

Repairing Pension Plans: Reform - Don't Destroy - Public Retirement Systems

By Girard Miller

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Readership of these columns in Governing on retirement systems has grown significantly in the two years since we started. In addition to trustees and practitioners who are looking for technical and strategic information that rarely appears elsewhere, we enjoy a public-policy following — the pension geeks — which consists of both advocates and critics of public pension systems. Then there are the financial services vendors who are looking for an edge somewhere to help them compete in this marketplace. Rounding out the readership are employees, union leaders and retirees keeping watch on what management is up to, or just simply interested in new developments in the benefits field. It's a vibrant community, and one lesson I've learned from reader feedback is to avoid broad generalizations about state and local government retirement plans.

About 90 percent of the workers in this sector have a defined benefit pension plan, and some 2/3 of the states have dominant, consolidated state pension systems, so there are some commonalities in those systems. Moreover, the aggregate unfunded liabilities of the pension and OPEB systems now exceed \$2.5 trillion with investment assets of less. That's about all one can say in general. Benefits formulas, eligibility requirements, investment and funding practices and supplemental systems are richly diverse across the country. In the retiree medical benefits area known as OPEB ("other post-employment benefits"), the variations are even more dramatic. There are very few statewide plans of any type at this embryonic time in the evolution of those plans, and each public employer has crafted a different and often unique benefit structure.

In the face of this broad variation, there is a natural tendency to generalize whenever we see an abuse of these systems. Sometimes this is justified when, say, there is a statewide plan that permits individuals to game the system on a broad basis (as with pension-spiking in certain states). Often-times, however, the problems are isolated to a specific employer. When the abuses are isolated, it makes for great headlines, but the criticism and finger-pointing doesn't help us build better systems. And that's the spirit of this column. I want to identify a series of constructive reforms for public sector retirement systems — both the high-profile defined benefit pension plans and cradle-to-grave OPEB plans — hoping to achieve a sustainable balance in the long run.

Public service and public abuses. Most public employees are indeed public servants. Some are professionals who joined the government workforce with high aspirations to make a difference in this world; others frankly took the best job they could get. But most public workers do understand that they have a responsibility to the public and the taxpayers they serve, and they understand the concepts of accountability and fairness. Thus, it's the small minority who draw media attention and the ire of taxpayer groups when they game the system. We need to remember the ratio of good to evil

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when we discuss retirement reform.

Unions vs. Reforms: Fix it or lose it. Powerful public employee unions have made it hard for public employers and retirement systems to clean up their act because the labor organizations have interjected themselves into the process. The resultant rules that become embedded in public plans enable abusers to find opportunities to exploit the systems. This is not to advocate the overturning of labor groups, but to remind them that they need to look in a mirror sometimes when we talk about reforms — and become partners in progressive change rather than obstacles. The retirement-advocacy groups need to honestly address the financial shenanigans some unions have played — and the resultant harm to their systems. That's a tall order when times are tough like they are now, but if we are to preserve the core values of retirement security, then the unions have to get on board as well.

Sufficiency and sustainability. There's growing talk in governmental finance circles about "sustainability," and the lack thereof in retirement benefits. According to the Government Accountability Office, in fewer than 30 years the federal government will consume all of its future tax revenues for interest payments and entitlement programs including Social Security and Medicare. Meanwhile state and local governments have run up pension deficits of \$1 trillion and OPEB deficits of \$1.5 trillion. Thus, it is becoming more doubtful that the tax revenues of some municipalities will ever grow enough to pay for the benefits already promised. The average adult working taxpayer is now on the hook for \$20,000 of state and local retirement deficits. In many cases, structural changes are absolutely necessary in order to preserve the benefits. Otherwise, we will find ourselves literally running out of money, and younger workers may never receive what we're now promising them.

Thus, it's essential that state and local leaders, union leaders and retirement plan officials begin working now to make sure that the level of benefits now promised is actually sustainable. I have referred to the concept of a "sustainability audit" or assessment in a prior column, and that would be a worthwhile place to start. Knowing now that most pension plans are facing the prospect of employer contributions rising 20 to 30 percent in the next three or four years if not sooner, this issue has now risen to front-and-center.

In many cases, a sustainability analysis will show that the employer-paid share of the overall retirement package will never be sufficient to pay all the benefits now promised. In many cases, that means that employees will have to begin paying a greater share of contributions into these systems in order to achieve a benefit level that will provide them sufficient savings and benefits when they retire. As we all know, the level of savings in this country is abysmally lower than most others, and part of the system-wide reforms of public retirement systems will need to involve greater employee participation through increased contributions. Whether these moneys go into a defined benefit plan, a defined contribution system of some type, a deferred compensation arrangement, or a hybrid blend of all three, is less important now than the idea of increased employee contributions and savings. In many cases this means mandatory payroll withholding in order to achieve the best tax advantages for the employees.

Meanwhile, public officials must also perform an analysis of the level of benefits their reformed systems will provide to new employees. With health care costs rising, a meager employer contribution to the overall retirement and benefits plans will leave employees well short of the amount they will need in order to avoid eating cat food when they retire. If so, then the plan must include features to encourage employee savings so that they can actually afford to retire if they follow the plan.

Getting real about benefits. In a recent column on retirement eligibility ages, I outlined a series of measures that will need to be implemented by many plans in order to achieve sustainable benefits

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levels. None of these reforms would reduce the sufficiency of retirement benefits. But they are virtually unavoidable, especially in light of the impact that the market meltdown has had on the taxpayers who contribute a majority of the funds that pay for these benefits. As one reader wrote me last week, "a public pension system cannot be sustainable if its retirees live far better off than the taxpayers who support them." That's like welfare in reverse. Although the vast majority of public employee pensions are modest, the early retirement benefits will likely draw increased attention, just like the high-profile benefits received by some public officials who find ways to double-dip.

Anti-abuse reforms. In addition to these more general structural reforms in plan design and financing, the public pension community needs to step up and fix the fatal flaws in those systems which presently allow employees to suck money from their coffers. I suspect that if some of these changes are not made voluntarily, they will be included in a future landmark ballot initiative somewhere, and provide fodder to the political campaigns of pension critics. So I would urge a proactive approach to rapid reform, rather than playing defense down the line.

Here's a shortlist of three anti-abuse reforms that every public plan should enact in order to eliminate the highly publicized and justifiable criticisms that inevitably arise when games are played with public funds.

1. Stop spiking. As I've written before, there are few abuses of the defined benefit pension system as outlandish as the payment of lifetime benefits to workers whose lifetime average earnings are far lower than their final compensation because they spike their pay at the end of their career. It's even worse when seniority practices institutionalize this nonsense, as recently reported as official practice in Buffalo, New York, with an actual formula that demonstrates the actuarial folly of these practices. When overtime and special pay are included in the pension benefits, it's an invitation to abuse. For more on this issue, and the strategies of a Pennsylvania retirement board and the City of New York fire department, see today's companion column. My November 2008 column on pension spiking provides a viable solution. Here's a new concept that could change the future of pension plans and collective bargaining: If unions want overtime included in the pension calculation, let the employees pay half the costs of a separate, actuarially determined employee contribution on their overtime. My guess is that for police and fire, their share will work out to 10 to 20 percent of their OT pay. That way the younger union members can help subsidize their elders — and we'll see how long that lasts.

2. Ban unfunded retroactive increases. This abuse needs to be on the list of permanent reforms, although it is too late to fix the many cases where retiree groups and unions already persuaded public officials to award them unsustainable benefits increases retroactively, without funding them. Giving workers a benefits increase for past service, and then charging future taxpayers for the cost, is a clear abuse of power. When elected officials approve these deals, often behind closed doors, they do a great disservice to their taxpayers. If they want to grant benefits increases, full payment should be made in the year awarded.

3. Prohibit ad hoc COLAs in underfunded plans. For several decades, public pension plans granted cost of living allowances and pension benefits increases without building the costs into their actuarial assumptions. Each time, the award was treated as if it would never happen again. And each time, it happened again. Meanwhile, the funding ratios of public pension funds have dropped as their liabilities increased. Even plans that systematically include COLAs in their actuarial formulas should look in a mirror and ask if their real returns have come anywhere close to what they projected. If not, maybe it's time for a rule that embedded COLAs can be awarded only when 10-year investment returns have actually met the actuarial assumptions, and the plan is at least 85 percent funded. And for those that don't even bother to reduce their assumed "real" investment returns to account for ad hoc COLAs, or project them

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in their liabilities, the requirements must be much stiffer: full funding and provisions for revocation in the event of subsequent market losses.

In addition to these reasonably obvious reforms, several others are equally important for long-run sustainability:

Pre-announce reform of your 'dirty' amortization schedules. This abuse is mathematical and thus, less visible to the public. Presently, many pension and OPEB plans are sweeping their dirt under the rug by amortizing their funding deficits beyond 2035. The accounting rules now allow that. So, when they suffer stock market losses or award new benefits increases for today's workers and retirees, many plans instruct the actuary to amortize that deficit over the next 25 to 30 years. Again, we can't generalize about everybody, and some plans use a shorter schedule. But the majority of public retirement plans today are using amortization schedules that are far longer than their corporate counterparts, and far longer than the remaining lives of their retirees and the remaining service lives of their employees. The result is that costs are transferred to future taxpayers — our children and grandchildren — for services provided to our parents by employees who will die before the benefits are fully funded.

The Governmental Accounting Standards Board is now revisiting this issue, and may have something to say about these practices in 2010. Regardless of what GASB allows, pension plans need to achieve intergenerational equity by tightening up their amortization schedules. The problem now is that if everybody cleaned up their act tomorrow, the costs of pension plans would skyrocket as these amortizations would boost the annual costs of unfunded liabilities. There is a phased solution, however: Do the actuarial analysis and determine the annual impact of a realistic, actuarially based amortization. Then tell the employer today what that cost will be in three years when you actually begin to implement it. That will give the employer sufficient lead time to make budget adjustments. The smart ones can then take that information to the bargaining table and begin to demand that employees share a portion of these costs going forward (see below).

Restructuring retiree medical benefits. Some municipalities offer lifetime medical benefits to early retirees; others pay only a supplement to Medicare after age 65. Many simply allow the employees to participate in the employer's group plan (implicit rate subsidy). Schools, cities, counties, special districts and states all have different deals. So when I write of cradle-to-grave benefits, it's not a universal problem. What we do know is that for those employers who permit 40- or 50-year-old retirees to receive full medical benefits at taxpayer expense, the plans are likely to be unsustainable going forward without significant restructuring. Except for OPEB plans that offer only the implicit rate subsidy, cost caps need to be installed in order to prevent runaway medical inflation from hitting future taxpayers.

Sharing the costs and risks. Sustainability will require genuine cost-sharing and risk-sharing between employers and employees for the entire spectrum of retirement benefits. I introduced this theme in a column on "gain-sharing and pain-sharing" last month, and I want to underscore its importance. In the past, public employers typically bore the majority of the cost of contributing and bore all investment risks. Again, there are exceptions: some systems require employees to make hefty contributions and already share a fair level of the costs. And a few systems even share investment risks. But nationally, the course-change most needed in the public retirement world is a shift toward an equal burden of costs and risks.

On the contribution side, this would mean employees pay half of the total contributions costs. That may take a decade to achieve in some cases, but a good place to start would be with the upcoming

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pension contribution increases that most plans will be sending to employers as a result of the recent market meltdown. If employees were to share half of those cost increases, that would be a good start. Likewise, as public employers begin to pre-fund their OPEB plans actuarially, it makes common sense to start sharing the normal service cost equally with employees. (Employers should bear the full costs of unfunded OPEB liabilities in my view, as they were the ones asleep at the switch here, not the employees.)

On the risks side, I would favor a hybrid DB-DC (defined benefit-defined contribution) arrangement where feasible, especially for OPEB but even for some pension hybrids. In Washington State, they have done this already with their pension plan, with half the benefits in the form of a fixed pension and the other half an individual DC account. Whether the DC component is an individual account or a collective defined contribution trust as I described in my previous column on ways to fix OPEB funding, the point is the same. If taxpayers and public employees share equal exposure to stock market risks and the contribution costs, they will develop a mutual respect for each others' interests.

"Pension holidays": A new twist. One reader has suggested to me that legislatures and public employers will need to consider several new forms of "pension holidays." In the past, this always meant that the employer would suspend contributions and take a payment holiday. That just makes the pension deficit grow larger and increases the long-term costs to taxpayers. But this idea has now taken on new life on the benefits side of the equation, and includes also the concept of COLA holidays (no cost of living allowances) and service-accrual holidays. A service-accrual holiday is when employees are granted no pension credit or fractional service credits for work during financial emergency periods. It is the governmental equivalent of private companies suspending their 401(k) match during unprofitable periods. In Florida, for example, there is legislative talk about suspending public sector labor agreements statewide in order to work out the budget crises. By combining all three forms of pension holidays, there would be an immediate budget savings but also a reduction of long-term liabilities so that the ultimate costs to taxpayers remain stable.

Is legislation necessary? Ideally, the public pension community will achieve these reforms on its own. I'd love to see the various conferences include this topic as a regular feature for trustees to consider, and for the National Conference of State Legislatures to monitor. Right now, the taxpayers' advocacy groups are focusing on bigger fish in the national financial crisis, so pension reform has taken a back seat to other issues. In California, we already have radio ads sponsored by the Howard Jarvis taxpayers group that initiated Prop 13 — and their focus for now is taxes, not pensions. But eventually the "pension envy" scenario is likely to return in legislative proposals and possibly ballot initiatives. Or, it could get wrapped into a tax limit initiative. Such proposals could mandate equal employee contributions, higher retirement ages, anti-abuse rules and other provisions that reasonable people would approve and frustrated taxpayer groups will demand.

My advice to all those who support public retirement systems is this: Start making these reforms proactively before another wave of unrest begins to foment. Begin with the anti-abuse suggestions, while working toward employer-employee partnership agreements and structural reforms. Then we might actually make it through the next decade, with retirement plans that can afford to pay for what's been promised.