

## PENSIONS AND RETIREMENT BENEFITS: DEFUSING THE BUDGETARY TIME BOMBS

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Employee compensation is typically the largest single element of a city's budget. As if current wages and salaries weren't costly enough, however, cities are also increasingly saddled with expensive deferred compensation promises that divert scarce resources from the vital public services—such as police and fire services, street maintenance, parks, and education—that cities exist to provide.

Taxpayer-funded contributions to the nation's state and local government pension systems jumped by 82 percent between 2000 and 2007. For local plans, the increase was fully twice as large.<sup>1</sup> But in the wake of the 2007-08 financial crisis, the worst is yet to come. Public pension fund asset values dropped 20 to 30 percent in the latest market downturn, a loss collectively estimated at \$1 trillion.

For some of the nation's largest cities—including Chicago, Los Angeles, and New York—annual pension costs already soak up 10 to 15 percent of total expenditures. Most municipalities will soon find themselves facing similarly large annual pension bills. Some chronically underfunded municipal pension systems, such as Pittsburgh's, are already desperately seeking state bailouts. While some local governments run their own pension systems, most participate in statewide pension plans. But even the best managed of these have seen their asset values battered by the Wall Street meltdown.

State and local governments have also amassed huge unfunded liabilities for "other post-employment benefits" (OPEB), chiefly retiree health coverage. Most cities were doing nothing to address these liabilities even before the economy turned sour. If they continue to do nothing, the result will be a steady erosion of their balance sheets, even as they struggle to emerge from the effects of the recession.

Fortunately, it is not too late to rein in retirement costs that threaten to crowd out the core functions of effective government. This essay presents five practical steps that

cities can take to shatter the old paradigm and reform their public pension systems.

### HISTORICAL BACKGROUND

Municipal pensions in the United States date back to 1857, when New York City policemen were first granted a retirement disability benefit. By the 1920s, states and cities were offering pensions to most of their full-time civil-service employees and teachers.

The standard model was the defined benefit (DB) plan, promising a stream of monthly retirement income based on an employee's longevity and final salary. While the earliest municipal pensions were financed on a pay-as-you-go basis, cities and states turned to pension trust funds based on actuarial calculations as the number of eligible retirees inexorably grew. Since retirement benefits for government employees were usually guaranteed by state laws or constitutional provisions, public pension funds were initially invested mainly in slow-growing but low-risk assets, such as government and corporate bonds.

Along with job security, a generous pension was considered compensation for the relatively low wages paid to civil servants during the first few decades of the twentieth century. However, long-term public pension obligations rose significantly as the widespread unionization of public employees during the post-World War II era brought with it an expansion of municipal payrolls and wages.

When money was tight, elected officials placated unions by agreeing to additional retirement benefits whose financial impact—always difficult to compute with certainty—could be deferred into the future. Statutory and constitutional guarantees ensured that benefits for current employees and retirees could head in one direction only: up. By the 1970s, state and municipal employees were enjoying competitive salaries, job security, and time-off allowances, plus retirement benefits far more generous

than those available to workers in the private sector.

The whole house of cards nearly collapsed during the stagflationary economy of the 1970s. By May 1980, the *New York Times* was reporting<sup>2</sup>: “The cost of financing pensions for retired and disabled employees is growing so fast for many American cities that some have been forced to curtail public services just to pay for pensions.”

Cities and other public employers avoided a full-blown pension crisis in the early 1980s only through a combination of good luck and risky financial behavior. A spike in bond interest rates during the 1982 recession created some breathing room by driving up short-term returns for pension funds. Then, as Wall Street boomed, public pension fund managers began to heed the advice of financial advisors to invest more heavily in stocks. As if on cue, the markets began producing annual double-digit returns, prompting even greater reliance on stocks and, in recent years, new investment vehicles, such as private equity and hedge funds.

Required employer contribution rates, which typically exceeded 25 percent of salaries in the early part of the decade, dropped to the low single digits in many jurisdictions by the late 1990s. Unions responded by demanding a larger share of the pie for their members—and often got it, in the form of larger pension benefit payouts and earlier retirement ages.

No sooner had pension benefits been sweetened in many jurisdictions than the “tech bubble” burst on Wall Street. By autumn 2002, the Dow Jones Industrial Average had dropped by nearly 40 percent from its 2000 highs, dragging down the nation’s public pension fund values with it. Cities and other government employers soon experienced a sharp spike in their contribution rates; in New York, to cite an extreme example, the taxpayer-funded pension contribution more than quintupled between fiscal 2000 and 2005 (it now stands at \$6.7 billion, more than ten times its 2000 level).

The impact of the market downturn was most severe in cities that had used fiscal gimmickry to reduce their pension costs during the 1990s. The most egregious high-profile offender was San Diego, whose finances were nearly ruined by an agreement between management and union trustees to simultaneously increase benefits and shortchange the city pension fund (and hide the cost on financial statements, to boot).

The V-shaped stock-market recovery and accompanying real-estate boom between 2003 and 2007 led to a temporary stabilization of pension contribution rates, since

funds based their rates on “smoothed” values over a multiyear period. But the 2007-08 market meltdown will inevitably bring further, bigger increases—just when cities can least afford them.

## DECEPTIVE NUMBERS

Public pension managers are lucky that their systems aren’t held to private-sector accounting standards. If they were, the bulk of these funds would appear to be in even worse shape than they do now.

The discount rate applied to future obligations is a crucial determinant of a system’s necessary funding levels: the lower the rate, the larger the contributions required to maintain “fully funded” status. Private plans must discount their liabilities based on a market rate—typically, a corporate or U.S. government bond rate—which is often much lower than the plans’ projected returns.

Public funds, however, are allowed to discount their long-term liabilities based on the targeted annual rate of return on their assets—which, for most public funds, is pegged at an optimistic 8 percent or higher. In other words, the risk premium in the investment target is compounded in the liability estimate.

The typical public pension manager doesn’t just hope to earn 8 percent a year. For all intents and purposes, he or she assures trustees, beneficiaries, and taxpayers that the fund is *certain* to earn an average, long-run return of 8 percent. Bernie Madoff went to prison for less.

While most public pension managers continue to resist the idea, a growing number of independent actuaries and financial economists agree that the net present value of risk-free public pension promises should be calculated on the basis of low-risk interest rates such as the rate on a thirty-year U.S. Treasury bond, which was 4.5 percent in mid-October 2009. Using this approach, two University of Chicago economists recently estimated that the nation’s state and local pension funds were actually \$2 trillion short of what they will need to make good on their obligations.<sup>3</sup> This estimate doesn’t even take into account the impact of the 2008 market downturn.

Health-insurance benefits for retired municipal employees, unlike pensions, are financed in most cities out of current budget appropriations on a pay-as-you-go basis. In effect, this means that future taxpayers are being saddled with a portion of the cost for current services. Newly implemented government accounting standards have revealed that the collective unfunded liability for

these OPEB amounts to between \$1.5 and \$2 trillion, according to an estimate by the Pew Center on the States.<sup>4</sup> Thus, state and local governments may fall short of their combined public pension and OPEB obligations by over \$4 trillion. Even in an era of trillion-dollar federal deficits and financial-sector bailouts, that's real money.

## STOPGAP MEASURES VS. REAL REFORM

Many state and city retirement systems sought to minimize the impact of their post-2000 pension cost increases by adjusting contribution schedules, "smoothing" investment return assumptions over longer periods and allowing government units to spread their increased annual contributions over a number of years. But this kind of tinkering merely pushed costs into the future, compounding the impact of the recent downturn.

Even under the deceptive accounting standards now used by government funds, public pension managers are being overly optimistic. For example, managers of California's massive CalPERS pension fund say that they require an average return of 7.6 percent a year over the next fifteen years in order to achieve "fully funded" status. But one of the nation's leading public investors has warned that this is unrealistic. "You're not going to get a 7.6 percent return when the U.S. is seeing a subpar (economic) growth rate of 2 to 3 percent," BlackRock Inc. chairman and CEO Laurence Fink told the CalPERS board. "You'll be lucky to get 6 percent on your portfolios, maybe 5 percent."<sup>5</sup>

Even if public pension funds hit their optimistic 8 percent return targets, they will fall below half of their required funding levels within the next fifteen years because of projected growth in the retired population, according to a recent analysis by PricewaterhouseCoopers.<sup>6</sup>

## SO WHAT'S THE ALTERNATIVE?

The answer lies in switching most employees from the traditional defined-benefit pension plan to a defined-contribution (DC) model. Instead of a single common retirement fund, a defined-contribution plan consists of individual accounts supported by employer contributions and usually matched, at least in part, by an employee's own savings. These contributions are not subject to federal, state, or local income taxes. The accounts are managed by private firms and invested in a combination of stocks and bonds.

The most common example of a defined-contribution plan is the 401(k), which has become the backbone of retirement planning for most private-sector workers (those

who have any retirement plan, that is). Such a plan is not unheard of in the public sector; for example, it has been the sole pension for state government employees hired since 1997 in one major state (Michigan) and as an option in another (Florida). A DC-type plan—such as the annuities packaged by the Teachers Insurance and Annuity Association (TIAA-CREF)—has been the retirement vehicle of choice for most employees of public higher-education systems throughout the country for decades.

The vast majority of private-sector workers with access to any employer-sponsored retirement plan are in DC plans, while less than one-third have access to a DB plan.

Timing is a key difference between the two types of plans. Under a DB system, the employer promises to deliver a *future* retirement benefit for a large group of current and former workers. The contribution rate necessary to fund the benefit promise is no more or less predictable than the financial markets in which the fund manager has invested its assets.

Under a DC system, the employer does not take on a future obligation but instead makes current contributions to the retirement accounts of each employee, usually with some matching contribution from each worker. The size of the ultimate retirement benefit generated by a DC plan depends on the amount of savings and investment returns that the worker is able to accumulate over the course of a working lifetime. The downside risk of unanticipated investment losses and the upside potential for unanticipated investment gains are both shifted from the employer to the employee. The upside, for the employers and the taxpayers ultimately footing the bill, is that the cost of providing these benefits is completely predictable and transparent.

A 401(k)-style plan would offer significant new advantages to many workers as well. Benefits for public employees would finally be portable from job to job, between levels of governments, across jurisdictions, and from public sector to private sector or vice versa. Portability will particularly benefit those who spend only a portion of their careers working for government, such as the "Teach for America" volunteers who have pumped new energy and effectiveness into many urban schools.

While the advantages for employers are obvious, politicians understand that moving toward such plans will upset public-sector unions. Even in San Diego, which could be considered a case study in the financial and moral hazards of DB pensions, city officials have been unwilling to move to the DC model, settling instead for a scaled-back DB plan and improved financial controls.

For all its obvious benefits to employers and taxpayers, a DC plan does not reduce the legacy costs of the traditional pension system. The disturbing but inescapable bottom line: in the short term, even after closing the plans to new entrants, there is *no* fiscally prudent way for cities and states to avoid higher DB pension bills in the near future without unfairly shifting a massive burden to future taxpayers and jeopardizing their own financial stability and growth in the process. Amortization, or stretching out pension fund payments in order to lessen their impact, can only be justified in cases where employers have embraced fundamental reform.

Here are five steps to a better system:

1. Calculate the true long-term cost of the traditional DB plan, discounting projected liabilities based on interest rates for Treasury bonds. The resulting figure will be shockingly large. However, unfunded pension liabilities must be honestly confronted and acknowledged for what they are: long-term debts.
2. Permanently close the DB pension plan to new entrants, enrolling all new employees in DC plans modeled after existing public university plans or the Thrift Savings Plan<sup>7</sup> offered to federal employees. (Cities may still prefer early retirement plans with a DB element for physically demanding police and firefighter positions; but even in those cases, the minimum retirement age should be reset to fifty or fifty-five, the use of overtime in calculating pensions should be ended, and the DB plan should be calibrated to deliver its maximum benefit after the employee has reached normal retirement age.)
3. In states where it is legally possible, such as Ohio, require current employees in DB plans to share the

burden through increased contributions to their plans.

4. Steer the DB pension fund investments into less risky, less volatile, asset classes.
5. Develop an amortization schedule designed to pay down and ultimately eliminate pension debt in the long term while capping DB contribution rates at the maximum tolerable level for current taxpayers.

The route to reform and control of retiree health benefits is a little less rocky, if not much easier politically. Retiree health benefits, unlike pensions, generally are not guaranteed by state laws and constitutions, although they are often subject to collective bargaining. Therefore, cities can significantly reduce their unfunded liabilities by working to scale back promised health-insurance coverage for future retirees, especially early retirees. Once controlled, the remaining unfunded liabilities should be financed through deposits to separate trust funds.

Mayors and council members in cities that control their own pension plans have the advantage of being able to act quickly to implement such reforms. Most others will need to lobby their state legislatures to make these changes and, in many cases, negotiate them with public-employee unions.

This will obviously require considerable political courage, persistence, and creativity on the part of city officials. In the long run, cities that fail to shatter the existing public pension paradigm will, at worst, be financially doomed; at best, they will be consigned to starving future public services in order to provide deferred compensation to employees who delivered those services in the past.

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## NOTES

1. See <http://www.census.gov/govs/www/retire.html>.
2. "Public Workers' Pensions Strain Cities and Increase With Inflation," *New York Times*, May 19, 1980, p. A1
3. Robert Novy-Marx and Joshua D. Rauh, "The Intergenerational Transfer of Public Pension Promises," Nation Bureau of Economic Research, working paper 14343, September 2008, <http://www.nber.org/papers/w14343>.
4. See [http://www.pewcenteronthestates.org/ttw/trends\\_map\\_data\\_table.aspx?trendID=11&assessmentID=29](http://www.pewcenteronthestates.org/ttw/trends_map_data_table.aspx?trendID=11&assessmentID=29).
5. Pia Sarkar, "Fink Tells CalPERS 7.6% Annual Return Unlikely," *Pensions & Investments*, July 31, 2009, <http://www.pionline.com/article/20090731/REG/907319998>.
6. David Cho, "Steep Losses Pose Crisis for Pensions," *Washington Post*, October 12, 2009, <http://www.washingtonpost.com/wp-dyn/content/article/2009/10/10/AR2009101002360.html?hpid=topnews&sub=AR&sid=ST2009101002620>.
7. <http://www.tsp.gov/>