

Setting the Record Straight About Public Pensions

BY LEIGH SNELL

State and local governments have recently come under substantial criticism about the condition of their pension plans. Critics maintain that the vast majority of public pension plans are significantly underfunded and seem to see this as the main cause for the current financial crisis in which state and local governments find themselves, along with the nation's difficulties in achieving a robust economic recovery. Indeed, some academics, as well as federal and state politicians, are claiming that state pension funds are running out of money. They are raising the specter of a large-scale federal bailout and calling for pension reform.

Is there really a public pension crisis of this magnitude? And what can — and should — be done to address legitimate concerns about the sustainability of the pension benefits of public workers? Before any productive discussion can occur, it is necessary to agree on some basic facts, distinguish reality from hyperbole, and set the record straight. (See “Addressing the Media Misconceptions about Public-Sector Pensions and Bankruptcy” in this issue of *Government Finance Review*, which more fully develops some of the points touched on in this article.)

NOT RUNNING OUT OF MONEY

Are State and Local Government Pension Plans About to Run Out of Money?

No, they are not. In fact, according to the Federal Reserve Flow of Funds, the combined value of public pensions was \$2.73 trillion as of the 3rd quarter of 2010 — the highest level in two years. This represents an increase of more than half a trillion dollars since a low of \$2.17 trillion at the end of the 1st quarter of 2009, and marks the fourth consecutive year-over-year quarterly increase.

Furthermore, at the same time asset values have been increasing, pension plans and their sponsors have been aggressively addressing long-term pension costs. Over the last several years, nearly two-thirds of states have made changes to benefit levels and/or contribution rate structures, often raising contributions for employees, employers, or both, and reducing benefits, in some cases for existing plan participants. Many more local governments have made simi-

lar adjustments. Indeed, more state and local governments adopted significant changes to their retirement plans in 2010 to restore or preserve their long-term financial sustainability than in any other year in recent history.¹

WHAT DECREASED FUNDING LEVELS MEAN

But Aren't Public Pension Funding Levels Dropping?

Despite the significant dollar gains in the value of their assets, it is true that the *funding levels* of many — but not all — state and local government pension plans are nevertheless still declining. This is in part because the value of global equities decreased significantly in 2008-2009. Since most well-diversified pension portfolios place a significant portion of their holdings in such investments, there was a corresponding decline in their asset values. In addition, nearly all public pension plans phase in their investment gains and losses over several years through an approved accounting process called smoothing, so the full extent of

this market drop will continue to be incorporated into funding levels over several years. Accordingly, public pension funding has generally declined. However, the aggregate public pension funding level is still at approximately 80 percent for fiscal 2009,² a level that is believed by many experts and government officials to be acceptable for public plans, according to the U.S. Government Accountability Office.³

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Overall, this funding level may continue to drop by as much as another 10 percentage points before bottoming out in fiscal 2013, as the smoothed market gains of 2009-2010 begin to offset the smoothed market losses of 2008-2009.⁴ For some plans, though, funding ratios are already improving as the result of plan modifications and actual investment gains that have substantially exceeded actuarially assumed rates of return.

If Most Pension Plans are Becoming Increasingly Underfunded, Aren't They Bound to Eventually Run Out of Money?

Asset values are increasing substantially, but funding levels are declining, a seeming contradiction that can make it sound like government pension plans are inevi-

tably going to run out of money. But judging the adequacy of funding requires more than a snapshot of the ratio of assets to liabilities. That is, a funding level is simply the actuarial value of a plan's assets divided by the value of its liabilities *at a specific moment in time*. In effect, this actuarial funding ratio represents a single day's view of a funding amortization process that averages approximately 25 years for most public pension plans,⁵ during which unfunded liabilities are paid off — one out of approximately 9,125 days.

Another way of looking at it is as one frame from a movie that is more than 9,000 frames long: Important for what it is, but hardly telling the entire story. Being technically underfunded is not necessarily a sign that a plan is about to run out of money. The key issue, experts agree, is whether a plan sponsor has a funding plan and is sticking to it.

A plan that has a funding ratio of 101 percent on one day and then, on that same day one year later, drops to 99 percent has technically gone from being overfunded to underfunded. The difference may sound dramatic and troublesome, but in reality, the plan has actually seen little real change in its funding condition.

Nevertheless, some critics of public pensions are using these underfunded percentages to support their arguments that states are about to run out of pension money in as few as six years. This is simply not true, and the research used to support these claims is seriously flawed. It is based on asset values from the end of a 12-month period when the S&P 500 had a return of -26.2 percent,⁶ and prior to many of the increases that have taken place since then; the assumption that, going forward, state and local governments will contribute *nothing* to amortize their past pension liabilities; and the idea that public pension funds will generate rates of return on their investments as if they were invested in bonds alone, rather than in the diversified portfolios these plans actually use. This makes a huge difference in the numbers: From 1871 to 2008, the mean real return on stocks was 6.3 percent, compared to 2.5 percent on bonds.⁷

There are, of course, some very poorly funded public pension plans. Typically, this is the result of a failure to live up

to the terms of the agreement, both explicit and implied, between pension plan sponsors and plan participants, and not because of a flaw in the defined benefit pension plan design itself. For example, if plan participants demand retroactive benefits that have not been adequately funded, or if employers fail to make their annual required contributions as agreed, then it is virtually inevitable that the plan's fiscal stability will become unbalanced over time. Critics focus on such instances to argue that the sky is falling, but serious underfunding is truly the rare exception to the general rule.

But Aren't Pension Funds "Cooking the Books" to Make their Funding Situations Look Better than They Really Are?

The facts do not support allegations that public pension funds are assuming unrealistically high returns on investments to make liabilities look smaller. Currently, the median investment return assumption for the nation's largest public pension funds — with membership and assets comprising approximately 85 percent of the entire state

and local government retirement system community — is 8 percent. None greater than 8.5 percent, and the lowest is 7 percent.⁸

The median annual public pension fund investment returns for the five-year period ended December 31, 2009, was just 3.5 percent, but when you look at the 25 years since 1985 — a period that has included three economic recessions and four years when median public fund investment returns were negative — public pension fund investment returns have exceeded 8 percent. The median investment return for the 25-year period ended December 31, 2009, was 9.25 percent.⁹

Although the largest public plans' median investment return for the year ended June 30, 2009, was -19.1 percent, the median investment return was 32.6 percent for the year ended March 31, 2010.¹⁰ This example underscores how it can be misleading to judge investment return assumptions based on relatively brief timeframes during periods of market volatility, and why the long-term investment experience of public plans provides a much more reliable basis for evaluating the validity of this important assumption.

Asset values are increasing substantially, but funding levels are declining, a seeming contradiction.

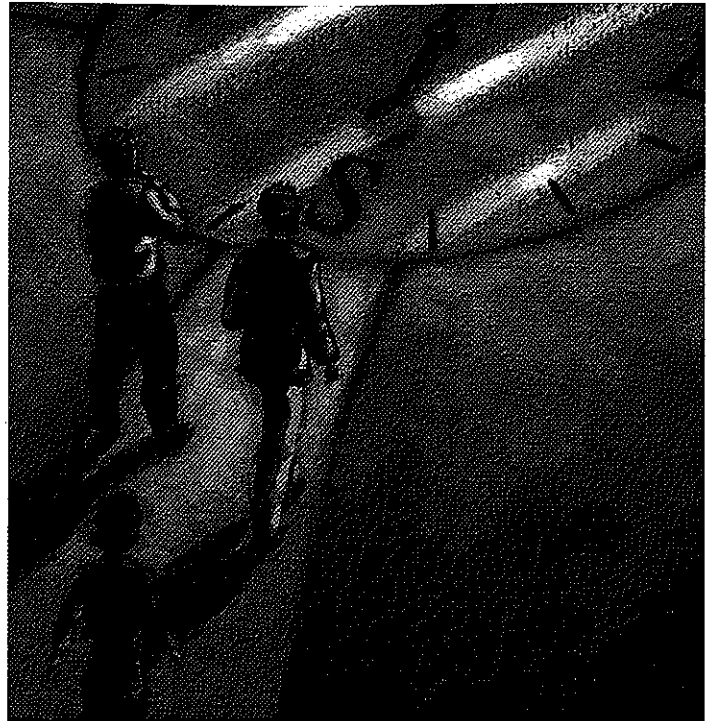
THE AFFECT OF PENSION FUNDS ON GOVERNMENT BUDGETS

Isn't the Pressure to Pay Down Pension Underfunding Causing the Fiscal Crisis Faced by State and Local Governments? Pension funding requirements are not the reason why governmental plan sponsors are struggling with their current financial situations. The primary cause of the deficit in state and local budgets is an economic downturn of crisis proportions, the consequences of which have been enormous and far-reaching. Millions of individuals have lost jobs and households have seen trillions of dollars in wealth disappear, largely due to stock losses and drops in home prices. This economic collapse has in turn generated a sharp decline in state and local tax revenue that is affecting every level of government. For example, during the two-year period from fiscal 2008-10, state revenues decreased nearly 12 percent, or by \$78.5 billion.¹¹ Local governments have also experienced significant decreases in tax revenue, with estimated declines in city revenues of about 3.2 percent in 2010.¹²

Pension plans did not create this crisis, and they are not exacerbating it now. In fact, the growth in the actuarial value of pension liabilities has generally been trending downward in recent years as a consequence of lower salary growth (due in part to furloughs, which were imposed by nearly half of the states in 2010) and fewer discretionary cost-of-living adjustments.¹³

Nevertheless, thanks to the dramatic market losses in 2008-2009 and the gradual incorporation of the corresponding losses into the actuarial value of assets over time (due to smoothing), the recent growth in asset values has not been enough to completely erase these asset losses. Since additional revenue is needed to amortize the increased shortfall between assets and accrued liabilities, the result is that contributions must be increased, all other things being equal.

Taken in context, however, these increases have not been disproportionately large or financially disruptive for the large majority of plan sponsors, nor are they likely to be, going forward. While pension fund contributions, in the aggregate, have ranged as high as 6 percent of states' and localities' combined budgets over the last 50 years, they have been gradually declining since the early 1980s, when states began implementing sounder funding methodologies and



the Governmental Accounting Standards Board (GASB) was created.¹⁴ In fact, for the last 15 years, plan sponsors' pension contributions have accounted for less than three percent of all state and local government spending.¹⁵

Furthermore, even when the 2008-2009 collapse in equity prices is included, paying off the total unfunded liability over the next 30 years would require employer contributions to increase to only about 5 percent of state and local governments' budgets, generally speaking. For jurisdictions that have been better about funding their pensions, the increase will be smaller. However, those that were already significantly underfunded going into the recession could see the percent of their budgets devoted to pensions rise to about 8 percent.¹⁶

One last point: public pensions are pre-funded. That is, a significant portion of the assets needed to fund pension liabilities is accumulated during an employee's working life and then paid during the participant's years in retirement. Therefore, benefits are not being paid on a pay-as-you-go basis out of state and local governments' general revenues, but rather from the pension trust funds. Furthermore, most of this trust fund money is made up of employee contributions and investment earnings. For example, according to the U.S. Census Bureau, from 1982 to 2008, 72 percent of pension fund

receipts came from these two sources, and contributions from employers accounted for the remainder. Furthermore, Census Bureau data show that although the amount of employee contributions decreased in the third quarter of 2010 from the same quarter one year ago, there was a shift of 1.5 percent in the composition of contributions toward higher employee contributions and lower government contributions, compared with the third quarter of 2009.

Consequently, in 2008 (the most recent year for which complete U.S. Census Bureau data are available), while government sponsors contributed \$82 billion to prefund their pension plans, the funds themselves paid out a total of \$175 billion in benefits, of which approximately \$126 billion came from employee contributions and investment earnings. Looked at another way, state and local governments did not have to find an additional \$93 billion in general revenues in 2009 to pay promised benefits to their retired employees and their beneficiaries because of defined benefit pension plans' pre-funded trust funds, only 28 percent of which comprised taxpayer dollars.

Isn't That Like Saying I Purchased an Expensive Luxury I Can't Afford, but I Somehow Save Money by Paying a Reduced Price for It?

Governmental pension benefits are not an expensive, unaffordable luxury. Governments must be able to compete with the private sector for talented employees. However, state and local employers are not able to offer stock options, profit-sharing plans, or higher salaries to attract well-qualified workers. Instead, governments use employee benefits as important tools in attracting and retaining the skilled workforce they need. Furthermore, governmental employers, who are in the business of providing essential services to the public instead of returning a profit to shareholders, have unique needs when it comes to their employees. For example, because government entities are more permanent than private-sector businesses, they are more likely to be interested in long-term attachments between employers and employees.

Defined benefit pension plans, which are the most common form of retirement vehicle in the public sector, are

particularly well-suited for governments in this regard. Pension plans have been shown to significantly increase employee commitment to their employers, as compared with other forms of retirement benefits, also helping with worker retention.¹⁷ Defined benefit plans are also desirable where workers make human capital investments that cannot be transferred to other employers or occupations. Such is the case with many jobs that make up the public-sector workforce, including teachers, police and firefighters, and judges.

Adequate retirement income in the form of pensions is also of particular importance to governmental employers because state and local governments are effectively the providers of last resort of social assistance for those who can no longer work and meet basic needs. Government employers (and thus, taxpayers) can either pay now by providing an adequate retirement benefit for their workers, or pay later in

the form of public assistance — which, in terms of human dignity as well as real dollar costs, is a much more expensive way of dealing with the well-being of elderly state and local government retirees. Studies have documented these savings. For example, in 2006, pensions saved \$7.3 billion in public assistance expenditures that otherwise would have been required of state and local governments.¹⁸ This

represented about 8.5 percent of aggregate public assistance dollars received by all American households for the same benefit programs.

Finally, the pensions paid by governmental plans to their retirees have also provided an overall economic benefit that has helped lessen the impact of the recession on state and local governments. This is because each dollar paid out in pension benefits has a multiplier effect. A recent study documented this impact for fiscal 2006, finding that each dollar in pension benefits paid to a retiree supported \$2.36 in economic activity, helping to generate \$21.2 billion in annual state and local tax revenue.¹⁹ Thus, the additional tax revenues generated by these pension benefit payments helped prevent tens of billions of dollars more in lost revenues during the two-year period from fiscal 2008-2010.

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DEFINED BENEFIT VERSUS DEFINED CONTRIBUTION

But Why Should Public Employees Have the Most Expensive Type of Retirement Plan? They shouldn't, and they don't. In fact, when you consider the cost of achieving a specific retirement benefit goal under both a defined benefit plan — which is made available to about 84 percent of all state and local government employees — and the other common form of retirement plan, a defined contribution (DC) plan such as a 401(k), recent analysis has found that a DB plan costs nearly half as much as the DC plan.²⁰ Specifically, it was determined that delivering the same retirement income to a group of workers is 46 percent cheaper using a defined benefit (DB) plan than a DC plan.

There are several reasons for this. First, DB plans provide for a pooling of the longevity risks of all plan participants, which can number in the hundreds of thousands. By doing so, DB plans must accumulate sufficient funds to provide benefits for only the *average* life expectancy of the overall group. On the other hand, a DC plan, covering only one individual, must have enough funds to last for the *maximum* life expectancy of that individual to avoid running out of money. Thus, more money will have to be set aside, per participant, in a DC plan than in a DB plan.

State and local government employees' wages are not excessive, and neither are their pension benefits.

DB plans can also invest their funds in a balanced portfolio for long periods of time, since the *average* age of the group in a mature DB plan does not change much. That is, as older participants retire, new, younger workers enter the plan. And state and local plans, given the virtually perpetual nature of their sponsoring governments, can expect to be able to invest over very long periods of time. This means that governmental DB plans can keep a well-balanced portfolio for a very long time.

However, a DC plan, built for individuals, typically shifts its investment focus to more conservative assets as individuals grow older and can ill afford the kind of market risks they could accept when they were younger and had more time to recover from any investment losses. And typically, the less risk associated with an investment, the less reward in the form of returns. Also, depending on the timing of the individual's retirement and the condition of the financial markets at that specific moment, the sale of assets necessary to provide retirement income can also result in unanticipated losses better avoided by a DB plan.

Finally, DB plans typically obtain higher investment returns than DC plans. This is due in part to professional asset management available (and affordable) to DB plans, as compared to the

average individual investor; access to alternative investment opportunities that can help to hedge risks, which are also often not available to individual investors; and the DB plan's ability to obtain the lower fees that are usually available to larger investors. For example, it was found that asset management fees average about 25 basis points for governmental DB plans, as compared to 60 to 170 basis points for private-sector 401(k) plans.²¹

THE COSTS

Nevertheless, Aren't Public Employee Retirement Benefits Just Too Expensive for Taxpayers? If you believed only what you read in the newspapers and online, and heard on radio and television, you would think that all public employees are paid too much and the pension benefits based on these salaries are extravagant and inappropriate. However, once again, the facts paint a different picture.

For example, two recent studies agree that employees of state and local government earn significantly less than what comparable private-sector employees earn, and one study found that this pay gap has widened over the last 15 years.²² Specifically, wages and salaries of state and local employees are lower — 11 percent less for state workers and 12 percent less for local workers — than those for private-sector employees with comparable education and work experience. Furthermore, although retirement, health-care, and other benefits make up a slightly larger share of compensation for the state and local sector, average total compensation is 6.8 percent lower for state employees and 7.4 percent lower for local employees than for their private-sector counterparts.²³

Critics would argue otherwise. However, the characteristics of state and local government employees are different than those of the private sector. For example, since state and local governments have a disproportionately large number of jobs requiring greater than average skills, government employees typically need more education, training, and experience than private-sector employees. Public employees also typically have longer tenures than employees in the private

sector. In addition, about a quarter of all public employees are not eligible to receive Social Security benefits, so these public pension benefits are often the only income they receive in retirement. If these differences are not adjusted for, then an “apples to oranges” comparison can occur, making it appear that state and local workers actually have an earnings advantage.

Unfortunately, there are others whose high pensions may be the result of abusive behavior such as “spiking,” a process involving increasing compensation in the year or years immediately preceding retirement in order to artificially increase the salary base on which a defined benefit pension is based. Common forms of spiking include certain retirement bonuses, payments for accrued leave and overtime, and other lump sum kinds of payments. Pension plans and their sponsors

have been taking steps to crack down on this practice. Employee organizations are also concerned that since the normal employer and employee contributions often have not been made to cover the cost of the spike, it creates an inequitable distribution of benefits and hidden costs. Plan sponsors are also aggressively pursuing constraints on spiking because it can create a perception of impropriety.

The facts do not support allegations that public pension funds are assuming unrealistically high returns on investments to make liabilities look smaller.

QUESTIONS ABOUT DISCLOSURE

If Everything Is in Such Good Shape, Why Don't Pension Plans Want to Disclose Additional Information About Their Accounting Practices? Public pension plans and their sponsors are not trying to hide anything. On the contrary, virtually every plan posts a copy of its most recent comprehensive annual financial report (CAFR) on its Web site. The CAFR conforms to GASB principles and reporting requirements and presents the plan's audited assets and liabilities. The disclosures it contains provide all the information needed to assess the funding status of a public pension plan, the progress made in accumulating sufficient assets to pay benefits when due, and whether employers are making actuarially determined contributions as required. Furthermore, the GASB is currently reviewing its reporting and disclosure requirements related to public pension plans and their spon-

sors, and it intends to formally modify these to further improve plan accounting transparency and accountability.

Some critics have argued that public pension accounting information needs to be better standardized so that plans can be compared one to another, but every plan and plan sponsor is unique, defined by variables that are specific to the plan and its plan sponsor or sponsors. These variables include:

- The level of required employee and employer contributions
- The plan sponsor's commitment and ability to make required contributions
- The fiscal condition of the plan sponsor
- The plan's demographic makeup
- The level of benefits provided by the plan
- The plan's governance structure, including the ability (or inability) to modify the plan design, including benefit levels and contribution rates
- The plan sponsor's level of support for the pension plan

Pension funding requirements are not the reason why governmental plan sponsors are struggling with their current financial situations.

- The plan's amortization period
- The required benefit payments in the current and future years relative to the plan's asset base
- The pension fund's investment performance, risk tolerance, and expected investment return

Taken together, the differences in these variables complicate meaningful

comparability among public pension plans. Furthermore, charging a federal department or agency with preparing any such "standardized" reports could result in confusion and could disrupt the consistency of public pension reporting as established by the GASB. Such confusion and inconsistency could in turn reduce accountability and decision usefulness of public retirement system financial reporting.

CONCLUSIONS

Public pension plans are not in crisis, and they are not seeking any federal financial assistance in connection with their funding needs. On the contrary, throughout 2009, organizations representing public pension plans, plan sponsors, and plan participants have been advising Congress that state and local governments are moving aggressively to address sustainability challenges confronting their pension plans; that federal involvement is neither sought nor needed, and would be counterproductive; and that public pensions are not in need of a federal bailout.

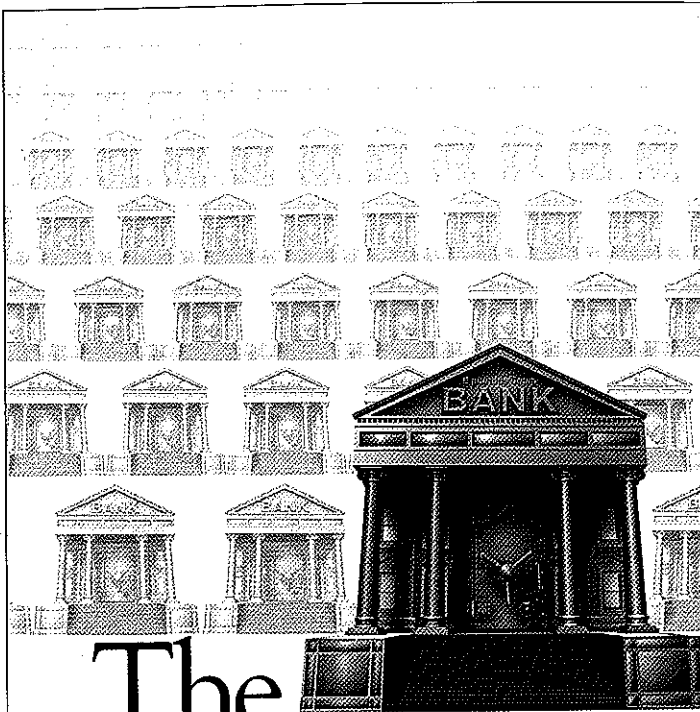
Nor are state or local governments in danger of filing for bankruptcy as a result of their pension obligations. Municipal bankruptcies are extremely rare, and are not the result of unfunded pension liabilities. The cities and counties that have filed have experienced a confluence of extreme and unique circumstances, including a series of poor investment decisions resulting in significant financial losses or excessive and inappropriate spending.

The public pension system is not in crisis. |

Notes

1. "Pensions and Retirement Plan Enactments in 2010 State Legislatures," National Conference of State Legislatures, November 2010.
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7. Andrew Biggs, "Social Insecurity?" American Enterprise Institute for Policy Research Outlook Series, November 2008, <http://www.aei.org/outlook/28971>.
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13. "Public Fund Survey Summary of Findings for FY 2009."
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15. "Employer (Taxpayer) Contributions as a Percentage of All State and Local Government Spending," compiled from U.S. Census Bureau data, January 2011.
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20. "A Better Bang for the Buck: The Economic Efficiencies of DB Plans," National Institute on Retirement Security, August 2008.
21. "State and Local Pensions Are Different From Private Plans," Center for Retirement Research at Boston College, November 2007.
22. "Out of Balance: Comparing Public and Private Sector Compensation Over 20 Years," National Institute on Retirement Security, April 2010.
23. Ibid.

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