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ISSUE UPDATE

# EVEN WITH RECORD CONTRIBUTIONS AND STRONG RETURNS, TEACHERS' PENSION PLAN TREADS WATER

## TPAF IS STILL ONLY 34.7%-FUNDED, OR 47% WITH LOTTERY ASSETS

June 5, 2024

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## Introduction

When addressing New Jersey's underfunded public pensions, Gov. Murphy has talked a great game:

> "When we keep making this payment, we'll go from a pension system that many said was destined for bankruptcy, to one that is solvent, healthy, and sustainable."

With regard to New Jersey's largest public pension, the Teachers Pension and Annuity Fund (TPAF), Murphy's statement is only partially true. With billions in extra funding and the contribution of most of the New Jersey Lottery, TPAF is currently solvent, in that it will not go bankrupt in the near future.

But TPAF is not healthy. It is still reliant on positive investment returns to avoid having to deplete its assets to meet its annual benefit payments to retirees. The Pew Charitable Trusts made clear that this is not a sound policy:

> " ... states cannot count on outsize investment returns to bail out underfunded pension plans ..."

Yet, that is precisely what Murphy is doing. In FY2021, pension investments posted a record 28.6% return and TPAF's assets grew by $5 billion. In FY2022, investments lost -7.9% and assets shrunk by -$2 billion -- meaning there was $2 billion less to earn a return the next year. So despite strong returns of 9.2% in FY2023, assets only grew by $2 billion and were essentially back where they were in FY2021. Meanwhile TPAF's liabilities continued to grow by $2 billion a year. The result: TPAF's FY2023 34.7% funded ratio (the amount of money set aside to pay for future liabilities) was actually lower than FY2021's 35.5%. Despite two full, required pension payments in FY2022 and FY2023, TPAF is only treading water.

A 34.7% funded ratio is not healthy. Gov. Christie's dedication of 77.8% of the state lottery until 2047 has helped a great deal -- $5 billion in annual contributions to TPAF and a $9.6 billion asset on its books -- but TPAF's internal dynamics are so weak that even with the addition of the lottery, TPAF's liabilities are less than 50%-funded.

Finally, there is a serious question as to whether TPAF's current condition is sustainable. Murphy's state budgets have benefited from large, pandemic-related revenue windfalls that have allowed him to massively increase state budgets as well as pension funding. The investment markets have largely cooperated with strong returns. But neither can be counted on to recur consistently. A deep recession could change the picture dramatically.

The bottom line is that Murphy chose to throw good money after bad because it was politically expedient. Rather than cross his largest political benefactor, the New Jersey Education Association (NJEA) and do the hard work of reforming TPAF, Murphy has thrown billions of taxpayer dollars at the problem. But he has not solved the problem. The status quo governor has left future generations with a malign status quo.

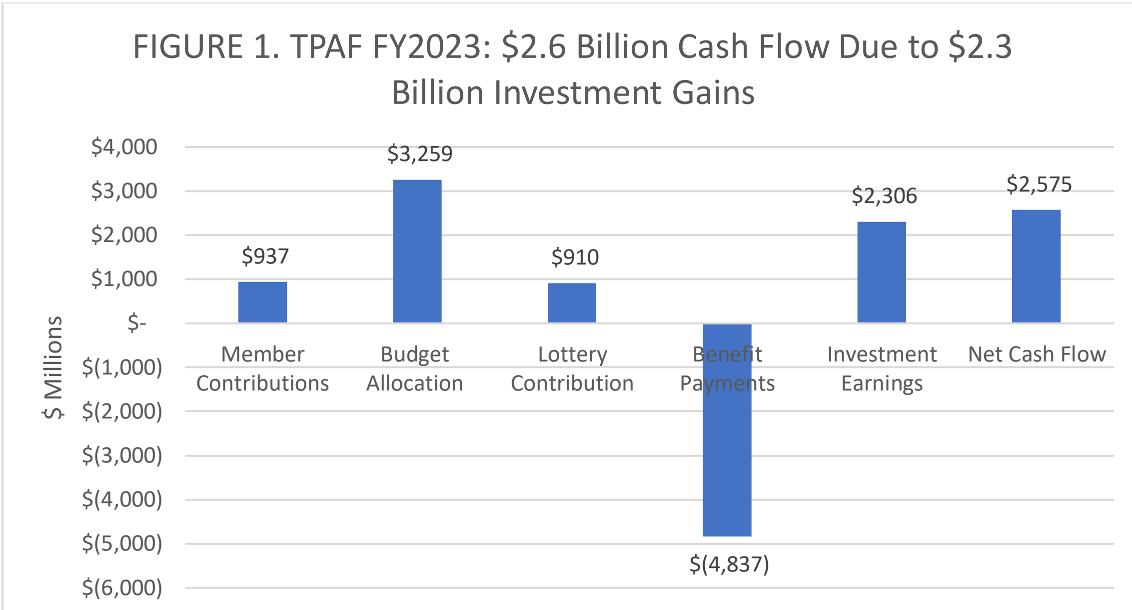
## Due to Robust Investment Returns in FY2023, TPAF Gains Assets

New Jersey's state pension funds have been woefully underfunded for decades and provide an example of the perils of underfunded pension funds relying on investment returns. Even with Murphy's full pension contributions in FY2022 and FY2023, New Jersey's largest public pension plan, the Teachers Pension and Annuity Fund (TPAF), was only break-even for in terms of operating cash flow[1] for those two years. As has been the case in the past, TPAF's ability to pay out annual benefits owed to retirees without having to sell assets depends on investment earnings, which makes TPAF highly vulnerable to a market downturn.

FY2022 was precisely such a year. TPAF's investments are part of the state's overall portfolio and suffered -7.7% loss. Just as predicted by Pew, in order to make the $4.8 billion in benefit payments, TPAF has to sell $2 billion of assets. That's $2 billion fewer assets invested in the market and able to generate returns.

FY2023 was a far better year for TPAF's investment, which returned 9.1%. As seen in Figure 1, TPAF's cash inflows came from $937 million in member (employee) contributions, a $3.3 billion appropriation from the state budget, and $910 million in lottery proceeds. Against those inflows was the outflow of $4.8 billion in benefits payments. The $2.6 billion net cash flow was almost entirely due to the $2.3 billion in investment earnings.

[1] According to Pew, operating cash flow includes all contributions into and payments out of a pension fund. Importantly, it does include investment returns. This is the first year TPAF has not had negative operating cash flow in at least 25 years.

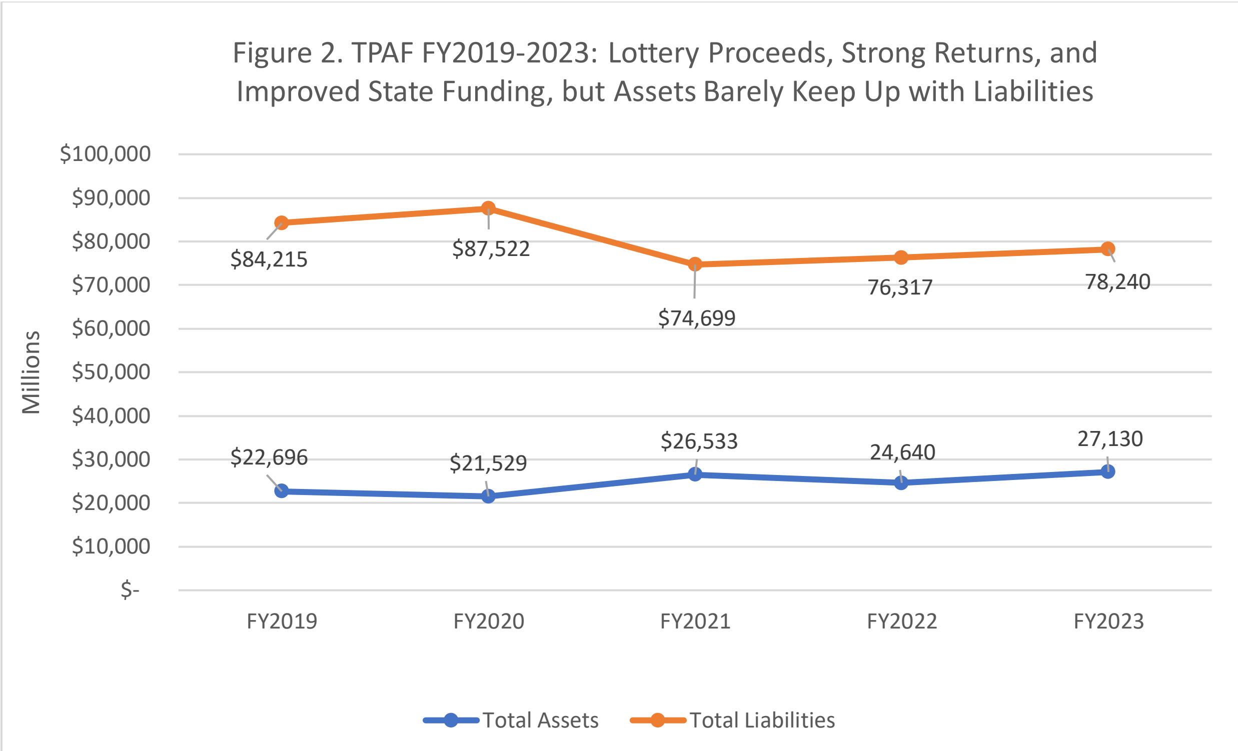



Source: State of New Jersey, Division of Pensions & Benefits, FY2023 Audit Report, p. 58.

## **<u>But Despite Asset Gains in FY2023, TPAF Is Treading Water</u>**

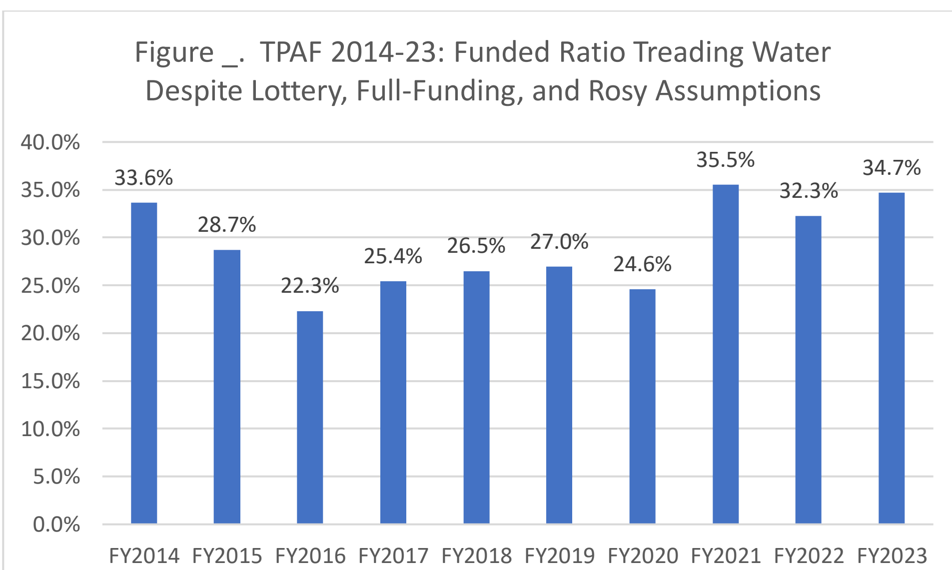
The past three years provide an excellent real-world example of Pew's warning about relying on investment returns for cash flow. In FY2021, TPAF had record investment returns of 28.6% and solid 9.1% returns in FY2023, but because the markets were down -7.7% in FY2022, total assets were essentially unchanged.

As seen in Figure 2, TPAF's assets were $26.5 billion at the end of FY2021 and $27.1 billion in FY2023. At the same time, TPAF's liabilities inexorably rose from $74.7 billion in FY2021 to $78.2 billion in FY2023.




Source: State of New Jersey, Division of Pensions & Benefits, FY2023 Audit Report, p. 58.

This dynamic is also reflected in TPAF's funded ratio (the amount of assets set aside to meet TPAF's liabilities). As shown in Figure 3, with $27.1 billion of assets and $78.2 billion in liabilities, TPAF's FY2023 funded ratio was 34.7%. That means that TPAF has about 35 cents set aside for every dollar it owes future retirees. This is an extremely low funded ratio that places TPAF among the worst-funded state pensions in the country. Despite the state's full contributions, it is also *lower* than FY2021's 35.5%.




Source: State of New Jersey, Division of Pensions & Benefits, FY2023 Audit Report, p. 58.

Note that TPAF's FY2023 funded ratio is about where it was ten years ago in FY2014. TPAF is treading water.

## The Very Low 34.7% Funded Ratio Is Based on Optimistic Assumptions

But even this very low 34.7% funded ratio benefits from some very charitable assumptions.

- **Full pension payments assumed -- until 2050**. The Government Accounting Standards Board (GASB) Rule 67 allows New Jersey to use the 7% discount rate because it assumes that New Jersey will continue to make the full, required pension contributions for every year until 2050. In other words, New Jersey will be expected to make TPAF contributions of $3.5 to $4 billion per year for the next 27 years.[2] If New Jersey does not contribute this full amount, then GASB 67 will revert to a lower discount rate and TPAF's funded ratio will drop commensurately.
- **Discount rate based on high return assumption**. The 7% discount rate derives from the plan's 7% investment return assumption, but Pew Charitable Trust emphasizes that "a reasonable return assumption for the typical pension plan will be closer to 6%" for the foreseeable future. Were New Jersey to use a 6% return assumption, and in turn a 6% discount rate, the funded ratio would be substantially lower.
- **Very high discount rate**. The amount of liabilities (the denominator) is derived from a 7% discount rate for the pension liabilities, a very high rate for what is essentially a guaranteed obligation of the state.[3]

TPAF's 34.7% funded ratio is one of the very lowest in the nation for public pensions.[4] And even this level is questionable because of all the optimistic assumptions. New Jersey taxpayers are on the hook for the 65% of these pension obligations that is unfunded, yet this reality has not been conveyed to them.

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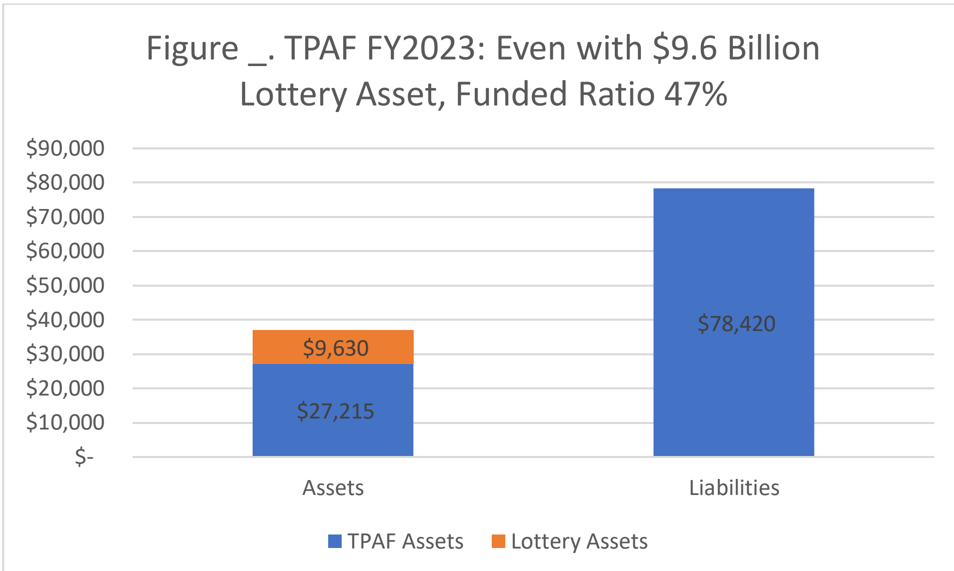
[2] Because Gov. Murphy and the legislature have made the full required pension payments for FY2022 and FY2023, under General Accounting Standards Board (GASB) Rule 67, TPAF's actuaries can assume that the state will continue to make full payments until TPAF is 100% funded in 2050. This allows the actuaries to use the 7% discount rate for TPAF's assets as the discount rate for TPAF's liabilities. This is a very high discount rate for liabilities and substantially reduces the annual required funding amount. GASB 67 Report as of June 30, 2023, Produced by Cheiron, February 2024, p. 31.

[3] Reputable economists argue that pension liabilities should carry a risk-free discount rate because they are "a form of government debt with strong statutory and contractual rights." Oliver Giesecke and Joshua Rauh, "Trends in State and Local Pension Funds," Annual Review of Financial Economics, Volume 15, October 2022. With a risk-free discount rate, TPAF's funded ratio would drop substantially per Stanford's Public Pension database.

[4] Andrew Biggs, et al., Addressing and Avoiding Severe Fiscal Stress in Public Pensions Plans, Urban Institute, January 2022, p. 15.

## Even with the Lottery Asset included, TPAF Is Only 47% Funded

In 2017, to shore up TPAF's finances, Gov. Christie and the legislature committed 77.8% of the state's annual lottery proceeds for 30 years (to 2047). Since then, the lottery has provided over $5 billion to TPAF. This resulted in the creation of a large asset outside of TPAF, itself, which is currently worth $9.6 billion. As shown in Figure _, if this asset is added to TPAF's own investment assets, TPAF is still only 47%-funded.

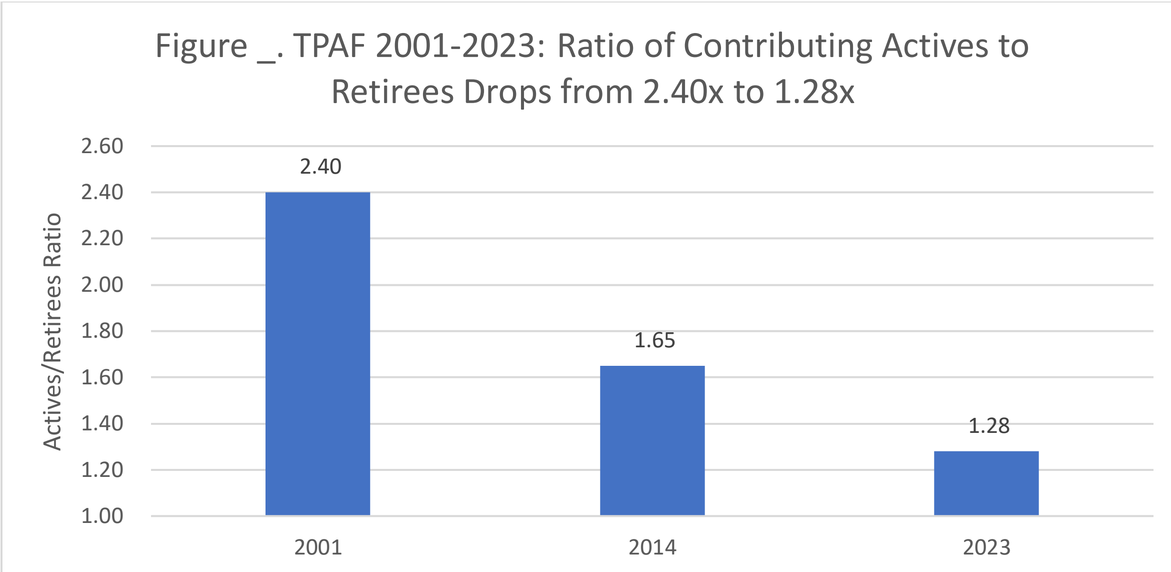



Sources: Teachers' Pension and Annuity Fund of New Jersey, Actuarial Valuation Report as of July 1, 2023, Produced by Cheiron, February 2024, p. 4.

While the addition of the lottery asset certainly shores up TPAF and helps it meet its annual benefit payments, it does not change the internal dynamics of the TPAF plan. With 65% of its liabilities unfunded, TPAF is playing catch-up every year due to its decades of underfunding. Thus despite the full, required payments being made, whether TPAF gains or depletes assets in any given year depends on its investment returns. As the past two years have shown, with normal market fluctuations, TPAF is only treading water.

## TPAF Retirees Will Soon Outnumber Active Workers

And the funded ratio is not the only problem with TPAF. In his 2022 report for the Garden State Initiative, highly regarded pension expert Andrew Biggs concluded that with retirees living longer and increasing in number, TPAF is approaching a demographic “tipping point,” where the number of retirees receiving benefits exceeds the number of active workers contributing into the pension system. As seen in Figure 4-2023.




Sources: Teachers' Pension and Annuity Fund of New Jersey, Actuarial Valuation Report as of July 1, 2023, Produced by Cheiron, February 2024, p. 7; and Andrew Biggs, "The Looming Tipping Point of New Jersey's Pension System," Garden State Initiative, January, 2022, p. 4.

According to TPAF's actuarial report (p.7): "As more of the liability moves from actives to inactives [retirees], the Fund will experience more volatility in contribution rates." In other words, as this ratio dips below 1.0x, more money will be owed to retirees who are no longer contributing into the plan, which could result in a situation where either the amount contributed by active workers must increase, or the amount contributed by taxpayers must increase, or both.

This is another way in which TPAF is not a healthy pension plan.

**The TPAF Choice: Unsustainable State Contributions or Depletion of Assets**

All told, as governor, Murphy has made over $32 billion in pension contributions to all New Jersey's public pension plans.

Of course, in tough times, when tax revenues are lower and the demand for state assistance is higher, spending $6.8 billion on pensions will mean less money for schools, social programs, public safety, and basic infrastructure. But if the state does not pour $6.8 billion a year into the pension system, then TPAF's unreformed structure means that it will rely entirely on investment returns to avoid having to sell assets to meet its obligations to retirees. A lose-lose situation.

**Conclusion**

So only one fiscal year after Murphy's happy talk, New Jersey's pensions have been revealed to be neither healthy nor sustainable, and potentially not even solvent in the long run. It is of course New Jersey taxpayers who will ultimately be on the hook for meeting New Jersey's pension obligations to retirees. They should be told the truth.

What about New Jersey's teachers? They have been told by Murphy and their union, the NJEA, that their pensions are sound. But their pensions are not sound. They should be told the truth.

But Murphy is not telling them the truth. Nor has he undertaken the difficult task of pension reform the way that the governors of Pennsylvania, Kentucky, Tennessee, Wisconsin and other states have. With his eyes set on national office, Murphy will likely be long gone when the reckoning comes. Too bad for the citizens (and teachers) who elected him.