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ECONOMIC PERSPECTIVES

THE PATH TO PUBLIC PENSION REFORM

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The large growth in public pensions has placed increasing pressure on state budgets, raising serious concerns about the ability of states to pay for the benefits promised to state and local government workers. By one estimate, without policy changes, contributions to state and local pension systems would have to increase 2.5 times,[1] which represents a tax increase of approximately $1,385 per household per year.

The severity of the problem has been obscured by poor accounting practices, which have hindered policymakers' efforts to improve the funding status of their plans. There is much room for improvement in the reporting and measurement of pension liabilities.[2] Even with the current practices, it is clear that the underlying value of pension debt is a real burden for states, beneficiaries, and taxpayers.

Failing to facilitate real reforms to public pension plans increases the risk of a deeper crisis,[3] even as some policymakers who resist reform claim to be reying on future market returns to improve their plans' solvency. Short-term tweaks such as minor adjustments to plan benefits or marginal funding increases fall short of addressing the structural problems of public sector pensions. Tinkering with the level of benefits provided only partially addresses the surface-level symptom of growing unfunded liabilities.

A long-term reform strategy requires addressing the root of the issue by altering the incentives facing policymakers. True reform must address the inherent problems of public-sector accounting and management of pension funds and consider the benefits of defined contribution plans for public-sector workers. Reforms should be equitable for all generations, fund retirement benefits adequately, and have a plan for funding legacy obligations.

EQUITABLE REFORM FOR ALL GENERATIONS

Any reforms undertaken should be based on the criterion of "intergenerational equity" between taxpayers and for employees promised retirement benefits. Taxpayers should fully pay for the compensation of public employees, including their deferred pension benefits, at the time that taxpayers receive services from those employees. Unfunded liabilities passed onto future generations—whether explicit liabilities or contingent liabilities that would become active in the case that pension investments produce returns below expectations—violate this precept.

Intergenerational equity should also be an important factor in pension reform. Most pension reform efforts have focused on changing benefits for young employees while preserving the benefits for older workers.[4] Although this is largely the result of legal constraints, such changes have the potential to force younger generations of public-sector workers to shoulder a disproportionate share of the cost of reforms, as their retirement benefits become more uncertain.

THE CAUSES OF PUBLIC SECTOR PENSION UNDERFUNDING

Defined benefit plans encourage policymakers to underfund long-term obligations because of how they are valued. Governmental accounting standards require states to use procedures that cause them to severely underestimate their liabilities. Moving toward a defined contribution, 401(k)-type plan structure aligns the incentives in such a way that provides a more sustainable path for states.

- *Underestimating obligations.* Market valuations of total unfunded pension obligations held by states have been estimated to be approximately $3.41 trillion, much larger than the state-reported total of $1.19 trillion.[5] This discrepancy is largely caused by the requirement for states to value their pensions based on the expected return of plan funds. It conflates the promised pension payments to beneficiaries with the much less certain performance of investment portfolios. Doing so directs public attention away from the growth in promised benefits and toward the expected performance of state plans. Such diversion of public attention often allows policymakers to reduce the size of payments into their pension system or to defer pension payments altogether.[6]

- *Unrealistic discount rates.* The different predictions about how pension plans will perform depend upon the discount rate of the retirement plan, or the rate of return that fund managers assume investments will earn over their lifetimes. For example, for FY 2014 Kentucky reports a total unfunded pension liability of $29 billion in its four plans,[7] based on an assumed rate of return ranging from 6.5 percent to 7.75 percent, depending on the plan. Using the risk-free discount rate that economists recommend[8] brings Kentucky's unfunded pension liability to $78.3 billion.[9] Using a higher discount rate is the more politically feasible option because it makes it appear as though the total liability owed is smaller and allows policymakers to make smaller pension contributions in the short term as a result. Additionally, defined benefit plans encourage more risky investment strategies in an attempt to meet their unrealistically high discount rate assumptions.[10]

- *Relying on funding ratios is misleading.* Many policymakers use a pension plan's funding ratio—the amount of assets on hand relative to the plan's liabilities—to determine the plan's ability to pay off promised benefits to plan beneficiaries. Recent research cautions against relying on this statistic because even a fully funded defined benefit plan may not be able to meet obligations.[11]

- When taking the uncertainty of market fluctuations into consideration, a "fully funded" defined benefit plan actually only represents a roughly 50 percent chance of being able to deliver on promised benefits.[12]

ADVANTAGES OF DEFINED CONTRIBUTION PLANS

A key advantage of defined contribution plans is that they eliminate the potential for policymakers to underfund long-term liabilities. Defined contribution plans are based on employer and employee contributions to a retirement savings account. After being subject to market risk, the employee receives earnings on those contributions. This structure permits individuals to maintain control over their retirement assets, makes policymakers more accountable for their decisions, and reduces taxpayer uncertainty.

- *Better incentives.* The valuation of defined benefit plans encourages policymakers to assume overly optimistic market returns in order to make liabilities appear smaller. By assuming a high rate of return on pension fund contributions, policymakers are able to make smaller contributions. By making smaller contributions to fund long-term liabilities, elected officials free up tax dollars that can instead by spent on current-year priorities. The simplicity of defined contribution plans eliminates the potential for policymakers to underfund long-term obligations because the level of benefits depends solely on total contributions and investment earnings. These improved incentives are also shown to improve the fiscal sustainability of plans.[13]

- *More flexibility.* Defined contribution plans allow for more flexibility and portability of benefits, often resulting in higher worker satisfaction.[14] This stands in stark contrast to defined benefit plans, where workers who leave before their benefits vest receive smaller pension benefits than workers who stay with the same employer until retirement.

- States like Utah and Michigan have made the switch and ended their defined benefit plans for new hires and created new defined-contribution-style retirement plan options. There is evidence that the switch saved Michigan a total of $167 million in pension costs and lowered unfunded liabilities by at least $2.3 billion.[15] Although there is still a chance for Utah to become insolvent in the next few decades, research finds that the state's 2010 reform has substantially decreased this likelihood.[16]

A SOLUTION FOR FUNDING LEGACY OBLIGATIONS

The transition to a defined contribution plan for new hires has only been successful in a few states, but reforms affecting current employees' benefits have been even more rare. In some states these benefits are constitutionally protected, and in that case policymakers may face few options for reform. In fact, for some states with the most stringent protections, such as Illinois, courts have found any cuts to workers' benefits to be illegal. As pension liabilities have crowded out other budget priorities, policymakers have employed "tinkering reforms" that reduce obligations.

- Reducing cost of living adjustments (COLAs), increasing employee contributions, and increasing the retirement age are a few examples of reforms that can modify pension benefits and reduce costs.[17]

- Often these changes apply to new hires, not to existing employees or those already in retirement. One such example took place in Virginia in 2010 where policymakers increased the retirement age and revised the COLA formula, both only applying to new hires.[18]

- Rhode Island's 2011 pension reform bill suspended COLAs for retirees, increased contributions for current workers, and increased the retirement age. It was a rare occurrence of benefit changes that affected current workers and retirees.[19]

Pension benefit tinkering may seem like an attractive solution for policymakers, but in addition to the legal challenges to applying them to current workers, they also usually only provide short-term relief. An alternative reform outlined by economist Mark Warshawsky would give plan participants the option to walk away with a portion of their accrued benefits as a one-time cash payment.[20] This solution, also known as a pension buyout, would serve as a long-term solution to reduce pension liabilities.

- The proposal would allow, but not require, government plan sponsors to offer plan participants a lump sum early rather than have them wait until they retire to receive benefits. This would give plan participants and retirees the choice to either keep their uncertain, poorly funded plan benefits or get a lump-sum benefit that represents a realistic valuation of what the plan can pay.

- When it becomes clear that many state and local governments cannot pay off their massive underfunded pension obligations—even with increased taxes—these retirees and older workers may be willing to accept a lump-sum payment that represents a significant, but not necessarily full, share of the actuarial value of their promised benefits.

- As unfunded pension liabilities push public plans toward insolvency, more benefits are likely to be reduced or cut. Plan participants who are growing concerned about not receiving their pension payments at retirement might prefer a more certain lump-sum payment sooner.

- In an attempt to predict how plan participants would react to this reform, researchers have looked at other public programs where lump-sum payments have been offered.[21] They find that the number of workers who take a lump-sum payment in exchange for forgoing a future stream of retirement payments could be quite high.

THE PATH TO REFORM

One of the strongest arguments against moving away from the current popular defined benefit structure for public plans is that the move from a defined benefit to a defined contribution plan would involve large transition costs. Recent Mercatus research finds that transition costs are actually quite small.

- Transitioning from defined benefit pensions to defined cost, cash balance, or hybrid plans would not create significant new costs for the public. Mercatus research finds that transition costs are more than offset by the reduction of newly accrued liabilities.[22] The argument that transition costs are prohibitive is based on a misunderstanding of public plan accounting and investment practices.

- When transitioning to new plans, economists suggest that policymakers move toward significantly more conservative investment strategies.[23] For example, in order for the Pennsylvania State Retirement System to fully fund future benefits, an optimal portfolio would consist of roughly 15 percent equities and 85 percent bonds. By contrast, the current portfolio includes roughly 15 percent bonds and 6 percent cash equivalents. The remainder of the portfolio is held in equities and other risky assets such as private equity and real estate.

- As pension liabilities grow in size and plans become more insolvent at the state and national levels, the political environment will likely become more conducive to sustainable, structural pension reform.[24]

LINKS

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3. https://www.mercatus.org/publication/crisis-state-and-local-pensions

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7. https://www.mercatus.org/system/files/Norcross_2016_KY.pdf

8. https://www.mercatus.org/publication/crisis-public-sector-pension-plans. The risk-free rate on June 30, 2014, was 3.21 percent.

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