

QUEEN CREEK'S PENSION PROBLEM

**HOW ONE TOWN CHANGED THE
PENSION CONVERSATION IN ARIZONA**

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Government Finance
Officers Association



The Government Finance Officers Association (GFOA) represents approximately 20,000 public finance officers throughout the United States and Canada. GFOA's mission is to promote excellence in state and local government financial management. GFOA views its role as a resource, educator, facilitator, and advocate for both its members and the governments they serve and provides best practice guidance, leadership, professional development, resources and tools, networking opportunities, award programs, and advisory services.

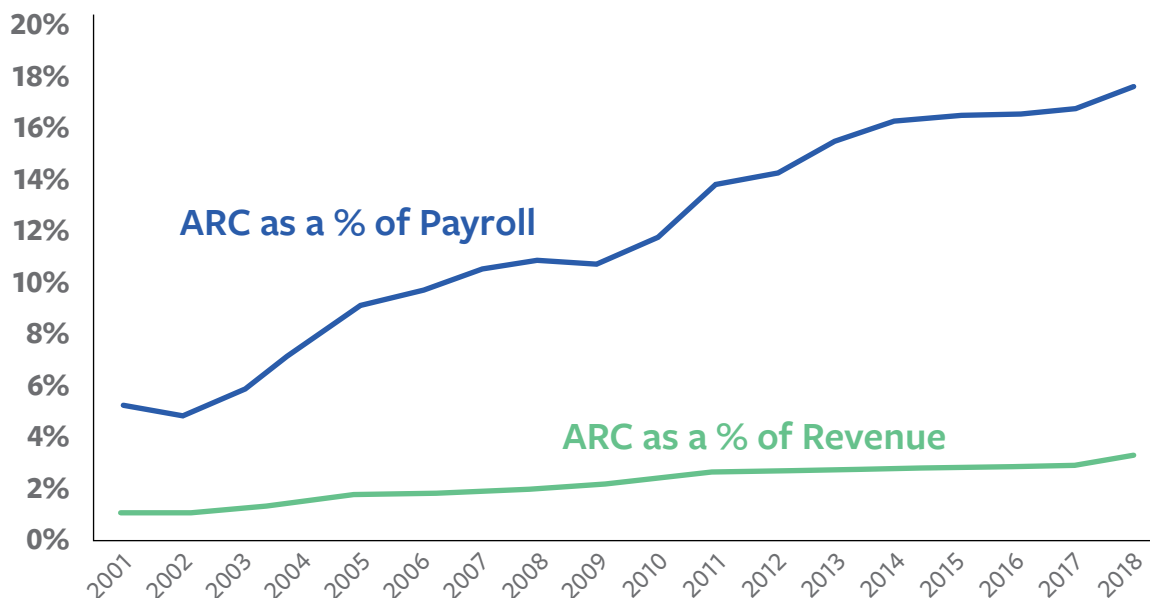
Pension costs are a challenge for local governments all over the country. When looking across the United States, the actuarial funded ratioⁱ for public pension plans dropped from around 90% at the beginning of the century to just over 70% in 2012. It has remained at about this level since.ⁱ The effect of this sustained underfunding of pension liabilities is that local governments' contributions to pension plans, both as a percent of payroll and total revenue, have been steadily increasing: rising to 17.4% and 3.2%, respectively, as of 2018.ⁱⁱ Exhibit 1 shows the long-term trend in these figures. These numbers are based on nationwide averages, so some individual local governments are experiencing even more difficult conditions than the numbers suggest.

This pension underfunding problem represents a collective action problem of the kind addressed by GFOA's Financial Foundations for Thriving Communities (www.gfoa.org/financialfoundations).

A local government budget is a collective action problem because a local government must reach a financially sustainable budget over the long term, despite the incentives that all stakeholders have to get as much as possible from the budget for themselves each year. A pension plan presents an even more challenging dynamic. Both public employees and elected officials have an incentive to increase pension benefits and underfund their costs. The people who have the strongest interest in responsibly managing today's pension plans are *future* officials, employees, and taxpayers—and they don't have a voice in today's decisions.

In this paper, we will share the experience of Queen Creek, Arizona—a community of about 50,000 that solved its pension problem and, in the process, transformed the entire state of Arizona. We'll see that Queen Creek's solution reflects many of the strategies described in the Financial Foundations Framework.

EXHIBIT 1 | Actuarial Required Contributions (ARC) Across the United States for Public Pension Plans



Source: Public Plans Data, publicplansdata.org

ⁱ The actuarial funded ratio is the ratio of actuarial value of assets to actuarial accrued liability.

QUEEN CREEK'S PENSION PROBLEM AND SOLUTION

Queen Creek had multiple pension plans that were cause for concern. Queen Creek had accumulated a great deal of what amounted to “debt” for services rendered by public employees in years past. This debt is known as an unfunded pension liability. Queen Creek was also paying “interest” in the form of higher contribution rates. Because Queen Creek was using today’s tax dollars to pay the “debt” costs for services rendered years ago, current taxpayers were not getting full value for the money they contributed to town government. According to the Financial Foundations Framework, this leads to two problems:

- People won’t see the value in contributing to the collective resource that is local government because they aren’t getting benefits back commensurate with their contribution. This would lead them to resist making contributions (e.g., paying taxes) in the future.
- People feel unfairly treated because their resources are being used to pay for something that benefits other people (past residents, past employees, past officials). When people feel unfairly treated, they are likely to leave (e.g., move out of the community) or fight back.

Hence, the public pension problem would not just make it more difficult for Queen Creek to balance its budget, it could drive a wedge between elected officials, staff, and the public, making it difficult for them to work together for a thriving community.

The solution began in June 2015 when the Town Council adopted a pension funding policy. We’ll examine the policy details later in this article, but the critical feature of this policy was to commit the town to fully fund its pension plans. As a result, the town was determined to reach 100% funding within a few years of adopting the policy. The town would reach its goal by directing budget surpluses to fund the liability: The town was frugal with its expenditures and was growing in population, so it could expect its revenues to grow as well.

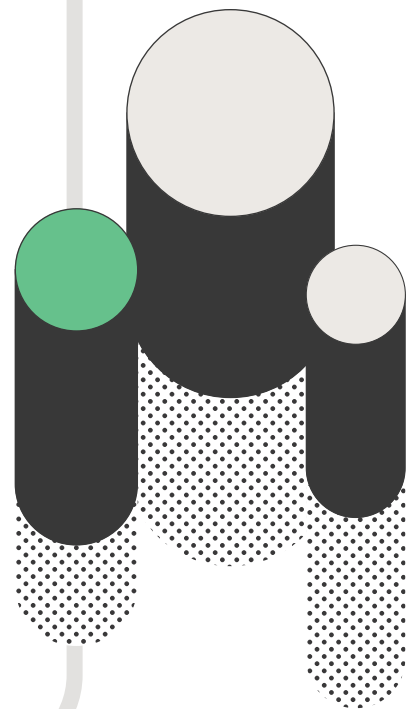
The policy first addressed the town’s plan for firefighters. This plan is part of a statewide system for public safety personnel (the Arizona Public Safety Personnel Retirement System). The system is set up so that each participating employer’s plan is administered separately. This means Queen Creek has its own employer contribution rate and unfunded liability. This made it easy for people to understand what the town’s responsibility was for the pension costs. In fiscal year 2015/16, the town’s annually required contribution rate was equal to 15.7% of the total payroll of the town employees covered by this pension plan (“covered payroll”). The plan was 65% funded. In June 2016, the town paid off its fire plan’s \$1.5 million unfunded liability and, per the adopted pension funding policy, annually

pays off any increase in the unfunded pension liability. In June 2018, the town amended its pension funding policy to create internal Unfunded Pension Liability Reserve accounts for its other two pension plans. In both of these cases, the unfunded pension obligation is only an estimate of the entire statewide pension system allocated to the town and, therefore, it is not possible for Queen Creek to pay off the liability with the system.

These two other plans were for: 1) police, and 2) all other nonpublic safety municipal employees. Queen Creek contracts with Maricopa County for police services. As part of this arrangement, the town pays its share of the county's pension costs. In fiscal year 2017/18, the town's contribution rate to the police pension plan was just over 45% of covered payroll, and the funded status was 43%. Nonpublic safety employees are part of the Arizona State Retirement System (ASRS), a statewide system, where all participating employers share costs. The ASRS is funded at just under 75%, and the town's annually required contribution is slightly more than 11% of covered payroll and is expected to steadily increase.

For both of these plans, Queen Creek's goal for creating the Unfunded Pension Liability Reserve was to achieve the same financial impact as paying down unfunded liabilities. For example, by June 2018, the town had created a reserve funded at \$19.7 million, the amount of the unfunded liability in the police pension plan. The town took a similar approach with the nonpublic safety pension. Queen Creek puts the funds in these reserves in longer-term investments to get a higher return than is obtained from the idle cash in a typical operating reserve. The reserve will be used over time to offset the higher contribution rates Queen Creek expects to experience. If circumstances cause an increase in the unfunded liability (like plan investment returns underperforming expectations), then Queen Creek funds the reserve appropriately.

Now that we've seen the essence of Queen Creek's pension solution, let's see how Queen Creek got there.



THE KEY TO THE PENSION SOLUTION: FISCAL FLUENCY

People could understand what the town was sacrificing if it did not address the pension problem.

The Financial Foundations Framework describes “trust and open communication” as a pillar of a strong financial foundation. Thus, for Queen Creek, a prerequisite to adopting its pension funding policy was to establish a common understanding of the problem. Once everyone was able to discuss the problem in the same way, it would be possible to make a collective decision about how to solve it.

This required education for elected officials, senior management staff, citizens, and even line employees. The town's CFO, Scott McCarty, led this effort to make people aware of the funded ratios, contribution rates and amounts, and other salient features of the pension problem. Of course, these details are not easily grasped by nonexperts, so it was important to repeatedly raise and explain these topics. The consistent message helped McCarty's audience better appreciate its importance. Also, as we will see in the following paragraphs, McCarty strove to make the pension problem understandable to people without a strong background in public finance.

Just telling people *what* that problem is isn't sufficient; they need to know *why* they should care. One effective technique McCarty used was to highlight the opportunity costs associated with the town's pension liabilities. “Opportunity costs” is a term from economics that describes what one gives up to pursue a different course of action. In Queen Creek, the course of action the town had been pursuing is to let its pension liabilities accumulate and pay interest in the form of higher contribution rates. The opportunity cost was the services it could be providing to citizens instead of paying these costs. Once Queen Creek addressed its unfunded pension liability costs, it would be more feasible for the town to open and staff new fire stations and hire additional police officers to meet the increasing service demands of one of the fastest-growing communities in Arizona and the country. This helped make the abstract concept of pension liabilities concrete: People could understand what the town was sacrificing if it did not address the pension problem.

McCarty also pointed out that this was not a cost that would remain stable. As Exhibit 1 showed, contribution rates have been rising across the U.S., and Queen Creek was no exception. This meant that the opportunity costs would get higher in the future as pensions took up a larger portion of annual revenues.

MOVING TOWARD A COLLECTIVE DECISION

After coming to understand what the problem was and why it was important, the next stage was deciding how to solve it. This required understanding how the pensions got to this point. McCarty pointed out that there were many causes, including a poorly designed benefit structure of the public safety system and a lack of active management by the town. Poor investment returns also played a role. The goal of this discussion was not to make everyone an expert on the history of Arizona pension plans but to make the point that this was a complex problem with multiple causes, so there would be no easy solutions.

As the town considered how to solve the problem, the metaphor of unfunded pension liability as “bad debt” and employer contributions as “interest” proved very useful. Most people do not deal with “unfunded liabilities” in their day-to-day lives. This makes the concept abstract and harder to grasp and, therefore, harder to resolve. However, almost everyone has some personal experience with the potentially crippling consequences of bad debt, either firsthand or by witnessing the struggles of a friend or family member. People appreciate the many problems associated with paying a high interest rate on a credit card balance, overbuying a house and having unmanageable mortgage and interest payments, or student loans for a degree that you are not getting sufficient value from later in life. Thus, just as everyday people are better off without bad debt, it was easy to appreciate that Queen Creek would be better off without the bad debt of unfunded pension liabilities. This encouraged town officials to implement a permanent solution.

Another benefit of the “bad debt” metaphor was that it focused the conversation on how to eliminate the debt and steered the conversation away from the fairness of the pension benefits received by public employees. The courts in Arizona have repeatedly ruled that changing benefits already earned by employees is not legal. A discussion about the fairness of the benefits employees received could be potentially explosive but would likely produce no progress toward a solution. However, as we will see later in this paper, Queen Creek did not brush concerns about fairness aside; it took up fairness later, under different circumstances.

Finally, Queen Creek looked at examples of how *not* to address the pension challenge. Many other municipalities in Arizona were in worse condition than Queen Creek. Examining these counterexamples proved helpful. One of the most common issues leading to the financial distress of pension plans is not actively managing the plan via a pension funding policy. Queen Creek became the first municipality in Arizona to adopt such a policy.

The foregoing shaped Queen Creek’s understanding of how a solution should be developed.

A PENSION FUNDING POLICY: THE RULES FOR PENSION AFFORDABILITY

The Financial Foundation Framework shows us that clear rules are necessary to reinforce constructive behavior. As we discussed earlier, the fundamental nature of public pension plans gives today's decision-makers the incentive to make destructive decisions that give resources to people in the present day and push higher costs onto people in the future.

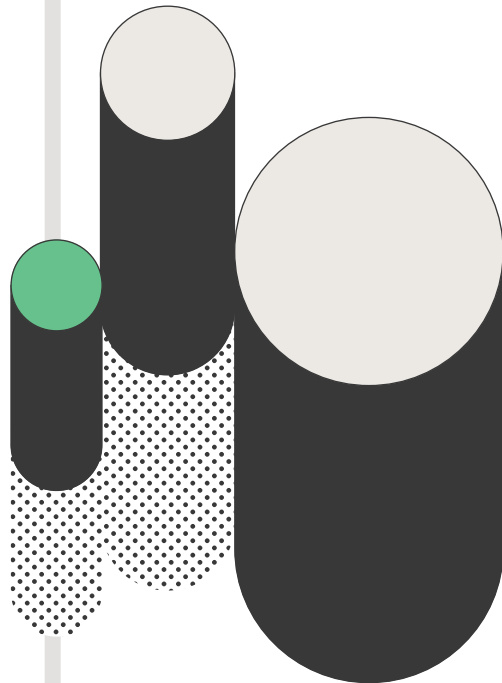
The Queen Creek Town Council wanted to create rules to prevent this. They believed it would be unfair to push the "bad debt" of pension liabilities onto future generations in the town. The combination of the bad debt metaphor and concern with fairness to future generations was very powerful. Research shows that people, even as young children, understand that resources should be divided equitably so people get what they deserve.ⁱⁱⁱ Asking future residents to pay the debt for services that past residents enjoyed would not be fair or equitable.

This led Queen Creek to develop and adopt a pension funding policy. The policy set the following objectives:

- **Fully fund the pension plans.** The town set a funding ratio goal of 100%.
- **Maintain intergenerational equity.** Fully funded plans represent current taxpayers paying the full cost of the services they receive today.
- **Maintain stability of the town's contribution amounts.** Maintaining a solid financial position on the pensions will be easier if the town's approach to pensions is consistent.
- **Maintain accountability and transparency.** Provide standards to determine if the town is meeting its pension funding objectives or not.

These objectives provided clear guidelines for the town to operate within.

Finally, the town annually updates and readopts the policy. This helps keep it top-of-mind for elected officials and staff.



REACHING THE GOAL: WHERE DOES THE MONEY COME FROM?

It is one thing to say you will fully fund pensions; it is another to do it. Queen Creek used surpluses that resulted from a conservative budgeting strategy. This was made easier by the fact that Queen Creek was growing rapidly, so revenues were on the rise. Regardless, other local governments should also be able to use a conservative budgeting strategy to realize surpluses each year to make steady progress toward a full funding goal—even if it does take a while longer than Queen Creek to get there. For example, the GFOA book *Financial Foundations for Thriving Communities* describes how San Bernardino County, California, used a similar strategy to pay down many different kinds of unfunded liabilities. The county faced very different circumstances than Queen Creek: The county was many times larger and was facing severe financial distress.

Another possible resource is excess operating reserves. Some local governments have accumulated large operating reserves. Operating reserves are a hedge against risk. Therefore, it may be wise to compare these reserves to the risks that the local government faces. The local government may find that it has accumulated more reserves than it needs in order to provide reasonable assurances that it can respond decisively to extreme events like a recession or natural disaster. If so, keeping these funds in operating reserves incurs a substantial opportunity cost: The government is missing the opportunity to pay down the “bad debt” of pension in favor of keeping a reserve that provides more-than-reasonable assurances against risk.

Finally, a local government might consider its capital funding strategy. If the local government uses cash to purchase capital assets with long, useful lives, it might consider using debt instead and redirect the cash to funding pensions. This could be a wise strategy for two reasons. First, as we have seen, pension liabilities create a severe inequity where tomorrow's taxpayers bear the cost of yesterday's services. Using cash to pay for long-lived capital assets creates a different inequity where today's taxpayers bear the cost of an asset that tomorrow's taxpayers will enjoy. Using debt for capital projects is equitable. The debt is paid off during the life of the asset, so all the citizens who benefit from the asset have a part in paying for it. If a local government is committed to paying down its unfunded pension liabilities, using debt for capital projects avoids overburdening today's taxpayers with paying off the bad debt of pensions and paying cash for assets that tomorrow's taxpayers will benefit from. Second, using debt to pay for capital might be especially wise if the government can put the cash in high-yield investment instruments (as are often found in pension plans), reduce its annually required contribution as a result, and borrow money for capital assets at lower interest rates (as might be available from tax-exempt bonds, for example).

QUEEN CREEK CHANGES THE STATE OF ARIZONA

The Financial Foundations Framework shows that forming a network of relationships with potential supporters outside of your local government is critical. These supporters can bring new resources to bear that the local government couldn't access on its own. While Queen Creek had made good progress independently, the town's pension challenge would be more manageable if more governments in Arizona were moving in the same direction.

Queen Creek's CFO, Scott McCarty, shared the town's experience with the GFOA of Arizona and League of Arizona Cities and Towns. Through these intergovernmental networks, a state legislator, Senator David Livingston, heard about what Queen Creek had done and about the town's pension funding policy. This inspired the Senator to create legislation requiring all employer members of the Public Safety Personnel Retirement System to adopt a pension funding policy.

Queen Creek also participated on a committee to help define the direction for statewide reform of public safety pensions. The committee developed a tool to guide how public safety pension reform elements would be evaluated. For example, the committee defined the standards for a new plan participant tier for employees hired after July 1, 2017. This new tier would be managed in a more sustainable fashion than the public safety pension had in the past.

QUEEN CREEK GETS AN UPGRADE

In 2019, Queen Creek saw its bond rating increase from AA- to AA. The town's pension funding policy had a strong influence on that upgrade.

CONCLUSION AND LESSONS LEARNED

Queen Creek's experience shows how the GFOA's Financial Foundations Framework can be applied to a public pension problem. The framework has five pillars for making solid decisions about shared public financial resources:

- **Establish a long-term vision.** Give people a reason to work together in supporting a financially strong local government.
- **Build trust and open communication.** Create the conditions for people to work together.
- **Use collective decision-making.** Develop forums for working together.
- **Create clear rules.** Reinforce constructive behavior.
- **Treat everyone fairly.** Promote and protect mutual trust and respect.

Here is how Queen Creek operationalized each pillar.

- ✓ **Establish a long-term vision.** Paying off the "bad debt" of pensions would make it more feasible for Queen Creek to provide the services for the community that elected officials wanted.

Also, the town's pension funding policy established a goal of maintaining full funding for the long term, and that goal is reaffirmed each year. The town followed a consistent strategy of using budget surpluses to pay down the liability. This kind of gradual approach will usually be more palatable to decision-makers.
- ✓ **Build trust and open communication.** The metaphor of "bad debt" made it easier for everyone to understand why paying off the unfunded liabilities was a good idea. Highlighting the opportunity costs of pension bad debt motivated action. Opportunity costs were the municipal services the town was not providing because it was paying this bad debt.

The town's CFO was also consistent in his messaging. Consistency is important because people may only remember a portion of the message each time they hear it. If they hear the same basic message repeatedly, it contributes to understanding. Also, if people perceive the finance officer to be consistent in what he or she says, that builds trust.
- ✓ **Use collective decision-making.** The policy solution was developed collaboratively with town staff and council.

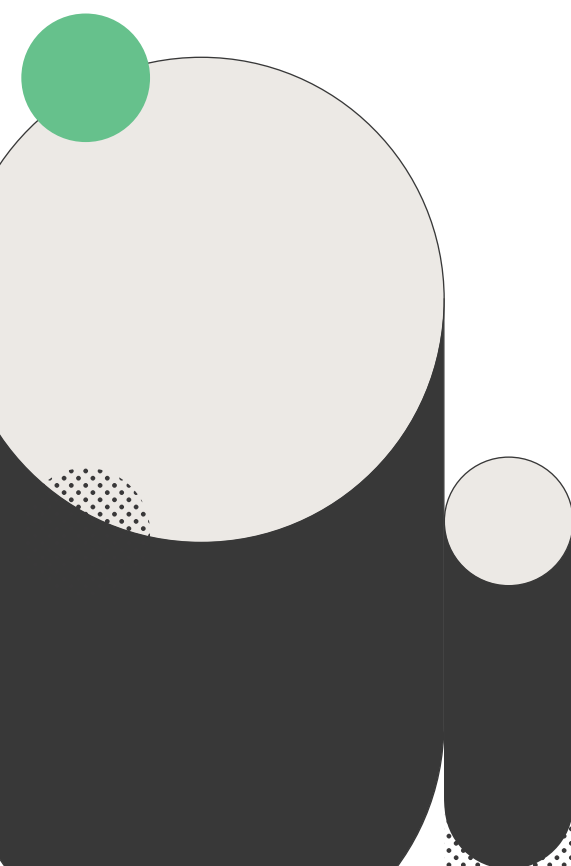
The town also worked with statewide organizations to improve the regulatory environment for pensions, which helped ease the challenge Queen Creek faced.
- ✓ **Create clear rules.** The town's pension policy establishes clear rules about how the town will actively manage its pensions, including funding standards and maintaining stability in contributions.
- ✓ **Treat everyone fairly.** The town officials showed their concern with treating the future generation of taxpayers fairly. This is critical because public pension plans present today provides public employees, elected officials, and citizens with an incentive to push the cost of today's services on to future generations.

Endnotes

ⁱ Source: publicplansdata.org/quick-facts/national

ⁱⁱ *ibid*

ⁱⁱⁱ Starmans, C., Sheskin, M., & Bloom, P. (2017). Why people prefer unequal societies. *Nature Human Behaviour*, 1(4), 0082.





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