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This newsletter from Reason Foundation's Pension Integrity Project highlights articles, research, opinion, and other information related to public pension challenges and reform efforts across the nation. You can find previous editions here.

In This Issue...

Articles, Research & Spotlights

Update on the Funding of State and Local Pensions

By Truong Bui, Reason Foundation

State pension funding levels saw little change in fiscal year 2015, according to a recent policy brief by the Center for Retirement Research at Boston College that provides an overview of the latest funding information. Covering 160 state and local plans, the brief finds that their aggregate funded ratio increased slightly from 73% to 74% in 2015 under the traditional GASB rules based on smoothed assets, but decreased from 74% to 72% in the same year under the new GASB standards due to 2015's poor investment performance. Funded levels differ significantly among plans. About 20% of the plans are less than 60% funded while 36% have a funded ratio equal to or above 80%.

The Actuarially Determined Employer Contribution (ADEC)—formerly the Annual Required Contribution (ARC)—as a percentage of payroll rose to 18.6% in 2015, compared to 17.6% in 2014. Required employer contributions have grown substantially over the last 15 years, from 6.7% in 2001 (measured by the ARC) to 18.6% in 2015 (measured by the ADEC), mostly due to the swelling unfunded liability amortization component. The overall share of required contribution actually paid also increased to 90.8% in 2015, compared to 86% in 2014.

It should be noted that the aggregate 74% funded ratio is derived from the average 7.6% discount rate. If a much more conservative 4% discount rate were used, the funded ratio would drop to 45% and the total unfunded liability would rise from $1.2 trillion to $4.1 trillion, according to the report. Only 10 among 160 plans adopted a significantly lower "blended rate" in 2015.

Looking forward, the funded ratio is projected to grow to 77.6% in 2020 if the plans' own return assumptions are realized. However, the ratio will likely fall to 71.2% if the returns are lower, as predicted by major investment firms.
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NASRA Highlights Recent Major Pension Policy Changes

By Truong Bui, Reason Foundation

Public pension assets plunged sharply in value and pension costs consequently rose substantially after the Great Recession, forcing many state pension plans to implement reforms. A recent paper from the National Association of State Retirement Administrators (NASRA) provides a good summary of different types of reform adopted by state plans since the financial crisis:

- *Higher contribution from employees*: Requiring employees to pay more into the system was among the most common types of reform. More than 40 plans in 36 states have raised member contribution rates since 2009.
- *Benefit adjustments*: Benefit levels can be adjusted by increasing the period used to calculate the final average salary, reducing the retirement multiplier, or reducing cost of living adjustments (COLAs). During the 2009-2014 period, 39 states passed reforms that reduced benefits. For COLA reductions, eight states reduced COLAs for new hires only; eight states reduced COLAs for current employees and new hires; and 14 states reduced COLAs for retirees.
- *Longer vesting period and higher retirement eligibility requirement*: Nine states raised the vesting period for new employees from 5 years to 10 years. 29 states increased retirement eligibility in the form of higher retirement age, more required years of service, or both.
- *Switch to other retirement plan types*: Most states retained their traditional defined benefit plans. A few states however introduced new plan types that

- include individual account features. Since 2009, five states created hybrid plans, two states introduced cash balance plans, and two states created individual account plans. Most of these changes applied to new hires only.

About half the states that enacted pension reforms were sued. The paper notes that the predominant feature shared by most reforms is a shift of financial risk from employers to employees.
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Common Pension Funding Practices Raise the Risks of Severe Underfunding

By Truong Bui, Reason Foundation

A recent report by the Rockefeller Institute, as part of their Pension Simulation Project, examines how the funding methods commonly used by public pension plans can increase the risks of severe underfunding. The report relies on stochastic model that assumes a normal distribution of annual rates of return, a 7.5% mean return, and a 12% standard deviation.

The risk-free rate has declined greatly over the last few decades while public pensions have maintained more or less the same return assumption (around 7-8%). This has led public plans to invest in increasingly risky assets that subject plan returns to significant volatility.

To dampen the volatility, public plans often adopt long unfunded liability amortization periods, combined with an "open" amortization approach, and asset smoothing. These practices reduce contribution volatility at a significant expense of funding health. According to the model used in the report, the typical plan using these practices would have a one in six chance of falling below 40% funding over the next 30 years even if its investment return assumption is correct on average. The risk is more pronounced when the plan does not fully pay its actuarially required contribution.

Solving this problem is not simple. Plans can choose a shorter amortization period under a closed approach to reduce the probability of severe funding, but doing so will raise contribution volatility. Another solution is to de-risk investments, but the resulting higher required contributions will crowd out services or increase taxes.
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Rising Pension Costs Crowd Out Educational Spending

By Truong Bui, Reason Foundation

In a new paper, Manhattan Institute senior fellow Josh McGee examines how rising pension costs crowd out spending on current teachers and students in the Chicago Public Schools (CPS), the third largest school district in the U.S.

Years of underpaying the actuarially required contribution (ARC) are the culprit of CPS's current dismal state. Since 2001, CPS has paid only 38% of its ARC, resulting in an unfunded liability of $9.3 billion in 2015. The ARC per student has also tripled over the last 15 years to $1,836, and debt amortization costs made up more than 80% of the ARC in 2015.

The value of the pension debt would be even higher if the plan used a lower discount rate instead of the 7.75% unrealistic assumed rate of return, which is above the median 7.6% for public plans. The debt would rise from $9.3 billion to $14.8 billion if a 6% discount rate were used.

Rising pension costs have played a major role in the school district's budget cuts in textbooks, classroom, and especially teacher compensation. Since 2001, teacher salaries as a share of total CPS spending have dropped by more than 20% while pension contributions have risen from 2% to more than 10% of the total spending. Swelling pension legacy costs also forced the state to pass reform that reduced retirement benefits for new teachers by an equivalent of 12% of annual pay.

Since additional revenue from tax increases and benefit reductions for current hires are infeasible, more service cuts to public schools appear to be the most plausible, albeit highly undesirable, option.
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Study Finds Teacher Retention Not Reduced by Cash-Balance Pensions
By Truong Bui, Reason Foundation

Due to its individual account feature, a cash balance (CB) plan tends to provide more portability and distribute pension value more evenly than a traditional defined benefit (DB) plan that backloads retirement benefits. While these features are valuable to young and mid-career public school teachers, they are said to also lead to lower teaching quality as they make it easier for mid-career, more experienced teachers to switch school systems or leave teaching. A traditional DB plan, on the other hand, tends to encourage teachers to stay in the same system until retirement.

In a recent paper, Josh McGee and Marcus Winters at the Manhattan Institute simulate the effect of moving to a CB plan on teacher quality. The simulation is based on empirical estimates from past research on relationships between teacher's future compensation, including pensions benefits, teacher attrition, and teacher experience and quality.

Through the simulation, the authors find that switching to a CB plan would in fact slightly increase the school system's teaching experience and quality. This is because while the switch would indeed encourage some mid-career teachers to leave the system, it would have a much stronger positive effect on late-career teachers' retirement postponement as the CB plan would remove the severe penalties for working beyond the official retirement age imposed by the traditional

DB plan.
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The Cost of Investment Mismanagement at the MBTA Retirement Fund
By Truong Bui, Reason Foundation

In a new policy brief, Iliya Atanasov at the Pioneer Institute shows how years of irresponsible management practices and unaccountability have caused serious damage to the Massachusetts Bay Transportation Authority Retirement Fund (MBTARF). The author finds that had the fund's assets been managed by the state pension fund, it would have been in a much better shape.

Over the last decade, the fund's leadership was riddled with scandals and lack of transparency, resulting in soaring costs and a heavily unfunded plan. The agency's pension contributions doubled from $35 million in 2007 to $70 million in 2015, and are expected to rise to $78 million in 2016. The plan was only 64.9% funded in 2014, compared to 97.4% in 2005. Worse, the plan raised the assumed rate of return from 7.5% to 8% at the same time that pension boards were revising discount rates downward across the country.

If the fund's assets had been managed by the Pension Reserves Investment Management (PRIM) Board in charge of the state pension fund, their value would have been $902 million higher, and the MBTA's pension plan would have been fully funded by 2014. The plan would have in turn saved $119 million in unnecessary contributions for fiscal 2014-2016, and would save $49 million in 2017.

The MBTARF's excessively risky investments are to blame for the low returns and high management expenses. The fund's target asset allocation for 2014 included 30% alternatives, of which hedge funds made up 11% and private equity 10%. Junk and unrated debt also accounted for 36% of the fund's fixed income investments in 2014.
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New Report on the Financial State of California
By Truong Bui, Reason Foundation

Truth in Accounting has just released its latest report on the financial state of California. According to this report, the Golden State's reported unfunded pension liability increased from $11 billion in 2014 to $74.5 billion in 2015 due to a new accounting rule. The state is still hiding $4.4 billion of pension debt, which adds to a sum of $78.9 billion. Combined, the state's total debt amounts to $335.4 billion while it has only $96.1 billion in readily available assets to pay for the debt, resulting in a shortfall of $239.3 billion, which translates to $20,900 per taxpayer.
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Glossary of Pension Terminology

Reason Foundation

Research and discussions about public pension systems often involve technical terms that may be difficult to understand by lay readers, especially voters and even plan members. To assist the dialogue about pension reform, Reason Foundation has recently released a glossary covering frequently mentioned pension terms and phrases.
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Quotable Quotes on Pension Reform

"Pushing retail and institutional investors into riskier assets would seem to make the whole economy riskier. And we aren't even getting the growth we normally associate with more risk-taking. Safety (insurance and a certain income) either costs a fortune or it isn't a realistic promise to make anymore."
- Allison Schrager, "Let's talk about interest rates," *Allison's Ode to the Second Moment* (e-newsletter), July 11, 2016.

"At the local level, many public employee pension boards are run by the employees themselves, with the board composition typically made up of one-third current employees, one-third retirees who are receiving benefits and one-third politicians who owe their positions largely to the first two groups. Other than being left with the bill, taxpayers are left out of this equation."
- Chuck DeVore, Vice President of National Initiatives, Texas Public Policy Foundation

"The Governmental Accounting Standards Board - known as "GASB" - recently held a joint conference with the International Public Sector Accounting Standards Board (IPSASB). Both organizations are responsible for setting accounting standards for government employee pension plans. But if GASB and the U.S. state and local pensions industry looked at IPSASB's pension accounting standards, they might be shocked: those standards precisely contradict the loose pension accounting rules that GASB promulgates and that the public pensions industry depends on. It's no exaggeration to say that U.S. state and local pension may not be financially viable if they were required to live under the IPSASB accounting rules that other countries follow."
- Andrew Biggs, resident scholar, American Enterprise Institute

"Like the insatiable Pac-Man, pensions are eating further and further into state and local education budgets, eating up dollars that could be spent on lots of other things. That's true for all public services, but higher education is uniquely harmed by rising pension costs."
- Chad Aldeman, Associate Partner, Bellwether Education Partners

"Currently, pension figures are buried in complicated hundred-page documents. To find the correct data, it takes me, who has over 30 years of experience analyzing financial documents, hours to sift through and examine. If so many citizens are counting on their pension when they retire, why are state and local governments making it so difficult to find the correct numbers and understand the data?"
- Sheila Weinberg, CPA, founder and CEO of Truth in Accounting

"Public pension funds should be congratulated for becoming more realistic about investment returns in recent years. The same goes for state and local governments that have stepped up and contributed more to their pension systems. But if future returns do indeed fall in line with historical averages, we will nonetheless find ourselves in an even deeper pension hole -- one that will make it almost impossible to avoid the existential question of whether traditional defined-benefit pensions remain a viable option going forward."
- Charles Chieppo, research fellow, Harvard Kennedy School

"Real meaningful reform most likely will have to be driven by an amendment to the California Constitution. Under California case law, pension benefits are vested contract rights that can be changed only with great difficulty even if they have not yet been earned. Trying to change benefits for future work under future contracts for current employees runs up against the so-called California Rule, which has been followed by about a dozen states."
- Chuck Reed, former mayor of San Jose

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Pension Reform Handbook

For those interested in the process and mechanics of pension reform, Reason Foundation published a comprehensive starter guide for state and local reformers. This handbook aims to capture the experience of policymakers in those jurisdictions that have paved the way for substantive reform, and bring together the best practices that have emerged from their reform efforts, as well as the important lessons learned.
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Contact the Pension Reform Help Desk

Reason Foundation set up a Pension Reform Help Desk to provide information on Reason's work on pension reform and resources for those wishing to pursue pension reform in their states, counties, and cities. Feel free to contact the Reason Pension Reform Help Desk by e-mail at pensionhelpdesk@reason.org.

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Follow the discussion on pensions and other governmental reforms at Reason Foundation's website or on Twitter (@ReasonReform). As we continually strive to improve the publication, please feel free to send your questions, comments and suggestions to leonard.gilroy@reason.org.

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