

NASRA Response to Reason Foundation Study, “The Gathering Pension Storm”

ABSTRACT

The Reason Foundation recommends terminating defined benefit plans for public employees because, Reason contends, it is inherent in DB plans that policymakers, operating solely in their own political interest, will approve higher pension benefits for their own selfish, short-term political gain while deferring the cost of those benefits to future generations. NASRA believes the Reason study makes its case by 1) distorting the true financial condition of public pensions in general; 2) mistakenly extrapolating a handful of public pension problems onto the entire public pension community; 3) failing to consider the many negative consequences that would result from terminating DB plans; and 4) advancing arguments that reflect an incomplete understanding of public pension issues. Rather than terminating DB plans (which would have negative consequences for all stakeholders), solutions are available to the public pension problems Reason cites, chiefly by working through normal political processes at the state level.



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Introduction

In June 2005, the Reason Foundation published a study titled “The Gathering Pension Storm: How Government Pension Plans Are Breaking the Bank and Strategies for Reform.” The study is critical of defined benefit (DB) plans for employees of state and local government and calls for the replacement of DB plans with 401k-style defined contribution (DC) plans.

A resolution approved in 2003 by the National Association of State Retirement Administrators (NASRA) states that NASRA “supports ... a defined benefit program to provide a guaranteed benefit and a voluntary defined contribution plan to serve as a means for employees to supplement their retirement savings ... and NASRA supports progressive changes within this prevailing system of retirement benefits in the public sector, either within the defined benefit plan or through supplementary plans, that accommodate a changing workforce and better provide many of the features advanced by defined contribution advocates.”¹

Flexibility of design is a central feature of DB plans. A DB plan can be designed to achieve myriad stakeholder objectives, while retaining core DB plan features—a benefit that cannot be outlived, investment risk that is borne entirely or partly by the employer, and a benefit that reflects the employee’s salary and length of service. Working within existing legislative and political processes, this flexibility can be incorporated into the design and governance structure of any public pension plan to achieve desired objectives of all relevant stakeholders: public employers, employees, and recipients of public services and other taxpayers. Indeed, design features already in place in public pensions around the U.S. demonstrate this flexibility, providing ample illustration that DB plans can attain objectives advanced by advocates of DC plans, while continuing to advance the overarching public policy objective of promoting the nation’s retirement security.

¹ National Association of State Retirement Administrators, “NASRA Standing Resolutions No. 2003-08.”

Summary of Reason's Argument

Reason's overarching complaint regarding DB plans for public employees is that they are a "moral hazard." According to Wikipedia:

In law and economics, moral hazard is the name given to the risk that one party to a contract can change their behavior to the detriment of the other party once the contract has been concluded.²

For public pensions, according to Reason, this moral hazard allows lawmakers to grant higher pensions for current workers while deferring the cost of those enhanced benefits to future generations of taxpayers.

Reason insists that state legislators and other policymakers cannot be trusted to make decisions regarding pension benefits, because elected officials will operate in their own selfish political interest while ignoring the long-term effects of their decisions. Reason bases this view chiefly on two criteria: 1) the purported poor financial condition of public pensions, and 2) several examples of alleged abusive pension practices, including pension spiking, deferred retirement option plans, "air time" purchases, and "public safety" employees' benefits expansion.

The Reason study specifies the following examples (accompanied by its title from the study) of alleged public pension abuses to illustrate what Reason contends is the hazard of public DB plans:

- San Diego: A "Perfect Storm" of Financial Mismanagement
- Illinois: Mired in Pension Debt
- California: The Politics of Increasing Benefits and Managing Portfolios
- West Virginia: Banking on Pension Obligation Bonds
- Los Angeles County: Suffering from Pension Obligation Bonds and "Chief's Disease"
- Detroit: Rising Pension Costs and a Declining Revenue Base

² Wikipedia, www.wikipedia.com

- Orange County, California: Ignoring the Lessons of the 1994 Bankruptcy
- Houston: Lavish Benefits and Bad Assumptions
- Contra Costa County, California: The Costs of Unreasonable Assumptions

NASRA Analysis and Response

The issue of retirement benefits for employees of state and local government is no small matter: state and local governments in the U.S. employ 16 million workers—more than 10 percent of the nation’s workforce.³ These employees perform a broad range of essential public services, such as teaching at and supporting public schools and universities, policing streets, fighting fires, guarding prisons and jails, and protecting public health. At the end of September 2005, state and local retirement funds held assets of \$2.66 trillion,⁴ and they distribute more than \$130 billion annually to over six million retired public workers and beneficiaries.⁵

If Reason’s chief recommendation—to supplant DB plans with DC plans—were implemented, NASRA believes the ability of public employers to attract and retain qualified workers would be impaired, as would the retirement security of millions of state and local government employees.

NASRA believes the arguments Reason presents in favor of terminating DB plans are flawed in at least four ways:

1. Reason distorts the true financial condition of public pensions in general and the ramifications of pension plan “underfunding.”
2. Reason mistakenly extrapolates a handful of public pension problems onto the entire public pension community.

³ U.S. Bureau of Labor Statistics, “The Employment Situation,” December 2005

⁴ U.S. Federal Reserve Board, “Flow of Funds,” Third Quarter 2005

⁵ U.S. Census Bureau, “2004 State and Local Government Employee Retirement Systems.”

3. Reason fails to consider the many negative consequences that would result from terminating DB plans.
4. Reason advances arguments that reflect an incomplete understanding of public pension issues.

As elected officials operating within the framework of the U.S. and state constitutions, federal regulations, and case law, state policymakers are entrusted with responsibility for drafting and approving laws to establish, govern, and administer pension benefits for employees of state and local government. Reason's belief that elected officials cannot be trusted to make decisions regarding public pension benefits is an indictment of our nation's entire governance structure, one that is based on representative democracy. If, as Reason alleges, our own elected officials are so beholden to narrow special interests that they cannot be trusted to make decisions for the greater good, then our system of government is imperiled.

State legislators and governors are elected to make decisions that have long-term consequences. Such decisions include those regarding development of roads and highways, establishment of educational institutions, taxation and spending, the purchase and sale of real property, protection of natural resources, hiring public employees, and others.

The nation's founders provided processes, within the legal and political framework, to correct problems such as some of those in the public pension community identified by Reason; and for use when citizens believe their elected officials are not making prudent decisions. These processes include:

- amending state constitutions and laws affecting retirement benefits and governance;
- elections, to vote out elected officials perceived to be making decisions not in the public interest, and to vote in others; and, in some states,

- initiative and referendum, whereby citizens and lawmakers can change state constitutions and laws.

One desirable attribute of a pension benefit is that its cost, as much as possible, should be paid by the current generation of taxpayers, a concept known as “intergenerational equity.” Acknowledging Reason’s concern regarding the potential conflict between the long-term nature of pension liabilities and the shorter time horizon of elected officials, Michael Peskin argues that pension costs can be made transparent and borne by the current generation of taxpayers:

The solution to this political imbalance is to adopt a rigorous and disciplined framework within which to calculate liabilities and assets, and to establish policies. Such a framework must make the price of options and transfer of costs or risks to future generations transparent. It thus includes a comprehensive stochastic model of the plan going forward many years with explicit modeling of investment, funding and benefit policies. The core economic cost is the present value of contributions to fund the appropriate level of benefits. It is possible to reduce the present value of contributions with appropriate investment and funding policy and tightening of benefit policy to avoid the provision of expensive options.⁶

An arrangement such as one described by Peskin exists in the State of Georgia, whose constitution requires that public retirement plans remain actuarially sound:

It shall be the duty of the General Assembly to enact legislation to define funding standards which will assure the actuarial soundness of any retirement or pension system supported wholly or partially from public funds and to control legislative procedures so that no bill or resolution creating or amending any such retirement or pension system shall be passed by the General Assembly without concurrent provisions for funding in accordance with the defined funding standards.⁷

Pursuant to this clause, Georgia statute requires that:

⁶ Michael Peskin, “Asset/Liability Management in the Public Sector.” In *Pensions in the Public Sector*, (1999) ed. Mitchell and Husted, Pension Research Council, Philadelphia, University of Pennsylvania Press

⁷ Georgia State Constitution, Article III, §X, Paragraph V

- Pension legislation with a fiscal effect may be introduced only in the regular session of the first year of the term of office in the General Assembly, and passed only during the regular legislative session of the second year of the term of office of General Assembly members.⁸
- Retirement legislation with a fiscal effect may not leave its committee or be considered by the House or Senate unless its actuarial cost has been determined.⁹
- First-year funding for retirement bills with a fiscal effect must be appropriated in that year, or the bill becomes null and void.¹⁰
- The state must maintain minimum funding standards for its pension plans and each year must contribute the pension plan’s normal cost plus the amount needed to amortize the unfunded liability.¹¹

The Employees Retirement System and Teachers’ Retirement System of Georgia are among the best-funded public pension plans in the nation, with costs and benefits near the national median.¹²

I. Reason Distorts the Financial Health of Public Pension Plans

The Reason study points to public pension funds’ combined unfunded liabilities—currently around \$340 billion—as evidence of an “ominous storm cloud” of public pension costs. Yet Reason never places this figure into context. As another form of government debt, the absolute dollar value of an unfunded liability, by itself, does not reveal much. To have real meaning, an unfunded liability must be compared with the resources—current and future—available to retire the obligations. These resources usually take the form of assets and future revenue streams of state and local governments that sponsor pension benefits.

⁸ Unannotated Georgia Code, §47-20-34

⁹ *ibid.*

¹⁰ *ibid.*, §47-20-50

¹¹ *ibid.*, §47-20-10

¹² Public Fund Survey, www.publicfundsurvey.org, National Association of State Retirement Administrators and National Council on Teacher Retirement

Based on these measures, as a group, public pension funds are in reasonably good condition:

- According to the most recent available information, public pension plans in the U.S. have combined actuarial assets of approximately \$2.48 trillion and actuarial liabilities of \$2.82 trillion, for an aggregate funding level of around 88 percent. Although this funding level is lower than it was several years ago, it is higher than it was for most of the last 25 years of the 20th century.¹³
- 70 percent of public pension plans are funded at 80 percent or higher.¹⁴

Funding a pension benefit takes place over a long period of time, and by itself, an unfunded liability is not necessarily a sign of fiscal distress: Not every public employee will retire tomorrow or next year, and pension liabilities usually extend years into the future. This extended time frame gives pension plans time to amortize their unfunded liabilities, through a combination of investment earnings and employer and employee contributions.

In “The Gathering Pension Storm,” Reason refers to sharply rising costs of pension plans. But as shown in Figure A, state and local governments spent approximately the same in FY 04 (the latest year for which data is available) on public pensions than they spent in the mid-1990’s, measured both as a percentage of employee payroll and as a percentage of total state and local government spending.

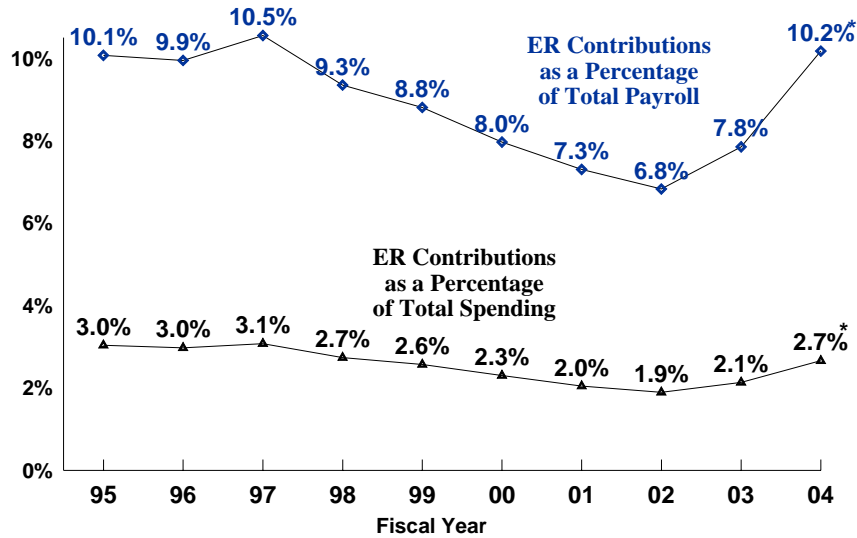
Pension costs for some employers have risen sharply in recent years. In many cases, a root cause of these sharply rising contribution rates is the plan’s design, and can be remedied with one or more design changes. But the idea that state and local

¹³Public Fund Survey, www.publicfundsurvey.org, National Association of State Retirement Administrators and National Council on Teacher Retirement

¹⁴“Summary of Findings for FY 04,” Public Fund Survey, NASRA and NCTR

government pension costs for the entire nation are spiraling out of control is not accurate.

Figure A. State and local government contributions to public pension plans, as a percentage of payroll and total spending.



*FY 04 figures include approximately \$8 billion in pension bonds; without which these figures would be 9.0% and 2.4%, respectively.

Source: US Census Bureau

Although the majority of public pensions are in fairly good financial condition, some plans do face serious unfunded liabilities that will require corrective action. Unfortunately, by painting the entire public pension community as awash in crippling unfunded liabilities that are the product of self-serving legislators, Reason ignores the reality of the current public pension funding picture. In so doing, Reason’s recommendation to terminate DB plans for public employees is based on a distorted picture of the public pension funding situation.

Of those public pension plans that face serious funding problems, most result from legislative failure over extended periods to remit required contributions. States that chronically failed to remit required contributions enjoyed the savings that were generated by diverting pension contributions to other priorities. Contribution rates in some states declined in recent years to unprecedented levels, including as low as

zero. Combined with the decline in equity values, very low or nonexistent contribution rates contributed to the decline. It would be disingenuous to call for the elimination of DB plans because they are expensive, in cases when a major factor contributing to their cost is the diversion of contributions over a period of years, or sharp reductions in contributions due to favorable investment gains.

II. Reason mistakenly extrapolates a handful of public pension problems onto the entire public pension community

The Reason study purports to illustrate the flaws inherent in DB plans, in part on the basis of nine examples of alleged abuse or excess. According to the U.S. Census Bureau, there are more than 2,000 public pension plans in the U.S., that provide pension and other benefits for more than 14 million active and 6 million retired public employees. Any community this large is likely to have its share of abuse and excess, and Reason's use of nine examples (of which five are in one state) to demonstrate the fundamentally flawed nature of DB plans, seems to lack proportionality. Every state sponsors at least one statewide retirement system; most states sponsor two or more. Hundreds of cities and towns and counties sponsor public retirement systems.

Reason does not mention the hundreds of public pension plans that are working well on behalf of millions of working and retired public employees, public employers, and recipients of public services and other taxpayers. The highly diffuse and diverse regulatory structure overseeing the public pension community creates an environment in which states and cities can experiment with, design and maintain cost-effective pension plans that meet the multiple objectives of public employers. For every case of public pension abuse and excess cited by Reason, there are many more cases of pension plans assisting, in a cost-effective and responsible way, public employers in providing essential public services. In cases of actual pension abuse and excess, the answer is not to get rid of the plan, but to change the plan's governance structure and benefit design. If necessary, this can be achieved through changes to the constitution, statutes, and elected officials.

Reason makes sweeping conclusions about the entire public pension community on the basis of a rather small subset of that community, a subset that is quite limited geographically and politically.

III. Reason Ignores Many Likely Effects of Its Recommendation to Terminate DB Plans

Like other employers, public employers must compete in the labor market for a limited pool of talent, and a DB plan has long been a central component of the compensation package for most public employees. Removing the DB plan from public workers' compensation would have consequences for all stakeholders: employers, employees, and taxpayers. Yet Reason pays little heed to these consequences, making its recommendations in a vacuum, as if switching from one plan type to another would be seamless and without consequence. In fact, switching plan types would involve costs and have consequences.

A majority of public sector positions are best served when those who occupy them are career-oriented or at least remain in them for ten years or longer. Two-thirds of public employees are classified by the U.S. Census Bureau as judicial, firefighters, police officers and support, corrections, or educational.¹⁵ The taxpaying public is well-served when individuals remain in these positions for an extended period—long enough to enable the employer and taxpayers to realize the investment made to train the employee and to serve the public through their knowledge and experience. Moreover, taxpayers are well-served when public sector positions are filled with skilled and qualified personnel, rather than inexperienced workers who are learning on the job. Retention of qualified workers is a primary reason that public sector employers continue to offer a DB plan—it creates an incentive for career-oriented workers to remain in their position.

¹⁵ U.S. Census Bureau, *2004 Public Employment Data, State and Local Governments*

Unfortunately, Reason's study does not acknowledge the role DB plans play in attracting and retaining public employees; nor does the study consider the effects on public employers of implementing Reason's main recommendation: the replacement of DB plans with DC plans.

Reason also does not contemplate the effects on public employers—school districts, police departments, fire departments, etc.—of losing what may be the strongest incentive for public workers to stay on the job. In the absence of a DB plan, public employers will be required to make adjustments in their compensation package. Such adjustments might include improved working conditions, better benefits, or higher pay. It is unrealistic to think that the behavior of current and future public employees will not change in the wake of a change to their compensation package. All else held equal, if the DB plan is taken away, other compensation costs would need to rise.

The Reason study does not acknowledge the improved financial security enjoyed by millions of working and retired public employees from having a DB plan. Studies have documented the crisis the nation faces as millions of workers approach retirement with savings far short of required levels. Many Americans face the real prospect of outliving their retirement assets. Some indigent elderly will turn to the state, as the provider of last resort, to meet their basic needs. Yet the Reason study is silent on this scenario, which is a real possibility were Reason's recommendation to be implemented.

A 2004 Pension Research Council paper identified the economic effects of public pension funds. These effects include the investment of pension fund assets in venture capital projects; the added liquidity and stability added by public pension assets to financial markets; and the stimulus provided to the nation's economy as a result of the additional assets produced by higher investment returns generated by public

pension funds.¹⁶ If public DB plans were terminated, the economic stimulus they provide to every city and town in the nation would diminish, slowly but surely, as the effects of higher investment returns from professionally-invested DB assets fades away. A generation of public employees relying on self-directed retirement accounts would result in fewer assets available for retirement and declining salutary effect on local economies.

In an analysis of public employers exploring switching to DC plans, bond rating agency Standard & Poor's recognized the potential risks of closing off DB plans in favor of DC plans:

The decision on pension plan design for a governmental entity should include a very long-term view of the welfare of employees: They must be given the tools to build sufficient resources to live during retirement, including the combined resources of pensions, Social Security (if applicable), and personal savings. If this strategy fails to meet expectations, the result could be that government retirees will require some form of public assistance at a point in the future. These unanticipated increased employer costs to make up for below-average retiree wealth could offset, partially or totally, the earlier direct benefits from lower, more predictable contribution rates gained through a DC conversion.¹⁷

S&P concluded its analysis by warning that converting to a DC plan is no silver bullet for challenges facing state and local governments:

From a credit perspective, a DC conversion plan cannot be automatically considered a positive factor in that the effects must be weighed over a very long time period. The benefits of a conversion to a government's cost structure in the early years could be undone in the later years if retiree income expectations are not realized and unexpected costs show up elsewhere. While the private sector has had some success with the DC model, the historical experience in the public sector is really too new to prove that it will be effective. When employers are considering the DC option, overall public policies concerning the well being of employee citizens and fiscal

¹⁶ Anderson and Brainard, "Profitable Prudence: The Case for Public Employer DB Plans," In *Reinventing the Retirement Paradigm*, (2005) Pension Research Council, Philadelphia, Oxford University Press

¹⁷ Parry Young, Standard & Poor's, "Public Employers Are Considering a Switch to Defined Contribution Pension Plans," November 2005

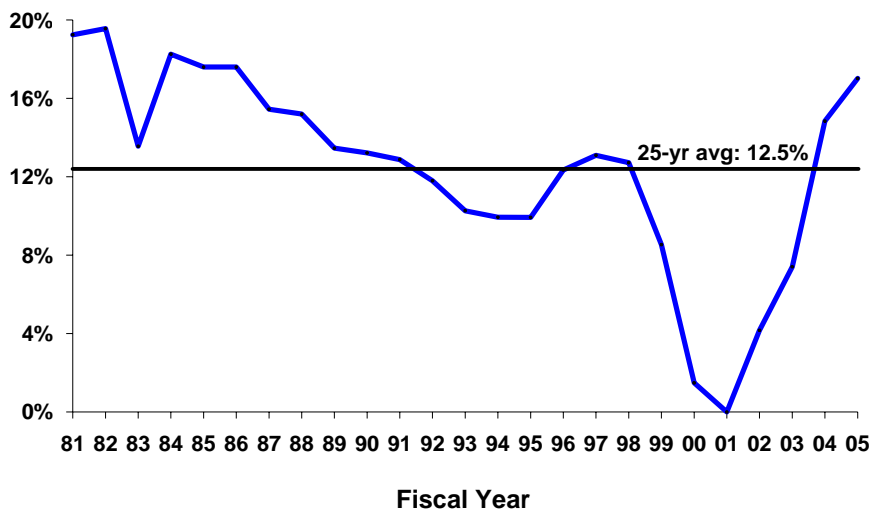
policies must be integrated into a monolithic policy for long-term retirement income stability.¹⁸

IV. Reason advances arguments that reflect an incomplete understanding of public pension issues

Many arguments advanced in the Reason study indicate an incomplete understanding of public DB plans. Following are some statements made by Reason in its study, followed by a NASRA clarification or correction.

Reason on employer contributions to public pension plans: “Ballooning pension obligations necessarily draw resources away from other quality-of-life priorities like transportation, education, and public safety. In California, for instance, the state’s obligations to its government-employee pension system have skyrocketed from \$160 million to \$2.6 billion annually just since 2000.”

Figure B. Employer contribution rate for California state employees, Tier I



Source: CalPERS

NASRA: Reason’s reference to “ballooning” pension obligations is based on a highly selective use of statistics which does more to confuse than clarify the issue of

¹⁸ Parry Young, Standard & Poor’s, “Public Employers Are Considering a Switch to Defined Contribution Pension Plans,” November 2005

employer contributions. Figure B (above) depicts a longer and more comprehensive data set of the employer contribution rate for the largest group of California state employees. This rate is representative of employer contribution rates for other large groups of CalPERS participants.

As the chart shows, due chiefly to robust investment earnings, the contribution rate fell sharply in fiscal year 1999, remaining well below historic averages through fiscal year 2003, when the effects of the decline in equity markets and the cost of recent benefit improvements were more fully recognized actuarially. Yet to make its argument that pension obligations are “ballooning,” Reason pointed only to the low and what is likely to be the high points of California state contributions to CalPERS. Reason excluded other information that would have presented the issue in a more complete and accurate context.

Presenting this issue in a fuller and more fair context would have mentioned the savings enjoyed by plan sponsors--the state and many of its political subdivisions—when contribution rates were low. Unfortunately, to make its point that benefit obligations are “ballooning,” the Reason study focuses exclusively on two narrowly-captured data points, while ignoring other relevant data.

A defining attribute of DB plans is that their design can be modified to reach any of multiple objectives. To reduce volatility in its contribution rates, the CalPERS Board of Administration in 2005 changed its method for calculating the actuarial value of assets, by:

- increasing the period over which investment gains and losses are recognized (a recommendation made by Reason in its study) and,
- widening the permissible corridor of the actuarial value of assets to market value of assets.

Criticism of CalPERS contribution rates should be tempered by the fact that for several years, California taxpayers contributed relatively little, on a historic basis, to

the pension plan for state employees and for many employees of local governments in the states. The reforms implemented by CalPERS are intended to smooth future year-to-year changes in the contribution rate.

Other changes public pensions have effected in recent years to moderate contribution rates include:

- Modifying the plan design to reduce pension “spiking,” which occurs when an employee’s salary rises sharply in the period immediately preceding retirement, resulting in a higher pension benefit? Several states in recent years have implemented anti-spiking provisions.
- Establishing a minimum contribution rate. This prevents contribution rates from declining to extremely low levels, including zero, which occurred at a number of plans around the nation in the wake of investment market gains during the late 1990’s.
- Placing a limit on the annual increase in contribution rates, such as to one percent, a policy in effect for pension plans in Iowa and Kansas.
- Establishing floating amortization periods. This moderates the funding level by extending the amortization period during times of underfunding and shortening it as the funding situation improves.
- Linking cost-of-living adjustments to investment returns. Establishing a relationship between COLA’s and investment earnings allows all participants—employers, actives, and annuitants—to benefit when investment returns exceed assumptions and to bear some of the burden of lower-than-expected market returns, either through higher contribution rates or by a smaller COLA.

Reason on participant access to retirement funds: “Under defined-benefit plans, employees have limited ability to access their money if they terminate employment before the regular retirement age. Also, benefits cannot be “rolled over” if the employee switches jobs, and usually cease upon the retiree’s death.”

NASRA: Reason is correct in saying that DB plans restrict employees' access to their retirement savings. The purpose for providing a retirement plan is not to serve as a source of ready cash, but to save money for retirement. A retirement plan that allows participants to spend retirement savings before retirement is falling short of its purpose, and Reason's criticism of DB plans in this way seems bizarre.

One of the chief shortcomings of DC plans is the amount of assets that leave the system prior to retirement. Studies consistently show that many DC participants borrow against their retirement savings; or "cash out" when switching jobs, leaving the employee financially unprepared for retirement. Although Reason cites the limited access employees have to their retirement savings as a problem, NASRA believes this restriction is actually one of many advantages DB plans have over DC plans.

Reason on the ability of public workers to "roll over" their retirement funds:
“(DB plan) benefits cannot be “rolled over” if the employee switches jobs, and usually cease upon the retiree’s death.”

NASRA: Reason's statement about the ability to roll over DB plan benefits, is simply incorrect. Most public DB plan participants are required to contribute to their pension benefit, and terminating employees are entitled to their contributions, usually with interest. Some public plans also allow entitle participants to some or all employer contributions made on the worker's behalf.

Moreover, many public DB plans allow workers to purchase service accrued with another public employer and to transfer their assets and service credit from other plans. Those states and cities that do not allow service purchase may do so if they wish; contrary to Reason's assertion, there is nothing systemic in a DB plan that prevents DB plan sponsors from allowing the purchase or transfer of service accrued at another plan.

Reason's contention that benefits usually cease upon the retiree's death is at best misleading and in the case of most plans, simply wrong. Public pension plans allow retirees to designate a beneficiary, such as a spouse, who continues to receive a benefit, should they be preceded in death by the retiree. In fact, it is not uncommon among public pension plans to require married pension participants to secure the written consent of their spouse to request an annuity benefit that does not include a benefit for the surviving spouse.

Reason on the cause of the recent decline in public pension funding levels:

"(T)he central causes of the (pension) crisis are poor planning and decisionmaking. At the heart of the pension crisis is a set of incentives which create a "moral hazard."

NASRA: What "poor planning and decisionmaking" represent to Reason is not clear, but it may be safe to infer that Reason is saying is that benefit enhancements approved by self-serving legislators are the primary cause of the decline in pension funding levels after they reached their peak in 2000.

An analysis by consultant Gabriel, Roeder, Smith¹⁹ strongly suggested that the chief cause of the decline in public pension funding levels after 2000 was the decline in equity values. The combined value of state and local government pension funds declined from 12/31/00 to 12/31/02 by more than \$360 billion, or nearly 16 percent.²⁰ Although benefit enhancements for public employees were approved during the past decade, there is no evidence that these enhancements are the primary factor contributing to these declines. (Public pension fund values rose to \$2.66 trillion in September 2005, an increase of nearly 38 percent above their low point at the end of 2000.)²¹

¹⁹ Paul Zorn and Norm Jones, Gabriel, Roeder, Smith and Co., "Questions About the Future of Public Pension Plans: Short-term Problems or Structural Failures?," in *Public Sector Pensions: Current Challenges and Future Directions*, Harvard Law School, October 2005, [http://www.law.harvard.edu/programs/lwp/Zorn-Jones%20\(POWER%20POINT\).pdf](http://www.law.harvard.edu/programs/lwp/Zorn-Jones%20(POWER%20POINT).pdf)

²⁰ U.S. Federal Reserve Board, "Flow of Funds," Third Quarter 2005

²¹ *ibid.*

In addition, benefit enhancements for many public employees often are approved in lieu of salary increases. Had salary increases been approved instead of pension benefit enhancements, pension funding levels might have been marginally higher, but current salary obligations for public employers would be greater, possibly leaving public employers worse off than they otherwise would have been.

Reason on compensation levels in the public and private sectors: “Supporters of pension benefit increases routinely argue that they are needed to attract a high-quality workforce that is paid less than their private-sector counterparts.

Unfortunately, this claim is simply not true. According to the Bureau of Labor Statistics, the average wage for state and local government employees is \$23.52 per hour, compared with \$16.71 per hour for private-sector employees. When benefits (including pensions) are included in the calculation, state and local government employee compensation jumps to \$34.13, compared to total private-sector compensation of \$23.41. In other words, even when private employees’ benefits are included, they still make less than the *raw wage* of state and local government employees.”

NASRA: Some public sector workers earn salaries that are higher than their private sector counterparts; many earn salaries that are lower. Broad comparisons of private and public sector salaries and benefits often overlook the fact that most public employees work in professional positions that require higher levels of education or physical risk than those in the private sector workforce. For example, more than one-half of all state and local government employees work in education. These are school teachers and administrators, librarians, college professors and higher education staff. Many other public employees work as firefighters, police officers, and correctional officers, whose responsibilities entail significant physical risk and have few comparable positions in the private sector.

When possible, most positions in the public sector—education and public safety in particular—should be filled with career-oriented workers. It makes good public

policy to encourage professionals such as these to remain in their positions long enough not only to realize a return on the investment public employers have made in their training, but also to enjoy the benefits of their experience and qualifications. Allowing qualified public employees to leave their position due to compensation shortfalls is disruptive to the orderly and effective delivery of public services and results in added costs to train new workers.

Finally, the BLS study cited by Reason does not acknowledge that most public employees are required to contribute to their pension benefit; the median contribution rate for Social Security-eligible public employees is five percent. State and local government employee contributions account for approximately 12 percent of all public pension revenue.

Reason on the effects of changing corporate pension policy: “The enactment of ERISA and the 1978 Revenue Act would prove to be a pivotal change in pension history. Since their passage, the private sector has seen a steady trend toward “401(k)” and similar “defined contribution” plans ... and away from defined-benefit plans. Now even government pension systems are re-evaluating defined-benefit plans in favor of defined contribution plans.”

NASRA: Despite good intentions to strengthen corporate DB plans, the passage by Congress of ERISA in 1974 and subsequent changes to the tax code, has contributed to the steady decline in the percentage of American workers with a DB plan. Many of these DB plans have been abandoned in lieu of DC plans. Unfortunately, as workers’ reliance has shifted from DB to DC plans, the nation’s overall retirement security has declined.

Yet advocates of supplanting DB plans with DC (like Reason) justify their view partly on the basis that relatively few DB plans remain in the private sector.

Although many corporate DB plans have been frozen or terminated, a majority of the Fortune 1000 continue to provide a DB plan to their workers.²²

More importantly, the relevant issue is not whether the public sector should abandon DB plans because many in the private sector have done so, but rather, whether it is prudent for state and local governments to pursue a policy that is known to diminish the retirement security of its employees and the nation as a whole. A DC plan, by itself, is a poor vehicle for delivering retirement assets and promoting retirement security. In fact, the primary DC plan type in the U.S., the 401(k) plan, was created not as a retirement savings tool, but as a tax shelter that was subsequently adopted by private sector employers (and a few in the public sector).²³ The mere fact that many employers in the private sector have embraced a DC plan does not mean that switching public sector workers to a DC plan is a good idea.

Reason's statement that, "even government pension systems are re-evaluating defined benefit plans in favor of defined contribution plans," paints a distorted picture of reality. Although some states have given some groups of public employees the opportunity to choose a DC plan, and two states (Alaska and Michigan) limit retirement coverage to large groups of their public workers to DC plans, far more legislative activity in recent years has surrounded modifications to existing DB plans, rather than incorporating DC plans.

Indeed, states and other sponsors of public pension plans are taking advantage constantly of the remarkable flexibility offered by DB plans to achieve key employer objectives.²⁴ This flexibility takes the form of hybrid pension plans, service purchase options, increased portability features, return-to-work provisions, and others. Despite extensive consideration given to which type of retirement plan they should use, most public employers have recognized that they are better off continuing to work within

²² "Recent Funding and Sponsorship Trends Among the Fortune 1000," *Insider*, by Watson Wyatt, June 2005

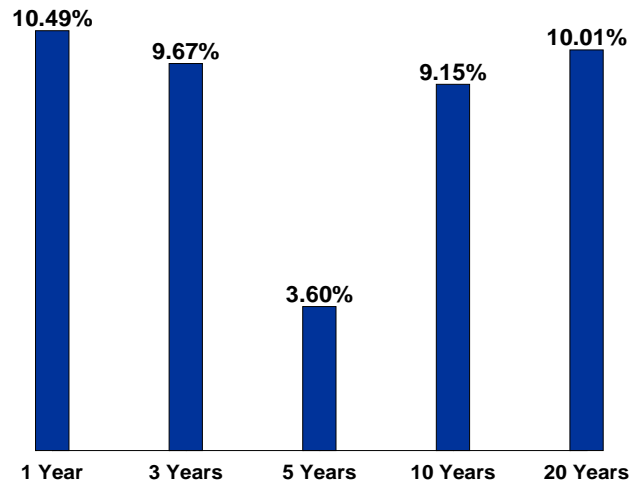
²³ Employee Benefits Research Institute, "History of 401(k) Plans: An Update," February 2005

²⁴ National Conference on State Legislatures, "Pensions and Retirement Plan Enactments in 2005 State Legislatures," and preceding years, <http://www.ncsl.org/programs/fiscal/pensun05.htm>

the prevailing framework of DB plans than to switch to a retirement benefit structure that is unreliable in terms of delivering retirement benefits and retaining qualified workers.

Reason on investment return assumptions: “Pension systems have become underfunded, in part, because investment returns are not meeting expectations and thus contributions are not covering costs. Moreover, over-optimistic expectations are not confined to just a few state and local governments. According to the *Public Fund Survey*, a survey of government pension plans conducted by the National Association of State Retired Administrators and the National Council on Teacher Retirement, the median investment return assumption for fiscal year 2003 was 8 percent. Unfortunately, nationwide, the median government pension has only grown an average of 4.1 percent over the past five years.”

Figure C. Median Public Pension Investment Returns for Periods Ended 6/30/05



Source: Callan Associates

NASRA: Reason’s use of a five-year period, to the exclusion of other data, is selective and exclusive and borders on the disingenuous. According to investment consultant Callan Associates, as shown in Figure C, for the 10-year period ended June 30, 2005, the median public pension fund investment return was 9.15 percent,²⁵ well above the public pension community’s standard investment return assumption of 8.0 percent.

For the 20-year period ended June 30, 2005, the median public fund return was 10.01 percent.²⁶ Pension plans are long-term operations, and investment returns over longer time periods, like 10 and 20 years, are more representative of public funds’ actual results than the single 5-year period cited by Reason (which happens to incorporate the first time stocks have declined 3 consecutive years since the Great Depression).

Reason on pension obligation bonds: “The idea of issuing one debt to pay another, particularly when issuing bonds to pay an annual operating expense, is poor fiscal policy. Pension obligation bonds are a short-term solution to a long-term problem—this is effectively the same as a family using a credit card to pay utilities because they don’t have enough money at the end of the month and, in the process, run up credit debt with increasing minimum payments. Not only has the credit bailout not addressed the underlying mismatch in revenues and expenditures, it has also contributed to higher minimum payments (in the case of pension bonds, this is new debt service). At the end of the day, the family that follows this strategy is actually worse off. Elected officials must abandon the idea of pension obligation bonds and learn to make difficult decisions to meet their pension obligations.”

NASRA: Reason’s characterization of pension bonds as issuing one debt to pay another, is misleading and misrepresents the benefit of using pension bonds. An unfunded pension liability is a form of public debt. Issuing pension bonds to reduce or eliminate an unfunded pension liability can be a responsible course of fiscal

²⁵ Callan Associates, “Returns for Periods Ended 6/30/05”

²⁶ *ibid.*

action, as it can enable a pension plan sponsor to take advantage of low borrowing rates to reduce long-term pension liabilities.

Issuing a pension bond is analogous to a homeowner who takes advantage of lower interest rates by refinancing her mortgage. A family that refinances their mortgage with a lower rate of interest is normally better off, not worse. With interest rates in recent years at historic lows, reducing or eliminating an unfunded pension liability through the use of pension bonds may well be a prudent course of action. Reason's characterization of pension bonds as using a credit card to pay utilities falsely represents the way they have been used in most cases. In an analysis of pension bonds, credit rating agency Standard & Poor's said:

While no panacea, POBs (pension obligation bonds) are basically an arbitrage play based on the premise that, as a result of the bond proceeds being invested at an expected yield above the cost of the bonds, net savings will be achieved by the sponsor over the life of the bonds. In other words, after the issuance of the POB, combined debt service plus pension contribution costs will be lower than they would have been without a POB. The success of this formula depends on the realization of a certain investment return, which is in no way guaranteed. Whether a POB succeeds or fails cannot fully be evaluated until the final maturity of the bond, and it is a given that some years will be winners and others losers. The bad years may add short-term fiscal stress to the POB issuer (pension sponsor), which could be significant based on the amount of leverage the POB exerts. With most POBs having been issued over the past 10 years or so, it would be premature to pronounce them an unqualified success (or failure). The best that can be said to date is that POB results have been mixed, with some having met or exceeded expectations while others have come up short based largely on the vicissitudes of market timing."²⁷

Reason on public employee preferences for pension plan types: Referring to Nebraska's shift from a DC plan to a cash balance plan, Reason says: "Tellingly, however, there has not been an exodus from the defined-contribution plan. In fact, approximately 70 percent of the members of the defined-contribution plan chose to remain under that plan when the cash-balance plan went into effect. If the defined-

²⁷ Parry Young, Standard & Poor's, "Managing State Pension Liabilities: A Growing Credit Concern," January 2005

contribution plan was so disastrous, as critics claimed, many more people would have switched out of the plan. Apparently, people value the freedom to make their own retirement investment decisions." Also, referring to choice in the Florida Retirement System, Reason says, "(N)ew employee participation in the defined contribution plan has increased from 8 percent in mid-2003 to 19 percent for the first half of 2004."

NASRA: Just as there was no exodus from Nebraska's DC plan, neither was there an exodus from DB plans in any of the five states Reason does not identify that have extended to some of its workers the opportunity to switch from a DB to a DC plan. Once again, Reason selects its comparative examples carefully, to the exclusion of other relevant examples.

Two common themes have emerged in each state where employees have been given a choice of retirement plans: 1) Most employees do not actually make a choice of retirement plan unless required to do so; and 2) of those who do express a preference, the vast majority elect the DB plan. Contrary to Reason's reasoning, Nebraska's experience of most workers not making a decision does not indicate employee preference to "make their own retirement investment decisions." Rather, this result is consistent with results in other states, which suggest employees—for whatever reason(s)—do not make a decision regarding their retirement benefit.

In Michigan in 1996-97, during a period of rising stock markets, fewer than six percent of state employees elected to switch to the DC plan. Similarly, in Florida in 2001-02, when given a choice, approximately five percent elected to participate in the DC plan. New workers in Ohio, like those in Florida, are permitted to choose their retirement benefit. Since the inception of choice in 2001, around five percent have elected the DC plan. South Carolina and Montana experienced similar results. No empirical evidence exists to support Reason's contention that a meaningful percentage of workers prefer a DC plan over a DB plan; in fact, just the opposite appears to be the case.

What are the real issues?

The issue of retirement benefits for public employees is not whether there are excesses or problems with DB plans. Any community this large, with this much money involved, is bound to have some problems. The real issue is how best to resolve these problems, how to avoid them in the future, and what retirement plan design best meets the multiple and sometimes conflicting objectives of public employees, public employers, and recipients of public services. Reason's solution—to terminate DB plans and replace them DC plans, is not only simplistic but also is likely to create more problems than it solves, problems that the Reason study largely ignores.

NASRA's response to the Reason study has attempted to clarify some of the issues raised by Reason's paper and to identify solutions that will yield better results than if Reason's recommendation—to supplant DB plans with DC plans public employees—were implemented. Our nation's legislative and political structure, complete with mechanisms to change and correct existing policies, enables those who wish to do so to address Reason's concerns, without threatening the retirement security of the nation's public employees or the ability of public employers to attract and retain qualified workers.

Rather than eliminating DB plans for public employees, the focus of the retirement plan debate should center on such issues as:

- What type of pension plan can best meet the objectives of key stakeholders—public employers, recipients of public services, taxpayers, and public employees?
- How can policymakers increase public pension intergenerational equity and increase transparency of public pension plan costs?
- How can the many positive attributes of defined benefit plans be extended to workers outside the public sector?

NASRA believes that a fair and factual analysis of these questions will lead to some form of a DB plan.