making the balance of the employer and employee credits additive. In contrast, under the existing plans, employee contributions set a minimum benefit level. For younger employees, the employee contribution with interest is typically greater than the value of the employee's total pension.

[88] Based on State pensionable payroll for 2013 of $5.775 billion, TPAF pensionable payroll of $10.038 billion and local pensionable payroll of $10.824 billion.

[89] The fact that pension funding is relatively stronger at the local level is not a reason for complacency. The local pension plans are final-average-salary plans and therefore are subject to the same disconnect between investment performance and benefits that helped undermine the State-level portion of the plans, concerns addressed in the Pensions discussion in the Additional Thoughts section of this Report. Moreover, the 67% funded ratio (the percentage of the actuarial accrued liability that is currently funded through the actuarial value of assets) of the local shares of the pension plans, while better than the average 33% funded ratio of the State shares, is not good. *See* State of New Jersey November 25, 2014, Supplement to Preliminary November 19, 2014, Bond Disclosure, I-1-1.

[90] *See, e.g.,* N.J.S.A. 18A:66-33; Yaffe, Deborah, *Other People's Children, The Battle for Justice and Equality in New Jersey's Schools*, 176-213 (Rutgers University Press, 2007).

[91] *Id.* at 182-97.

[92] The local health benefits costs in Table IX include pro-rata extrapolations based on data for enrollees, as the State does not maintain readily accessible data on cumulative nonenrollee costs. A pro-rata projection of nonenrollee costs based on enrollee costs is likely to be somewhat high; as it is reasonable to assume employers who elected not to enroll their employees in the State programs did so because they were able to provide the benefits mandated by the State at less cost. Given that the right to not participate in the State plan is conditioned on providing comparably similar benefits, however, a pro-rata projection expressed as a range is a reasonable means of estimation for the purposes of this Report.

[93]The health benefits costs in this table reflect an estimate based on historical data and projections from Aon on costs for enrollees in the SHBP and SEHBP, and a pro-rata projection of costs for the 35% of education active employees and 80% of local active employees and retirees not enrolled in the State health benefit programs.

**Costs After Reform for Local-Pay Health Benefits** (costs in billions)

| | Number of Enrollees | Projected Costs For Enrollees | Number of Non-Enrollees | Estimated Costs for Non-Enrollees |
|---|---|---|---|---|
| Education Employees | 95,678 | $1.081 | 57,770 | $0.653 |
| Local Employees | 47,297 | $0.645 | 180,487 | $2.461 |
| Local Retirees | 27,898 | $0.449 | 113,356 | $1.768 |
| Total | 170,873 | $2.175 | 351,613 | $4.882 |

Total estimated costs after reform: $7.057 billion.

**Costs Without Reform for Local Pay Health Benefits** (costs in billions)

| | Number of Enrollees | Projected Costs For Enrollees | Number of Nonenrollees | Estimated Costs for Nonenrollees |
|---|---|---|---|---|
| Education Employees | 95,678 | $1.502 | 57,770 | $0.907 |
| Local Employees | 47,297 | $0.892 | 180,487 | $3.404 |
| Local Retirees | 27,898 | $0.599 | 113,356 | $2.424 |
| Total | 170,873 | $2.993 | 351,613 | $6.735 |

Total estimated costs before reform: $9.728 billion. To reflect assumption that nonenrollee costs before reform night have been somewhat less than enrollee costs (*see* footnote 97), this figure is adjusted to $9.428 billion for the purposes of the computations in Table IX.

[94] Includes $681 million in normal cost pension funding.

[95] Includes $1.526 billion in pension funding.

[96] This use of the local surplus can also be depicted as a funding source:

**Proposed Uses of Local Benefits Surplus – 2016** (in billions)

| | |
|---|---|
| Education Retiree Health Payment | $0.950 |
| New Education Retirement Plan | $0.402 |
| Remaining Surplus | $1.482 |
| Total Uses | $2.834 |

**Proposed Sources of Funding Education Retirement Benefits – 2016** (in billions)

| | |
|---|---|
| Surplus Resulting from Local Benefit Reforms | $2.834 |
| Total Sources | $2.834 |

[97] Article VIII, Section II, para. 5 establishes a Council on Local Mandates to determine if a law imposes on local governments an obligation without authorizing resources other than property taxes to pay for it. For a variety of reasons, the State ending its assumption of a local obligation as an element of a larger integrated reform effort that is crucial to the State's fiscal future and intended to be cost-neutral to local governments is a sufficiently unique circumstance to warrant separate constitutional authorization outside of the Local Mandate process.

[98] Art. VIII, Sec. II, para. 2 provides that "No money shall be drawn from the State treasury but for appropriations made by law. All moneys for the support of the State government and for all other State purposes as far as can be ascertained or reasonably foreseen, shall be provided for in one general appropriation law covering one and the same fiscal year; except that when a change in the fiscal year is made, necessary provision may be made to effect the transition. No general appropriation law or other law appropriating money for any State purpose shall be enacted if the appropriation contained therein, together with all prior appropriations made for the same fiscal period, shall exceed the total amount of revenue on hand and anticipated which will be available to meet such appropriations during such fiscal period, as certified by the Governor."

[99] Art. VIII, Sec. II, para. 3 provides, in pertinent part, "The Legislature shall not, in any manner, create in any fiscal year a debt or debts, liability or liabilities of the State, which together with any previous debts or liabilities shall exceed at any time one per centum of the total amount appropriated by the general appropriation law for that fiscal year, unless the same shall be authorized by a law for some single object or work distinctly specified therein. Regardless of any limitation relating to taxation in this Constitution, such law shall provide the ways and means, exclusive of loans, to pay the interest of such debt or liability as it falls due, and also to pay and discharge the principal thereof within thirty-five years from the time it is contracted; and the law shall not be repealed until such debt or liability and the interest thereon are fully paid and discharged. Except as hereinafter provided, no such law shall take

effect until it shall have been submitted to the people at a general election and approved by a majority of the legally qualified voters of the State voting thereon."

[100] *Spina v. Consolidated Police and Firemen's Pension Fund Commission*, 41 N.J. 391 (1964); *N.J.E.A v. State of New Jersey*, 412 N.J. Super. 192 (App. Div. 2010).

[101] *See Enourato v. New Jersey Building Authority*, 90 N.J. 396, 409 (1982) (discussing this principle).

[102] *See, e.g., Holster v. Bd. of Trustees of the Passaic County College*, 59 N.J. 60, 71 (1971).

[103] Far from being a dead letter, these principles were recently strengthened and reaffirmed in a 2008 amendment requiring voter approval of long-term liabilities, even if they are not backed by the full faith and credit of the State. *See* Art. VIII, Sec. II para. 3 (b).

[104] *See N.J.E.A v. State of New Jersey*, 412 N.J. Super. at 215.

[105] Art.IV, Sec.VII, para. 3 provides that "The Legislature shall not pass any bill of attainder, ex post facto law, or law impairing the obligation of contracts, or depriving a party of any remedy for enforcing a contract which existed when the contract was made."

[106] L. 2010, c. 1, Echoing case law that had long declined to recognize contractual rights in public pensions, the Sponsor's Statement to L. 2010. c. 1 explained that nonforfeitable rights would no longer be extended to new employees because "the Legislature should not be permanently and inextricably bound by an action of a prior session of the Legislature."

[107] In the years that the nonforfeitable rights statute was in effect, the State's share of the pension system went from having a $1.2 billion surplus in 1997 to a $26 billion deficit by 2010.

[108]The argument that the State has the power to modify existing benefits rests on its inherent power as a sovereign entity to change its laws, as well as the principle of federalism, reflected in the Eleventh Amendment to the United States Constitution, of federal non-interference with this aspect of state sovereignty. As the United States Supreme Court explained in *Alden v. Maine*, 527 U.S. 706, 750-751 (1999), restrictions on the power of a state to define its own liability "would place unwarranted strain on the States' ability to govern in accordance with the will of their citizens." The Court went on to explain "the allocation of scarce resources among competing needs and interests lies at the heart of the political process. While the judgment creditor of a State may have a legitimate claim for compensation, other important needs and worthwhile ends compete for access to the public fisc. Since all cannot be satisfied in full, it is inevitable that difficult decisions involving the most sensitive and political of judgments must be made. If the principle of representative government is to be preserved to the States, the balance between competing interests must be reached after deliberation by the political process established by the citizens of the State, not by judicial decree[.]"

[109] *DePascale v. State*, 211 N.J. 40 (2012).

[110] Moreover, while in *DePascale* the State Supreme Court had held the protection in question exists, that Court has never decided whether nonforfeitable rights are entitled to protection under the Contracts Clause. Particularly given the long precedent under New Jersey law that employee benefits were amenable to statutory change, an amendment

taking these benefits outside of the scope of the Contracts Clause could be viewed as a clarification that the claimed right does not exist.

[111] Another 1.1 million, or 12% of the population, receive Medicaid benefits, http://kff.org/medicaid/state-indicator/total-medicaid-enrollment/,

[112] *See, e.g.,* http://www.forbes.com/sites/paulhsieh/2013/04/25/big-brother-has-a-new-face-and-its-your-boss/

[113] See http://www.kpmg-institutes.com/institutes/government-institute/articles/2014/10/attention-health-care-shoppers--new-value-based-purchasing-strat.html at 11.

[114] Senate President Sweeney has proposed a pilot program exploring this approach.
*See* http://www.nj.com/politics/index.ssf/2015/02/sweeney_says_state_can_cut_health_insurance_costs.html

[115] Horizon Data.

[116] Robinson, James C and Timothy T Brown, "Increases in Consumer Cost Sharing Redirect Patient Volumes and Reduce Hospital Prices For Orthopedic Surgery," (August 2013) *Health Affairs* 32(8) Available at http://content.healthaffairs.org/ content/32/8/1392.abstract

[117] *See* http://www.kpmg-institutes.com/content/dam/kpmg/governmentinstitute/pdf/2014/state-purchasing-strategies.pdf at 8.

[118] The required modifications would potentially include reduction in the percentage of final average salary credited for each year of service, an increase in the period for determining final average salary, an increase in retirement age and enhancement of early retirement penalties. There would also be a need to consider caps on pensionable salaries and increases in employee contributions.

[119] *See also* Status Report, p. 17 (discussing trends away from final-average-salary defined benefit plans).

[120] In considering moving from a final-average-salary defined benefit plan, the Commission considered and discounted as inapplicable to its proposed approach concerns reported in the press that transition from a final-average-salary defined benefit plan to a defined contribution plan would result in an additional $42 billion in transition liabilities.
*See* http://www.njpp.org/reports/how-to-dig-an-even-deeper-pension-hole. *See also* https://www.mackinac.org/15284 (questioning the analysis leading to that concern).

[121] A related concern is that defined contribution plans typically permit withdrawals and loans that can eat away at employees' account balances.

[122] *See* http://watchdog.org/171777/deadly-sins-pensions/

[123] Because it serves as the means of binding the State to long-term obligations, the State Constitution's amendment process is not nearly as onerous as its federal counterpart is. Since 2000, the State Constitution has been amended fifteen times (out of seventeen attempts). Five of the six bond issues during this time period were also approved by the voters. *See* http://ballotpedia.org/List_of_New_Jersey_ballot_measures#tab=2000-2009

[124] *See* State Farm Mut. Auto Ins. Co. v. State, 124, N.J. 32, 64 (1991).

[125] Whether the State has grounds to impair rights granted to employees in Chapter 78 to compel State funding of the statutory pension payment is among the questions at issue in *Burgos v. State*, and whether suspension of COLA payments is justified under this standard is among the questions at issue in *Berg v. Christie*.

[126] http://www.businesswire.com/news/home/20141125006410/en/Fitch-Jerseys-GASB-67-Pension-Figures-Paint